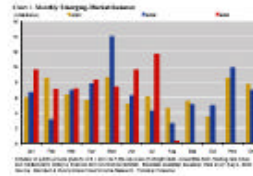




Emerging
Markets
Weekly



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Turkish Financial Markets Survival of the Fittest

The squeeze in global liquidity triggered by rising interest rates in major industrial countries has hit Turkey's financial markets much harder than underlying macroeconomic fundamentals would justify. The Turkish lira, in particular, has tumbled some 20% forcing the central bank to sharply hike interest rates and to renew its intervention in the foreign exchange market. Yields on benchmark Turkish bonds have shot up to their highest levels since January 2005.

Emerging market countries like Turkey that currently run large external current account deficits rely on foreign capital flows to cover these gaps, usually by tempting investors with high interest rates. Now that interest rates are rising in the US and Euro zone, there has been some unwinding of the carry trades into high-yielding countries and capital flow reversals are occurring raising vulnerability in these emerging economies. Yet, Turkey has come a long way since the 2001 financial crisis and the authorities have every intention to emerge victorious from the current plight. In fact, this month S&P affirmed its positive outlook on the Turkish economy.

Through prudent macroeconomic policies and structural reforms, the Turkish authorities have managed over the past few years to reduce the budget deficit from 16.5% of GDP to less than 2%, move from annual inflation of over 70% to single digit inflation territory, maintain an annual growth rate of over 7%, and to revamp the banking sector. It seems that international investors are yet to fully internalize these achievements and still hold lingering doubts in light of Turkey's history of financial and economic crises. Existing domestic political risks may have helped to worsen the impact of the recent market sell-off. Subsequently, on 8 June 2006, the Monetary Policy Council (MPC), meeting in emergency mode, decided to take a more aggressive approach to combating inflationary pressures and excessive foreign exchange volatility by hiking its overnight interest rate by 175 basis points, leaving lending rates at 15% and borrowing rates at 18%. The Turkish central bank also announced its direct intervention into the floating exchange rate regime for the first time in two years, selling US\$150 million to the financial system to support the lira.

Much resilience has been demonstrated by the Turkish government through prudent adherence to stringent macroeconomic policies in an effort to address excessive government debt coupled with demanding interest

payments. According to the IMF, the authorities have enacted *'measures to ensure that aggregate primary expenditures in 2006 do not exceed the approved budget and to keep the deficit in the social security system within the program ceiling of 4½ percent of GNP'*.

The Turkish government has successfully held a consolidated budget deficit of 4.4% of GNP in 2005. Turkish domestic debt fell to 50.5% of GNP in 2005 from 52.3% in 2004. The public sector debt to GNP ratio was also slashed to almost 55% from over 90% six years earlier. The foreign currency reserve stockpile has comfortably managed to accumulate to US\$50.5 billion in 2005 and is expected to build up to US\$64.6 billion by the end of 2006, equal to 5.7 months coverage of imports, and enough to smooth the volatility shock. Foreign direct investment (FDI) inflows are expected to surpass the 2005 record of US\$9.7 billion.

Even though the outlook on the Turkish economy seems positive, there are many significant risks that weigh heavily on the upside. Political leadership has changed hands twelve times during 1990 to 2002 causing considerable slowing in economic reforms. On a brighter note, the last political change of leadership in 2002 left the presiding party Justice and Development Party (AKP) with a high degree of domestic political support. However, political tensions are expected to mount further before the next elections carded for May 2007.

Against the backdrop of a widening current account deficit accounting for almost 7.5% of GNP at present, the drastic depreciation of the lira to a three-year low propelled a boost in net exports but will have an impact on inflation and put at risk the disinflation program.

With the will power to evade this problem, the Turkish government has been working alongside the International Monetary Fund (IMF), proposing additional policies to strengthen finances. Review of the Turkish social security system, tax laws and the effective functioning of state banks have all been recommended for reform. On this basis, Turkey is striving to enhance the chances of acquiring an immediate drawdown of almost US\$1.9 billion from the IMF to help ease balance of payments pressures and to send a signal to the international community about the quality of its economic program.

FINANCIAL & ECONOMIC INDICATORS

As at 22 June 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	116.12	114.75
Euro	1.26	1.26
Jamaica	62.5	65.88
Guyana	200.7	200.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	70.84	69.50
Natural Gas (US\$/mmbtu)	6.51	6.45
Gold (US\$/Troy Ounce)	580.65	577.05

Eurobond Indices (Returns, % YTD as of 22-June-06)

Lehman Brothers Global Aggregate Index	-1.23
JP Morgan EMBI+	-7.11
CMMB Eurobond Index	-0.78

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Month</u>
United States	5.00	5.00
Euro Zone	2.75	2.75
Japan	0.02	0.00
Brazil	15.25	15.25
Trinidad	7.00	7.00
Jamaica	12.45	12.45
Barbados	4.75	4.75

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	4.78	4.71
US 10-Yr Treasury	5.12	5.10
3-month UK Libor	4.75	4.73
Japan 90-day T-Bill	0.20	0.20
Brazil 90-day T-Bill	14.9	15.00
TT 90-day T-Bill	6.00	6.00
Jamaica 90-day T-Bill	12.28	12.28
Barbados 90-day T-Bill	6.05	6.05

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

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