

ACTIVE ACADEMY 2nd CAPITAL MARKETS SUMMIT
"New Trend: Investor focused Capital Markets"

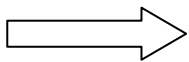
Session: Opening Remarks
April 27th, 2011, Istanbul
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- Good morning. Chairman Akgiray, Ladies and Gentlemen.
- At the outset, I would like to thank the Active Academy for inviting me to this conference and for the opportunity to share with you my views, the views of the World Bank, about the development of capital markets in Turkey.
- **This morning I would like to highlight two main points about capital markets development:**
 - **My first message is that expanding and deepening capital markets and making them more effective and efficient is a priority for Turkey ... and that it is a priority now, for 2 reasons—*growth* and *stability*:**
 - Capital markets development is crucial for sustained and robust economic growth.
 - Capital markets are also important for diversifying and reducing total financial risks in Turkey, and although they carry their own risks of course, they play a critical part in ensuring stability.
 - **My second message is that both the government and the private sector in Turkey can do something to promote capital markets development.**
- **Let me first elaborate on my first point, the message that capital markets development is a priority now for both stability and growth.**
- **Slide 2. To start off, global financial stability is not assured.** This graph shows that global financial stability, as measured in the IMF's Global Financial Stability Map, has improved over the last size months. The bright red line for April 2011 shows a decline in risk and an increase in risk appetite compared with the line for October 2010.

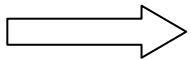
- **However, risks remain significant, especially in advanced economies.**
 - Advanced economies are recovering slowly, some very slowly. There remain unresolved sovereign risks in the Euro Area in particular, which is still under stress.
 - So far there has been no contagion beyond the euro zone zone's periphery, but the risk that financial turbulence expands beyond the euro area remains non-trivial.
 - In many advanced economies, households remain heavily indebted. And the health of financial institutions has not recovered in tandem with the overall economy.
- **By contrast, as we all know, emerging market economies have been recovering quickly. It's a two-speed recovery. And as a result, emerging markets face new challenges and risks:**
 - such as super-rapid credit growth, overheating and inflation risks, spillovers from relatively accommodative macroeconomic policies in advanced economies, and large capital inflows—including growing portfolio inflows that reflect emerging countries' faster growth.
 - This applies in Turkey, in Brazil, in China and elsewhere.
- **In addition, developments in the Middle East and North Africa raise new geopolitical risks and oil and energy supply and price risks.**
 - The price of crude oil rose another 20 percent just in the last three months (from 91 to 108 USD per barrel).
 - Energy price risks affect Turkey a great deal, as Turkey is highly dependent on energy imports.
- **For policymakers in emerging market economies such as Turkey,** the task is to reduce inflationary pressures, limit overheating and a buildup of vulnerabilities such as potential asset price bubbles.
- **The key point now is that deep and broad capital markets, enhance the financial sector's capacity to absorb increased financial flows. They can lengthen financing terms, and diversify and reduce financing risks.**

- So, capital markets development can help increase stability and reduce risks. For Turkey, this is one important lesson from the previous financial crisis in 2001, which was after all a banking crisis. The impact of that banking crisis was compounded then by the absence of a non-bank financial system.
- **Slide 3.** This slide provides a bird's eye view of Turkey's financial sector since 2002.
 - It shows the financial sector has grown overall.
 - It also shows that, the *banking* sector has grown by far the most.
 - At the end of 2010, total banking sector assets amounted to \$657. Turkey's banks account for 88 percent of the total financial sector. They *dominate* the financial sector. And due to highly successful major reforms, Turkey's banks are now not only bigger, but also healthy and sound and resilient.
 - By contrast, the Non-Banking Financial sector stood at TL63 billion, or 6.6 percent of GDP. Mutual funds are the largest part, at 3.5% of GDP (Thailand 16%, South Africa 25%), followed by insurance companies at 2.5 % of GDP (Brazil 8%, Malaysia 17 %), and private pension mutual funds, at 1% (Mexico 8 %).
- **Slide 4.** And correspondingly, three quarters of household financial assets are concentrated in bank deposits.
- The great reliance in Turkey on commercial banks for finance in general has led to excessive *short-term* debt financing, both domestic and foreign, rather than long-term capital market funding.
 - More than 90% of domestic deposits, which account for more than 2/3 of non-equity liabilities, bear a maturity of less than 3 months.
 - 45 % of loans are of a maturity less than 12 months.
- **Slide 5.** And the reliance on banks and the absence of a domestic market for corporate has also meant that corporate funded their long-term financing needs to a very great degree in FX, to the tune of \$ 120 billion in 2010.

- **So the shallowness of Turkey’s non-bank financial system implies more short-term and more FX financing. This means higher risks. And it means less long-term and less domestic financing for growth.**
 - Experience around the world shows that a deep and diverse financial sector, including a substantial non-bank financial sector, is important for sustained strong economic growth, in addition to stability.
 - The Turkish capital markets do not yet fulfill their full potential to support economic growth and stability.
- **Let me now turn to my *second* message this morning—that both the government and the private sector in Turkey can do something to promote the development of vibrant and effective capital markets.**
- **What can be done? Let me highlight 4 key areas:**
 1. The legislative and regulatory framework for capital markets
 2. Instruments
 3. Demand
 4. Supply
- **First, starting with the legislative and regulatory framework:** A sound legal and regulatory framework that is comprehensive and benchmarked against international best practices is a precondition for effective capital markets. Such a framework is important to facilitate market innovation in a timely manner to meet the demands of a dynamic economy and rapid changes in the financial markets.
 - Developing a new comprehensive and transparent capital markets law that is forward looking and responsive to market innovation is therefore a priority.
- **Second, let’s look at capital market instruments.**
- **Slide 6** Istanbul Stock Exchange. Starting with Equities.
 - As we all know, the Turkish stock market has been one of the top performing emerging stock markets during recent years.

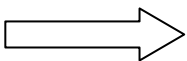


- The buoyant domestic equity market has lowered the cost of capital for issuing equity vis-à-vis debt for most listed Turkish companies, and IPOs increased sharply in numbers.
- For the Turkish stock market to do even better, one key element is an efficient market structure that promotes fair competition.
- The Istanbul Stock Exchange can become an even stronger vehicle to intermediate savings and long term financing and investment, and its capacity to withstand competitive pressures from abroad can grow.
- For this to happen, a so-called “demutualized” structure, which separates ownership from trading privileges, can help.



- The government has made the “demutualization” of the Istanbul Stock Exchange a priority to further develop the capital market in Turkey. This is very welcome.

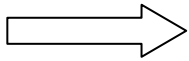
- **Slide 7** Local currency bond market. This slides looks at the fixed income debt markets. Turkey has **successfully** built a well-functioning government bond market. Turkey’s government bond market paper stood at US\$228 billion (2010) making it the fourteenth largest in the world when measured as percentage of GDP.



- The strong development of the Government debt market is very welcome.
- And continued strong and credible macro economic policies will help in Turkey’s plans to increase the maturity of the benchmark paper beyond 22 months.

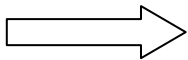
- **Slide 8.** Corporate Bond market. **At the same time, corporate bond market development has been slow.**
 - Of course Turkey has now achieved macro-economic stability, which is a basic prerequisite for corporate bond markets to grow.
 - The World Bank is now working with the CMB on next steps in corporate bond market development.

- In the recent past we have seen a number of improvements which have helped jumpstart the market. Already the CMB and the BRSA have taken regulatory actions that have resulted in a doubling in size of the corporate bond market in Turkey in the last 12 months.



- For example, BRSA has issued regulation making it transparent what volumes of corporate bonds a bank can issue. This is a welcome step. The potential size of only bank issued corporate bonds is estimated to be around TL 51 B.
- However a number of impediments limit the growth of this market. For example at the moment highly rated corporate bonds are not fully accepted as collateral for margin purposes. Addressing this and other constraints will be important.

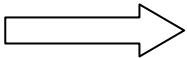
- **Finally, on the instrument side, there are derivatives.** A vibrant derivative market will foster the development of risk management products to hedge against, interest rate, credit and FX risk which in turn will further deepen the Capital Markets.



- Turkey has been successful in building one of the most active equity derivatives markets in the world. However, there are limited debt market derivatives and risk management products and their accelerated development will be important., there accelerated

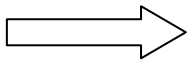
- So far I talked about the legislative framework and instruments. **Let's now look at demand and supply.**
- **Slide 9** – Pension/Insurance/Mutual Fund. Starting with the demand side, clearly broad investor base will be important for vibrant capital markets. Since 2003, Turkey has made good progress in expanding the investor base (Pension, Insurance and Mutual Fund). However, the size of Turkey's investor base is still small as a share of GDP, when compared with other emerging market economies at similar income levels.

- **Slide 10.** Pension sector.
 - This slide shows the very small size, in particular, of Turkey's pension market by international comparison.
 - The arrow at the bottom points to Turkey.
- **I would like to mention, illustratively, two areas for possible action on the demand side.** These are examples; there are several other areas as well.
 - One is a review of the institutional arrangements for regulatory and legal oversight of pensions, insurance, and mutual funds—to help them play a larger role in the growth in the economy.
 - A second illustrative area for possible action is to remove existing distortions in the treatment of some financial instruments in the capital market. For example, Turkey currently has a tax on gains from trade in equity exchange traded funds, but no capital gains tax on equities—which creates a relative disincentive for mutual funds.
- **Slides 11 & 12.** Savings. **Finally, let's turn to the supply side of capital markets.**
- Capital markets play a critical role in mobilizing the savings of households in offering a separate investment class for their investments. Savings in Turkey are low and have been declining at the household level (9% saving rate in 2009 down from 17.7 in 2003). In this regard WB is working with SPO to increase savings. In order for the households savings to be channeled into capital markets it is crucial that they have a high level of confidence in the integrity and fairness of the market.



- As on the demand side, **I would also like to share two examples of possible areas for action on the supply side.** Again, these are illustrative—and there are several other areas.

- One area are measures to enhance transparency.
 - For example, disclosure of information about the general issuance strategy could help market participants to formulate their investment strategies.
 - Also strict enforcement against abusive market conduct such as market manipulation and insider trading will promote investor confidence.
- A second area is promoting awareness and financial literacy. Individuals must, for example, be educated about what financial instruments they can use, about the risks and the rewards of investing as an individual in capital markets.



- **CONCLUSIONS**
- **Capital markets are a key engine for economic growth and are also critical for ensuring stability of the financial sector.**
- I have highlighted some areas for possible policy action—ranging from building a comprehensive legal framework, to the so-called demutualization of the Istanbul Stock Exchange, to removing distortion for financial products, to financial education ... and many more.
- All this will help making Istanbul a true financial center with all the nuts and bolts in place.
- **Thank You!**