THE TRANSITION PERIOD TO EURO AT FULL MONETARY INTEGRATION AND TURKISH FINANCIAL SECTOR

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Abstract

This article examines the significance and consequences of the Euro in European monetary integration and how it will affect the Turkish banking sector. For this purpose, the various stages of the realisation of European Monetary System (EMS) and, its theoretical context have been explained in detail. Furthermore, the functions of the Euro in the System and the advantages and the disadvantages it will create for Member States and non-member countries, have also been explained. The "TARGET" system, which was developed in order to facilitate settlement payments between the European Central Bank (ECB) and the national banking systems of the Member States, has also been studied. Conseguently, as the EMS is realized, the measures taken and the strategles adopted by the Turkish financial sector, especially in relation to the harmonisation of money and capital markets, have been evaluated.

I. Theoretical appraoch to full monetary integration[1]

Another explanation of the integration of the capital and factors of production markets on a regional or in other words on a global basis, as important as the real integration is the financial and monetary integration. The latter aims at the use of one common currency with only one balance of payment.

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1 Uludağ, İ. "AET'nin Reel ve Parasal Analizi (Teori-Uygulama)", Maliye Yazıları, April-May 1987,İstanbul, pp. 88-90

Therefore this approach is a complete complementary in a monetary sense to the economic integration. Without the transition to the monetary union we can not think of a complete realisation of real integration and consequently achieving an economic integration. The international mobility of goods and services is accompanied by monetary movements and in case where barriers to real integration are removed there is a need towards liberating the monetary movements. In that sense we can analyse monetary union in two steps; partial monetary union and complete monetary union.

According to Machlup[2], the concept of partial monetary union is defined as the unchangeable, persistent stability of the parities. This, definition is not about whether or not the use of a common currency is needed but rather the instruments, politics and operations facilitating the monetary operations. Therefore this approach leads us to the conclusion that monetary union covers two different applications. One of them is that between member countries every barriers to any monetary operation should be removed (the minimal aplication of monetary union) and the other is those countries use a common currency (the maximal application of monetary union). Consequently the maximal and minimal application of the monetary union defined above can be interpreted as partial and full monetary integration.

In the partial monetary union, complete convertibility is realised through the procedure where the participating countries determine an official exchange rate for their currencies and a band around these rates where the exchange rates can fluctuate freely. Stability of exchange rates is satisfied only by the perfect implementation of the policies designed to achieve the stability of the prices in the economy or to prevent the fluctuations of the economic activities, to accelerate the economic growth and to achieve full employment.[3] Consequently the realisation in a more comprehensive way of incomplete monetary union depends on two conditions. According to this, first the exchange rates should be integrated and in the field of integration complete convertibility which means definite absence of controls on exchange rates about current accounts and investment mobility should be implemented.

2 Makchlup, F., *A History of Thought on Economic Integration,* Colombia University Press, New York, 1977, p. 20

3 Bela Balassa, " Monetary Integration in the European Common Market", Swoboda, A.K. (Ed.); *Europa and Evolution of the International Monetary System,* Leiden, 1973, pp. 20-21

The realisation of full monetary union depends on the other hand on the integration of monetary and investment policies and the use of a common currency. The integration of monetary and investment policies covers the common agreement on the monetary and investment policies and the management of the exchange rates, their compatibility and unification. The basic aim of all countries is to achieve full employment, a stable price level, economic growth and equilibrium of the balance of payments. The monetary and investment instruments used in this respect would be used in order to get through a monetary union. However two instruments would be used for the realisation of a full monetary union.[4] First, in the monetary field the growth of money demand (M1 and M2) should be decided upon in common by all of the member countries. Except for the increase in the volume of external credits provided by the european union and distributed in equal amounts to the central banks of the participating countries every member should finance its budget deficit at the current interest rate in the capital market of the union. Consequently the resulting monetary and investment policies will act in a way to prevent the more or less existing inflationary pressures and the increase in the demand for money due to emissions and budget deficit. Second, a common policy measure adjusted to the financial niveau of the union will be conducted in the management of the balance of payments in the context of the relations with the third world countries. In order to achieve this end the monetary authorities could when needed draw from the common pool of foreign exchange reserves. Only the above conditions will ensure the stability of the currencies of the participating countries against the common currency of the union.

II. The monetary union from an historical perspective

As the European monetary system is a part of the international monetary system, for the reasons lying behind the european union to be clearly understood we must analyse the economic history concerning the monetary systems. Since this paper is limited to an article it is not possible to review the development of the international monetary systems in a historical context. Discussion about main international monetary systems such as the Gold Standard, Bretton Woods, Currency Snake and the European Monetary System, would be certainly very useful to understand the reasons behind the European monetary union. In this article we rather focus on the Latin monetary union which is the basis of many international monetary systems and especially the european monetary union leaving aside the analysis of all the former systems.

4 Robson, P., *The Economics of International Integration*, Second Edition, George Allen and Unwin, London, 1984, pp. 62-63.

In the period of the creation of the Latin monetary union in 1865 there were debates between the United Kingdom accepting the Gold Standard as an international monetary system, and France with the gold and copper system. The Gold Standard was argued to lie on economic hegemony and the gold and copper on mutual agreement and cooperation. According to the 1865 agreement on Latin monetary union (France, Italy, Switzerland and Belgium) participating countries decided on comforming the legal arrangements especially on monetary operations. The experience of Latin monetary union has put forward those following conclusions that can each hold nowadays.[5]

a.The experience of Latin monetary union emphasized the problems caused by the use of different currencies by the countries integrating in an economic sense.

b. This agreement while constituting the legal basis lacked the central institutions necessary for the system to be efective.

c. The Latin monetary union gave rise to debates about monetary integration on international platform consequently to conferences in economics on that matter.

The basic reason behind the institution of the European monetary system is to prevent the large exchange rate variability and to animate the economic cooperation by the integration process of the European countries. For these reasons the creation of the European union did not only depend on the efforts of the theoreticians of economics but also was an act based on a strong political background. Though there had been many steps through the European monetary union the manifestation of the European monetary system is the most important of all. Especially there had been significant contributions of the establishment of the currency snake. After Bretton Woods while in the international monetary system there was a move towards the floating currency system the European monetary system adapted an adjustable peg system.

In addition the European monetary system proposed a new approach to the new international monetary regulation: the question of whether an arrangement institutionalised on a worldwide basis or on regional grounds should ensure the international monetary regulation.

After the crash of Bretton Woods system the uncertainty of the market environment caused by the exchange rate variability had a negative impact on the strategies of economic growth of the European countries. On the other hand this period was seen as endangering the integration process of in Europe. Consequently

5 Papadia, F. and Saccomanni, F. "From Werner Plan to Maastricht Treaty:Europe's Stubborn Quest for Monetary Union", Steinherr, A. (Ed.); *30 Years of European Monetary Integration*, New York, 1994, pp. 58-59

we could say that the biggest contributions of the European monetary system is that it had emphasised the shift from the prevailing floating exchange rates system to the transition through an exchange rate system with specific variability and stability. We can conclude that the intarnational monetary system moved on a regionalist regulation system concentrating on three currency area namely the dollar area, the yen are and the euro area rather than a global system.[6]

III. The transition from the currency snake to the European monetary union

The European monetary system realised in two steps to insulate the currencies from the speculative attacks. One of them is in the short run when the exchange rates reach specified limits, to intervene so as to maintain the exchange rate within the margins and to prevent excessive fluctuations. The other is the effort to prevent the fluctuations that are bound to happen in the long run by ensuring the convergence of the economies of participating countries. Besides, due to the similarities between the economies and macro-economic convergences there is optimism that the increase in demand and employment will contribute to the continuity of economic growth. Due to the above reasons, the participating countries should follow carefully the precautions and requirements about the convergence of their policies. Otherwise if they behave according to their national priorities the success of the monetary union cannot be satisfied. In reality the system is expected to develop the trade as a result of the increase of demand in the countries where a steady state of growth insulated from the speculative attacks is ensured. After the implementation the foreign trade of member countries happens to occur within the union[7]. The development of the mutual dependency level in the commercial operations raised the prospects for the realisation of the full monetary union. As a matter of fact at the beginning of 70's the capital mobility between the member countries has been partially liberalised. In the case of Germany and Benelux countries the capital mobility is completely liberalised[8].

At 1978 it is seen that member countries agreed upon leaving the currency snake and passing through a new European monetary system but this decision didn't come up very easily. There were two conflicting theses. One of them is the French monetary approach and the other is German classical approach emphasising the real macroeconomic stability. In an effort to combine the two approaches both groups

6 Uludağ,I., *Uluslararası Para Sorunları,* Bursa İktisadi ve Ticari İlimler Akademisi Yayını, İstanbul, 1980, from p.34

7 Upersele, J.V. *European Monetary System Origins,* Operations and Outlook, England, 1985, p. 31

8 Haberler, G.,"The International Monetary System, The European Monetary System and a Single European Currency in Single European Market", Bub,N./ Duwendac, D. and R. Richter (Vice President of the German Bundesbank) (Eds.); Frankfurt, 1989, pp. 156-166.

(except UK) decided to join the European monetary system and the European monetary system came into being as a more comprehensive and rearranged version of the currency snake.

In both systems there are similarities and differences. For instance in both systems the membership is decided on mutual demand and the band of fluctuation around the central exchange rate is +2.25% (Italy was allowed to use a larger band of fluctuation +6%). When the margins are reached the central banks of the currencies involved are committed to intervene so as to preserve the parity rates of the currencies. This implementation held for the currency snake. In the European monetary system the mechanisms forced the national central banks to buy or sell the currencies affected and thus stabilise the exchange rates. On the other hand countries can undertake intra-marginal interventions i.e. interventions can be made when the exchange rate is near the margin, depending on the preferences and without the necessity to inform the other member countries, which makes possible to trade is terms of dollar. We can also refer to the interventions made according to the divergence indicator. Each country's divergence indicator varies with the weight of its currency in the basket of currencies. Accordingly the central banks intervene as the divergence limits are attained.

The ECU (European currency unit) is defined as a basket of currencies of the countries that are members to the European monetary union. Thus it is an important constituent of the European monetary system and a unit of account to determine the central currencies, the indicator of divergence. It is used as an instrument to bring more symmetry into the system of the interventions and to facilitate the simultaneous operations of the cental banks, in addition as a reserve currency among the central banks[9]. Privilaged by the use of this common currency and supported by all the political and economic entities (European Central Bank, European Investment Bank) the European monetary system has become a highly organised international authority.

9 Federal Reserve Bulletin, "Progress toward a European Monetary Union", Washington D.C., October 1991, Volume 77, Number 10, pp. 769-784

IV. The period of transtition to EURO

A. European Currency unit (ECU) and its functions

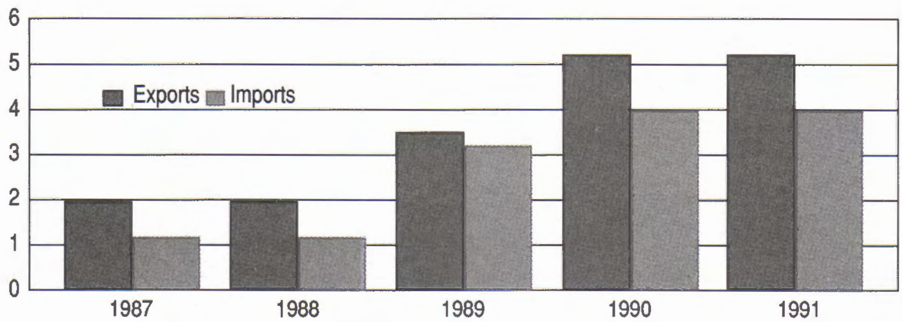
According to the article no: 3178/80 issued by the council and the legal arrangements of the monetary authorities ECU is created as a basket of the currencies of the countries that are members of the European monetary system. This currency was procured at the same time a political function as the weghts of the currencies in ECU reflect the economic power of the country. Only the bilateral central rates have significance because the interventions in the foreign exchange markets are carried out in national currencies and not in ECU. With this characteristic enhancing the stability of the international economic relations, ECU is an inseparable feature of the European monetary system established in 13 march 1979. The participating countries complied with the rules and guaranteed the stability of the value of ECU. As the European commission opened ECU accounts in banks and financial institutions so that the latter became familiar with the use of ECU. Thus the financial and monetary use of ECU developed very quickly. In addition European union authorities (European commission and other institutions) and economic institutions (European inverstment bank, European coal and steel community etc.) stimulated the use of ECU[10].

Figure 1

The use of ECU in commercial operations

(Billion ECU) (1987-1992)

(Belgium, Luxembourg, Denmark, Spain, France, Italy, Holland, Portugal)



10 'European Currency Unit', Kreditbank International Group, 1986, p. 6.

The financial institutions appreciative of the facilities brought about by the use of ECU in international financial operations made active supports in daily life. Hence the operations between ECU and the other currencies i.e. transfer and cheques in ECU had become easier. ECU markets had evolved in such a manner that demand and supply determine the ECU exchange rates. Especially after 1983 the use of ECU had accelerated, in addition to bonds in ECU the forward operations and options were initiated[11]. With these features, ECU, the starting point for a single European currency constituted the complete infrastructure. These arrangements and implementations increased the further daily use of ECU. The significance and contribution of ECU cannot be disregarded.

Table 1

The number and value of Eurobonds in ECU issued in the period 1981-1985

Years	**Number of Eurobonds in ECU**	**Value (million)**
1981	5	190
1982	17	722
1983	33	1930
1984	54	3194
1985	118	9176
Total		15212

Source: 'European Currency Unit', Kreditbank International Group, 1986, p.6

11 'European Currency Unit', Kreditbank International Group, 1986, p.15

Table 2

The stages in the process towards monetary union

I. Stage 1998 **The creation of the European Monetary Union**	II. Stage 1998-2001 **The beginning of the European Monetary Integration**	III. Stage January 2002-July 2002 **The intorduction of the single currency and the monetary reform**
The beginning of the stage	The beginning of the stage	The beginning of the stage
The determination of the countries which will participate to the monetary union	The exchange rates between the national currencies will be irrevocably fixed	ECU (EURO) coins and baknotes will be in circulation
The determination of the date for beginning of the second stage or the approval of the previous decided date	ECU (EURO) will no longer be a basket of currencies but a currency of its own right	Banks will complete the adjustments about their payment systems
The determination of the date for the transition to a single currency	The decision about the monetary policies concerning ECU (EURO)	The national currencies will lose their legal-tender status
The creation of the European Monetary Institute and the European Central Bank	The creation of inter-bank markets in EURO	The adjustments of the public and private entities to the monetary . union
The European Central Bank will issue the European currency	New issues of government bonds will be in ECU (EURO)	EURO will be the single currency
Campaigns to inform people about the monetary union	The establisment of the international balance of qayments	
Throughout the stage	Throughout the stage	Throughout the stage
The legal, banking and financial adjustments		
First stage can atmost last for one year	First stage can atmost last for three years	Third stage will last for only six months

Source : Paul De Grouwe, The Economics of Monetary Integration, oxford university press, oxford, 1997, pp. 126-136

B. The transition to EURO

In the below table, information about the three stages of the transition to EURO is summarised. In the first stage the most important point is that the strategy for moving towards a monetary union (Maastricht Treaty) has been viewed by the council and decisions have been taken and implemented for the second stage. Certainly, the issues to be decided upon are the establishment of the European central bank and the fulfilment of a legal background for the use of a common currency, the determination of the technical features of this currency. Furthermore in the first stage 11 countries to join the monetary union are determined. At this stage it was decided that the exchange rates would be irrevocably fixed after 10 january 1999 instead of the previous agreement 2 May 1998 and would be allowed to fluctuate until that time. The motive of this decision is that after 1 January 1999 the value of EURO will be irrevocably fixed relative to the value of the national currencies. Again in this stage EURO will be issued in the form of coins and banknotes and preparations concerning the banking and finance sector will get started.

Table 3

The compatibility of the member countries with the Maastricht convergence criteria

	Internal debt/GDP (60%)		Budget deficit/GDP (3%)		Inflation (3.2%)		Interest rates (7.2%)	Growth rate (3%)
	1997	1998	1997	1998	1997	1998		
Germany	61.3	61.2	2.7	2.5	1.1	1.5	5.6	2.6
Austria	66.1	64.7	2.5	2.3	1.4	1.3	5.6	2.8
Belgium	122.2	118.1	2.1	1.7	1.8	2.3	5.7	2.8
Denmark	65.1	59.5	-0.7	-1.1	1.9	2.1	6.2	2.7
Finland	55.8	53.6	1.1	-0.3	1.3	2.0	5.9	4.6
France	56.0	58.1	3.0	2.9	1.2	1.0	5.5	3.0
Holland	72.1	70.0	1.4	1.6	1.8	2.3	5.5	3.7
UK	53.4	53.0	1.9	0.6	1.8	2.3	7.0	1.9
Ireland	66.3	59.5	-0.9	-1.1	1.2	3.3	6.2	8.7
Spain	68.8	67.4	2.6	2.2	1.8	2.2	6.3	3.6
Sweden	76.6	74.1	0.8	-0.5	1.9	1.5	6.5	2.6
Italy	121.6	118.1	2.7	2.5	1.8	2.1	6.7	2.4
Luxembourg	6.7	7.1	-1.7	-1.0	1.4	1.6	5.6	4.4
Portugal	62.0	60.0	2.5	2.2	1.8	2.2	6.2	4.0
Greece	108.7	107.7	4.0	4.0	3.2	4.5	9.8	3.8

Source: Bank capital, Tek Paraya Doğru İlerlerken Euro July 1998 p.14

The second stage aims at the transfer of the management of the single monetary policy to the European central bank and it was decided to call the new currency EURO, with the latter replacing ECU at a 1 to 1 rate. At this period the markets where the national currencies are exchanged will be gradually removed. For technical reasons, this transitional period will last for three years.

The substitution of EURO for ECU is not automatic and some operations are anticipated. The parity of the national currencies against the dollar should be stabilised and ECU/US dollar parity and the proportion of ECU in EURO calculated[12]. As a result as from 1 January 1999 on 1 ECU will be equal to 1 EURO, the exchange value of ECU with respect to US dollar will hold for EURO. EURO in iterms of the currencies of the countries participating to the monetary union will be thereafter irrevocably fixed and the registered transactions in EURO will be initiated. The inter-bank dealings, accounts, transaction between European central bank and commercial banks, new issues of government bonds will be in EURO but the financial institutions will gradually use EURO. There will be no euro coins or banknotes in circulation during that period. The payments in the transactions in EURO will be done by the TARGET system.

In the third and final stage the single currency unit will be issued but EURO and the national currencies will be in circulation for a short period. Though commercial banks will use EURO for all their interbank dealings, on the other hand private individuals will have the choice between using their national currencies and opening a EURO account.

The period starting from 1 January 2002 is limited to 6 months to prevent the probable problems of having two kinds of currencies in circulation (EURO and national currencies). At 1 July 2002, the currencies of the countries participating in the monetary union will lose their legal-tender status. EURO will replace those currencies and will be the single European currency[13].

12 Türkiye Bankalar Birliği Raporu, Ekonomik ve Rasal Birlik Çerçevesinde Tek Para Politikası, Ankara, 1997, p. 12-16

13 Introduction of the Single Currency; The Views of the Banking Federation of the European Union, Brussels, Banking Federation of the European Union, November 1995, p. 8-9

Table 4

The Maastricht convergence requirements and the EU

	Adjustments concerning the central banks	Inflation*	Excess budget deficit	Longterm interest rates**	Participation to ERM and stability of the exchange rate	Participation to EURO after 1.1.99
1. Belgium	compatible	Below reference level (1.4%)	Non	Below reference level (537%)	Full filling without responsibility	Capabletojoin
2. Germany	Compatible	Below reference level (1.4%)	"	Below reference level (5.7%)	Full filling without responsibility	Capabletojoin
3. Ireland	Compatible	One of three countries with the lowest inflation (1.2%)	"	Below reference level (6.2%)	The exchange rate fluctuated more than determined band (2.5%)and Ireland was allowed to use a larger band of fluctuation.	The trend of the Irish exchange rate points at the dinamism of the Irish economy.
4. Austria	Compatible in case where the proposed modifications are realised before the establishment of the EMU	One of three countries with the lowest inflation (1.1%)	"	Below reference level (5.6%)	Full filling without responsibility	Capabletojoin
5. France	Compatible in case where the proposed modifications are realised before the establishment of the emu	One of three countries with the lowest inflation (1.2%)	"	Below reference level (5.5%)	Full filling without responsibility	Capabletojoin
6. Luxembourg	Compatible in case where the proposed modifications are realised before the estabilshment of the EMU	Below reference level (1.4%)	"	Below reference level (5.6%)	Full filling without responsibility	Capabletojoin
7. Spain	Compatible in case where the Proposed modifications are realised before the estabilshment of the EMU	Below reference level (1.8%)	"	Below reference level (6.3%)	Full filling without responsibility	Capabletojoin
8. Holland	Compatible	Below reference level (1.8%)	"	Below reference level (5.5%)	Full filling without responsibility	Capabletojoin
9. Portugal	Compatible	Below reference level (1.8%)	"	Below reference level (6.2%)	Full filling without responsibility	
10. Italy	Compatible	Below reference level (1.8%)	"	Below reference level (6.7%)	Italy rejoined ERM in november 1996 and the last 15 months its exchange rate fluctuated within the normal band steadily and without any interventions	Italy has been participating to ERM for two years and it accomplished real and stable convergence.
11. Finland	Compatible	Below reference level (1.3%)	"	Below reference level (5.9%)	Finland joined ERM since 1996 and the exchange rate fluctuated within the band without any interventions.	Finland has been participating to ERM for two years and it accomplished real and stable convergence.
12. Greece	Compatible	Above reference leel (5.2%)	"	Below reference level (9.8%)	Greece has not been a member for the last two years. It has been subject to fluctuations and subsequent interventions (interventions to the foreign exchange market and permanent increase of the internal interest rates).	Grece does not satisfy the convergence criteria and it can not join EMU at 1.1.99.

*Reference level : 2.7%

*Reference level : 2.7%
**Reference level : 7.8%

Source: "Tek Paraya Doğru ilerlerken -Euro, Bank Capital Hazine Birimi July 199, pp. 13-14

C. EURO as a new international currency

The international monetary system has the opportunity to develop more stable relations by the creation of the new currency and the definition of common currency area. The functions of EURO in the system will evolve gradually from reserve currency, investment currency and transaction currency. Table 5 depicts the economic indicators of the common currency area compared with those of USA and Japan. The indicators show that common currency area attained the level of the other two major currencies in the international market. In addition with a population of 290 millions habitants and 19.4% of the world product the common currency area is the second place in the world economy.

Table 5

The macroeconomic indicators for the major currency areas in the world money market

EC-11 countries Economic indicators	EURO area	USA	Japon
Population (million)	289.3	263.1	
Percentage in world product (1996)	19.4	20.7	
Bank assets (billion $) (1995)	11.971.6	5.000.0	7.382.2
Bonds, stocks and bank assets (billion $) (1995)	21.083.4	22.008.0	16.374.2

Source: World Economic Outlook, IMF, October 1997.

With Bretton Woods the foreign exchange reserves of the central banks gradually diversified and especially the percentage of US dollars in the foreign exchange reserves attained 70%. Keeping out the US dollar, Sterling, Deutche mark and French Franks made about 20%. As a result EURO replacing the national currencies will acquire a large percentage of the world reserves. On the other hand in the eliminate the need of the participating countries to intervene to stabilise their currencies[14].

As we explained above ECU was in reality used as an investment vehicle. Now that EURO replaced ECU, the former is increasingly used for investment purposes. EURO replaces the national currencies and contains the currencies of the member countries subsequently it is used in the transactions of these currencies in the international financial markets.

14 Silguy,T-T.D. "Euro ve Uluslararası para Sistemi", *Güncel Avrupa Dergisi,* September-October 1997, pp. 16-17.

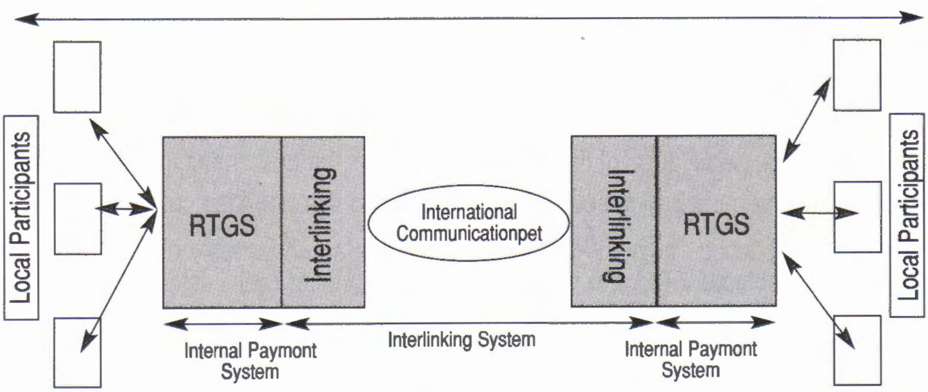
The percentage of EURO in the portfolio of the European currencies and bonds reaching 37% in 1995 indicates that there will be significant developments because it is natural that the public bond transfers of the participating countries will be indexed to EURO. Tough the private firms in the target zone are supposed to gradually register the transactions in EURO there is a widespread opinion that the transition will be shorter than expected. Furthermore Central and Eastern Europe where the trading is heavily in Deutsche mark and some Mediterranean countries where the French franc is widely used-due to the loyalty of the imperialist background- are expected to choose EURO as a more stable and less risky currency.

D. TARGET system and transactions in EURO

As from 1 January 1999 on, in the last stage of the process towards monetary union and there will only be one integrated money market. Consequently TARGET (Trans European Automated Real-time Gross Settlement Express Transfer) payment system is developed to facilitate the transactions between the European Central Bank and the national banking systems and satisfy the automatic redistribution of liquidity through the banking system (the article of European monetary union in March 1996). The system is based on linking the EFT (Electronic Fund Transfer) system of the member countries with RTGS (Real-time Gross Settlement System)[15].

Figure 2

The operation of TARGET payment system



Source: Okay, C., "TARGET Sisteminin Tanıtımı" *Bankacılar Dergisi,* 24 March 1998, p.61

15 Türkiye Bankalar Birliği, Avrupa Birliği Ödeme Sistemleri ve Elektronik ve Parasal Birlik, September 1997, 9.2-etc.

TARGET payment system will especially perform on facilitating the implementation of single monetary policy and the pricing policies. From this perspective it is advised that the TARGET pricing policies should aim at minimising cost. The latter on the other hand is strongly related to the system to satisfy equal working conditions to the participants, protect this environment and contribute to the implementations decresing the risk. Accordingly the design of the TARGET princing system should not cause excessive price differentiation and tolerate high transaction costs inceasing the interest rates.

E. EURO and its impact

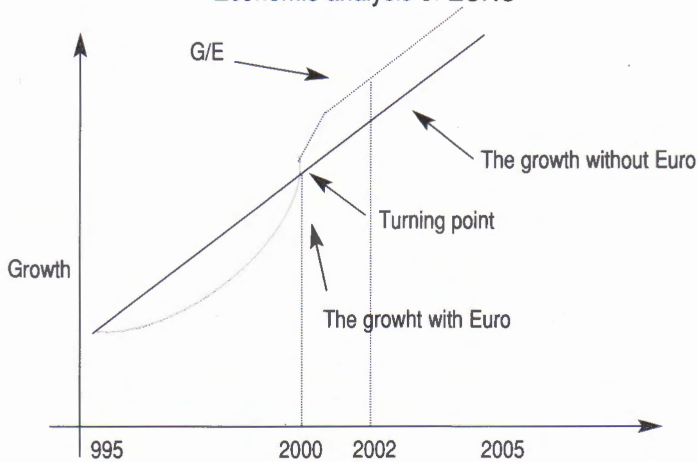
Before and after EURO we look at the main economic indicators of the thre major (monetary) zones in the world economy namely Europe, Japan and USA for the period starting from 1982. It is seen that until 1997 Japan and after 1997 USA had the highest GDP on the other hand Europe was behind those countries with a poor growth performance. The unemployment criterion alters the picture with Europe this time having the highest unemployment rate and USA following Europe with a decreasing unemployment rate at that period. The technological progress criterion shows that Europe had the lowest PC use rate compared with Japan and USA. Besides public sector and government expenditures have a large percentage in Europe[16].

Before EURO	After EURO
– Slow growth	– Elimination of foreign exchange transactions' cost
– Decrease in tax revenues	– Less uncertainty and risk in the financial markets
– Increase in government expenditures	– Strong investment expenditures
– Financial contraction	– Evolution of the financial markets
	– Increase of financial discipline
	– Increase of wages and salaries
	– Demand (production) increase
	– Low inflation rate
	– Growth

16 'Tek Paraya Doğru İlerlerken - Euro', Bank Kapital Hazine Birimi, July 1998, pp.15-16

Figure 3

Economic analysis of EURO



Source: 'Tek Paraya Doğru İlerlerken-Euro', Bank Capital Hazine Birimi, July 1998, p.16

Due to the elimination of the costs of exchanging one currency into the other by the use of a common currency, the cost of foreign exchange transactions of the firms is estimated to decrease by approximately 20-25 billions ECU, Especially concerning the transactions in foreign trade with the decrease of the exchange rate risk and uncertainty, elimination of welfare losses and increase of investment activity are expected to be the immediate benefits. Since 1979 the elimination of the exchange rate risk that has been highly reduced by the establishment of the present (high) unemployment rate is expected to remain in medium term and the acceleration of economic growth to gradually decrease.

With the operation of the TARGET payment system integrating the inter-bank markets in the monetary system, the financial markets will become deeper and more liquid. The more competitive environment will reduce the cost of financial intermediation and stimulate the investment activities in the financial markets.

The reduction of the interest rate due to the monetary union will expand the investment activities and increase the quality and diversification of financial services. It is expected that the financial outcomes will first affect the capital markets, the density in the bond market will shift through the stock market and the European capital market will get similar to the American markets[17].

Essentially the countries that participate to the European monetary union will avoid the interventions to stabilise the national currencies by the transition to a common stable currency. Hence firms are supposed to accelerate the investment activities in a less risky environment with lower interest rates increased liquiditiy and a more stable currency.

V. The effects of EURO in financial markets and Turkish financial sector

With the transition to the monetary union Europe will be one of the dominant monetary markets of the world, EURO will become immediately a major currency and the integration of the financial markets of the participating countries is bound to accelerate. In that case European financial market could become an oppenent for the other medium and long-term operating financial markets. The financial integration achieved and the gap between the financial instruments covered up the financial demand could be supplied on a larger scale. Besides, increased competition between banking and non-banking institutions, the elimination of the exchange rate risk and the operation of the TARGET payment system are expected to increase the deepening of the financial markets. As a result the interest rates will decrease due to economies of scale, promising the success of the monetary policies implemented by the European central bank and the cost of funding, the transaction cost of using EURO in foreign exchange and securities markets will fall.

The monetary integration will prevent the flucutations of the exchange rates, reduce the price instability and the cost of currency exchange. In other words the single currency will remove the uncertainty about future exchange rate changes. Though it has not yet been agreed upon whether these benefits can restrain the effects of economic crisis[18], there is a common belief among the participating countries that the transition to the single currency will facilitate the soution of especially the financial problems.

17 Erbil,B. "Tek Para ve Ekonomik Parasal Birliğin Son Aşamasına Geçişin Muhtemel Etkileri", *İKV Dergisi,* January-February 1998, pp. 29-30.
18 Financial Times, 23 November 1995.

The banking sector as a sub-sector of the European financial sector is subject to legal adjustments to be institutionalised in line with the economic and monetary integration. The aim is to create a common and single financial sector and market by integrating the legal regulations of the banking, insurance and capital market institutions of the participating countries. From this point of view, there must be some stages through the financial structuring of the monetary union. Since each national central bank will be part of European system of central banks, there is a tendency to structuring common norms regarding the banking sector. Especially there had been legal adjustments concerning the capital endowment, credit and investment procedures, deposit insurance systems, accounting principles of the banks and the wave of margers and consolidations. After the solution of technical problems the creation of financial products and the exchange of these will be completely liberalised. In other words the effects of this stage where the introduction of the financial products and services to the market will be liberalised, hence there will be increased competition between the banking sectors of the member countries have been observed for three years.

On the other hand the introduction of the single currency will in a sense remove the dominace of the banks provided by stronger currencies in the banking sector. As a result of increased competition and balanced opportunity the strategies of the banks of the participating countries will orientate through efficiency and profitability. Since the increased competition will reduce profit margins, the cost management will predominate. A part of the bank revenues are commissions paid to the banks in exchange of national currencies, this source of revenue will disappear with the monetary union and the banks will look for other profitable activities and diversify the range of their products and services.

There are significant efforts by the European financial institutions to get ready for the last stage of the monetary union. There is a wave of mergers in the sector; UBS and SBC (Switzerland), ING (The Netherlands) and Banque de Bruxelles Lambert (Belgium) and Bayerische Verelusbank and Bayerischettyppo Bank (Germany)[19]. These mergers are responsible for the branch closures and resulting unemplyoment. Consequently the restructuring in the transition to the monetary union will increase the unemployment.

19 'Tek Paraya Doğru İlerlerken-EURO', Bank Capital, July 1998, p.28.

In addition to the wave of mergers there is a tendency in financial institutions and insurance companies to establish themselves and offer their products and services in all the European countries. Despite the elimination of the transaction cost the decline of the decline of the profitability due to increased competition will stimulate these mergers.

The restructuring following the long line of consolidations while causing branch closures emphasies the significance of data processing and centralisation of the operations, the need to diversify the products and services and increases the volume of financial transactions both between countries of the union and the other parts of the world. The change in the structure of the banking sector is observed by the figures in Postal Survey: at the period between 1992 and 1996 the number of branches in the countries participating the monetary union decreased by 1% and the number of branches opened outside the union increased by 21%.

While the number of branches was decreasing in UK, The Netherlands, Denmar it increased by 34% in Germany, 19% in Spain, 39% in Portugal, 26% in Greece and 46% in Italy. According to the results of this research the establishment of the European monetary institution affected very significantly Greece, Spain, Portugal and Italy.

In the context of the technical changes in the banking sector, information systems can be recognised as crucial in the adaptation process and will require adjustments to integrate both the euro and the millennium change. Moreover humman resources will require training and information. The required costs of these processes are taking place among the expected to be covered up by the increase of productivity resulting from the impact of the common financial market and the diversification of financial products and service, the attraction of small inverstors to the market[20].

The research of Postal Survey (1977)[21] analysed for the period between 1992 and 1996 the changes of the prices of different financial services and products for each country. According to the results the prices of the corporate and consumer credit declined by approximately 20%. Especially the price of the corporate credits provided for large companies declined a lot in Ireland, France and Spain and more than 29% in Denmark and Greece. This is due to the removal of the legal barriers to

20 Türkiye Bankalar Birliği raporu, Avrupa Bankaları ve EURO, May 1998, p.6

21 'Tek Paraya Doğru İlerlerken-EURO', Bank Capital, pp. .24-30

the banking sector in the member countries and the increased competition. While the decrease of the credit costs provided to small and medium size companies is substantially high in Ireland, Spain and France, the average for the union is 24% This decrease is anticipated to the increased competition. The cost of consumer credits on the other hand decreased by 21% on the average and in France, Ireland and Spain this decline is more than the union average. For the mortgages the cost declined by 16% and again in Greece, France and Portugal the decline was substantially high. The fees of deposits on the other hand for the period 1992-1997 declined by 25% on the average.

The capital market is expected to be more affected than the banking sector by the transition to the monetary union. In fact, the volume of the stock market more than doubled and since the beginning of 1998 the rate of growth of the stock markets was about 25-40%[22]. This growth rate can be interpreted as the positive impact of the monetary union even in the period preceding the adoption of the single currency. Moreover it is possible to reckon that the positive effects of the European union on the economies of the participating countries led to these developments. In the transition period, particularly rapid privitisation is responsible for a part of the growth of the stock markets.

Table 6

Percentage changes in the cost of credits (%) (1992-1996)

Countries	Corporate Credits Large Companies	Corporate Credits Small and medium size companies	Consumer credits	Consumer Mortgages
Ireland	-44	-43	-43	-26
UK	-22	-22	-25	-29
France	-47	-41	-37	-41
Germany	-32	-26	-8	-19
Spain	-42	-41	-36	-45
Portugal	-19	-18	-4	-30
Belgium	-27	-25	-21	-23
Netherlands	-22	-23	-24	6
Greece	-39	-25	-26	-39
Denmark	-36	-21	-25	-31
Italy	-25	-16	-12	-18
EU	-29	-24	-21	-16

Source: Bank Capital, Tek Paraya Doğru İlerlerken - Euro, p.30

22 'AB'de Ekonomik ve Parasal Birlik Konusunda Son Gelişmeler', İKV, 15 May 1998, pp. 9-10

Some economists predict that banks will prefer the stocks markets to directly financing the companies and EURO will challenge the predominance of the dollar by the diversification of the portfolios and the improvement of the EURO stock market.

The new issues of government bonds will be structural changes in the bond markets due to the creation of a large bond market in that currency. Although the complications through the intergation of capital and securities markets seem to be surpassed many issues concerning taxation and fiscal policies to be implemented are still unresolved. Consequently full integration of the capital markets necessitates a few more years. To sum up the introduction of the single currency will ensure stability in both capital and money markets. Certainly along the way to the union the European central bank is expected to provide regulatory, protective and motivational contributions.

Even though there have been significant efforts to accommodate fiscal policies and the social security systems, related institutions should adopt more flexible policies in order to accelerate the integration processes and are expected to facilitate an efficient changeover to EURO. The members of the European union up to now rejected the conduct of a common taxation procedures. Although the price disparities may be due to various other factors, tax discrepancies have a special significance. Thus the decisions about the conduct of national fiscal policies can determine the success of the union.

Necessarily the policies implemented through the transition to the monetary union will affect the countries having economic relations with the members of the union. Turkey as one of those countries has to consider the implementations of the changeover and take the necessary measures.

When EURO is in circulation, the goods and services and financial markets will be through structural changes, For countries that are currently operating in European markets the effects of the changeover process is inevitable. At least EURO will allow Turkish companies to operate only in one currency instead of different currencies thereby, it will lead to significant reductions in costs related to foreign exchange transactions: hedging will become unnecessary, price lists and catalogues will be required solely in euros, etc. The opportunity to deal in euros will enable companies to eliminate the exchange rate risk and will therefore increase the trade volume especially the volume of exports.

As Turkey is a member of the Customs union, it will be affected in medium and long term positively by the economic growth and welfare of the union. Moreover the introduction of EURO will enhance the competition and Turkey can enjoy the external benefits of the enhanced competition. Though in this period Turkey must take necessary precautions and implements structural reforms to manage with the inflation and to stabilise the value of its currency against EURO.

The extent of the effects of the last stage through the economic integration, the introduction of the common currency on the Turkish financial sector –the capital and money markets and financial institutions- are still indeterminate. Besides the precautions that the European financial institutions are taking in the changeover process and their adjustment strategies are worthwhile to analyse. Especially the wave of mergers in the banking sector signals a similar development in the Turkish banking sector and it will be very useful. The decrease of the exchange rate risk and the further decrease of the interest rates with the introduction of EURO will reduce the transaction costs and will have a positive impact on the relations of the Turkish financial sector with the union. The banks are already reserving the adequate information technology resources in anticipation of the changeover processes however a long and costly preparation period consisting of evaluating and adapting the information systems is necessary in order to be effective and operational both during and after the transition period to the euro. In fact the Turkish central bank started to carry out the adjustments of the national regulation system, Foreign Currency Accounts with letterof guaranty the acceptance of the Turkish banking sector to the TARGET payment system[23].

The start of economic and monetary union will result in a tendency of the interest rates and the profitability (due to the increased competition) to decrease. Turish financial sector where the risk and profitability are at high levels this will most probably stimulate the investments.

23. 'Mali Sistem Euro'ya Hazır', Finansal Forum, June 1998, p.5

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