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DenizBank Political & Economic Update

Turkey

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Referendum: Turkish Constitutional Reforms Passed by Wide Margin

Turkish voters approved a controversial package of constitutional reforms by a wide margin on Sunday, September 12th , the anniversary of the military coup in 1980. A very controversial date, indeed, when “anti-coup constitution” rhetoric of AKP is taken into consideration. 58% of the voters were in favor of the amendments that were proposed by the AKP (conservative right) while %42 woted “no”, consisting mostly of main opposition CHP (secular democratic) and MHP (nationalist) voters. The 77% turnout was slightly disappointing, perhaps due to the Ramadan Holiday, when compared to the previous elections’ 80%+ turnout.

The main takeaways from the Referendum are as follows:

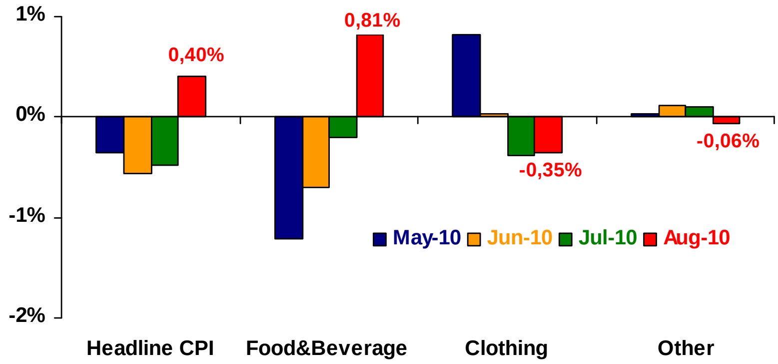
- The result could be argued as a “strong support” for the AKP (38% in 2009 local elections) such that even PM Erdogan had expect 53-55% ‘Yes’ votes just a few days prior to the Referendum. 58% support is signaling that AKP has not at least lost ground since the 2009 local elections. This is important because political analysts are arguing that in 2011 general elections the AKP needs at least 40% to continue to be a single party government.
- Moreover, if the AKP’s proposed constitutional changes were rejected, or even accepted by a slim margin such as 51%, this could have prompted early elections. Because, it would have then been perceived as a deterioration of the confidence in the governing AKP. The results also imply that general elections will likely be held on time in July next year (it might be brought forward a couple of months since elections are not usually undertaken in summer months).
- Although Mr. Kilicdaroglu, the new chairman of the CHP, has not had sufficient time to get organized for the referendum, he could be deemed successful for at least preserving the share of votes attained by his predecessor Baykal. As expected, the provinces on the Mediterranean and Aegean coast, such as İzmir and Antalya, together with Thrace, all being mainly CHP dominant provinces, voted against the package. On the flip side, the polls prior to the referendum were indicating that the CHP had increased its votes above 30% (23% in the 2009 local elections) with the new leader. The results showed that this is not the case and the CHP’s support is ranging in between 23% and 30%. In other words, the CHP with its new leader is still a question mark and likely to remain in opposition again in the 2011 general elections.
- The MHP (16% in 2009 local elections) on the other hand appears to have lost some of its voters to the AKP camp which had contributed significantly in the AKP’s clear victory. There was a resounding “yes vote” in some MHP strongholds such as Central Anatolia where the MHP runs the municipalities. The results signal that the MHP might be a victim of the %10 thresholds in the 2011 election. This would change all the political and parliament landscape in Turkey.
- The low participation rates in the predominantly Kurdish Southeast such as 9%, 23% ve 35% in Hakkari, Şırnak and Diyarbakır, respectively, indicates that the voters partially responded to the boycott call by the BDP (Kurdish Nationalist). But, it should also be noted here that the participation rate in Diyarbakir in 2007 elections was still low at 53%. The boycott call was not extremely strong in that respect.
- Interestingly, some cities in Southeast Anatolia (Kurdish Nationalists) and Central Anatolia (Turkish Nationalists) also voted strongly yes in the referendum supporting in fact the AKP. This might trigger/revitalize the AKP’s democratic initiative (of recognizing minorities further) through the general elections to be held in year 2011.
- The market’s reaction was positive to the referendum outcome of a “Yes” vote of 58%, since it can be interpreted as a solid confirmation that AKP’s single party government after 2011 elections is the most probable outcome, albeit one year horizon is a long run in Turkish politics and the political atmosphere could totally change.

In summary, the AKP remains the dominant political force while the CHP still offers uncertainty despite its new leader while the MHP is losing ground. The outcome decreases the probability of coalition government in July 2011 general elections, strengthening political stability anchor for Turkey.

Inflation Edged up in August, Though Temporarily…

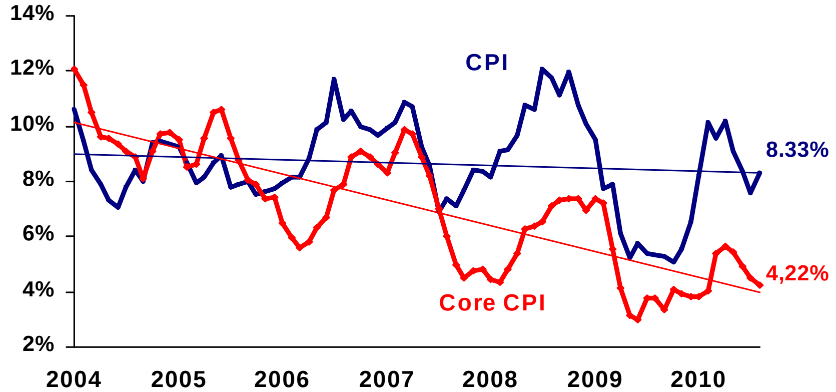
Annual inflation rose sharply in August to 8.3% from 7.6% in July, ending the secular downward trend that began in April 2010. Monthly increase of 0.4% exceeded the market expectation of 0.3%. The increase in food prices contributed a whopping 0.81% to the headline CPI (Figure 1). As stated in our previous report, the Central Bank of Turkey (CBT) was expecting the CPI to drift upwards for two months starting from August. This expectation stemmed from the fact that in Ramadan months, demand seasonally revives and food prices increase in Turkey. However, the rise in unprocessed food prices, mainly vegetables and fruits, showed that current increase in food prices were mostly due to adverse weather conditions. The Ramadan effect might be more visible starting from September.

Figure1: Contribution of Main Expenditure Groups (Last 4 Months)



Barring food prices, the inflation subgroups depict a benign outlook. That was also visible in the core inflation indices such that out of 9 core indices, only three indices which contain food prices went up, while the remaining six fell down. In line with this, the most famous core index is still depicting a favorable outlook, reflecting a strong disinflationary trend (Figure 2). In its latest Monetary Policy Meeting Minutes, the CBT has reiterated that inflation would increase temporarily in the short term before reverting back to a declining path by the last quarter of the year. The Committee has assessed that conditions are appropriate to gradually implement the measures outlined in the exit strategy as envisaged. However, there are risks, mainly related to capital inflows or global economy that could necessitate bringing forward or delaying the measures outlined in the exit strategy. Surprisingly, the CBT has explicitly stated in its recent minutes that should problems in the global economy further intensify, thereby increasing the possibility of a domestic recession, a new easing cycle may be considered. Yet the markets are aware of the fact that downward movement in policy rates is limited. The benchmark bond market did not react to the mentioned statement at all.

Figure 2: Headline and Core Inflation

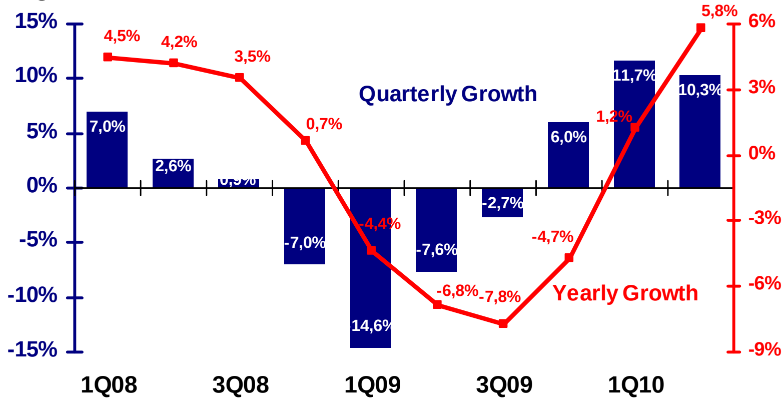


All in all, the inflation outlook for the remainder of 2010 and 2011 is fairly benign given that: **i-** the pace of economic growth has moderated, **ii-** it will take some time for the external sector to recover to the pre-crisis levels and propel growth, **iii-** .the TL is and likely to remain strong, and **iv-** energy and other input prices are expected to remain stable amid global slowdown.

One of the Best Growth Performance Among Emerging Economies

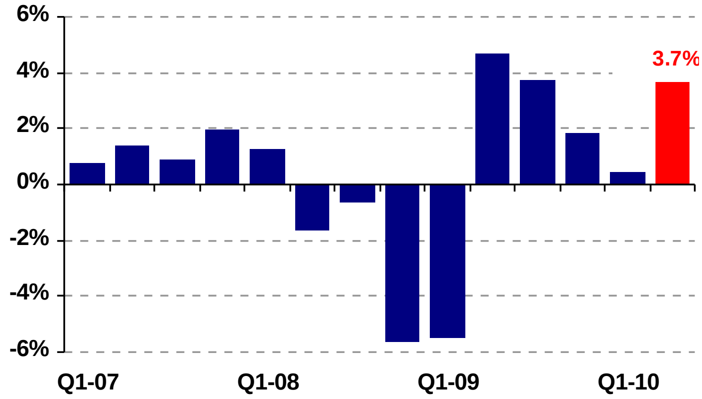
Turkey's Q2-2010 GDP growth at 10.3% was well above the market expectations of 9% (Figure 3), raising the annual growth rate to 5.8%. That is an outstanding rebound from the 4.7% contraction last year. When we look at the major emerging economies' GDP growth rates in the second quarter, Turkey ranks fourth with China at 10.3% following Singapore (18.8%), Taiwan (12.5%), and Peru (11.9%). Some of this strong growth is surely attributed to the low base effect, as it was the case in the previous four quarters. On the bright side however, the seasonally and working day adjusted performance is still very strong at 3.7% from the previous quarter. That was especially important after sequential deceleration in the previous three quarters (Figure 4).

Figure 3: GDP Growth



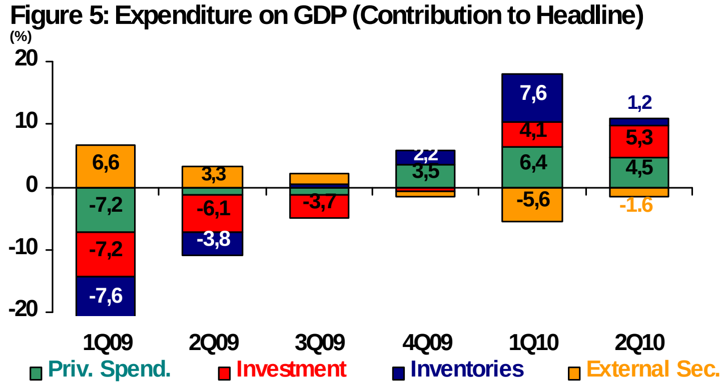
Similar to the previous two quarters, private consumption has gone up by a strong 6.2% QoQ, contributing to the headline GDP by a massive 4.5% (Figure 5). On the flip side, government consumption was up by a mere 4% QoQ, after strong average contribution to the GDP in the previous five quarters. Looking 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.

Figure 4: GDP Growth (Seasonally Adjusted)



Investment spending also seems to have quickly recovered from the crisis hang-over. Machinery investment of the private sector surged by 25% and 37% in the last two quarters (compared to the same quarter a year ago) respectively, carrying yearly growth rate to 5.3% from a decline of 22% at the end of 2009. Similarly, construction investment of the private sector is the hype of the late, such that last two quarters' growth has topped 20%, bringing yearly growth rate to 23%. Given that the private consumption is recovering quickly and external demand to correct further in addition to the low base effect, we should expect to see a secular growth trend in investment spending in the coming quarters. Additionally, as will detailed later, the government will likely to speed up infrastructure based investment spending, ahead of the elections, which is -5% on yearly terms, in the remainder of 2010. Hence, this will also support the GDP growth performance in the next quarters.

Figure 5: Expenditure on GDP (Contribution to Headline)



In terms of the sectoral performance, every single sector made a positive contribution to the headline growth, as it was the case in the previous quarter (Figure 8). Construction sector is especially worth noting. After eight consecutive quarters of contraction, it has finally grown by 8% and 22% in the last two quarters, respectively. Given the improvement in investment spending, the low base effect (yearly growth is still at -0.1%) and the infancy of the mortgage sector in the country, one should expect this trend to continue in the next quarters.

In conclusion, thanks to strong growth especially in terms of seasonally adjusted terms, we increase our growth estimate for 2010 to 6.5% from 4.5% and 5.8% for 2011. That is still less dovish than some in the sector such that the S&P has recently raised its growth expectation in 2010 above 8%.

However, the Leading Indicators are Depicting Less Favorable Outlook for the Next Quarters

Industrial production went up by a strong 8.6% in July, yet the pace of growth is decelerating gradually. The realization was slightly better than the market's expectation of 8% but it was good enough to pull the annual pace of growth into the positive territory (Figure 6). The step by step deceleration is stemming from the fact that low base effect is gradually fading out. This trend is strengthening our view that industrial production has lost momentum in the second half of 2010. This is more visible in seasonally and working day adjusted industrial production figures. After the sequential growth of eight successive months, industrial production went down by a strong 2.2% in June, and moved sideways in July (Figure 7).

Also, the data for capacity utilization in the manufacturing industry points to a weaker performance in August than in July, with capacity utilization rates falling to 73.4% (5.2 pps higher than in August 2009 and 4.7 pps lower than in August 2008) from a recent peak of 74.7% in July (Figure 7). The importance of industrial production is more noticeable in Figures 8 and 9. The manufacturing sector has contributed 4.9 and 3.8 pps to the headline growth in the recent two quarters. On the other hand, industrial production is losing pace and the current trend will take its toll on the next quarter's GDP outturn.

The slowdown in economic activity is even more visible in the confidence indicators of the reel sector and the consumers. The real sector confidence slid by 1.5% in August; the deterioration is more evident given that the index has gone down by a huge 6.6% since April 2010. Similarly, consumer confidence slipped by 0.6% in July; the first monthly decrease since November 2009.

Figure 6: Industrial Production Growth

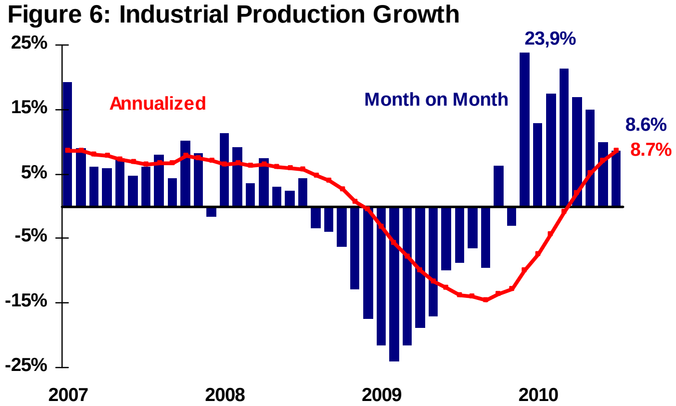


Figure 7: Industrial Production vs. Capacity Utilization

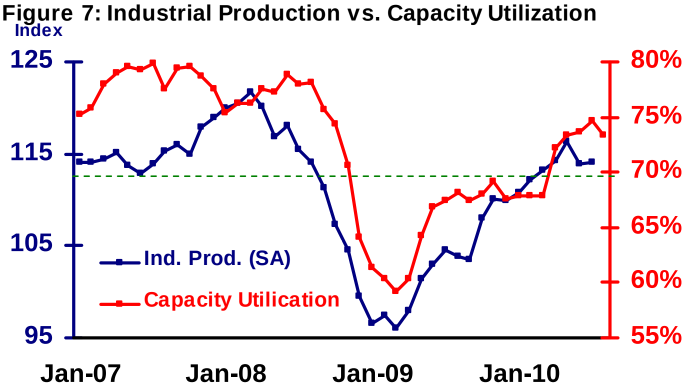
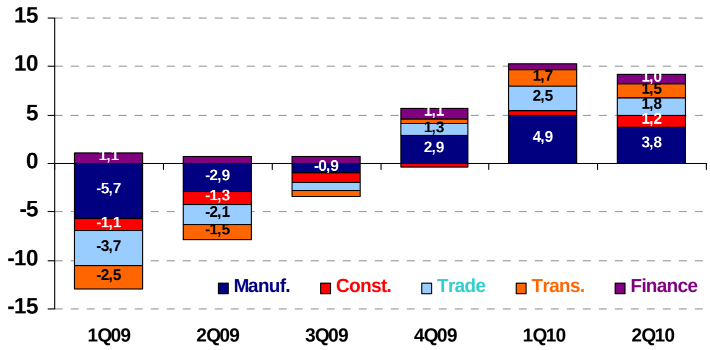


Figure 8: Production on GDP (Contribution to Headline)



The Budget: So far so Good…but Elections?

The budget performance in July and August combined has been released, showing the continuation of stellar performance. That was extremely important amid the discussions regarding the delay of the fiscal rule to an uncertain future date, most probably beyond the elections of July next year. 12M trailing budget deficit has decelerated to TL35 bn from TL53 bn a year ago. TL18 bn improvement is stemming from a decrease in interest rates (TL7 bn) and robust tax and non-tax revenues. Higher than expected economic growth was certainly very supportive.

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

	Aug-09 One Month	Aug-10 One Month	Nominal Change (%)	Aug-09 YtD	Aug-10 YtD	Nominal Change (%)	Aug-09 12M Rolling	Aug-10 12M Rolling	Nominal Change (%)
Expenditures	24	23	-2%	172	183	7%	255	279	9%
Non-Interest	15	20	30%	131	148	13%	201	231	15%
Personnel	4.4	4.9	11%	38	42	11%	54	60	11%
Goods&Serv. Purch.	2.3	2.2	-2%	15	15	-2%	26	29	12%
Current Transfers	6.4	7.6	18%	60	67	11%	86	99	15%
Cap. Spen. (Inv)	1.3	2.8	116%	8	10	28%	19	22	18%
Interest	8.1	3.1	-61%	41	35	-13%	55	48	-13%
Total Revenues	22.0	26.3	19%	140	169	20%	202	244	20%
Tax Revenues	19.3	23.2	20%	113	139	23%	165	198	20%
Income Tax	3.6	4.3	19%	26	27	4%	38	40	3%
VAT	2.5	3.2	28%	13	17	28%	19	25	32%
Special Cons. Tax	4.1	5.4	33%	28	36	31%	42	52	25%
VAT on Imports	2.2	3.2	48%	16	23	40%	25	33	29%
Budget Balance	-1.5	3.1	N/A	-31	-14	-54%	-53	-35	-33%
Primary Balance	6.5	6.2	-5%	9	21	127%	2	13	584%

Given that the budget deficit target of the Medium Term Programme of the Government was TL50 bn for 2010, the year-to-date performance is likely to exceed the target. However, the biggest question mark is whether the fiscal discipline will be maintained through the next year's election. According to the Economy Minister, the government is planning to stay in line with the TL50 bn deficit target, meaning that non-interest expenditures which rose moderately thus far in 2010 will surge in the last four months of the year (Figure 10).

As the CBT was able to decrease TL interest rates in real terms dramatically after 2008, providing the economy with the chance to grow at its potential and attract foreign investment, the government should prioritize fiscal discipline to crowd in the private sector. The recent performance was good but the primary budget surplus was nonetheless well below pre-crisis level (Figure 11). Any deterioration in fiscal discipline would cost much, since Turkey does not have any strong anchor like a stand-by agreement with the IMF. The details of what the government is planning in fiscal side will likely to be clarified within the new Medium Term Program, to be unveiled in the next couple of weeks.

Figure 10: Tax Rev. vs. Non Int. Exp. Increase (12M Rolling)

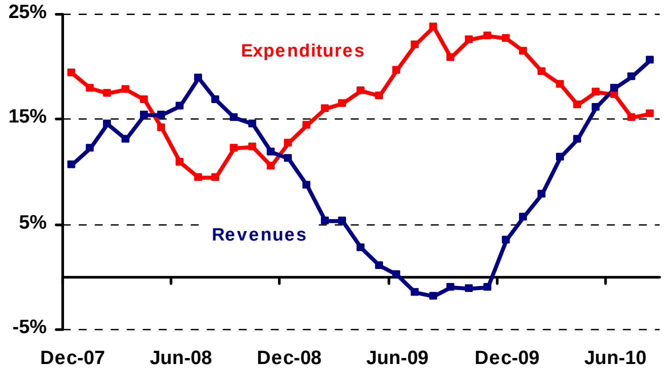
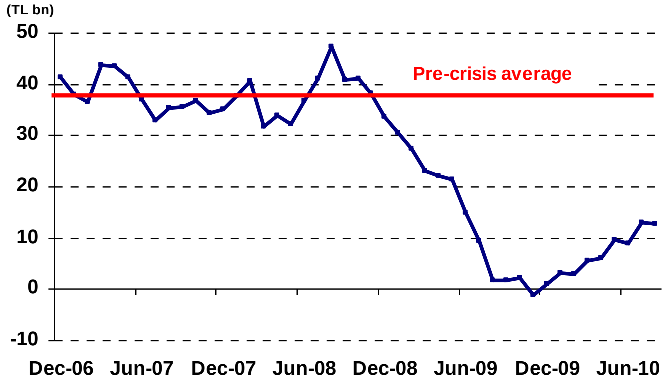


Figure 11: Primary Balance (12M Trailing)



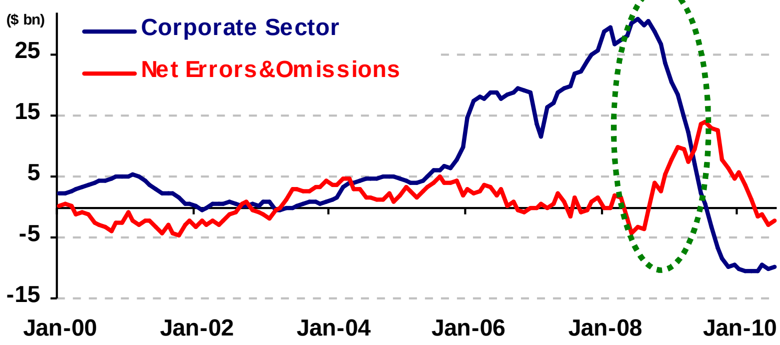
Industrial Sector

The Crisis Took its Toll in the Firm's Profits and Sales in 2009

Istanbul Chamber of Industry (ISO) has recently published Turkey's Top 500 Industrial Firms (ISO-500) year 2009 results. It was eye-catching among analysts that while the total sales went down by a strong 13% on yearly terms, net income went up by a strong 34%. Analyzing the results further yields the following:

1- Higher capital use: The businesses found it increasingly more difficult and expensive to borrow especially from abroad during the recent global crisis. They decreased their external borrowing while repatriating part of their funds abroad (used as collateral for borrowing) to the country. As result, the external debt to total liabilities ratio diminished to 51% in 2009 from 54% in the previous year. The net errors and omissions giving unknown capital movements in and out of the country in the balance of payments which topped $13 bn since the crisis begins also implied this capital repatriation (Figure 12).

Figure 12: Corp. Sector For. Borrowing and Net Errors&Omis.(12M Trailing)



2- Lower interest expenses: The businesses paid much less in interest expense in 2009 thanks to the dramatic decrease in TL (and also foreign currency) interest rates. Following the crisis the Central Bank of Turkey ("the CBT") has lowered the policy rate from 16.75% to 7%, corresponding to 1025 bps rate cut. The banking sector has trimmed loan interest rates in parallel to the policy rates. This decrease had its repercussions in interest expenses of the corporate sector.

3- Rise in productivity: As it was highlighted in our previous reports, the companies in Turkey have substantial crisis experience. Following the enormous financial and economic problems developing abroad and fearing repercussions domestically, the companies quickly responded by slashing idle workforce, such that total workforce decelerated from 544K in 2008 to 516K in 2009. Also, the fall in energy and many other raw material costs resulted in strong declines in the cost of goods sold (most of these are imported but the TL depreciation was much less). To put this effect into perspective, we calculated that the S&P GS commodity index went down by 47% when compared to the pre-crisis levels.

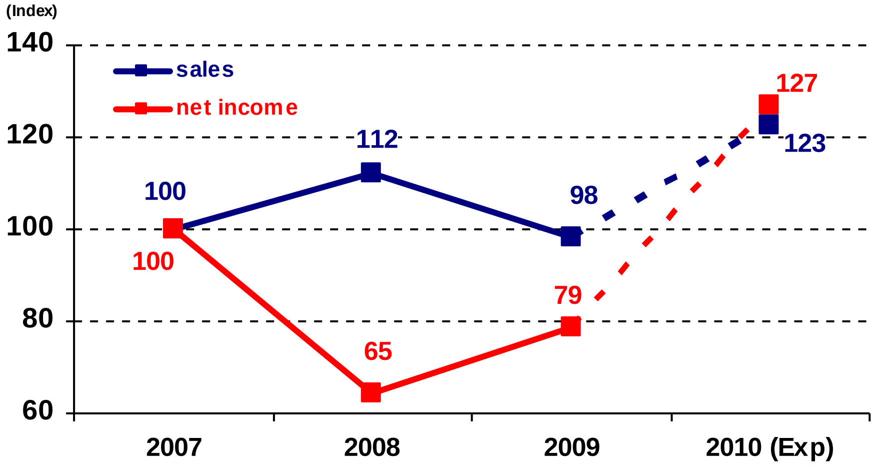
4- Window dressing: When the global crisis took its toll in the last quarter of 2008, the companies have carried over some portion of their profits to next year. The general view of the corporate sector and also of the banking sector in the first few months of the crisis was such that the global crisis it would take years for the private sector to return pre-crisis profitability as it was the case after the 2001 crisis. They therefore may have decided to defer some of the 2008 profits to the following year.

5- FX Income / FX Loss: The industrial sector had around $79 bn open FX position before the crisis and it did not change at all, standing at $82 bn as of 03/2010. Following the crisis starting in September 2008, the $/TL parity depreciated by 19% boosting companies' debt repayment in TL. In other words, the companies' profitability was hit due to TL depreciation. The effect of the short FX position on the non-financial companies listed on the ISE (Istanbul Stock Exchange) also confirms this. As expected, the ISE companies provisioned TL5.9 bn FX loss in 2008, corresponding to 60% of the total net income.

…but 2010 will Be Better a Year

Based on the reasons above, especially the last one, the net income has tumbled in 2008. But then the companies have recovered some portion of their losses in 2009, albeit still well below the 2007 level. The sales, on the other hand, were adversely affected by the crisis especially in year 2009. As a consequence, in terms of sales and net income, the companies are still performing below 2007 levels. The deterioration in net income is especially noteworthy.

Figure 13: ISO Top 500 Firms



In an aim to forecast ISO 500 performance in 2010, we worked on the performance of Istanbul Stock Exchange (ISE) non-financial companies for the financial term ending June 2010. In the last three years ISE companies' financials moved in tandem with ISO-500. In that respect, given that first 6 months performance will prevail in the remainder of 2010, 2010 ISO-500 performance in terms of sales and net income will be much better than that of both 2007 and 2009.