The Turkish Economy

The Turkish economy is thus far following almost verbatim the ‘stylized facts’ of an exchange rate based stabilization program. The common characteristics shared by countries that have implemented a stabilization program with the exchange rate as a nominal anchor as its centerpiece are a sharp decline in interest rates, rise in bank loans to consumers and firms, a subsequent consumption boom led by expenditures on durables, and a gradual appreciation of the local currency in real terms which will need to be checked if the stabilization effort is to be judged a success several years hence.

Figure 1 Leading Indicators 87Q1-00Q1(seasonally adj.)

Source: SIS, GR

Interest rates did, indeed, fall dramatically at the start of 2000 as the interest rate parity condition would have dictated. Overnight rates hovering around a mean of 73%pa prior to the stabilization program fell to around 34% in 2000. With the cost of foreign currency borrowing in TL terms declining in line with the lower TL per euro-dollar currency basket devaluation rate (year on year loss in the value of the Lira versus the basket was due to slow from over 60% to just 20%), it was only natural for the local price of money (ie; interest rates) to converge towards the change in the price of local money in terms of foreign currency. In simple terms, the exchange rate anchor has acted as a benchmark towards which all other prices in the Turkish economy should gradually converge. A lower cost of borrowing acts through several channels to boost economic growth. Interest rates act, in a sense, as an intertemporal lever which distributes consumption over time. A decline encourages consumption spending as households choose to apportion a lower share of income to savings. Firms then typically race to meet higher demand by raising investment expenditures, which have incidentally become more affordable with the steep interest rate fall. The consequence of this virtuous circle is a rise in national income.

Table 1— Composition of Investment Expenditures, % share in total

	1999	2000
Gross Fixed Capital Formation	Q1	Q1
Public Sector	14.6	13.6
Machinery (Public Sector)	4.3	5.3
Construction (Building)(Public Sector)	3.3	3.1
Construction (Other) (Public Sector)	7.0	5.1
Private Sector	85.4	86.4
Machinery (Private Sector)	49.3	54.8
Construction (Private Sector)	36.2	31.7

Source: CBRT

Table 2— Composition of Consumption Expenditures, % share in total

	1999	2000
Consumption Expenditures Breakdown	Q1	Q1
Food and Beverages	32.7	32.4
Durable Goods	16.9	19.6
Semi-Durable Goods	18.8	17.7
Energy, Transportation, Communication	14.8	13.6
Services	7.8	8.1
Ownership of Dwellings	9.1	8.6

Source: CBRT

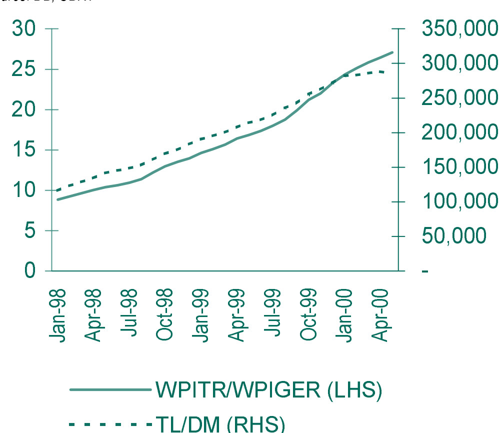
Turkey, at present, stands on the consumption boom phase. Capacity utilization rates in manufacturing industry have been on a rising trend, but sufficient slack must have remained as of Q1 so that investment spending is yet to register a veritable boom. An everpresent

pitfall under the present exchange rate regime is that more and more of the rise in demand may come to be met by foreign goods; ie; imports. The steady slide of the current account into negative territory may perhaps suggest that Turkey should now trod with care to avoid significant imbalances in the external sector.

This may well be true but several caveats need to be attached. First, the current account deterioration is in some part due to a tripling of oil prices from last year (which may fall following a pledge to raise output by OPEC and the oncome of Summer months). The decline of the Euro versus the Dollar may have had a hand as well. Second, 1999Q1 was the nadir of last year's recession, and indeed, were it not for the August earthquake economic recovery would have come about sooner. Regardless, 2000Q1 percentage rise figures reflect a low baseline effect carried over from last year. Third, the current account always displays a seasonal nature, with Q3 regularly registering a surplus or a very small deficit. Fourth, CBRT had announced at the onset an exit strategy from the daily peg regime. The regime is due to be diluted with a band by mid-2001 and abandoned altogether in 2003, eliminating exchange rate inflexibility. Last, but not least, the authorities are aware of the potential external imbalance problem and yet have time to react with appropriate fiscal tightening measures. In the meantime, the scale of economic recovery is in doubt by some economists. Our seasonally adjusted leading indicators graph confirms the resurgence of growth by exhibiting historically high levels. Direct, up-to-date evidence of solid economic growth is present in industrial production figures. A first look at the data reveals a modest average increase of 3.6% in the first five months of 2000 in comparison to 1999. Once the decline in refinery output—as a result of quake damage to a Tupras site in August 1999– is removed from the index, a completely different picture emerges. Not only has there been growth, but it has indeed been vigorous at some 9.5% from 1999. This, of course, will oblige the authorities to cool down the economy if the rate of inflation is to come down faster. High-end forecasts indicate that wholesale prices will rise by 31.4% y-o-y in 2000, somewhat higher than the 20% y-o-y official target, but far better than the 60% range at the start of the year.

Figure 2 Relative Producer Prices & TL/DM

Source: DB, CBRT



The Banking System

Financial institutions were one of the few sectors that actually grew in 1999. In fact, the rate of growth in the sector (5.34%) was the second highest (growth was 6.94% in 1998) since proper national income accounting statistics began to be published in 1987. Indeed, 1999 imputed bank service charge growth of 6.12% was the highest in at least two decades, closely followed by 6% in 1998. Yet, 1999 was also a year when several banks came close to collapse only to be weeded off by the government and put under the wing of the Savings Deposit Insurance Fund. In 1999, banks that concentrated on lending to the government won. Banks with loans to firms did less well. According to the CBRT, 9.7% of outstanding loans were categorized as non-performing in January 2000.

Tablo 3– Factors affecting financial sector growth

Correlation of Financial Sector Growth With	Financial Sector
External Debt	0.02
Govt. Consumption	0.63
Private Consumption	0.42
GDP	0.27
GNP	0.29
Industrial Output	0.63
Investment Spending	0.43
Priv.Sector Machinery Investment	0.40
Real Interest Rate	0.61
Interest Income	0.94

Source: CBRT, Garanti Research

Table 4—% Change in savings as of June 9, 2000		
% Change	31/12/99	25/6/99
Commercial sight deposits	-%13,51	%68,12
Savings sight deposits	%3,05	%102,95
Other sight deposits	%35,03	%129,54
Total sight	%5,21	%96,26
Commercial time deposits	-%15,71	%43,05
Saving time deposits	%3,51	%51,38
Other time deposits	-%3,91	%33,86
Total time deposits	%0,08	%47,52
Time & sight deposits	%0,81	%53,16
FX accounts in TL terms	%28,54	%96,98
REPO	%97,35	
Total (excl repo)	%13,56	%73,21
Total (incl repo)	%21,66	

Source: CBRT

The pendulum will now swing the other way in 2000. Banks must begin to expand consumer and business loans in order to make profits, but pitfalls may lie further down the line. While it is true that Turkey stands in the expansionary phase of a new trade cycle, a downturn should be expected within five to ten years at the latest. A slowdown would, naturally, lead to higher amounts of bad loans. Banks should therefore be extremely wary of overextending credit as was the case in Brazil in the aftermath of the stabilization episode there. The present trend is that credit to the private sector as a proportion of national income will rise while loans to the government will level off. The initial overall effect is certain to be a decline in the ratio of domestic credits to national income which will doubtless recover as the financial system matures in the coming years.

Banking sector assets grew by 14% in Dollar terms in 1999, to reach US$ 133.5 bn. Total sector assets in proportion to GNP grew from 69% to 92%. State owned commercial banks continue to dominate the sector both in terms of TL assets and liabilities, while private sector commercial banks have the largest share in FX assets and liabilities. State commercial banks, excluding banks taken over by the Savings Fund, command 45% of total TL assets and 18% of total FX assets. The comparable figures for the private sector commercial banks are 39% and 66%, respectively. A similar picture exists on the liability side. State run commercial banks accounted for 54% of all TL liabilities, while private commercial banks had 36%. The level of asset concentration in the banking sector increased for the largest five banks to 46%, but actually fell for the largest ten banks to 64% in March 2000, a four point drop from year-end. There was some improvement in the maturity structure of deposits in 1999. The share of demand deposits, 1 month and 3 month time deposits declined as a share of total TL deposits, while the share of deposits with maturities from 6 to 12 months increased. FX deposits displayed a shift from demand deposists toward time deposits. The pertinent maturity rose marginally from an average of 3 months to 3.4 months. Shareholders'

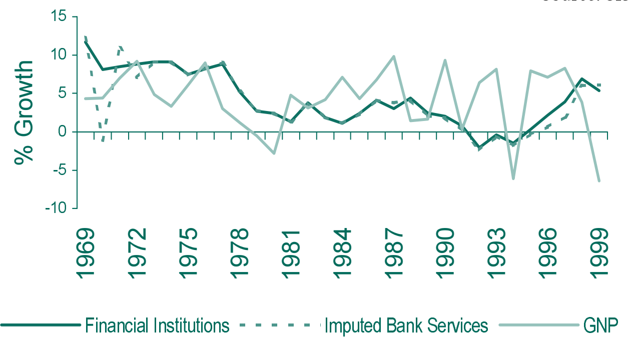
Table 4– Credit to Private sector			
	Credit (TL billion)	Nominal % Change	WPI % Change (1987 base)
1986	10,039		-
1987	15,379	53.2%	-
1988	22,395	45.6%	77.1
1989	37,817	68.9%	64.3
1990	65,540	73.3%	60.4
1991	108,186	65.1%	71.1
1992	196,164	81.3%	66.0
1993	359,178	83.1%	71.1
1994	616,658	71.7%	125.5
1995	1,434,983	132.7%	78.9
1996	3,372,212	135.0%	76.5
1997	7,583,996	124.9%	99.2
1998	12,066,233	59.1%	68.4
1999	17,389,421	44.1%	67.0
2000	23,997,401	38.0%	-
2001	30,932,650	28.9%	-
2002	37,737,833	22.0%	-

Source: IMF, CBRT (2000-2002 figures based on IMF projections; shaded areas represent recessions)

equity (excluding net income) decreased by 41%, to US$ 3.6 bn. The decline is largely due to the huge losses of the banks in the Savings Fund. Therefore, sectoral losses in 1999 rose from US$ 1.3 bn to US$ 4.7 bn in 1999. Inclusion of 1999 and 1998 income lifts shareholders' equity to US$ 7.8 bn, down by 26% compared to 1998.This was despite the fact that paid-in capital increased by 13% and reserves increased by 14%.

Figure 3 Whither Banking Sector Profits ?

Source: SIS



The performance of banks that were taken over by the SDIF limited the growth in shareholders' equity for the system as a whole. Banks continued to increase their open position to finance the purchase of high return local public debt instrumens. The foreign exchange position –open position- of the banking sector widened by 58% and reached from US$ 8.4 bn to US$ 13.2 bn. The limits brought to the ratio of FX position to capital base should limit further expansion in the open foreign exchange position.

Capital Markets

Foreign interest in Turkish paper will likely remain high because foreign investors look at their returns in US$ (or FX at any rate) terms. The Turkish authorities will continue to abide by the present tablita fixed exchange rate regime which ensures that the TL will be devalued by 20% in 2000(as of this writing in June the devaluation rate of the TL versus the currency basket on an annual basis going a year forward is in the low teens) against a Euro-Dollar currency basket (0.77Euro+1 US$). With government paper yielding 35%-40%, and by taking into account Euro-Dollar parity swings (or by hedging), foreigners can lock in relatively high FX returns. The successive rate hikes in the US may have lowered the spread somewhat, but returns from Turkish TL debt instruments still remain enticing in our view. The Central Bank of Turkey has sufficient reserves to continue the present exchange rate regime with the support and credibility that an IMF stand-by program will lend for the next two years. The switch from 2001 July from the present crawling peg to an ever widening crawling band regime, and then a managed float by 2003 means that significant external imbalances will not be allowed to threaten the gains from the stabilization scheme. On the equity side, the sharp decline in interest rates led to an equally sharp rise of the Istanbul Stock Exchange-100 index. The market entered a period of correction in the Summer as investors cashed in some of their gains. This year has seen an explosion in terms of international and domestic public offerings (IPO). The increase in the supply of shares has put downward pressure on the ISE in the short term, but the deepening of the market will no doubt raise Turkey's weighting in foreign portfolios. Foreign transaction volume at ISE reaches US$2.1 bn in June. The IPO boom was crowned by the sale of a portion of Turkcell shares which are now listed both in the NYSE and at the ISE.

Foreign confidence in the present reforms has come in the form of Sovereign rate hikes. The long overdue upgrade of Turkey's long term credit rating first came on April 25th. Standard and Poor's pulled its rating up a notch from B to B+. The outlook remained positive and a further upgrade could come in 2001. S&P rates Turkey one scale below the comparable Moody's and Fitch IBCA rating. Fitch IBCA raised Turkey's long term credit rating from B+ to BB– on April 27th. A Moody's upgrade of the Turkish Sovereign rating from Ba3 to B1 is also imminent in our view. In fact, Turkey's credit rating will be reviewed in August by Moody's, according to company sources. The agency has noted that the government had proved that the coalition government works in harmony.