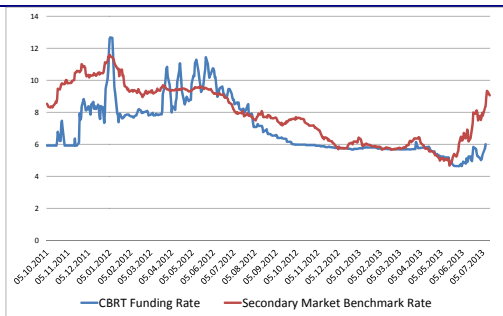


Turkey Weekly Macro Comment

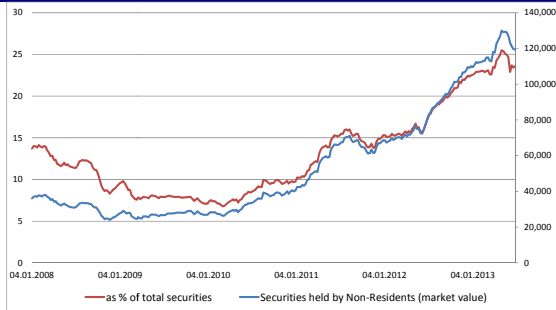
15 July 2013

Bond Rates vs CBRT Funding Rate



Source: Central Bank of Turkey

Foreign Bond Portfolios



Source: BRSA

How Not to Manage Expectations: the Sequel (number ?)

- These are definitely one of the more interesting times in Turkey, and presumably one of the riskier as external and internal risks hardly ever coincided the way they do at the moment.
- There were some interesting developments on the policy/decision maker front on this first day of the week and they tend to depict a previous weak link in the management process yet once again.
- If the FX market moves in a reasonably calm mood till the MPC meeting, an increase in the upper bound of the corridor will be the only change announced after the meeting. That is our take on the meeting at the moment based on our “use the ammunition sparingly” approach of the CBRT.
- Expectation management is a most delicate field of expertise and requires first rate assistance from all involved in the policy/decision making process. We would like to think that what we have seen so far is not the best that could have been achieved. Hence, there is still room for improvement and that should serve as some consolation for optimistic participants of Turkish markets.

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How Not to Manage Expectations: the Sequel (number ?)

These are definitely one of the more interesting times in Turkey, and presumably one of the riskier as external and internal risks hardly ever coincided the way they do at the moment. We have mentioned so many times before how globalization took away certain mechanisms that could have an impact on finance and trade channels from economy administrations and how that rendered expectations management so much more imperative and challenging than ever. The AKP Government has a fairly decent track record on expectation management with the exception of a few mishaps and a grand error that was committed at the outset of the subprime crisis that led to a 4.8% contraction in 2009. Yet there had been a growing threat in the form of a trend that amounted to a steadily widening gap between the demands of both the AKP constituency and the non-AKP voter base (which the ruling party by default has to cater to within reasonable limits as they are the ruling party per se) and the human resources that are put to work to fulfill these demands. This is a country that has been undergoing a tremendous social transformation thanks to the reform processes initiated by the AKP in many realms which need not be elaborated here. Yet it is imperative that the forces which initiated these processes remain in tandem with this transformation and maintain the competence and compatibility that is needed to meet the new challenges that arise almost on a daily basis due to the very same transformation.

It can be a very exhausting but joyful ride as you see the outcomes of the processes that you initiated which assume a life of their own after a certain point and accordingly require your adjustment to these processes. If the adjustment does not take place, the feeling of lagging behind which you are reluctant to register could turn into frustration and impact the decision making process. This is not only true for high level civil servants or government members; we had said the same thing some time ago for private sector executive managers as well. If executive managers mostly keep their seats while the environment is changing drastically in terms of macro fundamentals which will have a huge impact on the operational environment, these managers must be transforming mentally themselves. If not, there will be a compatibility problem.

Although many circles still remain reluctant to give credit to the AKP for the transformation that Turkey has undergone, credit has to go where it is due. Yet that is ultimately an

accounting issue of our recent past and does not necessarily imply much about future prospects though track record is admittedly a very good indicator. Though it sounds paradoxical at first, it also has to be registered that when a setting (economic and/or political) becomes more “normal”, it does not necessarily mean that “management” becomes easier. Quite to the contrary, skills and merits that are sufficient to normalize a fairly abnormal setting is likely fall short of the levels required for managing a “normal” setting. When the political entity that is in charge of this transformation is aware of and is adjusting to this refurbishment need, the ride can indeed be quite joyful and rewarding as we said before.

Interestingly enough, we had seen such a move by the AKP at the end of September 2012 when an appointment that made us very hopeful for more moves of that type to come went mostly unnoticed by both local and foreign analysts. Here is what we wrote in our Weekly dated October 1st, 2012:

“The highlight of the week may have been the AKP’s general assembly held on Sunday in which PM Erdogan was elected as the Party Head for the third and last time. This is a clear signal that he is indeed heading for the Presidency; for the first publicly elected president title to be more precise. It will be interesting to see how delicate internal balances within the AKP and AKP’s tenuous equilibria with outside forces will play out in this “three elections” period until the end of 2015.

That there was not much new that came out of the general assembly has been the message spread around, but we believe there were two important messages from the assembly. The first is the emphasis placed on what is taking place in Turkey’s hinterland and the messages to the Muslim world. The unconditional support to Turkey’s foreign policy by Egyptian President Morsi who was bodily present and gave a speech himself is very crucial in Turkey’s restoration of her ties with the Arab world. PM Erdogan is not trying to become the leader of the Muslim world; that is not a feasible project. But he is trying to make sure that he has the moral support of the Muslim world when he is at the table dealing with the powers to be of the world. One has to admit that he has come a long way in that respect. Presence of and the extraordinarily warm welcome for the leader of the Kurdish Autonomous Region of Iraq, Mesut Barzani, was also a crucial signal not only for reasons of foreign policy but also for its signal content with regards to the ongoing Kurdish problem within Turkey’s own borders.

And finally, an appointment significantly downplayed by the entire media which we believe is very explanatory in terms of the inevitable social transformation that the country is going through: Osman Can is in the new Central Decision and Executive Committee of AKP.

Osman Can is not your ordinary law expert in Turkey. He has a Ph.D in Law from University of Cologne in Germany and is known mostly for his “no closure” recommendation to the Constitutional Court in the AKP closure case in 2008. He is not your ordinary AKP high ranking officer and is as close to the definition of a liberal as you can get in this country. His appointment to the Committee is extremely promising for AKP’s approach to the new constitution efforts, and even beyond that, we believe. We would like to think, and we do indeed believe, that Can’s appointment is a sign of regaining of consciousness for the AKP who must be grasping that social dynamics here is evolving extremely fast and that they as a political entity run the risk of lagging behind. One man does not change anything by himself, but the signal content of one single appointment may be amounting to much more than the appointment itself. “

The pleasant surprise for us at that time is displayed above in the bold-highlighted paragraph. We perceived Osman Can’s appointment as a very crucial signal that the AKP was refusing to lag behind and was reading the mental transformation process properly, thus responding to the needs of this new setting with proper HR enrichments. Not much had taken place since then and one could say that there was no urgent need but that does not seem to have proved to be the case given the current setting. Contingent liabilities should never be lost track of as they may pop up quite abruptly in the political realm in particular. One needs to be prepared for the worst and preparation in terms of HR is always the most helpful for all entities; be it political, economic, public, or private. Towards the end of May, Turkey looked like the gem of the EM world and now it is presumably the most doubted and tested market of all. This need not have been the case despite the Bernanke fear and Gezi Protests. Better management via better HR at PM Erdogan’s disposal would have alleviated the situation, particularly given certain other historical moments that overlapped with our problems at home and with the Fed tapering fears.

We are referring here to the eternal Kurdish problem at home and the coup in Egypt that served as a litmus test for all political circles, both of which coincidentally were issues in the Weekly we quoted from above. The Kurdish solution is still intact thanks to prudent management of the situation by both Government and BDP authorities. That alliance is the most important direction setter for the path that Turkey will be sailing on for both the immediate and the foreseeable future. In vulgar terms, BDP’s strategy will mostly determine what kind of political developments will be taking place in the country and how the balance of power will evolve. Secondly but equally important was the immediate reaction of the AKP

to the coup in Egypt and the clear labeling of the coup as a coup which was backed up later on by all parties in Parliament by a common declaration. This was exhilarating to see, a common condemnation of the coup by all political parties, and is very telling about the political maturation in this country. In fact, given that such a condemnation came from the EU only very recently and that a coup is still not spelled by the US, one could get hyped up and claim that Turkey has more developed democratic instincts than the developed world. That would be stretching it a bit to say the least but it is true that our knee jerk reaction to coups may finally be more “developed” than the developed world for the simple reason that we have a history of coups.

As mentioned before, the section we quoted verbatim from our Weekly coincidentally has references to the Kurdish problem, Morsi and Egypt and Turkey’s positioning in this part of the world, and Osman Can’s appointment. These, we believe, are still the agenda setting issues in Turkey, the latter in the HR sense and in the personality of Mr. Can per se needless to say. And, given that the AKP has a fairly strong hand, even the moral upper hand in the first two issues, these two issues should not constitute any kind of handicap in policy formation and arguably work as leverage towards any other policy making. Yet the HR issue is a prominent one and the Osman Can appointment should not be registered as a freak incident in AKP’s track record but as the first reflection of a series of HR renewals that will make the AKP cadre more compatible with the society it so successfully has been transforming. This transformation has been partially intentional and partially beyond the intentions of the AKP but that also goes as a credit to them as the initiator. It is this latter part that has to be grasped in its essence and coped with.

One final comment regarding the internalization of “power and strength” by any political entity and how that should be affecting the behavior of those in power. We will make specific reference to the infamous conspiracy theories that are in circulation these days and the relevance of our claim pertaining to the internalization we mentioned above for the handling of those theories. It would be ludicrous for analysts like us to make claims about the existence or absence of such conspiracies, but let us assume for a second that such conspiracies do indeed exist and are aimed at political annihilation of those in power. True strength/power necessitates that you do not proclaim these conspiracies out loud but deal with them silently to the best of your capability but with a low profile. You need to create the impression that this is nothing to be made too much fuss of for a governing body equipped with true and deterrent

power. Strength is more deterrent when made felt and not displayed. More importantly, conspiracies cannot be defeated with friendly creators of conspiracies but with able and competent staff that can forcefully counter and defeat any PR campaign put forward by ill-meaning conspirators. Once again, this is not a recommendation for any existing state of affairs but one for a hypothetical situation and should only be entertained by those that tend to believe in such theories.

There were some interesting developments on the policy/decision maker front on this first day of the week and they tend to depict another weak link in the management process. On the very same day that CBRT Governor Basci announced that they were contemplating a measured hike in the upper end of the corridor, i.e. the lending rate, the Economy Minister was advising the CBRT not to succumb to pressures coming from the interest rate lobby in an interview he had given to a major daily newspaper. The Minister claims that there is a game going on that aims at nullifying the interventions of the CBRT in the FX market. The simple answer to that would be that if there is no genuine demand for FX as fundamentals definitely rule out the need for such a move, then the participants of the game should get burnt at some point and hence divine justice. When asked about the benchmark going to 9% levels and FX rates not cooling down, the Economy Minister responded by stating that if the 4.63% levels in the benchmark were broken, it would have gone down to 2.5% (sounds more like a technical analysts target figure than a fundamentally supported argument given the current macro setting when 4.63 prevailed). Does this mean the levels we observe today would not have been observed if that had indeed happened? Or how much sense does it make in the first place to have 2.5% benchmark rate in an economy where inflation expectations are around 6.5% and even the CBRT's bullish forecast is at 5.3%? Don't such negative levels indicate dire growth outlook and ultra- pessimistic economic activity expectations and most likely further drag down output? Don't misguided **cuts** by ANY central bank lead to **rises** in market rates in any economy? Don't we all know that mismanaged expectations could lead to catastrophic changes in asset prices with hardly any change in fundamentals but that the worsening of such prices could hurt the fundamentals in return and lead to vicious cycles in macro balances?

Turkey is facing tough times like many other emerging markets in this era of "tapering fears". We do not need additional domestic perturbations that exacerbate the overall scene, but that is beyond the control of the AKP. Such perturbations do occur, sometimes manufactured by opposition forces and sometimes even at the expense of national welfare (which the

opposition assumes to be temporary and to be corrected once power changes hand and is transferred to the “right” circles; mostly a miscalculation but attractive nevertheless to the schemers).

We cannot verify or confirm the sources behind such perturbations or make claims regarding their presence or absence; we assume impotence in that respect. Assuming away the presence of such manufactured perturbations will naturally eliminate the problem but that is not the route we take. Quite to the contrary, we assume for the sake of argumentation that such perturbations are indeed manufactured; not because we know or because we have evidence to that effect but simply to suggest the right way to deal with them. Our suggestions have probably been pronounced quite clearly so far but here they are at the expense of repetition:

- i) Diagnose the situation properly and do not fall into the “confirmation bias” trap. An event that surprises you is not without an explanation; search for the cause and the explanation with a clear head and do not let your presumptions/preconceptions guide you in your search. These may be very valid and true, but see if you end up with a result that fails to reject (not accept!!) your presumptions/preconceptions. Do not let them define your point of departure.
- ii) What may seem very negligible to a majority forming portion of the society may mean a lot to another¹. Demands of the latter, as unreasonable or as “without priority” as they may sound to the governing body, still have to be dealt with tactfully and in a way to appease those who come up with those demands (within reasonable limits needless to say).
- iii) Do not translate hardships/plots/schemes into conspiracy theories in order not to sound fragile if for nothing else. Even if there are conspiracies targeting a governing body, crying out conspiracy is arguably not the best approach towards dealing with such conspiracies. Conspiracy is an extreme definition and should not be spelled too easily unless documented and proved beyond doubt. Political rivals can and do try to reduce the power of a governing body and that is partially the name of the game in politics. No politician in his right mind would deny this. However, even if one subscribes to the “conspiracy” definition in hardships met during tenure in power, the governing body should seek refuge in the highest HR quality possible to deal with such hardships and that

¹ The first could be a very large portion and the second a small one and how they interact could indeed be the difference between a republic and a democracy. All democracies are republics per se but not the other way around; subjugation to the majority is the essence of a republic while minority rights underlie the foundation of a democracy. This not so subtle demarcation line is somehow missed in the Turkish public at large.

rarely includes manufacturers of conspiracy theories. Anything less than that will not only fail to work but will presumably prove to be counterproductive as well.

- iv) Make sure that decision/policy makers' views pertaining to the prevailing situation are mostly in line with each other, and preferably so are their solution suggestions. Conflicting views between decision/policy makers can be tolerated and swept under the carpet by market participants during honeymoon days, but once the tide turns, they may prove to be extremely detrimental to crisis management. Coherence or “house view consistency” is a necessary but not sufficient ingredient for any crisis management process.

Macro Data

In the light of the extraordinary days we are going through, we simply choose to refer to the upcoming MPC meeting next week in the light of Governor Basci's comments today. We believe a hike in the lending rate is almost a given now and maybe but not likely some minor hike in the policy rate as well. The CBRT will want to use its ammunition sparingly and we are thus not very convinced about a minor rate hike but we will not rule it out totally either depending on developments on the FX front till the meeting day. As for reductions in ROC and RRR, they have not been utilized so far and the Bank may opt for these two as well in principle, but we dare think that it will not be this time around and this “using ammunition sparingly approach” will be the preferred way to deal with the FX market at the moment. Keeping in mind that ROC and RRR changes are neutral with respect to the net foreign asset position of the CBRT and that the Bank has used direct interventions so far instead, it makes sense to purport that the Bank truly saw the situation to be alarming both in terms of level and volatility of FX and did not shy away from reducing its net foreign asset position. If the FX market moves in a reasonably calm mood till the MPC meeting, an increase in the upper bound of the corridor will be the only change announced after the meeting. That is our take on the meeting at the moment. That should probably help support the TL a bit more provided we have a ceteris paribus situation till the meeting day.

There are additional reasons to be on an alert mode regarding the FX front. The latest BoP figures for the month of May were alarming not because the CAD figure at USD 7.5 billion was slightly higher than the expectation around USD 6.8 billion, but for the significant drying up in funding that was crystal clear. Capital account registered a surplus of USD 4.7 billion but official reserve erosion stood at USD 4.5 billion, account for almost the entire funding on the capital account front. Net errors and omissions at USD 2.8 billion took care of the rest. A similar picture is likely to emerge in June figures given the FX interventions undertaken in June and this does not bode well with a sustainable financing picture needless to say. To claim that genuine FX demand should not have emerged or will not emerge with this sort of an outlook is at best ignorance. Authorities would be better off eliminating the reasons for concern rather than labeling the FX demand in a setting suffering from acute uncertainty as “manufactured”. This only makes life tougher for the CBRT who at the end of the day is laboring trying to bring some calm to the FX market.

Expectation management is a most delicate field of expertise and requires first rate assistance from all involved in the policy/decision making process. We would like to think that what we have seen so far is not the best that could have been achieved, and we tend to think that way as well. Turkish economy’s fundamentals do not deserve the hit it has been subjected to within the last month and a half though a hit was inevitable. If this is a premise we all agree on, then an act of retrospection and prudent inference seems to be the correct route to follow for all policy/decision makers.

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