TURKEY ECONOMIC REPORT

FAVOURABLE MACROECONOMIC CONDITIONS IN SPITE OF EMERGING DOMESTIC AND EXTERNAL PRESSURES

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- Turkey's real economic growth improves but remains moderate

  Despite the emergence of domestic political tensions, Turkey's economic growth has actually improved this year relative to last year, rotating back to domestic demand, with the IMF forecasting real GDP growth at 3.8% for 2013, following an estimate of 2.2% for 2012. Leading macro indicators actually point to a moderate but more balanced growth in the second half of 2013. This year's slight relative recovery is mainly a household consumption-led recovery on the back of weak capital formation. While inventory re-stocking made a large contribution to growth, private sector fixed capital investment remained weak, offset only by a large contribution from public investment.

- External sector marked by a widened current account deficit

  Turkey has seen an exacerbation of external sector imbalances so far this year. Improving economic activity favouring an increase in imports and relatively constrained demand from major trading partners leading to standstill in exports, exacerbated the trade deficit and led to a widening of the current account deficit, which is expected to close the year at 7.4% of GDP (6.1% of GDP in 2012), as per the latest IMF figures. The overall Turkish balance of payments closed the first nine-month period with a surplus of US$ 10.2 billion, though 44% lower than that of the similar 2012 period.

- Depreciation in Turkish Lira and shift to a tight monetary policy

  Turkey's monetary conditions were marked in 2013 by a shift from an easing monetary policy to a tight policy after the US Federal Reserve signalled in May 2013 it may taper its bond purchasing program, while the Turkish Lira depreciated by a double-digit rate so far this year, which contributed to keeping the annual inflation rate above the Central Bank's target. Inflation is expected to average 6.6% in 2013 (8.9% in 2012), according to the IMF estimates, still above the CBRT's target of 5% due to the exchange rate volatility. The CBRT's gross foreign exchange reserves fluctuated this year, moving up from US$ 100.3 billion at end-2012 to reach US$ 113.9 billion mid-November 2013.

- Sound banking activity growth amidst good financial standing

  The Turkish banking sector posted a healthy performance so far in 2013, with assets progressing by 20.6% in local currency terms (+6.5% in US Dollar terms) over the first nine months. Lending activity registered a 26.1% increase in local currency terms (+11.4% in US Dollar terms), with non-performing loans standing at a mere 2.7% of total cash loans. The favorable quantity effect ensured by lending volume increases, adding to the favorable effect of improving macroeconomic performances on non-interest income, offset slightly higher operating and provisioning expenses, and led to a 12.0% rise in banks' bottom lines over the first nine months of 2013. The return on average assets and return on average equity ratios reached comparatively satisfactory levels of 1.8% and 15.1% respectively.

- Price contraction across equity and fixed income markets

  The Turkish capital markets saw price drops during the first ten months of 2013 amidst concerns the U.S. Federal Reserve may scale back its monthly asset purchases and worries about domestic political and social unrest. The Istanbul Stock Exchange (ISE) reported a price contraction of 10.5% during the first 10 months of 2013 to trade at a P/E of 11.76x at end-October 2013, while the market dividend yield increased from 1.73% at end-2012 to 2.02% at end-October 2013. Turkey's five-year CDS spreads expanded considerably in 2013, moving up from 131 basis points at end-2012 to reach currently 213 basis points, along with increases in bond yields across the board.

- Challenges and opportunities for Turkey's economy looking ahead

  Turkey's output growth looks set to slow in the near term with higher rates and depreciated Lira. A stock build up led growth is not actually sustainable looking ahead. In the medium term, Turkey's demographic structure, strategic geographical location and dynamic economy present many opportunities. However, it will be difficult for Turkey to sustain an average growth of 5% per year while continuing to accumulate large external liabilities year after year. The present low level of domestic savings implies that investment is determined by the availability of highly volatile external flows. IMF believes that without structural reforms, growth would have to be below the historical trend to avoid increases in external imbalances and accompanying bout of instability.

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Despite the emergence of domestic political tensions, Turkey's economic growth actually improved this year relative to last year, rotating back to domestic demand, with the IMF forecasting real GDP growth at 3.8% for 2013, following an estimate of 2.2% for 2012. Leading macro indicators actually point to a moderate but more balanced growth in the second half of 2013. This year's slight relative recovery is mainly a household consumption-led recovery on the back of weak capital formation. While inventory re-stocking made a large contribution to growth, private sector fixed capital investment remained weak, offset only by a large contribution from public investment. The relatively improving economic growth is realized despite the fact that expectations of tighter liquidity conditions and higher interest rates in the US have adversely affected capital flows to emerging markets in general and to Turkey in particular.

At the external level, the Turkish economy witnessed a slight increase in its main vulnerability, namely the current account deficit that is set to rise from 6.1% of GDP in 2012 to 7.4% of GDP in 2013 according to recently released IMF forecasts. The first nine months of 2013 actually reported a relative deceleration in the balance of payments surplus that reached US$ 10.2 billion, against a surplus of US$ 18.1 billion over last year's corresponding period. Exports have stagnated in the first nine months of 2013 (+0.6% year-on-year), following higher growth rates seen in previous years, while imports grew by 6.1% over the period. Foreign direct investment in Turkey was considerably hit this year, dropping by 15.4% in the first nine months of 2013 relative to last year's corresponding period. In parallel, the number of foreign tourists rose by a considerable 10.2% in the first ten months of 2013 relative to last year's corresponding period, despite domestic political tensions.

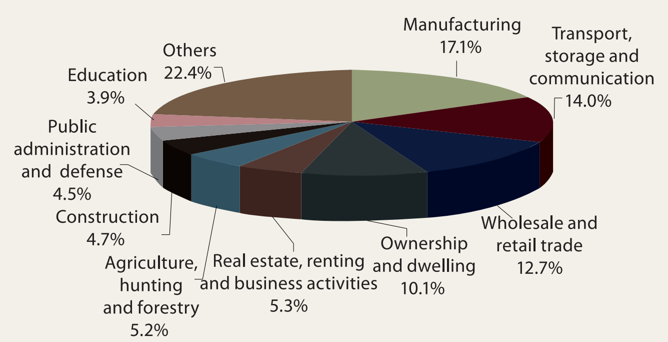
At the fiscal level, the government's commitment to meeting the fiscal targets seems to remain in place. Budget performance has been strong thus far this year, and continued primary surpluses leave the public debt dynamics as the main anchor in Turkey's macro environment. According to IMF forecasts issued in October for full-year 2013, the government deficit is set at a moderate 2.3% of GDP this year, maintaining the gross government debt to GDP ratio at a sound level of 36% by year-end 2013.

At the monetary level, tighter liquidity policy coupled with macroprudential measures lead to a tightening in monetary and financial conditions. Since last June, the Central Bank has raised its overnight rate in two steps to 7.75%. But policy actions by the Turkish Central Bank have been somehow insufficient to stem capital outflows. The Lira and bond prices have fallen sharply (11% currency depreciation and 156 basis points of 5-year CDS spread expansion over the first nine months). In parallel, inflation seems to have somehow moderated in 2013. According to new IMF forecasts issued in October, the average inflation rate is set to report a considerable net decline from 8.9% in 2012 to 6.6% in 2013, yet still above the official target of 5%.

GROSS DOMESTIC PRODUCT PERFORMANCE

Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (1H 2013)

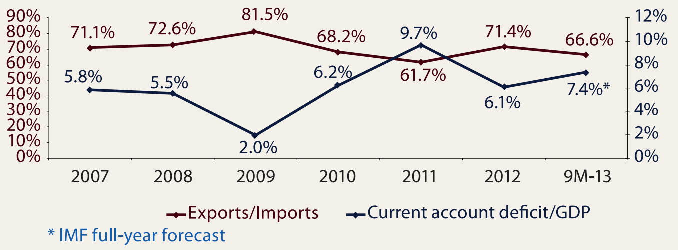


Sources: Central Bank of Turkey, Bank Audi's Group Research Department

At the banking sector level, banks operating in Turkey have managed to navigate the recent domestic and global market turmoil with minimal impact on their balance sheets. When expressed in US$ terms, assets grew by 6.5% in the first 9 months of 2013 (20.6% in Turkish Lira terms), and loans grew by 11.4% in US$ terms over the period (26.1% in Turkish Lira terms). This year saw an increase in the share of foreign currency deposits out of total deposits from 32.6% in December 2012 to 35.5% in September 2013, amidst the net depreciation of the Turkish Lira and the related conversion pressures. Having said that, profit growth has actually slowed down this year (12% over the first nine months of 2013) due to a gradual margin squeeze and higher net loan loss provisions.

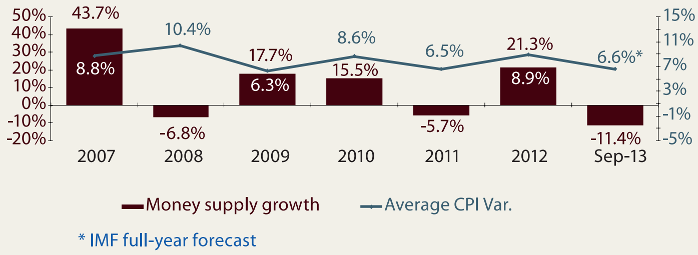
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economy on the back of political and macroeconomic drivers looking ahead.

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

Partial recovery at the level of the primary sector

The year 2013 has witnessed a mild rebound for the primary sector in Turkey. The agriculture, hunting, forestry, and fishing sector, which accounts for around 5% of Turkey's GDP, grew by 5.1% in the first half of the year, following a rise of 4.3% in the same period of 2012. Indeed, 2013 was kind of a compensation year, as the sector recovered from the adverse weather conditions, the slow local demand, and the sluggish international trade that shaped the previous season.

The country's exports of agricultural products reported a growth of 8.1% in the first ten months of 2013, reaching US$ 4.48 billion, after being almost stagnant in the same period of 2012 (growth of 0.1%). This is probably attributed to relatively recovered demand at the international level. Furthermore, growth in imports of agricultural products in the above mentioned period of 2013 is back in the positive territories. Indeed, agricultural imports grew by 2.0% to reach US$ 6.37 billion as of October 2013, following a decline of 18.4% registered in the first ten months of 2012.

As to crop production, the overall output remained almost constant on a yearly basis, according to the latest estimations by Turkstat. In fact, overall output grew by a mild 0.1% from the 2011/2012 season level to reach 106.5 billion tons. This follows another decline of 3.5% registered in the previous season. As to the cereals, which constitute the bulk of crop production, at around 56% of the total, they remained on their sliding trail for the second consecutive year. In fact, cereal production posted a decline of 4% this season, following another drop of 5.2% last year. On the other hand, production of fruits, nuts, and spices seemed to recover, rising by 12% year-on-year, whereas that of vegetables increased by a mild 1% yearly.

The year 2013 has brought in positive developments to the agricultural sector in Turkey. For instance, the European Union, Turkey's greatest trade partner, has approved the sale of Turkish milk to its countries as of April 2013. As a matter of fact, the export level of dairy products has reported an increase of 18.5% in the first ten months of 2013, following another rise of 11.4% in the equivalent period of 2012. In addition, after Saudi Arabia has removed the ban on imports of Turkish poultry in early 2012, the Kingdom has agreed, in early 2013, on importing livestock from Turkey. Consequently, Turkey's animal breeding sector, which the country considers as "strategic", is now able to additionally benefit from accession to a significant demand emanating from the large Saudi Arabian market.

CROP PRODUCTION IN 2012 (CEREALS, VEGETABLES AND FRUITS)

million tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**33,377**	**56%**	**Vegetables**	**23,005**	**83%**	**Fruits**	**10,654**	**55%**
o.w. Wheat	20,100	34%	o.w. Tomatoes	11,350	41%	o.w. Citrus fruits	3,475	18%
o.w. Barley	7,100	12%	o.w. Watermelon	4,022	14%	o.w. Pome fruits	3,485	18%
o.w. Maize	4,600	8%	o.w. Cucumber	1,742	6%	o.w. Stone fruits	2,381	12%
Sugar beets	**15,000**	**25%**	o.w. Melon	1,689	6%	o.w. Other fruits	1,313	7%
Potatoes, dried legumineus	**4,822**	**8%**	o.w. Pepper (green)	911	3%	**Grapes**	**4,185**	**22%**
Oil seeds	**3,138**	**5%**	**Bulb and root vegetables**	**3,108**	**11%**	**Olive production**	**1,820**	**9%**
Dry pulses	**1,191**	**2%**	o.w. Dry onion	1,736	6%	**Tea production**	**1,250**	**6%**
Raw vegetable materials	**858**	**1%**	o.w. Carrots	714	3%	**Nuts**	**1,151**	**6%**
Plants for perfumery, pharmacy	**112**	**0%**	**Other vegetables**	**1,707**	**6%**	**Spices crops**	**207**	**1%**
Tobacco	**80**	**0%**	o.w. Leafy or edible stem vegetables	1,474	5%			
Total Cereals and other crops*	**59,450**	**100%**	**Total Vegetables and other crops**	**27,820**	**100%**	**Total Fruits, nuts and spices crops**	**19,268**	**100%**

* Excluding fodder crops

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

1.1.2. Industrial Sector

Mixed performances for the secondary sector

Turkey's industrial sector which accounts for around 21.8% of GDP was subjected to downward pressures from the country's tighter fiscal policies but benefitting from a stronger external demand. The industrial sector seems to be benefiting from a strengthening of export markets, coupled with a more competitive exchange rate, according to the Economist Intelligence Unit. During the first half of 2013, the sector's output posted a real growth of 2.9% year-on-year which is equal to the growth rate posted in the same period of 2012. The average Industrial Production Index, published by Turkstat, marginally increased by 3.1% year-on-year in the first nine months of 2013 after having risen by 3.0% in the same period of 2012. The average industrial employment index moved up by 3.6% annually during the aforementioned period of 2013, compared to a relatively higher growth rate of 5.1% in the same period of 2012.

With regards to the manufacturing component, accounting for almost 75% of the industrial sector's output, it recorded a real growth of 2.5% year-on-year during the first half of 2013 against a rate of 3.1% in the same period of 2012. The average manufacturing employment index went up by 3.9% year-on-year in the first nine months of 2013, subsequent to having risen by 5.3% in the corresponding period of 2012. Also, the Capacity Utilization Rate of the manufacturing industry recorded an average of 75.8% in the first ten months of 2013 compared to a rate of 74.3% in the same period of 2012. A favourable baseline has contributed to this amelioration, as well as improvements in the Euro Zone that have fed through to rising export activity. Turkey remains vulnerable to any increase in external financial volatility, but seems to have weathered the turmoil of recent months. The Central Bank's seasonally adjusted manufacturing confidence index also rose to 111.9 in October 2013 from its six-month high of 108.6 in September 2013 (An index above 100 indicates rising optimism and below 100 indicates growing pessimism). The seasonally adjusted HSBC Turkey Manufacturing PMI, a composite indicator designed to provide a single-figure snapshot of the performance of the manufacturing industry, posted 55.0 in November 2013, up by 6.6% from 51.6 in November 2012, the highest growth in two and a half years.

As to electricity, gas and water supply, making up around 5.5% of the industrial sector's GDP, its value was unchanged year-on-year in the first half of 2013 following an increase of 7.2% in the same period of 2012. The average industrial production index of the aforementioned component marginally decreased. As a matter of fact, the average during the first nine months of 2013 was down by 2% year-on-year, a growth rate lower than the 8.4% increase registered in the corresponding period of 2012. As for the mining and quarrying component which accounts for around 1.8% of the industrial sector GDP, its value declined by 3.9% year-on-year in the first half of 2013, down from the 1.4% growth rate it had posted in the corresponding period of 2012.

Last but not least, during the first eleven months of 2013, the average Producer Price Index, a gauge of representative goods and services sold by manufacturers and producers in the wholesale market, was up by 5.6% compared to an increase of 6.4% in the same period of 2012, thus revealing a relative slowdown of the supply side of Turkey's industrial sector at large.

VEHICLES PRODUCTION

(unit)	2008	2009	2010	2011	2012	9M-12	9M-13	9M/9M
Automobile	621,567	510,931	603,394	639,734	576,660	428,194	463,102	8.2%
Pick-up	449,434	330,044	442,408	479,110	426,633	314,080	313,209	-0.3%
Tractor	24,807	14,861	30,425	45,506	42,255	34,695	30,326	-12.6%
Truck	36,800	8,246	23,851	37,396	29,129	23,634	22,237	-5.9%
Minibus	21,123	11,829	16,978	22,475	29,332	20,150	28,342	40.7%
Bus	7,562	5,931	5,268	6,907	6,427	4,941	6,718	36.0%
Midibus	10,624	2,624	2,658	3,509	4,158	2,974	3,807	28.0%

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

1.1.3. Trade and Services Sector

Improved performance driven by consumption, tourism and financial services

Trade and services, which accounts for around 60% of the country's GDP, has reported a relative improvement to date in 2013. Indeed, the latest numbers show that the sector registered an annual real growth of 4.6% in the first half of 2013, up from a level of 3.2% in the same period of 2012 on account of higher activity reported in most of its main components. Indeed, wholesale and retail trade, as well as financial intermediation, which together make up 43% of trade and services, and consequently 26% of Turkey's GDP, both reported higher levels of growth this year, and hence, boosted activity in the tertiary sector.

The wholesale and retail sub-sector, which makes up almost 23% of the country's trade and services sector, reported a real growth level of 4.0% year-on-year in the first half of 2013 up from an insignificant growth of 0.4% reported in the same period of 2012. This is probably due to two main factors. First, private consumption was up by 5.2% year-on-year in the first half of 2013 reflecting better local conditions on the internal level. Second, higher growth was registered in the number of tourists visiting Turkey. In fact, Turkey received 14.3% more tourists in the first six months of 2013 compared to the equivalent period of 2012 (10.2% in the first ten months).

As to financial intermediation, which contributes to 20% of the size of the trade and services sector in the country, it reported a year-on-year growth of 7.5% in the first half of 2013. This follows a lower growth of 4.0% registered in the same period of 2012. In fact, Turkey has attracted many financial players into its market in the last few years, where according to Ernst & Young, the top sectors that attracted the highest number of projects in 2012 were business and financial services, and the leading sectors in terms of value of projects, were manufacturing and financial intermediation as per the Turkish Government. The above mentioned investments have been definitely reflected in the growth levels registered by the sector in 2013.

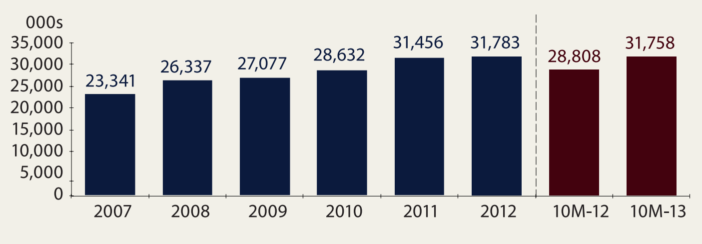
Regarding the sub-sector of transportation, storage, and communication, which makes up more than a quarter of the trade and services sector (15% of GDP), it has reported a real growth of 2.8% year-on-year in the first half of 2013. This follows a higher growth of 4.5% reported in the same period of 2012, making the above mentioned sector the only main sub-sector in the trade and services category to report a lower growth in the first half of 2013 when compared to a year earlier.

1.2. EXTERNAL SECTOR

Widening current account deficit remains a main vulnerability

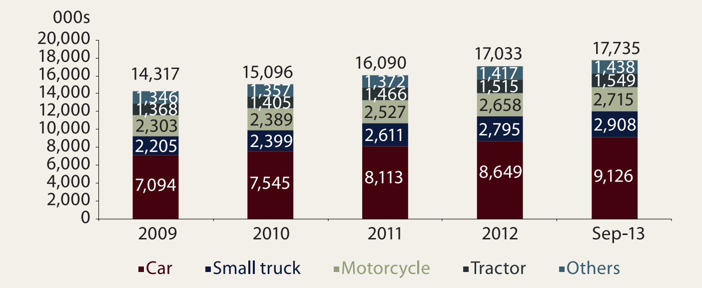
Turkey has seen an exacerbation of external sector imbalances so far this year. Improving economic activity favouring an increase in imports and relatively constrained demand from major trading partners, coupled with non-recurring 2012 exports driving a standstill in exports, exacerbated the trade deficit and

NUMBER OF FOREIGNER ARRIVALS



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

NUMBER OF ROAD VEHICLES



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

led to a widening of the current account deficit, which is expected to close the year at 7.4% of GDP (6.1% of GDP in 2012), as per the latest IMF figures.

In details, Turkish exports reached US$ 120.9 billion in the first nine months of 2013, as per the latest Central Bank figures, posting a mere 0.6% increase on a yearly basis. Economic woes and relatively constrained activity in Turkey's major trade partners have actually been exerting some pressure on domestic exports relative to previous years, as reflected by a dwindled share of Turkish exports to the European Union since the global financial crisis outburst (from close to 60% before the global crisis to around 40% currently), though a relative recovery in activity has had some positive spillovers on foreign trade prospects with Turkey. Indeed, Turkish exports to the EU have somewhat recovered over the period, posting a 7% rise from a weaker base in the first nine months of 2012.

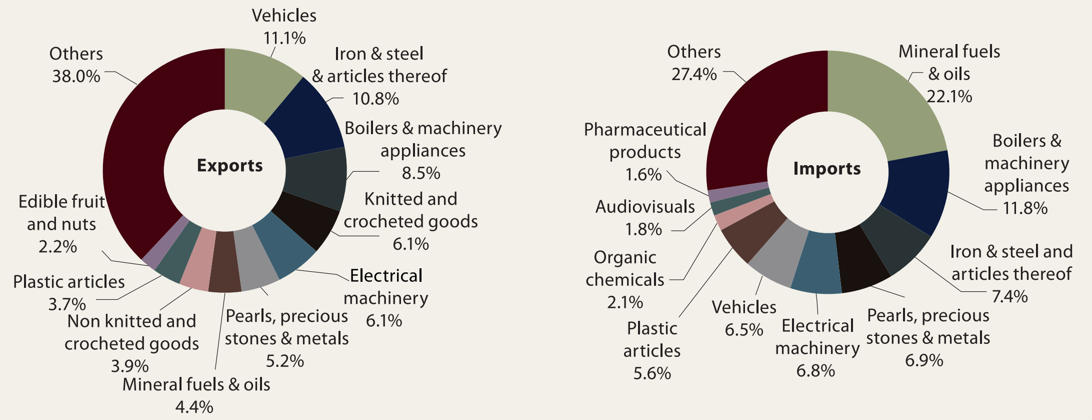
This has to be read in conjunction with the non-recurring effect of last year's surge in commodity exports to Iran. As a matter of fact, the year 2012 saw Turkey boosting its gold exports to Iran as payment for energy purchases. This year however, the sluggish overall export performance has been attributed to a marked decrease in extraordinary gold exports, with the depreciation of the local currency during this year seemingly of a slight benefit to exports thus far. Turkish exports to the Near and Middle Eastern region declined by 19.7% from a high base in the year ago period. A breakdown of exports by type shows that the overall performance was attributed to sluggishness in the main component, i.e. manufacturing exports (-1% year-on-year) more than offsetting higher exports of agriculture and forestry products. Amidst stagnating exports on the overall, Turkish authorities have prepared a list of high-priority target countries for Turkish exports, and unveiled plans to cut export-loan provisioning for banks to 0% from 1%.

In parallel, Turkish imports reported a 6.1% year-on-year increase to US$ 181.5 billion in the first nine months of this year, led by an 11% increase in manufacturing imports reflecting a relative pick-up in economic activity in the country and an ensuing higher demand for foreign goods from Turkish consumers and industries. Turkey became a net importer of bullion after ending exports to Iran in July, and gold imports increased partly due to the Central Bank's own purchase of gold to strengthen its reserves level and to meet domestic demand. Also, Turkey's dependence on energy remains the main source of vulnerability on the import side, with mineral fuels and oils accounting for almost a quarter of total imports in the first nine months of 2013.

A more detailed look at Turkish imports reveals that purchases from the European Union, which is still Turkey's major trading partner, increased by 6% relative to the year ago period. Imports from the other Asian countries and other European countries categories, respectively second and third most important in value, rose by 9% and 10% over the first nine months of 2013.

With imports reporting a moderate increase so far this year and exports stagnating on the overall, Turkey's trade deficit resumed its widening trend, reaching US$ 60.6 billion. This represents a 19.2% widening from US$ 50.8 billion in the first nine months of 2012, year during which the deficit tightened, boosted by gold

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-13)



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

exports. The deterioration of Turkey's foreign trade balance was largely responsible for the widening of its overall current account deficit. The latter reached US$ 49.0 billion over this year's first nine months, posting a 27.7% increase relative to the same period of 2012. The deficit of the current account balance is projected by the IMF to close the year at 7.4% of GDP, rising from 6.1% of GDP last year.

The deeper gap at the level of the current account has been once again more than offset by a surplus in the financial account. The latter reached US$ 54.2 billion, increasing by 4.4% year-on-year, driven by capital flows into Turkey and more specifically in the form of foreign direct investments, portfolio investments (especially debt rather than equity investments), and other investments notably to the benefit of banks. As a result, the overall Turkish balance of payments closed the first nine-month period with a surplus of US$ 10.2 billion, though 44% lower than that of the similar 2012 period, given that the current account deficit widened more than the financial account surplus increased. This actually raises the issue of the vulnerability of Turkish external accounts to swings in investor sentiment, especially that expectation of forthcoming US Fed tapering are likely to curb capital inflows to the country.

1.3. PUBLIC SECTOR

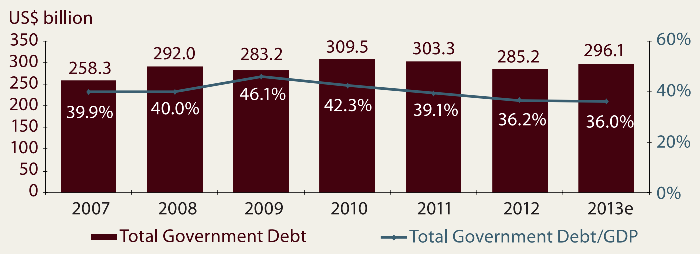
Healthy budget performance with sound debt metrics

Turkey's fiscal performance was satisfactory in 2013, with the budget deficit as a percentage of GDP revised down by officials towards the end of the year and the debt-to-GDP ratio continuing to follow a downward trajectory since 2009.

Central government revenues grew by 18.1% during the first ten months of 2013 to reach a total of TL 320 billion, mainly supported by an 18.4% increase in general budget revenues to TL 310 billion, a 9.3% rise in revenues from special budget institutions to TL 8 billion, and a 10.1% growth in revenues from regularity and supervisory institutions to TL 2 billion. General government revenues showed that tax revenues increased by 17.7% during the first 10 months of 2013 to reach TL 266 billion, grants and aids and special revenues widened by 4.9% to TL 1.5 billion, and capital revenues jumped to TL 10 billion during the first ten months of 2013 from TL 2 billion during the corresponding period of 2012.

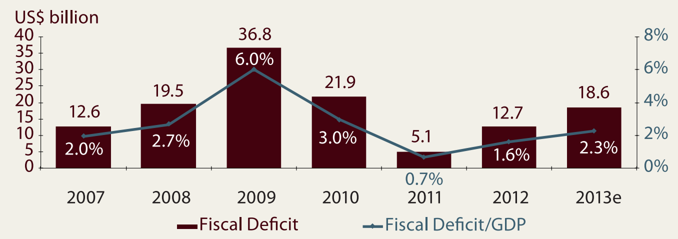
Expenditures went up by 13.1% during the first ten months of 2013 to reach TL 328 billion, due to a 14.2% expansion in non-interest expenditures to TL 281 billion and a 6.9% increase in interest expenditures to TL 46 billion. Non-interest expenditures showed for instance a 33.1% surge in capital expenditures during the first ten months of 2013 to TL 27 billion, an 11.3% rise in compensation of employees to TL 82 billion, a 10.6% increase in social security contributions to TL 13 billion, a 5.8% in good and services purchases to TL 24 billion, and a staggering 65.7% surge in capital transfers to TL 4.9 billion. Interest expenditures showed that interest of discount and short term cash operation hit TL 3.3 billion during the first ten months of 2013, up from TL 0.4 billion during the corresponding period of 2012, while foreign debt interest declined by a tiny 0.6% to TL 6.77 billion, and domestic interest retreated slightly by 0.2% to TL 35.94 billion.

PUBLIC INDEBTEDNESS



Sources: IMF, Bank Audi's Group Research Department

FISCAL DEFICIT



Sources: IMF, Bank Audi's Group Research Department

It is worth mentioning that Turkey revised down its year-end budget deficit in October 2013 to around TL 19.4 billion or 1.2% of GDP, well below a previous forecast of 2.2%. The total state budget expenses are projected at TL 406.6 billion and revenues are anticipated at TL 387.2 billion. A 1.2% budget deficit/GDP would be the third best budget performance since 1985, according to the Turkish Ministry of Finance.

The resulting deficit between revenues and expenditures is not expected to exert upward pressures on the indebtedness ratio. Effectively, the ratio of general government gross debt-to-GDP is anticipated to retreat slightly to a historical low of 36.0% in 2013, according to the IMF, recording its fourth consecutive yearly improvement after it had risen to 46.1% in 2009.

In parallel, the 2014 budget forecasts a central administration deficit next year of 1.9% of GDP or TL 33.2 billion. This is significantly wider than the deficit of 1.2% of GDP that the government now projects for 2013, reflecting unexpectedly high one-off revenue this year. The government projects that total central government revenue will rise by 4.1% in nominal terms to TL 403.2 billion in 2014. An increase in tax receipts of 7.1% (to TL 348.4 billion) will be offset by a sharp fall of 11.6% (to TL 54.8 billion) in other revenues. On the expenditure side, total spending is set to increase by 7.3% to TL 436.3 billion in 2014. The government projects that its debt-servicing costs will rise by 3% to TL 52 billion, while non-interest expenditure will increase by 7.9% to TL 384.3 billion.

According to the IMF, fiscal policy should be tightened, looking forward, in order to increase the structural primary surplus in 2014. In the medium term, the main challenges for Turkey remain raising domestic savings and pressing ahead with structural reforms. Both would serve to increase the long-term growth potential of the economy, while maintaining a sustainable external position.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Depreciation in Turkish Lira, inflation still above official target

Turkey's monetary conditions were marked in 2013 by a shift from an easing monetary policy to a tight policy after the US Federal Reserve signalled in May 2013 it may taper its bond purchasing program, while the Turkish Lira depreciated by a double-digit rate so far this year, which contributed to keeping the annual inflation rate above the Central Bank's target despite its contraction relative to last year.

The Central Bank of the Republic of Turkey cut all its reference interest rates by a total of 100 basis points in April and May 2013, despite the fact that in January-March 2013 the annual rate of the consumer price inflation remained just over 7%, above the official target of 5% for the end of 2013. The interest rate cuts came within the context of slowing economic growth and aimed to boost domestic demand and moderate short-term foreign capital inflows, which risk pushing up the value of the Turkish Lira and somehow eroding export competitiveness. As such, the CBRT's main policy rate, the one-week repo rate, was reduced to 4.5%, the overnight lending and borrowing rates were cut to 6.50% and 3.50% respectively.

However, the May 22 announcement by the US Federal Reserve signalling the possibility of starting to taper its asset repurchase program, exerted some downward pressures on the Turkish Lira and an upward pressure on interest rates, prior to the Federal Reserve's decision on September 18 not to trim its bond purchases, awaiting more evidence that progress would be sustained. In details, the Turkish Lira depreciated by 12.2% from year-end 2012 till September 17, 2013, moving from TL/US$ 1.78 to TL/US$ 2.00, yet remained relatively stable thereafter, closing currently at TL/US$ 2.02. In parallel, the corridor was widened in July-August 2013, when the overnight lending rate was raised by a total of 125 basis points to 7.75%, while the overnight borrowing rate was left at 3.50% and the one-week repo was kept at 4.50%. These measures contributed to enhancing the effectiveness of the additional monetary tightening.

In addition, the effective liquidity management helped short-term rates to be realized close to the upper band of the corridor. Hence, it all added up to a front-loaded monetary tightening that is stronger than the increase in inflation expectations. As of August, the CBRT decided to increase the predictability of the Turkish Lira liquidity policy in order to limit the impacts of global monetary policy uncertainties on the domestic economy. To this end, the Bank decided to pursue a strategy of reducing interest rate uncertainty by creating a framework where the relationship between global interest rates and domestic interest rates has largely weakened and market rates have become more sensitive to domestic macroeconomic developments as they should be.

Also, in order to contain the impact of the exchange rate volatility on the pricing behaviour, strengthen the CBRT's cautious monetary stance and reduce the volatility of short-term money market rates, the Bank decided in November 2013 to stop monthly repurchase auctions. This would force banks' demand for liquidity into the CBRT's one-week repo auctions and into the CBRT's more expensive overnight funding, which takes place at the 7.75% lending rate (the upper end of the interest rate corridor). The Central Bank's move to terminate 1-month repurchase agreement auctions brought the cumulative tightening in money market rates to around 350 basis points since May 2013, which is described by CBRT as "very serious tightening".

As far as prices are concerned, the annual Consumer Price Index rose from 6.16% at end-2012 to 8.88% in July 2013, mainly due to a weakening Turkish Lira, yet fell to 7.71% in October 2013 within the context of a cautious monetary policy, noting that the CBRT's latest measure to tighten access to credit could help curbing inflation further. All in all, inflation is expected to average 6.6% in 2013 (8.9% in 2012), according to the IMF estimates, still above the CBRT's target of 5% due to the exchange rate volatility.

The CBRT's gross foreign exchange reserves fluctuated this year, moving up from US$ 100.3 billion at end-2012 to reach a record high level US$ 113.3 billion early-May 2013 amid strong capital inflows, yet the sharp slowdown in net capital inflows since May 22 and the depreciation of the Turkish Lira have led to some loss of international reserves, with the latter falling to US$ 105.8 billion mid-September 2013. This could suggest that policy actions by the CBRT were somehow insufficient to stem capital outflows during the May-September period. However, the FX reserves started to trace an upward trajectory thereafter, due to a recovery in capital inflows following the US Federal Reserve's decision not to trim its securities buying program, to reach US$ 113.9 billion mid-November 2013.

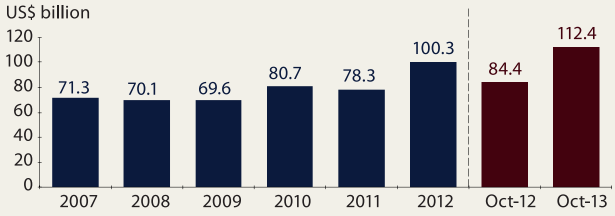
Looking forward, the monetary stance needs to be tightened further to be consistent with the authorities' inflation target of 5%, according to the IMF. The Turkish monetary authorities may rely on the flexibility afforded by the interest rate corridor, which allows the Central Bank to adjust in either direction on a daily basis the cost of funds to the banking system between the overnight lending and borrowing rates. Within this context, the CBRT indicated that it will maintain the cautious monetary policy stance and continue implementing additional monetary tightening at the appropriate frequency until the medium-term inflation outlook is in line with the medium-term targets.

MONETARY SITUATION

Flows in US$ million	2007	2008	2009	2010	2011	2012	9M-13
Net foreign assets	**14,003**	**5,924**	**-3,073**	**-25,493**	**-2,341**	**6,649**	**-4,472**
Foreign assets	19,270	6,669	-5,054	-93	7,123	28,861	-17,166
Foreign liabilities	-5,267	-745	1,980	-25,399	-9,464	-22,211	12,694
Domestic Assets	**106,673**	**-33,042**	**68,667**	**93,155**	**-26,520**	**94,369**	**-61,289**
Claims on private sector	73,522	-11,286	29,063	84,676	26,540	91,188	-46,465
Claims on public sector	29,289	-19,488	35,290	4,304	-49,055	-563	-12,721
Claims on non-bank financial institutions	3,861	-2,268	4,315	4,175	-4,005	3,744	-2,102
Total Money Supply	**120,676**	**-27,118**	**65,594**	**67,662**	**-28,861**	**101,018**	**-65,761**
Money Supply (M1)	11,970	-5,531	11,419	15,099	-6,572	10,383	-10,974
Quasi-Money	82,829	-9,380	33,539	43,183	-17,745	61,002	-43,669
Other Items (Net)	25,877	-12,207	20,635	9,380	-4,544	29,633	-11,117

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 activity growth in line with macroeconomic performances

The Turkish banking sector posted a healthy performance so far in 2013 in line with the overall improvement in macroeconomic performances relative to the previous year and despite temporary politico-security tensions earlier this year. Measured by the aggregated assets of all banks operating in Turkey, the sector's activity progressed by 20.6% in local currency terms (+6.5% in US Dollar terms within the context of the exchange rate depreciation) over the first nine months of 2013 to reach the equivalent of US$ 780.6 billion at end-September.

Total deposits, a traditionally main driver of activity accounting for close to 60% of total banks' balance sheets, reported a 16.9% increase in local currency terms (+3.3% in US Dollar terms), reaching the equivalent of US$ 444.6 billion at end-September 2013. The breakdown of deposits by type shows that time deposits, accounting for the bulk of sector deposits with 80% of the total, were responsible for three quarters of deposit growth over the first nine months of this year. A look at deposits from a currency angle shows that both local and foreign currency deposits almost equally contributed to the increase in deposits over the covered period, with a slight advantage to the latter. Within this context, the deposit dollarization ratio reached 35.5% at end-September 2013, inching up slightly from 32.6% at year-end 2012.

With additional funding at hand, Turkish banks have been financing the needs of the domestic economy through extending new loans, thus further deepening financial intermediation in the country. Relatively healthy financial inflows and relatively low lending interest rates, coupled with healthy domestic demand, allowed loan growth to gain some steam this year, including SME, retail and project finance loans. Lending activity at Turkish banks registered a 26.1% increase in local currency terms (+11.4% in US Dollar terms) since the beginning of the current year, with both Turkish liras and foreign currencies contributing to expanding lending volumes, noting that the bulk of the banks' loan portfolio continues to be labeled in the local currency with almost three quarters of the total. Consumer and credit card loans contributed to about 30% of total loan growth, underlining the healthy demand for retail loans in Turkey.

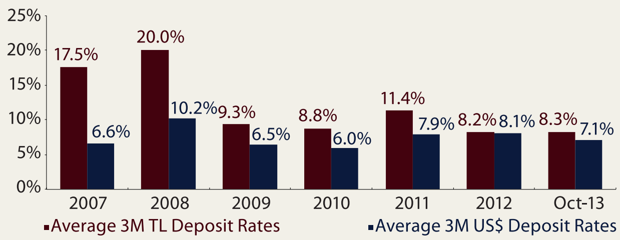
Within the context of bank loans growth continuing to exceed that of deposits, the banking authorities recently introduced measures to control rampant consumer loan growth, which exceeded so far this year the Central Bank of Turkey reference rate, and to raise domestic savings rate from lows attained, by making credit card loans more costly for lenders and tightening spending limits for consumers, which authorities deem is likely to curb loan growth in the remainder of this year. Authorities unveiled new limits on credit card debt and higher credit card related provisioning for lenders, which account for almost a quarter of retail loans and not far from half of non-performing retail loans.

BANKING SECTOR INDICATORS

in US$ million	2007	2008	2009	2010	2011	2012	Sep-13
Banking Activity							
Assets	460,213	444,998	513,059	611,275	606,184	732,820	780,579
Deposits	291,026	284,360	324,639	381,949	362,848	430,559	444,571
Credit facilities	206,817	197,788	224,285	312,929	338,027	426,933	475,703
Shareholders' equity	63,807	55,640	72,884	87,089	76,540	101,139	93,816
YTD Growth rates							
Assets	40.9%	-3.3%	15.3%	19.1%	-0.8%	20.9%	6.5%
Deposits	39.7%	-2.3%	14.2%	17.7%	-5.0%	18.7%	3.3%
Credit Facilities	54.3%	-4.4%	13.4%	39.5%	8.0%	26.3%	11.4%
Shareholders' equity	54.4%	-12.8%	31.0%	19.5%	-12.1%	32.1%	-7.2%

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

It is true that in order to finance loans, banks have been mainly resorting to customer deposits, but their use of alternative sources has been on the rise lately, including foreign liabilities. While the share of loans in total assets has been growing, the share of deposits in total balance sheets has decreased over the past few years to the benefit of non-deposit funding from foreign banks and securities issued. Banks have also resorted to shifting some of their liquid assets into less liquid loans, leading to a decline in the share of liquid assets in total assets which, coupled with a rising loan-to-deposit ratio of 107.0% at end-September 2013 (crossing the 100% mark this year), is putting some strains on banks' liquidity and funding profiles. It is worth noting that a source of vulnerability for Turkish banks is the structural gap between on-balance sheet foreign currency liabilities and foreign currency assets. As Moody's pointed out, banks hedge their currency risks through swaps which are partially short-term, but these bring rollover and counterparty risk.

At the level of profitability, the favorable quantity effect ensured by lending volume increases, adding to the favorable effect of improving macroeconomic performances on non-interest income, offset slightly higher operating and provisioning expenses on the overall, and led to a rise in banks' bottom lines over the first nine months of 2013. According to the latest figures published by the Central Bank, banks' net profits posted a 12% rise in local currency terms on a yearly basis over the covered period. Subsequently, the return on average assets and return on average equity ratios reached 1.8% and 15.1% in the first nine months of 2013, levels deemed as satisfactory relative to international benchmarks.

Banks in Turkey have managed to ensure a steady asset quality profile this year, partly underpinned by healthy lending activity. According to the latest Banking Regulation and Supervision Agency of Turkey data, non-performing loans accounted for 2.7% of total cash loans at end-September 2013, slightly improving from 2.9% at year-end 2012. The low stock of NPLs in both absolute and relative terms tends to be well provisioned, with provisions at 75.4% of NPLs at end-September 2013. The IMF recently said that risks are being taken in this period of rapid credit expansion, adding continued careful monitoring is needed. In particular, more attention to foreign currency credit to corporate clients is warranted, as FC-induced liquidity or solvency problems in the corporate sector can quickly lead to rising NPLs, as per the Fund. The Central Bank, in its latest financial stability report published earlier this year, said that even if there seems to be no serious concern over the quality of assets, earmarking provisions for NPLs higher than legal requirements would be a cautious stance to be adopted in times of favourable economic conjuncture and strong banking profitability.

Turkish banks' strong asset quality and high provisioning levels leave them with considerable profit and capital cushions against potential losses. The sector's capital adequacy ratio, despite having diminished relative to year-end 2012 partly due to lending growth and the local currency depreciation effect on risk-weighted assets, remains solid at 15.7% at end-September 2013 (17.9% at end-December 2012) and mainly comprises Tier 1 capital. The capital adequacy ratio remains well above the legal minimum of 8% and the target ratio of 12%. Solid profitability adds up to bank buffers, ensuring capital is increased through retained earnings and in line with the BRSA's policy of imposing certain restrictions on the distribution of profits within the sector.

As such, Turkish banks have steered through the temporary domestic tensions and difficult global environment quite well, posting healthy balance sheet and bottom line growth. While a rising domestic interest rate period is looming and could, along with local currency volatility, dampen banking sector activity and affect asset quality, Turkish banks are adequately positioned to withstand tough operating conditions. They boast a relatively good funding profile, satisfactory profitability feeding into banks' own funds through retained earnings and contributing to healthy capitalization, and consistently favourable asset quality metrics at large.

1.4.3. Equity and Bond Markets

Price drops across capital markets, expansion in five-year CDS spreads

The Turkish capital markets saw price drops during the first ten months of 2013 amidst concerns the US Federal Reserve may scale back its monthly asset purchases and worries about domestic political and social unrest.

In details, the Istanbul Stock Exchange (ISE) saw price declines during the first 10 months of 2013 after registering a rebound in 2012. The ISE 100, representing the 100 largest companies by market capitalization, fell by 10.5% during the first 10 months of 2013 to close at 2,292 at end-October 2013, bucking increases in emerging and global markets (+0.3% and +17.7% respectively, according to S&P indices). Turkish stocks saw price drops on US Federal Reserve taper concerns, weakening Turkish Lira, and worries about political uncertainties on the backdrop of anti-government demonstrations. Given price declines, the ISE traded at a P/E of 11.76x at end-October 2013, down from a P/E of 12.51x at end-2012, while the market dividend yield increased from 1.73% at end-2012 to 2.02% at end-October 2013.

On the backdrop of price falls, the market capitalization dropped from US$ 309.6 billion at end-2012 to US$ 285.5 billion at end-October 2013, down by 7.8%. Within this context, the total number of contracts reached 56.6 million during the first ten months of 2013, up from 47.4 million during the corresponding period of 2012. The total trading value increased from US$ 273.2 billion during the first ten months of 2012 to US$ 362.4 billion during the corresponding period of 2013, moving up by 32.7%. The turnover ratio, measured by the annualized total trading value to market capitalization, reached 152.3% during the first ten months of 2013 versus 115.2% during the corresponding period of 2012, spotting light on the firmly rising activity on the ISE.

At the level of the bond market, concerns that the US Federal Reserve may taper its bond-buying program, added to temporary domestic political and social unrest, notwithstanding some escalation in regional tensions, put some upward pressures on international Turkish bond yields. For instance, the 10-year US$ 1.5 billion bond issued on January 11, 2013 recorded a rise in its yield from 3.48% early-January to a record high level of 5.87% early-September, yet the bond started to see some decline in its yield after the US Federal Reserve decided not to trim its stimulus program on September 18, 2013, with the latter currently hovering around 5.00%. Also, the 30-year US$ 2.75 billion bond maturing in 2036 registered an increase in its yield from 4.43% at end-2012 to 6.99% early-September 2013, noting that its yield is currently quoted at around 6.40%.

In parallel, the local currency-denominated bonds have been hit by a sell-off in emerging markets that began when the US Federal Reserve said on May 22 that it may taper its bond buying stimulus program, noting that a weakening Turkish Lira that has spurred tightening bets and a rise in CBRT's reference interest rates in July-August 2013, also triggered a rise in Turkey's benchmark bond yields. In fact, the two-year Turkish benchmark bond index yield rose from 6.18% at end-2012 to its 2013 high of 10.16% late August, and currently hovers around 9.00%.

As to the cost of insuring debt, Turkey's five-year CDS spreads expanded considerably in 2013, moving up from 131 basis points at end-2012 to reach a record high level of 243 basis points on June 24, 2013 amid US Federal Reserve tapering concerns and domestic civil unrest, yet spreads started to contract on eased local political tensions and after the US Federal Reserve decided not to scale back its stimulus program, to reach currently 213 basis points.

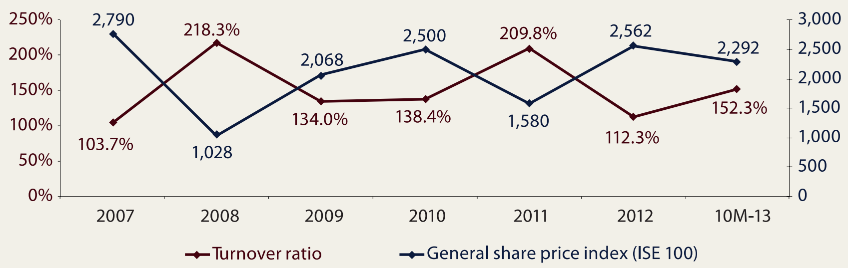
With respect to credit ratings changes, Moody's upgraded in May 2013 Turkey's government bond ratings by one notch to "Baa3" from "Ba1", the lowest investment grade ranking, with a "stable" outlook, citing the improvement in the country's economic and fiscal metrics, and the progress that the government has made on structural and institutional reforms that Moody's expects will reduce existing vulnerabilities to shocks to international capital flows over time. In parallel, Fitch affirmed in October 2013 Turkey's long-term foreign and local currency Issuer Default Ratings at "BBB-" and "BBB" respectively with "stable" outlook. Fitch believes that Turkey's sovereign creditworthiness remains resilient to recent shocks, notwithstanding its heavy reliance on net capital inflows on the basis of low domestic savings. While this key rating weakness leaves Turkey vulnerable to swings in global investor sentiment, it is mitigated by Turkey's underlying credit fundamentals: a strengthening sovereign debt profile, a robust banking system, a relatively deep domestic capital market and a dynamic private sector. These shock absorbers, according to Fitch, enhance Turkey's ability to deflect bouts of financial uncertainty and global investor unease without impairing sovereign creditworthiness at large.

SELECTED STOCK MARKET INDICATORS

	2007	2008	2009	2010	2011	2012	10M-13
Market capitalization (in US$ billion)	290.0	119.7	236.0	307.6	201.9	309.6	285.5
Market capitalization/GDP	44.8%	16.4%	38.4%	42.1%	26.1%	39.3%	35.0%
Trading value (in US$ billion)	300.8	261.3	316.3	425.7	423.6	347.9	362.4
Number of contracts (000s)	47,352	45,166	77,658	111,034	74,808	58,367	56,602
Change in share price index	72.1%	-63.2%	101.2%	20.9%	-36.8%	62.1%	-10.5%
Price/Earnings ratio	11.97	5.76	16.83	13.29	11.88	12.51	11.76
Dividend Yield (%)	1.90	4.93	2.37	1.79	2.57	1.73	2.02

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

STOCK MARKET PERFORMANCE



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

2. CONCLUDING REMARKS

Looking ahead, what would be the outlook for the Turkish economy and markets in the short to middle term, taking into consideration the expected development of the political framework and an increasingly competitive global environment marked by expected increases in advanced countries' interest rates with potential spillover effects on emerging markets at large?

At the political level, Turkey's domestic conflicts seem to have gradually calmed since the set of recent demonstrations. However, the political news flow will be at the top of the investor agenda going forward as municipal elections and presidential elections are due to be held next year. In case political tension elevates due to the double elections, this may put pressure on consumer and business confidence. Also, the Syrian conflict and the Kurdish peace process are the other hot issues going into 2014, although the tensions on these fronts are expected to be at subdued levels in the short to medium term. Having said that, it would be difficult for the government to pursue significant structural reforms in the current political environment.

The markets reappraisal of advanced economies monetary policies increasingly exposes Turkey's main vulnerability, i.e its low savings rate and its external imbalance which warrants external funding to fuel Turkey's growth. With gross external financing needs expected to remain in place over the medium to long term, a weakening or a reversal of capital flows present a major challenge for the Turkish economy. The timing and pace of Fed's eventual and inescapable tapering of asset purchases will determine the magnitude of the change in capital flows into Turkey.

Within this context, the CBRT strategy of having interest rate stability at the expense of FX volatility is not believed to be sustainable, with the Central Bank expected to be forced to hike rates to face risks of volatility of capital flows and depreciation pressure. The Fed's decision to postpone the tapering has provided some breathing room until at least 2014 but the CBRT will likely need to hike rates afterwards. While the TL exchange rate might appreciate prior to the end of the year, it is foreseen to depreciate under capital flows pressures though moderately afterwards. In the middle term, higher interest rate and further moderate drawdowns on foreign exchange reserves should help limit the Lira's depreciation. Given Turkey's modest size of foreign exchange reserves relative to external borrowing needs, large scale exchange market interventions do not appear to be a sustainable option with time. The Central Bank of Turkey's reserves look modest by most metrics and in cross-emerging markets comparison. Still, it has to be kept in mind that the majority of the short term external borrowing requirements of the Turkish private sector is emanating from Turkish banks, which are healthier than most peers in emerging markets.

At the level of inflation, the weaker Lira should keep 12-month headline inflation above 7% in the near term despite favorable base effects. In the medium term, as inflation reaches its cyclical peak and based on the assumption that domestic demand loses momentum, inflation should fall closely to near the 5% threshold. Uncertainties regarding food and oil prices pose downside risks on inflation forecasts. As to output growth, it is set to slow in the near term with higher rates and depreciated Lira. A stock build up led growth is not actually sustainable looking ahead. In the medium term, Turkey's demographic structure, strategic geographical location and dynamic economy present many opportunities. However, it will be difficult for Turkey to sustain an average growth of 5% per year while continuing to accumulate large external liabilities year after year. The present low level of domestic savings implies that investment is determined by the availability of highly volatile external flows. IMF believes that without structural reforms, growth would have to be below the historical trend to avoid increases in external imbalances and accompanying bout of instability.

Having said that, the observed recovery in demand from Europe and a more competitive TRY should support export performance, yet not enough to offset the softer domestic demand and drive output growth in the near term. CBRT's policy stance and tighter financial conditions, as well as a recovery in the Euro Area would put downward pressure on the current account deficit. Following considerably high current account deficits in recent years, the forthcoming slower growth should result in a relative reduction in the current account deficit in the near term that might approach the 6% threshold, according to consensus estimate, though remaining higher than official targets.

Finally, at the fiscal level, the government's commitment to meeting its near term and medium term fiscal targets seems to remain in place. It is also worth mentioning that the financing requirement of the Treasury is consistently turning out to be lower than originally projected thanks to continued fiscal discipline. Continued primary surpluses leave the public debt dynamics as the most favorable anchor in Turkey's macro environment, with consensus estimate showing further gradual improvement to 33% of GDP. Although some fiscal easing is expected in the pre-election period, it is believed that this will not reach a level that could upset investors in the near term, as the track record of the AKP government shows fiscally responsible policies in pre-election periods

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