Turkey central bank preview: Committed to deliver

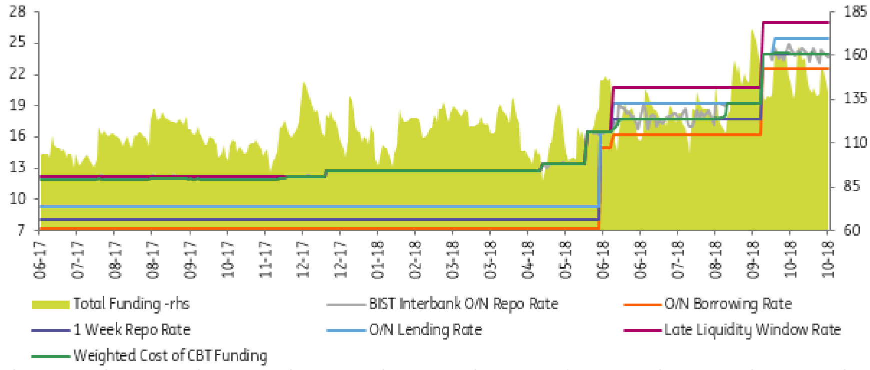
We expect the Central Bank of Turkey to hike its policy rate to 21% with a recalibration of monetary policy in response to weakness in the currency and a further deterioration in the inflation outlook. We think the bank will maintain its commitment to further action after the release of the Medium-Term Economic Program

Source: shutterstock

Expecting a rate hike to 21%

The CBT has already responded to the plunge in the Turkish lira in August by tightening liquidity via shifting funding from the one-week repo auctions to the upper band of the interest rate corridor, with a consequent 150 basis point rise in the effective cost of funding to 19.25%. The bank also took some other “low-level measures,” including adjustments in reserve requirement ratios and changes in coefficients of the reserve option mechanism. At the September MPC meeting, we expect the CBT to hike its policy rate (one-week repo) by 325 basis points to 21% while also returning to full funding from weekly repo auctions.

Key CBT rates (%)



Source: CBT, ING Bank

The CBT has signalled an adjustment in its policy stance

Following the release of August inflation data, the bank signalled an upward adjustment in policy rates to stop the Turkish lira slide and restore price stability, with the bank stating that "it would take the necessary action to support price stability. Accordingly, the monetary stance will be adjusted at the September MPC meeting in view of the latest developments". Our MPC call translates into 175 basis points of effective tightening from the current funding cost level. Such a move would pull the overnight lending rate and late liquidity window (LLW) rate to 22.5% and 24%, respectively.

Price stability top of agenda

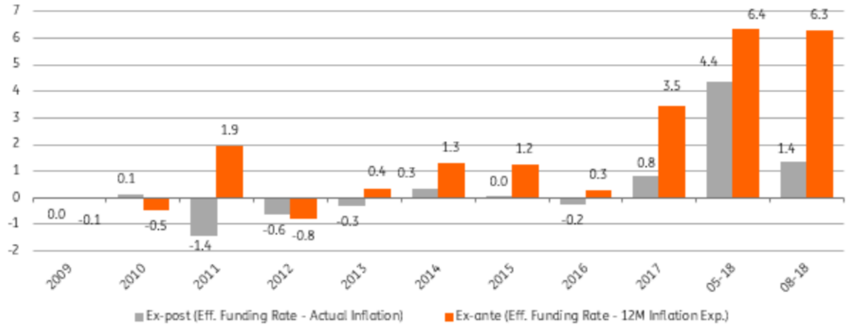
Despite relatively benign food inflation- mostly on the back of unprocessed foods- the latest August data presents a bleak picture, with general upward pressure across various sub-components, accelerated further by a sharp TRY depreciation as well as administrative price adjustments. Looking ahead, we expect inflation to increase further towards the 20% handle as the lira's depreciation continues to work its way through to prices. The performance of the Turkish lira and food prices will be key drivers of CPI.

Ex-post real CBT funding rate narrowing since May

The ex-post CBT funding rate, which has been low or sometimes even negative since the global crisis, has significantly eroded again after a sharp adjustment in May with a spike in CPI. Inflation expectations over 12- and 24-months have trended upwards in recent years to a near record, with the former hitting 12.96% and the latter at 10.67%. A further deterioration would create additional pressure on the real policy rate.

On the flip side, the ex-ante CBT funding rate is high by emerging market standards, slightly above 6 percentage points as of the end of August. But a further deterioration in the risk attitude towards Turkey in the face of the current inflation uptrend, along with other ongoing macro vulnerabilities, point to the importance of keeping the rate buffer strong.

Real Interest Rate (%)



Source: CBT, ING Bank

Possible actions by the MPC

Given this backdrop and the CBT's commitment to deliver, there are three possible lines of action at the upcoming MPC, in our view:

- *Matching the current market pricing and/or exceeding expectations:* Market pricing based on the short-end of the TRY swap curve points to c.450 basis points of upward adjustment priced in over the current effective funding at 19.25%, close to 24%. Back in May, we saw a strong reaction from the CBT but given the TRY plunge and its implications for growth and inflation, which have left the policy rate behind the curve, the bank could come up with a front-loaded hike.
- *Measured hike to extend ex-post real policy rate buffer:* Given that headline CPI inflation could be close to 20% in a few months, the CBT may opt to hike the one-week repo rate to around 21-22%. Depending on the extent of adjustment in fiscal policy to support disinflation efforts, we could see further action at the October MPC. At the July meeting, one of the reasons the bank kept rates unchanged was so policymakers could see the contribution of fiscal policy to the re-balancing process, as the MTP was released. This may keep the bank's policy action measured once again given that the fiscal response would determine the scale of the policy rate hike. As aforementioned, we see this action as highly likely.
- *Leaving the corridor system entirely and shifting to a single policy rate:* In the statement following the August inflation release, the CBT suggested it could "reshape the monetary stance". Given the strength of the wording, the bank could come up with an unprecedented move of removing the one-week repo rate and picking the overnight lending rate as the key policy rate, which was the case before the introduction of the current corridor system in 2010. Such a move would be unlikely though as the CBT has defined simplification as funding banks from the one-week repo rate.

Policy reaction of the CBT to be key for the markets

Overall, a less supportive global backdrop with US dollar strength, geopolitical issues and macro imbalances have been factors that have shifted the focus to Turkey in emerging markets, with significant volatility in domestic financial markets pulling TRY to the lowest level since the 1994 crisis in REER terms, and bond yields to the highest since the global financial crisis.

Given the large FX debt service requirement of the economy- as overall external financing needs remain high with low reserve adequacy- the authorities should be quick to act with credible measures to restore confidence. Accordingly, the policy reaction of the government and the central bank will be key for the stabilisation of domestic financial markets.

The MPC took no action in July due to a moderation in economic activity with milder demand conditions and as it awaited the lagged impact of earlier policy tightening and fiscal policy measures. But we expect the CBT to deliver this month by hiking the policy rate to 21%, with a measured recalibration of monetary policy in a response to the ongoing weakening in the currency and further deterioration in the inflation outlook. We also expect the bank to maintain its commitment to deliver more policy action after the release of the MTP to help restore confidence.

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