

# Turkey: Inflation outlook deteriorated further in May

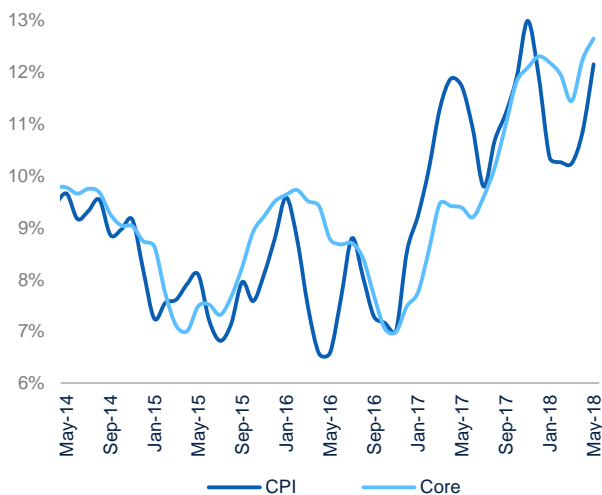
Adem Ileri / Alvaro Ortiz/ Seda Guler Mert / Serkan Kocabas

Consumer prices increased 1.62% (mom) in May, slightly higher than BBVA Research & Consensus estimate of 1.45%. Annual consumer inflation jumped to 12.15% from 10.85% on a broad-based worsening. Easing domestic demand conditions may have started to limit the deterioration in core prices, though ongoing cost-push factors over producer price inflation (D-PPI) that reached 20.2% yoy in May (up from 16.4%) and exchange rate pass-thru will keep inflation increasing in the short term. At these currency levels, the headline may reach 13.5% yoy in July, before starting to ease on favorable base effects in August. Although the deterioration should have been envisaged in the last Central Bank (CBRT) decision, further hikes from the CBRT cannot be ruled out depending on the market volatility. We expect a limited hike (around 50bps) in its next meeting on June, 7 to strengthen its recent policy decisions and enhance credibility. We estimate end-year inflation to be 11.5%, at least 1pp above our official forecast (10.5%).

## Pass-thru poses more upside risks on inflation in the short term

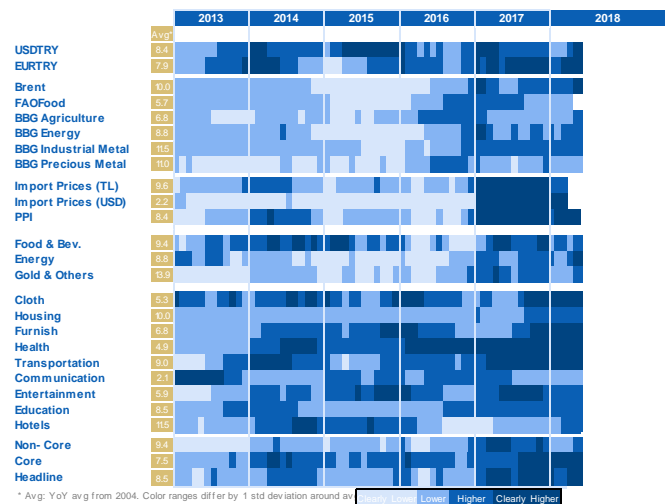
One of the upward surprising factors on inflation was the food prices that realized 1.5% mom increase in May, in contrast to its negative seasonal average. Together with recent currency overshooting, core inflation continued to increase on second round effects of exchange rate depreciation, high inertia and still supportive demand. The rise in clothing prices lower than its seasonal average also signaling moderation in demand, could have limited further deterioration in core inflation. According to our calculations, the cumulative pass-thru on annual consumer inflation is around 4pp as of May and, in the absence of further currency shock, it may have a peak at 5pp in September. The cumulative pass through which generally vanishes in two years, still shows an increasing trend since 3Q16 given the sequence of nasty shocks, which needs to be urgently tackled by comprehensive (Monetary and Fiscal) policy measures. Besides, the highest D-PPI inflation since 2004 will likely push consumer inflation up in the coming months. We expect the headline to converge to 13.5% in July before retreating towards 11.5% at the end of the year due to significant moderation in domestic demand on tighter financial conditions and base effects.

Chart 1 Core Inflation and CPI (YoY)



Source: BBVA Research Turkey & Turkstat

Chart 2 Core Inflation Heat Map

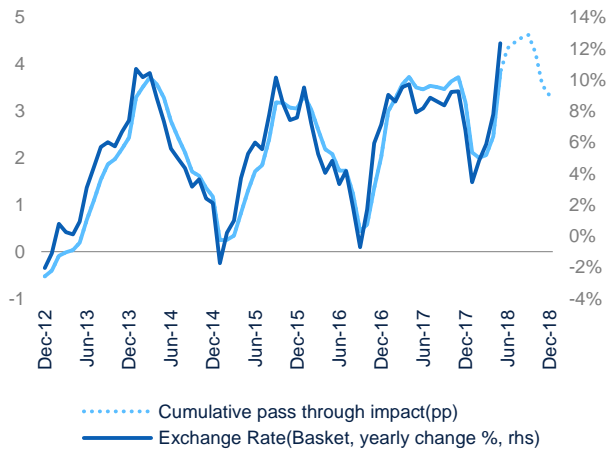


Source: BBVA Research Turkey & Turkstat

## Inflation risks remain and ask for extra monetary and fiscal tightening

Higher inflation stemming from the sequence of exchange rate shocks, supply side factors, inertia and increasing expectations will need further tightening from monetary policy (to be tentative, we expect 50 bps hike to 17% in June 7 meeting). Apart from this, it should be urgently supported by fiscal policy tightening. We estimate end-year inflation to be 11.5%; though exchange rate volatility, loose-than-expected policies and higher oil prices (despite the tax reduction in fuel prices) could pose upside risks.

Chart 3 Pass-thru on Annual CPI (pp)



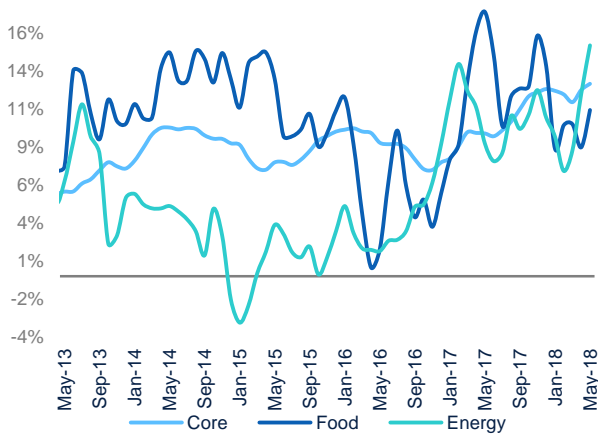
Source: BBVA Research Turkey Inflation Model & Turkstat

Chart 4 CBRT Survey: Inflation Expectations (YoY)



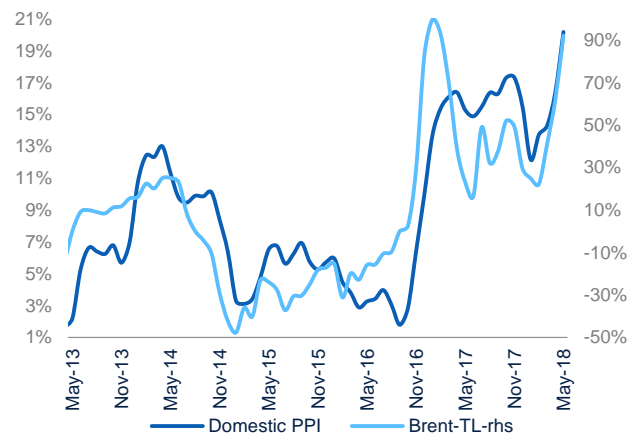
Source: CBRT & Turkstat

Chart 5 CPI Components (YoY)



Source: BBVA Research Turkey & Turkstat

Chart 6 Domestic PPI and Oil Prices in TL (YoY)



Source: BBVA Research Turkey, CBT & Turkstat

Chart 7 CPI in Subcomponents

| CPI                    | MoM         | YoY          |
|------------------------|-------------|--------------|
| <b>Total</b>           | <b>1.6%</b> | <b>12.1%</b> |
| Food                   | 1.5%        | 11.0%        |
| Beverage & Tobacco     | 0.2%        | 1.0%         |
| Clothing & Textile     | 5.2%        | 11.2%        |
| Housing                | 1.0%        | 11.2%        |
| Household Equipment    | 0.9%        | 16.9%        |
| Health                 | 0.3%        | 10.1%        |
| Transportation         | 2.3%        | 20.0%        |
| Communication          | 0.3%        | -0.2%        |
| Recr. & Culture        | 1.2%        | 6.9%         |
| Education              | 1.0%        | 11.0%        |
| Rest. & Hotels         | 1.5%        | 12.5%        |
| Misc. Goods & Services | 2.1%        | 15.4%        |

Source: BBVA Research Turkey & Turkstat

Chart 8 Domestic PPI in Subcomponents

| Domestic PPI               | MoM         | YoY          |
|----------------------------|-------------|--------------|
| <b>Total</b>               | <b>3.8%</b> | <b>20.2%</b> |
| Mining & Quarrying         | 2.6%        | 19.6%        |
| Manufacturing              | 3.4%        | 20.4%        |
| Food Products              | 2.4%        | 9.3%         |
| Textiles                   | 4.4%        | 18.2%        |
| Wearing Apparel            | 2.6%        | 8.4%         |
| Coke & Petroleum Products  | 12.2%       | 68.5%        |
| Chemicals                  | 4.1%        | 22.8%        |
| Other Non-Metallic Mineral | 2.8%        | 19.1%        |
| Basic Metals               | 4.7%        | 40.7%        |
| Metal Products             | 4.5%        | 24.9%        |
| Electrical Equipment       | 2.6%        | 19.5%        |
| Electricity, Gas, Steam    | 9.3%        | 18.7%        |

Source: BBVA Research Turkey & Turkstat

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