TURKEY ECONOMIC REPORT

AN IMPROVING ECONOMIC OUTLOOK FAVORED BY LOWER OIL PRICES

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- Sound growth this year though at a lower pace

  Economic growth has continued in 2014, although lower than the previous year amidst the effects of US tapering and domestic uncertainties. All in all, it is expected that growth would average 3% this year, yet below the four-year average growth rate of 6%. The largest contribution to growth is coming from exports of goods and services and contracting imports, which translates into a strong net export contribution to growth.

- Noticeable alleviation of the external constraint year-on-year

  As imports reported a downward movement over the first nine months of this year coupled with an upward movement in exports, Turkey's trade deficit shifted to a sliding path, reporting a double-digit improvement of 25.3%. Accordingly, the country's trade deficit reached US$ 45.5 billion in the first nine months of 2014, down from US$ 60.9 billion in the equivalent period of 2013. The improvement of Turkey's trade balance was a main driver behind shrinking the country's current account deficit. The latter reached US$ 30.9 billion during the first nine months of 2014, posting a 37.2% decrease relative to the equivalent period of 2013. The deficit of the current account balance is projected by the IMF to settle at 5.8% of GDP for full-year 2014, down from 7.9% last year.

- Wider budget deficit yet with ongoing decline in debt-to-GDP ratio

  Turkey's fiscal deficit relatively widened over the first nine months of 2014, while the debt-to-GDP ratio is forecasted to continue its downward trajectory to reach 33.6% of GDP at end-2014, as per the IMF, which is its lowest level in more than a decade. Turkey is set to preserve a tight fiscal policy, as fiscal restraint raises national savings and helps reduce the current account deficit, public debt and borrowing costs, and supports the monetary policy in curbing inflation.

- Aggressive tightening of monetary policy to defend the Turkish Lira

  Turkey's monetary policy remained in general tight over the year 2014 (despite some easing over the second half of the year), mainly to defend the Turkish Lira and rein in inflation, despite continuous pressures on authorities to adopt a more expansionary policy stance to bolster economic growth. This helped limit the local currency depreciation, while the Consumer Price Index remained well above the Central Bank's medium-term target, driven by high food prices.

- Good banking activity growth coupled with adequate financial standing

  The Turkish banking sector registered an overall good activity growth so far this year, in line with the continued expansion of the domestic economy and despite erratic exchange rate fluctuations amidst occasional internal tensions in the country. Total sector activity, measured by the aggregated assets of all banks operating in Turkey, grew by 11.8% in local currency terms in the first nine months of 2014 (5.5% in US Dollar terms) to reach the equivalent of US$ 814.1 billion at end-September. Financial soundness indicators remain favorable, with a non-performing loans to total loans ratio of 2.9% at end-September 2014, a capital adequacy ratio of 15.9% at the same date and annualized ROAA and ROAE of 1.3% and 11.7% over the first nine months of this year.

- Upward price trend across Turkish capital markets

  The Turkish capital markets witnessed a pick-up in prices and drops in risk premiums over the year 2014 on the back of tumbling oil prices and narrowing current account deficit, and on bets about easing inflation in the coming period. The BIST 100, which represents the 100 largest companies by market capitalization, advanced by 14.9% over the first ten months of 2014. The cost of insuring debt in Turkey contracted considerably since the beginning of the year, with the country's five-year CDS spreads falling from 244 basis points at end-2013 to 170 basis points currently.

- Turkey biggest regional beneficiary from a drop in oil prices

  Turkey's macroeconomic outlook has the potential to improve significantly if commodity prices were to stick at current levels. It just so happens that, leading up to this point, Turkey's imbalances were showing signs of improvement already. Turkey's core inflation and current account dynamics are thus likely to improve and not less importantly an emerging market's capacity to finance a given external gap improves dramatically on the back of improving imbalances.

The Turkey Economic Report can be accessed via internet at the following web address: http://www.bankaudi.com

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The Turkish economy has grown significantly well in recent years. The economy recovered promptly from the global financial crisis and unemployment reached its lowest level for the last decade. Lately, Turkish authorities effectively contained the fallout from heightened domestic uncertainty and financial market volatility. But low national savings and competitiveness challenges are constraining investment and exports, contributing to considerable external imbalances that expose the country to the risks associated with international capital flows.

Economic growth has indeed continued this year, although it has contracted from the previous year amidst the effects of US tapering and domestic uncertainties. All in all, it is expected that growth would average 3% this year, yet below the four year average growth rate of 6%. The growth rate over the first half of 2014 averaged 3.3% and it is unlikely that growth performance would strengthen in the remaining of the year in the presence of high inflation and interest rates, which dampens both domestic consumption and investment activity.

As a matter of fact, domestic demand slowed relatively as high domestic interest rates, coupled with uncertainty due to international developments, prevailed. The largest contribution to growth is coming from exports of goods and services and contracting imports (mirroring weak domestic demand), which translates into a strong net export contribution to growth.

External sector indicators appear to be mixed this year. Exports have increased by 6.6% in the first nine months of 2014, driven by the gains in competitiveness in the aftermath of currency depreciation.

Foreign direct investment in Turkey dropped by 7.7% in the first nine months of 2014 relative to the previous year's corresponding period. The number of foreign tourists rose by 6.1% over the same period. Last but not least, Turkey's balance of payments reported a surplus of US$ 2.9 billion in the first nine months of 2014, against a surplus of US$ 10.2 billion over last year's corresponding period.

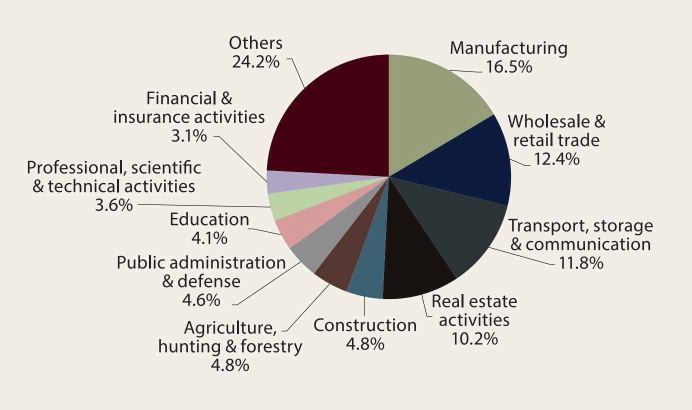
At the monetary level, inflation continues to be considerably higher than the Central Bank's target of 5%, reflecting the exchange rate pass through, high food inflation and partly premature monetary easing. That being said, consumer price inflation averaged 8.9% in the first ten months of 2014. Moody's forecast that inflation will reach around 10% at the end of the year (around double the CBT's target rate) and which also faces upside risks from geopolitical factors (through oil price impact) as well as market volatility.

Turkey's fiscal policy has eased in recent years, through increases in current transfers and capital spending, but the budget deficit has stayed low, thanks to a decline in interest rates. Public balances weakened slightly in 2014, as tax revenues contracted on a real basis due to a slowdown in domestic demand, whereas fiscal spending outpaced budget targets. The government deficit to GDP ratio rose from 1.6%

GROSS DOMESTIC PRODUCT PERFORMANCE

Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (1H 2014)



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

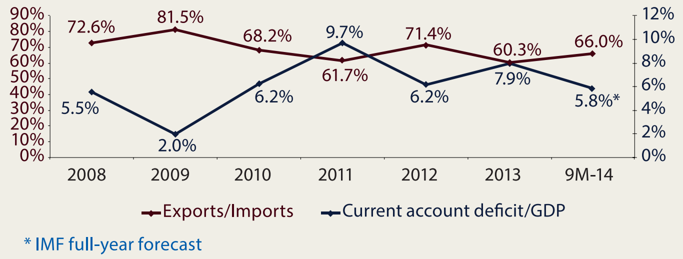
in 2013 to a forecasted 2.0% in 2014. Still, Turkey's public finances remain healthy and the stock of public debt to GDP ratio is likely to maintain its declining trend in 2014. The debt ratio is forecasted to decline from 36.3% in 2013 to 33.6% in 2014 as per the recent IMF World Economic Outlook released in October.

Within this environment, the new government announced its structural reform plan which is based on five main pillars: political stability, investing in human capital, investing in R&D and better use of technology, a macro policy that does not crowd out real sector, and better integration with the global economy. In general, there was a sense of relative optimism about the prospect of structural reforms although the full framework is yet to be unveiled.

At the banking sector level, Turkish banks continue to post a relatively sound growth with good financial soundness indicators. When expressed in TL terms, assets grew by 11.8% in the first nine months of 2014 (5.5% in US$ terms), and loans grew by 13.9% in TL terms over the period (7.4% in US$ terms). Capital adequacy ratios are high, with an average ratio of 15.9% at end-September 2014. Asset quality remains satisfactory with a NPL ratio of 2.9% of gross loans and a loan loss provision ratio of 72.8% of non-performing loans. Last but not least, profit ratios have contracted this year but remain acceptable with a ROAA of 1.3% and a ROAE of 11.7%.

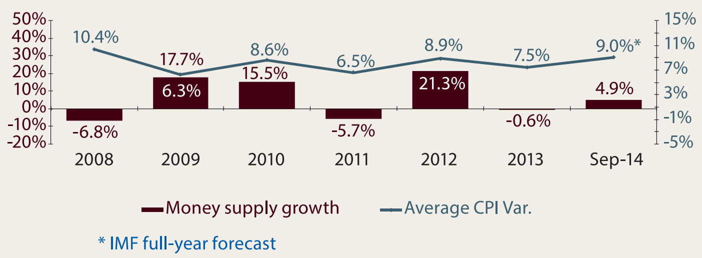
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economy on the back of the observed drop in oil prices with favorable effects on Turkey's economic imbalances at large.

FOREIGN SECTOR INDICATORS



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

MONEY SUPPLY GROWTH AND INFLATION



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

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agricultural Sector

Moderate growth in the primary sector

The year 2014 has been so far another period of quiet growth in Turkey's primary sector, affected among other factors by another season of poor weather conditions. Indeed, the agriculture, forestry, and fishing sector, accounting for around 5% of the country's GDP, grew by 3.1% in the first half of 2014, following another rise of 4.0% in the same period of the year before.

The country's exports of agricultural products reported a growth of 8.4% in the first ten months of 2014, reaching US$ 4.86 billion. This reflects a moderate strengthening of demand in international markets and follows a similar rise of 8.1% reported in the equivalent period of 2013. In addition, imports of agricultural products reported a growth of 10.4% in the above mentioned period of 2014, following a weaker growth of 2.0% reported in the first ten months of 2013. Accordingly, they have reached a value of US$ 7.03 billion by end-October 2014.

As to crop production, the overall output has registered a moderate growth in 2013, according to the latest estimates by Turkstat. In fact, total crop production grew by a yearly 5.4% to reach 111.4 billion tons. This follows stagnation in output production reported in the 2012/2013 season. As to the cereals, constituting the bulk of crop production, at 58% of the total, they were back on a rising trail, up by 8.4% after reporting declines for two consecutive years (-4.0% last year). On the other hand, production of vegetables reported a rise of 2.3%, while that of fruits, nuts, and spices increased by 1.7% yearly.

It is worth noting that agricultural policies implemented last year have been proving fruitful, as shown by a detailed look at agricultural exports. In fact, Turkey seems to keep on benefiting from the European Union's decision to allow the sale of Turkish milk to its countries as of April 2013. In fact, after growing by 18.5% in the first ten months of 2013, exports of Turkish dairy products grew by 16.2% in the equivalent period of 2014. Moreover, exports of livestock animals have more than doubled in the above mentioned period, reflecting a decision by Saudi Arabia in early 2013 to open its large market to Turkey's animal breeding sector.

CROP PRODUCTION IN 2013 (CEREALS, VEGETABLES AND FRUITS)

million tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**37,489**	**59%**	**Vegetables**	**23,515**	**83%**	**Fruits**	**11,315**	**58%**
o.w. Wheat	22,050	35%	o.w. Tomatoes	11,820	42%	o.w. Citrus fruits	3,681	19%
o.w. Barley	7,900	12%	o.w. Watermelon	3,887	14%	o.w. Pome fruits	3,747	19%
o.w. Maize	5,900	9%	o.w. Cucumber	1,755	6%	o.w. Stone fruits	2,445	13%
Sugar beets	**16,483**	**26%**	o.w. Melon	1,700	6%	o.w. Other fruits	1,442	7%
Potatoes, dried legumineus	**3,948**	**6%**	o.w. Pepper (green)	947	3%	**Grapes**	**4,011**	**21%**
Oil seeds	**3,313**	**5%**	**Bulb and root vegetables**	**3,187**	**11%**	**Olive production**	**1,676**	**9%**
Dry pulses	**1,148**	**2%**	o.w. Dry onion	1,905	7%	**Tea production**	**1,180**	**6%**
Raw materials used in textiles	**878**	**1%**	o.w. Carrots	570	2%	**Nuts**	**993**	**5%**
Plants for perfumery, pharmacy	**150**	**0%**	**Other vegetables**	**1,746**	**6%**	**Spices crops**	**244**	**1%**
Tobacco	**90**	**0%**	o.w. Leafy or edible stem vegetables	1,518	5%	**Total Fruits, nuts**		
Total Cereals and other crops*	**63,499**	**100%**	**Total Vegetables and other crops**	**28,448**	**100%**	**and spices crops**	**19,419**	**100%**
* Excluding fodder crops								

Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

1.1.2. Industrial Sector

Industrial sector reflects signs of improvement despite sluggish domestic and external demand growth

Turkey's industrial sector managed to gain some steam, despite sluggish domestic demand growth and weakened external demand. During the first half of 2014, the sector, which accounts for around 20.1% of GDP, posted a real growth of 3.8% year-on-year, against 2.4% recorded in the same period of 2013. The average Industrial Production Index, measuring the amount of output from the manufacturing, mining, electric and gas industries, rose by 3.7% year-on-year in the first nine months of 2014, compared to 3.1% in the same period of 2013, as per Turkstat.

Accounting for almost 82% of the industrial sector's output, Turkey's manufacturing sector recorded a real growth of 3.6% year-on-year during the first half of 2014, compared to a growth rate of 2.8% in the same period of 2013. Furthermore, the average industrial production index for manufacturing went up by 3.3% year-on-year in the first nine months of 2014, compared to a 3.9% rise in the corresponding period of 2013. It is important to note that Turkey's external demand was negatively impacted by a faltering economic recovery in Europe and escalating turmoil in Iraq, both major export markets for Turkish manufacturers.

As for the manufacturing sector's capacity utilization rate, it posted an average of 74.3% in the first eleven months of 2014 compared to 74.5% in the same period of 2013. Manufacturing capacity utilization figures suggest that output remained flat. Moreover, the seasonally adjusted HSBC Turkey Manufacturing PMI, a composite indicator designed to provide a single-figure snapshot of the performance of the manufacturing industry, reached 51.5 in October 2014, down by 3.4% from 53.3 in October 2013 (a reading above 50 indicates expansion in manufacturing activity).

It is worth adding that Turkish manufacturers, traditionally focused on relatively low value-added industries, successfully moved up the value chain and expanded into automotives, household appliances, LCD televisions, machinery and metals, as per Moody's.

With regards to electricity, gas and water supply, accounting for 8% of the industrial sector's GDP, its value rose by 4.1% year-on-year in the first half of 2014, after marginally dropping by 0.7% in the same period of 2013. The average industrial production index of the aforementioned component recovered during the first nine months of 2014, growing by 5.2% year-on-year, against a 1.5% contraction in the corresponding period of 2013. As for the mining and quarrying component, which makes up 6.7% of the industrial sector GDP, its value was up by 7.5% year-on-year in the first half of 2014, compared to a 3.3% contraction posted in the corresponding period of 2013. Within this context, the expansion in the mining and quarrying sector is related to the five-year action plan, recently announced by the Prime Minister, to meet the country's soaring energy demand via increasing its coal production.

Lastly, Turkey's average domestic Producer Price Index (PPI) revealed a relative supply side improvement of the country's industrial sector at large. The domestic PPI, a gauge of representative goods and services sold by manufacturers and producers in the wholesale market excluding the agricultural sector, was up by 10.9% during the first ten months of 2014, compared to 4.1% in the same period of 2013.

VEHICLES PRODUCTION

(unit)	2009	2010	2011	2012	2013	8M-13	8M-14	8M/8M
Automobile	510,931	603,394	639,734	577,296	633,556	399,331	455,528	14.1%
Pick-up	330,044	442,408	479,110	426,633	410,558	276,185	216,189	-21.7%
Tractor	14,861	30,425	45,506	42,255	40,511	25,935	31,611	21.9%
Truck	8,246	23,851	37,396	29,129	30,083	19,652	18,517	-5.8%
Minibus	11,829	16,978	22,475	29,335	37,751	24,219	20,482	-15.4%
Bus	5,931	5,268	6,907	6,427	8,374	5,983	4,446	-25.7%
Midibus	2,624	2,658	3,509	4,158	5,197	3,257	3,902	19.8%

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

1.1.3. Trade and Services Sector

Improvement in the trade and services sector supported by growth in sub-sectors

Turkey's trade and services sector, which contributes to around 64% of the country's GDP, encountered positive growth in the first six months of 2014, as per the latest available figures. Recent numbers reveal an improvement in the sector with a 10.3% year-on-year increase in the trade and services index compiled by the Turkish Statistical Institute in the second quarter of 2014, compared with 7.5% year-on-year in the corresponding period of 2013. This can be attributed to the increased activity in most of the branches of the tertiary sector.

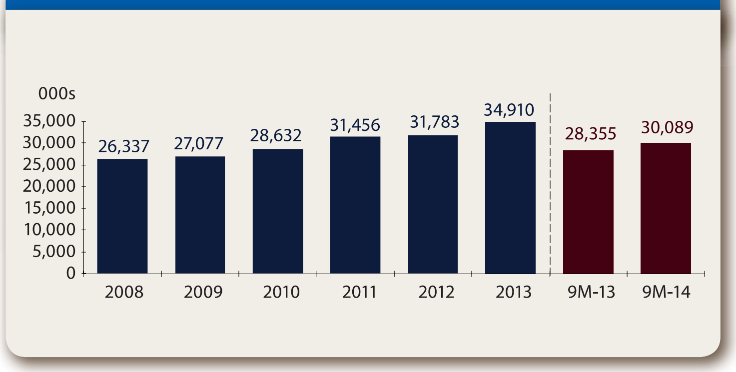
Wholesale and retail trade, which makes up 12.4% of the Turkish GDP in the first half of 2014, reported a 10.8% year-on-year growth in the second quarter of 2014, compared to a growth of 6.3% in the second quarter of 2014. This is likely to have been favored by a rise in both private consumption and the number of tourists visiting Turkey. Primarily, private consumption rose by 6.3% year-on-year in the second quarter of 2014. Moreover, the growth in the number of tourists visiting Turkey could have played a role in supporting this increase.

Tourism statistics highlight an overall improvement in the sector in the first nine months of 2014. The number of foreign arrivals registered a 6.1% increase year-on-year, rising up from 28.4 million arrivals in the first nine months of 2013 to 30.1 million in the first nine months of 2014. Moreover, tourism income rose by 8.5% year-on-year in the first three quarters of 2014 compared with the same period last year. It is worth adding that an 11% increase in tourism income was reported by the Turkish Statistical Institute in the third quarter of 2014 from the corresponding quarter of 2013.

Despite the positive performance of tourism in Turkey in the first three quarters of the year, hotel occupancy rates dropped in October, putting the country in the second-lowest position in hotel occupancy rates in Europe with 63.8%. The latter could be attributed to the turmoil taking place near the Turkish borders, as per the Turkish Touristic Hotels and Investors Association.

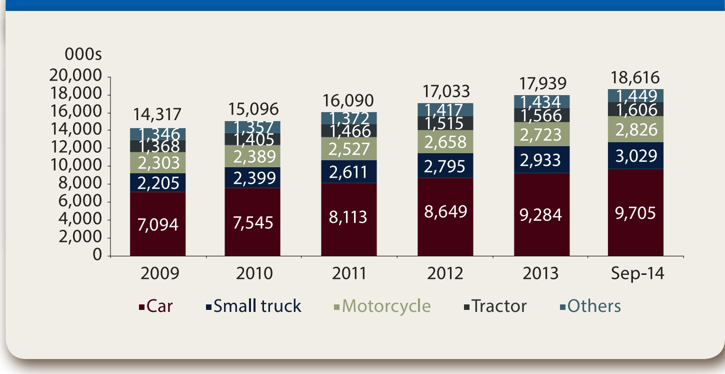
Growth in the transportation, storage, and communication sub-sectors, constituting 11.8% of the Turkish GDP year-on-year, also contributed to the overall growth in the trade and services sector. In fact, transportation and storage improved by 11.4% year-on-year in the second quarter of 2014, based on the transportation and storage turnover index released by the Turkish Statistical Institute. Within this context, it is worth mentioning that Turkey's aviation sector and share of air passengers faced significant growth over the past ten years, and are developing further with the establishment of the third airport in 2017, as per the Ministry of Transport. Last but not least, the country's telecommunications turnover index reported a 2.8% increase in the second quarter of 2014 from the corresponding period of 2013.

NUMBER OF FOREIGNER ARRIVALS



Sources: Ministry of Tourism and Culture, Bank Audi's Group Research Department

NUMBER OF ROAD VEHICLES



Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

1.2. EXTERNAL SECTOR

Noticeable current account improvement in 2014

Turkey's external sector imbalances have remained a main vulnerability this year. Improved exports to Turkey's major trading partner along with weaker internal demand have driven the current account deficit downward. However, this has been outweighed by lower surplus at the level of the financial account, driving the balance of payments surplus downward.

In details, Turkish exports reached US$ 128.8 billion in the first nine months of 2014, as per the latest Central Bank figures, posting a 6.6% increase on a yearly basis. This positive development on the export front was helped by both a considerably weaker Turkish lira and moderate strengthening of demand in European markets. In fact, exports to Turkey's main trade partner, namely the EU, have increased by 12.1% year-on-year during the first nine months of 2014. Accordingly, the share of the EU out of Turkey's total exports has rebounded to 43.7% in the first nine months of the year up from 41.1% in the equivalent period of 2013. The above mentioned effects have overweighed the downside resulting from troubled trade with Iraq and volatile trade with Russia, Turkey's second and fourth major trading partners, respectively.

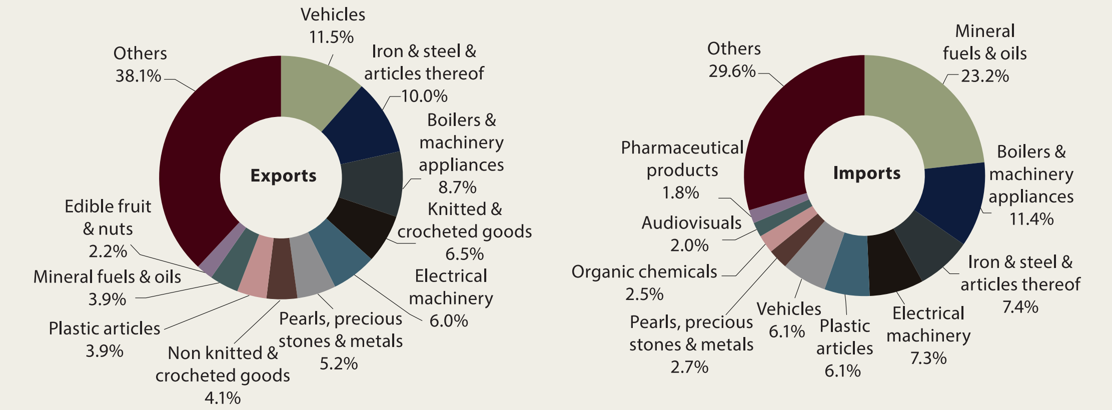
A breakdown of exports by type shows that the overall improvement can be attributed to a boost in the main component, namely manufacturing. The latter has posted a year-on-year increase of 5.8% during the first nine months of 2014. Add to this the rise in exports of agriculture and forestry products (+7.1% year-on-year), both more than offsetting the decrease of 10.1% registered at the level of mining and quarrying exports.

At the same time, Turkish imports reported a 4.1% year-on-year decrease during the first nine months of 2014 to US$ 174.2 billion, driven by a 23.4% decrease in the value of imported manufactured products. The latter is resulting from weaker aggregate demand on the internal front, which in turn, reflects slower economic activity on the overall. Moreover, the Central Bank of Turkey, in collaboration with other regulators, introduced restrictions on consumer lending growth in order to restrain imports and keep the country's large current account deficit under control.

A more detailed look at Turkey's purchases from the European Union, which constitute the bulk of the country's imports (at 36.7%), decelerated by 3.2% year-on-year during the first nine months of 2014. Imports from other European countries category, which is the third most important in value, dropped by 12.8% over the same period of the year.

As imports reported a downward movement so far this year coupled with an upward movement from the side of exports, Turkey's trade deficit shifted to a sliding path, reporting a double-digit improvement of 25.3%. Accordingly, the country's trade deficit reached US$ 45.5 billion in the first nine months of 2014, down from US$ 60.9 billion in the equivalent period of 2013, year during which the deficit also tightened

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-14)



Sources: Turkish Statistical Institute, Bank Audi's Group Research Department by 19.2%. The improvement of Turkey's trade balance was a main driver behind shrinking the country's current account deficit. The latter reached US$ 30.9 billion during the first nine months of 2014, posting a 37.2% decrease relative to the equivalent period of 2013. The deficit of the current account balance is projected by the IMF to settle at 5.8% of GDP for full-year 2014, down from 7.9% last year.

The shrinking of the deficit registered at the level of the current account has been accompanied by an even stronger drop in the financial account surplus. The latter reached US$ 26.2 billion, decreasing by 53.6% year-on-year. The drop was driven, among other reasons, by lower investments notably to the benefit of banks, as well as lower portfolio investment in debt securities.

Accordingly, the overall Turkish balance of payments closed the first nine months of the year with a surplus of US$ 2.9 billion, down from the US$ 10.2 billion surplus registered in the similar 2013 period, given that the decrease in the current account deficit was more than offset by the decrease in the financial account surplus. This highlights a main vulnerability of the Turkish economy, namely financial market nervousness about Turkey's large external financing requirement and its heavy reliance on volatile portfolio capital inflows to meet its funding needs. This, in turn, keeps the external deficit high despite improvement.

1.3. PUBLIC SECTOR

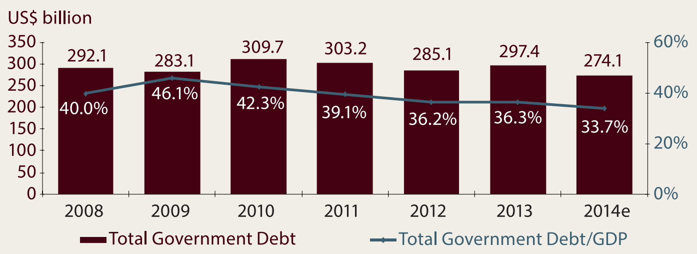
Wider budget deficit yet with ongoing decline in debt-to-GDP ratio

Turkey's fiscal deficit more than doubled over the first nine months of 2014, while the debt-to-GDP ratio is forecasted to continue its downward trajectory to reach 33.6% of GDP at end-2014, as per the IMF, which is its lowest level in more than a decade.

Central government revenues grew by 8.1% during the first nine months of 2014 to reach a total of TL 313 billion, mainly supported by a 7.4% increase in general budget revenues to TL 301 billion, a 31.3% rise in revenues from special budget institutions to TL 9 billion, and a 19.1% growth in revenues from regularity and supervisory institutions to TL 3 billion. General budget revenues showed that tax revenues increased by 7.7% during the first nine months of 2014 to reach TL 258.7 billion, grants and aids and special revenues widened by 25.0% to TL 1.8 billion, Interest, shares and fines increased by 21.4% to TL 22.1 billion, property income went up by a tiny 0.6% to TL 11.4 billion and receivable collections jumped to TL 803 million during the first nine months of 2014 from TL 74 million during the corresponding period of 2013.

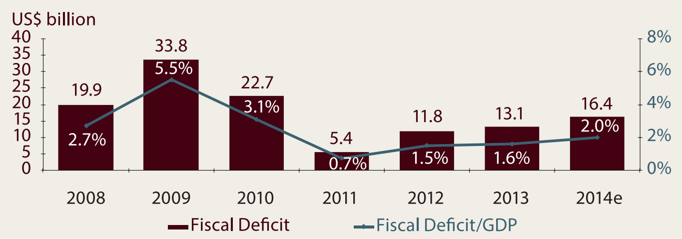
Expenditures went up by 10.5% during the first nine months of 2014 to reach TL 325 billion, mainly due to a 14.5% expansion in non-interest expenditures to TL 287 billion, while interest expenditures contracted by 12.7% to TL 38 billion. Non-interest expenditures showed for instance a 21.1% surge in capital expenditures during the first nine months of 2014 to TL 27 billion, a 12.7% rise in current transfers to TL 125 billion, a 15.0% increase in compensation of employees to TL 84 billion, a 17.3% growth in social security contributions to TL 14 billion, a 12.8% rise in capital transfers to TL 4 billion, a 17.1% rise in lending

PUBLIC INDEBTEDNESS



Sources: IMF, Bank Audi's Group Research Department

FISCAL DEFICIT



Sources: IMF, Bank Audi's Group Research Department to TL 8 billion and a 13.7% rise in goods and services purchases to TL 25 billion. Interest expenditures showed a 55.7% drop in interest of discount and short term cash operation during the first nine months of 2014 to TL 1.4 billion, a 15.8% fall in domestic interest to TL 28.5 billion, while foreign debt interest increased by 18.3% to TL 7.8 billion, and Certificate of rent expenditures moved up from TL 184 million during the first nine months of 2013 to TL 535 million during the corresponding period of 2014.

That being said, the Central government deficit reached circa TL 12 billion over the first nine months of 2014 as compared to a deficit of TL 4.5 billion during the same period of 2013, mainly driven by a staggering increase in social security expenditures during the month of September 2014.

In parallel, the Central government debt stock reached US$ 270 billion at end-October 2014, as per the latest figures released by the "Prime Ministry Undersecretariat of Treasury", and is split into US$ 185 billion in domestic debt (accounting for circa 69% of the total) and US$ 85 billion in external debt (accounting for the remaining 31%). Accordingly, the central government debt stock reached 33.1% of GDP at end-October 2014, and is expected to reach 33.6% of GDP at end-2014, as per the IMF, down from 36.3% of GDP in 2013. Total government and international bonds accounted for 90% of the total debt stock (the equivalent of US$ 243 billion), while loans accounted for the remaining 10% (the equivalent of US$ 27 billion).

Last but not least, the newly released Medium-Term Program (2015-2017) outlined three top priorities, namely fighting inflation, reducing the current account deficit, and increasing potential growth by accelerating structural reforms. Within this context, the three-year road map for the Turkish economy placed emphasis on the fiscal policy and the generation of larger surpluses to reduce inflation, which will improve the macroeconomic environment for savings. Total domestic savings are forecasted at 14.9% of GDP in 2014, as per the Turkish government, up from 13.4% of GDP in 2013, and this is expected to reach 15.2%-17.1% of GDP over the 2015-2017 period, as per the Medium-Term Program, though still fairly low by international standards.

Looking forward, Turkey is set to preserve a tight fiscal policy, as fiscal restraint raises national savings and helps reduce the current account deficit, public debt and borrowing costs, and supports the monetary policy in curbing inflation. Accordingly, consolidation efforts should primarily focus on improving spending efficiency and limiting current expenditure growth while preserving capital investment, as per the IMF.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Aggressive tightening of monetary policy to defend the Turkish Lira

Turkey's monetary policy remained in general tight over the year 2014 (despite some easing over the second half of the year), mainly to defend the Turkish Lira and rein in inflation, despite continuous pressures on authorities to adopt a more expansionary policy stance to bolster economic growth. This helped limit the local currency depreciation, while the Consumer Price Index remained well above the Central Bank's medium-term target, driven by high food prices.

The Central Bank of the Republic of Turkey aggressively raised all its main interest rates after an emergency monetary policy meeting on the 28th of January 2014 amidst currency crisis concerns in emerging markets and mounting pressures on the Turkish Lira following the US Federal Reserve's decision to taper its bond-purchasing program, suggesting that authorities are prepared to adjust domestic policy settings to avert more disruptive shocks to economic stability. The CBRT's move in January aimed at anchoring the Turkish Lira and halting its depreciation (the latter has depreciated by more than 10% since the US Fed's tapering decision on December 18, 2013), stemming capital outflows and restoring external financial stability. In details, the CBRT more than doubled the one-week repurchase rate, with the latter moving from 4.50% to 10.00%. Also, it raised the overnight lending rate from 7.75% to 12.00%, and the overnight borrowing rate from 3.50% to 8.00%, promising to keep the monetary policy tight until the inflation outlook "improves significantly".

Substantial rate hikes at the beginning of the year 2014, ranging between 425 bps and 550 bps, resulted into some appreciation in the Turkish Lira, yet weighed on domestic consumption and investment activity, threatening to undermine the growth targets. Under these circumstances and given easier global liquidity conditions, the reduced global uncertainties, the relative improvement in Turkey's risk premium gauges towards the end of the first half of 2014, and the local political pressures on policymakers to lower borrowing costs in order to shore up growth, the CBRT cut the one-week repo rate by 175 basis points over the May-July 2014 period to 8.25%, and reduced the overnight borrowing rate by 50 basis points in July to 7.50% and the overnight lending rate by 75 basis points in August to 11.25%. Within this context, it is worth mentioning that the Central Bank of the Republic of Turkey operates an interest-rate "corridor", which gives it the flexibility to vary the cost of funding to the banking sector on a daily basis.

The interest rate cuts by the CBRT over the May-August 2014 period came at a time when the annual inflation rate continued to rise, reaching 9.5% in August, well above the Central Bank's medium-term target of 5%. All in all, the Consumer Price Index rose by 8.9% on average during the first ten months of 2014, mainly driven by a 12.4% increase in food prices as the dry weather reduced supplies of agricultural products, and it is expected to average 9.0% in 2014 (7.7% in 2013), as per the IMF estimates, reflecting the exchange rate pass through, high food inflation, and partly, premature monetary easing.

Despite high inflation rate, the CBRT kept all its main interest rates unchanged in September and October 2014, stating that the recent fall in oil and food prices is expected to limit the upside risks on inflation (annual inflation rate forecasted at 6.1% by the CBRT by year-end 2015), while the role of the Turkish Lira is assumed to diminish.

The Turkish Lira has depreciated by 3.5% over the first ten months of 2014, moving from TL/US$ 2.15 at end-2013 to TL/US$ 2.22 at end-October 2014, following a sharper depreciation of 20.4% over the year 2013. The CBRT's gross foreign exchange reserves grew by US$ 2.4 billion over the first ten months of 2014 to reach US$ 112.7 billion at end-October 2014, covering 5.6 months of imports, despite losses incurred at the beginning of the year when it sold large amounts of its reserves in a bid to stabilize the Turkish Lira.

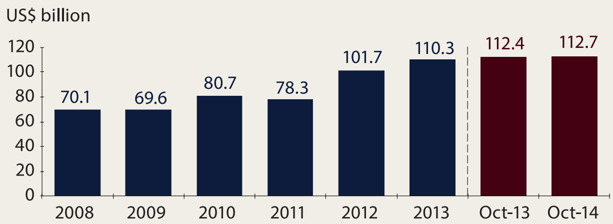
That being said, it is worth mentioning that the government has recently announced its 2015-2017 Medium-Term Program in which it states the main goals of the government over the medium term are to reduce inflation, lower the current account deficit and improve growth prospects with structural reforms. Maintaining strict fiscal policy (increasing public savings) is the main conduit via which the government is expected to reduce inflation. Within this context, the IMF said that the monetary policy should focus on the 5% inflation target by sustaining a positive real policy interest rate to anchor expectations and lower inflation to the targeted rate, stressing that the monetary effort to achieve the inflation target would be smaller if the fiscal stance were tighter.

MONETARY SITUATION

Flows in US$ million	2008	2009	2010	2011	2012	2013	9M-14
Net foreign assets	**5,924**	**-3,073**	**-25,493**	**-2,341**	**6,649**	**-25,739**	**-6,345**
Foreign assets	6,669	-5,054	-93	7,123	28,861	11,888	2,196
Foreign liabilities	-745	1,980	-25,399	-9,464	-22,211	-37,626	-8,541
Domestic Assets	**-33,042**	**68,667**	**93,155**	**-26,520**	**94,369**	**28,298**	**30,814**
Claims on private sector	-11,286	29,063	84,676	26,540	91,188	46,689	35,458
Claims on public sector	-19,488	35,290	4,304	-49,055	-563	-18,488	-5,093
Claims on non-bank financial institutions	-2,268	4,315	4,175	-4,005	3,744	97	449
Total Money Supply	**-27,118**	**65,594**	**67,662**	**-28,861**	**101,018**	**-3,533**	**28,068**
Money Supply (M1)	-5,531	11,419	15,099	-6,572	10,383	6,080	4,317
Quasi-Money	-9,380	33,539	43,183	-17,745	61,002	-4,927	13,433
Other Items (Net)	-12,207	20,635	9,380	-4,544	29,633	-4,686	10,318

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

CENTRAL BANK RESERVES



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

1.4.2. Banking Activity

Healthy lending growth coupled with adequate financial standing

The Turkish banking sector registered an overall good activity growth so far this year, in line with the continued expansion of the domestic economy and despite erratic exchange rate fluctuations amidst occasional internal tensions in the country. Total sector activity, measured by the aggregated assets of all banks operating in Turkey, grew by 11.8% in local currency terms in the first nine months of 2014 (5.5% in US Dollar terms when accounting for the FX depreciation over the period) to reach the equivalent of US$ 814.1 billion at end-September.

Total deposits, a traditional activity driver of banking activity in the country, progressed by 9.1% in local currency terms (2.9% in US Dollar terms) between end-December 2013 and end-September 2014 to reach the equivalent of US$ 451.4 billion. The breakdown of deposits shows that around 79% of the total growth registered in this year's first nine months was attributed to time deposits (accounting for an almost equal share of the total deposit stock at Turkish banks), with the remainder attributed to higher demand deposits.

While deposits account for close to 55% of total banks' balance sheets and thus constitute a major source of funding for Turkish banks that have established strong retail franchises, faster lending growth in recent years, coupled with relatively low domestic savings rates, prompted market players to turn to wholesale markets. This made them more subjected to fluctuations in global investor sentiment on international money markets and raised refinancing risks. It is yet worth noting that banks have been reportedly shifting more from short-term to medium and long-term funding as of late, notably through the issuance of Eurobonds. Moreover, the Central Bank of Turkey recently said it will provide further support for core liabilities in the aim of spurring balanced growth and domestic savings, and decided to remunerate the local currency component of banks' required reserves.

Having said that, the refinancing risk in the sector is exacerbated by the fact that Turkish banks' balance sheets also reveal a mismatch between assets and liabilities' maturities, with the latter having a shorter tenure than the former. Still, this is alleviated by the fact that most deposit accounts belong to residents, and these have proven historically sticky. Also, leverage in the banking sector increased in recent years, especially as balance sheet growth generally exceeded that of capital accounts, but the higher refinancing and leverage are mitigated by robust capital levels and more or less sustained bottom line generation.

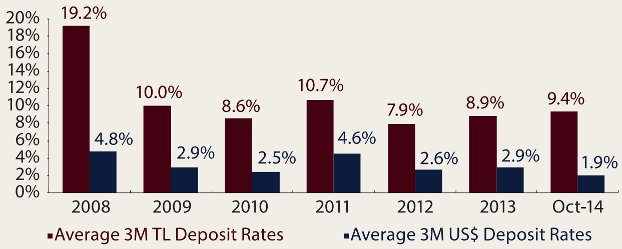
Whether additional deposits or external borrowings, Turkish banks have channeled the increased liquidity into lending to the domestic economy. As a matter of fact, total loans grew by 13.9% in local currency terms over the first nine months of 2014 (7.4% in US Dollar terms) to reach the equivalent of US$ 508.9 billion at end-September. While lending growth in absolute terms proved quite satisfactory, it also turned

BANKING SECTOR INDICATORS

in US$ million	2008	2009	2010	2011	2012	2013	Sep-14
Banking Activity							
Assets	444,998	513,059	611,275	606,184	732,820	772,002	814,085
Deposits	284,360	324,639	381,949	362,848	430,559	438,751	451,447
Credit facilities	197,788	224,285	312,929	338,027	426,933	473,763	508,942
Shareholders' equity	55,640	72,884	87,089	76,540	101,139	90,338	96,106
YTD Growth rates							
Assets	-3.3%	15.3%	19.1%	-0.8%	20.9%	5.3%	5.5%
Deposits	-2.3%	14.2%	17.7%	-5.0%	18.7%	1.9%	2.9%
Credit Facilities	-4.4%	13.4%	39.5%	8.0%	26.3%	11.0%	7.4%
Shareholders' equity	-12.8%	31.0%	19.5%	-12.1%	32.1%	-10.7%	6.4%

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

out to be 28% lower (in US Dollar terms) than during the corresponding period of 2013. This occurred within the context of rising interest rates post January 2014 increase, a weaker local currency and Central Bank measures aimed at curbing consumer lending growth introduced late last year.

With loan growth exceeding once again deposit growth, banks' liquidity was somewhat pressured. The loan-to-deposit ratio reached 112.7% at end-September 2014, increasing further from 108.0% at end-December 2013 and levels below the 100% threshold the year before. The loan book growth has resulted in not only higher use of non-deposit funding but also a shift from liquid assets to loans in recent times.

But while Turkish banks' loan book continued to grow, the local currency saw sharp fluctuations and interest rates surged, the sector's asset quality demonstrated resilience and ratios remained adequate in absolute terms and favorable in relative terms. On the one hand, the non-performing loans to total loans ratio barely nudged up to 2.9% at end-September 2014 (from 2.7% at end-December 2013) as per the Banking Regulation and Supervision Agency (BRSA) figures. This occurred despite the large FX exposure of Turkish companies, noting that the local currency depreciation is deemed as likely to put pressure on corporate balance sheets and on the NPLs ratio. It is worth noting that Turkish banks' NPLs ratio compares quite favorably to a higher emerging market average of 6.5%. On the other hand, those NPLs remain adequately provisioned for, with provisioning coverage at 72.8% at end-September 2014 (76.4% at end-December 2013) and pretty much in line with the emerging markets average.

Still, the recent interest rate and exchange rate fluctuations have had an impact on capital adequacy as well as the profitability of the Turkish banking sector. Nonetheless, the capital adequacy ratio continued to stay above the legal and target ratios of 8% and 12% respectively. In fact, Turkish banks have a substantial capacity to deal with potential credit losses risk, given their healthy capital adequacy metrics. The capital adequacy ratio stood at 15.9% at end-September 2014 as per the BRSA, noting that this is mostly based on high quality capital.

At the level of profitability, banks' bottom lines were subjected to some downward pressures as well since the measures to curb rapid consumer lending growth were introduced late last year, but some resilience in net revenue generation was observed partly owed to the sector's ability to maintain a strong net interest margin in spite of interest rate volatility throughout the year. BRSA figures indeed point out to overall satisfactory annualized ROAA and ROAE ratios of 1.3% and 11.7% over the first nine months of this year.

In its most recent note on Turkey, the IMF noted that the domestic financial system remains sound and well capitalized but called for continued vigilance. It welcomed the success of recent macro prudential measures to limit consumer credit growth, and to encourage more core funding in the banking sector. Furthermore, the Fund recommended additional steps to curb growth in wholesale foreign exchange funding and to reduce incentives for the non-financial corporate sector to take on exchange rate risk at large.

1.4.3. Equity and Bond Markets

Price rebounds across capital markets, contraction in five-year CDS spreads

The Turkish capital markets witnessed a pick-up in prices and drops in risk premiums over the year 2014 on the backdrop of tumbling oil prices and narrowing current account deficit, and on bets about easing inflation in the coming period.

In details, Borsa Istanbul saw a rebound in prices during this year on bets that falling oil prices would help narrow Turkey's trade deficit and boost the outlook of the country's external balance, and following declines in government debt yields that added to the attractiveness of the earning yields provided by Turkish equities. The BIST 100, which represents the 100 largest companies by market capitalization, advanced by 14.9% over the first ten months of 2014 to close at 2,130.21. The US Dollar-denominated

BIST 100 Net Total Return Index surged by 17.2% over the first ten months of 2014 after falling by 26.7% in 2013, which sheds light on the attractiveness of the Turkish stocks over the current year. Amidst price increases, the Borsa traded at a P/E of 13.25x at end-October 2014, up from a P/E of 10.22x at end-2013, while the market dividend yield decreased from 2.27% at end-2013 to 1.65% at end-October 2014.

The market capitalization increased from US$ 237.6 billion at end-2013 to US$ 265.1 billion at end-October 2014, up by 11.6%. The total number of contracts reached 67.1 million during the first ten months of 2014, up from 65.6 million during the corresponding period of 2013. The total trading value decreased from US$ 413.6 billion during the first ten months of 2013 to US$ 319.1 billion during the corresponding period of 2014, moving down by 22.9%. The turnover ratio, measured by the annualized total trading value to market capitalization, reached 144.4% during the first ten months of 2014, down from 173.1% during the corresponding period of 2013, spotting light on the declining activity on the Borsa Istanbul.

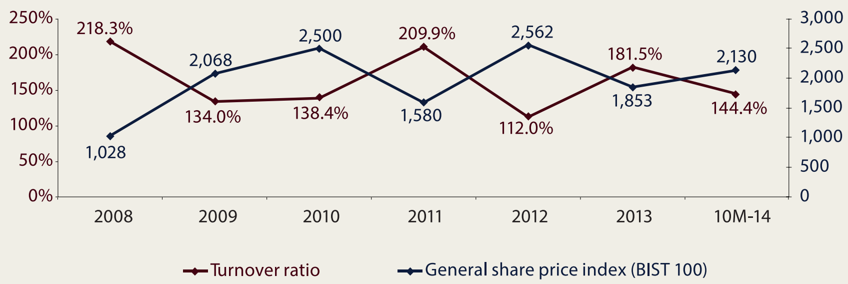
In parallel, in the aim of promoting and developing the Istanbul stock exchange and turning Istanbul into a regional financial center, Turkey's government authorized in November 2014 the sale of 42.75% of the Treasury's stake in Borsa Istanbul through an IPO. The Turkish Treasury said that it may sell its Class B by the end of 2015, with a possible extension of as much as one year. Borsa Istanbul's IPO price would be submitted to the government for approval. This strategic move came after the exchange brought the country's equity, debt, derivatives and precious metal markets under one umbrella following a restructuring that turned the bourse into a joint stock company in 2012.

SELECTED STOCK MARKET INDICATORS

	2008	2009	2010	2011	2012	2013	10M-14
Market capitalization (in US$ billion)	119.7	236.0	307.6	201.9	311.2	237.6	265.1
Market capitalization/GDP	16.4%	38.4%	42.0%	26.1%	39.5%	29.0%	32.6%
Trading value (in US$ billion)	261.3	316.3	425.7	423.9	348.6	431.3	319.1
Number of contracts (000s)	45,947	68,700	81,457	102,855	79,808	80,298	67,065
Change in BIST 100 price index	-63.2%	101.2%	20.9%	-36.8%	62.1%	-27.7%	14.9%
Price/Earnings ratio	5.76	16.83	13.29	11.88	12.51	10.22	13.25
Dividend Yield (%)	4.93	2.37	1.79	2.57	1.73	2.27	1.65

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

STOCK MARKET PERFORMANCE



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

At the level of the bond market, Turkish bonds posted price increases in 2014, as the country benefited from narrowing current account deficit, in addition to news that the Central Bank of the Republic of Turkey expects inflation to slow in 2015. Under these circumstances, the 10-year Turkish Lira Benchmark bond index yield fell from 10.14% at end-2013 to 7.98% at the time of writing this report. The cost of insuring debt in Turkey contracted considerably since year-end 2013, with the country's five-year CDS spreads falling from 244 basis points at end-2013 to 170 basis points currently.

Regarding new issues, Turkey raised US$ 7.3 billion over the first eleven months of 2014 through the issuance of Eurobonds, Samurai bonds and Islamic bonds, and plans to raise US$ 5.1 billion in 2015 through the issuance of bonds in international capital markets and through loans from World Bank and EIB.

With respect to credit ratings changes, Standard & Poor's changed in February 2014 Turkey's outlook to "negative" from "stable" and affirmed its long-term foreign currency credit ratings at "BB", saying that it saw risks of a hard economic landing and that the country's policy environment was becoming less predictable. S&P kept the country's rating outlook "negative" in November 2014, as it sees Turkey's growth potential constrained by lingering external vulnerabilities. Also, Moody's changed in April 2014 the outlook on Turkey's "Baa3" government bond rating to "negative" from "stable". This reflected, firstly, as per Moody's, the increased pressure on the country's significant external financing needs, driven by political uncertainty and volatile global capital flows towards emerging markets. Secondly, the outlook change reflected the growing uncertainty about Turkey's medium-term growth trend in light of the already moderating near-term outlook for GDP growth, especially since the prospects for growth-enhancing structural reforms may be diminished in the more uncertain policy environment.

2. CONCLUDING REMARKS

Turkey is the biggest beneficiary from a drop in oil prices within the region largo sensu, i.e Emerging Europe, Middle East and Africa and among the most significant beneficiaries in the emerging markets arena at large. As a matter of fact, its macroeconomic outlook has the potential to improve significantly if commodity prices were to stick at current levels. Since the end of June, Brent oil prices have fallen by 32% in USD and by 28% in Turkish Lira terms. Turkey's core inflation and current account dynamics are thus likely to improve and not less importantly an emerging market's capacity to finance a given external gap improves dramatically on the back of improving imbalances. Hence, a rise in US ten-year yields would have much less adverse impact on Turkish markets than it had in 2013 or early 2014.

A sharp decline in world commodity prices comes as a wholly positive external shock for Turkey, the only type of shock which can alleviate the current account and inflation problems without a concomitant growth sacrifice. It just so happens that, leading up to this point, Turkey's imbalances were showing signs of improvement already: the current account deficit (CAD) in particular had been narrowing noticeably (by 37% over the first nine months of 2014). Now, given the oil price drop, international banks have narrowed their 2015 CAD forecast to circa 5% of GDP. As energy constitutes 23% of Turkey's imports, one might expect these favorable oil price movements to support a more aggressive narrowing of the external imbalance. However, as exports growth is likely to decelerate in 2015 while imports growth is likely to strengthen on the back of accommodative monetary conditions, the improvement in the current account deficit ratio would remain constrained.

Core inflation outlook is likely to improve as well. Although the level of inflation is still high at circa 9%, the market is more relaxed because the outlook is dramatically altered by the present commodity price levels with core inflation forecasted at 6.5% by end-2015, and the threat of a lira depreciation relatively alleviated. There are actually five drivers behind the forthcoming decline in inflation, namely an expected mean-reversion in food price inflation, a dwindling impact of earlier FX-pass through, a cut in oil price assumptions following consistently tamed global commodity prices and lingering soft demand conditions and ongoing tight fiscal stance. Not less importantly, there now appears to be a better understanding between the Central Bank and the government regarding bringing down inflation.

In brief, Turkey's macroeconomic problems have not disappeared but given the improving imbalances, less pressure in terms of CAD financing and the lira are foreseen in the coming quarters, which may present the Central Bank of Turkey with the opportunity to lower rates. Indeed, with these more favorable numbers for inflation and current account deficit, there might be some modest scope to lower interest rates early next year. Yet, as the Central Bank of Turkey still commits to a flat yield curve in the foreseeable future, this will hinge on the impact of global liquidity conditions and the level of taming in inflation expectations on the long end of the curve.

Having said that, the Central Bank of Turkey does not have much room to stimulate growth by further loosening monetary policy and the Turkish authorities are likely to implement an expansionary fiscal policy in the near future to stimulate growth. The authorities are mindful of the concerns of investors and rating agencies over fiscal expansion, just when the spotlight is on the inflation rate and current account deficit. Therefore, the bulk of fiscal expansion will most probably be in the form of public-private partnerships (PPP), supported by Treasury guarantees, for the construction of large infrastructure projects.

Finally, the near term macroeconomic policy mix has to play a bigger role in rebalancing the economy and addressing imbalances, as recommended by the IMF. Turkey's growth continues to be constrained by its significant dependence on consumption, slow export growth and important investment needs against the background of a large external deficit. Within this environment, the challenge of rebalancing the economy has to be realized through the implementation of a stronger macroeconomic policy mix on the back of a firm implementation of structural reforms aimed at enhancing Turkey's economic potential at large.

DISCLAIMER

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