Keynote Speech

Global Economy and Turkey: 2016 and Beyond

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Abstract

Irrespective of whether advanced economies (AEs) or emerging market economies (EMEs), the number one problem of the global economy is not being able to generate a satisfactory growth. Income levels in some countries are barely above the per-crisis level. Despite ample liquidity due to quantitative monetary policies, consumption and investment demands are weak. Because high level of indebtedness deter economic agents from using credit. Credit markets still do not function well either. Quantitative easing policies have been successful in containing further deterioration. Despite ample liquidity inflation has not risen, but it did delivered the expected growth. Because banking system in AEs is weak and monetary transmission mechanisms are not functioning well. As for EMEs, commodity prices and World trade appears to be weak; economic growth are slowing down, capex is visibly falling in heavy industrial sectors due to already existing excess capacity. The academia as well as the business community are worried about the appropriateness of the present policies in case another recession comes, central banks will have little ammunition to deal with it. The option being talked of now is what is dubbed as “helicopter Money”. Turkey being an open economy, has been and will be effected by the developments in the global economy through trade, capital flows and expectation channels. By international standards, Turkey have a reasonable growth rate of 3 to 4 %, implying a new growth era where high growth cycle ended due to changing global financial conditions and its structural problems. Future growth performance will depend on the level of investments and savings to finance it. As her own saving is low, foreign capital flows is crucial. High inflation and interest rate are the two negatives, but it has a strong fiscal position, debt / GDP is 32.3%, the budget is almost balanced, producing primary surplus which proved it is resilience in the face of recent failed coup and the negative attitudes displayed by the rating.

Following the stagflation era of the early ‘70s due to the first oil shock, the global economy went through a very benign period ending with a crisis in august 2007. This era spanning for almost 20 years is called Great Moderation where the global economy, especially the Advanced Economies (AEs), generated, in relative terms, reasonably high and sustained growth, low inflation as well as high employment.

This benign environment had a profound impact on the economic policy designs and the regulatory approaches. That is free markets were functioning well, the lesser the interventions into the workings of the markets, the better it would have been. Because, at the time it was thought that less regulation and supervision would have led to higher efficacy and financial innovation, which in turn would reduce the cost of doing business and further enhance the economic growth. This thinking was in fact formulated into a set of neo-classical rules which are today known as “Washington Consensus”.

However, this episode ended unhappily in august 2007 with a crisis first in the financial sector, where asset prices plunged, and then permeating itself on to the real economy, causing dislocations in every part of the economies resulting in rising unemployment and falling output.

Since the crisis manifested itself first in the financial sector of the AEs with toxic assets, and the Emerging Market Economies (EMEs), being free of these assets, served at the early stages of the crisis, as the growth engine of the global economy. That is, while the AEs went into recession quarter after quarter, the EMEs played a vital role for the World Economy by generating a reasonably high growth by eliminating the demand deficiency to a certain extent and contained further contraction.

Today, irrespective of whether the AE or the EMEs, the most urgent and the number one problem of the global economy is not being able to generate a satisfactory sustainable growth. In some countries income levels are barely above the pre-crisis level. Despite ample liquidity due to the very large accommodative monetary policies, consumption and investment demands are weak. This is so, despite the fact that, in many AEs, the cost of capital is zero or close to. Even in some major economies interest rates are negative and literally money is free. In the meantime, what is ironic is the rise of global debt level. Indeed, as the combined global GDP went up to 78 trillion US dollars in 2014 from 28 trillion US dollars in 1994, the combined global debt, however, increased to 225 trillion US dollars in 2014 from 40 trillion US dollars in 1994.

Also economic policies coordination wise has changed. At the onset of the crisis, all countries especially the EAs, more or less being on the same or similar business cycles, made the global economic policy coordination easy. In this respect the G20 and the Financial Stability Board (FSB) served as policy coordinating platforms for both in terms of intellectual analysis and policy designs.

The response of the authorities, on the G20 and the FSB meetings, to the crisis was to take and implement strict austerity measures. Because the diagnoses made were that the crisis was the result of the debt burden mainly of private sector; households and corporates, which through various bailing out programs turned into public debt. As

a corollary, while fiscal policies were geared towards fiscal consolidation, the burden of tackling the problem fell on the monetary policy. The central banks of the major AEs adopted accommodative monetary policies known as Quantitative Easing (QE). Today the combined size of the balance sheet of four central banks has increased by five folds to around 18 trillion US dollars. The strict fiscal policy approach was then aided and justified by the academic literature that when the public debt of a country reaches to 90 percent of its GDP, the crisis becomes inevitable. Nowadays, this is disputed and challenged and the policy coordination by the G20 and the FSB is more difficult, since each country's needs are different. That is each country is on different phase of the business cycle.

Have these QEs policies worked? To a certain extent yes. It was effective in containing further deterioration and deepening the crisis, and in buying the time for politicians and other decision makers to address the structural issues. However, it cannot be said that politicians, especially in the European Union (EU) and the Euro Zone (EZ), used the time effectively and efficiently. It is true that cheap or rather free money has not generated inflation, neither did it deliver expected growth, but unemployment levels have come down in some countries. Except Russia, India, Brazil, South Africa and Turkey, in the rest of the World, inflation is very low, even negative in some countries. The average world inflation forecasted for 2016 is 4.3 percent and for the EMEs is 4.5 percent. Why then has the accommodative monetary policy, which is Keynesian in essence and aims at stimulating total aggregate demand, not worked? I believe the answer lies in the fact that, as an initial condition, the level of indebtedness of households and corporates was and is very high. Indeed household debt to the GDP is over 60 percent in the EU, 79.5 percent in the USA and 120.9 percent in Japan. When we look at the household debt to the disposable income levels, we see that it is 95.6 percent in the EU, 104.7 percent in the USA and 129.5 percent in Japan. Furthermore, those whose propensity to spend is high, do not have enough income; and those who have income but indebted save it in order to pay off their already high level of debt. Because in a recessionary environment, falling prices makes the debt burden even higher. This has led to the loss of confidence and spending cuts or postponements. For these reasons money is not demanded and hence the velocity of money tends to fall close to zero. This indicates that there are serious problems on both demand and supply sides of the credit markets.

Having, passed the mid-year and close to entering the last quarter of the year, what is the prospectus future of the global economy? When the International Monetary Fund (IMF) released its the World Economic Outlook and the Global Financial Stability Reports on the occasion of the IMF-WB spring meeting in last April warned the world community that already weak growth will continue in 2016 at an increasingly disappointing pace. In fact the title of the Report was "too slow for too long". In the said reports the IMF forecasted the world economy to grow 3.2 percent 2016 and 3.5 percent in 2017. Since then, these numbers have been revised downwards. For the downward revisions, the IMF has cited two risks: one is financial which capital flight from the EMEs to AEs is. This so far has not been materialized on a grand scale. The other risk was a non-economic one such as loss of confidence, further depreciation of the EMEs currencies, geopolitics risks, and the developments in China and its impact on the rest of the world.

As for country specific developments, the USA economy, which was the first to go into crisis, has also been the first to begin to recover earlier than any other country. But it has not recovered fully yet. Despite the ample liquidity provided by the FED, households, under the low inflation and the low interest rate environment, are not too eager to spend. The level of indebtedness was/is already too high. The economy, as if, was/is going through a liquidity trap. The growth forecasted by the IMF is 3.4 percent in 2016 and 2.5 percent in 2017. However, it seems that the economy has settled down to a growth rate of around 2 percent. The latest figure is 1.8 percent. Labor market is in better shape and inflation is around 0.8 percent, well below 2 percent target rate.

The FED in order to convince the markets that QEs policies are working, in May 2013 verbally communicated to markets, without any action then, that it will end the expansionary monetary policy sometimes in future. In fact, the FED stopped buying securities in October 2014, and hiked the policy rate, the FED Fund Rate, by 25 basis points to 50 basis points in December 2015. Since then, market participants have been guessing how many times more the FED will hike.

Early in the year, the FED watchers said there would be 4 hikes bringing the policy rate to 2.5 percent by end 2016. However, 4 hikes were reduced to 2 and now expectations are that in the remaining part of 2016 the FED will hike only once, probably in December. When and what number of hikes are made, it will have great impact on the global capital flows. Why has the FED postponed the rate hikes? Probably economy is weaker than it first appears to be. It is also aware of its action that will negatively affect the rest of the world. Another reason might be that the USA Banks and other financial institutions have large exposures to high yield corporate bond market. In order to finance the investments in shale oil sector, companies borrowed heavily but with the fall in oil prices, the companies have become unable to generate enough income to service bond payments and other borrowings. Higher interest rates would make these debt services even more difficult. In terms of capitalization and capital adequacy ratio, although there are still number of other issues to be tackled with, the USA banks are in a better shape than the continental banks.

In 2015 the Euro Zone (EZ) grew 1.6 percent and this has just brought the GDP to pre 2008 level. The IMF's April forecasts were 1.5 percent for 2016 and 1.6 percent for 2017. In order to sustain the fragile growth momentum, the European Central Bank (ECB) took further measures to support this incipient growth, where the

policy rate is zero. The union wide unemployment rate is 10.1 percent, public sector debt to the GDP is 90.8 percent which is rather high compared to post European standards, inflation is low around 0.2 percent. The EZ growth rate in the Q1 2016 is 1.6, the EU28 growth rate is 1.8 percent.

The ECB with its twin mandates of price and financial stability, in order to influence the economy through monetary policy, need a strong and efficient banking system, which is precondition to have a well-functioning monetary transmission mechanism. This even becomes more important under circumstances of negative interest rate environment. A strong banking system in its own right provides many indispensable externalities to the whole economy. For this reason one might say that “banking is a public good”. The European Banks under the regulation and supervision of the Banking Union are in need of further capitalization and re-structuring. The non-performing loans are rising, and existing excess capacity means that there are more banks than needed and therefore there is a need for further consolidation. Greek debt problems still pose a threat to the system and Brexit has made a dent into the institutional structure and to the decision making process. The question asked is: is this a market failure or institutional failure?

Japan has been in recession for more than 20 years now. The prices are falling and inflation is low, in fact it is negative 0.4 percent which increases the burden of debt. The levels of public and household debt are very high. Some say that the high levels of these debts are not for concern. Because all of the debt is denominated in national currency, Yen, and owed to the residents. However if and when interest rates begin to rise re-financing this level of debt would become costly. Japanese unemployment is low. As the EZ banks, Japanese banks’ financial conditions are weak and the monetary transmission mechanism is not working well either. Of late, the Bank of Japan (BOJ) has increased amount of bond purchases and brought the policy rate to negative area. Notwithstanding all these, the economy is weak and not growing. End of Q2 2016 y.o.y growth is a mere 0.1 percent. This indicates that Japan is really in liquidity trap for a considerable time.

The Brexit was cited by the IMF as one of the risks that might negatively impact the world growth. The UK has to negotiate the exit with the EU within 2 years. The UK decision to leave the EU will have wide range of disruptions and damages to the world trade and investment relationships due to the changing nature of international cross border productions pattern and trade. Since leave decision, the Bank of England (BOE) has cut the interest rate to lessen the negative impact on its own growth.

Russia, Brazil, South Africa, once the stars of the EMEs are experiencing hardships. Their economies are contracting, unemployment is rising and incomes are falling, due to the falling commodity prices. Russia’s inflation is 7.2 percent, and y.o.y growth at end Q2 2016 is minus 0.6 percent. Among the EMEs India is the best performer with the highest growth rate of 7 percent in the world.

China seems to be at the threshold of a paradigm change in terms of its growth model. As the global economy is slowing, demand for Chinese goods are not increasing as before, China is mulling to switch from export led growth to domestic demand led growth. China grew 6.9 percent in 2015 and according to the IMF forecast it will grow 6.5 and 6.2 percent in 2016-2017 respectively. These are high growth rates by international standards but not by China’s own historical performance standards. 6 to 7 percent growth rate is said to be not enough for China’s social cohesion. Its public central government debt / GDP is low but private and local government sectors within the last couple of years have accumulated huge debt, at least 2.5 times of the GDP. The debt is owed to banks as well as what is called shadow banking outside regulatory and supervisory realm. According to the said IMF Report “the health of the corporate sector is declining due to slower growth and lower profitability. This is reflected in the share of the debt by the firms that do not earn enough to cover their interest payments”. “Corporate bank loans potentially at risk amount to almost 1.3 trillion US dollars, approximately 7 percent of the GDP”. In an unpredictable and volatile environment, where commodity prices and world trade appear to be weak, China has already slowed down capital expenditure in heavy industrial sectors of mining, ship building, steel and aluminum. In these sectors there has emerged and excess capacity. On the financial front the Chinese currency has been accepted to the SDR basket and China is trying to internationalize its currency with the ultimate aim of making it convertible. China is also encouraging the use of its currency in regional as well as in international trade.

Coming back to the policy choices and their implementations, academic worlds as well as business community are worried about the appropriateness of the present policies. Because the expansionary monetary policies might have come to its limits. Here the worry is that if another recession comes, central banks will have little or no ammunition to deal with it. Academic world and the policy designers are now discussing what is metaphorically called “the helicopter money”. The former FED chairman Bernanke has written on this extensively. In case QE’s policies fail completely, Bernanke proposes what he calls “Money Financed Fiscal Programs” where central banks are directly financing earmarked government spending.

The performance of the economy of any country depends on its own internal dynamics as well as how far it has been integrated into the global economy. Turkey, being an open economy, has been and will be affected by the developments in the global economy through trade, capital flows and expectation channels.

In terms of the league of biggest GNPs, Turkey is the 18th largest economy with a 720 billion USA dollars GDP at end 2015. Of lately, its ranking has oscillated between 17th and 19th places.

Turkey's growth model rests on the realization of high current account deficit (CAD). High growth rate means high CAD. Because high growth entails high rate of investment, which under ideal conditions, should be financed by domestic savings. Since Turkey's domestic savings are low, the deficiency in saving is matched with the import of other countries saving through capital flows. In terms of economic activity, Turkey's growth model prioritizes construction industry over manufacturing. In terms of expenditure it is the domestic consumption rather than external demand that is decisive. Hence at the end, the total expenditure exceeds the total income which results in CAD. Turkey had current account surplus on its Balance of Payments (BOP) only in those years in which the economy grew negative.

The Turkish economy, at end Q1 2016, grew 4.8 percent y.o.y, mainly driven by domestic consumption, private sector investment being zero or negative for at least 13 quarters. In the medium term program, 2016 growth target is 4.5 percent and the latest forecasts by the WB, the IMF and the OECD are in a range of 3.5 – 3.9 percent. Latest available data for leading indicators such as industrial production, capacity utilization and similar other survey numbers suggest that 2016 growth will be around 4 percent. However, no one should attempt to attribute this performance. It is a reasonable growth by international comparisons. However, it is not really very satisfactory when compared to its own recent performances as well as to its own potential growth rate, which is estimated to be around 5.5 percent.

With this level of growth, Turkey cannot accomplish a catching up process and close the per capita income gap vis-a-vis the developed economies. When one examines the dynamics of the Turkish economic growth sees that growth pattern has been very erratic. Average growth rate of the past 50 years is around 4.8 percent. Due to instability, both political and economic, the volatility of growth has been rather high. Highest and lowest rates of growth realized were 9.5 percent in 1976 and minus 7.8 percent in 2001. Per capita growth trend has lagged behind that of European Economies. The standard deviation of the growth has also been high. It was 5.1 in '90s and 5.3 in 2000. The per capita income being 1,500 US dollars in 1980 increased to 3,000 in 1990 and to 10,000 US dollars in 2008. Since then, it remained around that amount; even fell below that in 2015. After 9.2 percent and 8.5 percent growth rates in 2010 and 2011, Turkish economy seems to be settled to a 3 – 4 percent growth band. 2012-2015 average growth rate is 3.2 percent. This implies that Turkey has entered a new growth era where high growth cycle ended due to changing global financial conditions and its structural problems. Should we say that it is already in middle income trap? It may not be so. But it is at the threshold. Turkey should waste no time to address its structural problems.

Under this low growth environment, if yearly labor forces happen to be growing around 3 percent, employment growth will be below economic growth. Therefore, in the coming period the level of per capita will be determined by the rate of population growth and the rate of economic growth. For example if the economy grows 4 percent yearly and the population growth happens to be 1.3 percent, in 20 years from now Turkey's per capita income, based on 2015 GDP of 725 billion US dollars, will be 20,000 US dollars. If population growth remains at 1.3 percent and the economy grows at 3 percent yearly rather than 4 percent, then in 20 years per capita will be around 15,000 US dollars, which is far below the per capita income target of 25,000 US dollars in 2023 target.

By the way, according to the data released by the TURKSTAT the unemployment rate was 9.4 percent in May 2016 compared to 9.3 percent in April 2016 and 9.3 percent in May 2015. Seasonally adjusted rate jumped from 9.8 percent to 10.2 percent being the highest since October 2015. What has happened that the unemployment rate increased? Is this a temporary phenomenon or, it is the beginning of a new trend due to the concerns mentioned above.

What should be done? After 2001 crisis up until 2007, the bulk of the growth came from productivity growths due to the structural reforms accomplished. Since then, productivity gains are falling. This is so whether it is measured in terms of output per worker or output per hour worked. It is low and stagnant.

High inflation and high interest rates are two of negatives of the Turkish economy. In its last inflation Report the Central Bank of the Republic of Turkey (CBRT) has revised its assumptions on oil and import prices upward. At the same time it made downward revisions to its food prices assumptions. Based on these assumptions, it forecasted the year end inflation as 7.5 percent and 6 percent in 2017, 5 percent in 2018, which is the target. Markets do not share this optimism. The latest expectations survey shows that market participants see the inflation at the end of the year as 8.21 percent up from 7.81 percent, 12 and 24 months expectations stands at 7.61 and 7.16 percent respectively. Market's position is understandable because, core inflation which is more sensitive to the interest rate changes is rather high and not responding much to policy changes.

In last August the CBRT communicated to the market that it would simplify its interest rate policy, meaning that when the process ended, it will give all the liquidity at the one week repo rate. Since then it has cut upper band of the corridor several times. Now its upper corridor lending rate is 8.75 percent. The corridor has been narrowed. The headline inflation being at 8.76 percent at the end of July, does not give further maneuver for the CBRT, I believe. The composite funding cost has come down from 9 percent level to just above 8 percent which is just about equal to inflation.

As was mentioned above, Turkey's growth model entail current account deficit. Because, Turkish manufacturing industry is dependent on imported raw materials and semi-finished goods. There is a high degree of tradeoff between growth and imports. According to a study, the rate of dependency of manufacturing industry on imports was 41 percent in 2008, 38, 40, 43 percent in 2009, 2010, 2011 respectively. These are average figures. The dependency ratio in iron and steel sector was 69 percent and in chemicals 56 percent etc. Due mainly to the collapsed commodity prices and the slower economic activity during the last 12 month, the current account position had improved considerably. However, June 2016 Balance of Payment (BOP) figures show that this improvement has been halted. The declining tourism revenues which make up 3 percent of GDP and 13 percent of total hard currency earnings, and rising imports seem to be the likely the cause behind this reversal. On a 12 month rolling basis the deficit widened from 27.7 billion US dollars to 29.4 billion US dollars. In terms of percentages the current account deficit to the GDP now stands at 3.5 percent down from 7.9 percent at end 2013. Re-establishing good relations with Russia is a right step in the right direction. But Turkey will feel its full impact next year.

As for capital flows into the country, which is vital for a saving deficit country, after the initial negative reaction in the wake of the failed coup attempt, flows continue as before. In the latest BOP, one can see that real sector, as of end June, was able to refinance its maturing debt to the extent of 179 percent. Similarly long term external debt roll-over ratio of banks was 123 percent. The FDI flows continue at a reasonable pace.

In the immediate aftermath of the failed coup, the Turkish currency depreciated to the tune of 6 percent. However when markets opened following Monday, currency recovered fast and it is now at pre-crisis level. It was a sell opportunity for domestic residents with foreign exchange deposits at the banks. Their foreign exchange sales as well as the communication with market by the CBRT and government were instrumental in restoring the confidence quickly.

Turkey is one of the few countries having exceptionally strong public finance positions. Budget deficit is forecasted as just below 1 percent and still producing primary surplus. In fact with the July numbers, one sees that the budget balance was in surplus by 1.3 billion TL in the first seven month of the year. In the same period the primary surplus was realized as 31.9 billion TL. Despite this overwhelming fact, in the markets there were concerns for the Turkish economy's investment grade rating. Yes there had been a failed coup, but it caused no damage to basic fundamentals of the economy. It is also true that there is high foreign exchange denominated debt maturing in a year's time. This is not a new thing, market already knew it. What mattered was and is the confidence of the investors in the economy. Out of 3 Rating Agencies, the 2 have acknowledged Turkey's investable rating grade and capital flows continue as before. Had one of the Agencies downgraded Turkey, by regulation, institutional investors would have to leave the country creating pressure on the currency.

Since 2001 crisis the Turkish economy has moved a long way through implementing the first generation of the reforms and the structural changes. Now there is a need for a second generation of reforms and structural changes. In this respect for development, volume of physical and human capital accumulation, including factories machines, tools and educational qualifications are all important. But more than that are the need for advanced knowledge, innovation, culture, social norms and well-functioning institutions.

For this end to maintain the resilience of the economy, the authorities must be ready to eradicate corruption, informal economy, political intransigence, weak legal system and the feeling of the wide spread insecurity. For the level playing for all, impartial and transparent enforcement of the rule of law, protection of the property rights, incentivizing for higher value added innovation and giving general assurance that peoples' rights not get violated must be the utmost priority of the authorities.