

## **Erdem Başçi: Financial and macroeconomic stability**

Speech by Mr Erdem Başçi, Governor of the Central Bank of the Republic of Turkey, at a conference on “Financial and macroeconomic stability”, organised by the Central Bank of the Republic of Turkey jointly with the Central Bank of Brazil, the Bank of Finland and the Journal of Financial Stability, Istanbul, 4 June 2012.

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Distinguished Guests,

Welcome to the conference on Financial and Macroeconomic Stability, organized by the Central Bank of the Republic of Turkey jointly with the Central Bank of Brazil, the Bank of Finland and Journal of Financial Stability. In November last year, we organized yet another conference on Financial Stability and Inflation Targeting, with a focus on financial stability. Country experiences since then have shown once more how costly it would be economically and socially if and when financial stability is neglected. Therefore, financial stability is of utmost importance for policymakers in attaining macroeconomic stability. As a matter of fact, this conviction, which is also supported by international platforms such as G20, IMF and BIS, has not only raised several new questions regarding the design and implementation of monetary policy, but also proposed a new research agenda in the academic literature.

Esteemed Participants,

Sustainable growth, low inflation, steady employment growth, low levels of unemployment and a balanced public finance can be listed as the main indicators of macroeconomic stability. Although economists were aware of the significance of the above listed for social welfare, financial stability had been in the back burner before the global financial crisis of 2008–2009. With the onset of the crisis, the importance of financial sector came to the forefront and it was understood that the costs will be immense if the instability in the financial sector spreads to the real sector. Therefore, in the period ahead, maintaining macroeconomic stability and financial stability concurrently remains a major challenge for policymakers. New policy tools and new policies might be needed to achieve both stability targets. In this context, I believe that the conference on “Financial and Macroeconomic Stability” will provide a significant contribution to policymakers.

Distinguished Guests,

Excessive volatility in macroeconomic aggregates, namely production, employment, budget, foreign trade and inflation, might impair the distribution of income and assets, and reduce the welfare of that society. It is therefore of utmost importance to achieve macroeconomic stability and to sustain the welfare of the society.

Financial stability is crucial in providing an effective mechanism for the transfer of the economy’s resources from savers to producers. An effectively-functioning financial system will ensure balanced distribution of risks and decrease the susceptibility of the economy to shocks. Otherwise, financial crises will disrupt real sector production and the economy will suffer sizeable loss of welfare. Thus, instability in the financial sector will jeopardize macroeconomic stability. As a striking example to this argument, we can mention the 2008–2009 global crisis that was triggered by the financial sector and paved the way to deteriorating macroeconomic indicators such as production, employment, unemployment and budget balance in many countries. We need to underline the fact that financial stability is also crucial for the economies of developing countries as well. During the convergence process, these countries experience rapid financial deepening and integration with global financial markets, as a result of which financial transactions become an indispensable part of economic activity. It is essential for a sound economic outlook in these countries that this process is managed effectively and risks likely to arise from the financial sector are predicted so as to contain their potential effects on the economy.

Another potential threat to financial stability is the international capital flows. Free flow of capital enables it to contribute to the growth prospects by moving where it is the most efficient. Yet, when capital flows are not stable, economies are likely to face severe damage. While on the one hand, the surge especially in short-term capital inflows ensure easier access to credit and boost consumption; on the other hand, they lead to over-appreciation of local currencies and thereby widen the imbalance between domestic and external demand. Overall, this leads to deterioration in external balance and increases the domestic economy's susceptibility to sudden changes in global risk appetite, and in turn, poses risk to macroeconomic and financial stability. In economic literature, capital outflows following the developments of this kind are called "sudden stops". Turkey and many other developing countries have occasionally experienced such sudden stops. Keeping excessive volatility and international capital flows under control is crucial for financial stability. In this respect, macroprudential measures stand out as an important tool.

The monetary, fiscal and financial sector policies adopted by advanced economies in the wake of the global economic crisis exposed even open developing countries with sound economic fundamentals to financial instability risk. The Central Bank of the Republic of Turkey, in view of this risk, safeguarded both price stability and financial stability simultaneously by adopting a flexible monetary policy, and thus contributed to the sustainable development path. In addition to the flexible monetary policy strategy implemented by the Central Bank as of the end of 2010, the prudent measures adopted by the BRSA accompanied by the safeguarded fiscal discipline strengthened the Central Bank's hand. We firmly believe that we will attain very positive results with respect to price stability and financial stability by the end of 2012.

Along with national macroprudential measures introduced by countries, some international criteria have also been developed for the sake of safeguarding financial stability. For example, the Basel III accords bring about new arrangements reinforcing the capital structures of financial institutions. These arrangements will ensure a more resilient financial sector against unforeseen risks and will contribute to financial stability. The recent efforts clearly point to a consensus among countries on the critical importance of safeguarding financial stability.

Despite the consensus among policy-makers on the importance of financial stability, the economic literature lacks adequate theoretical and empirical studies on the details of the transmission mechanism from financial stability to macroeconomic stability. At this point, academia is expected to do their share in this respect.

The two-day conference will stage parallel sessions, panel discussions and presentations on these issues. Banking sector dynamics, macroprudential measures and their impact on macroeconomic stability, systemic risk issue and sovereign debt dynamics are among the topics that will be addressed at the conference. Two of our distinguished guests, Mr. Ricardo Caballero and Mr. Franklin Allen, will be delivering speeches. Mr. Caballero will be presenting a speech on the first day of the conference and Mr. Allen's presentation is scheduled for the second day. On the second day of the conference, the panel discussion titled "How did the crisis challenge the Central Banking as we knew it? What should (not) change?" will be held, at which senior central bankers will be sharing their country experiences. I think this panel discussion will be very interesting and beneficial for all the participants.

The studies that will be presented throughout the conference will contribute to better understanding of the factors threatening financial and macroeconomic stability and developing policies to achieve these two objectives simultaneously. I believe that the conference will also serve as a forum for the participants for exchanging views. In this respect, I would like to thank the organization committee for their efforts in bringing these very interesting and enlightening studies under this conference. I wish the conference a complete success and I would like to thank all our guests for their participation.