

**Double digit inflation necessitates continued tightening**

**Jump in food prices determined the course of inflation in December...**

Inflation was above consensus in December. Consumer prices rose 0.58% MoM in December, more than the market consensus and our forecast (both at 0.38%). This monthly figure brought 12-month inflation to 10.45% from 9.48% in November.

The food group was the main contributor to monthly inflation. Prices in this group rose 1.97% MoM, and was the main contributor to monthly inflation with 53 bps. Meanwhile, clothing prices declining 2.17% MoM on the back of seasonal discounts and erased 16 bps from monthly inflation. While housing group prices were up 0.53% MoM mainly due to coal and firewood price hikes, transportation price inflation was moderate at 0.18% MoM as automotive companies did not reflect the currency weakness on automobile prices in December due to it being the traditional campaign period.

**We forecast 6.7% year-end inflation...**

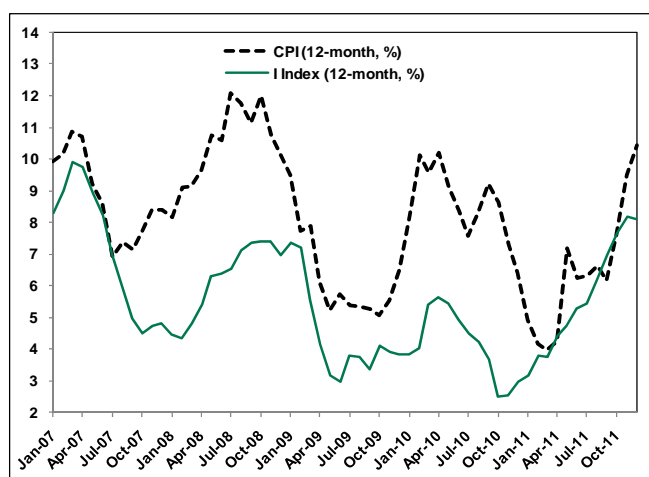
Annual core inflation indicators displayed some stabilization in December as I index inflation, which excludes food, non-alcoholic beverages, energy, alcoholic beverages, tobacco and gold edged down to 8.12% from 8.18%.

We see inflation remaining between 9-11% until the last quarter this year before sharply declining to 6.7% due to the strong base in the last quarter of 2011.

**Summary Inflation Data: December 2011**  
(in percent)

	Monthly		12-month	
	Dec 11	Dec 10	Dec 11	Nov 11
<b>CPI</b>	<b>0.58</b>	<b>-0.30</b>	<b>10.45</b>	<b>9.48</b>
Food and Beverages	1.97	-2.66	12.21	7.11
Tobacco and Liquor	-0.01	0.04	18.50	18.56
Clothing and Footwear	-2.17	-1.77	7.98	8.41
Housing	0.53	1.17	8.20	8.88
o/w: Rent	0.27	0.20	4.71	4.64
Houseware	0.29	0.33	11.04	11.09
Health	-0.09	0.04	0.34	0.46
Transportation	0.18	1.07	12.22	13.22
o/w: Maintenance	0.53	4.36	11.02	15.25
Communication	0.35	2.65	2.48	4.83
Entertainment and Culture	0.79	0.25	6.49	5.92
Education	-0.09	0.05	6.47	6.62
Hotels, Cafes and Restaurants	0.51	0.33	8.20	8.01
Miscellaneous goods and service	0.32	2.03	17.14	19.14
<b>PPI</b>	<b>1.00</b>	<b>1.31</b>	<b>13.33</b>	<b>13.67</b>
Agriculture	3.18	-1.76	10.54	5.25
Industry	0.57	2.00	13.92	15.54
o/w: Mining and Quarrying	0.13	1.80	19.77	21.77
Manufacturing Industry	0.37	1.96	14.59	16.41
Electricity, Gas and Water	2.51	2.41	6.38	6.28

Source: TURKSTAT



Source: TurkStat

**CBRT may be at the peak of the 'normal' day concept**

As expected, the Monetary Policy Committee (MPC) kept the policy rate (one-week repo rate) unchanged at 5.75% in January. The walls of the interest rate corridor, O/N lending and borrowing rate, were also maintained at 5.00% and 12.50% respectively, as is the case in the O/N lending rate for primary dealers (12.00%).

**CBRT will adjust the amount of one-week repo funding when necessary...**

Rebalancing in the economy continues and the current account deficit will continue to decline gradually, according to the CBRT. The bank expects a moderate course for domestic demand growth, which will limit the secondary effects of temporary price movements, and accelerate the decline in inflation in the last quarter of the year thanks to base effects. The CBRT reiterated that tight monetary conditions will prevail for a while in order to keep the inflation outlook in line with medium-term targets. On the other hand, the CBRT preserved its flexibility of adjusting the amount of funding provided through one-week repo auctions due to the uncertainties with regard to the global economy. The CBRT is likely to continue its policy of 'normal days' for a while barring a major deterioration in the risk appetite. However, removal of the regular FX selling auctions and increasing the limits of one-month repo funding point to the fact that we may be at a dip for funding costs and for the currency basket for now.

**CBRT likely to continue its policy of 'normal days' for a while barring a major deterioration in the risk appetite...**

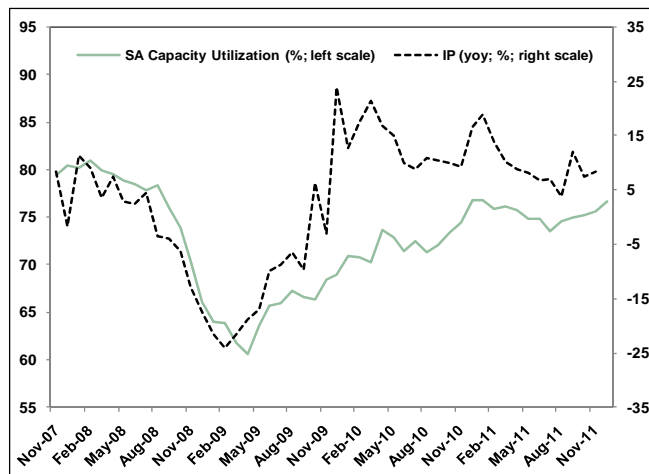
CBRT halted regular FX selling auctions in which it sells USD 50mn as of January 25th thanks to improvement in the current account balances and sudden changes in global conditions (increased risk appetite in our words). Instead of regular auctions, the bank will continue to use intraday FX selling auctions if needed, in which the bank will sell USD 50mn in each auction and a maximum daily amount of USD 500mn until the next MPC meeting (February 21st). As for lira liquidity, the bank will continue to open one-week repo auctions of TRY 3 – 7bn at 5.75% in normal days, when it opens an auction until February 21st. On the other hand, the upper limit provided in one-month repo auctions increased to TRY 5bn from TRY 3bn).

**Economic activity remains strong as of Q4**

**Economic activity remained strong in the last quarter...**

At 75.5%, capacity utilization came in above our 74.7% forecast in December. Capacity utilization declined 0.1 pp over December last year. On the other hand, the seasonally adjusted capacity utilization figures point to the continuation of strong manufacturing activity in the last quarter. Adjusted for calendar effects, capacity utilization increased 1.0 pp MoM to 76.6% on top of the 2.1 pp increase since August. On average, seasonally adjusted capacity utilization increased 1.5 pp in Q4 over Q3. Capacity utilization in intermediate and consumption goods accelerated in December, supporting strong economic activity in the last quarter. According to our calculations, the SA capacity utilization rate for intermediate goods rose 0.6 pp MoM to 79.3% in December, following a stable CUR in November. On the other hand, capacity utilization in investment goods jumped 2.8 pp to 78.1%, proving the strong investment appetite of the private sector. The release support our thesis that economic activity remained strong in the last quarter, which translates to 8.2% annual growth this year to be followed by some 1% next year.

**Our growth forecast for 2012 stands at 0.8%...**



Source: Turkstat, CBRT

**Adjustment in non-energy CAD continues**

**Decline in the cumulative current account deficit has begun...**

November's monthly current account deficit came in at USD 5.2bn, in line with our in-house forecast (USD 5.2bn) and slightly lower than the market consensus of USD 5.3bn. The 12-month rolling CAD declined to USD 77.8bn from USD 78.6bn registered in October as the monthly deficit compares favorably with the USD 6.0bn registered in November 2010. Meanwhile, the adjustment in non-energy CAD continued in November in 12-month rolling terms. It declined by USD 1.9 billion to USD 31.2 billion, following the USD 0.4bn improvement in October. We expect the narrowing in the non-energy CAD to continue in the upcoming period mainly due to the slowdown in non-energy imports.

**Decline in the cumulative current account deficit will be limited this year...**

On the financing side of the equation, we see net FDI remaining weak at USD 0.2bn in November. There were USD 1.9bn in inflows to portfolio instruments, as foreign investors sold USD 0.3bn in equities over the ISE, and debt securities saw an inflow of USD 2.2bn (USD 1.5bn was to government's domestic debt securities). USD 2.8bn in asset drawdown by local banks from abroad were another significant financing item in November. On the other hand, official reserves rose USD 1.9bn in November thanks to the increase of the ratio of FX that can be held as required reserves for TRY liabilities to 40% from 20% in late October. Meanwhile, there was an inflow of USD 0.7bn under net errors and omissions in November, which brought year-to-date financing under this item to USD 12.9bn.

We forecast a CAD of USD 78bn (10.3% of GDP) for 2011 before the deficit narrows marginally to USD 66bn (8.9% of GDP) this year.

**Current Account Developments  
(in millions of US\$)**

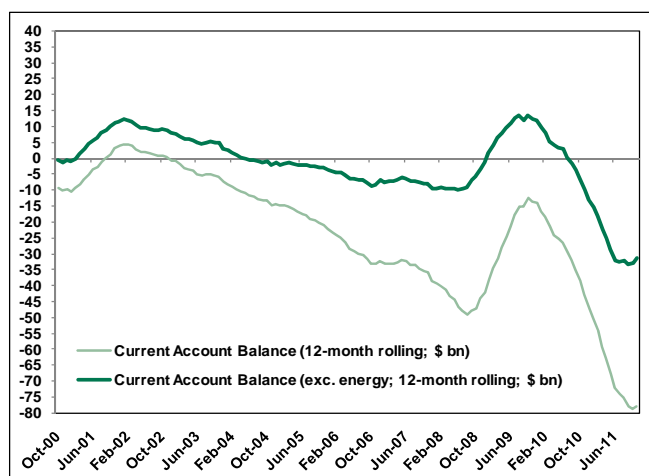
	Nov		12-month rolling	
	2011	2010	Nov	Oct
Current Account	<u>-5,188</u>	<u>-5,975</u>	<u>-77,820</u>	<u>-78,607</u>
o/w: Non-Energy 1/	-805	-2,658	-31,219	-33,072
Trade Balance	-6,255	-6,517	-90,002	-90,264
Exports	11,788	9,927	142,660	140,799
%	19	4	240	225
Imports	-18,043	-16,444	-232,662	-231,063
%	10	36	437	463
Services (net)	1,310	894	18,604	18,188
o/w: Tourism (net)	1,226	1,012	18,663	18,449
%	21	-3	238	214
Income (net)	-351	-452	-7,940	-8,041
o/w: Interest Expenditu	-334	-310	-5,116	-5,092
Current Transfers	108	100	1,518	1,510
Memorandum Items: 2/				
Trade Balance	<u>-7,533</u>	<u>-7,752</u>	<u>-106,467</u>	<u>-106,686</u>
Energy 3/	-4,383	-3,317	-46,601	-45,535
Non-Energy	-3,150	-4,436	-59,866	-61,151

1/ Current account less energy deficit by TURKSTAT definition, i.e. energy imports including cost-insurance-freight.

2/ TURKSTAT definitions.

3/ STIC definition; including crude oil, petroleum products and natural gas.

Source: CBRT



Source: CBRT

**Deterioration in monthly budget not confined to capital expenditures**

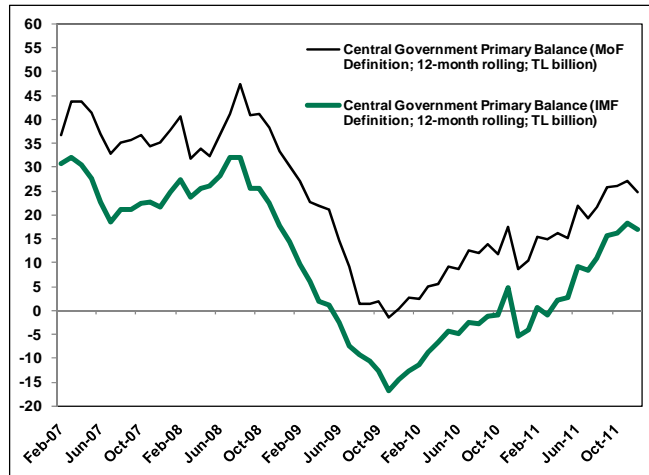
**Heightened investment expenditures as well as current transfers caused the budget deficit to surge in December...**

**Budget deficit and primary surplus will end the year at 2.1% and 1.5% of GDP respectively according to our forecasts...**

The central government's monthly budget balances deteriorated significantly in December compared to previous months due to heightened investment expenditures as well as current transfers. However, the central government's budget deficit of TRY 17.9bn and primary deficit of TRY 16.7bn does not seem so drastic compared to December 2010. The surge in primary expenditures was similar to the situation seen in December 2010, when the budget registered a deficit of TRY 16.1bn and a primary deficit of TRY 14.3bn.

Primary expenditures surged to TRY 39.7bn (up 10.3% YoY) in December, compared to an average of TRY 22.1bn in July–November, as the government depleted almost the entire TRY 9.1bn additional appropriations for investment expenditures. Capital expenditures rose 19.1% YoY to TRY 9.9bn, despite the elevated expenditure base in December 2010. In addition, current transfers jumped by 47% YoY in December to TRY 13.2bn, and half of the deterioration came from financing duty losses of state economic enterprises. On the revenue side, revenues rose only by 6.2% to TRY 23.1bn, while tax revenues rose 9.5% YoY to TRY 19.7bn.

Looking at the full year figures, budget balances compare favorably to the revised budget targets for 2011. The budget deficit and primary surplus for 2011 were TRY 17.4bn (-1.4% of GDP) and TRY 24.8bn (1.9% of GDP), comparing favorably with both the revised targets (-1.7% of GDP and 1.6% of GDP respectively). Strong economic activity and revenues from restructuring were the main factors behind the forecasted improvement of some 1% of GDP in the primary surplus in 2011. 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.



Source: Ministry of Finance