Economics
10 November 2015

MonitorING Turkey

Reforms in the pipeline?

Structural reforms (with a focus on boosting tax collection, improving competitiveness, supporting personal savings, employment and pensions) will be among the top priorities of the new government. The global economic conditions that supported Turkey's growth of recent years will be difficult to replicate in the coming period. A politically unstable Middle East and North Africa might continue to weigh on Turkey's trade and investment flows. In this environment the Development Programme, if implemented properly, can make a strong contribution to efforts to overcome the middle-income trap. So, the new government can focus again on internal economic problems that require structural reforms and can be tackled by following the earlier-announced roadmap. Statements that a number of economic reforms are in the pipeline to boost the Turkish economy following the November elections are encouraging.

Key points:

The government is currently working on a 100-day urgent action plan to fulfil election promises – the plan's details are expected to be announced soon. Ahead of the election, all political parties announced several promises. These promises envisaged raising the minimum wage, increasing social spending and abolishing the subcontracting system at public institutions, along with a few other measures to support household income. The AKP promises were the lowest-cost, at less than 1% of GDP.

Strategy:

FX: Improvement in political sentiment with continuity in government and a decline in the risk of another early election, as well as better appetite for EMs, have helped local asset markets recently, allowing the TRY to outperform other peer currencies, despite receding again in the past few days. Going forward, the evidence of a policy shift in economic areas should provide further support for the TRY, but in the medium term, the normalisation of US policy rates and concerns over global growth will continue to weigh on the performance of domestic markets.

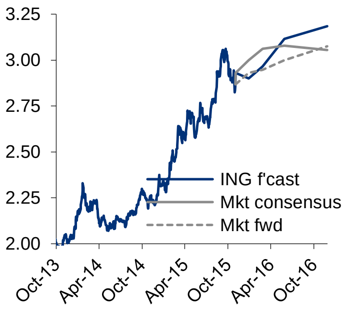
Local debt: Following easing political uncertainty with the repeat elections, we have seen a further drop from around 11.5% at end-Sep to 10% in 2Y bond benchmark yields, and from 11% to single digits in the long end of the curve. Despite a post-election rally, we have seen some pressure again given the difficult macro environment and challenging external funding conditions, along with reviving discussions about a new constitution, although we believe any news regarding structural reforms should be supportive.

Quarterly forecasts

	2Q15	3Q15	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F
Real GDP (%YoY)	3.8	3.2	2.6	2.3	2.8	3.4	3.7	3.5
CPI (%YoY) eop	7.2	7.9	8.1	7.1	6.9	6.7	7.1	6.9
Policy interest rate (%) eop	7.50	7.50	8.00	8.50	9.00	9.00	9.50	10.00
3-month interest rate (%) eop	11.34	12.18	11.12	11.01	11.00	11.00	11.00	11.00
10-year yield (%) eop	9.36	11.03	10.00	10.57	10.93	10.81	10.92	11.45
Exchange rate (USDTRY) eop	2.68	3.03	2.90	3.02	3.15	3.17	3.20	3.26
Exchange rate (EURTRY) eop	2.99	3.38	3.05	3.08	3.08	3.17	3.26	3.39

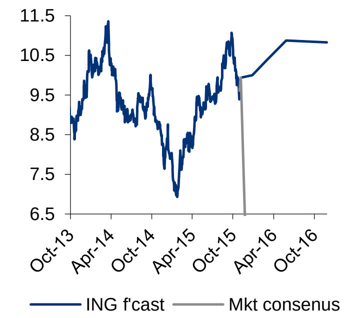
Source: Macrobond, ING estimates

USD/TRY



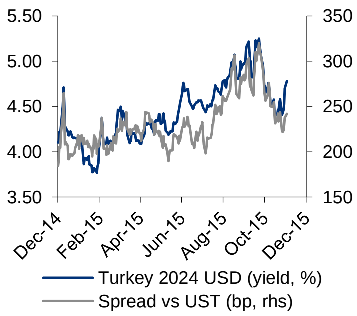
Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

Latest indicator surprises

Output	Positive
Consumption	Neutral
Inflation	Positive
External	Negative
Budget	Negative

Source: Bloomberg

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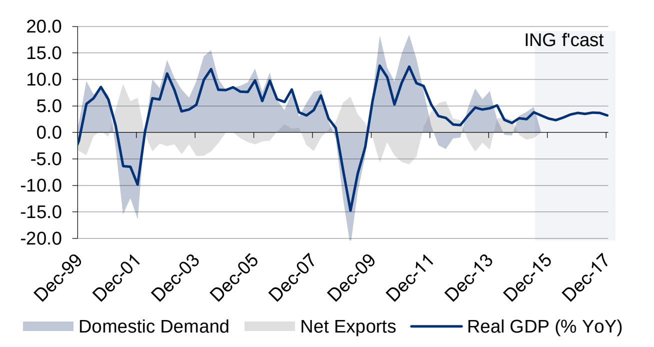
Fig 1 Real GDP (%YoY) and contributions (ppt)

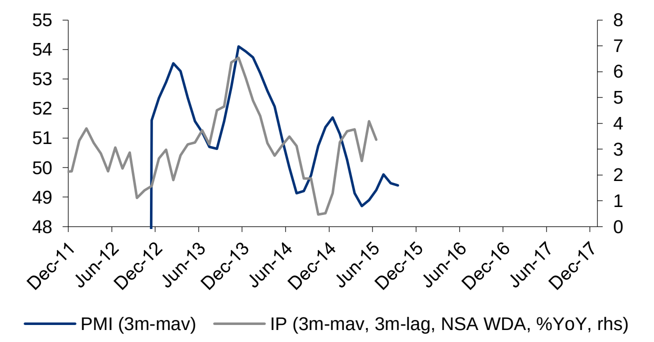


Source: Macrobond, ING estimates

Momentum loss in lending signals slowing activity

- Lending expansion has recently lost significant momentum, with FX-adjusted annual growth dropping from 20-25% in mid-June to single-digit levels at end-October. This is attributable not only to banks cutting down supply given slowing capital inflows, but also to low demand on the back of sluggish confidence and higher loan rates. This signals a slowdown in economic activity in 2H.
- Overall, domestic demand became the main driver of GDP growth in 1H, while net exports weighed on growth. Downside risks to the outlook are increasing, exacerbated by volatile and weaker capital flows as well as escalating geopolitical risks, although declining domestic political uncertainty might be a relief factor.

Fig 2 IP vs PMI

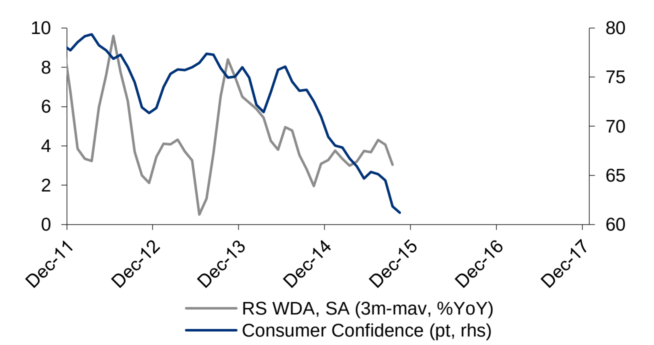


Source: Macrobond, ING estimates

Improvement in PMI, but still below 50 threshold

- Manufacturing PMI has been in contraction territory in 2015 so far, with the exception of May and July, and remained so in October, despite showing improvement to 49.5 from 48.8 a month ago. This data supports concerns about the growth outlook for 2H. In the breakdown, falling input and output price indicators hint at a moderation of inflationary pressures.
- September IP, on the other hand, was practically unchanged on a sequential basis following a far better August IP print than consensus expectations. Downside risks to the already modest growth outlook remained, although revived focus on structural reforms with the new government could provide support.

Fig 3 Retail sales vs consumer confidence

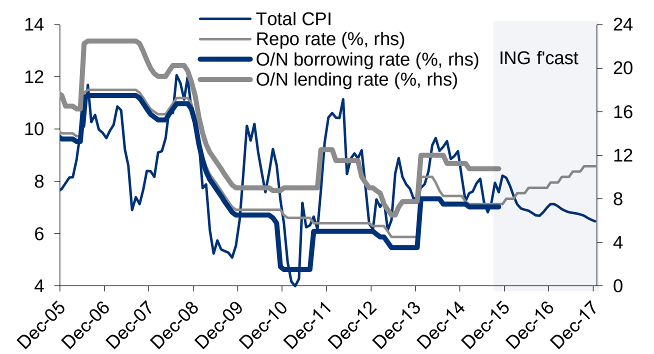


Source: Macrobond, ING estimates

Unemployment rate (SA) unchanged in July

- In the employment survey, the seasonally adjusted (SA) unemployment rate that started increasing after April 15 remained unchanged in July 15 at 10.4%, the highest reading this year. Labour force participation (SA), which remained broadly unchanged, helping the drop in the unemployment rate in 1Q, turned north in the past three months and hit an all-time high of 51.5%, driving up unemployment again.
- Given rapidly decelerating lending growth and consumer and business floating in short-term lows, domestic demand might weaken in the second half of 2015, which in turn might create further pressure in the labour market.

Fig 4 CPI vs policy rate

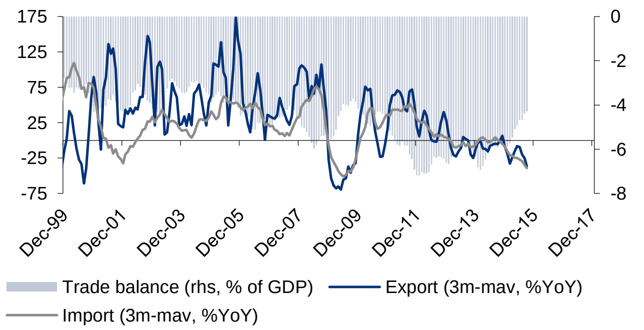


Source: Macrobond, ING estimates

Annual CPI inflation dropped temporarily

- CPI rose 1.55% last month. FX pass-through and seasonality impacted the monthly reading despite favourable food prices. Accordingly, annual CPI, which turned north in August and September, dropped in October from 7.95% to 7.58%, also contributed to by supportive base effects.
- Among core indicators, prices in H&I indicators rose 1.93% and 2.22%, respectively. As a result, annual inflation in the H&I indicators jumped to 8.74% and 8.92% from 8.26% and 8.23%. This shows the influence of cumulative TRY depreciation. An above-trend rise in clothing prices, with the highest monthly increase recorded in the past 15 years, also pushed up core inflation.

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

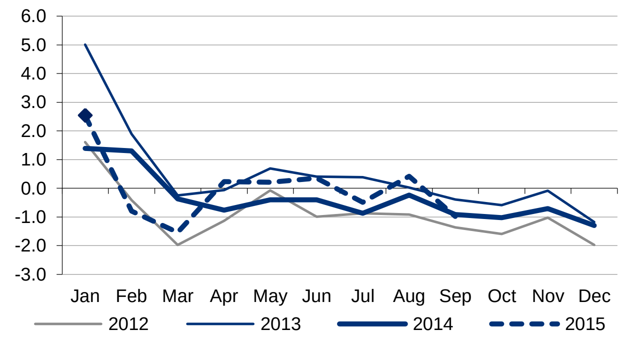


Source: Macrobond, ING estimates

Further improvement in foreign trade deficit

- The foreign trade deficit was USD3.7bn in September, pulling down the annual deficit, which showed a mild improvement in 2015 until August, to USD72.2bn from USD78.6bn two months ago. Exports, hit by weakness in the euro and major export markets such as Russia and Iraq, were USD11.7bn, down 14.2% in September alone. Imports, on the other hand, amounted to USD15.4bn, and dropped by a significant 25.2% YoY, continuing to register negative growth since Feb-14, mainly due to a plunge in the energy bill as well as weak domestic demand.
- September data hints that the improvement in external balances might continue in the last quarter of this year.

Fig 6 Budget performance YTD (% GDP)

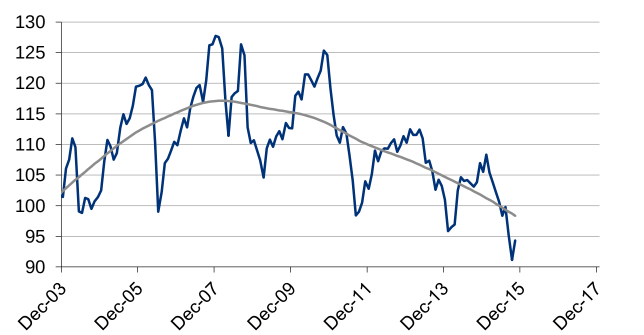


Source: Macrobond, ING estimates

2016 borrowing program

- The Treasury plans to reduce its domestic debt roll-over from 84.4% (estimated) in 2015 to 80.0% in 2016 given the drop in total debt redemptions in 2016 by about 1.1ppt relative to GDP, attributable to domestic debt being down by 1.2ppt.
- Of TRY93.6bn domestic debt redemption in 2016, TRY77.9bn will be made to the market (the remaining TRY15.7bn to public institutions with non-competitive sales). Assuming domestic borrowing from public institutions are rolled over totally (the usual assumption, while the Treasury has to meet total demand from these institutions), TRY59.2bn might be done from the market (corresponding to a market roll-over ratio of 76.0% in 2016).

Fig 7 FX: REER vs trend (index)



Source: Macrobond, ING estimates

Adjustment in CBT rhetoric

- In October MPC, the CBT dropped a reference to the shape of the yield curve. The bank has so far stressed a flat yield curve as clear proof of tight monetary policy, comparing short-term rates with 5-year bond yields to assess the slope of the curve.
- CBT recently adopted a strategy of simplifying its operational policy framework just after the Fed lift-off. The revision in the October MPC statement on how it defines policy tightness, though committing to a tight policy stance, can be seen a step in this direction by revising its rhetoric ahead of the transition to a single policy rate (implying a gradual pace by adjusting 1-week repo rate upward towards the centre of the corridor) and laying the groundwork.

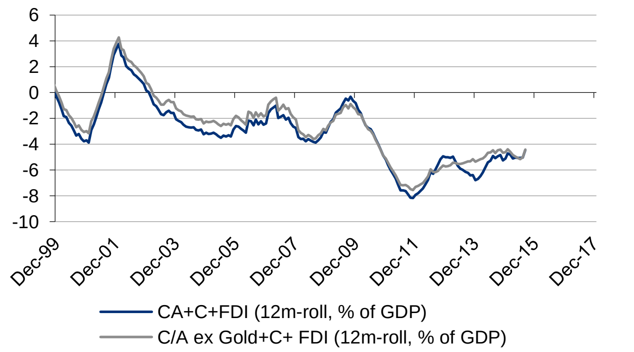
Fig 8 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Aug	74.8	Sep	75.9	Oct	75.5	-	76.4
Industrial Confidence	Aug	103.7	Sep	99.1	Oct	100.5	+	97
Industrial Production (SA WDA, MoM%)	Jul	-1.5	Aug	3.0	Sep	0.0	+	-0.9
Industrial Production (WDA, YoY%)	Jul	0.3	Aug	7.17	Sep	2.8	+	2.3
Consumer Confidence	Aug	62.4	Sep	58.5	Oct	62.8	+	55.55
Unemployment Rate (%)	May	9.3	Jun	9.6	Jul	9.8		9.8
GDP (SA WDA, QoQ%)	Q4	1.0	Q1	1.5	Q2	1.3	+	0.7
GDP (YoY%)	Q4	2.7	Q1	2.5	Q2	3.8	+	3.1
GDP (WDA, YoY%)	Q4	2.6	Q1	2.6	Q2	3.8	+	2.9
Core CPI (YoY%)C	Aug	7.7	Sep	8.2	Oct	8.9	+	8.5
CPI (YoY%)	Aug	7.1	Sep	8.0	Oct	7.6	-	7.8
PPI (YoY%)	Aug	6.2	Sep	6.9	Oct	5.7	-	7.0
1W Repo Rate Announcement (%)	Jul	7.50	Aug	7.50	Oct	7.50		7.50
Overnight Borrowing Rate Announcement (%)	Jul	7.25	Aug	7.25	Oct	7.25		7.25
Overnight Lending Rate Announcement (%)	Jul	10.75	Aug	10.75	Oct	10.75		10.75
Trade Balance ($bn)	Jul	-7.1	Aug	-4.9	Sep	-3.7	+	-4.0
Current Account ($bn)	Jun	-3.3	Jul	-3.2	Aug	-0.2	-	0.0

Source: Bloomberg

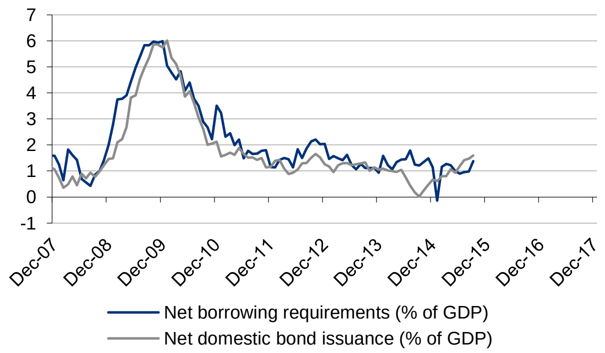
Additional charts

Fig 9 C/A (% of GDP) annual



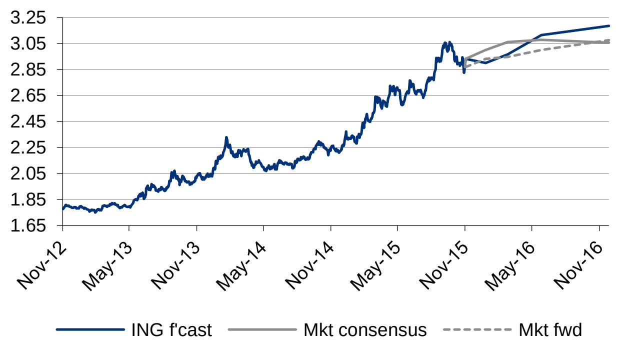
Source: Macrobond, ING estimates

Fig 10 Net borrowing requirements



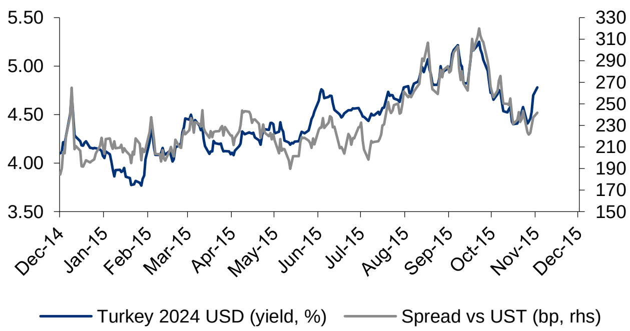
Source: Macrobond, ING estimates

Fig 11 USD/TRY



Source: Macrobond, ING estimates

Fig 12 External debt



Source: Macrobond, ING estimates

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