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DenizBank Political & Economic Update

Turkey

Politics…

Local Elections: AKP's Tamed Victory

Economy…

Sharp fall in industrial output

Signs of further weakness in February and March

Is a recovery on the horizon?

Recession harms fiscal prudence

Disinflation helped CB to lower rates, but a pause is on the horizon

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Local Elections: AKP's Tamed Victory

Turkish citizens cast their votes for mayors and provincial and municipal assemblies at the municipal elections held on March 29th. They also voted for neighborhood representatives to city councils. The AKP, the ruling party of conservative right, had a relatively strong victory in this election by getting 39% of total votes, although opinion polls had pointed around 50% support. The results were therefore disappointing for the AKP as it was reflected in the speech of Mr. Erdogan, the party leader and Prime Minister, after the initial results were released.

The results of 2009 elections are summarized below. Accordingly, the AKP votes are roughly equal to the sum of the votes of the two main opposition parties, namely the center left CHP and the nationalist MHP. Furthermore, the AKP maintained its strength in the major cities including Istanbul and Ankara, but with a relatively slight difference of 7 percentage points due to the successes of the CHP candidates who were cherry picked among the party's top names to be able to rival the AKP's advantage in the elections of being the ruling party.

<u>Table 1:</u> Election Results Since 2002 (% of total votes)

	2009 Local Elections *	2007 General Elections	2004 Local Elections	2002 General Elections
AKP - Conservative	**39.0**	46.6	41.7	34.3
CHP - Center Left	**23.2**	20.9	18.2	19.4
MHP - Nationalist	**16.1**	14.3	10.5	8.4
DTP - Pro-Kurdish **	**5.4**	5.2	5.2	6.2
SP - Islamist	**5.2**	2.3	4.0	2.5
DP - Center Right ***	**3.7**	5.4	10.0	9.5
DSP - Center Left	**2.7**	0.0	2.1	1.2
BBP - Ultra-Nationalist	**2.2**	0.0	1.2	1.0
Other	**2.4**	5.3	7.2	17.5

(*) Unofficial results, (**) Participated in 2002 Elections as DHP, (**) Participated in 2002 Elections as DYP

<u>Main highlights of the local elections:</u>

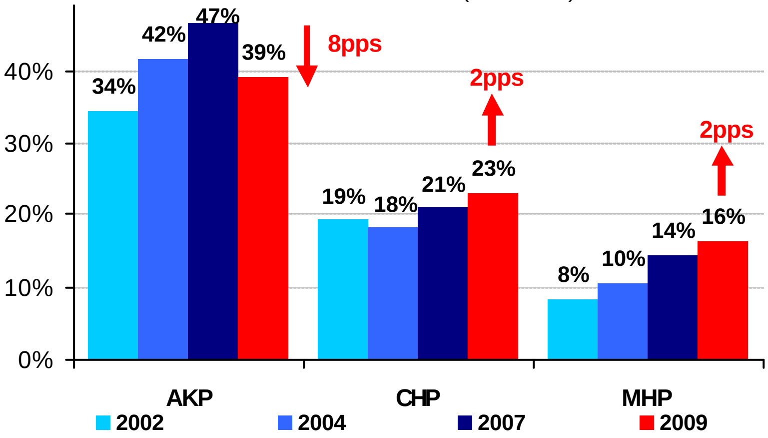
- **The AKP is still the leading force in the Turkish politics.** Though receiving the lowest support in the past five years, AKP is still the leading party by far in the Turkish political system.

- **The support for the main opposition parties somewhat increased.** The main opposition party the CHP increased its votes to 23% from 20.9% in the 2007 elections. The MHP also increased its share of vote to 16.5% from 14.3% in the 2007 elections. The DTP, the Kurdish backed party with 5.2% of the votes, won three more cities in the southeast region thus Pro-Kurdish DTP won the municipalities in all of the southeastern cities except Adiyaman, Sanliurfa and Mardin. Last but not least, thanks to its emerging new leader, SP increased its share of the vote to 5.2% from 2.3%. Many people didn't notice the radical Islamist SP's surge as a new trend in Turkish politics. However, it could be a serious threat to AKP's constituency for the upcoming elections since AKP is the successor of SP.

- **In addition to Southeastern Anatolia (dominated by ethnic Kurdish minority), the AKP lost its support in many of the seaside regions.** As mentioned above, in the southeastern region of Turkey, the AKP did not receive the votes it was expected to. It also lost some of its constituency in the Aegean and the western Black Sea regions to the CHP and the MHP. Surprisingly, the AKP lost its ground in most of the cities on the seaside of Turkey.

Figure 1:

Evaluation of Political Parties Votes (% of Total)



- **The AKP received strong support from the industrial cities which were hit the hardest by the economic crisis.** In cities whose economies were hardly hit like Denizli, Kayseri, Bursa, the AKP won a surprising victory.

The results do not signal any damage in Turkey's political stability of the last seven years. Better yet, the AKP is now going to prioritize focusing on the economic problems believed by many to have been neglected in the midst of elections such as finalizing the IMF deal soon and the required structural economic reform in that regards.

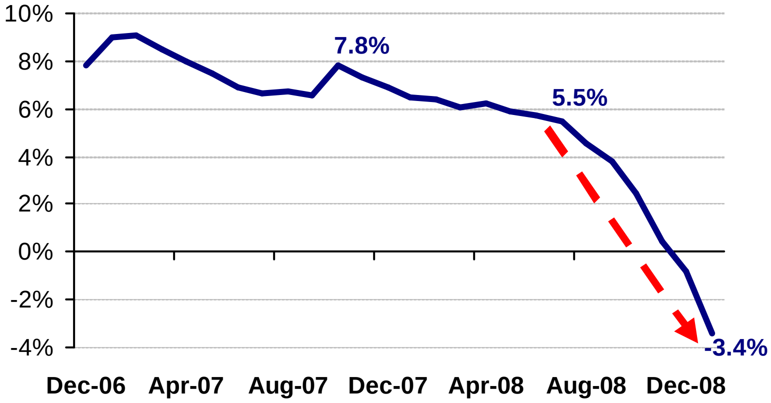
Sharp fall in industrial output in January

Following a 13% decline in the last quarter of 2008, industrial output contracted (for the sixth month in a row) in January, to a tune of 21% compared to the last year's same month, as the global recession cut both export demand and tarnished confidence for domestic spending dragging the Turkish economy into a severe decline. The January plunge corresponded to a fall of 3.4% in industrial production in the past twelve months exacerbating the downward trend seen since the late 2007 (Figure 1). Indeed, the downturn started to intensify severely after August; the rates of decrease were even higher than that those had been registered during the 2001 crisis.

Severe contraction in January was somewhat across the board according to sectoral breakdown. The only positive contributions came from food and beverage and tobacco sectors, albeit negligible due to their annual increases below 1%. However, it is worth noting that export-oriented sectors are particularly hit during this downturn. It was evident from the frustrating contractions in the output of the automotive and Radio-TV sectors by 60% and 56%, respectively.

Figure 2:

Industrial Production Growth (12-m MA, YoY change)



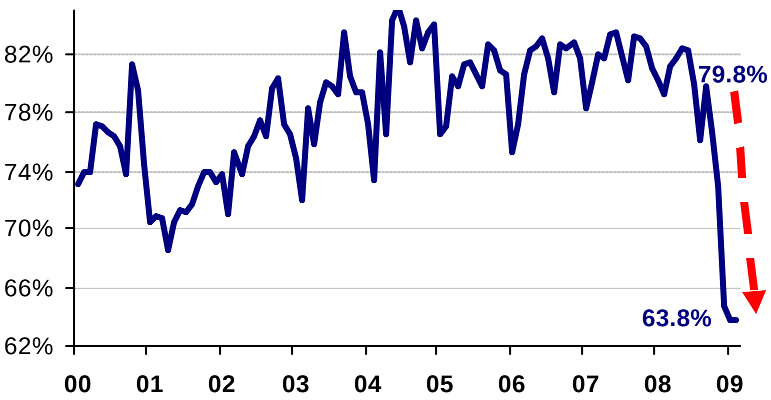
Signs of further weakness in February and March

With the surveys already signaling further weakening in manufacturing activity, the industrial sector's performance is likely to worsen in the next couple of months, rather than recover. Compared to one month ago, the capacity utilization rate remained flat at 64% in February, marking the lowest utilization since the introduction of the index in 1991 (Figure 2). The outcome also compared unfavorably with the 79% utilization a year earlier. Worse, the drop in capacity utilization was broad based among all the manufacturing sectors.

This suggests that industrial production is on the verge of another strong double digit contraction in February, in addition to the three double digit declines in the previous months. Moreover, real sector confidence indicators and anecdotal evidence hardly imply that the manufacturing sector has hit the bottom and poised to rebound in the short term.

Figure 3:

Capacity Utilization Rate in Manufacturing

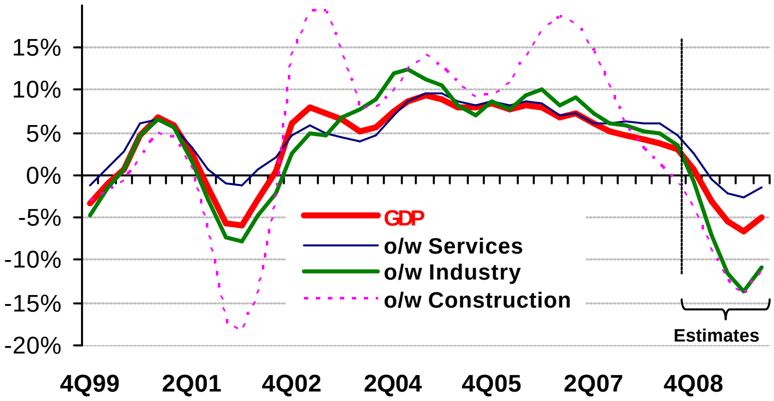


DenizBank Political & Economic Update

Economy

As shown in Figure 3, industrial output had grown at half pace in the 2006-2007 period, compared to the preceding three years. However the economy was able to grow in the range of 5 to 7% annually thanks to a flourishing service sector coupled with a boom in construction. The strong contributions of these sectors were absent last year. Therefore, the GDP growth in the last quarter of 2008, due to be announced on March 31st, is likely to have recorded a strong contraction, in line with the expectations of a fall in the vicinity of 5%. This way, the GDP growth in the whole of 2008 will not likely have exceeded 1%.

Figure 4:
Real GDP Growth (4-Q rolling, YoY change)



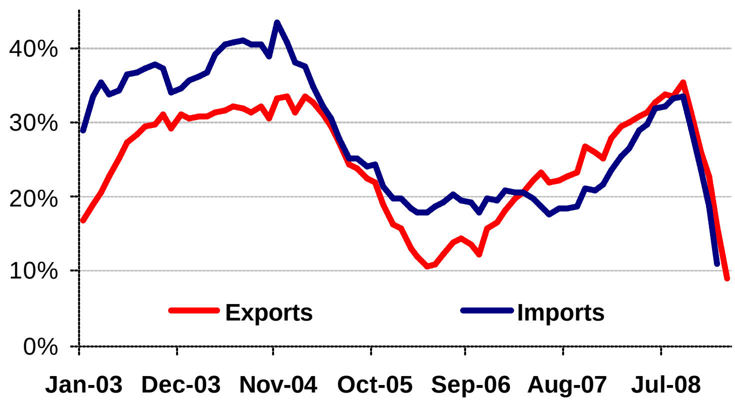
One can conclude that the current recession started sharper than the 2001 recession. The recession in industrial production has been more pronounced in the first quarter of the year as domestic demand was weakened further added to an already lingering external demand. This would also likely spill over to other sectors. We expect the GDP growth in the first quarter of this year may record another double digit contraction. The strong statistical base effect may also play a substantial role in a probable dramatic slowdown in the first (1Q08 GDP growth was as high as 6.7%) but the impact will be less depressing in the following quarters.

Is a recovery on the horizon?

Is there a chance for the economy to start moving out of the contraction in late 2009? As seen in Figure 3, Turkey may still be months, if not years, away from an economic growth at its potential, but the speed of the crash is very likely to slow as soon as the global conditions improve.

One major reason why the recovery will be delayed is the lack of the typical post-crisis push that comes from exports. During the 2001 crisis, for example, the economy was able to export its way out of recession thanks a significantly depreciated currency and higher productivity. This time, not only the weak external demand will not allow Turkey to use exports as the engine of growth but the fast slowing in export is one important reason why the economy has entered the recession in the first place. Neither the recent TL weakness nor higher productivity (that stems from rising unemployment) appears to be extending the helping hand the economy is used to. (Figure 4)

Figure 5:
Exports & Imports Growth (12-m rolling, YoY change)

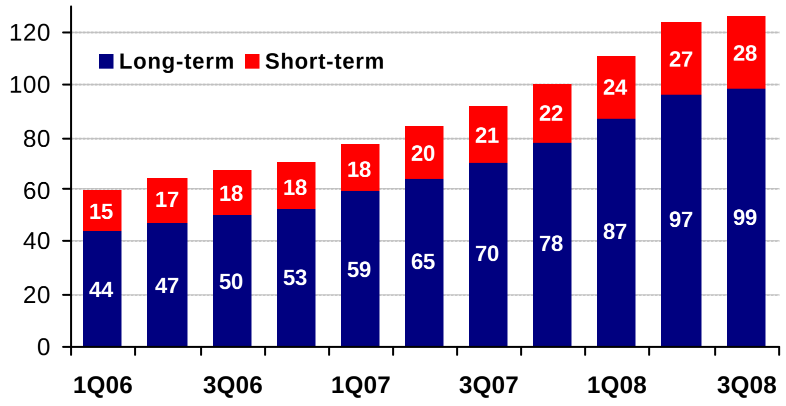


Economy

Exports started to decrease in annual terms after November, plunging 17% on average in December and January. Though the official figures have not been announced yet, leading indicators such as the advance exports figure of the Turkish Importers' Association signals that the contraction in February may have reached to 30% compared to the same month of the last year. This would be the steepest annual decline in a month since the introduction of the monthly foreign trade data in 1989.

One thing is certain, considering the post-2001 orientation of the Turkish industry towards exports; an upbeat external demand would be needed for the production to regain its momentum. Thanks to the abundant global liquidity during the period making external financing both cheap and readily available, local manufacturers borrowed and then invested the proceeds heavily to enhance their capacity to respond to rising external demand. This has also helped raise the potential economic growth to about 7%. Actually, they performed well until the last year, evident from the 23% growth in annual exports that increased Turkey's share world exports. But when the export markets began to shiver due to the global crisis, producers ended up with huge idle capacity, no strong domestic demand to turn to, and a significant level of external debt (Figure 5). High level of external debt (to be paid by export proceeds) is another reason why the economy needs a pull from external demand more than before. The local manufacturers did not face a significant trouble in rolling over their external debt thus far but a recovery in global markets would certainly be helpful as it would at least ease the rising costs of new borrowing.

Figure 6:
Gross External Debt of Corporates(USD bn)



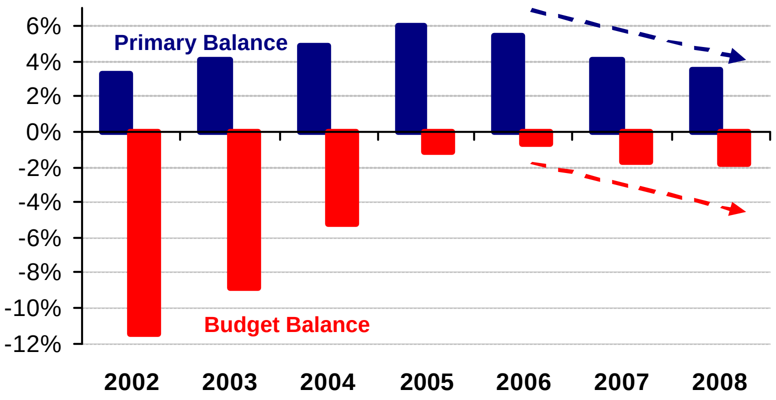
An economic recovery in the Continental Europe is essential as it is Turkey's main export market. But that would in turn depend on the US consumption, which has long been the engine of the global economy and arguably led the world into the current recession. Until recently, there has been no clear evidence that the Fed's and the US administration's rapid responses to the economic crisis paved the way for a recovery in the short term. Moreover, any revival in the US economy would affect the rest of the world with a lag.

Even though the economy owes much of the downturn to a slack in external demand, domestic demand has also weakened as the uncertainty abroad surrounding the global economic outlook hurt consumer confidence in the country. Neither the rapidly easing monetary policy nor anti-crisis measures implemented by the administration seems to have stimulated local demand yet. Key consumption metrics such as domestic automotive and white goods sales that plunged in February by 40% and 30%, respectively, still imply a gloomy outlook for private consumption spending.

True, the consumer sector confidence index has recovered slightly since December. The cumulative increase was 7% in three months. But this can hardly be taken as a trend reversal as the pick up was too feeble to offset the cumulative 26% fall recorded in 2008. Furthermore, the improvement in consumers' inflation expectation sub-index played an important role in the recovery of the headline figure but it should be taken as the side-effect of the current slump rather than a sign of improvement in economic activity that may gather some momentum in the short run. In addition, the unemployment rate has been on a rapid rising trend and reached an all time high at 13.6% by the end-2008. It would wipe out further from consumers' capacity to spend.

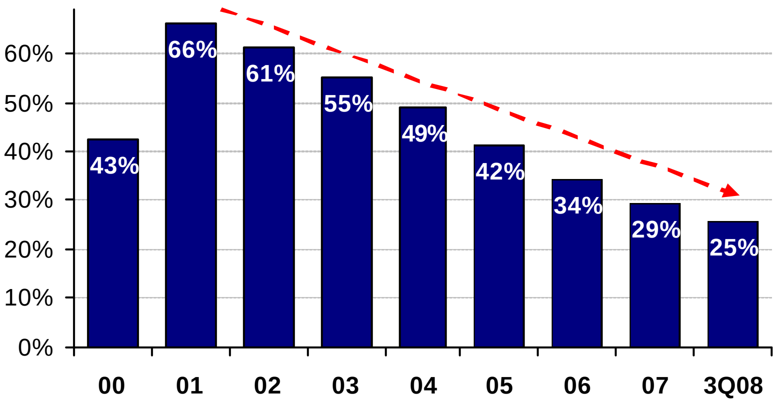
Recession harms fiscal prudence…

Figure 7:
Central Government Budget Balance (% of GDP)



Recent developments were evaluated above as the harbingers of a longer than expected recession (and then a slow recovery) in Turkey, however one should notice that the situation in the whole of emerging market universe –and in the rest of the world- looks very much similar. Industrial production and GDP growth rates have decreased almost everywhere, the recession is global at best, and Turkey, as an open economy well integrated with the world, should not be expected to escape unscathed from all this. The recessionary environment, however, may have different implications in different countries. In Turkey, the immediate impact would be on fiscal prudence which had played a pivotal role on the macroeconomic resilience during the period of 2002-2006 by bringing the public debt considerably down to sustainable levels (Figure 8). A long recession may affect fiscal balances very adversely through its impact on both revenues and spending. Indeed, since 2007, the adverse impact of the slowdown on public balances has become more visible and, what is worse, more worrisome. (Figure 7)

Figure 8:
Net Public Debt (% of GDP)



A combination of weaker tax revenues -especially on those depending on economic activity- and higher non-interest spending -due to the local elections and anti-crisis measures- further damaged the situation in 2008. This is evident from the fall in the surplus in central government primary balance (budget balance excluding interest expenditures) as a share of GDP to 3.5% in 2008 from 4.1% in 2007 and 5.4% in 2006.

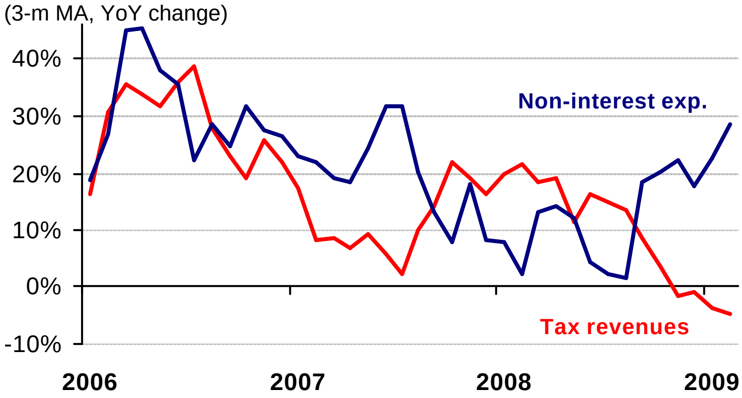
The fiscal performance went in the same direction in the first two months of 2009 which may easily be deemed the worst since 2002. The combined budget deficit of TL 10.4 bn in January and February, has already reached the full-year target (Table 2). However, the target, which has not been changed yet, is not credible anymore for it was based on the official 4% GDP growth expectation.

Table 2: Central Government Budget Realizations: January-February 2009

TL bn	Jan-Feb 2008	Jan-Feb 2009	*Nominal chg (%)*	*Real chg (%)*	Target 2009	*Jan-Feb % of target*
Budget expenditures	**32.9**	**44.6**	***35.5***	***24.8***	**259.2**	***17.2***
Non-interest expenditures	23.9	31.0	*29.5*	*19.2*	201.7	*15.4*
Interest expenditures	9.0	13.6	*51.6*	*39.6*	57.5	*23.7*
Budget revenues	**33.4**	**34.2**	***2.5***	***-5.6***	**248.8**	***13.8***
Tax revenues	29.3	27.6	*-5.8*	*-13.3*	202.1	*13.7*
Budget Balance	**0.5**	**-10.4**	**-**	**-**	**-10.4**	***99.6***
Primary Balance	**9.5**	**3.3**	**-**	**-**	**47.1**	***7.0***

There was certainly an outburst in non-interest expenditures which rose by a whopping 36% annually in the first two months of the year, underpinning the upward trend since September 2008 (Figure 9). A large part of the expenditures (56% in 2008) consists of personnel salaries and the transfers to the social security system which are not discretionary in nature. The former is indexed to inflation and economic growth while the latter rises along with the deficit of the social security system. The 28% annual increase in these items in the first two months, however high, may still be attributed to developments beyond the government's control. They can be reined in only through structural reforms whose results would come fruition after years. But, the fiscal prudence could still be deemed at stake for the authorities were profligate in discretionary spending as well. Such spending rose by as high as 43% in annual terms in the first two months of the year. What is more worrisome is that recently launched anti-crisis measures, whose impacts will be felt largely in the remaining months of the year, will worsen the situation.

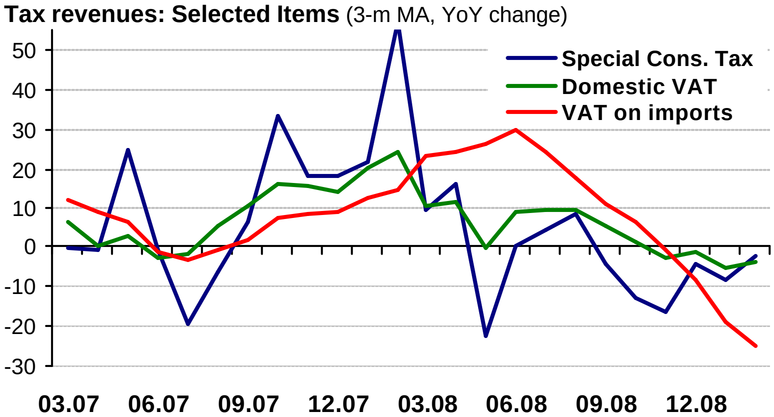
Figure 9:
Tax revenues and non-interest expenditures
(3-m MA, YoY change)



Interest payments on public debt also rose by a gigantic 52% in the first two months of the year, being a very instrumental in boosting the budget deficit. This was not alarming, however. It was merely a result of unfavorable debt repayment schedule that coincided with hefty redemptions (as much as TL 24 bn) in February. In fact, interest expenditure is expected to be the only favorable component of this year's budget considering significant ease in borrowing costs of the Treasury. One should note that the benchmark T-bond yield, which averaged around 19%c.a. in 2008, already decreased below 14%c.a. in the first quarter of 2009 and may even go down further on average in the whole of the year (mostly thanks to the central bank easing the policy rates). This reduction may allow the Treasury to save more than TL 10 bn this year.

The main culprit, however, was the fall in revenues (in fact, the recent increase in spending was largely due to saving tax revenues from falling further). The impressive economic growth after 2001 crisis oiled the wheels of the fiscal wagon by boosting the tax revenues. But things have turned reverse now. The economy has long been slowing and now appears to have ended up with a recession. And its impact on fiscal revenues has been alarmingly significant. Tax revenues were very disappointing having plunged by 6% annually in January-February combined, corresponding to a 13% plunge in real terms. The revenues from indirect taxes, which made up 65% of the total tax revenues in 2008, fell even sharper. The value added tax (VAT) revenues on domestic consumption fell by 4% while the special consumption tax revenue was down by 9%. In total, budget revenues were still able to rise by a meager 2.5% in the first two months, way below the inflation during the period, thanks to one-off rises in non-tax revenues.

Figure 10:
Tax revenues: Selected Items (3-m MA, YoY change)



The revenues from the VAT charged on imports sank by 32%, not a surprising outcome given the 33% collapse in imports. Income tax revenues, mostly withheld at the source, recorded the only nominal increase among the major tax items (up by 8% corresponding to a 0.7% decrease in real terms).

All in all, the fiscal outlook is not encouraging. As the weak economic activity has been suppressing tax revenues, there is no imminent solution to curb the personnel payments and transfers to the social security system, and more subsidies on the way, the primary budget surplus will likely substantially undershoot the target. A cap on discretionary spending after the local elections to bridge the gap seems necessary while the rising need for anti-crisis measures and stimulus packages weakens the administration's hand. The government has already launched five stimulus packages by the end of March. Their total cost to the budget is being estimated by the government at approximately TL 35 bn (Table 3). A stand-by arrangement with the IMF (still in negotiation phase and may be signed in May, after the local elections) is not likely to reverse the process, either.

Table 3: Anti-crisis packages and their costs to budget

	Measures	**Cost *** (TLbn)
1st Package	* Transfers to Development Projects (S. East Anatolian Project etc) * 5pps reduction in employer's social security premium * Increase in budget transfers to local governments * Increase in infrastructure investments * Tax amnesty, Repatriation amnesty * Increases in agricultural subsidies * Annulment of residents' withholding tax in stock market	**11.7**
2nd Package	* *Preservation of measures in 1st Package* * Increase in Treasury backed borrowing limits	**14.0**
3rd Package	* Increase in short-term labor allowance * Extension in employment incentives for women and youngsters * Improvements in R&D incentives	**5.6**
5th Package	* Special Consumption Tax reductions in automotive and white goods * VAT reduction in housing * Increase in Eximbank loans to exporters	**2.7**
6th Package	* VAT reductions in buildings, furniture, computers and construction equipments * Reduction in land registry fees	**0.9**
TOTAL		**35.0**

(*)Government estimates

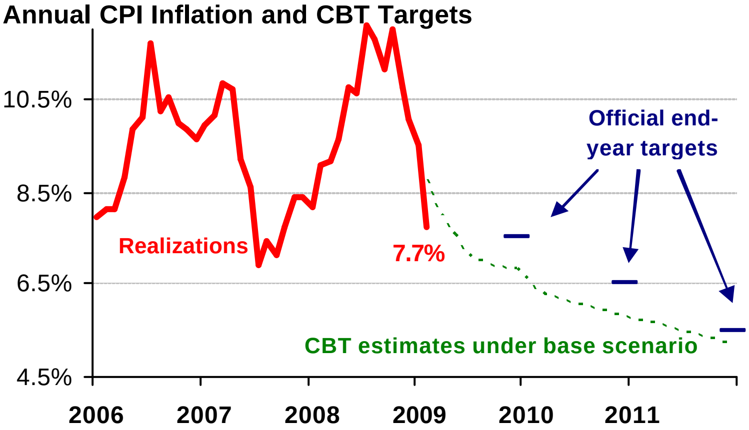
Our calculations suggest than the central government budget would only post a slim primary surplus –if any- to a tune of TL 0-5 bn at the end of the year, compared to the TL 28.5 bn projection of the Treasury. This suggests an additional borrowing need of around TL 25 bn in 2009 which would inevitably force the Treasury to raise its domestic debt roll-over ratio over 90% from 78% as budgeted. Indeed, the domestic roll-over ratio has climbed over 100% in the first quarter of the year. The lack of a buoyant foreign demand for external debt roll-over has also forced the Treasury to turn to domestic borrowing and put pressure on the roll-over rates.

The rise in the roll-over rate has not yet raised the public borrowing cost. While the Treasury needed to borrow more, for example, the banks, the largest T-bond investors in the economy, have also boosted their demand for these instruments offsetting the rise in supply, at least in part. They needed to curb lending given the recession in the economy, and substituted the lending to private sector with that to the Treasury which also helped them to manage their liquidity quite lucratively in an environment of easing monetary policy. Yet, the deterioration in fiscal balance has seemingly limited the positive impact of the monetary easing process under way on the bond yields.

Disinflation helped the CBT to lower rates, but a pause is on the horizon…

Annual inflation fell sharply in February to 7.7% from 9.5% in January, strengthening the downward trend that began in October 2007, where a near two-year record high inflation at 12.0% was recorded. The main culprit behind this disinflation trend is clear: ongoing problems in international credit markets and the global economy have been restraining both the domestic and external demand. Unfavorable demand conditions have also been instrumental in limiting the pass-through from exchange rates to domestic prices. Disinflation has long been reflected also by market expectations. After fluctuating at around 9% from June to November in 2007, the 12-months forward looking expectations registered a series of declines until 6.7% in late-March.

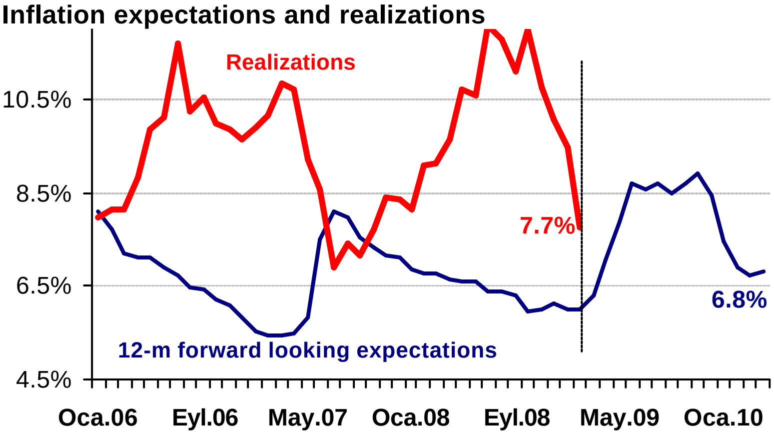
Figure 11:
Annual CPI Inflation and CBT Targets



Accordingly, the Central Bank of Turkey (CBT) judged that inflation was going to display a more rapid fall than had been envisaged before and embarked monetary easing with a 50 base points cut in November. Actually, the CBT does not emerge as an exception as central banks all over the world -even inflation targeting ones like the CBT- decided to switch to accommodative monetary policies, to soften the destructive impact of the recession on economy. Recall that the official inflation target for the end-2009 was revised up to 7.5% in last June (Figure 11). This also eased the CBT's job in easing the policy, which already reached a cumulative 625 basis points after the March meeting, where the policy rate was cut to 10.5%.

The pressure on consumer prices coming from the slump in economic activity is still in effect, hinting further disinflation as expected both by the CBT and markets. However, the welcomed and helpful downward trend in inflation expectations seems interrupted according to the late-March survey, where 12-month forward looking expectation rose to 6.8% from 6.7% of a survey earlier (Figure 12). Likewise, the Bank indicated in its March rate decision communiqué that the rate cuts have lowered the probability of significantly undershooting the 7.5% end-year inflation target. In its previous statements for quite a while, the CBT had been underlining the likelihood of an undershooting, implying that the March release corresponds to a change in rhetoric.

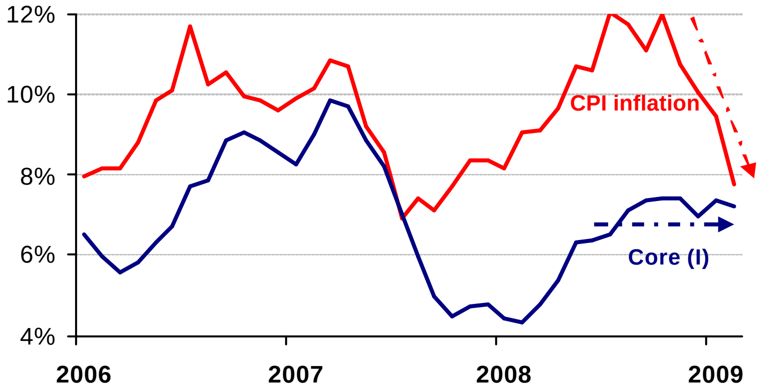
Figure 12:
Inflation expectations and realizations



Economy

Even though the headline index is used as reference in inflation targeting, core inflation, excluding prices that can not be controlled such as energy, food, alcoholic beverages and gold, cannot be ignored for it affects the future path of inflation. Indeed, core inflation has not been as favorable recently. Headline inflation may have been falling but the core inflation, has moved sideways since the middle of 2008 implying that there is not much room for the headline inflation fall further given today's macro conditions (Figure 13). We suspect that the recent inertia in core inflation stemmed mainly from the cost pressure on durable and semi-durable goods prices, as a result of the depreciation in local currency.

Figure 13:
Headline and Core Inflations (YoY)



The situation described above, on the other hand, does not necessitate an immediate termination of the easing cycle, in our view. Given the adverse impact of the global turmoil on the economy, the CBT can afford to support real economy by easing policy putting aside inflation worries. What is more, the risk of overshooting the inflation target should also be taken into consideration. Pointing to both risks, the CBT argued in its latest statement that the next rate cut may be measured, i.e. the rate cuts will continue in the coming meetings but with magnitudes lower than 100 basis points. The Bank explicitly underscored the necessity for the monetary policy to maintain an easing bias for a considerable period. A series of moderate rate cuts is more likely to be carried on at least further in April and May, a couple of 50 basis points cuts looks reasonable to us. The Bank might pause somewhere at 9.5-10.0% then and embark on a wait-and-see stance. In case of an absence of signs for a recovery in the late-2009, another series of rate cuts should be considered; otherwise we expect the rates to move sideways for quite a while.

As for the longer end of the curve, bond yields have been falling along with the policy rates cuts but increasingly less recently (Figure 14). The difference between the overnight funding rate and the benchmark bond yield, a.k.a. carry trade and/or risk premium reached 300 basis points. In the short term, this spread might ease to 200 basis points or more, barring a rapid and deep deterioration in public borrowing. Taking into account the expected effects of forthcoming cuts, the local bond yields, hovering around 14%c.a. nowadays, have still considerable downside potential. We think that the yields might go down to 12-13% c.a.in the coming months if global conditions improve, but again, fiscal performance should allow for that.

Figure 14:
Bond Yields vs Policy Rate (Compound annual rate)