

Downside surprise in June inflation

Annual core inflation indicators continued to rise in June...

In June, consumer prices sank 1.43% MoM, after the 2.42% rise in May. The decline is stronger than the market consensus (-0.72% MoM) and our more optimistic forecast (-0.94% MoM). Hence, annual inflation declined to 6.24% from 7.17% in May. Food prices – down 6.4% MoM in June – erased 1.78 pp from monthly inflation. The contribution of other groups to monthly inflation was negligible.

Year-end inflation forecast unchanged at 7.6%...

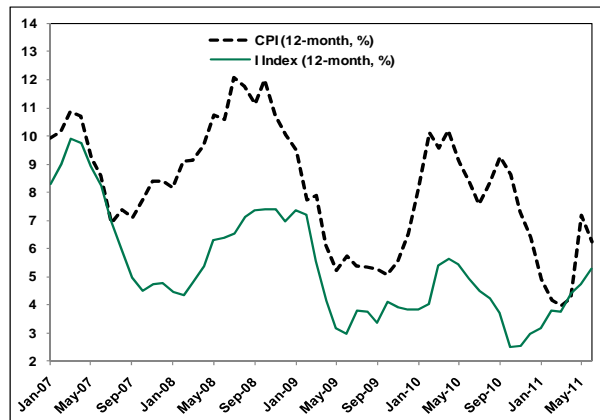
On the other hand, annual core inflation indicators continued to rise in June. I index inflation, which excludes food, beverages, energy, tobacco and gold, rose to 5.27% in June from 4.72% in May. Recall that it is the most closely observed core inflation indicator of the CBRT for monetary policy decisions. In addition, service inflation also does not provide a rosy picture for June. According to CBRT data, annual service inflation rose to 5.0% in June from 4.4% in May. As a note, annual rent inflation edged up from 4.24% to 4.43% in June.

Possibility of policy rate or RRR hikes significantly diminished...

Meanwhile, the producer price index edged down 0.01% in June over May as the annual inflation rose to 10.19% in June (May: 9.63%).

While we find the headline CPI data positive, annual core inflation indicators closely followed by the CBRT are around the 5.5% year-end inflation target, which is used as a proxy for core inflation by the CBRT. We kept our year-end inflation forecast unchanged at 7.6% as the decline is mostly based on unprocessed food prices which are volatile and as we expect hikes in energy prices, especially natural gas, in the last quarter as energy authorities have hinted. In addition, the lagged effects of the Lira's recent depreciation is another factor for us to put year-end inflation above the 5.5% official target, and the CBRT's 6.9% forecast.

We do not expect policy rate hikes or reserve requirement hikes in the remainder of 2011. However, we do not exclude the possibility that the bank may be forced to hike the policy rate after a shock to the Lira in the second half due to record CAD.



Source: Turkstat

Summary Inflation Data: June 2011
(in percent)

	Monthly		12-month	
	Jun 11	Jun 10	Jun 11	May 11
CPI	-1.43	-0.56	6.24	7.17
Food and Beverages	-6.40	-2.52	8.13	12.61
Tobacco and Liquor	0.00	-0.01	-1.50	-1.51
Clothing and Footwear	0.64	0.35	6.53	6.23
Housing	0.24	0.46	4.79	5.02
Houseware	0.55	0.37	7.59	7.40
Health	0.04	0.01	0.73	0.70
Transportation	0.32	-0.42	9.50	8.69
Communication	0.71	0.70	-0.28	-0.29
Entertainment and Culture	1.19	-0.10	1.08	-0.20
Education	1.41	1.04	5.58	5.19
Hotels, Cafes and Restaurants	0.48	0.20	7.50	7.20
Misc. goods and services	1.07	-0.25	9.11	7.68
PPI	0.01	-0.50	10.19	9.63
Agriculture	-3.13	-0.70	6.07	8.73
Mining and Quarrying	-0.05	-1.88	16.14	14.00
Manufacturing Industry	0.68	-0.50	12.58	11.27
Electricity, Gas and Water	1.04	0.33	-2.72	-3.40

Source: TURKSTAT

Growth: Q1 data release supports the need for additional monetary tightening

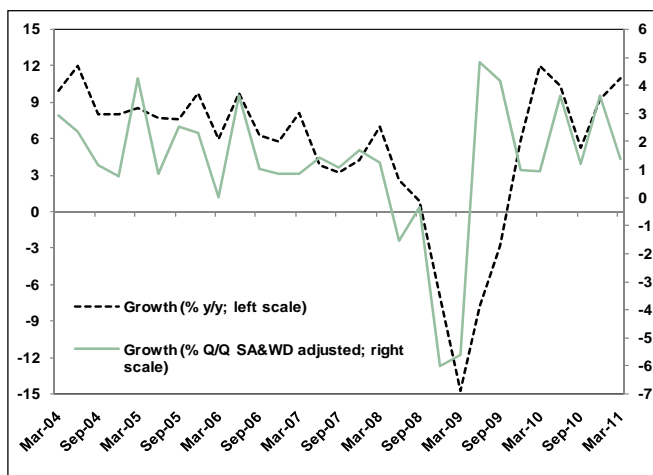
Domestic demand was once again behind strong growth in Q1...

Turkish economic output surged 11.0% YoY in real terms in the first quarter of the year, against the market consensus of 9.6%, while our forecast was 10.2%. In working day and seasonally adjusted terms, the economy grew 1.4% QoQ in the first quarter after expanding 3.6% in Q4 2010. It is the 8th consecutive quarterly increase in real output in WD & SA terms since Q2 2009.

We revise our growth forecast for 2011 to 6.2% from previous 5.7%...

Growth came completely from domestic demand in Q1, a pattern observed in Q4 2010. In terms of the contributions, domestic demand added 16.2 pp to 11.0% growth. Meanwhile, growth retreated by 0.3 pp by stock changes and 5.5 pp by net foreign demand, as exports rose 7.7% YoY compared to the 27% YoY rise in imports in Q1.

Given the CBRT's determination to support the economy with additional monetary easing if the economy contracts, we believe that the bank will keep monetary conditions relatively loose in order not to permit a contraction in the economy in QoQ terms. Therefore, we revise our growth forecast for 2011 to 6.2%, assuming a flat to slightly positive QoQ growth from Q2 onwards, from 5.7% previously for which we had previously assumed a slight slowdown in QoQ terms during Q2-Q4. For 2012, we forecast 4% GDP growth with a slightly positive contribution from external demand. However, we believe that there are even downside risks to our below consensus forecast for 2012 as uncertainty pertaining to financial outflows may cause the economy to display a sharp slowdown.



Source: Turkstat

Industrial Production: Broadly in line with the consensus in May

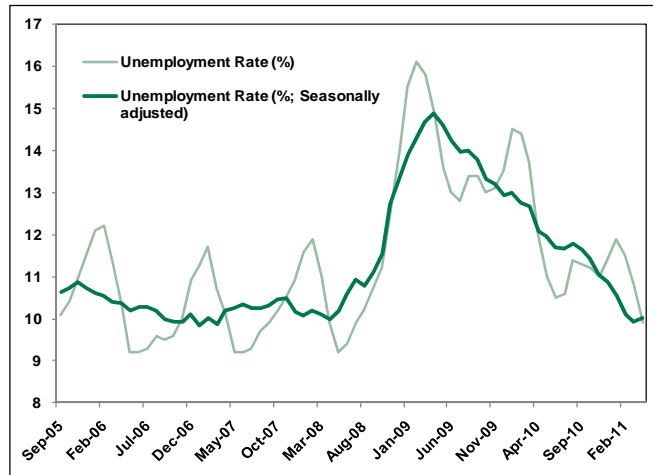
IP provides signs of slowdown ...

Industrial production expanded 8.0% YoY in May between the market consensus (7.5%) and our in-house forecast (8.5%). On the other hand, IP declined 0.3% MoM in May in seasonally and calendar adjusted terms following a cumulative 2.5% decline during February-April from its historical high in January.

April unemployment supports the CBRT's view of a slowdown in Q2

SA unemployment rate edged up a tiny notch to 10.0% from 9.9% in March...

The unemployment rate declined to 9.9% in April (March-May average), down 2.1 pp over April 2010. Unemployment rate was 10.8% in March. On the other hand, non-farm unemployment was down 2.4 pp year-on-year to 12.5% in April. Adjusted for seasonal effects, the unemployment rate edged slightly up to 10.0% from 9.9% in March. Though it is a marginal increase it is the first since August last year.



Source: Turkstat

CAD in line with market consensus in May, but requires further tightening

Non-energy imports were the main reason behind the widening CAD...

In May, the current account balance posted a deficit of \$7.8 billion, in line with the market consensus (\$7.8 billion) but slightly over our in-house forecast (\$7.5 billion). Accordingly, the 12-month rolling CAD rose to \$68.2 billion (9.2% of GDP) from \$63.4 billion recorded in April, while the CAD for January-May more than doubled (221% YoY) to \$37.3 billion. As the main component of the widening in the CAD, non-energy CAD reached \$29.2 billion from \$25.6 billion registered in April.

CAD in May was mainly financed with short-term inflows...

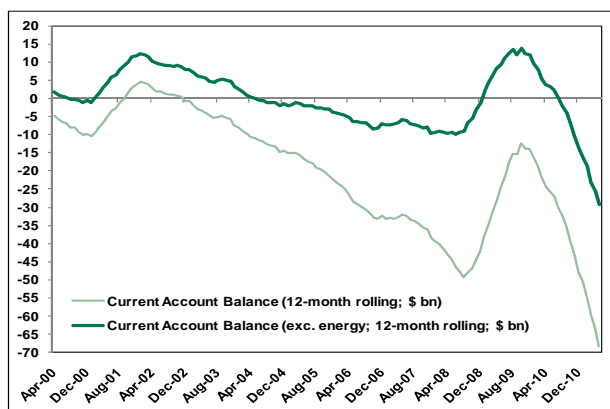
In May, while the trade deficit in the BoP definition was \$8.7 billion, the monthly CAD trimmed by TRY 1.3 billion in services (\$1.4 billion under tourism).

We revised our CAD forecast for 2011 up to \$73bn (9.5% of GDP) from \$67bn...

A particularly striking side of financing was the \$4.5 billion inflow under net errors and omissions in May. January-May financing under net errors and omissions amounted to \$8.4 billion. Other than this, net FDI in May was strong at \$0.8 billion compared to \$0.2 billion in May 2010. On the other hand, with the \$0.8 billion net outflow (\$0.2 billion from equities and \$0.6 billion from debt securities), portfolio financing was negative in May.

The banking sector and other sectors continued being net borrowers for medium to long term debt in May. The banking system secured a net \$0.5 billion in May with a 225% rollover ratio (198% for January-May), while the non-bank sectors borrowed a net \$0.4 billion with a 121% rollover ratio (129% for January-May), both are positive.

We revised our CAD forecast for 2011 up to \$73 billion (9.5% of GDP) from \$67 billion on the back of strong domestic economic activity and the continuation of the divergence between exports and imports.



Source: CBRT

Budget, strong in the first half

Very strong headline budget figures in H1 thanks to buoyant economic activity and restructuring...

The Ministry of Finance released central government budget figures for June, which posted a budget surplus of TRY 3.1 billion comparing favorably with the TRY 5.4 billion deficit recorded in June of last year. On the other hand, the primary surplus is TRY 4.7 billion compared to a primary deficit of TRY 2.1 billion recorded in June 2010.

For the first half of the year, the budget gave a TRY 2.9 billion budget surplus (H1 2010: TRY 15.4 billion deficit). On the other hand, the budget posted a primary surplus of TRY 25.3 billion in the first half, more than doubling the TRY 12.1 billion recorded the same period last year. In the first half, primary expenditures rose 10.9% YoY to TRY 120.8 billion. Meanwhile, revenues increased 20.7% YoY to TRY 146.1 billion on the back of strong growth and the restructuring of the public receivables.

Budget targets likely to be revised in the new Medium Term Program...

It is crystal clear that the government will overachieve its budget targets stated in the original budget (TRY 33.5 billion budget deficit and TRY 14.0 billion primary surplus) thanks to the continuation of strong economic activity and restructuring. The targets will likely be revised in the new Medium Term Program (MTP), which we expect to be published in September or October. Signs of additional tightening by the government in the MTP would be welcomed by the market as the market continuously expects the current account deficit to rise.

Central Government Budget: 2010-2011
(in billion TL)

	Jan-Jun		Real growth (%)
	2011	2010	
Central Government Revenues	146.1	121.1	13.6
o/w: General Budget Revenues	141.2	116.8	13.7
Tax Revenues	122.7	98.6	17.1
o/w: Corporation Tax	37.0	29.4	18.6
Tax on Income	13.9	10.1	29.6
Tax on Goods and Services	49.3	41.9	10.9
o/w: VAT	15.1	12.3	15.9
SCT	29.8	25.6	9.2
Tax on Foreign Trade	25.5	18.0	33.2
Non-Tax Revenues	23.3	22.4	-2.1
Central Government Expenditures	143.2	136.5	-1.2
Non-Interest Expenditures	120.8	108.9	4.4
o/w: Personnel	43.2	37.1	9.6
Government Prem. to Social Security Agen.	6.3	5.4	11.5
Good and Services Procurements	12.4	10.5	10.9
Capital Expenditures	6.8	5.5	17.2
Current and Capital Transfers	56.7	53.2	0.3
o/w: Social Security	28.0	29.0	-9.2
Transfers to Households	1.1	0.8	39.0
Agricultural Subsidy	5.5	4.6	12.5
Treasury Aid to Provincial Offices	1.4	0.9	56.4
Interest Expenditures	22.4	27.6	-23.4
Overall Balance	2.9	-15.4	...
Primary Balance	25.3	12.1	...

Source: Ministry of Finance

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