Economics
15 February 2016

MonitorING Turkey

Warming EU relations with difficult geopolitics

Geopolitical risks have increased in Turkey's neighbourhood, constituting a significant burden for its economic performance. In terms of the most important one – rising tensions with Russia and ongoing Syrian conflict – as long as tension remains limited with economic sanctions, Turkey is likely to be able to manage repercussions, mostly by diversifying its exports and finding alternative tourism partners. Although geopolitical dynamics exert pressure on the Turkish economy, warming relations with the EU, as a side effect, might prove to be an anchor again for Turkey, as both parties agreed on opening 'Chapter 17' (relating to economic and monetary policy), lifting visa requirements for Turkish citizens towards the end of this year and an initial EUR3bn of funding to ease Turkey's refugee burden.

Key points

- The CBT thinks that if it sees a permanent decline in global volatility or the policy tools specified in the August roadmap capping the effects of global volatility, then policy simplification will start. So it is safe to assume no action until the end of the governor's term in April. Given the global and domestic uncertainties, we expect this process to be more gradual. Now, we forecast the one-week repo rate at 9.0% in 2016, though we still expect the rate to reach 11% in 2017.

Fitch's rating review is scheduled to be held on 26 February. As long as the government adheres to budget discipline, the banking sector remains healthy and oil prices stay lower for longer, we do not expect a negative rating action in 2016.

Strategy

FX: In the short term, dovish statements from global central banks should support the currency, as we have observed recently, while lower oil prices have also contributed to a relatively better mood vis-à-vis the TRY. In fact, loose global monetary policies that help improve the capital flow outlook might further extend the outperformance period. However, long-term risk factors, like still-large financing risks, corporate-sector debt issues, domestic politics and geopolitical pressure remain, creating a cloudy outlook for the TRY.

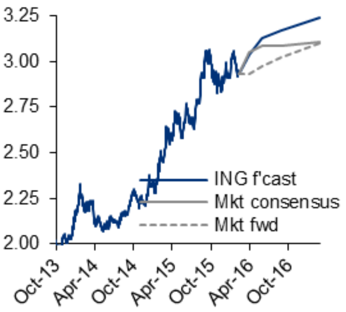
Local debt: Recently, we have seen a surge in risk aversion, with consequent intensification of effort to seek out safe havens. In this environment, the bond yield curve has relatively flattened, with a c.35bp drop in 10Y yields since mid-January, while 2Y yields have remained practically unchanged in the same period. We expect yields to remain elevated, given the difficult macro and political environment and challenging external funding conditions, while elevated inflation should support linkers.

Quarterly forecasts

	4Q15	1Q16F	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F
Real GDP (%YoY)	4.2	3.0	3.4	3.4	3.8	3.9	4.0	3.8
CPI (%YoY) eop	8.8	9.0	8.7	8.5	8.3	7.6	7.4	7.2
Policy interest rate (%) eop	7.50	7.50	8.50	9.00	9.00	9.50	10.00	10.50
3-month interest rate (%) eop	11.47	11.16	11.02	11.00	11.00	11.10	11.04	10.89
10-year yield (%) eop	10.74	10.14	10.25	10.76	10.70	11.75	12.33	11.90
Exchange rate (USDTRY) eop	2.92	3.00	3.08	3.16	3.20	3.26	3.33	3.39
Exchange rate (EURTRY) eop	3.18	3.24	3.23	3.32	3.52	3.65	3.83	4.00

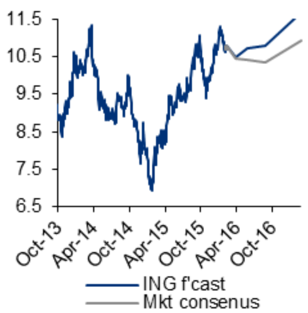
Source: Macrobond, ING estimates

USD/TRY



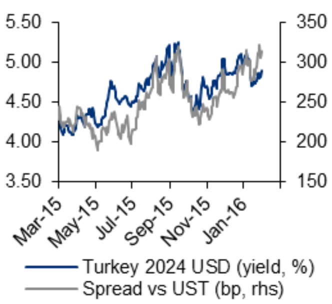
Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

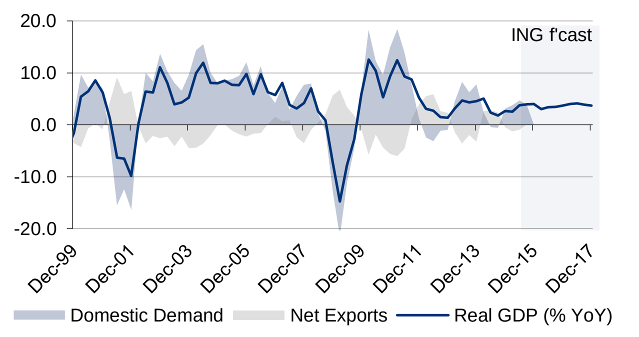
Latest indicator surprises

Output	Neutral
Consumption	Positive
Inflation	Higher
External	Negative
Budget	Neutral

Source: Bloomberg

Muhammet Mercan
Chief Economist
Istanbul +90 212 329 0751
muhammet.mercan@ingbank.com.tr

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

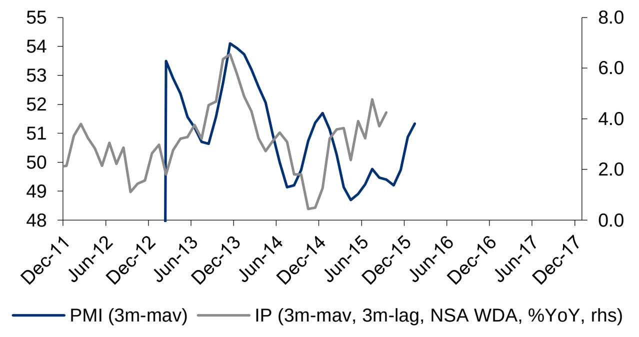


Source: Macrobond, ING estimates

Resilient growth performance

- Growth surprised last year, despite a difficult global environment, political uncertainty during the long election cycle and ongoing geopolitical risks. We forecast 3.6% growth for last year and the outlook should remain solid this year at 3.4%, supported by easing economic policies, especially due to election promises, though the capital flow outlook and tension with Russia continue to be drags.
- A credible reform program and dedicated implementation should support the long-term growth outlook, albeit a 4.5% GDP growth estimate in the recently announced revised MTP is quite optimistic, in our view. The government maintains a growth focus with strong willingness to deliver on the structural reform agenda.

Fig 2 IP versus PMI

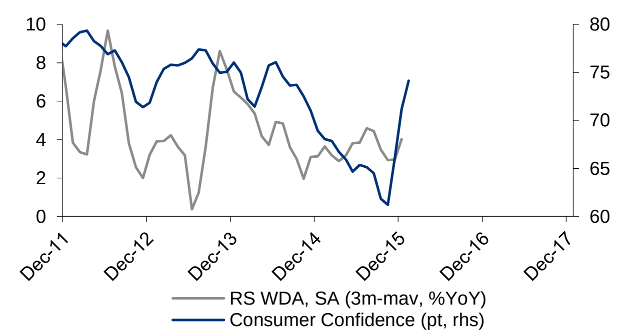


Source: Macrobond, ING estimates

Seasonally adjusted IP at an all-time high

- IP (calendar adj) recorded a 4.5% YoY increase in December, while seasonally adj (SA) IP expanded by 0.8% on a sequential basis, and hit an all-time high level. Accordingly, the QoQ change in the three-month average IP (SA) stood at 0.9%, well above that anticipated earlier, though it dropped a little from the 1.2%, 1.3% and 1.0% recorded in the first three quarters of 2015, respectively.
- The data hints at a growth of c.3.5-4.0% in 4Q, which should help secure a performance above the 3.5% seen last year. Only production in non-durable consumer goods remained in negative territory in 4Q15, though energy – the driver of performance in 3Q15 with 5.0% – decelerated to only 0.9% in the following quarter.

Fig 3 Retail sales versus consumer confidence

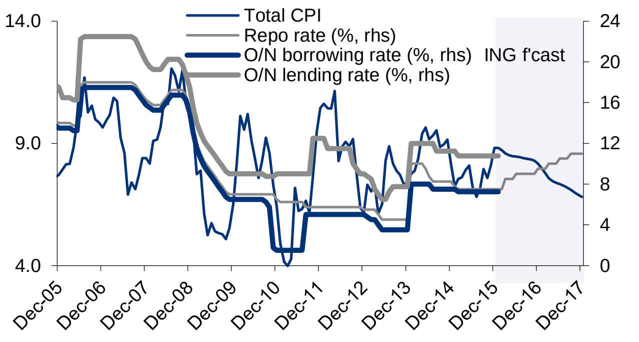


Source: Macrobond, ING estimates

Robust retail sales

- Retail sales came in at 4.9% YoY in December alone, on the back of a sharp increase in fuel sales, which remained in positive territory since Aug-14 and were supported by better demand due to lower energy prices. In SA terms, sequential growth remained flat, as the strength in fuel was offset by a drop in food sales.
- The recovery in consumer confidence on the back of lower political risk premium in the aftermath of November general elections, more room for spending attributable to the fall in oil prices and the effects of the recent wage developments on purchasing power are projected to boost consumption demand. Accordingly, further acceleration is likely to occur in retail sales this year.

Fig 4 CPI versus policy rate

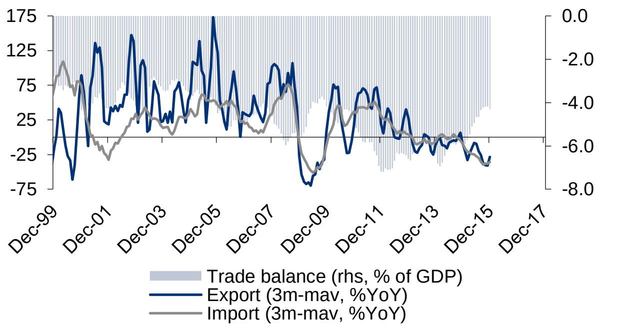


Source: Macrobond, ING estimates

Inflation outlook worsens

- CPI rose 1.8% last month, driven by stubborn food prices and alcoholic beverages & tobacco, albeit supported by seasonality in clothing. Annual CPI that was climbing since July, with the exception of October, reached 9.58%, from 8.81% a month ago.
- Overall, annual inflation maintained its uptrend and hit its highest level since May-14. Despite expectations of lower FX pass-through on inflation ahead and supportive base effects, the annual figure is likely to remain elevated in the coming period, given pressure on food prices and the ongoing impact of wage hikes. As a result, this year could be challenging for the CBT, though we think that a downbeat start to 2016 will not change its stance.

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

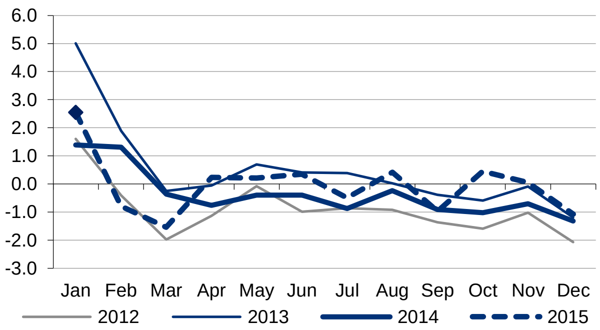


Source: Macrobond, ING estimates

Continuing improvement in the trade deficit

- Improvement in the external balances has become more pronounced since August, supported by Eurozone recovery (which is crucial for the external demand for Turkish exports) and a further drop in already low oil prices. Accordingly, the annual deficit has widened to USD63.3bn, the lowest level since Sep-10.
- This trend should prevail, though punitive economic sanctions introduced by Russia against Turkey might create pressure on external balances, given its close trade ties. For a sustained improvement, the government should be decisive on the structural reforms aimed at increasing savings, supporting the investment climate and reducing import dependency in favour of more exports.

Fig 6 Budget performance YTD (% of GDP)

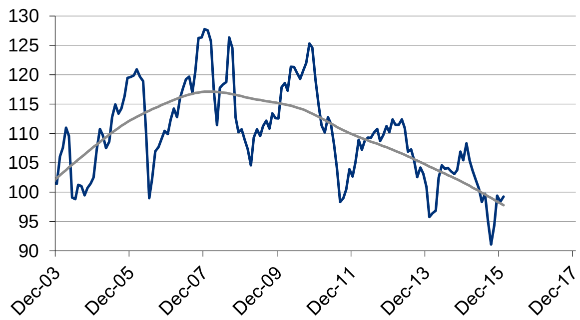


Source: Macrobond, ING estimates

The fiscal situation is under control

- Public finances performed strongly in 2015, with a budget deficit-to-GDP ratio of c.1.3%, lower than anticipated earlier, despite the long election cycle. The figure is attributable to strong revenue expansion and a modest increase in interest expenses, though primary expenses have grown markedly. Improvement in primary surplus was also healthy, though below the target set at end-2014.
- Despite an upward revision in the recently updated MTP, from 0.7% of GDP to 1.3% due to the additional cost of election promises, the budget deficit target still looks ambitious for 2016. Though we forecast 1.6%, it still remains relatively lower and continues to be a major driver of Turkey's investment grade rating.

Fig 7 FX: REER versus trend (index)



Source: Macrobond, ING estimates

Cautious over the sustainability of TRY strength

- Turkish residents generally move against sharp swings in the FX market. This time, in spite of a sharp depreciation of the TRY, these FX-deposit holders have preferred to accumulate further, rather than switch to TRY deposits, with a US$46.3bn increase in their holdings between May-13 and Oct-15. However, there are some signals of a behavioural change again since the November elections, as residents have reduced FX holdings by USD7.1bn.
- Dovish statements from global central banks supported risk appetite recently for EM currencies. Yet, we remain cautious over the sustainability of TRY strength, given concerns about policy implementation, geopolitical risks and ongoing macro imbalances.

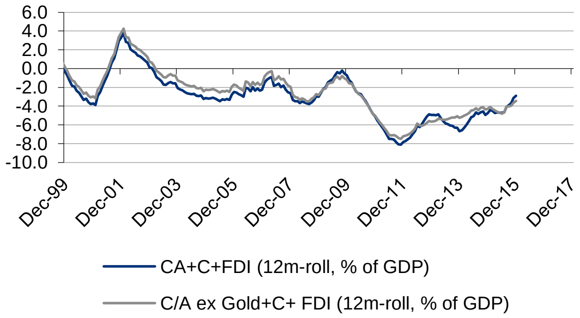
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Nov	75.9	Dec	75.8	Jan	74.9		-
Industrial Confidence	Nov	105.2	Dec	102.2	Jan	103.3		-
Industrial Production (SA WDA, MoM%)	Oct	0.2	Nov	-0.8	Dec	0.8	-	1.2
Industrial Production (WDA, YoY%)	Oct	4.6	Nov	3.6	Dec	4.5	+	3.6
Consumer Confidence	Nov	77.15	Dec	73.58	Jan	71.6		-
Unemployment Rate (%)	Sep	10.3	Oct	10.5	Nov	10.5	-	10.8
GDP (SA WDA, QoQ%)	Q1	1.5	Q2	1.4	Q3	1.3	+	0.4
GDP (YoY%)	Q1	2.5	Q2	3.8	Q3	4.0	+	2.7
GDP (WDA, YoY%)	Q1	2.6	Q2	3.8	Q3	5.4	+	3.3
Core CPI (YoY%)	Nov	9.2	Dec	9.5	Jan	9.6	+	9.5
CPI (YoY%)	Nov	8.1	Dec	8.8	Jan	9.6	+	9.5
PPI (YoY%)	Nov	5.3	Dec	5.7	Jan	5.9	-	6.1
1W Repo Rate announcement (%)	Jul	7.50	Aug	7.50	Jan	7.50		7.50
Overnight Borrowing Rate announcement (%)	Jul	7.25	Aug	7.25	Jan	7.25		7.25
Overnight Lending Rate announcement (%)	Jul	10.75	Aug	10.75	Jan	10.75		10.75
Trade Balance (US$bn)	Oct	-3.7	Nov	-4.3	Dec	-6.2	-	-6.0
Current Account (US$bn)	Oct	-0.4	Nov	-2.2	Dec	-5.1	-	-5.0

Source: Bloomberg

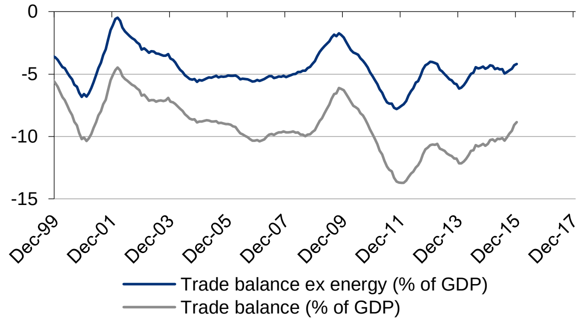
Additional charts

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



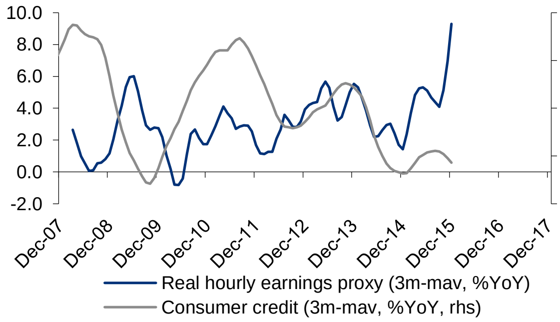
Source: Macrobond, ING estimates

Fig 10 Trade balance (annual)



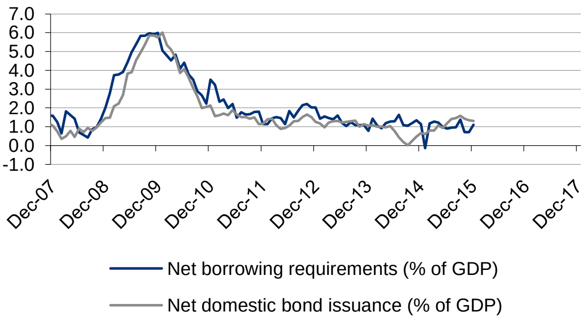
Source: Macrobond, ING estimates

Fig 11 Real wages



Source: Macrobond, ING estimates

Fig 12 Govt central borrowing requirements (annual)



Source: Macrobond, ING estimates

ING Bank A.Ş. Economic Research Group

Muhammet Mercan Chief Economist + 90 212 329 0751 muhammet.mercan@ingbank.com.tr

DISCLAIMER:

Investment information, comments and recommendations stated here, are not within the scope of investment advisory activity. Investment advisory service is provided in accordance with a contract of engagement on investment advisory concluded between brokerage houses, portfolio management companies, non-deposit banks and clients. Comments and recommendations stated here rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not fit to your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely to this information stated here may not bring about outcomes that fit your expectations.

This report has been prepared by ING Bank A.Ş. Economic Research Group solely for the information purposes of its readers. While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, ING Bank A.Ş. makes no representation that it is accurate or complete. The information contained herein is subject to change without notice. Neither ING Bank A.Ş. nor any of its officers or employees accepts any liability for any direct or consequential loss arising from any use of this report or its contents.

ING Bank A.Ş. is responsible for the distribution of this report in Turkey.