

TURKEY

Livin' On A Prayer?

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Executive Summary

Turkey grew by a much faster than expected 8.9% in 2010, as post-crisis rebound combined with ample external financing and expansionary fiscal and monetary policies. The key side effect, as it always is, was a rapidly widening CAD, which ended the year at a record-high 6.6% of GDP. Naturally, the key question of Turkish macroeconomics is, where do we go from here or how the CAD adjustment will play out on the way.

Unfortunately, there are no easy answers. The lira has weakened by around 10% against the basket since the Central Bank introduced its new policy mix in December, but the economy, and tied to that import demand, remained strong through February, growing at a rate double that of exports. While this wedge is likely to narrow in the coming months, that alone can't stabilize the CAD, which has likely reached a 12-month rolling \$55 billion, in February.

Tighter policies are called for, but with little over two months left before the general elections (on June 12), rate hikes and/or counter-cyclical fiscal policy are unrealistic to expect. The new monetary policy mix has been ineffective curbing credit growth thus far, but the latest aggressive hike in required reserve ratios should start to slow credit growth somewhat. Yet, its ultimate success remains in doubt, despite all the mayhem it has created in the markets. On fiscal policy, the central government registered improvement during the first two months of the year, but let us not forget, that is coming from an awfully weak December base. Moreover, the IMF-defined primary balance is barely in positive territory, despite the economy -- and the attendant revenue growth -- being turbo-charged. True, public debt dynamics look solid, but an unsustainable CAD outlook and an above-target inflation forecast call for a much tighter fiscal policy and expenditure curbs.

A difficult global and regional backdrop combined with Turkey's own challenges, like a huge CAD financed by low quality inflows, makes 2011 outlook "unusually uncertain", compelling us to work with an admittedly dull "muddle through" scenario, but without ruling out bouts of market volatility down the road. Our 2011 baseline hence entails growth slowing to around 5%-5.5% -- with a strong first half followed by a cooler second half -- coupled with a CAD heading, *ex ante*, to 8% of GDP. We see inflation edging up from March/April onward, ending the year at around 7.5%, markedly above the 5.5% target as well as the CBT's latest forecast of 5.9%.

The rating outlook is uncertain, but should the global environment remain supportive and the CAD show signs of stabilization, we wouldn't be surprised to see Turkey upgraded to investment grade awhile after the elections.

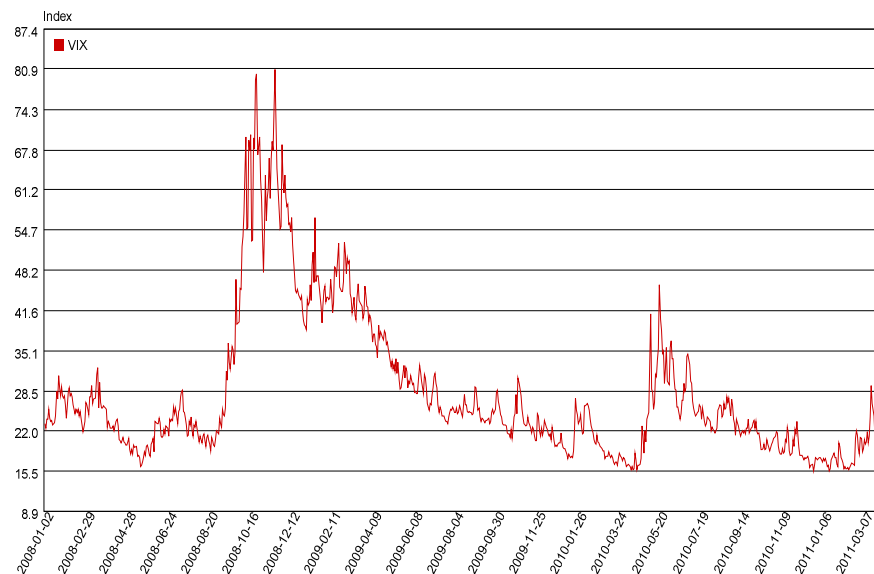
Assumptions

The global environment has deteriorated quite substantially since our latest Quarterly of December 24th, because of several unforeseen events, like the eruption of unrest in MENA and a devastating earthquake in Japan.

But the impact on the global risk appetite has remained relatively muted (Graph 1). EM rally appears to have lost steam, but we assume, as before, that the asset class will continue to do well, as the relatively low interest rate environment in advanced economies combines with more secular factors, like higher growth prospects in EMs. While the ride may not be as smooth as it was last year, this is a key assumption behind our generally constructive view on the Turkish economic outlook that is sketched out below.

GRAPH 1

CBOE Volatility Index (VIX)



The euro/dollar cross-rate, which influences our end-year TL/\$ forecast, has significantly moved in euro's favor, though we stick to our earlier assumption that it should end the year at around 1.35, mainly because we humbly think EU's sovereign risk troubles have been mispriced thus far in the year.

Strong global demand combined with supply-side risks, stemming from the turbulent politics of the MENA region, should not allow a marked softening of oil prices from the current \$110-\$115 p/b range. This is some \$10-\$15 p/b higher from our previous assumption, which has the impact of raising Turkey's net energy import bill to an all-time high of \$45-\$50 billion range.

Another assumption concerns Turkey's prospects for achieving an investment grade rating. Turkey's sovereign ratings and outlook have not changed since our last report (Table 1). As before, we maintain that the case for an upgrade is not overwhelming mainly because of the vulnerability of Turkey's "external savings-dependent growth model", which has become all the more apparent in recent months. Yet, Turkey could be upgraded to investment grade by Fitch after the elections, perhaps followed by other agencies later in the year, should Turkey's CAD start to stabilize and the global environment remain supportive.

TABLE 1
Long Term Foreign Currency Rating

	Rating	Date	Outlook	Date	Previous Rating	Date
S&P	BB	Feb-10	Positive	Feb-10	BB-	Aug-04
Fitch	BB+	Dec-09	Positive	Nov-10	BB-	Jan-05
Moody's	Ba2	Jan-10	Positive	Oct-10	Ba3	Dec-05

Source: Rating agencies' web sites.

In the next section, we provide our baseline and alternative scenarios on the political side. Table 2 presents our forecast summary, while the remainder of the report lays out the details of our macro forecasts through 2011.

TABLE 2
Macro Framework: 2008-11

	2008	2009	GlobalSource		MTP	
			2010e	2011f	2010e	2011f
Growth (GDP; %)	0.7	-4.8	8.9	5.4	6.8	4.5
GDP (YTL; bn.)	951	953	1105	1235	1099	1215
GDP (\$; bn.)	733	614	736	773	730	781
CPI Inflation (%)						
Avg.	10.4	6.3	8.6	6.0	...	...
EoP	10.1	6.5	6.4	7.6	7.5	5.3
Central Government Budget (YTL bn; MoF def)	-17.4	-52.8	-39.6	-33.5	-44.2	-33.5
as % of GDP	-1.8	-5.5	-3.6	-2.7	-4.0	-2.8
o/w: Primary Balance (as % of GDP)	3.5	0.1	0.8	1.1	0.5	1.2
Central Government Debt (as % of GDP)						
Domestic	40.0	46.4	42.8	41.7	42.3	40.6 1/
External	28.9	34.6	31.9	...	...	...
Current Account Balance (\$ bn)	-42.0	-14.0	-48.6	-62.8	-39.3	-42.2
as % of GDP	-5.7	-2.3	-6.6	-8.1	-5.4	-5.4
Trade Balance (TURKSTAT definition; \$ bn)	-69.9	-38.8	-71.6	-91.0	-65.8	-72.5
Exchange Rate (TL/\$)						
Avg.	1.296	1.551	1.502	1.598	1.505	1.556
EoP (December)	1.525	1.491	1.541	1.655	...	...
%	31.2	-2.2	3.4	7.4	...	...
Real Effective Exchange Rate (2003=100)						
EoP	114.7	116.6	125.9	123.6	...	...
% (up means appreciation)	-12.4	1.7	8.0	-1.9	...	...
Interest Rate (compounded; %)						
EoP (December)	16.5	8.9	7.1	9.5	...	...
Real Interest Rate (compounded eop; ex-post %)	5.8	2.2	0.6	1.8	...	...
Central Bank O/N (EoP; simple; %) ^{2/}	15.00	6.50	6.50	7.00	...	...

Source: CBT, MoF, Treasury, TURKSTAT, our calculations and projections. e= estimate, f= forecast.

1/ EU-defined

2/ One week repo rate for 2010 and 2011.

The Political Outlook

The baseline politics scenario, with 80% probability, is a very low risk environment until after the elections. With roughly 2 months left to general elections, AKP's poll lead is insurmountable. The party averages 47% support, compared to CHP's 26% and MHP's 12%. The bets focus on how many seats AKP will secure, and whether MHP will exceed the 10% national hurdle to qualify for parliament. The current prediction is AKP securing 315-335 seats, as MHP scrapes through. The downside scenarios summarized below would alter the number of AKP's seats, but not the baseline scenario conclusion of a third victory for the party.

Looking beyond a near-certain election victory, risks could increase to moderate, if AKP fails to produce 367 deputies. After the elections, the first order of business will be a brand new constitution, which can no longer be delayed, because Turkey's two large underprivileged groups, namely Kurds and Alevites, are very restive. If AKP fails to produce 367 seats, it will have to negotiate with the opposition to draft the constitution, or resort to a referendum. Both processes are time-consuming and divisive. Furthermore, with a soaring CAD and inflation potentially rekindled by higher oil prices and base effects (see below), the new parliament needs to attend to fiscal and monetary tightening, not to mention long-overdue structural reforms to underpin strong growth. A lengthy constitutional quarrel could detract attention from the required economic measures.

As such, the main upside to the baseline scenario would be a sweeping AKP victory, which would allow it to sort out the new constitution in-house and quickly, in order to focus on the challenges of the economy subsequently. The primary downside is the broadening civil disobedience campaign engineered by Kurdish-ethnicist BDP, which is gradually spreading to Western cities. In the eventuality of its success, it could attract Kurds who traditionally vote for AKP, costing the party a margin of victory. In the past, large-scale Kurdish protests have revived fears of secessionism among the majority Turks who tended to migrate to nationalist MHP as an insurance policy. With CHP receiving few Kurdish or nationalist votes, the civil disobedience campaign essentially shifts votes from AKP to BDP and MHP. Yet, the magnitude of these shifts is very unlikely to rob AKP off a majority.

The turmoil in MENA, which has spread to Syria and Iraq, is actually an uncertainty. It is very hard to model how even the most adverse developments would impact voter choices, or long-term political stability. We can only provide some examples. For instance, PM Erdogan fears refugees from Syria, if a civil war erupts. The Kurdish rights movements in Syria, Iraq and Turkey could merge, fostering a pan-Kurdish uprising, too. Finally, the collapse of the regional government in northern Iraq could embolden PKK to escalate terror attacks in Turkey.

All this being said, substantial negative contagion in the short-term is a low probability event, with Turkey standing a better chance of exploiting the shake-down in the region, if it succeeds in moving ahead with its own Kurdish and Alevite reforms at home.

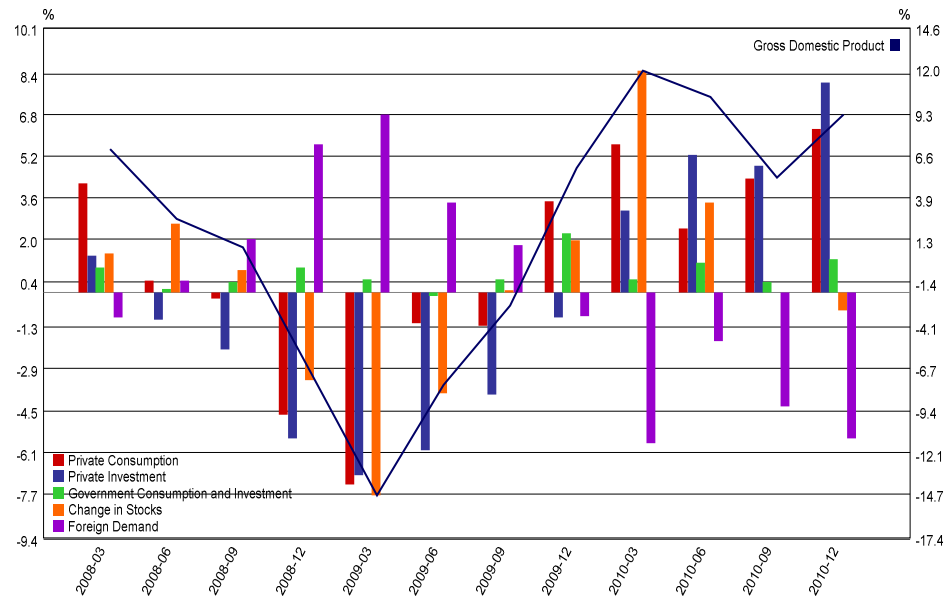
Growth and Employment

The Turkish economy grew by a stronger than expected 9.2% in Q4, bringing GDP growth for the year as a whole to 8.9% after a 4.8% shrinkage a year earlier. But the composition of growth – in the sense of relative contributions of domestic and foreign demand -- remains grossly unbalanced, even more so than in Q3 (Graph 2). Specifically, domestic demand (excluding stocks) contributed over 15 pp to growth, driven by a surge in private investment (49.5%, y/y), while foreign demand (net exports) trimmed some 5.6 pp off growth. Considering that these figures were some 9.6 pp and 4.3 pp, respectively, in the previous quarter, growth has become more unbalanced – and therefore less sustainable -- in Q4.

GRAPH 2

Sources of Growth: Exp. Side (as % of previous year's GDP)

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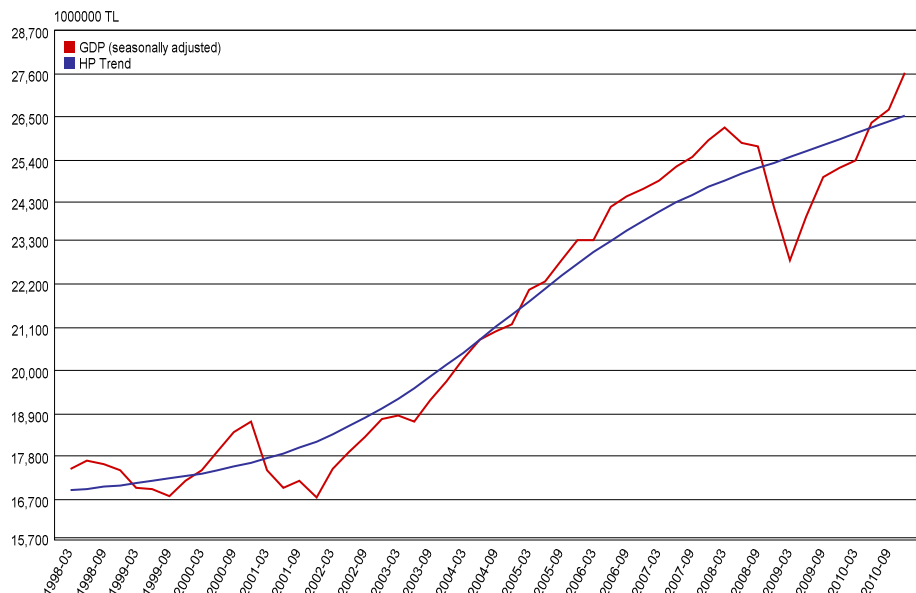


Most striking was the whopping 3.6% jump in seasonally- and working day-adjusted GDP, q/q, which pointed to a substantially stronger quarter than in Q3 (1.2%). While this series tends to be very volatile, it does not change the fact that GDP is now some 6%-7% above its pre-crisis peak, while the economy seems to be trending above its long-term growth path, the latter measured by the simple HP-filter (Graph 3).

GRAPH 3

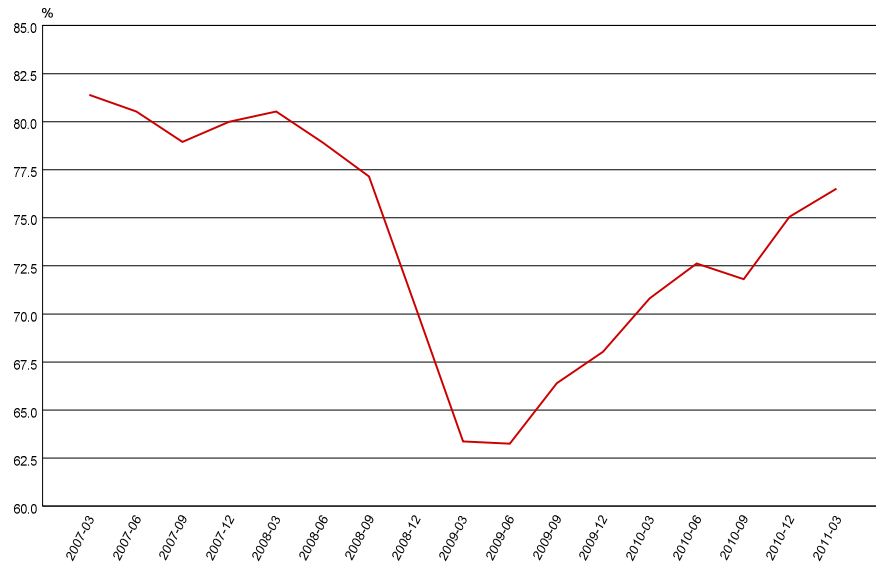
Output Gap (million TL)

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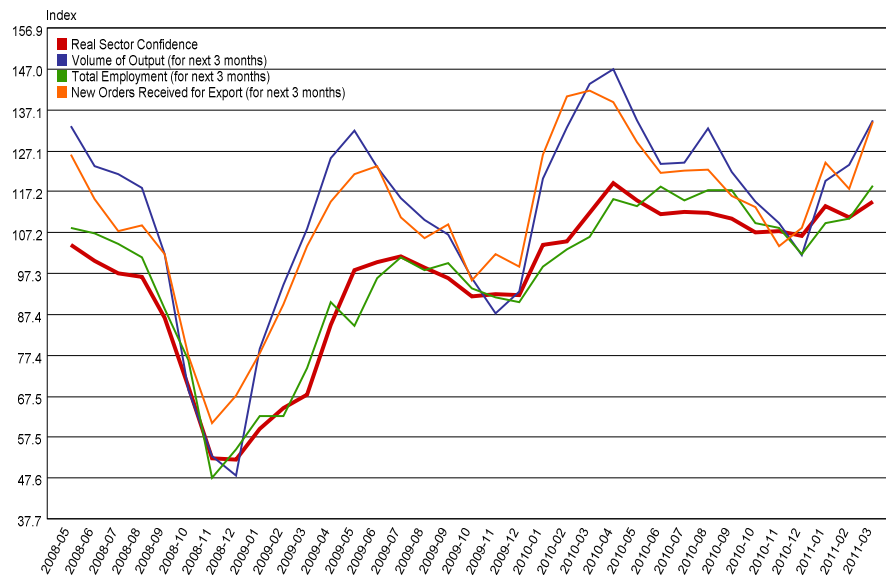


Although preliminary, with only a few indicators available through February-March, a host of growth indicators suggests that the economy remained strong through Q1 of this year. For instance, capacity utilization ratio in Q1 was above the previous quarter, while confidence indices point to strength not only in this quarter, but also for the period ahead (Graphs 4-5). Industrial production also had a strong start to the quarter, expanding by close to 20%, y/y, in January.

GRAPH 4
Capacity Utilization Rate: Seasonally Adjusted



GRAPH 5
Real Sector Confidence Index



With “carry-over growth” already running at above 4% -- i.e., the growth rate we would get assuming GDP stays at the Q4 level (in WDSA terms) throughout this year -- we think growth on the order of 5%-5.5% is highly likely in 2011 in the absence of a major accident, as a strong H1 gives way to relative slowdown in H2.

On technical grounds, inventory restocking should be broadly complete giving little push to growth, if any; government spending should remain modest during the course of the year, and there should be a moderate contribution from foreign demand, given our current account “adjustment” scenario, with export volumes growing somewhat faster than import volumes (see below). Growth will thus be driven by strength of private consumption and investment, though they should also slow substantially after the 2009/2010 pent-up demand is spent (Table 3).

Contrary to our expectations, employment has picked up considerably late last year, thanks to stronger than envisaged growth. As a result, the unemployment rate (UR) decelerated further to 11% in December (Nov.-Jan. average), from 11.2% a month earlier (Graphs 6-7). This favorable development notwithstanding, the composition of job growth tends to be tilted primarily toward agriculture and low productivity service jobs. While the former continues to puzzle us (and most observers), the latter seems to be driven by government policy. All in all, a working assumption of UR stabilizing at around 11%, some 1 pp higher than the pre-crisis level, looks plausible to us.

TABLE 3
Growth Components: 2007-11
(annual; %)

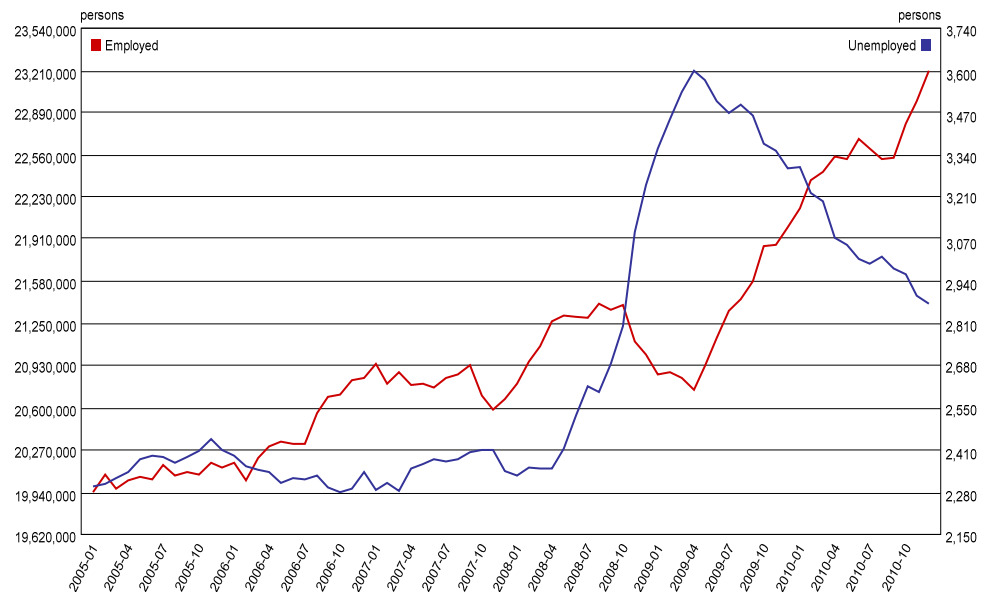
	2007	2008	2009	2010	2011 (f)
Domestic Demand 1/	<u>5.2</u>	<u>-1.6</u>	<u>-5.3</u>	<u>10.9</u>	<u>4.5</u>
Consumption	<u>5.6</u>	<u>-0.1</u>	<u>-1.0</u>	<u>5.9</u>	<u>2.9</u>
Private	5.5	-0.3	-2.3	6.6	3.0
Public	6.5	1.7	7.8	2.0	2.0
Gross Fixed Capital Formation	<u>3.1</u>	<u>-6.2</u>	<u>-19.0</u>	<u>29.9</u>	<u>9.3</u>
Public	6.3	12.7	-0.6	15.1	6.0
Private	2.6	-9.0	-22.5	33.5	10.0
Change in Stocks 1/	0.6	0.3	-2.3	2.5	0.5
Foreign Demand 1/	<u>-1.2</u>	<u>1.9</u>	<u>2.7</u>	<u>-4.4</u>	<u>0.4</u>
Exports	7.3	2.7	-5.0	3.4	14.8
Imports	10.7	-4.1	-14.3	20.7	11.2
GDP	4.7	0.7	-4.8	8.9	5.4

Source: TURKSTAT, our calculations.

1/ Contributions to GDP growth.

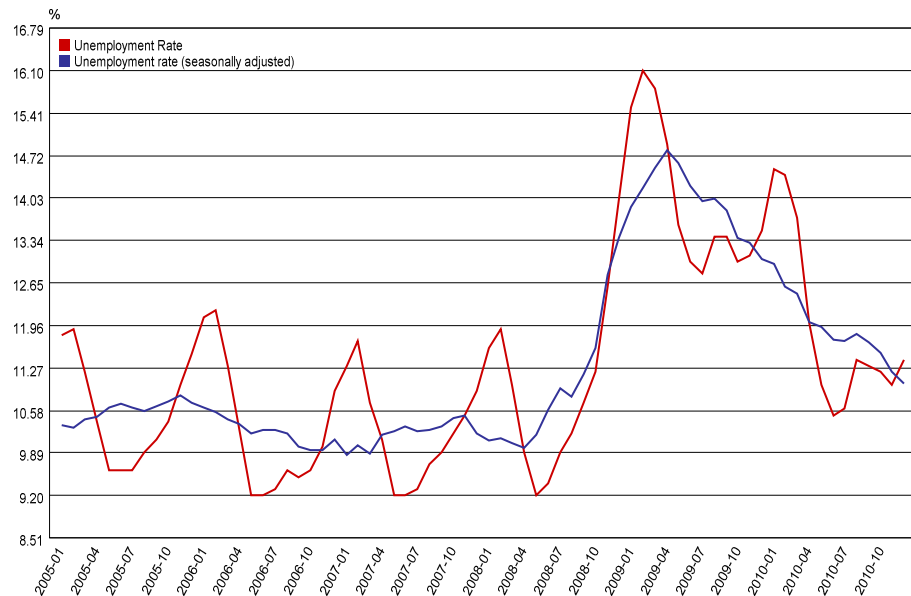
GRAPH 6

Civilian Labor Force Statistics: Seasonally Adjusted (persons)



GRAPH 7

Unemployment Rate (%)

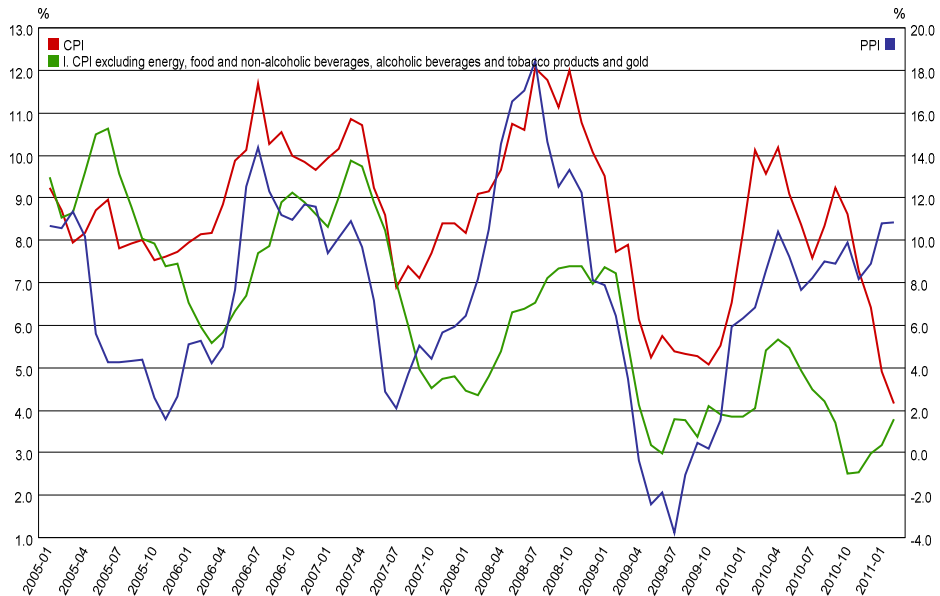


Inflation and Monetary Policy

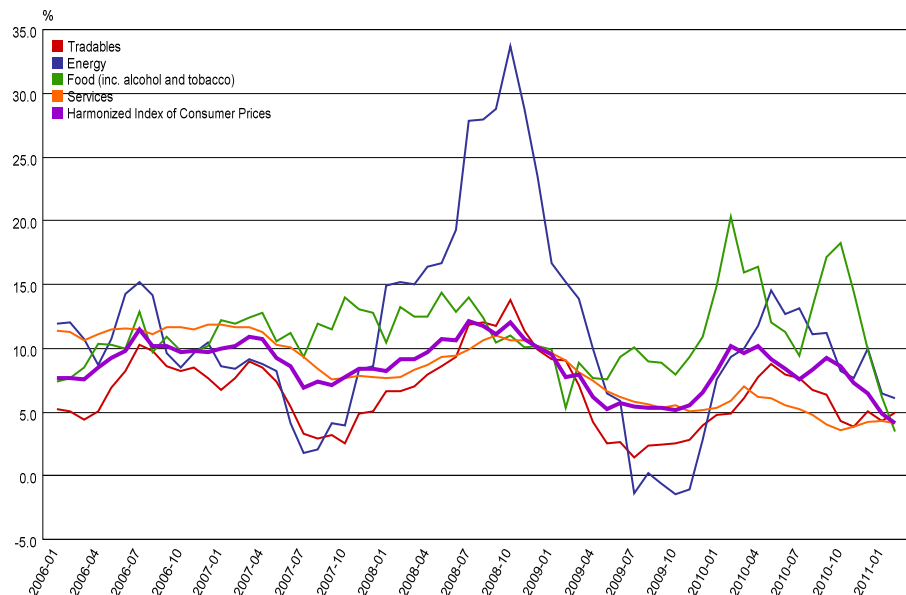
The divergent paths of the three main price indices – CPI, Core CPI (the so-called I-index) and PPI – have been the most interesting feature of recent inflation developments. PPI inflation, reflecting adverse shocks like the lira weakness and higher energy prices, had risen quite sharply through February to over 10%; CPI inflation had decelerated to 4.2%, thanks to favorable base effects resulting from food and previous year’s tobacco price adjustments; and core inflation, which excludes, among others, the latter two components of the CPI, had started to edge up toward 4% (Graph 8).

Going forward, this divergence is unlikely to persist: some of the PPI inflation should continue to be echoed in core and headline CPI numbers, as price-setters regain some pricing power thanks to a strong economy, while energy and food prices resume an upward trend. Simple bottom-up forecasts based on detailed CPI components or more aggregate categories (like food, energy, tradables, and services; Graph 9) confirm that the best is most probably behind us: CPI-inflation should start to turn up from March onward, hovering in the 6.5%-7% range during the summer months, before ending the year at around 7.5% -- notably higher than the Bank's current forecast of 5.9% (though a slight upward revision in the Bank's April Inflation Report is likely).

GRAPH 8
Inflation Indicators (yoy, %)

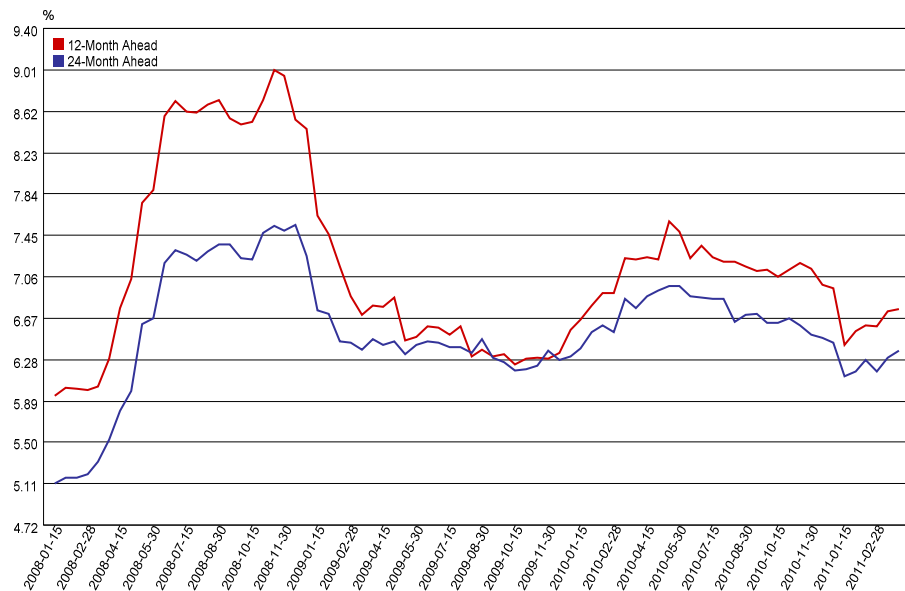


GRAPH 9
EU Harmonized CPI: Components (y/y, %)



More importantly, and leaving aside the cyclical volatility in the series, we do not see *trend* inflation decelerating to the medium-term target of 5%, mainly because: 1) the standard “right hand side” factors like the output gap, are unlikely to help; and 2) the price-setting behavior in the economy has yet to be attuned to an inflation rate in the 4%-5% range. Anecdotal and otherwise, evidence seems to confirm our skepticism on the latter, top of the list being inflation expectations, which remain sticky, particularly on longer horizons (Graph 10). That, in turn, is not too surprising, given history -- that historically inflation has been a lot higher in the past several years (above 8%, to be specific) -- and the Central Bank’s dovish (and highly asymmetric) track record, of being tolerant about upward deviations of actual inflation from target inflation.

GRAPH 10
Inflation Expectations (%)



How would the MPC react to the inflation scenario sketched out above, were it to materialize? Herein lies our conundrum. Our preposition regarding the Central Bank’s new policy mix – that it would have limited effectiveness – has been more or less validated thus far, mainly because, as we had conjectured then, liquidity was provided on demand through the repo window in order to prevent money market rates materially diverging from the policy rate (Graph 11), while banks did not increase loan rates in any significant way, but kept loan growth elevated (see our Quarterly of December 24th).

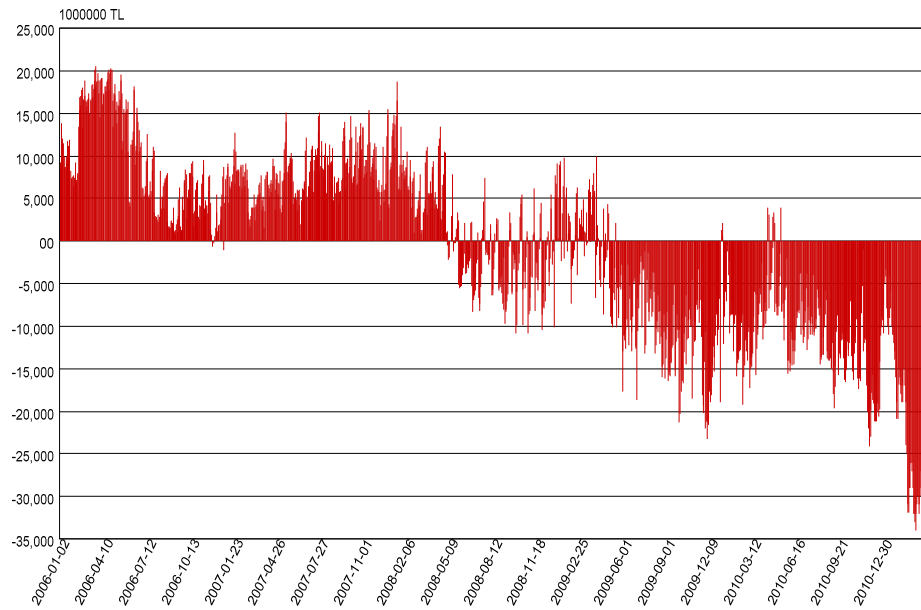
Hence, the future course of monetary policy is no less uncertain than before. The latest aggressive and largely unanticipated hike in the required reserve ratios (RRRs) on shorter maturity saving vehicles -- while leaving the policy rate unchanged at 6.25% -- has moved the ongoing “game of chicken”, up a level (Graphs 12-13).

In the meantime, “moral suasion” on banks has intensified, escalating the tensions between the policy-makers in Ankara and the banking sector executives. One vivid illustration of things not going too well – or that the Bank’s approach has created unnecessary mayhem -- has been the disproportionate drop in bank stocks, which reduced the valuation of ISE-listed banks by over TL30 billion, against the prospect of (relatively manageable) P&L losses stemming from higher RRRs, estimated by most bank analysts at around TL4 billion.

GRAPH 11

Open Market Operations (million TL)

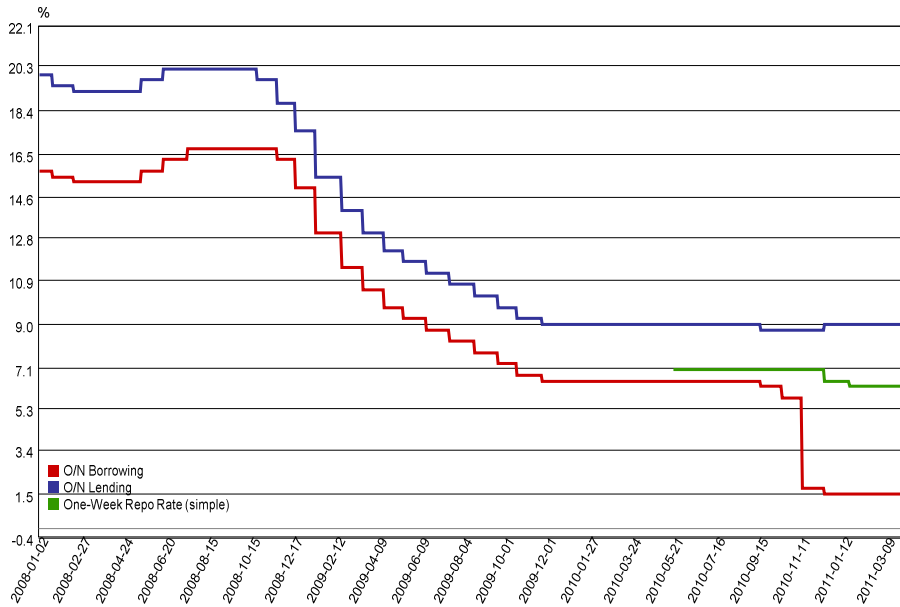
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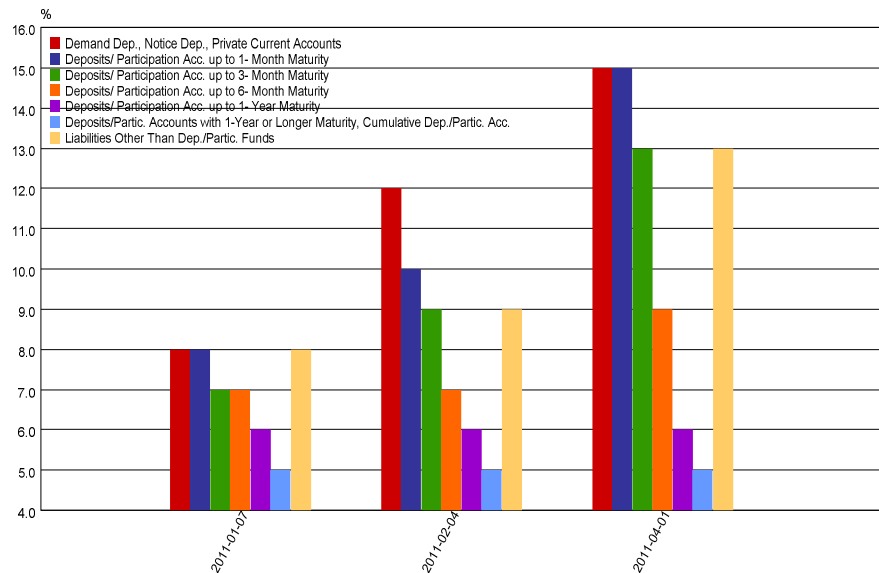
GRAPH 12

CBRT Policy and O/N Rates (%)

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GRAPH 13
Required Reserve Ratios



Without going into lengthy normative discussions as to the rights and wrongs of the CBT policy, what could be said on the Bank's future course of action, or simply put, where do we go from here in terms of monetary policy?

We think 3 scenarios are most pertinent:

In one scenario, where the current policy mix of higher RRRs-cum-stepped up moral suasion succeeds in curbing credit growth and slowing the widening in CAD, the Bank could try to delay rate hikes until late this year/early next, limiting its actions to a few further adjustments to the RRRs in the meantime.

An alternative scenario is one in which the policy mix continues to have limited effectiveness, compelling the Bank to restore order and its own credibility, by hiking rates starting in the summer months.

In a final scenario, which would, by definition, mean more market volatility than under the other two scenarios, some external trigger would combine with markets' uneasiness over the Bank's new policy mix, leading to a sharp sell-off. The Bank would, again, be compelled to react by raising policy rates, but perhaps more aggressively than in the previous scenario.

While we find the first scenario most likely, we would also assign significant probabilities to the other two – hence the confusion.

Fiscal Policy and Public Debt

Fiscal policy began to tighten in the first two months of the year, but that is from a very weak December base and largely on the back of strong revenue growth (Table 4; Graph 14). While it would not be surprising to see this "cyclical" improvement continue in the coming months, which is admittedly what the markets would be focusing on, a number of caveats should be made on the government's fiscal stance, which essentially boil down to the following: it is not as strong as the headline numbers suggest, and is prone to sudden reversals.

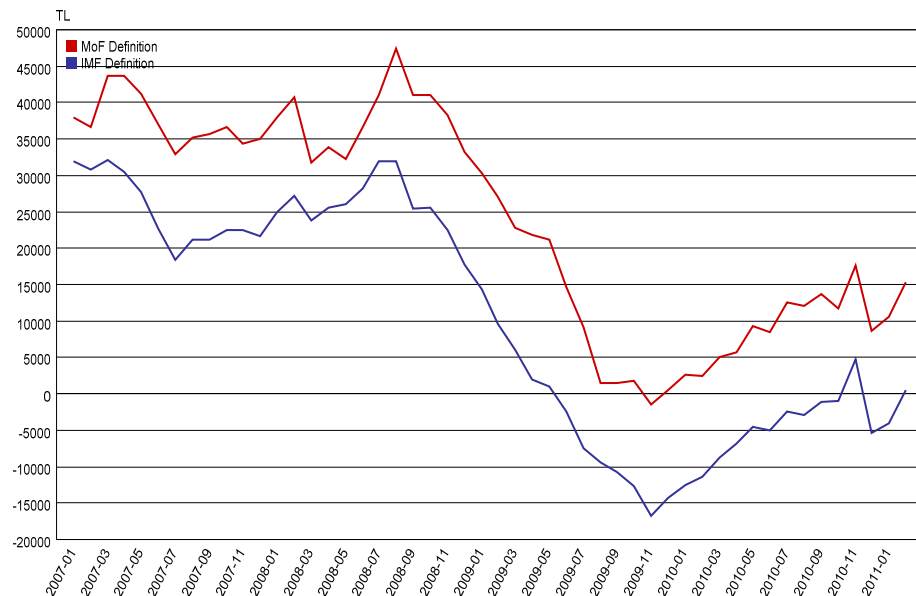
TABLE 4
Central Government Budget: 2010-2011
(in billion TL)

	Jan-Feb		Real growth (%)	% of Budget	2011 Budget
	2011	2010			
Central Government Revenues	48.1	39.5	16.3	17.2	279.0
o/w: General Budget Revenues	46.4	38.1	16.2	17.1	271.6
Tax Revenues	40.9	33.4	16.9	17.6	232.2
o/w: Tax on Income	13.1	10.3	21.8	18.6	70.5
Income Tax	6.8	6.0	9.7	14.4	47.3
Corporation Tax	6.3	4.3	38.5	27.2	23.1
Tax on Goods and Services	16.2	13.5	14.4	16.7	97.2
o/w: VAT	5.7	4.0	37.1	21.1	26.8
SCT	9.0	8.2	5.3	14.7	61.1
Tax on Foreign Trade	6.6	5.4	16.6	14.8	44.8
Non-Tax Revenues	5.5	4.7	11.7	11.7	46.8
Expenditures	46.1	44.9	-1.9	14.7	312.6
Non-Interest Expenditures	36.1	34.3	0.7	13.6	265.1
o/w: Personnel (inc. soc. sec. premiums)	15.4	13.1	11.8	21.2	72.3
Current Transfers	17.0	17.9	-9.0	14.7	115.8
o/w: Social Security	9.7	9.6	-3.2	15.2	64.0
Local Administrations	3.8	3.4	6.0	16.0	23.7
Investment	0.6	0.4	51.5	2.8	21.7
Interest Expenditures	10.0	10.7	-10.5	21.0	47.5
Overall Balance	2.0	-5.4	...	-5.9	-33.5
Primary Balance	12.0	5.3	...	85.8	14.0

Source: Ministry of Finance, GlobalSource.

GRAPH 14
Central Government Primary Balance (million TL, 12-month rolling)

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First, the 2010 performance as a whole was weak, once an adjustment is made for the cycle, i.e. after the economy's strength in 2010 is taken into account. To recall, our estimates suggest that last year, fiscal stimulus – which we measure as the gap between the actual and the counter-factual primary balances -- was close to 2% of GDP, at par with 2009. This was a factor contributing to the dramatic widening in the CAD, in our view.

Second, the IMF-defined primary balance was barely in positive territory in February, according to latest fiscal data we have, despite a very strong economy. This points to a lot weaker “structural” fiscal stance now, than in the pre-crisis period (see Graph 14 above).

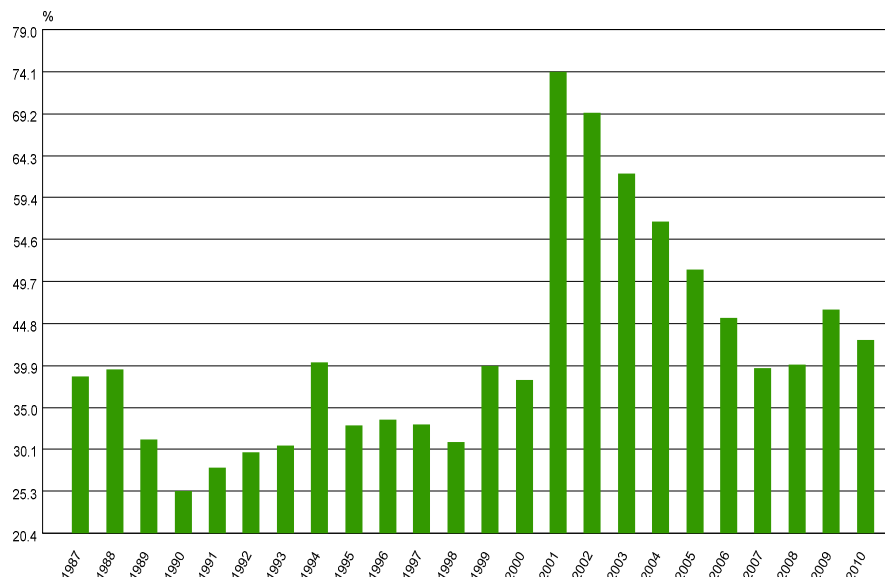
Finally, discretion and opacity in the implementation of fiscal policy appear to have escalated, which suggest that the cyclical improvements we are seeing now, should be taken with a grain of salt: Just recall, as we’ve pointed out before, how quickly the budget balance deteriorated in a single month last year, and think of the rather incomplete information available on fiscal activities outside the central government budget (like energy SEEs, local governments, and some other SEEs like TOKI, the State Housing Agency).

While these qualms of ours are very unlikely to have much market impact in the short-term, a tighter and more ambitious fiscal framework would help anchor inflation expectations and contain the widening in the CAD.

As for this year, we continue to think the 2011 MTP target of TL33.5 billion deficit, or some TL14 billion primary surplus is achievable, against a context in which growth runs around 5% and some of the tax amnesty and privatization proceeds start to flow in later in the year. Assuming the budget target is met, central government debt-to-GDP ratio would decelerate modestly further to a little below 42% by the end of this year, from around 43% at the end of 2010 (Graph 15).

Turkey’s public debt dynamics are difficult to destabilize under various shock scenarios, like lower growth and higher real interest rates, and the domestic debt redemption/financing schedule (barring a few months like May, August, November) is relatively light. The bottom line is that, CAD- and inflation-related risks notwithstanding, public debt arithmetic as such is supportive of the bond market dynamics.

GRAPH 15
Central Government Debt Stock (as % of GDP)

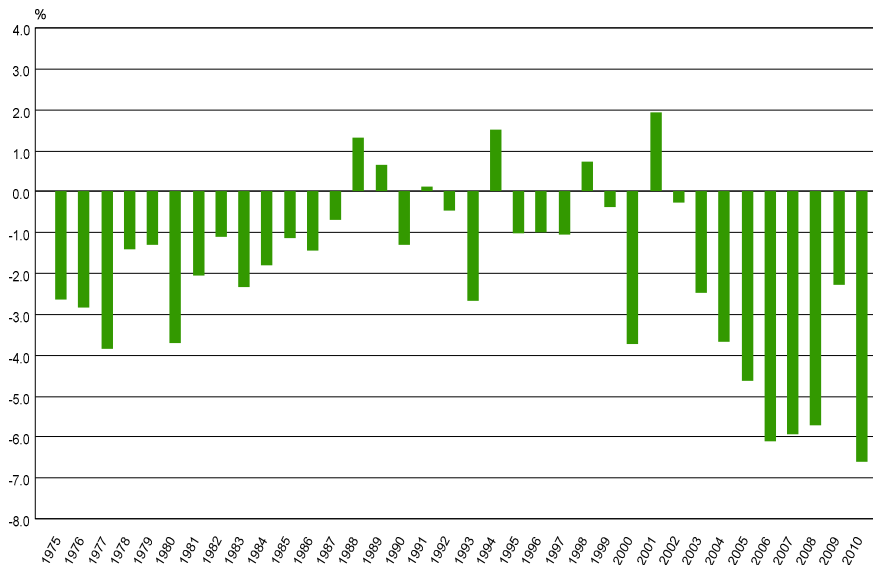


Current Account, Financing and the Real Exchange Rate

Having ended last year at an all-time high of \$48.6 billion, or 6.6% of GDP, CAD continues to expand; in January, the latest data we have, it stood at a 12-month rolling \$51.4 billion, and trade data suggests, it has likely reached some \$55 billion in February, thus far primarily driven by a wider non-energy deficit (Graphs 16-17). How the CAD dynamic will play out going forward, is the most essential macroeconomic question facing us. Put differently, will the adjustment work out smoothly, or will it, at some point, require a significant market correction?

GRAPH 16

Long View: Current Account Balance (as % of GDP)



GRAPH 17

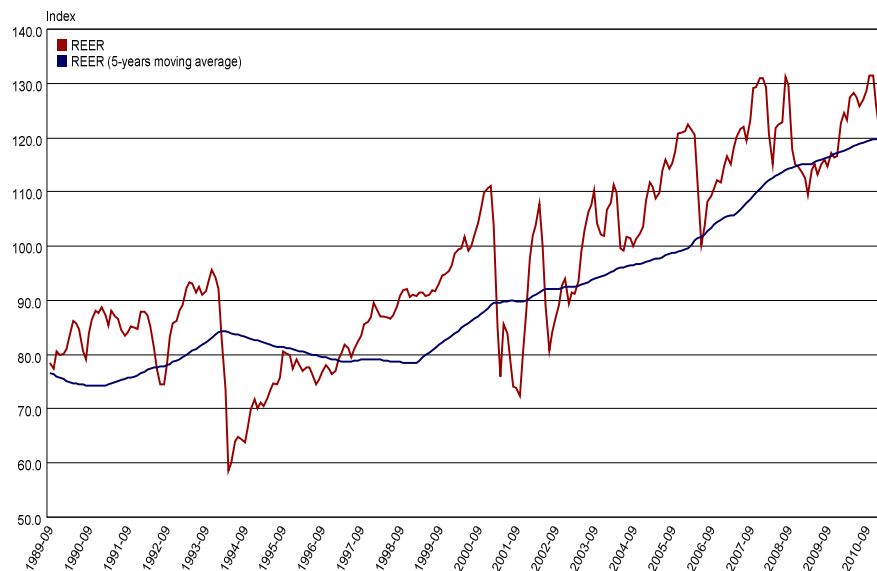
Current Account Balance (12-m rolling, million USD)



To be sure, there are no easy answers. In our projections, we have adopted a fairly optimistic baseline scenario whereby slower credit growth, weaker lira (having reverted back to its longer term trend; Graph 18), and post-crisis inventory build-up having run its course, should work to slow import volume growth markedly, to below that of exports. As things stand, i.e. given the huge divergence between export/import growth rates through February, this is a heroic assumption, to say the least, but one that we nevertheless make (Graph 19). Ironically, even that is no cure: with oil price hovering in the \$110-\$115 p/b range, a growing energy bill immediately moves CAD to above \$60 billion, or 8% of GDP. That is, even though non-energy CAD broadly stabilizes under this scenario, a higher energy bill still raises the overall CAD significantly (Table 5).

GRAPH 18

Long View: Real Effective Exchange Rate



GRAPH 19

Export and Import Growth (yoy, %)



TABLE 5
Current Account Balance: 2007-11
(US\$ billion)

	2007	2008	2009	2010	2011 (f)
Current Account	-38.4	-42.0	-14.0	-48.6	-62.8
as % of GDP	-5.9	-5.7	-2.3	-6.6	-8.1
Merchandise trade (BOP def.)	-46.9	-53.0	-24.9	-56.4	-72.9
as % of GDP	-7.2	-7.2	-4.0	-7.7	-9.4
Exports (f.o.b.; TURKSTAT def.)	107.3	132.0	102.1	113.9	140.2
o/w: Energy	5.1	7.5	3.9	4.5	5.6
Price (%)	12.7	15.5	-16.1	4.7	7.1
Volume (%)	11.3	6.6	-7.5	6.3	14.8
Imports (c.i.f.; TURKSTAT def.)	-170.1	-202.0	-140.9	-185.5	-231.1
o/w: Energy	-33.9	-48.3	-29.9	-38.5	-54.2
Price (%)	9.7	20.0	-19.5	8.0	12.2
Volume (%)	12.7	-1.4	12.9	21.2	9.7
Services	13.3	17.3	16.7	14.2	16.0
as % of GDP	2.1	2.4	2.7	1.9	2.1
o/w: Travel (net)	15.2	18.4	17.1	16.0	18.0
Income	-7.1	-8.4	-8.2	-7.8	-8.0
as % of GDP	-1.1	-1.1	-1.3	-1.1	-1.0
o/w: Interest (net)	-7.5	-8.7	-7.3	-5.4	-6.3
as % of GDP	-1.2	-1.2	-1.2	-0.7	-0.8
Current transfers	2.2	2.1	2.3	1.4	2.1
as % of GDP	0.3	0.3	0.4	0.2	0.3
Memorandum items:					
Non-energy current account deficit	9.7	1.2	-12.0	14.6	14.1
Merchandise trade deficit (TURKSTAT de	62.8	69.9	38.8	71.6	91.0
Non-Energy	34.1	29.2	12.8	37.6	42.3
Energy	28.7	40.7	26.0	34.0	48.7
Oil price (world price)	72.4	96.9	61.5	79.6	109.1
%	11.7	33.8	-36.5	29.4	37.1

Source: CBT; TURKSTAT; our calculations

With CAD heading towards \$65 billion, or perhaps even higher, putting together our usual table on the “sources” of external financing was again a challenge. True, we’ve been badly wrong on the *quantity* of inflows already once last year, and this ample financing scenario may simply replay this year. But we were not so off, regarding the quality of inflows, which showed a visible deterioration from longer to shorter term inflows in 2010 (Graph 20; Table 6). The question we naturally ask ourselves is this: Could this deterioration continue another year without a market setback, as the total amount of inflows required for the CAD financing increase?

GRAPH 20

Capital Account: Selected Items (million USD)

TURKEY DATA MONITOR

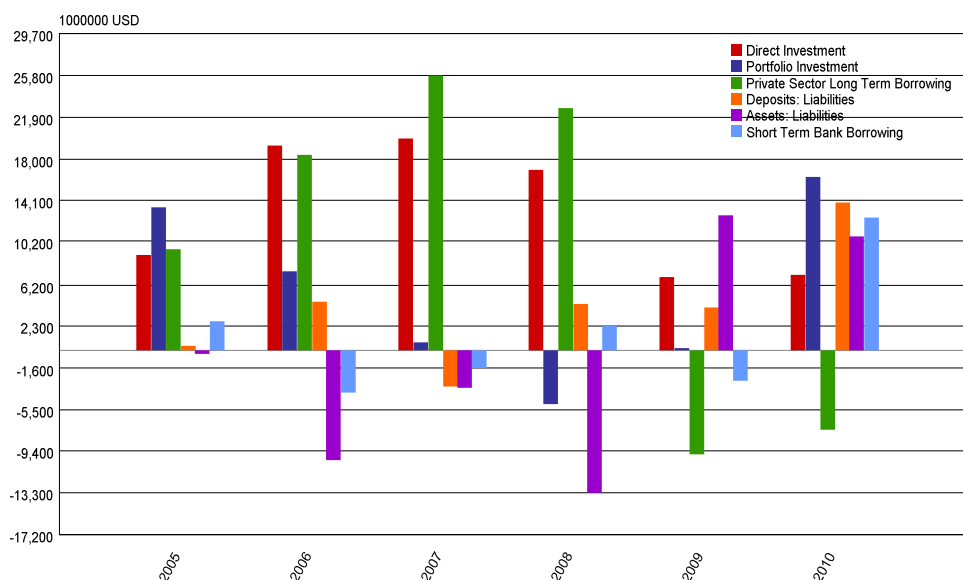


TABLE 6

**Capital Account Developments
(in millions of US\$)**

	Jan		12-month rolling	
	2011	2010	Jan	Dec
Current Account Deficit	-5,860	-3,062	-51,359	-48,561
Capital Account	3,072	2,027	58,425	57,380
Direct Investment	-270	394	6,490	7,154
Portfolio Investment	2,255	1,915	16,631	16,291
o/w: Equity	-630	410	2,428	3,468
Debt Securities 1/	2,667	2,957	15,859	16,149
o/w: Domestic Issues	2,764	957	12,522	10,715
Other Investment	<u>1,087</u>	<u>-282</u>	<u>35,304</u>	<u>33,935</u>
Assets	338	2,235	7,136	9,033
Liabilities	<u>749</u>	<u>-2,517</u>	<u>28,168</u>	<u>24,902</u>
Short Term	717	-1,228	17,752	15,807
Long Term	923	-835	-1,900	-3,658
o/w: Corporate Sector	249	-1,060	-6,074	-7,383
IMF Credits	0	0	-2,159	-2,159
Other	-891	-454	14,475	14,912
Net errors and omissions	3,651	1,783	5,884	4,016
Reserve Assets 2/	-863	-744	-12,918	-12,799

Source: CBT, GlobalSource.

1/ Including domestic issues to non-residents.

2/ Minus sign means reserve build up.

In the absence of a better alternative, and not taking the “significant setback scenario” as part of our baseline, we replicated pretty much what we had done in our previous Quarterly: we assumed continued reliance on portfolio inflows, as well as short-term flows, including non-resident deposits parked at Turkish banks (Table 7). We also assumed the latter will continue to tap syndication and short-term loan markets aggressively, ensuring that balance-sheet growth continues amid heightened competitiveness pressures, and providing the much-needed liquidity to the economy.

TABLE 7

External Financing: 2008-11
(US\$ billion)

	2008	2009	2010	2011(f)
Outflows	<u>84.9</u>	<u>62.4</u>	<u>94.9</u>	<u>100.6</u>
Current Account Deficit	42.0	14.0	48.6	62.8
Debt service (MLT)	<u>42.9</u>	<u>48.4</u>	<u>46.4</u>	<u>37.8</u>
Public	10.6	6.7	8.5	7.5
o/w: IMF	1.9	0.7	2.2	2.8
External debt securities	3.4	1.9	2.6	1.8
Private	<u>32.3</u>	<u>41.7</u>	<u>37.9</u>	<u>30.3</u>
Banks	7.2	7.6	6.7	5.4
Other sectors	25.1	34.0	31.2	24.9
Inflows	<u>84.9</u>	<u>62.4</u>	<u>94.9</u>	<u>100.6</u>
FDI (net)	17.0	6.9	7.2	9.0
Portfolio (private equity & debt; net)	-0.5	0.1	1.5	4.0
Borrowing (MLT)	<u>65.2</u>	<u>35.4</u>	<u>53.6</u>	<u>63.2</u>
Public	7.8	6.9	24.1	19.0
o/w: IMF	0.0	0.0	0.0	0.0
Debt securities 1/	-1.1	2.0	17.4	16.0
o/w: TL-securities (net)	-5.1	-1.7	10.7	10.0
Private	<u>57.4</u>	<u>28.6</u>	<u>29.6</u>	<u>44.2</u>
Banks	7.7	5.7	6.9	8.1
Other sectors	49.7	22.9	22.6	36.1
Short-term (net) 2/	4.3	-4.5	15.9	12.7
Currency and deposits (net) 3/	-6.8	19.6	25.6	14.0
Capital Transfers	-0.1	0.0	0.0	0.0
Errors & omissions 4/	4.7	5.1	4.0	3.7
Reserve use ('-' = reserve build-up)	1.1	-0.1	-12.8	-6.0
Memorandum Items:				
Public (net) 5/	2.2	1.8	4.9	1.5
Inflows from IMF (net)	-1.9	-0.7	-2.2	-2.8
Private (net)	25.2	-13.1	-8.3	13.9
All short term 6/	2.2	20.1	45.5	30.4
All short term (inc. portfolio flows)	-2.8	20.4	61.8	48.6

Source: CBT, Treasury, our calculations.

1/ Includes (net) issues of domestic debt to non-residents, in addition to eurobonds.

2/ Stock of short term loans stood at \$43.6 billion as of end-December.


3/ Inc. other assets and liabilities; (+) indicates asset drawdown abroad and liability build-up inside.

4/ We follow the convention of assuming zero E&O for projections.

5/ Excluding TL-securities.

6/ Includes short-term, errors & omissions, and currency&deposits.

On the FDI front, Turkey ended 2010 with a net FDI inflow of \$7.2 billion, some \$1 billion higher than our forecast because of the last-minute sale of Dogan Group's stake in the gas station chain Petrol Ofisi to Austrian OMV. While there has not been a material change in Turkey's FDI prospects, or in actual big-ticket deals that we try to track down individually, low interest rate environment, relatively high risk appetite in global markets and Turkey's more visible regional role compelled us to revise FDI forecast for 2011 slightly higher than before, to \$9 billion (net).

On the lira front, the picture presented in this section – a large and growing CAD financed by relatively fickle inflows – does not permit, in our view, lira strengthening in real (basket) terms, which, together with our euro/dollar cross-rate assumption, drive our end-period lira/dollar exchange rate forecast, which is provided on Table 2 above. 

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