March 2010

DenizBank Political & Economic Update

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Constitutional amendment will be challenging

The ruling Justice and Development Party (AKP) presented its package of 26 constitutional amendments to the Parliament on March 22nd. Highlights from the proposed constitutional reform package are listed below:

- The government will be restructuring the “Supreme Board of Judges and Prosecutors (“HSYK”) and the “Constitutional Court”. The AKP aims at changing the selection and promotion process in the higher judiciary that would be open to Parliamentary review. Currently, the HSYK has seven members of which five of them are elected from the Supreme Court of Appeals and Council of State. Thus, increasing the HSYK member number to 21, the AKP tries to diversify the members.
- The package is anticipated to make political party closures harder by requiring Parliamentary approval and applying the EU’s Venice Criteria, which brings punishment for individuals rather than institutions. With the amendment, any party member violating the political parties’ law would be banned from politics, but the party would not be affected. Additionally, the political parties that are not involved in terrorism or violence-related incidents will not be closed.
- The amendments include narrowing the sphere of the military judiciary to crimes related with the military duties.
- The package establishes an ombudsman system and introduces positive discrimination for women, would grant public servants the right to collective bargaining and strikes.

Opposition on constitutional amendment is making referendum more likely

The political party leaders addressed their party groups with making the AKP’s planned constitutional amendment package the main agenda. The opposition’s stance is important given that the AKP with 337 seats does not have enough seats of 367 at Parliament to approve the constitutional changes without a referendum. Any constitutional amendment passed with 330-367 votes would have to be put to referendum after the President’s ratification. Such a referendum is to take place in the next 60 days following the ratification according to a law that is expected to be approved by the AKP soon. Deputy PM Cicek recently announced that the AKP government is planning to submit draft constitutional reforms to the Parliament before the end of month. He also said more amendments could be added to the package and mentioned that the government was not against voting on articles separately. Furthermore, the AKP’s deputy chairman for public relations Kapusuz gave a possible deadline for the referendum for proposed changes as mid-July. According to the planned timetable, the constitutional amendment package will be submitted to the Parliament speaker’s office on March 29th, then it will be debated in Parliament’s Constitutional Commission in mid-April and referred to the General Assembly for approval. It will finally be submitted to public referendum in mid-July. Its rejection would be a heavy blow for the AKP and even could pave the way to early elections.

Support for the AKP is gradually decelerating

A possible referendum (as explained above) will also be a test for the AKP’s support. The recent opinion poll showed that the AKP’s support has weakened to 35% from their previous survey showing of 37% recorded in January - both levels are below the March 2009 local election results of 39%. On the contrary, the major opposition party CHP’s share of support has increased from 14% in January to 19% in March. The other opposition party MHP’s support, however, fell back to 18% from 20%. Another vital decline was observed in the share of support for the newly established TDH (former CHP major) to 7% from 11%. This indicates that a fourth party is not entering the Parliament which would be important with respect to determine the need to form a coalition government. Additionally, the 71% of the poll participants agree that Turkey needs a new Constitution. Yet, majority of the respondents think that now is not an appropriate time to deliver such a constitutional amendment; even though, 59% believes a judiciary reform has become a requirement.

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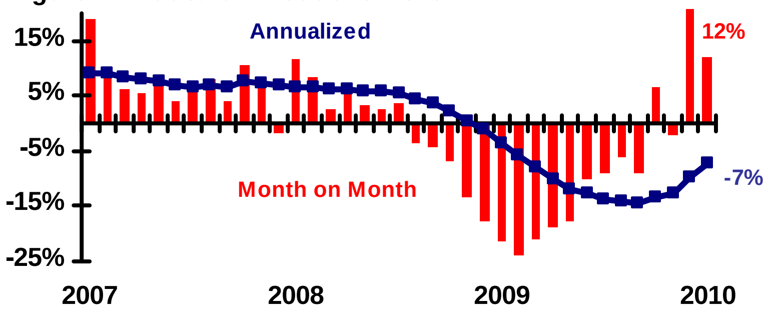
Economy

Sluggish recovery…

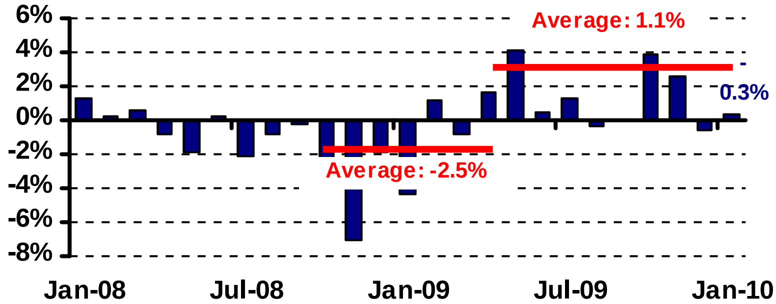
After the surprising increase of 25.3% in December 2009, industrial production has moved up by another 12.1% in the first month of 2010. Yet it remained below the average market growth estimation of 15.9% (Figure 1). On the contrary, the picture becomes gloomy when we look at the change in the industrial production on a seasonally and working day adjusted basis. The industrial production only grew at a monthly rate of 0.3% in January. (Figure 2)

Figure 1: Industrial Production Growth



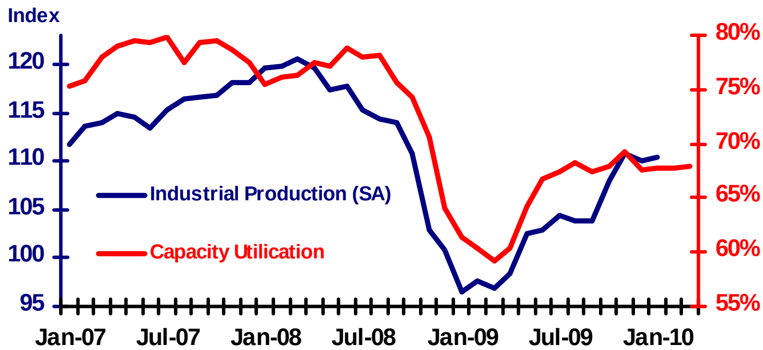
The manufacturing sector depicted 14.4% YoY growth. However, seasonally and working day adjusted manufacturing sector IP growth is relatively low at 0.7% as a result of montly drops in mining and in the energy production. 66.8% YoY jump in auto production is striking. Increases in the textile production (19.4%, YoY growth) and in the electrical machinery production (12%, YoY growth) are also eye-catching.

Figure 2: Industrial Production (SA, MoM)



Although below expectations, the 12% surge in industrial production might be perceived as good news and may imply the economy has been recovering relatively swiftly. This could increase the inflationary pressures and lead to early policy rate hikes. However, the real picture is a slightly different. Both increases in December and January are compared to the previous year when the economy was at the through. Therefore, the base effect is particularly misleading. As explained above, seasonally adjusted figures reflect a sluggish improvement, with a mere 0.3% increase in January from December, following a 0.6% monthly decrease. The reading is also in line with our view that although the contraction in economic activity has come to an end, the recovery will be rather slow in 2010. The recent 6% increase in GDP during the fourth quarter helped Turkey to contract only 4.7% in 2009. More than expected GDP increase in the fourth quarter is mostly due to the base effect therefore we do not change our GDP forecast of 3.8% growth in 2010.

Figure 3: Industrial Production vs. Capacity Utilization

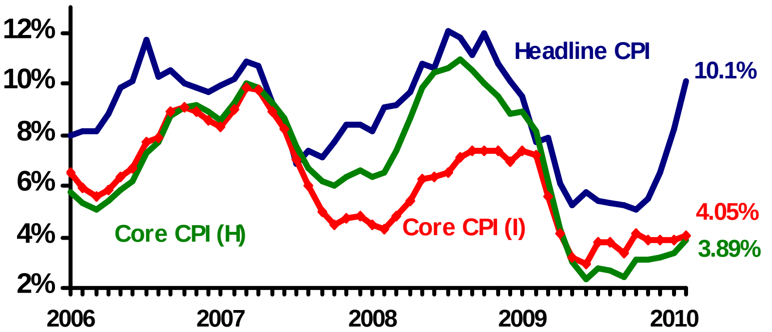


The manufacturing sector capacity utilization rate (CUR) at 67.9% in March did not surprise us, given our sluggish recovery scenario for the year 2010 (Figure 3). The CUR hit the bottom in March 2009 with 60.3%. Since June 2009, the CUR has been within the narrow range of 66.8- 69.2%. The flat CUR for the past nine months including March underscores the slow recovery in the real economy.

Inflation rose to critical levels…

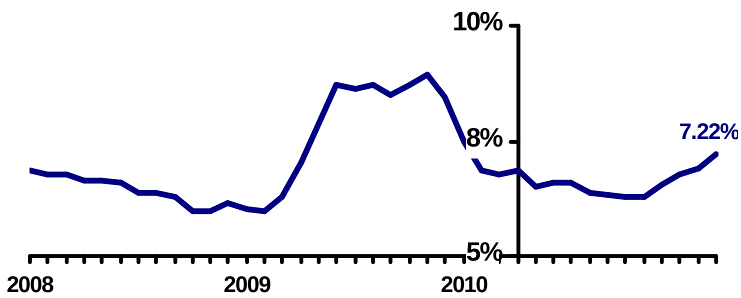
The February monthly inflation at 1.45% exceeded the average market expectation of 0.64%. Thus, the February YoY CPI increased to 10.13% from 8.19% in January. Without any noticeable jump in domestic demand, double digit inflation of 10.13% as of February will put pressure on inflationary expectations. The CBT has already warned the markets about a possible increase in the inflation in February.

Figure 4: Inflation and Core Inflation



The unexpectedly high headline CPI inflation increased the importance of CBT's favorite core inflation indices, namely H and I. It is the first time both indices edged higher, albeit both still ranging around 4%, well below the year end inflation target of 6.5%. (Figure 4)

Figure 5: CPI Expectation (12M Fw)



In parallel to the headline CPI inflation, 12 months forward inflation expectations rose to 7.22% in March. Given the unexpected rise in headline inflation to 10.1% in February, the markets and definitely the CBT were concerned of persistent pass through to inflationary expectations, yet this effect is very limited (Figure 5) That said, the March inflation print is still likely to be vital; if the headline rate increases further –given that the CBT expects the headline inflation in March to go back to single digits- the CBT will likely come under pressure to tighten more aggressively.

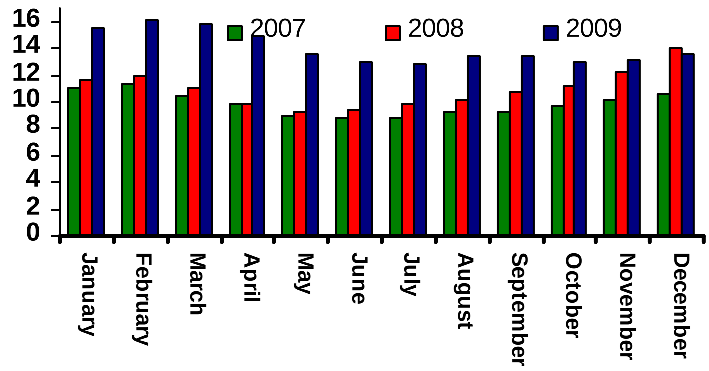
The CBT kept its benchmark policy rate unchanged at 6.5% in its March meeting. Same with the February statement, the CBT underlined that it will keep the policy rate flat for a long period of time. However, it warned that if the inflation expectations worsen due to the rise in headline CPI in January and February, it would damage pricing patterns. Although there is a mild recovery on economic activity and the recent increase in inflation is due mostly to low base effect and the uncertainties regarding the global economy still remain, we -parallel to the consensus estimation- continue to expect the CBT to deliver 150bps rate hike in last quarter of this year (Figure 6).

Last but not least, developed and emerging central banks' rate movements have direct and indirect effect on the CBT's rate decision. Recently, three emerging market peers, namely Russia, Hungary and South Africa have cut their policy rates, 25bps, 25bps and 50bps respectively. Moreover, as the economic growth lingering in the developed economies, especially in the EU and Japan, the central banks are likely to keep policy rates near zero for a prolonged period of time. In other words, policies of other central banks are likely to help the CBT to defer tightening further.

Unemployment is expected to improve in 2010 but at a slow pace…

The December 2009 unemployment rate fell to 13.5% from last year's 14%. However, compared to November's 13.1% unemployment rate, it is still very high.

Figure 7: Unemployment Rate (%)



Reaching its highest level at 16.1% in February 2009, the unemployment has followed a gradual recovery trend. Even though, Turkey shows some signs of economic recovery, similar to many benchmark countries, the number of unemployed will continue to preoccupy the policy makers. Agricultural sector has added 637K to employment during last 12 months. Two other major sectors, industry and services, are also correcting, albeit slowly. The construction sector is contributing to the biggest share in the number of unemployed. Accordingly, since we have bullish expectations regarding the mortgage market (Please refer to DenizBank Monthly December 2009), the unemployment rate is likely to decelerate further in the next months. For the year 2010, we expect the unemployment rate to be 13% on average, compared to 14% in 2009.

Maintaining stellar profitability performance...

Turkish banks" extraordinarily high profitability has continued also in the first month of 2010. According to the consolidated banking data of BRSA as of January 2010, the banks posted TL2.1 bn monthly profit which is the historical highest together with April 2009 monthly income (Figure 8).

As mentioned in our previous reports, the net profit has surged by a whopping 50% on yearly basis in the crisis year of 2009. When we look at the details of the extraordinarily high profitability in the first month of 2010, it is easily understood that the support from bonds portfolio is still intact. What is different this time is that loan provisions are decelerating, such that the provisions have plunged by 30% compared to average monthly provision for 2009 (Figure 9). Looking forward, the banks are likely to substitute the receding interest income –especially from bonds portfolio- by increasing volumes. Additionally, it is understood that on the back of decreasing NPL's the diminishing provisions will be instrumental in supporting profitability in the next months.

Figure 8: Net Profit/Loss (Monthly)

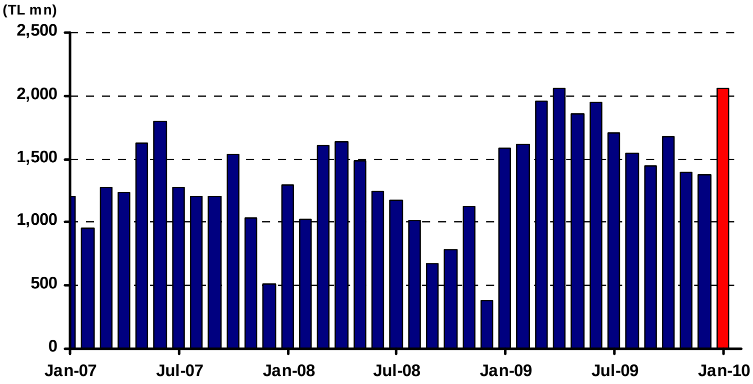
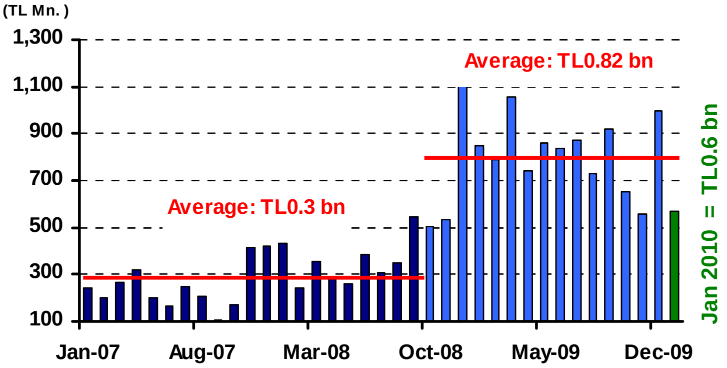


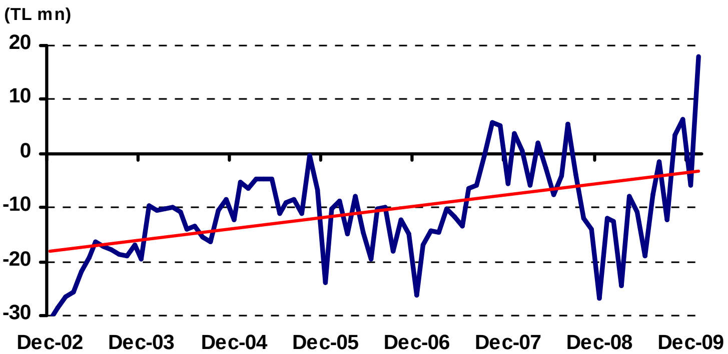
Figure 9: NPL Provision (Monthly)



The funding will be the most important driver of future growth…

Following the global crisis which intensified in the last quarter of 2008, bond portfolios and deposits had risen progressively. While the loans and foreign funding (syndications, securitizations, etc) moved sideways, especially, bond portfolios, surged by a whopping 53%, are worth mentioning. Many analysts focused on the simple leverage ratio (loans/assets) of Turkish Banking System which was gradually decelerating since the beginning of the crisis. However, the bonds to assets ratio is standing at 32% and so when gauging the leverage of Turkish Banking System, the weight of the bonds have to be taken into account. As it can be seen in Figure 10, (loans + bonds) – (deposits + wholesale + repo funding) is at its historical high.

Figure 10: (Loans+Bonds)-(Deposit+Wholesale+Repo Funding)



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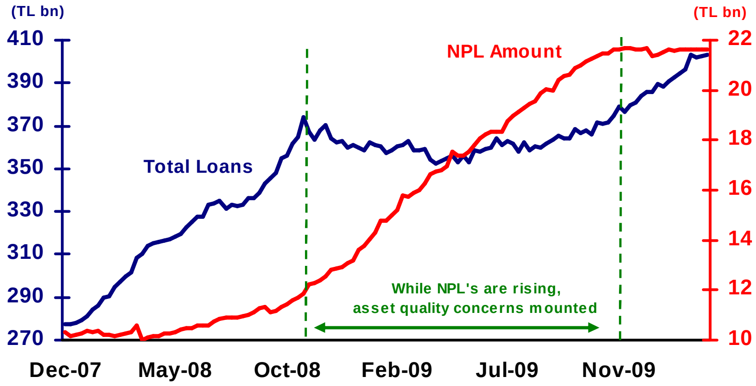
Banking Sector

Government bonds, unlike loans, are very liquid instruments and can be liquidated in case of emergency. In addition to liquidity management, banks benefited from bonds mainly in two ways during the crisis:

i- **Higher profitability:** Benefiting from 1050 bps rate cut of Central Bank of Turkey ("CBT"), which has certainly eased the shift in the TBS' balance sheet, since there is chronic duration mismatch between assets and liabilities (compared to one year average asset duration, liabilities, mostly deposits, have one month maturity).

ii- **Higher asset quality:** When the NPL's started to increase, government bonds were a perfect place to park vast amount of liquidity. This trend, however, ended when the NPL amount has stabilized following November 2009 (Figure 11).

Figure 11: Loans and NPL Amount



On the other hand, it should be taken into account that the banks are the main holders of government bonds and borrowing requirements of the Treasury is not likely to decrease in the foreseeable future. In such an environment, the banks need extra funding to increase loans and bonds simultaneously. However, deposits (+repo) increase trend is at its historical highs and cannot be "much" better than this, in our view. Additionally, wholesale funding is a mere 10% of total liabilities. That is the reason why we believe the system will face greater funding constraints in the coming months. The banks which have higher Capital Adequacy Ratio ("CAR") and/or easy access to domestic/foreign funding will be able to increase lending volumes/assets more easily. Accordingly, we have witnessed the first signs of deposit competition recently both in interest paid to the deposits and monthly average interest rates for deposits. To sum, this trend is likely to be pending and increasing in the next days (Figure 12).

Figure 12: Interest to Deposits (Monthly)