Inflation: Deteriorating outlook, but not likely to affect the CBRT

Lira's depreciation affects inflation through import prices…

Consumer prices rose 0.73% in August over July, which brought annual inflation up to 6.65% from 6.31%. The monthly realization exceeded both the market consensus (0.43%) and our in-house forecast (0.32%) mainly due to the higher than expected increase in food group prices.

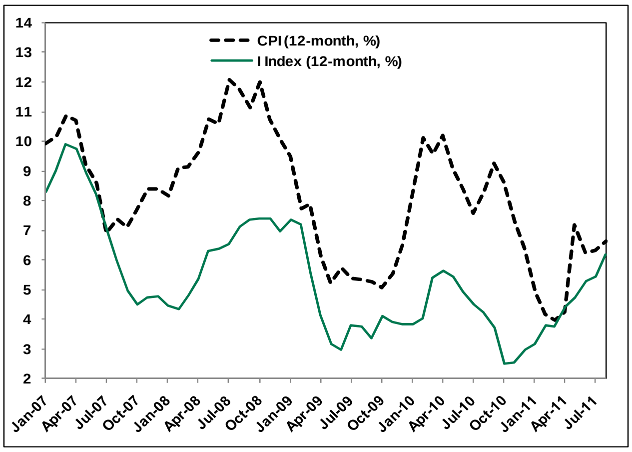
Looking into the details, food group prices rose 1.38% MoM and contributed 0.38 pp to the monthly print. The depreciation effect can be felt in other groups. Transportation group prices rose 1.90% MoM, contributing 0.29 pp to monthly inflation. On the other hand, houseware prices rose 0.83% MoM, but just contributed 0.06 pp to monthly inflation. Clothing group prices declined 4.35% MoM on the back of seasonal discounts.

Core inflation is increasing…

Annual H index inflation rose to 6.67% from 5.99%, whereas I index inflation, which excludes food, energy, tobacco products and gold, increased to 6.19% from 5.43%.

Deteriorating inflation outlook not likely to affect CBRT's dovish stance…

We forecast core inflation (I) to exceed 7% in October and annual CPI inflation to end the year around 7.6%, significantly above the 5.5% inflation target. On the other hand, annual service inflation continued to rise and reached 5.7% from 5.4% registered in July. Despite this negative inflation picture, the CBRT will not move in our view. In our opinion, the August inflation outcome will not affect the direction of monetary policy as the CBRT is focused on the problems in the global economy. In fact, concerns on inflation took a back seat to the current account deficit and growth for the CBRT, in our view.



Source: Turkstat

Summary Inflation Data: August 2011
(in percent)

	Monthly		12-month	
	Aug 11	Aug 10	Aug 11	Jul 11
CPI	**0.73**	**0.40**	**6.65**	**6.31**
Food and Beverages	1.38	2.95	6.00	7.65
Tobacco and Liquor	0.01	0.00	-1.50	-1.50
Clothing and Footwear	-4.35	-4.79	7.42	6.93
Housing	0.54	0.15	4.96	4.56
o/w: Rent	0.32	0.41	4.32	4.42
Houseware	0.83	-0.02	8.13	7.22
Health	0.06	-0.67	0.49	-0.25
Transportation	1.90	-0.17	12.08	9.81
o/w: Maintenance	2.20	-0.39	18.92	15.91
Communication	-0.09	-0.96	0.90	0.02
Entertainment and Culture	0.83	0.10	3.17	2.43
Education	0.31	0.14	5.59	5.41
Hotels, Cafes and Restaurants	0.64	0.47	7.98	7.79
Miscellaneous goods and services	4.55	-0.22	18.38	12.98
PPI	**1.76**	**1.15**	**11.00**	**10.34**
Agriculture	-0.76	3.48	-2.34	1.83
Industry	2.24	0.64	13.91	12.13
o/w: Mining and Quarrying	2.24	0.43	16.81	14.74
Manufacturing Industry	1.99	0.22	15.86	13.85
Electricity, Gas and Water	4.68	4.54	-2.84	-2.97

Source: TURKSTAT

Eurozone problems support further rate cuts in the upcoming period

In its September meeting, the Monetary Policy Committee maintained the policy rate at 5.75% in line with the market consensus and our in-house forecast. The Committee also kept other interest rates unchanged. In addition, there was no mention of reserve requirement changes, as expected.

We expect a 50 bps policy rate cut by year-end...

The Bank removed the expression in the last month's announcement that, "the Committee has agreed that the measures taken at the interim meeting on August 4, 2011 have contained the downside risks for the economy for the time being…" which we interpret to mean that the committee would likely cut rates further when the Lira outlook permits. On the day of the meeting, the spread between 10-year Italian and German bonds were around the levels on August 4th, when the CBRT cut the policy rate by 50 bps in the interim meeting. However, the Lira's weakness at the time kept the MPC from changing policy rates, in our view. "The Committee has also reiterated that all policy instruments may be eased should global economic problems further intensify and the slowdown in domestic economic activity becomes more pronounced." The CBRT will likely cut the policy rate by another 50 bps by year-end.

S&P increased Turkey's local currency rating to investment grade, from BB+ to BBB- with a 'positive' outlook

Foreign currency rating is more important for funds...

However, the foreign currency rating was kept at BB, two notches below investment grade. The S&P implied that if there is an improvement in the current account deficit, the foreign currency rating also may be increased. Recall that the majority of funds require an investment grade rating in foreign currency by two ratings agencies to invest.

Strong economic activity in Q2

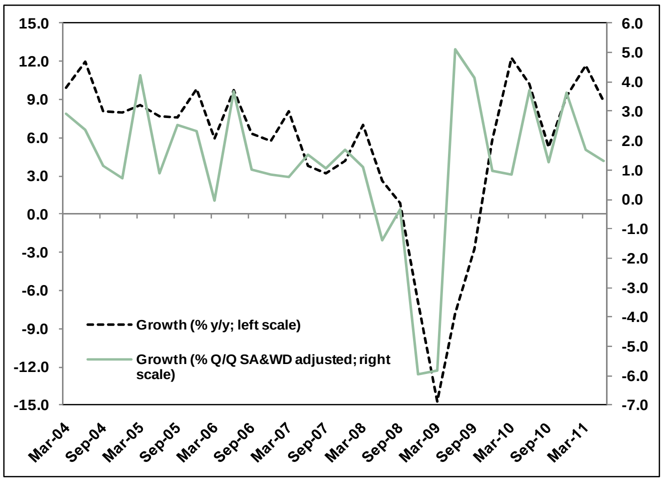
Strong private consumption in Q2…

The Turkish economy grew 8.8% in Q2, significantly above the 6.8% market consensus and our 6.4% in-house forecast. On the other hand, adjusted for calendar and seasonal effects, economic output rose 1.3% QoQ, reaching a new record high. The figures revealed the fact that the economy was also stronger than expected by the CBRT in Q2. However, we expect no major change in dovish monetary policy after the release, due to the heightened economic problems in the Euro region.

We revise our growth forecast up to 7.0% from 6.1%…

Domestic demand preserved its solid stance in the second quarter and contributed 14.0 pp to YoY growth, while foreign demand erased 5.2 pp from growth as imports significantly outpaced exports. On the other hand, stock changes made no contribution to growth. Digging deeper, while final consumption expenditures of residential households rose 9.2% YoY (Q1: 12.4%), private sector investments rose 33.5% (Q1: 38.0%). Sector by sector, industrial output rose 7.6% YoY, while services expanded 10.5% in the second quarter. Construction sector output increased 15.8% YoY in Q2 after expanding 17.3% in Q1.

After the Q2 release, we revised our GDP forecast for 2011 from 6.1% to 7.0%, even with the accompanied upside risks.



Source: Turkstat

CAD at a new record in July before the improvement

In July, the current account balance registered a deficit of USD 5.3 billion. The outcome was broadly in line with the market consensus (USD 5.4bn) and our in-house forecast (USD 5.2bn). The 12-month rolling CAD widened to USD 74.6 billion from USD 72.8 billion. On the other hand, the 12-month rolling non-energy current account deficit rose to USD 33.1 billion from 32.7 billion recorded in June.

The current account deficit was a new record in July...

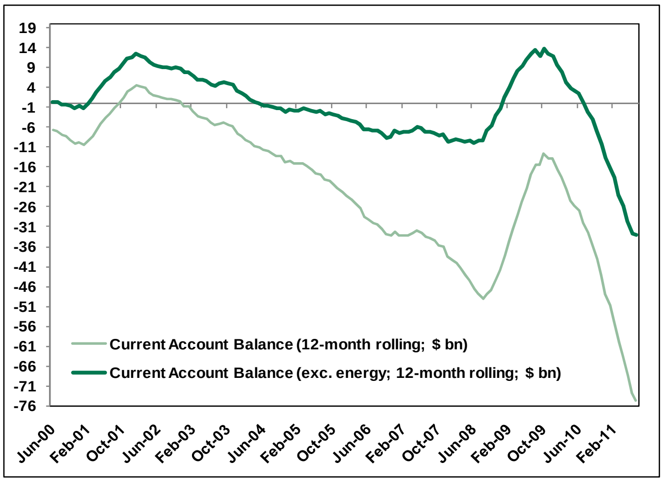
The monthly CAD figure is positive in the sense that the difference from last year declined significantly to USD 1.8 billion from USD 4.2 billion on average in the Q2.

Looking into the details, in July, services rose 36% YoY mainly thanks to the brilliant performance of the tourism sector (up 30% YoY), while income items behaved more or less the same with the July 2010.

High FDI in July was probably a one-off...

On the financing side, net portfolio inflows retained their strength with USD 2.0 billion (USD 1.7bn inflow to public debt securities). There were USD 4.0 billion new deposit investments abroad made by residents, almost all of them by banks (USD 3.8bn). A particularly striking figure is the USD 2.8 billion FDI inflow in July, a significant amount of which originated from the energy sector according to CBRT. Net errors and omissions continued their significant share of financing with TRY 1.4 billion, while the CBRT lost USD 0.7 billion in international reserves in July.

Rollover ratios for the medium to long term declined in July compared to the average of the first half, though they remained above 100%. For banks it declined to 143% from 167%, and for non-bank sectors it declined to 113% from 127%. The share of net MLT borrowing was confined to USD 0.5 billion.



Source: CBRT

Central Government Budget: Slightly weaker in July-August than 2010

Budget balance is in positive territory for January-August…

The Ministry of Finance (MoF) disclosed July and August central government figures together today due to the fiscal recess. The central government budget posted a deficit of TRY 0.8 billion in July-August compared to a surplus of TRY 1.0 billion the same period last year. On the other hand, the primary surplus figure of TRY 8.6 billion was parallel to the figure recorded in July-August 2010 (TRY 8.8bn). Though the positive YTD budget performance continued, we found the July-August figures not so strong as the MoF collected TRY 1.9 billion in revenues in July-August from the restructuring of tax receivables.

The government has important space to support economic activity…

Year-to-date, the budget balance remained in surplus territory as in the first half of the year, with TRY 2.1bn (January-August 2010: -TRY 14.4bn), while the primary surplus, at TRY 33.8 billion, was well above the January-August 2010 figure (TRY 20.9bn). For January-August, the budget deficit and primary surplus currently stands at 0.2% and 2.8% of GDP. We forecast them to end the year at -1.0% and 2.2% of GDP respectively.

Currently, the central government budget deficit target stands at 2.8% of GDP, which provides the government significant space to promote growth. We believe that the government is likely to use some portion of this difference by year-end with the heightened risks to Eurozone and US economies. Therefore, there are downside risks to our budget and primary balance forecasts, though not significant.

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

	Jan-Aug 2011	Jan-Aug 2010	Real growth (%)
Central Government Revenues	199.0	169.0	10.4
o/w: General Budget Revenues	192.8	163.7	10.4
Tax Revenues	169.5	138.8	14.5
o/w: Corporation Tax	51.5	41.8	15.6
Tax on Income	19.4	14.7	23.7
Tax on Goods and Services	68.2	59.1	8.2
o/w: VAT	20.7	17.2	13.0
SCT	41.5	36.5	6.5
Tax on Foreign Trade	34.4	24.8	29.9
Non-Tax Revenues	29.6	30.3	-8.3
Central Government Expenditures	196.9	183.4	0.7
Non-Interest Expenditures	165.2	148.1	4.6
o/w: Personnel	57.5	49.1	9.9
Gov. Prem. to Social Security Agen.	8.4	7.1	10.7
Good and Services Procurements	18.6	15.1	15.4
Capital Expenditures	12.6	10.2	15.7
Current and Capital Transfers	73.7	69.6	-0.8
o/w: Social Security	37.1	37.7	-7.8
Transfers to Households	1.4	1.0	33.5
Agricultural Subsidy	5.7	4.9	8.5
Tre. Aid to Provincial Offices	1.9	1.2	50.2
Interest Expenditures	31.7	35.3	-15.7
Overall Balance	2.1	-14.4	…
Primary Balance	33.8	20.9	…

Source: Ministry of Finance