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INVESTING IN TURKEY

Lessons learned in 2001 serve country well

Ankara opts to pursue its own fiscal policies rather than rely on IMF; strong recovery is forecast as exports rebound

By Catherine Bolgar

Fiscal discipline — learned the hard way — and a cautious reaction to the global recession, have given Turkey a tightly regulated, and therefore healthy, banking system and solid growth prospects.

"Turkey learned its lessons from the 2001 [financial] crisis," says Serdar Sayan, professor of economics at TOBB University of Economics and Technology in Ankara. "It was a local crisis triggered by huge budget deficits."

The government cleaned house, and even in the depths of the current recession ran a budget surplus if interest payments on debt are excluded. While some in Turkey complain the government has done too little, too late to deal with the global downturn, Dr. Sayan says it was a reaction, in a sense, to the excesses of the 1990s. "So fiscal discipline has not been completely lost," adds Dr. Sayan, who is also director of the Entrepreneurship Institute at the Economic Policy Research Foundation of Turkey, or Tepav.

How Turkey fares in the future depends on whether it can stick to its post-2001 healthy diet.

How Turkey fares in the future depends on whether it can stick to its post-2001 healthy diet. It has had almost a decade of fiscal prudence, but markets want a longer track record, especially for an economy that has come out of a half-century of instability, says Susan Schadler, former deputy director of the International Monetary Fund's European department, where she led surveillance missions to Turkey, among other countries, and now senior fellow at the Atlantic Council in Washington. "It has got its feet on the ground for the last decade," she says.

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Illustrations by Peter Hoey

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A healthy and highly profitable banking sector

By Catherine Bolgar

Turkey is one of a few countries today where "healthy banking system" is not an oxymoron.

No toxic assets. Well-capitalized. Plenty of liquidity. Profitable. Crisis? Been there, done that. Back in 2001, Turkey's entire economy was shaken to the core by a banking crisis. Turkey reformed its banks as well as its approach to government finances.

"The banking sector paid a very high price in 2001," says Gazi Ercel, governor of the Central Bank of Turkey from 1996-2001, and currently founder and principal of Ercel Global Advisory in Istanbul. "The banker doesn't want to make any more mistakes… Turkish banks were very happy in 2009, and not just because they didn't have toxic assets." The central bank reduced its [base rate] from 17.5% in 2007 to 6.5% today. Turkish banks mainly hold government securities, whose value rises if interest rates go down, he explains, adding: "Mainly their profits came from these sources." As the base interest rate fell, so too did rates on consumer loans, but not to the same extent, widening the banks' profit margins.

The profit of Turkey's banking sector rose to 20 billion Turkish lira (€10.48 billion) in 2009, up 50% from a year earlier, notes the Organization for Economic Cooperation and Development's Economic Outlook.

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Turkey currently has 45 banks with some 9,000 branches, and the third-largest credit card market in Europe.

The reforms of nearly a decade ago turned out to be "a big advantage now, because the banking sector is quite sound," says Josef Pöschl, economist at the Vienna Institute for International Economic Studies.

Rising household credit

Banks had been evolving before the crisis. Traditionally, their core business had been dealing with government treasuries. With little access to bank loans, small businesses and individuals had to rely on families for most financing. But credit to households was rising strongly before the global recession, Dr. Pöschl says.

The ratio of government securities to total assets fell to 30% in 2008 from 40% in 2002, suggesting banks were moving more into commercial activities and away from government treasuries, according to the "Turkish Financial Services Industry Report," published in January by the prime minister's office and compiled by the international accounting firm Deloitte. The loan to deposit ratio hit 81% in 2008, the highest in Turkey's history and up from 40% in 2002, the report says.

As of last September, corporate loans made up 45.3% of all loans, while small and medium-size enterprises accounted for 21.9%. Personal loans accounted for 32.8%, the report says. Mortgages jumped 78.2% in 2009 from 2006, thanks to the passage of the mortgage law in 2007. Credit card use, a relatively new phenomenon, has skyrocketed: Turkey now is the third-largest credit card market in Europe, after the U.K. and Spain, in terms of number of cards, and No. 10 in terms of money spent with cards.

Turkey currently has 45 banks with some 9,000 branches, whose total assets in 2008 made up 77% of GDP, a jump from 57% in 2002, the report adds. The entire financial sector, dominated by banks but also including insurance, amounted to 134% of Turkey's GDP in 2008, far below the 486% in China, the 608% in Germany or the 1,253% in Japan.

In other words, Turkey's financial system has room to grow.

"Room for expansion"

"As long as the Turkish economy continues to grow, there will be room for expansion in the banking industry, for foreign firms as well as Turkish firms," says Serdar Sayan, professor of economics at TOBB University of Economics and Technology in Ankara and director of the Entrepreneurship Institute at the Economic Policy Research Foundation of Turkey, or Tepav.

Much of the financial sector has been privatized, with two main banks still in state hands: Halkbank, whose long-delayed sale has been a moving target, and Ziraat, the country's biggest bank. Ziraat is likely to stay in state hands because of its specialization in agricultural loans, says Tevfik Aksoy, chief economist for Turkey, the Middle East and North Africa at Morgan Stanley in London.

Banking demand is poised to expand in Turkey, says Uğur Gürses, business columnist for Radikal Daily, a newspaper in Istanbul. "Turkey's population is much younger than in other countries. For the future 20 or 30 years, Turkey will be one of the main growth countries."

Hard lessons learned in 2001 are serving the country well

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The big issue for Turkey is whether they can maintain the fiscal situation from which they have benefited for the past decade, she says. The stimulus measures [announced March 2009 and valued at 5.5 billion Turkish lira (2.8 billion)] were "probably the right response," even though they caused the budget deficit and public debt to grow. "If that's not reined in quickly with the recovery, that would be a major source of uncertainty on the part of investors," she says.

Avoiding the IMF

In the past, investors counted on the IMF to keep Turkey's spending in line. Its last IMF funding deal, which had been implemented in the wake of the 2001 crisis, ran out in May 2008. Turkey pointedly avoided a new deal, despite the clutch of other countries lining up for IMF bailouts as the global recession bit. Finally, in March, the government said it had ended talks with the IMF about a new loan.

Rather than use the IMF as a watchdog, Turkey's parliament is preparing to vote on its own "fiscal rules" that would tie the government's hands from spending sprees. The rules would allow stimulus packages during downturns, for example, but include a clear program on ending that spending before it becomes addictive. If the measure passes, "it will be a very positive step," and already would guide the 2011 budget, says Tevfik Aksoy, chief economist for Turkey, the Middle East and North Africa for Morgan Stanley in London.

Though Turkey's government has shown fiscal prudence (its 2008 budget deficit was 2.2% of GDP, under the 3% limit for euro members) and the banking system is a model of health, the economy got slammed with a 4.7% contraction in 2009 — one of the worst among members of the Organization for Economic Cooperation and Development. Demand for Turkey's main exports — cars and durable consumer goods — slumped as its main market — the European Union, especially Germany — slid into recession. It was a headspinning switch from average annual growth of 5.9% between 2003 and 2008 — the fastest in Europe.

Efforts to stimulate the economy have met with mixed success.

> *"If Turkey has really turned the corner and its outlook is as bright as one could envisage, there'll be more and more people who will want to invest."*

The government cut the tax on car purchases, for example, to help battered auto makers replace exports with domestic sales. However, some Turks used the program to get a better deal on an imported car, since the breaks weren't limited to cars made in Turkey, says Dr. Sayan of TOBB University.

One of the worst effects of the recession has been a jump in unemployment, to 14% from 11% in 2008. Without much of a social safety net, Turks have to rely on family when they lose their jobs. Some 1.5 million people work in the agricultural sector, but without any payment, notes Uğur Gürses, business columnist for Radikal Daily, a newspaper in Istanbul. "They just define themselves as 'family workers.' As time passes these people are coming into the work force looking for new jobs, so the unemployment rate isn't going to go down quickly."

Only 46% of Turks ages 15-64 were employed in 2009. Few Turkish women work. Turkey is young, with half the population under 29, so a bulge of new job seekers is yet to come. How to channel these untapped sources of wealth is not easy. Turkish companies need to improve productivity to remain competitive with other makers of relatively sophisticated goods. Yet, productivity gains rarely create new jobs.

If growth picks up, jobs will come along, says Josef Pöschl, economist at the Vienna Institute for International Economic Studies. The government has invested a lot in infrastructure, a common way to create jobs. "The construction sector has a lot going on. It's incredible, and all over the country," he says.

Turkey has already shown signs of recovery. "It can be considered one of the fastest recoveries in the world," says Dr. Aksoy of Morgan Stanley. He forecasts 4% growth this year, but it could be higher "if the current trend continues." The OECD foresees 6.7% average annual growth for 2011-2017, the best of all OECD countries.

Tremendous growth

Turkey already has grown tremendously. It has become the second-biggest steelmaker in Europe and No. 10 world-wide. It's the top maker of textiles and televisions in Europe, as well as the No. 1 European exporter of cement, according to the "Turkish Financial Services Industry Report," published in January by the prime minister's office and compiled by the international accounting firm Deloitte. Per-capita GDP has risen to €10,400, or 44% of the EU average, in 2009, from €3,700, or 27% of the EU average, in 1991.

Recent signs of recovery include a rise in exports of 23% in the January-April period from the corresponding four months last year. And the World Bank says the economy rebounded strongly in 2009 and predicts growth in 2010 to surpass 5%.

"If Turkey has really turned the corner and its outlook is as bright as one could envisage," Ms. Schadler, the senior fellow at the Atlantic Council says, "there'll be more and more people who will want to invest."

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Turkey's exports to the BRIC countries of Brazil, Russia, India and China are growing fast. In the first quarter of 2010, exports to China rose 121%.

Market diversification brightens trade picture

For the past two or three years, Turkish businesses have been pushing into new markets, especially in Central Asia, the Middle East and North Africa. That has turned out to be a cushion, however thin, from the economic downturn that stifled exports to Turkey's traditional main markets in the European Union, especially Germany.

"In the past, Turkey had a lot of exposure to the euro zone as an export market," says Tevfik Aksoy, chief economist for Turkey, the Middle East and Africa at Morgan Stanley in London. "The Turkish government gave guidance and help for exporters to diversify to Africa, Asia and neighboring countries. Growth and demand from European countries came down, so the new markets really helped."

The EU accounted for 42% of Turkey's exports in 2009, compared with 58.1% in 2004, according to Eurostat, the EU's statistical office. The recession drove exports to the EU down 22% in 2009 to €36.1 billion from a year earlier. Turkey's overall trade deficit narrowed by half in 2009 from 2008, as the recession slowed imports (down 30.3%) more than exports (down 22.6%).

By contrast, exports to the BRIC countries of Brazil, Russia, India and China made up 6.7% of shipments in 2008 and are growing fast, albeit from a low base. In the first quarter of 2010, exports rose 121% to China and 23% to Russia, according to the Turkish Exporters Assembly, or TIM. And exports to Singapore grew more than sixfold.

Turkey also has been exploiting markets closer to home. Trade with Syria doubled in 2008 from a year earlier, and doubled again in 2009. Trade with Israel rose 46%.

Change of direction

"The big change in Turkey's trade portfolio has been the huge increase in trade with countries to the south and east," says Ross Wilson, director of the Dinu Patriciu Eurasia Center at the Atlantic Council, a Washington-based think tank. "Trade with Arab countries is way, way up over where it was 15 or 20 years ago. It isn't huge in global terms, but for the size of the economy, it starts to add up."

Turkish companies are particularly active in construction and retail in the former Soviet Union. "All those countries are stern climates for outside investment, but Turkish companies seem better able to navigate that than some others," Mr. Wilson says.

At the same time, it's easier for Turkish companies to grab market share in these countries, compared with expanding in Europe, where gaining a foothold and creating brand awareness are far more expensive, says Josef Pöschl, economist at the Vienna Institute for International Economic Studies.

> *"The big change in Turkey's trade portfolio has been the huge increase in trade with countries to the south and east."*

A report published last September by the Economic Policy Research Foundation of Turkey examined the geographic distribution of unemployment in the wake of the recession. Towns and provinces in eastern and southeastern Turkey didn't lose jobs to the same extent as the western and northwestern areas. "Firms in eastern and southeastern towns were exporting mainly to Middle East and North African markets, whereas firms in western and northwestern towns were exporting mainly to EU markets," says Serdar Sayan, professor of economics at TOBB University of Economics and Technology in Ankara and director of the Entrepreneurship Institute at the Economic Policy Research Foundation, or Tepav. Middle Eastern and North African markets didn't get hit as hard as the EU by the global recession, and oil-rich countries had full coffers from the high pre-recession crude prices. "By trying more aggressively to find new customers in these markets, firms managed to avoid employment losses. The lesson derived: Diversify markets and products."

Trade bridges

The government had coordinated a drive to grow in Africa and other markets before the recession started. The Confederation of Businessmen and Industrialists of Turkey, or Tuskon, has been particularly active in setting up "foreign trade bridges" to link up Turkish investors with opportunities in the Middle East, Africa and Eurasia. "Tuskon has been quite aggressive in finding new markets. It's one of the success stories," says Susan Schadler, senior fellow with the Atlantic Council and former deputy director of the International Monetary Fund's European Department.

Investment flow

Much as the networks of pipelines that have opened in recent years carry oil and gas from the East to the West via Turkey, so, too, does much of the investment flow from West to East. European and other international companies hoping to supply the Middle East, Central Asia, former Soviet republics or North Africa have frequently chosen Istanbul, Turkey's business center, as their regional headquarters.

"It's the obvious thing to do," Mr. Wilson of the Atlantic Council says. "Turkey has good air connections, good telecommunications, a well-educate work force and a business-friendly government."

The text of this Special Advertising Section was written by Catherine Bolgar