Turkey: Central bank sees upside inflation risk

The Central Bank of Turkey raised its 2018 forecast for CPI inflation to 23.5%, above the figure presented in the new economy programme, reflecting an unexpectedly high September reading. The Governor reiterated the commitment to tight monetary policy for an extended period

Source: iStock

Governor's message

In the latest inflation report and accompanying speech, CBT Governor Murat Cetinkaya 1) announced new inflation forecasts and explained the reasons behind the bank's significant adjustments to the July forecasts 2) reiterated the policy stance in the latest MPC meeting 3) outlined risks to the inflation outlook presented in the report.

A higher path for inflation vs July report

According to the report, the CBT now expects 23.5% CPI inflation this year adjusted by 10.1 percentage points and 15.2% for next year, up by 5.9 percentage points. This is due to changing expectations on food inflation, higher oil price assumptions, higher-than-projected inflation and a deterioration in the underlying trend, as well as the impact of recent weakness in the Turkish lira on TL-denominated import prices. It comes despite a downward adjustment in the output gap estimate, as the bank expects this to dive into negative territory in 3Q18 and remain there in the coming period. For 2020, the CBT now sees 9.3% inflation, up from 6.7% in the July report. The CBT expects inflation to stabilise around the 5% target after 2020, in three years time.

Inflation to peak in early 2019

Compared with forecasts in the new economic programme released in late-September, the CBT pencilled in a higher figure for this year vs 20.8% in the programme, likely reflecting an unexpectedly high September reading with the broad-based pick-up in price pressures and across-the-board increases in all major price categories. For 2019 and 2020, the CBT forecasts lower inflation vs forecasts of 15.9% and 9.8%, respectively, in the government plan.

For the rest of 2018, the bank predicts a possible further rise in October despite a 10% price cut campaign. We expect a modest decline towards the year-end amid some favourable base effects but the current uptrend won't peak until early 2019 due to the ongoing deterioration in pricing behaviour, which poses upside risks in the short-term. In the medium term, there are risks in both directions, according to the CBT, as the tightening in financial conditions and domestic demand will likely contribute to disinflation.

Commitment to a tight monetary stance for an extended period

In the latest MPC, despite a deteriorating inflation outlook, the surge in forward-looking expectations and a fall in the ex-post real rate into negative territory again, the CBT said nothing, likely because of the rapid improvement in financial stability risks and the ongoing impact of recent financial volatility on the growth outlook. It maintained a hawkish bias, keeping the main policy guidance in the statement unchanged. While highlighting the determination to tighten further, if needed, the bank will continue to monitor 1) the lagged impact of recent monetary policy decisions and 2) the contribution of fiscal policy to the rebalancing process in addition to 3) inflation expectations, pricing behaviour and other factors affecting inflation. In the inflation report, the Governor reiterated these same issues and the bank’s commitment to a tight monetary stance for an extended period.

Overall, the CBT adjusted the inflation forecasts further while the Governor maintained his cautious tone. Given the current elevated path and possibility of a further increase in headline inflation in early 2019, the CBT will likely keep the policy stance unchanged for a long period and refrain from any further upward adjustment in rates as long as the Turkish lira remains stable. This is due to the already tight conditions, which should start to mitigate the deterioration in the inflation outlook along with weaker demand.

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