EFFECTS OF GLOBAL CRISIS ON EMERGING EUROPE AND TURKEY

Doç. Dr. Kıvılcım Metin ÖZCAN[1]

Öğr. Gör. Dr. Ebru YÜKSEL[2]

ABSTRACT

In this paper, we aim to outline the initiation and evolution of Global Financial Crisis that spread over the world during 2008 and 2009. We analyze the influence of financial crisis on emerging Europe countries and Turkey based on main macroeconomic indicators including both monetary and fiscal policy instruments. After that some policy implementations are discussed. The financial crisis has showed that strong financial linkages and trade dependencies among national economies make the integrated markets open to significant short-term and long-term financial risks with extensive real economic consequences and recovery takes substantial time and effort. Precautionary measures, structural reforms and new policies are vital for growing economies to rebound.

Keywords: Emerging Europe, Fiscal Policy, Global Financial Crisis, Monetary Policy, Turkey.

Küresel Krizin Gelişmekte Olan Avrupa ve Türkiye Üzerindeki Etkileri

ÖZET

Bu makalenin amacı 2008 ve 2009'da dünyaya yayılan Küresel Finansal Kriz'in başlama ve gelişme safhalarını özetlemektir. Finansal krizin Türkiye ve gelişmekte olan Doğu Avrupa ülkeleri üzerindeki etkileri, para ve maliye politikası enstrümanlarını içeren temel makroekonomik göstergeler kullanılarak incelenmekte, ayrıca bazı politika uygulamaları değerlendirilmektedir. Finansal kriz göstermiştir ki, ulusal ekonomiler arasındaki güçlü finansal bağlar ve ticaret ilişkileri, birbiriyle bütünleşmiş bu marketleri kısa ve uzun dönemli finansal risklere açık hale getirmektedir. Önemli ekonomik sonuçlar doğuran küresel finansal krizden çıkmak için zaman ve çaba sarfetmek gerekmektedir. Büyümekte olan ekonomilerin tekrar ivme kazanabilmeleri için koruyucu tedbirler, yapısal reformlar ve yeni politikalar zorunludur.

Anahtar Kelimeler: Gelişmekte Olan Avrupa, Küresel Finansal Kriz, Maliye Politikası, Para Politikası, Türkiye.

[1] Bilkent University, Department of Economics ,Ankara Turkey, e-mail: kivilcim@bilkent.edu.tr

[2] Hacettepe University, Department of Industrial Engineering, Ankara, Turkey,e-mail: eyuksel@hacettepe.edu.tr

1. INTRODUCTION

In 2008, failure and default of some banks and insurance companies in the U.S. initiated the Global Financial Crisis, which gradually spread over national and international financial systems. Global financial crisis was, in fact, becoming evident in mortgage markets of the U.S. in 2007. At the beginning, most of the mortgage credits were given to high quality customers, whose credit histories were pretty well. These are called prime mortgages. However, these mortgage credits were started to be given to low quality customers in time. These are called subprime mortgages.

Due to low interest rates, people using subprime mortgage credits preferred altering interest rates for their repayment schedules. Increasing real estate prices let people think that their welfare was increasing and they could increase their consumption even through borrowing. So, increasing real estate prices resulted in increasing consumption spending and borrowing demand, high consumption increased economic activity and finally high economic activity increased real estate prices. This situation resulted in a balloon in real estate prices.

However, some problems were started to be seen in the repayment of some subprime mortgage credits. In time, the number of houses levied by banks due to unpaid debts started to rise. Moreover, financial institutions slowed down the mortgage credits and they became more conservative in giving housing loans to people. Increasing supply of houses together with decreasing trend in demand for real estates resulted in falling housing prices (Özatay, 2009). From mid-2007 to mid-2008, the Case Shiller Index, which is used to measure real estate prices in the U.S., decreased by 16% and specialists argued that this index should still decrease by 10% more (Eğilmez, 2009). People realized that they could not get as much money as they think when they sell their houses. This incident caused housing prices to decrease and collapse of price balloon. Later, in addition to decreasing real estate prices, the Fed increased the interest rates successively, so people taking subprime mortgage credits had difficulty in repaying their loans. This was the initiation phase of the crisis.

Although the cause of global financial crisis seems to be the highly increased housing prices and the subprime mortgage credits given to a lot of people, the main reason lies in the financial operations based on the mortgage credits. Derivative financial products were highly used to transfer default risk of mortgage credits to third agents. As financial institutions used more derivatives in their operations, they thought that they diversified their risk and they could take more risk through other derivatives. This loop caused mortgage credits and derivatives to reach enormous sizes. At the beginning, these derivatives were produced to offset risk of credits but later, they became risk element themselves.

In a global world, where there is no barrier in flow of capital from one country to another, many banks and financial institutions made international operations based on these derivative products so that the mortgage crisis started in the U.S. spread out to whole world. A great portion of these derivative operations were accumulated in Lehman Brothers and it was the first bank facing default risk. Since the Fed and the U.S. government did not help to the bank, Lehman Brothers could not fulfill its obligations to other world banks and it went bankruptcy. This was the clear start of the global financial crisis. The influence of this bankruptcy was spread like domino effect. After that time, many banks and financial institutions had difficulty in paying their debts and fulfilling their obligations.

Especially, developing countries were highly affected from the crisis in different aspects. First, foreign investors called back their money from these countries leading to decrease in hot money and liquidity. Second, since developed countries experienced decreasing growth, their consumption also decreased and this led to fall in their imports from developing countries. Therefore, international trade volume of developing countries decreased and their growth rates get smaller, too (Eğilmez, 2009).

In this paper, we aim to outline the initiation and continuation of Global Financial Crisis. We analyze the influence of financial crisis on emerging Europe[1] countries and Turkey based on main macroeconomic indicators. As for emerging Europe countries we will mainly focus on Bulgaria, Hungary, Poland, Romania, the Czech Republic, Russia and Ukraine. The main motivations behind the selection of these countries are threefold: Firstly, these countries are not net commodity exporters; secondly, they strike a balance between economic size, population, and financial market depth; thirdly, rapid growth in emerging Europe is based on strong fundamentals-productivity improvements and increases in the capital stock. Since financial institutions and financial sector of the region are closely integrated to rest of the world, it is inevitable that emerging Europe countries are highly affected by the financial crisis. Regarding to terms of trade, emerging Europe is quiet open to world markets so, financial crisis revealed some major problems of the region countries like accumulated economic imbalances and widening current account deficits that must be managed carefully.

The global nature of the financial crisis has made clear that financially integrated markets posed significant short-term risks with large real economic consequences. In the following sections of the paper a brief evaluation of the global financial crisis will be given. Comparisons will be made between the key macroeconomic developments that took place in Turkish economy and Emerging Europe countries. Finally, some policy implementations will be discussed.

2. GLOBAL MACROECONOMIC TRENDS DURING THE CRISIS PERIOD

The financial crisis first started in advanced countries in 2008. Immediately after it deepened so that growth rates dropped down globally especially in advanced countries. The effects of the financial crisis continued to dominate financial markets throughout

[1] The emerging European countries are the new EU member states Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia as well as the candidate (Croatia, FYR Macedonia and Turkey) and potential candidate countries (Albania, Bosnia & Herzegovina, Montenegro and Serbia) for EU accession.

2009. After having extensive central bank operations and government interventions, the effects of the crisis started to slowed down as of the second half of 2009 and the global economy showed a slow and gradual recovery owing to the expansionary monetary and fiscal policies implemented worldwide. However, unemployment rates remained high, all suggesting that it would take a long time for the global economic problems to be resolved permanently. The current global financial turmoil affected countries through following main macroeconomics aggregates such as growth, unemployment, commodity and consumer prices and interest rates. We summarize briefly each of these aggregates[2].

2.1. Growth

Growth rates of both developed and developing countries showed falling trends at high percentages. For instance, in the U.S. the output of goods and services decreased at an annual rate of 6% in the fourth quarter of 2008 and first quarter of 2009, with respect to activity in the year-ago periods. Such a recession in the U.S. resulted in falls in growth of other countries[3] since U.S. consumption accounted for more than one third of the growth in global consumption between 2000 and 2007 according to the Brookings Institution reports in June 2009. The Figure 1 below shows the growth rates of developed and developing countries together with export-weighted countries, on the left side. On the right side the unemployment rates of the U.S. and the Euro zone can be seen.

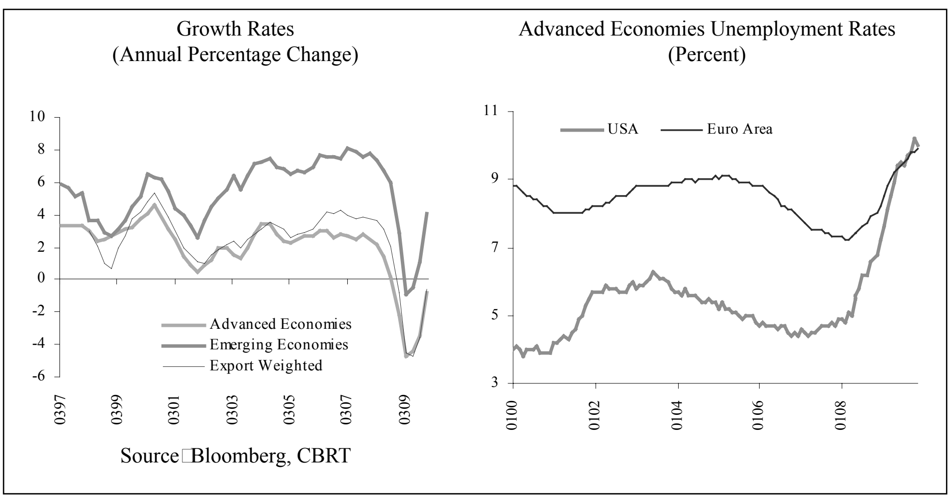


Figure 1: Growth rates and unemployment rates in developed and developing countries

2 This part is summarized from □ilmaz (2010).

3 For the first quarter of 2009, the annualized rate of decline in G□P was 1□□% in Germany, 1□2% in Japan, 7.□% in the U□, 9.8% in the Euro area and 21.□% for □exico. On □ovember 3, 2008, the European Commission at Brussels predicted for 2009 an extremely weak growth of G□P, by 0.1%, for the countries of the Euro zone (France, Germany, Italy, etc.) and even negative number for the U□ (-1.0%), Ireland and Spain. On □ovember 6, the I□F launched numbers predicting a worldwide recession by -0.3% for 2009, averaged over the developed economies.

As it can be seen from the figures above, the growth rates of both developed and developing countries have decreased sharply starting from the beginning of 2008 until the end of the first quarter of 2009. After that the recovery period has started. However, for the unemployment rate we could not speak of the same recovery period. Even starting from the beginning of 2008, the unemployment rates for the U.S. and Euro area have increased enormously and reached 10% approximately. Even with global economic growth, which based on expansionary monetary and fiscal policies, unemployment rates remain still high.

The following Table 1 presents the expected global recovery projections of the OECD countries, the U.S., Euro area, Japan and the world as a whole. Although world output growth was -0.9% during 2009, it is expected to be 4.5% this year and in 2011. For the OECD countries, GDP growth is forecasted as 2.6% in 2010 and 2.7% in 2011.

Table 1: Expected global recovery projections (OECD area, unless noted otherwise)

(Percent)	Average 1997-2006	2007	2008	2009	2010	2011
Real GDP growth[a]	2.8	2.7	0.5	-3.3	2.6	2.7
U.S.	3.2	2.1	0.4	-2.4	3.1	2.8
Euro area	2.3	2.7	0.5	-4.0	1.0	1.8
Japan	1.1	2.4	-1.2	-5.2	2.9	2.1
Output gap[b]	0.2	1.4	-0.3	-5.1	-4.0	-3.1
Unemployment rate[c]	6.5	5.6	6.0	8.1	8.5	8.3
Inflation[d]	2.9	2.3	3.2	0.6	1.5	1.3
Fiscal balance[e]	-2.1	-1.2	-3.3	-7.9	-7.8	-6.9
World real trade growth	7.1	7.2	3.3	-10.7	10.4	8.4
World real GDP growth[f]	3.7	5.1	2.8	-0.9	4.5	4.5

[a] Year-on-year increase; last three columns show the increase over a year earlier.
[b] Per cent of potential GDP.
[c] Per cent of labour force.
[d] Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
[e] Per cent of GDP.
[f] Moving nominal GDP weights, using purchasing power parities.
Source: OECD Economic Outlook 87 database

2.2. Behavior of Commodity Prices

The dramatic change in the global economy raises new challenges on commodity prices. Commodity price changes will impact each country differently depending on its particular resource endowments. The following Figure 2 displays the graph of commodity prices and crude oil prices till 2010. They did co-movements with different magnitude at their peak in July 2008 and then global financial turmoil has triggered a sharp decline in commodity prices till to the beginning of 2009. After that the recovery has started for all commodity prices including crude oil.

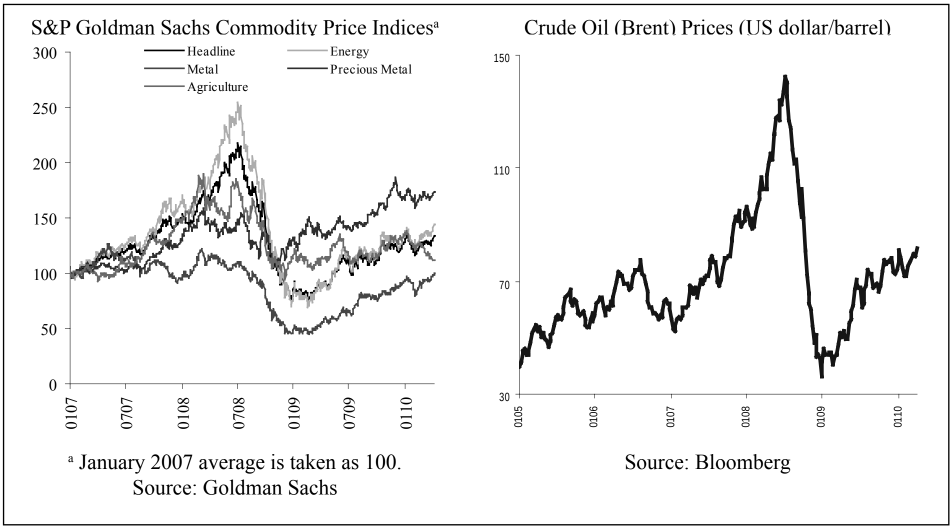


Figure 2: Commodity and crude oil prices

The CPI inflation in advanced and emerging countries is sketched in Figure 3. Due to the decrease in economic activity, demand for goods has decreased world-wide so that inflation has decreased starting from the mid-2008 until mid-2009. However, following the rise in commodity prices, the world inflation rate started to increase after the mid-2009.

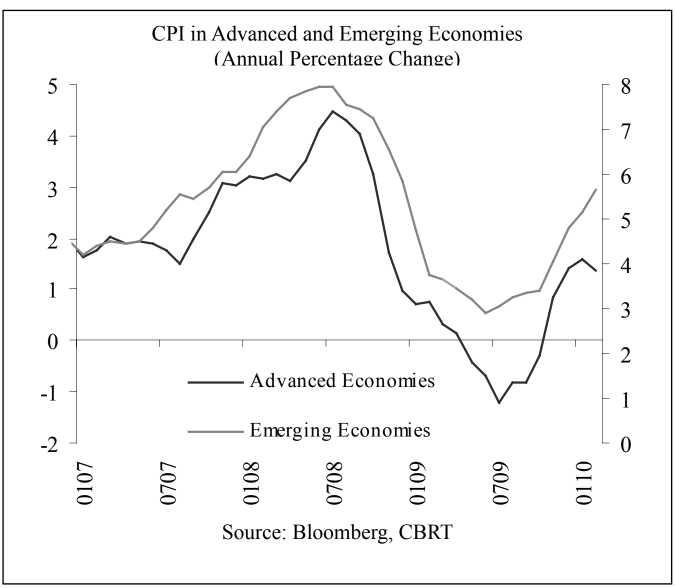


Figure 3: Inflation rates in advanced and emerging economies

2.3. Policy Interest Rate

The following Figure 4 displays the course of monetary policy interest rate in advanced and inflation-targeting emerging economies as well as Turkey. In order to increase economic activity and stimulate the growth, both developed and emerging countries implemented expansionary monetary policies which are consistent with decreasing policy rate. In all economies policy rates followed a decreasing trend starting from the mid-2008. High policy rate in Turkey during 2007 compared to other emerging economies may have exacerbated the severity of the impact of the crisis on the Turkish economy.

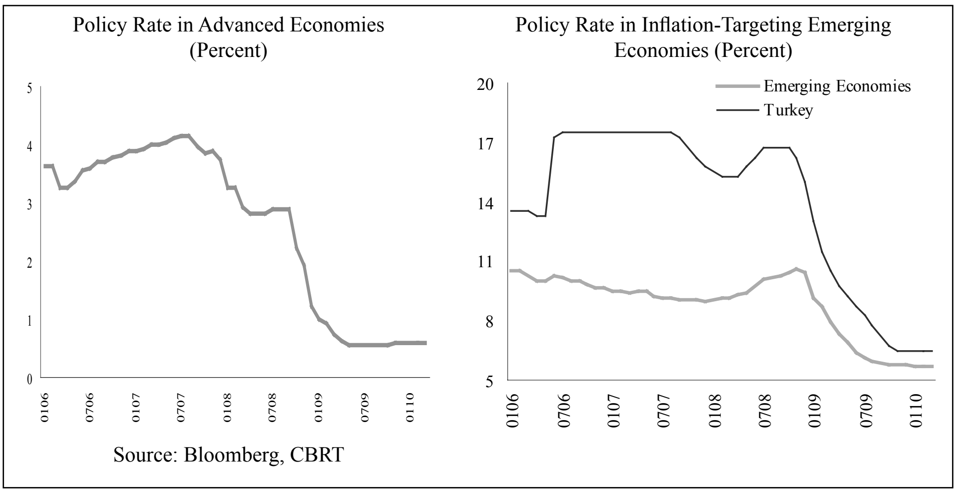


Figure 4: Policy interest rates in advanced and inflation-targeting emerging economies

In the first half of 2009, the global financial markets recovered. This recovery is mainly attributable to monetary and fiscal measures taken by advanced countries. The global risk appetite measures such as global risk appetite indices[4], currency and risk premium indicators for emerging economies[5] continued to improve slowly, as of the year-end and early 2010.

3. MACROECONOMIC AGGREGATES: EMERGING EUROPE

In this section, we are going to analyze the impact of financial crisis on emerging Europe countries. Like in the other developing countries, the crisis affected emerging Europe severely so that significant contraction has been observed in the GDP growth values. Fallen foreign demand for the output of emerging Europe is the main cause of the decrease in GDP. The following Table 2, Figure 5 and Figure

[4] Credit Suisse Risk Appetiate Index and VIX of Bloomberg.
[5] EMBI+basis points and Currency Index (1 US dolar and 1 Euro) of Bloomberg.

6 show the growth of real GDP in Eastern Europe countries. It is noticed that in the run-up to the crisis, particularly in the early part of 2008, the Turkish economy was already experiencing a slowdown. By contrast, a few of the other countries in the region where actually growing moderately. In other words, from a growth perspective, Turkey entered the crisis with weaker initial conditions. Recently, output has begun to recover in most of emerging Europe in response to the normalization of global capital markets. Real GDP looks likely to have increased 5% in the first quarter of 2010 which compares with a 5.7% decline in 2009. Recovery can be explained by the improvements in exports and inventory investment. Indeed export-led growth has been accompanied by a revival in domestic spending in Russia and Ukraine where higher commodity export prices have been observed. Real GDP is likely to have surged 13% from a year earlier in the first quarter in Turkey, where improved private sector's confidence and resurgent bank lending have contributed to a jump in private sector demand. Domestic demand increase has also helped accelerate growth in Poland. Real GDP rose also in the Czech Republic, where export recovery has been accompanied by increase in domestic demand (see Table 3).

Table 2: Real GDP for emerging Europe

Real GDP
12-month percent change

	2008	2009	2009		2010
			Q3	Q4	Q1e
Emerging Europe	4.1	-5.7	-5.9	-0.5	5.0
(EU countries)	(4.4)	(-2.4)	(-2.7)	(-1.1)	(1.1)
Bulgaria	6.0	-5.0	-5.5	-5.9	-4.0
Czech Republic	2.5	-4.2	-5.0	-2.8	1.2
Hungary	0.6	-6.3	-7.1	-4.0	0.1
Poland	5.0	1.7	1.7	3.1	3.2
Romania	7.2	-7.1	-7.1	-6.5	-2.6
Russia	5.6	-7.9	-8.9	-2.6	4.5
Turkey	0.7	-4.7	-2.9	6.0	13.2
Ukraine	2.3	-15.2	-15.9	-7.5	-0.4

e = estimate

Source: IIF Research Note, May 12, 2010

Table 3: Domestic demand for emerging Europe

Domestic Demand

12-month percent change

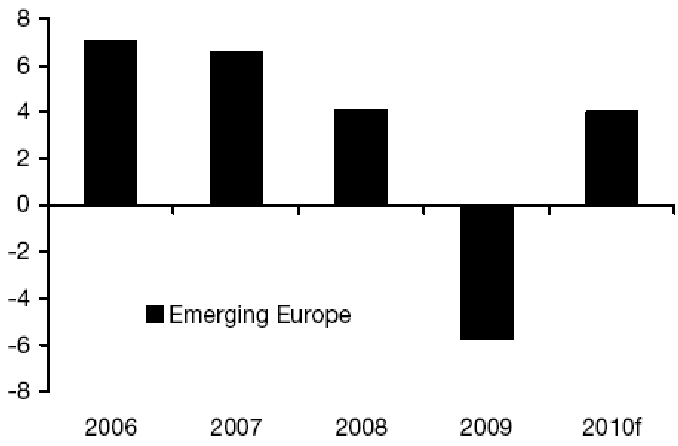
	2008	2009	2009		2010
			Q3	Q4	Q1e
Emerging Europe	5.7	-10.2	-11.2	-5.1	5.4
(EU countries)	(4.3)	(-6.0)	(-6.4)	(-4.8)	(1.0)
Bulgaria	7.2	-14.9	-16.3	-17.9	-7.0
Czech Republic	1.1	-4.7	-4.4	-7.3	0.8
Hungary	0.7	-11.5	-13.3	-8.0	0.5
Poland	5.5	-0.9	-1.2	0.9	3.9
Romania	6.4	-14.1	-14.0	-10.6	-3.9
Russia	9.5	-13.7	-17.3	-10.6	4.8
Turkey	-1.2	-7.2	-4.6	7.1	14.8
Ukraine	7.9	-22.5	-20.2	-14.3	-0.8

e = estimate

Source: IIF Research Note, May 12, 2010

Real GDP

percent change

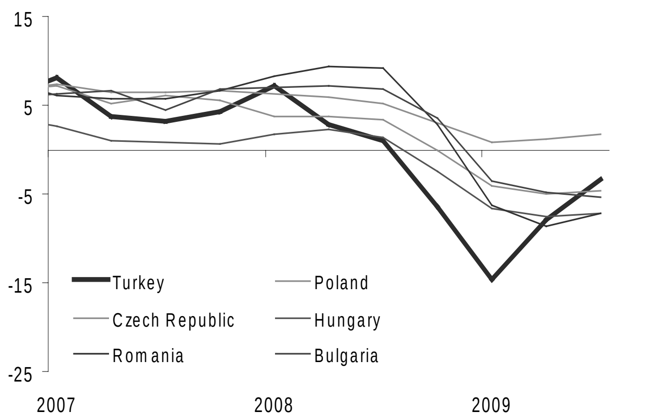


f = IIF forecast

Source: IIF Research Note, May 12, 2010

Figure 5: Real GDP for emerging Europe

Real Growth Rates
(Year-Over-Year Percentage Change)

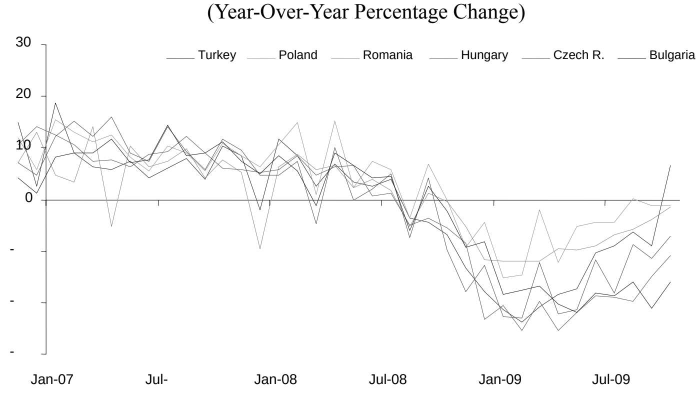


Source: Bloomberg, CBRT

Figure 6: Real growth rates of emerging Europe

To sum up, following the positive growth rates in real GDP, in 2009 real GDP contracted by 7 % on the average in Eastern Europe countries. Output decreased much especially in Ukraine, Russia, Romania and Hungary. However, recovery has started in the second half of the 2009, after the 5.7% decrease in the growth of emerging Europe, the forecast for the first quarter of 2010 is 5% . Recovery in domestic demand seems a little bit slower compared to real GDP due to high unemployment rates. Recovery pace of the countries is not the same for instance; Turkey is expected to have 13.2% increase in GDP growth due to its strong banking system.

Industrial Production
(Year-Over-Year Percentage Change)



Source: Bloomberg

Figure 7: Industrial production of emerging Europe

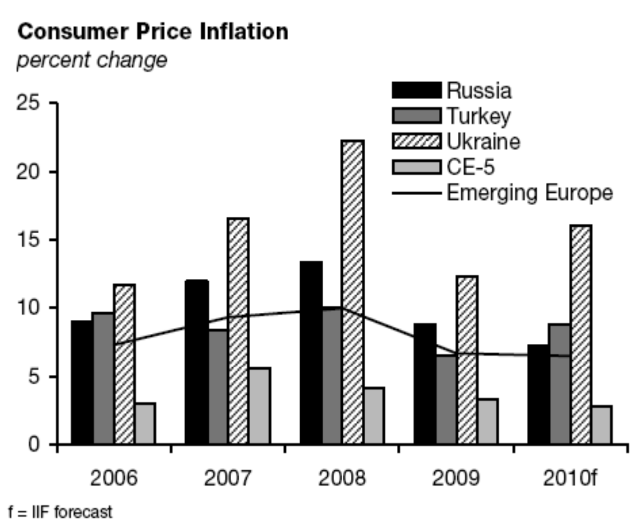
A similar pattern is observed in the courses of industrial production indexes of the countries. The Figure 7 above presents that industrial production volumes of Turkey, Poland, Romania, Hungary, Czech Republic and Bulgaria have decreased during 2009 almost 20% in some countries but then rebounded at the end of 2009.

Table 4: Headline inflation of emerging Europe

Headline Inflation
12-month percent change

	2009			2010	
	Jun	Sep	Dec	Mar	Apr
Emerging Europe	8.0	7.2	6.7	6.1	--
(EU countries)	(3.5)	(3.0)	(3.4)	(2.9)	--
Bulgaria	3.7	0.2	0.6	1.3	1.8
Czech Republic	1.2	0.0	1.0	0.7	1.1
Hungary	3.7	4.9	5.6	5.9	5.7
Poland	3.5	3.4	3.5	2.6	--
Romania	5.8	4.9	4.8	4.2	4.3
Russia	11.9	10.7	8.8	6.5	6.0
Turkey	5.7	5.3	6.5	9.5	10.2
Ukraine	14.9	15.0	12.3	11.0	9.7

Source: IIF Research Note, May 12, 2010.



Source: IIF Research Note, May 12, 2010.

Figure 8: Consumer price inflation for emerging Europe

Twelve-month inflation has slowed for all emerging Europe except for Turkey and Hungary (see Table 4 and Figure 8). Twelve-month inflation was lowest in April at around 1% in the Czech Republic, where it remained well below the central bank's target, and in Bulgaria at 1.8% . At 2.6% , inflation has fallen towards the target also in Poland. Inflation has remained above target in Romania as a result of rigidities in markets for goods and services. As a result of structural difficulties high inflation in Russia and in Ukraine, where the 12-month figure remained near 10% . In Turkey, core and headline inflation have both risen sharply, along with inflation expectations, leaving inflation on track to exceed the central bank target.

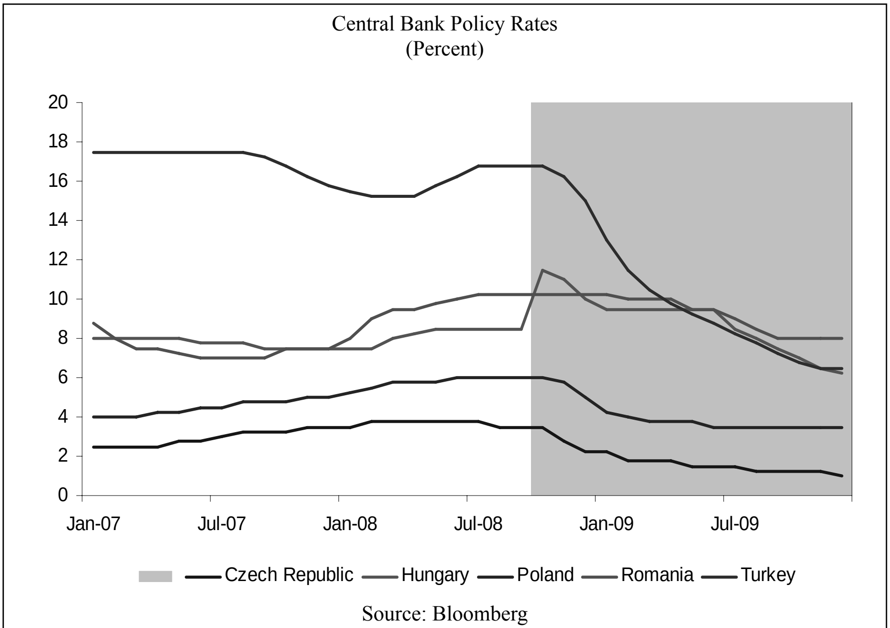


Figure 9: Central bank policy rates of emerging Europe

As Figure 9 demonstrates that Turkey had the highest real interest rate in the run-up to the crisis. By contrast, after the policy cuts, Turkey now has one of the lowest real rates in region.

During the crisis period all emerging Europe countries lived with continuously increasing unemployment rates. Turkey and Hungary are having two digit unemployment rates among the others. It seems that high unemployment rates are the common characteristics of the region (see Table 5) and due to high unemployment rates, recovery in domestic demand seems a little bit slower compared to real GDP.

Table 5: Unemployment rates in emerging Europe

Unemployment
percent

	2008	2009	2009 Q3	2009 Q4	2010 Q1e
Emerging Europe	7.4	9.5	9.1	9.3	10.2
(EU countries)	(6.4)	(7.9)	(8.0)	(8.3)	(9.3)
Bulgaria	5.6	6.8	6.7	7.9	9.3
Czech Republic	4.4	6.7	7.3	7.3	8.0
Hungary	7.8	10.0	10.3	10.5	11.6
Poland	7.1	8.2	8.1	8.5	9.6
Romania	5.8	6.9	6.8	7.5	8.0
Russia	6.4	8.4	7.9	8.1	8.8
Turkey	11.0	14.1	13.4	13.1	14.5
Ukraine	6.9	9.8	9.4	9.6	9.8

e = estimate

Source: IIF Research Note, May 12, 2010.

With the upsurge in domestic demand together with GDP growth and increasing world trade, export and import volumes of the Eastern European nations start to recover gradually to their pre-crisis levels owing to precautionary measures taken by governments. As monetary policy rates remain low, financial states of the countries will improve progressively. Although trade growth is sluggish in emerging Europe, it is expected to accelerate more in 2011. As for the visualization of the nature of foreign trade of countries during and after the financial turmoil, trade balance figures are worth to examine. The following Table 6 shows the trade balances of Eastern European countries including Turkey (Eastern Europe Consensus Forecasts, May 17, 2010).

Table 6: Trade balances of emerging Europe (US$bn)

		Bulgaria	Czech Republic	Hungary	Poland	Romania	Russia	Turkey	Ukraine
2006		-7.0	2.8	-2.6	-7.0	-15.0	139.0	-41.1	-5.2
2007		-8.9	5.9	0.3	-17.1	-24.7	131.0	-46.8	-10.6
2008		-12.7	6.3	-0.1	-26.0	-28.2	180.0	-53.0	-16.1
2009	Q1	-1.5	2.0	0.8	-1.0	-2.1	18.8	-1.3	-1.0
	Q2	-1.7	2.7	1.6	-0.7	-2.4	24.2	-6.8	-0.7
	Q3	-1.2	2.5	1.4	-1.2	-2.4	33.4	-9.4	-1.5
	Q4	-1.3	2.4	1.9	-1.6	-2.7	35.2	-7.4	-1.5
	Total	-5.8	9.5	5.7	-4.5	-9.5	112.0	-24.9	-4.7
2010	Q1	-1.1 [a]	2.7 [a]	1.6 [a]	-1.4 [a]	-2.3 [a]	42.4 [a]	-9.2 [a]	-1.0 [a]
	Q2	-1.6 [a]	2.5 [a]	1.4 [a]	-1.6 [a]	-2.6 [a]	34.7 [a]	-13.2 [a]	-0.2 [a]
	Q3	-1.5 [a]	2.3 [a]	1.2 [a]	-2.4 [a]	-2.4 [a]	35.8 [a]	-14.9 [a]	-0.6 [a]
	Q4	-1.6 [a]	1.3 [a]	1.5 [a]	-3.4 [a]	-2.6 [a]	36.5 [a]	-8.4 [a]	-1.0 [a]
	Total	-5.6 [a]	9.2 [a]	6.4 [a]	-8.4 [a]	-9.5 [a]	148.4 [a]	-45.0 [a]	-2.3 [a]
2011	Q1	-1.4 [a]	2.3 [a]	1.7 [a]	-2.9 [a]	-2.6 [a]	37.7 [a]	-13.2 [a]	-0.8 [a]
	Q2	-1.5 [a]	2.2 [a]	1.5 [a]	-2.8 [a]	-2.8 [a]	33.2 [a]	-12.2 [a]	-0.7 [a]
	Q3	-1.5 [a]	1.8 [a]	1.1 [a]	-4.0 [a]	-2.6 [a]	39.1 [a]	-15.0 [a]	-0.9 [a]
	Q4	-1.5 [a]	1.5 [a]	1.1 [a]	-4.5 [a]	-3.2 [a]	39.9 [a]	-13.1 [a]	-1.3 [a]
	Total	-5.8 [a]	8.2 [a]	5.9 [a]	-13.7 [a]	-10.5 [a]	146.3 [a]	-54.2 [a]	-3.1 [a]

[a] forecasts.

Source: Eastern Europe Consensus Forecasts, May 17, 2010

Shrinkage in aggregate demand during the crisis period explains the fall in the net export of the countries so that decreasing export and import result in reduction in trade surplus or trade deficit. However, due to revival in export markets, Czech Republic, Hungary, Poland and Turkey economies rebound. Forecasts for Turkey and Russia signal a quick recovery in 2010 and 2011.

One of the major indicators of a country's foreign trade structure is the current account balance, which is highly informative about the impact of a financial crisis on a nation's economy. The following Table 7 summarizes the current account balances of the nations under consideration.

Table 7: Current account balances of emerging Europe (US$bn)

		Bulgaria	Czech Republic	Hungary	Poland	Romania	Russia	Turkey	Ukraine
2006		-5.9	-3.6	-8.1	-9.4	-12.9	94.7	-32.2	-1.6
2007		-10.7	-5.7	-9.0	-20.3	-23.2	77.8	-38.3	-5.9
2008		-12.1	-1.3	-10.9	-26.9	-24.0	104.0	-41.9	-12.8
2009	Q1	-1.9	1.2	-1.0	0.0	-1.2	9.7	-2.0	-0.7
	Q2	-1.7	-1.6	0.2	-1.5	-2.1	7.3	-5.4	-0.2
	Q3	0.3	-1.3	0.5	-1.7	-1.4	15.7	-2.0	-0.1
	Q4	-1.1	-0.4	0.7	-4.0	-2.4	16.3	-4.6	-0.9
	Total	-4.5	-2.1	0.3	-7.2	-7.1	49.0	-14.0	-1.8
2010	Q1	-1.0 [a]	0.7 [a]	-0.4 [a]	-2.0 [a]	-1.9 [a]	27.7 [a]	-7.2 [a]	-0.2 [a]
	Q2	-1.2 [a]	-0.5 [a]	-0.4 [a]	-2.8 [a]	-1.9 [a]	18.4 [a]	-10.1 [a]	0.2 [a]
	Q3	-1.1 [a]	-0.7 [a]	-0.4 [a]	-2.6 [a]	-1.7 [a]	17.1 [a]	-5.8 [a]	0.3 [a]
	Q4	-1.4 [a]	-1.1 [a]	-0.4 [a]	-3.1 [a]	-1.8 [a]	15.5 [a]	-7.8 [a]	0.2 [a]
	Total	-4.3 [a]	-1.9 [a]	-1.0 [a]	-11.1 [a]	-7.7 [a]	78.0 [a]	-31.7 [a]	0.9 [a]
2011	Q1	-1.2 [a]	0.9 [a]	-0.8 [a]	-3.6 [a]	-2.0 [a]	22.8 [a]	-7.6 [a]	0.1 [a]
	Q2	-1.2 [a]	-1.2 [a]	-0.8 [a]	-3.8 [a]	-2.1 [a]	19.0 [a]	-10.1 [a]	0.3 [a]
	Q3	-1.1 [a]	-1.2 [a]	-0.5 [a]	-4.3 [a]	-2.6 [a]	17.9 [a]	-10.1 [a]	0.0 [a]
	Q4	-1.5 [a]	-1.6 [a]	-0.6 [a]	-4.0 [a]	-2.0 [a]	13.1 [a]	-10.3 [a]	-0.4 [a]
	Total	-4.4 [a]	-2.7 [a]	-2.2 [a]	-16.0 [a]	-9.4 [a]	71.4 [a]	-38.3 [a]	0.4 [a]

[a] forecasts.

Source: Eastern Europe Consensus Forecasts, May 17, 2010

All countries experienced decrease their current account deficits due to decreasing international trade volume. Nonetheless, current account deficits have decreased owing to recovering export volumes and slowly increasing import volumes. While Bulgaria, Czech Republic, Hungary, Poland and Romania had significant declines in their current account deficits, Ukraine had almost a balanced current account due to fast recovery in export and high export prices. For Russia, current account surplus showed a sharp decline in 2009 but then strong export prices and rise in oil price widen the current account surplus more. Similar to trade balance, the upturn in the growth rates of Turkey and Russia turn current account balance values to before-crisis levels. However, for Turkey speed of upturn in imports is greater than that of exports increasing deficit. As Turkish economy grows, widening current account deficit can be financed through remittances, Turkish funds abroad or foreign funding.

The next Table 8 demonstrates the public sector spending as a percentage of GDP. As it can be inferred from the table, after the financial crisis, government budget deficit reached peak levels in 2009 in all countries. However, due to preventive actions of governments and fiscal tightening, it is expected that the public sector deficit is going to decline in 2010 and 2011.

Table 8: General government budget balance (Percent of GDP)

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Russia	Turkey	Ukraine
2006	3.0 [e]	-2.6 [b]	-9.3 [b]	-3.6 [b]	-2.2 [e]	7.4 [c]	-0.5 [d]	-0.7 [f]
2007	0.1 [e]	-0.7 [b]	-5.0 [b]	-1.9 [b]	-2.5 [e]	5.4 [c]	-1.7 [d]	-1.1 [f]
2008	1.8 [e]	-2.7 [b]	-3.8 [b]	-3.7 [b]	-5.4 [e]	4.1 [c]	-1.9 [d]	-1.5 [f]
2009	-3.9 [e]	-5.9 [b]	-4.0 [b]	-7.1 [b]	-8.3 [e]	-5.9 [c]	-5.5 [d]	-5.0 [f]
2010	-2.6 [a, b]	-5.5 [a, b]	-5.0 [a, b]	-6.7 [a, b]	-7.0 [a, b]	-3.5 [a, c]	-4.8 [a, d]	-6.5 [a]
2011	-1.7 [a, b]	-5.0 [a, b]	-4.1 [a, b]	-5.5 [a, b]	-5.5 [a, b]	-1.7 [a, c]	-4.2 [a, d]	-4.5 [a]

[a] forecasts.

[b] Eurostat Methodology (ESA 95).

[c] Federal Government Budget Balance, IMF definition, excluding privatization proceeds.

[d] Consolidated Public Sector Budget Balance, including privatization proceeds.

[e] Maastricht definition.

[f] Consolidated Government Budget Balance.

Source: Eastern Europe Consensus Forecasts, May 17, 2010

4. MACROECONOMIC AGGREGATES: TURKEY

In this section, we focus on Turkey and analyze the effect of global financial crisis on main macroeconomic parameters of Turkey. The very first variable that we will consider is the growth rate of Turkey. As Figure 10 below shows that GDP of Turkey has sharply declined in the second half of 2008 and then recovery has taken place starting with 2009. On the left hand side, GDP growth rate shows a similar pattern so that the last quarter of 2009 has a positive GDP growth rate.

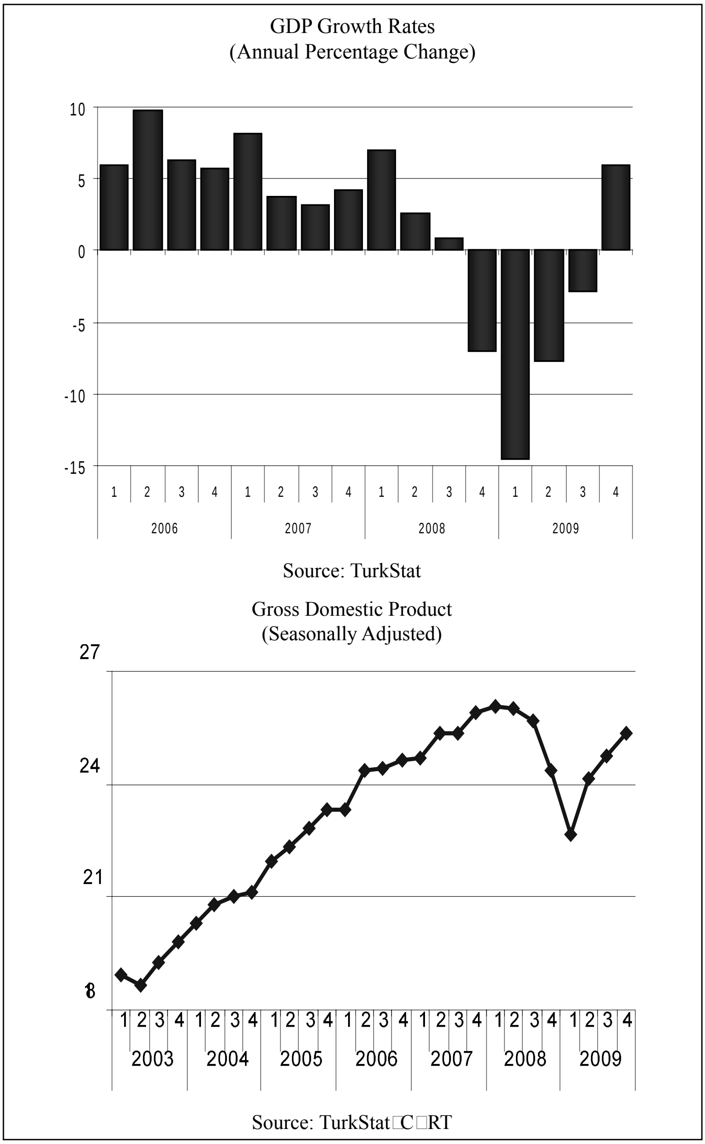
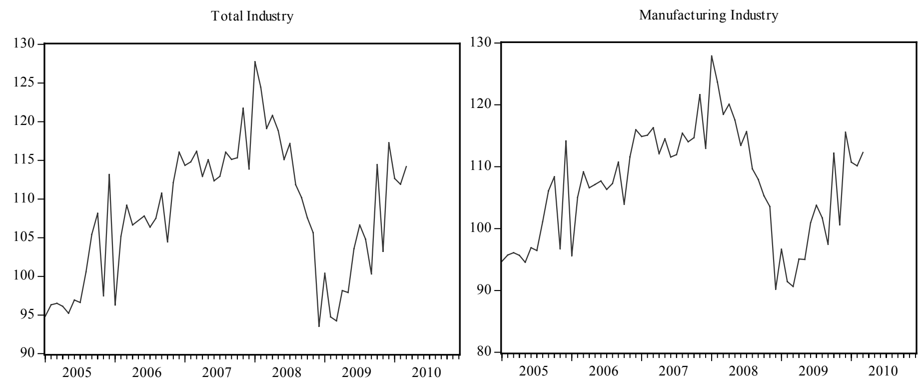


Figure 10: GDP growth rate

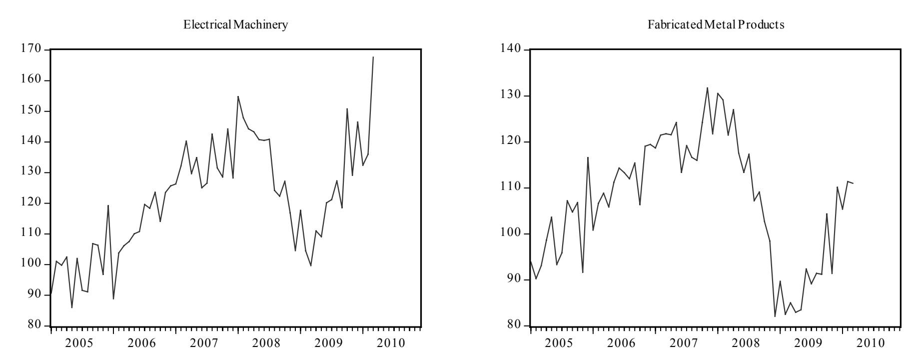
Together with the GDP growth rate, industrial production index can also be examined to see the adverse effect of the global crisis on the production volume of Turkey. Due to the contraction in export and credit channels, production volume and employment level have gone down in all sectors (Tepav Politika Notu, 2010). The following Figure 11 shows the evolution of total industrial production index and production index of manufacturing industry.



Note: Series are monthly and seasonally adjusted using moving average technique (2005=100)
Source: TurkStat, CBRT

Figure 11: Production index of total industry and manufacturing industry

As it is evident from the above graphs, there is a dramatic fall in the production volume during 2008 even below the 2005 values. This tells that the crisis affected real side of the economy significantly. Starting with 2009, production index turned up rapidly. It is clear that the crisis does not influence all sectors equally. Depending on the decrease in the foreign demand for goods and trade volume, export oriented sectors are expected to be affected more compared to non-tradable goods or less internationally globalized markets. Therefore, it can be more informative to analyze production index of export oriented sectors separately. The following Figure 12 displays the movement of production index of export oriented sectors. The degree of export orientation is determined according to export orientation indicator, which is described in Tepav Politika Notu (2010).

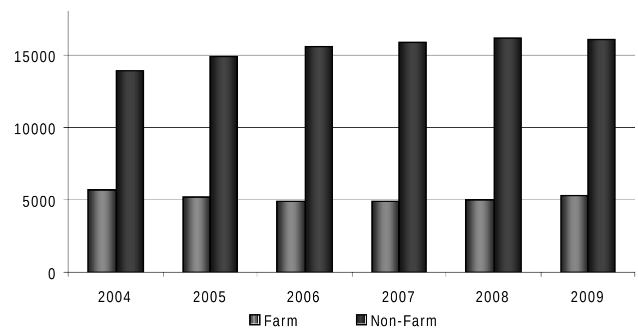


Note: Series are monthly and seasonally adjusted using moving average technique (2005=100).
Source: TurkStat, CBRT

Figure 12: Production index of export oriented sectors

Because of the contraction in world consumption, export volume of Turkey has been affected terribly and this adverse impact is observed in falling production indexes of export oriented sectors. Figure 12 indicates that although almost all sectors experienced similar sharp decreases in production volume, the recovery road is not the same depending on the degree of export orientation. For instance, while production index of manufacture of electrical machinery presented an immediate recovery roughly in one year, production index of manufacture of radio TV and communication apparatus could not restore the before-crisis position in the same duration.

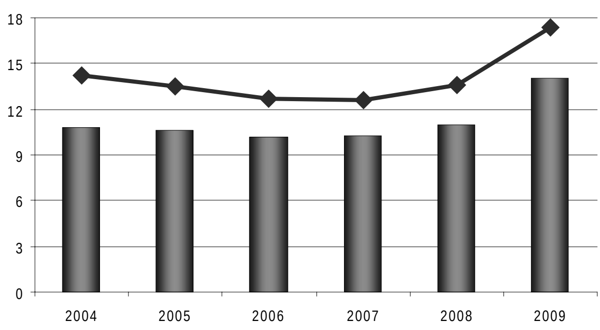
The next indicator is the employment and unemployment figures. The following Figure 13 indicates that during the crisis period, employment levels are more or less the same with respect to previous years both for farm and non-farm sectors.



Source: TurkStat

Figure 13: Farm and non-farm employment

So, new job-seekers could not find job resulting in rises in unemployment rates. Figure 14 reveals that unemployment increased from 11% to 14% while non-farm unemployment rate increased from 13% to almost 18% .



Source: TurkStat, CBRT

Figure 14: Unemployment rates

4.1. Demand Side Policies

Like in other developing countries, the major impact of the financial crisis was seen on demand for goods and services. Since world consumption as well as domestic consumption has decreased, domestic and foreign demand for goods and services has also decreased. This situation caused contractions in export and import level of Turkey. As of the last quarter of 2008 till mid-2009, substantial declines were observed so that exports decreased by 22.1% while imports fell by 30.7% . Including the fall in tourism revenues, the ratio of current account deficit to GDP dropped to 2.2% in 2009 from 5.6% in 2008, which is presented in Figure 15 below.

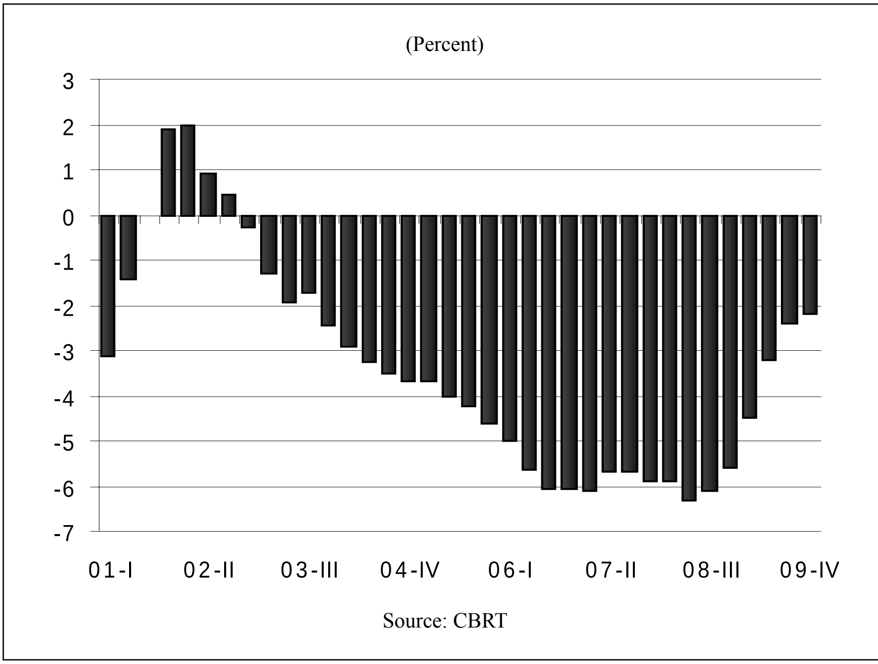


Figure 15: Ratio of current account balance to annualized GDP

Another development that has been taking place over the last decade is related to the composition of Turkish exports. Turkish exports have shifted to relatively more capital-intensive goods over the last decade, and therefore seem to have become much more sensitive to fluctuations in external demand. Necessity goods (agriculture, textiles, apparel, food and beverages) which are likely to be less cyclically sensitive. The share of exports associated with motor vehicles, machinery and equipment have increased dramatically. Therefore, even though Turkey is relatively less open, because goods sold to external markets have become relatively more capital intensive, Turkish exports, in general, have become more sensitive to the global business cycle (see Figure 16).

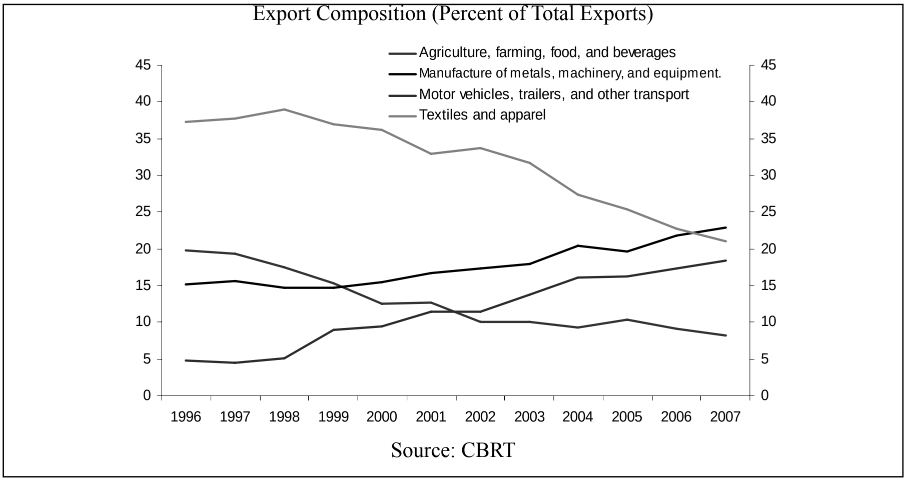


Figure 16: Export composition of Turkey

4.2. Monetary Policy Aggregates: Inflation and Policy Rate

As for the monetary policy implications of financial crisis over Turkey, we should take a closer look at two figures: inflation and policy rate induced market interest rates. Since economic activity has decreased dramatically due to the crisis, the CPI inflation rate also fell down rapidly starting in the last quarter of 2008 and ending in the last quarter of 2009 due to decreasing aggregate demand and decreasing commodity prices as well as due to decreasing exports. As a result, the CPI inflation rate decreased from 12% to almost 5% during this period, which is shown in Figure 17. However, the recovery takes place starting from the end of 2009.

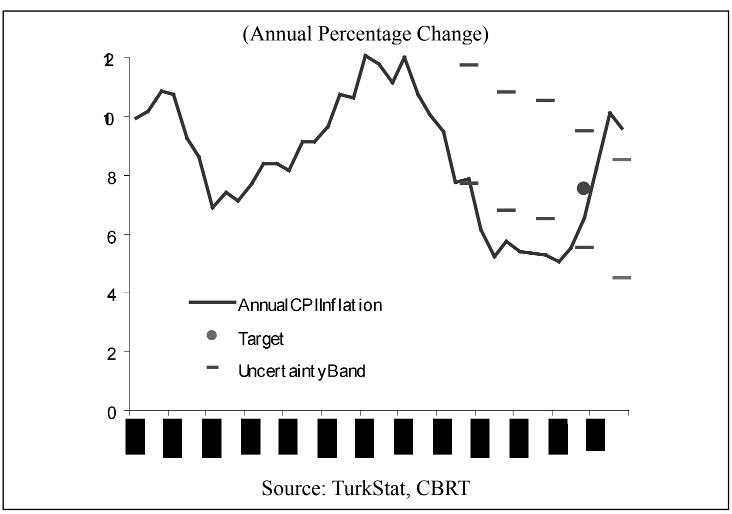
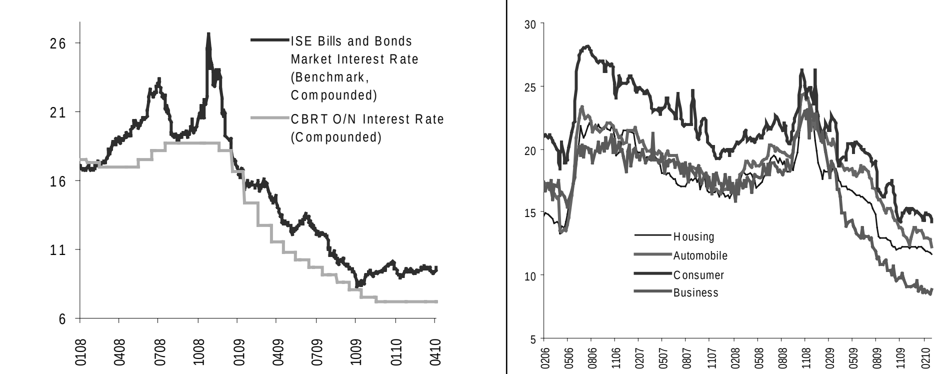


Figure 17: Annual CPI inflation rate (and target consistent path)

The next indicator for monetary policy developments is policy rate and related interest rates. In order to offset adverse effects of financial crisis on economic activity, Central Bank (CB) cut policy rate by 6.5% during 2009 gradually to stimulate aggregate demand. While the policy rate was 13% in January 2009, it was only 6.5% in December 2009 and after that CB did not decrease further the policy rate. This pattern is shown with yellow line on the left hand side of the Figure 18. Accordingly, ISE Bills and Bonds Market interest rate fell down to 9% . The reduction in the policy rate has reflections especially in the credit market so that housing, automobile, consumer and business loan rates dropped from 24% to almost 14% , on the average, during 2009.

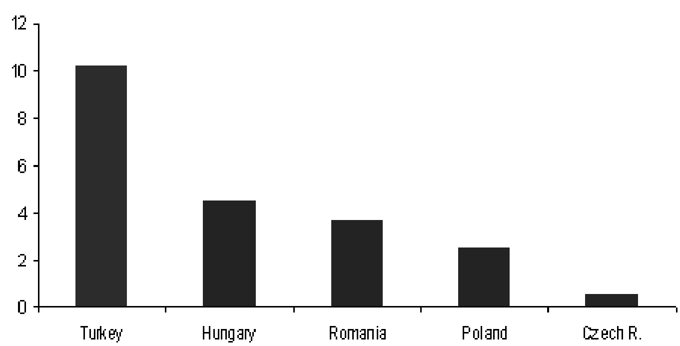
ISE Bills and Bonds Market and CBRT O/N Interest Rates	Loan Rates (Annual, Percent)



Source: ISE, CBRT | Source: CBRT

Figure 18: Interest rate developments

Ex-Ante Real Interest Rates
(As of January 2, 2008)



Source: Bloomberg, CBRT

Figure 19: Real interest rates of emerging Europe

As it can be seen in the above Figure 9, policy rates were higher in Turkey in contrast to the other countries at the beginning of the financial crisis. This initial condition is likely to show the reasons why the impact of financial crisis on Turkey was more severe than the other emerging countries.

While emerging Europe countries faced the globally synchronized recession, Turkey may have suffered disproportionately from the crisis was owing to three initial conditions: the high real interest rates, the slowdown before the crisis and cyclically more sensitive exports. When it comes to recovery there are certain risks that could damage it. For instance, foreign demand could turn out weaker than expected. This would damage Turkish export prospects, as well as those for the region. Commodity price shocks are another risk, which increases external deficits significantly, and therefore jeopardize the financing of the current account. However, Turkey is one of the largest economies with the fastest growth rates in the region. Besides, Turkish population is large, young and dynamic. Therefore, the stability of the financial system has positive contribution to growth prospects in the medium-term.

5. CONCLUSION AND POLICY RECOMMENDATIONS

The financial crisis has brought a number of weaknesses in macroeconomic policy. This required policy makers to set up new policies during the crisis and also post-crisis. When building new policies the ultimate goals should be to achieve a stable output gap and stable inflation (Claessens et al., 2010). Policy makers have to decide on many targets and many more instruments which are used in the best way. The combination of monetary policy and fiscal policy are two traditional policy options to build more stable national economy which also helps to create more stable global financial systems to maintain the resilience of the economy against global risk. Both fiscal discipline and the structural reforms are crucial for implementing the monetary policy decisions and for maintaining low interest rates. Restructuring and/or reforming the labor and product markets regarding to new competition regulations would contribute to raise potential output and productivity as well as to strengthen employment performance. To prepare the world for the post-recovery, increasing domestic savings and a favorable environment for the private investment through the structural reforms, such as tax and labor market reforms should be suggested as priorities for both emerging Europe countries and Turkey. In addition, enhancing private sector competitiveness and building innovative investments by using efficient energy resources will help for high long-run growth and an enhanced emerging Europe and global role for Turkey.

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