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THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON EU CANDIDATE AND POTENTIAL CANDIDATE COUNTRIES -TURKEY AND THE WESTERN BALKANS-

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THE IMPACT OF THE FINANCIAL CRISIS ON TURKEY AND THE WESTERN BALKANS

1. REAL ECONOMY: RECENT DEVELOPMENTS IN 2008

Growth slowed significantly in Turkey, primarily triggered by a deteriorating external environment. In the second quarter of 2008, real GDP growth fell to only 1.9% year-on-year from 6.7% in the first quarter. Sharp declines in both industrial production and capacity utilisation signal negative growth in the second half of the year. Survey-based evidence suggests that business and consumer confidence collapsed in October and November. Expectations about demand (both domestic and external), output, employment and investment have all plummeted. Credit conditions are becoming more restrictive as banks are tightening prudential standards and shifting FX lending into domestic currency. On the other hand, the central bank has embarked again on a course of monetary easing.

In the Western Balkans, while growth has started to decelerate in Croatia and Serbia, growth of the other Western Balkan countries has remained robust so far. In Croatia in the first half of 2008 real GDP growth came down to 3.8% (from 6.8% a year before). Recent high frequency indicators suggest a continued slowdown of economic activity, as retail trade dropped by 1.8% year-on-year in the third quarter and industrial production by 0.8% in the three months to October. In Serbia, second quarter GDP growth slowed to 6.2% year-on-year from 8.4% for the first quarter. During the third quarter, industrial production contracted by 2.1% year-on-year and export and import growth slowed considerably. Growth remained sustained in the former Yugoslav Republic of Macedonia (fYRoM), Montenegro, Albania, Bosnia and Herzegovina and Kosovo.

2. THE CURRENT ACCOUNT AND BALANCE-OF-PAYMENTS TRANSMISSION CHANNEL

The current account deficit in Turkey moderated in the second half of 2008 and dropped significantly in September while the relatively weaker FDI financing started to regain some ground in terms of CA deficit coverage. The current account deficit rose by around 36% in the first nine months of 2008 from the same period in 2007 and is projected to exceed 6% of GDP in 2008. However, in nominal terms the CA deficit has been on a declining trend since June and dropped sharply to below USD 1 bn in September. The structure of financing has deteriorated, with net FDI covering only 28.2% of the current account deficit in January-September 2008. Nonetheless, in September net FDI fully covered the CA deficit and prospects look relatively more favourable. Net portfolio investments contracted dramatically - by 95% - compared with January-September 2007 and amount to a mere USD 0.2 bn. The bulk of financing switched to borrowing (notably by the non-financial corporate sector), which covered almost 70% of the current account deficit. Against the background of the economic slowdown in Turkey and globally, the external outlook appears somewhat brighter. The current account deficit is likely to fall significantly from about 6% of GDP this year to only 3-4% of GDP in 2009, due to cheaper energy imports along with lower domestic demand, while exports may gradually start benefiting from a weaker TRY. It has a positive impact on Turkey's external financing needs, in particular as the relatively hefty

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external debt has continued to be rolled-over smoothly by the corporate and banking sectors so far.

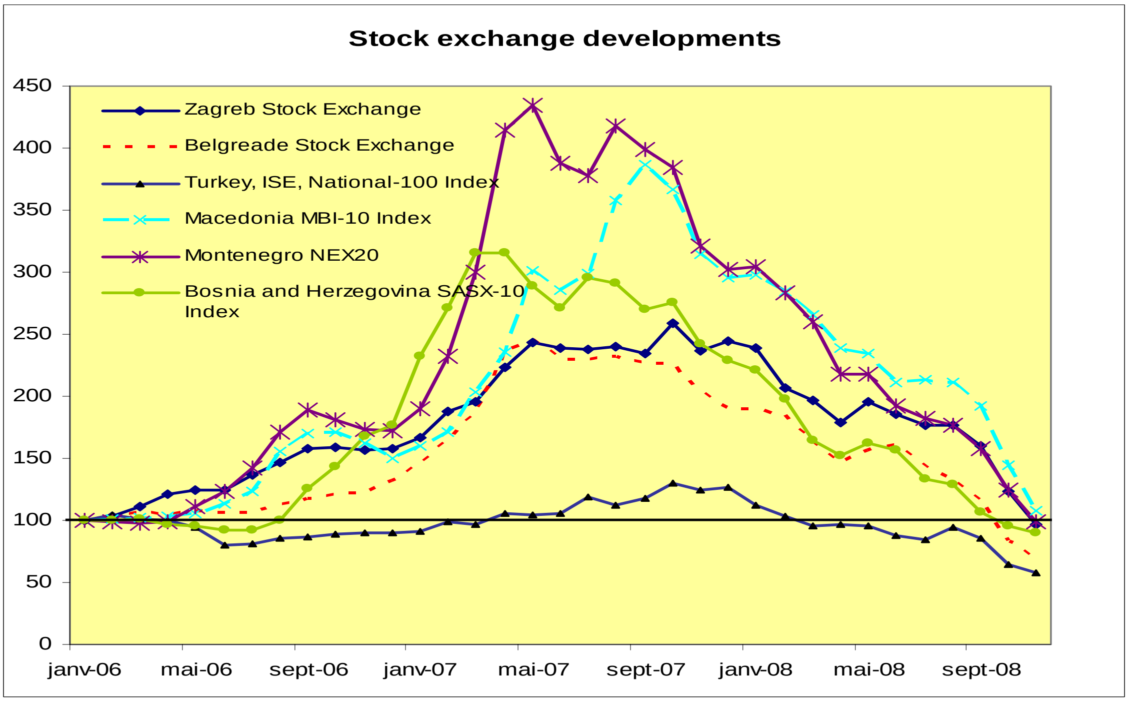
In the Western Balkans current account deficits have also widened considerably - reaching levels above 10% of GDP - in the second half of 2007 and first half of 2008, largely driven by the increase in commodity prices, and way beyond possibilities of financing from FDI. In Croatia the current account deficit has continued to widen, to slightly above 10% of GDP in the four quarters to Q2 08, and export performance has started to weaken, with a 14% drop in merchandise exports in October. However, net FDI inflows in 2008 continued to cover a large share of the current account deficit. In Serbia, the current account deficit widened further, reaching a projected 18% of GDP in 2008. While FDI remained strong during the first half of the year, it slowed rapidly during the third quarter. At the same time foreign borrowing grew strongly. In all other countries (Albania, the fYRoM, Bosnia and Herzegovina and Montenegro) the trade and current account balances deteriorated sharply during the first half of 2008. However, falling import prices since Q3 have had a smoothening effect on trade balances. FDI inflows have also slowed in all countries (except Albania and fYRoM), and current account deficits are increasingly being financed by private sector external borrowing.

Turkey's foreign exchange reserves stay at a comfortable level. The situation is more uneven in the Western Balkans. Turkey's foreign reserves have risen substantially, albeit at a slowing pace, in recent years. Central bank net foreign exchange reserves fell by about USD 3 billion in October, but remained sizeable at around USD 72 billion (or four months of imports). In Croatia, foreign exchange reserves continued to grow, staying at a comfortable level. In Serbia, foreign exchange reserves have started to decline and, since the beginning of October, the central bank has repeatedly intervened in the interbank foreign exchange market to boost liquidity and smooth the depreciation of the dinar. In the other countries, reserves are steady or slightly declining.

3. THE FINANCIAL SECTOR TRANSMISSION CHANNEL

The Turkish lira has weakened significantly since September, but regained some ground during the last month. The international liquidity crisis has now also become visible in Turkey, as money market interest rates have increased, although their impact has softened recently. Yields on government medium- and long-term securities have increased for both domestic and international issues, but receded again after they peaked in mid-November. The Turkish banking system, however, continues to show healthy profitability and solid asset quality. Turkish equities lost about 60% of their value for the year to end-November amid the global financial turmoil.

Since the beginning of September 2008, the Turkish lira (TRY) has depreciated by almost 25% against a US Dollar/Euro basket, but regained some ground in recent weeks. Market expectations over the future path of the TRY against the US dollar have worsened by around 27% since the beginning of September, almost in line with the nominal depreciation. The forward market projects a further depreciation of the TRY by around 10% over the next 12 months. The Turkish central bank, faced with the dilemma of still high underlying inflation and a weakening currency on one hand and rapidly slowing growth on the other, opted to ease monetary policy. It proved to be a well-grounded decision as CPI fell to 10.8% y-o-y in November from 12% in October. Unless tensions resurface on foreign exchange rates, it is likely that the Central Bank will continue to ease the monetary policy in the coming months. The benchmark bond yield fell to 19.4% by early December from a peak of 26% in the last weak of October. This is the lowest level since the end of September. Money market interest rates have also come down from their peaks recorded in mid-November. Recently, in late November, foreign net bond portfolio investments increased by some USD 0.5 bn. Since early November, the EMBI Turkey spread has increased by 50bps in line with the overall EMBI. Credit activity was still buoyant as of September as the y-o-y growth rate increased to 37%. Consumer loans were up 7.5% in the third quarter of 2008 (q-o-q). However, preliminary data show that domestic credit volumes have started to decelerate in November, mainly as FX lending is being gradually switched into domestic currency instruments. The capital adequacy ratio still stood at 15.4% at the end of 2008H1 and asset quality remained under control with the non-performing loans (NPL) ratio amounting to around 3%. Assets quality in SME lending, however, deteriorated as the NPL ratio on commercial instalment loans rose to 3.3% in the third quarter of 2008 from 1.6% at the end of 2007. Turkish equities lost about 60% of their value for the year to end-November, broadly in line with the fall in most stock markets worldwide. In one year, the value of foreign investors' equity holdings declined slightly more to US$24 bn from their peak of US$67 bn in November 2007. Foreigners however still own about 60% of Turkish equities, and as a result, a spike in risk aversion could really damage the local market.



Money market rates have recently risen throughout the Western Balkans, pointing to tighter liquidity in the banking system. There are no obvious signs so far of a loss of profitability of banks in the Western Balkans. Stock markets prices have shrunk throughout the region, in line with international stock market developments. With the exception of Serbia, no tensions have so far been seen in the foreign exchange markets. In Croatia, Serbia, Albania, and the fYRoM, money market rates increased, pointing to a tighter liquidity situation. Also, spreads on Serbian debt increased by 100 bps to 8% between September and October 2008, but 5 year credit-default swap (CDS) spreads on government securities have remained relatively stable at 250 bps. Banking sector profitability, however, has remained strong throughout the region and even rose in Serbia. Foreign re-financing of domestic banks has reportedly become more expensive, but loans have remained available so far. While stock exchange prices generally went down in the region, this evolution is broadly in line with international developments.

Tensions in the foreign exchange markets have been limited so far, with the recent exception of the Serbian dinar, which has come under increasing pressure since the beginning of October. The Serbian central bank has intervened repeatedly by selling a cumulative EUR 522 million or 6% of its official total foreign exchange reserves in support of the local currency.

4. MEASURES TAKEN - OR ANNOUNCED - IN RESPONSE TO THE CRISIS

The Turkish authorities have so far taken only limited measures in response to the crisis, but the worsening of global financial conditions adds pressure for an agreement on a new IMF-supported programme, on which negotiations are currently ongoing. With the global financial crisis still so intense and emerging market currencies under severe pressure, the government has stepped up efforts to secure a deal with the IMF, to bolster the country's credibility with markets and investors and its ability to finance the 2009's current account deficit and external debt obligations at a reasonable cost. In addition, the government has announced a package of measures to support the business and banking sectors, including some concrete steps to increase financing facilities for SMEs. There continues to be, however, a lack of a credible, coherent strategy to address the crisis, which aggravates the uncertainty. In another signal of concern about the state of the economy, the central bank unexpectedly cut its key rate by 50 bps to 16.25% in mid-November and took measures to support the FX liquidity of domestic financial institutions.

In the Western Balkans, the monetary authorities took several measures to improve banks' liquidity, and government guarantee ceilings on bank deposits were increased to secure confidence in the banking system. The Croatian central bank lifted the marginal reserve requirement for banks' foreign borrowing and reduced the minimum reserve on domestic deposits in order to boost liquidity. Also, the deposit insurance law was amended by Parliament, leading to a fourfold increase of the guaranteed amount of household deposits (to € 56,000). The Serbian authorities agreed a 15-month precautionary Stand-By Arrangement with the IMF, allowing Serbia to purchase € 415 million from the Fund, if needed. Subject to the enactment of the 2009 budget by Parliament, this is expected to reassure foreign investors that fiscal policy remains safely on track in Serbia. The central bank of Albania restricted capital placements of banks abroad to their parent banks, and announced the preparation of a new law on financial collateral arrangements. In order to safeguard the liquidity of the banking system, the Central Bank of Bosnia and Herzegovina has provided cash to the banking system, lowered the minimum reserve requirement rate from 18% to 14% and decided, as of 01 November, to no longer include all new credit lines drawn from abroad by commercial banks into the basis for required reserve calculations. In an urgent procedure, both chambers of the Bosnian parliament on 19 November and 04 December, respectively, approved the government's proposal to increase deposit insurance from around €3,500 to more than €10,000. The Sarajevo Stock Exchange has also introduced new fluctuation bands on the prices of traded securities. In mid-November, the government of the Republika Srpska set up a new body to monitor the impact of the global crisis and to propose measures for alleviating its negative domestic repercussions. In mid-September, the Central Bank of Montenegro raised the capital adequacy ratio from 8% to 10%. Moreover, on 16 October, the government adopted on a set of pre-emptive measures, including a full guarantee of bank deposits and inter-bank credits, and liquidity loans to -

and/or recapitalisations of - domestic banks; on the fiscal side, fiscal reserves were established as a crisis buffer.

5. OUTLOOK

The Turkish economy is better placed than in the past to weather the global financial turmoil, but its large external financing needs and narrow specialisation in some sectors highly sensitive to the current economic global down-turn increase its vulnerability to shocks. GDP growth in Turkey is expected to decelerate further to below 3% in 2008 and below 2% in 2009 as a result of weaker demand and tighter credit conditions. The global financial crisis has started to take its toll on the Turkish economy, but so far there are no apparent signs of a looming financial or exchange-rate crisis. The real economy is driven by the private sector and has developed a robust export base in key manufacturing sectors. However, the relatively narrow specialisation may prove to be problematic in the context of the current economic crisis as external demand (in particular from the EU) is faltering for key sectors, like automotive, white goods or equipment. The banking sector has been strengthened through privatisations and restructuring and appears to be in a better position to withstand pressures. It is relatively low leveraged compared to its European peers and it has tightened its prudential standards even more since the beginning of the financial turmoil. A restrictive fiscal policy has brought public debt down to sustainable levels (38.8% of GDP in 2007). In addition, a significant correction of the currency had already taken place in mid-2006, prompting the authorities to raise interest rates. The ensuing restrictive monetary policy, together with other domestic political uncertainties and international financial volatility, have depressed economic activity ever since. In parallel, foreign investors had started to reduce their Turkish positions long before October/November 2008, thus ensuring a smoother correction.

The significant external financing needs of the non-financial corporate sector are a source of concern, although this is mitigated by the relatively favourable maturity break-down, available FX assets of the private sector and the rapidly declining current account deficit. Even though the roll-over ratio of the corporate sector debt has remained above 100% so far, there is significant uncertainty going forward as the credit crunch continues to deepen in the source countries, which could lead to lower credit to Turkish firms. Therefore, despite the fact that domestic FX liquidity is ample and should provide a buffer against possible short-term funding problems, the significant financing needs and the slowdown in activity mean that the Turkish Lira remains vulnerable to global reallocation of risk and portfolio investment. A further correction cannot be ruled out as we move deeper into the global credit crunch. A new IMF arrangement would reassure investors that sound domestic policies are in place, thus easing the severity of the adjustment that the Turkish economy is currently undergoing.

While the unfolding of the crisis has been delayed in the Western Balkans, the region is exposed to substantial downside risks given the large external imbalances. The banking sector is dominated by subsidiaries of EU banks (mainly Austrian, Italian and Greek) that may be affected by possible difficulties, real or perceived, faced by the parent banks. The recently observed high economic growth rates do not appear sustainable in 2008-2009. In Croatia, GDP growth is likely to fall to below 3% in 2009, down from the 5.6% recorded in 2007. A growth slowdown was already expected before the outbreak of the financial crisis, partly due to specific domestic factors, including the political cycle. However, a significant worsening of the external environment is likely to amplify the downturn. GDP growth in Serbia is expected to substantially decelerate to 3% in 2009, compared with 7% in 2008. Given the low availability of credit, the increasing interest rates and the tightened lending standards, the real sector is set to significantly slow - or even contract - in areas such as construction, transportation and financial intermediation. In addition, export-oriented sectors are slowing as demand from the main trading partners is dwindling and obtaining export financing is getting more difficult. However, the decline in aggregate demand is expected to contribute to a slowdown in imports and to contribute to an improvement in the very high current account deficit (projected at 18% of GDP for 2008). In the former Yugoslav Republic of Macedonia, after 6% growth in 2007 and the first half of 2008, economic activity is likely to slow in the second half of 2008, leading to an annual growth rate between 5% and 5½%. A more difficult export environment and more difficult credit conditions might reduce GDP growth by at least another percentage point. Growth is expected to slow down in Bosnia and Herzegovina in the second half of 2008 due to dampened external and internal demand, as well as weaker investment activity, reflecting the increased cost of financing. Conversely, a relatively low level of international integration may reduce the impact of the global crisis on the Albanian and Kosovan economy. Albania is expected to face slower economic growth in 2009; the main risks lie in a possible deterioration in investment sentiment and in slowing remittance inflows. In most countries, the domestic banking sector seems profitable and in good shape, but may be vulnerable to the difficulties faced by the parent banks abroad.

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European Commission, ECFIN-D-1

Candidate and potential candidate countries: Summary table

	2003	2004	2005	2006	2007	Q1 08	Q2 08	Q3 08	Aug 08	Sep 08	Oct 08
Gross domestic product (in real terms, annual % change)											
Croatia	5.3	4.3	4.3	4.8	5.6	4.3	3.4	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	2.9	4.1	4.1	3.9	5.0	5.4	6.5	:	n.a.	n.a.	n.a.
Turkey	5.3	9.4	8.4	6.9	4.6	6.7	1.9	:	n.a.	n.a.	n.a.
Albania	5.8	5.7	5.7	5.5	6.0p	:	:	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	3.0	6.3	3.9	6.7	6.8	:	:	:	n.a.	n.a.	n.a.
Montenegro	2.5	4.4	4.2	8.6	10.3	8.1	8.0	8.0	n.a.	n.a.	n.a.
Serbia	2.8	8.2	6.0	5.6	7.1	8.4	6.2	:	n.a.	n.a.	n.a.
Kosovo*	-0.1	3.4	2.0	3.9	4.4	:	:	:	n.a.	n.a.	n.a.
Unemployment (LFS, in % of workforce)											
Croatia	:	:	:	:	9.6	14.7	13.2	12.4	12.3	12.6	12.9
The former Yugoslav Republic of Macedonia	36.7	37.2	37.3	36.0	34.9	34.8	33.8	:	:	:	:
Turkey	10.5	10.3	10.2	9.9	9.9	11.6	8.9	9.8	:	:	:
Albania	15.2	14.7	14.3	13.9	13.4	13.0	12.7	:	:	:	:
Bosnia and Herzegovina	42.0	43.1	44.7	44.2	42.9	39.9	41.0	40.5	40.8	40.5	:
Montenegro	26.0	22.3	18.5	14.7	11.9	11.8	11.0	10.7	10.7	10.6	:
Serbia	14.6	18.5	20.8	20.9	18.1	17.1	13.0	:	:	:	:
Kosovo*	49.7	39.7	41.4	44.9	43.0	:	:	:	:	:	:
Current account balance (% of GDP)											
Croatia	-7.4	-5.2	-6.4	-7.9	-8.7	-9.7	-10.6	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	-4.1	-8.4	-2.6	-0.9	-3.0	-6.8	-11.1	:	n.a.	n.a.	n.a.
Turkey	-2.4	-3.6	-4.6	-6.1	-5.7	-5.7	-6.1	:	n.a.	n.a.	n.a.
Albania	-6.9	-5.8	-8.9	-6.5	-10.5	-11.3	-12.9	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	-19.4	-16.3	-17.3	-7.8	-12.6	-15.1	-15.9	:	n.a.	n.a.	n.a.
Montenegro	-6.8	-7.2	-8.5	-24.7	-32.5	-36.9	-36.7	:	n.a.	n.a.	n.a.
Serbia	-10.1	-13.0	-8.1	-11.4	-16.0	-17.2	-20.7	:	n.a.	n.a.	n.a.
Kosovo*	-8.4	-12.7	-12.5	-13.8	-16.1	:	:	:	n.a.	n.a.	n.a.
Inflation (Consumer price index, annual % change)											
Croatia	1.8	2.0	3.3	3.2	2.9	5.9	6.5	7.4	7.5	6.4	6.0
The former Yugoslav Republic of Macedonia	1.1	-0.4	0.5	3.2	2.3	9.5	9.9	8.4	8.6	7.1	7.1
Turkey	21.6	8.6	8.2	9.6	8.8	8.8	10.3	11.7	11.8	11.1	12.0
Albania	2.4	2.9	2.4	2.4	2.9	3.7	4.2	3.0	2.5	2.7	2.8
Bosnia and Herzegovina	0.6	0.5	4.3	6.1	1.5	6.5	8.4	9.4	9.5	8.7	7.3
Montenegro	6.8	2.2	2.4	3.0	4.3	8.0	10.0	9.2	9.5	8.5	7.8
Serbia (RPI)	11.7	9.8	17.3	12.7	6.6	11.3	11.9	10.7	10.5	9.9	10.6
Kosovo*	1.2	-1.1	-1.4	0.6	4.4	11.8	13.9	9.8	7.8	7.8	4.5
General government balance (% of GDP)											
Croatia	-5.5	-4.1	-3.8	-2.2	-1.8	:	:	:	n.a.	n.a.	n.a.
The former Yugoslav Republic of Macedonia	-1.1	0.0	0.3	-0.5	0.6	4.8	0.2	:	n.a.	n.a.	n.a.
Turkey	-11.3	-4.5	-0.6	-0.1	-1.2	:	:	:	n.a.	n.a.	n.a.
Albania	-4.5	-5.1	-3.5	-3.3	-3.5	:	:	:	n.a.	n.a.	n.a.
Bosnia and Herzegovina	0.7	1.6	2.4	2.9	1.3	:	:	:	n.a.	n.a.	n.a.
Montenegro	-2.4	-2.6	-2.3	2.7	7.1	1.4	2.8	5.4	n.a.	n.a.	n.a.
Serbia	-1.1	0.9	0.7	-1.5	-1.9	0.1	-0.8	:	n.a.	n.a.	n.a.
Kosovo*	2.1	-4.5	-3.0	2.4	7.1	:	:	:	n.a.	n.a.	n.a.

***** *as defined by UNSCR 1244*