

WEEKLY MARKET COMMENT

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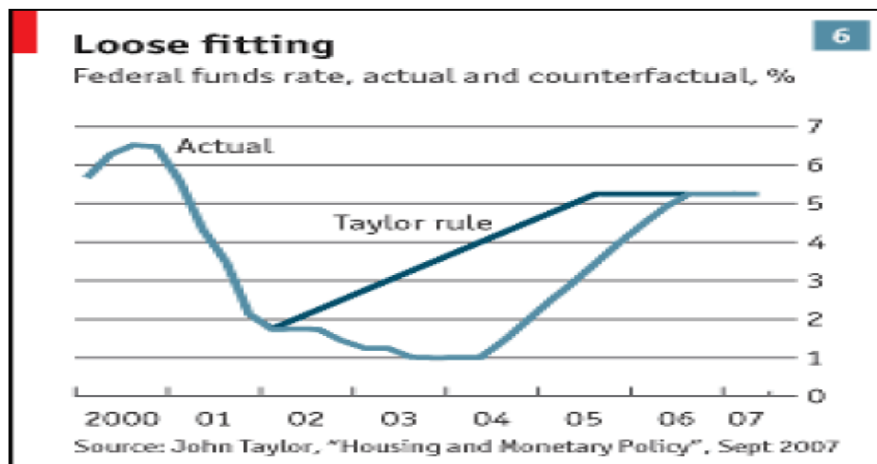
Today's post includes a miscellany of themes and ideas that range over quite wide a spectrum. We touch on inflation, both in Turkey and overseas, before and after the storm. We also provide a Turkish financial market wrap. The finalizing moment itches into the political, which should not remain unnoticed given its gravity although it stands on the apex of the market wrap as an addendum only.

Turkish inflation, head-on, soars, and this has been happening only in the last 5 months. In the beginning of October, even after the first wave of the IMF rumours to the effect that a stand-by was imminent had quietly receded, inflation looked benign and interest rates were virtually heading south by south-west. The benchmark rate had hit c. 7.50%, and I was ready to reinstate the intention of the CBT was to dive as deep as 5.75% O/N. However, things have changed and the policy rate stopped at 6.5%. Now, 6.5% is almost equally good, although it signalled that anywhere below 8.5% would possibly be unacceptable in the secondary bond market as regards the bench rate compound, unless an unanticipated IMF deal would come out of the blue. Now, this was almost happening in the beginning of January, or so markets thought for some brief span of time. The added variable since December data has been inflation, however. Upon the old proclamations of the CBT would be based an intriguing happening: 2010 inflation would be almost on a par with the 2009 inflation although an obvious recovery was already on its way. Could it happen? Well, maybe it could. However, exogenous factors such as unprocessed food prices soaring, and factors that are unrelated to demand, such as tax hikes, found their way into prices. The CBT cannot fight that kind of inflation via tightening. Yet, on the other hand, a consumer inflation that errs on the border of double-digits for at least 3 quarters-to-come, as now the CBT seems to timidly say, cannot be equilibrated with single-digit bond, and almost zero real rates of interest as regards time deposits. I do not like this grim picture, but add to this state of things the following sources of inflation momentum: a possible demand pick-up, a likely Fed move going forward, another round of indirect tax hikes (tobacco etc.), and further shocks to food and energy prices... Now, inflation might curb backwards to 7.5-8% by the end of the year, possibly December 2010, but on the other hand it might not. Some local banks defend the current bond rates, but they cannot do that ad infinitum. Hence, interest rates look set to rise, and deservedly so. I tend to think 6.5% CPI is a good trend inflation candidate in the next 3 years, which should drive into low double-digits deposit rates. To re-iterate, keeping the bench rate at single-digits would be quite an achievement, but I do not expect a runaway inflation and a runaway interest rate trajectory. The basic argument lies with the fact that non-controllable (by the CBT) elements of inflation drive the headline, while various core indicators remain tame.

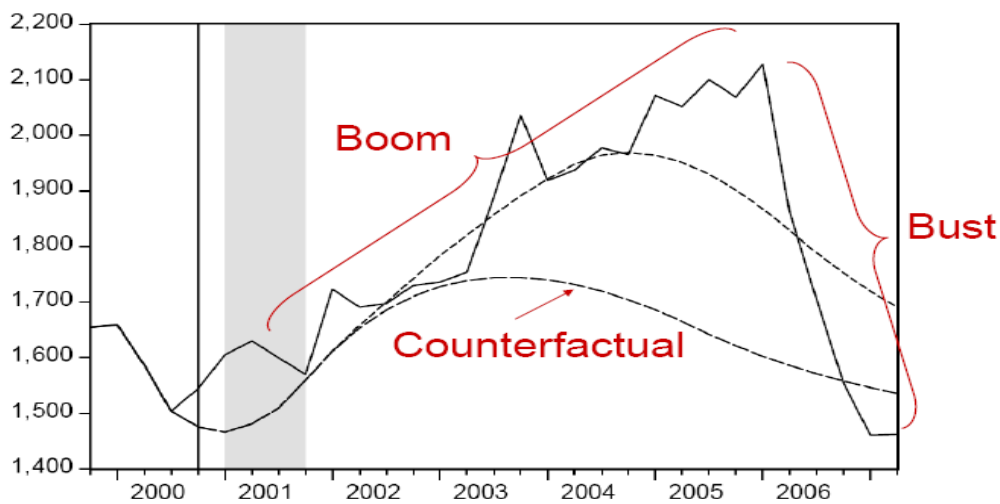
While disinflation was a major theme in Turkey after 2003, inflation was virtually flat and within tight bounds overseas before the storm. 2% core inflation and 2% headline inflation, both targeted and achieved, in the U.S. and in the Euro zone respectively, were not conducive to high interest rates. Hence, while the CBT had ample room to go south, and effectively eased from 16.75% to 6.5%, neither the ECB nor the Fed had the same opportunity. Low inflation and low real rates of interest are *desiderata* perhaps, but they have the unwarranted implication that risk-loving plays venture into perilous waters, adding yet another reason to the risky asset pile-up before 2007.

On the other hand, there was a period during which time the Fed had effectively eased and went way below the Taylor rule-implied interest rate. John Taylor is a famous economist, and he sort of invented, *inter alia*, the equally famous Taylor Rule whereby central bank policy reaction functions have been designed over the last 15 years or so. The Taylor Rule lies at the heart of inflation targeting. The initial US fit was like 1/3 weight to deviations from trend growth, and 2/3 weight to deviations from the inflation target.

Hence, the central bank would raise its policy rate should inflation deviate from target and drift upwards, attaching 1/3 weight to growth considerations at the same time. If growth is weak, then the interest rate hike will be less steep than it would otherwise be. Below is the graphic provided by John Taylor himself. It depicts how the Fed lowered the O/N rate below the Taylor Rule and kept it there for almost 4 years. The claim is thus that Fed's interest rate policy and monetary easing it resorted to apply after 2001 is at the main source of the boom-bust cycle the world is now through. Should Fed stick to the Taylor Rule, the 2008-2010 slump would not have occurred at the relative business cycle frequency with that kind of amplitude and steepness.



The counterfactual simulation John Taylor provides us with is displayed in the exhibit below. The cycle would be there obviously, but it would have been milder in terms of both the boom phase and the through phase. Fed sowed the seeds of disaster between 2001 and 2004.



Now the new idea is to set inflation targets at relatively high levels (such as 4% instead of 2%) and allow central banks to pursue low interest rate policy longer than expected. Admittedly, the long end would respond, thereby steepening the yield curve, and in the longer term the new level of targeted –and achieved- inflation would command higher nominal interest rates. Easing from a relatively higher level could empower central banks more, and prolong the journey from higher nominal rates to the zero interest rate policy loci. Interesting idea as it stands, and furthermore comes from Blanchard, but would it fit to the new era? Could inflation be controlled along a higher path, and would not its variance jump in tandem also?

The market wrap says equities dived down 5 consecutive days, and the ISE looks more responsive to bad news compared to other stock exchanges, absent the IMF deal perhaps. Ahead of the Fed meeting, and also the CBT will meet this week, bystanders should grow in number. Turkish unemployment offers no surprises despite the fact that non-farm unemployment fell only by 0.2% in December. The favourable base effect has not yet been fully felt in December since non-farm job creation was rather weak as opposed to strong but seasonally driven job creation in agriculture. However, sharp annual drops in the unemployment figures due to base effects await us in Q1 although *in toto* unemployment would remain high and not revert to the pre-crisis levels.

Political noise has never been pleasant for financial markets. Yet the recent agenda, although rather heavily loaded this time, has not yet full been priced, or else it will not have a large impact. Current account data shows the net errors and omissions item to soar again, and post portfolio inflows, but given somewhat lasting uncertainties we do not now expect a strong pick-up in FDI flows this year. Absent IMF, a lot of political noise, and c. USD7 bn expected FDI inflows in 2010 entails an implication: Turkey would need extraordinary FX inflows this year too, possibly in the form of net errors & omissions.