

FORTIS BANK

Macro Scope

23 February – 1 March 2009

Weekly Economic and Strategic Review

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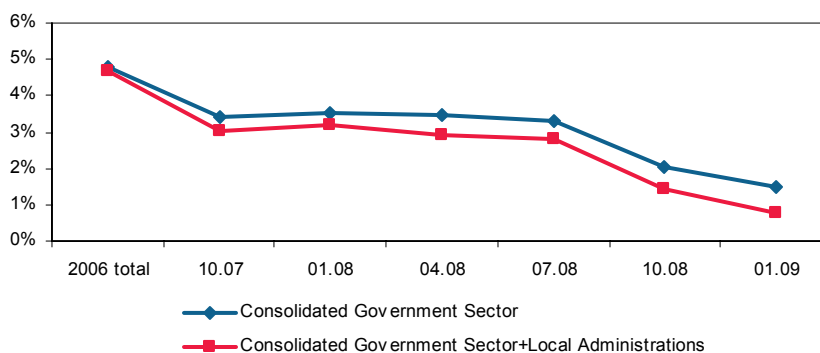
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It Is Transparent, But It Sure Isn't Sexy...

Economic Policy Research Foundation of Turkey (EPRI) published a report (*) on January 14th and drew attention to the deterioration in the expenditures by local administrations over the last years. This note was prepared by Assoc. Prof. H. Hakan Yilmaz who is well known by his successful research on public finance. Even though there has already been common awareness about the problems in the local administrations budgets, EPRI report is especially valuable as their analysis is based on actual figures. The local administrations' fiscal balances have been open for public access with the new code 5018 "Public Fiscal Management and Control Law" right after 2001 crisis. From 2006 onwards, fiscal performance of local administrations in quarterly periods is made available by Ministry of Finance, General Directory of General Accounting. The latest data at hand is as of end-September 2008. **The picture here shows that the fiscal performance of the local administrations has been deteriorating over the recent term, similar to the central government budget and the consolidated government sector balance. The ratio of the local administrations' budget deficit to GDP has been increasing, while they have constantly been producing primary deficit. More specifically, the budget deficit to GDP ratio soared to 1.0% from its 2006 level of 0.2% while the primary deficit increased to 0.5% from 0.1%.** Moreover, the fiscal performance will most likely to deteriorate further in 4Q08 and in 1Q09. The Turkish Parliament approved a new legislation in July 2008 to transfer a greater portion of general budget tax revenues to municipalities and special provincial administrations. Thanks to this new legislation, the government generated an additional TRY3.5bn source for their expenditures. Seeing the picture above, it is easier to understand why this regulation turned to be one of the main issues in talks with IMF.

Primary Surplus (Sum of last 4-quarter, % of GDP)



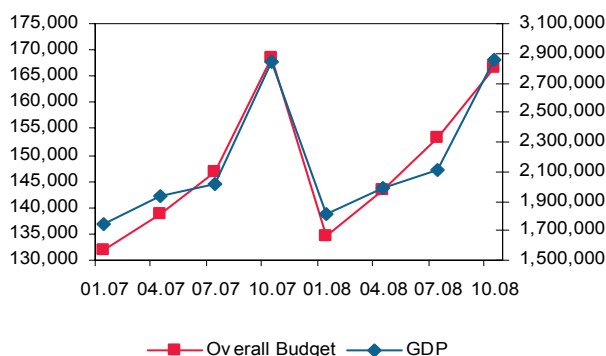
Source: Finance Ministry, Treasury, Fortis Economic Research and Strategy

PS: 4Q08 and 1Q09 PS of local administrations, as well as 1Q Consolidated Government PS are our guess.

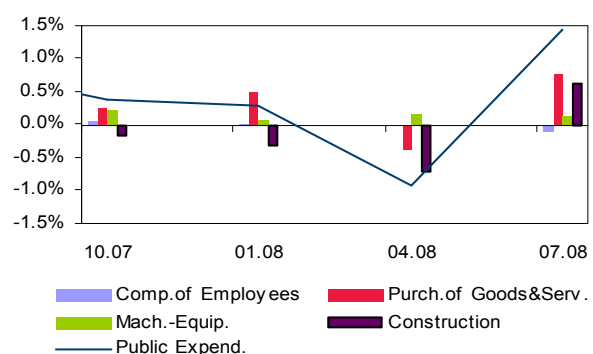
Against this backdrop, the government planned to save TRY500mn in 2009 central government budget by a new regulation, by which one-third of the personnel expenses in the municipalities would be paid by the special provincial administrations. In addition to the saving above, the media sources claimed that IMF has urged the government for TRY1.2bn cut in tax income transfers to municipalities, while this would be delayed until after the local elections. We will be monitoring the repercussions of these developments on the local administrations' fiscal performance going forward. However, it should be noted that the data is disclosed with a significant lag. As we mentioned in the preceding week, there has been a marked deterioration in budget performance especially from September 2008 onwards. In September-January period, the consolidated government sector primary surplus (PS) to GDP ratio declined by 2.1 pp, of which 0.9 pp portion was linked to the weaker revenues and 1.2 pp portion was the result of surge in non-interest expenditures. Unfortunately, a similar deterioration is very likely in the local administrations.

Aside from the noteworthy weakening in the fiscal performance, there are other striking changes in the fiscal structure, as well. **The purchases of goods and services by local administrations make up 30% of their overall expenses while the local administrations expenditures reach a mere 20% of the central government budget. Given this background information, excluding health expenses, the purchases of goods and services alone used to reach approximately 70% of the similar expense item in the central government budget. However, coming to January-September term of 2008, the local administrations spent almost as much as the central government did on goods and services (excluding health expenses).** Glancing at the capital expenditures, the local administrations' budget exceeded the central government budget. Yet, this was always like this in the preceding years and did not indicate at a structural change. EPRI makes the following comments on this issue: *"These numbers mean that with the fiscal power provided by the central budget, local administrations became an alternative budget in terms of public expenditures. In other words, public resources use for justice, security, defense, education, health and environment by central budget have now been shifted to local administrations.(...) On the other hand, the fact that local administrations use central government budget resources instead of their own for fiscal localization is a point that must be discussed thoroughly both in terms of distribution of roles and responsibilities between the central government and local administrations, and the prioritization of public services. It can also be said that local administrations becoming more center dependent in terms of resources has a negative effect on localization process of local administrations in the medium term."*

Government Final Consumption Expenditure (Budget vs. GDP)



Contribution of Public Expenditures to GDP



Source: Ministry of Finance, TURKSTAT, Fortis Economic Research and Strategy

(*) The consumption expenditures in the central government budget and local administrations' budget are aggregated and corrected for prices via CPI. The figures produced by this means are then compared to the government final consumption expenditures (in constant prices) as given in GDP. 4Q08 figures are all our estimates, except for the central government budget.

Under normal circumstances, rapid expenditure increase in any of the public sector constituents would not be desirable, due not only to the reasons mentioned above, but also to the general macroeconomic balances and especially worries regarding the Treasury's financing need. Yet, in periods of severe contraction, boosting public expenditures may seem more reasonable, hoping that this would eventually stimulate the private sector expenditures, provided that this expansionary fiscal policy will be reversed later. The public expenditures have direct and cyclical contributions to GDP. For example, in 3Q08 the public sector expenditures added 1.4 pp to growth, meaning that the GDP would have contracted by 0.9 pp in the absence of these expenditures. Approximately half of the contribution came from the consumption expenditures, while the remaining part was linked to the investment expenditures. We anticipate that in the last quarter, public sector investment expenditures will contribute growth more than the final consumption expenditures. Nevertheless, even this support will unlikely avoid a sharp contraction in GDP. As we mentioned above, the important thing is the stimulative power the fiscal easing on the private sector expenditures, rather than the direct contribution of public expenditures.

All in all, Public Fiscal Management and Control Law, one of the most important reforms launched after crisis, shed light on one of the least transparent fiscal area in Turkey, ahead of the local elections and IMF deal. This new application must be considered quite important in terms of the financial transparency and accounting liability, while the rapid deterioration in the fiscal performances of local administrations is quite worrisome. Separately, shifting the purchases of goods and services to the local administrations and generating an alternative budget by this means would be a negative signal for the Turkish Parliament's control on the budget and would have dismal implications for the relations between the public authority and local administrations.

(*) You can reach this EPRI report through

http://www.tepav.org.tr/eng/admin/dosyabul/upload/yerelyonocak_eylul2008butce_tepav_english.pdf

Economic and Political Agenda

- In this week's local calendar, the foreign trade and Real Sector Confidence Index may give important signals in terms of the economic activity. Meanwhile, the Treasury will not hold any auctions ahead of TRY490mn domestic debt service on Wednesday.
- The foreign data calendar is also loaded, with especially the 4Q growth revision in the U.S. Separately; Fed Chairman Bernanke will give a speech on monetary policy to the Senate Bank Committee.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis
High	Real Sector Confidence Index, Feb.	-	Feb. 23 rd , 15:00 GMT	-
High	Imports, Jan.	US\$ mn	Feb. 27 th , 15:00 GMT	9,800
High	Exports, Jan.	US\$ mn	Feb. 27 th , 15:00 GMT	7,300
Medium	Treasury Borrowing Program, Mar.	-	Feb. 27 th	-
High	ICC Price Index, Feb.	% m/m	Mar. 1 st , 10:00 GMT	-

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
Medium	Germany	Ifo Index, Feb.	-	Feb. 24 th , 9:00 GMT	83.3
Medium	U.S.	C. Shiller House Price Ind., Dec.	% y/y	Feb. 24 th , 14:00 GMT	-18.3
Medium	U.S.	Cons. Conf. Index, Feb.	-	Feb. 24 th , 15:00 GMT	37.0
High	U.S.	Existing Home Sales, Jan.	mn	Feb. 25 th , 15:00 GMT	4.75
High	U.S.	Durable Goods Orders, Jan.	% m/m	Feb. 26 th , 13:30 GMT	-2.4
High	U.S.	New Home Sales, Jan.	mn	Feb. 26 th , 15:00 GMT	0.33
High	U.S.	GDP (preliminary), 4Q	% q/q	Feb. 27 th , 13:30 GMT	-4.9
Medium	U.S.	Michigan Sentiment Ind., Feb.	-	Feb. 27 th , 14:55 GMT	60.0

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2007-2010

	2007	2008	2009f	2010f
GDP (TRY - mn)	853.7	971.7	1,011.2	1,112.5
GDP (US\$ - bn)	658.8	751.6	624.2	678.2
GDP Growth (y/y % chg)	4.6	1.0	-1.0	4.0
PPI (y/y % chg)	5.9	8.1	6.0	5.0
CPI (y/y % chg)	8.4	10.1	6.5	6.0
Trade Balance (US\$ - mn)	-62.8	-69.8	-37.4	-46.7
Exports (FOB, excl. luggage trade)	107.3	132.0	113.5	126.0
Imports (CIF, incl. gold)	170.1	201.7	151.0	172.7
Current Account Balance (US\$ - mn)	-38.2	-41.4	-12.9	-20.4
Current Account Balance / GDP (%)	-5.8	-5.5	-2.1	-3.0

Financial Indicators Forecasts

	Feb. 20 th	1M	3M	6M	12M	2009	2010
US\$/TRY	1.6749	1.7500	1.6500	1.6500	1.6900	1.6500	1.7300
EUR/TRY	2.1217	2.2400	2.1000	2.1000	2.1600	2.1100	2.2500
FX Basket	3.7966	3.9900	3.7500	3.7500	3.8500	3.7600	3.9790
EUR/US\$	1.2668	1.2800	1.2700	1.2700	1.2800	1.2800	1.3000
O/N	11.50%	10.50%	10.00%	10.00%	11.00%	10.00%	13.50%
Benchmark Bond	14.80%	13.50%	13.00%	13.00%	14.60%	13.00%	14.50%

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