türkiye ekonomi politikaları araştırma vakfı

Global Crisis Working Group

Economic Policy Research Foundation

# 2007-08 Global Financial Crisis and Turkey: Impacts and Recommendations

## 1. Introduction

The 2007-08 crisis differs from the crises that have been faced to date on account of its characteristic of "being global from the beginning".[1] The crisis not only brings to the forefront the need for coordination among nation states within the current global financial architecture but also generates debate on the designation of new global mechanisms. More significantly still, the crisis brings along a risk for Turkey to lose years 2008 as well as 2009 and 2010 in terms of growth potential unless necessary measures are taken immediately.

Within this framework, a pressing need emerges to make projections concerning the impact of the crisis, which started off in the financial markets, on the economies of developing as well as developed countries. The analyses on the spillover mechanisms of the crisis also shed light on what type of measures can be taken under which conditions.

Turkey should soon decide on a strategy in order to manage the negative effects of the crisis as well as turn the crisis into an opportunity. Under these circumstances, it would be appropriate to discuss various alternatives for a strategy within the agenda of economic policies. It should be stressed here that, apart from an attitude that can be summed up as "wait and see," there also exists another strategy option which is built upon the forecasts about the impacts of the crisis on Turkey and that consists of proactive measures.

It is obvious that a new strategy to be developed for tackling the crisis and a package of measures to be implemented accordingly require a new approach in economic policies. Several studies by TEPAV demonstrated in the pre-crisis environment that Turkey's priority should be second generation reforms to ensure the sustainability of productivity increases in the economy. The global crisis, however, temporarily change these priorities due to the urgent agenda it necessitates. In the new environment, the need to delimit possible production losses becomes a priority for Turkey. In the meantime, sustaining macroeconomic stability by preserving fiscal discipline will ensure that the success achieved in the last few years will not be in vain.

This policy note offers an assessment framework on the global crisis as well as some policy alternatives. The following section accounts for the structural foundations and the emergence of the crisis. The third section discusses the channels through and the ways in which the crisis will affect the Turkish economy. The final section proposes policy alternatives to manage the negative effects of the crisis and to turn it into an opportunity.

[1] In terms of globality, the importance of the 1997-98 East Asian Crisis can also be emphasized. In fact, the concepts of "contagion effect" and spillover had frequently been referred to in the literature during the East Asian Crisis. On the other hand, it is clear that the nature of the East Asian Crisis does not indicate the characteristic of "being global from the beginning".

## 2. The Structural Origins of the Crisis and Its Form of Occurrence

### Roots

The fact that the architecture of the existing financial market has "failed" is apparent. The system has allowed taking excessive risks, it has not been able to make appropriate pricing of the assets within its structure and it has created an important weakness as regards transparency.

Although, through an ethical perspective, the greediness and the corruptness of the world of finance is said to lie behind the existing crisis, the roots of the crisis essentially originate from the institutional regulation problems.[2] In this context, it is necessary to mention the two main changes, which have shaped the last forty years in USA. The first one that dates back to 1970s is the deregulation of commissions paid to stockbrokers. The second that dates back to 1990s is the elimination of the restrictions between commercial banking and investment banking activities. These developments in the field of financial market regulation had prepared the beginning of the 2007-08 crisis.

On the other hand, regulation and supervision of the traditional banking system much more than the "shadow banking system" in the last period caused this sector to gradually become less profitable. This situation has directed the regular banks that wish to increase their profit rates to those of the shadow banking system towards designing more risky derivatives.

The direct impacts of deregulation have been in the form of increased competition, narrowed profit margins and investment baking practices of commercial banks that are transcended over the usual levels. Creation and distribution of complex derivatives had been incorporated to the financial architecture as the main reaction of the investment banks against this trend of change. The originate-and-distribute model of securitization and intensive use of financial leverage have produced the first-hand causes of the crisis.

At this point, it is not possible to perceive what has been told as entirely a policy failure. The point necessary to be emphasized is that wisely taken policy decisions may sometimes produce undesired results.

### The Form of Occurrence

Mortgage credits, which have always had an important place in the portfolio of the banks in USA, are the starting link of the chain.[3] In this environment, the share of subprime mortgage credits available to the low-income group in USA in total mortgage credits has gradually increased. The rise of this share from 8.5% in 2003 to 20.1% in 2006 has increased the risk within the system. The problems faced in credit repayments, recalled credits and the subsequent liquidation of the securities (houses) has caused a considerable decline in housing prices. In that way, the meltdown process of bank stocks has been triggered and the system got trapped in a vicious circle.

The complexity of the dynamics of the crisis and its shock impact should be sought in the fund flows around the mortgage credits. In an environment where housing credits have extensively expanded, the prices of the mortgage could exceed the value of the credits with the housing prices index preserving its upward trend. The direct

[2] In relation to this section, the comment of Prof. Barry Eichengreen from the University of California, Berkeley published in the Daily News Egypt can be examined. The comment of Daniel Gross published in Slate titled "Shattering the Glass-Steagall: The Rise of the Commercial Banks" also offers useful insight. Lastly, the BIS Working Paper (No. 259) written by Luci Ellis titled "The housing meltdown: Why did it happen in the United States" is full of quite enlightening information, as well.

[3] The share of mortgage credits was around 33% by the end of 2007.

consequence of this was observed as the continuous increase in the secondary mortgage credits and in the other types of consumer credits.

The fact that the USA financial markets, which had remained normal until August 2007, have actually had a considerably risky balance of assets and liabilities became more visible with the designing of the ABX indices by the London based Markit company. With this new tool that the company has developed to measure the market risks, it became possible to collectively assess the riskiness of having securities "based on the liabilities of house owners with low credit worthiness". With the index gathering together the prices of the securities based on 25 subprime assets within its structure, information is being provided on the dimensions of the risk held by the owners of the assets that embody other assets based on these assets, whereas until that date, this type of securities[4] had been priced according to the in-house methods in the balance sheets of those purchasing them. Therefore, information asymmetry lies behind the existing global crisis to a large extent.[5]

In summary, the chain of events explained above can be presented as the sustainability of the income flows, obscurity regarding the contents of the derivatives, inclusion of the instruments with low credit worthiness and others into the same funds, lack of deposit insurance for the pool, insurance companies being the guarantor of the income flows within the pool and the fact that those who create the pool are non-bank intermediary institutions. On the other hand, the deficiencies in "public disclosure" regulations have prepared the setting for the crisis of confidence to arise.[6] This situation has resulted in the perception of the exceptions and exemptions provided for the "informed" investors and the perception of the risks for those uninformed lower than real. Hedge funds and similar investment fund models that have been brought into play recently took advantage of the weaknesses in the public disclosure regulations to a great extent.

It is not surprising to see that the period during which the chain of events explained so far have taken place coincides with the period where the "baby-boomer" generation moved on in the working life and the retirement funds gained weight in the financial system. Again, at the same time, these funds, which have reached to significant amounts thanks to the lowering of the policy interest rates by the US Federal Reserve, have made it possible for the USA financial system to expand its credit portfolio towards the low-income group. In this context, it would not be wrong to assert that a combination of the factors summarized above has initiated or at least aggravated the crisis.

**What is Next?**

From now on, the damages to be caused by the crisis will come to the fore. The shrinkage in the balance sheet of the financial system has already caused a narrowing down of the credit volume. This narrowing down is expected to continue for a certain

[4] These assets, the prices of which are not determined through trading in a collective market but within the system of the relevant institution are also called as "third type assets".

[5] In today's financial markets where complex investment instruments are traded in high volumes, diversification of risks also by using complex techniques becomes insufficient and in case of lack of information on these risks, the diversification activity itself can bring about the dissemination of risks throughout the system. That is why, it would not be wrong to recognize the fact that the ABX-Home Equity index, which was developed by the end of 2006 and put into service in the beginning of 2007, has made the dimensions of the risk that prevailed in the markets during 2007 starting from August visible as the "virtue of measurement".

[6] In relation to banking crises, "The Panic of 2007" by Prof. Gary Gorton from the Wharton School can be referred to. The study dated September 2008 published in NBER Working Paper series (No. 14358) includes a highly useful assessment framework.

while. Therefore, the corporate sector will also be negatively affected from these developments in the coming period.

The natural consequence of these developments will appear in the form of reduced global growth rate. There are increased signs indicating that some important economies have already gone into stagnation. It is also obvious that unemployment rates will rise. In order to reduce the damage, the countries that can afford will take measures to reactivate the credit system and at the same time to increase the domestic demand. Then, the next stage will be redesigning the global financial system.

## 3. The Transmission of the Crisis to the Turkish Economy

As mentioned above, from this point onwards the main priority in developed countries and in countries like Turkey will be not to control the causes of the crisis but rather the damage caused by the crisis. Increasing spillover of the existing risks over the system in proportion to the level and complexity of the linkages between the real sector and the financial system is among the possibilities. That is why; the scale of the damages to be caused by the crisis will actually be determined in connection with the direction of the credit relationships between the real sector and the financial system.

As a matter of fact, there is no problem in the bank balance sheets in Turkey to cause a crisis. Turkey's banking system demonstrates a much stronger structure in comparison to its former state owing to the legal regulations realized in the past few years. Nevertheless, it is deemed to be beneficial to be prepared for a series of losses in balance sheets in the economy in general.

**The crisis will affect Turkey from four channels. The first and most important of these is the credit channel.** The fact that there are no structural defects observed in Turkish banks in the present situation is an important factor that differentiates the existing crisis from that of 2001. However, since this situation will not be able to prevent the reduction in the funds that the banks obtain from abroad, difficulties are inevitable in syndication credits and in borrowing in foreign currency. Both the banks and also the companies in Turkey had used credit from banks abroad whose balance sheets have now become damaged. The credit volume, which will be narrowed as a result of the closure of this channel, will force companies and banks to scale down their balance sheets. The reduction in the credits used by the big companies will then have an impact on the supply chain of these companies. In that case, the impact created on the SMEs within the supply chain will be in the form of a domino effect. The shrinkage in the commercial credits will be heavily felt by the SMEs, tradesmen and by the employees. In such an environment, the deadlock of the companies will result in facing a structural damage in the bank balance sheets. Prevention of this situation should be among the top priorities of the package of measures to be designed.

**The second channel is the portfolio investment channel.** Hedge funds and private equities carry importance in the flow of financing to Turkey. Attention should be paid to the fact that in a period where global liquidity has expanded, both two channels operate with the leverage gained by the high amounts of credit. Reduction in the transfer of funds from this channel in the coming period will substantially decrease the supply of foreign currency to Turkey which will cause problems in terms of foreign exchange liquidity and which may accelerate the depreciation process of the Turkish Lira.

**The third channel is the foreign trade channel.** As a result of the reflection of crisis in the financial markets on the real sector as well, growth rate projections in the whole world have been updated downwards. It almost became certain that especially a significant part of the developed economies are going to enter into recession. Beyond these projections, there exist indicators showing that the global volume of trade is rapidly narrowing down. For instance, the Baltic Dry Index has declined by about 90% during the May-November period. Raw material prices have also displayed a similar trend in that period due to the same projections.[7] The volume of exports in Turkey will inevitably be affected by the narrowing down of the global volume of trade.

**The fourth and last channel is the negative impact of the increased risk perception and decreased confidence on consumer and investor behaviour.** The component which most quickly be negatively affected from this uncertainty environment is private investment expenditures. Rapid shrinkage of especially the durables consumption will be inevitable with the setback caused by the same environment on the household psychology and therefore on their expectations.

The probability of these four channels that will cause Turkey to be affected by the global crisis to be blocked at the same time is estimated to be considerably high. In such a situation, the concerns about the Turkish economy to face a series of negative consequences in a short period of time are increased. Further slowing down of the growth rate, continued high path of the interest rates, continued increase in inflation, reduction in stock prices, increased unemployment and rapid depreciation of the Turkish Lira are among these negative indicators. All these probabilities mean jeopardizing the sacrifices made after the 2001 crisis and the gains obtained through the successfully implemented economic programme.

## 4. Policy Alternatives and Recommendations

It is highly likely that Turkish economy will be adversely affected through the abovementioned channels both in the rest of 2008 and in 2009. In that case, what can be done to reduce the damage to a minimum? Today, the efforts to find answers to this important question should be at the centre of the economic policy debates. In addition to that, the importance of all measures to be taken in terms of restoring confidence in national and international economic agents should be noted.

In the present environment, it is beneficial to adopt a proactive attitude in economic policies that takes the initiative and that is aimed at restricting the possible adverse effects from the beginning. Important are those measures ensuring that Turkish companies and banks retain their connections to the foreign markets. The point to be kept in mind is that extraordinary times require extraordinary measures.

I- Measures regarding the financial system taken particularly in some emerging market economies may create unfair competition for Turkey. Although current global crisis has been taken under control at the moment, Turkey should hold necessary legislative regulations at disposal against the possibility that the financial crisis flares up again any time soon. Such measures include primarily increased assurances for deposits and strengthening of the capital structure of the financial sector. In that way, persistence of the main mechanisms operating the credit channel will be supported and therefore it will be possible to create the necessary precaution infrastructure to prevent a possible crisis of confidence.

[7] Baltic Dry Index is published by a London based information company called "The Baltic Exchange" which gathers information on the developments in maritime trade and it is issued in daily frequency. The amount of seaborne dry bulk carried in 26 different routes is taken into consideration when creating this index. It is possible to trace the course of the economic activity in the world by looking at this index. At the same time, BDI is also determining on the values of maritime transport companies.

II- The measures to ensure the continuity of the flow of funds to Turkish banks and companies from abroad are of crucial importance. In this framework, discussion of the following recommendations is deemed to be highly beneficial:

a. In the event of signing a new agreement with the IMF, the possible problems concerning foreign exchange liquidity will partially be solved.

b. In order to reduce the amount of reserves that the banks are required to hold in the Central Bank for foreign exchange deposits, the required reserve ratio can be lowered.

c. There is need for a radical and innovative approach for refinancing the credits obtained by the businesses that have foreign direct financing in foreign currency and for preserving the production capacity of the country. This approach should be based on excluding the workers' remittances from the balance sheet of the Central Bank, which puts it in a position of a commercial bank. This mechanism was introduced in order to overcome the problem of balance of payments financing, which had reached to critical levels during the 1970s. Of course, since the Central Bank does not act as a commercial bank, it cannot transfer these funds to the real sector like any commercial bank. Transfer of foreign exchange deposit accounts and the corresponding foreign exchange reserves either to a "corporate sector stabilisation fund" to be newly established or to the banking sector directly can ensure this resource to be put into operation in line with the current needs.

III- Another important point concerning the credit channel is to ensure the continuity of access to domestic credits by companies and consumers. The recommendations below are presented to achieve this goal.

a. If and when the requirement to strengthen capital adequacy in the financial sector arises, the legal preparations recommended above should be put into effect immediately.

b. A new fund can be generated by restructuring the budgetary expenditures, provided that the fiscal discipline is not violated. This fund can be transferred to the "corporate sector stabilisation fund". This can provide guarantee for credits to be opened by the banking sector. The purpose here is to prevent the domestic credit crunch in the banking sector by reducing the increased risk perception of the banks.

c. In order to reduce the amount of reserves that the banks are required to hold in the Central Bank for deposits in Turkish Lira, the required reserve ratio can be lowered. The required reserve ratio can be lowered more for banks, which will play a role in ensuring the continuity of consumer credits.

d. If necessary, a regulatory framework including the restructuring of the debts of the companies to the banks should be prepared. The possible burden to be placed on the public budget that will be caused by such a regulatory framework should be taken into consideration in the process of preparing/amending the 2009 budget.

IV- All these facilities that also involve the usage of public resources must be designed in a way that will preclude a moral hazard. The principle should be to prevent banks that benefit from these facilities from resorting to measures to dwindle their credit portfolios, and companies from resorting to measures to diminish their employment figures.

V- The Budgetary Act of 2009, the 2009 Programme and the Medium Term Programme (MTP) should be aligned with the abovementioned issues. Taking into consideration that there are limited public resources, the expenditure priorities in the existing budget proposal of 2009 should be revised. The main principle is that "the measures which will make the biggest contribution to growth and employment should be the top priority".

VI- There can be two forms of interventions to the global crisis. The first one is that every country takes its own measures aimed at ensuring stability and increasing growth and employment. The second is the establishment of a global coordination mechanism for the same purposes. Taking into consideration that global stability is a global "public good", it is clear that the second method should be supported by Turkey and by the similar countries. Within this framework, Turkey should put its pressure towards this direction during the G20 summit to be held on 15 November 2008. Such a stance will provide the opportunity of designing more integrated and participatory mechanisms that go deep into the root of the problem instead of existing individual support mechanisms such as ensuring foreign exchange liquidity. At the same time, this attitude will also bring about the opportunity for Turkey to benefit from the existing individual support mechanisms more easily.

VII- Considering that the design of the new G20 mechanisms will take some time, strengthening the foreign exchange reserves of Turkey in any case is of critical importance in the existing situation. Within this framework, creation of new channels, which will increase the transfer of funds from wealth accumulating countries like the Gulf countries will be beneficial. The performance of the London based markets developed recently within the framework of participation banking should not be overlooked. Necessary measures should be taken to include an increased portion of workers' remittances – part of which already takes part in the balance sheet of the Central Bank and that is recommended above to be channelled to the real sector – to the financial system in Turkey.

VIII- It is clear that these recommendations are aimed at bringing solutions especially to the short-term problems. At the same time, there are important structural problems of Turkey, which require solutions in the medium term. It will be beneficial to discuss the following recommendations which will function as an instrument for both initiating the solution process of these structural problems and also for turning the crisis into an opportunity:

a. The level of computer and foreign language training should be increased through mass mobilisation. For this purpose, the resources of the Unemployment Insurance Fund should be utilized in supporting training institutions.[8]

[8] Although one of the purposes of the Unemployment Insurance Fund is set forth as the training of the unemployed, it is known that at present, only 3000 people have benefited from this training opportunity. Putting more comprehensive applications on the agenda can be meaningful. How South Korea had turned the crisis period into an opportunity with the purpose of reforming the work force is addressed in ANNEX-B.

b. Economic Coordination Council (ECC) should play an important role in the realization of second-generation reforms. For this purpose, the operating rules of the ECC should be laid down in writing. It is observed that the objectives on this issue have been included in the 2009 Programme.[9]

[9] "2009 Programme Annexed to the Decision of the Council of Ministers No. 2008/14200 dated 13/10/2008 on the Implementation, Coordination and Monitoring of the 2009 Programme published in the Official Gazette No. 27028 dated 18/10/2008" published in the repeated Official Gazette No. 27039 dated 30 October 2008. Pages 73-77.