Merrill Lynch

Comment

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Mehmet Simsek
(44) 207 996 2877
mehmet_simsek@ml.com
Ed Butchart
(44) 207 996 2093
Mike Harris
(44) 207 995 4048
Zek Ozturk
(44) 207 996 2058

Turkey

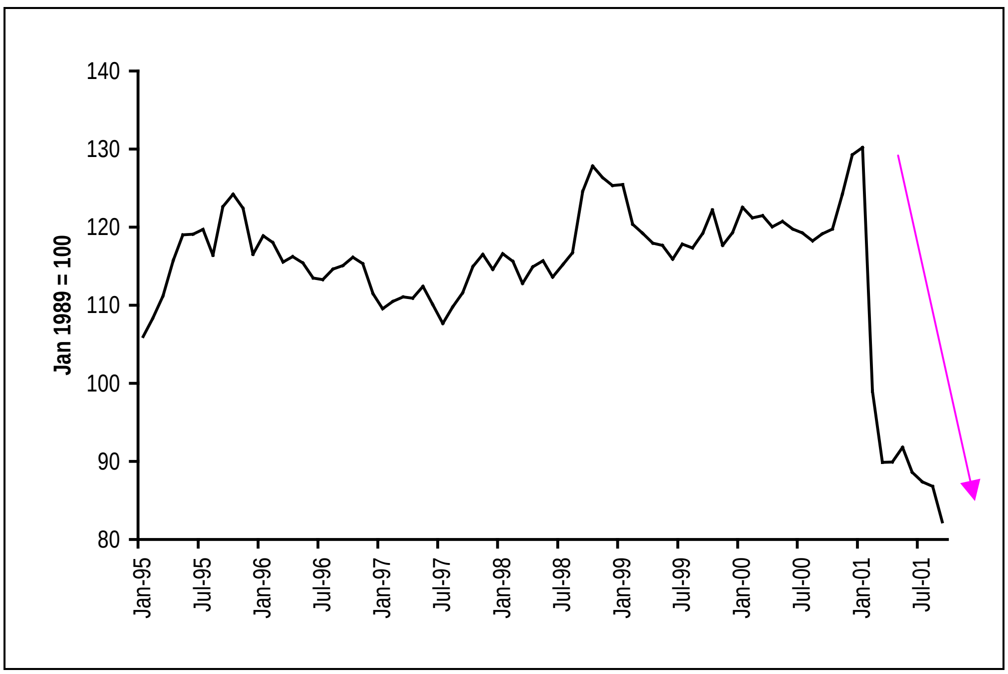
How Much Help is Needed?

Country

Highlights:

- **We believe two things are needed to turn the recent market bounce into a more sustained rally, namely (1) economic recovery and (2) clarity on financing for 2002. The size and timing of any extra help from the IMF matters for both.**
- **Depending on our assumptions for the world economy in 2002, Turkey's financing gap ranges from USD6.8bn to USD16.5bn.**
- **Our guess is that Turkey will likely get another USD 10-12bn because of its heightened geopolitical importance and the government's commitment to strong fiscal adjustment. Under our base case assumptions, this amount of aid tides Turkey over, but not with much room to spare.**
- **If the IMF provides USD15bn-USD17bn, then Turkey becomes a buy even at current levels, as this would significantly improve confidence and reduce debt rollover risk. If IMF package totals only USD5bn-USD7bn, then Turkey is likely to struggle, possibly necessitating domestic debt swaps.**

Chart 1: Real Exchange Rate Index (TRL/USD, 1989=100)



Source: Datastream, ML

Merrill Lynch & Co.
Global Securities Research & Economics Group
Global Fundamental Equity Research Department

Turkey: How Much Help is Needed?

We believe two things are needed to turn the recent market bounce into a more sustained rally, namely (1) economic recovery and (2) clarity on financing for 2002.

The size and timing of any extra help from the IMF matters for both. Our guess is that Turkey will likely get another USD 10-12bn.

Under our base case assumptions for the world economy in 2002, this amount of aid tides Turkey over, but not with much room to spare.

Additional IMF Funding Is Likely

We think Turkey's primary problem continues to be the financing requirements of its massive and expensive domestic debt. **We think the country is likely to secure additional financing** for several reasons:

- Its geopolitical importance has been heightened following the September 11 attacks on the US (a NATO member and US ally, it has already committed ground forces to the military campaign). We highlighted this issue in our EESA strategy report of 21 September 2001.
- The Turkish government has committed itself to a significant fiscal adjustment, a reduction in non-interest expenditure equalling about 2.5% of GNP. The primary surplus of the entire public sector (the broad IMF definition) is projected to rise significantly to 6.5% of GNP, up from an estimated 5.5% in 2001, 2.8% in 2000 and –1.9% in 1999. Much of the improvement is expected to come from cuts in transfer expenditure (2.2% of GNP) – savings in operating expenses of state economic enterprises. This is pretty impressive stuff.
- Turkey has done reasonably well implementing the IMF programme and attaining the performance criteria. The country has made significant headway in addressing banking sector weaknesses, which derailed the country's previous disinflation programme in February. In the absence of fresh external funding, the downsizing of state-owned banks and liquidation of troubled banks could be halted as debt management moves to a number one priority.
- With Argentine spreads widening again, Turkish access to private financing is likely to remain limited.

The key question is not whether Turkey will get any extra help, but rather how much help does it need? In this report, based on numerous assumptions, we attempt to estimate the financing gap and assess the likely impact of an additional external facility on the equity market.

■ Scenarios for 2002

Turkey's gross public debt is projected to total about USD126bn at end-2001 (roughly USD66bn in domestic debt and USD60bn in external debt). Markets remain most concerned about domestic debt rollover risks because of the high cost of domestic borrowing. As table 1 shows, nearly 70% of the domestic debt is held by state entities (state-owned banks, the unemployment fund, the central bank, and banks under administration of the Savings Deposits Insurance Fund), providing the Treasury with a significant degree of flexibility. As of end-September, about 33% of domestic debt was FX-linked, while 53% was floating rate note papers and about 14% was in zero coupon papers.

Table 1: Holders of Turkish Domestic Debt Stock (as a % of Total)

	End-2000	End-Sep 2001	End-2001E
Total	100	100	100
Held by Public Sector	**53.0**	**67.8**	**69.7**
Central Bank	2.9	23.2	26.2
-IMF	0	8.2	12.9
-Banking Operation	2.9	14.9	13.3
State Banks	35.0	20.3	19.0
-Securitised	5.6	20.3	19.0
-Other	29.3	0	0
SDIF-Administered Banks	7.0	15.6	16.9
Other Public Entities	7.8	8.7	7.7
Debt Held by Market	**47.0**	**32.2**	**30.3**

Source: Treasury, Merrill Lynch

To estimate Turkey's financing gap, numerous assumptions need to be made involving the maturity of any new debt that is issued, the average cost of borrowing, the exchange rate, inflation rates, the debt rollover rate, 2002 real GDP growth, privatisation proceeds, the primary surplus, the international macroeconomic environment, and so on.

Moreover, it is difficult to predict and quantify Turkey's financing needs with any precision because the IMF package itself will likely have a significant impact on the cost of borrowing, magnitude of exchange rate depreciation and investor confidence, etc.

We therefore examine three scenarios in order to provide an indicative range of possible financing needs. In all scenarios, the estimates assume that principal debt held by public sector entities will be rolled over at maturity.

■ Base Case Scenario – Muddling Through

Our base case (Scenario A) assumes that the global backdrop remains difficult in 2002, with the appetite for emerging market assets recovering only gradually. In addition, macro risks persist within the emerging market asset class, significantly limiting Turkey's access to private capital in the first half of the year.

On the domestic front, Turkey appears to have no choice under this scenario but to tighten fiscal policy, limiting its ability to pull out of the deep recession. Real interest rates would remain high, keeping the banking sector and the Treasury's finances in a weak position. Privatisation is also likely to remain constrained by the lack of demand for emerging market assets. Under such a scenario, we assume

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that all principal debt held by state entities is restructured (postponed) with only limited coupon payments to the SDIF-administered banks. **The financing need under this base case scenario amounts to USD12.5bn.**

Table 2: Base Case – Scenario A

	TRL Quadrillions	USD Billions
Financing Requirement	183.6	88.4
Domestic Debt Repayments	149.5	72.3
External Debt Repayments	34.2	16.1
Financing Sources	**156.9**	**73.1**
Primary Surplus	16.1	7.7
Privatisation	2.9	1.4
External Borrowing	3.2	1.5
Existing Commitments by IFIs	4.9	2.5
Domestic Borrowing	129.8	60.0
External Financing Need	**26.8**	**12.5**
Key Assumptions		
Domestic Debt Rollover Rate		
Debt held by Market	85%	
Debt held by Public Sector (Principal)	100%	
Debt held by Public Sector Coupon)	70%	
Cost of Borrowing		
Avg Nominal Interest Rate	80%	
Avg Real Interest Rate	19%	
Average Maturity of New Borrowing (Days)	224	
TRL/USD (end 2002)	2,400,000	
Public Sector Primary Surplus (% of GNP)	5.5%	
Real GDP Growth	2.5%	
Inflation (Avg WPI)		
2001	61.4%	
2002	73.8%	
2003	51.9%	

Source: Merrill Lynch, Treasury

We think Scenario A provides a realistic guide to Turkey's financing need, and provides some perspective in assessing any future announcement about aid to Turkey.

■ Scenario B – More Optimistic Scenario

The second – more optimistic – scenario (Scenario B) foresees a relatively strong and speedy recovery in global growth and appetite for emerging market assets. Interest rates fall in response to a strengthened IMF programme and Turkey's renewed commitment to fiscal adjustment and the privatisation programme. Economic recovery resumes in the second quarter of 2002 and gains momentum in the second half. **In this more optimistic scenario, the estimated financing gap amounts to about 54% of that in the base case scenario, but still stands at about USD6.8bn.**

Table 3: Scenario B - Optimistic

	Quadrillion TRL	Billion USD
Financing Requirement	**154.2**	**83.4**
Domestic Debt Repayments	124.1	67.3
External Debt Repayments	30.1	16.1
Financing Sources	**141.4**	**79.8**
Primary Surplus	19.5	10.5
Privatisation	6.0	3.2
External Borrowing	6.5	3.5
Existing Commitments by IFIs	4.5	2.5
Domestic Borrowing	104.9	60.0
External Financing Need	**12.8**	**6.8**
Key Assumptions		
Domestic Debt Rollover Rate		
Debt held by market	75%	
Debt held by public sector (principal)	100%	
Debt held by public sector coupon)	70%	
Cost of Borrowing		
Ave Nominal Interest Rate	60%	
Ave Real Interest Rate	11.0%	
Average Maturity of New Borrowing (Days)	300	
TRL/USD (end 2002)	2,000,000	
Public Sector Primary Surplus (% of GNP)	6.5%	
Real GDP Growth	5.0%	
Inflation (Ave WPI)		
2001	60.5%	
2002	58.8%	
2003	43.7%	

Source: Merrill Lynch, Treasury

Under this scenario, structural reforms – banking sector restructuring, deregulation of utilities, strong fiscal adjustment, and privatisations – remain the primary focus of the new arrangement with the IMF. While debt management continues to be a priority, the emphasis is on restoring long-term solvency of public finances through permanent spending cuts, improved tax collection, and asset sales which should ultimately lead to a smaller state. Disinflation remains as the ultimate target, but inflationary pressures remain strong due to economic recovery.

■ Scenario C – More Pessimistic Scenario

The final – more pessimistic scenario – foresees a prolonged synchronised global recession, taking its toll on countries with significant external financing needs. As a result, access to private capital remains constrained for almost the whole year and the appetite for emerging market assets continues to weaken.

Real interest rates under this scenario remain high, despite rising inflation, as the Treasury tries to finance more of its redemptions from an already weak banking sector and other domestic sources. The uncertainty over Turkey's domestic debt rollovers in 2002 would continue to adversely affect the confidence of both local and foreign investors and of consumers, with significant effects on spending and on the external current and capital accounts. This scenario estimates the financing need at USD16.5bn.

Table 4: Scenario C – Pessimistic

	TRL Quadrillions	USD Billions
Financing Requirement	**204.4**	**91.5**
Domestic Debt Repayments	167.6	75.4
External Debt Repayments	36.8	16.1
Financing Sources	**166.3**	**66.4**
Primary Surplus	8.6	3.9
Privatisation	0.0	0.0
External Borrowing	0.0	0.0
Existing Commitments by IFIs	5.1	2.5
Domestic Borrowing	152.7	60.0
External Financing Need	**38.1**	**16.5**
Key Assumptions		
Domestic Debt Rollover Rate		
Debt held by Market	90%	
Debt held by Public Sector (Principal)	100%	
Debt held by Public Sector Coupon)	80%	
Cost of Borrowing		
Avg Nominal Interest Rate	85%	
Avg Real Interest Rate	28.5%	
Average Maturity of New Borrowing (Days)	120	
TRL/USD (end 2002)	2,700,000	
Public Sector Primary Surplus (% of GNP)	3.0%	
Real GDP Growth	0.0%	
Inflation (Avg WPI)		
2001	60.5%	
2002	58.8%	
2003	43.7%	

Source: Merrill Lynch, Treasury

Market Strategy

Hopes that Turkey will get an additional IMF facility have apparently led to a bounce in the Turkish market. The key question is whether the expected fresh funding will prove to be adequate to enable Turkey to emerge from its deep recession and improve visibility on domestic debt rollover.

The timing of a new IMF facility remains uncertain. The Fund is reportedly sending a team to Ankara soon to assess the recent progress and identify the country's financing gap. While the release of USD3.1bn loan tranche, under current standby arrangement, seems likely over the next couples of weeks, an announcement regarding additional support could be delayed until after the IMF/WB annual meetings in Canada on November 17-18. In addition, the Fund staff will likely devise additional measures to strengthen the programme.

It is not clear how much Turkey has requested from the IMF. Market estimates for extra IMF lending range from USD5-7bn to USD12-13bn (including the deferral of debt repayments to the IMF). So, how much additional funding would make us more bullish on Turkey?

- **If the IMF gives USD11bn-USD13bn (including the likely deferral of some USD5.5bn in debt repayments to the Fund), it would be adequate to cover the financing gap under our base case scenario**, significantly more than the funding needed under the optimistic scenario, but less than the pessimistic case. Under such circumstances, Turkey remains a somewhat risky selection and we would buy Turkish equities only if we think that the global economic recovery is looking more likely. Turkey will likely remain vulnerable to potential withdrawals of access to private financing.
- **If the additional external facility totals USD15bn-USD17bn, then Turkey becomes a buy even at current levels.** This would significantly improve confidence among domestic lenders, reducing rollover risk. Increased visibility on domestic debt rollovers is one of the important factors in future asset performance. Also, a large funding facility would lower Treasury's borrowing to redemption ratio, thereby leaving additional resources for economic recovery. An added bonus would be if Turkey gets some sovereign debt relief from the US for its participations in the alliance against terrorism. Reducing quotas on Turkish textiles and apparels to the US market would also have a significant positive impact on the market.
- **If IMF gives only USD5bn-USD7bn, then Turkey is likely to struggle, possibly necessitating domestic debt swaps.** Lack of growth could place additional strains on the banking sector because of growing non-performing loans. Some of marginally solvent banks may not be able to grow out of their problems. Furthermore, the required fiscal austerity will likely increase political risks. Lack of growth and the need for strong fiscal position may breed impatience among some of the coalition members.