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Mounting tension in Turkish politics...

The Although Turkey’s military has a long history of intervening in politics, in recent years it has taken a back seat. However, a document published by Taraf, newspaper with a liberal stance, has once again elevated tensions between the military and the government. On 12th June, Taraf published a copy of ‘Plan to Combat Islamic Fundamentalism’ signed by a colonel, Mr. Dursun Cicek, serving in the army’s psychological warfare unit. The plan calls for organizing against the AK Party and aims at discrediting its members. Moreover, it speaks of placing weapons in the homes of members of the Islamic-rooted Gulen movement. According to the plan, members of this movement with its exiled leader in the U.S., are terrorists with connections to the PKK. By becoming the center of the public debate, this scandalous document occupied the newspaper headlines. It sparked anger in different segments of the society.

The leak of this document was not the first time the military is at odds with the incumbent governments over the country’s direction. The military has removed four governments from office in ‘coup models’ ranging from armed overthrow in 1960 to a campaign of political pressure in 1997. In the latter, the army has attempted to unseat the country’s Islamist-led government in 1997. The military’s latest intervention in politics, identified as e-coup by the Turkish media, came about during the recent presidential elections. It was peculiar since it was the first time the General Staff used internet to convey military’s message. The General Staff’s statement underlined military’s pursuance of the election situation with concern while reminding politicians the military’s role as the ultimate guardian of secularism. Despite a military declaration posted on its website, the parliament chose Abdullah Gul as a president in 2007. Abdullah Gul was previously the Minister of Foreign Affairs of the AK Party government, and his wife wears much debated head-scarf.

Recently, tensions between the government and its secularist enemies have risen during an investigation into the ‘Ergenekon’ group accused of trying to conduct a military coup for the purpose of overthrowing the AK Party. Approximately 200 people, including retired generals, lawyers, academics and eminent journalists are currently on trial for their links to Ergenekon. According to the secularist critics, Ergenekon is a revenge for the 2008 court case to close the AK Party on the basis of its political position against the Republic and its secularist base. Incidentally, The Court, which is believed to represent anti-AK Party, secularist wing in Turkey, ruled against the closure of the AK Party.

Now, the government is fighting back and has laid a formal complaint with public prosecutors, calling for a full criminal investigation into an attempted coup. The Military sent a report of its finding to the prosecutors conducting the Ergenekon probe. As mentioned by the report and the press statement, the signature on the plan does not belong to Colonel Cicek. Since the document is a xerox copy, it is not possible to draw clear-cut conclusions. However, if the further detailed report of civil judiciary confirms that the signature on the action plan belongs to Cicek, then this might result damaging military’s reputation in the public eye. Moreover, it might boost AK Party’s popularity, which is ideal after its tamed victory during the recent local elections (please refer to March 2009 DenizBank Monthly Update for further details).

The Chief of General staff Ilker Basbug denies all knowledge of the recent affair, but he has promised to punish any of his men who are guilty. If General Basbug doesn’t have the knowledge on the subject matter, then it was probably the act of a group of renegade officers within the army. Another possibility is that the police, penetrated by Gulenists, made up the document to humiliate the army. It seems like this subject matter will be discussed for a long time in Turkey, and the discussions, the trials and the allegations will come to naught. On the bright side, these recent discussions have not affected the local financial markets negatively at all. It is worth reminding ourselves that following the mentioned e-coup in 2007 the IMKB stock market has tumbled more than 7%, and benchmark bond yield surged by 71 bps.
Industrial production keeps contracting, though with lower rates…

Industrial production declined by 18.5% in April compared to the same month a year ago. This was roughly in line with the average market expectation of 18.3%. The reading reflects that production has continued to contract at an exceptional speed for Turkey; yet not at a pace so detached from Turkey’s peers in the EU. The annual change in the 12-month rolling production, a longer term trend indicator, fell further to -10% (a record high for decades) in April, from 7.9% in March, reflecting the severity of downward momentum (Figure 1).

The forces behind this strong contraction seem intact: the weakness in domestic and foreign demands have continued. The rigidity in global financial conditions still persists to some extent, uncertainties surrounding the real economy endure and the resolution is likely to take some time. Foreign demand for Turkish goods remains weak, evident from the 28% annual contraction in exports in the first four months of the year. But as governments all around the world responded strongly to the recession through considerable fiscal subsidies and central bank funding, economies are offloading their excess inventories. As per the Turkish side, it is true that recent data releases signal a partial recovery in domestic economic activity. Especially the temporary cuts in some indirect taxes, introduced in March, helped producers to deplete their inventory stocks (Figure 2).

It is of common knowledge that the factors restraining both external and domestic demand have not faded yet. Hence the strength and pace of further improvements are still uncertain. But from the data, we infer that industrial production has bottomed out. Recall that the deterioration in industrial production had accelerated consistently every month since July until February reaching as high as 24% in the latter. The fall in March by 20.9%, though still deep, suggested that the pace of contraction appeared to be slightly slower when compared to the first two months of the year. In April, the relative improvement continued, the annual contraction rate declined to 18.5%. The improvement becomes even more pronounced when eliminating seasonal trends. In seasonally adjusted terms, industrial production was up in April compared to March, registering the first positive monthly change since a year ago. It indicates that the pressure on manufacturers is receding some degree and orders for new production are likely to come back, though modestly.
Rise in capacity usage signals further increase in output…

The Tendencies in Manufacturing Industry Survey for May supplied a decent piece of hard data signaling a recovery in output. The capacity utilization rate for manufacturing rose from 66.8% in April to 70.4% in May (Figure 3). On the bright side, not only the outing was well above the average market expectation of 68.8%, but it also exceeded the record-low February level by 6.6 pps. Yet, one should note that the current levels are still way below the long term averages and suggest that the annual declines in production will continue, though at lower rates. Looking to seasonal trends, the capacity utilization rate tends to increase roughly 1-2 percentage point in May compared to April. But this year’s 3.6 percentage point rise does not imply just a seasonal up tick, but rather a sign of recovery.

The details shows that the recent temporary tax cuts played an important role in supporting the recent months increase in capacity usage. All sectors (excluding the furniture) subject to the recent tax cuts displayed monthly increases in capacity usage in May. Table 1 below reveals that the automotive benefited the most from the tax cuts among those sectors. After bottoming out in February with 47.5%, the capacity utilization rate for this sector registered successive monthly increases and reached 68.4% by May. The most recent news flow on the sector, claiming that some factories started to operate over the clock in order to meet the rising demand, hints that this increase is likely to persist in June.

Table 1:

<table>
<thead>
<tr>
<th>Capacity Utilization Rates for the Sectors Subject to Tax Cuts (%)</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive</td>
<td>47.5</td>
<td>54.0</td>
<td>58.4</td>
<td>68.4</td>
</tr>
<tr>
<td>Radio-TV apparels</td>
<td>70.5</td>
<td>81.7</td>
<td>83.7</td>
<td>85.3</td>
</tr>
<tr>
<td>White goods, other electrical apparels</td>
<td>67.8</td>
<td>62.0</td>
<td>62.9</td>
<td>66.9</td>
</tr>
<tr>
<td>Office apparels and computers</td>
<td>44.1</td>
<td>41.9</td>
<td>45.0</td>
<td>45.8</td>
</tr>
<tr>
<td>Furniture</td>
<td>59.2</td>
<td>60.3</td>
<td>66.6</td>
<td>64.3</td>
</tr>
</tbody>
</table>

The manufacturing survey suggests that businessmen saw an 8% rise in production in May and expect a further 7% rise in June. In our view, the contraction rate in industrial production is likely to ease towards 15% by May. In June, it would go further down, may even be single-digit. Compared to the record 23% annual decline witnessed in 1Q09, this will be a substantial improvement without doubt.

By the same token, businessmen said that domestic sales increased by 6% in May and will further go up by another 6% in June. That is to say, the imminent rise in production will likely be the result of a recovering domestic demand while external demand, on the other hand, will remain weak.
During the month, real sector and consumer confidence indicators kept supplying fresh evidence in favor of a revival in economic activity (Figure 3). The Real Sector Confidence Index registered its sixth monthly increase in a row. The index surged to 99.4 in June, a level very close to the optimism threshold level at 100. The reading also implies a 2.5 points rise vis-à-vis May and an amazing 47 points increase compared to its record-low December level. The improvement was broad based among all the sub-items such as both domestic and export orders, sentiment regarding general business situation, investment expenditures and inventories. Together with the capacity utilization reading, the survey is suggestive of lower contraction rates in industrial production.

The consumer confidence index was also up in May, for a sixth consecutive month, surged to 83.3. It corresponds to a 3% monthly increase and a 21% raise versus the bottom in November. The pre-Lehman Brothers level had been already surpassed in April and the current level is the highest since February 2008. On the flip side, the increase seems less impressive when compared to whose in the real sector confidence index. Moreover, the index still falls short of implying optimism by remaining way below the threshold level at 100. The worst of the recession has passed according to the survey, but it will take some time before we will see anything close to normal conditions. The details suggest that the recent improvement was across the board, as most of the sub-indices displayed increases. Consumers’ sentiment concerning general economic situation were particularly upbeat since April, this bodes well for the outlook for spending and for the rebound in the economy.

Given this background, growth dynamics may improve in the second half of the year, though the improvement should not be expected to be dramatic. Concerning the first half, we will likely be facing gloomy declines in the national income. The GDP growth figures for the first quarter will be announced on June 30th and the outcome is largely-anticipated to be a double digit contraction, the worst reading since decades. The second quarter may register another deep contraction, but its magnitude is likely to be milder. We anticipate a near zero growth in the third quarter and a positive number for the fourth, which can be taken as an optimistic recovery scenario. This kind of realization would bring the growth rate for 2009 towards to the vicinity of -4%. (Figure 5)
Budget figures deteriorate further in May…

In May, the budget balance registered TL 0.6 bn deficit, the lowest deficit since October 2008. However, this should not be taken as an improvement since May is seasonally a high surplus month as one of the installments of corporate taxes corresponds to the month. Indeed, the headline balance is unfavorable compared to the TL 3.4 bn surplus recorded a year earlier. The non-interest surplus of TL 4.4 bn, as well, points out a deterioration compared to a TR 5.1 bn surplus in May 2008.

On the bright side, the budget data imply that the full throttle increase in primary expenditures was halted in May. The non-interest expenditures totaled TL 14.5 bn, up only by 2% compared to the same month a year ago. The cumulative annual increase rate for the January-April period was as high as 27%. However, this deceleration is very unlikely to be sustained as there is not so much room for the administration to cut the expenditures going forward. Furthermore, the recently taken stimulus measures will put additional burden on the budget in the remainder of the year.

On the other hand, the deterioration in revenues lingers. The total budget revenues were down 2% compared to May 2008. The recession has taken its toll on tax collection as the tax revenues decreased by 10% (in nominal terms) in May, compared to a year ago. When the January-May period is concerned, the weakening in tax revenues is noteworthy (Table 2). Unfortunately, a revival in tax generation is unlikely before a solid recovery in economic activity. All in all, the fiscal outlook might not change substantially for the better for the rest of 2009.

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

<table>
<thead>
<tr>
<th>TL bn</th>
<th>Jan-May 2008</th>
<th>Jan-May 2009</th>
<th>Nominal chg (%)</th>
<th>Real chg (%)</th>
<th>Revised target 2009</th>
<th>Jan-May % of target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-interest expenditures</td>
<td>86.0</td>
<td>106.9</td>
<td>24.3</td>
<td>15.8</td>
<td>259.9</td>
<td>41.1</td>
</tr>
<tr>
<td>Interest expenditures</td>
<td>19.6</td>
<td>26.1</td>
<td>33.3</td>
<td>24.2</td>
<td>58.0</td>
<td>45.0</td>
</tr>
<tr>
<td>Budget revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax revenues</td>
<td>84.0</td>
<td>86.2</td>
<td>2.7</td>
<td>-4.3</td>
<td>211.6</td>
<td>40.7</td>
</tr>
<tr>
<td>Budget Balance</td>
<td>-2.1</td>
<td>-20.7</td>
<td>-</td>
<td>-4.3</td>
<td>-48.3</td>
<td>42.8</td>
</tr>
<tr>
<td>Primary Balance (exl. interest)</td>
<td>17.5</td>
<td>5.4</td>
<td>-</td>
<td>-</td>
<td>9.2</td>
<td>59.1</td>
</tr>
</tbody>
</table>

The cumulative figures suggest that revenue weakness and spending overruns cut the non-interest balance to a mere TL 5.4 bn surplus in the first five month of the year, down from TL 17.5 bn a year ago. This implies a TL 12.1 bn burden to the budget, emanated mainly from the crisis and the local elections related spending spree before March. Barring additional revenue increasing measures in the remaining of the year, the total burden is likely to exceed TL 40 bn (4% of GDP) in 2009. As the fiscal balances keep deteriorating, concerns over the sustainability of public debt have arisen considerably. The domestic market debt roll over ratio at 109% in the first half of the year already started to pressure borrowing costs of the Treasury upwards.
**Inflation hits another record low, but is likely to head up again...**

CPI inflation of 0.64% in May was encouraging, even though it exceeded the average market expectation of 0.45%. As the monthly figure stayed substantially below its level recorded the same month a year ago (1.49%), the annual rate of inflation touched another record low of 5.2%, following the earlier low level at 6.1% in April (Figure 7). Hence, the rapid disinflation course, which started after October (when the annual rate hit 12%) and was only interrupted in March (due to a jump in food prices), continued for another month. Reflecting the absence of any cost-push inflation pressure, the annual producer prices inflation too, eased to a historical low -2.5% in May, down from 18.4% witnessed in July 2008.

As per consumer prices, the encouraging monthly reading stemmed largely from the 1.9% fall in housing and rent prices. Weak demand conditions and lower commodity prices (which tamed natural gas, coal and indirectly electricity prices) enabled the monthly inflation for this sub-item to register fourth straight negative outcome. A part of this fall was emanated from the 25% reduction in natural gas fees introduced in May. Moreover, another negative monthly reading came from the household equipment sub-item with -0.19%, thanks to an appreciation in the lira and remaining (and probably the final) impacts of indirect tax cuts. Even after discounting the impact of tax cuts and reduction in natural gas fees, the underlying trend implies that a secular disinflation trend has remained intact. The course of core inflation supplies further support for this argument: the annual rates of increase in all special inflation indicators registered declines for the third consecutive month in May.

Considering the last seven months’ trend, consumer price inflation has come down along with the rising excess supply and resulting fall in commodity prices. Actually, this picture has been more or less the same around the globe. Reflecting waning demand conditions, the annual rate of increase in housing prices receded from 27% in October to 12% by May (Figure 8). Likewise, the annual food and beverage price inflation eased from 12% to 8% in the same period. The 14 pps fall in the annual transportation inflation (from 9% in October to -5% in May) is reflecting the combined impact of declining commodity prices and weakening consumer demand.

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**Figure 7:**
Annual CPI Inflation and CBT Targets

**Figure 8:**
Annual inflation by selected expenditure groups
Looking ahead, the Central Bank suggests that inflation could rise temporarily in June due to tax hikes and base effects, however expects it to remain at low levels in the foreseeable future since it expects the recovery in economic activity to be slow and gradual. Among the market participants, the odds are for an interruption in disinflation at least for a couple of months. This is the exactly the view we expressed in our pervious updates. On the other hand, in a longer term perspective, we are not as optimistic as the Central Bank. We believe that the outlook will not be supportive for maintaining these low levels, in fact we expect that inflation may embark on an increasing trend over the medium term because of the followings.

- The favorable base effect, which has been of much help in softening inflation in the recent months, will disappear as of June (A year ago, negative monthly inflations recorded in June and August). Moreover, starting from the late 2009, a lower base effect will come into play that is likely to result in higher annual rates.

Table 3:

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2008</strong></td>
<td>0.80%</td>
<td>1.29%</td>
<td>0.96%</td>
<td>1.68%</td>
<td>1.49%</td>
<td>-0.39%</td>
<td>0.58%</td>
<td>-0.24%</td>
<td>0.45%</td>
<td>2.60%</td>
<td>0.83%</td>
<td>-0.41%</td>
</tr>
<tr>
<td><strong>2009</strong></td>
<td>0.29%</td>
<td>-0.34%</td>
<td>1.10%</td>
<td>0.02%</td>
<td>0.64%</td>
<td></td>
<td></td>
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</tbody>
</table>

- The impact of the recent tax cuts will fade shortly. Tax incentives for white goods, vehicles, furniture, and electronics, which were originally set to expire on June 15th, extended until the end of September but with gradual hikes in rates. The administration also signaled that the reductions will not be maintained for good. Hence the re-introduction of the old tax scheme might come in the fourth quarter. After having fallen markedly during March-April on the back of tax cuts, prices of white goods and automobiles already started to increase in May.

- The impending recovery in global economic activity will likely pose upward pressure on prices. Recent data releases started already signaling a partial and moderate pickup in domestic activity, which has not been reflected in price dynamics, yet. But once the recovery starts to exert demand side pressure on prices, the outlook would change rapidly and dramatically.

- There is significant upside risk arising from the recent rebound of oil and other commodity prices. If a recovery scenario remains intact, oil prices will be adjusted further upwards. This will also pave the way for potential administrative price hikes for natural gas and electricity fees, which have considerable weights in the consumer price index.

- The ongoing deterioration in public balances necessitates revenue increasing measures. The government plans to implement tax hikes in selected items, as it already decided for an increase in the lump-sum special consumption tax on all tobacco products. Other hikes may follow.

- The fall in medium-term inflation expectations is halted. After easing from 9% in November, the 12-month forward inflation expectations have been sticky around 6.5-7% since late-February (Figure 9). In other words, economic agents do not believe the disinflation will persist. By pricing decision channel, this will likely put further pressure on inflation.
The downside potential in bond yields is fading…

In its June 16th meeting, the Monetary Policy Committee cut the policy rate by 50 bps, surprising the market which was largely anticipated only a 25 bps cut. The reasoning was the persistence of the downside risk for the real economy and the ongoing disinflation trend. The cuts since November totaled 800 bps and the over-night borrowing rate is now at 8.75%. The statement accompanying the decision reiterates that other "measured" cuts might follow however it also includes a phrase saying that the Bank will consider a pause if the signs of improvement in economic activity turn into a robust recovery. This is the first time that the word of “pause” is pronounced in a statement. In our view, also shared by many, we are very close to the end of the ongoing easing cycle. Considering that the favorable data flow on economic activity is unlikely to be interrupted, we believe a wait-and-see period will kick off following one or two 25 bps cuts in the next meetings.

Upon a friendly environment (disinflation, rate cut cycle), Treasury bonds displayed a strong rally. The benchmark bond yield eased to below 12% c.a. in May from 24% in November, when the first rate cut was implemented (Figure 10). Since late May, however, the ease in rates seems halted, the benchmark yield traded between 12-13% compound levels in June. Looking forward, we maintain our view that there is very limited downward potential in the bond market and Treasury yields might embark on a gradually increasing trend on the medium term through several reasons listed below.

- The rate cut cycle is coming to an end, as mentioned before.
- Inflation is likely to head north starting from June, as described above.
- The ongoing deterioration in fiscal balances has resulted in higher bond issuance. The domestic market debt rollover ratio reached 109% in the first six months of the year, compared to 78% in the whole of 2008. As we attach little probability to an improvement in budget numbers in the short term, the rollover rate is unlikely to ease below 100% this year. By definition, higher supply of bonds will result in increasing upward pressure on yields. The Treasury has hefty domestic redemptions in the months of July and August (TL11 bn and TL23 bn, respectively). Had a considerable IMF funds were transferred to the Treasury's accounts, the rollover ratio could decline to safer levels. However, the probability of an IMF deal has been consistently decreasing for the last couple of months. Even if the Treasury overcomes the domestic debt redemptions with ease in the remainder of 2009, the first quarter of 2010 will be tougher; with scheduled redemption of TL54 bn to domestic market.
- Emerging perception towards a recovery and increasing risk appetite might reduce the attraction of sovereign bonds over other assets. This may lead investors to shift their investments from risk-free government securities towards riskier assets, such as stocks. Any increase in risk appetite might also stimulate a foreign demand for local bonds, but the probable inflow would not be enough to offset waning local demand, in our view.
- By the same token, increasing perception of recovery will urge local banks to be more willing to lend and corporates to be more willing to invest. This will also decrease local banks’ appetite for safe-haven Treasury bonds.