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Economics Group

Special Commentary

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Turkey Overheating Presents Challenges

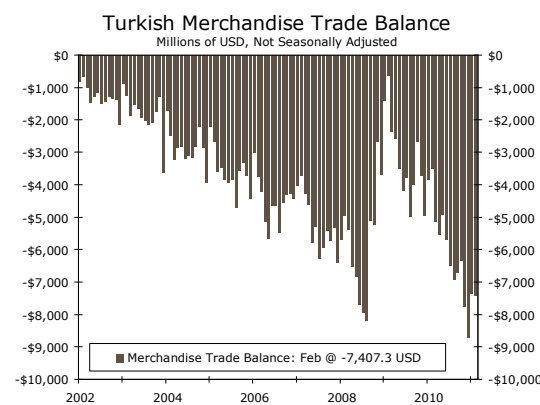
Turkey's economy expanded 9.2 percent year over year in the fourth quarter, up from 5.2 percent in the third quarter. This was second only to China's 9.8 percent in the fourth quarter among the Group of 20 major economies. For all of 2010, the economy expanded 8.9 percent. Driving fourth-quarter growth was a strong 9.0 percent year-over-year jump in household consumption, which accounted for about two-thirds of annual growth. Also providing support were a 42 percent surge in fixed investment and a 3.9 percent increase in government spending. However, trade remained a drag on growth as exports rose 4.3 percent while imports soared by 25.4 percent.

A big concern for the central bank has been the continued swift growth of credit, which is currently expanding at about a 30-40 percent year-over-year clip. The government would like to see this scaled back to about 25 percent. As such, the central bank hiked reserve requirements on March 23 by an average of 400 bps. While this is intended to slow credit growth, most banks are not planning to slow lending much. The central bank has raised reserve requirements rather than interest rates in an attempt to cool the economy without attracting more speculative capital inflows and pushing up the value of the lira. A strong lira would reduce the competitiveness of Turkey's exports. With the trade deficit already near unsustainable levels and the current account deficit continuing to widen as a result, tighter monetary policy is not the best option to steer the economy toward a soft landing. The best option would be tighter fiscal policy. However, with elections looming in June, it is likely that government spending will increase as Prime Minister Erdogan attempts to keep the masses complacent and win their support.

Figure 1



Figure 2



Source: Turkish Statistical Institute and Wells Fargo Securities, LLC

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Strong domestic demand has fueled robust industrial production, which was up 18.9 percent in January from a year ago. Rising employment and wages, along with improving consumer confidence, have spurred strong household spending and kept the factories humming. Even so, inflation remains benign, coming in at just 4.2 percent year over year in February, a record low. Although oil and commodity prices have risen, prices for clothing, tobacco and some services have dropped, keeping inflation low. The high base of comparison due to tax increases at the beginning of 2010 is also contributing to the low inflation numbers.

Low inflation has allowed the central bank to refrain from raising interest rates. However, the central bank is expecting further increases in oil and commodity prices to push inflation higher in the coming months. This will put a wrench in the government's attempts to slow the economy without hurting exports. Sooner or later the central bank will likely be forced to raise interest rates, which could put upward pressure on the lira, restrain exports and lead to a further widening of the current account deficit, which could be exacerbated by high prices for oil imports. The wider the current account deficit, the more dependent the country is on capital inflows, and the more vulnerable the currency and the economy are to changes in investor sentiment. In these volatile times, instability is a greater concern than in prior election years.

Figure 3

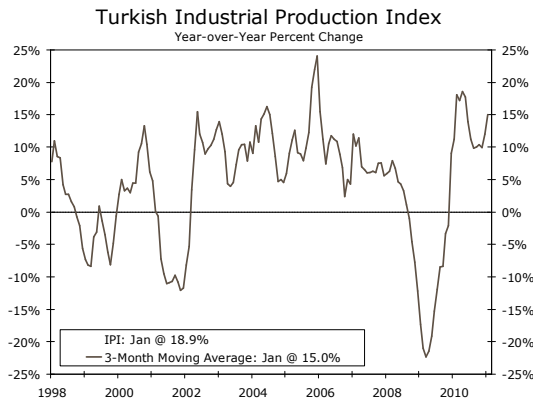
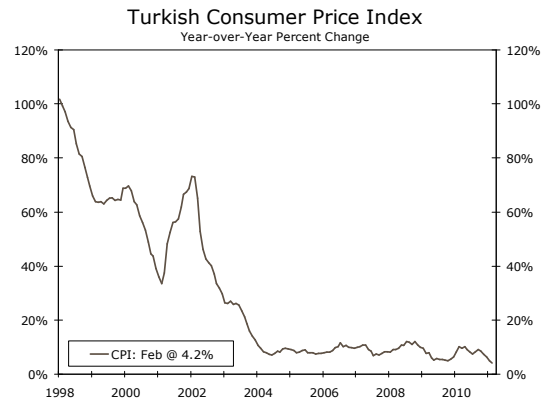


Figure 4



Source: Turkish Statistical Institute and Wells Fargo Securities, LLC

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