Central Bank of the Republic of Turkey

Global Crises and Economic Governance

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Distinguished Rector, Distinguished Academicians and Esteemed Guests,

First of all, I would like to thank everyone who has contributed to the organization of this conference, primarily Prof. Cemil Çelik, the Rector of İnönü University and distinguished faculty members of the university. I take great pleasure in participating in such an event with you.

I would like to start my speech with a brief evaluation of the global financial crisis. Later on, I will share with you my observations related to developments in the global economy and the Turkish economy. After presenting a brief overview of the monetary policy implemented and the measures taken by the Central Bank during the crisis, I would like to close my speech with the monetary policy exit strategy, which we announced to the public yesterday.

As you know, problems that emerged in the US subprime mortgage market in the second half of 2007 spread the whole world to reach threatening levels for both financial and economic stability.

We can say that the reaction of market players and the public has gone through four subsequent stages since the eruption of the crisis. These stages can be summarized as those of Denial, Disappointment, Panic and Hope.

In the first stage, the markets had difficulty perceiving the dimension of the damage caused by the crisis and considered that such an incident would be overcome shortly and/or would not reach significant levels. As a matter of fact, especially in the first half of 2008, one of the most discussed items on the agenda of international financial circles was whether there would be a decoupling of economies or not. In that period, many economists and market specialists supported the idea that the crisis that emerged in advanced economies would have a limited impact on emerging economies and that emerging economies had the capacity of compensating the global demand deficit, which was to be observed. In conclusion, they claimed that there would be a distinct decoupling in the growth dynamics of country groups.

It has been fortunate that the expected decoupling has not been as intense as estimated. It is inevitable for both developed and emerging economies to be affected by global economic turbulence in a period characterized by the progressively rising

interdependent nature of global economies. However, the scale of the impact has differed from one country to another.

When we look back, we see that the resilience of countries in the face of the crisis has been determined mainly by four structural factors. It is possible to examine them under four headings as (1) Floating exchange rate regime (2) Resilience of the banking system (3) Countercyclical monetary policy and (4) Room for maneuver provided by the fiscal discipline implemented in the pre-crisis period.

Countries implementing a fixed exchange rate regime have been hit more severely by the crisis compared to those implementing a floating exchange rate regime. In countries with free capital flows, a floating exchange rate regime, – by enabling monetary authorities to adopt a flexible approach in the face of a liquidity crunch in markets – acts as a safety valve preventing over-contraction of the economy, under rapidly deteriorating international liquidity conditions. As a matter of fact, in countries implementing a floating exchange rate regime, economic activity exhibited smaller fluctuations before and during the crisis. Moreover, countries under a floating exchange rate regime experience a stronger economic recovery compared to those under a fixed exchange rate regime.

The second structural factor that determines the resilience of countries against the crisis is the structure of the banking system. In this period, factors such as asset quality of the banking system, keeping leverage ratios at manageable levels, and proper implementation of regulatory and supervisory activities played an important role in containing the damage and credit crunch in financial markets.

The last two factors that determine the level of impact of the crisis on countries are monetary and fiscal policy practices that are considered as cyclical movements in the economy. In those countries, which observed fiscal discipline, implemented countercyclical monetary policies, prevented excessive increases in private sector's indebtedness ratios in the pre-crisis period, central banks and governments had the room for maneuver to implement monetary and fiscal policies that could recoup demand shocks.

Owing to the aforementioned reasons, many countries, including Turkey, has been able to be resilient beyond expectations, in the face of the crisis. However, it was

undoubtedly impossible to fully avoid the adverse effects of the crisis. In fact, an analysis of quarterly growth rates of world economies suggests that almost half of the economies contracted in the final quarter of 2008, and more than 90 percent in the first half of 2009.

The first half of 2008 became a period where problems driven by the crisis were ignored by the markets. Nevertheless, despite certain monetary policy measures that were taken, the global crisis entered the second stage, where the feeling of "denial and rejection" was replaced by "disappointment" and "anger" due to the growing frequency of problems emerging across financial markets. In this period, money markets were almost at a standstill due to the deterioration of risk perceptions, banks were faced with liquidity problems, asset prices experienced slumps, non-performing loans increased, balance sheets incurred losses that led to serious damage to the health of banking system, numerous banks and investment agencies came under strain and even went bankrupt – all of which describe the main characteristics of the second stage.

Especially the rescue packages that were inevitably implemented by governments to prevent the collapse of the financial system in developed countries gave way to serious public anger directed towards banks and investment agencies. The USD 700 billion worth of stimulus package, which was prepared in September 2008 to enable the government to assume bad debts of US financial institutions and which was considered the biggest state intervention in recent years, was pending at the US House of Representatives for a long time due to the harsh reaction from the public. In the meantime, there was a negative reaction from the public towards the excessively high salaries of banking sector managers, who frequently was urged a readjustment to the remunerations of managerial staff. Furthermore, new arrangements were brought onto the agenda for stricter supervision and to restrict the activities of the financial sector. In addition to these developments, views related to inefficient functioning of public institutions in charge of supervising the financial sector, primarily the Federal Reserve, in the pre-crisis period, raised intense criticism on these institutions, too. Meanwhile, under the name of financial protectionism there have been advocates of the discourse that international banks should halt their functions abroad and instead lend to the corporate sector experiencing difficulty in finding funds at home.

On the heels of “Denial” and “Anger”, the global crisis entered the third and most disturbing stage in the final quarter of 2008 and the first quarter of 2009. We can define the common public feeling that prevailed in the whole world in this period as “panic” and “fear of collapse”.

In early 2009, the effect of the global crisis on world economies deepened, world trade volume fell to historic lows, almost all countries suffered economic contraction, unemployment rates soared; in brief, the world had faced the possibility of an economic depression of such dimensions for the first time since 1929 – as a result of which the fears of a global and prolonged depression peaked.

In order to recoup the significant contraction in demand that emerged due to the decrease in the private sector’s total investment and consumption expenditures, governments and central banks have prepared historically extensive and comprehensive stimulus packages. The scope of the crisis and the economic contraction became worldwide in a short while, which necessitated the timely implementation of measures in coordination with other countries. Public resources that were allocated to the financial sector and the stimulus packages that were put into effect during the crisis have brought significant burden on public budgets. Research conducted by the International Monetary Fund indicates that the total amount of capital transferred to the financial sector was USD 4 trillion; state purchases to prop up securities markets amounted to USD 6 trillion; state guarantees to financial institutions and the corporate sector became USD 14 trillion; and fiscal measures such as tax rebates and new public spending reached USD 6 trillion.

As of the second half of 2009, we entered the fourth and last stage of the crisis. We can simply describe this stage as the period of “hope” emerging in the world public opinion with the support of the “green shoots” that appeared in economic activity.

Data, which have been released since April 2009, have confirmed that the worst of the crisis has been left behind and has reinforced expectations that a recovery in the global economy has started. The termination of monetary and fiscal stimulus programs and the inventory de-stocking process -especially in developed countries- constitute the basis for recovery signals in the global economy. The improvement in the Global Purchasing Managers’ Index of both developed economies and emerging markets in the first quarter of 2010 indicate that the recovery in economic activity

continues. An analysis of growth estimates of international institutions reveals that in 2010, the United States is expected to display a growth rate close to the long-term growth average and the recovery in Europe is expected to be slower than that in the United States. Taking into account the fact that the European Union is our leading export market, this constitutes an important risk factor for our economy.

Now, let us have a look at the risks with respect to the global economy in the upcoming period. The distressed assets problem in the banking sectors of developed countries is yet to be solved and vulnerabilities persist and they constitute the primary factors impeding effective functioning of the credit mechanism. Meanwhile, the rapid rise or high levels of unemployment rates in many countries affect the total demand adversely by reducing household expenditures. The persisting uncertainties about exit strategies from the extraordinary monetary and fiscal measures are another factor pose risk to the permanence of recovery.

The ever-growing budget deficits and swelling public debt stocks driven by the expansionary fiscal policies adopted especially in developed countries became an important risk factor as they push long-term interest rates up and affect private demand adversely. Meanwhile, sharp rises are observed recently in the risk premia of Greece, Spain, Portugal and Italy with high debt stocks as concerns over the sustainability of their current budget deficit are elevated.

After summarizing the stages that the crisis has gone through since mid-2007, I would like to talk about the reasons for the emergence of the crisis from the viewpoint of the main theme of this conference; i.e. “the issue of governance”.

There is a consensus over the fact that in the pre-crisis period, markets developed, deepened and grew more complex at an astounding pace but the institutions responsible for inspection and supervision failed to keep up with this change. Moreover, Basel II regulations made credit rating institutions a part of the regulation process; and complex derivative products and risk assessment methods spurred over-borrowing. In the pre-crisis period, the accommodating monetary policies adopted by central banks of developed countries in the form of the low interest rate-high liquidity led to moral hazards in financial markets.

Within this framework, assuming that financial markets always operate efficiently, we can list the reasons for the crisis as deregulation, financial innovations, problematic accounting standards and global instabilities. The liberty brought by deregulation led to shortsightedness driven by over-confidence and short-term profits were preferred at the cost of risking the financial system in the long run. Financial innovations generated complex derivative products, where who owes how much to whom is not clear and, which actually lead to multiplying of risk instead of distribution of it. Meanwhile, the accounting standards based on "Fair Value" principle made cyclical effects and fuelled the destructive power of the crisis.

Having mentioned the stages and reasons for the crisis, now I would like to share with you the monetary policy implemented by the Central Bank of Turkey during the crisis and my evaluations on the recent developments in the Turkish economy.

Projecting that inflation would decrease sharply as of the last quarter of 2008, the Central Bank of Turkey implemented a monetary policy focusing on restraining the potentially harsh impact of the global financial crisis on financial activity without conflicting with the primary objective of maintaining price stability. During this process, the CBT has delivered sizeable cuts in policy rates and a counter-cyclical monetary policy has been implemented with the aim of supporting the smooth operation of credit markets. Between November 2008 and November 2009, the CBT cut policy rates by 1.025 basis points, playing a pioneer role among central banks of developing countries.

As a result of the limited improvement in risk perceptions and the Central Bank's projections supported by actual inflation data, market interest rates decreased significantly. In this period marked by the crisis, policy rates continued to be one of the factors determining market rates. In an era where ballooning government deficits are likely to put upward pressure on medium to long-term interest rates across the globe and markets are still sensitive to risk appetite, the fact that market rates continue to be primarily determined by the CBT's policy rates is evidence of the increased effectiveness of monetary policy.

The course of real rates and financial tightening measures during the crisis are also indicators of the improved effectiveness of monetary policy in Turkey. Real market rates declined continuously amid CBT's policy rate cuts and reached historic lows.

The tendency of real rates to fall is quite common in well-functioning economies during times of recession; yet, it is quite unprecedented for Turkey. In this regard, the current level of real rates is an indicator of the improved effectiveness of monetary policy.

During the crisis, the monetary policy decisions of central banks in emerging economies had very limited short-term effect on their currencies. The values of these currencies were mainly determined by global risk perceptions. However, with the normalization in financial markets, we foresee that the distinguishing characteristics of countries will come to the fore in the upcoming period and currencies of those countries with lower risk, stronger economic and financial fundamentals and high growth potential are expected to perform better. In this regard, it would not be surprising if Turkey's credit rating is raised to reach the investment grade implied by the actual CDS spread.

As for recent developments in the Turkish economy, the moderate recovery in economic activity continues. Quarterly growth in GDP continued in the last quarter of 2009. As tax cuts that were put into practice with the aim of spurring economic activity were phased out, private consumption demand displayed a more moderate rise compared to the first half and the gradual recovery in private consumption expenditures continued in the third quarter. Meanwhile, private investment expenditures continued to pick up in the last quarter but remained lower compared to strong growth periods. Taking into account the uncertainties pertaining to domestic and foreign demand and the low capacity utilization rates, it is estimated that it would take an extended period of time for investment expenditures to reach their pre-crisis levels and no significant rise is expected in the short run. Recently, imports have increased faster than exports and this indicates that the recovery in the economy is mainly driven by domestic demand. The course of exports in the upcoming period will be determined by the pace of global recovery. As I have mentioned earlier while talking about global risks, forecasts for our largest trade partner, the European Union, suggest that it would take a long time for foreign demand to return to pre-crisis levels.

Industrial production has been increasing moderately since March 2009. According to the latest Business Tendency Survey conducted by the CBT, the moderate recovery in orders both from domestic and foreign markets continues. On the expectations

side, there is improvement both in the real sector and consumer confidence indices. Nevertheless, the still-weak foreign demand and the fact that Turkey's exports predominantly rely on products that are susceptible to cyclical developments are retarding a rebound in industrial production. Uncertainties regarding aggregate demand urge firms operating in the manufacturing industry to take a cautious stance and to be more reluctant about inventory building compared to the periods of strong growth.

The biggest headache for Turkey, unemployment, assumed a slight recovery trend in the third quarter of 2009 as the economy started to generate employment opportunities again. Industrial employment, which is the sector that is most severely affected by the crisis and became the main driver of contraction in non-farm employment, started to recover at a moderate pace. The services and construction sector supported non-farm employment as well. Despite the recent partial recovery, the unemployment rate is still quite high compared to the pre-crisis period. This high unemployment rate curbs the consumption demand as well. Putting the structural reforms that would remedy chronic problems in the labor market into practice immediately would prevent unemployment rates, which climbed during the crises, from becoming permanent and support potential economic growth.

The lending appetite of banks significantly decreased due to the decline in risk appetite accompanied by the erosion of confidence and elevated uncertainties during the crisis. However, we can assert that there are favorable developments thanks to policy rate cuts made since November 2008 and the improvement in global risk perceptions. Especially the most recent developments suggest that there is an apparent improvement in Commercial Loans. The rise in loans extended to SMEs, which have an important share in the labor market, indicates that there is moderate recovery in economic activity. The NPL ratios, which saw all time highs during the crisis, started to decrease, albeit slowly and gradually. To sum up, the upward trend in bank loans, which started in the second quarter of 2009, continues on a stable course.

As you all know, the impact of the global economic crisis on financial markets was terribly severe in the last quarter of 2008: countries' risk premia saw record-high levels and excessive volatilities occurred in the currencies of many developing

countries. Despite having been volatile at historically high levels and extremely sensitive to the global risk appetite, the Turkish lira displayed a relatively stable course, which lasted through the first quarter of 2010 following the peak of the crisis. Meanwhile, the improvement in global risk perceptions in the fourth quarter led the currency of many developing countries to appreciate. In terms of changes in currency values, the Turkish lira did not significantly differ from currencies of other emerging markets in this period.

Public debts and budget deficits have increased on a worldwide scale due to fiscal stimulus and decreasing tax incomes. In many countries, the ratio of public debt to national income went beyond the sustainable level of 60 percent (Maastricht Criteria), which may ease concerns about public finance and create upward pressures on market interest rates. I am of the opinion that, should market interest rates increase; the severity and duration of the global crisis will be adversely affected.

The discipline established by Turkey in public finance in the past has significantly increased the resilience of the public against external shocks as well as confidence regarding the sustainability of debts. These improvements in the structure of public finance and the sustainability of debts allowed the implementation of expansionary fiscal measures, albeit limited, in order to alleviate the impact of the global crisis. In this respect, SCT and VAT rates on some products were temporarily reduced to allow de-stocking for firms and a new investment incentive system was established to improve the investment atmosphere. Additionally, tax cuts and fiscal incentives were introduced to increase employment, and credit and guarantee supports were provided for SME's and exporting firms. It is thanks to the fiscal discipline already established that countercyclical policy could be implemented in this period.

Tax arrangements along with hikes in commodity prices that were put into effect at the beginning of the year played a significant role in the increase of inflation in the recent period. The hike in annual inflation mainly emanated from the co-emergence of many temporary factors rather than general pricing behavior. Meanwhile, the main inflation indicators remained consistent with medium-term targets. Moreover, the annual rate of increase in services prices and the inflation diffusion index saw historically low levels. These observations indicate that the increase in inflation in the last quarter of 2009 is mainly due to temporary developments, and to factors beyond

the immediate control of monetary policy, rather than the main components of inflation.

We consider the possible effect of inflation hikes on expectations due to the base effect a significant risk factor in forthcoming months. However, under the assumption that resource utilization in the economy will remain at low levels for an extended period, employment and credit conditions will not allow a strong expansion in consumption demand and fiscal policy will gradually generate a contractionary effect, we believe that the effect of price increases emanating from one-time shocks on general pricing behavior will be limited. It is important that economic units accurately perceive the temporary quality of the said factors and that medium and long term expectations do not deteriorate. The CBT are vigilant on pricing behavior as inflation follows a high course, albeit temporary. The CBT foresees that inflation will follow a fluctuating course significantly above the target and then reassume a decreasing trend in the last quarter of the year once the temporary factors taper off and come back to levels consistent with targets in the first months of 2011.

In the last part of my speech, I would like to mention about the general framework of the monetary policy exit strategy that we shared with the public yesterday.

As you all know, recently, one of the most discussed issues in monetary policies has been “exit strategies”, which include the withdrawing measures taken during the global crisis and normalization operations of monetary policies. We believe that the exit strategy of the CBT will be simpler and easier as no need for radical measures arose and the balance sheet structure was not damaged during the crisis period.

I would like to handle the exit strategy of the CBT in two groups as foreign exchange and Turkish lira.

The basic principle of the CBT on foreign exchange liquidity is that the Central Bank, which is the lender of last resort for Turkish lira and has broad flexibilities related to Turkish lira liquidity management, is not be considered as the lender of last resort for other currencies. For this reason, the banking system has to be much more discreet and prudent in its management of foreign exchange liquidity. The facilities provided by the Central Bank during the crisis should not result in complacency and the banking system should carry on with effective foreign exchange liquidity

management. Therefore, in the upcoming period, as normalization in the global markets becomes significant, it is planned that measures related to foreign exchange liquidity will gradually be taken to pre-crisis levels, in an orderly manner.

Even though the Central Bank's exit strategy related to foreign exchange liquidity may change as needs arise, it is foreseen to be as follows:

1. The FX required reserves ratios may gradually be increased in a measured pace.

2. Considering developments in global interest rates, foreign exchange deposit lending rates announced by the Central Bank may be increased.

3. Lastly, after the effects of developed countries' exit strategies are monitored, the intermediary function of the Central Bank in the foreign exchange deposit market will be abolished. However, banks will be able to borrow foreign exchange deposits from the Central Bank within the predetermined borrowing limits. The maturity of foreign exchange deposits borrowed within the predetermined borrowing limits by banks from the Central Bank will be decreased from 3 months to 1 week.

Considering the allocation of liquidity within the system in order to prepare the banking sector for technical rate adjustment, to reduce possible fluctuations in the money markets and to maintain liquidity management flexibility against unforeseen liquidity developments, the Central Bank decided to keep the integrity of both reducing overfunding in the context of the exit strategy and technical interest rate adjustment operations and to adopt a gradual strategy.

In the first stage, the amount of liquidity that has been provided as a part of the overfunding policy will be reduced gradually. In this process, as currently is the case, due attention will be paid to keep overnight interest rates close to the announced borrowing rate. The overnight borrowing rate announced by the Central Bank will continue to be the reference rate of monetary policy.

As for the second stage, the technical interest rate adjustment process will become operative. In this respect, in order to maintain the flexibility of liquidity management

against unexpected liquidity developments and not to create volatility in money markets, it is planned to be carried out in two steps.

In the first step, the Central Bank's borrowing and lending interest rates for overnight transactions will not be changed. However, the one-week repo auction procedure will be subject to change by implementing amount auction procedure via fixed interest rate instead of the traditional auction procedure. In this step, the fixed interest rate for one-week repo auctions will be determined by adding 50 basis points to the declared overnight borrowing interest rate of the Central Bank. Therefore, the fixed interest rate for one-week repo transactions will become the reference (policy) interest rate of monetary policy.

In the second step, the difference between the one-week repo auction interest rate and the overnight borrowing interest rate may be increased. The CBT may aim to create the secondary market average overnight interest rate around the one-week repo auction rate. The difference between the one-week repo auction interest rate and the overnight borrowing interest rate may be increased either by raising the one-week repo auction interest rate if the Monetary Policy Committee (Committee) decides that monetary tightening is required, or by lowering the overnight borrowing and lending interest rates if the Committee decides not to make any change in the policy interest rate. In this period, the differences between the one-week repo auction interest rate and the overnight borrowing and lending interest rates may not always be symmetrical and will be determined by the Committee as an element of the operational framework of monetary policy.

As a result, some of the measures taken in the foreign exchange and Turkish lira markets during the crisis are planned to be withdrawn gradually. In this context, primarily the measures taken in direct crisis management will be withdrawn, and, as is the case in the rest of the world, the exit strategy will be a cautious and gradual process that safeguards financial stability in our country as well.

I would like to end my remarks by extending my regards to all the participating academicians and policy-makers for their contributions to the "Global Crises and Economic Governance" congress. Also, I would like to thank, once more, the staff of İnönü University and everybody for their contributions to the conference.