



## Will EM Turbulence Take Away the Stuffing from Turkey?

2006 has proved to be a very volatile and testing year for Turkey. And 2007 may prove even more difficult. The unfolding saga should give pause to policymakers in other emerging markets (EM) who somehow believe they have immunity from prosecution by the financial marketplace.

Five years after the 2001 economic crisis, the fortunes of the Turkish economy have improved significantly, reflected in high economic growth, rapid disinflation, and falling public external debt. Yet, despite these improved fundamentals, several factors conspired to make the Turkish economy extremely vulnerable to a sudden shift in market sentiment in early May to June 2006.

First, inflation unexpectedly began to climb. After running below target for four successive years, inflation reached double digit territory in June 2006. This rekindled fears about Turkey's long-standing battle with high and persistent inflation, which peaked at more than 100% in the late 1970s. When combined with Turkey's over-dependence on hot money inflows to finance a large current account deficit of close to 7% of GNP, investors began to unwind their holdings of large unhedged lira positions.

Second, delays in implementing conditionalities associated with the IMF-supported Standby Arrangement dampened market confidence. Turkey has long been a poster child for the IMF, whose financial programs have been a critical anchor for economic policymaking in this high rolling EM credit. Delays touched politically delicate areas relating to pension reform, tax reform, and privatization of a state bank. Slippages in fiscal policy also weighed on investor confidence.

Third, political tensions between the ruling AKP party and the secular opposition about the Presidency added to market concerns. Secularists argue that the Presidency is the last line of defense against the AKP, which they claim has a secret agenda of imposing an Islamic program. A contest has been brewing over the Presidential succession due in May 2007. Markets, therefore, reacted badly to the Presidential veto of the government-sponsored pension reform law, assassination of a high court Judge in early May, and the prolonged

appointment of a central bank governor. Turkey's seemingly deliberate, limited progress on the Cyprus issue worsened the situation, which many observers view as the harbinger of difficulties in EU relations. Turkey's 1974 invasion and occupation of part of the island of Cyprus is a source of potential instability in the South-Eastern Mediterranean.

These developments coincided with a tightening of global liquidity, prompting international investors to scale back their exposures to high-risk EM assets. Turkey's financial markets were hit harder than most during the EM sell-off, with the Turkish lira and equities shedding more than 20%, and the spreads on the benchmark EMBI euro bonds widening by nearly 140 basis points.

**Table 1: EM Financial Turbulence (8 May - 23 June)**

	\$/FX (%)	Equity Index (%)	CDS-5yr Spread (basis points)	EMBI Spread (basis points)	ELMI (%)
Turkey	-22.8	-25.1	181	139	-21.9
Brazil	-8.2	-16.1	69	42	-6.0
Hungary	-9.1	-23.7	20	8	-8.0
Poland	-8.4	-17.0	10	6	-7.6
Indonesia	-6.6	-13.0	65	32	-4.7
South Africa	-18.6	-6.1	36	35	n.a.

*Source: Turkey, Third and Fourth Reviews under the SBA, IMF July 2006*

These events severely tested the newly installed management team at the Central Bank of Turkey (CBT). Some critics argue that new Governor Yilmaz met the political criteria but not the technical competency for the job. Others argue that the CBT genuinely felt that market volatility would be short-lived and that the problems were outside its scope. Whatever the reason, the CBT was too slow to appreciate the severity of the problem, issuing an overly dovish “wait and see” statement at its 25 May meeting. The market did not buy this line and sold the lira, forcing the CBT to call an extraordinary meeting on 7 June and to jack interest rates up by 175 basis points. Policy interest rates were left unchanged at the scheduled 20 June meeting, but with intense pressure on the lira and bond yields, the CBT was forced to sell more than US\$3 billion in foreign exchange. This large one-day intervention did little to calm the markets. The CBT then left the lira to drop, before hiking rates again, first by 225 basis points on 25 June and then a further 200 basis point on 28 June, which finally helped to soothe investor confidence.

Looking ahead, the immediate priority of the Turkish authorities is to rein in inflationary expectations. There are many risks to the Turkish inflation outlook – high energy prices, US rate hikes, weaker fiscal stance, and further

lira depreciation. Meeting the existing 2007 inflation target will prove difficult. Another priority is to contain the widening current account deficit, which fortunately is now less funded by hot money flows. As a result, gross debt ratios would spike at 59% of GNP in 2006 and decline to around 50% of GNP over the next three years.

The IMF Executive Board is expected to approve the latest review of Turkey's Standby Arrangement in December, providing some comfort to the markets. But it is difficult to see enough progress on the Cyprus issue to prevent the EU from imposing sanctions on Turkey at its mid-December meeting. Even bigger issues are looming on Turkey's political agenda. Political noise will intensify next year if the AKP ends up controlling both the government and the Presidency. This could undermine economic stability and investor confidence.

Risks are building in Turkey for 2007. If the traditional half year EM sell-off takes place, then Turkey is likely to again get its stuffing knocked out.

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**FINANCIAL & ECONOMIC INDICATORS**  
As at 30 November 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	115.80	116.30
Euro	1.32	1.29
Jamaica	66.80	66.71
Guyana	201.40	201.40

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	63.13	59.24
Natural Gas (US\$/mmbtu)	8.35	7.45
Gold (US\$/Troy Ounce)	648.00	631.25

**Eurobond Indices (Returns, % YTD as of 30- Nov- 06)**

Lehman Brothers Global Aggregate Index	4.13
JP Morgan EMBI+	-17.15
CMMB Eurobond Index	3.33

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Month</u>
United States	5.25	5.25
Euro Zone	3.25	3.25
Japan	0.25	0.25
Brazil	13.25	13.75
Trinidad	8.00	8.00
Jamaica	11.95	11.95
Barbados	4.75	4.75

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	4.90	4.93
US 10-Yr Treasury	4.46	4.56
3-month UK Libor	5.25	5.23
Japan 90-day T-Bill	0.33	0.28
Brazil 90-day T-Bill	13.40	13.52
TT 90-day T-Bill	6.74	6.74
Jamaica 90-day T-Bill	11.57	11.73
Barbados 90-day T-Bill	6.49	6.49

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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