Introduction

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After 50 years of inward-oriented development strategies, Turkey switched to outward-oriented policies in 1980. A new policy of opening up the economy has been pursued with the aim of integrating Turkey into the European Union (EU). At the Association Council Meeting in Brussels on 6 March 1995, Turkey and the EU agreed to form a customs union starting on 1 January 1996. Turkey's recognition as a candidate country for EU membership at the Helsinki European Council in December 1999 ushered in a new era in the relations between Turkey and the EU. After the approval of the Accession Partnership by the Council and the adoption of the Framework Regulation on 26 February 2001, the Turkish Government announced its own National Programme for the adoption of the *Acquis Communautaire* on 19 March 2001. In late 2004, another milestone was reached with the European Commission's recommendation that the European Council endorse the opening of formal accession negotiations and establish a timetable. The Copenhagen European Council, in December 2002, concluded that 'if the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decides that Turkey fulfils the Copenhagen political criteria, the European Union will open accession negotiations with Turkey without delay'. The December 2004 Council decided to start membership talks with Turkey on 3 October 2005.

Although the process has been launched, significant uncertainties continue to prevail as to whether Turkey will be able to achieve its goal of accession to the EU. The ultimate outcome will only be revealed in the long term. What matters in the short to medium term is the impact that continued progress towards meeting the conditions for membership will have on Turkey. The EU is the focal point for reforms in a large number of policy areas, and the pre-accession process, which has been ongoing for several years, is a unique experiment in using international harmonization as a tool for implementing a comprehensive reform strategy.

The purpose of this volume is to highlight the macroeconomic aspects and challenges of EU accession for the Turkish economy. After being hit

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by the most severe crisis of its recent history in 2000–01, Turkey has shown a remarkable recovery. Inflation fell from 68.5 per cent in 2001 to 9.3 per cent in 2004, thanks to the maintenance of fiscal and monetary discipline. The fiscal deficit decreased from 20.9 per cent in 2001 to 6.2 per cent in 2004. After contracting by 9.5 per cent in 2001, real GNP expanded by 7.9 per cent in 2002, 5.9 per cent in 2003 and 9.9 per cent in 2004. The unemployment rate, after reaching 12.3 per cent in the first quarter of 2002, fell to 10.3 per cent in 2004 and the average interest rate on government debt declined from 96.2 per cent in 2001 to 25.7 per cent in 2004. The ratio of gross public debt to GDP is still high, but it fell from 102.6 per cent of GDP in 2001 to 80.2 per cent in 2003, and further to 78.4 per cent in 2004 as a result of significant income growth, the attainment of sizeable primary surpluses over the last three years, and an appreciation of the real exchange rate. At the same time, the net public debt to GNP ratio decreased from 90.5 per cent in 2001 to 63.5 per cent in 2004.

Turkey realizes that, in the long run, price stability and fiscal discipline create the best conditions for sustained and robust economic growth. As of 2005, the challenge Turkey faces is how to move from the current state of affairs to the one in which the Maastricht criteria are satisfied. The main issues are reducing the inflation rate to about 3 per cent, the public debt to GDP ratio to below 60 per cent and decreasing the unemployment rate while preserving the sustainability of public finances as well as the external account.

The chapters constituting this volume were presented at a conference on Macroeconomic Policies for EU Accession held in Ankara, Turkey, on 6–7 May 2005. The conference focused on four main issues: fiscal policy, monetary policy, euro adoption and the management of capital inflows. Below, we give a brief summary of the chapters which are grouped under the same headings.

In Chapter 2, Jürgen von Hagen analyses fiscal policies and the sustainability of public finances in the EU. The author first evaluates the strength and weaknesses of the fiscal institutions of the EU. These institutions, though not perfect, were put in place as essential supporting elements of the European Monetary Union. He then criticizes the recent modifications to the Excessive Deficit Procedure, which has been put in place as a mechanism to enforce the Stability and Growth Pact.

EU countries experienced strong fiscal consolidations between 1998 and 2003. This has widely been attributed to the Stability and Growth Pact. Von Hagen, however, argues that a significant part of the improvements observed in the primary surplus ratios is a result of strong output growth experienced during this period. After filtering out the growth effects, the consolidation efforts are not all that impressive.

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Furthermore, von Hagen studies the 'quality' of fiscal adjustments in the EU countries, that is, their contribution to medium-term growth. He argues that, on the revenue side, direct taxes hurt output growth more than indirect taxes do. Likewise, on the expenditure side, higher investment spending and lower amounts of current expenditures and transfers would be better for growth. Empirical data from the past 10 years support this argument. Von Hagen concludes that maintaining a 'high quality' of fiscal policies is an essential precondition for the sustainability of public finances in the European Monetary Union, but one that has been neglected in the policy debate so far.

In Chapter 3, Graham C. Scott considers fiscal policy challenges and the sustainability of public finances in Turkey. He emphasizes that Turkey's fiscal policy rapidly went into crisis in 2000–01 due mainly to real interest rates rising to levels well in excess of the rate of economic growth and because government policies and weak fiscal institutions had rendered the government's financial position very vulnerable to disturbances in the economy and financial markets. In subsequent years, there have been remarkable improvements in this situation. The recovery was based on vigorous fiscal corrections leading to large primary surpluses. The author stresses that sustaining a fiscal framework that promotes growth, stability and social and political cohesion will require the design and implementation of an agenda of change in key fiscal institutions over the medium term, aimed at bringing these up to international standards of performance in supporting strategy, policy, greater efficiency and effectiveness in service provision and greater democratic accountability.

Turkey's past experiences show how difficult it can be to sustain a comprehensive, acceptable and determined initiative to reform fiscal institutions. The prospect of admission to the EU will, in the long term, have a significant influence on Turkey's fiscal policy, but it will not be decisive over the time period in which the authorities' endeavours will be tested with regard to the implementation of the new laws and other initiatives that are under way. Revenue policies, budget institutions, external surveillance, agricultural and regional policies will be influential, although the major influence will be through the growth-enhancing prospects of EU membership. Prosperity within the EU will be best assured by adopting fiscal policies and modern fiscal institutions that match the best anywhere and are better than those found in some EU economies, including some of the developed ones. Turkey should learn lessons from other EU accession countries in order to develop its fiscal policies in ways that ensure the greatest benefits to its prosperity in the transition years ahead.

In Chapter 4, Fabio Canova and Carlo Favero examine monetary policy in the euro area from both theoretical and empirical perspectives. They

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discuss what theory says about the strategy that central banks should follow and contrast it with the one employed by the European Central Bank. They review the accomplishments (and failures) of monetary policy in the euro area during the first five years and suggest changes that would increase the correlation between words and actions, streamline the understanding that markets have of the policy process, and anchor expectation formation more strongly. They examine the transmission of monetary policy shocks in the euro area and in some potential member countries and try to infer the effects likely to occur when Turkey joins the EU and, later, the euro area. Much of the analysis here warns against having too high expectations of economic gains that membership in the EU and the euro club will produce.

In Chapter 5, Fatih Özatay analyses Turkey's EU accession process from the perspective of monetary policy. He stresses that, while sound macroeconomic policies and structural reforms, such as those Turkey has been implementing since May 2001, are necessary for improving economic fundamentals and creating a positive trend in macroeconomic variables, a considerable amount of time is needed to reduce the vulnerability of an economy that has accumulated problems related to changes in international and domestic risk factors over the years. This points to the fact that challenges to monetary policy over the medium term will not only arise from the EU accession process, but that fiscal dominance and the transition to monetary dominance will also create problems.

Özatay highlights the difficulties inherited from the period of fiscal dominance as the first challenge to the monetary policy authorities. Given that the policy implemented since May 2001 has been successful, this problem will lose importance in the initial phase of the EU accession process. The main challenge to monetary policy will stem from a surge in capital inflows and a reverse dollarization process. Özatay envisages a monetary policy response based on two pillars: a non-aggressive market-friendly reserve accumulation strategy and policy rate cuts, provided that the inflation outlook looks promising. He argues that the third challenge is the need for a radical change in the balance sheet structure of the Central Bank of the Republic of Turkey (CBRT), which is a mirror image of the past macroeconomic imbalances. Finally, the CBRT Law should be amended to comply with the European Treaty.

Lucjan T. Orlowski's study in Chapter 6 revisits the process of macroeconomic stabilization policy in Poland in the course of the preparations for EU accession. It reviews the changes in fiscal policy that brought about compliance with the EU budgetary procedures and evaluates the Polish Government's fiscal consolidation efforts. It further addresses systemic changes in the monetary policy framework, mainly the implementation of a direct inflation targeting strategy, which helped establish a satisfactory

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degree of financial stability. Suggestions for modification of the current monetary policy framework for the final passage towards the euro adoption are also discussed. A policy framework based on relative inflation forecast targeting is advocated for effective monetary convergence to the euro.

In Chapter 7, Paul De Grauwe discusses the short and long-run conditions that countries must meet to join the European Monetary Union. The long-run conditions are those postulated by the traditional theory of Optimum Currency Areas, that is, the symmetry of the shocks hitting the candidate countries and the incumbent members of the EMU, a high degree of economic integration between them, and a high degree of market flexibility. The short-run conditions are set by the Maastricht Treaty.

De Grauwe reminds the reader that the incumbent members of the EMU are unlikely to represent an optimal currency area today, as numerous empirical studies have pointed out. To be sustainable in the long run, the EMU needs a sufficiently large degree of political integration. De Grauwe defines political integration in two aspects, the possibility of creating a system of taxes and transfers responding to asymmetric shocks across member countries and the absence of possibilities for creating asymmetric shocks by means of national economic policies such as tax or government spending shocks. In both aspects, the current EMU has a low degree of political integration today. De Grauwe argues that the willingness to increase political integration is likely to be even lower in an enlarged monetary union including the new member states of the EU. Furthermore, the enlargement will also aggravate the problem of asymmetric shocks in the EMU, which has already been larger than expected in the incumbent EMU. As a result, enlargement could threaten the sustainability of the EMU.

Turning to the short-run conditions for the adoption of the euro, De Grauwe points out that these are quite arbitrary. Whether or not future candidates for EMU membership meet the short-run conditions successfully has no implications for the sustainability of the monetary union in the long run, as the former concerns successful macroeconomic management in the period before entering the EMU and the latter concerns successful structural reforms. The most important requirement for meeting the short-run conditions is a credible political commitment to joining the EMU. Given that such a commitment exists, the short-run conditions become largely self-fulfilling, as financial market expectations will drive interest rates and exchange rates to their required terminal conditions. The only serious obstacle, which could result from the requirement of a two-year participation in the Exchange Rate Mechanism and a low rate of inflation, could be overcome by granting the candidate countries an exchange rate band of 30 per cent, which would make the exchange rate constraint largely irrelevant.

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Barry Eichengreen and Omar Choudhry in Chapter 8 discuss the problems of managing capital inflows in the accession economies of Eastern Europe and the rapidly industrializing economies of East Asia. The authors note that in Emerging Europe, savings are insufficient to finance domestic investments, whereas savings in Emerging Asia are larger than the amount needed for financing the region's investment. The result is, in most years, a current account deficit in Emerging Europe financed by capital inflows and a current account surplus in Emerging Asia requiring private capital inflows to be more than the levels absorbed into foreign reserves if they are not to produce unacceptable inflationary pressure. Hence, discussions in Eastern Europe have centred on the question of whether real exchange rates are overvalued and current account deficits at current levels can be sustained, whereas in Emerging Asia the focus has been on whether real exchange rates are undervalued and there are limits to reserve accumulation.

Analysing the determinants of real exchange rates reveals that real exchange rates are overvalued in the Czech Republic, Hungary, Slovakia, Slovenia and Turkey, and that they are modestly undervalued in most of the East Asian countries. Considering the risks associated with large capital inflows and appreciating real exchange rates, the risks are immediate for the economies of Emerging Europe but less immediate for the economies of Emerging Asia. Turning to the question of what governments and central banks should do when faced with a surge of capital inflows, the authors note that countries can respond by increasing exchange rate flexibility, maintaining capital account restrictions, strengthening prudential supervision, sterilizing inflows, loosening monetary policy, tightening fiscal policy, and negotiating a programme with the IMF. They emphasize that the economies of Emerging Europe have experimented with most of these strategies. However, most of the burden falls on tightening fiscal policy. Since this is problematic as there are political constraints on fiscal adjustment, the authors suggest that the authorities might impose holding-period taxes and/or deposit requirements on portfolio capital inflows in an effort to bias the latter towards longer maturities, like the taxes and deposit requirements used for a time by Chile.

In Chapter 9, Sübidey Togan and Hasan Ersel consider the problems related to current account sustainability in Turkey. The authors start from the notion that under current account sustainability, a country must satisfy its intertemporal budget constraint. The current stance of policies in Turkey can be sustained as long as neither these policies nor private sector behaviour lead to a drastic policy shift or a currency or balance of payments crisis. They clarify this concept by making use of the balance of payments relation. They show that the current account is not sustainable if the

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discounted value of the debt to GDP ratio at the end of a finite number of years exceeds the debt to GDP ratio at the beginning of the period. Calculations for 2004 reveal that the current account is not sustainable. The sustainability of the current account requires that the sum of non-interest current account to GDP ratio and foreign direct investment to GDP ratio be increased at each period under consideration. Turning to the question of how to increase these ratios, the authors note that the non-interest current account to GDP ratio depends largely on the real exchange rate and on aggregate demand for goods and services in the home country as well as the rest of the world. Since Turkey is following, and has to follow, a tight fiscal policy over the next few years, an alternative solution is to depreciate the real exchange rate. In addition, the authors show that the required rate of depreciation of the real exchange rate in order to attain sustainability in the current account decreases with increases in foreign direct investment to GDP ratio. Finally, they note that the appreciation of the real exchange rate and attainment of sustainability in the current account can be achieved in the case of Turkey by (i) taking measures to increase FDI inflow into Turkey, (ii) changing the exchange rate regime from independent float to crawling bands or managed float and/or by (iii) imposing restrictions on capital account transactions.

The conference on Macroeconomic Policies for EU Accession was organized jointly by Bilkent University, Ankara, the Central Bank of the Republic of Turkey and the Centre for European Integration Studies at the University of Bonn, with participants from Turkey, several EU member states, the European Commission, the European Central Bank, and the International Monetary Fund. We are grateful to the host institutions for their support.

The eight papers collected in this volume cover key policy issues related to fiscal policy, monetary policy, euro adoption and the management of capital inflows. The contributions of the discussants give the reader a glimpse of the lively debates held at the conference. We hope that this volume will provide a basis for and shape the debates about the challenges and exigencies of EU accession among policymakers and academics in Turkey as well as in other candidate and prospective candidate countries for EU membership.

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