August 2010

DenizBank Political & Economic Update

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Politics

The meeting of the Supreme Military Council was full of surprise. Every year, the Supreme Military Council (government and the army top figures) meets to discuss the top promotions in the Turkish Army. The Council proposes new commanders for each force, and the Council then decides in typically a day's meeting. This year the meeting (so-called YAS in Turkish acronyms) had an unusual tension being clouded by the alleged coup case. In an unprecedented move, Prime Minister Erdogan opted not to promote as many as 11 senior officers currently awaiting trial in a separate coup plot allegation, known as Sledgehammer. These included the candidate for land-forces commander and this was a first in the Turkish political history. The Chief of Army Staff Basbug turned to the B-Plan, Commander Isik but he declared that he would retire in a surprise move after submitting his petition for retirement. While, no declaration made on the reasons of retirement petition, some interpreted it as a protest against interference attempts by the government to the military actions. The prevailing uncertainty and controversial news on army-government aspect were closely followed by the markets.

The rejection of senior officers was widely portrayed by the Turkish media as a victory for the government, demonstrating the ability of the civilian executive to impose its will. On the other hand, the process has also been criticized by the opposition parties claiming that the allegedly Islamist AKP government is in fact trying to undermine the military, which has a constitutional role to guard Turkey's secular democracy, with commanders close to them.

What will the September Referendum Bring? The referendum vote on September 12th will decide about rewriting the Constitution, the so-called "Coup Constitution" for it was drafted under military authority in 1982. The attempt to amend it is not something new as it was amended 16 times in the last 28 years in line with the demands of nearly all political parties and non-governmental organizations. But this time changes are much more controversial. The government officials defend the 26-article package of constitutional changes stating that it will strengthen the democracy and help the secular Muslim nation's bid for the EU membership while the critics (opposition) say it will give the ruling AKP the ability to control the judiciary.

The amendments include substantial expansions of the Constitutional Court and the powerful Supreme Board of Judges and Prosecutors ("HSYK") that opponents say would allow the government to pack the courts with members close to the government, and damage the separation of powers. Furthermore, the amendments are planning to abolish the Provisional Article of the Constitution, which provides protection to coup leaders, and then there will be no remaining barriers for sending coup staff to the court. Another critical topic gives judiciary staffs who were dismissed by HSYK to appeal the decision of committee. The appeal option will also be valid for the military staff excluded from the army (for being overly religious for example). All these amendments have been controversially discussed in the media as the date of referendum approaches.

There are also other amendments that are not threatening and/or interesting for any political or interest group or do not trigger any argument among government and opposition parties. A couple of examples for those sections include problems between the state and citizens being resolved by an experienced ombudsman, businessmen with unpaid tax debts being able to travel abroad or the right to collective bargaining for government employees, etc.; all of which could be considered as sweetners for the major issues given above.

As per Metropoll Research Poll as of August 2010, the public backing for the legislative changes has jumped to 50% from 44% in July (please note that many people view the referendum as a vote of confidence for the government). Although there is no general consensus regarding the outcome of the Referendum, all the major poll' results show that the margin between Yes and No votes will be very thin. In the next Month's Report we will focus on the results of the Referendum and elucidate what it implies in terms of General Elections next year.

Economy

Benign Inflation Outturn in July…

Consumer prices fell by 0.48% in the month of July. Thus, yearly inflation has decelerated to 7.58% (Figure 1). It is in a decreasing trend within the last three months due to: **i.** strong base effect, **ii.** stable global commodity/energy prices, **iii.** strengthening TL, and **iv.** benign food prices. The effect of the food and clothing prices in the last three months is presented in Figure 2.

The Central Bank of Turkey ("the CBT"), however, warned the markets that inflation will rise in the next two months, and then start to fall again through the year end. This factor is mostly related to the demand reviving Ramadan effect where food and other prices may rise unusually (please note that the Ramadan month which started in the middle of August this year is not fixed in date, changes every year). As could be seen in Figure 3, food prices rise notably during Ramadan and the following month. Given the strong support of the food prices on the benign inflation figures in the last couple of months, the turnaround in inflation should not surprise the markets.

What is more important in terms of future outlook in inflation is the trend of the core inflation excluding food and energy prices. Figure 4 shows that although headline CPI is moving sideways around 8.5% since year 2004, core CPI (the CBT's favorite "I Index") is gradually decelerating, reflecting a strong disinflationary trend.

The CBT has explicitly stated in its quarterly inflation report that the rate hike will start at in 2011 earliest. (Please refer to DenizBank Monthly July) Given the benign outlook of inflation and tamed inflation expectations of the market, the analysts have pushed back their rate hike expectations towards the second half of 2011. Although we agree with the consensus expectations, we are still cautious about two exogenous factors. First, even though the central bank may have faith in benign inflation outlook in the remainder of the year, it will still have to take into consideration what other central banks are doing in terms of exit strategies. Once developed and emerging economies begin sequential hikes, as already started by the likes of Brazil and South Korean central banks, the CBT will find it increasingly difficult not to join.

Figure 1: Annual Inflation

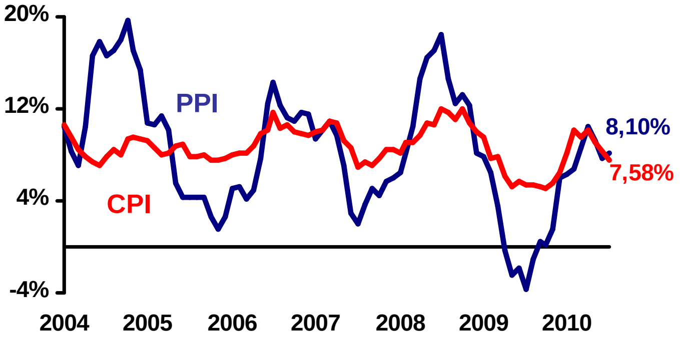


Figure 2: Contribution of Main Expenditure Groups

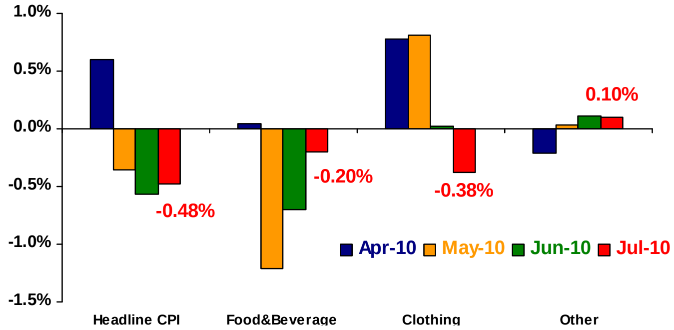


Figure 3: Ramadan Effect on Food&Beverage Inflation

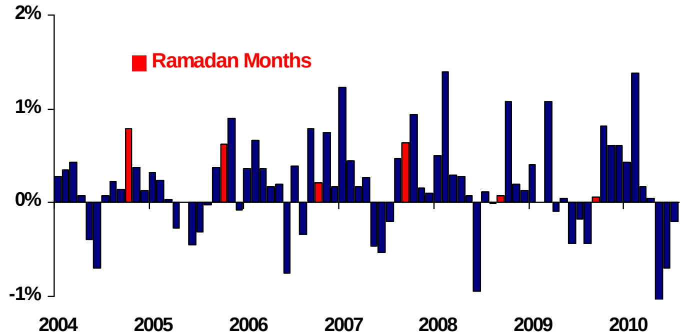
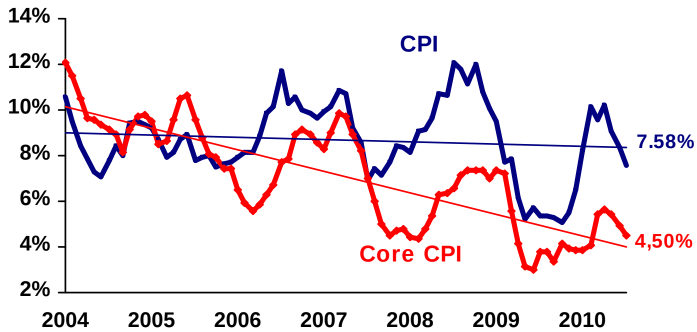


Figure 4: Headline and Core Inflation



If the narrowing interest rate differential pushes up the exchange rate (i.e. TL depreciates) it will have inflationary consequences and the Central Bank may want to preemptively act before that happens. In other words, the actions of other central banks will perhaps become a more important determinant than the CBT's own policy action.

Second, commodity prices, on the rise recently, might surprise the markets on the upside. Not only energy but also other commodity prices, like the recent surge in wheat prices, would affect inflation by worsening expectations.

Industrial Production is Slowing…

June industrial production ("IP") growth was broadly in line with the market consensus, expanding by 10.2% MoM basis. (Figure 5) This corresponded to a 14.2% growth in the second quarter alone, quite strong albeit at a slightly decelerated pace from the 17.3% rise in the first quarter. On the back of strong IP outlook, the GDP growth in the second quarter, to be announced as of September 14th, is likely to top 7%. However, as could be seen in Figure 5, the monthly IP growth is gradually decelerating due to the fact that the low base effect is waning, which will be more visible especially after this month.

The deceleration is more visible after adjusting the IP figure by the working day and seasonality which shows that production in fact fell by 2.1% in July from June (Figure 6). This is the strongest fall in seasonally adjusted IP since January 2009. Similarly, OECD leading indicators for June shows that the economic growth in Turkey is slowing down, yet not at a pace of her EU peers (Figure 7).

Looking forward, we do not have a gloomy outlook for the Turkish economy for the following reasons: **i.** the capacity utilization rate of July (and even June) is promising and still rising. June outturn of 75% is very close to pre-crisis average of 77%. **ii.** banking loans, both corporate and retail, are still rising, which is fuelling the economic growth. **iii.** the confidence indices, both consumer and corporate sector, are displaying a sequential recovery.

In summary, the Turkish economy might be losing momentum in line with the global trend but will still deliver a strong growth this year. It is, in our opinion, a most desired goldilocks scenario. Within this,

Figure5: Industrial Production Growth

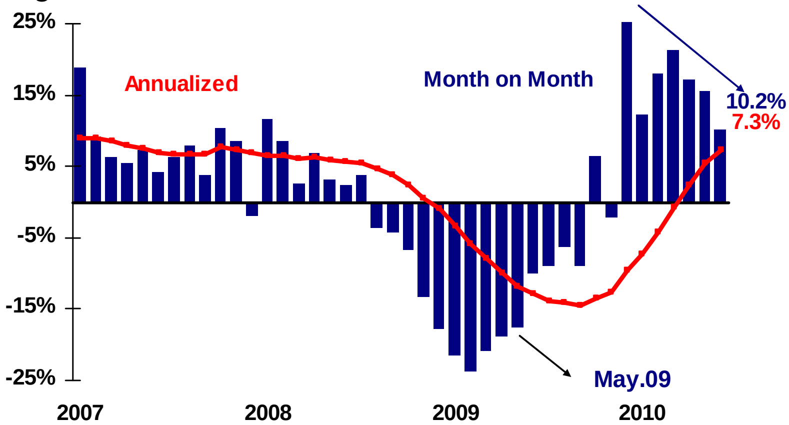


Figure 6: Industrial Production (SA, MoM)

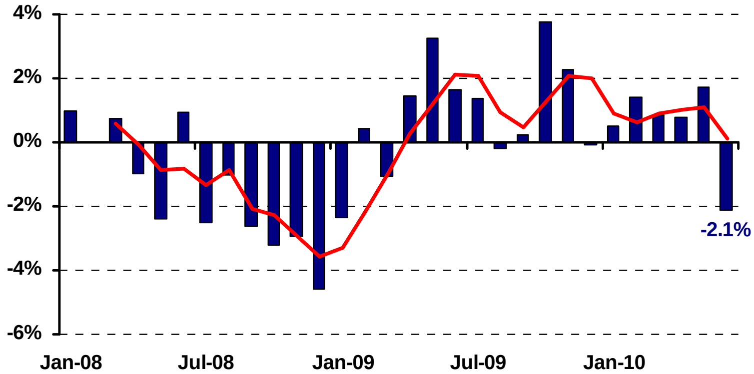
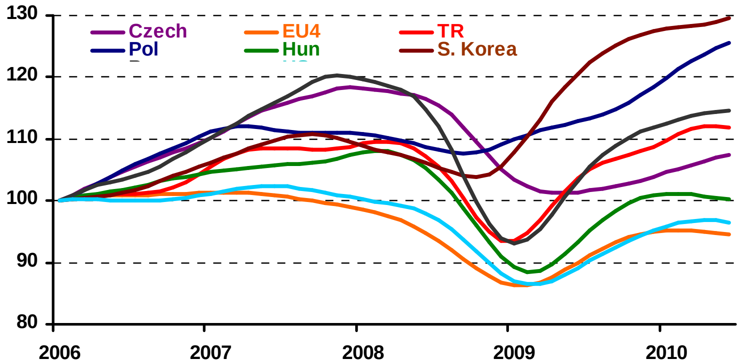


Figure 7: OECD Composite Leading Indicators

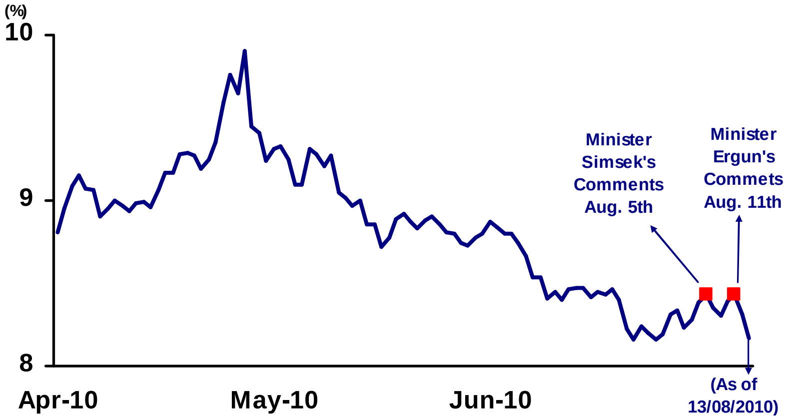


i. inflation expectations remain low, **ii.** the CBT defers hiking at earliest in 2011 (please refer to DenizBank Monthly July), **iii.** the TL remains stable, **iv.** the increase in the current account deficit is moderate, and **v.** all in all the economy grows close to its potential at about 4-5% a year and steadily.

The Impact of the Delay in The Long-Awaited Fiscal Rule…

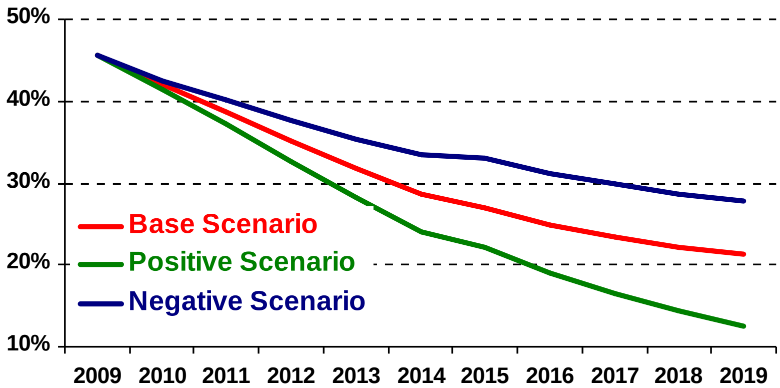
In August, we got mixed news from the government about the Fiscal Rule. As explained in detail in our last two Monthly Reports, following the consensus from various parties ranging from local academicians to the IMF, the government announced a carefully constructed fiscal rule to be effective from 2011. The draft law was passed in the initial commissions in the Turkish Parliament in July and was expected to be approved in the parliament in no time. But surprisingly the government announced that due to the busy schedule, the fiscal rule will be approved after the summer break of the Parliament and the rule may also be subject to some modifications. The uncertainty with respect to the rule only hastened after the statements of Finance and Industry Ministers. The latter nailed the coffin by explicitly stating that Turkey needs more time to debate the measure and examine its "flexibility" and it won't go into effect until 2012. Industry Minister Ergun also suggested the 3% budget deficit to GDP target instead of previous broad consensus of 1%. Although Minister Ergun has stated that the delay is not related with the 2011 general elections, the general perception in the market is in this direction.

Figure 8: Benchmark Bond Yield (Compounded)



The fiscal is important for the markets because it would be replacing the strong anchors of the EU membership efforts and the IMF stand-by between 2002 and 2009, which fell in importance and ceased to exist since 2008, respectively. It is also countercyclical measure pushing the government to be disciplined and save during high growth years while allowing room for fiscal support to the economy during recessions. This was perhaps one great lesson of the latest crisis.

Figure 9: Turkey Public Debt / GDP Projection



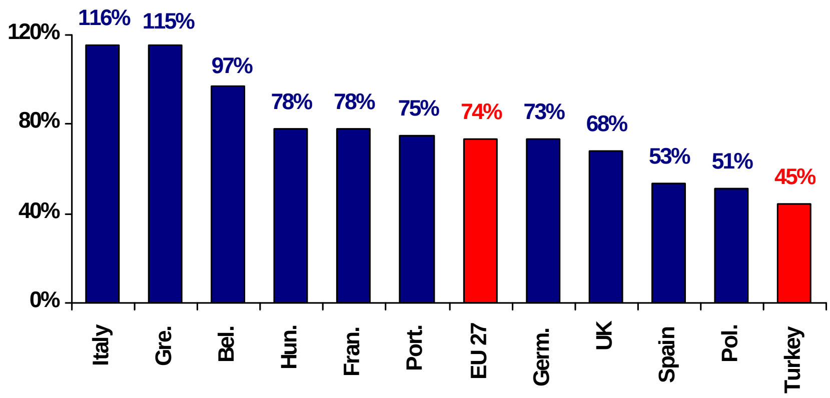
Assuming the economy has high growth potential, the fiscal rule would ameliorate Turley's public finances further. Our projections presented in Figure 9 show that under the fiscal rule policy setting, Turkey's debt to GDP ratio would gradually decelerate to 21% in 2020 in the base scenario[1]. In a "new normal" world where sovereign debt problems are so common, Turkey would be in a privileged position on the back of fiscal rule framework.

[1] Base scenario: GDP Growth of 5% until 2015, 4% thereafter. Positive Scenario: 6.5% until 2015, 6% thereafter. Negative Scenario: 3.5% until 2020.

That was the main reason why Turkey's rating was upgraded by all major rating agencies in the epicenter of the global crisis (2 notches by Fitch, one notch by Moody's and S&P). Fitch may elevate Turkey to investment grade next year which requires only one notch upgrade. Now, the rating outlook is bleaker amid the uncertainty about the fiscal rule. The rating firms' analysts following Minister Ergun's comments noted that this implies intention to loosen fiscal policy in 2011 before the general elections. The absence of high public sector saving would also deteriorate current account deficit prospects.

All in all, the benchmark T-bond yields are stable hovering still around 8.1%, showing that the markets, mainly the local banks, are still optimistic that the government would pass the Fiscal Rule Bill sometime this year, perhaps in October after the parliament comes back from the summer recess. We, however, consider that it is now small probability given the current polls show that 2011 elections will be more challenging for the AKP Government than previously thought. Last but not least, Turkey has still one of the lowest debt to GDP ratio in Europe (Figure 10). Some delay in fiscal rule should not be a catastrophic scenario for Turkey.

Figure 10: Debt to GDP Ratio (2005)

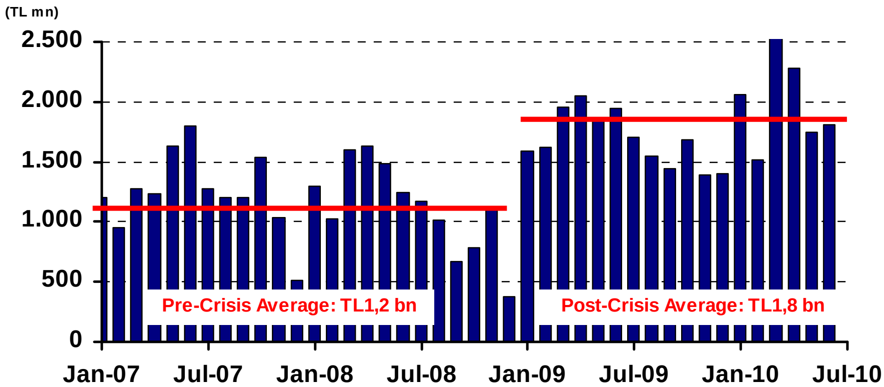


Banking

Still Robust Profitability

The June 2010 consolidated banking P&L figures were just released by the BRSA. On the back of decelerating interest income from the government bonds which is reflecting the end of easing in yields, net interest income is slowing down to pre-crisis levels. On the flip side, thanks to declining NPL provisions and robust commission income, the monthly net profit has posted TL1.8 bn, carrying H1-2010 profitability to TL12 bn, corresponding to 10% growth compared to H1-2009. Looking forward, it is obvious that net interest income will gradually decrease mainly due to the diminishing support from government bonds and spreads. Therefore, the banks are likely to substitute the receding interest income –especially from bonds portfolio- by increasing volumes starting from H2-2010.

Figure 11: Net Profit/Loss (Monthly)

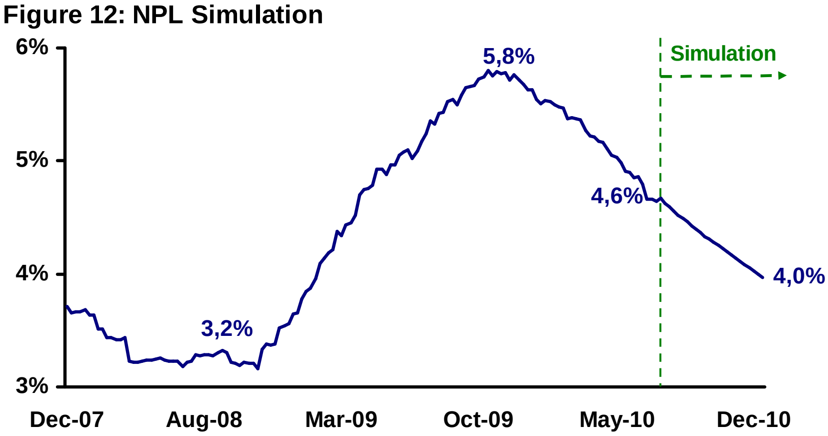


Slow Economic Growth is not too Bad for Profitability

Slowing economic growth is the main question mark in the benign outlook mentioned before. Slowing economy might pose two main threats on the banking sector.

1- As we know the banking sector has enjoyed a steady decline in NPL's since the end of 2010. The NPL ratio has decelerated to 4.6% as of July 2010 from the peak of 5.8% in November 2009. Our simulation shows that it may gradually decrease to 4.0% at the end of 2010.

Figure 12: NPL Simulation



2- Loan portfolios are growing strongly since the beginning of this year, such that annualized increase in general purpose (a sub segment of retail loans) and SME loans are exceeding %40. Banks responded strongly to the surging loan demand in the quickly recovering economy thanks to their ample liquidity and robust capital.

As highlighted on page 4, the economy is slowing recently, but not at a pace, according to the current economic data, both to reverse the trend of declining NPL ratio and to cut the loan demand strongly. In other words, as long as the growth rate stays between 3 to 5%, which is below Turkey's potential, banks do not suffer much in terms of profitability. The slowing economy is even good for the Turkish Banking Sector, holding a whopping 30% of total assets as government bonds which are vulnerable to the interest rate hikes. In other words, on the back of GDP growth below Turkey's potential, the Central Bank may delay rate hikes even to the second half of 2011, at the earliest.