Macro Scope

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Weekly Economic and Strategic Review

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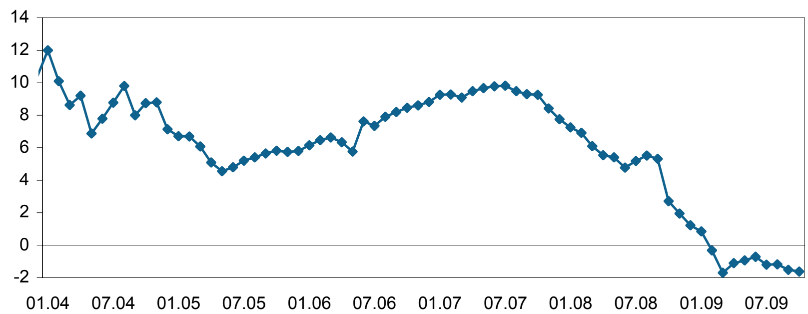
Letting The Cat Out Of The Bag…

We think that, the Central Bank's Inflation Report to be released on October 27th will be important for the lowest boundary of the downtrend in interest rates. As is known, **the most critical phrase in this comprehensive report is the one that describes the path of the policy rates in the Medium Term Outlook chapter.** After making detailed analyses, the Central Bank explains the most appropriate monetary policy stance - to be valid at least up until the release of the next report - that is consistent with the target inflation. After describing the baseline scenario in this part of the report, the risks to the chosen approach and alternative monetary policy stances are mentioned in the following parts. In the preceding Inflation Report released at the end of July, the Central Bank had described this policy rate path to be *"some further easing in the near term and constant policy rates until the end of 2010".* The Central Bank has moved in line with this scenario so far, introducing 50 bps rate cuts in each of the 3 meeting that followed the report. The next Inflation Report will be published at the end of January 2010. Therefore, considering that the Bank is likely to preserve their view that "the policy rates will be kept constant until the end of 2010" which was stated in the preceding report, the policy pattern to be described primarily for the forthcoming 3 months would be at the forefront. Given the Bank's emphasis on a possible slowdown in the rate cuts in the last MPC statement, **the word to be used for the size of interest rate cuts in the Inflation Report will be of critical importance for the amount of rate cut in November.** If the Bank says "measured", this would not be a clear signal, since this word had been previously used to imply 50 bps rate cuts. Such a choice would allow the Central Bank to be more flexible and make their decision according to the fresh data flow. If the Bank prefers to use a word which suggests a lesser amount of rate cut, the market would expect 25 bps rate cuts for the following meetings. **Another critical signal in the Bank's rhetoric would be whether the Central Bank would say "until the year-end".** If the Bank says so, then the market would think that the easing cycle will be ended with two final cuts in November and December. If it is not

Central Bank's Policy Rate (Real Rates Adjusted For EMBI+ Turkey Spread, %)

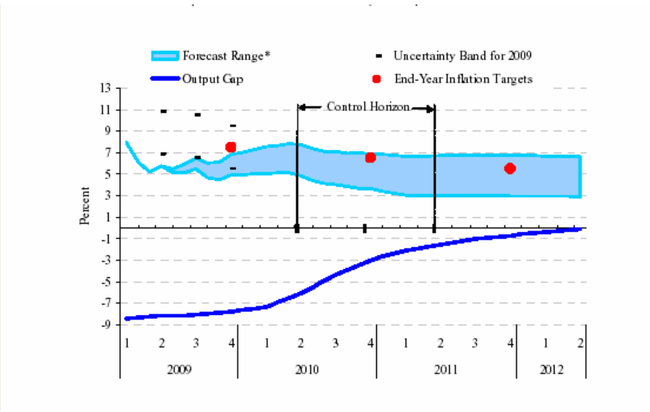


P.S.: 12-month forward looking CPI forecast is used for the calculation of Real Rate. EMBI+ spread is 238 bps.
Source: CBT, Fortis Economic Research and Strategy

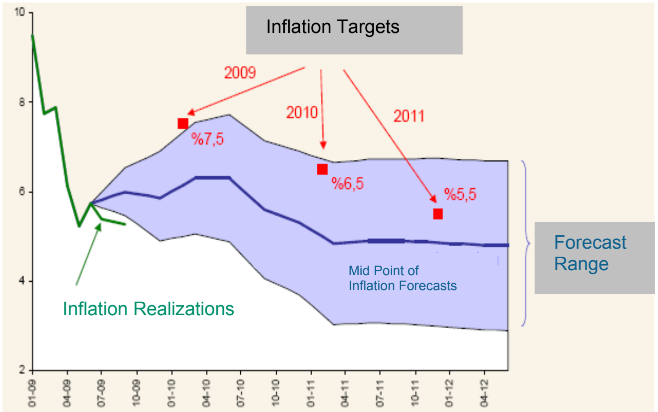
used, this time the market may interpret this as a sign that the rate cuts may be extended to January. Moreover, if the Bank assumes that the easing would continue in the “first months of 2010”, this would be consistent with further rate cuts in the whole 1Q10. Since the decisions are now more data-dependent, **Central Bank may prefer to use words which would allow more space for maneuver.** While the slow and gradual recovery in the economic activity appears quiet vulnerable, **the Central Bank is likely to stress that “interest rates will preserve their low levels for a considerable period of time” in order to avoid the markets even thinking of the idea of interest rate hike.**

Central Bank Governor Yilmaz indicated in his speech within the week behind that the economic recovery is running its course, yet the vulnerabilities remain. While these were similar remarks to the latest MPC statement, his comments about an IMF deal were equally important. **Yilmaz said that Turkey should learn how to stand on her own feet, giving the impression that the Bank’s expectations for IMF deal started to fade. We had the similar impression when the Bank had introduced the new measures about TRY liquidity (reduction in the required TRY reserves),** an issue that we will mention later in this report. As a reminder, the government had signaled to give their decision on IMF deal right after the IMF-World Bank meetings and it was claimed in the media that the economy team was expecting to hear IMF comments before the submission of the 2010 budget plan to the Parliament. Even though there is approximately one month before enacting the budget, there has been no intention yet, for concretizing this issue.

Inflation and Output Gap (*) Forecasts



Inflation Realizations, Forecasts and Targets (%)



(*)Output Gap: The gap between the actual GDP and potential GDP in an economy. The potential GDP is the theoretical GDP level which is estimated by using the labor endowment and capital endowment, as well as the productivity level in the country. If the actual GDP remains below the potential GDP, output gap emerges. In this case, demand is assumed not to produce any inflationary impact.

Source: CBT, Fortis Economic research and Strategy

Meanwhile, another issue stressed by Yilmaz, which may be more important in the short term, was about October inflation. He said that unlike the market expectations, **CPI would be high in October**. **This was a typical expectation management maneuver.** In the Bank’s Expectation Survey, the average CPI forecast was 1.1% in October. The low inflation expectations would raise the possibility of a negative surprise. We also stated in our Glocal Strategy Report released on September 24th that, the inflation figure may be visibly above the consensus, as the termination of tax cuts in many products (automotive, white goods, furniture), together with the electricity price hike may add around 0.9 pp to the headline. **However, as we mentioned beforehand, even this would not lead to an elevation in the annual CPI, thanks to the favorable base-year effect.** Accordingly, if for example CPI rises by 2.1% m/m in October in line with our expectation, the annual inflation would regress towards its historical low level at 4.8%.

In the meantime, one of the MPC members, Abdullah Yavas’s statements came to the forefront within the week behind. Yavas said in a conference that **there is lots of room to cut the rates if the economy is slower than expected. He also claimed that the Central Bank may theoretically push interest rates**

lower than the current inflation rate of 5.3% due to the large output gap. It is well known that the Bank expects the economic recovery to be slow and protracted. Yet, as the output gap scenario given in the preceding report (output gap disappearing completely in 2H12, after being around 9% of GDP in 2009 and starting to improve markedly in 2H10) was a worst case alternative, **we think that this time the Bank would try to justify the need for low levels of interest rates by emphasizing the better-than-expected course of inflation rather than depicting a worse output gap scenario.** The graph that depicts **"**Inflation realizations and CBT forecasts" above shows that the CPI is even below the lower bound of forecasts in the last months and also supports this view.

As a final point, let us discuss one of the aspects of the reduction in required reserve ratios. We think that the reduction suggests that **CBT started to implement Plan-B to improve the liquidity conditions.** Recall that, Plan-B was created to provide TRY liquidity to the markets in the lack of an IMF deal, which would have implied increase in the TRY liquidity. **Until recently, the Central Bank had postponed all the decisions which would have been taken as a sign that the IMF deal would not be done.** If Plan-B is fully implemented, a new reduction in the required reserves **or bond purchases from the banks,** which are also known as quantitative easing, would be the final stages. On the other hand, the **technical rate cut**, which is planned to be used in case of permanent liquidity shortage, **does not seem applicable to us** as it can create undesired volatility in the O/N rates. While we think that the level of liquidity shortage (liabilities on open market operations), which would propel the Bank to take advanced measures is TRY20.0bn, we are fairly far from this level for now (average of October is TRY13.6bn).

Summing up, we expect the Central Bank Inflation Report to bring some important information in terms of the lower bound of the policy rate. Meanwhile, the report may raise the downside risks to our 6.25% forecast for the lowest level that can be reached by policy rates. Adoption of such a stance would stem from the better-than-expected course of inflation, rather than deteriorating output gap. The implementation of Plan-B is another other important factor for the interest rates and all trump cards are not played herein, yet.

Economic and Political Agenda

- At home, we will eye the signals about the economic activity through the Real Sector Confidence Index, while Inflation Report and MPC summary to be released on Tuesday will be of critical importance in terms of the monetary policy. In the last day of the week, Treasury will unveil the Borrowing Program for November. The Treasury had foreseen TRY9.9bn and US$0.4bn domestic and external debt service, respectively. We reckon that the most important domestic debt redemptions will be on November 18th (TRY4.1bn) and November 25th (TRY2.2bn). In the meantime, Turkish market will be closed in the afternoon on Wednesday and for all day on Thursday due to national holiday. In the external arena, U.S. durable goods orders and 3Q GDP will be on the forefront. Meanwhile, there will be a slew of important balance sheet announcements this week, such as United States Steel Corp, Procter & Gamble, Exxon, Motorola and Chevron.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis *(Consensus)*
High	Real Sector Confidence Index, Oct.		Oct. 26th, 15:00 GMT	-
High	Imports & Exports, Sep.	US$bn	Oct. 30th, 15:00 GMT	12.5 & 8.6
Medium	Treasury's Borrowing Program, Nov.	-	Oct. 30th	-
High	ICC Price Index, Oct.	% m/m	Nov. 1st, 10:00 GMT	-

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
Medium	U.S.	C. Shiller House Price Ind., Aug.	% m/m	Oct. 27th, 13:00 GMT	-12.1
Medium	U.S.	Consumer Conf Index, Oct.	-	Oct. 27th, 14:00 GMT	54.3
High	U.S.	Durable Orders, Sep.	% m/m	Oct. 28th, 12:30 GMT	1.3
High	U.S.	New Home Sales, Sep.	mn	Oct. 28th , 14:00 GMT	0.44
High	U.S.	GDP (advance), 3Q	% q/q	Oct. 29th, 12:30 GMT	3.2
High	U.S.	Core PCE, Sep.	% m/m	Oct. 30th, 12:30 GMT	0.2
Medium	U.S.	Chicago PMI, Oct.	-	Oct. 30th, 13:45 GMT	49.1
Medium	U.S.	Michigan Sent Index, Aug.	-	Oct. 30th , 13:55 GMT	-

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2007-2010

	2008	2009f	2010f	2011f
GDP (TRY - bn)	950.1	924.9	1,013.2	1,120.4
GDP (US$ - bn)	734.9	596.7	645.4	681.6
GDP Growth (y/y % chg)	0.9	-6.0	4.0	5.0
PPI (y/y % chg)	8.1	4.0	5.0	4.0
CPI (y/y % chg)	10.1	5.5	6.5	5.5
Trade Balance (US$ - bn)	-69.8	-37.7	-56.9	-61.4
Exports (FOB, excl. luggage trade)	132.0	100.8	112.0	112.1
Imports (CIF, incl. gold)	201.7	138.5	168.8	173.5
Current Account Balance (US$ - bn)	-41.5	-11.3	-25.1	-26.9
Current Account Balance / GDP (%)	-5.6	-1.9	-3.9	-3.9

Financial Indicators Forecasts

	Oct. 23rd	1M	3M	6M	12M	2009	2010
US$/TRY	1.4625	1.4600	1.5000	1.5600	1.5600	1.4800	1.5600
EUR/TRY	2.1903	2.1600	2.2000	2.2600	2.2500	2.1800	2.2500
FX Basket	3.6528	3.6200	3.7000	3.8200	3.8100	3.6600	3.8100
EUR/US$	1.4976	1.4800	1.4700	1.4500	1.4400	1.4700	1.4400
O/N	6.75%	6.50%	6.25%	6.25%	6.75%	6.25%	7.75%
Benchmark Bond	8.10%	8.00%	8.50%	8.50%	10.00%	8.50%	10.50%

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