Durmuş Yılmaz: Green shoots – how vigorous and how sustainable?

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the Conference on "Green shoots – how vigorous and how sustainable", IMF-World Bank Annual Meetings 2009, Istanbul, 5 October 2009.

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Ladies and gentlemen,

First of all, I would like to welcome everyone to Istanbul. It is a great pleasure for me to be here addressing such a distinguished audience as we convene for the 2009 Annual Meetings.

"Green shoots" has been a popular metaphor to describe the recovery process. And today, I will try to elaborate on our path to build a career as a prudent gardener. I want to begin with discussing the path that brought us to this crisis. Then, I will talk about the recovery signals in both global and Turkish economy. I will conclude my speech with my thoughts on the solidity and sustainability of these signals.

As is well known, financial strains originated in advanced economies abruptly mutated into a full-blown crisis and had a devastating effect on international capital markets. As the crisis intensified, measures of perceived risk escalated to record levels and major financial institutions suffered massive losses. At the same time, liquidity shortages, tighter credit conditions, and heightened uncertainty were associated with a sharp decline in both private consumption and investment spending. In fact, many economies fell into recession or have seen their growth rates decline sharply. As a consequence, global trade contracted, financial flows dried up, and unemployment rates soared.

The global financial system is still under stress; but one can see some signs of recovery in the global financial markets and economic indicators around the world. Unprecedented policy reactions to the crisis taken by governments and central banks worldwide have managed to stabilize the financial markets and reduced liquidity concerns. Especially, thanks to ease of tension in the global financial markets, emerging market equities have boosted and spreads have narrowed. Commodity prices have rebounded from their recent low levels while capacity utilization and industrial production have globally recovered modestly. As a consequence, international institutions like the IMF and OECD announced that the global economy will recover sooner than expected and they are getting more and more optimistic regarding their projections.

In the words of Winston Churchill who had seen the sunlight after the darkest days of the Second World War: "This may not be the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

Dear Guests,

A key characteristic of the recent crisis was that it combined an acute international financial crisis with an outright global recession. At the same time, synchronized countercyclical policies were implemented by both advanced and emerging economies in response to global turmoil. In my opinion, it would be better to briefly elaborate on these distinctive features of the recent crisis to have a better understanding of the nature of the recovery going forward.

Recent research highlights that episodes of financial stress are more likely to be associated with deeper and longer downturns. This is particularly true for banking-related financial stress, and helps explain the severity of the recent crisis. Another factor that exacerbated the fallout from the recent crisis was the aggressive use of certain financial instruments. While derivatives can be effectively used for hedging purposes, use of these instruments for speculative gains with high leverage also allows for potentially unlimited losses.

The global recession was another distinctive feature of the recent crisis. The downturn in economic activity was virtually synchronized across both advanced and emerging economies.

Increasing interdependence owing to the rapid pace of globalization, as well as the rising contribution of emerging economies to global growth is among the main factors behind the synchronous behavior of global economic activity. Taken together, this implies that there may be less of a role for exports during the recovery. Also the unprecedented fiscal and monetary policy initiatives implemented across major economies makes this crisis truly unique. The awareness regarding the threat to financial and economic stability has emerged across both advanced and emerging economies. To this end, policy dialogues – particularly those fostered during international forums – served to catalyze simultaneous fiscal stimulus packages across some of the largest advanced and emerging economies.

On the monetary policy side, at first, many economies cut interest rates sharply with waning inflationary pressures. However, as the financial stress intensified and the economic contraction deepened, policy rates rapidly approached the zero interest rate floor. With their economies still under acute strain, central banks in some advanced economies responded by implementing a series of unconventional measures. The goal of these measures was to provide markets with ample amounts of liquidity to help restore the health of financial systems balance sheets, and thereby to reactivate the provision of credit to the real economy. However due to stress in the financial sector, the effectiveness of the transmission mechanism of monetary policy may be hampered to some extent. And the usefulness of conventional countercyclical monetary policy may be relatively limited during financial crises.

Distinguished Guests,

The global economy is still in unchartered territories creating lots of confusion among the policymakers on the consequences of the monetary and fiscal stimulus steps taken so far globally. Most governments have taken fiscal measures to mitigate the effects of global turmoil either by decreasing tax rates or increasing public investment spending and expenditures. So far we see a consensus about the need for accommodative monetary policies around the globe. On the other hand, high public debt of the most developed economies has aroused serious concern on debt sustainability. According to the OECD projections, by 2017 gross public debt as a share of GDP is expected to rise sharply to 125% in the US, 160% in the UK, 125% in France, and over 100% in Spain.

Sooner or later, with the recovery of global economy, money supply pumped up to the system involves the risk of inflation if the central banks miss the soft spot in the timing of the exit strategies. The solution I believe is the announcement of credible consolidation plans going forward in stabilizing global economy in order to reduce the risk of wilting the green shoots.

Therefore, it is vital for both monetary and fiscal authorities resolve the issues of long term fiscal sustainability and price stability.

Esteemed Guests,

Following my opinions about the recent developments in global economy, I would like to talk about the Turkish economy and our recent implementation of monetary policy.

The global turmoil has adversely affected financing facilities and external demand, and led to a significant slowdown in economic activity in developing countries. We also had our fair share of it. The Turkish economy, which had been growing for 27 quarters in a row, experienced a severe contraction during the last quarter of 2008 and the first quarter of 2009. The higher share of cyclically sensitive exports, firms' dependence on external financing, and high level of production capacity were all factors that exacerbated the severity of the recession.

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. 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 950 basis points have alleviated the severity of excessive volatility in economic activity.

The developments since November 2008 in domestic financial markets and falling inflation have confirmed the accuracy of our projections and the policy rate-cut decisions, increasing the confidence in monetary policy. As a consequence of the measures taken and the limited recovery in risk perceptions, the level of market interest rates today is below the pre-global crisis level in both nominal and real terms. Having neutral interest rates at lower levels during economic recessions is an expected development in well-functioning economies, but it has never been experienced in Turkey before. This development should be perceived as an indicator of the normalization of the Turkish economy.

Despite the marked deterioration in economic activity in Turkey, there were at least three factors that prevented an outright depression. These factors were the soundness of the financial system, low levels of Turkish household indebtedness, and an assertive monetary policy stance, which aimed at mitigating the impact of the crisis on the domestic economy. Reviewing these factors, albeit briefly, would allow a better understanding of Turkey’s economic prospects.

The Turkish financial system proved to be resilient to the financial crisis relative to many other emerging economies. Unlike some of its peers, the Turkish banking system did not require any rescue packages or other forms of government support throughout the crisis. The robustness of the Turkish financial system was to a large extent a consequence of the financial reforms implemented in the aftermath of the 2001 financial crisis we experienced in Turkey.

Therefore, in contrast to many other countries that have recently revised or put into practice restructuring, supervisory, and regulatory frameworks, many of these were already established in Turkey several years ago. Furthermore, leading into the recent crisis, the Turkish financial system was well capitalized – with capital adequacy ratios exceeding 18 percent – and had relatively low loan-to-deposit and leverage ratios, as well as low levels of foreign exchange rate exposure. Relative strength of the financial sector enabled the implementation of rapid and front loaded rate cuts. No bail out scheme or other forms of public support needed during this period. This has provided room for expansionary fiscal policies.

In addition to the sound structure of the financial system, low levels of household indebtedness relative to other emerging economies also contributed to the resilience of the Turkish economy during the crisis. Monetary tightening implemented by the Central Bank between 2006 and 2008 played a critical role in curbing the lending growth and checking the rise in household debt. Prudent and preemptive measures taken by the Banking Regulatory and Supervision Agency in the last 7 years prevented the spread of exchange rate risk among households. The share of foreign currency-denominated loans in the current debt stock of households is rather small compared to other emerging economies, especially those in Central and Eastern Europe. Financial markets seemed to have appropriately appraised these factors, as the risk premium in Turkey deteriorated by a smaller extent when compared to many other emerging economies during the peak of the crisis.

Relative stability in financial markets of Turkey has provided our bank more policy space relative to many other emerging economies. The Central Bank of Turkey has used this opportunity to guide expectations. As expectations were further aligned with the policy intentions of the CBT, bond yields decreased to historically low levels. This is an important development, because in previous crises real interest would tend to increase, thereby exacerbating the severity of the economic contraction. Current situation reflects the improved effectiveness of Turkish monetary policy and highlights the transformation of Turkish economy.

Dear Participants,

Turkey has always had a great climate for Green Shoots to blossom. Our recent crisis in 2001 was followed by a strong "V" shaped recovery process. However, despite the signs of partial improvement in domestic consumption in recent months, its strength and durability is questionable. We expect that demand uncertainty and low levels of capacity utilization will continue to weigh down on investment spending and employment. High unemployment will continue to contain private consumption demand and blur the prospects for a solid recovery.

Despite some recent easing, tightness in financial conditions still persists and the tightening of business loan lending standards continued – albeit at a slower pace – during the second quarter.

We predict that bank lending rates for consumer loans would follow gradually, as the lagged effects of cumulative easing of 950 basis points since November 2008 would start to ease credit conditions towards the last quarter of this year. However, the current unfavorable labor market conditions are expected to restrain the recovery in consumption, and therefore domestic demand conditions would continue to support disinflation.

The fiscal discipline is crucial in maintaining low levels of medium and long-term interest rates for the recovery of both consumption and investment. The implementation of a credible fiscal framework would bring down risk premiums further, and hence lead to a permanent fall in longer-term interest rates. This, in turn, would foster investment and labor demand, and thereby support the recovery process, providing the Green Shoots with the breathing room. Therefore, the determined execution of the medium-term program to ensure fiscal discipline and debt sustainability would have an expansionary rather than contractionary impact on economic activity.

In sum, while Turkish economy contracted sharply during the recent crisis, its well capitalized and sound financial system is likely to support the economic activity along the recovery. In fact, recent GDP releases suggest that economic activity in Turkey displayed a solid rebound in the second quarter. Therefore, we feel that the worst episode of the crisis is now behind us, which should in turn support Turkey's economic prospects.

However, it remains to be seen whether recent improvements in leading indicators will translate into a long lasting and durable recovery, since part of the rebound reflects the impact of the fiscal stimulus packages. The situation is similar across the globe: recovery has started in the global economy, yet the extraordinary policy measures taken since the last quarter of 2008 makes it harder to interpret the underlying trends. Given the elevated levels of unemployment and ongoing de-leveraging process, the recovery is likely to be gradual.

Distinguished Guests,

Let me close my speech by turning to the main theme of this session. Overall, I am encouraged to recognize initial signs of recovery but also I am anxious that the green shoots that have sprouted may still expose to a spring frost. "Green shoots" may not be vigorous enough and important downside risks still remain.

However, unlike a couple of quarters ago, we should also acknowledge that we can now at least talk about upside risks – that is, "blossoming shoots".

Thank you.