Durmuş Yılmaz: Global crisis, restructuring and national transformation

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the Forum Istanbul, Istanbul, 20 May 2010.

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His Excellency Deputy Prime Minister Babacan,
Distinguished Guests,

At the outset, I would like to thank Mr. Canevi for his kind invitation. It is a great pleasure for me to participate in this conference where we will discuss the future of Turkey in a global context.

I will start my talk with a brief review of imbalances in the global economy, which have ultimately led to the recent global crisis. Then I will discuss the evolution of the main mandates of central banks from a historical perspective. Finally, I will conclude my speech with some remarks on the future of central banking in the post crisis period.

Dear Participants,

Any elaboration on a new global story must start with an understanding of the roots of the current crisis. I believe it would be appropriate to analyze these factors under three headings.

The first one is the global macroeconomic imbalances. In the pre-crisis period, the consumption in the US and several advanced economies was excessively high, which was matched by high savings rate in the South East Asia (due to capital controls and downward pressure on wages) and also in oil rich countries (due to low public investment on infrastructure). One striking consequence of these macro imbalances was the financing of the private spending in rich countries by households in relatively poor emerging economies. To put it another way, excessive reserves accumulated in emerging economies through high current account surpluses flowed back to financial markets of advanced economies, which enabled households in these countries borrow beyond their means.

Despite rapid growing domestic demand and acceleration of commodity prices, global inflation remained subdued for a considerable period of time since surplus countries kept their labor cost under control to sustain their competitiveness in global markets. Therefore, price stability oriented central banks in advanced economies saw no reason for a strong monetary tightening and stayed idle as their economies dangerously overheated.

Second reason for the global crisis was the unprecedented amount of liquidity created in the global financial system. Innovations in financial engineering and technological advances facilitated the emergence of new and complex financial products, which in turn led to a massive growth in liquidity in advanced economies, well beyond the intention or control of central banks. High leverage ratios in financial institutions also played a significant role, thanks to creative accounting practices and lax regulations. Ample global liquidity coupled with low interest rates and excessive rise in asset prices fueled the rapid growth in the indebtedness of households.

As a final element, the institutions responsible for regulation and supervision of financial institutions failed to keep up with the extremely innovative, deep and complex nature of the financial markets. Ineffective regulation of financial markets led to unrestrained growth in global liquidity, rising indebtedness ratios and formation of systemic risks in financial markets. Lack of transparency in financial transactions blurred the boundaries of who owes what to whom, preventing the proper valuation of risks. Failure of credit rating agencies, inadequacy of risk assessment methods in addressing systemic risks and pro-cyclical accounting standards overtook prudential measures.

To put a long story short, if you look for a snapshot of the roots of this crisis in one simple statement, it is nothing but "***households consuming the present value of their future wealth, which they do not actually possess in the first place***".

In the aftermath of this crisis, households have increased precautionary savings to cover their debts and clean their balance sheets. This has caused a very sharp negative demand shock, especially in advanced economies. Furthermore, a significant part of the real sector was not able to pay off their debt leading to large-scale write-offs in the financial sector. In response, governments have both increased public spending to offset the fall in domestic demand and bailed out troubled financial institutions to prevent the collapse of the financial system. In other words, they have acted as both "***consumer-of-last-resort***" and "***lender-of-last-resort***" at the same time.

By doing so governments have prevented a repeat of the Global Depression that we experienced in the 1930s. As you may remember, at that time governments and central banks stood back as the private demand collapsed, leading to a downward spiral in the world economy, "beggar-your-neighbor" type of economic policies and protectionism that prolonged the depression well into the 1940s.

We did not repeat the same mistakes, but maybe we have committed in new ones. Fiscal stimulus packages and bailouts of financial institutions have caused budget deficits of epic proportions, skyrocketing the public debt ratios. The events of the last few weeks have demonstrated that governments, especially in advanced economies, face the risk of contagion of the financial crisis to public finances in the form of sovereign default.

In other words, the global crisis, which started as a financial crisis in mid 2007 has evolved into a sovereign debt crisis in 2010.

Today, there is a consensus among policy makers that in order to put the global growth on a strong, sustainable and balanced path, high debt economies should implement fiscal consolidation, which is both financially ambitious and politically feasible, while countries with low debt should implement policies that stimulate domestic consumption to offset the fall in global demand. One fundamental reason of high savings rate in developing countries is the weakness of safety nets (in employment, retirement and healthcare) and the lack of well-established financial institutions that serve the needs of households facing budget constraints. If safety nets and credit markets in developing countries were established, households would be able to raise their consumption.

There are also calls for establishing new global mechanisms to address the concerns of emerging market economies regarding FX liquidity, which has led to accumulation of high amount of FX reserves through capital controls and intervention on exchange rates to keep local currency undervalued. Of course, relaxing capital controls and gradual adoption of more flexible exchange rate systems should also be part of this package to achieve successful reorientation of global demand from advanced economies to emerging market economies. Last but not least, all countries should undertake necessary actions to repair, restructure and reform their financial system. Necessary structural reforms in product and labor market should also be a top priority to increase potential growth rates and reduce permanent unemployment.

Dear Guests,

Now let me turn to responsibilities of central banks and elaborate on their evolution over time.

Until recently when you asked the primary mandate of central banks, the typical response would be price stability. However, the history tells us that central banks were founded for quite different reasons in many countries. For instance the Bank of England was founded in the 17th century to cover the financing need of the British Government during its war against France. Likewise, Bank de France was created in the 19th century during the Napoleon Wars against the Great Britain. These institutions had the privilege of issuing banknotes in

exchange for providing funds for treasuries. In other countries providing stability in financial markets was the paramount concern. For example, the need for a lender of last resort following panics and crashes during the early 20th century led to creation of the Federal Reserve system in the US. The Central Bank of Turkey, on the other hand, was founded both as a symbol of national independence and to stabilize seasonal fluctuations in financial markets due to nature of agriculture-based economy.

The concept of price stability was not brought to the foreground during the initial stages of central banking, because there was not much concern for inflation in many advanced economies. The value of money was well-protected thanks to the use of gold standard. As Friedman once said, "***Inflation is always and everywhere a monetary phenomenon***." Therefore, there would be no permanent inflation as long as long term money supply expands in parallel to long term money demand. In this context, inflation concerns were kept in the background in many countries under the gold standard during the 19th and most of the 20th century. With the collapse of gold standard after the Great Depression and its successor (the Bretton Woods System) in 1973, we have entered the era of fiat money. In the absence of a solid anchor like gold, the only mechanism left behind to support the value of the fiat money was the credibility of central banks. This brought out the issue of price stability in the foreground of central banking.

Our initial experience with fiat money was not promising. In the late 70s, many countries including advanced economies experienced rapid monetary expansion and as a result very high inflation rates, in many instances in double digits. 1981 was the turning point of central banking. The Federal Reserve, under the leadership of its chairman Paul Volcker, engaged in a very tight and painful monetary tightening, despite the harsh criticism from the US administration and the real sector. As inflation rate in the US gradually declined to low single digits, the Federal Reserve earned the reputation of an uncompromised inflation fighter, which gradually extended to other central banks in advanced economies as well. This was also the period in which many central banks gained operational independence. Over time it became a conventional wisdom among policy makers that the most important and long lasting contribution of central banks to long term growth and financial stability is to establish and sustain price stability.

As the issue of financial stability has gained critical importance during the recent global crisis, central banks are asked to address directly not only price stability but also financial stability as well. As I explained before, to maintain smooth functioning of the financial system has been a concern of many central banks since their foundation.

In fact, that is the reason we are called as "***the bank of banks***" or "***the lender of last resort***" for financial institutions. However, over time as the financial system get more complicated and expanded exponentially, its supervision and regulation has been partially transferred to other institutions, which is also the case in Turkey.

The challenge faced by central banks is to establish a framework that combines both price stability and financial stability as primary mandates even at times they conflict with each other and identify the policy instruments to target both. As you know central banks have typically used short-term interest rates as their primary policy instrument. However, the "Tinbergen Rule" suggests that this one instrument could be deployed to achieve only one target, which is conventionally recognized as price stability. Addressing both price stability and financial stability simultaneously necessitates a second set of policy tools. This second instrument may be in the form of the supervision and regulation of financial activities. The question is that whether these responsibilities should be assumed solely by central banks. The downside of this option is that central banks may turn out to be too big, inflexible and in conflict with themselves, which eventually led to failure in both objectives.

Dear Participants,

Prior to the global financial crisis, central banks were conducting monetary policy through conventional banks and use government bonds in open market operations. However the

financial crisis led central banks employ a wider range of securities, ranging from corporate bonds to asset backed securities and mortgages. The reason behind this transformation was obvious. Thanks to financial engineering and innovative products, only a small portion of financial institutions' assets is in government securities. Therefore, asking for government securities as collateral in open market operations would no longer provide enough liquidity to the financial system. In the meantime, as banks have lost their dominance in the financial system, corporations and non-bank financial institutions have joined the conventional banks as the counter parties of central banks in market transactions.

The question in this context is (1) whether the innovative policies we have seen in the last year will lead to longer-term changes in central banking doctrine and behavior, (2) whether in parallel to new developments in financial structure central banks will adopt a more flexible approach in operational practices, and (3) maybe more importantly whether central banks will maintain their influence in the financial markets, which has grown rapidly due to extraordinary actions during current crisis?

These are important questions to discuss and I hope this conference would provide new insights to policy makers as we sail through uncharted waters.

While concluding my remarks, I would like to extend my thanks to the members of the Forum Istanbul, who have contributed to the constitution of constructive criticism environment that I perceive as an important element in building the future of Turkey.

Thank you for your attention.