**Economics**
12 May 2016

# MonitorING Turkey

## Rising worries

**Following a reshuffle in Turkey's governing party, three issues will be important to markets: (1) the economy management team; (2) the constitution-making process; and (3) early elections. Initial signals from AKP circles hint that Mehmet Simsek will keep his position. Going forward, a constitutional change is likely to dominate politics, increasing the possibility of a referendum this year. However, given the difficulties on this front under the current parliamentary structure, calls for an early election might still be on the agenda, to benefit from the increasing public support seen in recent surveys and to consolidate power with the qualified majority needed to change the constitution without a referendum.**

### Key points

- The reaction of the new CBT management to the growing political risks will be key in two aspects - the extent of the easing cycle and the pace of cuts. The governor signalled that the bank would maintain policy simplification, with the final objective of a narrow interest rate corridor and a single policy rate, by gradually cutting the upper band while closely watching market developments. Before the latest developments, we expected a total 100bp cut in May and June. However, rising domestic political risks might lead the CBT to consider more gradual moves with 25bp cuts or a termination of the process sooner than earlier expected.

### Strategy

**FX:** Turkey's idiosyncratic risks have weighed on the currency lately, with close to 5% depreciation in the basket. Davutoglu's departure should prompt investors to question how the CBT will respond to TRY weakness. Given geopolitical risks with an impact on tourism and capital flows, as well as political uncertainty, the TRY is now more vulnerable.

**Local debt:** Turkish local rates have delivered a strong performance, attributable to a supportive external backdrop and the CBT's easing bias since Feb. However, this has reversed lately given growing political risk anticipation and the recent downbeat sentiment surrounding EM assets. We see limited potential for bond yields to decline given the expected increase in inflation, less portfolio inflows and concerns about a potential rating downgrade.

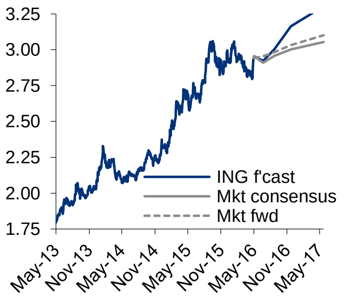
**External debt:** USD-denominated Turkey has returned an impressive 5.3% YTD. But we would argue for reducing exposure on domestic politics noise ahead. Relative value-wise, we like buying AZERBJ 4.75% 2024 US$ vs TURKEY 5.75% 2024 US$. We still do not see much point in arbitraging TURKEY vs SOAF, while we would look favourably at TURKEY 6.25% 2022 vs INDO 3.75% 2022 in a scenario of correcting oil prices.

**Quarterly forecasts**

| | 4Q15 | 1Q16 | 2Q16F | 3Q16F | 4Q16F | 1Q17F | 2Q17F | 3Q17F |
|---|---|---|---|---|---|---|---|---|
| Real GDP (%YoY) | 5.7 | 4.3 | 3.2 | 2.9 | 3.6 | 3.8 | 4.1 | 3.8 |
| CPI (%YoY) eop | 8.8 | 7.5 | 6.8 | 7.0 | 7.8 | 7.9 | 8.1 | 7.7 |
| Policy interest rate (%) eop | 7.50 | 7.50 | 7.50 | 7.50 | 7.50 | 7.50 | 8.00 | 8.00 |
| 3-month interest rate (%) eop | 11.47 | 11.07 | 10.22 | 10.02 | 9.85 | 10.00 | 10.15 | 10.30 |
| 10-year yield (%) eop | 10.74 | 9.95 | 9.34 | 9.62 | 9.87 | 10.23 | 10.89 | 11.09 |
| Exchange rate (USDTRY) eop | 2.92 | 2.82 | 2.92 | 3.06 | 3.20 | 3.26 | 3.33 | 3.39 |
| Exchange rate (EURTRY) eop | 3.17 | 3.18 | 3.22 | 3.37 | 3.52 | 3.75 | 3.89 | 4.00 |

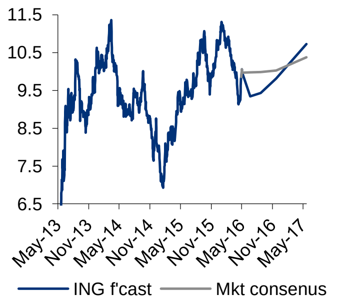
Source: Macrobond, ING estimates

**USD/TRY**



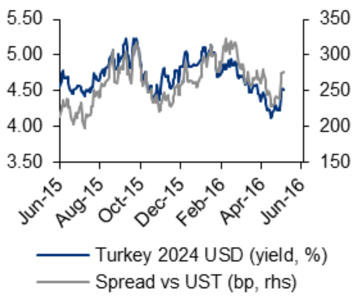

Source: Macrobond, ING estimates

**Local 10Y yields**




Source: Macrobond, ING estimates

**US$ Eurobond 10Y**




Source: Bloomberg, Reuters

**Latest indicator surprises**

| | |
|---|---|
| Output | Negative |
| Consumption | Positive |
| Inflation | Higher |
| External | Positive |
| Budget | Neutral |

Source: Bloomberg

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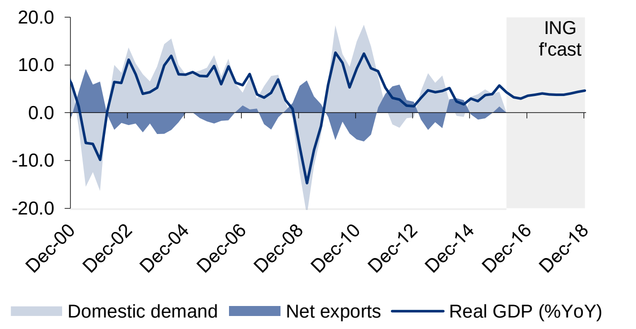
**Fig 1 Real GDP (%YoY) and contributions (ppt)**

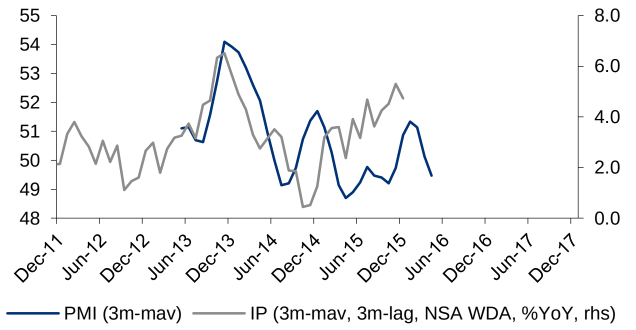



Source: Macrobond, ING estimates

### Increasing downside risks to growth

- Domestic demand should be supported by the Davutoglu government's easing economic policies aimed at delivering on election promises by hiking the minimum wage, raising pensions and public wages, and eliminating social security premiums for some of working population. However, the latest indicators hint at some momentum loss in activity given ongoing geopolitical risks and weak global trade dynamics still weigh on exports.
- Downside risks to growth are also increasing due to political risks returning with PM Davutoglu's decision to go to an extraordinary party congress and not be a candidate, while the current crisis with Russia shows the importance of geopolitical risks.

**Fig 2 IP vs PMI**

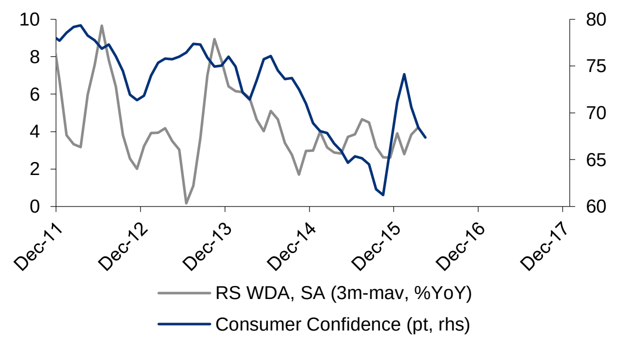



Source: Macrobond, ING estimates

### Weakening in March IP

- IP (calendar adjusted) has remained in positive territory, recording a 2.9% YoY increase in March. The seasonal adjusted (SA) IP index dropped by 0.5% on a sequential basis, the first negative reading after three consecutive positive figures.
- The volatile IP figures show a momentum loss, hinting that growth in 1Q might be lower than anticipated but will remain healthy due to a contribution from private consumption. However, not only IP data, but also other indicators highlight deceleration in growth – a further PMI drop in contraction territory, stagnant confidence indicators at relatively low levels and recent weakness in white goods and vehicle sales.

**Fig 3 Retail sales vs consumer confidence**

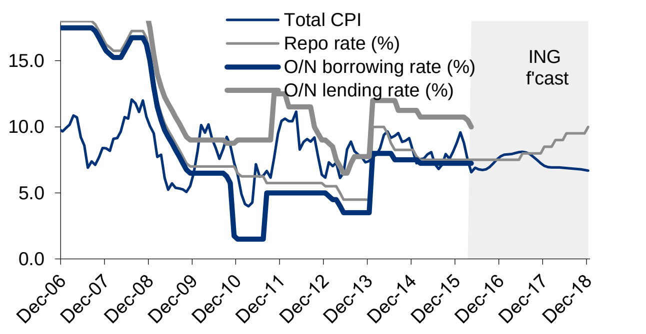



Source: Macrobond, ING estimates

### Temporary drop in unemployment

- The SA unemployment rate has been improving since November, with a drop to 10.1% as of January. Labour force participation (SA) remained broadly unchanged at around 51.6%, the all-time high, helping the unemployment rate in the past three months.
- This year, we expect the average unemployment rate to increase gradually due to ongoing problems in the tourism sector, which accounts for 7-8% of total employment when indirect sectors are included. Substantial minimum wage hikes should be another reason for the data on registered employment to show across-the-board weakness in the first month of the year.

**Fig 4 CPI vs policy rate**

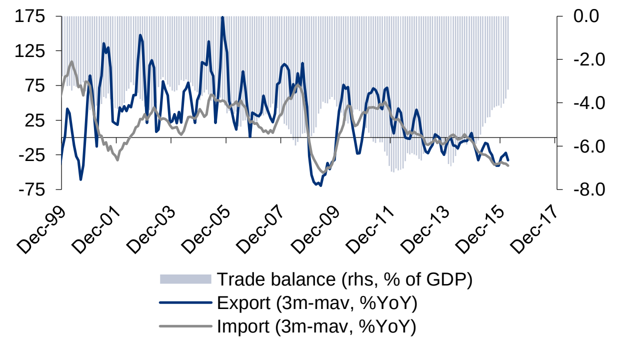



Source: Macrobond, ING estimates

### Inflation at a three-year low

- Annual inflation decelerated significantly due to a positive base, an unexpectedly sharp drop in food prices and TRY strength since mid-January, with a supportive global backdrop. However, given the volatility in the food group, we might see a reversal going forward. All core indices dropped in April, though the improvement in H&I indicators was limited once again. Accordingly, the CBT's favourable core inflation has remained close to double-digit levels, showing that improvement in the underlying trend is still modest, albeit encouraging.
- The data supports the CBT's easing bias as the bank has already signalled further rate cuts for as long as market conditions allow.

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

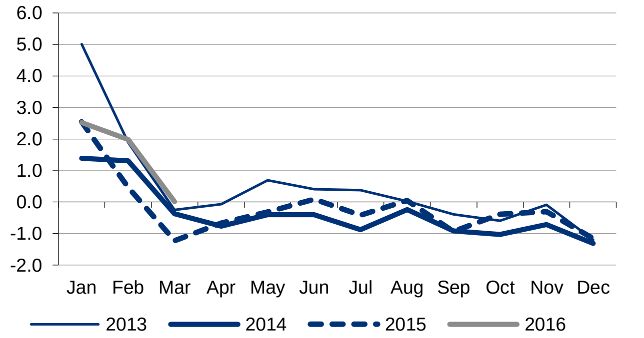



Source: Macrobond, ING estimates

**Further contraction in trade deficit**

- The foreign trade deficit was USD4.9bn in March, pulling the annual deficit – which has shown a long improvement since end-2013 and accelerated last year – down to USD60.1bn, the lowest level since Aug-10. The contraction is again due to lower oil prices, while exports were supported by a Eurozone recovery, supporting penetration of EU markets and still strong gold trade despite weakening demand from major oil exporters.
- As a result, coverage of imports by exports further exceeded the 70% threshold for the first time since the beginning of 2010. It is worth noting that the core trade deficit (excluding gold and oil) seems to have stabilised in the past five months.

**Fig 6 Budget performance YTD (% GDP)**

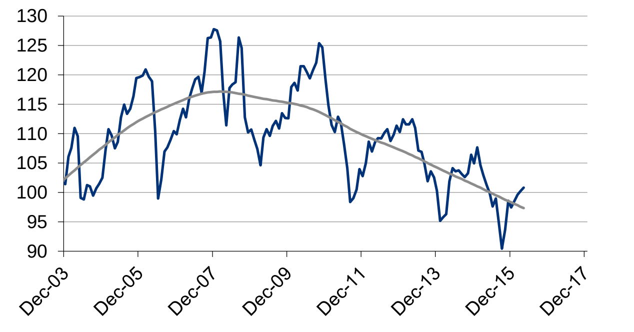



Source: Macrobond, ING estimates

**Budget revenues and expenses growing rapidly**

- In 1Q16, the central administration budget remained on balance, significantly up from the TRY5.4bn deficit in the same period last year, while the primary surplus of TRY16.5bn increased 30.4%.
- Registering a 16.4% YoY expansion, the strong revenue performance is attributable to income from prior privatisations implemented in 2015 and before, which amounted to TRY6.1bn. Expenditure grew rapidly, driven mainly by current transfers and personnel expenditure. According to the Minister of Finance, the surge in current transfers due to health, retirement and social aid expenditure is cyclical and fully expected.

**Fig 7 FX: REER vs trend (index)**




Source: Macrobond, ING estimates

**The CBT cut the lending rate again**

- The CBT delivered another cut at the upper band – by 50bp to 10.00%. Pricing in an easing cycle, both 2Y and 10Y bond yields had dropped by close to 90bp in April until the PMC meeting, also influenced by a supportive risk environment. However, it appears the CBT did not opt for a deeper cut, despite calls from politicians, as it is worried about a potential credibility loss.
- The global backdrop and consequent improvement in market sentiment, as well as recovering inflation, triggered the further cut from the CBT. Going forward, TRY performance, inflation dynamics and the extent of renewed political uncertainty should determine the extent of the cycle.

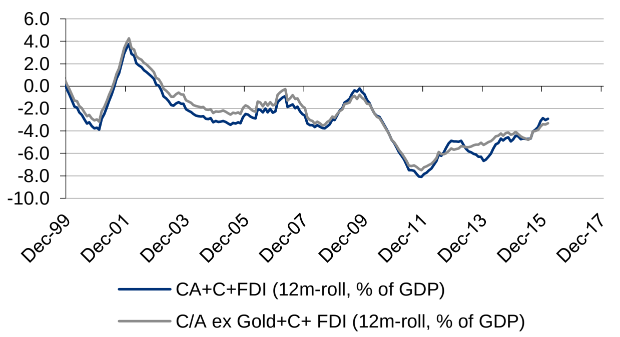
**Fig 8 Main macroeconomic recent releases**

| Indicator | Previous -2 | | Previous -1 | | Actual | | Surprise | Consensus |
|---|---|---|---|---|---|---|---|---|
| Capacity Utilisation (%) | Feb | 74.1 | Mar | 75.2 | Apr | 75.4 | | - |
| Industrial Confidence | Feb | 104.5 | Mar | 106 | Apr | 110.1 | + | 109 |
| Industrial Production (SA WDA, MoM%) | Jan | 1.0 | Feb | 0.5 | Mar | -0.5 | - | 0.1 |
| Industrial Production (WDA, YoY%) | Jan | 5.6 | Feb | 5.92 | Mar | 2.9 | - | 3.6 |
| Consumer Confidence | Feb | 66.64 | Mar | 67 | Apr | 68.5 | | - |
| Unemployment Rate (%) | Nov | 10.5 | Dec | 10.8 | Jan | 11.1 | - | 11.2 |
| GDP (SA WDA, QoQ%) | Q2 | 1.3 | Q3 | 1.2 | Q4 | 0.7 | | 0.7 |
| GDP (YoY%) | Q2 | 3.7 | Q3 | 3.9 | Q4 | 5.7 | + | 5.0 |
| GDP (WDA, YoY%) | Q2 | 3.8 | Q3 | 5.3 | Q4 | 4.1 | | 4.1 |
| Core CPI (YoY%) | Feb | 9.7 | Mar | 9.5 | Apr | 9.4 | + | 9.2 |
| CPI (YoY%) | Feb | 8.8 | Mar | 7.5 | Apr | 6.6 | - | 6.9 |
| PPI (YoY%) | Feb | 4.5 | Mar | 3.8 | Apr | 2.9 | + | 2.8 |
| 1W Repo Rate announcement (%) | Feb | 7.50 | Mar | 7.50 | Apr | 7.50 | | 7.50 |
| Overnight Borrowing Rate announcement (%) | Feb | 7.25 | Mar | 7.25 | Apr | 7.25 | | 7.25 |
| Overnight Lending Rate announcement (%) | Feb | 10.75 | Mar | 10.50 | Apr | 10.00 | | 10.00 |
| Trade Balance (US$bn) | Jan | -3.9 | Feb | -3.2 | Mar | -5.0 | + | -5.0 |
| Current Account (US$bn) | Jan | -2.2 | Feb | -2.0 | Mar | -3.7 | + | -3.9 |

Source: Bloomberg

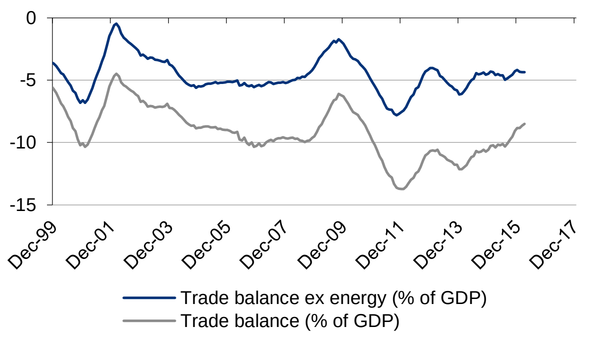
## Additional charts

**Fig 9 C/A (annual, % of GDP)**



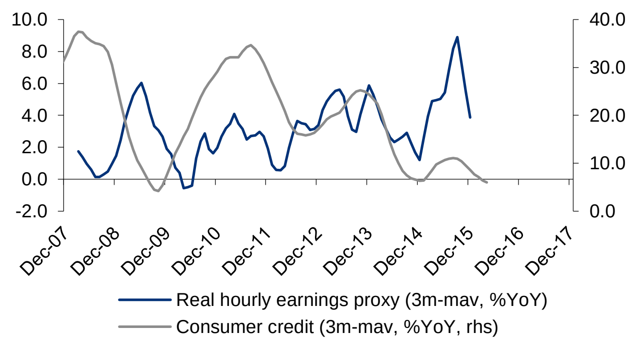

Source: Macrobond, ING estimates

**Fig 10 Trade balance (annual, % of GDP)**



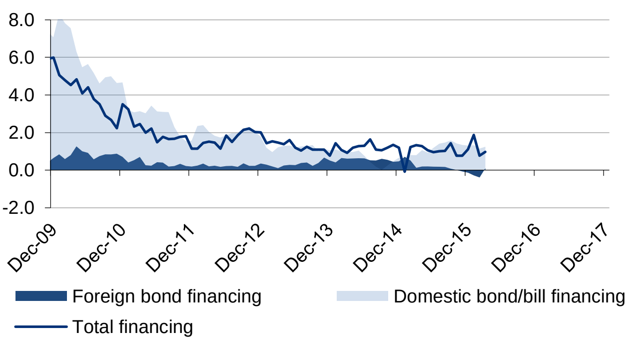

Source: Macrobond, ING estimates

**Fig 11 Real wages growth (%)**




Source: Macrobond, ING estimates

**Fig 12 Central govt borrowing (annual, % of GDP)**




Source: Macrobond, ING estimates

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