Equity Research
Europe

Economics

Turkey

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Economic Trends

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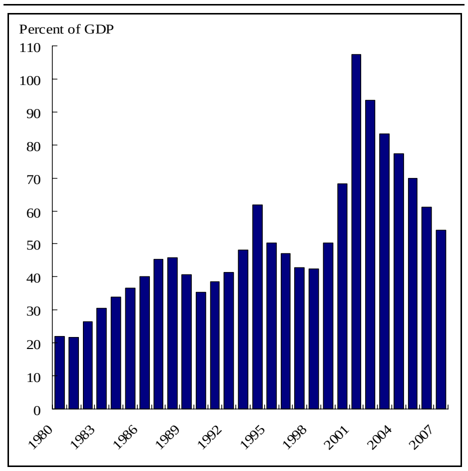
From Copenhagen to Maastricht

RECENT REPORTS

- **Turkey is moving steadily towards meeting the Maastricht criteria**
  Institutional improvements — fostering good governance and strengthening economic performance — are among the principal benefits of the accession process, but Turkey will also experience nominal and real economic convergence fuelling a virtuous cycle.
- **With secular disinflation, Turkey will achieve price stability in 2008**
  Inflation is already down to 7.7% and our projections show that it is likely to come down to 4.3% this year and then to 3.5% by the end of next year. In other words, Turkey will achieve price stability and meet the EU's inflation criterion in 2008.
- **The budget deficit, narrowing to 2.8% of GDP last year, is below the EU limit**
  The data based on European accounting standards show even more impressive improvement in public finances, as the public-sector budget deficit narrowed from 29.8% of GDP in 2001 to 3.9% in 2004 and then below the 3% mark last year.
- **Turkey's public debt-to-GDP will move below 60% by the end of next year**
  Though the composition and maturity profile of the country's domestic debt stock remain problematic, we expect further improvements in borrowing conditions and thereby a marked fall in the public-sector debt ratio to 54.2% by the end of 2007.
- **Interest rates will continue converging towards the European average**
  Lowering interest rates to the European average will take time, but the Treasury's diminishing borrowing requirement and Turkey's progress towards the investment-grade status will keep interest rates on a trajectory towards the European average.

Gross Public-Sector Debt, 1980-2007



Source: Treasury, 2005-07 Morgan Stanley estimates

Please see important disclosures starting on page 3.

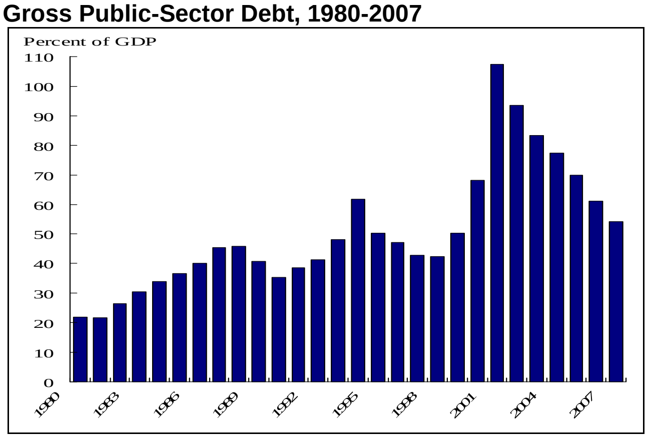
From Copenhagen to Maastricht

After the start of accession talks, Turkey is on the way to meeting the Maastricht criteria. With the completion of a range of legislative reforms at a breathtaking pace to meet the Copenhagen criteria, Turkey has started accession negotiations with the EU. Over the course of the next ten years, the convergence with the *acquis communautaire* will move the country out of institutional backwardness and help internalizing liberal democracy and the rule of law. In our view, institutional improvements — fostering good governance and strengthening economic performance — are among the principal benefits of the accession process (see *Law and Order*, November 26, 2004), but Turkey will also experience nominal and real economic convergence fuelling a virtuous cycle of declining cost of capital, increasing investment rates and output growth, improving credit quality and further compression of real interest rates. Indeed, the economy is already on such a trajectory and steadily moving towards meeting the Maastricht criteria for becoming a member of the European Monetary Union (see *Welcome to (Outskirts) of Maastricht*, October 27, 2005).

With secular disinflation, Turkey will achieve price stability in 2008. The consumer price index posted a year-on-year increase of 7.7% at the end of last year, down from 9.4% in 2004 and an average of 77.5% in the 1990s, thanks to far-sighted macroeconomic policies and structural changes raising the economy's growth potential. This is in fact the lowest inflation reading in the past three and a half decades and, considering the adverse effects of higher commodity prices on Turkey's import-dependent economy, reflects the strength of secular disinflation towards price stability. Our projections show that inflation is likely to come down to 4.3% this year and then to 3.5% by the end of next year. In other words, Turkey will achieve price stability and meet the EU's inflation criterion in 2008.

Exhibit 1

Gross Public-Sector Debt, 1980-2007



Source: Treasury, 2005-2007 Morgan Stanley Research estimates

The budget deficit, narrowing to 2.8% of GDP last year, is already below the EU threshold. Prudent fiscal policies and structural reforms have produced an average primary budget surplus of 5.8% of GDP in the last six years, leading to a dramatic drop in interest rates. As a result, the Treasury's interest payments declined from an enormous 23.3% of GDP (or 103.3% of tax revenues) in 2001 to 13.7% (or 55.9%) in 2004 and to 9.5% (or 37.5%) last year (see *The End of Fiscal Dominance*, November 8, 2005). And, not surprisingly, we have witnessed an astonishing correction in the central government budget deficit — from 15.2% of GDP in 2001 to 7.1% in 2004 and, on our estimates, to 2.8% in 2005. The data based on European accounting standards show even more impressive improvement in public finances, as the public-sector budget deficit narrowed from 29.8% of GDP in 2001 to 3.9% in 2004 and then below the 3% mark last year.

Turkey's public debt-to-GDP will move below 60% by the end of next year. Macroeconomic gains, coupled with soaring privatization revenues, have lowered the public-sector borrowing requirement from 16.4% of GDP in 2001 to 4.7% in 2004 and to a mere 0.8% last year. Accordingly, the public sector's net debt-to-GDP ratio declined from 90.5% in 2001 to 63.5% in 2004 and, according to our projections, to 57.5% last year. Though the composition and maturity profile of the country's domestic debt stock remain problematic, we expect further improvements in borrowing conditions and thereby a marked fall in the gross public-sector debt ratio — another Maastricht criterion — from the peak of 107.5% of GDP in 2001 to 61.2% this year and then to 54.2% by the end of next year.

Interest rates will continue converging towards the European average. The last condition of the Maastricht criteria states that the level of long-term interest rates must not exceed by more than 2 percentage points the average of the three member states with lowest interest rates. Of course, this is going to take a long time to achieve but we believe that the Treasury's diminishing borrowing requirement and Turkey's progress towards the investment-grade status will keep long-term interest rates on a trajectory towards the European average (see *Buy Bonds, Wear Diamonds a la Turca*, September 26, 2005).

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(as of December 31, 2005)

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