Central Bank of the Republic Of Turkey

PANEL ONE

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

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Dear Governors, Distinguished Participants,

In my introductory remarks, I would like to first discuss the performance of the Turkish economy during the recent global financial crisis. Then I will share my views on potential decoupling of countries in the post-crisis period and discuss its determinants.

The global turmoil, which emerged in the second half of 2007, adversely affected economic activity around the world; and Turkey was no exception. Our economy, which grew for 27 quarters in a row, fell into recession in 2009. The higher share of investment goods and durables in our exports, firms' dependence on external financing, and elevated level of production capacity were the factors that exacerbated the severity of the contraction. The growth rate dropped sharply, from its average of 6.8 percent between 2002 and 2007 to minus 4.7 percent last year. Unemployment rate increased by almost 4 percentage points. Exports declined by 23 percent.

However, I should emphasize that neither price nor financial stability has been seriously jeopardized during this period. Turkish economy has rebounded sharply from the recession in the second half of 2009 and it is likely to return its pre-crisis level some time this year.

This was a significant achievement in itself, because Turkey used to be one of the emerging economies with historically high volatility and particular sensitivity to global risk perceptions. However, this time the impact of the crisis has remained relatively subdued. A sound financial system, strong macro fundamentals and assertive monetary and fiscal policy stance were the main factors that prevented a prolonged recession and a financial turmoil in Turkey. Neither serious liquidity problems of global scale nor the bankruptcy of international financial institutions was enough to trigger a meltdown in our financial system. Unlike most of its peers, Turkish banking system has not required any rescue packages or other forms of government support. In fact, Turkey was one of the few emerging market economies that ended up with higher credit rating than its pre-crisis level.

How did the Turkish economy withstand the devastating impact of this global crisis?

I believe it is fair to say that we had already gone through in 2001, what the world has been experiencing today. Some of you may remember we had a very severe crisis in February 2001. Overnight interest rate climbed to 6,200 percent, the local currency lost almost half of its value within two days, the economy contracted sharply, as much as 6 percent, many banks collapsed and a huge IMF rescue package was needed to rescue the economy and even a larger bail-out package was put into action by the government to clean up the financial system.

After the 2001 crisis, we have implemented a very comprehensive reform agenda. Three main pillars of the reform program were fiscal consolidation, central bank independence and rapid structural reforms, especially in the financial sector, which were implemented without any compromise, excuses or delays.

Fiscal discipline was the cornerstone of the program, allowing rapid decline in debt ratios, facilitating a swift disinflation period and a permanent drop in interest rates. Ambitious fiscal targets were set for primary surplus, as high as 5 percent of GDP. These ambitious targets have been achieved almost to the point year after year. Between 2003 and 2007, the realization of primary surplus was as high as 4.8 percent of GDP.

Secondly, the monetary policy framework was changed quite radically. The Central Bank of Turkey started implementing inflation targeting and it was granted independence with the official mandate of price stability. The monetization of budget deficits through short-term advances from the Central Bank to the Treasury was abolished. These developments, coupled with a successful floatation of the national currency, internalized the risks to markets, reducing moral hazard problem in the private sector.

The Turkish banking system was overhauled and restructured almost completely, from top to bottom. Regulations on financial system put Turkish banks under strict discipline in terms of capital adequacy, liquidity, FX position and leverage ratios. The government injected fresh capital into the banking system, equivalent to one third of our GDP, to rehabilitate several private banks and to clean up the balance sheets of public banks. Without any doubt, using public funds of this magnitude was an enormous sacrifice for the society. Therefore, once the banking system was cleaned, the Banking Regulation and Supervision Agency has kept a close eye on the banking system to make sure that "***Never again, the taxpayer has to pay the price of reckless, irresponsible and sometimes outright fraudulent practices of the banking sector***".

Strict limits on FX-denominated consumer loans eliminated the vulnerability of households to exchange rate shocks. As you all know, the currency mismatch was particularly problematic for many Eastern European countries preventing the scope for accommodative monetary for many emerging market economies.

The Central Bank of Turkey followed a prudent monetary policy during the pre-crisis period, limiting a rapid expansion in bank credits and excessive rise in households indebtedness. Hence, when the global crisis started in mid-2007, Turkey had already accumulated modest, but vital capacity to put into action counter-cyclical monetary policies and fiscal stimulus.

Distinguished Guests,

Having discussed our experiences during the global turmoil, now let me turn to the present and share with you my views on economic outlook.

As you may all agree, we are witnessing green shoots around the globe, led by emerging market economies. The question is "What will be the speed of the recovery and how the performance of economies will differ in the aftermath of the crisis?"

I believe there are at least three factors that will lead to the decoupling of countries during the post-crisis period.

First and foremost, there is fiscal sustainability. The crisis has prompted large government interventions, both to restore confidence in the financial system and to contain the fallout of the crisis on economic activity. A looming danger threatening the future of global economy is a sudden deterioration of investor confidence over fiscal sustainability and a sharp rise in long term interest rates. Therefore, it is imperative to put forward a credible medium term framework to stabilize risk perceptions and to reinforce the confidence on fiscal policies.

To that end, the Turkish government announced a Medium Term Program (MTP) in September 2009. The Medium Term Program presents a comprehensive framework of policy actions to halt the rise in public debt ratio in 2010 and reduce it gradually in subsequent years.

In addition, the government is also planning to introduce a fiscal rule to ensure fiscal discipline during economic booms, facilitate countercyclical policies during economic slowdowns, and strengthen overall public governance in policy making. The legal structure of the fiscal rule would be completed in mid-2010. Both the Medium Term Program and the fiscal rule would contribute to better management of expectations by enhancing the institutional framework of fiscal policy and its long term predictability.

Having a healthy banking sector would be the second important factor that will lead to decoupling of economies. Looking at developed countries, we see no signs of meaningful acceleration in bank credits. Toxic assets in balance sheets have not cleaned up and underwritten yet, and many banks are likely to need new capital injections. Restoring the effectiveness of the credit mechanism is crucial in supporting the aggregate demand. As far as the banking system in Turkey is concerned, we are pleased to observe that it is regarded as one of the healthiest, robust, and profitable banking system among the emerging market economies. Therefore, our banking system is well positioned to support private sector for a sustainable economic growth in the foreseeable future.

The last critical ingredient of a rapid recovery in economic activity is a strong and sustainable rise in private demand. This requires a meaningful improvement in employment prospects and low indebtedness of households. In comparison to typical business cycles, employment has been extraordinarily slow to recover. Continuing high unemployment rates due to rigidity in labor markets has the potential to depress private demand. Unfortunately, Turkey is at the top of OECD countries in red tape and strictness of employment protection. Labor market reforms should clearly be at the top of our priority list to raise our potential growth rate.

Households' debt level is the second crucial determinant of private demand. Households in many countries accumulated significant amount of debt during pre-crisis period, which is beyond their ability to repay out of current income. For a meaningful correction in economic imbalances, savings rate has to stay elevated for many countries for years to come. In comparison, household indebtedness is quite low in Turkey. Therefore, a strong recovery in private consumption is not only probable but also sustainable in our economy.

Let me conclude my remarks by a quote that caught my eye recently:

"**Nobody can go back and start a new beginning, but anyone can start today and make a new ending.**"

It is the responsibility of policy makers to ensure that regardless of our starting point, we reach a better equilibrium. The key determinants of a better equilibrium are fiscal sustainability, a healthy banking system, a productive labor market and low household indebtedness.

Now, I would like to give the floor to Mr. Mark Allen.

Thank you.