

Don't go cold Turkey

Financial crisis reveals hidden strengths

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A decade is a long time in economics. This is particularly so in Turkey where the most recent ten years feel closer to an eternity. Back in the nineties you could almost guarantee that any period of strong economic growth would soon be followed by hyper inflation and a subsequent sharp hike in interest rates. If only Turkish capital markets back then were as deep and liquid as they are now, those that make a living forecasting these eventualities could all have retired happily to the beautiful beaches of Bodrum such was the predictability of this trend. But things have changed, comprehensive fiscal and banking reform following the 2001 Turkish crisis has evolved the countries economy beyond all recognition and greatly improved resilience to external shocks. Ironically, it took a global financial crisis for the rest of the world to fully appreciate this.

Warren Buffett once famously said that it is only when the tide goes that you learn who has been swimming naked. Whilst Bernanke, Trichet and Brown have been revealed to have insufficiently sized hands to cover their embarrassment, Turkey has emerged proud and strong. When the International Monetary Fund (IMF) came calling, other nations were queuing up to receive financial assistance. Turkey's increasing economic stability helped to repair a historically fractious relationship with the international capital markets and allowed them to reject the IMF as overly demanding and out of step with the needs of the country. They must be laughing from Istanbul to Izmir at the "do as I say not do as I do" attitude that has plunged developed market economies into crisis. This calculated dismissal of an IMF rescue package underlines the attitude of the new more independent Turkey that can now stand on its own two feet. The facts bear this confidence out.

Because Turkey entered the global financial crisis in relatively good shape, they have subsequently recovered strongly. Public debt levels as defined by the European Union fell from 73% in 2002 to 39% in 2008. Fiscal reform saw the fiscal deficit fall sharply from over 10% to little more than 1%. The banking sector, so often Turkey's Achilles heel, had been completely overhauled. Less obviously, Turkey enjoyed a fourfold increase in export volumes between the domestic crises in 2002 and 2008 led by a shift from labour intensive to technology intensive products.

Turkey went into the crisis in a position of financial strength with a primary surplus. This allowed the finance ministry the flexibility to adopt a looser fiscal policy to promote productive growth without potentially jeopardising the country's debt sustainability. There is no structural de-leveraging necessary and Turkey prides itself on the strength of its banking sector. In a recent meeting with central bank governor Yilmaz, he delighted in recounting that due to few toxic assets and limited mortgage exposure, not a single lira had been required to recapitalise domestic banks.

The resultant drop in risk premium has been phenomenal, but not without merit. The Turkish lira, once so volatile that in 2005 six zeros had to be deleted to make it functional, is now a pillar of stability. For over a year it has remained range bound between 1.5 and 1.6 to the dollar. Borrowing costs have fallen from high double digits to just 7% today with real rates hovering close to zero. Turkey has subsequently extended the overall maturity of its debt profile, even issuing a 10 year bond in January this year at a yield of 10.5% that was massively oversubscribed.

As an open economy, Turkey is not completely isolated from the vagaries of the global markets, but its economic recovery has been amongst the sharpest globally. GDP growth in 2010 is expected to be close to 8%, and unlike many struggling developed markets, this growth is not dependent on net exports and a weakening of currency. The V shaped recovery has been driven by investment and consumption and the majority of leading indicators suggest that this will continue into 2011 and beyond. The increasingly domestically oriented structure of the economy will drive investments into productive output capacity and should continue to help the country remain a primary beneficiary of overseas flows.

Politically the investment environment has improved too. The Islamic AKP party, elected in 2003 and under the leadership of internationally respected Prime Minister Erdogan, has effectively enacted much market friendly reform. The role of the military, perpetrators of many successful coups historically, has been diminished. This was underlined again recently when Turkey voted on amendments to the existing constitution and the AKP were successful with a strong majority of 60%. Another potential hurdle for investors has been removed as the potential for severe political disruption diminishes further.

Whilst the domestic story is compelling, Turkey remains vulnerable to the sentiment of the global market and there is little doubt that the risk premium has fallen partially because of strong yield searching international flows. Like any other investment - risks remain. Primary among these is the issue of EU accession. Whilst success in the venture is not necessarily beneficial for Turkey long term, this policy anchor is likely to be important to Turkey's ongoing modernisation process and investor sentiment.

Recent trips to Istanbul have left me with the impression that the EU is no longer perceived as a desirable club to join. You can hardly blame them for having this sentiment. Whilst the Turkish economy thrives, the EU struggles with unsustainable debt burdens and the threat of falling once more into recession. But it is not just for financial reasons that Turkey is turning its back. EU lawmakers have long been critical of the human rights policies in Turkey, amongst these is the controversial headscarf issue. However, in Paris last week the French senate approved a law banning the burqa. Double standards as well as double dip?

Investors also need to keep an eye on the current deficit. This has slipped back to 4% GDP recently and acts as a reminder as to how imbalances in the economy can quickly re-appear when times are good. The Organisation for Economic Co-operation and Development (OECD) recently warned Turkey that it should now remove its fiscal and monetary stimulus in order to embed its hard fought credibility. With the delay in implementing the fiscal rule to stabilise the public deficit at 1%, there are signs that these warnings are falling on deaf ears. I also have concerns that the central bank may be behind the curve and remain cautious about extending duration.

Overall as an investor in Turkey, I continue to believe that the positives outweigh the negatives and that Turkey remains at the beginning of a journey towards greater prosperity and convergence with the Western world. I expect to see rating agencies belatedly reward the reform efforts with investment grade status opening the doors to a new class of investor group and I remain overweight the country. More importantly, the Turkish authorities can continue to swim freely without feeling the need to keep half an eye on the tide.