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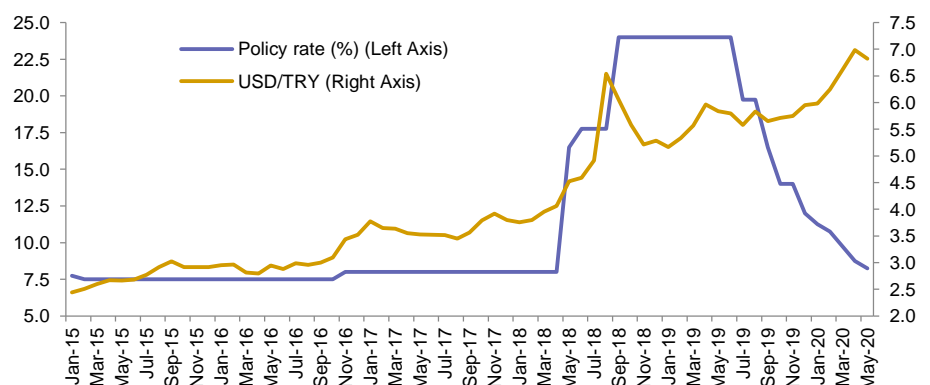
MUFG Bank, Ltd.
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27 July 2020

Turkey holds rates but funding gap will keep the currency under pressure, encouraging rate hikes

- **The Central Bank of Turkey (CBRT) left rates unchanged at 8.25% on 23 July, in line with expectations, but flagged that it is becoming less comfortable with the inflation outlook.** Concerning price developments, while the CBRT anticipates demand-driven disinflationary effects to become more prevalent in H2 2020, the risks associated with its year-end forecasts (+7.4% y/y) are considered to be on the upside. We concur with this evaluation, and forecast inflation averaging ~11-12% y/y this year, as the impact of the weak Turkish Lira (TRY) and a relatively high pass-through from exchange rate depreciation offsets the disinflationary impact of much weaker demand caused by COVID-19 consumption evisceration.
- **The CBRT emphasised that the economic recovery process is gaining momentum.** The wording in the statement following the rate announcement was central to us. Granted, the changes in the press release following the MPC meeting were broadly negligible, but the CBRT was somewhat more upbeat on activity, characterising the economy recovery as "gaining pace" – unlike the previous press release where it was noted that economic activity had started recovering. The CBRT took comfort that the easing in travel restrictions will contribute to a partial improvement in tourism revenues.
- **The funding gap remains front of mind, likely keeping the TRY under pressure, and encouraging rate rises before year-end.** The accommodate easing cycle that went without interruption, following 1,575bps of rate cuts in nine consecutive steps between July 2019 and May 2020, is over in our view. Given the combination of the current account deficit, a deleveraging private sector and the public sector not attracting any foreign inflows, we see an external funding gap in the economy which we believe is likely to keep the TRY under pressure – MUFG forecasts USD/TRY ending Q3 and Q4 at 6.95 and 7.05, respectively (see [here](#)). Hence, we view Turkish rates will have to go up again before the end of the year to encourage foreign inflows, contain the current account gap, limit dollarisation and curb domestic demand against a deteriorating trade balance. Indeed, in a dollarised economy with high external financing needs and private sector FX debt, the sharp base money expansion and credit growth warrant caution.

USD/TRY AND TURKEY'S ONE WEEK REPO RATE (%)



Source: Bloomberg, CBRT, MUFG MENA Research

Turkey holds rates but funding gap will keep the currency under pressure, encouraging rate hikes

CBRT keeps rates on hold as anticipated

As widely expected, the CBRT kept its key policy rate unchanged at 8.25% on 23 July, in line our and unanimous consensus expectations. The tone of the interest rate announcement was only modestly more cautious than before. The key change in the interest rate announcement note was the reference to upside risks to the official end-year inflation forecast of 7.4% y/y. This confirmed that the CBRT has become less comfortable about the disinflation story and further easing now looks quite unlikely. On the other hand, the CBRT still sounds optimistic surrounding growth prospects, disinflation and external balances. Of importance, while the CBRT mentioned financial stability as a factor when hiking FX reserve requirement ratios on 19 July, this factor was excluded in the announcement statement. On balance, the CBRT has begun referring to the normalisation of policies and the risks to financial stability, and continues to closely monitor the implications of the pandemic on capital flows, financial conditions, international trade and commodity prices. However, in our view, the CBRT may be missing an opportunity by not emphasising risks to price stability and by not sounding conservative enough.

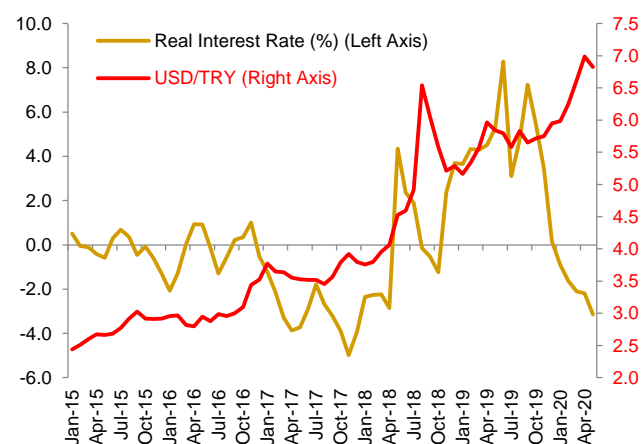
CBRT has become less comfortable with the inflation outlook

The CBRT attributes the recent rise in inflation (12.6% y/y in June from 11.4% y/y in May) to supply-side factors that it expects to fade and anticipated demand-driven disinflationary effects to become more prevalent in H2 2020. In a marked deviation from recent previous statements, the CBRT noted that risks to its end-year inflation forecast (+7.4% y/y) are to the upside. This is fundamentally owing to rising unit costs that have led to some acceleration in core price pressures, while seasonal factors and the impact of COVID-19 have pushed up food inflation, posing upside risks to 7.4% end 2020 target. We concur with this evaluation, and forecast inflation averaging ~11-12% y/y this year, as the impact of the weak Turkish Lira (TRY) and a relatively high pass-through from exchange rate depreciation offsets the disinflationary impact of much weaker demand.

The inflation report on 29 July could garner the CBRT credibility

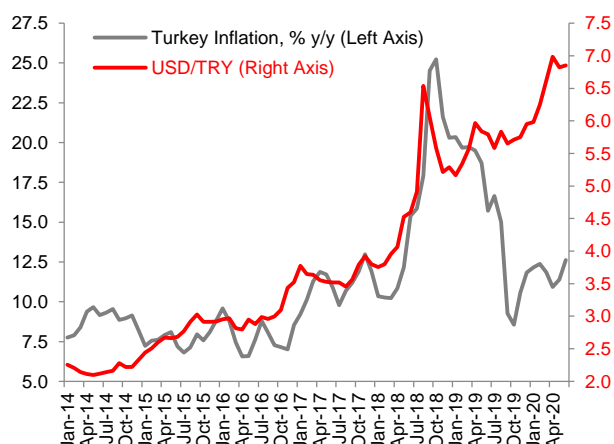
The CBRT is due to release its third quarterly inflation report on 29 July, which will provide the stage for a more comprehensive assessment of the economic environment, the associated risks and a chance for it to potentially revise its inflation target of 7.4% y/y at end-2020 higher. Indeed on inflation, the CBRT's forecasts appears outdated, especially given the upside surprises in the last two months. As

USD/TRY AND TURKEY REAL INTEREST RATES (%)



Source: Bloomberg, CBE, MUFG MENA Research

USD/TRY AND TURKEY INFLATION (% Y/Y)



Source: Bloomberg, Turkey Statistical Institute, MUFG MENA Research

such, it is conceivable that such an upside revision could unlikely be market moving. Of central importance will be to gauge whether there are any increased commitments to price and financial stability – language that will be a welcome step in the restoration of credibility in a significant way.

Widening fiscal and external imbalances remains front of mind

The COVID-19 pandemic is likely to push real GDP to contract -4.5% this year from +0.9% in 2019. Despite this sharp recession, we view that the nature of the risks facing the Turkish economy has no changed and see that the management of the widening fiscal and external imbalances remain front of mind. After a small current account surplus in 2019, we think that the current account in 2020 is now on track to shift to a deficit of 1.8% of GDP, despite the precipitous fall in oil prices. This will require additional funding. Given that the private sector is continuing to deleverage, this suggests that the public sector would need to fill this funding gap for the TRY to stabilise. Meanwhile, the pandemic is likely to lead to a widening of the budget deficit to 8.2% of GDP, according to our calculations. We believe that the funding of the external balance would be secured if the government was attracting foreign investors to fund just half of this. However, foreigners are continuing to be net sellers year-to-date, apparently judging the rates offered as insufficient given the risks.

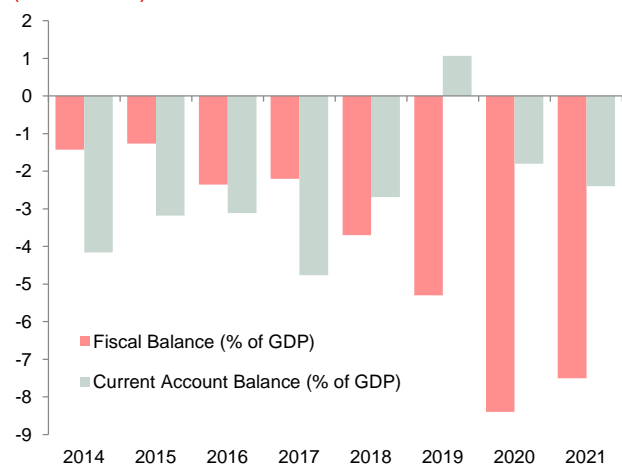
CBRT is in a challenging position given the funding gap

Such a funding gap leaves the CBRT in the challenging position of funding both the budget and the private sector deficit in the balance of payments – a role that it will not be able to fulfil for a sustainable period, in our view, given its limited reserve buffers. The authorities have increasingly applied administrative and regulatory policies to support the capital account. However, given the expected widening of the current account deficit, we see difficulties with this strategy. Assuming no significant foreign funding is attracted, we think import demand would need to fall more than can be achieved by solely relying on currency depreciation-driven import substitution. Instead, domestic demand would need to be restricted and/or imports would need to be sizably discouraged by administrative measures.

CBRT to remain on hold with prospects of a rate hike before year-end

The accommodate easing cycle that went without interruption, following 1,575bps of rate cuts in nine consecutive steps between July 2019 and May 2020, is over in our view. Going forward, we expect the CBRT to remain reactive, with recovering domestic demand and increasing price pressures, likely indicating that the next move will be a hike before year-end. Given the combination of the current account deficit, a deleveraging private sector and the public sector not attracting any foreign inflows, we see an external funding gap in the economy which we believe is likely to keep the

TURKEY FISCAL AND CURRENT ACCOUNT BALANCES (% OF GDP)



Source: Bloomberg, CBRT, IMF, MUFG MENA Research

TURKEY BALANCE OF PAYMENTS (BOP): JANUARY – MAY 2020 (USD BN)

Jan-May (USD bn)	Current Account Balance	Capital and Financial Account	Errors and Omissions	Reserve Accumulat.*
2008	-21.5	17.4	0.1	4.0
2009	-4.3	-2.2	4.7	1.8
2010	-15.8	25.0	-2.0	-7.2
2011	-36.3	40.2	5.2	-9.1
2012	-26.1	28.4	0.8	-3.1
2013	-27.9	48.3	-9.8	-10.6
2014	-17.6	12.4	5.0	0.2
2015	-16.0	3.8	8.4	3.8
2016	-12.2	15.6	1.4	-4.8
2017	-14.9	18.9	-9.4	5.4
2018	-26.7	21.5	4.4	0.8
2019	0.2	0.3	2.8	-3.3
2020	-16.7	-1.6	-4.1	22.4





Source: Bloomberg, CBRT, MUFG MENA Research; * a negative value represents reserve accumulation by CBRT

TRY under pressure – MUFG forecasts TRY ending Q3 and Q4 at 6.95 and 7.05, respectively (see [here](#)). Hence, we view Turkish rates will have to go up again before the end of the year to encourage foreign inflows, contain the current account gap, limit dollarisation and curb domestic demand against a deteriorating trade balance. In a dollarised economy with high external financing needs and private sector FX debt, the sharp base money expansion and credit growth warrant caution. This, coupled with the deterioration in the quality of external financing, leads us to believe that the CBRT may revisit its current accommodative stance in late Q3 or early Q4. Nevertheless, we also see a relatively large range of uncertainty around the timing of such a decision as it will ultimately depend on the extent to which policymakers will want to continue to use reserves to preserve TRY stability.

Economic Weekly Round-up

- **Key data and events in the past week:**
- **Egypt's** fiscal deficit in Egypt widened to USD24.4bn between July 2019 and May 2020, as the 2.2% rise in revenues was outpaced by the 6.8% growth in expenditures.
- **Kuwait** plans to issue between USD13-16bn in public debt by end of the current fiscal year (end-March 2021), subject to the approval of the debt law, according to reports.
- **Oman's** Shura Council's economic and finance committee has proposed linking VAT to economic growth, implementing VAT only if growth crosses 3% mark. It has also proposed excluding those who earn USD2,340 or less a month from the tax.
- In a bid to limit the spread of COVID-19, **Oman** will impose curfews (7pm to 6am) and travel bans for the upcoming Eid holidays, and a "total lockdown" of all governorates.
- Saudi Arabia's Finance Minister, HE Mohammed Al Jadaan, revealed privatisation plans in healthcare, education and water sectors to broaden its revenue base (raising an estimated USD13.3bn in the next 4-5 years).
- S&P estimates that debt drawdowns and debt will be used to finance fiscal deficits in the oil-dependent GCC nations, with borrowing estimated at a record USD100bn this year.
- **Key focus in the week ahead:**
 1. In **oil markets**, Shell, Exxon, total and Chevron report Q2 earnings.
 2. **Turkey's** quarterly inflation report

Economic Calendar and Forecasts

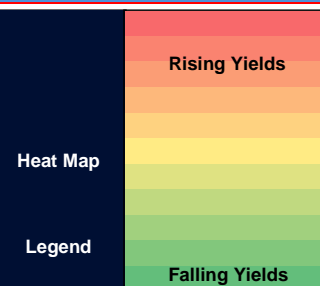
Upcoming Events and Data Releases								
Date		Country	Event	Period	Consensus	MUFG* Forecasts	Actual	Previous
27/07/2020		UAE	CPI, % y/y	Jun 2020				-2.7%
27/07/2020		Qatar	Real GDP	Q1 2020	---	---		-0.6%
28/07/2020		Saudi Arabia	SAMA Net Foreign Assets	Jun 2020	---	---		SAR1,668.4bn
29/07/2020		Turkey	Central Bank Inflation Report	Jul 2020				

* MUFG MENA Research
Source: Bloomberg, Refinitiv, MUFG MENA Research

MENA Market Indicators – Tables

Benchmark Bond Yields (% Local Currencies)

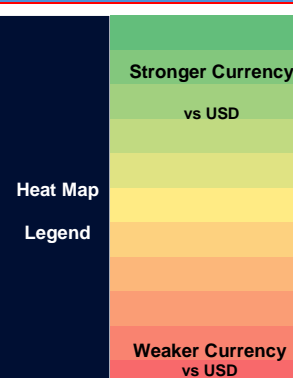
	Maturity	17-Jul	24-Jul	Change in Yield (bps)		
				Week	MTD*	YTD*
Advanced Countries						
US	10 yrs	0.63	0.59	-3.8	-6.7	-132.9
Germany	10 yrs	0.45	0.45	-0.1	0.6	-26.3
Italy	10 yrs	1.17	1.00	-17.3	-26.1	-41.5
Japan	10 yrs	0.02	0.02	-0.5	-0.9	3.0
MENA Countries						
Bahrain***	3 yrs	3.92	3.79	-13.6	-18.4	79.6
Egypt	4 yrs	14.16	14.18	2.0	-213.6	-2.3
Qatar***	10 yrs	2.01	1.86	-14.8	-38.1	-79.0
Saudi Arabia**	10 yrs	2.18	2.16	-2.3	5.5	-88.4
Abu Dhabi***	7 yrs	1.54	1.42	-11.7	-37.8	-99.0
Dubai***	9 yrs	2.97	2.91	-6.4	-22.4	-25.7



Note: * Month to Date and Year to Date; ** 10-year swap rate; *** USD denominated

Exchange Rates vs USD

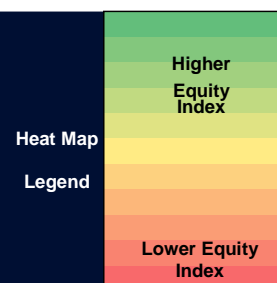
	17-Jul	24-Jul	Change (%)		
			Week	MTD	YTD
Advanced Countries					
US Dollar Index	95.942	94.435	-1.6	-3.0	-2.0
Euro Area*	1.143	1.166	2.0	3.8	4.0
Japan	107.020	106.140	0.8	1.7	2.3
MENA Countries					
Egypt	16.100	15.991	0.7	0.9	0.5
Kuwait	0.307	0.307	0.2	0.4	-1.1
UAE 12M Forward	3.679	3.678	0.0	0.0	0.0
Bahrain 12M Forward	0.378	0.379	-0.2	-0.2	-0.2
Oman 12M Forward	0.391	0.391	-0.1	0.0	-0.8
Qatar 12M Forward	3.661	3.662	0.0	0.0	-0.5
Saudi Arabia 12M Forward	3.765	3.765	0.0	0.0	-0.3
UAE Spot	3.673	3.673	PEGGED		
Bahrain Spot	0.377	0.377			
Oman Spot	0.385	0.385			
Qatar Spot	3.641	3.642			
Saudi Arabia Spot	3.751	3.751			



Note: * Exchange rate quoted as amount of USD per currency in line with market convention, other exchange rates are amount per USD

Equity Indices

	17-Jul	24-Jul	Change (%)		
			Week	MTD	YTD
Advanced Countries					
US (S&P 500)	3,216	3,216	0.0	3.7	-0.5
Europe (STOXX 50)	3,366	3,311	-1.6	2.4	-11.6
Japan (Nikkei 225)	22,696	22,752	0.2	2.1	-3.8
MENA Countries					
Bahrain (BB)	1,308	1,285	-1.7	0.6	-20.2
Egypt (EGX 30)	10,874	10,460	-3.8	-2.8	-25.1
KSA (Tadawul)	7,380	7,427	0.6	2.8	-11.5
Kuwait (KSE)	5,094	4,875	-4.3	-5.0	-22.4
Oman (Muscat 30)	3,461	3,564	3.0	1.4	-10.5
Qatar (Doha 20)	9,319	9,368	0.5	4.1	-10.1
UAE (Abu Dhabi)	4,221	4,261	0.9	-0.6	-16.1
UAE (Dubai)	2,048	2,053	0.2	-0.6	-25.8



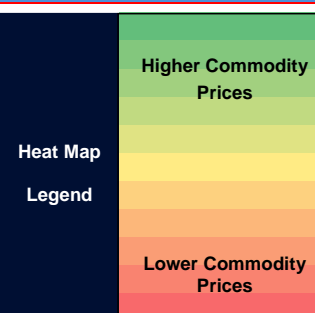
5 Year USD CDS Spreads

	17-Jul	24-Jul	Change in Yield (bps)		
			Week	MTD*	YTD*
MENA Countries					
Bahrain	350.71	337.77	-12.9	-10.7	161.8
Kuwait	62.03	61.75	-0.3	-12.0	25.0
Qatar	60.63	51.93	-8.7	-21.3	15.2
Saudi Arabia	103.06	88.67	-14.4	-18.6	31.8
UAE (Abu Dhabi)	62.13	54.59	-7.5	-19.7	18.5
UAE (Dubai)	192.85	181.81	-11.0	-11.4	90.8



Commodity Prices*

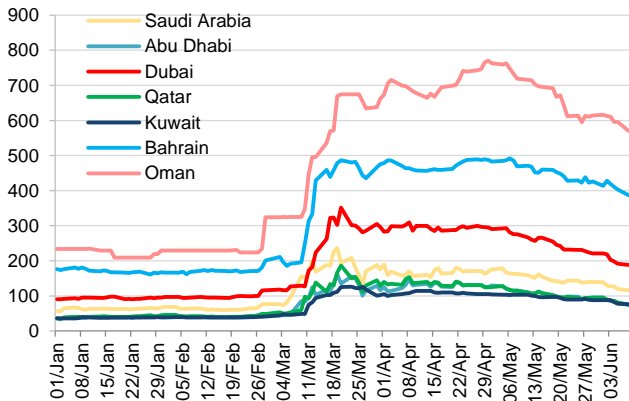
	17-Jul	24-Jul	Change (%)		
			Week	MTD	YTD
Energy					
Brent	43.1	43.3	0.5	5.3	-34.3
WTI	40.8	41.3	1.4	5.3	-32.3
LNG	1,569.8	1,549.8	-1.3	3.1	41.6
Precious Metals					
Gold	1,810	1,902	5.1	6.8	25.4
Silver	19.3	22.8	17.8	25.0	27.5
Industrial					
Copper	6,448	6,415	-0.5	6.7	3.9
Steel	475	475	0.0	-2.7	-19.2
Aluminum	1,662	1,700	2.3	5.0	-6.1
Wheat	535	540	0.8	10.1	-3.4



Note: * Spot prices or nearest expiring future

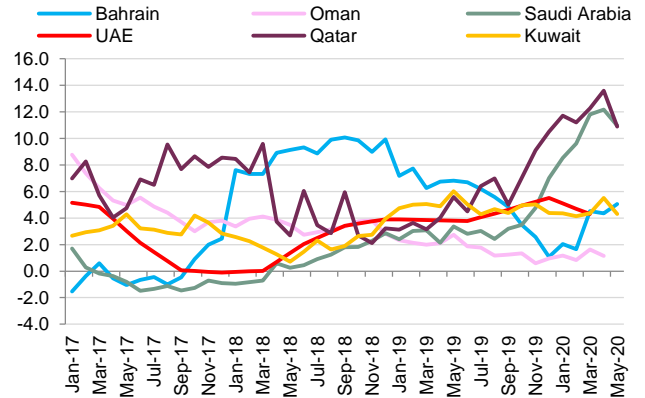
MENA Market Indicators – Charts

CHART 1. GCC 5 YEAR CDS SPREADS (BASIS POINTS)



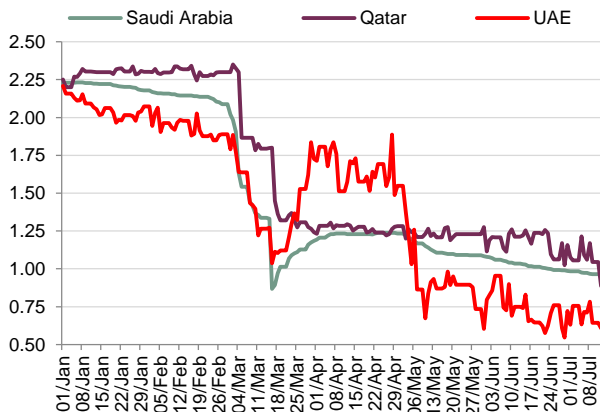
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 2. GCC PRIVATE SECTOR CREDIT GROWTH (% Y/Y)



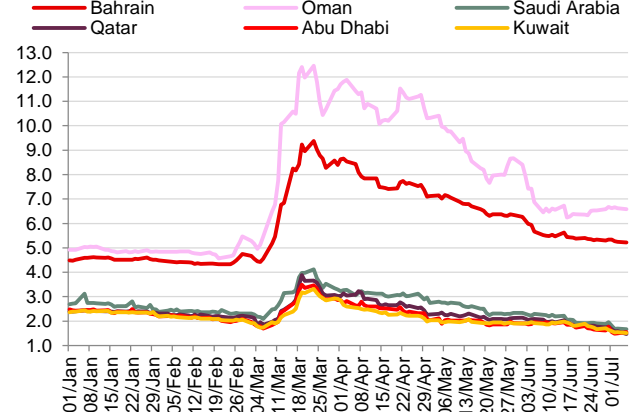
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 3. CORE GCC 3 MONTH INTERBANK RATES (%)



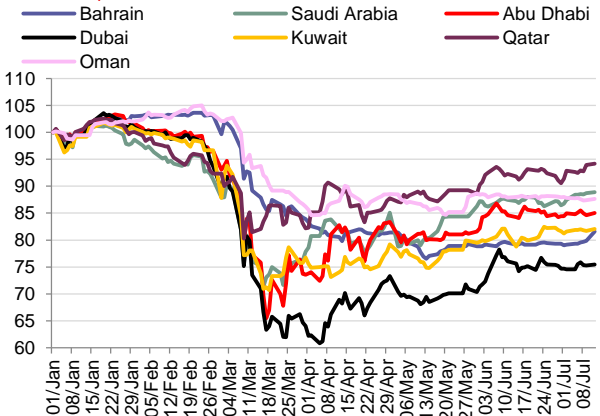
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 4. GCC 10 YEAR SOVEREIGN BOND YIELDS (%)



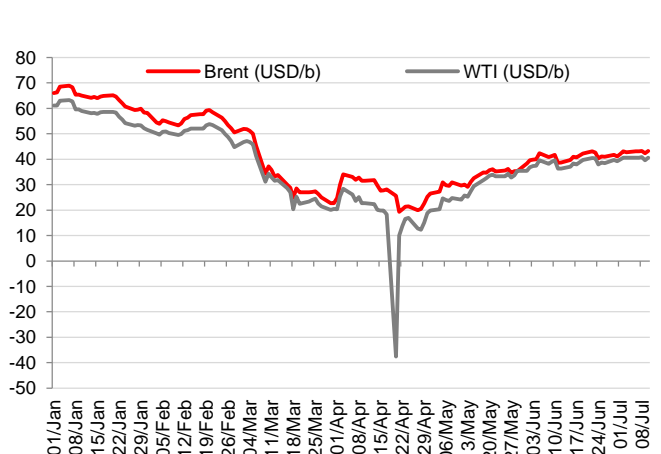
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 5. GCC EQUITY MARKETS (REBASED JANUARY 2017 = 100)



Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 6. BRENT AND WTI CRUDE PRICES (USD/B)



Source: Bloomberg, CEIC Database, MUFG MENA Research

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