Economics and Strategy

21 May 2014

Turkey

Assessing the possibility of an imminent rate cut

The historical relationship between the business cycle and CBT decisions shows that, in addition to inflation indicators, the CBT also closely watches the pace of the economy in its decision-making process – just as a dual mandate central bank does. A slowdown in lending and a relatively cautious business sentiment is already impacting IP growth.

Sequential IP performance, along with ongoing currency stability and the sharper than expected improvement in external balances. may create a case for a measured rate cut after the presidential elections towards the last quarter of the year. We attach a low probability to an imminent rate cut, with headline inflation at the end of April remaining close to short-term highs. Core inflation is more a cause for concern.

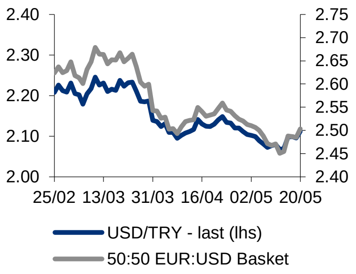
Despite market volatility and weakening confidence indices, especially at the beginning of the year, industrial production growth has been stable, if not better than expected. Along with the IP performance in the first two months of the year, the latest data suggest that GDP growth in 1Q14 might be close to average growth rates in recent years. However, on a sequential basis, adjusted IP growth remained weak at -0.4% MoM, after -0.3% MoM growth in February.

The question now is whether the end of uncertainty and improved investor sentiment will be reflected in the real economy. In order to observe the pace of the economic activity, we have constructed a business cycle clock (BCC) as also used by the OECD. The results suggest that the Turkish economy has entered slowdown since January. The movement in the index leads to the more general conclusion that the previous strong growth era is over, at least in the medium term, also supporting our growth calls. Comparing historical evidence with BCC and CBT actions, we expect the Bank to wait past the next few meetings to ensure proper timing for a rate cut, with more IP data to assess whether the slowdown in the economy and the possibility of contraction remain. With the CBT's wish to see a significant improvement in the inflation outlook, something which might start after reaching its peak in May, and the possibility of uncertainty returning with the presidential elections, we expect the first rate cut in the Fall. This is also in line with the findings from the BCC.

FX: We expect the currently favorable outlook to remain in place for the short-term. Additionally we may see a rate cut, possibly after the presidential elections. Any move will likely be influenced by improvement in risks associated with TRY assets, the extent of any slowdown in credit growth and the success of disinflation efforts. Such a move, if it materializes, could eventually pressure the TRY back towards 2.20 at the end of year.

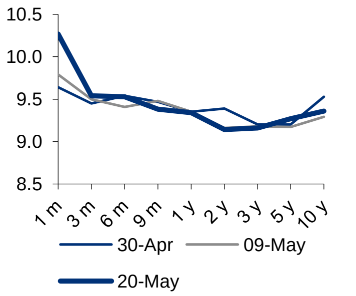
Domestic debt: In a relatively benign environment for risk we have witnessed a drop in 2YR benchmark yields of more than 200bp, also supported by recent rate cut signals from the CBT. However, given current real yields (measured by the spread between 2YR benchmark bond yields and 2YR CPI expectations), the risk-reward balance does not seem so attractive. In addition, in the short term and in the current inflation environment, we do not expect 2YR yields to fell below 8.5%. A movement below this level looks only possible if there are international movements that might support the whole curve, something which has low probability. Hence, for the rest of the year we expect a gradual increase in the level of global and domestic uncertainty.

USD/TRY, 50:50 EUR:USD basket



Source: Thomson Reuters

Bond yield curve (% cmp)



Source: ISE

Key macro forecasts

	2014F	2015F	2016F
Real GDP (%YoY)	3.0	4.0	4.5
CP (end-year %YoY)	8.5	6.3	5.6
Consolidated Gov't Balance (% of GDP)	-2.3	-1.9	-1.7
Current Account Balance (% of GDP)	-5.7	-6.2	-6.7
USD/TRY (end-year)	2.20	2.10	2.00
EUR/TRY (end-year)	2.86	2.52	2.60

Source: ING estimates

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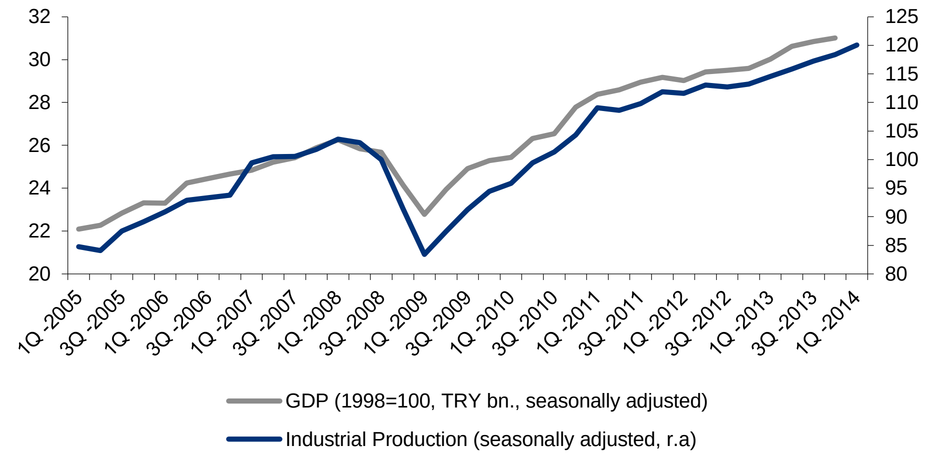
Turkish economy and Business Cycle Clock

We look at the Business Cycle Clock for Turkey to see the path of economic activity

In order to assess the current state of the economy, we have constructed a "Business Cycle Clock" (BCC) using the OECD's Cyclical Analysis and Composite Indicators System (CACIS)"[1]. The BCC is a graphical inference that is used to visualize business cycles and fluctuations of economic activity around long term potential levels.

In our BCC, we used the industrial production series to represent GDP. There is a strong correlation between these two variables, although the latter is released on the quarterly basis and is released with a lag.

Fig 1 Strong relationship between Industrial Production and GDP



Source: Turkstat

In Figure 2, the x axis shows the standardized level of the industrial production index, with the monthly change in the index on the y axis. The quadrants on the graph represent four distinct stages of the economic cycle: ***expansion, slowdown, contraction*** and ***recovery***. In the ***expansion*** period, the index is above its long term trend and still growing on a monthly basis (level>0, monthly change>0), meaning that the economy maintains momentum. In the ***slowdown*** region, the economy is still growing but has reached its peak and is now gradually slowing. In the ***contraction*** region, the economy is below its long term trend (the index contracts on a monthly basis) and heading towards the trough. Finally, having reached the bottom, the economy starts to recover again and converges to its long term trend, referred to as the ***recovery*** period in the business cycle clock.

The results of the BCC are broadly in line with the pace of economic growth

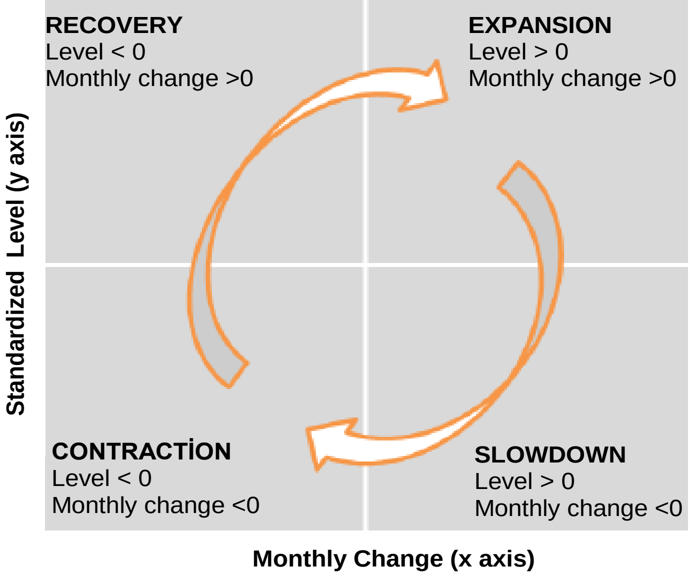
Turkish economy entered slowdown in January 2014

Checking the details of the BCC for Turkey (Figure 3) and comparing the suggested outcomes with annual GDP growth in the related zones, we observe that the results are broadly in line with the pace of economic growth and hence successfully represent the journey taken by economic activity. According to the details of the analysis, the Turkish economy entered slowdown as of 1Q08, before the loss of momentum worsened and the economy contracted in 4Q08. After dipping in 1Q09, a recovery had become more apparent, starting in 2Q09 and lasting until late 2010, when the index moved from recovery to expansion. Since 2011, the movement of the index between the quadrants has been speeding up - economic activity entered the slowdown towards 2Q11, followed by a contraction in 4Q12. Finally, the Turkish economy moved from recovery to expansion between February 2013 and June 2013. Since the beginning of this year, the

[1]i) OECD Cyclical Analysis and Composite Indicators System (CACIS) User's Guide (2010); ii) Demirhan, Aslıhan, Cosar Evren (2011), Analysis of Economic Activity in the Perspective of Composite Indices and Business Cycle Clock, CBRT Economic Notes, January 2012* (Published by Central Bank of Republic of Turkey)

results suggest that Turkey is growing but with a loss of momentum. There is a possibility of contraction in coming months.

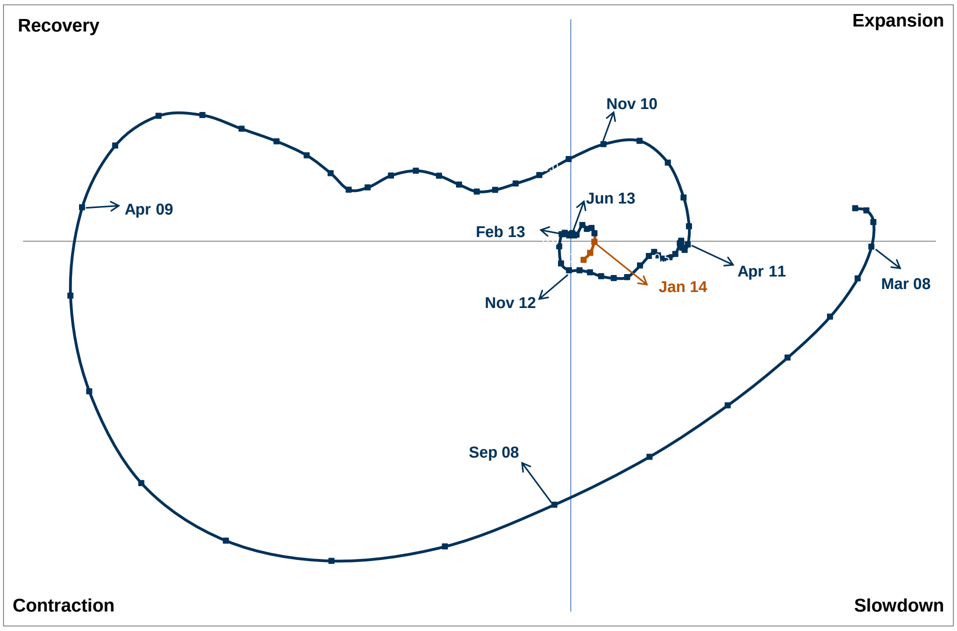
Fig 2 Business Cycle Clock



Source: CBT, ING Bank

It should also be noted that the recent movement between the zones is taking place within a narrow band - hinting that the days of “strong growth” are mostly over and that the economy is moving along a path of moderate growth.

Fig 3 BCC signals a slowdown since Jan-14



Source: Turkstat, ING Bank

BCC results support our slowdown expectations so far in 2014

All in all, our growth forecast of a slowdown in 2014, especially in domestic demand due to recent BRSA measures, the CBT rate hike, and the slowdown in consumer credits seems to be compatible with what we have gleaned from the BCC. We expect total growth to linger around 3% for 2014, lower than its 2013 level of 4%. This is despite the expected recovery impact on its main trade partner, the EU. Increased competitiveness of TRY than in the previous year that will help Turkish exports gain momentum and, in turn partially offset weakening in domestic demand.

Business Cycle and CBT conclusions

In order to assess the possible value of the BCC in anticipating monetary policy actions, we compared CBT conclusions with how the economy actually performed since the beginning of 2008 Normally, in an MPC meeting the CBT can monitor the results with a two-month lag. In the May meeting, for example, the Bank uses the March IP reading as the freshest data. Thus in our comparison, presented in the table below, we also take this time lag into consideration.

CBT considers the path of economic growth as well as price developments in its monetary policies

The comparison shows that, in addition to inflation indicators for the price stability objective, the CBT also closely monitors the pace of economic growth in its decision-making process, as a dual-mandate central bank would do. For example, the CBT started policy easing in August 2011, with the economy continuing to lose steam following an expansion period starting in the second quarter of 2011. The case now is similar, as we move into slowdown. More importantly, the table shows that CBT does not directly respond to changes in the state of economy, but rather waits for a while. This is possibly to confirm whether the activity trend is long-lasting or strong enough to reach the inflection point and so pass into the new phase. It generally takes three to four months for the Bank to determine the proper policy response to changes in economic momentum.

According to BCC, CBT should wait for the next MPC meetings for a rate cut. This is also plausible due to inflationary pressures and possible increases in political uncertainty before August

Overall, and bearing in mind the historical relationship between monetary policy actions and the pace of economy, BCC conclusions suggest that the CBT waits a few months to see any clear signal on economic activity. This has been in slowdown since January 2014 and may remain sluggish or even pass to the contraction phase in the coming period. This reading is also compatible with our skeptical stance on the chance of any imminent rate cut, with headline inflation at the end of April remaining close to short-term highs. The picture on the core inflation front is more a cause for concern. Taking into account presidential elections that might revive political ambiguity, together with the risks associated with the Ukraine and Russia standoff, the CBT will not start cutting policy rates in the immediate future, in our view. However, we may see an easing in rates, possibly after the presidential elections, given ongoing currency stability and the sharper than expected improvement in external balances. Any move will likely be influenced by improvement in risks associated with TRY assets, the extent of any slowdown in credit growth and the success of disinflation efforts. Industrial production data in the coming few months may provide further evidence on the strength of economic activity and should also support an easing towards the Fall of this year.

Fig 4 Pace of the economy and the CBT's stance

Period of IP	Phase that BCC suggests	CBT Decision	Monetary Policy Stance
Mar-08		**Slowdown**	
Mar-08		May-08 MPC: Hiked policy and lending rates by 50bp	Tightening
Apr-08	Slowdown	Jun- 08 MPC: Hiked policy and lending rates by 50bp	
May-08		Jul-08 MPC: Hiked policy rate by 50bp	
Aug-08		Oct-08 MPC: Lowered lending rate by 50bp	Easing
Sep-08		**Contraction**	
Sep-08		Dec-08 MPC: Lowered policy and lending rates by 125bp	
Nov-08		Jan- 09 MPC: Lowered policy and lending rates by 200bp	
Dec-08	Contraction	Feb-09 MPC: Lowered policy and lending rates by 150bp	Easing
Jan-09		Mar-09 MPC: Lowered policy and lending rates by 100bp	
Feb-09		Apr-09 MPC: Lowered policy and lending rates by 75bp	
Mar-09		May-09 MPC: Lowered policy and lending rates by 50bp	
Apr-09		**Recovery**	
Apr-09		Jun-09 MPC: Lowered policy and lending rates by 50bp	
May-09		Jul-09 MPC: Lowered policy and lending rates by 50bp	
Jun-09		Aug- 09 MPC: Lowered policy and lending rates by 50bp	
Jul-09		Sep- 09 MPC: Lowered policy and lending rates by 50bp	
Aug-09	Recovery	Oct-09 MPC: Lowered policy and lending rates by 50bp	Easing
Sep-09		Nov-09 MPC: Lowered policy and lending rates by 25bp	
Mar-10		May-10 MPC: Changed policy rate to one week repo rate	
Sep-10		Nov-10 MPC widened corridor 400bp	
Oct-10		Dec-10 MPC: Lowered policy rate, widened corridor by 50bp	
Nov-10		**Expansion**	
Nov-10	Expansion	Jan-11 MPC: Lowered policy rate by 25bp	Easing
Feb-11		Apr-11 MPC: Hiked FX and TL RRRs	Tightening
Apr-11		**Slowdown**	
Jun-11		Aug-11 Interim MPC: Lowered policy rate by 50bp, hiked lower bound of corridor, used the word "domestic recession"	
Dec-11		Feb-12 MPC: Lowered upper band of the corridor by 100bp	
Jul-12	Slowdown	Sep-12 MPC: Lowered the upper band of the corridor by 150bp	Easing
Aug-12		Oct-12 MPC: Lowered the upper band of the corridor by 50bp	
Sep-12		Nov-12 MPC: Lowered the upper band of the corridor by 50bp	
Nov-12		**Contraction**	
Nov-12		Jan-13 MPC: Lowered the upper and lower band of the corridor by 25bp	
Dec-12	Contraction	Feb-13 MPC: Lowered the upper and lower band of the corridor by 25bp	Easing
Jan-13		Mar-13 MPC: Lowered the upper band of the corridor by 100bp	
Feb-13		**Recovery**	
Feb-13		Apr-13 MPC: Lowered the policy rate, upper band of the corridor by 50bp	Easing
Mar-13	Recovery	May-13 MPC: Lowered the policy rate, upper band of the corridor by 50bp	
May-13		July-13 MPC: Hiked upper band of the corridor by 75bp	Tightening
Jun-13		**Expansion**	
Jun-13		Aug-13 MPC: Hiked upper band of the corridor by 50bp	
Sep-13		Nov-13 MPC: CBT terminated monthly repo auctions and elevated funding costs in a "measured way".	
Oct-13	Expansion	Dec-13 MPC: CBT signaled for further liquidity tightening by reducing total PD flexibility and pulling the ceiling down for weekly repo auctions.	Tightening
Nov-13		Jan-14 interim MPC: Aggressive hike in all policy rates with simplification of the operational framework	
Jan-14		**Slowdown**	
Jan-14		Mar-14 MPC: CBT signaled the continuation of tight monetary policy on the back of worsening inflation outlook	
Feb-14	Slowdown	Apr-14 MPC: CBT signaled the continuation of tight monetary policy on the back of worsening inflation outlook	Tightening
Mar-14		MPC meeting in 24 April	

Source: CBT, ING Bank

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