

# RATING PERSPECTIVE

## Republic of Turkey

### A Sharp Economic Slowdown - Issues and Prospects

The Turkish economy, which achieved a V-shaped recovery from a recession caused by the financial crisis in 2001, has grown at a robust rate until 2007. However the international financial and economic crises in 2008 resulted in its steep decline. This report outlines political and economic situations in Turkey at the moment and examines major issues to be addressed and future prospects of the Country.

#### 1. Overview

The international and financial crises had a negative impact on the Turkey's real economy, which rapidly and sharply deteriorated in 2008. In 2009, the economy is expected to experience a significant negative growth, for the first time since 2001, as a result of a sharp fall in domestic demand including the consumer spending and the private capital investments against a background of deteriorating employment circumstances and a significant decline in Turkey's export volume. Although the Turkish government and the IMF continued negotiations on a new arrangement, it appears that they are yet to be settled because of disagreement on some of the terms including the Country's fiscal policy. The Country has to change the fragile structure of its external balance in order to attain sustainable growth of the economy over the medium to long term. JCR considers that a new IMF stand-by agreement would play a heightened role in improving its international confidence, when the economy

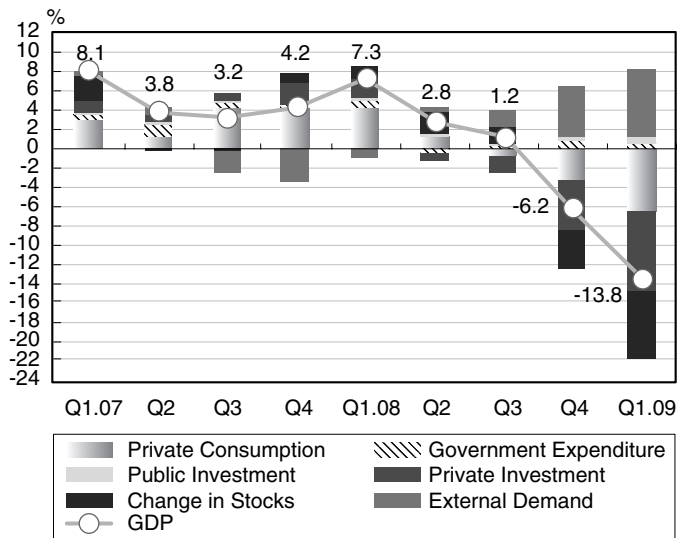
deteriorates sharply. JCR will watch the status of stand-by agreements as well as reforms aiming at its accession to the EU.

The Country has faced several political and social problems, such as those associated with the presidential election and the indictment to the Constitutional Court by the Turkish public prosecutors calling for the governing Justice and Development Party (AKP) to be closed down. JCR considers that political and social stability is indispensable for sustainable growth of the economy over the medium to long term. Given the deteriorating economy, the Erdogan government needs to restore international confidence in Turkey through a renewed relationship with the IMF and reforms aiming at the accession to the EU, in addition to its measures to regain public support and improve the Country's social stability.

#### 2. Macro-Economy

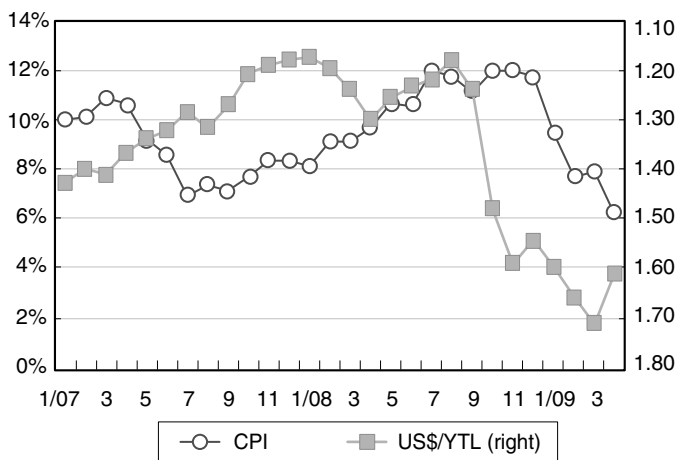
Although the Turkey's economy had grown at an annual 6.9 percent (on a year-on-year basis) in average for five years until 2007, it slowed sharply and its growth rate collapsed to an annualized -6.2 percent in the fourth quarter of 2008, from its peak level of 7.3 percent (on the same basis) in the first quarter of 2008, with the international and financial crisis affecting the real economy. As a result, the Country's real GDP growth rate fell sharply to 1.1 percent in 2008, from 4.7 percent in 2007. The growth rate will be at around -7.0

Chart 1. Contribution to % Change in Real GDP Growth



Source: Central Bank of Turkey

Chart 2. Trends of Inflation and FX Rate



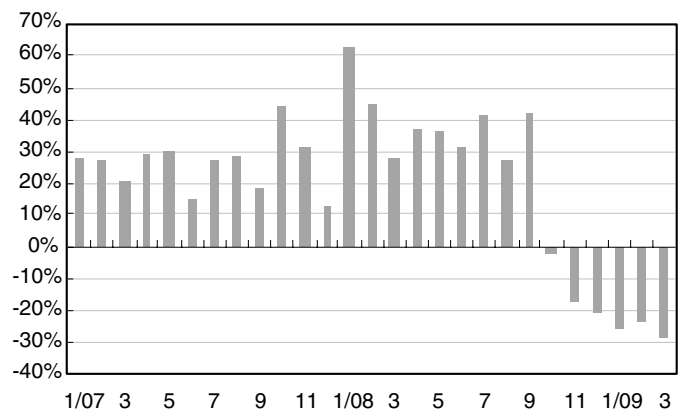
Source: Central Bank of Turkey

percent in 2009, a significant negative growth for the first time since 2001, as a result of slumping domestic demand including the consumer spending and the private capital investments, caused by a significant fall in exports and deteriorating employment circumstances. Although the economy is expected to rebound, provided the world economy shows a mild recovery in 2010, it is likely the growth rate will remain at a lower level (Charts 1 to 4).

On the other hand, the government's efforts in accordance with the stand-by agreement with the IMF have contributed to a dramatic improvement in the fiscal position, in comparison to that at the time of the Economic Crisis in 2001. The AKP, which came into power in 2002, carried out the restrictive fiscal policy in accordance with the economic reform program led by the IMF and privatization of state owned enterprises and was successful in maintaining a surplus in the Country's primary balance (the Government's fiscal balance before interest payment). As a result, its fiscal deficit/GDP ratio fell sharply to 0.6 percent in 2006 from 12.1 percent in 2001. Although the deficit began to rise from 2007 to 2008, because of the increased expenditure to accommodate countercyclical measures as well as the electoral spending, the fiscal deficit/GDP ratio is still below 2 percent and does not exceed one of the Maastricht criteria of 3 percent (its requirement for the Euroization.) Also the public debt/GDP ratio dropped significantly as a result of the government's efforts. However, in 2009, as the government takes additional stimulus measures to boost the economy, the fiscal deficit is expected to climb further and the public debt/GDP ratio is expected to rebound, which has declined until 2008 (Chart 5).

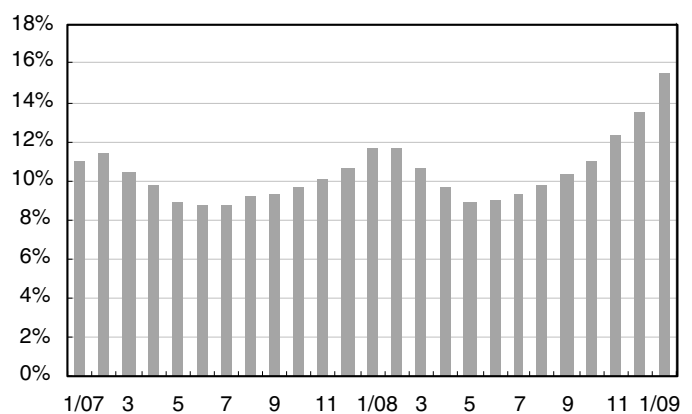
The Country's banking system reform in accordance with the economic reform program led by the IMF has been implemented, focusing on the state-run commercial banks whose assets account for nearly 30 percent of total assets of all banks in Turkey. In 2001, the Emlak Bank specializing in loans to real estate industry was integrated in the Ziraat Bank specializing in loans to agriculture industry, among three largest state banks. A merger between the other official bank, Halkbank specialized in loans to small and medium enterprises, and Pamukbank, a large private bank which was under the control of the Saving Deposit and Insurance Fund (SDIF), took place in 2004. JCR will watch future privatization of those two state banks. The government has put troubled banks under the control of the SDIF since 1997, for the purpose of either reconstruction or liquidation. Consequently 20 banks have been put under the control of the SDIF in total, with only one bank being still under its control at the moment. Therefore JCR considers that disposition of non-performing loans is almost complete in Turkey. The Country's non-performing loans ratio in all banks had stood at 12.1 percent at the end of 2001, when the Financial Crisis had occurred, and fell to 3.6 percent at the end of 2008. Although the ratio began to rise against sharply deteriorating economic conditions from the beginning of 2009 and

**Chart 3. Goods Export Growth (y-o-y)**



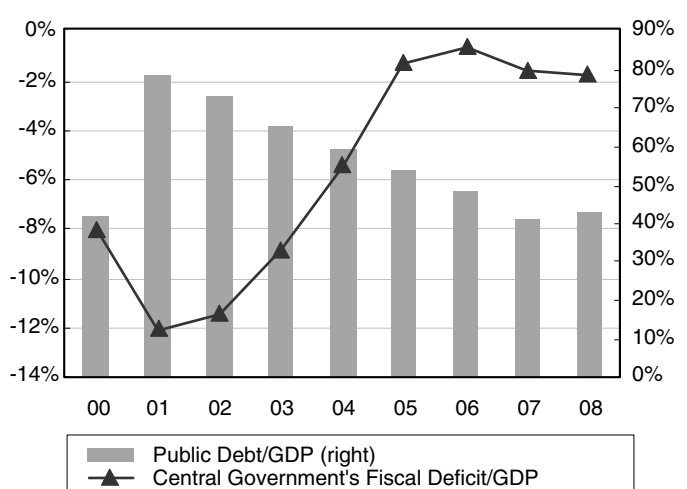
Source: Central Bank of Turkey

**Chart 4. Trend of Unemployment Rate**



Source: Turkish Treasury

**Chart 5. Trend of Fiscal Position**



Source: Turkish Treasury

stood at 4.2 percent at the end of February, 2009, the loan loss reserve coverage ratio was 78.3 percent and maintained at a relatively higher level. The capital adequacy ratio of all banks was 18.1 percent and remained at a higher level, as well. JCR will continue to watch the progress of the banking system reform, as it is important for the Turkish economy to see the system soundly develop so that the national savings can be smoothly mobilized for its sustainable growth.

### 3. External Balance

The ratio of the Country's current account deficit to GDP was staying at the level slightly below 6 percent from 2006 to 2008, which was a cause for serious concern on the Turkey's economy. However, it is likely that the trade deficit will shrink significantly, as import volume will decrease more than export thanks to a sharp fall in crude oil prices and a slowdown in the domestic demand. Consequently, the current account deficit to GDP ratio is expected to fall sharply to approximately 1 percent from 5.6 percent in 2008. However, JCR deems it unlikely that its foreign currency liquidity position will improve significantly, as there is a greater likelihood that the volume of capital inflow into Turkey will also decrease because of a serious business slump in the European economies amid the international financial and economic crises (Charts 6 and 7).

The current account issue is essentially an issue of IS Balance. Although the saving ratio in the private sector was as high as more than 25 percent in the early 2000s, the increased fiscal deficit brought that of the public sector to negative and lowered the overall saving ratio to the range of 20 to 25 percent. In the late 2000s, the saving ratio in the public sector became positive on an improvement in the government fiscal position as a result of progress in the economic reform program led by the IMF, while that of the private sector fell sharply as consumption and investment dramatically increased amid the great expansion of the economy. As a result, the overall saving ratio has ranged from 20 to 25 percent, more or less unchanged from the previous five years. On the other hand, the investment ratio in the private sector has risen sharply since 2004, a year of high economic growth. That widened the gap between the investment and the saving ratios and has driven up the current account deficit in 2008 (Chart 8).

From a viewpoint of the IS balance, JCR considers the improvement in the government fiscal position will lead to a change in the fragile structure of its external balance over the medium to long term. On the other hand, turning eyes to the private sector, JCR considers it important for the government to create a virtuous cycle of economic growth as what India's economy experienced from the 1990s and the 2000s. That is, the Country will need to promote the mobilization of the savings by implementing the banking system reforms while realizing an economic growth, and further to shift the savings to sound corporate investments through banks' intermediary function in order to make such an economic

growth sustainable. However, the gap between the investment and the saving may widen along with the Country's economic recovery and such gap must be filled by the external financing. Hence the government should better create the political and economic stability for the continued or improved international confidence, although it is desirable that such gap should be financed by the inward foreign direct investment in order not to increase its external debt. In that sense, it is critical to attain the new IMF stand-by agreement and to carry out the expected reforms for the purpose of the accession to the EU.

### 4. IMF-Supported Economic Reforms and EU Membership Talks

The IMF standby arrangement was completed in May 2008 when the IMF approved its seventh review and released the loan of relevant tranche. The Turkish government has since been negotiating with the IMF on a new arrangement, while the worldwide real economy has been affected rapidly by the international and financial crisis. However, they reportedly have yet to reach agreement due to the difference over a few conditions pertaining to Turkey's fiscal policy.

Meanwhile, talks on Turkey's EU membership have been making progress except for the several policy areas (eight of 35) which the EU decided to freeze in December 2006. In its Progress Report released in November 2008, the EU made a generally positive assessment of the improved stability of the Turkish economy while pointing out the necessity of further political reforms. In order to ease and absorb the impact of the international financial and economic crises on the Turkish economy as promptly as possible and to achieve the sustainable economic growth, the Country needs to raise its international confidence by taking advantage of a new standby arrangement with the IMF, which is expected to be finalized soon, and through the implementation of reforms aimed at the EU accession. JCR will keep a close watch on future developments in those matters.

### 5. Political Situation

Although the governing AKP retained its position as the leading party at the nationwide local elections in March 2009, its percentage of votes gained fell significantly, compared with the result of the general election in 2007 and the result showed that public support for the party was declining. In recent years, the Country faced various political and social problems, which include a series of terrorist campaigns which are presumed to be masterminded by the Kurdistan Workers' Party (PKK), problems associated with the election of President in 2007 and the filing of indictment to the Constitutional Court by the Turkish public prosecutors, which called for the AKP to be closed down in 2008. Conflicts between the secularists centered by the army and pro-islamic groups are an issue of social and political structure of the Turkish society, which is so deeply rooted and therefore hard to be resolved. Likewise, PKK issues cannot

be settled fundamentally without a broader settlement of the Kurdish problems. However the Kurdish problem has complex and serious historical backgrounds and therefore the settlement is also not easy to achieve. JCR considers it indispensable for the Country to enhance political and social stability which enables brisk corporate and investment activities, in order to achieve sustainable growth of the Turkish economy over the medium to long term, from the viewpoint of overcoming the fragile external balance.

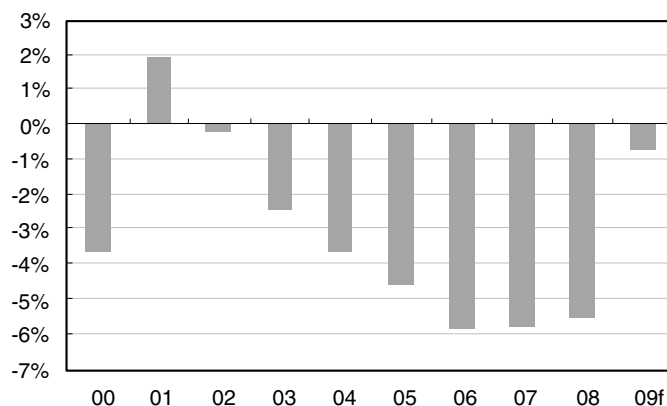
It takes time and much patience to improve political situations of complex and serious backgrounds. However current situations may become worse, if no measures are taken. JCR considers it necessary to establish a certain framework in which the conflicting groups can recognize differences each other, find a common interest to cooperate for, in order to avoid the worst case scenario. The economic field is easier to identify a common ground than in the political field which may lead people to an emotional antagonism with no way out. In that sense, the "realization of sustainable economic growth" can make a comprehensive goal which even conflicting groups can have in common. It can cover the economic divide issue between the south-eastern Anatolia where many Kurds live and other districts. A desirable scenario is that representatives of the conflicting groups are engaged on a regular basis in certain frameworks of communication and cooperation toward a better future of the Country, of which progress should be publicized from time to time.

Beside sociopolitical stabilization, JCR considers it important to further the structural adjustments centering on the reform of fiscal and financial systems and the privatization of overstretched state owned enterprises, so that the Turkey's economy can make a sustainable growth. On this point, the AKP, as an heir of the moderate reformists within the disband pro-Islamic Prosperity Party, has track records, since it established a stable government on the safe majority at the Parliament and actually carried out such reforms in cooperation with the IMF. The structural adjustment is hard to push through, since more often than not it harms vested, and socially or politically conflicting, interests. Therefore, the governing AKP needs to take a strategic approach by taking advantage of the renewed IMF standby agreement and with justification of the EU accession hereafter.

The Erdogan government is expected to tackle the deteriorating economy in the short term and carry out the structural reforms aiming at an improvement in stability of Turkish's politics and society as well as sustainable economic growth over the medium term. Such efforts will contribute to the restoration of public support for the government and of international confidence in Turkey. JCR will watch how Prime Minister, Mr. Recep Tayyip Erdogan will take a political leadership.

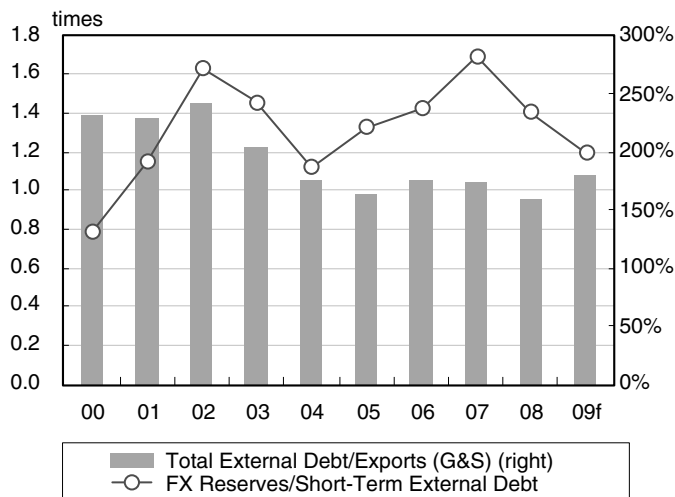


**Chart 6. Current Account Balance to GDP**



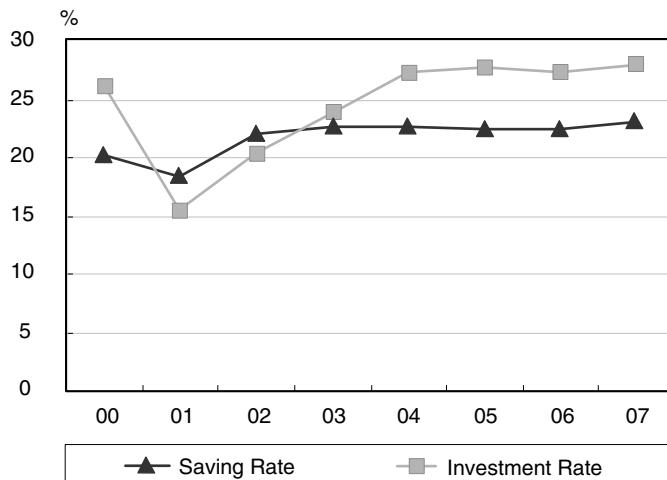
Source: Central Bank of Turkey. JCR's forecasts

**Chart 7. Trend of Foreign Currency Liquidity Position**



Source: Central Bank of Turkey. JCR's forecasts

**Chart 8. Trend of I-S Balance**



Source: Japan Center for International Finance

## RATING PERSPECTIVE

### Main Economic Indicators: Republic of Turkey

		2002	2003	2004	2005	2006	2007	2008	2009f
Real GDP Growth	%	6.2	5.3	9.4	8.4	6.9	4.7	1.1	-7.2
Unemployment Rate	%	10.3	10.5	10.3	10.2	9.9	9.8	10.6	16.0
CPI	%	47.2	25.5	8.6	8.2	9.6	8.8	10.4	7.0
Inter Bank Money Market Rate (December Average)	%	44.0	26.0	19.1	13.6	17.5	16.0	15.7	8.0
<b>Central Government Primary Balance/GDP</b>	%	3.4	4.0	4.7	5.8	5.4	4.1	3.5	1.5
<b>Central Government Fiscal Balance/GDP</b>	%	-11.4	-8.8	-5.4	-1.3	-0.6	-1.6	-1.8	-3.7
Public Debt/GDP	%	73.3	65.4	59.5	54.1	48.2	41.5	42.6	46.8
Goods Exports	US\$ bn	40.7	52.4	68.5	78.4	93.6	115.4	140.8	119.7
Change over previous year	%	17.2	28.7	30.8	14.3	19.5	23.2	22.0	-15.0
Goods Imports	US\$ bn	47.1	65.9	91.3	111.4	134.6	162.0	193.7	135.6
Change over previous year	%	23.7	39.9	38.5	22.0	20.8	20.4	19.5	-30.0
Goods Trade Balance/GDP	%	-2.7	-4.5	-5.8	-6.8	-7.7	-7.1	-7.1	-2.6
Current Account Balance/GDP	%	-0.3	-2.5	-3.7	-4.6	-5.9	-5.8	-5.6	-0.7
Foreign Exchange Reserves	US\$ bn	26.8	33.6	36.0	50.5	60.9	73.3	71.0	62.8
Import Coverage	months	6.0	5.4	4.2	4.9	5.0	5.0	4.0	5.0
Gross External Debt/GDP	%	56.0	48.0	41.2	35.1	39.1	37.9	37.3	48.0
Gross External Debt/Exports (G&S)	%	240.6	203.5	174.7	161.2	174.2	172.9	158.0	193.6
Public External Debt/Exports (G&S)	%	154.4	131.6	102.9	79.6	71.8	60.5	50.5	59.8
Short-term External Debt/Total Debt	%	12.6	15.8	19.7	22.6	20.6	17.3	18.3	17.8
Forex Reserves/Short-term External Debt	times	1.6	1.5	1.1	1.3	1.4	1.7	1.4	1.2
<b>DSR</b>	%	47.12	39.2	35.3	38.2	33.2	32.4	29.0	42.7