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RECENT DEVELOPMENTS IN TURKEY'S ECONOMY

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Welcome and Introduction:

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The Brookings Institution

Featured Speaker:

MEHMET SIMSEK, Minister of State
Republic of Turkey

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P R O C E E D I N G S

MR. PARRIS: (In progress) -- Gorbachev did just fine. But in any given year in Soviet agriculture, something almost always went wrong and then the record of (interruption) economy over the past decade or so has been mixed. But since the devastating crisis of 2001, Turkey's economic performance has gone from triumph to triumph. While it did not originate the programs responsible for that success, Minister Simsek's Justice and Development Party or AKP has shown great discipline and consistency in implementing those policies since coming to power in late 2002, and indeed, many believe its strong victory in last July's general elections was a vote of confidence in its stewardship of the economy during that period.

As we are gathering here this afternoon, there are some clouds economic and otherwise on Turkey's horizon. We are truly fortunate to be able to hear from the Minister a practitioner's assessment of what recent developments in Turkey combined with some frankly dicey global economic dynamics may mean for Turkey's economy in the period ahead.

The Minister by way of introduction was elected to Parliament last July and was appointed Minister in August. Prior to his entry into politics he was senior economist in Merrill Lynch's London office. He has also worked for Deutsche-Bender and UBS Securities. The Minister holds degrees from Ankara University and the University of Exeter. So I would ask you to join me in giving a very warm and cordial welcome to Turkey's Minister of State for the Economy, the Honorable Mehmet Simsek.

MINISTER SIMSEK: Ladies and gentlemen, distinguished guests, thank you for joining us today. I know it's Friday, Friday afternoon, really, so I'm delighted to see many of you here. I'll be as brief as I can and leave you plenty of room for the Q and A session, but in my previous life of course I was an analyst on the road. I used to travel very frequently. And I've learned that sometimes, and it's true, having a few charts really helps tell the story.

So I'll focus a little bit about why Turkey is more resilient to the ongoing external and possibly domestic stocks, not immune, certainly not immune, but why more resilient or less vulnerable to the way it used to be.

I think I'll skip the basics. I assume that you know where Turkey is, and I'll keep some of the long-term issues. I'll revisit for those of you who are relatively new to Turkey's story, I think you should know that Turkey is the second most populous country and is almost as big as Germany and France combined and also the sixth largest economy in Europe. And according to 2008 projections, PPP/GDP-wise which is over $900 billion, we are probably the fifteenth largest economy in the world. We have tripled per capita GDP over the past 5 years. It's very unusual for a country that doesn't have oil and gas to have had the experience such as an amazing improvement. I think very few in Turkey believes in this, but whether you look at the old numbers or the new numbers, we have almost tripled per capita GDP in 5 years and that's very unusual and that's why nobody wants to believe in it.

But let me tell you why we're in better shape now. I think the story here is that we've had the 1990s and early 2000s, massive fiscal deficits, and in the past these deficits used to be monetized, used to be accommodated by the monetary policy authority. As a result, we have growing inflation, debt accumulation, et cetera, but if you look at the past 3 years, you will notice that actually we have put our house in order, but it doesn't stop there. To verify the same picture, I will tell you the other part of the story. We have something called primary surplus. It's like looking at a bitta (?) of a company if you're looking at whether you should invest in that company or not. The bottom line is if you look at ex-interest payments, if you exclude interest payments, and look at the fiscal performance, you will be looking at primary balance. So excluding interest payments, how much primary surplus you're generating is a very important concept when it comes to dealing with debt dynamics, making sure that debt is on a more sustainable path, et cetera. In a minute I'll tell you what really these charts mean.

But in the 1990s essentially despite the fact that Turkey had double-digit inflation, double-digit in nominal rates, sometimes three-digit, by the way, and then Turkey had a very tiny primary surplus position and most of it actually is accounted for 2000-2002, so actually in the 1990s we had primary deficits, so even excluding interest payments, we had a budget that has a deficit meaning debt accumulation. So we reduced budget deficits. We have had significant fiscal adjustment or fiscal consolidation. But also we've done a lot of privatization, almost five times more than what Turkey had done in all previous episodes. In fact, year to date if you add year to date privatizations, it's about $40 billion, and when you consider that in the 1980s and 1990s all privatization totaled to about $8 billion, it tells you how much we've done.

So if you put fiscal performance and privatization together you get something called public sector borrowing requirement. Typically in the past, Treasury had a huge appetite for borrowing and anything that banks or anybody could bring in would be fine. We had a huge appetite (inaudible) slowed that appetite and even now we have gone on a diet. So if you look at the 1990s again, on average per year, Treasury's borrowing requirement was 7 percent of GDP, and then it peaked at around 12 percent, and now over the past 3 years actually we managed to reverse the trend, let alone public sector borrowing requirement, we have begun retiring debt. In fact, if you look at this simple chart, if you look at public sector net debt stock as a percent of GDP, we have more than halved it from over 60 percent, these are all based on new GDP numbers, to about 29 percent. And during that process actually sometime more interesting and also more significant to highlight is that if you look at the share FX denominated debt, these are Turkish so you wouldn't know it. That's a good surprise.

The blue part is Turkish denominated debt and the yellow bit is FX denominated, hard currency denominated debt. So we've actually reduced the share of FX denominated debt to one-tenth of what it was. So through this process we reduced FX risk, currency risk we used to obviously have plenty of that. Net debt is a bit complicated concept so why don't we look at gross debt, look at what Europeans tend to -- this is ISAR 95 (?) which is the European definition. Again on that basis if you take European 27 member average, it's over 60 percent, it's about actually 62 percent, and if you look at Turkey, we are now down to 38.8 percent. So the story so far is that Turkey over the past 30 years actually has satisfied Maastricht criteria on both budget and debt front. Now remember Maastricht criteria are not criteria to enter E.U., are criteria to join EMU, to adopt the euro, meaning you have to be really that good not only to join Europe, although quite a few members that joined in 2004 are nowhere near adopting EMU. Very few of them actually taken on board, meaning satisfied the

Maastricht criteria. There are two more criteria, I have to admit, but we are nowhere near satisfying those, they are all interrelated, it's inflation and interest rates, but I believe we'll get there at some point.

Just to show you this simple chart, this is really interesting because if you want to know really how much housecleaning we've done, is when we took the office we used to collect 100 lira of tax and pay 86 lira of that to interest. So interest payments as a percent of tax income was 86 percent. And now it's still huge by the way by any standard, 30, 32, 30-whatever, percent is still huge, but we've reduced it to one-third of what it was. And we've also started actually as I've said retiring debt, so we are no longer actually accumulating debt on a net basis. In fact, over the past 3 years even though we still have interest rates, nominal rates, in high teens and inflation in high single digits, we have begun to retire debt in absolute terms and that requires quite a bit of effort.

If you look at the overall total external debt now, this includes private sector debt again as a percent of GDP things have improved quite a bit even though we have experienced large current account deficits. I won't bog you down to details, but we have reduced as I've said FX risks and this chart shows you as well. We have interest rate risk because more of our lira debt is in the form of zero coupon debt versus floating rate notes. When you have floating rate notes, when rates move the interest rates on those papers, on that debt, can be adjusted moving forward, but when you have zero coupon, you're in good shape. Anyway, it looks like we have our sensitivity as well.

In fact, if you look at 2001, if Turkey were to experience a shock, a real exchange rate shock meaning 5 percentage points let's say real devaluation, what would be the impact of that on the gross debt to GDP ratio? Our gross debt to GDP ratio would have risen 2.2 percentage points, so 2.2 percentage points. But today if you have similar shocks, the impact would be roughly less than a third of what was in 2001. So I think the story here is that on the fiscal side we have really -- and by the way, these are hard gains. We have not had windfall gains. We do not have oil and gas, we have not benefited from rising commodity prices. If anything, we actually hurt significantly by what's happening globally in terms of commodity prices whether it's hard commodities or soft commodities. So these are hard-earned gains. That is on the fiscal side. We're in good shape and I think there is a fair bit of resilience.

If you move on to the banking sector which used to be the soft belly of the Turkish economy, we've also tried to fix that as well, and I think again we've gone a long way in terms of addressing that problem. Because in the past, Turkish banks, and I'm talking about the 1970s, 1980s, and even parts of the 1990s, were being treated like call centers rather than profit centers, a convenient way of setting up shop to attract deposits, then channel it to your sister group companies and keep some of it so that you can invest in the government securities business. To some extent I know that's a bit of an exaggeration, but roughly speaking, that was part of the story. Things have changed again a lot. So the banking system used to live off borrowing from overseas in hard currency, converting it to lira and lending it to the government. Occasionally you would have some accidents, risk would materialize, but then again you carry on. That's now over because actually with the post-2001 crisis we forced the banks to focus on call business call business which is financial (inaudible) lending properly. The fact that we've done fiscal adjustment, we've given them more space, and also we have introduced more stringent regulations and supervisory frameworks. So actually banks are now having to comply with all these E.U. compatible I would say regulations. Short effects positions they don't have it, even if they had it these will be tiny, but prior to 2001, I can tell you in 2000, if you looked at gross short positions meaning their FX liabilities, hard currency exceeding their assets, it was almost three times their equity. These numbers are not even a fraction of a percent of their equity.

Capitalization. The banking sector is now well capitalized. I know a lot of U.S. or British banks are now struggling to maintain regulatory requirements for 8 percent capital adequacy ratio, and as you can see, the Turkish banks, this is for the entire system, are well capitalized. Nineteen percent is a pretty good number. If you move to a basis of two which is more stringent, you will still be 11 or 12 percent which is still very comfortable. By the way, banks have grown very fast as well, meaning if you look at their loans to assets, their loan book has grown very fast. It's more than doubled. If you look at loans to GDP, it more than doubled. If you look at their asset quality in the meantime, normally you would expect the asset quality to deteriorate, actually not, because the economy has been growing so fast, we have created such an environment for them where they could actually have their cake and eat it sort of. In a way there's been strong growth and also asset quality has improved. So if you look at nonperforming loans as a percent of gross loans, it's about 3.5 percent. But if you look at provisioning which we forced them to provide for, there's a general provisioning, they have to provide up to 90 percent. So actually if you look at net NPLs, again it looks like they're in great shape. And if you look at them in free capital, meaning in case if they were to face a shock, their liquidity is still in very good shape or improving shape. And if you look at their profitability, in the past 3 years they have made ROE north of 20 percent. That is a very good number by the way. If you were to rank OECD countries and if you look at profit over assets, the Turkish banking system today would rank at the top. They would be around 2.7 percent meaning profit over total assets and I think that would be number one. So whether you look at ROE, whether you look at any other measure, the banks -- and by the way, all of them are making money. Last year there was not a single bank that was struggling because again we have provided them with a good backdrop. So the banking sector is in good shape, the fiscal picture is in good shape.

What else? We have also accumulated reserves. Remember that we have had large current account deficits. Normally you would expect Turkey to be running down its reserves, but what happens is that we've given investors so much confidence that even though we've run very large current account deficits, the amount of money that came into the country was sometimes 1-1/2 times, sometimes 2 times what we needed. So what we did is we said we'll accumulate reserves, so the reserves have gone up from about roughly speaking $26 billion when we took office to about $74 to $75 billion.

Something else has changed compared to the past. If there were a vote of confidence by international investors, I think it would not be in the form of petroleum inflows because they are very volatile, but it would be in the form of foreign direct investments. During the 1990s, and by the way, if you move to the 1960s, it wouldn't make any difference. You would just get worse. I just happened to pick up the 1990s. If you take the 1980s, the 1990s, the annual foreign direct investment inflows to Turkey would be about a billion dollars. And if you really want to know, that would be about a fifth or a sixth of what a typical emerging market would get as a percent of GDP. So in the 1980s, the 1990s, very little confidence. But when you move to the last few years, thanks to what we've done again, of course global (inaudible) has been favorable as well. People have been more aggressive. They had plenty of money so they were chasing assets. That's true. But you see there were other episodes similar to that in the past as well, so this time around they've actually finally invested.

If you look at competitiveness, again, some argue that the lira has been strong so we've lost competitiveness, but if you look at the World Economic Forum, if you take their word for it, the last couple of years actually we have enhanced our competitiveness. And here are a few hard facts. Foreign direct investment inflows were not pure luck. We are not purely dependent on global (inaudible) all countries are reforming themselves right now including Egypt, including Ukraine, so everybody is competing. But you know what, we were faster, because if you look at these numbers, we rank ninety-third among 155 countries. It's a horrible place to. Supposedly at that time we were the world's twenty-third largest economy or something like that. But within a couple of years we focused on these issues and we said how do we make it easy to do business? How do we create a level playing field to the extent that we can? How do we make sure that people who come to Turkey or people who are in Turkey and take risk have a good experience? They make money, they employ people, and they make my life easier and our lives easier, and that's the perspective we had. We said how do we do that? And we started looking at we have twelve technical committees at Treasury. They actually work around literally the clock and say how do we clean up nine-thousand pieces of legislation and regulation that actually mostly hinders business development rather than enhances it? So we've been working on that and that work has really been successful, and now we rank number fifty-seventh. Still in my view a poor place to be, but it's a good jump and we want to jump another 30 X places over the next 4 or 5 years and I'm convinced that it's doable because we've shown that it can be done even in a competitive environment.

And if you look at again the United Nations or some other surveys in terms of investment reports, our ranking has improved and FDI has improved. And if you look at real GDP growth again, there has been growth for consecutive 24 quarters. That may not be much by U.S. standards I have to admit because the U.S. has had very good bull runs, but this is unique in Turkey. We haven't had anything like this before meaning 24 quarters, and the average real GDP growth was round 7 percent, again the highest sustained real GDP growth in the entire Turkish history. Volatility of growth has come down. Inflation was a chronic problem and unfortunately it still is an issue but less so. If you look at the past three or four decades, the average inflation was close to 60 to 65 percent and we've finally managed to bring it down to single digits. Admittedly inflation is still high in Turkey, it's still a challenge, so I accept that. There are excuses, maybe we can go into them, but the bottom line is though we managed to bring inflation down to single digits in the past 3 years and keep it there in the face of both external and domestic shocks.

The unemployment rate is something that it looks like we have not been very successful because it's still running at around 10 percent. It's true. The numbers look like we're not, but I have to also here say something, that there is a transformation in the Turkish labor market. In 2002 when we took office, 35 percent of Turks, that's the yellow bit over there, were employed in the agriculture sector. Remember 35 is 10 times the U.S. as a share of total employment. In developed markets you get 35 percent of people working in the agriculture sector. So our agriculture sector clearly has a lot of unpaid family workers meaning the hidden unemployed. But as the economy developed as we began to deliver, they decided to move, so as of the end of last year, now we have only 26 percent of Turks actually working in the agriculture sector. So actually we did create jobs except that we couldn't reduce the unemployment rate because more people who were actually the hidden unemployed left the agriculture sector and I can show you an interesting chart as well. Unpaid family workers accounted for about 21 percent and they now count for about 14 percent. So there you go, actually the quality of the labor market has improved.

Now remember I told you that inflation was way above the target. We have a target that is ambitious, 4 percent, and we're running inflation at about 9 percent. So where do we go from here? External shocks have had their toll I would say last year and that's an excuse. If you look at inflation in the past 12 months, 70 percent of that inflation comes from energy, food, and tobacco. I always this, tobacco is our own fault because we don't want Turks to poison themselves. We push prices up and we try to -- in fact, we passed a piece of legislation a month ago. We had this dilemma. We wanted to sell the tobacco monopoly at a good price, but at the same time we wanted to ban smoking, and so the debate was which one first? We said let's first ban tobacco and then sell, and that's exactly what we've done. That is part of our strategy that we want companies coming to Turkey to have a good experience because we know that we need to have sustainable and lasting relationships. We still have our own mistakes, we still have shortcomings. I have to say we still a fair bit to fix. There is a lot, but on that occasion we did what was right. So first we passed a piece of legislation, then we -- by the way, we did privatize the tobacco monopoly.

So what I'm trying to say is that energy and food unfortunately has been a global phenomena everywhere including the United States. Inflation is rising in China, in India, in the Gulf region, in Kazakhstan, everywhere, and so we've had -- but if you look at core inflation, actually we're in good shape. In fact, if you look at inflation relative to other countries, we've actually reduced inflation relative to others, the Turkish inflation minus the rest of the world, I'm exaggerating, but the rest of emerging markets. So actually on a relative basis, we've done reasonably well. And all those blue lines tells you that core inflation actually is a lot more moderate than headline inflation like in the United States.

We have another challenge. We have a large current account deficit like the United States, in fact, the United States current account deficit is narrowing now because we've had a significant weakness in the U.S. dollar and of course the economy is also slowing. In Turkey we have a very large current account deficit partly because oil prices have been rising and we are a big importer like the United States of oil and gas. If you were to take out not energy but the impact of energy prices, so if you were to adjust our current account deficit and only use 2002 energy prices, we would actually have a current account deficit pretty moderate, around 2.7 percent. With this type of growth rate, with this type of FDI inflows, never we'd even be talking about it, but of course the headline one is still high. So the first really root cause, fundamentally we have low savings rate, so that's the reason. But how does it manifest itself? Again energy has been important. We've also been growing very fast. When you grow fast and in particular when there's a lot of investment, what do you do? We import machinery and equipment because remember we're not a developed country. We produce some machinery and equipment and we export some, but we still have to import some high-tech stuff. As you can see again we've more than doubled the imports of equipment, so that's another reason. So the economy has been growing, energy prices have been high.

How about exports? We've actually done really well. This is an 8-year performance meaning if you look at Turkish export growth per year for the past 8 years, so now 1 year or 2 years or 3 years, and in fact, the current growth rate and I'm talking first quarter is about 36 percent year on year export growth having had experienced such a large currency appreciation. In fact, if you were to compare Turkey with the rest of the world in terms of regions, not countries, there are countries that are doing much better than us, much better, but if you were to compare with other regional averages in terms of export growth, we have actually done reasonably well. That's Turkey's average annual export growth of about 15 percent for the past 8 years compared to the rest of the world. And financing of this current account deficit, quality has improved, more of the financing is now nondebt creating inflows, and I'm talking about foreign direct investment. Again if you look at exports I told you about growth rates, these are the numbers. So Turkey is a more open economy actually. We are more integrated with the rest of the world. We generate much of the value in Turkey by interacting with outsiders. There is no need to be concerned about where Turkey is heading. Turkey wants to become obviously a part of the global family, we want to join the European Union, but on trade-wise we want to be as liberal as we can and that's where we go. So exports have gone up from $36 billion, and if you look at actually February numbers, it is now $114 billion annualized. So it's more than three times, you could even argue that it's almost four times, increase in exports. In fact, the rate of export growth over the past 3 months has actually exceeded imports which is a good sign as well.

I'm not going to tell you about reforms we've done because we've done really a lot. This is the list of what we've done, lots of things, basically in terms of institutional reforms, in terms of structural reforms, fiscal, administrative, we've done a lot over the past 5 to 6 years. So these achievements did not come around simply by good luck even though luck in terms of global liquidity was on our side, but in terms of global commodity prices went against us.

There is plenty to be done, and I think if you were to prioritize what needs to be done I would say let's go for labor market reform because we have one of the most rigid labor market regulations and if you don't believe me, all the numbers tell you. Part-time employment is very limited. The U.S. is at one and then we are probably at the other end in terms of OECD countries, maybe occasionally some countries in terms of underperformance one or two, but in terms of labor we are -- so what do we need to do? We need to have labor market reform. We need to make the labor market more flexible, make part-time working more effective, reduce the burden on employment. And by the way, burden on employment is very high financial, tax wages essentially summarizes that. So that's exactly why we have now a comprehensive labor market reform on the agenda. In fact, we are looking at reducing the financial burden and administrative burden on employment, making the labor market more flexible, but equally important, putting money into short-term programs called Active Labor Market

Programs to help address the skill gap because we have a huge skill gap. We have millions of people who would say we can do anything, but actually they are not capable of doing one thing. And that's the problem, so we need to reeducate these people, and that's key. So labor market reform has been drafted and ready to be submitted to the Parliament. The reason why we've delayed this is because we were waiting for another important reform to clear the Parliament and that is an interesting one. The median age in Turkey is 28 years which means really Turkey is very young. We have 15 million students, by the way, and more than two-thirds or about two-thirds of the population is below the age of 30 to 35. So it's a very young country. Normally you would expect Turkey to have massive pension surpluses. I think that would be a reasonable proposition, but sadly that is not the case. Since 1990, we actually have massive deficits in the Social Security system. How does it come around? In the early 1990s, some of our elder politicians, wise people, thought that it would make sense to reduce the retirement age to 38 for women and 43 for men to fix the employment problem so that people can leave, they go and retire, and then we can bring in younger people to work. It didn't work actually because the system posted massive deficits and those deficits need to be covered so you borrow the money to pay them and that meant rising tax rates and that meant -- so long story, even as of this year, if you are a Turkish citizen and if you're a lucky woman, you can retire at the age of 44, or if you're a man you can retire at the age of 48. But in the meantime we say we want to be first class, we want to join Europe, we want to be number tenth biggest economy and these are ambitious targets and we put those targets, actually, we believe in them, but that means we have to reform this and there's a lot of resistance.

As you can see with most of our peers if you really were to include us in this club, we happen to be a member of OECD, they know something is wrong with us because that doesn't add up. So what we need to do, simply we need to do Social Security reform, and that's exactly what we're doing. The day the court case was announced against my party, prior to the case, I was not aware, I was on my way actually to Istanbul and then to the U.S. for another event, and Social Security reform had just cleared the commission so it needed to be pushed to the Parliament floor so that it can be debated and adopted. I went to the Prime Minister's office and I said I'm not leaving until I can see the Prime Minister. The commitment, the day after the court case was actually unveiled, we still managed to submit to push such an unpopular, it's not popular I can tell you, and considering so much misinformation is spread. Because when we go to hospitals, and I remember -- the Prime Minister and went to a hospital and there was a really old guy sitting in his bed and he said, "Prime Minister, I hear that you're going to reduce my pay." And the Prime Minister turned around and he looked at me and I said, "I can assure you that the current reform does not take away any of your benefits. In fact, it doesn't take away the benefits of the people who are in the system. We're talking about the next generation. We're talking about 2075 and fixing the problem."

So we managed actually. Right now we are almost halfway through getting the bill through the Parliament meaning it's some 170 articles, but the most important articles are the top 61 and the top 60 articles have cleared the Parliament, so we are not waiting for the rest to clear the Parliament. And that reform if it goes through, between 2008 and 2075 we will have still a cumulative deficit of about $500 to $600 billion, but if we don't do this reform, we'll have a $1.8 trillion deficit. So there you go, we will lower the deficit to one-third of what otherwise it would be and we would like to channel the money that is saved from here to research and development, to education, to infrastructure.

Education again just to show what type of political platform we have, we have actually build 115,000 new classrooms over the past 5 years which is equivalent to 40 percent of what Turkey had done in the previous 80 years or so. We have built 6,700 kilometers of dual-carriage highways in the past 5 years which is more than what Turkey had built in its entire history, and I can give you a few other items like this. And we have just adopted an R&D bill, a research and development bill, that actually gives up to 90 percent tax exemption if you have 50 plus full-time R&D personnel. Because we know what's wrong and, again, this is not a quick fix. We know it will take years to catch up, but you need to start somewhere and you need to start right. So that's why I have this chart. And by the way, when it comes to the pension system, we are very generous as well.

So here with this chart, I'm not sure if you can read it, but on average in the OECD, a high earner gets 61 percent of his salary when he retires. We pay them 108 percent. And if you are a middle income, it says mean and I don't know why they would translate it that way, it is 104 percent. We are only second to Greece our neighbors. When it comes to low-income earners, actually we are number six, so there are a few countries that seem to be more generous than us.

Softer reform-wise, another key reform agenda is to broaden the tax base. Right now unlike the United States, 70 percent of our taxes come from sales tax, consumption tax, indirect tax, fuel consumption, VAT, et cetera. So how much do we get from income from corporate? Only 5 percent of GDP, only 30 percent of total taxes, so what we need to do is to broaden the tax base. To do that we need to address causes that push companies underground meaning into the informal sector, and that's why over the past 5 years we reduced corporate tax rates from 33 percent to 20 percent, we reduced income tax brackets. So that process will continue.

In energy market reform, there may be some people interested in energy, and energy is a big issue in Turkey because we are a fast-growing economy. I told you in our region and not relative to the United States, we are a sizable country in that region in terms of GDP, in terms of population, in terms of whichever way you look at it. From that perspective, energy is a very important component in terms of competitiveness, but in terms of also security of an adequate supply of energy. Since we took office, by the way, as I said, some of these reforms we are almost done finishing, some of them we have done, when it comes to energy, actually we have gone a long way. It may take some convincing, but I have to tell you we rationally price the products now, there is more rationing, we have now a legal framework in place that actually does that exactly. We have begun diversification meaning diversifying away from hydrocarbons because right now 50 percent of Turkish electricity is generated through natural gas and we import 99 percent of that from mostly Russia and Iran, and similarly, across the board there is not much energy efficiency. We spend four times more energy to produce the same amount unit of GDP relative to Japan or two times relative to Europe, so quite clearly we've done what to do to move to more efficient pricing. That is in place. Secondly, we're diversifying. Now we have handed over hundreds if not thousands of hydropower plant projects to the private sector. We used to keep them to our hearts. When we took office there were 1,600 projects with lots of rivers and we've decided to hand them all over to the private sector, and we've done that, by the way. There are a few left and trying to get them done as well. But also we've just started investing, not us but allowing the private sector to invest in renewables like wind energy. And when we called on companies to express interest to apply for licenses, the applications amounted to two times the installed capacity of Turkey's total installed capacity for electricity, and I said my goodness, not realistic, but even if 5 percent of that materializes, even if 10 percent of that materializes over the next couple of years, that would mean anywhere 10 to 20 percent of electricity being generated from wind energy, and that is huge. In fact, the first bunch of it has just come on board, so I'm optimistic that last year we had a current account deficit of $38 billion and an oil import bill of $34 billion, so we really need to focus on that, hydro and renewables.

But also we passed a piece of legislation, don't be afraid, allowing private sector companies to come in and build and operate nuclear power plants. We don't have any other interest, it is simple, pure, we want U.S. companies or Canadians or some other companies, whoever wins the -- to come in and build and operate a power plant that will generate electricity from nuclear and that hopefully will take place in September and all the legal framework is in place. And we are quite wary as to whether or not Turkish companies are competitive enough in terms of their energy cost, and as you can see from all these charts, we actually are in decent shape both in terms of natural gas and electricity. And I'll stop here. Maybe I've gone a bit more than what I though I would, but then you get carried away when you have the microphone, so I'll stop here.

(Applause)

MR. PARRIS: Thank you for a very lucid and comprehensive overview. You make a splendid case that Turkey's data is not what it used to be, is relatively more resilient to both internal and external shocks. One couldn't help notice that a lot of your charts ended at the end of last year and I wonder if I could tease out of you a little bit a sense of simply the fact of that's happened in the first months of this year both with respect to the impact of broader global trends on you economy and of course the impact of the court case and what prospects are looking forward.

MINISTER SIMSEK: A difficult question. First of all, I'm a strong believer in the long-term prospects of Turkey. This is nothing new, and I genuinely think that with this type of demographics, even if you have an amazing ability to shoot yourself in the foot, ultimately things in the long run will work, but in the short term I have to admit it's a more challenging environment.

We try very hard to say it's business as usual and we carry on, and in fact, the fact that we've had the Social Security reform going through the Parliament and the fact that now we are pushing Article 301 through the Parliament, things like that, you might even go as far as to say there is a silver lining in every cloud, but even these might be a blessing in disguise. Countries tend to do well under pressure, and in particular we do tend to do well under pressure, so again I'm not pessimistic, I just recognize that it's more challenging.

So if you were to ask me the impact of what's happening right now, I would say probably we have a year or two of soft trend growth in whatever that might be. I believe that Turkey can grow for a decade or two really, really comfortable at 6 to 7 percent and we've shown it, because the working age population growth is almost 2 percent, it's 1.9 or 1.8 percent, so if you do reforms that would accommodate, if you do labor market reform and make it more flexible, an energy market reform that would attract investment, if you continue to improve the investment climate, people will go where the return is. It's understandable. So I'm convinced that Turkey can do well, but in the short term partly on the back of global (inaudible) partly on the back of what might be happening domestically, I think soft trend growth is certainly an issue.

MR. PARRIS: Soft trend meaning?

MINISTER SIMSEK: Below 6 percent. Well, it could be it could mean anything, it could be three. I'm not going to go into numbers. But we have a best case scenario which was built last year that Turkey would grow this year around 5.5 percent. Admittedly, the global backdrop means that the downside risk had risen prior to the latest events and even now I still think that Turkey can grow about 4 percent in 2008 which will be modest by Turkish standards but still respectable by international standards. Last year if you exclude agriculture, real GDP growth was about 5.7 percent, so in a year where we had two elections, one referendum, and also other issues with the global backdrop, I think we've had a decent rate of growth last year. This year I think agriculture will recover, but still downside risk to 5.5 percent target has risen.

Now if you focus on the rest, we do have a more challenging environment in terms of current account financing as well. Even though we're going to continue to stick to the right policies meaning obviously a fiscal policy that is focused on containing the current account deficit, containing inflation, and reducing debt, a monetary policy focusing on inflation, investors do have expectations and sentiment can change. So it's going to be a more challenging year in general, but no comparison with any other episode that we had in the past. So we're not talking about Turkey in the 1990s or even early 2000 or the 1980s or 1970s. I think Turkey is in much better shape, much more resilient, but that again does not mean that we don't have soft trend performance for a year or two.

MR. PARRIS: The Minister has kindly agreed to take a few additional questions. If I could ask you posing them to first identify yourself. Abdul Akyus?

MR. AKYUS: Thank you, Minister. Since we are now on U.S. soil, I would like to ask something about U.S.-Turkish economic relations since you are also in charge of investment and Turkey has shown a huge success in attracting more investments in the last specially 3 years. One observation is that economic relations, more trade and investment, is the missing link of this important partnership. And the second observation is that most of the investments Turkey has attracted in the last 3 years are coming from the E.U. which is fine but we want to see more U.S. investments and there are some very important cases where we see some American and Turkish companies operating jointly in surrounding countries and they benefit substantially. So is there anything your government is working on or can work on in terms of promoting more economic relations between the U.S. and Turkey or is it something left to market forces? Thank you.

MINISTER SIMSEK: Thank you. First of all, I have to be very clear, we have had for many years and I'm sure the future is also foolproof in the sense that we have great relations with the United States like with other -- there may be ups and downs, but ultimately I think relations are good, and economic relations have also improved. But I think relative to the size of Turkey and relative size of the United States, yes, you could argue that the potential is not utilized, and that that is true. Having said that, much of the investment that originates from the Netherlands is probably party to the United States because it's just better to have something there and then use that vehicle to invest in Turkey. So directly or indirectly I have to say the direct one looks small but indirectly probably the U.S. has a sizable stake in the Turkish economy, but the potential -- the United States is still the engine or still the largest world economy and we are obviously becoming more significant in our own region. So I think the format of the relationship ultimately in the past maybe it was predominantly political, military, et cetera, but ultimately I think it will shift. But that's the nature of things and I think it is happening everywhere and economics really is key to healthier sustainable dialogue.

So what are we doing? When I was in Davos I did sit in some behind-door sessions discussing the state of the world economy and it was quite distressing. I was quite depressed. But at the same time, I had plenty of meetings with the likes of CEOs of Siemens and Merck and Cisco, even Google, so we are working. We have an investment promotion agency. There's a smart gentleman who runs it. He used to run of the Swiss cantons. He's really good. He is full of energy. And we have already attracted some of the top U.S. names anyway, GE Capital has a state, Citi has a stake in some of the banks, and there are plenty. I'm not going to go one by one. But I think on the energy side there is a huge upside because I know there have been a lot of false starts and I know there have been lot of disappointments in the 1990s, but really times are changing and we have investment needs to the tune of $100 billion to $125 billion over the next decade or two in energy markets and the deregulation and privatization process will continue. In fact, we've just sold a bunch of small group of power generation assets, again, small, but still a good start, and very soon we're going to start with distribution networks. So energy is clearly one area where we could see more U.S. involvement.

And I think when I was in the United States back in the 1990s, 1997-1998, I remember at that time there was quite a bit interest, but unfortunately because we didn't have the right regulatory framework, we didn't have political stability, that interest did not translate, and it was our own fault, into any sizable investment, but I think that that is going to change. But in other sectors as well across the board whether you're talking about tourism, whether you're talking about steel, whatever, I think there are plenty of opportunities out there.

So the difference between now and the past, no, we're not going to leave it to the market. I think that's not enough. I think we should have one-on-one dialogues, I think we need to put Turkey on radar screens, and I think it starts with the ambassador here and with me and everybody else, I think we need to continue to focus on that element. We do have great a historic relationship, I think there's a great alliance, and the reason why we are friends is because we share common values. It really is fundamentally I think if you don't share common values, there cannot be a lasting relationship, and I do believe that with the E.U. and the United States there is quite a bit of that. So I am very comfortable on that, but I think moving and strengthening that, moving a step forward, I think we need to focus on opportunities and ultimately I think Turkey does offer a decent upside. Yes, we're still an emerging market, yes, we are a risky place, but you know what, if we are successful a few years down the road, you would probably have bought an emerging market growth at developed market risk, and this is we are hoping that we can achieve that.

MR. PARRIS: Are there other questions out there?

MS. WONG: My name is Sontel Wong. I'm with the U.S. Treasury Department. I just returned from Turkey on Wednesday actually as a guest of the Ministry of Finance to talk about and maybe learn lessons from the U.S. Treasury and the U.S. government on strategic planning and performance budgeting. I think you passed a law in 2006 that encourages all the ministries to go through strategic planning and performance budgeting. It was a very good process for me to come and talk to -- I think on last Friday we had all the ministries represented there and very good sessions that we had. So my question is, public expenditure reforms, something beyond that. I understood that there were a lot of development plans and maybe a plethora of plans, too many plans, going on, that there is a lot of confusion about how to go forward with public expenditure, so if you would talk a little bit about that.

MINISTER SIMSEK: Thanks for your help. We always say this, I think in the case of Turkey and going forward we do not want to reinvent the wheel, we do want to look at success stories, and I think your revenue administration, there is plenty for us to learn and build on that experience. The move toward this new budgeting system is new and understandably still we have with our own group good old habits and still lots of planning and it's a process and we are at the beginning of that. Now we are putting together another plan, and medium-term fiscal framework, which is actually prioritizing reform areas, prioritizing essential infrastructure investments. Infrastructure is another area where Turkey will need a lot of investments, and we want the private sector to do it. In fact, there is a piece of legislation in the Parliament that provides that enhances the scope and provides more flexibility for the private sector to come in and build and operate, if they can't make enough money, we'll prop it up and then they can transfer it, and we've been successful in building airports, et cetera, but we want to move from irrigation to toll roads to all sorts of things.

The fiscal framework is going to provide a 5-year perspective as to where debt numbers will look like, other fiscal numbers will look like, but also highlight priority areas and account for costs of those reforms. So I have to admit we are putting in place first-rate reforms but actually implementing them and living up to the promise, the commitment it will take years, but this is very normal, it really is, because it requires education, it requires new thinking, and it applies across the board. It's not unique to budgeting, it applies to even freedom of thought, fundamental rights and freedoms. Article 301 has been a big headache for us but really if the same article existed in Italy probably they wouldn't use, but in the case of Turkey they do, in fact, sometimes they use it overzealously. So what I'm trying to say here is that changing legislation and putting in place a new system is not enough, really it requires sometimes a mentality change and sometimes even requires a different generation of people to actually understand, digest, and respond. So it is one of those issues, but I think progress has been encouraging and I would say that over the next few years hopefully we will do that.

MR. PARRIS: One last question and I think then we're going to have close it down.

MR. YENNER: Thank you, Mister Minister. My name is Demir Yenner. I'm with the Emerging Markets Group of Bearing Point, Incorporated, McLean, Virginia. My question is about the corporate sector. You didn't mention anything about that, but I notice when I look at the numbers the indebtedness of the corporate sector is growing precipitously and that's kind of a concern for me as I look at this and I think that even though we have improved foreign direct investments, the weakness in the corporate sector might increase the further riskiness of repaying corporate debt. We hope that it won't repeat the 1997

Asian crisis like that. What are your views on this situation? Thank you.

MINISTER SIMSEK: Thank you. That's an important issue. In fact, we've also been sort of concerned and so we're decided to look at the numbers. If you look at the headline numbers, admittedly like everywhere else, like in Kazakhstan or Russia, the corporate sector has been borrowing and expanding and increasing leverage in general. I don't think it is as much as the Russians or anybody else, but still even by Turkish standards this is significant.

First of all, let's talk about some hard numbers. Short FX position of the entire corporate sector is about $50 billion. If you were to rank many countries, this will really be a huge one. Secondly, when we look at the maturity structure of corporate debt, unlike in the past when much of it was short-term in the form of (inaudible) right now there is plenty of medium- and long-term. In fact, two-thirds of Turkish corporate debt is in the medium- and long-term. It's important because let's just say things go south, things don't work out and there is pressure, it's important that a big chunk of it is not needed, and I think the confidence in Turkey's future, again we'll see how things work out, but it's still out there. Year to date, Turkish corporates have not had any difficulties bringing even extra money let alone rollover, so that's first. Secondly, the interest in Turkish corporate deals have actually remained very strong -- Megos was on sale and there were decent bids and it's gone. Some Turkish finance house acquired a Middle Eastern hotel. Turkish corporate groups continue to attract interest. I'm not saying it's as strong as it used to be, but it's certainly not at the point where you would think about how things would unravel.

More importantly, this is an important point, unlike Asia, there is no bubble in the Turkish corporate sector whether you look at the equity market, the multiples, Turkish companies are trading at a discount rather than -- so that's first. Secondly, money has not gone into real estate. A big chunk of borrowing when we look at it when you decompose it has actually gone into machinery and equipment, et cetera, so the productive capacity has expanded. So I'm not saying this is not an issue, it is an issue, meaning something that we look at and something we watch, but the similarities with Asia ends essentially here. There is no bubble. There are no pyramid schemes. So I think we're in good shape in terms of quality, but again if things really go bad, yes, there will be some fallout from that and that would mean probably slower growth, even slower growth, so that's my sense of how things are.

And we have plenty of reserves. I'm not saying that -- but we have a floating rate exchange regime, and equally important, there's plenty of FX in the system. In the Turkish corporates and individuals I think the last time I look at it was $90-something-billion of hard currency deposits and that's huge. So at a price there will be supply, but I don't think things will get to that point unless really things unravel, and that's certainly not something that I see happening.

MR. PARRIS: If it's very quick, we'll take the last one in the back there. Please be brief.

MS. RAFAEL: I'm Helen Rafael, Resources for the Future. Since so much of the water upon which Middle Eastern countries depend comes from the rivers flowing down from Turkey, can you really be planning increased hydroelectric generation without further inflaming relations with those Middle Eastern countries?

MINISTER SIMSEK: Thank you. I think you're referring to the Euphrates and Tigris. I think we're almost done with what we need to do down there with the exception of one major dam on the Tigris. It's called Ulusu Dam.

Past experience, and if you don't believe me you can ask Syrians or Iraqis at least, we have delivered on our commitments in terms of ensuring that there is a sufficient amount of water or the amount of water that we agreed flows. So most of the dams that

I'm talking about, the hydro plants, they are relatively small and they follow the previous ones, so on the same river and particularly rivers that are going into the Black Sea, I would say much of the focus right now is there, but, yes, there is a project for a major one on the Tigris. But we will in any case not -- clearly we like our neighbors, we want them to be stable, strong, we want them to actually thrive so that we can trade more with them.

We can make more money by selling goods and we can maybe important electricity from them. I understand your question, but I'm very comfortable that I think we are rational enough, pragmatic enough, that we will cater for those needs as well.

MR. PARRIS: In case the Minister has whet your appetite to hear more, he will be I believe participating in next week's Annual Conference of the American-Turkish Council and I'd encourage you to check it out on their website or directly. Mister Minister, thank you so much for sharing your insights with us. It's been a very informative session and we wish you every success in your very difficult job.

MINISTER SIMSEK: Thank you, ambassador.

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