Turkey

Country Report

Solid partners, flexible solutions

Turkey has made a remarkable recovery and economic adjustment at the same time but the consolidation of these results is now a major challenge.

Rapid disinflation has allowed a dramatic drop in interest rates that has been the base for reducing the weight of the public debt and boosting investments as well as private consumption.
However, the public debt of the country remains the major threat to long term growth and stability and structural changes have still to be implemented in order to reduce this public debt problem.

The strong recovery in 2004 has created another problem: a rapid worsening of the current account balance that could aggravate the debt problem and provoke a currency crisis.
In our view, the government is strongly committed to its adjustment policy (and is gaining lot of popular support for it) and the world economic slowdown will help reduce the overheating.

In our base scenario, the structural reforms will be implemented, perhaps more slowly than one could expect, and the pressure on the current account will be reduced by less dynamic domestic demand and a good performance of services.
The control of the domestic debt is not yet guaranteed but the weight of the debt will continue to decline as we expect inflation and interest rates to be lower than targets.

There are two kind of risks to this scenario:

- The country would still be vulnerable to a sudden rise in international interest rates and lack of confidence toward emerging markets in general.
- The other risk is domestic: if authorities were unable to impose the expected structural reforms, the weight of the domestic debt could remain excessive and would jeopardise the longer-term growth.

Political situation

Turkey has been quite rapid in initiating improvements required by the EU to begin negotiations in October and the EU had to agree to maintain the timing. The negotiating mandate has yet to be approved by all countries and the process as well as the timing could still be put in question although the agreement to negotiate is irrevocable. Turkey has yet to extend its trade agreement to new EU members including Cyprus and difficulties could also come from this side.

The US support remains very important especially now that tensions with Kurdish population seems to resume with violent attempts. These attacks may be an answer by the hard-liners of the PKK to government and more moderate factions attempts to discuss a cease-fire and possible amnesty. Tensions with Kurd extremists are also fuelled by the situation in Iraq.

In spite of its recent departures (15 MP left these last months), the AK party remains largely dominant and could provoke early elections in order to build on its current advantage. The centre forces are split in different parties and are unable to reach the 10 % of votes threshold to be present in parliament. If these parties were to collaborate or to unify somehow, the AKP could be forced into a coalition government.

Economic situation

During the last three years, Turkey posted a very strong growth, mainly linked to the development of domestic demand. The sharp reduction in inflation and in interest rates has boosted private consumption and investments. The impressive successes of the current government in matters of economic recovery and price stabilisation cannot hide the fact that major challenges remain.
The most important one is the still high level of public debt, its short maturity and the dependence on foreign markets to finance it.
Another important issue is the increasing current account deficit due to the excessive domestic demand.
Finally, in order to maintain growth in the long-term, important structural reforms have still to be implemented including fiscal reform, banking reform, inflation targeting and measures to attract more FDI.

In 2004, real economic growth reached almost 9 %, but the external environment will be less favourable in 2005 and 2006 and growth should stabilise at around 5 % mainly supported by a good performance of services. The disinflation process should continue in spite of high oil prices as inflation expectations are low and this will allow the central bank to further cut its reference interest rate.

The corporate sector has posted important productivity gains as the high level of unemployment has contained wage pressure in spite of recovery. The corporate sector is nevertheless highly leveraged and the IMF stresses that “the short maturity of the debt financing and its extensive denomination in, or indexation to, foreign currencies implies that corporations still have considerable exposure to interest rate and foreign liquidity risk”.

Balance of payments and external finances

The negative consequence of the strong growth of domestic demand is the worsening of the current and trade accounts to unsustainable levels.
Imports were boosted by investment growth (imports of capital goods) but also by increasing domestic consumption. Export growth, although high, was insufficient to offset this negative impact.

Part of the problem was linked to the rapid real appreciation of the Turkish lira but exports benefited from lower real wages, market diversification and gains of productivity.
The current level of current account deficit is unsustainable because it increases beyond acceptable limits the financing needs of the country and it could imply a devaluation with resumption of inflation.
The external debt of the country is not a threat but excessive levels of current account deficits would increase it and risk to aggravate the dependence on external financing. Besides, the share of short-term debt remains important and excessive in regards of foreign exchange reserves.
FDI are expected to grow rapidly now that the process begun with EU.

Outlook

Growth is expected to slowdown this year and next because of a less favourable environment, a depreciation of real exchange rate that will make imports more expensive and the pursuit of austere fiscal policies. We expect growth to stabilise at around 5%.
A better control of credit growth and a reduction in tax incentives to consumption will also contribute to a controlled slowing down of the economic growth.
Inflation will most probably be below target and this will allow the monetary authorities of the country to resume their loosening of monetary policy.

The fiscal target is more challenging. The declining growth will have an impact on revenues; on the other side, during recent years, authorities have cut investment expenditures and state enterprises role but current spending has increased substantially as have “unplanned spending initiatives” including wage and pensions increases. In order to consolidate fiscal successes the government will have to accelerate structural reforms that would structurally decrease expenditures. Social security and pension reforms are therefore strongly recommended by the IMF and will be key to the disbursement of the credits of the institution.

A major uncertainty is still linked to the current account deficit and to the increase or not of the financing requirements of the country.If the country was unable to control its external deficits, it could jeopardise the support of the IMF and the financial situation of the country.

Another risk is linked to a world adjustment in interest rates and decreasing appetite for emerging markets. The possibility of these developments oblige Turkey to accelerate the structural reforms in order to reduce its vulnerability to interest rates and external financing.

TURKEY

Statistics :

Memorandum items:

Population (growth rate): 72,34 mln (1,4 %)
Unemployment rate: 10,30%
GDP per capita : 4.170 USD (2004)

GDP by sector of origin:

Agriculture: 11,3 %
Industry: 28,6 %
Services: 58,8 %

Main economic indicators:

(e) estimates, (f) forecasts	2002	2003	2004(e)	2005(f)	2006(f)
Domestic economy:					
Economic growth rate (%)	7,9	5,8	8,9	5.1	5.2
Inflation rate (%)	45,0	25,3	9.4	6.5	4.0
Budget balance / GDP (%)	-14,5	-11,2	-7,0	-5,9	-5,9
Government debt(domes.+ext)/ GDP (%)	94	83	63.5		
External balance:					
Trade balance / GDP (%)	-4,0	-5,8	-7,9	-7,9	-5,4
Current-account balance / GDP (%)	-0,8	-3,3	-5,1	-5.1	-4.8
Financing requirement[(1)] (mln USD)	-23.589,3	-29.419,6	-40.352,0	-45.525,9	-41.918,3
Net foreign direct investment (mln USD)	862,0	1.063,0	1.711,0	4.150,0	3.750,0
Foreign-exchange reserves (mln USD)	27.069,0	33.991,0	35.669,0	38.139,0	35.783,0
External debt:					
Total external debt (mln USD)	113.457,0	145.700,0	161.522,0	157.135,0	147.981,0
Short term debt (mln USD)	16.400,0	23.000,0	31.910,0	30.590,0	28.263,0
Arrears (principal & interest) (mln USD)	0,0	0,0	0,0	0,0	0,0
External debt / GDP (%)	71,2	79,1	53,5	52,0	49,0
Debt service ratio[(2)] (%)	48,1	38,9	33,3	35,3	34,8

[(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)	13,9 %
Exports To Us (Fob)	8,8 %
Exports To Uk (Fob)	7,7 %

Origin of imports :

Imports From Germany (Cif)	12,8 %
Imports From Italy (Cif)	7,0 %
Imports From Us (Cif)	9,3 %

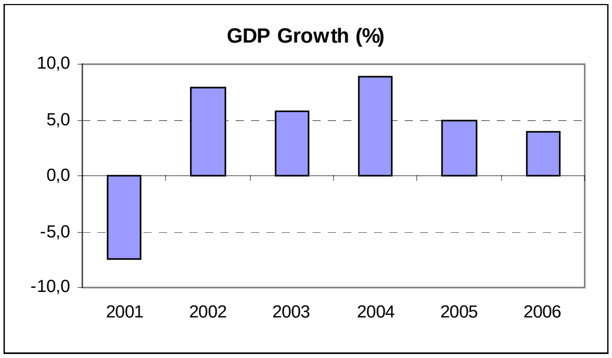
Principal exports :

Agro	20,0 %
Textiles (Fob)	8,7 %
Transport Equipment (Fob)	8,4 %

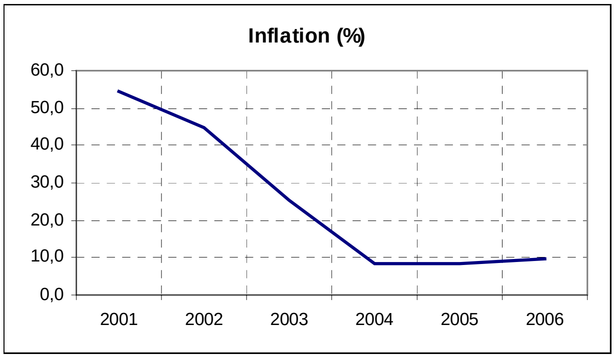
Principal imports :

Machinery (Cif)	13,8 %
Transport Equipment (Cif)	10,5 %
Chemicals (Cif)	6,5 %

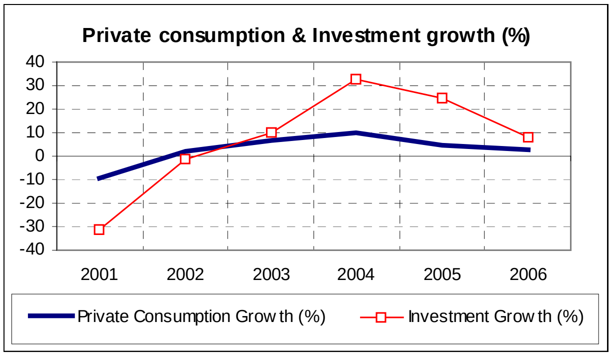
TURKEY



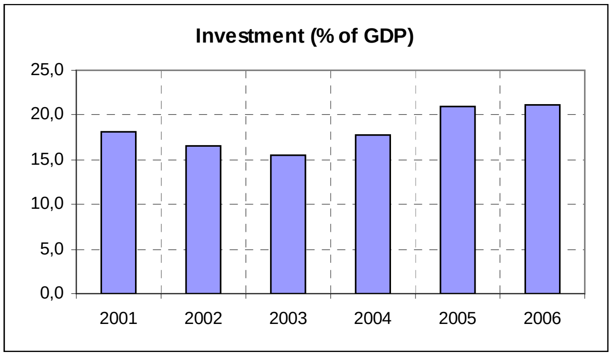
GDP Growth (%)
10,0
5,0
0,0
-5,0
-10,0
2001
2002
2003
2004
2005
2006



Inflation (%)
60,0
50,0
40,0
30,0
20,0
10,0
0,0
2001
2002
2003
2004
2005
2006

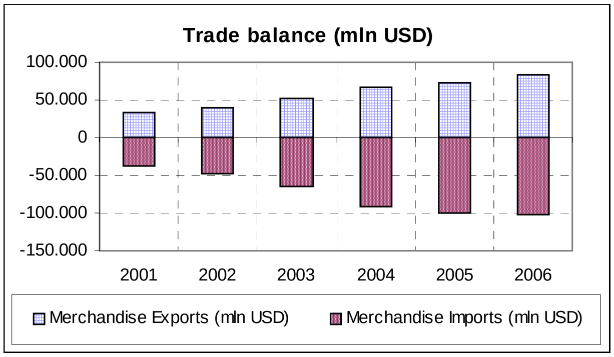


Private consumption & Investment growth (%)
40
30
20
10
0
-10
-20
-30
-40
2001
2002
2003
2004
2005
2006
Private Consumption Grow th (%)
Investment Grow th (%)

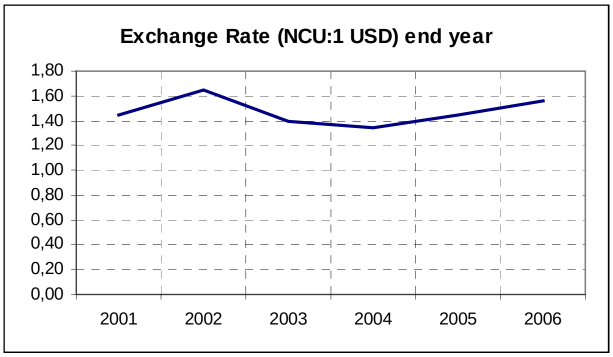


Investment (% of GDP)
25,0
20,0
15,0
10,0
5,0
0,0
2001
2002
2003
2004
2005
2006

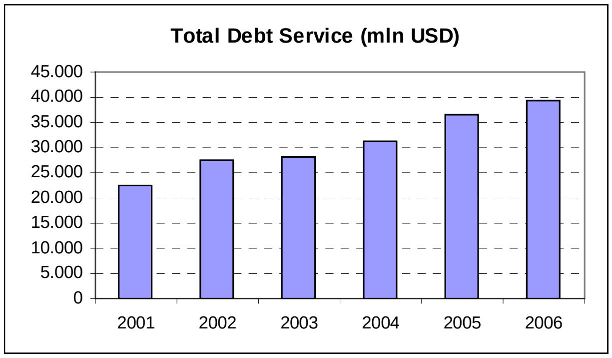
Exports and Imports growth (nominal terms, %)
50,0
40,0
30,0
20,0
10,0
0,0
2002
2003
2004
2005
2006
Merchandise Exports (%)
Merchandise Imports (%)



Trade balance (mln USD)
100.000
50.000
0
-50.000
-100.000
-150.000
2001
2002
2003
2004
2005
2006
Merchandise Exports (mln USD)
Merchandise Imports (mln USD)



Exchange Rate (NCU:1 USD) end year
1,80
1,60
1,40
1,20
1,00
0,80
0,60
0,40
0,20
0,00
2001
2002
2003
2004
2005
2006



Total Debt Service (mln USD)
45.000
40.000
35.000
30.000
25.000
20.000
15.000
10.000
5.000
0
2001
2002
2003
2004
2005
2006