



Central Bank of the Republic of Turkey

The 19th Annual World Business Congress

Durmuş YILMAZ
Governor

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Konya

Honorable Rector, Esteemed Academicians, Distinguished Guests,

We are gathered here today for the 19th Annual World Business Congress of the International Management Development Association (IMDA), where the lessons learned from past experiences in the global business world, current issues and future tendencies will be discussed. I would like to congratulate everyone, notably Prof. Dr. Mehmet Babaoğlu, Rector of Karatay University, and distinguished members of the University for their Contributions to organizing this esteemed Congress, which is held in a different country each year.

I would like to start my speech with a brief evaluation of global financial developments. Then I will address structural reforms, which we deem essential for raising Turkey's potential growth rate, when considering the Turkish economy on a macro scale and from in a long-term perspective.

1. Global Developments:

As is known, problems, which emerged in the global financial markets about two years ago and spread across the corporate sector over time, affected the Turkish economy as well as other economies. We see that the impact of global turmoil on economies mainly emerged through three channels: (1) Foreign Trade, (2) Capital Flows and (3) Expectations. The Turkish economy has been affected by global turmoil through all these three channels due to its structural features.

Low level of domestic savings in the Turkish economy, significant share of advanced economies in our exports, sensitivity of our exports to global economic cycles and deterioration in expectations of the private sector have caused a sharp slowdown in economic activity. However this contraction did not last long and Turkey has become one of the countries that have rapidly recovered from global turmoil. In other words, unlike previous crises, the Turkish economy has resisted global turbulence well owing to its structural transformation and policy implementations that have been underway since 2001.

The main reasons for this resistance are the resilience gained from the implementation of a floating exchange rate regime, the robust structure of our banking system, counter-cyclical monetary policy implemented before and during the crisis and the room for maneuver provided to public finance by the fiscal discipline observed in the pre-crisis period. These factors, coupled with the subduing effects of the crisis, have promoted an earlier and stronger recovery in the Turkish economy, compared to that of the global economy.

Accordingly, since the height of the crisis, by mid-2009 Turkey's GDP and industrial production have increased by 11 percent and 21 percent, respectively, while the unemployment rate has dropped by approximately 3 percentage points. Although the level of production is still below its pre-crisis level, we expect that it will exceed this level in 2010. Meanwhile, we envisage that it will take an extended period for the labor market to recover.

The global economy has displayed a mild recovery since the second half of 2009. Yet, European economies have recently shown signals of deceleration. Although problems in the credit markets of advanced economies have attenuated, they have not been completely eliminated yet. As a matter of fact, credit developments in the USA and the Euro area suggest no significant increase in credit volume. The unresolved issue of troubled assets in the banking sector of advanced economies impedes proper functioning of the credit mechanism. Meanwhile, soaring and persisting high unemployment rates in many countries reduce household expenditures and negatively affect the aggregate demand. Soaring budget deficits and public debt stocks stemming from loose fiscal policies implemented in developed countries are an important risk factor that may adversely affect private demand by increasing long-term interest rates in the years ahead.

The risks that I have mentioned above also have the potential to affect the Turkish economy in a negative way. Considering that our largest exports market is the European Union, problems prevailing in European economies pose an important risk for our economy, too. As a matter of fact, external demand indicators have recently indicated a partial slowdown. Global turbulence also has the potential to affect the

Turkish economy negatively through the channel of expectations. Problems in the global financial markets are likely to restrain the accessibility of external financing.

In conclusion, in an environment where the resource utilization has yet not reached pre-crisis levels and no demand pressure is observed, we anticipate that core inflation indicators will remain consistent with medium-term targets and economic recovery will be slow and protracted.

2. Turkey's Long-Term Growth Performance and Potential Growth Rate

In the second part of my speech, I would like to share with you my views on the necessary reforms for the establishment of strong and sustainable growth in Turkey as well as those to increase its long-term potential growth rate.

The growth rate of a country is determined by three factors.

These factors can be summarized as:

- (1) Capital deepening
- (2) Employment growth and
- (3) Total factor productivity

When we look at the last fifty years in the Turkish economy, we see that Turkey's average growth rate has been around 4.5 percent. A study carried by staff members of the Central Bank of Turkey, Dr. Şeref SAYGILI and Dr. Cengiz CİHAN, suggests that capital deepening has a large share, as much as 75 percent, in this growth rate. According to the same study, the contribution of employment growth and the increase in productivity remained very limited, at 20 percent and 5 percent, respectively.

There is no doubt that capital accumulation plays a leading role in the development of an emerging economy, as expected. Other country cases also present a similar outlook. However, given the economic transformation of fast-growing countries, such as Japan and South Korea, we see that the contribution of capital accumulation to growth in these countries has been moderate (at around 50 percent), whereas the

contributions of employment growth and the increase in total productivity have been higher (at around 25 percent), as compared to Turkey. In other words, Turkey's efforts for development are mostly based on increasing the current sources of production rather than using them more effectively and efficiently. In a country, where the propensity to save is low, any attempt at development through capital deepening would cause a high level of current account deficit and a restricted increase in employment.

At this point, I would like to annotate that the contribution of total factor productivity to economic growth climbed significantly to 30 percent on the back of the reforms and structural transformation implemented in the post-2001 period. I believe that the labor market and total factor productivity are crucial for improving the potential growth rate of Turkey. In the next part of my speech, I will cover these two issues, respectively.

3. Labor Market

As I have already mentioned, the contribution of the employment increase in the growth composition of the Turkish economy is very limited. Although it is often voiced that Turkey's younger population structure compared to other countries constitutes demographic window of opportunity, non-participation of this young population in the labor market is an important problem that should be addressed.

According to 2009 figures, labor force participation rate in developed economies is above 70 percent. This rate is hovering at around 60 percent in Eastern European countries. Although the labor force participation rate has surged by 3 percentage points in Turkey, it still remains low, at 49 percent. We see that the limited increase in this period was mostly attributable to the rising trend of labor force participation among the female population.

Government incentives for social security contributions oriented towards newly recruited women and young people, which have been in place since 2009, are very influential in this development. Nevertheless, at 28 percent, the female labor force participation rate in Turkey is very low compared to European countries. While the labor force participation among females with a university degree converges towards

the EU average, with a ratio of 71 percent, only 23 in every 100 women with a high school or lower education participate in the labor market.

Regulations to be implemented in the labor market in the forthcoming period will contribute to sustainable growth and an increase in employment on a permanent basis. Within this scope, it is essential that:

- Flexibility of the labor market should be increased,
- Competition within the private sector is promoted,
- Pay-roll taxes are reduced, and
- Necessary policies for establishing an educated and qualified labor force, which will accommodate private sector requirements, are followed.

I would like to lay special emphasis on the importance of education reforms for the future of our country. The necessary balance should be established between the need for a qualified labor force in the Turkish economy and the human resources provided by our educational system. Within this context, I believe that the Specialized Vocational Centers Project, implemented with the collaboration of The Union of Chambers and Commodity Exchanges of Turkey and the relevant ministries, will accommodate a very important need in Turkey and I would like to congratulate everyone who has been involved in this project. Such projects will equip hundreds of thousands of young population with the qualifications required by the labor market, and will not only contribute to the increase of employment but also raise Turkey's growth rate on a sustainable basis.

One of the major concerns of the labor force market is the informal economy. The rate of informal employment in Turkey is 43 percent. Such illegal practices lead to unfair competition and reduce the productivity of the Turkish economy. One of the major causes of the informal economy is the high level of labor costs in Turkey. Of course, the risk of the employment loss that may emerge in the short-term as a result of the reduction of informal employment should be minimized. At this point, we consider the implementation of arrangements regarding the reduction of labor costs to be crucial.

In the forthcoming period, parallel to the fading effects of the global financial crisis, the employment creation capability of economies will be determined by structural features of the labor markets. The long-term unemployment of individuals who had lost their jobs due to the crisis or those who had recently joined the labor force but could not find jobs also poses the risk of permanent unemployment for such people. In this respect, the implementation of structural reforms to improve the labor market will prevent a permanent rise in long term unemployment during the global crisis and underpin the increase in the potential growth rate of the economy.

4. Productivity

After sharing my views on the labor market, I would like to move on to total factor productivity, the third factor that influences the potential growth rate.

Total factor productivity in an economy arises from the interaction and combination of a number of elements. The leading one is the establishment of macroeconomic stability by alleviating the uncertainties that economic agents are confronted with. The prerequisite of macroeconomic stability is fiscal discipline and price stability.

Public balances that have improved thanks to prudent monetary and fiscal policies coupled with the inflationary gains following the deep economic crisis in 2001 are noteworthy steps on the road to establishing macroeconomic stability. Economic welfare only increases along with sustainable growth. Sustainable growth implies price stability. The growth rate we attained with the high inflation in the 1980's did not last long and had been replaced by higher inflation rates and economic recession. Meanwhile, between 2002 and 2007, high growth rates were attained while a remarkable decline was recorded in inflation.

In this scope, we are of the opinion that the monetary policy implemented by the Central Bank of Turkey, which is consistent with the main objective of price stability, has supported the establishment of price stability in Turkey and contributed to the permanent increase of the competitive power of the whole economy and the exports sector.

I would like to emphasize that the quality of fiscal adjustment is crucial for both the struggle with inflation and the permanence of the high growth rates. The fiscal rule, which is to be enforced in the near future will enhance predictability and create confidence for the future. Fiscal rules play a critical role in the establishment of fiscal policies consistent with sustainable debt dynamics and foster a more prudent and permanent implementation of fiscal discipline. However, in the light of country experiences, in order that fiscal rules can function as expected, these rules should be implemented in a transparent way as per the required institutional and legal framework to be established.

5. Exchange Rate

As you may have noticed, in my speech regarding how to increase the potential growth rate of Turkey, I have not mentioned the issue of foreign exchange rates.

Economic literature besides country experiences has shown that the value of the currency of a country is the result of all other economic variables. Putting interest and exchange rate policies in the forefront leads structural reforms, the prerequisites for sustainable and high growth rates, to remain in the background.

The level of foreign exchange rates is of course a noteworthy and influential factor on economic variables. In the short run, the foreign exchange rate is determined by monetary and fiscal policies, international capital movements, expectations and even political developments and current issues. However, in the medium to long term, the most important factor determining the value of a local currency is the economic performance of that country. The foremost factor influencing this performance is productivity increase. Productivity increase, at the same time, is the only variable to ensure the permanent increase in the welfare of a society.

The monthly real exchange rate index, which is released by the Central Bank, shows that compared to 2003, the Turkish Lira appreciated in real terms compared to the currencies of developed countries, while no significant change occurred against the currencies of developing ones.

This is not surprising. The increase in the real exchange rate index against developed countries is a natural consequence of the high productivity increases in our economy compared to these countries. For example, OECD data suggest that in the 2003–2008 period, the productivity increase per employee in Turkey is approximately 6 times higher than that in Europe.

Our currency did not mark a notable change against emerging market economies competing with Turkey in the exports markets. In this respect, the relatively stable course of the real exchange rate index compared to developing countries underpinned the maintenance of Turkey's competitive power in foreign trade.

As is the case across the world, the Central Bank's decisions on monetary and exchange rate policy also affects the economy as a whole in Turkey. Under a fixed exchange rate regime, it is possible to control the nominal level of the foreign exchange rate. Nevertheless, under free market conditions, whatever the exchange rate regime and exchange rate policy are, it is impossible to control the real exchange rate level. The real exchange rate level will ultimately move towards the long-term balance level according to the structural features of the economy. In an environment of pressurized nominal foreign exchange rate, this movement will emerge by the changes in the prices of goods and services; i.e. inflation. In countries like Latvia, Estonia, Lithuania, Bulgaria, where a fixed exchange rate regime was implemented, this was experienced before the global crisis and these countries faced the problem of high inflation.

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. Should macroeconomic stability be maintained and structural reforms be put into effect, Turkey will also have a place among these countries. This will support the increase in social welfare in the medium and long term and place our country among developed countries.

6. Conclusion

In conclusion, the high growth rate we witnessed in the 2002–2007 period is evidence of the importance of the implementation of policies based on price stability and fiscal discipline.

The high dollarization phenomenon that had adverse effects on our economy in the 1990's has been alleviated in recent years. Our currency has regained the confidence of economic agents and Turkish lira-denominated investment and loan instruments have been increasingly preferred over FX-denominated ones by institutions and citizens. All these improvements are the favorable consequences of the policies pursued in the post-2001 period. Disappearance of dollarization is a precious legacy entrusted to future generations.

Likewise, as you may recall, real interest rates reached 20-25 percent from time to time and entrenched in the minds of economic decision-makers as “normal” in the 1990's. This expectation of high real interest rates has recently been replaced by more reasonable levels. We note this normalization in real interest rates as a remarkable improvement. We assess that if fiscal discipline is not compromised and structural reforms go into effect, in the Turkish economy, equilibrium real interest rate will continue to remain at low single digits in the upcoming period as well.

Lastly, I would once again like to underline the fact that long-term productivity gains necessitate radical economic reforms. The enforcement of the said reforms is a challenging and time-consuming task. Moreover, the effects of these reforms will emerge slowly and gradually. However, this is the only way to ensure permanent economic welfare. Monetary policy does not have a lasting effect on the long-term growth performance of the economy other than the benefits of establishing and sustaining price stability. The Central Bank will continue to make a concerted effort to achieve price stability as per the duties and responsibilities entrusted by its Law.

I would like to end my remarks by extending my regards to all participating academicians and policy-makers for their valuable contributions to the “World Business Congress of the International Management Development Association”.

Also, I would like to thank, once more, the members of Karatay University their contributions to the conference.