

Economic Watch

Turkey: A big upside surprise on inflation

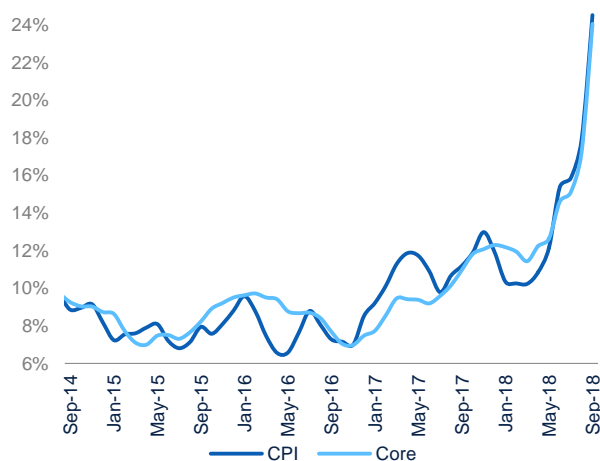
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Consumer prices increased 6.3% (mom) in September, significantly higher than our and market expectations (3.9% BBVA Research vs. 3.4% Bloomberg). This leads the annual figure to jump to 24.5% from 17.9% in August. The upside surprise was somehow broad-based on top of strengthening exchange rate pass-thru and increasing cost pressures, which resulted in an acceleration of core inflation to 24.1% from 17.2%. Two additional factors reinforced the inflation pressures: food inflation surprised on the upside and the recent upward trend in oil prices and utility price hikes led the producer prices inflation (PPI) to increase sharply to 46% from 32% in annual terms. All of these factors and October's utility price hikes will likely keep consumer inflation rising in October-November to around 26-27% and stabilize at these levels at the end of the year to moderate thereafter particularly from 2Q-2019 onwards.

Exchange rate pass-thru & second-round effects increase price pressures

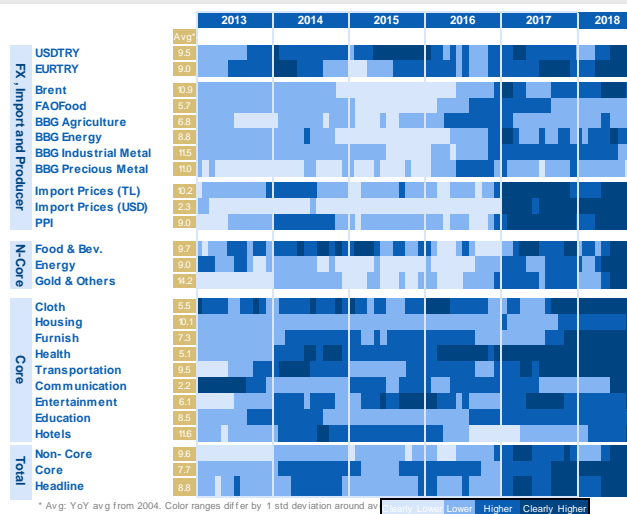
Across-the-board price deterioration signals that the pass-thru coefficient is increasing and firm pricing behavior is adjusting faster than expected. The highest contribution to today's upside surprise stemmed from core inflation, where transportation, furniture, housing equipment and services prices took the lead. Food inflation was extraordinarily high with 6.5% mom, the highest September figure in the 2003 series. Probably due to supply side problems and currency impact on processed food, annual food inflation jumped to 28.6% from 20.3%. Energy inflation showed the effects of recent price hikes and lagged impact of the partial elimination of the compensation in fuel prices and increased to 27% from 21.3%. Given October's utility price hikes and lagged effects of currency depreciation, upward pressures on energy inflation and producer prices will continue in the short term. There is high uncertainty on how pricing behavior will evolve in the short term and how inflation expectations will react. Our analysis shows that the pass-thru coefficient has been increasing in speed and magnitude (now closer to 20%, see charts 5-6) and will require to maintain a firm policy stance to curb down pricing behavior and re-anchor inflation expectations.

Chart 1 Core Inflation and CPI (YoY)



Source: BBVA Research Turkey & Turkstat

Chart 2 Core Inflation Heat Map



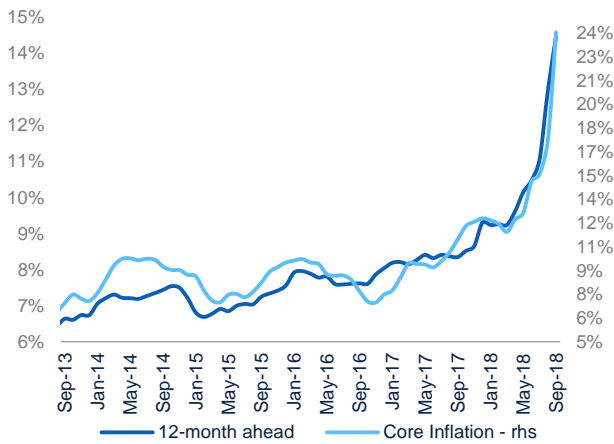
Source: BBVA Research Turkey & Turkstat

A further adjustment in monetary policy should not be ruled out

Today's inflation data shows that pricing behavior is adjusting faster than expected and this could be considered as a "factor affecting inflation requiring further monetary policy tightening". In our opinion, a new hike should not be ruled out in the CBRT's next meeting in October 25.

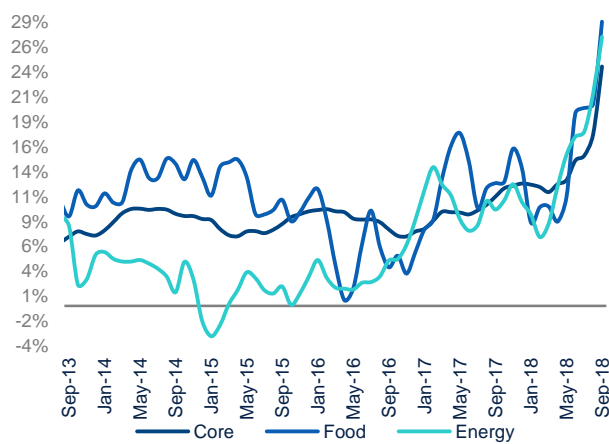
Creating Opportunities

Chart 3 Core Inflation vs Inflation Expectations (YoY)



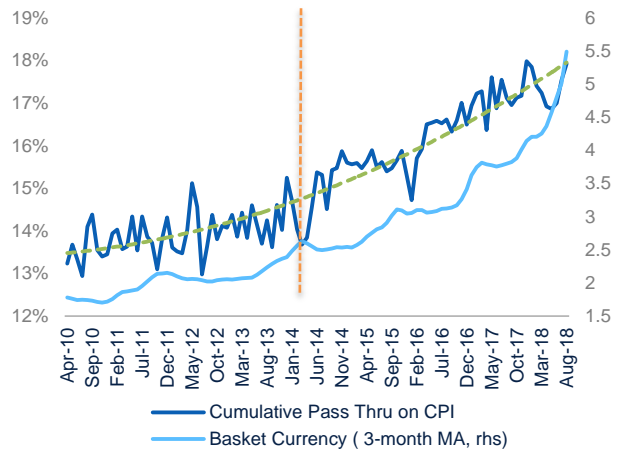
Source: BBVA Research Turkey Inflation Model & Turkstat

Chart 4 CPI Components (YoY)



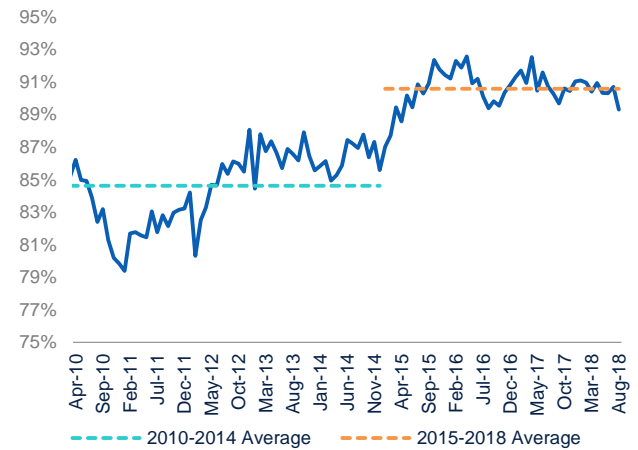
Source: CBRT & Turkstat

Chart 5 Time Varying Exchange Rate Pass Thru to Inflation



Source: BBVA Research Turkey (TVAR Model) & Turkstat

Chart 6 The percentage of FX Pass Thru completed in first three months



Source: BBVA Research Turkey, CBT & Turkstat

Chart 7 CPI in Subcomponents

	MoM	YoY
Total	6.3%	24.5%
Food	6.4%	27.7%
Beverage & Tobacco	0.1%	1.9%
Clothing & Textile	4.0%	17.2%
Housing	5.6%	21.8%
Household Equipment	11.4%	37.3%
Health	2.3%	14.7%
Transportation	9.1%	36.6%
Communication	1.1%	8.3%
Recr. & Culture	6.6%	19.4%
Education	4.0%	10.7%
Rest. & Hotels	4.8%	19.1%
Misc. Goods & Services	7.4%	30.6%

Source: BBVA Research Turkey & Turkstat

Chart 8 Domestic PPI in Subcomponents

	MoM	YoY
Total	10.9%	46.2%
Mining & Quarrying	5.6%	37.2%
Manufacturing	9.0%	44.8%
Food Products	8.0%	27.6%
Textiles	10.7%	49.1%
Wearing Apparel	3.7%	24.2%
Coke & Petroleum Products	9.0%	130.8%
Chemicals	13.7%	66.0%
Other Non-Metallic Mineral	5.3%	30.2%
Basic Metals	13.1%	77.4%
Metal Products	9.6%	53.6%
Electrical Equipment	11.3%	47.1%
Electricity, Gas, Steam	40.2%	71.9%

Source: BBVA Research Turkey & Turkstat

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