

**Middle East Economic Association
Istanbul Technical University
Reception Address – June 24, 2010**

**Economic Prospects, Risks, and Challenges for Turkey and the Middle East
in the Post-Crisis World**

Good evening. It is a pleasure and an honor to address you this evening. I would in particular like to thank Professor Serdar Sayan for the invitation. Before talking about the region and about Turkey, I will try to bring some international context from the World Bank's analysis of global economic trends and prospects and, since you are researchers, leave you with what I think are some of the questions that we are confronted by as we move away from the global crisis to what – we hope – will be less stormy seas.

I am going to underline ***three basic messages***.

First is that there has been a huge shift of debt from the private sector to the public sector in the high-income countries. You know this. But its consequences will be long lasting and will to some degree affect all countries, not just those where the debt built up first and fastest.

Second, we have learned new things from the sub-prime crisis, particularly about the functioning of financial markets, and this knowledge should now be reflected in public policy.

Third, as economists, there is more need now than ever for careful analysis of the traditional, core areas of the subject: the determinants of growth; the roles of public policy; and how best to use scarce resources.

The starting point I would like to take for thinking about the Middle Eastern region and about Turkey is to ask the question: what is different in 2010 from in 2008? Many things, one might say, but I will ***focus on two***.

First, we might ask another question: in what year was public debt in the G7 economies most recently higher (as a fraction of GDP) than it is now? The answer might surprise you... it is 1950! Global public debt is at its highest level since the aftermath of the Second World War. Clearly this did not happen overnight. In fact this measure has been rising fairly steadily since the mid 1970s. But there has been a huge, recent transfer of debt from the private sector – in the form of unsustainable lending based on the housing bubble and systemic failures of risk management, which we all know about and which I will not revisit here – to the public sector. The public sector inherited this debt in the form of economic contraction, fiscal stimulus, and bail-outs in various forms. Add to that the very high fiscal deficits in the same countries today, and a reaction in the other direction is now inevitable.

Public debt in the G7 is projected to reach 113 percent of GDP in 2010. To give you an idea of the size of adjustment that is likely to be needed, the IMF has estimated that the high-income countries would have to cut spending (or raise taxes) by nearly 9 percent of GDP for 20 years to reach the Maastricht criterion ratio of 60 percent of GDP by 2030.

If countries like the US, Germany, the UK, France and Spain really cut their public spending, who will be most affected? Analysis by the World Bank suggests a clear answer: in the short run, while these economies would suffer, everyone else would actually benefit from the reduced pressure on global interest rates, due to the reduced demand for global savings. In the longer run, all economies would benefit. We in Turkey and the Middle East should hope, then, that political economy allows the rich economies to take courageous measures.

To explain the **second difference** from before, let me share with you what we saw in Turkey during the global sub-prime crisis. Initially logic said we should expect a strong effect on Turkey through two channels: foreign trade and external finance. Foreign trade certainly hit: exports fell by a third here, although they are now recovering. The financial effects didn't work out quite as we expected though. On the external side, Turkish firms managed. They drew down their own foreign holdings. They cut investments. And they paid back some. But as a rule they retained reliable access to their foreign creditors, with the result that they managed to roll over more than 70 percent of their foreign loans in 2009. We learned that Turkish firms in general have not over-borrowed and that their banks value their long-term relationships.

So why did the Turkish economy contract by nearly 5 percent? The answer lay not primarily in international capital flows but rather in the behavior of domestic banks and firms. In late 2008 and early 2009 credit dried up. Not just bank lending but supplier credit, post-dated checks, all of the formal and informal mechanisms that keep the Turkish economy humming along in normal times. Investment fell

by a third. Industrial production fell by a quarter. Unemployment in urban areas topped 18 percent.

The lesson I think we can draw from this experience is that in the “post sub-prime” world, behavior has changed in the private sector. We should expect greater risk aversion, particularly from the financial sector. And this matters for growth, welfare, and poverty reduction. Turkey last year showed that Keynes’s “animal spirits” are alive and well and need to be taken seriously. I will return at the end to what this may mean for policy.

Risk aversion affects public policy too. For example we can expect that governments in the EU and the US will not in the near future easily let financial institutions fail, for fear of further crises of confidence in credit markets.

The World Bank forecasts growth in the world economy to be 3.3 percent this year and next, rising to 3.5 percent in 2012. GDP in developing countries should rise twice as quickly as in rich countries, by 6.2 percent this year and 6.0 percent in 2011 and 2012. But growth in this region, in the Middle East, North Africa, and Turkey is expected to be lower than this global developing-country average, which is driven up by high growth rates in India, China, and East Asia more broadly. An interesting feature of these expected growth patterns is the leading role of the *developing* economies: more than half of the growth in aggregate demand in each of the next three years is expected to come from developing countries.

One of the unfortunate consequences of the recent crisis was that countries that were more globally integrated tended to be harder hit. Thus GDP in Turkey fell by 4.7 percent, Thailand by 2.3 percent, whereas for example Egypt, a country which

is somewhat less integrated with the global economy through trade and finance, managed to grow at 4.7 percent. But we should not draw the wrong lessons from this and turn inward. Turkey and Thailand have recovered relatively quickly. The countries that were hit even harder, and which are still struggling to deal with the after-effects, are the Eastern European economies with the largest mismatches in their financial sectors and the greatest structural economic problems.

In Croatia, Romania and Ukraine, bank provisioning is lagging more than half non-performing loans. In Kazakhstan, Latvia, Lithuania, and Ukraine, repayments on corporate external debt will exceed 8 percent of GDP this year. In the post-crisis global economy, it will be ever more essential for countries in the Middle East, including Turkey, to differentiate themselves from these more “problematic” emerging markets through strong economic management, setting and hitting the right policy targets, to continue to attract the capital flows they undoubtedly need. Integration combined with good economic management remains our advice to countries in order to raise living standards fastest.

Turkey and the Middle East have certainly integrated their economies with each other more over the last few years than ever before. Turkish exports to Egypt have increased five-fold in the last five years (2004-09) while Egypt's to Turkey have more than doubled. Turkish exports to several other countries in the region, for example Algeria, Iran, Iraq, and Saudi Arabia have all doubled (in the same period). The Middle East accounted for 19 percent of Turkish exports in 2009. But integration could still be closer and the gains from trade could be greater. Turkish exports to its neighbor Iran, for example, represent only about half a percent of Iran's GDP. As Iraq stabilizes, it could export more to Turkey: in 2009 Iraq

imported more than \$5 billion from Turkey but exported less than a billion in return.

And trade regimes in the region are quite mixed. On a measure of overall trade restrictiveness constructed by the World Bank, while Turkey, Saudi Arabia, and Oman are among the least restrictive, Algeria, Morocco and Egypt are among the most restrictive (Egypt ranks 53 and Algeria 54 out of 56).

Assuming we do continue to manage our global integration successfully, then the World Bank forecasts growth of 6.3 percent this year in Turkey (a good 2 percent of this is the bounce-back effect from 2009) and 4.0 percent in the Middle East and North Africa region (where the bounce-back effect is weaker, because the downturn last year was less severe). Next year and the year after, Turkey is expected to grow at about 4.2 percent and then 4.7 percent, respectively. For the Middle East and North Africa the projected growth rates are similar, 4.3 percent and 4.5 percent.

What are the risks to this performance? The World Bank has modeled **two kinds of scenario**.

The **first** one we might call "realistically pessimistic" and assumes a more cautious, restrained lending environment and therefore lower investment and consumption, plus significant fiscal adjustment in the high-income economies. This affects growth mainly in those same high-income economies, with growth rates about 0.5 percent lower in 2011 and 2012.

What would this mean for our economies in Turkey and the Middle East? The good news is that according to the World Bank's analysis we would not be too

severely affected. The Middle East and North Africa region would grow at 4.0, 4.2 and 4.4 percent in 2010-12, so that's an effect of only about 0.1 percent on the region, from 0.5 percent slower growth in the richer economies. The effect on Turkey would be similar.

The second kind of scenario models the effects if a failure to take forceful fiscal action were to increase investors' risk aversion towards economies with high debts. If the yield on 10-year US Treasury Bonds were to rise by 100 basis points, and that of other sovereigns in line with the degree of their indebtedness, then growth in both the Middle East and North Africa region and in the Eastern Europe and Central Asia region would be likely to be lower by about 0.6 percent in 2011 and 0.8 to 0.9 percent in 2012.

If this increase in risk aversion were to worsen, and translate into a crisis of confidence, a possible sovereign default, and the drying up of credit to the five most vulnerable EU economies, the effects would be even more severe, with growth downturns of the order of about 2 percent over the next two years in this region. That would mean rates of per-capita GDP growth in our countries close to zero and, as you all know, higher unemployment, poverty, and greater challenges to government budgets. Even in these scenarios, however, the downturn would be most marked in the high-income countries, and in particular in those with the highest debt and the greatest need for fiscal adjustment.

I should add one further – if perhaps obvious – source of uncertainty for the region, and that is the oil price. The base-line for the simulations I have described to you assumes an oil price of around 75 dollars a barrel (\$78 this year falling to \$74 by 2012). There are risks to this price in both directions, but the more

pessimistic scenarios probably have a greater risk on the low side. This would be good for countries like Turkey, which import all their hydrocarbons, but clearly not so good for the many oil exporting countries in the region.

What do these conditions – greater debt, uncertainty, risk aversion – and these scenarios imply for policies? I would not try to give a policy prescription to any government and of course conditions differ from country to country, but I think we can discern **three big areas** that have gained in importance for emerging market countries and therefore for our region.

First is unemployment. Turkey, and many countries in the Middle East, have young populations, many young workers enter the workforce each year (700,000 in the case of Turkey), and in many cases our countries have rigid labor laws that discourage the creation of formal jobs. Add to that the fact that the education systems in many of our countries are not producing young workers with a good skills match for the firms that could be hiring them, and we have probably the biggest policy challenge for many countries in the region.

In Turkey there are several initiatives under way to try to address this. We in the World Bank are partnering with the Government on some of these, such as expanding pre-school education, improving quality in secondary education, and monitoring and evaluating vocational training. We value this partnership. But as I speak to you today, one in four young Turkish workers is unemployed, and clearly there are no quick fixes.

Second is fiscal management. The debt build-up in emerging markets has been less rapid than in the high-income economies, and so the need for adjustment is less urgent. But the recession has left debt and deficits higher, countries face

budget rigidities such as mechanical increases in social security deficits and other big-ticket spending items, and the challenge is not only to hit aggregate targets, but to protect dwindling investment budgets while doing so.

Turkey has made a significant move in this direction by tabling a draft Fiscal Rule, which targets an ambitious one percent overall public-sector fiscal deficit, and allows for some counter-cyclical revenue and spending policy over the business cycle. If implemented well, the rule would bring Turkey's gross public debt below 30 percent in the long term, certainly a healthy ratio. There remains the challenge of protecting key investments to maintain growth rates; indeed the rule itself assumes a long-run growth rate of 5 percent: possible, but a challenge in the post-crisis environment.

Third, let me return to our experience in Turkey last year and Keynes's "animal spirits." We have learned that we cannot tame them! So it is best to be prepared, particularly for possible future problems in credit markets. Last year the Turkish Treasury introduced a new facility to back loan guarantees to small and medium-sized enterprises. The World Bank and other international lenders have also increased their efforts to channel stable, longer-term credit to small enterprises and particularly to exporters. In the event of further disruption to credit in our economies, these initiatives may help limit the damage to real activity.

In closing, I would like to offer my support to this wonderful conference. As we stabilize our economies and look for ways to secure growth and raise living standards more reliably, the economics profession will be called upon ever more to think through new problems. What new, innovative labor market policies can reduce the stubbornly high unemployment in many of our countries? Are there

ways we can stimulate domestic saving to finance investment in economies (like Turkey) that today rely on significant capital inflows? What are the public investments that are most crucial to “crowding in” the private sector and stimulating economic development? These are questions for which our profession has developed the tools to seek answers. Those answers are even more important today than they were just a few years ago.

I wish you well!