Turkey Economic Report

November 2011

AN ENVIRONMENT OF DOMESTIC STRENGTHS OUTPACING EXTERNAL IMBALANCES

- **Healthy economic performances despite some slowdown amid tough global conditions:** Within the context of strong household consumption, robust fixed investment and mild net exports, the Turkish economy is reporting a healthy performance in 2011, though relatively slowing down from the track record of high growth of the past year. Real GDP is set to grow by 6.6% in 2011 as per the IMF forecasts, against 8.9% in 2010, yet still higher than the average 4.1% real growth of the past five years.
- **Softer monetary stance drives FX depreciation, but price pressures remain manageable:** With recent adverse external shocks generating a net slowdown, Turkey's monetary authorities have responded by easing policy in an attempt to avoid more serious output losses. The policy interest rate cuts and the large widening of the external deficits yet created pressures on the local currency which depreciated by 18% year-to-date amidst weakening capital inflows, thus calling for raising rates. Still, it is worth noting that after accelerating to 8.6% in 2010, inflation cooled down this year, with the most recent IMF forecast putting it at 6.0%, a relatively low level by historical standards.
- **Soaring import growth exacerbating external imbalances:** As a matter of fact, external imbalances have come to the fore this year, with strong import growth (+39.1% in the first nine months of 2011) outpacing export volume increase (+21.8%) and pushing the export-to-import coverage ratio to a decade low of 55% year-to-date (65% on average over the past five years). Within this context, the current account deficit/GDP ratio deteriorated to a record high double-digit level slightly above the 10% threshold.
- **Fiscal position getting close to balance and indebtedness ratios comparatively healthy:** Public finances are recording an improved performance this year, with a surge in general government revenues driven by sound economic activity outpacing an expansion in expenditures. General government fiscal deficit is estimated to narrow from 2.9% of GDP in 2010 to a mere 0.9% of GDP this year as per the IMF, thus getting the country's fiscal position close to balance and putting indebtedness ratios further on a downward path. General government gross debt to GDP is likely to record a second consecutive yearly decline to a low of 40.3% this year as per the IMF, against levels above the 70% mark less than a decade ago.
- **Sound banking activity growth at the image of the macroeconomy:** The banking sector displayed a healthy growth so far this year within the context of growing domestic macroeconomic activity seemingly offsetting the spillovers of a volatile external environment characterized by fiscal drifts in neighboring European countries and popular uprisings in neighboring Arab countries. Banking activity grew by 21.6% in local currency terms year-to-date, and additional liquidity at hand helped the well capitalized Turkish banking sector extend further waves of loans to an economy with increased financing needs (lending up by 27.6% year-to-date).
- **Opportunities firmly outpacing challenges at the horizon:** While it is true that prevailing macroeconomic imbalances will pose growing challenges for economic policies in the short run, we believe that opportunities outpace challenges at the horizon. These opportunities hinge over the country's strategic geopolitical location, the large scale of the economy along with its diversification potential and underlined dynamism, notwithstanding the country's strengthened resilience to economic, financial and political vulnerabilities. Beyond short term risks related to currency depreciation, widening external deficits and a slowing down real sector, the middle run is likely to carry with it an attractive real growth outlook on the background of such large mix of opportunities in an economy operating way below full employment and potential output.

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Bank Audi sal - Audi Saradar Group
Group Research Department
Bank Audi Plaza, Bab Idriss
Riad El Solh - Beirut - Lebanon
P.O.Box : 11 - 2560
Tel : (01) 994000
Telefax : (01) 985622
e-mail : research@banqueaudi.com

Bank Audi sal
Audi Saradar Group

Underlined by strong household consumption, robust fixed investment and mild net exports, the Turkish economy is reporting a healthy performance in 2011, though relatively slowing down from the track record of high growth of the past year. According to recent IMF estimates announced in its World Economic Outlook, real GDP forecast is set at 6.6% in 2011, against 8.9% in 2010 though higher than the average 4.1% real growth of the past five years. But after output reached levels above its pre-crisis peak in the early months of 2011, the economy has lost some momentum, in tandem with the global economy and also as a result of domestic policy tightening.

As the recent adverse external shocks have generated a net slowdown, Turkey's Central Bank has responded by easing policy in an attempt to avoid more serious output losses. The policy interest rate cuts and the large widening of the external deficits created pressures on the Turkish Lira which depreciated by 18% year-to-date amidst weakening capital inflows, thus calling for raising rates. Still, it is worth mentioning that while inflation had accelerated in 2010 reaching 8.6%, it cooled down this year, with the most recent IMF forecast putting it at 6.0%, a relatively low level by historical standards.

At the public finance level, the headline fiscal balance continues to improve, returning public debt to GDP to a downward path. As a matter of fact, the country's fiscal deficit contracted from 5.6% of GDP in 2009 to 2.9% in 2010 and to 0.9% this year as per recent IMF forecasts. Likewise, after debt to GDP retreated from 46.1% in 2009 to 42.2% in 2010, a further improvement is set for this year, as it is expected to close 2011 at 40.3%. Amid the worsening sovereign debt problems in the euro zone, key policy makers showed a great deal of self-confidence about Turkey's conduct.

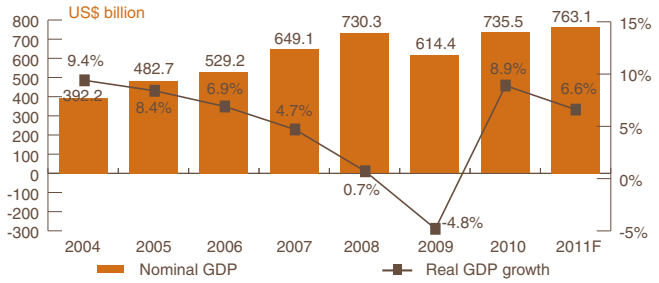
Turkey's external position is the weakest element in its credit profile. The country's exports to imports ratio fell to below 55% over the first nine months of 2011, its lowest level in more than a decade, within the context of relatively weakened demand conditions in Turkey's trading partners. The current account deficit is expected to reach 10.3% of GDP this year and to exceed 40% of current account receipts. The net external debt of the financial sector has risen quite sharply from 6% of current account receipts at the end of 2008 to 42% this year. The Central Bank's gross foreign exchange reserves amounted to US$ 88 billion in September 2011, the equivalent of 18.2% of Money Supply, a relatively low level by international benchmarks (an average of close to 30% for developing economies at large).

At the banking sector level, the well capitalized sector with little direct exchange rate exposure and primarily local deposit funding, together with long foreign currency positions, allowed Turkey to withstand the recent global deleveraging and exchange rate fluctuations. With an average 16% capital adequacy ratio against a regulatory requirement of 12%, banks sizeable capital buffers were seen as capable of absorbing a short lived macroeconomic shock. Leverage is persistently low and the funding base is robust, with deposits accounting for about two thirds of total balance sheet size. Asset quality is very satisfactory, with strong credit expansion and sound output growth reducing the non-performing loans to total loans ratio to 2.7% by September, down from 3.7% at the end of December 2010.

At the capital markets level, a relative volatility was reported this year. The ISE share price index actually fell by 24.9% over the first nine months of 2011 contracting the average Price to Earnings ratio to 12.7x at end-September 2011. The contraction in Turkey's equity market was realized over a period of intense trading, with the stock market annualized turnover as a percentage of market capitalization reporting around 200%, a historical record high. The 5-year Credit Default Swaps, a measure of the market perception of debt risk, widened by 91 basis points year-to-date, from 142 basis points at end-2010 to 233 basis points at end-September 2011.

The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economy looking ahead, given the status of current strengths and weaknesses, along with upcoming opportunities and threats.

Gross Domestic Product Performance



Sources: IMF, Bank Audi's Group Research Department

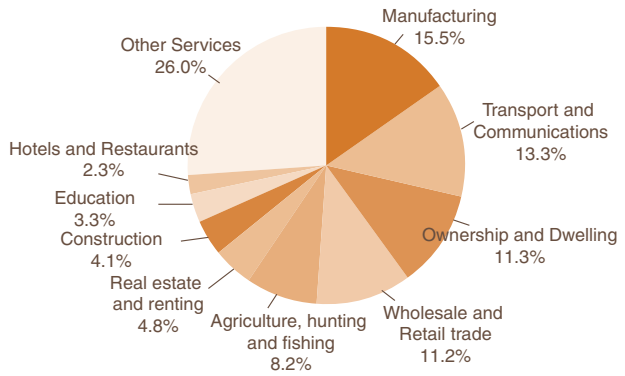
1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

Solid activity driven by buoyant industry and service sectors growth

The Turkish real economy is driven by its industry and services sectors, along with the traditional agriculture sector. Historically, the agricultural sector has been Turkey's largest employer and a major contributor to GDP. However, as the country has developed, the relative importance of agriculture has declined, while the position of industry and the service sector has increased. It is worth noting that a relatively aggressive privatization program has reduced State involvement in basic industry, banking, transport, and communication, contributing to the rise of middle-class entrepreneurs adding dynamism to the economy.

Breakdown of GDP by sector in 2010



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

1.1.1. Agricultural Sector

Having suitable land and favorable climate conditions, Turkey has the capacity to grow many kinds of crops and is one of the few countries in the world that is self-sufficient in food. Turkey benefits from a competitive labor force and continued government investments in the form of major irrigation projects as well as infrastructure improvements.

The contribution of the agriculture sector to GDP has reached 8.2% in 2010, with the sector accounting for about 25% of employment in the country. According to latest available figures, the agricultural sector grew by a healthy 6.0% in the second quarter of 2011 relative to the same period of 2010. But within a sluggish global environment, agricultural exports recorded US$ 3.4 billion in the first nine months of 2011, up by a mere 0.5% relative to the corresponding period of last year, after they had progressed by 13.4% year-on-year in 2010.

As around 40% of Turkey's land area is arable, the country offers a wide range of agricultural product groups including grains, pulses, fruits, vegetables and livestock. Grain production in Turkey is highly dependent on governmental policies. The Turkish government supports grain production through intervention prices and by subsidies on fertilizer and fuel costs.

The main products in the grain group are wheat, barley and corn. According to latest available official figures, the production of wheat has reached 19.7 million tons in 2010, down from 20.6 million tons in 2009. Barley production attained 7.24 million tons in 2010, slightly down relative to 7.30 million tons in 2009. Yet, corn production grew by 14.7% year-on-year in 2010. Turkey also produces pulses, of which chickpeas, lentils and haricot beans. The production of chickpeas reached 530 thousand tons in 2010, down by 5.7% relative to 2009, while lentils production reached 447 thousand tons in 2010, rising by 48% relative to the year before.

Furthermore, Turkey is an important producer of fruit and vegetables with 26 million tons of vegetables produced and 16.6 million tons of fruits produced in 2010, as per the latest available official data. With respect to vegetables, tomato production fell by 6.5% to around 10 million tons and cabbage production dropped by 2.0%, while eggplant production grew by 3.8% and onion production increased by 2.3%. As to fruits, grapes production reached 4.3 million tons in 2010, almost unchanged relative to the previous year; orange production attained 1.7 million tons, up by a yearly 1.2%, while mandarin production totaled 859 thousand tons, up by a yearly 1.5%. However, apple production fell by 6.6% to 2.6 million tons, and apricot production plummeted by 31.9% to 450 thousand tons.

On the other hand, it is worth noting that Turkey is the world's leading hazelnut producer, with approximately 60%-70% of global hazelnut production. Turkey is also a major exporter of dried figs and dried apricots. Finally, the country has a high potential in organic agriculture thanks to its farming experience, different climatic conditions and biodiversity. Organic agriculture activities are increasing with the spreading of organic lands in all regions and the rising number of farmers.

1.1.2. Industrial Sector

The industrial sector is a key sector of the Turkish economy and took the lead in the recent development process of the country. The manufacturing sector accounted for about 15.5% of GDP in 2010. Its output grew by 8.0% in the second quarter of 2011 relative to the same period of 2010, noting that it witnessed double digit growth in 2007 and 2008 but then a net decline in 2009.

Among the several sub-sectors of the Turkish industrial sector are the defense, electronics, iron and steel, automotive, glass and sugar industries. The cement industry plays an important role in the country, holding a high-ranking position in world production. The textiles and clothing sub-sector is another advanced segment. Turkey, as a major cotton producer, has been actually growing its exports of textile products every year.

The Turkish automotive industry positions the country as one of the twenty largest vehicle producers globally; Turkey ranked 17th globally among automotive manufacturing countries in 2009. In addition, the automotive sector has become the country's leading exports, with exports of motor vehicles and trailers accounting for about 13% of total exports in 2010.

The total automotive production realized reached 621,695 units over the first half of 2011, up by 14% relative to the first half of 2010. This follows a significant 26% growth over the year 2010, with automotive production at 1.1 million units. It is worth noting that the sector's total production increased by a CAGR of 14.3% over the previous five years.

The Turkish automotive production is divided between passenger cars and commercial vehicles (minibus, midibus, bus, pick-up and trucks). Over the first half of 2011, 335,783 passenger cars were produced, up by 7.5% relative to the same period of 2010, while commercial vehicles totaled 285,912 units, up by a higher 22%, according to the Automotive Manufacturers Association.

Three main manufacturers account for the bulk of production in the sector. Indeed, Oyak-Renault, Tofas-Fiat, and Ford-Otasan manufactured 80% of automotive production (in volume terms) over the first half of 2011, with respective shares of 29%, 27% and 24%. There has been a substantial amount of foreign investment in the sector, given the fact that the three automotive manufacturers mentioned above are partnerships between Turkish and foreign carmakers. It is worth noting that these joint-ventures date back to the 1960s. On the other hand, the Customs Union Agreement with the EU in 1996 and rising demand in the 1990s attracted investments from Far Eastern manufacturers such as Toyota, Hyundai, and Honda, which sought to establish a low-cost base to supply the local market and from which to export to Europe. Indeed, Toyota Turkey, which is now wholly Japanese-owned, produces 7% of total Turkish automotive output.

Turkey is an important exporter of vehicle production. As a matter of fact, over the first half of 2011, total automotive exports reached 417,348 units, posting a 5% increase relative to the corresponding period of 2010, and representing 67% of total production. Demand for commercial vehicles was the main trigger of exports in the first half of 2011, as exports of commercial vehicles grew by 14% during that period, while exports of passenger cars dropped by 2%. With respect to automotive exports, Oyak-Renault came in first position, accounting for 30% of total exports in volume terms, followed by Ford Otasan with 26%, Tofas with 24.2% and Toyota with 9.0%. Exports of motor vehicles and trailers amounted to US$ 8.6 billion, up by 15% relative to the first half of 2010, and accounting for 13.2% of total Turkish exports, according to official figures.

On the other hand, more than 50% of motor vehicle sales in Turkey are imported vehicles. The growth of both exports and imports of vehicles took place as the major global manufacturers integrated their Turkish plants into their global production planning. Indeed, more and more specific models are produced in Turkey for global or regional sales, while other vehicles that are not produced locally are imported. Turkey's inclusion in this type of global production planning was made possible by the Customs Union Agreement with the EU.

Retail automotive sales have increased by a yearly 54% to 445,090 units in the first half of 2011, following a significant 38% growth in 2010. Yet, car ownership is still very low in Turkey. Current motorization rate in Turkey is 142 per 1,000 people, significantly below the EU average of 529, which implies an important underlying growth potential.

Furthermore, the outlook for the automotive sector is supported by high export volume, enabled by Turkey's status as an alternative supply center, where labor costs are highly competitive and modern plants are located advantageously with respect to export markets such as Europe and the Middle East. In addition, incentives are granted to investors in various forms including tax exemptions, land allocation, and R&D support, while free zones, designed to encourage trade to and from Turkey, contribute to boost the automotive sector.

The textiles and clothing sub-sector is another developed branch of the Turkish industrial sector. Turkey's traditional textiles and clothing sub-sector still accounts for one-third of industrial employment, despite stiff competition in international markets that resulted from the end of the global quota system. Turkey still ranks among the top ten cotton producers countries globally, coming lately in the eighth position. As such, being a traditional cotton producer is an advantage for the country when it comes to the textile and apparel sector.

The Turkish textile industry benefits from basic raw materials, geographic proximity to main markets (especially European markets), qualified labor force, liberal trade policies, as well as the Customs Union agreement with the European Union and free trade agreements with many other countries. The country also benefits from the proximity to rapidly developing markets such as Russia, the Middle East and North Africa.

Textiles exports reached US$ 9.6 billion in the first nine months of 2011, accounting for 10% of total exports, while wearing apparel exports attained US$ 9.0 billion, accounting for 9% of total exports. Textile exports grew by a significant 25.4% over the first nine months of 2011, while wearing apparel exports progressed by 14.3% over the same period. A large share of Turkey's exports of textile and apparel products is directed towards EU countries.

The industry is undergoing a restructuring because of increased competition from low cost products from China in the European Union and the US, Turkey's principal markets for textiles. As such, Turkey's clothing and apparel industry is changing its image from a mass producer of ready wear for manufacturers, fashion houses and department stores in Western Europe and the United States to a creator and retailer of new designs, fashions and quality labels, producing higher value-added products.

Some Turkish clothing manufacturers have started to open their own fashion stores, building sales networks abroad, forming joint ventures with foreign distributors and acquiring retail chains to sell their own brands. In fact, some textile industrialists have created their own trademark along with the patent rights. In addition, Turkey's ready-wear manufacturers began relocating production in Eastern Europe and Central Asia to benefit from lower labor cost.

In sum, exports of textile and wearing apparel still account for an important share of total exports. The main objective of the sector today is to produce high value added, original and high quality products and sell them at a reasonable price.

1.1.3. Services Sector

The services sector of Turkey is another important sector of the country's economy. Amongst the services sector, transport and communication are the highest contributors to GDP with a 13.3% share in 2010, followed by ownership & dwelling with 11.3% of GDP, wholesale and retail trade with 11.2% of GDP, and hotels and restaurants with 2.3% of GDP.

Turkey's geographic location establishes links between the East and the West, which makes the transportation industry crucial

for the economic development of the region. According to latest available official figures, the transport, storage and communication sector grew by 11.7% in the second quarter of 2011 relative to the same period of 2010.

The transport sector covers about 88 airports. The government is expecting to finalize the construction of seven new airports in Turkey before the beginning of 2013. The General Directorate of State Airports Authority (DHMI) is responsible for the construction of the new airports, at a total investment cost of US$ 550 million. Four airports -Hakkari-Yuksekova, Sirnak-Cizre, Bingol and Igdir- are currently under construction. The remaining three airports will be in Adana-Mersin, Afyon-Kutahya and Ordu-Giresun regions. The Cukurova Airport will serve Mersin and Adana, while Zafer Airport will host passengers from Afyon and Kutahya.

The total number of passengers at Turkish airports reached 45 million over the first half of 2011, up by 14.8% relative to the corresponding period of 2010. This is actually a continuation of an upward trend witnessed over the past five years, when total passengers at the airports grew from 58.8 million in 2006 to 91.5 million in 2010. In parallel, aircraft traffic reached 412,605 planes over the first half of 2011, up by 14.3% relative to the same period of last year. The total freight reached 893 thousand tons in the first half of 2011, up by 10.8% relative to the corresponding period of 2010. The freight carried by domestic and international lines has been growing in recent years; over the period 2006-2010, the CAGR has been 10.5% for the freight carried by international lines and 7.4% for the freight carried by domestic lines.

Turkish logistics companies mainly serve the sector in which most foreign trade is concentrated, including textiles, automotive, FMCG, retail and food, petrochemicals, machinery production and the construction industry. According to the Logistics Performance Index (LPI) issued by the World Bank, Turkey is improving its logistics performance. LPI is based on a survey of operators on the ground worldwide, providing feedback on the logistics friendliness of the countries in which they operate and those with which they trade. Turkey ranked among the top ten upper middle income countries which recorded the best logistics performance in 2010.

Road transport is the major mode of freight and passenger transportation in Turkey, with 95% of passengers and 90% of goods conveyed by highway transport. The rail network is about 9,083 km, according to latest available official figures. The Turkish government aims to complete the Marmaray project in 2013; this major project consists of a rail tube tunnel under Bosphorus in Istanbul that has been under construction for several years and that would connect the European side with the Asian side. The length is 76 kilometers and the total cost is estimated at US$ 3 billion.

In addition, another major infrastructure project is the Baku-Tbilisi-Kars (BTK) railway line that would directly connect Baku in Turkey, Tbilisi in Georgia and Kars in Azerbaijan and which is expected to be completed in 2012. The BTK railway line would transport a million passengers and 6.5 million tons of cargo in its first stage. The key objective of the project is to improve trade and economic relations between the three regions, while Turkey would become a connection hub among Europe, Central Asia and the Middle East.

Turkey also benefits from a competitive advantage in maritime transport since it is surrounded by seas on three sides with the Mediterranean, the Aegean and the Black Sea, together with the straits of the Dardanelles and the Bosphorus. Maritime transport is mostly handled by Istanbul-Izmit, Izmir, Adana-Mersin and Samsun ports. In 2010, the ports of Bandirma, Iskenderun and Samsun were privatized, noting that a total of 16 ports were privatized over the past 13 years in Turkey. The Iskenderun port, which was in need of investment, was privatized for 36 years.

In sum, the transport infrastructure is well developed in Turkey and has a growth potential in the coming years. The development of new airports and the improvement in the railway infrastructure would grant Turkey a competitive advantage as a connection hub among Europe, Central Asia and the Middle East.

At the touristic sector level, several factors contributed to boost the tourism industry this year in Turkey. As a matter of fact, the regional turmoil, a weak Turkish currency and Ankara's closer ties with neighbors have been driving up tourism in the country. The tourism industry generated US$ 8.5 billion tourism receipts over the first half of 2011, up by 21.5% relative to the corresponding period of 2010. It is worth noting that the tourism industry generated US$ 21 billion in tourism receipts in 2010, according to official figures.

Furthermore, the number of tourists increased by a yearly 12.6% in the first half of 2011 to reach 13.1 million, surpassing the growth rate in tourist arrivals that reached 5.7% over the year 2010. The rise in tourist arrivals over the first half of this year is significant given the fact that the year 2010 registered a record number in tourist arrivals of 28.6 million. As such, Turkey has gained from tourists' desire to avoid the political fallout in Tunisia, Egypt and Syria and from the depreciation of the Turkish lira year-to-date. In fact, figures showed that vacationers were spending more; a 35% rise in foreign credit-card spending in the first six months of 2011 has been observed, compared with the same period a year ago. That far outpaces tourist spending growth in Italy (17%), Portugal (16%) and Greece (14%).

According to Turkey's culture and tourism ministry, Iran now sends more tourists to Turkey than any country, except Germany and the U.K. Visa-free travel and new Turkish airlines connections to Iranian cities as well as a larger availability of flights in general explain the rise, as per the Ministry. Figures show that German tourists accounted for 14.7% of total tourists over the first half of 2011, followed by visitors from the United Kingdom with a 7.4% share, and Iranian tourists with a 7.0% share. Arab tourism has also expanded robustly over the past years, mainly attributed to Ankara's warmer relations and visa-free policies with its neighbors.

It is worth noting that Turkey's coastal resorts, of which the

Mediterranean hub of Antalya and Bodrum, the Aegean peninsula well-known for its package tours and luxury resorts, have attracted a large number of visitors this year. There is actually a big expansion in high-end investments, with Armani hotels, the Mandarin Oriental and Bulgari hotels planning to open soon to take advantage of a fast growing tourist sector.

1.2. EXTERNAL SECTOR

Strong import growth fueling deterioration in current account deficit

Turkey's external imbalances have come to the fore this year, with strong import growth outpacing export volume increase and leading to a notable deterioration in the current account deficit/GDP ratio to a record high double-digit level just above the 10% mark.

that the European Union countries accounted for 37% of import growth during the first nine months of 2011, followed by non-Near and Middle Eastern Asian countries with 23%, Near and Middle Eastern countries with 12%, other European countries with 9%, and North American countries with 8% of total year-to-date import growth.

The breakdown of Turkish imports by product type shows that intermediate goods accounted for the bulk of total imports over the covered period with a 72% share, reflecting Turkey's structural needs for intermediate goods for industrial use, namely those used in export-oriented industries. Capital goods imports represented about 15% of total imports, while consumption goods' share amounted to about 12%.

As a result, the structural Turkish trade deficit widened further this year, reaching US$ 82.2 billion or an annualized 14.4% of GDP over 9M2011. The export-to-import coverage ratio actually reached a decade low, standing at 55% year-to-date,

Turkish Foreign Trade by Regions

US$ million

	Turkish Exports			Turkish Imports			Total Foreign Trade		
	9M 2010	9M 2011	Var 9M11/9M10	9M 2010	9M 2011	Var 9M11/9M10	9M 2010	9M 2011	Var 9M11/9M10
MENA	16,695	18,566	11.2%	5,716	5,762	0.8%	22,411	24,328	8.6%
Euro Area	26,438	33,459	26.6%	36,906	51,391	39.2%	63,344	84,850	34.0%
Major Advanced Economies (G7)	25,548	31,772	24.4%	39,652	55,403	39.7%	65,200	87,175	33.7%
Developing Asia	3,326	3,474	4.4%	19,467	27,868	43.2%	22,793	31,342	37.5%
World	**81,715**	**99,502**	**21.8%**	**130,554**	**181,661**	**39.1%**	**212,269**	**281,163**	**32.5%**

Sources: Undersecretariat of the Turkish Prime Ministry for Foreign Trade, Bank Audi's Group Research Department

Though at a lower pace than imports, Turkish exports have been on an upward trajectory during this year's first nine months, rising by a yearly 21.8% to reach US$ 99.5 billion. This year's performances could be attributed to increased export competitiveness on the back of a sharp local currency depreciation since the beginning of the year within interest rate cuts and widening external imbalances.

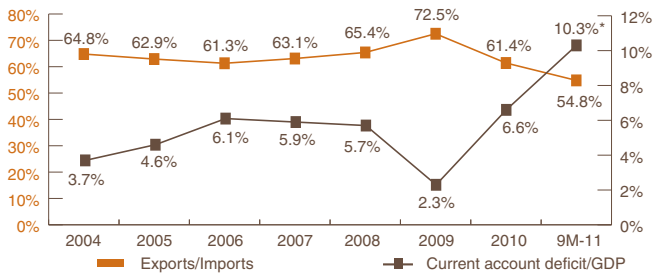
The breakdown of Turkish exports by region shows that exports to European Union countries contributed to 52% of Turkish export growth over the first nine months of 2011. Exports to Near and Middle Eastern countries contributed to 22% of total Turkish export growth over the covered period, followed by exports to other Asian countries with 7% of total growth, exports to other European countries with 6%, and exports to North America countries with 5%.

The breakdown of Turkish exports by product type reveals that intermediate goods (mostly processed material incidental to industry and parts of transportation vehicles) accounted for circa 51% of total exports during the covered period, followed by consumption goods with 38%, and capital goods with 11%.

At the same time, Turkish imports registered double the growth of exports, surging by 39.1% to reach US$ 181.7 billion in the first nine months of 2011. This was realized on the backdrop of relatively healthy domestic demand and higher average hydrocarbon prices this year, with the country mostly reliant on imports for its energy needs.

The breakdown of Turkish imports by region of origin shows

Foreign Sector Indicators



** IMF full-year forecast*
Sources: Central Bank of Turkey, IMF, Bank Audi's Group Research Department

against an average of 65% over the past five years. As such, Turkey witnessed an exacerbation of external imbalances this year. The current account deficit practically doubled from last year to attain the first double-digit level (just above the 10% mark) and a record high for the country.

In parallel, capital inflows grew over the covered period, notably within the context of still loose monetary policies abroad, with higher direct investment in Turkey (practically doubling in the first nine months of 2011) and rising corporate sector borrowings from abroad offsetting a slowdown in net bank borrowings from abroad following the tightening of prudential regulations aimed at curbing domestic lending. Still, capital inflows grew by less than the current account deficit widened, which drove the general balance of payments surplus, after net errors and omissions, to shrink to a mere 1.3% of GDP.

Turkish authorities have lately released their Medium Term Program covering the 2012-2014 period. While the latter focuses on growth and employment, it also tackles the current account deficit issue. The country's current account deficit is projected by Turkish authorities to decline -albeit gradually- to 7.0% of GDP in 2014.

Domestic authorities are actually seeking to rebalance the composition of demand and therefore ensure a current account deficit reduction. While the notable exchange rate depreciation year-to-date gives some boost to export competitiveness, a more sustainable correction to external imbalances not achieved at the detriment of real growth calls for a limited exchange rate pass-through to the general price index and low inflation differentials against other countries, in addition to a strong positive domestic supply response, as the IMF recently pointed out.

Although authorities had announced a broad plan aimed at increasing incentives to enhance the use of Turkish materials in manufacturing (the full results of which are likely to show in the longer term), some technical constraints on import substitution and the likely erosion of competitiveness gains could warrant a partial improvement in the country's external conditions, according to the Fund. In light of the latter structural issues, the current Euro zone debt crisis related uncertainties and the overall cautious investor mood (especially with regards to economies with accrued macroeconomic imbalances), Turkey's external environment is likely to continue facing some challenges in the short to medium term, and remain the weak link in the country's risk profile.

1.3. PUBLIC SECTOR

Fiscal position getting close to balance and indebtedness ratios on the decline

Turkey's public finances are recording an improvement in performance this year, with a surge in general government revenues driven by sound economic activity and outpacing an expansion in expenditures. As a result, the overall general government fiscal deficit is estimated to narrow from 2.9% of GDP in 2010 to a mere 0.9% of GDP this year as per the latest IMF estimates, thus getting the country's fiscal position close to balance.

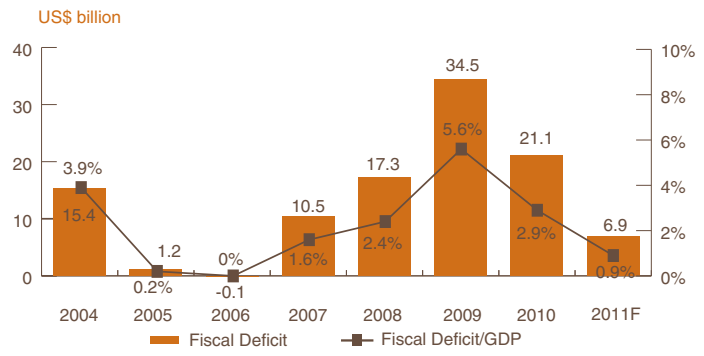
In details, general government revenues are estimated to record a 17.7% yearly rise in 2011 in local currency terms, against the backdrop of healthy domestic economic activity. The surge in total output and imports throughout this year, along with tax amnesty receipts, are leading to double-digit growth in both direct and indirect tax revenues, with the Turkish government also benefiting from a rise in revenues from social funds this year. This would also come within the context of increases in taxes on tobacco products, alcoholic drinks, mobile phones and cars through a special consumption tax as of October 2011. As such, general government revenues would account for 33.9% of GDP this year, slightly up from 32.7% in the previous year, as per IMF figures.

General government expenditures are also on an expansionary path this year, yet their growth appears to be falling short of State receipts. Expenditures are estimated to record an 11.1% yearly rise this year, but move slightly down from 35.6% of GDP in 2010 to 34.8% of GDP in 2011. This year's increase in general government expenditures would mostly result from a surge in current and transfer expenditures (especially current transfers, given a projected decline in capital transfers by Turkish authorities), and to a small progression in fixed capital investment spending, while interest expenditures would register a decline reflecting lower debt servicing.

With cyclically strong general government revenues somewhat overshadowing an expansionary budget this year, the general government fiscal balance would shrink by nearly two thirds, and move from a deficit of 2.9% of GDP last year to one of merely 0.9% of GDP this year. Excluding interest outlays, the general government would see an increase in its primary surplus by 2.5x on a yearly basis, moving from 0.8% of GDP in 2010 to 1.8% of GDP this year.

Within the context of Turkey's lower borrowing requirements this year, the relatively moderate rise in general government gross debt is likely to fall short of nominal output expansion this year as well, thus putting indebtedness ratios further on a downward path. The country is estimated to record a second consecutive yearly decline in the general government gross debt to GDP ratio from 42.2% in 2010 to 40.3% this year, as per the IMF, against levels above the 70% mark less than a decade ago.

Fiscal Performance



Sources: IMF, Bank Audi's Group Research Department

While Turkey's fiscal position is getting close to balance this year, the robustness of the fiscal performance, especially on the revenue side, remains dependent on the domestic and external economic environment. Within this respect, a sustainable strengthening of the primary surplus could to a certain extent shield the country's government finances from significant negative revenue shocks.

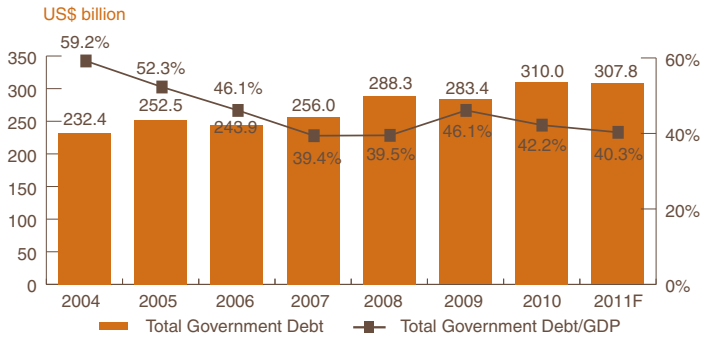
Turkish authorities lately unveiled their 2012-2014 medium term fiscal program which aims to maintain fiscal discipline while supporting employment and growth, and ensure a gradual reduction in the government's fiscal deficit to 0.4% of GDP by the 2014 horizon. At the same time, the primary surplus is projected to move upwards to circa 3% of GDP by the year 2014. The general government nominal debt stock

would continue to decline over the covered period, and reach 32.0% of GDP by the 2014 horizon, according to Turkish authorities.

Main highlights of the fiscal plan on the revenue side include, among others, the establishment of a more efficient tax system, the simplification of tax legislation, the reduction of tax evasion and the overall enhancement of tax compliance and broadening of the tax base. Main highlights on the spending side include, among others, the prioritization of health, education and social expenditures. Medium and long-term infrastructure investments would actually focus on education, health, technological research, transportation, drinking water and improvement of information and communication technologies; public investments would focus on economic and social infrastructure projects.

Meanwhile, Turkey's current fiscal indicators remain largely favorable, with a small deficit relative to the size of the economy, and debt dynamics widely positive, with a debt to GDP ratio relatively low by global standards. This should serve the country well at a time when fiscal driven distress and sovereign debt woes are triggering increased risk aversion and investor cautiousness while shaking the world's largest economies.

Public Indebtedness



Sources: IMF, Bank Audi's Group Research Department

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Shifting towards tighter monetary policy

Turkey's monetary conditions were lately marked by a shift from a dovish stance to a more hawkish stance, as shown by an increase in the overnight rates in order to prevent deterioration in inflation expectations driven by the price pressures from the exchange rate. In addition, rising global uncertainties and the deterioration in risk appetite triggered some outflows, which translated into a slight drop in money supply expressed in foreign currency, yet without impacting the Central Bank's international reserves position.

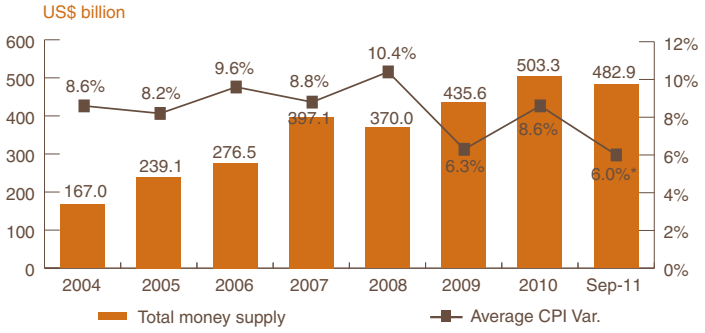
The Central Bank of the Republic of Turkey (CBRT) had unveiled in early-August 2011 a series of policy changes aimed at boosting banks' foreign exchange liquidity as global growth slows and the European debt crisis hammers investor confidence. In fact, the CBRT cut the FX required reserve ratios (RRRs) on up to one-year maturities to 11% from 11.5% and cut the RRR on maturities of one-year and longer to 9.0% from 9.5%. In addition, Turkey's Central Bank cut in August its key policy rate by 50 basis points to a lifetime trough of 5.75% to reduce the risk of a domestic recession that may be posed by the heightened problems in the global economy. In order to limit the potential downside volatility in the short-term interest rates, it decided to narrow the interest rate corridor by significantly increasing the overnight borrowing rate from 1.50% to 5.00%. This came within the context of growing concerns regarding sovereign debt problems in some European economies and the global growth outlook.

The ongoing deterioration in global risk appetite that was coupled with rapid capital outflows, has yet led to an excessive depreciation of the Turkish Lira in 2011. An accumulated depreciation of 18% since end-2010 started to pose risks on inflation outlook. Many other factors pose upside and downside risks to inflation in Turkey. First, administered price increases with an upward effect on inflation. In fact, the Special Consumption Tax rates were recently raised on some motor vehicles, mobile phones, alcoholic beverages and tobacco products as per the decision by the Board of Ministers. Second, base effects from unprocessed food prices would pose an upward pressure on inflation. In contrast, final domestic demand continued to slow down, with the depreciation in Turkish Lira weakening the demand for durable goods. Also, external demand remains weak, with the noticeable deterioration in the outlook for the world economy likely to continue restraining foreign demand.

In this respect, the Central Bank underlined that it would not tolerate these developments to have an adverse impact on medium-term inflation expectations and inflation outlook, and decided in October 2011 to widen the interest rate corridor by increasing the lending rate significantly from 9% to 12.5%.

In response to ensuing stress on Turkish Lira, the CBRT announced suspension of its daily FX purchase auctions starting from July 25th, noting that CBRT adjusted its FX purchase amount three times in 2011. In addition, the CBRT suspended auctions for seven-day repurchase agreements to curb further declines in Turkish Lira. These measures show that the Central Bank became lately more concerned about the upside risks to inflation -especially the depreciation in Turkish

Money supply and inflation



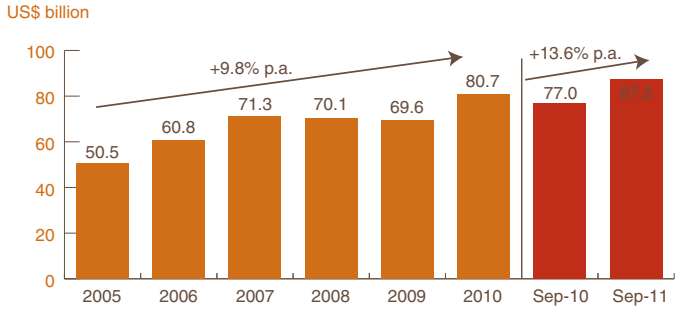
** IMF full-year forecast*
Sources: Central Bank of Turkey, IMF, Bank Audi's Group Research Department

Lira- rather than the downside risks to growth.

The Central Bank's reserves reached US$ 87.5 billion at end-September 2011, as compared to US$ 77.0 billion at end-September 2010, up by 13.6% per annum. To boost its FX reserves and meet the TL liquidity requirement of the Turkish banking system permanently and at a lower cost, the Central Bank raised in October 2011 the upper limit for FX reserves that may be held to meet Turkish Lira reserve requirements from 20% to 40% of Lira liabilities. In addition, 10% of reserve requirements for Turkish Lira can be maintained as gold.

Looking forward, monetary authorities shall continue to monitor global developments and take the needed measures promptly to maintain the stability in the domestic financial markets. The policies implemented by the Central Bank would aim at gradually rebalancing the economy towards a healthier growth composition without hampering the medium-term inflation outlook.

Central Bank Reserves



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

neighboring European countries and popular uprisings in neighboring Arab countries. Measured by total assets of banks operating in Turkey, banking activity grew by 21.6% in local currency terms in the first nine months of 2011. Yet, when translated into US Dollars and given the marked exchange rate depreciation, total bank assets grew by 3.2% year-to-date to reach US$ 630.8 billion at end-September 2011.

Total deposits, accounting for nearly 60% of banks' balance sheets, continued to be a major driver of sector activity this year. Total deposits grew by 13.7% in local currency terms between December 2010 and September 2011 (-3.5% in US Dollar terms to reach US$ 368.7 billion at end-September). Time deposits contributed to 78% of total deposit growth year-to-date, while demand deposits accounted for the remaining 22%. The rise in deposits was realized within the context of a pick-up in economic activity and an increase in interest rates on deposits in both local and foreign currencies, and proved 47% higher in local currency terms than that of the corresponding period of 2010.

A look at deposits from a currency angle shows that foreign currency deposit growth outpaced that of local currency deposits (82% higher in volume when expressed in local currencies). Subsequently, the deposit dollarization ratio reached close to 33% at end-September 2011, up from around 30% at end-December 2010.

In parallel, the additional liquidity at hand helped banks extend further waves of loans to an economy with increased financing needs. In fact, bank loans surged by 27.6% in local currency terms between December 2010 and September 2011 (+8.3% in US Dollar terms to reach US$ 338.9 billion at end-September). This year's lending activity on behalf of banks actually turned out to be 41% higher than during the 2010 corresponding period.

Monetary Situation

US$ million

	2004	2005	2006	2007	2008	2009	2010	Sep-11	Var YTD
Net foreign assets	**-1,315**	**9,815**	**28,282**	**42,285**	**48,209**	**45,136**	**19,643**	**18,637**	**-1,006**
Foreign assets	57,822	76,977	101,074	120,344	127,013	121,959	121,866	137,886	16,021
Foreign liabilities	-59,137	-67,161	-72,792	-78,059	-78,804	-76,824	-102,223	-119,249	-17,027
Domestic Assets	**168,299**	**229,284**	**248,175**	**354,847**	**321,805**	**390,473**	**483,628**	**464,248**	**-19,380**
Claims on private sector	62,480	105,557	135,959	209,481	198,195	227,258	311,934	342,015	30,081
Claims on public sector	103,158	120,493	108,801	138,090	118,602	153,892	158,197	112,787	-45,410
Claims on non-bank financial institutions	2,661	3,234	3,414	7,276	5,008	9,322	13,497	9,446	-4,051
Total Money Supply	**166,984**	**239,100**	**276,457**	**397,133**	**370,015**	**435,608**	**503,271**	**482,885**	**-20,386**
Money Supply (M1)	19,464	32,247	34,383	46,353	40,822	52,241	67,340	63,131	-4,209
Quasi-Money	120,615	165,823	196,188	279,017	269,637	303,176	346,359	337,978	-8,381
Other Items (Net)	26,906	41,030	45,886	71,762	59,556	80,191	89,572	81,777	-7,795

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

1.4.2. Banking Activity

Sound activity growth in 9M2011 reflecting broad macroeconomic performances

The Turkish banking sector displayed a healthy growth so far this year within the context of sound domestic macroeconomic activity seemingly offsetting the spillovers of a volatile external environment characterized by fiscal drifts in

The breakdown of loans by currency shows that local currency loan growth was 61% higher (volume wise only) than the rise in their foreign currencies counterparts. Still, the loan dollarization ratio augmented slightly over the first nine months of 2011, moving from about 27% at end-December 2010 to circa 29% at end-September 2011.

It is worth noting that the nine-month growth in banks' lending activity slightly surpassed the yearly Central Bank growth target of 25%. The government recently said it would not question banks with more than 25% yearly growth in lending, which somewhat suggests authorities are satisfied with the current slower pace of lending (during the fourth quarter of 2011). The Central Bank had actually increased required reserves ratios on local currency deposits to contain lending volume growth and limit the widening of the current account deficit, while maintaining rates at historical lows to deter foreign capital inflows. However, the Central Bank changed its stance in October, raising the overnight lending rate and tightening policy to support the local currency.

Yet, this year's surge in lending activity outpacing deposit growth has been squeezing banks' liquidity ratios. The loan to deposit ratio moved from 81.9% at end-December 2010 to 91.9% at end-September 2011, though it remains in line with emerging market averages.

with the return on average assets ratio moving from 2.7% in the first nine months of 2010 to 1.8% in the first nine months of 2011, and the return on average equity ratio going down from 18.9% to 13.7%, respectively, though these ratios remain satisfactory in both absolute and relative terms.

Turkish banks' other financial soundness indicators also remain favorable to date. The sector is well capitalized, with a capital adequacy ratio of 16.4% at end-September 2011, broadly in line with emerging market benchmarks and well above the 12% minimum threshold. It is worth noting though that Turkey's capital adequacy ratio slightly retreated from 19.0% at year-end 2010, due to a rise in risk-weighted assets in line with lending volume growth and the recalculation of exposure stemming from operational risk as of this year. Core capital accounts for as much as circa 90% of banks' own funds, thus highlighting the adequate capitalization of the Turkish banking sector. The latter also displays continuously low leverage, with the shareholders' equity to assets ratio at 12.4% at end-September 2011.

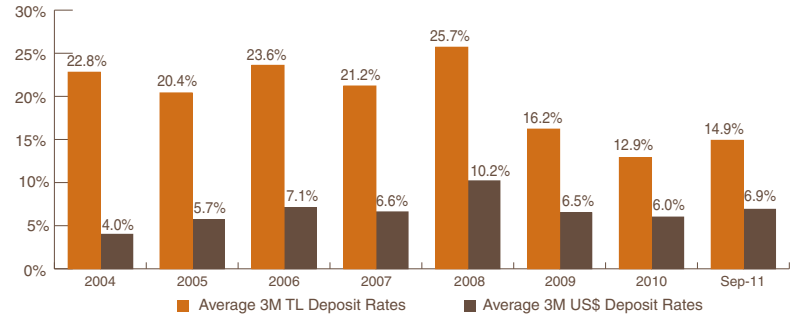
Banking Sector Indicators

US$ million

	2004	2005	2006	2007	2008	2009	2010	Sep-11
Banking Activity								
Assets	211,713	283,289	326,555	460,213	444,998	513,059	611,275	630,767
Deposits	136,112	179,456	208,365	291,026	284,360	324,639	381,949	368,652
Credit facilities	63,900	101,277	134,057	206,817	197,788	224,285	312,929	338,855
Shareholders' equity	32,909	40,206	41,329	63,807	55,640	72,884	87,089	78,061
Growth rates								
Assets	-	33.8%	15.3%	40.9%	-3.3%	15.3%	19.1%	3.2%
Deposits	-	31.8%	16.1%	39.7%	-2.3%	14.2%	17.7%	-3.5%
Credit Facilities	-	58.5%	32.4%	54.3%	-4.4%	13.4%	39.5%	8.3%
Shareholders' equity	-	22.2%	2.8%	54.4%	-12.8%	31.0%	19.5%	-10.4%

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

Banking Sector Deposit Rates



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

While the year-to-date lending activity growth provided a favorable quantity effect on banks' revenue base, this was seemingly offset by continuously tight interest margins, thus leading to a quasi-stagnation in net interest income over the first nine months of 2011 notwithstanding a small decline in special provisions for NPLs year-on-year. Within this context, banks' bottom line actually contracted so far this year, with net sector income down by 15.5% in local currency terms over the first nine months of 2011.

As a result, profitability ratios declined relative to last year,

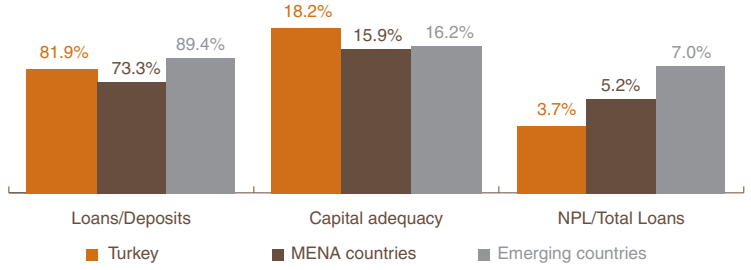
The Turkish banking sector likewise displays strong asset quality across the board. The ratio of non-performing loans (NPLs) to total loans contracted further this year, moving from 3.7% at end-2010 to 2.7% at end-September 2011, within the context of increased debt service capacity of the household and corporate sectors and strong lending growth, thus comparing quite favorably to international benchmarks. Provisioning levels remain broadly adequate, with the ratio of loan loss provisions to NPLs at 81.4% at end-September 2011.

While Turkish banks remain financially sound, the increased use of short-term funding during the recent lending activity expansion exposes the sector to renewed financing pressures across global markets in the wake of the Euro zone debt crisis and the global economic slowdown. This actually calls for more longer-term funding to allow a corresponding lengthening of loan maturities. The reserve requirement differentiation according to liabilities' maturity has started to extend deposit duration, and the regulator's mew measure aimed at containing interest rate risk through capital charges on large maturity mismatches should contribute to discouraging duration gaps. The IMF believes

that the introduction of minimum liquidity ratios at the three-month horizon would also foster longer non-deposit funding.

It is worth adding that following more than a decade without issuing a new banking license, the Board of the Banking Regulation and Supervision Agency granted Bank Audi a license for the establishment of a full-fledged commercial bank in Turkey in October. As a matter of fact, with ratios of deposits/GDP and loans/GDP ratios at circa 53% and 49% today, Turkey's banking sector is considered relatively under-banked, offering a strong potential for horizontal growth of the banking sector. A population of more than 72 million inhabitants with an income per inhabitant of close to US$ 11,000 and having important needs in terms of diversified financial products and services would represent an essential pillar for the development and expansion of banking activities in the period ahead.

Comparative Financial Soundness Indicators (Year 2010)



Sources: IMF, Bankscope, Central Bank of Turkey, Bank Audi's Group Research Department

1.4.3. Equity and Bond Markets

ISE down by 25%, tracking emerging and global drops

The Istanbul Stock Exchange (ISE) witnessed relatively difficult conditions during the first nine months of 2011 on concerns about the Eurozone debt crisis and the rising global uncertainties. The ISE 100, representing the 100 largest companies by market capitalization, closed at 1,877.73 at end-September 2011, down by 24.9% since year-end 2010, tracking drops in other emerging and global markets of 23.5% and 15.7% respectively, according to S&P indices.

In parallel with drops in prices, 20 additional companies were listed on the ISE during the first nine months of 2011. However, the impact of the fall in prices outweighed the effect of new listings. Accordingly, the market capitalization fell from US$ 307.6 billion at end-2010 to US$ 233.5 billion at end-September 2011, shedding by 24.1% during the first nine months of 2011.

The total number of shares traded reached 161 billion shares during the first nine months of 2011, up from 145 billion shares during the corresponding period of 2010. The surge in total traded volume somehow compensated for drops in prices. As a result, the total trading value rose from US$ 300.2 billion during the first nine months of 2010 to US$ 354.3 billion during the corresponding period of 2011, up by 18.0%.

The turnover ratio, measured by the annualized total trading value to market capitalization, reached 202.3% during the first nine months of 2011 versus 125.1% during the corresponding period of 2010, spotting light on the intense trading observed during this year.

As to valuation ratios, the ISE traded at a P/E of 12.68x at end-September 2011, down from a P/E of 13.29x at end-2010 on the backdrop of a decline in prices. Partly compensating the drop in prices to shareholders, the market dividend yield actually surged from 1.79% at end-2010 to 2.26% at end-September 2011.

At the level of the bond and bills market, the total trading value amounted US$ 1,479 billion during the first nine months of 2011, versus US$ 1,785 billion during the corresponding period of the previous year. The general Government Debt Securities index declined by 2.9% during the first nine months of 2011 to reach 135.23.

Regarding new bond issues, Kuveyt Turk, the Turkish banking arm of Kuwait Finance House, issued in October 2011 a US$ 350 million Sukuk with a coupon rate of 5.875%. This issuance was the first of its kind as it is the first Sukuk issued in accordance with the new law which allows sale and lease back structures in Turkey. It attracted orders totaling over US$ 550 million, with Gulf investors accounting for nearly 70% of final subscribers, according to data released by the lead arrangers. The strong appetite for the Turkish Sukuk

Selected Stock Market Indicators

	2004	2005	2006	2007	2008	2009	2010	9M-11
Market capitalization (US$ billion)	98.1	162.8	163.8	290.0	119.7	236.0	307.6	233.5
Market capitalization/GDP	25.0%	33.7%	30.9%	44.7%	16.4%	38.4%	41.8%	30.6%
Trading value (US$ billion)	147.8	201.8	229.6	300.8	261.3	316.3	425.7	354.3
Turnover ratio	150.7%	123.9%	140.2%	103.7%	218.3%	134.0%	138.4%	202.3%
General share price index (ISE 100)	1,075	1,726	1,621	2,790	1,028	2,068	2,500	1,878
Change in share price index	38.1%	60.6%	-6.1%	72.1%	-63.2%	101.2%	20.9%	-24.9%
Price/Earnings ratio	13.27	19.38	14.86	11.97	5.76	16.83	13.29	12.68
Dividend Yield (%)	1.37	1.71	2.10	1.90	4.93	2.37	1.79	2.26

Sources: Istanbul Stock Exchange, Bank Audi's Group Research Department

came along heightened interest in the Sukuk market in general as the latter has proved to be relatively resilient in times of global volatility. This is partly due to limited supply of Sukuk and since Sukuk investors tend to hold the bonds until maturity, reducing the chance of big swings in secondary market prices triggered by shorter-term speculators bailing out of positions.

Finally, with respect to credit ratings, S&P raised in September 2011 Turkey's long and short term local currency credit ratings to investment grade "BBB-/A-3" from "BB+/B", citing continuing improvements in the country's financial sector and the deepening of local markets as well as the CBRT's track record of independent monetary policy and a free floating FX regime. The agency affirmed the country's foreign currency sovereign ratings at "BB/B", two levels below investment grade, noting external position risks. The agency also mentioned that the current two-notch difference between LC and FC ratings reflects revised rating criteria for central governments at large.

2. CONCLUSION: The way ahead

Looking forward, the weakness of external demand is expected to be increasingly weighing on growth in the near term, especially that the room to stimulate domestic demand through policy remains somehow limited. Within this environment, the International Monetary Fund has adopted conservative growth forecasts for the couple of years ahead, set at 2.2% in 2012 and 3.4% in 2013. Inflation is also forecasted at relatively low levels by historical standards, with single digit rates of 6.9% in 2012 and 5.3% in 2013.

A large number of challenging issues creates a sort of a paradox for investors and observers carefully looking at Turkey on the backdrop of increased global uncertainty. The Turkish economy remains more robust than many economies, but the recent domestic demand boom has begun to affect performance in some areas. The prospective analysis of the Turkish economy thus calls for an in-depth SWOT analysis, i.e an analysis of current strengths, underlying weaknesses, upcoming opportunities and possible threats looking forward.

At the level of strengths, we actually mention the high per capita income, the strong and well regulated banking sector, the relatively attractive business environment and climate, the economy's effectiveness, transparency and rule of law, the well-entranched macro framework, and the track record of fiscal consolidation on the basis of favorable public debt dynamics, strong debt management and good debt service record.

At the level of weaknesses rises the record of volatile and high inflation, the history of political tensions and turbulence derived from conflict between secular and religious elements of society, the government's weak revenue-raising capacity and its short average debt maturities, the economy's persisting external imbalances along with growing needs to accumulate a larger buffer of both private and official foreign exchange reserves.

At the level of opportunities, they are actually enormous. The most important are tied to the country's strategic geopolitical location, the large scale of the economy and its diversification potential and underlined dynamism, the country's strengthened resilience to economic, financial and political vulnerabilities and the relatively deep local capital markets, with the development of new private savings vehicles apt to promote further domestic savings and enhance resilience to swings in global financial conditions.

At the level of threats, the most significant risks are tied to the substantial external vulnerabilities including a large current account deficit, the private sector dissaving which leaves Turkey exposed to liquidity cycles and swings in risk appetite, the lingering uncertainty regarding policymakers' determination to pursue economic reforms going forward and the areas of political risk stemming from secular-religious tensions and long lasting ethnic conflicts.

While it is true that prevailing macroeconomic imbalances will pose growing challenges for economic policies in the short run, we believe that opportunities outpace challenges at the horizon. Beyond short term risks related to currency depreciation, widening external deficits and a slowing down real sector, the middle run offers important growth opportunities on the background of an economy operating below full employment and potential output. On that background, sustaining a healthy, balanced and sustainable growth performance through better aligning domestic demand and supply and durably reducing external imbalances calls for a mix of broad structural reform measures in the Republic in years ahead. While such a policy mix is unlikely to be able to avert output losses entirely in the short run, it could mitigate the adverse effects of potential external shocks and provide a strong basis for a subsequent recovery in the medium to long run.