

VAKIFBANK TURKISH ECONOMY WEEKLY

**Souring Quality of C/A
Financing Together With
Increasing Uncertainty**

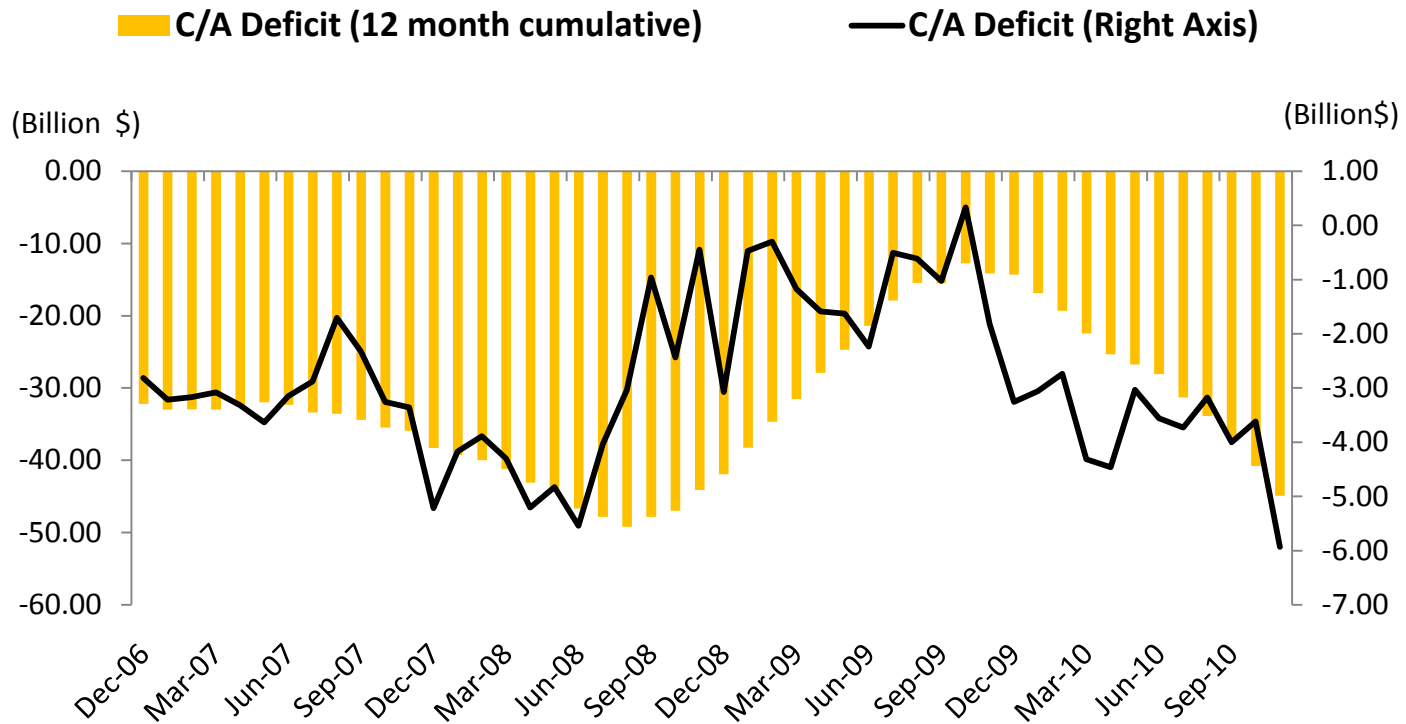


T. Vakıflar Bankası T.A.O



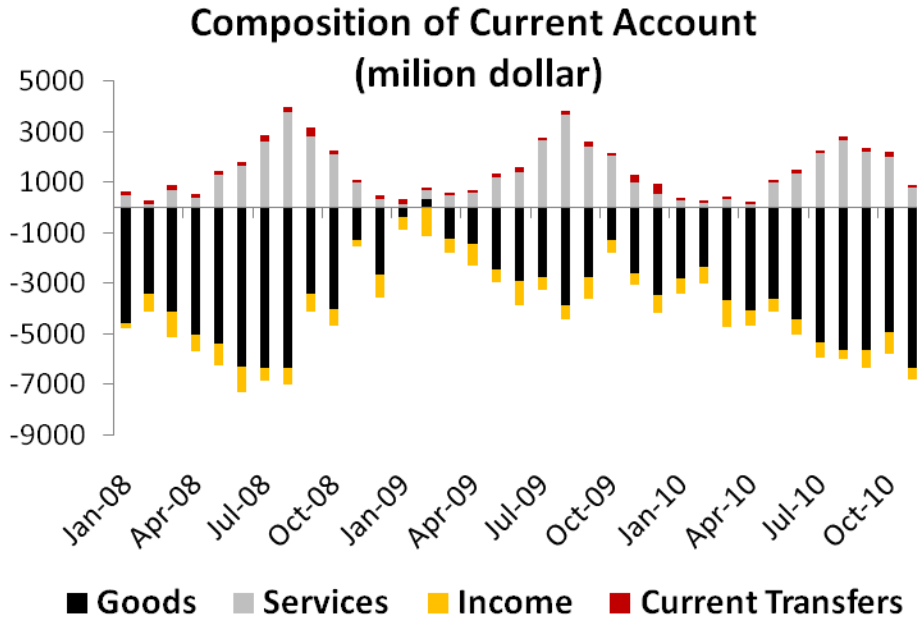
Current Account Deficit is wider than expected in November...

The current account (C/A) deficit came at US\$5.9 billion in November which is above market consensus of \$5.7 billion and under our forecast of \$6.3 billion. With November data the C/A deficit in the first eleven months of the year reached \$41.5 billion as compared to \$11.4 billion in the same period of 2009.



Source: CBRT

Foreign trade deficit has the highest impact on C/A deficit...



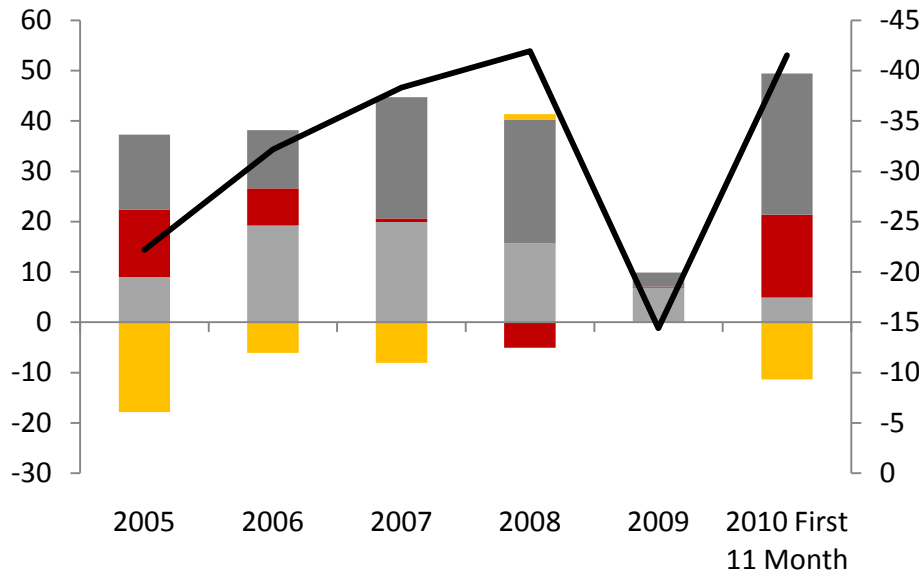
Source: CBRT

- Foreign trade deficit increased by 144.5% to \$6.37 billion in November 2010 compared to the same month of 2009. Increase in imports is the main reason of the rise in foreign trade deficit.
- Import/export ratio declined to 55.1% which is the lowest level of the last 5 years, due to weak foreign demand together with strong domestic demand conditions.

- Surplus in services decreased by 18% to \$13.1 billion in the first 11 months of 2010 while it was \$15.96 billion in the same period of 2009 as a result of the 8% fall in net travel revenues and 87% decline in net transportation revenues.
- Income deficit decreased by 7% to \$6.9 billion in the first 11 months of 2010.
- Current transfers decreased by 35%. Especially the 49% decline in general government sub item has been effective in this fall.

Main financing source for C/A deficit is portfolio investments...

Capital And Financial Account (billion \$)



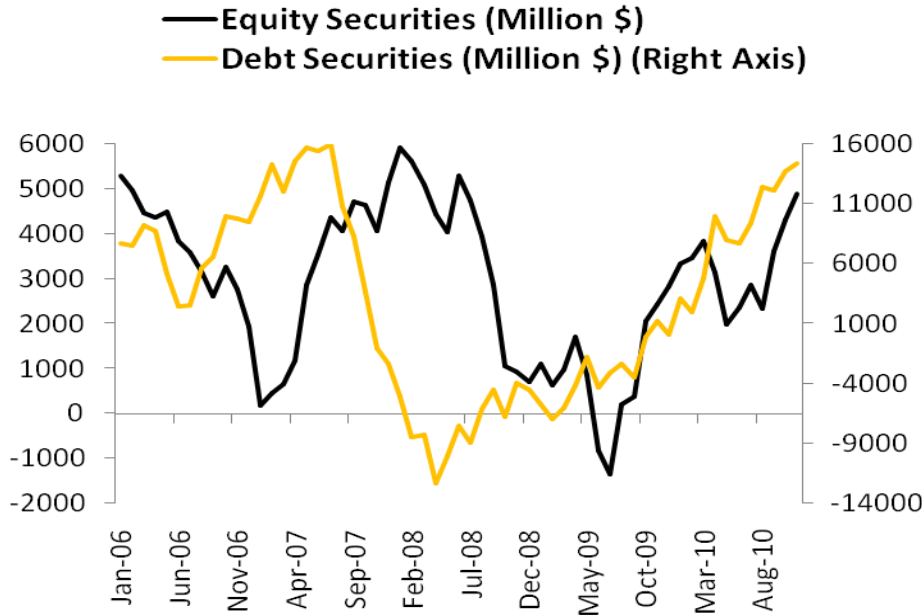
Direct Investment
 Other Investment
 Current Account (Right Axis)

Portfolio Investment
 Reserve Assets

Source: CBRT

- ▣ In January-November 2010 period, the capital and financial account cumulative total reached to \$38.1 billion compared to \$7.26 billion dollar in the same period of 2009.
- ▣ FDI inflows were lower (\$4.9 billion) compared to the same period of 2009.
- ▣ Portfolio investment was \$16.51 billion in Jan-Nov 2010 compared to \$851 million in the same period of 2009.
- ▣ With \$28 billion, other investment had the largest share in financing of the current account deficit in Jan-Nov 2010.

Foreign investors remained more inclined to government debt securities...

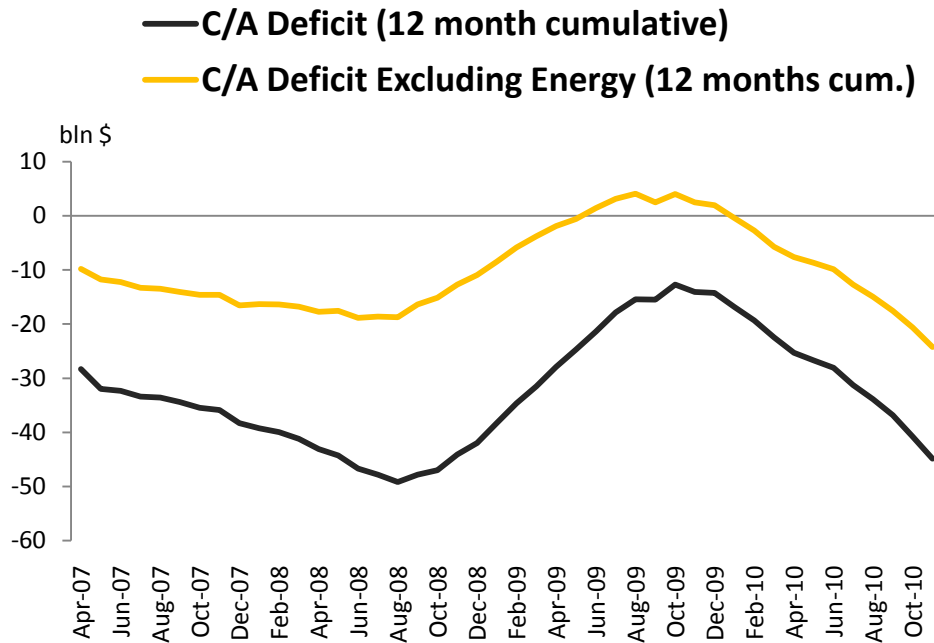


Source: CBRT

- Overall purchases of government debt securities was higher than equity purchases in November. In Jan – Nov 2010 period, total equity purchases amounted to just \$4.3 billion.
- On the other hand, foreign investors bought \$10.3 billion government debt securities in local markets.

- Reserve assets recorded an increase of \$11.4 billion in Jan – Nov 2010, contrary to \$1.1 billion decrease in the same period of 2009.
- Net errors and omissions also decreased to \$3.53 billion in the 11 months of 2010 while it was \$3.77 billion in the same period of 2009

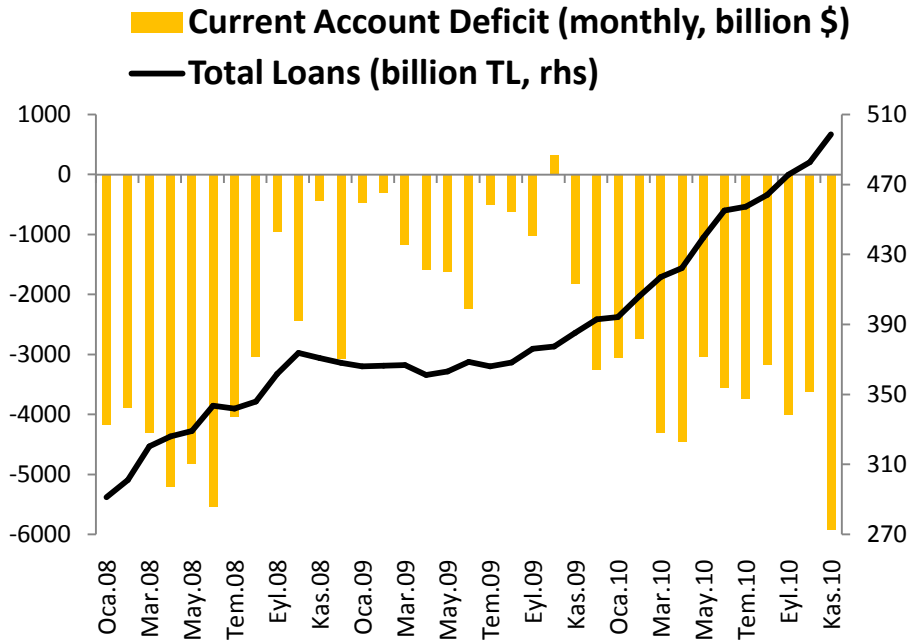
Another reason of the increase in C/A deficit is energy prices...



Source: CBRT, Turkstat

- ▣ The gap between C/A deficit and C/A deficit excluding energy continued to expand in November.
- ▣ The main reason of expanding C/A deficit in November is increasing imports due to strong domestic demand conditions rather than increasing energy costs.
- ▣ In the next period, there may be a risk of increase in Turkey's energy import cost due to increasing prices of oil and other production inputs.

Total credits of the banking sector remains high, while the quality of the C/A deficit financing is still weak...



Kaynak: CBRT, BRSA

Main reasons of the increase in C/A deficit in Jan-Nov 2010 period can be summarized as:

- Difference between the pace of domestic and foreign demand,
- Domestic credit expansion,
- Increase in commodity prices.








The increase in domestic loans carried C/A deficit to pre-crisis levels.

Increasing C/A deficit depends on not only domestic commercial loans but also appreciation in exchange rate, commodity prices and low rates in developed countries.










■ The widening of the C/A deficit has serious macroeconomic and financial risks.

■ Financing the deficit with short term capital inflows is at the top of the list.







Inflationary pressures may create vulnerability...

-  Strong growth performance, low price pressures, sustainable budget deficit and strong banking sector are drawing a bright outlook for Turkish economy.
-  However, rising C/A deficit stays as an important weakness.
-  Inflation may also turn into an additional cause of fragility.
-  World economy finished 2010 under subdued inflationary pressures.
-  It is generally expected that the inflationary pressures become stronger in specifically EM economies on a broad extent .
-  The loose monetary policies of developed countries especially the QE2 steps of the FED are expected to have inflationary effects in EM economies via capital inflows.
-  The probability of such an effect to arise in Turkey must not be overlooked.









Recent change in the CBT policy may cause inflationary pressures...

-  There's not a marked improvement in US growth outlook recently and the inflationary pressures seem to be subdued.
-  Problems of the Eurozone countries are still prevailing.
-  On the other hand, Germany has a strong growth performance with the record low unemployment rate, which may trigger inflation and as a result necessitate an earlier tightening of monetary policy.
-  CBT's rate cut decision in December has been taken in an environment in which the EM central banks are preparing for rate hikes and received cautious reactions.
-  It is claimed that CBT decision which was intended to limit portfolio capital inflows, might increase inflation under strong demand conditions.
-  However, CBT's concerns about potential inflationary pressures lies behind the rate cut decision.
-  Main risk about the CBT's unconventional policy is the failure in preventing the overheating of the economy.
-  Due to the low costs of borrowing, CBT's arrangements on reserve requirements may cause banks to increase their foreign liabilities and try to expand their credit portfolios further.
-  The decline in interest rates may also induce banks foreign liabilities as a result of the fall in the propensity to save.

The relationship between financial stability and overvaluation of TL...

-  The appreciation of the TL in real terms since the beginning of 2010 is an important factor on the C/A deficit expansion.
-  The rise in the exchange rate which resulted in some portfolio outflows from the equity market since December may limit the rise in C/A deficit.
-  Today, the world and Turkish economy is in a different conjuncture than May 2006.
-  If new policy of CBRT can't help prevent capital inflows and credit expansion, overheating in the economy may cause a rapid increase in inflation.
-  It is claimed that in this situation, even if CBRT begin to increase interest rates, loss of confidence as in May 2006 may cause capital outflows and a rapid increase in exchange rate.
-  But, due to the different conjuncture, the probability of a volatility effecting only Turkish economy is thought to be relatively low for the moment.

Turkey's credit rating is widely expected to increase...

-  If CBT fails to attain its policy goals, the possible loss of confidence may be prevented as a result of a possible increase in Turkey's credit rating.
-  The fact that the markets didn't overreact CBT's unconventional policy, indicate that a possible loss of confidence may be limited compared to the pre-crisis period.
-  On the other hand, it is a fact that the global financial crisis made the investors very sensitive to potential losses.
-  Due to the fact that Turkey's production is highly dependant on imports, depreciation of TL would increase import costs besides its positive effect on exports.
-  Eurozone countries problems are the main global threats which may trigger capital outflows in Turkey.
-  Inflation and strong capital inflows are the threats coming from EM countries.
-  Relative interest rate gaps are strongly related to the widening of the C/A deficit in Turkey.
-  A probable increase in Turkey's credit rating might induce foreign direct investments in Turkey.

CBT's unconventional policy increased uncertainty...

- EM central banks are signaling rate hikes emphasizing expected inflationary pressures.*
- CBT's rate cut in Turkey, brings out the widening of the gap between Turkish and EM interest rates.*
- As a result of this expectation, the fear of a sudden and serious depreciation of TL has recently increased uncertainty in Turkey.*

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