Turkey: Inflation estimate revised upwards

The central bank raised its 2018 inflation forecast to 7.8% reflecting recent TRY weakness as well as elevated core inflation. The Governor reiterated it would maintain the tight stance until the inflation outlook "convincingly" improves

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Gap between the CBT forecast and the consensus narrows

In the first inflation report of the year and the accompanying meeting, the Turkish central bank Governor Cetinkaya evaluated recent developments in inflation dynamics and laid out the CBT's inflation forecasts for 2018-20.

The bank revised its end-2018 inflation call to 7.9% (vs 9.55% market consensus and up from 7.0% in the previous inflation report), with a forecast range of 6.5-9.3%. Meanwhile, for 2019, inflation is expected to float in the range of 4.7-8.3% with a mid-point of 6.5%, up from October's forecast at 6.0%. So the CBT expects inflation to stabilise around the 5% target by the end of 2020.

Revisions in TL import prices are the drivers

The adjustment in the 2018 estimate is attributable to:

1) Upward revision to the forecast for TL import prices (an additional 0.7ppt)

2) Upward revision in the output gap forecast on the back of higher-than-expected economic activity (adding 0.1ppt), 3) higher-than-expected inflation and the rise in the underlying trend (creating a 0.1ppt impact).

The CBT's forecast increase between October and January inflation reports for the next year relies on updates in TL-denominated import prices (providing 0.5ppt contribution).

What else was discussed in the inflation report?

Other messages in the inflation report and the accompanied meeting are:

- On the inflation outlook, the annual figure followed a strong upwards trend until December despite a slight fall in services inflation. This is attributable to a) rapid TRY depreciation pushing core goods prices upward, b) reversal of tax incentives on certain consumer durables, c) robust economic activity, d) change in the calculation of clothing in the index e) elevated food inflation and f) spike in oil prices. The CBT acknowledges inflation expectations maintained the upwards trend without any concrete signal of direction change yet. For this year, oil price assumption is raised to a yearly average of USD66 from USD56, though no change in the food inflation at 7%. Still, the bank sees some disinflation in 2018 thanks to a) fading cumulative effect from TRY depreciation, b) declining inflationary impact of recent rapid rises in import prices c) expectedly milder course of economic activity this year.
- Recently-released data indicate that economic activity remains strong with sustained growth in IP, albeit some deceleration. Domestic demand maintains expansion despite some momentum loss in private consumption with the removal of tax incentives at end-3Q while investment appetite continues recovery path. The improving global growth outlook with strong EU performance and strength in external demand continue to stimulate exports. The CBT sees economic activity to "move towards its underlying trend and gradually near its potential level in 2018" with fading base effects and removal of growth-supportive economic policies, though to remain solid.
- Commercial lending continued to normalise in 4Q17 with the Credit Guarantee Fund (CGF) facility nearing the pre-determined ceiling, while consumer loans have lost momentum with reversal of tax incentives and the contribution of base effects. This year, the CGF support will remain in place though with a slower pace of growth.

The CBT reiterates continuation of the tight stance

In the latest MPC, the CBT struck a more hawkish tone and signalled that not only the pace of decline but also the quality of improvement would be important in the policy decisions.

So, noting that "...Tight stance in monetary policy will be maintained decisively until the inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets", the bank hints not to bring down the effective cost of funding rate gradually in tandem with the decline in headline CPI in the coming months, allowing ex-post real rate to enrich gradually.

The Governor reiterated it would maintain the tight stance until the inflation outlook “convincingly” improves

> In the meeting, the Governor maintained this stance saying that there would be no change in stance until the inflation outlook “convincingly” improves. Given that markets are already seeing a higher inflation path for this year, the upward adjustment in the CBT’s inflation report making the forecast more realistic did not lead to any significant reaction in the currency as USD/TRY remained range bound around 3.78-3.79 levels.

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

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