Turkey: CPI surprised on the downside but maintained an increasing trend

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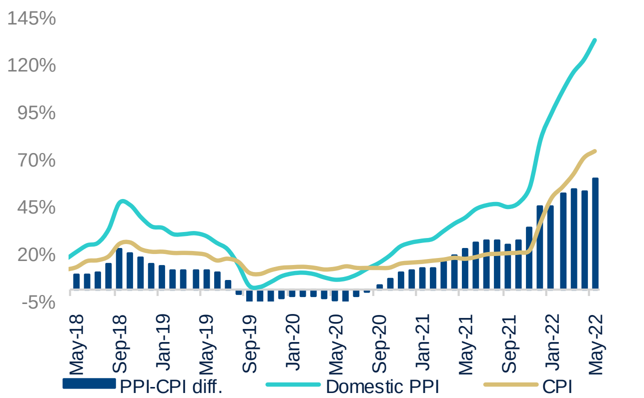
Consumer prices increased by 2.98% in May, much lower than market consensus (4%) and our expectation (4.5%), which resulted in an annual figure of 73.5%. The downside surprise was widespread in both food and core prices, conflicting with the strengthening cost push factors as seen in domestic producer prices rising 8.8% mom and 132% yoy. Looking ahead, we expect consumer inflation to accelerate above 80% in the coming months led by ongoing strong consumption -fueled by loose economic policies-, significantly deteriorating inflation expectations and recent hikes in energy prices. By year-end, we expect inflation to slow down to near 60% given positive base effects in the last two months of the year. However, this outlook assumes that the exchange rate will remain relatively stable. Furthermore, potentially longer than expected upsurge in global commodity prices and additional price hikes in administrative prices would worsen this outlook, implying that inflation would climb even higher.

Lower realization on seasonal food prices and limited increase in core prices

Food prices increased by 1.36% mom in May, leading to an annual figure of 93.1% up from 90.8% in April. Despite the increase in processed food (5.4%) and other unprocessed food prices (4.4%) led by recent price hikes in dairy products, seasonally sharp decline in fresh fruit and vegetable prices (-11%) prevented further deterioration in food prices. Meanwhile, energy prices rose by 2.9% mom with an annual figure surging to 121%. As of June 1st, the government increased electricity prices by 15% for households and 25% for businesses, while natural gas prices were raised by 30% for houses, 16% for companies generating electricity and 10% for other businesses. The overall impact on CPI will reach 2pp including indirect effects from PPI, which we already discounted in our revised forecast (60% year-end). However, since the timing is occurring before what we predicted, second round effects might still be more inflationary. These price hikes along with ongoing upward price adjustments in fuel prices, due to higher global energy prices and exchange rate depreciation, will keep upside pressure on energy inflation.

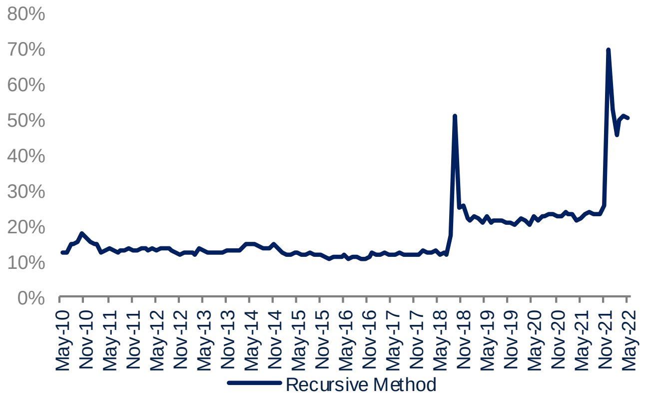
On the other hand, despite stronger cost push factors, recent currency depreciation and still robust demand, core prices increased less than expected (3.4% mom vs 4.8% expected). Nonetheless, annual core inflation edged up to 56% from 52.4% in April. Basic good prices rose by 3.2% mom, mainly on clothing (4.6% mom), furniture (2.9% mom) and auto prices (2.4% mom); while services prices were up by 3.7% on restaurants (5.5%) and transportation (5.1%). Hence, annual services price inflation reached 45.8%, signaling further strengthening inertia. Last but not least, cost push factors were reinforced as domestic producer prices rose by 8.8% mom and 132% yoy. All in all, worsening inflation expectations, high global inflation and commodity prices, loose domestic policies, exchange rate depreciation and second round effects keep upside risks on the inflation outlook. According to our latest estimates, if cyclical, seasonal and other idiosyncratic factors are excluded, trend CPI deteriorated further to 17.8%, up from 14.5% at the end of 2020 and 9% at the end of 2016.

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



Source: Garanti BBVA Research, Turkstat

Figure 2. **Exchange Rate Pass-thru on Core D, %**

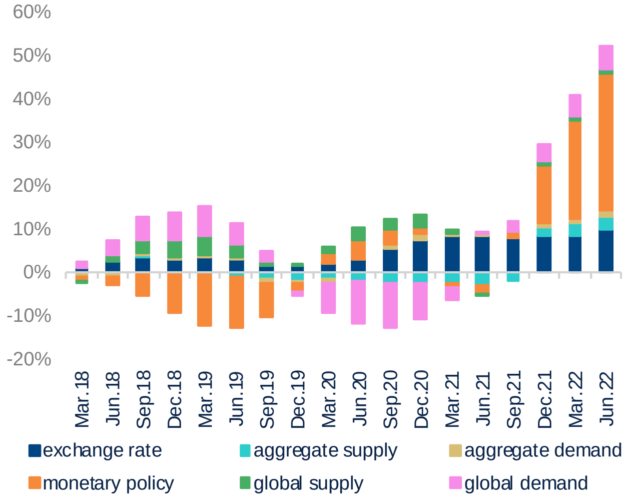


Source: Garanti BBVA Research, Turkstat

Major impact from domestic factors rather than external factors

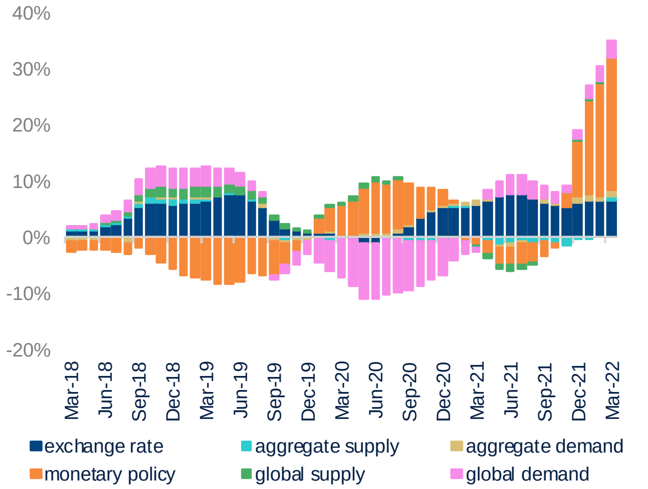
In order to better understand the drivers of core-D inflation (excluding unprocessed food, alcohol & tobacco and gold), we conducted an econometric analysis, which shows that the main contributors to the recent rapid acceleration in consumer inflation are the depreciation of the exchange rate, monetary policy and the global demand shocks (Figure 5 and 6). Based on our expectation for June, these factors had around 38pp and 46pp contribution out of 53% and 68% year-on-year average core inflation in 1Q22 and 2Q22, respectively. In contrast, domestic supply and global supply shocks also had an impact but the magnitude proved to be much lower. [1]

Figure 5. **Structural BVAR Shock Decomposition on Core D, quarterly annual**



Source: Garanti BBVA Research, Turkstat, BVAR

Figure 6. **Structural BVAR Shock Decomposition on Core D, monthly annual**



Source: Garanti BBVA Research, Turkstat, BVAR

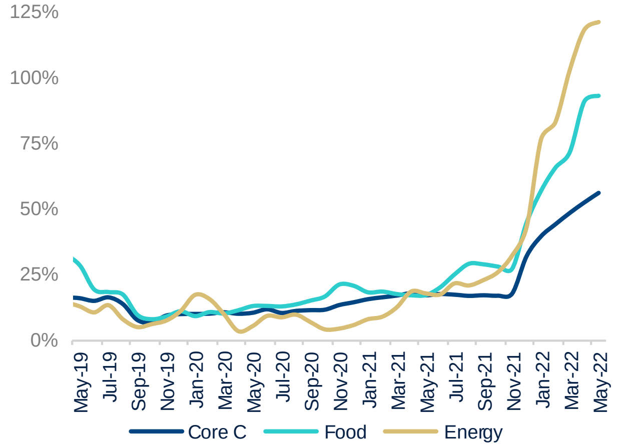
Inflation outlook worsening further due to both domestic and global factors

On May 26, Turkstat announced that to remain in line with Eurostat principles on data distribution and transparency details, some data tables will be removed while others will be added. As a result, prices data, which had been published for almost 20 years, were no longer released and only price indexes remain available. Although adhering to best principles is always welcomed, eliminating price data tables makes it harder to have a clear understanding of the diffusion of prices and reduces transparency. This could be more relevant when inflation expectations are significantly worsening, as it could trigger data credibility issues, which might reinforce a negative loop and increase the uncertainty going forward.

Looking ahead, domestic consumption stays strong, and credit impulses and other loose economic policies maintain the brought forward demand in a high inflation environment. Besides, longer than expected war conditions and post-pandemic supply side problems keep global commodity prices high. As a result, much stronger cost push factors lead companies to easily pass to consumer prices as long as demand continues. Also, reinforced external financing needs mainly due to stronger commodity prices led by the war in Ukraine and high dollarization in the economy keep the pressure on the exchange rate, which might well fuel the negative loop by means of both expectations and production costs. Last not but least, wage adjustments remain crucial so it is obvious that inflationary pressures will likely strengthen more until a clear policy reaction will be taken. Therefore, even though we already made an upward revision to our CPI forecast to a level near 60% for the end of the year, risks remain clearly on the upside and we cannot rule out additional revisions.

[1] We use a structural Bayesian VAR on both short and long run zero and sign restrictions to identify the impact of different shocks on Core-D inflation, following the studies made by Comunale and Kunovac (2017), and Chen and Górnicka (2020). We made different robustness checks such as using Mean BVAR to include possible changes in trends, using monthly data to increase the sample size, utilizing different macro variables like import prices and energy prices, and trying different sign restrictions.

Figure 7. **CPI Components, YoY**

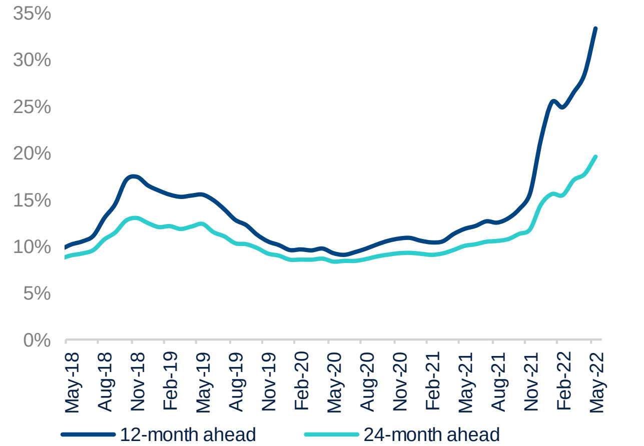


Source: Garanti BBVA Research, TURKSTAT

Figure 8. **Basic Goods and Services Inflation, YoY**

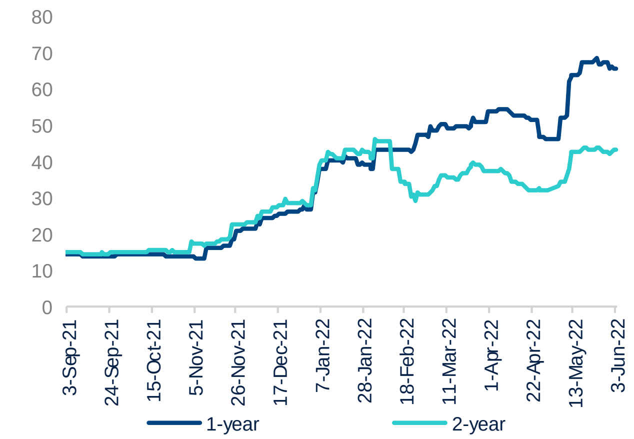
Source: Garanti BBVA Research, TURKSTAT

Figure 9. **Survey Based Inflation Expectations, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 10. **Market Implied Inflation Expectations, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 11. **CPI in Subcomponents**

	MoM	YoY
Total	**2.98%**	**73.50%**
Food & Non-alcoholic beverages	1.6%	91.6%
Beverage & Tobacco	6.5%	66.6%
Clothing & Textile	4.6%	29.8%
Housing	2.2%	63.5%
Household Equipment	3.3%	82.1%
Health	1.6%	37.7%
Transportation	3.4%	107.6%
Communication	1.5%	19.8%
Recreation & Culture	6.1%	54.1%
Education	0.4%	27.5%
Restaurants & Hotels	5.5%	76.8%
Misc. Goods & Services	3.1%	61.0%

Source: Garanti BBVA Research, Turkstat

Figure 12. **Domestic PPI in Subcomponents**

	MoM	YoY
Total	**8.76%**	**132.16%**
Mining & Quarrying	6.2%	133.5%
Manufacturing	5.5%	115.2%
Food Products	8.0%	127.9%
Textiles	4.8%	110.4%
Wearing Apparel	2.4%	44.3%
Coke & Petroleum Products	6.9%	246.1%
Chemicals	5.8%	119.5%
Other Non-Metallic Mineral	8.5%	174.2%
Basic Metals	1.1%	130.0%
Metal Products	4.5%	103.7%
Electrical Equipment	2.1%	95.6%
Electricity, Gas, Steam	38.5%	360.3%

Source: Garanti BBVA Research, Turkstat

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