

FORTIS BANK

Macro Scope

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Weekly Economic and Strategic Review

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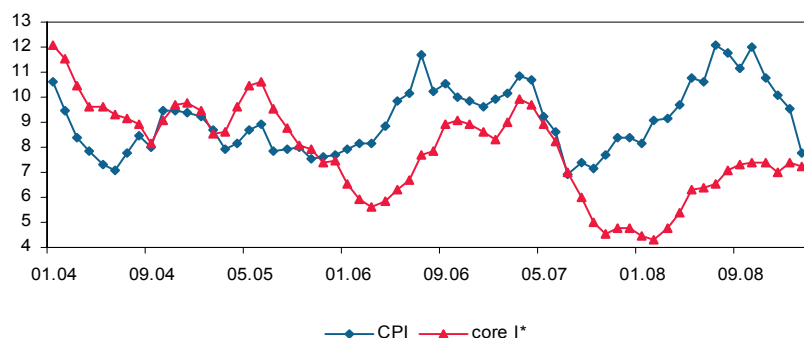
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The 'Core' Of The Argument...

Annual CPI inflation declined to 7.7% in February, increasing the odds for the year-end inflation to remain substantially below the 7.5% target. In fact the circumstances are quite favorable for the disinflation period, considering the surge in the output gap, tamed oil and commodity prices, as well as extensive inventory stocks that prevent F/X rate pass through. **After overshooting the official target for three years, it sounds to be good news that the Bank will finally be successful. Nevertheless, we must bear in mind that the targets we are referring to had been revised upwards by the Central Bank on June 3rd 2008 (*). The Bank had introduced significant lift to the target not only for 2009, but also for the following two years. Note that, back then the Central Bank's excuse for those revisions was the presumption of sustained elevation in oil and food prices.** For example, the average oil price assumption for 2009 was US\$105, while the food price inflation was assumed to be 8%. Coming to 1Q, however, the oil prices have been seesawing in a much lower range of US\$40-US\$45, while the future contracts are below US\$50 for the year's average. Moreover, food price inflation slumped to 6.2% in February. Our readers may recall that even though we had been great advocates for a revision prior to the Bank's announcement in June last year, we were not happy with revising the targets for such an extensive period of time, as that would be a bad signal in terms of maintaining price stability and fighting against inflation. **Even though this year may be seen as an exception, we believe it is not an appropriate approach to keep the CPI in the next two years above 4% medium term target.** Having shared our key argument, below we will analyze where the inflation is heading towards. Before that, let us remind you the pace of the headline CPI and core-I index, which is a good proxy to gauge the underlying inflation trend. The lowest annual changes of CPI and core-I index were 6.9% in July 2007 and 4.3% in February 2008, in the same order.

CPI and Core CPI (% chg. y/y)



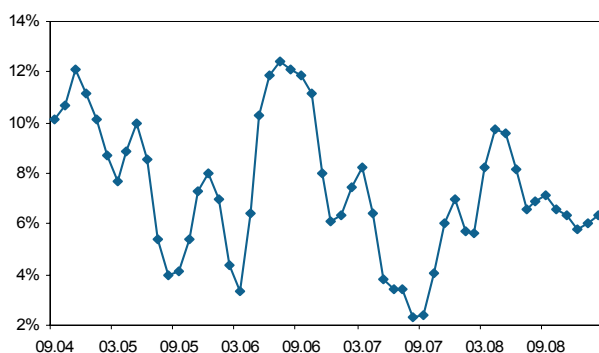
Source: TURSTAT, Fortis Research and Strategy

(*) CPI excluding food, energy, tobacco/alcoholic beverages and gold.

In inflation targeting regimes, the central banks generally target the headline CPI. Yet, core inflation is more important to them in order to monitor the underlying trend. After all, monetary policy decisions are unable to affect exogenous factors such as food and energy prices. For that reason, while they know that the headline inflation will shape the expectations, their decisions depend on the core inflation outlook. **As a natural consequence of that, it may be hard for them to convince the markets during periods where headline and core inflation head to opposite directions. For instance, in 2007, the core inflation was consistently falling, while the headline kept rising, complicating the acknowledgement of the favorable developments in the underlying price dynamics. Nowadays, we are at a similar point in terms of the dissynchronization of headline and core inflation. Yet, this time, even though the headline CPI heads towards below 7%, the core is stuck above 7% and that may be overshadowing some undesirable price developments.**

The annual CPI, which was 12% in October 2008, fell by a cumulative 4.3 pp in the consecutive 4 months. We expect the inflation continue falling gradually in the upcoming period, as well. This outlook is consistent with the convergence between the headline and core inflation by the end of February. Even though it is possible to see temporary jumps in annual inflation in some months due to the base effect; **we foresee that the CPI will regress below 7.0% in the middle of the year and toward 6.0% by the end-2009.** The most important factor which may alter this scene is the validity of the “early recovery” scenario, which denotes the exit from the recession in 2H09 for the U.S. economy. In that case, the output gap would narrow more rapidly in Turkey, paving the way for the cost pressures (elevated F/X rates and other factors) to be reflected to the consumer prices more easily, after the excess inventory levels come down. Under the light of current information, it can hardly be claimed that we are close to this scenario. Yet, there is no certainty about tendency towards a “late recovery scenario,” either. Although the 1st and 2nd quarter growth forecasts were revised down in the U.S., analysts still believe that the economy will start improving in 2H09.

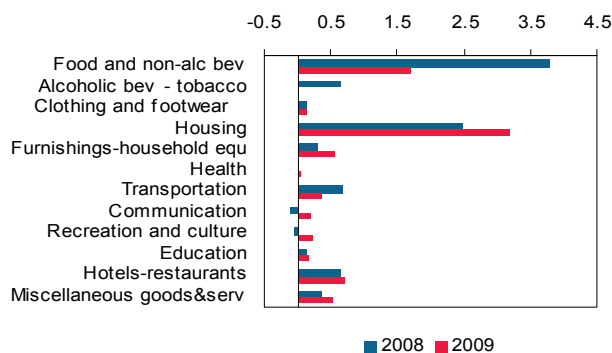
Core-I Index Trend (*)



Source: TURKSTAT, Fortis Economic Research and Strategy

(*) Seasonally adjusted, Annualized 2-month change.

Contribution of Main Groups to Annual CPI in Months of February (pp)



Source: TURKSTAT, Fortis Economic Research and Strategy

Accordingly, our check list for inflation outlook will be as follows:

- 1) First, we will watch whether the 2-month recovery in the U.S. PMIs will be able to turn into a permanent turnaround of the economy from the bottom.
- 2) Meanwhile, it will be critically important whether the recent halt of the deterioration in consumer spending helps reducing the inventories and whether this will eventually trigger industrial production. Although we expect 18% annual output contraction in January and although the February export figures showed that this trend prevailed, the key point will be whether the severe slumps in seasonally adjusted figures will cut pace.
- 3) Once this is realized, the F/X rate pass through, which has remained limited until now, will emerge as a more important risk. The core CPI kept surfacing higher than 7.0% since the annual inflation started declining in July 2008. This

underscores that even though such effects remain limited on the headline CPI, they nevertheless weigh on the underlying trends. Accordingly, while we are pleased to see that the trend of core inflation is surfacing around 6% vs. the annual inflation at 7.2%, we will eye closely whether the small increase seen over the last two months would turn into a permanent uptrend.

We do not anticipate that inflation outlook we depicted above will bring about a substantial change in monetary policy. In the latest MPC meeting's summary, the Bank judged that inflation is likely to undershoot the target significantly at the end of the year. Yet, they also stated that the amount of the next rate cut would likely be less than the current one. Under the lights of these statements, we stick to our forecasts for 100 bps rate cut in March 19th meeting and another 50 bps cut in the following MPC meeting. Separately, in the summary, CBRT mentioned two factors which undermine the efficiency of monetary policy that we underscored in our preceding weekly *MacroScope*, as well. **First is the spread between commercial loan rates and the policy rates that have remained at significantly high levels. Second one is the rise in the public sector borrowing requirement which could undermine the efficiency of monetary policy by weakening the impact of policy decisions over the longer end of the yield curve. The developments in these two factors are likely to be as important as the inflation tendency for the upcoming monetary policy decisions.**

All in all, the February inflation readings and other signals raised the possibility that the inflation will undershoot 7.5% target significantly at the end of the year. Therefore, we revised down our year-end forecast to 6.0% from 6.5%. The convergence between core and headline inflation suggests that the fall in the inflation will be gradual in the upcoming period. We want to underline that the F/X rate pass through effect, which has remained limited up to now, may appear as a more important risk especially for the underlying inflation trend.

(Food and energy prices continue to pose risks to the medium term inflation outlook and there is no clear evidence that this trend will reverse in the short term. Under these circumstances, we think that it would be appropriate to factor in the possibility of further supply side shocks; and thus to design the target path so as to minimize the risk of a second revision in the inflation target path. Accordingly, we envisage a target path with a more gradual convergence towards 4 percent inflation. Considering these assessments together with the three alternative projections presented in the April Inflation Report, we propose to revise the targets for 2009 and 2010 to 7.5 and 6.5 percent, respectively; and to set the target for the year 2011 at 5.5 percent. (Open Letter Written to the Government About Inflation Targets Pursuant to Article 4 of the Central Bank Law (Translation) – 03/06/2008.)*

Economic and Political Agenda

- At home, we will watch January industrial output index to see whether the economic contraction cut pace as expected. Separately, the Treasury's cash based PS will be the first signal for the fiscal performance in February. Meanwhile, the Treasury will issue 6-month reference bond on Monday and T-bill due 3.03.2010 on Tuesday ahead of Wednesday's redemption of TRY2.3bn.
- Glancing at external arena, we will see a quiet data agenda this week. The key data of the week seems to be the U.S. retail sales.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
High	CB's Expectation Survey, Mar. I	-	Mar. 9 th	-
Medium	Cash Based PS, Feb.	TRY bn	Mar. 9 th	-4.1
Medium	Central Government Bud. PS, Feb.	TRY mn	Mar. 9 th - 13 th	-
High	Industrial Output, Jan.	% y/y	Mar. 9 th , 8:00 GMT	-18.0 (-17.9)
Medium	CNBC-e Consumption Index, Feb.	-	Mar. 10 th , 8:00GMT	-
Medium	Capacity Use, Feb.	%	Mar. 10 th , 8:00GMT	(62.9)
High	C/A deficit, Jan.	US\$ mn	Mar. 10 th , 15:00 GMT	-200 (-516)

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
High	U.S.	Ret. Sales, Total & ex-auto, Feb.	%, m/m	Mar. 12 th , 12:30 GMT	-0.4 & -0.2
Medium	U.S.	Export & Import Prices, Feb.	%	Mar. 13 th , 12:30 GMT	0.0 & -0.5
High	U.S.	Foreign Trade Balance, Jan.	US\$bn	Mar. 13 th , 12:30 GMT	-38.2
High	U.S.	Michigan Sent Ind. (prel.), Mar.	-	Mar. 13 th , 13:55 GMT	55

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	6.0	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

	March 6 th	1M	3M	6M	12M	2009	2010
US\$/TRY	1.7314	1.8000	1.8000	1.6500	1.6900	1.6500	1.7300
EUR/TRY	2.1776	2.2700	2.2500	2.0800	2.1500	2.1000	2.2500
FX Basket	3.9090	4.0700	4.0500	3.7300	3.8400	3.7500	3.9800
EUR/US\$	1.2577	1.2600	1.2500	1.2600	1.2750	1.2700	1.3000
O/N	11.50%	10.50%	10.00%	10.00%	11.00%	10.00%	13.50%
Benchmark Bond	15.40%	15.50%	15.00%	13.00%	14.60%	13.00%	14.50%

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