

# New Europe Economics & Strategy

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Focus notes: **Turkey**

## August CPI exceeds expectations, but spike in inflation likely to prove temporary

Headline CPI surprised to the upside in August, coming in at 0.4%mom and exceeding expectations for a more modest, 0.2%mom, increase. On an annual basis consumer prices rose by 8.33% outpacing a 7.58% rise – the lowest in seven months - registered in July. The food component was the primary factor behind the spike, recording a 2.95%mom gain which brought the annual rate of increase to 10.37% in August from 5.52%yoy in July. Seasonal factors as well as adverse weather conditions are the most likely culprits of the jump witnessed in the food sub-index last month. Note that during Ramadan, which takes places in August and September this year, demand for food traditionally increases. Cost-push inflation was also instigated through heavy rain that affected Germany and a number of countries in Europe. A drought which hit several others, including Russia which was last year's third largest producer of wheat, also weighed. Nevertheless, the breakdown of the CPI data suggested that price pressures are relatively muted with six of the twelve components revealing monthly declines while the rest, with the exception of food, only modest increases. Signaling that the underlying inflation trend remains rather benign, most core inflation indicators eased further in August, with the "H" and "I" indices, closely monitored by the CBRT, marking respective declines of 0.46%mom and 0.69%mom which pushed both indices to their lowest level on an annual basis since February 2010. On the flipside, producer prices rose 1.15%mom in August, also exceeding the market's median forecast of +0.23%mom. In annual terms the index rose by 9.03% vs. an 8.24% gain in July.

In all, August's inflation data does not come as a complete surprise. The central bank had warned about a temporary spike in inflation in the short-term, having voiced expectations about reversal of the uptrend in Q4 2010. In line with most market participants, we had anticipated a spike in headline CPI to around 8% in August and September primarily due to seasonal factors. We expect a slowdown thereafter and see headline CPI easing towards 7.1%yoy by end-2010, slightly above its 6.5% target for the year. Note however, that the recent surge in wheat prices may have an inflationary impact in the coming months. Looking further ahead, we expect price pressures to remain relatively subdued through to Q1 2011, but become more evident in the second half of next year. The primary reason being, fiscal loosening ahead of parliamentary elections scheduled for July next year, to which we assign a rather increased probability. Also seizing to assist the disinflation

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process will be the narrowing of the output gaps created as a consequence of the crisis. In December 2011, we see CPI slightly below 7% but above the CBRT's 5.5% end-year target.

Along these lines we maintain our view that the CBRT will likely remain on hold in the months ahead and incept its monetary tightening cycle in H2 2011, after it assesses the impact of potential increased spending in the run-up to the upcoming general elections, and the global economic outlook becomes more transparent. The CBRT's policy remains highly accommodative, after a total of 1,025bps of rate cuts being delivered between November 2008 and November 2009. As such, we continue to expect 150bps of rate hikes to be delivered by the CBRT by the end of 2011. The central bank warned in late August that it may resume its easing policy cycle should global economic conditions worsen to an extent that likelihood of a new domestic recession increases. However, we would assign a rather limited probability to this scenario as domestic demand dynamics do not currently justify such a move.

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