T.C.
MARMARA UNIVERSITY
EUROPEAN COMMUNITY INSTITUTE

EFFECTS OF EUROPEAN MONETARY UNION ON EUROPEAN AND TURKISH BANKING SECTOR

Thesis submitted in Particular Fulfillment of the Requirements for the degree in Master of Economics

Yiğit Güler

İstanbul
1999

INDEX

INTRODUCTION

INDEX OF TABLES

INDEX OF GRAPHICS

ABBREVIATIONS

DM	**Deutsche Mark**
ECB	**European Central Bank**
ECSC	**European Coal and Steel Community**
ECU	**European Currency Unit**
EFTA	**European Free Trade Association**
EMI	**European Monetary Institute**
EMS	**European Monetary System**
EMP	**European Monetary Policy**
ERM	**Exchange Rate Mechanism**
ESCB	**European System of Central Banks**
EONIA	**Euro Overnight Index Average**
EURATOM	**European Atomic Energy Community**
EU	**European Union**
FX	**Foreign Exchange**
GBP	**Great Britain Pound**
GDP	**Gross Domestic Product**
GNP	**Gross National Product**
HICP	**Harmonized Index of Consumer Prices**
ICS	**Information and Communication Department**
JPY	**Japanese Yen**
MFI	**Monetary Financial Institutions**
NATO	**North Atlantic Treaty Organization**
NCB	**National Central Bank**
OECD	**Organization for Economic Corporation andDevelopment**
OEEC	**Organization for European Economic Cooperation**
PT	**Portugal**
SDR	**Special Drawing Right**
SIS	**State Institute of Statistics**
SPO	**State Planning Organization**
TBB	**The Bank Association of Turkey**

INTRODUCTION

Since The Bretton Woods System, The EMU is a very important economic and political event. Eleven member countries will lock their exchange rates irrevocably ant the national central banks will leave their authority to the newly created ECB.Simply it implies the loss of national monetary autonomy.

At the macroeconomic level decrease in deficits below 3% will create a room for fiscal stabilizers to offset cyclical turns. In addition to that some price and wage changes can be needed. The size of the member states, level of integration, their share in the world trade volume will effect the world economy without a doubt.

Turkey that is in Customs Union and has strong economic and financial relations with EU will also be affected from EU.

On balance, The Treaty has been ratified by all Member States and Convergence under the Maastricht criteria is also under way.

In the lightment of these issues, in the first part the historical settings of European Union are mentioned. In the second part, Institutions of European Union such as European Council, Commission , Parliament are mentioned.

A s a third part the historical settings of EMU, Convergence criteria, tasks and organizations of the ESCB and EMI are mentioned.

In the fourth part ,Economics of Europe is analyzed. As a fifth part Structural Features and Trends of Banking in Euro Area mentioned.

In the sixth part, Effects of EMU in the Euro Area on issues such as Banking profitability,capacity, structure, strategies and risks.

A s a next part Turkish Economy is considered. In the eighth part The Turkish Banking Sector is analyzed.

Lastly, Effects of EMU on Turkish Banking Sector are mentioned.

1.INTRODUCTION TO THE EUROPEAN UNION AND INSTITUTIONS OF EUROPEAN UNION

1.1.INTRODUCTION TO THE EUROPEAN UNION

1.1.1 POST WORLD WAR II SITUATION

The Second World War destroyed Europe's economic base and nation-states' self-confidence in ability to defend them effectively. After the war, there were various attempts for cooperation mostly on intergovernmental basis. For example, the following inter governmental organizations were established: Organization for European Economic Cooperation (OEEC) in 1948 to distribute Marshall Aid, in 1961 The OEEC was redefined as the Organization for Economic Cooperation and Development (OECD), the Benelux Union in 1948 creating a customs union between Belgium, Netherlands and Luxembourg, the Council of Europe in 1949 and North Atlantic Treaty Organization (NATO) in 1949.

For centuries France and Germany had disputed over the Saarland coal and steel district. Jean Monet put out a plan, known as the Schumann Plan to establish a common High Authority to control French and German coal and steel production. The plan suited both France and Germany. The Treaty establishing the European Coal and Steel Community (Treaty of Paris) was concluded in 1951 and entered in to force in 1952, with France, Germany, the Benelux countries and Italy as original signatories.[1] The ECSC created a common market for coal and steel by abolishing internal customs duties and quantitative restrictions and prohibited non-competitive measures. After establishing ECSC the participating countries tried to combine economic integration with political integration. However the Countries weren't ready for that.

At Messina in 1955 the Foreign Ministers of the Six discussed expanding economic integration by means of creating a common market. The Spaak Report in 1956 proposed a common market with a customs union, free movement of commodities and factors of production and a policy to ensure perfect competition.[2] This report was incorporated in the Treaty establishing the European Economic Community (Treaty of Rome) signed in 1957

[1] Dr Klaus- Dieter Borchardt, Integration of Europe, Ankara, European Commission Turkey Office,1996,pp.9-15

[2] Ibid pp.10-13

together with the treaty establishing European Atomic Energy Community (EURATOM). The Treaty of Rome was aimed to establish a common market through a transitional plan within 12 years. The original signatories are known as "The Six": France, Germany, Italy and the Benelux Countries.

1.1.2 INITIAL SUCCESS: 1958-1965

The late 1950s and the early 1960s were the time of rapid economic growth. The EEC was proving to be successful. 1966 would have completed the first two transitional stages. However increased nationalism of the French president de Gaulle caused a crisis. He promoted a view that European Integration should be conducted within a confederate structure meaning the member States would maintain their full sovereignty and cooperate through unanimous intergovernmental decision making process. The third transitional stage of the Treaty starting in 1966 would have changed the unanimous decision making mechanism in the council Ministers into qualified majority voting. On the other hand de Gaulle was very against the qualified majority voting in agricultural pricing decisions. In 1965 he opposed measures concerning financing of the Common Agricultural Policy and budgetary powers of the European Parliament, and withdrew France from the Council of Ministers (The Empty Chair Politics) lasted Jan 1966.[3] The legislative dead lock was broken by Luxembourg Accords where it was agreed that in a case of decision to be made by qualified voting and where there was a very important interest of one or more Member States, the Council would attempt to reach a solution which could be solved by unanimity.

1.1.3 YEARS OF STAGNATION (1966-1985) & ENTRY OF NEW MEMBERS

Following the crisis of 1966 the Community was characterized by loss of momentum. The situation was made even more difficult by global recession and oil crisis in the 1970s. Economic recession gave reason for return to national protectionism and the member states were reluctant to remove the hidden barriers for trade formed by national regulations. Attempts to move towards full economic and monetary union failed. The U.K. had excluded itself from the outset of negotiations to establish the ECSC. It still considered itself a world power and thought that continental Europe could not achieve anything without its help. Indeed after World War both politically and economically U.K. was the strongest country in Europe.

[3] Ilhan Tekeli and Selim Ilkin , Turkey and European Union, Ankara: Ümit Publications,1993, pp.36-77

U.K. thought that ECSC was a threat by foreigners to shut down British mines and steel works and strongly dislikes the idea of supranationality. Thus it did participate in the negotiations. After the ratification of the EEC treaty, Britain wanted to get into a free trade arrangement with the community without common external tariffs or harmonization. France was opposed to these kind of preferential treatments. Subsequently U.K. moved to established the European Free Trade Association (EFTA) by the Treaty of Stockholm in 1960 with the other non participants, (Denmark, Sweden, Norway, Austria, Switzerland, Portugal, later Finland and Iceland.[4]

At this moment The Community was enjoying its initial success. UK's economy was becoming weaker and losing momentum. Britain now wanted access to the rich European market. It first applied in 1961 with Denmark, Norway, and Irish Republic. De Gaulle vetoed. In 1967 second De Gaulle also stalled application. After the resignation of de Gaulle in 1969, U.K. joined in 1973 together with the Denmark and Irish Republic. Greece applied for full membership in 1975 and joined in 1981. Portugal and Spain applied in 1977 and joined in 1986. [5]

1.1.4 RELAUNCH OF THE COMMUNITY AND ESTABLISHING OF THE EUROPEAN UNION

Jack Delors as the President of the Commission revitalized the Community by a program for completion of the internal market. The White Paper by Lord Cockfield adopted by the European Council at Milan in 1985 listed nearly 300 measures needed to remove the remaining barriers to trade. Deadline was 1992.This led to the adoption of the Single European Act. The Single European Act contained a program for completing an area (Internal-Single Market) without internal frontiers in which the free movement of goods, persons, services and capital would be ensures.

The Single European Act had also provisions on economic and monetary union but they were left into preamble.[6] However Delors pressured on EMU. The Hanover European Council in 1988 reaffirmed the committed to EMU and set up a committee to study the issues.

Two intergovernmental conferences were held; one is on EMU other one about Political Union. The result was The Treaty on European Union (Maastricht Treaty) signed in 1992. The

[4] Ibid
[5] Ibid

[6] Ibid

Treaty established the European Union with three pillars: the Three Communities, common foreign and security policy, and cooperation in justice and home affairs. The provisions on EMU w0ere based on Delors' three-stage plan. The European Economic Area treaty was negotiated between the remaining EFTA countries in 1992.In 1995 Finland, Sweden, Austria joined in EU as full member.

1.2. INSTITUTIONS OF EUROPEAN UNION

The main institutions of the EU are named in Art 4 of the Treaty: The European Parliament, the Council of Ministers, the Commission, the European Court of Justice, the Court of Auditors, the Economic and Social Committee, the Committee of Regions and institutions of EMU.

1.2.1 The European Council

European Council is a summit of the heads of state or government of the Member States. It is an intergovernmental institution. It is formally outside of the institutional structure of the EU and its decisions have no legal power and are not subject to judicial review. According to the Treaty Council's function is to '...Provide the Union with necessary impetus for its development and define the general political guidelines.'

1.2.2 The Council of Ministers

It is main legislative body of the EU. It is an intergovernmental institution. The composition of the council is not static. It varies according to issues to be discussed. The general council consists of foreign ministers but for example internal market council is composed of ministers of trade and industry. The members of the Council are not politically accountable to any Community institution. The European Parliament (EP) can ask questions about the work of the Council and in practice the Presidency of the Council submits its 6 months program for debate in the EP when taking office.[7] When the council is exercising its legislative powers, European Court of Justice maintains the rule of law through judicial review. The decision-making procedure in the Council varies according to the competence field under discussion. According to the Art 118 the council use majority voting if the Treaty does not provide otherwise. Member States do have different number of votes in the Council:

[7] European Commission Turkey Office, The Institutions of European Union, Ankara: 1996, pp.36-77

Belgium	5
Denmark	3
Germany	10
Greece	5
Spain	8
France	10
Ireland	3
Italy	10
Luxembourg	2
Netherlands	5
Austria	4
Portugal	5
Finland	3
Sweden	4
UK	10

87

To pass a decision by qualified majority, 62 votes out of 87 are needed.

1.2.3 The Committee of Permanent Representatives (COREPER)

The Corrupter consists of permanent representatives of the member states. The members of COREPER represent their own national interest. Its function is to assist the council in its work by preparing the Council agenda for discussion. By doing this it increases the intergovernmental element in the work of the council.

1.2.4 The European Parliament (EP)

The EP consists of 626 directly elected representatives of the people of the Member States. It is the democratic institution in the EU. The original advisory role of the EP is called the simple procedure. The EP only gives an opinion to the Council on new legislative proposals prepared by the Commission. After the Single European Act, a cooperation procedure has added.[8] In this procedure the EP has no veto power. If the council does not like the amendment made by the EP the Council can still pass the act in its original form but it needs unanimity. The Maastricht Treaty further increases the role of the EP's role by adding a co - decision procedure.[8] When this procedure is followed the EP can make amendments and if the Council does not accept them, a conciliation committee is established to find a compromise. If the conflict is not solved the EP can block the adoption of the text.

1.2.5 The Economic and Social Committee

The ECOSOC represents employers, labor unions and other corporatist's interests such as farmers, professional associations and consumers. It has an advisory status. It has to be consulted by the Council and Commission where the treaty so provides. The Members of it act in personal capacity and independent from national governments in the general interest of the Community. The allocations of seats as follows:

Belgium	12
Denmark	9
Germany	24
Greece	12
Spain	21
France	24
Ireland	9
Italy	24
Luxembourg	6
Netherlands	12
Austria	12
Portugal	12
Finland	9
Sweden	12
UK	24

[8] Ibid.

1.2.6 The Committee of Regions

It represents regional and local bodies. The allocation of seats is same as in the ECOSOC. It has an advisory status and it can issue opinions on its own initiative. It is mostly consulted on economic and social cohesion (i.e. regional policy issues)

1.2.8 Commission

It is the main executive body of the Community, although it has some legislative powers. It consists of 20 commissioners. They are appointed by a common accord of the Member States. The main duties of Commission are defined in Art 155.The Commission ensures that the treaty provisions and measures taken by institutions based on the treaty are applied. Often the Commission is called as the Guardian of the Treaties. It mostly relies on indirect implementation of Community law by the member states and supervises that the members are fulfilling their obligations.

The European Court of Justice

It has 15 judges from each member state. It exercises judicial control on the legality of legislative and administrative acts within the Community.

2. ECONOMIC AND MONETARY UNION (EMU)

On January 1st 1999 Economic and Monetary Union will move to its third and final stage. The exchange rates between the parties will be locked irrevocably and the Euro will be introduced. The responsibility for monetary policy in the participating countries will be entrusted to the newly created European Central Bank (ECB).[1]

European Monetary Union must be understood as two separate but complementary facets; a single currency, and stable currency. These two facets correspond to the two interrelated objectives of EMU: efficiency and stability.

The commitment by national public authorities to meet the terms of the Treaty of European Union for creating EMU is already bearing importing body in terms of stability. Budget deficits have been substantially reduced. This has resulted in more stable nominal exchange rates and lower long term interest rates, thus paving the way to the current economic recovery.

Although EMU represents first a monetary union, its implications are much wider. The construction of EMU is geared toward the stability of the new currency. Together with the well functioning of Single Market this new policy regime is bound to bring about a new economic environment for the behavior of public and private agents.

The gradual elimination of budget deficits, as provided by the Stability and Growth Pact, implies that government debt will be set on a consistently downward path. This will have beneficial consequences for interest rates and private investment. Budgetary discipline will also imply a new contract between the current and next generation, which will not have the shoulder, the burden of today's spending choices.[2]

Private agents as consumers and producers will not only benefit from lower transactions costs and simplification entailed by the replacement of national currencies by the Euro. The Euro will strengthen the effects of the Single Market due to higher price transparency and greater competition.

By definition EMU implies the loss of national monetary autonomy. Member countries will not be able to respond to economic disturbances via changes in national monetary policy or in their nominal exchange rate. In reality the exchange rate being a national instrument is potentially appropriate only in a narrow set of circumstances. If the shock on effects a particular region or sector, devaluation would lead to over heating in other parts of the economy. Mutatis mutandis the same can be said of monetary policy. Shocks that are truly

[1] The Economists, A Survey of EMU 1998,London:1998,pp.1-12
[2] Gert Jan Hogeweg, General aspects of European Monetary Integration, Frankfurt:1998, pp.25-38

national are already relatively infrequent. Moreover the increasing trade interdependence among EMU members will further blur the economic importance of national boundaries thereby reducing the national specificity of economic developments.

At the macroeconomic level rapid reduction of deficits below the 3% threshold will create sufficient room for automatic fiscal stabilizers to offset cyclical downturns.[3]

For the introduction, we can say that EMU offers important opportunities for better allocation of resources. Also meeting these challenges will ensure not only the full success of EMU, but will also help in solving Europe's structural problems.

2.1 HISTORICAL SETTINGS

Plans to create a European zone of monetary stability have been laid a numbers of times in the post-war period. The reason for this is related to the desire to foster economic integration and trade between the European countries.

One major land marks the Werner Report of 1970.The Report was intended to pave the way towards Monetary Union in 1980 in three stages. In particular this was precisely the period during which the Bretton Woods agreement was breaking up as various economies exhibited differential policy responses to the shocks to the world economy in 1970s.One lesson that could be learned from this experience was that for a zone of monetary stability to succeed in Europe there must be a high degree of economic convergence among European countries. Comparing the plan set out by the Werner Report for monetary union with that laid down in the Maastricht Treaty there are some notable differences.

Of course this is not end of the story. Greater stability of exchange rates was the focus attention in the setting up of the European Monetary System (EMS) in 1979, which provided limits on the fluctuations of currencies participating in the exchange rate mechanism (ERM). [4]Further significant steps towards closer monetary and economic integration were taken in the mid 1980s.First the On the basis of Delors Report the European Council decided in June 1989 that the First Stage of the realization of economic and monetary union should begin on 1 July 1990 the date in which all restrictions on the movement of capital between member states will be abolished. At this time the Committee of Governors of the Central Banks of the Member States of the European Economic Community was given additional responsibilities. These were laid down in a Council Decision dated 12 march 1990. The Prepatory work for the Committee of Governors also initiated stages three of EMU. The first step was to identify all

[3] The Economists, op.cit.,pp.1-4
[4] Ibid

the issues which should be examined at an early stage, establish a work program until the end of 1993 and define the mandates of the existing sub-committees an d working groups established for that purpose.[5]

For the realisation of stage 2 and 3 it was necessary to revise the Treaty establishing the EEC (Treaty of Rome) to established the required institutional structure. The negotiations resulted in the Treaty on European Union, which was agreed in December 1991 and signed in Maastricht on 7 February 1992. [5]

The establishment of the European Monetary Institute (EMI) on January 1994 marked the start of the second stages of EMU and with this the Committee of Governors ceased to exist. The EMI transitory existence also reflected the state of monetary integration within the community. The EMI had no responsibility for the conduct of monetary policy in the European Union nor had it any competence for carrying out foreign exchange intervention. The two main tasks of the EMI are: (1) to strengthen central bank co-operation and monetary policy co-ordination, and (2) to make the preparations required for the establishment of the European System of Central Banks (ESCB). For the conduct of the single monetary policy and for the creation of a single currency in the third stage. To this end the EMI provided a forum for consultation and for exchanges of views and information on policy issues and it specified the regulatory, organisational, logistical framework necessary for the ESCB to perform its tasks in the third stage.

In December 1995 the European Council agreed to name the European currency unit to be introduced at the start of stage three the "Euro" and confirmed that stage three of EMU would start on 1 Jan. 1999. This scenario was mainly based on detailed proposals elaborated by the EMI. At the same time the EMI was given the task of carrying out preparatory work on the future monetary and exchange rate relationships between the Euro area and the other EU countries. In December 1996 the EMI presented its report to the European Council on the principles and fundamental elements of the new Exchange Rate Mechanism (ERM II) which was adopted in June 1997.

In December 1996 the EMI also presented to the European Council and subsequently to the public the selected design series for the Euro banknote, which will be printed on 1 Jan. 2002. So as to specify the Treaty provisions on EMU the European Council adopted the Stability and Growth Pact in June 1997. -Two regulations form part of the Pact, which aims to ensure

[5] Owen Evans, The European Monetary System, Recent Developments, IMF Occasional Paper No:48
[5] Hogeweg, op.cit., pp.26-30

the budgetary discipline in EMU.[6] The pact was supplemented and the respective commitments enhanced by a Declaration of the Council in May 1998.

On 2 May 1998, Council of the European Union decided that eleven Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) fulfilled the necessary conditions for the adoption of the Single Currency on 1 Jan. 1999. These countries will therefore participate in the third stage of EMU. The heads of state or Government also reached a political understanding on the persons to be recommended for appointment as members of the Executive Board of the European Central Bank (ECB). At the same time, the Ministers of the Member States adopting the single currency agreed together with the governors of the national central banks of these member states Member States, the Commission and the EMI that the current ERM bilateral central rates of the currencies of the participating Member States would be used in determining irrevocable conversion rates for the Euro.

On 25 May 1998 the governments of the eleven participating Member States appointed by the President, the vice-president and the four other members of the Executive Board of the ECB. Their appointment took effect from 1 June 1998 and marked establishment of the ECB. The ECB and the national central banks will form the ESCB, which will formulate and define the single monetary policy in the third stage of EMU.

With the establishment of ECB on 1 June 1998 the EMI completed its tasks and is in the process of liquidated.

On 1 January 1999 the third and final stage of EMU will begin with the irrevocable locking of the exchange rates of the eleven Member States participating in the Euro area and with the conduct of a single monetary union under the control of ECB.

2.2CONVERGENCE

In order to ensure that the Monetary Union is sustainable, the Maastricht Treaty provides that no Member State can enter EMU unless the Council finally concludes that fulfils the necessary conditions in terms of convergence. We can say that emphasis is on sustainability of fiscal positions, price stability, exchange rate stability and convergence of long term interest rates. Here the European Monetary Institute is assigned an important role. It should prepare a report to the European Council.

[6] International Financial Outlook Barclays Economic Department August 99, pp.38

The criterion on price stability reflects the consensus that it is essential for the achievement of the sustainable and balanced growth of economies so as to create the best conditions for fostering employment and improving the standards of living. It is widely accepted that beyond the very short term there is no trade-of f between inflation and unemployment to be exploited.
Similar arguments can be derived for the fiscal criteria with the %3 and %60-reference values for deficits and debts. These criteria will not only be examined for the purpose of convergence but will also be applied in stage three. There are a number of reasons why fiscal discipline is essential in the monetary union. This criterion will safeguard the Monetary Union against the risk of a situation where an individual member state is unable to service its debt within the parameters of its own fiscal revenues. The debt criterion is also included as a convergence requirement to prevent the risk of financial market instability.
Exchange rate stability requires markets to consider that current and expected inflation is sufficiently low enough to sustain competitiveness at the current exchange rates.[7]
Long-term interest rates are seen as being closely related to domestic inflation expectations. There is also a tendency for risk premium in long term rates to be linked with fiscal developments.

In addition to this public finances are the weakest points of convergence. The overall public sector deficit in the EU in 1994 amounted to around 5.5% of GDP which is one of the highest levels recorded since the foundation of the Community and almost twice the maximum of 3% permitted under the Treaty.[7] Despite an economic recovery during 1994-1995 the overall public deficit only declined marginally to stand at 5% in 1995. For most of the EU countries fulfilling the fiscal criteria will certainly entail an effort in reducing deficits and restraining public expenditure. [8]
Concerning the price stability the picture is brighter than this. Member States have made remarkable progress since 1990. This is reflected in average inflation in the EU, which stands at the low rate of 3%. Twelve years ago ‘t was nearly 8%.[9]
Turning to the exchange rates, the system of wide ERM bands instituted in 1993 is considered to have been successful in relieving tensions and preventing speculative attacks.

---

[7] European Commission, Report on Convergence and Recommendation with a view to theTransition to the Third Stage, EC1998,pp.34-43

[8] European Commission, op.cit., pp.36-40

2.3 TASKS AND ORGANISATION OF THE EUROPEAN MONETARY INSTITUTE (EMI)

Of course the tasks of the EMI are all related to the achievement of the goal of EMU. In broader term we can point out like that:

- Strengthening the co-ordination of the monetary policies of Member States and the co-operation between central banks.
- Preparations for the final stage of EMU, for the establishment of the ESCB, for the conduct of the single monetary policy and the introduction of the single currency.

The strengthening of the co-ordination of the monetary policies of Member States is a crucial element of the first category of tasks. By performing this task the EMI contributes to the fulfilment of the macroeconomics conditions necessary for entering the Stage Three of EMU. The Treaty stipulates that the co-ordination of monetary policies aims at ensuring the price stability. The latter one is called convergence criteria which Member States have to fulfil in order to qualify for entering the third stage of EMU. [10]

In stage two of EMU, the Member States remain responsible for the conduct of monetary policies. The EMI is not actively involved in monetary policy operations, nor does it have any specific powers to enforce the co-ordination of monetary policies. Rather, the EMI relies on the tools of analysis and persuasion. It can also give advice, may formulate opinions or recommendations on the overall orientation of monetary and exchange rate policies in the EU. It may make recommendations to the national monetary authorities concerning the conduct of their monetary policy and finally EMI may submit its opinions and recommendations to national governments and to the Council of Ministers on policies which might affect the internal or external monetary situation in the EU. [11]

Other activities, which fall within the first category, are:

- the monitoring of the functioning of the European Monetary System (EMS) and the administration of the EMS mechanism
- consultations on issues affecting the stability of financial institutions and markets

---

[9] Ibid.
[10] Ibid

[11] World Economic and Financial Surveys, World Economic Outlook,New York: October 1998,pp.123-155

- Support to central banks in the oversight of cross border participation in payment systems as well as the oversight of the EU clearing system.

As it can be seen the EMI plays a consultative, advisory and supervisory role. In contrast its work with respect to the tasks which fall within the second category, for example the preparatory work for stage three.

For the conduct of the monetary policy a regulatory, organisational framework has to be created. In order to conduct a single monetary policy it will be necessary to formulate the strategy as well as to define the monetary policy instruments; these instruments have to be harmonised. Alternative monetary policy instruments and operating procedure is based on a number of basic principles:

- Efficiency: the monetary policy instruments and procedures must enable the ESCB to control its target efficiently. It ensures that the monetary policy signals of the ESCB will be uniform and consistent;
- conformity with the market principles: monetary policy implementation should be in accordance with the principle of efficient allocation of resources.(ART. 105 of the Treaty)
- equal treatment: the ESCB should treat all groups of financial institutions that have access to its facilities equally
- simplicity and transparency: the monetary policy and procedures should be simple and be employed with clarity so as to contribute equal treatment and conformity with the market principles
- decentralisation: the ESCB shall have recourse to the national central banks to carry out operations " to the extent deemed possible and appropriate" (Art. 12 of the Treaty) In this way ECB can take advantage of national central banks' experience and knowledge of local markets
- Continuity: the transition to the new operational framework at the beginning of stage three may be facilitated by relying and employing instruments that can be adopted to the changing environment.

For the conduct of the single monetary policy, it is essential that the ESCB can operate in a single monetary market; a single money market presupposes arbitrage possibilities between the local centres of the single money market and hence a Monetary Union-wide system which allows cross border transfers in real time. This will be e possible through target system, which ha been developed by EMI.

Reliable statistics will also essential for the conduct of the single monetary policy. The EMI's work will lay the foundation for a common statistical base in the relevant areas. Especially those of money and banking statistics and statistics relating to the capital flows in the balance of payments.

A further aspect of the EMI's preparatory work relates to the change over to the single currency, which has recently been the Euro. According to Treaty, the EMI has been preparing the Euro banknote, which will be issued by 1st January 2002 at the latest.

As looking to the organisation of preparatory work, the EMI has organised its preparatory work on the basis of a comprehensive Master Plan. This plan acts as a guiding instrument for organising, monitoring and assessing the activities conducted by the EMI staff and the EMI's Working Groups and Sub-Committees.[12] Secondly where as the EMI is the central points of Monetary Union it is not the only party concerned? Al so national central banks will have to implement preparatory work. Meaning all economic agents will be involved in the changeover to the single currency and the public sector and the banking and financial industry will assume special responsibilities in the process.

Shortly looking to the organisation of the EMI, it is the body of the European Union with its own legal personality. It performs its tasks independently. It may not seek or take any instructions from Community institutions, bodies or governments of the member states. This feature already points out the independence of the ECB. At the same time the EMI is a central bank organisation. Article 1 stipulates specifically that the members of the EMI are the central banks of the member states.

The staff works under the authority of the president. The senior management currently includes the Director General and four heads of department. The four departments are [13]

- the General Secretariat
- the Monetary, Economic and Statistics Department
- the Information and Communication System Department
- the Administration Department

The General Secretariat consists of the Policy Division and the Legal Division. The Policy Division is responsible for:

- Preparing the Council meetings, maintaining inter-institutional relations and supporting the production and distribution of the EMI's reports

[12] Iktisadi Kalkinma Vakfi ,Weekly Bulletin Vol.20, Istanbul:1998
[13] Hogeweg, op.cit.,pp.26-32

- Overseeing the ECU Clearing and Settlement System, monitoring member states' payment systems and preparing for the EU wide payment system in stage three
- Supporting the activities of the Monitoring and Concentration Groups, monitoring the functioning of the EMS, facilitating the use of the ECU and overseeing its development and preparing the foreign exchange market operations to be carried out by the ESCB in stage three.
- Conducting background analyses for the consultations on issues affecting the stability of financial stability of financial institutions
- Co-ordinating the preparatory work for stage three

The legal division is responsible for handling all legal issues within the EMI. These include assisting in the fulfilment of the EMI's mandate, in particular the legal aspects of the preparation of the regulatory and institutional framework of the ESCB. [14] In addition to that the legal division assists in the preparation of EMI opinions when consulted by the EU council; or national authorities on draft Community or national legislation.

The Monetary, Economic and Statistics Department are the economic brains of the EMI. It consists of three divisions. The stage two divisions provide economic analyses of issues related to the strengthening of co-operation among central banks. It may also assist the Council in formulating opinions and recommendations on macroeconomics policies. The stage three division is responsible for providing analyses on the concepts, framework and rules for the single monetary policy in stage three of EMU

The Statistics Division has the principal duties of contributing to the improvement of the statistical information which is needed for promoting the co-ordination of monetary policies in stage two and preparing the harmonised concepts and approaches.

The Information and Communications System Department is responsible for devising and implementing a technical strategy for information and communications system for the EMI and the ESCB. Furthermore the ICS Department is responsible for providing technical support for the users of the EMI's information and communication in the EMI itself.

The Administration Department is responsible for recruitment and personnel policy, premises and office services, the organisation of conferences, and the EMI's internal financial accounts.

---

[14] European Central Bank Monetary Union, 1998

2.4 THE EUROPEAN SYSTEM OF CENTRAL BANKS (ESCB)& EXCHANGE RATE MECHANISM(ERM)

Article 109f(3) of the Treaty establishing the European Community requires the EMI to specify the regulatory, organisational and logistical framework consisting of the ESCB, ECB and the national central banks of the EU Member States, to perform its tasks in stage three of EMU. [15]

The primary objective of the ESCB as defined in article 2 of the Statute of the ESCB, is to maintain price stability. The ESCB will support the general economic policies in the community with a view to contributing to the achievement of the objectives of the Community/In pursuing its objectives the ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources. The basic tasks to be carried out by the ESCB are defined in Art 3 of the ESCB statute. These tasks include:

- to define and implement the monetary policy of the Community
- to conduct foreign exchange operations
- to hold and manage the official foreign reserves of the participating Member States
- to promote the smooth operation of the payment systems
- To contribute to the smooth conduct of policies pursued by the competent authority relation to the supervision of credit institutions and the stability of the financial system.

The ESCB Statute (Art 17 to 24) specifies the monetary functions and operations of the ESCB. The EMI prepared an operational framework for the ESCB's monetary policy. The Governing Council of the ECB will take the final decision on the operational framework. It may decide not to use al the available options or may change certain features of the instruments procedures presented below.

The operational framework consists of a set of instruments; the ESCB will conduct open market operations, it will offer standing facilities and it may require credit institutions to hold minimum reserves on accounts with the ESCB.

[15] Journal of Bankers, Vol.19, op.cit.

Open market operations will play an important role in the monetary policy of the ESCB for the purpose of steering interest rates, managing the liquidity situation in the market. [16] Five types of instruments will be available to the ESCB for the conduct of open market operations. The most important instrument will be reverse transactions. The ESCB may also use outright transactions; the issuance of debt certificates, foreign exchange swaps and the collection fixed term deposits. [17] Open market operation will be initiated by the ECB, which will also decide on the instrument to be used and the terms for the execution of such operations. With regard to their aim the ESCB open market operations can be divided into the following four categories:

The main refinancing operations are regular liquidity- providing reverse transactions with a weekly frequency and a maturity of two weeks. [18] They will be executed by the national central banks on the basis of standard tenders and according to the pre-specified calendar. The main refinancing operations will play a role pursuing the purposes of ESCB open market operation and providing the refinancing to the financial sector.

The longer term refinancing operations are liquidity providing reverse transactions with a monthly frequency and a maturity of three months. [19] They will be executed by the national central banks on the basis of standard tenders and according to a pre-specified calendar. These operations aim to provide counterparties with additional longer-term refinancing. As a rule the ESCB will not intend to send signals to the market by means of these operations and will therefore normally act as a rate taker.

Fine tuning operations can be executed on an ad hoc basis with the aim both of managing the liquidity situation in the market and of steering interest rates, in particular in order to smooth the effects on interest rates that is caused by unexpected liquidity fluctuations. [20] Fine-tuning operations will be e executed as reverse transactions but also can take the form of outright transactions, foreign exchange swaps and the collection of fixed term deposits. This operation will normally be executed by the national central banks through quick tenders or bilateral procedures.[21] The Governing Council of the ECB will decide whether, fine tuning bilateral operations may be executed by the ECB itself.

---

[16] Türkkan Gedikkaya and Cihangül Gürler, Monetary Union In European Union,Journal of Bankers,1998, Vol.24

[17] Melike Alparslan, European Central Bank System,Journal of Bankers,1996,Vol.19

[18] Ibid.

[19] European Monetary Institute, The Single Monetary Policy in Stage Three: General Documentation on ESCB Monetary Policy,1998,pp37-40

[20] European Central Bank,op.cit.

[21] Ibid

In addition the ESCB may carry out structural operations through the issuance of debt certificates, reverse transactions and outright transactions. These operations will be executed whenever the ECB wishes to adjust the structural position of the ESCB against the financial sector. Structural operations in the form of reverse transactions and the issuance of debt instruments will be carried out by the national central banks through standard tenders.
Standing facilities aim to provide and absorb overnight liquidity, signal the general stance of monetary policy and overnight market interest rates. Two standing facilities will be available to eligible counterparties on their own initiative: [22]

- Counterparts will be able to use the marginal lending facility to obtain overnight liquidity from the national central banks against eligible assets. The interest rate on the marginal lending facility will normally provide a ceiling for the overnight market interest rate.
- Counterparties will be able to use the deposit facility to make overnight deposits with the national central banks. The interest rate on the deposit facility will normally provide a floor for the overnight market interest rate.

Preparatory work has been carried out with a view to enabling the ESCB to impose minimum reserves as from the start of stage three. [23] It will be up to the Governing Council of the ECB to decide whether minimum reserves will actually be applied. Any minimum reserves system would be intended to pursue the aims of stabilising money market interest rates, creating a structural liquidity shortage and possibly contributing to the control of monetary expansion. The reserve requirement of each institution would be determined in relation to elements of its balance sheet. In order to pursue the aim of stabilising interest rates, the ESCB's minimum reserves system would enable institutions to make the use of averaging provisions.[24] This implies that compliance with the reserve requirement would be determined on the basis of institutions' average daily reserve holdings over a one-month maintenance period.
The ESCB is governed by the decision making bodies of the ECB: the Governing Council, the Executive Board and the General Council.
The Governing Council comprises all the members of the Executive Board and the governors of the NCB's of the Member States with out a derogation. The main responsibilities of the Governing Council are:

[22] Ibid.
[23] The Economist ,op.cit.,pp9-11

[24] Ibid

- to adopt the guidelines and make the decisions necessary to ensure the performance of the tasks entrusted to the ESCB
- To formulate the monetary policy of the Community and to establish necessary guidelines for their implementation.

The Executive Board comprises the President, the vice-president and four other members. They are all chosen from among persons of recognised standing and professional experience in monetary or banking matters. They are appointed by common accord of the governments of the Member States at the level of the Heads of State or Government. The main responsibilities of the Executive Board are: [25]

- to implement monetary policy in accordance with the guidelines an decisions laid down by the Governing council of the ECB and to give necessary instructions to the NCB's and
- To execute those powers which have been delegated to it by the Governing Council of the ECB.

The General Council comprises the President and the vice-president and the governors of all the NCB's. The General Council performs the tasks, which the ECB took over from the European Monetary Institute (EMI). The General Council also contributes to: [26]

- the ESCB's advisory functions
- the collection of statistical information
- the preparation of the ECB's quarterly and annual reports and weekly consolidated financial statements
- the establishment of the necessary rules for standardising the accounting an and reporting of operations undertaken by the NCB's
- the taking of measures relating to the establishment of the key for the ECB's capital subscription other than those already laid down in the Treaty
- the laying down of the conditions of employment of the ECB's staff
- the necessary preparations for irrevocably fixing the exchange rates of the currencies of the Member States with a derogation against the Euro

When performing ESCB- related tasks neither the ECB, nor an NCB, nor any member of their decision making bodies may seek or take instructions from any external body. [27] The Community institutions, bodies and governments of the member states may not seek or take

[25] Melike Alparslan
[26] Journal of Bankers Vol:19,op.cit.
[27] Key Indicators of The Monetary Union,Eurostat Press Releases Vol. 3199,309,1.16,1998

instructions from any external body. The Community institutions, bodies and governments of the Member States may not seek to influence the member states of the decision-making bodies the ECB of the NCB's in the performance of their tasks. The ESCB Statute makes provision for the following measures to ensure security of tenure for NCB governors and members of the Executive Board: [28]

- a minimum renewable term of office for governors of five years
- a minimum non renewable term of office for members of the Executive Board of eight years
- removal from office is only possible in the event of incapacity or serious misconduct
- the European Court of Justice is competent to settle any disputes

The NCB's are the sole subscribers to and holders of capital of the ECB.[29] The subscription of capital is based on a key established on the basis of the EU Member States' respective shares in the GDP and population of the Community. The capital of the ECB will be paid up by the NCB's of the eleven member states participating in the Euro area in proportion and up to their shares.

In addition the NCB's will provide the ECB with foreign reserve assets other than the Member States' currencies, Euro, IMF reserve positions and SDRs, up to an amount equivalent to ∈ 50,000 million Euro. The contribution of each NCB is fixed in proportion to its share in the ECB's subscribed capital. The ECB has the full right to hold and manage the foreign reserves that are transferred to it and to use them for the purpose set out in the ESCB statute.

[28] European Monetary Institute,op.cit.,pp41-42

[29] Michel Galy, Implementation of Monetary Policy in EMS Countries Participating in the ERM,IMF Working Paper WP/92/87

The National Central Banks' percentage shares in the key for the capital of the European Central Bank (as decided by the ECB Governing Council on 9 June 1998)[29]

Banque Nationale de Belgique	2.8885%
Denmark's Nationalbank	1.6573%
Deutsche Bundesbank	24.4096%
Bank of Greece	2.0585%
Banco de Espana	8.8300%
Banquet de France	16.8703%
Central Bank of Ireland	0.8384%
Banca d'Italia	14.9616%
Banque central du Luxembourg	0.1469%
De Nederlandsche Bank Oesterreichische	2.3663%
Banco de Portugal	1.9250%
Suomen Pankki	1.3991%
Sveriges Riksbank	2.6580%
Bank of England	14.7109%

Voluntary system for controlling exchange rates within the European Monetary System of the EU intended to prepare the way for a single currency. The member currencies of the ERM are fixed against each other within a narrow band of fluctuation based on a central ECU rate at floating against non-member countries. The ERM established in 1979 , In 1991 European leaders planned to complete the final stage of EMU by 1998-1999:Those who meet the economic convergence criteria in 1999 are required to move to EMU ,irrevocably fixing the conversion rates of their currencies.

[29] Ibid.

In stage three of EMU, all member states need to disciplined and will be responsible for monetary policies directed towards price stability. At this point co-ordination of monetary policies will be very important. Also fiscal and structural policies in all member states are vital for maintaining exchange rate stability. The final objective of economic,monetary and exchange rate policy co-operation is convergence towards macroeconomic stability. A nominal exchange rate mechanism may provide a reference for the conduct of economic policies in member states.

Five points need to be stressed before the exchange rate mechanism:[30]

- Price stability will need to be safeguarded
- The Euro is expected to play an important role in monetary and exchange rate policy in the EU.
- Sufficient flexibility would need to be allowed in order to provide economic convergence of the non-Euro area Member States.
- Adjustment of central rates has to conducted accurately so as to avoid significant mistakes.
- Convergence Criteria need to be ensured.

The new exchange rate mechanism will be based on central rates against the Euro. Fluctuation band will be established for the currencies around their central rates. Also no Euro area Member States could establish fluctuation bands between their currencies and intervention arrangements. This will aim limiting exchange rate fluctuations. Central rates and standard wide band would be set by mutual agreement between the ECB, the Ministers of the Euro area Member States, and the Ministers and Governors of the central banks of the non Euro area Member States.Intra EU monetary and exchange rate policy co-ordination between the Euro area and the non-Euro area Member States will be considered as a continuation of the present mechanism. At the level of central banks, The ECB General Council will monitor the functioning of the exchange rate mechanism and serve as a forum for monetary and exchange rate policy co-ordination.

[30] Alessandro Prati, EMU and International Capital Markets: Structural Implications and Risks, IMF Working Paper WP/97/62

2.5 ECONOMICS OF EUROPE

On January 1, 1999 the third and final stage of the European Economic and Monetary Union (EMU) began with the establishment of a currency union encompassing 11 of the 15 member countries of the EU- Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. On that date, these countries locked their exchange rates and adopt the Euro as their common currency. Also monetary and exchange rate policies are determined by area wide institutions. Thus each country will give up the possibility of independent monetary and exchange rate policy. In this regard the Stability and Growth Pact agreed in June 1999 sets out the procedures for maintenance of national fiscal policies, strengthening the framework provided in the Maastricht Treaty .[30]

The monetary and exchange rate policies conducted at the Euro area level will be considerable global importance. The Euro Area rivals the U.S. in terms of output and trade the role of Euro in financial transactions eventually may challenge U.S. dollar.[31]

The birth of EMU is being facilitated by a macroeconomic environment in the Euro Area that has improved from the early and mid 1990s.The strengthening of fiscal and inflation performance associated with meeting the convergence criteria for EMU has provided the basis for period of sustained, non-inflationary growth.

The initial increase in exports which occurred in response to a strengthening of global demand and a real depreciation of Euro area currencies. A sharp rebound in business and consumer behaviour followed quickly. This was supported by a stabilisation of conditions in the labour market.[32]

Within this over all picture, notable differences in cyclical positions have emerged in the Euro Area.There are two groups. For the more cyclically advanced countries (Austria, Finland, Ireland, Portugal, Spain, Netherlands) which account for about one fourth of Euro area GDP, output gaps in 1998 are on average .For the others less cyclical advanced countries (Belgium, France, Germany and Italy) gaps are approximately average close to 2%.[33] These differences in cyclical positions reflect recent variations across countries in growth performance Exports in a number of the more cyclically advanced countries (notably Finland, Ireland and Spain)

[30] European Central Bank web side,op.cit.
[31] European Commission ,Key Figures,op.cit., pp.58-61
[32] European Monetary Institute,op.cit, pp.42
[33] European Commission, The Implications of The Introduction of the Euro for Member and Non-Member Countries,Euro Papers Vol. 26,1998

were supported by a real depreciation between 1992 and 1995 while the less cyclically advanced countries as a group experienced real appreciation over this period. While differences in this respect between the groups are of course closely related to growth performance.

Consumer price inflation still low by most historical standards. On the other hand stronger in the more cyclically advanced economies running at an annual rate of close to 2% in the summer of 1998.

The potential for increased price pressures in the more cyclically advanced countries is suggested not only by the high rate of resource utilisation but also by faster increase in equity and real estate prices.

Looking forward the recovery in the Euro area is projected to maintain its recent momentum with growth of 2,75-3% a year in 1998/1999.[34] Consumer price inflation is projected to remain at around 1,5 % in 1999 for the area as a whole and to rise about 2,25% in the more cyclically advanced countries. Unemployment is expected to decline further as a result of above potential growth. Uncertainty about the degree of economic slack complicates the assessment of medium term prospects but the IMF staff's estimates seem to be consistent with the absence of all but localised symptoms of inflationary pressures. On the other side global economic conditions have deteriorated significantly in the course of 1998 as a result of severe financial and economic difficulties in Asia, Russia and spill over effects elsewhere. Exports to Japan, Russia, Korea and the Asian 4 countries taken together into account for 11% of Euro area exports and 1,5% of GDP.

As mentioned earlier there are differences between cyclical positions, If this is not properly handled this would impede the recovery in the area as a whole. Two aspect of the EMU Policy framework will help the Euro to meet this challenges[35]

The first is the clear commitment to price stability (Mean inflation of 2% or below) for the Euro area as a whole.[36]This strong commitment to preserving the nominal stability that had been established well for the longer-term growth performance of the Euro area.

The second is the Stability Growth Pact. Main aim is to achieve medium term budgetary positions that are close to balance or in surplus. Meaning it's the dedication of monetary

[34] Ibid

[35] F.Duisenberg, A.J. George and Dr. Lawrence Summers,The Euro is Coming,How will effect the rest of the World,www.amue.ıf.net/q-a/global 24/conf-3htm

[36] The Economist, op.cit.,pp3-5

policy to price stability. On another the pact can help the Euro to cope with and decrease the transmission of shocks and imbalances. It will be achieved by promoting the establishment of medium term fiscal positions. However when it comes to addressing real imbalances and divergences the EMU policy framework is not detailed sufficiently in two key areas. First, national policies will have inevitable spill over effects on other member states countries. Secondly, political opposition to reform is still strong. The monetary conditions resulting from the single monetary policy unlikely to fit well to the circumstances of all countries at times. The strategies for fiscal and structural policies need to ensure that countries are well positioned to deal with country specific problems. By the same time there's need for effective co-ordination of national policies fits well the overall macroeconomic dynamics of the Euro area.

As of September 1998 inflation prospects in the Euro area are: Euro area price inflation has decreased and there are no dangers either on the cost side or from output side. Recent wage increases remained moderate. The effective exchange rate of the Euro area has appreciated over the past year. Developments in the monetary aggregates also suggest the absence of inflationary dangers. [35]Over the past year, 12-month growth of M 3 in the area has stayed in the 4-6% range. Concerns about the inflation appear absent in the financial markets. The relatively flay yield curve for this stage of the cycle implies that monetary conditions are not easy and also decreasing trend in long term interest rates over the past year suggests a further decrease in inflation expectations. Decline in long-term interest rates in recent months raises questions whether there may have been a downward shift in the neutral interest rate. That is the interest rate, which is compatible with output at potential and stable inflation. Portfolio relocations in the wake of the Asian Crisis have favoured the mature financial markets of North America and Europe suggesting some influences on long-term interest rates. The above considerations together with the absence of inflationary dangers would suggest that a path for short-term interest rates is appropriate at the present juncture. While this would entail a reduction in the average Euro area short-term interest rate about ½ of 1-% point from its level in the summer of 1998 the fact that medium and long-term rates have already effectively converged n the Euro area will limit the expansionary implications. If the downsize risks to growth materialise or intensify, a more definite easing may be needed.

As we look to the Structural Policies, for EMU to be a long term success , structural policies will have to effect a change in the performance of European Labour Markets.It has adopted

[35] Manuel Guitian Policy Coordination in the EMS, IMF Occasional Paper No:61

a poorly to changes in the global economic environment since the 1970s. Unemployment in the Euro area rose from 2,5% of the labour force the to 12,5% in 1997 compared with no increase in U.S. and much more moderate increases in Canada and Japan.[37] At the same time developments in output per head of the working age population in the Euro area have been in line with those in the U.S. That is reflecting in part with the distortions in the Euro area that have favoured capital deeming.

One indication of the size of the problem in the Euro area is the employment rates which at about 57% in 1997. There is contrast with rates in the range of 70-76% in Denmark, Sweden, Switzerland, the U.K. and the U.S.[38] This contrast partly explained by higher unemployment also differences in labour force participation are also a key factor. Employment data especially such data distinguish part time from full time labour also indicate that relative employment performance within the Euro area is not well captured by unemployment data. For example despite its low unemployment rate and strong employment growth in recent years the Dutch economy has mobilised a relatively small share of its employment potential. On the other hand the employment rate in Finland is relatively high by Euro area standards despite a very high unemployment rate. The poor employment performance of the Euro area underlines the scope for shifting to a virtuous path that would combine unemployment, increasing labour force participation and strengthening of the long term foundation for the public finances. Even a moderate increase in Euro area participation rates could have notable impact on employment. Europe's structural problems have complex and wide ranging origins. Thus the OECD and the EU in their respective labour market strategies have set out list of guidelines. The mixed policies varies from country to country, most countries need to address issues in each of the areas identified. Structural policies at the national level are also relevant to the Euro area policy mix. First, more flexible markets can help economies adopt to shocks. Second, reforms that strengthen the Euro area's supply response would tend to postpone the need for the monetary tightening. Examining the overall policy mix, the cyclically advanced economies should put particular emphasis on fiscal tightening. The fiscal policy requirements are underscored by the need to ensure that monetary policy has adequate room for the manevour in light of the prevailing uncertainties. On the other hand, policy makers should pay attention to addressing inflexibilities in their labour ad product markets. This strategy would strengthen

---

[37] Ibid.

[38] European Banking Federation.Economic Figures of European Union Countires,fbe.be/f-e-new.htm,1998

the recovery by deferring the emergence of supply constraints and allowing lower interest rates. Policy requirements viewed from the perspective of individual member countries seem generally compatible with the policy mix needed for the Euro area. An important issue is now whether the more cyclically advanced countries recognise the urgency of taking measures to restrain demand. In this context there is a risk that in EMU inflation may seem less of a short-term policy. Inflation at the national level will carry adverse implications for competitiveness and hence for the employment. In this view the stance of fiscal policy in some eof these countries is not reassuring. Unfortunately there are risks that sufficient progress will not be made in implementing the desirable policy strategy for the Euro area. In the case of some of the more cyclically advanced economies, the monetary policy stance of the European Central Bank (ECB) may compensate in part of for the inadequacies of national fiscal policy making.

Looking at the Euro area and the World Economy, EMU and the economic performance of the Euro area will have their largest external effects on economies in Western Europe and on developing countries. Among emerging market economies those likely to be most affected by the transition countries of central and Eastern Europe and the Baltic's, the developing countries of the Mediterranean and countries in Africa. Other countries in Asia and Western hemisphere as well as the advanced economies outside Europe will be affected as well but to a lesser extent.

TABLE 1.

Euro Area and Selected Countries : Trade Linkages in 1996
(Exports and imports from trading partners as percent of total trade and output)

	Partner Countries						
	Trade				Output		
	Euro Area	Other Advanced	Developing	Total	Euro area	Other Adv.	Devpl.
Euro Area	51	30,8	18,2	22,9	11,7	7,1	4,2
Denmark	47,1	40,2	12,7	23,6	11,1	9,5	3
Greece	57,5	21,4	21,1	14,6	8,4	3,1	3,1
Sweden	44,5	43,1	12,3	29,1	13	12,6	3,6
U.K	49,4	34,9	15,7	22,3	11	7,8	3,5
Japan	11,3	54,7	34,1	8,2	0,9	4,5	2,8
U.S.	13,8	53,6	32,6	9,4	1,3	5	3,1
Asia	12,5	67,7	19,8	19,7	2,5	13,3	3,9
Africa	39,8	34,4	25,8	19,5	7,7	6,7	5
CFA franc zone	48,1	23,7	28,2	25,5	12,3	6,1	7,2
Middle east and Europe	26,9	42,8	30,2	25,6	6,9	11	7,8
Central and eastern Europe	51	16,1	32,8	32,9	16,8	5,3	10,8
Western Hemisphere	13,3	61,4	25,3	14,8	2	9,1	3,7

SOURCE: IMF, Direction of Trade Statistics and World Economic Outlook

The global environment has been favourable in a number of respects for the transition to EMU and the achievement of its economic objectives. Strong demand for the Euro-area exports from industrial countries and also depreciation of the currencies of area countries over the past 3 years fostered a strengthening of growth in the Euro area. This decreased the effects of Asian Crisis. Demand growth in these areas likely to slow. The global economic environment also provides challenges for EMU. Especially since the Asian and Russian crises and financial market volatility in emerging market economies could have spillover effects on the Euro area: Firstly, should these crises deepen or spread, external demand could be weaker than projected. Confidence effects in these cases should have adverse implications for domestic demand. Secondly, financial market volatility could add to uncertainty in the assessment of economic indicators that will be monitored by the ECB.Third the weakness of the Japanese yen since late 1997 and the volatility of the yen dollar exchange rate in recent months illustrate how market exchange rates among major currencies can move quickly in ways that are consistent with the medium-term fundamentals. Such changes could influence financial market conditions and monetary policy deliberations in the Euro area in the period ahead.

Finally the Crises in Asia and Russia and the possibility of a broader crisis in emerging markets could influence the transmission of policy to the real economy if Euro area commercial banks have to adjust their balance sheets to make substantial provisions for non-performing loans.

After having examine the Economics of Europe, before the Banking in the Euro Area (structural features and trends), it would be helpful to understand economic developments in the Euro area.

Reflecting the considerations at its meeting on 8 April 1999, the Governing Council of the ECB had the opinion to lower the interest rates on the monetary policy instrument of the Eurosystem. The Governing Council decided to reduce the interest rate on the main refinancing operations by 0.5% point to 2.5% starting with the operation to be settled on 14 April 1999. In addition to that, with effect from 9 April 1999 the interest rate on the marginal lending facility was reduced by 1% point to 3.5% and the interest rate on the deposit facility by 0.5% point to 1.5%.[39]

In February 1999 the 12-month growth rate of the broad monetary aggregate M3 fell to 5.2% from 5.6% in January 1999.[40] As the outrun for monetary growth in February 1999 was higher

[39] Ibid.

[40] World Economic and Financial Surveys, op.cit., pp128-132

than that recorded in late 1998. Twelve-month growth rates of M3 covering the period from December 1998 to February 1999 still increased by 0.2% point to stand at 5.1%. This figures which has to be compared with the reference value for M3 growth of 4.5% set by the Governing Council.[41] It reflects the specific environment related to the transition to stage three of EMU. The moderate slow down of M3 growth in February 1999 was mainly due to a deceleration in the rate of expansion of overnight deposits. It accounts for about one third the total stock of M3. Other deposits included in M3 also showed a slight reduction in growth.

The annual growth rate of overnight deposits decreased to 15.1% in February 1999 from 17.6%. Moreover in February 1999 the outstanding value of currency in circulation fell by 0.4% compared with the same month a year earlier.[42] These developments signalled that Euro area residents had reduced their preference for liquid assets compared with January 1999. As a consequence growth of the narrow monetary aggregate M1 (currency in circulation and overnight deposits) decreased to an annual rate of 12% in February 1999 from 14.3% in March 1999.[43]However the 12 month growth rate of M1 remained high reflecting the effects of the convergence to low levels of nominal interest rates in the Euro area. The aggregate 12 month growth rate of other deposits included in M3 also decreased from 2.1% to 1.5% in Feb 1999. This was due to a further drop in the pace of growth of deposits with an agreed maturity of up to 2 years. (To –4.1% from –2.8% in Jan. 1999). As a consequence growth of the intermediate monetary aggregate M2 slowed to an annual rate of 6% from 7.3% in Jan. 1999.[44] In Feb. 1999 the short-term marketable instruments included in M3 showed a recovery compared with previous months. This was entirely due to the faster expansion of money market paper and shares in money market funds, which rose to13.2% from 7.5% in Jan. 1999.

There's also moderate slowdown in credit growth. In March 1999 the first set of data which provide an insight in to the composition of Monetary Financial Institutions (MFIs) lending to Euro area residents by sector, type and maturity became available. At the end of the 1998 loans to households accounted for 52% of the total value of outstanding loans from the MFI sector to the non-financial private sector. Non profit institutions serving households such as consumer's associations, charities, social, cultural, sports clubs etc....) held the remaining 0.9% of the total value of loans. For households an additional breakdown by type of loans is available. This shows that loans for house purchases play an important role in the Euro area.

41 Ibid.
42 Ibid.
43 Ibid.,pp140-144
44 Ibid.

At the end of the 1998 they accounted for about 30.7% of total loans to the non-financial private sector. The share of loans classified as consumer credit stood at around 8.8%. Other loans to households accounted for 12.5% of total loans.[45] With regard to the maturity composition of loans to the non-financial private sector, it is notable that maturity of more than one year accounted for the largest share. This is the case both for households and for no-financial corporations. Loans with a maturity at issue of more than 5 years represented 50.1% of loans classified as consume credit. 95% of loans for house purchases and 48.9 of loans to non-financial corporations. This confirms that the current low level of medium and longer-term retail bank lending rates may be having a significant effect on the demand for credit. In particular in those Euro area countries which in the past had experienced considerably higher long-term interest rates.

Coming to the slowdown in credit growth, during Feb 1999 the total amount of credit granted by the MFI sector to the Euro area residents increased at an annual rate of 7.4%.[46]The growth of this item, which includes loans, provided by MFIs as well as their holdings of debt securities and shares showed a slowdown. This development was more than accounted for by a reduction in the annual growth rate of credit to household and corporations. (From 10.2% in Jan. To 9.5% in Feb).[47]Credit growth to the private sector remained strong. Yet only part of this appears to be related to underlying patterns of domestic demand. In this respect the considerable rise in land and housing prices in some part of the Euro area also appears to decrease the strength of lending to the private sector. Another possible factor, which may have contributed to supporting credit growth over recent months, may have been a demand for credit by non-financial corporations in order to finance inventories.

In contrast with credit to the private sector, the amount of credit granted to general government continued to grow at a very rapid pace (Feb 1999 rate was 2.2% compared earlier month rate 1.9%). This potential increase in the rate of expansion was the result of slow growth both of loans to general government and of the MFIs' holding of government debt securities.

Among other counterparts of M3 in the consolidated MFI balance sheet, the growth of longer-term financial liabilities of the MFI sector to the other Euro area residents decreased in Feb.1999 with the annual rate falling to 3.6%. The rate of expansion of debt securities issues by MFIs with a maturity over two years continued to increase at a relatively strong pace. (12-

---

[45] Ibid.
[46] European Banking Federation, op.cit.
[47] European Commission Key Figures, op.cit.

month growth rate was 6.8% in Feb. And 7.3% in Jan). This may reflect the changes in the minimum reserve base credit institutions in some Euro area countries compared with the situation in stage two.

The external assets and liabilities of the MFI sector showed a high degree of volatility in early 199 with a marked reduction occurring in both items in Feb. 1999. This reflected the inclusion of the temporary gross positions with central banks of member states not participating in the Euro area relating to the operation of the Target System.These points amounted to approximately €75 billion at end Jan. 1999.[48] Overall, the net external asset position of the MFI sector deteriorated by €50 billion compared with Jan. 1999 an d by €132 billion compared with Feb. 98.[49]

Looking through the overnight market interest rate as measured by EONIA (Euro Overnight Index Average) declined during March 1999 from 3.12% to levels below 3%.[50] This pattern mainly reflected the relatively abundant liquidity available to the banking system. Towards the end of the second reserve maintenance period the overnight rate fell to a level as low as 2.19% on 22 March before rising to 2.39% on the last day of reserve maintenance period. During the second maintenance period fell to 2.94% while it had been equal to 3.13% on average in the first period. During the third period it was 3%.[51]

The three-month market interest rate measured by EURIBOR was also on a declining path thorough out the month of March. After starting the month at a level of 3.1%, the three-month EURIBOR fell to a level of just below 3% on 25 March. On 8 April it stood at 2.9% which implied reduction of almost 35 basis points since the start of the stage three of EMU. The decline in 3-month interest rate may to some extent have been due to a change in the markets perception of the structural relationship between the overnight market rate and the main financing rate. But it's also reflecting the increased market expectations of an easing of money market conditions in the second quarter of 1999.Reflecting these factors the three month interest rate on futures contracts on Euro for delivery in June and September 1999 fell by 20-25 basis points between the end of February and April 1999. In April the interest rates on three-month futures contracts on Euro for delivery in June and September 1999 stood at 2.79% and 2.75% respectively.[52]

[48] Ibid.
[49] Ibid.
[50] Ibid.
[51] Ibid.
[52] Ibid.

The fall in the three-month interest rate was also reflected in the outcome of the third longer-term refinancing operation of the Eurosystem. As announced after the meeting of the Governing Council on 4march 1999 the Eurosystem conducted its monthly longer term refinancing operations in March 1999 for the first time through the multiple share rate method. The weighted average of this operation, which was settled on 25 March, was equal to the 2.97% with the marginal rate of sharing being equal to 2.96%. As the volume of the sharing in this operation was preannounce by the Euro system these interest rates reflected market conditions rather than monetary policy signals. As was expected the rates were below the three-month Euribor of 3.01%. This negative spread may be attributed to the fact that the EURIBOR transactions are unsecured and can be expected to incorporate a higher risk premium.[53]

Through to price developments overall consumer price increases remained unchanged. Consumer price inflation as measured by the Harmonised Index of Consumer Prices (HICP) was 0.8% in Feb 99(see table 2). The gentle development of consumer price increases in the past few months can be attributed to generally weak upward pressure on prices. Most recently the trend has masked a number of mutually offsetting factors. On the on hand recent months have seen a reversal of the downward trend in unprocessed food and energy prices. It was an important factor behind the lower increases in the overall price index during most of the second half of 1998. The annual increase in prices of unprocessed food rose from 0.6% in Nov. 1998 to 1.1% in Jan 1999 and further to 1.5% in Feb 1999.[54] Probably reflecting reduced supplies of fruit and vegetables due to less favourable weather conditions. Furthermore, oil prices have started to rise in recent months and this has resulted in slightly higher annual percentage change in energy prices in the HCIP. Energy prices were 4.3% lower than a year earlier in Feb 99 after having been 4.8% lower in Dec 1998. The announcement in March by much oil producing countries that they intended to cut production prompted a marked increase in the price of the oil. This increase is most likely to be reflected in the HICP energy index with only a short lag. An increase in the energy prices component will affect overall consumer price inflation in proportion to the weight of this component in the HCIP(8.8%).[55] As regards these latest developments it may be noted that both unprocessed food and energy prices have shown a high degree of short-term volatility in the past. The changes in

[53] Ibid.
[54] European Central Bank, op.cit
[55] Ibid.

unprocessed food and energy prices in Feb 1999 were offset by a continued decline in the rate of change in the prices of non-energy industrial goods and services. The increase in prices of non-energy industrial goods fell from 0.9% in Dec 1998 to 0.7% in Feb 1999, due to lower increases in the prices of new vehicles. With regard to services prices the annual increase fell for the fourth month.(from 2.1% in Oct. 1998 to 1.7% in Feb 1999). It's mainly on account of lower prices for communications but also a result of lower prices for transport services. Recent price developments in these sectors may be partly related to deregulation an increased competition. With regard to other cost and price indicators the rate of exchange in industrial producer prices has continued its downward trend. In Jan. 1999 was 2.7% lower than year earlier. Data for unit labour costs are only available up to the third quarter of 1998 and it was 0.6% lower than a year earlier.[56]

TABLE 2.

Price and cost developments in the euro area													
	1996	1997	1998	1998	1998	1998	1999	1998	1998	1998	1999	1999	1999
				Q2	Q3	Q4	Q1	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
(annual percentage changes)													
Overall index	2,2	1,6	1,1	1,3	1,1	0,8	-	0,9	0,8	0,8	0,8	0,8	-
Goods	1,8	1,1	0,6	1	0,7	0,2	-	0,3	0,2	0,1	0,2	0,2	-
Food	1,9	1,4	1,6	2,1	1,7	1,1	-	1,2	1	1	1,2	1,4	-
Processed food	1,9	1,4	1,4	1,6	1,4	1,2	-	1,3	1,2	1,1	1,3	1,3	-
Unprocced food	1,8	1,4	2	2,8	2,1	0,8	-	1,1	0,6	0,9	1,1	1,5	-
Indust. good prices	1,8	1	0,1	0,4	0,1	-0,2	-	-0,1	-0,2	-0,4	1,1	-0,4	-
Non-energ ind. gooods	1,6	0,5	0,9	0,9	1	0,9	-	1	0,9	0,9	-0,3	0,7	-
Energy	2,6	2,8	-2,6	-1,4	-3,2	-4,4	-	-4	-4,4	-4,8	0,8	-4,3	-
Services	2,9	2,4	2	2	2	2	-	2,1	2	1,9	-4,4	1,7	-
Other price indicators													
Ind. Producer prices	0,4	1,1	-0,8	-0,2	-1,3	-2,3	-	-2	-2,4	-2,6	-2,7	-	-
Unit labour cost	1,8	0,4	-	-0,6	-0,6	-	-	-	-	-	-	-	-
Compensation per employee	3,4	2,6	-	1,2	1,3	-	-	-	-	-	-	-	-
Oil Prices	15,9	17,1	12	12,8	11,7	10	10,3	11,2	10,2	8,8	9,5	9,4	11,8
Commodity prices	-6,9	13	-13	-11	-18,2	-21	-16	-24	-18	-19	-17	-17	-15

Source: Eurostat National Data,1998-1999

Coming through the output, demand and labour market developments the first estimate of real GDP growth. (Released by Eurostat on March 1999) was 0.2% compared with 0.7% in the third quarter. Industrial production in the manufacturing sector declined by almost 1% in the fourth quarter of 1998 compared with the previous quarter and according to the February

[56] European Monetary Institute, op.cit.,pp39

release of the European Commission Business Survey industrial confidence continued to deteriorate in early 1999(see table below)

TABLE 3.

tput , demand and labour market develpoments in the euro area
nual percentage changes)

	1996	1997	1998	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Aug.	1998 Sep.	1998 Oct.	1998 Nov.	1998 Dec.	1998 Jan.
al gross domestic product	1,6	2,5	3	3,8	3	2,9	2,4	0	0	0	0	0	0
ustrial production	0,2	4,3	4,2	6,6	4,6	4	1,9	4	3,5	2,9	1,9	0	0
ange from previous period				1,3	0,7	0,2	-0,1	0,2	0,1	0,2	-0,1	0	0
which													
nufacturing	-0,2	4,8	4,6	7,4	5,1	4,3	2	4,3	4	3,2	2	0	0
main industrial groupings													
ermediate goods	-0,4	5,4	4	7,5	4,4	3,3	0,8	3,3	2,6	2	0,8	0	0
pital goods	1,8	5	7,2	9,8	7,2	6,9	5,2	6,9	6,6	6,1	5,2	0	0
nsumer goods	-0,3	2,2	3,2	4	3,8	3,5	1,7	3,5	3,3	2,7	1,7	0	0
nstruction	-2,6	-1	0	3,6	0,2	-0,5	-2,6	-0,5	-1,4	-2,2	-2,6	0	0
pacity utilisation(%)	80,3	81,6	83,1	83,1	83,6	83,3	82,4	0	0	0	0	0	0
onomic sentiment index	-2,7	2,5	3,2	3,7	4,4	3	1,6	3	2,1	1,8	1,6	1,7	1,3
nsumer confidence indicator	-9	-3	7	4	6	8	10	7	7	8	10	11	11
ustrial confidence indicator	-8	3	7	10	10	7	0	7	5	3	0	-1	-2
tail sales,constant prices	1,1	0,8	2,5	2,6	1,7	2,8	2,8	2,8	2,2	2,7	2,8	0	0
ployment	6,6	3,9	7,7	12,7	3,3	7,4	7,5	7,4	5,1	7,7	7,5	9	5,9
employment (annual changes)	422	80	-831	-517	-798	-976	-1025	-977	-1010	-1043	-1026	-975	0
employment (% of labour force)	11,6	11,6	11	11,2	11	10,9	10,7	10,9	10,7	10,9	10,8	10,7	10,7

Source: Eurostat National Data, 1998

Consumer confidence didn't increase further , instead remained unchanged at the record level observed at the beginning of 1999. Retail sales in the three months to December 1998 rose by 2,8% compared with the same period a year earlier.. The picture of an overall worsening of growth rate of 3% in 1998 , the Commission now expects real GDP to grow by 2,2% in the Euro area in 1999. This compares with a growth rate of 2,6% projected in the autumn forecasts of last year.

Employment growth slowed while the decline in unemployment virtually stopped. Total employment continued to grow in the fourth quarter of last year, but at a slower rate. Measured quarter the growth rate was 0,3% in the last quarter of 1998. The slowdown that started in the manufacturing in the third quarter of 1998. However net job creation in the rest of the services sector has remained broadly on the same path.[57]

While total employment growth slowed in the fourth quarter of 1998. The standardised rate of unemployment in the Euro area remained unchanged at 10,7% during that period. However the unemployment rate began its decline in January 1999.[58] On the other hand the declining trend in unemployment has stopped in several countries in recent moths while the rate of unemployment remains high for the Euro area as a whole. Employment data, which are now available up to the end of 1998, provide a picture of the labour market for 1998 as a whole. On the basis of the data it appears that net job creation in 1998 as a whole was more dynamic than in previous years. In the course of the year employment increased b 1,5% (around 1,7 million). During the same period the absolute level of unemployment declined by 1 million meaning that the labour force grew by 0,5% last year. This is 0,2% point higher than the average growth rate observes in the past. The positive momentum in employment growth from around mid 1997 seems to have encouraged people to enter or re-enter the labour market.

Shortly examining the fiscal developments, but the help of the below table pattern of fiscal consolidation in the Euro area in 1998 can be characterised by the following elements.

TABLE 4.

General government fiscal position in the euro area (as a percentage of GDP)		
	1997	1998
Current Receipts	49	48,6
Direct Taxes	12,2	12,5
Indirect taxes	13,5	14,1
Social Contributions	18,3	17,2
Sales	2,7	2,7
Current Expenditure	48,6	47,4
Interest Payments	5	4,5
Transfers to households	23,1	22,6
Compensation of employees	11,6	11,3
Intermediate consumption	5,2	5,1
Gross saving	0,4	1,1
Capital Receipts	0,7	0,5
Investment	2,3	2,3
Capital Expenditure	3,6	3,7
Deficit/Surplus	-2,5	-2,1
Total receipts	49,7	49,1
Total expenditure	52,2	51,2
Primary deficit/surplus	2,5	2,4
Gross Debt	75,4	73,6

(SOURCE: ECB ,1998)

[57] Ibid.

[58] Ibid.

There's a modest reduction in the budget deficit. The weighted Euro area budget deficit amounted to –2,1% of GDP in 1998. (i.e. 0,4% point lower than in 1997) this is a more positive result than expected. Although the average deficit ratio still remains much closer to the value of 3%(it's laid down in protocol no 5 on the excessive deficit procedure to the Treaty as a reference for an excessive deficit than to balance.[59]

The reduction in the budget deficit matches the decline in interest payments. The surplus has remained constant at around 2,5% of GDP that does not allow for a rapid decline in the debt ratio.

There has been balanced reduction of 0,5% of point of GDP expenditure and total receipts . According to the past experiences this adjustment is more likely to be permanent than the alternative pattern of fiscal consolidation based on tax increases.[60]

The change in the composition of current receipts implies a lower weight of social security contributions (down 1,1% points of GDP) and a higher weight of direct taxes (up 0,3% points of GDP) and indirect taxes (up to 0,6 point of GDP) mostly due to changes in institutional arrangement in a few countries.[61]

The change in the composition of spending means a lower weight of current spending(down 0,7% point of GDP) and a greater weight of capital spending (up 0,1% point of GDP).The reduction in current spending as a percentage of GDP has been basically due to the reduction in transfers to households (down 0,5% point of GDP).[62]The increase in the ratio of capital expenditure to GDP is explained by higher government transfers.

The decline in the debt ratio by 1,8% points has also been stronger than previously anticipated. However one third of this reduction (0,6 % point) is attributable to deficit debt adjustments.

After shortly examining the fiscal conditions in Euro area, here come the exchange rate and balance of payments developments.

Foreign exchange rate market developments in March 1999 were characterised by a stranger U.S. dollar and Pound and by significant volatility of the Euro against the Japanese yen. The foreign exchange markets in the main emerging market economies moved toward lesser volatility.

---

[59] Ibid.
[60] Ibid.
[61] European Central Bank, op.cit.
[62] Ibid.

The strength of the U.S. dollar against the Euro was mainly attributable to economic data released recently, which demonstrated that the strong economic performance of the U.S. economy was continuing without losing momentum.[63] In particular indicators showed that growth was attributable not only to higher capital and labour inputs but also to productivity increases. Further indicators of inflationary pressures remained unchanged. The main driving force behind the expansion continued to be consumer spending with the level of consumer confidence remaining high. In addition the continued strength of the dollar relative to the Euro was characterised by uncertainties related to the military conflicts in Balkan's. Overall the Euro was declined by 2.2% against the dollar during the month.[64] Against the Japanese yen the Euro remained volatile in March while registering a decline of about 2.5% to a level of JPY 128 at the end of the month. Individual movements in the yen exchange rate against the dollar and the Euro are difficult to attribute to specific developments. But can say that the overall volatility of the yen has mainly been a result of the continued uncertainty surrounding the outlook for the Japanese economy.

The development of the Euro against the pound sterling was similar to that against the dollar and the Euro ended the month at GBP 0.67 down 2.4%from the beginning of the month. Part of the weakening against the pound sterling may be explained by the traditionally close link between movements of the dollar and the pound sterling as well as by the strong rise in oil prices.[65] Further some recent date have indicated that the slowdown in real GDP growth in the U.K. might be less strong than previously expected.

Trade surplus slightly reduced in 1998. In December 1998 the surplus on the balance of trade of the Euro area amounted to € 6.9 billion (€ 1.4 billion lower than in the corresponding month of 1997) For 1998 as a whole the trade surplus was €83 billion(1,4 % of GDP) compared with €88.8 billion in 1997.[66] According to December 1998 figures, the value of exports and imports amounted to € 63.9 billion and € 57 billion respectively. In that month exports declined by 4.6% compared with December with 1997. For 1998 as a whole the value of exports increased only 3.7% which was significantly less than in 1997.[67]

The slowdown in export growth reflects weaker foreign demand and some worsening of Euro area competitiveness as measured by the real effective exchange rate in 1998.As for imports

[63] The Economist,op.cit.,pp8-10
[64] The Potential Effects of EMU, www.ny.u.edu/global/beat/emu/EC0329528,html
[65] F. Duisenberg,op.cit.
[66] Ibid.
[67] Ibid.

their value decreased by 3% in December 1998 compared with 1997, for the whole of 98 the rate of growth of imports slowed to 5.1% from 13.4% in 1997.[68]

TABLE 5.(EUROSTAT, 1998)

Trade in goods of the euro area	1997	1998	1997 Q2	1997 Q3	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Nov.	1998 Dec.
Exports											
€ billions	762	790	192	194	207	194	204	195	198	65,8	63,9
Annual perc. change	13,8	3,7	15,4	19	13,4	13,9	6,4	0,5	-4,1	-0,8	-4,6
Imports											
€ bilions	673	708	708	167	180	181	179	170	178	59,3	57
Annual perc. change	13,4	5,1	5,1	18,2	14,2	13,8	6,5	2,2	-1,3	2,3	-3
Trade Balance											
€ billions	88,8	83	23,9	26,9	26,3	13,4	25,2	24,4	20,2	6,5	6,9
€ billions cumulative	88,8	83	35,6	62,5	88,8	13,4	38,6	62,8	83	76	83

[68] Ibid.

3. STRUCTURAL FEATURES OF BANKING IN EURO AREA &EFFECTS OF EMU ON EU BANKING SYSTEM

3.1 Structural Features of Banking in Euro Area

As its known competition in the banking sector has increased. This is of course due to some fundamental forces pressing for change in the financial system. These factors are financial liberation; innovation, technological progress and the investment portfolios are the most important ones. To be by the introduction of the Euro this will act as a catalyst for further competition and structural change in the banking sector. However in term of the timing and the nature of the effects, the impact of the Euro is likely to vary across different types of financial services and markets.

Together with the single market legislation liberalizing the cross border provision of financial services within the Union the introduction of the Euro facilitates the development of a more integrated and competitive banking industry in the Euro area. [69]The trend towards increased consolidation and concentration taking place by bank mergers and acquisitions are the sign of that kind of behavior. In the first weeks and moths after the introduction of Euro a integrated and highly competitive single money market has emerged as banks' treasury function have adopted to the new environment. The TARGET system has been very active during the cross-border payments.

Differences in overnight rates in the Euro area now mainly reflect differences in the credit standing of banks. This indicates that the overnight money market has begun to operate smoothly across the Euro area. It's also the example of how the functioning of financial markets might change by the introduction of Euro. The eurosystem has a strong interest in the banking industry, which have implications for the stability of the banking system and functioning of payment system. Both of them are relevant to the successful conduct of monetary policy in the Euro area and linked to the other tasks of the Eurosystem (Art. 105(2) and 105(5) of the Treaty)

The Eurosystem (The European Central Bank and the Euro Area National Central Banks-NCBs) has an interest in following development in the Euro area-banking sector. Firstly, the Eurosystem is interested in the structural features of the sector and development affecting the stability. More importantly the structure and stability of the banking sector can have an impact on overall macroeconomic performance, the efficiency of monetary policy implementation and the functioning of payment systems. In this respect all central banks have developed expertise and collected information about the banking system. This reflects the fact that banks constitute the key sector in the monetary policy transmission mechanism, as they are Eurosystem's counterparts in monetary policy operations.

Secondly, the Eurosystem is interested in developments which could affect the stability of the banking system that laid down in the Treaty (Art.105 (5)) which states that " the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and stability of the financial system."

As going through the structural features of the Euro are banking sector, the size of a banking sector can be described in terms of the amount of assets that are held by banks and which reflect the activity of financial intermediation by banks, for example the provision of funds to the various sectors of the economy. The aggregated balance sheet of the Euro area Monetary Financial Institutions (MFIs) excluding the Eurosystem was Euro 14.233 billion at end 1998 next page table) This figure only exceeds the amount of assets of Euro area credit institutions.

[69] Horst Ungerer EMS Developments and Perspectives, IMF Occasional Papers no :73

TABLE 6.

Aggregated balance sheet of the euro area MFIs (EUR billions)	end 1997	%share of total	end1998	%share of total
Total assets	13664,4	100	14233,2	100
Cash	36.5	0,3	37,2	0,3
Loans that	9748,2	72,9	10318,1	72,5
Domestic	7716,8	57,7	8215,3	57,7
Rest of the euro area	719,3	5,4	832,7	5,9
Rest of the world	1312,1	9,8	1270	8,9
Debt securities that	2099,5	15,7	2292,5	16,1
Domestic	1559,7	11,7	1630,2	11,5
Rest of the euro area	308,9	2,3	403	2,8
Rest of the world	231	1,7	259,2	1,8
Money market paper	99,6	0,7	102,6	0,7
Domestic	82,0	0,6	83,7	0,6
Rest of the euro area	17,5	0,1	18,9	0,1
Shares and other equity	379,5	2,8	481,6	3,4
Domestic	289,6	2,2	365,1	2,6
Rest of the euro area	40,3	0,3	57,9	0,4
Rest of the world	50,0	0,4	58,6	0,4
Fixed assets	238,9	1,8	243,3	1,7
Remaing assets	763,9	5,7	757,9	5,3
Total liabilites	13366,4	100	14233,2	100
Curency	0,4	0,0	0,4	0,0
Depoists that	9148,7	68,4	9749,2	68,5
Domestic	6900,8	51,6	7243,6	50,9
Rest of the euro area	864,8	6,5	989,4	7,0
Rest of the world	1383	10,3	1516,2	10,7
Money market fund shares	252,0	1,9	244,2	1,7
Debt securities	1925,1	14,4	2091	14,2
Money market paper	138,8	1,0	165,3	1,2
Capital and reserves	687,5	5,1	727,5	5,1
Remaining liabilites	1214	9,1	1255,6	8,8

Source: ECB, 1998

Referring to data from national sources total banking assets amounted to 176% of GDP in 1985 when measured in terms of the total assets of credit institution residents in the countries, which are now in the Euro area. At end 1997 this figure was 234%.[69] This means that the growth of the banking sector has been significantly faster than that of the economy as a whole. Furthermore there has been a general increase in derivative and other off balance sheet activities of banks. They are not entering into the above measurement. So the changes in total assets do not fully reflect the changes in the volume of services offered by banks.

The aggregated total assets of the Euro area Monetary Financial Institutions (MFIs) are still dominated by banks. At end 1998 the overall share of loans in total assets was 73%. Total holding of debt securities constituted 16% of total assets while shares and other type of equity holdings had only a 3% share. Investment in debt securities grew faster than loans in 1998 but equity holdings were the fastest growing asset item. Two features of the composition of assets appear to be significant. First, Interbank loans represent more them 20% total assets, which marked the m the second largest asset component after loans to the non-bank private sector.[70] Secondly, lending to general government is relatively important for Euro area bank (around 15% of total assets) when other loans and purchases of the securities issued by general government are taken into account.

In general the assets of Euro area MFIs are still domestic. Loans and securities holding s related to the residents in Euro area countries rather than the country of residence of the MFI.It had a 9% share in total assets at end 1998.

In the Euro area deposits are the main source of funding. It constituted 69% of the total liabilities of the MFIs at end 1998 which Interbank deposits have sizeable share.[70] The largest proportion of total deposits 74% is collected from the domestic market. Deposits received from Euro area residents from countries other than the country of residence of the MFI increased more rapidly than domestic deposits in 1998. Debt securities issued MFIs accounted for 15of total liabilities at end 1998 and capital and other reserves for 5%.

Th Euro area banking sector is still very fragmented in terms of national and sometimes even local characteristics.[71] In some countries a large part of the banking activity is in the hands of

---

[69] Ibid.

[70] European Commission Economic Policy in EMU part B Specific Topics, Economic Papers no:125,1997

[70] European Commission, Key Figures, op.cit

[71] Ibid.

a few nationwide banks. In some other countries the market share of banks that operate on nationwide basis is rather small.

TABLE 7.

Number of credit institutions 1 April 1999	
BE	121
DE	3.218
ES	395
FR	1.210
IE	78
IT	933
LU	210
NL	612
AT	899
PT	228
FI	345
TOTAL	**8.249**

SOURCE: ECB, 1998

The total number of credit institutions in the Euro area was 8249 at the beginning of April 1999. This reflects the large number of savings and Co-operative banks and specialized credit institutions in a number of countries. On the other hand number of institutions that operate on a nationwide basis is rather small in proportion to the total number of institutions. In the U.S. The number credit institutions is even higher as there were more than 10,400 insured commercial banks and saving institutions at end 1998 according to statistics published by the Federal Deposit Insurance Corporation. [72]

In the light of above numbers, particularly since the 1990s there's a declining trend in the number of credit institutions. This reflects the consolidation process within national banking industries. In 1985 there were more than 11,200 credit institutions in the current Euro area countries. This decline reflects mergers rather than closure of existing institutions. Two kind of mergers exist: First one is a offensive merger which aimed at repositioning the bank in the financial markets or enlarging to a size better enabling it. For example investing in modern

[72] Ibid.

technologies or entering in to a new banking activity. Second one is a defensive merger, which have been conducted among smaller credit institutions to reduce excess capacity, meet capital adequacy. It should be noted that consolidation has not only the result of EMU but rather to a more intense global competition and d the need to increase efficiency and reduce costs.[73]

TABLE 8.

Concentration at the national level
Assets of the five largest credit inst. as percentage of the total assets of domestic credit

	1985	1990	1995	1997
BE	48	48	54	57
DE	-	13,9	16,7	16,7
ES	38,1	34,9	45,6	43,6
FR	46	42,5	41,3	40,3
IE	47,5	44,2	44,4	40,7
IT	20,9	19,1	26,1	24,6
LU	-	-	21,2	22,4
NL	69,3	73,4	76,1	79,4
AT	35,9	34,6	39,2	48,3
PT	61	58	74	76
FI	51,7	53,5	68,6	77,8

SOURCE: ECB, 1998

For the upper table to be understood a relevant market definition should be done. For some retail banking services the relevant market can still be the local community, while for some wholesale banking services the relevant market is the single currency area? Therefore concentration tends to below in large countries at the national level. [74]

While the number of credit institutions has fallen, the measures of bank capacity for example branches, employees per number of inhabitants present a far more mixed picture. In general decline in number of banks has not so far generated reductions in the numbers of bank branches and employees. Overall by 1997 the total number of branches seem to be at around 160,000 in the Euro area. Since the early 1990s the number of bank employees has been declining in the Euro area amounted 2,139,000 at end 1997. Given the development of direct banking and ATM (automated teller machines) the banking industry seems to be becoming a

[73] European Monetary Institute, op.cit.

[74] Oliver Bandt and E. Philip Davis. A Cross Country Comparison of Market Structures in European Banking.European Central Bank Working Series Vol.8,1998, pp17-25

less labor-intensive industry. This causes an increase the pressure of reducing number of branches and employees.

TABLE 9

lumber of credit institutions' branches and mployees per 1000 habitants								
	1985		1990		1995		1997	
	Branches	Employees	Branches	Employees	Branches	Employees	Branches	Employees
E	0,87	7,26	0,9	7,94	0,76	7,56	0,72	7,57
E	0,61	9,46	0,63	11,1	0,59	9,28	0,57	9,16
S	0,76	6,06	0,83	6,22	0,93	6,35	0,97	6,29
R	0,47	7,71	0,45	7,63	0,44	7,05	0,44	6,89
E	0,24	4,23	0,27	4,99	0,29	6,4	0,32	6,29
-	0,23	5,66	0,31	5,92	0,41	6,23	0,44	6
U	0,68	25,37	0,78	41,78	0,85	44,9	0,75	45,75
L	0,59	7,54	0,54	7,86	0,44	7,13	0,44	7,19
T	0,54	8,94	0,58	9,86	0,58	9,78	0,58	9,43
T	0,15	5,9	0,2	6,2	0,35	6,09	0,41	5,97
I	0,89	9,61	0,58	10,15	0,38	6,31	0,32	5,21
uro area /eighted avg	0,51	7,38	0,54	7,97	0,55	7,52	0,56	7,37

Source: Eurostat, National Data, 1998

The diversification of saving and investment refers to the development increased investment in higher yielding and possibly more complex products for example mutual funds, securities, pension funds reduce the overall share of retail bank deposits in household and company savings and investment portfolios. The absolute amount of financial wealth has risen. These facilities the increasing in the size of the market for asset management services.[75]

This global diversification of savings and investments are also found in the Euro area countries. Ordinary bank deposits have continued to grow as percentage of GDP over the past

[75] Türkkan Gedikkaya,op.cit.

10 years.[76] But on the other hand investment funds has been much faster (20% more fast). As a result of this traditional banking has lost ground. Within an individual banking group this has meant that a larger share of the activity conducted outside the deposit bank. Also the profits of the non-bank subsidiaries have became more outstanding.

TABLE 10.

Unconsolidated assets of investment funds, insurance companies and pension and credit institutions as a percentage of GDP end 1997

	Investment funds	Insurance company.	Credit institutions
BE	32,4	30,9	294,1
DE	24,7	36,9	255,8
ES	34,9	21,7	183,2
FR	35,0	45,0	244,6
IE	69,8	26,3	299,0
IT	18,9	19,4	155,4
LU	2.770,9	44,8	3.695,9
NL	19,0	146,0	227,0
AT	22,5	26,4	238,3
PT	26,0	31,0	220,0
FI	3,0	42,4	113,3
Euro area weight. Avg.	**31,3**	**41,2**	**234,4**

SOURCE: ECB, 1998

Disintermediation refers to decreasing share of banks in the allocations of funds from savers and investors to borrowers. In practice it means that instead of borrowing funds from a bank, firm raise funds directly from the capital market

3.2 EFFECTS OF EMU ON THE EUROPEAN UNION BANKING SYSTEM

The participation of eleven countries in EMU reinforces the significance of the Euro for the whole European Banking Sector. Inside the European Monetary system exchange rate fluctuations were very limited. No national central bank had to effect a increase in short-term

[76] Landau Folkerts, The EMS in the Context of the Integration of European Financial Markets, IMF Occasional Paper no:66

interest rates to defend the parity of its national currency. Another important development is the shift on the assets side from the public to the more risky private debtors, which resulted from decrease in public debt due to the Stability and Growth Pact. The majority of EU government reduced direct borrowing from banks. The exchange in relative importance of banks' direct lending to the government sector from 1995 to 1997 decreased in most EU countries. (See next page table)

Banks' domestic claims on different sectors in term of total domestic assets lead to similar conclusions. [76] During 1997 governments' retreat from borrowing from banks became more outstanding. In 1997 an increase in lending to other categories was also noted. Interbank claims, claims to non-financial companies (BE, IE, ES) in household claims (BE, ES, IT, NL, SF).

TABLE 11.

	Banks' domestic interbank claims						
	1992	1995	1996	1997	%change 92-97	%change 95-96	%change 96-97
SE	25,16	30,44	30,74	29,83	18,57	0,99	-2,95
FI	24,93	24,67	24,67	26,32	5,59	4,31	2,28
ES	20,58	22,26	22,26			3,22	
IT	23,67	20,87	20,87	21,11	-10,81	-2,18	3,38
NL	24,53	18,39	18,39	20,14	-17,88	9,23	0,29
DK	7,61	15,87	15,87	17,58	130,99	1,83	8,77
FR	6,35	9,97	9,97	17,3	172,65	42,2	22,09
DE	14,25	12,97	12,97	15,57	9,27	9,36	9,81
BE		13,06	13,06	13,7		0,67	4,19
IE	13,8	13,37	13,37			-7,23	
UK	9,01	14,82	14,82	12,46	38,32	-11,99	-4,51
LU	8,35	9,76	9,76	11	31,67	27,08	-11,38
	6,65	5,87	5,87	5,05	-24,12	-8,32	-6,23

SOURCE:ECB, 1998

Banks' domestic interbank claims and claims on non financial corporations(as apercentage of banks' total domestic asets

	Banks' domestic claims on non-finacial corporations						
	1992	1995	1996	1997	%change 92-97	%change 95-96	%change 96-97
SE	52,06	42,21	4,26	42,3	-18,76	4,87	-4,44
FI	37,73	30,97					
ES	25,67	21,03	21,15	22,17	-13,66	0,56	4,83
IT	21,13	23,33	21,59	21,49	1,72	-7,47	-0,44
NL	24,73	23,46	22,88	20,78	-15,97	-2,47	-9,16
DK	27,01	18,82	17,44	16,98	-37,14	-7,33	-2,64
FR	22,41	19,31	17,59	16,26	-27,44	-8,92	-7,52
DE	19,88	16,74	16,41	15,85	-20,27	-1,95	-3,42
BE	13,39	11,8	11,25	11,45	-14,5	-4,62	1,75
IE		9,35	8,68	9,93		-7,23	14,49
UK	13,13	10,15	10,23	8,62	-34,38	0,8	-15,79
LU		1,35	1,39			2,51	

TABLE 12.

	Change in relative importance of foreign currenct,government and non resident deposits										
	1995			Non-Res.	1997			Non-Res.	Change in relative imp. 95-97.		
	Totaldep.	FX Dep.	Gov. De	Deposits	Totaldep.	FX Dep.	Gov.dep	Deposits	FX	GOV.	NON-RES
U	1417,59	1310,35	19,73	1048,53	1389,32	1282,93	24,28	963,39	-0,1	25,57	-6,25
K	215,8	112,1	2,79	114,06	222,5	115,73	2,93	126,71	0,13	1,86	7,75
K	148		2	8	154		2	11		-3,9	32,14
:	93,07	27,19	0,6	24,65	122,11	49,3	0,62	40,95	38,2	-21,24	26,62
T	113	5	5	23	116	5	5	23	-2,59	-2,59	-2,59
E	98,47	20,02	2,41	23,07	110,93	25,93	1,22	28,45	14,99	-55,23	9,48
E	98,52		8,08	25,96	101,09		7,72	34,02		-6,88	27,72
T	100,51	6,45		10,88	98,71	6,32	2,77	11,94	-0,26		11,7
L	90	5,9	2,1	38,7	93	6,3	2	47,6	3,34	-7,83	19,3
R	69,36	18,8	1,72		76,33	25,97	2,05		22,14	8,3	
S	79,09	7,12	4,71	6,71	73,86	7,78	4,18	6,86	17,01	-4,97	9,47
R	62,7	3,8		3,7	67,3	4,3		4,1	5,42		3,24
E	46,76	6,33	0	26,13	52,93	10,37		32,01	44,73		8,25
	56,04	2,7	0,14		49,11	1,99	0,03		-16,06	-76,25	
	37,8	1,4	1,5	0,6	38,03	1,5	1,5	0,8	5,74	-1,31	31,59

Source: Eurostat, National Data,1998

Another recent development is the wave of mergers and acquisitions in the EU banking system. This is of course affecting other parts of the world and other industries. [77]

Mergers and acquisitions outside the EU may have various effects on the EU banking system. Firstly, U.S. banks are already starting to set up separate banks in Europe. This can increase competitive pressure in the EU. Morely mergers between U.S. investment banks might increase competitive pressures in EU. Secondly the Euro area might be seen as a major area of business growth for non-EU banks and companies. In this respect worldwide companies that doing job with European companies might tend to rely on one correspondent bank in the Euro area. This may cause increasing price competition and decreasing rate of profitability.

[76] World Economic And Financial Surveys, op.cit.,pp128-130

[77] Ibid.

Shortly after examining the mergers and acquisition it would be useful to analyze effect of EMU on the profitability, structure, activities, banking risks, strategies of the European Banking system respectively.

3.2.1 BANKING PROFITABILITY

According to the study of the OECD Bank Profitability Statistics from 1979 to 1994 can be summarized as follows:

- A decline in profitability
- A reduction in operating expenses and staff costs
- A decreasing of net interest margins and a rise in non interest income

According to the below table it would be correct to say that a reversal in the downward trend in profitability has taken place in the EU since 1994. Average return of equity has increased from an 8,1% to 11,1% in 1996, also average return on assets rose during the same period (from 0,42% to 0,54%). [78] These good performance figures are due to favorable economic conditions such as increase in non-interest income and relative reduction in net provisions.
Cost income ratio is increasing at a slow pace on aggregate but in different member states there are different speeds.[79] Additional costs have been changed due to the year 2000 problem. Strategies too much changed. Meaning moving from staff quantity to staff quality.

78

The Economists, op.cit.,pp11

TABLE 13.

Selected bank profitability ratios

Return on equity(Net income as a percentage of equity)

	1990	1991	1992	1993	1994	1995	1996	1997
AT	%8,6	%8,6	%6,9	%8,7	%7,9	%8,1	%9,6	
BE	%8,3	%6,5	%5,7	%14,1	%13,2	%12,9	%15,3	%15,3
DK	-%3,3	-%0,1	-%21,0	%10,6	%0,1	%18,5	%16,1	%15,1
FI	%5,6	-%11,0	-%48,9	-%28,4	-%25,2	-%7,9	%8,0	%15,2
FR	%10,1	%10,4	%6,9	%2,9	%0,5	%3,6	%4,8	%7,7
DE	%11,9	%14,4	%13,2	%13,6	%11,8	%12,6	%12,3	
GR	%20,8	%31,5	%23,1	%21,6	%25,9	%24,4	%16,7	
IE						%20,2	%20,1	%18,4
IT	%12,2	%9,9	%7,5	%8,8	%3,0	%3,7	%5,1	%3,4
LU	%6,7	%7,6	%8,8	%19,9	%20,9	%19,9	%22,3	%23,0
NL	%12,3	%12,7	%13,9	%15,9	%16,2	%17,0	%17,6	
PT	%12,5	%12,4	%8,8	%9,2	%7,3	%7,7	%10,7	%13,1
ES	%13,6	%12,5	%10,7	%3,8	%8,2	%9,2	%9,7	%10,6
SE	%3,0	%56,3	%17,0	%5,7	%19,1	%21,1	%24,0	%13,0
UK	%14,4	%8,6	%7,3	%19,3	%27,4	%28,6	%25,6	%26,4
Avg. EU-14	**%10,9**	**%11,5**	**%8,1**	**%9,0**	**%8,2**	**%10,0**	**%11,0**	
Avg. EU-15						**%10,1**	**%11,1**	
Avg. EU-11							**%12,2**	**%12,2**
USA	%11,4	%9,0	%15,8	%19,1	%19,8	%19,3	%19,6	%22,0
JAPAN	%11,3	%9,5	%7,4	%5,0	%3,1	-%5,0	%0,2	
SWITZ.	%7,8	%8,2	%7,6	%10,3	%7,5	%8,4	%1,7	

Return on assets(Net income as a percentage of equity)

	1990	1991	1992	1993	1994	1995	1996	1997
AT	%0,4	%0,4	%0,3	%0,4	%0,4	%0,4	%0,4	
BE	%0,3	%0,2	%0,2	%0,3	%0,3	%0,3	%0,4	%0,4
DK	-%0,3	%0,0	-%1,2	%0,0	%0,0	%1,3	%1,1	%1,0
FI	%0,4	-%0,8	-%2,7	-%1,3	-%1,3	-%0,4	%0,4	%0,8
FR	%0,3	%0,4	%0,3	%0,0	%0,0	%0,2	%0,2	%0,3
DE	%0,5	%0,6	%0,5	%0,5	%0,5	%0,5	%0,5	
GR	%0,8	%1,5	%1,1	%1,3	%1,3	%1,1	%0,7	
IE						%1,4	%1,3	%1,0
IT	%0,9	%0,8	%0,6	%0,3	%0,3	%0,3	%0,5	%0,3
LU	%0,2	%0,3	%0,3	%0,5	%0,5	%0,5	%0,5	%0,5
NL	%0,5	%0,5	%0,6	%0,7	%0,7	%0,7	%0,7	
PT	%1,4	%1,4	%1,0	%0,7	%0,7	%0,6	%0,7	%0,8
ES	%1,2	%1,3	%1,0	%0,8	%0,8	%0,8	%0,8	%0,9
SE	%0,2	%3,1	%0,8	%1,1	%1,1	%1,3	%1,3	%0,7
UK	%0,7	%0,4	%0,3	%1,1	%1,1	%1,1	%1,1	%1,1
Avg. EU-14	**%0,5**	**%0,6**	**%0,4**	**%0,4**	**%0,4**	**%0,5**	**%0,5**	
Avg. EU-15						**%0,5**	**%0,5**	
Avg. EU-11							**%0,7**	**%0,7**
USA	%0,7	%0,6	%1,2	%1,5	%1,5	%1,6	%1,6	%1,8
JAPAN	%0,4	%0,3	%0,3	%0,2	%0,1	-%0,2	%0,01	
SWITZ.	%0,5	%0,5	%0,5	%0,7	%0,5	%0,5	%0,1	

SOURCE:OECD, 1998

[79] European Commission Economic Policy in EMU Part A Rules and Adjustments, Economic Papers no:124

TABLE 14.

Cost- income ratio(As a percentage of total income)								
	1990	1991	1992	1993	1994	1995	1996	1997
AT	%64,9	%64,9	%64,0	%63,5	%65,1	%69,5	%69,1	
BE	%72,3	%70,1	%68,3	%67,9	%71,7	%67,6	%65,7	%63,9
DK	%68,6	%62,6	%81,4	%51,1	%72,5	%54,0	%56,9	%59,2
FI	%81,5	%123,2	%190,4	%136,4	%139,9	%112,2	%88,6	%73,4
FR	%72,4	%69,5	%66,8	%64,7	%71,3	%65,6	%69,9	%68,7
DE	%64,8	%65,2	%64,5	%62,4	%60,8	%63,8	%63,8	
GR	%64,1	%51,3	%61,0	%62,7	%59,5	%64,3	%68,1	%68,1
IE						%59,3	%57,6	%58,3
IT	%62,1	%64,9	%65,9	%61,2	%68,8	%68,2	%67,1	%69,0
LU	%37,3	%40,5	%39,4	%38,0	%44,8	%46,5	%46,5	%43,3
NL	%68,9	%67,5	%67,2	%66,6	%67,1	%67,3	%67,3	
PT	%41,6	%44,9	%53,5	%56,2	%61,8	%64,9	%64,3	%57,7
ES	%61,1	%58,5	%60,4	%59,7	%59,7	%63,2	%62,2	%61,4
SE	%79,2	%117,5	%122,2	%106,5	%80,0	%71,6	%64,3	%64,0
UK	%65,9	%65,7	%66,1	%63,2	%64,1	%63,8	%62,3	%60,9
Avg. Eu-14	%66,0	%67,4	%68,6	%64,6	%66,3	%65,5	%65,4	
Avg. Eu-15						%65,5	%65,3	
Avg. Eu-11							%63,9	%62,9
USA	%70,5	%69,0	%64,9	%64,1	%64,9	%63,7	%63,3	%60,8
JAPAN	%67,5	%68,9	%70,1	%74,8	%76,3	%66,5	%74,3	
SWITZER.	%59,6	%82,3	%52,1	%48,6	%55,6	%56,4	%66,1	

SOURCE:OECD,98

3.2.2 BANKING STRUCTURE

3.2.2.1 BANKING CAPACITY

It is directly linked to competitive structure of the sector. Indicators of capacity are as follows. Branches or staff per head of population. The effects of regulation and the traditional structures of national banking systems makes complicate the measurement of capacity overall. Because between country banks' functions and size distribution differs. Below some capacity figures are summarized.

TABLE 15.

	1985	1990	1995	1996	1997	%change 85-95	%change 95-96	%change 96-97
Number of credit inst.	12.256	11.957	9.896	9.589	9.285	-23,86	-3,17	-3,17
Branches per 1000 capita	0,52	0,51	0,49	0,48	0,48	-5,59	-0,69	-0,17
ATMs per 1000 capita	0,1	0,2	0,36	0,4	0,44	253,06	9,93	11,04
Bank employees per 1000 capita	8,36	9,94	9,6	9,49	9,73	14,83	-1,14	0,56

SOURCE:ECB,1997

A reduction in the number of credit institution between 1985-1997 exists.[79] With regard to o the number of branches per 1000 capita, a reduction can also be observed. It can be said that further development in technology might be the part of the reducing the number of branches. The number of ATM increased. As of end 1997 ES, AT, PT have the highest number of ATM per capita. Number of employees per 1000 capita has also declined with only one exception being the U.K. The decline has been particularly strong in Finland Ten employees per r1000 inhabitant in1990 and 5,2 in 1997.

In conclusion there's overall capacity reduction because there's increase of competition between institutions.

3.2.2.2 DISINTERMEDIATION

Disintermediation means movement of services (borrowing and savings) away from the banking sector towards other financial or non-financial institutions. There are two perspective: Institutional and instrument perspective. The former deals with different financial intermediaries, the other one deals with different financial instruments. [80]

From an institutional perspective banking intermediation in the EU has been growing.

TABLE 16.

ssets of credit institutions as a percentage of GDP

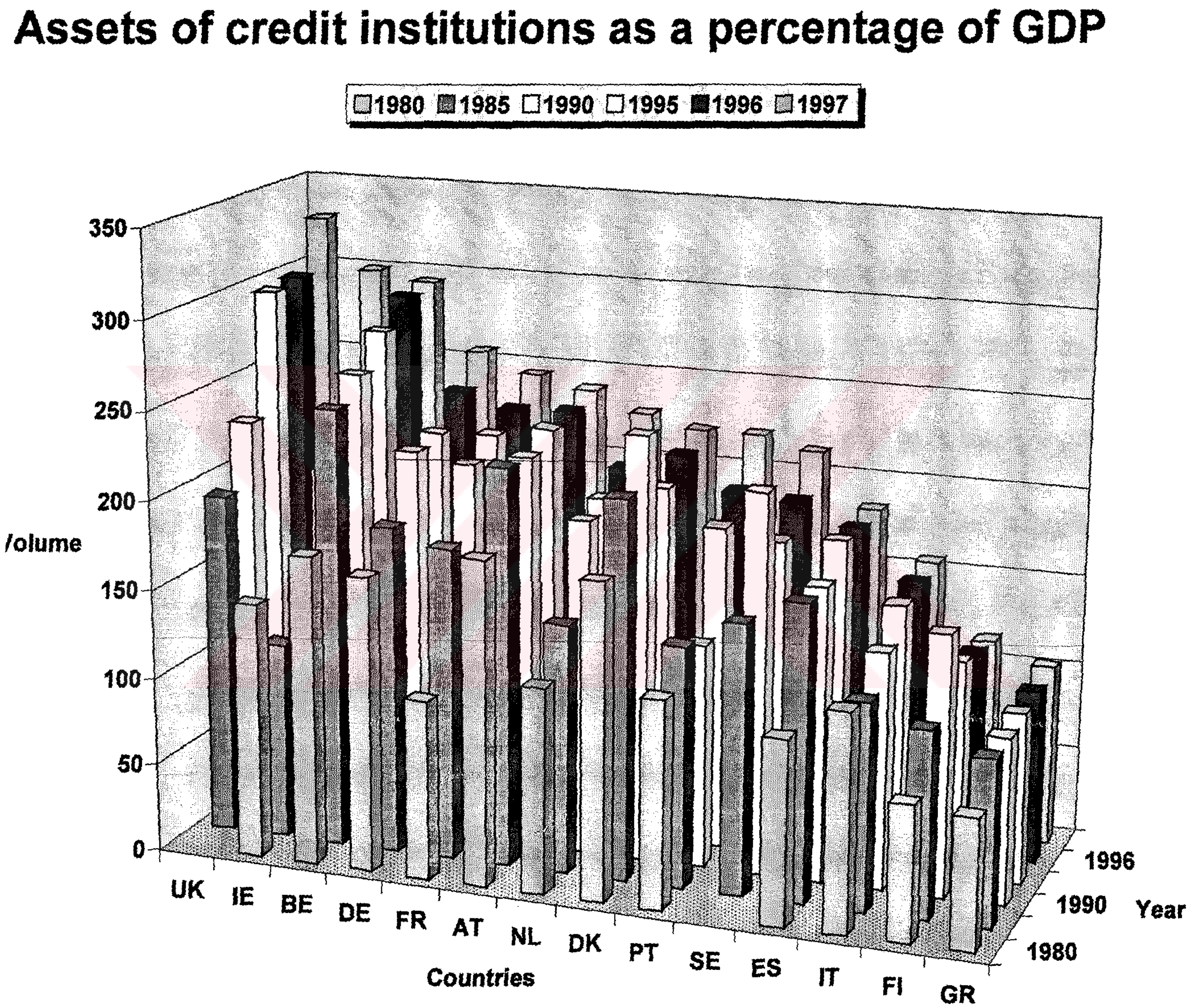
	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
K		193,58	227,88	296,4	298,6	327,6	53,11	0,74	9,71
E	144,59	111,85	145,16	195,45	223,02	299,05	74,74	14,11	34,09
E	174,8	248,35	260,8	278,65	291,98	294,17	12,2	4,78	0,75
E	166,74	185,47	220,24	222,95	239,51	255,82	20,21	7,43	6,81
R	101	177	216	224	231	244,6	26,55	3,13	5,89
T	182,98	224,77	222,8	230,59	233,36	238,38	2,59	1,2	2,15
L	116	141	190	194	203	227	37,59	4,64	11,82
K	178	214	240	203	213	220	-5,14	4,93	329
T	117	136	127	184	196	220	35,29	6,52	12,24
E		152	215	179	193	213	17,76	7,82	10,36
S	103,77	167,08	166,2	182,75	181,2	183,23	9,38	-0,85	1,12
	122,4	116,6	133,3	150	153,5	155,4	28,64	2,33	1,24
I	76,08	105	147,37	122,26	116,17	113,35	16,43	-4,98	-2,43
R	72,82	93,14	93,62	96,26	98,09	102,03	3,35	1,9	4,02
U	2670,82	3368,07	3609,35	3604,39	3665,28	3695,99	7,02	1,69	0,84
U weight. verage		177,24	206,86	221,6	230,01	244,23	25,03	3,8	6,18

Source: Eurostat, National Data, 1999

[79] Oliver Bandt, op.cit.,pp11

[80] AB Danismanlik ve Yatirim A.S., Economic and Monetary Union,Expectations andPossible Effects, 1998, pp3-19

GRAPH 1.



Assets of credit institutions as a percentage of GDP
1980
1985
1990
1995
1996
1997
350
300
250
200
150
100
50
0
/olume
UK
IE
BE
DE
FR
AT
NL
DK
PT
SE
ES
IT
FI
GR
Countries
1996
1990
1980
Year

In some countries (FI, PT and SE) Interbank landing has increased its share in the total assets.

TABLE 17.

sets of credit institutions net of interbank lending as a percentage of GDP

	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
				257,79	254,97	279,21		-1,09	9,51
	83,63	87,92	98,69	134,75	153,29	201,64	53,26	13,76	31,54
	85	107	147	161	174	196	50,47	8,07	12,64
	121,13	153,71	168,26	184,74	191,41	192,34	20,19	3,61	0,49
		142,65	195,82	164,34	172,43	184,91	15,2	4,93	7,23
	119,51	138,67	154,32	161,96	166,72	173,06	16,8	2,94	3,8
		123	148	157	173	173	27,64	10,19	0
		133,69	143,86	153,14	162	170,24	14,55	5,79	5,09
	91,15	140,41	140,73	152,28	150,77	150,58	8,45	-0,99	-0,13
	111,1	117	103	126	135	145	7,69	7,14	7,41
	107	103,5	119,2	130,9	131,2	133,2	56,47	0,23	1,52
				92,4	94,07			1,81	
	60,73	79,33	106,75	82,58	93,2	8,19	4,1	12,86	-8,6
	1254,52	1544,95	1430,55	1503,32	1693,94	1684,29	-2,69	12,68	-0,57

Source: ECB, 1998

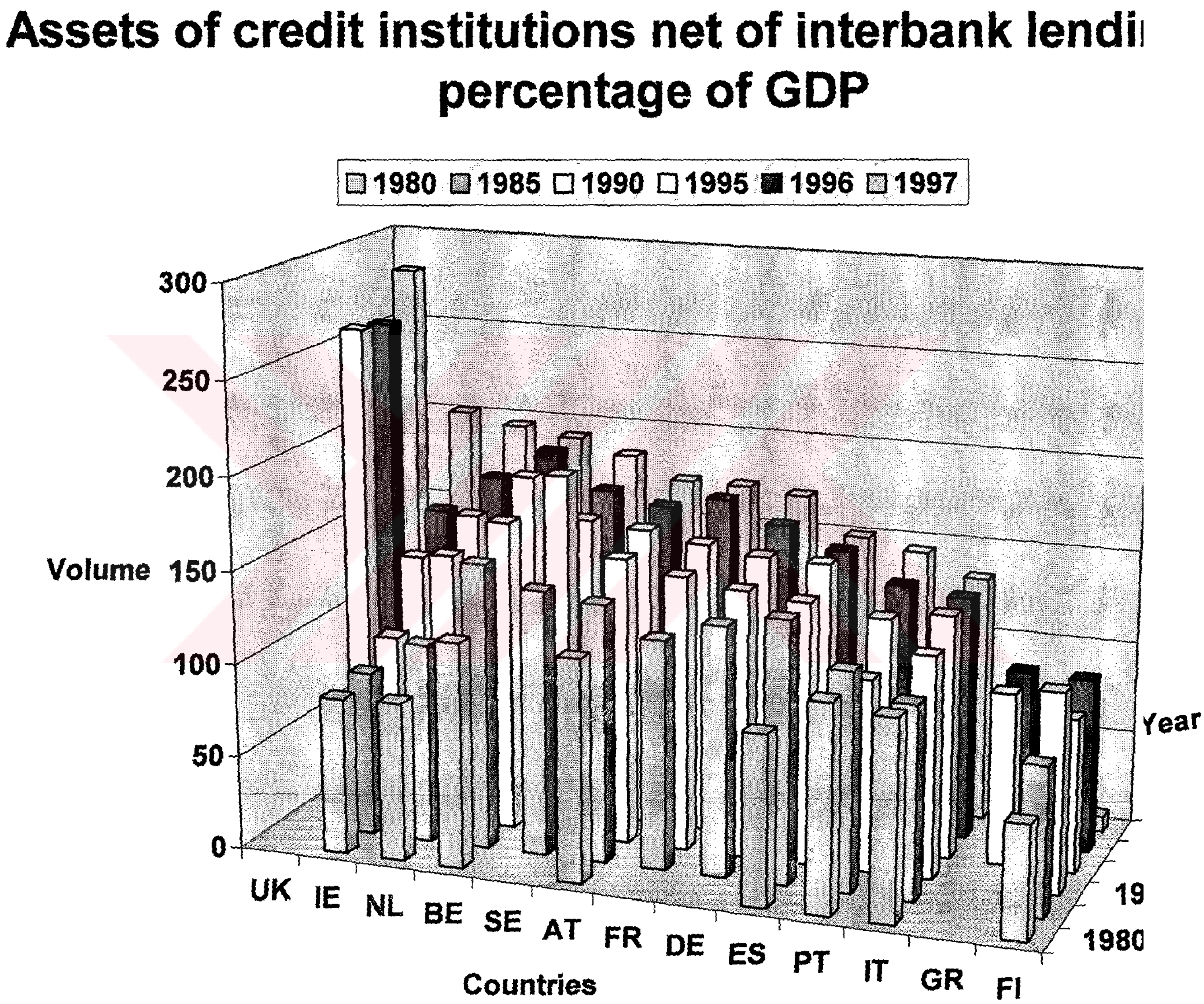
TABLE 18.

relative importance of financial intermediaries: Assets of credit institu tions,investment funds' irance companies' and pension funds' assets under management(as a percentage of GDP)

	1997 Absolute value as a % GDP			1997 Absolute value as a % GDP			% change in relative importance 1995-1997		
	ind funds	ins& pens	cred inst	ind funds	ins& pens	cred inst	ind funds	ins& pens	cred inst
			327,6	16,09		296,4			
	69,85		299,05	36,78	26,29	195,45			
	32,44	30,97	294,17	23,63	26,15	278,65			
	24,72	36,99	255,82	13,33	32,28	222,95	29,62	-2,02	-1,86
		45	244,6	33	40	224			
	22,55	26,49	238,38	14,26	23,2	230,59	47,37	6,47	-3,58
	19	146	227	16	124	194	1,25	0,3	-0,29
	8	69	220	5	66	203	47,8	-3,57	-0,03
	26	31	220	17	23	184	23,72	8,96	-3,31
	20,82	104	213	11	86	179	53,39	-1,19	-2,79
	34,93	21,71	183,23	17,95	17,8	182,75	77,13	11,04	-8,67
	18,9	19,4	155,4	7,2	17,4	150	136,89	0,5	-6,61
	3,05	42,46	113,35	0,95	38,42	122,26	225,42	12,45	-5,67
	22,92		102,03	9,68	12,48	96,26			
	2770,98		3695,99	2071,82	44,82	3604,39			

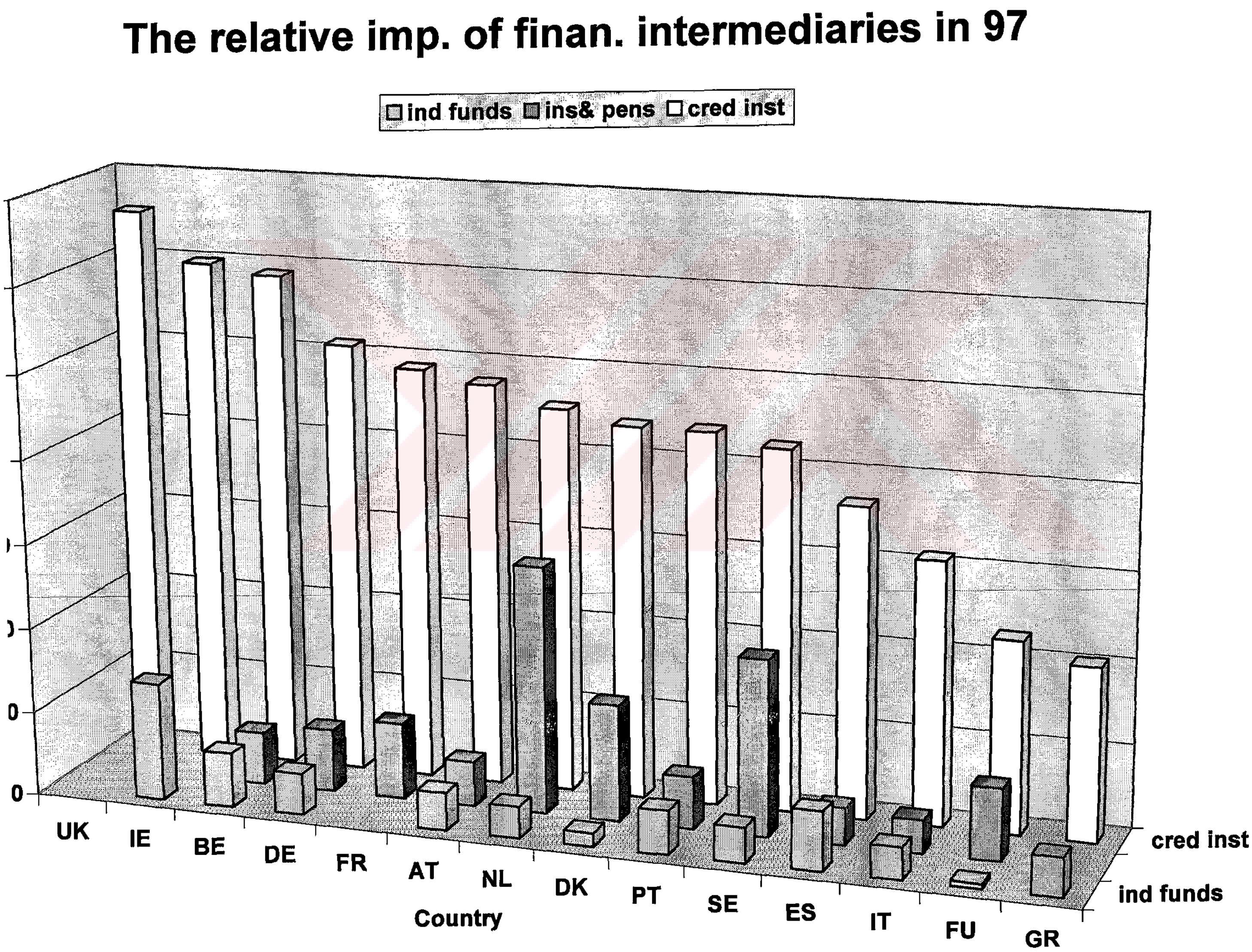
Source: ECB, 1998

GRAPH 2.


Assets of credit institutions net of interbank lendi
percentage of GDP
1980
1985
1990
1995
1996
1997
300
250
200
Volume
150
100
50
0
UK
IE
NL
BE
SE
AT
FR
DE
ES
PT
IT
GR
FI
Countries
Year
19
1980

Between period 1995/1997indicates that the relative importance of credit institutions decreased in all member states.

GRAPH 3.



Among the institutional investors, investment funds recorded the highest rate of growth. Investment funds' assets under management as a percentage of GDP show differences within member states. The highest in LU and the lowest in FI in 1997.

The annual growth rate of pension funds' assets was lower than that of investment funds. The highest rate of growth observed in AT, PT, ES and PE. This improvement may lead to a more rise in life insurance and pension funds' assets in the coming years. [81]

TABLE19.(ECB,1998)

vestment funds' assets under management as a percentage of GDP

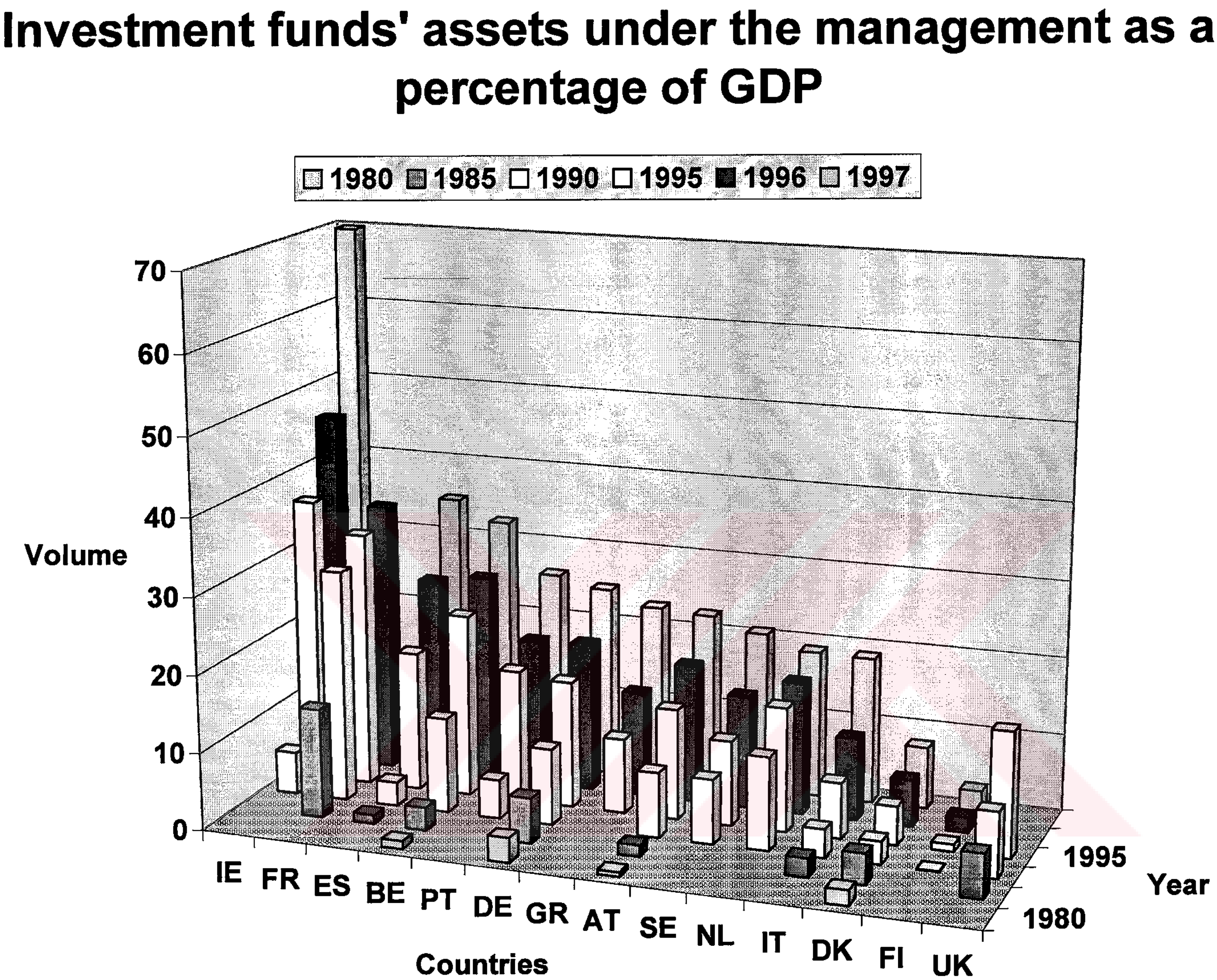
	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
			5,45	36,78	46,24	69,85		25,72	51,06
		14	30	33	35		135,71	6,06	
		1,13	3,07	17,95	25,73	34,93		43,34	35,76
	1	2,95	12,23	23,63	26,74	32,44	702,23	13,16	21,33
			5	17	19	26		11,76	36,84
	3,2	5,82	9,85	16,33	19,32	24,72	180,58	18,31	27,95
				9,68	13,49	22,92		39,36	69,9
	0,6	1,48	8,43	14,26	17,82	22,52	863,66	25,01	26,5
			8,32	11	14,52	20,82		32	43,39
			12	16	17	19		6,25	11,76
		2,5	3,7	7,2	10,6	18,9	188	47,22	78,3
	2	4	3	5	6	8	25	20	33,33
			0,06	0,95	2,04	3,05		114,74	49,51
		5,7	8,44	16,09			182,28		
	80,79	279,19	842,92	2071,82	2369,5	2770,98	642,08	14,37	16,94
average				21,79					

nsion funds' assets under management as a percentage of GDP

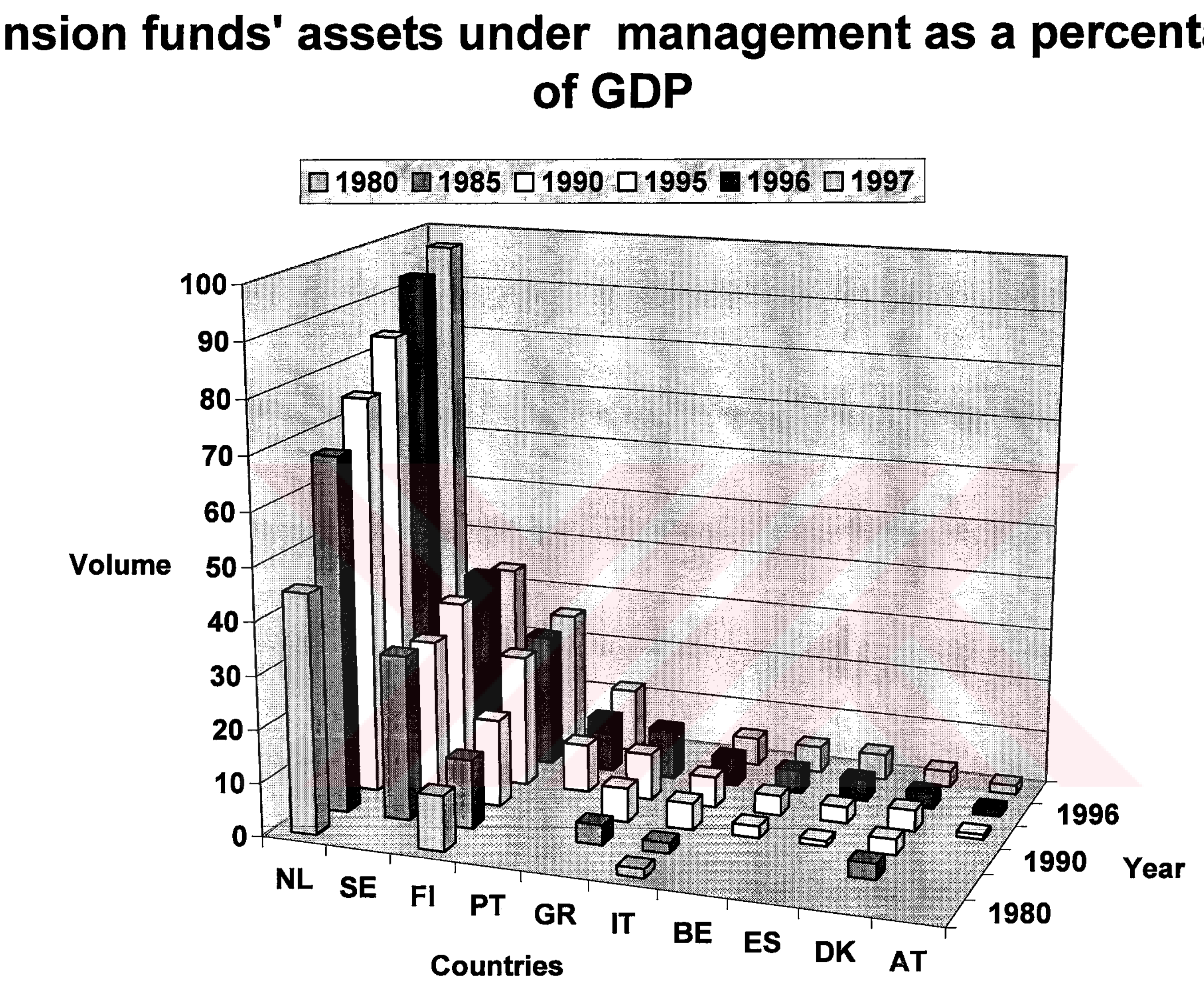
	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
	45	67	75	84	93	97	25,37	10,71	4,3
		31	30	34	36	34	9,68	5,88	-5,56
	10,5	12,86	16,41	24,73	25	25,87	92,25	3,52	-1,03
				9	10	12		11,11	20
		3,71	6,4	8,71	9,33		134,77	7,12	
	1,71	1,97	5,1	5,8	5,3	5,2		-8,62	-1,89
			2,28	3,74	4,28	4,88	89,51	14,43	14,17
			1,07	3,15	3,96	4,82		25,71	21,72
		3	3	4	3	3	33,33	-25	0
				0,97	1,23	1,73		26,85	40,8

[81] Key Indicators,op.cit.

GRAPH 4.


Investment funds' assets under the management as a percentage of GDP
1980
1985
1990
1995
1996
1997
70
60
50
40
30
20
10
0
Volume
IE
FR
ES
BE
PT
DE
GR
AT
SE
NL
IT
DK
FI
UK
Countries
1995
1980
Year

GRAPH 5.


nsion funds' assets under management as a percentage of GDP
1980 1985 1990 1995 1996 1997
100
90
80
70
60
50
40
30
20
10
0
Volume
NL
SE
FI
PT
GR
IT
BE
ES
DK
AT
Countries
1996
1990
1980
Year

By the establishment of EMU, the process of Disintermediation from an institutional perspective will probably speed up. In addition to that the Euro area will attract non-EU financial institutions so increasing competitive pressures from outside the EU.
From the instrument perspective, bank deposits and loans to non-bank grew at a lower rate than many of the other financial instrument. Commercial paper seems to have future potential. IE has the highest share of commercial paper in terms of GDP (5,7%) followed by BE and PT. [82]

In general terms EMU is expected to have widening, deepening and liquidity increasing effects on financial markets. This probably will encourage the growth of stock exchanges and the insurance of commercial paper.[83] Government or financial institutions' paper has tended to dominate the bond markets in Europe. The development of credit derivatives is expected to reduce the entrance barriers for new comers due to the higher tradability and transparency of credit risks.

TABLE 20.

Commercial paper outstanding as a percentage of GDP

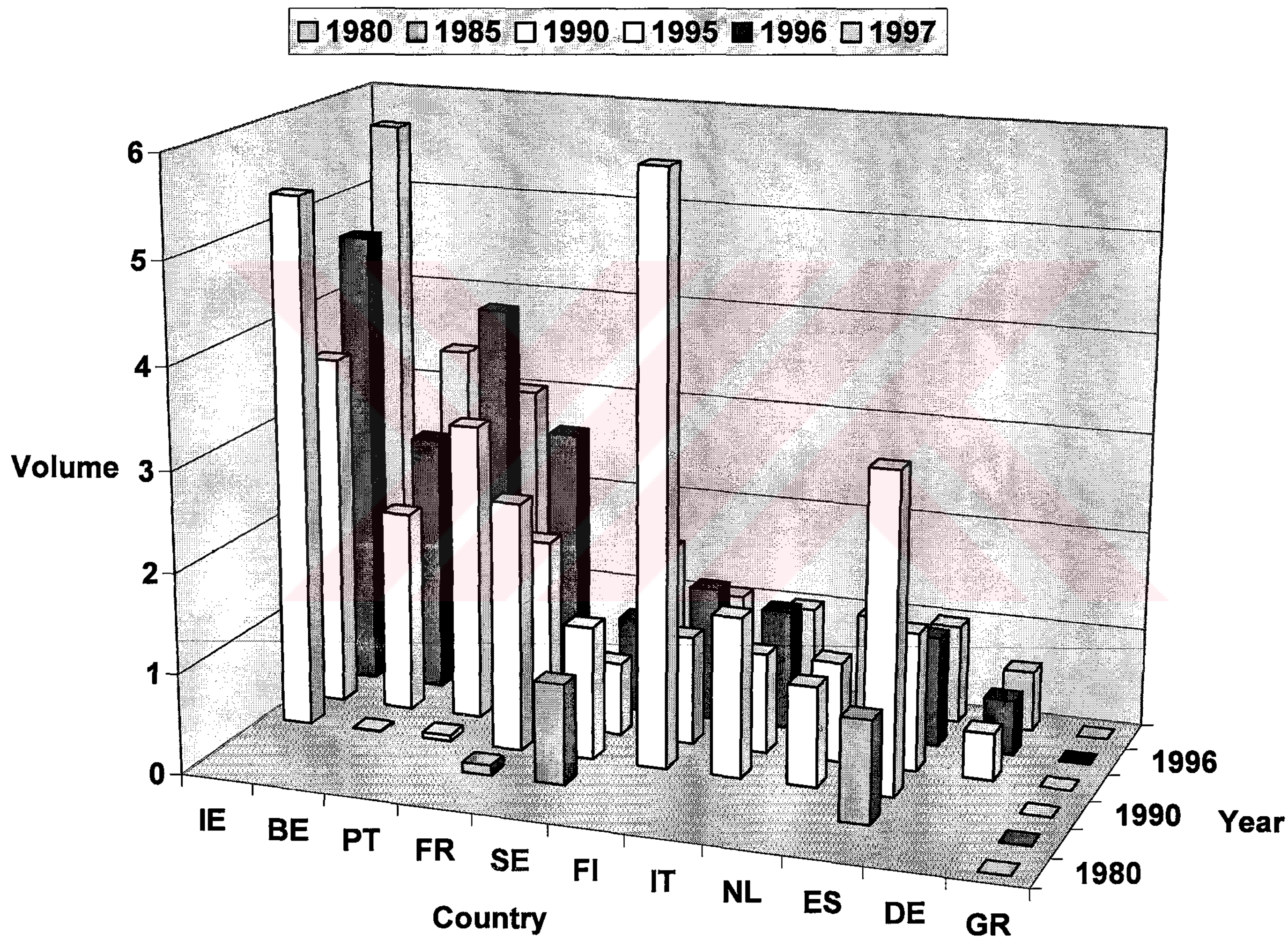
	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
IE			5,34	3,55	4,64	5,65		30,7	21,77
BE			0,01	2,04	2,61	3,36		28,06	28,77
PT			0,06	3	4	3		33,33	-25
FR		0,1	2,5	1,9	2,8		1800	47,37	
SE		1	1,33	0,73	0,95	1,5	-27	30,14	57,89
FI			5,86	1,08	1,35	1,06		25	-21,48
IT			1,6	1	1,2	1		20	-16,67
NL			1	1	0	1		-100	
ES		1,02	3,19	1,38	1,1	0,99	35,29	-20,29	-10
DE				0,47	0,55	0,6		17,02	9,09
GR	0	0	0	0	0	0			

Source: ECB ,1998

[82] European Banking Federation .op.cit
[83] Marcel Cassard, ERM Money Supplies and the Transition to EMU, IMF WP/94/1

GRAPH 6.

Commercial paper outstanding as a percentage of GDP



3.2.3 BANKING ACTIVITIES

A number of EU banks of different sizes were interviewed in mid 1997 in order to investigate the effects of the EMU on various banking activities. Majority of banks was of the opinion that their overall profitability would be negatively affected after the introduction of the Euro but the size of the loss was relatively small. There's a reduction in foreign exchange activities. This is considered as a negative effect of the introduction of the Euro. Another factor, which reduced the foreign exchange activities, is Asian financial crisis and Russian crisis. Foreign currency markets have already anticipated possible effects of EMU. [82]Competition in the foreign currency market is likely to increase. May be banks will try to increase their money and securities market activities to lower revenues from foreign exchange trading activities. [83]
In money market activities the competition tends to be increase. [84]The Euro will bring to an end the arbitrage between the different national money markets. The clearance of advantage in domestic interest rate is likely to have a negative effect on the profitability of banks. The concentration of market values on a few markets and within them on a few large banks is assumed. This tendency could also increase the trend towards concentration and the pressure for banks.

The composition in credit institutions' no-bank deposits in not uniform across member states.

TABLE 21.

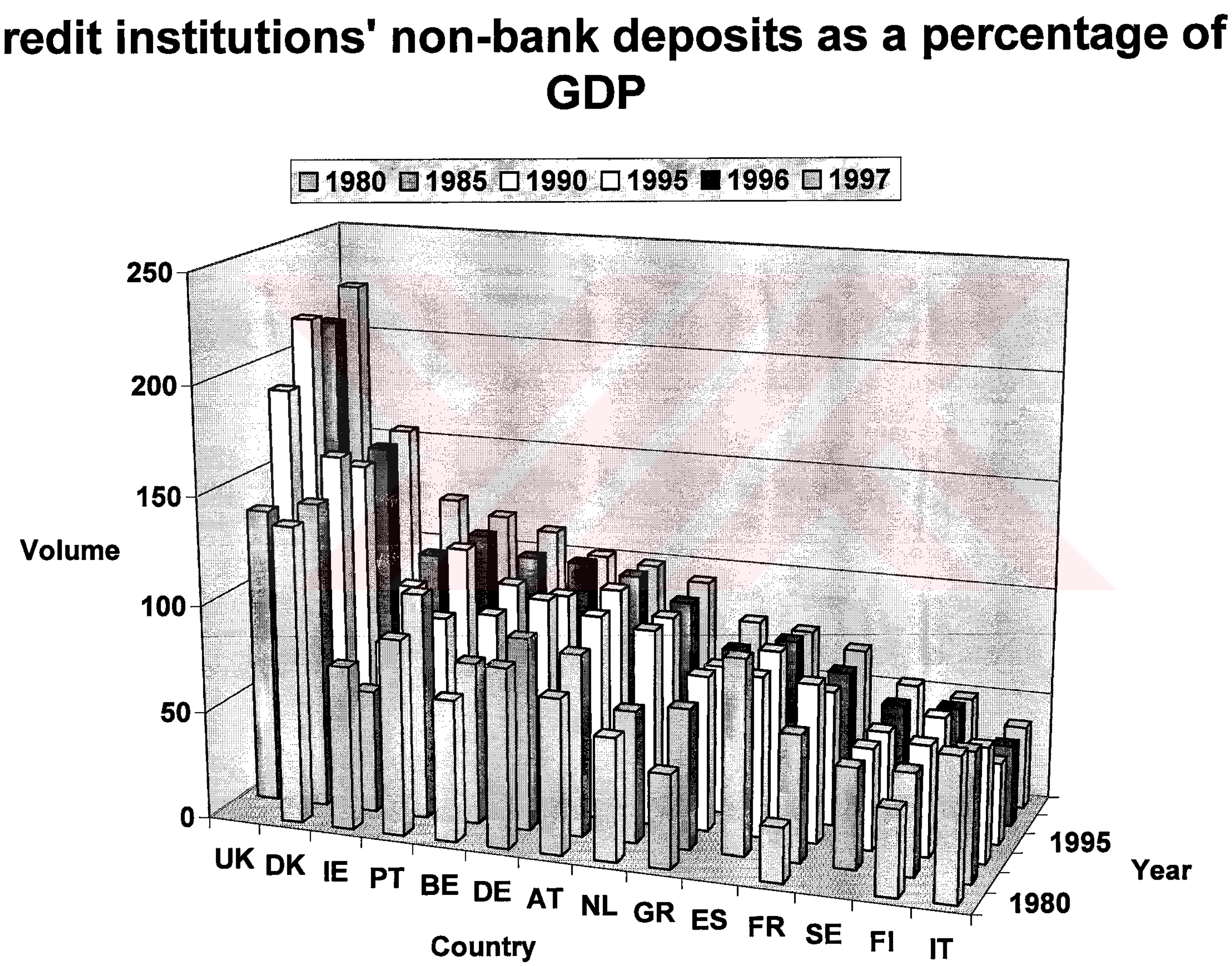
Credit institutions' non-bank deposits as a percentage of GDP

	1980	1985	1990	1995	1996	1997	% change 1985-1995	% change 1995-1996	% change 1996-1997
UK		136,79	187,35	215,8	209,8	222,5	57,76	-2,78	6,05
DK	138	142	158	148	151	154	4,23	2,03	1,99
IE	75,83	56,77	72,63	93,07	101,33	122,11	63,94	8,88	20,51
PT	91	105	87	113	113	116	7,62	0	2,65
BE	65,65	75,3	90,93	98,47	104,61	110,93	30,77	6,23	6,05
DE	83,33	89,42	100,47	95,52	104,07	101,09	10,18	5,63	-2,86
AT	72,03	84,66	95,16	100,51	100,19	98,71	18,73	-0,32	-1,48
NL	57	61	91	90	90	93	47,54	0	3,33
GR	43,4	64,94	72,22	69,36	69,75	76,33	6,81	0,56	9,43
ES		90,52	74,53	79,09	76,25	73,86	-12,63	-3,59	-3,13
FR	25,4	58,8	73,7	62,7	64	67,3	6,63	2,07	5,16
SE		46,77	47,24	46,76	50,99	52,93	-0,02	9,04	3,81
FI	39,8	47,38	51,46	56,04	52,14	49,11	18,27	-6,96	-5,81
IT	66,2	59,7	53,3	37,8	37,4	38,3	-36,68	-1,06	2,41
LU	497,03	775,34	1451,09	1417,59	1442,55	1389,32	82,83	1,76	-3,69

Source: ECB, 1998

[82] Luca Antonia Ricci, Adjustment and Exchange Rate Variability IMF WP/98/50
[83] European Commission , Key Figures,op.cit.
[84] Project Finance Jan 99, pp25-27

GRAPH 7.


redit institutions' non-bank deposits as a percentage of GDP
1980
1985
1990
1995
1996
1997
250
200
150
100
50
0
Volume
UK
DK
IE
PT
BE
DE
AT
NL
GR
ES
FR
SE
FI
IT
Country
1995
1980
Year

The reduction in government debt securities owing to fiscal consolidation under EMU is expected to faster markets for securities issued by private entities. [85]This is also supported by the liquidity of the private equity and bond markets resulting from the increase in the number of investors. It is also likely that a larger currency area will attract new investors and issuers to the European securities markets. In this context, the efforts undertaken to set up alliances between the stock exchanges should be mentioned. These will allow the participants to share the costs in the developments of a pan European trading system and enable them to introduce the latest technological innovations. In principle it is expected that trading will be localized on those markets in which the organization of trading is more efficient, the cost of transactions are lower and the security and reliability of trading and settlement are higher.

In this regard EMU is not regarded as a negative player.Instead remote banking and electric monet that cause the changing forms of saving away from ordinary bank deposits can be seen as the most important driving force.

The trend in credit institutions' loans to non bank varies across countries. It shows a decline from 1995 to 1997 in most of the EU countries.

At this point the possible impact the possible impact of EMU differs for whosale and retail lending.The positive macroeconomic figures show that wholesale lending will improve. As to retail lending EMU could effect this by reduction in interest rates on interest margins.Banks' profit from money transmission and banking services are seemed to be affected negatively. Large firms are expected to concentrate their treasury operations with the euro area and decrese their banking relations. Multinational corporations might also tend to minimise the number of their accounts within the euro area.

3.2.4 BANKING RISKS

By risks it's meant that credit,market liquidity, settlement, operational and legal risk.When investigating the effects of EMU on banking risks, distinction betwwen activiites that are occured within th euro area, non- EU countries or between euro should be well defined In addition to that risks may also differ regionally. In the overall credit risks, market risk are expected to decrease on the other hand legal and operational risks are likely to increse in the short term. By the help of the positive macroeconomic effects of EMU, credit risk is expected to decrease the within the euro area. On the other side some points contribute to negative affects. EMU losers among individual banks' debtors could increse credit risks.Credit

[85] P. Masson EMU and International Monetary System IMF Working papers 1997

derivatives are likely to have apositive influence on the management of the credit risks. On the other hand a number of factors are identified which could operate in the reverse direction. Firstly, the concentration of likley EMU losers among individual banks' debtors could possibly increse the credit risks.Secondly small and medium sized enterprises face th erisk of year 2000. Third banks can shift their business to area which seem to be more profitable but more higher risks. Lastly like Asian and Russian crisis credit risk can be affected by a variety of unexpected events. Market risks within EMU is expected to be decrease. It seem that banks will refresh their non Euro area market to replace their lost foreign exchange market by new or increased involvement in non Euro area markets', where interest rate, foreign exchange and price risks are significantly higher and where increased country risks might occur.

The liquidity risk of market is expected to decrease due to deeper and more liquid markets. The establishment of TARGET system is expected to reduce settlement risks and risk associated with payments in the Euro area. Probably market liquidity may focus on certain market places, which will give rise to emergence of deep market products. This will may crowd out some regional products.

3.2.5 BANKING STRATEGIES

As noted earlier EMU will bring more intense competition and pressure on banks' profitability. In this context new financial products will be crested by banks. With regard to this situation two or three banking system might develop in EU: National, EU regional and large EU-wide. One major advantage of the EMU for the banking system is that it enables banks to unbundled and rebundles risks easily with compared to the domestic banking system.

Strategic responses by the EU banking system cover three main areas: improvements in services and procedures, changes in product ranges, mergers and cooperation agreements.

The first one may take various forms. Following better quality of services, staff. On the other hand well-trained staff of course will be costly. Banks aim to improve risk management and internal control systems. Another one is attempting to cut costs and improve efficiency.

The second one is broadening the range of products and services that are given to customers. For example shift from operating services to consulting reconsideration of product ranges, looking for alternative sources of income[84]

[84] Bikker, op.cit

In his respect the banks operating in universal banking system have not with drawn from any field of activity in view of EMU. [85]Universal banking facilities the possibility of cross subsidization, which due to increased competition, specialization, will also come under the pressure.. In short there's a increasing need for strategic partnership.

The third one consists of mergers, strategic alliances and Co-operation agreements. The reasons vary from cost and efficiency improvements, alternative distribution channels (ATM) and geographical expansion in particular the application of new technologies brings heavy investment expenditures. This can be made profitable only by a sufficient number of transactions. A larger size permits a more efficient organization of resources on the other side small firms less able to achieve a high degree of division of labor. Strategic responses of banks are more active in large size institutions than the medium sized to smaller institution. This may be explained by uncertainties basing from the level of customers' demand for Euro. In this respect the additional risk for banks which the transition to the Euro will be a slow during which they will be forced to offer services both in Euro and in national currencies. This point should be well examined in order to prevent from competitive disadvantages.

Coming to the internationalization there are two types: Inward and outward.

Inward internationalization in EU is relatively low. This is due to the still existing legal, institutional obstacles. The function of LU, IE, UK as international banking centers is confirmed by overall market shares of foreign branches more than 50% of total domestic assets. Foreign market shares grew in 1997 at a rate higher than 25% in BE, PT and SE and 10%, 20% in IE and FI. Overall the number as well as the market share of foreign branches vary within the EU. [85]

With respect to possible impact of EMU those countries that are already under a high degree of competition by non domestic financial institutions can be better prepared for competitive pressures which have not been under a large degree of international competition in their home market.

As to outward internationalization the total number of branches and subsidiaries has increased or remained stable in all countries. BE, DE, IE banks have a higher number of subsidiaries in other EEA countries Where as the opposite is true for AT, ES and PT. It is the result of

[85] Francesco Mongelli, The Effects of EMU on national Fiscal Sustainability Working Paper WP/96/72

[85] Key Indicators, op.cit.

diversification efforts in Eastern Europe and Latin American countries. Overall a noticeable increase in internationalization noted both in EEA and in third countries.

There's a point in Nordic countries'internationalisations where domestic banks enter each others' market. However the Nordic area is perceived as homogenous market with high cultural connections. So this might be a gaining strength for the international competition.

TABLE 22.

Outward internationalisation
Number of branches and subsidiaries of domestic institutions in foreign countries

Number of branches of domestic institutions in EEA and third countries

	EEA			Change		Third Countries			Change		total branches			Change	
	95	96	97	95/96	96/97	95	96	97	95/96	96/97	95	96	97	95/96	96/97
FR	70	76	0	8,57		125					195				
DE	75	79	82	5,33	3,8	81	83	83	2,47	0	156	162	165	3,85	1,85
IE	117	85	106	-27,4	24,71	3	4	4	33,33	0	120	89	110	-25,83	23,6
ES	83	67	69	-19,3	2,99	40	40	35	0	-13	123	107	104	-13,01	-2,8
IT	59	52	53	-11,9	1,92	52	49	49	-5,77	0	111	101	102	-9,01	0,99
BE	20	19	20	-5	5,26	16	24	26	50	8,33	36	43	46	19,44	6,98
PT	16	17	18	6,25	5,88	22	25	24	13,64	-4	38	42	42	10,53	0
SE	12	11	12	-8,33	9,09	10	12	13	20	8,33	22	23	25	4,55	8,7
DK	12	15	17	25	13,33	6	6	6	0	0	18	21	23	16,67	9,52
AT	7	9	10	28,57	11,11	9	12	12	33,33	0	16	1	22	31,25	4,76
FI	3	4	4	33,33	0	6	6	6	0	0	9	10	10	11,11	0
GR	4	5	5	25	0	4	4	4	0	0	8	9	9	12,5	0
LU	4	6	6	50	0	2	3	3	50	0	6	9	9	50	0

Source: ECB, 1997

Number of subsidiaries of domestic institutions in EEA and third countries

	EEA			Change		Third Countries			Change		total branches			Change	
	95	96	97	95/96	96/97	95	96	97	95/96	96/97	95	96	97	95/96	96/97
FR	163	0	0	0		117					280				
DE	76	76	79	0	3,95	41	49	52	19,51	6,12	117	125	131	6,84	4,8
IE	51	64	65	25,49	1,56	14	17	20	21,43	17,7	65	91	85	24,62	4,94
ES	11	11	10	0	-9,09	52	49	66	-5,77	34,7	63	60	76	-4,76	26,7
IT	6	6	7	0	16,67	33	36	52	9,09	44,4	39	42	59	7,69	40,5
BE	28	27	27	-3,57	0	26	28	29	7,69	3,57	54	55	56	1,85	1,82
PT	11	14	15	27,27	7,14	25	31	34	24	9,68	36	45	49	25	8,89
SE	22	22	23	0	4,55	14	14	15	0	7,14	36	36	38	0	5,56
DK	6	11	11	83,33	0	6	8	8	33,33	0	12	19	19	58,33	0
AT	4	4	4	0	0	2	3	4	50	33,3	6	7	8	16,67	14,3
FI	4	6	5	50	-16,7	2	2	2	0	0	6	8	7	33,33	-13
GR	6	5	4	-16,7	-20	4	4	3	0	-25	10	9	7	-10	-22
LU	1	1	1	0	0	5	3	3	-40	0	6	4	4	-33,33	0

Source: ECB, 1997

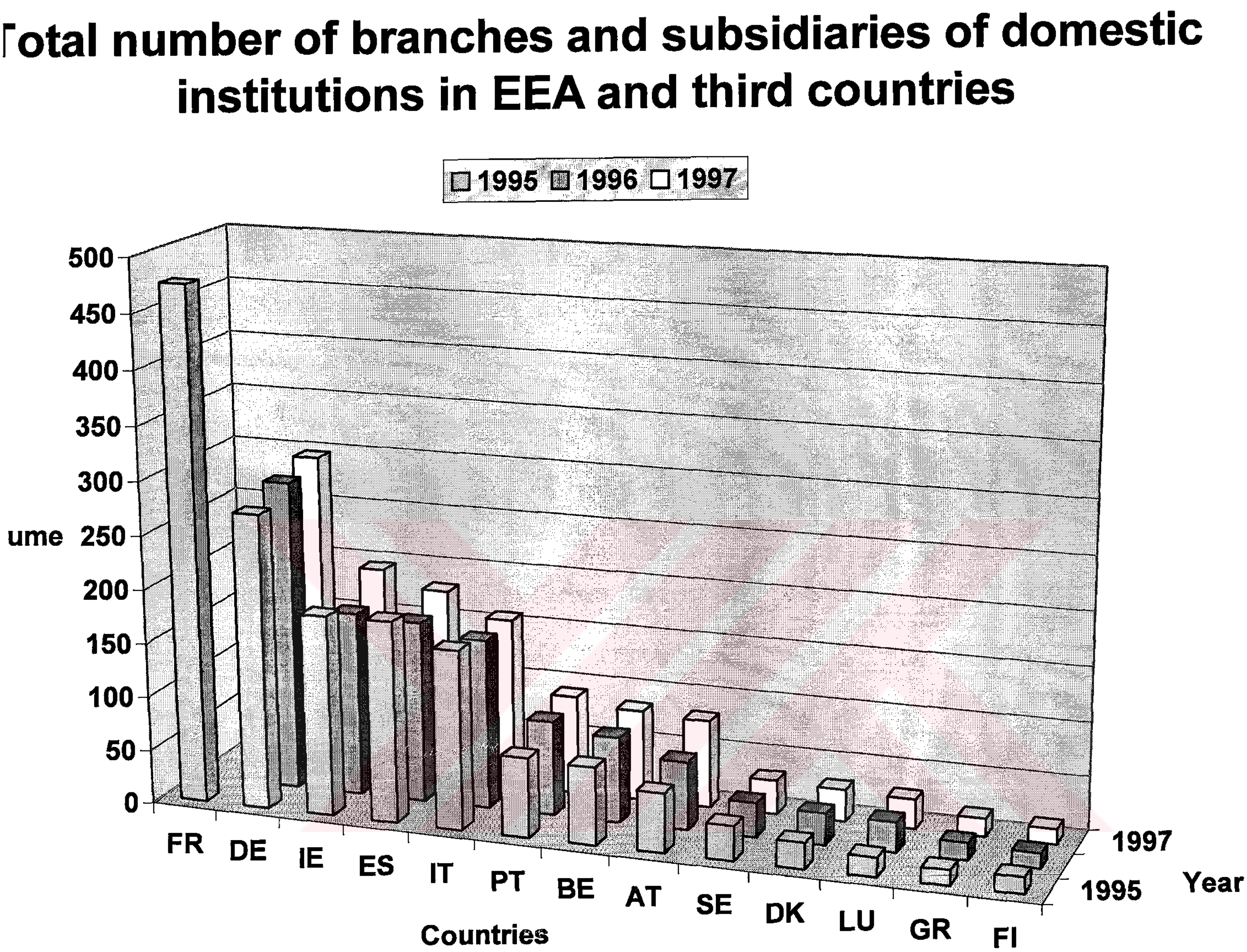
TABLE 23.

Total number of branches and subsidiaries of domestic institutions in EEA and third countries.

	total B+S				
	1995	**1996**	**1997**	**95/96**	**96/97**
FR	475				
DE	273	287	296	5,13	3,14
IE	185	170	195	-8,11	14,71
ES	186	167	180	-10,2	7,78
IT	165	156	158	-5,45	1,28
PT	74	87	91	17,57	4,6
BE	72	79	84	9,72	6,33
AT	55	63	81	14,55	28,57
SE	32	32	32	0	0
DK	24	29	30	20,83	3,45
LU	18	28	28	55,56	0
GR	14	16	17	14,29	6,25
FI	15	14	14	-6,67	0

Source: ECB,1997

GRAPH 8.


Total number of branches and subsidiaries of domestic institutions in EEA and third countries
1995
1996
1997
500
450
400
350
300
ume
250
200
150
100
50
0
FR
DE
IE
ES
IT
PT
BE
AT
SE
DK
LU
GR
FI
Countries
1997
1995
Year

Coming to the geographical diversification in lending activities, total lending by EU banks to emerging, transitional or developing countries amounted to 57% of all international banks' lending compared with 14% for Japan and 12% for U.S. This can be explained by increased diversification efforts due to EMU but can also be seen as excess capacity and liquidity market saturation within the EU.

EU banks hold the majority of claims to emerging Asian countries. The EU countries have shown a higher share in lending to Eastern Europe. As of mid 98 the EU lending to this area amounted 79% of all international banks' lending compared with 3% for Japan and 9% for U.S. With regard to Latin America the market share is56% for EU, Japan 5%. EU banks have replaced Japanese banks as the most important lenders to the emerging Asian economies and Latin America, Eastern Europe. [86]A noticeable wave of mergers and acquisitions is occurring within the EU banking system. The mergers and acquisitions activity affects the degree of concentration of the banking system. As can be seen in the table the degree of concentration varies across the EU countries. Larger economies tend to have less concentrated banking system than the smaller ones. First countries with a high concentration above 70% (SE. NL, FI, PT, DK, GR). Secondly, countries with a medium concentration between 40 and 60% (AT, BE, ES, IE, FR) and with a low concentration below 30% (DE, LU, UK, IT). Over the years with regard to concentration three patterns can be observed. The tendency of polarization at the upper end for example an increase in concentration where the highest concentration for the medium group. We can say that the concentration in banking is lower than in other industries. So concentration level may further increase under EMU. Following some empirical data EMU will facilitate the concentration process on the other hand overall environment might become less competitive. Also in the study it's claimed that there's negative correlation between degree of competition and concentration. The concept of local, national, regional markets are expected to change over the time under EMU communication technologies will link banking markets. At the EU level two main types of mergers are to be seen. First strategic, second one is a defensive merger.

In strategic mergers at least one large player is involved and aiming repositioning in the EMU market. [87]Defensive mergers are aiming efficiency gains. In basic following motivations can be summarized for the merger activities: extension of product range, increase in market share,

---

[86] Oliver Bandt, op.cit

[87] European Commission The Implications of the Introduction of the Euro for non-EU countries, Euro Papers no:26, 1998

realization of economies of scale and scope, privatization, international expansion transfer of resources and capabilities, risk diversification.
In some member states both type of mergers are observed. Meaning the involvement of the largest player in the domestic market, consolidation among the smaller. In AT, BE, FI, SE the larger market players are also involving in merger and acquisition activities. In some mergers are affecting the larger domestic banks. Meanwhile there is breaking of traditional sector barriers between cooperative and saving banks, commercial and mortgage banks. In AT, BE, GR, IT and PT the motive is privatization.
Most of the activities take place in the domestic side. [88]This can be seen as to increase market power at the domestic level so increasing their size and creating the necessary preconditions for future cross borer expansion. There are two basic ways in cross border mergers. First one is the expanding in to market and entering in to foreign retail market. Second one is accessing to an adequate distribution network. For example recent developments in the area of remote baking make the cross border activities easier. On the other hand of course there are some obstacles in this respect. For example cultural differences with regard to management style, customers' preferences, management philosophy.
The other one or not the quality of management is the decisive factor with regard to mergers. On the other side there are operational risks that to be keep in mind such as cultural barriers, information technology system competitive disadvantages. The winners will be who individualize strategic choice according to their own situation and aim.

3.2.6 TARGET SYSTEM

A single monetary policy for the Euro area requires that uniform interest rates are needed in the market. In order to achieve this issue credit institutions need to have capability to manage their liquidity effectively,An existence of an integrated area wide payment system to ensure that liquidity can be transferred from one participant to other in a safe way.
In other way one of the main objectives of the TARGET payment system is to help safeguard the prospective pan European financial markets and institutions from systemic events. The system is composed of as many real- time gross settlement(RTGS) national payments systems as there are EMU members linked to each other through a communications network. In non-RTGS systems, financial institutions accumulate very large open positions against counterparties and the run the risk of losses due to the settlement failures. The advantage of

[88] Paul R. Masson Characteristics of the Euro, the Demand for Reserves and Policy Coordination Under EMU IMF Working Paper WP/97/58

RTGS system is that each payment is made final as it occurs so that large outstanding positions are not accumulated. This was a key reason why the EU made the decision too have national authorities incur the considerable costs to establish TARGET as a network of RTGS system.

The 1997 Capital Markets report noted that TARGET might face competition for providing payments settlement services from other RTGS systems in Europe. There is the impression that a significant share of high value payments would be sent through TARGET might turn out to be incorrect. Large value transactions used intraday credit and the requirement of collateral for obtaining intraday credit within the TARGET means that institutions will have to acquire and maintain. Because maintaining collateral is costly institutions might choose to use alternative netting systems such ad Euro Clearing System(ECS) and Euro Access Frankfurt 2 (EAF2). ECS is the privately owned net clearing system of the European Bankers' Association(EBA). EAF2 is a net clearing system based in Germany but allowing remote membership. For the sake of their high value transactions and might use TARGET only for time critical payments that need intraday credit.

Cost per transaction will be another determinant of the volume of transactions sent through TARGET. The TARGET price structure is the following: 1,75 Euro for each of the first 100 transactions a month, 0,80 Euro for each subsequent transaction in excess of 1000 a month. ECS and EAF2 have announced they will charge a price close to 0,25 Euro for each payment

Trans European Automated Real-time Gross settlement Express Transfer has been developed for this purpose. This system consists of 15 national real time gross settlement systems an ECB payment mechanism. It is intended mainly for the settlement of monetary policy operations and large value Interbank payments but can also used for cross border retail transactions.

The aim is to allow payments to be made through the Euro area at low cost with high security and very short processing times. In addition to that the System also contributes to the development of sound and efficient payment mechanisms in the single market area. This is achieved by the use of real time gross settlement procedures within the Target, which are the safest payment mechanism for processing large value payments.(RTGS system).

TARGET will interlink the domestic RTGS systems, which NCBs have agreed to implement in their respective countries. It provides the banking sector with a payment mechanism, which will enable it to process cross-border RTGS payment in Euro, so that adaptation costs will be minimized.

The above cost and logistical considerations suggest that the TARGET payments system may not realize all of the systemic risk reductions exhibited when the system was designed because the overwhelming majority of high value transactions might be channeled through private netting systems. One thing that can be done is to encourage the use of TARGET by abandoning the policy of full cost recovery and by reducing the need for using collateral for obtaining intraday credit.

The creation of a new integrated market requires a certain degree of standardization such as denomination of operations in Euro ,calculation of interest rates,maturities. In short market agreement will be needed for the single currency area. The role of the market operators will be able to prepare and develop this agreement.

Coming to the effects of Euro, there is a impact of the Euro on international trade. In order to prepare for the Euro member states need to follow economic policies based on low inflation, strong public finances and stable monetary conditions. These improved growth prospects will be benefited by the firms across all round the world. The strength of Europe as a trade partner will open new prospects for exporters in the rest of the world. The share of EU in world GDP is bigger than that of the U.S. or Japan.The EU is still the most important commercial power in the world with a share 20,9% of world trade against 19,6% for the U.S. and 10,5% for Japan.It is also evident that this influence will also correct for countries which have close economic and trade tie with The European Union.A gradual shift has already taken place out of dollars into DM and it can be expected that this issue will be reinforced by the introduction of the Euro.The use of Euro will probably increase in the rest of the world although there are strong factors such as where the dollar will continue to play a very important role given the limited internationalization of the yen.[88] In any case the commercial weight of the Euro zone will increase the use of the Euro for international payments.

Coming to the capital markets, by the end of the 1995 , 48% of capital exports were expressed in dollars, 39,8% of portfolio holdings were in dollars and 83% of all transactions on exchange markets had the dollar as a counterpart. From these figures it can be said that in this respect the use of the Euro will gradually increase.

The growth of financial market in Europe and the stability of the Euro that will gain shoud contribute to an increase of its use as a reserve currency. Central Banks of non EU countries are expected to continue diversification of their reserve holdings which has been underway

[88] N. Funke, International Implications of European Economic and Monetary Union, OECD Working Paper no 174 Paris,1997

for some decades.[89]Between 1973 and 1994 the share of the dollar in offcial reserves has declined from 76% to 63%. This issue will be accelarated by the close strong trade ties with the Euro zone.Another isue concerns the reserve holdings of the ECB itself.Currently the centra banks of the European Union hold six times more reserve than the U.S and twice more than Japan.In addition more than 60% of current external transactions of the EU member states will become domestic transactions in the monetray union. This is another reason why the need for international reserves in the euro area will be smaller than the total of reserves of its members.In any case the ECB will only gradualy reduce its excess dollar reserves in order to limit the impact on the exchange market.

It is to be expected that the introduction of the euro will induce portfolio shifts in favour of euro denominated assets.The policy mix in the euro area will be stability oriented. Monetray policy will be stable with an independent ECB committed to price stability and fiscal policy will be stable based on the Union's strong commitment to budgetary discipline as confirmed in the Stability and Growth Pact.Also the size of the euroa rea will give rise to the development of deep and liquid markets in euro denominated instruments.

These factors are likely to produce a strong demand for euro assets over time.A factor operating in the opposite direction will be the tendency for EU domestic investors to diversify somewhat away from euro assets in order to achieve an optimal risk- return balance.

Also the introduction of the Euro implies a further increse in cross border operations caused by disapperance of national currencies reduces the risk and costs for both suppliers and users of financial services.

After the introduction of the Euro there can be concentration in wholesale banking activities.The whole sale banking markets linked to interest rates and currencies are likely to become very colsely integrated and highky competitive, cause in these markets the traded instruments are relatively homogeneous in terms of credit risk and yield and there is efficient arbitrage across national ,markets and financila centers.Therefore when national instruments and markets are replaced by euro area wide instruments and markets the largest banks at the euro area level could capture a larger share of the activity than they had before. For some banks this tendency could be a motive for mergers or acquisitions. For others it could mean a greater focus on retail banking activities in the home marketand revenue losses.The end result could be a further polarisation of the euro area banking industry with a limited number of a

[89] European Monetary Institute, The Single Monetary Policy in StageThree, September 1997,Frankfurt

large banks active in the wholesale markets related to homogenous foreign exchange and interest rate products and a large number of credit institutions concentrating at the national or local level .

Cross border operations are also likley to increase in retail banking. A general view that the euro assuch is not the most significant force for the change at the moment in this area.The spread of direct banking and the shift in consumers' preference for other forms of saving and away from bank deposits are generally regarded as more important factors.Both will increae competition for established banks. The need to establish a branch network which is always been considered a major barrier to entry into retail banking markets will lose its importance with the spread of new distribution technologies. The Euro may have indirect impact on both forces. It may speed up the adoption of new delivery technologies as there is a larger market in a single currency and the disappearance of foreign exchange risk may increse the tendency of banks' retail customers to seek higher returns through alternative forms of financial instrumentsBy lowering thr barriers to entry for banks' cross border operations the euro might also encourage the development of regional retail banking strategies. The most important aspect is the fact that banks are able to fund their lending in another euro area country from their domestic retail deposit base or eurodenominated money and capital markets.

The expected increse in competiton as a result of the introduction of the euro may force institutions to broaden their customer base across national borders in order to spred their fixed bankinf costs.Cross border mergers or acquisitions represent the fastest way to acquire local expertise and customers in the retail sector.Strategic alliances giving individual banks access to each other's distribution networks could provide an alternative way of expanding cross-border retail banking. A single branch or a small number of branches could be sufficient to attract retail customers in many cases

In conclusion, European Monetary Union includes the irrevocable fixing of exchange rates leading to the progressive introduction of a single currency, the Euro. The Euro would have to stand the burden of a permanent risk, which would result either in higher interest rates with negative consequences on growth or in a depreciation of its value.

EMU will result in price stability for the whole Euro zone. This is guaranteed by the mandate of the ECB according to the Maastricht Treaty. Respect of the convergence criteria will ensure that only stability-oriented countries may become EMU members. Individual savings and retirement plans will therefore keep their purchasing power. Moreover, there seems to be a positive link between low inflation and higher real growth.

EMU's economic features are likely contribute to growth within the Single Market. At a time when competition in the world market is increasing Europe has to turn its own market in order to find growth and prosperity. But the European Single market is currently split by the existence of 14 currencies. This must be changed as it is only with a common currency that companies can fully benefit from the advantages of Single market offers. Due to the rate unpredictability and the resulting disadvantages, which exists in the Single Market, companies are reluctant to invest and to expand production. This has probably led to a slowdown of economic growth of about 0,25% to 0,5%. Unemployment results from the lack of competitiveness, from industrial choices and from general economic developments. International competitiveness is partly a question of exchange rates. In the past, countries lost competitiveness because o high inflation. With EMU this becomes an unlikely development. The ECB will have the obligation to ensure below inflation, which will create incentives for investment by lower interest rates, and better planning predictability.

One of the most important effects of the EMU will be the elimination of exchange rate fluctuations among EMU members. In the present world of low inflation every change in nominal exchange rate is immediately felt as a change in competitiveness. For example, an appreciation of major European economies such as France, Benelux or Austria results in rise of unit labor cost compar~~ed with other countries. But~~ these nominal exchange rate fluctuations are the consequence of opinions, moods and shifts in financial markets and do not necessarily reflect the economic fundamentals in each country.

EMU will improve the competitiveness of European business against American and Japanese companies for example which already benefit from integrated markets with strong currencies. The elimination of exchange rate movements will reduce the risk of cross border investments. A t the Euro will probably gain importance to the disadvantage of the dollar, With a single and widely used currency European companies will have more facilities to invoice or be invoiced in euro. This will contribute to stabilizing their foreign trade relationships and therefore increase the return on commercial investments. Transaction costs will be suppressed for companies operating across borders of EMU countries. Although thee costs may be marginal in relation to the Gross Domestic Product, their suppression will have an multiplier effect. Particularly, small and medium sized companies in border regions will have substantial advantages.

Apart from EMU's positive impact on employment and growth consumers will benefit directly from monetary union. Most goods purchased today include a proportion of foreign components and therefor eof costs linked to the multiplicity of currencies. The elimination of these cots will help reduce prices and raise the purchasing power of the consumer.

Although the national currencies will continue to exist for around three years after the start of EMU the cost of changing money when travelling room one EMU country to another will drop in 1999, because banks will no longer have to include a margin for foreign exchange risks. As soon as the Euro bank notes are introduced in 2002 these costs will disappear completely. In addition to that, charges for international payments are likely to be reduced.

Due to increased capital mobility and globalization of the markets, European economic and financial developments can not be isolated from international economic trends. Not only has increased mobility reduced the possible impact of national economic policy measures but it has also amplified internal and external instability. In recent years volatility between the major anchor currencies (Dollar-DM-Yen) has escalated, causing problems not only for the European market. On of the reasons for this instability is the fact that D-mark has gained importance as an international anchor currency. Yet the economic weight of the DM is insufficient to support currency shifts on the financial markets. The Euro currency area with an economic weight, which equals that of dollar area would correspond to the importance of the Euro in world trade. [86]The Euro, could gain importance in world trade. A single European currency will reflect more accurately Europe's importance in output and export shares and the realities in the global economy.

As regards monetary, exchange rate and fiscal policies, Monetary Union raises fears of further surrender of national authority in addition to that in other policy area such as agricultural policy the member states have to accept limitations on public borrowing and public debt. They will be no longer be able to create inflation or control independent exchange rate and independent interest rates. For the sake of macroeconomic stability many EU countries have already given up voluntarily a great deal of policy freedom when trying to stabilize their currency versus the DM.

Regional macroeconomic imbalances could increase within the EMU. These imbalances need not necessarily involve increased income transfers to weaker countries. Greater wage flexibility and labor mobility combined with the already existing regional and structural funds of the European Union can limit these effects. In any case if new transfer payments were

[86] European Central Bank, A Stability Oriented Monetary Policy Strategy for the ESCB,October 1998' Frankfurt

created they would result from a political decision and not from an economic necessity created by EMU.

The costs at the beginning of EMU, e.g. For the production of billions of Euro notes and coins will probably amount over 0,25% of gross domestic product and correspond to the annual savings on transaction costs. [87]In addition national governments will have to pay for information campaigns and changes in their accounting system.

The adjustment costs for companies involve a changing of the accounting system, stock control and price labeling. Banks have to calculate the costs of software changes, changes of currency distribution system and reconversions or even reduction of certain posts. It can be said that although there are various negative consequences besides the advantages, Europe should catch up the unique opportunity to improve its economy and competitiveness in comparison to Japan or U.S. Europe has no time wait for EMU for another 50 years.

[87]Hogeweg , op.cit

4.FEATURES OF TURKISH BANKING SECTOR & EFFECTS OF EMU AND EURO ON TURKISH BANKING SECTOR

4.1 TURKISH ECONOMY

The general equilibrium of the economy consists of the total resources in the economy, economic growth and the sources of this growth, the distribution between the public and private sectors of these resources, consumer trends including patterns of deposits and investments of the private and public sectors.

The rapid growth of the Turkish economy, which started in the second quarter of 1995, continued through al the quarters of 1997 and was maintained through out the year as a whole. [88]National income increased from USD 165.7 in 1995 to USD 183.5 in 1996 total national income rose by 8% in 1997 to USD 193.1. There was a radical change in the pattern of the public and private sector's relative shares in the Gross National Product as compared to 1996 with the private sector's share declining. The share of the private sector in the total disposable income, which had been 93,2% for 1996, went down to 90,5% for 1997. The share of the public sector in the economy in the economy in general, rose from 6,8% to 9,5%.

TABLE 24.

General Equilibrium of the economy

	1991	1992	1993	1994	1995	1996	1997
GNP	100	100	100	100	100	100	100
Net Foreign Resources flow	2,1	2	4,85	-1,47	1,84	5,62	5,22
Total savings/GNP	23,5	22,8	25,3	24,3	23,4	25,64	25,36
Domestic savings/GNP	21,2	20,9	21,8	22,9	21,4	19,6	20,14
Private savings	25,2	27	28,3	26,7	28,2	24,82	21,81
Private investment	15,7	16,16	19,31	17,75	19,19	21,06	19,38
Private sector saving surplus	9,5	10,84	8,99	8,95	9,01	3,74	2,45
Public savings	0,72	-0,8	-2,83	-1,2	-1	-3,61	-1,67
Public investment	7,61	6,66	7,29	3,71	4,1	4,58	5,98
Public sector Investment deficit	6,89	7,46	10,12	4,91	5,1	8,19	7,65

Source: State planning organization, 97

The increase in public spending in 1997 played a part in the rise of the public sector's share in total disposable income. The public investment/GNP ratio, which had fallen to 37,1% with the 1994 crisis, rose to 6%for 1997. The savings deficit of the public sector was also reduced in

[88] Ibid.

1997: it feels from 3,61% in 1996 to 1,67% in 1997. As for the public sector's investment saving deficit it had been 8,19 in 1996 and improved in 1997 by falling to 7,65%. [89]

In spite of the decline of the private sector share in total disposable income resources in1997, the trend towards increased consumption was accelerated. This upward trend in private sector consumption encouraged domestic demand and played an important role in the rapid economic growth. [90] The savings and investment levels of the private sector declined. In particular there was a rapid decline in savings. The private sector saving ratio fell from24, 82% in 1996 to 21,81%, while investment rates fell from 21,66 to 19,38.[91] On the other side, the rapid decline of the savings graph caused the private sector investment savings surplus to fall below 3% for the first time to 2,45%. This is compared to 9% for 1995 and 3,74% for 1996.

After the recession caused by the economic and financial crisis of 1994, from the second quarter of 1995, the economy entered a phase of accelerated growth. Following growth rates of 8,1 in 1995 and 7,9 in 1996 the GNP increased by 8% in 1997.[92]This was a phase stable and rapid expansion linked to the lively domestic demand levels. Economic growth is dependent on domestic demand levels. There was a major rise in consumer and investment spending over the year as a whole Th source of the vitality of the domestic demand over the years as a whole was the effect on incomes of the highlevels of public borrowing and attendant high real interest rates and increased financial savings.

TABLE 25.

National Income and Growth

	GNP(growth%)	GNP(Bn USD)	Per capita income
1993	8,1	181,5	3056
1994	-6,1	130,9	2161
1995	8,1	168,4	2734
1996	7,9	183,5	2928
1997	8	193,1	3048

Growth by sectors

	1994	share	1995	share	1996	share	1997	share
Agriculture	-0,7	16	1,8	15	5,2	16	-2	15,1
Industry	-5,7	27	11,3	28	7,1	26	10,4	25
Services	-6,6	57	6,5	57	6,8	58	7	59,9
GDP	-5,5		7,3		7,2		7,2	
GNP	-6,1	100	8,1	100	7,9	100	8	100

Source: State Planning Organisation(SPO),97

89 European Central Bank,op.cit
90 Ibid.
91 The Economist, op.cit.pp 9
92 European Central Bank, Indicators of Europe,op.cit

The effect of foreign demand on the economic growth was limited compared to domestic demand. Exports, which had risen by 7,3% in 1996, rose by 13% in 1997. [93] The slow increase in performance levels in exports and the attractiveness of the domestic demand in contrast to the lack of foreign demand can be blamed on the inadequacy of policies aimed at increasing export levels. On of the factors of the rapid increase in industrial production in 1997 was the expansion of the manufacturing industry. Private sector manufacturing rose by 14,1% in 1997 while the increase for the public sector remained at around 4%. The share eof the public sectors in the manufacturing industry averaged at 80,9% for 1997 and did not shown fluctuations over the year.

The employment level lagged well behind economic growth. According to the data released by State Institute of Statistics total employment fell from 21,7 million October 1996 to 21,2 million in April 1997.This fall in employment figures was due to the decrease in employment in the agricultural sector. 44% of total employment was in urban areas, 56% in rural areas. [94]

Although the public sector cash borrowing requirement for 1997 was reduced in real terms compared with the previous year it reached a total of TL 2,613.6 trillion In order to repay the net foreign debt of TL 452.6 trillion in addition to the cash deficit of TL 2,161 trillion in the consolidate budget of 1997. [95] This borrowing requirement, which consisted of the consolidated budget of the public sector and the extra-budgetary components, was largely met by the domestic borrowing. In 1997 the borrowing requirement was met by domestic borrowing amounting to TL 2,5 quadrillion and cash advance accounts amounting to TL 107 trillion. In net the public sector made no use of the Central Bank's short-term account in 1997.

The foreign trade deficit, which had amounted to USD 20,2 billion in 1996, rose by 10,9% to USD 1104 billion in 1997. [96]The increase in imports which had accelerated by 22,2% in 1996 following the entry into the Customs Union continued but at a slower rate in 1997. The most important factors behind the increase in imports in 1997 were the high increase in production and the lively domestic demand levels. The increase in export revenues for 1997 was 13% and exports rose to USD 26,2 billion. The ratio of exports to imports fell by on point compared to the previous year to 54%.

---

[93] European Commission , Key Figures, op.cit

[94] Can Fuat Gürlesel.Turkey, The Year In Finance 97-98, Istanbul:1998 ,pp24-26

[95] Ibid.,pp45-52

[96] Iktisadi Kalkinma Vakfi: Kirk Soruda Ekonomik ve Parasal Birlik, Istanbul: 1997,IKV ,pp2-10

TABLE 26

Foreign Trade(Billions USD)

	1994	1995	1996	1997
Export	18,1	21,7	23,4	26,2
Import	23,3	35,7	43,6	48,6
Foreign Deficit	5,2	14	20,2	22,4
Export/Import	78	6,1	55	54

Source:Foreign Trade,1997

Foreign trade figures including the shuttle trade showed a trade deficit of USD 10,6 billion for 1996 and USD 15,4 billion for 1997 representing a 46% increase and reflecting the decrease in shuttle trade revenues.

In the visible income lines of the current account the rise in tourism revenues in particular caused an increase of 45% with the net surplus invisibles rising from USD 3,7 billion in 1996 to USD 7,85 billion in 1997. As a result of this increase in the invisible income line and in spite of the expansion of the foreign trade deficit, the current account deficit for 1997 remained data around USD 2,75.This is compared to a 1996 figure of USD 2,43.

TABLE 27.

Current Account Surplus(Millions USD)

	1995	1996	1997
Merchandise Exports	21975	32446	32631
Merchandise Imports	-35187	-43028	-48097
Other goods and services			
Credit	16094	14628	21273
Debt	-9717	-10930	-13423
Private and Official Transfers	4496	4447	4866
Current account balance	-2339	-2437	-2750

Source: Foreign Trade, 1997

The financing of the USD 2,75 billion current account deficit was through capital inflow. The current account deficit was met by a net capital inflow of USD 8,6 billion. Of these funds USD 6,9 were long term, USD 1,8 were short-term. As a result of these capital movements and increases of USD 3,3 billion was recorded in official reserves. [97]

[97]State Institute of Statistics, Figures of Turkey, www.die.gpv.tr,1998

As of the third quarter of 1997 the outstanding foreign debt rose by 5,9 from 79,8 to 84,5 billion dollars. There was no change in the maturity structure of the foreign debt. At 1997-year end the distribution of medium and long-term foreign debts between the public and private sectors has changed. The rate of foreign debt repayment, which is calculated s, the ratio of foreign debt principal and interest payments over foreign exchange income fell by on point in 1997, to 21%. [98] The rate of increase in foreign exchange income exceeded that the increase in foreign debt principal and interest payment. [99]

The increase in foreign exchange income and capital movements, total foreign exchange reserves grew by 8,7% in 1997 to USD 27,2 billion. [100] Total foreign exchange reserves had been USD 24,95 billion at 1996-year end. The increase in foreign exchange reserves was largely due to the 14% or USD 2,2 billion increase in the Central Bank's foreign exchange reserves.

TABLE 28.

Foreign Reserves (Billion USD)

	Gold	Central Bank	Commercial Banks	Total Gross Reserves
1994	140	7112	7997	16519
1995	1383	12391	10169	23942
1996	1383	16273	7352	24966
1997	1124	18419	7625	27138

Source: Turkish Central Bank, 1997

Following the financial crisis in 1994, the increase in whole sale prices had fallen to around 60% in 1996, price increases occurred again, continuing trend in 1997, reaching 91% on an annual basis. While the increase in domestic demand was the main cause of the price increases in the first semester in the second semester it caused by the rising price of the oil. Another important factor that leaded to Price increase was agricultural sector prices.

TABLE 29.(Source:Foreign Trade,1997)

Foreign Debt Stock(Billion USD)

	1993	1994	1995	1996	1997
Medium and long term	48,8	54,3	57,6	59,3	62,8
Public	42,9	48,1	50	48,8	47,9
Private	5,9	6,1	7,6	10,5	15
Short term	18,5	11,3	15,7	20,5	21,7
Banks	11,1	4,7	6,7	8,9	9,4
Private Sector	6,7	5,8	6,7	11,6	12,3
Total	67,3	65,6	73,3	79,8	84,5
Total/GNP	37,1	41,5	43,5	43,5	43,7

[98] Ibid.
[99] Ibid.
[100] Ibid.

TABLE 30.

Basic Economic Indicators								
	1990	1991	1992	1993	1994	1995	1996	1997
Population(million)	56,1	57,3	58,6	60	61,1	62,5	63,2	64
Growth(1)								
GDP	8,2	1,1	4,9	7,5	-6	7,3	7,2	7,1
GNP	9,3	0,4	6,4	7,6	-6	8,1	7,9	8
Agriculture	6,8	-0,9	4,3	-2,2	-2,5	2,6	5,2	-2
Industry	8,6	2,7	5,9	8,2	-5,7	12,1	7,1	10,7
Services	10,3	0,6	6,5	10	-3,2	6	6,8	7
Sectoral Distribution(1)								
Agriculture	17,5	15,2	15	15,4	15,5	14,8	16	15,1
Industry	25,5	25,9	25,6	25,4	26,4	26,5	26	25
Services	57	58,9	59,4	59,2	58,1	58,7	58	59,9
GNP(2)	152	151	160	182	131	168	183	194
GNP per capita(2)	2662	2655	2744	3056	2161	2732	2928	3048
Fixed Capital Investment/GNP(1)	24,4	24,1	23,5	25,1	21	21,5	24	25,3
Domestic Savings/GDP(1)	23,5	22,6	21,6	21,9	19,7	20,9	19,6	20,1
GNP deflator(1)	57,6	59,9	63,5	67,4	107,3	64	81	83
Employment								
Employment	18,2	19	19,2	19,9	20,4	20,89	21,4	21,2
Unemployed(1000)	1572	1715	1674	1722	1740	1613	1433	1336
Sectoral Distrbution(1) of employment								
Agriculture	47	48	45	43	44	47	46	45
Industry	16	15	15	22	22	21	22	22
Services	37	37	40	35	34	32	32	33
Collective Agreement	1945	4967	1822	3888	1423	2357	1871	2056
General unemployment(1)	8,9	7,4	8	7,3	10,5	8,8	6,3	5,9
Urban	13,8	12,1	12,1	11,2	14,5	12	9,3	9,2
Rural	5,5	3,9	4,7	4,1	4,6	5,5	3,8	3,2
Inflation(1)								
Wholesale								
12 month Change	45,6	59,2	61,4	60,3	149,8	65	84,9	86
Average change	52,3	55,3	62,1	58,4	118	89	75,9	81
Consumer								
12 month Change	60,4	71,1	66	71,1	125,5	79	79,8	99
Average change	60,3	60	70,1	66,1	104	94	80,4	85
Public sector balance(1)								
Public deficit/GNP	7,5	10,4	10,6	12,1	8	7,2	9,2	8
Budget deficit/GNP	3	5,3	4,3	8,9	3,5	4,2	8,4	7,5
SEEs deficit/GNP	3,8	3,1	3,3	2,5	2,1	2	0,2	-0,6
Local Governments	0	0,3	0,8	0,8	0,4	0,5	0,2	0,4
Funds/GNP	0,8	1,3	2	1,2	1,1	0,7	0,1	0,2
Other	-0,3	0,1	0,2	0,6	0,4	0,9	0,3	0,5

Consolidated Budget(3)								
Budget revenues	57	97	174	351	742	1377	2738	5854
Budget expenses	69	130	222	485	889	1697	3955	8035
Budget deficit	12	34	48	134	147	310	1217	2181
Finance								
Foreign debt	0,04	1,9	4	21	-69	-81	-134	-456
Bonds	8	2	15	30	-70	86	274	1484
Short term	2,2	25,5	41,3	75,2	296	292	1021	1021
Bonds	1,9	12,8	23,9	22,2	246	197	792	1021
The Central Bank advances	0,3	10,7	17,4	53	52	95	229	-
Budget revenue/GNP(1)	13,9	15,2	15,8	18,2	18,7	18,1	18,5	19,7
Budget expenses/GNP(1)	16,9	20,5	20,1	25,2	22,2	22,3	26,8	27,2
Personel payments/GNP(1)	6,5	7,7	8,5	8,8	7	6,6	6,4	7
Interest payment/GNP(1)	3,5	3,8	3,7	6	7,5	7,6	10,11	7,7
Pers. Pay./Total expenses(1)	2,5	37,8	42,4	34,9	31,2	29,6	24,6	25,6
Int. Pay./ Total expenses(1)	20,8	18,5	18,2	24	33,5	33,9	37,9	28,4
Investments/Total expenses(1)	13,2	13,2	13,2	11	7,8	5,2	6,4	7,9
Domestic Debt Stock(3)	56,8	99,3	194,7	366,5	784	1422	3149	6257
Government Bonds	22,5	33,4	86,4	189,5	225	550	1250	3544
Treasury Bills	5,5	18,3	42,3	64,5	307	550	1528	2375
Public Securities	28	51,7	128,7	254,1	532	1200	2778	5919
Advance from the Central Bank	2,8	15,6	31	70,4	122	192	371	338
Exchange rate differentials	26	32	35	32	130	30	40	-
Public Securities/GNP(1)	7,1	8,2	11,7	13,2	13,3	15,9	18,4	21
Domestic Debt/ GNP(1)	14,3	15,7	17,6	18,5	19,6	18,8	20,3	21
Foreign Exchange Rates								
USD (average)	2608	4170	6888	10986	29670	45679	80044	155178
12 month change(1)	24	61	67	68,9	162	54	81	91
Average change(1)	27	73	68	63	170	54	82	87
DM	1915	2509	4418	6627	18474	31937	55003	89137
12 month change(1)	43	72	59	57,4	182	67	66	66
Average change(1)	45	56	74	52,4	192	73	72	62
Real change(USD) (1)	18,6	-1,7	-4	-1,2	-19,1	15,7	-0,6	-2,2
Monetary developments (12 month change) (1)								
Currency	65	45	71	71	86	87	87	82
M1	50	44	68	52	85	74	110	66
M2	48	61	63	49	125	99	120	88
M2Y	51	78	88	77	136	101	109	97
Deposits in foreign curr./M2Y	21	29	37	47	49	51	49	51
Total deposits in TL	46	67	65	46	131	102	132	102
Deposits and credits	79	53	78	82	121	237	114	121
Financial system and Public Sector Deficit								
M2/GNP	17,4	17,5	16,2	13,9	15	16,7	18,5	18
M2Y/GNP	21,9	24,6	25,7	26,2	29,1	34,8	38,4	37
Public sector deficit/M2	43,2	59,1	65,4	86,9	80	45	50	62
Public sector deficit/M2Y	34,3	42,1	41,2	46	35	22,6	25,4	30
Public sector deficit/M2(change)	129,6	156,2	172,1	280	100	91,8	91,4	132
Public sector deficit/M2Y(change)	95	91	91,4	105	46	44,9	48,7	61

Foreign Trade(2)								
Export	12,9	13,6	14,7	15,3	18,1	21,7	23,4	26,2
Import	22,3	21	22,9	29,4	23,3	35,7	41,9	48,3
Trade deficit	9,4	7,4	8,2	14,1	5,2	14	18,5	22,1
Exports/GNP(%)	8,4	8,9	9,2	81,6	13,3	13,6	13	13,7
Imports/GNP(%)	14,6	13,8	14,3	16,6	17,2	21,6	24	25,1
Trade deficit/GNP(%)	6,2	4,9	5,1	8	3,9	8,5	11	11,4
Sectoral Distribution of exports(%)								
Agriculture	18,4	20	15,4	32,5	13,6	10,7	109	11,2
Mining	2,6	2,1	1,8	14	1,5	1,9	1,1	1,6
Manufacturing	79	77,9	82,8	53,5	84	87,4	88	87,2
Distrbution of Imports(%)								
Capital Goods	26,6	28,7	29,6	32,5	29,6	29,4	30	31
Consumption Goods	12,9	13,8	13	14	11,9	12,4	14,7	11
Raw materials	60,5	57,5	57,4	53,5	56,5	58,2	55,3	58
Balance of payments(2)								
Foreign Trade Deficit	-9,6	-7,3	-8,2	-14,2	-4	-14	-18,5	-22,4
Invisibles	7	7,6	7,3	7,8	6,6	12	20,5	17,5
Current Account	-2,6	0,3	-0,9	-6,4	2,6	-2	-4,4	-4,9
Current Account/GNP(1)	-1,7	0,2	-0,5	3,6	1,9	-1	-2,4	-2,5
Worker Remittances	3246	2819	3008	2919	2627	3327	3521	4211
Tourism	3225	2654	3639	3959	4321	4957	5741	5325
Capital movements								
Companies	1856	2123	2330	2554	2830	3161	3582	4068
Permissions(million USD)	1861	1967	1820	2125	1485	2938	3837	1678
Cumulative(million $)	6423	8390	10210	12335	13820	16758	20526	22207
Foreign reserves/Short foreign debts	103,1	117,6	107,9	88,1	133,9	108,3	135,1	125,3
Foreign reserves(2)								
Central Bank foreign	5,9	4,9	6,1	6,2	7,1	12,4	16,5	18,7
Commercial bank	3,9	5,8	7,6	10,1	7,9	8,5	9,9	8,5
Total	9,8	1,07	13,7	16,3	15	23,9	27,8	27,2
DTH billion USD	9301	11506	14425	19105	18643	25561	29959	31121
Foreign debt stock(2)								
Medium and long term	39,5	41,4	42,9	48,8	53,2	57,8	59,3	62,8
Short term	9	9,4	12,7	18	11,2	15,7	20,5	21,7
Total (1)	49	50,5	55,6	67,3	64,4	73,3	79,8	84,5
Medium and long term/GNP	25,9	27,2	26,7	27,6	39,5	34,6	32,3	32,5
Short term/GNP	6,2	6	7,9	10,5	8,2	9,2	11,2	11,2
Total/GNP	32,1	33,2	34,6	38	47,9	43,5	43,5	43,7

Source:SIS

(1) percent
(2) billion USD
(3) trillion TL

4.1.1 TURKISH ECONOMY IN 1998

Having see the high growth in the previous years, the economy experienced a high slowdown in this year. The most important reason for this reaction was the struggle to pulling down the rate of inflation and pulling down the domestic demand. The GNP and pr capita income rose to USD 204 billion and 3224USD respectively. [101]

The taxation of capital gains above certain levels, the uncertainties in the existing in the tax laws, capital outflow caused to decrease in the level of domestic demand.

In the area of public sector deficit, the obligatory reforms weren't made by the government again in order to narrow the public spending. Th e ratio of public sector deficit to GNP remained around at 8,7%. Besides, the tax revenue and expenditures increased above the inflation level. Ratio of interest expenditures to GNP increased to 11,7%. Primary balance gave surplus due to the non-interest expenditures improvements. Although there are changes in the tax law, it is no supported by the necessary reforms in order to reduce the public deficit. (Social security institutions, The roles of SEEs, Agricultural subsidiaries, Efficiency in public services)

By the tax law which realized in 1998 were aimed the widening of tax registration of unrecorded economy. The law of course has brought very important changes in terms of financial sector. For example the valuation of securities is to be made form their market values instead of cost value, the transitory tax implementation of 25 percent on a three monthly basis was started. After that as a result of global financial crisis and reaction to the new tax law, the government declared certain changes in the regulations. According to it the tax regarding the Interbank transactions was removed, the banking and insurance transactions tax in government securities was reduced from 5 percent to 1 percent, government securities having more than one year maturity were allowed to be valuated at their cost value. A type investment funds remained as it as before.

After the second half of the year interest rates increased which caused by the increase in non-budget financing requirement the change in the tax law following by a capital out flow. Government securities' interest rates increased rapidly. Meanwhile the real interest rates increased at rapid pace in the period of decreasing trend in inflation and devaluation policy consistent with the inflation.

[101] Ibid.

Although there are negative results, on the inflation side nearly program targets were met.Wholesale and consumer prices decreased to 54% and 70% respectively. Slowdown of price adjustments in the public goods and services, decline in the prices of imports of raw materials facilitated the positive improvement in the rate of inflation.

In 1998 the very primary target was to maintain the stability of financial markets and the monetary aggregates in order to meet inflation target.In the first half of the year the reserve money as the second period net domestic assets set as a monetary targets. In the first half the Central Bank foreign currency reserves increased rapidly and foreign exchange position improved due to the desired capital inflow. During the second half of the year, rapid capital outflow was experienced an d this of course affected the monetary aggregates negatively.Foreign currency reserves fell rapidly. Despite the rapid capital outflow and the liquidity provided by the open market operations the targeted monetary aggregates was almost reached.The protocol signed between the Treasury and the Central Bank in 1997 related with the Treasury's short term borrowing form the Central Bank had important positive effect in this respect.

The stability in foreign exchange rates had appositive effect on a demand for TL. Investors' preferences moved from repo to TL deposits.Money supply including repo M2R grew by 69% and M2YR including foreign exchange account increased by 63%.

As coming to the trade figures, there's decline in foreign trade deficit and current account balance gave a surplus due to the slowdown in the economy. Imports declined rapidly while the exports remained same. As a result of this trade deficit declined to USD 19 billion from USD 22 billion. The current account balance improved from USD 2,7 billion deficit to USD 2,7 billion surplus. [102] Foreign currency reserves amounted to USD 19 billion by the year-end.

Financial system and the banking sector had affected negatively as a result of poor economic conditions.The asset prices fluctuated all over the year. The cost of funding increased, the market capitalization of the companies declined.Investors switched from repo to TL deposits.Of course this effected the growth of the banking sector balance sheet. Macroeconomic imbalances and uncertainties affected the financial structures of the banks.Loan performance worsened, cost of fund rose, profitability ratios decreased.

[102] Gürlesel , op.cit., PP 37

1998 figures showed that the economy grew by 80% in current prices and 4% in constant prices. Per capita income amounted to USD 3,224 and GNP of USD 204 billionth growth rate was 6,6% and 1,7% in the first and second half respectively.[103]

Decrease in domestic demand and external demand caused to economy slowed down. Significant decline in public sector borrowing, decrease in inflation and depreciation of TL against other foreign currencies facilitated the capital inflow. On the other hand these very rich figures lost momentum during the second half. Together with the financial cross in Russia, negative developments had experienced. Capital outflow had accrued and despite the low inflation and stable exchange rate policy interest rate increased its highest level compared to first half of the year. Fixed capital investments declined by 2,4% in 1998.In the public sector the growth in fixed capital investment decreased from 28% to 15 %. Total consumption grew by 0,9% compared to the previous year.

TABLE 31.

Gross National Product(GNP)

	1996	1997	1998
Growh rate (%)			
In current prices	91	96	80
In constant prices	7	8	4
Deflator (prices)	78	81	74
GNP			
TL trillion	14798	29393	53013
USD billion	185	194	204
Per capita income (USD	3000	3079	3224

Source:SIS,1998

According to the poor economic conditions, also the employment side of the economy affected negatively. According to the data the unemployment rate remained the same both in the urban areas the rate has increased. It was 10 in 1998 compared to 9,4 in 1997.

[103] State Institute of Statistics,op.cit

Unemployment(%)

TABLE 32. (SIS, 98)

	1996	1997	1998
Unemployment rate			
Overall	6	6,4	6,3
Urban	9,2	9,4	10
Underemployment rate			
Overall	6,3	5,6	5,7
Urban	6,1	6,3	5,9

The exchange rate policy parallel to inflation, the real appreciation of the TL, the better harvest in the agricultural sector, the decline in imported input prices including the petroleum facilitated the target inflation figure. But , public sector deficit, high real interest rates, increase in real wages in the private sector, increase in the agricultural subsidy prices all contributed to the negative effect to the desired figures.

The 12-month inflation was 54% in whole sale prices and the consumer prices increased by 70%compared the 80% and 99% for 1996,1997 respectively. Annual average rate was 72 % and 84% respectively. The increase in public sector prices slowed down. It was 58% and 86% respectively.

TABLE 33.

Inflation(%)

	1996	1997	1998
Annual Average			
Wholesale	76	82	72
Public	82	86	58
Private	74	81	76
Consumer	81	86	84
12 month			
Wholesale	85	91	54
Public	101	98	36
Private	81	89	60
Consumer	80	99	70

Source:SIS

The consolidate budget revenue reached USD 37,9 billion. Tax revenue constitutes the 78 % of the total revenue. The expenditure was USD 4907 billion. Non interest expenditures increased by 7% while the interest expenditures increased by 78%. Budget expenditure to GNP ration rose to 29,4 by increasing 1,7% from the previous year. The shares of personnel, non-interest transfers current and investment expenditures in total expenditures were 25%, 27 %, 8% and 6%. The ratio of expenditures to GNP increased by 12,5% and the ratio of revenues to GNP increased by 8,5%. down. Thirty five percent of the net domestic borrowing of total 12,2 billion was realize by the government bonds, the remaining realized by the treasury bills.

TABLE 34.

Public Sector Borrowing Requirement(As % of GNP)

	1996	1997	1998
Consolidated Budget	8,1	7,5	7
SEEs	-0,5	-0,3	1,3
Local administrations	0,2	0,3	0,3
Funds	0,1	-0,1	0,1
Other	0,7	0,1	-0,1
Public sector deficit	8,8	7,6	8,7

Consolidated Budget(USD Billion)

	1997	1998
Revenues	28,1	37,9
Tax revenues	23,1	29,4
Non-tax rev.	4,9	8,5
Expenditures	39	49,7
Non-tax	27,9	29,9
Personnel	10,1	12,3
Current	3,4	4,2
Investment	2,8	3,2
Transfer	11,4	13,2
Interest Expenditures	11,1	19,7
Domestic debts	9,7	17,9
External debts	1,5	1,7
Budget balance	10,5	-11,8

Source: SIS, 98

Financing of the Budget(USD billion)

			% of GNP	
	1997	1998	1997	1998
External Borrowing(Net)	-2,1	-2,8	-1,5	-1,7
Domestic Borrow.	12,2	12,2	8,6	7,2
Goverment Bonds	7,3	3,7	5,1	2,2
Treasury Bonds	4,9	8,4	3,5	5
Central Bank Advances	0	0	0	0

Source: SIS, 98

TABLE 35.(Source: SIS 98)

Financing of the Budget(USD billion)

			% of GNP	
	1997	1998	1997	1998
External Borrowing(Net)	-2,1	-2,8	-1,5	-1,7
Domestic Borrow.	12,2	12,2	8,6	7,2
Goverment Bonds	7,3	3,7	5,1	2,2
Treasury Bonds	4,9	8,4	3,5	5
Central Bank Advances	0	0	0	0

TABLE 36.

Outstanding Domestic Debt(USD billion)

	1998	1997
Government Securities	37	20
Cash	30,3	16
Non-cash	6,7	4
Government bonds	18,4	12
Cash	12,2	8
Non-cash	6,2	8
Treasury bills	18,6	8
Cash	18,2	8
Non-cash	0,4	0
Central bank advances	0	1
FX differences	0	0
Outstanding Domestic Debt	37	21

Source: SIS, 98

The outstanding domestic debt amounted to USD 37 billion.The ratio of government securities to GNP reached 22% , increasing two points compared to 1997.The short term maturity structure of borrowing is a important point to remember.

Public sector deficit to GNP ratio was 9% in the 1998. For M2R(included repo) was 25and M2YR was 42% respectively.In the same period the ratio of public sector borrowing requirement to funds created in the financial system increased rapidly.In these periods preferences turned to be very sensitive to the changes. Currency substitution increased, maturity structure changed, the pressure on exchange rates were increased.

TABLE 37.

The Public Sector and The Financial Sector

	1990	1995	1996	1997	1998
% of GNP					
Public sector deficit	7	5	9	8	9
M2R	17	25	23	27	25
M2YR	22	43	41	46	42
Ratios(%)					
M2R/M2YR	79	59	56	59	61
Pub. Sec. Def/Change in M2R	131	33	85	63	83
Pub. Sec. Def/Change in M2YR	98	20	45	38	54
Outstanding gov. Sec./M2R	41	60	80	74	85
Outstanding gov. Sec./M2YR	32	35	45	43	52

Source: Central Bank of Turkey, 98

In 1998 the growth rate of monetary aggregates decreased .M1R increased by 19%(Money in circulation+the banks' repo transactions with costumers). M2R (M1+TL time deposits) grew by 69%,M2YR grew by 63%(M2R+foreign exchange deposits).There was a switch from repo to TL deposits caused by the introduction of with holding tax to repo and decline in short term interest rates as result of this TL deposits increased by 127. On the on the other hand the e growth in foreign currency accounts was only 54%.

Also there's a decrease in the currency substitution caused by the high real interest rates.The share of total of cash in TL and TL deposits an d repo in M2YR rose to 61%. The share of foreign currency deposits decreased to 39%. Also there is a significant drop in the volume of the repo transactions. It was 11%.The foreign exchange accents of residents which amounted to USD 26,6 billion at the end of August rose to USD 30,7 billion at the end of September and by the year end it was28,7 billion.The total deposits increased by 94%.TL deposits grew faster than the foreign currency deposits.It was 101% and 87% growing rate respectively. There had been a significant transition from demand deposits to 3-month time deposits. For the FX there had been a tendency to 12-month maturity. Also the break down of financial assets changed The share of money declined with compared to previous years. The share of government securities increased. On the other side the share of repo and FX accounts fell, TL deposits' share increased.

TABLE 38.

Monetary Aggregates(12 month % change)

Trillion TL		Percentage Change		
	1998	1996	1997	1998
M1R	4.772	47	166	19
Money in circulation	1.106	80	81	72
Demand deposits	1.178	173	55	60
Repo	2.488	4	291	-5
M2R	13.345	88	127	69
Time deposits	8.573	137	97	121
M2YR	21.914	100	118	63
FX deposits	8.569	119	106	54

Source: Central Bank,98

TABLE 39.

Composition of Financial Assets

	% Share			% of GNP		
	1990	1997	1998	1990	1997	1998
Money quasi money	68	67	62	23	49	42
TL	54	40	38	19	30	25
Cash	10	3	3	3	2	2
Demand deposits	13	3	3	4	3	2
Time deposits	31	22	24	12	16	16
Repo	0	12	7	0	9	5
FX	15	27	24	5	20	16
Securities	31	34	35	10	24	25
Public	19	29	33	6	21	22
Private	12	4	5	4	3	3
Total	100	100	100	33	73	67

The Maturity Structure of Deposits(%)

	TL		FX	
	1997	1998	1997	1998
Demand	26	23	27	25
Time	74	77	73	75
1 month	13	14	14	23
3 month	35	40	32	31
6 month	22	20	10	9

Composition of Financial Assets

	% Share			% of GNP		
	1990	1997	1998	1990	1997	1998
Money quasi money	68	67	62	23	49	42
TL	54	40	38	19	30	25
Cash	10	3	3	3	2	2
Demand deposits	13	3	3	4	3	2
Time deposits	31	22	24	12	16	16
Repo	0	12	7	0	9	5
FX	15	27	24	5	20	16
Securities	31	34	35	10	24	25
Public	19	29	33	6	21	22
Private	12	4	5	4	3	3
Total	100	100	100	33	73	67

Source: Turkish Central Bank,1998

Due to the regional convergence the developments in Russia affected Turkey negatively in terms of trade figures. Exports rose to USD 26,9 billion, imports decreased to USD 45,9 billion. The volume of foreign trade amounted to USD 72,8 billion. The foreign account deficit decreased by 15%.The ratio of imports to GNP and the ratio of exports to GNP was 22,5%,13% respectively.By looking to sectors, the manufacturing constituted a 87 % of exports and imports. By commodity groups the exports of intermediate goods constituted the

41% of total exports, where as it was 5% for the capital goods and 3% for consumer goods. For the imports it was 23%, 64%, 12% respectively. [104] %OECD countries take the first place in the trade volume (73%). For the European Union it was 52%. Non OECD country group takes the third degree.

The foreign trade deficit amounted to 14,4 billion dollar.Transfer revenues and invisible accounts increased by 18%, 45% and amounted USD 11,4 billion, USD 5,7 billion respectively.The current account balance improved from 2,7 billion deficit in 1997 to surplus of 2,7 billion surplus in 1998 caused by decline in foreign trade deficit and increase in the invisible income. USD 1,9 billion entered to the related markets through portfolio investment. On the other hand USD 6,4 billion outflow was realized at the end of the year. [105]

TABLE 40.

Foreign Trade(USD Billion)

	1996	1997	1998
Exports	23,1	26,3	26,6
Imports	42,4	48,1	45,9
Foreign trade deficit	19,3	21,8	19
Export/Import	54	55	59

Source:SIS,199

[104] Gürlesel,op.cit., pp. 32-35.
[105] Ibid.

TABLE 41.

Foreign Trade 1998

	Export			Import	
	USD billion	% change	% share	USD billion	% change
OECD	16.910	9	63	33.473	-4
EU	13.437	10	50	24.091	-3
NAFTA	356	-14	1	1.168	-9
Other	3.117	7	12	8.215	-5
Non-OECD	9.972	-7	37	12.448	-9
Europe	3.972	-15	15	4.670	1
Africa	1.817	47	7	1.760	-20
America	234	14	1	724	-5
Middle East	2.336	-16	9	2.214	-31
Other Asia	635	-46	2	2.625	3
Other	979	59	3	454	25
Total	26.881	2	10	45.921	-5

Source:SIS

Balance Of Payments(USD Million)

	1996	1997	1998	
			June	Dec.
Foreign Trade deficit	10.582	15.398	15.772	14.412
Other goods and sev.	14.628	21.273	23.661	26.702
Tourism	5.650	7.002	7.201	7.177
Interest	1.577	1.900	2.090	2.481
Other	7.401	12.371	14.370	17.044
Other goods and serv. Exp.	10.930	13.420	14.534	15.325
Interest	4.200	4.588	4.726	4.823
Goods and serv. Trade	6.884	7.545	6.645	3.035
Transfers	4.447	4.866	5.384	5.727
Current account balance	- 2.437	- 2.679	- 1.261	2.692
Capital Movement	8.763	8.616	11.359	773
Direct Inv.	612	554	518	573
Portf. Inv.	570	1.634	1.902	- 6.386
Other long term	1.636	4.667	5.660	3.985
Short term	5.945	1.761	3.279	2.601
Assets	331	- 1.750	- 1.688	- 1.464
Liabilities	5.614	3.511	4.967	4.065
Net errors	- 1.781	- 2.593	770	- 3.018
General Balance	4.545	3.344	10.868	447
Reserve	- 4.545	- 3.316	- 10.760	- 447

Source: Central Bank

4.2 Features of Turkish Banking Sector

The figure of USD 117,4 billion was realized by the banking sector as a total asset and the sector grew by 24%. The ratio of total assets to GNP was 70%.As of banking groups , 25% of the growth was realized by commercial banks.Following to that figure namely the state-owned and privately –owned banks got the same level of growth.Foreign banks had 16%.

In terms of assets, the share of commercial banks increased from 94,6 to 95,2%.State-owned and private-owned banks had 34,9% and 55,9% respectively.

TABLE 42.

Total Assets as of Banking Groups

	USD million 1998	% Change 1998	1997
Commercial Banks	111582	25	14
State Owned	41012	25	22
Privately Owned	65696	25	25
Foreign Banks	5143	16	15
Dev. And inv. Banks	5547	9	9
Sector	117399	24	14

Source: TBB, 1998

TABLE 43.

The Sector Shares of the Banking Groups(%)

	Total Assets			Total Deposits			Total Loans		
	90	97	98	90	97	98	90	97	98
Commercial Banks	91,2	94,6	95,2	100	100	100	88,1	91,8	91
State Owned	44,8	34,6	34,9	48,6	39,9	40,6	45,4	34,7	29
Privately Owned	13,5	55,4	55,9	49,2	56,7	55,8	39,8	54,4	58,1
Foreign Banks	2,9	4,7	4,4	2,2	3,4	3,9	2,9	2,7	2,9
Dev. And inv. Banks	8,8	5,4	5,8	-	-	-	11,9	8,2	9
Sector	100	100	100	100	100	100	100	100	100

Source: TBB, 98

The share of total deposits in the total assets reached to 66%. Moving towards TL deposits was attributed to deceleration of inflation, the stability in exchange rate and high interest rates. The ratio of TL deposits to total deposits reached to 49%. TL deposits increased by 32%. The share of total deposits in the total liabilities was 76% in state owned banks. It was 67% and 40% for private and foreign banks respectively. [106]

[106] Ibid.

TABLE 44.

Total Deposits(%)

	Distribution			Share in total liabilities		
	TL	FX	Total	TL	FX	Total
Commercial Banks	49	51	100	34	35	69
State Owned	74	26	100	56	20	76
Privately Owned	33	67	100	22	45	67
Foreign Banks	33	67	100	13	27	40

Source: TBB, 98

The share of 1 month and 3 months deposits in TL deposits increased, the share of deposits with a maturity of 6 months and 12 months decreased. For the FX deposits the share eof time deposits with a maturity of 1 month and 6 months increased.

TABLE 45.

Maturity Structure of Deposits(%)

	TL Deposits		FX deposits		Total deposits	
	1997	1998	1997	1998	1997	1998
Demand	23	23	24	25	23	24
Time	77	77	76	75	77	76
1 month	12	14	20	23	16	18
3 months	36	40	34	31	35	36
6 months	24	20	8	9	16	15
12 months	5	4	13	12	9	8

Source: TBB, 98

Non deposits funds increased by 16%. As a result of negative developments in the international market, the funds borrowed from the abroad, which constituted the largest part, slowed down in this period. With an increase of 12% funds from abroad reached USD 8,4 billion. In the second half of 1998 due to the capital outflow of USD 10 billion liquidity decreased and the cost of funding increased respectively. 90% of the funds from abroad was supplied by the private owned banks and the rest by development and investment banks.

TABLE 46. **(Source: TBB, 98)**

Selected liabilities of the Banking Sector

	USD million	% Change	% Share 1997	1998
Total Deposits	77.097	26	65	66
TL	38.122	32	30	32
FX	38.975	20	35	33
Non-dep. Funds	18.218	16	17	16
TL	3.846	57	3	3
FX	14.372	8	14	12
Other Liabilities	11.595	32	9	10
Shareholders' equity	6.786	11	6	6
Total Income	3.703	32	3	3
Total Liabilities	117.399	24	100	100
TL	61.932	32	49	53
FX	55.466	15	51	47

The current year income of the only profit making banks in the sector reached USD 3,6 million, increasing by 31%. The current year losses of the sector increased by 1936% and amounted to USD 1,259 million. The total losses rose USD 1,764 million. As a result the consolidated current year net income of the banking sector increased only by 2%. On the other hand net income increased by 18% state owned commercial banks, 27 % in privately owned commercial banks, 47% foreign commercial banks, 76% in development and investment banks. Although there are increased risks, widening open positions at a high rate was one of the important factors that contributed to the profitability of the banking sector. The open foreign exchange position in the sector reached USD 8,353 million increasing by 68%. All the banks increase their open foreign exchange positions due to the continuing domestic borrowing, decreasing trend in the inflation, the high level of real interest rate, tightening in the foreign trade volume due to slowing down in the economic activity and improvement in the current account balance.

TABLE 47.

Net Income and Loss(USD million)

				% change		
	Net Income	Loss	Total	Net Income	Loss	Total
Commercial Banks	3374	1258	2116	28	212	-5
State Owned	351	104	248	25	46	18
Privately Owned	2735	1154	1581	27	248	-1
Foreign Banks	289	1	288	47		-47
Dev. And inv. Banks	307	0	307	76	-98	109
Sector	3681	1259	2423	31	193	2

Source:TBB, 98

A noticeable deceleration in the inflation, the stability maintained in the foreign exchange rates and high real interest rates had all affected the preferences of the deposits to the TL side. The TL deposits increased by 32%, which was higher than an increase in FX deposits of 20%. The ratio of TL deposits to total deposits reached to 49% by increasing 2% points and the e ratio of TL deposits to total liabilities increased from 30% to 32%. TL deposits increased by 39% in the state owned banks, 26% in privately owned banks but decreased by 12% in the foreign banks. While the open foreign exchange position of banks was expanding, the share of FX liabilities in the total liabilities realized as 47% by decreasing 4% points. The share of FX assets in the total assets decline to 40% by decreasing 5% points. The main reasons behind this development were the increasing demand on TL deposits compared to the FX deposits and the real increase in repo transactions, confidence to the monetary policy that followed by Central Bank, slowing down of the foreign trade operations. [107]

TABLE 48.

Currency Structure and FX Positions of Sector

	Liabilities(%)		Assets(%)		FX Position(USD million)	
	1997	**1998**	**1997**	**1998**	**1997**	**1998**
Commercial Banks	50	47	44	39	- 5.078	- 8.453
State Owned	29	24	30	24	203	- 216
Privately Owned	62	59	53	48	- 4.481	- 7.544
Foreign Banks	61	63	43	50	- 800	- 693
Dev. And inv. Banks	64	59	66	60	112	98
Sector	51	47	45	40	- 4.966	- 8.353

Source: TBB, 98

Total loans which have the largest share in the total assets, decreased in the second half of the year due to the rapidly increasing real interest rates, slowdown in the economy, increasing needs of liquidity due to the limited foreign borrowing. The growth rate of the loans slowed down from 20% to 5%. While the loans increased by 11%, TL loans declined by 2%.

The main reason behind this development was the transfer of USD 5,4 billion recorded in the Ziraat Bank's agricultural loan account to special duty accounts in the other assets in October.This amount was equal to the 12% of the total loans on that date. On the other hand total loans increased 14% in the privately owned banks and 12 % in foreign commercial banks. The share of total credits in the total assets decreased to 38%. This ratio decreased 15% points and realized as 31% in the state owned commercial banks.

[107] TBB. Turkish Banking Sector, www.tbb.org.tr/194.133.171.194/bankingsystem.html,1998

TABLE 49.

Selected Assets of the Banking Sector

	1997			1998
	USD Million	% Change	% Share	% Share
Liquid Assets	38.074	20	33	32
TL	16.191	35	13	14
FX	21.883	11	20	18
Total Loans	45.019	5	45	38
TL	22.269	-2	24	19
FX	22.750	11	21	19
Permanent Assets	9.237	46	7	8
Other Assets	25.069	85	15	21
Total Assets	117.399	24	100	100
TL	70.285	36	55	60
FX	47.113	10	45	40

Source: TBB, 98

Net interest income, which made the most important contribution to the income, increased by 44%. Besides this improvement interest expenses rose by 41%. In the interest income the share of interest income on loans decreased from 61% to 46% and the total share of other interest income increased from 8 % to 23%. While the net interest income increased, net non-interest income continued to stay lower. The main reason was the increase in the FX transactions from the enlarging open position both in the balance sheet and off –balance sheet items. Net FX transaction loss reached USD 2,8 million increasing by 49%. On the other hand non-interest expenses increased by 58% due to the increase in the personnel expenses. The share of it was 42%. The ratio of interest income over the average assets was improved by 1,6% point and reached 9,4%. This ratio increased from 3,2% to 4,2% in the state owned banks, 10,3% to 11,7% in the privately owned banks.

TABLE 50. (TBB, 98)

lected Items from the Income Statement(USD million)

	1998			% Change		
	State	Private	Sector	State	Private	Sector
rest Income	13.499	18.045	34.183	39	48	44
rest expenses	11.837	7.867	23.126	38	52	41
vision for non-perf	126	960	1.099	66	362	269
rest income after p	1.536	6.907	9.958	47	39	43
1-interest income	602	- 301	144	1	-6	2
1-interest expenses	1.656	3.824	6.007	34	72	58
ome before tax	482	2.783	4.094	18	14	23
provision	235	1.202	1.671	17	94	75
ome after tax	248	1.581	2.423	18	-13	2
int. Inc./Avg. Tot.	4	12	9			

Return on average assets declined. The ratio for the sector decreased from 2,7% to 2,3%. The return on average assets remained the same at 1% in the state owned banks and decreased from 3,8% to 2,7% in the privately owned commercial banks. However the same ratio was from 5,7% to 6% in the foreign commercial banks and from 2% to 5,8% in the development and investment banks.

TABLE 51.

'rofitability Ratios(%)

	Return on Average Assets			Return on Average Equity		
	1996	1997	1998	1996	1997	1998
ommercial Banks	3,1	2,6	2,1	50,9	43,8	36,4
tate Owned	0,7	0,6	0,7	17,6	14,2	16,2
rivately Owned	4,6	3,8	2,7	63,8	54,1	39,9
oreign Banks	5,5	5,7	6	63,6	80	103,6
ev. And inv. Banks	3,7	2,9	5,8	58,4	29,8	47,5
ector	3,1	2,7	2,3	51,4	42,5	37,5

Source: TBB, 98

By The end 1998, excluding Central Bank, the number of banks operating in the sector increased to 75.Of these 60 are commercial banks and 15 are development and investment banks. Of the commercial banks, 18 of them are foreign owned banks, 38 of them privately owned, 4 of them state owned banks. Of the development and investment banks, 3 of them are state owned 9 of them private and 3 of them are foreign banks. In 1998 the number of branches reached to 7370 by increasing 8%. A significant increase observed in the privately owned banks. In this group total number of branches which was 3764 in 1997 reached 4393 in 1998 by increasing 629.The number of bank employees increased in 1998 according to the increase in the number of branches. It was 4 % from 154,867 to 166,492 in 1998. 43% of the employees were employed by the state owned commercial banks, 52% by the privately owned commercial banks, 2% by the foreign banks and 3% by the development and investment banks.

4.3 EFFECTS OF EMU AND EURO ON TURKISH BANKING SECTOR

With out a doubt, not directly but indirectly the introduction of EMU will affect Turkey's Financial and Banking Sector. Although it's hard to assess the possible effects of EMU on banking sector, the international effects of EMU will be useful for the analysis.

As it's known, as a value of transaction the Deutsche Mark is used commonly in Turkey. It wouldn't be wrong to say that the Euro will take the functions of Mark after its introduction. On the other hand the Euro's performance and its stability will be important for this criteria. During this period especially among small investors, there can be an increase in demand for dollar.[107]

After the issuing of Euro and abolishment of mark, some costs will rise according to transportation and exchange.[108] In this context, during the transitional period financial institutions have to face some operational costs. There can be personnel training, harmonizing the accounting system and computer system, conversion of financial assets to the Euro basis. These costs probably effect the profit levels of the financial institutions.

After the introduction of Euro the transactions of currency exchange, hedging operations, intra-trade operations between member states naturally will be ended. On the Turkey side, probably by abolition of these operations the banks and financial institutions will not affected too much as a result of lack of competitive power of banks on both finance and foreign trade operations. [109] The introduction of the Euro will make its effects not only in countries belonging to the European Union but also in countries outside the Union which have close trade or financial ties with the Union. The emerging market countries having close and extensive economic and financial relationship with the European Union will probably be affected most of all. For the effects of the Euro on emerging market economies, it can be said that the magnitude of such effects depends mainly on, first their share in trade relations; second the intensity of financial transactions; and third the size and currency composition of their external debt.

---

[107] Emerging Markets Quarterly' Europe Middle East and Africa, Credit Suisse First Boston Economics Research Jan 99, pp. 73-79

[108] Ibid.

[109] Ibid

For the short term the impact of the Euro on the emerging market countries will not be great. But in the medium term, stability in EMU combined with expected large cross border transactions and increased competition within Europe should present these countries with several opportunities.

An integrated' deeper, more liquid European securities market would be attractive to debt managers and has the potential to strongly affect debt management.[109] The current financing habits of emerging economies make heavier use of the Euro by debt managers likely. As a matter of fact the currency composition of the emerging markets' debts shows a larger share for the U.S. dollar and Japanese Yen than for the European currencies. But if there were a broader, deeper and more liquid European bond market debt managers outside Europe would be interested in increasing the proportion of their debt denominated in Euro.

The structural changes resulting from the introduction of the Euro will definitely affect Turkey in the medium term even though Turkish participation in the EMU is not yet an issues. On the other hand occupying such a strategic location as the bridge between Europe and Central Asia it is impossible for Turkey to reject integration into the globalized world economy. This trend can give Turkey a good opportunity to obtain a larger share of the international capital flows resulting from the introduction of the Euro.[110]

Provided that the Euro is accepted by international financial markets as a stable reserve currency, the Euro's share in Turkey's financial accounts would increase further.Probably it will take less time for the Euro to be accepted in Turkey daily life and financial transaction than n in other countries.Euro bond market will provide an opportunity to Turkish sovereign and private bond issuers. In addition the volume of transactions in the Euro bond market is expected to be much larger than today.

A larger acceptance of Euro for trade and financial transactions in Turkey of course in combination with a low inflationary environment will make direct investment opportunities in Turkey more attractive to European firms. Under these circumstances one can expect an increasing trend for both Turkish and European banks to increase their merger and acquisition activities,As it becomes more deeply integrated with the European financial markets the Turkish Banking system will face new competition. But the dynamism of Turkish banks with

---

[109] P. Hartmann, The Future of the Euro As an International Currency, Center For European Policy Studies, Brussels, 1996

[110] Economic and Fixed Income Research, Investment Review West LB Research 1st quarter of 99, pp. 53-58

the high technology' electronic infrastructure, better quality services will be attractive to European counterparts.

For Turkey to benefit these advantages and decreasing the negative effects of EMU some actions have to be taken in the Banking Sector.

In the sector, the role and share of public is so heavy. After transforming the free market economy, this trend continued. In addition to that collection of official deposits in the public banks increases the imperfect competition in the sector. This prevents the banks from overtaking additional risks and paying attention to the risk management.[110]

On the other side, in EU the share of public banks' are so limited. This increases the efficiency and competition in the sector, especially in UK, Belgium. [111]

Also there are some efforts in privatization of public banks in EU. The high share of public definitely decreases the competition power and efficiency.

In Europe, the main type of banking system is retail banking system that assisted by international banking. [112] There are various kinds of banks such as saving, mortgage banks. In Turkey the lack of international banking causes disadvantage in competing with European banks. Besides, development and investment banks are also operated by public in Turkey. This decreases the level of competition. [113]

By the introduction of Euro and financial integration, most of the European Banks had strengthen their financial bodies and saved competitive power in the sector. This is achieved by acquisitions and mergers activities.

In Turkey, financial body and scales of the banks are so behind the European banking system. There are some merging activities between public banks. In reality, this is done for rescuing purposes. At this point privatization process is so vital. In private banks, which is mostly owned by big group firms, there are also some merging activities but resulted ineffectively.

From the view of competition the comparison of profitability should be done between to banking sector. In Turkey net interest income / total assets ratio is so high.[114] In the net non interest income is greater than the non interest expenses. In the EU both these items are so close to each other and the margins are very narrow. The personnel expenses are also very

---

[110] The Central Bank of Turkey, EMU, www.tcmb.gov.tr./emu/ing.html

[111] Yener Altuntas & Ayhan Sarisu. Avrupa Birligi Sürecinde Türk ve Avrupa Bankacilik Sistemlerinin Karsilastirilmasi, Istanbul:TBB,1993,pp 29-57-42-35

[112] Ibid.

[113] Bikker and Grooneveld. Competition and Concentration in the EU Banking System, De Nederlandsche Bank Research Series Supervision Vol.8 1998

[114] Ibid.

high compared to EU. This is because of the personnel surplus and inefficiency in work performance not due to the high wages.

The ratio of total assets to number of branches is also low in Turkey. This is due to high number of branches and poor capital structure and causing to decrease competitive power of banks.

EMU will also have effect on trade figures.[114] The size of World GNP is shared by Euro zone countries (18%), USA (18%), Japan (11%) respectively. From this point of view, the share of EU in World economics is fairly important. From the foreign trade figures it can be said that EU has 20%, USA has 16%, Japan has 10%.

Turkey has an increasing portion of trade transactions with EU since 1980s. In 1998, the share of EU in total exports was 50,1% for EU members, 41% for monetary union member states. Roughly, this is equal to 5,4% of Turkish GNP.The side of imports have the same trend with exports. It was 52,4% for EU members and 43,3% for EMU members. [115] It is 9,7% of Turkish GNP. European Union countries are the most important partners of Turkish foreign trade. In EU, more than 60% of foreign trade took place by means of intra-trade transactions. Trade figures show that Turkey has 3,1% of exports of the Union. For imports it was 1,8%. [116]

The value of Euro against Dollar and yen will determine the effect of EMU on Turkish economy. In case of appreciating of Euro, the revenue from exports will increase where as imports will decrease.

From the study done by IMF (1998), a 1% increase in Euro area GDP will cause 0,1% and 1% for total production volume and total export volume respectively. For example in Hungary and Tunisia this will have greater impact on above mentioned figures that are realized. The effect of EMU on trade figures will be determined by

- Political and economical stability in Turkey
- Applying of necessary strategies by Turkish firms in order to increase competitive
- Strategies that will be applied in Euro area
- The stability of Euro
- Demand elasticity of Turkish exports by Euro countries

---

[114] Jacop Frenkel, Monetary Policy In an Emerging European EMU: Key Issues, IMF Working Paper WP/90/73

[115] Hazine Müstesarligi Parasal Birlik, Avrupa Para Birligi ve Türkiye, Hazine Müstesarligi Ekonomik Arastirmalar Genel Müdürlügü, Ankara:1999,pp127-140

Changes in the Euro against the dollar and yen affect the competitiveness. It could have important effects on external debt. For example an appreciation of the Euro would decrease the domestic currency cost of debt service. Also a depreciation of the Euro would increase domestic currency cost of debt service. In order to avoid these effects Turkey like all the developing countries should adjust its exchange rate regimes. As the Euro becomes widely used in trade and financial markets, it is likely to account for a larger share of debt securities, so that countries choosing to peg to the Euro on account of their extensive trade lies will be able to reduce their exposure to changes in their dollar dominated debt payments.

Euro may tend to increase capital flows to emerging markets like Turkey.Deeper and more liquid capital markets in Europe will lower borrowing costs both for countries in the Euro area and for countries raising funds through Euro dominated instruments like Turkey.Secondly, Euro will allow Euro area institutions such as insurance companies and pension funds to shift some of their portfolios into Turkey. As a next point, Turkey can benefit from direct and portfolio capital inflows if the convergence of assets returns in Europe leads global investors to increase their emerging market shares. From the point of emerging market economies like Turkey, Euro also carries financial market risks for emerging market countries. A successful Euro that raises productivity and growth could make Europe more attractive for investors and tend to increase the cost of capital for emerging markets economies. In addition to that increased competitiveness of European financial institutions and the greater depth of Euro area financial markets could lead firms in developing and transitions countries to raise funds in euros rather than domestic currency, which could challenge to development of domestic capital markets.[115] Thus Euro provides further incentive for countries to strengthen financial intermediation and banking system.

Overall, increasing costs result in loosing blood in competitive power with European Banks. The number of branches should be decreased to its optimum level. [116] Especially the branches with low transaction volume and rate of return have to be eliminated. In addition to that for decreasing high management cost, the number of working people in public banks should be lowered in order to provide efficiency in services.

The cost of services and credit rate of services have to be decreased by means of lowering deposit reserve rates This rate shouldn't be used for monetary policy purposes. The

[115] H.W. Buiter, The Economic Case for Monetary Union in the European Union, Review of International Economics, 1997

[116] Mehmet Sükrü Erdem, Avrupa Iç Pazari ve Türk Bankacilik Sistemi Sorunlar ve Öneriler, Ankara,TBB, 1993 ,pp61-65,70-76

composition of short term deposits can be moved to al long term one so those banks won't suffer from short run liquidity problem. Strengthening of capital structure is an another important point in order to compete in international market. For this reason small banks can get in to merging activities with others just like in Spain and Greece.

Public banks have the nearly 50% of the baking sector. [117]This causes inefficiency and heaviness in services and transactions. Privatization can be a solution for this. In Europe banks have more range of services than in Turkey. In Turkey it is so limited. There are more than 150 types of different services in Europe where as it is about 40 in Turkey. Firstly financing of foreign trade and international banking is very important at this respect. For those reason services such as factoring, leasing will be very important. Also the options, future and swap markets should be used effectively. Before managing this activities, the legal and accounting arrangements have to be realized by constructing efficient background.

[117] Ikibinli yillarda Turk Bankacilik Sektoru, TBB Haziran 1999,pp.10-11-12-14

5.CONCLUSION

European Union member states represent one of the world's strongest economic areas in term of GDP, with the largest volume of foreign trade and payments. 30% of global GDP is generated in Europe and 20% of world trade relates to Europe.The share of international bonds issued in EU countries is today at 35%, second only to U.S. dollar with 38%. The statute of the ECB points to a policy of a stable Euro which together reduced fragmentation of European capital markets will make the Euro more attractive than the sum of the national currencies today.The Euro will attract the attention of international institutional investors more than the previous national currencies.

Equity markets will become more transparent. The presently fragmented national equity markets which are limited by national regulations will develop. The European equity market has the strongest potential in the future currency area with the growing consolidation of financial centers.

Currency risks will be moved away.Greater transparency of the single market and intensified financial communication will be leading issue.Market forces will lead to harmonization of national regulations and stimulate European equity market integration.

Its commonly agreed that EMU will affect the degree of competition in the banking sectors of member states by means of increased Disintermediation, cross border competition. These tendencies may put banks' profitability downward pressure and leading to restructuring. In recent years, European banking system is faced with increased competition pressures, which is resulted from loosing of some legal regulations, abolishing of some restrictions on capital movements. This caused to decrease in interest rate margins and profitability ratios. On the other side, The Euro will be an actor in increasing the competition in the sector. Euro will abolish currency risk and will harmonize the interest rate margins between member states.

During the transitional period need for consultation, reconstructing the computer system, personnel training will increase additional costs. After abolishing of member states' currencies, the demand for foreign currency transaction by the firms will decrease respectively. This will be reflected to the institutional and investment banks, so they can loose some part of their source of income.

Increasing pressures in competition and costs will cause restructuring for banks in order to not too affected from decreased profits. Banks will increase their efficiency and try to lower their expenses some merging and take over activities can be observed naturally. Small and middle sized firms shall speed up their merging activities. Widening of electronic service network, more efficient and qualified service to customers will help catching up the international and global markets. By merging activities, employment figures can change. But, in Europe employment law rigidness and state control over these issues can slowdown this trend for some time.

Big firms in Europe are demanding European wide banking services. After the introduction of EMU small firms can also demand services like this, so there can be hard competition between strong regional banks and European banks that are aimed to increase their market share. Besides, huge financial institutions which are engaged in vertical an d horizontal integration can compete in this potential market.

Restrictions in entering in to Euro market can go down which is faced by international huge finance institutions. For increasing price, wide delivery network advantages merging activities can take place that mentioned before. Global banks, which are experienced in investment banking, will facilitate from EMU.

Decrease in the number of intermediary banks will increase competitive powers. Target System will be used for only huge amount Euro transactions. For this reason small banks and firms will demand for other banks' electronic banking services. In addition to that banks will increase their attention to new products and widening their range of products. But large amount of capital and sufficient experience is needed for realizing investment banking. So the global competition can be observed. Huge banks try to hedge their risks by corporating with pension funds and insurance companies.

For Turkey it can be summarized as follows.(It is also true for European banking side)

- Co-operation between public authorities, banks, firms and trade institutions that provide a long term point of view to the sector
- Flow of financial information, management methods from banks to middle and small sized firms
- In the sector, big banks should take part in self arrangement mechanism so independent auditing institutions will have importance in this respect
- Merging activities between small size banks.Privatization program can be wise in this context.One bank can't operate in all kind of international finance center, so markets can be shared and Co-operation between domestic banks can ease the access to foreign markets
- Attraction of foreign capital by improving the quality of finance center
- Abolishment of intervention of public banks to the sector

- Decreasing the costs to the International level
- Improvement in electronic banking
- Improvement in human resources quality by means of training programs, improvement in working conditions

In conclusion, by Disintermediation, The EMU will increase the attractiveness of repos, bonds as an asset for the non financial sector. Banks may need to attract more costly way of financing. Disintermediation can increase attractiveness of commercial papers, bonds to companies relative to bank loans. It can be said that this will affect the banks' comparative advantage in the longer term.

There could be an increased competition across border and from outside the Union for other types of non interest income. By cross border banking competition, size of deposits can increase. On the other hand partly for small borrowers this competition will be in a limited way. Also the technological development in remote and Interbank banking will be very important and will effect competitive power.

On the other hand, macroeconomic conditions and changes in the sector can affect banks adversely. Euro banks can face with downward pressure in interest margining that can be caused by lower inflation in member states. EMU can reduce non interest income sources such as foreign exchange transactions and trading. Daily volatility can be decreased by the introduction of EMU. Some degree of segmentation can be observed in banking sector, which is caused by regulatory, legal , fiscal barriers as well as differences in consumer preferences.

In conclusion, Emu will stimulate cross border trade and will increase the integration and liquidity of European equity markets. Banks especially big European universal banks that are already well prepared for EMU will benefit from the upcoming cross border business.The independent status of the future ECB, the strict mandate to ensure the price stability and the regulatory environment will be helpful to a strong and stable Euro.

Further integration of the banking systems will depend on the degree to which the remaining fiscal and regulatory differences across countries are removed.It includes, taxation,subsidies and other fiscal issues related to financial services' definition and legal protection of financial instruments and contracts.The more these differences are reduced the faster the Euro will have the anticipated effects.

It is likely that the Euro area banking systems will continue to become more integrated and that banking competition will increase more and more.These effects will differ between different banking activities. Money market, asset management and corporate finance services are likely to take on an area wide dimension. The development of integrated money and capital markets and the evolution of cross border bank-customer relationship will affect the emergence of Euro area wide market in certain banking activities.

For Turkey all these can be done in a certain period of time. High costs, decreasing in efficiency and profitability is resulted from instabilities in macroeconomic figures. So decreasing public deficit and inflation will prevent the price , interest and exchange rate balances from changing in a negative way. For this very important reason, main concern is have to be imbalances in economic structure.

From this point of view harmonizing to the EU macroeconomic criteria's will diminish the negative effects of EMU and increase the competitive power of all sectors as well as the banking. The decrease of currency risk and interest rates by the introduction of the Euro will diminish the transaction costs . Also The Turkish Central Bank has already begun investigating the possibility and the feasibility of connecting with this system.Maybe in the coming days connecting the Turkish RTGS system to TARGET by some form of access will enable both parties to realize better management of their funds with all the advantages of RTGS system.In addition to that of course EMU will have great impact on banks' profitability. So banks in Turkey should seek for adaptation to the newly created environment by means of organizational changes, new products and services,mergers,strategic alliances,co-operation agreements .

So Turkey should adapt this newly created environment and strengthen her economy by strong and stable policies in order not to adversely affected by the new international monetary system. Otherwise it wouldn't be possible to use the favorable conditions that are created by European Monetary Union.

REFERENCES

1. AB Danismanlik ve Yatirim, Economic and Monetary Union, Expectations and Possible Effects, Istanbul,1998
2. Alparslan Melike, European Central Banks System, Journal of Bankers, 1996,Vol.19
3. Altunbas Yener and Sarisu Ayhan, Avrupa Birligi Sürecinde Türk ve Avrupa Bankacilik Sistemlerinin Karsilastirilmasi, Istanbul: TBB,1996
4. Bandt Oliver and Davis E. Philip, A Cross Country Comparison of Market Structures in European Banking, European Central Bank Working Series Vol. 7, Sept. 1999
5. Bikker and Groonveld, Competition and Concentration in the EU Banking Industry, De Nederlandsche Bank Research Series Supervision Vol.8,1998
6. Borchardt Dr. Klaus Dieter, Integration of Europe, Ankara: European Commission Turkey Office, 1996
7. Buiter, H.W., The Economic Case For Monetary Union in the EU, Review of International Economics,1997,pp. 20-33
8. Cassard, Marcel, ERM Money Supplies and the Transition to EMU, IMF Working Papers, WP/94/1
9. Central Bank of Turkey, Banking Sector In Turkey, www.tcmb.gov.tr/yeni/banka/html,1998
10. Central Bank of Turkey, EMU, www.tcmb.gov.tr/emu/ing.html, 1998
11. Deutsche Bank, Turkey Global Head of Emerging Market Research, April 1999
12. Dis Ticaret Müstesarligi, Economic Effects of EMU, World Economy Bulletin, Ankara: 1998
13. Duisenberg, A.J. George and Dr. Lawrance H. Summers, The Euro is Coming,How Will It Effect the Rest of the World, www.amue.if.net/q-a-7/global24/conf-10htm
14. Duisenberg, A.J. George and Dr. Lawrance H. Summers, The Euro is Coming,How Will It Effect the Rest of the World, www.amue.if.net/q-a-7/global24/conf-3htm
15. Economists, A Survey of EMU 1998, London,1998
16. Economic and Fixed Income Research, Investment Review West LB Research Department, First Quarter of 1999
17. Effects of EMU on Foreign Trade, www.foreigntrade.gov.tr/AB/Ab%20sayfası/euroası/kitap.html
18. Emerging Markets Quarterly, Credit Suisse First Boston Economic Research Department, January 1999
19. Erdem Mehmet Sükrü, Avrupa Iç Pazari ve Türk Bankacilik Sistemi Sorunlar ve Öneriler, Ankara: TBB,1993

20. European Central Bank, A Stability Oriented Monetary Policy Strategy for the ESCB,October 1998, Frankfurt
21. European Monetary Institute, The Single Monetary Policy in Stage Three: Elements of Monetary Policy Strategy of the ESCB, February 1997, Frankfurt
22. European Commission, Report on Convergence and the Recommendation with a view to the Transition to the Third Stage, EC 1998
23. European Commission,Key Figures: Bulletin of Economic Trends in Europe, 1998: European Commission
24. European Banking Federation, Economic Figures of European Union Countries, fbe.be/f-e-new.htm,1998
25. European Monetary Institute, The Single Monetary Policy in Stage Three: General Documentation on ESCB Monetary Policy, 1998
26. European Commission, The Implications of the Introduction of the Euro for Member and Non-Member Countries, EuroPapers Vol.26
27. European Commission, Economic Policy in EMU, Part A Rules and Adjustments, Economic Papers, no:124,1997
28. European Commission, Economic Policy in EMU, Part B Specific Topics, Economic Papers, no:125,1997
29. Euro and Turkey, www. treasury.gov.tr/yayın/euroapo/er-b8.html,1998
30. Feldman, R., Impact of EMU on Selected Non-European Union Countries, IMF Occasional Papers, No:174
31. Folkerts, Landau, The European Monetary System in the Context of the Integration of European Financial Markets, IMF, Occasional Papers, No:73
32. Frenkel, Jacop, Monetary Policy In an Emerging European Economic and Monetary Union: Key Issues, IMF Working Papers, WP/96/108
33. Funke, N., International Implications of EMU, OECD Working Paper No:174, Paris,1997
34. Galy, Michel, Implementation of Monetary Policy in EMSS Countries Participating in the Exchange Rate Mechanism, IMF Working Papers, WP/92/87
35. Gedikkaya Türkkan and Gürler Cihangül, Monetary Union In European ,Journal of Bankers,1998, Vol.24
36. Guitian, Manuel, Coordination in the European Monetary System, IMF Occasional Papers, No:61
37. Gürlesel, Can Fuat,Turkey The Year In Finance 97-98, İstannbul,1998

38. Hartman, P., The Future Of the Euro as an International Currency, Center for European Policy, Research Report No:20, Brussels, 1996

39. Hazine Müstesarligi, Parasal Birlik Avrupa Para Birligi ve Türkiye, Hazine Müstesarligi Ekonomik Arastirmalar Genel Müdürlügu, Ankara: 1999

40. Gert- Jan Hogeweg, General Aspects of European Monetary Integration, Frankfurt: 1998

41. International Financial Outlook, Barclays Economic Department, August 1999

42. Iktisadi Kalkinma Vakfi, Weekly Bulletin Vol.20, İstanbul:1998

43. Iktisadi Kalkinma Vakfi, Kirk Soruda Ekonomik ve Parasal Birlik, Istanbul:1998

44. Journal Of Bankers, European Single Currency:Euro Vol.19, İstanbul:1996

45. Key Indicators of The Monetary Union,Eurostat Press Releases Vol.3199,3099,1.16,1998

46. The Potential Effects of EMU, www.ny.u.edu/globslbeat/emu/EC 0329528.htm,1998

47. Masson, Paul, Characteristics of the Euro,the Demand for Reserves and Policy Coordination under EMU, IMF Working Papers, WP/97/58

48. Masson, Paul, EMU and International Monetary System, IMF Working Papers, WP/97/11

49. Mongelli, Francesco, The Effects of the EMU on National Fiscal Sustainability, IMF Working Papers, WP/96/72

50. Project Finance Monthly Journal, The Euro, January 1999, pp.25-27

51. Prati, Alessandro, EMU and International Capital Markets: Structural Implications and Risks, IMF Working Papers, WP/97/62

52. Ricci, Luca Antonio, EMU and Exchange Rate Variability, IMF Working Papers, WP/98/50

53. Salvotore,D.,The European Monetary System: Crisis and Future, Open Economies Review, 1996

54. State Institute of Statistics,Figures Turkey, www.die.gov.tr,1998

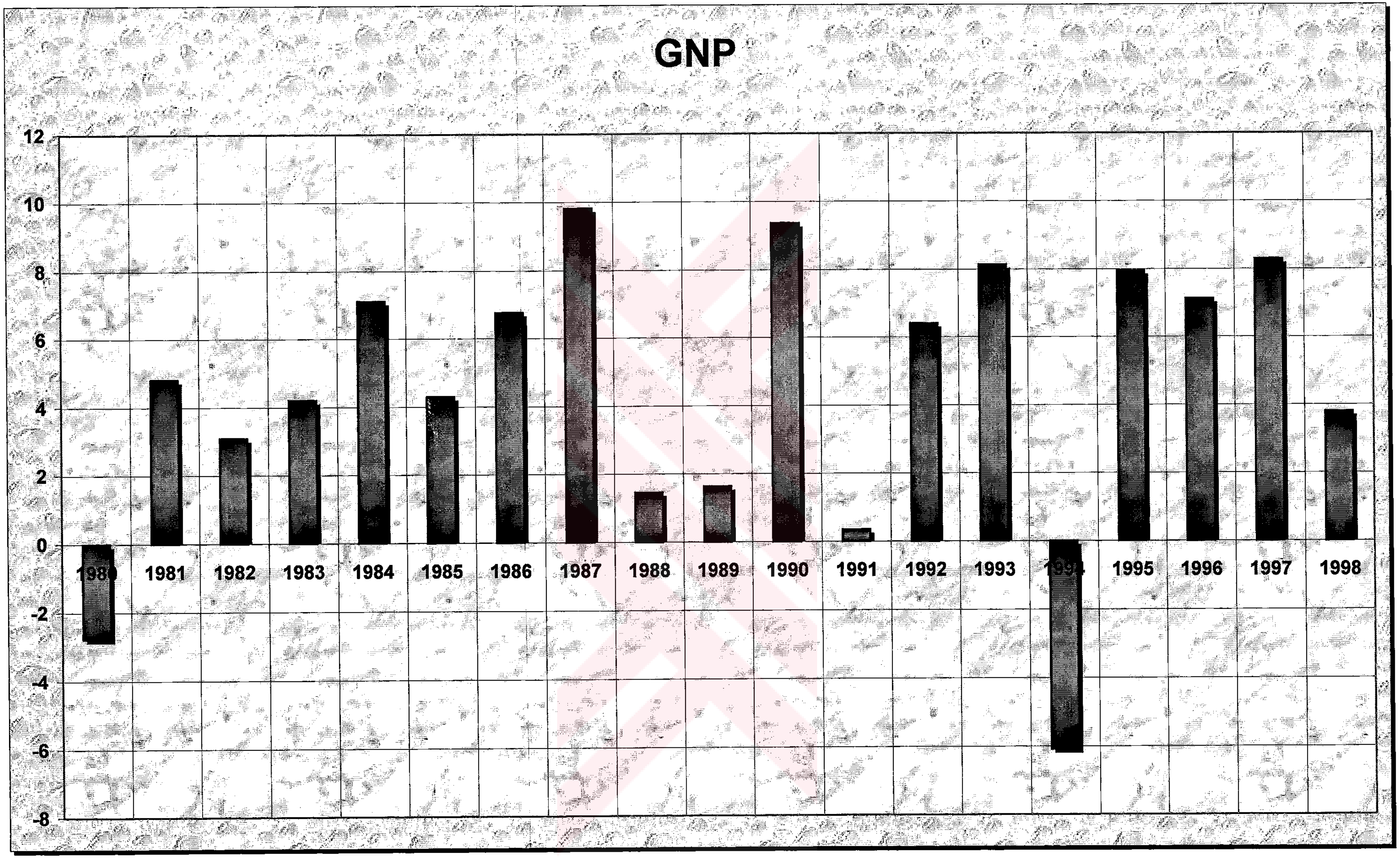
55. TBB, Ikibinli Yillarda Turk Bankacilik Sektoru, Haziran 1999, pp.10-11-12-14

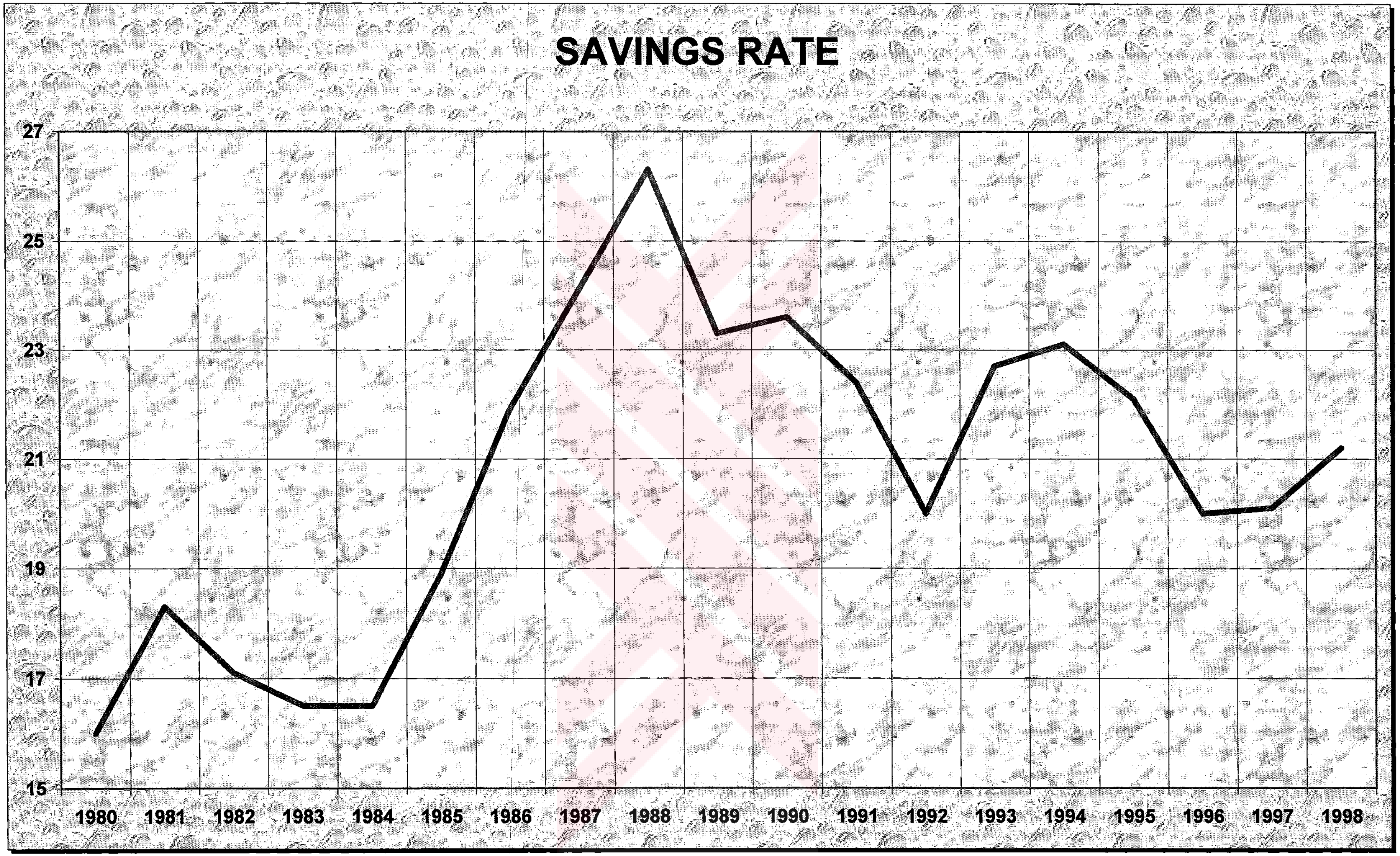
56. Turkish Banking Sector, www.tbb.org.tr/194.133.171.194/bankingsystem.html ,1998

57. Ungerer, Horst, European Monetary System: Developments and Perspectives, IMF Occasional Papers, No:73

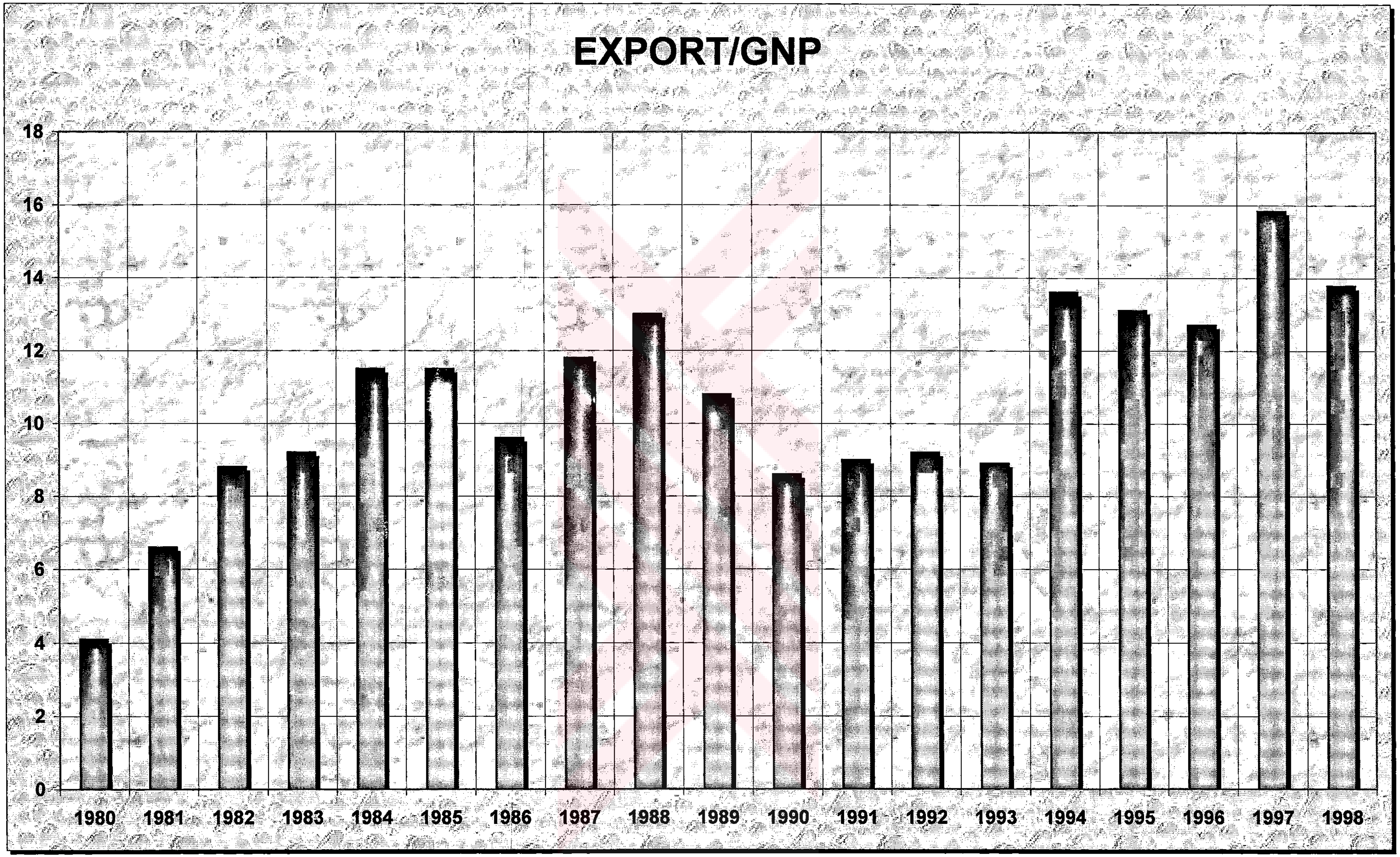
58. Ungerer, Horst, The European Monetary System: Recent Developments, IMF Occasional Papers, No:48

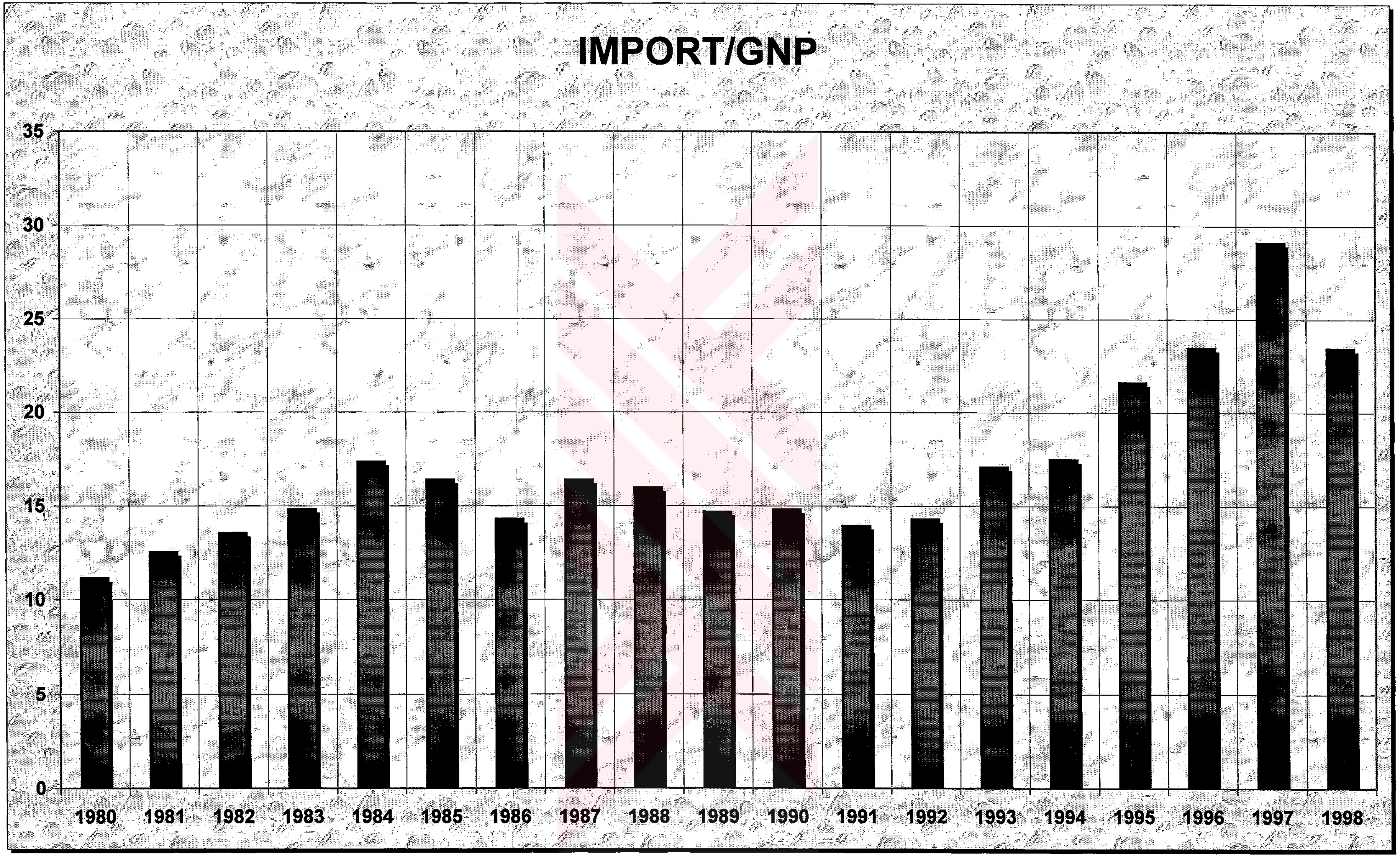
59. World Economic and Financial Surveys, World Economic Outlook, New York : October 1998

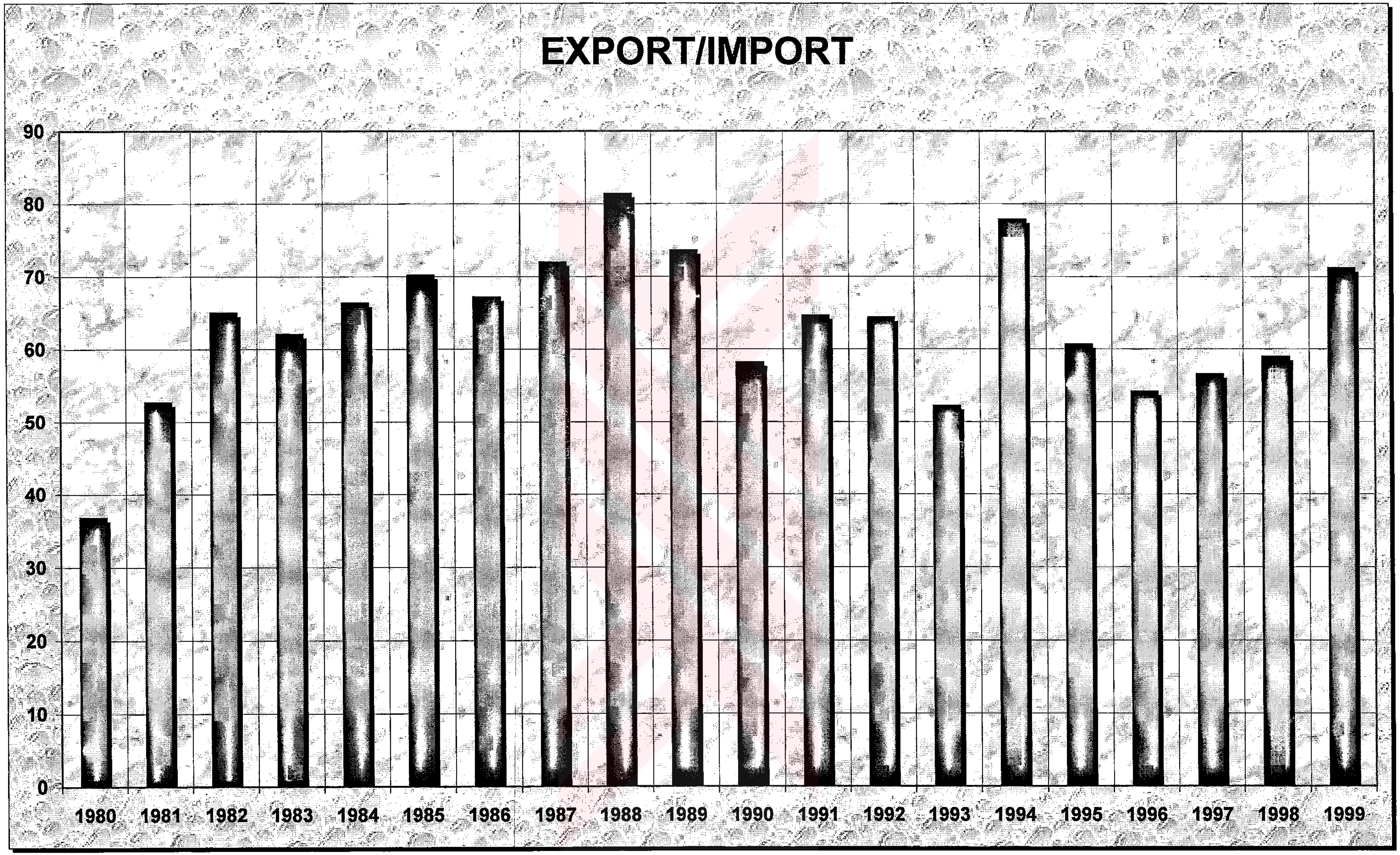

GNP
12
10
8
6
4
2
0
-2
-4
-6
-8
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1995
1996
1997
1998

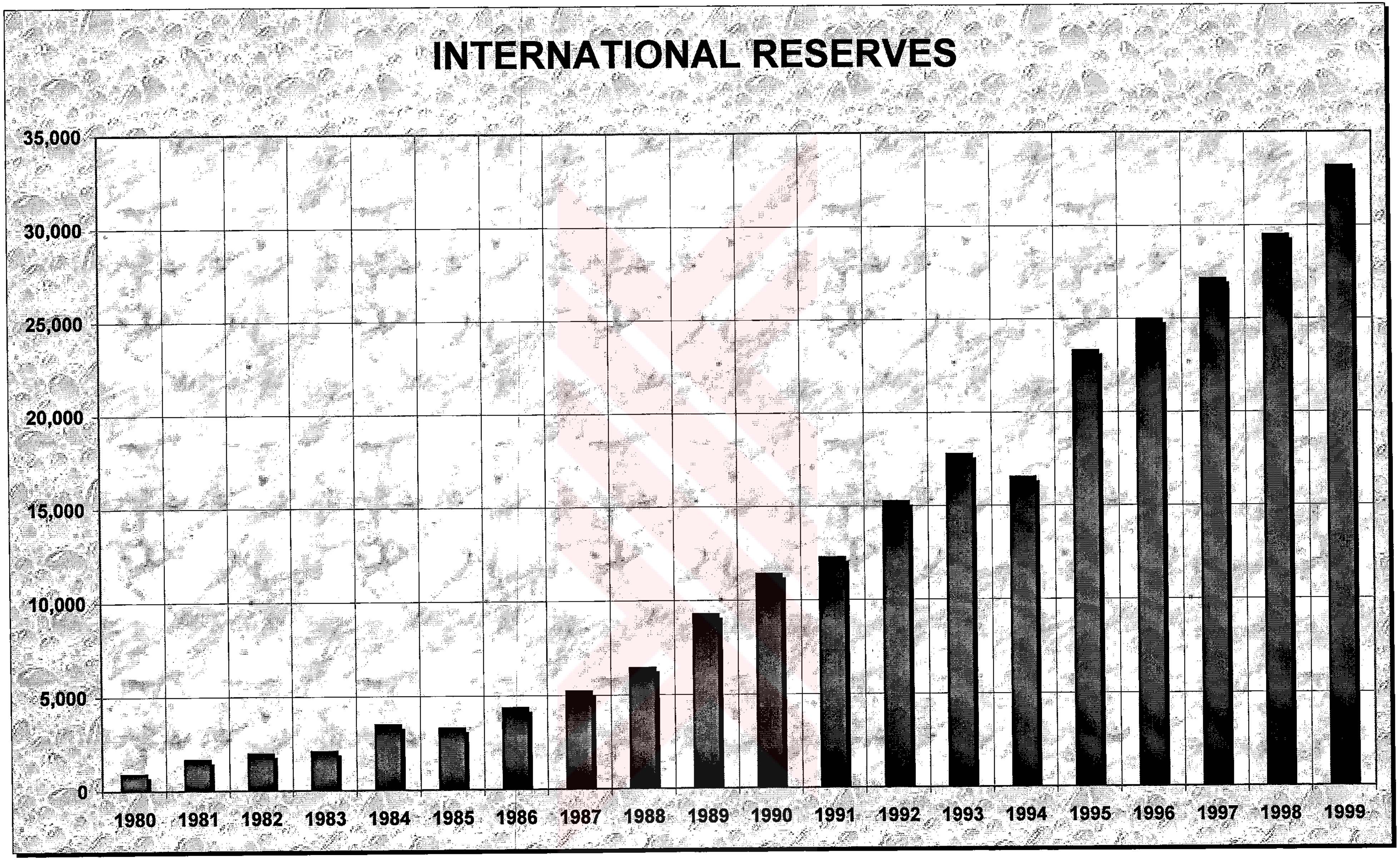


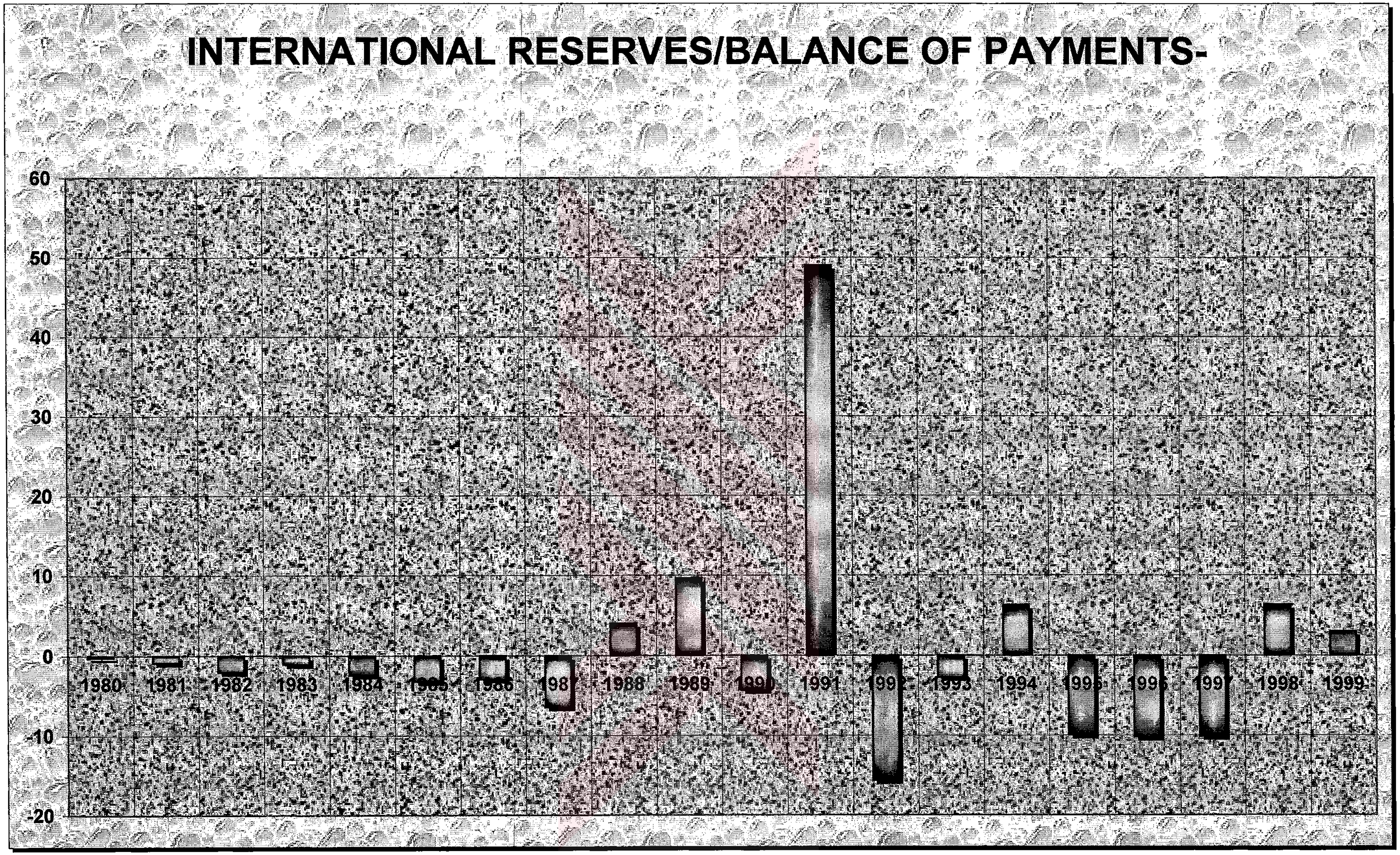
SAVINGS RATE
27
25
23
21
19
17
15
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998


EXPORT/GNP
18
16
14
12
10
8
6
4
2
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998

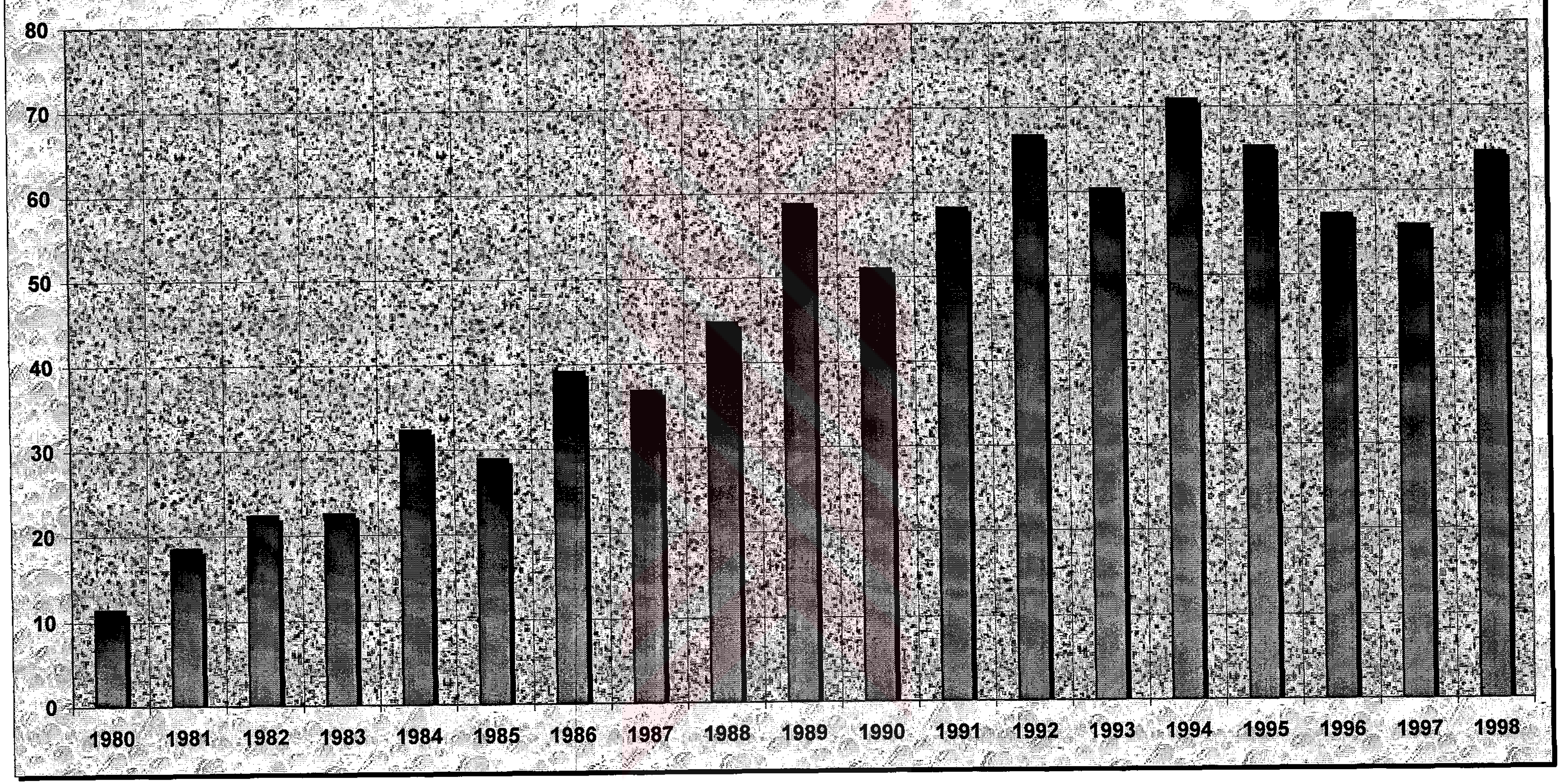

IMPORT/GNP
35
30
25
20
15
10
5
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998

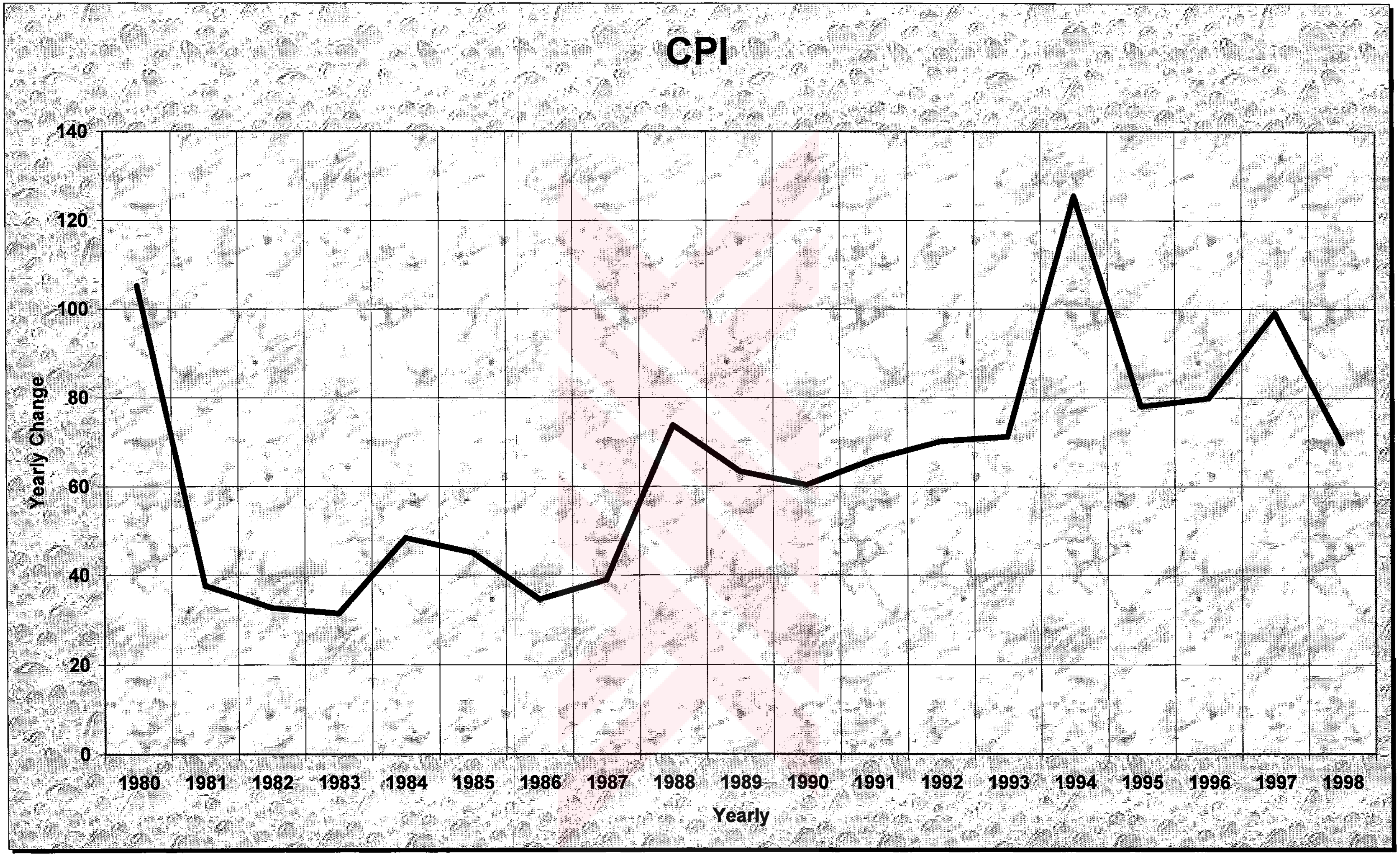

EXPORT/IMPORT
90
80
70
60
50
40
30
20
10
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999

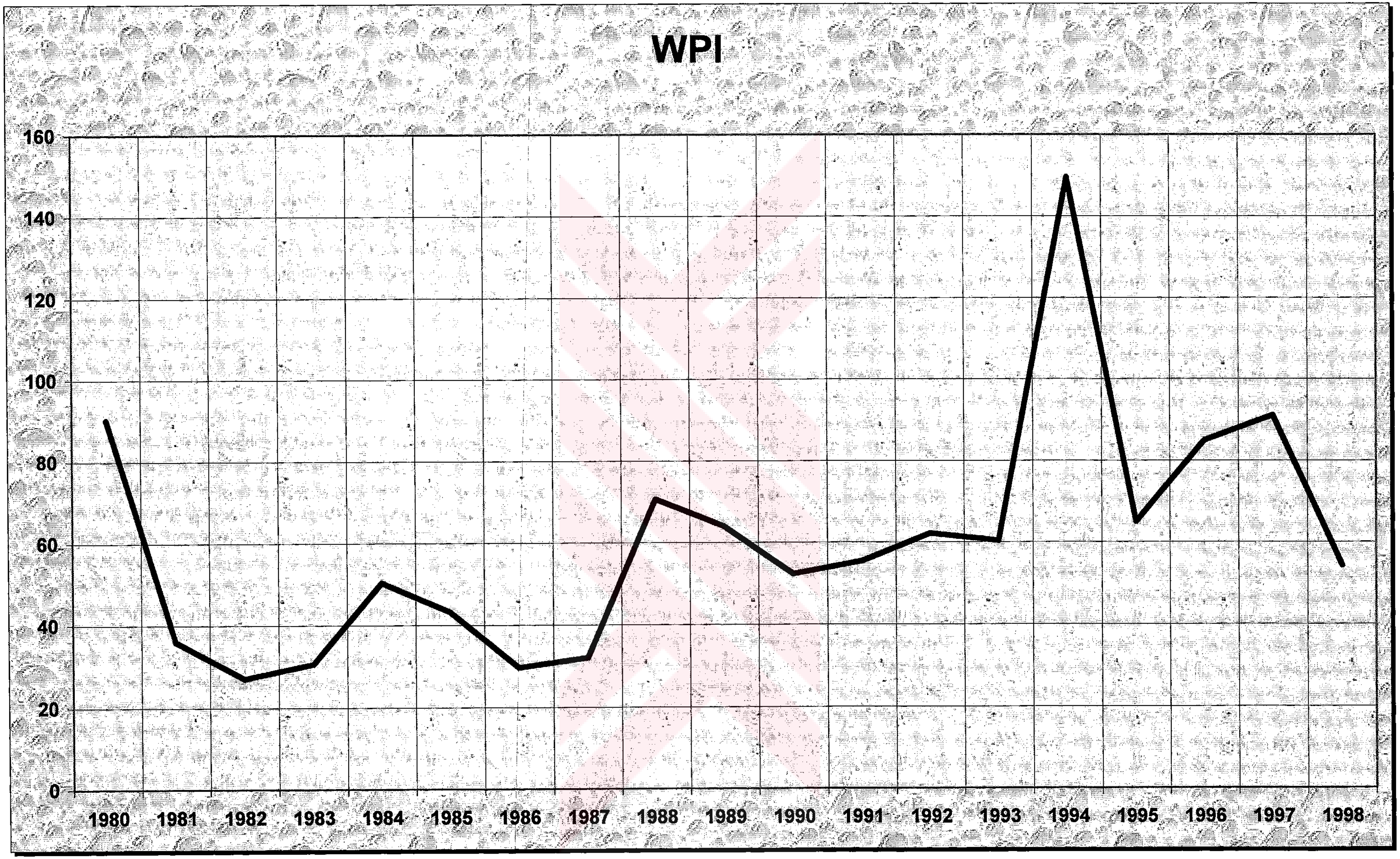

INTERNATIONAL RESERVES
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999

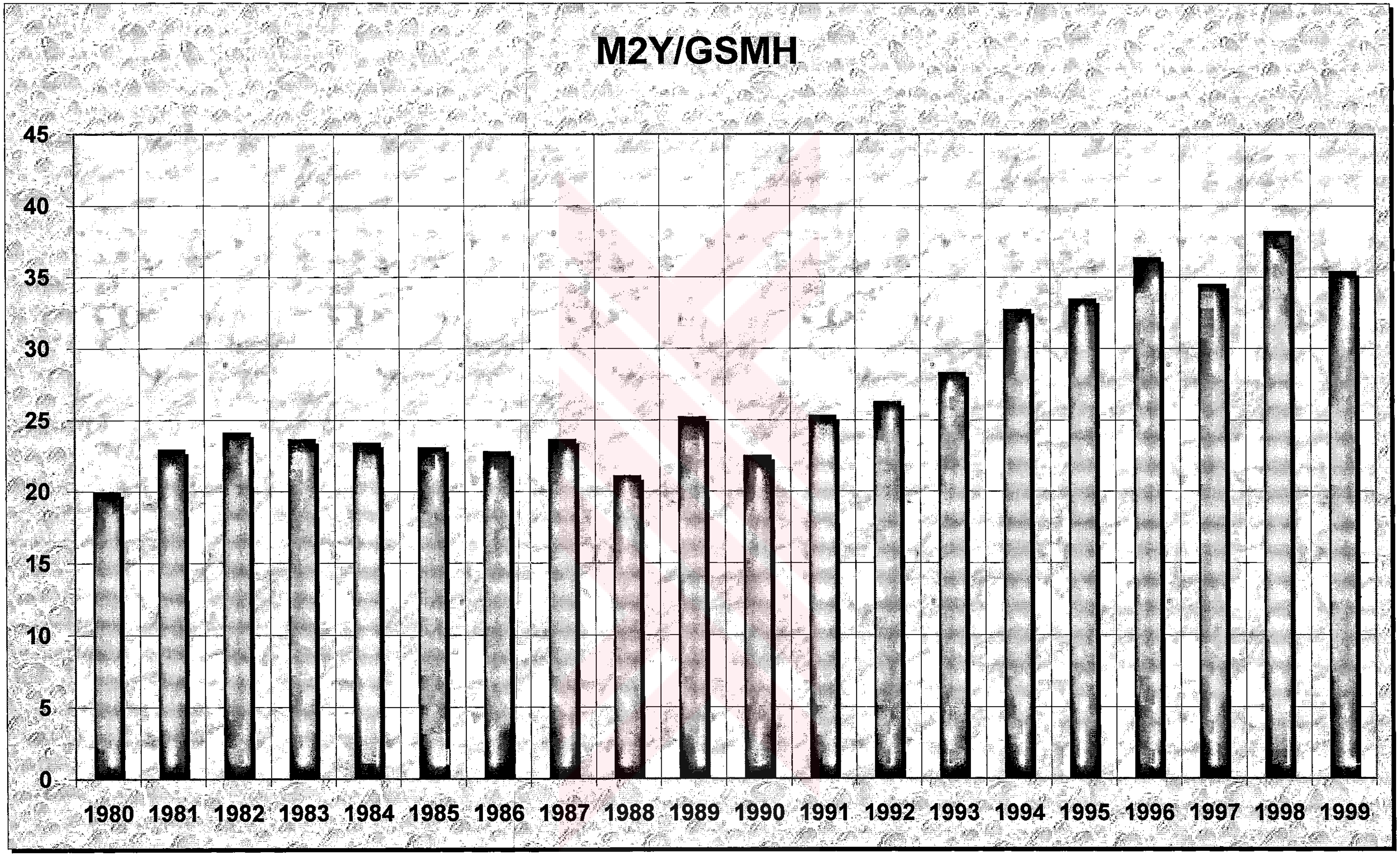

INTERNATIONAL RESERVES/BALANCE OF PAYMENTS-
60
50
40
30
20
10
0
-10
-20
1980
1981
1982
1983
1984
1988
1989
1991
1993
1994
1998
1999

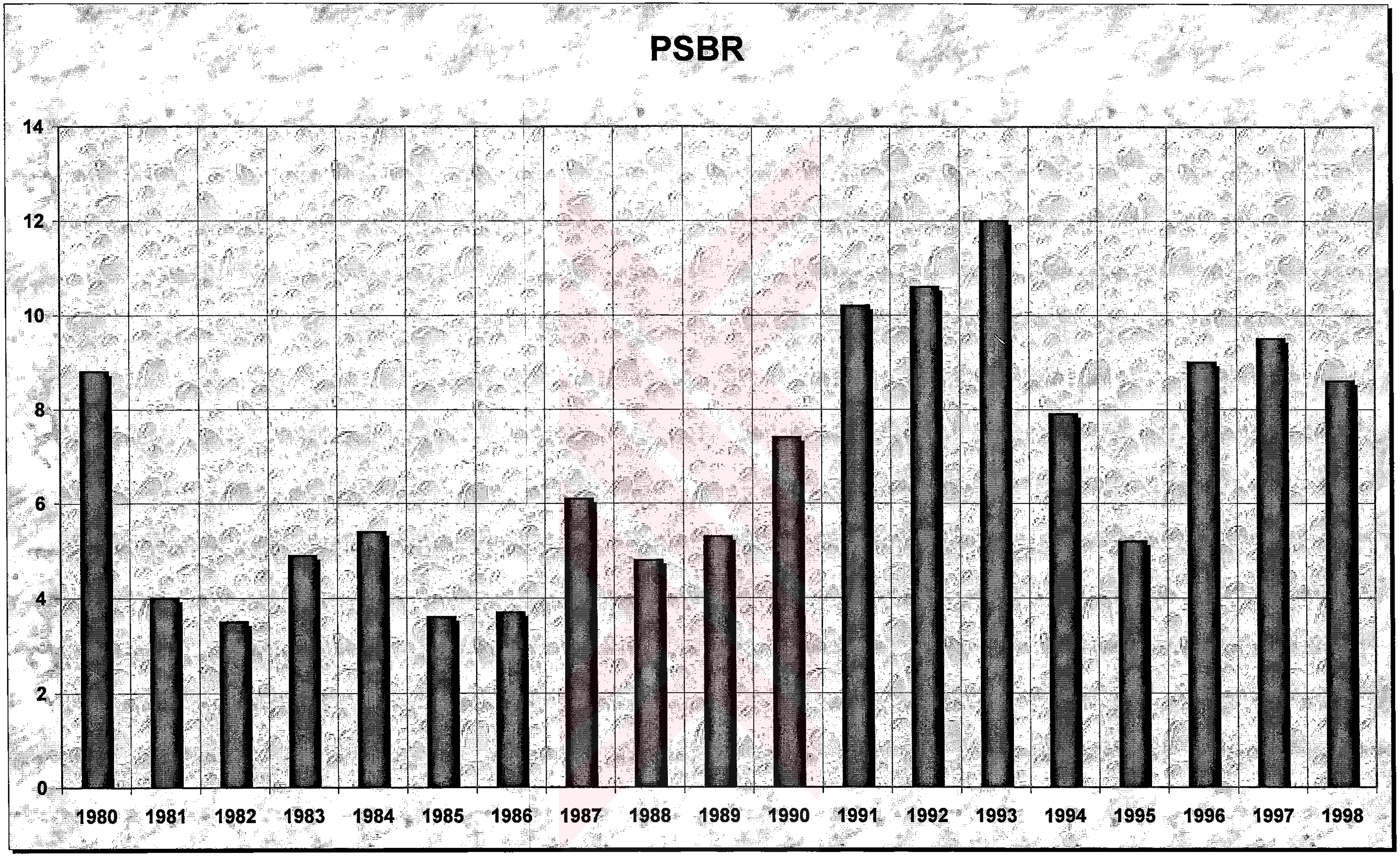
INTERNATIONAL RESERVES/IMPORTS




CPI
Yearly Change
140
120
100
80
60
40
20
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
Yearly


WPI
160
140
120
100
80
60
40
20
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998


M2Y/GSMH
45
40
35
30
25
20
15
10
5
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999


PSBR
14
12
10
8
6
4
2
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998