Türkiye: Base effects start to help annual CPI

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Consumer prices rose by 2.9% in November, slightly lower than both consensus and our expectation of 3%. Accordingly, annual consumer inflation declined very limitedly to 84.4% from the previous 85.5%. Food prices remained to be the most strongly contributing factor but also became the reason for our downward deviation (5.7% mom vs. expected 6.5%). The composition of core prices maintained the pressure from cost push factors, high FX pass-thru and second round effects but some details surprised to the downside. Meanwhile, domestic producer price grew very mildly by 0.7% m/m, showing a strong, unusual pass-thru from lower energy prices and rose 136% y/y. Given the recent weaker inflation realizations and the Government's efforts to maintain a manageable currency depreciation, we now forecast 2022 year end inflation to be 67%. Since we envisage more counter-cyclical policies ahead of the elections to reverse the current rapid deceleration in activity, consumer inflation might remain high with near 45% in early 2Q23 despite the support from base effects led by the expected gradual currency depreciation.

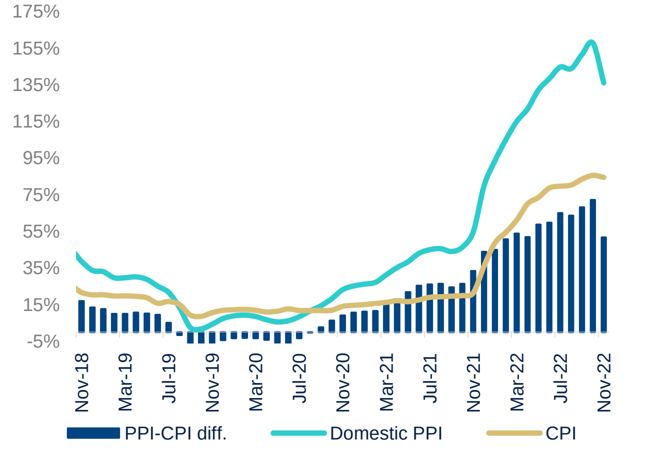
Prominent slow down in producer prices

Core prices inflation slowed-down to 1.9% m/m due to mainly basic good prices, recording its lowest increase since June 2021, despite continuing cost push factors, high exchange rate pass-thru and still strong demand. Accordingly, annual core inflation decelerated to 69% from 70.5% in October. Contraction in clothing and footwear prices (-1.5% m/m) was the main driver of the deceleration in basic good prices compared to previous month (1.6% m/m vs. 3.7% m/m in Oct.). Similarly, services inflation slowed down in monthly terms (2.2% m/m vs. 2.6% m/m Oct.) led by the contraction in transportation prices (-0.2% m/m) and weaker increase in rent prices (3.3% m/m vs. 4.9% m/m prev.), while restaurant and telecommunication services prices accelerated by 3.2% m/m and 3% m/m, respectively. However, annual services inflation still rose to 60.7% y/y, signaling clear signs of inflation inertia.

Consistent with our expectations, food price inflation maintained an upward trend (5.7 m/m), resulting in an annual inflation of 102%. The sharp increases in fresh fruit and vegetable (9.9% m/m), processed food (5.9% m/m) and other unprocessed food prices (3.4% m/m) led by recent price hikes -particularly in milk- and other supply side problems worsened the outlook further. On the other hand, energy prices inflation decelareted slightly to 1.3% m/m, due to the decline in fuel prices, leading to an annual inflation of 118% in November (vs. 128.1% in October).

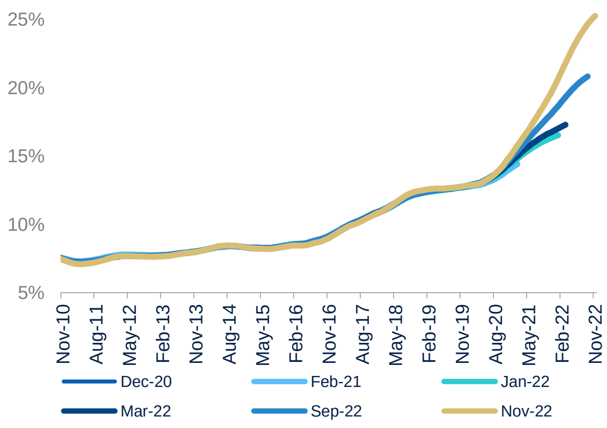
The drop in energy prices also helped domestic producer prices to gear down sharply to 0.7% m/m from 7.8% m/m in October. Depite the still high annual producer price inflation of 136% y/y, signaling persistent strong cost push factors, PPI posted the lowest annual increase in the last 6 months. Therefore, the gap between annual CPI and domestic PPI narrowed down to 51.6pp from 72.2pp in the previous month (Figure 1).

Figure 1. **CPI vs Domestic PPI, YoY**



Source: Garanti BBVA Research, Turkstat

Figure 2. **Trend CPI, YoY**



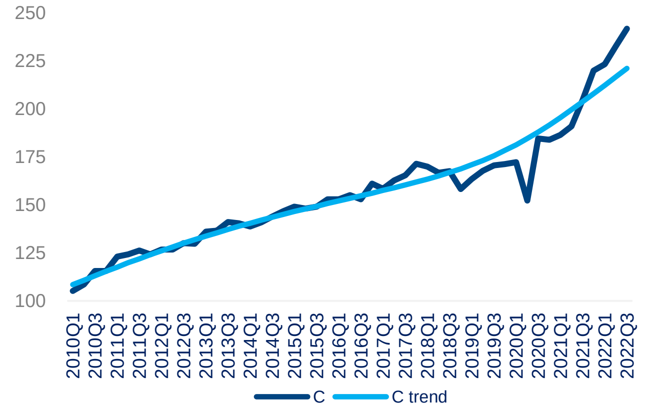
Source: Garanti BBVA Research, Turkstat

Private consumption growing above potential will keep inflationary risks alive

According to our latest nowcasts, Turkish economy is decelerating very fast with 2.5-3% y/y% GDP growth rate at the start of December due to weakening production on top of more challenging external and internal macro environment. Meanwhile, private consumption remains to be the main driver on domestic demand and continues to grow significantly above its historical trend (Figure 3). Very large negative interest rates, significantly worsened expectations and maintanence of populist measures continue to support consumption, which we expect to be boosted further with additional counter-cyclical policies ahead of the elections. Therefore, this will likely keep inflationary risks alive with the continuing pressure from cost-push factors and second round effects. Furthermore, the expected high adjustment in wages will increase the risk of a wage inflation spiral in 2023. Our calculations of a very high exchange rate pass-thru (near 50%, Figure 4) and deepening inertia (backward indexation) increase the uncertainties on inflation outlook. Although our expectations of a gradual currency depreciation will help in terms of base effects, the expected decline in inflation will be very moderate with near 45% annual inflation in early 2Q23.

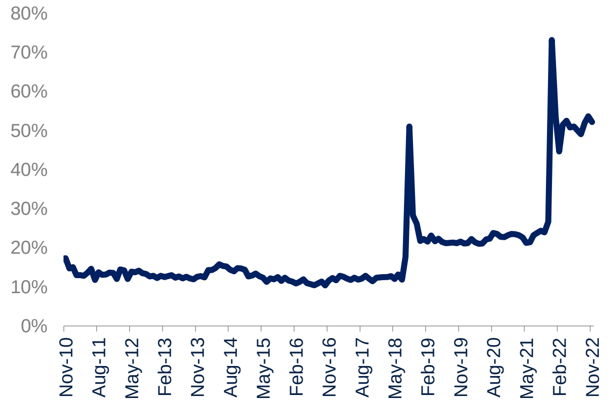
According to our calculations made after inflation observations in each month (Figure 2), the trend of permanent inflation deteriorates over time (current 25.3% vs. 17.3% in March 2022 and 14.6% in November 2020). Without having clear commitment to fight against inflation, the trend will most likely continue to worsen further. Consequently, the important question will be when the deterioration of permanent inflation might come to an end. Depending on the recent realizations, bringing inflation to below 20% will be very challenging and costly in the medium term.

Figure 3. **Private Consumption vs Trend (sa, 2019=100)**



Source: Garanti BBVA Research, Turkstat

Figure 4. **Exchange Rate Pass-thru on Core D, recursive**



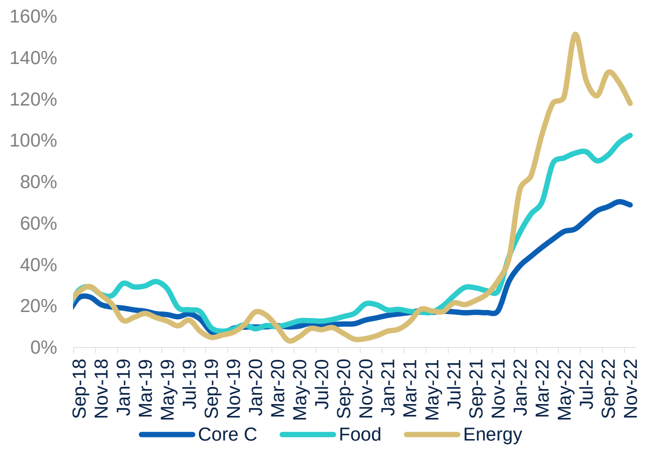
Source: Garanti BBVA Research

Inflation outlook remains clearly uncertain

The Central Bank (CBRT) reduced the policy rate by 150 bps to 9% in its November MPC meeting, in line with its previous communication, and also stressed that this will be the end of the easing cycle that started in August. They signaled to implement new measures to support the monetary transmission mechanism, which means keeping interest rates as low as possible under the current framework. The set of policies will be published before the end of the year in the 2023 Monetary and Exchange Rate document. There might be rules to reduce the pressure on TL deposit interest rates or some others to ease credit conditions and add some flexibility for TL liquidity in order to reverse the recent fast deceleration in economic activity, in our view.

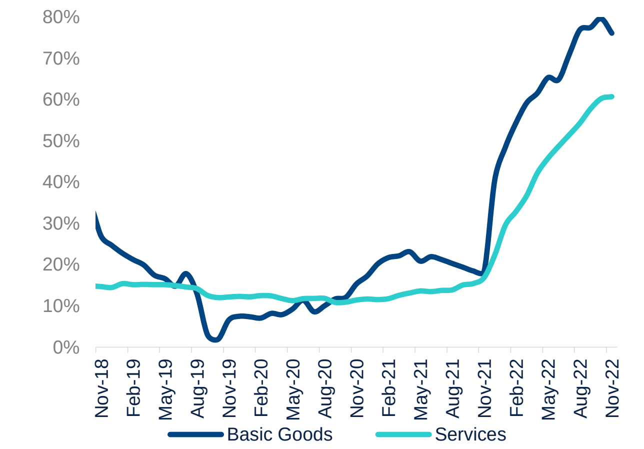
As a result, in addition to the ultra loose monetary policy, additional counter-cyclical policies, expected high minimum wage hike and other populist measures at the start of 2023 will contribute to inflationary pressures, keeping a positive output gap till the elections. Also, tighter supply conditions along with fueled domestic demand on negative real interest rate maintain upward risks through both backward and forward indexation on inflation. Hence, we expect annual inflation to come down to 67% at the end of 2022 and near 45% in early 2Q23 under the assumption of a managed currency depreciation. The inflation outlook in the 2H23 will depend on the adjustment in economic policies and therefore the exchange rate. Under the assumption of a very gradual normalization towards orthodox policies after the elections, we forecast inflation to remain above 40% throughout 2023 with a year-end level of 42%.

Figure 5. **CPI Main Subcomponents, YoY**



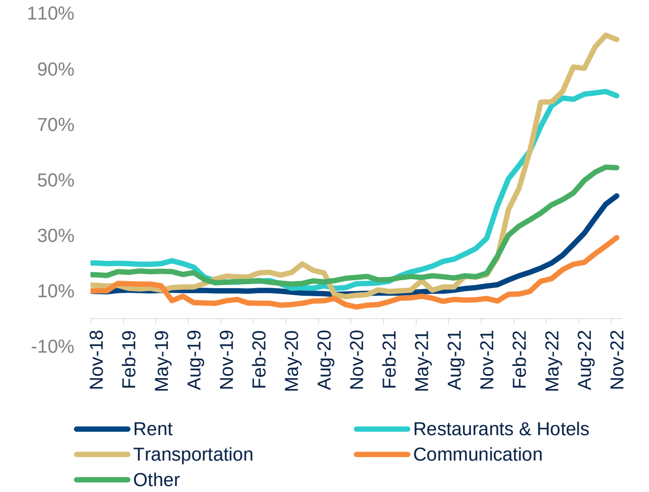
Source: Garanti BBVA Research, TURKSTAT

Figure 6. **Basic Goods and Services Inflation, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 7. **Services Inflation, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 8. **Survey Based Inflation Expectations, YoY**

Source: Garanti BBVA Research, TURKSTAT

Figure 9. **CPI Subcomponents**

	MoM	YoY
Total	**2.88%**	**84.39%**
Food & Non-alcoholic beverages	5.7%	102.5%
Beverage & Tobacco	3.2%	83.5%
Clothing & Textile	-1.4%	37.0%
Housing	1.8%	82.8%
Household Equipment	3.0%	92.8%
Health	1.0%	62.9%
Transportation	1.4%	107.0%
Communication	2.4%	35.9%
Recreation & Culture	2.1%	61.2%
Education	0.3%	37.2%
Restaurants & Hotels	3.2%	80.3%
Misc. Goods & Services	2.6%	70.7%

Source: Garanti BBVA Research, Turkstat

Figure 10. **Domestic PPI Subcomponents**

	MoM	YoY
Total	**0.74%**	**136.02%**
Mining & Quarrying	5.0%	146.4%
Manufacturing	2.0%	107.6%
Food Products	2.9%	138.6%
Textiles	0.8%	97.7%
Wearing Apparel	2.4%	78.3%
Coke & Petroleum Products	-2.0%	140.8%
Chemicals	1.5%	100.7%
Other Non-Metallic Mineral	4.0%	203.4%
Basic Metals	1.1%	64.5%
Metal Products	3.3%	98.3%
Electrical Equipment	-12.5%	61.4%
Electricity, Gas, Steam	-5.2%	443.0%

Source: Garanti BBVA Research, Turkstat

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