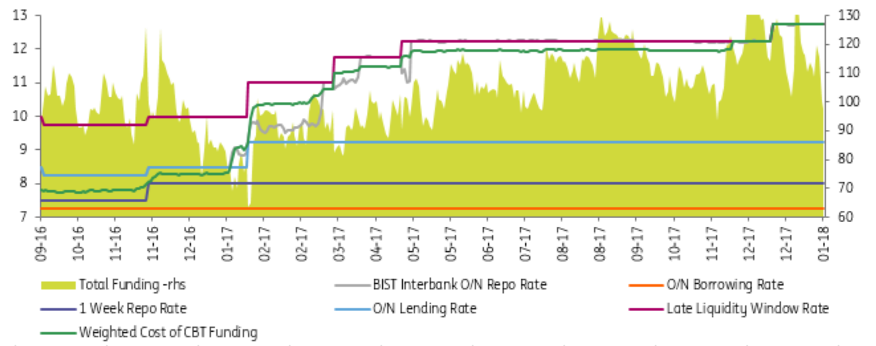
Turkey: Central bank keeps all rates unchanged

The Central Bank of Turkey kept interest rates on hold and maintained its policy guidance, as expected

Source: istock

Key CBT rates (%)



Source: CBT, ING Bank

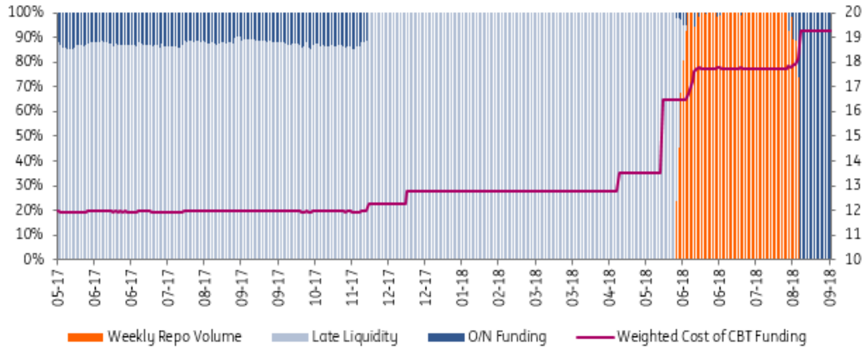
No hike in late liquidity window rate this time

At the January rate-setting meeting the CBT kept all rates stable, in line with ING's forecast and the consensus expectation. Accordingly, the late liquidity window (LLW) rate, currently the only channel for CBT funding, was flat at 12.75%, while the overnight borrowing rate, overnight lending rate and 1-week repo rate stood at 7.25%, 9.25% and 8.0%, respectively.The CBT kept its cautious stance despite ongoing gradual disinflation on the back of easing base effects. This suggests the effective cost of funding will remain stable at 12.75% in the near term, with no change in current liquidity conditions. After announcing the decision, the Turkish lira dropped slightly to below of 3.79 vs the US dollar.

The CBT to refrain from early easing

The language in the MPC statement showed some revisions. First, the CBT continued to point out that the "tight stance in monetary policy will be maintained decisively until the inflation outlook displays a significant improvement and becomes consistent with targets", but with an addition of "independent of base effects and temporary factors". It seems it is not only the pace of decline, but also the quality of improvement that will be important for the bank. This revision signals that the CBT will not bring down the effective cost of funding rate gradually in tandem with the decline in headline CPI in the coming months. While the pace of CPI inflation has been decelerating due to large base effects, it is still likely to remain well above the target range this year, hinting that the CBT will refrain from an early easing given its concerns about currency volatility and the deterioration in pricing behaviour. Although the bank revised one key sentence, it kept another one unchanged, notably that "Inflation expectations, pricing behaviour and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered". Both statements indicate a continuation of the relatively hawkish stance.

Liquidity composition (5d-MA, TRY bn and %)



Source: CBT, ING Bank

Risks remain on pricing behaviour

Regarding the inflation outlook, the bank revised its previous assessment which stated that "current elevated levels of inflation and recent developments in cost factors have increased the risks on expectations and the pricing behaviour". Now it sees that "current elevated levels of inflation and inflation expectations continue to pose risks to pricing behaviour", pointing to the fading impact of adverse cost factors. However, given that 24-month inflation expectations have risen close to the highest since early 2006, there is little room for a policy mistake by the CBT.

Robust domestic demand

On the growth side, the CBT said "domestic demand continues to expand", a change from "domestic demand conditions keep improving". Indeed, as evidenced by the latest high-frequency indicators, with robust PMI and IP prints as well as CUR and business confidence indicators, economic activity remained buoyant in the last quarter of 2017.

CBT decisions dependent on market developments

Of the two likely options in January (the CBT either remains on hold or delivers a dovish hike), the bank delivered the former attributable to (a) the expected further disinflation in the headline CPI in early 2018 (b) the somewhat tight market funding policy contributing to currency stability and (c) a benign global risk environment and a conducive backdrop for EM assets. The statement reveals that the CBT is wary of risks on pricing behaviour despite the easing base effects. The CBT's recent actions show that its rates policy seems to be driven not only by changes in the inflation outlook but also market conditions. Turkey's idiosyncratic risks and shifts in global risk appetite will likely put the currency under pressure from time to time and will remain key variables in the CBT's decision making.

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr