Turkey

Business cycle update: prices and exchange rate

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MONETARY POLICY AND LIRA OUTLOOK

The Monetary Policy Committee kept the policy rate unchanged at 17.75% at the July meeting undershooting market expectations for a 100bp increase. The press statement keeps the door open for a rate hike soon, which we suspect will materialise in the coming month taking the policy rate to 18.75%. The MPC in our view is waiting to see evidence on the pace of economic activity, the new plans for fiscal policy and the external conditions. The upcoming Budget announcements will be critical to decide whether the government will support a moderation of activity or whether it will pursue short term growth at all costs.

You can find in page 4 a projection of the overnight borrowing costs, deflated by inflation, assuming the policy rate remains unchanged at 17.75% through 2019. The chart signals that aside from the near term bout in inflation, real borrowing costs will remain high in historical and international context in Turkey. We see modest scope for monetary easing in the form of at most 200bp of cumulative rate cuts in the fall, consistent with what the President has indicated and only if inflation stabilises at 12-14% in coming quarters.

You can find on page 5 our model for the trade deficit, on a 12 month rolling basis, under various scenarios for growth, oil prices and lira level. The chart shows that in order to stabilise the currency, we need to see real GDP growth below 3%yoy and lira at 5.5 to the dollar or weaker.

The balance of payments data available at this stage confirms a funding shortage of around USD10bn, but it signals that there is a recent increase in inflows via the other investment category. This means that there is growing capital inflow probably due to multinationals bringing capital into Turkey to address the domestic funding challenges. This in turn signals that maturing external debt is being rolled over and that if the funding needs drop as activity weakens, the currency should stabilise even without much portfolio investment.

INFLATION OUTLOOK.

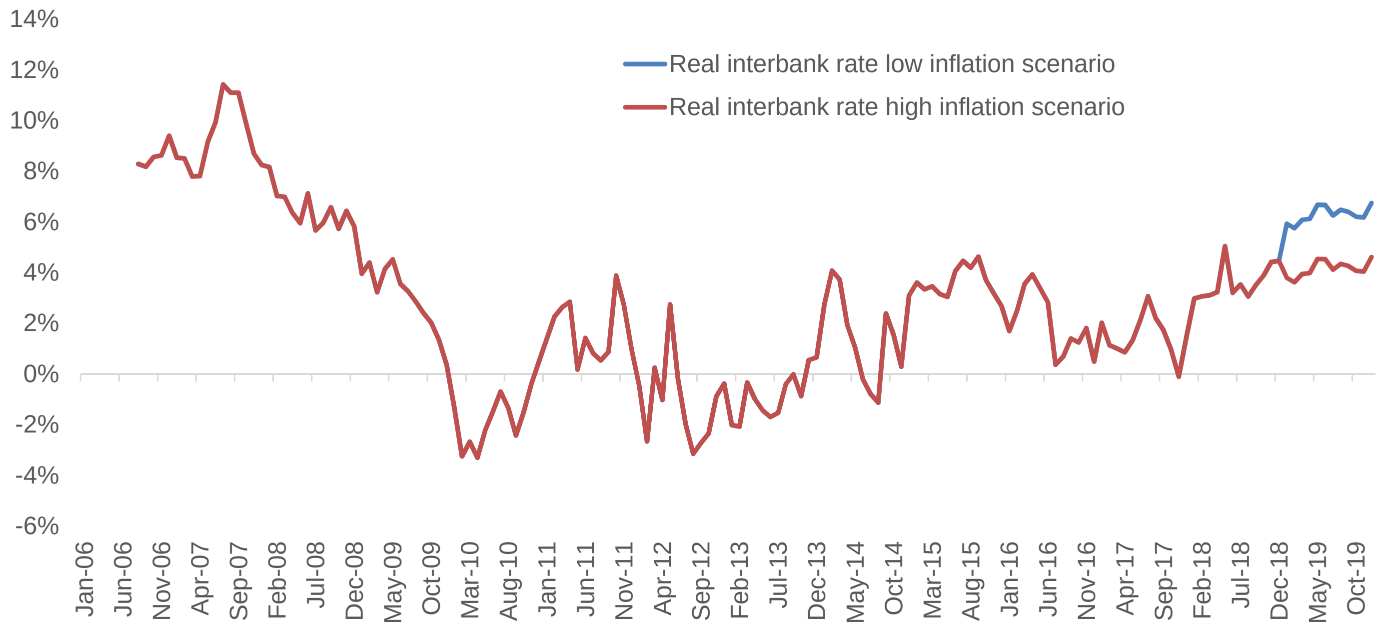
Headline inflation has been trending between 10.35% and 10.85% in the first half of the year, climbing to 15.4%yoy in June, the highest value registered since 2004. The drivers of inflation were the lira depreciation, as well as a pick up in transportation costs, household equipment and food prices.

Our inflation model proved quite correct in predicting the June spike, but on the whole this year it has been under-forecasting inflation by 1 to 2 points on average, so its predictions should be taken as guidance rather than a very accurate forecast. At this stage inflation reflects both the acceleration in world commodities prices, as well as bigger capacity constrains in Turkey and the accelerating depreciation of the currency.

If we stress test our inflation model, assuming that food inflation will stay exceptionally high at 25% for the next 18 months, we assume global oil prices rising to USD100pbbl and lira depreciating to 5.5 to the dollar in coming months, the model predicts inflation between 13% and 16% through 2018-2019. If food inflation moderates next year, which appears a more plausible scenario to us, then inflation is likely to drop quickly closer to 10-11%yoy: still high but closer to the recent history.

Our estimate of the output gap – *which is a measure of how much is the country growing above or below its potential growth rate and thus whether it is experiencing rising or falling inflationary pressures in the coming two years* – stood on average at 3.3% of GDP in Q118 and is forecast to reach 4.91%- 5.50% in the coming year.

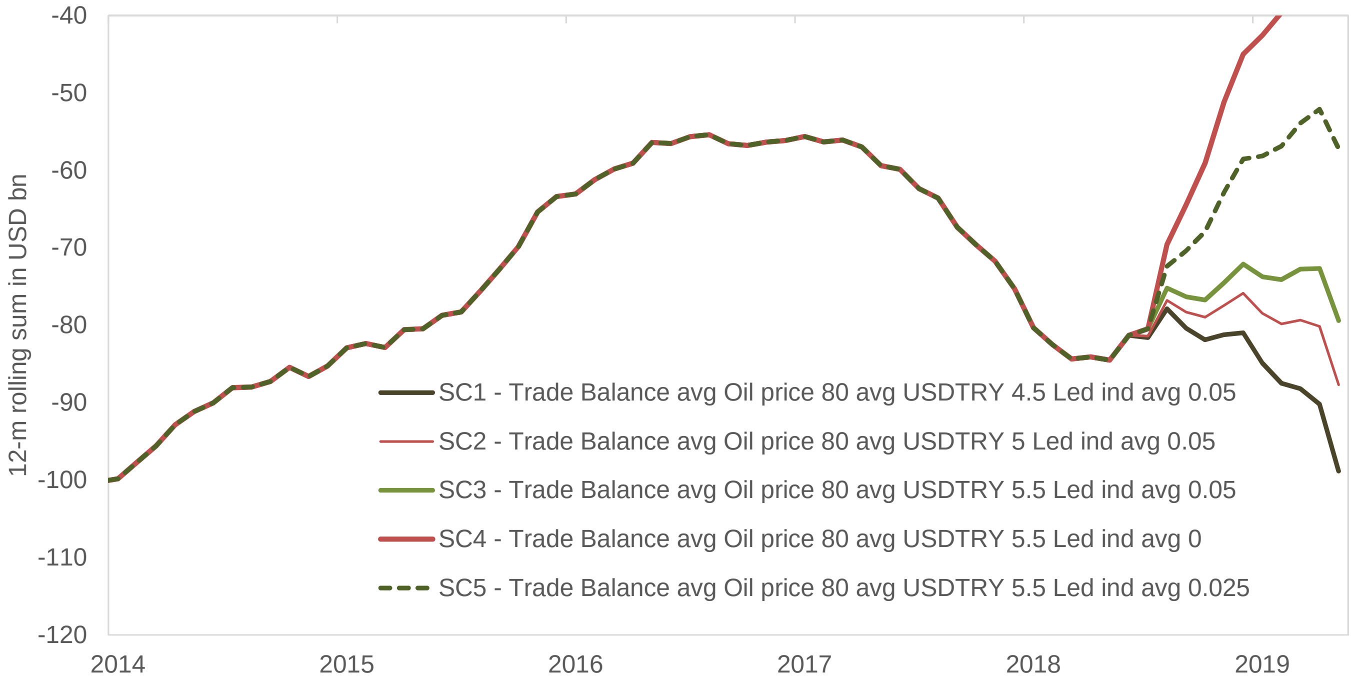
REAL INTERBANK BORROWING COSTS



The two inflation scenarios showing ahead are the same described in page 6: a high inflation outcome assumes food inflation steady at 25% until the end of 2019, crude prices rising to USD100pbbl and lira weakening to 5.5 to the dollar; a low inflation scenario assumes that food inflation drops to 18%yoy in 2019. These scenarios are not going to be super-accurate, but broadly capture the bulk of the uncertainty ahead and in our view food inflation is likely to drop materially next year returning closer to historical averages. The model also assumes a modest rise of unemployment as the economy decelerates.

Sources: CEIC, ADA ECONOMICS LTD

LIRA AND TRADE DEFICIT DYNAMICS



The chart above shows the result of a simple model for the 12-month rolling sum of the trade deficit – which is a critical part of the current account deficit and thus Turkey's funding needs.

Under the assumption of world oil prices at USD80pbbl, a sharp reduction of the trade deficit is only likely if growth is zero and lira is at 5.5 to the dollar. A material improvement is viable already with growth decelerating to 2.5-3%. Should oil prices rise even further, then lira will most likely end up even weaker.

Sources: CEIC, ADA ECONOMICS LTD

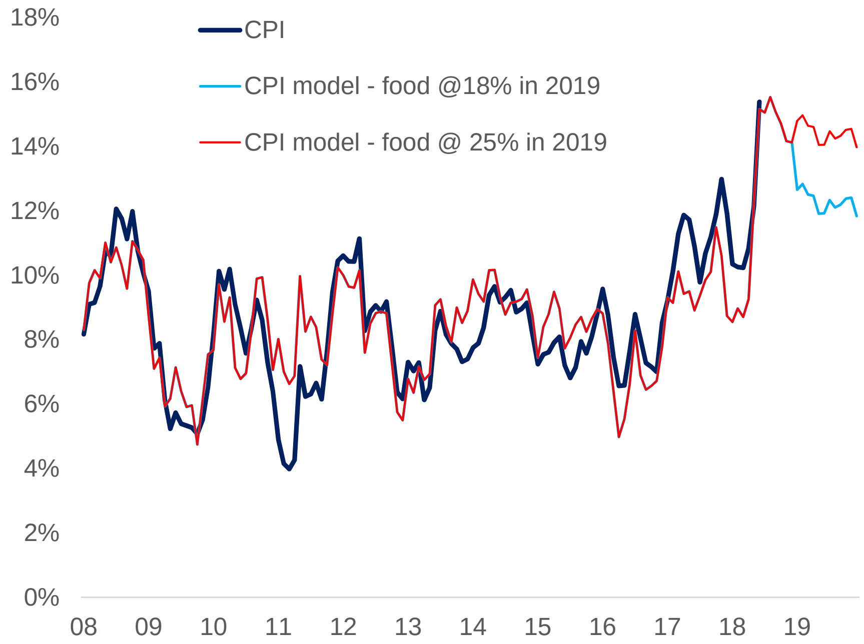
INFLATION OUTLOOK: USEFUL RULES OF THUMB.

A 5%yoy increase in USD global crude prices increase inflation on average by 0.1p.p.

A 5% increase in food inflation increases overall inflation by 1.5p.p.

An increase in the unemployment rate by 5%yoy reduces inflation by 0.1p.p

A 5%yoy increase in the output gap level increases inflation by 1.1p.p. with 9 months of delay on average



Sources: CEIC, ADA ECONOMICS LTD

MONETARY POLICY COUNCIL: RECENT COMMENTS & STRUCTURE.

On 11th July, 2018, Turkey's President Tayyip Erdogan was quoted by the local media saying that he believes interest rates would fall and Berat Albayrak (Turkish Treasury & Finance Minister) will do what is necessary. This comment resulted in rapid depreciation of Turkish-Lira to a record low level.

On the 22nd July, just two days before interest rate decision, Albayrak portrayed a softer stance and was quoted saying that Turkey will not fight with the markets but instead pursue a win-win relationship with them while ensuring Turkey has an effective central bank (Reuters).

The Monetary Policy Committee is composed of the President (Governor), three vice-presidents, a member elected by and from among the Board members and a member who is appointed by a joint decree on the recommendation of the President. The term of office for the President is 5 years and is appointed by a decree from council of ministers, while the Vice-presidents are appointed for a period of 5 years on the recommendation of the President. The member of MPC appointed from the board has a term of 3 years while the second member has a term of 5 years.

Member	Term starts	Term ends
Murat Çetinkaya (President)	20th April, 2016	April, 2021
Erkan Kilimci (Vice President)	12th May, 2016	May, 2021
Murat Uysal (Vice President)	9th June, 2016	June, 2021
Emrah Şener (Vice President)	2nd September, 2016	September, 2021
Ömer Duman (Member of MPC)	25th July, 2017	July, 2020
Prof. Abdullah Yavaş (Member of MPC)	11th March, 2008	March, 2023

As per amendment to the Central Bank Law in May 2001, CBRT is independent and the primary objective is to achieve and maintain price stability and keep inflation as close as possible to its target of 5%.

As of April, 2016, Murat Çetinkaya was appointed as the new President of the CBRT, replacing the previous President Erdem Başçı. Murat Çetinkaya has graduated with a double major in Political Science and International Relation and pursued his doctoral work in the fields of International Finance, Economics and Politics from Boğaziçi University, Istanbul.

Sources: CBT website

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