DenizBank Economic Update

February, 2011

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Officials Confirmed the Policy Mix Yields Results...
But the Oil Prices May Change CBT’s Plans...

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* Industrial production in Turkey (IP) was up by 16.9% in December 2010, compared to the same month a year ago. The rise was much above the consensus estimate of c. 11%. It corresponded to the 13.1% expansion in 12 month trailing IP.

* Similarly, the seasonally adjusted (SA) figures depicted a bright picture by rising 5.7% compared to the previous month, which has been the sharpest rise since the beginning of the SA data release.

* Based on the Q4 IP outturn, it is likely that 2010 growth will exceed 8%. Our growth expectation for 2011 still remains unchanged at 5%.

* Given that the low base effect we have witnessed in 2010 will disappear, we expect to see some slowing in production growth starting from next month.

* The current account (CA) has posted $7.5 bn deficit in December and 12M trailing deficit jumped to $49 bn, which is around 6.6% of the year-end projected GDP.

* The strong rise in CA deficit (CAD) in the recent months were mainly due to strong imports and a seasonal fall in tourism revenues.

* Starting early 2011, we may see some correction in CAD thanks to CBT’s recent attempts to curb hot money inflows. They helped the TL to depreciate vs the Euro-USD basket by about 12% since November, which should support foreign trade. But the rise in oil prices will boost imported energy bill and will delay the correction.

* We expect CAD to GDP ratio rise slightly towards 7% in 2011. The main issue is not the level, but the financing behind it.

* Currently, a mere 15% of CAD is financed with FDI and FDI / CAD ratio is at its lowest level since year 2005. Yet the other channels of financing, especially the bank borrowing, are more robust than the markets currently believe.
Economy (II)

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**Inflation**

- Annual CPI inflation has decelerated to 4.9% in Jan-2011 from 9.2% four months ago. The substantial decrease in the last four months in food prices in addition to the high base effect were instrumental in this outlook.

- The benign trend in food prices, however, has reversed in January 2011, a sign of global rise in food prices took its toll in domestic CPI. The rise in the CPI may have bottomed in February.

- Accordingly, inflation may then rise gradually due to: 1– about 12% fall in TL (vs. the basket) since the beginning of November 2010; 2– the global rise in energy and food prices and 3- strong domestic growth (see Growth Section)

- The sharp rise in producer prices (PPI), reflecting higher food & energy prices and weaker TL, supports our expectation. The CPI is poised to rise also on the back of a pass-through from PPI.

**Public Sector**

- The central government budget posted TL1 bn surplus in November, performing better than expectations.

- The performance was a result of 68% jump in non-tax revenues relative to the same month last year. Other than this, there is no big change as non-interest spending rose by 13% well in line with the 14% increase in tax revenues.

- Additionally, the drop in VAT on imports in January (by about 5% compared to Jan-2010) could signal that the CBT’s recent efforts to diminish external imbalances may be bearing fruit.

- As per the Medium Term Programme, 2011 budget deficit to GDP target is 2.8%, which is likely to be achieved, thanks mainly to the strong drop in interest payments as it was the case in 2010.

- General elections are scheduled to be held in June-2011. Therefore, fiscal discipline in the remainder months will be closely watched. The continuation of current stellar performance is especially important amid large external financing needs.
The benchmark bond yield has risen recently due to the CBT’s new policy mix of lowering short-term interest rate and raising reserve requirements. This was a matter of policy tightening rather than an increase in risk premium. Turkey’s CDS spreads are moving in parallel to her emerging peers.

The TL has underperformed its emerging peers, due to CBT’s move to cut policy rates by 75 basis points and to reduce the risk adjusted carry for short-term off-shore investors by slashing O/N bid rate from 5.75% to 1.5% since November 2010.

The latest reserve requirement rate hikes will wipe off up to 15% of banks year-end profitability in 2011 – with the assumption that the banks do not pass the related costs to their customers. That is the reason the banking sector stocks have underperformed.
Banking Sector (I)

**Capital**

Sector’s capital adequacy ratio is more than triple the Basel requirement. Also, the imbalance between the banking groups have diminished. As state banks engage in more lending, their CAR has decelerated to the sector average.

**Funding**

Both wholesale and deposit funding are growing robustly. Due to the recent rises in reserve requirements in short term deposits, we might see stronger growth in longer term deposits and wholesale funding in year 2011.

**Lending**

Given stable funding capacity, loan books continue to grow steadily with some switch from T-bond positions. But the recent increases in reserve requirements may take its toll on loan demand if reflected to the loans which could also adversely affect loan growth with a lag.
The SME lending has picked up strongly in 2010 while retail loans were driven by general purpose and mortgage loans. Auto loans are also the hype of the late, thanks to strong domestic demand conditions.

The NPL ratio fell significantly and the provisions decelerated to pre-crisis levels. Due to the strong rise in loans and gradual decrease in NPLs, the NPL ratio is likely to fall below pre-crisis level of 3.2% within this year.

The system remains profitable despite an enviable balance sheet growth. Monthly net interest income has rebounded especially due to the positive contribution from CPI linkers in the banks’ portfolios.
The Officials Have Confirmed That the Policy Mix Yield Results...

We had explained in detail the CBT’s unconventional policy mix in the last DenizBank Economic Update. To remind, the main agenda behind this policy mix, which consisted of raising reserve requirements (in an aim to curb domestic loan growth) and decreasing the policy rate (mainly in an aim to limiting speculative fund inflows) at the same time, was to limit the rapid rise in the current account deficit (CAD). The authorities believe that the strong loan growth (especially the retail loans) is reinforcing the rise in the CAD, which has topped 6.6% of GDP at the end of 2010 from 2.3% in 2009.

The CBT’s policy mix delivered to some extent what was intended, in our view. The YoY rise in loan growth moderated to below 30% of the last year’s pace, in the first six weeks in 2011. Mr. Babacan, the minister of economy, also stated that the current pace of loan growth is promising, i.e. it is rising below the 30-35% threshold level. It was clear in February that the CBT seemed to have shared the Minister’s view since the CBT has decided not to raise the RRR one more time (contrary to consensus estimate).

The CBT (and the government) has not only aimed at curbing bank loan growth, but also at weakening the strong TL to some extent. This might help exporters to gain competitive advantage in the coming months while lowering the cost of domestic sourcing and thus stabilize the CA deficit at more sustainable levels. After the CBT raised the RRR from 5% to 5.5% the first time in September 2010 (then gradually to a weighted average of 9.4%) and decreased sharply the O/N CBT borrowing rate from 6.5% to 1.5% in an aim to discourage short-term carry trade, speculative funds were discouraged indeed and the currency depreciated by 7.5% (vs. USD) in the last six months. The switch from emerging markets to mature markets on the part of global investors may also have been effective in this as Turkish stocks and T-bonds also fell in value over the past five months. But the banking sector stocks were also affected adversely by the rise in reserve requirements that would slow the system’s profitability.

Oil Prices May Change CBT’s Plans...

Thanks to the reasons explained above we are likely to see some correction in the CAD starting early in 2011. However, the newly emerging and spreading uncertainty in the Northern Africa and the Middle Eastern (MENA) political crisis may force the CBT to reassess its assumptions. The region is not very important for Turkey economically. The countries with civil uprising constitute around 5% of Turkey’s total exports and the share of the whole MENA region is a mere 12%. Therefore any change in the amount of exports to the Middle East would have limited effect on the CAD.

On the murky side, however, the CAD is very dependent on oil prices. The yearly CAD was $49 bn at the end of 2010. $34 bn (70% of total CAD) was stemming from energy deficit. Given that current trend of rising oil prices still continues in the coming months, the CAD would widen further. As per our calculations, $10 rise in oil prices increases CAD to GDP ratio c. 0.4 pps. Such a rise in oil prices, which is not in our base case scenario in the meantime, would wipe off any positive contribution of the unconventional policy mix.