Central Bank of the Republic Of Turkey

Global and Regional Outlook and the Effects of the Global Financial Crisis

(Closing Remarks)

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Dear Governors, Participants, and Guests

I would like to extend my sincere thanks to our keynote speaker, Mark Allen and esteemed Governors for their informative presentations and valuable discussions. This conference contributed significantly to our understanding of the effects of global crisis on our region.

As Mark Allen explained quite clearly yesterday, systemic risks to global financial markets have eased substantially since the first quarter of 2009 and global economy has been recovering from the recession steadily, albeit very slowly and gradually. It appears that Europe, especially Western Europe is lagging behind the US and Japan. This is of course bad news for its trade partners. The major trade destination of many countries in our region is Western Europe. You may all remember the famous saying: "***If the US sneezes the world catches cold***". In our case it is the prospects of the core Europe that matter. According to consensus forecasts, the US economy will return to pre-crisis level by the end of this year. For the Euro zone, a similar recovery is expected to take a longer time, prolonged well into the next year.

My colleagues also made a very important observation on regarding the fragility of the recovery. Threats to financial systems have not completely disappeared. Significant rise in sovereign debt and heightening risk perceptions due to doubts on the sustainability of budget deficits are of major concerns. The crisis has caused a massive damage in public budgets. Due to large government interventions, both to restore confidence in the financial system and to contain the fallout of the crisis on the real economy, budget deficits have reached levels not seen since the World War II. The ratio of public debt to GDP is likely to reach triple digits in the US, as well as in several major economies in the Euro zone.

It is quite understandable from a Keynesian point of view to compensate the severe contraction in private demand through higher government investment and consumption. However, we should be mindful of the fact the capacity of developing countries is rather limited in pursuing expansionary fiscal policies. Developed countries should also be very cautious. Following a countercyclical fiscal stance and accommodative monetary policies for too long prolongs the desired correction in global imbalances.

Listening to the presentations of governors, it is quite clear that during the last decade, South Eastern European economies had benefited considerably from the era of abundant liquidity and the Great Moderation. Many countries in the region achieved high economic growth driven by booming domestic demand, foreign capital flows in ample quantity and rapid credit expansion. But, that was not the whole story. The financial crisis has also revealed that most emerging economies, which were previously seen as a danger zone, were not as risky as once believed. I attribute this resilience to long-lasting memories of the developing world on past crisis.

Let me quote a short passage from *Animal Spirits*, the recent book of Akerloff and Schiller:

"***People's memories of essential facts are indexed in the brain around stories. Facts that are remembered are attached to stories. Other facts may enter short-term memory. But such memories tend not to be influential, and they are eventually erased***."

Unlike mature economies, authorities in developing countries accustomed to have frequent crisis and consequently, bad memories of previous crises were fresh in their minds. Thus, during the pre-crisis period, many developing countries strengthened their fiscal positions, reduced public debt, accumulated FX reserves and kept a close eye on financial systems.

Mr. Radovan Jelasic, the Governor of National Bank of Serbia made a very good point, when he said "***Counter-cyclicality is highly praised today although it was heavily criticized during the boom years***." As I was listening to the Governor, I recalled William Martin, America's longest-serving central banker, who defined the job of a central bank as "***taking away the punch bowl just as the party gets going***."

Central bank governors are not supposed to be popular and praised by the market. Nobel award winner Paul Krugman once said "***During the last decade some people***

thought central bank governors should do nothing as the party got crazy, and be ready to be the designated driver afterwards to take the market home safely." This crisis has demonstrated that this was the wrong approach. Sometimes the aftermath of boom years may leave such a legacy that, to clean up the subsequent mess you may need unprecedented scale of public money and social sacrifice.

All in all, this crisis has proved that policy makers in general, policy makers of developing countries in particular should always consider leaning against the wind, rather than surfing on the waves of investors' risk appetite. During expansionary phase of the cycle, central banks should reign on excessive credit growth and formation of bubbles in asset prices. Fiscal authorities should reduce public debt to accumulate enough fiscal space for the lean years.

This is particularly true for developing countries. Unlike major economies, we are quite sensitive to capital flows. Dependence on external savings makes our region extremely vulnerable to shifts in risk perceptions and fluctuations in global capital flow. Developing countries also suffer from the so-called original sin. In times of crisis they are more likely to face difficulty in borrowing in their local currency. Therefore, like prudent farmers, we should store away extra grains in times of prosperity to mitigate the suffering in hard times.

Dear Participants,

This program, which takes place at a time of an unprecedented global financial crisis has provided us with an opportunity to reflect on the challenges confronting us and to consider the issues emerged in the context of the global financial crisis. I hope you have benefitted from our discussion as much as I do.

Thank you for your participation.