Central Bank of the Republic Of Turkey

IE Business School Speech

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Distinguished Guests,

First of all, let me express my pleasure to be here today to address such a distinguished audience in this prestigious school. I have prepared a short speech for this occasion, which will last about 20 minutes. Then, I will be happy to answer your questions.

The main focus of my remarks covers the recent recovery in global economic activity and the main risks in this process. I will pay a special attention to fiscal policies and sustainability of fiscal measures. As a part of my speech, I also plan to discuss the recent noteworthy experience of the Turkish economy, a period when fiscal discipline generated expansionary impact on economic activity.

Dear Guests,

As you may all agree, we are witnessing green shoots around the globe, led by emerging market economies. The recovery process is supported by monetary and fiscal measures of unprecedented scale in advanced economies, as well as positive contribution from inventory adjustments and strong pick-up in demand in developing countries, especially in Asia.

However, even though the recovery is under way, financial crisis has casted a long shadow on global economy.

Where do the main risks lie?

1. First, households accumulated significant amount of debt during pre-crisis period, beyond their ability to repay out of current income. The ongoing uncertainty and lack of risk appetite may induce households to further reduce their debt through increased

precautionary savings, causing a substantial and prolonged slowdown in consumer spending.

2. Second, in comparison to typical business cycles, the pace of recovery in employment has been extraordinarily slow, which raises the question of whether the output and employment relationship has shifted. Indeed, unemployment rate have reacted much stronger to change in output during this crisis. Unemployment rates may stay elevated for a long time and turn out to be structural. This may hinder a strong rebound in private consumption.

3. Third, there has been no meaningful acceleration in bank credits. Given the dismal outlook for demand and unemployment, credit losses still pose a significant threat due to poor loan quality. Also, toxic assets in balance sheets have not cleaned up and underwritten yet, leaving many banks in need of new capital injections.

4. Last but not least, there comes the question of 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 the real economy. A sharp deterioration of investor confidence over fiscal sustainability is a looming danger threatening the future of global economy.

Ladies and Gentlemen,

Let me further elaborate on my last point.

During the second half of 2008, as concerns over global growth were heightening, decision makers realized that monetary policy might not be sufficient to avert a sharp contraction in output. Therefore, many countries launched fiscal stimulus packages of extraordinary magnitude.

We can put these fiscal measures in two groups.

First group of packages surfaced in the initial phase of the crisis to prevent meltdown of financial system. Hundreds of billions of US dollars were spent to support financial institutions that faced severe liquidity problems and to rescue the ones on the brink of bankruptcy. While bank recapitalization packages and government guarantees arguably prevented the collapse of the financial system, they were insufficient to lift the economic activity up in the short term.

As the global crisis spread from financial sector to real economy, second group of packages came into forefront. The main goal of these packages was to compensate the severe contraction in demand caused by dwindling investment and consumption spending of the private sector.

The amounts involved with these interventions have been extraordinarily large. As of June 2009, the ratio of fiscal packages to GDP has reached 38 percent in England, 24 percent in Japan and 13 percent in US and the Eurozone. The public guarantees extended to financial institutions and liquidity supports of Central Banks are not included in these figures.

These measures, together with contraction in economic activity raised budget deficits and public debt in both advanced and emerging economies. The economic contraction led to a reduction in tax revenues, while the decline in employment caused the payment of social security premiums to fall and unemployment benefits to rise.

In recent months, the cost of protection against sovereign default has increased noticeably in several countries, mostly in Euro area. Concerns over high level of fiscal debt have been voiced in other parts of the world as well. It is clear that huge public sector imbalances have the potential to further deteriorate and constitute a major risk to the global financial system and sustainable economic growth.

There are at least three ways in which, concerns over fiscal sustainability could thwart current and future economic growth.

1. First and foremost, in case the public deficits absorb an increasing proportion of national saving, sharp rise in long-term interest rates may lead to the crowding out of the private sector.

2. Second, financial markets may lose their faith on the sustainability of fiscal deficits and force a sudden adjustment by governments. This may lead to early exit from expansionary policies and the evaporation of public demand, which has been the engine of growth in most advanced economies.

3. Third, commercial banks could tighten lending standards if they were to suffer losses on their government bond holdings which in turn lead to a sudden, unexpected steepening of the yield curve. If market participants were to suspect about asset quality of the banks, the cost of funds would increase even without any change in other market

rates. Besides, any further deterioration of corporate and household financial balance sheets coming from collapse of economic growth prospects may also induce banks to restrict their lending.

All in all, fiscal imbalances – either through higher interest rates or through a rise in expected loan losses – could very well result in a second dip in global economic activity.

Distinguished Guests,

Having laid the groundwork for the crucial role of confidence in public finances and sustainability of fiscal policies, in the second part of my speech, I will focus on the Turkish economy and discuss our experience.

Turkey used to be one of the emerging economies with historically high volatility and particular sensitivity to global risk perceptions throughout the 90s. However, this time the impact of the crisis has remained relatively limited due to the resilience of our financial system and prudent macro policies. Of course, the growth rate has dropped sharply, but neither price nor financial stability has been seriously jeopardized during this period. In fact, Turkey was the only country among emerging market economies that end up with higher credit rating than pre-crisis level.

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

High and persistent inflation rates and towering public deficits were the main characteristics of the Turkish economy for almost 30 years until 2001. Throughout the 70s and early 80s, monetization of deficits was the primary choice of governments. In the second part of 1980s, domestic borrowings assumed the role of the favorite instrument in public finance.

Since the savings rate in Turkey was quite low, the size of financial markets was not sufficient to finance the needs of both the public and private sector. This led to very high interest rates and hindered the emergence of a typical banking system, serving the needs of households and firms.

In early 90s, with the liberalization of capital flows, local banks relied heavily on short term external funding in foreign currency and financed the public deficit through government bonds. The appetite of public sector for new funding was relentless. The interest rates hovered around 20 to 30 percent, in real terms; the financial sector became extremely sensitive to swings in risk appetite due to short term FX positions; and inflation rate hovered around 70-80 percent.

Soaring deficits and significant debt-to-GDP ratios imposed unreasonable costs on the economy. Due to fiscal dominance, the risk premium and fragility of Turkish economy happened to be a key concern, especially for the foreign investors.

It is needless to point out that the fundamentals of the Turkish economy were not sustainable. Finally, we experienced a severe crisis in 2001. Overnight interest rate climbed to 6,200 percent, the local currency depreciated against the dollar by 36 percent within two days, economic activity contracted sharply, unemployment rate soared, many banks collapsed, a huge IMF rescue package was needed to rescue the economy and even larger rescue package by the government (equivalent of one third of our GDP) was put into action to rescue the financial system.

2001 crisis was a turning point for Turkish economy. Steps were taken to restructure the dynamics of the economy based on sustainable public finance, price stability, and high growth rates led by productivity and private sector. Furthermore, persistent distortions in the economy were removed and a sound financial system was restored. Hence three main factors of success were prudent fiscal and monetary policies, rapid structural reforms implemented without compromise, excuses or delays, and a comprehensive restructuring of once corrupted, inefficient and insolvent financial sector that aims at bringing the banking practices in line with the international standards.

Disciplined fiscal policy has been the cornerstone of the program, allowing lower debt ratios, declining real interest rates and disinflation. Ambitious fiscal targets were set for primary surplus, as high as 5 percent of GDP. These targets have been almost totally achieved year after year. Between 2003 and 2007, the realization of primary surplus stood around 4.8 percent of GDP.

Public debt's positive response to sound fiscal policies was swift. Thanks to high primary surpluses, budget deficit to GDP ratio fell sharply from over 10 percent in 2002 to less than one percent in 2008. Subsequently, debt to GDP ratio dropped from 73 percent in 2002 to 39 percent in 2008. Besides; maturity, interest rate and currency composition of the debt stock also improved significantly.

It is quite clear that having primary surplus of this magnitude was an enormous sacrifice for the society, but it worked. Fiscal consolidation, high primary surplus, and reduction in interest rates have encouraged private capital formation, building the foundation for sustainable growth.

Moreover, the risk premium came down with the decline in public borrowing as well. Hence a virtuous cycle formed; primary surplus causing a decline in public borrowing requirement, which diminishes roll over ratios resulting in significantly lower interest rates that cut back public spending and hence alleviates further fiscal consolidation.

Of course there were also other pillars of the restructuring program that played a major role in normalization of the Turkish economy. Central Bank independence, implicit inflation targeting regime and floating exchange rates, more robust and comprehensive legal and institutional framework for better regulation and supervision of the financial system, restrictions on excessive risk taking by banks with the introduction of heavy personal liability of bank owners and top managers, strict limits on FX short positions and high standards for capital adequacy ratios were just a few highlights of the radical transformation that the Turkish economy has gone through since 2001.

In summary, what many countries have experienced today had already been experienced in Turkey in the aftermath of the 2001 crisis at the cost of imposing a heavy burden on the public budget.

Distinguished Guests,

Fiscal discipline in public sector and consequent reduction in public debt during the pre-crisis period in Turkey have provided some room for fiscal stimulus unlike the previous crises. Turkey was able to implement stimulus package towards the real sector by cutting taxes and increasing public expenditures. Also, the tax cuts in certain items have stimulated demand instantly and pushed GDP up in second quarter of 2009. In accordance with the global trend, Turkey's public sector budget deficit

increased in 2009, pushing the debt-to-GDP ratio 6 percentage points higher to 45 percent, still well below the Maastricht criteria.

This global crisis has proved the importance of reducing policy uncertainty and managing expectations. Announcement of credible medium term frameworks is critical in stabilizing the risk perceptions and reinforce the confidence on sustainability of fiscal policies. To that end, Turkish government announced a Medium Term Program (MTP) in September 2009. The MTP presents a comprehensive framework of policy actions to halt the rise in public debt-to-GDP ratio in 2010 and trim it down gradually in subsequent years.

In addition, the government is also planning to introduce a fiscal rule to ensure fiscal discipline, limit the public debt-to-GDP ratio over the long term and strengthen the institutional framework. The legal structure of the fiscal rule is expected to be completed in mid-2010. These legal measures are intended to ensure a better management of expectations by enhancing the institutional framework of fiscal policy and its medium to long term predictability.

Thanks to fiscal discipline and the resilience of the financial system, the Central Bank of Turkey was able to take prompt action to cut interest rates and adopted a pioneer role among emerging markets. The policy rate cuts totaling 1025 basis points have alleviated the severity of the decline in economic activity without compromising our price stability objective.

Distinguished Guests,

To conclude my remarks; I believe the main challenge for policy makers in the near future would be unwinding the massive stimuli and support mechanisms that have been introduced to "prevent another Great Depression".

The timing of the exit strategies should be evaluated thoroughly. One should always consider the risk that that, expansionary fiscal packages may undermine the sustainability of public finances going forward. Therefore, it is imperative to provide a credible medium term framework that explains how to control the sharp rise in public debt. This will help private consumption and investment recover and take over the role of fiscal stimulus. We should always keep in mind that fiscal discipline is not a goal by itself, but some sort of social contract between the people and the government to raise social welfare, ensure social harmony and build trust in government.

The Turkish experience that I shared with you today may shed some light on continuing debates about the importance of implementing fiscal discipline in a timely manner to manage expectations and risk perceptions in times of crisis.

Thank you for your attention.