



## Macro Scope

8 - 14 March 2010

# Weekly Economic and Strategic Review

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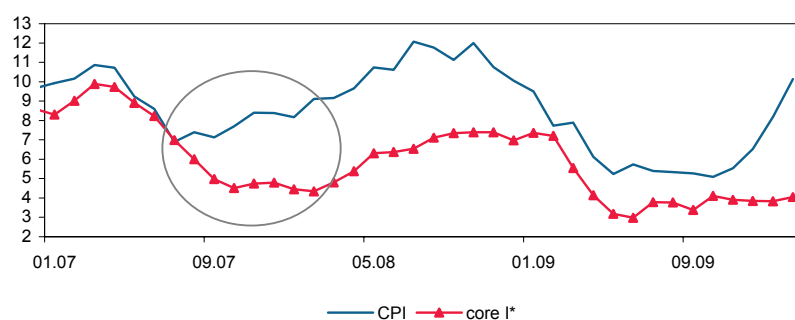
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## Inflation Running Amuck?...

The annual CPI rate has jumped to over 10 percent in only a few short months, a giant leap from 5 percent last October. Admittedly, the Central Bank of Turkey has been preparing us for this news. However, it is nonetheless shocking, regardless of underlying causes. Anyone following our reports recalls that we predicted a rise in inflation up to 9.6 % in the first few months of this year. However, this current awakening has certainly upstaged any of our expectations, outstripping our own pessimism. Furthermore, this has come about without a substantial increase in natural gas prices, which we had also predicted for the first few months of the year. **But the most important point is to prevent this demoralizing development from giving the impression that inflation is out of control, which would only serve to eliminate worsening expectations of inflation disrupting pricing patterns.** This is the role of the Central Bank, which could be accomplished in two ways. **First, the Central Bank must rely on their estimates of inflation and economic activity by trusting that a rise in food prices will not be permanent and those prices will converge with average inflation rates once again.** At the same time, the bank must also persevere with their current policy yet with eyes and ears open to negative developments in core inflation. This position could be maintained as long as non-food and energy inflation rate continue to be as low as current rates, even though this strategy in 2007 did end negatively. Arguably, being insistent is not the best way to go either. **Secondly, the bank must instill tighter controls on their current monetary policy, either gradually or pre-emptively.** At present, the bank is implementing a combination of these two alternatives but tightening the monetary policy gradually. Substantiating this strategy even more is that no one in the international community is showing signs of restraining monetary policies, apart from a few countries. Also observed are low short-term and long-term interest rates, without a major shift in inflation. However, developments in these areas should be scrutinized since they determine our relative position in terms of real rates.

CPI and Core CPI (% chg. y/y)

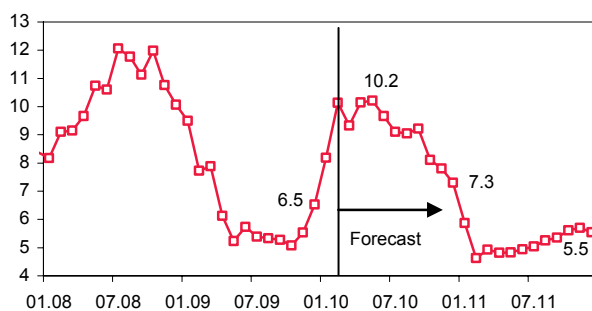


Source: Turkstat

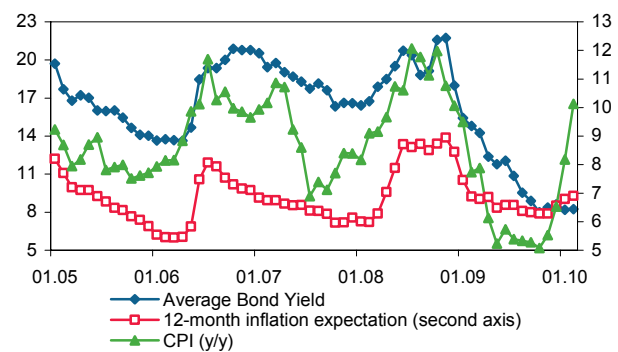
(\*) CPI excluding food, energy, tobacco/alcoholic beverages and gold.

Despite debates over keeping long-term low interest rates, touched on in “Macroscope” two weeks ago, the Central Bank realizes as much as we do that interest rates will certainly climb in the near future. What we don’t know is which month and to what extent. But we contend that the Central Bank will react to economic data with an unbiased approach. **Another important uncertainty is the issue of additional monetary policy tools and liquidity opportunities to constrict financial conditions prior to interest rate hikes.** During the economic crisis, the decrease in policy rates (November 2008) had already started before these measures were put into force, especially the first measure pertaining to the Turkish lira, which initiated long-term repos (three months) in June 17, 2009. The last measure pertained to the required reserves for the Turkish lira, which had dropped to 5 percent from 6 percent on October 16, 2009. **Therefore, if the exit strategy in easing monetary controls is implemented by withdrawing these types of support before increasing interest rates, the hike will in effect be the last measure. Conversely, another option could be a symbolic policy rate increase that would not be communicated as a new tightening cycle.**

Consumer Prices in Turkey (% y/y chg.)



Inflation, Inflation Expectations and Bond Yields (%)



Source: Turkstat, CBT, Fortis Economic Research and Strategy

With these assessments, what is the outlook for inflation? As mentioned in Flash Note, published after the release of current economic data, the uptrend in one-off tax and food prices comprises 6.6 ppt. of the 10 percent annual inflation rate, which will probably be temporary. While these factors drive up inflation, the underlying inflation trend remains benign, as seen from the core price indicators. The annual price increase of Central Bank’s favorite core indicator (excluding food, energy, gold, alcoholic beverages and tobacco), namely the “core-I” index, increased by a mere 0.2 pp to 4.0%.

In addition, the 5 percent monthly increase in food prices from 9.4 percent to 14.8 percent on an annual basis is the highest historically, except for July 2008, when worldwide commodity prices sent shock waves across the globe. However, the situation today is not the same because the food prices are more likely to converge to at least its long term average of 9%. **After a sharp rise in inflation in the first two months of the year, fluctuations should also be expected to continue in the short term, to a large extent caused by the base effect.** For example, while expecting annual inflation to go down in March by around one percentage point, primarily because of the high rate in March of last year, we also anticipate an increase in April and May, peaking at 10.2 percent and remaining high in the 9-10% range until the last quarter. **We estimate that the base effect will have a positive influence beginning in the last quarter and that the CPI will stabilize at 7.3 percent towards the year-end. However, we must admit that there are upside risks on our estimations.** Since end of November, inflation expectations for the next 12 to 24 months have gone up by 62 bps and 32 bps to 6.91 percent and 6.54 percent, respectively. The future outlook of this climb, albeit limited, is also quite important. We are almost sure that the 12-month forward looking inflation expectations would go up. However, the expectations considered most important by the Central Bank are those over the next 24 months.

Although a rise in annual inflation raises the risk of negative outcomes, we surmise that the Central Bank will sweat it out for the next few quarters before making any changes to their current monetary policy. With a hike in interest rates beckoning in the last quarter, we still predict an increase of 150 bps over the entire year.

In conclusion, despite the reasons or preparation, we are facing a harbinger of shocks wrought by inflation. We expect the Central Bank to continue propagating the message through their talks and actions that whatever is necessary is forthcoming to eliminate any illusion that inflation is running amuck. Although presently more difficult, a delicate balance is a must to avoid any more damage to an already tenuous recovery and to keep a tight grip on inflation.

## Economic and Political Agenda

▪ At home, there will be some critical data disclosures such as industrial production and current account balance during the week. Treasury will issue zero coupon reference T-Bill due 08.0.2010 and fixed-coupon bond due 06.08.2014 on Monday and Tuesday respectively ahead of remaining TRY2.9bn redemption in March, big portion of the redemptions is to the market. At external arena, US retail sales and foreign trade balance will be eyed by the market.

### Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
High	Industrial Output, Jan.	% y/y	Mar. 8 <sup>th</sup> , 8:00 GMT	16.4 (15.9)
Medium	CB's Expectation Survey, Mar. I	-	Mar. 8 <sup>th</sup>	-
Medium	Cash Based PS, Feb.	TRY bn	Mar. 8 <sup>th</sup>	-
Medium	CNBC-e Consumption Index, Feb.	-	Mar. 10 <sup>th</sup> , 8:00 GMT	-
High	C/A Balance, Jan.	US\$ mn	Mar. 11 <sup>th</sup> , 8:00 GMT	-

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
Medium	U.S.	Foreign Trade Balance, Jan.	US\$ bn	Mar. 11 <sup>st</sup> , 13:30 GMT	-40.3
High	U.S.	Retail Sales, Total & ex-auto, Feb.	%, m/m	Mar. 12 <sup>th</sup> , 13:30 GMT	0.0 & 0.2
Medium	U.S.	Michigan Cons. Sent. Index, Mar.	-	Mar. 12 <sup>th</sup> , 14:55 GMT	73.5

## Macro-Economic and Financial Forecasts

### Macro Economic Outlook of 2008-2011

	2009	2010f	2011f	2012f
GDP (TRY - bn) (*)	969.4	1,090.1	1,193.8	1,297.4
GDP (US\$ - bn) (*)	626.6	721.9	774.4	829.8
GDP Growth (y/y % chg) (*)	-5.7	5.0	4.0	4.0
PPI (y/y % chg)	5.9	5.0	4.0	4.0
CPI (y/y % chg)	6.5	7.3	5.5	5.0
Trade Balance (US\$ - bn)	-38.6	-64.5	-64.8	-68.0
Exports (FOB, excl. luggage trade)	102.2	115.3	132.6	144.4
Imports (CIF, incl. gold)	140.8	179.9	197.4	212.3
Current Account Balance (US\$ - bn)	-14.2	-35.8	-33.3	-33.4
Current Account Balance / GDP (%)	-2.3	-5.0	-4.3	-4.0

(\*) 2009 values are our forecasts

### Financial Indicators Forecasts

	Mar. 5 <sup>th</sup>	1M	3M	6M	12M	2010	2011
US\$/TRY	1.5323	1.5500	1.5400	1.5200	1.5300	1.5200	1.5600
EUR/TRY	2.0894	2.1100	2.1100	2.0800	2.1400	2.1300	2.1800
FX Basket	3.6217	3.6600	3.6500	3.6000	3.6700	3.6500	3.7400
EUR/US\$	1.3636	1.3600	1.3700	1.3700	1.4000	1.4000	1.4000
O/N	6.50%	6.50%	6.50%	6.50%	9.00%	8.00%	10.00%
Benchmark Bond	9.10%	9.30%	10.00%	10.50%	11.20%	11.00%	12.00%

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