



Central Bank of the Republic of Turkey

The Global Financial Crisis and the Central Bank

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Distinguished guests,

It is a great pleasure for me to address the pioneers of the world of finance at this conference held by the Finance Managers Trust of Turkey, one of the prominent non-governmental organizations in the field of Turkish finance that conducts studies to enhance the financial markets in Turkey.

In the first part of my speech, I would like to share my views about the global financial crisis.

The turmoil in the US subprime mortgage market, which erupted in the second half of 2007, started to spillover to the overall credit markets challenging both financial and economic stability. I believe that there are mainly two reasons underlying the widespread and devastating effects of this crisis.

The first of these is the globalization phenomenon that has gained pace since early 1980s reaching its peak in the 2000s. Globalization led the world economies and financial systems to become highly integrated. A natural consequence of this integration is the increasing commonality among the business cycles of individual economies.

The second factor is that this is a financial crisis and that erupted in many developed economies simultaneously. Empirical studies indicate that financial crises are more severe and long-lasting compared to other types of crises and that emerging from such crises is a slow and gradual process. Derivative products, which comprise a large portion on the balance sheets of financial institutions, and which are too complex to be priced, exacerbate the loss. Therefore, I believe that it would be more realistic to adopt a cautious approach in the face of the claims that the global crisis will come to an end in the short-run.

A certain degree of optimism has predominated the financial markets in recent weeks. The stress tests applied to banks in the USA turned out to yield better-than-expected results. This development, along with recent data on economic activity and first quarter balance sheets of companies in the USA, stimulated perceptions that the global crisis may have already hit the bottom and that the economic recovery process may start earlier than predicted.

However, we should remember that this crisis produced tremendous losses on the balance sheets of financial institutions as well as with the assets of households. The total losses incurred by financial institutions have reached USD 2 trillion and is still on the rise. The total loss in the assets of households is estimated to reach USD 11.5 trillion in the USA alone in 2008. Assuming that the wealth effect on consumption expenditures is 0.04, a simple calculation leads us to predict a USD 500 billion fall in consumption expenditures in the USA solely due to the wealth effect. The loss of confidence and deterioration in risk perceptions on the back of the ongoing crisis has led to a reduction in both the lending tendency of banks and investment expenditures of the corporate sector. Asset write-downs coupled with the negative expectations of households pertaining to the future has effected an increase in the precautionary saving tendency. Moreover, in line with the severe contraction in demand, massive slumps have been witnessed in production and employment not seen since the World War II.

Considering the size of the loss incurred by financial institutions and households, it is not very probable to eliminate the financial squeeze, to restore confidence and/or to revive global demand in the short-run. The recent optimism witnessed in global markets is mainly attributable to economic data not being as bad as expected rather than showing signs of recovery. This should be perceived as an indicator of the extent of the loss that the crisis produced on expectations.

Distinguished guests,

As I have just mentioned, because of the globalization process and the crisis originating from the financial system, the current global crisis is expected to be deeper and last longer than previous ones. Meanwhile, this crisis also has a distinctive favorable characteristic, which is the implementation of global fiscal and monetary measures of the size, speed and coordination that were never witnessed before. This raises ambiguity pertaining to the responses from financial markets and economies in the upcoming period to these measures.

In spite of the recent slight improvement in expectations, it still remains uncertain as to when recovery in the global economy will start. The gradually accelerating downtrend of global industrial production indices since the second half of 2008 decelerated in March 2009. However, the indices are still in decline, albeit at a slower pace. Monthly growth rate forecasts for developed countries continue to be

revised downwards each month. Likewise, despite some recovery recently, indicators such as the volume of future orders, real sector confidence indices, house sales and credit conditions of banks indicate that economic contraction still persists.

To sum up, as the Central Bank of Turkey, we maintain our opinion that the credit crunch in international credit markets still persists, that there is yet to be a significant recovery in the global economy and that global economic recovery to be slow and gradual.

Distinguished guests,

After a short assessment of the global developments, I would like to devote the second part of my speech to the recent developments in the Turkish economy and the monetary policy that we have implemented.

The global turmoil, which emerged in the second half of 2007, adversely affected financing facilities and foreign demand, and led to a significant slowdown in economic activity in developing countries, and Turkey was no exception. Parallel to the contraction in aggregate demand coupled with the sharp drop in commodity prices, inflation plummeted markedly.

Easing of concerns over inflation enabled us to focus on containing potential adverse effects of global financial turmoil on the domestic economy without compromising our price stability objective. Slowdown in domestic demand conditions, low level of exchange rate pass-through, tight financing prospects, declining import prices, the relative resilience of the Turkish financial system and improving inflation expectations not only necessitated but also facilitated a controlled but quite rapid rate cut cycle. With the reversal of global developments fueling inflation in the last quarter of 2008, the Central Bank took prompt action to cut interest rates and adopted a pioneer role among emerging markets. The analysis conducted by the CBT indicates that policy rate cuts of a total of 750 basis points have alleviated the severity of excessive volatility in economic activity. The developments observed since November 2008 in domestic financial markets and especially the recent inflation data have confirmed the accuracy of the CBT's projections and the policy rate-cut decisions thereto, thus have increased confidence in monetary policy.

Besides policy rate-cut decisions, a series of measures have been taken to ensure the mobilization of the financial system and efficient functioning of credit markets. The liquidity need of the market was met via auctions in due time and overnight interest rates were meticulously kept close to Central Bank borrowing interest rates.

During times of increasing global uncertainties, the CBT took measures to maintain foreign exchange liquidity in order to avoid any liquidity squeeze and to ensure smooth operation of foreign exchange markets. The CBT has also taken measures to mitigate the adverse effects of global financial turmoil on the corporate sector and has introduced some new arrangements regarding export rediscount credits. These arrangements led to a sharp increase in the volume of export rediscount credits extended via Turkish Eximbank. While the total credit utilization in 2008 was USD 1.7 million, credit utilization in the first four months of 2009 rose to USD 550 million.

As a consequence of the measures taken and the limited recovery in risk perceptions, the level of market interest rates is below the pre-global crisis level in real terms. The realization of neutral interest rates at lower levels during economic recessions, which is an expected development in well-functioning economies, has never been experienced in Turkey before. This development should be perceived as an indicator of the normalization of the Turkish economy.

The considerable decline in policy rates and interest rates of government securities is not commensurately reflected on credit interest rates and this causes the additional tightness in financial conditions to persist, though at a lesser extent. We believe that the run-up in default risk of credit users, maturity mismatch between deposits and credits, and limitations on the financing facilities of banks are some of several factors curbing banks' tendency to extend credits. As I have mentioned before, the necessary measures to avoid a possible TL liquidity squeeze were taken in due time. However, it should be borne in mind that even if the liquidity facilities provided by the CBT alleviated the liquidity squeeze in the market; with respect to maturity, they cannot be a substitute to the financing facilities that the banks used to utilize. The Bank Loans' Tendency Survey conducted by the CBT indicate that the investment-driven credit demand has significantly decreased recently; a large portion of the credit demand stems from the intention of companies to restructure their

corporate credits and that the risk perceptions of banks play an important role in banks' tightening their credit conditions.

Distinguished participants,

In the first part of my speech, I explained our expectations for the global economy and stated that it would take time for growth rates to turn positive. In the last part of my speech, I would like to share with you our expectations for the Turkish economy.

Subsequent to the recent rate cuts and fiscal measures, we anticipate that domestic demand in Turkey might gain relative stability in the second quarter of 2009 and growth will post positive figures from the last quarter onwards. In other words, the recovery in the Turkish economy might start earlier than that of the global economy. Our expectation is underpinned by two main factors.

The first of these is the sound and stable structure of our financial system. Unlike its emerging market peers, the Turkish banking system has not required a stimulus plan up to now. The volatility in the financial markets in Turkey – one of the emerging economies with historically high volatility and particular sensitivity to global risk perceptions – has remained relatively limited since October 2008. The restructuring plans along with regulatory and supervisory reforms, which were put into effect in the aftermath of the 2001 financial crisis at the cost of imposing a heavy burden on the public budget, enhanced the Turkish banking system's resilience to shocks compared to the banking systems of other countries. Balance sheets free of distressed foreign assets, the strong level of capital and liquidity adequacy ratios of our banks will support the normalization of the Turkish credit markets earlier than its peers worldwide. The hikes in Turkey' risk premium during the crisis lagged behind those of many other emerging market economies, and Turkey has shown significant resistance to the crisis at an extent more than implied by her credit rating. We note these developments as a natural outcome of the structural transformation that the country has undergone.

Another factor that will facilitate a relatively faster recovery for the Turkish economy is the household indebtedness ratio, which is lower than those of many other emerging economies. Households have been affected relatively less by

exchange rate shocks owing to the significantly low share of FX-denominated and FX-indexed loans in consumer loans. Backed by the prudent monetary policy implemented since mid-2006, credit expansion in Turkey has been more moderate compared to other countries and this, in turn, has led households to defer their consumption demands. The increase of household consumption between the first quarter of 2006 and the last quarter of 2008 lagged behind the economic growth rate and the share of household consumption in the GDP declined from 72 percent to 69.7 percent. Therefore, we anticipate that the revival of economic activity in the short term will be mainly driven by the rebound in private consumption expenditures. Confidence indices and coincident indicators of demand expectations suggest that the economy may start to recover slightly by the second quarter of the year.

However, I would like to underline once more that economic recovery is expected to be gradual and slow as opposed to the rapid recovery in economic activity after the 1994 and 2001 crises experienced in Turkey and that a significant acceleration in aggregate demand is not expected anytime soon. Persisting tightness in external financing conditions, lagged and gradual recovery in our primary export markets and the large share of durables and capital goods exports, which are sensitive to foreign demand, indicate that the recovery in the Turkish economy will be different from what we have experienced so far. Likewise, private sector investment expenditures, which are influential in overcoming crises, are not expected to display a rapid recovery in the forthcoming period. We think that the rise in unemployment rates will persist throughout 2009 and put further downward pressure on disposable income and unit labor costs for quite some time. Moreover, non-farm employment indicators will recover with a further lag compared to aggregate demand.

Temporary tax reductions imposed on some goods in this period, by advancing future demand, have led to a slight improvement in expectations in the domestic market. Fiscal measures taken to mitigate the effects of global turmoil coupled with the reduction in tax revenues have recently led to a rise in budget deficit. Some easing in fiscal policy is understandable under the current conditions. The current debt structure of the public sector provides some room for maneuver, albeit limited, to implement a counter-cyclical fiscal policy. However, it should be kept in mind that the average maturity of public debt is still short and that financial depth is relatively low in Turkey. The significant and constant increase in public borrowing

coupled with the recovery of domestic demand might exert upward pressure on market rates and reduce the effectiveness of monetary policy. I would like to emphasize once more the importance of building a mechanism that will observe business cycles but will safeguard fiscal discipline in the medium term as well as the significance of supporting the short term fiscal easing with a concrete medium term fiscal framework.

While concluding my remarks, I would like to extend my thanks to the members of the Finance Managers Trust of Turkey, who have organized this event and to those who have contributed to it.