BBVA Research

Creating Opportunities

Inflation Pulse

Türkiye | Inflation will accelerate in near term

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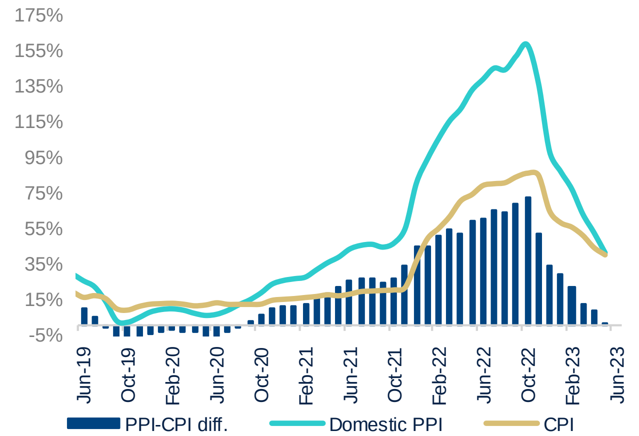
Consumer prices rose by 3.92% in June, lower than both our expectation (4.85%) and market consensus (4.3%). Annual inflation dropped to 38.2% from 39.6% in May on favorable base effects led by energy prices. Although the increase in food prices was in line with our expectation, core inflation was weaker than we expected due to slower-than-anticipated exchange rate pass thru. On the other hand, cost push factors have strengthened as domestic producer prices increased by 6.5% mom, above our call. The upside risks on inflation are strengthening in the short term, led by the recent faster than expected depreciation in the exchange rate, additional cost pressure being reinforced by above inflation wage adjustments and expected increase in corporate tax rate, demand-pull factors remaining strong on recent signals that the monetary policy will only gradually normalize, and therefore worsening second round price effects and inflation expectations. We expect annual consumer inflation to increase now onwards and finish the year at 55%. The disinflation path thereafter will depend on the magnitude and the duration of the expected tight stance of the new economy management in monetary and fiscal policies.

Increasing cost-push factor but less than expected exchange rate pass-thru in June

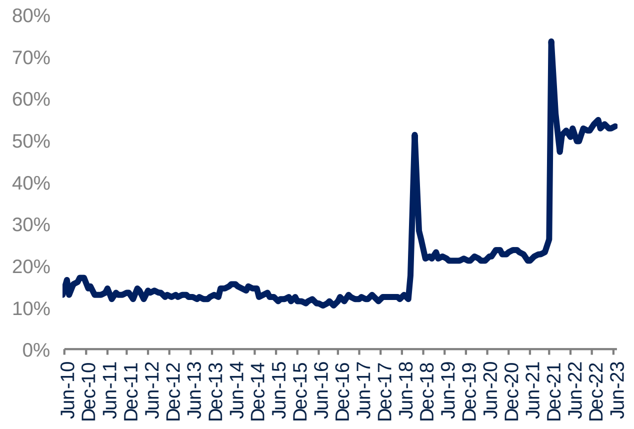
After increasing only 7.8% in the first 5 months of the year, domestic producer prices rose by 6.5% mom in June especially on the back of manufacturing prices (6.15% mom), but annual producer prices still decelerated to 40.4% on supportive base effects led by energy prices. We expect producer prices to increase near 10% mom in July, which will lead cost push factors to accelerate further and continue in the near future due to the expected increase in corporate tax rate, currency depreciation and high adjustment in wages (34% hike in minimum wage in July).

Figure 1. **CPI VS DOMESTIC PPI** (YOY)



Source: Garanti BBVA Research, TURKSTAT

Figure 2. **EXCHANGE PASS-THROUGH ON CORE D INFLATION** (RECURSIVE METHOD)



Source: Garanti BBVA Research, TURKSTAT

Despite the recent upward pressure, the increase in core prices (C index, 3.8% mom) was slightly below both market consensus and our forecast (4% m/m and 4.8% m/m, respectively) in June on the back of less-than-expected exchange rate pass-thru in some sub-items such as furniture and household equipment which are sensitive to currency movements. Basic goods prices (especially durable goods with 6.5% mom) led by the increase in auto prices (10% mom) and services inflation (3.7% mom) maintained high contributions to core inflation. The ongoing robust trend in services prices continues to signal strong inflation inertia, which was mainly driven by rent (5.8% mom) and hotel prices (9.8% mom), whereas restaurant prices (3.8% mom) remained subdued despite the high demand and second round effects. To sum up, core and services prices increased by 25.5% and 35% in the first half of the year, respectively. Strong demand, lagged impact of currency depreciation, second round effects, expected rise in indirect taxes and strengthening cost push factors on high wage adjustments and increase in corporate tax will keep upside pressure on core and services prices in the coming months.

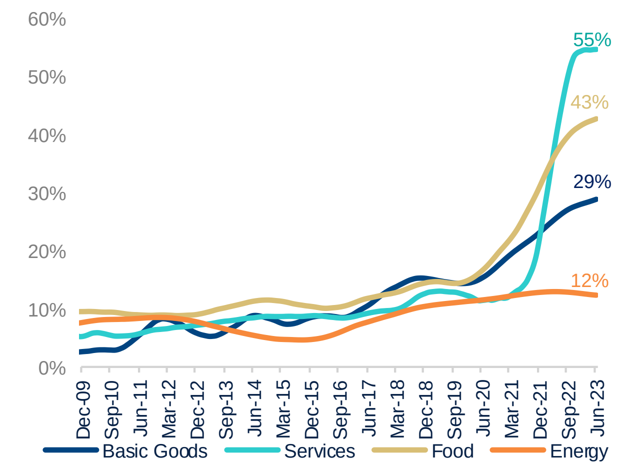
Food price inflation increased by 2.8% mom in June, mainly due to the acceleration in fresh fruit and vegetable prices (+7.7% mom), much higher than their seasonal average of -5% since 2010. Hence, annual food inflation climbed up to 54.1% from 52.1% in May. The rise in other unprocessed food prices remained high at 2.7% on the back of continuing price hikes in meat prices while processed food prices remained relatively subdued by growing 1.9% mom despite the sharp depreciation in currency in the post-election period. All in all, cumulative increase in food prices materialized as 28.7% in the first half of the year, larger than the rise in core prices.

Energy prices were the main supportive factor on inflation since their negative annual inflation deepened further with 17% in June due to almost stable currency and ease in energy prices year-to-date. Going forward, recent sharp depreciation of the currency will weigh on energy prices after their monthly rise of 4.2% in June.

Gradual normalization would not be enough to alter inflation trend in the short run

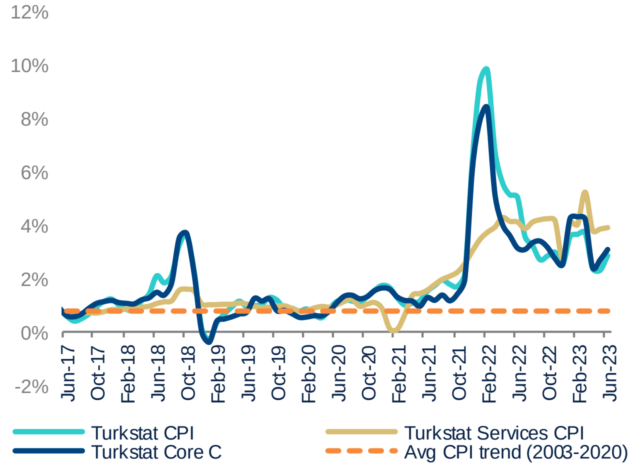
The Central Bank (CBRT) hiked the policy rate to 15% from 8.5% in June MPC meeting, lower than market expectation of 20%, signaling the normalization would be very gradual to achieve a soft landing scenario before the local elections scheduled in March 2024. Loose monetary policy accompanied with different external and internal shocks has been leading to a deterioration in inflation trend, pricing behavior and expectations. Based on our previous studies, we observe that exchange rate pass-thru to consumer prices remains above 50% (Figure 2), while backward indexation in wages results in additional inflation inertia pressuring over the services prices. According to our calculations, if seasonal and temporary factors are eliminated, annual trend inflation in services and food prices remains strong except for the energy prices on top of the ease in commodity prices (Figure 3). If we check seasonal adjusted 3 month moving average monthly inflation trend (Figure 4), CPI and Core-C trends have already been increasing since April and have reached near 3% (40-45% if annualized), while services prices trend remains near 4% (58% if annualized). Considering the historical average of monthly CPI trend inflation of 0.7%, the recent data confirms a substantial deterioration in pricing behavior. Hence, considering the commitment of the CBRT to ensure a decline in trend of inflation, we think that it will be challenging to decrease inflation trend from 3% to low levels in medium run considering very gradual normalization steps in monetary policy.

Figure 3. **TREND INFLATION IN SUB-COMPONENTS (YOY)**



Source: Garanti BBVA Research UCSV-MA Model, TURKSTAT

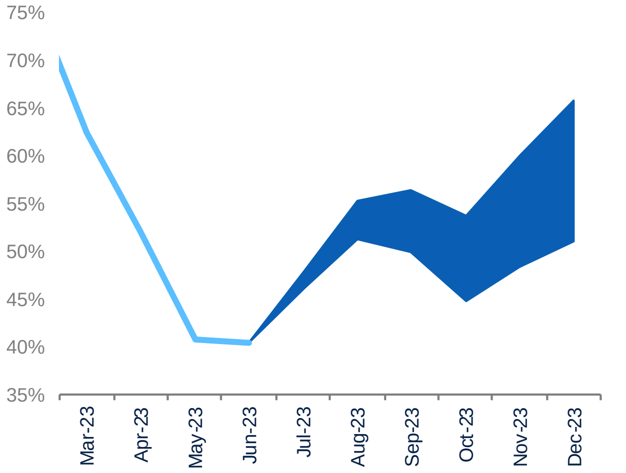
Figure 4. **INFLATION TREND (seasonal adj., 3 month moving average, MoM)**



Source: Garanti BBVA Research, TURKSTAT

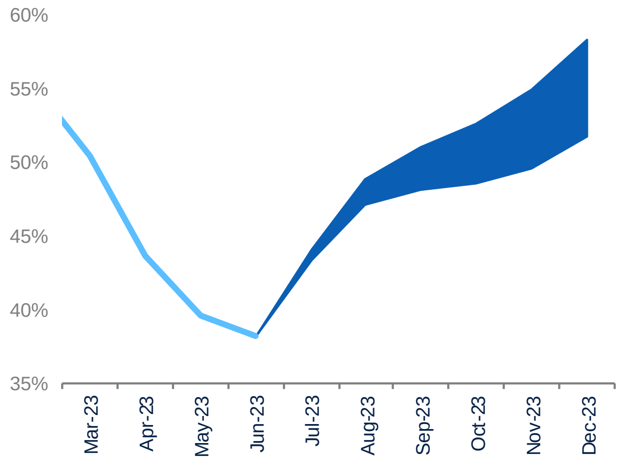
Based on gradual normalization and some stabilization in exchange rate assumptions in the second half of the year, domestic producer prices could reach 60-65% at the end of the year (Figure 5). Since the government seems to target a soft landing scenario, domestic demand might remain high at least till the local elections. Therefore, led by above potential domestic demand, strong inertia, robust inflation trend and acceleration in cost push factors, we expect consumer inflation to rise around 55% at the end of the year (Figure 6).

Figure 5. **GARANTI BBVA DOMESTIC PPI FORECASTS (YOY, 50% Confidence Band)**



Source: Garanti BBVA Research, TURKSTAT

Figure 6. **GARANTI BBVA CPI FORECASTS (YOY, 50% Confidence Band)**



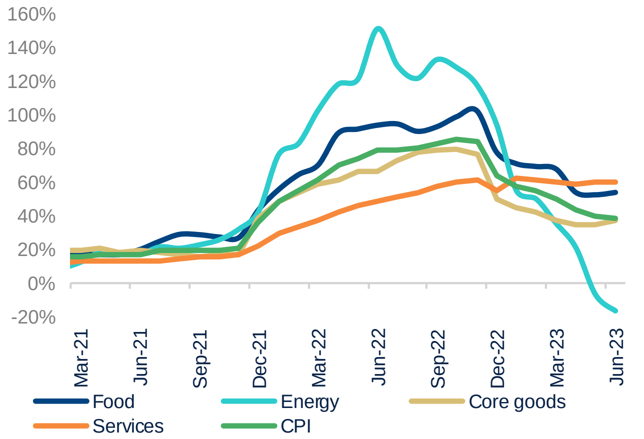
Source: Garanti BBVA Research, TURKSTAT

Stance of the economic policies will be decisive on inflation outlook

Inflation report of the CBRT scheduled to be released on July 27 will provide a clearer picture on interim inflation targets of the CBRT. We expect 2023 inflation target to be raised substantially while the next year target should also be rational (based on gradual normalization pattern) in order to restore confidence. Additionally, Medium Term Program (MTP) would be an important factor to check objectives such as growth and budget deficit targets and the stance of fiscal policy against inflation. All in all, reducing inflation below 20% in the medium run will require structural reforms in a well-coordinated monetary and fiscal policy framework.

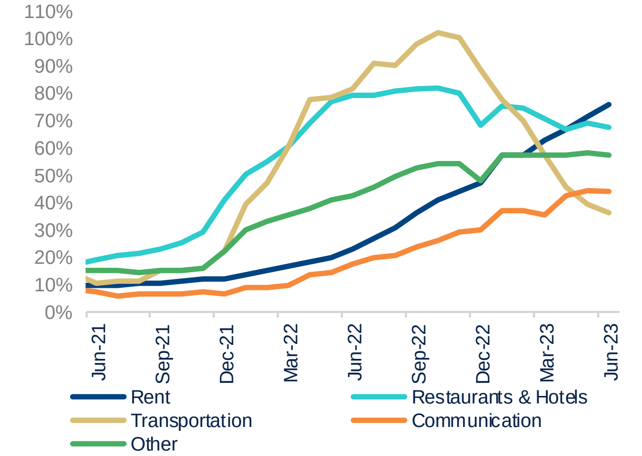
We expect rate hikes to continue with gradual steps in the remaining of the year. We underline the political objective to keep positive growth outlook at least till the local elections, which will still sacrifice inflation in favor of growth. Accordingly, the pressure over the currency can continue and we expect year end inflation to be 55% and decline to around 30% at most next year. The overall stance of the economic policies against inflation and the pace of the adjustment in activity will be decisive about the inflation outlook.

Figure 7. **CPI MAIN SUBCOMPONENTS (YOY)**



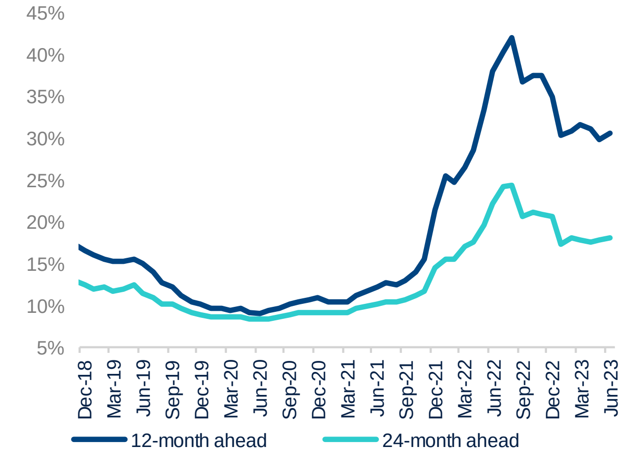
Source: Garanti BBVA Research, TURKSTAT

Figure 8. **SERVICES INFLATION SUBCOMPONENTS (YOY)**



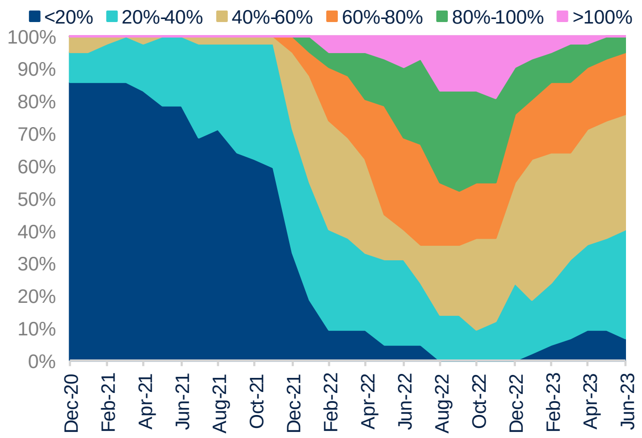
Source: TURKSTAT

Figure 9. **CBRT SURVEY INFLATION EXPECTATIONS (YOY)**



Source: Garanti BBVA Research, TURKSTAT

Figure 10. **CPI DIFFUSION ANALYSIS (YOY)**



Source: Garanti BBVA Research, TURKSTAT

Figure 11. **CPI SUBCOMPONENTS**

	MoM	YoY
Total	**3.92%**	**38.21%**
Food & Non-alcoholic beverages	3.0%	53.9%
Beverage & Tobacco	11.1%	40.9%
Clothing & Textile	1.5%	21.0%
Housing	3.0%	14.8%
Household Equipment	2.6%	43.2%
Health	1.2%	65.7%
Transportation	8.0%	20.7%
Communication	3.9%	37.0%
Recreation & Culture	2.1%	43.0%
Education	2.3%	50.7%
Restaurants & Hotels	4.3%	67.2%
Misc. Goods & Services	2.6%	43.5%

Source: Garanti BBVA Research, Turkstat

Figure 12. **DOMESTIC PPI SUBCOMPONENTS**

	MoM	YoY
Total	**6.50%**	**40.42%**
Mining & Quarrying	4.8%	53.6%
Manufacturing	6.1%	42.1%
Food Products	2.5%	59.7%
Textiles	8.5%	34.1%
Wearing Apparel	7.0%	53.6%
Coke & Petroleum Products	18.2%	-20.0%
Chemicals	6.5%	31.0%
Other Non-Metallic Mineral	1.5%	59.3%
Basic Metals	1.1%	16.6%
Metal Products	10.4%	51.4%
Electrical Equipment	6.5%	54.5%
Electricity, Gas, Steam	12.5%	3.3%

Source: Garanti BBVA Research, Turkstat

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