February 2010

DenizBank Political & Economic Update

Turkey

Politics…

The tension between the government and state institutions is rising…

Economy…

Recovery has arrived
Inflation is on the rise, as expected
Promising budget
Thanks to the Global Crisis, rating agencies remembered Turkey

Banking Sector…

Rising loans did not cut the bond appetite yet
Funding requirements are rising as well

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Turkish military officers were arrested over the 'Sledgehammer' plan

Turkish anti-terror police arrested retired and serving military officers of senior ranks. Also, more than 40 detentions in major cities across the country included previous heads of the air force and the navy. The detentions were due to their connection with an alleged 2003 coup plot called 'Sledgehammer'. The sledgehammer allegations and the ongoing Ergenekon case are increasing political tensions.

According to the 'Sledgehammer' plan which was exposed in January by a small independent newspaper Taraf, bombs target the faithful in Istanbul's busiest mosques; a Turkish air force jet is shot down over the Aegean, provoking a war with Greece. Chaos descends over Turkey. The army steps in, overthrows the mildly Islamist Justice and Development Party (AKP) that has governed Turkey since 2002, and takes control. The disclosure of this plan increased tensions. The army said it was just a "simulation exercise". "Sledgehammer" is only the latest of alleged coup plots exposed in recent years.

Mounting tension between the government and the judiciary

A public prosecutor (of the city Erzincan) was arrested in the course of claims that he was linked to the so-called Ergenekon plot alleged to bring down the AKP government. The judiciary (in this case, the Supreme Board of Judges and Prosecutors) have reacted furiously claiming that this is q political interference by the AKP-led Ministry of Justice in the legal process, given that the Erzincan governor was thought to be investigating cases of Islamic extremism.

Those prosecutors who arrested the Erzincan prosecutor were then suspended and pulled from the Ergenekon investigation. In turn this brought a harsh reaction from Minister of Justice (from the AKP), suggesting that the suspension of the Ergenekon investigators risked bringing the legal system into chaos. Both sides claim political intervention in the judicial process.

President Gul underlined that the affair confirms the need for judicial reform which could be implemented by means of a constitutional referendum. The referendum issue, however, is very controversial as the secular opposition has thus far circumvented government plans for broader constitutional reform. The government would need a two-thirds majority to pass these reforms through the parliament. Without support from the opposition they would need a nationwide referendum.

The constitutional amendment package is on the way

The government has completed its work on a limited constitutional amendment package. The AKP's Group Administration is planning to pass the package in a week in May or June. As per the plan, the party will impose a ban on its deputies during this week on traveling to other cities. The AKP has also decided not to put any effort into convincing the other parties to support the package. Currently, the AKP has 338 seats in Parliament, which is above the 330 seat level which calls for a referendum.

Spain is supporting Turkey's EU Membership

Spanish Foreign Minister Moratinos said that Spain would advance Turkey's EU accession process during its rotating EU presidency that started in January 2010 and will last until the end of June 2010. Delivering a speech at a meeting organized by a Spanish think-tank, Moratinos said that enlargement had strengthened the EU. According to Moratinos, Turkey is a big country with strategic importance in the region. He added that Turkey was the best mediator for peaceful steps in the Middle East.

Recovery has arrived, but the pace is slow…

Compared to 19% consensus estimation, industrial production has surged by a whopping 25% YoY in December 2009. As we stated in our previous monthly report that industrial production was expected to beat market expectations in the coming months mainly due to low base effect. The steady increase in bank loans, strengthening exports and rising inventories were also instrumental in our forecast.

After the contractions of 22%, 15% and 8% in the first, second and third quarters respectively, the fourth quarter industrial production posted a strong 9% growth. All sectors, (see Figure 2), have shown a similar trend during 2009, except the automotive. After shrinking a record low of 57% in the first quarter of 2009, it has surged by 25% in the last quarter. Compared to a more normal 4th quarter of 2007, however, the automotive sector has still shown the greatest plunge among all. The mostly exporting sector is likely to continue to underperform until the Euro zone (Turkey's major export destination) and Turkey reach their true potential economic growth.

The 25% surge in industrial production seems huge and may imply the economy has been galloping forward. Not exactly. The base effect obscures recent performance in terms of year-on-year growth. Seasonally adjusted figures on the other hand, depict a moderate improvement, with a mere 0.7% increase in December from November. Although they show an increase in production every month in 2009 except the slight contraction in September, it is also clear the pace of recovery has been very slow. The reading supported our view that although the contraction in economic activity has come to an end, the recovery will be rather slow in 2010. After the December data, we have not made any revisions on our GDP forecasts of -6% and +3.8% for 2009 and 2010, in that order.

Figure 1: Industrial Production Growth

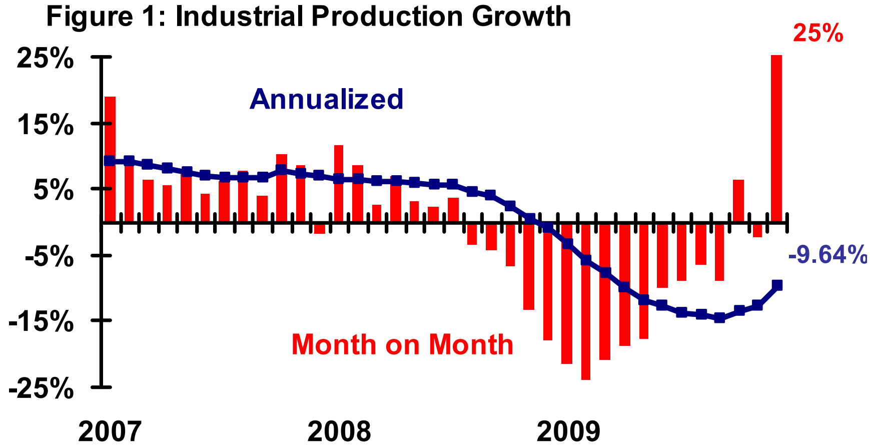


Figure 2: Industrial Production: Sectoral Performance

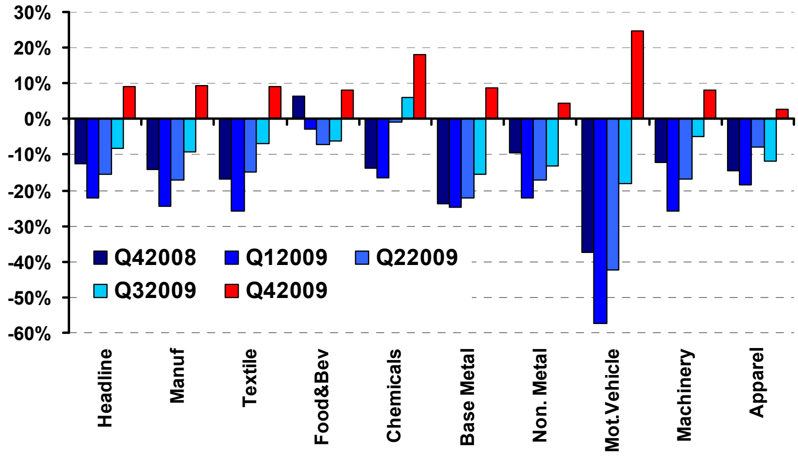
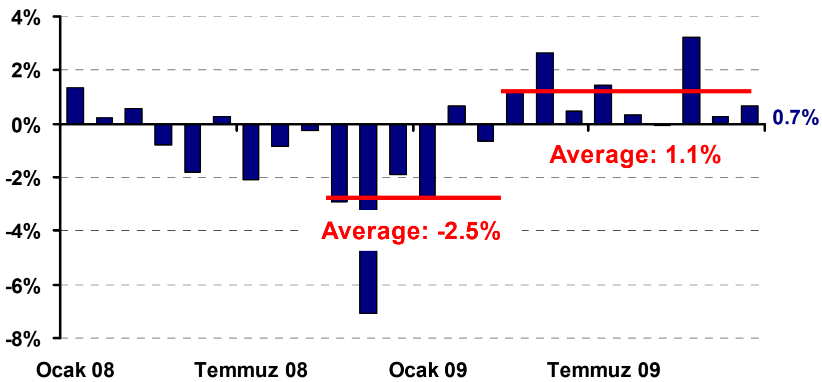
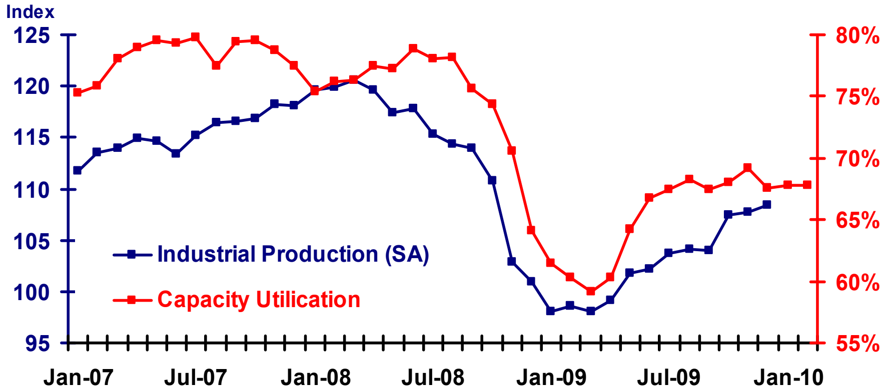


Figure 3: Industrial Production (SA, MoM)



Capacity utilization in the industry also lend support to the view that the pace of recovery will be steady but slow in 2010. The figures released by the Central Bank of Turkey ("CBT") for February indicate a rather sideways move in capacity utilization flat since the middle of 2009 (Figure 4, these figures are not to be confused with those released previously by the Turkish Statistics Institute–TurkStat which was less up-to-date).

Figure 4: Industrial Production vs. Capacity Utilization

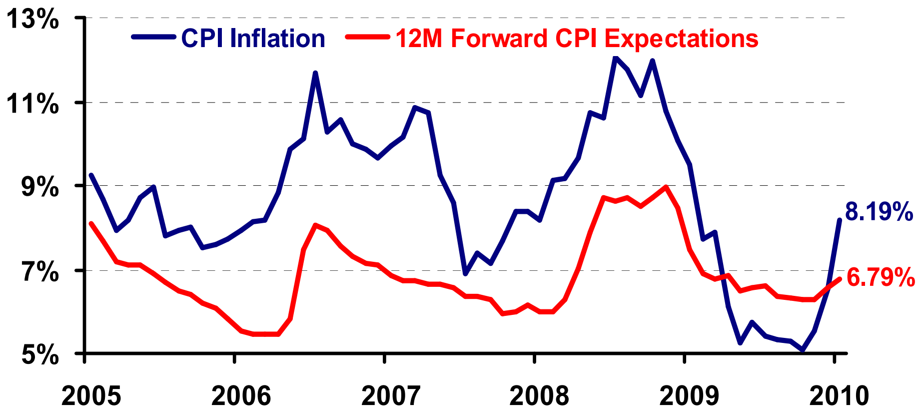


Inflation is on the rise, as expected…

The yearly CPI inflation of January has surged to 8.19% from 6.53% a month ago. The figure supported our inflation scenario revealed in DenizBank Monthly January Report that inflation is expected to jump over 8% and move sideways around 9% until summer 2010 due to low base effect, reviving demand, rising commodity prices and tax hikes. The CBT had also warned the markets about the recent increase and it now adds to its credibility. Looking forward, two further points need to be emphasized regarding the inflation outlook:

i- Inflation expectations likely to remain subdued… In parallel to the CPI inflation, 12 months forward inflation expectations are rising, albeit gradually. Given the high correlation between inflation and inflation expectations, the CBT appears to have reached its aim of reining in the expectations while headline inflation is rising. The gap between the inflation and the inflation expectation was 2.3 percentage points on average between 2005 and 2008 (Figure 5). If that still holds when inflation jumps further towards 9% inflation expectations are likely to go up to around 7.5% which would be well in line with the ±2% range of the 6.5% inflation target in 2010.

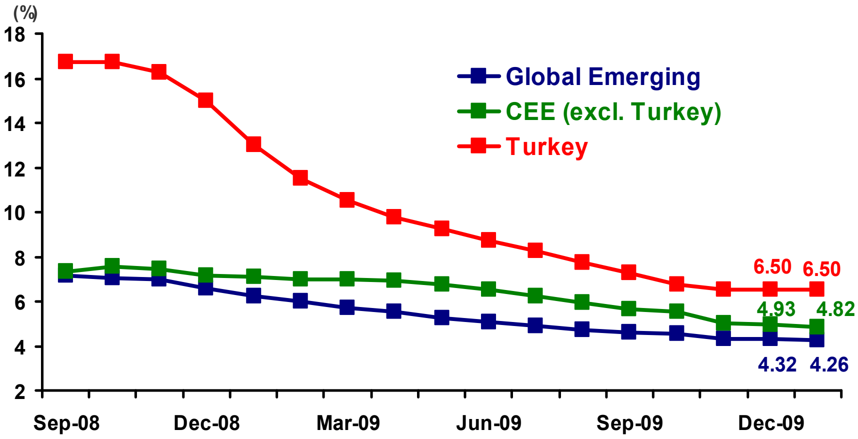
Figure 5: CPI and 12M Forward Expectations



Moreover, the core CPI inflation indices, namely H and I, remained almost flat at 3.8% and 3.4% y-o-y in January, substantially below headline inflation. This confirms that the increase in inflation is not demand-pulled and is due mostly to one-off supply related factors. This will certainly ease the CBT's job in managing expectations ahead.

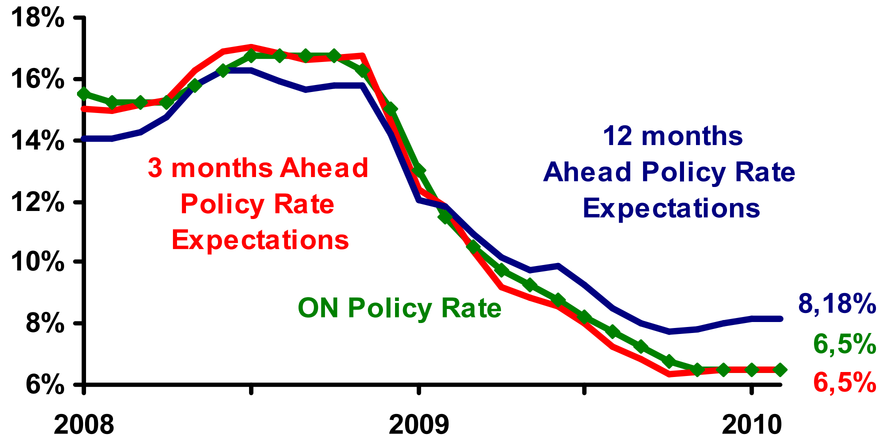
ii- The CBT may be forced to start hiking towards the end of the year: Although the supply and demand conditions are favorable and the recent increase is due mostly to temporary factors the central bank may have to begin tightening, albeit modestly, towards the end of the year. True, Turkey's policy rate is still one of the highest among the emerging markets (Figure 6) although Turkey cut the interest rates the most during the crisis. Even though the central bank may have faith in the lingering weak state of demand conditions in the remainder of the year, it will still have to take into consideration what others are doing in terms of the much trumpeted exit strategies. Once developed and emerging economies begin sequential hikes, as already started by the likes of Australia, Israel and Norway, the CBT will find it increasingly difficult not to join the herd. If the narrowing interest rate differential pushes up the exchange rate (i.e. TL depreciates) it will have inflationary consequences and the Central Bank may want to preemptively act before that happens. In other words, the actions of other central banks will perhaps become a more important determinant of the CBT's policy action.

Figure 6: Emerging Countries Policy Rates (Average)



The markets also share similar a view and the recent consensus in the CBT's "Survey of Expectations" for 12M forward policy rate is 8.18%, corresponding to a 168 basis points ("bps") hike from today (Figure 7) beginning towards the end of the year. The risk however is that the hikes may come earlier rather than later than what the market expects, in our view.

Figure 7: Policy Rate vs. Expectations



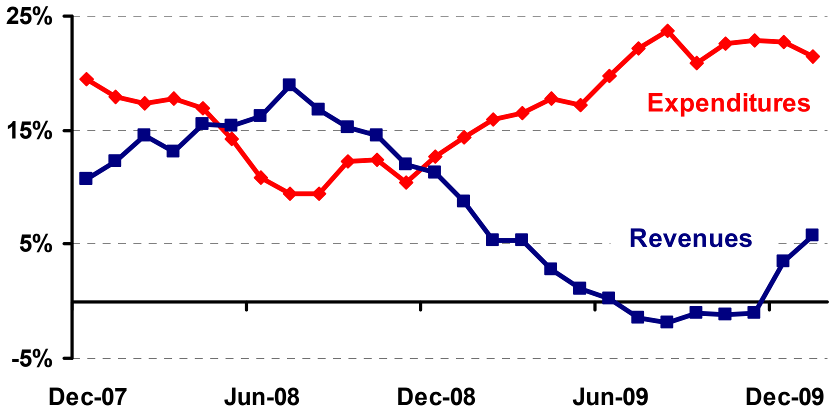
Promising budget…

The Central Government Budget posted a deficit of TL3.1 bn in January 2010, corresponding to 5.2% increase compared to January 2009. Although the reading compared unfavorably on YoY basis, primary balance which is excluding the interest payments is depicting a whopping 264% increase. Thanks to the increasing in tax rates and recovering economy, tax revenues ballooned by 25%. On the flip side, the increase in non interest expenditures was limited to 10%, showing the government's efforts to secure the budget deficit to GDP target ratio of 4.9% as described in Medium Term Fiscal Plan ("MTFP").

Table 1: Central Gov. Budget Realizations (TL bn.)	Jan-2009 One Month	Jan-2010 One Month	Nominal Change (%)	2009 12M Rolling	2010 12M Rolling	Nominal Change (%)
Expenditures	18.8	22.6	20%	228	271	19%
Non-Interest	15.0	16.6	10%	178	216	21%
Interest	5.6	6.3	12%	50	57	14%
Revenues	15.8	19.5	23%	209	219	5%
Tax Revenues	13.8	17.3	25%	168	176	5%
Income Tax	4.1	3.9	-6%	38	38	-1%
VAT	1.9	2.9	50%	17	22	31%
Special Cons. Tax	3.3	4.1	23%	42	45	7%
VAT on Imports	1.5	2.7	82%	29	27	-7%
Budget Balance	-3.0	-3.1	5%	-20	-52	168%
Primary Balance	0.8	3.0	264%	31	3	-90%

The discipline in fiscal management is becoming more important since the hopes of an IMF stand-by agreement is gradually waning following the latest comments from the government which indicate that negotiations did not bear fruitful yet. Looking forward, the main risk regarding the revenue side of the budget is slower growth; and the main risk regarding the expenditure side is the general elections which are scheduled to be held in July 2011. Due to the current domestic political turmoil as the details explained in the Politics Section, the government may decide to call for an early election. Nevertheless, the current trend of revenues and expenditures is promising and wel lin line with the year-end targets (Figure 7).

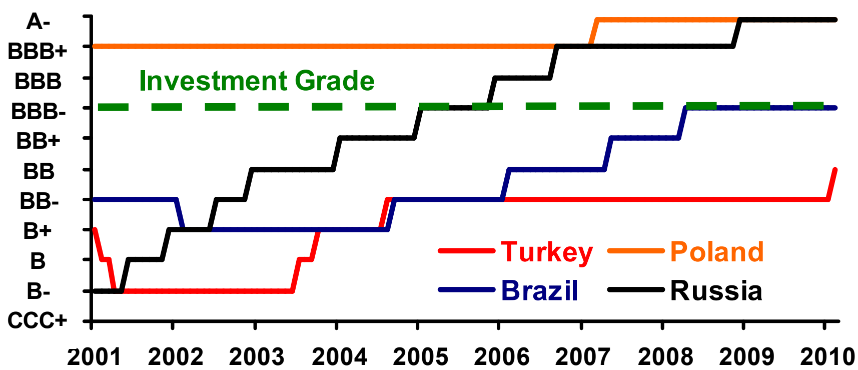
Figure 7:Tax Rev. vs. Non Int. Exp. Increase (3M Rolling)



Thanks to the global crisis, the rating agencies remembered Turkey…

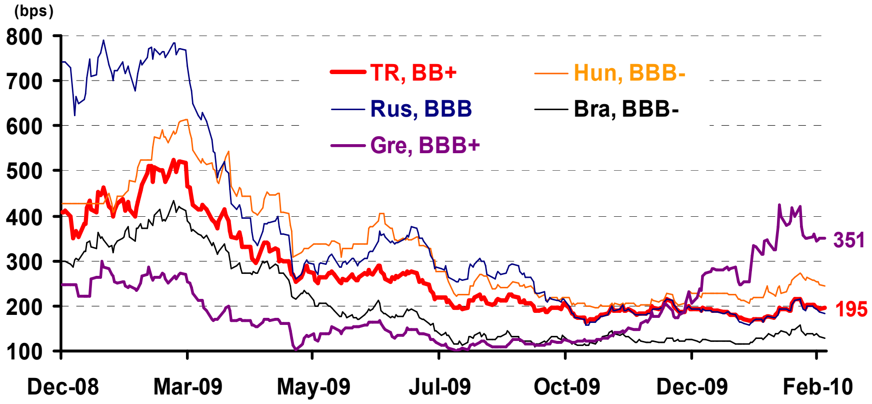
S&P upgraded Turkey's long-term foreign currency rating to BB from BB- (LT, FX) with positive outlook, implying the likelihood of additional rating increase(s) in the next year or two. Thus, S&P has joined Moody’s by rating Turkey two notches below investment grade (Figure 8). S&P announced that the rate hike was based on the low debt burden, a robust and prudently regulated

Figure 8: S&P Ratings (LT, FX)



banking system and improving conditions in local capital markets (e.g. the successful and oversubscribed 10 year TL bond issue of the Treasury). Fitch was the first rating agency increasing Turkey's rating (LT, FX) by two notches as of December 3rd, 2009, corresponding to one notch below investment grade.

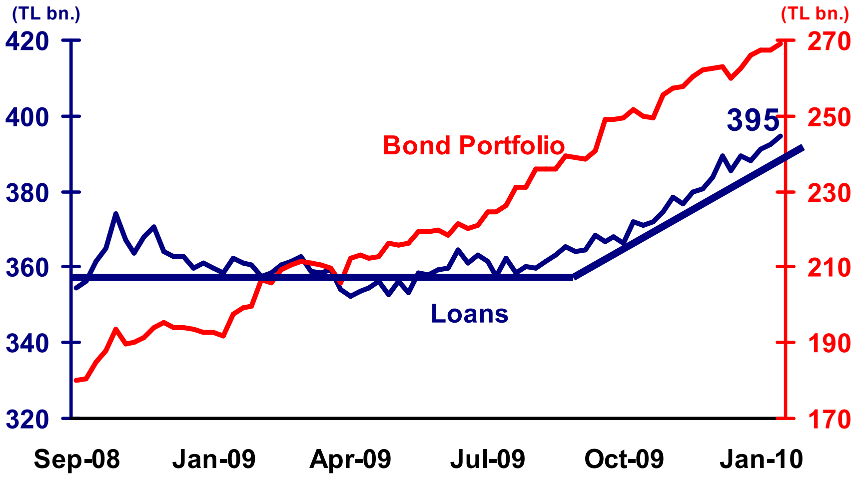
Figure 9:CDS Spreads and Ratings, (5 Years, S&P LT FX)



The rating agencies are too conservative in our view, a view that is shared widely in the markets. The CDS spreads of Turkey at around 200 bps are much lower than many other emerging economise with higher and in fact investment grade ratings. Iceland, for example, with huge economic problems and defunct banking system unable to pay its liabilities has a BBB- S&P rating above Turkey's. But its CDS spreads are more accurate at more than twice as high as Turkey. Over time, it is clear that the rating agencies will converge to the markets by raising Turkey to investment grade in the next couple of years.

Rising loans did not cut the bond appetite yet…

Figure 10: Turkish Banking System, Bonds vs. Loans



According to the latest from the BRSA (the banking regulator in Turkey) both loans and bonds edged up by 1.3% and 2.3% in the year to date, corresponding to an increase of TL5 and TL6 mn, respectively. Although still below the increase in bond portfolios, the pace of loan growth is accelerating especially after August 2009, driven mainly by the recovery in consumer loans. The trend in mortgage loans is worth mentioning such that the average weekly increase since the beginning of September 2009 is topping almost 0.5% which will reach a YoY increase of 30% at the end of 2010 if continues at that speed. Also the SME loans are the hype of the late, surging by a massive 3.9% MoM in December, which has been the highest monthly increase recorded since June 2008.

Figure 11: NPL Ratio

The deceleration in non-performing loans ("NPLs") (Figure 11), both in absolute and ratio terms, is another noteworthy development strengthening our forecasts for stronger loan growth in the next months. The main theme of the next year will be the following:

i) Both consumers and companies will increase their borrowing in the growing economy

ii) The banks in search of profitability will respond to it by increase their lending volume

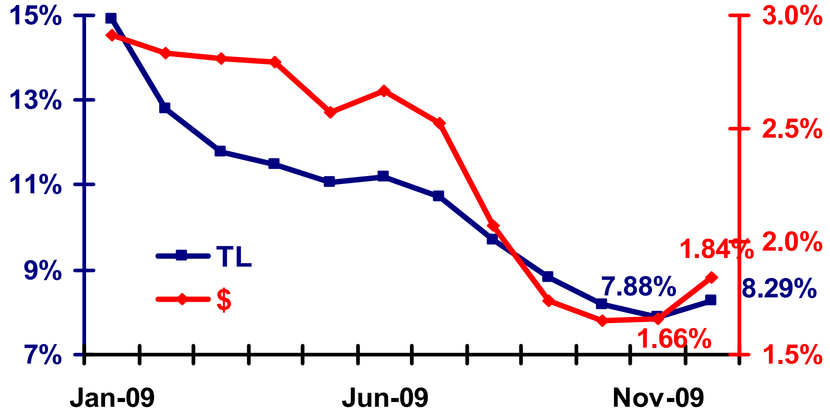
iii) The waning NPLs stimulate banks' lending appetite further.

Funding requirements are increasing as well

On the murky side, however, banks may increasingly face some funding constraints down the road especially in TL lending that is the main growth area (consumer and SME lending). One big customer of TL funds is the Turkish Treasury who raised its domestic debt service projection of the Treasury to TL183 bn in 2010 from TL134 bn in 2009. Additionally, debt rollover ratio target is 100% as described in year 2010 Treasury Financing Program. Therefore, the banks will need to transfer an important portion of their main funding, deposits, to the Treasury as its primary creditor. That is the reason why most observers including us have two loan growth scenarios: with or without IMF. If there is a stand-by with IMF and the IMF provides the Treasury with funding support, the Treasury will crowd out the real sector less by being able to roll-over less than 100% of its redemptions and freeing funds for the banks. While our YoY loan growth projection is 16% in the scenario without the IMF, it is topping 24% in the one with the IMF.

In fact, the funding pressure has already surfaced since December. Deposit rates, both in TL and USD, have recently bottomed and begun to increase though slowly (Figure 12). Efforts of expanding the loan portfolios are clearly pulling the demand for deposits along while the end of easing on the part of the central bank also ended further decreases in other interest rates. What will relieve the banking system especially on the lending side is the wholesale funding possibilities, mainly from abroad. Compared to the pre-crisis period, TL funding gap[1] of private banks has corrected by a monstrous TL42 bn and currently standing at a mere -TL4 bn. Before the crisis, they were able to borrow wholesale at reasonable cost and quench their TL thirst by swapping FX funding to TL. After the crisis, such mechanisms have been constrained thanks to rising funding costs and the banks have been less willing to raise wholes sale funds but relying on deposits.

Figure 12: Deposit Rates, 1 Month



Looking forward, this is likely to put pressure on the banks' margins and thus their profitability. As the competition heats up in lending the real sector along with the economic recovery, it will be increasingly difficult for the banks to pass the rising deposit costs to the clients.

[1] TL Deposit – TL Loans