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Turkish Macro Outlook and Financial Markets

Outlook for 2008 and Beyond

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Presentation Outline

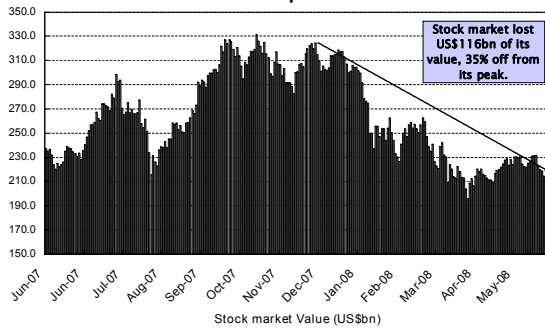
- **Impact of Global Turmoil on Turkish Economy**
 1. Analysis of Foreign Capital Inflows
 2. Vulnerability to Energy Prices
 3. Outlook for Turkish Lira

- **Impact of Global Turmoil on Turkish Banking Sector**
 1. Major Risk Factors for the sector
 2. Foreign Funding of Turkish Banks
 3. Outlook for Home Loans

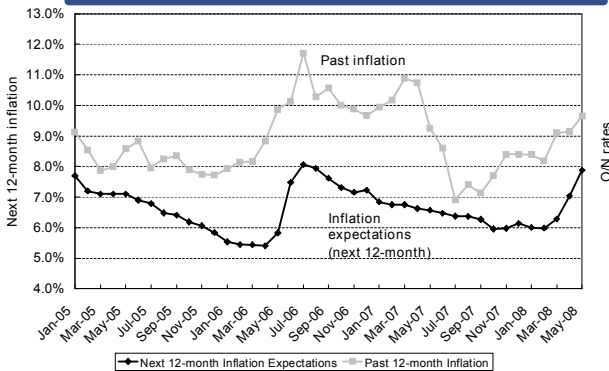
- **Foreign Investment into Turkey**
 1. The Breakdown of Foreign Investments Since 2003
 2. Sustainability of FDI and Real Estate Inflows

- **Conclusion**

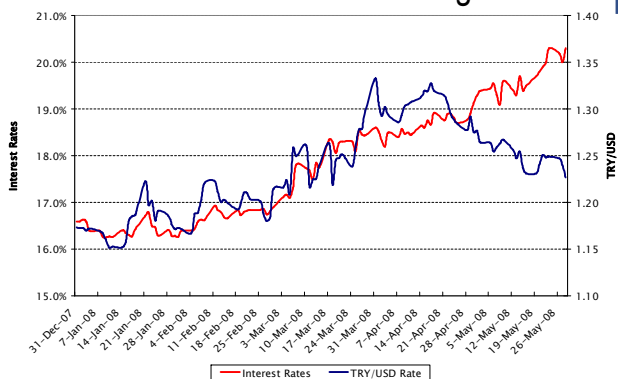
Stock Market Capitalization



Inflation and Expectations



Interest Rates and Exchange Rates



Impact of Global Turmoil on Turkish Economy

Major Risk Factors for Turkey

1. Slowdown in foreign inflows – Funding of banks and deficit
2. Global inflation – rising food prices and commodities etc.
3. Rising energy prices – its impact on C/A deficit

The Impact So Far. . .

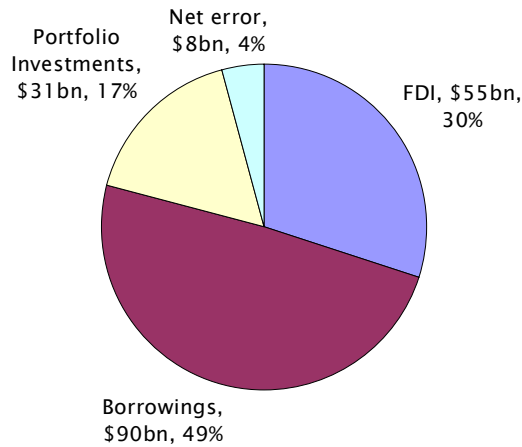
1. Major impact on the stock market – Lost US\$116bn in value
2. Second biggest impact on interest rates – Jumped 4% points
3. TL was much more resilient – Lost 4% & 13% vs. \$ and Euro.
4. Inflation has picked up – From 7% to almost 10%
5. C/A deficit growing – 30% annual increase in the 1st quarter.

Further Risks

1. Short FX exposure of Turkish non-financial industry
2. Oil price rising further and increasing pressure on C/A deficit
3. Speculative attacks on emerging market currencies

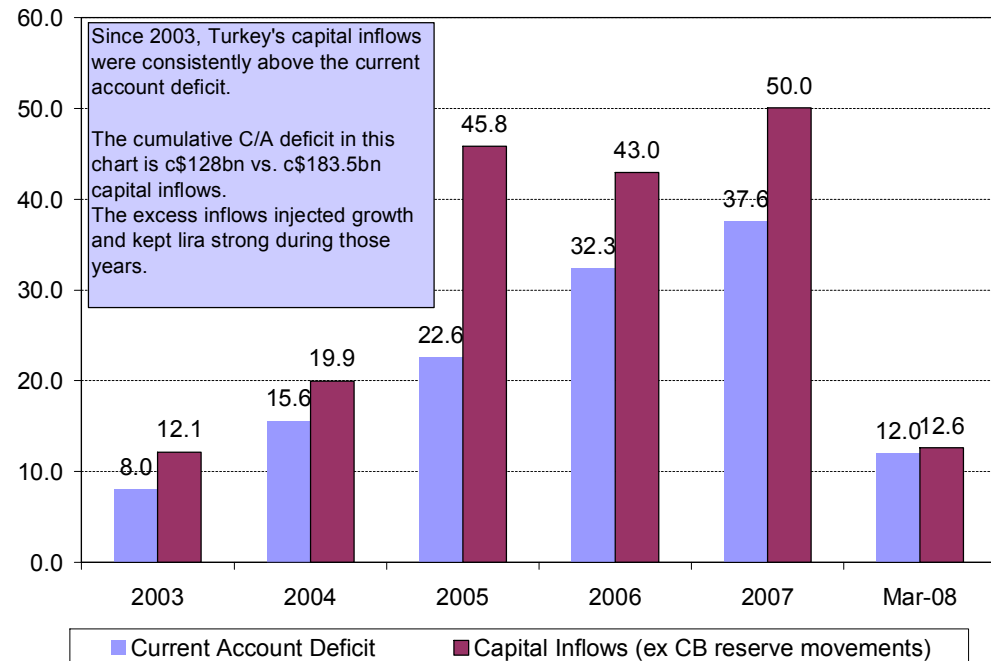
1. Analysis of Capital Inflows

Capital Inflows (2003-Mar08)



- Total inflows of US\$183bn
- Almost half is borrowings
- FDI is 30%
- Portfolio investment is only 17%

Figure: C/A deficit versus Capital Inflows



- Turkey accumulated US\$128bn of current account deficit since 2003...
- ... but capital inflows of US\$183bn was more than enough to finance this
- The excess inflows of US\$55bn increased Turkish CB reserves

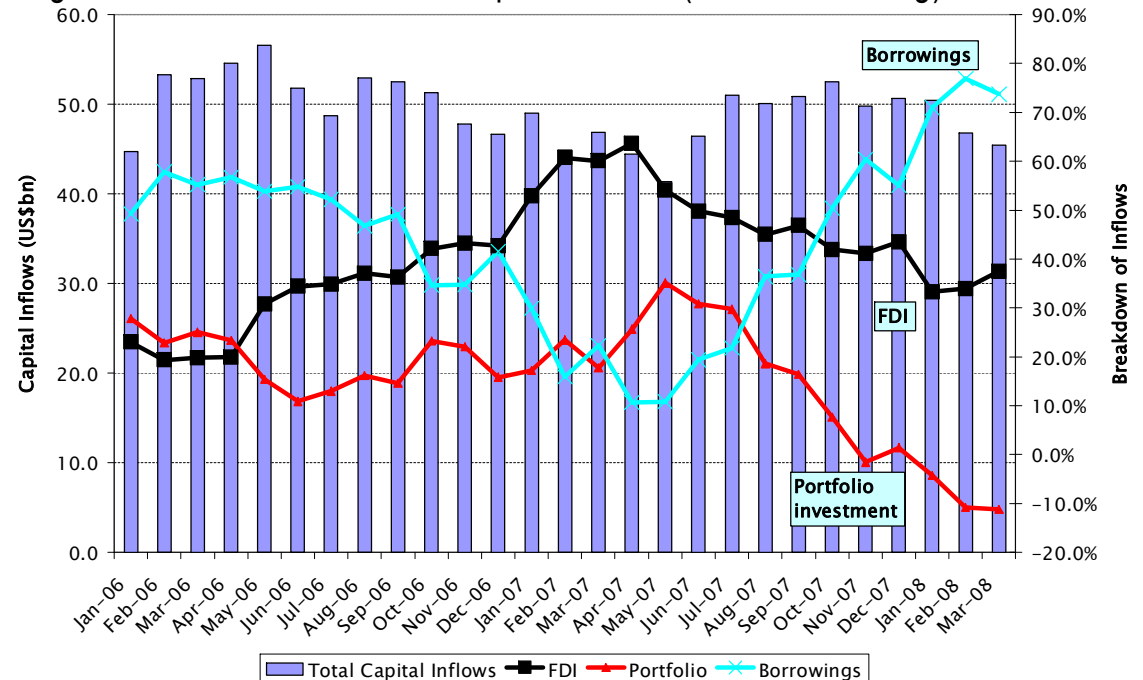
Analysis of Capital Inflows

Capital Inflows since June-2007

	FDI	Portfolio	Borrowings
Jun-07	1.3	-1.0	5.7
Jul-07	1.7	2.5	1.7
Aug-07	1.1	-4.2	6.3
Sep-07	1.5	-0.2	2.1
Oct-07	1.0	-0.3	3.7
Nov-07	0.6	-3.7	3.2
Dec-07	3.1	0.6	3.3
Jan-08	1.1	0.2	5.4
Feb-08	0.7	0.4	1.2
Mar-08	2.3	-1.9	3.4
TOTAL	14.4	-7.6	35.9

- Borrowings don't seem to be affected by the global turmoil. . .
- . . . while there were sizeable portfolio outflows
- Despite a slowdown, FDI is still reasonably strong

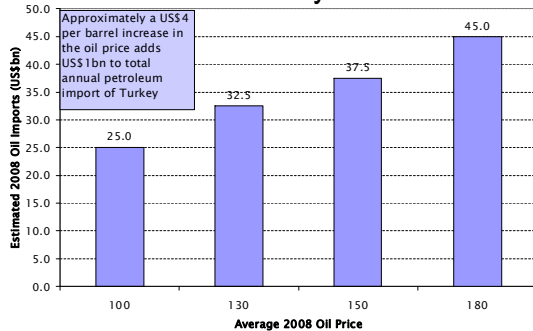
Figure: Breakdown of Recent Capital Inflows (12-month rolling)



- Total Capital inflows into Turkey has not been affected much from the recent global turmoil. . .
- . . . However the breakdown of capital inflows have changed dramatically
- Portfolio inflows (or hot money) went into negative while borrowings increased sharply, increasing Turkey's dependence on foreign borrowings to continue finance its current account deficit
- FDI has also slowed down

Energy Prices and Current Account Deficit

Oil Price Sensitivity

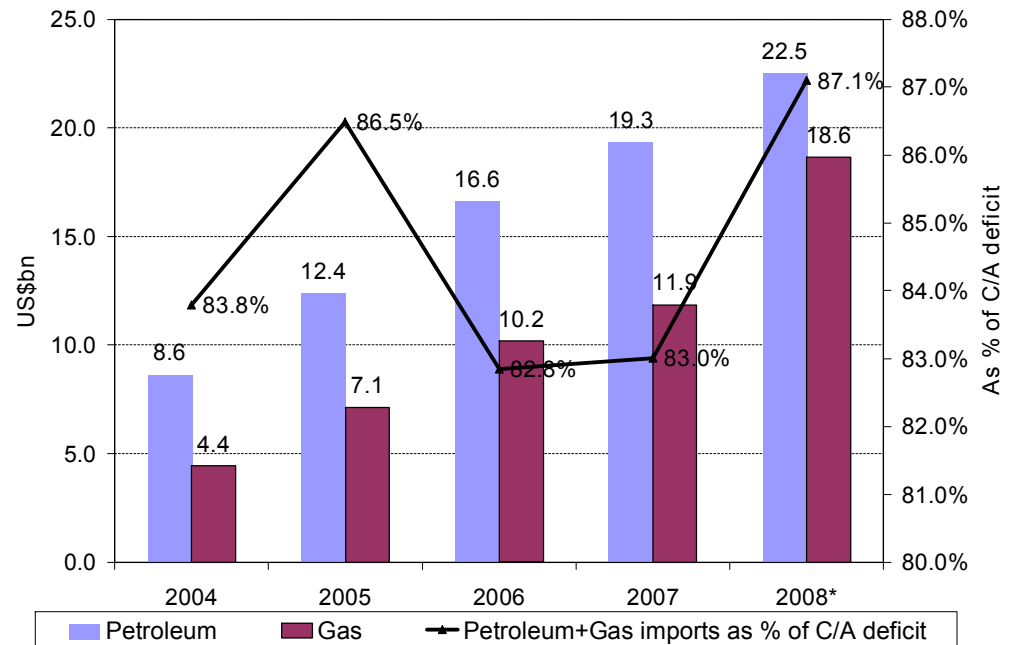


Oil Price Chart – Last 3Y



- A \$4 increase in oil price adds US\$1bn to total petroleum bill
- Average oil price year-to-date is 103.6 per barrel. . .
- . . . but current levels of 130 and rising trend creates a big risk

Figure: Petroleum and Gas Imports, 2004-2008



* 2008 annualized based on first two months

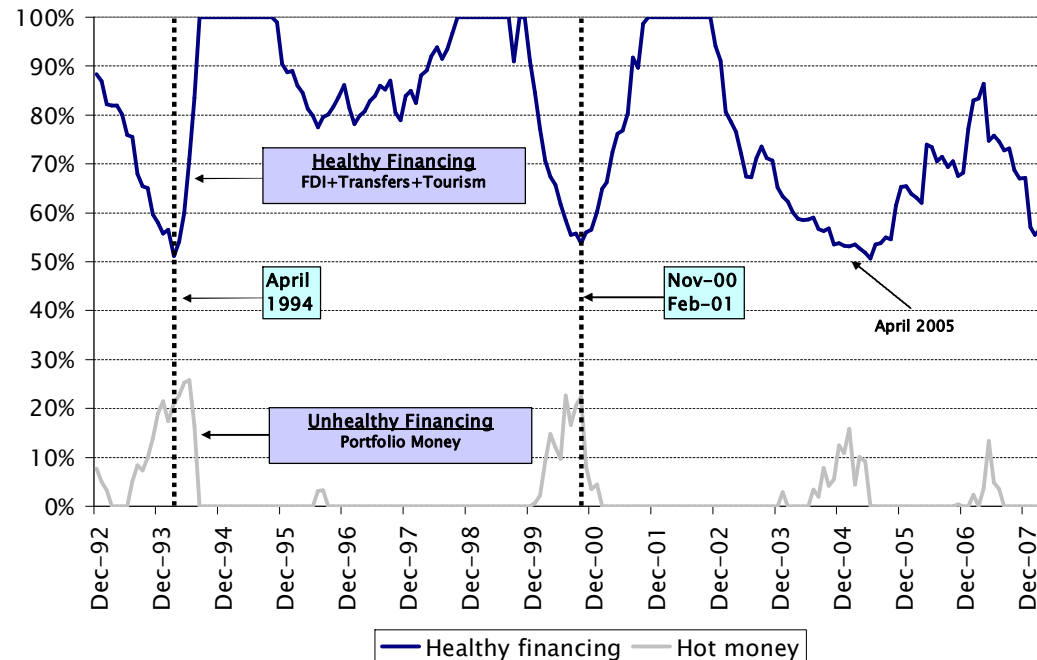
- Turkey's C/A deficit is widely driven by petroleum and gas imports, making up 85% of the deficit on average.
- Rising oil price is the major threat on Turkish macro balances
- The consumption of natural gas is also rising and based on the first two months of 2008, the y-o-y rise is very substantial

Vulnerability of Turkey to External Financing

CONCLUSION:

1. Turkey has to live with a huge current account deficit
2. What matters is how this is financed
3. In the short-term US\$75bn+ CB reserves provides a cushion
4. Given the problems in financial capital markets, all capital items are under threat: FDI, portfolio inflows and borrowings

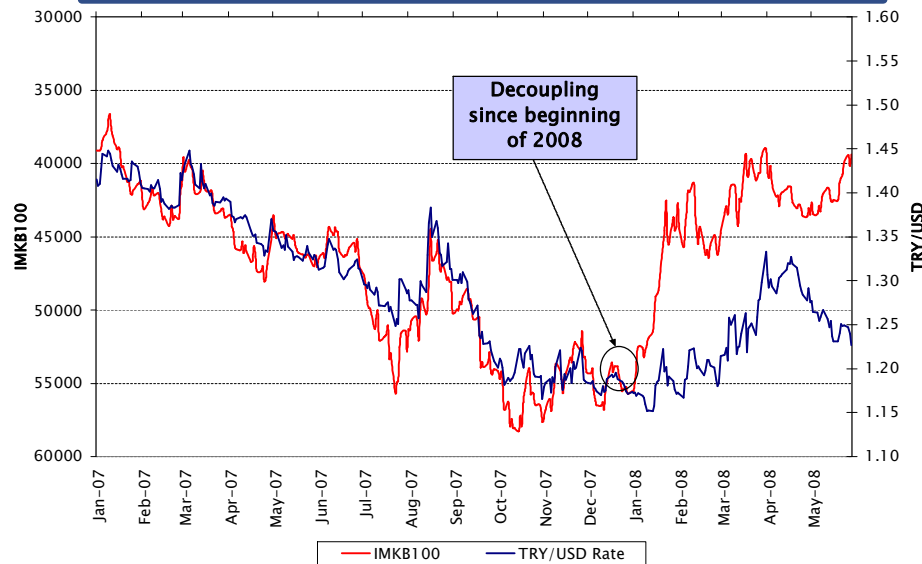
Figure: Financing of Turkey's External Deficit and Past Crises



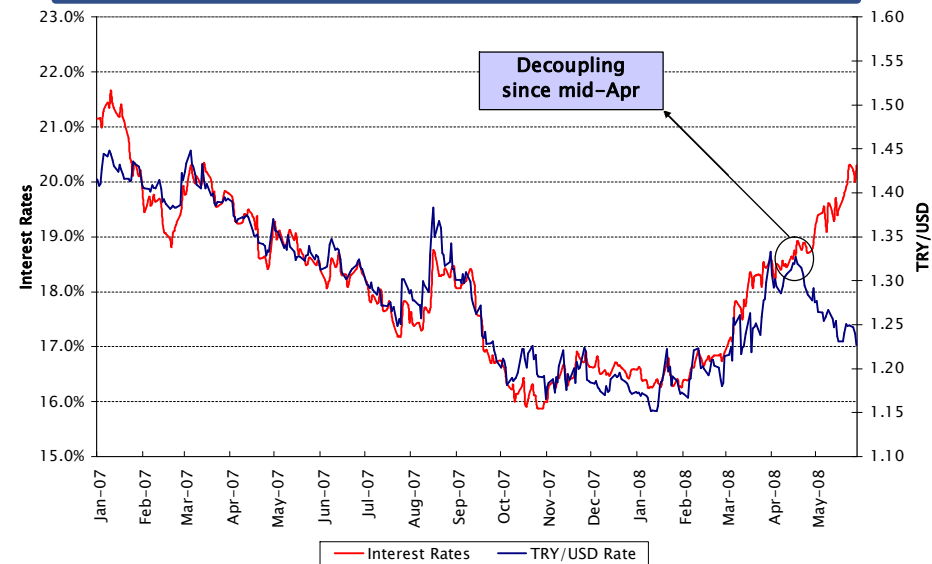
- External deficit is defined as trade deficit + income deficit + other deficits
- Healthy financing is defined as FDI + Transfers + Service revenues (tourism)
- Strong correlation between 1994 and 2001 crises and the financing of deficit
- Today, the healthy financing remains low but there is no dependence to portfolio money.
- Sustainability of FDI is the key

Outlook for Turkish Lira

TRY/USD vs. Stock Market



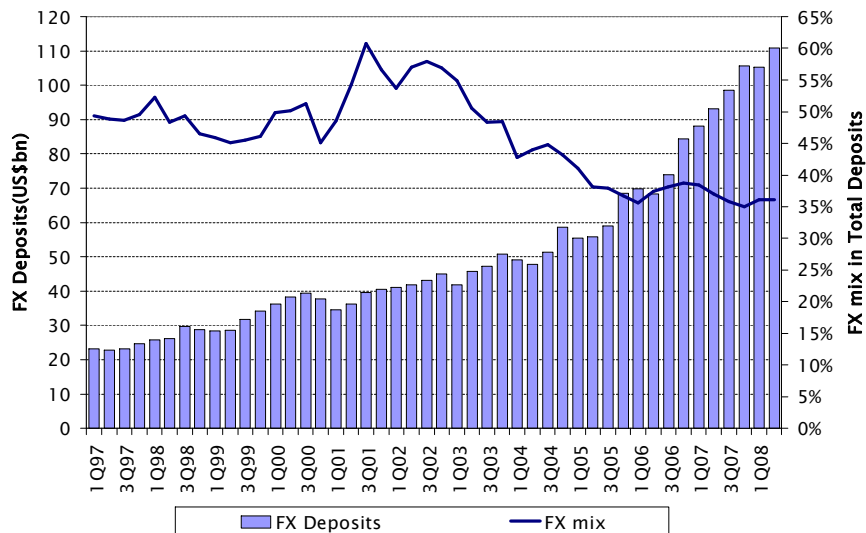
TRY/USD vs. Interest Rates



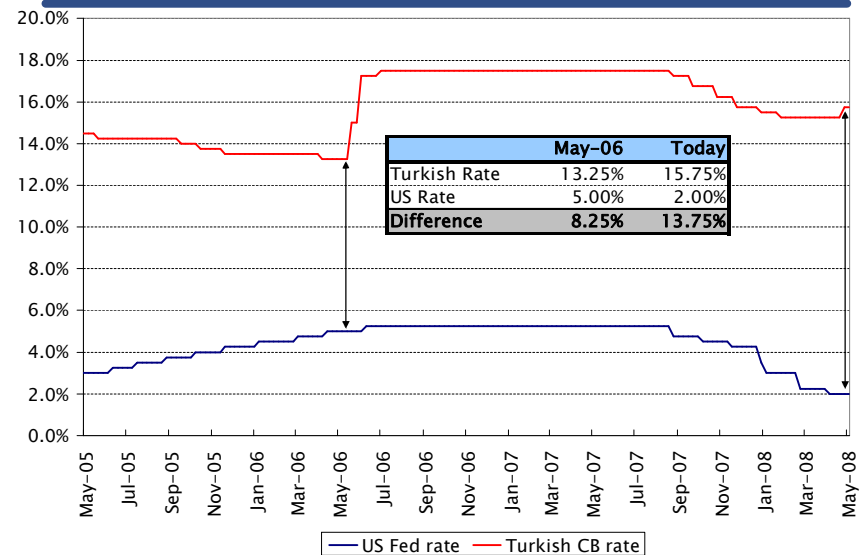
- Unique decoupling of Turkish Lira from stock market and interest rates.
- The current levels of stock market and interest rates suggest much higher TRY/USD exchange rate of 1.40-1.45 based on past correlation...
- Turkish lira looks overvalued on technical correlation with the stock market and fixed income market.

Why is Turkish Lira Too Resilient?

FX Deposits and FX mix



Difference Between Central Bank Policy Rates



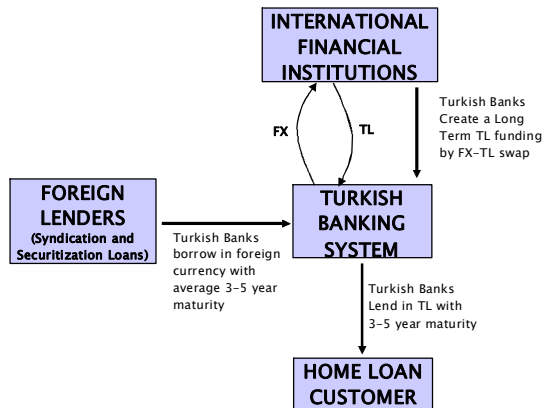
- Despite the de-dollarization since 2002, more than one third of deposits in the system are in foreign currency. Turkish deposit holders tend to switch to Turkish lira when lira depreciates.
- There is visible accumulation of FX reserves in the banking system since the turmoil in May-2006.
- 'Carry' has further improved: With US base rate falling faster than Turkish rate, the attractiveness of lira has improved.
- Weakness of dollar globally helps TRY/USD to be more resilient versus fixed income and stock markets.

2. Impact of Global Turmoil on Banking Sector

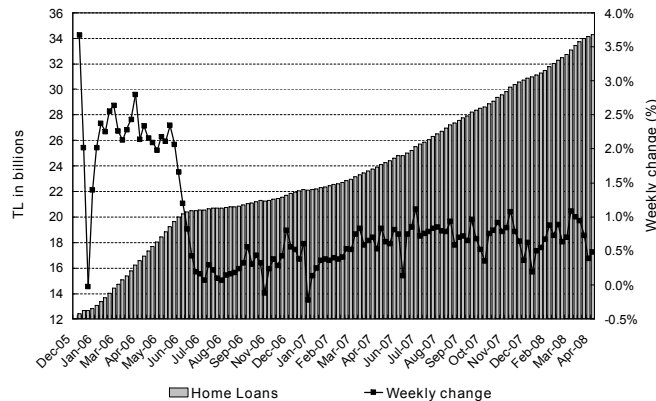
1. **No direct impact**
 - Turkish Banks do not have direct exposure to mortgage securities.
 - The major indirect impact is the credit squeeze which ended the era of cheap and easy foreign borrowing Turkish banks enjoying for several years
 - Rising interest rates and depreciating Turkish lira are other impacts on the sector
2. **Foreign Funding Problems**
 - Inter-lending among global financial institutions has diminished due to mortgage crisis
 - This affects Turkish banks' foreign borrowings including syndication loans, securitizations and swap funding.
 - This is not a dramatic problem for Turkish banks as only 16% of total funding is generated from international sources. . .
 - . . . However it is a problem particularly for home loans as Turkish banks used to finance approximately 2/3 of home loans by foreign borrowings and TL/FX swaps
3. **Rising Local Interest Rates**
 - This increases the opportunity cost of capital and increases the cost of TL/FX swap
 - As a result, mortgage interest rates also picked up
 - This also reduces the value of securities portfolio of Turkish banks and erode banks' capital.
4. **Depreciation in Turkish Lira**
 - This is the least important issue as the banking system do not carry a material FX position
 - However, corporate sector has substantial FX risk which may turn into bad debt risk for banks
 - Also, a sharp depreciation in lira may impact capital adequacy ratios as some portion of risk weighted assets are in FX denomination.

Home Loan Funding of Banks

Foreign Funding of Home Loans



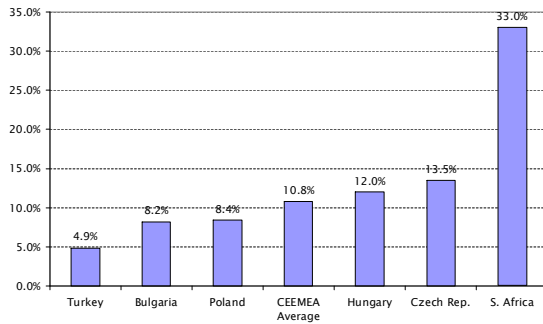
- Turkish Banks typically fund 2/3 of home loans by foreign borrowings, due to lack of availability of long term TL funding in the domestic market.
- Despite the global turmoil, Turkish banks do not yet have major problems in international funding and also in the TL-FX swap market.
- However, further squeeze in global credit markets and rising spreads could put pressure on home loan interest rates in Turkey.



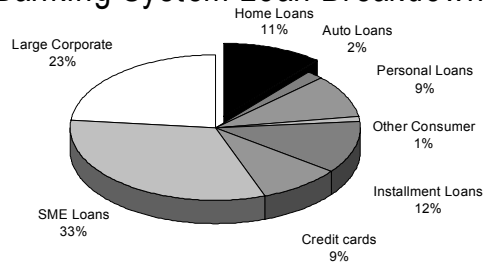
- Until the May 2006 crisis, home loans were growing at 2.0%-2.5% weekly rate, when monthly home loan interest rates were hovering around 1%...
- ... since then, the home loan market maintained its growing trend, albeit at a slowing pace, and weekly growth rate stuck between 0%-1%.
- We expect this growth rate to continue for the remainder of 2008. . .

Home Loans

Home Loans – to - GDP

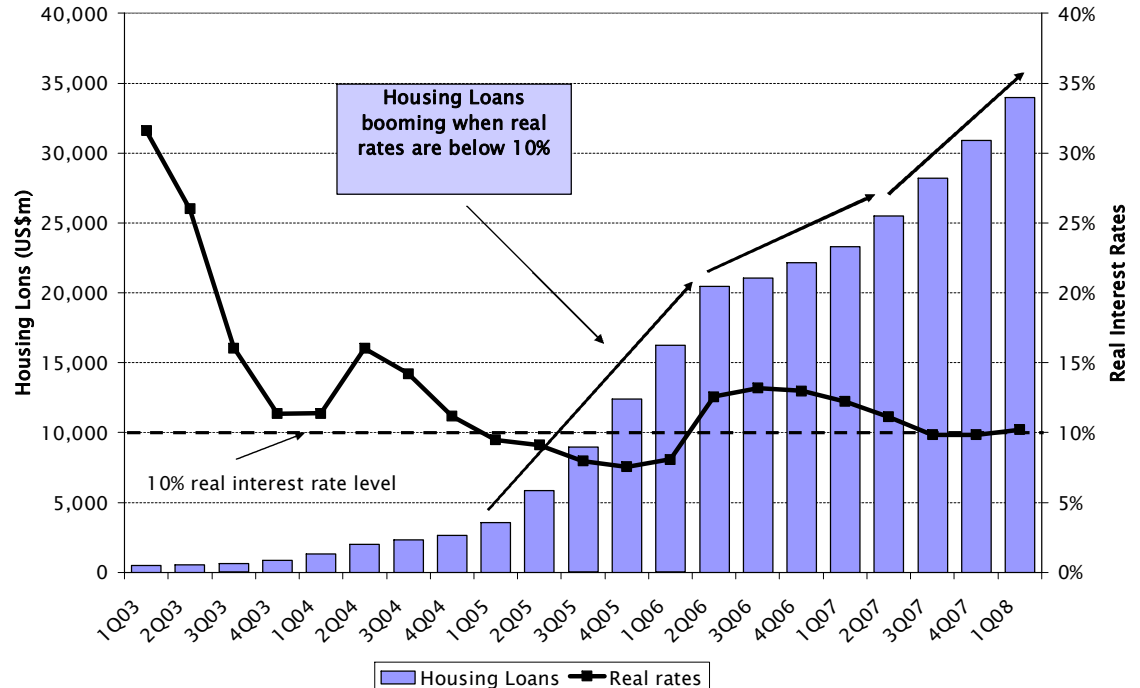


Banking System Loan Breakdown



Total Loans: TL307.4bn (May-08)

Figure: Home Loans and Real Interest Rates

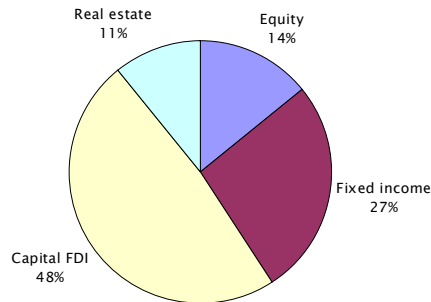


- Turkey well below regional emerging markets in home loans as % of GDP
- Home loans only make up 11% of total loans in the system

- Home Loans are highly sensitive to real interest rates... Not nominal interest rates... As proven by the rising growth recently...
- When real rates fall below 10%, the demand rises sharply.
- The best growth period was between January 2005 and June 2006
- The growth seems to have picked up again since the second half of 2007

3. Foreign Investments into Turkey

Breakdown of Total (2003-Mar08)



- The majority of the foreign capital inflows (ex borrowings) were privatizations and private sector asset sales, mainly in banking sector.
- Real estate was 11% of total inflows since 2003, but in the first three months of 2008, it increased to 21%.

Figure: Selected Foreign Capital Inflows into Turkey (US\$bn)

US\$bn	Short-term		Long-term	
	Equity	Fixed income	Capital FDI	Real estate
2003	0.9	2.9	0.7	1.0
2004	1.4	8.0	1.1	1.3
2005	5.7	9.0	8.1	1.8
2006	1.9	9.5	17.0	2.9
2007	5.1	-2.4	18.5	3.0
Mar-08	-0.7	-0.1	3.5	0.8
TOTAL	14.4	26.9	48.9	10.9

- Portfolio inflows (mainly hot money) slowed down considerably in 2008. . .
- . . . While capital FDI and real estate have not as much as feared.
- At current valuations, the stock market and fixed income are very attractive for long term investment purposes... but the investor type for these assets are very short-term oriented.
- Short-term outlook for global financial markets do not promise a short-term recovery in portfolio investments (i.e. equity and fixed income)
- Despite the global turmoil, the appetite for M&A and real estate seem strong, because investor profile for these assets are not bothered by the short-term risk factors... In fact, the short-term turmoil provide a good opportunity.

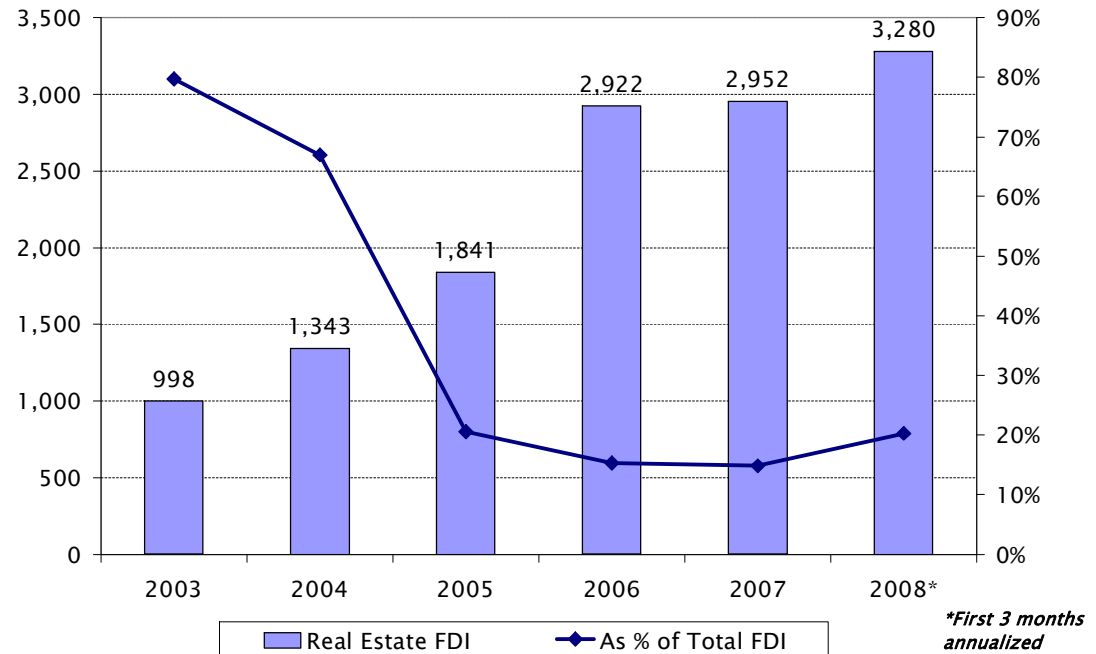
Sustainability of FDI and Real Estate FDI

FDI Movements, 2003-March 2008

	US\$bn	As %
a. Equity Inflows	50.9	81%
b. Real Estate Inflows	10.9	17%
c. Other Inflows	1.1	2%
Total Inflows	62.9	100%
a. Equity Outflows	(1.9)	-3%
b. Investment Abroad	(5.7)	-9%
Total Outflows	-7.63	-12%
Net FDI Inflows	55.3	

- The bulk of total FDI inflows since 2003 were privatizations and asset sales
- Real estate contributed to 17%
- **Energy, Tourism and Real Estate** are the major areas of FDI inflows into Turkey over the next decades.

Figure: Real Estate Foreign Direct Investments into Turkey



- Turkey attracts around US\$3bn foreign investment into real estate.
- This is less than 0.5% of GDP – a low figure compared to Eastern Europe, and particularly to Spain, Portugal and Greece.
- Sustainability of FDI is the key for Turkey's balance of payment dynamics and real estate FDI should play an important role in this.
- Latter parts of EU convergence stages and macro economic stability should boost foreign interest to Turkish real estate.

Conclusion

- Foreign capital inflow is likely to slow down in 2008. . .
- . . . but this is unlikely to lead to a major crisis for Turkey.
- Interest rate and inflation likely to remain high but a major currency crisis looks unlikely
- The common view of 'global crisis will evaporate FDI into Turkey' is not true. We witness continuous appetite for M&A in Turkey from foreign investors.
- The banking sector cannot be aggressive in mortgage lending this year, due to lack of easy foreign borrowing . The focus will be on corporate lending.
- Turkish lira has uniquely decoupled from equity and fixed income market. There may be a short-term correction in lira.
- In order for home loans to catch the growth trend pre May-06, real interest rates must fall below 10%.
- Given the global crisis, rising inflation on food and energy prices, and domestic issues, real interest rates are unlikely to fall in 2008, and early 2009.
- The major risk factor for Turkey is the energy prices, due to rising current account deficit.
- With close to US\$50bn current account deficit, Turkey needs substantial foreign capital inflow. As portfolio inflows and major privatizations slow down this year, Turkey has to attract foreign capital particularly in real estate.
- In the long-run, there are three main areas (which are inter-correlated) that turkey needs to attract foreign capital: **Tourism, Real Estate and Energy**