Turkey central bank to remain on hold this time

After the 625bp front loaded hike last month and the recent lira strengthening feeding optimism that geopolitical risk for Turkey has been improving, we expect the central bank to stay on hold

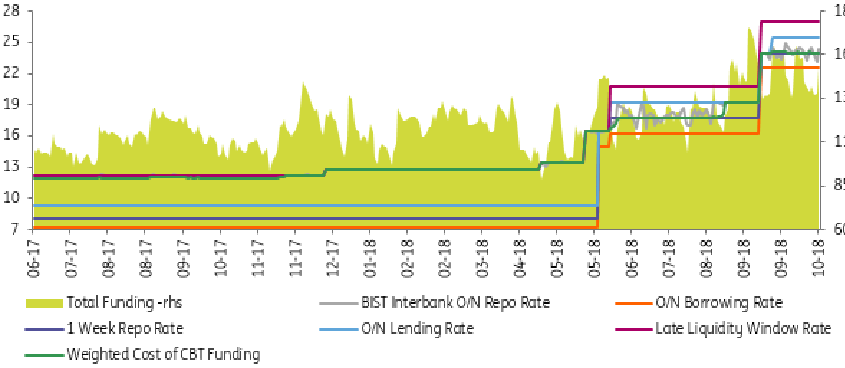
Source: istock

We're not expecting a hike but the risks to our call are to the upside

Given the 625 basis point front loaded hike in September, the ongoing strengthening of the lira on the back of Pastor Brunson's release and subsequent signals from the US on lifting some sanctions have all been feeding optimism that geopolitical risk for Turkey may finally be improving - we expect the central bank of Turkey to keep on hold rates at 24.0% at the next meeting.

However, given the marked deterioration in price-setting behaviour as observed by the big inflation surprise in September and forward-looking expectations, a further adjustment in monetary policy to push the ex-post real policy rate back to positive levels should not be ruled out.

Key central bank of Turkey rates (%)



Source: CBT, ING Bank

Recent policy actions have supported the lira

The lira has outperformed its peers since early September thanks to the central bank's reaction in the form of a sharp rate hike, making the currency the highest yielding in the emerging market space in nominal terms and the new program is a step in the right direction, as it acknowledges the need for a soft landing and improvement in external imbalances while anticipating strong fiscal performance and a return to fiscal discipline.

Signs of improvement in the geopolitical picture

The lira has further strengthened in recent weeks in line with the emerging market bounce and better news flow on political issues including the release of US pastor Brunson, statements from the US that some sanctions could be lifted after the release and finally a more conciliatory US tone for reducing Turkey's imports of Iranian oil before the resumption of US sanctions in November.

All this points to improvements in the geopolitical picture that will likely support capital flow outlook. Recent sovereign supply with books 3x oversubscribed and strong US participation with 60% up from the Treasury's previous bond issues, demand for Turkish risk remains in place.

Improving external balances contributes to the lira sentiment

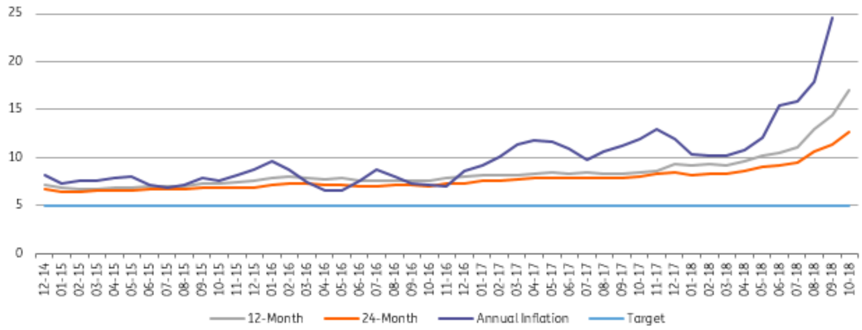
Finally, the ongoing improvement on external imbalances on the back of rapid weakening in domestic demand sharply weighing on imports as evidenced by the first current account surplus in August for the first time since September 2015 that was also the largest monthly current account surplus on record may continue to support the lira rebound sentiment.

Accordingly, the latest 625bp tightening at the September MPC meeting and the strengthening TRY performance are factors that can lead the CBT to keep rates unchanged this month. Also, market pricing based on the short-end of the TRY swap curve shows a limited upward adjustment (around 50bp) priced in over the current effective funding.

Lira strength helps ease FX pass through and improves financial stability

The current recovery process in the lira could reduce some repercussions that we have witnessed since early 2018 (1) declining FX pass through on inflation, given the high correlation between TRY performance and core inflation, and (2) improving financial stability with improving operating environment of Turkish corporates that have a large short FX position. That would be a relief factor for the central bank despite continuing vulnerabilities.

Inflation Expectations (%)



Source: CBT, ING Bank

Inflation outlook and uptrend in expectations are still concern

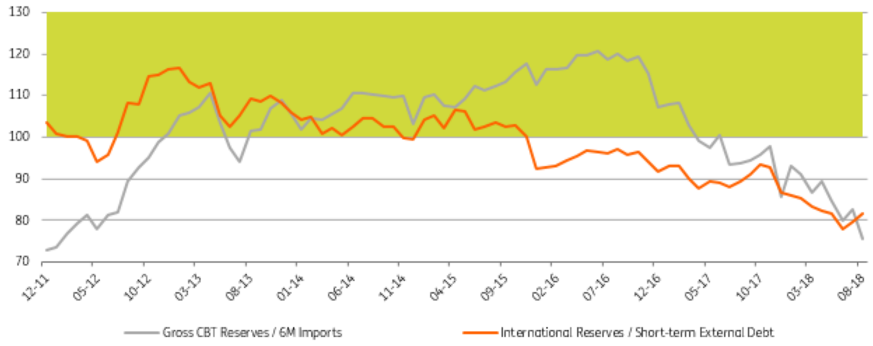
It should be noted that the risks to our call are to the upside, continuing fundamental macroeconomic challenges, such as inflationary pressures. Consumer prices with a big surprise in September recorded the highest monthly inflation since the 2001 financial crisis, pulling the annual figure to 24.5% from 17.9% in August. Core inflation also increased from 17.2% a month ago on a yearly basis to 24.0% as the significant TRY depreciation leads to a faster pass-through.

With the broad-based pick-up in price pressures and across-the-board increases in all major price categories, the continuation of the exchange rate impact and strengthening cost-led price pressures as evidenced by annual PPI inflation widening above 46%, headline CPI is likely to rise further in coming months. With oil prices under pressure lately because of supply-driven factors, inflation outlook will likely remain challenging for Turkey, while the impact of the 10% price cut campaign on the inflation trend may be a relief factor, to some extent.

According to the CBT’s latest expectations survey, year-end inflation is expected to rise to a 24.22% vs an estimated 19.61% in September. 12M and 24M expectations have also maintained uptrend with the former is up 17.03% (the highest since late 2003) and latter to 12.7% (all time high since the start of data collection in Mar-06) from 14.46% and 12.7% a month ago, respectively. The inflation outlook should increase pressure on the CBT.

Reserve Adequacy* (%)

* Total Reserves (Including Gold at the CBT and Banks Correspondence Accounts) / Net Debt due in 12M (Debt at Offshore Branches and Affiliates are excluded)

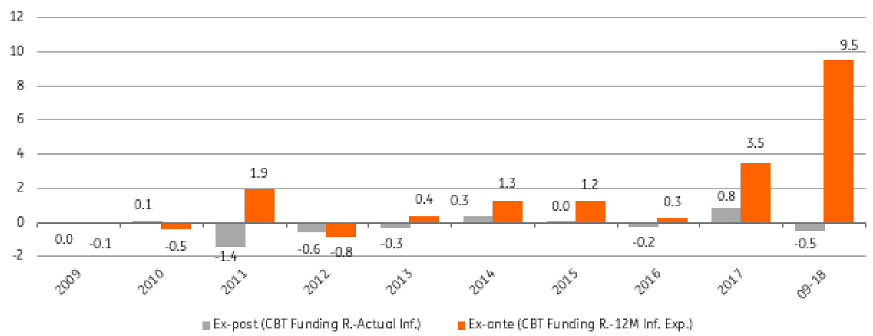


Source: TurkStat, CBT, ING Bank

Downtrend in FX reserves attracts attention

Additionally, Turkey does not have a sizeable FX reserves, at USD84.4bn (including gold) as of 12 October with a significant USD31.7bn decline since 16 February this year just before the start of TRY's long weakening trend. Some reserve adequacy indicators show that international reserves cover roughly 82% the short term external debt, while the CBT has 76% of the reserves it requires for the coverage of 6-month imports.

Real Interest Rate (%)



Ex-post real rate at the negative territory currently

So, there is a risk of a further hike given that the ex-post real rate has fallen into negative territory again, while fragility of the risk attitude towards Turkey in the face of the current inflation uptrend along with other ongoing macro vulnerabilities as well as low reserve adequacy, imply the importance of keeping rate buffer strong.

Overall, following a front-loaded hike last month that helped support the central bank's credibility and the recent performance of the currency, we expect the CBT to remain on hold this month and confidence to continue, while it will likely maintain hawkish bias with a promise to deliver policy tightening if needed.

However, still deteriorating inflation outlook with surge in forward-looking expectations, additional measured policy tightening should not be ruled out to push the ex-post real policy rate towards positive territory again.

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