

Inflation Report: The Pandemic put its mark on the CBRT Report; inflation expectation down to 7.4% for 2020

Meryem Çetinkaya

The CBRT published the second Inflation Report of the year. Concerns over the Covid-19 pandemic was very prominent in the report. In parallel with global markets, economic activity is expected to contract sharply in the second quarter and recover with the return of domestic demand in the second half. However, foreign demand will also be important in the overall recovery. Inflation is expected to decline due to collapse in commodity prices and plunge in domestic demand conditions. CBRT expects inflation to fall significantly especially from July onwards. While a moderate course is expected in the balance of payments, CBRT sees no problem in reserves to meet short-term liabilities.

According to the report and CBRT's Governor Murat Uysal's statements;

- **CBRT cut its 2020 inflation expectations from 8.2% to 7.4%.** Inflation is expected to remain within the range of 5.5% to 9.3% with a probability of 70%. Components of the revision are
 - -1.2 points due to the update on output gap
 - -0.3 points due to fall of food inflation expectation from 11.0% to 9.5%
 - + 0.5 points from real unit labor costs
 - + 0.2 points from TL denominated import prices. Although oil price assumption has been reduced from \$60 to \$32.6 per barrel, TRY depreciation limited positive effect of fall in oil prices.
- **CBRT kept its 2021 year-end inflation expectation constant at %5.4.** Inflation is expected to be between 3.1% and 7.7% with 70% probability. The update in TL import prices is expected to push inflation up by 0.3 points while the output gap is expected to bring inflation down by 0.3 points.

Global Economic Outlook:

- Coronavirus causes a sharp contraction of global economic activity. In addition to the impact it had on the supply chain and production, the increase in uncertainties, tightening in financial conditions, loss of income and disruptions in cash flows also caused a serious decline in demand conditions. The pandemic seems to have caused a tougher contraction than the global financial crisis.
- High fund outflows are observed in emerging markets (EMs).
- Disinflationary pressure is increasing due to the collapse of global demand and commodity prices.
- Monetary and financial easing steps are being taken in both developed and developing countries.
- Despite high uncertainties, normalization is expected in the second half of the year. In parallel, fund flows to emerging markets are expected to recover in the second half of the year.

Domestic Economic Outlook:

- Although economic activity was quite strong in January and February, it started to slow down as of mid-March due to the negative impact of pandemic on foreign trade, tourism and domestic demand channels. High frequency data indicate a marked slowdown for the second quarter.
- CBRT expects economic activity to start recovering in the second half of the year; but economic outlook of the trading partners will be crucial in the overall recovery.
- The necessary support will be provided and the credit mechanism and the monetary transmission mechanism will work effectively.
- Public banks' credit support is important. The loans provided are CGF backed and this mechanism is limiting the risks.
- In regard to the job market, it is stated that the forecast uncertainty is very high, but measures will limit the spike in unemployment rate.

Inflation: Inflation was consistent with expectations in the first quarter of the year. Despite the depreciation in TRY and the rise of unit costs amid contraction of production and sales activity, the crash in commodity prices and total demand conditions will support disinflationary process. CBRT expects more downward pressure on inflation from July onwards. CBRT stated that the policy measures are conservative, target-oriented and predictable, and does not expect an inflationary pressure. Moreover, commodity prices and aggregate demand conditions will be decisive.

Real interest rate: CBRT stated that the expected inflation is the reference for real interest rate, adding that CBRT's policy rate offers reasonable real return given the 7.4% inflation expectation. CBRT also stated that because of the extraordinary period, real interest rates decreased in both developed and emerging markets. It is stated that the next monetary policy steps will be in line with the main trend of inflation. Real interest rates based on actual inflation readings are -2.8% for Turkey, -2.9% for Hungary, -1.4% for India, +0.1% for South Africa and +3.4% for Russia. Real interest rate is 1.3% based on year end inflation expectation at 7.4%.

Currency: CBRT stated that the depreciation in TRY was so far in parallel with that in other EMs. Since the beginning of the year, JP Morgan EM currency basket has lost its value by 14.7% and USD/TRY rate rose by 17.4%. The depreciated level of the currency, the FX deleveraging process of the private sector and the high dollarization of residents will give support to TRY.

Balance of Payments: Beside negative impact of pandemic on the EU, Turkey's major trading partner, collapse of oil prices also affected Russia, another important trading partner together with the Middle Eastern and African countries severely. Thus, exports of goods and services will inevitably weaken. On the other hand, falling commodity prices and import demand will help a moderate trend for the current account balance.

Fund flows and Reserves: In line with fall in risk appetite and global fund outflows from EMs, TRY and Central Bank reserves also see some pressure. CBRT stated that fluctuations in its reserves is normal in order to sustain financial stability, adding that reserves will be re-build once conditions restore. Meanwhile, the BRSA's swap actions helped reduce speculative volatility in the market.

Since the current balance is expected to remain moderate throughout the year, no additional pressure to reserves is expected from this side. On the financing side; the risk of additional portfolio outflow is limited since non-residents' share in bonds and equities are already at historical low. Debt roll-over rates are still high in both the banking and real sectors. Additionally, the supportive stance of global central banks and residents' strong FX holdings is expected to provide additional support.

The CBRT also stated that swap negotiations with countries with strong commercial ties and other central banks are in progress, adding that there is no negotiations with the IMF.

Monetary Policy: In addition to interest rate cuts, the CBRT supports the economy with liquidity. CBRT stated that the recent developments increased the system's funding need. Swaps and repo channels provide short-term funding and purchase of government bonds provides long-term funding. With the necessary measures maturity of funding was extended and more activity in bond market and swap transactions was observed. CBRT increased the OMM portfolio limit from 5% to 10% of its balance sheet; however, these transactions will not include purchases from the Unemployment Insurance Fund. As of April 28, the CBRT's total securities portfolio (including the Unemployment Insurance Fund) was TRY56.0bn, 8.0% of its balance sheet. It was stated that 10% rate is reasonable when compared to other EMs, and there is no need for an update yet. Moreover, private sector bond purchases are not on the agenda.

This report is prepared by Akbank Economic Research

Economic.research@akbank.com

Dr. Fatma Melek – Chief Economist

Fatma.Melek@akbank.com

Dr. Eralp Denktas, CFA

Eralp.Denktaş@akbank.com

M. Sibel Yapıcı

Sibel.Yapici@akbank.com

Meryem Çetinkaya

Meryem.Cetinkaya@akbank.com

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