July 2010

DenizBank Political & Economic Update

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Politics

The constitutional court cleared the way for the vote by rejecting an opposition appeal to annul the entire package of constitutional amendments. The two most controversial proposals relating to the methods of electing new members to the Constitutional Court and the High Council of Judges and Prosecutors were annulled by the Constitutional Court decision. Since the uncertainties about the future of voting for new amendments have almost disappeared, the entire "remaining" package (the closure of the political parties to become more difficult, military personnel to be subject to civilian courts, etc) will go to a national vote on September 12, as it was decided by the Turkish parliament. These rejected provisions have some political insight because the ruling AKP has frequently clashed with the constitutional court and senior judges. It provided a relief in politics since the markets feared the court would block the whole package or it would prompt another attempt to close the AKP, causing the government to cancel the referendum and call early election.

The main opposition parties, namely the CHP and the MHP, are working hard to block constitutional change, and they are claiming that the AKP has a hidden aim of changing the secular infrastructure of the Republic. But for them the referendum is not all about the content. The opposition parties have been trying to convert it to a decision of vote of confidence in the government and use a possible "No" as a propaganda tool for the approaching elections.

Against this backdrop, all eyes have now turned to the outcome of the referendum on September 12. The current polls show that "yes" votes are marginally above the "no" votes.

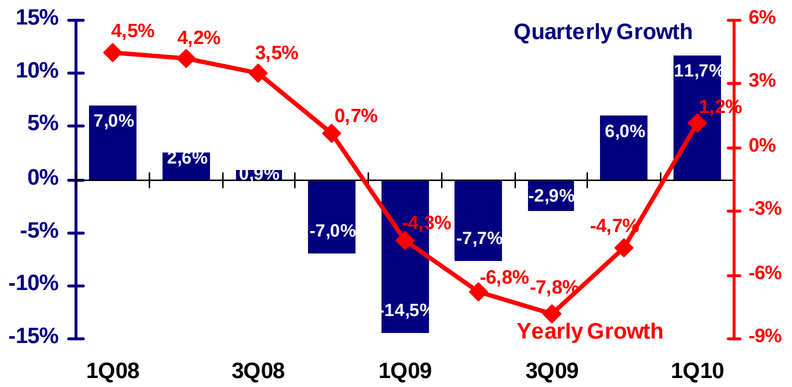
2011 elections approaching, AKP-SP and CHP-MHP coalitions among possible outcomes. If held on time, the general election will take place on July 22, 2011. The CHP (center left) and the MHP (nationalist), expect an early election in the fall 2011. Although the main opposition party, CHP, has gained substantial momentum in recent polls thanks to the fresh breath of its new elected leader, Kemal Kilicdaroglu, the party could not still capture majority in the parliament according to the current poll results. Yet, political atmosphere can change very quickly in Turkey because of a large amount of swing votes. From this perspective, the political experts highlight that nationalist sentiment may also strengthen toward the elections, paving the way for an anti-AK Party and anti-European Union CHP and MHP coalition. On the other side, radically Islamist Happiness Party (SP) is trying to shake off its dull and lame position with new faces and restructuring and indeed rising in the polls providing an alternative to the AKP. After the SP gave support to the constitutional amendments speculation has risen that it may be for a possible electoral alliance between the two parties.

AKP and CHP meet regarding the PKK issue after the request of Prime Minister. PM Erdogan and the main opposition party leader Kilicdaroglu met to discuss "fight against terrorism". Kilicdaroglu has made several suggestions in the summit. His first suggestion was to decrease the election threshold to 7% to strengthen the democracy and confirm the representation of different political views in the parliament. He also recommended the removal of the special courts which perform in contradiction to judicial principles in cases of emergency. According to Kilicdaroglu, building new factories in the 'East Anatolia' region and creating employment in the region would block the separatist views. Also giving the chance to benefit from the farming and livestock to the villagers will reduce the unemployment in the region. Lastly, cleared minefields in the east should be provided for the usage to homeless villagers. Almost on all suggestions PM Erdogan and Kilicdaroglu shared the same views except reducing the election threshold. From the public opinion's view it was found very encouraging to see that the leading party, AKP and the main opposition party CHP are hand in hand over the fight against terrorism, supporting the view that the fight against terrorism is not only the leading party's problem, but all parties' issue. It certainly has meanings for the upcoming elections as well.

Growth is Losing Momentum…

Turkey's Q1 GDP growth at 11.7% was slightly above the market expectations of 11.5% (Figure 1). That is an outstanding rebound from the 15% contraction in the first quarter of last year. As for the performance in the last four quarters the economy thus grew by 1.2% by the end of first quarter from a recession of 4.7% a year ago. Remarkable figures, indeed. Yet, it is not that remarkable when figures are adjusted seasonally allowing us to concentrate more on recent performance instead of a comparison to the crisis period. Then the performance is much less conspicuous, as seen in Figure 2, revealing a marked slowdown from the rates of growth enjoyed in preceding three quarters of 5.4%, 3.3%, and 1.7%, respectively. The main takeaways from the Q1 GDP figures are:

Figure 1: GDP Growth



- Record high outcome is mainly due to the low base effect; gradually decelerating seasonally adjusted figures prove this. Moreover, the strong growth figures in Q2 and Q3 2009 were supported by government support via tax cuts encouraging earlier purchases. That was the main reason why we were skeptical about the strength and the durability of the recovery.

- Similar to the previous quarter, private consumption has gone up by a strong 9.9% QoQ, contributing to the headline GDP by a massive 7.4% (Figure 3). On the flip side, government consumption was up by a mere 1% QoQ, after strong average contribution to the GDP in the previous five quarters. Looking forward, we expect private consumption to continue its upward trend, albeit slowly; and government consumption to accelerate due to the upcoming general elections next year.

- Another strong contribution has come from stock piling. As it might be remembered from our previous reports, in an aim to better cash flow management, the companies have melted down their inventories in the crisis atmosphere. Starting from Q3-2009, the inventory depletion process has been reversed, albeit slowly until last quarter. Thanks to the strong recovery in private consumption the companies have accelerated their inventory accumulation in Q1-2010.

Figure 2: GDP Growth (Seasonally&Calendar Adjusted)

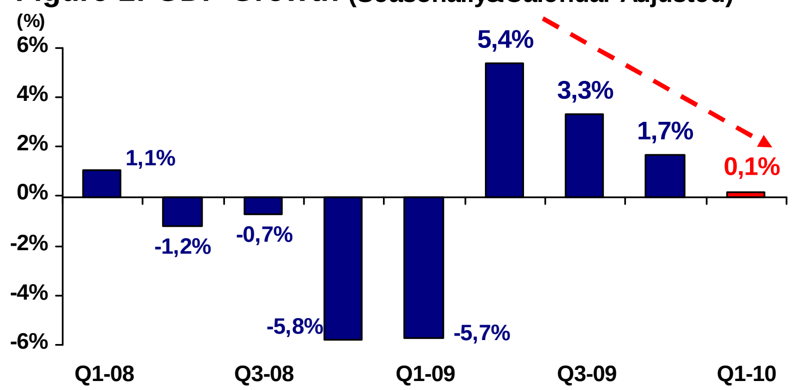
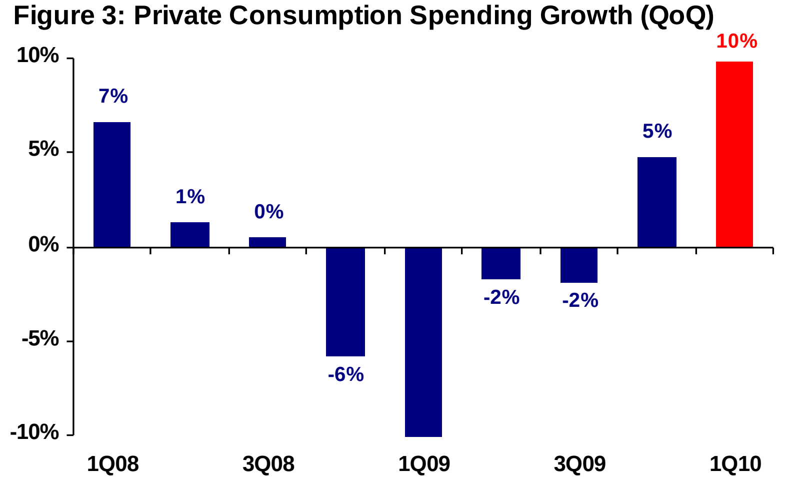
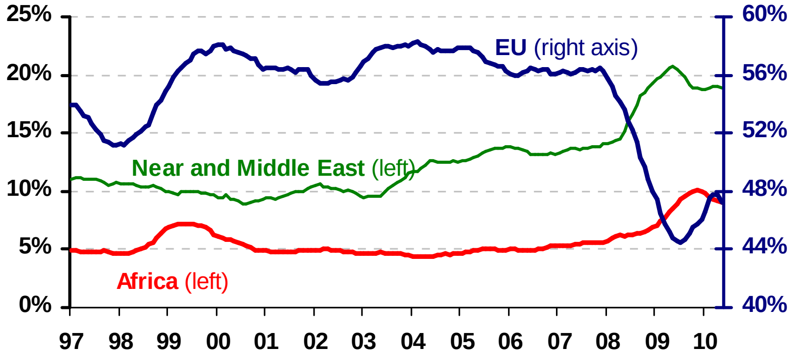


Figure 3: Private Consumption Spending Growth (QoQ)



- The ongoing economic problems in the EU have also taken its toll in Turkey's exports. The net exports took 5.3 percentage points off the headline GDP growth. However, the recent rebound in the EU exports and improving economic and financial conditions in the EU provide some relief for the next quarters (Figure 4).

Figure 4: Exports by Country Groups (%, 12M Rolled)



- Investment spending also seems to have quickly recovered from the crisis hang-over. Capital investment expanded by a whopping 14.4% in the first quarter (compared to the same quarter a year ago) but in annual terms (last four quarters) it was still down by 10.2%. Given that the private consumption is recovering quickly and external demand to correct further in the coming quarters in addition to low base effect, we should expect to see a secular growth trend in investment spending in the coming quarters.

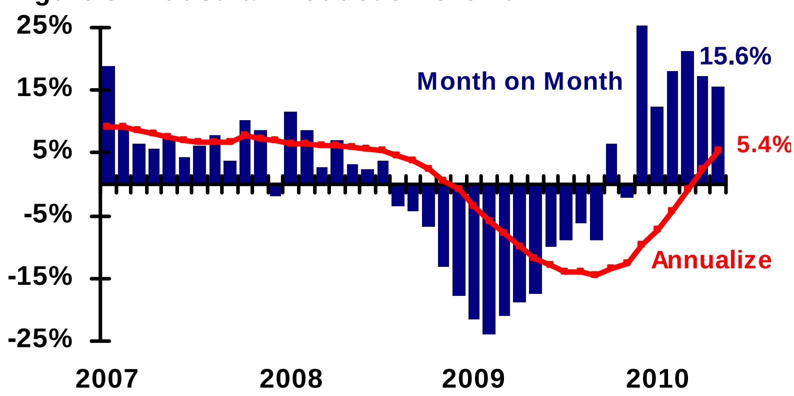
- In terms of the sectoral performance, agriculture and construction sectors are worth noting. The former was one of only two, together with financial intermediation, to mark positive growth consecutively in the last six quarters. However, the sector has surprised on the downside and contracted by 3.8% in Q1-2010. On the flip side, after eight consecutive quarters of contradiction, the construction sector has finally grown by 8%. Given the improvement in investment spending and the infancy of the mortgage sector in the country, one should expect this trend to continue in the next quarters.

In conclusion, we still keep our 4.5% growth estimate for 2010 and 5.8% for 2011, being less dovish than many in the sector. That means that 2010 growth will barely bring the economy back to its pre-crisis level of production (in real terms).

Industrial Production Expanded Again, Thanks to Low Base…

The economy has been recovering gradually and consistently since 2Q09. Industrial production expanded further by 16% in May compared to the same month a year ago (Figure 5). The realization came in line with consensus expectations.

Figure 5: Industrial Production Growth



The seasonally adjusted industrial production figures also depict a similar recovery as they are rising in a row since the beginning of year 2010. The recovery is across the board but more visible in those sectors serving domestic consumption rather than exports. Also, capacity utilization which correlates significantly with industrial production, for the reasons that may well be known, was on the rise as well recently, lending support to the growing perception that industrial production will likely display similar increases in June and July (Figure 5). It should be also noted that capacity utilization rate is at it's highest since the crisis and very close to the pre-crisis levels. While we believe that this is for now a product of closing the output gap and therefore not very interesting, it may begin to stimulate new fixed investment in the coming periods if continues at this rate (please refer to GDP section of this report).

In line with the strengthening production, business confidence has also risen well above the optimism threshold recently and continuing its ascent. Similarly, consumer confidence is also on the rise. Although it has surpassed pre-crisis levels lately it is nevertheless faring still below the optimism threshold. This outcome is well expected of course because it normally responds to a lasting and stable recovery in unemployment, which in turn responds with a long lag after recessions. We are likely to wait much longer to see that consumer confidence will exceed the threshold.

Figure 5: Industrial Production vs. Capacity

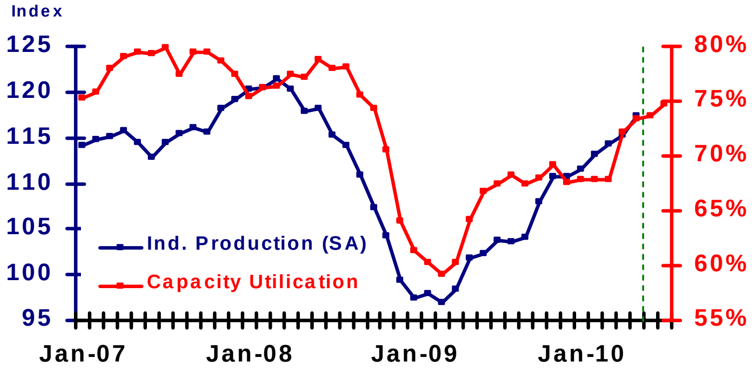
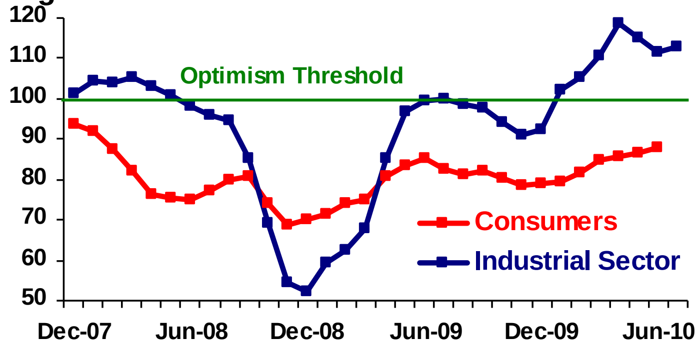


Figure 6: Confidence Indices

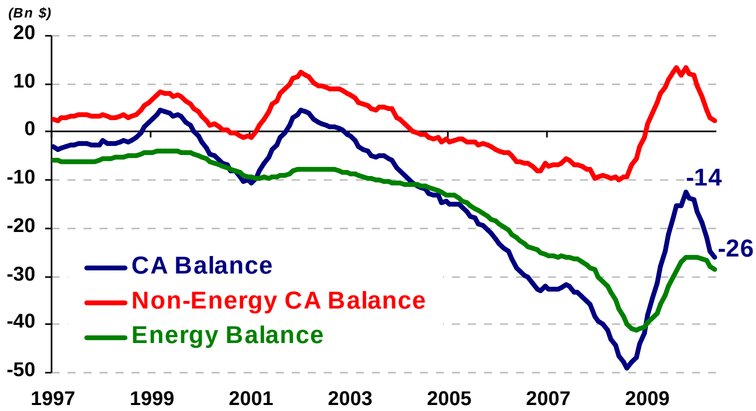


Current Account Deficit (CAD) is Widening…

The current account balance posted a $3 bn deficit in May, down from the $4.4bn deficit of April, but slightly above the $3.2 bn consensus estimate. Thus the deficit in the last twelve months has increased to $26 bn, which is corresponding to 3.8% of GDP compared to 2.2% at the end of 2009 (Figure 7). Rising strongly but still at mild levels, in other words.

There are two headline messages. The deficit is a result of the strong economic rebound from the crisis, not for example a result of a rise in commodity prices (Turkey is a commodity importer). This is clear from Figure 7 as it is non-energy balance that deteriorated more. It was the other way round in 2007 and 2008 when CAD was increasing dramatically given the spike in oil and energy prices. The other message is that the strong increase in CAD is mainly due to the fact that, while the economy is actually recovering faster than expected it has been relying more on domestic demand in doing so than exports.

Figure 7: The Current Account Balance



This 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 consist mostly of finished or consumption goods, she is especially vulnerable.

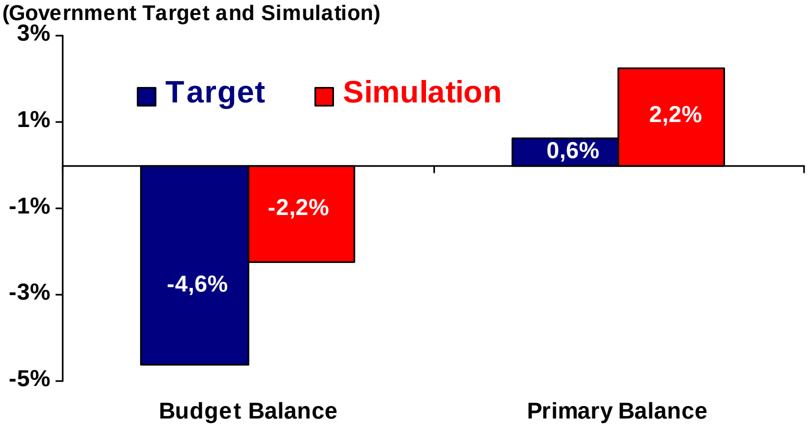
The quality of financing can be deemed satisfactory but not as quality as pre-crisis scenario. FDI has now fallen as a mere 7% of year to date total financing has come as a result of direct investment from abroad (FDI). For the first 5 months of the year net FDI was running at just $1.7bn, half the year earlier level which was already very depressed. Note that net FDI likely come in below $5 bn this year, which would be a mere 25%-30% of the highs of pre-crisis levels. None of this surprising, however, banking system has come to the end of foreign demand while privatization bowl of the government is not as full and attractive as before. The remaining 93% of the CAD financing has come mainly from government and bank borrowing from abroad.

Successful Budget Performance had Its Repercussions on Bond Yields

June central government budget data demonstrated that there is some increase in non-interest spending, mainly due to increase in social security transfers and local governments. However, mid year figures proved that yearly targets will likely to be outperformed mainly on the back of strong tax collection.

Given that half year performance is carried through the year-end, the revenues will exceed the targets by more than 2% while the expenditures will be 95% of the year-end target (but in the last two months of the year when the payables are realized and the caps are exhausted, figures deteriorate substantially as we know it). This means TL31 bn budget deficit compared to TL50 bn budget deficit target of the government. Given the GDP growth will also likely to exceed the 3.5% official estimate as announced in Medium Term Programme, budget deficit to GDP ratios are very likely to beat the targets (Figure 8).

Figure 8: 2010 Budget Balance to GDP Ratio
(Government Target and Simulation)

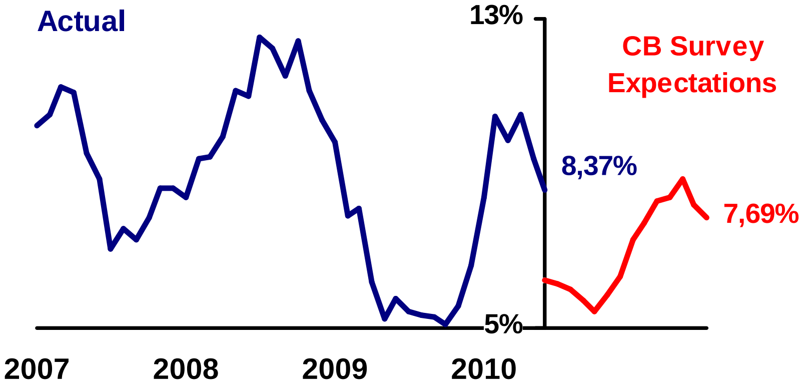


It should be highlighted that 2011 will be year of a general election such that budget performance may display a different picture in the second half of 2010. The renowned Fiscal Rule, on the other hand, is a strong policy anchor in this respect. In July, the government representative has announced that there is a risk the parliamentary approval of the fiscal rule is delayed to October. The market's reaction to the announcement was slightly negative since this delay could complicate the preparation process of next year's budget and could increase uncertainties over the future fiscal performance. Had the fiscal rule not approved in the Parliament in October 2010 and/or delayed to be starting from year 2012, the market reaction would have been strongly negative depending on the global liquidity conditions at the time.

Although the negative news concerning the Fiscal Rule, the benchmark government bond is trading at its historical lows due to: i- the encouraging outlook on public debt dynamics, ii- increasing global risk appetite, iii- local banks' interest in keeping their bond portfolios and iv- most importantly easing policy rate expectations. It is worth noting that the spread between the overnight funding rate and the benchmark bond yield -risk premium- has decreased below 170 bps at the end of July.

The Rate Hikes Will Not Start Before 2011

Figure 9: CPI and CPI Expectation (YE 2010)



The Central Bank of Turkey ("CBT") has published its third quarterly Inflation Report for 2010. As widely expected, the CBT revised down the YE 2010 inflation forecast to 7.5%, from 8.4%. The 0.9 percentage point (ppt) decrease in the CBT forecast mainly stemmed from the downward revision of the Bank in food (0.4 ppt) and oil (0.2 ppt) prices in addition to the weak external demand conditions (0.3 ppt). Similar to the CBT, the market's year-end inflation expectation is on the decline, albeit still slightly above the CBT forecast (Figure 9). The revision of the 2011 year-end forecast was limited (to 5.3% from 5.4%) compared to the 5.5% 2010 year-end inflation target. The 2012 inflation forecast was left at 5%, in line with the official target.

Despite the increase in risk premium during the second quarter of 2010, with the decline in inflation and strengthening expectations that policy rates will stay low for a long period, longer-term market interest rates continued on a downward trend and the yield curve flattened. The last Inflation Report has proved that the market's forecast is true in this respect, such that The CBT has explicitly stated to start tightening at earliest in 2011. In terms of the timing of tightening (or easing), four scenarios were outlined in the report:

1. **Baseline:** during 2011
2. **Longer-than-anticipated period of anemic growth in global economy:** towards the end of 2011
3. **Global economic problems intensify and negatively affect domestic economy:** new easing cycle
4. **Earlier-than-expected recovery in domestic economy:** earlier period during 2011

However, the CBT has also stated that if the composition of strong domestic demand and weak external demand continue as envisaged, and if this pattern of growth coexists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, than the CBT may bring forward the measures outlined in the exit strategy that are expected to be implemented until the end of 2010.

Moreover the CBT will monitor the fiscal developments, since successful fiscal discipline would provide the room to initiate countercyclical monetary policy. In this respect, should the fiscal discipline implemented through institutional and structural improvements, such as enacting and establishing the fiscal rule, it would be possible for the CBT to keep policy rates at single-digit levels over the medium term.

Banking

Loan Driven Asset Growth

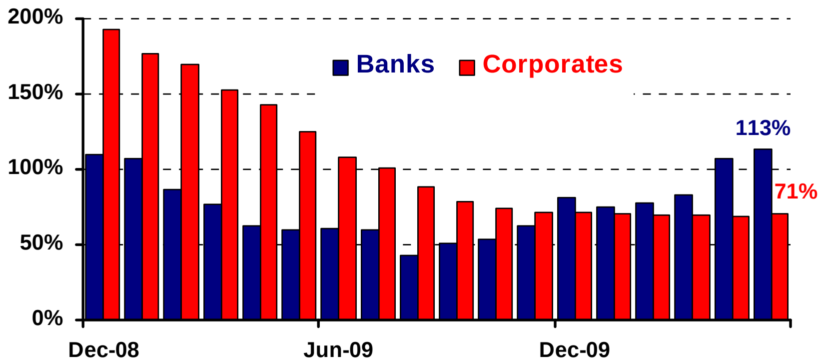
Year to date changes in the balance sheet of Turkish Banking System ("TBS") are presented in Table 1. Asset growth is loan driven, such that loans went up by a whopping TL60 bn while bonds went up only 4 bn;. This increase is almost equally divided between Corp.+Commercial, SME and Retail loans. It is surprising that Corp+Commercial loans are leading other loan segments. One factor behind this could be the banks' asset quality concerns. As explicit in Table 1, NPLs went down by a mere TL0.8 bn; in other words the recovery in the economy has its repercussions on NPLs with a lag.

Table 1: Δ *in BS of the TBS Year to Date, TL bn (19/07/2010)*

Assets		Liabilities	
Bonds	14	Deposits	50
Loans	60	Wholesale Funding	10
NPL	*-0,8*		
Corp.+Commercial	25		
SME	16		
Retail	19		
Mortgage	8		
Auto	0		
General Puspose	9		
Credit Card	3	Capital	9

Another factor would be the corporates' limited funding from abroad. As seen in Figure 10, the TBS' (medium and long term) foreign funding has quickly recovered in the aftermath of the crisis and the roll-over ratio surged above 100%. On the other hand, the corporates' rollover ratio was down to 70%, i.e. they are still net payers in foreign debt with a tenure longer than a year, and moving sideways around that level since then.

Figure 10: 12M Trailing Foreign Debt Rollover Ratios



On the funding side, although banks' foreign wholesale funding roll-over ratio has exceeded 100%, their main funding remains to be deposits, 87% of which is also in short-term time deposits in TL.

Enviable Profitability…

The TBS has increased its average monthly profitability by 50% following the crisis. In that respect the TBS has reached record high profitability mainly due to increasing spreads and favorable duration gap between assets and liabilities. These enabled the TBS to benefit from 1025 bps rate cut following the crisis. Since the spreads would likely to narrow during the normalization period following the crisis and the CBT was at the end of easing cycle and even likely to start hiking in 2010, the analysts were expecting the 2009 profitability to recede to some extend in 2010. However, as can be seen from Table 2, the first 5 months profitability has exceed the 5M profitability of last year by TL1.3 bn, which corresponds to 14%. The enviable profitability increase is mainly coming from TL1.8 bn decrease in NPL provisions in addition to banks' successful net interest margin management.

Table 2: Δ *in Income Statement**

Net Interest Income	0,2
NPL Provision	-1,8
Non-Interest Income	1,6
Non-Interest Expense	0,8
Trading+FX Income	-1,3
Net Income	1,3

* *First 5 months of 2009 vs. 2010*