Minister of State and Deputy Prime Minister Mr. Ali Babacan

Global Financial Crisis and the Turkish Economy

17 September 2009

Distinguished Academicians and Participants, Ladies and Gentlemen,

It is a great pleasure to address such a distinguished gathering. At the outset, I would like to extend my heartfelt thanks to London School of Economics European Institute for this kind invitation and for organizing this event.

My remarks today come in the context of the current global financial crisis and Turkish economy. First of all, I would like to set out observations on the challenges that the global economy has faced and recent developments in the global economy. Later on I will discuss the prospects for Turkish economy and what we have done so far.

The economic and financial landscape has been shaken by an unprecedented crisis whose seeds were sown over years. In the first half of this decade benign economic environment and lax credit conditions, fostered by declining interest rates and ample liquidity, spurred excessive risk taking. Build up of huge amount of debt by financial institutions, corporations and households increased their vulnerability to unexpected shocks.

FED’s monetary policy tightening between 2004 and 2006, stoked by the inflationary concerns, ultimately drove up the mortgage rates. Following the trend reversal in the financial markets and deterioration in the demand conditions, house price appreciation halted and prices in the U.S. began to slide. Consequently, delinquency rate and foreclosures mounted and default rates on sub-prime mortgages rose to record high levels. Financial institutions that had significant exposures to mortgage related assets, especially those that have low credit quality, faced severe deterioration in their balance sheets.

Interconnectedness of the international banking system and significant exposure of major banks to complex, toxic assets transformed what started as a liquidity crisis into a solvency problem. In the aftermath of the collapse of a systemically important bank and a near failure of an insurance giant in September 2008, the financial crisis entered a new phase. Nearly all money and credit markets came to a standtill as a result of widespread confidence loss and deterioration in investor appetite. Intensifying solvency concerns triggered a domino effect. And we witnessed a series of

bankruptcies, forced mergers, and government interventions in the United States and Western Europe.

The problems in the developed markets inevitably spilled over to the rest of the world and began to undermine the real sector activities. Trade and financial linkages spread the effects of the turmoil across the globe. As a result, the world economy will undergo the deepest recession in the post-World War II era.

Against this background, policy makers have moved quickly on all fronts to respond with wide ranging and unprecedented measures. In this context, major central banks have cut their policy interest rates and pumped enormous liquidity to the financial system. Furthermore, central banks have also implemented unconventional measures such as supporting secondary mortgage markets, consumer and commercial credits, purchasing corporate and government bonds. While most emerging economies have also eased their monetary policies, some of them could not, due to pressures on their currencies and also huge external funding needs.

Along with these monetary policy measures, several financial sector policies have been implemented in order to restore confidence and rebuild stability in the financial sector. Recapitalization of the

financial institutions, establishing guarantee schemes for interbank lending, purchase of impaired assets and nationalization of some financial institutions were among the major financial sector policies implemented.

In the meantime, both advanced and emerging governments introduced substantial economic stimulus packages that include tax cuts, investment incentives and increased public spending on infrastructure projects.

G-20 has emerged as the most relevant platform to coordinate the global response. In this regard, the declaration issued at the G-20 Leaders Summit in April 2009 and the Communiqué released at the G-20 Meeting of Finance Ministers and Central Bank Governors this September, proved to be the milestones on the road to recovery. Measures taken at the global scale include;

- strengthening international financial institutions,
- supporting additional lending by multilateral development banks and backing international trade,
- and providing a strong commitment to take the steps necessary for strengthening global financial system.

Such wide ranging and unparalleled measures taken to date, across the globe, succeeded in stabilizing the financial markets and dissipating fears of a system wide collapse. We have seen several signs of improvement in the global economic and financial conditions since the G-20 summit in early-April.

Parallel to the upturn in the consumer and business sentiment, consumer spending seems to be recovering. Activity in the housing market in most of the advanced economies, after months of decline, has also shown some signs of stabilization. Inventory drawdown has gained pace as the firms adjust their level of inventories to match up the gradual recovery in demand. To sum up, recent data suggest that the rate of decline in economic activity has moderated, although to varying degrees among regions. The recovery is most pronounced in large emerging-market economies, which were not directly affected by the financial meltdown.

The pace of sustained global recovery depends on consumer spending and capital investment around the globe. The major emerging economies will fill some of the void that will emerge from higher savings both from households and businesses in the advanced economies. Therefore, it is very important to establish a

successful rebalancing of demand between advanced and emerging economies.

Notwithstanding the noteworthy progress achieved so far, most of the financial and economic indicators are still below their pre-crisis levels. Moreover, there are several challenges remaining.

First of all, maintaining fiscal sustainability is the most critical problem that needs to be addressed. Stimulus packages, financial sector rescue programs and other measures taken, have brought about deterioration in budget deficits and a subsequent rise in the public debt. For instance, European Commission[1] projects that budget deficits in 13 countries out of 16 Euro Area members will exceed the critical level of 3 percent. Also, government debt to GDP ratio will increase (by 18 points compared to 2007 levels) to 84 percent in 2010. Outlook, in this regard, is gloomy especially in the advanced economies. According to IMF forecasts, average debt to GDP ratio of the advanced economies will rise to 115 percent by 2014. All these figures highlight the extent of the problems on fiscal balances. Mounting fiscal deficits will need to be consolidated to

[1] European Commission's spring forecasts. In its interim forecast Commission did not reassess the budgetary outlook but warned that public deficits way be higher than the spring forecasts. Main reason behind this evaluation is the higher than expected decline in revenues.

bring public finance back on a sustainable trajectory. Hence, governments should establish medium-term fiscal policy frameworks in order to alleviate fiscal sustainability concerns.

Another difficulty related with the fiscal policy is the timing, design and coordination of the exit strategies. A premature exit from crisis measures may risk the recovery. Unwinding stimulus measures too late, on the other hand, may deteriorate the macroeconomic balances which in the medium-term may stoke inflationary or solvency concerns and yield higher interest rates. Therefore, we, as the policymakers, should pay great care while formulating our strategies. Summit of G-20 countries in Pittsburg and the World Bank-IMF annual meetings, which will take place in Istanbul this October, will contribute to the exit efforts of the governments and central banks.

Distinguished Guests, Ladies and Gentlemen,

Following this brief assessment of the global developments, I would like to give you a perspective about how our economy is affected and also our responses to these extraordinary challenges. Before doing so, I would like to go over the developments of the pre-crisis period in Turkey, so that we may get a better

understanding about the economic conditions when Turkey started to be affected by the current crisis.

Throughout the 1990s, rising macroeconomic imbalances, hampered our development and growth. Periods of high growth were followed by deep recessions. Large budget deficits, political instability, high inflation and interest rates were the major reasons of this unsustainable macroeconomic framework

We initiated comprehensive structural reforms in the aftermath of 2001 crisis which would sustain macroeconomic stability, improve our economy's resiliency, productiveness and efficiency. These reforms, without doubt, strengthened our macroeconomic fundamentals. Especially, the soundness of our banking sector provided a buffer against external shocks.

Fiscal discipline was the cornerstone of our economic program. We have achieved noteworthy success on the fiscal policy front. By generating high primary surpluses, budget deficit over GDP ratio fell sharply from more than 10 percent in 2002 to less than 1 percent. Subsequently, EU defined debt to GDP ratio dropped from 73 percent in 2002 to 39 percent in 2008.

Significant steps were taken in order to restructure and rehabilitate the banking sector, which was once Turkey's Achilles Heel. In this context, we strengthened the financial structure of private banks, restructured state banks and improved the regulatory and supervisory framework.

Our banking sector has achieved much healthier and more robust position through strengthening its capital structure and implementing effective risk management. In the meantime, decline in the public sector borrowing requirement, thanks to the fiscal discipline, has considerably contributed to the improvement in banking sector's balance sheet. Our banks gradually reduced the share of government securities in total assets and instead extended credits to the real sector and households.

Political stability, structural reforms, coupled with the prudent fiscal and monetary policy have paved the way for uninterrupted growth periods of 27 quarters up to the last quarter of 2008. Our gross domestic product (GDP), which was 230 billion US dollars in 2002, more than tripled and reached 741 billion US dollars at the end of 2008. Moreover, our GDP per capita almost tripled to 10,436 US dollars in 2008. This astounding economic performance achieved

in the last six years placed Turkey as the second fastest growing economy among the OECD members and now Turkey is the 17th largest economy in the world.

Determination of our government towards creating a stable economy, has attracted both domestic and foreign investors. Turkey has emerged as a top investment destination due to the elimination of bureaucratic barriers to a large extent, improvement in tax system, facilitation of profit transfers and successful privatization programs. Foreign direct investment inflows which were 1.1 billion US dollar on average between 1993 and 2002, increased gradually afterwards and reached to 20.1 billion US dollar on average between 2006 and 2008.

Economic development, financial stability and proactive foreign policy made Turkey an integral part and one of the key players of the global economic, financial and political system.

Turkish entrepreneurs' ambition in widening and strengthening their trade links with the rest of the world and their success in differentiating their products and services yielded more than a fourfold increase in the export volume between 2002 and 2008. Also a shift from labor intensive product exports toward relatively

technology intensive exports have contributed to this remarkable achievement. Total exports which were 36.1 billion US dollar in 2002 reached 132 billion US dollar in 2008.

After this short assessment of Turkish economy in the pre-crisis period I would like to discuss the effects of the global crisis and the recent situation in our economy.

The global crisis has taken its toll on the emerging markets via distorting producer, investor and consumer sentiment, deteriorating risk perceptions, adversely affecting external financing conditions and foreign demand. Majority of the emerging markets suffered a significant slowdown in the economic activity. Being an open economy, integrated with the global economic and financial system, Turkey was no exception.

Financial turmoil and slowdown in the global demand have put a brake on the Turkish economy. Starting with the second quarter of 2008, economic growth has slowed down gradually and in the last quarter of 2008 our GDP started to contract. Consequently, overall growth rate in 2008 decelerated well below the remarkable performance that we achieved between 2002 and 2007. As the global economic uncertainties intensified at the beginning of 2009,

economic slowdown deepened. However, pace of the decline in the economic activity fell in the second quarter owing to the measures that we have taken so far. After a double digit decline in the first quarter, our GDP contracted by 7 percent, on year-over-year basis, in the second quarter.

Major driver of this relative improvement was the recovery in the household private consumption which parallels the rise in the household confidence. Also inventories had a role to play. On the other hand, decline in the business investment has slowed down, yet, it may take time for the businesses to increase investment spending.

Turkey’s exports have been declining since October 2008 due to the significant slowdown in our major trading partners, especially the European Union (EU). Exports declined by 13 percent in the last quarter of 2008 and 30 percent in the January-July period of 2009. The stagnation in automotive industry and decline in machinery and equipment exports have been decisive in shrinking export performance. Moreover, contribution of iron and steel products to the growth in total exports decreased substantially due to the fall in the commodity prices.

It is worth mentioning that, both our exports and imports have experienced slumps in dollar terms. However, exports in real terms dropped by approximately 10 percent and have displayed a stable course recently[2]. Expectations pertaining to foreign demand have improved.

Consumer and producer confidence indices and many other indicators started to improve in the last few months. GDP figure and leading indicators reveal that our economy has done measurably better than most had thought and support the view that *"worst may be behind us"*.

The impacts of the global financial crisis on the Turkish economy have been fairly limited thanks to the healthy banking sector, prudent fiscal and monetary policy stance, floating exchange rate regime and strong international reserves. The main difference between the Turkish economy and its peers is that we did not transfer any public funds to the banking sector or change the deposit guarantee scheme.

The soundness of our banking sector provided a buffer against external shocks. The current crisis has pointed out that Turkish

[2] Export volume index declined, on average, by 11 percent.

banking system is in a healthy state and well functioning with its strong capital base and improved risk management system. The absence of toxic assets also prevented the sector from experiencing write-downs.

Sharp contraction in the global economic activity, weak domestic demand conditions and low level of food, energy and other commodity prices have accelerated the disinflation process in 2009. Also, significantly weaker short-run exchange rate pass-through supported the disinflation process in this period. As a result, declining trend in the inflation rate continued and inflation fell to 5.3 percent in August.

Distinguished Guests,

It is obvious that in this highly integrated global environment, the recovery from crisis depends on coordinated policy responses with other countries. Taking this fact into consideration, as an active member of G-20, Turkey is contributing to the global efforts.

Additionally, many measures have been taken by our government and the Central Bank in order to mitigate the adverse effects of the crises. Besides lowering short-term interest rates, Central Bank of Turkey resumed its intermediary role in the Foreign

Exchange Deposit Market, extended the maturity of FX deposits borrowed by the banks and reduced the lending rate. Furthermore, FX required reserves ratio was lowered and daily foreign exchange selling auctions were carried out.

To strengthen the real economy we have undertaken a series of initiatives, such as credit guarantee scheme for enterprises, as well as interventions in the sectors that are under increased pressures. In this context, we have taken immediate action to stem the rise in the non-performing loans, especially loans extended to small and medium sized enterprises. Value added tax and special consumption tax on selected products have been cut temporarily so as to boost the domestic consumption and subsequently revive the economic activities.

Regarding the labor market we reduced the financial and non-financial burdens on employers and we widened the scope of unemployment insurance payments made by the government.

Furthermore, we announced a new investment incentive scheme which is quite comprehensive. It involves reduced corporate income taxes, low employment taxes and allocation of treasury land for those investments which will start before the end of 2010.

On improving innovative capacity, one of the most important steps that we have taken was the introduction of a new and comprehensive Research and Development (R&D) Law in 2008. With this law, we aim to accelerate both foreign and local R&D investments and develop a more conducive environment for innovation.

Positive impacts of these measures have already been observed on the economy and are expected to continue in the upcoming period. Both our own forecasts and international institutions' forecasts confirm that, the Turkish economy will return to its high growth trajectory once the global economic conditions improve.

Distinguished Guests, Ladies and Gentlemen,

Macroeconomic policies must be guided by a medium-term compass since short-term effectiveness of these policies will depend on medium-term credibility. Exit strategies, in this context, will be needed so as to shift the policy priorities from extraordinary short-term supports to sustainable medium-term frameworks.

While focusing on mitigating the threats posed by the crisis, we are not losing sight of the long-term vision. With this in mind we

have taken necessary measures that will strengthen Turkey's macroeconomic fundamentals. In this respect, after long weeks, days and hours of discussions and meetings, we have finalized our work and announced our Medium Term Program. This program, which covers the 2010-2012 period, outlines our fiscal targets for the following three years, exit strategy and forecasts of major macroeconomic variables.

Current juncture requires us to design a fiscal exit strategy and speed up the implementation of structural reforms. Measures and reforms, within the context of the Medium Term Program, first and foremost will put budget balances back on track. Moreover, the reforms will enhance our economy's resilience to external shocks and improve our economy's competitiveness.

Main purpose of this program is to establish a framework that will enable us to achieve a sustainable growth rate in the aftermath of the exit from the crisis and to raise our society's welfare.

Also, in this program we have revealed our forecasts pertaining to the key macroeconomic variables.

Considering the weakening in the domestic and external demand conditions as well as tight external financing, we expect

Turkish economy to contract by 6 percent in 2009. Since it will take time for trade flows and global economy to rebound, recovery in economic activity will be gradual. Our forecasts reveal growth rates of 3.5, 4 and 5 percent for the period 2010-2012, respectively. In parallel with this growth perspective we expect that employment will increased by 1.25 million over the following three years. This translates into a 1.5 point decline in the unemployment rate by 2012 compared to the expected level of 14.8 percent in 2009.

On the fiscal front we are targeting a gradual improvement. Budget deficit is expected to close this year at 6.6 percent of GDP while declining gradually to 3.2 percent in 2012. Public debt to GDP ratio, on the other hand, will peak at 49 percent in 2010, stabilize by 2011 and start to decline in 2012.

We have defined several medium term goals in this program. To mention some of them;

- supporting private sector led growth by eliminating any obstacle on their resources and increasing predictability in the economy;
- increasing competitiveness and flexibility of the economy through necessary structural reforms;

- maintaining sustainable growth rate through taking advantage of both socially and economically strong sides that Turkey possesses.

We have established macroeconomic priorities and a comprehensive structural reform agenda in order to achieve these medium term goals. For instance, we will try to converge the growth rate gradually to its potential, create jobs, maintain downward trend in the inflation rate and improve the public sector balances which have deteriorated due to the financial crisis.

Among the main pillars of the medium-term structural reform agenda, related to public finance, we have developed a fiscal rule. By adopting that rule we will attain a long-term sustainable fiscal position both in terms of debt stock and budget deficit. Last but not least, fiscal discipline mentality will be sustained permanently.

While concluding my remarks I would like to thank you for your attention.