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Esteemed Governors and Distinguished Guests,

At the outset, I want to express my gratitude to the Turkish Economic Association for their efforts in organizing this conference. As the Central Bank of the Republic of Turkey, we are very pleased to be a part of this prestigious event congregating such an esteemed group of participants.

In my remarks today, I will share with you my observations regarding the latest developments in the global economy, as well as the Turkish economy. Following a brief overview of the monetary policy we implemented during the crisis, I would like to touch upon our exit strategy. Then, I will conclude my speech with my views on economic outlook before giving the floor to my distinguished colleagues.

Distinguished Guests,

Three years ago, in the summer of 2007, we witnessed a short lived turmoil in financial markets, which seemed not that different from other fluctuations observed in the past. Dow Jones Index dropped by 300 points, and then recovered after a short period. Based on the standards of the Wall Street, this seemed like nothing but a typical correction. At that time almost nobody had predicted that the collapse of two hedge funds of Bear Stearns or the suspension of several investment funds by the BNP Paribas was only the tip of an iceberg that would endanger the stability of financial markets.

About one year later, in the summer of 2008, many pundits and analysts were congratulating central banks and treasuries in advanced economies for their timely measures and surgical intervention to put back the markets in a steady course. "***The Greenspan put***" had worked once again, just like it did after the 1987 stock market crash, the Gulf War, the Mexican crisis, the Asian crisis, the LTCM crisis, the burst of the internet bubble, and the 9/11 attacks. In a few weeks, however, all hell broke loose and the global economy witnessed the most challenging times since the Great Depression.

One year ago today, in the summer of 2009, the buzz word was the green shoots sprouting everywhere. The free fall in advanced economies was over, emerging market

economies were growing in double digits, financial markets had bounced back sharply and commodity prices were on the rise.

Today, in the summer of 2010, we are experiencing another mood swing in risk perceptions. A casual look at the LexisNexis database that covers more than 40 thousand news sources reveals that the use of "***double dip***" as a phrase has increased by more than ten folds in the last few months. It is clear that the global economy has entered another period of subdued growth and worsening expectations, although it is not as dismal as the one in late 2008. We do not know how long it will last or whether another dip is likely. Paraphrasing the words of Winston Churchill: It is clear that we have not witnessed the end of financial turmoil yet; some skeptics may argue that this is not even the beginning of the end. But, in my opinion we can at least argue that we have left behind the end of the beginning. The worst is behind us, the future looks less gloomy; however, the road to recovery is expected to be long and bumpy.

Let me elaborate further on recent developments.

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. Global growth had been stronger than expected during the first half this year, but a significant slowdown is projected for the second half of 2010.

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.

If John Maynard Keynes lived today, he would be proud with the policy actions of the central banks and treasuries to compensate the severe contraction in private demand through higher government investment and consumption. However, we should be mindful of the fact that the capacity of developing countries is rather limited in pursuing similar expansionary fiscal policies in the future. Front-loaded fiscal adjustment in several European countries, gradual fiscal consolidation in some others coupled with the announcements or adoptions new consolidation measures have eased concerns about sovereign solvency. However, a delicate balance should be set between supporting domestic demand and addressing fiscal concerns, since confidence still remains extremely fragile.

Some of you may recall, back in 2001, the Turkish economy had experienced a devastating economic crisis, leading a sharp contraction in economic activity. In the aftermath of the crisis, the government implemented a very ambitious program based on fiscal discipline and high primary surplus (about 5 percent of GDP for 5 years in a row). That program was a perfect example of expansionary fiscal contraction. Many policy makers in European countries, most notably Germany and Britain, are advocating a similar approach. The difference is that fiscal contraction in Turkey in the aftermath of 2001 crisis was compensated by external demand, which is not possible today due to stagnant pace of global economic activity.

We are living in a globalized world, but the world is still a closed economy. All countries cannot rely on external demand simultaneously. Prospects for a quick and strong recovery in demand conditions are bleak. Households in advanced industrial nations need years to repair their balance sheets. Corporate sector would be reluctant to engage in new investments in light of excess in current capacity. High unemployment rates, depressed asset prices and problems in banks' balance sheets would continue to put pressure on private consumption.

All in all, risks regarding the global economy remain. Recent data releases on global economic activity have increased the downside risks and raised uncertainties on near term outlook.

Dear Participants,

Now let me turn your attention to emerging market economies. It is quite clear that during the last decade, emerging economies had benefited considerably from the era of abundant liquidity and the Great Moderation. Many developing countries achieved high economic growth driven by booming domestic demand, ample flows of foreign capital and rapid credit expansion. But, that was not the whole story. The financial crisis has also revealed that most emerging economies were not as risky as once believed. I attribute this resilience to long-lasting memories of the developing world on past crisis. As Akerloff and Schiller explained in their recent book, *Animal Spirits*, "***People's memories of essential facts are indexed in the brain around stories. Facts that are remembered are attached to stories.***" The story of emerging market economies during the 1990s usually ended in tears. The markets were 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 followed prudent policies, strengthened their fiscal positions, reduced public debt, accumulated FX reserves and kept a close eye on financial systems.

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. 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 rein in excessive credit growth and formation of bubbles in asset prices. This approach would prevent the subsequent mess of popped bubbles and the unprecedented scale of public money and social sacrifice in terms of joblessness.

From the aspect of public finance, fiscal authorities should reduce public debt to accumulate enough fiscal space for the lean years. This is particularly true for most developing countries. Unlike advanced economies, we are quite sensitive to capital

flows. Dependence on external savings makes our economies 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 difficulties 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.

The Turkish economy is a good example of such prudent policies. Despite the turmoil in world economies, neither price nor financial stability has been seriously jeopardized in Turkey. 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. Moreover, Turkish economy has been one of the few countries those rebounded sharply from the recession. 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 could have triggered 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.

Of course, recent deterioration in risk perceptions has continued to put pressure on the Turkish economy. Recent data suggest that the recovery in economic activity has slowed down. The latest PMI and Consumer Confidence Index figures came out lower than expectations confirming the deterioration in the outlook. The drop in production is likely to be temporary, but that downside risks regarding the pace of recovery remain. Investment demand continues to recover, but remains below pre-crisis levels. The recently increased uncertainty about the pace of recovery in foreign demand might dampen new investments, particularly in the manufacturing industry. There are signs of a moderate slowdown in foreign demand. It would take a while before industrial capacity utilization rates return to their pre-crisis levels. Although employment conditions continue to improve, unemployment rates remain at elevated levels. Weaker foreign demand conditions could dampen the labor market and thus the recovery in domestic demand in

coming months. Unemployment rates would continue to remain at higher levels compared to pre-crisis period for sometime, containing the unit labor costs.

During the global financial crisis, monetary policy strategy of the Central Bank of the Republic of Turkey comprised of three complementing pillars:

(1) Initiating a rapid and front-loaded rate-cut-cycle (1025 bps in total);

(2) Minimizing volatility in Turkish lira (TL) money markets (by extending the maturity of repo facilities, reducing required reserves ratios in TL, injecting more TL liquidity than needed); and

(3) Meeting foreign exchange (FX) liquidity need of the banking sector in a prudent manner (through daily FX selling auctions, reducing required reserves ratios in FX, resuming our intermediary functions in the FX deposit market to address counterparty risk, extending the maturity and lowering the interest rates of FX deposits borrowed by the banks).

In light of the normalization in monetary and credit market conditions, we announced the general framework of our exit strategy on April 14, 2010. Since our balance sheet has not been subject to a significant change throughout the crisis, the exit strategy envisages a simpler and easier transition compared to those of many other central banks.

In line with the provisions of the exit strategy, we have started to gradually reduce excess TL liquidity supplied to the banking system parallel to the normalization of the money markets. We have also changed the operational structure of its liquidity management to ensure better allocation of liquidity within the banking system and to reduce the dependence of banks on our lending facilities. Some of the measures taken during the crisis (such as introduction of 3-month repo auctions and the reduction of the TL required reserves ratio) are still in effect, although the share of 3-month repo auctions is on the decline. Depending on future developments (such as a rapid credit expansion exceeding the desired levels), the required reserve ratios may be used more actively as a policy tool to reduce macroeconomic risks.

As part of the exit strategy related to FX liquidity, we have raised the FX required reserves ratio, first in April and then in July 2010. Our exit strategy also envisages raising FX lending rates of the Central Bank in the FX deposit market. Our intermediary function in the FX deposit market would be abolished altogether after monitoring the effects of the developed countries' exit strategies. Banks, however, would still be able to borrow FX from the Central Bank within the predetermined borrowing limits, but the maturity would decrease from 3 months to 1 week.

Measures outlined in the exit strategy are expected to be completed to a large extent by the end of the year, and that policy rates are expected to be kept constant at current levels for some time followed by limited increases in 2011, staying at single digits throughout the three-year forecast horizon. However, there are risks that could necessitate bringing forward or delaying the measures outlined in the exit strategy. Recently, strengthening perceptions that developed economies will keep their policy rates at low levels for a long period, together with ample liquidity conditions have led to a surge in capital flows toward emerging markets. Given the relative improvement in the creditworthiness of Turkey during the post-crisis period, it is possible that capital inflows may further increase in the forthcoming period. Such a development would exacerbate the divergence between the pace of recovery in the domestic demand and external demand. If this pattern of growth coexists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity tools more effectively. Accordingly, we may bring forward the measures outlined in the exit strategy that were envisaged to be implemented by end-2010. By contrast, should the uncertainties regarding global economy intensify and consequently dampen domestic demand, these measures may be implemented at a later period.

Of course we monitor fiscal policy developments closely while formulating monetary policy. The delay in the enactment of the fiscal rule has increased the importance of current fiscal policy implementation. Budget realizations in the first half of 2010 suggest that the better-than-expected performance in budget revenues, due to stronger

economic activity than envisaged in the Medium Term Program, is largely being used to reduce government debt. Sustaining fiscal discipline in the period ahead as well is crucial, both in terms of providing more flexibility regarding the conduct of countercyclical monetary policy, and also for keeping the market interest rates at low levels permanently. In this respect, we will continue to monitor the fiscal developments and their impact on inflation outlook closely. Should fiscal discipline be implemented through institutional and structural improvements, rather than indirect tax hikes, it would be possible to keep policy rates at single-digit levels over the medium-term.

Distinguished Participants,

In the last part of my speech, let me say a few words about the economic outlook. After a respectable recovery in global economic activity in 2009, we have entered another period of uncertainty regarding the pace of economic growth. Putting aside potential ups and downs in the near future, economic performance of countries in the post-crisis period is likely to be determined by three factors.

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.

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 been 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, most robust, and profitable banking system among the emerging market economies. Therefore, our

banking system is well positioned to finance private sector recovery for a sustainable economic growth in the foreseeable future.

The last critical element of decoupling is a strong and sustainable rise in private demand. The pre-requisites for a surge in private demand include 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. Thus, 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.

It is the responsibility of the policy makers to ensure that we reach a better equilibrium consistent with price stability, fiscal sustainability, a healthy banking system and a competitive labor and product market. The Central Bank of Turkey will utilize all available policy tools to ensure price stability and financial stability to reach our ultimate goal, which is strong and sustainable growth.

Thank you for your attention.