Turkey: Central bank revises up inflation estimates sharply

The Central Bank of Turkey raised its 2018 inflation forecast to 13.4%, reflecting the recent sharp increase in price pressures due to a weaker lira and unprecedented spike in food inflation. The governor reiterated the CBT's commitment to a tight monetary stance for an extended period

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The governor's messages in a nutshell

In the inflation report and accompanying speech, CBT Governor Murat Cetinkaya announced new inflation forecasts and explained the reasons behind the bank's significant adjustments. He also defended the MPC decision last week and reiterated the Bank's determination to bring inflation down from the current elevated levels and thus to rebuild credibility.

The CBT sees a longer period for inflation to converge to target

According to the report, the CBT now expects CPI inflation of 13.4% this year, up five percentage points from its previous forecast. It also forecasts 9.3% inflation for next year, up by 2.8 percentage points on the back of changing food inflation expectations, higher oil price assumptions and the impact of recent weakness in the Turkish lira. This is despite a downward adjustment in the output gap estimate, which the Bank now expects to fall into negative territory in the third quarter and remain there in the coming four quarters. For 2020, the CBT now sees 6.7% inflation, up from 5% in the April report. So the CBT expects inflation to stabilise around the 5% target after 2020, in three years time. It previously hoped to bring inflation down to the target level in just two years.

The governor reiterated the same message of the MPC

In the July MPC last week, the CBT ended its tightening cycle in place since April, despite a sharp deterioration in the inflation outlook, ongoing uptrend in forward-looking expectations and external imbalances. The market had been expecting a roughly 100 basis point hike. In today's meeting, the governor repeated the central bank's arguments, citing:

1. Milder demand conditions and the likely disinflationary impact from this.
2. A likely reversal in food inflation (the CBT sees unprocessed food inflation dropping to 12% at the end of this year from 23% in June vs 13% food inflation down from 18.9%).
3. Support from fiscal policy (though it assumes a neutral fiscal stance rather than a pro-growth stance that's been in place since 2016).
4. The lagged impact of tightening since April.

Accordingly, Governor Cetinkaya once again reiterated the CBT's commitment to a tight monetary stance for an extended period. He sounded concerned about the worsening in inflation expectations and the rise in core inflation and he stated that the Bank remains ready to react to inflationary risks (by closely following pricing behaviour, and global risk appetite), signalling the CBT may tighten policy more if inflation and inflation expectations prove sticky.

Next thing to watch is the new Medium Term Programme

In raising inflation forecasts, the CBT has reduced the gap with the market consensus, which is looking for 13.9% inflation. The governor also maintained his cautious tone. Given that the CBT attaches a bigger role to fiscal policy in the disinflation process, the new Medium Term Programme (out likely end-August/early September) will be key for the markets after a series of packages released before the snap elections proved disappointing.

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