16 May 2003

Turkey: the risks of another financial crisis remain high

The war with Iraq created new political and economic problems for Turkey. The short conflict and Turkey's renewed commitment to far-reaching economic reform, backed by the IMF, have recently had a positive impact on domestic financial markets, but the risks of another financial crisis remain high. The optimism triggered by last November's decisive election result, in providing scope for a fresh start, has been severely dented.

The war with Iraq created new political and economic problems

Recip Tayyip Erdogan, leader of the Justice and Development Party (AKP) that decisively won last November's general election, took over as Prime Minister in March 2003. He succeeded interim Prime Minister Abdullah Gul, who had held the position until Parliament removed the obstacles that had prevented Erdogan being elected to Parliament and thereby becoming prime minister immediately after the election. On stepping down, Gul was appointed Foreign Minister.

Turkey has faced serious problems over recent months and much of the optimism that followed the decisive election result has faded. The economy has been adversely affected by the war against Iraq, while relations with the US suffered a major setback when Parliament refused to allow US land forces access to Turkey to invade Iraq from the North (the vote was actually in favour but the majority fell short of the constitutional margin required). A substantial US financial package was withdrawn.

The failure of the UN plan for Cyprus harmed relations with the EU

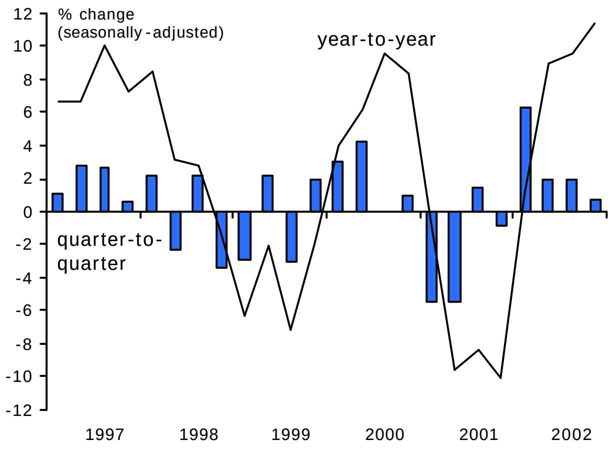
In addition, relations with the EU deteriorated when the collapse of a UN peace plan for Cyprus was blamed on the failure of the Turkish government to exert sufficient pressure on the Turkish-Cypriot side to make the necessary compromises. Whether this blame is fully justified is not clear given the ambivalence of some Greek Cypriot leaders to the peace plan. Nevertheless, the failure of what had appeared to represent the best-ever prospect of resolving the Cyprus issue, thereby allowing a reunified Cyprus to join the EU in 2004, is likely to strengthen the resolve of those European politicians determined to ensure that Turkey itself is not admitted to the EU. As well as disappointment that the Cyprus problem remains unresolved, the episode provided fresh evidence of the strong influence that the Turkish military continues to exert on the elected government.

Some better news since March

Subsequent developments, since March, have been moderately encouraging and should help to limit the adverse consequences which are, nevertheless, still likely to be significant. The success of the US-led coalition in quickly getting rid of Saddam Hussein's regime means that the detrimental impact on the economy will be less severe than would have been the case had the conflict escalated or become protracted. Parliamentary approval of overflight rights for US aircraft operating from Europe, and co-operation with the US that prevented incursions by Turkish troops into Northern Iraq, have gone some way to restoring relations with the US and were sufficient to secure a smaller financial package. While the failure to grant land access is still expensive in terms of lost financial assistance (see below), the bilateral relationship with the US is a strong and important one that both sides want to preserve and seem prepared to make efforts to do so.

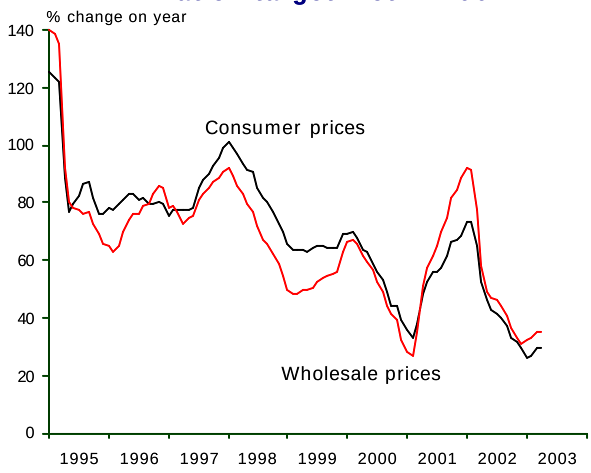
As with the US over Iraq, Turkey is trying to mend relations with the EU by seeking alternative approaches towards Cyprus. Turkey is pushing for all sanctions to be lifted following concessions by the Turkish Cypriots in lifting restrictions on the freedom of movement and the Greek Cypriot response in easing restrictions on Turkish Cypriot exports. While the government recognises that a unified Cyprus would significantly boost Turkey's own prospects of EU membership, a cautious approach to the UN plan is likely to be maintained as long as Turkey's armed forces continue to support Raul Denktash, the intransigent Turkish Cypriot leader, in opposing the plan.

Strong economic growth in 2002



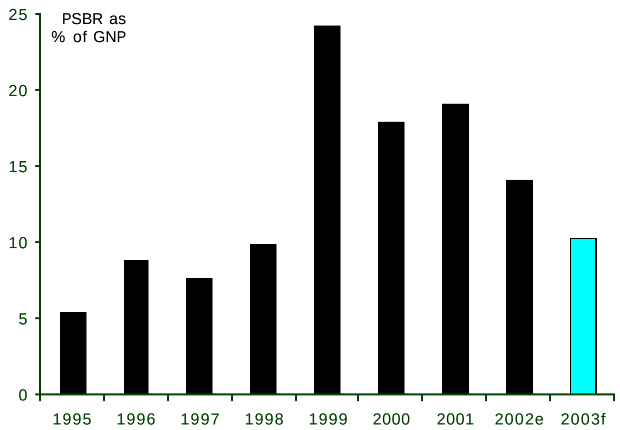
Real GDP growth of 7.8% in 2002 was the strongest increase since 1990 and substantially above the initial 3% target. However, the strong rise was mainly due to a surge in inventories and the contribution of other components of demand was much less impressive. Government consumption rose by 5.4%, but private consumption rose by just 2.0% and both investment and net exports had a negative impact. While investment fell by only 0.8% in 2002, this was disappointing following the plunge of 32% in 2001. In terms of output, there were strong increases in manufacturing, agriculture and most services, but declines in mining and construction.

Inflation target met in 2002



Consumer price inflation fell sharply from 73% in February 2002 to 29.7% by December, comfortably below the official end-2002 target of 35%. The latest figures show inflation only marginally lower at 29.5% in April with a temporary rise in food prices being blamed for the interruption in the decline. A further decline is expected over coming months although opinions about the credibility of the end-2003 target of 20% are mixed, partly reflecting a divergence of views about the exchange rate outlook.

The PSBR is declining but is still substantial



Source: Institute of International Finance

The public sector borrowing requirement remains substantial, but at 14% of GNP in 2002 it was well below levels equivalent to 19% of GNP in 2001 or the peak of 24% in 1999. Despite this improvement, some spending and revenue targets were missed during the final months of 2002 so fiscal policy has been weaker than envisaged in the IMF agreement. The primary budget surplus was equivalent to approximately 4% of GDP in 2002, well below the 6.5% target agreed with the IMF. Total government debt was equivalent to 97.6% of GNP at end-2002.

IMF approves new US$700 mn disbursement

In April 2003 the IMF approved the disbursement of US$700 mn under the current stand-by facility that had been delayed pending a thorough review of the new government's economic policies. Approximately US$14 bn of the US$18 bn facility approved in February 2002 has now been disbursed. The facility does not expire until end-2004 but, with most having already been drawn, the IMF welcomed and accepted the government's proposal that future disbursements be phased more evenly and closely linked to the implementation of specific economic reforms.

Commitment to structural reform is renewed

Economic reforms to be implemented in 2003 are detailed in a new letter of intent to the IMF dated April 2003. While welcoming the government's renewed commitment to economic reform and stabilisation, the IMF is concerned about the adverse impact that recent policy slippages have had on the credibility of the government's economic policies. For its part, the government recognises the vital importance of quickly getting fiscal policy back on track and has reiterated the commitment to a primary budget surplus equivalent to 6.5% of GNP in 2003 and beyond. It has made a specific commitment to meeting targets relating to the elimination of redundant positions in state enterprises missed in 2002. As at last October some 21,000 redundant positions had been eliminated and the government has pledged to meet a new target of 46,000 by end-2003. This commitment was politically difficult and is likely to be monitored closely by financial markets, as well as by the IMF, as a gauge of the commitment to structural reform.

An ambitious privatisation programme, unveiled in January, is a key feature of the IMF agreement. The plan involves selling stakes in 26 state enterprises, that include an oil refiner, tobacco and alcohol monopoly and national airline, with the aim of raising US$4 bn. However, there is concern that the replacement of experienced staff at the government's Privatisation Administration by people close to the government provides scope for political meddling by, for example, linking disposals to specific employment commitments. There is also concern that the need for energy sector liberalisation could delay the programme.

Another central feature of the IMF agreement is financial sector reform. While progress has been made in several areas, overall progress has been hampered by legal challenges and political pressures from the AKP which prevented the bank supervision and regulation agency (BRSA) from fully exercising its authority, particularly in resolving ownership issues surrounding Pamukbank. An agreement with the former owner of Pamukbank has now been struck and the bank is up for sale with bids due by June. While the IMF agreement details plans to resolve the overhang of non-performing assets of the banking sector, to privatise banks taken over by the Saving Deposit Insurance Fund (SDIF), and to strengthen the independence of BRSA, serious concerns persist about political meddling in this area from the moral hazard created by the government's blanket state guarantee of bank deposits and other liabilities.

US financial assistance is cut sharply…

Financial pressures on Turkey increased sharply in March 2003 when the US announced at the start of the war against Iraq that it was ending negotiations on providing direct financial assistance and loan guarantees worth up to US$26 bn following Turkey's failure to allow land access to US forces. In recognition that Turkey did provide some limited assistance to the US-led campaign, the US Congress approved new grants totalling US$1 bn to Turkey in April, which the government will use to secure loans and loans guarantees of up to US$8.5 bn.

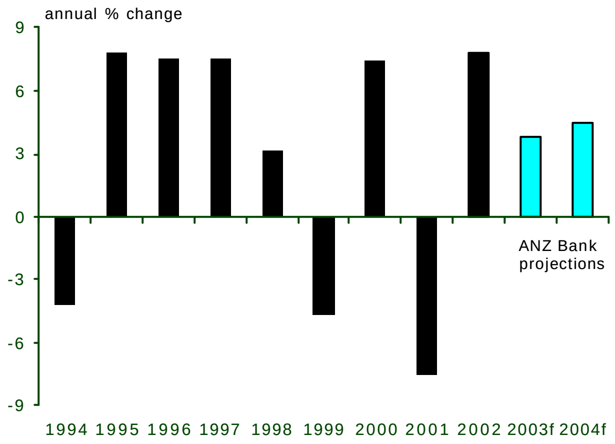
… but the direct impact of the war is limited

The direct impact of the war on the Turkish economy is much smaller than if the conflict had lasted for several months. The main adverse effects are from higher oil prices in the lead-up to the conflict and in terms of lower tourism receipts. However, there will be a partial, and possibly significant, offset insofar as the outcome of the conflict produces lower oil prices than would otherwise have been the case, and to the extent that Turkish firms participate in the rebuilding process in Iraq.

The government sticks to its 5% GDP target

While recognising the risks posed by the Iraq war, the government reiterated in early April that its 5% GDP growth target for 2003 was still appropriate. With the war largely over by mid-April, the downside risks associated with the GDP forecast have diminished significantly although the consensus GDP forecast in May was still below the official projection at 3.6%.

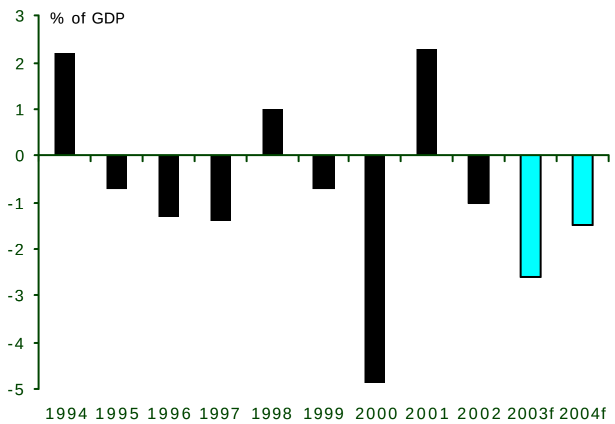
Real GDP growth in 2003 may fall short of official projection



A bigger current account deficit is in prospect

The US dollar value of exports rose by about 13% in 2002, well below import growth of 22%. Mainly as a result of the resultant sharp rise in the visible trade deficit, a current account deficit equivalent to 1.0% of GDP was incurred in 2002 following a 2.3% surplus in 2001. International reserves rose from approximately US$19 bn at end-2001 to US$27 bn at end-2002, largely reflecting new borrowings from the IMF.

Current account balance



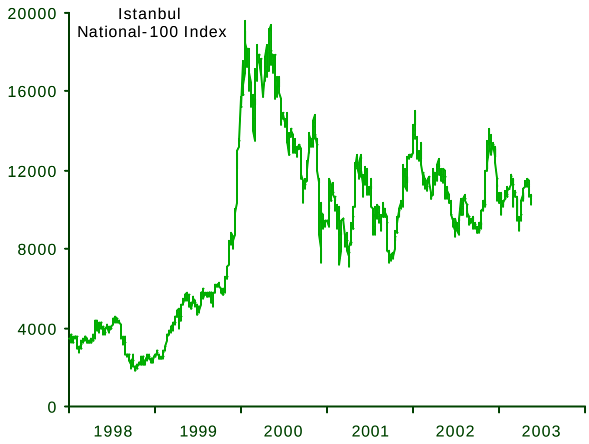
Source: Institute of International Finance

Projections by the Institute of International Finance envisage the current account deficit reaching 2.6% of GDP this year, partly due to lower earnings from tourism. The IIF is optimistic that flexible exchange rate policy will prevent the deficit becoming a significant constraint on economic policy and envisages a smaller deficit in 2004.

The Central Bank cut interest rates as economic risks diminished

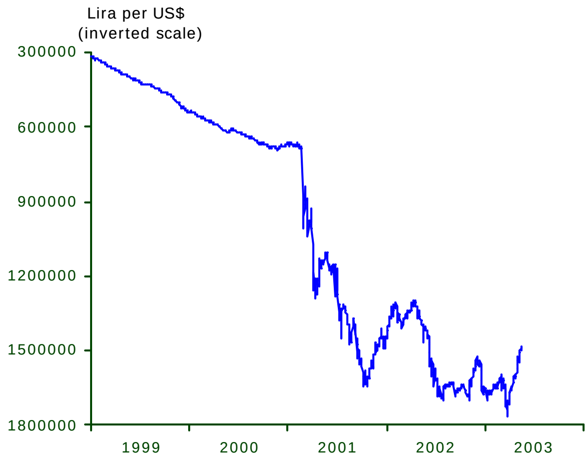
Short-term market interest rates have fallen since March in response to the better news for the economy including the end of hostilities in Iraq, approval of the 2003 budget, release of a new tranche of the IMF facility, and approval by the US Congress of the revised financial package. In April the Central Bank cut its short-term rates by 300bp - its new range is 41-53% - citing the end of the "extraordinary period" associated with the Iraq issue and the positive impact on the inflation outlook. The level of interest rates has a crucial impact on the cost of servicing the large public sector debt, in addition to the influence on the general level of economic activity.

No clear stock market trend



The stock market has been quite volatile over the past few years with big movements driven by the strength of relations with the IMF and the perceived commitment to economic reform. The Istanbul National 100 Index was 15% above March lows in mid May, but no clear longer-term trend has been apparent since late 2000.

Lira recovers modestly after hitting new low



The Turkish lira hit a new all-time low of TRL1,776,000 against the US dollar on 24 March shortly after the outbreak of the war against Iraq and the withdrawal of the main US financial package, but there was a clear recovery as expectations mounted that the conflict would be over quickly.

Risks of another financial crisis remain high

The withdrawal of most of the US financial assistance seems, at least for the time being, to have stiffened the government's resolve to adhere to the IMF programme. However, the possibility of further slippage in implementing fiscal reforms that could trigger another financial crisis cannot be discarded. Public sector debt dynamics are fragile because the average maturity is short and over 70% of total debt is indexed to the exchange rate or to floating interest rates. Consequently the debt burden is highly sensitive to changes in market sentiment. The risk of another financial crisis is considered higher than immediately after last November's election. This is partly because of the hesitancy that has been evident in the economic policy arena over recent months and doubts about the government's willingness to implement unpopular legislation. It also reflects a risk that even if the government is serious in its commitment to economic reforms, it could still fail to get sufficient parliamentary support necessary to implement them despite its large majority.

In the political arena, there are also significant risks and uncertainties. The main domestic risk is the distrust between the military, who consider themselves the staunch defenders of the country's secular tradition, and the AKP government. The latter insists that it is now a modern, secular party, but suspicions persist that its Islamic origins could reassert themselves and that tensions with the military could escalate and impede effective government.

With regard to international relations, it is too early to gauge the scale of the lasting damage from recent serious setbacks to relations with the US and EU. While the flexibility being displayed by the AKP government in trying to improve relations is encouraging and could produce results in the short term, there are also longer term risks. The divisions within the EU concerning Turkey's accession bid are well known, but the post-war situation in Iraq presents a new potential threat to the security relationship with the US. If a reasonable level of political stability were to be secured in Iraq and a US-friendly government eventuates, then the value of the bilateral relationship with Turkey to Washington would probably diminish over the medium term.

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