June 2010

# DenizBank Political & Economic Update

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# Politics

**Israeli Raid on flotilla, organized by Turkish, sparks crisis.** Nine pro-Palestinian activists died as Israeli commando team raid on the flotilla carrying aid to Gaza strip in international waters. Turkish flag was held by three of the convoy's six ships which were mainly under the management of the so-called Turkish Human Rights ("THR") group. The critical point is that the death list includes eight Turkish and one Turkish born-US citizen. The THR is known to be a pro-islamist organization that has indirect relationship with the AKP's supporters. In response, the Turkish government urgently called its Israeli Ambassador back home and asked for an urgent convention of the United Nations Security Council. Turkey also pushed for a UN Human Rights Council investigation into Israel's attack. Thousand of Turkish protestors gathered to show their anger toward state of Israel in the famous Taksim square.

Although Turkey and Israel have a history of close co-operation in terms of military forces and being close allies in the chaotic Middle East region for years, the official relationship between the two countries has been in tatters after Turkish Premier Erdogan stormed out of a debate with Israeli President Perez in Davos Summit. The recent crisis will only add to that. Some Turkish MPs went so far as to blame Israel for supporting PKK terrorism in Turkey. The foreign media has mostly interpreted the crisis as another example of Turkey's "leaning towards the East" after the episodes of improving relationships with Syria and Iran, two of the members of the West's not favored list. Given that the spat has only grown further as Turkey took additional military and commercial measures against Israel and banned Israeli military flights over Turkish territory the tension between the two will remain an issue for sometime.

**PKK terrorism is on the rise again.** After a year old unilateral ceasefire, PKK stated that they will restart terrorist activities in the beginning of June 2010. They first targeted the military compounds in Southeastern Turkey and then hit military shuttles in Istanbul with remote-controlled bombs killing several military personnel after the intelligence warned about PKK targeting big cities. Political voices against terrorism have dramatically escalated following the events as to serve the growing public hatred against Kurdish terrorism. Whereas PM Erdogan harshly criticized the media by claiming its extreme concentration on terror is quite supportive to the PKK, opposition parties condemned the AKP Government for its unfruitful "democratic initiative". It is also argued by many, however, that the reviving PKK terrorism is actually aiming to stop the initiative fearing the votes of Kurdish minority in the region swinging towards the AKP. PM Erdogan has therefore stated that the government will not give in to terrorism and continue its democratic initiative. Indeed, the Kurdish population in the region is quite enthusiastic about the ongoing reform process. Aware of all this, in a rebuke of the terrorist PKK, civic groups and nongovernmental organizations, numbering around 100, in the predominantly Kurdish Southeast have called on the terrorist organization to put an end to its violence and have urged the government to continue on the path of reform.

**Google's woes in Turkey elevate.** Turkey's Communications Minister used offensive language against Google for "picking up a fight" with Turkey after the government accused the company to avoid paying taxes in Turkey for the business it does in Turkey. Added to the two year ban for Youtube –a Google subsidiary- it certainly hurts the internet users in Turkey. However, the Minister asserted with good reason that the online video-sharing site must register in Turkey and open office in order to be an official tax payer as it did in many other countries. Then, the government might assist the website through necessary changes in legislation, as the court would lift its ban.

**Will Prime Minister target presidency?** The first serious speculation on PM Erdogan's potential presidential candidacy in the future came upon the passing of a bill that entirely changes the election system. Under the new bill, citizens are permitted to elect president directly, and the candidates can keep their current post without resigning during election period. Previously, PM Erdogan stated that next 2011 election would be his last term as a PM and MP (Member of Parliament). Therefore, the new bill signals that Mr. Erdogan will target the office of the Presidency if the AKP gains enough majority to establish the government. However, the length of Abdullah Gul's term is uncertain and complicates the speculation above. While the old bill gives seven years to president for his ruling period, the new bill has reduced the term to five years. It will be the Supreme Election Board (YSK) to be deciding which rule Mr.Gul will be subject to.

# Economy

### *The Central Bank to Tighten Less and Later Than Expected…*

Consumer price inflation surprised the market on the downside and the index decelerated to single territory on annual basis in May (Figure 1). While the sharp drop in food prices was the main reason behind it, the core indices have also softened, albeit slightly. It is quite early to say that inflation has entered a secular downward trend but the Central Bank put his weight behind it foreseeing further easing in inflation especially in the last quarter of the year, largely thanks to the post-crisis slack in the economy yet to be used up along with the prospects of weak external demand, especially in Europe, Turkey's main export market. Concurring that, inflation expectations for the year-end eased further towards to 8% in June from 8.6% in May. Similarly, the 12M forward CPI expectations eased as well from 7.48% in May to 7.35% in June (please not however that the end 2011 inflation target is 5.5% ± 2%).

**Figure 1: Annual Inflation**

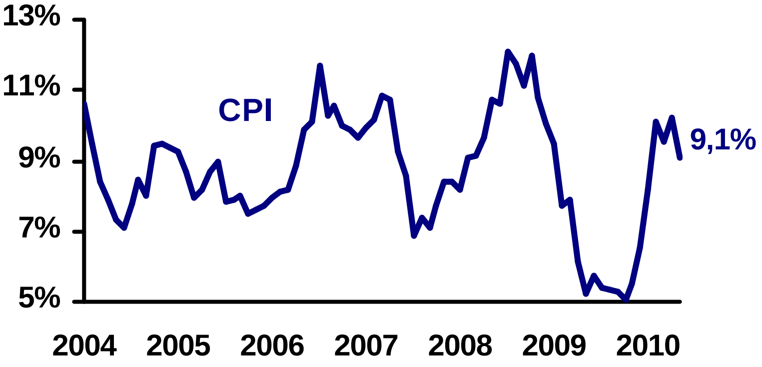
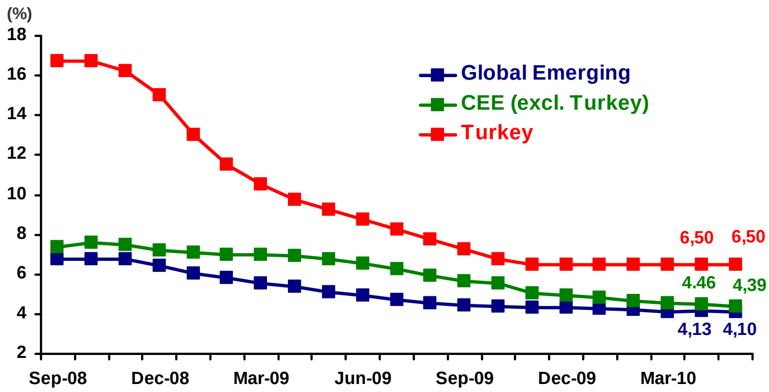



**Figure 2: Emerging Countries Policy Rates (Average)**




The recent improvement in actual inflation and the outlook should make the Central Bank of Turkey ("CBT") even more comfortable in keeping rates unchanged for an extended period. Turkey's policy rate is still one of the highest among the emerging markets although Turkey cut the interest rates most during the crisis (Figure 2). Even though the central bank may have faith in the demand conditions not pushing inflation higher, it will still have to take into consideration what others are doing in terms of the exit strategies. While the mature economies appear to have delayed their tightening of monetary policies given global double dip worries, the easier stance also continues in emerging markets as a whole although some countries opted for some pre-emptive yet mild hikes (Figure 3). Turkey being well above her peers in policy rates may afford to wait.

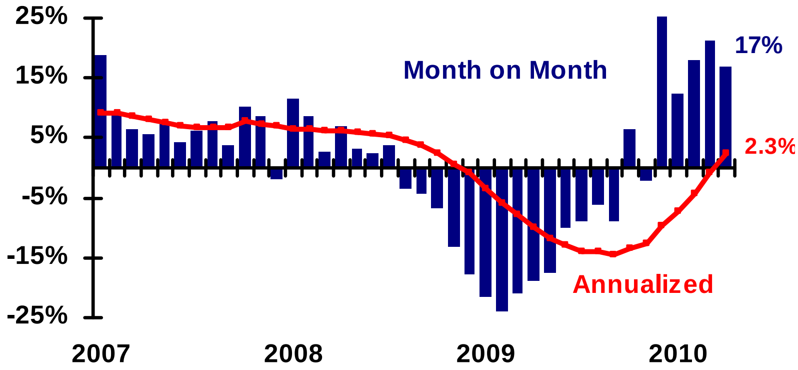
**Figure 3: Inflation Surprise Indeces** (Last Data May 2010)


In this regard, we also halved our rate hike expectations from 150 bps to 75 bps in the last quarter of this year while holding on to our previous expectation of the tightening to begin in the last quarter. But it will be largely pre-emtive rather than a catch-up move with the yield curve.

### *Industrial Production Expanded Again…*

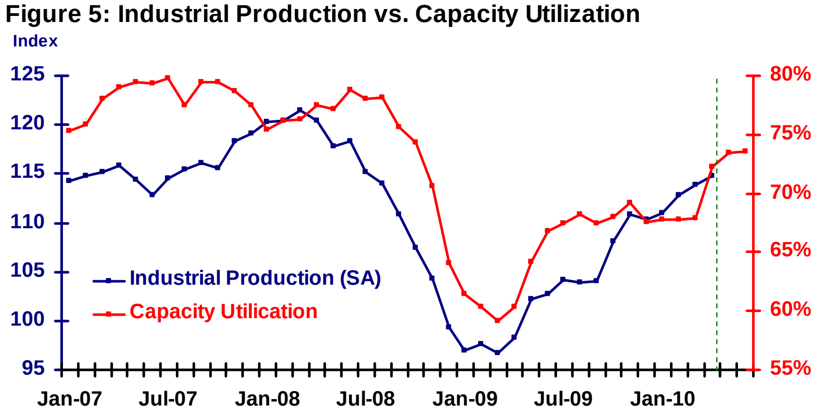
The economy has been recovering gradually and consistently since 2Q09. Industrial production expanded further by 17% in April compared to the same month a year ago (Figure 4). The realization was slightly worse than the market's expectation of 19% but it was good enough to pull the annual pace of growth into the positive territory, which had shown a contraction by as high as 24% in February-2009.

Figure 4: Industrial Production Growth



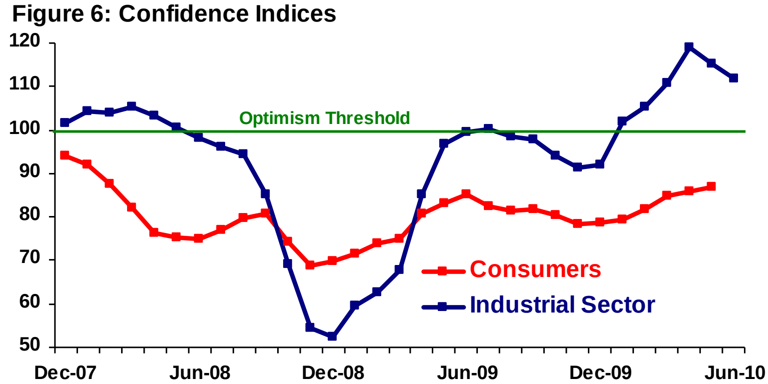

Of course statistical base effect due to 2009 being a recession year has been influential for so high double digit increases. But the seasonally adjusted industrial production figures also depict a similar recovery as they are rising in row since the beginning of year 2010. Capacity utilization which typically moves in tandem with industrial production was on the rise as well recently, lending support to the growing perception that industrial production will likely display similar rise in May and June (Figure 5).

Figure 5: Industrial Production vs. Capacity Utilization




Despite the strengthening production data, the upward trend in business confidence has been reversed lately, probably emanating from the growing regional worries in Europe suggesting that a durable recovery has yet to materialize. Although the consumer confidence index increased slightly in May, it still remained well below the optimism threshold implying that the consumers still remain largely pessimistic with respect to the economic outlook (Figure 6). Consumer confidence will not improve strongly either until unemployment, which only responds with a long lag after recessions, decreases further.

Figure 6: Confidence Indices

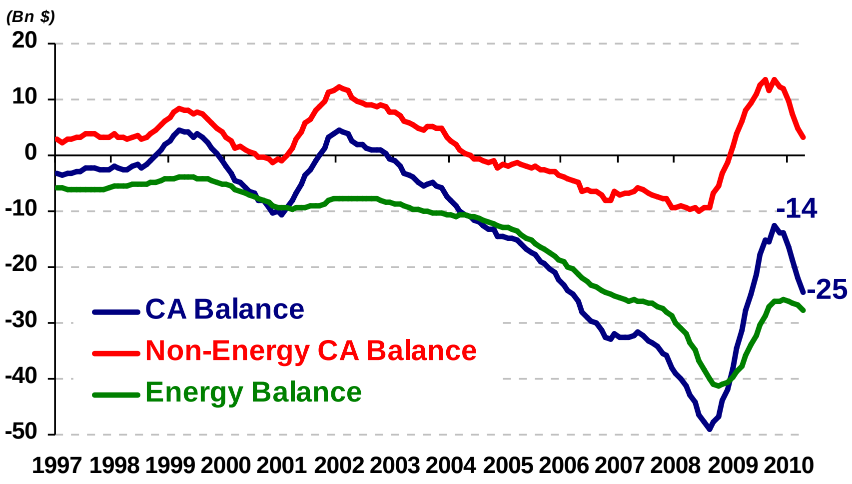



Therefore, it would be appropriate to expect that the recovery will be less pronounced in the second half of the year as the restocking will slow and base effect will cease to a large extent. But it would still be enough to reinstate the lost production in 2009 and even further by the end of the year as yearend GDP growth may exceed 5%.

## *Current Account Deficit is on the Rise*

Turkey has a structurally current account deficit economy if she is to grow at least at its potential. She needs foreign savings (longer in maturity than domestic sources) to invest and reveal the potential of the real economy as well as importing high technology to boost competitiveness and raw materials. Therefore it was very well expected that her current account deficit would have decreased during last year's recession, and it is equally of no surprise this year that it is rising back up as the economy recovers (clear in Figure 7). The deficit (CAD) has risen to $25 bn in the last twelve months bouncing back from its lowest level of $14 bn last year following the crisis.

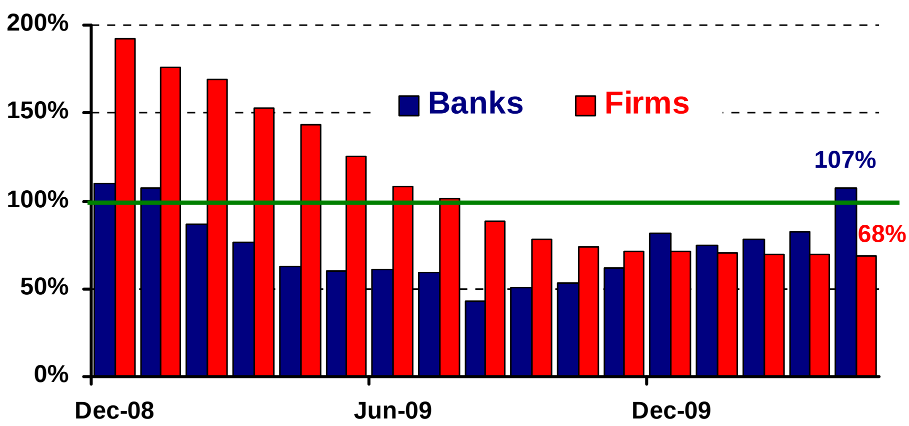
**Figure 7: The Current Account Balance**




While the direction is no surprise, $11 bn increase in CAD in the last six months is eye catching. Going into details, a mere $2 bn is due to the increase in the energy prices during the period. In other words, while the economy is actually recovering faster than expected it has been relying more on domestic demand in doing that rather than exports. That is no surprise either as the European economies, Turkey's major export market, are fiscally in trouble and have to save rather than consume in the next few years. Considering that Turkey exports mostly finished or consumption goods, she is especially vulnerable. Indeed, annual exports have risen by only 4% in annual terms since the end of last year vs. 10% of imports. Nonetheless, we do not see it alarming and believe that it may stabilize between 4 to 5% of GDP by the end of the year as inventories are replenished and recovery gives way to a stable growth at potential.

As for the financing, most of the CAD financing was provide by government sovereign issues and bank borrowing year to date while foreign direct investment, given the lingering global financial worries remains lower than last year at $1.7 bn since the year-end ($2.8 bn in the corresponding period last year). It is also worth noting that companies are still in the process of deleveraging (at least on loans from abroad). While banks 12 months trailing debt rollover ratio has risen to 107% in April from 43% in August 2009, companies continue to repay in net terms (Figure 8).

**Figure 8: 12M Trailing Foreign Debt Rollover Ratios**



### *Stellar Budget Performance*

Another unsurprising recent development in the economy is that the authorities have actually yielded a very handsome primary budget surplus in the first five months of the year and decreased the overall budget deficit while most of the mature economies are only giving promises these days in that regard. Why is it not surprising, because the economy is growing at respectable pace and bolstering state coffers with tax revenues.

The budget posted a surplus of TL6 bn in May 2010, the best monthly performance since August 2008. Similarly, year to date budget balance has improved by 52% mainly on the back of successful performance in tax collection. 12 months trailing budget deficit is TL42 bn, which is in line with YE2010 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-. Lending support to this, high primary budget surplus does not mean the authorities are tight in spending at all. Non-interest spending rose by 11% in the first five months, quite fast indeed in comparison to the last few years. It is the rise in tax revenues that actually eases the authorities hand thanks to the recovery in the economy.

**Table2: Central Gov. Budget Realizations (TL bn.)**

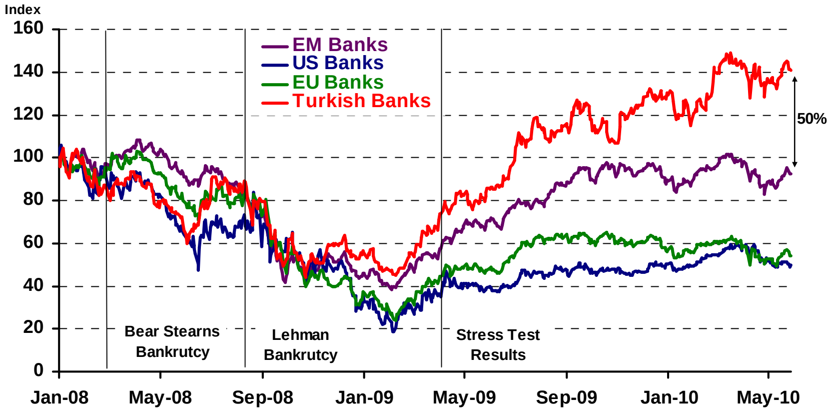
| | May.09 One Month | May.10 One Month | Nominal Change (%) | May.09 YtD | May.10 YtD | Nominal Change (%) | May.09 12M Rolling | May.10 12M Rolling | Nominal Change (%) |
|---|---|---|---|---|---|---|---|---|---|
| Expenditures | 19 | 19 | -2% | 107 | 113 | 5% | 247 | 273 | 11% |
| Non-Interest | 14 | 17 | 17% | 81 | 88 | 9% | 190 | 222 | 17% |
| Interest | 5 | 5 | 11% | 24 | 27 | 11% | 52 | 59 | 13% |
| Revenues | 19 | 25 | 32% | 86 | 103 | 19% | 211 | 231 | 10% |
| Tax Revenues | 15 | 20 | 28% | 66 | 83 | 25% | 164 | 189 | 15% |
| Income Tax | 4 | 4 | -6% | 13 | 13 | 0% | 39 | 38 | -2% |
| VAT | 2 | 3 | 50% | 6 | 8 | 24% | 17 | 22 | 28% |
| Special Cons. Tax | 3 | 4 | 23% | 12 | 16 | 30% | 41 | 47 | 14% |
| VAT on Imports | 1 | 3 | 82% | 7 | 11 | 58% | 27 | 30 | 12% |
| Budget Balance | -1 | 6 | - | -21 | -10 | -52% | -36 | -42 | 16% |
| Primary Balance | 4 | 8 | 82% | 5 | 14 | 162% | 21 | 10 | -54% |

As presented in our previous report, the long-term growth target is 5% whereas long-term target for the ratio of the general government deficit to the GDP is -1% according to the new policy anchor, namely 'Fiscal Rule', which will be effective starting from year 2011. The current trend of the budget performance shows that budget deficit to GDP ratio will hover around 4% at the end of this year. When we put this year's budget deficit to GDP ratio and growth forecasts of the next 3 years, the Fiscal Rule formula tells us that budget deficit to GDP ratio will gradually decelerate to 1.1% in year 2013. Given that G-20 leaders have recently agreed to halve their budget deficits by 2013, Turkey's fiscal policy targets and performance is eye catching.

## *Turkish Banks are Outperforming Peers*

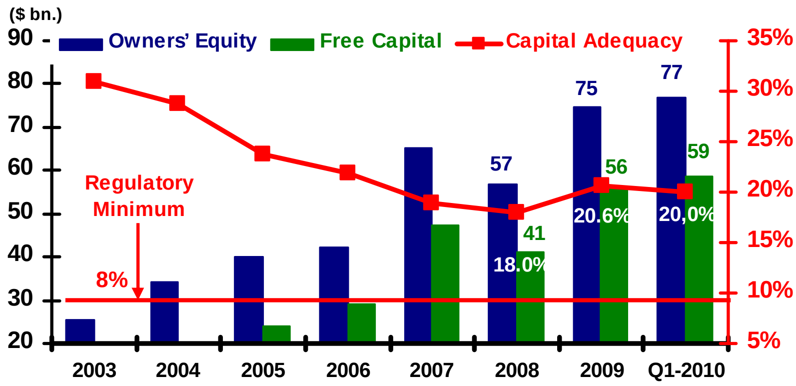
It might be quite paradoxical for those who remember the aftermath of the crisis which started in the last quarter of 2009, many bank analysts had published reports underweighting Turkish Banks. Defying those expectations, Turkish Banks have not only outperformed the developed countries' banks by far, but also the peer banks of emerging countries (Figure 9).

Figure 9: Share Prices (January 2008 = 100)




Turkey's investment grade path story (Please refer to February 2010 Monthly Report), low P/E ratios of Turkish Banks, young demographics of the country, prudent regulation, and her diversified real economy were all instrumental in this paradox as those analysts disregarded the fundamentals but acted with crisis sentiment. What is more, Turkish Banking system continues to outperform concerning the important three pillars of banking systems:

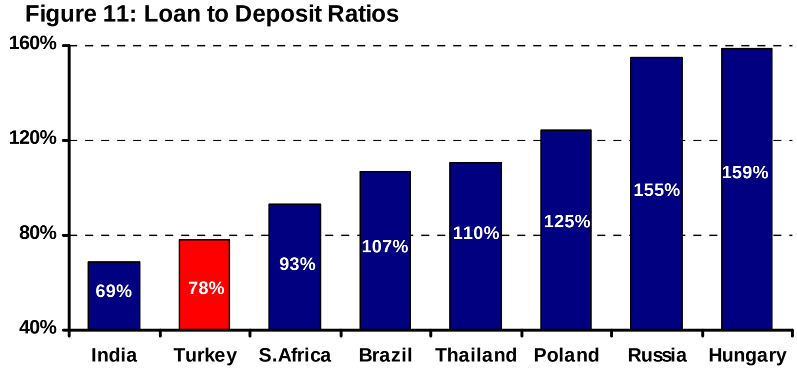
Figure 10: Turkish Banking Sector Capital Adequacy




**1- Robust Capital:** The Turkish Banking System's ("TBS") capital adequacy ratio is standing at 20% at the end of Q1-2010, which is 2.5 times the regulatory capital set by Basel-II (Figure 10). The strong capital creates an extra cushion during crisis; 2008 crisis was a good example in that respect.

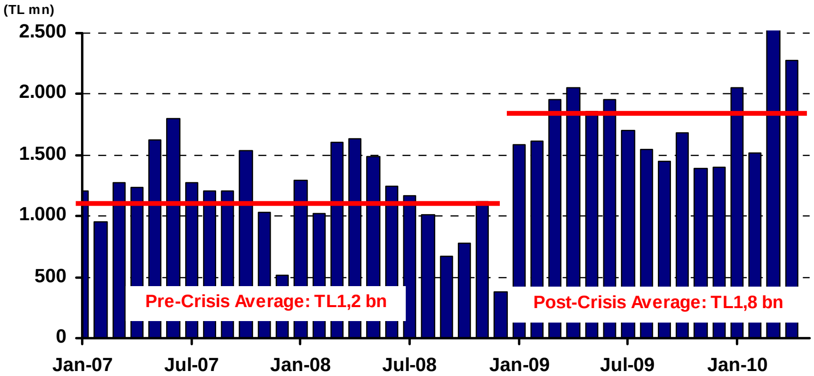
**2- Stable Funding:** Total deposits to total assets is moving around 62% since 2003 and the Turkish banking system is in a very good position in terms of loan to deposit ratio relative to her peers and has a more than adequate a domestic deposit base to fund loan portfolios (Figure 11). But the system has already started an ambitious growth after the crisis in loans and efforts of expanding the loan portfolios are clearly raising the demand for deposits, such that the year-to-date increase in loans was 28% annualized vs. 15% in deposits. Facing the shortfall, banks are resorting to wholesale funding from abroad (mostly syndications and trade finance) which is the second important source of funding for the Turkish funding system. As given above, the 12M trailing debt rollover ratio for banks exceeded 100% in April 2010.

Figure 11: Loan to Deposit Ratios



**3- High Profitability:** Last but not least, the third pillar of the TBS is high profitability, which became more important especially after the global crisis. Each day a new tax levy is imposed on banks in the world or plans for extra capital cushion is at work. Since the banks in Turkey are already working with with substantial tax burden, and liquidity, capital and leverage requirements by the regulator, they are relatively insulated. But almost each new regulatory change put pressure at least on spreads of the banks. Nevertheless, the TBS has increased its average monthly profitability by 50% following the crisis. This should enable Turkish Banks to expand their network in under penetrated domestic market and peripheral countries.

**Figure 12: Net Profit/Loss (Monthly)**




On the risk side, two factors are worth mentioning that may strain the balance sheets ahead. The first one is the possibility of a sudden and larger than expected increase in policy rates, and the second is the rise in NPLs. For the former, as we detailed the reasons in page 3 of this report, rate hike expectations are limited for this year and 2011. For the latter, thanks to rising loans and the recovering economy, NPL ratio has peaked at 5,8% in November 2009 and has been in a decreasing trend since then. The size of NPLs has also stabilized.

To sum up, on top of the three pillars detailed above, waning risks are also fueling the growth of the Turkish banks. This trend is likely to continue at least in the remainder of the year.