



**TÜRKİYE CUMHURİYET
MERKEZ BANKASI**

**Whether New Policy Experiments Alleviate
Growth Challenges for Turkey: A
Comparative Perspective**

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Board Member

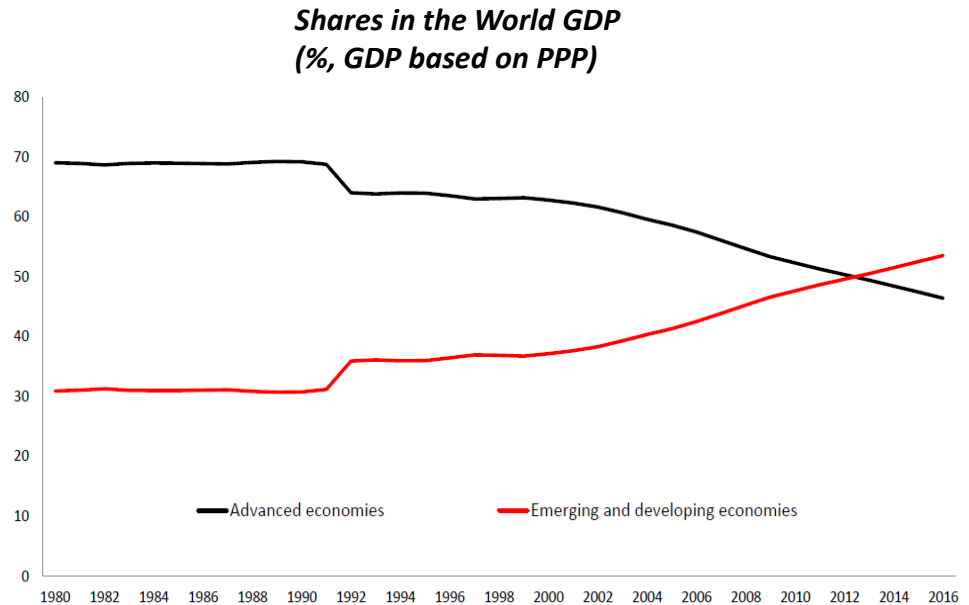
Monetary Policy Committee Member

Outline

- I. Introduction
- II. Sustainable balanced growth and its requirements
- III. Turkish economy
 - i. Structural anomalies in the economy before 2001 crisis*
 - ii. Fundamental economic change in the economy between 2002-2012*
 - iii. Proactive monetary policy after Lehman Crisis*
 - iv. Rebalancing in the Turkish economy after 2010*
- IV. Comparison of Turkey's performance with selected CEE countries
- V. Lessons learned and conclusion

High but Volatile Growth in Emerging Markets

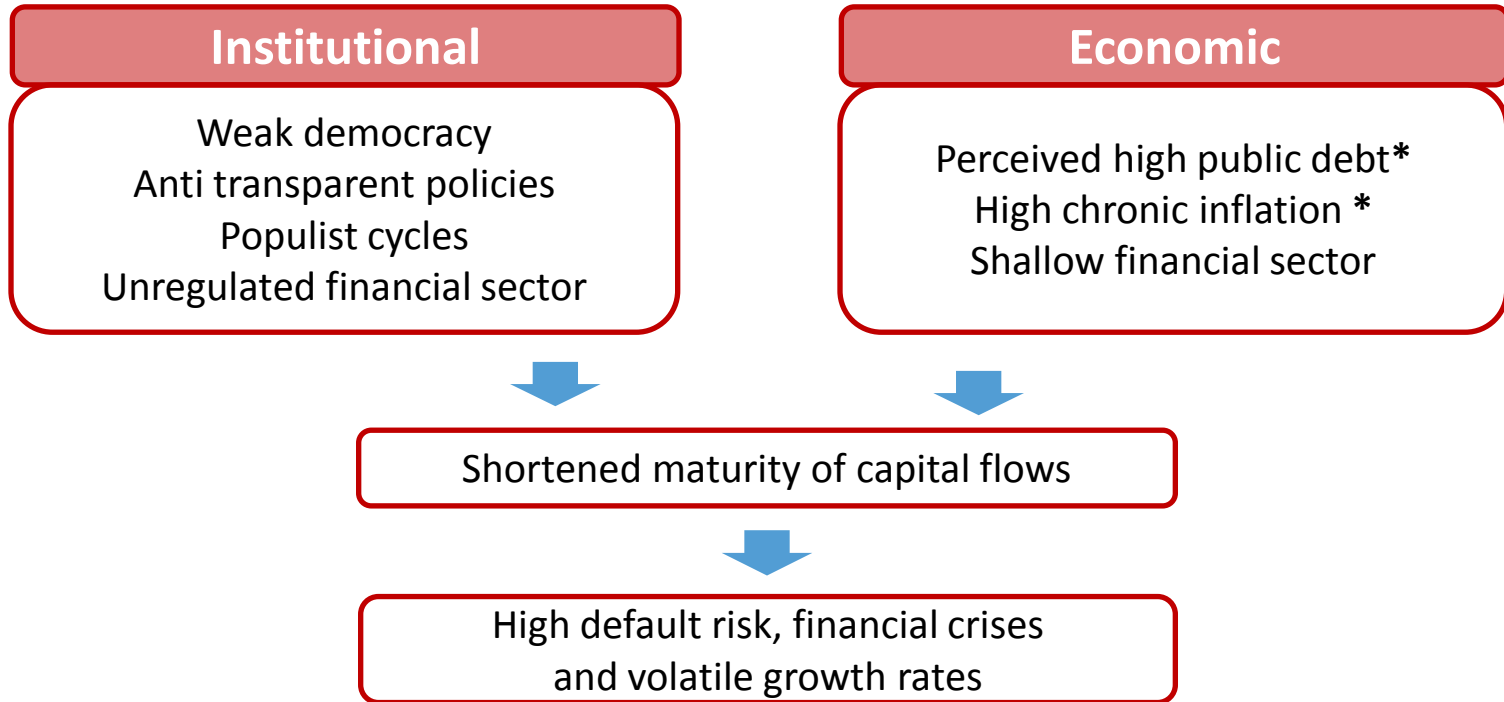
- ❑ In the last decade, emerging economies contribution to the global output has been increasing.
- ❑ After the recent global crisis their role in the global economy became more important.
- ❑ Despite their high growth rates and their importance for the global economy, they have serious problems that make their high growth performance unstable and volatile.



Source: HSBC, World in 2050, Jan 2012

Let's check the common problems
in these economies...

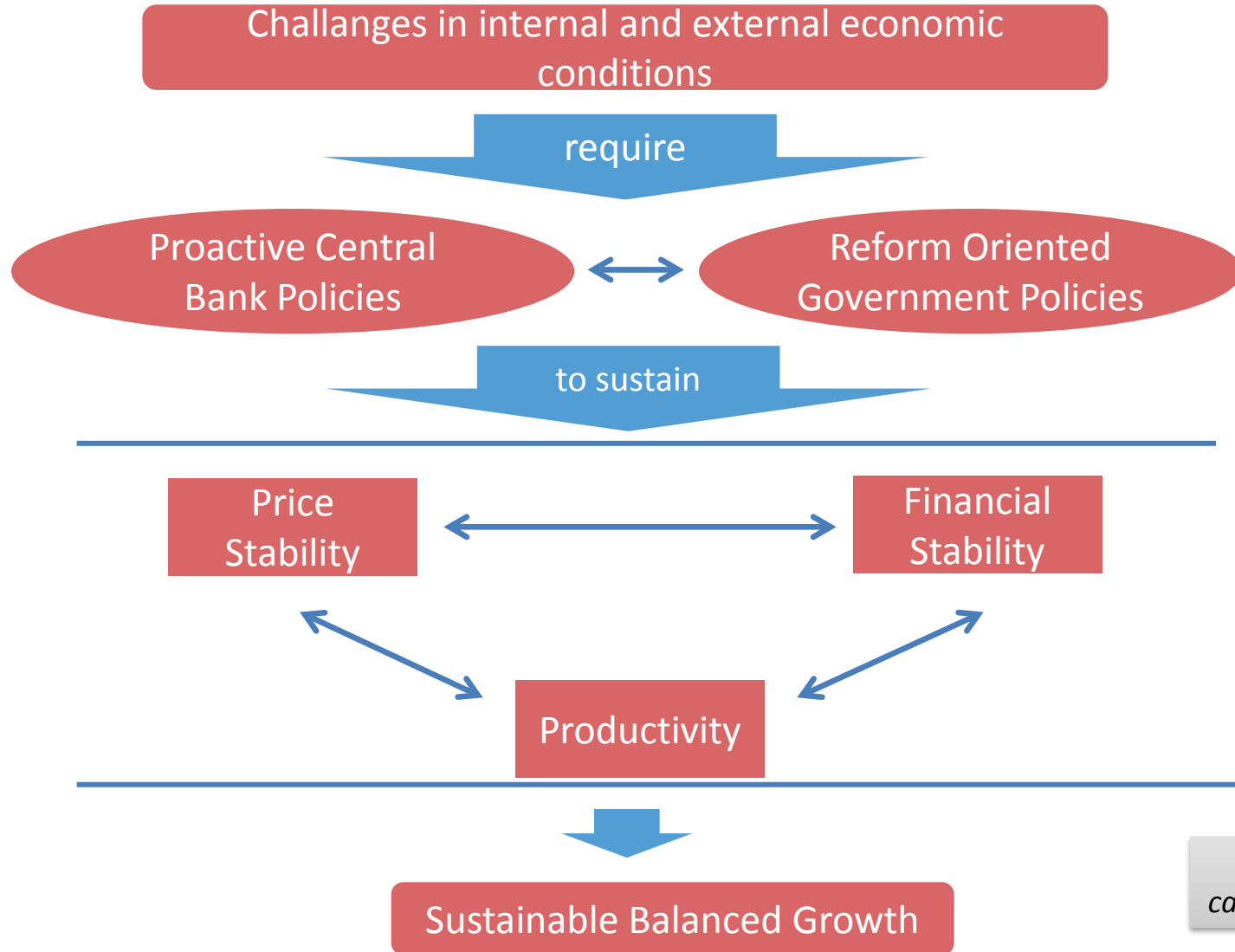
Common Problems in Emerging Countries



- ❑ In order to solve these problems political and economic reforms need to be implemented with the true monetary and fiscal policies.

* Carmen M. Reinhart and Kenneth S. Rogoff (2010) found high correlation between public debt and inflation and growth rates.

Requirements for Stable Growth

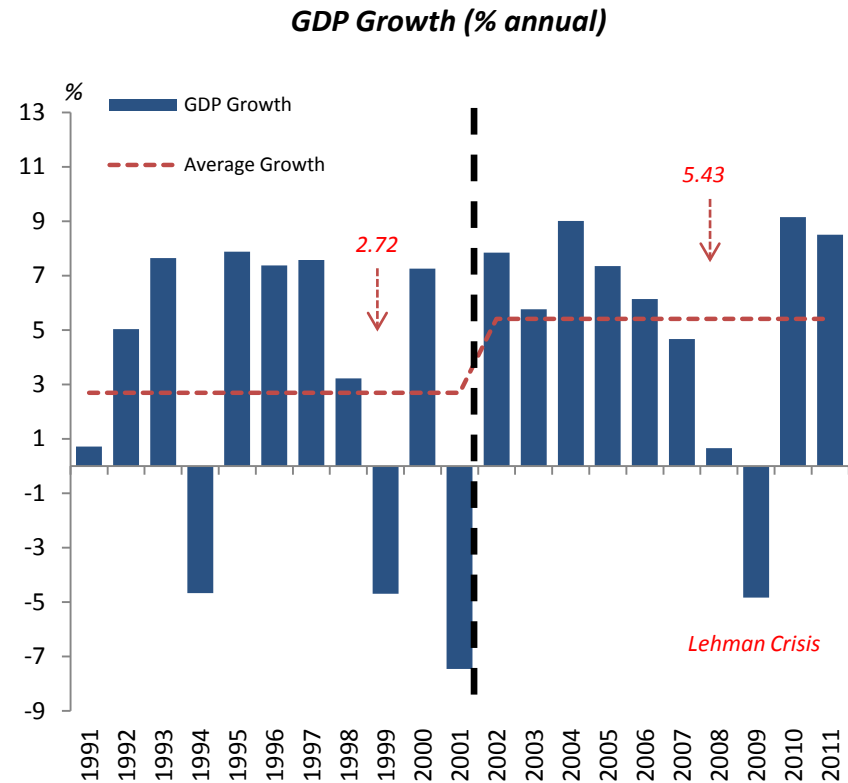


What is the case of Turkey ?

TURKISH ECONOMY

Growth Path of Turkish Economy

- ❑ Before 2001 crisis Turkish economy's growth was volatile and there were frequent growth reversals causing average growth to be lower than her potential. (so called lost decade of Turkey)
- ❑ After 2001, growth has become more stable and higher thanks to the reforms and the wise monetary policy implementation.
- ❑ Since 1953, Turkish economy has reached to the highest average growth rate of 6.74% between 2002-2007 and grew by 70% in the last decade.
- ❑ The growth dynamics needs to be analyzed in detail in order to understand the factors behind this performance.



Source: CBRT

Structural Anomalies in Turkish Economy Before 2001

Institutional Setup

- Fragile coalitions and weak governments (*the average life of coalition governments were only 16 months between 1991-2001*)
- Anti transparent and unaccountable government policies (*e.g. large duty losses of public banks that were financing discretionary political spending*)
- Lack of a totally independent monetary authority
- Unregulated banking system (*banks were taking excessive risks*)

- Weak democratic system
- Short term policies (*sought to satisfy short-term demands*)
- High political influence on economy

Economic Vulnerabilities

- High and persistent public and budget deficits
- CBRT monetized the deficits
- Shallow banking system

- High inflation (*hyperinflation-like process*)
- High debt stock
- Fragile and underdeveloped banking system (*banks heavily involved in short-term borrowing in foreign currency and the size of their open currency positions got larger*)

- Financing needs being satisfied with short term capital flows
- Shortened maturity of domestic debt
- Upward pressure on real interest rates due to uncertainties

Unstable and low growth rates

2001 crisis happened and then...

Fundamental Changes After 2001

Institutional Reforms

- Single party government (*the average life of government is 60 months between 2002-2012*)
- More transparent and accountable government policies (*EU compliance package passed from the Parliament*)
- An independent monetary authority (*with an aim to lower inflation*)
- Regulated banking system (*BRSA was established*)

- Stronger democratic system
- Long term policies instead of populist perspectives
- Less political influence on economy

Economic Changes

- Fiscal Discipline, Budget surpluses and tight fiscal policies
- CBRT has been following active monetary policy
- Deep banking system

- Low debt stock
- Lower inflation
- Strong banking system
- Effective monetary transmission

- Increase in term structure of capital flows
- Increase in maturity of domestic debt
- Lower real interest rates

Stable and high growth rates

Let's look closer to the changes in economic system that create a fruitful environment for stable growth ...

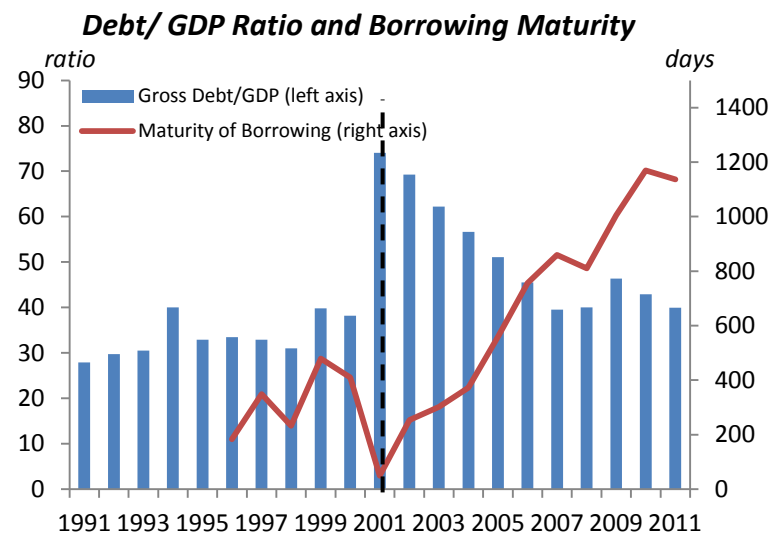
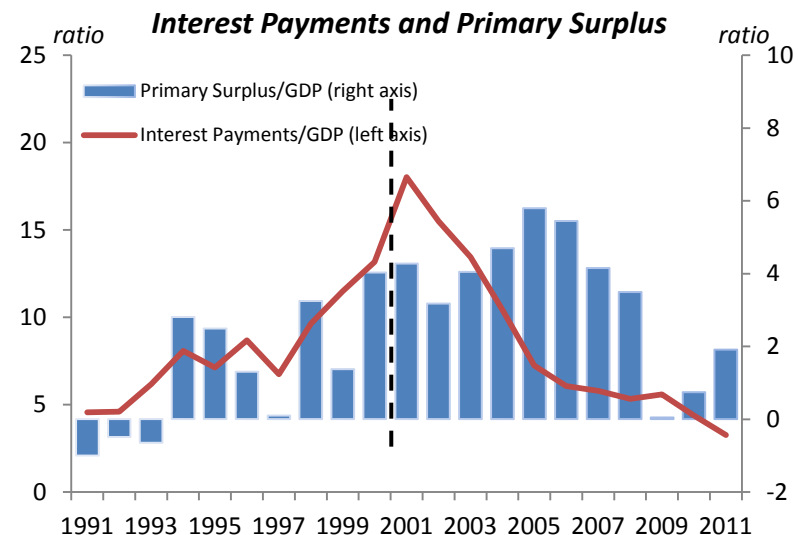
Changes in Turkish Economy After 2001

Tight fiscal policy

- ❑ High and persistent budget deficits that is far away from fiscal discipline in the 1990s created short-maturity debt and increased the interest rates which led debt stock to increase rapidly.
- ❑ After the 2001 crisis, very high primary surplus targets were announced, thus, interest payments began to decrease immediately.
- ❑ Eventually, the debt stock began to decrease and the maturity of borrowing improved significantly. The average maturity of borrowing increased from 410 days in 2000 to 1170 days in 2011.



Increase in the flexibility of fiscal policy tool



Source: Undersecretariat of Treasury

Changes in Turkish Economy After 2001

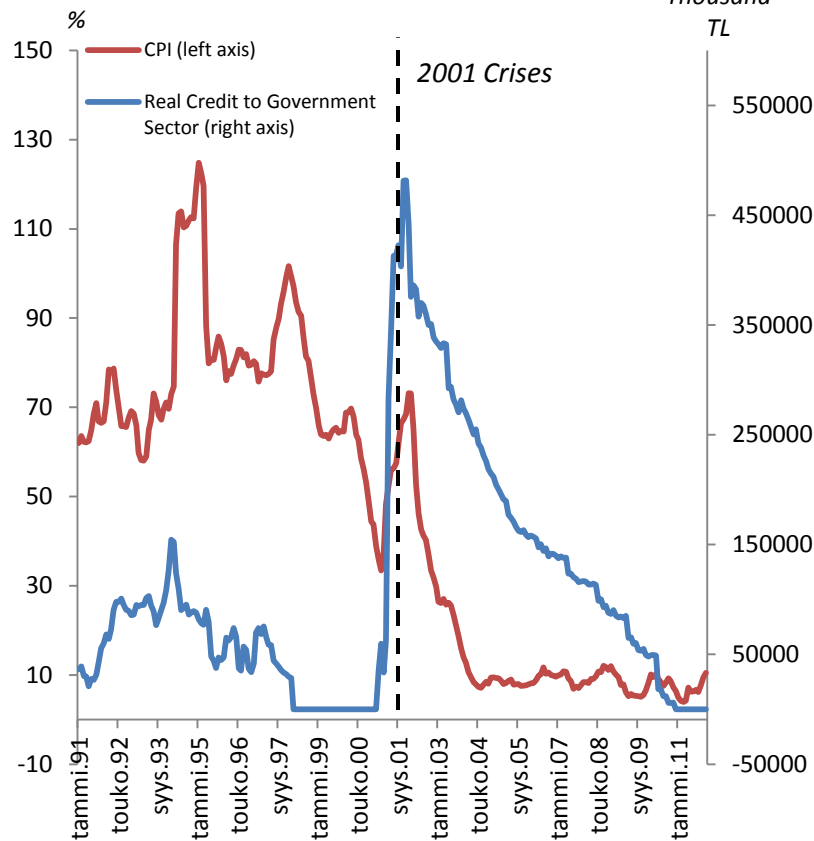
Central Bank Independence

- ❑ Before 2001, CB helped the financing of Treasury by monetizing the debt.
- ❑ After the crisis, Central Bank of the Republic of Turkey (CBRT) became independent and its main duty is price stability enforced by the new law.
- ❑ The CBRT has been following inflation targeting framework.
- ❑ The CBRT reform was fruitful to a great extent. The inflation rate that was about 60 percent before the crisis declined rapidly and by 2004, a single-digit inflation was achieved for the first time in decades.



Inflation decreased sharply

CB Monetization and Inflation



Source: CBRT

Changes in Turkish Economy After 2001

Banking Sector Reforms

Before 2001

- ❑ In a system of pegged exchange rates and unsupervised financial system, banks took excessive risks with their open currency positions.



- ❑ The maturity structure of capital flows remained short due to uncertainty in a high inflationary period.



- ❑ The large duty losses of public banks were financing discretionary political spending.



Fragile financial system

After 2001

- ❑ A domestic debt swap was launched in order to ensure easy liquidity for Treasury and to lower the risks of banks by closing the banks' open currency positions.



- ❑ Banking Regulation and Supervision Agency, which was established not long before the crisis, was activated and authorized as the sole authority in the banking sector.



- ❑ The practice of duty losses of state banks due to political spending was ended. Some state banks were either merged or liquidated.



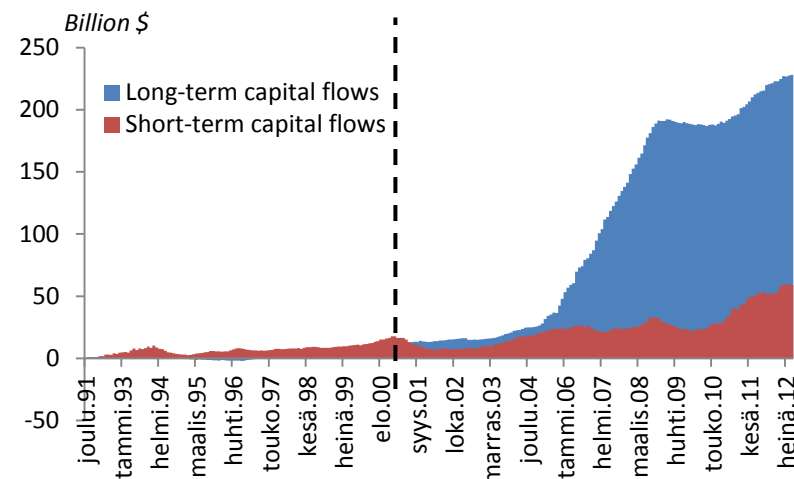
Sound financial system

Changes in Turkish Economy After 2001

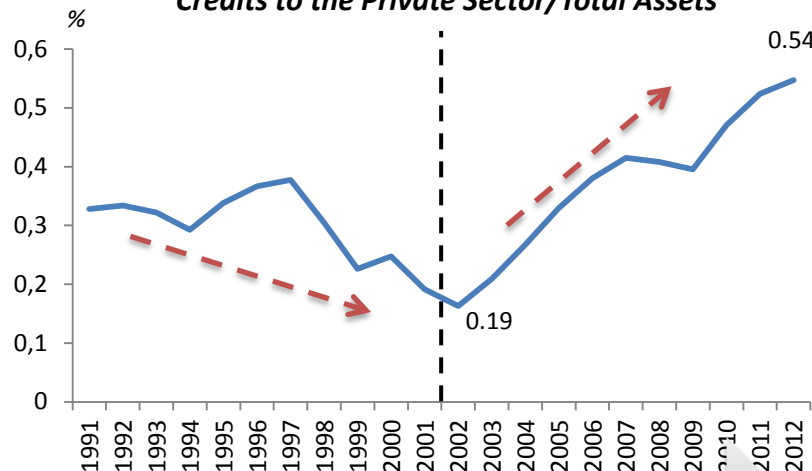
Results of Sound Financial System

- ❑ Prior to 2001, private sector credits were decreasing and their ratio remained low in banks' actives. Instead, the banking sector used its resources to finance the short-maturity public debt.
- ❑ After the reforms, banking system has been growing faster and becoming more liquid to offer greater resources to the private sector.
 - ➡ While the share of private sector credits in banks' actives was declined to 19 percent in 2001, this rate reached to 54 percent in 2011, and in real terms, the consumer credits increased by 242%.
- ❑ The maturity structure of capital flows became longer due to reduced uncertainty in the economy.
- ❑ Banking sector open currency positions eliminated.

Capital Flows (cumulative)



Credits to the Private Sector/Total Assets



Source: CBRT

Let's check the changes on growth dynamics

Changing Dynamics of Turkish Economy's Growth

Higher contribution from productivity;

- There has been considerable increase in productivity in last ten years. Productivity's contribution to the output has increased. This increase is one of the major sources of growth seen in last 10 years.

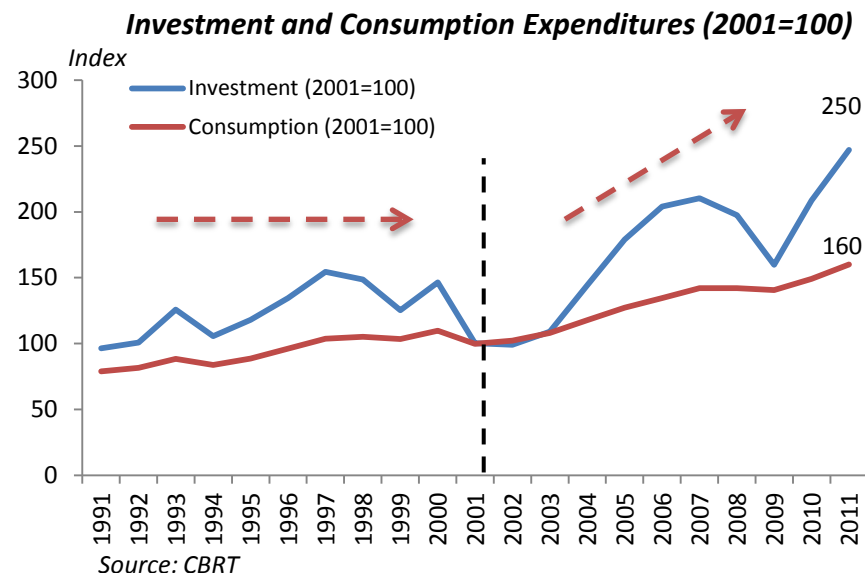
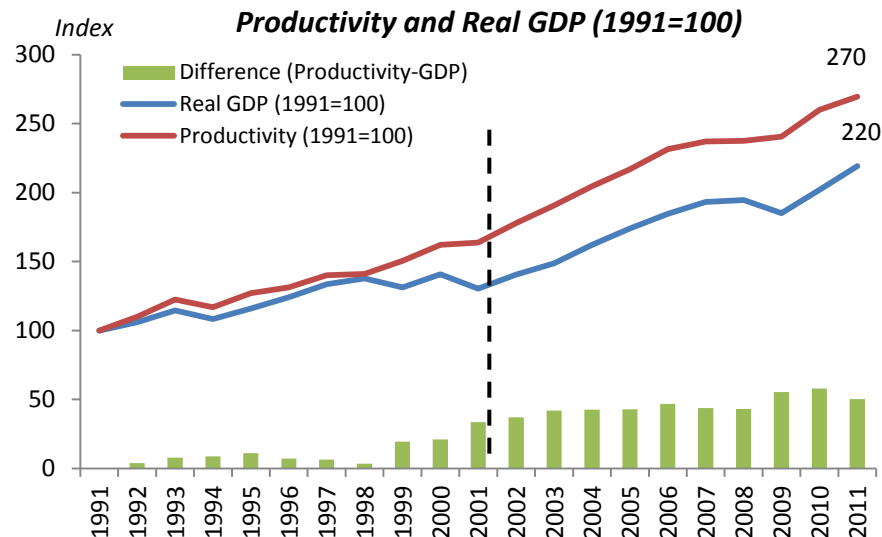


Sources of Growth			
	Contribution		
	Employment	Capital Stock	Total Factor Productivity
1990-2000	24.3	75.6	0.1
2002-2010	21.8	53.5	24.6

Source: Republic of Turkey Ministry of Development

Investment-led growth;

- Investment expenditures has increased more than consumption expenditures. Especially after 2001, investment expenditures has been the main contributor to the growth which increases the potential growth rate of the economy in the long run.



Changing Dynamics of Turkish Economy's Growth

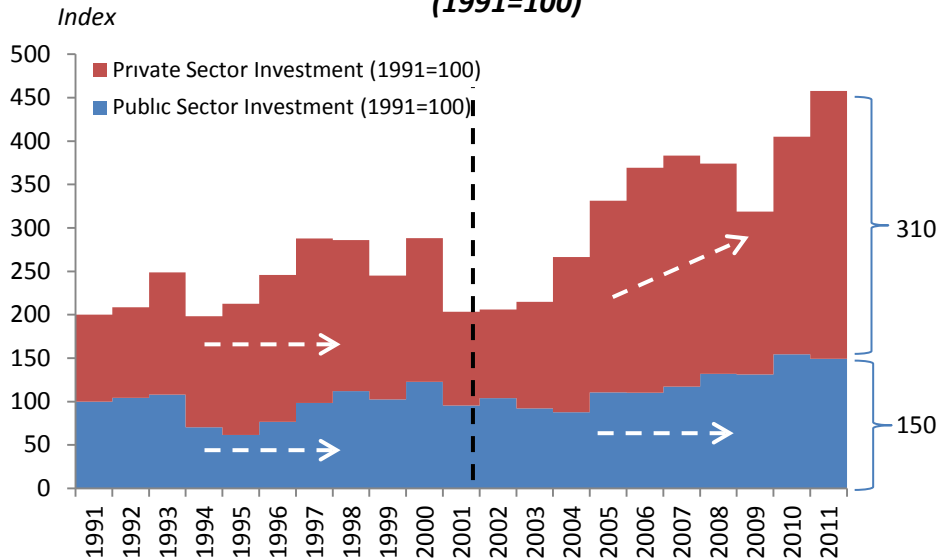
Increase in private sector's role on economic activity;

- ❑ After 2002, government investment expenditures' contribution to growth has not changed much whereas private sector's contribution increased dramatically.
- ❑ Private sector has been creating employment while government sector employing less.



Hereafter, private sector is the main source of growth and employment.

Public and Private Sectors' Investment Expenditures (1991=100)



Source: CBRT

MONETARY POLICY STANCE AFTER LEHMAN CRISIS

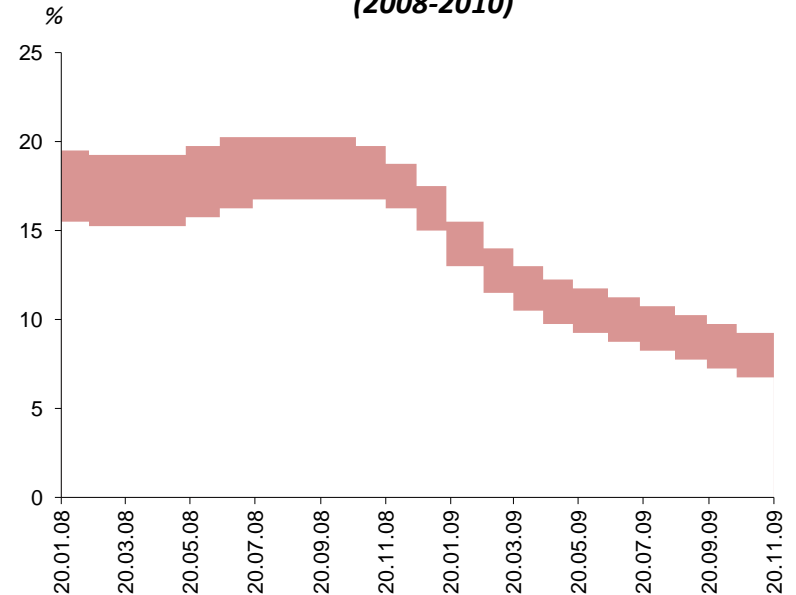
Monetary Policy Response to the Lehman Crisis (2008-2010)

- ❑ CBRT adopted a strategy of front-loading policy easing by cutting overnight rates by a total of 11 percent between November 2008-2009.
- ❑ Borrowing and lending rate band has been gradually decreased in order to reduce fluctuations in the overnight interest rates.
- ❑ Liquidity need of the market in local currency has been provided in a timely fashion.
- ❑ FX reserves have been used primarily to support the banking system.



The impact of the crisis has remained rather limited.

**O/N Lending - Borrowing Interest Rate Corridor
(2008-2010)**



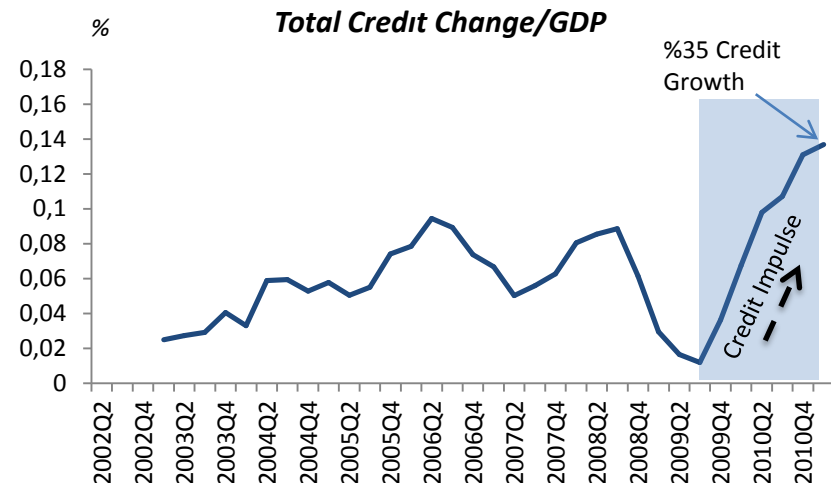
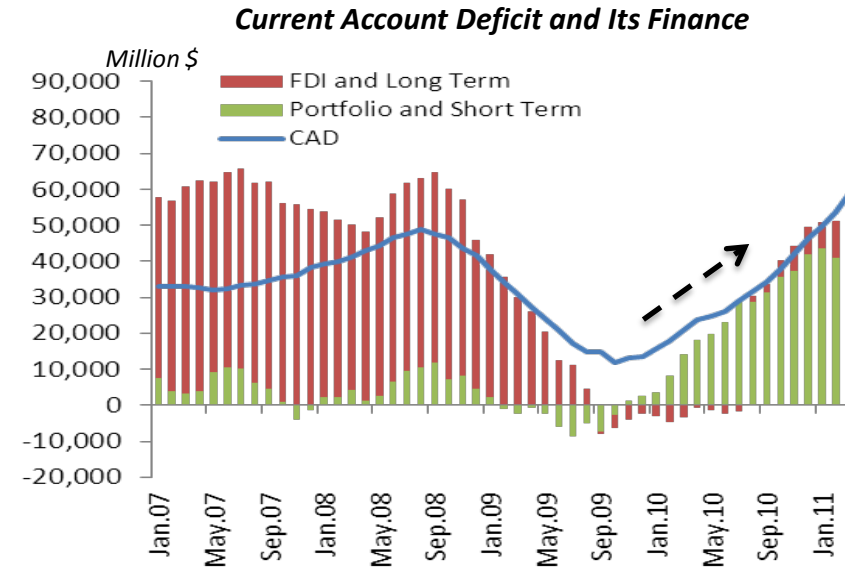
Source: CBRT

After mid 2009, credit growth and then current account deficit began to increase rapidly...

Increasing Risks After QE2

Increasing risks in the financial system after QE2;

- After 2009, current account deficit (CAD) (2.1% of GDP) and credits (0.4% of GDP) had begun to rise rapidly and reached to 9.9% and 14.8% of GDP respectively.
- The term structure of the capital flows financing the CAD deteriorated. Short-term capital flows had increased rapidly whereas long-term capital flows had almost disappeared.



Risk of a Sudden Stop

Threat for Financial Stability and Stable Growth

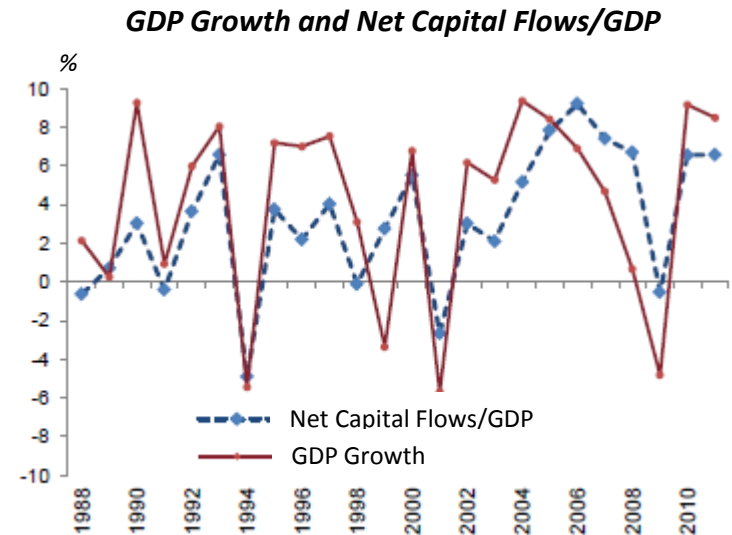
Source: CBRT

Necessity of Proactive Policies

- For Turkey, volatility in capital flows plays a key role in growth performance and affects the macroeconomic stability. (see the graph) High current account deficit increase this effect and macroeconomic fragility. In other words, low CAD and balanced capital flows are vital for stable growth in Turkish economy.



Thus, CBRT introduced new policies and measures to rebalance the economy.

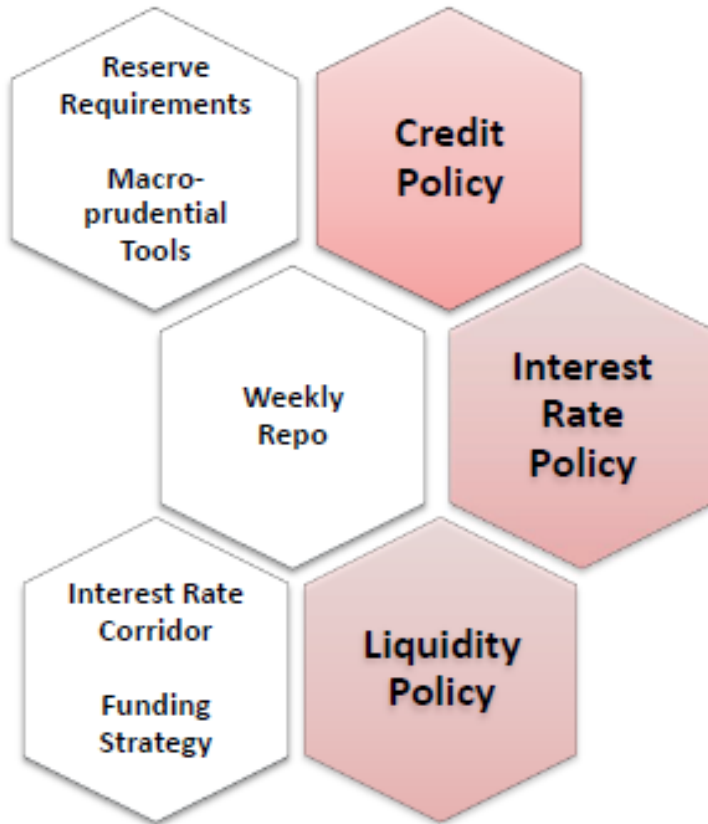


Source: CBRT

SOFT LANDING AFTER 2010

Multiple Instruments, Multiple Objectives

INSTRUMENTS



KEY INDICATORS

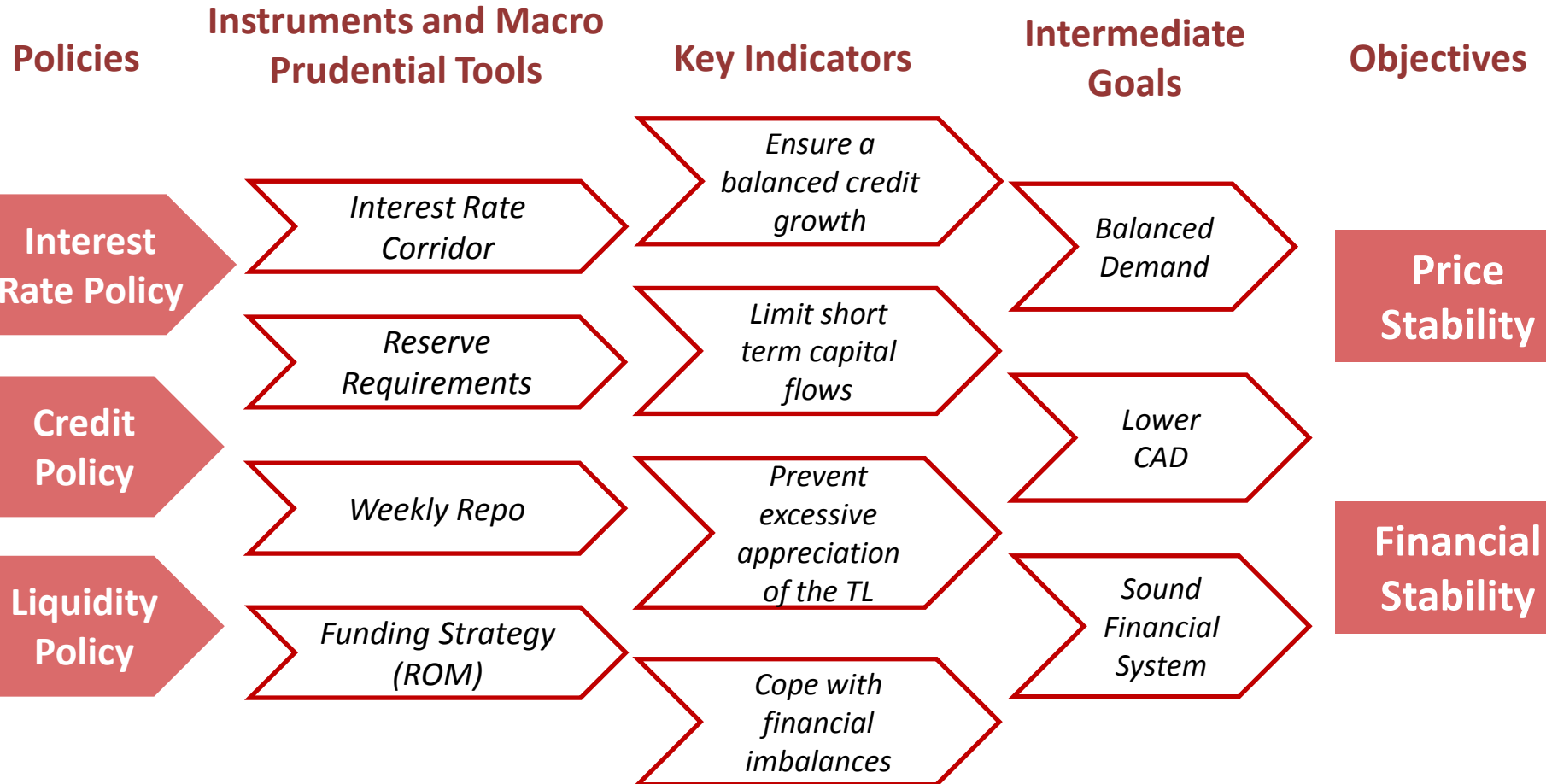


OBJECTIVES



Monetary Policy After 2010

New monetary policy strategy was designed for soft-landing.



Main Objectives of CBRT

1- Price Stability (Safeguard)

2- Financial Stability (Contribute to)

Central Bank of Turkey Monetary Policy Unconventional Tools

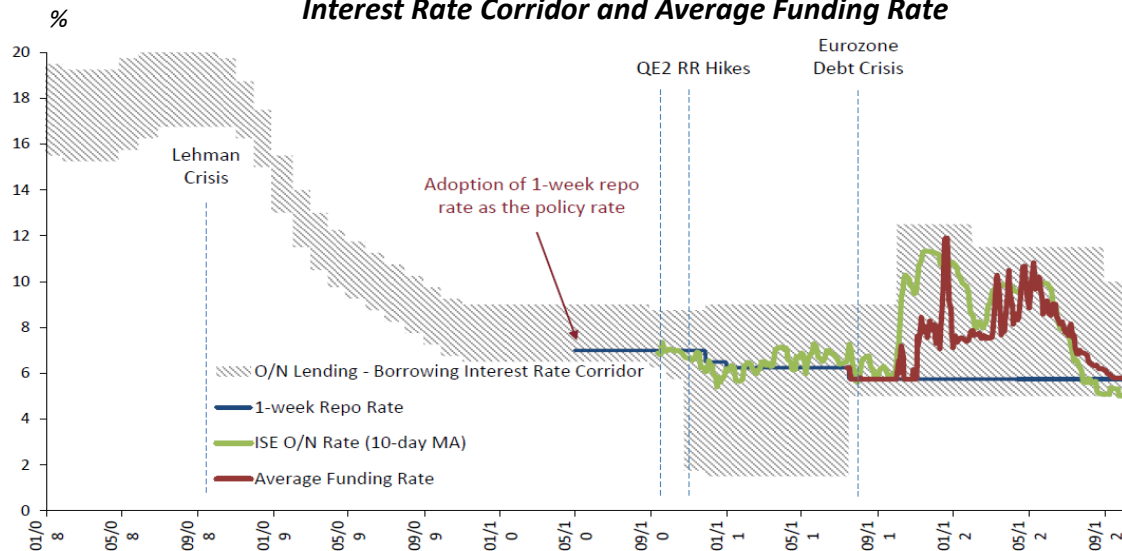
- 1. Interest Rate Corridor Policy**
- 2. Limits on Credit Growth Policy**
- 3. Limits on Loan to Value Ratio Policy**
- 4. Reserve Requirement Policy**
- 5. Reserve Option Mechanism**

Monetary Policy After 2010

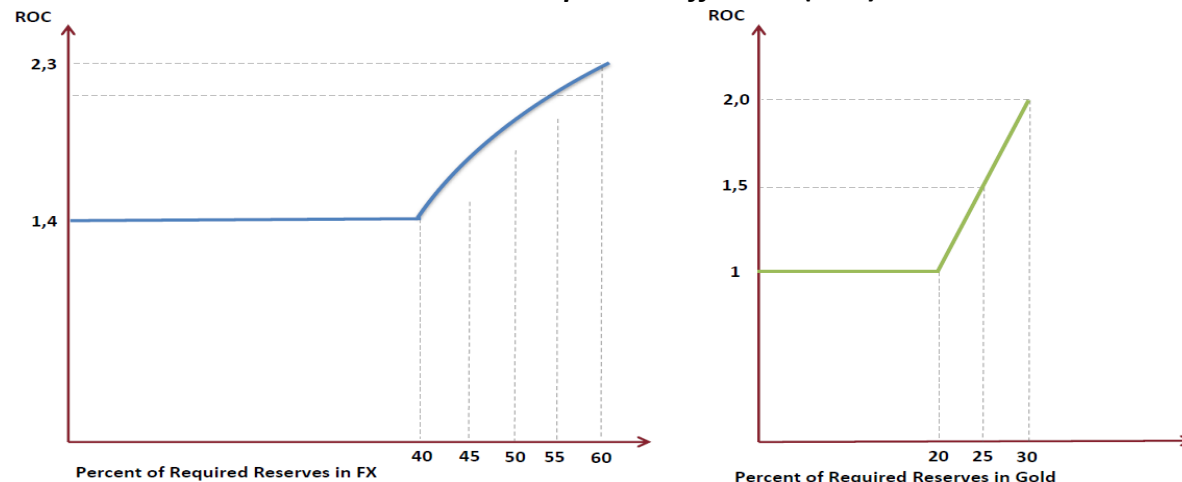
❑ In the **interest rate corridor system**, the average funding rate, moving in the corridor, becomes more responsive to shocks and thus, it becomes more volatile and less predictable.

❑ In the **reserve option mechanism** banks are allowed to deposit FX or Gold instead of their Turkish lira reserve requirements. This facility not only provides the Turkish lira liquidity to the banks in a more permanent way and lowers their cost. It also supports the CBRT's reserves and thus, reduce the adverse impact of volatile capital flows on the financial system.

Interest Rate Corridor and Average Funding Rate



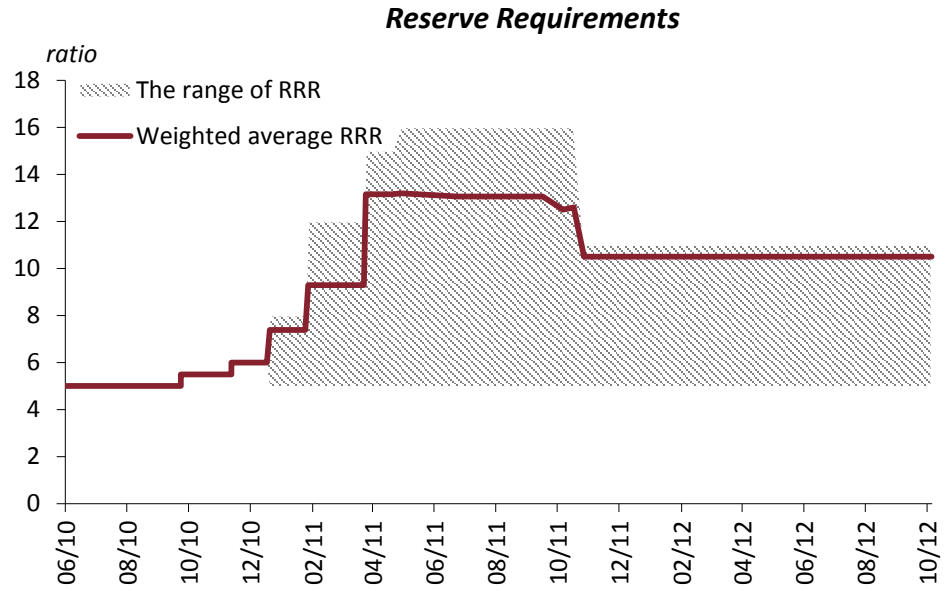
Reserve Option Coefficients (ROC)



Source: CBRT

Monetary Policy After 2010

- In order to enhance financial stability by extending maturity of the banking sector liabilities, reserve requirements were differentiated by maturities, with higher reserve requirements for short-term liabilities. These measures reduced the net short-term capital inflows (thus, mitigate excessive appreciation pressures on Turkish Lira) and stopped the acceleration of the credit growth.



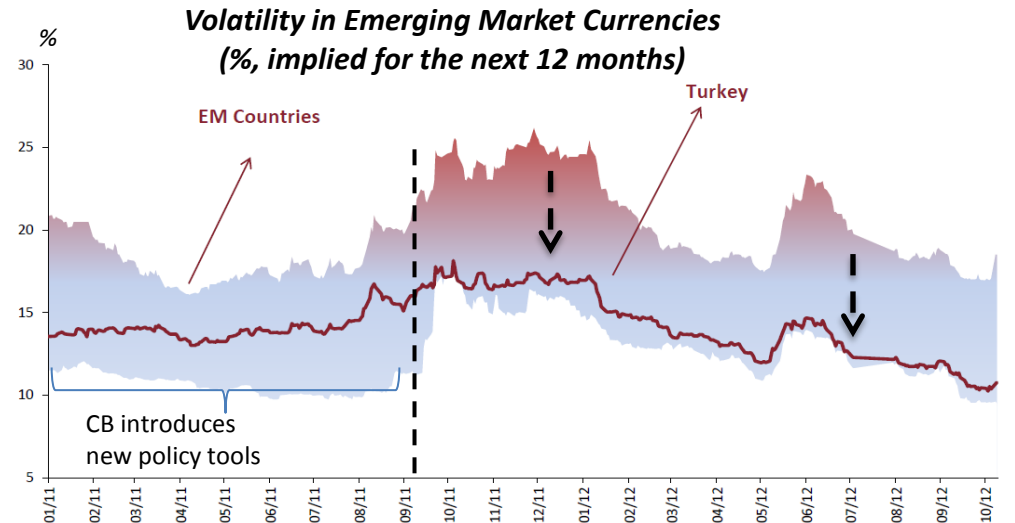
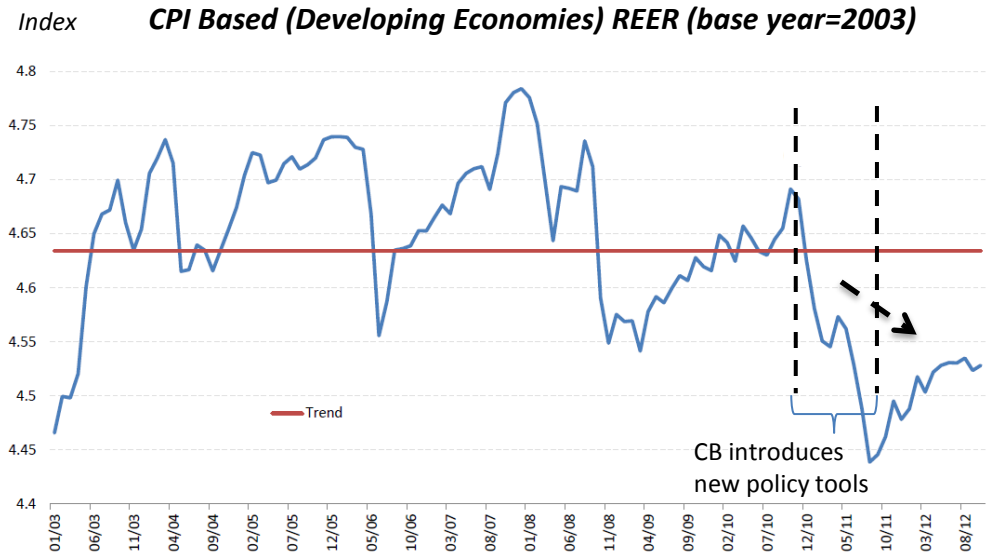
Source: CBRT

Rebalancing After 2011

Monetary policy has been successful to rebalance the Turkish economy ;

□ After the new policy measures, real exchange rates began to depreciate and, by 2011, turned to its base value in 2003.

□ Increases in the volatility of short-term interest rates result in decreases in the volatility of the exchange rate. This fact creates an environment that encourages long-term capital movements.

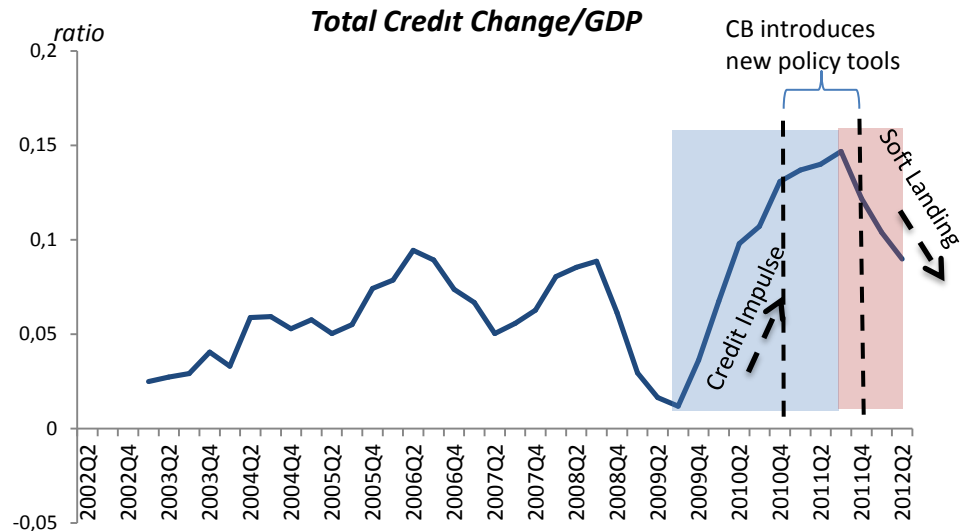
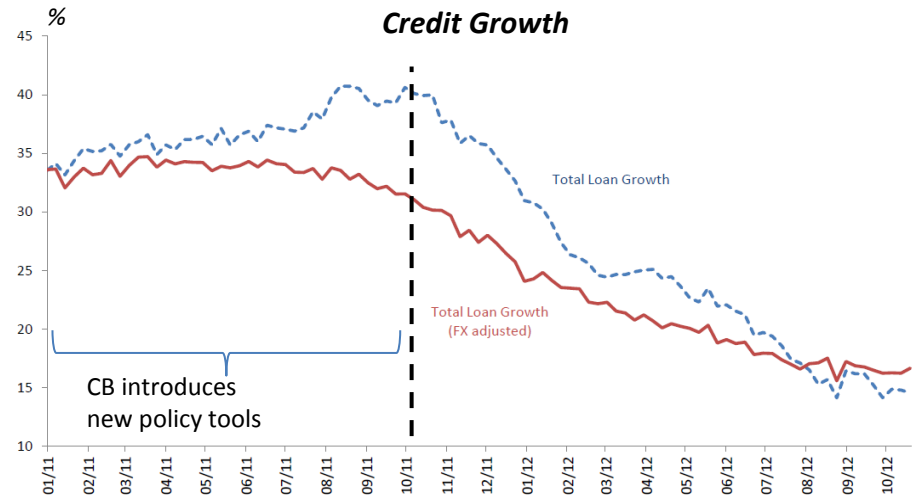


Source: Bloomberg, CBRT

Soft Landing After 2011

- With the CBRT policy mix, the composition of demand started to move in the desired direction and a rebalancing domestic demand was initiated as of mid-2011.

- After 2011, credit growth have begun to decrease.



Source: CBRT

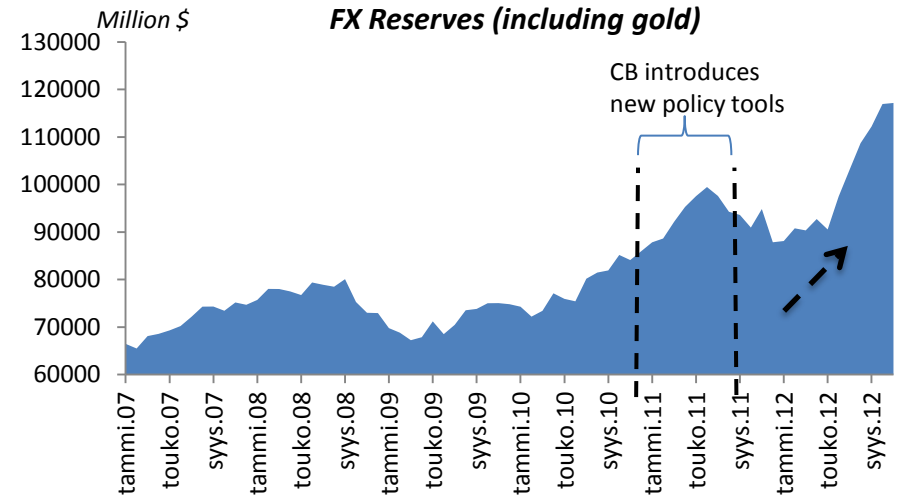
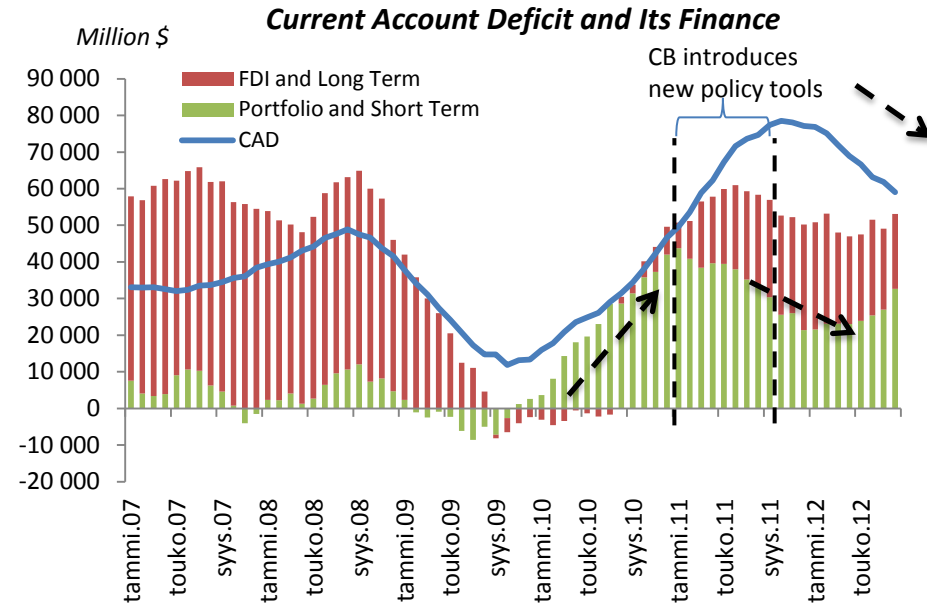
Balanced Demand

Soft Landing After 2011

- The quality of capital inflows has started to improve. Short-term capital flows have begun to decrease whereas long-term capital flows have increased.
- CAD has begun to decrease whereas FX reserves began to increase.



*Improving Financial Stability
and Contributes Stable Growth*



Source: CBRT

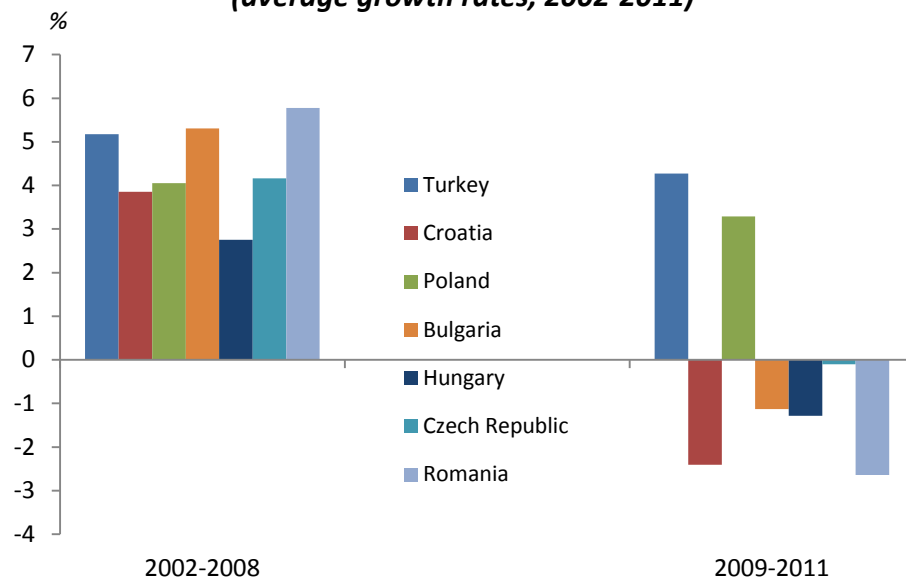
TURKISH ECONOMY VS. SELECTED OTHER ECONOMIES

Turkish Economy vs. Selected Other Economies

Growth Performance

- Between 2002-2008, Turkey's and the other selected countries' growth performances are close to each other. However, after the Lehman crisis in 2008 and uncertainties in Euro area, Turkish economy's growth performance significantly differs from other countries. Performance here refers to 'high and stable growth'.
- Cumulatively, Turkish economy grew 53.6 percent in the last ten years which is higher than other selected countries' growth rates and also one of the highest in the world.
- As we also mentioned at the beginning, three main factors that are necessary for stable and high growth can explain this performance difference.

Growth Performances of some Selected Countries
(average growth rates, 2002-2011)



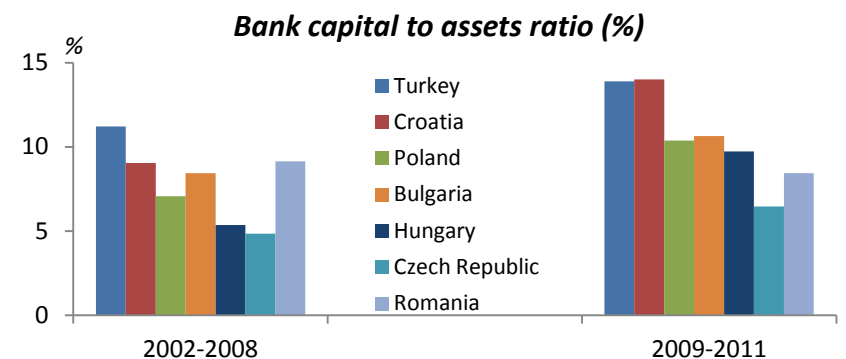
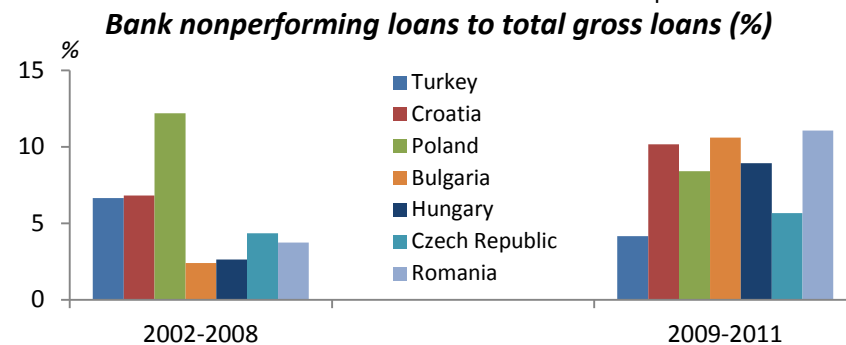
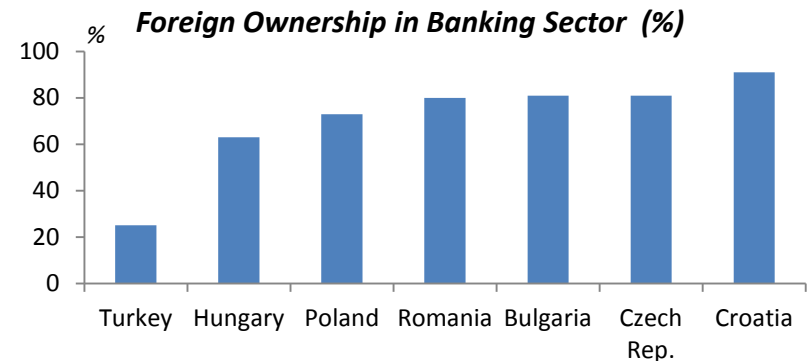
Cumulative Growth between 2002-2011						
Turkey	Croatia	Poland	Bulgaria	Hungary	Czech Rep.	Romania
53.6	21.4	37.2	32.8	17.3	29.9	28.9

Source: WDI

Turkish Economy vs. Selected Economies

Sound Banking System

- ❑ One of the main factors that help to explain the Turkish growth performance is the sound banking system and low foreign ownership.
- ❑ Compared with selected countries, Turkish banking sector has the lowest foreign ownership. Since the level of financial openness is lower, Turkey has been affected less than the others from the recent crises.
- ❑ Low non-performing ratio and high capital adequacy are the other factors that can explain the sound banking system in Turkey .
- ❑ After the Lehman crisis, Turkish banking system has become stronger and it now has the lowest non performing loan ratio and one of the highest capital adequacy ratio.



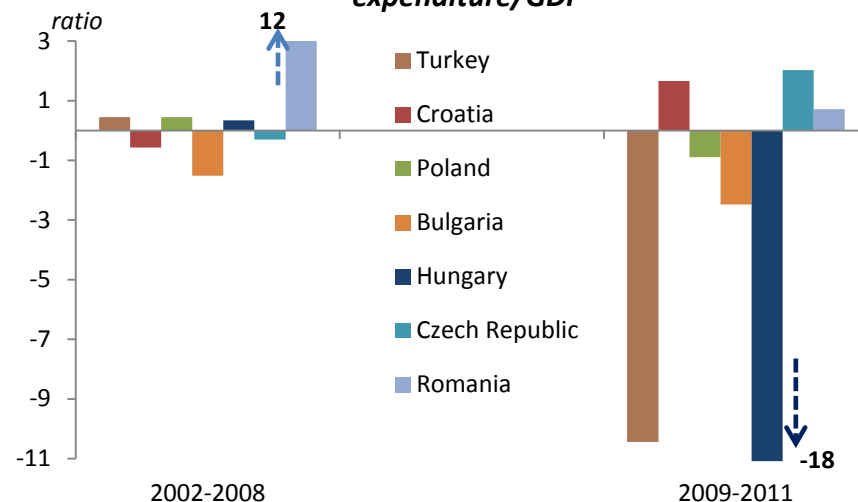
Source: WDI, EBRD, Transition Report

Turkish Economy vs. Selected Other Economies

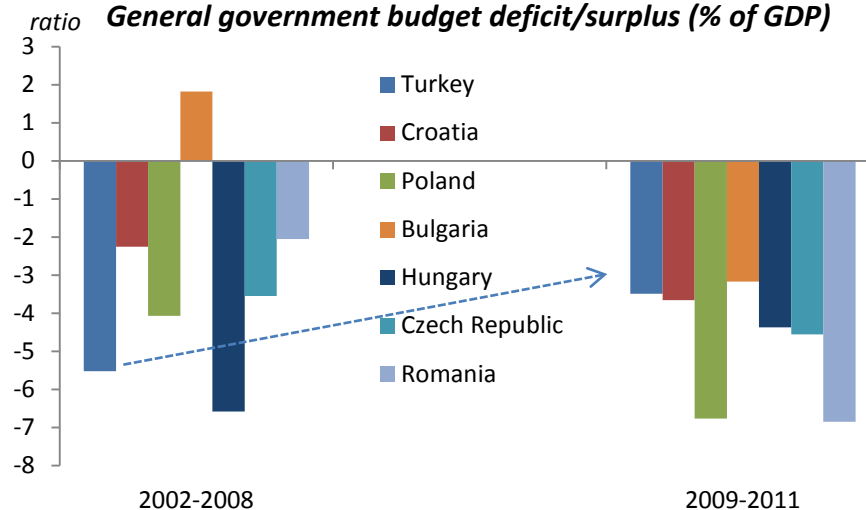
Tight Fiscal Policy

- Another key factor that help to explain the Turkish growth performance is the tight fiscal policy.
- Tighter policy refers to smaller government expenditure and income. This implies higher expenditure and income possibilities for private sector and lower uncertainty for efficiency-seeking market economy.
- Compared with the other selected countries, Turkey has succeeded to sustain its tight stance in government expenditure. It has one of the lowest budget deficit in the selected country group.

Increase in General government final consumption expenditure/GDP



General government budget deficit/surplus (% of GDP)



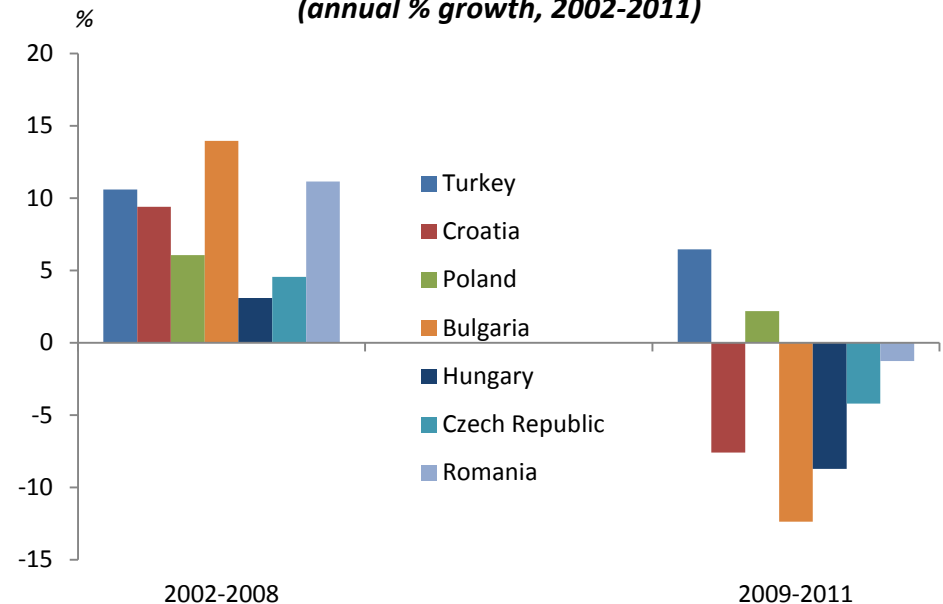
Source: WDI

Turkish Economy vs. Selected Other Economies

High Investment Growth

- Sound banking system, tight fiscal policy and the wise monetary policy that support previous two reduce the uncertainties in the economy and help investment increase in the economy.
- Investment is important for the economy since it helps growth rates to be high and stable.
- Thus, high investment expenditure can be another factor to explain Turkish growth performance.
- As seen from the graph, different from selected countries, Turkey succeeded to sustain his high investment profile after the crisis.

Gross Fixed Investment of Selected Countries
(annual % growth, 2002-2011)



Source: WDI

Lessons and Comments

