Creating Opportunities

Inflation Pulse

Türkiye | Renewed inflationary pressure

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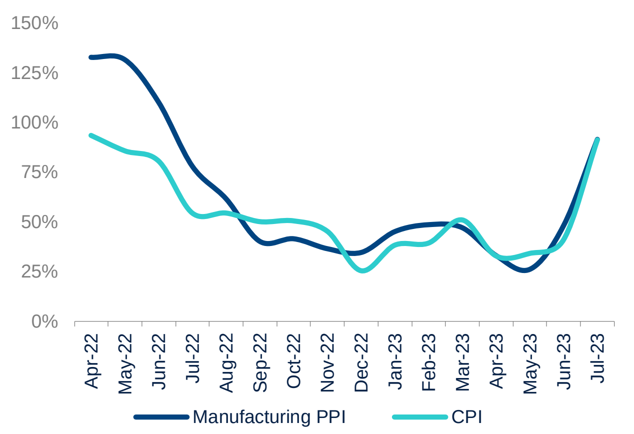
Consumer prices rose by 9.49% in July, slightly higher than our expectation (9%) and market consensus (8.6%). Annual consumer inflation accelerated significantly to 47.8% from 38.2% the month before, led by the exchange rate pass-thru triggered by the fast depreciation of the currency since late May and strong price adjustments on top of the recent tax hikes and wage increases. In this context, cost push factors continued to gain momentum as the monthly increase in domestic producer prices stood at 8.2%, resulting in annual PPI inflation of 44.5%. As domestic demand, particularly consumption, stays robust, renewed worsening in price setting behavior will reinforce second round price effects and therefore inertia, which will likely keep inflation expectations deteriorating and upward risks on inflation outlook in the near term. Selective credit and quantitative tightening policies might not substitute the needed restrictive stance to anchor inflation expectations, which the CBRT aims to achieve with only gradual rate hikes. We expect annual consumer inflation to accelerate to near 65% at the end of this year and only decline to 35-40% by end next year if Turkish lira can stabilize with rebalancing economic activity in favor of exports.

Sharp deterioration in inflation trend led by currency depreciation and tax hikes

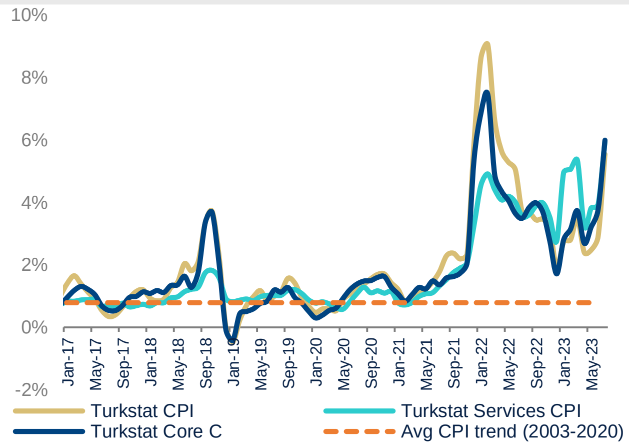
Turkish lira has depreciated by almost 40% since late May and surged from 19 to 27 against the US dollar. In addition to the delayed upward adjustment in prices after the elections, the government rose the special consumption tax on fuel prices, VAT on consumer goods (except for basic food), corporate tax and some other tax rates in order to reduce pressure on the budget deficit. According to our calculations, the direct and indirect effects of taxes will have an impact close to 5 percentage points on consumer inflation until the end of 2023. Sharp depreciation in currency and high adjustment in wages led cost push factors to accelerate further as the trend of manufacturing industry producer price inflation (annualized level of 3-month moving average of its monthly change) started to move upward after its downward trend since last year (Figure 1). Fueled by second round effects and deterioration in pricing behavior in a period of strong domestic demand caused further pressure on inflation and its sub-items' trends (Figure 2).

Figure 1. **CPI vs Manufacturing PPI**
(Seasonal adj., 3 month moving average, annualized)*



Source: Garanti BBVA Research, TURKSTAT

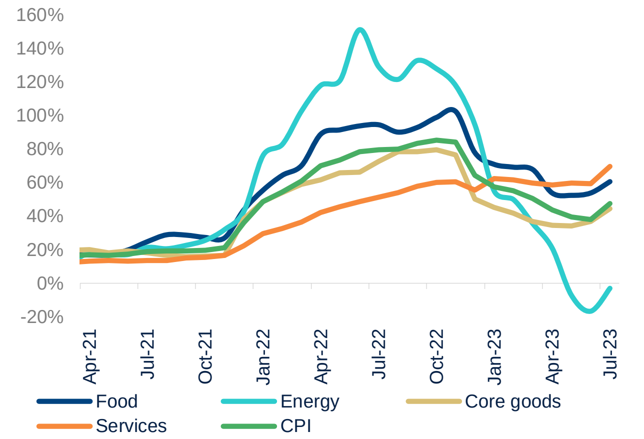
Figure 2. **INFLATION TREND**
(Seasonal adj., 3 month moving average, MoM)*



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

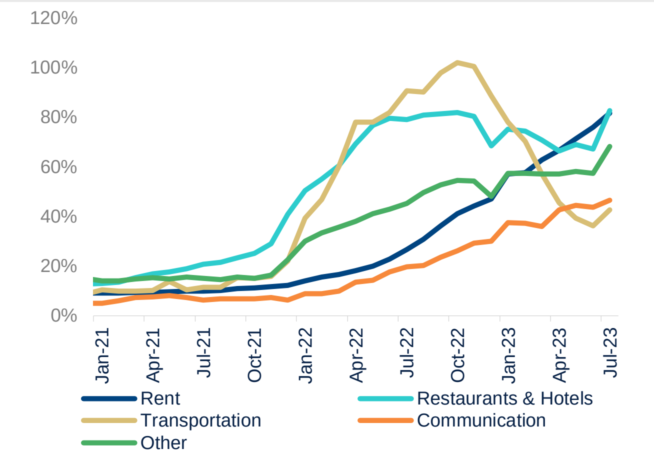
Core prices (C index) posted a 9.6% monthly increase in July on the back of basic goods and services, which led annual core prices inflation to gear up to its highest rate with 56.1% in the last 8 months. Basic goods prices climbed up by 9.4% m/m due to the significant contributions from durable goods (12.5% m/m vs auto prices 16% m/m) and other basic goods prices (8.7% m/m). Monthly core inflation could remain high at around 6-7% in August since price increases in some products were made in the second half of July, which will have delayed effects with varying time differences among regions where administrative prices such as transportation services, bread etc. are adjusted. The deterioration in services prices were broad-based as the acceleration in services prices became clearer (9.8% m/m), following an average monthly increase of 5.8% since the beginning of the year and signaled strengthening inflation inertia. Therefore, annual services inflation recorded a historical peak of 69.7%.

Figure 3. **CPI MAIN SUBCOMPONENTS** (YOY)



Source: Garanti BBVA Research, TURKSTAT

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



Source: TURKSTAT

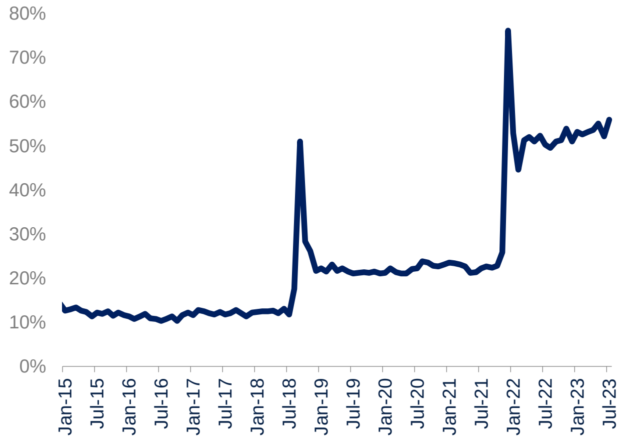
The recent special consumption and value added tax hikes in fuel prices and the currency depreciation led energy prices to increase significantly by 12.7% m/m, while annual energy inflation continued to contract by 2.9% on annual basis with the support of favorable base effects. The increase in fuel prices accompanied with a dry season, high wages and most importantly rise in agricultural input prices such as seed and fertilizer etc. due to the sharp currency depreciation would put upside pressures on food prices especially on unprocessed food in the coming period. The monthly increase in food prices hit 7.6% in July (vs. 1% of its seasonal average in the last 6 years) mainly due to the significant acceleration in fresh fruit and vegetable prices (17.6% m/m). Moreover, seasonal disruptions also create supply-side problems, putting upward pressure on unprocessed food prices, especially considering the damage caused by hail and flood in June, as expressed in the Central Bank (CBRT)'s Inflation Report-III. While the monthly acceleration in other unprocessed food remained relatively modest at 5.2% m/m (compared to other sub-components in food prices), processed food inflation accelerated significantly with 6.1% m/m. Hence, mainly the rise in cost-push factors led annual food inflation to climb up to 61% from 54% the month before.

Realistic inflation forecasts from the CBRT but risks are on the upside

In the third inflation report of the year, the CBRT revised its inflation forecasts significantly to the upside, by 35.7pp to 58% for 2023 and by 24.2pp to 33% for 2024 and brought its year-end annual inflation forecasts close to the market consensus. Inflation forecast for 2025 is also revised upward to 15%, indicating that the CBRT does not expect to achieve its 5% inflation target within the next 3 years. The CBRT also acknowledged the inflationary effects of robust aggregate demand in the recent years, upsurge in exchange rate pass-through, cost push factors stemming from high wage increases and inertia in services prices.

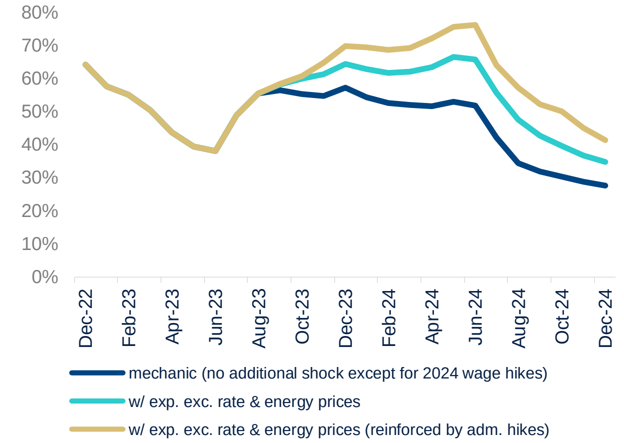
Our analysis on historical decomposition of core inflation show that most of the deviation from its steady state level is explained by the loose monetary policy and therefore higher aggregate demand than supply. Since the CBRT is likely to follow a very gradual normalization path, positive output gap will also be closed only gradually. Therefore, the deterioration in inflation trend might continue. In addition, their calculation on the exchange rate pass-through as near 25% since 2018 is well below our in-house monthly inflation model result of 56% (Figure-6) and might generate upward risk on the CBRT's inflation forecasts.

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



Source: Garanti BBVA Research, TURKSTAT

Figure 6. **GARANTI BBVA CPI SIMULATIONS** (%, YoY)



Source: Garanti BBVA Research, TURKSTAT

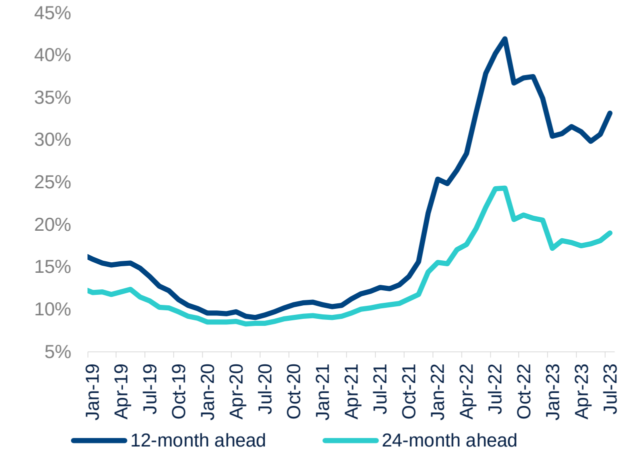
Our inflation simulations under varying assumptions (Figure 6) show that CBRT's projections might still be optimistic. Our mechanical exercise under the assumption of stable exchange rate and energy prices until the end of 2024 yield annual inflation of 57% by 2023 end, which decelerates to 28% by 2024 end at best with backward-indexed wage adjustments at the start of the year. Other simulations with exchange rate gradually depreciating in nominal terms but appreciating in real terms yield 65-70% year-end inflation for 2023 depending on whether energy price hikes are introduced (in order to reduce energy subsidies). Consumer inflation might decline to 35-40% by end 2024 under the assumption of a gradual tightening in economic policies.

Renewed pressure on inflation outlook will keep CPI at 60-70% in 1H24

Recent currency depreciation, tax rate hikes mostly through indirect taxes and above inflation wage adjustments in a period of prevailing strong consumption have reinforced inflationary pressures. Authorities communicate that the transition to orthodox monetary policy will happen only gradually, where real interest rates continue to be suppressed in order to reduce the negative impact on growth. We underline the need of a much tighter stance to guarantee a disinflation pattern. Macro prudential policies may help to squeeze consumption in the short term, but they could not be substitute of stronger policy rate hikes. Therefore, if the policy rate will remain far below the inflation in the coming period, anchoring inflation expectations will be challenging.

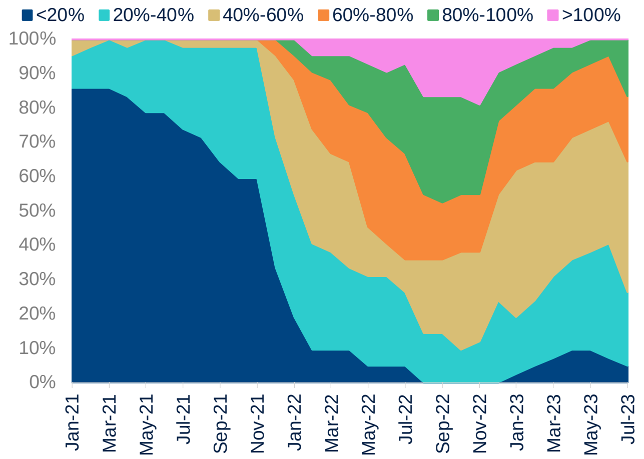
We expect 2023 year-end inflation to be near 65% and decelerate to 35-40% by end 2024, assuming that positive output gap will be closed with a rebalancing in economic activity, which will help stabilize the currency and maintain a disinflation course. Otherwise, reliance on demand restrictive macro-prudential measures will be required to be reinforced and we will continue with upward risks on inflation without a clear anchor on inflation expectations.

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



Source: Garanti BBVA Research, TURKSTAT

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



Source: Garanti BBVA Research, TURKSTAT

Figure 9. **CPI SUBCOMPONENTS**

	MoM	YoY
Total	**9.49%**	**47.83%**
Food & Non-alcoholic beverages	7.7%	60.7%
Beverage & Tobacco	11.2%	46.6%
Clothing & Textile	3.2%	22.7%
Housing	6.0%	19.3%
Household Equipment	8.9%	50.1%
Health	13.6%	76.0%
Transportation	17.8%	43.4%
Communication	6.2%	43.0%
Recreation & Culture	6.1%	45.3%
Education	2.7%	53.6%
Restaurants & Hotels	11.9%	82.6%
Misc. Goods & Services	8.7%	52.8%

Source: Garanti BBVA Research, Turkstat

Figure 10. **DOMESTIC PPI SUBCOMPONENTS**

	MoM	YoY
Total	**8.23%**	**44.50%**
Mining & Quarrying	9.1%	57.5%
Manufacturing	9.3%	50.8%
Food Products	4.6%	59.7%
Textiles	11.2%	46.1%
Wearing Apparel	6.4%	58.5%
Coke & Petroleum Products	20.2%	5.7%
Chemicals	10.4%	40.6%
Other Non-Metallic Mineral	6.0%	58.6%
Basic Metals	1.1%	30.8%
Metal Products	11.4%	62.2%
Electrical Equipment	12.3%	67.9%
Electricity, Gas, Steam	-5.1%	-17.6%

Source: Garanti BBVA Research, Turkstat

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