

Turkey: the essentials

- ▶ **Activity data is surprising on the upside and near-term prospects look bright, potential fallout from Greek crisis notwithstanding. As consumption outpaces production, sticky high inflation and a wider external gap are likely**

Turkey to remain fixed in its election-focused mindset

On 22 March, the ruling AK Party (AKP) revealed a contentious justice reform and constitutional amendment package. The package cleared the first round of voting by only a few votes (opposition parties offered little support), and barring any surprises in the second round, it is likely to go to a public referendum by mid-summer. However, an unpredictable court challenge by the main opposition party may change this. By the time the referendum is over, the next general elections, scheduled for early next year, will be around the corner. Thus, Turkey is likely to remain fixed in its election-focused mindset. The main fallout of this process could be postponement of the economic reform agenda, though we do not expect domestic political noise itself to impact market sentiment, as economic recovery, on the surface, appears impressive so far.

Can Turkey become an EM economic locomotive?

As private final demand in the developed world is likely to remain below potential for some time, the global economy needs EM countries with: young populations that can drive consumption demand; cleaner household and public balance sheets; relatively diversified economies; and high savings or accumulated past savings (reserves) to fuel demand growth. Turkey passes inspection on the first three conditions with flying colours, but domestic registered savings are still low due to structural bottlenecks and a very large unrecorded/untaxed economy. Thus, the growth model depends on external financing, making it rather volatile and costly, with a high inflation and wide current account gap. Nonetheless, at this stage of the economic recovery, investors will focus on growth, hence Turkey is likely to attract interest and post respectable growth for a while.

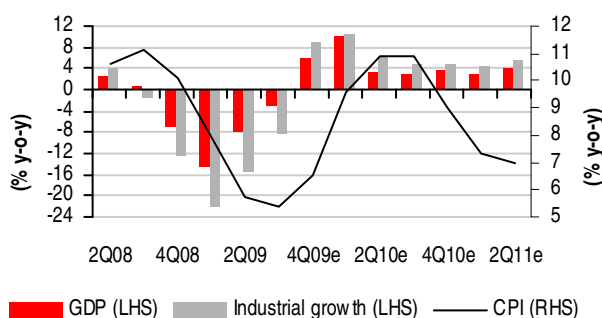
	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010e	Q3 2010e	Q4 2010e	Q1 2011e	Q2 2011e
GDP (% y-o-y)	-14.5	-7.7	-2.9	6.0	10.3	3.4	2.9	3.6	3.1	4.1
Industrial production (% y-o-y)	-22.0	-15.4	-8.1	9.0	10.6	6.5	5.0	5.0	4.5	5.5
CPI, end quarter (% y-o-y)	7.9	5.7	5.3	6.5	9.6	10.9	10.9	9.0	7.3	7.0
PPI, end quarter (% y-o-y)	3.5	-1.9	0.5	5.9	8.6	9.0	10.5	9.6	7.0	7.1
Trade balance (% GDP)	-8.7	-7.1	-6.4	-6.3	-7.2	-7.9	-8.7	-9.4	-9.7	-10.6
Current account (% GDP)	-4.7	-3.2	-2.5	-2.2	-3.2	-3.9	-4.3	-4.8	-5.2	-5.6
International reserves (USDbn)	67.1	65.9	70.9	69.3	70.9	70.1	68.5	67.0	67.5	68.0
Policy rate, end quarter (%)	10.50	8.75	7.25	6.50	6.50	6.50	6.50	8.00	9.00	9.00
1-yr rate, end quarter (%)	13.5	10.9	8.0	8.0	7.8	7.9	8.4	9.9	10.7	10.8
TRY*/USD, end quarter	1.67	1.52	1.48	1.49	1.52	1.51	1.50	1.52	1.54	1.53
TRY*/EUR, end quarter	2.22	2.15	2.16	2.14	2.04	2.04	2.03	2.05	2.23	2.21

Sources: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts

Domestic consumption outpaces production

GDP recovered in the final quarter of 2009, increasing 6.0% year-on-year, after four quarters of contraction. In seasonally adjusted quarter-on-quarter terms, the growth rate slowed from 6.6% in Q2 to 2.7% in Q3 and 2.3% in Q4, but remained very impressive. While current recovery is supported mainly by household and public spending, higher frequency monthly data for 2010 suggest that a measured recovery is underway in production as well. Industrial production posted a commendable 2.1% seasonally-adjusted, sequential growth in first two months and April capacity utilisation surprised on the upside with 72.2% after months of stagnating below 70%. Given continued uncertainties in foreign demand (particularly with regard to the Eurozone outlook) and record low real rates, consumption has been recovering faster than production so far.

Activity & inflation

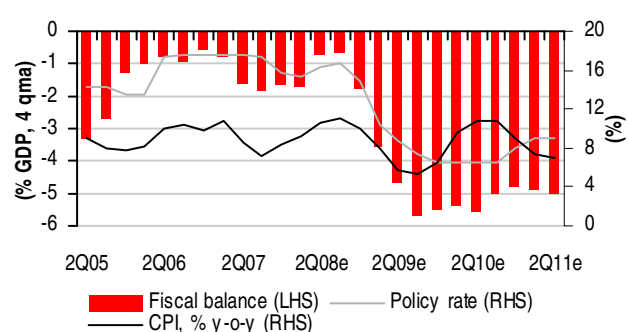


Source: CBRT

Sticky high inflation due to loose monetary-fiscal policy mix

After posting an annual increase of 6.5% in 2009, below the Central Bank's revised year-end target of 7.5%, CPI has been creeping up to around double-digit levels in the first few months of 2010. In February and March, headline inflation rose 10.1% and 9.6%, respectively, driven mainly by cost and supply-side impacts. Even though the CBRT's preferred core indicators remain benign, there are concerns about supply-side pressures contaminating general pricing behaviour, increasing services inflation and deteriorating long-term inflation expectations. These concerns become more immediate when viewed in light of Turkey's loose monetary-fiscal policy mix. Despite raising its 2010 and 2011 inflation forecasts in its Q2 inflation report, and withdrawing liquidity from the market, CBRT's base case calls for rate hikes to begin as late as Q4. In short, sticky high inflation is likely to continue.

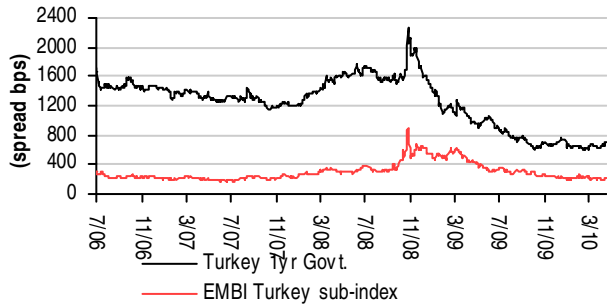
Policy stance



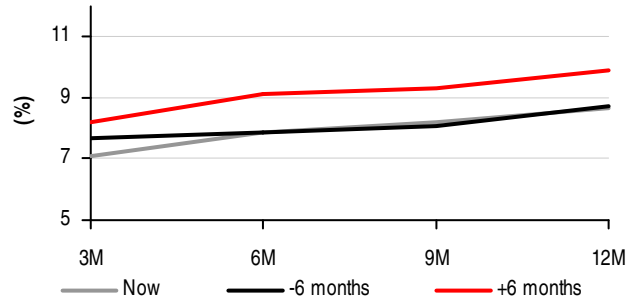
Source: CBRT, Ministry of Finance

Turkey: at a glance

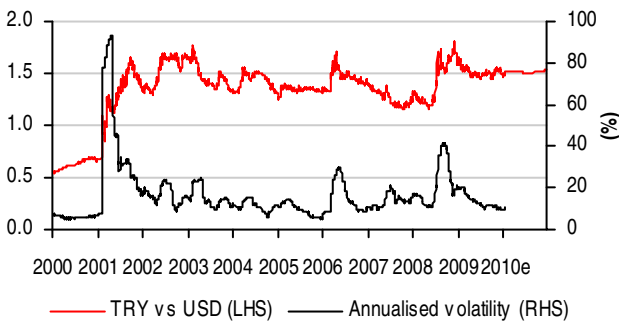
Local vs convertible currency yields



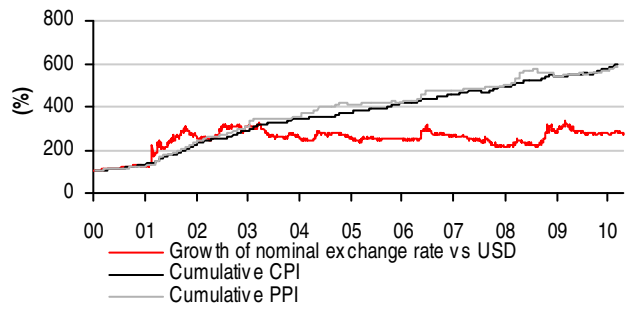
Yield curve dynamics



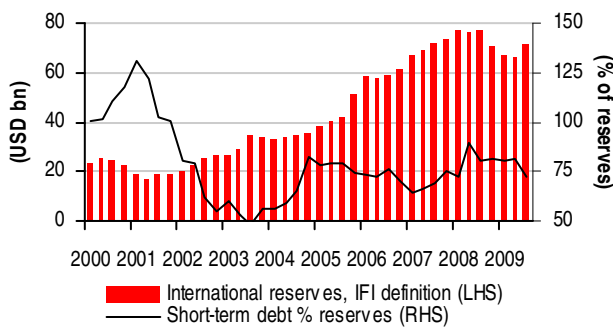
Exchange rate dynamics



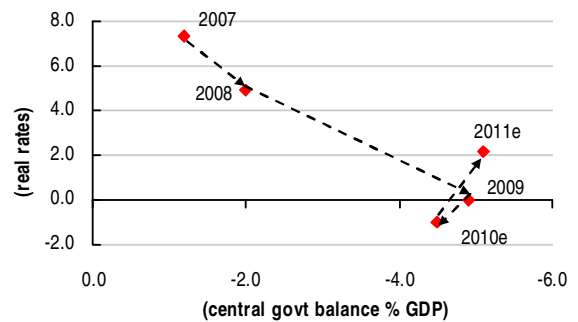
Exchange rate and inflation



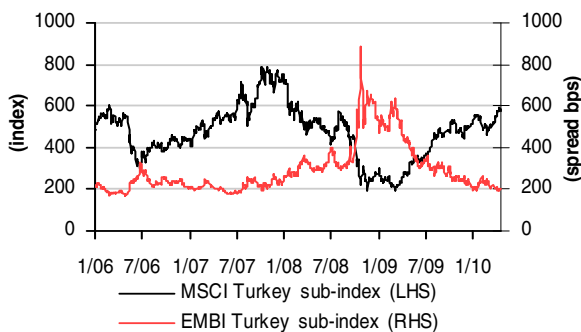
International reserves & liquidity ratio



Policy dynamics



Equity vs fixed income



Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts

Turkey: local knowledge/global drivers

- ▶ **Weaker EUR, due to sovereign crisis in EU, and rising commodity prices result in terms of trade deteriorating when TRY is appreciating in real terms. Capital account also yet to improve for more sustainable external balance in future**

A well-timed exit? A new operational framework

The CBRT announced its (liquidity) “exit strategy” on 14 April in an effort to reduce its presence in money markets. In the first phase, CBRT has started to lower its overfunding of the market by smaller Repo auctions and higher reserve requirement. It will then switch to the second phase, a new operational framework, dubbed as “technical rate adjustment”, whereby it will tender one-week Repos in quantity auctions at a fixed rate (new policy rate) 50bps above the O/N bid rate. If the liquidity deficit deepens further, the third phase will kick in, whereby the CBRT will widen the band between O/N bid rate and weekly repo rate. In sum, by separating liquidity measures from its policy stance, the CBRT may have bought itself some time in terms of the tightening that is set to begin Q4.

An illustration based on current 6.50% O/N bid rate

	2nd phase	3rd phase
LON* Borrowing	2.50	2.50
CBRT Borrowing	6.50	6.50
Secondary Market	6.50 - 7.00	6.50 - 7.25
CBRT Policy	7.00	7.25
PD** Lending Rate	8.00	8.00
CBRT Lending	9.00	9.00
LON Lending	12.00	12.00

* Late Liquidity Window (assuming unchanged)

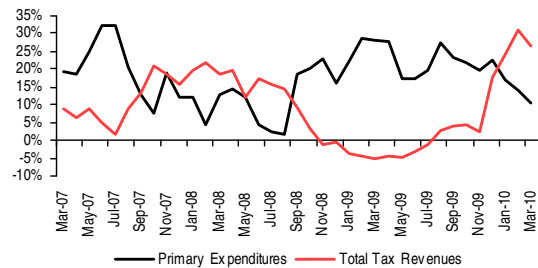
** Primary Dealers

Source: CBRT

A virtuous cycle for fiscal balances, how about structural measures?

There was great improvement in fiscal balances in Q1 2010, with tax revenues soaring at 25.6% year-over-year, more than double the 10.4% pace of increase in primary expenditures. As consumption recovers, so do transaction-based tax revenues; domestic value-added tax revenues soared 40.0% in Q1 with special consumption tax receipts rising 33.7%. Both have also benefited from one-off tax hikes in late 2009. Currently, IMF-defined 12-month primary deficit is at 0.9% of GDP, down from 1.7% in November. That said, expenditure growth remains in double digits, while public sector hiring and potential spending pressures in the run-up to the referendum and general elections may pose challenges to fiscal performance. Meanwhile, investors are still eagerly waiting for the all-important “fiscal rule”.

Primary Expenditures and Total Tax Revenues (YoY, 3MMA)

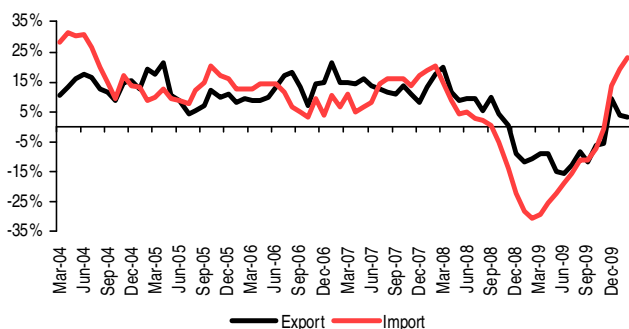


Source: Ministry of Finance

Stronger domestic demand risks widening in external balances ...

Record low real interest rates and a strong banking system that has made significant gains from last year due to sharp fall in interest rates, both fuel consumption-demand-driven recovery, despite record high unemployment.. High public sector spending, as evident in Q4 2009 GDP, contributes to this improvement. Consequently, imports are rising much faster than exports, arguing for a potentially swift widening of Turkey’s external imbalance. Turkish exports could also suffer from falling competitiveness due to appreciation of the lira’s real effective exchange rate when EU demand also looks fairly uncertain (exports to the EU still make up more than half of the total). In short, we expect the current account deficit to widen once again closer to 5.0% of GDP levels this year, assuming no further domestic and external shock.

Trade quantity indexes (3MMA, y-o-y)

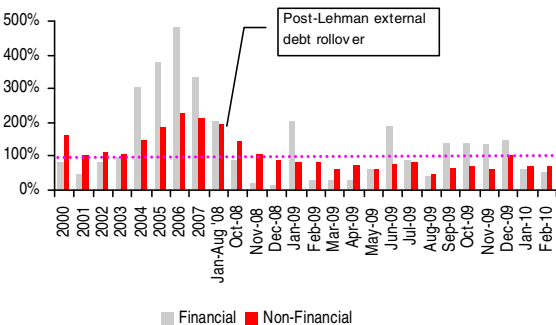


Source: TURKSTAT

... which could be further complicated by a weaker EUR

Continuing sovereign concerns in Europe weaken EUR versus USD, which worsens Turkey’s terms of trade because 50% of export revenues are in EUR versus 43% in USD, whereas 60% of import payments are in USD versus 36% in EUR. The balance of trade is also affected by rising global commodity prices; Turkey imports c95% of its energy supply. Consequently, the current account gap is likely to become an issue much earlier than previously expected. Meanwhile, growth has so far been financed by banks’ accumulated capital and unaccounted inflows, namely net errors and omissions (USD8.6bn in 2009) that partly stems from government’s successful “wealth amnesty” efforts. However, FDI is weak, and the private sector still de-levers external debt, thus the capital account is still far from its pre-crisis strength.

Long-term external credit rollover ratios



Source: CBRT

Turkey: macro framework

	2004	2005	2006	2007	2008	2009	2010e	2011e
Production, demand and employment								
GDP growth (% y-o-y)	9.4	8.4	6.9	4.7	0.7	-4.7	5.0	4.1
Nominal GDP (USDbn)	390.4	481.5	526.4	646.5	731.4	617.5	728.6	803.2
GDP per capita (USD)	5,487	6,681	7,214	9,157	10,243	8,539	9,949	10,830
Private consumption (% y-o-y)	11.0	7.9	4.6	5.5	-0.3	-2.3	4.9	3.5
Government consumption (% y-o-y)	6.0	2.5	8.4	6.5	1.7	7.8	4.9	4.4
Investment (% y-o-y)	28.4	17.4	13.3	3.1	-6.2	-19.2	4.2	5.7
Industrial production (% y-o-y)	9.8	5.4	7.8	6.9	-0.9	-9.6	6.8	6.2
Gross domestic saving (% GDP)	16.8	16.5	17.1	16.5	18.2	21.5	21.0	19.7
Unemployment rate end-year (%)	10.3	10.3	9.9	9.9	13.6	13.7	14.1	13.8
Prices & wages								
CPI, average (% y-o-y)	8.6	8.2	9.6	8.8	10.4	6.3	10.0	7.4
CPI, end-year (% y-o-y)	9.4	7.7	9.7	8.4	10.1	6.5	9.0	7.4
PPI, end-year (% y-o-y)	15.3	2.7	11.6	5.9	8.1	5.9	9.6	7.6
Manufacturing wages, nominal (% y-o-y)	11.7	12.5	11.5	9.6	8.2	4.0	7.0	7.5
Money, FX & interest rates								
Broad money supply M3 (% y-o-y)	34.7	41.0	19.8	22.7	24.3	18.0	15.5	16.5
Real private sector credit growth (% y-o-y)	43.9	38.4	43.0	26.9	28.2	4.1	12.5	14.0
Policy rate, end-year (%)	18.00	13.50	17.50	15.75	15.00	6.50	8.00	9.00
1-yr interest rate, end-year (%)	21.9	14.1	20.6	16.7	15.8	8.0	9.9	10.9
TRY*/USD, end-year	1.34	1.34	1.41	1.16	1.52	1.49	1.52	1.51
TRY*/USD, average	1.42	1.34	1.43	1.30	1.30	1.54	1.50	1.52
TRY*/EUR, end-year	1.83	1.60	1.85	1.71	2.13	2.14	2.05	2.19
TRY*/EUR, average	1.77	1.67	1.80	1.78	1.90	2.15	2.03	2.19
External sector								
Merchandise exports (USDbn)	63.1	73.5	85.5	107.2	132.0	102.1	114.9	135.0
Merchandise imports (USDbn)	97.5	116.8	139.6	170.1	202.0	140.9	183.2	224.4
Trade balance (USDbn)	-34.4	-43.3	-54.0	-62.9	-69.9	-38.8	-68.3	-89.4
Current account balance (USDbn)	-14.4	-22.1	-32.2	-38.3	-41.9	-13.9	-34.8	-49.7
Current account balance (% GDP)	-3.7	-4.6	-6.1	-5.9	-5.7	-2.2	-4.8	-6.2
Net FDI (USDbn)	2.0	9.0	19.3	20.0	15.3	6.1	7.5	12.5
Net FDI (% GDP)	0.5	1.9	3.7	3.1	2.1	1.0	1.0	1.6
Current account balance plus FDI (% GDP)	-3.2	-2.7	-2.4	-2.8	-3.6	-1.3	-3.8	-4.6
Exports (% y-o-y)	33.5	16.4	16.4	25.3	23.2	-22.6	12.5	17.5
Imports (% y-o-y)	40.7	19.8	19.5	21.8	18.8	-30.2	30.0	22.5
International FX reserves (ex gold) (USDbn)	36.0	50.5	60.9	73.3	70.1	69.3	67.0	69.0
Import cover (months)	4.4	5.2	5.2	5.2	4.2	5.9	4.4	3.7
Public and external solvency indicators								
Commercial banks' FX assets (USDbn)	79.3	95.6	117.1	141.2	147.0	148.6	152.5	156.5
Gross external debt (USDbn)	161.0	169.7	207.6	249.4	277.7	271.1	278.0	298.0
Short term external debt (% of int'l reserves)	89.4	75.8	70.0	58.8	71.9	73.2	73.3	70.1
Private sector external debt (USDbn)	63.9	83.9	120.3	160.1	185.3	174.4	180.0	177.0
Consolidated government balance (% GDP)	-4.1	-0.6	-0.2	-1.2	-2.0	-4.9	-4.5	-5.1
Central government balance (% GDP)	-5.4	-1.3	-0.5	-1.6	-1.8	-5.5	-4.8	-5.2
Primary balance (% GDP)	3.8	3.8	4.4	2.4	1.9	-1.5	-0.8	-1.3
Gross public domestic debt (TRYbn)	224.5	244.8	251.5	255.3	274.8	330.0	375.0	420.0
Gross public domestic debt (% GDP)	40.2	37.7	33.2	30.3	28.9	34.6	34.4	34.4
Gross public external debt (USDbn)	75.7	70.4	71.6	73.5	78.3	83.5	85.5	87.0
Gross public external debt (% GDP)	19.4	14.6	13.6	11.4	10.7	13.5	11.8	10.8
Gross public sector debt (% GDP)	59.5	52.3	46.8	41.6	39.6	48.1	46.2	45.3

Source: CBRT, TURKSTAT, Ministry of Finance, HSBC estimates