

Economics

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Turkey Macro Flash

Pressure on core inflation continues to rise

- At 10.6% YoY, the January inflation reading came in line with the consensus (10.6%) but considerably higher than our projection (10.1%). The transport and consumer durable goods inflation, which came in markedly higher than our projections, were the key drivers of our forecast error. Using seasonally adjusted data, the January inflation reading translates into a rise of about 0.5% MoM, compared with 1.1% MoM in December.
- Standard core measures rose notably in January, with the H and I indices standing at 8.76%YoY (8.55%YoY in December) and 8.42%YoY (8.12 %YoY in December), respectively. With the January print, core measure (I) reaches its highest level since May 2007, as the monthly core measures got stuck above 8% since August 2011 in seasonally adjusted and annualized terms (Figure 4).
- In our view, the noted deterioration in core measures, along with the likely rise in food prices due to the recent bad weather conditions, further overshadows the inflation outlook in the near term. Accordingly, we expect inflation to remain in double-digits until May before declining to around 7% at year-end thanks to favorable base effects.
- As the new Inflation Report suggests, the CBT is likely to stick with its flexible policy. In our view, the Bank's inclination to let the currency appreciate and its unwillingness to forgo growth are likely to complicate the external adjustment process. This will in turn overshadow the appreciation potential of Turkish assets through leading valuation concerns among investors.

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Figure 1. Turkey – Consumer Prices, Actual and as Forecast, January 2012 (% Change, YoY)

January 2012	Actual	Citi Forecast	Market Forecast	Previous Release
CPI (% YoY)	10.6	10.1	10.6	10.4

Source: TURKSTAT, Bloomberg and Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 2. Turkey Inflation (Percent Change, MoM)

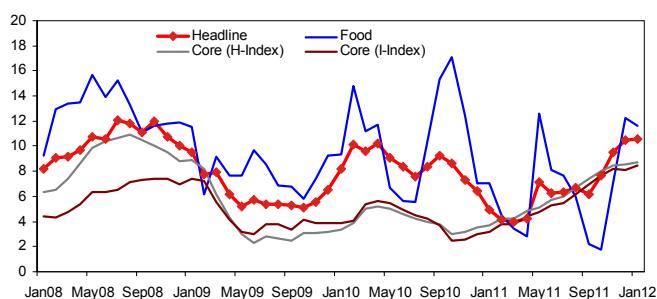
	Jan-11	Jan-12	12-month
CPI (headline)	0.41	0.56	10.61
Food and Beverages	1.61	1.13	11.67
Tobacco and Liquor	0.00	0.02	18.53
Clothing and footwear	-7.76	-7.88	7.84
Housing, water, electricity	0.58	1.32	8.99
Furnishing and household equipment	1.02	1.58	11.65
Health	0.28	0.09	0.15
Transportation	1.44	2.06	12.90
Communication	1.21	-0.01	1.24
Entertainment and Culture	-0.08	0.83	7.45
Education	0.04	-0.05	6.38
Hotels, cafes, and restaurants	0.76	0.75	8.19
Miscellaneous	1.37	1.79	17.63

Source: Haver

Forecast Implications

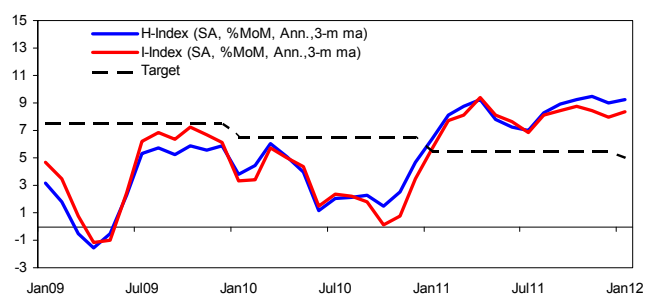
In the new Inflation Report, the CBT raised its year-end inflation projection for 2012 to 6.5% from 5.2%, while keeping its medium-term forecast at 5.0%. We think the Bank's new end-2012 forecast looks more realistic, as it represents the lower end of our projection band (6.5-7.0%). In our view, the continued deterioration in core measures, along with the likely rise in food inflation due to bad weather conditions, further overshadows the inflation outlook in the near term. Accordingly, we expect inflation to remain in double-digits until May before declining to around 7% at year-end thanks to favorable base effects. Moreover, our analysis also casts doubt on the CBT's longer-term inflation projections. Due to a relatively moderate decline in the contribution of the trend component to inflation (only about 0.5% per year), our rough calculations suggest that it would take more than 5 years to reach the CBT's medium-term target of 5%.

Figure 3. Inflation Components (percent, YoY)



Source: Haver and CIRA

Figure 4. Evolution of Core Inflation Indicators (SA, % MoM, Annualized)



Source: CBT Note: 3-month moving average

Policy Implications

Evidence to date suggests that the CBT remains reluctant to normalize monetary policy. The combination of the recent respite in risk aversion and the CBT's willingness to defend the currency seems to have contained the lira depreciation, at least for the moment. While the CBT's threat to defend the lira may appear credible in the near-term, as is evidenced by the recent lira recovery, we believe that there has to be a considerable improvement in capital flows to avoid further volatility and renewed bouts of currency weakness.

All in all, as the new Inflation Report suggests, the CBT is likely to stick with its flexible policy. In our view, the Bank's inclination to let the currency appreciate and its unwillingness to forgo growth are likely to complicate the external adjustment process. This will in turn overshadow the appreciation potential of Turkish assets through leading valuation concerns among investors.

Appendix A-1

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