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05 April 2021

Turkey: rising inflation pressures the CBRT's reaction function

Development

Headline inflation in Turkey increased from 15.6% y/y in February to 16.2% y/y in March, in line consensus but below our expectations of 16.5% y/y. A confluence of base effects, the rise in energy prices and the renewal of Turkish Lira (TRY) weakness drove the rise. The specific sub-components signals that the increase was largely driven by transportation (24.9% y/y), furnishings and household equipment (23.6% y/y) and health (19.2% y/y), though most other categories of the CPI basket also registered increases, pointing to a broad-based rise in consumer prices.

Key data

Turkey headline inflation March 2021: 16.2% y/y (MUFG 16.5% y/y; consensus 16.2% y/y)

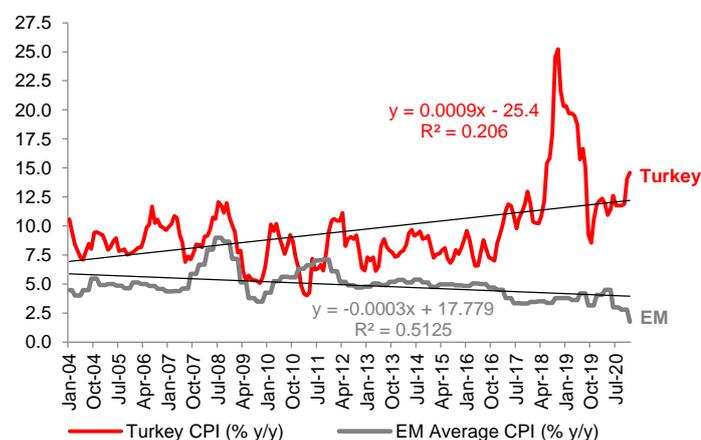
Macro

The evolution of inflation and the Central Bank of Turkey's (CBRT) reaction function to price developments will play a pivotal role in shaping market sentiment. High trend inflation, sticky services prices and elevated cost-push pressures signal that a challenging disinflationary process lies ahead in the coming months. With this in mind, our inflation forecasts suggest that CPI will peak at 17.5% y/y in June, before only mildly falling to 15.0% y/y by year-end.

We view that there are strong signs to be cautious about how swift inflation can fall.

RECENT DEVIATION OF TURKISH INFLATION WITH ITS EM PEERS HAS BEEN STRIKING

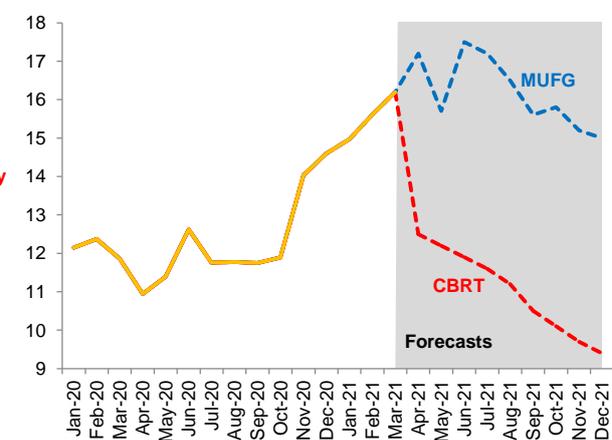
TURKEY AND EM HEADLINE INFLATION (% Y/Y)



Source: Bloomberg, CBRT, IMF, MUFG Research

HIGH TREND INFLATION, STICKY SERVICES PRICES AND ELEVATED COST-PUSH PRESSURES TO PUSH CPI HIGHER

TURKEY HEADLINE INFLATION FORECASTS (% Y/Y)



Source: Bloomberg, CBRT, MUFG Research

First, developments following the August 2018 TRY sell-off demonstrated that, while goods inflation normally responds promptly to a stabilisation of TRY, services inflation is stickier and more challenging to ebb. Second, services inflation may prove stickier at this juncture as with the economy on the cusp of reopenings, the service sector will encounter considerably higher costs stemming from the 22% hike in the minimum wage rate. Third, the economy is running at or above potential growth in recent quarters, this suggests that, unlike most other EM peers, there is limited spare capacity to put downward pressure on prices. On net, our conviction that inflation will remain well-above the CBRT's 9.4% y/y year-end target is high. In order for the CBRT to achieve such a target would need a constant exchange rate (and thus a real appreciation) as well as some magnitude of administrative prices to repress inflationary pressures.

Separately but in related vein, historical Turkish Lira (TRY) depreciations have been followed by higher inflation readings. As the large share of the largest leg lower in TRY occurring towards the end of March, our expectation is that the brunt of the exchange rate pass-through pressures onto CPI will be reflected in the April reading. With our forecasts for the TRY to hit 8.75 against the USD in Q2 2021, we can only expect further pricing pressures this quarter.

With this inflation outlook in mind, we do not believe that the Central Bank of Turkey (CBRT) has the policy room to theoretically lower rates this year. Indeed, in the absence of an improvement in the inflation picture and reversal of the recent capital outflows, the case for monetary easing is misplaced. However, given political priorities, our base case is that the change of CBRT leadership will result in the start of an accommodative monetary policy cycle. We do not have a strong conviction on the timing of this commencement, which will be data dependent and conditional on movements in the currency as well as broader Turkish risk assets. As it stands, we price in the reversal of the March 200bps hike in Q2 2021.

Treasury

Upside trend on inflation has further support from recent TRY depreciation seen after unexpected CBRT management change whereas overshooting core inflation & producer prices data suggest new highs are yet to come. We observed PPI surged to 31.2% - its highest since January 2019 as key indicator for stickiness of high inflation readings for coming months. Following CBRT governor's messages combined with today's inflation data, the likelihood for early rate cut in the next meeting seems low under current environment while lira volatility is likely to remain until April 15th.

According to latest BRSA data, we monitored local retail investors FX deposits dropped around \$9.0bio during the market turmoil caused by foreign investor exodus as can be seen for take profit action whereas further de-dollarization could be achieved by higher TRY deposit pricing. While we observed recently some upside adjustment from local banks around 100bps level and also noted government action for prolonged withholding tax incentive until 31st May as another positive development on that front, we think the maintenance of net positive real returns will be crucial factor to support de-dollarization trend gradually to help lira stability for upcoming months.

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