FORTIS

Macro Scope

5 - 11 April 2010

Weekly Economic and Strategic Review

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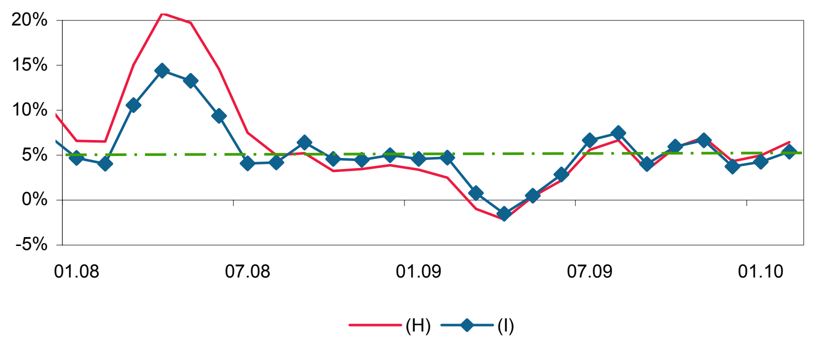
Soft Core, Gimme Some More...

The release of March inflation data early next week will reveal how much headline inflation retreated after surging to 10.1 percent in February. **While it is almost a given that the rate of inflation will return to single digits due to last year's base effect, the most pressing concern is whether the recent spike in inflation will lead to a deterioration in price setting behavior.** In other words, the bigger question is whether inflationary pressure will spread to other price groups – and since inflation has so far been limited to food prices and tax adjustments the question as to whether the share of inflated-price goods within the total (430 items) has gone up is still unanswered. **Equally important is how high the anticipated jump in core inflation will turn out to be.** The Central Bank noted in a recent assessment that due in large part to the base effect of tax cuts last year, core inflationary indicators would rise in March and April but nonetheless remain below the target. **While the Central Bank publicly discloses its CPI target, it seems to also have an implicit core inflation target.** We will come back to this issue later, but let us first cover possible developments and expectations in the short term. Surveys show that the average expectations of 0.5 to 0.6 percent for the March CPI are close to our 0.6 percent forecast; such a figure would rein in the annual CPI to 9.5 to 9.6 percent. Meanwhile, we expect the I-index – the Central Bank's favorite core inflation indicator – to go up from 4 percent to 5.1 percent. The months ahead will see the H and I indexes climbing steadily from their current 4 percent level to above 5.5 percent – even if core indicators maintain their current trend (seasonally adjusted 0.4 percent monthly growth), with the worrying outcome being an uptrend pushing core inflation above this normal level. **This begs the question – would a steady core inflation rate above 5% force the CBT to take action, even if the 2010 CPI target is kept at 6.5 percent? Let's delve into the issue…**

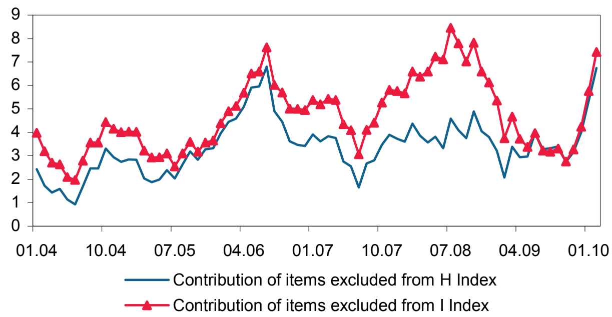
Core Inflation Indicators (H) and (I) (Sea.Adj. Annualized 2 month chg.)



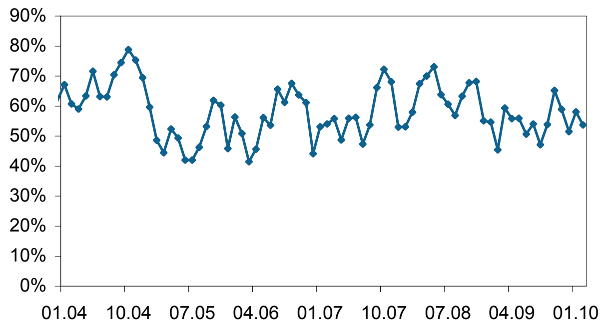
Source: Turkstat, Fortis Economic Research and Strategy

The Central Bank's innermost thoughts on core inflation, which is kept under control through the bank's monetary policy, are brought to light in the Annex to **the Monetary and Exchange Rate Policy announcement for 2010**, which sets the inflation target for 2012 at 5 percent. In this document, the CBT outlines **five main factors** instrumental in pushing the medium-term inflation target from 4 percent to 5 percent: **1) Factors specific to the Turkish economy** (high intermediation costs, inefficiencies in distribution channels, rigidities in labor market regulations, and imperfect competition conditions in some sectors) and **the ongoing structural reform process** (as the budget structure is not flexible enough, measures towards improving public balances can occasionally exert additional pressure on inflation); **2) Rigidities formed by the high inflation period in the past** (due to the prolonged period of high and sticky inflation in Turkey, price increases and inflation expectations show resistance against falling below a certain threshold value); **3) Convergence Process to the European Union** (in developing countries completing the accession process, prices converged to the average price level of the EU); **4) Considerations Regarding the Measurement of Price Indices** (biases originating from quality, new products and shopping center substitution); **5) Effect of External Factors.**

The Contribution of the Items excluded from H and I to Annual CPI



Dispersion Index (*)



Items excluded from H Index: Energy, Unprocessed Food, Alcoholic Beverages and Tobacco and Gold.
Items excluded from I Index: Energy, Food, Alcoholic Beverages and Tobacco and Gold
(*) The share of items whose prices rose among all CPI basket items.
Source: CBT, Turkstat, Fortis Economic Research and Strategy

Most significant was the analysis of the impact of external factors as it also revealed the required target for the core inflation rate. The contribution, over time, of the item groups excluded from the H and I indexes formed the mainstay of this analysis. We have updated these analyses with the most recent data available. The current data suggests that sub-items like food, energy, gold, and tobacco contributed a minimum of 0.9 and maximum of 6.8 percentage points to annual inflation as items excluded from the H index; the corresponding figures for items excluded from the I index are a minimum of 2.0 and maximum of 8.5 percentage points. **The average annual contributions from 2004 through 2009 stood at 3.3 and 4.6 percentage points for the H and I indexes, respectively.** At the end of February, the ratios of contributions to inflation for both the H and I indexes were near historical peaks at 6.7 and 7.4 percentage points, respectively.

While the contribution to the annual CPI of items excluded from the core inflation is likely to converge toward the average over time, annual growth in the H and I indexes is estimated to be 3.2 and 1.9 percentage points, respectively, consistent with this year's 6.5 percent CPI target. And if we assume that Central Bank could tolerate a rise in inflation to the upper limit (8.5 percent) of the inflation uncertainty band (two percentage points above or below the CPI target), these same values would rise to 5.2 and 3.9 percentage points, respectively. The increases in line with the medium term inflation target of 5 percent are extremely low at 1.7 and 0.4 percentage points, respectively. While in February the H index stood at 3.9 and the I index at 4.0 percentage points, the seasonally adjusted monthly increases hovered around 0.4 percent on average for the last three months. This in turn points to a steady uptrend of approximately 5 percent annually. This trend may indeed stay the course, but core inflation will most likely edge up above the 5.5 percent level, and stay conspicuously above the CPI target when contributions from external factors are taken into consideration. **Also, price levels in the services sector should also be monitored in relation to underlying inflation trend; the inflation rate in the services sector has been growing over the last two months and has reached 5.9 percent on an annual basis.** Growth in rents – typically the key component of services sector inflation – has been limited to 4.75 percent, meaning that the overall inflation rate hike in the services sector can be attributed to escalating prices in the restaurant-hotel and transportation sectors. Seasonally adjusted service prices, more relevant in forecasting trends, also confirms the limited expansion recently observed. **Last but not the least, the dispersion index, which shows how common price increases among all items in CPI basket, were not much different from earlier months: of the total 430 items in the CPI basket, the share of items whose prices rose was 54 percent.** Historically, this share has ranged between 40 percent and 70 percent.

Given the current outlook for external factors, benign core inflation will not spell relief for the Central Bank although this would give the bank more time to monitor developments. Insight into short-term price developments and their impact on general pricing behaviors should be closely monitored as it continues to play a critical role in monetary policy decisions.

In summary, while the annual headline CPI may take a downward turn in March, core inflation indicators are likely to climb – and the Central Bank is trying to prepare the public for this eventuality. Nonetheless, only the data will reveal how much the underlying trend is affected. The current outlook and historical progress of items excluded from the core inflation make us wonder whether the medium and long-term targets will be jeopardized if core inflation surpasses the 5 percent mark.

Economic and Political Agenda

- This week, on Monday March CPI and PPI figures and on Thursday cash based Primary Surplus and industrial production data will be important at home. Glancing at external arena, in the US on Monday non-manufacturing ISM and pending home sales will be released. On Wednesday Euro zone last quarter GDP second revision figure and services PMI will be important. On Thursday, Bank of England and European Central Bank will also declare the rate decisions

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis *(Consensus)*
High	CPI & PPI, Mar.	%m/m	Apr. 5th, 7:00 GMT	0.6 *(0.5 & 0.7)*
High	Industrial Output, Feb.	% y/y	Apr. 8th, 7:00 GMT	*15.8 (17.1)*
Medium	CB's Expectation Survey, Apr. I	-	Apr. 8th	-
Medium	Cash Based PS, Mar.	TRY bn	Apr. 8th	-

Data issuances Abroad

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
High	U.S.	Non-manufacturing ISM, Mar.	-	Apr. 5th, 15:00 GMT	54.0
Medium	U.S.	Pending Home Sales, Feb.	% m/m	Apr. 5th, 15:00 GMT	-0.1
High	Eurozone	Services PMI, Mar.	-	Apr. 7th, 7:58 GMT	53.7
High	Eurozone	GDP (2nd revision), Q4	% q/q	Apr. 7th, 9:00 GMT	0.1
High	Japan	BoJ Rate Decision	%	Apr. 7th	No change
High	U.K.	BoE Rate Decision	bps	Apr. 8th , 11:00 GMT	No change
High	Eurozone	ECB Rate Decision	bps	Apr. 8th , 11:45 GMT	No change

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2009-2012

	2009	2010f	2011f	2012f
GDP (TRY - bn) (*)	975.6	1,114.3	1,220.9	1,326.9
GDP (US$ - bn) (*)	630.6	733.1	791.9	848.6
GDP Growth (y/y % chg) (*)	-5.1	6.0	4.0	4.0
PPI (y/y % chg)	5.9	5.0	4.0	4.0
CPI (y/y % chg)	6.5	7.3	5.5	5.0
Trade Balance (US$ - bn)	-38.6	-62.8	-70.7	-70.6
Exports (FOB, excl. luggage trade)	102.2	116.0	132.6	144.4
Imports (CIF, incl. gold)	140.8	178.7	203.2	215.0
Current Account Balance (US$ - bn)	-13.9	-35.3	-39.9	-37.1
Current Account Balance / GDP (%)	-2.2	-4.8	-5.0	-4.4

(*) 2009 values are our forecasts

Financial Indicators Forecasts

	Apr. 2nd	1M	3M	6M	12M	2010	2011
US$/TRY	1.5115	1.5300	1.5300	1.5200	1.5300	1.5200	1.5600
EUR/TRY	2.0395	2.1000	2.1000	2.0800	2.1400	2.1300	2.1800
FX Basket	3.5510	3.6300	3.6300	3.6000	3.6700	3.6500	3.7400
EUR/US$	1.3493	1.3700	1.3700	1.3700	1.4000	1.4000	1.4000
O/N	6.50%	6.50%	6.50%	6.50%	9.25%	8.00%	10.00%
Benchmark Bond	8.90%	9.50%	10.10%	10.60%	11.50%	11.00%	11.50%

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