

Economic Watch

Turkey: June inflation opens the door for rate cuts

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03 July 2019

Consumer prices increased by 0.03% in June, lower than consensus but slightly higher than ours (0.2% Bloomberg vs. -0.15% BBVA Research). Supported by the base effects, annual inflation declined to 15.7% from 18.7% in May. Both food and energy prices were supportive, while core inflation maintained its improving trend by falling to 14.9% from 15.9% despite the stickiness in services prices. Electricity price hike as of July and removal of tax incentives on automobiles and some durable consumer goods will likely push inflation to 17-17.5% in July before falling very rapidly to near 10% in September to reverse thereafter. The recent appreciation in the currency thanks to both tight monetary policy and the risk premium reduction and still negative output gap could support further the disinflation path. However, uncertainties over the pricing behavior, still high inflation expectations and backward looking inertia would require the Central Bank to be prudent in the magnitude of the easing cycle which we expect to start next July.

Food inflation normalization leads to a faster disinflation path in June

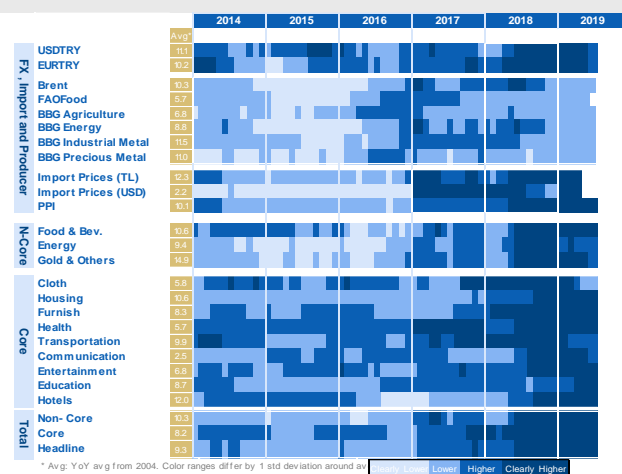
Food inflation maintained its correction as it fell by 1.9% mom on the back of seasonal unprocessed food prices (-5.6% mom), which led the annual figure to ease from 29.5% to 19.5%. Energy inflation also curbed the consumer inflation as the energy prices retreated by 1% mom, which resulted in an annual figure of 10.5%, down from 12.7%. On the other hand, core prices increased by 0.9% mom mainly on top of services prices, while seasonally negative clothing inflation was the downside factor. Though, annual core inflation maintained its declining trend on diminishing exchange rate pass-thru thanks to weak demand and somewhat easing cost-push factors (annual domestic PPI declined to 25.0% from 28.7% in May). According to our calculations, the permanent inflation (trend core inflation) also improves faster in recent months and reaches below 13% (see Chart 4). Easing volatility in the currency if continued to accompany with poor demand could facilitate further correction by reducing the already declining pass-thru (see Chart 5). Though, still high inertia led by backward-looking indexation prevails as the services inflation remains close to 15% in the last 9 months. The likelihood of the end of tax incentives and electricity price hike in July (around 1.5-2pp both direct and indirect total impact) will temporarily push inflation up to 17-17.5% in July. Despite the recent faster than expected correction in inflation and favorable base effects from now onwards till November, still uncertainties in geopolitics and policy reactions (mainly diverging fiscal policy) and likely unexpected price adjustments including cost-push factors and high inertia could require the CBRT to be very cautious on inflation and initiate the easing cycle only gradually.

Chart 1. Core Inflation and CPI (YoY)



Source: BBVA Research Turkey, Turkstat

Chart 2. Inflation Heat Map

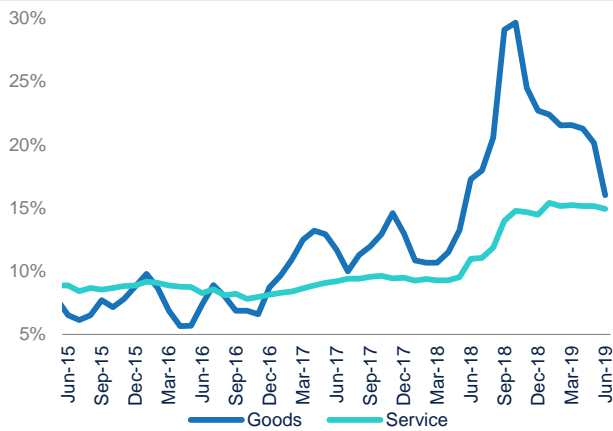


Source: BBVA Research Turkey & Turkstat

Disinflation will accelerate to 10% area in October to reverse at the end of the year

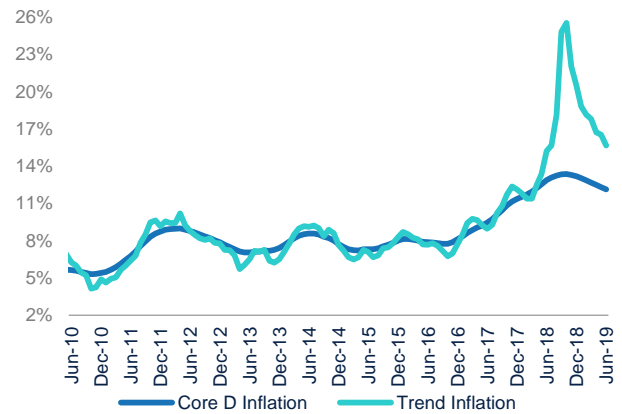
Recent faster than expected correction in inflation and favorable base effects from now onwards till November will help inflation experience around 10% levels in September and October before having a reversal to near 15% by the end of the year. Uncertainties over the pricing behavior and potentially high inertia over the services prices would require the CBRT to be prudent and initiate the easing cycle only gradually starting from its next meeting in July.

Chart 3. **Goods and Services Inflation, YoY**



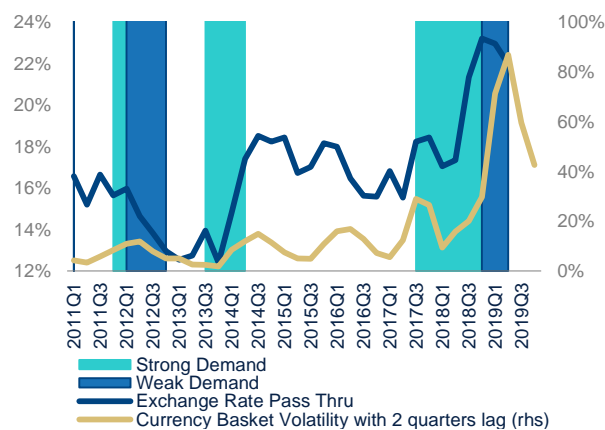
Source: BBVA Research Turkey, Turkstat,

Chart 4. **Core D and Trend Inflation, YoY**



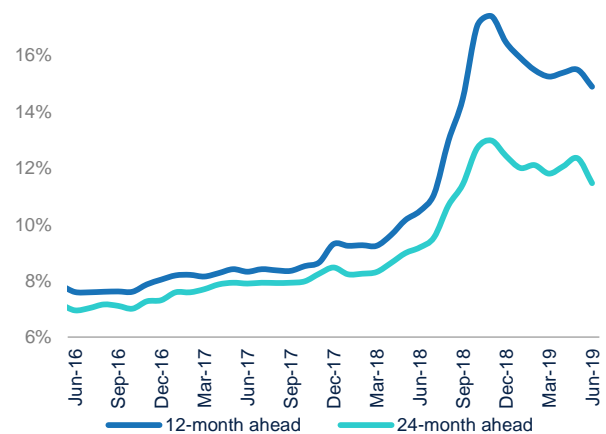
Source: BBVA-Research Turkey UCSV-MA Model, Turkstat,

Chart 5. **Time Varying Exchange Rate Pass Thru and Currency Basket Volatility (200 hundred days)**



Source: BBVA Research Turkey TVAR Model, Turkstat

Chart 6. **Inflation expectations, YoY**



Source: BBVA Research Turkey, Turkstat

Chart 7. **CPI in Subcomponents**

	MoM	YoY
Total	0.0%	15.7%
Food & Non-alcoholic beverages	-1.6%	19.2%
Beverage & Tobacco	0.0%	19.2%
Clothing & Textile	-1.6%	4.3%
Housing	0.3%	13.8%
Household Equipment	0.6%	22.5%
Health	0.6%	19.1%
Transportation	0.5%	10.0%
Communication	0.4%	5.3%
Recreation & Culture	0.0%	17.5%
Education	1.5%	13.9%
Restaurants & Hotels	2.7%	20.8%
Misc. Goods & Services	1.9%	26.9%

Source: BBVA Research Turkey & Turkstat

Chart 8. **Domestic PPI in Subcomponents**

	MoM	YoY
Total	0.1%	25.0%
Mining & Quarrying	0.5%	22.1%
Manufacturing	-0.4%	23.2%
Food Products	1.8%	27.2%
Textiles	-0.7%	24.8%
Wearing Apparel	0.3%	11.4%
Coke & Petroleum Products	-11.8%	9.7%
Chemicals	-1.3%	28.9%
Other Non-Metallic Mineral	0.3%	21.2%
Basic Metals	-2.7%	16.3%
Metal Products	-0.9%	22.3%
Electrical Equipment	-0.2%	27.1%
Electricity, Gas, Steam	7.8%	54.2%

Source: BBVA Research Turkey & Turkstat

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