April 2010

DenizBank Political & Economic Update

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Politics

Discussions about constitutional amendment package started last week. So far, eight articles of the package were ratified by the parliament. Previously, the CHP, the major opposition party, proposed dividing the package and submitting each article separately for voting in the public referendum. The chances of the CHP and the AKP to reach a consensus appear very low. Discussions in Parliament are expected to last for about two weeks. Constitutional amendment proposals are voted confidentially in two rounds in the general assembly. Each vote is held 48 hours apart. At least 367 votes in favor are necessary for the package to be enacted without a referendum while it takes at least 330 deputies' confidential votes to go to referendum.

According to Deputy PM Arinc at least 60% of voters will support the amendments if a referendum takes place. He said if the package exceeds 330 votes resulting in a referendum and the opposition takes to the Constitutional Court for annulment, it would be an attempt to circumvent the law, which could result in an early election. He reminded that back in the April 2007 presidential elections, the opposition's efforts to block the presidential elections and the Constitutional Court's decision had resulted in a whopping 47% support for the AKP at the early election held in July 2007. With respect to the referendum, a poll carried out by Consensus (March 24-April 1; 1,531 people) indicates that 83% of the respondents would like to vote separately for the items in the constitutional amendment package. More importantly, 55% would vote "yes" in the case of a referendum and 45% would vote "no".

The latest poll underlined a continuous decrease for the AKP support. The gap between the AKP and the CHP in case of a general election has narrowed with the AKP support at 30% and the CHP support at 27%, according to the most recent poll carried out by AKAM (March 25-April 3; 7,231 people). The opposition MHP's support is at 19% showing a significant decline compared to the previous records of 21%. Pro-Kurdish BDP's support remained at 6% while center right DP's share of support rose to a noteworthy 7%. If only three parties enter the Parliament plus the BDP deputies through independent seats, the probability of a single party AKP government is still high, albeit with a significantly fewer seats. If a fourth party enters Parliament, the chance of a collation government increases.

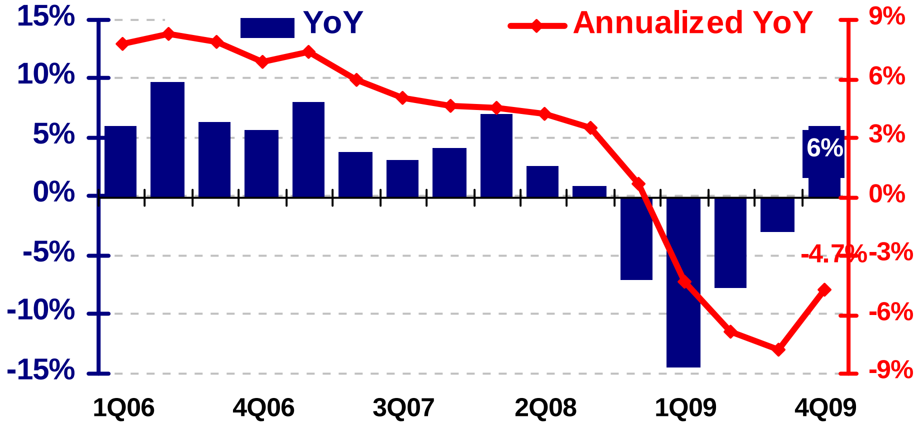
Nationalists' candidate won the elections in the Turkish Republic of Northern Cyprus (TRNC). In line with the previous polls, Nationalist Dervis Eroglu beat the leftist incumbent Talat in the presidential election. In order to win a presidential election in the TRNC, the candidate should win at least 50% of the votes. Eroglu received 50.4% of the votes against Talat's 43%. Eroglu, who is a member of the National Unity Party, favors independence for the North on the divided island while assuring that he will continue the negotiation process for reunification. Eroglu is seen by many voters as an opponent of the reunification of Cyprus, supporting a two-state solution. A two-state solution was already rejected by Greek Cypriots. President Talat has been in office since 2005 and has not finalized the U.N. sponsored reunification talks with the Greek Cypriots. His defeat ignited fears that the talks could come to an end. The peace talks are also significant for Turkey's EU bid.

April was a very busy month in diplomacy over Armenia. Erdogan met with Armenian President Sarkisian during the nuclear security summit in the US. According to the media reports, the two leaders agreed that the Armenian and Turkish foreign ministers would focus on the ratification process of the protocols. Turkey-Armenia normalization process was on top of the agenda. The parties agreed that the current opportunity should not be missed. Armenia appeared to accept ratifying the pending protocols and also to open the border before April 24. No official announcements were made at the conclusion of the meeting and furthermore these expected outcomes are not likely.

Turkish Economy is Bouncing Back…

Turkey Q4 GDP growth at 6% beats the market expectations of 4%. (Figure 1) That is an outstanding turnaround from the 15% contraction in the first quarter last year, one of the largest in the world, while it was insufficient nonetheless to take the annual growth into the positive territory.

Figure 1: Real GDP Growth



The improvement was largely owed to the stronger domestic demand. After five consecutive quarters of contraction, private consumption recorded 4% growth in 4Q09, increasing 2% for the whole year. More importantly, the government spending recorded a whopping 18% yearly increase in 4Q09, 8% increase in 2009. Another encouraging development is the inventories' positive contribution to growth: inventory depletion ended as of 3Q09.

However, investment side is yet to shake off the crisis hang-over. Capital investment recorded a 5% contraction during the last quarter which corresponded to an overall contraction of 19% in 2009. Similarly, the contraction in the private sector fixed investment decreased to 4% in the final quarter, unable to offset the 22% contraction in 2009. Given the chronically low capacity utilization, we should expect in the coming quarters that the recovery in private sector investment will lag recovery in the economy.

Robust banking and household balance sheets were not enough to overcome the 5% contraction during 2009, but they should play an important role in the recovery in 2010. Turkish economy contracted 4.7% in 2009, more than EU-27. But 2010 forecasts show that the recovery is anticipated to be faster than EU countries and the US. We still keep our estimate of 3.8% for 2010 which will take place mainly due to the base effect while also acknowledging that there are upside risks to our GDP forecast as high as 5% given the loose domestic financial setting and the faster than expected global economic recovery.

Table 1: Yearly Growth Rate

	2008	2009	2010F
Czech Republic	2.5%	-4.8%	0.8%
Greece	2%	-2%	-0.3%
EU-27	0.8%	-4.2%	0.7%
Turkey	0.7%	-4.7%	3.8%
Eurozone	0.6%	-4.1%	0.7%
Hungary	0.6%	-6.3%	-0.5%
U.S.A	0.4%	-2.4%	2.2%

Industrial Production: Getting There…

After increasing by 12% in January, industrial production recorded 18% real growth in February vis a vis the February of 2009 (Figure 2). When adjusted for working days and deseasonalized it has also posted a handsome growth of 1.6% from January (Figure 3). Compared to the pre-crisis levels, however, this figure is far from being satisfactory.

As for the sub-sectors, the picture is very promising. Due to base year effect, the yoy growth rates in the sub-sectors remained high: 23% increase in intermediate goods, 28% increase in durable consumer goods, 33% increase in capital goods. 71% yearly increase in the automotive production and 30% increase in machinery production were eye-catching.

While industrial production has displayed a clear upward trend well above the market expectations capacity utilization rates still remain sluggish in stark contrast staying within the narrow range of 67 to 69% (as elaborated in the March issue of DenizBank Monthly). Although these levels are above the last year's levels, they are considerably below the long term average rate of 76%. Whether the currently vigorous growth pattern will continue still remains to be seen.

Figure 2: Industrial Production

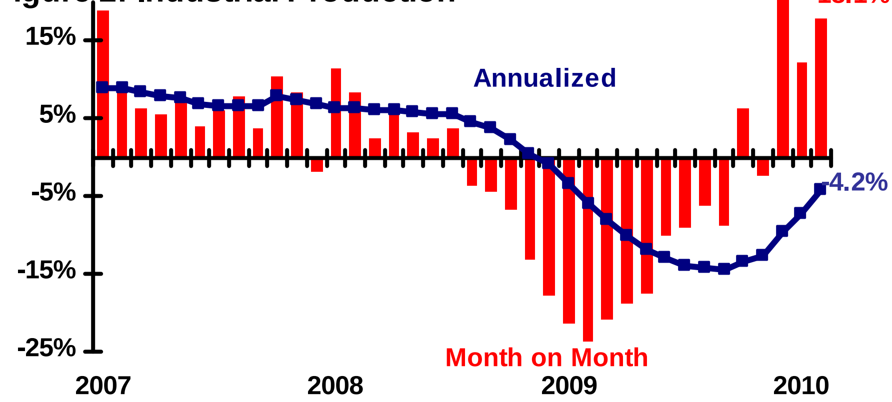
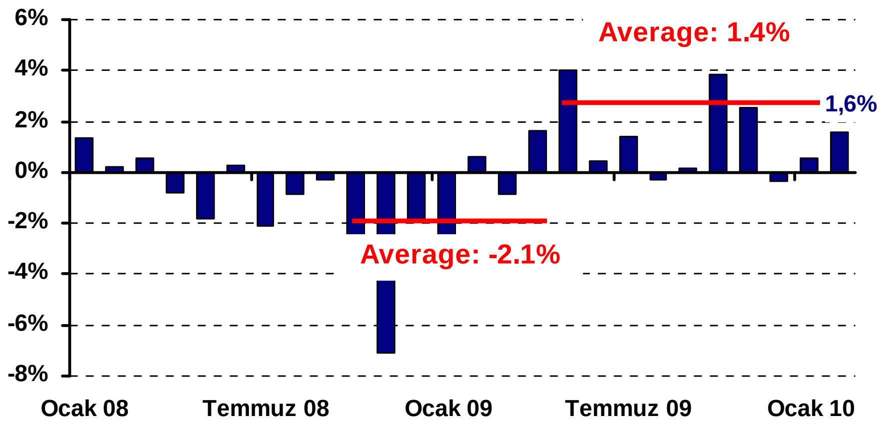


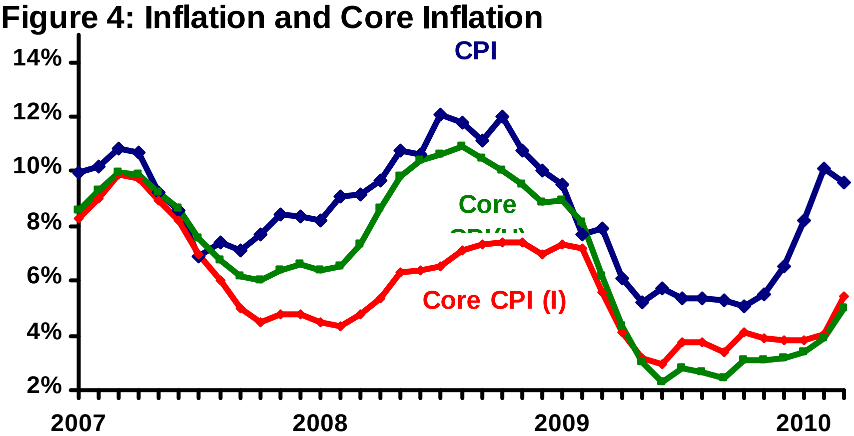
Figure 3: Industrial Production (SA, MoM)



Core Inflation Will Be Followed Closely…

The March consumer price inflation came in line with market expectations at 0.58%, easing the yearly inflation to 9.6% from 10.2%. With 28% share in the CPI, (unprocessed) food prices were an important contributor having risen by 11% in the last twelve months. Given the adverse weather conditions of the previous weeks, this trend is likely to be persistent in

Figure 4: Inflation and Core Inflation

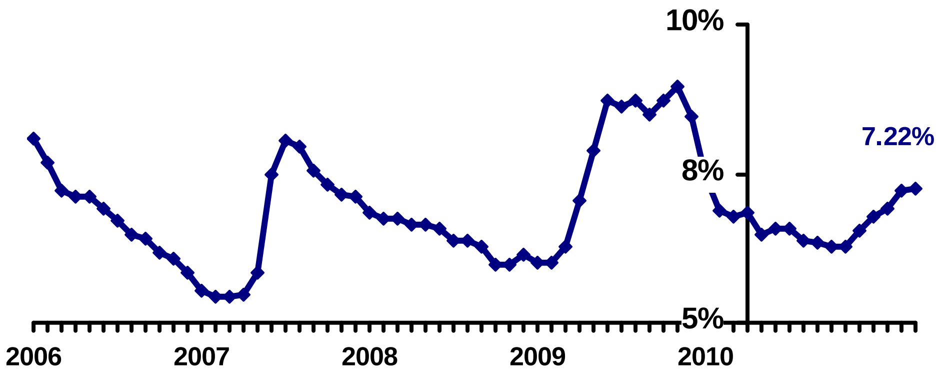


coming days. Price increases in other sectors are neither significant nor posing a threat for the remaining quarters of the year.

Despite a decrease in the headline CPI from 10.2%, the closely-watched core indices (H&I) both posted increases, making core-H 5% and core-I 5.4%. Both indices have edged higher since February. Bu they still remain below the year-end inflation target of 6.5%. (Figure 4)

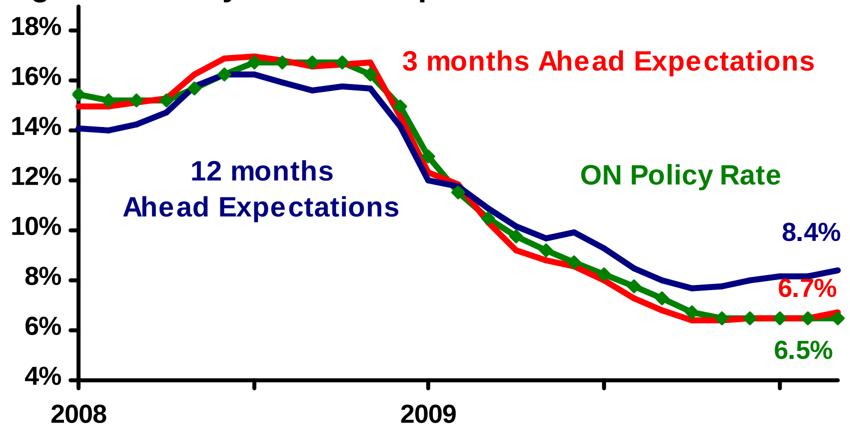
12 months forward inflation expectations in the meantime moved up only moderately in the past few months while in fact easing slightly to 7.22% in April. Given the recent significant run-up in the headline inflation recently, inflation expectations were followed closely both by the market and more importantly by the Central Bank of Turkey ("CBT") (Figure 5). Recently, the CBT has warned that the headline inflation will exceed the target rate but it would be due to temporary factors. They will be more in line with targets rather in the beginning of 2011. The moderate rise in expectations indicates that the markets are mostly convinced by the CBT's arguments. The CBT also referred to the recent increase in core inflation as temporary with an additional warning of an increase in core inflation in April. If these increases are due to temporary factors indeed - like tax cuts, food prices, and the base effect - then the increase in core inflation figures should end after April. If not, managing inflation expectations will be a challenge ahead.

Figure 5: 12M Forward Inflation Expectation



The CBT has kept its benchmark policy rate unchanged at 6.5% in its April meeting as expected. In line with its recent statements, the CBT reiterated that it will keep the policy rate at low levels for a long period. It also added a sentence indicating that it will gradually remove the liquidity measures implemented during the crisis. The CBT statement reflected that they are not in a hurry to hike policy rates yet, provided that the inflationary pressures are subdued till the end of the year. Although there is a slight recovery on economic activity and the recent increase in inflation is due mostly to low base effect, the uncertainties regarding the global economy still linger. Therefore we keep our forecast for the CBT to deliver 150bps rate hike in the last quarter of this year (Figure 6).

Figure 6: Policy Rate vs. Expectations



Gradual Exit…

The CBT announced its exit strategy the day after it released the recent monetary policy meeting statement. In nutshell, the strategy resembles those of the mature economies in the sense that the central bank will first cancel the unused liquidity support mechanisms and than the decrease gradually those in effect. Rate hikes will follow afterwards if necessary. Although the document describes the policy moves, it doesn't include information on the timing of these moves.

Regarding the FX liquidity, the CBT will raise FX reserve requirements and its lending rates on FX depos while ending its intermediary role in the FX depo market. As for TL liquidity, the 3-month repos will stay as a regular funding instrument, TL reserves will remain the same, but if liquidity shortage eases significantly then TL reserve requirements could be raised again. CBT's gradualism in both FX and TRY liquidity is noteworthy and will not have an immediate effect. Rate hikes will not come before an increase in reserve requirements.

Finally, there is the issue of technical rate cut. Currently, the policy rate is the Bank's borrowing rate but the banks are short TL and the borrowing rate is of no use. Instead, the bank funds the system with repos at rates slightly above the policy rate. The much-talked technical rate cut refers to the decrease of the bank's both borrowing and lending rates, the latter being more in line with the repo rates while the repo rates will become in fact the policy rate. The "word" technical therefore means that there may be a cut in borrowing and lending rates but that will not mean that the central bank is easing the monetary policy.

The CBT did not clarify the timing of the technical rate adjustment (we think it will happen in June or in July). In the first stage, the CBT intends to keep the band between 1-week repo rate (new policy rate) and the overnight borrowing rate (old policy rate) initially at 50 bp less than what the CBT mentioned earlier. In a second stage, however, the CBT will expand the gap between the 1- week repo rate and its overnight borrowing rate. This can be achieved by cutting the borrowing rate or hiking the 1-week repo rate.

As discussed above, the CBT did not announce the timing and the size of the moves. The announcement of the exit strategy did not change our stance regarding the rate hike.

DenizBank Political & Economic Update

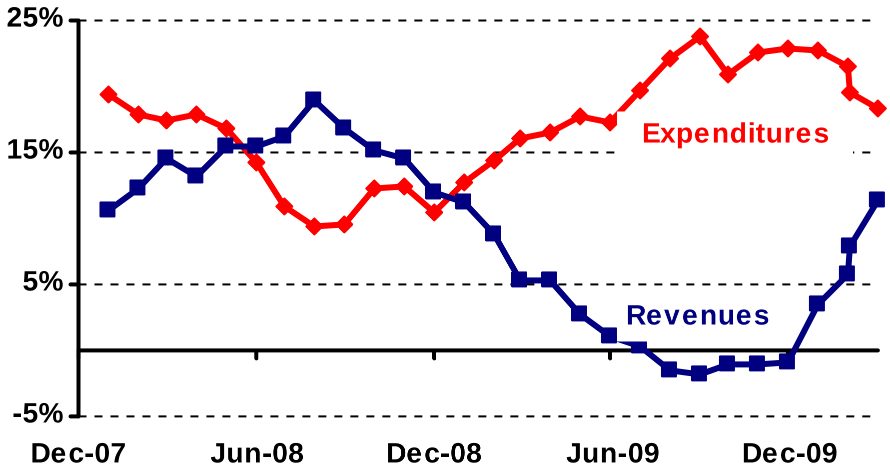
Economy

Strong Revenue Performance Accompanied with a Limited Rise in Expenditures…

Table 2: Central Gov. Budget Realizations (TL bn.)

	March-2009 One Month	March-2010 One Month	Nominal Change (%)	2009 12M Rolling	2010 12M Rolling	Nominal Change (%)
Expenditures	21.8	23.4	7%	241	269	12%
Non-Interest	17.4	19.1	10%	186	219	18%
Interest	4.4	5.0	13%	51	58	13%
Revenues	13.1	17.5	34%	209	225	8%
Tax Revenues	10.5	14.5	38%	166	182	10%
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	-8.8	-5.9	-32%	-32	-44	40%
Primary Balance	-4.3	-1.6	-63%	23	6	-75%

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



The Central Government Budget performance has remained robust since December due to an increase in tax revenues and the tax hikes introduced at the beginning of the year. This is largely expected because the economy has started growing generating handsome tax revenues and yielding less need for subsidies.

In figures, the budget posted a deficit of TL6 bn in March 2010, corresponding to a 32% decline compared to March 2009. The primary deficit decreased TL1.6 bn from TL4.3 bn one year earlier, a whopping 63%. (Table 2) Note that the target was to cut the primary deficit to TL4.3 bn for the whole year in 2010 from TL7.3 bn for the whole year of 2009. Economic recovery and the tax hikes contributed to the 34% increase on the revenue side. But spending was also under control as non-interest expenditures rose moderately by 10%, reflecting the government's cautious stance. (Figure 7)

Given the double digit growth in revenues and limited growth in expenditures, the budget target (4.7% budget deficit to GDP ratio) is well within reach. Moreover, in case of a faster economic growth than expected in 2010, budget deficit (to GDP) may even be lower than 4.7%. The fiscal performance in the first quarter signals that such a benign outcome is possible and the fiscal house may remain in order even in the absence of an IMF stand-by agreement.