

ECONOMICS: EASTERN EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES—MARCH 5, 2010

Why Inflation Poses More Immediate Risks for Turkey than for Russia or South Africa

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Growing concerns about inflation and its impact on the exchange rate mean that Turkey’s central bank is likely to hike interest rates before Russia and South Africa.

Among the major EEMEA economies, Turkey, Russia and South Africa are all expected to experience strong recoveries and supply-side inflation this year. We have discussed both issues extensively in previous commentaries. This combination of recovery and inflation is particularly likely to complicate policymaking in Turkey, where inflation has risen the most, financial conditions are loosest and the economic recovery is most advanced. As a result, Turkey’s currency and local bonds are most at risk of a sell-off, which would likely force the central bank to hike rates to stabilize asset prices.

Inflation and Central Bank Credibility

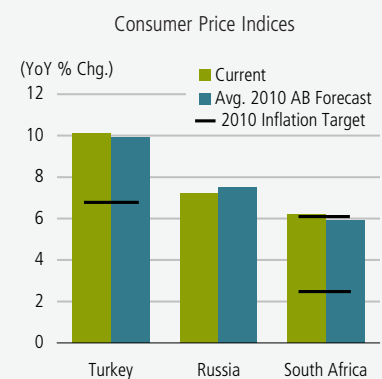
Inflation is rising fastest in Turkey and is likely to deviate more from the central bank’s target than in Russia and South Africa (**Display 1**). As a result, the credibility of Turkey’s central bank is more at risk than elsewhere.

Inflation in February rose by more than expected to 10.1% year-over-year from 8.2% in January and a low of 5.1% in October 2009. Turkey faces supply-side inflation from excise tax and administrative price hikes, which have partially reversed

last year’s tax cuts, and from higher energy prices. In addition, demand-side inflation may also be building as month-over-month price increases are above historical averages, the negative output gap (actual GDP being below potential GDP) is closing much faster than anticipated, and input prices are rising. Inflation is likely to finish the year around 10% year-over-year, which exceeds the 6.5% target by a wide margin.

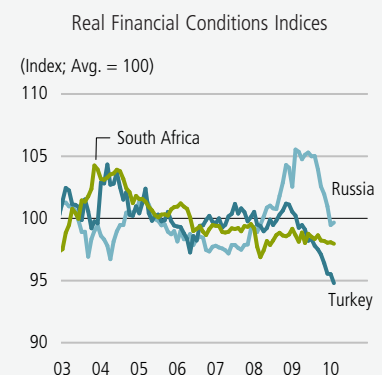
The central bank’s credibility is also challenged by its frequent shifts in policy focus. During the commodity price boom in 2008, the central bank was the only one globally to raise its inflation target to 7.5% from 4.0%. The bank then adopted varying rationales for cutting interest rates and keeping them low. Following the decline in commodity prices in late 2008 and early 2009, the bank argued that headline inflation was falling. Once headline inflation started to rise in late 2009, the bank started to move its focus to core inflation. Since core inflation itself started to rise in January this year, the bank has argued that the increase in core inflation will only be temporary.

Display 1
 Turkey’s Inflation Deviates the Most from Its Target



Source: Haver Analytics, national central banks and AllianceBernstein

Display 2
 Turkey’s Financial Conditions Are Loosest



Source: Bloomberg, Haver Analytics, JP Morgan, national central banks and AllianceBernstein

At some point, the market is likely to become less complacent towards the central bank's dovish stance on inflation. An important trigger is long-term inflation expectations, which have only just started to rise. Expectations over a 12-month horizon have risen to 6.9% from a low of 6.3% in October, and to 6.6% from 6.3% over a 24-month horizon. If these expectations start to approach the peaks reached in 2008 of 9.0% and 7.7%, respectively, then the central bank would likely be forced to hike rates.

By contrast, inflation does not pose immediate risks in Russia and South Africa. In Russia, the central bank has no explicit target. The current inflation rate of 7% is consistent with its expectations for 2010. Inflation remains structurally high in Russia, given recurring administrative price increases, high nominal growth in government expenditure and weak domestic competition. However, we do not expect inflation to increase until the second half of the year, at which point the central bank is likely to allow more currency appreciation and to raise interest rates.

In South Africa, inflation is likely to remain within the central bank's 3% to 6% target range this year. The central bank is aware of inflation risks from electricity price hikes, energy prices rises and real wage increases. As these factors have remained within the central bank's expectations, however, we do not expect inflation to start rising until the end of 2010, once the recovery becomes more advanced.

Financial Conditions

The second reason inflation is more problematic for Turkey is that financial conditions are far looser, which implies that demand-side inflation pressures are likely to build sooner (**Display 2**). We are in the process of developing a financial conditions index for each country, based on short-term and longer-term domestic interest rates, foreign interest rates, equity markets, the real exchange rate and, in

Russia, monetary aggregates. The preliminary indices shown in Display 2 show each country's current position relative to its average since 2003.

Turkey's financial conditions are the loosest of the three after a 10.25 percentage point reduction in the policy rate since November 2008. This has reduced the real policy rate to -3.6% from an average of 6% since 2002. South Africa's financial conditions have also loosened as the central bank has cut interest rates by 5.00 percentage points since November 2008. However, South Africa's real policy rate of 0.8% remains higher than in Turkey, while financial conditions are still tighter than they were in early 2008, when the currency depreciated and higher commodity prices pushed inflation higher.

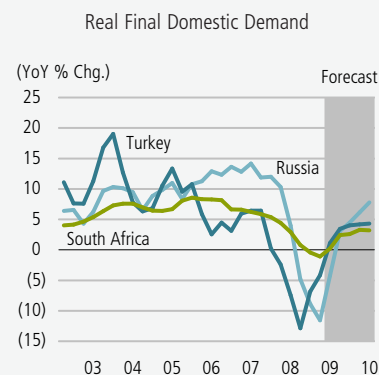
In Russia, rate cuts of 4.50 percentage points since March 2009 have helped to loosen financial conditions, when the central bank started to reverse its previous policy of tightening monetary policy to stabilize the exchange rate.

Timing of the Recovery

A third reason for heightened concerns about inflation in Turkey is that the economic recovery is most advanced there (**Display 3**). Turkey's economy started to contract in the second quarter of 2008, two quarters before Russia and South Africa. Similarly, its economy started to recover in the second quarter of 2009, whereas growth only resumed in Russia and South Africa in the third quarter. The earlier turnaround and stronger-than-anticipated recovery in Turkey suggest that the negative output gap is likely to close faster than is widely expected. In Russia and South Africa, these demand-side inflation pressures trail Turkey by one to two quarters.

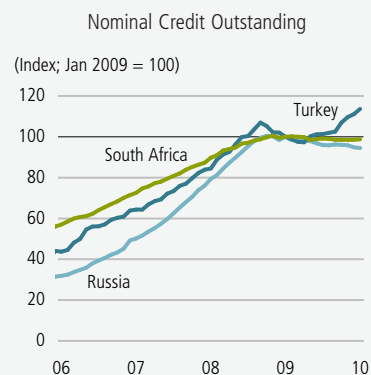
High-frequency monthly data generally support this divergence. In particular, nominal credit has grown by 17% since April in Turkey, compared with a contraction in Russia and virtually no change in South Africa (**Display 4**). While we expect

Display 3
Turkey's Economy Started to Recover First



Source: Haver Analytics and national statistical agencies

Display 4
Turkey's Credit Growth Is Highest



Source: Haver Analytics, national central banks and AllianceBernstein

credit growth to rise in all three countries this year, the divergence at this stage is a useful signal of the timing of the recovery in final domestic demand.

These three reasons—inflation dynamics, financial conditions and the timing of the recovery—all suggest that the exchange rate and bond prices are most at risk of a sell-off in Turkey. As a result, we expect Turkey's central bank to hike rates before its counterparts in Russia and South Africa, either to reduce these risks or in response to market pressure. Risks in Russia and South Africa are only likely to materialize toward the end of 2010, as the recovery becomes entrenched and both supply- and demand-side inflation pressures rise. ■

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