Turkish inflation drops sharply in May

In May, a strong base effect and broad declines in pricing pressures have driven Turkish annual inflation downward, resuming improvements in the underlying trend

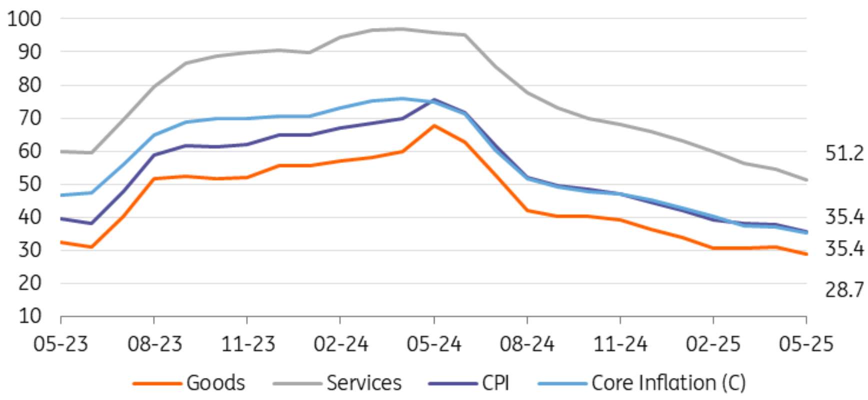
If there are no further shocks – sharp exchange rate movements, large wage adjustments, unexpected hikes in regulated prices, or a surge in commodity prices – we expect inflation to remain below 30% at the end of this year

In May, Turkey's CPI inflation stood at 1.53% month-on-month, coming in lower than the consensus estimate of 2.0% and our expectation of 2.2%. This was largely due to moderate price increases across both food and non-food categories. As a result, annual inflation, which has been on a downward trend for the past year, saw a sharp drop to 35.4%, down from 37.0% in the previous month. However, it remains above the Central Bank of Turkey's (CBT) unchanged year-end forecast of 24%, which falls within the projected range of 19–29% according to the latest inflation report release. While inflation rose by 3.4% in May 2024, the five-year average for May in the 2003-based index was just 1.7%. This suggests a strong base effect, reinforcing the continued decline in annual inflation.

The PPI increased by 2.5% MoM, driven mainly by food products and utilities. Annual producer inflation reached 23.1% year-on-year, marking the first monthly increase in a year. This indicates that despite a slower pace of currency depreciation at 1.9% MoM in May, the sharp currency basket (50:50 EUR/USD) increases of 6.5% MoM in March and 3.9% MoM in April led to a stronger pass-through effect, pushing prices up. However, cost pressures remain under control due to the CBT's continuing grip on the exchange rate, with the FX basket rising by around 25% YoY as of May.

Core inflation (CPI-C) rose by 2.4% MoM, bringing the annual rate down to 35.4%. Preliminary seasonally adjusted data, set to be published by TurkStat and closely monitored by the CBT, indicate an improvement in underlying trends. The surge seen in March and April has reversed, showing widespread progress, particularly in goods.

Inflation outlook (%)



Source: TurkStat, ING

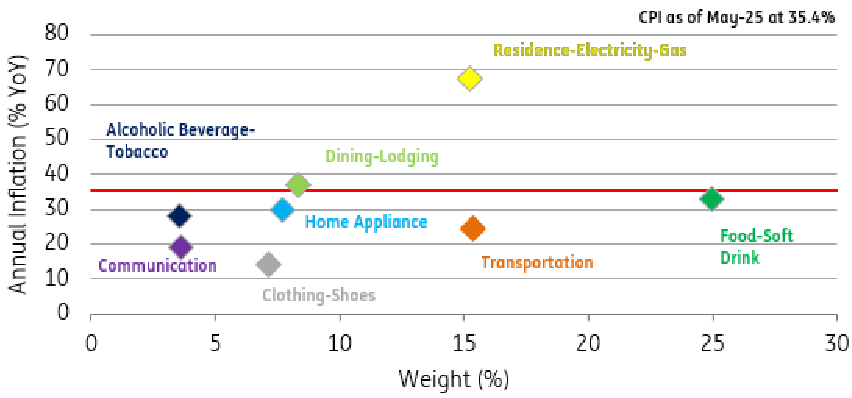
Breaking down the data:

- The housing group made the largest contribution to inflation (0.48 percentage points), driven by water fee adjustments and persistently high rents.
- The clothing group added 0.41ppt due to seasonal factors.
- Transportation lifted inflation by 0.4ppt, mainly due to car price adjustments following currency depreciation.
- On the other hand, the food sector reduced inflation by 0.18ppt, thanks to price declines in unprocessed foods and stable processed food prices.
- Communication services also contributed negatively, with falling telecom service prices helping to ease inflation.

As a result:

- Goods inflation dropped to 28.7% YoY, while core goods inflation stood at 20.0% YoY.
- Services inflation, more influenced by domestic demand and wage increases than currency fluctuations, continued to decline. It reached 51.2% YoY, its lowest level since mid-2022.

Annual inflation in expenditure groups



Source: TurkStat, ING

Overall, a strong base effect and broad declines in pricing pressures have driven annual inflation downward, reinforcing an improving trend. This suggests that the impact of recent market volatility on inflation remains contained, thanks to timely and comprehensive action by the CBT. If there are no further shocks – sharp exchange rate movements, large wage adjustments, unexpected hikes in regulated prices, or a surge in commodity prices – we expect inflation to remain below 30% at the end of this year.

Currently, the CBT employs macroprudential measures and relies on policy rate and credit caps at the same time to control both the price and volume of credit. In its latest inflation report, Deputy Governor Cevdet Akcay stated that the bank has two options: a) lowering rates if conditions permit, while maintaining macroprudential measures, or b) keeping the policy rate high while gradually removing volume restrictions. The choice between these strategies is unclear at this stage, but the CBT is unlikely to adjust the policy rate at its MPC meeting scheduled for 19 June.

Currently, the bank mainly funds lenders at the upper band, keeping the overnight rate close to 49%. May's inflation data, combined with stabilising market conditions and the resumption of reserve accumulation (from $138.5bn in early May to $153.1bn at the latest) may enable the CBT to shift its funding toward one-week repo auctions, potentially leading to a lower effective funding rate that aligns with the policy rate.

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