Athens, March 5, 2009

Trip Notes: Turkey

Notes from our recent trip to Ankara and Istanbul: February 5-6

Ratings	Outlook
S&P: BB-	Negative
Moody's: Ba3	Stable
Fitch: BB-	Stable

In early February 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:

According to our estimates, the Turkish economy grew by 1.5% in 2008, while for the current year we forecast a 1.5% contraction in gross domestic product. Despite the negative short-term growth trajectory, longer-term prospects remain positive as structural reforms and fiscal prudence have greatly improved Turkey's growth dynamics in recent years. Also in a rather reassuring note, the Turkish economy is comparatively less leveraged than most CEE peers and therefore less susceptible to credit-related contagion risks. With regard to domestic price developments, Eurobank EFG Research now forecasts Turkish CPI at 6.5% YoY at the end of 2009, a rate lower than the 7.5% official inflation target. Responding to favorable supply-side developments and retreating demand pressures in recent months, the CBT delivered 525bps of cumulative rate easing since last November, bringing its key overnight borrowing rate to 11.50% currently. In view of recent CBT comments, the approaching municipal elections and the disappointing budget-execution data for January, we anticipate a slowdown in the pace of rate cuts relative to recent central bank moves and see the policy rate at 10.00% at the end of 2009.

Turkey's fiscal performance has been particularly strong in recent years. Yet the underlying fiscal stance deteriorated in 2008, with the primary surplus coming in well below the 3.7%-of-GDP initial target. The 2009 budget plan targets an overall fiscal deficit of 1.2%-of-GDP, with the corresponding primary surplus projected at 2.4%-of-GDP. These projections were framed on an overly optimistic domestic macro environment, envisioning real GDP growth of 4% and a 15% rise in budgetary revenue. Given widespread tax evasion, overdependence on indirect taxation and the inelastic nature of current spending, it is clear that corrective measures will soon be needed if a significant deterioration in fiscal accounts is to avoid in 2009.

Turkey's current account balance is improving rapidly as a result of lower oil & commodity prices and weakening domestic demand. Yet, in the present trajectory of reduced risk appetite and lingering distortions in the global credit markets, we project a net funding gap *(excluding FX reserves usage)* of ca $25-30bn in 2009. This represents the net funding need required to finance this year's current account deficit and external debt redemptions, if a sharp drawdown in foreign exchange reserves is to be avoided. If a new IMF deal is finally reached, the new funds will be channeled to the Turkish Treasury with the intention to replace private-sector external debt with IMF debt via optimally using the domestic banking system.

Turkey: Macro-Indicators

	2007	2008	2009f
GDP growth	4.6	1.5	-1.5
CPI eop (yoy%)	8.4	10.1	6.5
Budget Balance (% of GDP)	-1.2	-1.5	-2.5
C/A Deficit (% of GDP)	5.7	5.8	3.5
Public Debt (% of GDP)	38.9	35.1	36.0
	latest	**6m**	**12 m**
Policy rate eop	11.50	10.50	10.00

Economic growth decelerating with an outright recession expected in 2009

Domestic economic prospects continue to deteriorate as indicated by a recent stream of dismal readings in a number of key domestic activity and sentiment indicators. According to the latest national account statistics, real GDP growth decelerated to 0.5% YoY in 3Q 08 from 2.3% YoY in the prior quarter, driven by a sharp weakening in private consumption and investments. This was 26th consecutive quarter of positive economic growth in Turkey – the longest period of uninterrupted growth on record – but most recent data point to a contraction of GDP growth in the final quarter of 2008. Industrial production plunged by a record 17.6% YoY in December, bringing the 2008 average growth of output to -0.9% YoY, while capacity utilization in manufacturing fell to an 18-year low of 63.8% in January. Meanwhile, the fall in the domestic automotive production that started in August 2008 continued into January, with overall output contracting by 65.8% YoY and exports declining by 64% YoY that month. Automotive production represents one of the main pillars of domestic manufacturing activity and according to the Turkish Automotive Industry Association it is expected to shrink by 25% in 2009 due to lower domestic and external demand. Besides the sharp output contractions experienced in higher value-added sectors of domestic economic activity, other more traditional ones such as textiles have also started to feel the pinch of the global economic slowdown. The textiles industry association now expects sales to fall by 25-30% in 2009 along with a continuation of lay-offs in the sector. These negative tends have been reflected in a rapid worsening of business morale in recent months. Turkey's manufacturing confidence index remained below the 100-point optimist-pessimism threshold throughout 2H 08, recording a multi-year low of 59.4 in January. Consumer confidence has also being hit hard by tightening domestic credit conditions and worsening employment prospects. Turkish unemployment climbed to its highest level in five years in the last quarter of 2008 *(12.3% vs. 10.1% in 4Q 07)* while the year-on-year growth of TRY loans to domestic households is now almost half vs. a year earlier, standing at 21.8% YoY in January. According to our estimates, full-year GDP growth was 1.5% in 2008. This was exclusively driven by public and primate consumption, while the external sector exerted a negative contribution to the tune of ca 0.2ppts. For the current year, our forecast is for a 1.5% contraction in real GDP growth, in line with the latest IMF projection. Note that the 2009 budget assumes economic growth of 4%, but government officials now admit publically that this is unrealistic and foresee flat or even negative growth this year. Our contacts at the Finance Ministry and the CBT forecasted GDP growth between -0.5% and -1.0% and admitted that the contraction in national output would be more pronounced without a new IMF loan.

Strengthening disinflation suggests room for more CBT policy-easing

Following a 4-year peak of 12.06% YoY in July 08, headline CPI decelerated sharply, assisted by weakening demand-side pressures and lower food and energy prices. Consumer prices fell by 0.34% mom in February 09, undershooting consensus expectations of a 0.28% mom increase. This brought the corresponding year-on-year rate to 7.73%, just 0.23ppts above the 7.5% year-end CBT target. The drop in headline inflation was broad-based, with price declines recorded in six of the twelve sub-sectors. Core CPI, which excludes the volatile food & energy prices also dropped in February *(-0.46% mom),* with the year-on-year rate falling to 7.98%. The broad-based declines recorded in the prices of consumer durables, which are sensitive to exchange-rate developments and the accelerated disinflation evidenced in service sector prices are indicative of weakening domestic demand dynamics and suggest more disinflation in the period ahead. *Eurobank EFG Research now expected consumer inflation of 6.5% YoY at the end of 2009.* Responding to favorable supply-side developments and retreating demand pressures in recent months, the CBT delivered 525bps of cumulative rate cuts since last November, bringing its key overnight borrowing rate to 11.50% currently. The rate easing implemented thus far has been three times as large as that expected by markets and indicates the central bank's resolve to address the domestic economic contraction. It also suggests a relatively low exchange rate pass-though to inflation as a result of weak domestic demand as well

as the strengthening of CBT credibility reflected in the most recent expectations surveys. *Eurobank EFG Research expects the key overnight borrowing rate at 10.00% at the end of 2009.* Yet, in view of recent CBT comments, the approaching municipal elections and the disappointing budget-execution data for January 09 we anticipate a slowdown in the pace of rate cuts relative to recent central bank moves. Our expected CBT policy trajectory ahead is for a 75bps rate cut in March, accompanied by another 75bps move in one of the following two policy meetings. Thereafter, the CBT is seen pausing on rates to assess the impact of its recent policy easing.

Stellar fiscal performance in recent years, but 2009 budget targets seam unattainable without corrective measures

Turkey's fiscal performance has been particularly strong in recent years. The budget deficit has been reduced to 1.7%-of-GDP in 2008, from 11.9%-of-GDP in 2001, while the primary surplus of the consolidated budget averaged 4.5%-of-GDP in the last eight years. This facilitated a fast reduction in the public debt-to-GDP ratio to 35.1% at the end of last year, from 41.3% in 2007 and around 80% in 2001. Yet the underlying fiscal stance deteriorated in 2008, with the primary surplus coming in well below the 3.7%-of-GDP initial target. According to the IMF definition, the primary surplus amounted 1.8%-of-GDP in 2008 with some 0.5-0.7ppts of that attributed to one-off items. The 2009 budget plan, which was granted parliamentary approval late last year, targets an overall fiscal deficit of 1.2%-of-GDP, with the corresponding primary surplus projected at 2.4%-of-GDP. These projections were framed on an overly optimistic domestic macro environment, envisioning real GDP growth of 4% and a 15% rise in budgetary revenue. Given Turkey's widespread tax evasion, overdependence on indirect taxation and the inelastic nature of current spending it is clear that corrective measures will soon be needed if a significant deterioration in fiscal accounts is to avoid in 2009. The necessity of additional measures to boost tax revenues and cut budgetary spending has already been underlined by the government, with a supplementary budget expected to be announced shortly after the March 29 local elections. Even accounting for corrective fiscal measures, however, the Finance Ministry expects a 3-4ppts-of-GDP rise in the public debt ratio this year, while the CBT sees "absolutely no room" for additional fiscal relaxation. These developments deserve particular attention in the present trajectory of reduced access to capital markets as the IMF estimates that Turkey needs to run a primary surplus of 2.5%-3.5%-of-GDP until 2013 in order to stabilize its public debt ratio. Furthermore, a lasting deterioration of the country's fiscal position could *ceteris paribus* result to higher interest rates and the crowding out of the private sector. In this respect, the most recent data on the 2009 budget execution are not particularly encouraging. The primary surplus of the central government budget fell 78% YoY in January, while the cash budget deficit amounted to around TRY3.0bn, nearly six times the corresponding deficit recorded in same month a year earlier.

Current account balance improving...

Turkey's current account balance is improving rapidly as a result of lower oil & commodity prices and weakening domestic demand. The trade gap narrowed to US$1.38bn in January, around half of a consensus market forecast of a US$2.70bn deficit, as the fall in imports *(-43.3% YoY)* outpaced the decline in exports *(-25.7% YoY).* The share of exports to the EU-27 *(as % of total exports)* posted a further decline to 43.1% in January compared to average annual rates of 48% and 56.3% in 2008 and 2007, respectively. On the other hand, the share of Turkish exports to the Americas remained relatively steady in recent months *(4.8% of total exports in January)*, while the share of exports to Near & Middle east counties rose to 22.6% in January from 18.9% in the same month a year earlier. According to certain estimates, every US$1decline in the oil price saves Turkey around US$ 400mn in imports and this along with the weaker lira may translate to a considerable improvement in the overall current account balance this year. On a less positive note, considerable uncertainty currently surrounds the 2009 outlook for tourism revenues. Last year, foreign visitors in Turkey rose 12.8% YoY to 26.4mn, with full-year revenues amounted to US$ 21.9bn (*(~3%-of-GDP).* Tourist arrivals grew 7.11% YoY in December but the latest official data showed a 3.96% YoY decline in the first month of 2009. All in all, we expect an improvement in the current account

deficit ratio this year to 3.5%-of-GDP or lower from around 5.7%-of-GDP in 2008.

...but external financing gap remains a concern

Foreign direct investment in Turkey amounted US$17.7bn in 2008, down 19.6% from a year earlier, with the net FDI coverage of the current account deficit falling to 36.5% from 52.2% in 2007. Separately, foreign portfolio investments in Turkey plunged by $56.9bn to $49.9bn in January-November 2008, as local financial markets were hit hard by the global financial crisis and the domestic economic slowdown. In the present trajectory of reduced risk appetite and lingering distortions in the global credit markets, we project a net funding gap for Turkey *(excluding FX reserves usage)* of ca $25-30bn this year. This represents the net funding need required to finance this year's current account deficit and external debt redemptions, if a sharp drawdown in foreign exchange reserves *(~ US$ 70bn currently)* is to be avoided.

New IMF loan needed to a serve external funding needs

Domestic financial markets have long awaited a new stand-by IMF loan programme to replace a US$ 10bn accord, which expired in May 2008. Negotiations with the Fund started in October 2008 but were discontinued in January due to disagreements over the terms of the loan. According to local press reports, Turkey has rejected three demands by the IMF, including giving autonomous status to the country´s revenues administration, obliging taxpayers to declare the source of their incomes and reducing transfer of funds to municipalities. Turkish Prime Minister was recently quoted as saying that the government would sign a deal with the IMF either before or after the coming municipal elections, provided that this serves the country's interests. During our talks with high-levels IMF official in Ankara, it was transpired to us that a preliminary agreement with the government has been reached over the county's 2009 fiscal targets. Yet, some pending disagreements remain over certain longer-term fiscal conditionalities the IMF wants to impose in order to institutionalize Turkey's past fiscal performance. The Fund recognizes that a new loan package for Turkey would be of a less preventive nature relative to those given to Ukraine or Hungary and thus, its focus should be on strengthening the country´s medium-term fiscal framework. It appears that the Fund is in favor of the implementation of a fiscal rule, which will be over-sighted by an independent body without ministerial or political influence. The existence of hidden deficits of 0.4%-0.5%-of-GDP per annum in the local-authorities level was highlighted as one the problems that need to be resolved as municipalities can be currently given permission by the Interior Ministry to borrow beyond their legal limits. Allowing local authorities to raise their own taxes could be a solution to that problem. Elsewhere, the IMF would not be in favor of further cuts in investment spending, while it considers certain measures taken by the Turkish government as both unreasonable and distortionary. Such measures include special transfers to the agricultural sector and recent VAT cuts to the hotels and restaurants industry as well the textiles sector. During our talks with the Fund, particular emphasis was also given to the need to increase the tax base and reduce widespread tax evasion in Turkey, as current estimates of informality run between 30% and 50% of GDP. With regard to a new stand-by agreement for Turkey, the IMF estimates the country's net external financing gap for this year at $25-$30bn. If a new deal is finally reached, the new funds will likely be channeled to the Turkish Treasury with the intention to replace private-sector external debt with IMF debt via optimally using the domestic banking system.

Domestic political jitters have subsided recently

Domestic political risks have subsided considerably since last July, after the legal case for a closure of the ruling AKP party was dropped by the Constitutional Court. With regard to Turkey's relationships with the European Union, PM Erdogan has recently appointed a chief EU negotiator, in a move that has been interpreted by market participants and foreign diplomats as a new effort by the Turkish government to jump-start stalled EU-related reforms. Note that Turkey has been in an Association Agreement with the EU since 1960 and currently receives 500mn per year in pre-accession aid. Yet, a recent slowdown in EU-related reforms remains a source of concern. Since the

start of its EU-entry talks with European Union authorities, Turkey has managed to open only 10 out of a total of 35 required negotiations chapters. No chapter has been closed yet, while as much as 3 chapters cannot be opened for as long as Cypriot ships & aircrafts are not allowed to land in Turkey. EU authorities want to see further progress towards a fulfillment of the required political and economic criteria for EU entry, which among others include respect for democracy and human rights, a genuine fight against corruption, civilian oversight of security forces, respect of the rule of law and intellectual property rights.

Medium-term growth prospects remain positive...

Despite the negative short-term growth trajectory, longer-term prospects remain positive as structural reforms and fiscal prudence have greatly improved Turkey's growth dynamics in recent years. Indeed, over the past 6 years the Turkish economy appears to have departed from the previous boom-boost cycles, supported by strong productivity gains and a reorientation of the domestic production base and exports from traditional sectors such as textiles and agriculture towards higher value-added industries such as automotives and consumer durables.

..while relatively low level of private-sector leverage suggests reduced susceptibility to global contagion relative to CEE peers

The Turkish economy is less leveraged compared to CEE peers and therefore less susceptible to credit-related contagion risks. With regard to the public sector, as we have noted already the debt-to-GDP ratio has been reduced considerably following the 2001 domestic banking crisis and currently stands below 40%-of-GDP. In the private sector, domestic households are current long FX and the banking sector remains well capitalized, while a source of concern is the current net open FX position of the non-banking corporate sector. According to the CBT statistics, the latter is estimated at ca US$ 85bn. Some key private-sector leverage and banking-sector liquidity/capitalization ratios in Turkey are as follows: total loans-to-deposits ratio: 0.87; banking industry-wide capital-to-assets ratio: 12.2; private sector credit-to-GDP: 37%; households´ local currency credit to FX credit ratio: 3.02. Again, in most of these ratios, Turkey compares favorably with the majority of CEE countries and this can be interpreted as relatively low susceptibility to credit-related contagion risks.

Strategy Implications

FX: After hitting 2½-year lows of 1.7479 against the USD in November 20, the TRY has staged a tentative recovery in the first two months of 2009, recouping part of its losses. More recently, a further 150bps cut in the key policy rate and the much-softer-than-expected Feb. inflation reading weighed on the lira as strengthened expectations of more CBT rate cuts eroded further the currency's yield appeal. The dynamics remain for further TRY downside as the worsening global environment, slowing domestic economic activity, lower FDI inflows, a highly leveraged corporate sector and more rate cuts by the CBT rates will continue to affect negatively investor sentiment towards the lira. In the short-term, key remains the outcome of the negotiations with the IMF on a new loan deal. Anything not matching the market's expectations will probably weigh on the Turkish currency. **Local rates:** Local government bond yields staged a gallant recovery in recent weeks, outperforming most of EMEA peer-markets. Since late October, the 3- and 5-year benchmark T-bill yields have each narrowed more than 900bps, currently standing at 15.31% and 16.76%, respectively. The benign inflation outlook and the prospect of lower interest rates ahead are likely to continue supporting the local rates market. **External debt:** Turkey's external debt has remained impressively resilient since October. After spiking to highs of 824bps in October, Turkey's 5-year CDS spread narrowed sharply and currently remains close to 500bps, ca 85bps below Hungary's.

Written by:

Gikas Hardouvelis
Chief Economist & Director of Research
GHardouvelis@eurobank.gr

Platon Monokroussos
Head of Financial Markets Research
PMonokrousos@eurobank.gr

Research Team:
Gikas Hardouvelis, *Chief Economist and Director of Research*
Platon Monokroussos, *Head of Financial Markets Research*
Paraskevi Petropoulou, *Economist*
Roubiniana Drakopoulou, *Economist*
Galatia Phoka, *Economist*

Sales Team:
Fokion Karavias, *Treasurer*
Dimos Arhodidis, Danai Manoussaki,
Alexandros Tsourinakis, Nikos Laios, Kostas Karanastasis

EFG Eurobank Ergasias, 8 Othonos Str,GR 105 57, Athens,Tel: (30210) 3718 906, 3718 999, Fax: (30210) 3337 190, Reuters Page: EMBA,Internet Address: http://www.eurobank.gr

Disclaimer: This report has been issued by EFG Eurobank – Ergasias S.A and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank – Ergasias S.A., as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank – Ergasias S.A. and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank – Ergasias S.A., as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.