Eurobank EFG

Economic Research

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Trip Notes: Turkey

Key notes from our recent trip to Ankara & Istanbul: July 23-25

On July 23-25th we travelled to Ankara and Istanbul, where we met with high-level officials from the Central Bank, the Ministry of Finance, the Ministry of Economy, the IMF office, prestigious market participants and renowned politicians.

The main focus of our discussions was the domestic political tensions and their effects on the economy, in light of the Constitutional Court verdict for the ruling Justice and Development Party (AKP). In addition, we discussed the impact on the economy from the international credit crunch and the world commodities' rally. Special attention was given to inflation and the balance of payments developments.

Other topics included the relationship with the IMF after the stand-by accord agreement expiration, the pending privatizations and the latest developments in the flourishing banking sector.

Turkey: Macroeconomic Indicators

	2006	2007	2008
GDP growth (%,yoy)	6,9	4,5	4,2
Curent Account (% of GDP)	-6,1	-5,7	-7,0
Inflation (%yoy e.o.p)	9,7	8,4	11,5
Unemployment rate (%,Eurostat definition)	9,9	9,9	10,0
General Government Deficit (% of GDP)	-0,1	-1,2	-1,4
Primary Surplus (% of GDP)	4,8	3,5	3,5
General Government Debt (% of GDP)	46,1	38,8	37,0

Sources: National statistics, IMF, European Commission, EFG Eurobank

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Key points

- The Court's decision to only impose financial sanctions on AKP is the best outcome for financial markets. It is thought to be even better than a *full-dismissal-of-the-case* scenario
- Output growth is expected to slow further to 4-4.2% in 2008, with a potential on the upside. Inflation will remain at double digits through the end of the year.
- Meeting the revised inflation targets is now crucial for CBRT credibility. We expect the bank to remain cautious and the tightening cycle to continue for a while.
- The rally in oil and commodities prices is what drives current account deficit to new highs. The current account balance excluding net oil imports remains broadly unchanged.
- The composition of capital inflows, which finance the current account deficit, has changed dramatically: FDI fell while private borrowing increased.
- Fiscal policy tightening in 2008 has stopped and no longer contributes to the disinflation process.
- A precautionary arrangement with the IMF is underway, which would serve as an anchor for economic policies and structural reforms.
- At current levels, the TRY appears to be fundamentally overvalued vis-à-vis its medium-term equilibrium, but a sharp depreciation appears unlikely in the foreseeable future in view of its strong carry appeal.
- Compared to 2001, the banking sector is well positioned to absorb the impact of the world credit crunch.

Political jitters subside, for now

The optimism surrounding the (market-friendly) outcome of last year's general and presidential elections proved to be short lived. Domestic politics took a turn for the worse when tensions between the secular elite and the ruling Justice and Development Party (AKP) erupted once again following parliamentary and presidential endorsement of a government-backed constitutional amendment, which paved the way for lifting a headscarf ban in universities. Preceding the Constitutional Court's decision to annul the headscarf reform, the Chief

Prosecutor of the Court of Appeals asked in mid-March for the closure of the AKP and the imposition of a five-year ban from politics on seventy one of its members on alleged "anti-secular" activities. Amongst the accused thirty nine were members of parliament, including Prime Minister Tayyip Erdogan and President Abdullah Gul. The Court decided to deliberate on the case and the hearing began on July 28th. A final verdict was reached two days later. The Court decided that the AKP was guilty of anti-secular activities. However, the character and extent of these activities were not judged to be significant enough so as to justify the closure of the party. As a result, the Court imposed financial sanctions on the AKP, cutting by half the Treasury funding the party receives. Six out of the eleven judges voted in favor of the party's closure, four in favor of financial sanctions and one voted for dismissal of the case. According to the Constitution, seven votes are required to close down a political party, which the AKP marginally escaped. Most importantly however, the charges which could have led to a ban from politics of AKP members, and particularly of Prime Minister Tayyip Erdogan, were dropped.

Amongst the most probable scenarios mentioned in our meetings in Istanbul and Ankara, which took place before the announcement of the Constitutional Court's verdict, were: i. the dismissal of the AKP closure case ii. the imposition of financial sanctions on the AKP by cutting part or all of the Treasury aid the party receives iii. the closure of the AKP and/or the ban of all or some party members from politics. The first two were considered to be positive for the markets as neither would significantly alter the domestic political landscape. An AKP closure, though in principle seen as a rather negative development, did not particularly worry our contacts either. In such a scenario, the AKP members could form a new party, which would still enjoy parliamentary majority. However, nearly everyone we conferred with highlighted the importance of a ruling against Prime Minister Erdogan, admitting that his absence from politics would be the worst possible outcome. A government without his leadership could crumble in the months/years ahead, leaving the door open to fragile coalition governments and creating an unstable political environment.

In our view, the Court's decision to only impose financial sanctions on the AKP is the best outcome for financial markets. It is thought to be even better than a *full-dismissal-of-the-case* scenario. This is because, the AKP is now expected to show more prudence and adopt a mollifying attitude towards its opponents. On the other hand, any impulsive movement against the party on similar grounds is likely to be deterred as it is unlikely under the current circumstances to bear fruit. The upcoming parliamentary recess will probably see politics moving to the background for the rest of the summer. Upon return, the focus will shift to the resumption of political and economic reforms, the 2009 budget and a pending IMF follow-up agreement. Although in the short-term the prospect of a large-scale political crisis appears to have ebbed, looking further ahead, the re-emergence of political jitters can not be ruled out.

Risks for growth skewed to the upside

Turkey had to face two adverse factors in the beginning of 2008: Political uncertainty and a less favorable external economic environment. Political uncertainty dampened domestic economic sentiment. Global credit developments made external financing more scarce and costly. Large capital inflows, both FDI and portfolio helped to finance domestic investment, which has exceeded national savings in recent years. Turkish markets have proven relatively resilient to both headwinds, mirroring the progress towards economic stabilization made in recent years.

The Turkish economy has embarked on a growth deceleration trajectory, but remains dynamic enough to avoid an outright recession. Deceleration extends throughout 2008 as well, before picking up in 2009. Output growth, lagging below potential, is expected to slow further to 4-4.2% for this year. This is slightly below the 4.5% government target and the average growth recorded in 2007.

The risks lie clearly on the upside. Political uncertainty is cleared out after the recent Constitutional court ruling against the AKP party. This is not changing ultimately the picture of an economy which is slowing down. Nevertheless, on a

macro level it gives a chance for structural reforms to get back on track. In addition, it reduces the risk premium required by investors for holding Turkish assets. On the downside, further rise in the oil and commodity prices will weigh negatively on inflation, household balance sheets and the current account shortfall.

Growth is slowing down, but is not collapsing. The 6.6% GDP growth reading in the first quarter was above market consensus. Higher export oriented industrial production and the agricultural production rebound made up for the positive difference. Investment grew by 10% yoy against only 2.6% yoy last year driven by private sector machinery equipment. Consumer spending remained strong (7.3% yoy against 5.6% yoy last year) helped by credit growth. In contrast to what the high frequency survey based indicators signal, domestic demand growth will remain relatively sound, but decelerate modestly as the monetary policy tightening will take effect.

Inflation pressures to stay elevated in the remainder of the year

Domestic inflation remains elevated, with high food and energy prices representing the main culprits of the prolonged uptrend. Domestic political uncertainty and the turmoil in financial markets also weigh on the inflation outlook. In May, inflation returned to double digits for the first time since April last year. June's reading surprised on the downside *(10.61%yoy vs. 10.74%yoy a month earlier),* allowing a temporary stabilization in inflation expectations. This was reflected in the CBRT's bi-monthly survey of business leaders' and economists' expectations (*10.76% expected for 2008-end*). However, a further CPI spike to 12%yoy or higher levels is likely in July, on account of unfavorable base effects and a recent 21-22% rise in regulated electricity prices. The CBRT expects the price hike to add some 0.5ppts to this year's average CPI figure, though the impact could be even more pronounced due to second-round effects. The new energy tariffs are part of the automatic pricing mechanism, launched on July 1, targeting liberalization of the energy market ahead of a series of privatizations in the sector. Under the new pricing system, electricity distribution tariffs will be revised quarterly, based on foreign exchange developments, oil prices, inflation and wholesale tariffs. Further regulated price adjustments are on the cards and another electricity price hike could materialize in October. If so, it will likely add further to price pressures. But, note that electricity prices had remained stable for the last five years, possibly leading to excess consumption. A correction in the current levels of energy consumption in view of the price hikes could partially offset their impact on inflation. All in all, we forecast year-end CPI to end the current year at 11.5% yoy, overshooting the official 4.0% target by a large margin.

Acknowledging the rising risks to the inflation outlook, the CBRT revised recently its CPI forecasts for 2008-2010. According to the bank's new baseline scenario, year-end consumer price inflation is now seen at 10.6%yoy in 2008, compared with a 9.3%yoy forecast included in the previous inflation report. Year-end inflation is expected to decelerate to 7.6%yoy in 2009 and to 5.9%yoy in 2010, compared to earlier forecasts of 6.7% yoy and 4.9%yoy, respectively. The CBRT's new baseline scenario assumes oil prices at $140/bl, through to 2010 (*USD $105/bl estimated previously*) and food inflation higher by 1ppt at 14%yoy and 9%yoy in 2008 and 2009, respectively. Note that the recent revision in oil price projections adds some 1.8ppts to the year-end forecast for 2008 and 0.6ppts for 2009, while the revision to the food component around 0.3ppts to both 2008 and 2009. On the flipside, the recent rebound of the lira has prompted a downward revision in the estimated FX pass-through to around 1.2ppts for 2008, from 2ppts seen in April's report, with the majority of the impact already felt between March-May.

In view of the market-friendly Constitutional Court decision, risks to the lira's likely pass-through lie further to the downside and its effect may be even more subdued if economic growth slows down. The recent moderation in oil prices, if sustained, is also likely to help contain upside inflation pressures. Our contacts estimate that inflation will remain at double digits by the end of this year with expectations ranging from 9.7%yoy to 12%yoy.

CBRT: Strengthening of policy credibility a key priority

In early June, the Central Bank of Turkey revised upwards its year-end inflation target of 4% for the years 2009-2011. The bank highlighted that a more prolonged impact of supply-side shocks and global economic uncertainties suggested that a long period of time would be required for inflation to converge to its target. As such, the 4% mark no longer serves as a nominal anchor of inflation expectations in the short-term. In detail, the CBRT revised the 2009 and 2010 targets to 7.5% and 6.5%, respectively, and set the 2011 target at 5.5%. The 2008 target remained unchanged at 4%. Although the bank was initially scrutinized for its decision, after digesting the news many market participants agreed that the revision was after all necessary.

Although the revision was widely anticipated, its timing came as a surprise to market participants. The CBRT admitted that during its April policy meeting, a revision of inflation targets had been brought up, but its minutes read that such a decision would be postponed towards the end of the year.

A view shared by several commentators is that a revision later in the year could have provided a better grasp of the inflation outlook, especially if political tensions had by then appeased. Nevertheless, most of our contacts welcomed the move, arguing that the main aim of an inflation-targeting regime is to provide an anchor for inflation expectations. In Turkey, however, this had long ceased to be the case as the inflation target had been consistently breached each year since 2006. It is certain that this year's target will also be missed by a significant margin, while chances of hitting the 4% level in the medium-term are slim.

Meeting the new inflation targets is now of crucial importance for the credibility of the CBRT. Our contacts believe that the 7.5% target for next year is within reach. It was also mentioned that although the 2008 year-end target is out of reach, a CPI reading well above the CBRT´s 10.6% yoy forecast could raise questions about the attainability of next year's target. On a more positive note, a better than expected outcome would not only increase the likelihood of meeting the 2009 target, but would also give a much-needed boost to the bank's credibility. It was also suggested that the bank should tacitly aim for the outperformance of its inflation targets. Domestic political uncertainty was named as the main risk to inflation, as new episodes of political instability could weigh on the lira. The lira's pass through, which can be fully encompassed in the economy within six months, is calculated by the CBRT to be around 30% i.e., a 10% depreciation of the lira is estimated to add ca 3ppts to inflation.

Other risks to the domestic inflation outlook include the recent hikes in regulated energy prices and the prospect of political pressures on the central bank to abstain from an overly aggressive tightening of monetary policy that could negatively affect economic growth. On a more positive note, the recent retreat of world oil prices and subsiding domestic political jitters, if sustained, could facilitate a gradual return to disinflation from the last quarter of the year.

Our CBRT contacts expressed their strong commitment to the revised inflation targets and, in our view, the trade-off between inflation targeting and growth remains asymmetrically skewed towards the former. Although, the Constitutional Court's market-friendly ruling, the recent stabilization in inflation expectations and the stronger lira argue for a less hawkish CBRT in the near future, further rate hikes can not be ruled out as the bank remains committed in meeting its new inflation targets in the years to come.

Even before the Court's announcement, our CBRT contacts signaled that interest rates may have approached their peak, but warned that lingering uncertainties are blurring the inflation outlook. Meanwhile, the wording of the statement, which accompanied the last MPC meeting, and the suggestion that "the Committee believes that the current level of the policy rate is supportive of disinflation" make us believe that any future rate hikes will likely be of a smaller size than the ones delivered thus far i.e., 25bps rather than 50bps moves. Key for upcoming monetary policy decisions will be oil price developments, July's CPI, the next bi-monthly surveys of business leaders' and

economists' expectations and the lira's behavior. We expect the bank to remain cautious and the tightening cycle to continue for a while.

Growth slows down but current account deficit widens further

The current account deficit remains a key concern for the macroeconomic developments in Turkey. Economic recovery from the 2001 crisis has been accompanied with widening current account deficits during 2002-2005. GDP growth peaked in 2004 but the economy embarked on a decelerating growth trajectory. Nevertheless, external imbalances continued. The current account deficit widened further to 6.1% in 2006, only to scale down to 5.7% in 2007. From our discussions we concluded that it will further deteriorate to 7% in 2008.

Record-high energy prices have an adverse impact on the current account deficit. The Turkish economy is highly energy intensive and dependent on oil and gas. According to Central Bank calculations, approximately half of the deficit comes from the higher energy bill, which reached an equivalent of 3 pps of GDP in 2007. On the other hand, the non-energy current account deficit has broadly stabilized in the range of 2.5-3% of GDP, a picture compatible with the domestic demand slowdown. The prospect of a further weakened growth rate in 2008 should improve the non-energy current account deficit.

Despite robust exports growth, the trade deficit widened to 7.8% in 2006 and 7.1% in 2007. Exports continue to perform well in the first five months of 2008, both in USD terms (+38% yoy) and volumes. A downside in export performance from the Euro Area slowdown is partially offset by stronger demand in the areas of the former Soviet Union and the Gulf states. The structural dependency of the economy on intermediate imported goods maintains import growth firm.

Current account financing remains a key issue

Turkey has accumulated a total of US$ 114bn in current account deficits since 2003. Yet, capital inflows were always considerably above the levels required to finance the deficits. Consequently, there was significant accumulation of reserves at the Central Bank. However, the quality of financing was always an issue. More recently, we have witnessed a significant deterioration in the financing quality. The capital inflows decomposition has changed dramatically since the credit crunch began in the summer of 2007. Financing has shifted from non-debt inflows (FDI and portfolio investment) towards debt.

The successful privatization deals in 2005-2007 brought sizeable FDI inflows in the country-52.5 bn USD. As a result, the net FDI inflows coverage improved to 53% in the end of 2007 against only 14% in 2004. Subsequently, the lack of big privatization tickets, as well as the poor market conditions, brought the FDI inflows down significantly. The FDI inflows declined to USD 6 bn in the first five months of 2008, compared to USD 11 bn last year. Even if the current scheduled privatization projects (lottery, sugar factories, and energy distribution networks) are completed in 2008, the FDI inflows are not going to beat the 23 bn USD record inflows of 2007. The decline in FDI inflows shows the need to diversify away from privatization revenues. The need to attract Greenfield FDI becomes even greater as privatization revenues as a percentage of GDP are expected to slow down after 2010. The real estate and tourism sectors could potentially become locomotives for capital inflows. Real estate related inflows averaged only approximately 15% of total inflows in 2005-2007.

The gap of FDI inflows and portfolio outflows is covered by increased borrowing by the corporate and the banking sectors. Despite the global credit tensions, corporates continued to borrow heavily in FX. Borrowing by the non-bank corporate sector has risen from USD 51bn to 71bn in 2007. This has been accomplished relatively easily but at the same time a portion of it is unhedged, which highlights a big vulnerability in case of adverse currency developments. If banking sector borrowing is added (USD 27.6 bn in 2007 against 32.1 bn in 2006), the bill comes up to more or less at USD 100 bn. On the positive side, the medium and long term components comprise two thirds of total borrowing. This reduces the imminent repayment needs.

In conclusion, Turkey remains relatively resilient compared to other credit crunch episodes. Current account financing remains a key vulnerability for the Turkish economy. As the current account deficit magnifies, so will its financing needs. Financing current account deficits of such magnitudes becomes increasingly susceptible to changes in investors' risk appetite and global market conditions which would entail significant currency risks. Some of our discussants highlighted that such large current account deficits are not sustainable in the first place, and a correction is inevitable at some point in the future.

Fiscal policy is no longer a contributor to the disinflation process

The fiscal position of Turkey improved considerably since the 2001 crisis. The high primary surpluses achieved after 2001, served as a fiscal policy anchor and have also allowed for a significant decline in the public to GDP ratios, as well as lower real interest rates and inflation. That is not the case any more.

After a fiscally loose election year 2007, the government planned some fiscal tightening for 2008. Nevertheless, the consolidated government sector primary surplus, initially targeted at 4.2% of GDP in the medium term fiscal framework, was revised downwards in May. The consolidated government primary surplus target now stands at 3.5% of revised GDP. This move, ahead of the IMF stand by arrangement expiration, spurred worries over fiscal slippage. Fiscal slippage was thought to more probable to materialize in the background of the uncertain political environment. If so, it would imply further inflation deterioration.

Our discussants argued that, contrary to what the market believes, there is no fiscal relaxation, since the fiscal target is set at the same level as the fiscal outcome recorded last year. The difference accounts for increased spending in infrastructure in the Anatolia project, as well as financing labor market and local administration reforms. In their view, those pro-growth initiatives would enhance productivity gains and would be beneficial for the economy in the long-term. On the other hand, those measures increase short-run domestic demand, pushing up the rate of inflation.

Although not in full agreement, IMF officials seem to feel comfortable with the recently adopted looser fiscal targets. Nevertheless, they underscore the importance of adherence to the 3.5% of GDP primary surplus for 2008, and of the achievement of fiscal targets in the years to come. These are essential in order to bring the public debt to GDP ratio down to 30% by 2012. On the other hand, they are worried that the government could increase public sector expenditure without securing the necessary funding.

The expiration of the stand-by agreement in May compels the government to examine its future relationship with the IMF. According to our contacts, a new stand-by arrangement would be highly unlikely, as there is no real need for IMF funding. Instead, a precautionary arrangement is underway that would serve as an economic policies' anchor for investors.

Markets

The TRY has shown impressive resilience to the recent political crisis as well as the ongoing financial markets turmoil. In spite of a sharp depreciation in the first four months of the year - *from a six year high of 1.1425/USD in early January to a multi-month low of 1.3462/USD in the aftermath of the inception of the AKP closure case* - the lira bounced to levels of 1.20/USD in July. Shortly after the announcement of the Constitutional Court's verdict, the lira hit 6-month highs of 1.1490/USD. At current levels, the TRY appears to be fundamentally overvalued vis-à-vis its medium-term equilibrium, but a sharp depreciation appears unlikely in the foreseeable future in view of its strong carry appeal. That said, as politics move to the background and the focus turns to the macroeconomic front, a widening current account deficit, shrinking FDI inflows and the crisis in global financial markets may pose as downside TRY risks.

On the flipside, the domestic bond and stock markets have so far proved to be more vulnerable to the negative external environment and the heightened domestic political uncertainty. However,

the market-friendly ruling by the Constitutional Court and the easing oil prices allowed a rebound in the stock and bond markets. The XU100 index stood ca 20% down year-to-June 31, after falling by 40% in H1. In the local bond markets, the yield on the January 13, 2010 benchmark, which had soared to levels above 24% on July 1, stood at 20% at the close of July 31. However, the current monetary tightening cycle is unlikely to end in the near-term and as such further significant declines in yields seem unlikely for the time being.

The banking sector is well positioned to absorb the impact of the world credit crunch.

One of the issues we touched upon in our conversations was the impact of the world credit crunch on the banking sector. The banking sector has performed relatively well. There are a number of reasons for that. First, there is no direct exposure to the sub-prime mortgage securities. Second, although wholesale funding became more costly, wholesale borrowing is a relatively small fraction of the Turkish banking sector liabilities. Wholesale borrowing takes the form of syndicated loans (1.6 years average maturity) and securitizations (7.5 years average maturity). In fact, some major refinancing rollover liabilities will take place next year, which gives the banking sector some additional flexibility.

The banking sector has addressed its fundamental weaknesses since the 2001 crisis, becoming more resilient. The banking system, unlike the corporate sector, doesn’t carry a significant net FX position as it used to. Today, the regulatory watchdog BRSA closely monitors all off-balance sheet positions.

By the standard measures of liquidity and solvency, the banking sector position is strong. Total deposits growth stands at 17.4% yoy in May, which brings the loans to deposits ratio at approximately 85%. The Capital Adequacy Ratio stood at 18.8% in late 2007, compared to 22.4% in late 2006. The ratio stands well above the 8% requirement and the CBRT target ratio of 12%.The asset quality seems to be stable over the last two years, despite concerns expressed recently for consumer loans and SMEs. The NPL ratio fluctuates around 3% and it is half than it used to be in 2004. In the last months, the NPL ratio has declined due to the general tendency of banks to sell their NPLs and speed up write offs.

Appetite for credit remained solid so far. Despite the domestic political uncertainty and the global financial markets jitters, the sector’s growth was impressive. Total credit was registering a solid 35% yoy in May. Our contacts argued that credit growth would eventually decelerate by the end of the year to around 25% yoy, on the back of increased domestic interest rates and wholesale borrowing costs.

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