Turkey's central bank – not moving just yet

At the next central bank meeting, we expect the Bank to keep rates on hold at 24% and continue to closely watch price and financial stability risks

Source: Shutterstock

The central bank remains cautious on signalling any cuts

In the upcoming central bank meeting on 6 March, we expect the central bank of Turkey to keep the 1-week repo rate on hold at 24%, as the Bank continues to be cautious on signaling any rate cuts while preferring macroprudential policies for the time being. So, the central bank will likely maintain a tight stance until there is visible improvement in the inflation outlook to gradually restore credibility with potential modest cuts likely in the second quarter.

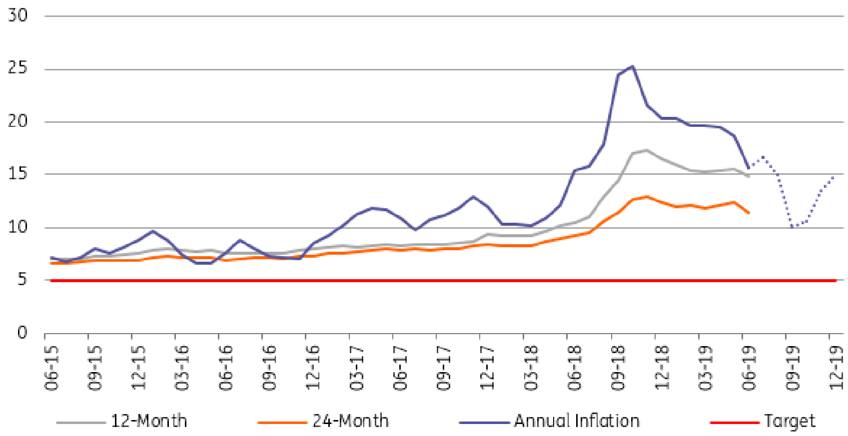
Significant downward adjustment priced in

Market pricing based on the short-end of the lira swap curve shows a significant downward adjustment until the end of the year, priced in over the current effective funding.

Improved sentiment and a significantly aggressive easing path are likely attributable to a contracting external deficit. Recovery in the trade balance is set to remain in place in the first half of the year given ongoing domestic demand and the strength in exports with the inclusion of tourism, though the pace of external rebalancing will likely slow, before gradually rising in the second half of the year.

The supportive global backdrop with a cautious Fed helps along with disinflation since October and weak domestic demand, stable currency and lower oil prices.

Evolution of annual inflation (%)



Source: TurkStat, ING Bank

Still challenging inflation outlook

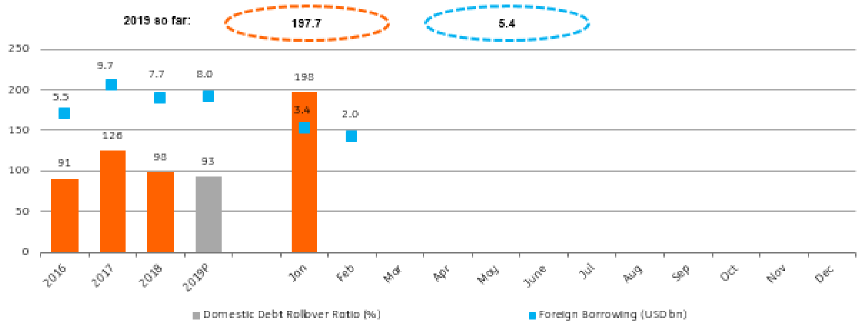
Importantly, signals from the central bank that it would avoid premature rate cuts have contributed to sentiment the most.

The Bank has shown no signs of complacency and recently came up with strong wording, promising to maintain a policy that reduces inflation to single digits in the least possible time.

This stance shows the Bank's continuing sensitivity to ongoing challenges on the inflation front. The risks on inflation remain tilted to the upside in the near term given the marked deterioration in pricing behaviour and likely reversal of supportive factors, i.e. tax cuts on consumer durables.

Risk of the lira coming under pressure again can't be ignored, given upcoming elections and geopolitical issues and fragile capital flows mainly driven by government re-leveraging recently with US$5.4billion borrowing from international financial markets this year until mid-Feb (US$3.4 billion in4Q18) vs US$8 billion target for 2019 and still large external financing needs.

The Treasury's domestic and external borrowing



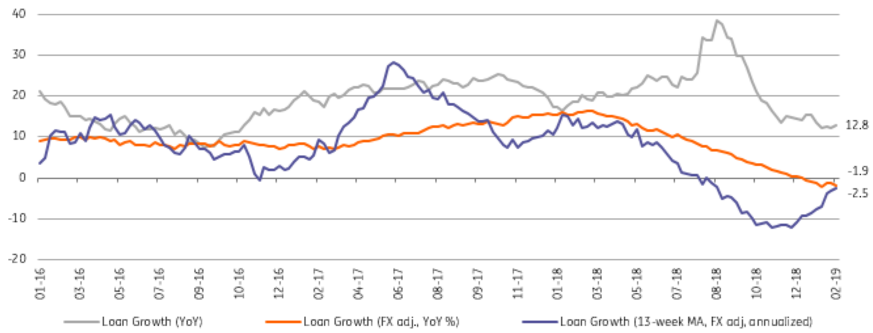
Source: Ministry of Treasury and Finance, ING Bank

Adjustment in reserve requirements to support lending

Given domestic deleveraging cycle with the current lending indicators point to a sharp negative credit impulse on the back of asset quality issues, declining banking sector external rollovers and elevated rates, efforts to boost lira liquidity attract attention.

Accordingly, the central bank cut the lira reserve requirement (RR) ratios in mid-February by 100bp for deposits and participation funds with maturities up to 1 year and other liabilities with maturities up to 3 years, and by 50bps for all other liabilities, injecting an estimated TRY 3-3.5 billion lira liquidity and US$2-2.5 billion FX liquidity to the banking system.

Volume Growth



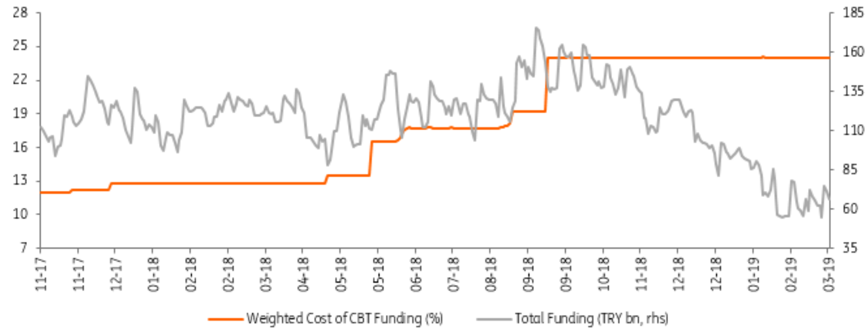
Source: BRSA, ING Bank

Lira liquidity has been improving

Momentum indicators on the lending side (the 13-week average annualised growth rate) that were deeply negative towards the end of the year have been improving lately, though FX-adjusted credit growth is still negative, justifying macro-prudential easing moves from the central bank to support recovery.

Another signal of bolstering lira liquidity is a downtrend in the central bank's funding to the banking sector, more evident in early 2019.

Central bank funding



Source: CBT, ING Bank

Overall, we expect the central bank to remain on hold this month, keeping a hawkish bias with a promise to deliver policy tightening if needed until the disinflation trend becomes more pronounced.

However, the Bank may further resort to macro-prudential tools in the near term to support credit growth. So, the central bank will remain in wait-and-see mode and closely watch price and financial stability risks, as well as deterioration in the growth outlook.

Author

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

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