TURKEY

Country Report

April 11, 2005

FORTIS BANK

Solid partners, flexible solutions

The Turkish economy is on a very positive trend with strong growth linked to a dramatic improvement in the control of inflation and interest rates. The EU and IMF recognition of the progresses made during recent years are also contributing to reinforce market confidence and to reduce the country vulnerability to monetary shocks. As a result the debt sustainability is improving and the risk of a crisis, even on a short-term liquidity point of view, receded rapidly. Turkey is nevertheless still facing major challenges including the need to boost structural reforms in order to reduce the link between market confidence and fiscal discipline.

Political situation

The AK party has been elected on a program centred on socio-economic improvement. As it delivers results on these issues, its popularity remains very strong and has been recently further increased by the EU decision of accepting to begin negotiations. These developments are extremely positive for the country, and Eu negotiations ar eexpected to begin in October. Before going forward, Turkey has to settle the problem with Cyprus. Negotiations with EU will be long and even the most optimistic observers don't expect an adhesion before 12 to 15 years but this is a normal delay for such a country and economic ties will develop already in the short-term. Currently the important issue is not the success or not of the negotiations but the fact that negotiations will begin.

Turkey is strongly supported by the US that see in the country a stable and mature partner in the Muslim world. The situation in Iraq could however have some destabilising effects through the Kurdish problem but, even in a worst case scenario of dramatic split in Iraq, we expect that Turkey will manage to avoid a domestic open conflict.

Economic situation

The two last quarters confirmed the trend that was clear for more than a year. **Growth** was supported by strong developments of private investments and consumption. Growth only moderated marginally in the second half with industrial capacity utilisation climbing to 83.4 % in November from 79.4 % one year before. **Private consumption** and **investment** were boosted by lower interest rates, slowing inflation that increases real wages and a strong lira. In spite of high oil prices and strong demand, inflation decreased further and it ended the year at 9.32 %, well under the 12 % target. The country and the IMF agreed on the details of a new 3-year stand-by credit to be supported by USD 10 bn. The IMF notes that this program should enable Turkey to create the conditions for sustained growth and employment creation.

The other good news, generally expected however, came from **EU** that gave a datum for the opening of negotiations, although it is still conditional to an implicit recognition by Turkey of Cyprus (no explicit one is required, it is through the expected signing of custom union). This immediately boosted stock markets further; it should also have a positive impact on inflationary expectations and the Central bank took this opportunity to cut once again its ref rates. These cuts in interest rates are fuelling credit growth and bank lending to non-government borrowers (mainly private consumers) rose by 70 % in the 12 months ending September 2004.

The major challenge for the Turkish government is still the control of the **public deficit**. The primary surplus rose to 6.8 % of GDP thanks to higher revenues linked to growth. Public investment fell by 6 % from a year before and this offset the increase in social spending. The consolidated fiscal deficit has been further reduced by the sharp decrease in interest payments that came down from 16.8 % of expenditures in 2003 to an estimate 12.8 % in 2004. The deficit is mainly financed domestically. The domestic debt is increasing in absolute terms (from USD 139.3 bn in Dec 2003 to USD 159 bn in Nov 2004) but it is reducing as a percentage of GDP (from 80 % end 2003 to 78 %). Deposits in local currency increased rapidly partly thanks to a shift from foreign exchange deposits into lira accounts.

In average, the **Turkish lira** remained relatively stable against the Euro in 2004. At its current level, the TRL in real term is just above its average in 2003, the nominal appreciation being offset by the reduction in inflation. The worsening of the current account could however weaken the currency next year if it is not compensated by capital inflows.

Balance of payments and external finances

The negative consequence of the very strong domestic growth is a deterioration of the trade and current balances. However, an important part of the import growth is reflecting imports of inputs and capital goods and this is positive for the future production growth. The trade deficit is only partially offset by the rapid growth of tourism revenues and the current account deficit reached 5 % of GDP. Although FDI doubled last year, they were subdued when compared with the potential of the country and with FDI in other emerging countries. This is, in our view, mainly due to the fact that investors were waiting for the economic performance to be confirmed and for the decision of the EU. They should therefore increase rapidly in coming years, in line with the potential offered by the opening of the negotiations with the EU. Besides, most of the amount of inflows registered in 2004 was linked to real estate investments and not to investments in productive activities.

The net amount of FDI is also limited by the important capital outflows reflecting Turkish investments in the Middle East and Central Asia regions.

The external debt amounts to 64 % of GDP but this amount includes eurobonds held by domestic banks (est. 8 bn) and domestic bonds (est. 6 bn) held by foreigners. The debt service is not negligible and amounts to 36 % of export revenues but this ratio has been halved since the beginning of the years 2000 thanks to GDP growth and stabilisation of debt service and its level is now manageable. The debt problem is much more linked to the domestic debt than to the external one.

Outlook

We expect growth to slowdown in 2005 after the very strong recovery effect of 2004. Inflation will continue to decline and we expect Turkey to remain on track with its IMF program. Prospects for financial stability and debt sustainability are improving rapidly but the country will remain vulnerable to fluctuations in confidence as long as it will be dependent on short term external financing. In order to reduce this dependence it has to accelerate structural reforms including privatisation. We are confident that the government is committed to such a program in the framework of very rigid fiscal discipline. The recent agreement with the IMF as well as the “yes” of the EU should also ease the situation by reinforcing market confidence.

TURKEY

Statistics :

Memorandum items:
Population (growth rate): 71,32 mln (1,5 %)
Unemployment rate: 10,50%
GDP per capita : 3.360 USD (2003)

GDP by sector of origin:
Agriculture: 11,8 %
Industry: 28,4 %
Services: 58,8 %

Main economic indicators:

(e) estimates, (f) forecasts	2001	2002	2003(e)	2004(f)	2005(f)
Domestic economy:					
Economic growth rate (%)	-7,5	7,9	5,8	9,5	6,5
Inflation rate (%)	54,4	45,0	25,3	10,8	9,4
Budget balance / GDP (%)	-19,6	-14,4	-11,7	-8,5	-6,0
External balance:					
Trade balance / GDP (%)	-3,1	-4,5	-6,0	-10,9	-12,6
Current-account balance / GDP (%)	2,3	-0,8	-2,9	-5,0	-5,5
Financing requirement[1] (mln USD)	-12.790,3	-23.584,7	-28.312,0	-37.977,0	-35.266,2
Net foreign direct investment (mln USD)	2.768,0	862,0	1.063,0	2.000,0	2.375,0
Foreign-exchange reserves (mln USD)	18.879,0	27.069,0	33.991,0	35.582,0	37.000,0
External debt:					
Total external debt (mln USD)	113.457,0	131.556,0	146.953,0	150.261,0	150.964,0
Short term debt (mln USD)	16.345,0	15.192,0	22.568,0	28.075,0	26.869,0
Arrears (principal & interest) (mln USD)	0,0	0,0	0,0	0,0	0,0
External debt / GDP (%)	77,9	90,4	62,4	64,5	63,0
Debt service ratio[2] (%)	42,1	48,1	37,5	36,6	40,9

[1] *current account balance - principal repayments on external debt*
[2] *principal & interest repayments on external debt / exports*

Trade Flows

Destination of exports :

Exports To Germany (Fob)	15,9 %
Exports To Us (Fob)	8,0 %
Exports To Uk (Fob)	7,8 %

Origin of imports :

Imports From Germany (Cif)	13,7 %
Imports From Italy (Cif)	7,9 %
Imports From Us (Cif)	7,9 %

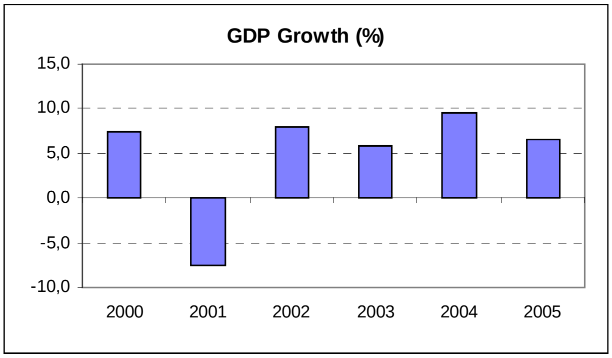
Principal exports :

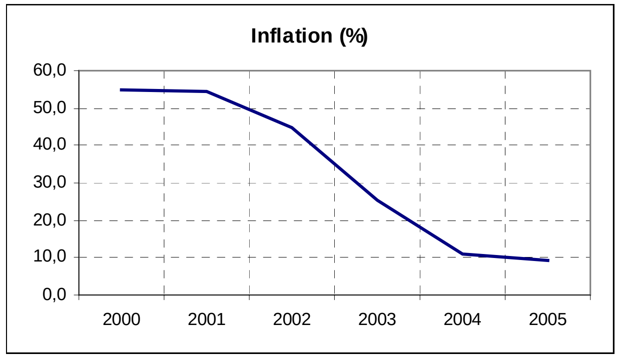
Agro	23,9 %
Textiles (Fob)	6,5 %
Transport Equipment (Fob)	5,8 %

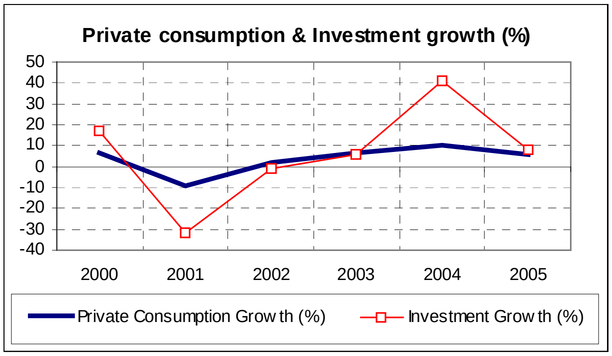
Principal imports :

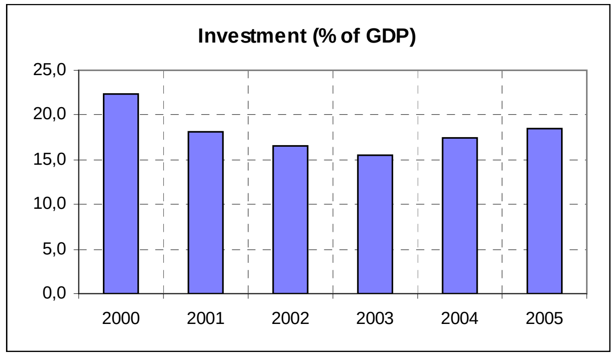
Machinery (Cif)	15,7 %
Transport Equipment (Cif)	9,3 %
Chemicals (Cif)	8,6 %

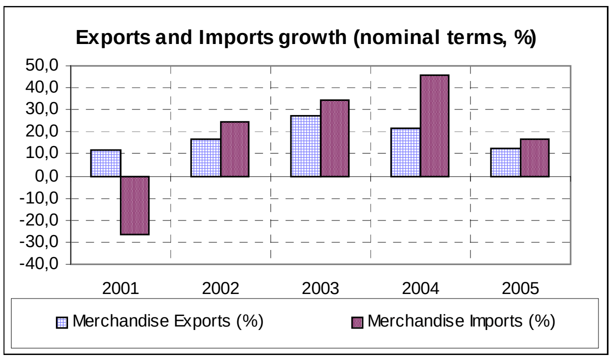
TURKEY

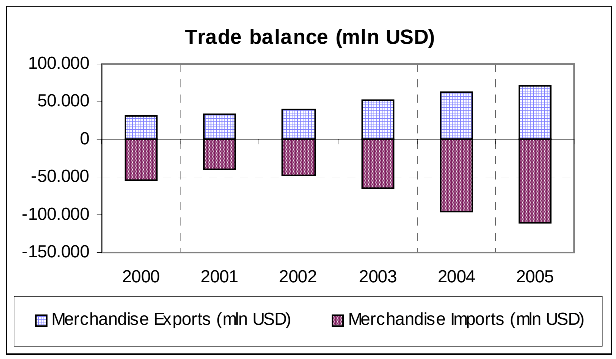

GDP Growth (%)
15,0
10,0
5,0
0,0
-5,0
-10,0
2000 2001 2002 2003 2004 2005

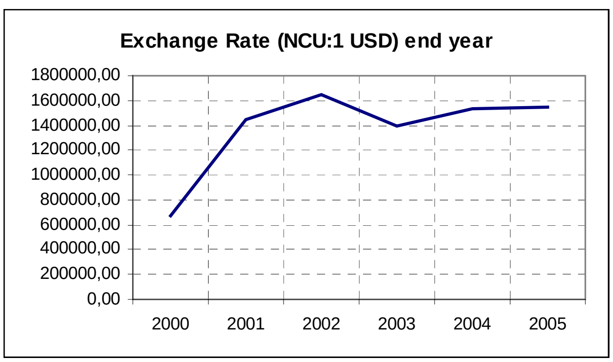

Inflation (%)
60,0
50,0
40,0
30,0
20,0
10,0
0,0
2000 2001 2002 2003 2004 2005

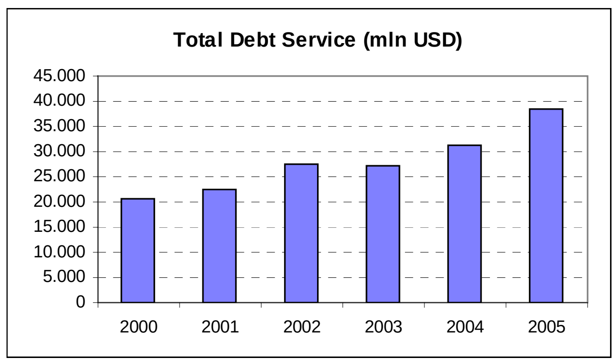

Private consumption & Investment growth (%)
50
40
30
20
10
0
-10
-20
-30
-40
2000 2001 2002 2003 2004 2005
Private Consumption Growth (%)
Investment Growth (%)


Investment (% of GDP)
25,0
20,0
15,0
10,0
5,0
0,0
2000 2001 2002 2003 2004 2005


Exports and Imports growth (nominal terms, %)
50,0
40,0
30,0
20,0
10,0
0,0
-10,0
-20,0
-30,0
-40,0
2001 2002 2003 2004 2005
Merchandise Exports (%)
Merchandise Imports (%)


Trade balance (mln USD)
100.000
50.000
0
-50.000
-100.000
-150.000
2000 2001 2002 2003 2004 2005
Merchandise Exports (mln USD)
Merchandise Imports (mln USD)


Exchange Rate (NCU:1 USD) end year
1800000,00
1600000,00
1400000,00
1200000,00
1000000,00
800000,00
600000,00
400000,00
200000,00
0,00
2000 2001 2002 2003 2004 2005


Total Debt Service (mln USD)
45.000
40.000
35.000
30.000
25.000
20.000
15.000
10.000
5.000
0
2000 2001 2002 2003 2004 2005