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DenizBank Economic Update

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DenizBank

DEXIA

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

Post Referendum Agenda

The constitutional referendum that took place last month in Turkey demonstrated that even after seven years in office, the AKP remains on the side of change that gets strong support from the Turkish people irrespective of their political parties. While the AKP support is currently around 40% according to the polls, the support to the AKP's constitutional change was a whopping 58%. Following the referendum, domestic agenda was full of new discussion topics. We would like to summarize the most important ones in the four headings below:

1- Turban (Islamic Headscarf) Debate: We should not ignore that the ideological divergence, especially the one between Islamic conservatives (mainly AKP supporters) and secularists (mainly CHP supporters), became more apparent within society in the post referendum environment. The controversial turban issue (a type of headscarf representing Islamic values) is again on the agenda. As it is known, it has been one of the most debated issues in Turkey in the last three decades. The Turkish constitution restricts the use of turban particularly in public areas including schools. Islamists attack the issue as an impediment to democracy in the sense that it forces female students to compromise on their religious beliefs to get education. Secularists on the other hand, regards it as an inevitable feature of modernized Turkey (claiming that there are such restrictions even in most democratic countries). With the dominance of the AKP in Turkish politics in the last decade the issue is hot again. A change in the constitution which has been more possible after the latest referendum may pave the way for Islamists to allow Turban in the schools. In fact, students who wear turbans are ignored in many universities today, contrary to the past, as almost all political parties are fine with it. The CHP, the staunchest opposition to turban, has also changed its view, with its new leader. But the secularists are still wary about its spreading to lower ranks of education and other state institutions. To remove the ban in universities officially, opposition parties have asked the AKP to declare that there is not a new regulation in the pipeline which will pave the way for permitting headscarves in primary and high schools in addition to public works (such as doctors, teachers, etc.) Although there was not a clear answer from the AKP to this question, the general tendency is likely support further changes related to turban in the coming days.

2- Changing the Structure of Legal Bodies: It is well known that previous attempts of AKP to lift headscarf ban since 2002 was blocked by the Constitutional Court, ruling that removing the ban was against the founding principles of the constitution. Moreover, the highest court's decision to uphold the headscarf ban cannot be appealed. Majority members of the Constitutional Court and the Supreme Board of Judges and Prosecutors (HSYK) were strong supporters of secularist state in the eye of publicity. The most hotly discussed changes in the recent referendum pertain to the structure of the two key institutions of the Turkish judicial system: The Constitutional Court and the High Council of Judges and Public Prosecutors. According to the new amendments, the Constitutional Court will have 17 members instead of its current 11, and the Turkish Grand Assembly will be able to choose three members to the Court from among the candidates proposed by the independent bar associations. Such changes in the legal bodies will likely to pave the way for further changes like removal of headscarf ban in the near future. There may be more changes in the constitution than these given the more collaborative approach of the CHP after the referendum.

3- Approaching 2011 General Elections: The results of the referendum have boosted the morale of the AKP leadership and its supporters while doing the opposite to the CHP (secularists) and the MHP (nationalists), the parties in opposition. Especially, the alarm bells might be ringing for CHP's newly elected leader, Mr. Kilicdaroglu as the woes against him have mounted recently. However, the referendum results do not necessarily demonstrate a close association with the outcome of the general elections because the referendum was mostly about a change in the constitution many secularists and nationalists also supported. Therefore, drawing far-reaching conclusions from the referendum results about the approaching 2011 general elections should be avoided. One year horizon is long enough in Turkish politics for the political atmosphere to change completely.

4- A solution to the Kurdish Issue Gaining Momentum: Some Kurdish dominated regions in Turkey also voted strongly 'Yes' in the referendum supporting in fact the AKP's drive for a democratic initiative (of recognizing minorities further). This might trigger/revitalize the AKP's efforts after the general elections if they remain in sole power. They also announced plans to pursue a peace plan in that regard. Accordingly, the Kurdish terrorist organization PKK also extended its bilateral ceasefire.

Inflation is rising, but no Need to Worry…

Inflation in September surprised the markets on the upside and annual inflation rose sharply to 9.2% from 8.3% in July (Figure 1). The Central Bank ("CBT") was not uneasy about the sharp rise mainly because it was a result of a significant jump in food prices, similar to the previous month, contributing a whopping 1.3% to the headline CPI (Figure 2). The Bank reiterated in the minutes of September meeting that it expected the upsurge to be temporary and the annual inflation to revert back on its downward trend by October. We agree with the CBT's inflation trajectory largely because of the following:

1- The effects of the holy month of Ramadan on food prices were visible in August and September. Starting from October following Ramadan, food price increases should moderate. Additionally, barring food prices, the sectors with inelastic prices such as services and housing also depict a benign outlook.

2- The TL has strengthened by a strong 12% since June 2010 and most of the appreciation took place within the past one month. Therefore, its disinflationary impact is yet to be seen as the pass-through will be reflected in prices after September. Moreover, the recent rally in the TL as well as many other major emerging currencies likely to continue through the year end, supporting the disinflationary trend further.

3 - Domestic demand is recovering, but still remains below the pre-crisis levels. Both consumer confidence and consumption goods imports are on the rise but gradually. Employment conditions are still far from supporting a robust domestic demand despite its recent improvement. Additionally, external demand is not only weak but also has a negative outlook given the persistent structural problems in the EU, Turkey's main export market. All these imply that inflation is less likely to be a headache in the remainder of the year.

4- Observing all this dynamics, the markets also keep their expectations tame for future inflation, such that compared to 9.2% CPI inflation, 12 months forward CPI inflation expectation is still 7.1% and on the decrease recently (Figure 3).

Figure 1: Yearly CPI&PPI

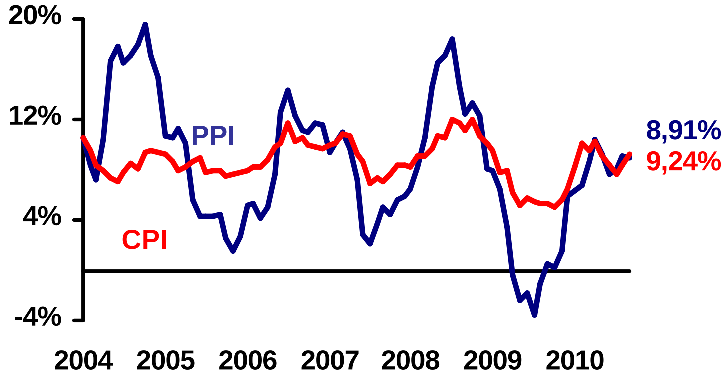


Figure 2: Contribution of Main Expenditure Groups

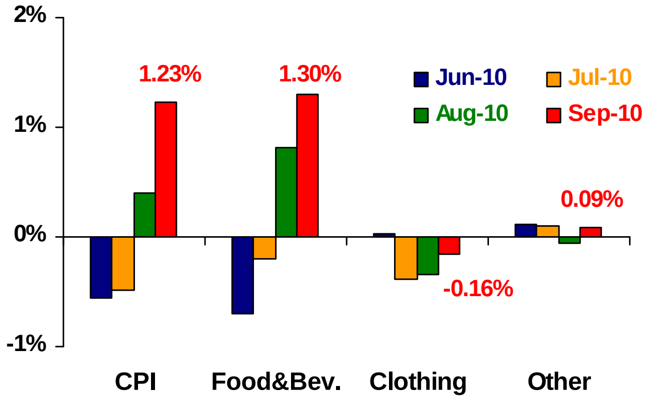
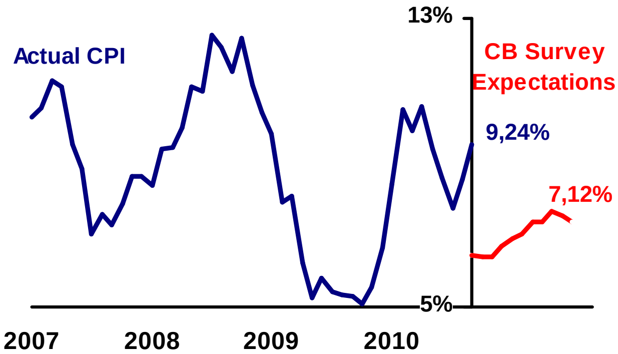


Figure 3: CPI and CPI Expectation (12M Fw)



5- Base effect will also be supportive starting from October. While the average monthly CPI inflation was 0.24% in the first nine months of 2009, it had jumped to 1.4% in the last quarter of 2009.

6- Core inflation, excluding food and energy, is still trending downwards, showing that the recent rise in CPI inflation is due to seasonal and temporary factors like food prices (Figure 4).

Last but not the least; the Turkish CPI has recently diverged from that of the 10 major emerging economies[1]. It had mostly moved in tandem with the group in the past while reverting soon back to i during the rare and brief periods it had diverged, e.g. in 2007. A similar performance would not be surprising this time as well.

Euphoria in the Local Markets

The recent performance of the currency, stock and bond markets are eye-popping. The TL has gone up by a strong 6% in the last two weeks against the USD, such that the TL/USD parity has eased to 1.42 from 1.52. True, the USD weakened across the board among almost all major currencies but the strong appreciation vis a vis the TL was mainly related to ballooning foreign inflows to Turkey. In response, the CBT decided to increase its FX purchases, which had been up to $80 bn thus far. The CBT upped the ante now buying an additional $300 bn on weekly basis. The mentioned policy change is not instrumental in changing the direction of TL/USD at least for now. Looking at the other developed or emerging country examples including Japan, Switzerland and Brazil, it is not difficult to say the CBT's policy also will have a minimal effect on the TL's appreciation in the future. On the bright side, however, the new policy will help the CBT to bolster its $80 bn of total reserves more quickly. Given that Turkey has underperformed its peers in terms of FX reserves accumulation since 2006, the new policy may also be aimed at reversing this trend (Figure 6).

Figure 4: Headline and Core Inflation

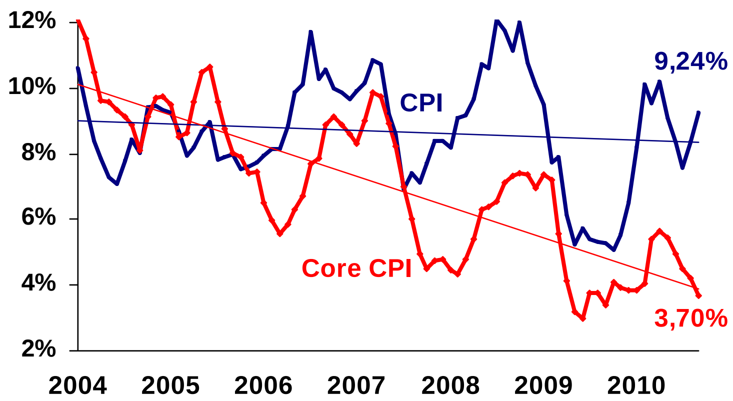


Figure 5: Turkey CPI vs EM CPI

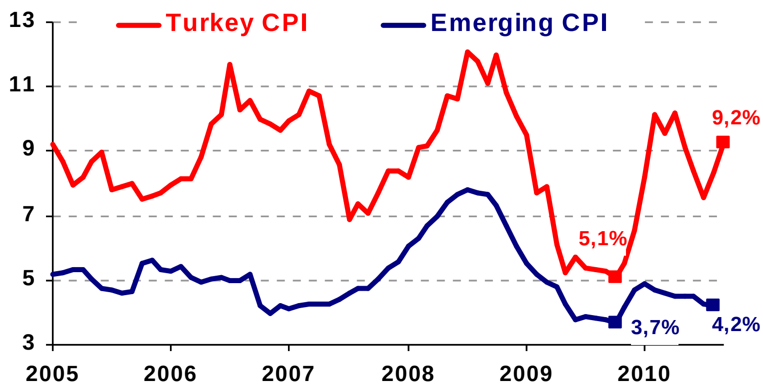


Figure 6: Turkey's FX Reserves / Global FX Reserves

[1] Brazil, China, India, Russia, Czech Rep., Hungary, Poland, Indonesia, the Philippines and Malaysia CPI arithmetic average.

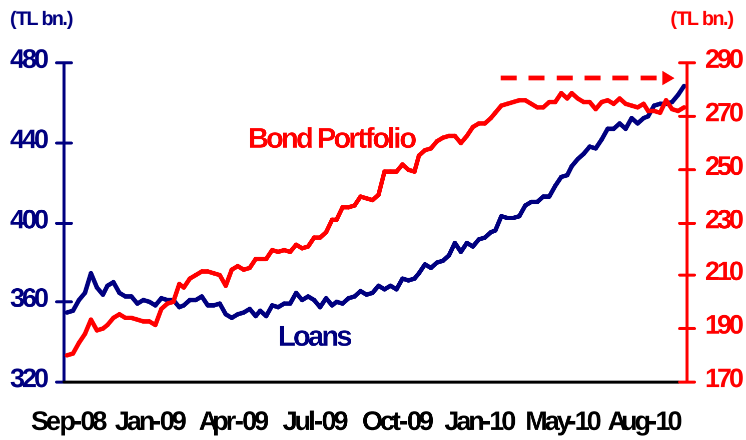
Economy

Similar to the TL, the domestic bond market has also benefited strongly from the foreign inflows. Thanks to the recent recent rally, the compounded yield of the benchmark T-bond has decelerated to 7.75%, which is very close to the all time low of 7.59%. We envisage this trend to continue, albeit more slowly, mainly due to five factors:

1- Given the developed (safe haven) economies' T-bond yields such as those of the US and Germany which are at their historical lows below 1%, Turkey benefits significantly from the global search for yield. Turkish sovereigns offer as high as 7.75% for the 2 year benchmark while the CDS spreads signal low risk having decelerated to 130 bps, a historical low.

2- Turkey is also on a very benign rating trajectory offering a story of a possible rating upgrade to investment grade. Currently Turkey is rated one notch below investment grade by Fitch and two notches below by Moody's and S&P which just recently raised Turkey's outlook to positive in October. Given the ambitious budget targets of the government, it is quite likely that another round of rating hikes is very close.

Figure 7: Turkey CPI vs EM CPI



3- Additionally, as outlined in the recent Medium Term Programme (MTP), the government debt to GDP ratio is envisaged to gradually drop to 37% from 47% as of today in year 2013. The MTP plans to decrease the central government deficit to 1.6% of GDP from 4.0% in the next four years. Interestingly, this is a stronger adjustment than what the fiscal rule would require. And more interestingly, the fiscal adjustment is projected to stem mainly from spending cuts. "More interestingly" because, as we know the general elections will be held in June 2011 and the former Turkish governments would usually prefer lax spending budget plans in the period before elections. Furthermore, our calculations based on fiscal rule framework starting from 2014; show that debt to GDP ratio could decelerate around 20% in year 2020.

4- As we gave the full detail in our previous report, the outcome of the referendum decreases the probability of a coalition government in July 2011 general elections, strengthening political stability anchor for Turkey.

5- Last but not least, the banks, the main and captive buyer of the government bonds, are still in a position to support the bond market. They have returned to the wholesale funding market to fund their new lending which lowers the urgency to decrease their bond portfolio which has not been reduced drastically indeed despite the relentless increase in new lending recently (Figure 7).

Growth Figures Have Surprised on the Upside

August industrial production ("IP") growth of 11% YoY was well above the consensus of 8% (Figure 8) that the working day and seasonally adjusted IP went up by a strong 2.7% on a monthly basis was even more striking after a lackluster growth in June and July. This marked the fourth biggest monthly growth since the beginning of 2005.

In terms of sectoral performance, the highest monthly jump was mostly in the export oriented sectors such as apparel and motor vehicle manufacturing.

The August IP outturn after all was a surprise. Because, the leading indicators, including August and September capacity utilization and OECD leading indicators, had signaled that economic growth was slowing down. Also, not only Turkey, but other EM's IP[2] has already been gradually decelerating since April 2010 (Figure 9). To sum up, August IP was a good one, but both internal and external indicators are implying that it may be a one-off performance. Starting from September, we are likely to see gradual deceleration in IP.

In the Medium Term Program, the Government has raised 2010 growth target to 6.8% from previous 3.5%. For the following three years, the growth targets are set at 4.5%, 5% and 5.5%, respectively. The revised targets are very close to DenizBank estimates (Figure 10). Similarly, 6.8% growth forecast implies that the government expects GDP growth to decelerate strongly in the last quarter of 2010.

Figure 8: Industrial Production Growth

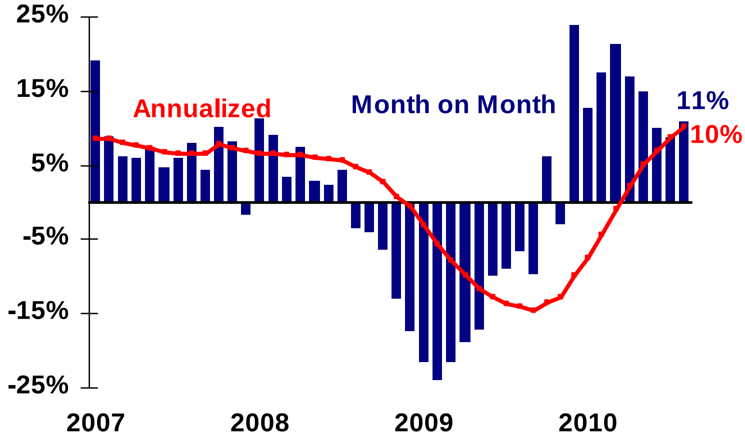


Figure 9: Turkey IP vs EM IP

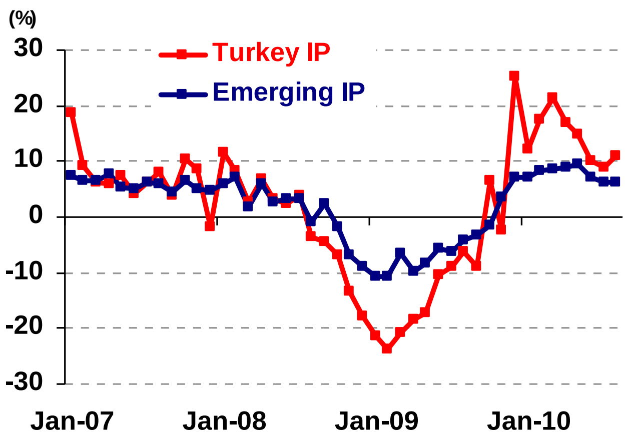
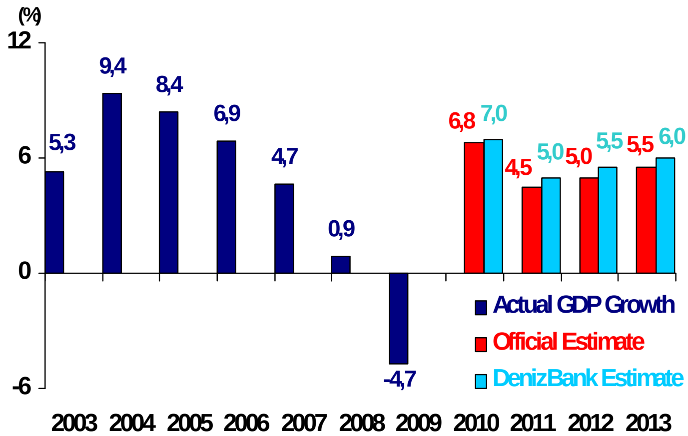


Figure 10: GDP Projections



[2] Brazil, India, Russia, Czech Rep., Hungary, Poland, Indonesia, Philippines and Malaysia CPI arithmetic avarage.

Current Account Deficit (CAD) is Widening…

Table 1: The Balance of Payments

Mn. $	2009 August	2010 August	% *Incr.*	2009 YtD	2010 YtD	% *Incr.*	2009 12M Trailing	2010 12M Trailing	% *Incr.*
Current Account	**-609**	**-2.966**	***387,0%***	**-8.735**	**-27.978**	***220,3%***	**-15.663**	**-33.645**	***114,8%***
Foreign Trade	-3.876	-5.735	*48,0%*	-14.737	-32.037	*117,4%*	-26.136	-42.192	*61,4%*
Services	3.658	2.965	*-18,9%*	10.365	8.223	*-20,7%*	16.551	14.163	*-14,4%*
Income	-555	-316	*-43,1%*	-5.585	-4.938	*-11,6%*	-8.090	-7.467	*-7,7%*
Current Transfers	164	120	*-26,8%*	1.222	774	*-36,7%*	2.012	1.851	*-8,0%*
Capital&Fin. Account	**1.180**	**1.801**	***52,6%***	**3.025**	**26.826**	***786,8%***	**2.547**	**33.562**	***1217,7%***
FDI	866	771	*-11,0%*	5.336	4.148	*-22,3%*	10.260	5.691	*-44,5%*
Portfolio Investment	725	3.010	*315,2%*	1.598	13.805	*763,9%*	-4.765	12.403	*-360,3%*
Other Investment	2.330	1.372	*-41,1%*	-4.547	18.906	-	-7.311	26.250	-
Reserve Assets	-2.741	-3.352	-	638	-10.033	-	4.363	-10.782	-
Net Errors&Omissions	**-571**	**1.165**	**-**	**5.710**	**1.152**	**-**	**13.116**	**83**	**-**

The current account balance posted a $3 bn deficit in May, down from an average deficit of $3.5 bn a month year to date, but slightly above the $2.6 bn consensus deficit estimate. Thus the CAD in the last twelve months increased to $34 bn, which corresponds to around 5% of GDP compared to 2.2% at the end of 2009. The recently released Medium Term Programme provides an estimate of $39 bn CAD for the whole of 2010, which corresponds to 5.4% of the estimated 2010 YE GDP. Based on the first eight month performance, the 2010 targets look feasible. As we know, the main component of CAD is the trade gap which is the result of a boost in imports thanks to greater reliance on domestic demand than exports given the problems in the export markets. Looking forward, the future trajectory of exports and imports looks achievable in the MTP. On the flip side, however, oil prices are projected to remain stable between $80-83 in the next three years which may easily be wide off the mark given the quantitative easing efforts in developed economies boosting commodity prices in general.

While the CAD is on the rise, its financing has also deteriorated in quality. Foreign direct investment (FDI) has now fallen to a mere 11% of total inflows year-to-date. For the first 8 months of the year net FDI was depressed at just $4.1 bn (Figure 11). Most of the financing appears to come through speculative flows going into bond and stock markets given their recent record highs as well as bank

Figure 11: Foreign Capital Inflows into Turkey (2010 is YtD)

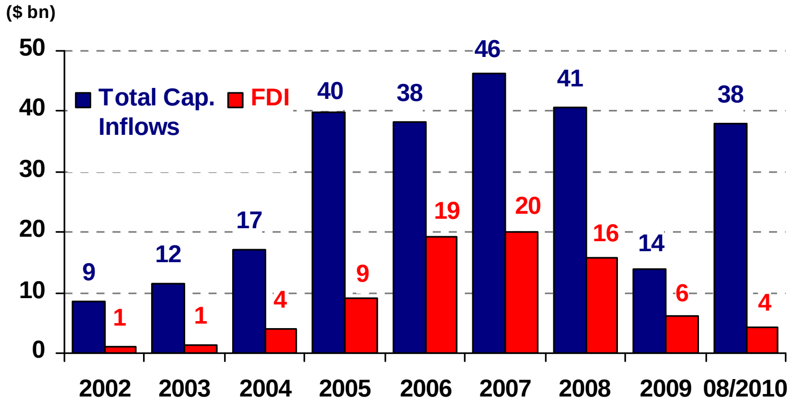
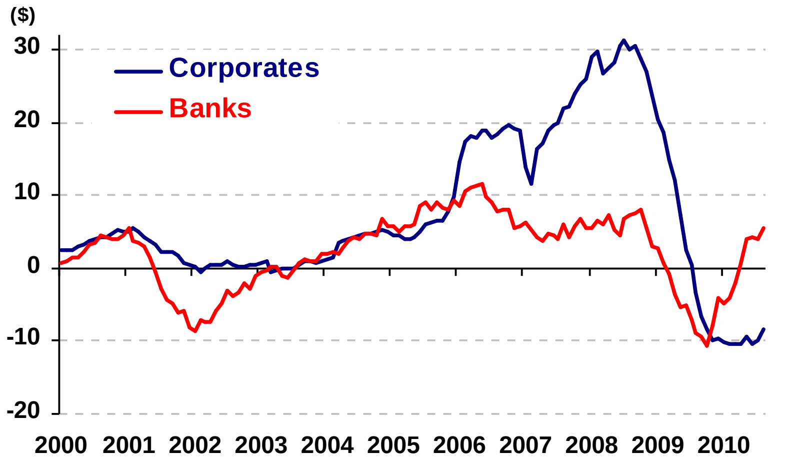


Figure 12: Foreign Debt Flow (12M Trailing, $ bn)



borrowing. Real sector borrowing has also stabilized recently while still being net payers of foreign debt in terms of 12M trailing figures (Figure 12). The switching of corporates to domestic borrowing in foreign currency rather than from abroad was also instrumental given the change in the old regulation restricting company borrowing in foreign currency within the country.

FDI prospects may improve in the near future if privatization comes to the rescue as projected by the MTP. It envisages an average of $7.5 bn annual privatization revenues in the next three years compared to the weak $2.5 bn of privatization revenue in 2010. It thus far appears to be focusing on the energy and infrastructure investment. Given that numerous plans including electricity and gas distributions, electricity generation assets and state banks are in the privatization pipeline, the projected privatization revenues look doable. What is more, banks are also devoting more of their foreign borrowing such has syndications that expanded in maturity recently, to such long-term project financing.

Thanks to the New Regulation, the Banks will be Able to Issue TL Bonds

There were important regulatory changes regarding the banking sector last month. The most important change was related to the local currency bond funding of the deposit banks. As it is known, the deposit banks in Turkey were always able to issue foreign currency bonds abroad but not TL denominated bonds domestically. Thanks to new regulation of the BRSA (the Banking Watchdog), the banks will now be able to issue TL denominated bonds, but the issuance will be subject to some conditions. The capital adequacy ratio of the issuer Bank shall not be under 12% as of the date of application. Similar to many countries, the minimum CAR limit is 8% in Turkey. It is important to point out here that sector's CAR ratio is much higher than 12% exceeding in fact 18% currently. Additionally, retail investors shall be informed that their money is not under the insurance coverage of Saving Deposits Insurance Fund (SDIF). Let us remind that retail deposits up to TL50K in any single bank are under SDIF guarantee.

The issuance amount will be limited by the hypothetical example stated below. As it was the case before, the participation and the investment banks shall be exempted from this limit.

1- Equity: TL5 bn, 50% of equities= TL2.5 bn
2- Saving Deposit: TL12 bn, 25% of deposits=TL3 bn
Amount subject to issuance limit = MAX (1,2) = TL3 bn
4- Total Assets of the Issuer Bank: TL40 bn (4.4% of the sector, 5 Folds of the Share of X Bank in the Sector: %22)
5- Total Assets of the System: TL908 bn
6- CAR: 17%, difference from target CAR= 5%. 2 Folds of the Difference: %10

Issue Limit= TL3 bn * (1-22%+10%)=TL2.6 bn

When we apply the formula above to the deposit banks, total issuance could amount TL50 bn, which is 9% of the total deposits in the system. The amount might not be very high, but the future effects would be quite priceless. The average deposit maturity is slightly more than one month in Turkey. Therefore, thanks to the issuance of TL bonds, the deposit banks will have the chance to lengthen their funding duration. Given that the long-term mortgage loans are surging in the last couple of years, the banks also need more long-term financing. Interestingly, the maximum allowable amount of TL50 bn is almost exactly in line with TL55 bn of total mortgage loans in the system. The depositors would also be willing to switch to buy bonds if there could be an active secondary market that will allow them to sell their holdings quickly (the reason behind the short-term deposits).

The yields of such bonds are also crucial. They must be high enough to lure depositors and low enough for banks to justify new lending. High quality two year company bond yields are currently hovering around two year government bond (benchmark bond) yield + 125 bps. This means the newly issued bank bond yields will likely to settle around 9%, given that the benchmark government bond yield is currently 7.75%. Similarly the deposit rates are currently around moving around 9% while mortgage loans yield around 12% without fee income generated along with them. They therefore may serve the purpose.

The CBT Stopped Paying Interest for TL Reserves

Another important change in regulation concerning the banks was the CBT's unexpected decision of ceasing the interest payment on required reserves. The Bank first raised the TL reserve requirement ratio to 5.5% from 5% within the confines of its exit strategy so it was expected. It was 6% before the global crisis. But that the CBT ceased the interest paid for TL reserves was more noteworthy and not expected. As per our calculations, this will cost banks 30 bps. Now the banks have two options. One is to bear the cost of TL1 bn annual cost, which is equal to 5% of yearly profit. The other is to reflect all or some portion of 30 bps as an increase in deposit cost or loan interest rates. Barring retail and SME segments, the loan demand is still subdued in the post crisis environment. Therefore, we can envisage that it will be difficult for banks to reflect all of the cost increase to the loan rates. In other words, the banks will have to bear some of this cost.