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Macroeconomy Research
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Turkish economic outlook for 2010

- As the economy recovers faster than expected from the great recession, headline inflation has surged due to external supply shocks such as food prices and one-off adjustments on tax hikes. The hottest issue is when the Central Bank of the Republic of Turkey (CBRT) will hike its policy rates to respond to rising inflation expectations.
- The CBRT revealed its exit strategy from its massive monetary policy measures in April. The process will be gradual and market-friendly and rate hikes are not in the pipeline for the next several months.
- We forecast the year-end CPI for 2010 at 8.5% for 2010 with an average of 9.7%. Annualized CPI will remain above 10% for the next 5 months before starting to ease in 4Q10. We expect the CBRT to enter the rate hiking cycle in 3Q10 with a 200bps total rate increase in 2010.
- Despite the lack of the external financing, economic growth will be bolstered by strong restocking, low base year affects and improved global sentiments. We maintain our annual GDP growth estimate for 2010 at 4.0%, while reserving the right to upgrade.
- 1Q10 budget realizations have been impressive, backed by stronger than expected revenue collections thanks to better-than expected economic growth. The numbers show that the government continues to prioritize fiscal discipline. Yet the 2010 budget will be closely watched given the approaching general elections and a possible surge in pre-election expenditures.
- The current account (CA) deficit will widen in 2010 after narrowing significantly last year. Its widening pace and magnitude will remain at manageable levels for the next 2 years. But, a stronger local currency is likely to speed up its widening pace in 2010.
- Finally, it is premature to rule out political risk in Turkey. The discussion around the new constitutional reform package, possible referendum in 3Q10 and 2011 general elections all have the potential to put pressures on markets.

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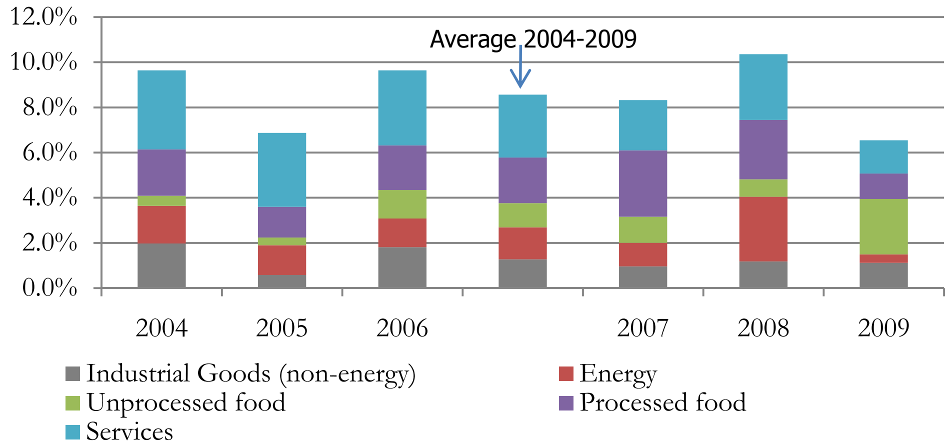
Major macro variables		2005	2006	2007	2008	2009	2010E	2011E
GDP	TLbn	649	758	856	951	954	1,088	1,196
Real GDP growth	%	8.4%	6.9%	4.7%	0.7%	-4.7%	4.0%	3.9%
Budget balance / GDP	%	-1.1%	-1.3%	-2.0%	-1.8%	-4.7%	-4.5%	-4.0%
Current account / GDP	%	-4.6%	-6.1%	-5.8%	-5.7%	-2.2%	-3.3%	-4.0%
CPI	year-end	7.7%	9.7%	8.4%	10.1%	6.5%	8.5%	6.0%
US$/TL	average	1.34	1.43	1.30	1.30	1.55	1.53	1.60

Inflation and interest rates

Administrative price hikes on petroleum, alcohol and tobacco products, along with commodity price surges have brought annual CPI to the 9.5%-10.5% territory for the next 5 months (higher than the official target of 6.5%) before the high base year affects fade out in 2011. We estimate the year-end CPI for 2010 at 8.5% for 2010 with an average of 9.7%. Annual CPI temporarily eased to 9.2% in March from 10.2% in February due to base year affects. It will remain above 10% for the next 5 months before starting to ease in 4Q10.

Food prices are champion with a 2.9 percentage point contribution to our year-end CPI estimate of 8.5% whereas alcohol beverages and tobacco items are to add 2.1 percentage points due to tax hikes. Energy price surges and tax hikes on petroleum products also spill over to the housing and transportation sectors. The former is expected to raise annual CPI by 1.4 percentage points and the latter to add 1.3 percentage points. Thus, recent price surges are mainly due to the supply side shocks such as food and energy prices while the demand-driven inflation remains benign. The contribution of the service prices sharply declined to 1.5 percentage points in 2009 following its average level of 3.0 percentage points. Still, significant improvement in the dynamics of inflation in service sector needs to be tested during the recovery period as the contracting domestic demand had been supportive last year.

Exhibit 1: Contributions of the subsectors to the annual CPI



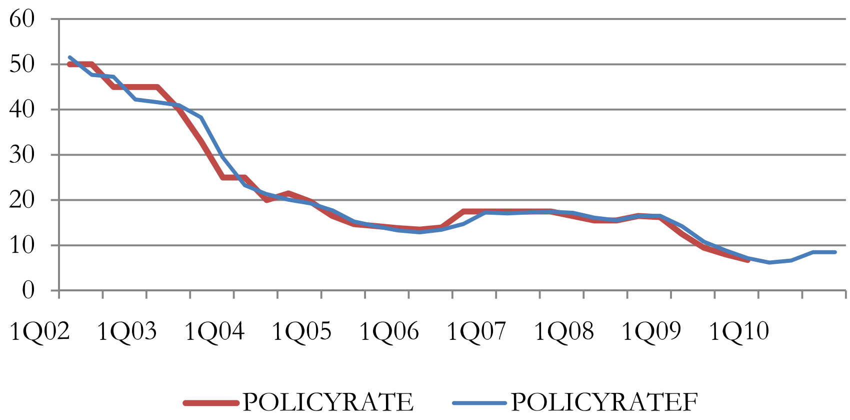
When to hike?

Headline inflation figures are up and the economy has already started to heat up. The crucial question at this juncture is when the CBRT will enter the rate hiking cycle. The CBRT has preserved the policy rate at 6.50% since December 2009, which was achieved by astounding policy rate cuts totaling 1025bps over a year, much more than execrated, one of the most aggressive among the emerging markets. The real interest rate (calculated with forward-looking inflation expectations) has declined to below 1% in December 2009 from 9% in 2008.

We visit the Taylor rule which is a normative tool for predicting how equilibrium interest rates are set. The rule is a monetary-policy tool that stipulates how much the central bank will change the nominal interest rate in response to a divergence in actual inflation from target inflation rates, and of actual gross domestic product (GDP) from potential GDP.

In the light of the above described inflation prospects and our GDP growth projection of 4.0% this year, we investigate the path for the CBRT's policy rate by considering the rules in which the bank responds to deviations from the inflation target and output gap to varying degrees. We explore two alternatives: (i) policymakers attach equal weights to deviations from the inflation target and output gap (Rule 1), and (ii) we employ the fitted Taylor rule where the lagged independent variable is introduced as a constraint.

Exhibit 2: Estimated fitted Taylor rule



Both rules work well but only if one constrains the measurement period to the post-2002 flexible exchange rate period. The exchange rate is statically insignificant but we improve the fit if we add the lagged dependent variable and the country specific risk premium (the EMBI spread) is interestingly statistically insignificant. Rule 1 indicates more aggressive rate hike cycle, but the second rule is better to explain the variation in policy rate changes. In this respect, the model indicates that the CBRT will hike rates as much as 200bps by year-end, likely starting in 3Q10.

No need to rush

Following its regular Monetary Policy Committee (MPC) meeting on April 13, the CBRT kept the policy rate unchanged at 6.5% and revealed its long-awaited exit strategy from monetary measures taken during the financial crisis. The process will be gradual. The CBRT first aims to reduce the more-than adequate liquidity provided by the Bank to the markets through lessening the amount of its repo funding. Secondly, as the liquidity shortage becomes permanent as anticipated, technical rate adjustment will be introduced gradually within two phases.

The CBRT has introduced several monetary measures to support the local markets during the global financial crisis:

On FX liquidity:

(i) The CBRT ceased FX buying auctions in October 2008 and started FX selling auctions to curb possible volatility in the FX markets. It utilized the FX auctions according to global sentiments. As capital inflows started to recover in 3Q09, FX buying auctions have restarted.

(ii) The Bank also started its financial intermediation in FX markets in October 2008 and doubled its FX deposit limits to USD 10.8 billion to calm the FX. Moreover, it decided to extend the maturity of FX deposits to 1 month from 1 week, along with reducing borrowing rates to 7% for USD and to 9% from 10% for EUR.

(iii) In February 2009, the CBRT further extended maturities of FX deposits to 3 months from 1 month along with reducing borrowing rates to 5.5% for USD and to 6.5% for EUR.

(iv) The CBRT cut the reserve requirement rate on FX deposits to 9% from 11% in October 2008, increasing FX liquidity by USD 2.5bn.

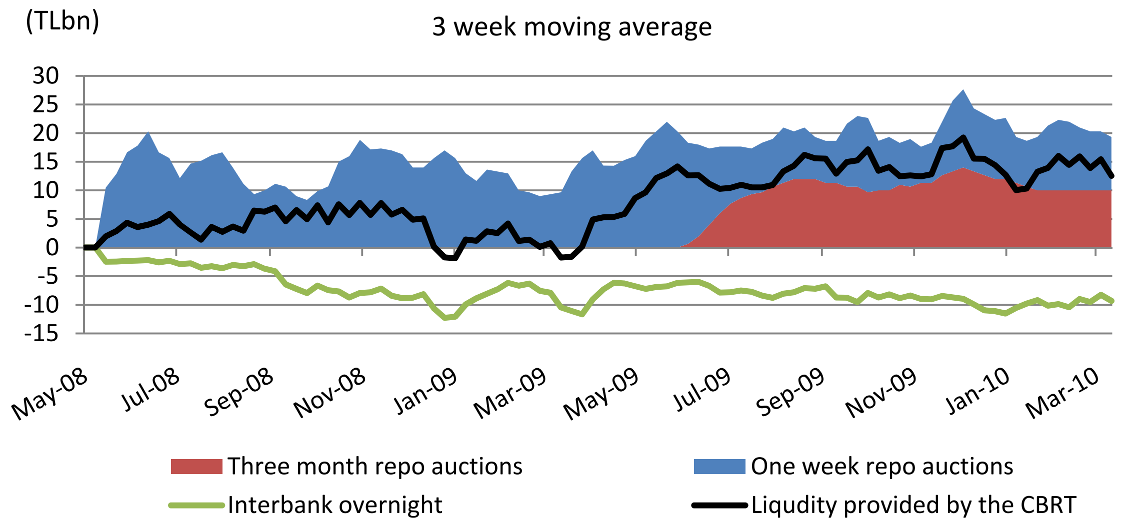
On TRY liquidity:

(i) It reduced the spread between the overnight borrowing and lending rate to 250bps in 4Q08 from 350bps to ease volatility. Moreover, the CBRT started to provide more liquidity to the monetary markets through 1 week repo auctions, but sterilized the excess liquidity at the end of the day through the overnight transactions.

(ii) The reserve requirements on TL deposits were reduced by 1 percentage points to 5% in 4Q09 and 3-month repo auctions were also introduced in 2Q09.

(iii) Finally, the overnight borrowing rate declined a staggering 1025bps to 6.5% over a year.

Exhibit 3: Turkish Liquidity Conditions



The CBRT will reverse the FX liquidity measures it introduced during the crisis, raising FX reserve requirements, raising the CBRT's lending rates on FX deposits and ultimately, ending the CBRT's intermediary role in the FX deposit market when necessary. Given the normalized FX liquidity situation and the CBRT's intention to execute the process gradually, this should not have much impact.

The CBRT continues to inject liquidity into the market of an amount above the net market need via repo auctions at the start of the day and to withdraw the excess liquidity at the end of the day via overnight transactions, so as to minimize fluctuations in overnight interest rates and possible concerns related to access to liquidity. As of March 26, 2010 the net liquidity shortage in the market was TRY 9 billion, prompting the CBRT to inject a total of TRY 17 billion of liquidity, of which TRY 7 billion was injected via 1-week repo transactions and TRY 10 billion via 3-month repo transactions. The Bank withdrew end-of-day excess liquidity of TRY 11 billion via overnight transactions. The amount lent to the CBRT ranged from TRY 7 billion to TRY 12 billion at the borrowing rate over the past 3 months with occasional changes depending on the distribution of liquidity among banks. In this sense, the Bank intends to reduce the amount of repo funding step by step to induce some banks with a liquidity surplus to be more reluctant to lend to the CBRT.

In addition, the CBRT preserved 3-month repo auctions as a regular funding tool despite general expectations that these facilities would eventually be phased out. The reserve requirement on TRY deposits could be raised again if credit conditions improve in the future. Also it is noted that other monetary policy tools such as increasing reserve requirements might be activated to manage macro risks along with conventional tools.

Gradual Technical Rate Adjustment

Technical rate adjustments get special attention, as they facilitate changes in liquidity conditions. In a permanent liquidity shortage, the CBRT, after considering the distribution of liquidity within the system, will opt for the 1-week maturity repo auction rate to be the reference interest rate and hence adjust overnight lending and borrowing interest rates accordingly. But, with the purpose of avoiding any miscommunication on the monetary policy stance, the CBRT is to introduce the adjustments in two phases:

(i) Initially, 1-week repo auction rates will be set at 50bps above the current overnight borrowing rate of 6.50% and the auctions will be on the amount rather than the interest. This new policy rate will not necessarily indicate a tightening since the current 1-week repo auctions are trading slightly above the overnight borrowing rate.

(ii) As liquidity shortages become more common place, the Bank anticipates that the spread between the 1-week repo rate and overnight borrowing rate may vary. To combat this, the CBRT will incorporate overnight borrowing rates from the secondary market close into the new 1-week repo rate.

Given these facts, technical rate adjustment are in the pipeline although their timing uncertain at this time. We expect the CBRT to fully shift to the new system in 3Q10 when it enters into the rate hiking cycle. In the meantime, the market participants will have sufficient time to digest and get familiar with the new framework.

Growth: Strong rebound

Turkey officially exited the economic recession in 4Q09 with a 6.0% annualized growth rate, following four consequent quarters of contraction. However, a decline in economic activity intensified in 1Q09 with a 14.5% YoY decline due to a collapse in domestic demand. Annual GDP declined in 2009 to 4.7% with the relative rebound in the activity in the second half of the year. Domestic demand brought overall GDP down by 7.4 percentage points while the positive contribution of the foreign demand at 2.7 percentage points supported overall GDP. Investments in the private sector were effected by shrinking capital inflows, contracting by 22% YoY in 2009. Inventory also deteriorated significantly and made a negative contribution of 2.1 percentage points to the overall GDP contraction last year.

Exhibit 5: Early growth-related indicators

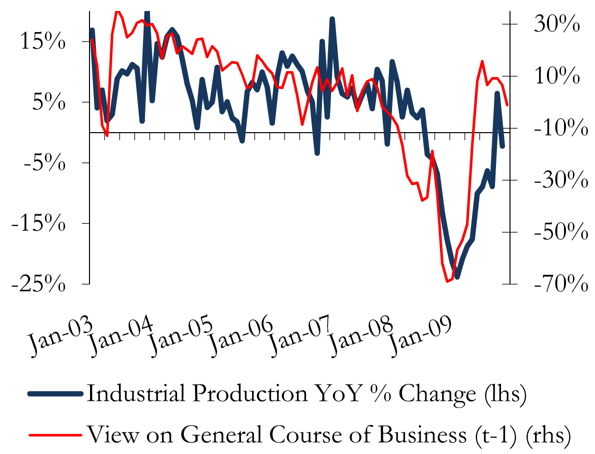
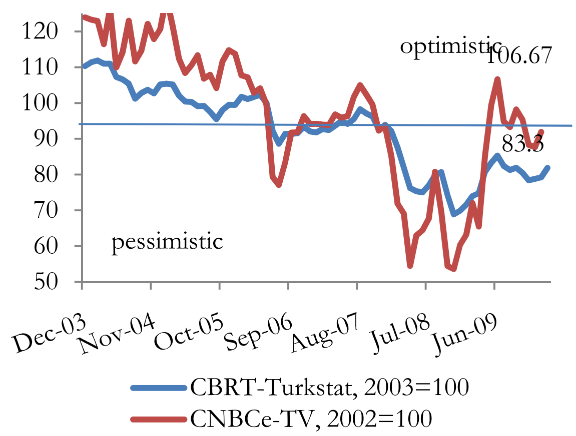


Exhibit 6: Consumer Sentiments



Moreover, 1Q10 early growth-related indicators reveal a robust recovery in economic activity due to low base year affects and a rebound in the inventory cycle. The CBRT Business Tendency Survey recommended a cautious view on the general course of business, as key economic drivers have been lacking in momentum. While private consumption remains lower than before, the positive contribution of foreign demand has also faded out. Imports have shrunken sharper than exports during the global economic recession, thus net exports have supported economic growth. January export volume indicates that a recovery in trade balances. Imports are much more sensitive to domestic fundamentals and are likely to grow faster than exports, thus diminishing the contribution foreign demand in 2010. We expect quarterly GDP to accelerate in 1Q10 with around 9% YoY rise due to weak base year affects, before cooling down in the coming quarters. So, quarterly GDP growth will gain momentum in 1H10 with a 7% YoY rise before settling down to an average of 3% in the 2H10. We preserve our annual GDP growth rate estimate for 2010 at 4.0% although recent economic data releases point to possible upwards revisions After all, the public sector seems to manage its 2010 domestic borrowing program well, without external financing. However, crowdingout affects on private sector credit conditions will be a main concern over private investment this year, with a high domestic debt rollover ratio of 100%.

Exhibit 7: National Accounting

			Şeker			Official		
		2008	2009	2010E	2011E	2009	2010E	2011E
GDP	TLbn	950	954	1,088	1,196	954	1,029	1,118
Real growth	%	0.9%	-4.7%	4.0%	3.9%	-4.7%	3.5%	4.0%
GDP	US$bn	742	617	712	749	617	641	669
Population	million	72	73	73	74	73	73	74
GDP per capita	US$	9,221	8,456	9,695	10,072	8,456	8,821	9,096

Source: Şeker Securities, SPO, the Treasury

In the year to come, the private sector will unlikely speed up its investment activity, as it tries to adjust its balance sheets to the new financing environment. We anticipate domestic demand to lift GDP by 3.5 percentage points, and foreign demand to bump up GDP by 0.5 percentage points.

Exhibit 8: Domestic and Foreign demand

	2005	2006	2007	2008	2009E	2010E	2011E
Real GDP	8.4%	6.9%	4.7%	0.9%	-5.6%	4.0%	3.9%
Contributions to GDP growth (%)							
Private consumption	5.6%	3.3%	3.8%	0.0%	-1.3%	1.8%	1.5%
Govenment	0.3%	0.8%	0.6%	0.2%	0.4%	0.3%	0.3%
Investment	3.9%	3.2%	0.8%	-1.3%	-4.5%	0.1%	1.3%
Change in inventory	0.1%	-0.1%	0.6%	0.3%	-3.2%	1.3%	0.0%
Net Exports	-1.4%	-0.3%	-1.2%	1.7%	2.9%	0.5%	0.8%
Real YoY % Change							
Private consumption	7.9%	4.6%	5.5%	-0.1%	-1.9%	2.5%	2.1%
Govenment	2.5%	8.4%	6.5%	1.9%	4.0%	2.8%	3.0%
Investment	17.4%	13.3%	3.1%	-5.0%	-19.1%	0.5%	6.6%
Exports	7.9%	6.6%	7.3%	2.3%	-4.3%	9.0%	8.0%
Imports	12.2%	6.9%	10.7%	-3.8%	-14.2%	7.0%	5.0%

Source: Turkstat, Şeker Securities

The crucial question is whether Turkey can sustain 4-5% growth after the inventory cycle normalizes and what dynamics will back such growth? In developing counties, the main obstacles to performance are poor financing and poor returns. Mainstream economic growth models have been based on an assumption of capital shortages, a low savings rate, along with weak domestic financial markets. Lack of financing, rather than poor returns, seems more relevant for Turkey (Rodrik 2009) since the foreign-borrowing has spurred investment to higher levels. The ratio of investment over GDP has been at around 22% during the 2000s, despite high real interest rates. At the peak of high current account deficits (6.1% of the GDP) in 2006, considerable external financing lifted domestic investment as far as 25% for that year. But, there are inherent limits to how much the CA can help finance domestic investment and this leaves the economy vulnerable to sudden stops.

Exhibit 9: GDP growth

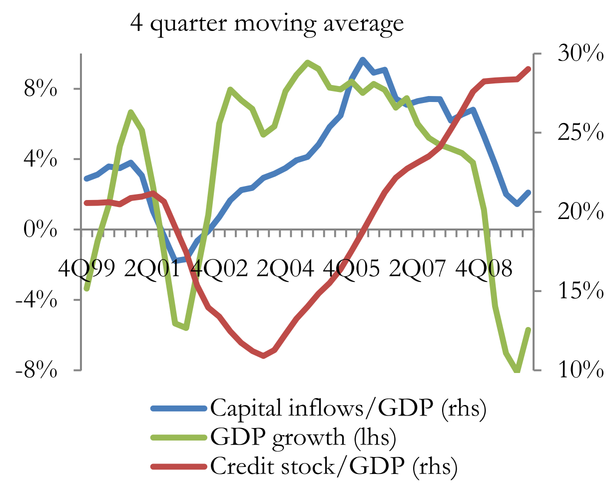
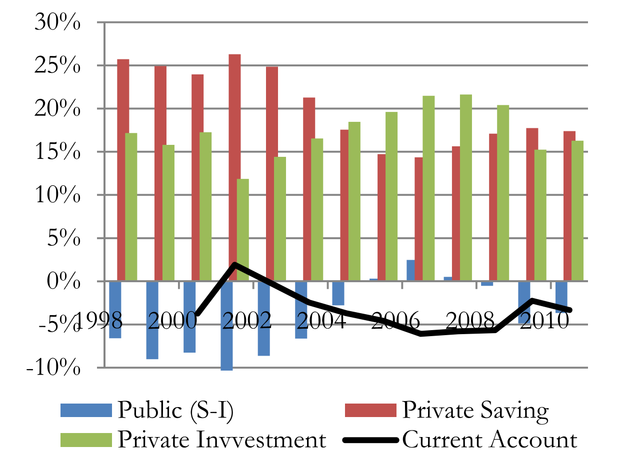


Exhibit 10: External and internal sources of the growth as % of GDP



The composition of investments suggests that recent growth has been sound, as the share of manufacturing has doubled to 40% in 2008 since 1998. This exhibits strong performance for the period despite some degree of real local currency appreciation. Note that investment in housing has dropped drastically to 6% of total investments in 2008 from 26% in 1998 while the proportion of investment in transportation has stood stable at 25% over the past 10 years.

Exhibit 11: Private investment by sectors

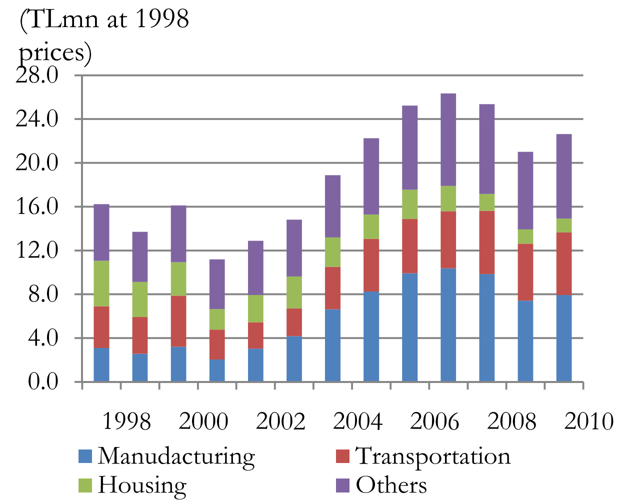
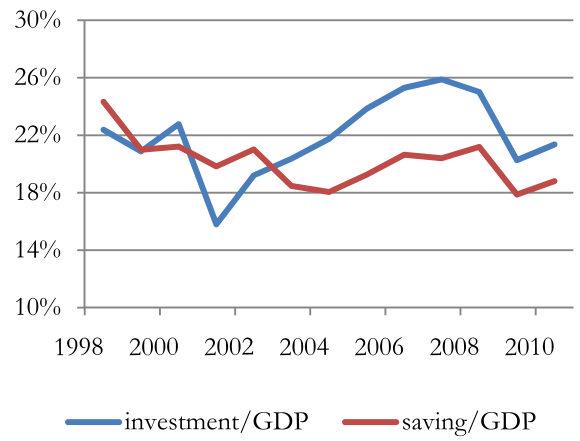


Exhibit 12: Total investment and saving



The key point is that despite some improvements in investment structure during the 2000s, the growth model based on the foreign savings and large current account deficit is not sustainable for Turkey. It will be necessary to discuss whether the widening large current account deficit is a threat to the economy or not. Unless there is a shift in the macroeconomic policy, private sector savings and investment will not change soon.

Budget: So far so good, but caution advised

1Q10 budget realizations have been impressive and backed by the stronger than expected revenue collections and better-than expected economic growth. The numbers show that the government continues to prioritize fiscal discipline. That said, the 2010 budget will be closely watched given the 2011 general elections and the possible surge in election-related budget expenditures.

In the 2010 budget bill, budget expenditures are expected to rise by 7% to TRY 287 billion while revenues are estimated to increase by 11% YoY to TRY 237 billion. Thus, the overall budget deficit is projected at TRY 50 billion, 4.9% of the estimated GDP. We consider the budget projections for this year to be feasible, given recent developments on budget dynamics, better-than expected growth prospects and fiscal measures.

Exhibit 13: Central government budget figures

		Şeker			Official		
As % of estimated GDP	**2008**	**2009**	**2010E**	**2011E**	**2009**	**2010E**	**2011E**
Budget revenues	21.9%	22.4%	23.5%	23.0%	22.4%	23.0%	22.6%
privatization	0.5%	0.5%	1.0%	0.8%	0.5%	1.0%	0.8%
Budget expenditure	23.8%	28.0%	28.0%	27.0%	28.0%	27.9%	26.7%
Budget balance	-1.8%	-5.5%	-4.5%	-4.0%	-5.5%	-4.9%	-4.0%
Budget primary surplus	3.5%	0.1%	0.0%	0.5%	0.1%	-0.3%	0.4%
EU-defined debt stock	39.5%	45.5%	47.0%	47.0%	45.5%	49.0%	48.8%

Source: The Treasury, Şeker Securities, SPO

The government plans to formalize its Medium-term Program Framework by introducing explicit fiscal rules in 2011 to provide an anchor for investor sentiments on Turkey's economic outlook and to prioritize fiscal discipline in order to reduce concerns about the soundness of public finances. Turkish officials aim to limit deficit spending depending on the rate of economic growth, the previous year's shortfall and the long-term target for the ratio of outstanding debt to GDP. The values of the parameters, definition and content of the public deficit, details about application, monitoring and reporting and other issues are yet to be finalized, and are likely to be announced in mid-June 2010.

Fiscal rules are useful policy tools to trace out fiscal policy implications, but should not be treated as a main policy tool to bring about economic stability or manage public finances. Moreover, their vulnerabilities to external shocks became more apparent during the financial crisis as a fourth of counties with such rules ended up modifying their parameters or pushing them aside. In addition, given Turkey's record of budget and public finance mismanagement (except in the last decade), the government needs to manage the process with a technically sound, consistent and transparent framework of fiscal policies. These policies are slated to be introduced in 2011, during the general election, when public sector spending is usually higher. In summary, we consider such attempts to be constructive, but reiterate that their feasibility and effectiveness need to be monitored and tested along the way.

External Balance: Return of the widening gap

Annual current account (CA) deficit closed last year at USD 14.04 billion due to contracting economic activity and the collapse of commodity prices after hitting USD 41.95 billion in 2008. The 12 month rolling CA bottomed out in October 2009 at USD 12.63 billion before heading north. We expect this upward trend in the external gap to continue as the economy started to recover in 4Q09. In our recent scenario for annual 4.0% growth, should oil prices remain at USD 80 per barrel on average in 2010, the CA deficit will rise to around USD 25 billion (3.3% of estimated GDP). Note that the risks on our CA estimates are upside given the weak start on the export front.

Turkey is a net commodity importer, thus its current account is sensitive to commodity price movements. Brent oil prices per barrel averaged at USD 63 in 2009, which brought the energy bill to USD 29.9 billion in 2009 from USD 48.3 billion in 2008. In addition, energy costs are less sensitive to declining oil prices than rising ones due to their lagged effects on natural gas prices. While a 1-dollar rise in oil prices, together with a consequent rise in natural prices, adds USD 0.6 billion to the total energy bill, its decline reduces the bill by USD 0.4 billion. Should oil prices further rise to USD 95/bbl in 2010, Turkey will shed 1% of its estimated GDP next year and the ratio of the annual CA deficit will increase to 4% of GDP for the year.

Exhibit 14: External Balance

			Şeker			Official		
		2008	**2009**	**2010E**	**2011E**	**2009**	**2010E**	**2011E**
Current account	US$bn	-41.9	-13.9	-23.6	-29.7	-13.9	-18.0	-22.0
CA/GDP	%	-5.7%	-2.2%	-3.3%	-4.0%	-2.2%	-1.8%	-1.8%
Exports	US$bn	132	102	113	129	102	108	118
Imports	US$bn	202	143	167	199	143	153	168
Trade balance	US$bn	-70	-41	-54	-71	-41	-46	-50
Brent oil price (average)	US$ per barrel	98.3	62.7	79.0	87.0	62.7	75.2	78.0
US$/TL (year-end)		1.52	1.51	1.55	1.64	1.51	1.61	1.67
€/TL (year-end)		2.13	2.17	2.08	2.22	2.17	-	-
Euro-$ parity (year-end)		1.40	1.44	1.34	1.35	1.44	-	-

Source: The CBRT,SPO, Bloomberg, Şeker Securities

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BASIS FOR 12m RECOMMENDATIONS

BUY: Requires 15% or more estimated upside.

SELL: Requires 10% or more downside.

HOLD: When estimated relative return is limited between -10% and 15% in either direction.

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