

# VAKIFBANK GLOBAL ECONOMY WEEKLY

## Sustainability of low levels in core inflation in Turkey



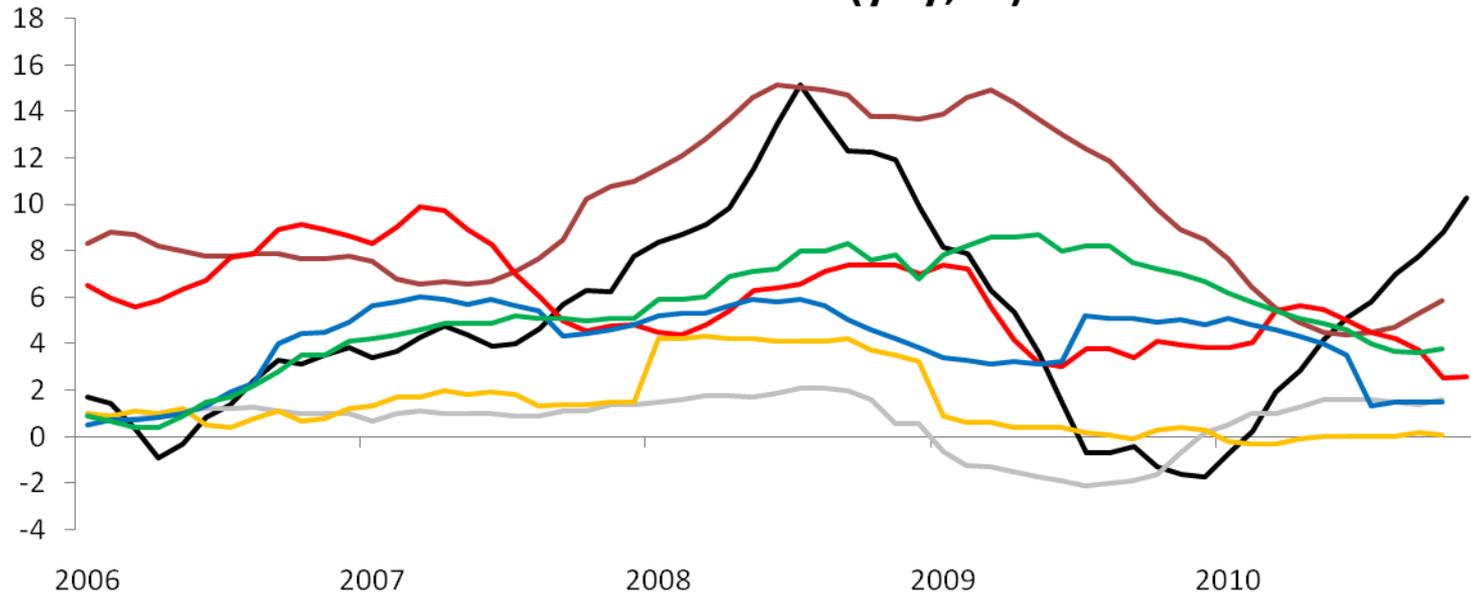
T. Vakıflar Bankası T.A.O



# Decoupling in core inflation in EMs...

*It is remarkable that Turkey has a decreasing core inflationary behavior while other EM economies have been experiencing an upward trend in core inflation. Can these low levels in core inflation be sustainable in Turkey?*

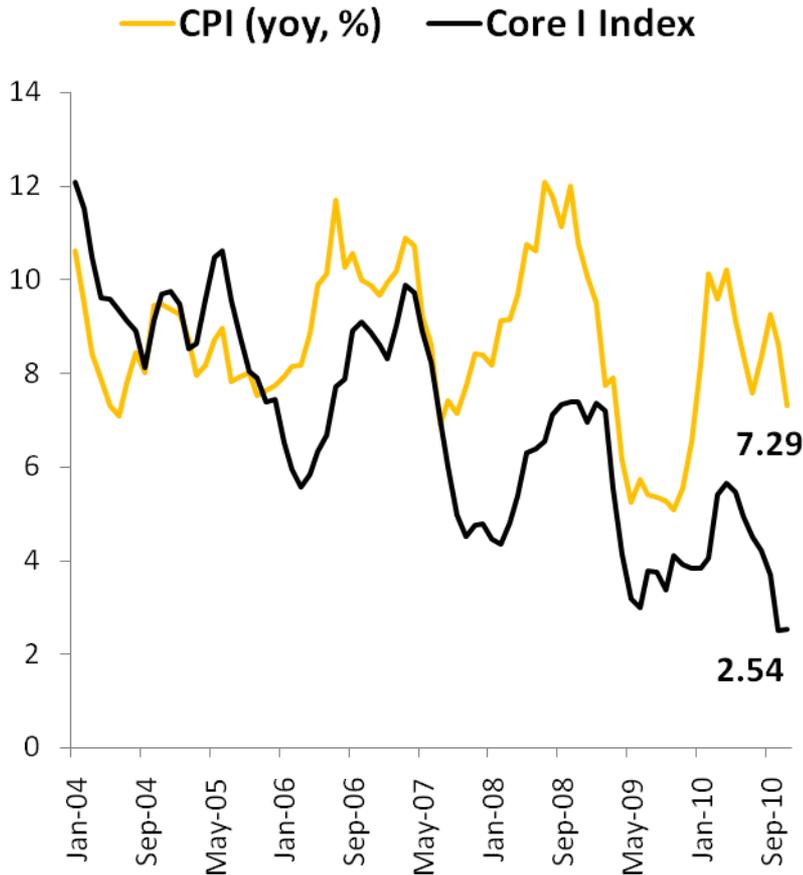
### Core Inflation (yoy, %)



— Brazil — Russia — China — Turkey — Czech Republic — Hungary — South Africa

Source: Bloomberg

# The causality relationship between headline and core inflation...

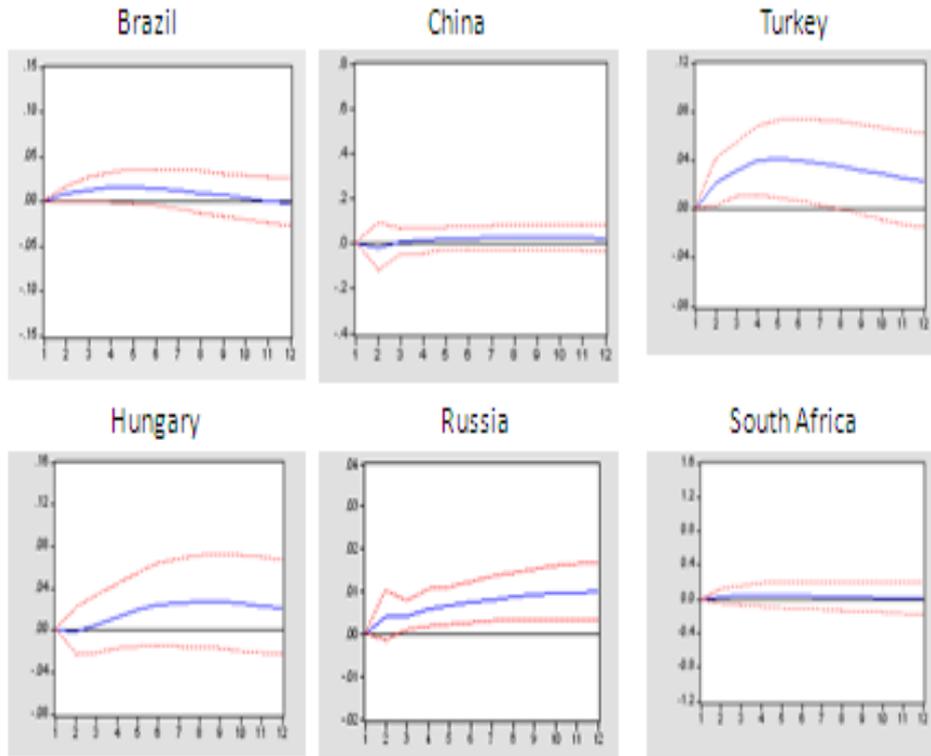


Source: CBRT

- Granger causality test results show that the core CPI does not Granger cause headline CPI, on the contrary causality direction is from headline CPI to core CPI.
- When the past periods are analyzed further to find how much headline CPI is reflected to core CPI, 0.79% correlation between the variables is calculated.
- As a result, movements in headline CPI are important for sustainability of the low levels in core inflation.

# High pass through effect of import prices in Turkey

## Response of headline inflation to import prices



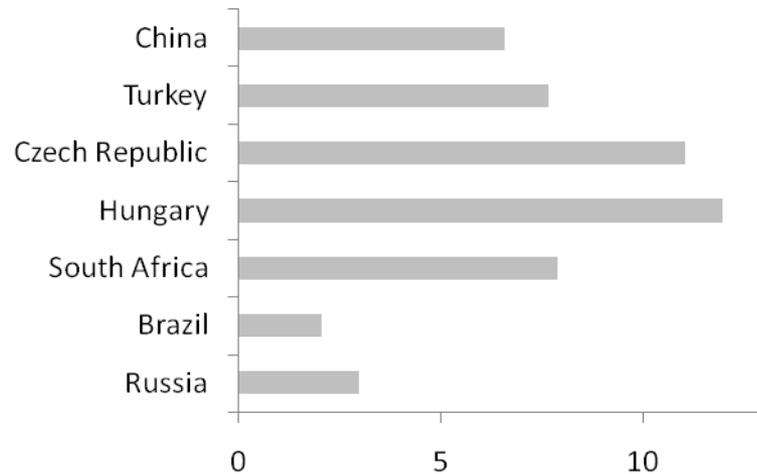
 The graphic on the left handside shows the impulse response analysis of a VAR model which we set up to analyse the response of inflation to 1 standard deviation shock in import prices.

 While response of headline inflation to import prices is positive in EMs, pass trough effect of import prices is higher in Turkey than other EM countries. Whereas the effect of import prices on CPI is low especially in China and South Africa.

Source: BIS, CBRT, World Bank, Vakifbank

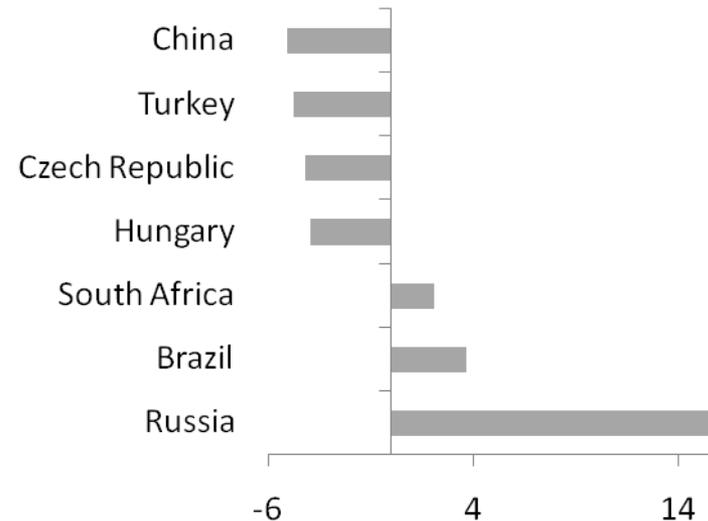
# Turkey is a highly import dependent country...

### Commodity Imports / GDP



Source: World Trade Organisation, Vakifbank  
Commodities includes agricultural products, petroleum, petroleum products and minings

### Net Commodity Export / GDP

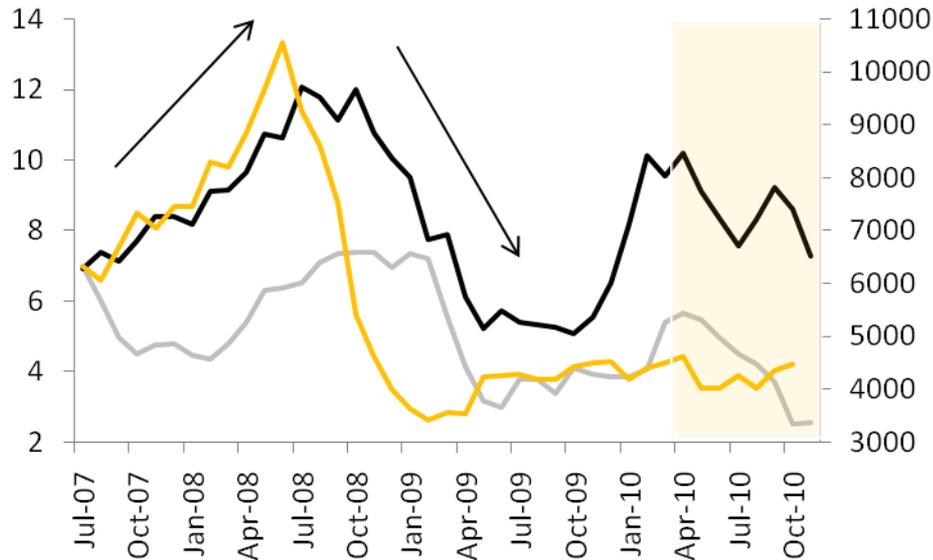


Source: World Trade Organisation, Vakifbank

 Turkey's commodity imports to GDP ratio is higher than Russia, Brazil and South Africa. In addition, Turkey's net commodity export to GDP ratio is lower than other EMs except China. In other words, Turkey is a highly import dependent country. Hence rise in commodity imports has been effective on Turkey's headline inflation.

# The correlation between CPI and commodity-energy prices is weak recently...

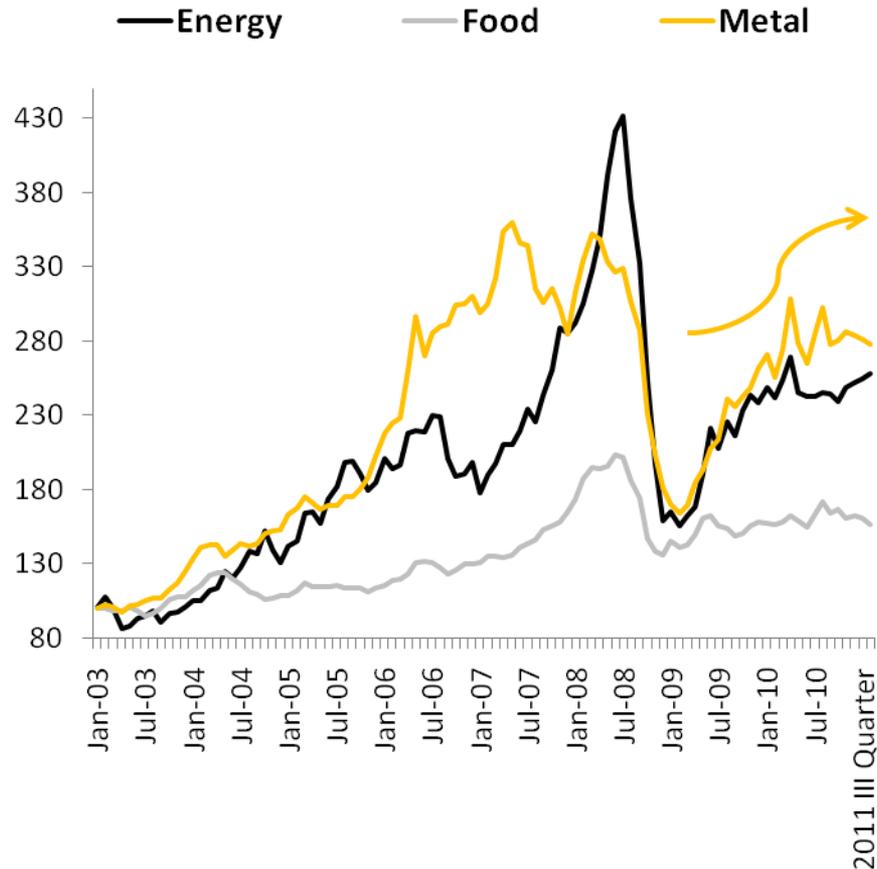
— Core CPI (yoy, %) — CPI (yoy, %) — S&P GSCI (rhs)



Source: CBRT, Bloomberg

- ▣ The graph reveals that there is a high correlation between CPI, core CPI and commodity-energy prices.
- ▣ There is a positive correlation between CPI and commodity price index after the second quarter of 2007 and it is remarkable that CPI follows negative trend of commodity price index within several months. The reason behind this low correlation between variables is the appreciation of Turkish lira.
- ▣ Although, the correlation between variables has been weak recently, fluctuation of Turkish lira may strengthen this correlation. In this case, it is expected that CPI will follow positive trend of commodity price index.

# Commodity-energy prices are expected to rise ...



Source: IMF

- According to IMF forecasts the commodity-energy prices are expected to rise in 2011.
- The pass through effect of import prices are higher in Turkey compared to other EM economies. Rising commodity-energy prices may lead to a rise in CPI after several months.
- A rise in CPI will also cause a rise in core CPI.

# The low level of core CPI can not be sustainable in Turkey...

-  The recent improvement in global demand, the recovery of labor market and rising commodity-energy prices lead to a rise in core CPI in EM economies.
-  In recent months, Turkey has a decreasing core inflationary behavior while other EM economies have been experiencing an upward trend in core inflation. Rising real effective exchange rate of Turkish lira and import dependent foreign trade composition of Turkey make Turkish core CPI decoupled from other EM's.
-  The important question is whether this low core CPI in Turkey is sustainable or not. The key point here is the behavior or trend of commodity-energy prices and the real exchange rate of Turkish lira. Since it is expected that global commodity-energy prices will have an upward trend in 2011, the inevitable result is that CPI will rise in Turkey because pass through effect of import prices is more notable. A rise in CPI will Granger cause an upward trend in core CPI depending on the Granger Causality test results. Hence, the low levels of core CPI in Turkey is not sustainable, especially in the second half of 2011 when low base effect will promote the rise in core CPI.

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