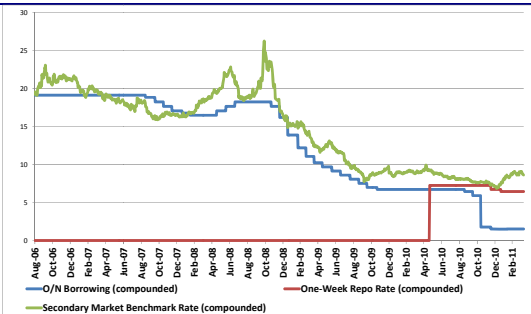


# Turkey Weekly Macro Comment

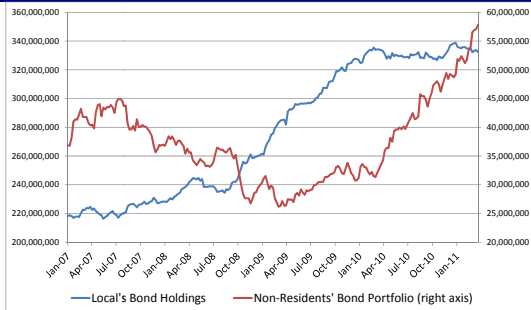
11 April 2011

## Bond Rates vs O/N



Source: Central Bank of Turkey, YK Economic Research

## Domestic & Foreign Bond Portfolios



Source: Central Bank of Turkey, YK Economic Research

## The Miscalculated Burden of Reform Disposition (or Systemic Voter Underestimation)

- The relative calm two months before elections unlike the heated and very confrontational environment we had observed prior to the 2010 September Referendum is presumably testimony to a “lack of issues” perception.
- The fact that some election gimmicks do not sell should be warning signals for politicians we believe; they should consider the fact that they may be underestimating their constituencies.
- The first expectations survey conducted by the CBRT for the month of April was released last week and there was some improvement in 12 and 24-month horizon inflation expectations.
- There is still a wide-spread inflation surge expectation by most analysts for year-end yet an overheating scenario underlies almost all of these analyses. We find it extremely difficult to detect any credibility in output gap estimates that rely on a drastically defective H-P filter methodology.
- The most striking feature on the financing side of the BoP is the huge net errors and omissions term that stood at USD 3.3 billion for the month of February and at a total of USD 5.5 billion for the first two months of the year.
- Consumer loans had another strong showing in the first week of April and YoY growth in the category surged to 42.2% from 41.5% a week ago (our frontloading hypothesis is still being tested).

Cevdet Akçay

Chief Economist, Yapı Kredi Bank & Yapı Kredi Yatırım

Tel: +90 212 319 8430 cevdet.akcay@yapikredi.com.tr

## 1.1 General Outlook

A very crucial day before June elections as all political parties will have to submit their final MP candidate lists to the High Election Council by 5:00 PM today. As we have not so far seen a meaningful program or a list of agenda items from any party with the exception of a new constitution promise from the AKP, it looks like individuals are assumed to reflect higher vote potential than issues themselves. The relative calm two months before elections unlike the heated and very confrontational environment we had observed prior to the 2010 September Referendum is presumably testimony to this “lack of issues” setting we refer to. This does not mean that such issues do not actually exist; quite to the contrary, they do exist and are of pivotal importance for the future of the regime here but there does seem to be an implicit agreement between parties on not rocking the boat with the intention of shaking off the opponent. That is presumably because no one truly knows how a reformist agenda will be selling in today’s Turkey. They all seem to be playing to the audiences on the “conservative” wing of the population without realizing that the very same conservative wing is becoming more reformist and pro-change on a daily basis. We are aware of the booby traps involved in talking about the concept of “reform” on this land; a professional army, the equal opportunity employer approach being adopted by the public sector, an overhaul of the existing education system ending up in a new one focusing on “cognitive skills”, rationalization of higher education and introduction of universally acceptable benchmarks to the academia on a wide-spread basis, etc. are some reform items that pop up instantaneously for us but we know that the very same bundle represents regression or divergence from unquestionable/unalterable givens of the system. It has been our contention that whoever perceives, acts upon, and markets this reform agenda to the society more fully and in a candid, credible tone will reap the benefits of their choice much sooner than they anticipate (assuming that they do anticipate a favorable outcome in the first place).

The AKP seems to be aware of this need for change but does not mind compromising every now and then as their working assumption is that the “perception gap” between them and the main opposition party CHP is too large to be closed any time soon. However, the CHP also seems to have woken up to the situation and is much more aware of the reform need than they had been in the past. Their problem seems to be in marketing this need to their constituency and rank and file at large which has associated “reform” with change and thus with perturbations inflicted on the status quo, and the agent of change with the AKP. Hence, for all the wrong reasons, the battle has turned into one between defenders of change and defenders of the status quo whereas it should have been about competence of agents demanding to sit at the steering wheel while the reform process is under way.

As we mentioned at the outset, we need to reach a consensus as to what the most major concepts in the political realm truly refer to. Reform means different things to different people here; so different that its definition becomes the demarcation line for categorizing us into

camps. As a second example, take a more fundamental concept, democracy. Truly living it for the first time with all its minuses and pluses, its proper uses and misuses/abuses, we are still trying to absorb and digest the concept. The two sine qua non prerequisites of that still most perfect regime for mankind (though it is variant over time and space), rule of law and constitution, have only recently become genuine discussion items here. And the discussion has not been extremely productive based on conclusions reached so far. Take the rule of law, for instance. The consensus perception is that the very existence of laws is enough to have “the rule of law” in a society. It is quite difficult to persuade even the most educated people here that some laws that you have may indeed reflect the “absence” of the rule of law in your country. Or as final example take the magic word of the recent times in Turkey, “compromise”. Our keen divisions of late and our more aged problems as well are now being smoothed by preaches of “compromise”, telling us all that democracy is all about compromise and failing to achieve that reflects lack of democratic institutionalization. That is not indeed the case, and the truth indeed lies in an almost exact opposite proposition: Democracy is about living together without having to compromise. And that is exactly when the very crucial concept of “the rule of law” assumes its preeminence. When we fail to agree/compromise, which is very probable and natural, it should not be a problem because we have all agreed on the “rule of law” that will settle our disputes. The very logic of that rule of law should be embedded in your constitution, and that is all a constitution truly has to be about. And a constitution has to be meaningful to the citizens of the country in the sense that the very idea of the rule of law inserted in that social contract serves as the underlying building block of the social fabric in that country. It is by no means a dry, sophisticated piece of document with many esoteric items implanted in it that will make it inaccessible to masses. It should be the exact opposite of that. We still seem to favor the construction of a constitution that will be exhaustive in the sense that it will entail all possible states of the world including all kinds of special cases and exceptions. That is a mere impossibility. Moreover, such a document will not generate a “common sentiment” that will serve as the building block that we referred to above. The demand for such a constitution at historical junctures like the one we are undergoing comes partially from the members of the society, but only partially we have to admit. The main burden usually falls on the shoulders of politicians who do not exclusively cater to public’s demands but also shape them in such a way that the fulfillment of those shaped/transformed/manufactured demands ultimately enhances their welfare. That is a valid description of the current setting in Turkey, we believe. The mere fact that the grassroots pressure for such a transformation is not vociferous enough seems to suggest that our supposition mentioned at the outset that individuals seem to be more crucial than issues is probably an accurate reflection of reality here.

There are some signs that the main opposition party is indeed better aware of these new circumstances as they left out three so called “politbureau” members that had carried high rank positions within the Party for decades. It came as a shocker to everyone, but the perception is that this is yet another indicator of the Party’s warm-up efforts towards reform

and change albeit less than wholehearted, but efforts nevertheless. The candidacy of two jailed Ergenekon suspects seems to have created some havoc within the Party as well but most people seem to discount the inclusion at a much higher rate than they do the exclusions, thus a net net positive impression left on floating votes one could say. On the AKP front, a quite controversial appointment to a sure bet placement in the elections will be quite indicative if it materializes. A journalist who lashed out at the AKP for years after the AKP took over in 2002 and accused them of treachery and treason for selling out the country to foreigners with a most derogatory tone is now a sure MP if the rumor is true. It is still a rumor but we have not heard any falsification of the rumor from either front. His unyielding defense of the AKP and PM Erdogan in particular despite not having changed his mind about the first 6 years of AKP's tenure (the most successful and reformist era of the AKP by most metrics one can think of) was a complete turnaround and according to some an opportunistic move necessitated by his new position within the media. Is this "inclusion" move anywhere as tactful as the "exclusion" move by the CHP? We do not think so. The flash news we received while penciling this Weekly is that the journalist we mentioned above has denied rumors of his candidacy though he has not declared whether he considered the position or was told about considerations to that end by AKP officials in the past. We still believe he may have been. The proclamation of "no candidacy" coming from him just one hour before the deadline suggests that there may have been a waiting period after all. Hence, not an inclusion as we purported above, but still a semi-inclusion case as the likelihood that he was considered seems higher than that he was not at any point in time.

As we had mentioned numerous times to some of our foreign clients and friends who have been of the contention that political risk in Turkey was minimized by the certainty of a single party following the election in June, that prospect merely by itself is not the risk determinant or risk repellant if you prefer. Our contention is that falling behind the constituency's expectation curve is the real risk factor here as such failure due to complacency/overconfidence/reform fatigue will eat the AKP up slowly but surely and ultimately lead to a truly reformist coalition force with defectors from all over the political sphere.

We do not purport that this will be an imminent or for that purpose a rapid process, but it will be inevitable if the AKP fails to transform itself to an entity that can at least accommodate demands and aspirations of its constituency. Remember the times when they were above and beyond those demands and aspirations with an agenda that paid off dearly for them and their constituency who enjoyed the outcomes of the agenda without necessarily understanding it. Times have changed, so has Turkey, and so has their constituency. Managing this Turkey that now enjoys a per capita income of USD 10,000 as against the Turkey that they took over in 2002 with roughly USD 3,000 is definitely more demanding and requires a skill level that has to be commensurate with the difficulties involved in managing this born again country. There is no room for gimmicks or cheap PR moves here. They simply will not sell. We heard one

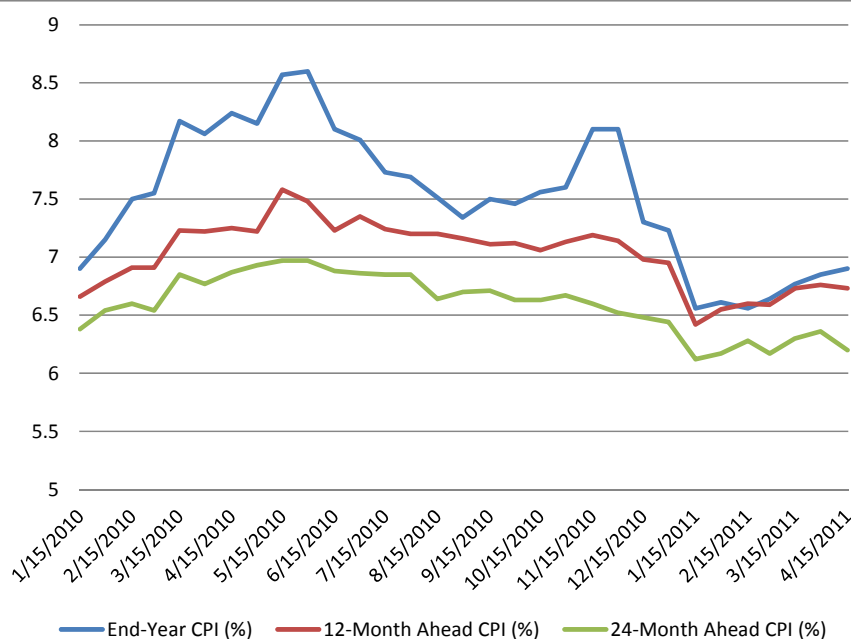
such nonsensical gimmick quite recently and some people chose to put it as a smart move by the AKP. We desperately beg to differ. Prof. Daron Acemoglu of MIT Economics Department was offered the position of Turkey's Permanent Representative to the OECD by the AKP Government. He politely declined the offer saying he was honored and that he could consider it later in his career. Daron Acemoglu is the winner of the Clark Medal in 2005, the so called Nobel Prize for the under-40 class of economists and has been since then one of the most industrious and productive researchers in economics. His research is groundbreaking, of an extremely wide range and embracing of many aspects of the economics discipline in their cutting edge forms. The research is very unique, very comprehensive and he is one of the leading candidates for the Nobel Prize at some point in the not so far future. Now, severing this most distinguished academic from his post in MIT and placing him at this bureaucratic position in Paris is the equivalent of demotion. Taking it one step further, it is tantamount to ignorance regarding his tremendous volume of research. Moreover, Mr. Acemoglu, a Turkish citizen of Armenian origin who was born and raised in Turkey, has problems entering his native country due to his military service obligation. Seeking a solution to mandatory military service issue in a constructive fashion and utilization of hundreds of extremely capable Turkish citizens abroad for public service purposes while leaving prospective Nobel laureates alone with their work would have been a much better sales pitch. Yet that requires effort, commitment, and true intention while a PR campaign on a hardly feasible sell with payoffs expected from the sales pitch only anyway is a no-effort gimmick. And it did not sell. The fact that these gimmicks do not sell should be warning signals for politicians; they should consider the fact that they may be underestimating their constituencies.

There are no new poll results at the moment but they should be abounding fairly soon. Though our trust in many of them is limited, we will inform our readers about the results of those that we feel more comfortable with due to methodology and track record.

## **1.2 Macro Data**

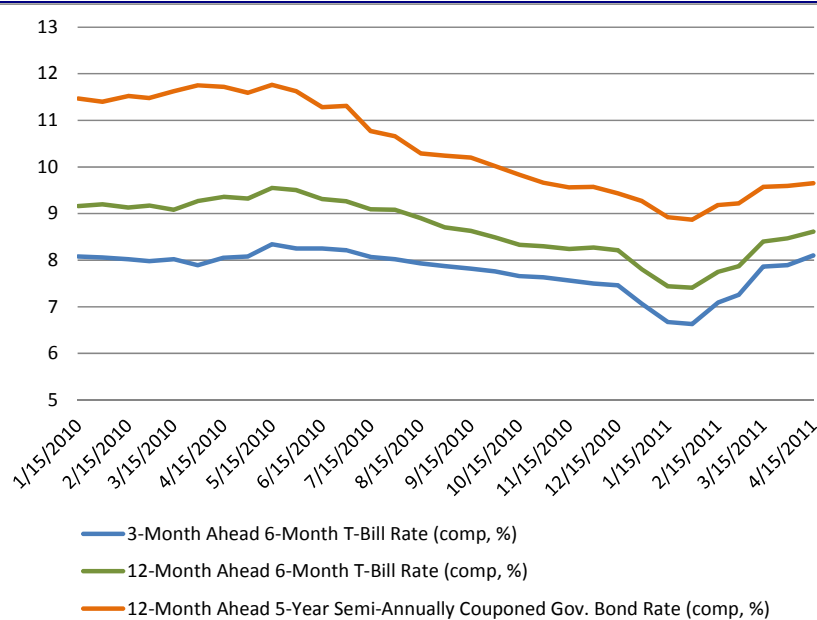
The first expectations survey conducted by the CBRT for the month of April was released last week and there was some improvement in 12 and 24-month horizon inflation expectations with the latter quite discernible at 16 bps from 6.36 to 6.20%. Year-end expectation edged up a bit, by 5 bps, and we wonder why given the other two. A cost-push contribution this year which in turn creates a more favorable base next year maybe, but it is not very wise to second-guess survey respondents in such cases.

## Inflation Expectations



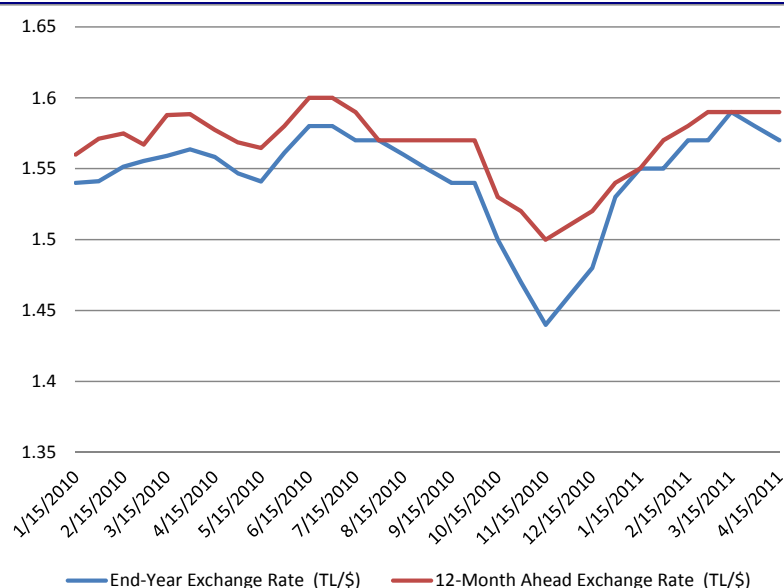
Source: Expectations Survey, Central Bank of Turkey

## Interest Rate Expectations



Source: Expectations Survey, Central Bank of Turkey

## Exchange Rate Expectations



Source: Expectations Survey, Central Bank of Turkey

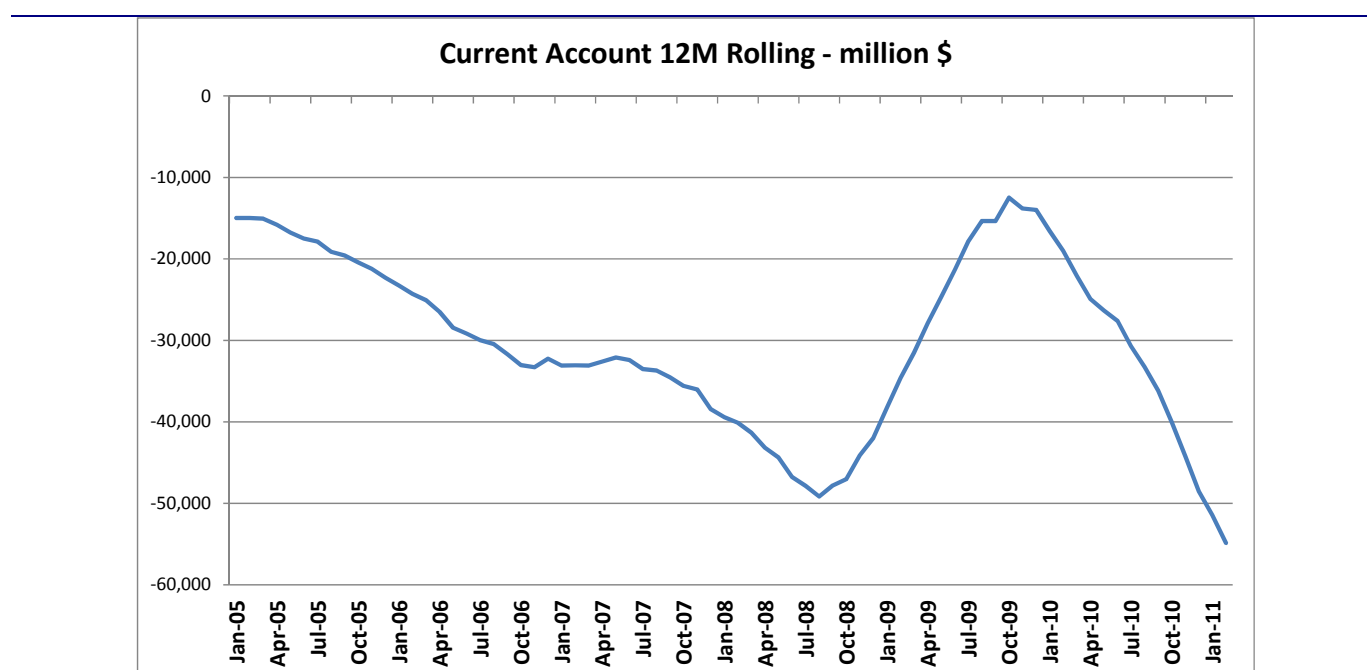
There is still a wide-spread inflation surge expectation by most analysts for year-end yet an overheating scenario underlies almost all of these analyses. We find it extremely difficult to detect any credibility in output gap estimates that rely on a drastically defective H-P filter methodology. When your underlying premise is defective, it is only natural to expect the same deficiency from your conclusions and your policy propositions. We need to clarify one point one more time at the expense of being repetitive for our readers who might be thinking that we are insulting their intelligence. We are NOT claiming that inflation will be in the 4% range (currently 3.99%) or that it will be very close to the CBRT forecast of 5.9% for year-end. All we are saying is that analyses that intend to discredit the CBRT forecast need to come up with more convincing analyses of overheating if they base their argumentation on it. What they suggest about the year-end inflation may indeed turn out to be true for one reason or another. That is one legitimate “opinion” which will either stand the test of time or it will fail to do so. But passing the test will not be based on overheating argumentations that are being put forward by its advocates as those argumentations are methodologically deficient *at this moment*.

Current account deficit for the month of February came mostly as expected at USD 6.1 billion carrying the 12-month rolling figure to USD 54.8 billion. We expect some “taming of the shrew” in a few months when rate of growth of imports will converge down towards that of exports as CBRT measures will have impacted the expansion in economic activity. The most striking feature on the financing side is the huge net errors and omissions term that stood at USD 3.3 billion for the month of February and at a total of USD 5.5 billion for the first two



months of the year. Considering the USD 12.1 billion cumulative deficit for the first two months, NEO financing at USD 5.5 billion is mind boggling. Whether the figure will be reduced going forward with transactions leading to it having cleared is a question mark, and we would highly doubt it for the bulk of the total figure. Portfolio inflows is another crucial financing item with USD 3.8 billion in the first two months but it is worth noting that it exclusively comes from bond financing rather than equity inflows (the former is at USD 5.0 billion while the latter is at minus USD 1.2 billion). Low quality financing continues uninterrupted with equity outflows and with FDI inflows low as expected in the beginning of the year.

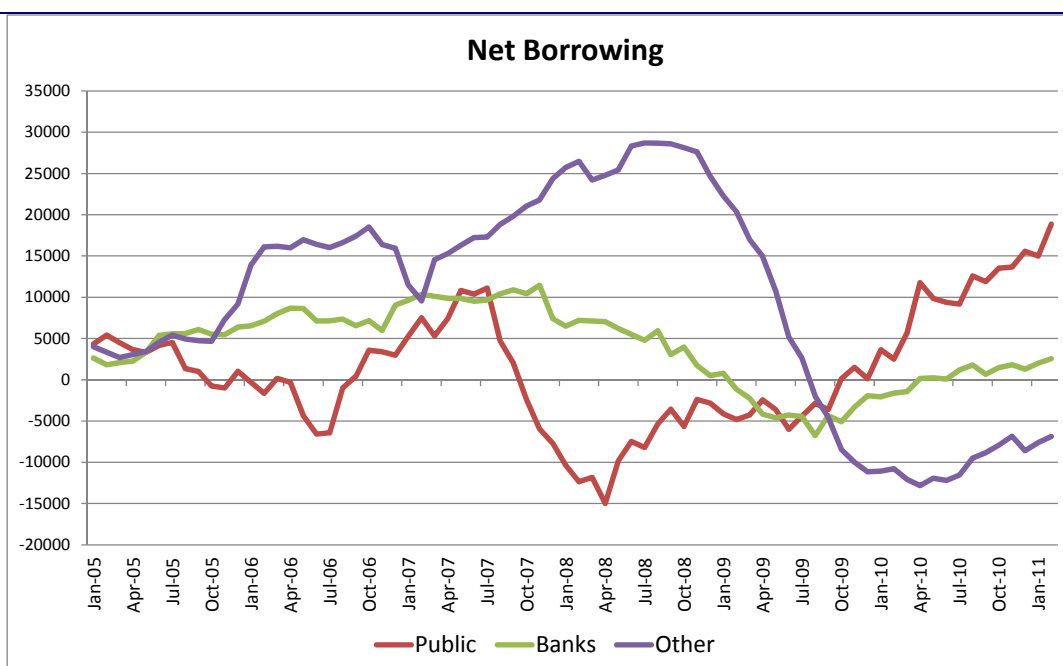
**Figure. Current Account (12-Month Rolling)**



Source: Central Bank of Turkey, Turkey Data Monitor

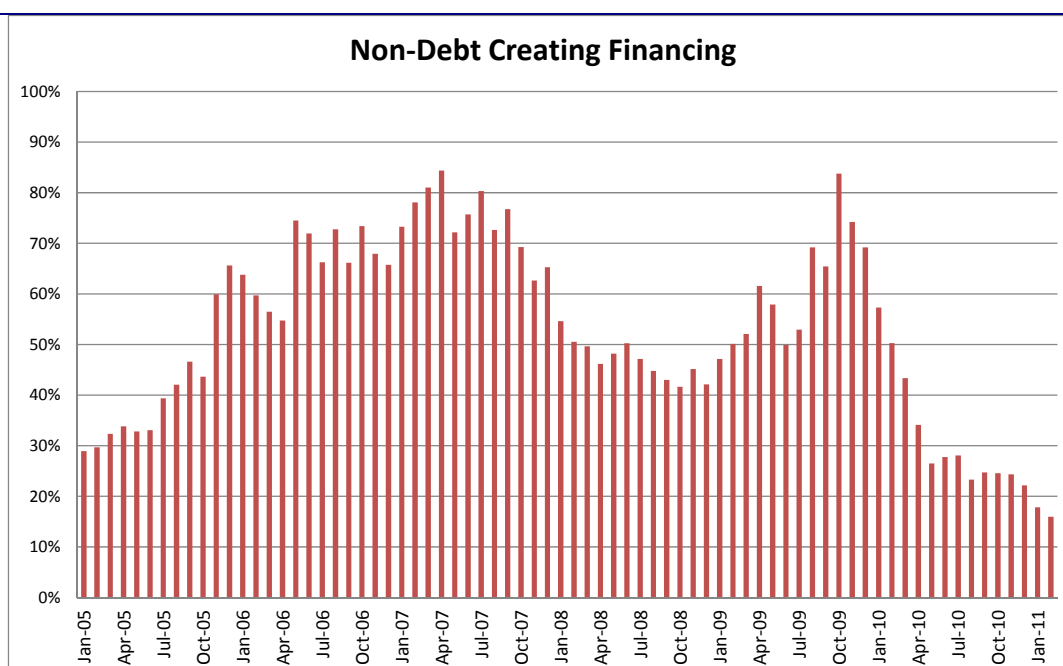


Figure. Net Borrowing (12M Rolling- Million \$)



Source: Central Bank of Turkey, YK Economic Research

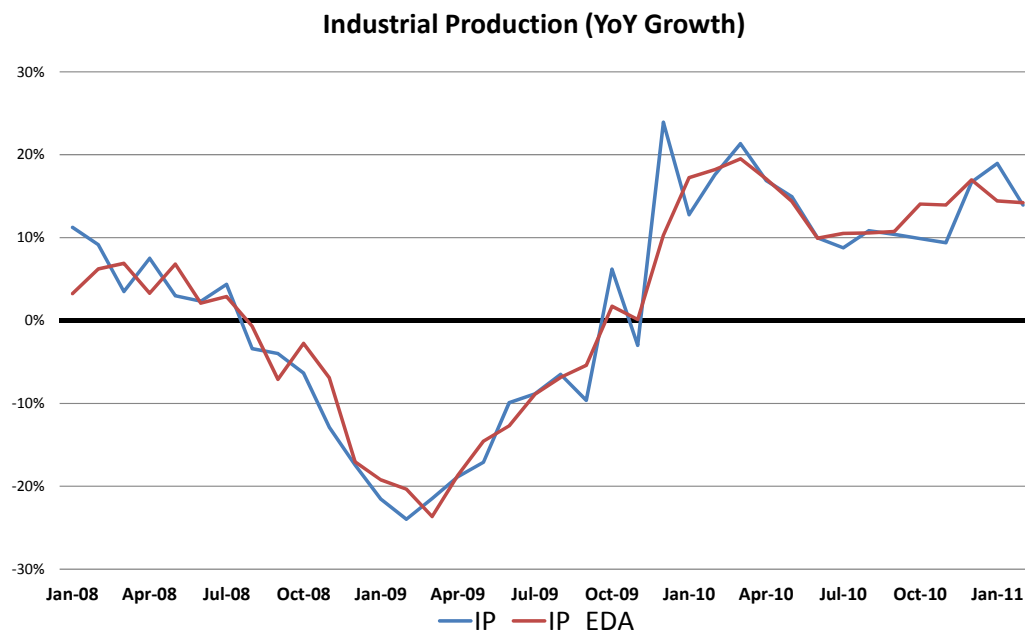
Figure. Non-Debt Creating Financing



Source: Central Bank of Turkey, YK Economic Research

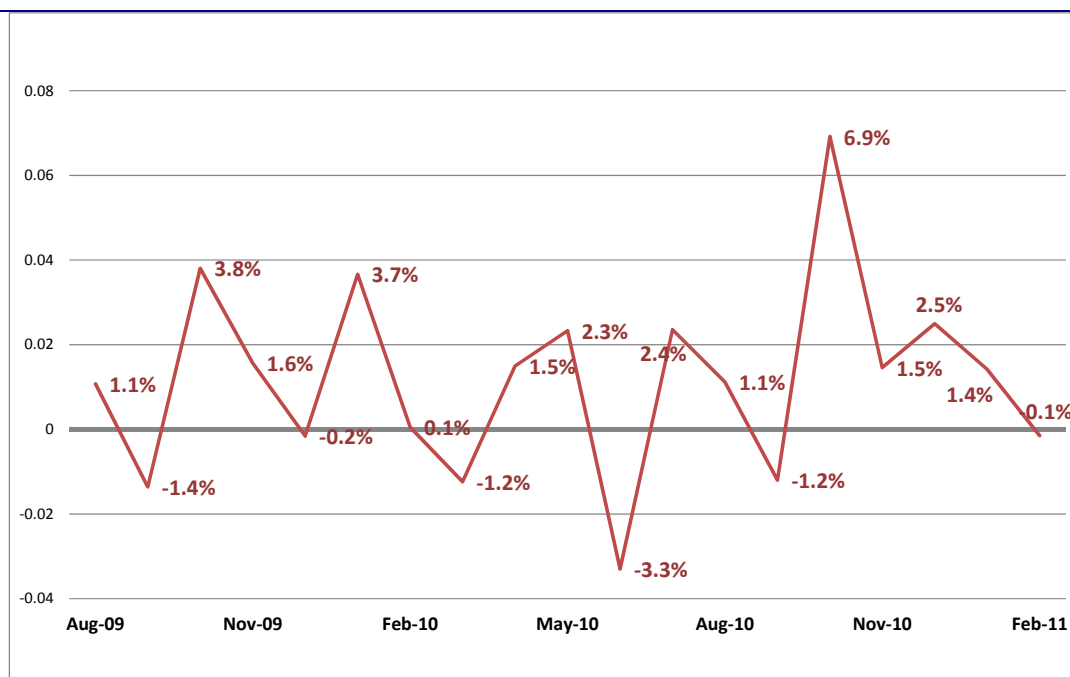
IP growth for March came at 13.9%, slightly below the market expectation around 15% and significantly below our forecast of 18.1%. Whether this figure that corresponded to a month on month figure of minus 1.7% adjusted for seasonal and working day effects is suggestive of any slowdown in the making is difficult to tell.

## Industrial Production YoY Growth



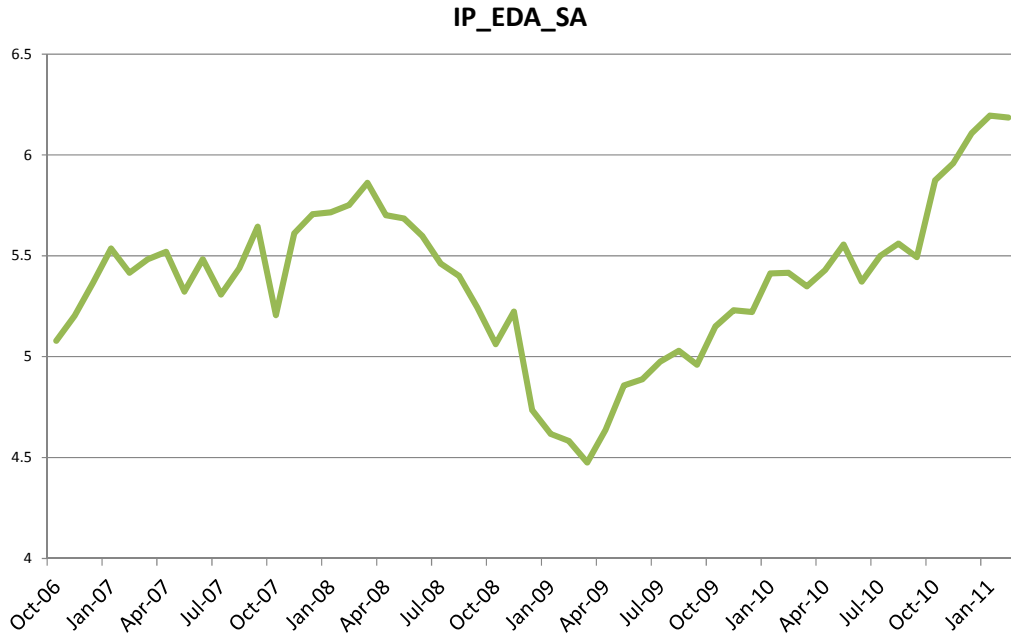
Source: Turkstat, YK Economic Research

## Industrial Production-Effective Days & Seasonally Adjusted Series MoM Growth



Source: Turkstat, YK Economic Research

## Industrial Production Level ( Seasonal and Effective Days Adjusted Series)

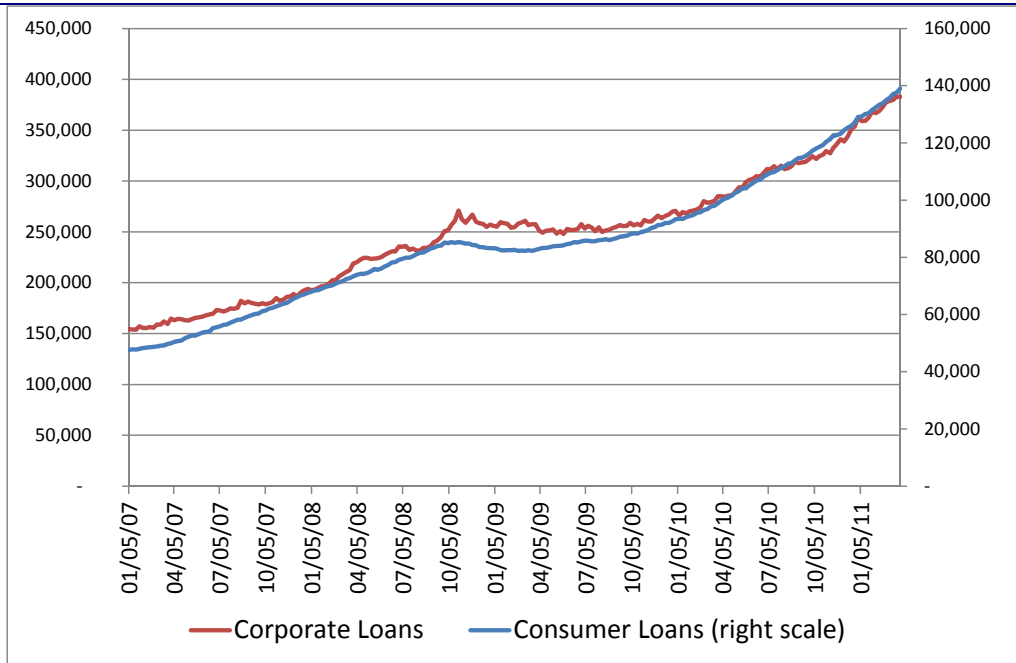


Source: Turkstat, YK Economic Research

### 1.3 Weekly Data (all weekly data terminate on March 25, 2010 while consumer credits are one extra week updated)

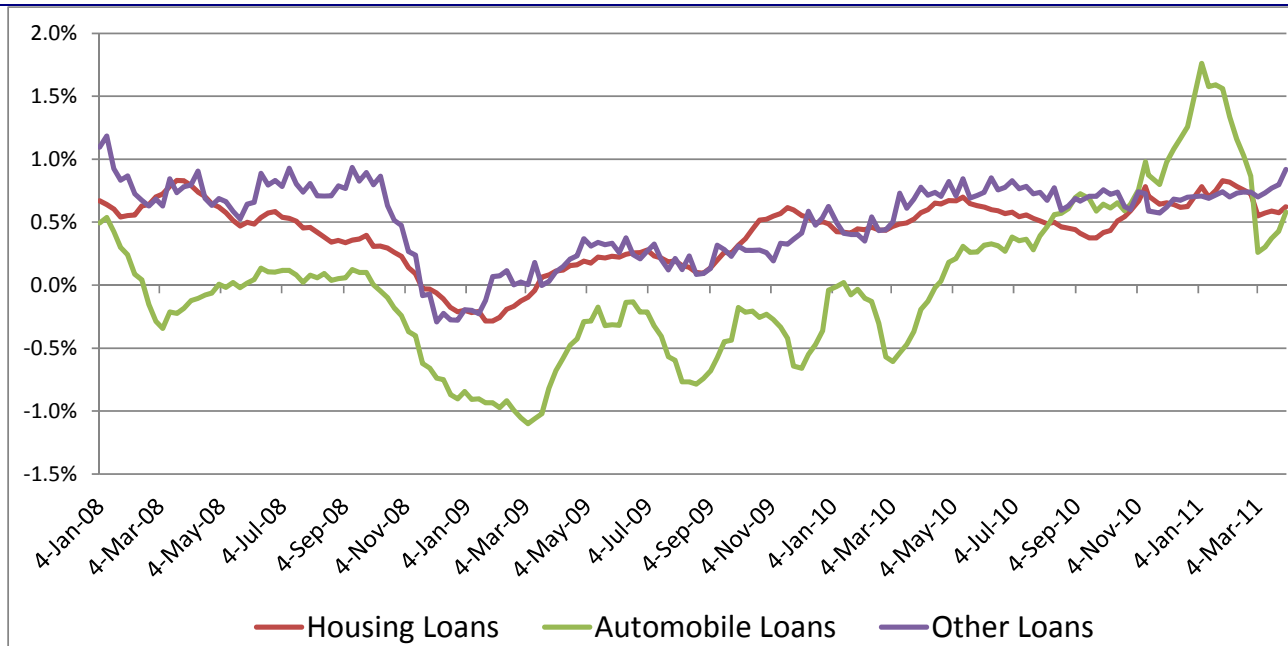
Consumer loans had another strong showing in the first week of April and YoY growth in the category surged to 42.2% from 41.5% a week ago. Housing loans had a strong performance with a weekly increase of TL 630 million, and the same was true for general need loans as well with an increase of TL 1.1 billion. Weekly volatility is quite high as we mentioned a few times before and changes in the aftermath of “harsh” TCMB measures happen to be particularly drastic. The slowdown in credit growth is indeed expected by most banking sector members who are currently pushing for the highest semiannual growth rate possible that will keep them close to their year-end targets.

### Consumer/Commercial Credits - Levels



Source: Central Bank of Turkey, Yapı Kredi Economic Research

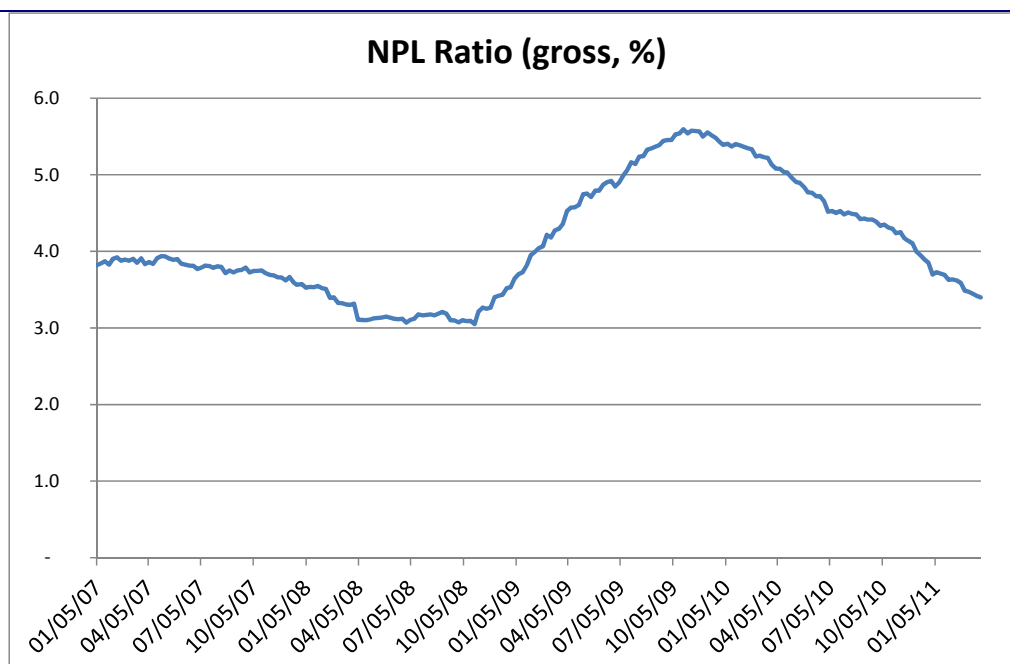
### Consumer Credit Volume (\*)



Source: Central Bank of Turkey, Yapı Kredi Economic Research

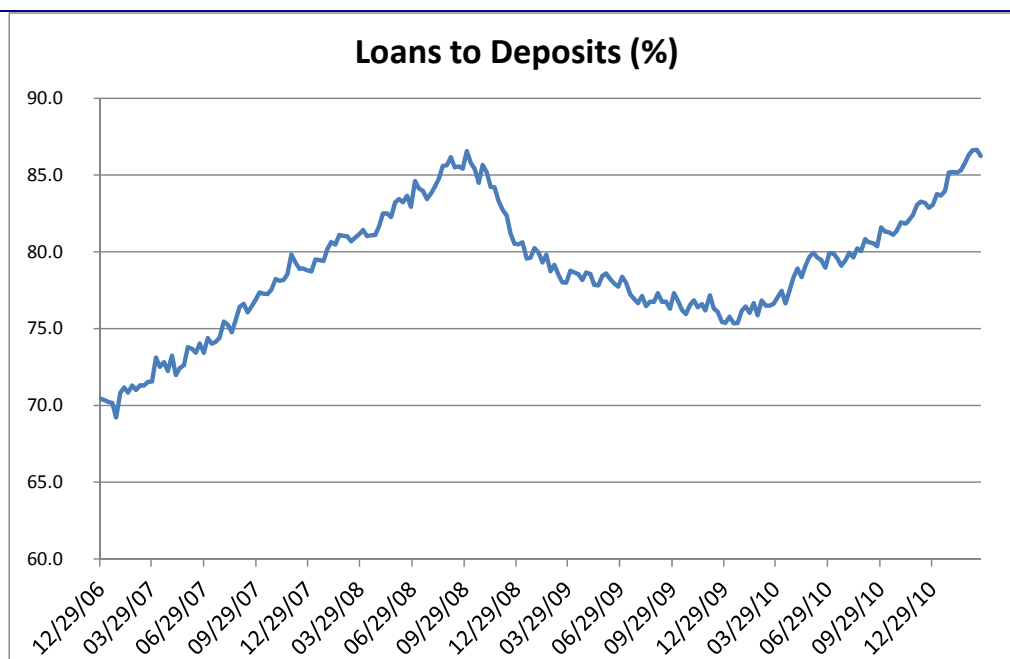
(\*) Weekly % change of 8W average

## NPL



Source: Central Bank of Turkey, Yapı Kredi Economic Research

## Credit/Deposits Ratio



Source: Central Bank of Turkey, Yapı Kredi Economic Research

## *Markets*

*by Murat Berk / Economist and Investment Strategist*

### **The desert of the real itself**

*"We analysed a deterministic society deterministically. Today we have to analyse a non-deterministic society non-deterministically—a fractal random, exponential society, the society of the critical mass and extreme phenomena, a society entirely dominated by relations of uncertainty."*

Jean Baudrillard (2001)

In 1998-2000, while I was studying for my MBA at NYU, almost everyone in New York was talking about the stock market and especially technology stocks. Investment bankers, analysts, economists, strategists visiting our school were all so optimistic. Sure, there were occasional scares (i.e. in 1998) but each time, officials, policymakers and experts came out, mumbled something and everyone stopped worrying.

At the time, I could not figure out what they were saying. I thought that I was not good enough to understand the expert's musings. Over time, I realized that nobody really could. That is their magic. They leave so much to the imagination. They can send investors into frenzy, especially when they mention things like "new paradigms".

If we step outside our economic comfort zone and look beyond a deterministic financial analysis that there are "laws" of economics which lead to certain market outcomes, we arrive at complexity and political choices. This kind of analysis doesn't lend itself to refutation or confirmation by financial models of the sort being bandied about—it's more a behavioral analysis mixed with history, game theory, crowd behavior and politics.

How many people truly understand the precise mechanics of today's capital movements? Does anyone really understand what interactions of momentum/trend following trading computers lead to a discrepancy between perception and underlying reality, or is there reflexivity at work?

What sort of cause and effect relation ties the Fed's moves to other central banks? What happens if that web breaks down or seizes up? Who is vulnerable to disruptions which could quickly cascade in a series of inter-connected, self-reinforcing feedback loops and waves of selling turning into a self-reinforcing cascade, otherwise known as a crash?

Is most of the monetary growth outside the US on the back of dollar funding trade? Thus is it sensible for central banks like the CBT to try cool this off before the risks get too big but can not really hike rates because raising rates may in the short term attract even more capital into the country?

It still seems that most of money is leaking out of countries such as the US and Japan, financing risk assets and resulting in higher commodity prices. I think the risks are growing. As we get closer to the end of QE2, it seems likely the perception that the supply of dollar funding will fall heavily could lift the dollar and put pressure on risk assets.

As inflation is increasing amid stick unemployment, stagnant real wages, the public's purchasing power declines.

What if high commodity prices are becoming structural rather than cyclical, which means that it is likely to be "sticky" even as economic growth slows? Even in this environment, the bullish tone of the stock market can continue, but traditional high-beta stocks could underperform.

On a more personal level, while the best and brightest are focused on the normal in financial systems, they may be overlooking deeper dynamics/fundamentals. While they are concerned about economic imbalances could the major imbalance lie in national income shares, which is rarely discussed. Despite the harsh (and unwarranted in my view) criticism Keynesian policies have been receiving, could the real challenge become to achieve self-sustaining economic growth? Does it matter whether wealth is highly concentrated? As you know a nation's aggregate income can be divided into two parts: wages and salaries on one hand and profits on the other. I wonder whether a shift of national income shares toward profits and away from wages and salaries and increase in debt levels contributed to the global crisis? Also, are countries with higher income equalities (as measured by GINI scores, for example on a scale of 0-1, the higher score is associated with greater income inequality), more prone to financial crisis?

*“Abstraction today is no longer that of the map, the double, the mirror or the concept. Simulation is no longer that of a territory, a referential being or a substance. It is the generation by models of a real without origin or reality: a hyperreal. The territory no longer precedes the map, nor survives it. Henceforth, it is the map that precedes the territory — precession of simulacra — it is the map that engenders the territory and if we were to revive the fable today, it would be the territory whose shreds are slowly rotting across the map. It is the real, and not the map, whose vestiges subsist here and there, in the deserts which are no longer those of the Empire, but our own. The desert of the real itself.”*

Jean Baudrillard – (1981)

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