

# **TURKISH ECONOMY: NOVEMBER 2005 SNAPSHOT**

## **Summary**

1. Turkey has been able to achieve macro-economic stability under the AKP government and started accession negotiations with the EU on 3 October 2005. The government signed a new three year stand-by agreement with the IMF in May this year. The IMF and EU anchors have helped record substantial increases in FDI inflows this year.

## **Growth**

2. The Turkish economy has recovered remarkably quickly from a financial crisis in 2001. The economy grew by 7.8% in 2002, 5.9% in 2003 and 9.9% in 2004. The Turkish economy recorded the highest growth rate among OECD countries in 2004. Economic growth slowed down to 4.3% during the first half of this year, but full year growth is expected to reach 5%, which is in line with official projections. The main drivers behind growth in the last two years were an increase in private sector investment and domestic demand.

## **IMF Program**

3. The government has established a strong track record over the last four years in implementing its IMF reform program, which was replaced by a new \$ 10 billion Stand-By Arrangement in May. Turkey will make \$ 20.8 billion in repayments to the IMF over the next three years.

## **Inflation**

4. The policies of the newly autonomous financial institutions (such as the Central Bank and Banking Regulation & Supervisory Agency - BRSA) have had a significant impact on the economy. Consumer Price Inflation (CPI) fell from 73.2% in January 2002 to 7.5% as of October 2005.

5. The Central Bank introduced a new currency (the New Turkish Lira YTL) on 1 January 2005 and has adopted a new monetary policy framework, which will lead to the formal adoption of inflation targeting in 2006. The Bank believes year-end inflation will come out in line with the 8% target despite rising oil prices and global volatility.

## **Banking Sector**

6. Perhaps the most significant aspect of the economic reforms has been the rehabilitation of the banking sector. The Banking Authority (BRSA) completed a three-stage audit of banks' balance sheets in 2002. Many banks required capital injections from shareholders in order to meet strict capital adequacy criteria. Around twenty failed banks were taken into the Savings Deposit Insurance Fund (SDIF) for sale, merger or liquidation. The cost of this rehabilitation is estimated at \$47 billion (30% of 2002 GNP).

7. A stronger supervisory role for the BRSA has reduced the likelihood of another banking crisis. Macroeconomic stability and the prospect of "EU convergence" has contributed to an increased interest from foreign banks in the Turkish banking sector. A number of recent mergers included BNP Paribas-Turk Ekonomi Bank, Koc-Uni Credito and Yapi Kredi Bank, Garanti Bank-General Electric Consumer Finance and the acquisition of Disbank by Fortis. Falling interest rates and a decreasing reliance on government debt instruments have encouraged local banks to adopt an aggressive policy on property and consumer loans. The government is expected to pass the legislative framework for the introduction of a mortgage system next year.

8. The government has recently passed a new Banking Act to bring local banking practices closer to EU standards. The law will introduce strict rules regarding the "fit and proper" criteria for bank ownership, restrict risk exposure to group companies and enhance the supervision of the sector.

9. State banks still have a large share of the market (around 10%), which distorts competition to an extent. The government is expected to announce an action plan for the privatization of state banks soon. The Banking Regulatory and Supervisory Agency estimated that the share of foreign participation in the sector might reach 20% by the end of this year. Also the abolishment of a full state guarantee on deposits in July 2004 (guarantee was limited to deposits of up to \$ 35,000) was an important factor in enhancing competition in the sector.

## **Fiscal Policy**

10. The early elections in November 2002 had a negative effect on the outgoing government's fiscal discipline. The overall fiscal performance of the AKP government in the last three years, however, has been quite successful. The budget recorded a primary surplus of 6.9% of GNP (over the 6.5% target) in 2004 and is expected to record a 6.5% primary surplus this year. The fiscal position is somewhat distorted by the unregistered economy and a large social security deficit. The government is committed under the new IMF program to enact a pension reform law in 2006.

11. The government submitted the 2006 budget to the Parliament in October. The draft budget reflected tight fiscal policies for the fourth year in which the primary surplus

target was set at 6.5% of GNP. In line with the change in legislation, the budget, for the first time, included macroeconomic and budgetary projections for the coming three years and covered all public sector entities in order to make it more transparent.

### **Debt Sustainability**

12. Turkey's net debt/GNP ratio fell from 79% in 2002 to 63.5% in 2004, helped by the appreciation of the local currency and a rapid decrease in interest rates (from 76% during the Iraq war to the current 14% level). The government's target is to reduce the debt stock to the 60% level (in line with Maastricht criteria) by the end of 2006. Due to continuing tight fiscal policies and the successful privatization performance the debt stock is expected to decrease in nominal terms starting from next year. The market demand for Treasury debt has remained high. Some of the foreign pension funds, which did not enter the Turkish market because Turkey's credit rating was below investment grade, have invested in Turkish debt instruments this year. This helped the government to extend the maturity of domestic borrowing (up to 5 years) and reduce interest rates more aggressively than original estimates. Also, local corporate and individual investors have substantially increased their holdings of Treasury papers.

### **FDI**

13. Turkey has experienced some difficulties in the past with attracting significant volumes of FDI. The average FDI inflow per year has been less than \$ 1 billion since the 1980s. The year 2001 was an exception as Turkey's FDI inflow reached \$3.2 billion, but more than half of this was accounted for by Telecom Italia and HSBC acquisitions. The AKP government enacted a new FDI law in 2003, which removed the need for investment permission. The company registration procedure has also been considerably simplified.

14. Foreign interest in the Turkish market has rapidly increased since 17 December 2004 when Turkey was given a date to start negotiations with the EU and inflows have accelerated since the start of accession negotiations on 3 October. The projection for FDI inflows this year was \$ 5.2 billion.

15. High levels of local demand for quality products make Turkey an attractive proposition for foreign firms prepared to take the investment risk. The local Marks and Spencer franchise opened their third store in Ankara in 2003, Tesco invested in the local supermarket chain Kipa and Cadbury's Schweppes took over the local confectionery company Kent. A BP led consortium has almost completed the construction phase of the \$3 billion trans-Turkey Baku-Tbilisi-Ceyhan (BTC) oil pipeline. Vodafone has also expressed interest in the sale of the second largest GSM operator.

## **Privatization**

16. The government has completed \$ 20 billion worth of privatization projects so far this year. The size of privatization projects completed this year was double the amount in the last 20 years.

17. The 2005 privatization program included the blocksale of 55% of Turk Telecom (which was purchased by Saudi Oger), the blocksale of 46.1% of iron and steel company Erdemir (which was purchased by the Army Pension Fund Oyak); and the blocksale of 51% of oil refinery Tupras (which was purchased by local Koc Holding in partnership with Shell). The privatization program also included public floatation of some state assets such as Turkish Airlines (raised \$ 190 million) and Tupras (raised \$ 459 million) and a few other contracts like the privatization of the vehicle inspection stations (at \$ 614 million) and the transfer of operating rights of Istanbul Ataturk Airport for 15.5 years at \$ 3 billion.

Source:  
British Embassy  
Economic Section  
November 2005