Equity Research
Europe

Economics

Turkey

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Economic Trends

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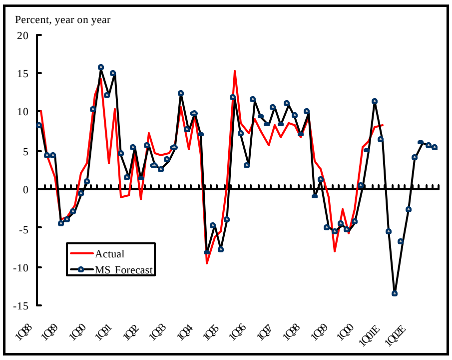
Exit Wounds

- **Currency devaluation brings stagflation, recession and rising inflation**
  After rising out of the abyss at an impressive growth rate of 7.0% last year, the Turkish economy is facing extreme difficulties this year. We cut our real GDP growth forecast from -3.5% to -7.2% for 2001.
- **Credit crunch discourages consumer spending and worsens output decline**
  Given the weak state of the banking system, financial disinter-mediation heightened by a major liquidity squeeze imposes borrowing constraints on households and consequently drives down spending.
- **Tourism is likely to be the only engine of growth in 2001**
  We project a 12% rise in tourist arrivals in 2001, bringing the annual total up to 11.5 million visitors, and a 25% increase in tourism revenues, boosting the annual amount to US$9.4 billion.
- **The endless quest for fiscal discipline continues**
  We expect public finances to deteriorate significantly this year, due to the higher interest burden. Therefore, the government must signal its commitment through fiscal consolidation or face more challenges.
- **Central-government debt stock is rising at an unsustainable pace**
  The most important concern for us is still debt dynamics. Even with optimistic assumptions, we project the central-government debt stock to jump up to 88.6% at the end of this year, rising to 90% in 2003.
- **The risk of early election is not negligible, in our view**
  The rising risk of an early election is an obstacle for the normalisation process in financial markets. However, we note that breaking the coalition would not benefit parties in the middle of a major crisis.
- **Becoming an EU nation remains the most important policy objective**
  Turkey's candidacy for EU membership encourages economic stabilisation and economic and political structural reforms. All in all, we expect Turkey to 'join the club' no earlier than 2012.

Real GDP Growth, 1986-2002E



E = Morgan Stanley Dean Witter Research Estimates
Source: State Institute of Statistics, Morgan Stanley Dean Witter Research

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Exit Wounds

This is an extract from a report (28 pp) dated April 12, 2001.

Currency devaluation brings stagflation, recession and rising inflation. After coming out of the abyss at an impressive growth rate of 7.0% last year, the Turkish economy is facing extreme difficulties this year. It has been hit by two consecutive financial crises triggered by rumours and political concerns: first, a banking crisis and, second, a currency crisis that resulted in the collapse of the crawling peg exchange-rate regime. Consequently, we are cutting our real GDP growth forecast from minus 3.5% to minus 7.2% for 2001. There are several factors that contribute to our out-of-consensus forecast revision (which we discuss below), but the underlying reason for the 18.3% collapse we estimate in total domestic demand is our belief that the Turkish authorities are already too late in introducing a new stabilisation programme. Without a policy framework, disappearing 'visibility' for the real economy has deepened the recession. Therefore, we see no hope for the first half of the year, while we think the performance in the second half will largely depend on politics — namely, the risk of early elections — and the scope of debt restructuring.

Negative income/wealth effect to lower private consumption and investment. For 2001, we are projecting private consumption and gross fixed capital investment to contract by 9.0% and 21.5%, respectively, after rising 6.2% and 16.0% last year. The leading culprits are the negative income/wealth effect of currency devaluation and dysfunctional financial markets. With the start of the now-defunct IMF-prescribed stabilisation programme in 2000, interest rates dropped beyond market expectations, generating a wealth effect that boosted private consumption and investment, which is being reversed this year with interest rates running at an annualised 150%. Wages and salaries are likely to be depressed this year as well, on the top of last year's real increase of only 0.3% in the manufacturing sector average wages, for example.[1] With unemployment on the rise, a recent local consumer survey supports our view, as 94% of consumers have reduced their consumption (particularly in clothing, communications, food and restaurants, travel, and personal care). Furthermore, consumers do not expect a resolution of the ongoing crisis any time soon. Only 15% of consumers think that it will be over in the next six months, which means that the precautionary saving mood is likely to last longer than consensus expectations.

Dysfunctional markets will have adverse effects on the real economy. The strong correlation between private consumption and bank lending to households suggests that credit growth and consumption move closely together. Therefore, the problems in the banking system, which have adverse effects on the credit channel, contribute to this year's underlying theme of negative income and wealth effects of exchange-rate devaluation. Along with excessively high interest rates, currency devaluation reduces the propensity to consume and undertake fixed investment. Credit growth in 2000 was one of the leading engines of the staggering rise in domestic demand, as, in absolute terms, the stock of consumer loans rose by 380% year on year to US$7.0 billion. More importantly, the crowding-in effect generated by the sharp fall in interest rates and improving public finances boosted the ratio of consumer credit flows to private consumption from minus 0.6% at the start of 1999 to 7.6% in the second quarter of last year, which later declined to 5.2% in the third quarter and 2.7% in the fourth. The recent trend is quite similar to what we observed before the 1994 crisis: the ratio of consumer indebtedness reached 7.8% in the third quarter of 1993 (up from 0.2% in the previous year) and declined to 3.0% in the subsequent period, followed by negative readings throughout 1994. Since we reason that the crisis of 2001 is likely to be much worse than that of 1994, we think credit availability is likely to diminish significantly this year and probably recover only in the second half of 2002. In addition, the standstill in the payment system has had a crippling effect on the whole economy, as people are not paying their bills, because they expect that the lira will weaken further.

The crowding-out effect of public finances is key in determining credit availability. The country is already suffering from a sudden reversal in capital inflows and a sharp contraction in foreign bank lending, which put enormous pressure on financial markets and the real economy (see the section in this report entitled *Once Bitten, Twice Shy — On the Supply of New Loans*). Furthermore, liquidity constraints are unlikely to go away soon, since the public-sector borrowing requirement is rising. Until 2000, Turkey had long suffered from the crowding-out effect of an ever-increasing public-sector budget deficit. Once more, we

[1] Excluding the public sector, which recorded annual average real wage growth of 15.8% (due largely to backward-looking wage indexation schemes), wages in the private manufacturing sector actually declined by 2.6% in real terms last year.

Crisis and the Real Economy

expect the deterioration in public finances to crowd out the private sector and thus reduce domestic absorption.

The economy is also likely to suffer from the vicious circle of currency devaluation and inflation. Since its flotation, the Turkish lira has depreciated by 87% against the US dollar, which will, to a lesser extent, feed through to domestic prices. We still believe that inflationary dynamics can easily turn into a self-perpetuating vicious circle of currency devaluation and inflation, possibly leading to hyperinflation. Given that the exchange rate has not yet settled, assuming an average lira/dollar rate of 1,251,742 this year, we project year-end inflation rates of 73.0% for the CPI and 81.2% for the WPI. Even though it seems that recession is limiting the pricing power of the private sector, price adjustments in the public sector will boost inflation. Thus, to avoid a destructive devaluation-inflation spiral that can lead to hyperinflation, we think the authorities need to dampen the inflationary effects of the weak lira through policy tightening.

We envisage a cyclical improvement in external accounts. The contraction of the domestic economy should improve the country's external accounts. We estimate that the contribution of net international trade to national income should increase from minus 3.3% in 2000 to 8.7% this year, as exports rise by 15.0% and imports decline by 19.0% in real terms. We think export-oriented industries (particularly those with low import content) and services sectors (especially the tourism industry) should carry the economy this year. Consequently, we project that the trade deficit will narrow to 7.2% of GDP this year from 10.5% in 2000, while the current account balance will move from a deficit of 4.6% of GDP in 2000 to a surplus of 2.4% in 2001.

The policy response to economic difficulties risks becoming a case of 'too little, too late', in our view. Given the unfavourable global economic trends, the recovery of the Turkish economy demands a quick response, but it has been almost two months since the collapse of the previous programme and there are still no concrete measures in place. Above all, we believe the authorities must deal swiftly with the problems of the banking system that are linked to public finances. A stabilisation programme cannot be implemented on a sustainable basis without a working banking sector, which is the transmission channel. Furthermore, as we have previously highlighted, debt dynamics have worsened, and we feel the government must undertake costly fiscal measures — such as domestic debt restructuring. Our projection for 2002 is therefore based on an optimistic scenario that envisions political stability, although we feel the risks to this scenario are rising.

Exhibit 1

Turkey: Macroeconomic Forecasts, 1993-2002E

(%)	1993	1994	1995	1996	1997	1998	1999	2000	2001E	2002E
National Accounts[1]										
Real GDP	7.8	-4.2	7.8	7.5	7.5	3.6	-4.7	7.0	-7.2	5.2
Private Consumption	8.4	-4.8	5.5	8.7	8.4	0.9	-2.6	6.2	-9.0	4.6
Public Consumption	6.3	-2.9	6.7	8.3	3.1	8.0	6.8	6.8	-4.6	3.0
Gross Fixed Investment	24.1	-14.0	11.3	15.0	14.5	-2.7	-15.9	16.0	-21.5	5.2
Exports	7.8	14.6	9.4	21.7	19.0	13.1	-6.9	19.2	15.0	16.4
Imports	35.4	-20.2	30.7	22.2	22.3	3.1	-3.6	25.7	-19.0	12.3
Inflation										
CPI										
Year-End	71.1	125.5	76.0	79.8	99.1	69.7	68.8	39.0	73.0	48.7
Annual Average	65.6	103.9	92.4	80.3	84.5	86.7	64.8	56.4	55.8	59.2
WPI										
Year-End	60.3	149.6	65.6	84.9	91.0	54.3	62.9	32.7	81.2	45.1
Annual Average	58.2	117.7	91.8	75.1	81.0	74.0	52.7	53.0	58.4	57.7
External Accounts (US$ bn)										
Exports	15.6	18.4	22.0	32.3	32.7	31.2	29.3	31.2	35.0	37.3
Imports	29.8	22.6	35.2	43.0	48.0	45.4	39.8	53.6	46.0	51.2
Trade Balance	(14.2)	(4.2)	(13.2)	(10.7)	(15.3)	(14.2)	(10.5)	(22.4)	(11.0)	(13.9)
% of GDP	-12.3	-4.4	-9.3	-7.1	-8.5	-7.1	-5.4	-10.5	-7.2	-8.8
Services (Net)	4.0	3.8	6.4	3.7	7.9	10.5	3.9	7.4	8.9	7.3
Current Account Balance	(6.4)	2.6	(2.3)	(2.4)	(2.6)	2.0	(1.4)	(9.8)	3.6	(0.6)
% of GDP	-5.6	2.8	-1.6	-1.6	-1.5	1.0	-0.7	-4.6	2.4	-0.4

1. Annual average

E = Morgan Stanley Dean Witter Research Estimates

Source: State Institute of Statistics, Central Bank of Turkey, Treasury, Morgan Stanley Dean Witter Research

Credit Crunch and the Indebted Consumer

This is an extract from a report (4 pp) dated April 23, 2001.

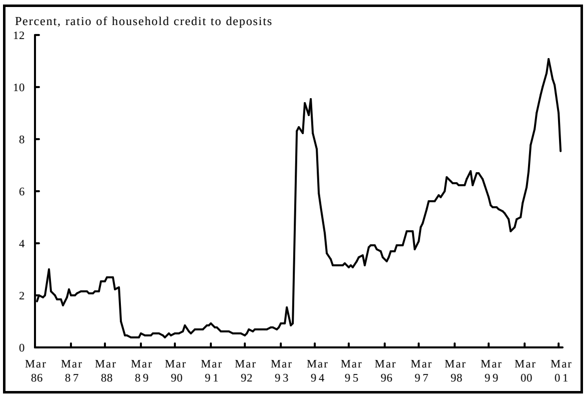
In our view, one of the underlying reasons for such an aggressive, out-of-consensus cut is the credit crunch that we believe is developing quite rapidly and becoming a widespread threat for the real economy. The credit crunch — sudden contraction in the supply of credit — has been triggered by the twin crises in progress: troubles in the banking sector and currency devaluation. We focus on the consequences of credit rationing for consumption behaviour.

Wealth effect and credit growth boosted domestic consumption in 2000. Last year's huge rise in domestic demand was realised on the back of the wealth effect that was generated by a sharp decline in interest rates and a borrowing spree that boosted private consumption. This year, however, we estimate an 18.3% contraction in total domestic demand due to dysfunctional financial markets, along with the long delay in policy response, the lack of concrete fiscal and monetary measures, and the rising risk of an early election. In 2000, bank loans to households jumped by 146% in US dollar terms — the largest ever rise in credit availability to consumers. More specifically, within the household loan portfolio, consumer loans (for housing, automobile and other personal expenses) soared 270%, along with a 47% increase in credit card debt. As a result of the crowding-in effect generated by the sharp fall in interest rates, household debt stock rose to 5.3% of GDP at the end of last year, from 2.7% in 1999 (and from 0.2% in 1990). With the ratio of household credit to total bank deposits rising to an all-time high of 11% in 2000, the ratio of consumer credit flows to private consumption rose from minus 0.6% at the start of 1999 to 7.6% in the second quarter of last year, which later declined to 5.2% in the third quarter and 2.7% in the last. Starting from early December, these trends, however, suddenly changed due to increasing concerns in the banking sector. Therefore, in our view, coupled with the negative income/wealth effect, the credit cycle puts downward pressure on consumption.

Dysfunctional markets are likely to have adverse effects on consumer behaviour. There is a strong correlation between consumption and bank lending to the household sector. The problems in the banking system have adverse effects on the credit channel and therefore contribute to a major reduction in the propensity to consume. The recent trend is quite similar to that we observed before the 1994 crisis: the ratio of consumer indebtedness reached 7.8% in the third quarter of 1993 (up from 0.2% in the previous year) and then declined to 3.0% in the subsequent period, followed by negative readings throughout 1994. As a share of GDP, household debt stock reached 2.6% of GDP in 1993 (up sharply from 0.2% in the previous year) and then plummeted to 1.1% in 1994. Since we reason that the crisis of 2001 is likely to be much worse than that of 1994, we think credit availability will diminish significantly this year.

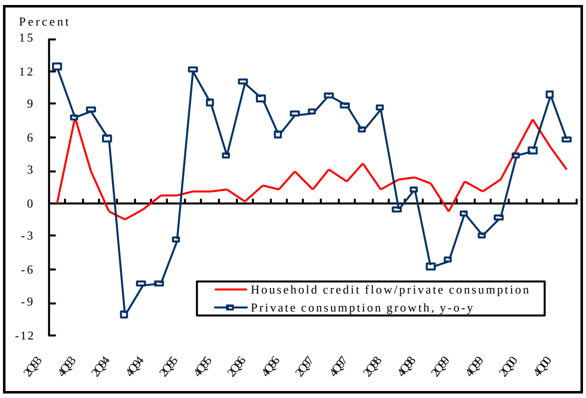
The credit crunch is already evident in the latest figures on bank lending to households, as credit availability to the household sector shrank by 21% in real terms in the first quarter compared with the end of 2000. Consumer loans contracted at an even greater pace, down 27% in real terms in the same period. The commercial banking system, which is already under great pressure due to balance sheet problems (stemming from structural factors as well as

Exhibit 2
Turkey: Consumer Loan Expansion, 1986-2001



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Exhibit 3
Turkey: Credit Growth & Consumption, 1993-2000



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Crisis and the Real Economy

unmonitored intermediation and the rising cost of unhedged external obligations) has become concerned about credit quality and is thus cautious in giving loans. Credit availability — the ratio of household credit to total bank deposits — declined from 11% at the end of last year to 7.6% in March. Commercial banks are struggling to stay as liquid as possible and racing to reduce the size of their loan book to limit the hit from bankruptcy and/or default risks, which are rising. The ratio of past-due consumer loans and credit-card debt rose from 2.7% last November to 4.0% at the end of March.

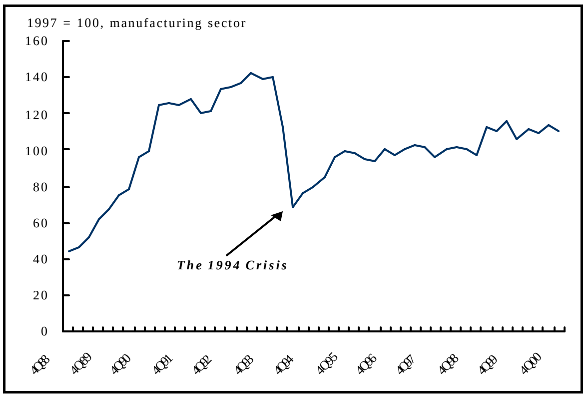
Rising interest rates reversed the wealth effect. On the other hand, both the 'unexpected' currency devaluation and sharply rising interest rates undermined consumer confidence. Last year's (positive) wealth effect has been reversed, putting contractionary pressure on consumer spending. Once again, the latest survey results support our 'great depression' call in domestic demand, as an increasing number of respondents still expect loan rates to increase on a three-month horizon. Furthermore, while banks' asset quality concerns are reducing the supply of consumer loans, in light of deteriorating economic prospects, the consumer's precautionary savings mood is undoubtedly reducing the demand for new loans. Even those consumers who do not face liquidity constraints are being forced to reduce their demand for new loans by prohibitively high interest rates.

Currency devaluation is eroding personal incomes. We believe average income growth will be negative this year. Average wages and salaries in the manufacturing sector, for example, increased by only 0.3% last year. Furthermore, excluding the public sector, which recorded annual average real wage growth of 15.8%, due largely to backward-looking wage indexation schemes, wages in the private manufacturing sector actually declined by 2.6% in real terms in 2000. We think that the 1994 experience could guide us in understanding the developing trend in income growth. Real wages in the manufacturing sector — weighted average of public and private sectors — fell by 43.3% in 1994 and, at the end of 2000, had only reached 78% of the pre-devaluation level in 1993. Given the widespread indexation schemes, we believe that wages will start to recover, but that the initial shock would be enough to damage extensively consumer confidence.

Policy response and the state of public finances will be key in determining credit availability to consumers. The country is already suffering from a sudden reversal in capital inflows and a sharp contraction in foreign bank loans, which put enormous pressure on financial markets and the real economy (see the section entitled *Once Bitten, Twice Shy — On the Supply of New Loans*). Moreover, liquidity constraints are unlikely to go away soon, since the public-sector borrowing requirement is rising. Accordingly, we expect the deterioration in public finances to crowd out the private sector and reduce domestic absorption.

Credit contraction is discouraging consumer spending and thus worsening the output decline. All in all, given the weak and inefficient infrastructure of the banking system, financial disintermediation heightened by a major liquidity squeeze doubtless imposes borrowing constraints on households and consequently drives down consumer spending. For that reason, we do not expect an immediate shift in liquidity preferences of financial institutions, even well after the introduction of solid policy measures. As a result of all these structural factors and borrowing constraints, we estimate that Turkish consumers will lower their spending by 9%, contributing to an unprecedented decline in total domestic demand this year.

Exhibit 4
Turkey: Real Income Growth, 1988-2000



Source: State Institute of Statistics, Morgan Stanley Dean Witter Research

Crisis and the Real Economy

Validating Our 'Great Depression' Call

Everything points to a 'great depression' this year. Validating our 'great depression' call is no challenge, as the latest 'hard' data and the business survey conducted by the Central Bank of Turkey provide ample evidence. Above all, the capacity utilisation rate in the manufacturing sector declined by 3% on average in the first quarter of 2001, compared with a year ago, and industrial production posted a year-on-year drop of 5.3% in February. However, in our view, these figures do not reflect fully the worsening in economic activity, as retail sales figures are much more telling in this case and signal significant contraction in industrial output in the coming months. For instance, domestic white-goods sales were down 36% year on year in the first quarter and 55% in March alone. In addition, the composite business sentiment index worsened to minus 64.8 in terms of balance of responses in March — the lowest reading since 1987.

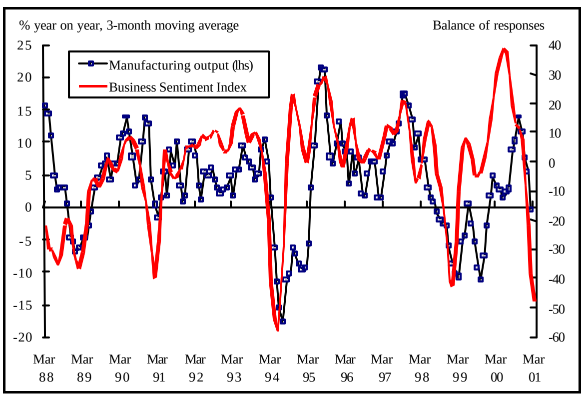
Output expectations are on a nosedive. The business survey shows that both the trend and expectations in manufacturing output volume have worsened since the first wave of crisis in November 2000. As of March, the trend of the last three months moved to an all-time low of minus 40.4, while output expectations for the next three-month period worsened to minus 21.4. We think output expectations will get even poorer, as new domestic order expectations for the second quarter worsened significantly to minus 28.6 and new export order expectations show no turnaround in foreign demand yet. Consequently, investment spending plans over the next 12 months hit the bottom (minus 69.5) and financial conditions deteriorated with past due receivables rising to an all-time high of 45.9 in March.

Ample evidence for output contraction in the second quarter. The survey results provide ample evidence for an ongoing manufacturing output contraction in the second quarter. Given the significant correlation between the business sentiment index and manufacturing production, we think the rate of deterioration in manufacturing output, which posted a year-on-year decline of 5.0% in February after rising by 7.6% the previous month, will accelerate sharply in the coming months. The sudden rise in inventory levels supports our view. On a seasonally-adjusted basis, the amount of monthly stocks of finished goods rose from 4.1 in terms of balance of responses in November to an average of 17.1 in the first quarter of 2001.

Without a concrete policy framework, disappearing 'visibility' for the real economy will only deepen the recession. All in all, these survey results and retail sales figures support our out-of-consensus forecast for the 18.3% drop in total domestic demand, and even point to further downside risks. In our view, the Turkish authorities are already too late in introducing a comprehensive stabilisation programme and, without a concrete policy framework, we think disappearing 'visibility' for the real economy will only deepen the recession.

Exhibit 5

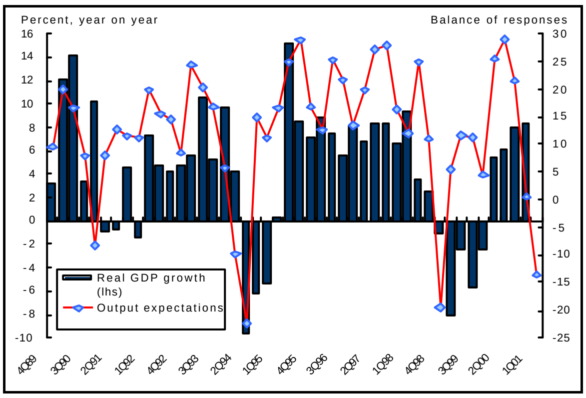
Turkey: Business Sentiment & Manufacturing, 1988-2001



Source: Central Bank of Turkey, State Institute of Statistics

Exhibit 6

Turkey: Real GDP & Output Expectations, 1989-2001



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

O Liquidity, Where Art Thou?

This is an extract from a report (4 pp) dated March 20, 2001.

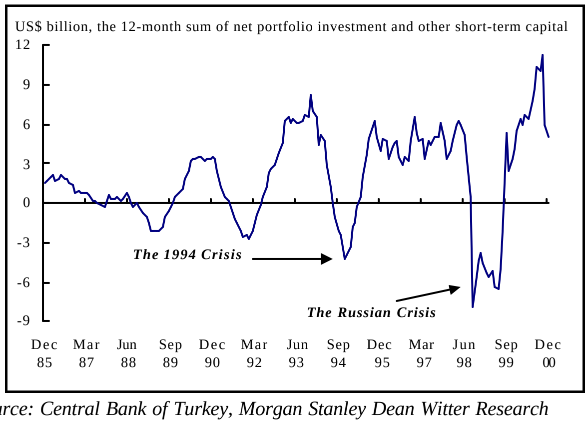
"Markets can remain irrational longer than you can remain solvent." John Maynard Keynes

International illiquidity is one of the leading factors that have contributed to the ongoing crisis in Turkey. The transmission channel of monetary dynamics, shifting liquidity preferences of domestic banks in the wake of a sudden stop in foreign lending, has triggered the liquidity problem that cripples not only the financial system but also the real economy through dysfunctional credit markets and the failure of payment systems. We have long argued that the underlying problem in the Turkish banking system lies with the two mismatches, currency and maturity. Above all, the country has always relied heavily on short-term external financing — net foreign direct investment (FDI) covered a mere 1.1% of the current account deficit in 2000, whereas net portfolio investments and other short-term capital flows financed 51.8% of the external deficit. We believe this fundamental imbalance is the chief source of financial fragility in Turkey.

The sudden-stop syndrome — a massive reversal of capital inflows — makes Turkey vulnerable to unexpected shocks. Several studies have already identified the abrupt reversal of capital inflows as the major contributory factor behind currency crises around the world. In the section of this report entitled *Once Bitten, Twice Shy — On the Supply of New Loans*, we express our views on the possible direction of capital movements this year. Last year, Turkey's short-term liabilities grew at an unprecedented rate, up US$6.2 billion, while its liquid international assets declined by US$2.1 billion. Therefore, a sharp contraction in foreign bank lending as a result of increased risk aversion is likely to result in further net capital outflow. In terms of the mismatch between the accumulation of short-term external liabilities and assets, the situation is even worse than the period prior to the 1994 financial crisis. Furthermore, given the authorities' commitment to force a reduction in the Turkish banking system's short foreign-exchange position, private banks are rushing to trim down their mismatches by accumulating FX-denominated assets. For that reason, we are cautious on the supply of new loans and expect further suffrage from international illiquidity.

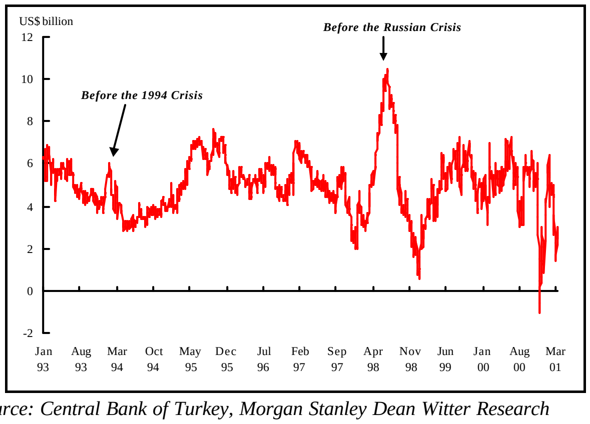
Uncertainty and liquidity constraints change portfolio allocation. In a time of crisis, the leading priority for financial institutions (and even for individuals) is to stay solvent by having a 'cash cushion' — the precautionary demand for liquidity. Thus, uncertainty-driven liquidity constraints and expectations about the future path of economic variables force Turkish banks to stay in liquid assets and readjust their portfolio allocation. Furthermore, domestic banks have three funding sources: depositors, foreign lenders, and the central bank as the lender of last resort. The same set of variables that makes banks stay liquid affects investment decisions of depositors in the same fashion, promoting investment in short-maturity assets. The share of short-term Turkish lira deposits (loosely defined as deposits with maturity of less than three months) in total deposits reached 82.9% in November — the highest reading since the 87.7% peak recorded during the 1994 crisis. This increases the cost of funding and worsens the maturity-

Exhibit 7
Turkey: Short-Term Capital Flows, 1985-2000



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Exhibit 8
Turkey: Banking System Liquidity, 1993-2001



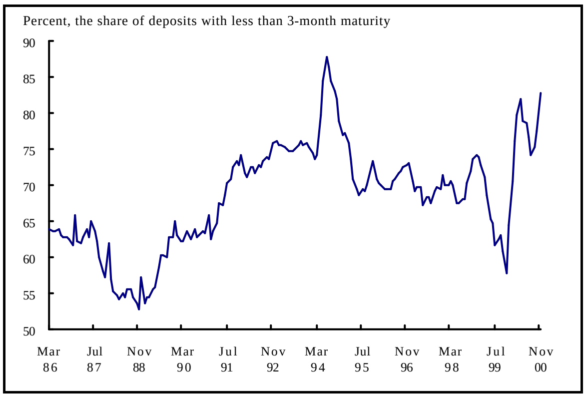
Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Crisis and the Real Economy

mismatch problem of banks that hold 90% of government securities. The first priority for the ailing Turkish banking system is to meet its short-term (external and domestic) obligations in case of a bank run during the ongoing crisis. We estimate that the country is likely to be required to become a net external debt payer this year. This means a net contraction of US$6-10 billion in short-term liabilities.

Illiquidity creates dysfunctional markets. The Turkish economy is facing a major gridlock — a market failure — as a result of liquidity constraints. The amount of liquidity that banks tender depends on the liquidity of financial markets and *vice versa*. Since November, however, all-time low trading volumes have confused financial institutions in Turkey. Because of the rumour mill and the apparent lack of trust, commercial banks hardly undertake transactions with each other. The credit channel is too severely damaged as a result of the heightened uncertainty. All these are due largely to the fact that the banking system is failing to function as a market maker in liquidity and a clearinghouse for settlement of payments. The gridlock problem stems partly from the 'black hole' in the balance sheet of state-owned banks, in our opinion. Three state banks (Ziraat, Halk and Emlak) have an outstanding 'duty loss' (due to subsidised lending activities) of TL 13,000 trillion (approximately US$13.4 billion). Of course, this is just a snapshot amount. Until the Treasury fully repays this sum, these banks will continue to rely on money markets to finance this gap and consequently to accumulate further losses. Therefore, we think the first step to solve the liquidity gridlock should be breaking this vicious circle by injecting equity into state banks. Furthermore, in the interim period, we believe the Central Bank of Turkey should also lower reserve requirements (which are effectively a tax on the banking system) for all banks, which could provide some relief — liquidity — for commercial banks that are coming under pressure from the sudden reversal of capital inflows.

Exhibit 9
Turkey: Maturity of Bank Deposits, 1986-2000



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Crisis and the Real Economy

Sandals and Dollars

This is an extract from a report (4 pp) dated January 15, 2001.

Last year marked a turnaround in tourism. After a period of sustained growth in the 1990s, the Turkish tourism sector suffered two consecutive major setbacks: the Russian crisis in 1998 and the earthquakes in 1999 that brought down the number of tourist arrivals by 20.5% and tourism revenues by 27.5% at the end of 1999. However, since then, we think the sector has become an impressive turnaround story, despite structural problems (such as air transportation limitations). In January-October, arrivals rose by 39.7% year on year to 9.4 million, signalling that our estimate for 10 million visitors in 2000 is well on track. Furthermore, tourism revenues rose by 43.7% to US$6.9 billion in the same period, leaving us comfortable with our projection of US$7.6 billion for the whole year, in spite of the euro's weakness.

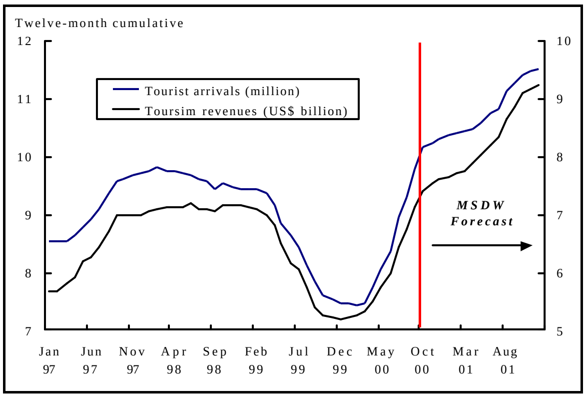
Rolling out our 2001 forecasts. We believe tourism will continue to be a locomotive for the Turkish economy in 2001. As a part of our macroeconomic outlook for the year, we project an 11.8% rise in tourist arrivals, which would bring the annual total up to 11.5 million visitors, and a 21.6% increase in tourism revenues, which would boost the annual amount to US$9.2 billion — the highest ever figures— by the end of this year.

Increasing market share. We believe Turkey has great potential to boost tourism, which would in turn increase the potential GDP growth rate (for example, through factor reallocation from agriculture to services) and generate much-needed foreign currency. At the end of 1999, its market share in the Mediterranean region stood at only 3.7%, below Greece's 5.6% share. Security fears stemming from the Kurdish issue kept foreign visitors at bay. Along with Turkey's bid to join the European Union (EU), the normalisation process in the aftermath of the Ocalan trial has been a key driver of the country's tourism industry. We think further progress on these issues will improve the sector's prospects. The World Travel & Tourism Council predicts annual growth of 7.2% over the next 10 years in terms of visitor exports for the Turkish tourism sector, which exceeds its 2.8% projection for EU countries.

Counting on the strength of euro. Turkey's tourism sector relies heavily on Europe, as 80% of visitors originate from there. The per-capita spending of European tourists in Turkey rose from US$540 in 1992 to US$776 in 1998. However, since then, per-capita revenues have fallen sharply to US$674, due largely, in our view, to the weakness of the euro. As our currency economics and strategy team predicts a sustainable recovery in the euro this year, we foresee a positive effect on Turkey's tourism earnings stemming from the strength of the euro against the US dollar.

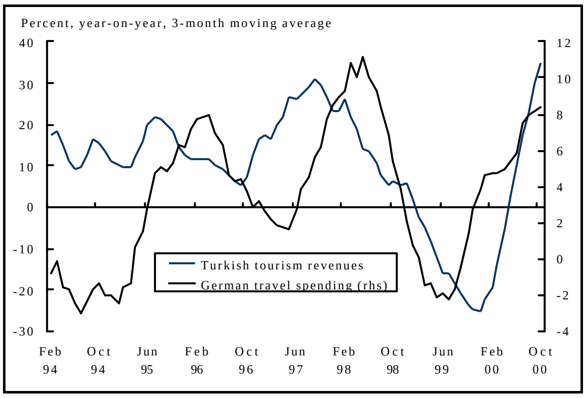
Tourism should be an engine of growth in 2001 as well. We estimate that the tourism sector's direct contribution to the economy reached 5.6% last year, up from 4.7% in 1999. As we expected, the sector made a significant direct contribution to real GDP growth last year. The hotel and restaurant component of national accounts posted an average growth rate of 16.0% in the first three quarters of the year, making it the fastest growing business sector. Furthermore, the strong indirect links of tourism with other

Exhibit 10
Turkey: Tourism Sector, 1997-2001



Source: State Institute of Statistics, Morgan Stanley Dean Witter Research

Exhibit 11
Turkey: Euro Dependence, 1994-2000



Source: Datastream, Central Bank of Turkey economic sectors (and even with budgetary performance, as the sector contributes more than 10% of tax revenues) are an important factor for overall economic performance. We estimate that tourism stimulated 38 other sectors, pointing to a larger multiplier effect; this implies that the sector generated some US$35 billion in 2000.

Tourism revenues contribute to the correction of external accounts. We project an improvement in Turkey's current account balance from a deficit of 4.6% of GDP in 2000 to a surplus of 2.4% this year, partly on the basis of our expectations for the tourism sector. We think the contribution from tourism revenues to the improvement of the current account balance should become even more noteworthy this year and that tourism will continue to play a leading role on the financing front. Approximately 18% of FDI in Turkey is related to tourism, and foreign companies own 20% of the country's existing accommodation capacity. With a strengthening legal framework and the removal of bureaucratic hurdles, tourism is a growth area that should, we believe, attract FDI to Turkey.

Exhibit 12

Turkey: Origin of Tourist Arrivals, 1998-2000

(%)	1998	1999	2000[1]	Change[1]
Europe	82	78	80	45
Americas	6	7	7	42
Africa	1	2	1	38
Asia & Middle East	10	12	11	23
Others	1	1	1	72

1. January to October
Source: Ministry of Tourism, Morgan Stanley Dean Witter Research

The Endless Quest for Fiscal Discipline

This is an extract from a report (4 pp) dated April 12, 2001.

"In this world, nothing can be said to be certain except death and taxes." Benjamin Franklin

This is the most challenging year for fiscal authorities. Turkey is suffering from a devastating financial crisis that, we estimate, will result in an economic contraction of 7.2% this year. Given the tax elasticity relative to real GDP growth (1.44 in 2000 and 1.09 in 1988-2000), we think tax revenues will decline from 20.8% of GDP in 2000 to 19.2% this year, despite the introduction of new, higher tax rates. As a result, we think that, despite declining spending, the overall budget deficit will worsen from 10.1% of GDP to 11.2%, due largely to the higher interest burden.

Interest burden should rise compared with the original budget outlook. Before the crisis, the Treasury was projecting an average interest rate for its domestic borrowing programme of 22% this year and 17.5% in 2002. It was also planning to extend the maturity structure of its domestic debt issuance. However, the ongoing crisis has changed everything: we think that the average interest rate is likely to be above 80%, while the average maturity will probably remain below 12 months for the rest of the year. In addition, the Treasury plans to issue TL 13,000 trillion worth of domestic debt to patch the 'black hole' in the state banks' balance sheets and transfer TL 3,000 trillion to these banks to comply with the capital adequacy requirement. All these mean that the servicing cost of domestic debt will rise significantly compared with the official fiscal outlook at the start of the year. The original budget earmarked around TL 16,000 trillion for interest payments on domestic debt and TL 2,400 trillion for interest payments on external debt. First, we think that, with the currency devaluation, external interest payments are likely to increase to TL 4,120 trillion this year. Second, with higher interest rates and shorter maturity, we expect the domestic interest bill to increase to TL 24,500 trillion. In other words, on our projections, interest payments will stand at 15.2% of GDP this year and 10.5% next year, compared with official estimates of 10.0% and 5.0%, respectively.

Exhibit 13

Turkey: Fiscal Outlook, 1996-2002E

% of GDP	1996	1997	1998	1999	2000	2001E	2002E
Revenues	18.8	20.4	22.2	22.5	26.5	23.4	22.9
Tax Revenues	15.6	16.5	17.3	17.9	20.8	19.2	17.0
Income Taxes	6.2	6.7	8.0	8.1	8.5	7.2	6.2
Indirect Taxes	9.5	9.8	9.2	9.8	12.3	10.6	10.8
Other Revenues	3.2	3.8	5.0	4.7	5.7	4.2	5.8
Expenditure	27.5	28.0	29.1	33.8	36.6	34.6	28.3
Non-interest	17.0	20.0	17.6	20.9	20.5	19.4	17.8
Interest	10.4	8.0	11.5	12.9	16.0	15.2	10.5
Primary Balance	1.8	0.3	4.6	1.7	6.0	4.0	5.0
Overall Balance	-8.6	-7.6	-6.9	-11.3	-10.1	-11.2	-5.4

E = Morgan Stanley Dean Witter Research Estimates
Source: Ministry of Finance, Turkish Treasury, Morgan Stanley Dean Witter Research

Rising inflation will increase primary spending. Turkey's public finances have deteriorated over the decades, not just because of the higher interest burden, but also due to populist policies that have boosted primary spending, which rose from 13.5% of GDP in 1985 to 20.5% last year. Under the existing budget law, the Ministry of Finance is required to increase personnel spending in line with rising inflation. The budget law grants a salary adjustment to civil servants if CPI inflation exceeds the official inflation target. Therefore, *ceteris paribus*, non-interest spending will rise to TL 6,000 trillion (or 3.1% of GDP), due simply to a higher wage bill. In order to limit the deterioration in public finances, the authorities are considering a number of options that would increase savings in the public sector. The government aims to generate savings of at least 1.5% of GDP. However, we see limited scope for an immediate reduction in primary spending by, for example, partitioning gas usage or turning off computer screens on lunch breaks. In our view, the only way to limit the rise in non-interest spending is to limit wage increases, military spending (which stands at 5% of GDP), and transfers to state enterprises.

New taxes are unfortunately a *sine qua non* for stabilising public finances. In a contracting economy, tax collection is not an easy task. Nonetheless, we think the Turkish government must levy new taxes to improve public finances in the short term. The government has already increased the fuel consumption tax by 20%. In our view, there is room for further adjustment in this area. For instance, the average gasoline price in Europe is about US$1.0 per liter, whereas it is less than US$0.7 per liter in Turkey. Such a permanent adjustment would have a twofold impact on the budget: it would increase tax collection by approximately 0.5% of GDP and indirectly reduce the amount of budgetary transfers to state enterprises in the energy sector. In addition, a number of tax rates (the general VAT rate, the VAT rate on luxury goods, the special telecommunications tax rate and the withholding tax rate on bank deposits and repurchase agreements) may be increased in the coming weeks. However, market participants should not be surprised if the government introduces a new 'windfall' tax on financial assets and/or a 'wealth' tax. The most likely outcome, in our view, is the net asset tax and the 'economic balance' tax that were introduced after the 1994 crisis. The problem with such draconian measures is that the Constitutional Court would probably rule against them, as was partially the case in 1994.

Price adjustments in the public sector are also important for the central government budget. In 2000, the public sector raised its prices on average by 24.7%, whereas price increases in the private sector reached 35.7%. Although this is not the best yardstick to measure the magnitude of price adjustment needed by public-sector enterprises, it has been a reliable proxy for that purpose. Since the tax base in Turkey is limited, the authorities have always relied on state enterprises as a taxation (or subsidy) tool. During this cycle, we expect price adjustments in the public sector to exceed the inflation rate in the private sector and, therefore, generate a cushion that would reduce the amount of budgetary transfers to state enterprises.

In the long run, fiscal discipline must come through spending cuts and improving tax collection. We have long argued that increasing the tax burden can only help for a short period of time, and that, to ensure sustainability, fiscal discipline must come through spending cuts and improving tax administration, not from levying higher and new taxes. Despite similar tax rates (for example, the corporate tax rate in Turkey is 33%, marginally lower than the average rate of 34.1% in the industrialised OECD countries), the government's tax collection stood at 32.8% of GDP in 2000, much lower than averages of 37.0% and 44.5%, respectively, in OECD and EU countries. Turkey has a rather outmoded tax system, which, we believe, places an additional burden on the economy, and which is not reflected in the tax rate we mentioned above, as a variety of quite creative taxation schemes increases the corporate tax bill. For insistence, social security taxes in Turkey are considerably higher than in other OECD countries (but the government's intake from social security premiums is a mere 4% of GDP, compared with an OECD average of 10%, highlighting the substantial size of the unregistered economy in Turkey). Historically, the overall tax burden in Turkey has been rising, while European countries ranging from Ireland to Germany are seeking to lower taxes, particularly on capital, to attract and keep foreign investment.

Increasing tax burden may foster tax avoidance and evasion, resulting in revenue loss. Structural factors (such as the large agricultural sector, which employs 44% of the labour force in Turkey, whereas that ratio is less than 5% in EU countries, and the lack of institutional capacity) limit the expansion of the tax base, which ultimately determines the amount of tax revenue. In addition, the withdrawal of economic activity from the formal sector due to macro-economic instability and institutional factors leads to a decline in tax revenues, whereas raising tax rates to compensate for revenue loss leads to further withdrawal. As a result, the tax burden is placed largely on the shoulders of those who are unable to avoid and/or evade taxation. Although it is reasonable to rely on tax measures — new and higher taxes — in the short run to address the deterioration in public finances, we believe that only a comprehensive structural reform programme including an eventual reduction in corporate and income tax rates can break down the vicious circle.

Privatisation is a must for sustainable fiscal outlook. In our view, privatisation — reducing the size and influence of the public sector — is the key to restructuring the government sector in a way that would bring sustainable balance to public finances. It would not only generate precious cash flow that would help stabilise the country's debt dynamics; it could also be the trigger for FDI. Turkey receives a very low level of FDI: 0.3% of GDP on average, compared with, for example, over 5% in Poland. As in numerous other countries, privatisation could become a trigger for FDI flows and accelerate Turkey's integration with the global economy. Putting the privatisation programme back on track requires a political commitment to undertake challenging but necessary legal amendments.

In short, fiscal consolidation is a *sine qua non* for stabilising debt dynamics. We believe the government must signal its commitment through fiscal consolidation; otherwise, the economy is likely to face further deterioration and eventually face hyperinflation and debt restructuring.

Remembering Tax Reform and Ibn Khaldun

This is an extract from a report (5 pp) dated February 15, 2001.

"It should be known that, at the beginning of the dynasty, taxation yields a large revenue from small assessments. At the end of the dynasty, taxation yields a small revenue from large assessments." Ibn Khaldun (1332-1405)

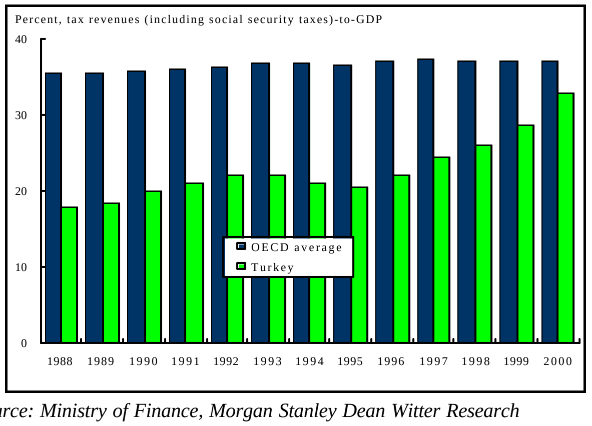
Fiscal discipline must come through spending cuts and improving tax collection, not by levying higher taxes. We have supported the Turkish authorities' (sometimes extreme) tax measures in pursuit of bringing order to public finances. However, an increasing tax burden can only help for a certain period, and we think the country is rapidly approaching the end of that stage. Therefore, to ensure sustainability, we believe fiscal discipline must come via spending cuts and improving tax administration, not via levying higher and new taxes. Last year, thanks to booming domestic demand, declining unemployment and one-off measures, we estimate that tax revenues rose to 32.8% of GDP, up from 28.6% in 1999, bringing the tax elasticity up to 1.4 from an average of 1.1 in 1988-99. Although this is impressive, we think that it cannot be maintained over the long run, and that it indicates an increase in the tax burden on the economy. Therefore, we believe it is not consistent with the spirit of the structural reform process, which aims to improve the country's standard of living.

On paper, Turkey's tax burden is less than in other OECD countries. Despite similar tax rates (for example, the corporate tax rate in Turkey is 33%, marginally lower than the average rate of 34.1% in industrialised OECD countries), the Turkish government's tax collection stood at 32.8% of GDP in 2000 — much lower than the averages of 37.0% and 44.5% in OECD and EU countries, respectively. Turkey has a rather outmoded tax system, which, we believe, places an additional burden on the economy, and which is not reflected in the tax rate we mentioned above, as a variety of quite creative taxation schemes increases the corporate tax bill. For instance, social security taxes in Turkey are considerably higher than in other OECD countries (but the government's intake from social security premiums is a mere 4% of GDP compared with an OECD average of 10%, highlighting the substantial size of the unregistered economy in Turkey). Historically, the overall tax burden in Turkey has been rising, while European countries, ranging from Ireland to Germany are seeking to lower taxes, particularly on capital, to attract and keep foreign investment.

In our view, the situation in Turkey stems largely from structural factors. At the start of the IMF-supported economic stabilisation and disinflation programme, Gazi Ercel, the governor of the Central Bank of Turkey, announced greater integration with the global economy as the ultimate goal. This requires skills to compete on multiple grounds, including taxation. An increasing number of developing and industrialised countries are using the tax system as a 'sweetener' to attract foreign investment and keep domestic investment at home. As a result of this tax competition, the average corporate tax rate in OECD and EU countries has declined by about 3.5 percentage points since 1996.

However, the tax burden in Turkey is not equally distributed. The agricultural sector in Turkey represents around 14% of the economy (compared with an average of 5% in other OECD countries) and is largely unrecorded. In other words, very little tax revenue comes directly from farmers to the state coffers. This picture looks even worse if we compare the ratio of the labour force employed in the farming sector — 44% in Turkey versus 8% in other OECD countries and less than 5% in EU countries. Furthermore, the farming sector's very high share in total employment reflects the informal sector in the Turkish economy, in our view. Such an economic structure limits the expansion of the tax base, which ultimately determines the amount of tax

Exhibit 14
Turkey: Tax Burden, 1988-2000



Source: Ministry of Finance, Morgan Stanley Dean Witter Research revenue. In addition, the withdrawal of economic activity from the formal sector due to macroeconomic instability and institutional factors leads to a decline in tax revenues, while raising tax rates to compensate for revenue loss leads to further withdrawal. As a result, the tax burden is placed largely on the shoulders of those who are unable to avoid and/or evade taxation. We therefore believe that only a comprehensive structural reform programme including an eventual reduction in corporate and income tax rates can break down the vicious circle, highlighted seven centuries ago by Ibn Khaldun, a philosopher and an early scholar of economics, whose main contribution lies in the philosophy of history and sociology.

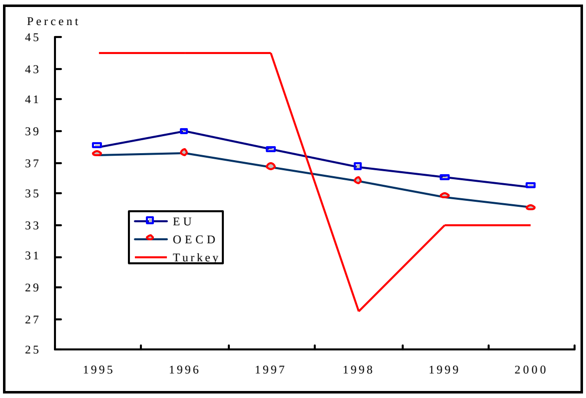
Seven-century-old advice on the taxation dilemma. In his masterpiece, *the Muqaddimah — An Introduction to History*, Ibn Khaldun identified factors that contribute to the rise and decline of civilisations, discussing economic issues ranging from consumption to utility to capital accumulation-driven growth — issues that Smith, Ricardo, Malthus and Marx touched upon centuries later. In particular, Ibn Khaldun developed a clear theory of taxation based on ideas that Keynes later called aggregate effective demand and the multiplier effect, leading Ibn Khaldun to denounce excessive taxation and government intervention as "they would lower productivity, provide no incentive to engage in commercial activity, and ultimately ruin the state."

An excessively high tax burden can cause an economy to degenerate. Ibn Khaldun argued that the tax revenues of the ruling dynasty increase as commercial activity prospers with an accommodating taxation system. However, "gradual increases in the amount of the assessments succeed each other regularly, in correspondence with gradual increases in the luxury customs and many needs of the dynasty and spending required in connection with them. Eventually, the taxes will weigh heavily upon the subjects and overburden them. Heavy taxes become an obligation and tradition, because the increases took place gradually and no one knows specifically who increased them or levied them."

Ibn Khaldun and the optimal rate of taxation. We think the much-discussed Laffer curve mirrors Ibn Khaldun's optimal tax rate argument, above which less revenue is generated as higher tax rates discourage taxable enterprise. "The assessments increase beyond the limits of equality. The result is that the interest objects in cultural [commercial] enterprises disappears, since when they compare expenditures and taxes with their income and gain and see the little profit they make, they lose all hope. Therefore, many of them refrain from all [commercial] activity. The result is that the total tax revenue goes down, as [the number of] the individual assessments goes down. Often, when the decrease is noticed, the amounts of individual imposts are increased. Thus, the total revenue continues to decrease, while the amounts of individual imposts and assessments continue to increase because it is believed that such an increase will compensate [for the drop in revenues] in the end. Finally, civilisation is destroyed, because the incentive for [commercial] activity is gone. It is the dynasty that suffers from the situation, because it [is the dynasty that] profits from [commercial] activity." Conversely, lower tax rates encourage taxable enterprise and thus produce more revenues for the state coffers. Therefore, a tax system should impose as little a tax rate as possible on commercial activity — that is, taxes on capital — to encourage savings and investments.

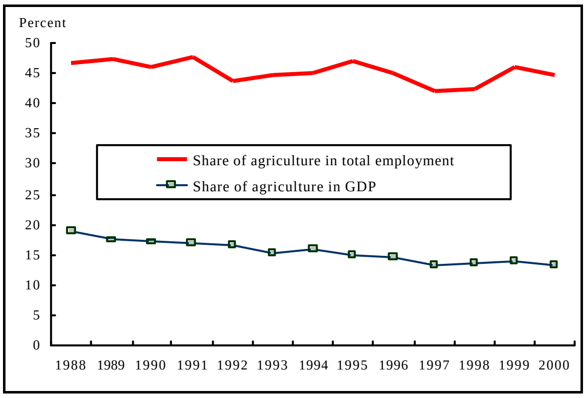
Increasing tax burden may foster tax avoidance and evasion, resulting in revenue loss. In our view, a

Exhibit 15
Turkey: Corporate Tax Rates, 1995-2000



Source: KPMG, Ministry of Finance

Exhibit 16
Turkey: Agriculture Sector, 1988-2000



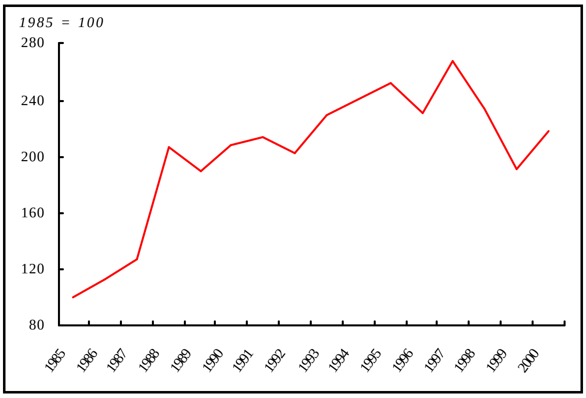
Source: State Institute of Statistics, Morgan Stanley Dean Witter Research

significantly large informal economy and a lack of institutional capacity to control tax collection properly results in less-than-optimal tax revenues in Turkey due to tax avoidance and evasion. For example, the Ministry of Finance every year finds a significant discrepancy between reported income and actual income. In 1999, the close inspection of 51,353 taxpayers (about 1.5% of all taxpayers) showed that they failed to disclose income of TL 1,063 trillion. That brought the ratio of unreported income to actual income up to 45.5% from 20.8% in 1996. We note that the ratio does not necessarily mean an increase in tax evasion, as it could be an indication of improving tax administration. Nevertheless, it highlights a problem that cannot be neglected.

The TIN project should improve institutional capacity for taxation. We have long argued that the full implementation of tax identification numbers (TINs) is essential for expanding the tax base in Turkey. This should not only improve tax collection, but also help to achieve a more equitable tax system and to fight corruption. The number of TINs reached 15.3 million in January, up from 4.8 million in 1995, which is adequate for the widespread use in tax collection and tracking financial flows. In its latest Letter of Intent to the IMF's board of directors, the Turkish government promised to require the usage of TINs in all financial transactions by the end of September 2001. Better monitoring of economic activity should reduce the size of the unregistered economy and thus enlarge the tax base. That, in turn, would contribute to the social security reform process and to tax collection, without increasing the tax burden on those who already pay their taxes promptly.

Tax reform requires restructuring not just in the public sector, but also in the private sector. Turkey's corporate structure is largely based on small businesses, resulting in an expansion in the informal sector and making tax monitoring difficult. We expect the consolidation of small businesses into more sizeable enterprises with greater transparency and accountability in the post-disinflation period to accelerate corporate restructuring, thereby reducing the size of the unregistered economy in Turkey. Meanwhile, the authorities should, we think, incorporate tax reform into a strategy that aims at reducing Turkey's dependency on short-term capital flows, attracting FDI and improving the domestic savings rate through, for example, allowing the creation of private pension funds.

Exhibit 17
Turkey: VAT Productivity, 1988-2000



Source: Ministry of Finance, Morgan Stanley Dean Witter Research

Recent measures should accelerate the collection of tax arrears. The Ministry of Finance recently announced a programme that should accelerate the collection of tax arrears, which currently stand at TL 4,954 trillion (around US$7.3 billion). If we include arrears on social security contributions, total tax arrears would amount to TL 11,154 trillion (US$16.4 billion), which is almost 8% of GDP. The Ministry of Finance aims to collect 20-40% of private-sector tax arrears (currently TL 2,380 trillion, excluding social security taxes, which are not included in this programme), equivalent to TL 500-1,000 trillion, half of which could be collected in 2001. A similar programme in 1997 allowed the collection of 13% of outstanding tax arrears. In the meantime, we believe that success on the privatisation front would also improve tax collection in the long run — state-owned enterprises account for half of the outstanding tax arrears. For example, the government recently passed a law for the privatisation of Tekel, the state monopoly in alcoholic beverages and tobacco, which has a stock of tax arrears that amounts to almost 1% of GDP.

We think the government should focus on spending cuts and on improving tax administration. We agree with the Turkish authorities and the IMF team that it is reasonable to rely on tax measures — new and higher taxes — in the short run to address the deterioration in public finances. However, in our view, fiscal discipline can only be sustained through structural reforms to reduce public spending, increase tax collection and eventually provide, in the words of Ibn Khaldun "the strongest incentive for [commercial] activity [that] is to lower as much as possible the amounts of individual imposts levied upon persons capable of undertaking [commercial] enterprises."

On Debt Dynamics

This is an extract from a report (4 pp) dated May 2, 2001.

External support and domestic policy commitment improve market sentiment. At last, the Turkish authorities have convinced international lenders to pull the 'wild card' — that is, a significant amount of additional financing for the country's new attempt at stability. Amid one of the deepest recessions, we think the domestic policy commitment and external support will surely improve market sentiment in the short term, as highlighted by the favourable reaction of financial markets. With the new financing package (and the details of the new policy framework, which are likely to be announced in the Letter of Intent before mid May), the short-term debt rollover risk is on the decline. However, multilateral financing alone does not solve the country's problems and guarantee that Turkey is out of the woods. The authorities must now complete a marathon of reforms, and foreign lending only fuels the first sprint in that race. The most important concern for us is still long-term debt dynamics.

Is the central-government debt stock rising at an unsustainable pace? At the end of 1999, Turkey's central-government debt stock rose to 50.3% of GDP, up from 42.4% in the previous year (and from 22% in 1980). Given the unfavourable maturity profile of domestic debt, the cost of servicing debt — the ratio of interest payments to national income — reached 13% in 1999 from 0.5% in 1980. The realisation of this unsustainable trend forced the authorities to initiate the now-defunct fiscal consolidation plan. Following a 'stabilisation' period in 2000 (during which the central-government debt stock rose only by two percentage points of GDP to 52.3%, despite excessively high interest rates used to roll over domestic debt in 1999), the original programme aimed to lower the debt-to-GDP ratio this year. Unfortunately, the twin crises have transformed that goal into nothing more than a dream for the foreseeable future.

The cost of servicing central-government debt has brought the country to the verge of a debt trap. In our view, Turkey is rapidly approaching a dangerous debt trap, in which rising interest payments consume the government revenues to such an extent that total debt continues to grow even when the government is not overspending. High public debt is a major concern, because the cost of servicing it amounts to a significant portion of government spending, perpetuating the deterioration in fiscal imbalances. With the crisis in progress, the problem has evolved into a self-sustaining vicious circle, running from debt stock to higher interest rates, interest payments, budget deficits and, once again, to higher debt stock. To service public debt, the central government channelled 77% of tax revenues (about 16.4% of GDP) to interest payments in 2000, up from a mere 17.6% of tax revenues in 1985. Once again, on our 'rough' estimates, the cost of interest payments is likely to be reach 94% of tax revenues this year, which would place Turkey in the same league with Lebanon.

In addition, banking restructuring, a *sine qua non* for economic stabilisation, generates a huge cost. We estimate the initial cost of banking sector restructuring at around 24% of GDP. There is an intriguing interplay between public finances and the state of the banking sector. Throughout the 1990s, banks financed the growing fiscal deficit at lucrative real interest rates. However, given the awkward nature of its balance sheet, the banking system has limited capacity to carry rising domestic debt stock. Because of currency and maturity mismatches in the

Exhibit 18

Turkey: Central-Government Debt Dynamics — An Optimistic Scenario, 2001-10

(%)	Real GDP Growth	GDP Deflator	Real Interest Rate	Primary Balance	Change in Debt[1]	Debt Stock[1]
2001	-7.2	57.0	24.0	4.5	36.4	88.6
2002	5.2	50.0	18.0	5.8	-0.8	87.9
2003	5.8	35.0	14.0	4.5	-0.4	87.4
2004	5.4	22.0	12.0	4.5	-2.5	85.0
2005	4.8	14.0	10.0	4.0	-1.7	83.3
2006	5.0	10.0	10.0	4.0	-1.3	82.0
2007	5.6	10.0	10.0	3.5	-1.6	80.4
2008	6.2	10.0	8.0	3.5	-2.3	78.1
2009	6.2	8.0	8.0	3.5	-1.8	76.4
2010	6.4	6.0	6.0	3.5	-3.7	72.7

1. Percentage of GDP

Source: Morgan Stanley Dean Witter Research Estimates

Crisis and Debt Dynamics

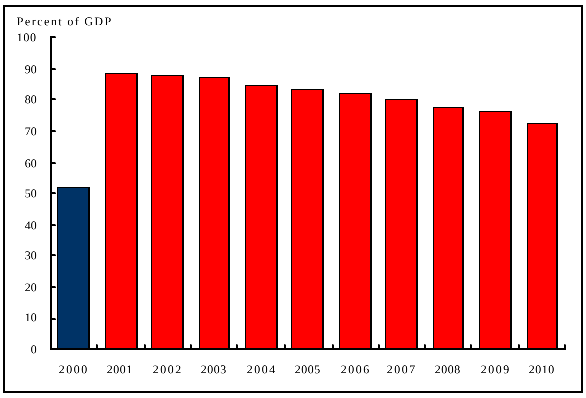
Turkish banks' balance sheets and the lack of an institutional investor base — a point which we have long highlighted — the Treasury is largely unable to issue long-maturity securities that could potentially save the country from falling into a dangerous debt spiral.

The debt-to-GDP ratio is on a perilous path. The analytics of debt dynamics are well known. A country will have a sustainable fiscal regime if current and future primary balances, interest rates and economic growth rates are such that the government's intertemporal budget constraint is satisfied. Our simple model for debt dynamics depends on the primary budget balance, inflation, growth, real interest rates and outstanding debt stock. We think official macroeconomic parameters are quixotically optimistic. However, even with those figures, the central-government debt stock would rise to 78% of GDP. Our macroeconomic estimates and assumptions (including the initial cost of banking rehabilitation at 24% of GDP and no debt restructuring scheme) suggest that Turkey's public debt stock will jump up to 88.6% at the end of this year. Thus, we think the Treasury is running out of time and the debt rollover risk that we have been highlighting since the collapse of the crawling peg exchange-rate regime is about to reach a prohibitive level — we fear the game could be over unless a comprehensive policy framework is immediately put in place.

External aid alone is not enough to stabilise debt dynamics. As we write, the details of the new stabilisation programme and external financial aid are not available, but we feel sure that the package will be heavily conditioned to a large number of structural (economic and political) reforms that will require time and political arm-wrestling to see the daylight in Turkey's highly fragmented political system. In addition, as highlighted by recent sovereign credit downgrades, the outstanding possibility of outright domestic debt default makes private foreign lenders extremely cautious in granting new loans.

Domestic debt restructuring may still be required. The authorities have limited capacity to undertake further fiscal adjustment. Even with the additional foreign aid and optimistic assumptions we used for this projection, the central government debt-to-GDP ratio would rise to 89% this year and would only decline in the coming years if the government did not deviate from fiscal austerity. Although such (and even poorer) debt ratios have been experienced by a number of industrialised countries, they are too high to handle in Turkey's shallow financial markets. For instance, the ratio of domestic debt to deposits rose from 25% in 1980 to 57% last year. Given the troubles in the banking sector, the Treasury has limited room to rely on domestic investors. Furthermore, the key variable that policymakers can influence is primary fiscal balance. *Ceteris paribus*, a one-percentage-point improvement in the primary balance would only limit the deterioration in the central-government debt stock by 1% of GDP, which implies that fiscal adjustment alone is not enough to do the trick as well in this case. Thus, we think the Turkish authorities should consider introducing a domestic debt restructuring plan. Swapping a certain amount of lira-denominated domestic debt with FX-linked securities is one of the options. We note that foreign-currency debt also has risks, and excessive reliance on it can lead to monetary pressures. The terms of a debt swap have implications for public finances, the banking sector and even politics. In our view, debt restructuring should be completed in a burden-sharing framework that would first put public finances on a sustainable path. Furthermore, it should be done in conjunction with a wide range of structural reforms that would take the political risk out of the equation and attract foreign and Turkish capital from abroad. In short, we think that, to break the vicious circle, the authorities should restructure domestic debt and promote a macroeconomic environment that would boost the potential growth rate above 6% and lower real interest rates. That, in turn, would help sustain the one-off correction in public debt stock.

Exhibit 19
Turkey: Central-Government Debt Stock, 2000-10E



Source: Treasury, Morgan Stanley Dean Witter Research Estimates

Crisis and Debt Dynamics

Debt Overhang and the Rollover Risk

This is an extract from a report (4 pp) dated March 15, 2001

Currency devaluation created a debt overhang that increases the debt rollover risk. High public debt is a major concern, because the cost of servicing it amounts to a significant portion of government spending, perpetuating the deterioration in fiscal imbalances. The corrosion in public finances over the decades is a fundamental problem in Turkey and has caused an accumulation of public debt stock. This problem has evolved into a self-sustaining vicious circle, running from debt stock to higher interest rates to interest payments to budget deficits and once again to higher debt stock. The cost of servicing public debt, which already accounts for a significant portion of government spending, has long been one of Turkey's bugbears. The central government channelled 77% of tax revenues (about 16.4% of GDP) to interest payments in 2000, up from a mere 17.6% of tax revenues in 1985.

Even with favourable assumptions, domestic debt stock will remain a major policy concern. We simulate possible paths of domestic public debt rollovers. Even with favourable assumptions, we think the evolution of the domestic debt stock will remain a major policy concern in the foreseeable future. The bottom line is that we see a new risk: not being able to roll over the debt in the event of a crisis.

Exhibit 20

Turkey: External Debt Service, 2000-03

(US$ million)	2000[1]	2001[1]	2002[1]	2003[1]
Public Sector	**9,398**	**11,843**	**10,470**	**11,041**
Loan	6,315	7,362	5,908	5,547
Principal	4,679	5,628	4,412	4,300
Interest	1,636	1,734	1,496	1,247
Bond	3,084	4,481	4,562	5,493
Principal	1,543	2,504	2,786	3,957
Interest	1,541	1,977	1,776	1,536
Private Sector	**9,550**	**13,381**	**5,548**	**4,151**
Loan	9,547	13,377	5,545	4,101
Principal	7,988	11,415	4,541	3,421
Interest	1,559	1,962	1,004	680
Bond	3	3	3	50
Principal	0	0	0	47
Interest	3	3	3	3
Total	**19,068**	**25,310**	**16,157**	**16,590**
Loan	15,981	20,826	11,592	11,047
Principal	12,753	17,043	8,953	8,971
Interest	3,228	3,783	2,639	2,076
Bond	3,087	4,484	4,565	5,544
Principal	1,543	2,504	2,786	4,004
Interest	1,544	1,980	1,779	1,540

1. Official projections *Source: Turkish Treasury*

Public debt stock rose from 22.0% of GDP in 1980 to 52.2% in 2000 and has further accelerated since the start of this year, due to the restructuring of the banking sector. We estimate that Turkey's public debt stock stood at TL 76,897 trillion (61.8% of GDP) before the lira's recent flotation. We estimate that the exchange-rate devaluation creates a debt overhang, increasing the central-government debt stock to about 76.5% of GDP, due to the existence of indexed debt and growing external debt stock. Furthermore, the official figures understate the true level of debt, because Turkey's public accounts are particularly opaque. They exclude, for example, duty losses of state-owned banks. If hidden debts are included, we believe Turkey's public debt is probably already around 90% of GDP, raising doubts in the aftermath of the currency devaluation about debt sustainability.

External debt repayments are looming on the horizon. Given the widely expected capital outflow and increasing risk aversion of international investors, external debt repayments pose a problem. According to the Treasury's projections, the public sector is set to repay US$11.8 billion in external debt this year, while the private sector has external debt obligations of US$13.4 billion. We see numerous economic and political risk factors on the horizon that could make external debt rollovers very difficult. Thus, the Treasury relies on domestic markets to meet its financing requirements, further increasing the size of the domestic debt rollovers.

As debt maturity decreases, the amounts to be rolled over in each auction increase. Short-maturity debt must be refinanced often, which is not only costly, but also leads to a heightened risk of debt crisis. The likelihood of a debt rollover crisis has thus increased considerably since the currency devaluation in February, as the short-maturity structure of domestic debt stock is an important source of concern, especially on the part of foreign investors. On the other hand, if the Treasury places long-maturity instruments at excessively high interest rates, it could spark a new panic due to the informational content of such decision. Issuing domestic debt at 140% for short periods might be an option, but paying such high interest rates for long periods would appear to put the government budget on an unsustainable path, thereby triggering expectations of a debt default or hyperinflation. We think the best way to deal with such a situation in the short term is to place indexed bonds that would increase average maturity and decrease the rollover risk.

Debt accumulation signals a growing rollover risk. The Treasury originally planned to have two domestic debt auctions (with six-month and three-year maturities) in March. In light of recent developments, we think it is likely to revise the borrowing programme and issue significantly shorter maturities, compounding concerns about sustainability, as this would accelerate the debt accumulation process considerably. Furthermore, in February, the Treasury was partly saved by the collection of the third mobile phone licence fee. In the first month of last year, it borrowed at an average interest rate of 38.3% and a maturity profile of 452 days. This year, however, the average interest rate in Treasury auctions rose to 64.9%, while the maturity profile deteriorated to 195 days. Based on the Treasury's first-quarter domestic debt data, we simulate three scenarios and find that, even with a set of optimistic assumptions, the cost of debt servicing is likely to rise this year. In the worst-case scenario, we estimate the average monthly domestic debt rollover would amount to 4.7% of GDP this year, while more favourable assumptions imply an average rollover amount of 2.2%, which would be slightly lower than last year's 2.5%.

The sudden reversal of capital inflows increases the rollover risk. Net portfolio investments recorded an outflow of US$5.0 billion in the fourth quarter of 2000. However, we expect the net capital outflow to slow down. Nonetheless, the capital account data indicate that short-term liabilities were growing much faster than the country's liquid international assets. Therefore, a sharp contraction in foreign bank lending as a result of an increase in volatility is likely to result in further net capital outflow. In addition, troubles in the banking sector nurture dysfunctional markets, despite the central bank's large liquidity injections (the central bank cannot expand credit to the banking system forever, as it has inflationary implications). All these boost funding costs, making the Treasury's borrowing task even more difficult.

Exhibit 21

Turkey: Domestic Debt Rollover, 2001

(TL trillion)	Current	Scenario 1 (E)	Scenario 2 (E)	Scenario 3 (E)
January	2,586	2,586	2,586	2,586
February	5,389	5,389	5,389	5,389
March	3,379	3,379	3,379	3,379
April	1,318	4,796	4,716	1,055
May	5,772	10,614	4,607	8,409
June	4,795	4,219	9,357	3,835
July	4,424	16,100	9,232	4,761
August	3,884	8,248	3,301	12,761
September	1,050	19,278	11,278	840
October	2,771	11,808	12,971	2,217
November	579	22,313	4,272	463
December	2,068	1,819	1,757	6,555

Assumptions:
Scenario 1: *Average maturity of two months, annual compound yield of 130% and borrowing 88% of scheduled debt redemption.*
Scenario 2: *Average maturity of four months, annual compound yield of 92% and borrowing 85% of scheduled debt redemption.*
Scenario 3: *Average maturity of seven months, annual compound yield of 76% and borrowing 80% of scheduled debt redemption.*
E = Morgan Stanley Dean Witter Research Estimates
Source: Turkish Treasury, Morgan Stanley Dean Witter Research

Debt accumulation will lead to deterioration in public finances. Given that the 2001 budget assumes an annual average interest rate of 25-30%, the current level of interest rates is clearly inconsistent with macroeconomic targets. The authorities are striving to keep primary spending at TL 31,683 trillion, while hoping to collect revenues (including privatisation receipts) of TL 43,127 trillion. Even if we accept these assumptions, keeping the outlay for interest payments at TL 16,677 trillion is now almost impossible. Thus, avoiding a self-sustaining debt trap requires significant strengthening of the fiscal aspects of the programme — additional spending cuts and revenue-generating measures — to increase the primary budget surplus even further than the budget proposes, since the future path of the ratio of public debt to GDP depends partly on the primary budget balance.

A binary choice — hyperinflation or rapid stabilisation. A government that has nominal debt stock has an incentive to try to inflate away so as to decrease the debt burden. It is likely to resist the urge if the rewards are small and the cost of a reputation loss is high. A higher level of nominal debt leads to a stronger temptation to inflate. However, the lower the maturity of debt, the smaller the decrease in the market value of the debt associated with a given unexpected increase in inflation. Thus, we think the Turkish government must introduce a new stabilisation programme immediately that aims to tackle the country's structural problems. Along with the introduction of a new stabilisation plan, which is key to rebuilding credibility and confidence, we believe the Turkish authorities must also urgently convince the US administration and the EU to provide financial support for bank restructuring to prevent a debt restructuring — read debt default — from looming on the horizon.

Once Bitten, Twice Shy — On the Supply of New Loans

This is an extract from a report (5 pp) dated March 6, 2001.

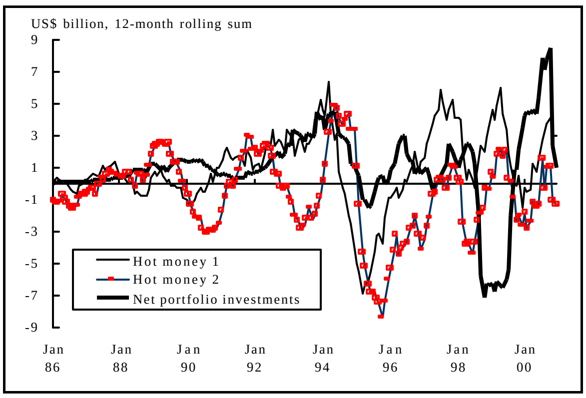
Play it again Sam. Financial crises following the implementation of an economic stabilisation programme in emerging markets show surprising similarities. With the introduction of an IMF-supported programme, short-term foreign capital flows into a country, pushing down domestic interest rates and boosting domestic demand. That usually causes a worsening in external accounts, after which any bad news could easily trigger a self-fulfilling currency crisis. We believe this is exactly what happened in Turkey. We look at capital flows' race-of-vultures reaction to exchange-rate realignment. This year, the Turkish public and private sectors will have to repay around US$25.3 billion in external debt — not an easy task, given the state of the country and the increasing risk aversion of foreign investors. The private sector is in particularly dire straits, as it needs to roll over some US$13.4 billion in external debt, US$11.4 billion of which is principal payments.

Watching the 1994 episode all over again? In our view, the triggers of both the 1994 and 2001 Turkish crises were the same: a sudden deterioration in confidence. In 1994, the Treasury was forced to cancel domestic debt auctions for political reasons; this time, the unexpected row between Prime Minister Bulent Ecevit and President Ahmet Sezer was the straw that broke the camel's back. In January 1994, the Turkish lira lost 19.0% of its nominal value against the US dollar. In the following three months, the currency depreciation reached over 130%. Since the flotation on February 22, the lira has depreciated by 32% against the dollar; since the factors that contributed to this currency crisis are still in place, we think the currency may depreciate further. The implication of the currency crisis is that, just like in the aftermath of the 1994 crisis, when short-term foreign capital rushed to exit in panic, the sudden reversal of 'hot money' flows will take place.

Hot money — the obvious culprit? Emerging markets affected by financial troubles have one thing in common: a large ratio of short-term external debt to international reserves. The crises in Mexico, East Asia, Russia, Brazil, and Turkey show that large short-term liabilities nurture a confidence crisis and a reversal of capital flows, causing a collapse in asset prices and, finally, in the exchange rate. Just before the 1994 crisis, speculative or 'hot money' flows — easily reversible short-term capital flows — reached all-time highs. Even though Turkey has always depended on short-term external financing, this time hot money was not a problem of the same magnitude, according to our numbers. However, portfolio flows reached a peak — US$8.5 billion on a 12-month rolling-sum basis — in October. Moreover, Turkey's net short-term liabilities rose to US$6.2 billion last year, highlighting the accumulation of external debt.

The policy mistake — breaching the 'Holy Trinity'. We believe that both the Turkish authorities and the IMF turned a blind eye to the impossibility of a 'Holy Trinity' — it is not possible simultaneously to have free capital mobility, a pegged exchange rate and a cap on interest rates — during the crisis in November last year. Interest rates were supposed to be the shock absorber of the now-defunct

Exhibit 22
Turkey: Short-Term Capital Flows, 1986-2000



Hot money 1 = [– (net errors and omissions + other assets)]
Hot money 2 = [– (net errors and omissions + short-term capital)]
Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Exhibit 23
Turkey: External Debt Stock, 1997-2000

(US$ billion)	1997	1998	1999	2000[1]
Total	84.8	97.0	102.9	106.9
Short Term	18.0	21.2	23.5	26.5
CBT	0.9	0.9	0.7	0.6
Deposit Banks	8.5	11.2	13.2	15.8
Other Sectors	8.6	9.2	9.6	10.1
Medium/Long-Term	66.8	75.7	79.4	80.4
Public Sector	39.3	40.5	43.4	46.7
General Government	35.3	36.4	39.1	41.8
CBT	10.9	12.1	10.3	10.1
Private Sector	16.6	23.2	25.7	23.6
Financial	5.5	7.0	6.7	5.5
Banks	3.7	4.4	4.0	3.2
Non-Banks	1.8	2.6	2.7	2.3
Non-Financial	11.1	16.2	18.9	18.1

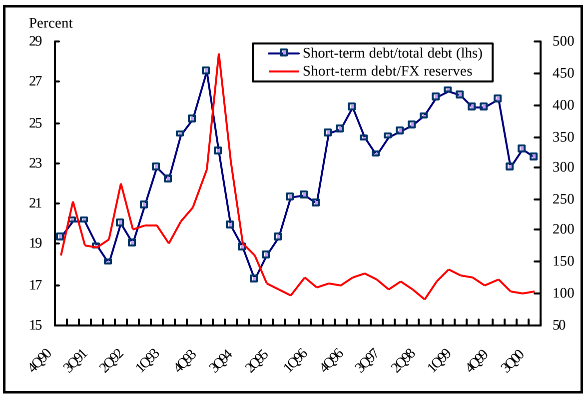
1. As at the end of the third quarter of 2000 *Source: Central Bank of Turkey* stabilisation programme. The central bank's response in November simply opened the door to further testing of the willingness to protect the exchange-rate regime. That unleashed a vicious circle of capital outflows — international illiquidity — amplifying the pressure on the exchange-rate system at a time of rising uncertainties.

Is Turkey excessively dependent on short-term debt? The two best indicators of financial crises are the ratios of short-term external debt to total external debt and short-term external debt to foreign-exchange reserves. Turkey's outstanding short-term external debt stock declined by US$1.9 billion to US$24.9 billion at the end of the third quarter of 2000 compared with the same period in 1999. This represents 23.3% of the country's outstanding foreign debt, down from 27.5% at the end of 1993. However, Turkey's short-term external debt stock reached its peak — 482.4% of official foreign-exchange reserves — just before the 1994 financial crisis. Since then, this critical ratio, which was a very good predictor of the Asian crisis, actually posted an impressive deceleration in the debt build-up relative to the country's foreign-exchange reserves, as it declined to 102.7% at the end of the third quarter of 2000. Nonetheless, these gauges still highlight Turkey's dependence on short-term financing, making it vulnerable to self-fulfilling confidence crises.

Short-term foreign capital usually flows out at a rapid pace. The financial panic feeds on itself, causing foreign creditors to call in loans and depositors to withdraw funds from banks, all of which magnify the illiquidity of the domestic financial system and force costly asset liquidation. In short, when a financial crisis hits, there is a sudden reversal of foreign capital movements, causing contraction in domestic lending and thus output. Looking at Turkey's balance-of-payments data for the first 11 months of 2000, we see that there has already been a significant reversal in capital flows. For instance, net portfolio investments recorded an outflow of US$5.0 billion in the fourth quarter of 2000. We think this is highly likely to become the trend for 2001. Furthermore, the capital account data indicate that short-term liabilities were growing much faster than the country's liquid international assets. Therefore, a sharp contraction in foreign bank lending as a result of an increase in volatility is likely to result in further net capital outflow.

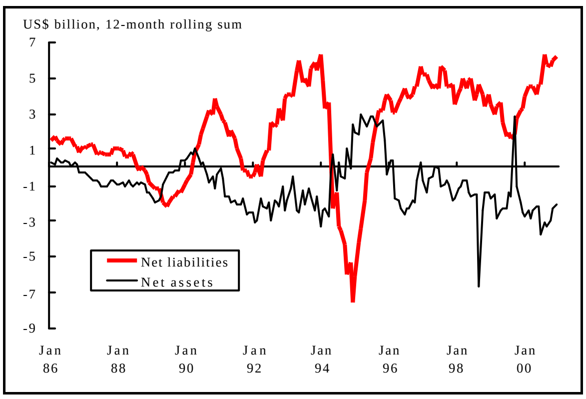
The disappearance of confidence makes debt rollovers quite difficult. The currency devaluation has created a debt overhang that is likely to reduce the supply of external loans. In 2000, Turkey accumulated US$17.5 billion of long-term capital and US$6.2 billion of net short-term liabilities. In particular, Turkish banks borrowed US$10.4 billion as syndicated loans from foreign banks. The trend of capital flows in the aftermath of the 1994 crisis sheds some light on the trend in progress. For example, in 1994, Turkey repaid US$7.6 billion of its short-term liabilities after a build-up of US$6.4 billion in the previous year. In the worst-case scenario, the country would have to pay back its entire stock of short-term external debt, which stood at US$24.9 billion at the end of the third quarter of 2000. However, based on the 1994 experience, we think it is more likely to see a net repayment of US$6-10 billion in short-term liabilities. The key issue for the authorities is the elimination of uncertainty that reduces the supply of international credit when there is a chance of debt default.

Exhibit 24
Turkey: Dependence on Short-Term Debt, 1990-2000



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Exhibit 25
Turkey: Short-Term Assets & Liabilities, 1986-2000



Source: Central Bank of Turkey, Morgan Stanley Dean Witter Research

Currency Devaluation and Debt Dynamics

This is an extract from a report (5 pp) dated February 26, 2001.

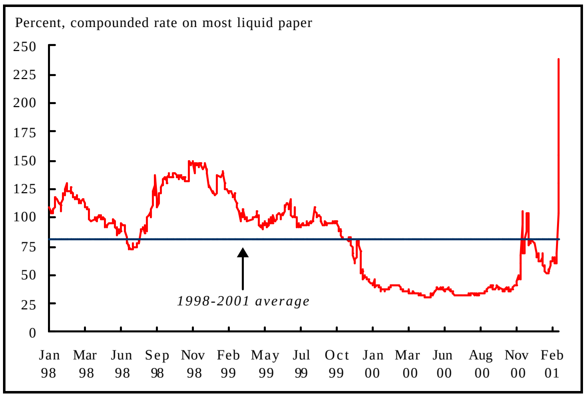
Nurtured by rising political tension, a self-fulfilling mechanism triggered the flotation of the Turkish lira. Following numerous other experiences, a self-fulfilling mechanism fuelled by creditors' pessimistic view of the coalition government's ability to fulfil its commitments finally triggered the flotation of the Turkish lira. Since then, the currency has lost 56.6% of its value against the US dollar. We expect the flotation to have a variety of implications for the economy; we explain the impact of exchange-rate realignment on public debt and finances.

Debt dynamics are critical for public finances and financial markets. We estimate that Turkey's public debt stood at approximately TL 76,897 trillion, or 61.8% of GDP, before the exchange-rate adjustment. Even though this ratio was not alarming by international standards, given the poor clear political and macroeconomic outlook, the currency crisis raises concerns about the issue of debt sustainability. Furthermore, the official figures understate the true level of debt, because Turkey's public accounts are particularly opaque. They exclude, for example, duty losses of state-owned banks — a problem the Treasury has started to deal with under IMF auspices. If hidden debts are included, we think Turkey's public debt is probably already above 75% of GDP. In addition, restructuring in the banking sector is likely to increase the public debt stock.

Currency devaluation has two opposing effects on the government debt. Currency devaluation erodes the real value of lira-denominated debt, while increasing the nominal lira value of external debt stock. The market value of domestic government debt was TL 44,420 trillion at the end of January, corresponding to approximately 35.7% of GDP. From this gross figure, we have to deduct what cannot be inflated away (that is, debt denominated in foreign currencies and indexed bonds). Summing up, we estimate net nominal government debt of approximately TL 38,000 trillion, or 30.5% of GDP, that could be depreciated in real value by higher inflation. However, the public-sector external debt stock was US$47.3 billion at the end of September. At the current exchange rate, the lira value of external debt stock rose to 40.8% of GDP from 26.1% at the pre-float exchange rate. This means that the central-government debt stock rose from 61.8% to 76.5% in the first couple of days of the post-flotation period.

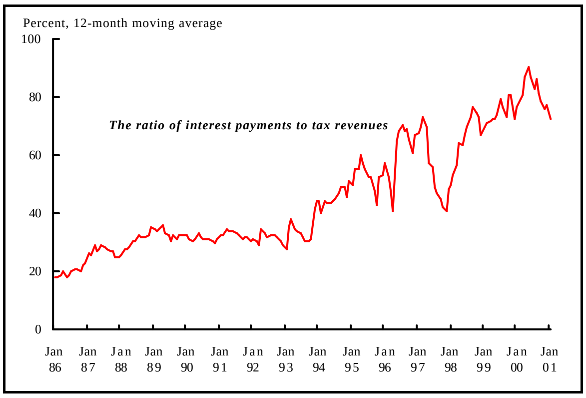
Debt sustainability should be an integral element of any economic stabilisation programme. A key problem in Turkey is the deterioration of public finances over the decades, which has resulted in the accumulation of ever-increasing public debt stock. The problem has evolved into a self-sustaining vicious circle running from debt stock to higher interest rates to interest payments to budget deficits once again to higher debt stock. The cost of servicing public debt, which already accounts for a significant portion of government spending, has long been one of Turkey's economic bugbears, contributing to further deterioration in fiscal imbalances. For example, the government channelled 77% of tax revenues (about 16.4% of GDP) to interest payments in 2000, up from a mere 17.6% in 1985. That is almost five times as much as public spending on health and education combined. We identify three reasons why a high

Exhibit 26
Turkey: T-Bill Yields, 1998-2001



Source: Reuters, Morgan Stanley Dean Witter Research

Exhibit 27
Turkey: The Burden of Debt Stock, 1986-2001



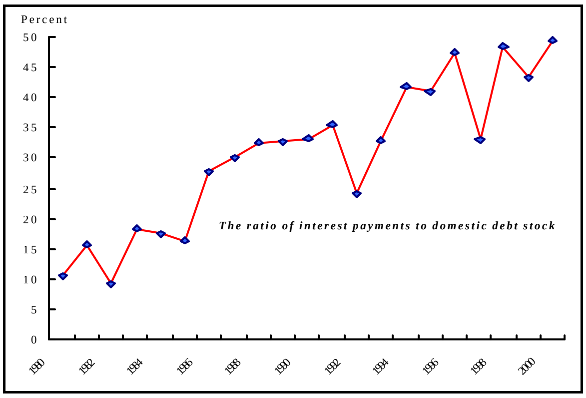
Source: Ministry of Finance, Morgan Stanley Dean Witter Research level of public debt can be dangerous.

- If government borrowing pushes up interest rates, it can crowd out more productive private-sector investment.
- When debt is high, a government may be tempted to print money and let inflation rise, in order to erode the real value of its debt.
- There is the danger of a 'debt trap', in which rising interest payments swell the government's budget deficit to such an extent that total debt continues to grow even when the government is not overspending.

The future path of the ratio of public debt to GDP depends on two factors: the primary budget balance and the relationship between interest rates and nominal GDP growth (real growth rate plus inflation rate). At the outset, higher inflation has two opposing effects on debt dynamics: it worsens debt dynamics by necessitating higher nominal interest rates to provide investors with a given real return and improves the situation by raising the nominal GDP growth rate. Therefore, the higher the inflation and growth rates, the more a government can borrow while keeping debt as a percentage of GDP constant, since the real value of existing debt shrinks faster. If, however, interest rates exceed nominal GDP growth and the government runs a primary deficit, public debt will increase indefinitely relative to GDP. In the meantime, the average interest cost of public debt depends on the markets' assessment of its sustainability and the probability that the adjustment will occur through fiscal consolidation rather than inflationary methods and default. The following equation explains the debt dynamics:

Exhibit 28

Turkey: The Vicious Circle of Debt Burden, 1980-2000



Source: Turkish Treasury, Morgan Stanley Dean Witter Research

$$D_t = D_{t-1}\,(1 + i_t) - (R_t - S_t) - M_t$$

where D_t, i_t, R_t, S_t and M_t are debt stock, average interest rate, revenues, spending and monetary financing, respectively. If we consider this equation relative to GDP, along with the inflation rate, the primary fiscal balance becomes an important determinant of the debt dynamics. For simplicity, we assume a country with a public debt stock of 100% of GDP. A one-percentage-point increase in the average real interest rate on public debt is, *ceteris paribus*, equivalent to a one-percentage point slippage in primary fiscal balance (as a share of GDP). In the case of Turkey, this model suggests that, with a real GDP growth rate of 1%, inflation of 50% and a real interest rate of 30%, the public debt-to-GDP ratio can be sustained at its current level by a primary budget surplus of 14.7% of GDP. However, the current budgetary framework implies at best a primary budget surplus of 7.5% of GDP, which would result in a 7.2-percentage-point increase in the debt-to-GDP ratio, based on the assumptions above. With a more pessimistic outlook (such as a real GDP contraction of 3.5%), the required primary budget surplus for keeping the debt-to-GDP ratio constant would rise to 17.5% of GDP.

Budget deficits lead to unsustainable debt accumulation. Neither economic theory nor history offers much to determine what is a sustainable level of public debt. In the end, it is investors who decide by demanding higher interest rates on bonds. In the first month of last year, the Treasury borrowed at an average interest rate of 38.3% and maturity profile of 452 days. This year, on the other hand, the average interest rate in Treasury auctions rose to 64.9%, while the maturity profile deteriorated to 195 days. Given that the 2001 budget assumes an annual average interest rate of 25-30%, the current level of interest rates is inconsistent with macroeconomic targets. The Ministry of Finance is striving to keep primary spending at TL 31,683 trillion, while hoping to collect revenues (including privatisation receipts) of TL 43,127 trillion. Even if we accept these assumptions, keeping the outlay for interest payments at TL 16,677 trillion is now almost impossible. Thus, to avoid a self-sustaining debt trap, we believe the authorities must strengthen the fiscal aspects of the programme (that is, additional spending cuts and revenue-generating measures) to increase the primary budget surplus even further than the budget proposes.

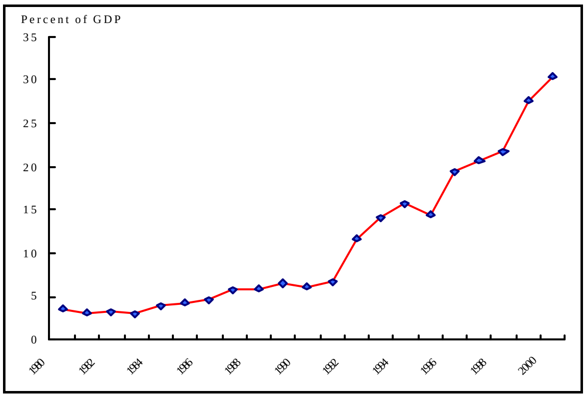
Turkey has a significant advantage over other big central-government debtors. According to our models, tax revenues in Turkey amount to 32.8% of GDP, well below the average for OECD countries of 37.0%. The tax burden in EU countries is even higher, at 44.5% of GDP. In the section of this report entitled *Remembering Tax Reform and Ibn Khaldun*, we highlighted structural factors (namely the largely unrecorded agricultural sector and the outmoded tax system) that have contributed to this situation. We concluded that Turkey had scope to increase tax revenues and improve its public finances. The best way to do this, in our view, would be to broaden its tax base, rather than raising tax rates.

In addition, privatisation can have a significant effect on debt sustainability. If the government channels the proceeds from the sale of public enterprises to pay off public debt, privatisation can have a significant effect on the sustainability of public debt. In addition, privatised entities will generate tax revenues. The authorities announced that they would change the strategy for the sale of key state enterprises. Although we find this encouraging, international investors may prove risk-averse; they have proven reluctant to bid for these public assets in the past.

Asymmetric information explains higher volatility in financial markets. Asymmetric information — the government and private investors do not share the same information set — plays a crucial role in the implementation of a stabilisation programme. As the government's commitment to carry out the programme is not fully acknowledged by market participants, interest rates may remain high relative to the government's expectations until such time as uncertainty regarding the outcome of the stabilisation is reduced. Higher volatility in financial markets can therefore be explained by a fear that politicians may lose control of public finances and resort to higher inflation as a solution. In this situation, a committed government may reduce the cost of debt servicing by issuing short-term debt. The decision to issue short-term or indexed debt signals to the market the government's commitment to the stabilisation programme. Only when the uncertainty is resolved and credibility is gained should the government issue long-maturity debt, in our opinion. Thus, we think that, for the time being, since high interest rates reflect expected inflation (and further exchange-rate adjustment) and the rewards from unexpected inflation are increasing levels of debt and increasing maturities, the government would keep its disinflation pledge credible by decreasing maturity as debt levels and/or interest-rates increase. Furthermore, we believe that issuing short-term, price-indexed and foreign-currency-denominated debt is the right borrowing strategy for the Treasury to minimise the costs of asymmetric information.

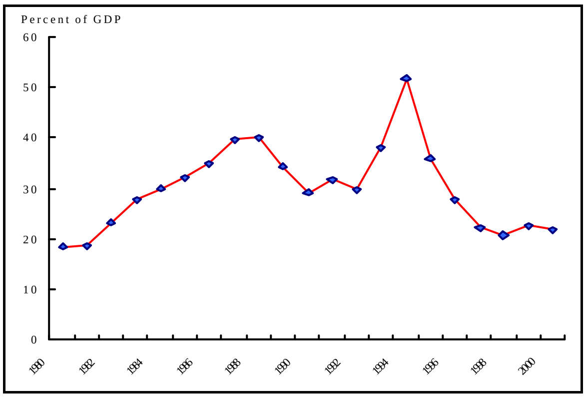
A difficult situation that requires policy commitment more than ever. So far, the authorities have pledged to strengthen the stabilisation programme in a way that would support the decision to float the currency, while keeping the disinflation process in place. That could only be achieved by fiscal discipline and tight monetary policy, along with additional IMF financing. Since rising public debt may also constrain the ability of monetary authorities to pursue price stability (as an unsustainable debt may put pressure on the central bank to monetise some debt to alleviate the burden), market participants may be reluctant to buy into a new plan. Thus, we believe fiscal consolidation (possibly including a debt restructuring), which would bring further hardship to the real economy, is key to building confidence and managing the consequences of devaluation.

Exhibit 29
Turkey: Public-Sector Domestic Debt Stock, 1980-2000



Source: Turkish Treasury, Morgan Stanley Dean Witter Research

Exhibit 30
Turkey: Public-Sector External Debt Stock, 1980-2000



Source: Turkish Treasury, Morgan Stanley Dean Witter Research

Crisis and Politics

Without Money, It's Just Wishful Thinking

This is an extract from a report (4 pp) dated April 18, 2001.

The authorities correctly identified the problems, but without financing, the new programme is just wishful thinking. Turkey's new economy minister Kemal Dervis presented the new stabilisation programme and is endeavouring to gather foreign financial support. In his inaugural presentation, he earnestly criticised all recent governments (including the ruling coalition) for employing populist policies that have devastated public finances. He argued that unsustainable debt dynamics, structural problems in the public sector and the weak state of the banking sector were the leading culprits of the crisis in Turkey. Although we pretty much agree with his observations, we continue to reason that, without a substantial (external) cash injection, the new programme cannot be sustained, due to political concerns. We think that Mr. Dervis' outline presents a half-full/half-empty picture and that, without money and unquestionable political commitment, it will remain wishful thinking.

The new programme contains few details on fiscal policy adjustments and nothing on monetary policy. The new stabilisation plan reads as a letter of (frank) observations and intentions. Although it provides some guidance on macroeconomic variables (for example, the authorities expect a negative growth rate of 3.0% and year-end inflation rates of 57.6% for the WPI and 52.5% for the CPI), it contains limited information on fiscal policy (except for some grand targets on primary budget balances in the public sector), leading us to conclude that the coalition government has not reached a consensus on the extent (and appropriate measures) of fiscal adjustment. Moreover, the programme does not even address monetary policy and, without a credible monetary policy framework, which ultimately determines the paths of the exchange rate and inflation, the whole programme lacks credibility, in our opinion.

Exhibit 31

Turkey: Official Macroeconomic Projections, 1999-2002

(%)	1999	2000	2001[1]	2002[1]
Real GNP	-6.1	6.1	-3.0	5.0
WPI[2]	62.9	32.7	57.6	16.6
CPI[2]	68.8	39.0	52.5	20.0
Primary Surplus (% of GNP)				
Public Sector	-1.9	2.8	5.5	6.5
Central Government	1.5	4.6	5.1	5.6
State Enterprises	-1.5	-1.5	0.1	0.5
Other Public	-1.9	-0.3	0.3	0.4

1. Official projections *2. Year-end*
Source: Turkish Treasury

Banking system restructuring is a must, but it has a huge cost for the Treasury. One key issue that is directly relevant to short-term functioning of financial markets is banking system restructuring. In addition to legal changes that would, for example, provide incentives for mergers and acquisitions in the banking sector, the authorities aim to patch the black hole in the balance sheet of state-owned banks by transferring TL 13,000 trillion of government securities (and TL 3,000 trillion to meet the capital adequacy requirement) to three public banks. So far, Mr. Dervis has pledged that, in the future, state banks will not be forced by politicians to run so-called duty losses (generated by subsidised lending activities). These are much-needed steps to improve both liquidity conditions, eliminating a major gridlock in financial markets, and structural factors, eliminating moral hazards. However, without knowing the exact nature of financing for such an ambitious undertaking, we remain very cautious on the implications for debt dynamics due simply to rising costs of restructuring. As at the end of 2000, if we include the cost of nationalising troubled private banks, we estimate that the total charge for banking-sector reorganisation reached approximately TL 29,000 trillion (or 22.8% of GDP). Since then, however, due to a higher interest burden, the bill has risen even further, requiring immediate and drastic policy action.

Rising risk of early election is an obstacle for normalisation. Although we continue to believe that the government is likely to get most of the legislative action list (the so-called 15 laws) ratified in the parliament before the IMF board meeting in mid-May, the risk of early election is rising along with the cost of stabilisation. We see political risk as the most important obstacle for the normalisation process in financial markets. Without external financing, domestic liquidity will continue to disappear. On the other hand, external financing is conditioned by political commitment and public support for the programme. Since coalition governments are not usually successful at implementing an austerity programme, foreign lenders are questioning the viability of the current coalition. Therefore, the only way to end this catch-22 situation is to show ubiquitous political commitment, which is still not obvious in Turkey.

Crisis and Politics

Populism is still alive! Just before Mr. Dervis introduced the new programme, which focuses on the damage caused by populist policies (such as subsidised lending to small firms and farmers by state banks), the government launched a number of populist measures that aimed to provide 'relief' to small and medium-sized firms. Along with an instalment plan for delayed tax payments, the most dramatic step was the rate freeze on loans provided by state banks at 55% until the end of the year, which will increase duty losses of state banks and thus the borrowing requirement for the Treasury. The official estimate for the cost of this particular 'relief' is TL 300 trillion. The authorities are still shying away from a firm commitment to a strict incomes policy, which is the key for curbing hyperinflationary tendencies. Thus, despite the introduction of a new stabilisation programme, we still have doubts about the coalition government's conviction to undertake painful but necessary measures.

All in all, we think the new programme is a good start, but not comprehensive enough to deal with Turkey's short-term problems. Even though the diagnosis of underlying economic problems and long-term structural prescriptions seem on target, the programme is not comprehensive enough, in our view, to get domestic financial markets out of the troubled waters in the short term. Nonetheless, we expect Mr. Dervis to make a more detailed announcement concerning monetary policy and fiscal measures in the coming weeks, possibly after securing external funding. However, in our view, what Turkey needs to bring a sustainable solution to its problems, which have accumulated over the decades, is to aim to improve its integration with the global economy. That will mean a marathon of structural reforms, not just economic, but also social and political, which introduce more political risks. We argue that an economic stabilisation programme would be a sub-section of Turkey's 'convergence plan' for EU membership. Reforms such as creating an independent central bank, ending the era of public banking and introducing private pension funds will, we believe, have long-term (positive) implications regardless of the outcome in the short term. We remain cautious on the politics of stabilisation and continue to highlight the risk of hyperinflation and debt default in the case of limited external support. Even with an assumption of foreign financial assistance in the range of US$10-18 billion, we project that the country will go through its 'great depression' this year, which would boost the political cost of fiscal adjustment and the risk of early elections.

Exhibit 32

Turkey: Central Government Budget, 1999-2001

(% of GNP)	1999	2000	2001[1]
Revenues	**23.9**	**25.9**	**25.5**
Tax Revenues	18.9	21.0	20.5
Direct Taxes	8.6	8.6	7.3
Indirect Taxes	10.3	12.4	13.3
Non-Tax Revenues	5.0	4.8	5.0
Primary Spending	**21.8**	**20.5**	**19.7**
Personnel	838	7.9	7.8
Other Current	2.8	2.8	2.6
Investment	1.8	1.8	2.1
Transfers	8.4	7.9	7.4
Primary Balance	**2.1**	**5.4**	**5.6**
Primary Balance[2]	1.5	4.6	5.1

1. Official projections
2. Excludes privatisation revenues, interest income and profits of the Central Bank of Turkey
Source: Turkish Treasury

Crisis and Politics

The Odds Are in Favour of the Talented Mr. Dervis

This is an extract from a report (4 pp) dated April 3, 2001.

"A poor prince would not be able to undertake glorious action." Cardinal Richelieu

Kemal Dervis — the fourth leg of the coalition? After the collapse of the IMF-supported stabilisation programme, the coalition leaders invited Kemal Dervis to lead Turkey's economic reform endeavour. He has impressive credentials, but limited 'experience' of Turkey's mainstream politics. So far, he has focused on rallying international support and urging his fellow cabinet members to accelerate the legislative process. Although there are technical difficulties and some members of the coalition voiced concern about 'rushing' legislation, we believe the government has the capability, thanks to the new parliamentary proceedings law, to get most of the action list completed before the self-imposed deadline of 15 April.[2]

Like President Sezer, Mr. Dervis is a non-politician. In our opinion, the appointment of Mr. Dervis has positive implications that complement President Ahmet Sezer's depoliticised approach. However, as with the President's confrontation with the *nomenklatura* (the ruling political class), we think challenging days lie ahead for Mr. Dervis. Even without domestic wrangling, he faces obstacles in convincing foreign lenders to support Turkey's new stabilisation attempt. The US administration and multilateral organisations are asking the Turkish government to show its commitment not just with economic reforms, but by restructuring the political system. We agree with the prognosis that the underlying source of instability in Turkey is the state's involvement in a large number of economic sectors (notably banking, which has been used as a political campaign financing tool) and the leader-centric political party system, both of which nurture corruption and limit the development of a parliamentary democracy and an entrepreneurial private sector. However, coalitions do not usually survive the challenges of an economic crisis, as the political cost of what needs to be done to put the country back on track is so great, which, increases the risk of early election. Since the collapse of the currency, we have witnessed the 'blame game' among coalition members, stressing the possibility of an early election scenario that could be easily staged in the existing conjecture.

[2] It is technically possible to 'combine' all laws together and push through the parliament as one piece of legislation.

Economic instability endangers political stability. The risk of early elections is still insignificant, but, in our view, it is partly a function of the political cost of stabilisation, which has risen recently. Radical measures (new taxes and possibly a debt-restructuring scheme) would no doubt make the government parties extremely unpopular. However, if the government chooses not to 'go the distance', we think the outcome will most likely be a period of hyperinflation, which will probably be even more damaging than the austerity track for the coalition. This simple scenario analysis explains why foreign lenders are questioning the viability of the current coalition even before they start looking at the details of the new economic programme. Paul Wolfowitz, deputy US defence secretary, publicly expressed the US administration's concern about political commitment by stating that "No man, no matter how brilliant, can fix the problems of the Turkish economy by himself. It will require enormous political will to make the

Mr. Dervis Action List

- Amending the banking law
- Supplementary 2001 budget law
- Closure of remaining public funds
- Accelerating the liquidation of banks
- New central bank law
- Legislation for the sale of 51% stake in Turk Telekom
- Tobacco law
- Sugar law
- Public procurement law
- New borrowing law
- Civil aviation law
- Oil law
- Natural gas law
- Abolishing the concept of 'duty losses' in state banks
- Tax deductibility of loan provisions

necessary changes. And political will is not a normal characteristic of coalition governments, whether in Turkey or anywhere in the world."

Political corruption is at the centre of Turkey's problems. The lack of transparency in politics and the size of the public sector foster corruption, which has crippled the political system and put an enormous burden on the real economy in Turkey. Transparency International's corruption index ranks Turkey 50th out of 90 countries. Given Turkish politicians' poor track record, it seems to us that foreign lenders would support Turkey's new bid to stability if, and only if, the political clean-up measures are part of the reform programme. However, the question in our mind is how realistic it is to expect some politicians to de-couple from their livelihood — namely, the public banking sector.

What dreams may come. One should always expect the unexpected in Turkey. A 'rational' politician has very little incentive to support a reform effort when all the glory would go to a non-politician. But Turkey is facing its most serious crisis to date. This may lead politicians to behave 'irrationally' and initiate a rapid structural reform process that could also help secure an external financial support package of US$10-18 billion. From a game theory perspective, the creditors' opportunity is to tie politicians' hands by forcing them to undertake measures that would make it almost impossible to opt for an early election, addressing Mr. Wolfowitz's main concern. Opinion polls suggest that no political grouping has the public's outright blessing. Thus, it is conceivable that even the opposition could support Mr. Dervis, who might become the next Turgut Ozal, another former World Banker who initiated the first wave of liberalisation in Turkey and later became prime minister and then president. There are, of course, other alternatives that, we hope, will not become the last resort. According to Article 119 of the Turkish constitution, the government could declare a state of emergency and freeze the market process for a certain period of time. In a more extreme case, the military could intervene in the name of protecting unity. In our view, given the global conjecture and Turkey's aspirations to become a member of the EU, these 'alternatives' are not really an option for the country.

Turkey needs market-based solutions, not confiscatory measures. We hear all sorts of 'solutions' to Turkey's problems. One should realise that these problems are not a by-product of the now-defunct IMF-designed economic programme. Rather, they have accumulated over the decades as a result of mismanagement and statist and populist policies. To promote sustainable economic growth (which is one of the most important factors in determining fiscal balances and debt dynamics), we believe the authorities need to decentralise the economy — through deregulation, privatisation, tax reform and democratisation. We think they need to restructure the country's archaic political system and the public sector, both of which have become a burden. Without a doubt, having external financial support would be great for Turkey amid the present crisis. However, it would be only the icing on the cake, in our view. The 15 laws prioritised by Mr. Dervis are key to reducing the size and involvement of the public sector in the economy, and the extent of structural reforms should not be a function of the size of foreign financial support. Most of these legislative actions should have been ratified decades ago in order to nurture a politically stable environment that is essential for sustainable economic growth and for the country's bid to become an EU member.

The odds are in favour of Mr. Dervis. The debt rollover risk that we have been highlighting since the flotation of the Turkish lira remains the underlying fear for financial markets (see the section of this report entitled *Debt Overhang and the Rollover Risk*). Even a small slippage may trigger a hyperinflationary spiral and/or set off a debt trap, as the economy is operating on thin ice that has already cracked. We do not have a crystal ball, but we reason that the odds are in favour of policy commitment, which could break the vicious circle that Turkey is going through. Furthermore, there is a 'wild card' on the table. If the government gets external funding (conditional on all sorts of structural measures ranging from privatisation to the overhaul of the political system), market sentiment could easily turn around and the economy could start growing once again. However, our 'best guess' is that foreign creditors will employ a 'wait and see' approach and provide financial support once the government proves its commitment not just by introducing legislation, but by actually implementing it. As we have already highlighted, Turkey faces a binary choice: hyperinflation or rapid stabilisation, as the era of muddle-through is over. Since Turkey's gradual approach to reforms has failed on numerous occasions, we should brace ourselves for a 'big bang' in structural adjustment, if Turkey chooses truly to reform. After all, a crisis also represents an opportunity to change for those who are up for the challenge.

Show Me the Money

This is an extract from a report (4 pp) dated March 16, 2001.

The outline of the stabilisation programme is encouraging, but financial markets are (rightly, in our view) curious about the source of funding. Although macroeconomic targets and further details of Kemal Dervis' plan will probably be released in the coming days, the outline appears satisfying to us for the time being. As Mr. Dervis acknowledged, the success of the new endeavour hinges on international financial support. So far, however, we have not received any cheering message from the international community. Turkey already has an outstanding standby loan and supplemental reserve facility from the IMF and structural adjustment loans from the World Bank. What it needs now, however, is outright budget financing.

Outline of the new stabilisation programme

Banking system. The restructuring of the Turkish banking system is the single most important aspect of the new stabilisation programme. At the outset, two state-owned banks, Ziraat and Emlak, will be merged and the management of three state banks, Ziraat, Emlak and Halk, will be controlled by an 'independent' board of directors (all professional bankers) and operate free of political intervention until the eventual privatisation. This means that the excess branches will be closed down, personnel will be 'encouraged' to retire, and these banks will no longer incur new duty loans as they stop providing subsidised lending. Furthermore, supported by international funding, the Treasury plans to transfer TL 16,000 trillion to state-owned banks — TL 13,000 trillion for their accumulated duty losses and TL 3,000 trillion for meeting capital adequacy requirements. Most immediately, these banks need a cash injection of approximately US$5 billion to reduce their dependence on money markets, which consequently clogs the financial system. Concerning the ailing private banks, however, Mr. Dervis did not specify the action plan other than stating that the Treasury would satisfy their funding needs. We think the authorities should develop a comprehensive strategy to liquidate the troubled private banks, the number of which has already reached 13.

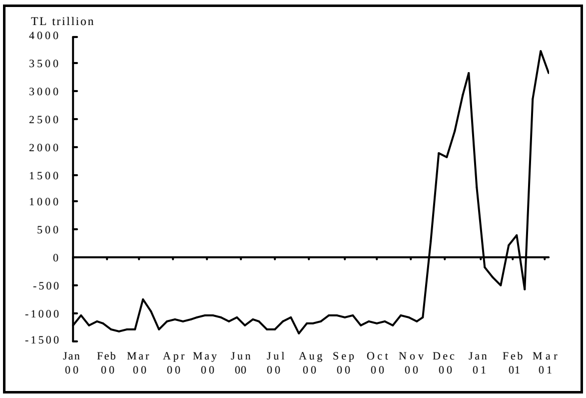
Privatisation. The authorities have pledged to make the legal changes that would allow the full privatisation (100%) of Turk Telekom — a strategic sale of 51% (up from 33.5% previously) and a public offering of 49% — and deregulate the telecommunications and energy sectors. The privatisation of other state enterprises and the sale of third-generation mobile phone licences will also be accelerated. In the meantime, Turkish Airlines will be granted autonomy to determine its domestic ticket prices without being required to obtain government approval. All these are encouraging signs, but, given the global recessionary environment, macroeconomic targets should not be dependent on privatisation receipts, in our view.

Legal changes. A new budget will be prepared to reflect the impact of the currency crisis on the public finances. It will also have a borrowing limit. The authorities intend to amend the bankruptcy law to provide incentives for M&A in the banking sector. The Central Bank of Turkey (CBT) will be granted independence. Institutional credibility will always be the 'sword of Damocles' for the stabilisation programme and, therefore, legal improvements should

Exhibit 33
Turkey: Official Foreign Exchange Reserves, 1998-2001

Source: Central Bank of Turkey

Exhibit 34
Central Bank of Turkey: Net Domestic Assets, 2000-01



Source: Central Bank of Turkey

significantly increase the odds for the successful implementation of the new programme.

Monetary policy. Mr. Dervis said that the ultimate aim of monetary policy will still be achieving disinflation and eventually price stability. However, in the short term, to facilitate the restructuring efforts in the banking sector (especially to reduce the short-term liabilities of state-owned banks and those under the management of the Deposit Insurance Fund), the central bank will be accommodative (read continuing to provide liquidity), while intervening in the foreign-exchange market to manage the lira's flotation in an orderly fashion. In the medium to long term, the CBT will become independent and exclusively focus on money supply and interest rate targeting (and possibly adopt some form of inflation targeting mechanism) to accomplish price stability. In short, at least until the end of the second quarter of 2001, monetary policy is likely to accommodate an initial wave of inflationary bursts stemming from the currency devaluation and, later in the year, the CBT will once again concentrate on its net domestic assets and net international reserves.

Fiscal policy. Pricing strategies for state enterprises (particularly those in the energy sector) will be based on market trends, and the fuel consumption tax will be increased in line with the inflation target. The overall framework for agricultural reform will remain intact (that is, expanding the pilot programme for direct income subsidies instead of price subsidies) and subsidised prices will be increased according to the new inflation target. Public-sector wage increases will also be determined according to the inflation target. A strict employment reduction policy will be implemented to put an end to the ever-growing size of the public sector. In addition to spending cuts, new revenue-generating measures may be introduced to support the primary budget surplus target. We expect to see new tax measures to boost revenues during a recessionary year. In the long term, the rapid implementation of TINs should help expand the country's tax base. The bottom line, in our view, is that, to avoid a damaging debt trap, the government must considerably strengthen the fiscal aspects of the programme to increase the primary budget surplus even further than the 2001 budget proposes (see the section entitled *Debt Overhang and the Rollover Risk*).

Incomes policy. Wage increases in the public sector will be linked to the new inflation target. Mr. Dervis has met representatives of leading labour unions and the business community to form a consensus approach to incomes policy. With the devaluation, convincing labour unions to dispose of backward-looking indexation schemes has become more challenging. In addition, since the agriculture sector 'employs' about 42% of the country's labour force, agricultural subsidy prices are also an integral component of the incomes policy. The government has said it plans to increase these subsidies in line with the official inflation target.

In addition to international lending, Turkey must create domestic funding for the programme. We think the programme's outline is encouraging, but we need to see the details to reach a firm judgement. All in all, it confirms the view that the authorities acknowledge the extent of the damage and seem willing to undertake necessary adjustments. However, without a significant financial package, an ambitious programme like this cannot be implemented on a sustainable basis. Therefore, we are eagerly waiting to see the size of international financial support and new revenue-generating measures (increasing public-sector prices and tax revenues). The fiscal adjustment to support such an ambitious programme requires substantial spending cuts as well. The bottom line is that the cost of adjustment has increased considerably, both in monetary and political terms. Hence, going forward, we think investors should pay attention to possible frictions between the coalition partners.

A Passage to Europe

This is an extract from a report (5 pp) dated November 6, 2000.

After 37 years of virtual candidacy, Turkey is formally at Europe's door. At the Helsinki Summit in December 1999, the EU announced that "Turkey is a candidate state destined to join the Union on the basis of the same criteria as applied to the other candidates". However, this does not automatically open the door for full accession negotiations, which we expect will not start in the immediate future. The EU first wants to see significant improvements in Turkey's political and human rights performance — meeting the Copenhagen criteria — and the resolution of territorial disputes with Greece.

The EU's roadmap will set the stage for a 'national programme'. On November 8, the European Commission (EC) will announce the roadmap, or Accession Partnership Accord, for Turkey, which will become the foundation for the country's own National Programme for the Adoption of the *Acquis Communautaire*, which should be completed by the end of 2000. We expect no surprises in the accord that will identify policy priorities, which Turkey must tackle in preparing to join the EU.

The Copenhagen Criteria

- Stability of institutions guaranteeing democracy, the rule of law, human rights, and the respect for and protection of minorities.
- The existence of a functioning market economy with a sufficient degree of macroeconomic stability. Besides price stability and sustainable fiscal and external finances, this criterion requires free movement of capital, lack of barriers to market entry, a developed financial sector and a legal system protecting property rights and contract enforcement.
- The capacity to withstand competitive pressure and market forces within the Union. This criterion requires adequate physical infrastructure, human capital, competitive trade policies and sufficient trade integration with the EU.
- Incorporating EU legislation — the *acquis communautaire* — into national legislation and ensuring its effective application through appropriate administrative and judicial structures.

IMF programme complements the EU accession process. From an economic point of view, the IMF-supported disinflation programme overlaps with the requirements for EU membership. Along with the customs union agreement between Turkey and the EU signed in 1995, which has demonstrated "the Turkish economy's ability to cope with the competitive challenge of free trade in manufactured goods", the programme's aim to lower the inflation rate to single digits, the budget deficit below 3% of GDP, and central-government debt to a sustainable level by the end of 2002 should help in meeting the Maastricht criteria.

But the EU's primary focus is on political issues. The EC recommends that Turkey follow a rapid democratisation process that would bring the country's political framework and legislation in line with the EU standards. In previous reports, the EC has always highlighted the intensive role of the military, which does not report directly to the minister of defence, in domestic politics. We think what is important from the EU's perspective is not the fact that an agency such as Turkey's National Security Council (an 'advisory' body that brings civil government and military leaders together) does not exist in any other European country, but rather its influence on domestic politics. As the Chief of Staff Huseyin Kivrikoglu has emphasised on several occasions, Turkish military forces seemingly support the country's bid for EU membership. However, the very idea of military encouragement to politicians for undertaking necessary reforms is a sign of where reform is really most needed, in our view.

Constitutional reform is a difficult task, but a *sine qua non* for the EU accession. Recently, the Turkish government signed two United Nations treaties covering civil, political, economic, social and cultural rights that are pre-requisites for EU accession. Although these treaties set the stage for 'minority rights', improving the country's human rights record and making its constitution compatible with the EU standards, they basically call for a brand new constitution, in our view. Minister of Justice Hikmet Sami Turk has already identified at least 20 areas where the constitution needs amending. Amendments from individual rights to a party political system and from the military's role to union rights for civil servants are a *sine qua non* to realise the most important national objective: joining the EU.

Technical challenges would take a significant amount of time to overcome. Given the country's poor legislative track record and the lack of human capital for screening and institution building, this process would take a significant amount of time, in our opinion. For instance, an initial examination of agriculture and fisheries, which account for nearly half of the *acquis communautaire*, revealed that the legislative workload would take several years to complete. Corruption is another area of concern for EU officials, who are pressing hard for the ratification of new public procurement and civil-servant legislation that is consistent with EU practices.

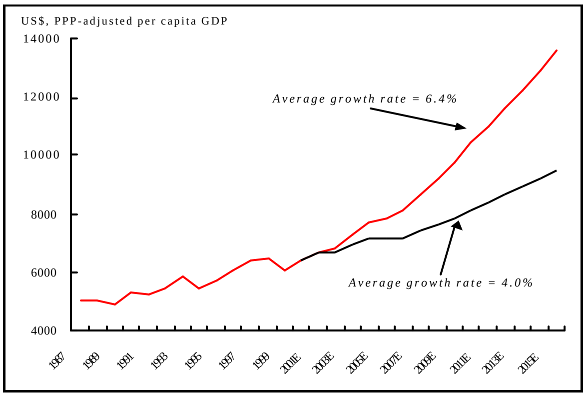
EU membership would spell the end of the political status quo in Turkey. Even though there is widespread support in Turkey for joining the EU, thereby achieving greater political stability and promoting economic dynamism, there seems to be lack of understanding of what needs to be done to achieve such an ambitious goal. The challenge, in our view, is not meeting economic criteria such as lowering the inflation rate and budget deficit, but achieving a constructive discussion of taboo subjects such as the Kurdish issue and restructuring the governing mentality. Despite the fact that becoming a European nation has been a geo-strategic and cultural necessity for almost two centuries, satisfying the Copenhagen Criteria could spell the end of the status quo, as it calls for the establishment of a new political path. Creating a new *modus operandi* to improve the public sector's efficiency and responsiveness is likely to create tensions between interest groups and result in hiccups in the convergence process.

The Ocalan case is an obstacle in the passage to Europe. Although no death penalty has been carried out in Turkey since the early 1980s, given the emotional context of the Ocalan case, it requires political courage to abolish the death penalty. Turkey's new president, Ahmet Sezer, has an impeccable background in constitutional law and liberal aspirations and is an enthusiastic supporter of human rights, democratisation and anti-corruption measures. Although we have long argued that he represents the *Zeitgeist* — the spirit of the moment — in Turkish politics and uses the presidential platform to push the country's democratisation agenda forward, we think the country's recently established EU General Secretariat should immediately start co-ordinating efforts to set policy priorities. We believe that Mesut Yilmaz' appointment as Deputy Prime Minister in charge of EU accession will speed up the reform process, as this is an excellent platform from which Mr. Yilmaz could reclaim the centre-right leadership.

Structural obstacles to the convergence process. From a cost-benefit point of view, Turkey is the least popular candidate for EU membership by virtue of its size and uneven income distribution. One of the EC's major concerns is the income inequality between Turkey and member countries and regional income discrepancies within Turkey. Two leading culprits are high inflation and extremely high dependency on the agricultural sector in 'job creation'. Despite efforts to achieve economic stability, the factor allocation out of the agricultural sector will take a significant amount of time.

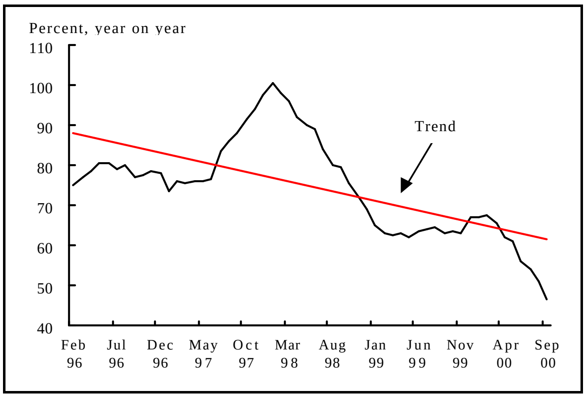
Stability and strong growth needed to catch up with the EU. Nevertheless, the improved macroeconomic stability should help in boost total factor productivity in Turkey. By virtue of higher productivity growth, we think the economy could achieve an average real GDP growth rate of 6.4% in the next 15 years, as opposed to 3.0% in the rest of Europe. However, that would only bring the purchasing power of

Exhibit 35
Turkey: Income Convergence, 1987-2015E



E = Morgan Stanley Dean Witter Research Estimates
Source: Morgan Stanley Dean Witter Research

Exhibit 36
Turkey: Inflation Convergence, 1996-2000



Source: Morgan Stanley Dean Witter Research

Turkish people to 41% of the EU average in 2015, from 28% in 1999. Given the population growth differential between Turkey and the EU, to converge with the EU-15 average by 2010, we estimate that Turkey would need to achieve annual per capita GDP growth of 17% in the next 10 years. At an average growth rate of 6.4%, which is two-and-a-half percentage points higher than the average growth rate of the last two decades, Turkey would reach 50% of the average per capita income level in Europe by 2020. With an average real GDP growth rate of 4.0%, the country would only reach 40% of the average EU income in 2050! To put it in a broader perspective, one should keep in mind that, when Greece and Portugal joined the EU in 1981 and 1986, their PPP-adjusted per capita income levels were 68.5% and 56.4% of the EU average, respectively.

Income inequality could delay Turkey's accession. Therefore, we should not be surprised if the EU favours delaying the accession process for Turkey as much as possible. Letting the income convergence take place outside the EU would lower transfers from the EU budget to the Turkish economy. However, we think that such an approach could cause a backlash against Europe and discourage investment, which is key for convergence.

But Turkey has 'strategic' and economic significance for the EU. Although Turkey lacks a 'sponsor' in the EU, it represents a bridge from Europe to the energy-rich countries of central Asia and a cultural link to the Islamic world. Furthermore, stability in the Balkans, one of the EU's most important foreign policy objectives, requires Turkey's weight in the region. In addition, we see the country's cosmopolitan cultural background and experience as an asset for the EU, not a burden. Furthermore, with an average age of 26 and strong growth potential, we think Turkey could be an economic powerhouse in the region, as it does more than half of its international trade (US$84 billion) with Europe.

Turkey could 'join the club' no earlier than 2012, in our view. Unlike the Turkish authorities, which plan to 'join the club' by 2004, we believe that the country could start the accession process in 2003, following the 2002 national elections in Germany and France, complete membership talks by 2010, and allow up to two years for ratification by member states. This would mean joining the EU by 2012, when we estimate per-capita income would reach 40% of the EU average, which we think is the bare minimum, with an optimistic assumption of 6.4% average growth (an average rate of 4.0% would bring Turkey's per capita income to barely 30% of the EU average in 2012). Nevertheless, we expect an acceleration in the reform process, as the EU candidacy will discourage any deviation from the IMF-sponsored disinflation programme and give Turkey's reformers an achievement to point to, and a promise of better things to come.

Turkey's possible contribution to and burden on the EU budget

If Turkey had been an EU member in 1998, it would have received €10.3 billion from the EU budget, including agricultural support from EU outlays, according to a study by German think-tank Zentrum für Turkeistudien. However, Turkey would also have contributed €2.9 billion to the EU budget. As a result, the net burden of Turkey's membership to the EU would have been €7.4 billion — that is, for every €1.0 contribution the country made to the EU budget, it would have obtained €3.57 in return.

Compared with other net recipients, Turkey's burden on the EU budget would have been reasonable. Even including transfers under the common agricultural policy, Turkey would have received €3.57 for every €1.0 contribution made to the EU budget in 1998. In that year, Greece and Ireland entertained transfers of €4.86 and €0.07 from Brussels, respectively. Per capita, Turkey would have collected €117 — only 18% of that which, for example, Ireland obtained in 1998 (€650.1).

Exhibit 37

Net Contribution to the EU Budget, 1998

(€ million)	Turkey	Greece	Portugal	Ireland	Spain
Contributions					
To EU	2,886	1,209	1,055	766	5,331
From EU	10,308	5,877	3,939	3,120	12,235
Net Amount	7,422	4,668	2,884	2,354	6,906
Equivalent to €1	3.57	4.86	3.73	4.07	2.30
Per Capita (€)	117.0	446.1	290.3	650.1	175.9

Source: Zentrum für Turkeistudien, Morgan Stanley Dean Witter Research

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BCE Place, 181 Bay Street, Suite 3700 Toronto, Ontario M5J 2T3, Canada Tel: (1) 416 943-8400	Serrano, 55 28006 Madrid Spain Tel: (34 91) 412 11 00		23 Church Street #16-01 Capital Square Singapore 049481 Tel: (65) 834 6888	The Chifley Tower, Level 33 2 Chifley Square Sydney NSW 2000, Australia Tel: (61 2) 9770 1111

V = More volatile. We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "volatile" can still perform in that manner.
