

VAKIFBANK TURKISH ECONOMY WEEKLY

Turkish Economy 2012 Forecasts: INFLATION







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We increase our 2011 year-end CPI forecast to 8.6%...

After declining to its record low level in Q1 2011 with positive base effect, annual CPI sharply increased in Q2 2011. The upward pressure in annual CPI has increased since Q3 2011.

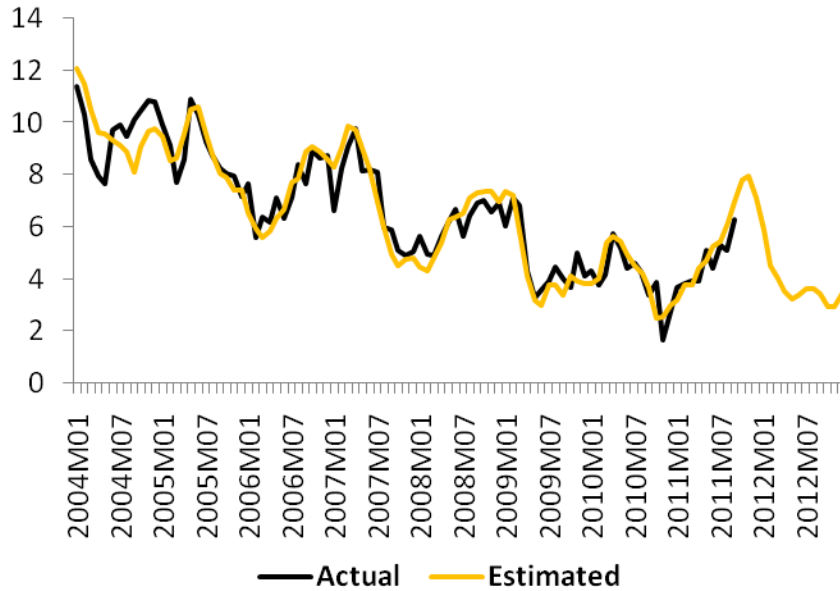
The factors behind the increasing price pressures:

-  Pass through of exchange rate to domestic price indicators,
-  Rise in natural gas and electricity prices,
-  Additional special consumption tax adjustments in some product groups,
-  Negative impact of unfavorable seasonal conditions on food prices.

Our year-end CPI forecast (7.15%) was well above the expectations of CBRT and market in our report (2011 Turkish Economy-II) published in October 2010 and in the same report we stated that we were expecting CPI to be in the range of 5.5-9.4% by the end of 2011. The recent excessive depreciation of TL and the recent tax increases indicate that year-end CPI will be closer to our first scenario. Under these considerations, we revised our 2011 year-end CPI forecast from 7.15% to 8.6%.

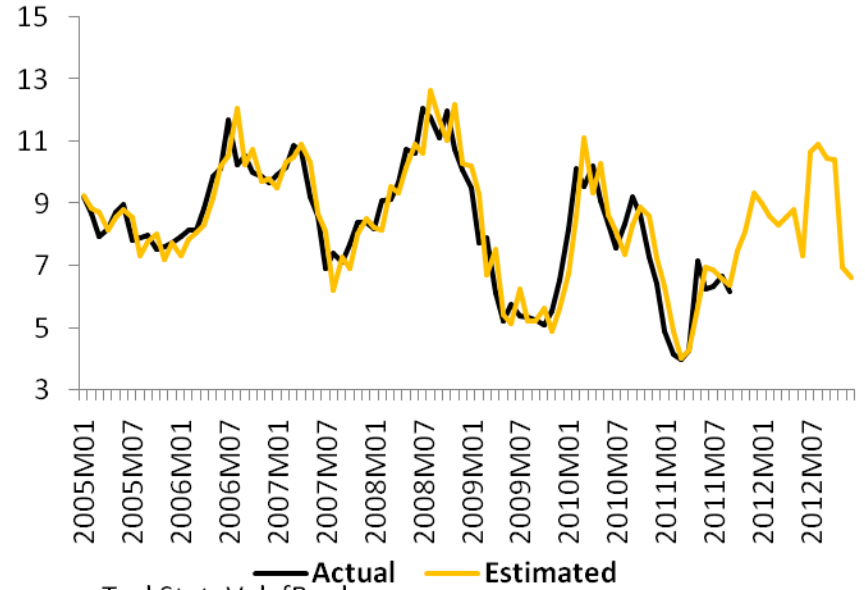
Our 2012 year-end CPI stands at 6.6%...

Core I Index (y-y,%)



Sources: TurkStat, VakifBank

CPI (y-y,%)



Sources: TurkStat, VakifBank

According to our econometric model estimates, after a sharp increase in 2011, core CPI will move downward until Q2 2012 and then fluctuate limitedly to the end of 2012. Within these expectations, our 2012 core CPI forecast is 3.4%. Our 2012 estimates indicate that upward movements in headline CPI in Q1 will reverse in Q2 with the positive seasonal effects. After a sharp increase in Q3, CPI will decrease sharply in the last quarter of 2012 with the positive base effect. Under these considerations, our 2012 CPI forecast is 6.6% which is well above CBRT's expectation (5.2%).

CBRT changed its policy stance...

- 📌 In the face of the excessive depreciation in TL, CBRT increased efforts to limit the downward pressure on the value of TL, increasing the USD selling auction amount and intervening directly in the FX market for the first time since June 2006.
- 📌 In its latest meeting on 20th October 2011 CBRT didn't touch the policy rate but increased the O/N borrowing rates and hence widened the interest rate corridor to a certain extent.
- 📌 On the other hand CBRT put larger weight on inflation risks but didn't reveal a neat opinion regarding its policy stance.
- 📌 Finally, in the introduction meeting of its fourth Inflation Report of 2011, CBRT clarified its current policy view stating that it has passed onto a tighter policy stance.
- 📌 Also, CBRT didn't leave aside its growth concerns totally and cut the TL RRRs considerably in line with our expectation and increased the upper limit for FX reserves which might be held to meet TL RRRs, from 20% to 40% of TL liabilities.
- 📌 To sum up, CBRT changed its attitude with a sudden stroke in the face of changing macroeconomic and financial circumstances.
- 📌 We think that this is reflecting the elasticity and determination of CBRT against sudden changes in local and global outlook.
- 📌 And, CBRT's revision of its 2011 inflation forecast is a part of this stance.

CBRT stated that inflation will rise significantly in the upcoming months and revised its 2011 year-end CPI forecast due to the factors discussed below:

i. Output Gap:

Since GDP data indicated a more robust economic activity in the second quarter of 2011, CBRT revised the output gap estimates upwards for the short term. In 2012, in addition to the negative global outlook, the slowdown in domestic demand is expected due to the tight policy measures. Therefore CBRT revised the output gap estimates downwards for the medium term.

iii. Additional Price Adjustments in Tobacco:

Under the recent developments, the estimated contribution of the price increases of tobacco products to inflation is revised upwards to 0.9 percentage points. This has led to an increase in short term inflation forecasts by 0.6 points.

ii. Recent excessive depreciation of the TL:

The main factor behind the recent revisions of CBRT is the pass-through of exchange rate to CPI. The exchange rate pass-through effect to 2011 CPI is estimated to be 0.9 points.

iv. Commodity Prices:

Oil prices were revised downwards from 115 USD per barrel to 110 USD per barrel for 2011. These revision lowered the 2011 year-end inflation forecasts by 0.1.

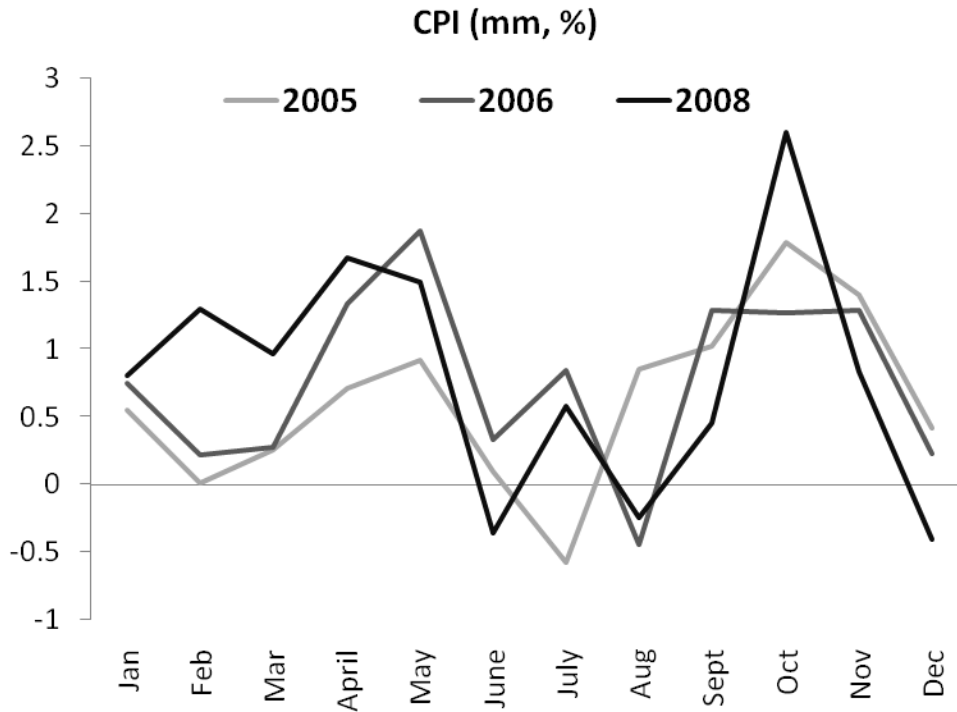
Comparison of last two CBRT Inflation Reports in 2011...

	Inflation Report 2011-III	Inflation Report 2011-IV	Revisions
Output Gap	2011 Q2:-1.1 pp	2011 Q2:-0.4 pp	<i>Upward in short term</i>
	2011 Q3:-0.8 pp	2011 Q3:-0.7 pp	<i>Downward in medium term</i>
	2012 Ave.: -0.01 pp	2012 Ave. : -1.08 pp	<i>term</i>
Food Prices	2011: 7.5%	2011: 7.5%	<i>Unchanged</i>
	2012: 7.5%	2012: 7.5%	
	2013: 7.5%	2013: 7.5%	
Oil Prices	2011: 115\$	2011: 115\$	<i>Downward</i>
	2012: 110\$	2012: 100\$	
Additional Price Adjustments in Tobacco	2011: 0.3 pp	2011: 0.9 pp	<i>Upward</i>
Exchange Rate Pass Through	--	2011: 0.9 pp	<i>Upward</i>
		2012: 0.4 pp	
CPI	2011: 5.9%-7.9%	2011: 7.8%-8.8%	<i>Upward</i>
	(Mid Point:6.9%)	(Mid Point:8.3%)	
	2012: 5.2%	2012: 5.2%	
	2013: 5.0%	2013: 5.0%	

Source: CBRT

pp: percentage points

We expect 2012 CPI to be between 5.1% and 8.25%...

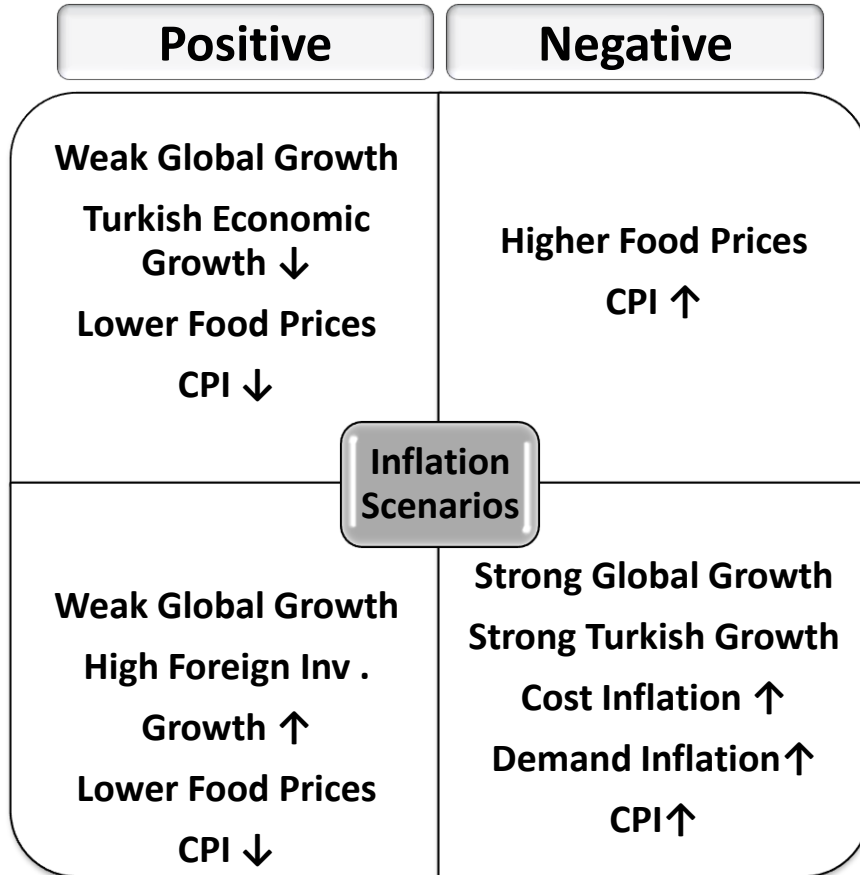


Source: TurkStat, VakifBank

CPI (yy, %)	Positive Scenario	Negative Scenario
Our Forecast	5.1%	8.25%
Source: VakifBank		

- To determine the 2012 path of headline inflation, we studied the periods following the years in which monthly food price increases are similar in the sense that they're too high and volatile .
- 2005, 2006 and 2008 monthly CPI data are taken as a sample.
- The values below and above the average of these three years are reflected to 2012 inflation.
- Lower values gave a 5.1% increase and higher values resulted in an 8.25% increase in 2012 year end inflation.

2012 Inflation Scenarios...



-  Our positive scenario is mainly based on lower food price pressures.
-  Weak global growth environment might be supportive for lower year-end inflation.
-  Downside risks on Turkish growth in line with lower global growth dynamics might also result in a decline in inflationary pressures.
-  Negative scenario might come out as a result of higher than expected food prices.
-  Strong global growth and an unexpected increase in Turkish growth performance might also create an upside risk on our 2012 inflation forecast.

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