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Turkey: Sturdier than thought

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Advice you can bank on

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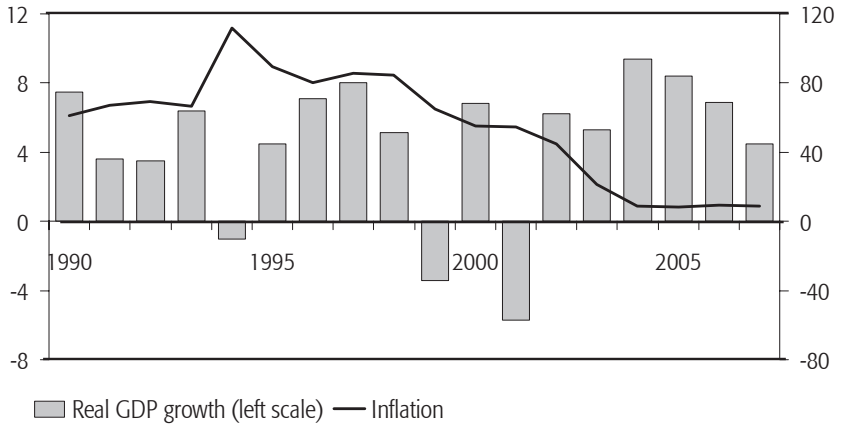
After several years of political stability and high economic growth, hard times lie ahead for Turkey. Political uncertainty is on the rise again. The case brought to the Constitutional Court to have the ruling AKP banned finally ended with the court deciding in favor of the AKP and the government, removing considerable uncertainty from the country. At the same time, international capital markets have entered choppy waters in the wake of the subprime crisis. How will Turkey accomplish the balancing act between a tricky domestic political situation and the confidence of international investors upon which Turkey relies given its substantial foreign capital requirements?

1. PHOENIX OUT OF THE ASHES: THE ECONOMIC SUCCESS STORY SINCE 2001

Until the beginning of this millennium, Turkish economic development resembled a roller-coaster ride, with years of booming economic activity usually culminating in a steep down-turn, often coupled with a sharp slide in the currency and hefty knocks to prosperity. Turkey underwent the last of these crises in the year 2001, sparked off - among other things - by a very vulnerable commercial banking system and an overly ambitious exchange rate policy which was intended to tame the notoriously high inflation once and for all. However, inflation as such was not the root of the evil but, if anything, a symptom of the real cause of the crisis, namely the disastrous state of public finances. The latter was, by extension, greatly influenced by the domestic political situation, characterized by frequently changing coalition governments and the massive influence of politics on economic developments. The AKP's election victory in 2002 gave Turkey a government which for the first time did not need to rely on coalition partners. Exploiting its stable parliamentary majority, the new government was able to make sweeping reforms: the central bank became independent and committed to inflation targets, the exchange rate was floated. This, together with the resolute consolidation of public finances, formed the basis of the economic success of the last few years, with average growth rates of close to 7 %.

Chart 1: Boom-bust cycles in Turkey
(Real GDP growth und inflation in %)

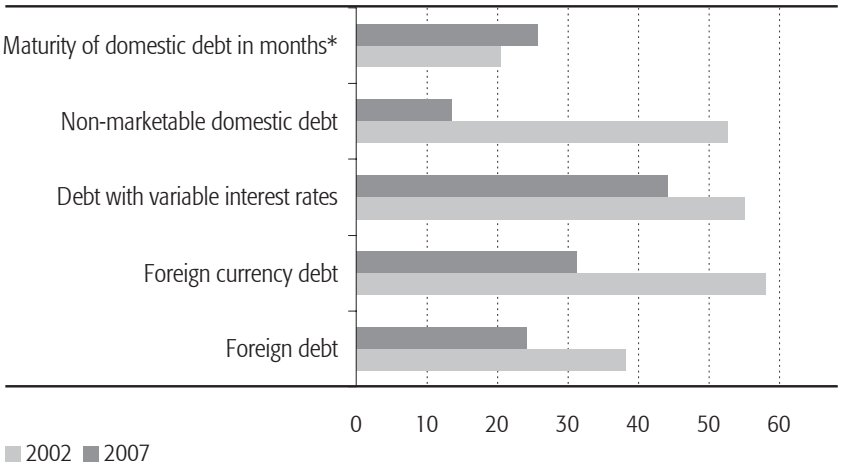


Source: Ecowin.

Healthy public finances no longer at the mercy of politics

Budget deficits of over 10 % of GDP at the beginning of the millennium have made way for deficits of between 1 and 2 % of GDP in the last three years. Factors behind this success were the persistently high primary surpluses (budget balance excluding interest payments) of some 5 % of GDP since 2003 and lower interest rates as inflation was tackled. Interest payments on public debt still account for nearly one quarter of budget spending or 5.7 % of GDP. However, when considering this indicator which is representative of all Turkey's woes it is vital to bear in mind how far Turkey has come since 2001 when the rate had stood at over 50 % of spending or over 17 % of GDP. Thus, **Turkey's vulnerability when it comes to debt servicing and ongoing deficit funding has reduced visibly. Public debt** which has more than halved to nearly 39 % since 2002 in relation to GDP **reflects an altogether brighter budget situation.** Of almost greater importance is the fact that the structure of public debt has also fundamentally improved: i.e. proportionately lower foreign debt, a far higher share of lira and fixed interest liabilities as well as longer maturities. The reduction in public debt was also made possible by the **privatization of state-owned companies** which is making good progress. Proceeds to the tune of some USD 30bn have been generated in the years since 2003, i.e. no less than some 1.2 % of GDP annually. By comparison: during the years 1985 to 2002 the figure amounted to only some USD 8bn.

Chart 2: Improved structure of public debt (Share in %)



Source: Ministry of Finance of Turkey, own calculations, * data for 2004 and 2007.

With the presentation of the **„medium-term fiscal framework"** in May 2008, the government has staked out the framework for future fiscal policy following the expiry of the last IMF Program with its strict conditionality. The key numbers of the program - primary surpluses to drop from 3.5 % of GDP in 2008 to 2.4 % in 2012 - are **less ambitious** than in recent years, arousing critical comments from analysts. Overall, though, the budget boils down to a **quite acceptable deficit** of some 1.5 % of GDP, with public debt projected to fall from nearly 39 % of GDP today to 30 % in five years.

Structural improvement in the budget

Much has also happened structurally: first, the **budget has become more transparent** following the abolition of special funds and special financing. Proposals recently made to reintroduce similar funds have also been rejected in spite of the muddled domestic political situation, thereby rendering the budget increasingly immune to

arbitrary political influence. The **rules introduced to govern price adjustments of (still) subsidized goods** are also a step in the right direction. On 1 July a new regulation came into force governing the adjustment of electricity prices. A similar directive for petrol prices has already been in force since the beginning of the year. This is important given that the price structure, which had not been cost-covering until now, had impeded investment and privatization in this sector, raising fears of, for example, electricity shortages. Furthermore, the Turkish parliament gave its seal of approval in April of this year to the **reform of the social security system** which, among other things, lifts the retirement age to 65 years after an initial attempt had been turned down by the Constitutional Court. Time and again the IMF has called for the introduction of this reform, given that the pension deficit of currently some 3.5 % of GDP would have mushroomed to as much as 6 % of GDP by 2030. Thanks to the reform, the social insurance deficit should gradually decline over the next thirty years.

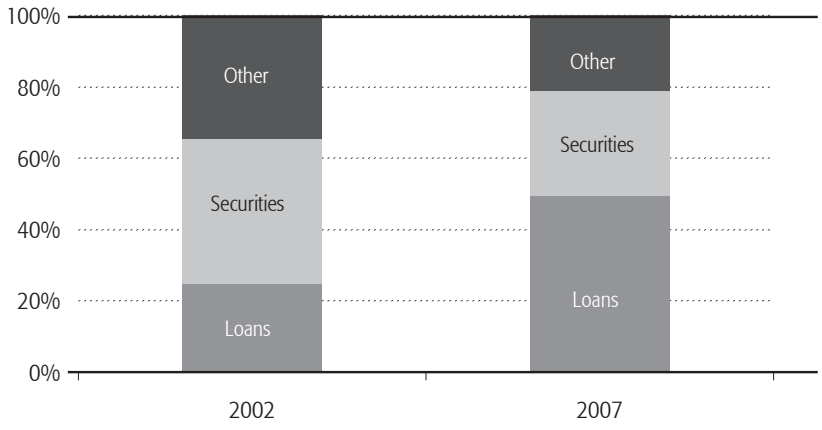
More efficient financial system

As a result of the drastic decline in inflation and the end to state meddling, the Turkish financial system has also established a new foundation for itself in recent years after having more or less collapsed during the crisis of 2001. **Having previously been viewed as the catalysts of crisis, banks today are ascribed the role of a crisis buffer. The former role of the credit institutions as financers of the state has made way for active financial intermediation with more loans to companies and private households.** Whereas at the end of 2002 only a good third of deposits were granted as loans, this share has now risen to a good 80 %. The expansion in consumer loans is the main reason for this trend, having grown at twice the rate of corporate loans and meanwhile accounting for a good 40 % of lending volume. Slowly but surely maturities are also lengthening: companies can now also get funding in lira with a maturity of several years, a new phenomenon for Turkey with its history of hyperinflation.

The mortgage market is still in its infancy, but is making huge strides forward. **Turkey can therefore be said to be catching up from a low level as regards the development of its financial system,** even if the share in GDP of bank assets as well as private lending of 87 % and nearly 30 % respectively is still lower than in most central and eastern European countries and has more in common with countries like Mexico or the Philippines. Above all the ratio of private household debt to GDP of 12.4 % in 2006 is still far lower than in Poland or Hungary. These figures also highlight the **great development potential** which, backed by the healthy macroeconomic stabilization, has caught the eye of foreign investors. The share of foreign banks has also surged fivefold to a good 22 % following the privatization of state banks between 2004 and 2006.

The growing presence of foreign institutions, a new banking law and tighter supervision have also strengthened the risk management of banks. Banks are no longer allowed to enter into open currency positions, and the scope for politically-inspired directed lending has also been curbed substantially. The introduction of Basel II has been postponed for the time being – particularly given the information requirements which are practically impossible for small and mediumsized companies to fulfill when taking out loans. However, this is not preventing the supervisory regulations from being continuously developed, such as the valuation of operational risks. Fundamentally, with capital adequacy of currently 17.3 % of risk-weighted assets and a non-performing loan share of 3 %, **the banking system is also in good shape by international standards.**

Chart 3: Financial intermediation on the right track
(Share in total balance sheet)



Source: Bank Regulation and Supervision Agency; own calculations.

Less vulnerable to crises

Lower inflation, healthy public finances and a more efficient banking system have created scope for strong growth which is now being generated first and foremost by the private sector. These factors together with the stable political situation of recent years have caught the eye of foreign investors and attracted inflows of capital into Turkey. The central bank has been able to raise its currency reserves to meanwhile USD 75.8bn, covering imports by some four months. **All this is serving to strengthen Turkey's resistance to crisis.** For example, the country managed to survive more or less unblemished the latest upheavals such as the sudden surge in risk aversion in May 2006 when risk premiums soared sky high, or the difficult domestic political situation when the presidential election was annulled in 2007. Not even the growing uncertainty over EU membership has failed to halt the flow of capital into Turkey.

2. SORE POINTS: WHOPPING CURRENT ACCOUNT DEFICIT AND OPEN CURRENCY POSITIONS

Inhospitable global environment and domestic political tension

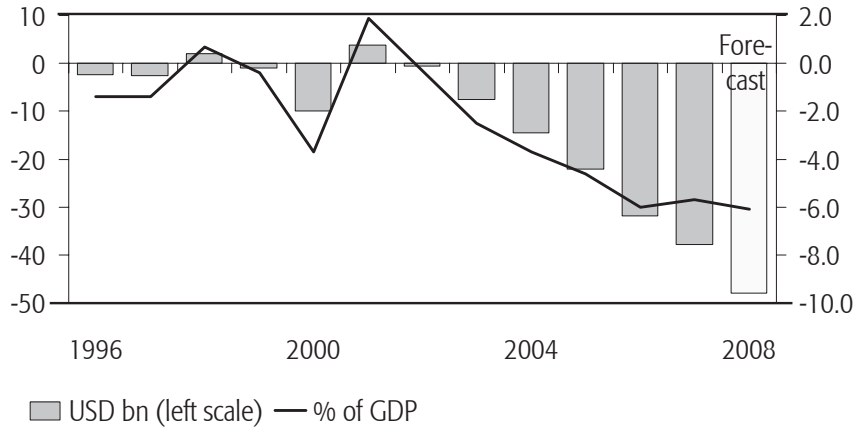
At the moment, however, Turkey is coming under pressure from two angles: on the one hand, the country is faced with a **tense domestic political situation:** even if the failed attempt to have the Constitutional Court ban the AKP ended innocuously, the conflicting positions in Turkish power structures it exposed portend further conflict. Second, the **international climate has clouded over considerably:** global economic development most likely passed its peak in the first quarter 2008 and is now cooling down noticeably. Even more serious for Turkey, however, is the international financial crisis which has greatly soured the risk appetite of international investors and banks. However, the government is currently attempting to at least retain the IMF as stability anchor via a „precautionary standby" deal despite the fact that the last regular standby agreement expired in May of this year.

Heavy reliance on foreign capital inflows

Among the emerging markets Turkey has the highest foreign capital requirement. Although in volume terms exports are rising more strongly than imports, the **current account deficit** is nonetheless expected to expand to USD 48bn or **6.1 % of GDP** in the wake of this year's oil price increase. Oil prices were the first reason for this trend – oil imports account for a good 7 % of imports – as well as rising interest and divi-

dend payments abroad. On the other hand, direct investment - amounting to only USD 4.4bn up to May – is weak in the current environment. Privatizations, including foreign companies, fared relatively well in the first half of the year. However, privatization activity is expected to ease up now, with a similar trend also predicted for M&A activity which is important for Turkey. We therefore expect an influx of only USD 12bn for the whole of this year, **with direct investment thus covering just one quarter of the current account deficit**. Moreover, foreign investors have also wound down positions on the Turkish equity and bond market since the middle of last year to the tune of USD 8bn, **making the country increasingly dependent on foreign currency loans.** Until now, though, it has been possible to meet the capital requirement in return for a premium on the financing costs. This also explains the relative strength of the lira.

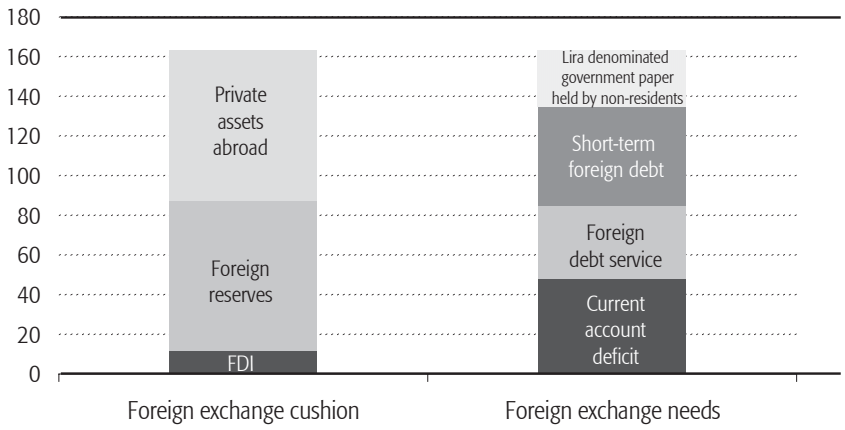
Chart 4: Yawning current account deficit



Source: Central Bank of Turkey, own calculations.

Nonetheless, **risks** remain: For alongside the need to finance the current account balance, Turkey is still sitting on **hefty refinancing requirements on its external debt** totaling almost USD 90bn. Shortterm liabilities account for some 60 % of this, while the remainder relates to payments for long-term loans. Furthermore, foreigners also hold lira-denominated government bonds in a volume of a good USD 27bn. **This compares with currency reserves of USD 75.8bn**, which however have recently halted their uphill march. In addition to this, Turks also hold significant assets abroad which add up to a further USD 75bn or so. However, there is no guarantee that these assets would be drawn on in the event of a crisis; experience from recent years tends to suggest that foreign deposits are built up especially in times of domestic political tension.

Chart 5: Foreign currency liquidity situation 2008 (USD bn)

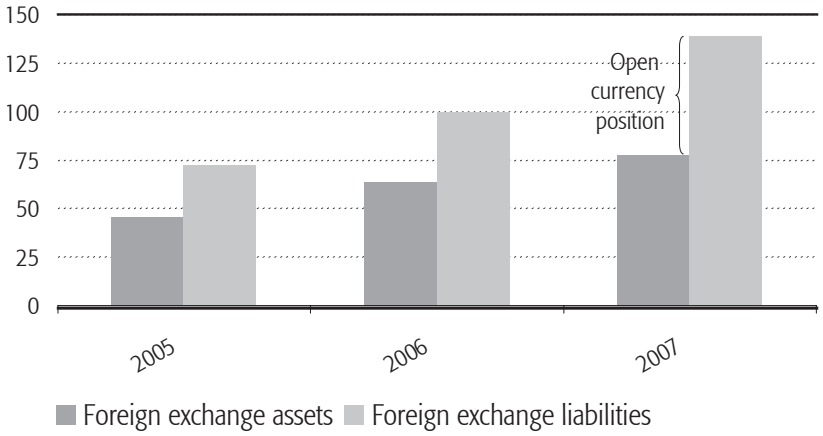


Source: Central Bank of Turkey, own calculations.

Corporate sector susceptible to devaluation

A further soft spot are the **open currency positions in the Turkish corporate sector** which, according to central bank information, amounted to USD 60bn or a good 8 % of GDP at the end of 2007. These do not by any means relate solely to export-oriented companies which are naturally hedged against currency fluctuations by their currency revenues. A clue is offered by the fact that more than half of the foreign debt of the Turkish corporate sector relates to the services area and here, in particular, to the sectors transport/communication, real estate and construction. The **vulnerability of the corporate sector to a slide in the currency** is thus very high as debt servicing would not only soar but the economy and, hence, profits would most likely tumble and domestic interest rates would rocket up. Such a scenario would naturally **also have repercussions** for Turkish banks, even if - contrary to the phase before the crisis of 2001 - they no longer themselves have any open currency positions on their balance sheets. Incidentally, the branches and subsidiary companies of foreign lenders would have to bear the full brunt of this, given that two thirds of outstanding currency loans stem from them. However, USD 41bn of foreign-denominated corporate loans would remain at Turkish banks, thus confronting them with a higher default risk.

Chart 6: Open positions in the corporate sector (USD bn)



Source: Central Bank of Turkey.

3. POLITICS: NEW OLD WAYS

The new elite against the Kemalists

Turkey's Achilles' heel was and still is politics. The economy has been more effectively shielded from the volatile political situation since the last financial crisis of 2001 by establishing stable institutions - for example, the central bank which has meanwhile been rendered independent and committed to price stability, and the commercial banking system, which has been protected from the previously customary influence of politics on credit decisions. Nonetheless, the economy still lives in close symbiosis with politics which in Turkey is also more difficult to comprehend than in most other emerging markets. On the one hand, there is the usual struggle between the political directions. On the other hand, a conflict has been raging for decades between the old Kemalist and strictly secular Istanbul elite and the increasingly influential conservative-oriented Anatolian bourgeoisie, as represented by the ruling AKP. The military, which belongs to the secular camp, represents a further key component in the power structure. On top of this comes the proposed membership in the EU which the government and most of the population desire. Should EU membership start assuming a more concrete form, the military would have to surren-der some of its privileges.

The conflict between the Kemalist elite and the AKP escalated sharply in recent months with the public prosecutor's attempt to have the AKP banned and have leading members of the ruling party, including Prime Minister Erdogan, banned from practicing their professions. The arrest of former members of the military some days ago in connection with an alleged putsch is also an expression of this escalation.

Government back in action again, but with reservations

The Constitutional Court ruled against this ban and instead „merely" imposed fines on the AKP. However, the voting was extremely close. In effect, this ruling can be interpreted as a shot across the bows with a real possibility that a similar situation could arise again some time in the future. The main thing is that the government is now back in action again and can push ahead with further reform projects, such as the new constitution.

Reforms are also necessary in other areas. A large number of state-owned companies still exist which are generating high losses, weighing on the budget and preventing a more efficient allocation of resources. Turkey also has to rely on large inflows of foreign direct investment in order to finance its yawning current account deficit. To date the bulk of the inflows has come from privatization. But now that fewer privatizations are being made, fewer foreign companies are investing in the country. Reforms, e.g. on the labor market and in corporate taxation, could create a climate for attracting greater inflows of foreign capital again and thus render the balance of payments less susceptible to crisis. This would also revive competition in Turkey.

4. THE WORST CASE: HARD LANDING

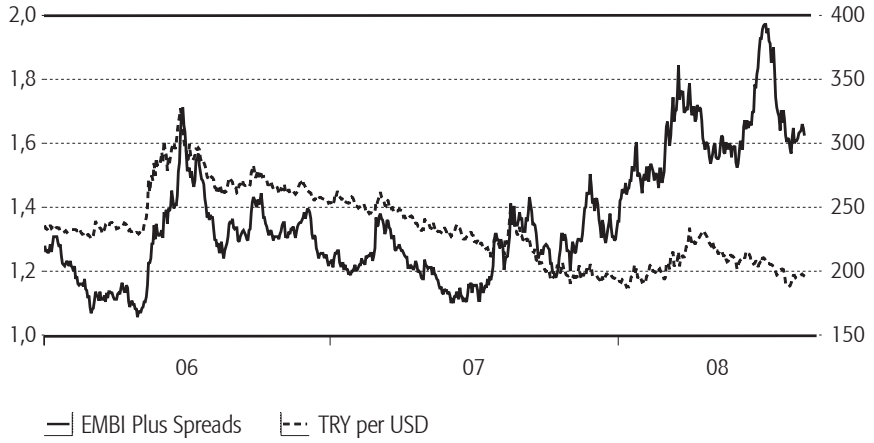
Naturally, reforms only pay off in the medium to long term. However, the overall fragile political situation and the nervousness on international financial markets will also represent a challenge for Turkey in the coming months. The main question here is whether capital will head for the exit and what damage this could inflict on the economy.

Political hullabaloo easily digested to date

The risk aversion on the part of international banks and investors, which has risen in recent months, tends as experience shows to hit countries with a high foreign capi-

tal requirement, such as Turkey, particularly hard. To date, however, the spread on Turkish foreign currency loans has hardly widened much more than the spreads of the emerging markets overall. Moreover, in recent years the economy has always coped well in the face of political uncertainty, for example when hopes of EU entry took a battering or the Turkish military became involved in northern Iraq. At least there were no financial disasters or a sharp slide in the lira. The exchange rate has been fluctuating strongly against the euro, but there are no signs of a distinct and strong downward trend. Against the US dollar, the lira has actually risen. If anything, a substantial real appreciation has taken place in connection with the high inflation differential versus the euro area, undermining international competitiveness and increasingly becoming a problem for the current account balance. Also likely to contribute towards the relative stability of the currency are the portfolio investments of the Arabian Gulf countries on the Turkish equity market, which are known to be less volatile but are practically impossible to quantify.

Chart 7: Risk premiums and exchange rate



Source: Ecowin.

Lower capital inflows – lower economic growth

All told, these factors do not suggest that a sudden and massive withdrawal of foreign capital of the kind seen in the financial crisis of 2001 is in the offing. With record-high currency reserves and the largely flexible exchange rate, the country would be in a better position than in the past to counter this. For this reason we are unlikely to see a repetition of these events. More likely is an ebbing of foreign capital inflows into Turkey, particularly in the event of political eruptions in Ankara. This alone would suffice, however, to put the current account balance under adjustment pressure. Owing to the relatively unfavorable economic outlook in western Europe, export activity is in any case likely to lose momentum in the months ahead. Thus, imports and economic growth, already feeling the pinch from restrictive monetary policy, would be primarily affected by lower capital inflows. Turkey would naturally be quite familiar with an adjustment cycle of this kind. In the more distant past, phases of this kind occurred in intervals of nearly every ten years within the framework of stabilization crises, even with far greater intensity than might be expected today.

But a lower influx of capital would also have negative repercussions in the more immediate future too. A downswing of this kind would demand its toll in the form of increased company insolvencies. This would be coupled with a more pronounced

devaluation which, due to the **high open currency positions** of Turkish companies, would also filter through negatively to balance sheets as well as to the balance sheets of Turkish banks. Naturally, with the international competitiveness having then been improved again, the devaluation would by no means be only disadvantageous.

But it doesn't have to come to that. In our **base scenario**, to which we attribute the highest probability and which contains our forecasts (see table below), we expect only a moderate **decline in economic growth** in **2008** and **2009** which should also be seen in connection with the boom phase of the last five years. **In the medium and longer term, we are upbeat about Turkey's economic outlook**, for the following reasons:

- In demographic terms, Turkey is the **„youngest" European economy**. The share of young persons under the age of 15 of a good 28 % is nearly double that of the EU countries. Combined with improvements to education, this signals high productivity growth going forward.

- We expect the government and central bank to continue their **stability-oriented economic policy**. Temporarily slower reforms will not prove a hindrance to this. For the time being at least, Brussels will continue to leave the door open for Turkish **EU membership**. In line with this, Ankara will attempt to continue implementing the **"Acquis Communautaire"**. That will promote foreign trade and capital transactions between Turkey and the community.

- Even if accession should one day come to nothing, this need not necessarily mean major disadvantages for the country economically. For Turkey will continue to have unrestricted access to the EU area as a sales market within the framework of a **„privileged partnership"**. The EU would also have to offer a fair amount of financial aid as „compensation" so to speak for rejecting the membership application.

- Turkey's trade with the **central Asian countries** has already revived and will presumably gain in significance particularly given the country's key position in the transport of commodities from the region. If **Iraq** stabilizes further, Turkey would (re)gain an important trading partner.

- In spite of the many economic crises of the past and the massive economic fluctuations accompanying them, Turkey has managed to modernize its economy and to transform from an **agricultural country to an industrialized country**. Annual average economic growth in the period 1980 to 2007 of 4.5 % in real terms was half a percentage point higher than that of the emerging markets overall.

TURKEY | Economic indicators and forecasts

		2005	2006	2007	2008e	2009f
Domestic economy	GDP change in % (real)	8.4	6.9	4.5	4.5	4.3
	GDP (USD bn)	482	528	659	807	903
	Inflation in % (annual average)	8.2	9.6	8.8	10.5	7.5
	Budget balance in % of GDP**	-1.5	-0.7	-1.7	-1.8	-2.0
External sector	Merchandise exports	78.4	93.6	115.3	142.0	165.0
(USD bn)	Merchandise imports	111.4	134.6	162.1	200.0	225.0
	Current account balance	-22.1	-31.9	-37.4	-48.0	-51.0
	Current account balance in % of GDP	-4.6	-6.0	-5.7	-5.9	-5.7
	Net foreign direct investment	9.0	19.0	19.8	12.0	15.0
	Gross foreign debt	168.7	205.5	247.2	280.0	315.0
	Short-term foreign debt	37.1	40.4	41.8	50.0	55.0
	Foreign debt in % of exports*	155.2	166.7	164.4	153.0	148.9
	Foreign debt service in % of exports*	35.0	30.6	28.1	24.5	18.7
	Foreign exchange reserves excl. Gold	50.6	61.1	73.3	74.0	75.0
	Import cover in months*	4.6	4.7	4.6	3.8	3.4
Interest rate	Treasury bill rate (annual average)	14.2	15.5	16.4	16.6	15.8
	Spread (EMBI+) (basis points, year-end, 2008: 11/08)	219	207	239	300	
Stock market	ISE index (year-end, 2008: 11/08)	39777.7	39117.46	54873	41733	
Exchange rate	Year-end (Turkish Lira per USD)	1.35	1.41	1.17	1.20	1.25
	Annual average (Turkish Lira per USD)	1.35	1.44	1.30	1.22	1.22

* Goods, services and income.

e= estimate, f= forecast.