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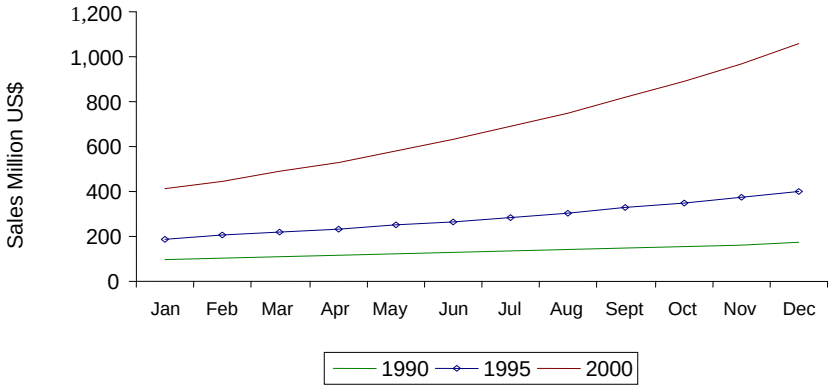

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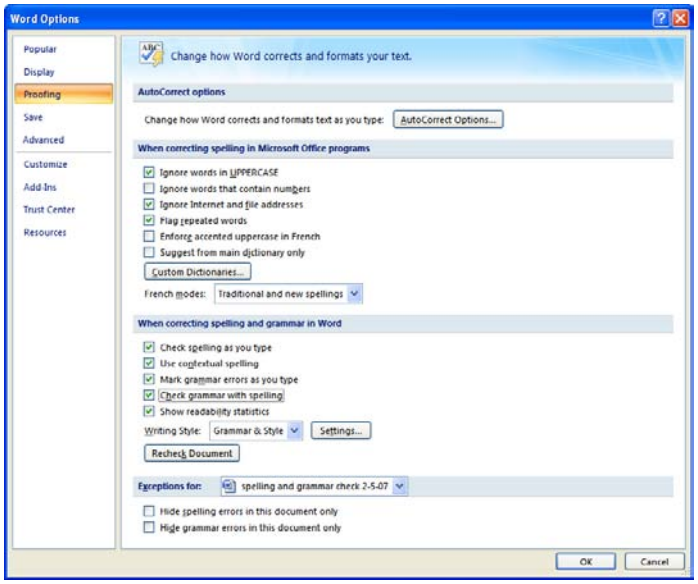

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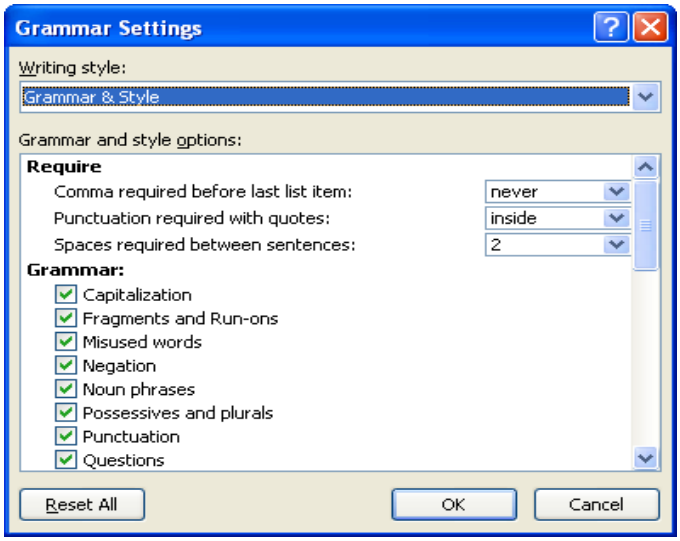

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ABSTRACT

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JEL: F3; G1; N2

KEYWORDS: Emerging markets, stock market, economic development

INTRODUCTION

Turkey formally applied to join the European Community (now, the European Union) on April 14, 1987. It was officially recognized as a candidate for membership on December 10, 1999. The hope of joining the EU has driven major reforms in Turkey, including economic liberalization, human rights protection, and greater civilian oversight of the military. In 2002, the EU outlined the political and economic conditions that Turkey would have to satisfy before formal accession talks could begin. The criteria required that Turkey have a functioning market economy and stable institutions that guarantee democracy, the rule of law, and human rights.

The remainder of the paper is organized as follows. Section 2 briefly discusses the relevant literature. Data selection, research methodology, and empirical models are described in Section 3. Section 4 provides analysis and interpretations of the empirical findings and Section 5 concludes the paper.

LITERATURE REVIEW

Finance theory suggests that pricing of assets always starts by evaluating the risks involved with investing in them. When it comes to stocks traded in emerging markets, finance literature suggests that risks are both fundamentals-related and country-specific. For instance, Erb, Harvey and Viskanta (1995) show how a country risk rating model explains the return generating process in world markets. The authors use composite risks such as political, economic and financial risk ratings and country credit ratings from the International Country Risk Guide (ICRG) and explore how these are correlated with wealth.

They also observe that a lower rating (higher risk) is associated with higher expected returns. In a related article, Erb, Harvey and Viskanta (1996b) investigate how ICRG composite risk scores (political, financial and economic risk) explain the cross-sections of expected returns on IFC country indexes. They find that economic and financial risks convey the most information about expected returns in developed markets, while political risk has some marginal explanatory power in emerging equity markets. They also investigate the relationship between the world beta, the index volatility, one fundamental attribute at the

country level (index aggregate book-to-price value) and composite risk scores. Their findings suggest that composite risk scores are highly correlated with country fundamentals. Similar conclusions have been reached by other authors. For instance, Oijen and Perotti (2001) indicate that changes in political risk are a priced factor and tend to have a strong effect on local stock market development and excess returns in emerging economies. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) find that countries with lower quality of legal rules and law enforcement have smaller and narrower capital markets. Demirgüç-Kunt and Maksimovic (1998) show that firms traded in countries with high ratings for the effectiveness of their legal systems are able to grow faster by relying more on external capital.

DATA AND METHODOLOGY

The sample consists of firms traded at the Istanbul Stock Exchange during the period September 1988 to June 2004. Monthly indexes, stock prices and firms' fundamentals are obtained from the S&P/IFC Emerging Markets Data Base[2] . The country risk ratings are obtained from the ICRG[3] managed by the Political Risk Group. ICRG country risk scores are grouped into three categories, which consist of 12 political risk, 5 financial risk and 5 economic risk scores. ICRG scales rank risks from a high score, indicating a low risk, to a low score, indicating a high risk. We retrieve the Turkish IFCG market indexes[4], individual firms' monthly stock returns, market capitalization and price-to-book values. We choose monthly prices in US dollars to circumvent the problem of high inflation. All monthly indexes and stock returns are then deflated[5] using the US 90-day T-bill rate in the following formulae:

$$R_{i,t,deflated} = \frac{\left(r_{i,t} - r_{f,t}\right)}{\left(1 + r_{f,t}\right)} \tag{1a}$$

$$R_{m,t,deflated} = \frac{\left(r_{m,t} - r_{f,t}\right)}{\left(1 + r_{f,t}\right)} \tag{1b}$$

where $r_{i,t}$ and $r_{m,t}$ are the monthly stock and market returns[6] , while $r_{f,t}$ is the monthly US T-bill rate.

We compute local betas by regressing each stock dollar's returns on a country index to which the firm belongs as in Rouwenhorst (1999). This equally weighted country index is comprised of dollar-denominated stock returns averaged each month[7]. One lag of the equally weighted country index is included to allow for a delayed response due to non-synchronous trading. Betas are computed with a minimum of two years and a maximum of five years of historical monthly returns. Each stock return is matched by a monthly size (market capitalization in US dollars) and a price-to-book value (PB). The total number of Turkish firms included in the IFC is 91. However, out of the original sample, 13 stocks had less than 24 months of data; hence, we have to exclude those firms from the analysis. Our sample consists of 78 firms traded from September 1988 to June 2004.

We investigate the cross-sections of risk premiums of stocks traded in the Turkish capital market with k-risk factors comprised of three groups of firm risk components (beta, the logarithm of a firm's market capitalization, and the logarithm of price-to-book value) and 22 risk scores (12 ICRG political risk scores, 5 ICRG economic risk scores, and 5 ICRG financial risk scores). Our approach is similar to that of Girard and Omran (2006). We follow a principal component analysis methodology to reduce the factor loading, and identify the significance of each risk factor's effects on stock risk premiums. Finally, we test the information content of our multifactor expression as compared to a simpler nested model — a three-factor composite risk model. In order to avoid arbitrary weighting of risk scores by using a composite measure, we utilize a principal component analysis to select the main risk drivers within a risk category [8]. Our fundamentals and country risk factor model should have each asset return linearly related to *k* factors plus its own idiosyncratic disturbance as follows:

$$R_{i,deflated} = b_0 + b_1\beta_i + b_2 \log(PTBV) + b_3 \log(size) + \sum_{i=1}^{k} \lambda_i \tilde{Z}_i + \varepsilon_i \quad (2)$$

where $R_{i,deflated}$ is a vector of monthly deflated stock returns; b_1, b_2 and b_3 are the risk premiums associated with beta, the price-to-book ratio and the market capitalization of a stock; Z_i is a vector of common country risk score factors determined using a principal component analysis; and λ_i is a vector of risk premiums associated with the country risk score factors. Finally, we compare equation 2 to a model proposed in the literature at an aggregate level and on a country basis. As in Erb, Harvey and Vistanka (1996a), a country risk composite model relates return to political risk (PR), economic risk (ER), and financial risk (FR), i.e.,

$$R_{i,deflated} = \lambda_0 + \lambda_1 Ln(PR) + \lambda_2 Ln(ER) + \lambda_3 Ln(FR) + \varepsilon_i \quad (3)$$

We use three tests[9] to compare the explanatory power of equation 3 to that of equation 2. These include the Davidson and MacKinnon test (1981), the posterior odds ratio and a partitioned residual analysis.

EMPIRICAL RESULTS

We first provide information about the monthly IFCG index's return, the monthly standard deviation of the index return, the market capitalization, the price-to-book ratio, four composite macro risk ratings, and twenty-two individual macro risk ratings[10] (see Table 1). Metrics are reported over three periods: the overall sample period (1988:09 to 2004:06), a period prior to candidacy for EU membership (1988:09 to 1999:11), and the current period of candidacy for EU membership (1999:12 to 2004:06). The average monthly index return is 0.65% during the overall sample period. It decreased from 0.88% (1988-1999) to 0.27% (1999-2004). The average monthly standard deviation is 16.33% for the overall period; it increased from 15.91% for the first period to 17.02% for the second period. Hence, Turkish stocks appear to be providing less and have become riskier. The average market capitalization of the index is $40 billion and it has increased from $26 billion to $65 billion. The number of firms traded at the ISE increased from 164 in the pre-candidacy period to 290 during the candidacy period. Turkish stocks are traded at 4.66 times their book values during the overall period.

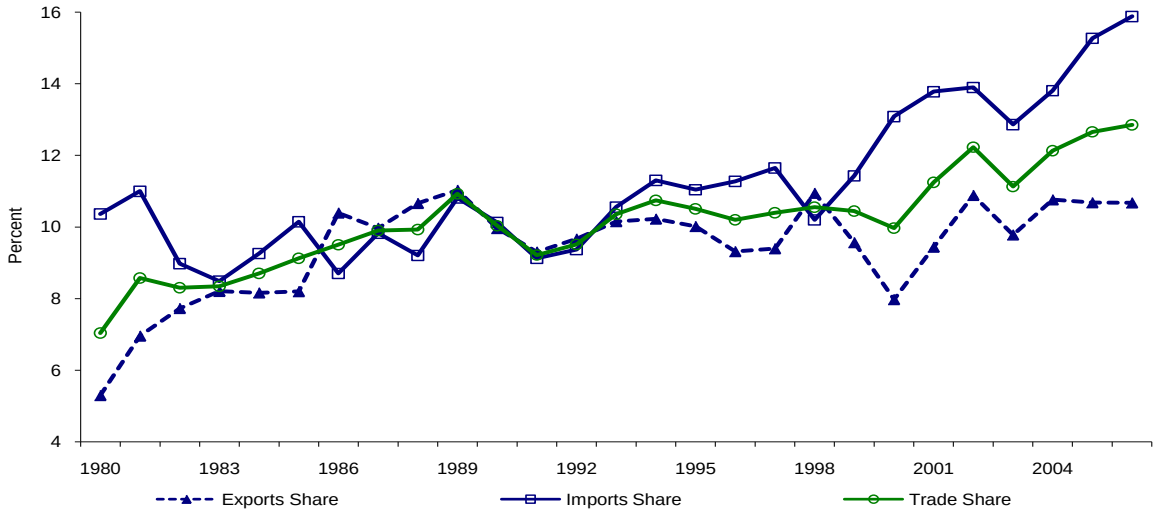
This figure decreased from 5.16 during the pre-candidacy period to 3.82 during the candidacy period. This is an indication of how Turkish stocks have become riskier and value-oriented. While composite risk ratings (50 percent weighted in political risk rating) and political risk ratings are higher during the candidacy period compared to the pre-candidacy period, financial and economic risk ratings are lower during the latter period. This indicates that Turkey has improved its political landscape but has failed to do the same at a financial and economic level. More specifically, issues related to government stability, investment profile, trade deficit, inflation and stability of GDP growth have dramatically improved from the pre-candidacy to the candidacy period. However, risks associated with socioeconomic conditions, corruption, democratic accountability, ethnic tensions and debt servicing have slightly increased from one period to the other.

Table 1: The Turkish Capital Market: Risk and Return from January 1988 to June 2004

	Overall Period	Pre-candidature[a] Period	Candidature[a] Period:
Median # of companies traded	229	164	290
Median # of companies included in IFCG	44	38	53
Average IFCG Turkey Return	0.65%	0.88%	0.27%
IFCG Turkey Standard Deviation	16.33%	15.91%	17.02%
IFCG Turkey Market Value	40,374.69	25,611.10	64,980.67
IFCG Turkey Price-to-Book Ratio	4.66	5.16	3.82
Composite Risk Rating	56.66	56.31	57.25
Political Risk Rating	56.29	54.88	58.63
Financial Risk Rating	29.57	29.71	29.34
Economic Risk Rating	27.35	27.88	26.45
Political Risk Ratings Variables			
Government Stability	7.33	6.45	8.80
Socioeconomic Conditions	3.96	4.04	3.83
Investment Profile	6.42	5.42	8.09
Internal Conflict	7.19	6.74	7.95
External Conflict	9.24	9.30	9.14
Corruption	2.65	2.82	2.38
Military in Politics	3.23	3.58	2.64
Law & Order	3.74	3.59	3.99
Religious Tensions	3.71	3.40	4.22
Ethnic Tensions	2.26	2.42	2.00
Democratic Accountability	4.22	4.59	3.60
Bureaucracy Quality	2.35	2.56	2.00
Financial Risk Rating Variables			
Budget Balance	3.58	4.06	2.79
Current Account as % of GDP	8.40	6.75	11.14
Current Account as % of XGS	11.73	11.65	11.86
Debt Service	6.38	6.62	5.99
Exchange Rate Stability	5.31	5.31	5.32
Economic Risk Rating Variables			
Foreign Debt	4.91	4.78	5.12
GDP Growth	5.84	4.84	7.50
GDP per Head of Population	1.89	2.01	1.68
Inflation	2.57	2.11	3.34
International Liquidity	0.60	0.32	1.06

Composite Risk Rating: ½ of the sum of political, financial and economic risk ratings. Politic Risk Rating is the sum of the following risk ratings: Government Stability: risk associated with a government's ability to carry out its declared program(s), and its ability to stay in office. Socioeconomic Conditions: risk associated with the general public satisfaction with the government's economic policies. Investment Profile: risk associated with expropriation, taxation, repatriation of capital, and labor costs. Internal Conflict: risk associated with political violence and its impact on governance. External Conflict: risk to both the incumbent government and inward investment. Corruption risk: risk associated with corruption within the political system. Military in Politics: risk associated with military involvement in politics. Religious Tensions: risk associated with the domination of a single religious group or the suppression of religious freedom. Law and Order: risk associated with the weakness and partiality of a legal system, and the lack of observance of the law. Ethnic Tensions: risk associated with tensions within a country attributable to racial, nationality, or language divisions. Democratic Accountability: risk associated with a government that is not responsive to its people. Financial Risk Rating is the sum of the following risk ratings: Foreign Debt as a % of GDP: risk associated with gross foreign debt in a given year, converted into US dollars. Foreign Debt Service as a % of Exports of Goods and Services: risk associated with foreign debt service per year, in $US. Current Account as a % of Exports of Goods and Services: risk associated with the annual current account deficit, in $US. Net International Liquidity as Months of Import: risk associated with the total estimated official reserves for a given year, in $US. Exchange Rate Stability: risk associated with the appreciation/ depreciation of a currency against the $US (against the DM for the US). Economic Risk Rating is the sum of the following risk ratings: GDP Per Head: Risk associated with a low GDP per head for a given year, converted into $US. Real GDP Growth: risk associated with a % increase or decrease in the estimated GDP, at constant 1990 prices. Annual Inflation Rate: Risk associated with annual inflation rate. Budget Balance as a % of GDP: Risk associated with a government budget deficit for a given year in the national currency. Current Account as a % of GDP: risk associated with the current account balance deficit for a given year, converted into $US.[a:] Turkey was officially recognized as a candidate for membership on December 10, 1999

Figure 1: Share of Intra-MENA Trade 1980-2006



This figure shows the trends in export share, import share and trade share of the MENA *region during the period 1980-2006. Import share remained consistently above the export and trade shares during this period.*

CONCLUSION

Turkey formally became a candidate for EU membership on December 10, 1999. The hope of joining the EU has driven major reforms in Turkey, including economic liberalization, human rights protection, independence of the judiciary system, as well as economic and financial reforms leading to reduced hyperinflation, a more fairly valued currency, and lower interest rates. Nevertheless, the EU still perceives Turkey as politically too unstable, and financially and economically too underdeveloped to become a member. Turkish general opinion widely believes that the underlying reason for rejection by the EU is cultural differences rather than economic, political and financial weaknesses.

In sum, we have identified that size, price-to-book value, and mostly all country risk factors affect Turkish stocks. On the other hand, group 2 stocks are equally affected by fundamentals and country risk factors. These findings are in accordance with our earlier discussion in that the EU concerns of Turkey being politically unstable, and financially and economically less developed may be warranted. Overall, Turkey has been quite successful at pursuing reforms since commencing its candidacy for EU membership. It has liberalized its political system and relaxed restrictions on freedom, reduced hyperinflation, strengthened its currency, lowered interest rates, and provided a more stable growth in GDP. However, political, financial, and economic instabilities appear to be dominant issues throughout the study period.

APPENDIX

Appendix A: KMV Model

We use the KMV model – a model developed by the KMV Company in 1993 – to estimate and measure the default risk for the firms used in this study. The KMV model calculates the 'expected default frequency' (EDF) based on the firm's capital structure, the volatility of the asset returns, and the current

asset value in accordance with the option pricing model of Black and Scholes (1973) and Merton (1974). This model is best applied to publicly-traded companies for which the value of equity is determined by the market.

There are three steps involved in deriving the actual probability of default. Firstly, we estimate the asset value and the volatility of the asset returns. Financial models usually consider the market value of assets, not the book value, since the latter represents only the historical cost of the physical assets, net of depreciation. Secondly, we calculate the default point. According to the KMV model, default occurs when the asset value reaches a level somewhere between the values of total liabilities and short-term debt. This point, which is referred to as the default point (*DPT*), is considered within the KMV model as the sum of the short-term debt plus half of the long-term debt. Thirdly, we calculate the 'distance to default' (*DD*), an index measure of default risk, which is the number of standard deviations between the mean of the distribution of the asset value and *DPT*. We then scale the *DD* to the actual probability of default using a default database. The estimation procedure is as follows.

$$\frac{dV_A^t}{V_A^t} = ud_t + \sigma_A dZ_t \qquad (1A)$$

where V_A^t is the total market value of the assets for the firm at time *t* for China; *u* is the expected rate of return; and σ_A is the volatility of the asset returns. Thus, we can state the above equation in accordance with the option pricing model as follows:

$$V_E = V_A N(d_1) - Xe^{-rt} N(d_2) \qquad (2A)$$

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