Turkey sees big drop in annual inflation on base effects but July prices remain high

Annual inflation continued to trend down in July helped by supportive base effects. The drop came despite revisions to the special consumption tax (SCT) and administrative price adjustments as well as upward pressure on food prices

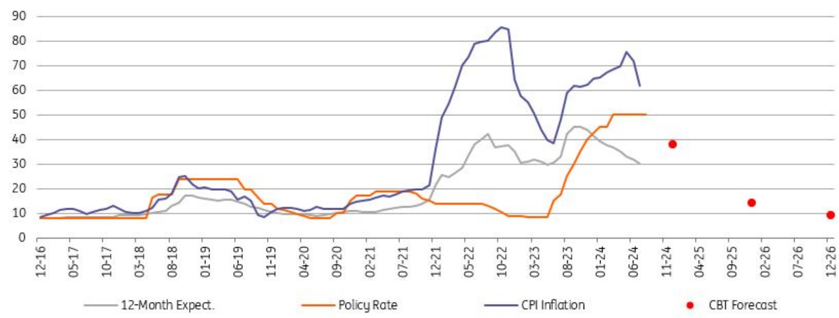
The Beyoglu district in Istanbul, Turkey

Following the Central Bank of Turkey's warning related to a temporary rise in July inflation due to "adjustments in administered prices and taxes as well as supply-side factors in unprocessed food prices", the turnout was 3.23% vs the consensus of 3.45%. However, because of the large favourable base effect (9.49% in July 2023), annual inflation recorded a significant drop to 61.8% from 71.6% a month ago and maintained its downtrend. Cumulative inflation in the first seven months of this year was 28.8% vs the 38% CBT forecast for this year.

The PPI stood at 1.94% month-on-month, dropping to 41.37% YoY vs a month ago. The data implies moderating cost pressures with supportive currency developments lately (around a 1.5% increase in USD/TRY, up by 12.4% on a year-to-date basis). Global commodity prices, which moderated in July, will likely remain the key determinant of the PPI trend ahead.

Core inflation (CPI-C) came in at 2.45% MoM, moving down to 60.2% on an annual basis, supported by the relatively slow-moving FX basket after the local elections. While cost-push pressures are easing, as evidenced by recent PPI data, pricing behaviour and inertia in services have been key factors adding to the inflation pressure.

Inflation outlook (%)



Source: TurkStat, CBT, ING

Regarding the underlying trend, the CBT sees a decline in seasonally-adjusted monthly inflation to around 2.5% on average in the third quarter, and slightly below 1.5% in the last quarter of the year. The July headline figure, on a seasonally adjusted basis, showed a MoM increase as expected, mainly driven by the goods group, while the increase in services and core trends remained relatively limited. However, the underlying trend in services is still elevated, confirming the challenges to disinflation.

In the breakdown:

- The housing group turned out to be the main contributor at 1.19ppt with a 38% hike in electricity fees and continuing upside pressure in rent.
- Transportation, which pulled the headline rate up by 0.62ppt, was the second biggest contributor, reflecting the impact of revisions to the special consumption tax on certain products, with the release of first half PPI.
- Food prices and catering services, closely linked to food prices, were the other major drivers with a 0.46ppt and 0.31ppt impact on the monthly reading, respectively. In the food group, while annual inflation dropped markedly given the July figure was 1.83% vs 7.71% in the same month of the last year, the turnout was quite high in comparison to the long-term average. This was driven by both unprocessed (ie fresh fruit and vegetables) and processed food (ie bread and cereals) products.

As a result, goods inflation moved down to 52.7% YoY, while core goods inflation, a better indicator of the trend, inched down to 38.3% YoY with a more pronounced drop likely due not only to base effects but also to exchange rate-related factors. Services, which are less sensitive to currency movements but more impacted by domestic demand and minimum wage increases, fell to 85.6% YoY mainly due to transportation and catering services.

The downtrend in annual inflation will likely continue with another pronounced drop in August. The extent of the decline will be determined by administrative price adjustments as we saw at the beginning of this month. A 38% increase in natural prices is expected to have a direct and indirect impact of around 1ppt on the headline rate. However, the lagged effects of monetary tightening on credit and domestic demand and the continued real appreciation of the Turkish lira are likely factors that will keep the underlying inflation trend on a downward path over the remainder of this year. The CBT will release its inflation report on 8 August, which will likely provide further insights into how the bank sees the inflation outlook.

Recent statements by the governor and deputy governor show efforts to guide inflation expectations and calls related to the timing of the rate cut cycle. Governor Fatih Karahan reiterated the Bank's guidance that any change in the monetary policy stance will be based on the evolution of the underlying inflation trend and inflation expectations. Deputy Governor Cevdet Akcay stated that "central banks naturally tend to err on the side of caution. What a central bank is cautious about depends on the situation. This could be the risk of reviving pricing pressures due to a premature interest rate cut, or a situation in which an excessive or unnecessarily prolonged tightening process leads to a hard landing. Since the current conditions pose a higher risk in the first case, a rate cut is not on the agenda now." These statements suggest that the CBT will likely remain on hold for longer, while the timing will be determined by the underlying inflation trend and the alignment of inflation expectations with the CBT scenario.

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