

Annual Economic View

“No Repose in the First Half”

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- Sustaining the high growth and high current account deficit duo is impossible for Turkey, especially considering that the financing prospects to deteriorate in 2012. After the ECB's 3-year loan of EUR 490 billion to Eurozone banks in December, we are now more optimistic over the continuation of the financial inflows to Turkey compared to our previous report published in late October. However, sizable sovereign redemptions of Eurozone countries in 2012 and Eurozone banks' capital needs will likely prevent a strong inflows scenario.
- The next step in monetary policy may be a further widening in the interest rate corridor by hiking the O/N lending rate further, should the lira squeeze in the market and FX interventions be insufficient to stem further lira depreciation as the CBRT reached its upper limit in repo funding costs. Shifting to an orthodox monetary policy in which the Bank returns to a higher single policy rate may be the following move. Funding costs will stay high on average in the first quarter, maintaining a barrier to bond rates below 11%, as the lira will remain under pressure, which will likely render providing cheap and abundant lira to the market difficult. However, in the second half of 2012, the CBRT will likely provide permanent funding at lower costs as the economy will slow down, and pressure on the lira will ease to some extent parallel to the improvement in the current account deficit.
- As for inflation, the CBRT expects a sharp decline in annual inflation starting in May. Our inflation path diverges notably from the CBRT's, however. We see inflation to remain between the 9-11% range until the last quarter before sharply declining to 6.7% by year-end thanks to the high base in the last quarter of 2011.
- The sustainability of high growth is questionable as the economic activity reached a strong base after the crisis and the CBRT's "reasonable" 10% trend growth for consumer credits implies weak private consumption growth in 2012. Meanwhile, private investments will likely lose steam this year. Hence, we continue to expect the economy to barely expand in 2012 (0.8%) this year.
- The expected slowdown and decline in oil prices on average in 2012 will likely cause a narrowing in the current account deficit this year as there is a strong relationship between non-energy import volumes and GDP growth rate. We forecast a CAD of USD 78 billion (10.3% of GDP) for 2011 before the deficit narrows marginally to USD 66 billion (8.9% of GDP).
- External financing will be a key issue for investment decisions to Turkey this year as the problems in Europe continue. We calculate that the Turkish economy will need some USD 135 billion in 2012 to finance its current account deficit (USD 65.9bn), MLT debt service (USD 44.5bn) and short-term debt service of some USD 25bn (excluding short-term trade credits). Although financing conditions will likely be tighter in 2012, we expect the pressure on the lira to ease slightly in the second half of the year with the help of the options, which were used in 2008-2009 episode and alternative to MLT borrowing. Inflows to bond market in the second half and reserve use as well as improvement in the CAD will likely be another factors supporting the currency.
- Low growth this year will likely press budget balances both through its effects on tax collection and potential government measures to support economic activity. However, expected revenue from paid military service and the sales of state-owned land (known as 2-B), may behave as restructuring did in 2011. Hence, we forecast the budget balance and primary surplus at -2.1% of GDP and 1.5% of GDP respectively in 2012, slightly unfavorable compared to the targets of a -1.5% budget balance and 2.0% primary surplus.
- The chance of a rating upgrade to investment grade by one of three major ratings agencies in 2012 is close to zero in our view as the uncertainty over external financing remains.

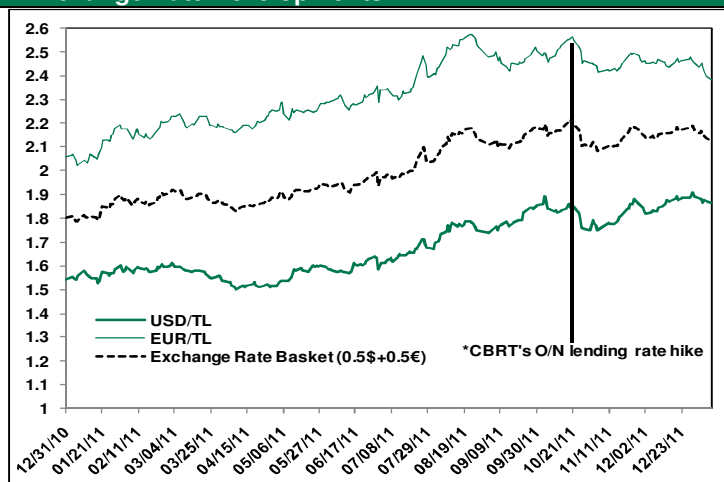
No Repose in the First Half

Eurozone problems and CBRT's unorthodox strategies to direct economy's destiny this year

The European debt crisis and the CBRT's strategy shift to another unorthodox policy at the end of October was the most influential factors on Turkish financial markets since we published our last quarterly report "*When the side effects come in*" on October 25, 2011. The debt crisis made no significant impact on Turkey's economic activity, which is still strong as of last quarter, but there were indirect effects as the increased risk perception decelerated inflows to EMs including Turkey.

The side effects of the CBRT's unorthodox policy mix, which began in late 2010 became more visible in the last quarter of 2011 as inflation surged from 6.15% as of September to 10.45% by year-end, significantly above the 5.5% target. The central bank's former unorthodox policy and Eurozone concerns caused the lira to slide some 22% against the dollar and 21% against the currency basket composed of \$0.50 and €0.50 last year, which created 3.5-4.0 pp of the year-end inflation. (Graph 1)

Graph 1: Exchange Rate Developments



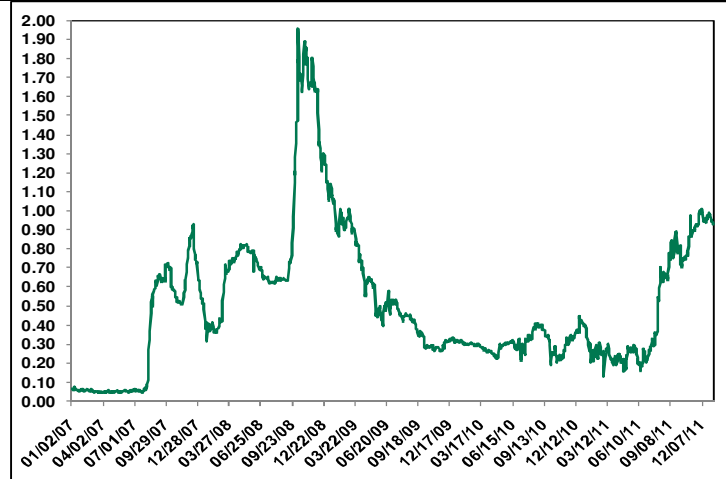
Source: CBRT

On the other hand, the compound yield on the benchmark bond surged above 11% as the CBRT increased the O/N lending rate 350 bps and squeezed lira liquidity in the market from October 20, 2011. While growth remained strong and the rebalancing in the economy continued, the pace of rebalancing remained slower than necessary for sustainable growth as of the third quarter. The CBRT's additional monetary tightening started on December 29th and frequent shifts in monetary policy strategies will be among main determinants for the economy this year as they will create a slowdown in the economy. The CBRT is likely to continue with its unorthodox monetary policy in 2012 should conditions permit. If not, the bank may be forced to return to orthodox monetary policy by hiking the one-week repo rate and fund the market at this new higher level.

The discussions on Europe's debt problems continued in the last quarter and uncertainty still lingers. (Graph 2) After the ECB's 3-year loan of EUR 490 billion to

Eurozone banks in December, we are now more optimistic over the continuation of the financial inflows to Turkey compared to our previous report. However, sizable sovereign redemptions of Eurozone countries in 2012 and Eurozone banks' capital needs will likely prevent a strong inflows scenario in our view. Turkey will not see significant benefit unless the ECB provides high amounts in February's auction and beyond as it did in December. All in all, the strong inflows from European banks is not our base case scenario for 2012 as the long-term solution will still necessitate balance sheet downsizing for the Eurozone banks.

Graph 2: 3-month Euribor & OIS spread (percentage points)



Source: Bloomberg

We revised our average oil price forecast for 2012 up to the previous \$105 per barrel of Brent from \$93 as political tension between Western countries and Iran threatens supply routes and EU banned the use of Iranian oil in principle. We expect oil prices to remain slightly above \$100 on average this year as the global economic slowdown and political tensions will likely offset their effects on prices.

As for EURUSD parity, which has an important effect on the lira, we expect the USD to strengthen against the EUR before losing some value in the third quarter after the stress in the Eurozone is further priced-in. However, we assume a weaker euro by year-end compared to the level at the time of this writing (1.28)

In domestic politics, we still assign a high probability for a referendum on constitutional changes as political parties are far from a compromise and the ruling AK Party does not have enough seats in parliament to change the constitution on its own. However, the referendum itself may be delayed to 2013 as the constitutional commission's work is progressing slowly and compromise is difficult to reach.

Our 2012 projections are depicted in the table below:

Table 1: Macro framework: 2007-2012

	2007	2008	2009	2010	Şeker Securities	
					2011f	2012f
Growth (GDP; %)	4.7	0.7	-4.8	9.0	8.2	0.8
GDP (TL; bn.)	843	951	953	1104	1271	1397
GDP (\$; bn.)	647	730	614	735	757	742
CPI Inflation (%) 1/						
Avg.	8.8	10.4	6.3	8.6	6.5	9.1
EoP	8.4	10.1	6.5	6.4	10.4	6.7
Central Government Budget Balance (TL bn)	-13.7	-17.4	-52.8	-39.6	-14.7	-29.8
as % of GDP	-1.6	-1.8	-5.5	-3.6	-1.2	-2.1
o/w: Primary Balance (as % of GDP)	4.2	3.5	0.0	0.8	2.2	1.5
Central Government Debt (as % of GDP)	39.6	40.0	46.3	42.9	40.7	39.1
Domestic	30.3	28.9	34.6	32.0	...	...
External	9.3	11.1	11.7	10.9	...	...
Public Debt (as % of GDP)	42.2	42.9	48.9	45.0	42.8	41.2
Current Account Balance (\$ bn)	-38.4	-42.0	-14.0	-47.1	-78.0	-65.9
as % of GDP	-5.9	-5.7	-2.3	-6.4	-10.3	-8.9
Trade Balance (TURKSTAT definition; \$ bn)	-62.8	-69.9	-38.8	-71.7	-107.0	-99.7
Oil price (Brent) 1/	72.7	98.4	61.5	79.5	111.2	104.9
Exchange Rate (TL/\$) 1/						
Avg.	1.303	1.302	1.550	1.502	1.679	1.883
EoP	1.175	1.540	1.503	1.518	1.894	1.870
%	-17.7	31.1	-2.4	1.0	24.7	-1.2
Real Effective Exchange Rate (2003=100)						
EoP	132	115	117	126	109	118
% (up means appreciation)	17.5	-12.7	1.6	7.6	-13.2	8.3
Interest Rate on Benchmark Bond (comp.; %) 1/						
EoP (December)	16.6	17.9	9.2	7.4	10.4	9.6
Real Interest Rate (compounded eop; %) 1/ 2/	7.6	7.1	2.5	1.0	0.0	2.7
Central Bank Policy Rate (EoP; simple; %) 1/ 3/	15.75	15.00	6.50	6.50	5.75	5.75

Source: CBRT, MoF, Treasury, TURKSTAT, Turkey Data Monitor, Şeker Securities. f= forecast.

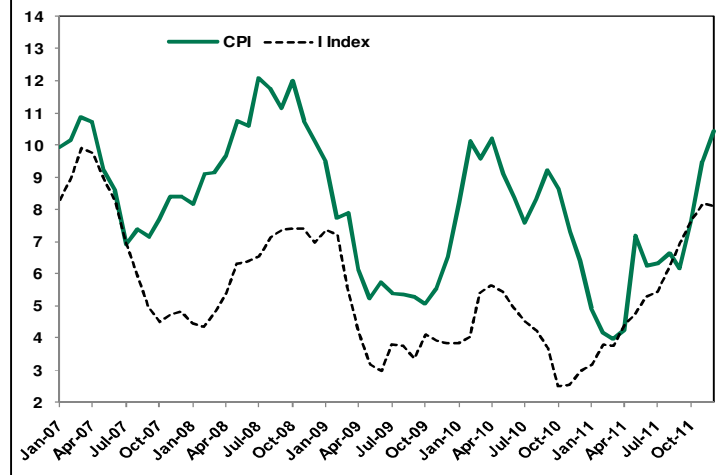
1/ Actual figures for 2011.

2/ Ex-post annual: $(1 + \text{nominal interest}) / (1 + \text{eop inflation})$.

3/ One week repo rate for 2010-2012; O/N borrowing rate for the previous years

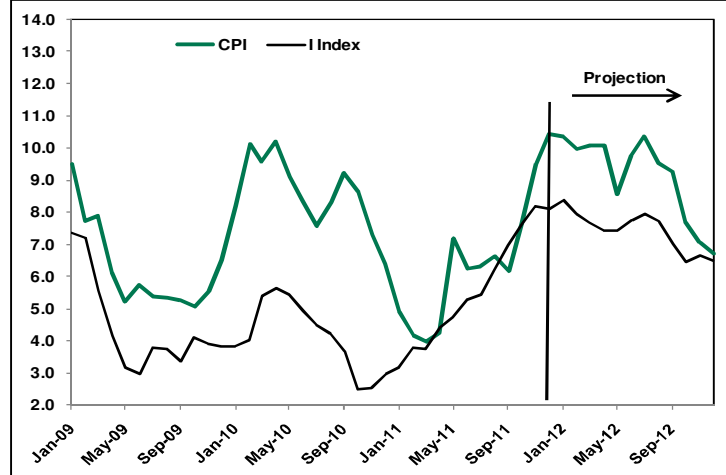
Inflation to remain elevated until Q4

Due to currency pass-through, administrative price changes in October and the surge in unprocessed food prices in the fourth quarter of 2011, CPI inflation ended the year at 10.45%, almost twice the inflation target of 5.5% for 2010. The increase has been accompanied by core inflation with a more moderate pace as annual I index inflation ended the year at 8.1% from 7.0% at the end of September. (Graph 3)

Graph 3 : CPI and Core Inflation (12-month, %)

Source: TurkStat

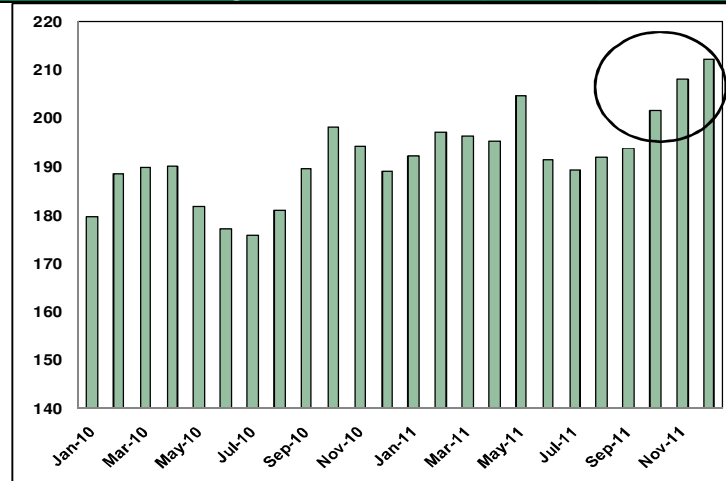
According to the CBRT, “...second round effects of the temporary price movements to remain contained and inflation to fall gradually throughout 2012, converging to 5 percent target during the final months of the year” and “...inflation is likely to stay at high levels during the first few months of 2012 due to exchange rate pass-through, administered price hikes and adverse developments in unprocessed food prices.” To be more specific, the bank expects a sharp decline in annual inflation starting in May. Our inflation path diverges notably from the CBRT’s, however. We see inflation to remain between the 9-11% range until the last quarter before sharply declining to 6.7% by year-end thanks to the high base in the last quarter of 2011. (Graph 4) We admit that May might be an exception where inflation declines slightly below 9% temporarily according to our projections. There are a lot of factors, which might prevent inflation declining significantly in the first three quarters of the year.

Graph 4: CPI and Core Inflation (12-month, %)

Source: TurkStat, Seker Securities

The first of these factors is the base effect. Recall that annual inflation remained within 4.0%-7.2% during January-September last year, thanks to favorable unprocessed food price inflation. Food price inflation parallel to seasonal averages would cause inflation to remain within the 9-11% range until the last quarter even if we assume a moderate correction in food prices following the sharp increase in the last quarter. On the other hand, the high base in food prices as well as administrated prices in the past quarter will be positive for Q4 2012 inflation, which will likely contribute to the decline. (Graph 5)

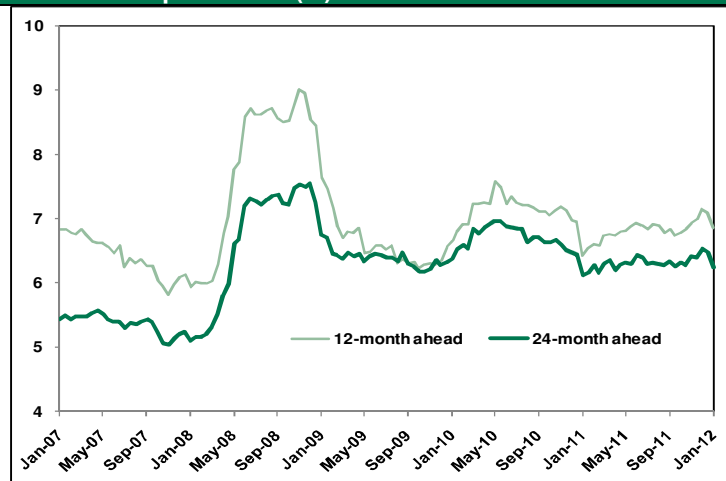
Graph 5: Food and Beverages Index under CPI (2003=100)



Source: TurkStat

Secondly, medium-term inflation expectations are still very high to achieve 5% inflation target. (Graph 6) Meanwhile, missing the inflation target by a wide margin in 2011 may lead price setters to use past inflation as an anchor rather than inflation expectations, which may deteriorate pricing behavior and prevent the CBRT to reach its 5% year-end target.

Graph 6: Inflation Expectations (%)

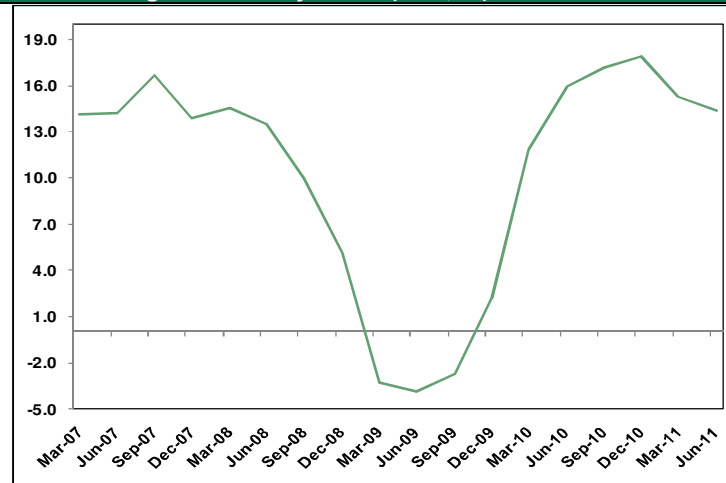


Source: CBRT

Another interesting factor is wage pressures in our view. (Graph 7) Notwithstanding the weakening domestic demand, wage pressures will likely

prevent a downside in CPI inflation for the above-mentioned period as it will affect producers after 10.45% consumer inflation may cause further upside for wages, which is a significant cost item for producers.

Graph 7: Gross Wage and Salary Index (YoY; %)



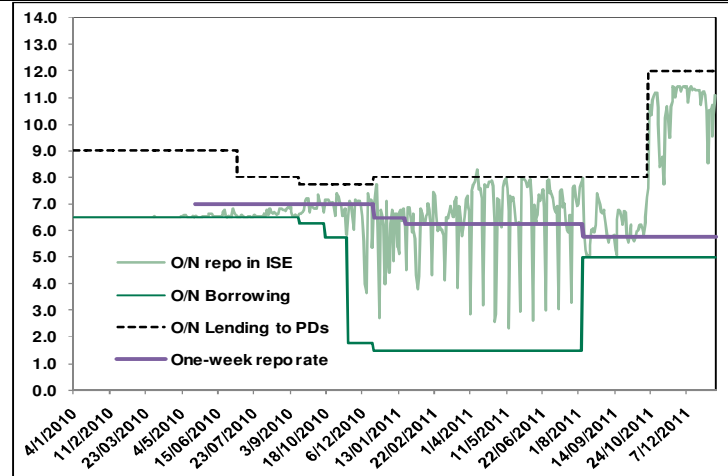
Source: TurkStat

We expect no significant depreciation in the Lira and no surge in energy prices this year. However, our base case for the lira in the first half of 2012 is that it will stay around its record weakness; this may cause the exchange rate pass-through to be stronger than the CBRT's forecast of 15-20%. The CBRT had previously stated that currency pass-through remained at 15%, while later they used a figure of 20%. Such a situation may be another factor preventing annual inflation declining below 9% in the first three quarters.

All in all, we forecast annual inflation to remain between 9-11% until the fourth quarter before ending the year at 6.7%, higher than the 5% inflation target. However, there is a downside risks to our band should there be a sharper downward correction than we assume in unprocessed food prices. Please note that our year-end food inflation forecast for 2012 stands at 9%, which is lower than the 10.5% observed in the last five years on average.

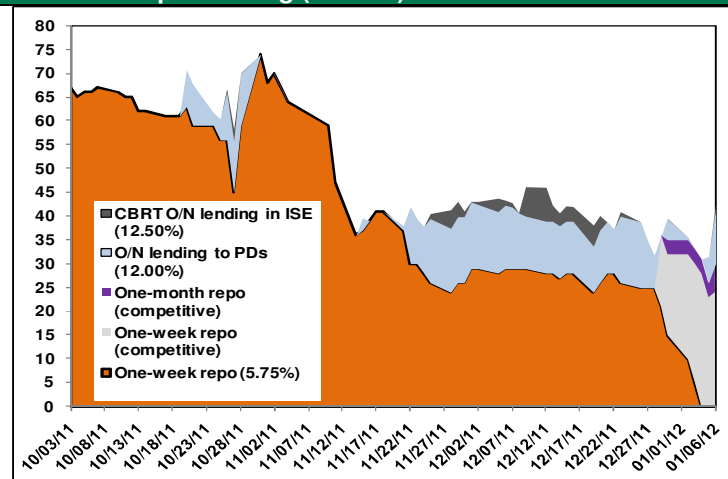
CBRT determined to defend the lira in its fight with inflation but at a cost

The central bank changed its unorthodox monetary strategy of high reserve requirement ratios (against high credit growth) combined with a wide interest rate corridor (against FX inflows) with a new elevated interest rate corridor with two moves in O/N borrowing and lending rates in August and October respectively. (Graph 8) Since October, the central bank has used an interest rate corridor of 750 bps with a higher lending rate accompanied with the lower funding at the previous policy rate (5.75%) through one-week repo auctions. The reasoning behind the move was controlling depreciation of the lira through squeezing the local currency's liquidity in the market in an effort to combat inflation.

Graph 8: Interest Rates (simple; %)

Source: CBRT, ISE

Since then the CBRT has recently started an additional tightening effort in the last days of 2011. The CBRT separated FX selling and lira liquidity strategy by distinguishing “normal days” and “exceptional days”, though Governor Basci did not comment on the definition of “exceptional”. Under this strategy, it cut one-week repo funding at 5.75% to zero and shifted funding to the competitive one-week and one-month repo auctions, in which interest rates was above 11%. (Graph 9) The shift caused funding costs to move to a new higher plateau. The one-week repo amount provided at 5.75% may decline even below the lower limit announced for a two week period in “extraordinary days” as it declined to zero last week. Meanwhile, the CBRT uses unsterilized FX interventions and FX selling auctions concurrently in “extraordinary days” in order to defend the lira. Both corporate and speculative FX demand caused the currency to depreciate to the levels the CBRT intervened in the FX market directly on January 30th (~TRY 2.2 against the currency basket composed of \$0.50 and €0.50). The CBRT’s attitude to sell a minimum amount of FX combined with the problems in international markets facilitated the rise before the intervention.

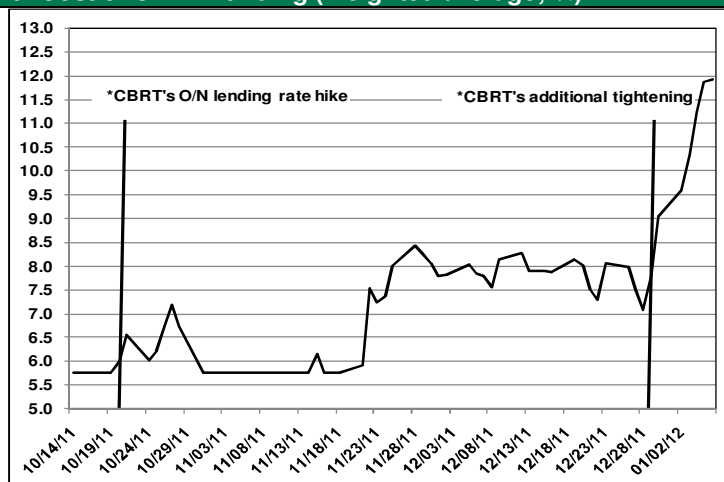
Graph 9: CBRT's Repo Funding (TRY bn)

Source: CBRT

The CBRT tries to preserve its FX reserves by channeling banks to higher rates with competitive one-week and one-month repo auctions instead of one-week repo at 5.75%. This change may not mean providing more stable funding to banks as markets do not know which days are extraordinary or normal. Funding costs will stay high on average in the first quarter, maintaining a barrier to bond rates below 11%, as the lira will remain under pressure, which will likely render providing cheap and abundant lira to the market difficult.

The one-week repo rate lost its policy rate character since October. Cost of CBRT funding is at a new record since the bank started to effectively use the interest rate corridor in October. It rose to 11.93% on Friday (January 6th) from the 7.88% in the last week of 2011 on average, as outstanding one-week repo funding at 5.75% was completely replaced by competitive one week repo auctions as of January 4th. As of Friday, the CBRT provided the market a total of TRY 42.7 billion (TRY 24bn through competitive one-week repo auctions and TRY 6bn through one-month repo auctions, TRY 11.6bn through O/N lending facility to PDs at 12.00%). The total cost of CBRT funding approached a step further to the 12–12.5% upper band of the interest rate corridor. (Graph 10) The CBRT's recent moves were bond negative both due to higher funding costs and uncertainty over lira liquidity.

Graph 10: Cost of CBRT Funding (Weighted average; %)



Source: CBRT, Şeker Securities

In our view, the CBRT will likely continue tightening monetary conditions until the lira appreciates and depreciation will not be a risk for the inflation outlook. However, we keep our view unchanged that the bank will return to funding at lower costs as long as the lira remains under control. As the lira is likely to remain under pressure in the first quarter at least, we expect the number of extraordinary days to remain higher than that of the normal days. In a speech on Friday (January 6th), the CBRT's Governor Basci said that this week they may return to the normal day concept barring any major developments. The bank reiterates at every occasion that it may provide funding at lower costs if economic activity slows down to undesirable levels. However, pressure on the lira should ease to enable the bank to use its flexibility. Otherwise, such a move may create further pressure on the lira as the financing outlook will be harder in 2012, which we will analyze below.

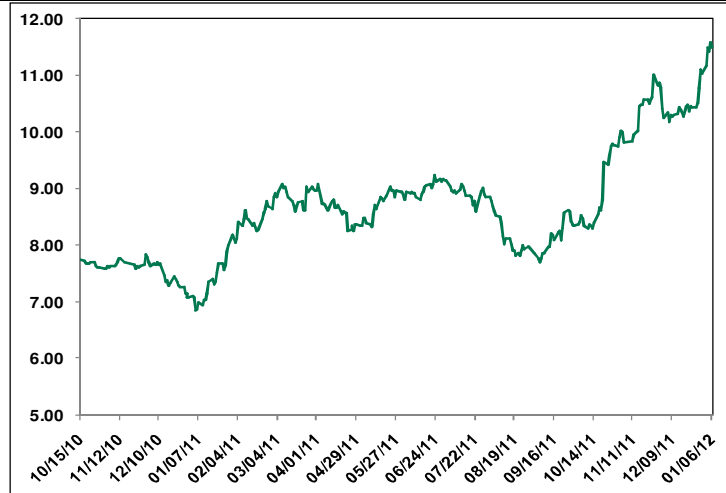
The next step in monetary policy may be a further widening in the interest rate corridor by hiking the O/N lending rate further, should the lira squeeze in the market and FX interventions be insufficient to stem further lira depreciation as the CBRT reached its upper limit in repo funding costs as of Friday (January 6th). However, shifting to an orthodox monetary policy in which the Bank returns to a higher single policy rate will likely be the following move.

The cost of the current monetary policy is that economic activity may decelerate to undesirable levels due to a higher interest rate environment, and higher borrowing costs for the Treasury. Knowing this risk, the CBRT aims to retain flexibility. However, returning to the funding market at lower interest rates may not be possible for an extended time if the lira remains under pressure.

Bond rates: The journey ahead doesn't point south

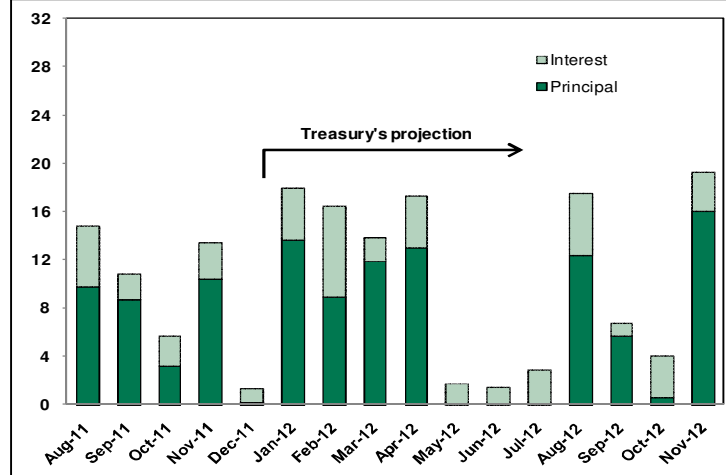
Elevated inflation expectations combined with tight liquidity conditions, which caused the CBRT's repo funding costs to jump, created upwards pressure on benchmark bond yield, causing it to exceed 11%. (Graph 11)

Graph 11: Secondary Market Benchmark Rate (compounded; %)



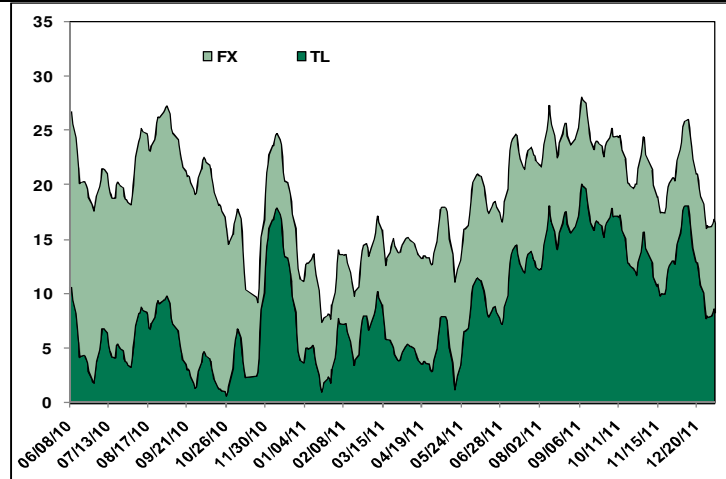
Source: ISE

In addition, the heavy domestic debt redemption profile of about TRY 65 billion in the first four months of the year is another factor to prevent a secular decline in bond yields in the first quarter of the year. (Graph 12) The Treasury will repay TRY 17.8 billion domestic debt of which TRY 14.9 billion is to the market in January according to the January-March domestic borrowing strategy. Meanwhile, it will repay TRY 16.4 billion and TRY 13.8 billion in February and March respectively. The Treasury aims for market rollover ratios at 77% for January, 82% for February and 87% for March, which we find high and will likely create upwards pressure on bond yields as uncertainty on funding costs limits the appetite for government bonds.

Graph 12: Domestic Debt Redemptions, 2011-2012 (TRY bn)

Source: Treasury

Meanwhile, the central government's accounts at the CBRT do not seem so strong and the Treasury may try to achieve these high rollover ratios with increased costs unless the CBRT provides the market more permanent funding and guarantees that it will remain, which will not be in the first quarter in our view. (Graph 13) However, in the second half of 2012 the CBRT will likely provide permanent funding at lower costs as the economy will slow down and pressure on the lira will ease to some extent parallel to the improvement in the current account deficit. Under such a scenario, we expect benchmark bond yield to end the year slightly below 10%.

Graph 13 : Public Deposits (billion TL, 5-day moving average)

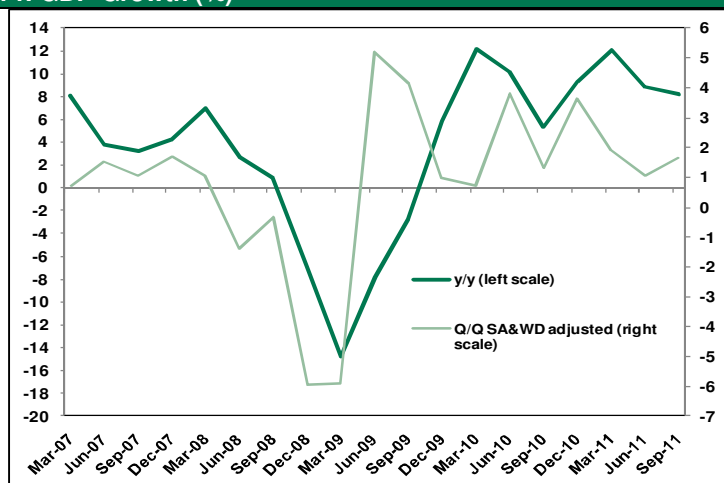
Source: CBRT

Growth strong in Q4 2011 but risks loom

Economic activity accelerated in the third quarter contrary to expectations. Real output grew by 8.2% YoY in the third quarter, corresponding 9.6% YoY growth for Q1-Q3. Adjusted for seasonal and calendar effects, economic activity accelerated

and output rose by 1.7% QoQ following the 1.1% growth in the second quarter. (Graph 14)

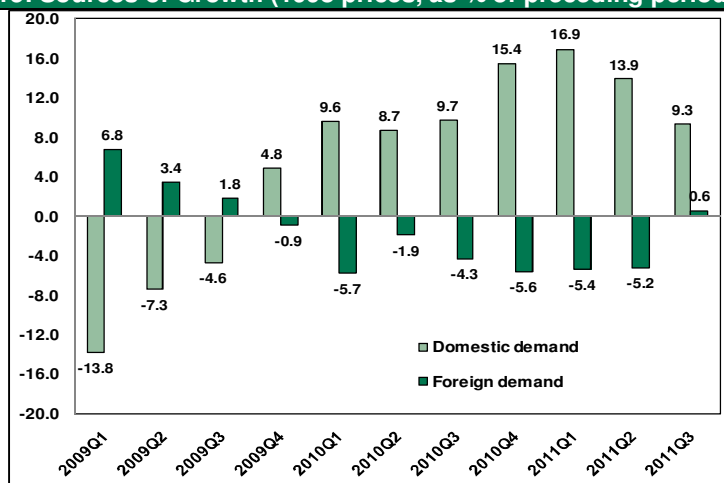
Graph 14: GDP Growth (%)



Source: TurkStat

Q3 data provided strong evidence that rebalancing in the economy has started. While private consumption remained strong, the contribution of net external demand turned positive in Q3 as we expected. (Graph 15) Private consumption was once again behind the aggressive growth, rising 7.0% YoY in Q3 on top of 8.8% in Q2. On the other hand, private sector investment growth seems to have cut its pace to 17.2% YoY following the 34.1% rise observed in the second quarter.

Graph 15: Sources of Growth (1998 prices, as % of preceding period's GDP)



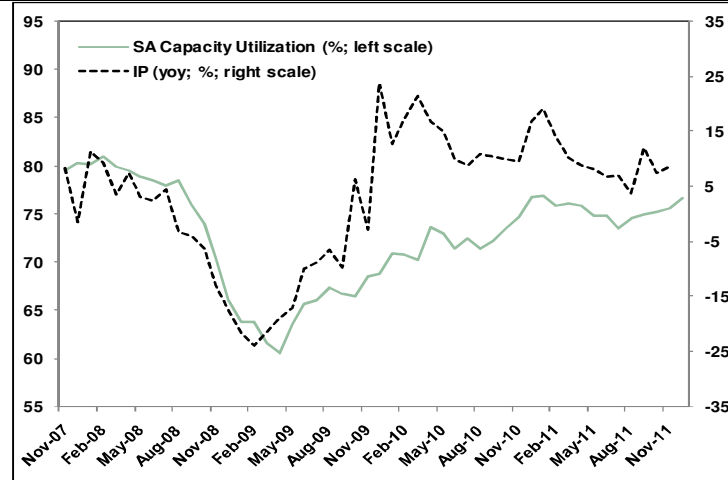
Source: TurkStat, Seker Securities

Net external demand made its first positive contribution to growth (0.6 pp) since Q3 2009 as the exports under GDP rose 10.8%, higher than the 7.3% in imports. Meanwhile, domestic demand made a 9.3% contribution to the Q3 growth figure, while stock changes erased 1.6 pp off the headline figure.

Economic activity remained strong in the final quarter of the year according to various indicators. Growth indicators like PMI indices, capacity utilization and

industrial production imply a YoY growth rate of about 5% for the last quarter of the year, which would bring the 2011 growth rate to 8.2% according to our forecasts. (Graph 16)

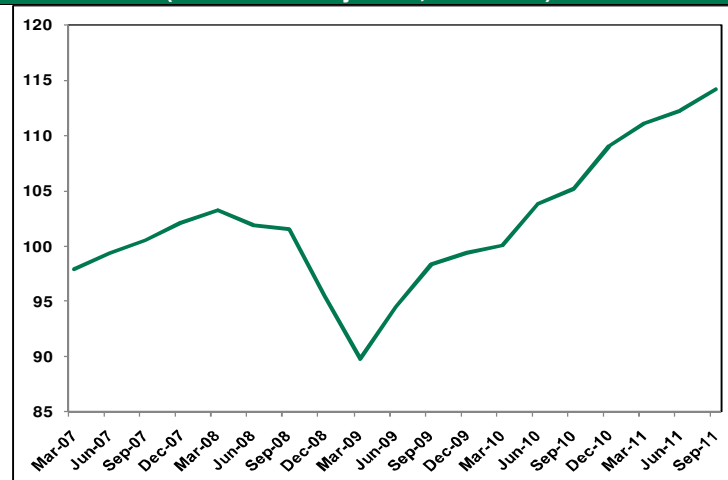
Graph 16: Capacity Utilization and Industrial Production



Source: TurkStat, CBRT

However, the sustainability of this high growth pattern is questionable as the economy created a strong base, which is difficult to sustain with weak external sources as the GDP level (SA and WD adjusted) was 14.2% above the pre-crisis levels as of third quarter. (Graph 17)

Graph 17: Real GDP (SA and WD adjusted; 2007=100)

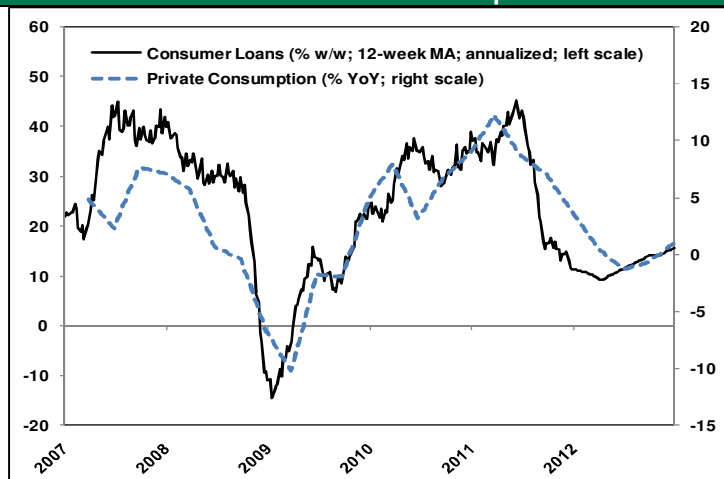


Source: TurkStat, Turkey Data Monitor, Seker Securities

Secondly, the CBRT's "reasonable" 10% trend growth for consumer credits implies weak private consumption in 2012. The CBRT's definition of reasonable levels of consumer credit growth not detrimental to financial stability, points to a significant slowdown in private consumption, which will likely take its toll on growth according to our projections. Our private consumption growth path can be found in the graph below. In the same graph, trend growth of consumer credits corresponds to around 10% for the first three quarters, before steadily rising to 13-14% by year-end as we expect the bank to ease monetary conditions in the

second half of the year to support growth. We forecast private consumption to remain broadly stable this year.

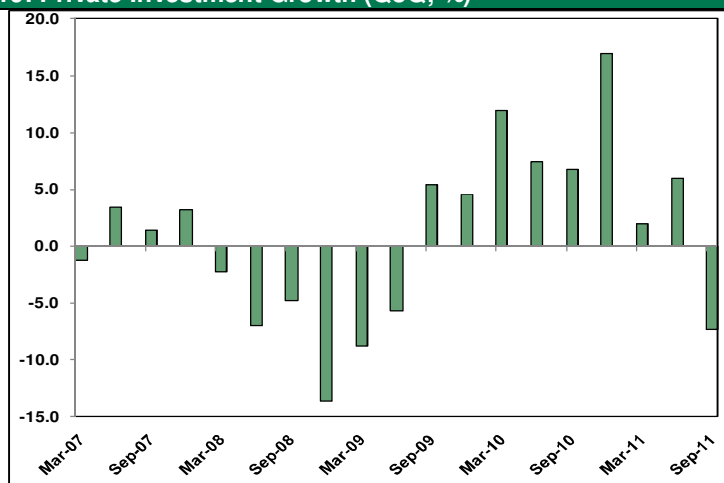
Graph 18: Consumer Loans and Private Consumption



Source: BRSA, TurkStat, Seker Securities

Meanwhile, private investments will likely lose steam. According to our calculations, adjusted for working day and calendar effects, private investments declined 7.4% in Q3 over a quarter ago. (Graph 19) Accompanied by signals from soft data like the real sector confidence index for December, and slowing private consumption, we forecast private investments to show a moderate contraction this year.

Graph 19: Private Investment Growth (QoQ; %)

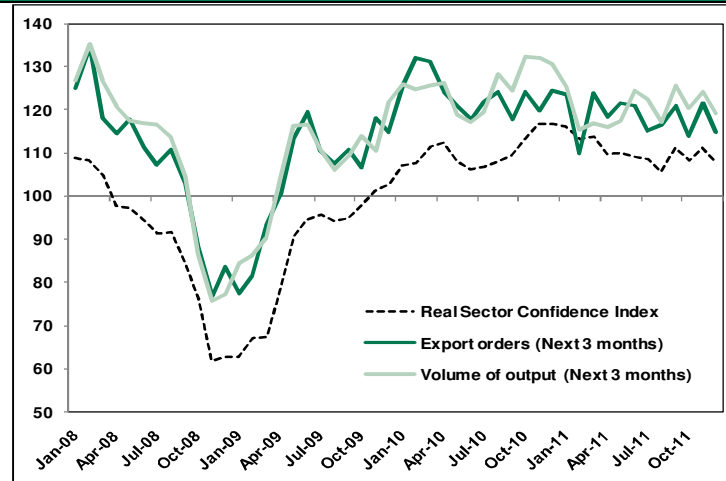


Source: TurkStat, Seker Securities

The real sector confidence index compiled by the CBRT declined 4.9% MoM to 97.2 in December, below the 100 mark separating expansion and contraction in manufacturing activity. Meanwhile, the seasonally adjusted index fell 3.2% MoM. The decline in the sub-indices were broad based as the SA sub-index for output volume for the next three months declined 3.9% MoM, while the sub-index pertaining to new export orders (for next three months) fell 5.6% MoM. While there seems to be a contradiction between the real data and expectations, the

deterioration in expectations will likely reflect on economic activity in the first half of the year. (Graph 20)

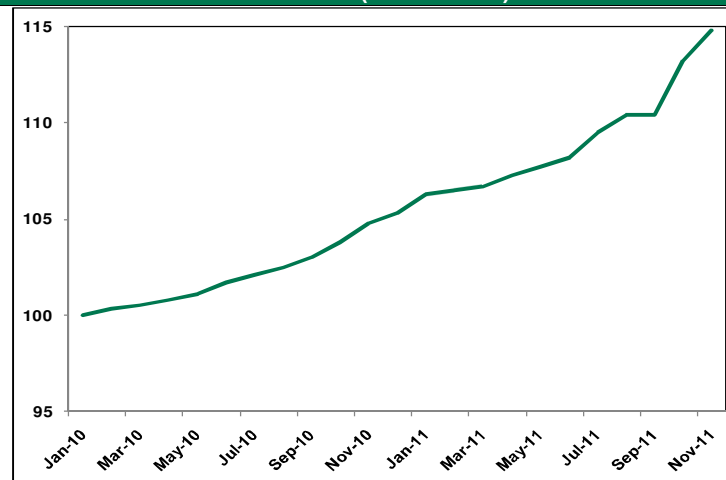
Graph 20: Real Sector Confidence Index (SA index)



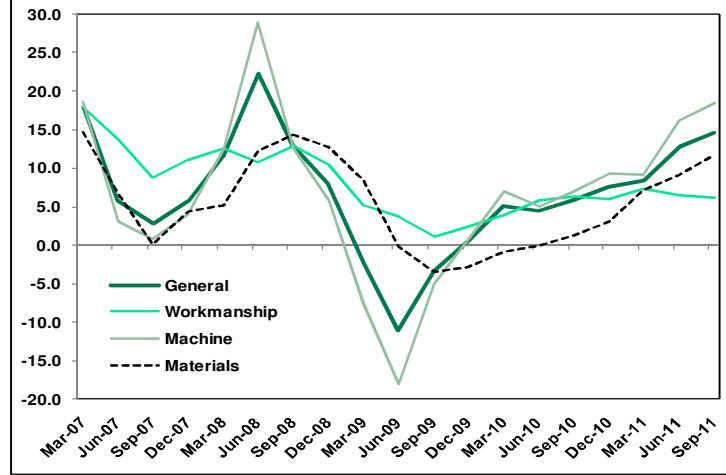
Source: CBRT

Another factor directing us to a lower than consensus growth rate for 2012 is the vulnerability of the construction sector, which made a significant contribution to employment growth last year. New home prices are still increasing as of November, while cost pressures on the construction sector also rising. (Graph 21-22) Maintaining the momentum in the construction sector is difficult given the CBRT's monetary tightening, which caused housing loan rates to increase although they are still low compared to historical standards. (Graph 23) Combining these facts, the economy may lack the support of a significant sector in terms of its broad effects on the economy in 2012, despite its share in nominal GDP (including directly related sectors like real estate) was only 9% in the first three quarters of last year.

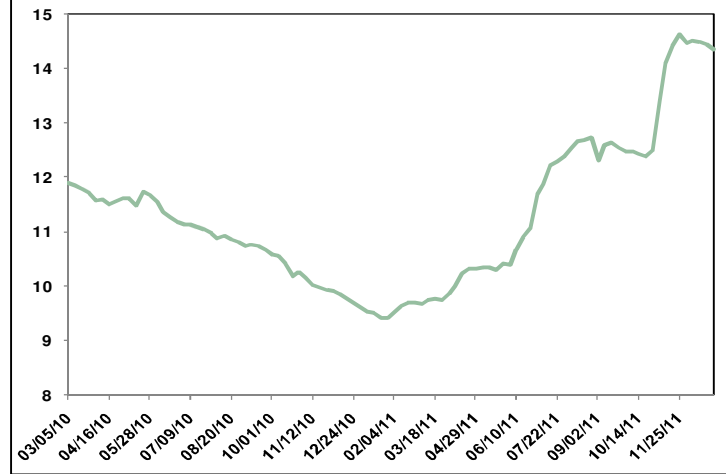
Graph 21: New Home Prices for Sale (Jan-10=100)



Source: REIDIN.com

Graph 22: Building Construction Cost Index (% YoY)

Source: TurkStat

Graph 23: Housing Loans Lending Rate (Weighted average; %)

Source: CBRT

As for external demand, the positive contribution to growth will continue through 2012 with an overall 1.1 pp contribution. (Table 2) Meanwhile, we expect a slight contribution from stock build up as manufacturers will face a significant slowdown in demand. All in all, we continue to expect the economy to barely expand in 2012 (0.8%) due to the high base of last year, external funding constraints and higher credit costs due to CBRT's steps to keep credit growth and the lira under control. However, we admit that there are upside risks to our growth forecast as the momentum in the economy may prevent a deceleration in economic activity to the levels we expect.

Table 2: Growth components, 2007-12 (% annual)

	2007	2008	2009	2010	2011			2012 (f)
					Q1-Q3	Q4 (f)	FY (f)	
Domestic Demand 1/	5.2	-1.6	-5.3	10.9	13.1	3.9	10.7	-0.6
Consumption	5.6	-0.1	-1.0	6.1	9.3	3.0	7.6	0.3
Private	5.5	-0.3	-2.3	6.7	9.2	3.7	7.8	-0.1
Public	6.5	1.7	7.8	2.0	10.2	-0.5	6.7	3.1
Gross Fixed Capital Formation	3.1	-6.2	-19.0	29.9	25.4	5.3	19.3	-3.1
Private	2.6	-9.0	-22.5	33.5	29.4	4.0	21.9	-3.6
Public	6.3	12.7	-0.6	15.1	5.0	11.0	7.0	-0.6
Change in Stocks 1/	0.6	0.3	-2.3	2.4	-0.4	0.4	-0.2	0.3
Foreign Demand 1/	-1.2	1.9	2.7	-4.4	-3.1	0.1	-2.3	1.1
Exports	7.3	2.7	-5.0	3.4	6.7	2.7	5.6	3.8
Imports	10.7	-4.1	-14.3	20.7	17.3	1.9	12.9	-0.6
GDP	4.7	0.7	-4.8	9.0	9.6	4.4	8.2	0.8

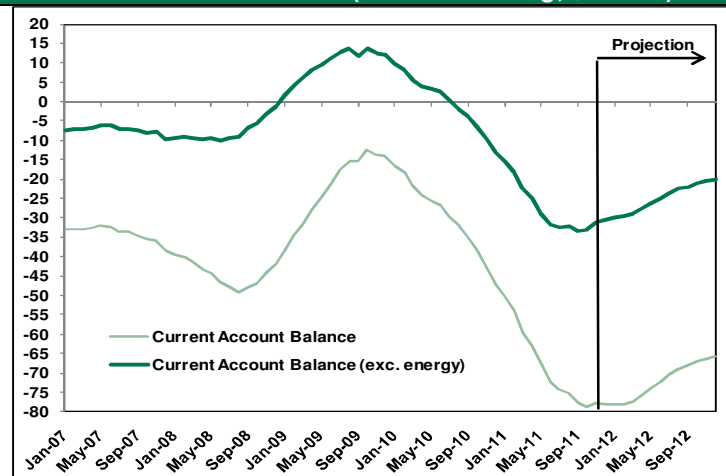
Source: TÜRKSTAT, Şeker Securities.

1/ Contributions to GDP growth.

Current account at new record before moderate improvement in 2012

Deterioration in terms of trade and a surge in import volumes due to high domestic demand and an import dependent manufacturing sector were the main factors behind Turkey's record current account deficit after the global crisis. As we have long argued, sustaining the high growth and high current account deficit duo is impossible for Turkey, especially considering that the financing prospects to deteriorate in 2012.

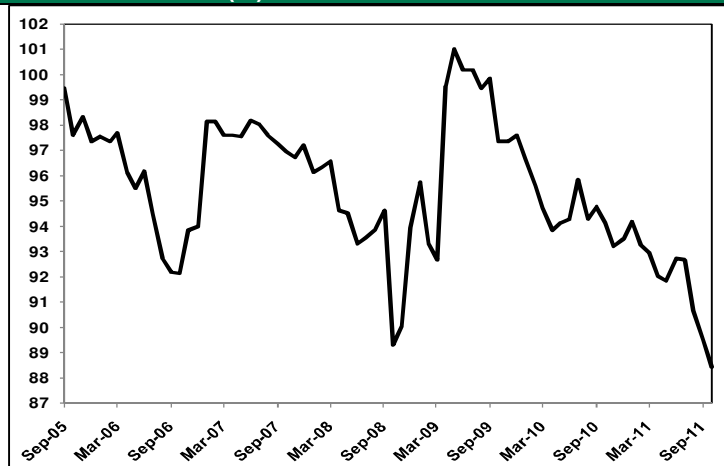
The Turkish economy created a cumulative record current account deficit of USD 78.6 billion as of October, up from USD 78.0 billion in September. Meanwhile, the adjustment in the cumulative non-energy current account deficit is beginning. In 12-month rolling terms, it declined by USD 0.4 billion to USD 33.1 billion in October. The monthly non-energy current account balance turned positive in October for the first time since February last year, posting a surplus of USD 0.2 billion. Although this development is very recent, we expect the narrowing in the non-energy CAD to continue in the upcoming period mainly due to the slowdown in non-energy imports. (Graph 24)

Graph 24: Current Account Balance (12-month rolling; \$ billion)

Source: CBRT, Şeker Securities

The increase in oil prices after prices collapsed in the post-Lehman period was the main cause for the deterioration in terms of trade. (Graph 25) We expect oil prices (Brent) to remain above \$100/bbl on average this year as tension between Iran and the Western countries is an important factor that prevent oil prices sliding below the \$100 mark, in addition to abundant liquidity in the market. We revised our oil forecast back to \$105 from \$93, which caused an expansion of some USD 5 billion in our CAD forecast for 2012.

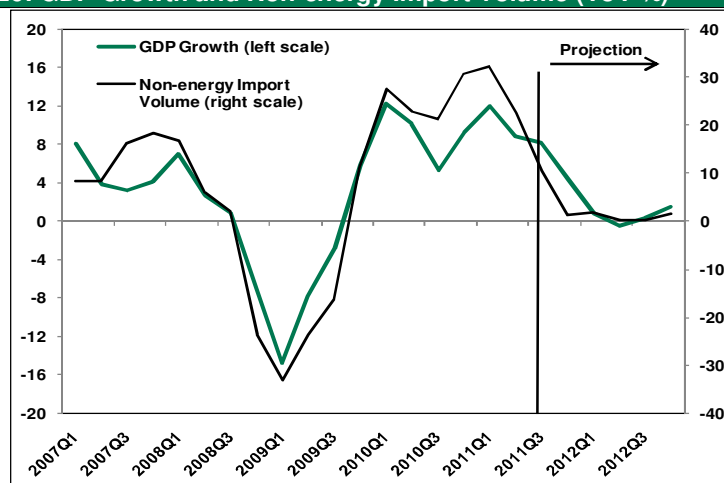
Graph 25: Terms of Trade (%)



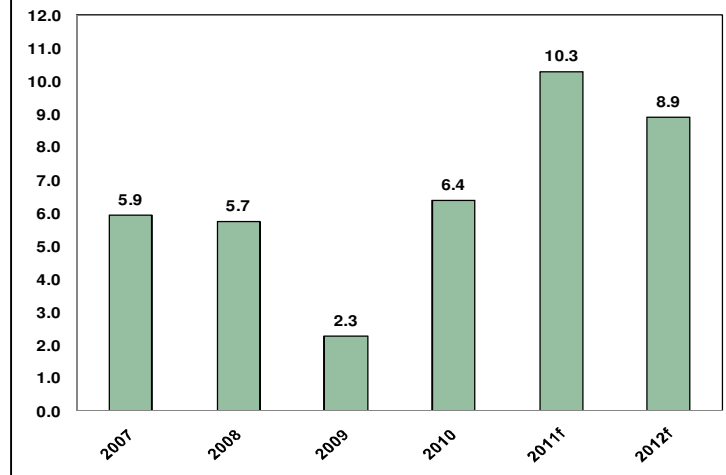
Source: TurkStat, Seker Securities

The expected slowdown in 2012 and the decline in oil prices on average will likely cause a narrowing in the current account deficit this year as there is a strong relationship between non-energy import volumes and GDP growth rate. (Graph 26) We forecast a CAD of USD 78 billion (10.3% of GDP) for 2011 before the deficit narrows marginally to USD 66 billion (8.9% of GDP) despite growth slowing down from 8.2% to 1% this year. (Graph 27) The marginal decline in CAD compared to the significant slowdown may be surprising at first sight. However, the slowdown we expect will not be enough for a meaningful narrowing in the current account deficit in 2012 as the high base in the level of economic activity will still necessitate high levels of imports.

Graph 26: GDP Growth and Non-energy Import Volume (YoY %)



Source: TurkStat, Seker Securities

Graph 27 : Current Account Deficit (as % of GDP)

Source: CBRT, TurkStat, Seker Securities

We expect an accelerated positive contribution to the current account balance from the service sector this year as it was in 2011 due to the effect of a weaker lira on the tourism revenues and Turkey's increased importance as a tourist destination. We expect tourism revenues to improve to 3% of GDP in 2012 up from 2.5% of GDP in 2011 (forecast). (Table 3)

Table 3 : Current Account Balance, 2007-12 (USD bn)

	2007	2008	2009	2010	2011 (f)	2012 (f)
Current Account	-38.4	-42.0	-14.0	-47.1	-78.0	-65.9
as % of GDP	-5.9	-5.7	-2.3	-6.4	-10.3	-8.9
Merchandise trade (BOP def.)	-46.9	-53.0	-24.9	-56.4	-90.4	-82.1
as % of GDP	-7.2	-7.3	-4.0	-7.7	-11.9	-11.1
Exports (f.o.b.; inc. Shuttle and gold)	115.4	140.8	109.6	120.9	142.9	150.9
Exports (f.o.b.; TURKSTAT def.)	107.3	132.0	102.1	113.9	134.6	144.4
o/w: Energy	5.1	7.5	3.9	4.5	6.7	6.5
Price (%)	12.7	15.5	-16.1	4.9	11.7	2.2
Volume (%)	11.3	6.5	-7.5	6.3	5.6	5.0
Imports (f.o.b.)	-162.2	-193.8	-134.5	-177.3	-233.2	-233.0
Imports (c.i.f.; TURKSTAT def.)	-170.1	-202.0	-140.9	-185.5	-241.7	-244.1
o/w: Energy	-33.9	-48.3	-29.9	-38.5	-54.3	-52.3
Price (%)	9.7	20.0	-19.5	8.6	14.9	0.2
o/w: Energy	7.7	42.6	-36.9	21.7	31.4	-5.5
Non-energy	11.4	4.2	-5.3	2.4	5.4	1.5
Volume (%)	12.7	-1.4	-12.9	21.2	13.4	1.0
o/w: Energy	10.1	0.6	4.8	3.9	4.9	1.3
Non-energy	12.9	-0.6	-17.0	25.5	15.4	0.9
Services	13.3	17.3	16.7	15.0	18.9	23.0
as % of GDP	2.1	2.4	2.7	2.0	2.5	3.1
o/w: Travel (net)	15.2	18.4	17.1	16.0	18.9	22.1
Income	-7.1	-8.4	-8.2	-7.1	-8.1	-8.5
as % of GDP	-1.1	-1.1	-1.3	-1.0	-1.1	-1.1
o/w: Interest (net)	-7.5	-8.7	-7.3	-5.4	-5.1	-5.4
as % of GDP	-1.2	-1.2	-1.2	-0.7	-0.7	-0.7
Current transfers	2.2	2.1	2.3	1.4	1.6	1.7
as % of GDP	0.3	0.3	0.4	0.2	0.2	0.2
Memorandum items:						
Non-energy current account deficit	9.7	1.2	-12.0	13.1	30.4	20.1
as % of GDP	1.5	0.2	-2.0	1.8	4.0	2.7
Merchandise trade deficit (TURKSTAT def.)	62.8	69.9	38.8	71.7	107.0	99.7
Non-Energy	34.1	29.2	12.8	37.6	59.5	53.9
Energy	28.7	40.7	26.0	34.0	47.6	45.9
Oil price (Brent)	72.7	98.4	61.5	79.5	111.2	104.9
%	11.5	35.4	-37.5	29.3	39.9	-5.6

Source: CBRT, TURKSTAT, Turkey Data Monitor, Şeker Securities

External financing

External financing will be a key issue for investment decisions to Turkey this year as the problems in Europe continue. We calculate that the Turkish economy will need some USD 135 billion in 2012 to finance its current account deficit (USD 65.9bn), MLT debt service (USD 44.5bn) and short-term debt service of some USD 25bn (excluding short-term trade credits). Our projection should not be misleading if you compare it to around USD 200 billion, which are the figures circulating in the market, as we do not include short-term trade credits. In fact, including financing to rollover short-term trade credits (around USD 75 billion for 2012), our financing need forecast would reach some USD 210 billion. Our reasoning for not including short-term trade credits in external financing need is that trade credits are very easy to rollover as it is a low risk trade for banks.

Table 4: External Financing, 2008-12 (USD bn)

	2008	2009	2010	2011 (f)			2012(f)
				Jan-Oct	Nov-Dec (f)	FY (f)	
Outflows	84.9	62.4	93.7	98.4	21.1	119.5	110.4
Current Account Deficit	42.0	14.0	47.1	65.1	12.9	78.0	65.9
Debt service (MLT)	42.9	48.4	46.6	33.3	8.1	41.5	44.5
Public	10.6	6.7	8.5	7.8	1.4	9.2	8.0
o/w: IMF	1.9	0.7	2.2	2.1	0.7	2.8	2.0
External debt securities	3.4	1.9	2.6	1.8	0.0	1.8	2.4
Private	32.3	41.7	38.1	25.5	6.8	32.3	36.5
Banks	7.2	7.6	6.7	5.9	0.7	6.6	8.3
Other sectors	25.1	34.0	31.4	19.6	6.1	25.7	28.3
Inflows	84.9	62.4	93.7	98.4	21.1	119.5	110.4
Capital account	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0
FDI (net)	17.0	6.9	7.6	9.8	2.0	11.8	11.5
Portfolio (private; net)	-0.5	0.1	1.3	4.0	-0.3	3.7	1.5
Borrowing (MLT)	65.2	35.4	54.5	49.5	14.4	63.8	61.5
Public	7.8	6.9	24.1	17.2	6.2	23.4	21.5
o/w: IMF	3.6	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities 1/	-1.1	2.0	17.4	13.2	5.4	18.6	16.5
o/w: TL-securities (net)	-5.1	-1.7	10.7	9.0	5.4	14.4	10.0
Private	57.4	28.6	30.3	32.3	8.2	40.5	40.0
Banks	7.7	5.7	7.2	9.5	1.2	10.7	10.3
Other sectors	49.7	22.9	23.1	22.8	7.0	29.8	29.7
Short-term (net)	4.3	-4.5	15.5	12.9	2.0	14.9	-3.6
Currency and deposits (net) 2/	-6.8	19.6	23.6	10.8	2.2	13.0	21.0
Errors & omissions 3/	4.7	5.1	4.1	13.1	-2.6	10.5	0.0
Reserve use ('-' = reserve build-up)	1.1	-0.1	-12.8	-1.7	3.4	1.7	18.5
Unidentified Flows / Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:							
MLT debt rollover ratios (%)							
o/w: Banks	107	75	107	161	170	162	125
Other sectors	198	67	74	116	115	116	105

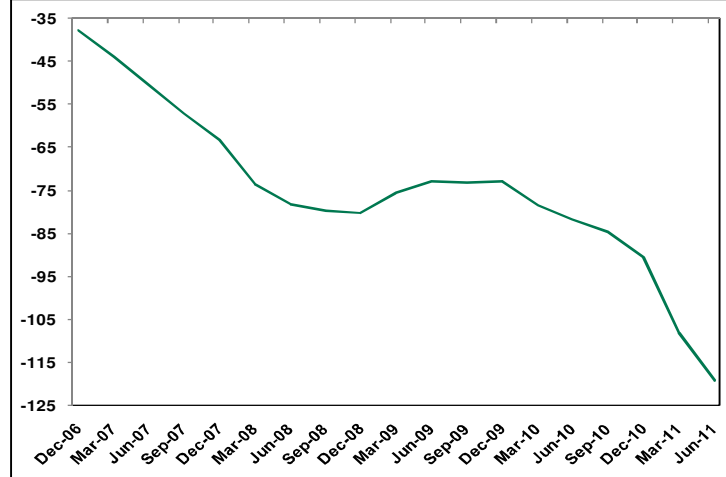
Source: CBT, Treasury, IMF, our calculations.

1/ Includes (net) issues of domestic debt to non-residents, in addition to eurobonds.

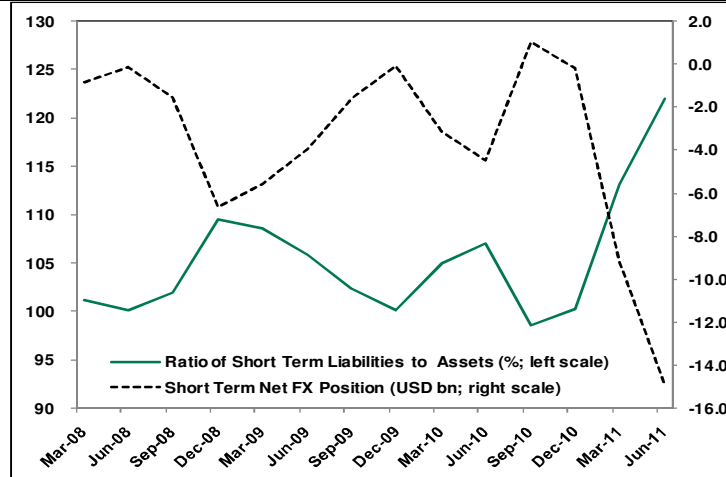
2/ Inc. other assets and liabilities; (-) indicates asset build up abroad and liability draw down inside.

3/ We follow the convention of assuming zero E&O for projections, but keep history unchanged.

Given the fact that 80% of non-bank MLT borrowing comes from Europe, it is certain that MLT debt rollover ratios will decline, which is negative for the lira, barring a new round of quantitative easing from the Fed or ECB fills the market with Euros. In addition, at USD 119 billion, the net FX position of the corporate sector is significantly higher than pre-crisis levels as of second quarter and the ratio of short-term liabilities to assets is also higher, with the net short-term FX position rising. (Graph 28-29) Although, these will likely be negative for the lira in 2012, we assume a significant asset drawdown from abroad as was the case in 2009, which will offset some pressure on the lira from the corporate side this year.

Graph 28: Corporate Sector Net FX Position (USD bn)

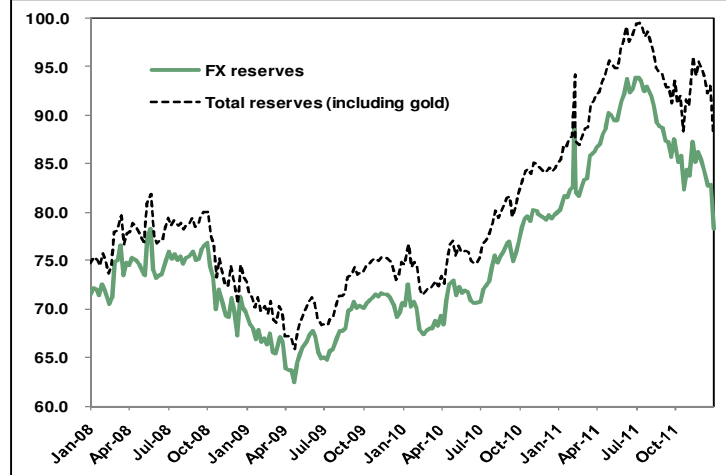
Source: CBRT

Graph 29: Corporate Sector Short-term Net FX Position (USD bn)

Source: CBRT

In 12-month rolling terms, the share of MLT debt and FDI in external financing is increasing though at a slow pace. After the ECB's 3-year loan of EUR 490 billion to Eurozone banks in December, we are now more optimistic about MLT debt rollover ratios. Meanwhile, we forecast an FDI of USD 11.5 billion this year, almost stable compared to last year due to the expected financing problems by European banks and domestic economic risks.

In our view, the CBRT's use of reserves as well as inflows to bond market in the second half will partially prevent further depreciation of the lira in addition to asset drawdown by the corporate and banking sector in 2012 as in the previous episode of 2008-2009. Combining the above-mentioned facts led us to the conclusion that the pressure on the lira will remain during the first half, which will necessitate significant erosion in the CBRT's reserves this year. According to CBRT data, the central bank's FX reserves (including gold) stands at USD 88.2 billion as of December 30. (Graph 30) However, after the FX interventions and FX selling auctions last week, it might have declined to USD 85-86 billion as of Friday, January 6th.

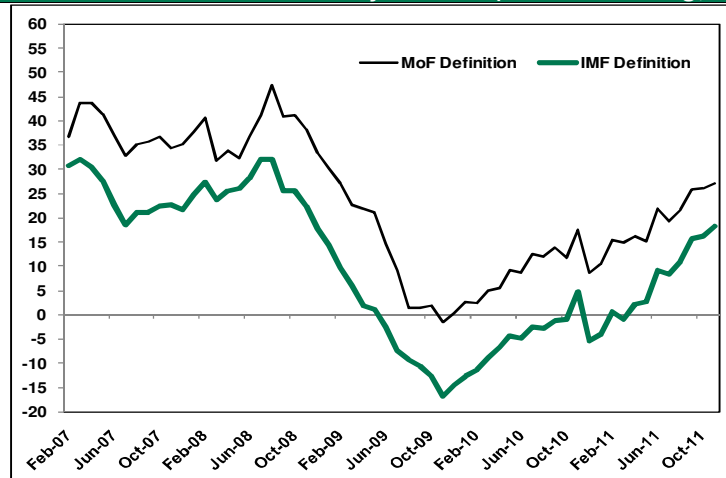
Graph 30: International reserves (USD bn)

Source: CBRT

All in all, although financing conditions will likely be tighter in 2012, we expect the pressure on the lira to ease slightly in the second half of the year with the help of the options alternative to MLT borrowing, also used in 2008-2009, inflows to bond market and reserve use as well as improvement in the CAD.

Structuring, high growth and lower interest payments supported the budget in 2011 but what about 2012?

The central government budget registered a budget and primary surplus of TRY 0.4 billion and TRY 41.4 billion respectively in January-November. (Table 5) They improved by TRY 23.9 billion and TRY 18.5 billion respectively compared to the same period in 2010, which was impressive. In November, the 12-month rolling program defined primary surplus, which excludes one-off revenues and expenditures but not revenues from restructuring, increased to TRY 18.2 billion (1.4% of GDP) from TRY 16.2 billion (1.3% of GDP) in October. (Graph 31)

Graph 31: Central Government Primary Balance (12-month rolling; TRY bn)

Source: Treasury

Table 5: Central Government Budget, 2010-2011 (TRY bn)

	Jan-Nov		Real growth (%)
	2011	2010	
Central Government Revenues	<u>272.8</u>	<u>232.3</u>	7.3
o/w: General Budget Revenues	<u>264.3</u>	<u>225.0</u>	7.3
Tax Revenues	<u>234.1</u>	<u>192.6</u>	11.0
o/w: Corporation Tax	71.2	57.6	12.9
Tax on Income	26.5	20.7	16.9
Tax on Goods and Services	95.2	83.8	3.9
o/w: VAT	28.3	24.5	5.5
SCT	58.4	51.8	3.1
Tax on Foreign Trade	48.2	34.8	26.4
Non-Tax Revenues	38.7	39.7	-11.1
Central Government Expenditures	<u>272.3</u>	<u>255.8</u>	-2.8
Non-Interest Expenditures	231.3	209.3	1.0
o/w: Personnel	79.7	68.1	6.9
Government Prem. to Social Security Agen.	11.6	9.9	6.6
Good and Services Procurements	26.1	21.6	10.3
Capital Expenditures	20.8	17.6	8.0
Current and Capital Transfers	100.6	96.8	-5.1
o/w: Social Security	50.3	52.7	-12.9
Transfers to Households	1.9	1.4	23.8
Agricultural Subsidy	5.7	5.4	-3.1
Treasury Aid to Provincial Offices	2.5	1.6	43.6
Interest Expenditures	41.0	46.5	-19.4
Overall Balance	<u>0.4</u>	<u>-23.5</u>	...
Primary Balance	<u>41.4</u>	<u>23.0</u>	...

Source: Ministry of Finance

TRY 13.1 billion in previously unpaid debt collection under restructuring and less social security transfers due to the increased unpaid premium collection by Social Security Institution which we forecast at around a net of TRY 5 billion made a significant contribution to the central government budget. Without them, the 12-month rolling IMF defined cumulative primary surplus would be near zero as of November. These items will continue to contribute to the budget figures in 2012 at a slowing pace as the installments will continue this year.

The central government's primary expenditures may have jumped in December due to heightened capital expenditures if all of the additional appropriations of TRY 9.1 billion in capital expenditures were used. According to our forecasts, the budget may have posted a deficit of some TRY 15 billion and a primary deficit of TRY 13.5 billion, similar to December 2010. Therefore, the budget balance and primary surplus for 2011 might be announced at -TRY 14.7 billion (-1.2% of GDP) and TRY 27.9 billion (2.2% of GDP) respectively according to our forecasts. These figures are favorable compared to the government's revised budget targets for 2011 (budget balance: -1.7% of GDP and primary surplus: 1.6% of GDP).

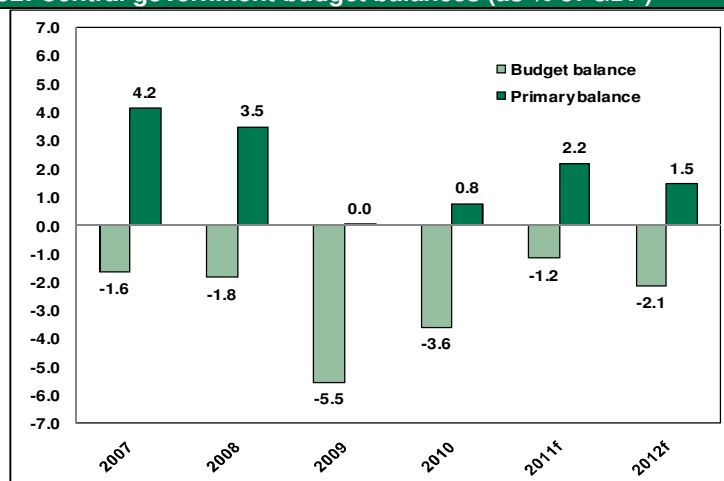
Strong economic activity and revenues from restructuring were the main factors behind the forecasted improvement of 1.4% of GDP in primary surplus in 2011, though the effect of these two will fade away this year. Low growth this year will likely press budget balances both through its effects on tax collection and potential government measures to support economic activity. While the former will likely show itself through consumption taxes and VAT on imports, the potential

primary expenditure increase and tax cuts may be examples for the latter. We calculated the effect of growth differential between our and government's forecast (1% vs. 4%) and incorporated in our budget projections. In addition, due to inflation missing the target, the government will make a 2.7% additional increase in civil servant salaries, that will cost an additional TRY 2.5 billion according to the Minister of Finance.

However, there will be one-off factors supporting the revenue side in 2012. Revenue from paid military service and the sales of state-owned land (known as 2-B), may behave as restructuring did in 2011. About 20% of the eligible 420,000 people will likely apply for the paid-in military service as in the previous application in 1999, which may add around TRY 2.4 billion to the 2012 budget revenues. The law for the state land (2-B) may come to parliament in late February at the earliest according to news. The land is expected to be sold for 70% of its market value, which corresponds to TRY 19 billion in revenue for the government. However, as 20% will be paid in cash, others may be paid in installments and a 15% discount will be made if all payment are made in cash, we forecast around TRY 5.5 billion in additional revenue collection for 2012.

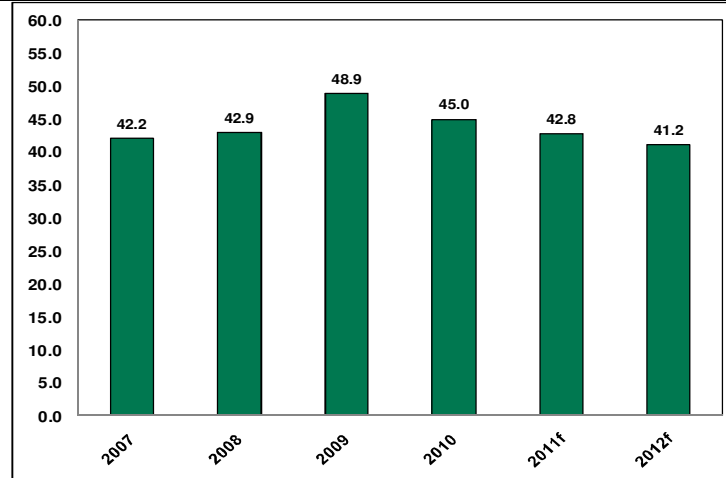
Taking all of these facts into account for 2012, we forecast the budget balance and primary surplus at -2.1% of GDP and 1.5% of GDP respectively, unfavorable compared to the targets of a -1.5% budget balance and 2.0% primary surplus. (Graph 32)

Graph 32: Central government budget balances (as % of GDP)



Source: Ministry of Finance, TurkStat, Seker Securities

Public debt as a percentage of GDP maintained its decline in 2011 according to our forecasts. While the year-end figures were not published, we forecast that CG debt stock declined to 40.7% of GDP in 2011 from 42.9% in 2010. On the other hand, it will decline further to 39.1% in 2012 according to our projections, which corresponds to a 1.6 pp decline in public debt to GDP ratio to 41.2% in 2012. (Graph 33)

Graph : Public Sector Debt Stock (as % of GDP)

Source: Treasury, TurkStat, Seker Securities

Hopes for investment grade in 2012 vanish

The chance of a rating upgrade to investment grade by one of three major ratings agencies in 2012 is close to zero in our view as the uncertainty over external financing remains. Large external financing requirement due to record current account deficit, which makes Turkey vulnerable to external shocks, is the primary concern for ratings agencies nowadays. This concern caused Fitch to revise Turkey's foreign and local currency rating outlook to stable from positive, affirming both ratings at BB+, in late November.

"The revision ... reflects an increase in near-term risks to macroeconomic stability as Turkey faces the challenge of reducing its large current account deficit and above-target inflation rate against the background of deterioration in the global economic and financing environment", Fitch said. While the ratings agency argued that success of the CBRT's unorthodox policy mix is debatable, "evidence that Turkey can attain a 'soft landing', with GDP growth returning towards trend, coupled with greater confidence that inflation is on a path towards its target rate and the CAD is narrowing to a more sustainable rate could lead to an upgrade " according to Fitch. "However, severe macroeconomic or financial instability such as a 'balance-of-payments crisis' and recession or a failure to secure disinflation, for example triggered by external shocks or domestic policy mistakes could lead to negative rating action", the agency added.

Another warning on ratings came from Moody's in late November. *"Turkey's most significant challenge is the current account deficit and its financing, which renders it vulnerable to balance-of-payment shocks and offsets some, though not all, of the progress that the government has made in improving its own financial strength"* said Moody's. Moody's added that *"an upgrade of the rating would be possible if Turkey were to pursue fiscal and monetary policies that reverse the recent growth in internal and, more importantly, external imbalances."*

Fitch's current rating on Turkey's foreign currency debt is one notch below investment grade compared to two notches by S&P (BB) and Moody's (Ba2) with positive outlooks. Risks to external financing in 2012 and the difficulty in achieving

a high growth rate will be the reasons for not achieving a ratings upgrade to investment grade this year in our view. The agencies will wait for signals of normalization in the current account to sustainable levels by a process that doesn't harm the growth outlook, which would be very difficult to attain this year. All in all, for 2012, we see almost no chance of a ratings upgrade to investment grade as the financing picture will likely deteriorate and the current account deficit will only moderately narrow.

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