

**TÜSİAD High Advisory Council Meeting  
Bodrum, Turkey**

**Moving Beyond the Crisis: Global Outlook and Policy Challenges**

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**Keynote address by  
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It is an honor to address this distinguished forum. I have been asked to discuss the challenging topic of when and how it will be possible to move beyond the current Great Recession that has been unfolding since the US economy's downturn began in late 2007. While the latest data point to a slowing of the global contraction, the timing and pace of the global economic recovery remains uncertain. Moreover, it is clear that whatever comes next will not simply be a return to the status quo ante. Rather, if a new global expansion is to be sustained, it will have to be based on rebalanced sources of growth across countries and regions. Moreover, the current crisis has made it abundantly clear that a substantial strengthening is needed regarding international collaboration in the design and implementation of economic and financial sector policies.

In my remarks today I will discuss the outlook and risks for the global economy, highlighting the key challenges facing policymakers—both in the coming months and over the longer term—as they seek to lay the foundation for a resurgence in global growth. I will conclude with a few remarks on how global developments are challenging the Turkish economy.

**The global outlook has improved but remains clouded**

After two quarters of an unprecedented global economic contraction that carried through this year's first quarter, signs are emerging that the rate of output decline has moderated. Financial conditions have improved, confidence is recovering gradually, and indicators of future production and demand have firmed. Reflecting these developments, I expect that in the coming weeks we will revise our growth projections modestly upward, mainly with regard to 2010.

The improving prospects for the global economy owe much to resolute policy actions across a broad range of countries. As you all know well, these measures have included sizeable fiscal stimulus, a dramatic easing of monetary policy—through both conventional and unconventional means—and wide-ranging measures to support the financial system. It is noteworthy that policies have been coordinated globally to an unprecedented extent—including, but not only—through the G-20 process. This collaboration has magnified notably the positive impact of the measures taken at a national level.

As rising unemployment rates around the world attest, it is far too early to conclude that the goal of restoring global growth has been accomplished. Moreover, financial conditions are still far from normal, despite recent improvements. While the risk of new systemic financial system disruptions has been reduced sharply, credit growth in

most markets remains subdued amid ongoing deleveraging, and many securitization markets remain dormant.

Even the upbeat indicators widely cited as representing “green shoots” still point to a global recovery that would be sluggish by historic standards. Activity in the advanced economies likely will revive only gradually over the course of 2010, weighed down by financial deleveraging, limited credit growth, weak household income growth and declining household net worth. And while emerging economies as a group have weathered this crisis better than in the past—thanks in many cases to strong policy frameworks put in place over the preceding decade—they are unlikely to return to trend growth while advanced economies are still underperforming. As a result, output gaps and unemployment rates in most economies likely will continue rising through 2010.

### **Policies must remain focused on recovery**

In this context, it should be clear that in most cases, continued strong policy actions will be needed during the remainder of this year and into 2010 in order to insure that economic activity begins a sustained improvement.

First and foremost, robust growth will not be achieved until continuing financial sector problems are addressed forcefully. Recent bank stress tests in major advanced economies, notably the United States and the United Kingdom, have represented a significant step toward rebuilding market confidence and attracting new private capital. However, progress overall in restoring banks to health has been slow and uneven, and limited progress has been made in dealing with problem assets on bank balance sheets. In order to lay a foundation for revived bank credit growth, the near-term focus of policies should continue to be on restructuring weakened financial institutions by cleansing banks' balance sheets of impaired assets, assessing bank viability, and ensuring bank recapitalization where needed. Policy responses should be coordinated internationally to avoid regulatory arbitrage and competitive distortions, and to ensure reasonable burden-sharing of crisis costs.

Second, for the time being, macroeconomic policies in most countries should continue to support demand to insure that the risks of a deeper and more prolonged recession are capped. Fiscal policy in advanced and many emerging market economies should remain expansionary, at least through 2010. In line with their Leaders' Summit commitments, G-20 governments are providing discretionary stimulus of about 2 percent of GDP in 2009 and 1½ percent of GDP in 2010. Moreover, additional support still could be needed if downside risks to the outlook materialize. To be most effective, near-term stimulus measures should be anchored in a credible medium-term fiscal policy framework. Otherwise, fears of future crowding-out pressures from sustained government debt growth could prove to be counter-productive.

Monetary policy also should remain supportive until a sustained recovery takes hold. Thus, major central banks should be explicit regarding their commitment to keeping policy interest rates low. They should also continue to consider whether unconventional measures might be useful in order to improve credit flows and stimulate economic activity. In emerging economies, monetary policy will need to

balance the desire to support demand against the risk of exacerbating capital outflows or deteriorating credit quality.

### **Moving beyond the crisis: the need for an exit strategy**

Even as policy remains focused on ensuring an end to the global recession, it is not too early to begin planning to unwind the extraordinary policies that have been put in place during the past year. While continuing to provide short-term support, credible and coherent exit strategies should be prepared to unwind substantial public intervention in the financial sector—and the economy more broadly—in order to limit medium-term risks, to alleviate inflation concerns, and to minimize policy distortions. In recognition of the importance of this issue, G-8 Finance Ministers at their meeting last week asked the IMF to take a leading role in helping countries to prepare exit strategies.

In this regard, fiscal deficits in most economies will need to be consolidated after rising dramatically in 2009, in order to bring public finances back to a sustainable trajectory. Of course, fiscal deficits inevitably will remain wide in 2010 as fiscal support continues to sustain still-fragile economic conditions. Thereafter, a return to more self-sustaining economic growth would provide the basis for a deliberate withdrawal of stimulus.

Even assuming near-term budget consolidation, however, longer-term fiscal prospects in many economies already give rise to serious concern. This is especially the case in many advanced economies, considering the impending pressures that will derive from population aging and rising healthcare costs. Market confidence in the sustainability of budget positions would be helped by formulating medium-term fiscal frameworks and by announcing an outline of measures that will be used to tackle rising health care and retirement costs.

Second, the restoration of healthy and innovative financial systems will be central for returning to a new period of economic progress. After being propped up by massive government intervention, private capital must be rebuilt, government guarantees rolled back, and the expansion of central bank balance sheets unwound as confidence and trust are gradually restored. At the same time, it is agreed almost universally that the regulation of financial markets and institutions will need to be overhauled. The principal goals are to broaden the regulatory perimeter in order to bring all systemically important institutions under regulatory oversight, to establish more effective tracking of systemic leverage, and to promote more robust risk management.

Traditional regulation—that focuses almost exclusively on individual institutions and specific financial instruments—also should be supplemented by a macroprudential approach that would take account of systemic and cyclical factors, in order to create awareness of overall systemic leverage and to mitigate potential pro-cyclical effects of regulation. Market discipline will need to be strengthened through improved transparency and more incentive-compatible compensation structures. To maintain a level playing field and alleviate risks of regulatory arbitrage, strengthened international cooperation and coordination will be essential.

Third, major central banks have brought interest rates close to their lower bounds and have dramatically expanded the size of their balance sheets. Monetary authorities will need to devise plans to exit from unconventional measures. The goal is to ensure a smooth return to private intermediation and to forestall concerns that inflation pressures could be allowed to rise rapidly.

### **Finding new sources of growth**

It is obvious to all that policy-makers around the world will face a daunting task over the coming months maintaining supportive policies while simultaneously planning for their well-timed reversal. This is not the end of the policy challenges, however. Even when the recession is past, several longer-term structural issues will have to be addressed if the global economy is to return to solid and sustained growth. Perhaps most important is that the basic source of growth in many key economies will shift relative to the pre-crisis period.

The earlier period was associated with an unsustainable pattern of global imbalances that reflected a historically low US rate of household saving out of current income, mirrored by very high savings in many emerging market economies. Already, the US private saving rate is returning to a more normal position, such that it should not be assumed that growth in US consumer spending will provide the same degree of support for global growth as previously.

For its part, the Fund had long concluded that the pattern of global growth would have to change if the broad-based expansion experienced earlier this decade were to be sustained. During 2006/2007, the Fund sponsored the innovative Multilateral Consultation on Global Imbalances, with the participation of the euro area, China, Saudi Arabia, Japan and the United States. The aim of the Consultation was to develop a set of mutually consistent economic policy programs that would support growth while reducing imbalances. The Consultation produced a policy agenda that included structural reforms to raise potential growth in Europe and Japan; steps to boost domestic demand growth in China, including increased social outlays and public investment plus increased currency flexibility; investment in new energy production and other support for domestic demand among oil producers; and higher public and private savings in the United States. In my view, that policy agenda, if it had been implemented adequately and expeditiously, would have greatly reduced the depth and scope of the current Great Recession.

In the wake of the crisis, it is inevitable that this agenda will become relevant. Most important, the composition of global demand will have to adjust in order to restore and sustain growth. In particular, just as US growth will become relatively more dependent on expanding net exports and business investment, growth in those emerging economies that have relied principally on export growth while building up large current surpluses in the future will have to depend relatively more on domestic demand growth.

The fiscal consolidation that will be required after the crisis and the inevitable rise in private saving in advanced economies—reflecting the steep decline in financial and housing wealth and tighter credit availability—will need to be matched by an increase in emerging market domestic demand. In turn, this would be facilitated by stronger social safety nets that would reduce the need for precautionary savings, by

developing more effective financial systems, and by more flexible currency management that would support more fluid rebalancing of global supply and demand.

### **Turkey and the global crisis.**

With its economy closely integrated into world markets for goods and capital, Turkey is experiencing many of the hardships facing other emerging market countries. Indeed, the fall in worldwide demand, coupled with deleveraging in global financial markets, caused a severe 6.2 percent annual rate contraction in output here during last year's fourth quarter and it is likely that the first quarter results were even more severe, with industrial production, capacity utilization and employment by now having contracted more sharply than during the 2001 crisis. As a result, the IMF forecast anticipates that economic activity this year will decline by at least 5 percent.

However, the Turkish economy also has displayed resilience and flexibility. The Central Bank of Turkey's inflation targeting framework and the floating exchange rate regime have worked well to absorb external shocks. Despite considerable volatility in the value of the lira and in interest rates, the banking sector has weathered the initial stages of the crisis, reflecting minimal net foreign currency exposures, robust profits, and strong capitalization—with the average capital adequacy ratio above 18 percent at the end of this year's first quarter. This resilience has been particularly gratifying, as strenuous efforts to strengthen the banking sector was a focus of Turkish policy earlier this decade, representing an important element of the IMF-supported stabilization and recovery program. Many households, with their considerable holdings of foreign currency savings, also had significant insurance against exchange rate fluctuations. Broadly speaking, large corporations' performance has held up fairly well, reflecting low leverage, together with high liquidity and interest coverage ratios. The need to maintain adequate buffers was a lesson the private sector learned the hard way—from the pain experienced during Turkey's previous crisis episodes.

In line with recent global developments, some hopeful signs are visible on the economic horizon. Improved international investor sentiment toward emerging markets has helped to stabilize the exchange rate and to return Turkish government bond spreads back to levels that prevailed prior to the September 2008 market turmoil. Consumer confidence has rebounded strongly and the earlier declines in manufacturing and employment have begun to be reversed. Also, lending to the private sector has gained positive momentum. These indicators suggest that the Turkish economy may be on the verge of recovery. However, the rising fiscal deficit and weakening loan quality could—if not addressed forcefully—cloud the growth outlook, including by curtailing banks' ability to extend new credit.

Earlier this decade, the combination of strengthened and sustained fiscal discipline, an increasingly credible monetary policy framework and notable structural reforms helped to produce the best economic performance in Turkey's modern history. There is every reason to expect that a return to that policy path would help to more fully unleash the Turkish economy's impressive potential. There is no doubt that a necessary condition for addressing the pressing social issues that were discussed at the opening session yesterday—including informality, youth unemployment and regional disparities, among others—is a return to sustainable, solid growth rates. My IMF colleagues and I share great optimism regarding Turkey's future, and we stand ready to help support Turkey in any way that we can.

Of course, the broad global issues that I have discussed today will be addressed at the Annual Meetings of the IMF and the World Bank, that will take place in Istanbul in early October. By the way, Turkey thereby will become the only country that will have hosted the Annual Meetings twice. These Meetings provide an opportunity for Ministers of Finance and Central Bank Governors from the Fund's 185 member countries to discuss the global outlook, developments in financial markets, and to provide guidance to the institution on key policy directions. The 2009 Annual Meetings will be particularly important, given the current economic crisis.

I am very much looking forward to returning to Turkey at that time. I hope that the global outlook will have continued to improve, reflecting the unprecedented and cooperative policy efforts of Fund members. I am confident that Turkey will be looking forward to renewed economic success, and I am sure that the Meeting participants will leave Istanbul with a sense that Turkey is going to be playing a growing role in the region and in the world. And I know that you will play a pivotal and positive role in assuring Turkey's future progress.

Thank you for your attention.