

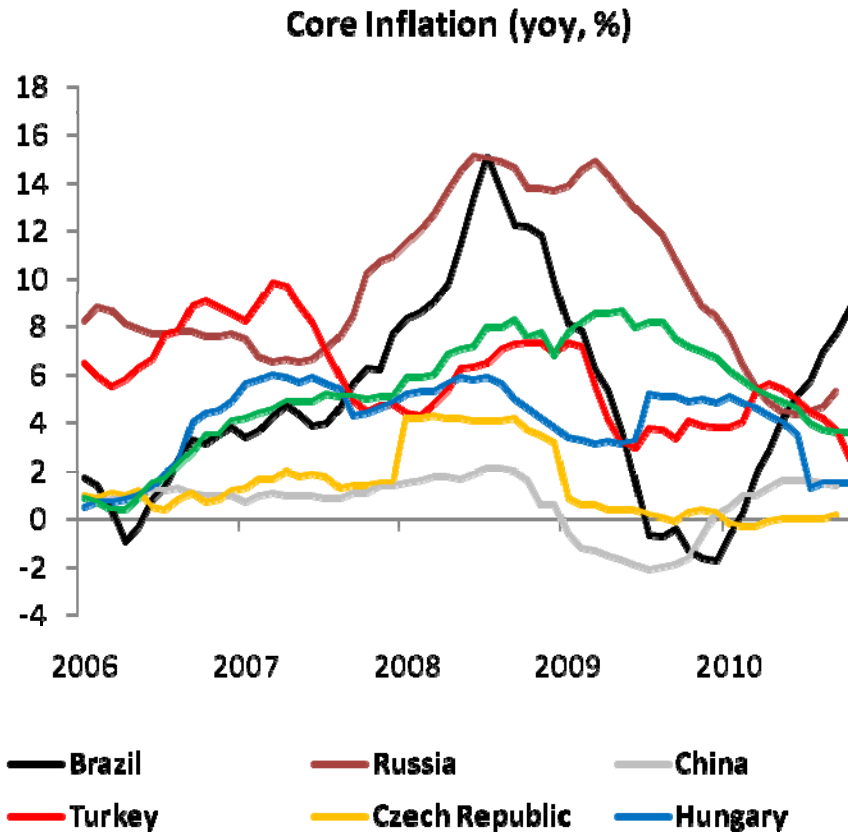
VAKIFBANK GLOBAL ECONOMY WEEKLY

Decoupling in core inflation in EMs



T. Vakıflar Bankası T.A.O

EM core inflation rates began increasing after crisis...

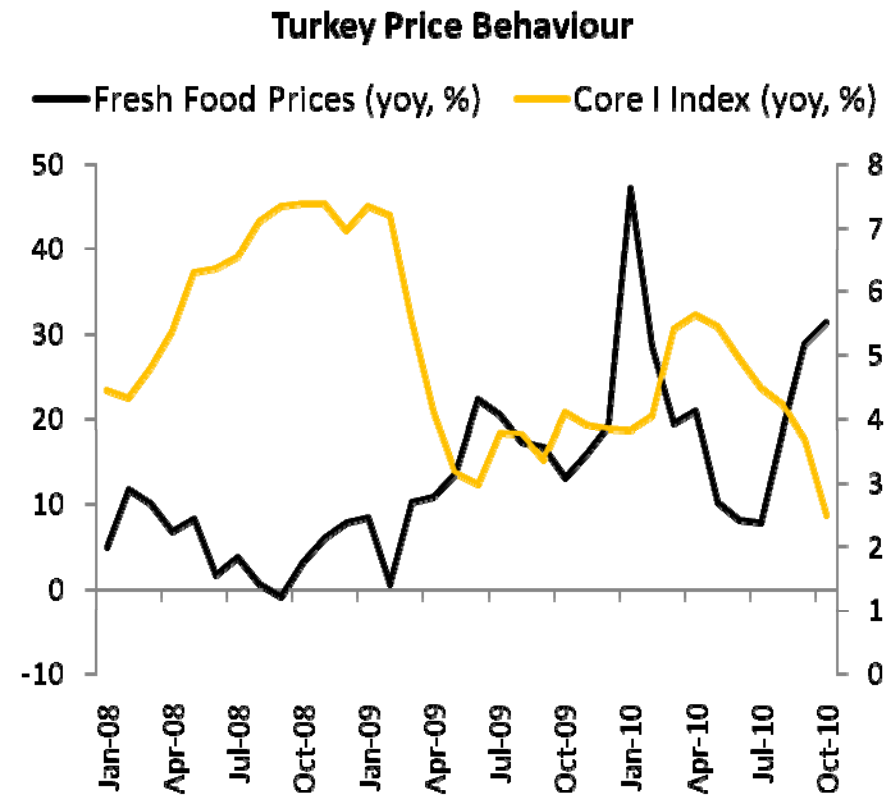


Source: Bloomberg

- EM core inflation rates which have fallen as a result of the global financial crisis began increasing since June 2009 with the start of the global recovery.
- It is remarkable that Turkey has a decreasing core inflationary behavior while other EM economies have been experiencing an upward trend in core inflation.

Turkey's core inflation is hitting historical lows...

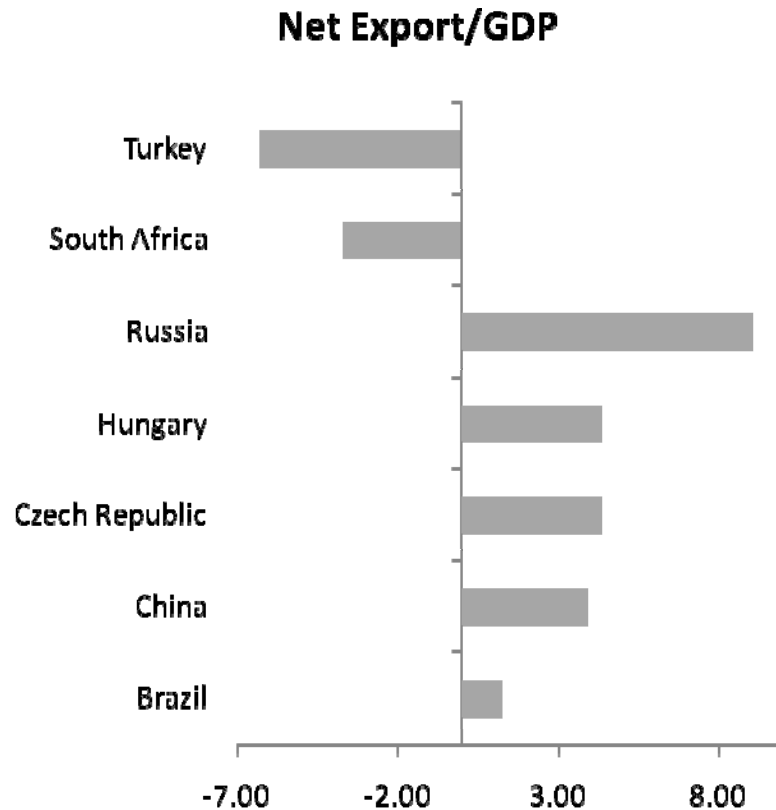
- ✔ 'I Index' known as core inflation which excludes energy, food and non-alcoholic drinks, alcoholic drinks, tobacco and gold dropped to an historical low of 2.5% in October. However, there was a sharp reversal in headline inflation driven by a surge in fresh food prices.
- ✔ Turkey's core inflation performance has been a result of Turkey's relatively high commodity import dependence compared with other key emerging economies and appreciation of TL.



Source: TURSTAT

Main reasons of decoupling of Turkey's core inflation:

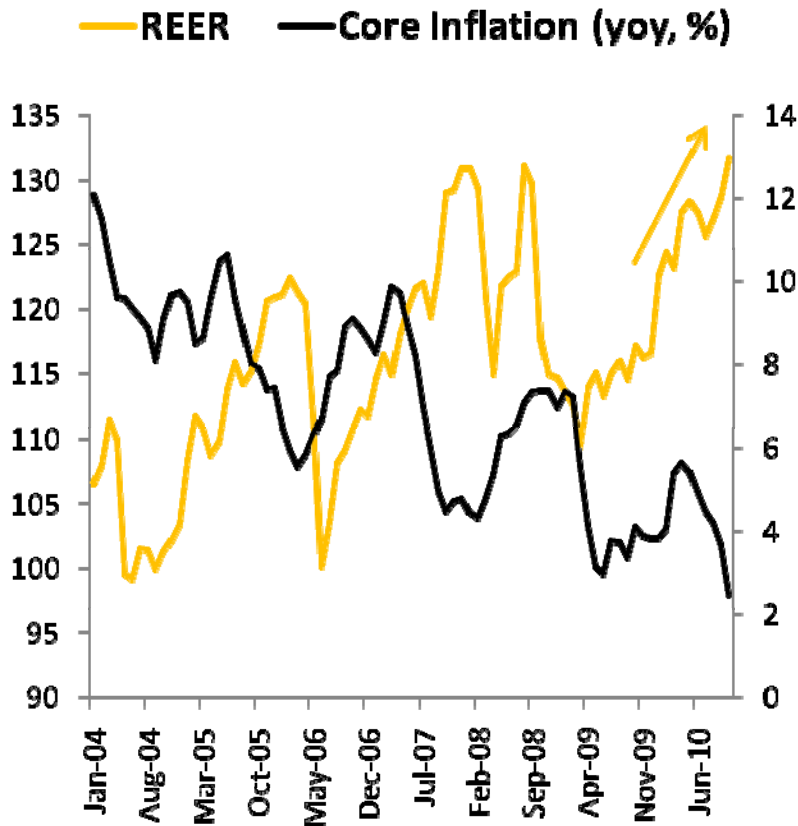
1 - High import volume of Turkey



Source: World Trade Organisation, Vakifbank

- Turkey has the lowest net export/GDP ratio among seven countries.
- Manufacturing industry in Turkey depends on intermediate goods import. Hence increasing prices in raw materials, petroleum and petroleum products directly affect producer prices.
- Appreciation in TL makes import cheaper and causes core inflation remain in historical lows.

2 – Appreciation of real exchange rate

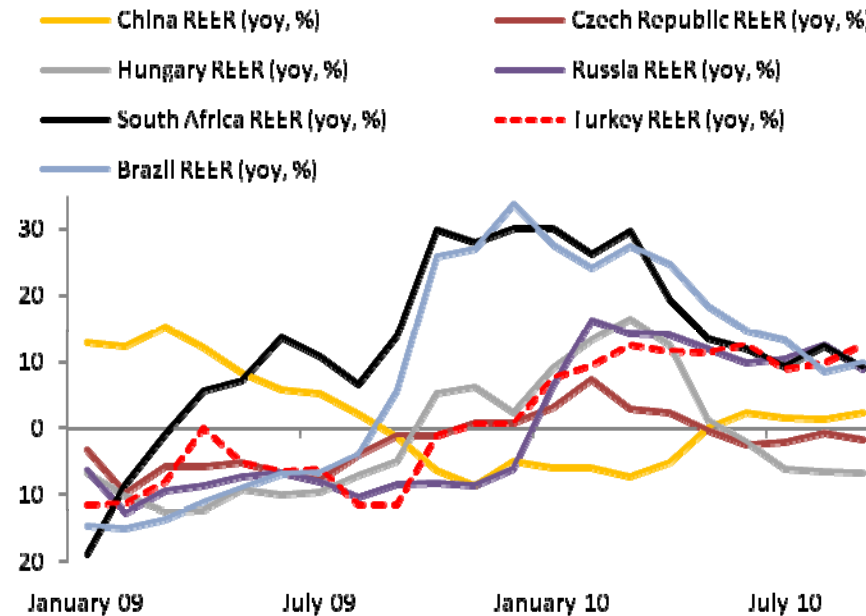


Source : CBRT

- ✎ The REER (Real Exchange Rate) refers to the purchasing power of two currencies relative to one another. It is calculated by taking into consideration the inflation rates of Turkey and its' foreign trade partners to find the change in the value of Turkish lira.
- ✎ The rise in real effective exchange rate indicates appreciation in Turkish lira which has incurred downward trend in core inflation indicators. The graphic on the left handside indicates the inverse correlation between core CPI and CPI based real exchange rate.
- ✎ According to CBRT, real appreciation in TL is resulted from differentiation in inflation rates and not from changes in nominal exchange rates. And, the real appreciation in TL could be prevented by decreasing the inflation.

Among the EMs, the sharpest increase is seen in Turkey's REER...

REER of Brazil, Hungary, Russia, South Africa and Czech Republic are decreasing since the beginning of 2010 whereas Turkey's REER is increasing.



Source : BIS

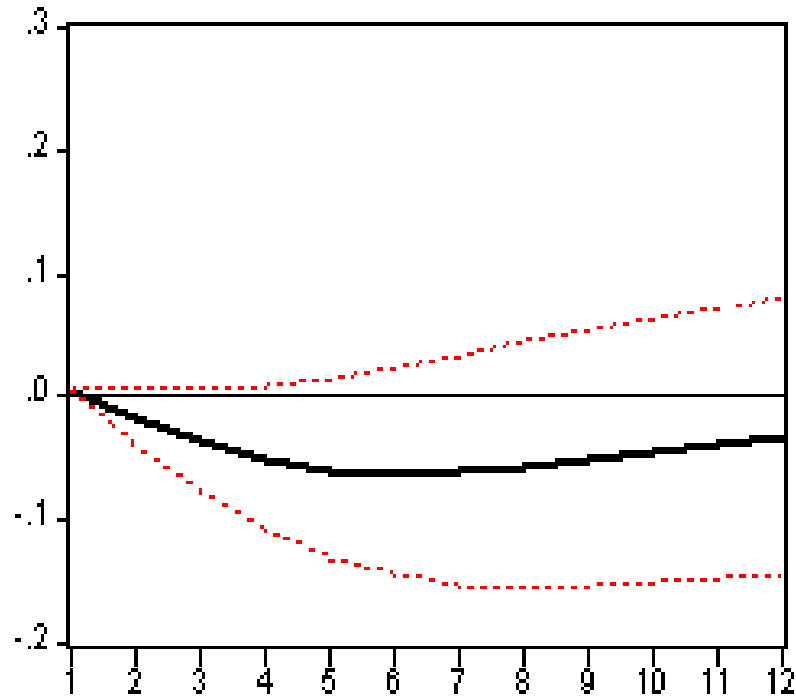
The Big Mac Index is published by *The Economist* magazine as an informal way of measuring the purchasing power parity (PPP) between two currencies and provides a test of the extent to which market exchange rates result on goods costing the same in different countries.

	Turkey	US	Adv. Countries
Big Mac	3.89 \$	3.57 \$	2-2.50 \$

Source : The Economist

The effect of movements in real exchange rate on CPI...

Response of core inflation to a shock in real exchange rate in Turkey ± 2 SH



Source: BIS, CBRT, World Bank, Vakifbank

- Depending on the VAR model which we set up to analyse the effect of movements in real exchange rate on CPI, the response of core CPI to 1 standard deviation shock in real exchange rate is presented by the graphic on the left.
- The VAR model results show that the effect of appreciation in REER is negative as expected, is lagged one period, reached to maximum level on the 6th month and maintained its effect more than 1 year.
- The model also indicates that the decrease in core inflation will continue in the future with the appreciation of real exchange rate.

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