

Headline July inflation strengthens CBT's hand

Consumer prices declined 0.41% MoM in July, more than the market consensus (-0.08% MoM) and our in-house forecast (-0.04% MoM). This outcome brought annual inflation up to 6.31% in July from 6.24% (June) due to base effects.

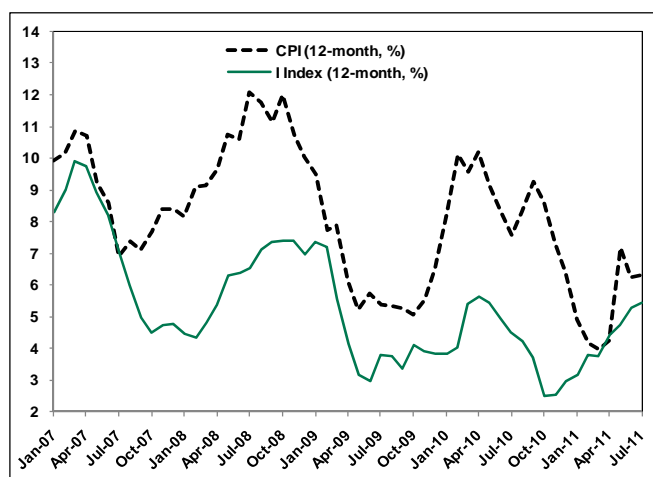
Annual core inflation indicators continued to rise in July...

Digging deeper into the details, food group prices declined 1.18% MoM, erasing 0.33 pp from monthly inflation, while clothing prices declined 4.84% MoM trimming off 0.36 pp from the headline figure. On the other hand, the effects of exchange rate pass-through remained limited in June as house-ware prices rose only 0.28% MoM and prices of private transportation vehicles remained almost flat in MoM terms in July. Annual rent inflation remained broadly stable at 4.4% in July compared to June according to the TurkStat.

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

Annual core inflation indicators continued to rise in July in contrast to monthly indicators showing a benign picture. While annual H index inflation increased to 5.99% from 5.73%, I index inflation (CPI excluding food, energy, tobacco products and gold) was up to 5.43% from 5.27% registered in June. Recall that the I index is the CBT's favorite core inflation indicator, and the bank is currently focused on SA core inflation indicators (3-month-MA), which would point to a more benign picture. We still see upside risks to the bank's year-end inflation forecast, which was kept at 6.9% in the recent inflation report, and maintain our year-end inflation forecast at 7.6%

There are upside risks to the CBRT's year-end inflation forecast (6.9%)...



Source: Turkstat

Summary Inflation Data: July 2011 (in percent)

	Monthly		12-month	
	Jul 11	Jul 10	Jul 11	Jun 11
CPI	-0.41	-0.48	6.31	6.24
Food and Beverages	-1.18	-0.73	7.65	8.13
Tobacco and Liquor	0.01	0.01	-1.50	-1.50
Clothing and Footwear	-4.84	-5.19	6.93	6.53
Housing	0.06	0.28	4.56	4.79
Houseware	0.28	0.62	7.22	7.59
Health	-0.72	0.26	-0.25	0.73
Transportation	0.78	0.49	9.81	9.50
Communication	0.19	-0.11	0.02	-0.28
Entertainment and Culture	0.94	-0.40	2.43	1.08
Education	0.73	0.88	5.41	5.58
Hotels, Cafes and Restaurants	0.61	0.34	7.79	7.50
Misc. goods and services	1.47	-2.01	12.98	9.11
PPI	-0.03	-0.16	10.34	10.19
Agriculture	-6.06	-2.15	1.83	6.07
Mining and Quarrying	1.20	2.44	14.74	16.14
Manufacturing Industry	1.34	0.21	13.85	12.58
Electricity, Gas and Water	0.16	0.41	-2.97	-2.72

Source: TURKSTAT

MPC meeting: On hold, but still dovish

On August 23rd, the Monetary Policy Committee kept the policy rate (1-week repo rate) at 5.75%. It also maintained other interest rates at previous levels. The rate decisions are in line with the market consensus. In addition, there was no mention of any RRR changes in the announcement. The market consensus was for no change on TRY RRRs and half of the participants in the CNBC-e's survey expected an average 100 bps RRR cut on FX liabilities.

The MPC will likely to cut policy rate further due to global recession risks...

The committee reiterated that it expects a significant improvement in the current account balance in the coming period. However, the committee implies stabilization, not contraction, in the 12-month rolling CAD in the second half as the CBRT's Governor Erdem Basci recently said that they expect a CAD of USD 70-72.5bn by year-end. Recall that as of June, the 12-month rolling CAD was at USD 72.5bn.

We forecast the policy rate to end 2011 at 5.25% barring a major shock to the Lira...

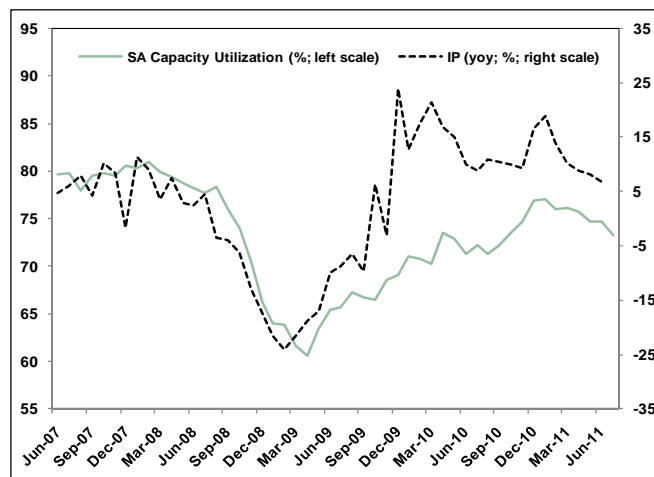
Stressing that downside risks to domestic economic activity balanced after the decisions taken in the interim meeting on August 4th, the MPC reiterated that it may use all policy instruments in the easing direction, should the deterioration in the global economy continue and the slowdown in economic activity deepen. In short, the CBRT maintained its dovish stance. We believe that the MPC will continue cutting rates after pausing this month as there is no short-cut solution to the problems in the Eurozone and the risk of a recession in the world economy significantly increased. Therefore, we forecast the policy rate to end 2011 at 5.25% barring a major shock to the Lira, which implies that there is still a downside in the benchmark rate due to the premium provided by the spread between bonds and policy rates. However, given the record CAD and associated risk premium, below 7.50% is unlikely for the benchmark at this point.

IP figure supports slowdown thesis

Industrial production rose 6.7% YoY in June, less than the market consensus of 7.9%, implying a significant slowdown after the 8.0% YoY rise in May. In fact, IP (adjusted for seasonal and calendar effects) fell 0.9% MoM in June, declining by a cumulative 3.7% between February-June. In seasonally and working day adjusted terms, IP is at the lowest level since December last year.

Slowdown in IP continues...

The 1.7% QoQ decline in IP in the second quarter supports our flat QoQ preliminary GDP growth forecast, which corresponds to around 6.5% YoY growth for the second quarter.



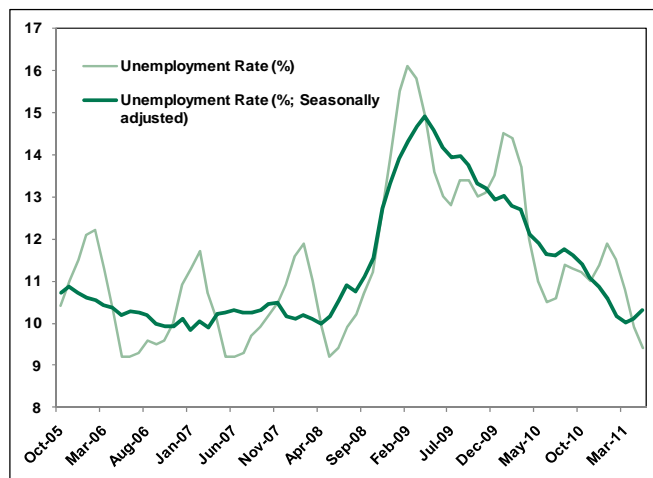
Source: Turkstat, CBRT

SA unemployment rate increases in May due to economic slowdown

The slowdown in economic activity made its effects felt on labor statistics as the seasonally adjusted unemployment rate stopped its decline. It rose slightly to 10.3% in May (up 0.2 pp over April), its second consecutive decline. On the other hand, the unadjusted unemployment rate declined to 9.4% from 11.0% in May 2010. It was 9.9% in April, but 0.5 pp decline over April was due to the seasonal employment patterns in tourism and agriculture, as the seasonally adjusted employment figure declined 13k in May. On the other hand, non-farm unemployment declined to 12.0% from 13.8% recorded in May 2010.

Slowdown in Q3 will likely to prevent further fall in SA unemployment rate...

With the slowdown in the economic activity as pointed by capacity utilization rates in the third quarter, it seems as though the slight increase in SA unemployment rate has continued since May. The stop in the decline in the SA unemployment rate will make the CBRT's hand stronger in cutting policy rate further.



Source: Turkstat

CAD in line, but pressure on the Lira is likely to remain

The current account deficit was USD 7.5bn in June, right in line with the market consensus and our in-house forecast. Meanwhile, the 12-month rolling deficit widened to USD 72.5bn (around 9.5% of GDP) in June (May: USD 68.4bn). The non-energy component was once again behind the widening in the current account deficit in June. The 12-month rolling non-energy deficit widened to USD 32.4bn from USD 29.4bn, showing the strength of non-energy imports.

Current account deficit was a new record in June...

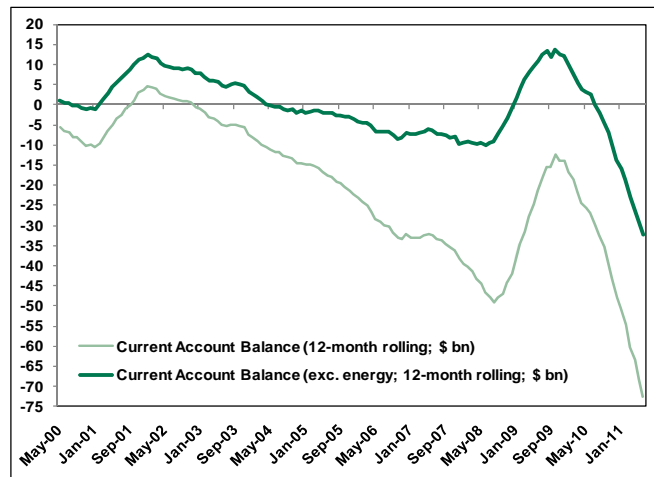
On the financing side, net monthly FDI remained weak at USD 0.6bn and short-term monetary inflows once again were the main financier. Net portfolio inflows were USD 2.0bn (a net inflow of USD 1.5bn to debt securities). Banks' short-term credits had a role of USD 1.7bn in financing. In June, the CBRT accumulated a net USD 1.6bn of FX reserves, and USD 2.2bn came from under net errors and omission, which amounted to USD 9.8bn in the first half.

Financing with short-term funds continue...

The June data reveals the continuation of short-term financing. For H1, net FDI and MLT borrowing by banks and other sectors financed 14% and 12% of the CAD respectively. On the other hand, net portfolio inflows (33%) and deposit withdrawals from abroad (31.4%) were the main financing sources, followed by 22% CAD financing by net errors and omissions.

We forecast that pressure on the Lira will likely remain due to record CAD and short-term financing...

While, the CAD for H1 more than doubled to USD 45.0bn from USD 20.2bn registered in H1-10, we forecast a current account deficit of USD 73bn (9.5% of GDP) for the whole year thanks to slowdown in economic activity and the limited increase potential of oil prices. Combining the record CAD and the dominance of short-term financing, we forecast that pressure on the Lira will likely remain, especially after the CBRT comments implying that more rate cuts are in the pipeline.



Source: CBRT

Cash budget strong in July thanks to restructuring

Additional revenues from restructuring increases budget performance...

In July Treasury’s cash budget registered a cash deficit of TRY 2,1bn and a primary surplus of TRY 1.5bn comparing unfavorably with July 2010 figures (cash budget: TRY - 0.8bn, primary surplus: TRY 1.7bn) at first sight. However, the deterioration reverses after adjusted for TRY 6.3bn tax collection shift to August. Making this adjustment, the cash budget would have posted TRY 4.2bn cash surplus and TRY 7.8bn primary surplus thanks to restructuring. Including tax shift, revenues would increase 38.6% YoY against the 9.4% increase in primary expenditures, which shows the significant contribution of the restructuring. We will have more information regarding the restructuring revenue on September 15 when the Ministry of Finance is expected to release central government budget for July and August.

**Cash Based Budget: 2010-11
(TL billion)**

	Jul		
	2011	2010	(%) 1/
Revenue	21.7	20.2	1.0
Expenditure	23.8	22.6	-0.9
Non-Interest	20.2	18.5	2.9
Interest	3.6	4.1	-18.2
Primary Balance	1.5	1.7	...
Privatization and funds income	0.1	1.6	...
Overall Balance	-2.1	-0.8	...
Financing	2.1	0.8	...
Borrowing (net)	0.7	2.1	...
External	-0.2	-0.3	...
Domestic	1.0	2.5	...
Privatization	0.0	0.0	...
Transfers from SDIF	0.1	0.0	...
Receipts from onlending	0.1	0.2	...
Change in bank accounts	1.1	-1.6	...

Source: Treasury, our calculations.

1/ Deflated by CPI inflation.