



Macro Scope

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Weekly Economic and Strategic Review

Haluk Burumcekci (Managing Director)
Tel: +212 318 34 49
Email: haluk.burumcekci@fortis.com.tr

H. Erkin Isik, CFA (Manager)
Tel: +212 318 34 05
Email: erkin.isik@fortis.com.tr

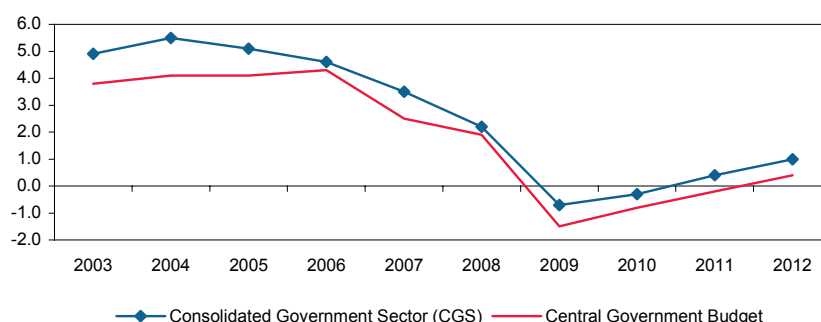
Nilufer Sezgin (Assistant Manager)
Tel: +212 318 37 90
Email: nilufer.s@fortis.com.tr

Email: research@fortis.com.tr
Tel: +212 272 79 98
Fax: +212 275 44 05

On Fiscal Discipline and Normalization...

Among Turkey's macroeconomic indicators, budget balances bore the brunt of the global financial crisis. On the one hand are the measures that resulted in a rise in spending following the discretionary tax cuts made as of the first quarter of 2009, and on the other are the indirect taxes and social security premiums collected taking a blow from the limited economic activity and surge in unemployment, respectively. Together, these factors culminated in a quick deterioration in budget performance. As a result, the year 2009 saw the largest ever budget deficit as a percentage of GDP and the first primary budget deficit since the 2001 crisis. But on the bright side, the deterioration in the budget was recognized as the cost of minimizing the destructive effects of the recession and building the necessary infrastructure to escape this cycle, given the crisis scenario. Turkey seized the opportunity stemming from this perceived positivism and for the first time in history jointly implemented anti-cyclical monetary and fiscal policies. As the economy bottomed out, both policies spelled the end of the downward flexibility almost simultaneously; interest rate cuts were suspended in November 2009, and tax hikes in December 2009 marked the turning point in budget performance. Although uncertainties persist as to the strength and resilience of the recovery, the normalization process in the coming period will continue to push policies further away from the point brought about by the extraordinary circumstances. This week, the Central Bank took the first steps along the road to normalization. Despite the positive budget performance in recent months, the normalization of fiscal policy will require the passing of some important tests in the structural (fiscal rule) and cyclical (use of fiscal space generated by higher than expected growth) areas. On the structural side, the fiscal rule pledged at the end of the first quarter seems to have been put on the back burner on the Parliament's busy political agenda. On the cyclical side, this year's unambitious budget targets may seem easy to achieve but a risk remains of the fiscal space generated by the economic recovery being commandeered for

Evolution of Primary Surplus and Medium Term Program Targets (Program defined, % GDP)



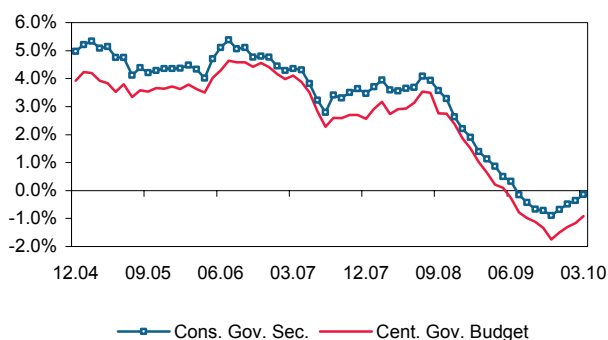
Source: Finance Ministry, Treasury, Fortis Economic Research and Strategy

a pre-election spending spree before the general elections scheduled for mid-2011.

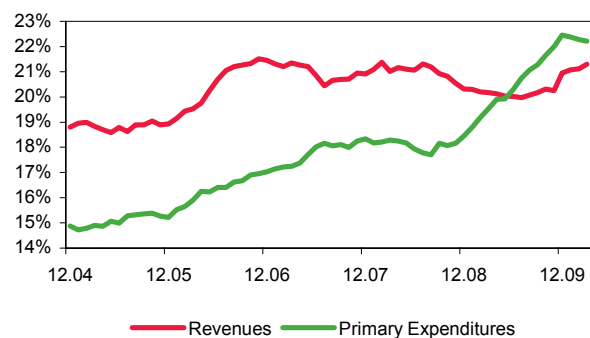
With the basics now behind us, we would like to discuss both current budget performance and the 2009 performance of the consolidated government sector – a wider definition than the central government budget– in light of the recently announced data. Let us start by giving the 2009 actuals; all data presented here are defined in the economic program and given as a percentage of GDP. While the 2009 Central Government Budget (CGB) primary balance reached 1.5% in deficit, the Consolidated Government Sector (CGS) primary deficit, which includes SEEs and other non-budgetary funds, remained at 0.7%. In contrast, the CGB budget deficit came in at 6.3% and the CGS budget deficit at 5.1%. These figures were better than the revised CGB and CGS targets but represent a negative performance compared to 2008 and previous years.

A review of the first quarter of 2010 reveals that this year, as mentioned in our FlashNote issued this week, the central government budget had a deficit of TRY 1.6bn in March, an improvement over the TRY 4.3bn primary deficit in the same quarter of last year. The program-defined values, which we favour because they reflect basic trends and exclude one-off revenues, also confirm that the improvement that began in December carried through into March. According to our calculations, the program-defined CGB primary balance had a deficit of TRY 2.1bn – lower than last year's primary deficit of TRY 4.5bn. We also calculated the primary balance numbers for the consolidated public sector. We were able to obtain December 2009 data for the SEEs and January 2010 data for the non-budgetary funds and the Unemployment Insurance Fund. Assuming that the as-yet unpublished data for the remainder of the period is similar to the previous year's data, the ratio of the 12-month cumulative primary deficit to GDP dropped from 0.7% at end-December to 0.1% at end-March. The year-end target set by the government for the 2010 CGS primary deficit was 0.3%, and we repeatedly argued that this target was not indicative of a sufficiently tight fiscal policy. While it may now seem easy to reach this target, there is a risk that the fiscal space stemming from the economic recovery could fuel a pre-election spending spree prior to the general elections to be held in mid-2011. It has been reported, for instance, that the recently announced measures to support small businesses will cost approximately TRY 2bn (2% of GDP) over two years.

Primary Balance (Last 12 months cumulative, % GDP)



Budget Revenues & Primary Expenditures (Last 12 months cum., % GDP)



Source: Finance Ministry, Treasury, Fortis Economic Research and Strategy

Key to trends in primary balance performance are the progress of budget revenues and primary expenditures as a percentage of GDP. The true indicator of fiscal discipline is a clear perception that primary expenditures are under control. The data reveals that recently observed improvements originate from the revenue side, and that primary expenditures hover around the levels reached when budget performance was at its poorest. At end-December, primary expenditures equalled 22.5% of GDP, the highest level to date, and then decreased marginally to 22.2% at the end of the first quarter of this year, to apparently settle at a level significantly above the approximately 18% average of the pre-crisis period. The higher revenues generated by the recent recovery in

economic activity are not a comforting sign for the long-term performance of the budget. In fact, even in years when growth was quite robust, the ratio of revenues to GDP stood at around 21.5% – leading us to believe that unless the expenditure run is stopped, it will be quite difficult to get the primary deficit in the 0.5% - 1.0% range and hold it there permanently. The real challenge is to reverse this elevated primary expenditures trend given the potential for continued fragility in the outlook for economic activity. Expenditures not yet seen to be under control point to the need for a structural solution, as current account transfers and personnel expenditures – the most important items of primary expenditures – rose by 14.6% and 11.9% respectively over the first quarter of 2009. But resorting to indirect taxation whenever the need arises for a new budgetary measure does not bode well for the quality of fiscal compliance.

The budget recovery that began in early December continues apace, helping to reduce the pressure on borrowing requirements. We contend, however, the trends in primary expenditures and enforcement of the fiscal rule – a crucial structural regulation – will truly put the country's fiscal discipline to the test. While reaching this year's budget targets may seem a simple task, the risk is real of the fiscal space created by the economic recovery being exploited for pre-election spending in the run-up to general elections in mid-2011.

Economic and Political Agenda

▪ This week, Central Bank's expectations survey on Thursday will be important at home. Besides, on Monday, meetings at Turkish Grand National Assembly regarding Constitutional Law's change proposal will start. Glancing at external arena, there will be a busy agenda especially in the US, with housing data, durable goods orders and in Euro-zone services and manufacturing flash PMI's will be eyed. In Germany IFO index will be important.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
Medium	Cent. Gov. Debt Stock, Mar.	TRY mn	Apr. 20 th , 14:00 GMT	-
High	CB's Expectation Survey, Apr. II	-	Apr. 22 nd , 13:30 GMT	-

Data issuances Abroad

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
Medium	Germany	ZEW Index, Apr.	-	Apr. 20 th , 9:00 GMT	45.4
High	Eurozone	Services Flash PMI, Apr.	-	Apr. 22 nd , 7:58 GMT	54.4
High	Eurozone	Manufacturing Flash PMI, Apr.	-	Apr. 22 nd , 7:58 GMT	56.5
High	U.S.	Core PPI and PPI, Mar.	% m/m	Apr. 22 nd , 12:30 GMT	0.1 & 0.3
High	U.S.	Existing Home Sales, Mar.	-	Apr. 22 nd , 14:00 GMT	5.21
Medium	Germany	Ifo Index, Mar.	-	Apr. 23 rd , 8:00 GMT	98.6
High	U.S.	Durable Ord. (ex-transport.), Feb.	% m/m	Apr. 23 rd , 12:30 GMT	0.4
High	U.S.	New Home Sales, Feb.	mn	Apr. 23 rd , 14:00 GMT	0.32

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2009-2012

	2009	2010f	2011f	2012f
GDP (TRY - bn) (*)	954.0	1,090.6	1,198.1	1,311.5
GDP (US\$ - bn) (*)	616.6	722.2	777.2	834.8
GDP Growth (y/y % chg) (*)	-4.7	6.0	4.0	4.0
PPI (y/y % chg)	5.9	5.0	5.0	5.0
CPI (y/y % chg)	6.5	8.0	6.0	5.5
Trade Balance (US\$ - bn)	-38.6	-62.8	-70.6	-70.5
Exports (FOB, excl. luggage trade)	102.2	115.6	132.6	144.4
Imports (CIF, incl. gold)	140.8	178.3	203.2	214.8
Current Account Balance (US\$ - bn)	-13.7	-35.3	-39.8	-36.9
Current Account Balance / GDP (%)	-2.2	-4.9	-5.1	-4.4

(*) 2009 values are our forecasts

Financial Indicators Forecasts

	Apr. 9 th	1M	3M	6M	12M	2010	2011
US\$/TRY	1.4720	1.5000	1.5200	1.5200	1.5300	1.5200	1.5600
EUR/TRY	1.9958	2.0400	2.0800	2.1000	2.1400	2.1300	2.1800
FX Basket	3.4678	3.5400	3.6000	3.6200	3.6700	3.6500	3.7400
EUR/US\$	1.3558	1.3600	1.3700	1.3800	1.4000	1.4000	1.4000
O/N	6.50%	6.50%	6.75%	7.50%	10.00%	8.50%	10.00%
Benchmark Bond	8.90%	9.40%	9.70%	10.80%	11.50%	11.00%	11.50%

Fortis Bank SA/NV Montagne du Parc 3 B-1000 Brussels Belgium Tel: +32 2 565 11 11	Fortis Bank Austria Euro Plaza/D Wienerbergstrasse 41 1120 Vienna Austria Tel: +43 1 81 10 43 81 85	Fortis Bank Czech Republic Myslbek Building Ovocny Trh 8 117 19 Prague 1 Czech Republic Tel: +420 225 43 60 10	Fortis Bank Denmark Gothersgade 49 3. 1123 Copenhagen Denmark Tel: +45 32 71 19 09
Fortis Bank, Succursale en France 30, quai de Dion Bouton F-92824 Puteaux Cedex France Tel: +33 1 55 67 72 00	Fortis Bank Germany Cäcilienkloster 8 50676 Cologne Germany Tel: +49 221 1611-0	Fortis Bank Greece Sygrou Ave 166 17671 Athens Greece Tel: +30 21 09 54 43 70	Fortis Bank Hong Kong 27/F, Fortis Bank Tower 77-79 Gloucester Road Hong Kong Tel: +852 28 23 04 56
Fortis Bank Hungary Deak Ferenc 15 1052 Budapest Hungary Tel: +36 14 83 81 09	Fortis Bank Italy Via Comaggia 10 I-20123 Milano Italy Tel: +39 02 57 53 24 61	BGL 50, avenue J.F. Kennedy L-2951 Luxembourg Luxembourg Tel: +352 42 421	Fortis Bank Norway Haakon VII's gate 10 0161 Oslo Norway Tel: +47 23 11 49 50
Fortis Bank Polska S.A. P.O. Box 15 02-676 Warszawa Poland Tel: +48 22 566 90 00	Fortis Bank Portugal Rua Alexandre Herculano 50-6 Andar 1250-011 Lisboa Portugal Tel: +351 213 13 93 16	Fortis Bank SA/NV, Singapore Branch 63 Market Street #21-01 Singapore 048942 Tel: +65 65 38 03 90	Fortis Bank S.A., Sucursal en España Serrano 73 28006 Madrid Spain Tel: +34 91 436 56 00
Fortis Bank Romania Tipografilor 11-15 013714 Bucharest Romania Tel: +40 21 401 17 02	Fortis Bank Sweden Birger Jarlgatan 25 10396 Stockholm Sweden Tel: +46 8 505 375 59	Fortis Bank Switzerland Rennweg 57 8021 Zurich Switzerland Tel: +41 58 322 09 70	Fortis Bank Turkey Yildiz Posta Caddesi No: 54 Gayrettepe 34353 Istanbul Turkey Tel: +90 212 274 42 80
Fortis Bank SA/NV, UK Branch 5 Aldermanbury Square EC2V 7HR London United Kingdom Tel: +44 20 32 96 80 00	Fortis Bank USA 520 Madison Avenue, 3rd Floor New York, NY 10022 United States Tel: +1 212 418 87 00		

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