Creating Opportunities

Inflation Pulse

Türkiye | Strengthening upward pressure on inflation

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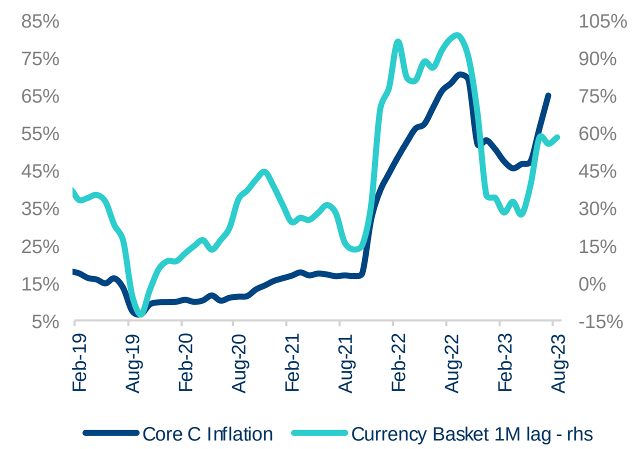
Consumer prices rose by 9.09% m/m in August, higher than both our expectation (7.0%) and market consensus (7.2%), resulting in an annual inflation of 58.9% up from 47.8% in July. The lagged impact of currency depreciation with stronger exchange rate pass thru and higher than expected second round price effects especially on services prices led annual core inflation to upsurge to 65% from 56% the month before. Food prices continued to worsen on the back of the recent increase in fuel prices, supply distortions and delayed price adjustments. Accelerating inflation trend, deteriorating inflation expectations, strengthening cost push factors and still robust domestic demand keep upside risks on the inflation outlook. Despite the Central Bank's latest positively surprising rate hike, the policy rate remaining well below inflation rate may not be able to compensate for the strengthening upward pressure on inflation. Considering higher-than-expected August realization and its potential dynamic effects, consumer inflation will likely get closer to 70% at the end of this year. The gradual normalization in economic policies in line with the soft landing target of the Government increases the likelihood of annual inflation staying above 40% by end 2024.

Upside surprise on core prices along with worsening food inflation

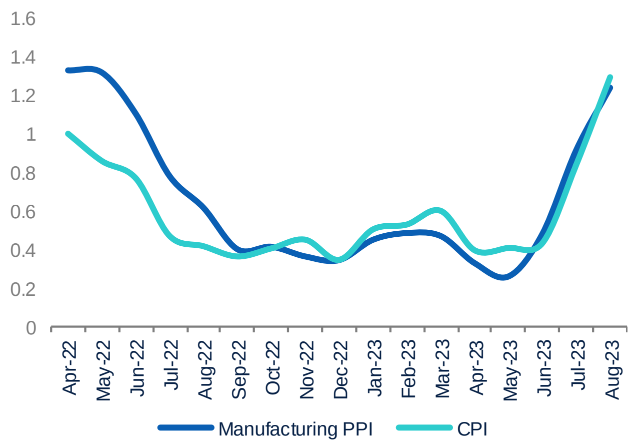
Core prices (C index) surprised to the upside, rising by 8.9% m/m in August (vs. 5.6% ours and 6.8% consensus). Broad-based price pressure both in basic goods and services prices induced the acceleration of annual core prices inflation to 65% (vs. 56% in July), the highest rate since November 2022. Continuing high and fast exchange rate pass-thru pushed goods prices upward, particularly for the increase in durable goods prices (such as furniture and household equipment), while the monthly upsurge in clothing and footwear prices occurred contrarily to its seasonal average (+8.3% m/m vs. -1.3% of its average in the last 5 years), altogether causing basic good prices to maintain its strong upward trend (8.6% m/m vs. 9.4% m/m in July). According to our calculations with a recursive approach, exchange rate pass-thru has gained pace significantly since June and reached almost 60% on core prices. Lack of an anchor for inflation expectations remains an important risk on potential distortions in price formations.

Figure 1. **CORE INFLATION & CURRENCY BASKET (YoY, %)**



Source: Garanti BBVA Research, TURKSTAT

Figure 2. **CPI vs Manufacturing PPI (Seasonal adj., 3 month moving average, annualized)***



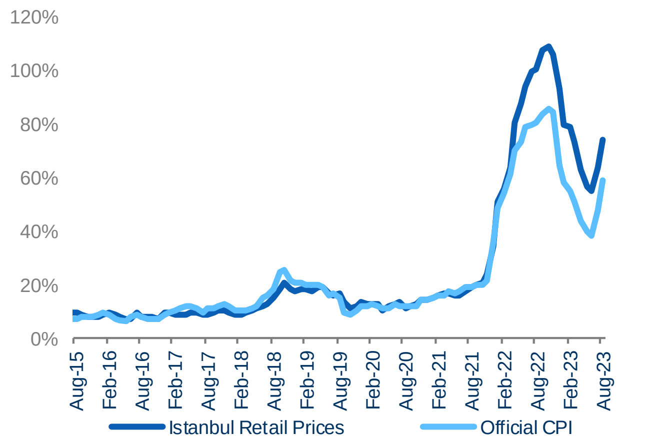
Source: Garanti BBVA Research, TURKSTAT, * excluding zero price impact from natural gas

Besides, services prices kept signaling strong inflation inertia, led by strong wage hikes in recent months and second round effects, up by 9.2% m/m, resulting in an annual inflation climbing up to 79.6% from 69.7% the month before. The sharp increase in transportation services was quite evident (27.6% m/m) due to the 50-60% price hikes in public transportation as of August and the delayed effects of fuel price hikes led by the increase in the special consumption tax in the second half of July. Moreover, increases in rental prices (7.9% m/m vs. 7.7% m/m prev.) and restaurant and hotel prices (7.1% m/m vs. 11.9% m/m prev.) remained strong, which indicated the continuation of high demand and secondary effects. On the other hand, domestic producer prices inflation eased in August from 8.2% to 5.9% m/m, but its quarterly trend already picked-up by 12.4% compared to 2Q23 and underlined strengthening cost factors.

The other main driver on the upsurge of inflation was food prices rising by 8.4% m/m in August, which led annual food inflation to climb up significantly to 73.6% from 61% the month before mainly due to rising cost-push factors. Monthly increase in processed food prices stood at 11.2%, reaching the highest level since December 2021, mainly led by the recent administrative price hikes in bread (18% m/m) coupled with 12%-16% monthly increase in dairy products stemming from a 35% hike in raw milk prices. Also, unprocessed food prices rose by 5.6% m/m, mainly due to continuing strong price pressures in fresh fruit and vegetables (9.3% m/m) compared to the relatively limited increase in other unprocessed food prices (3.4% m/m) so far. Despite favorable seasonal factors, recent fuel price hikes, lagged effects of currency depreciation and supply-side effects led to ongoing worsening in food prices. The impact of tax hikes, recent increase in global oil prices together with a weaker Turkish lira was also visible in energy prices, which rose by 14.2% m/m (vs. 12.7% prev.) and reassured cost factors going forward on prices.

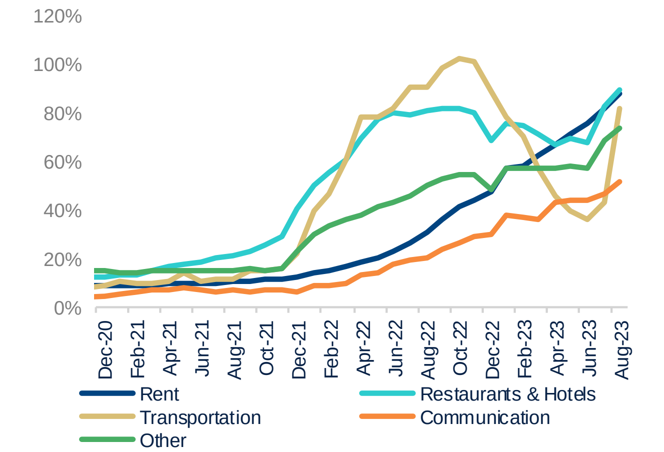
One important aspect of August consumer inflation is that official figures were again announced closer to Istanbul retail prices inflation released by the Istanbul Chamber of Commerce. Possible adjustments over price collection or index calculation might have contributed to closure of the gap between the two series which had been historically correlated prior to early 2022. Eliminating such discrepancies will be key to apply the right monetary policy reaction function so that the expected adjustment in real rates will be restrictive enough to achieve the desired rebalancing in economic activity. Moreover, it will help credibility, accountability and transparency so that inflation expectations can be more accurately managed and the significant deterioration in price setting behavior can be more rapidly reversed.

Figure 3. **OFFICIAL CPI VS ICC ISTANBUL RETAIL PRICES** (YoY)



Source: Garanti BBVA Research, TURKSTAT

Figure 4. **SERVICES INFLATION SUBCOMPONENTS** (YoY)

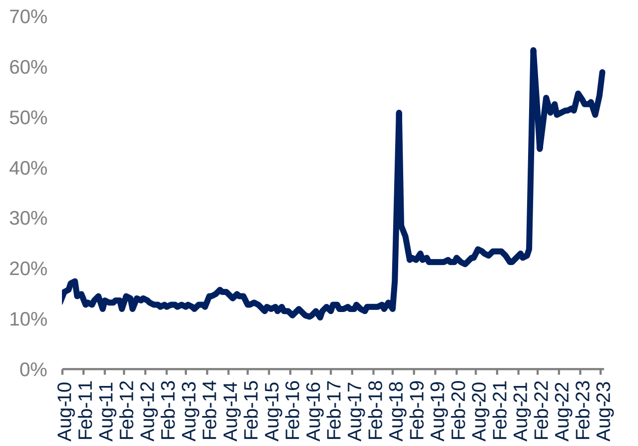


Source: TURKSTAT

Inflationary pressures prove harder to restrain with gradual policies

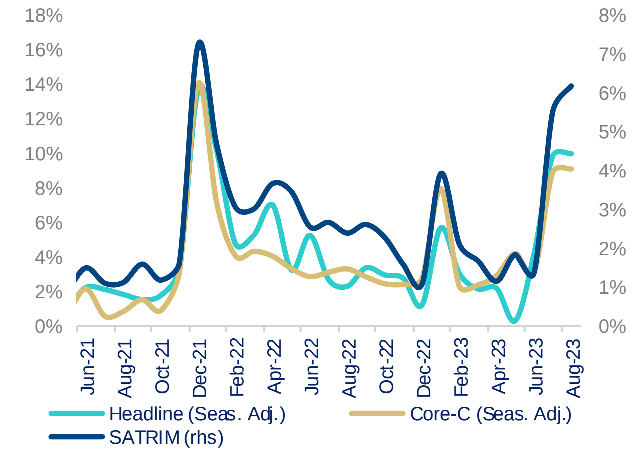
Although the CBRT's latest positive surprise with 750bps rate hike is considered as a signal of the continuation of a tighter stance in monetary policy, the real interest rates are still in the negative territory continuing to fuel domestic demand. The economy management prefers a transition from consumer to commercial lending with a policy mix of selective credits and targets on the banking sector to achieve a rebalancing in activity. However, growth performance above the potential driven by still strong private consumption show that it would be hard to achieve the intended results in the short term with a policy rate far below inflation. Given the lack of an anchor in pricing behavior as well as the dollarization motivation of residents, inflationary pressures prove harder to eliminate in the upcoming months. Trend inflation according to seasonally adjusted trimming method edged upwards, showing steeper deterioration in comparison to monthly trend levels of core and headline inflation levels in August.

Figure 5. **EXCHANGE PASS-THROUGH ON CORE D** (Recursive Method)



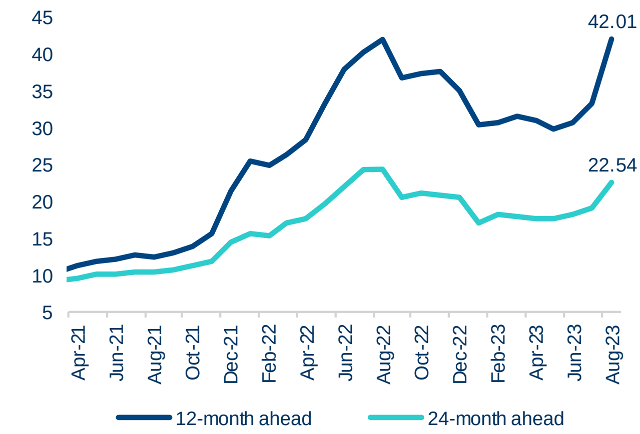
Source: Garanti BBVA Research, TURKSTAT

Figure 6. **INFLATION INDICATORS** (Monthly Changes)



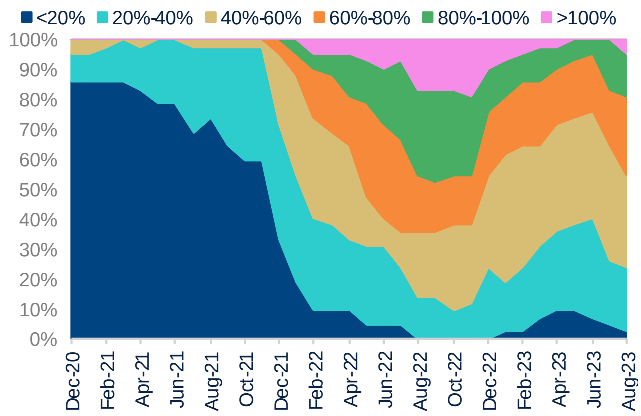
Source: Garanti BBVA Research, TURKSTAT

Figure 7. **CBRT SURVEY INFLATION EXPECTATIONS** (YOY)



Source: Garanti BBVA Research, TURKSTAT

Figure 8. **CPI DIFFUSION ANALYSIS** (YOY)



Source: Garanti BBVA Research, TURKSTAT

Further pressure from cost channel might be on the way

From the political point of view, the impact of wage adjustments in July on consumer sentiment may be short-lived as the consumer confidence hit the lowest level since June 2022, on the back of worsening expectations of the economic situation over the next 12 months. The government may prefer to focus on restoring confidence towards the end of 2023 by another wage adjustment and possible expansionary fiscal policies, prior to the local elections which will be held in March 2024. Political objective to keep a satisfying domestic demand level might limit the expected rebalancing in activity, which will weigh on current account deficit, exchange rate and so inflation. Therefore, risks on the inflation outlook remain alive in the presence of continuing second round effects and inertia especially in services prices. We acknowledge the upward risk on our current inflation forecasts, which will likely get closer to 70% at the end of this year, and then be followed by 70-75% in the first half of next year. We expect consumer inflation to come down to 40-45% at best by end next year.

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