



**CENTRAL BANK OF THE REPUBLIC OF TURKEY**

**TURKEY BEYOND 2008**

**Durmuş Yılmaz**

**Governor**

**March 17, 2008**

Dear Guests,

As you all may know, the Turkish economy used to experience boom-and-bust cycles throughout the 1990s. The economic crisis in 2001 was the low point of this period, when the economy contracted more than 5 percent. Since then, Turkey has put in place a very intense and ambitious structural reform agenda, coupled with sound monetary and fiscal policies, to establish macroeconomic and financial stability and to improve the business environment.

Central Bank independence that was granted by Law in 2001 was one of the milestones of this agenda. The introduction of free-floating exchange rate regime in 2001 and inflation-targeting regime in 2002 were other key steps. The Central Bank of Turkey has also experienced a comprehensive institutional change towards a better communication policy and clearly defined accountability measures.

We have experienced a significant disinflation process since 2001. The consumer price index came down from 68.5% in 2001 to 8.4% in 2007. I should call your attention to the fact that the list of countries that lowered inflation in 2007 was quite short, thanks to global inflationary pressures in food and other commodities. In fact, the average inflation around the world increased from 3.5 percent in 2006 to 4.8 percent in 2007 and to 5.5 percent in January 2008. In this environment Turkey was able to reduce inflation by 1.3 percentage points in 2007. In fact, this was the sharpest drop among 60 major developed and emerging countries.

The disinflation process is even more pronounced in core inflation, which excludes energy and food prices. It stood at 4.36% as of February 2008. The favorable outlook in core inflation indicators despite the surge in energy and food prices has allowed the Central Bank to cut policy rates since September 2007. The cumulative rate cut reached to 225 basis points as of February 2008 bringing the overnight borrowing rate to 15.25% from 17.50%.

The timing of further easing depends on developments in global markets, demand conditions, fiscal policy performance and other factors affecting the medium term inflation outlook. According to the forecasts of our January 2008 Inflation Report, the year-end inflation may stay above the target in 2008, but within uncertainty band, due to factors outside the control of monetary policy such as

energy and food prices. The mid-point of our forecast for 2008 is 5.5%, whereas the year-end target is 4%. However, inflation is forecasted to converge to the target in 2009 and come down to 1.8- 5.5% range with 70% probability at the end of 2009.

At this point let me say a couple of words about fiscal policy of the last six years and fiscal discipline, which has also contributed much to the macroeconomic stability in Turkey. One of the main characteristics of the Turkish economy in the 1990s was high budget deficits, which was around 7% of GDP on the average. During the 2002-2007 period setting ambitious primary surplus targets and realizations of these targets, coupled with almost balanced budgets paved the way for significantly improved debt dynamics. Even before recent upward revisions in GDP figures, Turkey easily met the Maastricht criteria for the budget deficit and debt stock. According to most recent data, the ratio of net government debt to GDP has come down to 29%, whereas budget deficit is less than 2%.

Dear Guests,

As you all know, financial system plays a key role in accumulation of savings and its distribution among productive sectors. Therefore, health and stability of a financial system is crucial for economic growth of a country. We attribute utmost importance to financial stability as a country that experienced deep financial crises in the past. Price stability is the primary objective of the Central Bank. But, we also regard financial stability as our auxiliary objective and monitor the system closely. The achievement on the inflation front has significantly improved the macroeconomic environment and eliminated the vulnerabilities that put burden on the proper functioning of the financial system. The Banking Sector Restructuring Program and other measures that were taken following the 2001 crisis, led to the formation of a very strong and resilient financial system. This contributed to the high growth rates achieved after the crisis. I can comfortably say that today the banking sector in Turkey compares well with those of new members of the European Union. The Banking Law enacted in 2005 is in line with the best international practices.

Asset size of the Turkish banking sector increased by more than three-folds in the last six years and reached USD 500 billion as of 2007. Still, there is a huge and unexplored potential in the sector taking into account the size of Turkey's young

population and low rate of credit utilization among households and private business. Capital adequacy ratio (CAR) of the banking sector stood at 18.8%, well above the minimum legal requirement of 8% and the average of the European Union, which is 12.1%. Short-term liquidity ratios comfortably meet the legal thresholds. Thanks to sound and resilient structure of the sector, foreign direct investment to the Turkish banking system has surged since 2005 and the share of foreign investors in the total capital of the sector is now more than 40%. Rather than financing government deficits, the banking sector has returned to its core function, which is being intermediary between borrowers and lenders. The ratio of total credits to total deposits, which is a proxy for the intermediation function of the banking sector, has increased almost two-folds since 2001 and reached to 80% as of 2007.

The strong growth performance of the Turkish economy may be considered as the fruit of these structural reforms, fiscal discipline, and cautious monetary policies of the last 6 years. Turkey has grown for 23 consecutive quarters since 2002 and has been one of the fastest growing countries in the world during this period. The real GDP has grown almost 50% on a cumulative basis in that period, bringing the average annual growth rate to 7%. This strong growth performance was private sector driven and supported by continuous productivity gains. Along with high economic growth, openness of Turkish economy has also increased substantially. Exports, which stood at only USD 31 billion as of 2001, increased by more than two-folds and reached to USD 107 billion in 2007.

Dear Guests,

There are four distinguishing characteristics of Turkey that set her apart from other emerging market countries.

First, unlike other countries in the Central and Eastern Europe region, Turkey has a young population, which is a demographic gift that could accelerate economic growth. Of course, having great potential does not guarantee success. Currently, the Turkish economy is utilizing less than half of its workforce. Improving the state of the labor market, removing rigid labor market regulations, reducing the tax wedge, and more importantly enhancing the human capital through education reforms are essential to accelerate the growth rate of the economy on a sustainable basis.

Second, Turkey is a net commodity importer in contrast to Latin American countries and South Africa. We need to import in excess of 35 billion USD worth of oil and natural gas each year, almost 5% of our GDP. Looking at the composition of the foreign trade, you can see that our imports are mainly commodities and intermediate goods, whereas industrial goods cover more than 90% of our total exports. Therefore, promoting Turkey's competitiveness is the key to her future success.

Third, domestic savings rate, which is the main characteristic of emerging countries in Asia, is quite low in Turkey. It is around 20%. We need to attract foreign savings to finance investments. It is not surprising to observe a strong and direct positive relationship in Turkey between growth rate and current account deficit. Of course, the upward trend in energy prices has also contributed to the widening of the current account deficit to 5.8% in 2007. The current account deficit is a structural problem and a source of vulnerability. However, Turkey did not have difficulty in its financing in the last 6 years. In fact, the quality of foreign capital flows has improved sharply. The current account deficit can now be financed through foreign direct investments (FDI) and long-term capital inflows. The FDI inflows were in excess of USD 20 billion in each of the last two years, putting Turkey among the top 5 developing countries in FDI inflows.

Fourth, Turkey is one of the few countries with a "convergence story". Negotiations with the European Union over the full membership status provide a major stimulus to policy makers to put Turkey's huge potential into life and complete the reform agenda. This agenda consists of next generation policies and reforms that focus on removing structural bottlenecks and improving the economy's capacity for labor absorption, innovation, and competitiveness.

Dear Guests,

Turkey has had a heavy structural reform agenda since 2001. However, continuation of structural reforms is of vital importance for the sustainability of economic gains achieved in recent years and for the resilience of the economy to further shocks in the future. The most important structural reform in the pipeline is the social security reform that is expected to significantly improve Turkey's fiscal

balances in the medium and long term. It is also expected to contribute to our domestic savings rate. Other prominent steps that should be taken include reducing the size of the unregistered economy and broadening the tax base, reforming the labor market to increase job creation and bringing the business environment to a level on par with international competition, re-designing the education system in order to make it consistent with labor demand and to raise the quality of labor force, privatizing the energy market and ensuring energy supply security. These steps together with macroeconomic stability will undoubtedly make Turkey a more competitive country in the international arena.

Looking ahead, our main goals are to achieve and sustain price stability and economic growth. Prerequisites are macroeconomic stability, structural reforms and adherence to good governance principles both in public and private institutions. We recognize that economic growth at the expense of price stability cannot be permanent. Together with the EU anchor in place, we are moving decisively to become a trillion USD economy.

Thank you.