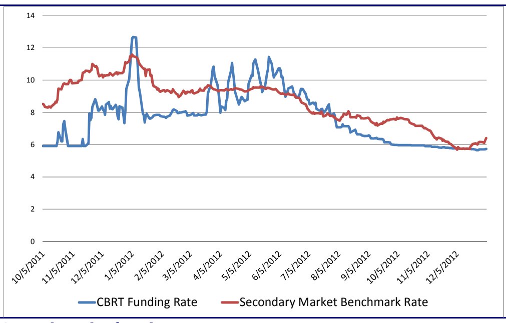
Macro Update

Turkey Weekly Macro Comment

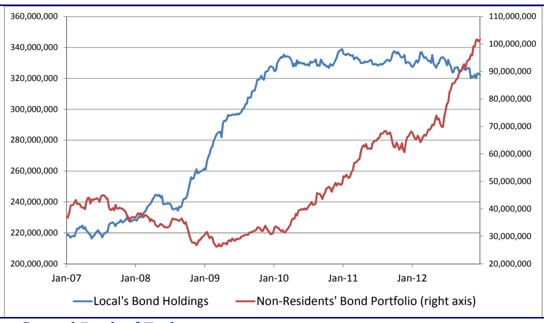
07 January 2013

Bond Rates vs CBRT Funding Rate



Source: Central Bank of Turkey

Domestic & Foreign Bond Portfolios



Source: Central Bank of Turkey

Between Caution plus a Dose of "Realism" and Coherence

- We are yet at another crossroads regarding the Kurdish problem but the probability of a workable set up seems to be significantly higher this time around.
- The confusion regarding the dynamics of normalization in Turkey is still rampant among locals and foreigners alike. Contemplation has been lacking and we seem have an awareness process that only uses ex-post realizations for perception formation.
- Inflation for the month of December at 0.38% yielded a year-end inflation of 6.2%, a number significantly below market's expectation until very recently.
- No need to be pessimistic about 2013 inflation due to domestic demand recovery (or a significant exchange rate shock) as output gap should prove to be fairly supportive at least for the entirety of 2013.
- Yet the CBRT begins the year with some "inflation gift" on its lap due to scheduled but somewhat revised tax on tobacco and alcohol products; a 0.8 percentage point contribution to January inflation according to the CBRT.
- Both consumer and commercial loans had a strong showing in the most recent weekly data release. This is further supportive of our view that the CBRT is likely to stay put for a while.

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Between Caution plus a Dose of "Realism" and Coherence

We refrain from writing on politics unless something extraordinary happens or we have a totally different view on something that is not extraordinary in itself. We believe an extraordinary political development is in the making regarding the Kurdish issue and we may be witnessing some historical announcements this week. Even if we do not, or if the announcements we hear turn out to be disappointing rather than encouraging regarding a solution to the infamous Kurdish problem, we still believe that the change in the counterparty position for the Turkish State is drastic enough to ensure a more predictable and more pleasant path regarding the future of talks.

We have witnessed quite a few historical junctures in this country within the last decade where "normalization" proceeded at full speed both in political and economic spheres barring a few episodes of intermissions. Those intermissions mostly turned out to be accelerators for the next step in normalization and can thus even be not looked at as intermissions. Such was the episode we experienced within the last two years and such is this new stage we are undergoing at the moment regarding the epic Kurdish saga. This is a long story in itself and is far beyond the scope of a weekly but those who follow Turkey closely would remember how the first "Kurdish initiative" had been sabotaged by almost all political entities except the implementing agent AKP in 2009. The annihilation of the initiative had been registered as political gain by the sabotaging parties as their perception of politics was one that was limited by the boundaries of a zero-sum game. Jailed leader Ocalan was marginalized by hardliners within the armed insurgence and his leadership was de facto questionable. Syria turned into a mess, Kurds in Syria could not make up their minds who to side with for a while and then sided with Asad who relinquished the land Kurds have been residing on out of a newborn generosity. Revolutionary Kurdish armed insurgence conjectured that the Arab Spring was the predecessor of the Kurdish summer, long-awaited and belated revolution was about to move into the Turkish land to be supported by the uprising of the Kurdish population here, and things seemed to be getting out of control while not so paradoxically Northern Iraq was getting closer with Turkey, whom she perceived as her only reliable ally/big brother on a daily basis. Hunger strikes by jailed Kurdish insurgents that began in Turkish prisons towards the end of last year were brought to an end by jailed leader Ocalan who managed to assume a prominent role in the power distribution in Kurdish politics once again. What had been infuriating Ocalan was the sheer fact that he was put on the injured list and not allowed to play while everyone was still talking about him as the franchise player. He was being used, and there were times he openly accused both the Government and the PKK for using (abusing would be the better translation) him in the past. The Government part is a natural sweetener but accusing his own pet project for using him was neither light nor usual. His de jure divine status seemed to have no de facto essence until the ending of hunger strikes. His polished status as a major actor in Kurdish politics is now being leveraged by the Government who is keen on and candid about a solution to this eternal problem. Promotion of Ocalan to main counterparty position in the bargaining process not only makes life easier for the Government but will also lead to the discrediting of any sabotage attempt designer.

Kurdish party BDP will be coming up with a public announcement this week regarding the initiation of the process and it will have to endorse it as Ocalan is openly and firmly behind this possibly three-step plan (cease fire, move beyond Turkish borders, and abandon arms provided adequate legal arrangement are made for PKK members). No one will want to be the party spoiler at this stage. What makes us very hopeful is that provocations will not work the way they used to in the past as has been demonstrated quite a few times within the last decade. The simple reason for these provocations not working was the fact that the Turkish public saw them as provocations. For it to be successful, a provocation should not look like one and should be perceived as “the real thing”. Turkish public had finally reached the level of awareness and health of mind that equipped them with the capability to see an act of provocation as an act of provocation and as nothing else. Kurdish public is either there or is almost there, we believe. And we are very close the final resolution stage of what seemed to be an eternal problem until very recently. We are optimistic, yes, and moreover, not really cautiously so.

I had made a call more than a decade ago that Turkey had finally entered a stage of “normalization” that would entail a restructuring of her economic and political realms. The economic part was met with much less skepticism and was indeed admitted to be taking place with an attitude that could best be described as “reluctantly yet pleasantly surprised”. The political half of the bet served as the ground for excommunication. A politically “backward” stance suffering from an Islamic heritage would be delivering us a “normal” economic setting but was by default incapable of producing anything that approximated “normal” in the political realm. I had difficulty understanding how such an odd pair would be able to survive in today's global system, but not many did. The only logical argument I would buy coming from the opposing side (opposing me that is) would be the following: the AK Party will not be able to continue with or even cope with this economic normalization it has initiated as they have no genuine intentions of normalizing the political realm here. I would have to entertain that kind of a counterargument that does not entail a compatibility problem (the abnormal economics and abnormal politics combo vs. my bet of normal economics and normal politics). That counterargument would be assuming a bleak outlook with no compatibility problem and mine would assume a positive outlook again with no compatibility problem. Both arguments are internally coherent but reflect different judgment calls regarding the AK Party's intentions/capabilities/limits. The interesting observation within the last decade has been that there were no proponents of the counterargument I described above; a **re-abnormalization** of economics was fortunately ruled out as a prospect. Yet "normalization on both fronts" call found very little support and led to an ostracizing of those who dared bet on it. The majority of analysts drew a catastrophe picture regarding politics while forced to admit the normalization on the economic front albeit less than wholeheartedly. How these assumed prospective courses for the two realms in our lives were perceived to be compatible and sustainable has always been beyond me.

This confusion regarding the dynamics of normalization is still rampant and will be with us for some time to come. This is a historical transformation in all its aspects and will take some time to be absorbed in full. What is very crucial to understand at this juncture is that this normalization was initiated by a political entity but it has assumed a life of its own now. It will continue regardless of who is in charge. Costs, the speed of adjustment, and the slope of the normalization curve may be varying drastically depending on who is in the driver's seat but this is not the country that the AK Party had taken over more than a decade ago.

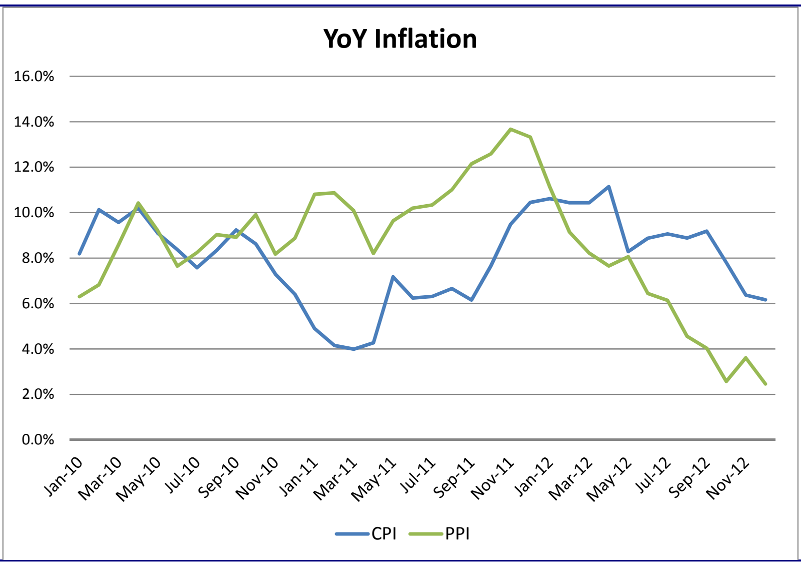
Regarding normalization on the economic front, we have a recent example that shows how temporary setbacks can indeed be observed. Everyone is quite well-informed about the maturity mismatch problem in the Turkish banking sector, the low level of savings, the extremely short maturity nature of deposits, etc. These problems are all intertwined, needless to say. The economy administration intends to ameliorate these problems to the extent that it can through certain incentive schemes. In an effort to make TL deposits more attractive than FX deposits and lengthen maturities, the government lowered the withholding tax for longer maturities. The withholding tax on TL deposits with a maturity of at least one year was reduced to 10% from15% while the reduction was limited to 12% for deposits with a maturity between 6 months to 1 year. TRY deposits up to 6-month maturity will enjoy no withholding tax reductions and will continue to be subject to an intact 15%. FX deposits with a maturity longer than one year was the only category that enjoyed a tax cut, from 15% to 13%. There was no change for maturities between 6 months to 1 year and those deposits with less than 6-month maturity were punished with a hike in the withholding tax from 15% to 18%. All this is fine; these measures may or may not have the intended impact but they make sense.

What is bothersome is that there is yet another set of some more new measures being talked about at the moment which seem to be inspired by the "tax the rich" mode in crisis countries. A most fashionable rhetoric among some ministers of the cabinet at the moment is that the rich should be paying more. We would like to think that this is about making the tax system more progressive, which in itself would be a dubious policy even in a country with minimal tax administration problems at this day and age. It goes without saying that we still cannot affiliate Turkey with the description for a representative country provided in the previous sentence. There is room for a serious and bone fide income tax reform in this country which should first and foremost secure a wide tax base and a rate scheme that encourages registration into the system and minimizes tax evasion. There has been some progress in tax administration but it is far being adequate. Given the current state of affairs vulgarly described above without any details, the intention to subject capital gains above a certain threshold WITHOUT any inflation indexation is tantamount to taxation of wealth rather than income yet in a disguised fashion. Known as the "bracket creep hypothesis", the idea is very simple. In an economy that suffers from discernible inflation (and so does Turkey at around 7 percent levels), an economy administration that does not index capital gains with respect to inflation may indeed be taxing the capital itself. You move recipients of capital gains into higher tax brackets due to the nominal increase in their incomes (capital gains) while they may have simply protected the real value of their asset by the gain registered and may have enjoyed no gain in real terms. They may even have registered losses in real terms, gains remaining nominal only. The Government will surely be enjoying a higher real tax revenue caeteris paribus, but the caeteris paribus condition may not be relevant the next period. You may be talking about capital gains taxation that will be generated through a much smaller asset base due to the disincentive that the absence of indexation produces.

Macro Data

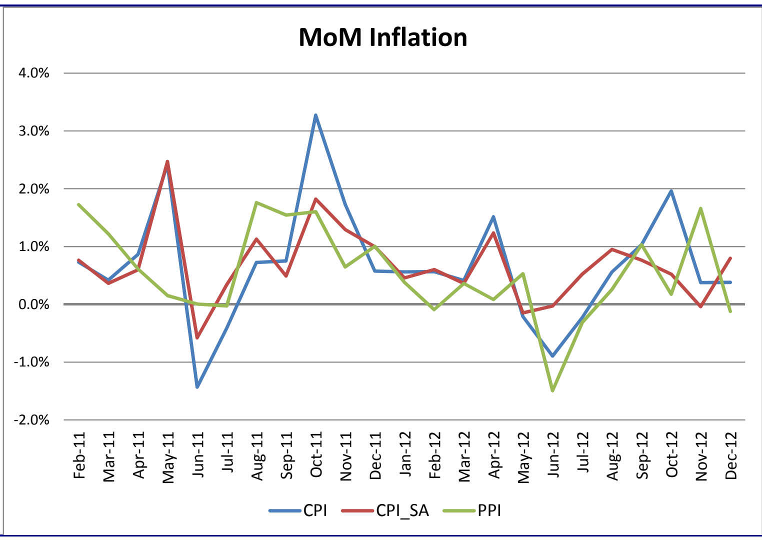
Inflation for the month of December at 0.38% yielded a year-end inflation of 6.2% (6.16% to be precise; a happy coincidence follows, to be mentioned shortly), a number significantly below market's expectation until very recently. The highest monthly increase was 1.55% in food and non-alcoholic beverages, possibly due to some mean reversion of prior months' low prints. When looked at in terms of contribution to the headline figure, the category's contribution stood at 0.39 percentage points, virtually telling us that monthly inflation was virtually a food inflation given extremely low figures in other categories. Barring the impact of utilities price hikes on housing and transportation categories, shoes and clothing and restaurant and hotels categories are the only categories with sizeable annual inflations. Special Consumption Indices are overall well-behaved and do not provide any negative news about inherent dynamics of inflation.

YoY Inflation



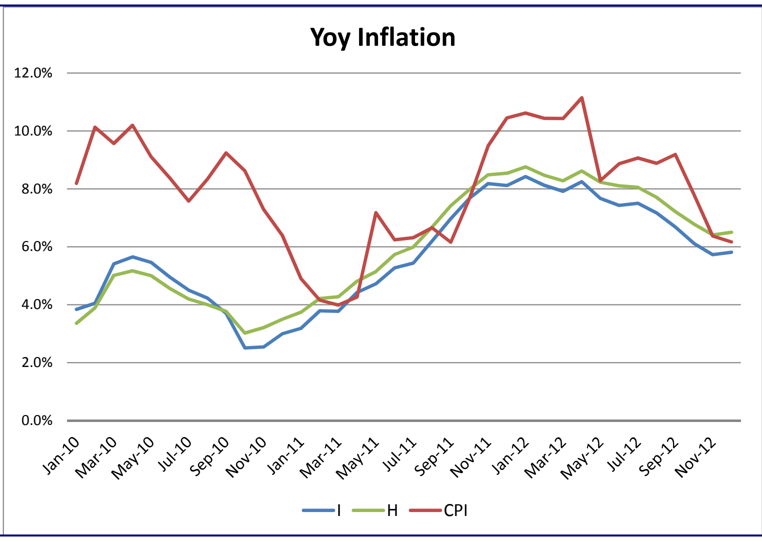
Source: TURKSTAT

MoM Inflation



Source: TURKSTAT

H and I Indices



Source: TURKSTAT

Considering expectations formed as recently as in October 2012, how could one miss the year-end inflation this big just a few months before the end of the year? The object of the question just posed, ONE that is, by the way, includes almost everyone including us and the CBRT. Our inflation and growth forecasts for 2012 provided to our Bank in September 2011 for budget purposes were 3.6% and 6.8%, respectively. These numbers were so off of consensus figures at the time that we were bypassed as forecast providers for the first time in our careers by our own Bank (consensus moved close to these numbers with a delay of roughly six months). Such was the level of gloom at the time. And we revised our predictions only when growth prospects deteriorated during the 3rd quarter and when the administrative price hikes package was introduced in fall 2012. The CBRT had also revised its inflation forecast to 7.4% in its inflation report as a result of the hike package and had estimated the impact of the package on inflation to be 1.16 percentage points in 2012. Could this be a divine sign that 5 is indeed a doable inflation rate (take the year-end figure of 6.16, subtract the impact estimate by the CBRT, 1.16 percentage points, and you end up with a very clear 5% :))? Kidding aside, a vulgar yet similar argument runs for last year's inflation above 10 percent as well. The contribution from pass-through and a similar tax and administered price hike package combined was around 5 percentage points, a point not disputed by any analyst in the market. Barring that joint impact, you have a core (plus sum non-core) inflation of around 5.5% for 2011! We know this is a vulgar statement that assumes away a number of interactions and non-linearity in the inflation process but it is not totally devoid of sense/meaning either.

No need to be pessimistic about 2013 inflation due to domestic demand recovery (or a significant exchange rate shock) as output gap should prove to be fairly supportive at least for the entirety of 2013. We observe a significant number of analysts counting on pent up demand and to exert significant upward pressure on inflation. We dare to differ and anticipate a very mild domestic demand pressure on the inflation process.

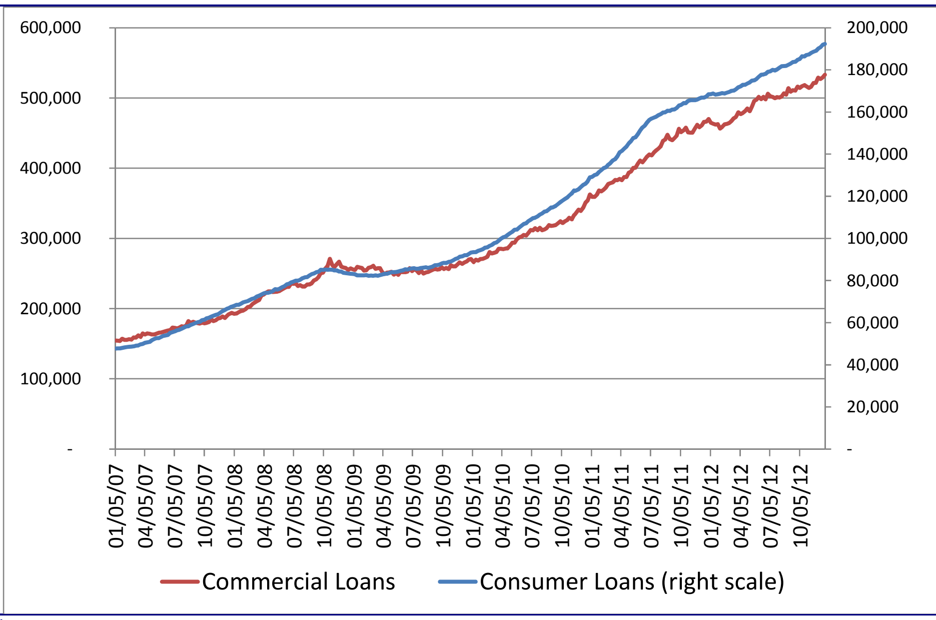
Yet the CBRT begins the year with some "inflation gift" on its lap due to scheduled but somewhat revised tax on tobacco and alcohol products. While the rise in ad-valorem tax remained significantly below what had been scheduled before, the minimum specific tax on each pack was raised while another excise tax has also been introduced. The impact on inflation is estimated to be between 0.5 to 0.8 percentage points. The latest from the CBRT is that the impact will be 0.8 ppt. in January

Here is the upshot; the CBRT had better focus on and target 4 percent inflation as games did not commence with zero inflation for the first month (leg) of the 12-month (leg) competition. This is the third year in a row whereby the CBRT has been taken/ambushed by other bodies in the decision making process and an otherwise much more amicable inflation picture set has been thwarted. There are those who claim that the CBRT should have followed a tighter policy in the face of higher than expected inflation as we have been observing these last two years. Advocates of such a higher rate policy are either failing to diagnose the reason for missing the target or they see the reasons clearly but are adamant to costs that may be attached to bringing inflation down (an "at all costs approach" stemming from a fixation on inflation targeting).

Weekly Data (all weekly data terminate on December 21, 2012 while consumer credits are one extra week updated)

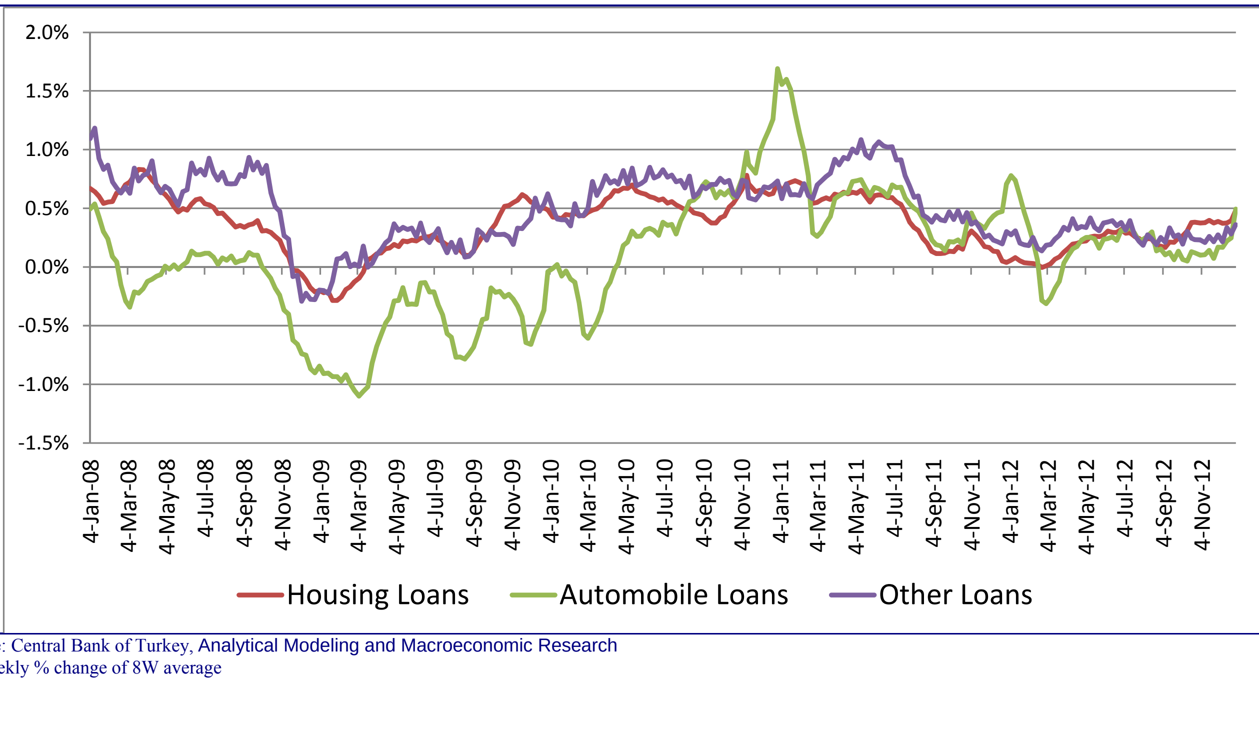
Both consumer and commercial loans had a strong showing with weekly increases of TL 1.6 billion and TL 3.8 billion, respectively, in the last week of the year for consumer loans and in the week before the last for commercial loans. The latter may have initiated a second streak of uninterrupted increases in loan volume after the blip that ended a four week streak two weeks ago. Commercial loans series is a very erratic one as we highlighted many times before, but the picture in the last two months does indeed suggest some momentum picking up in this category. That is more than welcome by all including the CBRT. Provided the pace of expansion in consumer loans is under control, the current picture is a fairly benign growth-inflation pair picture. Market watchers will be witnessing quite a number of inflation-growth-current account triplet projections now that the time to guesstimate has arrived and some will present their triplets as "equilibrium" triplets. It is truly mind boggling to see such rampant reference to a concept that goes so un-analyzed. Where the equilibrium nature of these numbers comes from we have no idea. We would only warn our readers that these variables have fairly complicated inherent dynamics that are doubly challenging to analyze in a transforming economy like Turkey. Making a bold statement about any of them is quite a task but to know what a daunting task it is, one would have to have engaged in some research that hint at the complications, peculiarities, and intricacies involved. That the question is easy to formulate says nothing about the effort needed to provide an answer assuming that a reasonable answer is available, which, in certain situations, is unfortunately not the case.

Consumer/Commercial Credits – Levels



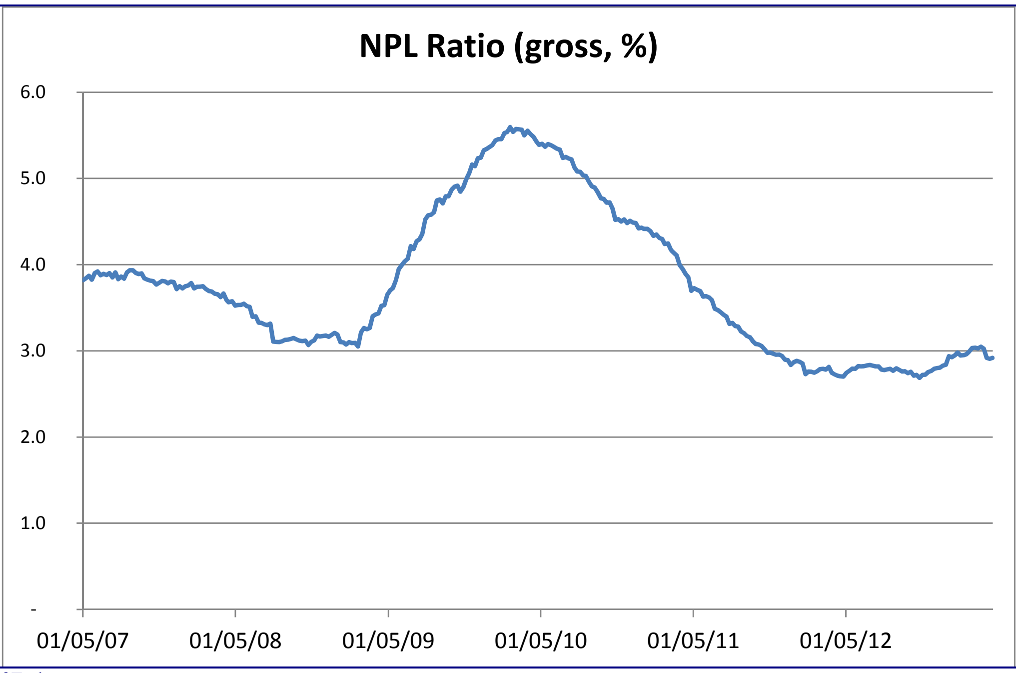
Source: Central Bank of Turkey

Consumer Credit Volume (*)



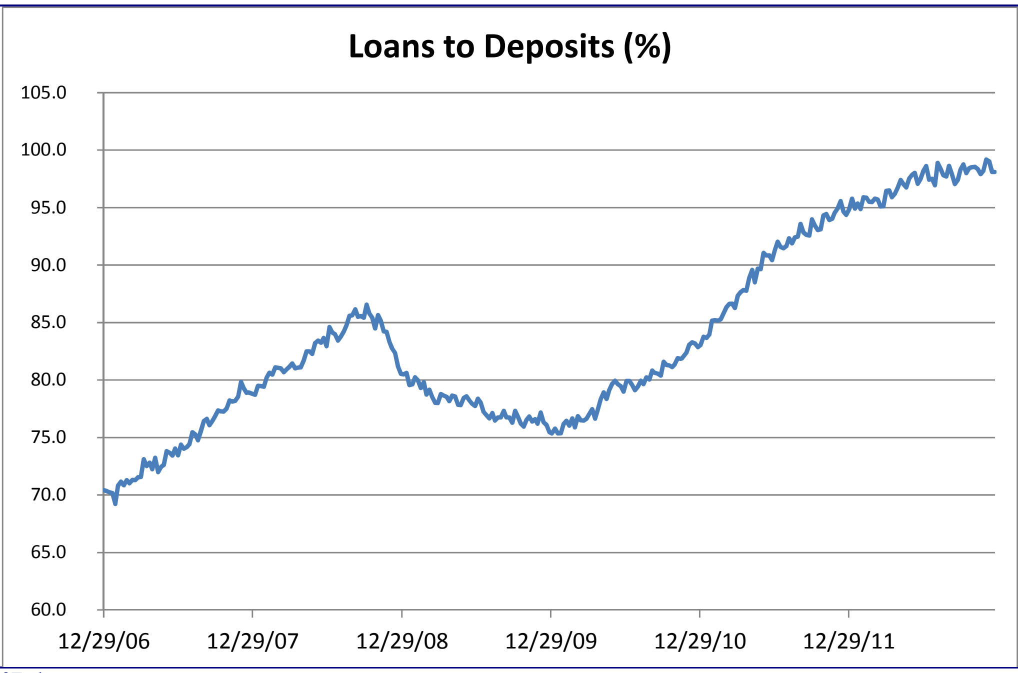
Source: Central Bank of Turkey, Analytical Modeling and Macroeconomic Research
(*)Weekly % change of 8W average

NPL



Source: Central Bank of Turkey

Credit/Deposits Ratio



Source: Central Bank of Turkey

Markets

by Murat Berk / Economist and Investment Strategist

Shifting Themes

I don't know whether F. Scott Fitzgerald was right when he said *"The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function."* but holding different and sometimes ideas in mind is usually helpful in markets.

It's so early to be drawing conclusions for the whole year but reflation and higher rates accompanied switch from bonds into equities seems themes gaining some traction. In addition to perceptions of stronger global growth ahead, the Fed's changing tactics may have played a role here. My view as discussed before (e.g Dec 12 "Monkey Wrench, Volatility, High Yield") remains that the Fed has shaken the belief that the yields around the world will remain low forever.

However, market prices do not follow a straight line and headline risks in the US and Europe could turn more bond friendly and equities in the coming weeks.

In the US: Republicans are likely to use the debt-ceiling negotiations as a bargaining tool to get more expenditure cuts implemented. However, Democrats are highly unlikely to give in as suggested by President Obama's latest comments. Some data such as US consumer confidence suggest that uncertainties have started to have an effect. A longer period of uncertainties would not boding well for the consumer and investment environment going forward, in our view.

Also, some political developments in Europe seem to suggest that the next risk off episode could involve some sort of disinflationary/growth negative headlines from Europe and/or debt ceiling from the US.