Turkey: Central Bank to stay on hold in December

Speculation has been mounting that the Central Bank of Turkey (CBT) may be able to cut its policy rate earlier than expected, following some favourable news on inflation. But we think the bank will keep rates on hold at 24.0% this month, as an easing in the stance is not yet warranted

Source: iStock

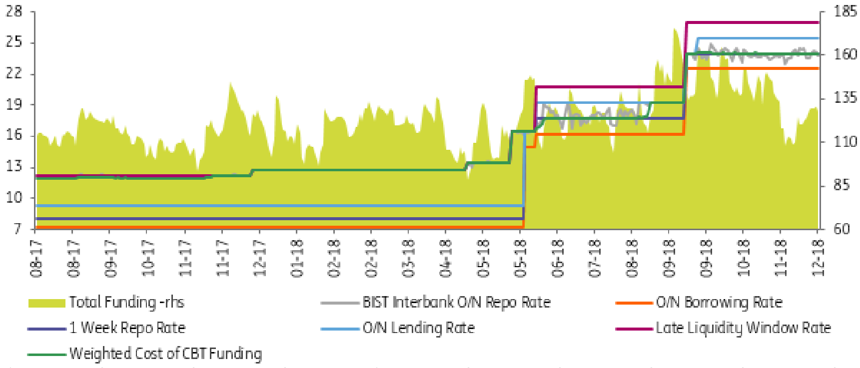
No hike expected

We're not expecting a hike this month due to:

1. The short-term favourable trend in inflation
2. The sharp recovery in the Turkish lira, which has contributed to financial stability
3. The relatively supportive global backdrop for Turkey helped by lower global energy prices

But we're not expecting a cut either, despite growing speculation that the central bank might reduce the policy rate earlier than expected. We expect the CBT to keep rates on hold rates at 24.0% this month, as conditions for easing at this meeting are not warranted.

Key CBT rates (%)



Source: CBT, ING Bank

CPI inflation markedly lower than the consensus in November

With the lowest monthly figure since the inception of the current inflation series in 2003, yearly inflation in November posted its sharpest monthly decline in more than ten years (-1.44%). The favourable reading is largely down to tax cuts in consumer durables, furniture and automobiles introduced by the government in early November. The government's decision to freeze prices in targeted items in the consumer basket along with voluntary help from the private sector to offer temporary price discounts has kept a lid on inflation, as has a sharp decline in oil prices.

The impact on goods' inflation has been clear, plunging from 29.6% a month ago to 24.5% with significant contributions from energy, unprocessed food and core goods. However, sticky services inflation remained broadly unchanged at 14.7% despite price drops in transportation services.

Despite market pricing on rate cuts, the CBT should remain cautious

The recovery of the currency since September has boosted optimism on the inflation front, while market pricing based on the short-end of the TRY swap curve shows a significant downward adjustment-close to 250 basis points priced in by May- over the current effective funding. However, the CBT should remain cautious as:

1. There has been a significant deterioration in inflation expectations, according to the CBT's surveys, with 12-month and 24-month expectations on an uptrend throughout all of 2018. The former is at the highest level since late 2003 while the latter is at the highest level since this data was first collected in March 2006.
2. There is a risk of fiscal easing ahead of the March local elections.
3. The currency is still fragile as seen in recent days, with rapid moves likely attributable to a recovery in oil prices, concerns about a change in the CBT's tight stance and an end of the temporary cut in withholding tax collected from TRY deposits.

Inflation outlook to remain challenging in the near term

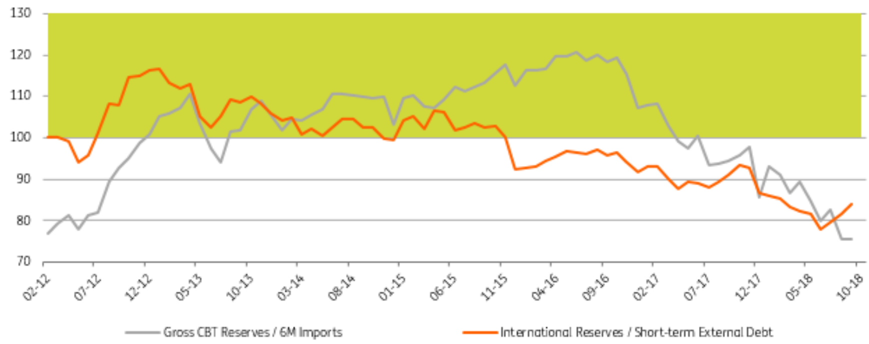
It should also be noted that we'll likely see some further inflationary pressures in early 2019 before falling more rapidly in the second half given the impact of a reversal in temporary tax cuts and unfavourable base effects. As the outlook remains challenging, the CBT should maintain a tight stance to fight inflation and re-anchor inflation expectations, as policy credibility will remain key in the period ahead.

Sharp drop in FX reserves this year, despite a recovery lately

Additionally, Turkey does not have sizeable FX reserves, at USD91.0 billion (including gold) as of 30 November with a significant USD25.1 billion decline since 16 February this year, just before the start of TRY's long downtrend, though we have seen some recovery since mid-October. Some reserve adequacy indicators show that international reserves cover roughly 84% the short-term external debt, while the CBT has 80% of the reserves it requires for the coverage of six-month imports.

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)



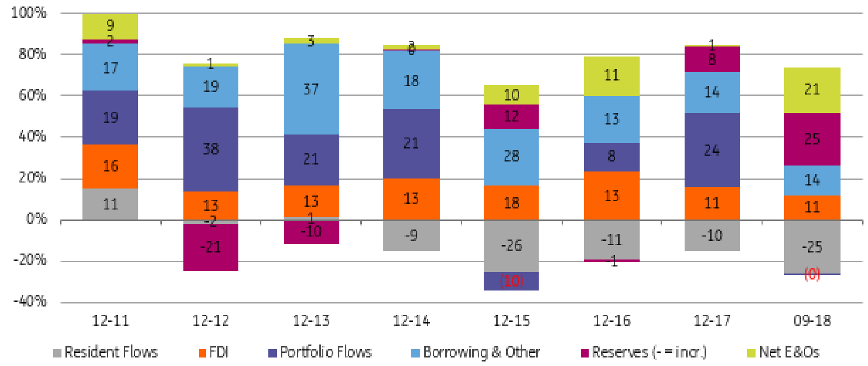
Source: TurkStat, CBT, ING Bank

Fragile external financing situation

Not only does Turkey have a low reserve adequacy it also has a weak capital flow outlook, with reliance on net errors and omissions and reserve depletion to fund the current account deficit in the last 12 months. This should reduce the possibility of an early rate action by the CBT.

1. External funding will likely remain challenging in the period ahead with asset quality risk in the banking system and the risk of policy easing in the run-up to the elections
2. The global backdrop could turn less supportive for countries like Turkey with further US dollar strength, there should be little room for the CBT to start easing policy in the near term.

Breakdown of current account Financing (USDbn, 12M rolling)



Source: CBT, ING Bank

> Overall, we expect the CBT to remain on hold this month, while it will likely maintain its hawkish bias with a promise to deliver policy tightening if needed. This is due to continuing challenges on the inflation front, the risk of the TRY coming under pressure again, low reserves and currently fragile capital flows. So the CBT will remain in wait-and-see mode and closely watch price and financial stability risks, as well as the ongoing deterioration in the growth outlook.

Author

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

Disclaimer