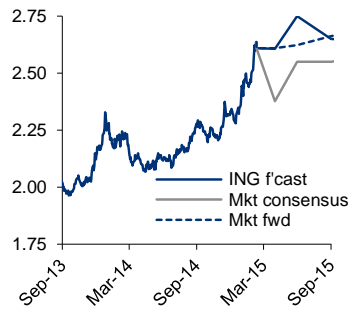


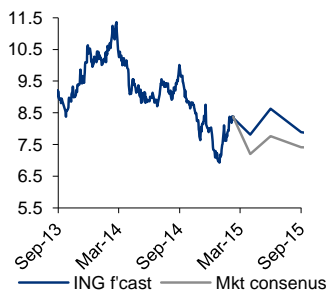
Economics  
13 March 2015

**USDTRY**



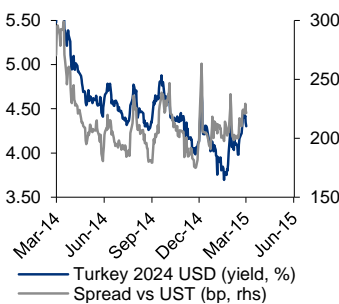
Source: EcoWin, ING estimates

**Local 10Y yields (%)**



Source: EcoWin, ING estimates

**US\$ Eurobond (2024)**



Source: Bloomberg

**Latest indicator surprises**

Output	Negative
Consumption	Neutral
Inflation	Neutral
External	Positive
Budget	Neutral

Source: Bloomberg

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## Higher rate path?

Controlled loan growth, modest activity and softness in oil prices continued to support external rebalancing. We think the c/a deficit-to-GDP ratio will improve further and close this year below 5%. Regarding inflation, the downtrend in core indicators continued despite a slight increase in the headline CPI, due to the impact of weaker TRY and recent rise in oil on transportation prices and hike in food prices attributable to adverse weather conditions. Despite expectations that lower oil prices and the ongoing easing cycle would support domestic demand, supply-side indicators signal some downside risks to growth in 2015.

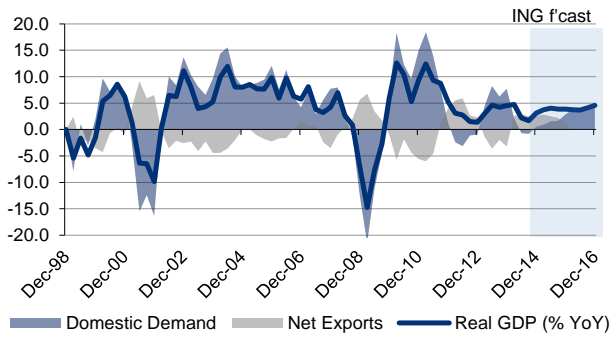
- CBT made continuation of the easing cycle conditional on improvement in the inflation outlook, and any rate-cut action should also be determined by market volatility. Given vulnerability to bouts of risk aversion with the Fed's lift-off getting closer, recently the TRY has depreciated significantly against the USD and a 50:50 USD:EUR basket. In this environment CBT might be more reluctant to cut policy rates and maintain a cautious stance, at least until they get a better idea of the Fed's next move, hinting at a higher policy rate path.
- We have raised our year-end CPI forecast from 6.5% to 6.8%, incorporating TRY weakness and the recent rebound in oil prices.
- The main focus over the month ahead will be the February MPC. We think the CBT will remain mute. Going forward, we continue to see scope for some further policy easing.
- **FX:** Political statements exerting pressure on the CBT to aggressively cut policy rate/s caused TRY to decouple from other EM peers from end-January. Going forward, we expect **the currency to remain under a weakening bias, but the authorities are committed, in our view, to preventing an abrupt move.**
- **Local debt:** Positive sentiment has reversed since the beginning of February, leading to a c.125bp increase on the long end, and a much higher 200bp on the short end. Despite the ongoing inflation story, the curve will remain inverted, with increasing risk anticipation from the political side, in our view. The sub-7% levels realised at end-January may not be seen for a while. **Yet, there is considerable daylight above this level currently, and we find the 5Y segment attractive at c.8.50%.**
- **External debt:** TRY volatility caused a more than 20bp increase in CDS premiums, with consequent pressure on Eurobond yields. **We prefer the front end of the US\$ papers, given their pricing-in of a rating downgrade.**

**Quarterly forecasts**

	3Q14	4Q14	1Q15F	2Q15F	3Q15F	4Q15F	1Q16F	2Q16F
Real GDP (%YoY)	1.7	3.1	3.7	4.0	3.8	3.9	3.7	3.7
CPI (%YoY) eop	8.9	8.2	7.1	5.8	6.4	6.8	6.3	6.3
Policy interest rate (%) eop	8.25	8.25	7.50	7.00	7.00	7.00	7.00	7.00
3-month interest rate (%) eop	10.95	10.02	9.11	9.50	8.37	7.86	7.42	7.37
10-year yield (%) eop	9.95	8.02	7.88	8.63	7.89	7.71	7.59	7.57
Exchange rate (USD/TRY) eop	2.28	2.33	2.58	2.75	2.65	2.60	2.63	2.65
Exchange rate (EUR/TRY) eop	2.88	2.82	2.71	2.75	2.60	2.47	2.42	2.39

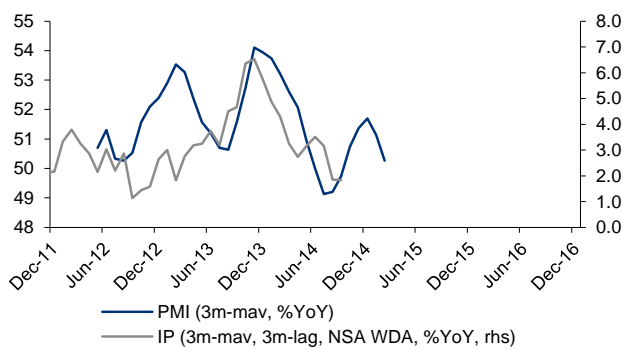
Source: EcoWin, ING estimates

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



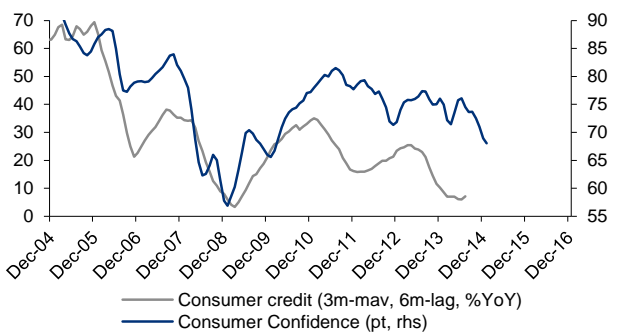
Source: EcoWin, ING estimates

**Fig 2 IP versus PMI**



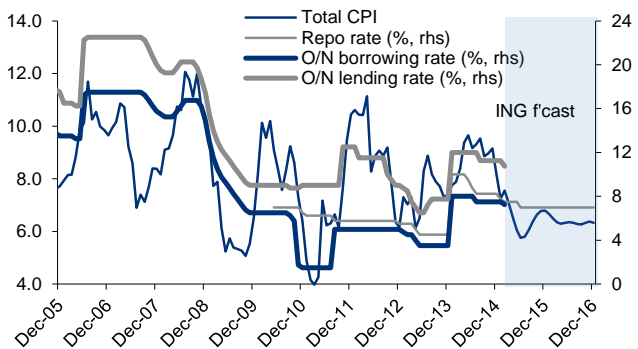
Source: EcoWin, ING estimates

**Fig 3 Consumer confidence versus credit**



Source: EcoWin, ING estimates

**Fig 4 CPI versus policy rate**



Source: EcoWin, ING estimates

**Domestic demand to improve in 2015F**

- In 2014, private domestic demand softened from 1Q onwards and contributed little to annual growth, due to decelerating household borrowing stemming from macro-prudential measures introduced by the BRSA and the CBT's substantial rate hike in Jan 2014.
- Sluggish domestic demand was to a large extent offset by improving net exports, given export resilience and lower non-monetary gold imports.
- We expect a better growth outlook in 2015F, supported by lower oil prices, with a consequent recovery in private consumption expenditure. Public consumption and investments are expected to remain strong ahead of the June parliamentary elections.

**IP remained weak in January**

- January IP fell 2.23% YoY, worse than consensus of 1.60%, translating into a sharp 1.22% MoM contraction in seasonally adjusted (SA) indicators. The data indicates a sluggish start to 2015, following negative growth in 4Q14, due especially to weak October and November IP readings.
- Overall, despite expectations that lower oil prices since Sep 2014 and the ongoing easing cycle would support domestic demand, January IP data signals growing downside risks to growth in 2015, on the back of upside pressure on the currency and rates, stemming from volatility in global financial markets and political pressure on the CBT to cut rates significantly.

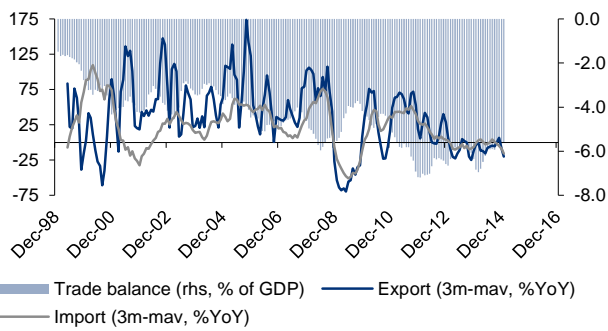
**Slight increase in consumer confidence, but still low**

- Consumer confidence that dropped significantly from 74.0 in Sep 2014 to 67.7 in Jan 2015, improved marginally to 68.1 in the second month of the year, especially due to better employment expectations and the rising probability of borrowing and consumption, stemming from the start of the easing cycle. However, weaker TRY, with intensifying pressure on the CBT to deeply cut rates, holds back further improvement in confidence.
- Annual credit expansion stood at 19.10% at end-Feb, thanks to strong 23.9% growth in lending to companies, while retail lending remained slow with a mere 8.7% increase. Volume growth should remain healthy, with easing financial conditions.

**Core indicators down in February**

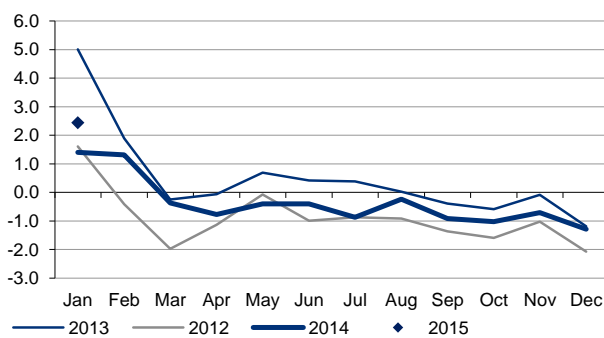
- The disinflation process may be more difficult than envisaged earlier. In February, we saw some pressure on transportation prices on the back of slightly higher oil prices globally and the weaker TRY. Additionally, adverse weather conditions weighed on food prices, with a 6.2% increase in the first two months.
- It should be noted that the downtrend in core indicators has continued so far, signalling a continuation of improvement in the outlook. In particular, H and I indices slowed markedly on an annual basis from 9.36% and 8.63% to 8.44% and 7.73%, respectively.
- Despite a rise in headline CPI, we continue to expect inflation to decelerate further on the back of favourable base effects.

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



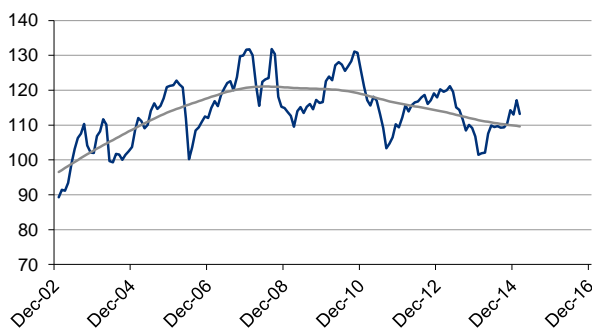
Source: EcoWin, ING estimates

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



Source: EcoWin, ING estimates

**Fig7 FX: REER versus trend (index)**



Source: EcoWin, ING estimates

**Further improvement in external balances**

- The foreign trade deficit came at USD4.3bn in January, pulling annual deficit down to USD82bn from USD84.5 a month ago. Exports stood at USD12.3bn, down 0.6% YoY, while imports amounted to USD21.6bn, contracting by a significant 13.7% YoY.
- Sluggish imports are stemming from a downtrend in commodity prices. Exports, on the other hand, turned out to be weak, on the back of a lesser number of business days and the impact of a sharp drop in EUR/USD parity.
- Accordingly, the 12M-rolling deficit maintained its general improving trend since end-2013; excluding gold and energy, it dropped to the lowest level since end-2010.

**A good start to 2015**

- The budget surplus doubled to TRY3.8bn in January, on the back of weak expenditure growth and better performance on the revenue side as tax revenues grew notably.
- On the spending side, primary expenditure grew by a mere 1.1% YoY, driven by current transfers (mainly to social security institutions), followed by capital expenditure.
- On the revenue front, we see relatively higher growth with 5.3% YoY, while tax income generation was stronger, up 6.6% YoY. Going into detail, tax income added 5.7ppt to the headline increase, standing as the main driver of revenue generation, attributable to income tax, domestic VAT and special consumption tax.

**Political risk weighs on TRY**

- With an increasing political risk premium due to pressure to cut rates sooner and significantly, and consequent distortion in the CBT's policy signals, we see weakness in the currency from the beginning of February.
- Accordingly, REER that increased from 101.5 in Jan 2014 (the lowest level since Jun 2006) to 117.1 in Jan 2015, above the long-term average, dropped markedly in February to 113.2. Given ongoing volatility, we might see another fall in March REER.
- Weaker TRY is a major concern for the inflation trajectory as FX pass-through is still strong, given that a persistent 10% TRY depreciation adds 1.2-1.3ppt to the CPI in a year.

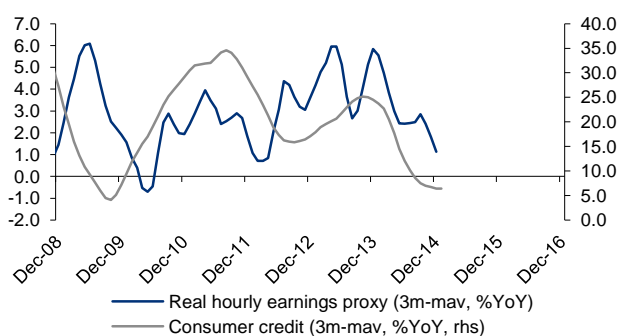
**Fig 8 Recent main macroeconomic releases**

		Previous-2		Previous-1		Actual	Surprise	Consensus
Capacity utilisation (%)	Dec	74.6	Jan	73.7	Feb	72.8	-	-
Industrial confidence	Dec	101.2	Jan	103.2	Feb	103.4	-	-
Industrial production (SA WDA, MoM%)	Nov	-0.2	Dec	0.7	Jan	-1.4	-	1.0
Industrial production (WDA, YoY%)	Nov	0.6	Dec	2.53	Jan	-2.2	-	2.7
Consumer confidence	Dec	67.7	Jan	67.7	Feb	68.1	+	68
Unemployment rate (%)	Sep	10.5	Oct	10.4	Nov	10.7	+	10.45
GDP (SA WDA, QoQ%)	Q1	1.8	Q2	-0.5	Q3	0.4	+	0.4
GDP (YoY%)	Q1	4.8	Q2	2.2	Q3	1.7	-	2.8
GDP (WDA, YoY%)	Q1	4.8	Q2	2.5	Q3	1.8	-	2.8
Core CPI (YoY%)	Dec	8.7	Jan	8.6	Feb	7.7	-	8.2
CPI (YoY%)	Dec	8.2	Jan	7.2	Feb	7.6	+	7.4
PPI (YoY%)	Oct	6.8	Nov	5.7	Dec	7.0	-	-
1W repo rate announcement (%)	Dec	8.25	Jan	7.75	Feb	7.50	-	7.50
Overnight borrowing rate announcement (%)	Dec	7.50	Jan	7.50	Feb	7.25	+	7.00
Overnight lending rate announcement (%)	Dec	11.25	Jan	11.25	Feb	10.75	-	11.00
Trade balance (US\$bn)	Nov	-8.3	Dec	-8.5	Jan	-4.3	+	-4.6
Current account (US\$bn)	Nov	-5.7	Dec	-6.8	Jan	-2.0	+	-2.8

Source: Bloomberg

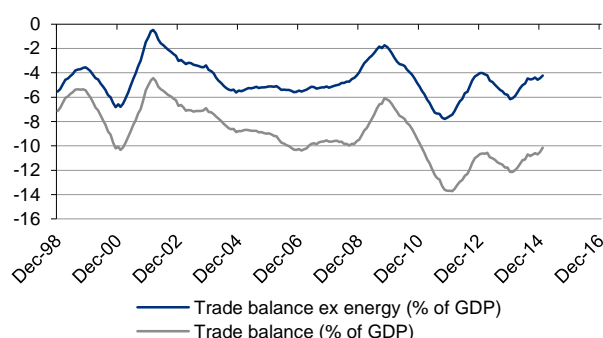
### Additional charts

**Fig 9 Wages and credit growth**



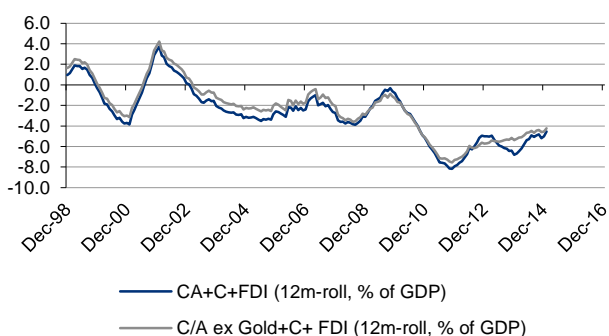
Source: EcoWin, ING estimates

**Fig 10 Trade balance (annual)**



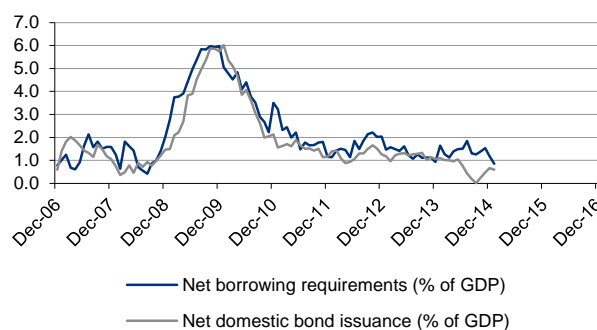
Source: EcoWin, ING estimates

**Fig 11 Current & capital accounts + net FDI**



Source: EcoWin, ING estimates

**Fig 12 Govt central borrowing requirements (annual)**



Source: EcoWin, ING estimates

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