Turkey: CPI above 54% and still climbing

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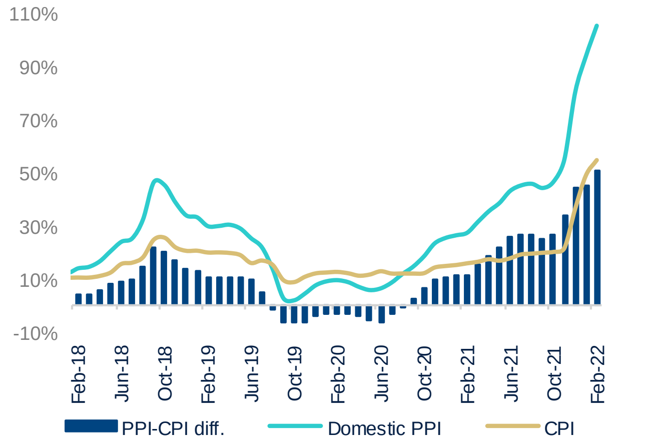
Consumer prices increased by 4.8% in February, above expectations (BBVA Research 3.5%, Consensus 3.75%) and resulted in an annual inflation of 54.4%, up from 48.7% the month before. The largest surprise was the upsurge in food prices but the broad-based worsening of price pressures also weighed upward reflecting strong cost-push factors. Meanwhile, domestic producer prices jumped 7.2% m/m and 105% y/y due to higher commodity prices and lagged effects of currency depreciation and energy price hikes. Looking ahead, Russia's invasion of Ukraine and its impact on commodity prices add uncertainty to an already high inflationary environment.

A continuing wide-spread deterioration of inflation

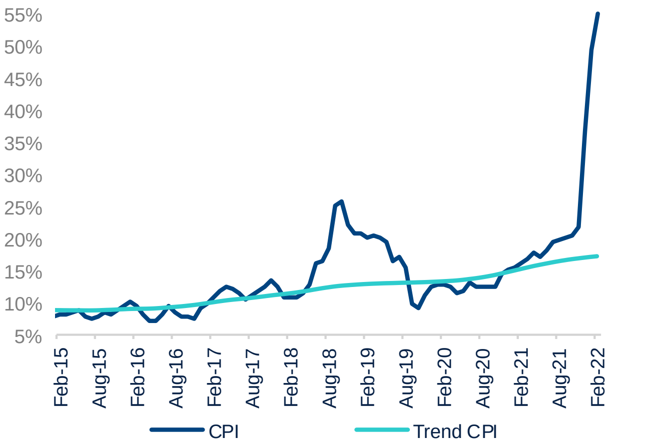
Food prices recorded a new peak of monthly inflation (8.4%) once again in February, mainly due to the highest price increase in fresh fruit and vegetables (32.2% m/m) since 2017. As a result, annual food inflation climbed up to 64.5%, where fruit and vegetables had a staggering 80.8% increase. Energy prices continued to rise (4% m/m), bringing the annual figure to a whopping 83% and facing further deterioration given the negative outlook for natural gas and oil prices following Russia's invasion of Ukraine. In contrast, core inflation slowed-down relatively (3.75% m/m) but remained elevated with an annual figure of 44.1%, given high second round effects from high energy and food prices, worsening expectations and strong consumption growth. Services prices reinforced stickiness implied a 3.6% m/m increase, and reached 32.9% y/y, led by transportation services and restaurant & hotel prices. Meanwhile, cost push factors kept deepening, which will likely continue given the bias on commodity prices due to the war in Ukraine (figure 1). The lack of decisive monetary policy countermeasures amid loose fiscal and credit policies resulted in further worsening of inflation expectations, which reached a high of 25% and 15% for 12-month and 24-month ahead, respectively. Therefore, the uncertainty on second round effects and inertia, fueled by accelerating cost push factors, and worsening inflation expectations keep upside risks to the inflation outlook. If cyclical, seasonal and other idiosyncratic factors are excluded, trend inflation could reach almost 17%, requiring a significant change of anchor in order to achieve a fast and effective disinflationary environment, which seems highly unlikely in the short term, given the current policy bias (figure 2).

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



Source: Garanti BBVA Research, Turkstat

Figure 2. **CPI vs Trend CPI, YoY**

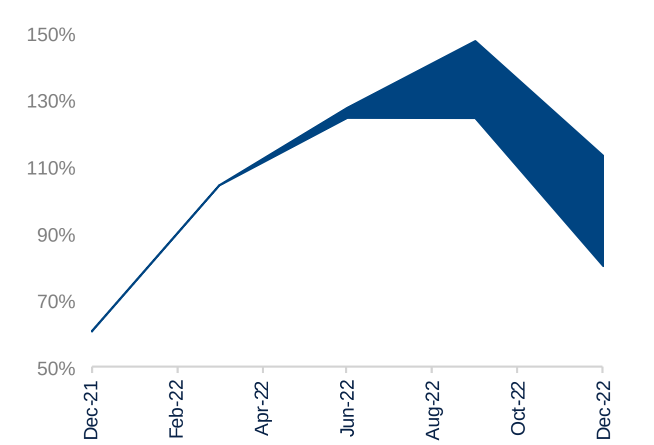


Source: Garanti BBVA Research, Turkstat

Potentially stronger cost effects will weigh on the upside

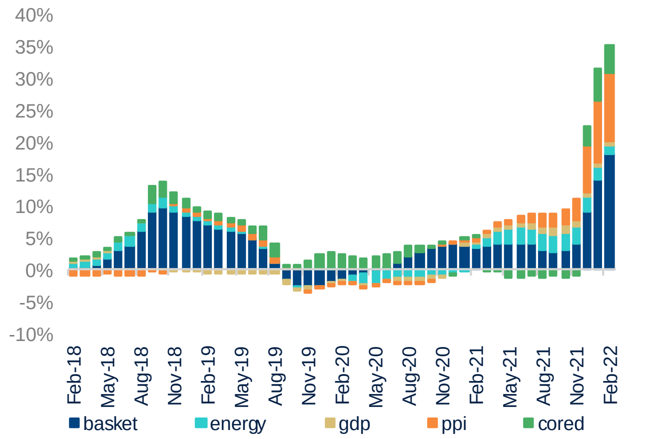
Depending on the duration of the conflict in Ukraine, the implications on the inflation outlook could be severe. For example, if average annual Brent oil and natural gas prices follow current future prices (100$/barrel and 4.9$/MMBtu, respectively), and we assume high (low) exchange rate pass-thru and high (low) second round effects, producer prices could average above 100% in 2022 (figure 3). If other commodity prices like grains, metals and fibers also stay elevated, the pressure on producer prices would be even higher. This means that even under a gradual exchange rate depreciation, the spike in energy prices will be enough to keep cost pressures for several months. Given the accelerating contribution of producer prices on consumer prices in the recent months, the risk of experiencing high inertia and an inflation spiral is edging up dramatically (figure 4). Considering latest wage hikes, the real change in income levels will be larger negative in coming months, affecting the overall welfare severely.

Figure 3. **Domestic PPI Forecasts, quarterly YoY**



Source: Garanti BBVA Research, Turkstat

Figure 4. **Historical Decomposition on Core D, annual**

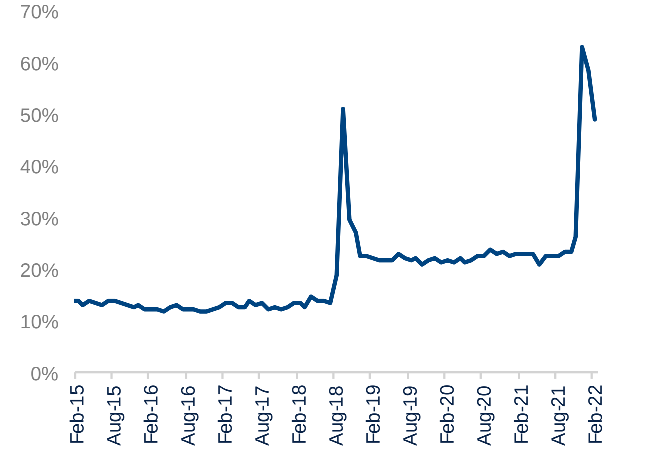


Source: Garanti BBVA Research, Turkstat

Exchange rate pass-through running wild

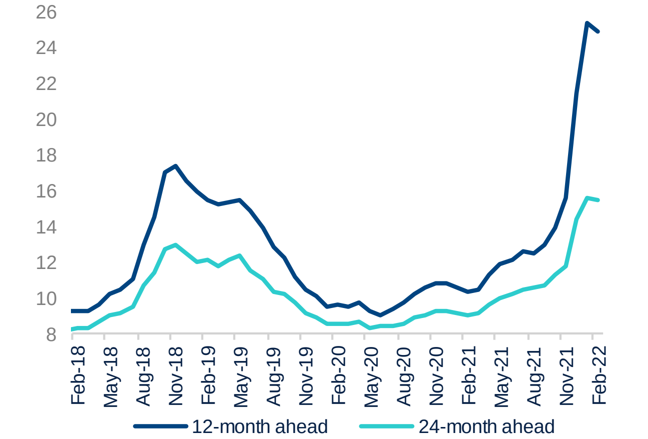
Following the stabilization of the currency in the recent weeks, we calculate a very slight normalization in the exchange rate pass-thru, which remains far above the previous years' level of near 25%. This is basically linked to the continuously worsening of inflation expectations in the absence of a clear monetary policy reaction aimed at tightening financial conditions. Given the strong commitment of the authorities with the "new economic model", it is highly uncertain at which level the exchange rate pass-through will stabilize.

Figure 5. **Exchange Rate Pass-thru on Core D**



Source: Garanti BBVA Research, Turkstat, recursive method

Figure 6. **Inflation Expectations, annual %**

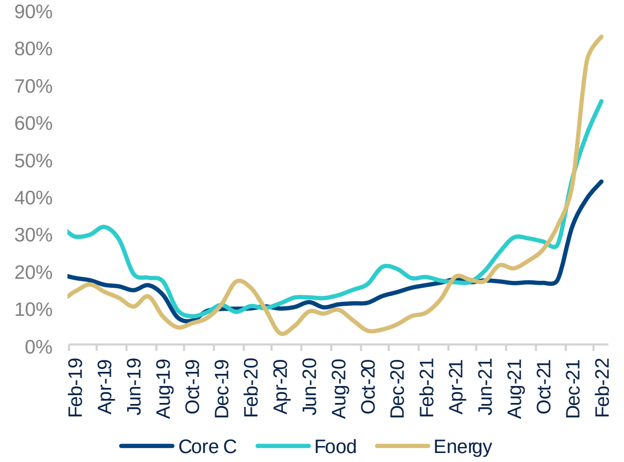


Source: Garanti BBVA Research, Turkstat

A glimmer outlook for inflation

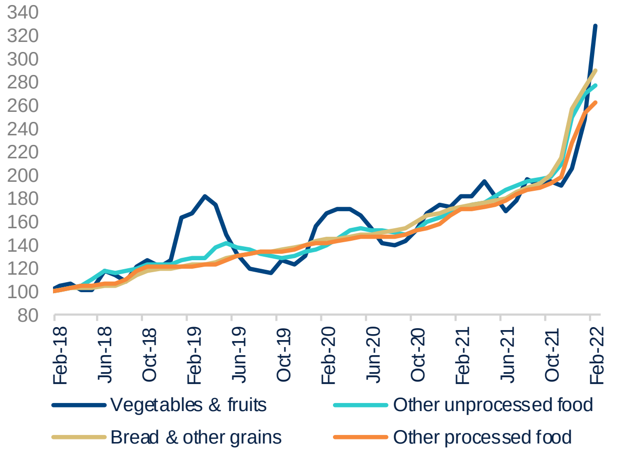
Given mounting upward pressures, we expect consumer inflation to surpass 60% in both 2Q22 and 3Q22, before slowing down to above 40% in December, on the back of positive base effects. Therefore, it is obvious that continuing with the current loose monetary and fiscal policies will become even more challenging, particularly when considering that foreign yields are also rising and global inflation remains high. Recent developments on both inflation expectations and second round effects confirm the risk of a potential inflation spiral, which would exert pressure on the currency and bring forward the monetary policy reversal.

Figure 7. **CPI Components, YoY**



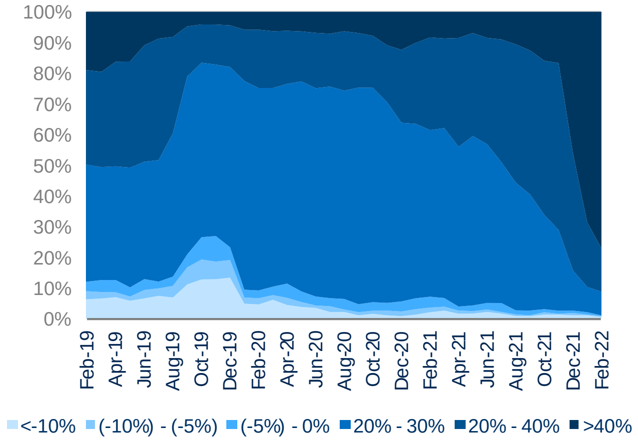
Source: Garanti BBVA Research, TURKSTAT

Figure 8. **Food Prices, January 2018 = 100**



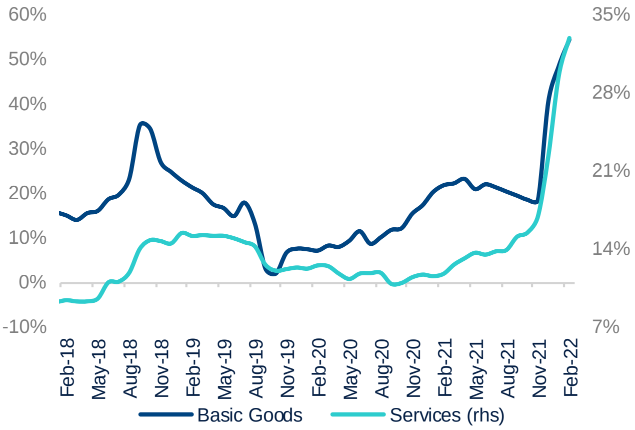
Source: Garanti BBVA Research, TURKSTAT

Figure 9. **Consumer Inflation Diffusion Map, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 10. **Basic Goods and Services Inflation, YoY**



Source: Garanti BBVA Research, TURKSTAT

Figure 11. **CPI in Subcomponents**

	MoM	YoY
Total	**4.81%**	**54.44%**
Food & Non-alcoholic beverages	8.4%	64.5%
Beverage & Tobacco	0.4%	45.8%
Clothing & Textile	0.3%	26.9%
Housing	1.5%	49.7%
Household Equipment	7.0%	64.8%
Health	6.4%	32.9%
Transportation	4.6%	75.8%
Communication	1.6%	11.9%
Recreation & Culture	2.7%	39.8%
Education	3.9%	22.2%
Restaurants & Hotels	4.5%	55.2%
Misc. Goods & Services	6.0%	55.8%

Source: Garanti BBVA Research, Turkstat

Figure 12. **Domestic PPI in Subcomponents**

	MoM	YoY
Total	**7.22%**	**105.01%**
Mining & Quarrying	6.4%	98.7%
Manufacturing	5.6%	97.9%
Food Products	4.3%	78.4%
Textiles	4.5%	108.7%
Wearing Apparel	2.8%	34.4%
Coke & Petroleum Products	12.3%	198.9%
Chemicals	4.6%	122.7%
Other Non-Metallic Mineral	11.8%	109.8%
Basic Metals	1.1%	144.3%
Metal Products	5.9%	93.2%
Electrical Equipment	8.7%	98.3%
Electricity, Gas, Steam	24.7%	202.5%

Source: Garanti BBVA Research, Turkstat

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