2008-38
November 27, 2008

Republic of Turkey

Foreign LT: BB-/Stable, Local LT: BB-/Stable

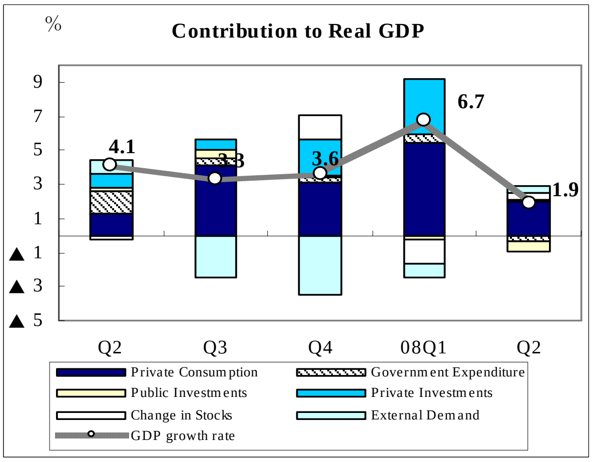
《Rating Perspective》

Positive Factors

- Progress on IMF-led economic reforms
- Progress on reforms geared for EU membership
- Turkey's geopolitical importance
- Improving macroeconomic performance

Negative Factors

- Weak fiscal position and heavy public debt burden
- Heavy external debt
- Impact of unstable political situation in Iraq



<Update: from August to October 2008>

Positive Factors

- Nothing in particular

Negative Factors

- The real GDP growth rate declined steeply to 1.9% (y-o-y) in 2Q of 2008 from 6.7% in 1Q.
- The growth of industrial production index decelerated to -5.5% (y-o-y) in September (3.4% in July and -4.1% in August).
- The current account deficit in the eight months of 2008 widened to USD34.8 billion from USD23.8 billion in the same period a year before.
- Stock prices (ISE-100) fell sharply to YTL23,495 on November 18, down 59.7% from the latest peak at YTL58,232 on October 15, 2008.
- Turkish lira substantially depreciated to YTL1.654 against the dollar on November 18, 2008, down 44.4% from the latest peak of YTL1.145 on January 11, 2008.

<Outlook and Points to Watch>

The Turkish economy losing steam. Its relations with the IMF need to be watched

(1)The Turkish economy, which posted an unexpectedly high 6.7% real GDP growth rate in 1Q of 2008 mainly on recovery of domestic demand, decelerated to 1.9% in 2Q due mainly to the impact of an interest rate hike by the central bank and an intensified political turmoil as the consumer confidence went on deteriorating under mounting inflationary pressures. While the economy was slowing down, both the stock prices and the Turkish lira took a battering amid the global financial crisis following the collapse of Lehman Brothers in September. The real GDP growth rate for 2008 is expected to settle at the 2.0% level. For 2009, the economy is likely to further slow down due to the impact of the slumped European economy, Turkey's main export market.

(2)Turkey's standby agreement with the IMF was successfully completed in May. However, given the capital outflow caused by the global financial crisis and the country's widening current account deficit, its relation with the IMF remains still significantly important. Although its economic fundamentals have considerably strengthened as compared with a few years ago, under the extraordinary situation where the global financial system seems to have fallen into a systemic risk, Turkey will need to conclude a new arrangement with the IMF as soon as possible in order to improve its international confidence and calm down the market turmoil at home. JCR will keep a close watch on the development of Turkey's relations with the IMF and the country's foreign currency liquidity position along with possible impacts on its credit

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worthiness.

(3)On the political front, the worst crisis has been narrowly averted after the constitutional court turned down the state prosecutors' demand to close the ruling Justice and Development Party (AKP) in July. Future developments need to be watched to see whether this ruling means that Turkey has made a historical step forward to overcome the fatal antagonism between the secularism and the Islamism.

<Topics: EU Progress Report 2008 on Turkey>

(1) On November 5, the EU released its 2008 Progress Report on Turkey. It was a regular review of progress made by a candidate state with its political and economic reforms in preparation for membership. As in the previous year's report, the EU generally made a positive assessment of the improved stability of the Turkish economy while pointing out the necessity of further efforts for political reforms. The report made the following points:

(2) As regards the existence of a functioning market economy among the economic criteria, Turkey broadly implemented the economic policy agreed with the European Commission and international financial institutions and successfully completed its standby arrangement with the IMF in May 2008. Although the domestic political crisis sometimes hampered the decision-making process with regard to reforms, the presence of a consensus on economic policy essentials between government agencies has been maintained and coordination has improved. On macroeconomic stability, GDP growth slowed down in 2007 due mainly to deceleration of domestic demand caused by a tighter monetary policy. In the first half of 2008, economic growth went on decelerating, due to combination of weaker aggregate demand and the global financial crisis and domestic political developments. However, overall economic performance demonstrated that the foundations and resilience of the Turkish economy are substantially stronger today than some years ago. Although higher oil and commodities prices put pressure on Turkey's current account balance, long-term capital inflows remained high. Turkey's external position remained solid throughout 2007 and the first half of 2008. However, the global financial crisis has necessitated an adjustment of Turkish asset prices and the currency value. The existence of sizable external financing needs makes Turkey potentially vulnerable to changes in the investor sentiment.

(3) Meanwhile, labor market conditions remained challenging. Job creation continued to be hampered, in part, by labour market rigidities, by the skills mismatch between labor demand and supply and by the cost of hiring and firing. Price stability has weakened significantly over the last year, partly due to external factors. Fiscal performance has been satisfactory, although the government missed its 2007 fiscal targets. Fiscal targets for the first half of 2008 have been met, due in large part to the higher revenue. In June 2008, the authorities announced the introduction of a five-year (2008-2012) medium-term fiscal framework. Under this program, the public debt to GDP ratio is projected to decrease from around 39% in 2007 to 30% in 2012 with a primary surplus decreasing from 3.5% of GDP in 2008 to 2.4% of GDP in 2012. On legal system, the legal environment continues to pose practical challenges and creates an obstacle to a better business environment. The financial sector grew steadily in 2007 and 2008. In spite of severe bouts of instability during 2007-2008 the financial sector has shown remarkable resilience.

(4) As regards the capacity to cope with competitive pressure and market forces within the Union among other economic criteria, macroeconomic stability has been broadly preserved. Financial market turbulence and domestic political developments added some uncertainty to the business environment, but at the same time underlined the economy's improved shock resilience. On human and physical capital, the authorities continued to implement the educational reform program. However, there still remain significant challenges such as the problem of the capability gap between students. On economic integration with the EU, it remains Turkey's largest trading and investment partner.

(5) Regarding political criteria, the report appreciated certain efforts and improvement by Turkey in various areas including public administration reforms, civilian oversight of the security forces, judicial system, anti-corruption policy and observance of international human rights law. However, it also pointed out the necessity of further reform efforts.

Republic of Turkey: Main Economic Indicators

		2002	2003	2004	2005	2006	2007	2008f	2009f
Real GDP growth	%	6.2	5.3	9.4	8.4	6.9	4.5	2.4	1.2
Unemployment Rate	%	10.3	10.5	10.3	10.2	9.9	9.8	10.0	10.5
CPI	%	47.2	25.5	8.6	8.2	9.6	8.7	10.7	9.0
Interbank Money Market Rate (December avg)	%	44.0	26.0	19.1	13.6	17.5	16.0	16.8	15.8
Government Primary Balance/GDP	%	3.2	4.0	4.7	5.8	5.7	4.2	3.9	3.8
Government Deficit/GDP	%	-11.6	-8.8	-5.4	-1.3	-0.4	-2.0	-1.8	-1.6
Public Debt/GDP	%	73.0	64.5	58.3	52.3	46.5	39.9	39.9	38.0
Exports	US$ bn	40.1	51.2	67.0	77.0	91.9	113.2	149.9	172.4
Change (year on year)	%	16.7	27.6	30.9	14.8	19.5	23.1	32.5	15.0
Imports	US$ bn	47.4	65.2	90.9	110.5	133.3	160.7	208.8	236.0
Change (year on year)	%	24.4	37.6	39.4	21.5	20.6	20.5	30.0	13.0
Trade Balance/GDP	%	-3.1	-4.6	-6.1	-6.9	-7.8	-7.2	-8.6	-9.6
Current Account/GDP	%	-0.9	-2.8	-4.1	-4.9	-5.9	-5.7	-7.2	-8.0
Foreign Exchange Reserves	US$ bn	26.8	33.6	36.0	50.5	60.9	69.0	61.7	55.3
Import Cover	Month	5.9	5.5	4.2	5.0	5.1	4.7	3.3	2.6
Gross External Debt/GDP	%	56.0	48.0	41.2	34.9	38.7	37.4	45.4	54.8
Gross External Debt/Exports (G&S)	%	240.6	207.0	177.6	162.9	175.1	174.2	167.7	172.3
Public External Debt/Exports (G&S)	%	156.1	133.8	104.5	80.9	73.0	61.4	50.0	45.2
Short-term External Debt/TTL External Debt	%	12.6	15.8	19.7	22.0	19.7	16.9	16.4	16.6
Foreign Exchange Reserves/Short-term External Debt	Times	1.6	1.5	1.1	1.4	1.5	1.6	1.2	0.9
DSR	%	47.1	39.2	35.3	38.2	33.2	32.0	29.0	28.0

Source: Treasury, Central Bank, JCR's forecast

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Note: All references to GDP are based on the revised national accounts data released on March 8, 2008.