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NEW EUROPE
ECONOMICS & STRATEGY

September 22, 2011

FOCUS NOTES: TURKEY

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CBT likely to maintain easing bias in Q4:2011; room for further rating upgrades ahead

- CBT keeps its key policy rate at 5.75%, in line with expectations
- S&P raised Turkey's local-currency (LC) sovereign ratings to investment grade

CBT keeps its key policy rate at 5.75%, in line with expectations

Turkey's Central Bank decided on September 20 to keep its key 1-week repo rate unchanged at 5.75%. The CBT also kept reserve requirement ratios (RRRs) stable and maintained its dovish tone adopted in August. The Bank highlighted anew concerns about the domestic and external macro environment and signaled its readiness to ease monetary policy further if global risks intensify and the economic slowdown proves deeper than currently expected. The CBT acknowledged that core inflation may remain on an uptrend in the short-term. However, it added that a weakening domestic demand outlook would likely offset the lira depreciation pass-through and reiterated that the 2012 inflation outlook remains consistent with its 5% target. Furthermore, the Central Bank expressed confidence about an imminent *significant* (changed from *notable* in the prior month's statement) improvement in Turkey's current account deficit.

It is worth recalling that at its extraordinary policy meeting on August 4, the CBT surprised markets by delivering a 50bps cut in its key policy rate to a lifetime trough of 5.75% in tandem with a 350bps hike in its overnight borrowing rate to 5.00%. The overnight lending rate was kept stable at 9.00%. Back then, the Bank cited rising global risks behind its policy move. The decision confounded expectations that the CBT would soon resort to a (more conventional) policy tightening mode and exacerbated market concerns about a *behind-the-curve* policy in addressing domestic inflation / overheating risks. At its August 4 meeting, the CBT also cut FX RRRs, halted FX buying auctions and initiated FX selling tenders in order to support the domestic currency, which lost more than 15% against the USD so far this year. It is also worth noting that at the scheduled meeting on August 23 the CBT stayed put on rates, saying that the measures employed earlier that month had balanced downward risks to the domestic economy.

CBT likely to maintain easing bias in Q4: 2011

We expect the CBT to stay put on policy interest rates throughout this year, though additional cuts in its RRRs (or even in its key policy rate) as a means of supporting the domestic economy can not be entirely ruled out, especially in case of additional QE measures by the Fed and /or a significant worsening in the macro environment in the period ahead. However, taking into account lingering inflation risks and ongoing depreciation pressures on the TRY, we see a rather limited room for much additional policy easing at this stage. In any case, the CBT's recent switch from FX buying to FX selling auctions signals worries over further significant lira depreciation.

S&P raised Turkey's local-currency (LC) sovereign ratings to investment grade

On September 20, S&P raised Turkey's long and short term local-currency (LC) sovereign ratings to investment grade "BBB-/A-3" from "BB+/B". The agency affirmed the country's foreign-currency (FC) sovereign ratings at "BB/B", noting external position risks. It also assigned a positive outlook for both long-term FC and LC ratings. S&P cited "continuing improvements in Turkey's financial sector and the deepening of local markets" as well as the CBT's track record of independent monetary policy and a free floating FX regime. The agency also argued that the current two-notch difference between LC and FC ratings reflects revised rating criteria for central governments. At present, S&P and Moody's rate Turkey's long-term FC debt two notches below investment grade, at "BB" and "Ba2" respectively, while Fitch rates it only one notch lower at "BB+".

Potential upgrade of Turkey's FC credit rating ahead

As recently signaled by S&P, the key obstacle for an upgrade in Turkey's FX sovereign ratings currently is the current account deficit. Indicatively, July's current account deficit widened nearly 50% yoy, reaching $5.3bn. On a positive note, the deficit shrunk from a $7.7bn shortfall in the prior month (and an $8bn record hit in May) on the back of rising tourism revenues, weakening domestic demand and a depreciating lira. Note that the impact of these drivers was reflected in July's external trade data (deficit eased to $9.01bn from a lifetime peak of $10.2bn a month earlier). Nevertheless, according to our calculations the 12-month trailing current account deficit already reached in July a record 9.3 percent of projected full-year GDP. The shortfall is broadly anticipated to narrow as domestic demand cools down, strengthening the case for a FC sovereign credit upgrade at some point down the road. In support of the latter view, in its September 2011 assessment S&P left the door open for such an upgrade, provided that domestic demand cools down further, the current account deficit narrows, the fiscal position strengthens and credit activity decelerates. Although a FC rating upgrade would likely be more favorably perceived by financial markets, as it constitutes a better gauge of the country's sovereign outlook relative to international peers, S&P's latest decision could be regarded as a precursor of such a move at some point over the next twelve months.

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