



## Macro Scope

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# Weekly Economic and Strategic Review

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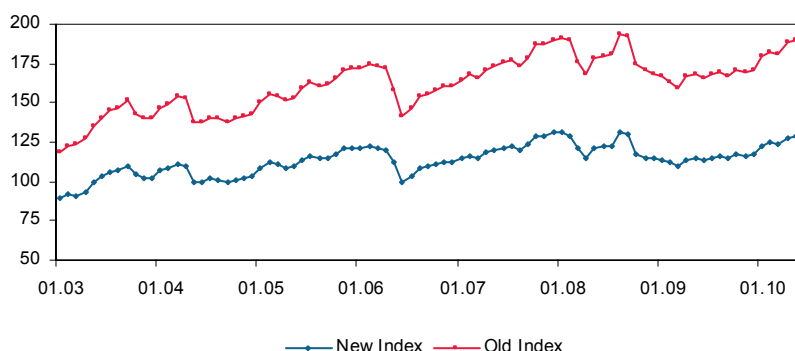
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## Change Ex-Policy...

Once the annual growth rate of exports eased to 13% in June in an environment of heightened risks regarding the European economies as well as the slowdown expected in this region, the appreciation of TRY and in a broader sense the exchange rate regime, which has always been a popular theme of discussion since Turkey let the currency to float in 2001, have come under spotlight. Lately, voices have been raised in part of the media and the government, calling for a solution to this problem. That means the pressure on the Central Bank has increased. Fortunately, the Bank is quite used to this type of pressures. Moreover, at least the criticisms centering on the argument of keeping TRY appreciated via high interest rates are not valid anymore, thanks to the substantial decline in interest rates, which have come to comparable levels with the rest of the world. The Bank may also defend themselves by pointing to the CBRT law that says one of the fundamental duties of the Bank shall be “to take necessary measures in order to protect the domestic and international value of Turkish Lira and to establish the exchange rate policy in determining the parity of Turkish Lira against gold and foreign currencies jointly with the Government.” This article says that the Bank cannot change the policy on their own, despite their operational independence. Moreover, in an economy of free capital movements, the Central Bank cannot control the exchange rate and interest rate simultaneously (impossible trinity). If the discussion comes to this point, controls over capital movements or the inflation targeting regime would also need to be reviewed. In essence, the policy change that people have in mind is quiet obvious. Nobody is asking for a fixed exchange rate regime that is not even applicable by China any more. Instead, designing a manageable exchange rate regime that avoids sizeable appreciation of Turkish Lira is desired. Therefore, even though the discussions have been taking place at wrong addresses and through wrong arguments, this subject is more than worth to discuss. Those who remember policy of devaluing currency in proportion with inflation that was

CPI Real Exchange Rate Index (2003=100) and CPI Real Exchange Rate Index (1995=100)



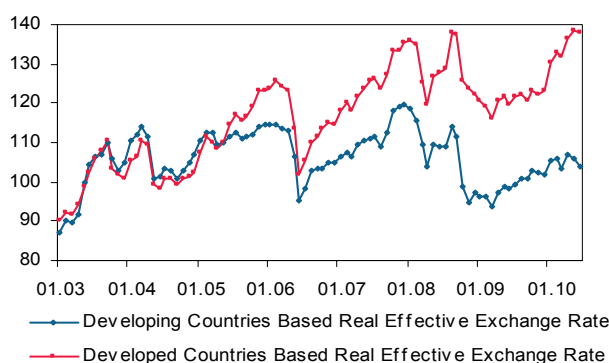
Source: CBRT, Fortis Economic Research and Strategy

implemented at the second half of 1990s would know quiet well that attempts of managed exchange rate regimes had not been smooth and successful. The real exchange rate index had surged to 127 by 1999 from 100 in 1995, pointing to a substantial appreciation even in that term.

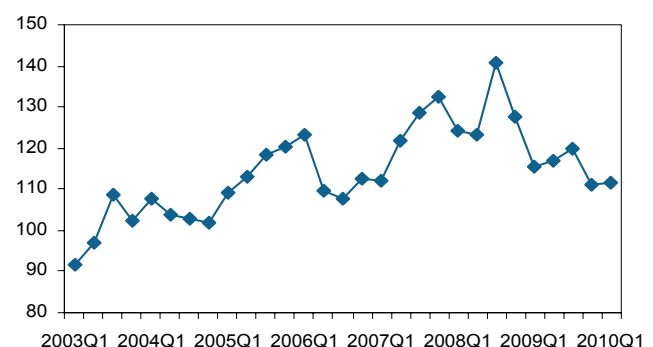
Well then, is there no solution?... Fatih Ozatay, former Deputy Governor of CBRT and one of the architects of the current monetary and exchange rate regime, has been very much involved with this issue. *“Considering the recent inflation regime, is it possible to execute another exchange rate policy that takes into account the competitiveness of Turkey? Yes, it is possible. In the following way: Firstly, it is important to emphasize that the idea of increasing the cost of short term capital inflows (hot money) in search of discouraging it, are not globally detested anymore. Turkey may consider this policy. However, while doing this the experiences, both success and failures, of other countries must be analyzed. As a second step, when inflation declines, alternative ways of implementing inflation targeting regime may be found. In addition to the two parameters (the difference between actual and target inflation, production level and potential output), as a third parameter, the Central Bank starts directly reacting should our currency deviates from a certain threshold. In technical terms, Central Bank may introduce third parameter in the objective function, the difference between real exchange rate and its equilibrium value. Thirdly, Central Bank may increase the purchase amount in the foreign exchange auctions. Yet, it should be underlined that the things the Bank can do are limited under this framework. The TRY supply that will be available from hard currency purchases should be kept at reasonable levels. Besides, there are certain conditions where the foreign currency purchases cannot be sustained. Recall that the foreign exchange auctions were interrupted many times in the recent past.”*

Obviously, the strength of the impact on TRY would depend on whether all of the above mentioned 3 suggestions are implemented at the same time or separately. The most striking suggestion to us is the addition of the real exchange rate to the equation and Mr. Ozatay has long been putting forward this option. **As an interesting point, CBRT’s current response function which is not disclosed to the public seems not to be involving exchange rates, considering that the suggestion to include it comes from a former Deputy Governor of the Bank. Whether this is really the case, or whether the exchange rate enters the equation in a different way, or whether things have changed since Mr. Ozatay left the Bank remain to be answered by the Bank in order to divert the discussions to the right direction.**

Developing and Developed Countries Based REER (2003=100)



Unit Labor Cost Based REER (2003=100)



Source: CBRT, Fortis Economic Research and Strategy

Meanwhile, the Central Bank presented an important study that may set a starting point to the discussions over the exchange rate policy. While explaining the aim of this study, the Banks says *“The changes in Turkey’s international trade structure necessitate the reel effective exchange rate (REER) index to be updated in a way that reflects Turkey’s commercial product variety and country diversity.”* We will not dig into the details of the results and we will be limit

ourselves with saying that the new REER index (\*) points to the appreciation tendency of TRY (approximately 27% during 7 years between 2003 and 2010, a yearly average rate is 3.5%) though at a lesser extent than the previous index. However, let us stress that especially this year the pick up in Turkey's CPI against the very low inflation in the World was responsible for the appreciation, rather than the nominal exchange rate movements. The exchange rate basket fell by 4.6% in the first half of this year, compared to more than 9% appreciation in REER. In that context, if the decline in inflation that has become more apparent over the last months continues and the exchange rate basket keeps rising, the real exchange rate index would indicate that the appreciation has declined somewhat. **With the revision of the old REER index, in addition to CPI and PPI-based indexes, a Unit Labor Cost-based index is produced in the new series, and also, CPI based REER index is computed separately for each developed and developing country groups that are included in the computation of country weights. The unit labor cost-based index would allow for comparisons of competitiveness, while the country groups-based index would help understanding Turkey's position relative to rival countries.**

In conclusion, the theory (\*\*) also suggests that the local currencies of developing countries with high growth potential should be normal due to the productivity differentials. However, similar to many other developing countries, significant appreciation of the local currencies yield many problems (lower competitive power and higher imports) in Turkey, as well, besides many benefits (tamed inflation and expanding services sector). In such periods that are not in favor of tradable good sectors, the Central Banks and their policies happen to come under spotlight. Yet the criticisms miss the point that the governments play a great role in that outcome. The current policy mechanism, which does not have a long history, gives room for some maneuver. So we believe there are things that can be done in the limits of the current system and discussions on this topic need to be encouraged.

(\*) Data for the new REER Index is published on the official web site of the Central Bank of the Republic of Turkey (CBRT) ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)) under the sub-heading "Data/Statistical Data/Real Effective Exchange Rates" and is also be available as a time series on CBRT's Electronic Data Delivery System (<http://evds.tcmb.gov.tr/yeni/cbt-uk.html>).

(\*\*) Samuelson-Balassa hypothesis explains the change in real exchange rate in the long run as the relative prices in tradable and non-tradable goods and the relative change in the productivity levels that determine these prices.

## Economic and Political Agenda

▪ This week at home, current account deficit due Monday, MPC rate decision and unemployment rates due Thursday will be critical. At abroad, the US inflation, retail sales, industrial production are the most important data releases. Besides, US NY Fed manufacturing, Philadelphia Fed and Michigan sentiment indexes will be in focus as they are the preliminary economic indicators and helpful in giving an idea regarding the outlook in July.

### Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
Meidum	Consumption Index, June	-	July 12 <sup>nd</sup> , 6:00 GMT	-
High	C/A deficit, May.	US\$ mn	July 12 <sup>nd</sup> , 7:00 GMT	3,200
Medium	Central Gov. Bud. PS, June	TRY mn	July 15 <sup>th</sup> , 7:00 GMT	-
High	Unemployment, Apr.	%	July 15 <sup>th</sup> , 7:00 GMT	-
High	MPC Rate Decision	bps	July 15 <sup>th</sup> , 16:00 GMT	no change
Medium	TURKSTAT Consumer Conf., June	-	July 16 <sup>th</sup> , 7:00 GMT	-

### Data issuances Abroad

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
Medium	Germany	ZEW Index, July	-	July 13 <sup>th</sup> , 9:00 GMT	24.0
Medium	U.S.	Foreign Trade Balance, May	US\$bn	July,13 <sup>th</sup> , 9:00 GMT	-39.5
High	U.S.	Ret. Sales,Tot.&ex-auto, June	%, m/m	July 14 <sup>th</sup> , 12:30 GMT	0.0 & 0.0
Medium	U.S.	New York Fed Man. Index, July	-	July 15 <sup>th</sup> , 12:30 GMT	18.95
High	U.S.	Core PPI and PPI, June	%, m/m	July 15 <sup>th</sup> , 12:30 GMT	0.1 & -0.1
Medium	U.S.	Capacity Use, June	%	July 15 <sup>th</sup> , 13:15 GMT	74.2
High	U.S.	Industrial Production, June	% m/m	July 15 <sup>th</sup> , 13:15 GMT	0.1
Medium	U.S.	Philadelphia Fed Mnf. Index, July	-	July 15 <sup>th</sup> , 14:00 GMT	11.5
Medium	Japan	BoJ Rate Decision	%	July 15 <sup>th</sup>	no change
High	U.S.	Core CPI and CPI, June	%, m/m	July 16 <sup>th</sup> , 12:30 GMT	0.1 & 0.0
High	U.S.	Michigan Sent. Ind., July	-	July,16 <sup>th</sup> , 13:55 GMT	74.0

## Macro-Economic and Financial Forecasts

### Macro Economic Outlook of 2009-2012

	2009	2010f	2011f	2012f
<b>GDP (TRY - bn)</b>	954.0	1,095.5	1,203.7	1,317.6
<b>GDP (US\$ - bn)</b>	616.6	716.0	779.1	839.3
<b>GDP Growth (y/y % chg)</b>	-4.7	7.0	4.0	4.0
<b>PPI (y/y % chg)</b>	5.9	5.0	5.0	5.0
<b>CPI (y/y % chg)</b>	6.5	7.2	6.0	5.5
<b>Trade Balance (US\$ - bn)</b>	-38.6	-64.2	-72.9	-74.2
Exports (FOB, excl. luggage trade)	102.2	103.3	117.8	140.1
Imports (CIF, incl. gold)	140.8	167.6	190.8	214.3
<b>Current Account Balance (US\$ - bn)</b>	-13.8	-37.1	-42.5	-40.6
<b>Current Account Balance / GDP (%)</b>	-2.2	-5.2	-5.5	-4.8

### Financial Indicators Forecasts

	July 9 <sup>th</sup>	1M	3M	6M	12M	2010	2011
<b>US\$/TRY</b>	1.5447	1.5600	1.5500	1.5500	1.5300	1.5500	1.5600
<b>EUR/TRY</b>	1.9543	1.9500	1.9500	1.9700	2.0000	1.9700	2.1100
<b>FX Basket</b>	3.4990	3.5100	3.5000	3.5200	3.5300	3.5200	3.6700
<b>EUR/US\$</b>	1.2652	1.2500	1.2600	1.2700	1.3100	1.2700	1.3500
<b>Policy Rate</b>	7.00%	7.00%	7.00%	7.00%	7.75%	7.00%	9.00%
<b>Benchmark Bond</b>	8.40%	8.50%	8.90%	9.20%	10.30%	9.20%	11.00%

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