

Turkey: a mandate for far-reaching political and economic reform

The new government has a strong parliamentary position and has quickly bolstered its commitment to far-reaching political and economic reform. Details of economic policies will be scrutinised carefully to check that the government's pro-growth agenda does not conflict with the pressing need for fiscal consolidation. Turkey is pressing for EU accession talks, but next month's EU Summit is unlikely to provide a firm starting date.

The new government has a strong parliamentary position ...

The Justice and Development Party (AKP) convincingly won the November general election, which saw the coalition led by Bulent Ecevit that had ruled Turkey since mid-1999 swept from office. Although there have recently been signs of economic recovery, the popularity of all three parties that comprised the coalition had been all but destroyed by the scale and severity of the economic problems that have confronted Turkey over the past few years. The coalition began to disintegrate in mid-2002 as it became clear that Prime Minister Ecevit was determined to cling on to office despite serious ill health.

Eleven parties contested the November election, but only two of them - AKP and the Republican People's Party (CHP) - secured the minimum 10% of votes necessary to secure parliamentary representation. AK won 34.3% of the vote but, with most parties failing to pass the threshold for parliamentary representation, this was sufficient to secure 363 seats in the 550-seat parliament so AKP will govern on its own, the first party to do so since 1987.

... and has quickly bolstered its commitment to far-reaching political and economic reform

AKP is a new centre-right party with Islamic origins. Its leader is Recep Tayyip Erdogan, who is currently barred from becoming prime minister because of a conviction in 1998 for inciting hatred on religious grounds after reciting a well-known poem. Erdogan, who used to be involved in an Islamist political movement, insists that AKP is a modern, secular party and emphatically denies that it has a pro-Islamic agenda. He is determined not to trigger a clash with the secular establishment which in 1997 forced the resignation of an Islamist-led government. Many political commentators believe that Erdogan is genuine in asserting his strong commitment to Turkey's secular system of government. The AKP's stated priorities are moderate and pro-western, but the establishment will remain on guard for any signs that links with political Islam are reviving.

The new prime minister is Abdullah Gul, a former banker who is popular and well respected in Turkey. He is firmly committed to the economic reform

programme agreed with the IMF, as well as to maintaining Turkey's close links with the US and implementing the political reforms that are a prerequisite of EU membership. He has reduced the number of cabinet positions, a sensible move that should make the government more efficient and fulfils one of AKP's election promises. The new cabinet as a whole is strongly committed to economic and political reform and the new Economy Minister, Ali Babacan, is a strong advocate of market-friendly policies.

Despite the government's unequivocal assurances that it respects Turkey's secular tradition, its plans to relax a ban on wearing headscarfs in schools and government offices could trigger a damaging political clash with President Sezer, a staunch defender of secularism.

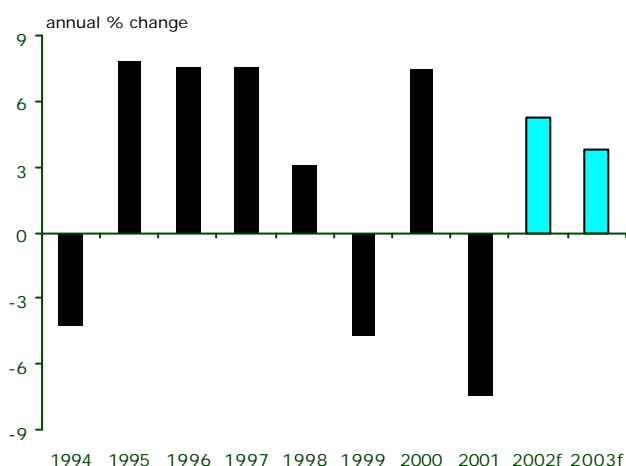
The centre-left CHP, the other party to secure parliamentary representation with 19.4% of the vote, is the party that former Economy Minister Kemal Dervis chose to work with following his resignation from the Ecevit-led coalition in August. Dervis is highly regarded as the main architect of the stabilisation plan following economic crises in late 2000 and early 2001. Prior to the election, there had been some speculation that AKP and CHP might form a coalition government, but AKP's strong parliamentary performance ensured that it is able to govern on its own. The CHP is also firmly committed to political and economic reform.

The stock market has risen, encouraged by a credible government & reform agenda



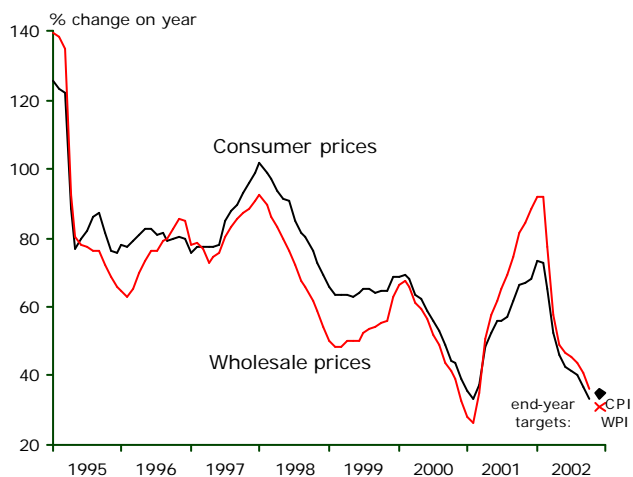
The new government's modern pro-reform agenda, and the energy with which it has begun its term in office and clearly set out its objectives, has had a positive impact on domestic financial markets and will be welcomed by its international creditors. The stock market rose by approximately 28% between 1 November and 27 November, but is still well below the highs reached in 2000. The lira has reacted more modestly to the election result, rising by 8.3% against the US dollar over the same period.

Real GDP is recovering strongly following last year's severe recession



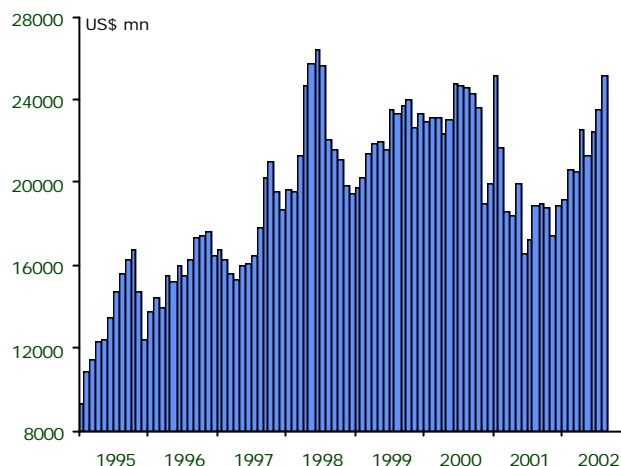
Prior to the election there had also been some encouraging economic news. There has been a stronger-than-expected recovery in economic activity with consensus expectations of real GDP growth rising to around 4% for both 2002 and 2003. ANZ is more positive about real GDP growth this year, with a projection of 5½%, although the prospect of only a slow recovery in global demand could see economic growth in Turkey slip back to around 4% next year.

Inflation has resumed its decline



Inflation has resumed its decline and the central bank is confident that consumer price inflation targets of 35% by end-2002 and 20% by end-2003 are realistic. Short-term interest rates and bond yields have declined and a recent Central Bank survey of business expectations reveals a decline in inflation expectations.

International reserves have recovered with additional financial support from the IMF



There has been significant new money from the IMF with net disbursements totalling approximately US\$6.6 bn since a new stand-by credit was approved in February 2002. This is reflected in international reserves, which have recovered from US\$17.4 bn in November 2001 to US\$25.1 bn in August 2002.

The economic challenges facing Turkey remain formidable

Notwithstanding recent encouraging economic news and the new government's impressive start, significant risks remain. The economic challenges facing Turkey remain formidable and the government's lack of experience could impede effective economic management.

The government has outlined a series of new policies to boost economic growth, which include assistance for farmers and small and medium-sized businesses. It is hoped that liberalisation of the energy sector will secure lower energy prices which are high compared to many other countries. The need for faster privatisation is recognised with detailed plans to be drawn up by early next year. The government has signalled its commitment to the broad thrust of the current IMF economic stabilisation plan so it will need to ensure that new initiatives to boost growth do not undermine the fiscal objectives of the stabilisation plan. Details of specific policies will be scrutinised closely by financial markets and the IMF as they are finalised

over coming months. Some modest changes to the IMF programme are quite likely, but the IMF would firmly resist any push for a significant softening of the main fiscal targets that underpin the plan.

The fiscal position this year will have been adversely affected by the rise in domestic interest rates caused by political developments and renewed uncertainties in mid-year. In deciding whether to release the next tranche of the stand-by credit, however, the IMF's main focus will be the new government's overall commitment to the stabilisation plan, rather than on the adverse impact of the recent spike in interest rates. Provided that the government's broad initial support for the plan is confirmed when fiscal policies are set out in detail, then there are good prospects that the next tranche of the IMF credit will be available soon. This would boost confidence and strengthen the prospect of a virtuous circle developing whereby lower domestic interest rates and a decline in the sovereign risk premium would, in turn, have a beneficial impact on the prospect of meeting fiscal and broader economic goals.

A strong positive feature for financial markets is the reform credentials of the new government which provide "ownership" of its policies in contrast to the reform policies of its predecessor which, to a significant extent, were forced on it at a time of economic crisis.

Turkey is stepping up pressure for EU accession talks

Turkey has made concerted efforts over recent months to meet the conditions set by the European Union for formal negotiations about membership to begin. Against a background of mounting political uncertainty, the Turkish parliament approved a series of political and human rights reforms in August 2002 that included abolition of the death penalty (except in wartime), eased restrictions on free speech, and scrapped laws that banned broadcasting and teaching the Kurdish language.

These reforms are ambitious and an attempt to provide a clear signal to the EU that Turkey shares "European values". The new government has made further commitments to strengthening human rights and seems supportive of the latest attempt by the United Nations to secure a political settlement in Cyprus, while Erdogan has undertaken a tour of European capitals as part of the government's campaign to secure an early launch of negotiations.

The EU still seems divided about Turkey's application for membership

It remains in doubt, however, whether these efforts will be sufficient to secure a date to begin accession

talks at the forthcoming EU summit in Copenhagen. It is clear that there is still considerable opposition from some politicians to the idea of Turkey joining the EU. Former French President Giscard d'Estaing, who currently heads an EU convention with responsibility for drawing up a new European constitution, maintains that Turkey is not a European country and that its accession would represent "the end of the EU". His opinions have been strongly criticised within the EU and probably represent a minority view among political leaders, but it is clear that there is still significant opposition to beginning accession negotiations with Turkey in the foreseeable future.

The reasons for such opposition are diverse. Whether or not they forthright in setting out their views, it seems that some politicians oppose Turkey joining the EU because of significant differences with existing members be they of a geographical or religious nature. Others oppose Turkish membership on the grounds that the country is too large in population terms, and would unbalance EU institutions. Most mainstream politicians, however, maintain that they are not opposed to the idea of Turkey joining the EU in principle, but are unwilling to sanction accession negotiations at this stage because of doubts about Turkey's democratic credentials or its commitment to human rights.

These arguments are becoming increasingly untenable. Turkey applied for membership of the European Community in 1987 and in 1993 the EU spelt out accession (Copenhagen) criteria for applicant countries. A customs union between the EU and Turkey came into effect in January 1996 and Turkey was formally recognised as a candidate for membership in 1999. While Turkey's relations with the EU have come under severe strain from time-to-time and regular reports by the European Commission have concluded that Turkey does not yet meet the Copenhagen criteria, the possibility of Turkey eventually joining the EU has long been accepted.

On that basis, recent objections to Turkey's membership on the grounds of economic size, location, culture or religion seem ill-founded, but it is much more difficult to determine whether Turkey has made sufficient progress towards meeting the specified accession criteria, which cover democracy, the rule of law, human rights, and protection for minorities, for formal negotiations to begin. However, most political commentators accept that significant progress in these areas has been achieved. There is certainly a lot more to be done and it is generally accepted that formal negotiations will be long, complex, and difficult. Most supporters of Turkey's membership accept that it will probably be more than 10 years before Turkey is able to adopt the detailed laws that underpin the EU.

The reunification of Cyprus would boost prospects of early EU negotiations with Turkey

At its forthcoming summit meeting in Copenhagen on 12-13 December, the EU is hoping to approve the accession of 10 countries (8 in Central/Eastern Europe plus Cyprus and Malta) to the EU in 2004. However, with just 2 weeks to go, there are uncertainties about whether renewed international efforts to secure a political settlement in Cyprus will have made sufficient progress to provide assurance that the way will be clear for a reunified Cyprus to be admitted to the EU in 2004.

If a framework agreement is not in place by 12 December, the EU will have to decide whether to defer a decision about the accession of Cyprus to give more time for negotiations about reunification, or whether to admit just the Greek part of the divided island. Either course of action could cause a major row within the EU, with a number of countries, in addition to Greece, apparently holding strong views on the issue.

Turkey recognises that its own bid to secure a starting date for negotiations is linked to the Cyprus issue. A political settlement in Cyprus that cleared the way for the newly reunified island to join the EU would clearly provide a major boost to Turkey's own hopes of securing a starting date for accession talks. However, it seems increasingly likely that

negotiations about Cyprus will extend beyond mid-December.

In these circumstances, the Turkish government is likely to accept the need for compromise and some delay in setting a firm starting time for its own accession talks. There is a significant risk, however, that if the EU continues to be equivocal in its response to Turkey and unwilling to provide a date for negotiations to begin then popular and political support within Turkey for EU membership will begin to wane. Current efforts to pursue far-reaching reforms could falter and the prospect of Turkey achieving political stability and regaining economic prosperity, while remaining an important ally of the west, would recede.

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