

**Inflation outlook deteriorating despite the decline in annual headline**

In September, consumer prices rose 0.75% over August, slightly above the 0.68% market consensus and above our forecast of 0.50%. Annual CPI inflation is down to 6.15% from 6.65% thanks to the high base of September last year.

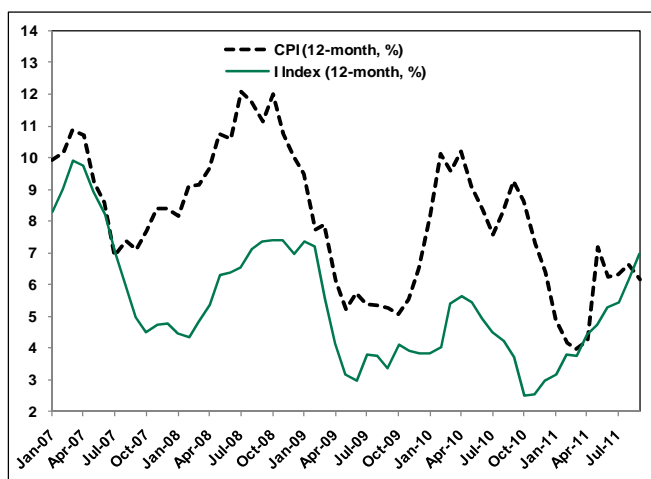
Depreciation of the lira affects inflation through import prices...

Broadly in-line with our 0.8% forecast, food and non-alcoholic beverage group prices rose 1.0% MoM, contributing 0.3 pp to headline inflation. Transportation and houseware prices rose 1.9% MoM, and 0.9%, respectively, contributing 0.3 pp and 0.07 pp to headline inflation in September. Private transportation vehicles rose 3.1% MoM in September, while transportation service prices increased 1.67% MoM. On the other hand, clothing prices, which declining 3.2% MoM due to seasonal discounts, erased 0.2 pp from the headline figure.

Core inflation is increasing...

Among core inflation indicators, annual I index inflation rose to 6.96% - the highest level since February 2009 - from 6.19% observed in August. Recall that the I index is the most closely observed core inflation indicator of the CBRT, and excludes food, energy, tobacco products and gold. Meanwhile, annual H index inflation increased to 7.42% from 6.67%. Moreover, core I index inflation is set to exceed 7% in October.

It is explicit that the lira's losses have been reflecting on both headline and core inflation. After the special consumption tax hikes, we revised our inflation forecast up to 9.1%, while we kept our forecast for end-2012 at 6.4%.



Source: Turkstat

**Summary Inflation Data: September 2011**  
(in percent)

	Monthly		12-month	
	Sep 11	Sep 10	Sep 11	Aug 11
<b>CPI</b>	<b>0.75</b>	<b>1.23</b>	<b>6.15</b>	<b>6.65</b>
Food and Beverages	0.99	4.72	2.23	6.00
Tobacco and Liquor	0.11	-1.10	-0.29	-1.50
Clothing and Footwear	-3.24	-2.21	6.29	7.42
Housing	0.63	0.33	5.27	4.96
Houseware	0.92	0.48	8.61	8.13
Health	0.03	0.16	0.35	0.49
Transportation	1.92	0.12	14.10	12.08
Communication	0.18	-1.85	2.98	0.90
Entertainment and Culture	0.43	0.86	2.74	3.17
Education	1.79	1.16	6.24	5.59
Hotels, Cafes and Restaurants	1.10	0.74	8.36	7.98
Miscellaneous goods and services	2.78	1.23	20.19	18.38
<b>PPI</b>	<b>1.55</b>	<b>0.51</b>	<b>12.15</b>	<b>11.00</b>
Agriculture	0.80	0.44	-2.00	-2.34
Industry	1.69	0.52	15.23	13.91
o/w: Mining and Quarrying	1.42	0.86	17.46	16.81
Manufacturing Industry	1.57	0.56	17.03	15.86
Electricity, Gas and Water	2.90	0.09	-0.11	-2.84

Source: TURKSTAT

**MPC meeting: Negative for bonds**

CBRT is reacting to excess depreciation by cutting lira liquidity...

The CBRT kept the policy rate (one-week repo rate) unchanged at 5.75%. On the other hand, the Committee increased the O/N lending rate to 12.5% (up 350 bps) and the interest rate on borrowing facilities provided for primary dealers via repo transactions to 12.0% (up 400 bps). In addition, the late liquidity window lending rate increased to 15.5% (up 350 bps). Meanwhile, the bank kept O/N borrowing rates unchanged.

Though the MPC announcement implies that the widening O/N rate corridor was to prevent any deterioration in medium-term inflation expectations, we believe that the move is to prevent further depreciation of the Lira. The bank aims to attract foreign investors to the O/N market in our view. After this move, the O/N rate may be realized between the O/N borrowing rate and the new O/N lending rate to primary dealers (between 5.0% and 12.0%) instead of 5-8% previously. The move may cause the O/N rate in the repo market to increase, should the CBRT cut funding via one-week repo auctions further to obtain a meaningful increase in the O/N repo rate.

**IP declines 2.6% MoM in August**

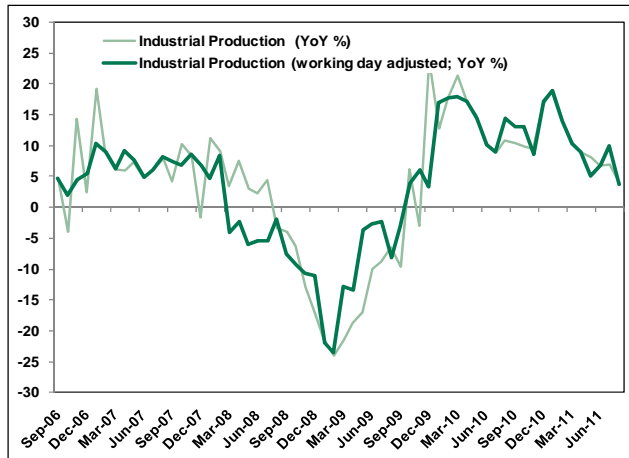
IP declined significantly in August in MoM terms...

In August, industrial production rose 3.8% YoY, less than the consensus (5.0%). On the other hand, adjusted for seasonal and calendar effects, IP declined 2.6% MoM in August, reversing the 2.6% MoM gain observed in July.

Most of the slowdown comes from capital goods production, which increased 9.7% YoY in August. Its contribution to IP growth declined to 1.5 pp in August compared to 4.5 pp observed in July. The energy sector trimmed off 0.1 pp from IP growth, compared to the 0.7 pp positive contribution in July. Meanwhile, intermediate goods production (4.7% YoY) made a 1.8 pp contribution to IP growth in August.

We revise our growth forecast for 2012 down to 1.0% from 2.0%...

We forecast the economy to expand 7.0% before slowing down to 1.0% next year due to both the high base in 2011 and negative implications of the problems in the European banking system on the Turkish economy through both trade and credit channels.



Source: Turkstat

**Decline in 12-month rolling CAD to start soon**

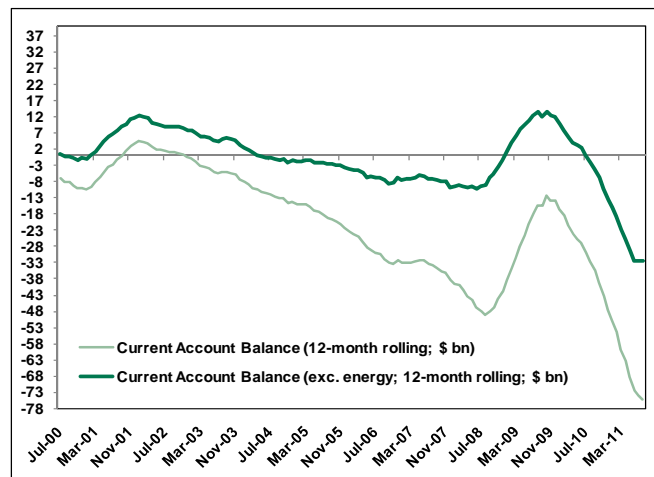
Non-energy current account deficit seems to have stabilized...

The current account balance registered a deficit of USD 4.0bn parallel to the market consensus (USD 4.0bn) but slightly higher than our in-house forecast (USD 3.7bn). Meanwhile, the 12-month rolling trade deficit rose to USD 75.1bn (10% of GDP) up from USD 74.2bn registered in July. On the other hand, the 12-month rolling non-energy current deficit stabilized at USD 32.6bn compared to July.

The monthly figure is positive in the sense that the year-on-year difference in the CAD declined significantly to USD 0.9bn from USD 1.7bn in July and from USD 4.2bn average observed in Q2, which implies that we are near a peak in the CAD. This expectation is supported by the slowdown in the Turkish economy and pressure on oil prices.

Official reserves declined USD 4.4bn in August due to FX selling auctions...

Though there has been an improvement in the share of MLT debt and FDI in financing, the share of short-term sources remained dominant in external financing. FDI and MLT debt financed 16% and 27% of the CAD respectively during January-August. Portfolio inflows and deposit withdrawals from abroad financed 33% and 16% of the CAD, while net errors and omissions financed 18% of CAD. Though the share of short-term sources stabilized, it is still very high for a sustainable external account, which makes the lira vulnerable to declines in risk appetite.



Source: CBRT

**Buoyant CG budget in January-September thanks to strong growth and restructuring**

There are risks for 2012 budget targets due to a sharper-than expected slowdown...

The central government budget registered a budget surplus of TRY 0.2bn in January-September compared to a deficit of TRY 21.3bn last year. Meanwhile, the primary surplus almost doubled to TRY 35.0bn from TRY 18.0bn registered in the same period last year. Non-interest expenditures rose a reasonable 3.4% YoY in real terms to TRY 186.1bn. Meanwhile, central government revenues supported by revenues from the restructuring of unpaid public receivables rose 11.1% to TRY 221.1bn. According to MoF figures, the government (excluding the Social Security Institution) collected TRY 11.4bn under the restructuring program as of September 30th. If we exclude this amount, revenues would have risen around 5% in real terms year-on-year, which is not so strong despite strong domestic consumption taxes and VAT on imports supported by high growth rates in 2011. January-September realizations are positive as they combine support from various factors, as we stated above. However, most of them will likely dissipate in 2012 as the economy slows down and the effect of restructuring declines next year.

**Central Government Budget: 2010-2011**  
 (in billion TL)

	Jan-Sep		Real growth (%)
	2011	2010	
Central Government Revenues	<u>221.1</u>	<u>187.5</u>	11.1
o/w: General Budget Revenues	<u>214.2</u>	<u>181.7</u>	11.0
Tax Revenues	<u>188.4</u>	<u>153.8</u>	15.4
o/w: Corporation Tax	55.5	44.8	16.6
Tax on Income	19.7	15.0	24.1
Tax on Goods and Services	76.9	66.8	8.4
o/w: VAT	23.4	19.5	13.0
SCT	46.7	41.3	6.7
Tax on Foreign Trade	39.2	27.9	32.3
Non-Tax Revenues	32.7	33.7	-8.7
Central Government Expenditures	<u>220.9</u>	<u>208.8</u>	-0.4
Non-Interest Expenditures	186.1	169.5	3.4
o/w: Personnel	64.9	55.4	10.3
Government Prem. to Social Security Agen.	9.4	8.0	10.9
Good and Services Procurements	20.5	17.0	14.2
Capital Expenditures	14.5	12.2	12.0
Current and Capital Transfers	82.7	80.5	-3.3
o/w: Social Security	41.1	44.1	-12.0
Transfers to Households	1.5	1.1	29.2
Agricultural Subsidy	5.7	5.0	9.1
Treasury Aid to Provincial Offices	2.1	1.3	46.9
Interest Expenditures	34.8	39.3	-16.6
Overall Balance	<u>0.2</u>	<u>-21.3</u>	...
Primary Balance	<u>35.0</u>	<u>18.0</u>	...

Source: Ministry of Finance

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