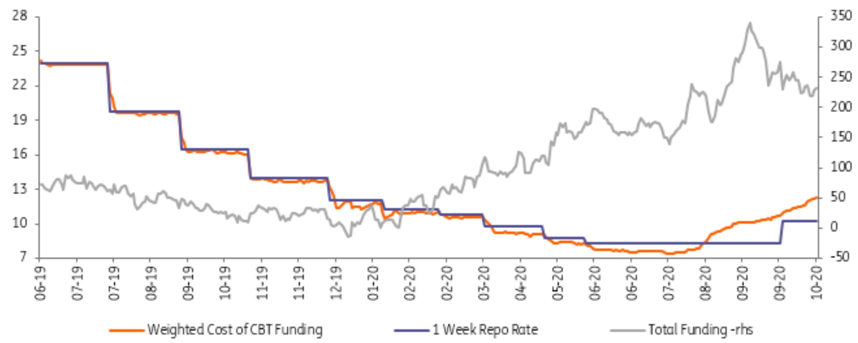
Turkey: Another rate hike on the cards

Turkey's central bank has maintained tightening measures in October to control inflation and support the currency. At the next meeting, we expect the Bank to hike rates again bringing the policy rate to 11.75% from 10.25%

Source: Shutterstock

Turkey's central bank funding (Rates in %, Funding in TRY billion)



Source: CBT, ING

Following a surprise policy rate change last month, Turkey's central bank has further raised its effective cost of funding rate to above 12% in a continuation of its previous tightening measures to control inflation and support the currency.

At the next meeting, the Bank is likely to continue tightening the policy rate to 11.75% translating into a 150 basis point hike. An outright hike, as we saw last time will be more effective especially in restoring credibility. In our view, the central bank's recent decision to raise the one-week currency swap rate that generally moves in tandem with the policy rate, by 150bp to 11.75% should also be an early signal.

The pandemic has made the policy mix highly accommodative with unprecedented credit stimulus, jump in base money and a plunge in real rates. Widening external imbalances, weak capital flows, higher dollarisation and worsening inflation dynamics contributed to price and stability concerns - all increasing pressure on policymakers for some normalisation since late-July.

In the framework of policy normalisation, the BRSA i) relaxed asset ratio twice, easing government intervention in banks' portfolio decisions 2) cut macro-prudential limits on offshore swap transactions 3) reduced the general maturity limit for consumer loans 4) loosened limits on TRY transactions with foreign banks.

These moves are targetted to slow down credit formation and support non-residents flows. The impact of these steps has been seen given that FX adjusted lending volume have been broadly unchanged since early September with a significant momentum loss in comparison to March-August period, though further deceleration may be needed to control the deterioration in the external deficit.

In addition, the government cut withholding tax on TRY deposit accounts and FX transactions tax in early October with an objective of supporting TRY deposits in locals' portfolio preferences. Such steps will likely continue to hamper FX demand by local investors and to attract capital inflows.

On the central bank front, the Bank made adjustments in reserve requirement framework and started tightening via an outright hike in the policy rate and changing funding composition. In the current setup, the CBT has been using 1-month repo auctions (interest rate being determined by the liquidity conditions) along with the upper band of the rate corridor (at 11.75%) and late liquidity window (at 13.25%) in providing liquidity to the banking system.

This allows the Bank to push the effective cost of funding up the late liquidity window rate, implying a relatively small room from the current level.

> Another rate hike will provide further flexibility to tighten liquidity and raise the effective funding rate if required.
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> Given that end-year inflation expectations are slightly below 12%, according to the central bank's latest survey and additional room to tighten by 300bp to newly set late liquidity window rate to be at 14.75%, such a move would provide more support to ex-post real interest rates.

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