Central Bank of Turkey initiates rate cuts with 250bp and narrows the corridor

At the December Monetary Policy Committee meeting, the CBT cut its policy rate by 250bp to 47.5%, which was more than the consensus forecast of a 150bp reduction, but in line with our expectation and narrowed the interest rate corridor from 600bp to 300bp

Fatih Karahan, Turkey's central bank governor

At the final MPC meeting of the year, the Central Bank of Turkey (CBT) initiated an easing cycle as widely expected and cut the policy rate by 250bp to 47.5%, though expectations related to the size of the cut varied between 100bp-to-250bp. Additionally, the CBT narrowed the interest rate corridor from 600bp to 300bp (by setting the overnight borrowing and lending rates 150 basis points below and above the policy rate), returning to the width before the March 2024 meeting. Given excess liquidity in the system, creating downward pressure in ON rates being sterilised by the CBT through net open market operations (OMO), and sell-side TL currency/gold swap auctions (reverse swap), the narrower corridor will reduce the volatility in ON rates and push closer to the policy rate.

The governor's remarks at the introduction of the latest Inflation Report in early November signalled the start of rate cuts as he explained that keeping the policy rate unchanged implies a more restrictive monetary stance as inflation and inflation expectations decline. Accordingly, we saw a revision to the statement last month with an implicit guidance on real rates and setting the scene for the start of gradual rate cuts in line with a decline in realised and expected inflation. Given this backdrop of raising expectations for a rate cut in December, recent developments have also added to them, including i) a lower-than-expected 30% hike in minimum wage, implying a measured 1ppt additional impact on the headline inflation and ii) eight planned MPC meetings in 2025 vs twelve originally, hinting at a higher size of rate cuts per meeting.

In the December statement, the CBT has kept the policy guidance with a continuing commitment to i) keep rates higher for longer until a significant and sustained decline in the underlying trend of monthly inflation and convergence of inflation expectations to the CBT's projected forecast range and ii) determine the level of the policy rate in a way to ensure the tightness required by the projected disinflation path, taking into account both realised and expected inflation. The CBT also added a relatively hawkish message and stated that it would take its decisions "prudently on a meeting-by-meeting basis with a focus on the inflation outlook". While implying a continuation of interest rate cuts in the period ahead, the addition to forward guidance shows that the cuts will depend on the data, but not be aggressive and uninterrupted.

In the MPC note, the other points worth mentioning are:

- Regarding the assessment of the inflation outlook, while acknowledging flat underlying trend in November the CBT has remained cautiously optimistic as it sees leading indicators point to a decline in the underlying trend in December with a moderation in unprocessed food inflation after an elevated course in October and November.
- For domestic demand, the bank assessed that domestic demand continues to slow down in the last quarter in currently disinflationary levels.
- The CBT continues to expect a significant contribution from increased coordination of fiscal policy to the disinflation process. The government announced some actions recently, including an increase in withholding tax collected from dividends, introduction in tax for e-commerce transactions, more than 40% adjustment in some administrative fines. This implies that the government is taking some steps towards the 3% budget deficit target for 2025, supporting the CBT view.

All in all, given the expected normalisation in unprocessed food prices leading to the higher-than-expected November inflation, growing evidence of an economic slowdown and recent CBT signals implying the initiation of an easing cycle, the bank cut the policy rate in December. While the cut was 250bp with a message implying data-driven, cautious, and meeting-based decision-making, the spread between overnight borrowing and lending narrowed to 300bp. The narrowing of the corridor would prevent a significant decline in ON rates with the excess liquidity.

Author

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

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