

Inflation: Thank you base effects!

Annual inflation declined to the lowest level since 1970 due to base effects...

Consumer prices rose 0.7% in February, parallel to the market consensus. The high base of February 2010 (1.5%) led annual inflation to fall to 4.16% – a new historic low since 1970 – in February from 4.91% in January.

Core inflation indicators started to reflect the secondary effects of higher commodity and energy prices...

Digging deeper into the monthly data, food and non-alcoholic beverages group prices were the primary contributor to monthly inflation, rising 2.5% MoM and contributing 0.7 points to the headline. Meanwhile, transportation prices rose 1.8% MoM, and this group was the second largest contributor at 0.3 points. Clothing group prices declined 5.2% MoM on the back of seasonal discounts.

Core inflation indicators do not provide a comfortable picture, and reflect the secondary effects of higher commodities and energy prices on core consumer prices. The H index rose 0.3% MoM, and I index, which is the most closely followed core indicator by the CBRT, increased by 0.1% MoM, whereas both indexes displayed declines in the last five years. On the other hand, annual I index inflation, which excludes food, energy, beverages, tobacco products and gold, increased to 3.8% from 3.2% in January.

High producer prices will likely pass its effects to CPI inflation in the months to come...

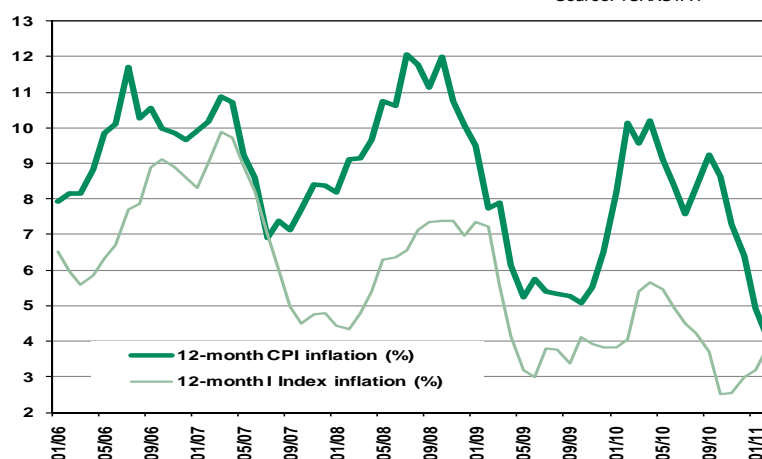
In addition to the increase in core inflation, a 1.7% MoM increase in producer prices raises our concerns that high commodity and energy prices and a weaker Lira will pass its effects to CPI inflation over producer prices in the months to come.

The recent events in the MENA region caused oil prices to jump to a new plateau, and these levels undoubtedly placed an upside risk to our previous inflation forecast for this year (6.8%). Given the rise in oil prices and depreciation of the Lira, we have revised our year-end CPI inflation forecast to 7.8%.

Summary Inflation Data: February 2011
(in percent)

	Monthly		12-month	
	Feb 11	Feb 10	Feb 11	Jan 11
CPI	0.73	1.45	4.16	4.90
Food and Beverages	2.54	5.01	4.53	7.06
Tobacco and Liquor	0.01	3.72	-1.51	2.15
Clothing and Footwear	-5.15	-5.25	5.35	5.24
Housing	-0.14	0.39	4.38	4.93
Houseware	0.92	-0.11	4.66	3.59
Health	0.11	-0.20	1.29	0.97
Transportation	1.77	0.42	6.03	4.63
Communication	0.43	0.11	-1.50	-1.81
Entertainment and Culture	-0.40	-0.57	-1.97	-2.13
Education	0.14	0.02	4.35	4.22
Hotels, Cafes and Restaurants	0.45	1.17	8.60	9.38
Misc. goods and services	0.83	0.22	7.36	6.71
PPI	1.72	1.66	10.87	10.80
Agriculture	2.15	4.04	12.86	14.95
Mining and Quarrying	2.77	0.28	12.77	10.03
Manufacturing Industry	2.32	0.39	10.98	8.89
Electricity, Gas and Water	-4.42	9.14	5.33	20.28

Source: TURKSTAT



Source: Turkstat

MPC decision: Negative in the short-run, but positive in the medium to long term...

The Monetary Policy Committee kept the policy rate (1-week repo rate) unchanged at 6.25% in March meeting. This was in line with the market consensus.

The CBRT shocked the market with regard to the reserve requirement ratios...

However, the CBRT shocked the market with regard to the reserve requirement ratios (RRR) as most of the market players had not been anticipating an increase in reserve requirement ratios. (In fact, the CBRT's governor Durmus Yilmaz had stated before the meeting that they will wait end-March data to decide whether new measures are necessary.) The bank increased RRRs on demand deposits and time deposits with a maturity up to 3-months by 300-500 bps. The new regulation on reserve requirement ratios is expected to withdraw TRY 19.1bn from the market on April 15 as per the announcement.

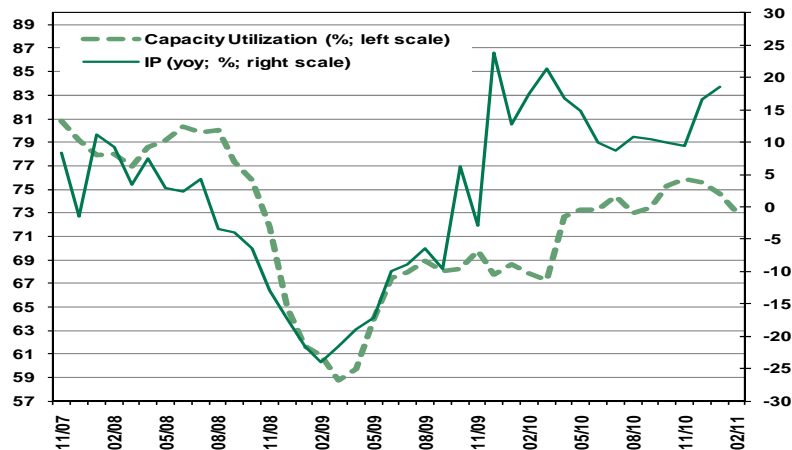
The committee says that it increased the RRRs to both consolidate financial stability and to limit possible secondary effects of the recent increase in oil and commodity prices on inflation. In our view, the move will have a positive effect on inflation and current account deficit in the medium-term as the RRR decision without an accompanied rate cut will surely be contractionary.

January IP figures increase over-heating concerns...

Working day and seasonally adjusted IP broke a new record in January...

Industrial production expanded 18.9% YoY in January, above the market consensus (16.2%) and our in-house forecast (14.5%). On the other hand, seasonally and working day adjusted IP rose 0.5% MoM to a new record level above the previous one observed in December.

Reflecting the private sector's continued investment appetite, capital goods production surged 34.9% YoY in January. On the other hand, intermediate goods production rose 22.2% YoY, signaling that the strong momentum of industrial production will continue in the remainder of the first quarter. The latest figures validate the idea that the economy is in fact on the road to over-heating, and that inflationary pressures on consumer prices will emerge in the months to come.



Source: CBRT, Turkstat

Unemployment rate declined to 11.9% last year, still above pre-crisis levels...

We expect the decline in annual unemployment rate to continue in 2011....

The unemployment rate declined to 11.9% last year from 14.0% in 2009, improving 2.1 points. (The rate was 11.0% in 2008 and 10.3% in 2007). The improvement in the unemployment rate comes from the 425k decline in the number of unemployed and 893k increase in the labor force. The agriculture, industry and services created 443k, 542k and 333k new jobs, totaling to 1,317k. Meanwhile, non-farm unemployment declined to 14.8% from 17.4% in 2009.

We expect that the decline in the unemployment rate to continue in 2011 given the strong economic momentum. However, the decline will be limited as the existence of contractionary monetary policy (to cope with the current account deficit widening) may limit the speed of job creation in the economy this year, in addition to the dissipation of base effects.

Net errors and omissions item was the primary financier in January ...

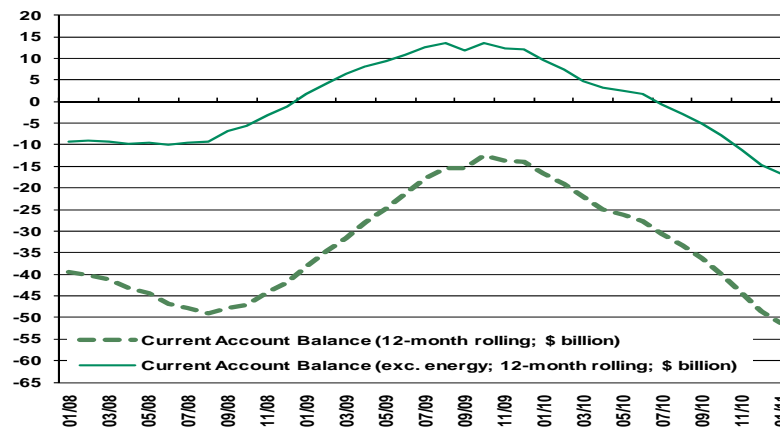
12-month rolling current account deficit at a new record in January...

The current account deficit (CAD) for January came in at \$5.9bn, generally in line with our in-house forecast of \$6.0bn and slightly below the market consensus (\$6.2bn as per the CNBC-e survey). Inclusion of the January figures brought 12-month rolling CAD to \$51.4bn from \$48.6bn (6.5% of GDP) in December. On the other hand, 12-month rolling non-energy CAD continued to widen, from \$14.6bn to \$16.7bn in January, reflecting the strength of the economic momentum.

Net errors and omissions item was the primary financier of the CAD in January...

On the financing front, the economy saw \$6.7bn of inflows, including the reserve accumulation of the CBRT (\$0.9bn). Particularly striking is the \$3.7bn inflows under the net errors and omissions item in January, partially may be related with the events started in Tunisia in December. In fact, the net errors and omissions item was the primary financier of the CAD figure in January. On the other hand, Turkey attracted a portfolio inflow of \$2.0bn in January, as Treasury bills absorbed \$2.8bn, and foreign investors withdrew \$0.6bn from the stocks listed in the ISE.

We revised our current account deficit forecast for this year to \$61.5bn (7.8%) of GDP from the previous \$57bn (7.3% of GDP) after rising our Brent price assumption to \$107 from \$91 previously, as well including the impact of the events in the MENA region to service and non-energy trade balance of Turkey.



Source: CBRT

Budget: Strong once again in February despite the June elections ...

Relation between economic momentum and tax revenues in budget is crystal clear...

In February, central government budget posted a surplus of TRY 1.0bn and a primary surplus of TRY 7.2bn. The subdued expenditure growth (5.7% YoY) and the surge in tax revenues (30.7% YoY) were behind the positive budget performance, even interest expenditures rose 34.8% YoY to TRY 6.2bn in February.

As for the revenues, the improvement in February primarily stemmed from the increase in corporate taxes (47% YoY, to TRY 6.2bn) and domestic taxes on goods and services (21% YoY, to TRY 7bn). The relation between economic momentum and the improvement in the budget is crystal clear.

We find the budget figures for the first two months of the year encouraging...

With the inclusion of February figures, the budget registered a surplus of TRY 2bn and a primary surplus of TRY 12bn compared to the figures for January-February 2010 (TRY - 5.4bn and TRY 5.3bn respectively). Clearly, we find the budget figures for the first two months of the year encouraging for the government to attain its budget goals this year. The government targets a TRY 33.5bn budget deficit (2.8% of GDP) and TRY 14bn primary-surplus for 2011.