



**Minister of State and Deputy Prime
Minister Mr. Ali Babacan**



**MINISTERIAL DIALOGUE BETWEEN
THE ECONOMIC AND FINANCE MINISTERS
OF THE EU AND THE CANDIDATE
COUNTRIES**

18 May 2010

Distinguished Ministers, Dear Colleagues, Ladies and Gentlemen,

I am pleased and honoured to be with you on this occasion.

The global economic outlook since our last meeting in 2009 has changed quite a lot. Coordinated efforts of the global community, as well as responses of governments and central banks worked well. Confidence is being restored and downfall in economic activity has been limited. Despite the divergences in recovery dynamics and growth rates across the regions and countries, economic recovery is on track and global economy is emerging from one of the deepest recessions ever. However, there are several risks involved in this recovery period and many challenges lie ahead. Of these risks, debt sustainability and fiscal imbalances stand out as the critical challenges which not only pose threat in the short-term but also for many years to come.

As the recent developments in the financial markets revealed, deterioration of sovereign creditworthiness and mounting concerns about debt sustainability can hamper macroeconomic and financial stability and therefore ongoing problems especially in some European countries should be resolved in a quick, effective and credible manner. Otherwise, it may bring about substantial repercussions inside and outside of Europe. It is important that those countries should come up with credible fiscal consolidation plans, and sincerely adhere to these plans on the implementation side and if we do not act now and fend off this challenge, costs will be higher later on than it would be now. In this context, several governments have already announced measures to bring down budget deficits to manageable levels and limit the rise in the public debt. We welcome this set of measures. What's more, especially in peripheral Eurozone countries there is need to implement a set of structural reforms and this should enhance their economies' competitiveness, boost labor market flexibility, rehabilitate the banking sector and eliminate vulnerabilities and furthermore, we regard Commission's efforts to enforce economic governance and synchronize economic policy making as the right steps. These will enhance the resilience of the Eurozone and European economies overall.

Distinguished Ministers, Ladies and Gentlemen,

Following this overall evaluation, I would like to make a brief assessment of Turkish economy.

Our economy was affected from the global crisis mainly through three channels. The first one is the trade channel. Our export sector suffered from the deterioration in the shrinking external demand especially in the European markets and European Union is our main trade partner. Second channel, namely the expectations channel, worked through decreases in consumer and real sector confidence. Finally, we observed deterioration in external financing position of private companies.

Rising public expenditures and fall in tax receipts brought about a relatively limited weakening in our fiscal balances. Our budget deficit as a percentage of our GDP increased from 1.6 percent in 2008 to 5.5 percent in 2009. Meanwhile debt to GDP ratio increased from 39.5 in 2008 to 45.5 as of end of 2009. So, 3.9 percentage points increase in deficit, 6 percentage increase in debt to GDP ratio and because of the worries about increase in deficit and debt, we started fiscal tightening quite early and actually June in 2009 and again, last year, in September we announced our Medium Term Programme. This program covers 2010 to 2012 period and basically outlines our expectations and fiscal targets for the following three years. This plan is actually our fiscal exit strategy in a way.

Measures and reforms, within the context of the Medium Term Program, are putting our budget balances back on track. In this context, we are reducing our general government budget deficit to GDP ratio to 2.7 percent by year 2012 and debt to GDP ratio will stabilize at the end of 2010 and will start declining in 2012. Moreover, the structural reforms will enhance our economy's resilience to the external shocks and boost our economy's competitiveness.

The program, which we declared last September, was considered realistic and credible by international institutions like World Bank or IMF or OECD and also by market analysts and credit rating agencies and following the announcement of the program and fulfilling our commitments in a timely manner, four different rating agencies upgraded Turkey's credit rating and Turkey is probably the only country which got a two notch upgrade in the credit rating during the recent global financial crisis.

Another critical step that we have taken to ensure fiscal sustainability was the announcement of our new fiscal rule and the new fiscal rule says that our medium to

long-term deficit target is going to be 1 percent of our GDP and there is a convergence mechanism by which year by year we converge to this target. And there is also counter-cyclicality element by which if the growth rate in Turkey is more than 5 percent than we do additional savings and for those years when we see the growth less than 5 percent, than we allow for more deficits. So, two elements are embedded in the fiscal rule and this is going to be law which is going to be enacted by our parliament and the budget of 2011 will be prepared according to the new fiscal rule. We hope that implementation of this fiscal rule will enhance the predictability, especially long-term predictability on our fiscal policy. It will ensure continued fiscal discipline and also macroeconomic stability.

Dear Colleagues,

Starting from the second quarter of 2009 pace of the decline in our economic activity was broken and in the last quarter of 2009 our economy grew by 6.0 percentage points, year on year basis and as a result of this sharp rebound, the overall contraction for 2009 was limited to 4.7 percent and as of now leading indicators such as industrial production, orders, consumer and business confidence indices, credit conditions and credit volume, all indicate a strong recovery. Although our Medium Term Program is based on the assumption of 3.5 percent growth for 2010, many international organizations and market analysts expect a growth rate of at least 4.5 percent for this year.

Our unemployment rate last year increased by 3 percentage points compared to 2008 but since last May the seasonally adjusted unemployment figures started to decline and as of first quarter 2010 we are now at 12.7 percent. So, the average of last year was 14 percent, it is down to 12.7 percent as of first quarter. So, the unemployment is moving in a good direction together with the strong recovery.

Current account deficit which was down to 2.3 percent of our GDP last year is now going up and it may go as high as 4 percent this year, depending on the rate of growth and also depending on the oil and gas prices.

The impact of the crisis on Turkish financial markets has been limited owing to the robust structure of our banking sector which provided a buffer against external shocks. This was a consequence of the structural reforms and prudent policy approach that we have been implementing since 2003. Actually in the wake of the

2001 crisis, we have taken significant in order to restructure and rehabilitate the banking sector and we increased the capital adequacy ratios, we increased the liquidity requirements and we did that in 2004, 2005 and 2006 and the financial structure of private banks have been completed and the restructuring of the state banks also have been completed. Regulatory and supervisory framework has been improved also.

The capital adequacy ratio of our banking sector is now at 20 percent as of end of March 2010 which is well above our regulatory limit of 8 percent and targeted ratio of 12 percent. And similarly, banking sector's asset position preserved its sound structure to a great extent. During the recent crisis we did not have to bail out any bank, we did not transfer any state funds to any bank and we did not have to change our guarantee scheme, as well.

Dear Colleagues,

Unfortunately Central Bank Governor Mr. Yilmaz is unable to attend today's meeting due to the pre-scheduled Monetary Policy Committee meeting and the vice governors are also locked up in a way in Ankara for the Monetary Policy meeting. Hence, I would like to touch upon briefly recent inflation developments in Turkey.

In 2009, low international food prices, low energy and commodity prices in general, together with the weak domestic demand conditions resulted in a rapid decline in our inflation rate. However, the recent jump in unprocessed food and administered prices has brought about a temporary rise in headline inflation. Having said that, I would like to emphasize that core inflation indicators do not point to a significant deterioration in the price setting behavior. Therefore, inflation is expected to revert back to a downward trend as the temporary factors taper off.

Taking into account the normalization in the money and credit markets the Central Bank of Turkey announced that liquidity measures implemented during the crisis would be removed gradually. In this context, a comprehensive exit strategy document has been announced in April and by this way now there is more predictability about the monetary policy and how our central bank is going to be exiting from the extraordinary measures. As the first stage of this strategy, on the foreign exchange side, central bank hiked the FX required reserve ratio by 0.5 percentage point. Considering the exit strategy for Turkish Lira markets central bank

reduced the amount of liquidity that has been provided as a part of overfunding policy. Further measures include technical rate adjustment, widening the margin between central bank borrowing and one week repo auction rates and also increasing Turkish Lira required reserve ratios.

Distinguished Ministers, Colleagues, Ladies and Gentlemen,

This year, as in the previous years, the last sentence of the first paragraph of the draft Joint Conclusions of the Ministerial Dialogue Meeting does not contain the word “accession” and our position remains unchanged on this matter and as such, the meeting of candidate countries and ECOFIN Ministers of the EU is of a technical nature and we think that political considerations should not be allowed to play a role in such a gathering. Turkey does participate in the Dialogue Meetings as a negotiating candidate country. Therefore, the exclusion of the word “accession” is not in line with the purpose of these meetings. We would like to see the text revised, so that the wording in the first paragraph reverts to its original formulation. This would be in the interest of further strengthening our mutually beneficial cooperation on economic and financial issues. It would also enable us to give our approval to the adoption of the Joint Conclusions.

Thank you for your attention.