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THE GLOBAL FINANCIAL CRISIS AND TURKEY

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Keynote Address

by

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Thank you very much for inviting me to speak at this important meeting of Tusiad's High Advisory Council. I am delighted to be in your beautiful country once again. Everyone's attention is understandably on the global economic crisis, which is having profound repercussions here in Turkey. I hope we can have a bit of an exchange around this so I can hear from you first-hand. I also know this must be a tense time. One of the jokes doing the rounds is about this banker whose friend asks him how he is sleeping at night. "Like a baby," he replies, to which his friend says, "That's amazing, in the midst of all this turmoil." "Yes," replies the banker, "I wake up every hour and then cry myself back to sleep!"

1. How do we see the impact of the global crisis on Turkey?

As you know better than me, Turkey is no stranger to macroeconomic crises and volatility. During the last crisis, which came to a head in 2001, gross public debt climbed to 80 percent of GDP, output fell by a huge 6 percent and several banks had to be taken over by the Savings Deposit Insurance Fund. You must be wondering, "Why is the she dwelling on those gloomy past events? Isn't the current crisis bad enough?" **My main reason for doing so is to acknowledge the remarkable resilience which Turkey has displayed during the current global crisis.** Far from being an accident, this resilience is a direct result of the difficult reforms implemented after 2001—ramping up primary fiscal surpluses to pay down debt, building up foreign exchange reserves to provide a buffer against shifting market sentiment and adopting

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flexible exchange rates to lower incentives for one-way bets and currency mismatches. Not only did these reforms restore the credibility of macroeconomic policy, they at last gave Turkey's private sector the stability needed to make long-run investment decisions with confidence. **The one thing we know is that such credibility is neither instantaneously nor permanently achieved**; I talk from experience, having had the challenge of implementing fiscal and structural reforms in my own country as Minister of Finance in the second Obasanjo administration from 2003-06, against a three-decade-long legacy of bad governance and fiscal profligacy.

Returning to the current crisis, as you know, it originated in the financial sector of the US and spread like wildfire as a result of financial globalization and securitization. **The most important channel from this global crisis to the Turkish economy is the sharp decline in world trade in goods and services.** Turkey is an open economy: trade is more than 50 percent of GDP, and exports in 2008 were nearly a quarter of GDP. More than half of Turkey's exports go to the EU, which as you know is mired in a deep recession. And Turkey's exports, much like those of many other countries including those in East Asia, have fallen by about a third compared to a year ago. So while past crises in emerging markets originated in developing regions – Latin America, Russia, East Asia – and the richer export markets could potentially provide a way out after currency depreciations, this crisis is different. Not only, as many in Turkey have pointed out, is it not of your making. But also, unfortunately, since it is a truly global crisis, exports will be insufficient for a full recovery in the near term.

Turkey entered the current crisis with a relatively high level of private external debt and a large current account deficit. So the global crisis has also affected Turkey through financial channels: a decline in private external capital flows and a crunch in trade finance. Investment and credit flows had already declined throughout 2008 and portfolio flows turned broadly negative in mid-2007, with 5 billion dollars leaving in 2008. Still, notwithstanding the intensification of the crisis after the September collapse of Lehman Brothers, the corporate sector was able to keep refinancing its external debt obligations in October and November, as was the banking sector. Only in December did Turkish corporations start paying back, in net terms, to the rest of the world. And after an initial depreciation of about 25 percent in October, the lira has withstood pressures from the repayment needs of Turkish corporations and banks, with reserves declining by a relatively small 9 billion dollars since last September.

Now a third channel is becoming evident: the feedback from real sector performance to the financial sector and the fiscal accounts. Falling exports and output are being transmitted to fiscal revenues, which have also fallen and the fiscal deficit is expected to exceed 6 percent of GDP this year with a primary deficit for the first time in many years.

Turkey has not suffered as much as some other countries from effects through the two main other channels of transmission of the global crisis: balance sheet effects in the financial sector where large currency or maturity mismatches have amplified the effects of the crisis as in some Eastern European countries but not in Turkey; and remittances, which are not an important part of the Turkish economy.

And on the plus side, Turkey has benefited considerably from the "good housekeeping" it did in response to the 2001 crisis. The banking sector is well capitalized and boats a solid balance sheet. And after years of growth combined with fiscal prudence and strong improvements in public debt management, the ratio of gross public debt to GDP was slashed to just below 40 percent at the end of 2008, with a much more favorable composition.

The textbook response in such circumstances is to compensate at least partially for the decline in aggregate demand through an increase in the fiscal deficit through a combination of so-called automatic stabilizers and discretionary increases in spending. The limits for emerging market countries are defined to a large extent by holdings of foreign exchange reserves and inherited public indebtedness and creditworthiness. **A temporary deterioration in the fiscal accounts as is expected in Turkey may not only be unavoidable but also desirable to soften the impact—provided the government charts a credible path to medium-run sustainability.** This means that public spending and guarantees need to be slanted towards bolstering confidence in solvent banks and resuming the credit flow to sound enterprises as well as towards the protection of the most vulnerable and investments which will support long-run growth. **This is a highly relevant agenda for Turkey.**

2. **What can we expect for the rest of 2009 and 2010 and What is the Bank Group Doing?**

Let me now address the question of what we can expect until the end of 2010 with the caveat that we live in highly unpredictable times. Having acknowledged Turkey's commendable resilience, it also needs to be said that we are not out of the woods yet… Particularly in the latter part of this year, Turkish corporations will have to pay debt obligations of between 3 and 4 billion dollars each month. As long as "errors and omissions" – balance of payments inflows unexplained by the usual categories of debt and equity inflows – can keep up their recent performance, this poses no problem! I would be interested I hearing your views in whether this can be the case.

The export-driven slowdown is having highly differential impacts across Turkey, with manufacturing sectors and the workers in those sectors really suffering, especially the automotive industry, machinery, shipping, textiles, and apparel. This translates into very different patterns across Turkey's major cities. At the end of 2008, with unemployment averaging 11 percent in Turkey, cities as far apart as Trabzon (*pronounced as written, trAbzon*) in the northeast and Canakkale (*chanAkaley*) in the west had unemployment rates around 6 or 7 percent. At the same time, Adana (*adanA*) and Gaziantep (*gAzi-Antep*) had open unemployment rates of 16 or 17 percent. These differences will not have diminished in the current downturn. And among workers, the statistics show wage-earners with lower levels of skills and education have been the hardest hit. [I want to stress that it is also of considerable importance to assess the impact of the crisis on women in the workplace, as they typically constitute a vulnerable group.]

The social impact of the crisis is not going to be easy to manage; higher unemployment and falling wages create budget strains at exactly the time that tax revenues are falling and it is hardest for government to meet the increased needs. Budgeting and public sector efficiency gain added importance. Moreover, our own analysis at the Bank suggests that those working in the informal sector are among the most vulnerable to falling incomes and consumption. Some one-half of those at risk of falling below the poverty line are urban, informal workers, who are not registered by their employers, do not contribute to social security, and typically do not receive any social assistance from public programs. [Overall, it is of vital importance to protect the most vulnerable during this crisis, as experience from all over the world shows that this group has the thinnest cushion to cope, with the result that big crises tend to have permanent negative effects on them in terms of malnutrition and the cognitive development of small children. And in the longer run, improving the quality of education, especially for young women. This is a fundamental development challenge recognized the world over.]

At the global level, the news is mixed.

There is evidence of a financial thaw in the world—in interbank markets, stock markets and developing country government bond markets. Export volumes have started to pick up slowly. And emerging market equities have staged a remarkable rally in recent months. As Peter Orszag, the Director of the White House Office of Management and Budget recently said with reference to the US, “The freefall in the economy seems to have stopped.”

But I don’t think one can hold out much hope for a quick recovery – the longed-for “V-shaped” recession; however, with the fears of another Great Depression fast receding, we can at least set our sights on a “U” rather than an “L” shaped recession. Nevertheless, any recovery this year will remain weak, with Japan, the Eurozone and the US all registering sharp contractions in output—although the IMF has only this week upgraded its growth forecast for the US for both this year and the next.

The World Bank’s forecasts for 2009 have been lowered yet again with global GDP now likely to register a fall of some 3 percent. High income countries are expected to contract by 4.5 percent and low-income countries to grow just by a little over 1 percent compared to 6 percent in

2008. For the Eastern Europe and Central Asia Region we now expect a decline in GDP in 2009 of about 5 percent to be followed by a relatively weak recovery of about 2 percent in 2010. It will not be until 2011 before we see the kind of growth rates we saw in 2007.

In addition to a slow recovery in its main export markets, the virtually unprecedented, global nature of the current crisis poses novel challenges for countries like Turkey. The first is the very real possibility of being "crowded out" from the international capital markets by the advanced economies as their governments borrow on a large scale either for fiscal stimuli or helping their own financial institutions. And the second relates to provisions to "buy national" in the fiscal stimulus plans of the rich countries, which could have protectionist consequences. In fact, most of the 19 countries in the G20 had taken some protectionist action between the Washington meeting last November and the April 2009 meeting held in London and this is certainly a key challenge for the G20, of which Turkey is a member.

But probably the biggest challenge stems from the uncomfortable reality that global confidence crises, such as the one we witnessed after the September collapse of Lehman Brothers, tend to have a disproportionate impact on emerging market countries **EVEN when there is no deterioration in the economic fundamentals of the emerging market country. This is something to watch out and prepare for.**

What is the Bank Group doing to help?

The World Bank's goal is to help its member countries protect the most vulnerable, maintain long-run infrastructure investments and sustain the private sector, including through the financing of SMEs and microfinance. For middle-income or emerging market countries, IBRD expects to lend some $100 billion over the next three fiscal years. In the fiscal year which is about to conclude, IBRD will have lent $34 billion compared to a standard amount of $15-19 billion per year. Following the spring meetings, the demand for IBRD loans is expected to amount to some $50 billion; as you can imagine, these number are unprecedented and fully responding to the increased demand is very likely to require a capital increase for the World

Bank. For Turkey, we have lent approximately $2 billion in fiscal year 2009 compared to a normal volume of $1-1.5 billion. **And for low-income countries, we expect to do over $40 billion over the next three years with a similar focus as in the middle-income countries but with an enhanced focus on vulnerability through a new vulnerability financing facility.**

IFC has launched a broad set of initiatives to help private enterprises cope with the global crisis, with financing expected to total more than $40 billion over the next three years. The initiatives aim to counter the sharp contraction in trade credit both by working through global and regional banks to **extend trade finance** to importers and exporters in developing countries and by **providing guarantees for trade transactions**. **Turkey is benefiting from both the preceding programs.** IFC has also launched initiatives to invest in the banking sector through a $3 billion **IFC Capitalization Fund** launched with the Japanese Bank for International Cooperation. And a $2 billion **Infrastructure Crisis Facility** is being finalized in partnership with the German and French Governments to support viable infrastructure projects that can pave the way for strong economic growth once the crisis is over. A $500 million facility launched with German development bank, KfW, aims to provide credit for micro enterprises which are essential for reducing poverty and creating jobs. **You will be able to obtain more information from our IFC office in Istanbul on these initiatives.**

3. Preparing for the post-crisis world

Let me now move to the topic of how best to prepare for the post-crisis world.

Dani Rodrik of Harvard University (who hails from these shores) is one of several economists who has emphasized that the post-crisis economy is likely to be, for some time at least, a <u>less globalized</u> economy than that of recent years. Barriers to trade may make something of a political comeback (despite our common recognition of their undesirability from a welfare perspective), but most importantly, there will be greater risk aversion in capital markets and finance will therefore flow less readily across borders, and especially towards emerging markets.

This means that while exports will still be important, competitiveness in export markets may be even harder to achieve and to maintain, as competition for those markets becomes more intense. This places a premium on addressing administrative and regulatory frameworks that impede private-sector competitiveness.

Another important implication is that emerging markets will have to make do with less capital from abroad. This means that to maintain the rates of growth, social progress, and poverty reduction that countries like Turkey have grown accustomed to, they will have to shift their own balance towards domestic saving and away from consumption. Turkey's national saving rate is low, at about 16 percent of GDP, leading to reliance on foreign saving and corresponding current account deficits and external debt to finance national investment.

The public sector can contribute to growth in a savings constrained world in two ways. First, it can save more itself. The evidence is very strong that when governments cut their *consumption*, in the long run, private investment and growth benefit. Second, the public sector is also an important investor, in infrastructure and in human beings via education, health and social protection programs. The public sector can carry out these investments *more efficiently* than before and this – plus the agenda of public sector management – will also gain in importance in the post-crisis world economy. There is a third, subtler way in which the world is changing as a result of this crisis, related to climate change. Many of the investments that are being supported by governments' fiscal stimulus packages the world over are "green"; more than a half of South Korea's package is being directed towards areas such as energy efficiency and clean technology and the US and the UK are also pursuing these areas as part of their crisis response.

4. What does all this mean for the specific case of Turkey?

To prepare for the post-recovery world, these changes at the global level in my view imply four priorities for Turkey: (1) increasing domestic savings; (2) turning legislative and institutional public sector reforms to date into greater value for money in public services and infrastructure; (3) further strengthening the private investment climate; and (4) taking on greater regional and global leadership. Let me speak briefly about each of these areas.

Even before the crisis hit, Turkey was a country where domestic saving was one of the factors constraining economic growth and social welfare. In recent years, as the economy grew faster, foreign savings were sucked in. Fortunately, these inflows did not lead to currency mismatches in the banks or households in Turkey. Another big plus as you know is that the capital inflows were mainly used for investment rather than consumption. Of course increasing savings, either for the government or for households and firms in the middle of a demand-constrained crisis is not an optimal strategy; this is the rainy day for which the economy saves! But in the post-crisis world the saving challenge will gain in importance. Turkey must make sure that the spending measures taken in the public sector are not locked in but are temporary and targeted towards infrastructure and protecting the most vulnerable. And by building secure financial systems in which households are readily willing to save when growth returns. **Turkey succeeded the last few years in passing a suitably ambitious legislative reform package on its social security system and is following this up with effective secondary legislation and implementation.** This is a wise investment in the future: social security reform is one of the most effective ways of raising national saving in the long run.

Second, on the public investment side, Turkey has built a firm base of improvements in public sector management institutions, legislation, and systems. Our team works closely with your government on these reforms. But again, as I have underlined, the post-crisis world is likely to raise the stakes.

Third, Turkey can certainly have an edge in the post-crisis world provided it accelerates private sector development. In recent years, Turkey has moved from 93 out of 181 in the overall “Doing Business” rankings produced by the World Bank in 2006 to 59 this year. But as you all know there are reforms pending that may not have taken a front seat during this global crisis. Tax reform as well as reforms to the Commercial Code and in capital and labor markets regulation would all enhance the competitiveness of Turkish companies in the medium term. Some of these reforms could happen now and help during the crisis, for example, allowing short-term and part-time labor contracts – and indeed the most recent employment package announced by the government has taken steps in this direction.

Fourth, Turkey is well-prepared to assume an even greater leadership role, regionally and globally. Large Turkish companies are increasingly at the global cutting edge of their industries; they will increasingly be able to invest in lower-income economies to leverage their knowhow and reach new markets. For example, Soktas (So-oktash), which supplies high-end shirting fabric for some of the biggest brand names in the world, is investing in an eighty million dollar greenfield project in Kolhapur, India – in which I'm happy to say IFC is playing an important financing role. **You know that the support of the World Bank Group, in particular of the IFC and MIGA, is on hand to help Turkey take advantage of such opportunities.** I would encourage you to look farther afield, to Sub-Saharan Africa for example, where improving governance and rising macroeconomic and political stability are likely to create profitable investment opportunities. **And finally, let me come back to the prizes on offer to those countries that are first and boldest in the area of climate change, energy efficiency, and renewable energy.** Turkey is pursuing a long agenda of reforms in the energy sector, freeing prices, privatizing distribution, increasing capacity, and investing in renewable sources and efficiency improvements. Moreover, in February Turkey ratified the Kyoto Protocol to the UN Framework Convention on Climate Change.

The World Bank Group has been a close partner with Turkey on this path. We recently approved a loan of 800 billion dollars to support regulatory and policy reforms in the electricity sector and IFC recently invested in a 135 MW wind farm: the largest of its kind in Turkey. The World Bank is working with the Turkish government to make Turkey the first country to use the funds of the new Clean Technology Fund, administered by the Bank. This is a landmark achievement and underlines Turkey's potential leadership in this area.

Let me conclude by returning to the theme I began with: that Turkey is no stranger to economic crisis and indeed has developed valuable crisis-management skills by dint of its past experience. As a result, there is a solid foundation for agreement between the government and the private sector about what needs to be done—in response to the crisis as well as following it. As Lawrence Summers, Director of the National Economic Council in the US noted in a recent speech, "There is one ineluctable lesson of the history of financial crises: they all end."**… Therefore, even now when there is a natural temptation for horizons to shorten, it is vitally important for policymakers and the private sector to step back and assess the fundamental long-run strengths and weaknesses of the economy.** Priorities in the post-crisis world would need to center around (*i*) increasing domestic saving; (*ii*) improving public-sector performance and value for money; (*iii*) enhancing private sector competitiveness and improving the investment climate through the structural reforms I listed earlier including tax and labor market reform; and: (*iv*) building innovative investments in clean and efficient energy. These reforms will serve as a spring board for high long-run growth and an enhanced regional and global role for Turkey. **And let me add a corollary to Lawrence Summers' observation: that, when the next crisis occurs as inevitably it must some time in the future, Turkey will be ready.**

Once again, thank you for inviting me to deliver this keynote address in this beautiful historic city of Bodrum. I firmly believe that Turkey is well-positioned not only to ride out this global crisis, protecting its most vulnerable as it does so, but to take advantage of the opportunities that the post-crisis recovery will offer. And I wish you, the representatives of Turkey's private sector, famed for its dynamism and resilience, great success.

Thank you.