

Omni Bridgeway reviews recent suggestions that Turkey has earned investment grade status and demonstrates why this confidence is premature

# Turkey – making the grade?

**T**urkey's efforts to join the European Union have been progressing in stops and starts since 1963, but can the country's efforts to join the elite club of investment grade countries be more successful? Despite the fallout from the global financial crisis and predictions of a double dip recession, some analysts have kept their faith in Turkey's economic fundamentals and its overall story. These analysts reason that Turkey ought to be rated investment grade by the major credit rating agencies, based on a comparison of key metrics across countries that either are investment grade or that are closer to this status than Turkey. Is this confidence in the upgrade argument justified, or is a more realistic assessment required? Economic and political factors on both sides of the argument will be examined.

## Economics Upgrade?

Ratings are intended to gauge the credit worthiness of a country relative to others, but some analysts accuse the rating agencies of a somewhat myopic perspective. One analyst notes that Poland's budget deficit is double that of Turkey's and that its public sector debt-to-GDP ratio is 10% higher than that of Turkey, arguing that

Turkey does not deserve to be four or five notches below Poland's A-rating. Similar comparisons to the likes of Egypt, Hungary, Latvia and Russia all purport to paint Turkey in a more flattering light. Indeed, Moody's improved its outlook on Turkey in October 2010 – from stable to positive, perhaps preparing for an upgrade. To put this in context, Moody's rating is two notches below investment grade, on a par with S&P's rating, while Fitch has it just one notch below investment grade.

The rating agencies are not the only ones that appear to favour such an upgrade. The outperformance of the Turkish lira and Turkish equities versus its peers over the course of 2011 also suggest investors think Turkey should be rated higher – and that Turkey will stick to its path of reform. The low levels of Turkish credit default swap spreads also point to Turkish risk being under-priced and to an upgrade.

Having experienced the near meltdown of much of the West's financial infrastructure over 2007-09, investors perhaps find it refreshing that Turkey's banking sector in a relatively robust state. However, these lessons have been learnt the hard way. Turkey defaulted on its foreign currency bank debt in 1978, and began its long march towards a market economy in 1980. General teething problems across many sectors, exacerbated by factors such

as an overly ambitious exchange rate policy and vulnerable commercial banking sector, ultimately manifested itself in Turkey's financial crisis of 2000-01.

Banking reforms instituted in the wake of this have led to today's well-capitalised banks, with low loan-to-deposit ratios. Turkey thus has no tangible exposure to toxic debt, and the levels of non-performing loans that it does have are falling. Turkey also benefits from a low foreign exchange lending ratio, since banks have been prohibited from lending to households in foreign currencies – saving Turkey from the problems being experienced in countries like Hungary. Beyond obviating the toxic debt problems of its neighbour Greece, Turkey has been able to achieve a low public sector debt-to-GDP ratio – 45% compared to the 115% of Greece. Turkey is also subject to relatively few adverse judgments and arbitral awards. The dismissal of several ICSID and UNCITRAL arbitral claims against Turkey over the last few years has helped strengthen the country's reputation with some investors.

The result of these banking reforms is that a sound banking sector has the flexibility to respond to increased demand for credit from young consumers. This has helped to fuel Turkey's impressive rebound in GDP growth, which stood at 8.9% in

2010 and around 6% in 2011, although of course growth of this magnitude can cause its own problems.

### Downgrade?

The Turkish economy has several weaknesses that policy makers are not addressing. The rebound in growth has been accompanied by the re-emergence of familiar vulnerabilities. This is largely due to the fact that Turkey's growth model is problematic – with it typically financing itself with external funds while relying on domestic demand.

Turkey's current account of around

introduced to govern price adjustments in subsidised goods and, together with an increase in the retirement age to 65, the social security system was reformed. However, Prime Minister Recep Tayyip Erdoğan suspended the fiscal rule in the run-up to his re-election in June's general election, and this has now been indefinitely suspended. The suspension of this prudent fiscal rule and the postponement of other structural reforms drew negative comments from both the IMF and OECD late last year.

Growth, however it might be funded, is certainly high. But so too is inflation, which

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\$40bn, or around 8% of GDP, has widened rapidly in recent years. Moreover, it is funded by flows that are volatile: drawdowns on bank and non-bank residents' overseas assets as well as portfolio debt flows. Another flow that has become a trickle is foreign direct investment (FDI). Pre-crisis, 50% to 60% of the current account deficit was covered by FDI inflows; post-crisis, FDI inflows now only cover less than 20% of the deficit – the rest being covered by portfolio flows. Although the drop is largely due to a widespread lack of appetite among Western investors rather than fears over Turkey's economic health, the drop is helping to reinforce the latter. This makes the US\$120bn of forex deposits held by Turkish citizens and corporates – a legacy of being accustomed to domestic currency crises – even more vital.

Turkey's 'fiscal rule' was introduced in May 2008 and aimed to set the framework for future fiscal policy and to limit public spending in the wake of the expiry of Turkey's last International Monetary Fund (IMF) programme. It aimed at reducing the budget deficit to 1% of GDP and to reduce the ratio of debt-to-GDP to 15%. It had produced encouraging results: the budget became more transparent, rules were

stood at 10% earlier this year. The central bank's current – and frequently adjusted – inflation target is 5.5%. A generous inflation target combined with one of the lowest real policy interest rates is unlikely to result in price stability. The central bank's unorthodox and counterintuitive monetary policy has seen it cut interest rates since December 2010. Its rationale appears to be that cutting rates will deter hot money and weaken the lira, thus keeping growth and prices low. However, apart from the slowdown in growth, the policy does not appear to be working, since inflation figures are proving sticky. The central bank's credibility in the financial markets has thus plummeted.

Even where some macroeconomic factors appear positive, the truth is more concerning. For example, central government debt-to-GDP of 45% appears manageable, but, when one discovers that the maturity of most of the debt is around three years, this is worrying. Other regional macroeconomic factors give cause for caution. Turkey's neighbouring markets, like Greece, are already economically weak – hindering Turkey's potential export growth. Now, geopolitical turmoil in Egypt and Syria have the potential to disrupt economic relations with Turkey's other



export partners. Furthermore, given the low educational level of its workforce, Turkey suffers from higher labour costs than its peers in the region. Turkey's reliance on energy imports exposes it to both price volatility in the markets and geopolitical threats. If oil prices remain high in the long term, growth could be dampened.

### Politics Upgrade?

On the political front, those in favour of Turkey's upgrade to investment status cite the country's political maturity. One reminder of this political maturity is that Turkey chose to respond to its 2000-01 crisis in a completely different manner to that chosen by Argentina at the same time – and by Russia in 1998. Turkey's situation in 2001 was perhaps greater than that in which many of the distressed eurozone economies find themselves today. It then had a public sector debt-to-GDP ratio of around 100%, and faced higher foreign currency-denominated debt, lower average debt maturity and higher real interest rates than several in the eurozone today. Turkey chose not to default and implemented painful measures, meeting its obligations in full. One of the fruits of this is Turkey's low debt-to-GDP ratio – and it was one of the few countries for which this ratio fell this year. Some analysts argue that the rating agencies should give greater weighting to this willingness to pay than they currently do.

Beyond Turkey's crisis of 2000-01, it



had also experienced a currency crisis in 1994 and defaulted on its foreign bank debt in 1978. Despite these and several other booms and busts during its challenging transformation towards a market economy, Turkey appears to show other characteristics of political maturity. It is but

Erdoğan's re-election and the continuing – if somewhat diminishing – popularity of his Justice and Development Party (AKP) do give some semblance of stability. However, the resignation on 29 July of Işık Koşaner, the chief of the general staff, has underscored the rift

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one of a handful of states in ‘Emerging Europe’ that has had neither a minority nor caretaker government within the last seven years. Most of these other states have been accorded an investment grade from one of the three main ratings agencies. Erdoğan's re-election in June further underscores this maturity. Already well endowed with a commanding population size and resources, political continuity is also allowing Turkey to further carve its place in history as a dynamic regional power.

#### **Downgrade?**

A more realistic counter-argument to those pressing for an upgrade can also be found within Turkey's political situation. Others would argue that Turkey is not accorded investment grade by the major rating agencies precisely because of its difficult politics. Threats to stability can be found in both domestic and international arenas.

between some sections of the military and the AKP. Koşaner resigned together with the chiefs of the air force, army and navy, in protest at the detention and prosecution of several generals and admirals over an alleged plot to bring down the government. The indictment alleges that an ultra-nationalist group is behind an attack on a court and the bombing of a secularist newspaper in 2006, as well as the alleged military coup – the so-called Sledgehammer plot – said to date back to 2003. The rift between the military and the AKP can be seen within the wider debate of secularisation. Erdoğan has tried to position the AKP as a mainstream conservative party within the European tradition, downplaying any Islamist tradition. However, the Sledgehammer plot has divided the nation, with many voters believing that the AKP has a hidden, Islamist agenda. While Turkey's

domestic politics can thus be viewed as quite politically polarised, analysts and voters alike view Turkey's judiciary as being politicised, and view the judicial system as relatively inefficient.

In addition to these internal, organisational problems, the military is also experiencing increasing violence from the Kurdistan Workers' Party (PKK). The PKK's attacks on troops over July and August have hit hopes of finding a democratic solution to the Kurdish quest for separatism. Internationally, the military is facing further pressures. Turkish troops are participating in the NATO-led military intervention in Libya, but the protests and counter-insurgency against al-Assad's regime in Syria have the potential to spill over across Turkey's south-eastern border. With the Arab Spring at its doorstep (*see TFR*, September 2011, page 44), the AKP is finding its policy of ‘zero problems with neighbours’ challenged: the desire to increase trade and remove travel restrictions in the region will have to be balanced with the desire to halt the spread of the turmoil.

#### **Not there yet**

Turkey has undergone a challenging transformation on its path towards a market economy, and has in particular made great strides since its 2000-01 crisis. The political maturity it showed and the painful reforms it chose over defaulting have put it in a strong position, relative to others in Emerging Europe. However, with a new mandate, the AKP must return to its fiscal rule and its programme of structural reforms to build upon this success. Financially, geographically and politically, Turkey sits between Europe, the Middle East and the CIS countries – and has the potential to leverage this. Turkey may be closer than ever before to achieving investment grade status, but a closer examination of its economic and political fundamentals suggests that Turkey is not there yet.

We invite holders of defaulted trade debts and rendered arbitral awards relating to Turkey to contact us for advice.

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## Emerging market debt pricing

### Latin America & Caribbean hyper-exotics

Country/Issue	Price range	
Cuba / Trade	2.000%	4.000%
Cuba / Loans	5.000%	10.000%
Suriname / Loans, Trade	14.000%	18.000%

### Eastern Europe hyper-exotics

Country/Issue	Price range		
Azerbaijan / Trade	18.000%	23.000%	
Kazakhstan / Trade	60.000%	65.000%	
Georgia / Trade	11.000%	15.000%	
Serbia / Trade	44.000%	54.000%	
Turkmenistan / Trade	25.000%	35.000%	↑
Ukraine / Trade	20.000%	25.000%	↑
Uzbekistan/Trade	20.000%	24.000%	
Tajikistan / Trade	15.000%	20.000%	
Kyrgyzstan / Trade	11.000%	15.000%	↑

### Asia hyper-exotics

Country/Issue	Price range	
Mongolia / Trade	22.000%	30.000%
North Korea / Loans, Certificates	9.000%	12.000%

### Africa hyper-exotics

Country/Issue	Price range		
Angola / Trade	60.000%	65.000%	
Cameroon / Trade (non-HIPC)	14.000%	20.000%	
Congo / Trade (non-HIPC)	22.000%	26.000%	
DR Congo / Loans, Trade (non-HIPC)	16.000%	20.000%	
Ghana / Trade (non-HIPC)	74.000%	78.000%	↓
Kenya / Trade	39.000%	49.000%	
Mozambique / Trade (non-HIPC)	20.000%	26.000%	
Senegal / Loans, Trade (non-HIPC)	12.000%	16.000%	
Sudan / Loans, Trade (non-HIPC)	17.000%	21.000%	↑
Tanzania / Loans, Trade (non-HIPC)	10.000%	13.000%	
Uganda / Trade (non-HIPC)	14.000%	16.000%	
Zambia / Loans, Trade (non-HIPC)	13.000%	20.000%	
Zimbabwe / Trade	1.000%	4.000%	

### Middle East hyper-exotics

Country/Issue	Price range		
Egypt Trade	65.000%	75.000%	
Iraq / Paris Club	70.000%	72.000%	↓
Iraq / Bonds	78.000%	80.000%	↓
Libya / Trade	25.000%	35.000%	
Syria / Trade	6.000%	11.000%	

Figures correct as of October 2011

**Trade:** Trade Debt Instruments

**Loans:** Loan Agreements

**PDI:** Past Due Interest

**Pns:** Promissory Notes

**Pars:** Brady Par Bonds

↓↑: Changes compared to last edition

Prices are a percentage of principal only, however assuming inclusion of an average amount of PDI for the specific debt instrument and the specific debtor. Trade debts and their documentation differ from case to case and price ranges should therefore be considered as benchmark only.

Price ranges are based on a monthly compilation of sources and analytics. Liquidity on most instruments is very limited and trading may not have taken place for some time.

Prices of debts of other countries and/or other classes are available on request.

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