JUNE 2014

GENERAL OUTLOOK

Economic Developments:

The Central Bank has cut the policy rate, but the Prime Minister was not satisfied…

Turkey's Central Bank surprised markets with its first rate cut in a year on May 22, weeks after Prime Minister Recep Tayyip Erdoğan called for rates to fall. The bank said "decreasing uncertainty" and an improvement in risk-premium indicators prompted the 50-basis-point cut in its one-week repo rate to 9.5 percent. The bank kept its overnight lending rate at 12 percent and overnight borrowing rate at 8 percent. In its statement, the bank argued that a "recent decline in uncertainties and improvement in the risk premium indicators" had led to a fall across the board in market interest rates. It insisted that "the monetary policy stance will continue to be tight" despite the latest cut. The Central Bank forecast that inflation should decelerate later this year because of domestic demand growing more slowly than in the past. Buoyant exports should help Turkey to narrow its large current account deficit.

However, the Prime Minister Erdoğan is not happy with the decision. He has stepped up his criticism of the Central Bank's monetary policy, slamming the Bank's recent slight drop in interest rates as not enough. "You raised the interest rate by 5 points all at once, but now you reduce by only half point. Are you kidding?" Erdoğan told a group of reporters in his plane while returning from a rally in the German city of Cologne. The Bank had raised rates sharply at the end of January to combat a fall in the Turkish Lira to record lows amid an emerging markets sell-off and a corruption scandal. He also lashed out at criticism that he is thwarting the Central Bank's independence and trustworthiness. "Why this intervention? If I am the prime minister of this country, I will express my opinion. At this point, it [the Central Bank] should clean up its act. The Central Bank is independent. The Central Bank's independence doesn't affect my view on interest rate. They are separate issues," he said. The prime minister also slammed the Bank's pledge to keep monetary policy tight until inflation is reduced to the desired levels, going against conventional wisdom by suggesting that "inflation is the outcome of high interest rates and they are directly proportional." Recalling that inflation is currently hovering at around 9 percent, far from the Bank's year-end target of 7.6 percent, Erdoğan said this proved the Bank's current policies were not working.

On the other hand, Erdogan, said again that he did not accept Governor Erdem Basci's approach on rates and hoped the bank would act immediately to resolve the issue recently on

June 3rd. Speaking to reporters a day after Basci briefed the cabinet on central bank policy, Erdogan said the latest data showed that inflation was not falling.

S&P affirmed its rating on Turkey…

International ratings agency Standard & Poor's has affirmed its rating on Turkey at BB+, but kept it within the junk territory, citing poor political management. "In our view, the authorities have not used fiscal and monetary policy settings consistently enough to build up buffers against potential external risks," the agency said in a statement. "Furthermore, we believe the limited policy buffers have also partly stemmed from an erosion of institutional checks and balances," it added. According to the S&P analysts the erosion poses risks to business confidence and economic stability. "A crowded electoral calendar and an uncertain external environment make many of our forecasts highly contingent on investor confidence in the policymaking framework," it also said, but remained optimistic that authorities would not give up steady fiscal and monetary outcomes. However, the agency argued it did not see any need for a reduction in the credit rating, betting on its base-case scenario that the Turkish economy is gradually rebalancing as export growth improves. "The economy is benefitting from the portion of nominal exchange rate depreciation that Turkey has not yet lost to higher relative inflation," the agency said, as for the stronger sides of the economy. The agency also issued a warning against the fiscal weaknesses of the country with towering debts and potentially rising refinancing rates. "Between 2009 and 2013, gross financial sector external liabilities increased 3.2 times to $178 billion. This is equivalent to an annual inflow of non-resident lending to the financial sector of 4 percent of GDP per year," the statement read. "If the external financing environment were to deteriorate, rollover rates on this stock of debt – 60 percent of which we estimate is short term – could decline below 100 percent and refinancing rates could rise significantly," the agency warned. The agency also noted it sees Turkey's external vulnerabilities less manageable due to Turkish companies' sizeable and partially unhedged foreign currency position, still sizeable current account deficit, uncertainty in global economic environment and a high pass-through of exchange-rate depreciation into inflation. The S&P also said it had marginally raised its base-case forecast for 2014 GDP performance to just under 3 percent, but without improving the expectations for long-term growth. "Our view takes into account the deceleration in credit growth, currently running at a 13-week average of 15.5 percent (annualized weekly change) and forecast to drop below 10 percent in 2015," the statement said. "Absent credit-fuelled growth, we see Turkey's growth potential as curtailed until structural changes take place. Such changes could include higher net foreign direct investment into the tradable sector; continued increases in labour participation and improved labour flexibility; and improved productivity and value-added in the economy," the agency said.

Turkey rate cut sends mixed message according to Fitch…

Fitch Ratings has said the Turkish Central Bank's 0.5 point rate cut on May 22, highlights policy swing risks by sending mixed messages. "The Central Bank of the Republic of Turkey's decision to cut its main interest rate while leaving other rates unchanged sends a mixed message regarding its monetary policy that may dent its credibility and highlights the risk that policy reversals could undermine economic adjustment," Fitch said in a statement released on May 23. "Cutting the main policy rate as inflation continues to head upwards toward the double digits reinforces our judgment that policy coherence and predictability remain weaker in

Turkey than in some of its rating peers, a point that we highlighted when we affirmed Turkey's 'BBB-' sovereign rating last month," the agency said commenting on the move.

Moody's warned Turkey and Russia for high inflation

International credit rating agency, Moody's cautioned Turkey and Russia for both countries' high inflation, stressing it constitutes a risk for sovereign ratings. In a statement, the agency reported that inflation exceeds the forecasted or targeted levels estimated by central banks in Turkey and Russia as a negative risk to these countries' governments and corporate bond ratings. However, the report estimated that growth in Turkey will remain on higher levels than Russia and inflation is expected to continue to be high in the second half of the year. The agency emphasized that high inflation slows growth and causes tight monetary policy, while having a negative risk for government and corporate bond ratings.

Moody's revised ratings on 11 Turkish banks…

Moody's has taken rating revisions on 11 Turkish banks, citing an increasingly challenging operating environment, which is expected to persist for the next 12-18 months. "The two key drivers of the ratings are pressures on the standalone credit strength of some of the institutions and Moody's reassessment of the level of systemic support it believes should be incorporated into some of the banks' senior ratings," the agency said in a statement on June 3. The 11 banks identified by Moody's are: Akbank, Asya Participation Bank, Denizbank, Garanti Bank, İşbank, Şekerbank, Türk Ekonomi Bankası, Vakıfbank, Yapı Kredi, Halkbank and Ziraat Bank. The rating agency estimated the tough environment for lenders will persist for the next 12-18 months due to a slowdown in real GDP growth, higher funding costs and a climate of uncertainty affecting the banks. Moody's has said it expects that, in these conditions, Turkish banks' asset quality and profitability will weaken and liquidity will tighten. "Additionally, the banks will increasingly need to adapt to a capital-optimizing lending model against the background of moderate GDP growth and persistently high funding costs, coupled with weakening capital adequacy, as credit growth outpaces internal capital generation," the statement read. The agency also says the reduced expectation of the level of systemic support poses risks to the sector. "This view takes into account the fact that the banking system and its financial obligations have grown significantly in relation to the GDP in recent years and will continue to do so, increasing the potential cost of any government support, in case of need. The charged domestic political environment and less predictable policy responses add additional elements of uncertainty," it said. The banks' higher reliance on market funds has eroded some of the banking system's previously strong elements of protection against market turbulence, according to the agency.

OECD has cut Turkey growth forecast…

The Organization for Economic Co-operation and Development (OECD) has trimmed its growth forecast for Turkey from 3.8 to 2.8 percent, holding political tensions and the U.S. Federal Reserve's policy shift responsible for higher interest rates and capital outflows. OECD predicted that Turkish economic growth, which slowed down in 2013, will remain subdued through mid-2015. The main risk facing faster growth is the loss of confidence in global and domestic markets due to strained politics and the uncertain global monetary environment. "Further financial market turmoil during the prospective normalization of U.S. monetary policy and intensifying internal political tensions are two major risks," the OECD said. "Sustaining domestic and international confidence is crucial," the organization's economic outlook report said. "Political tension has dented confidence, provoking capital outflow and forcing the Central Bank to raise interest rates sharply in 2014," it said. The organization also said the country's two Achilles heels, high inflation and a large current account deficit, remain sensitive. "Growth is weak but headline inflation, at about 8.5 percent, far exceeds the 5 percent official target Core inflation is also rising and is above even headline inflation," the report said, predicting that the indicator would stay high this year "as a result of additional pass-through from exchange rate depreciation and indirect tax increases, which could erode competiveness." According to the OECD, the country's slight progress in balancing current account deficit is not sufficient as well. "The current account deficit approached 8 percent by 2013 and despite progress in rebalancing demand in early 2014, the terms of trade losses will likely keep it above 6 percent for some time," the report said. The organization suggested "improving the business environment in the formal sector by implementing regulatory reforms envisaged in the 10th Development Plan, noting that other measures could spur FDI inflows and reduce reliance on external debt.

EBRD has cut 2014 growth forecast for Turkey…

Growth in Turkey is likely to accelerate to 3.7 percent this year before moderating slightly to 3.6 percent in 2014, the European Bank for Reconstruction and Development (EBRD) has forecast in its latest "Regional Economic Prospects" report. In its May forecast, the EBRD had foreseen a GDP growth of 4 percent for 2014, but it has now lowered its predictions amid warnings against large macroeconomic imbalances, as Turkey's current account deficit is still above 6 percent of GDP, leaving the country vulnerable to sudden shifts in global market sentiment. Overall, the bank cut its 2013 forecast for Central and Eastern Europe from 2.1 to 2.0 percent, and its 2014 projection from 3.1 to 2.8 percent. Turkish economic activity picked up in the first half of the year, driven mainly by domestic demand, but the Central Bank's recent decision to contain inflation pressures through tightening is expected to further moderate economic activity in the second half of the year, the EBRD said. "The prospect of the tapering of the U.S. Fed's quantitative easing program has led to a reversal of capital flows since May 2013, and the currency weakened to record lows against the U.S. dollar (losing about 15 percent of its value at one point). However, markets have stabilized since then, following the Fed's decision to delay tapering," the EBRD said.

Banking sector results in the first quarter…

Profits in the banking sector fell 13.9 percent in the first quarter of 2014, according to the report published by the Banking Regulation and Supervision Agency (BDDK). Through March, Turkish banks reported profits of TL 6.069 billion, a year-on-year loss of TL 980 million. The overall size of assets of the Turkish banking sector reached TL 1.797 trillion, a TL 370 billion gain from the end of 2013. The sharp drop in banking profits during the first quarter can likely be attributed to a sizeable interest rate hike earlier this year. The banking sector's loan portfolio increased 29.9% on the year to TL 1.08 trillion at the end of March, while deposits were up 21.5% to TL 959.4 billion.

Political Developments:

Turkey will ignore ECHR ruling to pay compensation to Greek Cyprus…

Turkey will not pay a fine imposed on the country by the European Court of Human Rights (ECHR) for the Turkish military's 1974 intervention in Cyprus, officials in Ankara have announced. "In terms of the grounds for this ruling, its method and the fact that it is considering a country that Turkey does not recognize as a counterpart, we see no necessity to make this payment," Foreign Minister Ahmet Davutoğlu said at a press conference on May 13. The ECHR's ruling consists of some "legal contradictions" and therefore Turkey does not see it at as binding in terms of payment, he said. No court can force Turkey to pay a penalty to a state – Greek Cypriot State – that it does not recognize, the minister said. "The court has exceeded its authority in intervening into a state-to-state problem." Turkey previously refused to pay similar penalties on the ECHR's Cyprus rulings over individual applications by Greek Cypriots, Turkish diplomatic sources said, also referring to a separate ECHR ruling that Russia did not carry out. The Turkish government will inform ECHR about its decision to not pay the fine, outlining its reasons, according to sources. Davutoğlu described the timing of the ruling as "not well-intentioned." "The ECHR should rule on all the missing people cases, including the Turks in Turkish Cyprus," he said. "The timing is unfortunate, the comprehensive peace talks have been dealt a huge blow," Davutoğlu said, referring to the recently restarted negotiations between the two sides of the divided island. The minister drew attention to a committee established for missing persons in Cyprus. If the ECHR has taken a decision about the missing Greek Cypriots, then the court should take a decision about missing Turkish Cypriots as well, he said.

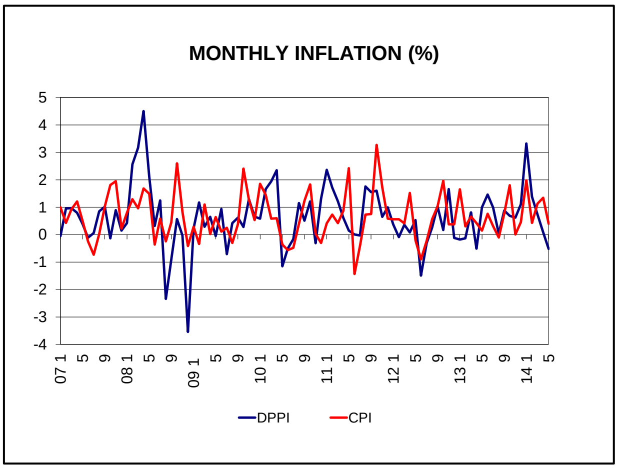
Soma mine disaster…

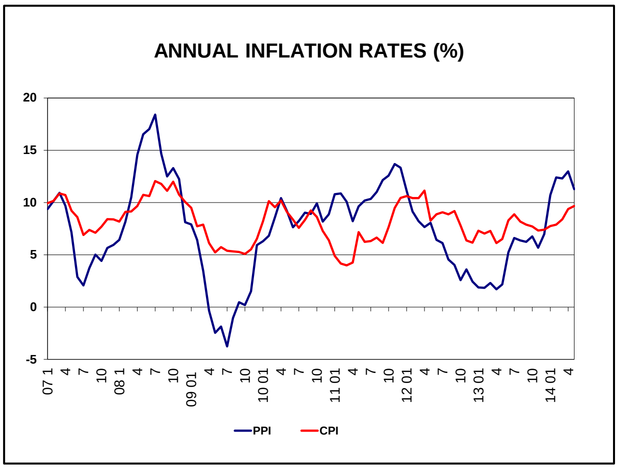
On 13 May 2014, an explosion at a coal mine in Soma, Manisa, Turkey, caused an underground mine fire, which burned until 15 May. In total, 301 people were killed in what was the worst mine disaster in Turkey's history. The mine, operated by coal producer Soma Kömür İşletmeleri A.Ş., suffered an explosion, the cause of which is still under investigation. The fire occurred at the mine's shift change, and 787 workers were underground at the time of the explosion. After the final bodies were pulled from the mine on May 17, 2014, four days after the fire, the Minister of Energy and Natural Resources Taner Yıldız confirmed the number of dead were 301. Disaster and Emergency Management Presidency (AFAD) announced the names of 301 workers who died in the mine disaster and 486 people who survived but some politicians claimed that the number of dead is more than 340.

MACRO ECONOMIC DEVELOPMENTS

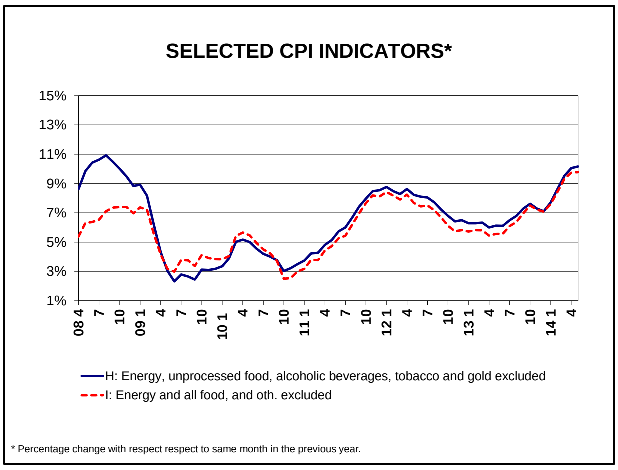
CPI rose by 0.40% in May: yearly CPI inflation is 9.66%...

Inflation continued to rise in May although at a lower rate. The CPI (consumer price index) rose by 0.40% on a monthly basis in May and the annual increase rose to 9.66%. This was the highest rate in 25 months. On the other hand, the DPPI (domestic producer price index) fell by 0.52% on a monthly basis and the yearly DPPI increase fell to 11.28%. The monthly increase in the CPI was lower than expectations. The rise in clothing prices due to the new season were the main factor affecting the CPI inflation. On the other hand, falling food prices due to seasonal factors lowered the inflation rate.





In this light, the highest price increase within the CPI index was in the prices of clothing and shoes sector which increased by 9.19%. The contribution to inflation was 0.61 percentage points. This was followed by the prices of restaurants-hotels group which rose by 1.1%. The rise in other groups was lower than 1%. There was a decline of 1.35% in the prices of food and non-alcoholic products and the negative contribution to inflation was 0.31 percentage points. Transportation prices fell by 0.50. In annual terms, the largest price increase was in transportation sector with 13.11%, which was followed by the food and non-alcoholic beverages group with 12.88% and restaurants-hotels with 12.88%.



The core inflation indicators continued to climb on yearly basis but the increase was lower on monthly basis compared to the previous month. The favourite core inflation index I (excluding all food and beverages, energy, and tobacco products) rose by 1.50%, with a yearly increase of 9.77%. This was the highest increase since April 2007. On the other hand, the second favourite H index rose by 1.40% on monthly basis, causing an increase of 10.16% on yearly basis.

The DPPI inflation which comprises the industrial producer prices fell by 0.52% in May, indicating that the cost-push inflation and FX pass-through have slowed down. Prices dropped by 0.20% in the manufacturing sector, by 1.11% in the mining sector and by 3.60% in the electricity and gas sector; however they increased by 1.40% in the water sector. On yearly basis, the prices in the manufacturing sector rose by 13.35%.

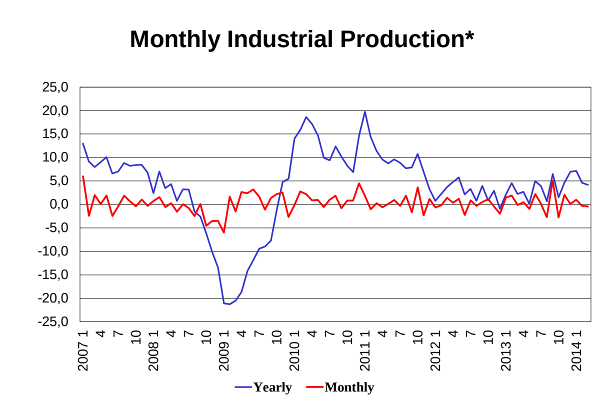
CPI Components			
% change	Weights	2014 May	2014 May/ 2013 May
TURKEY	**100,00**	**0,40**	**9,66**
Food and non-alco. beverages	24,45	-1,35	14,11
Alco. beverages and tobacco	5,29	-0,15	2,97
Clothing and footwear	7,17	9,19	7,97
Housing, water, electricity, gas and other fuels	16,41	0,36	5,34
Household equipment	7,52	-0,16	8,91
Health	2,44	0,98	8,57
Transport	15,54	-0,50	13,11
Communications	4,70	-0,11	0,34
Recreation and culture	3,36	0,21	7,04
Education	2,26	0,99	9,57
Hotels, cafes and rest.	6,58	1,11	12,88
Miscell. goods and services	4,28	0,49	7,03

Special (core) CPI Aggregates		
% change	**2014 May**	**2014 May/ 2013 May**
A. CPI excl. seasonal prod.	0,12	9,49
B. CPI excl. unprocessed food	0,97	8,75
C. CPI excl. energy	0,54	10,49
D.(B) and (C)	1,26	9,56
E. (C) and alcoholic bev. And tobacco prod.	0,59	11,03
F. (E) and admins. prod, other prod., indirect taxes	0,58	10,99
G. (F) and (B)	1,38	10,04
H. (D) and alcoholic bev., tobacco and gold	1,40	10,16
I. (C) and excl. food and non-alco. bev., alco. bev. and tobacco	1,50	9,77

We expect that inflation will start to decrease in the summer months to around 8-8.5% as we think that food prices can continue to fall and the FX pass-through effects are decelerating. However, although this is the case we are still thinking that the CPI inflation can rise to around 9% at the end of the year. On the other hand, the Central Bank can diminish the policy rate due to political pressure but our view is that this will be a riskier action for the Bank as inflation is still high and the outlook is uncertain for the future months considering that there can be new hikes in the prices of natural gas and electricity as of the autumn months.

Industrial production rose by 4.2% in March…

Although there is a slowdown in the growth rate, industrial production continued to rise in March. Industrial production rose by 4.2% compared to the same month of the previous year according to the calendar-adjusted production index. Production increased at the same rate according to the non-adjusted figure. The rise was 5.3% in both indices for the first quarter of the year. Finally, production fell by 0.4% in March compared to the month before according to the seasonally and calendar-adjusted index.



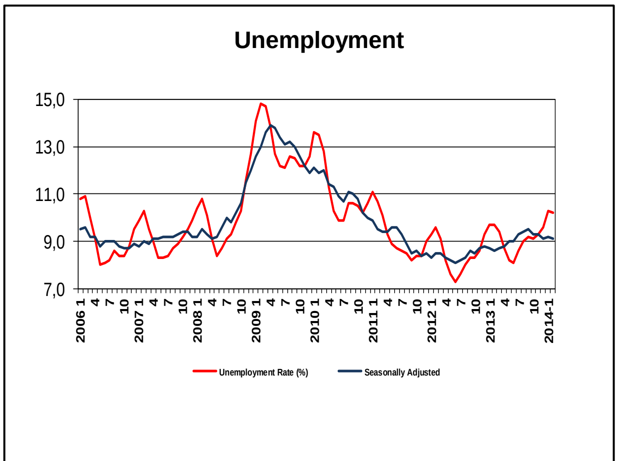
* Calculated from the 2010-based industrial production index. Yearly growth is calendar adjusted, monthly growth seasonally and calendar adjusted,

The strongest production increase in March compared to the same month of the previous year according to the calendar-adjusted index was in the non-durable consumption goods sector with 4.7%. This was followed by the energy sector with a rise of 4.4% and by 4.2% in the intermediate goods sector. Production also rose by 3.7% in the durable consumer goods sector. The increase was 3.4% in the capital goods sector. The rise in production in March was 4.3% in the manufacturing industry and the mining sector; 3.1% in the electricity, gas and water sector.

As a result, March figures indicated that industrial production grew by more than 5% in the first quarter of the year. This confirms that both production and the GDP growths are stronger than expected in the first quarter. Industrial production was not much negatively affected by the depreciation of the TL, the hike in interest rates and the macro-prudential measures in the same period. We think that the production rise in exporting sectors has an important role in the strong growth of industry. In this light, we think that GDP growth for the first quarter of the year can exceed 4%. Although it is hard to predict the outlook for the second quarter yet; the rising consumer confidence indices and the relief in financial markets after the March 30 local elections signal that the rise in the industrial production can continue, although there can be a deceleration in the growth rate.

Turkey's unemployment was 10.2% in the first quarter of 2014...

Employment data has been generally revised by the State Institute of Statistics in order to conform to EU statistics and applications. Consequently, we must be cautious when making assessments about the new data and we believe that it is too early to make strict statements about the employment outlook.

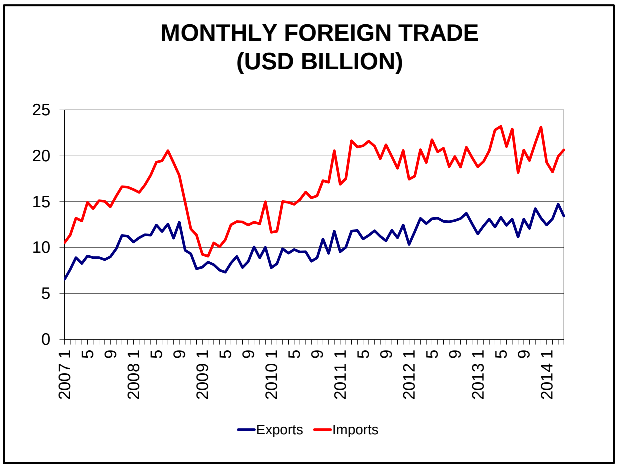


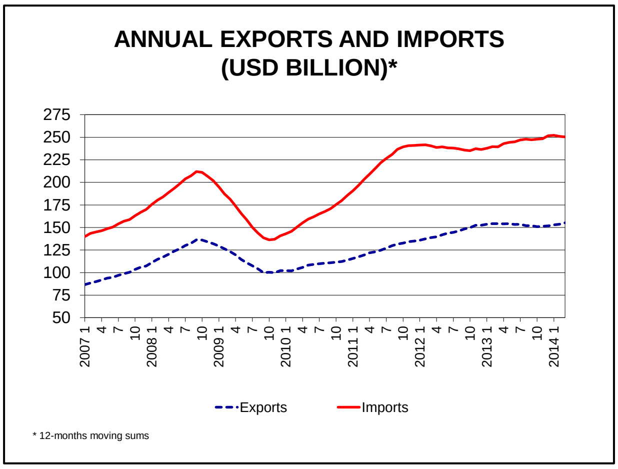
In this light, unemployment rate in the February period (January-February-March) increased compared to the same period of the previous year. However, there was a slight amelioration compared to the previous January period. The unemployment rate was 10.2% and the non-agricultural unemployment was 12.1% in the first quarter of 2014. The unemployment rate was 9.7% in the same period of 2012, whereas the non-agricultural unemployment rate stood at 11.6%. The unemployment rate of the previous period was 10.3%. Meanwhile, the seasonally adjusted unemployment rate was 9.1%; rising compared to the rate of 8.6% in the same period of the previous year but slightly falling compared to the January period.

The number of unemployed persons rose to 2,825,000 from 2,539,000 compared to the same period of the previous year. The number of employed persons rose also to 24,999,000 from 23,703,000. While the agricultural employment rose by 239 thousand; non-agricultural employment increased by 1,057 thousand. In parallel, the employment rose by 507,000 in the services sector, by 336,000 in the industry and 214,000 in the construction sector.

Foreign trade deficit was USD 24.5 billion in January-April 2014...

The improvement in the foreign trade has continued in April and the trade deficit fell compared to the same period of the previous year. The gold imports were higher than the exports in this month, although they were modest. The foreign trade deficit in April was USD 7.2 billion with 30.3% decrease compared to the same month of the previous year. Exports rose by 7.9% to USD 13.45 billion while imports decreased by 9.5% to USD 20.66 billion. According to the calendar and seasonally adjusted index, exports decreased by 7.3%, while imports rose by 1.5% compared to the previous month.





Exports rose by 8.5% in the January-April period to reach USD 53.7 billion from USD 49.5 billion; while imports fell by 4.2% to 78.2 billion from USD 81.6 billion in the same period of the previous year. The foreign trade deficit also fell by 23.8% to USD 24.5 billion from USD 32.1 billion. The foreign trade deficit dropped to USD 92.2 billion as well, in yearly cumulative terms.

The share of both the exports and imports towards the EU countries increased in January-April 2014, compared to January-April 2013. The exports to the EU countries rose by 13.5% to USD 22.9 billion. Imports from these countries fell by 0.9% to USD 28.9 billion. The share of the EU countries within the total exports was 42.7%, whereas the same share was 37.1% for imports. Exports towards the Middle East and Africa have stagnated in this period. The share of the exports towards Middle Eastern countries which was 23.7% in January-April 2013 fell to 22.1% in January-April 2014. Exports towards these countries rose by 1.3%. Exports towards African countries fell by 1.4%, while their share fell to 9.1% from 10% within the total exports. On the other hand, the first destination of exports was Germany with USD 5 billion, Iraq was the second country of destination and United Kingdom was the third. The first country for imports was Russia with USD 8.8 billion, followed by China and Germany in the first four months of the year.

Motor vehicles were the largest export items in the January-April period with USD 6 billion rising by 11.8% compared to same period of the previous year. Boilers-machinery and mechanical appliances, iron-steel, knitted goods and articles and electrical machinery and equipment were the other large export items. Export of precious metals increased by 31.8% in this period. Meanwhile, the largest import item was mineral oils and fuels with an import bill of USD 18.4 billion in the same period, rising by 2.5% as compared to January-April 2013. Boilers-machinery and mechanical appliances, electrical machinery and equipment, iron-steel, plastics and motor vehicles were among other major import items. There was 77.30% decrease in the imports of precious metals. In this light, gold imports fell to USD 1.2 billion, while exports rose to USD 2.5 billion. On the other hand, imports of consumption goods fell by 3.3%; the drop was 5.2% intermediate goods; however there was a rise of 1.1% in capital goods imports.

FOREIGN TRADE DEVELOPMENTS						
(USD Million)	April 2013 (I)	April 2014 (II)	(%) Change (II)/(I)	Jan.-April 2013 (III)	Jan-April 2014 (IV)	% Change (IV)/(III)
Export	12,469	13,449	7.9	49,458	53,680	8.5
Import	22,825	20,662	-9.5	81,582	78,146	-4.2
Trade Balance	-10,356	-7,214	-30.3	-32,124	-24,466	-23.8
Export//Import (%)	54.6	65.1	-	60.6	68.7	-

Current account deficit was USD 11.5 billion in the January-March period...

The current account deficit fell to USD 3.2 billion in March 2014 from USD 5.6 billion in March 2013. The surplus of USD 0.9 billion in the energy-excluded deficit was instrumental in the contraction of the current account deficit in March; triggered by the surplus in the gold trade. On the other hand, the current account deficit fell to USD 11.5 billion from USD 16.6 billion in the first quarter of the year. The cumulative deficit also fell to USD 59.9 billion from USD 62.4 billion registered in February.

The foreign trade deficit and the outflow from the income balance were instrumental in the current account deficit in the January-March period. The tourism revenues did not change in this period. The trade deficit was USD 11.9 billion in January-March 2014; it was USD 17.2 billion in January-March 2013. There was a surplus of USD 1.1 billion in the trade excluding energy. The deficit in the gold trade turned to a surplus of USD 1.6 billion in this period. The service surplus reached USD 2.7 billion, while net tourism revenues amounted to USD 2.8 billion. The balance of income was in deficit with an outflow of USD 2.3 billion. The inflow from the current transfers reached USD 165 million.

On the financing side, the capital inflows which were USD 27.9 billion in January-March 2013 turned to an outflow of USD 55 million in the same period of 2014. There was an increase in the direct investments. The net direct investments which were USD 2.1 billion in January-March 2013 rose to USD 3.1 billion this year. On the other hand, the real estate investments of non-residents reached USD 1 billion.

Portfolio investment, which had resulted in a net inflow of USD 8.1 billion in January-March 2013, showed a net outflow of USD 2.5 billion in January-March 2014. There was a fall of USD

263 million in the assets of the portfolio account which comprise of the securities transactions abroad of the residents. There was a net sale of USD 3.87 billion in the government debt securities in January-March 2014, after the sale of USD 1.7 billion in March. The bonds issued abroad by the government amounted to USD 898 million. On the other hand, there was a net purchase of USD 408 million in the equity securities in the same period, after the purchase of USD 811 million registered in March. Meanwhile, while the bond issues abroad of the banks were USD 370 million; there was a USD 6 million repayment from the other sectors in the first quarter of the year.

There was an outflow of USD 713 million in the form of other investments in January-March 2014 compared to an inflow of USD 17.7 billion in January-March 2013. While the inflow of the corporate sector reached USD 73 million in the form of deposits and loans; the banking sector registered a capital inflow of USD 168 million. In this respect, the foreign deposits of the other sectors fell by USD 914 million, while the loans used reached USD 2.1 billion. The government realized a USD 269 million net long-term loan repayment. Currency and deposits item, which is composed of the deposits of non-residents held with the resident banks, recorded a fall of USD 943 million. The banking sector cash loans utilizations amounted to USD 1.2 billion. The loans abroad of the banking sector fell by USD 63 million. On the other hand, banks' currency and deposit placements abroad in the form of foreign exchange and Turkish Lira recorded a decrease of USD 2 billion. The roll-over ratio for long-term debt was 175% for banks and 139% for the non-bank sectors.

In sum, while there was a deficit of USD 11.5 billion in the current account balance, the financial and capital account posted a deficit of just USD 55 million in January-March 2014. The net errors and omissions item registered a net inflow of USD 6.6 billion with the help of USD 2.4 billion inflow registered in March. The Central Bank reserves fell by USD 4.9 billion in the first quarter of the year. As a result, the reserve assets which rose by USD 7.5 billion in January-March 2013; decreased by USD 4.9 billion in January-March 2014.

Consequently, the current account deficit contracted in the first quarter of the year due to the decrease in the foreign trade deficit initiated by the fall in imports and rise in exports. The surplus registered in the gold trade this year contrary to last year was also an important factor. In addition, the macro-prudential measures of the government, the rise in FX and interest rates and the parallel fall in domestic demand were also other factors causing the current account deficit to fall. On the other hand, the problems in the financing of the deficit are still continuing. Although the direct investments rose in the first quarter of the year – which is still insufficient- , there was a fall in portfolio and other investments. Thus, the current account deficit is financed by the net errors and omissions item and the Central Bank reserves. Consequently, we believe that the contraction in the current account deficit can continue with the help of the slow domestic demand and growth limiting the imports, the relative recovery in EU countries and the weak Turkish Lira supporting the exports. However, the possibility of the TL to re-appreciate in the following months can be a negative factor for the ongoing growth in exports. On the other hand, as a positive factor, we think that the fall in portfolio investments can stop and turn to a rise in the following months considering the relief in the Turkish financial markets observed as of the second quarter of the year.

Balance of Payments

(USD Million)	Jan.-March 2013	Jan.-March 2014
CURRENT ACCOUNT	**-16,551**	**-11,460**
Foreign Trade Balance	-17,215	-11,987
Balance of services	2,447	2,676
Tourism income	*2,780*	*2,767*
Balance of Income	-2,035	-2,314
Current Transfers	252	165
FINANCIAL and CAPITAL ACCOUNT	**27,866**	**-55**
Direct Investments	2,109	3,141
Portfolio Investments	8,122	-2,467
Other Investments	17,652	-713
Central Bank	-238	-354
General Government	-452	-454
Banks	14,012	168
Other Sectors	4,330	-73
NET ERRORS AND OMISSIONS	**-3,860**	**6,635**
RESERVE ASSETS*	**-7,455**	**4,880**
Official Reserves	-7,024	4,880
Use of Fund Credit and Loans	-431	0

*Minus sign indicates an increase in reserves

The budget registered a deficit of TL 4.2 billion in January-April 2014….

The budget gave a deficit in March amounting to TL 2.7 billion; compared to a deficit of TL 595 million in the same month of 2013. The primary surplus increased to TL 3.7 billion as well from a surplus of TL 1.1 billion in April 2013. The significant climb in the April deficit compared to the same month of the previous year can be attributed to the faster rise in total expenditures versus the rise in revenues. The surge in total expenditures was mainly due to the financing of the Social Security Institution deficit and the debt of BOTAŞ (natural gas institution) and the rise in personnel expenses. On the other hand, the climb in capital transfers and capital expenditures were noticeable on the expenditures side. There was also a rise in interest expenditures. On the revenues side, although the non-tax revenues continued to rise considerably, the increase in the tax revenues slowed down and there was a decline in corporate tax receipts.

The budget figures for January-April 2014 indicated that the budget deficit has increased significantly compared to the same period of the previous year. While the budget deficit was TL 4.2 billion; the primary surplus was TL 13.6 billion. The budget had registered a deficit of TL 302 million, while the primary surplus was TL 17.9 billion in the same period of 2013. The rise in the budget deficit was mainly originated by the faster increase in budget expenditures than the revenues. While the interest expenditures has declined; the capital transfers, capital expenditures, liabilities and social security government premiums have climbed considerably in real prices. On the other hand, the rise in non-tax revenues was faster than the rise in tax revenues and the increase in tax revenues was sluggish in real terms.

The total expenditures increased by 5.7% in real prices and they realized as TL 142.6 billion in January-April 2014. While the non-interest expenditures rose by 8.3% in real terms to reach TL

124.8 billion, the interest expenditures decreased by 9.5% to TL 13.6 billion. The current transfers rose by 4.6% in real terms. The social security institutions and health payments increased also in real terms and rose to TL 28.2 billion, whereas the funds allocated to local administrations amounted to TL 11.7 billion and agricultural supports attained TL 4.4 billion.

The budget revenues rose by 2.8% in real terms in January-April 2014 to reach TL 138.4 billion. There was 8.2% increase in non-tax revenues in real terms, while the tax revenues climbed by 1.3%. While revenues from corporate tax fell significantly, the receipts from domestic VAT, banking and insurance tax and stamp duties have increased in real terms. There was stagnation in other tax item revenues indicating the slowdown in domestic demand.

The budget results of April indicate a significant deterioration in the budget performance. We think that this situation is related to the rise in spending due to local elections and the relatively slow domestic demand and economic activity. Although we do not believe that the year-end budget deficit target is under threat for now, the performance of the budget should be closely observed in the following months.

Central Administration Budget

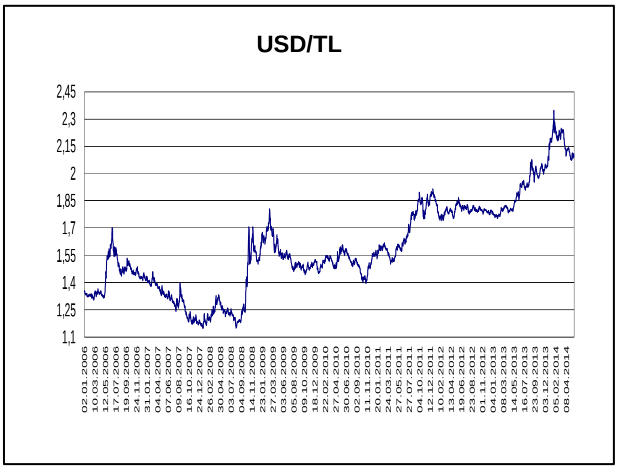
Central Administration Budget (TL Thousand)	January-April 2013	January-April 2014	Real* % change	Budget Realiz.(%)	2014 Budget Target
Expenses	**124.930.742**	**142.606.131**	5,7	32,7	**436.432.901**
1-Excluding Interest	**106.706.761**	**124.796.317**	8,3	32,5	**384.432.901**
Personnel	33.173.236	38.635.114	7,9	35,1	109.969.100
Govern. Premiums to Social Security Ag.	5.511.990	6.540.545	9,9	34,7	18.874.583
Good and Service Purchase	8.154.338	9.545.726	8,4	25,4	37.590.028
Current Transfers	49.652.360	56.057.887	4,6	34,3	163.553.913
Transfers to social security inst.	25.629.681	28.168.896	1,8	36,6	77.059.462
Capital Expenses	6.284.077	8.014.652	18,1	21,8	36.688.695
Capital Transfers	532.406	1.523.325	165,0	23,4	6.518.197
Liability	3.398.354	4.479.068	22,1	58,6	7.645.162
Reserve Appropriation	0	0	0,0	-	3.593.223
2-Interest	**18.223.981**	**17.809.814**	-9,5	34,2	**52.000.000**
Revenues	**124.628.809**	**138.369.175**	2,8	34,3	**403.174.813**
1-General Budget Revenues	**120.189.382**	**132.812.784**	2,3	33,8	**392.967.693**
Taxes	101.473.704	110.952.603	1,3	31,9	348.352.781
Non-Tax Revenues	18.715.678	21.860.181	8,2		44.614.912
Enterprise and Ownership Revenues	4.467.735	6.473.149	34,2	79,5	8.140.485
Grants and Aids and Special Reven.	499.046	779.949	44,8	50,1	1.556.477
Interest, Shares and Fines	8.483.017	10.784.909	17,8	41,4	26.025.984
Capital Revenues	5.220.587	3.135.379	-44,4	35,8	8.749.559
Receivable Collections	45.293	686.795	1304,4	482,3	142.407
2-Special Budget İnstitutions	**2.944.857**	**3.984.717**	25,3	55,2	**7.222.934**
3-Regularity & Supervisory Institutions	**1.494.570**	**1.571.674**	-2,6	52,7	**2.984.186**
Budget Balance	**-301.933**	**-4.236.956**	1199,7	12,7	**-33.258.088**
Balance Exclusive Interest	**17.922.048**	**13.572.858**	-29,9	72,4	**18.741.912**

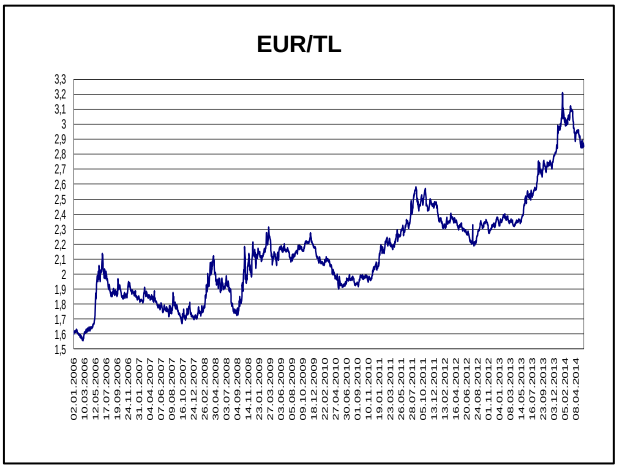
*Rate of change in 12 months moving averages (%)

FINANCIAL MARKETS

Markets in May…

The beginning of May was positive for the Turkish markets; as the global capital inflows continued and markets believed that the Central Bank would continue to its tight monetary policy due to higher than expected inflation data. While the USD/TL parity fell, the interest rates climbed. The USD/TL parity fell to 2.09, while the FX basket of the TL was around 2.50. The compound benchmark interest rates of the February 24, 2016 bond went up to 9.5%. On the other hand, the ongoing chaos in Ukraine and negative Chinese economic data were factors negatively affecting the markets. However, the speech of the Russian President Vladimir Putin concerning that Russian troops will be withdrawn from the Ukrainian border positively affected the mood in the markets. Thus, the USD/TL parity fell to 2.08 and the FX basket of the TL went down to below 2.50. Furthermore, the statements of the US Fed and the ECB were welcomed by the global markets and the Turkish markets as well. Thus, the USD/TL parity fell to under 2.07 and the compound rate of the benchmark bond dropped to below 9% for the first time since December.

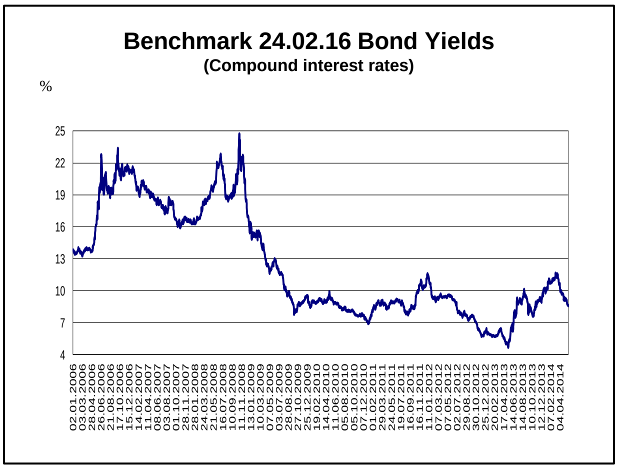




The FX and interest rates were slightly up in the middle of May with the profit realizations. However, the USD/TL parity went down again to around 2.06 after the current account deficit data -which showed a contraction- was released and the expectations of a new monetary easing decision from the ECB have increased. The interest rates were around 9%. Meanwhile, later on the FX rates started to climb again with the negative mood and the decreasing risk appetite in the global markets. Furthermore, the expectations of a new rate cut from the Turkish Central Bank in its MPC meeting on May 22 was another destabilizing factor for the Turkish Lira. While the USD/TL parity went up to 2.10; the compound rate of the benchmark bond surged to 9.20%.

The interest rates fell after the Treasury auctions realized towards the end of the month and the expectations that the Central Bank will cut the rates on May 22. The rates which rose to 9.30% went down to 9.09% after the auctions. The USD/TL parity fell to below 2.10 due to the rising risk appetite towards emerging markets with the market-friendly minutes of the Fed and positive data from China. On the other hand, benchmark interest rates went down to 8.70% from the first time since November 20, after the Central Bank cut the policy rate to 9.5% from

10% in a surprising move, but soon after they increased to near 9%. Meanwhile, the USD/TL parity first surged to 2.10 after the Central Bank decision, but it went down to around 2.08 shortly after. The statements of the rating agency Fitch did not affect much the markets.



Turkish markets were volatile at the end of May due to the statements of the Prime Minister Erdoğan related to the interest policy of the Central Bank. The Prime Minister reiterated his call to the Central Bank to cut the rates with a harsh rhetoric. The USD/TL parity went up to 2.11 within the final week of May, but it slightly fell at the end of the week. Nevertheless, the USD/TL parity closed the month around 2.0950; while the compound rate of the benchmark bond was around 8.50%.

The total domestic borrowings of the Treasury reached TL 12.1 billion, while it repaid TL 14.9 billion in May.

Consequently, while the USD/TL fell to the level of 2.0954 in May from 2.1193 at the end of April; the EUR/TL parity decreased to the level of 2.8522 from 2.9305. On the other hand, the average compound interest rate of the benchmark bond fell to 8.53% at the end of May from 9.39% at the end of April.

FOREIGN EXCHANGE RATES							
	(1) 31.12.13	(2) 30.04.14	(3) 30.05.14	(3)/(2) %change	(3)/(2) real % change	(3/(1) % change	(3)/(1) % real change
USD/TL*	2,1343	2,1193	2,0954	-1,1	-1,5	-1,8	-6,8
Euro/TL*	2,9397	2,9305	2,8522	-2,7	-3,1	-3,0	-7,9
FX basket**	2,5370	2,5249	2,4738	-2,0	-2,4	-2,5	-7,5
Euro/USD rate	1,3774	1,3828	1,3612	-1,6	-	-1,2	-
* CB's selling rate. ** 0.5 USD + 0.5 euro. *** The real change has been calculated using the CPI.							

The domestic borrowing program of the Treasury for June – August 2014 …

The Treasury has disclosed its domestic borrowing program for the June – August period. In June, domestic debt redemption is projected as TL 16.9 billion, while domestic borrowing is projected as TL 13 billion. In July, domestic debt redemption is planned as TL 14.8 billion, while domestic borrowing is projected as TL 12.3 billion. In August, domestic debt redemption is envisaged as TL 12.1 billion, while domestic borrowing is projected as TL 9.2 billion.

TREASURY FINANCING PROGRAM			
(Billion ₺)	June	July (1)	August (1)
Total Debt Service	**17,5**	**15,9**	**13,0**
Domestic Debt Service	**16,9**	**14,8**	**12,1**
Principal	15,4	11,3	9,9
Interest	1,4	3,5	2,2
External Debt Service	**0,7**	**1,1**	**0,9**
Principal	0,4	0,4	0,3
Interest	0,3	0,6	0,6
Financing	**17,5**	**15,9**	**13,0**
Non-Borrowing Resources (2)	**4,5**	**3,6**	**3,8**
Borrowing	**13,0**	**12,3**	**9,2**
External Borrowing (3)	**0,0**	**0,0**	**0,0**
Domestic Borrowing	**13,0**	**12,3**	**9,2**
Borrowing from Domestic Market by Auction	9,3	9,0	9,0
Public Institutions	3,7	3,3	0,2

(1) *Provisional.*

(2) *The cash primary balance, privatization revenues, the revenues from 2-B land sales, receipts from on lending and guaranteed debt, reciepts from SDIF, use of cash account and FX changes are shown under non-borrowing resources item.*

(3) *The amounts are subject to change depending on borrowing from international institutions or international markets.*

Expectations for June…

The European Central Bank cut interest rates to record lows on June 5, imposing negative rates on its overnight depositors to stimulate banks into lending more and to fight off the risk of deflation. The cut and the negative deposit rate which effectively charges banks to deposit overnight for the first time in ECB history, was a response to a slowdown in inflation far below the ECB's target and to weak euro zone lending. The ECB lowered the deposit rate to -0.1 percent, meaning it will effectively charge banks for holding their money overnight. It cut its main refinancing rate to 0.15 percent, and the marginal lending rate - or emergency borrowing rate - to 0.40 percent. With the decision the euro fell to four-month low of 1.3503 against the US dollar, but soon after it recovered. The ECB stated that further policy measures to enhance the functioning of the monetary policy transmission mechanism will be communicated. Parallel to this, ECB President Mario Draghi mentioned about a new LTRO funding facility for the banks amounting of Euro 400 billion which will be started in September and continued in December 2014. The risk appetite towards the emerging markets is high after the ECB decision of June 5. On the other hand, the negative GDP growth for the first quarter in the US seemed to be a temporary phenomenon related to the severe winter conditions in the US at the beginning of the year. It is expected that the US economy will gain speed in the following quarters. The tension in Ukraine is still high and remains a reason of anxiety for the global markets, but there are also signs of appeasement in the conflict. Meanwhile, the recent economic data from China indicate that the Chinese government efforts to stimulate the economy were relatively successful. Gold prices went down compared to the previous month. Although prices of Brent oil were stagnant, there was a climb in the US crude oil prices. The price of Brent oil hovers around USD 109 per barrel and the price of the US crude is around USD 102.70. The gold price is around USD 1252 per ounce as of the beginning of June. The euro/USD parity is at the level of 1.3645; while the USD/JPY parity is around 102.40.

In Turkey, recent economic data showed that the foreign trade deficit continued to decline; however, inflation went up to the highest level in many months and approached to 10%. The greatest debate is between the Prime Minister R. Tayyip Erdoğan and the Governor of the Central Bank Erdem Başçı. Although the Central Bank decreased the policy rate in June Mr. Erdoğan and his advisers were not satisfied; criticizing harshly the attitude of the Central Bank. It is interesting that both Mr. Ali Babacan, the Deputy Prime Minister Responsible From the Economy and the Minister of Finance Mehmet Şimşek are supporting the Central Bank stance in this argument. Although the inflation rate will start to slightly decrease in the summer months, we think that to continue to cut rates is a risky decision, both for the fate of the Turkish Lira and the resistant inflation rate which is expected to close the year at around 8.5-9%. However, faced with severe criticism by the political authorities the Central Bank can decide to another symbolic rate cut in June. The new rate cut and the monetary easing measures of the ECB and the rising risk appetite towards emerging market assets will support the Turkish Central Bank in taking such a decision.

We believe that the risk appetite towards the emerging markets will continue in June especially after the ECB decisions, thus we expect that Turkish market will be relatively positive. In addition, we do not think that the tension in Ukraine will further escalate beyond the current level. On the other hand, the increasing political pressure to the Central Bank to cut rates is a source of concern for the independence of the Central Bank and the outlook of the Turkish economy. Nevertheless, we also wait for a symbolic rate cut from the Bank to respond to these pressures. As a result, we envisage that the USD/TL parity will oscillate around 2.08-2.12. On the other hand, the average compound benchmark rates can move within a band of 8.10-8.60% in June.

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