May 2010

DenizBank Political & Economic Update

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DenizBank

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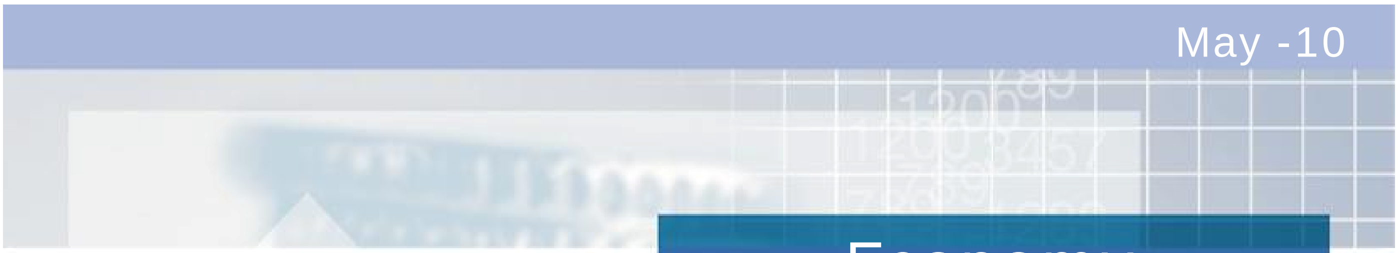
DenizBank Economic Research – (90) 212 272 99 65 or ekonomikarastirmalar@denizbank.com

New era for the Turkish main opposition party ("CHP"). The CHP had to look for a new chairman upon the resignation of the party's veteran ex-leader Deniz Baykal after the release of his alleged sex tape. The party lost three consecutive elections against the Justice and Development Party ("AKP") under Baykal, despite raising its share of votes from %19 to 29% in the last local election. The successor has become Kilicdaroglu, who was nicknamed as "Turkish Gandhi", being elected by 1.189 votes out of the 1.197 delegates which have been a strong indicator how well he is supported by the party organization in the convention. The new leader who is a 62 year-old former bureaucrat introduced his political priorities as fighting against both unemployment and corruption. He first became a popular public figure when he coerced some senior AKP officials to resign by exposing their corruptions. The inauguration of Kilicdaroglu is welcomed by many who are not pleased with the AKP government for its anti-secular practices under the cover of democracy for he will become a fresh breath, or a new start, for the CHP which has apparently the only party that can challenge the AKP and its popular leader Erdogan. He has mild and a more conciliatory tone than Baykal, with an increasing popularity among rural part of Turkey. However, it still remains to be seen whether he can push forward with convincing reforms to lead the country as an effective and charismatic leader.

Amendments in the constitution will be finalized by referendum after President Gul approved package of changes. Most of the legislation proposal was passed by parliament except the clause that makes it difficult to ban a political party. However, constitutional amendments which are ratified by votes within the range of 330-360 out of 550 as it was the case this time, are subject to popular vote (unless president vetoes it back to parliament). The supreme electoral board set September 12 as the date of referendum. The CHP, however, took it to the Constitutional Court for annulment, claiming that prominent clauses of the package had a hidden aim of overhauling the constitutional court and senior judiciary which had sued for a prosecution of the ruling party AKP in 2008 for its non-secular tendencies. The application of the CHP carried 111 signatures including the former Prime Minister and Independent deputy Mesut Yilmaz. In the petition, the CHP offended the ruling party claiming that the AKP made procedural mistakes and that the articles regarding judiciary were in the breach of the constitution.

A new deal was brokered by Turkey and Brazil for Iran's Uranium. Turkish PM Erdogan and Brazilian President Lula da Silva visited Iran's capital to sign a nuclear fuel swap deal such that 1200 kg of low-enriched uranium that is 58% of total stock pile would be transferred to Turkey which then would be transformed into 120 kg of higher quality uranium (with the help of France and Russia) for use in a civilian reactor in Tehran. The deal was a result of the effort to remove the need for sanctions pushed by the US in conjunction with China and Russia against Iran for its nuclear program. Although the timing of the brokerage of Turkey and Brazil was very important and likely to prevent mounting tensions in the region, the US, bruised by being sidelined in the deal, seems not satisfied with deal's features and wants to carry on with the sanctions.

Turkey and Russia agreed to build Turkey's first nuclear plant. Russian President Medvedev's visit to Ankara ended with plenty of agreements including a new oil pipeline, the lifting of short term visa requirements between the two countries, and last but not least, the launching of Turkey's first nuclear facility. Russian President declared both countries as strategic partners, not in just words but in reality. The parties have also unveiled their trade target of $100 bn in the next five years (from about $ 25 bn in 2009). Sergei Kirienko, head of the country's nuclear agency, informed that Russia would be a stakeholder in the nuclear plant and sell 49% of its stake to another investor later. Additionally, Turkey guarantees the purchase of at least 70% of the energy produced by the plant in the next 7 years following its start-up.

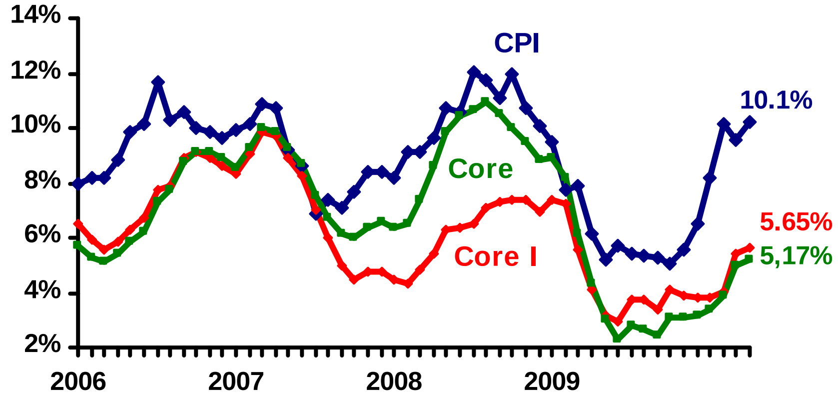


Economy

Inflation is Stubbornly High

The CPI inflation has continued its upward trend and reached 10.2% in April, slightly higher than the March figure of 9.6% (Figure 1). Year to date inflation average corresponds to 9.5%, in other words it is not wrong to say inflation is hovering around 10%. To put it into perspective, let us emphasize that YE2009 CPI inflation was 6.5%. Not only the headline, but also the core CPI indices are also on the rise. The famous core indices, namely H and I, have gone up by 2 and 1.9 pps respectively compared to YE2009. Accordingly, the Central Bank of Turkey ("the CBT") has revised its YE2010 CPI forecast upwards to 8.4% from 6.9%. On the bright side, the CBT is still convinced that inflation will decelerate starting from the Q42010 and it will be in line with inflation targets of 5.5% and 5% in year 2011 and 2012, respectively.

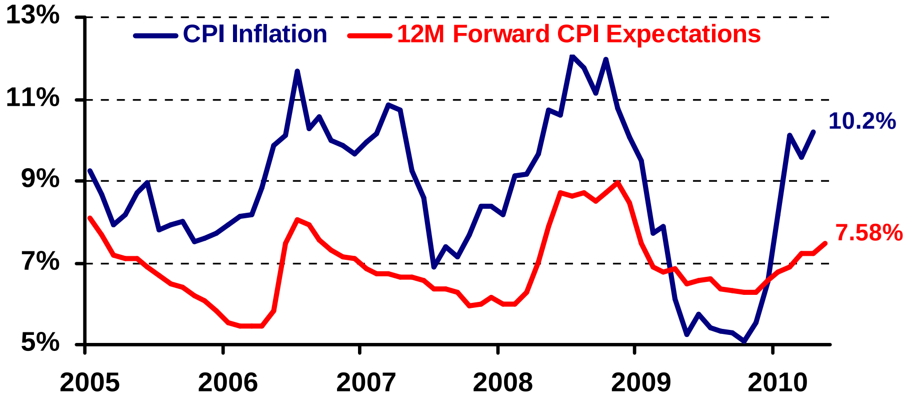
Figure 1: Headline and Core Inflation



The CPI has been rising mainly due to: i- low base effect, ii- reviving demand iii- rising food prices, iv- rising energy/commodity prices and iv- tax hikes. The CBT is right to assume that except the second one, all factors are fading and/or will fade gradually. Moreover, banks' lending appetite might be curbed by the latest financial turmoil, which would finally diminish the reviving demand.

On the currency side, as a result of the recent crisis, the TL has somewhat depreciated prompting the worries that this would eventually increase the CPI further. However, during the global crisis, the TL had depreciated by a whopping 25% while the CPI had in fact plunged from 11% to 5% mainly due to diminishing local and global demand. In other words, the pass-through is not always granted and the revival in demand is not yet strong enough to reinvigorate pass-through worries.

Figure 2: CPI and 12M Forward Expectations



The markets are not very concerned, either. Inflation expectations for the YE2010 and 12M forward are 8.6% and 7.5% currently and have not diverged too much from the CBT's targets. As detailed in our previous reports (please refer to DenizBank Monthly February 2010) the CBT is quite successful at managing expectations, the latest developments are not exceptions in that respect. As might by seen in Figure 2, except the extremely low CPI figures after the global crisis, there is no single period in which 12M forward expectations exceed the actual inflation figures.

The 1-week Repo Rate Has Become the New Policy Rate

The CBT announced its exit strategy in April, and increased the reserve requirement ratio for FX deposits by 0.5 point to 9.5%, accordingly at the end of April. In the coming months, both FX and TL reserve requirements are likely to be gradually increased to pre-crisis levels of 11% and 6% (5% for TL as of today) respectively.

As of May 18th, the CBT has also announced that it will implement the technical rate adjustment by setting the one week repo auction rate at 7%. The minutes stated that current rates for one week repo auctions were fluctuating around 7%, the Committee decided to start conducting one week repo auctions via quantity auction with fixed interest rate, in order to eliminate such fluctuations. By this change:

Figure 3: One Week Repo Rate (%)

i-) One week repo rate is the new policy rate (instead of O/N Borrowing rate which is 6.5%)

ii-) Quantity auctions will be organized where participants bid quantities at the fixed rate of 7% (currently) instead of the traditional ones of bidding prices.

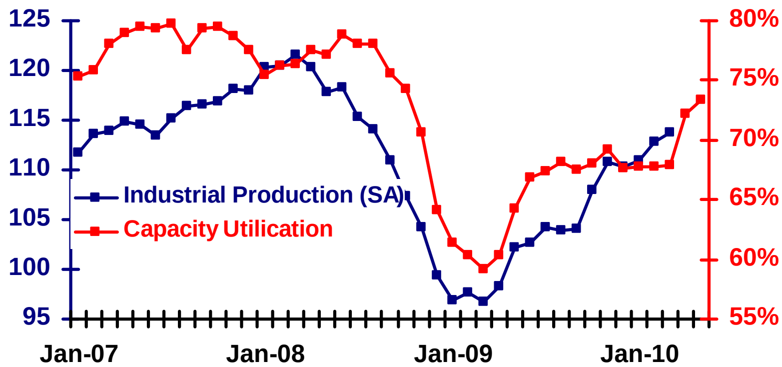
iii-) O/N borrowing and lending rates will be kept as same at 6.5% and 9%, respectively

As highlighted in the Exit Strategy Document published as of April 14th, the difference between 1W repo rate and O/N borrowing rate will be increased in the second stage of technical rate adjustment. When the tightening period is taken into consideration, it is likely to be done in the way of keeping O/N borrowing rate constant at 6.5% and increasing 1W repo rate. Upon the latest developments on the inflation and liquidity side, we still keep our 150 bps hike projection in the last quarter of this year (i.e. increasing 1W repo rate to 8.5% from 7%).

Robust Industrial Output Growth

Reflecting the strong recovery in the economy, the industrial production has gone up by 21% in March. When it is deseasonalized and decalendarized, the production has also risen by 0.9% in March. Also, the CBT has revealed a capacity utilization rate ("CUR") of 73.4% for May, the highest CUR since the crisis. This is signaling further improvement in the industrial output in April and May. We expect this upward trend to continue also in the second half of the year due to **i-** strong consumer loans, **ii-** recovering exports,

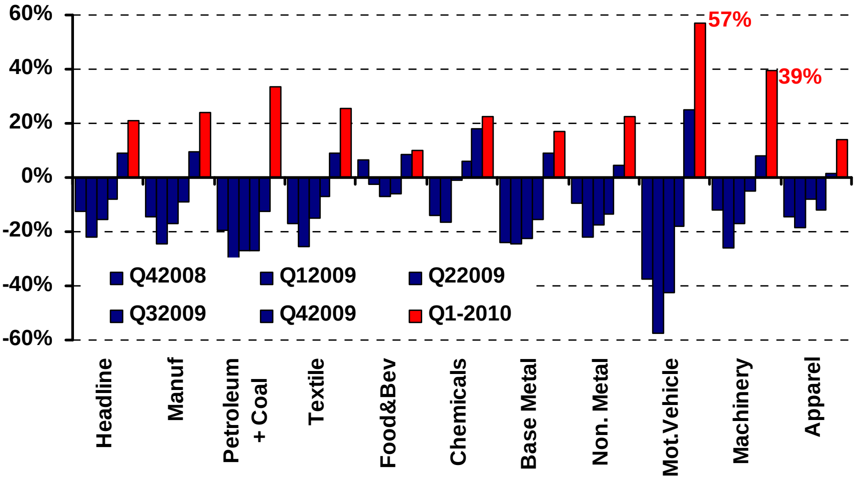
Figure 4: Industrial Production vs. Capacity Util. Rate



iii- bottomed out inventories and **iv-** low base effect.

In terms of quarterly sectoral outlook, export oriented sectors', namely motor vehicle and machinery, spectacular performance is eye-catching. This success might be partially attributed to low base effect; yet it should be highly praised amid the slow economic growth in the Eurozone which is the main trading partner of Turkey (48% of exports, 39% of imports)

Figure 5: Industrial Production: Sectoral Performance (QoQ)



Improvement in the Budget, with Downside Risks on the Expenditures Side

The Central Government Budget posted a deficit of TL4.5 bn in April 2010, worse than TL0.9 bn deficit in April 2009. Similarly, 12M rolling deficit has went up by an enormous 51% and has reached TL48 bn. Yet, current trend of the budget figures are in line with the target of TL50 bn as depicted in the Medium Term Fiscal Plan ("MTFP"), although there are still some risks especially regarding the spending discipline through the year end, given that general elections are scheduled to be held in 2011.

Table 1: Central Gov. Budget Realizations (TL bn.)

	Apr-2009 One Month	Apr-2010 One Month	Nominal Change (%)	Apr-2009 YtD	Apr-2010 YtD	Nominal Change (%)	Apr-2009 12M Rolling	Apr-2010 12M Rolling	Nominal Change (%)
Expenditures	21,0	25,2	20%	87	94	7%	243	273	12%
Non-Interest	18,0	18,1	1%	66	71	8%	189	219	16%
Interest	4,7	5,2	10%	19	21	11%	51	58	13%
Revenues	20,1	20,7	3%	67	78	15%	212	225	7%
Tax Revenues	12,8	15,3	20%	51	63	24%	166	185	11%
Income Tax	4,1	3,9	-6%	13	13	0%	39	38	-2%
VAT	1,9	2,9	50%	6	8	24%	17	22	28%
Special Cons. Tax	3,3	4,1	23%	12	16	30%	41	47	14%
VAT on Imports	1,5	2,7	82%	7	11	58%	27	30	12%
Budget Balance	-0,9	-4,5	371%	-20	-16	-21%	-32	-48	51%
Primary Balance	2,1	2,6	24%	1	6,3	493%	22	6,2	-72%

Thanks to recovering economy, 12M rolled tax revenues has ballooned by 11%. The year-to-date improvement was also eye-catching by topping 24% mainly due to improvement in the VAT, Special Consumption Tax and VAT on Imports revenues. On the cloudy side, the increase in non-interest expenditures was 16% on 12M rolled basis, showing some weakness in the current transfers (social security and agricultural subsidy expenses).

Next Policy Anchor: The Fiscal Rule

The details of the Fiscal Rule have been presented by Deputy PM Babacan. In the presentation it was stated that the Treasury has contacted with various local and international institutions –including the IMF and the World Bank- in determination of Fiscal Rule framework and the formula. First impression in the market has been positive, but there are still some questions regarding its implementation. As of today, the EU defined debt to GDP ratio is a mere 45%, therefore it is not wrong to say that fiscal rule of Turkey is a pre-emptive policy rather than being a necessity like it is the case in many EU countries, especially the PIIGS.

The formula of the fiscal rule is as follows: $\Delta a = -0.33\ (a(t\text{-}1) - 1) - 0.33(b - 5)$

Δa: Adjustment in the general government deficit / GDP

a(t-1) : Previous year's general government deficit / GDP

b: Real GDP growth rate

as it can be understood from the formula above, while long term growth target is 5%, long-term target for the ratio of the general government deficit to the GDP is -1%. The draft proposal of the Fiscal Rule is to be discussed in Parliament in June 2010, and will be implemented starting from year 2011.

To understand its repercussions, let's take this year as an example: The government's GDP growth forecast in Medium Term Fiscal Programme for 2010 is 3.5% and the last year's budget deficit to GDP ratio is 6.6%. Under this setting, the Fiscal Rule formula yields an adjustment of -1.4% (of GDP) (Table 2) which means that the government will have to take the necessary actions to decrease the last year's deficit of 6.6% to 5.2% in 2010. On the other hand, we know that the GDP growth projections are being revised upward for this year. Say the GDP growth projection is revised to 5% by the government. In this case, the adjustment becomes -1.8; -6.6%- (-1.8%) = -4.8%. Please also note that when the GDP growth projection and last year's Budget Deficit to GDP ratio is in line with long term targets of 5% and -1% respectively; the adjustment is zero.

Table 2: Fiscal Rule Matrix

Budget Deficit / GDP	GDP Growth: -2,0%	-1,0%	1,0%	2,0%	3,0%	3,5%	4,0%	5,0%	6,0%	7,0%
0%	2,6%	2,3%	1,7%	1,3%	1,0%	0,8%	0,7%	0,3%	0,0%	-0,3%
-1%	2,3%	2,0%	1,3%	1,0%	0,7%	0,5%	0,3%	0,0%	-0,3%	-0,7%
-2%	2,0%	1,7%	1,0%	0,7%	0,3%	0,2%	0,0%	-0,3%	-0,7%	-1,0%
-3%	1,7%	1,3%	0,7%	0,3%	0,0%	-0,2%	-0,3%	-0,7%	-1,0%	-1,3%
-4%	1,3%	1,0%	0,3%	0,0%	-0,3%	-0,5%	-0,7%	-1,0%	-1,3%	-1,7%
-5%	1,0%	0,7%	0,0%	-0,3%	-0,7%	-0,8%	-1,0%	-1,3%	-1,7%	-2,0%
-6%	0,7%	0,3%	-0,3%	-0,7%	-1,0%	-1,2%	-1,3%	-1,7%	-2,0%	-2,3%
-6,6%	0,5%	0,1%	-0,5%	-0,9%	-1,2%	**-1,4%**	-1,5%	-1,8%	-2,2%	-2,5%
-7%	0,3%	0,0%	-0,7%	-1,0%	-1,3%	-1,5%	-1,7%	-2,0%	-2,3%	-2,6%
-8%	0,0%	-0,3%	-1,0%	-1,3%	-1,7%	-1,8%	-2,0%	-2,3%	-2,6%	-3,0%
-9%	-0,3%	-0,7%	-1,3%	-1,7%	-2,0%	-2,1%	-2,3%	-2,6%	-3,0%	-3,3%
-10%	-0,7%	-1,0%	-1,7%	-2,0%	-2,3%	-2,5%	-2,6%	-3,0%	-3,3%	-3,6%

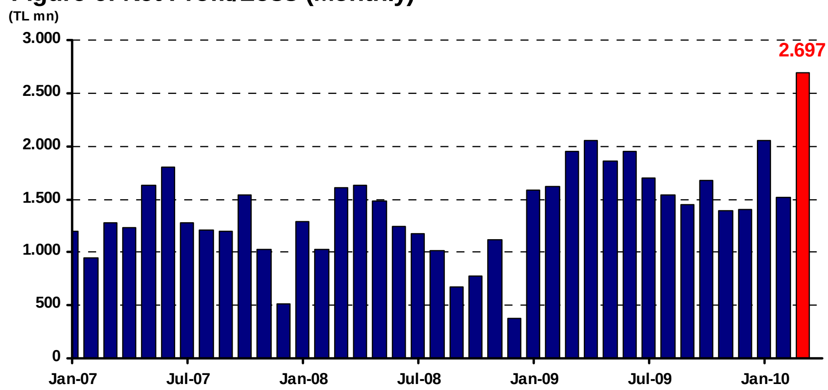
The budget performance will be continuously monitored during the year. If a possibility of exceeding the ceiling emerges, alternative measures will be prepared and submitted to the Council of Ministers by the Minister chairing the Economic Coordination Council. It is good that revolving funds, local administrations and SOEs will be subject to fiscal rule constraints as well. On the other hand, the Fiscal Rule will be audited just by The Turkish Court of Accounts ("Sayıştay").

Although it is a very respectful organization, there have been many comments criticizing the Fiscal Rule for the lack of an independent auditor. But we believe this is a very minor issue and it is easy to make some modifications on this setting.

Last but not least, expectations regarding the rate hike by the rating agencies are mounting, since this will be a strong policy anchor in the future given the lack of an IMF stand-by agreement. It should be noted that another round of rating hikes are likely to raise Turkey's rating above investment grade. As of today, while Turkey is rated one notch below investment grade by Fitch, and S&P and Moody's rate Turkey two notches below investment grade, the former with positive outlook. It is also interesting that fiscally troubled Greece is rated one notch above Turkey by all major agencies.

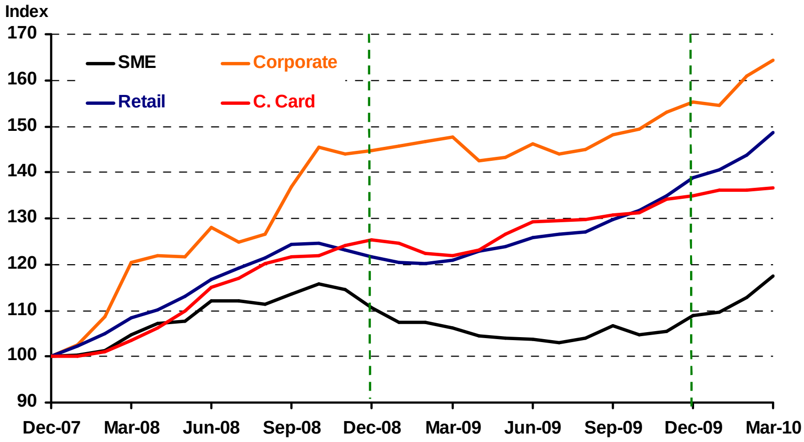
Record High Profitability Still Continues in March: The Q1 profitability surged by a strong 22% stemming mostly from strong net interest income. The dazzling performance however would be difficult for banks to continue in the quarters ahead. 14 percentage point of the 22% rise emanated from the increase in net income from government bonds portfolio which represents 30% of total assets in the sector. Taken into account that interest rates are likely to have seen the lowest (in fact deposit and repo rates funding T-bonds nudged up) and one-off capital gain on bonds is very limited, it would be hard to repeat such a high rise in interest income on bond portfolios. As described in our previous reports, the banks in Turkey benefited much from the CBT's 1025 bps policy rate cut thanks to the duration mismatch between assets and liabilities. (While average bond duration is exceeding one year, average deposit maturity is 30 days in Turkey). To compensate for the decreasing interest income from bonds and sustain high profitability, banks will have to increase their assets by expanding loan portfolios.

Figure 6: Net Profit/Loss (Monthly)



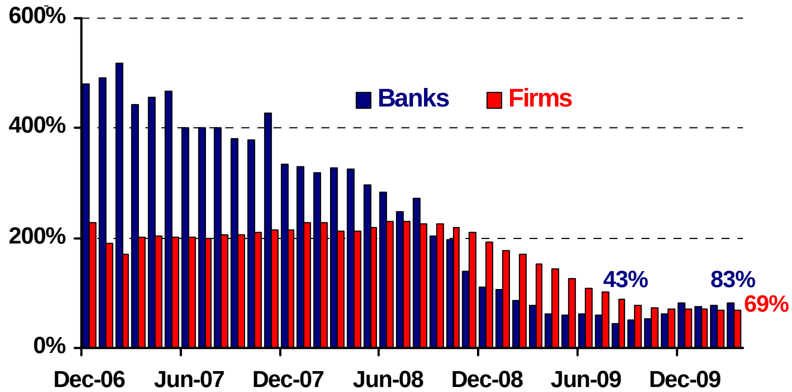
But Expanding Assets Will Be No Easy Task: Banks are in fact increasing their lending volumes since September 2009 (Figure 7). They had two major constraints in doing so: 1) Whether asset quality will continue to deteriorate following the global turmoil, and 2) how quickly loan demand will recover. The former is currently in decreasing trend, and the NPL ratio has decelerated to 5.0% as of May 2010 from its highest -5.8%- in November 2009. Our simulation shows that it will gradually decrease to 4.0% at the end of 2010. For the latter, the loan demand side, currently all loan segments have turned north, especially the increase in demand and mortgage loans is eye-catching. Annualized increase in these segments is exceeding 30%. Therefore, banks not constrained by either factor were able to expand their loan portfolios. However, if the double dip scenario concerning global growth comes to fruition following the worries for European sovereign borrowing, it remains to be seen whether the currently benign trend can continue.

Figure 7: Loan Segments (2007=100)



Funding Will Be An Issue: Year to date, total loans are up by 24% vs. 13% for deposits. In other words, the current trend is not sustainable without the banks expanding their funding base. Since deposit funding has its limits banks have been turning to foreign wholesale markets for additional

Figure 8: 12M Trailing Foreign Debt Rollover



funding (while they can get substantial liquidity from the central bank in return for T-bonds, Turkish Central Bank is not as generous as ECB or FED in funding duration). The recent news of new syndications by big Turkish banks are therefore very encouraging (Table 3). As could be seen from Figure 8, 12M debt rollover ratio has surged from 43% in August 2009 to 83% in March 2010.

Table 3: The Completed Syndications in 2010

Date	Bank	Amount (Mn. $)	Rollover	Maturity	Interest Rate
24.03.10	Vakifbank	950	128%	1 Year	(Libor+%1,50) + (Euribor+%1,50)
25.03.10	Akbank	1.200	93%	1 Year	(Libor+%1,50) + (Euribor+%1,50)
08.04.10	Bank Asya	250		1 Year	(Libor+%2,25) + (Euribor+%2,25)
04.05.10	Garanti Bankası	833	97%	1 Year	(Libor+%1,50) + (Euribor+%1,50)
17.05.10	Abank	183	245%	1 Year	(Libor+%2,10) + (Euribor+%2,10)