Murat Ucer & Atilla Yesilada
October 24, 2010

TURKEY

Weekly Tracker: October 24-30

EXECUTIVE SUMMARY

The turban controversy gained new dimensions during the week, which renders a second closure suit against AKP a possibility. AKP is not perturbed, because turban controversy and a new lawsuit are ace cards for the upcoming elections. The party moved ahead with its plans to consolidate power over the judiciary and state agencies during the week, reinforcing secularist fears.

A Kurdish challenge to AKP's rule may emerge in November, either by terror organization PKK, or its legal wing BDP. The ATC meeting in the U.S.A. confirmed views that American policy establishment remains deeply suspicious of Ankara's diplomatic course.

Deputy PM Babacan reiterated that a short-term inflow tax on capital flows is not in the cards, while consumer confidence continued to recover through September. We expect September trade deficit in the $5.5-$6 billion range, though import growth, as always, is the wild card. As well, the Central Bank will release its Inflation Report on Tuesday, where we expect no major change in inflation forecasts, or the policy rate outlook.

The Corporate Focus looks at new dynamics in between the government and Turkish business, asking whether the former is redefining the concept of a "level playing field".

Cosmo warns against wave of global profit-taking in November, but remains confident that Turkey could survive the headwinds with minimal pain. In fact, he would advise buying into the correction.

POLITICS

Turban Controversy: The prosecution rests

Turkey's ageless and age-long turban controversy gained new dimensions after the Chief Prosecutor of Turkey (CP) Mr. Yalcinkaya, warned all parties and the Higher Education Board (HEB) that the ban on wearing the Islamic headscarf is mandated by the constitution. The insinuation was crystal clear: Reinstate the ban, or another closure lawsuit could be underway. His admonishments were scorned by AKP and MHP, which claimed that the CP was usurping the authority of the parliament by pre-empting preliminary talks on lifting the turban ban.

These talks, by the way, have been declared dead by CHP, which demanded guarantees that the ending of the ban would not open the way for turban freedom in secondary schools and civil service. The CHP delegation also insisted on deliberating the turban ban as part of a broader reform package that might encompass abolishing HEB, lowering the 10% hurdle to qualify for the parliament, as well as restricting the immunity of the MPs.

These demands were summarily rejected by the AKP team, though on Sunday there was talk of reviving the negotiations. Second thoughts might be useful, because the CP may indeed press a new lawsuit. After his warnings, the Ministry of Education (MoE) was compelled to admit that there were not two, but half a dozen cases of turban wearing teens and pre-teens currently attending secondary schools. Even Moslem scholars are divided on the wisdom of garbing teenage girls in the headscarf, but as of Sunday, the MoE had not yet issued a circular to expel these from classes. We understand that there was an "oral instruction" to do so, the effectiveness of which the Turkish media is certain to test this coming week. Failure to enforce the dress code in secondary schools would be considered undeniable intent to undermine the secularism clause of the constitution.

Readers may accuse the politic author of being too alarmist about yet another probe against AKP, which he certainly is, but no worries: this story has a Happy Ending. AKP is not perturbed by a second closure lawsuit, neither is the party too likely to revive talks for a legal compromise. The turban tension is one of the energy sources that feed support for the party. Thus, it is possible though not too likely, that a second lawsuit could be launched. The case may be heard by the Constitutional Court, where according to our headcount the secularists may hold a very slim majority. In as much as the current composition of the bench is almost certain to clear AKP of all charges, the party may prefer to exploit the court case and the shaky legal status of turban in universities in an early election.

The specter of a second closure lawsuit against AKP and the possibility of early elections is only one facet of this controversy. The second and probably more important aspect is that AKP's undeclared intention to open the way for turban in other areas may reshape the electoral map, a topic which we'll take up in our upcoming Monthly this week.

A Steamroller Called AKP

The secularists increasingly fear that no mercy or forbearance would be forthcoming from AKP. It is important to treat AKP's actions from the secularist viewpoint, because it will settle the important question of whether the secularist have the backbone to resist AKP orchestrated reform, or capitulate to it, a topic that will also be tackled in the Monthly.

According to the secularist world-view, AKP is now firmly on a course to consolidate its power on the judiciary, state agencies, and perhaps even in the business community. After the Ministry of Justice slate won by a landslide in the elections to Higher Commission of Justices and Prosecutors, President Gul appointed the remaining 4 members to complete the list. To the extent we could conduct a background search, his appointments were all names known for their open advocacy of turban and the ratification of the constitutional reform package in the 12th September referendum. Even the liberal association of prosecutors and judges formed to counterbalance the secularists on the bench was aghast. One commented: “We may have inadvertently voted to replace the Kemalist cabal [in the justice system] for a conservative one.” The Justice Minister firmly denies these allegations, claiming that pro-liberty jurists banded voluntarily to defeat the chokehold of status quo in the judiciary.

A last minute amendment to the new law on the High Court of Audit (Sayistay) excluded it from inspecting the books and activities of all state agencies, including state economic enterprises. If the law is approved by the President, there will be no entity, except the Office of the Prime Ministry that can supervise the state sector. When asked about the wisdom of the amendment, AKP members stated that Sayistay audits “were slowing things down”. True, Sayistas proved inadequate in evaluating complex business transactions, but from the opposition’s perspective, there is now no official watchdog to blow the whistle against corruption.

According to CHP, social conservatism is casting a deeper pall over the media as well. The amendments to the new law on Radio and TV Supervisory Board (RTUK) change the wording for programs to be censored from “pornographic” to “vulgar” or “obscene”. If the new language is approved, contends the CHP member of RTUK, it would grant the agency such a broad brief to shut down radio and TV broadcasts that would be the envy of the Saudi Arabian *fatwa* authorities.

Turkey’s supreme religious authority, the Directorate of Religious Affairs, or Diyanet, officially advocated independence from the state, of which it is formally an agency. The Head of Diyanet, Mr. Bardakoglu, told the daily newspaper Radikal that the congregation doesn’t take Diyanet too seriously as long as it is funded by the state and its leaders appointed by politicians. A Diyanet funded by the pious, with its head elected by member imams? This would be fine, even desired, if the constitution didn’t ban all religious entities except Diyanet and the clergy of Christian and Jewish minorities who are also state servants by the way. Since Alevites contend that Diyanet doesn’t represent them, where would its autonomy leave their 10-15 million flock?

More pertinently, there are signs that AKP may also be intervening in the business world in discriminatory way, as the Corporate Focus below recounts.

PKK Marks 1st of November

The trial of 150 pro-PKK activists and BDP members got underway in Diyarbakir this week, with protests, vigils, mayhem and Kurdish depositions. The defense attorneys’ request to end the year-long detentions was rejected by the bench, as protests erupted in several provinces with three cops being injured by PKK loyalists. PKK and Turkish Army clashed in small scale engagements across the Southeast Region, as several crack army battalions were moved into the rural areas to chase out the terrorists.

BDP implored AKP to begin negotiations on Kurdish rights. As the 1st of November deadline approaches when PKK will reconsider its self-imposed cease fire, there is concern that it will not be renewed and may trigger wide-spread Kurdish unrest. Well, you guessed it. Could Kurdish unrest reshuffle the electoral landscape? The answers would be in the Monthly.

Turkey and the U.S.A: It could get worse

This week's meetings organized by the Turkish American Council, a pro-business lobby, was attended by Industry Minister Caglayan, economy czar Babacan and Defense Minister Gonul. The meetings have allowed the Turkish press to hear first hand what Americans think about Turkish diplomacy. The broad conclusion is that the American policy establishment is generally clueless about its new direction in the Middle East and is deeply perplexed by recent Turkish behavior. However, the White House expressed its displeasure openly, as Defense Secretary Mr. Gates left a meeting immediately after making his speech, without bothering to listen to his counterpart, Mr. Gonul. This behavior is considered gross diplomatic discourtesy in Turkish culture.

An American Treasury team made the rounds at the Turkish Bankers Association, the Treasury and Turkey's anti-money laundering watchdog, MASAK, where reportedly Turkish banks were openly warned against doing any business with Iran. So what, you may wonder, so did we, and provided some clues in our upcoming Monthly.

ECONOMICS

Come, Come Again, Whoever You Are, Come!

Heathen, fire worshipper or idolatrous, come!

Come even if you broke your penitence a hundred times!

Ours is the portal of hope, come as you are!

Thus chanted Mevlana Celalaeddin Rumi, the world-famous 13th century sufi mystic, who is buried in Turkey's Konya province, and thus seems to be the attitude of the Turkish government toward capital inflows. After PM Erdogan declared a few weeks ago that a strong lira is "Turkey's pride" and called on the CBT to lower rates further to stimulate domestic demand -- signaling that Turkey's top man has no problem in pushing the balance of demand in the exact opposite direction the world is going -- Deputy PM Babacan said that Turkey is not considering to impose a "Tobin tax-like restriction" on capital inflows, and that capital will be as free as ever to flow in and out of the country, because such restrictions "don't work".

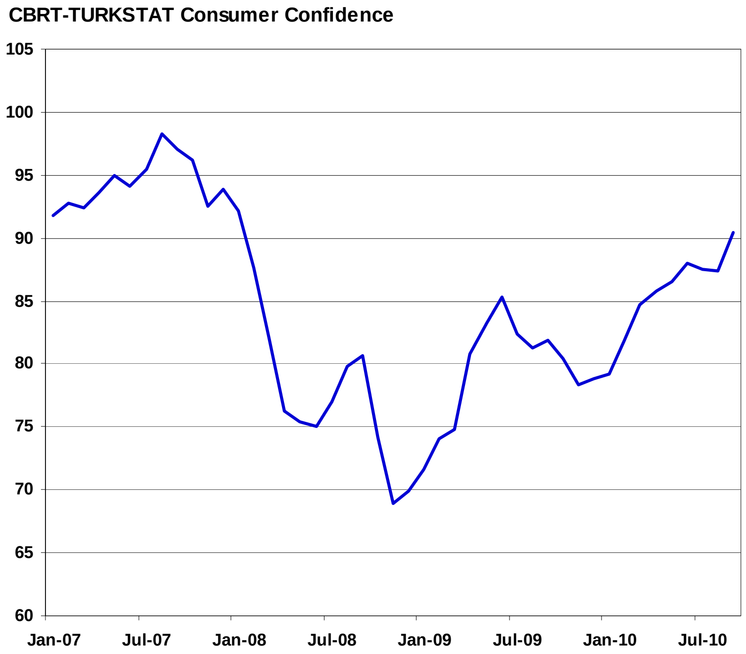
As an orthodox economist programmed in the Washington Consensus tradition, this should come as music to our ears. But in the current environment, Mr. Babacan's *laissez faire, laissez passer* approach sounds a little too imprudent and too complacent to us. Put differently, being friendly to global capital is one thing, managing it effectively, is another. The latter is a must, and it requires aggressive and effective coordination among various government agencies and lending significant support to monetary policy from tighter (cyclically-adjusted) fiscal and prudential policies, as well as as the IMF itself has been pointing out, from capital controls when necessary. The trouble is that, not much is happening on the fiscal and prudential side, while the Central Bank is more or less being left to its own fate in coping with the inflows.

This is understandable politically, because all that the politicians care about is to continue the "China-like" growth rates of the past few quarters through the general elections. But someone of a technocratic bend like Mr. Babacan should know better that a too welcoming language to capital inflows in this environment surely complicates the CBT's job in the short term, and is a recipe for creating another boom-bust cycle in the medium-term.

Recovering Confidence, Sticky Expectations

The CBT-TURKSTAT Consumer Confidence Index rose to its highest level since early 2008, when it had begun to decline, first because of political uncertainties of the AKP closure case and then, because of the global crisis (see graph). The level is still below the critical 100-mark, but the improvement is broad-based and the trend clearly shows that the consumer is feeling more optimistic.

This data is consistent with other consumption side indicators, like the 15% growth in the consumption index (CNBC-e) in Q3 that we've reported last week, and the 17% real growth (y/y) in consumer credit in September.



Meanwhile, the CBT's second expectation survey of the month suggests that inflation expectations are improving little, if at all, and analysts continue to jack up their growth and CAD forecasts for this year quite noticeably (see table; graph).

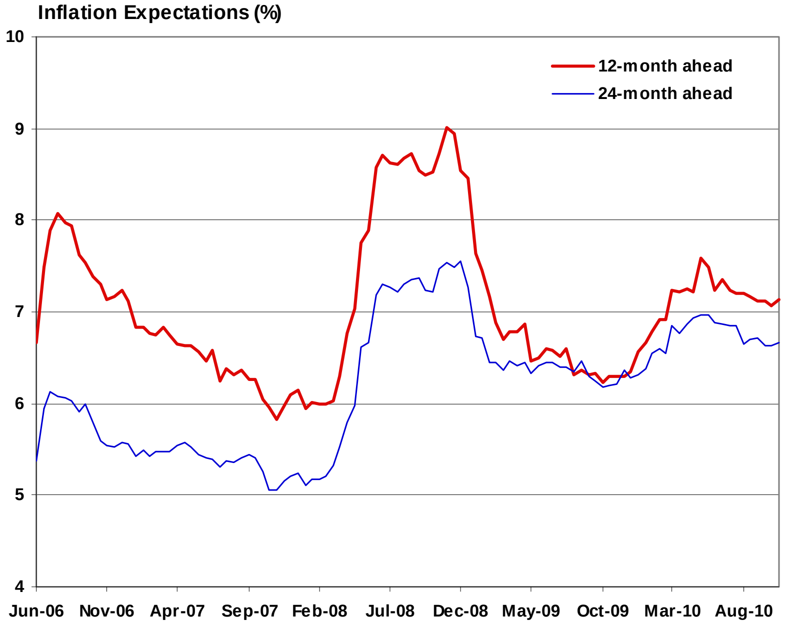
The CBT's policy rate is expected to be some 90 bps higher than it is now, which is unchanged from the previous survey.

Finally, the analysts expect October inflation at little over 1%, which, if true, suggests that the 12-month rate could drop by at least 1 pp from September's 9.2%. This is in line with the figure reportedly pronounced by the CBT Governor in his behind-the-scenes meeting with TUSIAD a week ago.

CBT Expectations Survey

	Aug-10		Sep-10		Oct-10	
	I	II	I	II	I	II
Monthly inflation (%)	0.16	0.23	0.69	0.76	1.13	1.15
Year-end inflation (%)	7.51	7.34	7.50	7.46	7.56	7.60
12-month ahead inflation (%)	7.20	7.16	7.11	7.12	7.06	7.13
24-month ahead inflation (%)	6.64	6.70	6.71	6.63	6.63	6.67
12-month ahead 6-months T-bill rate (comp.; %)	8.90	8.70	8.63	8.49	8.33	8.30
12-month ahead 5-year fixed coupon bond rate (comp.; %)	10.29	10.24	10.20	10.02	9.83	9.66
12-month ahead O/N rate (simple; %)	7.53	7.61	7.60	7.48	7.47	7.46
End of The Current Month's One-Week Repo Rate (simple, %)	7.00	7.00	7.00	7.00	7.00	7.00
12-month Ahead One-Week Repo Rate (simple, %)	8.00	8.01	8.00	7.94	7.89	7.90
Year-end current account deficit (billion US$)	32.47	32.98	33.74	35.06	36.22	37.52
Year-end growth (%)	5.50	5.52	5.54	6.19	6.37	6.72
Next year year-end growth (%)	4.67	4.64	4.60	4.61	4.72	4.78
Year-End US$/TL exchange rate	1.560	1.550	1.540	1.540	1.500	1.470
12-month ahead US$/TL exchange rate	1.570	1.570	1.570	1.570	1.530	1.520

Source: CBRT



Upcoming Attractions

The Central Bank will release its October Inflation report on Tuesday. We do not expect major changes from the July report in terms of inflation forecasts and the policy rate outlook. We shall follow up the Bank's deliberations with a Brief later that day.

The key data release of the upcoming week is trade balance where we expect a deficit in the $5.5 billion-$6 billion range. We expect exports to come in at some $9.3 billion, based on TEA data that excludes gold. But as always, imports are the wild card, which we forecast around $15 billion. In recent months, imports have been expanding at over 20% (y/y), which we forecast to have continued at little below this pace, in September.

THE CORPORATE FOCUS: PUTINISM, TURKISH STYLE?

The Turkish government may be taking a keen interest in Turkish corporate governance, which could raise eyebrows and affect business confidence. Courts rejected an appeal by Dogan Holding to have one of its many tax fines repealed, letting stand most of the TL3 billion tax evasion bill intact. On late Friday, Dogan Group announced the sale of its oil distribution chain Petrol Ofisi to the minority shareholder OMV of Austria for Euro 1 billion. As we had reported last week, Dogan Group is also trying to sell most of its media assets. To the extent we can inquire, it has no plans to invest into new areas. In other words it may be voluntarily liquidating itself. This could be a straight-forward business decision by the aging patriarch of the Dogan Family, Mr. Aydin Dogan, and his children to seek life's pleasures rather than enduring the stresses of the modern business world. However, it must be recalled that Dogan Media companies were blackballed by the AKP government for dirty propaganda against the party and PM Erdogan.

Dogan is not the only group that is battling huge tax fines "discovered" in a retroactive audit. Koc Holding flagship TUPRAS, Turkey's only refiner, was slapped a TL650 million penalty for evading VAT on asphalt sales. Tupras claims that the management simply booked these transactions, as it was the custom when the company was a State Economic Enterprise. Needless to say that Koc is the creme de la creme of secular Istanbul capitalists in the country, routinely harangued by AKP.

It is the proper role of the government to battle tax evasion, but skeptics may wonder WHY AKP refuses to investigate the affairs several Islamist holding companies, like White Holding, whose boss has been officially named as the co-defendant of a new lawsuit in Germany probing the donations embezzlement scandal by the charitable foundations Lighthouse Foundation.

Concerns that the government may be acting in a discriminatory manner against corporations may be unfounded. But there is concrete evidence that AKP does pursue positive discrimination. An extraordinary shareholders meeting of GSM company Turkcell was canceled, because the state supervisor "was stuck in the traffic". If the meeting had taken place, the other two foreign shareholders TeliaSonera and Alfa Group could have captured the majority in the board of directors from the Turkish owner, the Karamehmet Group. After the incident, Transport Minister told the press that the government has a vested interest in keeping "strategic companies like Turk Telekom and Turkcell" in Turkish hands.

Ankara needs to clarify its business policies soon, because Turkey is already attracting too little foreign direct investment. Careless acts and words could worsen the paucity of FDI and undermine AKP's painstaking work of erecting a level playing field.

COSMIC STRATEGIST: THE END IS NEAR

The first week of November could well mark a sea change in global markets. The calendar of events includes U.S. mid-term elections and QE2. Less noticed are two other developments. These are the mortgage foreclosure mess in the U.S. as well as the critical question of what kind of lessons the Chinese authorities have drawn from the G20 meeting. In a world where all the good news are amply reflected into asset prices, negative shocks could easily precipitate a sell-off, that may see the end of the year, if such a shock was to be accompanied by new data that U.S. or European economies are sliding closer to a Double Dip.

Specifically, mid-term election results or the mortgage mess could trigger a sell-off in the Wall Street, which has in the past infected EMs. Cosmo thinks in light of very solid views of EMs decoupling from the developed world, this first type of shocks may be bearable, or not even be felt in his part of the world. However, QE2 disappointing expectations of liquidity would directly feed into the long-rates, and subsequently into the Turkish government bonds. Cosmo also suspects that less liquidity from Fed than expected could strengthen the dollar, which has developed a strong inverse correlation with investors' appetite to buy risky assets like Turkish bonds and stocks. Reluctance by Chinese authorities to allow the remninbi to appreciate could trigger new countries joining the capital controls camp, or deepen fears of Currency Wars mutating into Trade Wars.

In conclusion, a correction in EMs, as well as Turkey, could be underway. However, there is little reason to believe that Turkish outperformance of EMs would go away even in the presence of such shocks. The Economist calling Turkey "the China of Europe" is apt in many ways, the least being AKP's Chinese-style governance. Joking aside though, the hype factor, including perhaps a seat in the IMF Board of Directors strongly favors Turkey.

So do rising 2011 growth expectations and the strongly held view that the CBT will have to hike rates the same year. Cosmo would like to take a moment to clarify this point. He firmly supports his colleague Murat Ucer's 2011 baseline growth and inflation forecasts, at least in the *gist.* In other words, he has no idea whether the numerical forecasts would materialize, but he is certain that growth would head south, while inflation won't. But, as evidenced in CBT's bi-monthly expectations survey, the market is now firmly pushing 2011 growth forecasts beyond those of the government, which is not yet discounted in the prices.

Inflation expectations, too, are stuck at a level that is consistent with CBT rate hikes in 2H2011, which means foreign investors could make even more money in money market assets and in linkers and floaters. Finally, unless Ankara pronounces intentions to the contrary, Turkey will probably be the last bastion of an open capital account in the EM space, meaning that prospective higher rates would further strengthen the currency, underpinning dollar carry in the a.m. assets.

Buy the profit taking, if it takes place, says Cosmo. In a momentum driven world, Turkey is a steam roller with brakes off. In the good old days, Cosmo would have added "eventually the excesses would come back to haunt the markets". But, this is no country for old bears.

SELECTED MARKET INDICATORS

	Oct 22	Oct 15	% Change Weekly	Monthly	3-Month	Year-to-Date	Annual
Treasury Benchmark Rate (compounded;%) 1/	7.70	7.74	-0.04	-0.35	-0.48	-1.17	-0.41
CBT O/N Interest Rate (simple %) 1/	5.75	5.75	0.00	-0.50	-0.75	-0.75	-1.00
Eurobond 2030 Price (US$) /2	181.40	182.75	-0.74	5.31	8.46	11.89	10.52
Exchange Rate Basket (0.5$+0.5€)	1.70	1.69	0.86	-1.43	-1.90	-6.34	-6.93
USD/TL	1.43	1.40	1.63	-3.77	-6.33	-4.42	-2.80
EUR/TL	1.98	1.98	0.32	0.32	1.55	-7.68	-9.69
ISE 100 (TL, close)	71,007	70,101	1.29	10.12	18.50	34.42	39.18
ISE 100 (US cents)	4.98	5.00	-0.33	14.44	26.51	40.63	43.19
ISE Trading Volume (billion TL)	3.03	3.45	-12.25	8.74	37.77	15.82	15.92
MSCI TR Index (Aug-08=100) 2/	138.36	138.91	-0.39	13.87	25.03	40.18	41.93

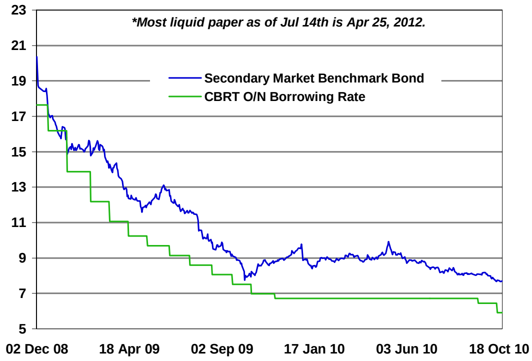
1/ % change columns are differences in basis points for the corresponding periods. Benchmark paper as of Apr 14th is Jan 25, 2012.
2/ Latest data: as of Oct 21

DATA RELEASE AND EVENT CALENDAR: OCTOBER 25-29

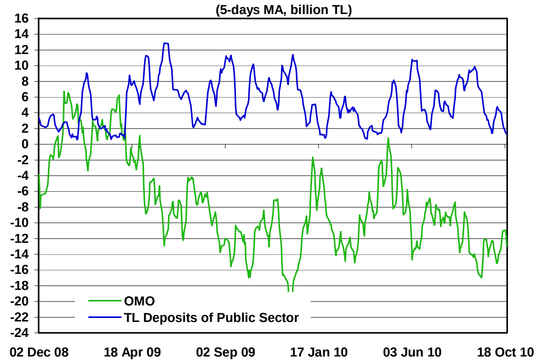
25	Capacity Utilization (Oct-10)	Oct-09 Capacity Utilization (%): 68.2%
	Real Sector Confidence Index (Oct-10)	Sep-10 Real Sector Confidence Index: 110.7
26	October Inflation Report Press Conference	
	Tourism Statistics (Sep-10)	Sep-09 Number of Incoming Tourists (%): 5.2%
27	Trade Balance (Sep-10)	Aug-10 Trade Balance (12-months rolling): -57.3 bn
29	Official Holiday	

Financial Markets

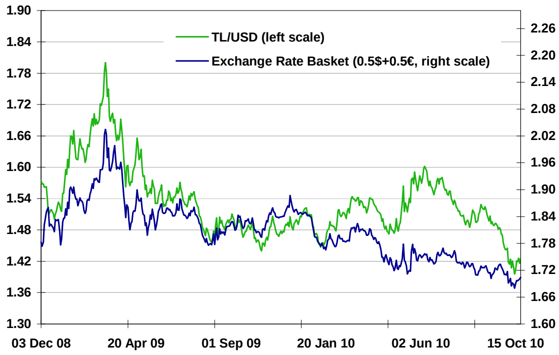
Secondary Market and O/N Compounded Rates



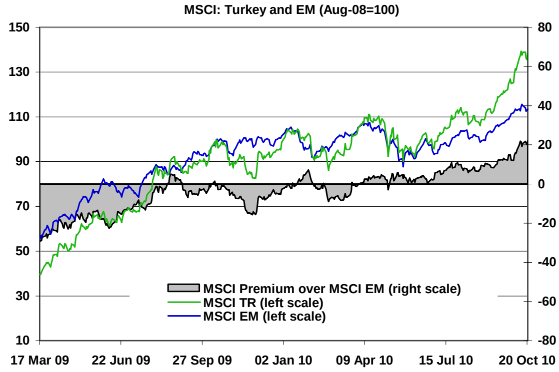
Reverse Repo Stock and TL Deposits of Public Sector (5-days MA, billion TL)



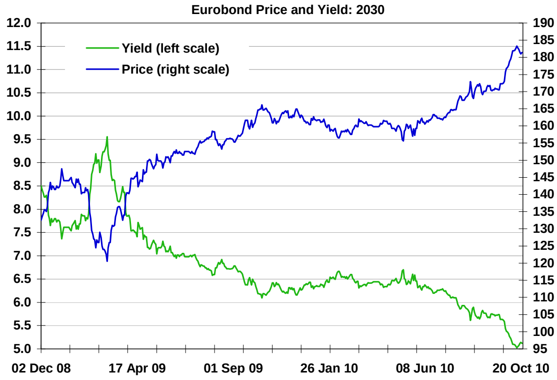
Exchange Rate



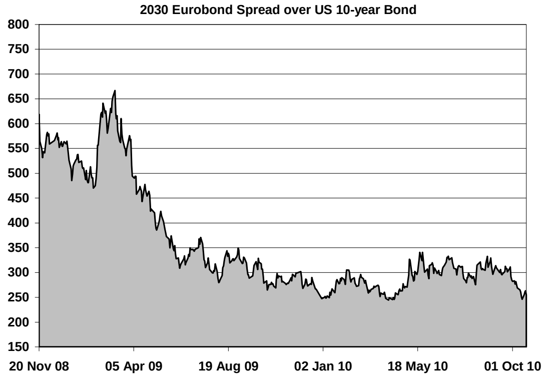
MSCI: Turkey and EM (Aug-08=100)



Eurobond Price and Yield: 2030



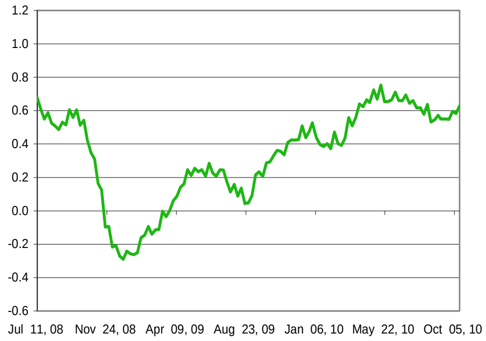
2030 Eurobond Spread over US 10-year Bond



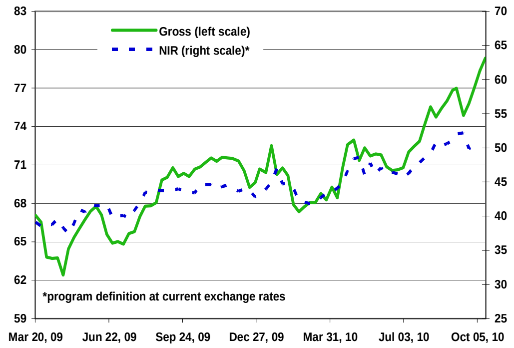
** All financial data are last business day's market close, OMO is 1 day lagged.*

Money and Credit Indicators*

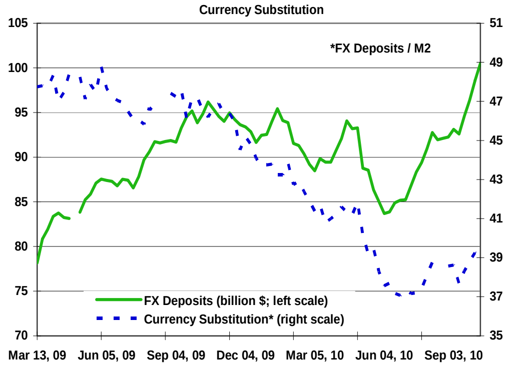
Consumer Credits (Weekly %; 8-Weeks MA)



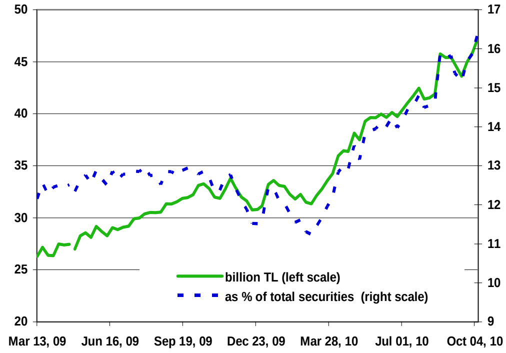
CBT Gross and Net International Reserves (billion $)



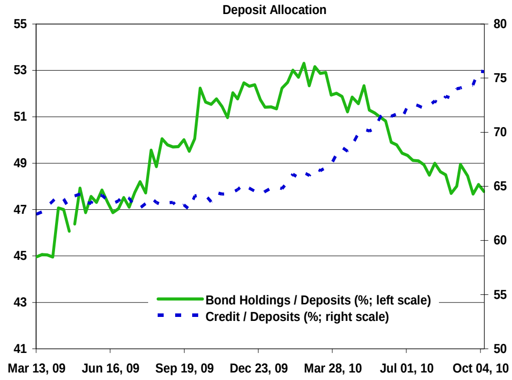
Currency Substitution



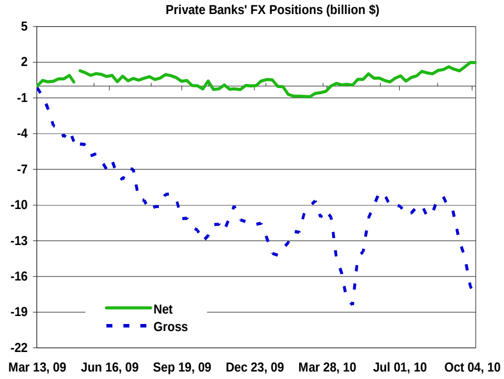
Non-Residents' Bond Holdings



Deposit Allocation



Private Banks' FX Positions (billion $)



**CBRT data and consumer credits through October 15, 2010 others through October 8 2010.*

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