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FOCUS NOTES: TURKEY

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Current account deficit adjustment underway

- August's current account deficit data confirms gradual adjustment in progress
- Nature of financing remains dominated by short-term capital inflows

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August's current account deficit data confirms gradual adjustment in progress

The latest flurry of balance of payment and foreign trade data vindicate the Central Bank's recently voiced expectations that an adjustment in the current account deficit (CAD) has already started. In support of the aforementioned, the current account shortfall gradually shrunk to a 10-month low of $4.0bn in August, in line with the market's median forecast, after touching a record peak of $7.9bn in May 2011. What's more, excluding energy imports the current account swung into a surplus, for the first time since October 2010.

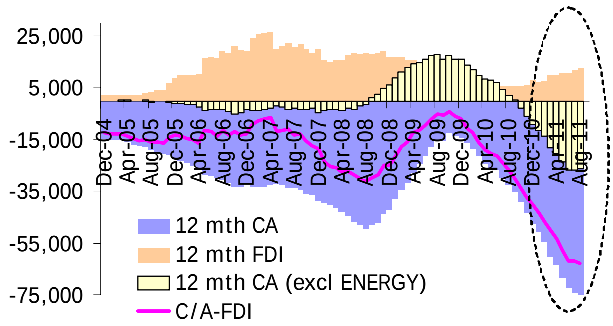
The recent adjustment in the current account data has been primarily driven by a narrowing trade deficit. Notably, after reaching a record peak around $10bn in June the trade shortfall has embarked on a narrowing trend. July's and August's data showed a further improvement in exports' growth in tandem with a significant slowdown in imports. In detail, exports grew by 32.2%yoy to $11.3bn in August, marking the highest pace of increase since May last year. Moreover, August's rise outpaces July's 24%yoy jump and a 19%yoy gain in H1: 2011. On the flipside, imports' growth slowed to 26.3%yoy ($19.5bn) in August, its lowest annual rate in nearly a year, from 30%yoy a month earlier and an above-40%yoy average growth in H1.

The recent significant adjustment in the trade, and as a consequence, in the current account balance has been, among other factors, driven by a sharp recovery in tourism revenues (+17%yoy in the first eight months of the year), which received an additional support from the political turmoil in the MENA region. The sharp depreciation of the lira over the last few months has also favoured exports significantly. Indicatively, the USD/TRY stands nearly 20% higher year-to-date. This deems Turkish exports cheaper and more appealing and thus partly offsets any impact from the slowdown in Turkey's main trade partner, the EU (44% of all exports). At the same time, it also assists in containing imports' growth, with foreign products and services now more expensive. Another factor behind the recent slowdown in imports' growth has been the easing domestic demand against a background of the lingering euro area debt crisis and slowing global growth.

Nevertheless, the 12-month rolling current account shortfall widened 132%yoy to $75.1bn in August from $74.2bn a month earlier and $32.5bn over the same period a year earlier. According to our calculations the 12-month rolling CAD corresponded to nearly 10% of this year's projected GDP in August. This is well in excess of a 3.7%-of-GDP shortfall recorded over the same period a year earlier. At such high levels it remains among key risks for the Turkish economy. However, on a more positive note the pace of expansion of the 12-month rolling CAD appears to be on a gradual slowdown since reaching a peak of

+240%yoy in December 2010.

Current account deficit adjustment underway



Source: CBT, Turkstat, Eurobank EFG

Nature of financing remains dominated by capital inflows

Another area of concern with regard to Turkey's elevated current account deficit is that most of its financing continues to be dominated by capital inflows. Indicatively, over the 12-months to August net portfolio investment accounted for nearly 30% of the CAD, nearly double a 16.5% net FDI inflows coverage. This deems the country highly susceptible to global mood swings. An indication of this sensitivity to the external environment was evident in August when Turkey witnessed outflows of ca $0.9bn in government bonds and $0.6bn in equity due to the worsening in global risk appetite. However, it is worth noting that FDI appears to be on an ongoing improving mode this year, with 12-month rolling net inflows having registered a 124%yoy increase to $12.4bn in August, after a meager 14%yoy growth in FY2010.

Current account adjustment likely to continue ahead

In all, we expect the recent adjustment in the current account deficit to continue ahead as domestic economic activity cools down further, the lira remains under pressure and energy prices stay around current levels. Government and CBT policies aimed at curbing the CAD will also be key for a sustainable improvement ahead. Along these lines, our 9.5%-of-GDP forecast for this year may eventually prove rather conservative. We pencil in a further contraction towards 7.0%-of-GDP next year as domestic economic activity is braced to slowdown further in 2012. Even so, in spite of the anticipated improvement next year, Turkey's current account deficit still echoes elevated. And, with its financing relying heavily on capital inflows, the domestic economy is braced to remain vulnerable to global risks ahead.

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