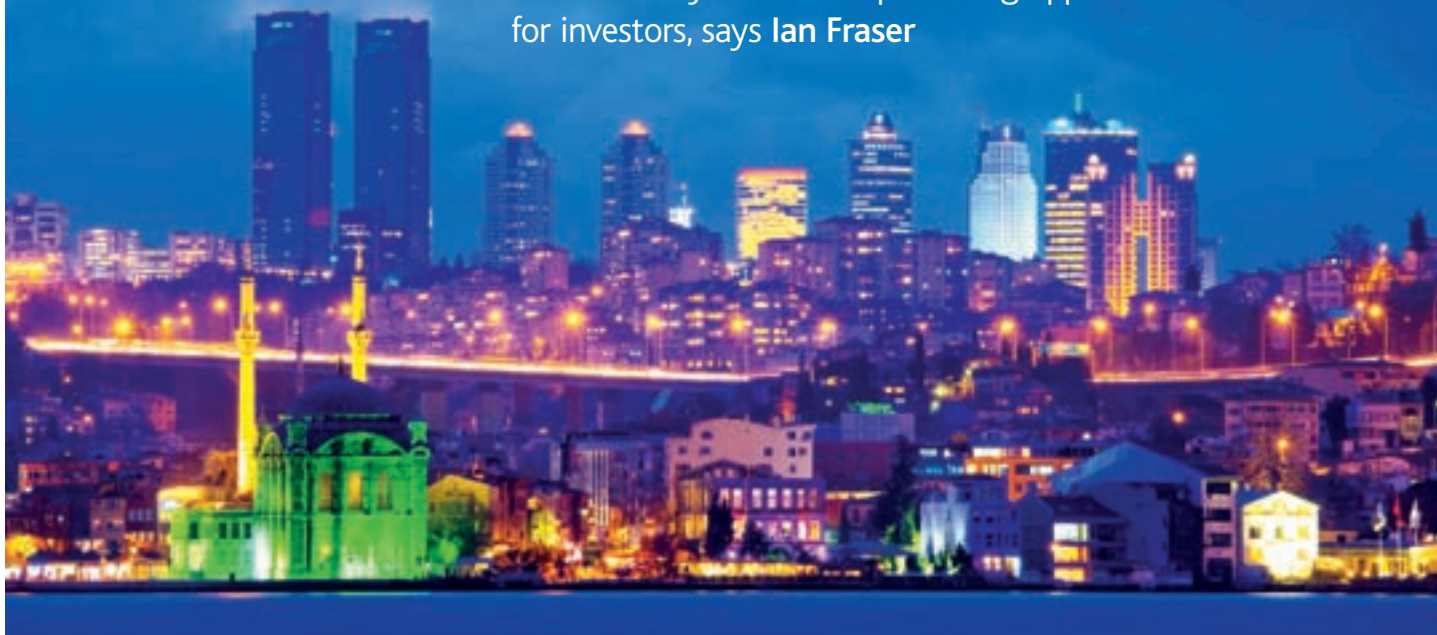


MIGHTY EMPIRE

Turkey has succeeded in transforming its finances and economy with some promising opportunities for investors, says Ian Fraser



In the early stages of the financial crisis in May-September 2007, there was a widespread hope that the 'credit crunch' would be a short-term liquidity crisis – or even a mere 'blip'. The hope proved horribly vain for most countries.

Turkey, however, can lay claim to being one of the few European economies where such predictions proved remotely accurate. The country's \$710bn economy has proved remarkably resilient in the face of global financial meltdown. Gross domestic product slipped by 4.7 per cent in 2009, but the economy has bounced back quickly and is expected to grow by 5.2 per cent this year. The consensus among economists is that, on the back of continued strong domestic demand, Turkey will grow GDP by 3-5 per cent for the foreseeable future.

RESCUE PACKAGE

Prime minister, Recep Tayyip Erdogan, re-elected in a snap election in 2007, said last year that Turkey could walk tall without any need for 'walking stick' loans.

He was referring to the humiliation of 2000-01, when after a period of excessive risk-taking by the nation's banks and fiscal lassitude from government, Turkey had to accept a \$10bn rescue package from the International Monetary Fund and World Bank.

The bailout came with hefty strings attached. These included a commitment to fiscal discipline, a restructuring of the economy and an overhaul of regulatory institutions. The Turkish lira was shifted from a fixed to a floating rate, permitting disinflation; the central bank was given a clear anti-inflation mandate; and financial regulators were given their independence.

These reforms, forced through by Erdogan's moderate but conservative Islamist-leaning AKP government, provided the rock on which the nation's current stability is based. The Ankara-based Banking Regulation & Supervision Agency (BRSA), founded in 1999, is today seen as one of the world's most effective banking regulators. It has enforced a stringent 12 per cent capital adequacy requirement on the nation's banks

as part of a wider regime of 'tough love'.

On its website, the BRSA said, "Resolution of banks that were taken over by the Savings Deposit Insurance Fund (SDIF) was the most critical part of the restructuring programme... The resolution process can be considered rapid and efficient in light of international experiences. The SDIF carried on an intense judicial struggle for the collection of receivables, protection of public rights and legal punishment of those who are responsible."

TRANSFORMATION

Thanks to resolute action like this, Turkey's economy has changed dramatically in recent years. GDP grew by an average of 6 per cent between 2004 and 2008; meaning Turkey became Europe's seventh-largest economy. Turkey is also helped by its strategic location (with the former USSR to the north, the Middle East to the south and Europe to the west), has benefited from reform measures taken in the context of EU accession talks, and its youthful population of 72 million.

"Over the past decade Turkey has transformed itself," said Andrew Stobart, emerging markets specialist at Baillie Gifford. "It has put the political, economic and monetary instability of the 1990s behind it. There are

still some huge challenges ahead, but it has the great fortune of a large, ambitious and youthful population, eager to drive development and improve their individual and collective wealth."

However, it is not all going to be plain sailing. In particular, political tensions are running high, with occasional flare-ups between the AK party and the secularists, who are embodied by the judiciary and the military. The secularist establishment accuses Erdogan of having autocratic tendencies and suspects his real agenda is to undermine the country's secular nature, as enshrined in the Turkish constitution of 1924. However, a failed coup attempt in February 2010, which led to dozens of military officers being tried on charges of plotting to oust the prime minister, has weakened the secularists' hand.

ONGOING CHALLENGE

Other risks include higher than expected inflation, and that the country's inflexible labour market reduces growth rates. Low savings rates are also seen as a threat. Kemal Dervis, vice president and director of global economy and development for the Brookings Institution, recently warned that Turkey will be unable to achieve growth of 7-8 per cent if savings rates remain as low as 17 per cent of GDP. "Turkey needs to increase its national savings rate to ensure sustainable growth in the long-term and avoid encountering new problems," Dervis told the Anatolia news agency.

Other challenges facing Turkey include the east-west divide in wealth and culture, disparities in educational standards and the current account deficit (which is also a consequence of Turkey's energy deficit). Exports, which currently account for close to 25 per cent of GDP are likely to spur growth as Turkey takes increasing advantage of its fortuitous geographic positioning and its wealth of labour capital.

Against this backdrop Stobart believes the most promising sector is banking. Thanks to the restructuring imposed by the BRSA earlier this decade, the banking system today is among the best capitalised in the world, with low levels of non-performing loan ratios, foreign exchange positions that are almost totally hedged and high profitability.

Stobart said, "Banking is a relatively consolidated sector and pretty under-penetrated; only one in ten Turks has a bank account. Given the current low ratio of credit to GDP, there is scope for strong growth in lending in the foreseeable future."

OPPORTUNITIES

The Monks, Mid Wynd, Edinburgh Worldwide and Scottish Mortgage investment trusts hold shares in



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Istanbul-based Garanti Bank. On recent visits to Garanti, Baillie Gifford's fund managers have been impressed by Garanti's management team, the bank's IT systems, (partially derived from its US partner GE Capital) and their credit scoring techniques.

Another area of interest to the investment trusts managed by Baillie Gifford is consumption. Both Mid Wynd and Monks are invested in Istanbul-based 'hard discounter', BIM (Birlesik Magazalar). With 2,675 branches across Turkey, BIM is one of the country's largest retailers, and aims to have a footprint of 4,000 stores by 2020. Stobart believes a combination of rising living standards and the fragmented nature of Turkey's existing offering mean players such as BIM have excellent growth potential. "They have been incredibly good at managing their costs," he said.

Stobart is encouraged by recent plans announced

by Deputy Prime Minister Ali Babacan to adopt a self-imposed fiscal rule, which commits Turkey to having a budget deficit of no more than one per cent of GDP in the long-run and is far more stringent than anything required by the eurozone. "That will bring greater accountability for the government, and is another step in an ongoing process of reform," said Stobart.

Please remember that ongoing stock market conditions and currency exchange rates will affect the value of investments and any income from them. Investors may not get back the amount invested.

Investing in emerging markets is only suitable for those investors prepared to accept a higher level of risk. This is because these markets could go down or up more than the main international markets.

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