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Trip notes: **Turkey**

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Notes from our recent trip to Ankara and Istanbul: March 1-2, 2010

Ratings	Outlook
S&P: BB	Positive
Moody's: Ba2	Stable
Fitch: BB+	Stable

In early March we traveled to Ankara and Istanbul where we met with officials from the Turkish Central Bank, the Finance Ministry, the IMF as well as market participants to discuss recent economic developments and prospects going forward.

Assessment:

Political jitters have again returned to the forefront with the "Ergenekon" case and, more recently, the "Sledgehammer" plan. Both cases involve coup plot accusations against several high profile military officials. A number of proposed AKP-backed reforms have further aggravated tensions between the government and the secularists. And a possible referendum on these constitutional amendments is seen as key for the formation of the political landscape in the near future, and more importantly, for the timing of the 2011 general elections.

In view of the latest political developments and Turkey's shrinking external financing requirements, the fall through of the IMF loan deal negotiations did not come as a major surprise. Indeed, it was questionable whether the AKP would opt for a programme encompassing painful fiscal austerity measures that could weigh on public support ahead of the 2011 general elections. Besides, the deal is not considered to be a necessity for Turkey any more.

In the short-term, with the support to market sentiment from a prospective IMF deal having been waved, Turkish assets are likely to prove more susceptible to external as well as internal shocks. On a more positive note, news that an IMF deal will not be sealed *does* help to somewhat reduce market uncertainty about domestic policy deliberations and, as such, it may exert a incremental positive effect on consumer and business morale in the period ahead.

According to our estimates, the Turkish economy contracted by around 6.0% in 2009, while for the current year we forecast GDP growth of around 5.0%. Main drivers of the recovery are expected to be base effects and the rebuilding of business inventories. A rebound in exports and tourism are also likely to favor.

A severe deterioration was witnessed in government finances last year amid a deep economic downturn. The government budget ran a deficit of TRY 52.2bn or 5.5%-of-GDP. While outperforming expectations -- the government's forecast was for a deficit of 6.6%-of-GDP in 2009--, the shortfall marked a sharp widening from a deficit of 1.8%-of-GDP in the prior year. However, the government is already showing increased commitment to fiscal prudence, with several economic stimulus measures having been waved in late 2009 and tax hikes having been imposed on several consumer items. In September, the AKP announced a realistic and feasible medium-term fiscal plan, which was well received by the IMF and financial markets. In addition, a "fiscal rule" is currently on the table, crucial for providing an anchor for future budgets. In all, we expect this year's budget to run a deficit of 4.5%-of-GDP on the back of the economic rebound and rising taxation.

With regard to domestic price developments, Eurobank EFG Research now forecasts Turkish CPI at 8.7%yoy at the end of 2010. If realized, this would significantly exceed the CBRT's 6.5% inflation target for this year. However, against a background of weak demand-pull pressures, still weak domestic demand dynamics and 1025bps of CBRT rate easing delivered since late 2008, we expect the Central Bank to hold its horses over the next few months. That said, we anticipate the CBRT to initiate a new monetary tightening cycle in Q4, raising its key o/n borrowing rate by 150bps by the end of the year in order to preempt medium-term inflation risks as the economic rebound gains traction.

Turkey: Realisation and Eurobank EFG Forecasts

	2008	2009E	2010F
Real GDP (yoy%)	0.9	-6.0	5.0
CPI (annual average)	10.4	6.3	9.4
CPI (end of period)	10.1	6.5	8.7
General Government Balance	-1.8	-5.5	-4.5
Gross Public Debt	39.5	47.0	49.0
Current Account (% GDP)	-5.7	-2.3	-3.3
Net FDI (USD)	15.8	6.1	8.5
Financial Markets	**3M**	**6M**	**12M**
Policy Rate (e.o.p.)	6.50	6.50	8.00
USD/TRY (where applicable)	1.54	1.55	1.50
Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting			

Politics taking centre stage once again…

Political jitters -- which largely remained just a noise in the background after the AKP-closure case was dropped in July 2008 -- recently returned to the forefront. The “Ergenekon” case, which escalated last summer, was an awkward reminder of Turkey’s frail political landscape. And, the recent tensions over the “Sledgehammer” plan, which also involved coup plot accusations against a number of military officials, once more revealed the ongoing power play between the secular elite and the Islamist-rooted AKP government. The military, which along with the judiciary and part of the academia are seen as bastions of the country’s secular elite, has denied both counts. The AKP supports that these incidents highlight the need a move towards a more democratic state.

…with jitters likely to escalate in the months ahead

Over the last 50 years the army staged three separate coups, in the early 60s, 70s and 80s. More recently, in 1997, it assisted in overthrowing the then incumbent government. It appears that the military is presently facing its biggest challenge to date. However, we would assign a rather limited probability for another coup nowadays. The surroundings, domestic as well as international, are unlikely to create a fertile environment for a direct challenge to the government. Furthermore, General Chief of Staff Ilker Basbug acknowledged recently that coups belong to the past. And the recent meeting between the President, the Prime Minister and the General Chief of Staff does indicate improved communication between the two camps. That said the recent turmoil does raise concerns about the prospect of early general elections and, by implication, the government’s commitment to fiscal consolidation and structural reforms. It also adds to worries over a deeper social polarization. A period of prolonged political uncertainty may also bear a brunt on the domestic economy and weigh down on consumption and investments.

A public referendum for proposed constitutional reforms could instigate rapid political developments.

The government plans to pursue a number of reforms that could further aggravate tensions with the secularists. Among others, these include amendments to make the closure of political parties more difficult and change the structure and the way the Supreme Board of Judges and Prosecutors (HSYK) is elected. The latter would effectively curb the powers of the judiciary. Cabinet officials have signaled that if the two-thirds majority in the 550-seat parliament necessary to amend the constitution is not obtained, a referendum will be called. At present, opposition parties have indicated they will strive to block the changes and the AKP appears unlikely to lure the required quota in order to pass the amendments into law. However, the ruling party will probably be able to collect half of parliament’s vote required to push through a referendum. According to the latest opinion poll, two-thirds of Turks would vote in favor of the referendum, while 79% believe that the judiciary needs to be reformed. That said, even if a referendum is passed it may still be challenged in the Constitutional Court, which in the past has annulled AKP-backed constitutional changes. Even if vetoed however, it will still renew the AKP’s reformist image, which is likely to positively impact popular support towards the party. The government unveiled the details of its plan earlier this month and it appears likely that a referendum will be held in June. If passed, the amendments may come into effect after the general election. According to our contacts, strong public support for the proposed constitutional changes in the referendum would serve as an indirect vote of confidence for the current government. As such, the referendum’s outcome is likely to bear significant importance on the upcoming political developments in Turkey.

Developments likely to pave the way for a snap election

Recent political frictions have fanned speculation that the July 2011 general election will be brought forward. Chief Prosecutor Abdurrahman Yalcinkaya, who was behind the 2008 case to ban the ruling party, is presently collecting evidence that may lead to another closure bid. Such an event may pave the way to early polls in an AKP-bid to increase its popularity as the public traditionally shows compassion towards the weak. However, we assign a rather low probability to that outcome, as the previous closure attempt fell through, not too long ago. Consequently, we see the referendum as key to the timing of the next general elections. Its pro-reform character is likely to boost the AKP’s status. Note that popular amendments such as on political immunity, arbitration laws and labor unions’ right to strike are also expected to be included in the proposed reforms. Should the referendum’s outcome be in line with the AKP’s expectations for 50-60% support, the prospect of snap polls is likely to be decreased. The reason being, that such a result would be perceived as a forerunner of a significant increase in the party’s popularity, which currently stands below 40%. However, according to our contacts, a rejection of reforms in the upcoming referendum would likely open the door for a snap election, possibly in autumn 2010. We assign a rather limited likelihood for the latter outcome, as the AKP is rather unlikely to pursue a referendum if uncertain of its endorsement by the public. As such, if a referendum is held, we expect the vote to be a positive one for the ruling party.

Next general election crucial for political stability ahead

The latest opinion surveys show that support for the ruling AKP has slid to below 40% from 47% achieved in the previous general election in July 2007. If opinion polls are reasonably accurate, it is questionable whether the AKP would be able to form a single party government if elections were held today. Such an outcome would likely lead to lengthy coalition negotiations and, eventually, to an unstable multi-party cabinet that would weigh on fiscal and structural reforms and the country's EU convergence outlook. The MHP opposition party has recently indicated that they would not deny an alliance with Erdogan's bloc. A coalition with the ultra-nationalist CHP would also be another potential scenario. In any case, the political landscape is likely to become more transparent in three months time as we will know by then whether a referendum will be held, and if so, its outcome. Meanwhile, as developments gain pace, political noise is likely to become louder.

IMF loan negotiations fall through…

Following nearly two years of negotiations with the IMF on a new Stand-By Arrangement, it was announced in early March that discussions are no longer taking place. Turkey's Prime Minister Tayyip Erdogan later added that a new IMF package was "out of the question". Economy Minister Ali Babacan also confirmed that discussions were terminated, but left the door open for a resumption of negotiations after Article IV consultation review in May, when an IMF mission is expected to visit the country. In reality, Turkey is among the few countries in the region having managed to steer through the crisis without external financial aid. In recent months it was becoming increasingly clear that an IMF loan deal was not as important for Turkey as it used to be. The reason being that previously alarming external imbalances significantly improved lately. Thus, since late last year, it was acknowledged that, if agreed, the programme would be of a recovery-enhancing character. It would be primarily used to underpin the domestic economy by reducing the government's roll-over needs and thus, alleviating the crowding out of the corporate sector. It would also provide a valuable policy-anchor market participants would like to see in place. Yet, it was lately becoming increasingly evident that the AKP would be reluctant to agree on a programme that could encompass painful fiscal austerity measures ahead of the 2011 elections.

… with limited impact on domestic financial markets

News that negotiations with the IMF fell through had a limited impact on domestic financial markets, as the outcome had already been largely priced in. Yet, with support stemming from a potential IMF deal having been waved, Turkish assets may prove more susceptible to external as well as internal jitters in the period ahead as a result of e.g. sudden swings in global sentiment, domestic political uncertainty and upcoming fiscal and monetary developments. That said, even if it becomes apparent in the near future that financial aid is urgently needed, Turkey will still be eligible to ask for it. Also, in a rather reassuring note, news that an IMF deal will not be sealed does eliminate some uncertainty regarding the process and thus, it may act favorably on domestic investment and economic activity in the period ahead.

Economic recovery underway

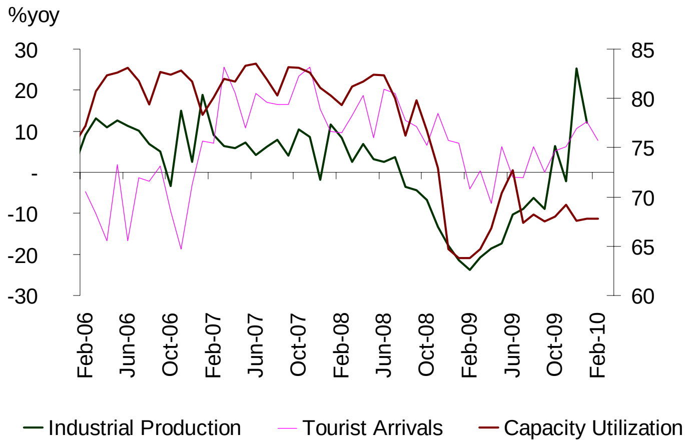
Since the second quarter of 2009 the pace of domestic economic contraction marked a notable slowdown. The recession appears to have reached its bottom in Q1 when GDP declined by 14.7%yoy, while economic growth (on an annual basis) is estimated to have been broadly flat, if not marginally positive, in Q4 2009. A further improvement is anticipated in the quarters ahead, primarily driven by base effects and the adjustment in inventories. A rebound in exports as well as tourism and a stabilization of credit conditions are also likely to provide support. Most of our contacts predicted GDP growth to reach 4%-5% this year, a view we broadly concur with. Downside risks to that forecast stem from slower that anticipated recovery in main trading-partner economies, further significant increases in commodity and food prices and domestic political uncertainty.

High-frequency activity and sentiment indicators continue to improve

Industrial production, which was badly hit against a background of a deep economic downturn, appears to have embarked on a sustainable rebound recently (Graph 1). Industrial output growth came in at 12.11%yoy in January, having swung into a positive territory in October for the first time in more than a year. Meanwhile, domestic credit growth is showing signs of a pick up lately, while recent employment increases in the construction and industrial sectors suggest that investment is on, or close to, a rebound. Capacity utilization, a leading indicator of manufacturing activity and GDP growth, stood at 67.8% in February, having rebounded from a record low of 63.8% reached in early 2009. In January, consumer confidence bounced above the 100pts threshold (which separated pessimism from optimism) for the first time since July, remaining above that level in February as well. Albeit with its rate of expansion slowing down, PMI manufacturing came in at 50.9 in February, signaling expansion in the sector for the tenth month running. Meanwhile, according to the Turkish Exporters Assembly (TIM), exports rose for the first time in a year in October (+4.6%yoy), mirroring improved external demand. Exports soared by 20.3%yoy in February 2010. Elsewhere, vehicle production jumped by 89%yoy cumulatively in January-February 2010, following a 24.2%yoy decline in the whole of 2009. And, the number of foreign visitors to Turkey rose for the seventh month running in January.

GRAPH 1

The trough of the recession appears to have been reached in early 2009



Inflation bounced to double-digit levels in February

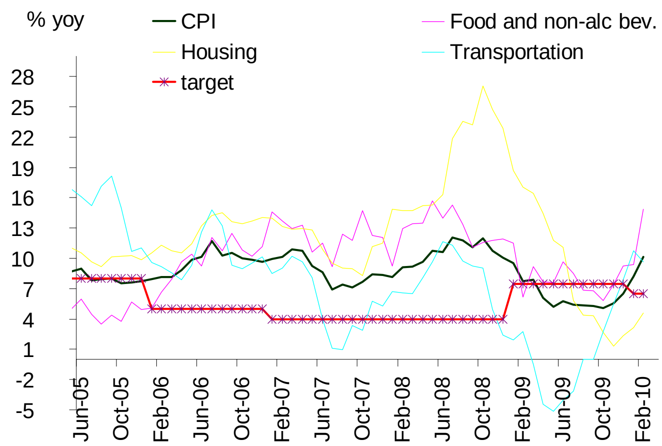
Having hit a 40-year trough at 5.08%yoy in October, headline CPI has accelerated significantly in recent months (Graph 2). The main culprits of the increase were unfavorable base effects, higher food prices - against a background of adverse weather conditions - and regulated price hikes. In February, the consumer price index exceeded expectations of 0.68%mom, coming in at 1.45%mom. On a year-on-year basis, headline CPI bounced to 10.13% in February (highest level since November 2008), deviating further from the CBRT's 6.5% year-end target. The rise was broad-based, with price increases being recorded in eight of the twelve sub-sectors. However, suggesting weak demand-side pressures, core CPI measures remain near recent lows, with the closely monitored sub-index I (excluding food, energy, alcoholic and non-alcoholic beverages and tobacco products and gold) coming in at -0.48%/+4.05% mom/yoy.

CBRT turns more hawkish, but reiterates interest rates to stay at record lows for a long time

At its latest MPC meeting in early March, the CBRT kept its key policy rate unchanged at 6.50% for the four month running, in line with the market's consensus.

GRAPH 2

Inflation picking up on higher food prices and base effects



However, the Bank adopted a more hawkish tone in its policy statement, explicitly referring to the possibility of future rate hikes, for the first time in many months. In an obvious move aiming to reinstate its inflation-fighting commitment, the CBRT signaled it was ready to hike interest rates on evidence of worsened pricing behavior or rising inflation expectations. The Bank expects inflation to temporarily ease in March, but remain above its target for a while. It anticipates disinflation to resume in Q4, with CPI likely to ease in line with its targets early next year. In spite of turning notably more hawkish compared to recent months, the CBRT reiterated that interest rates need to stay at their current historically low levels for ''a long period of time''. Note that in its January quarterly inflation report, the Central Bank revised its 2010 CPI forecast higher due to base effects, tax hikes and firmer food prices. The CBRT assigned a 70% probability for end-2010 inflation to come in between 5.5-8.3%. If realized, the mid-point of that range (6.9%) is higher than the CBRT's 6.5% inflation target for this year. The Central Bank's forecast is also well below our own 8.7%yoy CPI projection for the end of the current year. As such, we expect the CBRT to resort to monetary tightening before the end of the year in order to contain rising price pressures and keep inflation close to its target.

CBRT likely to start hiking rates in Q4

Against a background of weak demand-pull pressures, still weak domestic demand dynamics and 1025bps of policy rate easing having been delivered since late 2008, we expect the CBRT to hold its horses over the next few months. That said we see the Bank hiking its key policy rate by 150bps in Q4, in order to contain medium-term inflation risks as the economic rebound gains traction.

Risks to our forecast lie in the face of upside surprises in the domestic economic recovery, prolonged political instability and renewed signs of fiscal slippage.

A severe deterioration in government finances in 2009 due to the economic downturn

Although Turkey registered a strong fiscal performance in prior years, a significant deterioration occurred in 2009. As proved to be the case in other economies in the region, the crisis took a severe toll on the government's coffers in 2009. The public budget ran a deficit of TRY 52.2bn or 5.5%-of-GDP. In spite of outperforming earlier official expectations for a 6.6%-of-GDP gap, the realized shortfall marked a sharp widening from a deficit of 1.8%-of-GDP in 2008. Budgetary revenues were hit by lower-than-projected tax income and the temporary stimulus measures employed by the government to support domestic economic activity. On the other hand, expenditures were contained broadly in line with initial targets in spite of a deep GDP downturn.

Government reinstates commitment to fiscal consolidation

In spite of last year's deterioration in public finances, the government has lately shown renewed signs of commitment to fiscal consolidation. Since late last year the budget appears to be on the mend, assisted by improving tax receipts. The measures employed in 2009 to support the domestic economy expired and the government recently introduced tax hikes on several items to boost its coffers. In September, the AKP announced a realistic and feasible medium-term fiscal plan, which was well-received by both the IMF and financial markets. In addition, a "fiscal rule" is currently on the table, aiming to provide an anchor for future budgets, especially in view of the absence of a new IMF deal. In effect, it will allow increased spending in times of economic downturn, from savings generated in years of buoyant growth. It will also increase the credibility and transparency of fiscal policy. According to our contacts, a fiscal rule is expected to be ready by this summer and to come into effect some time next year. In the meantime, we expect this year's budget to run a deficit of 4.5%-of-GDP on the back of the economic rebound and rising taxation. Risks for a higher fiscal deficit this year lie in the face of the 2011 general elections. Risks for a potential outperformance include among others, high than expected GDP growth this year. Note that the 2010 budget is framed of a macroeconomic scenario assuming 3.5%yoy GDP growth this year; an assumption that may well prove pessimistic.

Public debt ratio seen stabilizing at around 49% of GDP in 2010, before resuming downward trend in the coming years

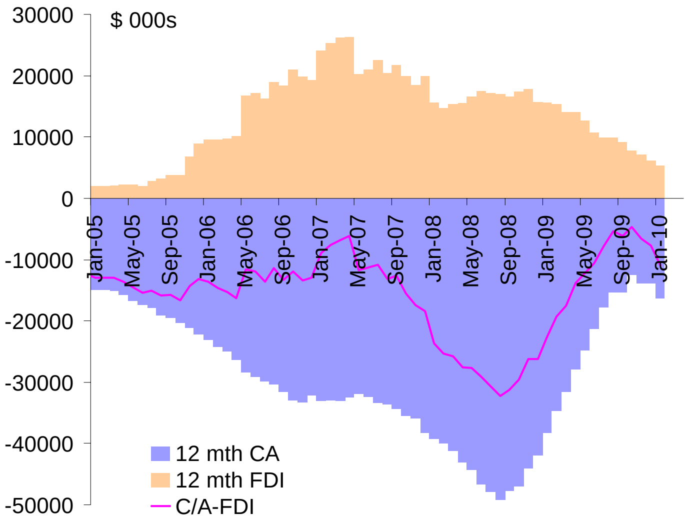
The recent deterioration in Turkey's fiscal balance is also being reflected in public debt. After falling to 39.4%-of-GDP in 2007 from near 100% levels in 2001 the (EU-defined) general government debt-to-GDP ratio is estimated to have ended last year at around 47.3%-of-GDP. The government expects the ratio to peak at 49% in 2010, before resuming a gradual downtrend in the following 2 years[1]. With respect the roll-over ratio for this year, the Treasury said in mid-March that it expects it to fall to 90-95% this year, compared to an earlier forecast of 99.5%.

Current account deficit marked a significant improvement in 2009

A large and widening current account deficit was one of Turkey's main economic vulnerabilities in recent years. A high import content of domestically-produced manufacturing products for exports and the country's high dependence on energy imports were the main culprits of the current account deterioration in recent years. However, the current account gap fell by 67%yoy last year (to 2.3%-of-GDP from ca 5.7%-of-GDP in 2008), mainly on the back of a sharp drop in imports and lower oil prices (Graph 3). However, since November 2009, the pace of improvement in the current account balance has slowed down. Indeed, the deficit increased by 95%yoy cumulatively in November 2009-January 2010.

GRAPH 3

The current account deficit improved in 2009 on the back of a deep recession and lower oil prices



[1] According to the government's Medium-Term Programme (2010-2012) public debt is expected to ease to 48.8%-of GDP in 2011 and 47.8%-of-GDP in 2012

A further deterioration is expected in the months ahead as the economic rebound gains traction. Higher oil prices from a year earlier are also likely to weigh on the shortfall. We expect the full-year deficit to reach 3%-of-GDP or slightly higher levels. Meanwhile, foreign direct investment (down by 60%yoy to USD 6bn in 2009), financed 44% of the smaller, more easily financed, current account shortfall last year. The respective coverage ratio was 37.5% a year earlier. In 2010, FDI inflowing are expected to increase slightly, on improved investor sentiment and the global economic upturn.

Market Strategy

FX: After hitting 7-month lows of 1.5641 against the USD on February 25 amid rising domestic political jitters, the TRY has staged a tentative recovery, recouping a small part of its losses. The fall-through of the IMF deal bore a limited impact (and it could actually be considered as a resolution to lingering uncertainty over whether a loan deal would finally be sealed). With the CBRT's monetary easing cycle having reached a trough and risks for an inception in the Bank's tightening cycle earlier than currently anticipated, especially if upcoming inflation data surprise to the upside, there appears to be room for some further lira appreciation in the coming months. Increased FDI inflows are also likely to provide support. On the flipside, pockets of global market instability, increased domestic political jitters, fiscal slippage ahead of the 2011 elections and perceptions that the CBRT is not doing enough to ensure medium-term price stability are among the main downside risks for the lira outlook in the period ahead.

Local rates: Inflation has embarked on an uptrend recently and although the Central Bank staunchly defends its view that the spike is temporary, potential for a rise in commodity prices in the imminent future, second round effects and the potential a speedier than anticipated economic recovery raise risks for sooner-than-expected rate hikes. This environment is rather unfavorable for the local rates market, especially since government bond yields touched record lows in recent months. That said, it is worth mentioning that foreign investors currently appear to be very light positioning in the local rates market. In addition, most of the government's credit appears to be parked among the few large domestic banks. The latter continue to view investments in TRY T-bills and notes as a major source of income, especially since domestic credit growth remains scarce. As such, we see limited room for a spike in local yields, at least in the short-term. Presently, the benchmark November 16, 2011 bond yields around 9%, some 100bps higher than lows hit late last year. Along these lines, we continue to see value in lira CPI-linked bonds.

External debt: After peaking at levels near 800bps in October 2008, Turkey's 5-year CDS spread has narrowed more than 600bps since then. The fall through of the IMF deal had limited impact on the country's external debt, as was largely priced in by markets. Meanwhile, all three major credit rating agencies upgraded Turkey's sovereign ratings over the last few months, on reflection of the government's fiscal consolidation efforts and its ability to steer through the global financial crisis. The new fiscal rule and the formation of the political landscape will be key for the market near-term. Eurozone credit periphery jitters may also play a role. Along these lines and with 5-year CDS near 156bps 4-year lows touched on March 10, we see limited room for further spread narrowing in the coming months.

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