

Global Crisis and Turkey, November 12, 2008

Slide 1. Title Slide

Good morning.

I would like to make 3 main points remarks this morning.

1. **The global economic downturn and financial turmoil will affect Turkey, like virtually all emerging countries. Economic growth will slow down in Turkey. There will be much slower growth, lower income growth, less job growth, and a challenge for fiscal, monetary, and social policies.**
2. **There is exceptional uncertainty in future global developments and therefore there is a wide range of scenarios. There also are rapid changes every day.**
3. **Therefore: it is important to be prepared. That is, to be prepared with good, strong policies and with contingency measures in case downside risks materialize.**
 - **Turkey has a good track record since 2001.**
 - **Turkey's fundamentals remain strong, and Turkey remains a good investment—as long as Turkey continues those same sound policies and long-term reforms that have already helped make Turkey perform well and make it more resilient than in the past.**

Slide 2. Growth slide

Even before the current turmoil, economic growth was already slowing down.

- **Since 2000 developing countries have outpaced high-income countries,**
- but the year on year changes of the two groups still track each other...
- Growth is now slowing down in both groups of countries.
- **So there is some de-coupling of levels of growth, but there is no de-coupling of the rates of change and the trends in growth.**

Slide 3. Spreads since 1997

The **simplest indicator** of the effect on emerging markets is **sovereign spreads**. This chart shows that sovereign **spreads in emerging markets overall (the EMBI+ line) have widened—and that Turkey's spreads have moved closely in line with overall emerging markets.**

- **Since early September the EMBI+ has risen by over 300 basis points.** Currently spreads are in the 600s.
- That's quite a big swing—the biggest and most rapid since 1999-2002.
- **Indeed, the flight to quality may continue, and policy makers must be prepared for its possible effects.**

Slide 4. Turkey's external financing needs

Turkey has projected gross financing needs of around \$ 130 billion in 2009.

- This includes short-term rollovers, mostly of trade credits. These are likely, although not certain, to remain available in our judgment.
- FDI has increased much in the last couple of years. FDI flows this year will likely be up to \$13-15 billion—but next year will likely be lower.
- Expected further decline in the capital flows to emerging markets will also put pressure on private sector's external financing needs, with a negative impact on growth.

So Turkey is more exposed than most emerging markets to global liquidity movements. This is the conventional wisdom, and it's true--partly.

Slide 5. Financial Markets.

These charts compare Turkey with the EMBI+ countries' average—in the three major financial market indicators: spreads in bond markets, currency valuation (depreciation or appreciation), and stock exchange movements. Overall these charts show that, if we take a medium-term view, Turkish markets have been performing broadly in line with emerging markets.

The first chart covers the period September 5-November 7

- Turkish **spreads** widened, but by less than the emerging markets average. While Turkish spreads widened by 203 bps, EMBI+ increased by 284 bps.
- The Istanbul stock exchange was hit by increasing international risk aversion, but **not more than other EM stock exchanges** (investors have pulled out of EM equities throughout 2008).
- So: since the beginning of the recent most serious financial turmoil, that is, **since September, Turkish spreads and stocks have performed broadly in line with Emerging Markets.**
- But: **the Turkish Lira substantially underperformed other emerging market currencies.** Indeed the Turkish lira has become much more vulnerable recently.

However, let us now look at the second chart, which shows movements since the end of 2006.

- This chart shows that **the most recent disproportionate depreciation of the TL in fact offsets the earlier disproportionate appreciation** in 2007 and until August 2008.
- Overall, since end 2006, movements in financial markets have been in line with the emerging markets.

Nevertheless, markets are clearly concerned about the Turkish currency today, especially because of the high CAD, Turkey's Achilles Heel. The prices that Turkey pays for its local currency finance also reflect that concern.

And there is a risk of a generalized loss of market confidence—despite the strong past reforms and despite the strong fundamentals.

So: How will things play out in Turkey? What to do to reduce risks?

Let's look in turn at the 3 key sectors and transmission channels: the financial sector; public sector balances; and the real sector and external accounts.

Slide 6. Transactions of Banks with Banks Abroad

Since the 2001 crisis, the banking sector has become significantly stronger.

- **Regulation and oversight have been overhauled.** The Central Bank is strengthened. There is comprehensive revised legal framework for banking supervision and regulation.
- Banks were privatized. Others were allowed to fail. **Today, banks are well capitalized.** Capital adequacy ratios are about double the regulatory requirement of 8 percent
- Banks are also overall **well run today and profitable.**
- One reason for the health of Turkish banks is that, while **credit** has expanded, it **has not expanded too fast. Credit to the private sector as percent of GDP remains low in Turkey by international comparison.**
- **Also as this slide shows, Turkish banks finance themselves more through deposits, not wholesale, and to a limited extend from abroad.**
- And the **financial system is not exposed to mortgage-backed securities.**

Of course, banks in Turkey rely on trust and confidence like everywhere else. They are not immune from market risk. For instance, if **nominal interest rates** rise rapidly, the assets of banks with large holdings of government paper will contract, and their lending will **contract somewhat**. **But the financial sector in Turkey can likely withstand a downturn without suffering systemic risks.**

It is important for Turkey to build on and expand the reforms that have driven this resilience and further strengthen regulation and oversight. Critical steps looking ahead include

(1) a new capital markets law to harmonize regulations with the EU; and (2) adoption of the Basel II capital adequacy framework—though timing will be important).

Slide 7. Fiscal policy

- **Let's now look at the public sector.** As this slides shows:
- Turkey's budgets have shown a substantial **primary surplus since 2003.**
- And recent budgets have been close to **overall balance.**

Slide 8. Gross public debt

Turkey's public sector is much less vulnerable than in 2001.

- **Consistently prudent fiscal policy have brought down Turkey's public debt to around 40 percent today...**
- **and the composition of public debt has improved.**
 - **share of foreign currency in total debt has fallen to 30 percent as of Sept 2008, from 58 percent in 2002.**

The now much lower public debt / GDP ratio, and much lower external public debt, are great achievements. At the same time, because Turkey has a high CAD high and private sector debt is rising, a further reduction in public debt will help greatly not to crowd out lending to the private sector.

- Prior to the 2001 crisis, high public sector debts meant fewer resources being allocated to the private sector.
- This is much less a concern now. But especially now, with credit to the private sector constraint, the government can help most by limiting its own borrowing.

Over the long term, full implementation of Turkey’s sound Medium-Term Fiscal Framework, and also of the Social Security and Universal Health Insurance Reform is crucial in consolidating the gains achieved so far.

The introduction of a Medium-Term Fiscal Framework has been critical for maintaining sound fiscal policies.

- Maintaining a realistic Medium Term Fiscal Framework and adhering to it will be crucial.
- So will implementing revenue raising measures or expenditure reductions, as needed, particularly in the event of a slower than expected economic growth in 2009.
- The authorities are considering developing a fiscal rule—this is also welcome.

Slide 9. Social security reform

- **Turkey’s now effective social security reform** is a quantum leap forward.
- The reform is **stronger than many** of those in more developed economies.
- This slide shows the very large long-term fiscal savings from the reform.
- Implementing it fully will help achieve **long-run fiscal sustainability**, and it will help **credibility with investors**.

Slide 10. CAD and “non-energy” CAD

- We have looked at the financial sector and the public sector. Let’s now look at the private sector and external balances.
- **This slide shows that Turkey’s major vulnerability is its high Current Account Deficit, of which the largest part stems from energy imports.**
- **Oil prices coming down will help bring down the CAD in the near term.**
- **In the medium term, improving energy security and efficiency is the key to help to help reduce the CAD (and also, of course, to improve productivity).**

Slide 11. External debt

Most external debt is taken on by the corporate sector, and this will likely continue.

- The **refinancing** of corporate FX liabilities will become more **difficult**.
- This will mean higher **refinancing** cost; some increased local currency borrowing; probably less investment
- I have talked with many business people & investors in the past week, and it is clear that many will face challenges.

Slide 12. Low TL-CAD sensitivity

What if problems do arise? How large an adjustment may be needed? This slide shows that Turkish exports and imports are relatively insensitive to exchange rate movements.

- In Latin America and Asia, a 1% depreciation in the exchange rate means on average more than a 1% increase in exports. In Turkey it means a 0.2% increase in exports.
- This means that – potentially at least – the **currency movements** needed to **stimulate exports, reduce import demand**, affect interest rates and reduce growth could be significant.

So Turkey is not immune. The primary vulnerability comes through the foreign borrowing and exposure of the private sector.

- So it is crucial to be prepared.
- We have talked about what being prepared means on the macroeconomic and fiscal side.
- I would like to speak briefly about the other, equally important half of the picture continued strong medium term reforms.

Among the key medium term reform areas, today I would like to focus on one: **Making it easier to do business and increasing productivity, including labor market flexibility and better education.**

Slide 13. How competitive is Turkey for doing business?

- **Turkey now ranks 59th among 181 countries in the WB's Doing Business indicators**—and its rank has been moving up over the last years.
- However, neighboring countries such as Armenia, Azerbaijan, Bulgaria, and Romania all do better—countries with which Turkey competes as a destination for business and investment.
- Turkey can, and I am convinced will, do even better.

Let me mention **2 critical reforms for Turkey to ease doing business** and help growth and generate jobs:

1. **Adoption of a modern Commercial Code**—which is now in Parliament.

Slide 14. Turkish employment generation has been low

2. **A second phase of labor reform.**
 - This slide shows that **growth created fewer jobs** in Turkey than elsewhere.

Slide 15. Employment rates

- And Turkey faces a particular challenge in **increasing female employment**.
- Less than a quarter of Turkish women participate in the labor force—that is, less than half the share in the EU 27 countries.

Turkey's rigid labor markets are a major reason for low job creation, and for particularly low job creation for women and for young people.

- The first phase of labor market reform in the summer of 2008 has made a good start—with lower labor taxes, especially for the young and for women.
- **The second phase of labor market reform will be critical, with a focus on labor market flexibility**—including options for short-term and part-time work and severance pay reform.

Slide 16. Education: Focus on Quality

- As we're talking about productivity and labor, one final quick word on education: In my view, **in the long run, education is probably the most important driver of productivity and of jobs in the long run. And improving the quality of education and further increasing access to education, especially secondary & tertiary education and especially for girls, is probably the single most important long-term public policy challenge for Turkey.**

Slide 17. **Thank you.**