THE CLAIM OF THE TURKISH ECONOMY TO BE A REGIONAL HUB THROUGH A ROBUST BANKING SECTOR

Global economies have been caught in a perfect storm, which nearly devastated the international financial system. Timely and decisive intervention by governments and financial institutions helped restore stability. However, the full impact of systemic risk and of certain persistent problems has yet to be fully resolved. This paper evaluates the experience of Turkey in successfully weathering the recent crisis. It highlights the significant role played by the country's robust banking sector in enhancing the economy's resilience to the crisis.

Ziya Akkurt*

* Ziya Akkurt is Board Member and CEO of Akbank.

The unprecedented magnitude of the most recent global economic crisis has inflicted severe systemic woes on the global financial system since the first half of 2008. Global financial institutions joined forces with policy makers to undertake concerted action, with governments worldwide announcing record stimulus packages in order to prevent a potential global financial meltdown.

Two years have now passed since Lehman Brothers went into administration. Although financial liquidity conditions have improved, the strain this has left on the balance sheets of affected financial institutions is yet to be fully alleviated. Meanwhile, there have not been any noteworthy increases in loan volume, and unemployment remains high on both sides of the Atlantic. Planned regulatory measures to reduce the level of risk within the financial system could further impair credit allocation in the forthcoming period. The combination of all these factors continues to undermine the strength of recovery.

The stimulus packages introduced have resulted in significantly high levels of public debt. The IMF estimates that the budget deficit to GDP ratio by 2015 is expected to soar above pre-crisis levels. Not only are high deficit countries expected to cut their deficits to three percent of GDP in the next few years, but also the larger European countries, Germany, France and UK, have also announced significant fiscal consolidation plans. However, the key concern is what impact budget deficit reduction will have on the already weak growth prospects for the (EU) region.

Emerging countries, meanwhile, are expected to support the global economy by registering strong GDP growth and by playing a stronger role in the post-crisis period. This is due to the favorable outlook presented by a shift in the balance of power from the West to the East. IMF forecasts that lower initial debt stocks of emerging markets will keep interest expenditures down despite suffering higher interest rates than to the more developed economies.

Turkish Economy Prevails as a Regional Hub with Significant Growth Prospects

Turkey, which has weathered the recent crisis better than many of the developed and developing economies, continues to present strong fundamentals. Indeed, the country's high growth prospects have allowed Turkey to emerge as a safe haven for international investments.

The three key factors that have contributed to differentiating Turkey are:

- A robust banking system
- Strong budget figures and fiscal discipline
- A low-leveraged yet growth-oriented market

The Turkish financial system, fiscal outcomes and the vibrant local real economy all show signs of promise. Turkey has a strong investment thesis and is ready to move into a higher gear for an improved economic position.

As the financial crisis evolved into a debt-crisis, many European nations have been struggling with budget deficits that exceed ten percent of GDP and as much as 100 percent in some countries. By comparison, the ratio of Turkey's budget deficit to GDP only rose to 5.5 percent in 2009. The ratio of public debt to GDP was also a more favorable 45 percent compared to 74 percent for the EU.

Moreover, Turkey's commitment to fiscal discipline means the medium-term budget deficit will be successfully reduced and the adoption of the fiscal rule in 2011/2012 should provide further benefit as the new policy anchor for the wider markets.

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Turkey has already established itself as a strong economy. It is the eighth largest economy in Europe and ranks 17th globally in terms of total GDP. Provided the right steps are taken to place the economy on a sustained growth path, we believe Turkey has the potential to become a regional power.

Sectors such as finance, energy, construction and automotives carry high growth potential in the medium-term. The construction sector, in particular, has the potential to benefit from under-developed neighboring regions, and despite the recent surge in financial services, financial products are still under-penetrated. In terms of the automotive sector, Turkey has become a production hub especially for the European market.

Future Economic Growth Prospects, Privatization and Liberalization/Deregulation of the Energy Sector Still Help to Attract Wide Investor Interest

Turkey's geographically unique location connecting resource-rich economies of the East to the prosperous economies of the West makes it an energy corridor.
Taking a close look at the energy sector and energy financing,one can conclude that Turkey's energy demand is poised to expand in parallel to the country's economic growth. This reality makes energy investments a priority for registering sustainable growth performance.

The fact that energy investments are large scale, capital-intense investments puts the banking sector at the heart of the issue. The Turkish banking sector plays a significant role in this regard, by providing the necessary financing to the energy sector. Indeed, the total cash credits allocated to the energy sector have reached 13.3 billion dollars as of May 2010 with a CAGR of 56 percent since 2000.

Another method to evaluate investments to the energy sector is by measuring sustainability. Indeed, there is a growing consciousness of sustainability considerations in Turkey. The Banking sector has also helped to foster awareness in initiatives to promote investments in sustainable energy resources and energy efficiency. For example, the Carbon Disclosure Project (CDP), which invites the world's largest, publicly listed companies to disclose their greenhouse gas emissions, has recently launched in Turkey. The project, which is supported by Akbank and led by the Sabancı University, will issue the carbon tags of the companies listed on the ISE-50 index with stocks traded on the ISE (Istanbul Stock Exchange) and provide data to institutional investors on the relevant carbon tags, with the aim to promote a more habitable earth for future generations. The first annual results of this project, in which companies have been invited to disclose their carbon emissions as well as their policies on climate change, will be announced in the last quarter of 2010.

Meanwhile, the Turkish banking sector has also been cooperating with global financial institutions to provide loans to both households and the private sector at more favorable terms (longer maturity, flexible payment terms and better pricing) to finance energy investments and further promote sustainability. To this end, Turkish banks have been expanding their cooperation with financial institutions, including EBRD and EIB to provide energy friendly loans targeting projects from insulation/energy-saving/transition to the use of household solar energy projects. However, due diligence requirements mean banks must attain an environmental impact assessment for all energy projects before considering the projects for financing.

A Robust Turkish Banking Sector Reinforced by Effective Regulatory and Supervisory Framework has Increased Turkey's Resistance to the Recent Crisis

In comparison to many economies, the Turkish banking sector has remained resilient through the current crisis and has weathered fluctuations well. This was accomplished thanks to a robust capital structure, reliance on core banking activities, a healthy loan portfolio and a low-leverage structure. These conditions were achieved through:

Strong capital levels: The recent crisis has emphasized the importance of a strong capital structure. Global banks have been seeking to improve their capital base

and deleverage their balance sheets. In this respect, the sound capital base of Turkish banking has acted as a significant advantage.

Capital adequacy ratio of the Turkish banking sector is currently around 19 percent. This is higher than the target ratio of 12 percent and the legal limit at 8 percent. This robust capital base has also acted as a buffer to absorb shocks.

Low penetration of risky assets: The penetration of off-balance sheet items and derivative products has always been low in the Turkish banking sector. Banking was pursued through the "traditional channel" and with a focus on core banking activities.

Healthy growth: Credit growth has been strong in the years following the 2001 crisis when Turkey experienced an average annual GDP growth of around 7 percent. However, it did not reach excessive levels. Average real credit growth in Turkey was around 30 percent whereas the level reached up to 40-50 percent for many other EM's.

This relatively cautious expansion in the credit book helped keep the loan portfolio healthy. Although the non-performing loan ratio (NPL) rose, it was still only at 5.4 percent in November 2009. This marked an increase of two percentage points since the start of the crisis and indicated slower growth than many other emerging markets and developed countries. The NPL ratio currently stands at 4.4 percent.

Importance of core funding: The Turkish banking sector relies heavily on core funding. The ratio of loans to deposits is around 78 percent in Turkey. This is a relatively low level in comparison to many EM's with ratios of above 100 percent. This level helped to support banking sector liquidity.

Low leverage reduced risks: Finally, on the back of robust risk management, leverage remained low in the sector. The ratio of assets to shareholders' equity remains around eight, well below the international average of 30-40.

High profitability maintained: The sector sustained its profitability even through the crisis and at no point required a line of support from the government. Its strength will continue to support the economy through its path to recovery.

In Turkey, the allocation of bonuses and compensation packages has not been perceived as controversial as within other markets. This is because Turkish pay packages never reached excessive levels. However, on a global scale the subject of bonuses and remuneration/compensation continues to be widely discussed. Such bonus schemes are causing analysts and investors to seek higher RoE

ratios, which are, in turn, pushing institutions to undertake higher risks to increase profitability. However, as we have seen in the crisis, this contradicts the long-term wellbeing of both the financial sector and the economy as a whole. We therefore believe bonus schemes should be rearranged so as to promote long-term, healthy returns rather than quick and risky gains.

Meanwhile banks have followed more conservative dividend policies to give priority to the long-term health of their balance sheets. We have seen first-hand the importance of retaining a strong capital structure. Therefore, we believe it would be beneficial to allocate a larger proportion to the banks' equity rather than distributing as dividends.

Resilience of the Banking Sector Supports Turkey on the Way to Receiving Investment Grade

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The banking sector's resilience has supported rating upgrades. Since December 2009, Fitch, S&P and Moody's have positively revised Turkey's ratings. Turkey is now rated two notches below investment grade by Moody's and S&P and one notch below by Fitch.

Credit upgrades are now especially important given that many European nations are experiencing sharp downgrades. Turkey is anticipated to reach investment grade in the next few years. The Government's commitment to fiscal discipline will be instrumental in generating further upgrades.

Turkey has learned a great deal from its domestic financial crisis of 2001. Its experience has helped the country to establish a firm regulatory framework in the sector to stimulate the implementation of timely and necessary reforms. Experiences gained during and after the 2001 crisis were key to weathering the current crisis with such ease. Looking forward, Turkey's experience serves as an insightful guide to other countries looking to go through a reformation phase.

We firmly believe that Turkey, which has set a benchmark with its stellar economic performance during the global financial crisis, will soon join the league of the top ten economies and serve as the business hub for its region.