

Banking on Turkey, October 21, 2008

Slide 1. Title Slide

Good morning.

- **The global economic downturn and financial turmoil mean that economic growth will slow down in Turkey. There will be much slower growth, even if probably not a recession: lower income growth, less job growth, and a major challenge for fiscal, monetary, and social policies. – This is the first of two points I am going to make this morning.**
- **My second point is this: Turkey has a good track record since 2001. It is a different country today from the Turkey in 2001. Turkey's fundamentals remain strong, and Turkey remains a good investment—as long as Turkey continues those same sound policies and long-term reforms that have already helped make Turkey perform well and make it more resilient than in the past.**

Let's now first look at how current global economic and financial developments affect Turkey.

Slide 2. Growth slide

Even before the current turmoil, economic growth was already slowing down.

- **Since 2000 developing countries have outpaced high-income countries**
- but the year on year changes of the two groups still track each other...
- **developing countries will continue growing faster, but the world economy is integrated**, and growth is now slowing down in both groups of countries.
- **So there is some de-coupling of levels of growth, but there is no de-coupling of the rates of change and the trends in growth.**

Slide 3. Spreads since 1997

The **simplest indicator** of the effect on emerging markets is **sovereign spreads**. This chart shows that sovereign **spreads in emerging markets overall (the EMBI+ line) have widened—and that Turkey's spreads have moved closely in line with overall emerging markets**

- **Since early September the EMBI+ has risen by over 300 basis points.** Currently spreads are in the 600s.

- That's quite a big swing—the biggest and most rapid since 1999-2002.
- However, so far we are nowhere near the effects on emerging markets of the Asian crisis and its aftermath: in 1998 the EMBI+ widened by over 800 bps in a month and got close to 1700 bps.
- **Indeed, the flight to quality may continue, and policy makers must be prepared for its possible effects.**

Slide 4. Capital flows

As spreads are widening, capital flows to emerging markets are declining.

- Flows fell by about 1/3 in the first 3 quarters of 2008 compared with 2007.
- And this fall will likely worsen in the near term.
- **This matters for Turkey** because its private sector depends on access to external finance, and declining capital flows will further affect economic growth negatively—in addition to the impact through trade.

Slide 5. Turkey's financing needs and sources

Turkey has projected gross financing needs of around \$ 140 billion in 2009.

- This includes short-term rollovers, mostly of trade credits. These are likely to remain available.
- Excluding these, **MLT financing needs are about 90 billion:** a lot of money in the current environment.
- FDI has increased much in the last couple of years. FDI flows this year will likely be up to \$15 billion—but next year will likely be lower.

So Turkey is more exposed than most emerging markets to global liquidity movements. This is the conventional wisdom, and it's true--partly.

Slide 6. Financial Markets--Triangle.

Since September, that is, since the beginning of the recent most serious financial turmoil, the Turkish Lira substantially *underperformed* other emerging market currencies, but Turkish spreads and stocks have performed *in line with* Emerging Markets.

- This chart compares Turkey with the EMBI+ countries' average declines—in the three major financial markets: spreads in bond markets, currency valuation (depreciation or appreciation), and stock exchange movements—all relative to the average of emerging markets.

- Turkish **spreads** widened, but by less than the emerging markets average. From **September 5 – October 17**, last Friday, Turkey widened by 244 bps, EMBI+ by 304 bps.
- The Istanbul stock exchange was hit by increasing international risk aversion, but **not dramatically more than other EM stock exchanges** (investors have pulled out of EM equities throughout 2008).
- **So Turkey has been relatively resilient during the last several months.**
- **Indeed, Turkey has become increasingly resilient during the last several episodes of market volatility**—much more resilient than in the past—due to the major reforms that have completely reshaped the economy since 2001.

But the Turkish lira has become much more vulnerable recently.

- Lira 1.52 last Friday Oct 17 versus 124 in early September, 20 percent down. 12 month forward price 1.74 (as of yesterday Mon Oct 20). Of course the numbers change daily.
- **Markets are clearly concerned about the currency, especially because of the high CAD, Turkey's Achilles Heel.** The prices that Turkey pays for its local currency finance also reflect that concern.
- **And there is a risk of a generalized loss of market confidence**—despite the strong past reforms and despite the strong fundamentals.

So: How will things play out in Turkey? And what to do to reduce risks?

Let's look in turn at the 3 key sectors and transmission channels: the financial sector; public sector balances; and 3) the real sector and external accounts.

Slide 7. NPLs in the Turkish financial sector, 2003 to today

The 2001 crisis had its origins in the financial sector. Since then:

- **Regulation and oversight have been overhauled.** The Central Bank is independent. The Banking Regulation and Supervisory Agency has been built and strengthened.
- Banks were privatized and recapitalized, while others were allowed to fail. **Today, banks are well capitalized.** Capital adequacy ratios are about double the regulatory requirement of 8 percent
- Banks are also overall **well run today and profitable.** **As this slides shows, non-performing loan ratios are very low.** Even though delinquencies will go up somewhat.

Slide 8. Turkish credit to the private sector in international comparison

One reason for the health of Turkish banks is that, while **credit** has expanded, it **has not expanded too fast**. As this chart shows, credit to the private sector as percent of GDP remains low in Turkey by international comparison.

- Also, Turkish banks finance themselves through deposits, **not wholesale**.
- And the **financial system is not exposed to mortgage-backed securities**.

Slide 9. Limited foreign controlling ownership

Contagion through foreign ownership also poses limited risks for Turkey.

- Foreign entities control **just over 1/3** of assets in the financial system.
- But Turkey's **larger banks are only minority owned**. For example, Citi and GE own minority stakes in large Turkish banks. The National Bank of Greece, Dexia, HSBC and ING have controlling interests in smaller banks.
- So foreign ownership poses no major systemic risk.

Of course, banks in Turkey rely on trust and confidence like everywhere else. They are not immune from market risk. For instance, if **nominal interest rates** rise rapidly, the assets of banks with large holdings of government paper will contract, and their lending will **contract somewhat**. But the financial sector in Turkey can likely withstand a downturn without suffering systemic risks.

It is important for Turkey to build on and expand the reforms that have driven this resilience and further strengthen regulation and oversight.

- Banks are well capitalized and profitable, as I mentioned.
- BRSA has raised **provisioning requirements**, strengthened **capital adequacy**, and enhanced offsite **supervision** efforts.
- Critical steps looking ahead include (1) a new capital markets law that harmonizes regulations with the EU; and (2) adoption of the Basel II capital adequacy framework (though timing will be important).

Slide 10. Fiscal balance

- Let's now look at the public sector. As this slides shows:
- Turkey's budgets have shown a substantial **primary surplus since 2003**.
- And recent budgets have been close to **overall balance**.

Slide 11. Gross public debt

As a result, Turkey's public sector is much less vulnerable than in 2001.

- Then currency depreciation hit the public sector, which was highly exposed.
- **But consistently prudent fiscal policy have brought down Turkey's public debt to around 40 percent today...**

Slide 12. Evolution of currency structure of public debt

... and the share of foreign currency in total debt has fallen to 30 percent

The now much lower public debt / GDP ratio, and much lower external public debt, are great achievements. At the same time, because Turkey has a high CAD high and private sector debt is rising, **a further reduction in public debt will help greatly.**

I would like to highlight here the importance of full implementation of Turkey's sound Medium-Term Fiscal Framework, and also of the Social Security and Universal Health Insurance Reform.

The introduction of a Medium-Term Fiscal Framework has been critical for maintaining sound fiscal policies.

- Turkey has just announced a 2009 budget consistent with its Medium Term Fiscal Framework targets, and future planned budgets are designed to **keep bringing down the public debt.**
- Adhering to the medium-term fiscal framework will be crucial.
- **A continued sound and cautious fiscal policy is especially important in Turkey—to help increase aggregate savings, to reduce the CAD, and to reduce external vulnerability.**
- The authorities are considering developing a fiscal rule—this is welcome.

Slide 13. Social security reform

- **Turkey's now effective social security reform** is a quantum leap forward.
- The reform is **stronger than many** of those in more developed economies.
- This slide shows the very large long-term fiscal savings from the reform.
- Implementing it fully will help achieve **long-run fiscal sustainability**, and it will help **credibility with investors.**

Slide 14. CAD and “non-energy” CAD

- We have looked at the financial sector and the public sector. Let’s now look at the private sector and external balances. **This slide show that Turkey’s major vulnerability is its high Current Account Deficit, of which the largest part stems from energy imports.**
- **Oil prices coming down will help...**
- Still, we expect Turkey’s CAD to **remain around 6 percent of GDP.**

Slide 15. **External debt** [graph assumes 3-5% growth, continuing inflows]

Most external debt is taken on by the corporate sector, and this will likely continue.

- The **refinancing** of corporate FX liabilities will become more **difficult**.
- This will mean higher **refinancing** cost; some increased local currency borrowing; probably less investment

What’s the likely effect of all this?

Slide 16. FX borrowing by sector

Well, FX borrowing in Turkey is spread **broadly across sectors**. **So there’s there’s likely to be a broad balance-sheet led slowdown in Turkey, with implications for jobs, that will affect many sectors.**

- Financial and public-sector strengths will help mitigate the effect...
- ...and the low **leverage ratios** of Turkish companies will also help (debt-to-equity ratios on the ISE are below one).
- Nonetheless, a substantial, broad-based slowdown in economic growth.

And, on a cautionary note: if international illiquidity really does require a big CAD correction in Turkey, the bad news is that, by international standards, Turkey’s **CAD is not very sensitive to currency movements.**

Slide 17. Low TL-CAD sensitivity

In Latin America and Asia, a 1% depreciation in the exchange rate means on a average more than a 1% increase in exports. In Turkey it means a 0.2% increase in exports. This means that – potentially at least – the **currency movements** needed to **stimulate exports, reduce import demand,** and the **associated nominal interest rate movements** (that reduce growth) could be significant.

So Turkey is not immune. The primary vulnerability comes through the foreign borrowing and exposure of the private sector.

What is the reform agenda that addresses this external vulnerability?

Most of all, sound fiscal policy and macroeconomic stability. We have already discussed this: fiscal policy is at the heart of securing investor confidence.

In addition, I would like to highlight 2 key areas for medium-term reform: (1) Making it easier to do business and increasing productivity, including labor market flexibility and better education. (2) Improving energy security and efficiency, to help reduce the CAD and also, again, improve productivity.

Slide 18. The private sector wants stability, less informality, and finance

This slide shows those areas that Turkish firms cite most as areas where they face a “very severe” or “major” constraint on operations and growth. [2005 Survey]

- 2 of the 6 top concerns are macroeconomic policy and access to finance—which we already talked about.
- The other 4 are high tax rates, especially labor and social security taxes, tax administration, informal practices, and labor regulations.
- Reforms in all these 4 areas are important to reduce the cost of doing business for firms in Turkey.
- **They are even more important NOW to reduce the impact of the global economic crisis on Turkey’s real economy—people’s incomes and jobs.**

The next 3 slides show this clearly.

Slide 19. Ease of Doing Business ↑ => Growth ↑

Making it easier to do business means on average higher economic growth

Slide 20. Ease of Doing Business ↑ => Unemployment ↓

Making it easier to do business means on average lower unemployment

Slide 21. Ease of Doing Business ↑ => Informality ↓

And making it easier to do business means on average less informality

- Reducing informality is important to create a level playing field for large firms and foreign investors, which are a source of growth, technology transfer and know-how, and foreign finance.

- It is important so workers have social protection.
- And it is important as a source of revenues and **aggregate savings**.
- The government is working on an approach to reducing informality **reflecting international good practice**—which we are supporting.

Slide 22. How competitive is Turkey for doing business?

- **Turkey now ranks 59th among 181 countries in the WB's Doing Business indicators**—and its rank has been moving up over the last years.
- However, neighboring countries such as Armenia, Azerbaijan, Bulgaria, Romania all do better—countries with which Turkey must compete as a destination for business and investment.
- Turkey can, and I am convinced will, do even better.

Let me mention **2 critical reforms for Turkey to ease doing business** and help growth and generate jobs:

1. **Adoption of a modern Commercial Code**—which is now in Parliament.

Slide 23. Turkish employment generation has been low

2. **The second phase of labor reform.**
 - This slide shows that **growth created fewer jobs** in Turkey than elsewhere.

Slide 24. Employment rates

- And Turkey faces a particular challenge in **increasing female employment**.
- Less than a quarter of Turkish women participate in the labor force—that is, less than half the share in the EU 27 countries.

Turkey's rigid labor markets are a major reason for low job creation, and for particularly low job creation for women and for young people.

- The first phase of labor market reform in the summer of 2008 has made a good start—with lower labor taxes, especially for the young and for women.
- **The second phase of labor market reform will be critical, with a focus on labor market flexibility**—including options for short-term and part-time work and severance pay reform.

Slide 25. Education: Focus on Quality

- As we're talking about productivity and labor, one quick word on education: **in the long run, education is probably the most important driver of productivity and of jobs in the long run. And in my view, improving the quality of education and further increasing access to education, especially**

secondary & tertiary education and especially for girls, is probably the single most important long-term public policy challenge for Turkey.

Slide 26. Energy: an emerging bottleneck?

In addition to macro-fiscal policies, we talked about reforms to make it easier to do business and improve productivity, including labor market and education reform.

Continued energy sector reform is a second critical area of medium-term structural reform that gains particular importance in the current global environment.

- As this slide shows, Turkey faces an **emerging electricity supply gap.**
- Moreover, high oil prices, even at current levels, are a key drivers of **Turkey's external deficit and need for foreign finance.**
- **Continued energy sector reform and advances are essential.**
- **Including increased energy investments** to help diversify energy sources, including renewable energy.
- And **including increased energy efficiency** to help reduce the supply gap.

All these are long-term reforms! But they are also important in the short term—because they are signals to markets, and because they take time and, if delayed, take longer and cost more.

I want to close with a picture that illustrates an even longer-term but arguably even more urgent and important challenge: climate change

Slide 27. Climate change agenda

- Turkey is **vulnerable economically to the effects of climate change**
- **A law for Turkey's accession to the Kyoto Protocol is in Parliament. Ratifying it quickly will help Turkey and will help the world.**

Slide 28. **Thank you.** I am happy to take questions.