



Turkey – Back from the brink?

From being one of the most favoured Emerging Market credits earlier this year, Turkey's fortunes have changed significantly, as demonstrated by Standard & Poor's outlook on the economy being revised to negative on the basis of a weakening external position and political uncertainty. Turkey has felt the brunt of the global credit crunch and the general heightened risk aversion, as carry-trade unwinding has accelerated and portfolio flows have slowed significantly. Adding to the bad news, Moody's warned that Turkey's 'Ba3' rating could come under pressure if present economic or political troubles weaken debt ratios.

Let's examine each of the major factors affecting confidence in Turkey's economic outlook:

Debt Servicing - Gross debt is estimated at 37% of GDP. For the next year, Turkey has to pay out an estimated US\$3.6 billion in interest payments and roughly US\$108 billion in domestic debt maturities for 2008, while FX reserves stand at about US\$73 billion with the Central Bank, and Turkish treasury reserves totaling US\$16.5 billion. To honor its debt, Turkey is expected to borrow US\$400 million from the World Bank and roll over no more than 70% (US\$75 billion).

Inflation - Turkey is also expected to continue to suffer from commodity driven inflationary pressures, and hike rates in response to this. Inflation is expected to reach 10% and the policy rate is expected to peak at 17% in the second half of 2008 – however, only 50% of the CPI basket is interest rate sensitive. The CBT has also abandoned its target of 4% inflation for 2009, setting a goal of 7.5% after record oil prices made the target unachievable. For the 12 months to May 2008, the inflation rate stood at 10.7%.

Interest rates - The Central Bank of Turkey (CBT) has been aggressively tightening interest rates, to combat inflation by raising the benchmark rate by a cumulative 100 basis points during the second quarter of 2008. The base rate now stands at 16.75% and is expected to be raised by at least another 25 bps by the end of the year.

Current Account Deficit - Rate hikes would generally mean increased carry-trade inflows (once risk appetites allow) which augurs well for external balances, where the growing current account (CA) deficit is estimated to reach about US\$47 billion this year, or 6.5% of GDP. So far, roughly 30% of the CA deficit is financed by FDI inflows, which makes Turkey very vulnerable to the risk appetite and confidence of the markets. According to JP Morgan "During the period of May-December 2008, financing is likely to be from greater public sector borrowing (US\$3.7 billion in IMF, World Bank, and Eurobond inflows), positive portfolio inflows and continued borrowing by the non-bank private sector'.

Currency - Higher interest rates and increased carry trade should strengthen the Lira and help to alleviate the FX-weakness effect on inflation (estimated at 30-40% of inflation) particularly since Turkey imports 100% of its energy needs and has no energy subsidies.

Growth - Higher interest rates also means however that the Government will have to pay higher interest costs for domestic debt, leaving less for other spending, and growth is likely to suffer as a result and is estimated to reach 3.8% in 2008. Growth is also likely to suffer as a result of exports to the EU cooling, given a stronger Lira and the EU's economic woes taking hold.

Politics - Political risks are rising in Turkey, with the latest terrorist attack outside the US embassy in Istanbul. Six people were killed including three police officers. If the courts ban the ruling party, elections may be held in Q4 2008. Up until this week, it seemed almost inevitable that the ruling AKP party will be banned, but a ruling which is likely to come in early August is not as certain now. There is a greater indication that the Government will enter into a new stand-by deal with the IMF, which will engender confidence in Turkey once the agreement is signed.

Fiscal Spending – The government has revised its surplus downward to 3.5% of GDP, as spending has slowed in the wake of political tensions and the ongoing court case with the ruling Justice and Development Party (AKP) being accused of anti-secular policies.

Based on the foregoing, it is quite obvious that Turkey is in a vulnerable position, which is not likely to improve until the political situation is resolved – as these problems could negate whatever macroeconomic positives may lie ahead. It seems apparent however that the authorities are fully aware of the significant effect the market's perception has on its economy and are managing the CA deficit and debt servicing situation prudently.

FINANCIAL & ECONOMIC INDICATORS

As at 17 July, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	106.27	107.08
Euro	1.59	1.58
Jamaica	72.20	72.28
Guyana	204.40	204.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	129.29	141.65
Natural Gas (US\$/mmbtu)	11.41	11.83
Gold (US\$/Troy Ounce)	957.43	947.66

Eurobond Indices (Return % YTD, as of 17-July-08)

Lehman Brothers Global Aggregate Index	4.28
JP Morgan EMBI+ (percentage change)	15.20
CMMB Eurobond Index	n/d

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	2.00	2.00
Euro Zone	4.25	4.00
Japan	0.51	0.51
Brazil	12.25	12.25
Trinidad	8.25	8.25
Jamaica	13.50	13.50
Barbados	4.50	4.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	1.38	1.64
US 10-Yr Treasury	3.99	3.80
3-month UK Libor	5.81	5.84
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	12.85	13.08
TT 90-day T-Bill	7.17	7.17
Jamaica 90-day T-Bill	14.19	14.19
Barbados 90-day T-Bill	4.16	4.16

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

DISCLAIMER

The information contained in this documentation is for your information only. All information contained in this documentation has been obtained from and is based on sources, including but not limited to, newspaper and magazine articles that CMMB believes to be accurate and reliable. However such information, facts, calculations, methodology, assumptions and estimates contained in this documentation have not been verified by us. All opinions and estimates constitute the Author's judgment as of the date of the documentation which are subject to change; however neither its accuracy and completeness nor the opinions based thereon are guaranteed. As such, no warranty, express or implied, as to the accuracy, timeliness or completeness of this documentation is given or made by CMMB in any form whatsoever. Consequently, CMMB assumes no liability for the accompanying information, which is being provided to you solely for general information.