European monetary union: Turkey's prospects for joining

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EUROPEAN MONETARY UNION:

TURKEY'S PROSPECTS FOR JOINING

by

NEVIN ÖNAL

Department of Economics

University of Durham

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ABSTRACT

The thesis examines the likely effects on the European Community of the prospective European Monetary Union (EMU). It examines some of the structural problems which the newly joined but less developed members encountered on joining the customs union and then the Exchange Rate Mechanism (ERM). Analogies are drawn between these events and what might happen were Turkey to join first the customs union, then the ERM and finally the EMU. The status of Turkey as an Associate Member of the EC since 1963 is compared with countries in the European Free Trade Area and Eastern Europe. The main conclusion is that a further decade of successful structural reform would enable Turkey to benefit from joining an EC which continued on the same path for a further decade, and to benefit from joining an ERM in a wide band, but joining an EMU is unlikely to be beneficial.

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INTRODUCTION

The thesis initially examines the principles and procedure of forming a Monetary Union in Europe (EMU), based on the Delors Report, within the current decade.

Chapter II gathers the recent literature and arguments on the likely effects of the prospective EMU on the EC compared with the existing Exchange Rate Mechanism (ERM) of the European Monetary System (EMS).

Chapter III deals with the structural problems which have been encountered by the less developed Community members when they joined first the customs union and then the ERM, and which are likely to occur if they were involved in an EMU at an early stage. Analysis here is mainly from a customs union enlargement point of view.

I feel obliged to point to the lack of literature on discriminatory aspects of the EC and the proposed EMU as an entire block in the face of the rest of the world. There is a shortage of up-to-date data on the adjustment paths of those recently joined EC members which are characterised by varying structural problems and this also remains an area for further investigation.

The thesis continues, in Chapter IV, with a review and

assessment of Turkish structural and stabilisation policies which have been pursued with little reversal since the beginning of 1980. The Chapter compares the OECD area, within which Turkey itself is a member, with those less developed new EC entrants: Greece, Spain and Portugal. The impact of these policies implemented for more than a decade in Turkey on its economic and social life, is analysed in such a way as to enable us to distinguish the useful policies from those which were ineffective or, in some cases, counter-productive.

By doing so, it is intended to derive some suggestions for the future management of Turkish economy in the 1990s on its way towards the approaching provision of customs union with the EC by 1996 according to the relevant Agreements.

It is the findings of the Chapter that Turkey has not yet achieved a bright picture of a structurally adjusted and stable economic nation; however, Turkey's problems are basically similar to, if greater than, those of its Mediterranean neighbours, Greece, Spain and Portugal, which are still only partly solved.

The main conclusion is that a further decade of successful structural reform could enable Turkey to join a customs union, and an efficient stabilisation policy could lead the country to participate in both the EMS and the ERM if the Community continued the same economic path. However,. if the EC succeeds in forming the EMU by the end of the current decade, as well as accommodating 3 or 4 EFTA countries within itself, again in the same period, the economic case for Turkey joining does not seem to be realistic

before the next decade.

The current challenges together with the previous developments of Turkey-EC Association Status established since the entry into force of the Ankara Agreement in 1964 are demonstrated in Chapter V.

It is the conclusion of the thesis that Turkey, as an Associate Member of the EC for twenty-eight years, is set up to reach the customs union by 1996 entitled by all the other provisions arising from the relevant Agreement and other documents; but has not benefited from this Associate Status properly, as was initially intended by both sides.

Recently coupled with the current EC goal and ambitions such as the EMU and the new candidates from EFTA, and consequently from the Central and Eastern European formerly Communist countries, Turkey's case to participate fully in the European Community looks rather, if not blocked, troubled.

CHAPTER I

EUROPEAN MONETARY UNION

1. INTERNATIONAL ECONOMIC INTEGRATION SCHEMES

Introduction

Before starting the study of monetary integration in the European Community, it would be useful to point out the different forms of 'international economic integration' which have actually been implemented. Most specifically, it can be defined as the discriminatory removal of all trade impediments between the participating nations and the establishment of certain elements of cooperation and coordination between them. The latter depends entirely on the actual form that integration takes. Hence, the various forms of economic integration are:

i) Free trade areas where the member nations remove all trade impediments among themselves but retain their freedom with regard to the determination of their policies vis-à-vis the outside world; the European Free Trade Association (EFTA) and the Latin American Free Trade Area (LAFTA);

ii) Customs unions, which are very similar to free trade areas except that member nations must conduct and pursue common external commercial relations; for instance, they must adopt common external tariffs (CETs) on imports from the non-participants, as is the case in the European Community (EC)..

iii) Common markets, which are customs unions that also allow for free factor mobility across national member frontiers, i.e. capital, labour, enterprise should move freely between the

participating countries. Examples: the East African Community (EAC), and the EC;

iv) Complete economic unions, which are common markets that ask for complete unification of monetary and fiscal policies, i.e. a central authority is introduced to exercise control over these matters so that existing member nations effectively become regions of one nation;

v) Complete political integration, where the participants become literally one nation, i.e. the central authority needed in (iv) not only controls monetary and fiscal policies, but is also responsible to a central parliament embodied with the sovereignty of a nation's government.

Beside these different forms of integration, there are two types of international economic integration: "positive" and "negative". The term negative integration (Tinbergen,1954) refers to the removal of impediments on trade between the participating nations or to the elimination of any restrictions on the process of trade liberalisation. The term positive integration relates to the modification of existing instruments and institutions, more importantly, to the creation of new ones so as to enable the market of the integrated area to function properly and effectively, and also to promote other broader policy aims of the union.

2. DEFINITION OF MONETARY UNION

Monetary integration has two essential components: an exchange-rate union and capital market integration. An exchange-rate union is established when member countries have what is, in effect, one currency. The actual existence of one currency is not necessary, however, if member countries have permanently and irrevocably fixed exchange-rates among themselves, the result is effectively the same. Of course, one would argue that adoption of a single currency would guarantee the irreversibility of undertaking membership of a monetary union, which would have vast repercussions for the discussion in terms of actual unions; but one could equally well argue that if a member nation decided to opt out of a monetary union, it would do so irrespective of whether or not the union entailed the use of a single currency.

Convertibility refers to the permanent absence of all exchange controls for both current and capital transactions, including interest and dividend payments and the harmonisation of relevant taxes and measures affecting the capital market within the union. It is absolutely necessary to have complete convertibility for trade transactions; otherwise an important requirement of CU (customs union) formation is threatened, namely the promotion of free trade among members of the CU, which is an integral part of EU (economic union). That is why this aspect of monetary integration does not need any discussion; it applies even in the case of a free trade area (FTA). Convertibility for capital transactions is

related to free factor mobility and is therefore an important aspect of capital market integration which is necessary in common markets, not in CUs or FTAs.

In practice, this definition of monetary integration should, especially, include the following:

1. An explicit harmonisation of monetary policies.
2. A common pool of foreign exchange reserves.
3. A single central bank.

The central bank would operate in the market so as permanently to maintain the exchange parities among the union currencies and, at the same time, it would allow the rate of the reference currency - (suppose union members decide either that one of their currencies will be a reference currency, or that a new unit of account will be established) - to fluctuate, or to alter intermittently, relative to the outside reserve currency. For instance, if the foreign exchange reserves in the common pool were running down, the common central bank would allow the reference currency, and with it all the partner currencies, to depreciate. This would have the advantage of economising in the use of foreign exchange reserves, since all partners would not tend to be in deficit or surplus at the same time. Also, surplus countries would automatically be helping deficit countries. If one country ran a large deficit, the union exchange rate would depreciate, but this might put some partner countries into surplus. If wage rates were

rising in the member countries at different rates, while productivity growth did not differ in such a way as to offset the effects on relative prices, those partners with the lower inflation rates would be permanently financing the other partners.

3. PAST AND PRESENT DEVELOPMENTS ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY

3.1 The Objective of Economic and Monetary Union

In 1969, the Heads of State or Government, meeting in The Hague, agreed that a plan should be drawn up with a view to the creation, in stages, of an economic and monetary union within the Community. This initiative was taken against the background of major achievements by the Community in the 1960s: the early completion of the transition period leading to a full customs union; the establishment of the common agricultural policy (CAP) and the creation of a system of own resources. At the same time, the "Bretton Woods system" was showing signs of decline. The Werner Report, prepared in 1970, presented a plan for the attainment of economic and monetary union. In March 1971, following the Werner Report, the EC Member States expressed "their political will to establish an economic and monetary union" in the foreseeable future.

Several important moves followed: in 1972 the 'snake' was created; in 1973 the European Monetary Cooperation Fund (EMCF) was set up; and in 1974 the "Council Decision" on the attainment of a high degree of convergence in the Community and the "Directive" on stability, growth and full employment were adopted. Yet, by the

mid-1970s the process of integration had lost momentum under the pressure of divergent policy responses to the economic shocks of the period due to the crisis in oil prices.

In 1979 the process of monetary integration was relaunched with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU). The success of the EMS in promoting its objectives of internal and external monetary stability has contributed in recent years to further progress as reflected in the adoption, in 1985, of the internal market programme and the signing of the "Single European Act".

3.2 The European Monetary System and the ECU

The European Monetary System was created by a Resolution of the European Council followed by a Decision of the Council of Ministers and an Agreement between the participating central banks.

Within the framework of the EMS the participants in the exchange-rate mechanism have succeeded in creating a zone of increasing monetary stability at the same time as gradually relaxing capital controls. The exchange-rate constraints have greatly helped those participating countries with relatively high inflation rates in gearing their policies, notably monetary policy, to the objective of price stability, thereby laying the foundations for both a downward convergence of inflation rates and the attainment of a high degree of exchange-rate stability. This, in turn, has helped moderate the cost increases in many countries, and has led to

an improvement in overall economic performance. Moreover, reduced uncertainty regarding exchange-rate developments and the fact that the parities of the participating currencies have not been allowed to depart significantly from what is appropriate in the light of economic fundamentals have protected intra-European trade from excessive exchange-rate volatility.

The EMS has served as the focal point for improved monetary policy coordination and has provided a basis for multilateral surveillance within the Community. Moreover, the system has benefited from the role played by the Deutschemark as an 'anchor' for participants' monetary and intervention policies.

At the same time, the EMS has not fulfilled its full potential. Firstly, two of the Community countries (Greece and Portugal) have not yet joined the exchange-rate mechanism and two of those recently involved in the ERM (Spain and the UK), currently participate with wider fluctuation margins. Secondly, the lack of sufficient convergence of fiscal policies as reflected in large and persistent budget deficits in certain countries (such as Greece, Italy and Ireland) has remained a source of tensions and has put a disproportionate burden on monetary policy. Thirdly, the transition to the second stage of the EMS and the establishment of the European Monetary Fund, as foreseen by the Resolution of the European Council adopted in 1978, have not been accomplished.

In launching the EMS, the European Council declared in 1978

that a "European Currency Unit (ECU) will be at the centre of the EMS". Apart from being used as the "numeraire" of the exchange-rate mechanism and to denominate operations both in the intervention and credit mechanisms, the ECU serves primarily as a reserve asset and means of settlement for EMS central banks. Although it is an integral part of the EMS, the ECU has for some reasons, played only a limited role in the operating mechanisms of the EMS. One reason is that central banks have preferred to intervene intra-marginally; therefore, compulsory interventions and the build-up of intervention balances to be settled in ECUs have remained fairly limited.

By contrast, the ECU has gained considerable popularity in the market-place, where its use as a denominator for financial transactions has spread significantly. It ranks fifth in international bond issues, with a 6% market share. The expansion of financial market activity in ECUs reflects in part a growing assurance of ECU-denominated debt instruments by the Community institutions and public sector authorities of some member countries, and in part the ECU's attractiveness as a means of portfolio diversification and as a hedge against currency risks.

International banking business in ECUs grew vigorously in the first half of the last decade, but has moderated since then, although the creation of an ECU clearing system has contributed to the development and liquidity of the market, as did the issue of short-term bills by the UK Treasury. The lion's share of banking business represents interbank transactions whereas direct business with non-banks has remained relatively limited and appears to have

been driven primarily by officially encouraged borrowing demand in a few countries. ECU denominated deposits by the non-bank sector have stagnated since 1985, suggesting that the ECU's appeal as a near money substitute and store of liquidity is modest. In addition, in the non-financial sphere the use of the ECU for the invoicing and settlement of commercial transactions has remained rather limited, covering at present only about 1% of the Community countries' external trade.

3.3 The Final Objective of the Monetary Union

The final objective of the monetary union was defined as long ago as 1970 in the Werner Report in a formulation that still applies today:

> A monetary union implies inside its boundaries:
>
> - the total and irreversible convertibility of currencies;
> - the complete liberalisation of capital transactions and full integration of banking and other financial markets;
> - the elimination of margins of fluctuation and the irrevocable locking of exchange-rate parities.

The first two of these requirements have already been met, or will be with the completion of the internal market programme. The single most important condition for a monetary union would be fulfilled only when the decisive step was taken to lock exchange rates irrevocably.

Decisive criteria for a monetary union are thus the

irrevocable fixing of exchange-rates and movements of capital within the single monetary area that is free from restrictions.

The monetary union is the "monetary superstructure" of the economic union in which the "four freedoms" have been realised, namely the free movement of goods, services, labour and capital. Within the common single market, economic activity is to be based on a free market system of "competition". Besides agreement on regulative policy, an economic union demands a far-reaching harmonisation of government regulations in order to bring about equal competitive conditions and uniform markets. The three above-mentioned requirements define a single currency area, but their fulfilment would not necessarily mark the end of the process of monetary unification in the Community. In principle, national currencies can be retained in the monetary union, but the adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen for economic as well as psychological and political reasons, as a natural and desirable further development of the monetary union (see Report on Economic and Monetary Union in the European Community, 1989). A single currency would clearly demonstrate the irreversibility of the move to a monetary union; considerably give the union a "monetary identity"; facilitate the monetary management of the Community, avoid the transaction costs of converting currencies; eliminate the residual risk of parity changes among the national currencies and hence assure the continuing existence of the single monetary area. A single currency, provided that its stability is ensured, would also have a much greater weight relative to other major currencies than

any individual Community currency has. The replacement of national currencies by a common currency could thus be seen as the "crowning act" of the process of the monetary integration.

The establishment of a monetary union would have far-reaching implications for the formulation and execution of monetary policy. The coordination of many national monetary policies with their own currencies participating in the union would not be sufficient. The responsibility for the single monetary policy would have to be vested in a new institution, in which centralised and collective decisions would be taken on the supply of money and credit as well as on other instruments of monetary policy, including interest rates (see, D. Gunter Baer and T. Padoa-Schioppa, 1989).

This shift from national monetary policies to a single monetary policy is an inescapable consequence of monetary union and constitutes one of the principal institutional changes. Although a progressively intensified coordination of national monetary policies would in many respects have prepared the way for the move to a single monetary policy, the implications of such a move would be far-reaching. On the other hand, the permanent fixing of exchange rates would deprive individual countries of an important instrument for the correction of economic imbalances and for independent action in the pursuit of national objectives, especially in price stability reflecting, probably, the main obstacle to a rapid move to such a union.

Besides these integration effects of a single European

market, a monetary union provides a number of additional economic advantages. Firstly, the irrevocable fixing of parities means that the exchange-rate associated with the intra-Community exchange of goods, services and capital is eliminated. This will foster, in particular, the integration of financial markets and the strengthening of competition. Secondly, there will be saving in transaction costs since market participants will be increasingly willing to accept partner currencies or the common currency without taking recourse to hedging operations and to hold them as a means of payment or investment in the place of national currencies. Thirdly, the creation of a monetary area with a greater weight internationally entails advantages in transactions with third currencies since the international acceptances of the Community currencies will grow; the Community will become less susceptible to external shocks and it will be able to represent its monetary policy interests more effectively at the international level.

4. THE DELORS REPORT

At its meeting, in Hanover on 27 and 28 June 1988, the European Council agreed that, "in adopting the Single Act", the Member States of the Community confirmed the objective of progressive realisation of "Economic and Monetary Union". The Heads of State or Government therefore decided to examine, at the European Council meeting in Madrid in June 1989, the means of achieving this union. They decided to entrust to a Committee chaired by M. Jacques Delors, President of the European Commission,

the task of studying and proposing concrete stages leading towards the union. The Committee reported just before the Madrid summit and its report is referred to as "The Delors Report" on the EMU.

According to the opinion of the Committee, the EMU must be seen as a single process, but this process should be in stages which progressively lead to the ultimate goal; thus the decision to enter upon the first stage, should commit a member state to the entire process. They emphasised that the creation of the EMU would necessitate a common monetary policy and require a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field. The Report pointed out that the realisation of the EMU would require new arrangements which could be established only on the basis of a change in relevant parts of he Treaty of Rome and consequent changes in national legislation.

During the first stage, which should be related to the creation process of the EMU, there would be a greater convergence of economic performance through the strengthening of economic and monetary policy coordination within the existing institutional framework. The economic measures should be taken for the completion of the internal market and for the reduction of existing disparities through programmes of budgetary consolidation in the member states involved and more effective structural and regional policies. In the monetary field, the emphasis would be on the removal of all obstacles to financial integration and on the intensification of cooperation and coordination of monetary

policies. Realignment of exchange rates was seen to be possible, but efforts would be made by every member state to make the functioning of other adjustment mechanisms more effective. To the Committee, it is important to include all EC currencies in the exchange-rate mechanism (ERM) of the EMS during this stage. The 1974 Council Decision defining the mandate of central bank governors would be replaced by a new decision indicating that the Committee itself should formulate opinions on the overall orientation of monetary and exchange-rate policy.

In the second stage, which would commence only when the Treaty had been amended, the basic organs and structure of the EMU would be set up. The Committee stressed that this stage should be seen as a transition period leading to the final stage; thus it should constitute a "training process leading to collective decision-making", but the ultimate responsibility for policy decisions would remain with national authorities during this stage. With this understanding, the EC should:

1. Establish "a medium-term framework for key economic objectives aimed at achieving stable growth, with a follow-up procedure for monitoring performances and intervening when significant deviations occurred."
2. "Set precise, not yet binding, rules relating to the size of annual budget deficits and their financing."
3. Assume a more active role as a single entity in the discussions of questions arising in the economic and exchange-rate field."

In the monetary field, the most significant feature of this stage would be the establishment of the "European System of Central Banks (ESCB)" to absorb the previous institutional monetary arrangements. The ESCB would start the transition with a first stage in which the coordination of independent monetary policies would be carried out by the "Committee of Central Banks Governors". It was envisaged that the formulation and implementation of a common monetary policy would take place in the final stage; during this stage exchange-rate realignments would not be allowed except in exceptional circumstances. The Report stresses that the nature of the second stage would require a number of actions, e.g.:

1. National monetary policy would be executed in accordance with the general monetary orientations set up for the EC as a whole;
2. A certain amount of foreign exchange reserves would be pooled and used to conduct the interventions in accordance with the guidelines established by the ESCB;
3. The ESCB would have to regulate the monetary and banking system to achieve a minimum harmonisation of provisions (such as reserve requirements or payment arrangements) necessary for the future conduct of a common monetary policy.

The final stage would begin with the irrevocable fixing of member states' exchange rates and the attribution to the EC institutions of the full monetary and economic consequences. It is envisaged that during this stage the national currencies would

eventually be replaced by a single EC currency (see A.M. El-Agraa,1990).

In the monetary field, the irrevocable fixing of exchange rates would come into effect and the transition to a single monetary policy would be made. The ESCB would assume full responsibilities, especially, in four specific areas:

1. The formulation and implementation of monetary policy;
2. Exchange-market interventions in third currencies;
3. The pooling and management of all foreign exchange reserves;
4. Technical and regulatory preparations necessary for the transition to a single EC currency.

In the EC summit which opened in Madrid on 24 June 1989, EC member nations agreed to call a conference which would decide the route to be taken to EMU. This agreement was facilitated by a surprisingly conciliatory Mrs. Thatcher on the opening day of the summit, setting out five conditions for joining:

1. A lower inflation rate in the UK, and in the EC as a whole;
2. Abolition of all exchange controls (which still existed in Italy, France and Spain);
3. Progress towards the single EC market;
4. Liberalisation of financial services;
5. Agreement on competition policy.

After having agreed on these conditions, all member nations endorsed the Report and agreed on 1 July 1990 as the deadline for the commencement of the first stage. Indeed, the economic and finance ministers of the EC at a meeting on 10 July agreed to complete the preparatory work for the first stage by December, thus giving themselves six months to accommodate the adjustments that would be needed before the beginning of the first stage.

As a conclusion, all these proposals for the EMU envisaged in the "Delors Report" are consistent with and satisfy all the requirements of an actual economic and monetary union. But there are some possibilities of loss of momentum, such as the reluctance of the British Government to proceed to the single currency, disparities markedly existing in various regions of the Community, and the deep recession which has been recently escalated by the rises on oil prices and uncertainties, caused by the Gulf Crisis. Consequently, in the EC meeting on monetary and political union, in December 1990, it was agreed to delay the date for the start of "stage 2" by 1994, instead of the end of 1992 set before.

5. SOME PROPOSALS AND ARGUMENTS RELATED TO THE ECU

5.1 The ECU, as a common currency

A common currency describes a currency which is used throughout the Community and is not the national currency of either a Member State or a third country. Two types of common currency can be distinguished;

i) A parallel currency, which is a common currency that is created independently of, and in addition to, national currencies. It circulates in parallel with national currencies and competes with them;

ii) A single currency is a common currency that has replaced all existing national currencies as a result of an institutional decision (rather than a market process).

A common currency may, however, also be understood as signifying the use of a common numeraire (as in the case of the private ECU today) or a common reserve instrument as a means of implementing a common monetary policy.

a) What is the need for, and role of, a common currency in the process leading to a monetary union?

b) What should be the future role of the ECU?

a) One of the various views on this question is that no common currency is needed in order to achieve a monetary union, because the irrevocable locking of parities, full mobility of capital and the pursuit of a single monetary policy would suffice for the creation of such a union, i.e. a single currency area. The alternate view argues that ultimately the move to a single currency is necessary in order to reap the full benefits of monetary union. According to this view, only a single currency can provide a convenient numeraire for the transactions of private economic agents and for substantially reduced uncertainties and transaction costs. It also points out that no monetary union has ever existed without a common

currency and the credibility of the "irrevocable locking" would be at risk if many different currencies continued to exist.

b) The role of the ECU. Any proposal concerning the role of the ECU depends, very much, on the views held regarding the need for a common currency. To many observers the ECU's role should grow with progress towards monetary union and it should become the Community's single currency. To some others it is premature to formalise arrangements for a common currency, all that is needed is to promote convergence and monetary stability (mostly the British view).

There are three major options regarding the future role of the ECU:

Firstly, the ECU would remain a basket of Community currencies and serve as a common numeraire. All possible impediments to its voluntary use in private financial and commercial transactions would be removed, but no particular official action would be taken to promote it; no new institution would be required to manage the ECU, but the monetary effects of its growing use would have to be monitored.

Secondly, the official ECU which could remain a basket would be used as a common reserve instrument in managing a common monetary policy; thus the ECU would become the reserve money of the European system of central banks. This approach has been suggested in

Governor Crampi's paper. The expanded use of the official ECU in this case would not require a link between the official and the private ECU (the first one is created according to fixed rules by converting international reserves and held exclusively by central banks; the other one is an asset denominated in ECUs and held primarily by the market).

Thirdly, suggested by some academic economists, the ECU could be made a "parallel currency". It would be issued by a central institution and allowed to circulate freely throughout the Community as a means of payment, store of value and unit of account. The ECU would be an additional - 13th - Community currency and it would be defined in its own right (so-called "abstract ECU") and it would form part of the exchange-rate arrangements. Its acceptance and use by private market participants would depend essentially on its quality as money.

Propositions relating to the ECU

According to some critics,

a) A parallel currency approach is neither a useful nor a desirable way of establishing a monetary union. The critics of this approach reject it on two grounds:

Firstly, it would not contribute to solving the problem of coordinating national monetary policies; on the contrary, it would add a 13th player to an already difficult coordination exercise.

Secondly, it could undermine a monetary policy oriented towards price stability, because it would add a source of money creation that is difficult to link to the needs of economic activity. Some

concrete implications of this proposition are that before the final stage:

i) the ECU should remain a basket;

ii) the independent monetary policy would be instituted for the ECU;

iii) no link would need to be built between the private and official ECU.

b) An imprimatur should be given to the ECU as the future single currency of the Community. A single currency, while not strictly necessary for the creation of a monetary union, might - for economic as well as psychological and political reasons - be seen as the natural and desirable further development of such a union. Before the Community could consider adopting a single currency, exchange rates would have to be irrevocably locked and once exchange rates are permanently fixed the ECU will become a very close substitute for any national currency. One concrete implication of this proposition is that there should be no discontinuity between the present ECU and the future single currency, i.e. any debt contracted in ECUs before the introduction of the single currency would be payable at the face value in the ECUs if the transition to the single currency has been made.

c) All impediments to the voluntary use of the ECU as a "common numeraire" and a means of settlement by private economic agents would have to be removed. Barring official action discriminating in favour of the ECU (which would result in undesirable financial

market distortions) and excluding a link between the official and the private ECU, there are two types of measures: direct encouragement (e.g. increased borrowing in ECUs by public sector entities; larger exchange market interventions in ECUs; some official support for the ECU clearing system), and indirect encouragement (e.g. removal of restrictions on the private use of the ECU by giving it the status of a foreign or national currency in each member country; demonstration effects through increasing operations in official ECUs within the EMS and by enlarging the group of other holders). Some concrete implications of this proposition are:

i) as a numeraire the ECU would have equal, but not privileged, status vis-à-vis the national currency denomination,

ii) therefore, the ECU would be an additional unit of account whenever national legislation specifies the use of a numeraire.

d) As another proposition, Governor Ciampi suggested that "the official ECU could play a role in the conduct of a common monetary policy in an advanced stage of monetary union." He presented a scheme in which the official ECU would be used as a reserve instrument in managing a common monetary policy in the Community. This scheme represents one way of giving operational meaning to the concept of a single monetary policy.

In considering whether there are other operational schemes for a common monetary policy, it has to be borne in mind that the ECU should not become a parallel currency (i.e. the official ECU

must remain an asset used only within the circle of central banks) and that the official ECU already performs a number of functions in central banks' operations.

5.2 The ECU as a Parallel Currency

The development of the ECU as a parallel currency would imply its increased use in international transactions, both within and outside the European Community, while national currencies would - at least for the foreseeable future - retain their functions and their central rates could continue to be adjusted. A parallel currency therefore implies the absence of a monetary union, which is an area with either a single currency or with national currencies with margins eliminated, full convertibility and central rates irreversibly locked (Duisenberg, 1989).

At present two separate ECUs exist:

a) the "official ECU", created according to fixed rules by converting international reserves and held exclusively by central banks. The official ECUs are created when the Community central banks receive them from the "European Monetary Cooperation Fund" (EMCF) in exchange for their gold and dollar reserves. The official ECU is simply another term for these reserves and it cannot circulate in the private market.

b) the"private ECU" comes into existence through bankers

bundling together the component currencies in the required proportions to produce ECU-denominated loans and deposits. In the last analysis the creation of ECUs is regulated by the average monetary policies of Community central banks. (ECU bond issues were running in 1988 at nearly $20bn or some 5 to 6 per cent of total international bond issues) (ibidem).

The development of the ECU as a parallel currency widely used in international transactions refers to ECUs held by the private sector. There are some plans for increasing the use of the ECU and allowing the official ECU to circulate by removing the distinction between the private and the official variety, while the Bundesbank is particularly worried about the spread of ECUs, which have an over thirty per cent D-Mark component, outside Germany and thus beyond its effective control.

Table 1 Weighting Coefficients of Each EMS Currency in the Composition of the ECU basket from 21 September 1989:

Deutschemark	30.1	Luxembourg franc	0.3
Irish pound	1.1	Greek drachma	0.8
Dutch florin	9.4	Danish krone	2.45
Italian lira	10.15	French franc	19.0
Belgian franc	7.6	Portuguese escudo	0.8
UK sterling	13.0	Spanish peseta	5.3

Source: Commission of the European Communities (1989) "New Composition of the ECU", Background Report No.21,pp.1.

reluctant to await market development and they feel the need for a more active stance on the part of monetary authorities. They see two major different avenues along which official measures can be taken to promote its use:

5.2.1. The market-oriented approach: Actions (like those taken by the UK authorities) are taken with a view to facilitate the functioning of the private ECU market and to contribute to its depth and its overall liquidity. A greater use of the private ECU by governments, especially in the sphere of the Community budget, could also be seen as a possible element in this approach. It has been agreed that the "Dalgaard Group" will closely monitor the development of the private ECU, and will call for consultations if problems of a monetary character were to arise. A further step could be taken by the inclusion in their domestic monetary aggregates of Member States' liquid assets denominated in ECUs held by residents. In this case, liquid assets denominated in all Community currencies should be included also in this extended monetary aggregate.

In general, it would seem that the market-orientated approach would ensure a market appetite for the ECU by further increase in its use. Therefore, this avenue is likely to be less problematic than the situation in which the authorities would provide the market with private ECUs which at times may not be absorbed by the market without consequences for the exchange rates and the monetary policies of the Member States.

5.2.2. The institutional approach suggests that the use of the private ECU can only be stimulated by giving that task to a European institution. More precisely, official involvement in the private ECU would be increased by charging the EMCF with responsibility for the ECU and exchange-rate relationship between the ECU and third currencies. Another suggestion is to abolish the basket definition, introducing an "abstract ECU".

Committing the Fund with responsibility for the exchange rates vis-à-vis third currencies means that the decision at what level and for what amounts to support a weak dollar - at present taken by the central bank of the strongest EMS currency - would be transferred to the Fund. The Fund will have to be permanently provided with both third currencies and with either Community currencies or the possibility to sell newly created ECUs to be able to discharge its interventions.

The effect on member countries would depend on the ECU's definition:

a) if the basket definition were maintained any intervention would affect exchange and monetary policies of all member countries, strong and weak;

b) if the basket definition were abolished and an "abstract" ECU were introduced, the maintenance of stable exchange rates between member countries and the ECU would require the introduction of ECU intervention obligations for each member country. In that case, dollar purchases by the Fund against

ECUs would lead to ECU purchases against national currency by the strongest members. The difference compared to the present situation, where the stronger members buy dollars directly, will be that the decision to intervene is taken by the Fund and no longer by the countries concerned. This implies that exchange and domestic monetary policies of mainly the strongest member countries would be affected by actions beyond their control. The size of the dollar purchases by the Fund and thus of the monetary consequences for the latter countries would increase if the EMCF would be enabled to create ECUs by granting credit;

c) if an "abstract" ECU through its definition were to become a near-perfect substitute for the strongest ERM currency, the need for the monitoring of an extended monetary aggregate would increase.

5.2.3 Arguments for parallel currency

a) It is believed that the increased use of the ECU in international transactions will enable it to compete with the dollar in a stronger position than any national currency in Europe could do and this, also, will help Europe to reduce its sensitivity to dollar fluctuations (Duisenberg, 1989).

b) The ECU as a parallel currency is expected to contribute to the development of a decision-making procedure in the EMS which would be considered more European than the present one.

c) Some hope that if the ECU is widely used for international transactions it may in time develop into a common currency in a way that is less painful than the process requiring the

high degree of economic convergence and surrender of sovereignty, as foreseen in the Council Resolution of 1971.

d) It is suggested by the industry side that a wider use of the private ECU would diminish transaction costs and also the exchange risks for intra-Community trade.

Reducing Europe's dependence on a strongly fluctuating dollar would largely be welcomed by most of the European countries through forming a solid bloc by the European currencies in order to diminish the adverse effects of dollar fluctuations on them. But, the development of the ECU as a parallel currency would not by itself reduce the exchange rate risks, neither outside nor inside the EMS. There is no inherent disciplinary capacity of the private ECU which would bring about price and exchange stability. This could be ensured only by firm national policies succeeding in wiping out expectations of EMS realignments and, of course, by the complete liberalisation of capital movements.

Increasing the European Fund's role in managing the ECU and charging it with interventions will, surely, limit the national central bank's domestic monetary control. For this reason it could never take place in isolation but only in the context of wider economic and monetary integration.

How far could a parallel currency provide a path towards a common currency less painful than the one agreed in 1971 requiring convergence and loss of sovereignty? On the contrary, it would imply an unnecessary detour towards a common currency. There is

also a strong possibility of it becoming a permanent feature, not facilitating further integration in any way and, moreover, of weakening discipline in member countries with higher inflation and balance-of-payments deficits.

It would, of course, be a desirable feature for European industry to decrease the transaction costs. Presently there are, in most countries, no major obstacles for European industry to use the ECU as the transaction currency or the currency of denomination. However, it is the level of convergence which will determine the exchange risk, not the greater use of the ECU. Only the near-elimination of realignments could provide a measurable decrease in transaction costs.

5.3 Britain's "Hard ECU" Proposal for Europe

How would monetary policy be conducted in hard ECUs? According to the British Government's proposals, the quantity of "hard ECUs" would depend on how much the peoples of Europe decide to surrender their national currencies for hard ECU notes or balances with a newly-created "European Monetary Fund". However, it should be highly questionable, here, whether the peoples of Europe would want to convert any of their national monies into it because of its redundancy in transactions. Even supposing that large-scale conversions did take place, could a sensible "monetary policy" still be imagined? One difficulty is that the EMF could not control the quantity of its own liabilities because the EMF can issue "hard

quantity of its own liabilities because the EMF can issue "hard ECUs" only if it has already received national-currency backing (Congdon, 1990).

On the other hand, the British Government has not yet made clear whether the "hard ECU" is to be legal tender or not. If the hard ECU were not to be a legal tender, banks could ignore any so-called "policy actions" emanating from the EMF, including any putative "interest-rate decisions" taken by it. In the case that the "hard ECU" might be granted legal tender status from the outset, implied invasion of sovereignty would be as deep as anything envisaged by the Delors proposals.

As Congdon (1990) argues in his article, the preference for the existing currencies does not stem only from the convenience of having prices in one unit, but also from the inertia due to the inheritance of past contracts expressed in the national currency. As a result "the very notion of a 'parallel currency' in which two currencies and central banks are supposed to co-exist, is a contradiction in terms and a currency is a currency, because it is the only one in being."

6. CONCLUSION

The ideal European currency would be the German mark. But national feelings and lingering memories in other European countries make this impossible. The next best route to a common currency would be to set on the achievements of the EMS and strengthen them

currencies become interchangeable, allowing a common money to emerge by an evolutionary process. This evolutionary route would largely, and inevitably, depend on economic convergence and the acceptance of the loss of sovereignty implicit in the elimination of the exchange rate as an adjustment instrument. To this end, regional policies, in the effort to approximate the member countries' economic position, together with the political enthusiasm towards the ultimate goal of the EMU would be of vital importance.

CHAPTER II

OPERATIONAL ASPECTS OF THE ERM

INTRODUCTION

In this chapter it is aimed to review the ways in which the ERM operates with its participating currencies as well as the influence which has so far been imposed by the ERM on the member countries involved. It is also attempted to draw some assessments on the possible benefits and losses of the very objective of creating a "European Monetary Union" (EMU) in the nearest possible future, as proposed in the Delors Report, within the framework of the EC.

1. THE EXCHANGE RATE MECHANISM OF THE EUROPEAN COMMUNITY: A Review of the Literature

The ERM is only one part of a wider system of cooperation between the central banks of the EC which forms the European Monetary System (EMS). EMS consists of four distinct elements:

- The Exchange Rate Mechanism (ERM)
- The European Currency Unit (ECU)
- The European Monetary Cooperation Fund (EMCF)
- The Very Short-Term Financing Facility (VSTF)

Although the system also provides credit facilities to help smooth temporary balance-of-payments problems (for example, through the VSTF and the Medium Term Financial Facility), its focal point is the "exchange-rate mechanism". The EMS formally came into operation in March 1979, with all Community Member States participating, but the United Kingdom did not initially join the ERM (Bank of England,

1991). Following their accession Greece, Spain and Portugal are all now EMS members, though participation in EMS is not a condition of EC membership. Spain joined the ERM in June 1989, and more than a year later the United Kingdom became the ERM's newest participant in October 1990. Greece and Portugal are, still, outside the mechanism under discussion.

2. OPERATIONAL ASPECTS OF THE ERM

The Exchange Rate Mechanism links the exchange rates of all Community currencies, with the exception of the Portuguese escudo and the Greek drachma, to each other and to the European Currency Unit (ECU), so each participating currency establishes a central parity against the ECU. Member currencies can fluctuate only within the permitted margins of ±2¼% (±6% in the case of Spain and the United Kingdom), around these central parities. For example, Sterling has joined the ERM at the level of 2.95DM and 9.82FF (French franc) with a permitted fluctuation band of ±6%. This means that the pound can not be more than 6 per cent above the weakest currency in the system, or more than 6 per cent below the strongest. When the pound rises 6 per cent above its central parity against the weakest currency, then that currency is 6 per cent below its central parity against the pound, and just the opposite when the pound falls against the strongest one. The 12 per cent total band is the maximum variation against another currency which the pound's exchange rate (and the same rule for the one of Spanish peseta, of course) could show at different times.

At the time of writing, November 1990, the pound could rise to DM 3.13 against the D-mark, or 6 per cent above the central parity of DM 2.95, but it cannot fall to DM 2.78, or 6 per cent below. Because the pound is 1¼ per cent below its central parity against the peseta - the strongest currency - it can not fall by more than 4.3/4 per cent, which means DM 2.87, if other currencies maintain existing rates against each other. Additionally there is a "divergence indicator", which aims to measure the relative extent of each currency's divergence from its central ECU parity. When a currency reaches 75% of its maximum ECU divergence limit (the "divergence threshold"), the central bank is presumed to take action, and all the central banks are obliged to intervene intra-marginally to support bilateral parities in the case of any currency reaching the edge of its parity bands.

Intervention is conducted by using official foreign exchange reserves or unlimited amounts of credit facilities through the VTSF - which is available between central banks for this purpose - to buy one's currency when it is weak or using one's currency to buy foreign exchange reserves or repay credit facilities when it is strong. Intervention to raise a currency tends to increase short-term interest rates, and intervention to lower a currency tends to decrease them. The effect on interest rates can be reduced by redeeming or issuing treasury bills or government bonds in the context of "open market operations". Alternatively, the authorities can use the "discount window" to raise or lower interest rates in order to keep their currency within its bands. [The "discount window" refers to the loans made by the Central Bank to

the commercial banks to tide them over very temporary shortages of liquidity. For example, if the inter-bank borrowing rate for overnight money might otherwise double].

Much of the original EMS blueprint was motivated by a desire to counteract some of the less favourable features implicit in the earlier Bretton Woods fixed exchange-rate system; such as asymmetry, capital immobility and destabilising realignments.

2.1 Operational Asymmetries in the ERM

In any exchange-rate system there must exist a "numeraire" or nominal anchor determining the actual level of prices in the system "because exchange rates, by themselves, define only 'relative prices' in the system" (Mundell, 1969). Under the Bretton Woods system, gold acted as the legal - de jure - numeraire. In the ERM, the ECU (as a weighted basket of the participating currencies) was originally intended to be its numeraire, with the ERM parity net, thereby defined relative to ECU parities; policy adjustment between ERM member countries should be "symmetric". For this purpose a special institutional device - "divergence indicator" (DI) - was set up to assist such symmetry of adjustment. The aim of this action was to remove many of the operational asymmetries which had been revealed under the Bretton Woods regime and which often had forced adjustment upon only the weak currencies in the system.

In practice, in a quite different way, the Deutschemark is

now known as the de facto nominal anchor in the ERM, just as the dollar became the same under the Bretton Woods. Consequently, ERM members have found themselves constrained more often by bilateral limits relative to the strongest currency (usually the DM) than by the divergence threshold.

There is some confusion in economic studies regarding this so-called "German leadership" hypothesis. A number of empirical studies suggest that, in opposition to a strong form of German leadership proposition, there is some reciprocal influence from non-German ERM members upon policy in Germany particularly from France and Italy (Cohen and Wyplosz, 1989; Artis and Nachane, 1990; Fratianni and von Hagen, 1990; Weber, 1990). This conclusion proved true of the relationship between a range of monetary policy instruments (short and long-term interest rates and money supplies).

The clearest evidence of an asymmetric functioning of the ERM has been found by studies considering the (offshore) large interest rate adjustments (responses to the expectation of a realignment) observed among non-German ERM members relative to those seen in Germany in an attempt to dampen realignment pressure. These observations suggest that the ERM has indeed worked in an asymmetric style, with Germany often being used as the focal point for the operation of monetary policy, but there has not been absolute German leadership of the system (de Grauwe, 1989; Glavazzi and Giovannini, 1990).

One school of thought believes that the ERM's asymmetric

operation has been "intentional", in the sense of its emergence as a result of the policy preferences of participating countries. Specifically, it has been suggested that non-German ERM members could be able to "import" Germany's credibility in countering inflation by following the Bundesbank's monetary policy through an exchange-rate peg with the Deutschemark, explaining why high-inflation countries might accept voluntarily some dependence upon German monetary policy (Giavazzi and Pagano, 1988).

Others have stressed the potentially systematic nature of asymmetries within semi-fixed exchange-rate mechanisms, (Wyplosz, 1989) with the average inflation of the system receding naturally towards that of the country with the most contractionary stance. The feeling behind this is that, under a fixed exchange-rate regime, the countries building up their stock of reserves the fastest will be those with the most restrictive monetary stance. Conversely, those countries following the most expansive monetary policy will be losing reserves the fastest. Given that a country's stock of reserves is finite, the burden of adjustment is more often placed upon the expansionary/weak currency country (whose stock of reserves is being exhausted) than upon the contractionary strong currency one (whose reserves are being added to). The weak currency country will therefore be forced to tighten its policy to hold the exchange rate fixed, with the strong currency country isolated from this policy adjustment. The result is convergence on the strong currency standard.

Mastropasqua et al.(1988) indicated that Germany plays a negligible role in intra-marginal interventions involving the ERM currencies (which comprise the vast majority of total intervention) and that any movement in reserves in Germany are fully sterilised, with the opposite generally being true among other ERM countries. These observed trends show a potentially important role for the adjustment mechanism, with Germany, as the inflation leader targeting nominal interest rates and the others largely targeting foreign exchange reserves.

As a result, it seems highly likely that the asymmetric operation of the ERM has emerged from both inherent and intentional reasons. Nevertheless, the ERM played a considerable role in assuring a disinflationary formation for the currencies in the system, with low inflation currencies near the top of the system exerting discipline upon high inflation currencies placed near to the floor. This configuration has been actually observed during much of the latter half of the 1980s (Bank of England, Quarterly Bulletin, February 1991).

2.2 Capital Mobility

The second feature of the Bretton Woods system which EMS protagonists have sought to counteract is capital immobility. The United Kingdom formally abolished its exchange controls in 1979. More recently, largely under the impetus of the 1988 Capital Liberalisation Directive, France and Italy removed remaining exchange controls and Belgium abolished its dual foreign exchange

market in 1990, at the same year with France and Italy. Although some exchange controls remain in Spain, Portugal, Ireland and Greece, they are, now, in much-relaxed form compared with the 1970s. Regarding potential covert capital controls within the EC, some progress has already been made towards removing remaining indirect discriminatory restrictions upon freedom of "cross-border" capital flows (the existence and role played by capital controls in the ERM countries is analysed by, among others, Giavazzi and Giovannini, 1990; and for the UK by Artis and Taylor, 1989).

De Grauwe (1989) and Giavazzi and Giovannini (1990) show how capital controls enabled the non-German ERM countries to maintain a relatively high degree of monetary independence during the early 1980s despite asymmetries in the system's operation, allowing a combination of behaviour in the domestic money and euro-currency markets.

These two empirical observations suggest that capital controls may have acted as a "stabilising" device upon exchange and interest rates of some ERM members during the system's turbulent formative years, preventing excessive speculative capital flight - "speculative attack" - from countries facing devaluation (the elements of this "speculative attack" scenario in anticipation of a realignment, in the absence of capital controls, are given in Drifill, 1988; Obstfeld, 1988 and Wyplosz,1989). In practice, realignment procedures in the ERM were modified so as to reduce the probability of discrete market exchange-rate movements and hence of

speculative attack, allowing for the more widespread use of (intra-marginal) intervention in pre-emptive and coordinated interest-rate actions between members, markedly after arrival of the Basle-Nyborg Accord in November 1987. Finally, it is likely that increased financial market credibility, associated with the success achieved in boosting inflation convergence within the ERM bloc, has acted further to discourage speculative attack in recent years.

2.3 The Realignment Process

EMS participants, finally, have aimed to guard against dramatic parity realignments which occurred under the Bretton Woods system, in part by adopting a more symmetric approach to realigning their currencies than was seen in the earlier "semi-fixed" exchange-rate regimes. The ERM has experienced twelve realignments in its twelve-year history, seven of which occurred in the system's first four years in operation and the last of which, in January 1990, had the sole purpose of enabling the Italian lira to move to the narrow band. The last general realignment of the currencies in the ERM emerged in January 1987. However, as can be seen in Table 2, realignments have been few in number, have not always included the major currencies, have usually been small and have become less frequent, especially since 1983, over the period.

Padoa-Schioppa (1985) observes that while early realignments were *de facto* unilateral decisions, from around 1982 the realignment process became more collective. Giovazzi and Giovannini (1990) isolate the differential interest rate response of member countries

Table 2 Realignments of EMS Currencies (per cent changes)

Dates of realignments	24 Sept 1979	30 Nov 1979	22 Mar 1981	5 Oct 1981	22 Feb 1982	14 Jun 1982	21 Mar 1983	21 Jul 1985	7 Apl 1986	4 Aug 1986	12 Jan 1987
Belgian franc	0.0	0.0	0.0	0.0	-8.5	0.0	+1.5	+2.0	+1.0	0.0	+2.0
Danish krone	-2.9	-4.8	0.0	0.0	-3.0	0.0	+2.5	+2.0	+1.0	0.0	0.0
German mark	+2.0	0.0	0.0	+5.5	0.0	+4.25	+5.5	+2.0	+3.0	0.0	+3.0
French franc	0.0	0.0	0.0	-3.0	0.0	-5.75	-2.5	+2.0	-3.0	0.0	0.0
Irish punt	0.0	0.0	0.0	0.0	0.0	0.0	-3.5	+2.0	0.0	-8.0	0.0
Italian lira	0.0	0.0	-6.0	-3.0	0.0	-2.75	-2.5	-6.0	0.0	0.0	0.0
Dutch guilder	0.0	0.0	0.0	+5.5	0.0	+4.25	+3.5	+2.0	+3.0	0.0	+3.0

Source: R. Barrell (1990), "Has the EMS Changed Wage and Price Behaviour in Europe?" National Institute Economic Review, November 1990, No.139, p.67.

in anticipation of a realignment and demonstrate this as an evidence of some form of German leadership in the realignment process. Indeed, realignment consultations may have set up one effective channel through which Germany exerted its counter-inflationary influence over other ERM members in the mid-1980s by limiting the number of devaluations within the system.

A particular feature of the more recent ERM realignments, from the "speculative attack" perspective, is the observation that they have been free from speculation - "non-provocative" (Artis,1989) - that is the shift in the bands has been overlapping, with the new band set without disturbing the existing market rate. An innovation of the EMS in this regard acts as a device in avoiding the opportunity for the market to make a "one-way-bet". The difference is illustrated in Figure 44. In the case of the one-way-bet realignment sketched in Figure 44b, the discrete disturbance of the market rate yields huge gains to speculators, if correctly foreseen. For example, if a currency is allowed to slide to the bottom of its band so that it can only be expected to be devalued by, say 5 per cent, the gross gains from correctly anticipating the day on which this takes place exceed, in annual interest rate terms, a rate of 1,500 per cent (5x365). Speculators could benefit from this situation by borrowing the weak currency to buy the strong one in anticipation of devaluation, thereafter redeeming the loan in cheaper currency. In this case interest rates in the weak currency country would, indeed, have to be very high to challenge the huge gains in prospect. Hence, the ERM

technique of changing the central rate and thus the bands around the current market rate in a "timely" realignment could be considered as a substantial improvement upon the Bretton Woods system which effectively offered speculators a one-way-bet on currency.

In practice, EMS realignments have not always been "timely" -Kenen (1988) estimates the proportion to be just over 70 per cent - and exchange controls have also played a role in deterring speculation. The abolition of these controls will therefore put a higher premium on the practice of the non-provocative realignment procedure described above.

3. EXCHANGE-RATE STABILISATION IN THE ERM

In empirical studies concerning the system's role in fostering exchange-rate stability, closely related to the EMS's original objective of promoting monetary stability, the distinction typically made is between high-frequency ("nominal" exchange-rate "volatility") and low-frequency ("real" exchange-rate "misalignment") deviations from the exchange-rate bases, following Williamson (1983,1985).

3.1 High-frequency measures of exchange-rate stability

Early empirical studies concentrated on descriptive measures of volatility (as measured by, for example, the standard deviation of the percentage change in the exchange rate), using real, nominal, and/or effective exchange rates over a variety of time periods and

frequencies (Ungerer et al.,1983; Padoa-Schioppa, 1985).

A recent and authoritative example of this kind of approach is provided by Ungerer et al (1986), in a study for the IMF, which is shown in Table 3. The results quoted in this table are for nominal bilateral exchange rates against ERM currencies, the exchange rates being weighted together according to the pattern of weights provided by the IMF's multilateral exchange-rate model (MERM), which is standard for this type of application. Two concepts of stability are, here, stability of the actual level and stability of the (log) change-weighted average of variability of bilateral nominal exchange rates against ERM currencies. As can be seen from Table 3 for both levels and log changes, the index of variability rises for the three main non-ERM countries and falls for the three main ERM countries. Including, in addition, the smaller ERM countries in the coverage and a set of other developed countries in the non-ERM average, the result remains the same: where volatility falls sharply for the ERM countries between the pre-EMS and the EMS period, it rises for the non=participant countries over the same period.

More recently, a number of empirical studies have attempted to set some measures which, effectively, explain exchange rate "uncertainty" (unanticipated changes in currency prices): called "conditional" variability approach. The evidence from these studies is generally in keeping with that from earlier results (Ungerer et al.,1983 and 1986; Padoa-Schioppa, 1985): the ERM has,

substantially, contributed to stabilise both real and nominal intra-ERM bilateral exchange rates, but has had little effect upon the stability of member's global effective exchange rates. These observations may be considered consistent primarily with "internal", rather than "external" exchange-rate stabilisation.

3.2 Interest Rate Stability

A related question is whether lower intra-ERM exchange-rate volatility has been achieved at the cost of greater short-term interest rate variability (Batchelor,1883). Vinals (1990) reports this "to have been an important concern for the Spanish authorities prior to joining the ERM." In practice, the experience of many countries on joining the ERM has been that interest rate variability has increased initially, but that this increased uncertainty has gone away over time as financial market credibility has been attained. Most empirical studies strengthen this evidence in suggesting that there has been no observable increase in short-term interest rate uncertainty among ERM members in the post-1979 period (Ungerer et al.,1986; Artis and Taylor,1988). However, Ungerer et al.(1986) point out that there is less evidence of the ERM having stabilised "long-term" interest rates among its members.

3.3 Low-frequency measures of exchange-rate stability

There is some disagreement in the literature about how best real exchange-rate equilibrium is to be defined. For example, Wren-Lewis et al.(1990) have recently investigated the practical

usefulness of classical purchasing power parity exchange-rate theory but using as their equilibrium exchange-rate benchmark Williamson's concept of the fundamental equilibrium exchange-rate (FEER), i.e.

Table 3 Exchange-Rate Variability Against ERM Currencies 1974-85[a]

	Period Means			
	Levels		Log changes	
	1974-8	1979-85	1974-9	1979-85
France	31.6	15.9	16.8	7.6
Germany	29.2	16.3	14.7	7.0
Italy	36.0	19.3	19.3	8.8
Average ERM[b]	24.8	15.1	14.8	7.3
Japan	44.5	48.1	21.1	21.7
UK	32.7	37.8	16.8	20.9
USA	34.7	55.7	18.8	27.4
Average non-ERM[c]	34.5	35.9	17.2	17.9

Notes: a) Weighted average of variability of bilateral nominal exchange rates against ERM currencies (their log change), monthly data, IMF MERM weights. Variability is measured by the coefficient of variation for levels, and by the standard deviation for log changes (in both cases x 1000). Period means are unweighed.

b) Including all ERM countries.

c) Includes Japan, United Kingdom, United States, Australia, Canada, Norway, Sweden and Switzerland.

Source: H.Ungerer et al.(1986) "The European Monetary System: Recent Developments", occasional paper no.48, IMF, Table 7, p.35.

that real exchange-rate which is capable of supporting internal and external balance in the medium term. In addition, only recently

have studies sought to formalise the link between sluggish adjustment of real exchange-rates to their equilibrium values and inter-sectoral factor movement. Consequently, it is not yet possible to form a view as to whether the system does contribute actively or passively, to exchange-rate misalignments among the members or not.

4. MACROECONOMIC CONVERGENCE IN THE ERM

Within the academic literature, however, there is still some debate as to whether the (inflation) convergence undergone during the 1970s is specific to the ERM "arrangements" or whether it is a more general feature of the EMS "period" in which there were determined shifts towards the control of inflation in both ERM and non-ERM countries (Fratianni and Von Hagen,1990).

4.1 The EMS credibility hypothesis

The literature supporting the view that the ERM has exerted a strong and independent influence upon members' counter-inflationary stance typically stresses the disciplining role played by Germany vis-à-vis other ERM members; particularly the "reputational" benefits that could emerge if high inflation countries fix their nominal exchange-rate to that of the country with the highest anti-inflation credibility. This is called the "EMS credibility Hypothesis" (Collins, 1988; Giavazzi and Giovannini, 1988/1990; Giavazzi and Pagano, 1988). Analytical models of this hypothesis

have usually been presented in a game-theoretic framework, often in the spirit of Barro and Gordon (1983).

Equilibrium inflation in the Barro-Gordon framework is determined by the credibility of a policy-maker's commitment to price stability, i.e. where actual and expected inflation - the decisions of the authorities and of price sector agents (agents in financial and labour markets) respectively - coincide. High inflation countries can "import" credibility by fixing their nominal exchange-rates relative to the lowest inflation currency, thereby pre-committing themselves to an anti-inflation strategy and hence setting a credible constraint upon their policy "operations". This will result, provided that this commitment is credible, in lowering the threshold of inflationary expectations among agents, recouping any "inflationary bias" which might otherwise emerge (Kydland and Prescott, 1977) - and consequently lowering the equilibrium inflation in the game. This result is directly similar to Rogoff's (1985) observation that "inflation inefficiencies can be offset by handing control over to a 'conservative' central bank with a declared anti-inflation strategy." This is a clear shift in policy "preferences" of the authorities rather than constraining the policy actions.

> A number of authors have stressed the important role played by the 'real' exchange rate as a disciplining device upon high inflation countries, given that any adverse movements in relative inflation will automatically result on a worsening of competitiveness under a fixed nominal exchange rate regime.
>
> (Fratianni and Von Hagen, 1990)

The reason behind this is that the "real" rate of exchange - the

nominal rate corrected for relative prices, thereby an index of competitiveness - governs an economy's competitiveness, hence a sharp change, for example, a large appreciation in the real rate will cause a large fall in competitiveness, perhaps followed by protectionist pressures which could threaten the reversal of the process of removing internal tariff barriers. By reflecting this "inner logic", Table 2 shows that whereas the real rates of exchange of both the United Kingdom and the United States have undergone large changes in the 1980s, changes in competitiveness of the EMS economies, namely France, Germany and Italy (with the exclusion of the UK), have been more muted. This evidence points that, possibly, the ERM might have contributed to reducing the extent of exchange-rate "misalignments", which are deviations of real rates of exchange from equilibrium levels.

The ERM practice of "under-indexing" realignments, readjusting the nominal central rate by less than is needed to compensate fully for the cumulative inflation differential, has added to the discipline imposed through this real exchange-rate channel. This has meant both that the autonomous inflationary drive provided by a realignment in high inflation countries has been muted, and that realignments have proved more costly in terms of competitiveness (and hence acted as more of a discipline) than fully accommodating parity adjustments. In the expression of the game theory, under-indexed ERM realignments might, therefore, have acted as a punishment mechanism upon imprudent policymakers, prompting a monetary/fiscal policy adjustment in these countries to help prevent

the continuation of losses in competitiveness. This feature is likely to characterise accurately the policy responses of many ERM members, (in particular, the French experience following the March 1983 ERM realignment, with its aftermath of a package of budgetary and monetary austerity measures was implemented), as they acclimatised to the disciplines of the system, especially after 1983.

As a counterpart to the under-indexing of realignments, the anchor (lowest inflation) country would make absolute gains in competitiveness during any transitional phase of inflation convergence which in turn provides a rationale for the anchor country's participation in the system. However, more reasonably, it has been suggested that it is the desire for stabilisation, rather than absolute gains in competitiveness which better explains Germany's interest in participating in the ERM. Consequently, there is clear evidence of the ERM having helped stabilise German competitiveness with European partners by reducing the volatility of the German real effective exchange-rate after 1979 - (correspondingly, a number of commentators have noted a weakening of the Dollar-Deutschemark polarisation between the periods before and after the inception of the ERM, i.e. Giovazzi and Giovannini, 1990; Haldane and Hall, 1991).

Finally, no single model has yet been invented to explain both the divergence of ERM inflation differentials up to around 1983 and the convergence thereafter. This observation supports the view that there have been changes both to the functional characteristics

of the ERM, for example, a shift towards a more asymmetric regime of greater capital mobility and infrequent realignments, and to the policies of its members over time.

4.2 The EMS credibility hypothesis and inflation convergence: empirical evidence

Several attempts have been made to verify, in empirical terms, some of the implications of the "EMS Credibility Hypothesis". For example, Giavazzi and Giovannini (1988) find evidence of inflation expectations having undergone some downwards reversion after around 1983, though this structural shift is not statistically significant. Kremer (1990) finds relatively strong evidence of inflation expectations in Ireland, having followed the United Kingdom's prices before 1979, but having been more closely related to the price behaviour of ERM partners thereafter. Ireland has been following a similar course with France by adopting a monetarist policy towards inflation, but a monetarism based on the exchange rate, and now has an inflation rate of around 5 per cent. In a similar line, Artis and Nachane (1990) find a significant role for German inflation expectations in the price equations of other ERM members, while the same is not true either of non-ERM members or of ERM members in the pre-ERM period. In general, these studies point towards there having been some adjustment of inflation expectations during the EMS period in the direction suggested by German monetary policy, which was achieved some time after entering the ERM whereas agents "learnt" the true policy preferences of the authorities as

they adapted to the new regime.

On the other side, a number of studies have attempted to capture credibility shifts indirectly, by calculating the output (or unemployment) costs of disinflation: these costs are lower when credibility which attaches to a disinflation is higher because of the effects of credibility in lowering inflation expectations (and hence in lowering real wages).

As can be seen from Table 4, during the period of 1980-88, inflation has fallen in the United States and the United Kingdom (during this period the UK was not a participant of the ERM) as well as the group of some ERM countries. A "quick" indicator of the costs of disinflating is the ratio of the cumulative rise in unemployment to the reduction in inflation - the so-called "sacrifice ratio". Table 4 gives estimates at three intervals for this ratio. As presented in Table 4, it can be seen that Germany has the highest sacrifice ratio of all, presenting, at first sight, an inconsistent evidence with the credibility hypothesis under discussion. But one must consider that it is the non-German members which are supposed to reap the benefit of Germany's extreme inflation aversion by targeting the Deutschemark. However, Table 4 also displays that the sacrifice ratios for France and Italy are lower than those for the United Kingdom, being quite consistent with the hypothesis. It is the USA, on the other hand, which seems to have done best of all. While this might be treated as a special case, it is clear that the evidence, itself, is far from being unambiguous. Relatedly, De Grauwe (1989) finds no evidence of the

ERM having lowered the output costs of disinflation relative to countries outside the ERM pointing to an implicit rejection of the ERM Credibility Hypothesis. However, once acquired, policy credibility within the ERM may then have proved more robust than under a floating exchange-rate regime because of the additional

Table 4 Inflation and the "Sacrifice Ratio"

	Consumer price inflation %p.a.				
	USA	Germany	France	UK	Italy
1980	11.0	5.8	13.3	16.2	20.2
1981	9.3	6.2	13.0	11.4	17.9
1982	6.0	4.8	11.5	8.6	15.9
1983	3.5	3.2	9.7	5.0	14.8
1984	3.9	2.5	7.5	4.8	11.4
1985	3.1	2.1	5.7	5.2	9.3
1986	2.1	-0.5	2.5	3.6	6.1
1987	3.7	0.3	3.2	4.2	4.9
1988[a]	4.1	1.0	2.7	5.1	4.8
		Sacrifice ratios[b]			
1980-4	0.86	4.09	1.43	1.73	0.83
1980-6	0.66	3.37	1.51	2.33	0.95
1980-8[c]	0.51	5.77	2.33	3.18	na

Notes: a) 1988 data partly estimated
b) The ratio of the cumulative increase in unemployment to the difference between inflation in 1980 and inflation in the terminal year (1984,1986,1988).
c) Unemployment data for 1988 are average of the first three quarters

Source: OECD Economic Outlook, December 1988.

constraints placed upon member countries.

In general, much of the empirical evidence to date has found it difficult to disentangle statistically the global disinflation level of the 1980s from that which may have been ERM-inspired.

4.3 Convergence of other macroeconomic indicators: empirical evidence

The results in the report presented by Ungerer et al (1983,1986) indicate that progress has been made towards convergence of monetary policies and inflation rates among ERM members during the EMS period, but that less progress has been made towards an equilibrium of relative fiscal and external positions (broadly similar conclusions are reached by Cohen and Wyplosz (1989) and Weber (1990), using slightly more sophisticated analysis). This lack of convergence of some real indicators points that significant differences may have persisted between members during the EMS period. Indeed, it is these differences, for example, divergences in the relative external positions of ERM members which give rise to the adjustment mechanism for using exchange rates as a means of fostering convergence between high and low inflation countries. Finally, even though one may expect that policy differences among member countries could be avoided in static equilibrium, it is difficult to ignore those differences during the dynamic transition to that equilibrium.

5. THE "NEW EMS" AND THE "EXCESS CREDIBILITY" PROBLEM

A number of commentators have highlighted an apparent "paradox" which has occasionally emerged within the ERM in more recent years, for example, in Spain and Italy during periods in 1989 and 1990 (Artis and Dupuy, 1990; Giavazzi and Spaventa, 1990; Vinals, 1990). The paradox is characterised by high-inflation currencies operating near the top of their bands and low-inflation currencies operating near their floors, the opposite to what is expected from the "classic" ERM conformation of currencies.

The emergence of such a paradox has been related directly to increased financial integration, especially to capital liberalisation among the ERM bloc. Giavazzi and Spaventa (1990) show the narrowing of the differential between variability of on-shore and off-shore interest rates in France and Italy after 1987 to illustrate this enhanced capital mobility, indicating that this is due more to a reduction in off-shore interest rate variability than to an increase in the volatility of on-shore rates; which is taken as evidence of a stabilisation of exchange rate expectations in the ERM. They believe that this regime shift in the ERM financial markets credibility, resulting from enhanced financial integration, is to be the essence of the "New EMS".

The effect of this enhanced exchange-rate stability and financial integration has often been to stimulate large-scale

capital inflows into countries with the highest nominal inflation and interest rates and offering fastest growth. For Spain and Italy the result was a rapid swelling of reserves as their currencies moved towards the top of their ERM bands. These large increases in reserves often proved difficult to sterilise fully, including monetary relaxation in these high interest rate/high-inflation countries (for example, Spain sought to impose selected administrative controls on capital inflows during 1989 because of the difficulties involved in full sterilisation of increases in reserves).

> Since enhanced financial integration now limits the scope for realignments for fear of sowing the seeds of future speculative attack, it is possible that parity adjustments may be less well equipped to defuse such instabilities currently than was the case during the early 1980s.
> (Bank of England. Quarterly Bulletin, February 1991)

A formal explanation of the paradox is provided in Artus and Dupuy (1990), Giavazzi and Spaventa (1990), and Miller and Sutherland (1990). Their common conclusion was that short-run inflation instabilities can emerge only when expectations in the financial market are incompatible with those in the labour market; in particular when there exists "excess credibility" (of monetary policy) in financial markets relative to that in labour markets. Hence, the likelihood of instability is greater when wage-bargainers are less forward-looking relative to participants in financial markets, i.e. the ERM is less credible in labour than in financial markets.

While differential credibility in two markets is possible in the short run, inconsistent expectations between them (and hence instabilities) are not contingent in steady-state. The real exchange rate will act as an additional stabilising channel over the long run; therefore excess credibility problems are likely to be temporary. Giavazzi and Spaventa illustrate that excess credibility problems may actually "accelerate" convergence towards equilibrium by stimulating inflation at the beginning of the adjustment process and hence shifting competitiveness losses toward the early stages of a disinflation. The external adjustment costs of disinflation, i.e. current account deficits, emerged in the transitional period of inflation convergence may therefore be lower if a country "suffers" an initial excess financial market credibility problem than would be the case otherwise.

6. SUMMARY

In general, the ideas and opinions of academics and policymakers on the operation and performance of the ERM have not yet matured and remain diffuse. This uncertainty in the literature possibly reflects the evaluation of the system itself having been fragmented and episodic. The ERM's operational framework, in particular, does not seem to have been constant over time: the system now functions in a largely asymmetric style, rather than symmetrically as intended; capital mobility between ERM members is much greater recently than during the system's formative years; and ERM realignments are now both infrequent and non-provocative, unlike the early 1980s. Policies of the ERM member countries during the

1980s have also been subject to frequent and often marked variation. Correspondingly, no standard framework for analytically modelling the system has emerged.

On the other hand, limited degrees of freedom and somewhat disparate historical experiences of member countries have implied that conclusions from empirical studies have rarely proved certain. But, empirical evidence that the ERM has stabilised bilateral exchange rates between members (in the sense of reducing short-term volatility) and that the system has contributed effectively to the process of inflation convergence among ERM countries is relatively clear cut. Finally, with time, data, and further experience of the regime, it is likely that more conclusive outcomes will be obtained, rather than through elaborate econometrics.

7. OTHER ELEMENTS OF THE EMS

7.1 The ECU:

since we examined the ECU in the first chapter, it is mentioned again here only shortly, including the participation of the Spanish currency, peseta, in the ERM of the European Monetary System, on 17 June 1989.

The European Currency Unit (ECU) replaced the "European Unit of Account" in 1981. It is the accounting currency of the Community which is used in producing the EC's budget, paying grants and even for calculating staff salaries. It forms part of each

Member State's national foreign currency reserves. It is also available in travel cheques, though it is not, yet, a coin in your pocket, and it is receiving larger acceptance amongst financial institutions throughout the world as a denomination for financial instruments, such as ECU bonds.

The ECU is calculated by reference to certain proportions of each Community currency, contained in a so-called "basket". The actual proportion is weighted according to the size of each Member State's economy, which are defined as the weighting coefficients shown on Table 1, with the German D-mark forming its strongest component. The amounts are recalculated every 5 years. The level of proportions that each ECU contains set in September 1989 are as follows:

Table 5 The Amounts of National Currencies in the Composition of the ECU

German mark	0.624	Irish punt	0.009
Dutch guilder	0.219	Italian lira	151.8
Belgian franc	3.301	Pound sterling	0.087
Luxembourg franc	0.13	Greek drachma	1.44
Danish krone	0.198	Spanish peseta	6.885
French franc	1.332	Portuguese escudo	1.393

Source: Commission of the EC, 1989 Background Report.

The figures above simply provide the amount of each national currency which is taken into account in counting the value of the ECU. Participation of the Spanish peseta in the ERM did not change the central rates and intervention rates of each national currency

within the EMS, and had no agri-monetary consequences.

7.2. The European Monetary Cooperation Fund

The EMCF is the means by which cooperation is provided between the central banks of each Member State. Eventually it is to become a European Central Bank, politically independent of Member States but maintaining very close links with national monetary authorities.

The Board of the EMCF consists of governors of the national central banks. It issues ECUs to each Member State in return for the deposit with it of 20% of each Member State's gold and dollar currency reserves, although actually, no money physically changes hands. These exchanges take place on a three-monthly basis, but allow the ECU to be used in intercentral bank accounting, i.e. in settling debts emerging from the buying or selling of particular currencies within the ERM.

7.3. The Very Short-Term Financing Facility

The VTSF, as an integral part of the ERM intervention mechanism, is a means of financing rapid assistance often required by the participating Member State's central banks on foreign exchange markets in order to maintain ERM currencies within permitted margins.

Each central bank in the ERM provides automatic unlimited credit facilities to the other Member States' central banks to finance intervention either once currencies reach permitted margins or, subject to prior agreement, before the limits are reached. Repayment is made fairly soon after the credits are used, though this may be delayed in certain circumstances.

8. BENEFITS AND COSTS OF THE EMU

The purpose of this section is to review the possible benefits and costs of the European Monetary Union in the light of the recent work of the European Commission, "One Market One Money" (October,1990) and to evaluate them by taking into consideration various opinions on the subject, as well as using some empirical evidence.

According to the Commission:

1. The elimination of currency transactions costs could save as much as 13 to 19bn ECU yearly (0.3 to 0.4% of Community GDP), accounting for larger gains for small, open economies (0.9% of GDP) than for larger economies (0.1 to 0.2% of GDP). Together with other gains which are difficult to figure, total gains from the removal of currency transactions are expected to be at least 0.5% of GDP per year.
2. The EMS would completely eliminate nominal exchange rate variability which recently has averaged 0.7% per month for ERM currencies and 1.9% for non-ERM currencies (each currency

against all other EC currencies). It would also eliminate uncertainty (which interest rate premiums show to be considerable even where actual exchange rates have been stable).

3. Efficiency gains may also be obtained by improving the internal market, for example, by strengthening the measures in the fields of competition, energy, transport, research and development, environment and taxation policies. For example, calculations for Germany suggests that, the removal of subsidies could improve efficiency by 0.9 per cent of GDP.

4. The combination of the 1992 programme and the EMU could be promising not only for "static" efficiency gains but also "dynamic" gains (i.e. higher sustainable rate of economic growth). There are expectations of a moderate reduction in the riskiness of investment (e.g. exchange rate uncertainty) which could have a significant growth effect in the long run.

5. Reductions in uncertainty will allow a reduction in the rate of return on investment asked by shareholders, which in turn fosters investment and growth. Only a modest reduction in this rate of return of 0.5 percentage points could well amount to a gain in output accumulating to 5 per cent of GDP.

6. Price stability is itself advantageous for efficient resource allocation. Low inflation is associated with low variability of inflation, and therefore of relative prices. The economic literature suggests that a 1 per cent decrease in relative price variance could lead to an increase of 0.3

of a percentage point of GDP in real output for instance.

7. Lower inflation will mean lower inflation tax (seignorage) revenues for high inflation countries. In considering the present situation of inflation rates, this would mean a yearly loss, say during a period of 5 years, of some 1 per cent of GDP for the governments of Greece and Portugal and less than 0.5 per cent for Spain and Italy.

8. Gains for interest payments on public debt and allocation of capital could come from the equalisation of real interest rates. Imperfect credibility of exchange rate commitments meant a real interest rate differential of 1 to 2.5 per cent for EMS countries relative to Germany on average over the period of 1985-1989. Hence, the equalisation of real interest rates could compensate inflation tax losses in the high inflation countries through gains, during the transition to EMS, on the interest payments averaging between 2 and 5 per cent of GDP.

9. EMU would lower the costs of economic shocks. Simulation of the shocks over the past two decades under alternative exchange rate regimes estimates that the EMU with a single currency might, compared to the EMS of the mid-1980s, have a reduction in inflation fluctuations of one-fourth (0.6 to 1.5 percentage points less variation) and of output growth fluctuations by one-fifth (0.3 to 0.7 percentage points less variation).

10. Financial flows will be available to cushion the effects of economic shocks. Monetary union will remove external financial constraints, and national and Community budgets

will also help absorb shocks.

Impacts on the international systems:

11. As an international currency, the ECU would allow a saving in the Community's exchange reserves of about 160bn ECU (200bn$), increase the share of ECU-denominated assets in the world financial portfolio by 5 percentage points and increase the invoicing in ECUs (with 10 per cent of EC trade). This increased use of the ECU would provide for a decrease in transaction costs with third countries (0.05 per cent of the EC GDP) and bring international seignorage revenues from a possible long-run accumulation of some 28bn (35bn$) in ECU notes outstanding abroad.

12. Finally, the EMU should facilitate international coordination and also the establishment of a balanced tri-polar regime.

9. ASSESSMENTS OF THE BENEFITS AND COSTS OF THE EMU

The calculations and suggestions of various academics and economists are approximately consistent with those in the Commission's work ("One Market, One Money", Oct.1990) on the quantification of the benefits and costs of the EMU.

In their recent study Daniel Gros and Niels Thygesen (1990) suggest that total potential savings in transaction costs should - regarding to the intra-EC trade which accounts for about 20 per cent of GDP on average, should be in the region of 0.25-0.5 per cent of

the EC's GDP, close to the Commission's estimation of 0.5 per cent of the GDP. They argue that a single currency would significantly reduce the scope for discriminatory national pricing, through the elimination of information costs and of incentives for price discrimination inherent in the continued use of a number of currencies. They strongly stress, that an additional 2 per cent of the EC's GDP could be attainable. In their recent questionnaire study, Ernst and Young (1990) also suggest that the addition of a single currency to the 1992 programme would have major effects. Samuel Brittan and Michael Artis (1989), note that the transaction cost saving on trade might amount to ½ per cent of GDP, quoting the margins of ½-1 per cent for commercial transactions and 2½-3 per cent for tourist transactions for the Community given by Eltis (1989) in a recent NEDO paper. They also suggest that the existence of exchange rate uncertainty militates against the efficient allocation of capital and impedes the operation of an integrated European capital market; hence, the removal of exchange rate uncertainty should increase the net flows of capital within Europe. An important source of gross flows of capital (each-way flows of portfolio investment) would be eliminated by EMU, for those which are stimulated by exchange-rate risk spreading would no longer be required. As a difference, Samuel Britton and Michael Artis estimate (uncertainly) the gains from elimination of currency-exchange transaction costs to be 1½ per cent or more of the GDP, possibly in an over-pessimistic way.

In dealing more briefly with the costs of a single currency,

Gros and Thygesen (1990) stress the matter of political costs in surrendering the exchange rate adjustments as an instrument of monetary policy. They point out that a government would find a realignment of its exchange rate desirable if its economy were to experience shocks different from those to which its partners in the union are exposed, since, whether they are external or domestic, accommodation through a realignment may require lower costs of adjustment than the alternate way of a necessarily more protracted realignment in the national price level, with its associated output costs. If European governments anticipated that such differentiated shocks were likely to emerge in the future, they would be taking a serious risk by accepting a commitment in the strongest form, i.e. by joining a single currency area. Although there are important differences in the industrial structure across member states, these shocks tend to be cancelled out as most economies are based on a number of different sectors. Even if this recognition is widely shared, they suggest that governments are correct in perceiving that their ability to conduct stabilisation policies is further restrained by undertaking exchange-rate commitments that go beyond those in the present EMS.

Then they question if this cost will be offset by benefits:

> The EMS experience suggests that this is the case. Governments that wish to retain the freedom to realign pay a price. Agents in the national markets for goods, labour and financial assets will assume that the freedom of manoeuvre will eventually be used. They will tend to settle down to a more rapid rate of increase of prices and wages than if the exchange rate were definitively removed as an instrument. They will add a risk premium to the required return on assets denominated in the domestic currency. If

> the exchange rate in fact remains fixed, there will be temporarily higher inflation and lower output than in the case of a definitive commitment. If the currency is devalued, the critical perceptions of private agents will have been borne out and a non-inflationary reputation will be much harder to build up in the future.
> (Gros and Thygesen, 1990)

And they conclude by stressing that the success in converging inflationary expectations and interest rates will depend crucially upon the extent to which firms, households, labour unions and financial market participants can be convinced that the exchange-rate commitment will not be withdrawn, in other words "there is no substitute for complete EMU and single currency in this respect."

9.1 Evaluation of the Costs of Fixing Exchange Rates/Adjustment without Exchange Rate Changes

According to the Commission's recent paper,"One Market, One Money" (1990):

1. The main cost of the EMU is the loss of the national monetary and exchange rate instrument, but this cost should not be exaggerated since changes will remain possible for the Community as a whole in relation to the rest of the world.
2. Changes in real exchange rates (competitiveness) remain possible and desirable within EMU, "This is why wage and price flexibility is a necessary condition of success."
3. EMU will reduce the incidence of those country-specific shocks that warrant real exchange rate changes as a result of

changes in industrial structure and wage bargaining. Also shocks resulting from exchange rate instability and uncoordinated monetary policies will be eliminated, and so the variability of output and inflation will be reduced.

4. Financial flows will be available to absorb economic shocks and national and Community budgets will also help absorb shocks.

Both exchange rates and monetary policies can be seen as shock absorbers. Their use can mirror the structural differences between economies, both in absolute advantages - arising from natural endowments like oil reserves - and in wage and price behaviour, which may take some time to remove.

Barrell(1990) suggests that the unified market does not mean the loss of the control of monetary policy. Policy makers can still choose the inflation rate that they see as desirable and they have to accept the exchange rate consequences. In the case of accepting the effects of an inflationary shock, the costs to each country will vary depending on differences in the speed of response. In his analysis based on GEM - National Institute's world model (1990), Barrell argues that there are currently large differences in structure among European economies, in particular in relation to the speed of response of prices to shocks and in the degree of impact of overseas prices on the domestic price level. In particular Italy and the UK react more rapidly to inflationary shocks than France and Germany do. Given, also, that they have higher inflation rates, Barrell (1990) envisages that the union will impose progressively

greater effects on output and prices in order to remove these differences.

In his synthetic monetary union Barrell (1990, Table 6) shows that it is relatively costless to unite France and Germany over the period of 1991 quarter 1 and 1999 quarter 4 assuming that the Bundesbank's policy is adopted by the ESCB with negligible inflation being a major policy target. The slightly tighter fiscal stance in France lowers the level of output and in the transition to inflation convergence there is a loss of competitiveness against Germany. The process of adaptation is more costly for the UK in terms of lost output, and even more costly for the Italian economy (however, Barrell (1990) points out that, over the period of 1980-1988, the fall in inflation differential through the ERM operation cost 700,000 jobs in France and almost 1 million in Italy). He assumes that in order to lower inflation and to keep it within certain bounds in the long run Italian growth would have to be held 0.75 per cent below capacity for some years. This, obviously , represents a very high price to pay in order to get inflation down to German levels, rather than keeping it 1½ to 2 per cent higher.

In his simulation models on the effect of an external shock, here it is an oil price shock, Barrell (1990, Tables 7 and 8) finds that abandoning the exchange rate as a shock absorber in a monetary union could lead to worse consequences in response to shocks than there would be without a union. In the light of his findings, he strongly stresses that only a serious attempt to understand and then

reduce the structural differences would allow the economies of Europe to reduce the costs of abandoning independent shock absorbers.

In a similar study, Patrick Minford and Anupam Rastogi (1990) (Liverpool Research Group working paper) suggest that the EC is handicapped as an optimum currency area because of the absence of labour mobility and the existence of large structural differences between members. As an outcome of their simulations of Liverpool models, they claim that the UK would be better off outside the EMU than being inside it by reasons of losses in output and employment, resulting from tightening the fiscal and monetary policies throughout the Community.

Daniel Gros and Niels Thygesen (1990) question the argument that the joint monetary policy pursued by the ESCB could be expected to be less inflationary than the average performance of the participants in a decentralised framework. To this end, they, in line with Delors' proposals, suggest that two prerequisites should be given. The first is to grant the ESCB a statutory mandate to aim at price stability. In this case, access to direct central bank credit and other forms of monetary financing for national government deficits is to be excluded, except for open market operations in government securities at the discretion of the ESCB. Decisions related to intervention in third currencies would be made on the sole responsibility of the ESCB, in accordance with Community exchange-rate policy. The second is to assure the independence of the ESCB from the instructions from national governments and the

Table 6 Effects of the Union[a]

Year	GDP[b]	CED[c]	Balance of[d] payments	3-month interest rate[e]	US dollar exchange rate[c]
Germany					
1	-0.1	0.0	-1.6	0.0	0.0
2	0.2	0.1	-1.7	0.0	0.0
3	0.4	0.1	-2.7	0.1	-0.1
4	0.5	0.2	-3.4	0.1	-0.1
5	0.6	0.2	-4.6	0.2	-0.2
6	0.6	0.2	-5.4	0.2	-0.2
7	0.8	0.2	-5.6	0.2	-0.2
8	0.9	0.3	-7.0	0.2	-0.2
France					
1	-0.3	-0.1	2.4	-1.0	+1.0
2	-0.3	-0.2	1.7	-1.0	+1.0
3	-0.4	-0.4	1.3	-1.0	+1.0
4	-0.5	-0.6	1.0	-1.0	+1.0
5	-0.6	-0.8	0.1	-1.0	+1.0
6	-0.7	-1.0	-0.9	-1.0	+1.0
7	-0.8	-1.3	-2.2	-1.0	+1.0
8	-0.9	-1.6	-4.2	-1.0	+1.0
Italy					
1	-0.4	-0.2	2.9	-1.9	+1.9
2	-0.5	-0.4	-0.5	-1.7	+1.7
3	-1.4	-0.8	2.9	-1.7	+1.7
4	-2.0	-1.2	-2.0	-1.7	+1.7
5	-3.2	-1.6	4.3	-1.7	+1.7
6	-4.2	-2.1	-1.2	-1.7	+1.7
7	-4.8	-2.3	-5.0	-1.7	+1.7
8	-5.6	-2.7	-8.6	-1.7	+1.7
UK					
1	-0.4	-0.1	3.3	-3.0	+3.0
2	-0.3	-0.5	0.1	-2.5	+2.5
3	-0.3	-1.0	-4.0	-2.0	+2.0
4	-0.8	-1.3	0.5	-2.0	+2.0
5	-0.7	-1.5	-3.8	-2.0	+2.0
6	-1.2	-1.6	3.0	-2.0	+2.0
7	-1.0	-1.7	-1.5	-2.0	+2.0
8	-1.4	-1.6	8.6	-2.0	+2.0

Notes:a) Difference from base b)In percentage terms
c) Rate of change d) In US dollar billion
e) Percentage points

Source: R. Barrell (1990) "European Currency Union and the EMS"
National Institute Economic Review, May 1990,p.62.

Table 7 Shocks with a Monetary Union: Oil Price Rise[a]

Year	GDP[b]	Domestic demand[b]	Unemployment[e]	CED[c]	Balance of payments[d]	Dollar rate[c]	3-month interest[e]
Germany							
1	0.3	0.0	-0.1	0.6	-9.0	0.6	0.3
2	0.7	0.1	-0.2	0.6	-8.4	2.5	0.6
3	0.9	0.2	-0.3	0.4	-2.8	0.0	0.4
4	0.9	0.1	-0.4	0.3	0.4	-2.2	0.3
5	1.0	0.0	-0.5	0.4	-0.9	-1.9	0.3
6	1.1	-0.1	-0.6	0.4	-3.2	-0.4	0.4
France							
1	-0.1	-0.1	0.0	0.9	-9.4		
2	-0.1	-0.3	0.0	1.1	-7.5		
3	-0.1	-0.5	0.0	1.0	-4.4		
4	-0.1	-0.6	0.0	1.0	-2.9		
5	-0.2	-0.6	0.0	1.0	-3.3		
6	-0.2	-0.7	0.0	1.2	-3.3		
Italy							
1	0.1	-0.4	0.0	0.6	-8.9		
2	0.3	-0.2	0.0	1.1	-7.4		
3	0.4	-0.5	-0.1	0.9	-4.0		
4	0.3	0.6	-0.1	0.7	-3.7		
5	-0.2	-0.6	-0.1	0.6	-4.0		
6	-0.2	-0.7	-0.1	0.7	-5.8		
UK							
1	0.2	-0.1	-0.0	0.4	-1.0		
2	0.5	-0.6	-0.1	1.7	5.5		
3	0.4	-1.0	-0.1	1.8	14.4		
4	0.1	-1.4	-0.1	1.4	20.2		
5	-0.2	-1.7	-0.0	0.9	22.9		
6	-0.2	-2.0	0.0	0.5	26.4		

Notes: a) Difference from base b) In percentage terms
c) Rate of change d) In US dollar billion
e) Percentage points
Dollar rate and interest rate figures for France, Italy and the UK are the same as those for Germany.

Source: ibidem, p.63.

Table 8 Shocks Without a Monetary Union: Oil Price Rise[a]

Year	GDP[b]	Domestic demand[b]	Unemployment[e]	CED[c]	Balance of payments[d]	Dollar rate[c]	3-month interest rate[e]
Germany							
1	0.2	-0.1	-0.1	0.6	-8.2	0.6	0.3
2	0.6	0.1	-0.2	0.5	-7.2	2.5	0.6
3	0.7	0.1	-0.3	0.3	-1.3	0.0	0.4
4	0.6	-0.1	-0.3	0.2	1.8	-2.2	0.3
5	0.6	-0.2	-0.4	0.3	0.5	-1.9	0.3
6	0.6	-0.2	-0.4	0.3	-2.4	-0.4	0.3
France							
1	0.1	-0.1	0.0	1.1	-11.5	5.6	0.4
2	0.2	-0.3	0.0	1.6	-8.9	8.2	1.2
3	0.3	-0.6	0.0	1.6	-2.8	4.3	1.5
4	0.0	-0.9	0.0	1.5	1.3	2.9	1.6
5	-0.2	-1.2	0.0	1.7	2.5	3.9	1.7
6	-0.4	-1.5	0.0	1.8	4.3	5.2	1.9
Italy							
1	0.1	0.0	0.0	0.6	-9.9	4.2	0.3
2	0.7	-0.1	-0.1	1.5	-8.6	7.0	1.0
3	1.0	-0.5	-0.2	1.5	-3.0	5.7	1.4
4	1.1	-1.0	-0.4	1.4	0.0	6.9	1.4
5	1.2	-1.2	-0.4	1.5	3.0	8.7	1.4
6	1.1	-1.6	-0.4	1.5	6.6	9.8	1.5
UK							
1	0.2	0.0	0.0	0.4	-0.8	1.5	0.0
2	0.3	-0.6	-0.1	1.5	7.5	-0.9	1.5
3	0.0	-1.0	-0.1	0.9	12.9	-2.9	1.0
4	-0.2	-1.4	0.0	0.7	18.0	-4.9	1.0
5	-0.4	-1.5	0.0	0.0	19.2	-3.8	1.0
6	-0.2	-1.6	0.1	-0.1	19.6	-1.5	1.0

Notes:
a) Difference from base
b) In percentage terms
c) Rate of change
d) In US dollar billion
e) Percentage points

Source: ibidem

Community authorities. In supporting this second case, they claim that an independent central bank does not face the "temptation" to create surprise inflation or lower the real value of public debt. They illustrate the idea by emphasising the consequences of much of the empirical works on the impact of various dimensions of central bank independence, displaying that there is a link between political independence and low inflation (Alesina, 1989).

10. CONCLUSION

It is quite clear that besides large gains to be obtained from a monetary union there is also a strong case for substantial costs to occur, especially (and more heavily) in the weaker countries. In this context it is essential for the fulfilment of economic convergence of the European economies to pursue a sound and just regional policy and fiscal policy coordination throughout the Community.

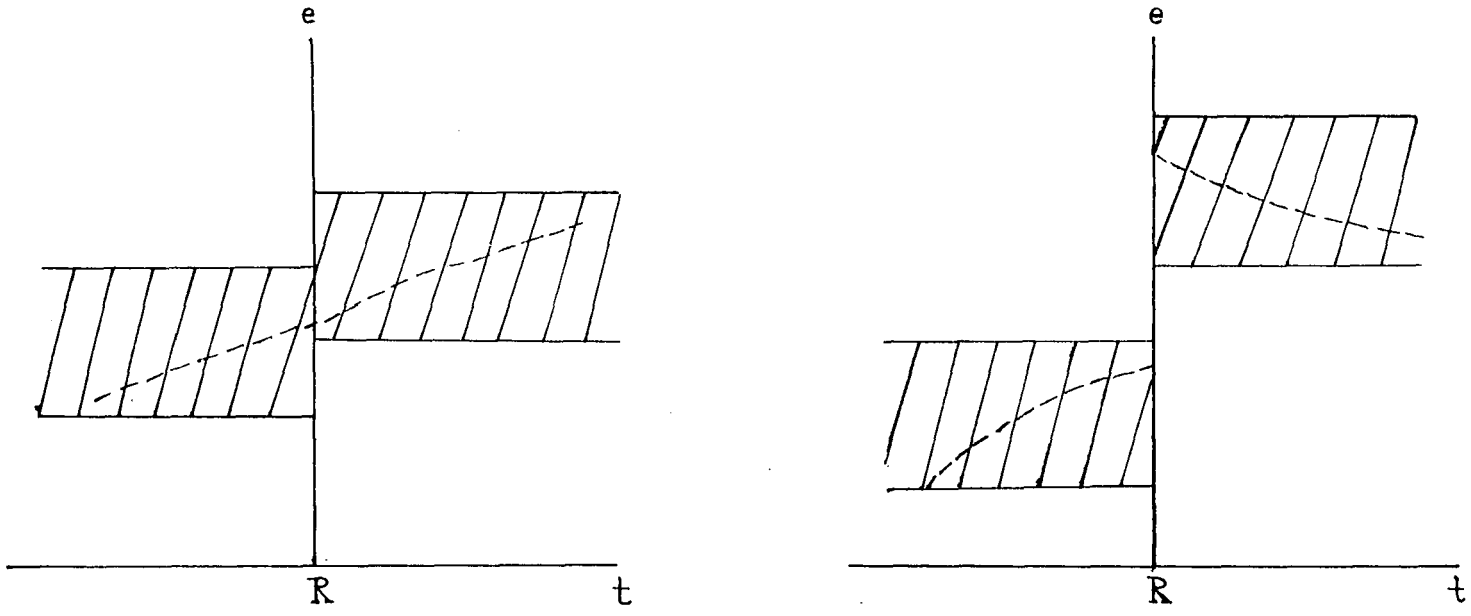
On the other hand, monetary convergence does not occur unless a strong commitment is made to the ultimate objective of fixing exchange rates and having a single currency and institutions that will ensure the credibility and surveillance of the system. That is why an accelerated move toward the EMU is likely to be more successful.

In addition, events like the linking of the currencies of Austria, Norway and - informally - Switzerland, to the D-Mark

without being members of the Community strengthen the view that policy makers have lost faith in exchange rates as a tool of economic management and inflation is not, any more, regarded as an alternative to unemployment by some countries - bringing about a stronger case for the EMS than it was a few years ago.

Nevertheless, it should be noted here that the German economy is in trouble. It is the rapid rise in broad money supply which left, according to the Bundesbank's latest report, an excessive money growth of about 5 per cent for the year January 1990 (Norman, 1990). This would inevitably call for a substantial increase in German interest rates as well as the inflation rate, making, probably, monetary convergence among the ERM participants somewhat easier.

Figure 44 Exchange-rate Realignments



a) a timely realignment

b) A discrete adjustment

-------- = exchange rate

= bands

e = exchange rate.
R = date of realignment.
t = time.

CHAPTER III

STRUCTURAL ADJUSTMENT PROBLEMS OF THE RECENTLY JOINED MEMBER COUNTRIES (SPAIN, PORTUGAL AND GREECE)

INTRODUCTION

This chapter deals with structural consequences of a customs union on participating countries in general, and on the poorer and most recently joined Mediterranean countries in the EC in particular. However, it is felt obliged, here, to point to the lack of up-to-date study on the difficulties which new member countries have been facing following their accession to the EC.

1. TARIFF CHANGES AND ADJUSTMENT

Removal of the tariffs and other barriers on trade between the member countries of a customs union leads to an increase in the amount of trade. According to the customs union theory there are two sources of this increased trade; "trade creation" and "trade diversion". If the common external tariff (CET) - the alignment of national tariffs on trade with the non-union countries - results in a reduction in duties, external trade creation may be expected, that is lower-cost non-union production replaces higher-cost domestic production in the union market. On the contrary, an increase in duties may lead to "trade suppression" as higher-cost union production displaces lower-cost non-union supplies because of the discriminatory impact of the CET.

"Trade diversion" has no direct consequence, initially not involving a change in the amount of domestic production and no

movement of resources is required. There might be an indirect effect if, for example, a country from whom imports are reduced takes retaliatory action against the home country.

The main source of adjustment problems that newly participating member countries will face is "trade creation", where resources are displaced from domestic production and may become temporarily unemployed as a result of increased import penetration. This will be particularly likely if the resources are highly specific to a particular industry, if the industry is regionally concentrated (like Spain, Italy), if factor markets are not flexible, and if economic growth is slow (Greece). Redeployment of resources will be costly for those involved in terms of temporary loss of earnings, relocation, job search and retraining expenses (Greenaway and Milner, 1986).

"Trade creation" takes a number of forms with differing adjustment implications; inter-industry trade creation entails the closure in whole or part of the industry in one member country and the corresponding expansion of industry in a partner country. The structure of industry in the two countries becomes more divergent. "Intra-industry trade creation" involves a two-way expansion of trade in a particular product as the national industries concentrate on a narrower, but more complementary product range. Two analyses suggest that labour adjustment problems may be less acute with intra-industry than with inter-industry trade creation. Firstly, a group or package of job skills may be more easily transferable where a job change occurs within the same industry than where there is a

change of industry. Secondly, to the extent that industries tend to be geographically concentrated, a job change is less likely to involve relocation when there is intra-industry trade creation than when trade creation is inter-industry.

On the other hand, the effect which customs union formation may have on the growth rate is important because workers who were displaced through greater competition from imports will be more likely to find alternative employment speedily if the economy is growing rapidly than if entry to a customs union is accompanied by economic stagnation or contraction.

2. STRUCTURAL ADJUSTMENT PATHS FOR THE LEAST DEVELOPED MEMBER STATES OF THE COMMUNITY

2.1 Inter-industry scenario

In this scenario, the removal of non-tariff barriers allows the southern countries to increase the level of their Community exports of those products in which they currently have a comparative advantage, i.e. labour-intensive sectors such as clothing and footwear, resulting in an increase in the level of inter-industry specialisation of these countries (namely, Spain, Greece and Portugal). This process would be reinforced by relocation of some manufacturing investment away from the north towards the southern countries. Surveys of European companies have demonstrated that such relocation would only affect a limited number of sectors but that they would be particularly relevant for traditional industries

where labour costs account for a large proportion of total production costs (IFO survey of German firms).

Another policy open to the concerned Member States under this scenario consists of increasing product quality in traditional sectors (upgrading). Italian success in the footwear and quality clothing industries indicates this development route. Similarly, in Portugal and Spain, a modernisation of traditional industries such as footwear and clothing can be observed. The purpose of this strategy is to develop "non-cost" competitive factors such as quality, design and brands and to produce more sophisticated products in order to compete with producers from less-developed countries. It will also require a fostering of management skills, improving professional training and the modernisation of productive capital.

2.2 Intra-industry scenario

Under the second scenario, it is assumed that the southern members will progressively transform their current industrial specialisation patterns by seeking to strengthen their position in high-tech industries where higher rates of demand growth can be expected. Thus, there would be a reduction in inter-industry specialisation in the southern members for those sectors where they have comparative advantages and an improvement of their performances in sectors where they have traditionally been net importers. This dual evolution would correspond with an increase in their level of intra-industry trade with the rest of the Community.

The relocation of EC investment can encourage this restructuring process by introducing more modern production processes and by contributing to the increased specialisation of these countries on proper markets with higher technological content.

As to trade diversion, in the importing country this would affect trade policy formation to the extent that there are potential reciprocity/retaliation effects. The importing country might be concerned that a contraction of imports from a traditional supplier could affect exports to that country because of commercial policy retaliation or balance of payments effects.

3. SPAIN'S ACCESSION TO THE EC

In the case of Spain, the economic reform programme of the early 1980s which set the basis for an acceleration of national economic growth, together with the fall in the oil price which coincided with the entry of Spain to the EC, played an important role in moderating the adjustment problems of EC membership for Spain. "Dynamic" effects from customs union formation mainly include encouraged investment effects and economies of scale resulting from the enlarged market and increased competition (Marques Mendez, 1987).

3.1 Manufacturing industry

A history of heavy protection has left Spain with an economy which was the least open to industrial trade of any EC member country in the first half of the 1980s; with its imports of manufactured goods amounting to only 11.0 per cent of the GDP, the next lowest country being Italy with 14.4 per cent. The relatively closed nature of the economy was reflected also in the low level of industrial exports, totalling 10.9 per cent of GDP against the EC average of 21.7 per cent (R.C. Hine, 1989).

The future expansion of EC-Spain trade in manufactures seemed likely to arise mainly from trade creation rather than trade diversion. Any negative impact on non-EC suppliers of manufactured goods was to be limited for two reasons; first, the EC had, already, some concessions in the Spanish market under the 1970 agreement, so the removal of tariffs on EC exports would have a lesser impact. Secondly, Spain's tariff on non-EC imports had to be aligned with the much lower "Common Customs Tariff" rendering the Spanish market more accessible to non-EC countries. The total reduction in the nominal tariff facing EC and non-EC suppliers was similar - almost 10 per cent - with marked variation between products. On the other hand, the EC's Value Added Tax (VAT) replaced Spain's cascade type tax which gave rise to over-generous discount of taxes on exports - in fact an export subsidy - and this change could have negative effects on Spanish exports.

The scope for trade creation in industrial products stems not just from the high level of protection in Spain prior to EC entry (Table 9), but also from the general similarity of the structure of industry in Spain and the EC. The result obtained from data (UN 1983, Commodity Trade of Spain) on the share of gross value added (GVA) at factor cost - as a measure of the size of a particular industry - in each of 82 industries calculated for France, W.Germany, Italy, Spain and the UK in 1983 showed that the patterns of industrial specialisation in Spain and three of its four principal EC partners widely resemble each other. However, the bilateral comparisons for Germany implied that Spain was further away from the German norm than France, Italy or the UK (Eurostat, 1989). On the other hand, the trade data, between Spain and the Ten, demonstrate that shortly before joining the Community over 45 per cent of Spain's trade in manufactured goods with the EC was accounted for by the two-way exchange of items in the same three-digit SITC group with individual EC members. Thus, the trade data based on shares of GVA in the period 1975-83[3], reinforced the evidence obtained from the industry surveys that the pattern of specialisation in Spain and the other EC members (except Portugal) was largely similar, meeting Grubel and Lloyd's[4] requirement for a trade-creating customs union.

Table 9 Customs Union Enlargement and Adjustment
Average Nominal Customs Duties on Industrial Products, EC and Spain, 1985

Chapters	Spanish Imports from		EC Imports from	
	Third Countries	EC	Spain	Third Countries
26 Ores	0.30	3.70	0.00	0.00
25 Minerals	3.37	2.28	0.33	0.87
47 Wood pulp	4.32	2.13	0.11	0.28
27 Petroleum	6.72	3.94	1.19	2.97
31 Fertilizers	9.15	7.97	1.87	4.67
49 Books	9.62	7.38	1.08	2.69
29 Organic chemicals	10.65	7.96	3.08	7.70
33 Essential oils	11.56	8.60	2.13	5.32
57 Other fibres	12.15	5.31	1.90	4.76
28 Inorganic chemicals	12.76	9.57	2.57	6.42
73 Iron and steel products	12.80	11.70	4.87	4.92
30 Pharmaceuticals	13.25	12.00	2.59	6.47
38 Other chemicals	13.40	10.04	2.49	6.22
52 Metal articles	13.47	5.38	2.10	5.25
48 Paper	14.28	14.24	3.34	8.36
37 Photographic products	14.71	13.28	1.63	4.08
90 Instruments	14.83	11.13	2.36	5.94
32 Dyes	14.88	11.13	2.36	5.91
84 Machinery	14.95	11.92	1.58	3.96
50 Silk	16.00	12.07	1.64	4.11
40 Rubber	16.65	11.74	1.33	3.32
39 Plastics	17.92	13.37	3.37	8.42
36 Explosives	18.42	12.66	4.75	6.88
35 Glues	18.65	14.73	3.64	9.10
34 Soap/detergents	18.66	13.29	2.38	5.96
59 Rope and twine	18.92	17.04	2.56	6.39
85 Electrical equipment	19.46	16.23	2.02	5.06
56 Discontinuous filaments	20.03	15.03	3.51	8.77
54 Flax/linen	21.02	8.40	2.24	5.61
62 Domestic goods	21.74	16.16	3.70	9.24
94 Furniture	23.86	17.60	1.70	4.25
55 Cotton	24.75	19.12	2.35	5.88
51 Continuous fibres	24.86	18.65	2.69	6.72
58 Carpets	26.60	19.80	3.22	8.06
87 Motor vehicles	26.64	20.20	3.44	8.60
60 Knitwear	27.06	20.44	4.70	11.74
97 Toys	29.07	21.77	2.45	6.13
61 Clothing	31.18	23.37	4.36	10.89

Source: J.M. Alvarez and E. Bonet (1985) "Efectos de la Union Aduanera" Papeles de Economia Espanola,25,p.87.

However, Spain has remained relatively weak in the advanced technology industries, although the government has been trying to attract new industries like information technology. A systematic difference between the composition of Spanish industry and that in the other main EC countries can be seen clearly if, for example, industries are ranked according to relative wages paid. Compared with the four countries; for Germany, France, Italy and the UK, Spain had a broad concentration of GVA in the low-wage industries like leather and footwear (Eurostat, Structure and Activity of Ind.1982-83, 1987). This was also clear in the composition of Spain's trade with the Community.

Industries like footwear, textiles and clothing, steel and shipbuilding have undergone substantial job losses since the beginning of the 1970s, mainly because of technological change and sluggish demand, but growing competition from the NICs has added to the adjustment pressures. Producers in the Ten initially feared that Spain's low wages were going to put them at a competitive disadvantage when the EC's trade barriers were to be lifted on Spanish goods. (A third of the tariff lines in footwear have nominal rates of duty over 20 per cent in the Common Customs Tariff (CCT), and two-thirds of clothing duties are 13 per cent or more - data from 1989 - representing considerable restrictions to trade even with a 60 per cent preferential tariff cut).

Before EC entry in 1986, Spain had nominal tariffs of 10-20 per cent for most product areas (Table 9). Effective protection was

enhanced in some industries by selective duty exemptions on some inputs and by lower duties on raw materials. Increased competition, thus would come from both EC and non-EC suppliers. For example, in textile and clothing, Spain can expect growing competition in low-cost products from Portugal as well as from countries benefiting from the EC's Generalized System of Preferences and the Lomé Convention, which is likely to result in a negative impact on Spain's trade balance. On the other hand, multinational companies which made some two-thirds of Spain's manufactured exports and operating in Spain, possibly to evade the high tariff barrier, might tend to concentrate their resources elsewhere in Europe when the EC-Spain barriers were to be removed. Beside this, it should be added that Spain has a large number of attractions as both a market and production base with a well-educated labour force, and considerable growth potential which was averaged at 4,7 per cent from 1986 to 1989, compared with the EC average of 2,4 per cent for 1990 (European Economy, 1990) .

The loss of protection, both tariff and non-tariff, is likely to be quite heavy particularly in terms of an expected upsurge in imports and many casualties among Spain's industrial ventures. Given its amazing and exceptionally high unemployment rate - which stood at 20,4 per cent averaging from 1986-88 (Table 10) - "Spain is considered particularly ill-placed to suffer a rash of factory closures."

Table 9 Spain: Macroeconomic Performance

	1983-85	1986-88	1989	1990	1991[a]	1992[a]
GDP growth rate (% change)	2,0	4,7	4,9	3,5	2,5	3,2
Total domestic demand (% change)	0,7	7,1	7,7	5,3	3,1	3,8
Employment (% change)	-1,4	2,6	4,1	2,7	1,5	1,8
Unemployment rate (%)	20,1	20,4	17,0	15,8	15,6	15,0
Inflation (%)	10,5	6,4	6,6	6,8	6,6	5,5
Balance of current account (%) of GDP)	0,5	0,2	-2,9	-3,8	-4,0	-3,9

a = Estimations

3.2 Entry Arrangement for Manufactured Goods

The negotiations on Spanish entry did not cause any significant modification of EC policies affecting industry (the Common Commercial Policy (CCP), competition policy, research and development sponsorship in advanced technology industries and policies for problem sectors, like steel). The main concession given to "sensitive industry" groups in Spain was an extended transition period of seven years - as a compromise against Spain's request for 10 years - on tariffs, coupled with a slow phase-out of Spain's quota restrictions in view of both the extent of dismantling of protection entailed, and the delay which Spain was expected to face before benefiting substantially from the agricultural arrangements. Hence, by 1 January 1993 all customs duties, quotas and other similar measures have been scheduled, as below, to disappear on EC-Spain trade (as a percentage of the base duties

those actually applied on 1 January 1985):

Table 11 Tariff Schedule

1.3.86	90%	1.1.90	35%
1.1.87	77,5%	1.1.91	22,5%
1.1.88	62,5%	1.1.92	10%
1.1.89	47,5%	1.1.93	0%

Source: R.C. Hine (1989), "Customs Union Enlargement and Adjustment: Spain's Accession to the EC", Journal of Common Market Studies, 28(1).

Additionally, Spain accepted to open a reduced tariff quota for cars for the first three years of the transition from January 1986 to January 1989 (R.C. Hine, 1989). On intra-EC trade, quotas are scheduled to end on 1 January 1992, so that they would initially continue to restrain the increase of imports, reinforcing the effect of the tariff transition. On the other hand, there are tariff-free quotas on certain types of clothing, and monitoring of Spanish imports of pulp and paper, iron and steel from Portugal.

For iron and steel products, Spain agreed in 1984 to reduce its annual rolled steel capacity to an amount not exceeding 18 million tonnes at the end of a three-year restructuring programme which was to be carried out parallel to that in the Ten (Spain is the tenth largest producer of steel in the world)[7]. Meantime, Spain's exports had been subject to quantitative restrictions. For textile and clothing, a combination of administrative and quota controls were scheduled to apply during the transitional period.

With regard to the possible measures to ease the adjustment problems of EC entry, for industrial goods the main reliance has been placed on the transition period of Spain which was agreed to be 2 years longer than the general previous enlargements. During this time, some safeguard measures have been provided by quotas and other general safeguard clauses (Article 379 of the Accession Treaty). Spain was also going to get financial assistance from the EC's structural funds, which consist of the European Regional Development Fund, the Social Fund and the Agricultural Guidance and Guarantee Fund (AGGF), even though their contribution to Spain does not appear to be sufficient in relation to the size of the country's adjustment problems.

3.3 Agriculture

Before 1986, Spain was entirely outside the CAP; the 1970 trade agreement had excluded almost all agricultural products. Agricultural arrangements were of great importance for Spain during the negotiations because of the large proportion of the population engaged in agriculture - about 17 per cent overall and much higher in some of the regions in 1986 - even though farming's contribution to GDP was small. On the Community side, Spain's agricultural output was of substantial importance accounting for 16.5 per cent of Community's total agricultural production (except Portugal) and competing especially with products from the EC's Mediterranean zone, with its concentration of low-income farmers.

For Spain, the CAP seems to be a process for pushing up farm

incomes in the short term coupled with expanding production and trade, especially in fruits and vegetables, wine and olive oil. It has been estimated that the initial application of EC support prices would have increased the total value of farm production in Spain by 14.1 per cent, even assuming no change in the amount of production (Commission of the EC 1987).

As to dairy products for which prices in Spain were above those in the Community, it has been estimated that an immediate application of EC prices would reduce the value of final production by 7.4 per cent in Galicia, in the northwestern part of the country where the bulk of Spain's milk production is concentrated. So, in the northwest where farm incomes were already very low, price reductions in the EC would depress them further in a region with few alternative job opportunities.

Concerning olive oil and wine, the support costs in these sectors were likely to increase substantially with Spanish membership of the EC. In the case of olive oil, the opening of the Spanish market to substitute oils and fats could lower consumption of olive oil in Spain, beside providing a price incentive by the EC support prices. Rising support costs might lead to demands for further production controls in the Community, making the adjustment problems severe for Spain in areas where there are few alternatives to the cultivation of olives and wines.

Hence, for Spain one of the main difficulties in adapting to

the CAP has been related to the regional diversity of its agriculture so that farmers in the regions adversely affected by the CAP can not easily switch to products in stronger demand.

3.4 Entry Arrangements for Agricultural Goods

In order to minimise the adverse impact of the enlargement, with the fear of negative effects particularly in the Ten, the EC agreed to avoid some adjustments by making some changes to the CAP prior to Spain's entry, providing additional support for producer groups (Commission of the EC, 1986:22).

The EC provided for a long transitional period - 7 years in general - for Spanish agriculture to be gradually integrated into the CAP, with an immediate adoption by Spain of the CAP support system of border measures and intervention buying. Existing barriers to trade between Spain and the Ten were lifted on entry but the price alignment was going to be gradual. For fruit and vegetables, a longer - 10 years - transition period was provided, with an initial standstill period of 4 years to allow the basic mechanisms of the EC market organisations to be set up. National import restrictions were going to remain in force during that standstill period, but during the second stage there would be a gradual alignment on CAP. Spanish exporters were not able to sell to the EC below certain minimum prices before 1996. For olive oil, a ten-year transition period was provided with an initial standstill of 5 years.

The EC established "indicative export ceilings" allowing a certain steady progress regarding traditional trade flows (Commission of the EC, 1986:31).

The EC established direct financial assistance to individual farmers seeking to adjust or to assist local development schemes, like the farm structural reform programme and special funds to the less favoured areas, contributing to the cost of drainage projects or more generally providing for some "compensatory allowances" to farmers usually in the form of headage payments on livestock, and lastly, the "integrated Mediterranean Programme" to assist regional development in the Southern part of the Community[8].

Thus even though full entry into the CAP and consequently unprotected access to the EC market does not come, in most cases, until 1993 and despite major infrastructural investments lasting during 1988-92, the costs of the substantial adjustment procedure could be heavy for Spain with its relatively uncompetitive and higher-priced agricultural products and its many small-sized farms compared with the EC standard (R.C. Hine, 1989).

As a conclusion, the entry terms for agriculture mirror Spain's weak bargaining position in the negotiations against the farmers from France, Italy and Greece - who were claimed to be most affected by the enlargement - so that they ruled out full access of Spanish agriculture to European markets until 1996.

3.5 Initial Outlook of the Membership

Over the first two years of membership, the flow of foreign direct investment into Spain doubled, encouraged by Spain's gradual access to the EC market and high domestic growth prospects (Table 12).

Table 12 Foreign Investment in Spain by Country, 1982-87
(Pta bn, unless otherwise indicated)

	1982	1983	1984	1985	1986	1987	Cumulative 1982-87 Pta bn	%
West Germany	18.9	20.7	26.9	28.9	104.5	26.8	226.7	14
Belgium	1.0	1.6	3.4	3.9	11.5	33.5	54.9	3
France	8.0	29.3	15.6	28.8	25.1	50.1	156.9	10
Netherlands	16.3	10.5	18.4	20.0	30.5	122.5	218.2	13
Italy	2.0	4.5	4.3	6.3	25.3	67.1	109.5	7
UK	10.3	10.9	20.7	18.3	28.0	45.4	133.6	8
Switzerland	35.4	14.4	22.5	21.7	21.1	61.0	176.1	11
USA	42.3	18.5	35.0	62.3	32.1	40.1	230.3	14
Japan	3.5	4.2	15.6	14.1	9.9	33.3	80.6	5
Other	24.7	24.3	75.4	35.8	52.0	60.5	272.7	17
Total of above	162.4	138.9	237.8	240.1	314.9	540.3	1634.4	100
in $mn	1,478	968	1,479	1,412	2,242	4,375	11,954	
Spain[a]	20.4	19.3	33.0	40.0	86.0	187.0	385.7	24
Total	182.8	158.2	270.8	280.1	400.9	727.3	2020.1	124

NB: Data are from notifications to the Direccion General de Transacciones Exteriores. Since some projects are delayed, foreign direct investment on a cash basis shows different annual totals - though the difference should disappear over time.

a - Capital increases or takeovers by subsidiaries of foreign companies established in Spain.

Sources: Banco de Espana; Ministerio de Economia y Hacienda, Direccion General de Transacciones Exteriores.

In manufactured goods, Spain's exports to the EC rose slightly while imports from the EC increased much more dramatically - especially in machinery and transport equipment (Table 13) - over the first three years (1986-89). After the rising complaints from Spanish industrialists about the huge import penetration to the country, some limits were placed on urea, as well as steel imports in 1986.

Table 13 Changes in Spain's Trade by SITC Sections 1984-5 to 1988

SITC sections		Percentage change in ECU value 1984-5 to 1988						Change in net trade 1984-5 to 1988 (billion ECU)
		EC		non-EC		Total		
		X	M	X	M	X	M	
0,1,4	Food, beverages	+57	+245	+21	+ 35	+41	+ 78	- 0.5
2	Raw materials	+64	+ 5	+45	+ 11	+58	- 5	+ 0.7
3	Mineral fuels	-58	- 26	+33	- 58	-31	- 56	+ 6.2
5	Chemicals	+61	+ 79	+19	+ 46	+37	+ 69	- 1.2
6	Manufactured goods chiefly classified by material	+36	+128	-29	+ 99	- 4	+119	- 3.6
7	Machinery and transport equipment	+58	+158	+16	+134	+45	+151	- 7.7
8	Miscellaneous manufactured articles	+57	+131	+17	+105	+33	+120	- 1.0
5-8	Manufactured goods							
	Total	+52	+134	- 4	+106	+24	+125	- 13.5

X - exports; M - imports; exports f.o.b.; imports c.i.f.

Source: Eurostat, Monthly Trade Statistics

Since 1984-85, Spain has switched from being a substantial net exporter of manufactured goods to being a net importer, bringing about its deteriorating effect in the trade balance in manufactures which accounted for 13.5 billion ECU by 1988. Relative unit labour costs fell in comparison with the EC average (-2.2 between 1986-88, -1.8 in 1989 - as percentage change). The negative impact on manufactured goods trade was considerably offset by increasing revenues from tourism and by the fall in the oil price.

Spain's trade balance in agricultural products did not experience any dramatic change over the first three years of the membership. Imports were buoyant, growing by 245 per cent between 1984-85 and 1988, confirming the expectations on intensification of trade following the EC entry. Nevertheless, imports from outside the Community have not declined.

3.6 Results

The main adjustment problem for Spain is related to industrial capacity in that enterprises might need more than the 7-year transition period to adjust to external competition, as observed from its initial experience.

In agriculture Spain could press for an intensification of support arrangements for "Mediterranean" products such as citrus fruit and olive oil on the basis that farmers' incomes in the south are below the EC average and that the allowance of support for

Mediterranean products is less than that for "northern" products like milk and beef (Tsoukalis, 1981). But this, on the other side, could carry some potential danger in a form that would raise the burden on the EC's budget leading to further demands for restraining the production level which would be more costly for Spain with its already rampant unemployment rate. Hence, if the future pattern of specialisation will tend to be of a more inter-industry nature, especially in the context of the 1993 internal market, adjustment problems for the new member countries are expected to be heavier.

On the monetary side, without introducing an effective policy for moderating incomes, the peseta's entry in June 1989 into the ERM, bringing about the constraints imposed on monetary policy, meant that budgetary policy has to bear the brunt of the adjustment.

The labour market still has to cope with problems of labour immobility (spatial and sectoral), and the relative high costs of redundancy and retraining which does not match the demands of enterprises. These rigidities partly explain the high unemployment rate in Spain. On the other hand, the high proportion of temporary jobs created in recent years could indicate a greater fragility in the Spanish economy.

In response to the challenges of the internal market and the EMU, Spain has to foster its competitiveness, increase domestic saving and remain attractive to foreign capital which will ensure the continuation of a high rate of growth during the catching up process with the rest of the Community.

4. PORTUGAL

Portugal joined the European Community in 1986 - in the same year with Spain. At the time of accession its inflation rate was 12 per cent and unemployment rate was 8.7 per cent. In the years following its entry to the Community, Portugal had a higher growth rate than the other Community member states which was averaging at 4.7 per cent from 1986 to 1990, aided by growing foreign investments and assistance provided by the EC funds. But it is still a relatively poor country; traditional sectors from agriculture to textiles are inefficient, productivity is among the lowest in the EC, particularly in agriculture. There are, in general, four areas in need of fundamental structural change: agriculture, industry, social welfare and education.

Portuguese agriculture employs about 10 per cent of the active population with a contribution to the GDP of only 6 per cent. The problem in the agricultural sector stems partly from, the size of the farms which are divided into an excessive numbers of tiny plots mainly in the north, and inefficient huge cooperative farms mainly in the south. Most farmers survive with the assistance of subsidies.

Portuguese manufactured goods are, generally, of lower quality and produced by inefficient methods which are compensated by the lowest labour costs in the Community, Portugal's largest market.

This comparative advantage is being increasingly eroded as competition from other EC and non-EC producers becomes more intense and as wages rise nearer to those in European partners. Most Portuguese companies are not yet prepared for the extensive competition after 1992, performing with old production and management methods and low wages. A large number of small and medium-size companies are likely to close because of the lack of capacity to modernise themselves, which will lead to enormous job losses.

One of the main problems of Portugal is related to the educational system. Illiteracy is between 15 and 20 per cent of the population which is very high by EC standards. The quality of the labour force in Portugal is in crucial need of improvement.

Another problem area in the Portuguese economy is the overwhelming weight of the state, particularly in the financial sector where it controls about 80 per cent of activity. Privatisation is the basic instrument for the government to diminish the burden of the State and open the economy to market forces even though the progress has been slow.

5. GREECE'S ACCESSION TO THE EC

Greece's decision to join the EC was taken in 1961 and under Article 238 of the Treaty of Rome, she became an associate member of the EC as from 1st October 1962 after signing the relevant agreement in 1961. She was given a twenty-two year transitional period before full membership to allow time for domestic industries to be prepared for the competition to be faced once duties were eliminated or reduced to EC levels.

However, following the military coup in Greece in 1967, all the financial and political provisions of the associate membership were suspended until the restoration of its democratic rule in the summer of 1974. In the meantime, the tariff reduction provisions remained in force. By 1968 Greece had attained complete duty free access for all its exports to Europe. By 1977, two-thirds of the EC's exports to Greece were also duty free and Greece had adopted most of the EC policies towards third countries.

After the restoration of democracy in 1974, the Greek Government signed the accession treaty in May 1979, which became fully effective from 1st January 1981, with a final five-year transition period granted up to 1986 during which time it would abolish the rest of the import duties on EC industrial goods. Over the same period Greece was to complete the adaptation of its tariffs towards third countries with those of the EC including those concerning the textile and artificial fibres agreements. Secondly,

a transitional period of five years was granted over the liberalisation of capital and investment activity with an extra two years added for the movement of labour. Greece was to join entirely the European Monetary System (EMS) by 1988 and introduce the VAT by 1984. Thirdly, over a flexible five to seven-year period Greece had to harmonise its agricultural policies and prices with those of the EC by ending state subsidies and by introducing the CAP rules (support, guaranteed prices, etc.).

However, following full membership, Greece was left with a number of forthcoming risks. Firstly, on the front of industry, the complete removal of tariffs on industrial imports by 1986 would engender sudden competitive pressures on Greek industries which appeared to be still unready or unable to compete with their EC partners. Secondly, the agricultural sector, particularly meat and dairy production was relatively weak and would be an easy target for EC import. On the other hand, the expected accession of Spain and Portugal would put further pressures on traditional Greek agricultural exports such as fruit and olive oil. Thirdly, there was uncertainty about the net impacts of trade with the Community on Greece's balance of payments, after considering the trade diversion following the removal of tariffs and the various funds from the EC.

Hence Greece, under the ruling Pasok Government led by A. Papandreou, started to impose, after pronouncement of the 1982 Greek memorandum agreed by the EC, additional controls on industrial imports from the EC over a further five year period and postponed

the introduction of VAT until 1986 instead of 1984. This was because Greece's contribution to the EC budget was to be based on VAT receipts and it would have made some domestically produced import substitutes more expensive, hence aggravating the competitive pressures.

5.1 Initial Impacts of the Accession

Although there is a lack of up-to-date information on the overall effects of such a radical change on the Greek economy, some forecasts could be drawn by looking at the initial implications posed during the first few years of the full membership.

First of all, it is useful to point out the state of major sectors of the Greek economy at the time of the entry. Initially, the productivity of Greek farmers was much lower than that of their EC counterparts, with the average size of a Greek farm being about 8 acres whereas it was 42 in the EC (Fagris, 1988); there was similar evidence in the rate of mechanisation and fertilizer use per acre. For peaches, citrus fruits, currants, tobacco and olive oil, which have been Greece's key export items, both competitive and structural problems were at stake.

However, given that the majority of Greece's manufactured exports involve food products and textiles, these goods were likely to face growing competition; firstly, from the highly standardised and heavily advertised food products within the EC, and secondly, from third country imports into the EC. Similar problems face the

exports of yarn, garments and footwear industries[9].

In the case of the steel industry, Greece had to close one of its steel smelters as a result of the general international surplus of steel capacity. According to the findings of the study undertaken by the Institute of Economic and Industrial Research in Athens, the overall comparative structure of Greek industry in terms of the composition of industrial output was found to have certain similarities with the industries of other EC members, but in the case of productivity Greece lagged behind a number of countries by a factor of 30-40 per cent (Fagris, 1986). On the other hand, in relation to the size of the enterprises, it has been found that the key characteristic of Greek industries was the lack of large units - where there was a clear correlation between the size of firms and their markets. In terms of specific sectors, the removal of tariffs was expected to be felt more on edible oils and margarine, flour, drinks, garments, shoes, paper products, rubber, plastics, glass, metal pipes, tin products, electrical motors and tools. In the area of common tariffs towards third countries, the most sensitive (exposed) sectors were canned goods, edible oils, flour, textiles and garments.

As to financial inflows provided by various EC funds, during the years 1981-1983 Greece received from the agricultural price support fund of FEOGA 131.2 billion drks, excluding any sums payable by FEOGA for restructuring or redirecting farming activities, etc. The annual inflows were equal to about 11 per cent of the gross

agricultural production or about 13 per cent of value added in agriculture. The major part of these payments were received by the tobacco sector (27.4%), vegetables and fruit (25.5%), cotton (15.1%) and rice (12.4%). But as a result of the distribution of these funds, only 15 per cent of these payments went directly and exclusively to the actual producers of the goods[10], increasing the gains available to wholesalers rather than to producers. During the same period (1981-83) adding net inflows from other EC funds, like Regional Development Fund (RDF), Social Funds (SF), etc., to the trade costs Greece benefited from a positive inflow, as shown in Table 14.

Table 14 **Net Benefits to Greece of the Application of CAP,1981-83**
(first ten months of 1983) billion drks

	1981	1982	1983	1981-83
Trade costs	-10.3	-11.4	-10.4	-32.1
Other inflows	10.1	39.9	65.5	115.1
Net effect	- 0.2	28.5	55.1	83.0

Source: Oikonomikos Tahydromas 7.6.84 p.25

In the trade scenario the most striking aspect of trade diversion was experienced in agricultural imports, as demonstrated in Table 15, recording a tremendous increase by 91 per cent from the EC, but a decline by 50 per cent from the rest of the world (Bank of Greece, Monthly Statistical Bulletin, Apr.1984). Hence the overall deficit in the agricultural trade of Greece with the EC increased, especially in meat and dairy products (Table 16), during the period

of 1981-1984.

Table 15 Import of Industrial and Agricultural Products, Current Prices, 1979-1983 (first ten months of 1983), $1ml

Year	Agricultural imports from: EEC	Rest of world
1979	311.1	593.7
1980	362.2	529.2
1981	704.3	266.2
1982	907.8	316.2
1983	772.0	218.5
Year	Industrial imports from: EEC	Rest of world
1979	3,247.4	1,384.4
1980	3,168.9	1,626.6
1981	3,313.7	1,450.8
1982	3,253.1	1,479.6
1983	2,583.8	1,040.9

Source: Oikonomikos Tahydromos,2.2.84,p.9.
The figures in this table exclude imports of fuel and vehicles.

Although the Greek industrial sector enjoyed some protection until 1989, it still has a long way to go, especially in the sector of high technology, added to the crucial need to increase its competitiveness. In agriculture, adjustment requires consolidation of small farms into large farming units.

Table 16 Agricultural Trade Balance, Current Pices, Million drks, 1979-82

	EEC			Rest of the World		Trade Balance with	
Year	Imports from	Exports to	Imports of animal/dairy products (% of total imports)	Imports from	Exports to	EEC	Rest of the World
1979	12,089.5	19,416.8	6,479.1 (53.5)	24,024.2	24,051.9	+ 7,327.3	- 27.7
1980	16,494.7	23,556.3	9,476.3 (57.4)	24,420.1	33,951.5	+ 7,061.6	+ 9,531.4
1981	37,932.1	29,625.6	22,238.8 (58.6)	19,005.0	34,067.8	- 8,306.5	+15,062.8
1982	61,744.5	42,234.6	40,881.1 (66.2)	24,236.5	42,548.4	-19,509.9	+18,311.9

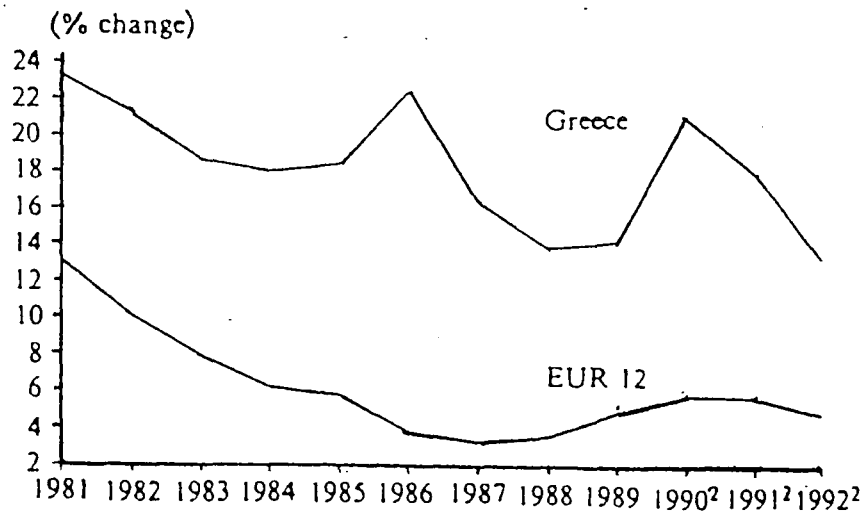
Source: P.Kolyris in Oikonomikos Tahydromos, 7.6.84,pp.25,26.

5.2 Recent Developments in the Greek Economy

In terms of income per head, Greece lags behind the Community at only 75 per cent of the average - as all of Ireland and Portugal, large parts of Spain and Italy, and N.Ireland. Adding to this, the Greek economy is in serious disequilibrium in many areas, like the very high rate of inflation of about 20 per cent (Graph 117a) in 1990, compared with the EC average of 4.6 per cent - budget deficits at more than 18 per cent of GDP and the level of gross public debt approaching 90 per cent of GDP (Table 17). On the other hand, the immediate effect of the new economic policy which was implemented in May 1990, with the aim of correcting the large fiscal imbalances and setting the foundations for a more medium-term oriented restructuring of the economy, was a further worsening of most recent trends (slow down in output, acceleration in inflation).

The Gulf Crisis is expected to aggravate further the macroeconomic situation on all fronts. In addition, during the period between 1985 and 1989 the volume of manufacturing investment fell by 18 per cent in Greece, whilst it rose by 79 per cent in Spain and 43 per cent in Portugal over the same period, explaining the relatively slow in growth of industrial production in Greece during 1988-89 (6%) compared to the 17 per cent increase in Spain and 19.5 per cent rise in Portugal. Turning back again to the possible effects of the Gulf Crisis, convergence with the rest of the Community countries is highly likely, at least in the short-term

Graph 117a Greece: Inflation Compared with Community Average[1]



[1] Deflator of private consumption.
[2] Commission forecasts (November 1990).

Table 17 Greece: Economic Policy Indicators

	1983-85	1986-88	1989	1990	1991	1992
Money growth (% change)	25.5	22.2	24.1	18.5	16.0	13.0
Short-term interest rate	16.4	16.9	18.7	20.0	20.5	18.0
Long-term interest rate	17.5	16.6	20.6	23.5	23.0	21.2
Competitiveness (1980=100)	118.5	102.4	116.4	122.9	126.5	127.3
Budget deficit (% of GDP)	-10.7	-15.8	-18.5	-18.6	-17.1	-14.9
Gross public debt (% of GDP)[1]	53.3	72.2	85.1	89.5	94.3	97.4
Nominal wages per head (% change)	22.3	14.4	18.8	18.0	16.7	13.2
Real wages per head (% change)	3.6	-2.3	3.8	-2.1	-1.5	1.6

[1] central government.

to be more difficult to attain for Greece since it is more vulnerable to oil price shocks than most other Community countries because of its high energy and oil dependence - 67 per cent in terms of net imports as proportion of total consumption in 1987 (although Spain has 61%, and for Portugal the figure is 96%) (Nat.Inst.Economic Review, May 1990).

6. CONCLUSION

All of Greece, Portugal and large parts of Spain - as well as Ireland, large parts of Italy, Corsica, the overseas departments of France and Northern Ireland - are included under the category defined by Objective I of the EC Structural Funds by which the sum available to these parts of the Community doubled in 1988 for the period 1989-1993 to the amount of 38,300 million ECU, as shown on Table 18. Hence the structural funds - which consist of the European Regional Development Fund (ERDF), the European Social Fund (ESF), and the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) - as well as the external trade policy of the Community can well influence the adjustment paths of the southern Member States.

Continued protection vis-à-vis less developed countries could prompt these countries to keep a specialised inter-industry structure. In contrast, a greater opening up of the Community market would lead these countries to concentrate their

specialisation on growth sectors. In the short-term, the first scenario (inter-industry development) requires less effort and carries lower adjustment costs for the Southern States but in the longer term, it appears more reasonable to suggest that the second scenario, namely the intra-industry trade creation, could be more effective in allowing these countries to catch up, notably by providing for larger technological transfers as well as an improvement in the level of investment in human capital.

Table 18 Structural Funds Appropriations for the Period 1989-1993

Objective		Amount (Million ECU[1])
1. Regions lagging behind in development of which -		38,300
Community support frameworks	36,200	
Community initiatives	2,100	
2. Regions in industrial decline		7,205
3 & 4. Long-term unemployment and vocational integration of young people		7,450
5a. Adaptation of agricultural structures		3,415
5b. Development of rural areas		2,795
Transitional measures and innovation		1,150
Total		60,315

[1]At 1989 prices

Source: Commission of the European Communities (1990). "The New Structural Policies of the EC". European File, No.7,p.10.

Notes to Chapter Three

1. See Hine, C. Robert (1989) "Customs Union Enlargement and Adjustment", Journal of the Common Market Studies,Vol.28,No.1, pp.1-27.

2. Data source: Eurostat, "Structure and Activity of Industry" various issues (Lux:CEC). The Finger-Kreinin Index was used to measure the similarity of industry structures: $S(ab)=\{\Sigma_1 \text{ minimum}[x_1(a),x_1(b)]\}$ where $x_1(a)$ is share of GVA in industry in country a; see J.M.Finger and M.E.Kreinin (1979) "A Measure of Export Similarity and its Possible Uses", Economic Journal (89), Dec,pp.905-12.

3. Source: Commodity Trade of Spain (1983) UN.

4. Grubel and Lloyd (1975) suggest that trade creation gains from customs union formation stand to be greatest "the more competitive or similar are the lists of the member countries' tradable differentiated goods produced before the union and the more production of these differentiated goods is subject to economies of scale."

5. See: European Economy, 1990, No.46,pp.49 "National Economies".

6. The EC had pressed for a more rapid reduction in the highest duties but this was not accepted, except for cars. However, Spain by switching to VAT in 1986 had to abolish its compensatory levy on imports which had provided a substantial hidden protection (Donges and Schatz, 1985) see R.C. Hine 1989,p.14.

7. Source: Tsoukalis (1981) "European Community and Mediterranean Enlargement." p.178.

8. The measures mentioned are financed out of the Guidance section of the EAGGF. However, only about 6 per cent of the EAGGF's expenditure is under the Guidance section.

9. There is some evidence that the price elasticity of demand for exports of tobacco, electrical goods and some other industrial goods is less than one as well as that for all exports from Greece have a prime elasticity approximately equal to one. These estimates show that the Greek exports have to compete primarily via quality, standardisation and marketing rather than by price alone.

10. Production subsidies were paid directly to farmers in the cases of wheat and edible oils. Exports, processing, and tobacco subsidies were paid, not to the actual farmers, but to exporters and middlemen and, in particular, producers of juices, tinned foods etc. (Source: Oikonomikos Tahydromos, 14.6.1984,p.20).

CHAPTER IV

DEVELOPMENT PATH OF TURKEY IN THE 1980s

1. STRUCTURAL ADJUSTMENT AND STABILISATION POLICIES IN THE 1980s

Introduction

In January 1980, Turkey adopted a comprehensive economic adjustment programme whose main directions have been pursued without interruption for a decade, though with varying outcomes from time to time. Around 1986 the Turkish programme was frequently quoted as an example of successful structural reform in a developing economy, in terms of balanced and dynamic economic performance which it has displayed from the start in 1980. Despite a sluggish world conjuncture Turkish export volumes had been growing at an annual average rate of almost 30 per cent between 1980 and 1985[1], whereas world trade rose only a modest 3 per cent a year. In the meantime, the external current account deficit, which reached 5.4 per cent of GNP in 1980, fell to about 2 per cent in 1985 whereas the rate of inflation decelerated from three-digit figures - almost 110 per cent - to about 30 per cent in 1986[2]. However, from 1987 onwards, macroeconomic performance became more complicated as a result of policy-induced acceleration of domestic demand. Longer-term expectations for sustaining high growth became less certain in the presence of a highly growing external debt - which rose from $31.2bn at the end of 1986 to an estimated $38.3bn at the end of 1987, equivalent to 56.6 per cent of GNP[3], and of persistent deficiency in manufacturing investment.

Although the reform in question is not yet completed, we will

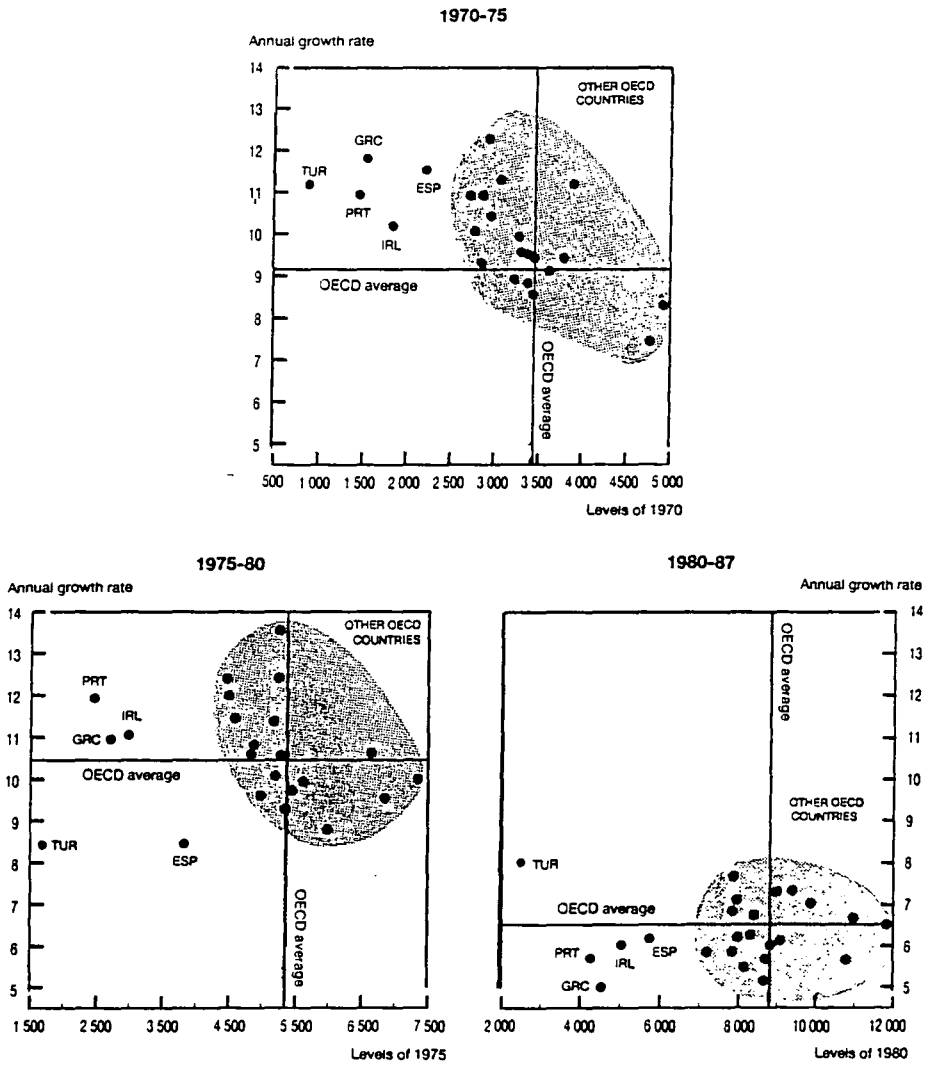
try to display; first, the development of the macroeconomic indicators over the last twenty years in the OECD area, then the main areas of structural reform pursued in Turkey since 1980 and the effects of the reform on industrial development, and finally the interaction between structural adjustment and stabilisation of the economy.

2. STRUCTURE OF THE ECONOMY

Diagram 124a compares growth rates and per capita GDP levels at purchasing power parities in OECD countries from 1970 to 1987. Throughout this period, Turkey appears as the country with the lowest income per capita, though its growth performance has usually been higher than the average. But following the first oil-price shock, in the second half of the 1970s, Turkey's rate of growth became one of the lowest in the OECD area. Whereas a number of OECD Member countries applied appropriate adjustment policies during the period in order to cope with the real income effects of the oil price rise, Turkish authorities continued - as has been usual, and also the major failure of the recent Özal governments - expansionary policies which were incompatible with the changed external environment. The resulting shortage of domestic savings which was compensated by increased foreign borrowing in the Euro-markets imposed on Turkey a balance-of-payments crisis in 1977, when the foreign debt service could no longer be secured, coupled with the world recession.

In January 1980, as part of the new economic policy, adoption

Diagram 124a Growth and Levels of GDP per capita
(At purchasing power parities)



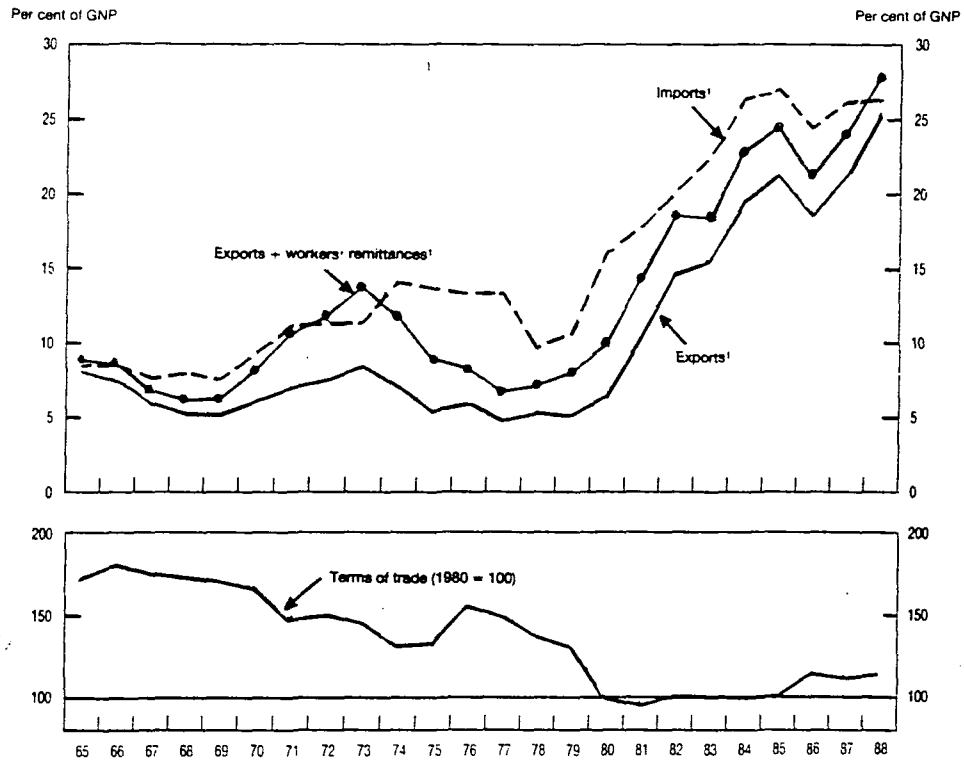
Source: OECD Secretariat.

of a market-oriented approach comprising the setting of realistic interest rates and of a competitive exchange rate helped exports to rise dramatically and hence reduce the burden imposed on the economy by the external constraints (Diagram 126a). As can be seen from Diagram 126b, improvements in the external position of the economy in the early 1980s were combined with a decline in the share of gross investment in GNP, just reaching again, the levels attained in the mid-1970s, after 1985. However, despite the increase in aggregate investment, investment in manufacturing has declined constantly since the second half of the 1980s (Diagram 126c). As a result of the existence of excess physical capacity and unutilised productivity reserves in the early 1980s, capacity utilisation, in manufacturing rose by 15 points with a 2½-3 per cent growth in capital productivity during the period 1980-87 (OECD, 1989-1990).

3. MAIN AREAS OF THE STRUCTURAL REFORM

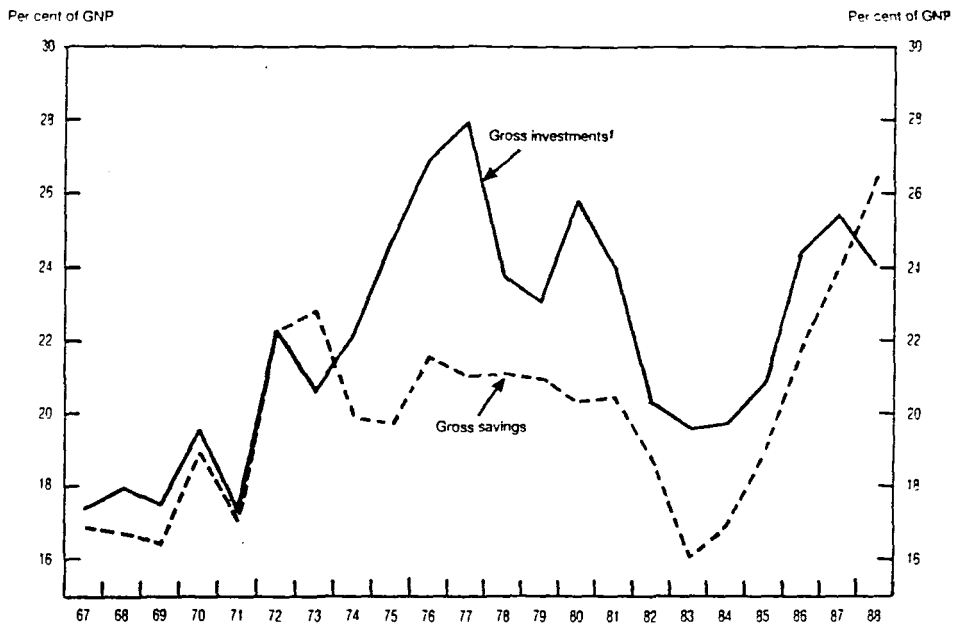
Tables 19-21 present indicators of the relative size of external transactions, financial markets and the public sector in Turkey, compared with Greece, Portugal and Spain during the period from 1975 to 1987. Apart from a common trend of dramatic increases in foreign trade for all four economies, the degree of integration of Turkey in international product markets is particularly significant by the end of the period, considering the small volume of its foreign trade at the beginnings of the 1980s. Table 20 shows the structure of financial markets. There is still a large difference between Turkey and the other countries as indicated by the relatively low ratios for outstanding equities and government

Diagram 126a The Trade Gap



1. Balance-of-payments data.
Source: OECD Secretariat.

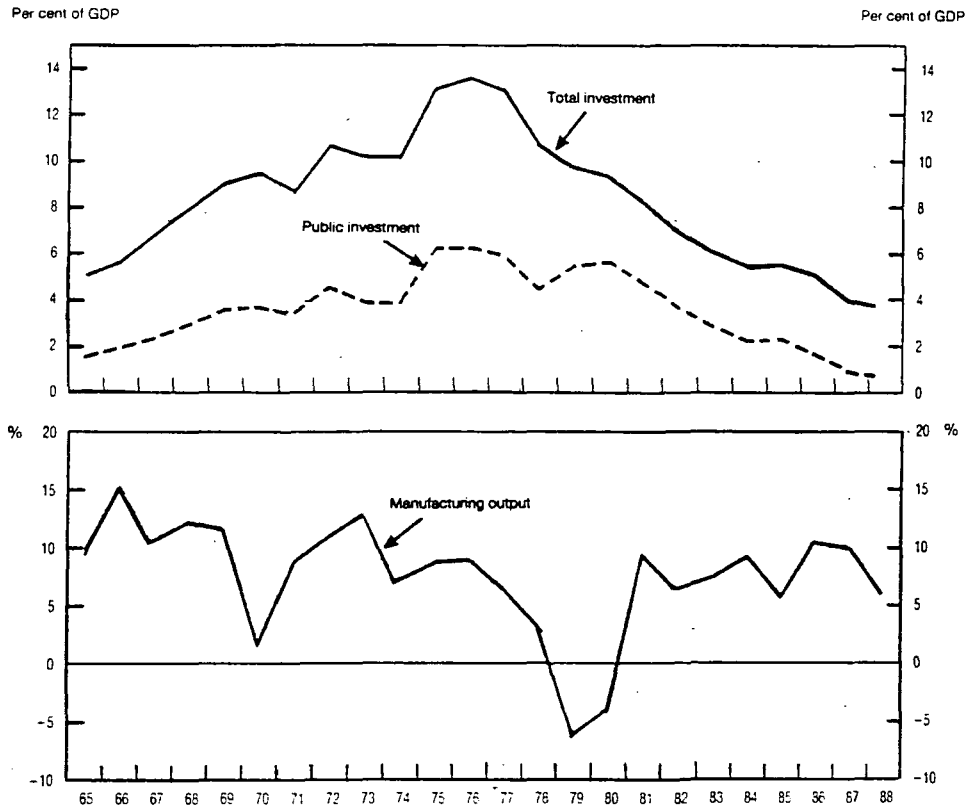
Diagram 126b The Savings Gap



1. Nominal gross investments on nominal GNP. Since over the 1980s the investment deflator has been growing faster than the GNP deflator, the diagram overestimates the volume growth of investments.

Source: OECD Secretariat.

Diagram 126c Manufacturing Investment and Output
Constant Prices



Source: State Planning Organisation, OECD Secretariat.

securities to GNP in Turkey. This is not the reflection of lower public sector deficits, but of the large degree of monetarisation of the Turkish deficit. Turkey - unlike Greece, Portugal or Spain - did not experience strong growth in the share of general government in GNP, although the share of publicly financed capital formation in total investment has been strikingly larger than in the other three countries. When investments of SEEs - State Economic Enterprises - are added to those of general government, they accounted for more than 50 per cent of total investment in the economy in 1987 (Table 21).

Table 19 The Size of External Transactions
Per cent of GDP/GNP

	Exports	Imports	Imports & Exports
Turkey			
1975	9.3	14.3	23.5
1980	10.7	16.2	26.9
1985	25.0	26.9	52.0
1987	24.8	26.2	50.9
Greece			
1975	16.9	26.9	43.7
1980	20.9	26.2	47.1
1985	21.2	32.8	54.0
1987	22.9	29.5	52.4
Portugal			
1975	20.4	32.8	53.2
1980	27.4	42.0	69.4
1985	37.3	41.4	78.7
1987	34.2	40.0	74.2
Spain			
1975	13.6	17.3	31.0
1980	15.8	18.1	34.0
1985	23.4	21.2	44.6
1987	19.7	19.5	39.2

Source: OECD, Trade Statistics

Table 20 The Size of the Financial Sector
Per cent of GDP/GNP

	Claims on the banking system	Government securities	Private debt instruments	Equities	Total
Turkey					
1975	30.5	8.0	0.6	1.1	40.2
1980	24.2	3.5	0.6	1.0	29.3
1985	35.8	6.0	0.3	1.6	43.7
1987	40.0	9.0	0.5	1.2	50.8
Portugal					
1975	91.1	29.1	n.a.	n.a.	n.a.
1980	108.5	28.7	n.a.	n.a.	n.a.
1985	118.5	39.7	2.7	n.a.	n.a.
1987	106.6	56.6	5.1	39.7[2]	208.0
Spain					
1975	87.9[1]	8.0	3.1	5.4	104.4
1980	82.5	8.8	6.7	11.2	109.2
1985	79.4	29.9	4.2	24.5	137.9
1987	62.1	34.5	7.3	28.4	132.3

[1] 1976
[2] Outstanding shares in the secondary market
Source: Data submitted by national authorities

Table 21 The Size of the Public Sector
Per cent of GDP/GNP unless otherwise stated

	Turkey				Greece				Portugal				Spain			
	1975	1980	1985	1987	1975	1980	1985	1987	1977	1980	1985	1987	1975	1980	1985	1987
General Government																
Total outlays	24.6	28.5	26.7	30.7	26.7	30.5	43.7	42.9	30.8	33.8	42.7	46.2	22.8	32.6	41.5	40.4
Current receipts	25.7	25.1	24.7	26.2	27.4	30.4	34.6	37.2	30.5	31.4	36.0	35.8	24.8	30.0	34.5	35.8
Balance	1.1	-3.4	-2.0	-4.5	0.7	-0.1	-9.1	-5.7	-0.3	-2.4	-6.7	-10.4	2.0	-2.6	-7.0	-3.6
Share in total investment	25.2	29.3	27.3	30.0	13.6	10.5	23.5	18.7	11.3	14.4	14.2	10.7	9.9	8.2	18.9	17.2
Share in total employment	8.4	10.0	9.9	9.3	8.2	8.9	9.9	10.1	9.3	10.7	13.2	13.8	7.7	10.5	13.4	13.8
State economic enterprises[1]																
Value added	8.6	8.8	11.7	11.3	n.a.	n.a.	n.a.	n.a.	10.0	13.0	17.6	14.3	n.a.	9.0[2]	14.0	n.a.
Share in total investment	23.6	27.4	30.9	23.7	n.a.	12.7	19.0	11.7	20.0	18.3	17.0	13.8	n.a.	22.0[2]	21.0	n.a.
Share in total employment	3.9	4.5	5.2	5.5	n.a.	3.5	4.5	n.a.	4.5	5.2	4.7	4.4	n.a.	5.0[2]	6.0	n.a.

[1] Figures for Spain represent shares in non-agricultural value added, investment and employment.
[2] 1982.
Source: Data submitted by national authorities.

3.1 Trade Reform

Two principal features of the Turkish structural reform programme, which was initially introduced by the Demirel Government in January 1980, but pursued with more momentum by Özal governments since the collapse of military rule from September 1980 to the resumed democratic elections of December 1983, have been trade liberalisation and export promotion. In 1980, the Turkish lira was devalued by 33 per cent, many quotas on imports were replaced by tariffs, and substantial tax rebates were granted for exporters. In the period from 1980 to 1984, quotas were almost completely abandoned and replaced by tariffs, and export subsidies were increased in order to offset the bias against export activity incited by import restrictions. From May 1981 onwards, the Turkish authorities proceeded to daily adjustment of the nominal exchange rate, which consequently led to gradual depreciation of the real effective exchange rate averaging 6 per cent a year in the period 1982-87.

In 1984, export subsidies were cut back, and Turkey began to rely more on exchange-rate policy for trade promotion. However, there was a serious setback to exports in 1986, mainly caused by the real appreciation of Turkish lira when the authorities intervened to control the degree of nominal depreciation in the national currency. The fall in exports prompted the first Özal Government to reintroduce export tax rebates which progressively drove exporters

to the abuse of export incentives through over-invoicing, or "fictitious exports" in the following years. Hence, in 1989 export tax rebates have been gradually withdrawn and replaced by preferential credits to exporters via the newly established Eximbank, together with tighter controls over the allocation of credits. Later in 1989, many tariffs on imports of industrial supplies and finished products were reduced.

In August 1988, a system of partial market setting of the official exchange rate was introduced, basically making the exchange rate freely negotiable between authorised parties for transactions above a minimum margin - above $50,000 in 1988. Moreover, since January 1989, commercial banks have been given authority for engaging in overseas trading of Turkish lira in selected countries. However, the partial freeing of the exchange rate has again been associated with a slowdown of devaluation of the Turkish lira, caused by mainly strong inflows of foreign exchange through growing tourism revenues. The real appreciation was one of the elements which caused growth rate of exports to reduce substantially, apart from the other factors such as the decline in demand from Middle East countries.

Especially in the last half of the 1980s, the reduction or dismantling of commodity-specific tariffs was associated with the simultaneous introduction of special levies for the benefit of various Funds for the subsidising of exports and various social expenditures. Although this has contributed to reducing diffusion of nominal and effective protection across industries, the level of

nominal protection is still high in Turkey which taxes exports with higher input prices as well as compelling the Government to allocate various heavy subsidies to exporters (Table 22).

Table 22 The Structure of Nominal Protection
Per cent

	1983	1988	1989
Taxes			
Customs duty	c.s.[1]	c.s.[1]	c.s.[1]
Municipality tax[2]	15	15	15
Stamp duty	1	10	10
Wharf tax[3]	5	5	5
Production tax	c.s.	-	-
Value-added tax	-	c.s.	c.s.
Surcharges			
Housing fund	c.s.	c.s.	c.s.
Support and price stabilisation fund	-	8[5]	10
Resource utilisation support fund[4]	-	6	6
Infrastructure fund	-	-	4

1. Commodity specific.
2. Per cent of the applicable custom duty.
3. Per cent of the sum of the cif value, custom duty, municipal tax and customs clearing expense.
4. On imports with acceptance credits or against goods.
5. Raised from 4 to 8 per cent in August 1988.

Source: Data submitted by the Turkish authorities.

On the other hand, unlike other developing countries such as Taiwan and Korea (Table 23), Turkey has not yet succeeded in diversifying its exports over a wider range of products that, according to standard measures, have a relatively high labour

Table 23 Trends in Trade of Labour-Intensive Manufactures to Industrialised Countries
Per cent

	Share of labour-intensive manufactured exports in total non-fuel exports				Share of textile and clothing in labour-intensive manufacturers exports			
	1965	1975	1985	1986	1965	1975	1985	1986
Taiwan	45.5	78.9	85.6	85.0	13.4	28.0	15.9	15.6
Korea	51.1	79.2	78.7	78.2	19.3	35.8	28.5	26.3
All developing countries	16.0	33.7	52.8	55.2	17.8	28.2	24.1	24.9
Turkey	8.7	26.8	51.5	57.6	1.5	4.1	38.9	43.7
Greece	29.0	47.2	52.9	55.6	5.6	26.7	35.4	39.1
Portugal	66.1	63.1	66.7	69.0	16.5	35.6	43.9	44.6
Spain	23.4	41.9	38.7	39.2	8.5	7.9	6.2	6.5

Source: A. Yeats "Shifting Patterns of Comparative Advantage: Manufactured Exports of Developing Countries", World Bank Working Paper, No.165,1989.

content. The overwhelming and growing importance of textile and clothing sector in Turkish exports is in contrast to world trade, where the share of these products has declined from 1975 due to the growing importance of other items such as electronic equipment and electrical machinery whose labour-intensity ratio has increased over time. This suggests weakness in the industrial structure and dramatic ineffectiveness in finance, organisation and management skills on the part of investments to respond to emerging international opportunities. Furthermore, this poor performance of Turkish industry has been fostered by a relatively high degree of protection and the absence of competition in the domestic market, as

well as by the modest level of foreign direct investment in the country despite the relatively favourable legislation and administrative practice in force.

3.2 Reform in the Financial Sector

Before the beginning of the last decade, the Turkish economy had all the characteristics of financial repression: intermediation costs were high, credit was rationed, capital markets were underdeveloped, and ex-post real interest rates were negative. Hence, initially, interest-rate ceilings on time deposits were abolished in July 1980, in an effort to encourage savings and deposits in the banking sector and facilitate channelling of loanable funds towards productive investments. Another objective of the authorities was also to reduce the degree of leverage of larger corporations in the private sector and to force inefficient firms to improve their operations. However, in the absence of proper supervisory control of the banking system, this led to rapid credit expansion at higher and higher interest rates, and ended up with the so-called "broker crisis" of 1982.

The events that led to the financial crisis of 1982 appears to be worth recalling in order to understand better the then deficiencies in the government's financial policies and the developments that followed. When interest rates were freed in principle, the major banks began setting interest rates collusively. This caused a number of smaller banks to elude the cartel by selling

newly introduced financial instruments - Certificates of Deposit and bonds - to brokers and via these to the public, at interest rates two to five percentage points higher than the market rate. Coupled with the absence of an efficient regulatory authority, Turkish banks were, to a large extent, under-capitalised and therefore highly sensitive to default of their clients. Accordingly, when several larger firms were unable to discharge interest payments on their bonds or to their creditor banks, the system had undergone a liquidity crisis and bankruptcy for the brokers, together with no legal framework for dealing efficiently with non-performing loans. The cost of the rescue operation through the rapid provision of liquidity by the Central Bank and official arrangements to solve the outstanding claims on banks is estimated to have been as high as 2.5 per cent of GNP.

After this highly costly outcome of the faults in Government's financial policies, market interest rates on deposits were again determined by the monetary authorities, which allowed key deposit rates to yield a positive real return most of the time, manipulating the term structure of interest rates in an effort to dampen the dynamics of inflation. In order to strengthen the regulatory power of the monetary authorities, a closer scrutiny of the activities of the banking sector and a deposit insurance scheme were introduced. The banking law of 1985 introduced uniform accounting standards; from 1987 banks were audited externally. In 1987, also, the Central Bank started open market operations in Government securities, with the initial objective of building up a portfolio of securities necessary for conducting these operations,

though they were used mainly to slow down monetary growth during the last quarter of the same year. Other measures undertaken were unification and reduction of the legal reserve and liquidity ratios, reduction of taxes on financial transactions, and the opening of an interbank money market in 1986 (OECD 1990, p.92).

As to the steps taken towards extending the range of the reform to external transactions, foreign direct investments and domestic capital markets: firstly, foreign banks were authorised to open branches in Turkey; foreign exchange transactions were simplified and transferred from the Central Bank to commercial banks. Secondly, in 1984, residents were allowed to open foreign-currency accounts with banks and make payments, cash withdrawals and transfers abroad. Restrictions, however, were introduced on commercial bank's external transactions in 1986 and early 1988 in an attempt to reduce speculative pressure against the Turkish lira. Thirdly, regulations concerning profits and capital transfers, and reinvestment of funds in Turkey by foreign citizens were substantially eased. Finally, Istanbul Stock Exchange was reopened in 1986.

In order to strengthen further the liberalisation of capital movements: from July 1988, foreign investors were admitted to the Turkish capital market, and starting from June 1989, foreign investment funds were allowed to operate. Finally, an official gold market started operating in April 1989.

These changes had several consequences. Lowering the reserve requirement for domestic deposits and the changes introduced in the portion of government securities that could be held towards the liquidity requirement led to an increase in the reserve money multiplier - which could have been compensated by lowering the growth in reserve money. As this was not the case, in September 1987 only reserve requirement ratio, then in the wake of the instability in the financial markets at the beginning of 1988, both reserve and liquidity requirement ratios were further increased, from 10 per cent in July 1987 to 16 per cent in December 1988, and from 12 per cent to 27 per cent respectively (Turkish Review, Autumn 1988). This was contrary to the medium-term objective of the Government which was to reduce the cost of funds to banks by lowering the reserve and liquidity requirements. It would also be essential to reduce the expansion of reserve money either by curbing the public sector borrowing requirement or by relatively larger financing via financial markets, such as open market operations.

However, the unsophisticated nature of Turkish security markets has restrained the use of open market operations - which were started by the Central Bank in February 1987, as stated above - in conducting monetary policy. In order to increase the effectiveness of the Central Bank in influencing the reserve position of banks, a new branch of the interbank market was created in March 1988. The reserve ratio on foreign exchange deposits was also increased to 20 per cent in July 1987, with a view to controlling their expansionary effect on the money supply.

On another front, the rapid increase in government securities outstanding has imposed a heavy burden on the government budget. New stock started to be auctioned at market-determined interest rates in May 1985 in order to finance the excess public sector borrowing requirements. Furthermore, fluctuations in prices from one auction to another negatively affected the secondary market. Thus, the method of auctioning government securities was changed in the beginning of June 1988: the Government no longer announces the amounts to be sold in the auction, but only the maximum acceptable yield.

The financial reform appears to have been successful in prompting private financial savings, as well as increasing the depth of financial markets. But the ultimate goal of the reform, i.e. to channel a greater flow of savings towards productive investment has still a long way to go. Because of the insistence on expansionary policies pursued by the ruling "Motherland Party" (ANAP) especially in the second half of the 1980s, a large percentage of excess private savings in capital and money markets has been absorbed by the highly expanded public sector borrowing requirements, curbing the way for these savings to be used in more productive investments undertaken by the private sector.

Table 24, displays the changes in the composition of financial assets. First, and quite naturally, the rise in interest rates generated a major shift from cash to time deposits, indicating the responsiveness of the market to yield differentials in favour of the rentier class and big industrialist groups who own most of the

private banks[4].

Table 24 The Composition of the Stock of Financial Assets
Per cent of total

	1980	1981	1982	1983	1984	1985	1986	1987
Banking sector	82.5	85.8	86.7	84.5	82.8	81.9	81.3	78.7
Currency	16.7	11.2	11.3	11.6	9.7	8.3	7.8	7.7
Sight deposits	37.4	27.7	25.4	29.5	20.0	18.1	19.8	20.2
Time deposits	13.7	26.7	33.1	28.4	38.6	40.6	36.5	27.8
Official deposits	14.6	20.2	16.9	14.6	10.0	8.6	8.1	9.3
Foreign exchange deposits by residents	-	-	-	0.5	4.5	6.3	9.1	13.7
Government securities	12.0	9.8	8.9	9.1	11.6	13.8	14.9	17.8
Government bonds	8.6	6.5	5.3	7.6	7.0	8.5	8.3	8.1
Treasury bills	3.4	3.3	3.5	1.5	4.5	4.0	4.5	6.5
Income sharing certificates	-	-	-	-	0.1	1.2	2.1	3.2
Private securities	5.5	4.4	4.4	6.4	5.6	4.3	3.8	3.5
Debt instruments	2/2	1.7	1.4	1.3	0.9	0.7	0.8	1.1
Equities[1]	3.3	2.7	3.1	5.1	4.7	3.6	3.0	2.1
Memorandum item								
Stock of financial assets/GNP	29.3	38.1	41.9	41.0	41.2	43.7	46.2	50.8

1. Quoted at the Istanbul Stock Exchange.

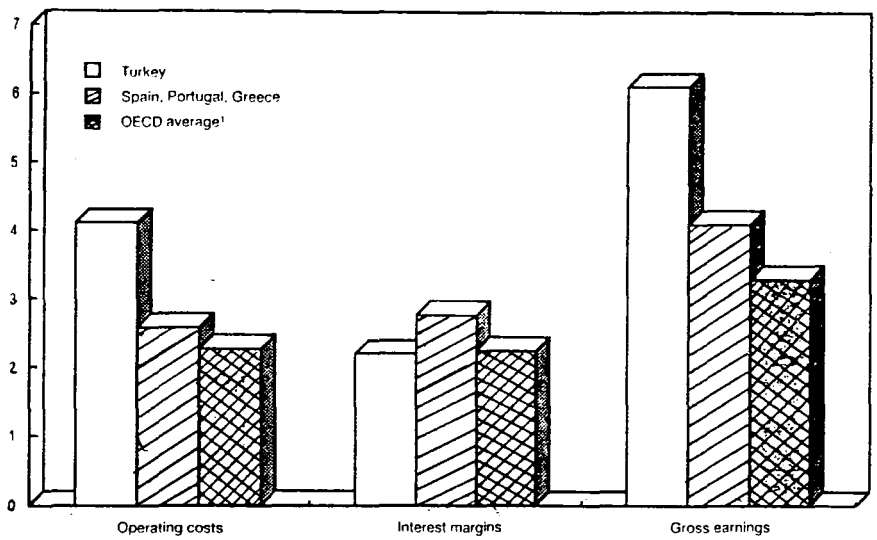
Source: Data submitted by the Turkish authorities.

Second, there has been a rapid rise in foreign exchange deposits, which is the indication of currency substitution risks to which countries with lax and inflationary monetary and fiscal policies are exposed.

Third, the share of outstanding private bonds and equities in the total stock of financial assets has notably decreased between 1980 and 1986, because they did not expand as quickly as other financial assets, in particular Treasury Bills and Income Sharing Certificates. Debt instruments and shares of the corporate sector have thus been by-passed by the process of financial deepening, whereas the reform has increased the importance of inflation guards, such as foreign currency holdings.

The dominance of the banking sector in financial markets has been strengthened. Through the introduction of modern banking techniques, efficiency has increased; the quality of the personnel vastly improved; a new generation of young, independent and innovative managers have taken over; and most importantly, the customer has been recognised as the focal point of all activities (Briefing, Jan.1990). On the other hand, bank intermediation in Turkey is inefficient by international comparison: operating costs and gross earnings margins are much higher than in other OECD countries (Diagram 143a), and there is a large spread between deposit and lending rates, indicating the high costs of financial intermediation and lack of competition.

Diagram 143a Indicators of Efficiency of the Banking Sector
Per cent of intermediated assets, 1987



1. The OECD average has been calculated with data of the following countries: United States, Japan, Germany, France, Italy, Spain, Portugal, Greece, Austria, Finland, Norway and Switzerland.

Source: OECD Bank profitability 1988; Turkish Bankers' Association, Annual Reports, OECD Secretariat calculations.

Another problem concerning the high dependence of corporations on bank loans is the inflexibility of the liability structure of firms. As long as banks and private firms cannot be made less dependent one on another and thus less exposed to changes in the costs of borrowing and lending, a high interest rate level would continue to carry the risk of undermining the stability of the Turkish financial system, together with its chronically high inflationary rate.

Some of the weaknesses of the Turkish banking sector have, remarkably, been reduced as a result of regulatory, as well as operational, developments over the last decade. There are now uniform accounting practice, external auditing, higher capital standards, introduction of the deposit insurance system, retail banking services and other financial alternatives such as leasing and factoring, and provisioning against non-performing loans. However, capital markets are still largely in need of further improvements due to the limited role of equity capital in Turkish corporate financing. Socio-cultural factors, like the large presence of family-owned firms and passive attitudes created by the history of easy bank lending have played a considerable role in discouraging the equity participation. Another factor, as stated before, is the high degree of interlocking between large firms and commercial banks. On the demand side, portfolio shifts towards the stock market have also been restrained by the recent strong increase of government debt instruments floated in the market which is at present heavily dominated by Treasury bills, government bonds and

income sharing certificates (Table 25).

Finally, information asymmetries between managers and stockholders, with little emphasis on research, could be considered as another effective element in reducing households' incentives to invest in equity markets.

Table 25 Financial Assets, New Issues
Per cent of total

	1981	1982	1983	1984	1985	1986	1987
Banking sector	89.3	88.8	76.9	79.9	80.6	80.1	74.
Currency	5.3	11.3	12.6	6.6	6.0	6.7	7.
Sight deposits	17.1	20.5	43.2	4.3	14.9	23.4	20.
Time deposits	40.7	47.0	12.5	55.6	44.0	28.1	13.
Foreign exchange deposits by residents	-	-	2.2	11.1	9.4	14.7	21.
Government securities	7.3	6.8	10.1	15.8	17.3	17.3	22.
Government bonds	4.1	2.9	15.2	6.09	11.0	8.0	7.
Treasury bills	3.2	3.9	-5.1	9.4	3.3	5.5	9.
Income sharing certificates	-	-	-	0.4	3.1	3.7	5.
Private securities	3.3	4.4	13.0	4.4	2.1	2.7	3.
Debt instruments	1.2	0.6	0.9	0.2	0.3	1.1	1.
Equities[1]	2.1	3.8	12.1	4.1	1.8	1.6	1.
Memorandum item							
Security issues/ GNP	1.9	1.5	2.2	3.1	3.2	3.0	5.
Total new issues/GNP	18.2	13.3	9.3	15.5	16.4	15.3	19.

1. Quoted at the Istanbul Stock Exchange.

Source: Data submitted by the Turkish authorities.

With the words of Mr. Rüstü Saraçoglu, the Governor of the Central Bank:

> Changes in financial markets in the past few years have enhanced the ability of the Central Bank to undertake defensive actions to offset seasonal or temporary shortages or surpluses of reserves and money supply. However, the monetary policy still remains very much constrained by public sector borrowing requirements and preferential credit extended through its rediscount facilities. The liberalization and development of financial markets have also made the conduct of monetary policy more difficult. Due to uncertainties created by new instruments, the measurement of liquidity in the system and the demand for money the relationship became more complex...and necessitated more coordinated and consistent policy actions by the Central Bank.
>
> In the future, the proper functioning of financial markets will very much depend on appropriate policy signals and the performance of the economy, especially on the inflation front. These parameters will become all the more crucial if Turkish markets are to be integrated with the world's financial markets.
>
> (Saraçoglu, 1988)

3.3 Reform in the Public Sector

Major objectives of the public sector reform in Turkey were the broadening of the tax base, the greater decentralisation of public finance and investments, the improvement of the operation of the State Economic Enterprises (SEEs/Kit'ler) and their eventual privatisation. The reform of the tax structure was considered necessary in order to increase fiscal revenues and to reduce "fiscal drag" caused by years of steep inflation. The reinforcement of the fiscal autonomy of local administrations and the attainment of

greater flexibility in the allocation of investment expenditures encouraged making resource allocation more efficient. And finally, the main objective of the reform of the isolated SEEs sector was to reduce their sizable financial losses generated by years of overstaffing, bad management and delayed price adjustments.

When the tax reform programme was started, public revenues were strongly biased towards income taxes, but were becoming increasingly inelastic to changes in output and income because of the failure in adjusting income tax rates to the periods of steep inflation with the resulting increase in evasion. There was also a lack of policies aimed at widening the base of taxes on goods and services. The "fiscal drag" had gradually eroded incentives to save and work, and led to strong inequities: wage-earners (of whom a large percentage of the total were accounted for by minimum-wage earners) provided almost two-thirds of revenues from income taxation, i.e. almost 30 per cent of total tax revenues[5]. In 1980, public authorities rearranged income tax brackets, whilst initially raising the basic rate to 40 per cent, then progressively reducing to 25 per cent in the period of 1981-86. This was accompanied by upward adjustment of income-brackets and by measures aimed at partly reducing the tax burden on fixed-income earners such as the introduction of tax rebates up to a determined limit, at the end of 1983, against proof of purchase of basic commodities and services.

Corporate taxes were set at a uniform rate for all private firms, which was first set at 50 per cent in 1981, cut to 40 per cent during the following four years, and raised again to 46 per cent in

1986. Moreover, in order to reduce collection lags, the system of advance payments of corporate taxes was introduced in the same year (1986). And finally, the structure of indirect taxes was substantially changed in January 1985 so as to apply a 10 per cent value-added tax, modelled on VAT schemes as applied by many European countries, replacing previous duties and production taxes on particular groups of commodities and services.

The policy changes introduced towards the SEEs between 1980 and 1987 have been subject to freeing expansion plans, intensifying supervision and approximating operation conditions to those of the private sector, by raising sales prices to cover production costs, thereby cutting budgetary transfers, and borrowing from commercial banks at preferential rates - which were eventually withdrawn in 1984[6]. The management of publicly owned enterprises according to private efficiency principles was also considered as a preliminary step towards privatisation which was legally authorised since 1986. Decentralisation of public finance and rationalisation of public investment programmes were pursued, on the one hand by fostering the fiscal autonomy and increasing the resources of local governments, and on the other hand creating a number of extra-budgetary funds (EBF) financed by indirect taxes such as import surcharges on certain goods, and by selling participations to the public. These funds are not subject to the full spectrum of budgetary control procedures and have been particularly active in orienting public investments towards infrastructural and mass housing projects.

However, the deterioration of the financial situation of the SEEs led to a rise in their borrowing requirements which amounted to 4.3 per cent of GNP in 1987 compared with 3.3 per cent in the previous year (Table 26)[7]. This induced the government to monitor more cautiously the budgets of municipalities and EBFs, notably the Public Participation Fund and the Mass Housing Fund, leading to transferring back to the central government of almost 30 per cent of fiscal revenues previously reserved by some of these funds through the budgetary law approved the same year.

Table 26 Public Sector Borrowing Requirement 1984-88
Per Cent of GNP

	1984	1985	1986	1987	1988
Central Government	5.3	2.8	3.6	4.2	2.2
State Economic Enterprises	2.3	3.1	3.3	4.3	2.4
Local Governments	-0.2	-0.2	0.1	0.4	0.3
Revolving Funds	-0.4	-0.4	-0.4	-0.2	0.0
Extra-Budgetary Funds	-0.5	-0.5	-2.1	-0.5	0.7
Total	6.6	4.7	4.5	8.3	5.7

Source: State Planning Organisation. 1988 based on revised projections of May 1988.

Almost one half of the total financing requirement of the SEEs was accounted for by TEK (the Turkish Electricity Authority) and PTT (Post Office, Telephone, Telegram Company) in 1987. All in all the SEEs accounted for over two-fifths of total fixed investments by the public sector[8]. Their losses were induced by delayed price adjustments to the high inflation, poor management based on outdated technology, excess employment. Financing their

losses further fuelled the inflation and led to the drive towards their privatisation introduced by the Özal government in 1986.

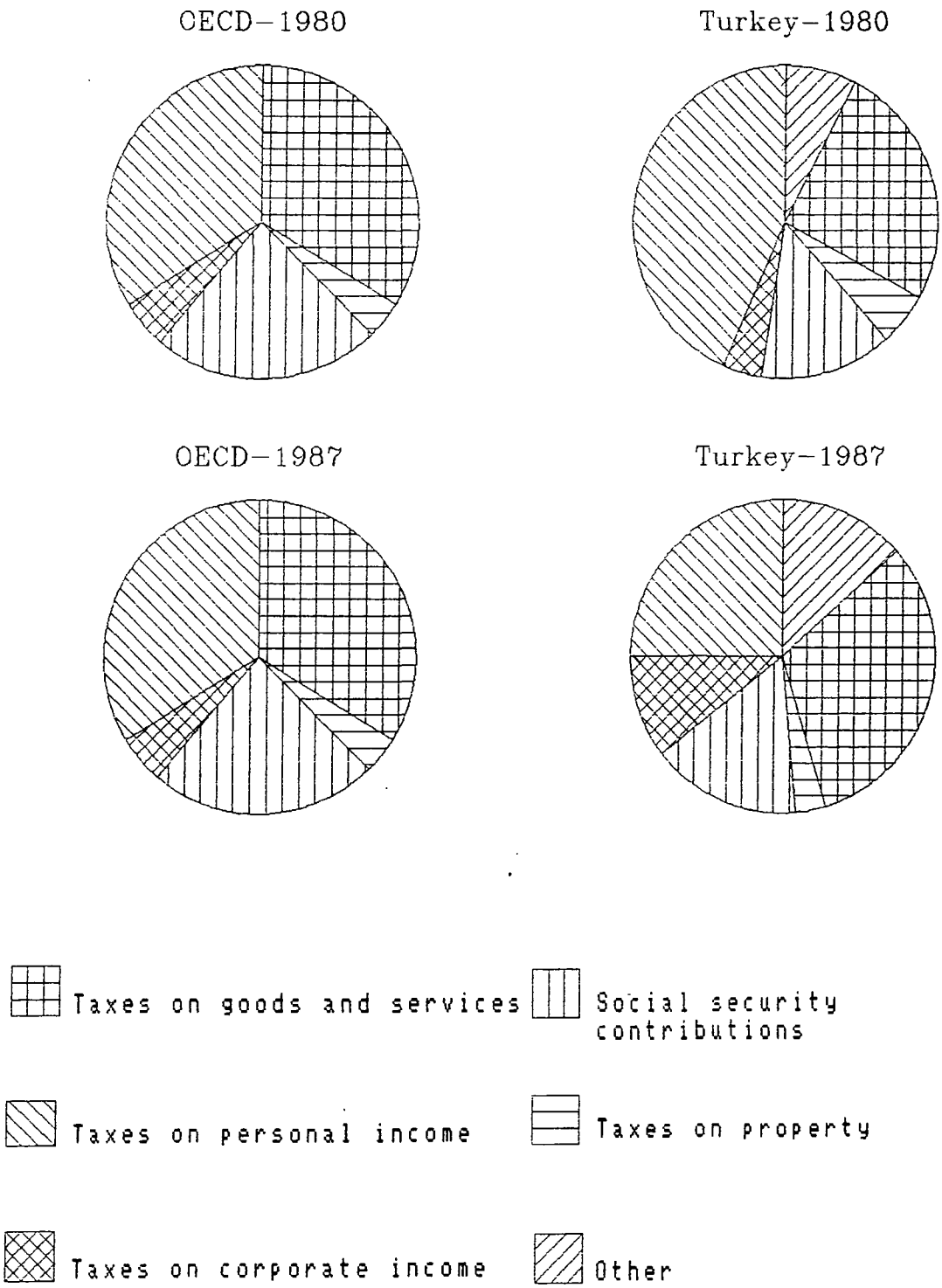
Of particular importance among the general government's infrastructural public investment schemes is the GAP (Southeastern Anatolia Project), consisting of a series of dams and plants which, upon completion in the early 90s, would increase the surface of irrigated land by 48 per cent, and electricity production by 68 per cent. The effects on agricultural output are expected to be quite substantial for products such as cotton (+118%), rice (+84%), oilseeds (+73%), fruits (+51%), vegetables (+28%). Most importantly, the GAP project with 14bn$ budget - equal to one-fourth of total public infrastructural investments in Turkey - is destined for helping to reduce regional imbalances, which are characterised by strong disparities in incomes and hence migration flows. This policy is consistent with the EC's regional policies in catching up with the more developed Community zones (Cankorel, 1989).

In order to increase public revenues, a wide range of indirect (especially value-added) tax rates was increased in the second half of 1988, and the Government was authorised to adjust VAT rates, to those applied by EC member countries. Further improvements in tax collection were pursued mainly by allowing the Ministry of Finance to compound penalty interest payments for overdue taxes, and to enforce compulsory closures of enterprises which systematically evaded fiscal obligations, as well as by computerising the local tax administration.

As a result of these efforts, tax revenues have slightly increased relative to GNP in the period of 1980-87, but this rise has been almost entirely offset by the increase in current transfers to SEEs, low income earners and exporters. As shown by Table 27, the tax reform together with the containment of inflation has succeeded in significantly reducing the share of personal income taxes in total revenues which had peaked at the beginning of the decade. The reduction of several tax concessions and the reform of the system of taxes on goods and services undertaken since 1985 have induced greater reliance on indirect taxes. The share of revenue from corporate taxes also increased significantly - although not sufficiently because of the still high level of tax-evasion during the period. In the context of the process of decentralisation of public finance, the share of local administrations in total tax revenues has increased, in particular after 1984. Overall, as can be observed from Diagram 152a, the Turkish tax structure has moved closer towards that of other OECD countries, even when account is taken of the large share of "other tax revenues" in Turkey at the end of the period mainly for special levies, hence indirect taxes for the extra-budgetary funds (EBFs)[9].

Nevertheless, the ratio of tax revenues to GNP is the lowest in the OECD area reflecting the limited possibilities for the Turkish authorities to provide an adequate volume of basic services aimed at improving the standards of living, and at strengthening the qualification of the Turkish labour force. The rising costs of servicing the public debt have also reduced budget flexibility; for example a reduction in defence outlays did not result in any

Diagram 152a The Tax Structure in Turkey and the OECD
As percentage of total tax revenues



Source: OECD Revenue Statistics of OECD Members, 1965-1988.

Table 27 The Structure of Tax Revenues
Per cent of total

	1980	1981	1982	1983	1984	1985	1986	1987
Personal income tax	43.5	40.7	39.3	39.2	36.6	27.5	26.6	24.9
Corporation tax	4.1	8.8	11.4	9.6	9.3	9.5	12.0	10.7
Taxes on property	5.4	5.5	5.2	4.9	4.7	4.6	3.3	3.2
Indirect taxes	25.6	24.9	26.8	29.0	27.9	36.0	31.2	32.0
Other	7.4	7.0	3.6	2.2	4.1	8.1	13.3	13.3
Social security contributions	14.0	13.1	13.7	15.1	17.4	14.3	13.6	15.9
Collected by:								
Central government	81.8	83.2	81.9	80.4	76.2	64.7	64.6	63.2
Local administration	4.2	3.7	4.4	4.5	6.2	6.7	9.6	9.2
Social security institutions	14.0	13.1	13.7	15.1	17.4	14.3	13.6	15.9
Special funds	-	-	-	-	0.2	4.3	12.2	11.7
Memorandum item								
Tax revenues as percentage of GNP	21.7	23.4	22.4	20.7	17.8	19.7	22.8	24.1

Source: OECD, Revenue Statistics 1965-88, Paris 1989, and data submitted by the Turkish authorities.

increase - but in a decrease actually - in resources devoted to the basic services such as health and education. This was because of the seven-fold increase in interest payments, as can be seen from Table 28, during the period of 1980-87. In 1989, with a total $41bn foreign debt (51% of GNP), Turkey had interest payments accounting for 9.4 per cent of its GNP. (The corresponding ratios

for Greece and Portugal in 1988 were 44.9 per cent and 42 per cent for debt, and 11 per cent and 7 per cent for interest payments[10]). The breakdown of expenditure by broad functions shows also that, parallel to the institution of EBFs, there was a significant increase in investment expenditure between 1985 and 1987, which was reversed by severe budgetary cuts undertaken in recent years. Transfer expenditures have now become the major component of public expenditure; interest payments, compensation for wage earners, subsidies to exporters and some allocations to SEEs, such as the Turkish Electricity Company (TEK), Turkish Railways, lignite and hard coal companies.

Table 29 presents some performance indicators for the largest SEEs, drawn from the annual report on the 500 largest Turkish firms published by the Istanbul Chamber of Industry. The Table shows that the largest SEEs have experienced significant profit improvements between 1981 and 1985, but subsequently a decline as the all performance indicators. In 1987 more than one-fifth of the largest SEEs reported operating losses. There is no synchronisation between the largest public and private firms observed: when profits of the former increase, profits of the latter decrease, and vice versa. This might reflect the influence of a policy of price hikes for SEE products in the initial years of the programme and inadequate adjustment to inflation in 1986-87.

Table 28 The Structure of General Government Expenditures
Per cent of total

	1980	1981	1982	1983	1984	1985	1986	1987
General services	35.0	34.5	31.8	35.1	33.8	26.9	22.2	25.4
Defence	16.6	14.0	14.0	12.7	12.6	12.2	11.8	12.0
Other public services	18.9	21.6	21.8	18.4	18.2	25.9	28.3	23.2
Health	3.9	2.8	2.9	2.7	2.7	2.5	2.3	2.2
Education	12.6	11.5	12.4	11.1	10.7	9.9	9.8	10.0
Interest payments	2.2	3.9	4.0	5.7	8.2	8.7	12.3	14.2
Social security outlays	10.8	11.7	13.1	14.3	13.8	13.9	13.3	13.0
Current expenditures	41.4	37.4	39.0	36.8	36.9	34.4	31.3	30.6
Investment expenditures	20.4	23.1	23.1	18.4	18.0	21.5	25.4	23.4
Transfer expenditures	38.2	39.6	37.9	44.8	46.0	44.1	43.3	46.0
Central government	81.3	81.5	80.2	78.0	78.7	73.5	68.4	65.1
Local administrations	7.2	6.2	6.1	7.3	6.9	9.0	11.4	11.2
Social security institutions	11.5	12.3	13.7	14.7	14.4	14.3	13.9	13.5
Special funds	-	-	-	-	-	3.2	6.3	10.2
Memorandum item								
Total expenditures as per cent of GNP	28.5	27.3	26.4	27.7	25.0	26.7	29.5	30.7

Source: OECD Secretariat calculations based on data submitted by the Turkish authorities.

Table 29 Summary Statistics on the Largest SEEs

	Public firms					Public firms			Private firms		
	1980	1984	1985	1986	1987	1980-82	1983-85	1986-87	1980-82	1983-85	1986-87
	Per cent					Average annual percentage change					
Profits/sales revenue	4.8	6.5	10.8	7.8	7.1	11.7	56.4	9.2	-21.4	-5.9	48.8
Export/sales revenue	-	9.1	8.0	4.9	6.9	-	28.0	40.4	-	-0.1	2.8
Rate of return on capital[1]	16.2	20.6	26.8	9.6	18.5	25.6	22.4	-5.7	-13.9	4.2	54.1
Number of firms with negative profits (per cent of total)	22.8	16.7	18.1	15.4	21.1	36.8	-21.1	37.2	17.4	22.6	-38.6
Compensation per employee (1983=100)						-	41.6	56.8	-	29.5	101.8
Manufacturing wholesale prices (SIS 1981=100)						27.7	36.4	21.8	26.8	43.6	40.2

1. Profits over net fixed assets.

Source: Secretariat calculation on data submitted by the Istanbul Chamber of Industry.

The limited growth of public revenues relative to GNP, and the large gap existing between Turkey and the rest of OECD - and most of the EC - in terms of standards of education, health care, and basic infrastructures, indicate that it is certainly necessary to increase government revenues by further reforming the tax administration both to broaden the tax base and to reduce the very high level of tax evasion. Additionally, there is a clear need to reduce the basic income tax rate which amounts to 25 per cent of the gross wages of minimum wage-earners, and to increase the rate for the higher wage-earners.

If one questions the role of EBFs in allocating public investment expenditures in the long run, it appears that they have been used as an instrument for remedying failures such as the practical absence of any private mortgage lending in Turkey. The "Mass Housing Fund" was a response to existing market deficiencies. Hence, through gradual reduction in the number and amount of funds and a tighter control and prioritisation of their expenditure, the functions of these funds need eventually to be reallocated to both the private and public sector.

The reform of the public sector should be strictly in accordance with the target of reducing the public debt. Within the framework of this prerequisite:

1. The process of fiscal decentralisation should not lead to loss of control over borrowing strategies of SEEs, EBFs and local administrations. Excessive external borrowing by SEEs

and more recently by municipalities has imposed a heavy burden on policies aimed at rationalising the public expenditure.

2. The issue by EBFs of income-sharing certificates yielding real returns higher than those on other public sector liabilities ultimately reduces government revenues that would be otherwise available for reducing the debt.

3. It would be misplaced to consider the process of privatisation of public firms as a way to obtain debt relief, rather than as a strategy to improve the functioning of markets through reforming their management and performance and hence attracting additional household savings to capital markets.

Apart from the fairly understandable public opposition created by the bloc sales of shares of the SEEs to foreigners, only a small number of these sales has so far resulted in some improvements in the management and technological equipment of these public firms in spite of the government's determined, though incautious persistence on the issue.

4. AN ASSESSMENT OF THE POLICY CHANGES UNDER ORTHODOX PROGRAMMES: INTERACTION BETWEEN STRUCTURAL REFORMS AND STABILISATION

There have been positive developments in the Turkish economy during the 1980s: increased rates of capacity utilisation, positive GNP growth, increased exports, especially the substantial rise in

industrial component of exports from 35 per cent in 1979 to 78 per cent in 1989[11]. These were largely dependent on the availability of additional external finance in very large amounts; and the availability of the major portions of this external finance (via the intermediation of IMF) was in turn dependent on the adoption of the stabilisation programme.

In the mid-1970s, the economy had an extremely weak export performance and a comparatively high and increasing degree of import dependence. These factors had led to chronic external deficits and an incapacity to sustain the import requirements of the economy for a warranted path of expanded reproduction from its national resources. Secondary elements of the structural deformations consisted of a prematurely large tertiary sector and, within industry itself, the existence of a relatively large but non-viable and weak sub-sector of consumer durables and a small capital goods sub-sector (Boratav, 1987).

As a result of these fairly negative features the liberalisation process has been addressed first to foreign trade, then financial markets and capital markets, together with the gradual reform of the public sector from the beginning.

After years of financial repression, the initial reaction of financial markets to liberalisation was a large increase in interest rates for deposits - banks were left free to set deposit interest rates and loan interest rates between mid-1980 and the end of 1983 - and private bond issues. Coupled with general euphoria in the

goods market after years of recession and trade reforms, speculation was encouraged which culminated in the "broker crisis (banker krizi)" in 1982, left a very heavy burden on the Central Bank in the same year. This could have been abated by a timely reform of banking and capital market regulation. As to the influence of this incident on income and wealth distribution, it is quite clear that the small rentiers whose wealth was wiped out were the principal losers. On the other hand many rentiers, particularly the "early comers" to the bonanza - as Boratav put it - managed to obtain extremely high interest rates for more than two years at the cost of the "late comers" whose savings and wealth disappeared without significant returns. Additionally, the unpaid "bad debts" to the moneybrokers and banks during this period - between mid-1980 and the end of 1983 - resulted in windfall gains for the firms and media engaged on these activities.

The high government financing requirements and the resulting inflation have, in turn, impacted on the gradual liberalisation of currency markets. Removing controls on capital movements stimulated capital outflows during periods of high inflation and negative real interest rates. Then efforts by the monetary authorities to limit these outflows led to real interest rates well above the levels prevailing in international markets, yielding again large amounts for the big rentiers. With the tighter regulation of domestic credit flows, the partial lifting of capital controls led to stimulation of foreign borrowing by private and, even more, public firms. When interest rates on domestic assets have exceeded

those on foreign assets capital inflows have led to the appreciation of the exchange rate, which had been one of the underlying causes of the slowdown in the export performance since the second half of the 1980s.

Empirical analysis on the effective costs of borrowing for the business sector indicates that the high credit costs have been an important element behind the poor performance of private industrial investment, also reflecting a significant built-in element to the inflationary process (ibidem).

In so far as weak investment had impeded shifts from the sheltered to the exposed sectors of the economy, high credit costs have created obstacles to the development of productive sectors, in particular in exports, and the broadening o the country's industrial structure. Moreover, the interaction of stabilisation and liberalisation policies tends to increase the price of non-tradeables relative to tradeables and shift capital from competitive sectors to the sheltered sector of the economy.

The initial "big bang" of trade reform included a sizeable real currency depreciation, excessive export subsidies to counter the greater liberalisation of imports. There was also a ban on employee lay-offs which shifted wage-costs from components of prime costs into overheads thus encouraging high rates of capacity utilisation. Finally, demand management via income policies led to a significant contraction of internal demand which proved immediately successful in encouraging exports. Whereas

agricultural exports in current dollars showed a modest overall progress of 21 per cent between 1978-79 and 1984, the increase in industrial exports in the same period was 7.3-fold with its share in total exports rising from 30.9 per cent to a striking 72.1 per cent in five years. By 1989, the share of agricultural products in total exports was 9 per cent and the share of industry together with agro-based industry was 89 per cent (Briefing, 1990). Adjustment was helped by the presence of large idle capacity in most manufacturing sectors, whose increased utilisation was also made possible by the availability of external finance which sustained a high level of intermediate goods' imports. On the demand side, the successful entry into the oil-rich Middle East and North Africa markets was an important factor behind the "export boom" of the 1980s[12].

However, apart from the distributional and allocational costs of excessive export subsidies, the problem of "fictititious exports" had been experienced during the mid-1980s due to over-invoicing by the exporters, encouraged by the "exorbitant" export incentive schemes; and there has been a decline in workers' remittances from abroad, one of the sources from which foreign exchange for "fictitious exports" was provided, by 40 per cent from 1981 to 1983 (Boratav, 1987).

Turkey could not sustain this bright picture in export performance in the last few years of the 1980s, especially after abolishing the excess tax rebates through VAT schemes provided to

exporters in 1988 and the implementation of unrealistic exchange rate policies in the face of much more rapidly rising domestic inflation rates, hence the over-valuation of Turkish lira. Apart from the financial constraints caused by high credit interest rates; there were also quality, capacity, technological equipment and demand constraints - i.e. quotas on Turkish textile exports imposed by the EC and the USA and declined demand in the Middle-East market. All these factors contributed to the relatively low level of Turkish export earnings compared with its huge and well-diversified natural resources.

In his analysis on the trend and shares of the major components of imports from 1976-77 to 1984, Boratav (1987) indicates that the gradual process of liberalisation through its incidence on import competition worked against capital formation, in favour of consumption and current production requirements, coupled with uncontrolled and hence unnecessarily high levels of imports. He also argues that the same average growth rates could have been sustained with a lower level of imports (and of smaller external deficits). Alternatively, higher levels of capital accumulation could have been provided with the same import bill during this period. During the whole decade domestic absorption was suppressed by an incomes policy which significantly reduced the real income of fixed-income earners such as civil servants, workers.

5. CONCLUSION

All these negative effects arose from the implementation of reforms and underline the importance of macroeconomic stability and synchronisation of all the relevant parts of a structural reform programme. Negative interactions between different areas of reform can be minimised by making private business firms and the government less dependent on the banking sector with the new, efficient markets to be created where private firms and the government could have access to loanable funds without necessarily passing through bank intermediation. Equity financing through capital markets would lower debt/equity ratios for firms and would reduce the destabilising effects of financial reform. Increased competition among banks would hasten improvements in the efficiency of the banking sector and eventually reduce the costs of financial reform by narrowing the spread between the borrowing an lending rates.

Whatever the explanation of short-term movements of domestic inflation rates, the structural cause of growing monetary aggregates must be sought in the large, and not efficiently controlled, public sector deficits. Simulations conducted by the OECD in the framework of a public finance model of inflation for Turkey suggest that real growth of GNP at a target rate of 5 per cent together with a reduction of inflation rate from 60 to 20 per cent would require a very sharp cut, by 4 or 5 percentage points of GNP, in the public sector borrowing requirement, which was at a level of 9.7 per cent of GNP in 1990 (EIU, 1991)[13]. A further monetary contraction that

was not accompanied by a consistent fiscal policy would further exacerbate the low level of investment and lead to stagflation. Further steps to limit the central government's access to Central Bank financing would help to curtail the most important source of structural inflation, as well as strengthening the Central Bank's role in the control of inflation.

As a result of unstable monetary and fiscal policies during the 1980s, the main objective of the financial sector reform has not yet been achieved. Channelling more savings towards fixed capital formation, has been thwarted by weak financial markets, and a vicious cycle has been established of high deficits leading to high interest rates and thereby still greater pressures on the public budget. High real interest rates, by lowering the overall rate of investment, in particular in the manufacturing sector, have reduced the speed with which the tradeable sector could expand.

The impressive trade gains of Turkey for most of the 1980s - until 1987 - cannot disguise the continuing weaknesses in the structure of exports. Turkish comparative advantages in labour-intensive production have not been fully exploited and the continuing specialisation in a few sectors, notably textiles and some agricultural products such as currants, citrus fruit, tobacco, had made Turkish industry more vulnerable to changes in the world demand, as well as to the protectionist measures adopted by other countries, particularly the USA and the EC.

Tax reform seems to have succeeded in giving some incentives to save and to work, but has not yet provided the tight supervision which would remedy fiscal inequities due to widespread tax avoidance, and therefore has not resulted in a substantial increase in government revenues. Further success in structural adaptation, notably full external liberalisation and the provision of a higher standard of public services, will crucially depend on reducing the large public sector deficits. The fight against inflation would also become less burdensome if the structural causes of the high public sector borrowing requirement could be removed. The major one being he existence of inefficient state enterprises due to lack of new technology and proficient management, lack of competition as a result of inappropriate incentive structures and government subsidies, and inadequate revenue largely arising from delays in adjusting their prices to rapidly rising inflation. The efficiency of monetary policy must be enhanced by greater independence of the Central Bank. Some progress in structural adjustment of the Turkish economy has been achieved in the last decade - though at the expense of low income groups and farmers.

Notes to Chapter VI

1. OECD, 1989/90. Economic surveys, Turkey, p.79.

2. Turkish Review, Autumn 1988, p.43. Hastings Kong.

3. Ibid., p.45.

4. Barchard, David. Financial Times, May 20 1991,p.VII.

5. OECD, Economic Surveys 1989/90, Turkey, p.96.

6. A new law enforced in 1983, distinguished SEEs, to be operated under private profitability criteria, from public utilities, providing basic goods and services (OECD, 1989/90, p.97).

7. Turkish Review Autumn 1988, p.46.

8. Ibid., p.47.

9. These changes in the structure of public revenues have improved the responsiveness of tax receipts to output growth, as shown by the OECD Secretariat estimates of tax elasticities. See previous surveys on Turkey.

10. Cankorel, Bilge (1990) Lecture notes on "Western European Integration". University of Ankara, Faculty of Political Sciences.

11. Ibid.

12. The share of these countries in total exports rose from 10.8 to 43.1 per cent between 1979 and 1983 with four leading countries (Iraq, Iran, Libya and Saudi Arabia) constituting 34.2 per cent of total exports (State Institute of Statistics, 1981,1985). Boratav, K. 1987,p.28.

13. Economic Intelligence Unit (1991) "Turkey", Country Report,No.1,pp.14-29.

CHAPTER V

TURKEY-EC RELATIONS AND PROSPECT FOR THE 1990s

INTRODUCTION

In the previous chapter, the stabilisation and structural policies introduced by Turkey since the second half of the 1970s, in contraction with the IMF, have been briefly studied. This chapter aims to review the evolution of relations between the EC and Turkey from 31 July 1959, the date when both Turkey and Greece applied for Associate Membership just 2 years after the signing of the Treaty of Rome which laid the foundations of the Organisation with its original six member states. The chapter covers the period up to Turkey's application for full membership in April 1987. The chapter analyses the reasons underlying Turkey's rejection from that organisation by an "Official Opinion" issued by the Commission of the EC in 1989, and the prospects for Turkey in the context of global development and welfare as well as in the Community.

1. ASSOCIATION AGREEMENT

Turkey applied to the Community to establish an association relationship within two years of the Treaty of Rome. This application which was welcomed by the Community and the Ankara Agreement laid the foundations for the EC/Turkey association signed on 12 September 1963. The Association Agreement which went into force on 1 December 1964 aimed at strengthening economic and trade relations between the parties, while (Article 2) "taking full account of the need to ensure an accelerated development of the Turkish economy and to improve the level of employment and the

living conditions of the Turkish people." In the Preamble of the Agreement, it is stated that the parties have decided to conclude the Agreement, "recognising that the support given by the European Economic Community to the efforts of the Turkish people to improve their standards of living will facilitate the accession of Turkey to the Community at a later date" (Bozer, 1987). The aims of the Treaty are to be obtained through a customs union, coordination of economic policies and gradual liberalisation in the field of services, free movement of workers, capital and right of establishment. Hence, Turkey signed the Association Agreement with the ultimate aim of becoming a full member of the Community in the future and the Community undertook various obligations intending to facilitate this aim. Turkey had no obligations during the Preparatory stage - which was designed in the Ankara Agreement to be followed by the Transitional Stage and the Final Stage - but the Community agreed to assist Turkey's economic development by providing commercial and financial facilities unilaterally.

Article 28 of the Agreement states that "as soon as the operation of this agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community." This period was completed earlier than the five years foreseen in the Ankara Agreement.

The implementation principles of the Transitional Stage are

specified in the Additional Protocol which was signed on 23 November 1970 and went into effect on 1 January 1973. This Protocol, beside envisaging that the customs union be completed at the end of 22 years - maximum date - also includes articles regarding the common agricultural policy (CAP), the free movement of workers from both sides and financial aid.

The Agreement offered the prospect of ultimate free entry into the EEC of certain Turkish agricultural exports - due to be liberalised by 1995 - which were added in 1970 to all Turkish industrial products. The latter included most of the industrial products except "textiles", "machine woven carpets" and "petroleum products" (Wyles, 1980). As stated in the Additional Protocol (Annex 2) "cotton thread" which is not in final form for retail sale, "other cotton fabrics" and "machine woven carpets" made from wool or refined wool are subject to quantity restrictions. The permitted amounts have sometimes been increased due to a supplementary protocol, which was signed on 30 June 1973, and general preference systems (Karatas, 1986). The EEC does not levy customs duty on these items, provided that they are imported to the EC within the specified quantities; but a 25 per cent duty is applied to quantities in excess of the specified amounts.

The Additional Protocol did not lay down a specific timetable about how free movement of agricultural goods would be ensured during the transitional stage, but during this period Turkey's agricultural policy would be brought closer to the Common Agricultural Policy (CAP). Furthermore, Article 35 of the

Additional Protocol states that both parties accord reciprocally preferential treatment to their agricultural exports; according to the Community paper Turkey did not implement this provision until 1988.

However, according to the Additional Protocol which arranges the transitional period of Turkey-EEC Association, Turkey has been provided with some concessions by the Community for a number of agricultural products which were arranged by the EC Council decisions taken on 30 June 1980. According to this arrangement;

i) customs duties (including previous concessional taxes) which were imposed on imports of agricultural products from Turkey to the EEC, would be lifted by 1 January 1981 according to a pre-determined schedule which comprises four phases;

ii) customs duties which were 2 per cent or lower than this rate would be reduced to nil on 1 January 1981;

iii) customs duties which were at 2 per cent and higher than this rate would be reduced to nil within a specified period as shown below:

Table 30

Date	Reduction %	Cumulative % Reduction
1.1.1981	30	30
1.1.1983	30	60
1.1.1985	20	80
1.1.1987	20	100

Source: C.Karatas, 1986 Turkish Review, Autumn,Vol.1,No.5.

As can be seen from Table 30, on 1 January 1987 the customs duties charged upon imported agricultural goods from Turkey were lifted. However, the concessions mentioned above were only related to Common Customs Tariff (CCT) and did not include the pre-levy, which EC countries impose in the process of imports from third countries, in the schedule arranged for reductions in customs duties. In this scheme annual quotas were imposed on products such as hazel-nuts and apricot paste which are among the few commodities Turkey has for long held comparative advantage and relied upon as foreign exchange earning sources. Exports of "tomato ketchup" and "tinned tomato" which are listed in CCT have also been restricted by the imposition of annual quotas (ibidem). Exports from Turkey conducted after the expiry of the specified periods would have been subject to Common Customs Tariff (CCT).

At this point it would be useful to point out the obligations of the Community and Turkey arising from both the Ankara Agreement and the Additional Protocol.

1.1 Obligations of the Community

a) Reductions of customs duties:

After the Additional Protocol went into effect the European Community agreed to abolish customs duties and taxes with equivalent effects on industrial products from Turkey with the exception of textiles, machine-woven carpets and petroleum products, and the import of these products (exceptions) by the member countries is determined separately.

b) Abolishing quantitative restrictions

The Community also accepted to abolish quantitative restrictions (Article 24 of the Additional Protocol) and to consolidate this in favour of Turkey (except for raw silk and petroleum products). At the same time, it agreed to abolish customs duties and changes with equivalent effects on exports to Turkey.

The Community has, however, since 1982 reintroduced restrictions on Turkish textile exports and Turkey has refused to negotiate a "voluntary restraint" agreement in the context of the MFA. Hence, the Community has conducted agreements with variousTurkish producers' associations, limiting their exports for a range of goods, mainly cotton yarn and cloth, acrylic and synthetic fibres, certain garments (European Parliamentary Working Paper,1988).

1.2 Obligations of Turkey

a) Abolition of customs duties and quantitative restrictions

Turkey will progressively abolish customs duties on products originating from the Community within a period of 12 to 22 years. According to a predetermined timetable, Turkey would also abolish quantitative restrictions on products imported from the Community; security deposits for imports, customs duties for exports and charges and quantitative restrictions with equivalent effects.

b) Acceptance of the Common Customs Tariff

Within period of 12 to 22 years, Turkey will harmonise the customs duties for third countries to the Community's CCT.

Turkey achieved a tax reduction of 20 per cent in the 12-year list and 10 per cent in the 22-year list on its imports from the Community up to 1976, starting from 1971, but no measure was taken by Turkey during this period towards the harmonisation of its customs duties to the CCT. Consequently, due to severe economic problems, Turkey applied for the postponement of the liberalisation schedule vis-à-vis the Community in 1976, consistent with Article 60 of the Additional Protocol (European Parliament Working Paper, 1988).

However, it was a general consensus in Turkey that the

current transitional agreements with the EC have not produced greater benefits for Turkey as a prospective full member. For instance, textile and clothing accounted for over 18 per cent of exports in 1982 - in 1990 over 30 per cent - hence the quotas imposed by the Community constituted a considerable restriction for Turkey. The postponement of further tariff cuts was also prompted by the fear in Turkey that exports of agricultural products which constituted almost 58 per cent of the total in the early 1970s - in 1990 this ratio was 18 per cent of total exports - would have been set back because of restrictions imposed on them by the EC which were clearly against the spirit of free trade and expansion of trade between Turkey and the EC (for the detailed study of the impact of these restrictions on Turkish export and trade balance with the EC, the reader is referred to Karatas (1986) Turkish Review,pp.68-70).

On the other hand, due to the Community's agreements with Mediterranean and ACP (African, Caribbean and Pacific) countries, the Turkish preferential margin for agricultural products has been significantly eroded.

2. FREEDOM OF MOVEMENT FOR WORKERS IN THE ANKARA AGREEMENT AND THE ADDITIONAL PROTOCOL

Article 12 of the Ankara Agreement states that the contracting parties agreed to be guided by Articles 48,49 and 50 of the Rome Agreement for the aim of progressively securing freedom of movement for the workers between them. The Additional Protocol ensures the freedom of movement for workers to be secured, by the

decisions of Association Council within a 12 and 22-year period starting when the Ankara Agreement (1 December 1964) went into effect.

However, these provisions were not implemented by the Community side due to both economic and political reasons. While the Council of Association decision No.2/76 aimed to start the first stage (1 December 1976-1 December 1980) which was entered into force in 1976, the same Council's Decision No.1/80, besides launching the second stage of freedom of movement of workers (1 December 1980 - 1 December 1983) postpones the freedom of movement to a later date and only attempts to improve the legal status of those Turkish workers who were in the Community labour market already. Actually, Article 6 of Decision No.1/80 states that a Turkish worker, taking apart in the legal market of a member state has the right:

- to renew employment permission if there is vacant employment, after working legally for one year and on the condition of working in that state and under the orders of the same employer.
- to apply for employment with an employer that is offered under normal circumstances and registered by the Employment Bureau of that state on the condition of having worked in that state legally for three years and giving priority to the workers of that state.
- to apply freely for any employment with remuneration after working legally for four years (Yülek, 1987).

When the Association Council Decision No.1/80 is compared to basic Community Regulation 1612/68, it is fairly clear that the Turkish workers, with the condition of obtaining permission, were largely restricted by matters concerning time, type, place of employment and furthermore by giving priority to workers of that specific state. Additionally, Clause No.3 of the above regulation states that the application of the conditions of this article would be determined by national legislation; causing diverse practices between countries and even within a country when federal states are concerned. However, Article 7 of the Council of Association Decision No.1/80 also states that the dependents of a Turkish worker could only apply for employment after residing legally in that country for "5 years" while Community Regulation No.1612/68 - which is the EC's fundamental regulation in relation to the rights for the free movement of workers - does not state any restriction of that kind for dependents of a worker of a member state.

Briefly, the Ankara Agreement and the Additional Protocol ensure that the freedom of movement for workers between Turkey and the Community would go into effect at the end of the 22-year period (December, 1986). But the freedom of movement stated in Article 36 of the Additional Protocol could not be secured completely except for partial implementation of the first two stages. In the Article, however, it was stated that the "Association Council" was going to decide on the necessary methods concerning the application of the matter. In conclusion, the right exists but in order for it to be a binding commitment the Association Council should determine the application methods and, of course, consequently member states

must pass these through their national legislatures.

However, on 24 November 1986, the EC Council made a different decision. Article 12 of the Ankara Agreement concerning freedom of movement was interpreted in such a way as to exclude the concept of freedom of movement for workers and ignoring Article 36 of the Additional Protocol. The Council tried to block the right of Turkish workers for freedom of movement - of a country which had, during the 1980s an unemployment rate of much less than half of that prevailing in Spain.

This decision was, naturally, not agreed by the Turkish Government and the matter was taken to the Court of Justice. On 30 September 1987, the Court of Justice (case 12/86) found that,

> the provisions contained in the Association Agreement (Article 12) and in the Additional Protocol (Article 36) concerning free movement of workers did not, in the absence of implementing legislation adopted by the Association Council, produce direct effects and could not be invoked directly, by individuals before the Courts of Member States.
> (European Parliament Working Papers, 1988, Session Documents, A2-350/88).

Additionally, with the introduction in the 1980s of visa requirements for Turkish people travelling to most European states, further obstacles (instead of improvement) have been created towards the unification of Turkish guest workers with their parents.

It has been understood that there are two major reasons

behind the reluctance shown by the European Community member states on the issue:

a) Political reason: Greece opposes the freedom of movement for Turkish workers and claims that this would cause a threat to its national security (being a view which many Turks find consistent with Greece's unfounded and ill-placed propaganda and antagonism against its neighbouring country).

b) Economic reason: especially after the petroleum crisis in 1973, the need and demand for foreign workers declined and unemployment increased in European countries. Laws were made encouraging foreign workers to return to their countries and other laws that would assimilate foreign workers into their host society. Under these circumstances, provision of freedom of movement for Turkish workers induced great opposition in particular from Federal Germany.

3. RIGHT OF ESTABLISHMENT AND FREE CIRCULATION OF SERVICES

Article 13 and Article 14 of the Ankara Agreement state that the Contracting Parties agree to be guided by Articles 52 to 56 and Articles 58 to 65 of the Rome Agreement for the purpose of abolishing restrictions on freedom of establishment and freedom to provide services between them (Yülek, 1987).

However, Article 41 of the Additional Protocol expresses these two concepts: freedom of establishment and freedom to provide services together and states that the decisions concerning the

application will be taken by the "Association Council" especially taking into account the economic and social conditions of Turkey.

No regulation has been set up between Turkey and the Community on these matters. At present Turkish workers are subject to different regulations on practising their professions in different member states. France, Holland, Belgium and Denmark allow enterprising Turkish workers to function independently under special conditions while Germany, which hosts the largest number, only permits Turkish workers to practise their professions in partnership with a German national and provided that the permit itself is issued in the name of that German partner.

4. FREE MOVEMENT OF CAPITAL

Article 20 of the Ankara Agreement states that the Contracting Parties will consult each other to facilitate movement of capital between Turkey and the Community, seeking all means of promoting the investment of capital in Turkey, from countries of the Community which can contribute to Turkish economic development. According to Article 53 of the Additional Protocol, Contracting Parties will not bring any new restrictions that would harm capital movements among themselves and current payments for debt servicing, and they will simplify the procedures on the issue as soon as possible.

Since the entry-into-force of the Additional Protocol, no

progress in relation to the above regulations has been made between the Parties concerned.

5. FINANCIAL COOPERATION

The Community has dispersed, though the EIB (European Investment Bank), a total of 695 million ECU in loans (Eur.Par.Session Doc.,1988) in order to contribute towards the fulfilment of the aims of the Association and to increase the productivity of the Turkish economy throughout the period of 1963-1977 through the first three financial protocols. In addition, a special aid of 75 million ECU was granted in 1980 and the last 19 million ECU on 28 November 1988. However, apart from the inadequacy of the amounts as the contribution to improvement of such a vast country's economic and social level, a 600 million ECU worth of loans agreed through the "Fourth Financial Protocol" which was initialled on 19 June 1981, could not be released owing initially, to the Community's reservations about human rights problems during and after the 1980 military coup in Turkey, then to Greece's veto on the financial issues in relation to Turkey.

6. NORMALISATION PROCESS AND THE APPLICATION OF TURKEY FOR FULL MEMBERSHIP OF THE EC

When Greece announced in 1975 that it would apply for full membership of the Community at an early date, signals from some Western parliamentarians, especially the one from the then EC Commission Secretary-General, Emile Noel, "that Turkey should

immediately lodge its own application," did not draw much attention from the Turkish authorities at that time. Possibly, this was due to the prevailing climate of anti-EC feeling but mostly to widened doubts about the feasibility of a customs union in a domestic environment highly grasped by foreign exchange bottlenecks at the end of the same period. In 1980, the ultra-European foreign minister of the Demirel minority government, Hayrettin Erkmen, announced that Turkey would be applying for full membership, probably before the end of 1980; but by then it was too late. Because, at this time, a military coup took over the political life in Turkey on 12 September 1980 ruling out any chance of that kind for some years ahead.

Thus, according to some academicians and politicians, Turkey missed a good opportunity by not applying at the same time with Greece as being another NATO member country in the Mediterranean region and as a result faced a Greek-Spanish-Portguese alliance against itself. Hence, Turkey lost much of its bargaining position in relation to the Community.

However, with the return to a democratic system of elections held in December 1983, the new Özal Government consequently expressed its will towards normalising the country's relation with the EC. On 16 September 1986, the Association Council met again for the first time since 1980. Following this, considering that the Association Agreement did not work as it was intended, and the Turkish economy was already committed to a much more liberal

evolution based on European terms and opened up to external competition to a larger extent, the Government decided that the best solution would be to proceed with an accession request and to reorganise the relations in a more definite manner. Hence, Turkey submitted on 14 April 1987 its formal application to join the Community under the terms of Article 237 of the Treaty of Rome, which states that the European Community is open to any European State which asks for it and accepts the terms unanimously agreed by its members.

During the examination of the Turkish accession request by the EC from 27 April 1987, a high level ad hoc Committee meeting took place between the Turkish Government and the Commission in Brussels during November-December 1988. Turkey announced that it will proceed to the customs union with the Community in a much accelerated way so as to be completed by the end of 1995 according to the schedule below:

a) 70 per cent tariff reduction in 12-year list;
b) 60 per cent reduction in 22-year list, will be provided by Turkey on its industrial imports from the Community by the end of 1992;
c) 60 per cent reduction will be ensured on its quantitative restrictions against the Community;
d) 40 per cent harmonisation to the Community CCT will also be made by the same date.

Consistent with this schedule, Turkey further reduced its

tariffs, starting again from 1988, on both of the lists in 1989 and 1990, as well as securing a 20 per cent harmonisation to the CCT.

7. COMMUNITY'S REPLY AND ITS ASSESSMENT

The EC Commission issued an "Official Opinion" on the Turkish application in December 1989 which was later adopted unchanged by the Community's Council of Ministers.

The eligibility of Turkish entry was once again confirmed, but the "Official Opinion" proposed that negotiations for an eventual possible Turkish accession should not begin until 1993 as regards the creation of "Common Market", and did not commit the Community to opening negotiations even after that date. The economic disparity between Turkey and the Community members as well as political reasons, such as the state of civil rights, the Cyprus problem and other disputes with Greece, were defined as the main reasons for this postponement (Briefing, 1990).

However, it should be clear that those last reasons, namely, the Cyprus problem and other conflicts with Greece, are solid evidences of the impact of Greece's membership on defining the Community's attitude towards its relations with Turkey, violating the condition of Greek entry to the Community put into her accession agreement that "The Greek entry should not affect the relations of the Community with Turkey." (Barchard, 1985).

In the meantime, Turkey is exhorted to prepare the way for membership by reaching a full customs union with the Community (originally planned by 1995) backed by proposed enhanced financial, industrial, commercial and cultural cooperation - as well as in the field of research an development, science, etc. It should be noted here that no other country has so far achieved customs union with the Community in association status, without becoming a full member. Even the package of cooperation proposed in the Commission's "Report", including the release of 600 million ECU financial aid committed in the "Fourth Financial Protocol" since 1981, still remains unachieved due to lack of willingness on the part of the Community's Council of Ministers in passing it through their approval.

However, while the Commission report did not include any certain date for initiating negotiations on Turkish accession in the future, it also did not rule such negotiations out "in the longer term." To do that, would have been a flat contradiction of both the 1963 Ankara Agreement and the existing Association Agreement. Even any suggestion by the Community for some looser form of integration with Europe would have further aggravated the damage done in Turkish public opinion, bringing about a serious risk that nationalist and/or extreme fundamentalist forces would obtain the upper hand in the country with all that could mean for democratisation (a 58-year process since the establishment of the Turkish Republic on 29 October 1923), economic liberalisation and foreign policy.

Underlying reasons behind such a reserved action are shown in the Commission's Report as below:

First of all the Turkish application poses a challenge of considerable proportions both in terms of being - if it joined - its largest member state in land area, and more importantly, by the year 2000 being its second largest, after the unified Germany of nearly 77 million, in population (op.cit.).

On the other hand, according to the Commission its present level of economic development is some way behind that of the member states that joined the Community most recently; as it was shown in Chapter III, Greece, Spain and Portugal.

The report, while loudly acknowledging Turkey's process of economic liberalisation, which it notes is aimed at making Turkish industry more competitive, nevertheless charges that it is still far from complete by the current standards of the Community. For one thing, it says, the effective level of protection for Turkish industries is still significant. Certain surcharges (which Turkey is scrapping stage by stage under its reviewed import regime) including the EBFs (extra budgetary funds) are also illegal under the terms of 1970 Additional Protocol. Export subsidies, especially to sensitive sectors, are still generous in the eyes of the Community.

What is of more basic concern to the Community is the conclusion of the Report that:

> ...Since the population of Turkey is expanding very rapidly, the effect on GDP growth per head is correspondingly less marked... The distribution of income is very uneven, both from a regional and from a social view-point... Labour productivity is also very low... Turkish agriculture is characterized by major structural and socio-economic deficiencies... Inflation is a big problem and, in any event, inflation does not appear to be the result of excessive domestic demand fed by wage increases since real wages remained fairly stable during the 1980-1988 period... The size of Turkey's external debt and the burden of interest payments to foreign creditors is strikingly awesome.
>
> (Briefing 1990/772)

Again, according to the Community, "social and employment policies are still very poorly developed in Turkey, most noticeably in the organisation of the labour market, the education system and the provision of social security benefits."

8. COMPETITION

The most comprehensive study on the competitiveness of Turkish industry has been conducted by the Istanbul-based Foundation for Economic Development (IKV), which was given much credit in the "Commission Report". According to the findings of this study, around 75 per cent of Turkish industry would be capable of withstanding international competition if it joined the Community. Of the 53 industrial sectors studied, only 15, representing around 12 per cent of industrial output, would be in a weak competitive position. The products best able to fend off competition from European industry are textiles and clothing (cotton), carpets, leather goods, cellulose, synthetic fibres, glass, cement, steel

tubes, aluminium castings, some commercial vehicles, consumer durables and some sectors of the agri-food industry.

Non-competitive sectors include wood products, cosmetics, automobiles, and in the agri-food industry; meat processing, dairies, preserves, sugar, wine and animal feedstuffs.

On the other hand, the latest "World Competitiveness Report" jointly published by the Switzerland-based International Institute for Management Development (IMD) and the World Economic Forum, places Turkey 20th among the OECD countries, ahead of Portugal and Greece and not far behind Italy, Spain and New Zealand (Briefing, 1990/779).

In brief, Turkey ranked between 18th and 21st among the OECD countries in respect of the factors of "industrial efficiency," "dynamics of the market," "financial dynamism," "human resources," "outward orientation," "innovative forward orientation," "socio-political stability" and in terms of "natural endowments." On the other hand, Turkeycame fourth on the "state interference" scale, reflecting strong government policies to help industrial development and lower taxes. According to this report, between 1981 and 1987 Turkey had the fastest growing real GDP measured in local currency, the fastest real growth in industrial production and the best productivity increases and capital formation rates and these are described as "points of strength" by IMD officials

The figures based on export performance between 1982 and 1987

showed that Turkey's exports, and its average share in the international markets for the products it exports remain low but those markets are seen to be expanding quite rapidly. This is true, especially after 1990 due to expanded export markets and trade relations with the Eastern European new liberalising countries, Soviet Union and the Turkish-speaking Soviet Republics which most recently declared independence, as well as with the EC and USA as a result of decreased level of quotas imposed on Turkish exports. The IMD officials also note the increasing importance of more capital-intensive industries such as iron and steel products, plastics, fibres and resins in Turkey's industrial portfolio (for further details see Briefing, 1990, issue 779, pp.20-1).

9. GULF WAR EFFECTS

In this section it is aimed to review the continuing effects of the Gulf Crisis on the Turkish economy together with its political implications on both sides in the aftermath of its postponed case for joining the EC as a full member.

In the wake of the Iraqi invasion of Kuwait on 2 August 1990, following the UN Resolution on imposition of economic sanctions against Iraq, Turkey has closed the petroleum pipeline operating between the two countries for carrying the Iraqi oil to the outside world, as well as suspending its trade with both Iraq and Kuwait.

Overall, according to the Treasury's recalculations in mid-

May on total losses from the Gulf Crisis up to the end of April 1991, Turkey has suffered a total figure of $6.25bn (see EUI, No.3,1991), the main items in this latest calculation being:

- loss of earnings from transit trade to Iraq and Kuwait: $1.3bn;
- extra cost of oil imports: $1.1bn;
- loss of direct exports: $1.1bn;
- losses by banks and contractors: $1.5bn;
- extra expenditure on defence and refugees: $550mn;
- other losses (mainly from the decline in tourism earnings): $700mn.

According to the same source, in compensation for the losses above, Turkey has received, up to the first half of 1991, around $2.9bn in international assistance, of which $2.3bn has been in grants and $600mn in loans, and it has been expected by the Turkish officials that this amount would reach $4.2bn by the end of 1991. Of this, $1.1bn from Saudi Arabia in the form of free oil and $900mn grant from Kuwait $250mn by grants from the United Arab Emirates, $250mn from the USA and $45mn from the EC has been received. Saudi Arabia is also expected to sell Turkey 8.5mn tonnes of oil at spot prices in 1991, and Iran another 3mn tonnes.

Also, pledges have been received by the USA for the creation of a $3-4bn defence fund for Turkey with contributions from Gulf countries in due course. Due to Turkey's role in the Crisis, the quotas imposed on Turkish textile exports to the USA have been expanded by 100 per cent and to the EC by 25 per cent, bringing

about some enhanced chances for the sector to grow (Briefing, 1991).

Despite the flow of compensation for Turkey's losses during the Gulf Crisis, current figures are showing that the adverse impact of the Crisis on the Turkish economy still prevails. In 1991 the rise in the domestic market prices of petroleum products along with those of commodities and services produced by the Turkish public sector has pushed inflation up further. According to the OECD (Economic Perspectives, July 1991) because of both the demand for wage increases and the Gulf Crisis, it would be very difficult for the Turkish authorities to maintain public expenditures at the levels announced earlier this year. There is already a decline in tourism revenues and service exports in mid-1991 due to the same adverse conditions.

Significantly, the West once more witnessed the loyalty and staunch support given by the Turkish Government to the Western Alliance and principles simply by opening its land and borders for the use of Western air forces and the flow of hundreds of thousands of Iraq refugees in the aftermath of the Gulf War. As Mr. Michael Lake, Chairman of the EC Commission representation in Turkey puts it, "we need each other. This fact is an integral phenomenon and tested by the recent Gulf Crisis. This establishes a firm ground for an economic relation at much higher level."(EC News, July 1991).

CONCLUSION

Following the momentous events in the Soviet Union, Central and Eastern European countries launched attempts to transform their centralised economies into free market ones.

The EC Commission has recently concluded 'Association Agreements' with the governments of Hungary, Poland and Czechoslovakia and is preparing the way for the extension of associate status to Romania and Bulgaria. The EC also proposed opening trade talks with Albania and the three formerly Soviet Baltic States.

Alongside these new candidates with Socialist pasts, the EC has also been considering the negotiation terms for the membership of Austria and Sweden in the face of their application for full membership in 1990 which is hoped to be concluded by the second half of 1990s (see ICOC Digest 1991). Finland and Norway are expected to be the next ones to join the queue by the end of the current decade.

Together with the agreement reached in Maastricht last December 1991 on the timetable to reach the EMU in stages by, at latest, 1999 it is likely that the EC's budget will be largely constrained by the financing of the Southern entrants' deficits on their way to financial integration within the EC. The EC is also prepared to grant large funds to contribute to the transformation of the Central European, and then the Eastern European, candidate's

economies in order to reach a customs union with them by the turn of the current century.

Overall, in the face of these rapid changes Turkey's case for joining the EC as a full member, even though it is proceeding to creating the customs union by 1996, looks rather ambiguous.

This chapter has shown that it is unlikely to political backing for economic union between Turkey and the present EC in the near future. However, the experience of trade growth during the mid-1980s shows the likelihood of increasing economic ties between Turkey and the EC even if not with formal customs union.

In the previous chapter, the structure of Turkish financial markets was examined together with Turkish fiscal and monetary policy which combined to cause the high inflation since 1987 and the consequent depreciation of the Turkish lira. This nominal depreciation was inadequate compared to the rising inflation and there was a real appreciation of the lira since then.

In the next and final chapter, the possibiity is examined of moving towards tracking the ECU with the lira.

Notes to Chapter Five

1. For a comprehensive discussion on the future enlargement of the EC, see Istanbul Chamber of Commerce Digest (ICOC, in Turkish) No. 305, 22 July 1991, pp.53-60.

2. For brief and comprehensive studies of the Cyprus issue, the interested reader is referred to:

   i) Denktas, Rauf, "Cyprus: The Final Round?" Turkish Review, Autumn 1988, Vol.3, No.13.

   ii) Leigh, Monreo, "The Cypriot Communities and International Law" and Plumer, F. Aytug, "Unjust and Illegal Economic Warfare: The Case of Northern Cyprus", Turkish Review, Winter 1990, Vol.4, No.22.

CHAPTER VI

CONCLUSION

INTRODUCTION

In this concluding chapter, an assessment is made of the possible implications of pegging the Turkish lira to the present EMS grid and then to the EMU by 1999. These implications are explored for the main areas of the Turkish economy.

For this purpose, it is thought necessary first to recall the recent timetable and the entry obligations prior to joining the future EMU as agreed in Maastricht Summit last December 1991.

In conclusion it is argued that unless the Turkish inflation rate is lowered to a much closer level relative to the EC average and also a genuine factor mobility is guaranteed between itself and the EC countries, surrender of flexible exchange rates is not feasible for Turkey, at least, in the short run.

1. THE MAASTRICHT AGREEMENT

On December 11, 1991 European Community leaders meeting in Maastricht agreed on the text of a Treaty on European Union, Economic and Monetary Union and associated protocols. The texts are subject to ratification by all twelve national Parliaments of the member states, a process which should be completed by the end of 1992.

The Agreement extends Community action into areas not previously covered by the EC Treaties, especially Economic and Monetary Union and defence. As the thesis in question attempts to deal with the issue of monetary union and the convergence criteria in general, this section will look at the timetable and other

decisions agreed in Maastricht relating to the progress towards Economic and Monetary Union in stages as it was proposed in the Delors Report.

1.1. The Timetable

Progress towards Monetary Union is in three stages, as explained in Chapter I. Stage 1 was launched under existing EC powers; Stages 2 and 3 require changes in the Treaty because they involve setting up new institutions. Hence the timetable agreed in Maastricht is as below:

i) January 1 1994: Stage 2 to begin with establishment of a European Monetary Institute;

ii) December 31 1996: UK to notify the Council whether it then intends to move to Stage 3; or by January 1, 1998 if no decision has yet been taken by the Council; or later;

iii) December 31 1996: deadline for decision by qualified majority to launch Stage 3, Economic and Monetary Union, if a "critical mass of member states (a majority would mean six out of 12 member states if the UK were not taking part in Stage 3) meet the convergence criteria;

iv) July 1 1998: A European Central Bank and European System of Central Banks to be set-up if this has not already happened;

v) July 1 1998: deadline for member states to make the national central banks independent;

vi) January 1 1999: EMU to begin "irrevocably" if this has not yet happened.

So the second stage begins on January 1, 1994. By then each member state is to adopt programmes for price stability and sound public finances. In that regard, where a member state is in severe difficulties, the Council may agree unanimously on a Commission proposal to grant financial assistance. Member states shall avoid excessive budget deficits; the Commission must monitor government debt; if the risk exists of too high a deficit, the Commission should inform the Council which can make recommendations to the member state and require that action to be taken.

From the second stage, the process leading to the independence of its supra-national central bank should begin. The European Monetary Institute (EMI) is established.

1.2. Progress to Convergence

The Commission and the EMI will report on progress of member states towards convergence. Their findings will go to the European Council, which will decide by December 31 1996 whether a majority of member states meet the convergence criteria:

i) Price Stability: the rate of inflation should be no more than 1.5% above the average of the three best performing member states;

ii) Government Deficits: these should not be above 3 per cent of GDP; public debt should not exceed 60 per cent of GDP;

iii) Exchange rates: currency should have stayed within normal fluctuation margins in EMS for at least 2 years;

iv) Interest rates: these should have been not more than 2 percentage points above the three best performing states over the previous 12 months.

The European Council will determine by qualified majority which member states are able to participate; those which do not will have a derogation.

When Stage 3 begins, all the participating members will agree the conversion rates at which their currencies will be irrevocably fixed and will be exchanged for ECUs.

The European Central Bank will have exclusive rights to authorize issue of ecu banknotes in the Community, both by the European or national central banks. Member states can issue coins subject to ECB approval.

The Council can unanimously agree on exchange rate system for the ecu towards non-Community currencies decisions, speaking as one in the international area on monetary issues.

1.3. The British Protocol

A special protocol to the Union Treaty provides the "opt-out" clause for the United Kingdom, recognizing that it will not be obliged or committed to move to stage 3 without a separate decision to do so by its government and parliament. The main points are:

i) The UK is to notify the Council by December 31 1996 whether it intends to move to stage 3; or by January 1 1998 if no decision has yet been taken by the Council; or later;

If not joining Stage 3:

i) The UK retains all its powers for monetary and exchange rate policy; and is not subject to EC disciplines (although accepting the Stage 2 commitment not to run excessive public deficit);

ii) The UK is free to change notification and move to the third stage if it satisfies the necessary conditions of convergence;

iii) The UK Government may maintain Ways and Means facility with Bank of England "if and so long as the UK does not move to the third stage";

iv) The Weighted votes of the UK are suspended in calculating the qualified majority for EMU decisions, etc.

Overall, the Maastricht Agreement could be considered as successful confirmation of the principles covered in the Delors

Report (1989) as discussed in Chapter I, but with an even more speedy route to the final objective of a single currency.

The opt out clause provided by a special protocol for the UK, however, could be a useful means for the prospective new entrants by which they can obtain some lessons from the experience of the future EMU before they decide whether joining the single currency area would be feasible for themselves.

1.4. The Case for Turkey Pegging the Lira to the ECU

The benefits of exchange rate stability and of a common currency are clear as have been experienced by the operation of the countries inside the ERM. These, together with its costs, are covered in Chapter II of this thesis.

For Turkey, joining the EC and then the ERM is not likely for the near future because of the various reasons which were explained in the last two chapters. However, even without Turkish entry into the Community, the Central Bank in Turkey may wish to have the Turkish Lira "shadow" the ECU, rather like the Austrian Schilling or the Swedish Krona.

Regardless of being a full member of the EC, Turkey can still obtain stability by shadowing the ECU on its exchange rates via its major trading partner. More than 50 per cent of Turkish export volume is to the EC in 1991. This would bring about less uncertainty on their commercial operations, reducing the risk of transaction and translation. That would also impose firm constraints on the monetary

policy of the Turkish authorities thereby preventing the further inflationary pace of the economy.

Nevertheless, the costs of deflating associated with the firm commitment to exchange rate stability via the EC, on trade balance and unemployment in particular, are expected to be substantially high for Turkey.

To look at the current figures in Turkey as concerns these indicators noted above:

The inflation rate for 1991 is about 70 per cent, interest rates for one year deposits range between 68 and 71 per cent (annually);

The public sector borrowing requirement is over 9 per cent of GDP; and nominal devaluation of Turkish Lira against main currencies is about 60 to 65 per cent annually.

The new coalition government consisting of True Path and Social Democratic Party took office in November 1991 in such an inflationary and unstable economic environment. It defined its primary objective as reducing inflation to about 10 per cent over a period of 4 years. Accordingly, some of the public investment projects under progress have been halted and large cuts from the defence budget have been planned.

For a start, both state and private banks pulled their deposit and credit rates down by 2 to 3 percentage points to be

applied from January 1992. In the mean time the government deficit is planned not to exceed 5 per cent of GDP over the period.

Whether the new government will succeed better relative to its predecessors would of course depend on the progress to be made towards a more successfully coordinated policy-mix between the urgent stabilization measures and the necessary structural adjustments.

Furthermore, as has been experienced by the past petrol price hikes of late 1970s and more recently the Gulf War, Turkey's volatile structure together with its location in a highly unstable region makes for any researcher or academician, further attempts to predict the future performance of the economy more difficult.

2. IMPLICATIONS OF PEGGING THE TURKISH LIRA TO THE ECU

Before trying to foresee what implications of fixing the currency on the Turkish economy would have, it is worth recalling the logic which militates for close currency ties between the Southern entrants, including Turkey, and the EC core:

i) The large volume of trade between the Southern countries and the EMS countries means that the cost in terms of risk and uncertainty associated with unstable exchange rates is fairly large (EC's share in Turkish exports is just over 50 per cent and its share in Turkish imports is about 42 per cent);

ii) The administration of EC programmes, notably the CAP, is considerably complicated by large exchange rate fluctuations;

iii) Given the freeing up of capital movements that is part of 1992, small countries will have difficulties in avoiding the eroding use of their currencies unless they have strongly credible stability in terms of the major currencies;

Finally all the Southern European countries have recent histories of fairly serious inflation. As in the case of countries such as Italy and France, they will require a Teutonic anchor to make their future price stability credible (that is obviously even more relevant for Turkey with its excessive inflation problem).

Given the future prospect of stable exchange rates, it is quite important that the entering countries get the initial exchange rate right. For example, an overvalued initial exchange rate would ensure the necessity of either an embarrassing and credibility-threatening early realignment or a prolonged period of depressed economic activity as monetary policy is obliged to gradually deflate the country relative to the rest of the EC.

For that reason, it is essential to make the best possible estimate of the post-entry equilibrium real exchange rate and to set the nominal rate at a level that allows establishment of the real rate without inflation or deflation. Experience and common sense suggest that the cost of a few years' inflation that would be needed to eliminate a 10 per cent undervaluation falls far short of the cost of prolonged recession that would be needed to correct a 10 per

cent overvaluation. Hence, Turkey also should try to err on the side on undervaluation; to peg the Lira to the ECU at exchange rate that will probably turn out to have been undervalued.

In fact, that was the policy that Spain attempted to follow when it first joined the ERM, to keep the peseta low against the ECU (and the DM in particular) so that Spanish industry would be in a favourable competitive position in the early post-entry years. The problem is that the capital markets try to set the rate at a level that makes sense to them, not at the level that is optimal from a policy point of view. That was the conflict which caused the continuous appreciation of the peseta inside the ERM since its entry in 1989. Presently, the peseta is the strongest currency in the ERM.

2.1. Initial Impact of Financial Integration-Excess Credibility Problem

As it is noted under the 'EMS Credibility Hypothesis' in Chapter II (Barro and Gordon, 1983) Turkey can import credibility by fixing its nominal exchange rate to the lowest inflation currency, thereby pre-committing to an anti-inflation strategy and setting a credible constraint upon its monetary policy operations.

The impact of this enhanced exchange rate stability, depending also on the expectations that the lira will be fixed indefinitely to the ECU, would normally be to stimulate capital inflows into the currency with relatively higher inflation and interest rates within a large market offering fast growth coupled with a highly favourable legislative environment for foreign

investments. Increased demand for domestic currency would lead to appreciation of the Turkish lira, with, normally unfavourable effects on the Turkish exports because the large increases in reserves are likely to be difficult to sterilise fully. These increases might not be as high as has been in the Spanish case which the capital inflow led to an increase in the money supply but not a fall in interest rates. As credits became freely available at the cost constant rate, there occured an expansion of economic activity and a slight rise in inflation since the entry into the ERM in 1989.

However, at the macroeconomic level, the result of such capital inflows can be a simultaneous investment boom and a trade deficit.

With the real appreciation of the currency, Turkish exports would loose competitiveness in an integrated market. Given that under the fixed exchange rate regime monetary policy will be constrained with the absolute task of exchange rate stability, that would imply a large deficit in the trade balance, as imports are also expected to be affected from the overvaluation of the currency, further reducing the total demand for those tradeables produced in Turkey.

The resulting loss of competitiveness in exports and increased demand for imports could lead to the aggravation of the trade deficit from possible import penetration effects of further trade liberalisation with the EC, as it is envisaged in related agreements.

The logic behind this is that the entry of the Southern European countries in the EC combines a liberalisation of imports by the entrants and an opening for their exports by the core nations. The first pushes toward appreciation; the second toward real depreciation.

However, the visible protective barriers that need to be brought down by Turkey are much higher (nominal effective protection rate is about 33 per cent in 1991) than those that need to be brought down by the EC core; on the other hand, the elasticity of the EC's demand, as a trading bloc, for imports from Turkey is expected to be larger than the elasticity of demand of Turkey for EC products as the whole bloc, excluding Turkey, would be able to produce close substitutes.

However, if Turkey does not succeed in improving the components of its export volume towards more capital-technology intensive products rather than the present dominance of labour-intensive manufactured goods, exceeding 50 per cent in its total exports, in the near future then the import penetration effects of the trade liberalisation would be higher. With the addition of the new associate member countries from Central Europe which offer close substitutes to major Turkish exports, such as textile and clothing, this presents an essential point to Turkey that deserves urgent attention.

Overall by pegging the lira to the ECU, the Turkish lira seems likely to appreciate to some varying extent depending on the macroeconomic indicators, specifically the inflation rate, and the

attractiveness of the country for foreign capital investments at the time of pegging the currency.

That is why it is essential for Turkish authorities to ensure a consensus with capital markets on the expected impact of the financial integration and possible entry into the ERM on the domestic currency, even by shadowing the DM for some time, before deciding to tie it, but erring on the side of undervaluation.

Perhaps these losses of competitiveness on the part of the peripheral countries with relatively higher inflation and interest rates during the trade liberalisation and financial integration period provide part of the motive for the highly industrialised EC core nations to become involved in such a far-reaching objective, i.e the single currency area. These core nations are, and will be the ones to enjoy the substantial gains in competitiveness against the new comers. That is reflected with the growing aggregate surpluses of a core group around, and, including Germany which consists of Belgium, Luxembourg, the Netherlands and Switzerland, while the peripheral countries are having increasing deficits (OECD Europe Current Accounts 1990, IMF 1989).

On the other hand, the logic for the periphery is that with an integrated financial system Europe would be approximately self-financing with the excess savings in the surplus countries flowing to investment in the deficit countries together with the assurance of various funds and credit facilities in order, first, to help contribute for their regional and national development as well as

their adjustment process, then to cushion the income effects of integration.

In the integrated financial system of 1992, European governments will have to finance their deficits on the open market at risk premia that reflect the market's assessment of the difficulty that the country would experience in servicing its debt.

If exchange rates were fixed in Europe then borrowing and lending in Europe would not entail the exchange risk that would come with external financing such as borrowing from Japan or lending to the USA. It seems likely that intra-European financing of current account imbalances could be more efficient, with relatively small flows outside the area to finance net external imbalances.

2.2. The Expected Effect of Exchange Rate Stability on Direct Foreign Investments in Turkey

At the beginning of last decade, the government of Turkey, in awareness of world trends, initiated the process of the integration of the Turkish economy to the world market system by radical economic reforms, as discussed in Chapter IV and V, including the promotion of direct foreign capital investments. Relatively, liberalising the capital controls, simplifying the bureaucratic procedures for foreign investors as well as giving equal rights for the acquisition of various incentives and tax exemptions or reductions by both national and foreign investors recently started to bear fruit. As the disutility of its strategic location between hostile blocks is reduced by the ending of the cold war, Turkey

becomes better positioned as a relatively sound base, both in the economic and political sense, at the crossroads of the world's most rapidly expanding markets.

In this context, the newly opening markets of Central and Eastern Europe, the former Soviet Union, in particular Central Asian Republics with close historic and cultural ties seems to have made Turkey more attractive for foreign investments due to its geographic proximity to the region.

The foreign capital permissions during the whole year period of 1990 totalled to 1.8 billion US. dollars, most importantly, of this figure 1.25 billion dollars investment permission ensured by the EC countries. So the EC's share in total foreign investment permissions granted by Turkey recorded a large upward trend from 46.5% in 1987 to 70% in 1990. With the future integration to the EC single market this upward shift is expected to grow faster.

Of the total foreign capital permissions issued since 1980, 61% was in manufacturing sector within which automative and components industry ranked first followed by chemical products, and food-beverages and tobacco; 36% in the service sector - banking, financial intermediaries and insurance followed by tourism; 3% in agriculture and mining (Turkish Review, 1991).

However if the Turkish currency becomes pegged to the Euro-currency in the EMS grid, it is likely that the relatively small amount of foreign direct investments can benefit considerably from

the political and economic credibility to be acquired by the strong commitment to the exchange rate stability.

Consequently with the reduction of inflation and interest rates within Turkey during the fixed exchange rate regime domestic costs of production should be reduced as the risk premia fall due to improved certainty on the exchange rate of Turkish lira, together with the opportunity of financing of 'firms' deficits from within the EC integrated market.

The prospect of exchange rate stability would further strengthen the already advantageous position of the Turkish market for foreign investors. The four main attractions to such potential investments are:

- its large domestic market which will approach 60 million people by the second half of the 1990s;
- qualified, although the number of which need to be increased, manual and technical labour forces with low labour costs and high productivity;

- improved public utility and transportation facilities along with a geographic and economic location to nearby major markets offering new enhanced opportunities for Turkish exports.

- more importantly, Turkey is a country which has been scoring the highest economic growth in the OECD area since the second half of 1970s and is likely to continue on the same path for

some years ahead possibly until the growth rate of its population can be reduced to a level closer to the EC average.

The total number of foreign firms operating in Turkey were 2000 and of foreign banks were 33 at the end of 1990. The share of foreign investment in industrial investments is almost 15%.

It is relatively clear cut to presume that with the exchange rate stability added to those highly favourable factors for attracting foreign capital, the current rate of increase in foreign direct investments in Turkey could not only accelerate but might also be dispersed to less favourable sectors, such as agriculture and also mining.

There might not occur an instant investment boom to the extent experienced in Spain, for example, but in the absence of capital controls, which have been already freed to a large extent since 1986, and of less worry that depreciation will undermine investments, foreign capital inflows could well increase significantly.

2.3. The Impact on Tourism Earnings

The initial impact of appreciation of the Turkish lira could be to lower the attractiveness of the country as being a relatively cheap holiday resort for tourists considering spending their holiday there. The price elasticity of demand for tourism in Turkey is considered to be high, as it is revealed from various surveys. Most of the tourists going to the country mention their first reason for

choosing Turkey as being cheap country with good food and drink, followed by its natural and historic assets.

When the Turkish currency stops its varying degree of devaluation, sometimes by more than the real rate of increase in domestic price levels, i.e the exchange rate misalignments, then the price of domestic currency in relation to the ECU, and others, would become more expensive through the appreciation effect of fixing the currency. Thus the country might start to loose its price competitiveness, and tourists might substitute other destinations.

On the other hand, if Turkey achieves improved infrastructure and high quality services with enhanced capacity in the tourism sector then it can appeal to high income group of tourists, so-called the up-market tourists, in the longer run, who would leave more income in the country than the average of down-market tourists do. In addition, because the present level of uncertainty on the exchange rate between Turkish lira and Eurocurrencies would be lowered by the pegging of the currency, tourists from Europe, in particular could become more inclined towards the idea of spending their holiday in Turkey. They would feel safer for the value of Turkish money they would have in exchange for their domestic currency.

During the period prior to pegging the Turkish lira to the ECU, Turkey can still attract potential tourists who previously went to Spain and the other candidates for accession to the ERM, as it would be in a more advantageous position whereas in those countries the price of touristic facilities and services have been increasing.

However after pegging the currency Turkey should be attracting more up-market tourists by exploring the high income elasticity of demand through improving the quality of services and promotion, by spending more attention to environmentally friendly construction as well as developing cultural and rural tourism within the country.

By doing so, Turkey can offset the possible loss in its price competitiveness by attracting more high income group of tourists and even increase the revenues from tourism in the country. In this context more foreign direct investments in the sector can play an important role. Provided that Turkey achieves that, then the impact of pegging the currency might not leave a drastic negative effect on the tourism revenues in the country.

2.4. The Impact on Workers Remittances

The workers remittances from abroad have been a considerable source of foreign exchange in Turkey since the early 1980s. As a response to the policy of continuous devaluation of the Turkish lira, workers' remittances were held in hard currency accounts in Turkey, so called the Dresdner Bank accounts, mainly in DMs. Apart from the effect of this policy, the amount of such remittances have been quite volatile especially in relation to the political stability of the country.

Thus the appreciating effect of the increasing exchange rate credibility, both economic and political sense, could lead to a

shift in the demand of Turkish workers abroad to hold their savings in Turkish lira deposits rather than keeping them in DMs or any other hard currency. However if those remittances switched to liras, that would put further pressure on the value of the domestic currency and exacerbate the over-valuation. But it would also increase the supply of savings to finance investments.

As those upward pressures on the currency are likely to deteriorate further the current account deficits to be caused by the capital inflows into the currency following the pegging of the lira to the ECU , government authorities would feel obliged to intervene to prevent the lire from further appreciating. In the absence of capital controls they would attempt to lower the interest rate differential between Turkey and the EC. Even so the lower interest rates, domestically, is expected to continue encouraging the domestic investments even possibly, in the excess of domestic savings.

So the initial expansion of the economy and hence, its reflection as upward pressure on inflation seems to be inescapable in the short run in Turkey, similarly to what actually happened in Spain following the entry to the ERM on June 1989.

2.5. Turkey's Economic Structure in relation to the Optimum Currency Area Argument

An optimum currency area is sometimes defined in economic literature as an area of regions within which there is factor mobility but bewteen which there is factor immobility. The argument

is developed by the inclusion of other matters, such as the influence of the openness of the economy, i.e the size of tradeables sector to non-tradeables sector and the facilitating of inter-industry production shifts (McKinnon, 1963; Mundell, 1959).

Importantly, the theory is based on the assumption of the absence of chronic differential rates of inflation among regions.

The inflation rate in Turkey has ranged between 30 and 100 per cent since 1980 whereas the unemployment rate has been ranging between 12 and 10 percent (9.8% in 1988). That is quite different from the original Phillips Curve argument and poses mixed policy implications.

The absence of a trade off between inflation and unemployment figures in Turkey over the past decade might partially reflect the existence of supply-side constraints, such as the insufficient number of skilled labour and of training programmes and also other rigidities towards the mobility of labour from the less favoured sectors to the more expanding sectors of the economy.

There are also rigidities on the dispersion of capital across the country as private agents do not usually wish to invest in the less developed parts of Turkey, namely the East and the Southeast Anatolia.

In this case, a policy which aims at reducing the inflation rapidly, say, from 60 to 10 per cent in a few years time would imply a large contraction on fiscal policy. That could lead to a rapid

fall in public sector expenditures, about 4 to 5 percentage points of GDP, as in the share of public sector borrowing requirement (the public sector borrowing requirements was 9.7 per cent of GDP in 1990).

Due to existing imperfect factor mobility and the relatively small size of the country's tradeable sector, those large fiscal cuts would mean that unemployed labour, especially in the large non-tradeable public sector services, will not be shifted easily towards the more expanding sectors of the economy.

In this context, the level of foreign direct investments coming to the country and more importantly the dispersion of new investments to the sectors which would meet the production shifts following the inter-industry and also intra-industry trade creation effects of trade liberalisation with the EC, would play a crucial role in lowering the unemployment costs of price stability efforts in Turkey. Increasing foreign direct investments in more competitive sectors of Turkish economy as well as in the large agriculture and dairy products area can create essential job opportunities for the rapidly growing Turkish labour force (about 2 per cent per annum from 1980). The fall in inflation, which is a precondition for the Turkish lira tracking the ECU, would be expected to be accompanied by a rise in unemployment in line with the Philips-type prediction of the effects of a demand squeeze while expectations change.

It is equally essential that Turkey achieves the reform of its public sector and a successful privatisation programme, the

fostering of its weak capital markets and also increasing the efficiency of tax collection thereby the share of tax revenues in the government budget. It is particularly important that Turkey achieves the fulfilment of the provision of free labour mobility between itself and the EC before undertaking any exchange rate commitment via the Community.

The cost of fiscal tightening will depend on the level of macroeconomic convergence achieved by Turkey relative to EC standards, as discussed in Chapters IV and V, as well as the inflation rate with which it is about to peg the currency to the ECU or the DM.

Thus it has to proceed with gradual reduction of inflation, starting by shadowing the ECU or the DM together with maintaining a stable path of economic growth so as to complete the basic infrastructural investments underway. The largest is the GAP Project consisting of 21 dams - according to the latest report the revised number is 21 - and hydro-electric power stations with giant irrigation tunnels along the east and southeast Anatolian territory due for completion in late 1990s. On the other hand it has to do everything possible to minimize tax evasion so as to increase the tax revenues and to lessen the reliance of the public sector on domestic borrowing including the Central Bank's resources.

A rapid lowering of inflation would not be an appropriate step in Turkey if it is achieved at the cost of a sharp decline in output in a country where the rate of population growth is high and

unemployment is a major social issue. Thus, a prudent demand management has to be accompanied by supply and productivity rises.

However unless the inflation is reduced, and stabilised at a level close to the EC average and the country is guaranted a fair allocation of the Community's various funds as well as by the genuine labour mobility within the EC market, pegging the Turkish lira to the ECU does not seem to be feasible for Turkey, at least in the short to the medium term.

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