ÜNLÜ & Co

05 June 2020

Macroeconomics Insight

Macro and political outlook – June 2020

- **Turkey opens up:** The ramifications of the Covid-19 pandemic in terms of public health and the economy remained the predominant topic of the past month, as was the case worldwide. In Turkey, where the first case of the virus was noted on 10 March, the number of cases is observed to have dwindled to below one thousand, and the number of deaths to below 30, following a milder path from the onset compared with countries that struggled with their health systems. In response to these developments, President Erdoğan unveiled a new phase of the normalisation plan. Accordingly, the inter-city travel ban has been lifted, effective from 1 June, while airlines' domestic flights have resumed. Moreover, public personnel have returned to regular working hours, and day-care centres as well as nursing homes have resumed operation. Businesses such as restaurants, cafés and bakeries also started to serve customers until 22:00 from 1 June, and beaches, national parks and gardens have been re-opened.

- **Regulatory measures to limit dollarization:** Meanwhile, efforts to ameliorate the effects of the pandemic on the economy and financial markets appear to remain largely in the form of regulatory measures. In view of persisting dollarisation by residents and a marked increase in gold accounts, the banking insurance and transaction tax (BSMV) applicable to foreign exchange transactions was raised from 0.2% to 1.0%, while the withholding tax rate applied to real persons for commercial papers was increased from 10% to 15%, and gold transactions were included in the scope of foreign exchange expense tax.

- **BRSA changes asset ratio formula:** The Banking Regulation and Supervision Agency (BRSA) made major changes to the Asset Ratio (AR) formula applicable to banks, which had been introduced as of May 1 and was to be assessed monthly. Accordingly, the fact that loans with a maturity of up to three months are excluded from the scope of the calculations is expected to affect the sector substantially, while bank bonds will lose their appeal. On the other hand, that the coefficient will be lowered to 1 for that part of foreign exchange deposits that matches in amount foreign exchange loans is construed as a positive development. In the new regulation, the weighting of SME, project finance and export loans with a coefficient of 1.1 in the calculations is expected to attract banks to these loans. Bank bonds and TL repos with clients, previously excluded from the scope of the formula in the denominator, will henceforth be added to TL deposits; and with the previously introduced withholding-tax amendment, bank bonds are expected to lose their appeal. While banks tended to make repo on Eurobonds, engaging in repo transactions - in lieu of foreign exchange deposits - with clients having foreign exchange, the fact that such transactions are considered in the framework of foreign exchange deposits with the new regulation is noteworthy.

Economics insight

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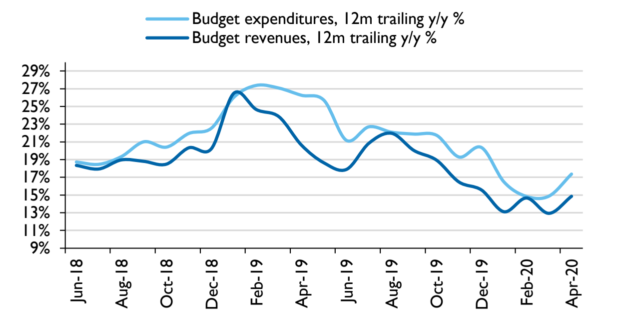
The pandemic hurt the budget balances

The slowdown in economic activity and the adverse consequences of the economic-support package on the budget had started to become evident as of March. The budget gave a deficit – once again – of TL 43.1 billion in April, with the deficit as of the past 12 months reaching TL 142.0 billion. A contraction in tax revenues was averted in April, as income and corporate taxes under direct tax collections slid notably, down by 15.0% and 54.7%, respectively, though indirect taxes, where VAT collections included those deferred from a month ago, and SCT collections, were elevated. As such, tax revenues rose by 0.7% on an annual basis and aggregate revenues by 13.1%, while non-interest expenditures advanced by 28.9%, higher than a month ago. With the April realisation, the ratio of the last-12-month budget deficit to national income (based on a 5.0% growth estimate stipulated in the NEP) increased to 3.2%, while the primary balance is calculated to show a deficit of 0.6%. New measures may be added to the existing support package, or some of the measures may be extended. Moreover, indirect taxes are also expected to continue to be undermined by the lethargy in economic activity. As such, the odds that the budget deficit will close the year at about 5% have increased substantially.

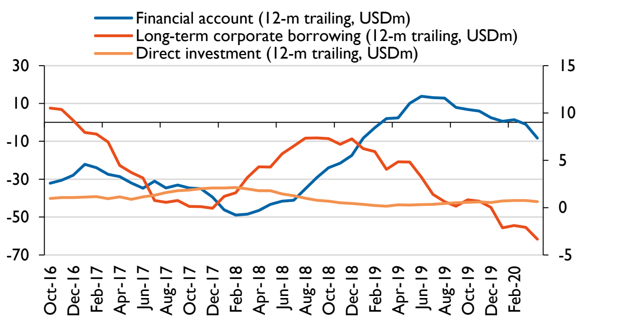
The Treasury's domestic borrowing appears to be continuing its marked upward trend. The CBRT's profit transfer and hefty foreign borrowing notwithstanding, the domestic debt renewal rate continued to rise, with January-May and last-12-month realisations of 200% and 172%, respectively. We thus estimate cumulative net borrowing as of end-May to have reached close to TL 170 billion. This indicates that the TL 140.1 billion annual limit has already been breached. In the borrowing programme unveiled in June, on the other hand, the borrowing target from the market for the next three months was seen to have been raised again. As such, it seems all but certain that the limit will be increased via a bill to be passed in Parliament this year as well.

Figure 1: Budget expenditures and revenues 12m trailing y/y



Source: BRSA

Figure 2: Financial account, LT borrowing & direct investment



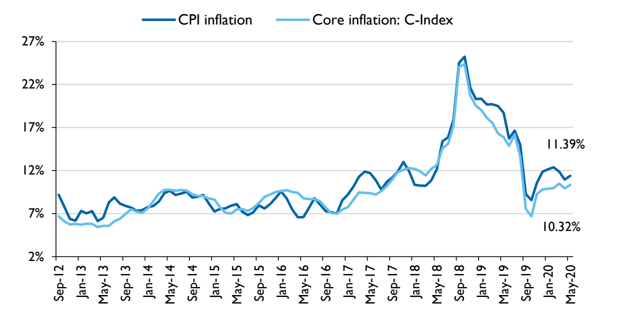
Source: CBRT

Inflation to close the year within the 10.0-10.5% range

CPI was up by 1.36% in May, above both the consensus expectation and the historical average for May of 0.78%. Consequently, despite a favourable base effect due to last year's comparatively higher 0.95% reading, annual CPI increased to 11.39%. In contrast, core inflation (Index B) retreated to 11.2%, despite TL devaluation and the base effect, while the annual change in domestic PPI, which leads the pressures from this channel, eased to 5.5%, on account of declines in energy and commodity prices; and the change in prices of intermediate goods – the main inputs for production - retreated to 6.1%, reflecting limited pressure on the cost front. Additionally, services prices, which are not sensitive to exchange rates and exhibit resistance to declines in inflation, driven by backward indexation, continued to ease, down by 11.3%, reacting to the marked loss of momentum in the services sector as Covid-19 continued.

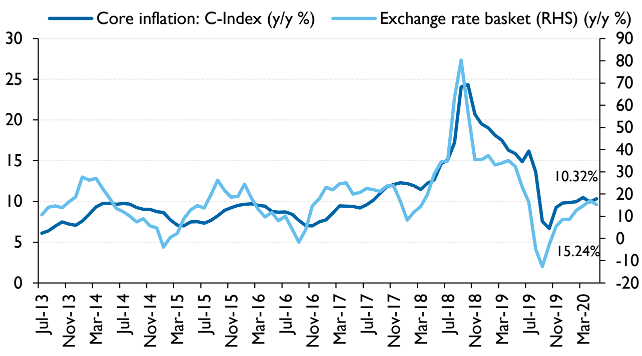
In the short run, while adverse ramifications of the recovery in oil and commodity prices remain evident, the fact that the change in the value of the currency basket since the start of the year has reached 14% – despite a recent retreat – attests to the sustained strengthening of a factor that lends upward pressure to inflation. Additional customs duties introduced in May might also be expected to drive up inflationary pressure through the cost channel. However, given a pronounced slowdown in domestic demand on account of the pandemic, and the services sector – where prices typically exhibit downward rigidity – having ground to a virtual halt, one might infer that total demand conditions should help restrain the inflationary pressure. The inflationary effect of the significant monetary expansion, on the other hand, could be expected to be visible in the second half – rather than in the short term – once supply conditions get back to normal. Consequently, provided that TL devaluation does not evolve into a more pronounced currency attack, it seems possible for annual inflation to continue its gradual decline as of July, owing to a favourable base effect from the comparable period last year, to close the year within the 10.0-10.5% range.

Figure 3: CPI and core inflation



Source: TurkStat

Figure 4: Exchange rates and core inflation



Source: TurkStat

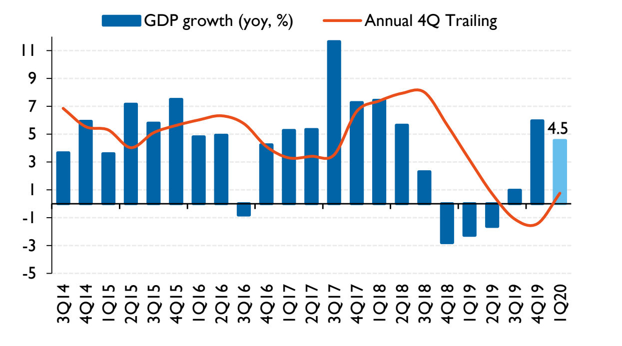
Rate cuts to continue, albeit at a moderate pace

With consecutive rate cuts implemented over the last nine meetings, the CBRT pulled the 1-week repo rate down by 1,575 basis points to the 8.25% level. In the last MPC meeting text, the CBRT indicated that the CPI could trend somewhat higher in the short term on account of periodic and pandemic-related factors, adding that, consequently, they had decided to go for a measured cut in the policy rate, and that based on the current monetary policy stance, the inflation outlook was consistent with the year-end forecast. This message may be perceived to suggest "measured" cuts commensurate with improvements in expectations and inflation trends, as opposed to a pause in the rate-cut phase attributable to prevailing circumstances. To that end, the CBRT should take a course of action monitoring exchange rates and the risk premium, and the evolution of forward-looking inflation expectations to be disclosed ahead of its 25 June meeting.

Double-digit GDP contraction likely in 2Q20

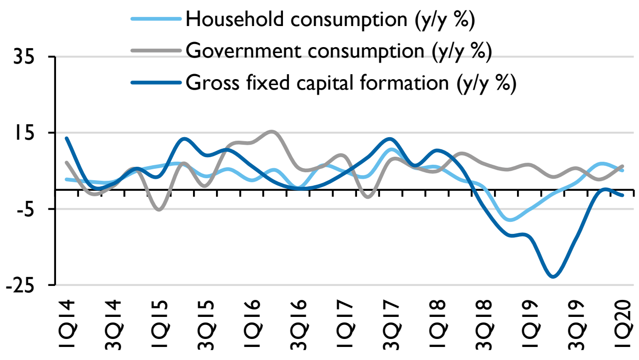
Meanwhile, with the effects of the pandemic having appeared from mid-March in Turkey, national income grew 4.5% in the first quarter of the year. Growth was driven by private and public consumption as well as stock accumulation, while investments and net foreign demand pulled it lower. However, with i) exports having started to diminish substantially on an annual basis, and the contraction reaching around 40% in April and May; ii) the Turkish Manufacturing PMI Index posting a limited recovery to 40.9 in May, after slipping to 33.4 in April, its lowest level since January 2009; and iii) sectoral confidence indices, along with the Sameks services sector PMI Index, trending close to the nadir of the series, despite the recovery in May, double-digit declines in national income in the second quarter – as in the global crisis – seem possible.

Figure 5: GDP growth y/y



Source: CBRT, TDM

Figure 6: Consumption and gross fixed capital formation

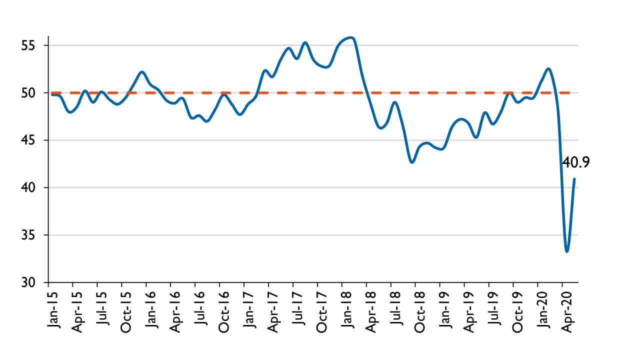


Source: TurkStat

Consequently, while first-quarter data reflect a robust start to the year, there have been powerful signs of a deepening of the slowdown in the second quarter. Henceforth, the outlook should hinge on the extent to which the Covid-19 pandemic prolongs the abrupt halt in economic activity, and whether and for how long banking-loan volume can manage to keep its trend growth hovering at around 70%. In this context, new and extensive funding facilities created by the CBRT to ensure the continuity of loan flow and stepped-up bond purchases have reflected a much more limited tightening in financial conditions compared with prior crises. Moreover, frequently posted leading data, such as electricity consumption and credit-card expenditures, suggest that the worst is over and a modest recovery is under way. All these developments appear to portend a drastic slump in growth in the second quarter, though a recovery might follow as of the third quarter, provided that the battle against Covid-19 proves successful and quarantines are gradually relaxed, to be eventually lifted altogether. The most recent CBRT survey points to a 1.3% contraction for the year. Whether the realization will prove better or worse than this median estimate will depend on the vigour of the recovery as of the third quarter.

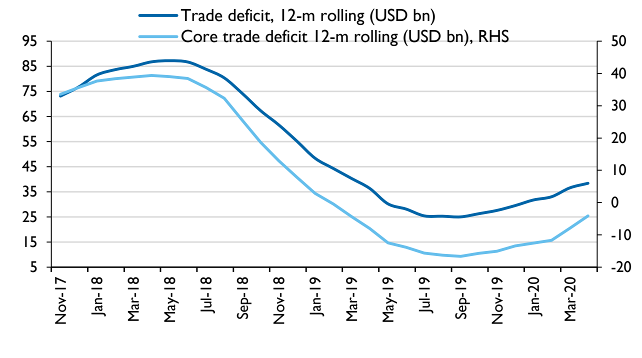
Macroeconomic indicators

Figure 7: Manufacturing PMI



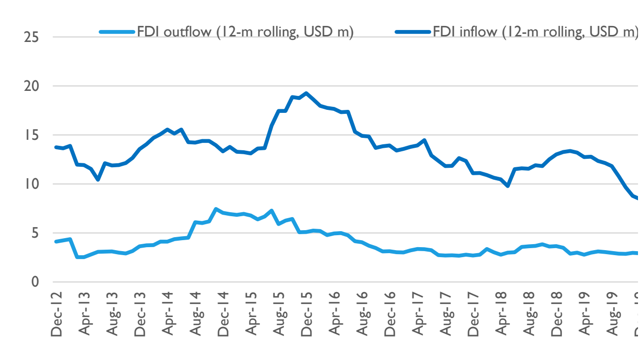
Source: TurkStat

Figure 8: Trade deficit



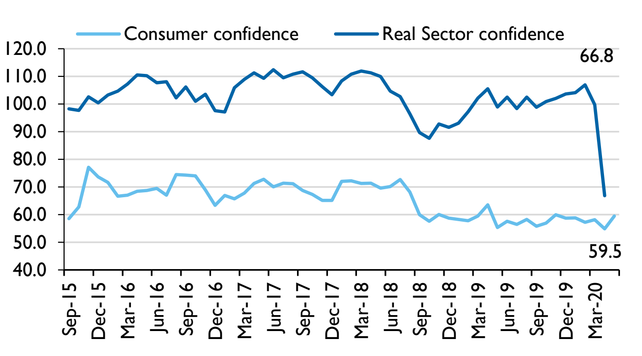
Source: TurkStat

Figure 9: FDI flows



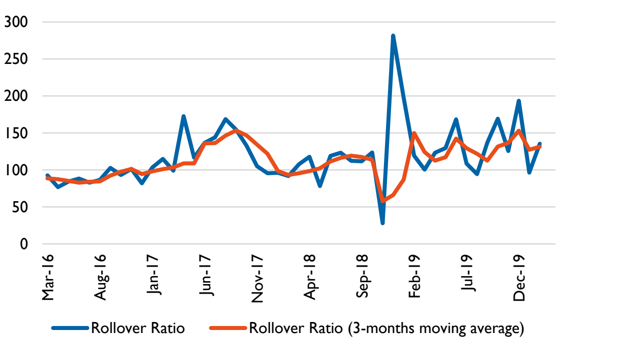
Source: CBRT

Figure 10: Consumer and real sector confidence



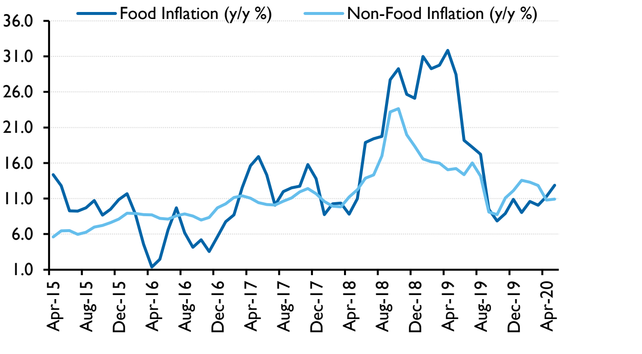
Source: TurkStat, CBRT

Figure 11: Treasury domestic debt rollover ratio (%)



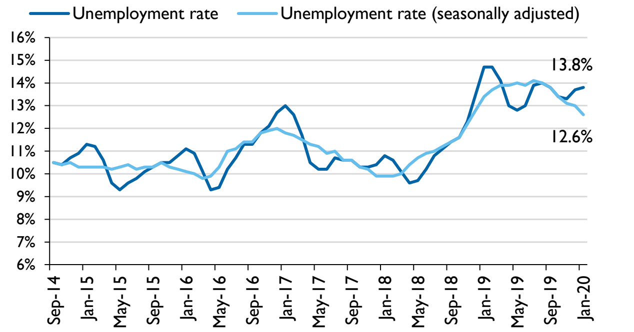
Source: Ministry of Finance

Figure 12: Food and non-food inflation



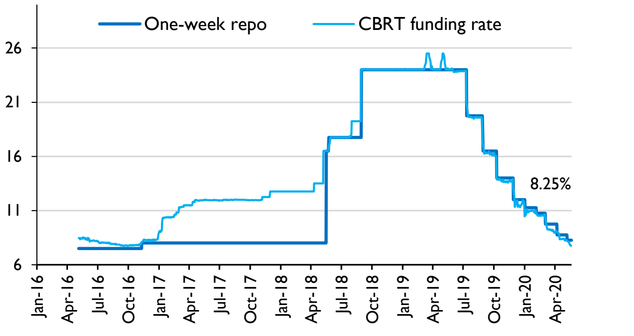
Source: TurkStat

Figure 13: Unemployment



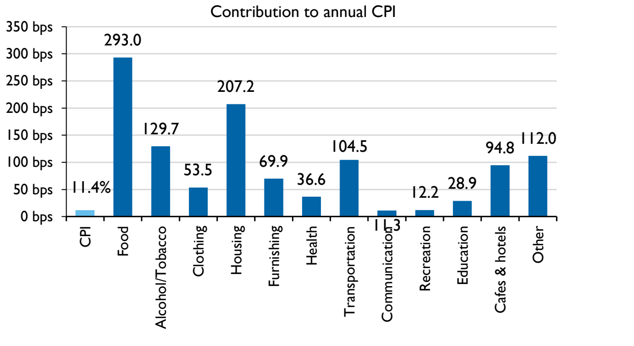
Source: TurkStat

Figure 14: CBRT rates



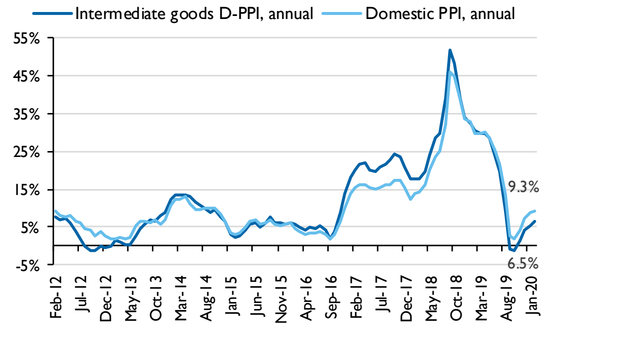
Source: IHS Markit

Figure 15: Contribution to CPI



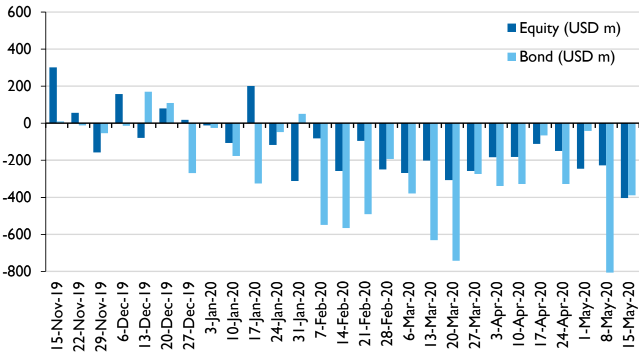
Source: TurkStat

Figure 16: Domestic PPI and intermediate goods D-PPI



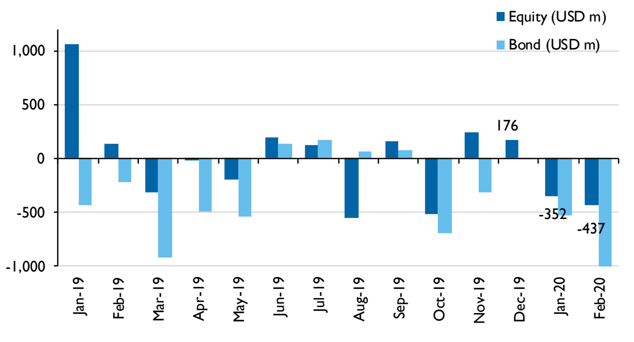
Source: TurkStat

Figure 17: Weekly bond and equity flows



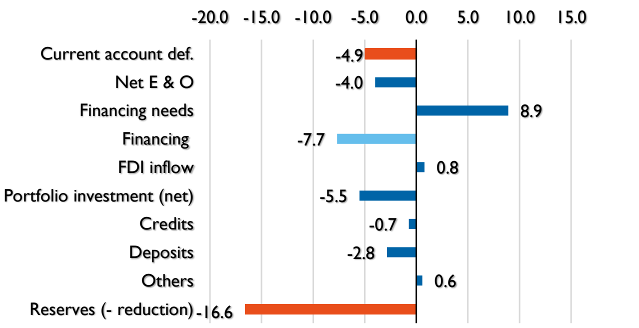
Source: CBRT

Figure18: Monthly bond and equity flows



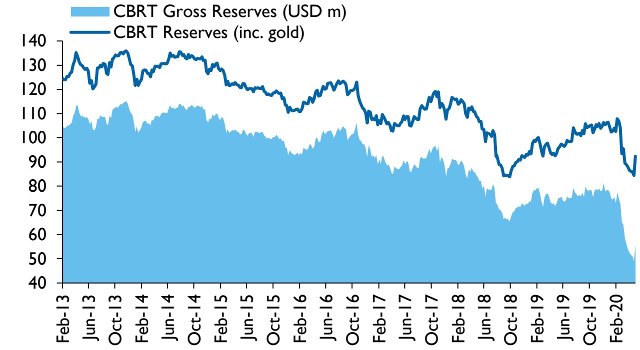
Source: CBRT

Figure 19: Current account deficit



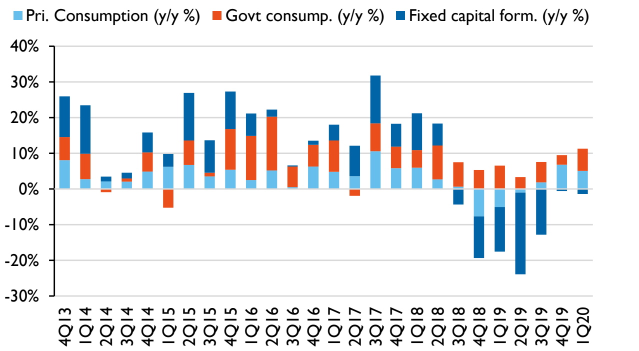
Source: CBRT

Figure 20: CBRT reserves



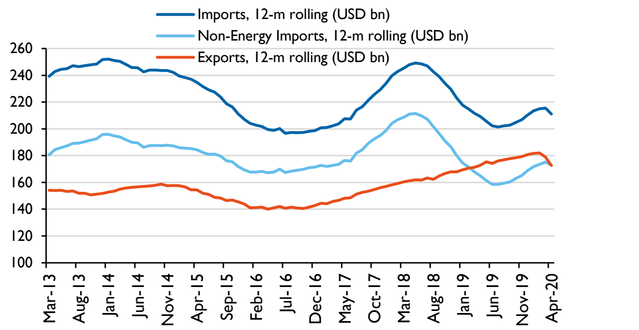
Source: CBRT

Figure 21: Growth breakdown by consumption



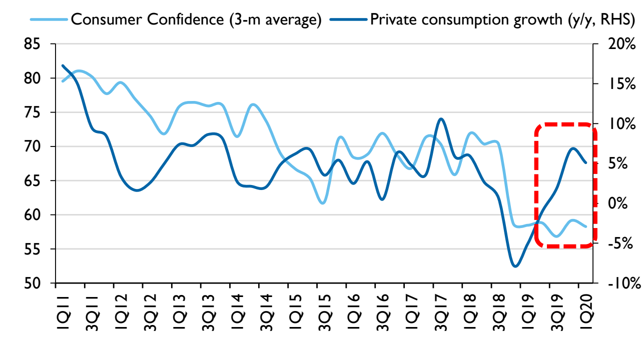
Source: TurkStat

Figure 22: Imports, exports and non-energy imports



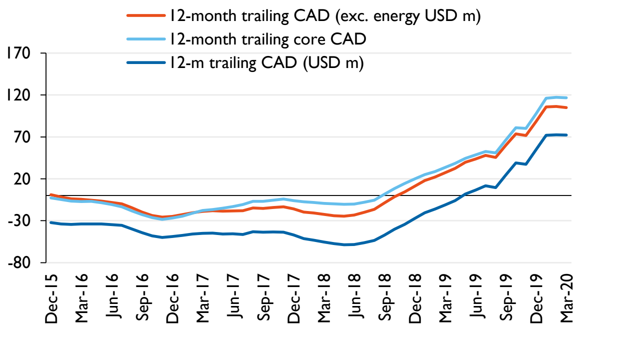
Source: TurkStat

Figure 23: Private consumption and consumer confidence



Source: Ministry of Finance

Figure 24: 12m trailing CAD, core CAD and ex-energy CAD



Source: BRSA

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