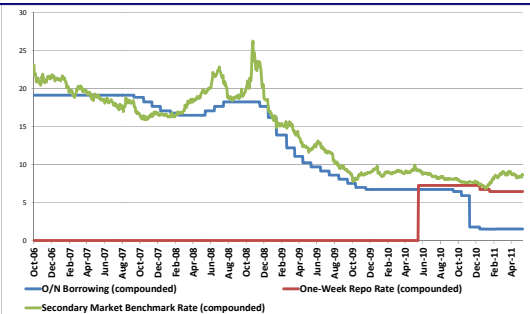


Turkey Weekly Macro Comment

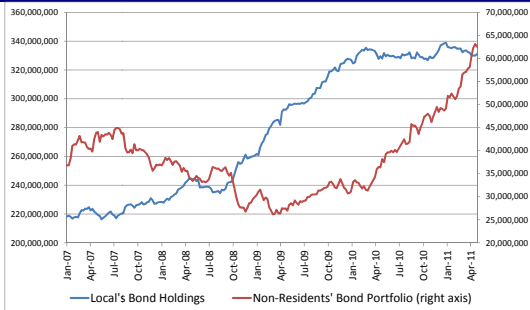
16 May 2011

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

On Science, Pseudo-Science, Junk Science, Spurious Relations, and Convictions

- It is exactly one month before election time and the consensus seems to be that it will be one of the most uninteresting elections we have had in recent history. Not necessarily, we believe. There seems to be ample room for some surprises in our view.
- Employment data for the month of February were announced this morning and there seems to be discernible improvement in labor market conditions. It is yet a totally different argument to assert that wage pressures have been building accordingly. TURKSTAT data still suggest otherwise.
- Current account deficit for March exceeded expectations at USD 9.8 billion and created a minor havoc in markets for a while, triggering some sell-off which was helped by adverse external conditions.
- Budget figures for the month of April depict a strong showing with a 25.8% YoY increase in revenues and an 8.3% increase in non-interest expenditures. There is a similar strong showing for the first quarter as well where the corresponding figures stand at 21.4% and 9.8%, respectively.

Cevdet Akçay

Chief Economist, Yapı Kredi Bank & Yapı Kredi Yatırım

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

1.1 General Outlook

It is exactly one month before election time and the consensus seems to be that it will be one of the most uninteresting elections we have had in recent history. Not necessarily, we believe. There seems to be ample room for some surprises in our view. It is by now a given that the AKP will form a single party government once again but what will be the support they enjoy vote-wise and seat-wise? The two could be differing significantly if nationalist MHP fails to move above the 10% national threshold, which is a distinct possibility in the aftermath of the video releases involving party deputy heads.

Efforts to contain the damage by MHP officials are not likely to prove very successful for the simple reason that violation of privacy for supporters of a conservative party is of tertiary importance. The content of the videos is probably too aggravating for conservative voters to relegate it to a position that is below the status assigned to the method through which these videos were obtained. There is a significant amount of philosophical food for thought here albeit the indisputable fact that violating the privacy of another human being is against the law and is punishable in almost every court on earth. The problem mostly lies in “the asymmetry in importance” such an act may carry in the eye of different individuals. While one person might be totally indifferent to the content of any private footage for the simple reason that it is private, another might be asserting that the content is vital to him/her for the reason that it entails not an ordinary person but a politician who is asking for mandate to make decisions about our lives. The thin red line here is both thin and red. It is beyond doubt that we are all constrained by certain affiliations we choose to be defined by. We may alternatively be opting to minimize such affiliations. Choosing to work freelance is an option entertained in that respect for instance. We have our very personal identities in addition to the institutional identities we carry due to our affiliation with the institution we work in. Our institutional identity constrains us in many ways but we have willingly or voluntarily agreed to sacrifice that additional degree of freedom we would have enjoyed in the absence of that institutional identity. If that constraint becomes too binding for one reason or another, you opt out and seek work in an institution in which it is not binding. If no such institution exists, you are on your own and/or out of that particular sector.

We are all aware of such constraints and act accordingly in our daily lives. Trade-offs is the essence of life. The good thing about an economics education is that if you are lucky enough, you are contaminated in lecture one with the idea that you are indulging in the pseudo-science of trade-offs, economics that is. As for politicians, it is not an institutional identity that they carry in addition to their personal identities but a public identity which is even more constraining. Their trade-off is thus keener in most cases than the one involving institutional identities. Then again, you may be a politician in a political party that is extremely liberal and overly protective of privacy and thus be subject to a milder constraint than that suffered by an employee of a private firm with an extremely conservative ethical stance. The reaction to a

release of some footage could be minimal or even non-existent from the standpoint of that political party in comparison to the reaction that could be coming from our conservative private firm, but that does not alter the generic conclusion that political identity is more constraining than an institutional one for the simple reason that it involves structuring the mode of operation for the entire society through the engineering of rules and regulations that apply to all. At the expense of vulgarizing the argument, consider the following hypothetical example: A Green Party MP (we unfortunately do not have one in Turkey as you all probably know) happens to be mistreating his/her cat at home, but is vehemently supportive of animal rights in the public realm. Would a Green Party voter like to be informed of the MP's mistreatment practices regardless of the means through which he gains access to this info or would the violation of the MP's privacy in obtaining this info override party supporter's disgust about the very same MP's acts of mistreatment? Or mistreatment of the cat could be replaced with disposal of detergent infected water in his/her own garden, an almost equally fatal sin by Green standards. While an ordinary individual's misdeeds of the sort exemplified above would create frustration and aggravation in any sensible individual, it becomes a totally different story in the eye of a Green Party supporter when the perpetrator is a Green Party MP. Mr. John Doe, as a supporter of the Conservative Party, could be equally distant to two potential perpetrators who might happen to be Mr. Unaffiliated and Mr. MP, but the Green Party supporter is very likely to think otherwise. These are murky issues with when it comes to assessing the ethical repercussions of a leakage/release/disclosure. While there is wide consensus on the illegality of the means of obtainment, once obtained, how to treat the content itself is a very dubious matter for reasons we tried to elucidate above. All this is naturally a novice approach as far as the science of law is concerned, but that is precisely the point here; relevance of perception and assessment for a novice, or your representative voter.

Short of story is that it is very difficult to assume that these latest incidents will not be hurting the nationalist MHP. The beneficiary of any possible erosion in their voter base is likely to be the AKP first and then the other nationalist party BBP (to remain below the threshold for sure) and to some extent the main opposition CHP. Having sensed this, MHP leader Bahçeli is taking on the leader of the influential Gulen Movement Fethullah Gulen who currently resides in the US. Mr. Bahçeli seems to be trying to appeal to those among CHP voters who are disillusioned by the mild and in some cases favorable treatment of the Gulen Movement by CHP officials. Hence, we might be seeing some interesting shifts of votes come election time which most analysts do not seem to be assigning much probability to at the moment.

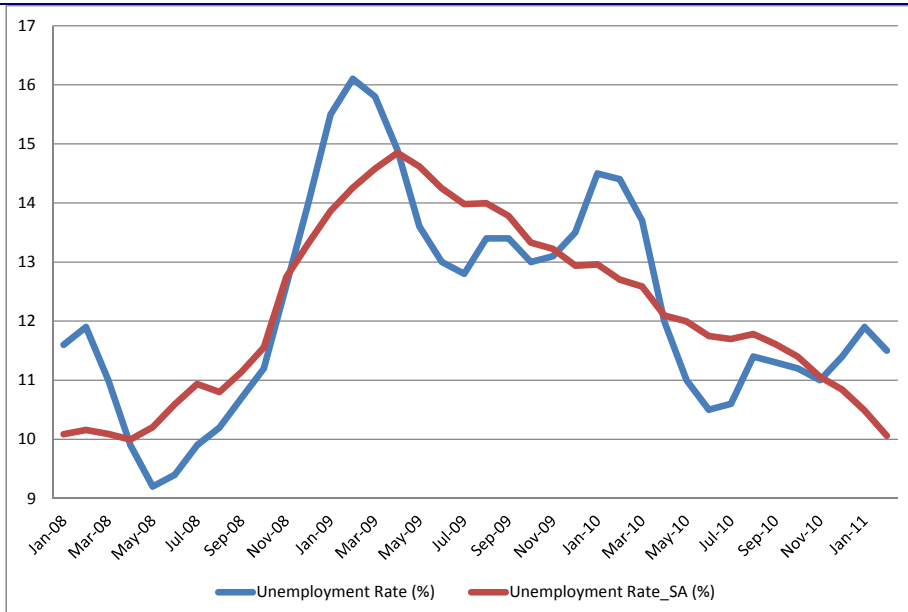
Meanwhile, Kurdish Party BBP and their semi-explicit jailed leader Ocalan continue to up the ante. Ocalan stated a few days ago that following the election in June, there will either be a vicious war or a great peace, formulating future prospects as a purely binary game. Two police members were killed with long-range gun fire last week by the PKK and 12 PKK members trying to infiltrate into Turkey through the Iraq border were killed by Army forces. Tensions are building up, and a common goal seems to produce a setting in which the country

looks unmanageable. As a provocation campaign, this strategy is much less likely to produce any results as we discussed last week. For a provocation act to be successful, we argued, it has to look like the real thing and not like a provocation. Fortunately, most acts of provocation in Turkey are perceived as provocation and the likelihood of success on the part of provocateurs is thus much less than it used to be.

1.2 Macro Data

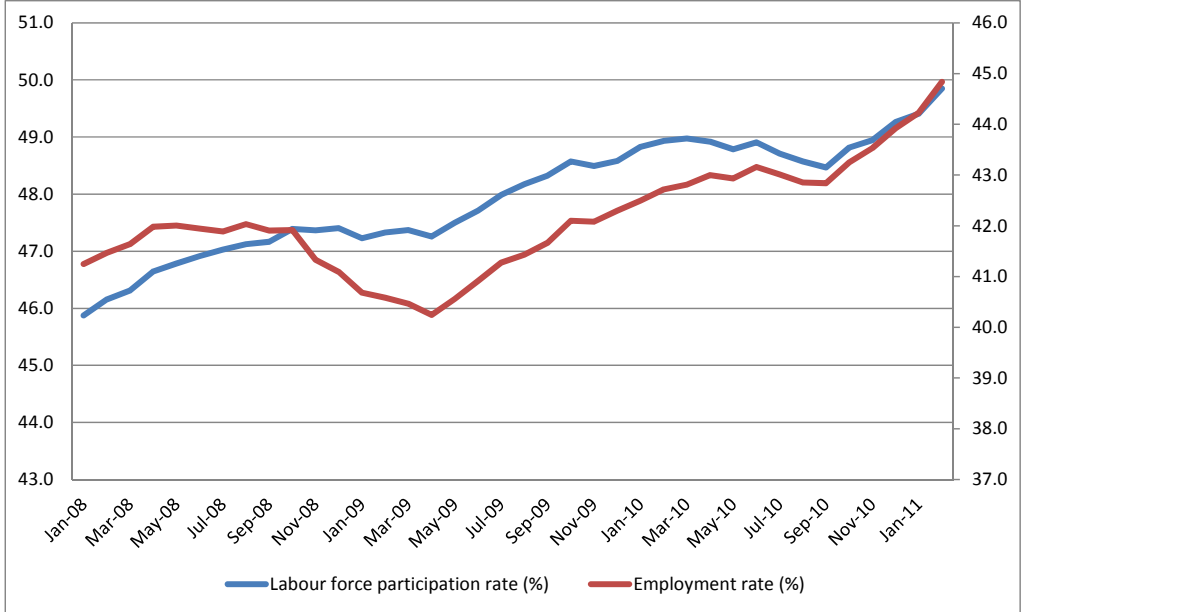
Employment data for the month of February were announced this morning and there seems to be discernible improvement in labor market conditions. Unemployment rate is down to 11.5%, to 10.1% in seasonally adjusted terms, and labor force participation is up and is at an all-time high at 49.8%, thus making the reduction in the unemployment rate doubly precious. Labor force has grown by 3.36 million since the beginning of 2008 and 3.03 million new jobs have been created since then, massively absorbing the new recruits, limiting the increase in the number of the unemployed to 297,000 during the same period.

Unemployment (%)



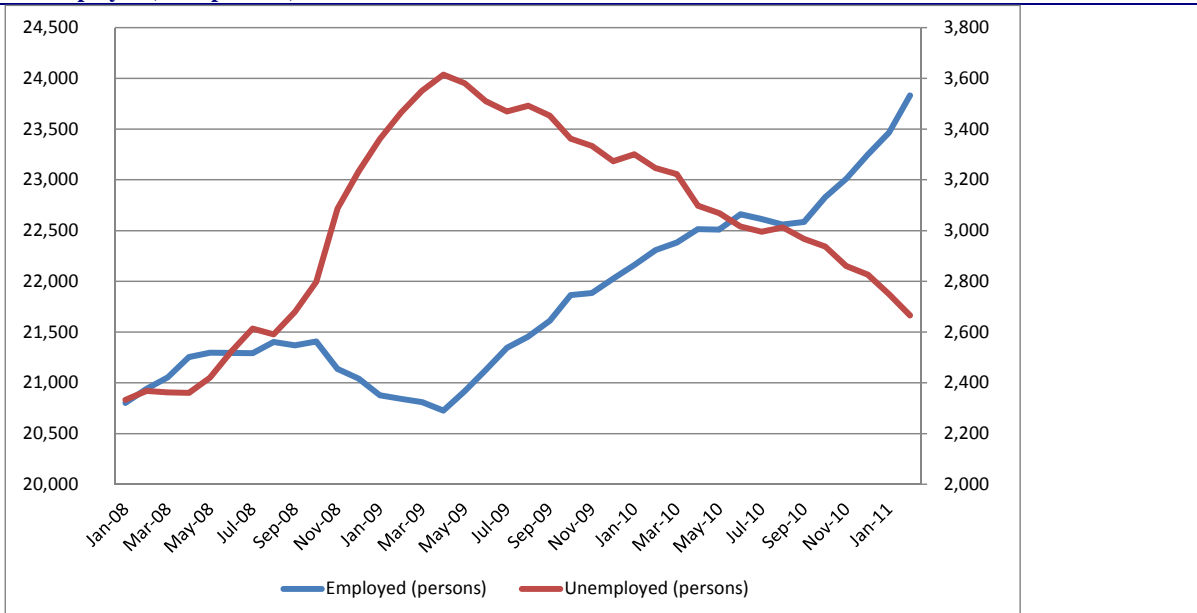
Source: TURKSTAT

Seasonally Adjusted LFPR and ER (%)



Source: TURKSTAT

Seasonally Adjusted Employer (1000 persons)

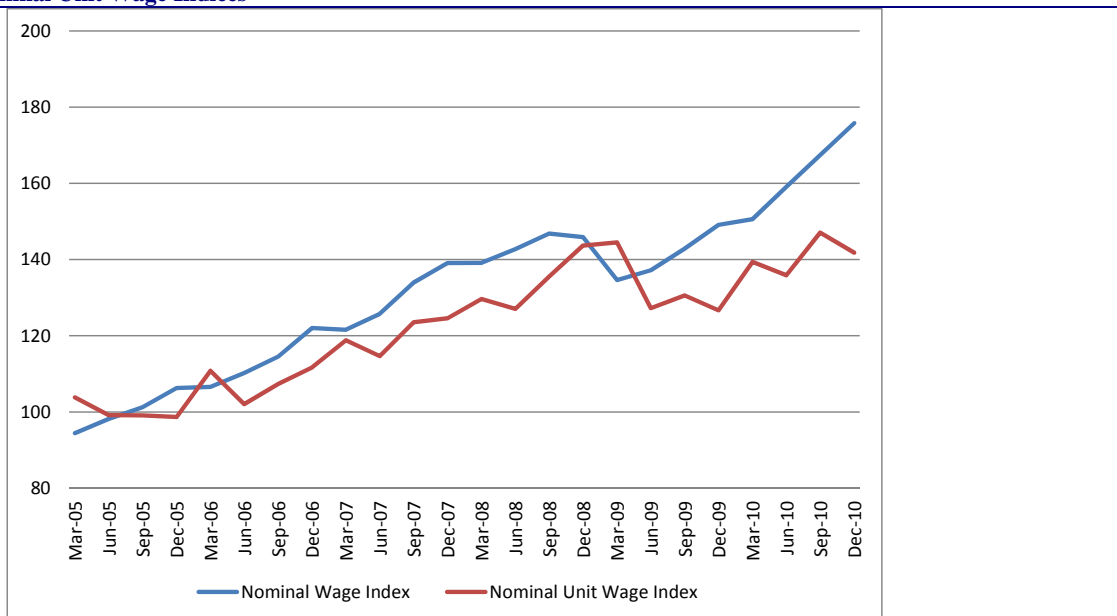


Source: TURKSTAT

Charts above clearly depict the improvement in the labor market. It is one thing to diagnose the improvement in the labor market in terms of quantity adjustments, but a totally different thing to assert that these dynamics have been leading to “inflationary dynamics” through wage pressure. TURKSTAT’s wage indices clearly depict that when corrected for

productivity increases and adjusted for CPI, there could be anything but wage pressure in the labor market. Charts below clearly depict the situation.

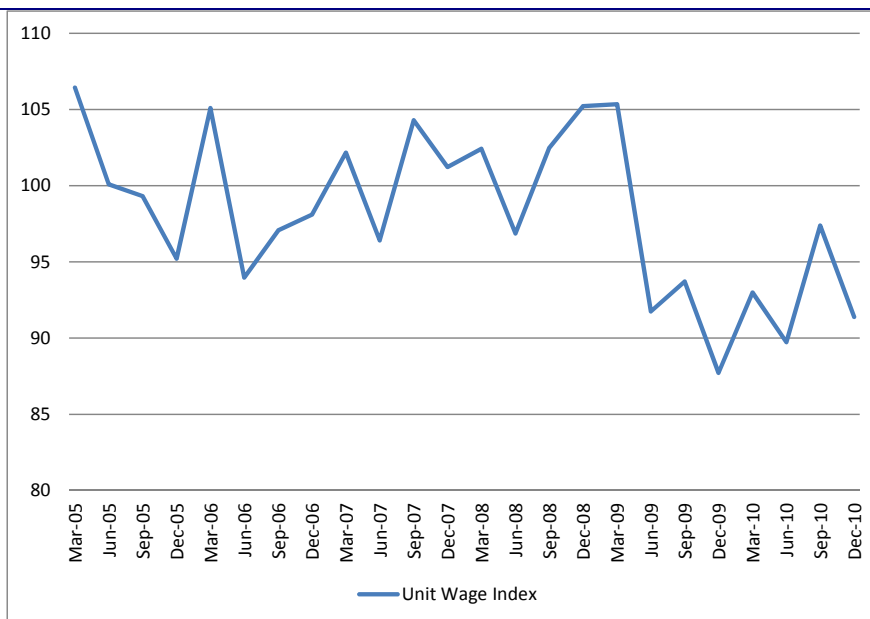
Nominal Wage and Nominal Unit Wage Indices



Source: TURKSTAT

If one looks at the Nominal Wage Index in the chart above and infers that there is wage pressure in the market, it would be similar to looking at the nominal GDP figure in 2009 and claiming that Turkish economy did not contract after all (TL 950.534 billion in 2008 followed by TL 952.559 billion in 2009, thus a nominal increase). We all know otherwise. Nominal Unit Wage index in the same chart tells more since it corrects the nominal index for productivity changes, but it is still an imperfect measure of wage pressure. When one finally adjusts the index that is already corrected for productivity successively for the CPI, the best proxy for wage pressure is obtained and that happens to be the schedule presented in the chart below. How that picture corresponds to wage pressure building - an assertion perfectly compatible with the (still non-existent in our view) overheating argument pronounced by advocates of a major CBRT screw-up since December- is beyond us.

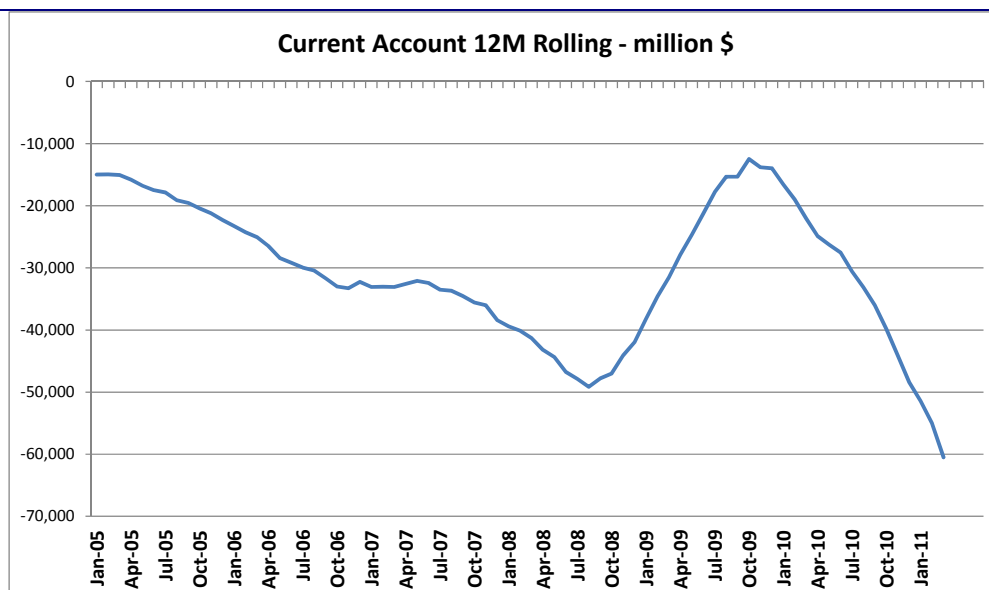
Unit Wage Index



Source: TURKSTAT

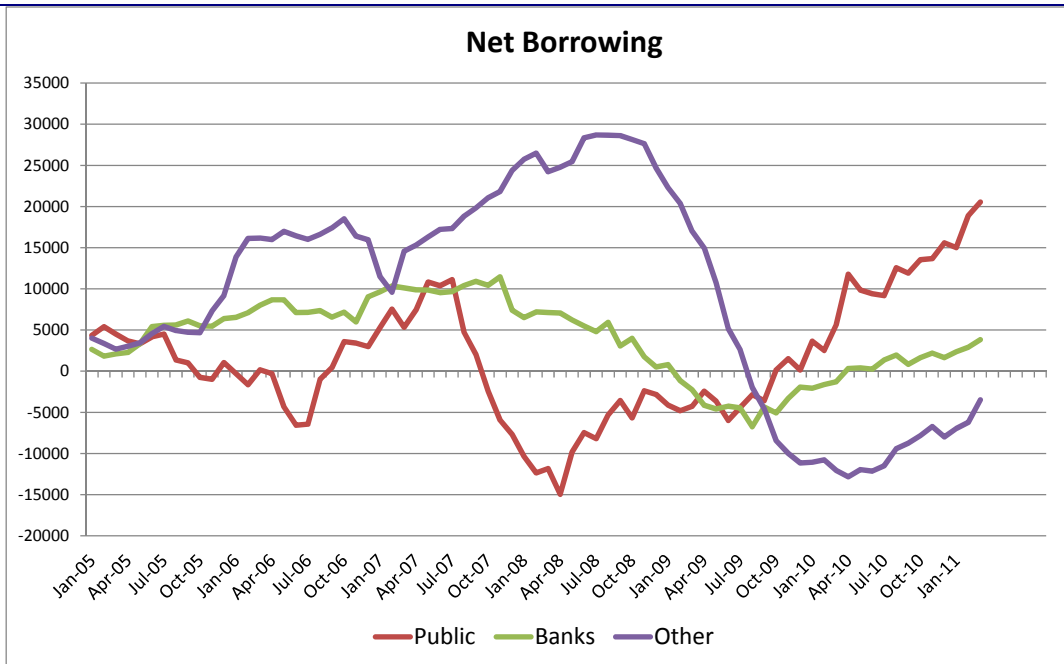
Current account deficit for March exceeded expectations at USD 9.8 billion and created a minor havoc in markets for a while, triggering some sell-off which was helped by adverse external conditions. Profit repatriations which exceeded previous averages by more than USD 1.0 billion explain most of the divergence between market consensus and realization. 12-month rolling deficit is at USD 60.5 billion and will be rising for some more time to come presumably until the last quarter of the year. The extent of cooling off which is still uncertain due to the gestation period of measures taken so far and to be taken going forward by the CBRT will have an impact on the pace of widening of the current account deficit.

Figure.Current Account (12-Month Rolling)



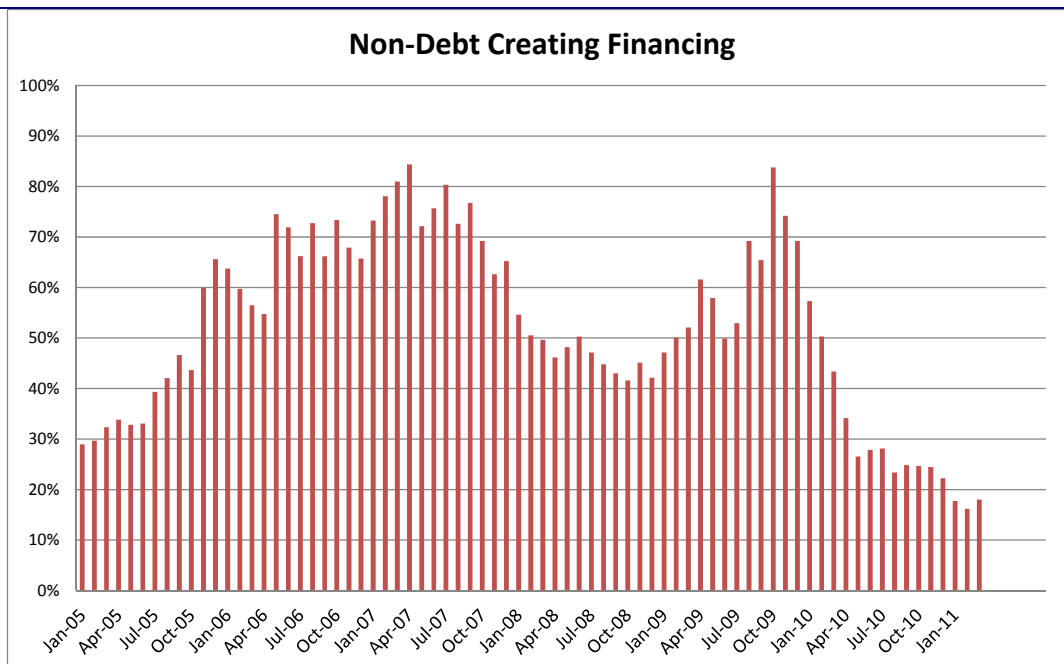
Source:Central Bank of Turkey, Turkey Data Monitor

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

One consolation one could find in the deficit number is the source of widening in the deficit number itself. Private sector investment expenditures had been galloping since the beginning of 2010 and we had finished last year with a YoY increase of 33.5% in real terms. The surge seems to continue uninterrupted in 1Q2011. YoY increase in total imports, capital goods

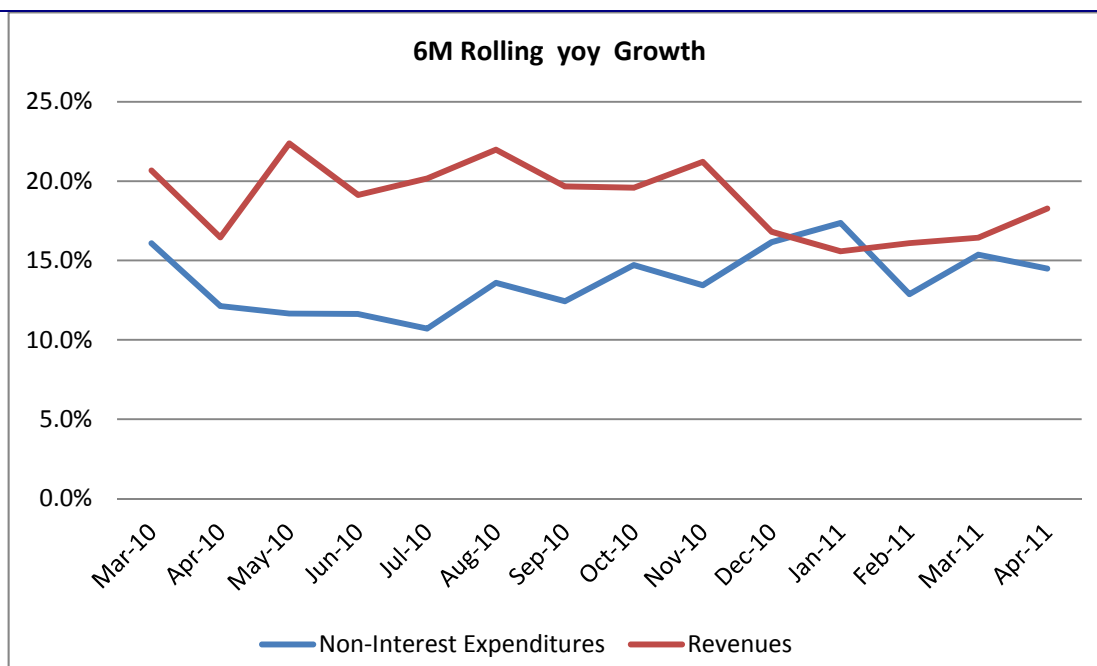
imports, intermediate goods imports, and consumption goods imports stand at 44.1%, 63.4%, 40.1%, and 43.5%, respectively. The picture does not change much if one looks at YoY increases for Q1 instead of March only; rate of increase in investment expenditures beats all others hands down.

Budget figures for the month of April depict a strong showing with a 25.8% YoY increase in revenues and an 8.3% increase in non-interest expenditures. There is a similar strong showing for the first quarter as well where the corresponding figures stand at 21.4% and 9.8%, respectively. Changes in real terms accordingly depict a similar strong showing needless to say.

Budget Balance (million TL)						
			year-to-date	year-to-date	12-month rolling	12-month rolling
	Apr-11	Apr-10	Apr-11	Apr-10	Apr-11	Mar-11
Central Government Revenues	23,523	20,718	92,252	77,750	268,530	265,725
Taxes	19,287	15,330	76,737	63,232	224,037	220,081
Non-Tax Revenues	4,237	5,388	15,515	14,518	44,493	45,644
Central Government Expenditures	22,467	25,173	95,320	93,546	295,402	298,109
Excluding Interest	19,626	18,121	78,511	71,494	252,348	250,843
Interest	2,841	7,053	16,809	22,052	43,054	47,266
Budget Balance	1,056	-4,455	-3,068	-15,796	-26,872	-32,384

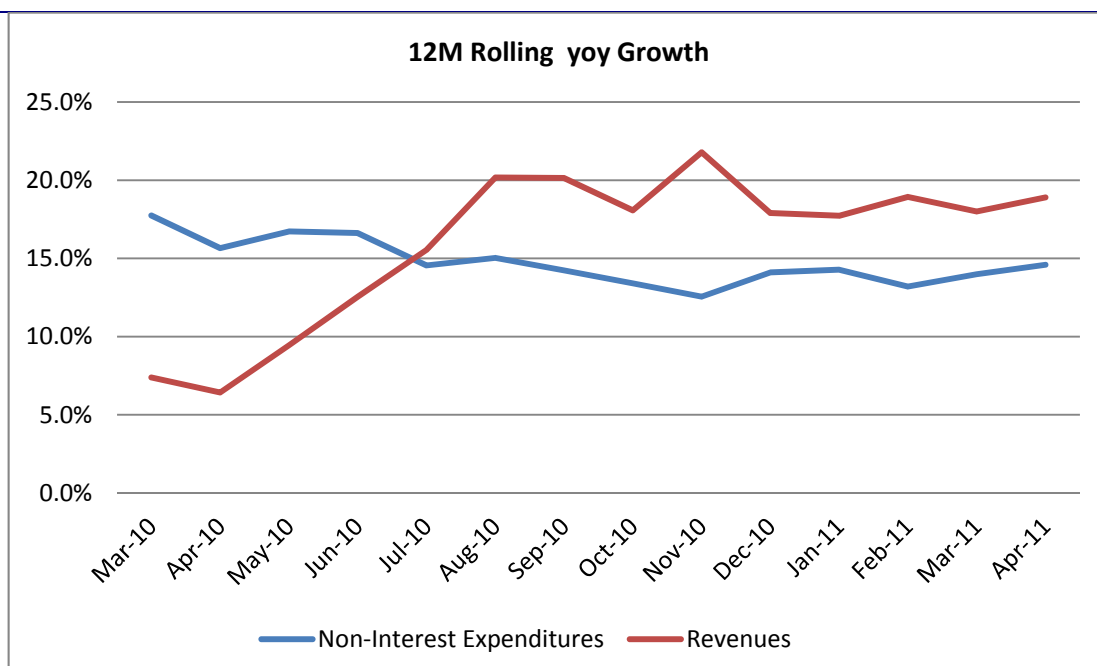
Selected Tax Revenues and Non-Interest Expenditures (million TL)						
			year-to-date	year-to-date	12-month rolling	12-month rolling
	Apr-11	Apr-10	Apr-11	Apr-10	Apr-11	Mar-11
Tax Revenues	19,287	15,330	76,737	63,232	224,037	220,081
o/w: Income Tax	4,542	3,424	14,955	13,014	42,332	41,215
Corporation Tax	243	420	6,796	5,046	22,675	22,852
Domestic VAT	2,269	2,159	9,612	7,974	27,962	27,853
Special Consumption Tax	5,215	4,261	18,529	15,944	59,870	58,916
Taxes on International Trade and Transactions	4,710	3,163	16,031	11,543	44,015	42,468
Non-Interest Expenditures	19,626	18,121	78,511	71,494	252,348	250,843
o/w: Personnel (inc. SSI premiums)	7,019	6,041	29,102	25,019	77,444	76,465
Good and Services Procurements	2,593	2,214	7,367	6,416	29,775	29,395
o/w: Health Expenses	391	441	1,481	1,563	5,669	5,719
Current Transfers	7,918	7,531	37,472	35,250	104,113	103,726
o/w: Social Security	4,149	4,533	20,208	19,621	56,967	57,352
Shares of Local Government	1,621	1,392	7,513	6,471	21,952	21,724
Capital Expenditures	1,798	1,626	3,563	2,919	33,287	33,115

Revenues Expenditures



Source: Central Bank of Turkey, YK Economic Research

Revenues Expenditures



Source: Central Bank of Turkey, YK Economic Research

6-month rolling and 12-month rolling growth pictures for revenues and non-interest expenditures also depict an improving picture though it has got to be noted that the favorable status stems mostly from revenue increases. This is a luxury that the Turkish economy has been enjoying unlike some of his peers in the CEE region and most developed markets which have to resort to fiscal correction via expenditure cuts. This, however, is self-defeating to the

extent that public sector expenditures have discernible impact on growth. Lower growth will lead to a situation on fiscal dynamics that would be similar to the “paradox of thrift” in consumer theory. In the case of Turkey, public sector’s contribution to growth has been further mitigated within the last decade and was almost negligible last year when the economy grew nearly 9%. It is a truism that the current account deficit is a savings (total) - investment imbalance, but sizeable correction in the deficit coming through fiscal contraction would make more sense in a setting where public sector contributes to growth in a meaningful manner (either through a sheer size effect or an obnoxiously large expenditure multiplier). The process seems to be a bit asymmetric at this juncture in Turkey in the sense that an explosion in public expenditures and a significant contribution to growth via public sector would have a sizeable adverse impact on the current account deficit but reductions in expenditures are likely to have much less of an impact due to the predominantly private sector-led growth process particularly in the aftermath of the global crisis.

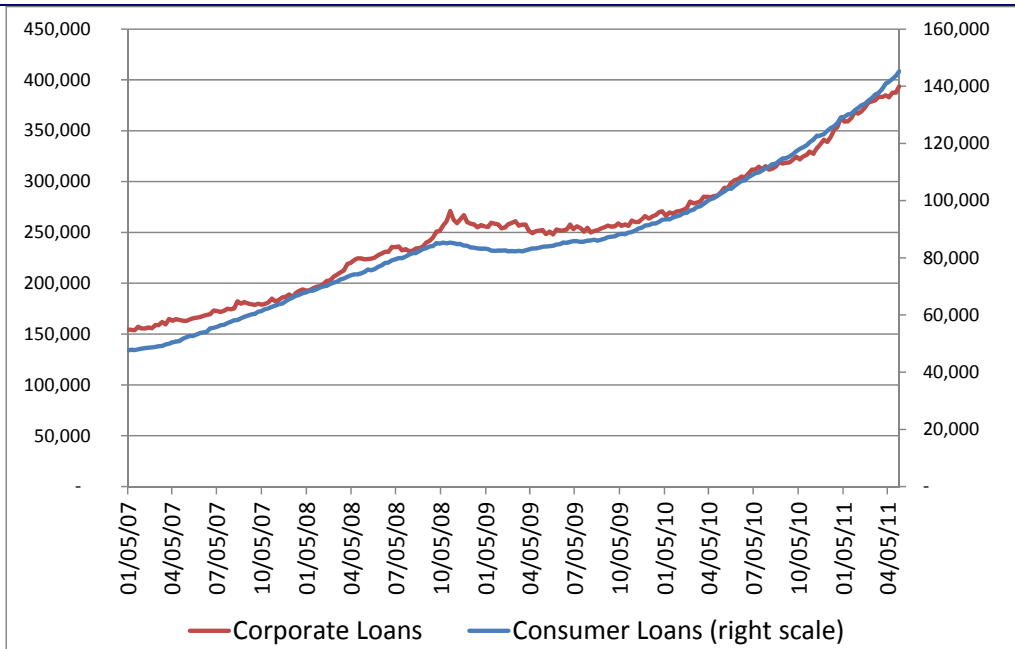
The issue of cyclically adjusted fiscal balances is crucial regardless of whether one believes fiscal balances have a discernible impact on current account dynamics. In all likelihood, filtering for cyclical behavior is a bit trickier than it seems at first sight due to the importance of the assumptions or underlying premises one takes as given or yet better estimates at the outset. We intend to have a separate piece on this and plan to circulate it as soon as possible for readers who have confidence in our methodologies.

The difficulty of the mechanism design in the Turkish case seems to be that private sector restraints are being introduced on the supply side, on the financial sector in particular, with policy makers trying to impose the burden more on the quantity front than on the price front. It also has to be noted that this experiment is a luxury one can indulge in provided that overheating/wage pressures/demand side inflation concerns are not your imposing agenda items. Once the scene changes, price adjustments become inevitable. The CBRT strategy seems to be to make the most of the time until such pressures exert themselves. Where we differ from most of the market is with respect to the inference that such a state of affairs already rules in Turkey. We say “not yet” if data is interpreted prudently and if solid research with sound methodologies into the investigation of these issues is the path taken in search of the answer.

1.3 Weekly Data (all weekly data terminate on April 29, 2010 while consumer credits are one extra week updated)

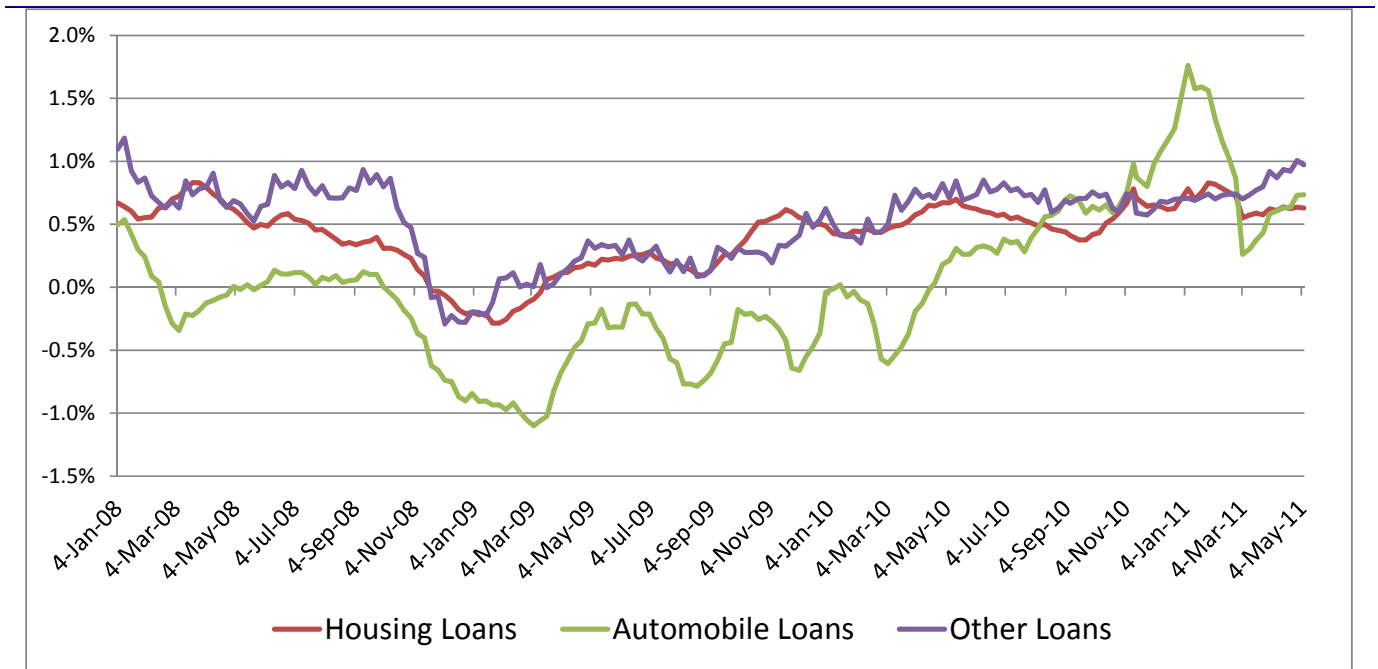
Consumer credits displayed a subpar performance relative to its heyday performances and 8-week moving average growth chart depicts a loss of momentum in housing and auto loans while other loans category will probably follow suit with some lag. Corporate credits continue to be obnoxiously volatile, but the YoY increase has sailed south to 33% levels from 35% plus a few weeks ago. We do believe that the current 42.1% YoY increase in consumer loans and the 33.9% YoY increase in corporate loans will be tamed discernibly in the second half of the year. One probably will not find many banks exceeding the ad hoc limit of 25% imposed by policy makers when the package was first announced.

Consumer/Commercial Credits - Levels



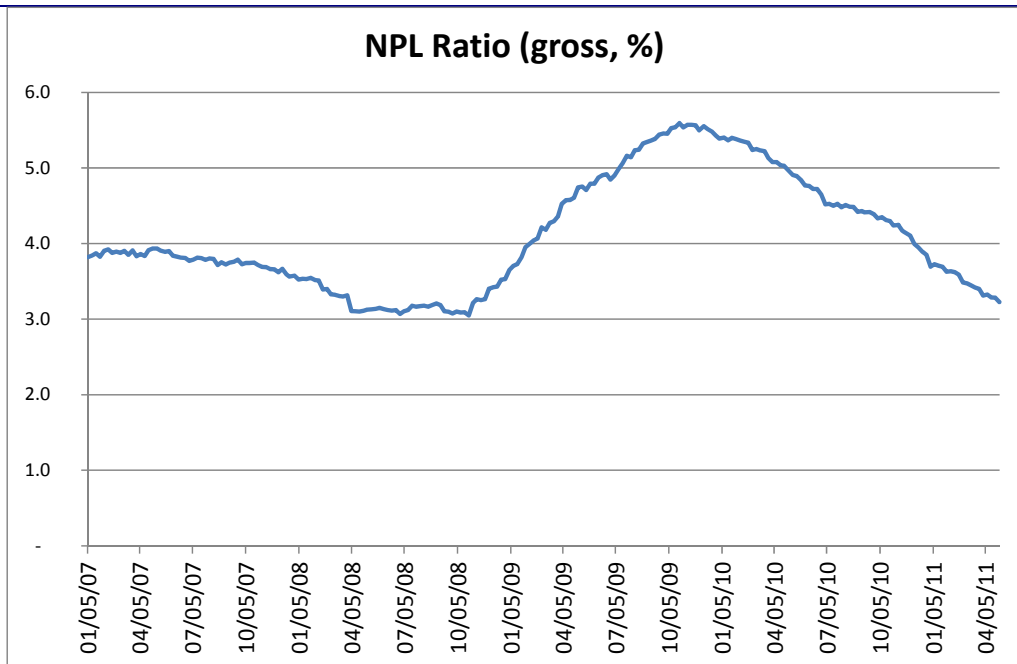
Source: Central Bank of Turkey, Yapı Kredi Economic Research

Consumer Credit Volume (*)



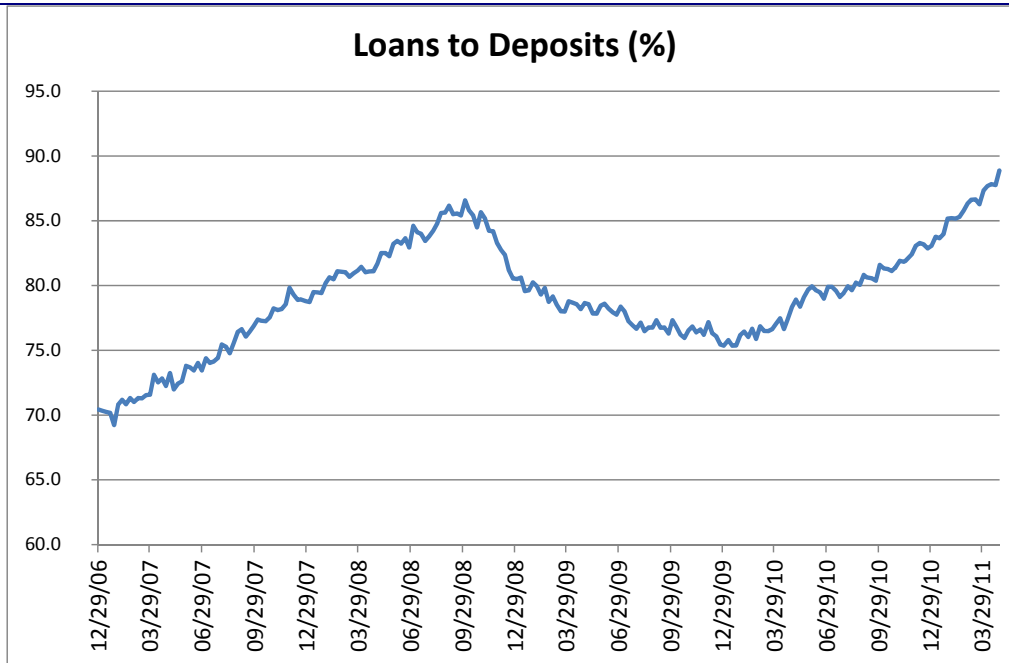
Source: Central Bank of Turkey, Yapı Kredi Economic Research
 (*)Weekly % change of 8W average

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 Wheel of Samsara

“To set earnestly about the task of building a new (truly solid!) order, it was necessary to get rid of the ballast with which the old order burdened the builders. 'Melting the solids' meant first and foremost shedding the 'irrelevant' obligations standing in the way of rational calculation of effects; as Max Weber put it, liberating business enterprise from the shackles of the family-household duties and from the dense tissue of ethical obligations; or, as Thomas Carlyle would have it, leaving solely the 'cash nexus' of the many bonds underlying human mutuality and mutual responsibilities. By the same token, that kind of 'melting the solids' left the whole complex network of social relations unstuck - bare, unprotected, unarmed and exposed, impotent to resist the business-inspired rules of action and business-shaped criteria of rationality, let alone to compete with them effectively.”

Zygmunt Bauman, “Liquid Modernity”

“A financial crisis is surely going to happen as big or bigger than the one we had in 2008 if we continue to behave the way we're behaving,”

Stanley Druckenmiller, The Wall Street Journal (The Weekend Interview May 14, 2011)

Almost all of us are influenced to a degree by our biases and we don't think much about the broader background in which economic and financial activity occurs. We just assume that somehow all changes are marginal. It is part of our marginalist mindset. However, there's a gap between our psychological attitudes, mental processes and the complexity and inherent uncertainty of the real world.

Views do not to be binary and pooled in viewpoints (polarized between bears and bulls). Most of our views are probably driven out of a (known or unknown) bias in the first place. Perhaps the truth is...no one has a clue. Even the current sell off is either believed or not believed, but certainly not predicted by many.

Thich Nhat Hanh (Vietnamese Buddhist monk, and a peace activist who Martin Luther King, Jr. nominated for the Nobel Peace Prize in 1967) prays that we may all escape the wheel of Samsara, our addiction to nefarious vicious circles.

As long as things continue to go up we think its all working. They say, “It's working now, lets keep it this way until there's a visible problem.” But I continue to think we need to have alternative plans/scenarios and be willing to think the unthinkable.

It is relatively easy to assume that Turkish domestic demand is overheating. However, we'd like to remind you that the MPC's real aggressive reserve requirement hikes came into effect during 1-15 April. Thus, it might not be the best idea to look for signs of a slow down in domestic demand growth in the March C/A data. More timely data (i.e. weekly credit data) more useful, rather than the lagging current account deficit figures. Loyal readers of Yapi Kredi research and our Chief Economist Cevdet Akcay's, Can Aslak and Eren Ocakverdi's pieces probably know where we stand on these issues.

It's worth bearing in mind, the broader macro backdrop, then specifics and the direction of change (or so called second derivatives) in markets. Yes backward looking economic data gives heart to the monetary and fiscal hawks but going aggressively hawkish could pave the way for a potential policy mistake, in the form of austerity at the wrong point in the cycle.

We have to be willing to look at things from a different perspective. The seemingly obvious dynamics could be interpreted in a completely different way. Unemployment remains relatively high, capacity utilization rates

relatively low and bank lending will come under further pressure. These – particularly the latter– may have important implications going forward.

Seemingly contrary to market consensus, our macro view remains that the underlying pressures in the economy are not conducive to demand led inflation. Thus, we do not think that the Turkish economy is overheating and the latest data releases suggest that the growth momentum is losing its strength.

As a tangent, the current economic situation also raises an important question: Why, given all this so called “loose money”, have payrolls, real wages and CPI not responded more as would be expected in an “overheating” economy?

It's a question that raises other questions, not many are asking. Could it be that the financial system's increasing concentration on mortgage and consumer debt is adding to different dynamics (i.e. a self-reinforcing housing dynamic?). Does history suggest that there could be longer-term financial and economic consequences for a system that creates and directs disproportionate money (and "profits") to the likes of aggressive lenders and at the expense of traditional prudent lenders and goods manufacturers.

Furthermore, could group behavior and performance anxiety be leading to a condition where pricing signals get distorted and asset price inflations (which may sowing the seeds of oversupply and deflation in the future) become barely noticed amid low and stable consumer prices (ala “Austrian” analysis)? Should we not start to weigh the direction of real estate more highly in our assessment of where the economy and markets are heading? Did you know that, according to TurkStat data, nationwide house sales in 2010 have contracted by around 33% yoy to around 357thousand, a level even lower than 2008's 427thousand?

I believe there are clear signs of demand destruction in some countries around the world causing social unrest etc, not too dissimilar to 2007/08. When, commodity prices “super spiked” in 2007/2008, it hit some of the “weakest links” first and the US subprime homeowner especially heavily. Their already limited free income was squeezed further.

The one thing I think we know is that most policymakers will not want to be seen as tolerating asset price deflation because of the impact it will have on balance sheets and the ability and willingness to take on more risks (animal spirits). On the other hand, thanks to harsh criticism by hawks of current policy and the bad side effects (rising commodity prices) the hurdle for further easing is now quite high. This is setting up a big macro trap, in my view. Thus, I think deflationary forces could gain further momentum and depending on the policy response stagflation is now more possible (broadly speaking stagnation in the developed world and a slowdown in most EM amid stick headline inflation).

From a market perspective, as we have been arguing for quite some time, the current narrative of overheating is likely to disappear and be replaced by the “reality” of a slowdown amid sticky headline inflation. Then, “perceptions” and sentiment can this time undershoot and lead to a dramatic slow down/stagnation narrative, which would have implications for markets.

DISCLAIMER

All information enclosed in this e-mail and document has been obtained from sources believed to be reliable and accurate but which without further investigation cannot be warranted as to their accuracy or completeness. There may also appear opinions which are of non-factual nature and subject to change without notice for which Yapı Kredi Yatırım Menkul Değerler A.Ş. cannot be held responsible. This document and its contents are provided solely for the recipient(s), who is/are expected to make their own investment decisions without undue reliance on any information contained in this e-mail. In no circumstances should any information contained herein be used or considered as an offer to sell or a solicitation of any offer to buy the securities or commodities mentioned. Any of the directors, officers or employees of Yapı Kredi Yatırım Menkul Değerler A.Ş. or of their affiliates may serve as a director for companies mentioned in this document. From time to time, Yapı Kredi Yatırım Menkul Değerler A.Ş. and any of its directors, officers, employees or representatives, directly or indirectly, may have positions or otherwise be interested in any transactions, in any securities, or in any commodities mentioned. The views and opinions expressed in this document belong to the members of the Research Team of Yapı Kredi Yatırım Menkul Değerler A.Ş. and do not represent views and opinions of the Yapı Kredi Yatırım Menkul Değerler A.Ş. management. It is possible that individuals employed by Yapı Kredi Yatırım Menkul Değerler A.Ş. elsewhere or affiliates of Yapı Kredi Yatırım Menkul Değerler A.Ş. may disagree with the recommendations or opinions in this document. Yapı Kredi Yatırım Menkul Değerler A.Ş. or their affiliates may, from time to time, perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this document. This document is for the use of addressees only. It may not be copied or distributed to any other persons without the written consent of Yapı Kredi Yatırım Menkul Değerler A.Ş.