Economic & Financial Analysis

Economics

5 December 2017

Emerging Markets

MonitorING Turkey

Inflation to revert

Annual inflation rose further in November at its highest since the inception of the 2003=100 series, on the back of a spike in oil prices, a pickup in food inflation and TRY depreciation in recent months. Accordingly, core inflation is at its highest level on record. Looking ahead, we think that inflationary pressures will likely remain elevated, though to fall in early 2018 on the contribution of base effects. However, the expected decline in headline CPI seems to be shorter and shallower than envisaged earlier, adding pressure on monetary policy implementation.

- Given further worsening inflation dynamics, with currency weakness ongoing since mid-September and a higher than expected November reading, we have revised our 2017 inflation forecast up to 11.7%, while seeing end-2018 inflation at 8.6%.

Markets will look for a strong 3Q17 GDP reading, given the impact from supportive government measures and ongoing recovery in tourism as well as accommodative base effects from last year. Given the strength of high-frequency economic activity data, we expect 7.5% GDP growth in 3Q17.

Although the CBT seems committed to a tight stance, investors remain concerned about the bank's ability to deliver a meaningful tightening - this has weighed on TRY performance in recent months, along with other idiosyncratic risks. Given the marked deterioration in inflation dynamics and challenging external financing conditions, whether the CBT responds with a sufficient monetary policy tightening at the upcoming MPC meeting on 14 Dec would be closely watched by the markets.

FX and Money Markets: The effective CBT response is now key – repetition of the previous piece-meal approach won't be sufficient. But once meaningful tightening is delivered then TRY should rebound, at least temporarily. Yet, given the low likelihood of inflation meeting the target (or even the upper level of the tolerance band) and the dented inflation targeting credibility, any TRY rebounds will not likely be structural. With inflation still very high, the currency should appreciate in real terms, in turn lowering the need for a persistent spot TRY adjustment.

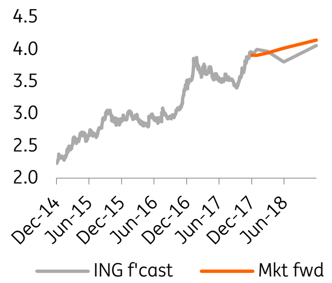
Domestic Debt and Rates: Continued slippage in CPI and less-supportive external backdrop seem to be hardly supportive, having helped push the 10yr bond yield to its all-time high in November. Given geopolitical risks, negative sentiment for local assets and expectations of an emergency hike bonds will likely underperform in the near term.

Quarterly forecasts

	2Q17	3Q17	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F	1Q19F
Real GDP (%YoY)	5.1	7.5	4.2	4.2	3.9	3.3	3.9	3.8
CPI (eop, %YoY)	10.9	11.20	11.7	9.7	9.8	9.6	8.6	8.4
Central bank key rate (eop, %)	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
3m interest rate (eop, %)	12.71	12.81	13.99	13.35	12.93	12.93	12.93	12.68
10yr yield (eop, %)	10.53	10.97	12.47	11.20	11.16	11.12	10.96	10.85
USD/TRY exchange rate (eop)	3.52	3.56	4.00	3.90	3.80	3.95	4.10	4.18
EUR/TRY exchange rate (eop)	3.94	4.28	4.72	4.68	4.75	5.02	5.33	5.47

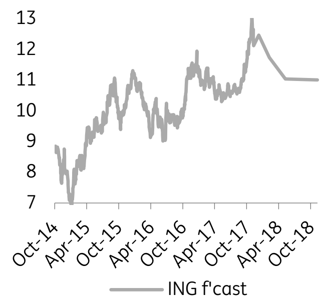
Source: Reuters, ING estimates

USD/TRY



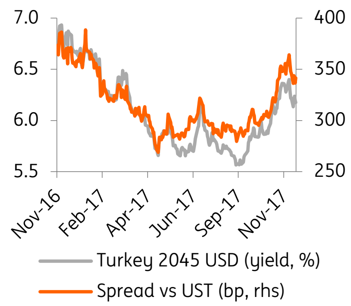
Source: Reuters, ING estimates

Local 10yr yields



Source: Reuters, ING estimates

US$ Eurobond 30Y



Source: Reuters

Latest indicator surprises

Output	Positive
Consumption	Positive
Inflation	Neutral
External	Neutral
Budget	Negative

Source: Bloomberg

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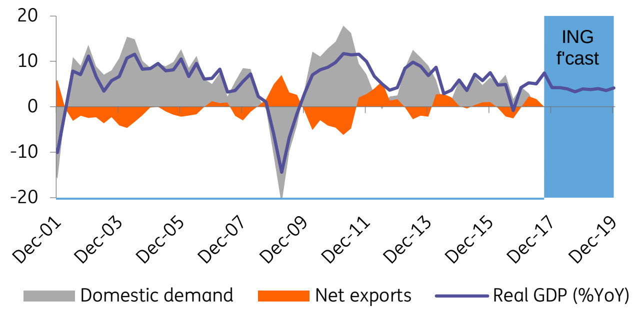
Fig 1 Real GDP (%YoY) and contributions (ppt)

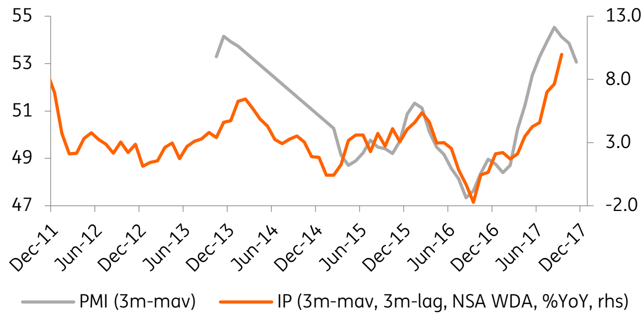


Source: TurkStat, ING estimates

Upside risks to full-year 2017 growth

- The IP figures hint that the recovery started in the last quarter of 2016 continues, driven mainly by policy measures such as macro-prudential easing, credit guarantee fund facility and supportive fiscal stance, along with buoyant external demand. Manufacturing PMI slightly above 54 in 3Q on average provides further evidence that growth was resilient during 3Q. Combined with accommodative base effects from last year, these indicators hint that annual headline growth looks set to be close to 7.5% in 3Q.
- However, some deceleration in 4Q is possible given deceleration in credit growth, signals of momentum loss in retail sales and deterioration in confidence indicators.

Fig 2 IP vs PMI

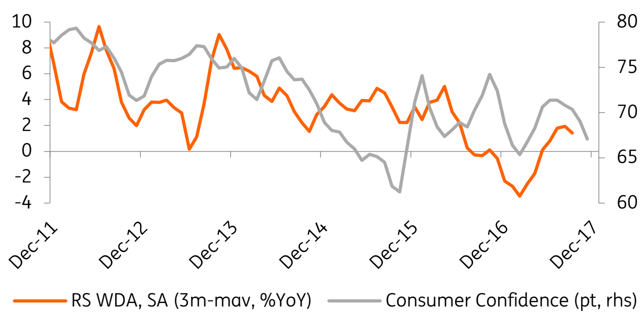


Source: Markit, TurkStat

IP remains strong in 3Q

- The September reading supports the view that activity strength remains in the third quarter, following momentum gained over the previous quarter.
- Production in all groups with the exception of capital goods rose markedly in 3Q. Durable goods stood out with the highest sequential growth rate at 7.1% QoQ, showing the impact of tax incentives, followed by energy at 3.5% QoQ and heavyweight nondurable goods at 2.6% QoQ. Capital goods production that recorded a robust sequential pace in 2Q seemed to have lost momentum in 3Q at -1.5% QoQ, showing fading impact of credit impulse with the credit guarantee fund facility nearing the ceiling.

Fig 3 Retail sales vs consumer confidence

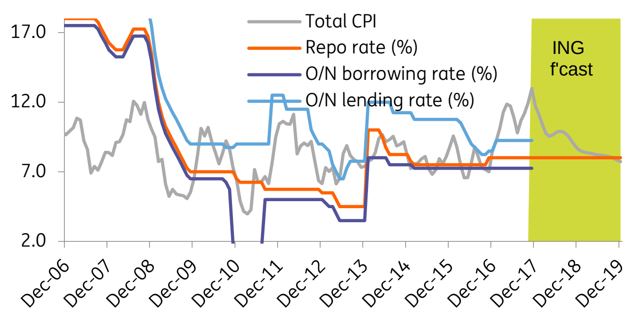


Source: TurkStat

August unemployment rate back to recovery

- The seasonally adjusted (SA) unemployment rate that has taken a downtrend in 1H17, from the highest rate in close to seven years at end-2016 with moderating pace from 2Q and with a flat reading in July, returned to recovery with a strong drop to 10.8% in August. Despite continuing labour force expansion pulling the participation rate to an all-time high at 52.9%, large employment gains were the reason for the favourable reading.
- Given robust 3Q activity with improving tourism, accelerating exports and supportive base effects, labour market conditions continued to ease, along with support from government measures and President Erdogan's call for hiring mobilization.

Fig 4 CPI vs policy rate

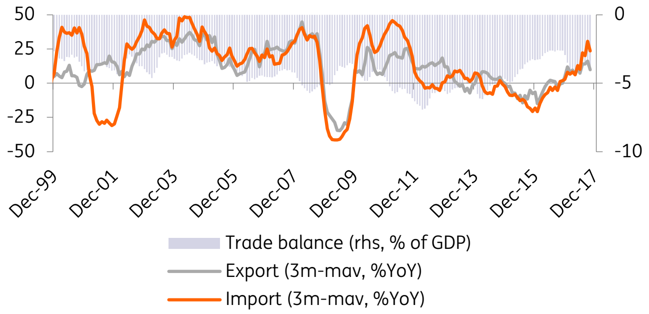


Source: CBT, ING estimates

Continued uptrend in core inflation

- Annual CPI inflation rose from 11.9% in October to 13.0%, its highest since the inception of the 2003=100 series. The continuation of the uptrend in goods prices has contributed the most, mainly driven by a spike in oil prices, a pickup in food inflation and the impact of TRY depreciation. Services inflation apart from rent turned out to be relatively benign, with the first decline in the annual rate in more than a year.
- The Domestic Producer Price Index (D-PPI) rose by 2.02%, while annual inflation remained unchanged at 17.3%, its highest level since Jul-08. Widespread price increases in almost all PPI groups showed that producer-driven cost pressures remained elevated.

Fig 5 Trade balance (3m, % of GDP)

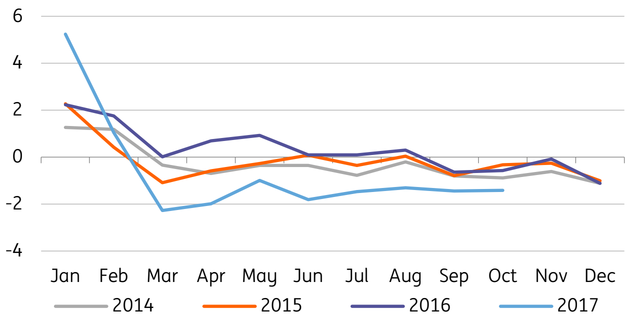


Source: TurkStat

Further expansion in 12M rolling trade deficit

- The foreign trade deficit came to USD7.3bn in October, while the 12M rolling deficit stood at USD71.0bn, the highest in more than two years. Imports maintained double digit growth at 25.0% YoY vs continuation of healthy increase in exports by 9.0% YoY. Accordingly, we saw a sharp 74% YoY widening in the merchandise trade deficit, translating into a coverage of imports by exports on a 12M rolling basis at 68.5%.
- All in all, the core trade deficit (excluding gold and energy) continues to widen thanks to impact of robust domestic demand, while less supportive net gold trade and a growing energy bill have also contributed to expansion in the monthly deficit.

Fig 6 Budget performance YTD (% of GDP)

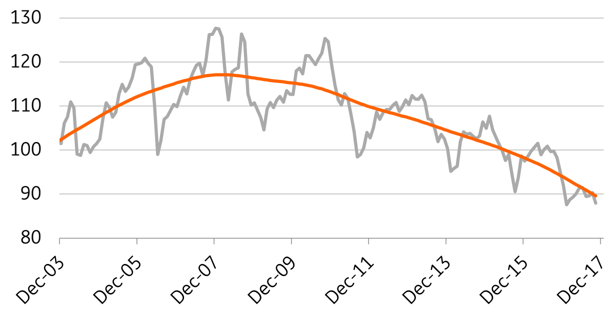


Source: Ministry of Finance

Another weak budget in October

- October saw strength in revenue generation (up 21.8% YoY), while primary expenditures accelerated again with a 29.8% YoY expansion following the unexpected contraction a month ago. We also saw a sharp 22.0% YoY jump in interest expense. Accordingly, the primary surplus in Oct-16 of TRY2.8bn melted to a barely positive reading of TRY0.2bn, showing the extent of the deterioration in monthly performance.
- Following a benign September reading, we see another bout of widening in the deficit in October despite reversal of most of the stimulus measures at end-3Q. However, according to the Ministry of Finance, the target at 2.0% of GDP for this year is within reach.

Fig 7 FX: REER vs trend (index, ppt)



Source: CBT, ING estimates

The CBT on the move

- The CBT has introduced a couple of measures to reduce FX demand and stabilize TRY: (1) Adjustments in the reserve option mechanism, providing USD1.4bn FX liquidity to the market, (2) temporarily allowing for TRY repayment of rediscount credits available to exporters at below market exchange rates with an objective of limiting exporters' FX demand, (3) offering non-deliverable forward (NDF) contracts so as to help companies hedge against FX risks, and (4) hiking the effective cost of funding by 25bp to 12.25%.
- With markets currently pricing in some rate hike, if we see the CBT ahead of the curve once again, TRY performance can show some improvement in 1H18.

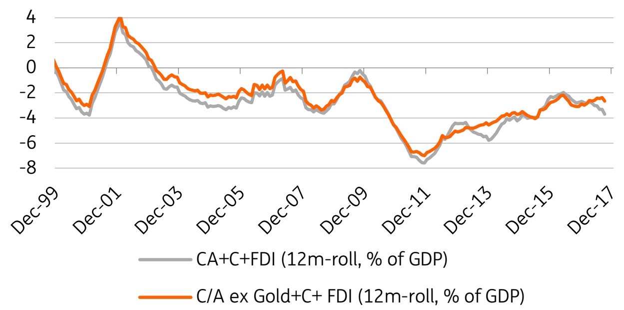
Fig 8 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Sep	79	Oct	79.7	Nov	79.9		-
Industrial Confidence	Sep	111.6	Oct	109.5	Nov	106.3		-
Industrial Production (SA WDA, MoM%)	Jul	2.3	Aug	0.0	Sep	0.6	+	0.4
Industrial Production (WDA, YoY%)	Jul	14.5	Aug	5.2	Sep	10.4	+	9.7
Consumer Confidence	Sep	68.7	Oct	67.3	Nov	65.2		-
Unemployment Rate (%)	Jun	10.2	Jul	10.7	Aug	10.6	-	10.95
GDP (YoY%)	Q4	3.5	Q1	5.0	Q2	5.1	-	5.3
GDP (WDA, YoY%)	Q4	4.2	Q1	4.9	Q2	6.5		-
Core CPI (YoY%)	Sep	11.0	Oct	11.8	Nov	12.1	-	12.3
CPI (YoY%)	Sep	11.2	Oct	11.9	Nov	13.0	+	12.5
PPI (YoY%)	Sep	16.3	Oct	17.3	Nov	17.3		-
1W Repo Rate (%)	Jul	8.00	Sep	8.00	Oct	8.00		8.00
Overnight Borrowing Rate (%)	Jul	7.25	Sep	7.25	Oct	7.25		7.25
Overnight Lending Rate (%)	Jul	9.25	Sep	9.25	Oct	9.25		9.25
Trade Balance (USDbn)	Aug	-5.9	Sep	-8.2	Oct	-7.3	+	-7.4
Current Account Balance (USDbn)	Jul	-4.7	Aug	-1.0	Sep	-4.5	-	-4.1

Source: Bloomberg

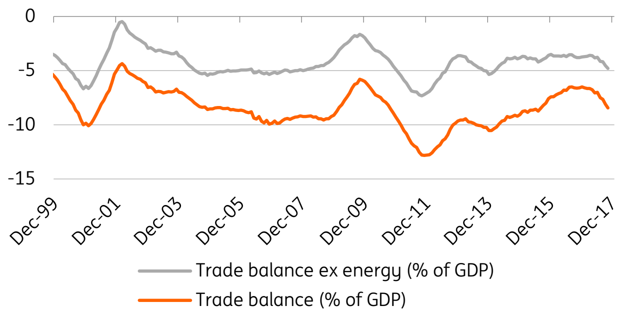
Additional charts

Fig 9 C/A (annual; % of GDP)



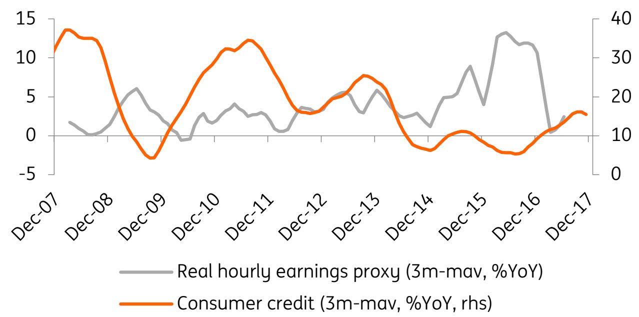
Source: CBT

Fig 10 Trade balance (annual; % of GDP)



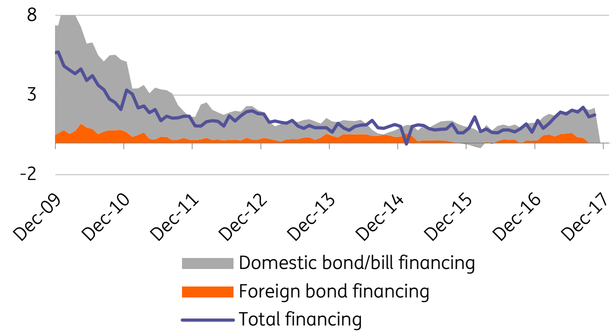
Source: TurkStat

Fig 11 Real wage growth (%)



Source: TurkStat, BRSA

Fig 12 Central govt borrowing (annual; % of GDP)



Source: Treasury

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