

Turkey: political risks diminish but the economic outlook remains uncertain

The threat of an early general election was lifted in October 2003 when the electoral board rejected petitions to cancel last November's election results. Economic growth slowed sharply in Q2, but the government is confident that full-year growth in 2003 will be close to its 5% projection. Turkey remains committed to its IMF programme, but fiscal conditions are tough and the possibility that this commitment could falter, triggering another financial crisis, cannot be ruled out.

The threat of an early general election is lifted

The prospect of an early general election was lifted in October 2003 when the electoral board rejected petitions by several political parties to cancel last November's election results. The petitions followed a court case that upheld the convictions of leaders of the pro-Kurdish DEHAP party in an electoral document fraud case. The thrust of the petitions was that DEHAP, which won 6.2% of last November's vote, should have been barred from standing and, had it been, then the results would have been different and the True Path Party (DYP), which gained 9.5% of the vote, would have got across the 10% threshold necessary for parliamentary representation. Had the petitions succeeded the election result could have been cancelled or the DYP could have been awarded seats at the expense of the two parties currently represented in Parliament, severely denting the commanding majority held by the Justice and Development Party (AKP).

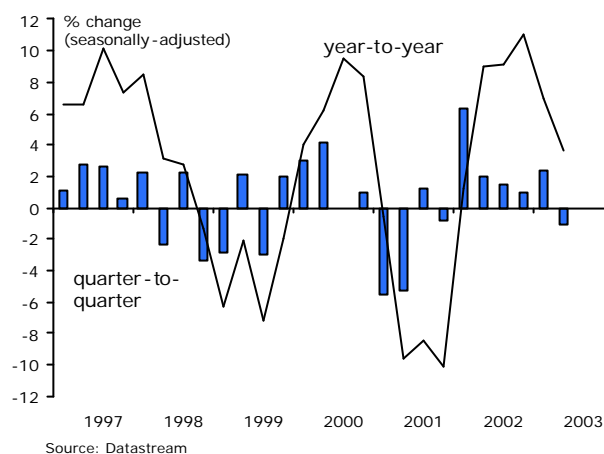
Financial markets reacted positively to the removal of this threat of political uncertainty while the way was cleared for Parliament to approve the deployment of Turkish troops to Iraq, a decision welcomed by the US government. This will help to repair the damage on bilateral relations inflicted by Turkey's decision in March not to allow US troops to invade Iraq from Turkey.

Turkey appears to be making good progress towards meeting the conditions established by the EU for negotiations about accession. An interim report from the EU about Turkey's progress is due shortly, but a final decision on whether full negotiations can begin is not due until December 2004. Despite faster progress in implementing political reforms and improving human rights, the Cyprus issue remains a major obstacle.

The main IMF conditions are being met

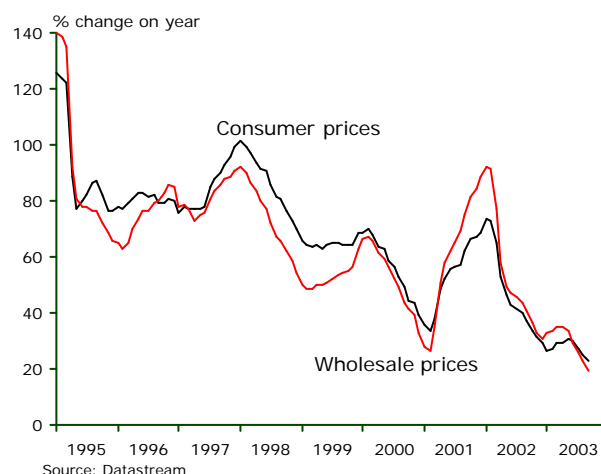
Turkey is meeting the main conditions attached to the IMF stand-by arrangement worth US\$18 bn approved in February 2002. However, Turkey's failure to implement all of the agreed reforms has resulted in actual disbursements being delayed; the IMF approved the latest disbursement in August rather than in June as had initially been expected. The IMF also agreed to extend the repayment schedule by one year.

Real GDP growth slowed sharply in Q2



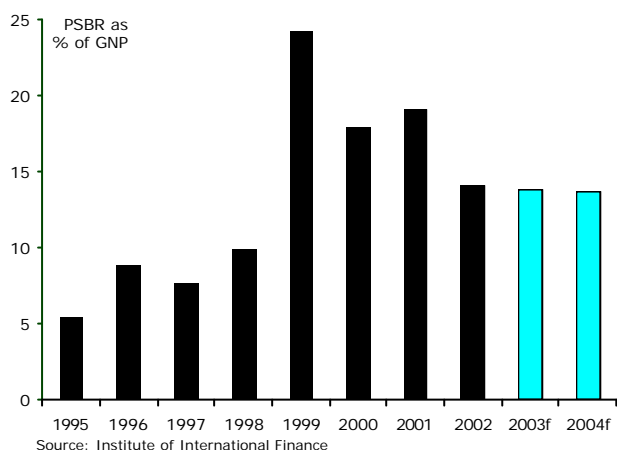
Real GDP rose by 3.9% in the year to June 2003, down sharply from 8.0% in March. The June result was well below expectations and some of the details were also surprisingly weak. While GDP growth of 5.8% in the first half of 2003 was the fastest in the OECD, this mainly reflects a surge in inventories; excluding inventories, growth was only 1.0% in H1. GDP figures are extremely volatile so there are reasonable prospects that revised figures will not show as big a dip in Q2 and/or that there will be a good bounce in Q3 as the economy recovers from the impact of the Iraq war. The government remains confident that full-year growth in 2003 will be close to its 5% projection.

Inflation has fallen sharply



Progress in reducing inflation is being sustained with year-on-year consumer price inflation down to 23.0% in September and on track to meet, or fall below, the official target of 20% at end-2003. The pronounced decline in inflation has created scope for significant interest-rate reductions; the latest reduction of 300 bps in September took the range for short-term interest rates to 29-35%, but interest rates remain high in real terms.

The public sector deficit remains substantial



Important fiscal target may be missed

There are doubts about whether Turkey will generate a primary fiscal surplus equivalent to 6.5% of GNP in 2003, the main objective of the IMF programme. Recent monthly budget results have been mixed; a good outcome in August has partly compensated for disappointing results in preceding months, but has not removed concerns that the full-year target will be missed mainly because weak tax compliance has produced a smaller increase in revenues than projected. Irrespective of whether the 2003 target is met, the scale of the fiscal problem is such that large tax and expenditure reforms will be needed over coming years.

The immediate focus of the IMF is on the 2004 budget. Most revenue measures adopted in 2003 are of a one-off nature and recent estimates suggest that tax increases and spending cuts equivalent to about 2% of GNP will be needed to meet next year's primary surplus target which is also 6.5% of GNP. Measures of this magnitude will be difficult politically for the government to implement, but the prospects of producing a budget acceptable to the IMF are considered reasonable with both favourable access to financial markets, as well as direct financial support, at stake. A credible 2004 budget would also clear the way for further interest rate reductions.

Public sector 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.

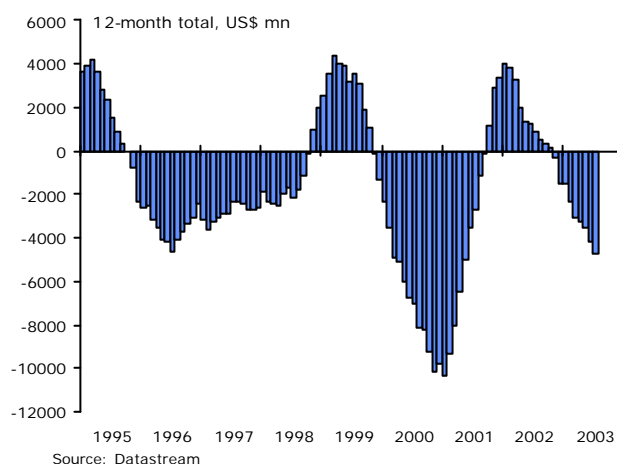
US loan package is approved

The US approved a US\$8.5 bn loan package in September 2003, which is dependent on Turkey sticking to the objectives of its IMF agreement and cooperating with the US in Iraq. The latter requirement is to deter Turkish forces from taking unilateral action against Kurdish separatist forces in northern Iraq.

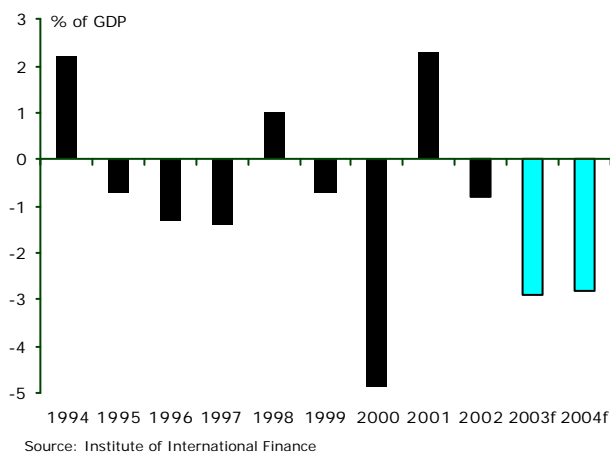
A major bank fraud is uncovered

The scale of the problem of embezzlement and corruption in the banking system was underlined in October when the Banking Regulation and Supervision Agency released a report claiming that almost US\$6 bn had been embezzled from Imarbank deposits. All bank deposits are insured by the state so the fraud has a direct adverse impact on the government's heavy debt burden. The blanket state deposit guarantee is due to be lifted in mid-2004 and replaced by a limited deposit insurance scheme.

The current account deficit has risen...



... and is likely to reach 3% of GDP this year



The US\$ value of exports during January-July 2003 was up by about 27% from the year-earlier period, imports rose by 34%, and the visible trade deficit widened from US\$4.1 bn to approximately US\$7.0 bn. The adverse impact of the Iraq war was felt in terms of higher oil prices and a decline in tourism revenues. There has subsequently been a decline in oil prices and a good recovery in tourism, but the current account deficit is projected to widen from 1% of GDP in 2002 to approximately 3% of GDP in 2003. Recent Institute of International Finance (IIF) projections envisage the current account deficit remaining close to 3% of GDP in 2004 with oil prices, the strength of economic recovery in W Europe, and the lira exchange rate likely to be the key variables. While the sensitivity of the exchange rate to economic conditions can have a significant impact on export competitiveness over fairly short time periods, flexible exchange rate policy should prevent the current account deficit becoming a major constraint on economic policy.

International reserves (excluding gold) stood at US\$29.1 bn in July 2003, close to record levels and sufficient for approximately 5 months' imports.

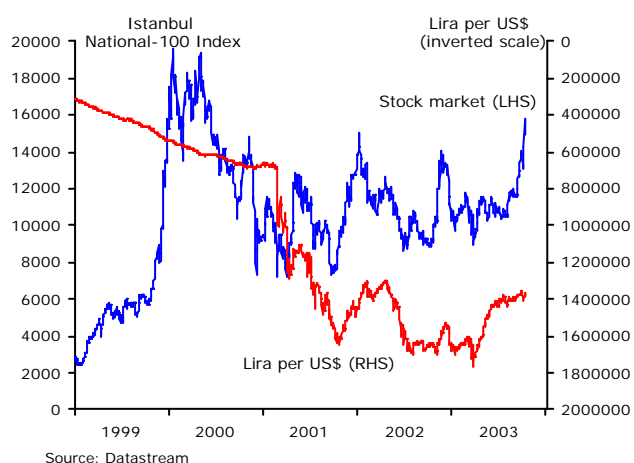
The IIF expects total external debt to rise from US\$135 bn at end-2002 to US\$143 bn by end-2003, but the debt-to-GDP ratio is projected to decline from 74% to 60%. The debt service ratio is forecast to decline from 62% in 2002 to 49% in 2003, but remains onerous.

There has been a clear improvement in market sentiment since shortly after the start of the Iraq war. The stock market on 9 October was up by 67% from its 2003 low on 24 March. The lira has also strengthened, rising by 27% against the depreciating US dollar since hitting a record low, also on 24 March.

Significant economic progress in recent months but risks of another financial crisis persist

The government still seems firmly committed to the IMF programme and the fiscal and structural reforms, and crackdown on corruption, that it entails. There is a risk, however, that the commitment could falter over coming months and the chances of another financial crisis are therefore quite high. The Economist Intelligence Unit, for example, is predicting a financial crisis in 2004 as its main case scenario; the consequences are a 5.5% contraction of GDP in 2004 and surge in consumer price inflation to over 80% by end-2004. Some government ministers have spoken of their desire to dispense with the IMF when the current programme expires in 2004. The risks of a financial crisis would increase significantly if the government were to do so. The biggest risk is of a sharp rise in spending by the government to try to bolster its popularity ahead of municipal elections in 2004. Such a course of action would be disastrous, as it would produce a break in relations with the IMF and significantly increase the prospect of debt default.

Market sentiment improves



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