November 2010

DenizBank Economic Update

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Latest Developments in Politics

"Turban" Again Tops The Political Agenda: The Turban (a type of headscarf symbolizing Islam) controversy was revived in the media recently after the leader of the leftist CHP, the main opposition party and top army officers preferred not to participate in the renown Republic Day Reception in protest of the First Lady's wearing a turban in the reception. As is well known, top military officers in Turkey oppose the turban for it is perceived to be defying the secular establishment, which have deep roots in the foundation of the Republic of Turkey. Instead, the military held an alternative reception of its own arguing that First Lady can not wear the turban because the official reception is held on state premises where wearing the turban is prohibited by the Law. On the other hand, CHP's new leader Mr. Kilicdaroglu, restrained himself in making hawkish comments about the controversy regarding it as totally her personal preference. It was revealing that the CHP's leader did so given the CHP's hard core stance in turban issue.

CHP Goes Through a Major Change: Mr. Kilicdaroglu, the CHP leader, saw it necessary to make changes in the governing council as he struggles to transform the party from a so-called "state party" to a "party of the people". The biggest obstacle against this kind of radical change was Mr. Onder Sav, the veteran secretary general, with deep roots in the CHP thanks to his 50 year career in the party. He naturally belonged to the old school and represented a very conservative stance on issues such as secularism, the turban issue and the democratic initiative in Southeast Anatolia, while Mr. Kilicdaroglu planned to change these orthodox thoughts radically through "the new CHP." It is likely to be the only way for the CHP to extend its share of votes beyond 25% in the next elections to be held on June 2011.

To serve the purpose, Mr. Kilicdaroglu recently replaced Mr. Sav with Suheyl Batum, a young academician who was selected as a CHP delegate in May 2010. Other old school representatives in the governing council also were replaced with new faces. Following the appointments, the CHP began to show signs of new policy initiatives. For example, Mr. Kilicdaroglu has recently come together with Iraqi President Jalal Talabani in the Socialist International convention in Paris. The ex-CHP leader had protested Mr. Talabani last year due to the Kurdish issue in Turkey. After returning from France, Mr. Kilicdaroglu visited Diyarbakir in Southeast Anatolia in an aim to draw his road map for an alternative to the governing AKP's democratic initiative in the region. It was the first visit by a CHP leader in the region after years.

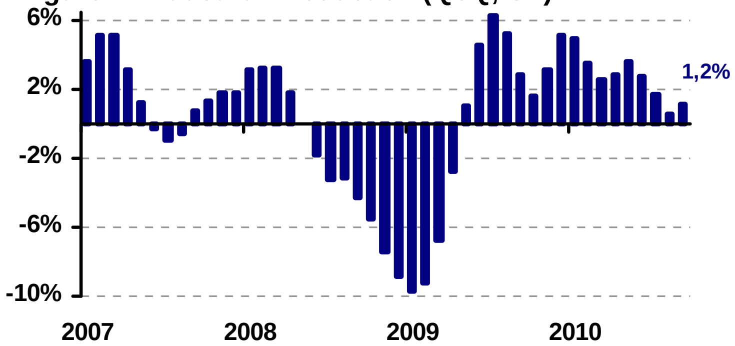
Suicide Bomber Has Links to the PKK: A suicide bomber targeted the police forces in the center of Istanbul on Sunday, September 31st, during the Republic Day commemorations. He tried to board a police bus and blew himself up next to it when he failed to do so. 30 police officers were injured. It was first the terrorist group PKK, listed as a terrorist organization by both the European Union and the US, to be pointed as the prime suspect for the attack although it had initiated a unilateral ceasefire until the day of the attack. To defy the beliefs that this was how the PKK ended the ceasefire, it announced an extension of the ceasefire until after the national elections next June. Nonetheless the TAK, a group which has direct links to the PKK, claimed responsibility for the suicide bombing.

President Gul Declared Turkey's Commitment to the EU: Abdullah Gul, Turkey's president has emphasized his country's long-term commitment to joining the European Union by stating that Ankara would make sure it meets all standards required for membership, even though large parts of its entry negotiations are still frozen. Turkey began the EU accession negotiations in 2005 but was thus far able to open only 13 chapters out of 35 and close only one, which was on science. Most of the chapters are blocked either by the EU as a whole, by the Greek Cypriot-led government of Cyprus and by France. Although the president did not name names in criticizing the EU attitude towards Turkey, he complained that some "short-sighted" EU countries had hidden behind the Greek Cypriots to pursue their own objectives of delaying Turkey's membership bid. He also acknowledged that the close relationship with Middle East countries of late was in line with the rising importance of the East in global economic and politics rather than the search of a new strategic alliance other than the EU. He confirmed that Ankara has not yet lost its enthusiasm about joining EU as a full membership.

Third Quarter Performance Beats Expectations

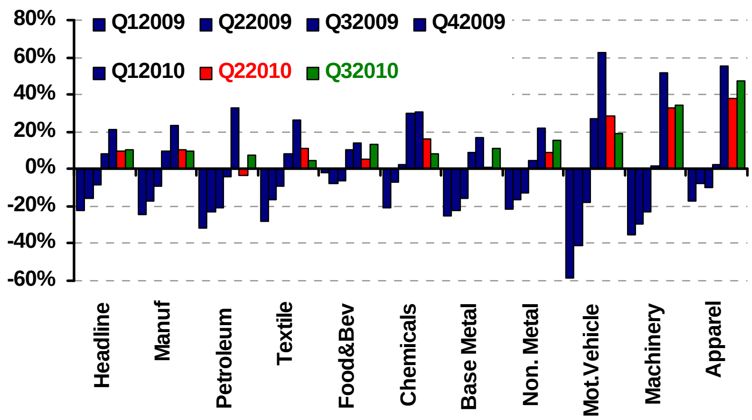
Although, the seasonally adjusted industrial production index went down by a minor 0.4% in September on a monthly basis, it was still up by 1.2% in the third quarter on a 3 month basis (last vs. previous three months). The latter was also higher than the 0.6% rise in the June through August period (vs. March through May, Figure 1). The outlook is favorable also in sectoral performance such that six out of ten major sectors composing the industrial production index, have performed better in the third quarter compared to the previous one (Figure 2).

Figure 1: Industrial Production (QoQ, SA)



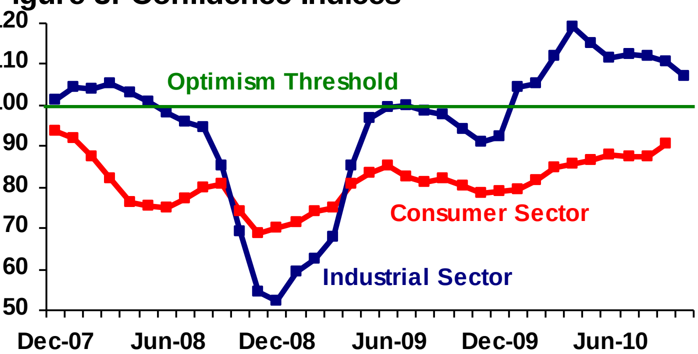
Moreover, the capacity utilization rate, the leading indicator for the industrial production and the GDP, has jumped to 75.3% in October, the highest level since the crisis began in the last quarter of 2008. It then rose even further in November hitting 75.9%. These are signaling that the underlying trend in industrial production will remain strong as we roll into 2011. Diving deep in the details, the biggest rise was in the food and beverage sector, which jumped from 69% to 75%. To put it into perspective, 2007-2008 average of food and beverage capacity utilization was 73%, which is another indication of the strength of domestic demand, yet far from creating inflationary pressures.

Figure 2: Industrial Production: Sectoral Performance



Last but not least, the consumer confidence index has surged above 90, the highest level since the January 2008, lending support to our view that the growth prospects are promising on the back of strong robust internal demand conditions. While the decelerating trend in industrial sector's confidence index appears worrisome, it is still moving around 110, well above the pre crisis average of 101. Also, the details show that main reason for deteriorating business confidence stems from insufficient export demand. As is known, the EU is the main export market of Turkey, and the economic malaise and the lackluster demand conditions prevailing in the region is putting pressure on Turkey's exports. As the EU comes closer to improve domestic demand back to the pre-crisis levels, hopefully before too long, Turkey's fast growth will also be more balanced as internal demand will be accompanied by faster growth in exports.

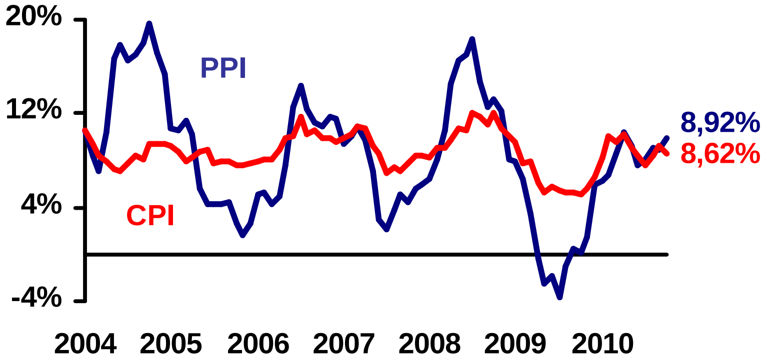
Figure 3: Confidence Indices



Food Prices are Still Rising, but Core Inflation is More Than Satisfactory

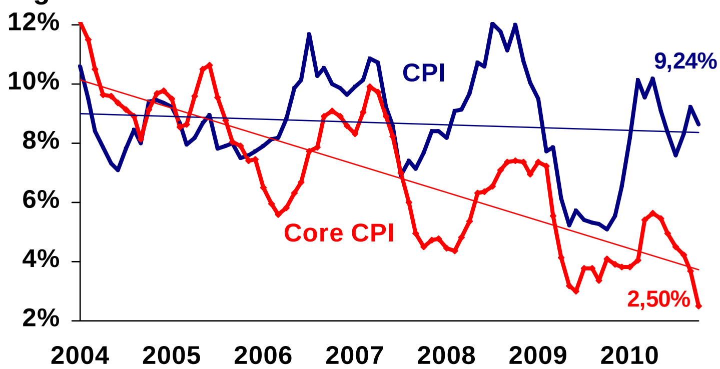
In October, consumer inflation was up by 1.83%, compared unfavorably with 1.30% consensus estimate. But since inflation in October last year was even higher, annual inflation was down to 8.6% from 9.2% (Figure 4). As it was also the case in the previous months, the non-food price increase, barring the seasonal rise in clothing prices, was limited. The increase in food prices was substantial such that it contributed a whopping 1.25 pps to the 1.83% inflation. Looking at the past 12 months, the headline went up by 8.6%, while food and beverage prices surged by a strong 17.1%, almost twice the size of the headline.

Figure 4: Annual Inflation



The headline at 8.6% is of course still high. But, the core inflation indices are still drifting lower, on the bright side. The Central Bank of Turkey's (CBT) favorite core index (CPI excluding food and beverage, energy and alcohol) has come down to the historic low of 2.5% in October. In its latest inflation report, the CBT kept year-end forecast the same at 7.5%, compared to our call of 8% despite the upward pressure on food prices. The CBT has also stated that the aggregate demand conditions, especially the external ones unsurprisingly, would continue to support disinflation for a while. Therefore, the inflation will likely to follow a downward trend in the next two years and will be in line with the medium term targets by mid-2011.

Figure 5: Headline and Core Inflation



Given the benign inflation outlook, the CBT has stated that should the global economy face a longer-than-anticipated period of anemic growth, the monetary tightening envisaged during the final quarter of 2011 under the baseline scenario may be postponed. Moreover, an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity may trigger a new easing cycle.

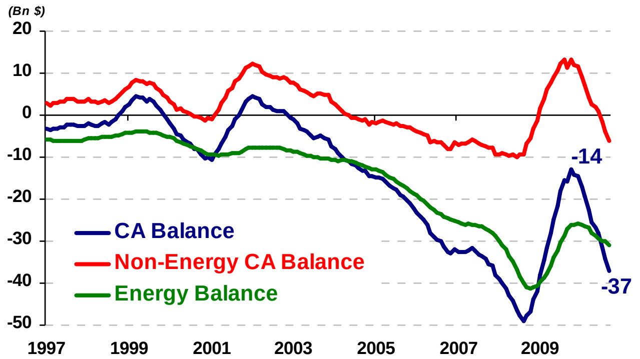
On the other hand, as a part of its exit strategy, the CBT has increased TL reserve requirement ratio to 6% or to the level before the global crisis, from 5.5%. It had also ceased paying interest on the required reserves. As per our calculations, the new regulations will cost the banks around 6% of their annual revenue in 2011.

The second significant monetary policy move was in the O/N interest rates. As is known, the CBT has made the weekly repo rate its policy rate, which is 7% since May 2010, instead of the Bank's O/N borrowing rate. Because the latter was meaningless in the sense that the system was short in cash and the Bank was funding the system as a whole not borrowing from it. But when the Bank switched to the weekly repo rate as the policy rate, the O/N borrowing rate remained very close to it at 6.5% needing a downward revision. After pulling it down to 5.75 in gradual moves, the CBT went for a hefty one-off decrease of 400 bps to 1.75% in November. While another gradual cut was expected, the size of 400 bps was shocking to many. It was widely interpreted as a sort of capital control in the sense that by making overnight TL parking in the CBT low yielding the Bank would be discouraging short-term inflows, which would not prefer to take a bank risk but the CBT in taking advantage of a significant carry trade in TL O/N. The Bank also revealed its worry of the substantial rise in the current deficit thanks to such speculative inflows.

Current Account Deficit is Still Rising

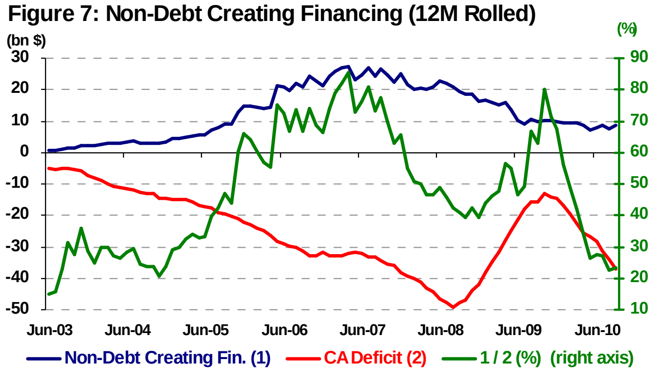
The current account balance posted a $4.1 bn deficit in September, up from the $3.5 bn average monthly deficit year to date, and above $3.6 bn consensus deficit estimate for September. Hence, the deficit in the last twelve months has increased to $32 bn; and $37 bn in terms of 12 months rolling, compared favorably with the government's $39 bn deficit estimate for 2010. However, given the acceleration in monthly trend of current account deficit (CAD), year end figure is very likely to exceed $40 bn. Yet, the year-end CAD to GDP ratio estimated around 5.4% is still below the pre-crisis levels of 6%. The following point out to the risks of the CAD rising even further:

Figure 6: The Current Account Balance



1- Non-energy CAD is still increasing, close to historical high: As seen in Figure 6, the non-energy CAD was at its historical high of $10 bn just before the global crisis began in August 2008. Due to the rapid deterioration in CA balance in year 2010 especially, the non-energy CAD has risen to $6.2 in September from non-energy current account surplus of $1.1 just three months ago. Based on its current trend, the non energy CAD is likely to exceed $10 bn, the historically highest level, at the end of this year.

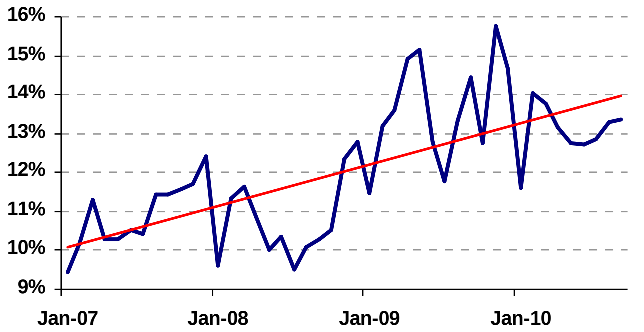
Figure 7: Non-Debt Creating Financing (12M Rolled)



Moreover, should the recent quantitative easing of the FED and the other central banks in the pipeline is to increase oil prices further, the CAD deficit would rise even further. The oil price projections in the government's CAD forecasts mentioned above are $80, $82 and $83 in the next three years, respectively, which means that the official CAD estimates would have to change following such possible rises in oil prices.

2- The quality of financing is still worsening: Speculative portfolio inflows and bank borrowing are strong, but FDI is still weak, such that 12 months rolling $5.1 bn is showing a massive 47% plunge compared the same period in 2009, the time the FDI was also extremely depressed due to global crisis. The 12M rolling September figure is the lowest one since October 2005. The related parties should focus on the reasons why FDI does not prefer Turkey despite the 22% surge in the global M&A activities in the first nine months of 2010 compared to last year while speculative money inflows do. Privatization could come to the rescue as usual such that compared to $2.5 bn privatization revenue in 2010, the Medium Term Program (MTP) envisages $7.5 bn privatization revenues on average in the next three years. On the flip side, given that the average 12M trailing FDI was $22 bn in the pre-crisis period, the authorities have to do much more to make Turkey a popular FDI destination again. Additionally, a broader measure of FDI, non-debt creating financing (FDI + equity investment) to CAD ratio also deteriorated to 2004 levels (Figure 7).

Figure 8: Consumption Goods Imports Share in Total Imports



3- Export Growth is weak: The ongoing economic problems in the EU have also taken its toll in Turkey's exports weakening its support in the current account balance. EU exports made up 58% of Turkey's total exports before the crisis. It decreased to as low as 44% in June 2009 but then started to crawl back up. However, due to the recent second phase of sovereign debt crisis in the EU, the increasing trend has rebounded in May 2010. Accordingly, the ratio is a mere 47% as of September 2010.

4- Strong internal demand to exacerbate the CAD problem: According to the first ten months data, the annualized increase in retail loans is a whopping 34% which is one of primary reasons boosting imports. The strength of internal demand is also visible in the share of consumption goods imports. As seen in Figure 8, the consumption goods imports to total imports ratio has recently risen to the 13% to 14% range from around 10% before the crisis. In an aim to diminish internal demand, the deposit reserve requirement was increased to 6%. As per our calculations, this will increase the breakeven deposit rate by 40 bps. Moreover, the CBT has stated that should the current state of robust internal demand persists, the reserve requirement ratio would be increased further, and will likely to do so, in our opinion. In parallel to the CBT, the government has also taken some steps to curb internal demand. Resource Utilization Support Fund (KKDF) on consumer loans, barring the mortgage loans, was raised to 15% from 10%. Moreover, we can state that the CBT's recent move to increase its FX purchases would serve to reduce strong internal demand through weaker TL.

To sum it up, the CAD is on the rise showing that the economy is growing handsomely in response to the hefty capital inflow. While the authorities resorted to stabilize inflows rather than reining the economic growth in the last decade, they have recently begun to question the level of the CAD is rising to rather than the quality of inflows. The eyes have turned to restraining loan growth in the banking system (the main channel of FX inflows) as one possible measure of curbing the rise in the CAD further.

Benign Budget Performance

The year to date primary balance has jumped to $18 bn in September from $5 bn in the same period last year. Although it is a stellar performance, 12 month trailing primary balance is still well below pre-crisis average (Figure 9). Similarly, 12M trailing budget deficit has decelerated to TL33 bn from TL62 bn a year ago. TL29 bn improvement is mainly stemming from a decrease in interest rates (TL13bn) and robust tax and non-tax revenues. Plus, a higher than expected economic growth was certainly very supportive.

According to our public debt projections through 2014, the interest expense to GDP ratio will gradually decelerate to 2% from its 6% before the recent global crisis (Figure 10). That is the paradigm shift for both Turkey's budget dynamics and public indebtedness. This will help Turkey to lower its debt to GDP ratio from current 42% to 29% in 2014. That was the main reason why Turkey's rating was upgraded by all major rating agencies in the epicenter of the global crisis (two notches by Fitch, one notch by Moody's and S&P). Fitch, rating Turkey one notch below investment grade, is likely to raise Turkey in investment grade in 2011.

Figure 9: Primary Balance (12M Trailing)

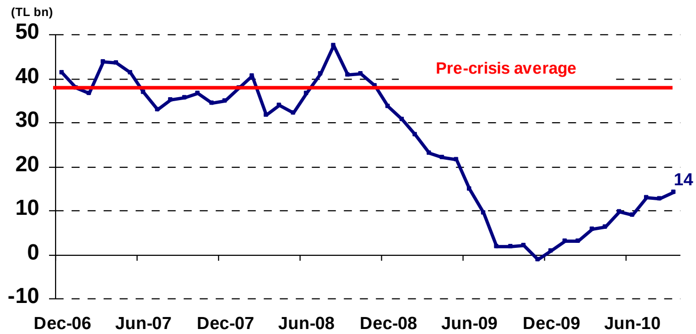
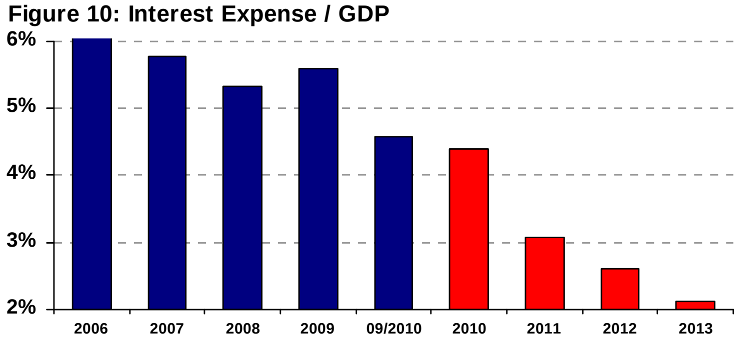


Figure 10: Interest Expense / GDP



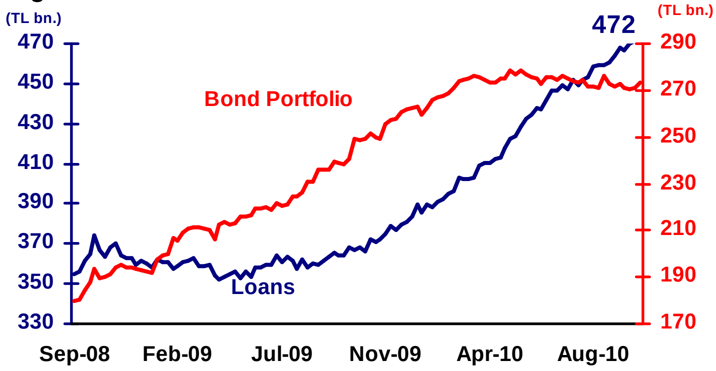
Banking

The Main Takeaways From Recent Trends in Turkish Banking System

As per the BRSA weekly data as of the end of October 2010 and monthly data as of September 2010, the main highlights were as follows:

1- Loans: The annualized increase (based on the first 10 month data) in loans is an enormous 27% in 2010, compared to 8% in 2009 (Figure 11). The retail loans, with its 35% annualized increase, is especially eye-catching. The SME loans are the hype of the late and the annualized increase is substantially high 41%, yet some portion of it is primarily due to low base effect of the pull back of the yesteryear. This increase in loans is mainly stemming from two reasons. The first one is the strong internal demand as described above. The second one is the improving asset quality, encouraging banks to lend more. The regulators attempted to curb loan demand through increasing the reserve requirement ratio, ceasing interest payments on the TL deposit requirements and increasing the tax rate on consumer loans (barring mortgage loans) in the last two months. If we do not see any strong moderation in loan increase, more restrictive measures may come.

Figure 11: Bonds and Loans



2- NPLs: The authorities' recent move to curb loans is questionable in effectiveness. Because, as long as the NPL ratio continues to diminish continuing its current trend, banks' appetite to lend more will rise further. Currently, the NPL ratio is 4.4%, 1.1 pps higher than pre-crisis levels, but it is much lower than the 5.8% of a year before. Our simulation denotes that the year-end NPL ratio is likely to ease to 4.2%.

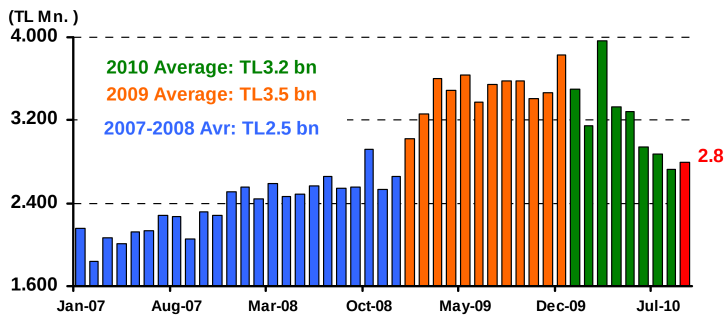
Table 1: NPL Breakdown

(Bn TL)	26.12.2008	31.12.2009	29.10.2010	YtD Change
Total Loans	343	390	476	22,3%
NPL	13,2	21,7	20,8	-3,9%
NPL Ratio	3,8%	5,6%	4,4%	0,0%
Corp.+Comm. +SME Loans	229	260	314	20,9%
NPL	8,9	13,4	13,0	-3,0%
NPL Ratio	3,9%	5,2%	4,1%	0,0%
Retail Loans	81	93	120	28,9%
NPL	1,9	4,0	3,7	-7,5%
NPL Ratio	2,3%	4,3%	3,1%	0,0%
Credit Cards	33	36	42	15,3%
NPL	2,4	4,3	4,1	-3,5%
NPL Ratio	7,4%	11,8%	9,9%	

3- Deposits: Compared to the loans' whopping 27% annualized increase, total deposits (annualized) went up by a humble 16%. The gap was bridged by the rise in wholesale funding from abroad (thanks to the rise in the confidence in the country's banks by foreign creditors). While the biggest portion of the deposit increase has come from TL time deposits reflecting the reverse currency substitution the recent revaluation in TL are also prompting depositors to switch to FX deposits lately.

4- Profitability: According to the September 2010 consolidated banking P&L figures released by the BRSA, net interest income of the sector is slowing down to pre-crisis levels on the back of decelerating interest income from especially the government bonds which is reflecting the end of easing in government bond yields (Figure 12).

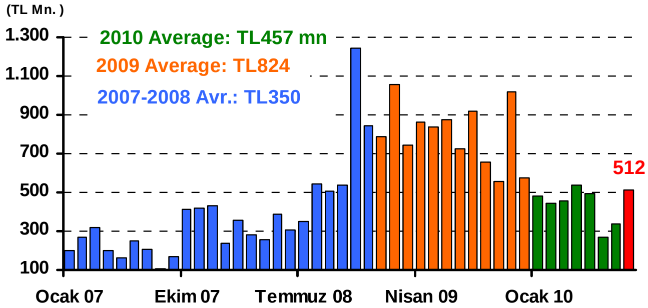
Figure 12: Net Interest Income



Banking

Additionally, due to the recent deceleration in the CPI linker bonds, some percentage of the negative performance would be gauged as temporary. Additionally, since the CPI linkers have gained their losses in the fourth quarter, we will see this effect to bounce back starting from October.

Figure 13: NPL Provisions (Monthly)



On the flip side, thanks to the declining NPL provisions (Figure 13) and robust commission income, the monthly net profit has posted TL1.9 bn, carrying H1-2010 profitability to TL16.9 bn, corresponding to 7% growth compared to first nine months of 2009. Looking forward, it is obvious that net interest income will continue to decrease gradually mainly due to the diminishing support from government bonds and spreads in general. In such an atmosphere, it is important for banks to increase their lending volumes substantially in an aim to preserve their robust profitability. As a result, we can conclude that this year's profitability is expected to be flat vs. last year. As far as next year is concerned, we think that it will be more difficult to preserve the stellar profitability levels of 2009 and 2010.