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# Turkey: inflation, exchange rate's pass-through and monetary policy

Research & Macro Strategy

# Turkey: inflation, exchange rate's pass-through and monetary policy

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## The essential

Despite a huge collapse in activity, the Turkish inflation is still flirting with 20% yoy and the main monetary policy rate is stuck at 24% for 8 months. Since the beginning of the year, fiscal policy has been used as a tool to support the economy that has just exited recession. However, the fiscal stimulus cannot be extended for long, at least not at this path. In such a context, using monetary policy could be another option to boost economy in the coming months, should the authorities have room to do so. In other words, it is still necessary for inflation to fall sufficiently and for the currency to stabilize, if not appreciate.

While the Turkish economy has just exited recession, financial conditions are still very tight with the main policy rate is 24%. Fiscal expansion has been fruitful for supporting growth. However, it has its own limits. A marked deterioration of public finances could increase risk perception. Easing monetary policy is then a tempting option to stimulate the economy, should the authorities have room to do so. In other words, it is still necessary for inflation to fall sufficiently and for the currency to stabilize, if not appreciate.

## Food and Non-alcoholic Beverages prices are running up and weighing on consumers' prices

**In our central scenario, we forecast Turkish inflation for 2019 to be around 16% yoy on annual average and 13% yoy end-December 2019.** We are closed to Bloomberg's consensus (June 20) where inflation is supposed to be 17.3% yoy on annual average in 2019 (19.9% yoy in Q1, 18.5% yoy in Q2, 13.8% yoy in Q3 and 15% in Q4). **Still, these forecasts are very fragile.**

> "Food and Non-alcoholic Beverages prices account for almost 25% of the CPI index."

Headline inflation reached a peak of 25% yoy in October 2018. Since, it has decreased slightly and slowly. End of May this year, it was around 18.7% yoy. Core inflation *-i.e excluding Alcohol, Tobacco, Energy, Food, Non-alcoholic Beverages and Gold-* released just a bit lower at 15.9% yoy at the same date. *(See chart 1)*. Inflation excluding administered prices has also decelerated for several months but remained at 20% yoy end of May.

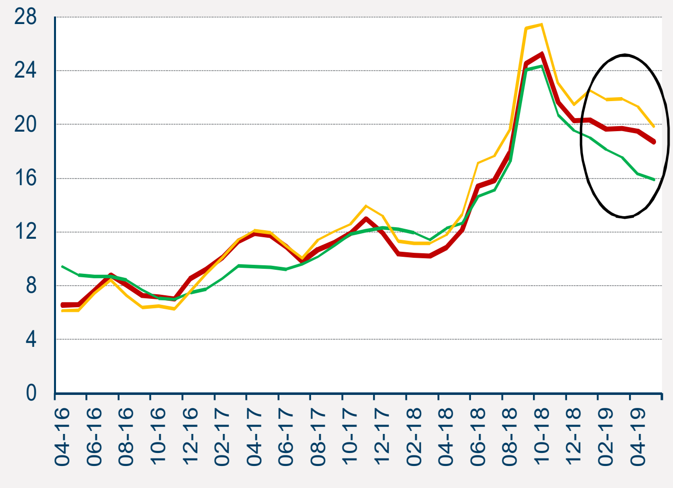
The growing inflation trend in Food and Non-alcoholic Beverages 'sector (which is representing almost 25% of the CPI i.e the largest share of the index) has and continues to weight hardly on headline inflation. *(See charts 2 and 3)*. End of May, it was close to 30% yoy.

On the opposite, despite the recent rise in oil prices, as prices in the Energy sector are administered[1] or subject to tax adjustments, inflation in the Energy's sector fell sharply. It is now about 12.7% yoy, much lower than 6 months ago (25% yoy). It has proved support for lower headline inflation *(See chart 4)*.

[1] *Among administrated prices, one can find Water, Electricity, Gas and Oil prices, transports by railway and Postal services. Even though Alcoholic Beverages and Tobacco as well as Pharmaceutical products prices are determined by the private sector, the main determinant of these prices being the tax level they can also be considered as "administrated prices". Indeed, the tax represents almost 75% of the price of Alcoholic Beverages and Tobacco.*

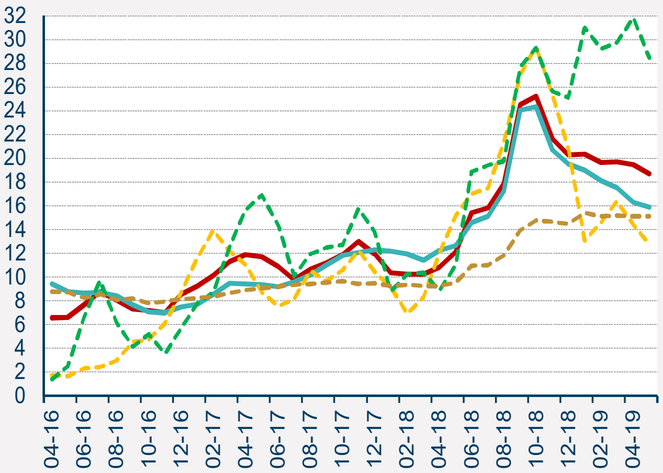
Forecasting Food and Non-alcoholic Beverages ‘prices is quite uneasy as it depends on seasonal factors and imported prices. The other main items of the index such as Water, Electricity, Gas & Other Fuels and Transports *-that are representing 15% of the index-* are administered or subject to tax adjustments so as they are not very useful to predict the outlook for inflation. Forecasting oil price is also very difficult as geopolitical issues heavily influence it.

### 1/**Inflation (%,yoy)**



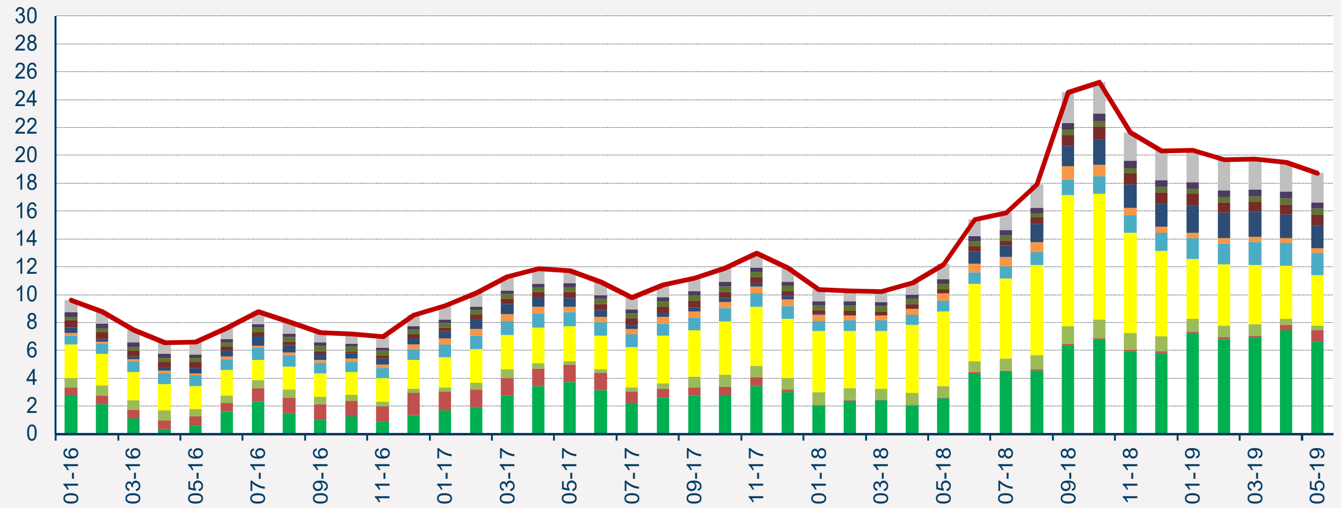

*Source: CEIC, Data: 06/21/2019, Amundi Research*

### 2/**Inflation and main components (%,yoy)**



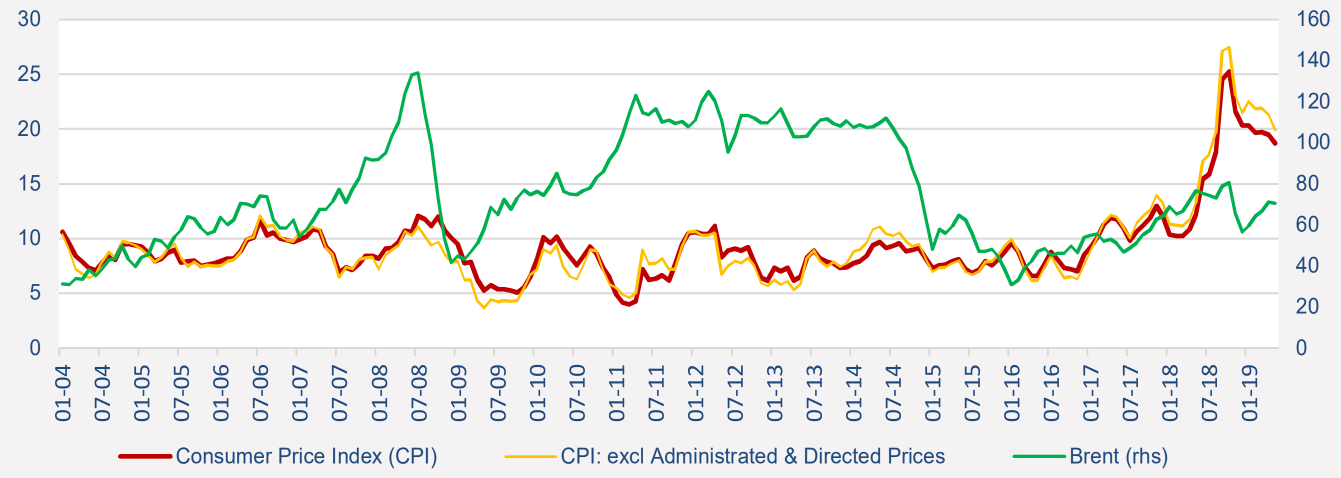

*Source: CEIC, Data: 06/21/2019, Amundi Research*

### 3/**Inflation (%,yoy) and main components (pp,contributions)**




*Source: CEIC, Data:06/21/2019, Amundi Research*

4/**Inflation (%,yoy) and Brent (USD per brl)**




*Source: CEIC, Data:06/21/2019, Amundi Research*

## Exchange rate pass-through can help to predict headline inflation's outlook

Even though many prices are administered or subject to tax adjustments, Turkish headline inflation is much correlated to exchange rates' variations. *(See chart 5)*. Moreover, focusing on the more recent period (i.e 2018-2019), it clearly appears that the correlation has increased.

While the depreciation of the Turkish lira against the US dollar grew over the three first quarters of 2018, it started to slow down after having reached a highest of 45% last September. **In the current context of high (geo)-political uncertainties and re-escalation of trade tensions between the US and China, the volatility of emerging currencies has increased. It is even more pronounced in the case of Turkey** where the macro fundamentals are weak and the (geo)-political context is still a gridlock.

> "Exchange rate pass-through is sizeable in Turkey."

Considering different scenarios on exchange rate's outlook may help navigate in uncharted territory. We **retain two scenarios regarding the exchange rate's path of the Turkish lira versus the US dollar on one-year horizon.**

In the first scenario, we fix the exchange rate at its average over June 2019 that is roughly USD/TKY at 5.81 or TKY/USD at 0.172. In the second scenario, we retain the forwards. *(See table 1).*

**Table 1:**
**Exchange rates' assumptions**

| TKY/USD | Q2-2019 | Q3-2019 | Q4-2019 | Q1-2020 |
|---|---|---|---|---|
| Forward | 5.8 | 6.1 | 6.4 | 6.7 |

In the first scenario, the depreciation from now to the end of year is null while in the second one it is about 10%.

We ran a quick estimation on a monthly frequency basis between consumers' prices and the exchange rate of the Turkish lira versus the US dollar. *(See chart 6)*.

Data are expressed in logarithm. The sample covered the following period: January 2011 -April 2019:

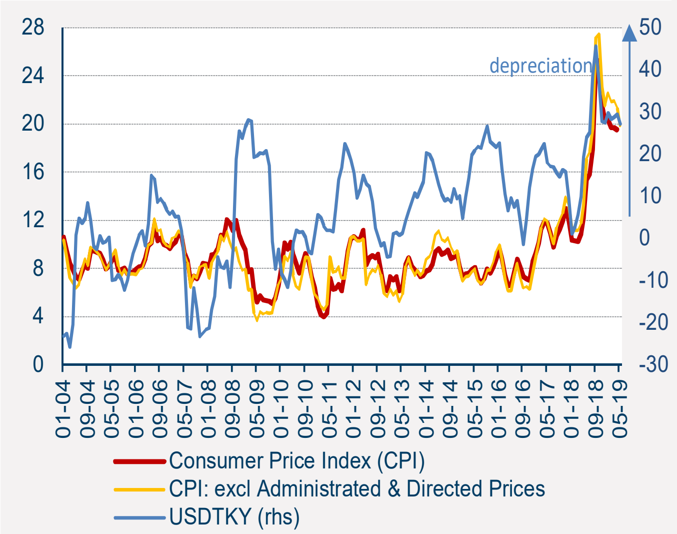
$$ln(cpi_t) = \propto + \beta * ln(e_t) \qquad with\ t = jan2011 - apr2019\ and\ \ e = USD/TKY$$

The results are consistent with the expectations: a depreciation of the currency leads to a rise in consumers' prices. The coefficient β is quite elevated.

A depreciation of the Turkish lira by 1% should result in an increase of 0.57% in consumers' prices. Taking the peak of the depreciation of the Turkish lira last year, (45.5% in September) should have led to a rise of consumers 'prices of more than 30%.

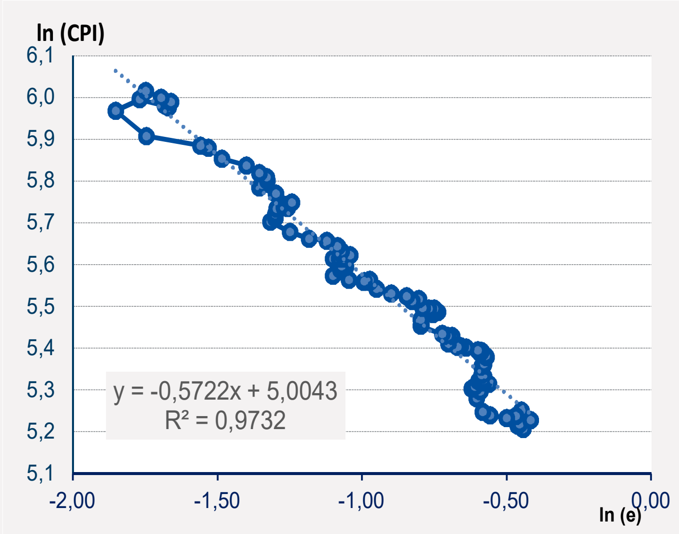
Also as expected, the inflation simulated by our equation looks globally more volatile, i.e with larger variations, than the current one. *(See chart 7)*.

### 5/**Inflation and exchange rate (%,yoy)**



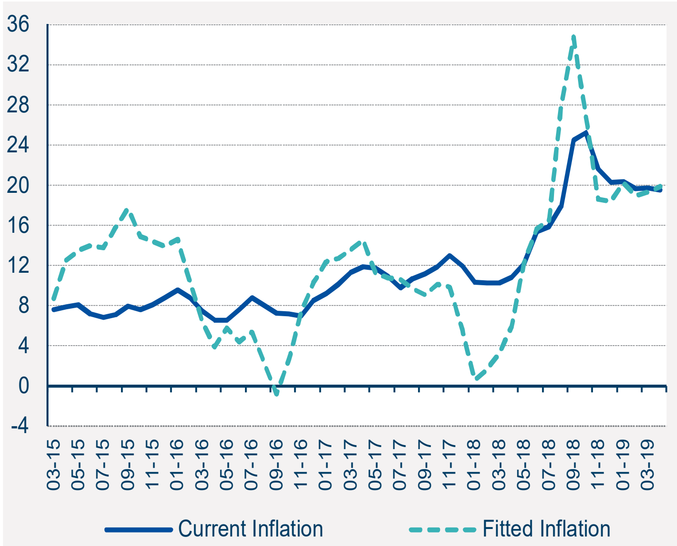

*Source: CEIC, Data: 06/21/2019, Amundi Research*

### 6/**Inflation and exchange rate (ln)**



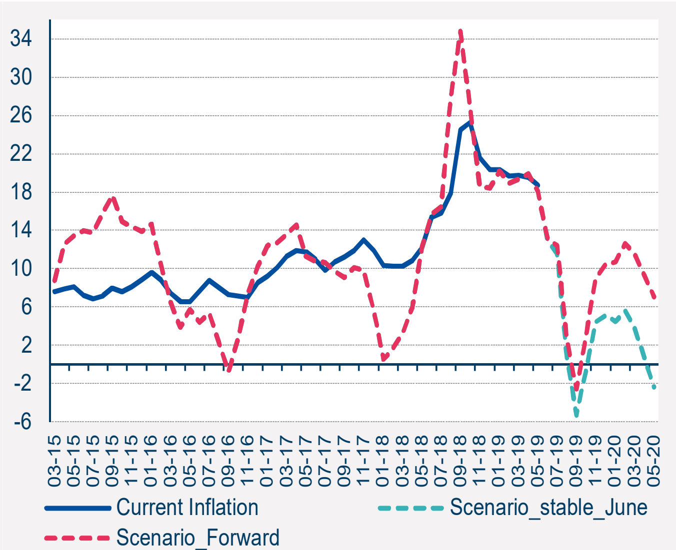

*Source: CEIC, Data:06/21/2019, Amundi Research*

### 7/**Current and fitted inflation (%,yoy)**




*Source: CEIC, Data:06/21/2019, Amundi Research*

### 8/**Inflation on alternative scenario (%,yoy)**




*Source: CEIC, Data: 06/21/2019, Amundi Research*

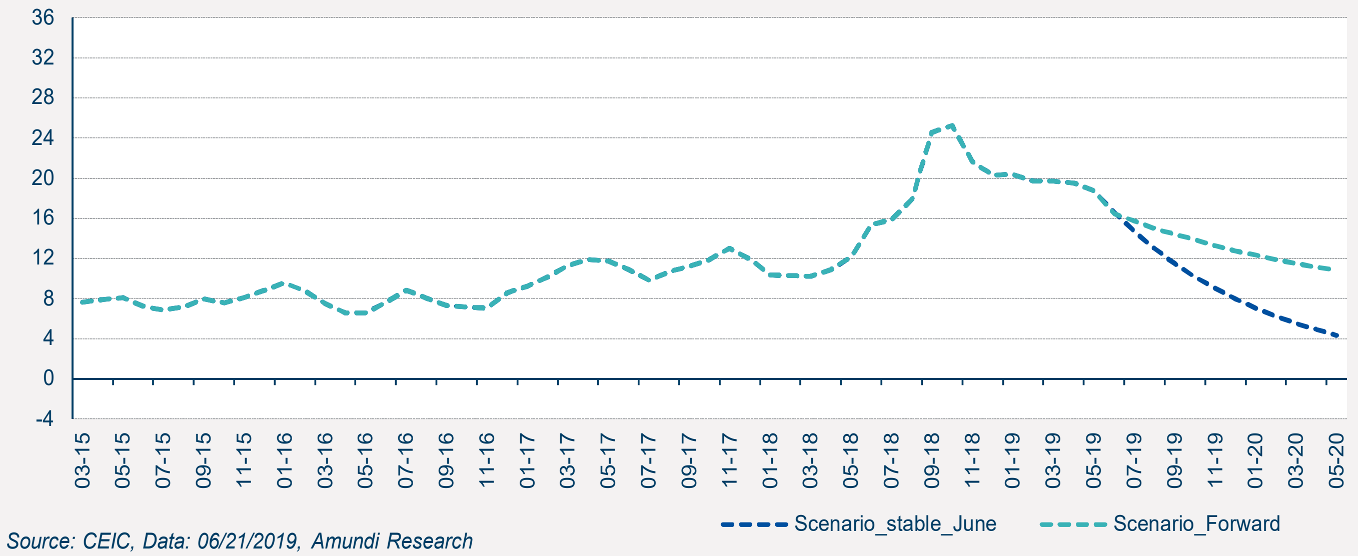
From this very simple equation, we have run our scenarios *(see charts 8)* and smoothed the path from early January this year to the levels of inflation estimated for December 2019 *(see chart 9)*.

We get to different outlooks for inflation according to the scenario retained. **On annual average for year 2019**, inflation should be **15% yoy and 17%** yoy respectively considering **scenarios 1 and 2. End- December 2019**, inflation should be comprised between **8% yoy and 13% yoy** respectively considering **scenarios 1 and 2.**

> **"July 25 would likely mark the beginning of the easing cycle."**

Considering **our central scenario, with a 16% yoy annual average for 2019 we are close to both scenarios while for the end of the year with a forecast of 13% we are more in line with the scenario retaining the forward.**

9/**Forecasted-smoothed Inflation on alternative scenarios (%,yoy)**




*Source: CEIC, Data: 06/21/2019, Amundi Research*

## What can we expect from the Central Bank of Republic of Turkey?

For many reasons, it is difficult to extrapolate monetary policy from these estimations. Other factors than just the exchange rate are driving prices, such as sectors' prices, wages, GDP growth and also an arbitrary component.

At its last meeting hold on June 12, the CBRT kept its policy rates unchanged with the one-week repo at 24% as expected by the consensus while it adopted a more dovish tone opening the door to future cuts. While the debate regarding future cuts appears closed, the date of the first cut is more questioning. Indeed, the current environment of weak growth, still elevated inflation and political gridlocks is much complex.

Many large investment banks are expecting the first cut to occur in Q3. Among them, some are mentioning that "*the CBRT could start easing monetary policy as early as its next meeting, July 25, if risks remain subdued*". For others September 12 meeting, looks more likely.

For sure, the evolution of the Turkish lira against dollar will be one of the most important driver of easing cycle departure. Assuming the CBRT to be cautious regarding i) the current (geo)-political environment, ii) the ongoing fiscal slippage and iii) inflation path (not cutting before inflation being below 15% yoy), than the first cut could occur **beginning of July according to our first scenario of Turkish lira stabilisation, two months later i.e September in the second scenario of a larger depreciation.**

Note that after reaching a peak of 6.19 TKY per USD in May 9, the Turkish lira has regained some ground and is at 5.81 at the date of writing this text (June 20). If the currency stabilizes at this level, with Istanbul's election to be over and a decrease in tensions with US or sanctions from the US to be limited, the probability of a cut at the next meeting is quite substantial.

Nevertheless, it is also important to note that while the decrease in inflation is important in the first scenario, it is less pronounced in the second. In other words, if the Turkish lira is going to depreciate as shown by the forwards than the room for manoeuvre of the CBRT will be very limited in the year ahead.

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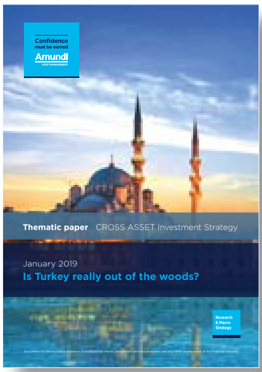


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