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TURKEY

On Auto Pilot

Executive Summary

Turkey crashed hard in the global crisis, but is now recovering at a pace that we've clearly underestimated. We now think that growth of more than 7% is comfortably achievable this year, up from our previous forecast of around 6%. Inflation has also started to decelerate from April peaks, and food prices permitting, could even drop to around 5%, early next year.

But that does not mean all is well. The current account deficit keeps widening, external financing quality remains low, and the policy framework appears to be weakening. Combined with a difficult global environment that may feed into political uncertainties around the upcoming general elections, these make us less sanguine on next year's growth, which we see decelerating to about 4%.

The central government budget improved in the year through August, but most of the improvement is driven by the recovery, and primary expenditures appear to have picked up in recent months. While this may be related pre-referendum pork barreling, we think election-related spending is a serious risk going forward, despite AKP's clear victory in the September 12th referendum. In this connection, the fact that the Fiscal Rule has now been dropped off the agenda, apparently upon Prime Minister Erdogan's directives, leaves no room for complacency.

Recent inflation dynamics have largely been driven by volatility in food prices and some fiscally-motivated price adjustments, but the softening in 12-month CPI-inflation, combined with MPC's dovish rhetoric, helped to put off rate hike expectations to the latter part of next year. However, overshooting next year's 5.5% inflation target remains a significant risk.

We see CAD closing this year in the \$36 billion-\$37 billion range (around 5% of GDP), before widening further to over \$40 billion next year (5.5%). Combined with the relatively fickle nature of financing, this is the main reason we feel *lira* should not strengthen in nominal terms. But the inflation differential between Turkey and its trading partners could continue to erode Turkey's competitiveness.

A further loosening of the policy framework, resulting from a combination of over-confidence and political motivations, is the most significant risk, which could backfire against the backdrop of a widening CAD and strong *lira*. Yet, Turkey's generally strong fundamentals (like solid banks and low debt-to-GDP ratios), easy money abroad, and prospects for a third AKP reign should help cushion Turkey from a severe setback.

Assumptions

Although the global economy continues to recover, downside risks are still prevalent, as the IMF pointed out in its July Update. Despite this jittery environment, Turkey has proven somewhat more resilient as an investment destination than we had anticipated. But the volatility in risk appetite, combined with the lower quality of inflows, continues to be a key source of vulnerability, given Turkey's large financing need.

The euro/dollar parity, which influences our end-year TL/\$ forecast, has turned around in favor of the euro in recent months, with the latter strengthening against the dollar from a low of less than 1.2 in early June to around 1.3 more recently. In the absence of a better alternative, we work with the parity hovering around this level throughout our forecast horizon (to the end of 2011).

Oil prices have been stable in the \$75-\$80 per barrel range, averaging \$77 p/b (Brent) in the year through early September, broadly in line with our assumptions. We hence continue to work with an oil price of \$80 p/b for next year.

Our baseline scenario on politics, which commands better than even odds, is stability for the rest of 2010 and 2011. AKP should win the next general elections, albeit with a diminished majority. In the interim, we are monitoring three risk factors. These are AKP sliding deeper into authoritarianism, forcing opponents to fight back for their lives; PKK terror and Kurdish unrest; and the reaction of Western allies to Turkey's increasingly intimate alliance with Iran. Moreover, there have been some indications lately – such as the postponement of the Fiscal Rule, a malign rhetoric on Central Bank independence, and various interventions in state banks – which suggest that lack of policy discipline could escalate in the run-up to general elections, despite AKP's clear victory in the recent referendum.

Turkey's sovereign ratings have not changed over the past three months, at one notch below investment grade according to Fitch, and two notches below according to both S&P and Moody's. As before, we feel we should be open to positive surprises, but an upgrade to investment grade by any of these agencies is unlikely under our baseline scenario. Despite Turkey's obvious strengths (like low leverage ratios), CAD-driven growth in the absence of strong policy anchors remains a significant source of vulnerability.

Details of our forecasts under the baseline scenario are provided in Table 1 below.

Growth and Employment

GDP bounced back by a sharper-than-expected 10.3% in Q2, largely driven by private consumption and investment, though government spending also contributed, as did stock build-up (Graph 1). In working-day and seasonally-adjusted (WDSA) terms, GDP growth was a whopping 3.7% in Q2 (q/q), which brought the average quarterly growth in the past four quarters to over 2% (Graph 2).

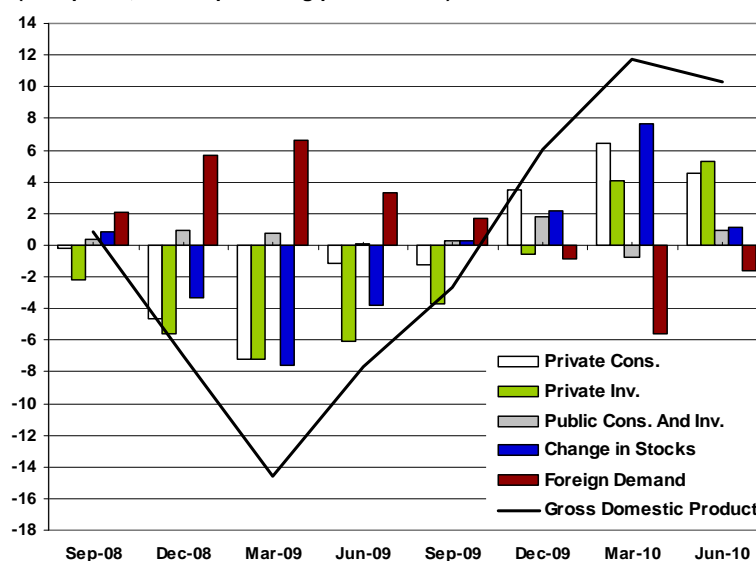
TABLE 1
Macro Framework: 2007-11

	2007	2008	2009	GlobalSource	
				2010f	2011f
Growth (GDP; %)	4.7	0.7	-4.7	7.1	3.9
GDP (YTL; bn.)	843	951	953	1107	1220
GDP (\$; bn.)	647	733	614	724	752
CPI Inflation (%)					
Avg.	8.8	10.4	6.3	8.5	6.1
EoP	8.4	10.1	6.5	7.1	6.9
Central Government Budget (YTL bn; MoF def)	-13.7	-17.4	-52.2	-43.0	-46.0
as % of GDP	-1.6	-1.8	-5.5	-3.9	-3.8
o/w: Primary Balance (as % of GDP)	4.2	3.5	0.1	0.9	0.6
Central Government Debt (as % of GDP)	39.6	40.0	46.4	44.3	44.6
Domestic	30.3	28.9	34.6
External	9.3	11.1	11.7
Current Account Balance (\$ bn)	-38.3	-41.9	-14.0	-36.5	-41.3
as % of GDP	-5.9	-5.7	-2.3	-5.0	-5.5
Trade Balance (TURKSTAT definition; \$ bn)	-62.8	-69.9	-38.8	-62.0	-70.2
Exchange Rate (TL/\$)					
Avg.	1.304	1.296	1.551	1.530	1.623
EoP (December)	1.162	1.525	1.491	1.576	1.670
%	-17.5	31.2	-2.2	5.7	6.0
Real Effective Exchange Rate (2003=100)					
EoP	130.9	114.7	116.6	124.4	123.6
% (up means appreciation)	17.2	-12.4	1.7	6.7	-0.7
Interest Rate (compounded; %)					
EoP (December)	16.6	16.5	8.9	8.5	10.0
Real Interest Rate (compounded eop; ex-post %)	7.6	5.8	2.2	1.3	2.9
Central Bank O/N (EoP; simple; %) 1/	15.75	15.00	6.50	7.00	8.00

Source: CBT, MoF, Treasury, TURKSTAT, our calculations and projections. e= estimate, f= forecast.
1/ One week repo rate for 2010 and 2011.

GRAPH 1

Sources of Growth
(1998 prices, as % of preceding period's GDP)



GRAPH 2

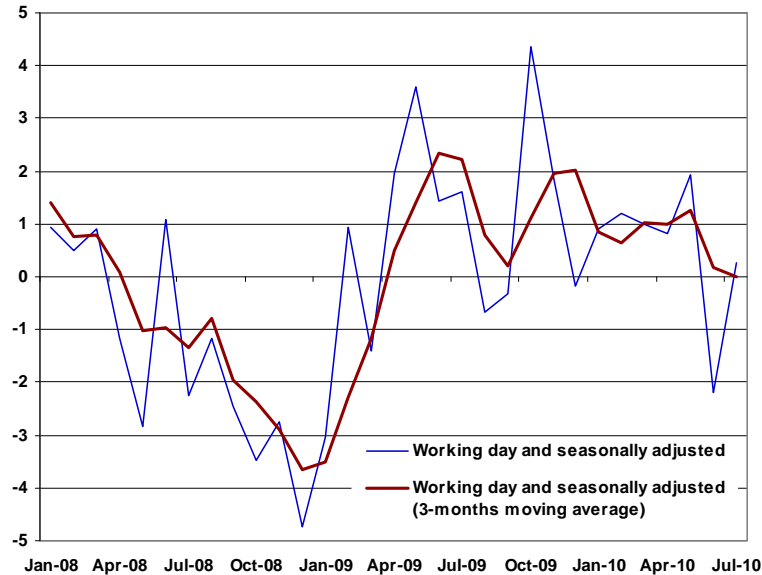
GDP Growth: Seasonally adjusted (%)



More recent indicators suggest that economic expansion is continuing into the third quarter, though probably at a decelerating pace. Twelve-month growth in industrial production slowed in July to 8.6%, from almost 14% in Q2, while it was broadly flat in WDSA terms (Graph 3). But indicators of private consumption and investment generally point to a robust picture.

GRAPH 3

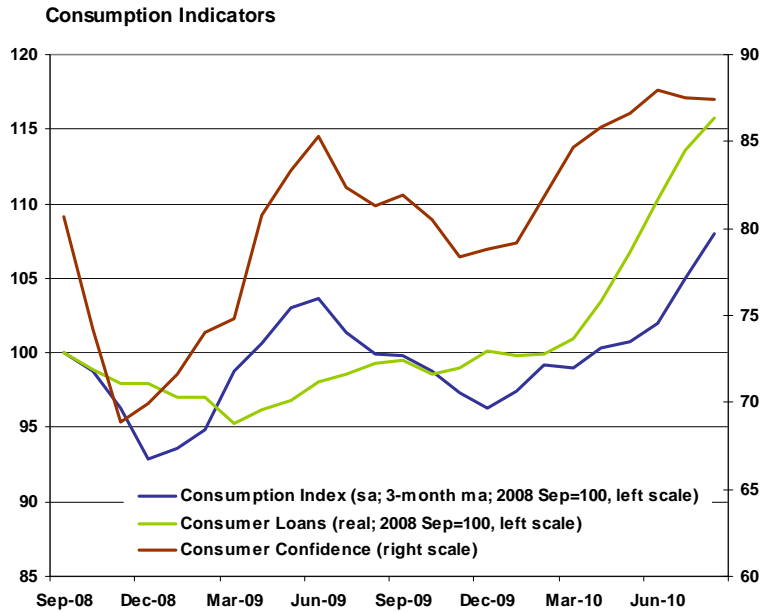
Industrial Production (monthly, %)



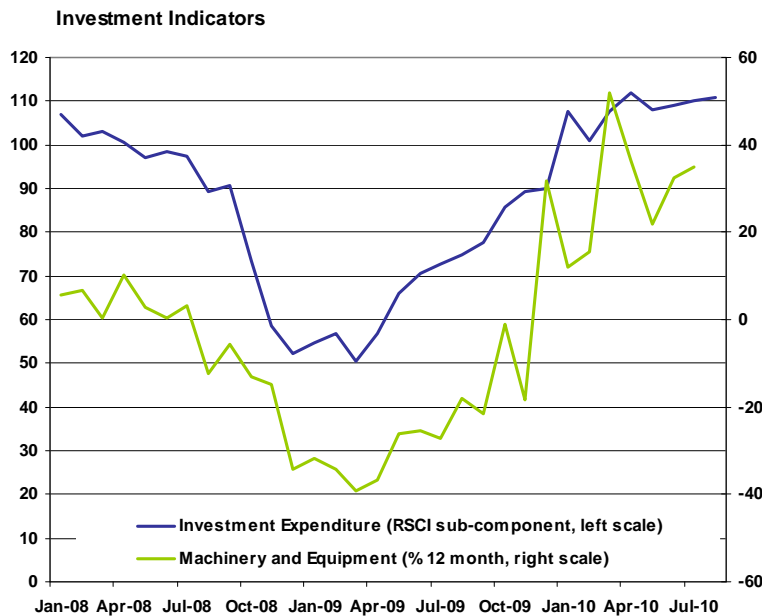
For instance, consumption indicators like credit growth and the CNBC-e's consumption index, appear to be expanding through August/September. Consumer confidence remains below the critical 100 mark, but is relatively stable.

Likewise, investment indicators suggest that expansion there continues as well. Investment expenditure, a sub-component of Real Sector Confidence Index, and machinery and equipment production (an IP sub-component), are both in expansion territory (Graphs 4-5).

GRAPH 4



GRAPH 5



Where does all this leave us regarding the 2010 growth rate? The economy has already expanded by 11% in the first half, and several growth indicators, though preliminary, suggest that there is no sign of a sharp slowdown yet. Having left behind the period with the strongest base effects, growth should decelerate to single digits in H2 (y/y). But even then, a growth rate at over 7% looks comfortably achievable for the year.

But going into 2011, we cannot be as sanguine. True, there are a number of positive growth drivers: Turkey is on investors' radar; and it has sound fundamentals. It has managed an impressive rebound from the crisis, at a pace we've clearly underestimated. The banking sector has been willing to expand credit, and the household sector has generally low debt-to-income ratios.

But we see considerable headwinds too, which could work to mitigate these positives. Specifically, the global backdrop is jittery; there are rising political uncertainties ahead of next year's general elections; and there's a disconcerting CAD/strong lira combination. These, along with the lack of a strong policy anchor, are likely to begin to take their toll on Turkish growth next year. With output gap almost closed already (our calculations), it would be natural for the economy to settle down to a sub-par growth rate. That makes little below 4% a plausible working number for 2011 growth, in our view (Table 2).

TABLE 2
Growth Components: 2007-11
(annual; %)

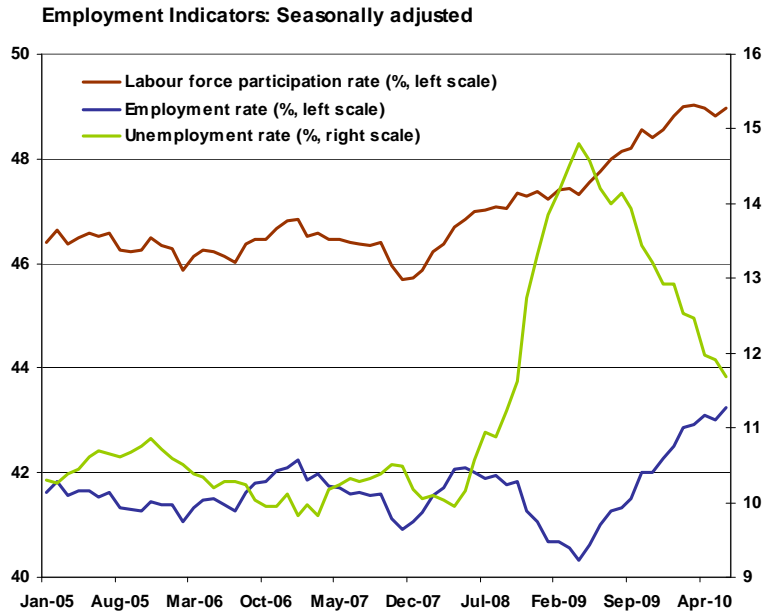
	2007	2008	2009	2010 (f)	2011 (f)
Domestic Demand 1/	<u>5.2</u>	<u>-1.6</u>	<u>-5.2</u>	<u>7.6</u>	<u>3.8</u>
Consumption	<u>5.6</u>	<u>-0.1</u>	<u>-1.0</u>	<u>5.1</u>	<u>3.5</u>
Private	5.5	-0.3	-2.2	5.4	3.5
Public	6.5	1.7	7.8	3.1	3.5
Gross Fixed Capital Formation	<u>3.1</u>	<u>-6.2</u>	<u>-19.1</u>	<u>17.0</u>	<u>4.3</u>
Public	6.3	12.7	-2.3	1.9	6.0
Private	2.6	-9.0	-22.3	20.6	4.0
Change in Stocks 1/	0.6	0.3	-2.1	2.0	0.8
Foreign Demand 1/	<u>-1.2</u>	<u>1.9</u>	<u>2.7</u>	<u>-2.4</u>	<u>-0.6</u>
Exports	7.3	2.7	-5.3	6.0	4.0
Imports	10.7	-4.1	-14.3	15.7	6.0
GDP	4.7	0.7	-4.7	7.1	3.9

Source: TURKSTAT, our calculations.

1/ Contributions to GDP growth.

The seasonally-adjusted unemployment rate (UR) continued to ease though June (May-July average), though it remains some 2 pp higher than the pre-crisis levels. The employment level as such has exceeded pre-crisis levels, but a higher labor force participation rate is keeping the UR more elevated than in the pre-crisis period (Graph 6). More importantly, the increase in employment since the crisis seems largely driven by reverse migration to rural areas, and an increase in low productivity service jobs. This leads us to think that the somewhat puzzling increase in the "growth elasticity of employment" during the post-crisis period -- with employment rising faster than output in all sectors of the economy other than industry -- will prove temporary, and that the unemployment rate will edge up again, say by the middle of next year, to above 12%.

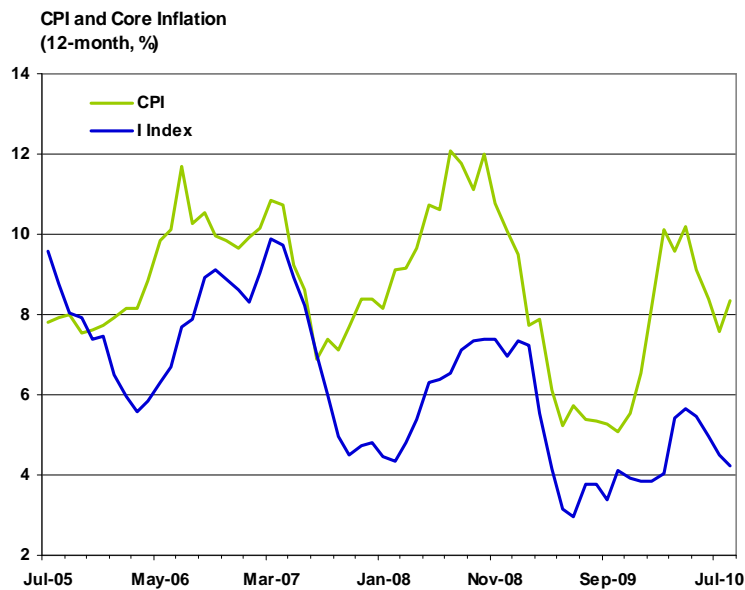
GRAPH 6



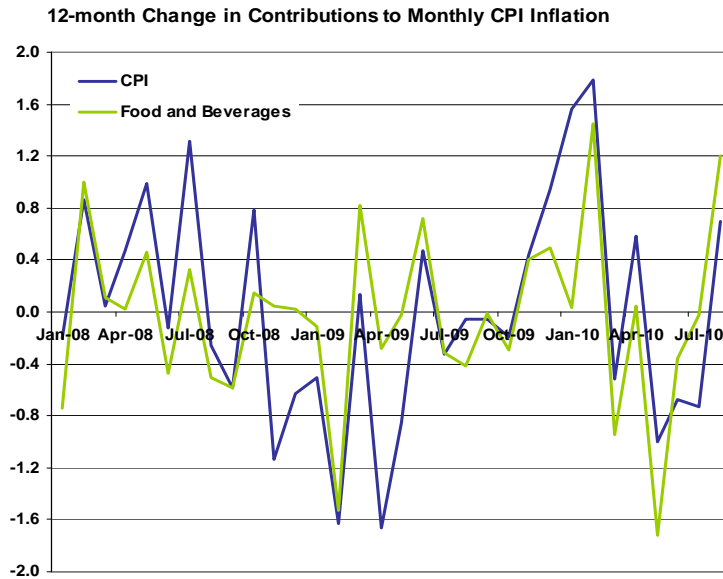
Inflation and Monetary Policy

Consumer price inflation is down to around 8%, from April peaks of some 10%, while core inflation is heading toward 4%. Food prices explain a large part of the recent volatility in headline CPI, while the recent up and down movement in core inflation (I-index that excludes food, energy and gold) largely reflects the base effect, resulting from temporary tax incentives that were granted during 2009 (Graphs 7-8).

GRAPH 7

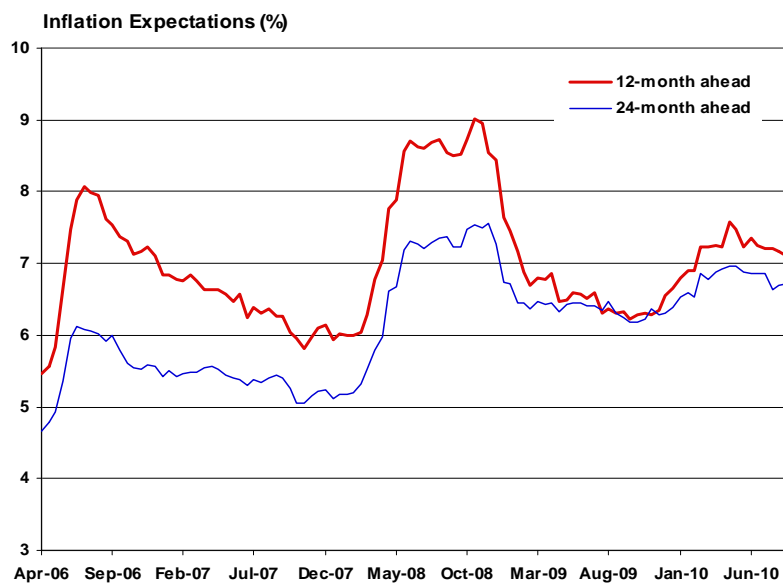


GRAPH 8



The benign behavior of core inflation in recent months – and the fact that it has been contained below the 5% (headline) inflation target in the medium-term -- has repeatedly surfaced in the recent statements of the Central Bank. While this is encouraging, there is some unpleasant arithmetic to take note of. By construction, the core indicator leaves out some 50% of the index, which suggests that for headline inflation to converge to below 5%, as the Bank forecasts that it will, core inflation will need to decelerate to around 2%-3% by the end of next year. The question then becomes: how likely is this? With the slack capacity in the economy rapidly narrowing, and longer term inflation expectations showing persistence above the 5% target (Graph 9), it is not very likely, in our view, unless the *lira* appreciates considerably, which we do not see happening in our baseline.

GRAPH 9



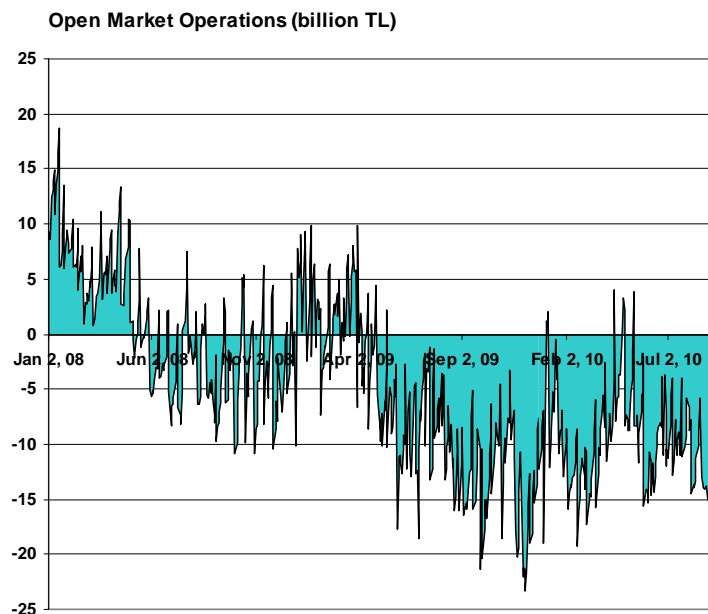
This is not to say, however, that we will never see inflation drop to the 4%-5% range. Food prices permitting, that could happen early next year, largely reflecting the base effect from higher tobacco prices of a year earlier. But then we forecast that inflation will start to pick up again toward 7% or so, above the Bank's 5.5% target for end-2011, as base effects reverse and inflation inertia kicks in.

Encouraged by the softer inflation print and weaker external demand conditions of recent months, the Monetary Policy Committee changed the policy rate outlook in its July Inflation Report (of July 27), pushing expectations of the first rate hike generally out to the second half of next year. We are also part of that camp, expecting the first hike to come in later rather than earlier part of the year.

That said, we continue to believe that monetary policy is too accommodative at the moment, judging from, among other things, strong credit growth, rapid narrowing of the output gap, and the sizable amount of funding provided to markets (Graph 10). The Bank's recent "technical rate cut" is another example of a much-ado-about-nothing in this connection that should not have much of an impact, other than perhaps leading to some modest improvements in money market efficiency. More important from a monetary policy perspective will be the exit from *lira*-related measures, namely 3-month repo auctions and the required reserves on *lira* deposits, which the Bank said will be completed before the end of this year. This process should have started already in our view, but the Bank's pro-growth and pro-financial stability bias explains its continuing reluctance for a speedy exit.

But all this comes at a price: We believe that the Bank's overly accommodative stance despite the limited support from fiscal policy creates a "credibility gap" for the Bank that will prevent the convergence of inflation expectations to the inflation target.

GRAPH 10



Fiscal Policy and Central Government Debt

The central government budget has improved in the year through August y/y (Table 3). Tax revenue expanded by 13% in inflation-adjusted terms, compared with much more moderate growth (of about 4%) in primary expenditures.

TABLE 3
Central Government Budget: 2009-2010
(in billion TL)

	Jan-Aug		Real growth (%)	% of Budget	2010 Budget
	2010	2009			
Central Government Revenues	<u>169.0</u>	<u>140.4</u>	<u>10.5</u>	<u>71.4</u>	<u>236.8</u>
o/w: General Budget Revenues	<u>163.7</u>	<u>136.3</u>	<u>10.2</u>	<u>71.2</u>	<u>229.9</u>
Tax Revenues	<u>138.8</u>	<u>112.8</u>	<u>12.9</u>	<u>71.8</u>	<u>193.3</u>
o/w Tax on Income	41.8	37.7	1.6	70.2	59.5
Tax on Goods and Services	59.1	47.2	14.9	68.4	86.4
o/w: VAT	17.2	13.5	17.1	75.9	22.6
SCT	36.5	27.8	20.7	66.8	54.6
Tax on Foreign Trade	24.8	17.9	27.3	74.9	33.1
Non-Tax Revenues	30.3	27.6	0.7	69.6	43.5
Expenditures	<u>183.4</u>	<u>171.7</u>	<u>-1.9</u>	<u>63.9</u>	<u>287.0</u>
Non-Interest Expenditures	148.1	131.2	3.6	64.3	230.2
o/w: Personnel	42.0	37.7	2.6	69.5	60.3
Current Transfers	67.1	60.2	2.9	65.6	102.2
o/w: Social Security	37.7	35.5	-0.5	64.0	58.9
Agricultural Subsidy	4.9	3.8	-5.5	87.3	5.6
Investment	10.2	8.0	18.0	54.0	18.9
Interest Expenditures	35.3	40.5	-20.1	62.2	56.8
Overall Balance	-14.4	-31.3	...	28.7	-50.2
Primary Balance	20.9	9.2	...	318.4	6.6

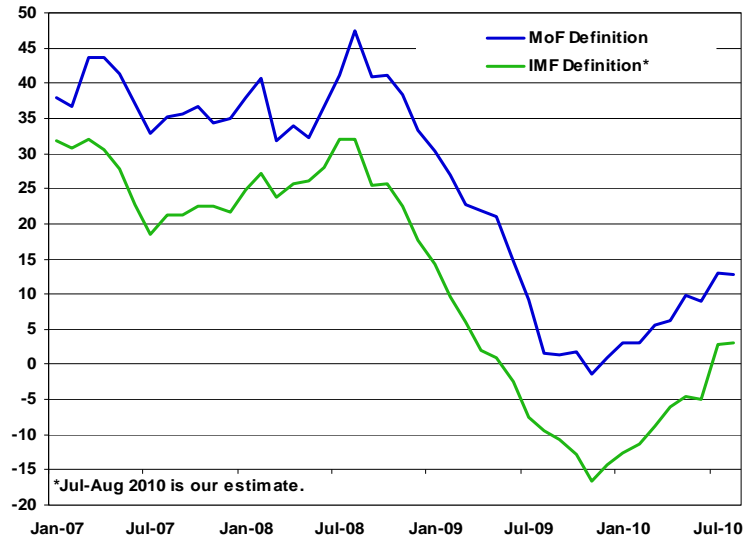
Source: Ministry of Finance, GlobalSource.

The primary surplus during the first eight months of the year reached TL21 billion, compared with TL 9 billion last year, and the annual target of some TL7 billion. Strong growth in tax revenue was driven by indirect taxes, where domestic transaction taxes grew by 15%; growth in international trade taxes was even more dramatic (up 27%). The 12-month rolling primary surplus hence rose to some TL12 billion in August, though by program definition, improvement was somewhat more modest (Graph 11). This strong performance notwithstanding, developments in the past few months are somewhat less impressive, with primary expenditure growth picking up and tax revenue growth slowing, a pattern that we've seen recur quite a few times in recent years (Graph 12).

With the Fiscal Rule postponed indefinitely, this discretionary bias in fiscal policy gives us little confidence that primary spending growth will be contained in the run-up to elections, or curbed in the event of tax revenue growth markedly slowing. Thus, despite the improvements to date, we cannot be too confident that the overall deficit will come in substantially below the targeted TL50 billion this year, but nevertheless expect to see a sizable improvement as a percent of GDP over the previous year (5.5% vs. 3.9%), owing in part, to a higher than programmed nominal GDP.

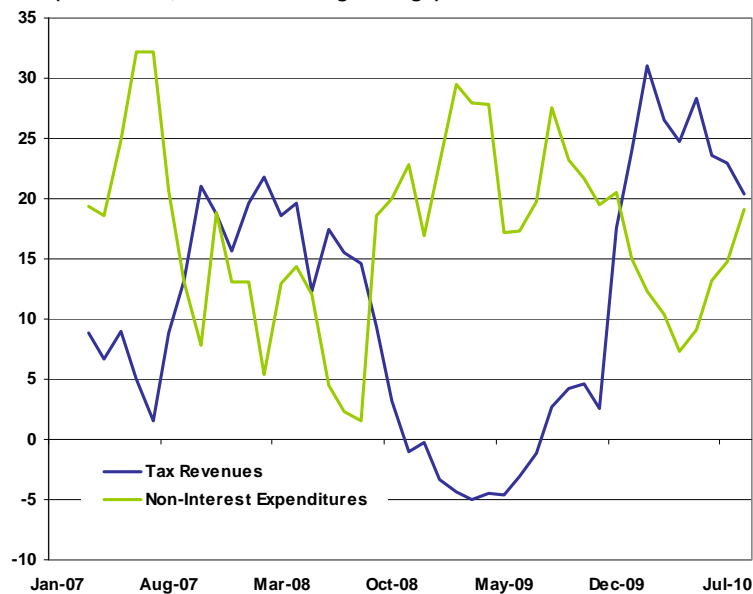
GRAPH 11

**Central Government Primary Balance
(12-month rolling; TL billion)**



GRAPH 12

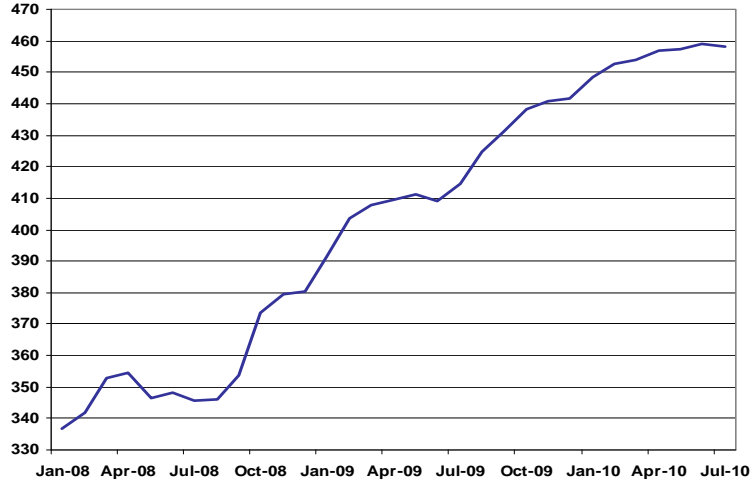
**Tax Revenues and Non-Interest Expenditures
(12-month %; 3-months moving average)**



Growth in central government debt appears to have stabilized (Graph 13). We now forecast the central government debt-to-GDP ratio to drop by some 1 pp, to below 45% of GDP by the end of this year. While this is some 5 pp lower than the forecast in last September's MTP, it is noteworthy that this performance largely owes to a higher-than-programmed GDP and a stronger *lira*.

GRAPH 13

Total Central Government Debt Stock (billion TL)

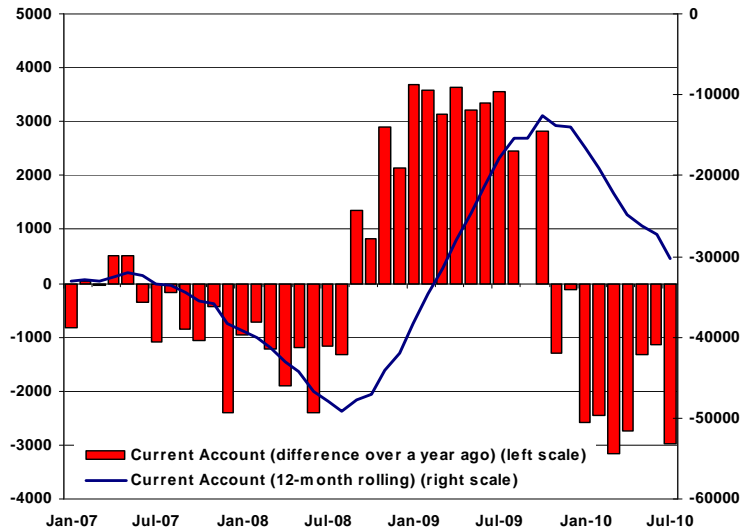


External Financing and the Real Exchange Rate

The 12-month rolling CAD rose to over \$30 billion in July, up from some \$27 billion a month earlier, and from a low of \$13 billion late last year. The sudden acceleration in the pace of CAD widening in July is noteworthy (Graph 14).

GRAPH 14

Current Account Dynamics (million USD)



While some of this may be a statistical aberration, with the benefit of hindsight, it also seems partly attributable to the lagged effect of a strong *lira* (particularly against the euro). Our revised forecast, which partially takes this effect into account, shows that our earlier forecast of \$32 billion-\$33 billion might now be an underestimate, and that a figure of around \$36 billion-\$37 billion (or some 5% of GDP) is more realistic (Table 4).

TABLE 4
Current Account Balance: 2007-11
(US\$ billion)

	2007	2008	2009	2010 (f)	2011 (f)
Current Account	<u>-38.3</u>	<u>-41.9</u>	<u>-14.0</u>	<u>-36.5</u>	<u>-41.3</u>
as % of GDP	-5.9	-5.7	-2.3	-5.0	-5.5
Merchandise trade (BOP def.)	-46.8	-53.0	-24.9	-47.4	-54.2
as % of GDP	-7.2	-7.2	-4.1	-6.5	-7.2
Exports (f.o.b.; TURKSTAT def.)	107.3	132.0	102.1	114.8	124.1
o/w: Energy	5.1	7.5	3.9	4.2	4.5
Price (%)	12.7	15.5	-16.1	5.8	4.0
Volume (%)	11.3	6.6	-7.5	6.3	4.0
Imports (c.i.f.; TURKSTAT def.)	-170.1	-202.0	-140.9	-176.8	-194.3
o/w: Energy	-33.9	-48.3	-29.9	-37.4	-40.6
Price (%)	9.7	20.0	-19.5	8.1	3.7
Volume (%)	12.7	-1.4	-12.9	16.2	6.0
Services	13.3	17.1	16.3	16.7	19.0
as % of GDP	2.1	2.3	2.7	2.3	2.5
o/w: Travel (net)	15.2	18.4	17.1	17.3	18.5
Income	-7.1	-8.2	-7.7	-8.0	-8.5
as % of GDP	-1.1	-1.1	-1.2	-1.1	-1.1
o/w: Interest (net)	-7.5	-8.5	-7.3	-6.2	-6.4
as % of GDP	-1.2	-1.2	-1.2	-0.9	-0.9
Current transfers	2.2	2.1	2.3	2.2	2.4
as % of GDP	0.3	0.3	0.4	0.3	0.3
Memorandum items:					
Non-energy current account deficit	9.6	1.2	-12.0	3.3	5.2
Merchandise trade deficit (TURKSTAT def.)	62.8	69.9	38.8	62.0	70.2
Non-Energy	34.1	29.2	12.8	28.8	34.1
Energy	28.7	40.7	26.0	33.2	36.1
Oil price (world price)	72.4	96.9	61.7	78.1	80.0
%	11.7	33.8	-36.3	26.5	2.5

Source: CBT; TURKSTAT; our calculations

The financing of the CAD is undergoing an interesting transformation. In a nutshell, while we see a massive pick-up in the amount of capital inflows, we also see the role of portfolio flows and the banking sector increase significantly, while that of FDI and corporate borrowing decline (Table 5; Graph 15).

Some of this transformation results from a statistical distortion related to the shift of corporate sector borrowing from offshore to onshore sources (because of the legislative changes of last summer), as we mentioned in our previous Quarterly (of June 8th, 2010) and was comprehensively analyzed by the IMF staff in the latest Staff Report on Turkey (see IMF Staff Report of July 13, Box 3). For instance, this shift could explain some of the sharp increase in short-term liabilities in recent months -- which show up under other investment/liabilities/currency and deposits -- whereby offshore branches of local banks collect deposits abroad and place them with their onshore parent, which are then onlent to Turkish companies onshore as FX-denominated credit.

Then again, several factors, such as the continued weakness in FDI flows as well as the increased reliance on portfolio debt flows and asset drawdowns by both banks and corporates, suggest that serious "quality" issues have emerged, and that the financing of the CAD could be problematic, should market sentiment deteriorate.

TABLE 5
Capital Account
(million \$)

	Jan-Jul		12-month rolling	
	2010	2009	Jul	Jun
Current Account Deficit	-24,230	-7,854	-30,339	-27,372
Capital Account	<u>31,442</u>	<u>-1,789</u>	<u>42,670</u>	<u>40,837</u>
Direct Investment	3,344	4,097	5,543	5,154
Portfolio Investment	10,809	873	10,132	7,428
o/w: Equity	1,322	1,276	2,873	2,354
Debt Securities 1/	10,335	1,049	9,397	7,647
o/w: Domestic Issues	6,939	-1,655	6,885	4,885
Other Investment	<u>17,289</u>	<u>-6,759</u>	<u>26,995</u>	<u>28,255</u>
Assets	3,955	382	13,764	17,176
Liabilities	<u>13,334</u>	<u>-7,141</u>	<u>13,231</u>	<u>11,079</u>
Short Term	3,579	-4,915	4,340	4,948
Long Term	-3,875	-5,679	-8,037	-7,685
o/w: Corporate Sector	-5,592	-4,174	-10,642	-10,909
IMF Credits	-915	-680	-915	-678
Other	14,545	4,133	17,843	14,494
Net errors and omissions	-531	6,264	-2,160	-2,826
Reserve Assets 2/	-6,681	3,379	-10,171	-10,639
Memorandum Item				
Debt Flows 3/	<u>26,776</u>	<u>-7,162</u>	<u>34,254</u>	<u>33,329</u>
Public	9,998	919	9,212	9,401
Private	13,671	-7,011	13,416	9,325
Assets	3,107	-1,070	11,626	14,603
Non-Debt Flows (net) 4/	4,135	11,637	6,256	4,682

Source: CBT, GlobalSource.

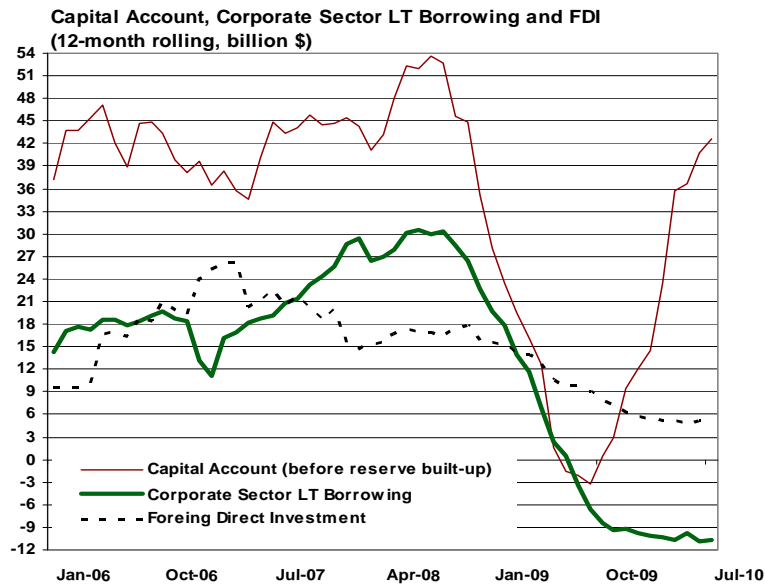
1/ Including domestic issues to non-residents.

2/ Minus sign means reserve build up.

3/ All liability items in the capital account and assets under portfolio&other investment.

4/ All items other than those in footnote 3 including e&o.

GRAPH 15



Our external financing projections for this and next year are provided in Table 6. Outflows are broadly similar to what we had in our previous report, but now our CAD forecast for both years is somewhat higher. One presentational change in our standard table relates to the elimination of the “financing gap” line, but this is not to say that the external financing outlook is comfortable. So far the “quality” of flows rather than the quantity has been the issue, and reflecting this development, we’ve opted for showing no financing gap for the next year, essentially by assuming more of the same. That is, we assumed Turkey’s growing CAD will be financed heavily by a combination of banking sector reflows and portfolio debt flows next year as well. Whether this makes a sustainable story is another matter however, and we sure have our own doubts on that.

We’ve also made some changes to our FDI forecasts, which we revised downward for both this year and next. While energy privatization has been a boon to the Treasury, it has had no impact on the FDI. Furthermore, we expect no interest for the asset sales intended by the Privatization Administration for the rest of the year, i.e. hydropower plants, and perhaps the sugar factories. Our FDI (net) forecast for 2010 is a relatively meager \$5.5 billion, against some \$3.3 billion in the year through July.

For 2011, we tentatively forecast \$2 billion of net receipts from privatization-related sales, as thermal plants and the National Lottery sales should attract interest. We also believe an ex-privatization FDI forecast of \$7 billion (including real estate) is achievable, should the global backdrop remain broadly supportive. Assuming outflows on the order of \$2 billion, which has become a natural concomitant of not only domestic cost pressures but also AKP’s new foreign policy of “African and Middle East outreach.” We thus pencil in an FDI (net) forecast of \$7 billion for 2011.

TABLE 6

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

	2008	2009	2010(f)	2011(f)
Outflows	84.7	61.7	79.6	77.0
Current Account Deficit	41.9	14.0	36.5	41.3
Debt service (MLT)	<u>42.7</u>	<u>47.8</u>	<u>43.1</u>	<u>35.8</u>
Public	10.6	6.7	7.8	7.3
o/w: IMF	1.9	0.7	2.1	2.1
External debt securities	3.4	1.9	2.6	1.8
Private	<u>32.1</u>	<u>41.0</u>	<u>35.3</u>	<u>28.5</u>
Banks	7.2	7.3	4.4	6.5
Other sectors	24.9	33.8	30.9	22.0
Inflows	84.7	61.7	79.5	77.1
FDI (net)	15.7	6.3	5.5	7.0
Portfolio (private equity; net)	-0.6	0.1	0.9	2.0
Borrowing (MLT)	<u>65.1</u>	<u>35.3</u>	<u>50.2</u>	<u>54.6</u>
Public	7.8	6.6	17.6	12.5
o/w: IMF	3.6	0.0	0.0	0.0
Debt securities 1/	-1.1	2.0	13.6	9.5
o/w: TL-securities (net)	-5.1	-1.7	7.5	4.0
Private	<u>57.3</u>	<u>28.8</u>	<u>32.6</u>	<u>42.1</u>
Banks	9.9	4.6	5.2	9.1
Other sectors	47.4	24.2	27.4	33.0
Short-term (net) 2/	4.6	-4.0	7.7	5.0
Currency and deposits (net) 3/	-7.0	19.5	24.4	10.5
Errors & omissions 4/	5.6	4.6	0.0	0.0
Reserve use ('-' = reserve build-up)	1.1	-0.1	-9.1	-2.0
Memorandum Items:				
Public (net) 5/	2.2	1.5	2.3	1.2
Inflows from IMF (net)	1.7	-0.7	-2.1	-2.1
Private (net)	25.2	-12.2	-2.7	13.6
All short term 6/	3.3	20.1	32.0	15.5

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 \$31.7 billion as of end-2010Q2.

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

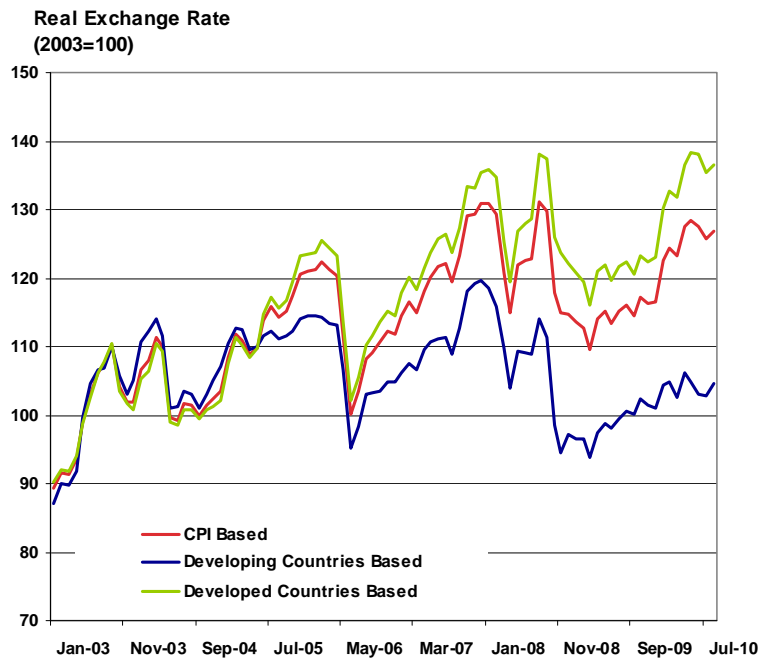
4/ We follow the convention of assuming zero E&O for projections.

5/ Excluding TL-securities.

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

The real exchange rate has been hovering around all-time highs this summer (Graph 16). While this partly results from *nominal* appreciation, Turkey's "excess inflation" problem vis-à-vis its trading partners continues to erode competitiveness. As we've argued before, we think the *lira* is strong by a number of yardsticks, which was portrayed, euphemistically in our view, as a "competitiveness gap" in the latest IMF report. A relatively challenging financing outlook, combined with an already strong *lira*, should not permit significant nominal appreciation going forward.

GRAPH 16



The Political Outlook: Smooth Sailing

AKP's resounding victory in the referendum on the Constitutional Reform Package (CRP) has eliminated a serious threat to political stability. Had the CHP/MHP-led rejection camp won, several forces would have been activated to force AKP into early elections. There is even more good news. An imprecise, yet realistic extrapolation of referendum results translates into a clear victory for AKP in the 2011 summer general elections. As such, our base case scenario for the rest of 2010 and 2011 is low risk perception, though the factors outlined below could lead to shocks and permanent deviations from the baseline. Generically, it should also be mentioned, regardless of their poll fortunes, the fiscal discipline track record of Turkish governments in an election year has been historically dismal.

Before discussing "bad" and "good" case scenarios, it is worth mentioning that we consider AKP the party best-qualified to govern Turkey, even though we do have serious objections to the divisiveness of its social agenda and the crass populism of its economic policies. Nevertheless, any coalition in general, and a CHP-MHP coalition in particular, remains the main risk in 2011 and beyond. The following opinion should have rarity value, but we think the most likely scenario for 2011 is also our best-case scenario. Our best-case scenario entails AKP winning a third term with roughly 300 deputies, strong enough to govern alone, but insufficient to adventure on the Constitution without opposition consent.

Defined in a.m. terms, a good-case scenario would be AKP sweeping 2011 elections with 366 or more deputies (out of 550), which would allow the party to enact constitutional changes that are likely to annoy the Kemalist-secularist minority, which by scoring 42% in the referendum proved what a formidable force it remains. We think this scenario would only be possible if the economy grew faster than our expectations, or if MHP and CHP imploded amidst intra-party power struggles.

We should also add that the latest poll results for AKP at 42% are comfortable, but not convincing enough to live to the promises of strict fiscal discipline, frequently uttered by PM Erdogan. Until the general elections, the following risk factors, too, could act as spoilers to these benign scenarios:

AKP's intentions: Prime Minister Recep Tayyip Erdogan has vowed forgiveness and reconciliation to the party's opponents in his post-referendum messages. Turkey desperately needs social peace, after the dirtiest and most divisive referendum campaign in a decade. While we have no evidence that it will do so, except by referencing the party's past behavior, if AKP chose to leverage its CRP victory to purge its opponents, the resulting clashes could undermine business and consumer confidence.

Kurdish conflict and PKK terror: Killing 10 civilians by a remote-controlled bomb, PKK is back at the terror game, demanding immediate amnesty for its leadership and the incarcerated leader Abdullah Ocalan. Its political wing, BDP, has launched a campaign of civil disobedience, which aims at internationalizing the conflict, to bring in the UN or EU to arbitrate. Any success by either organization could sour the majority of Turks against the AKP, strengthening MHP.

AKP's love affair with Iran: As we go print, Ankara announced intentions to triple trade with Iran, and even to explore the possibility of a free trade agreement. Relying on new sanctions to deter Iran from its nuclear race, the U.S. and EU are very likely to express severe dismay if this course is pursued. There is reason to think that allegations of AKP receiving a \$25 million donation from Tehran to finance its election campaigns are not-a-subtle clue to AKP to back off. As a corollary, a further alliance with Iran could compel the new U.S. Congress to adopt the Armenian genocide resolution. This would foster xenophobia at home, putting AKP in the untenable position of pandering to the domestic outcry AND preserving its good relations with Western allies. [①](#)

MURAT UCER & ATILLA YESILADA

Tepecik Yolu, Devran Apt.
1/18, Etiler
Istanbul, Turkey

Murat Ucer
murat@istanbulanalytics.com
+ 90.212.352.1270
Mobile 90.532.432.5873

Atilla Yesilada
atilla@istanbulanalytics.com
+ 90.212.352.1271
Mobile 90.533.216.9795

GLOBALSOURCE PARTNERS

708 Third Avenue
New York, NY 10017

info@globalsourcepartners.com

+ 1.212.317.8015
Fax 1.212.317.8318

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