Central Bank of Turkey responds sharply to deteriorating inflation outlook

Following the stronger-than-expected inflation and recent FX pressures, the Central Bank of Turkey (CBT) hiked its policy rate by 500bp to 50% and announced a large set of macro-prudential measures and significant efforts to mop up excess TRY liquidity. These moves will likely further ease concerns about the CBT's disinflation priority

Fatih Karahan, Turkey's central bank governor

The CBT hiked the policy rate (1-week repo rate) by 500bp to 50% at the March MPC meeting, while the prevailing market call, including our own, was for no change. The market expectation was mainly based on the view that the bank would prefer to see the impact of the additional quantitative and macro-prudential tightening steps introduced since the February MPC as a response to the increased pressures on inflation and FX. Additionally, the CBT widened the interest corridor from 300bp to 600bp (by setting ON borrowing and lending rates 300 basis points below and above the policy rate). This change will provide further room to increase the effective cost of funding to the upper band by delivering additional liquidity tightening, if needed. Following the decision, USD/TRY declined to below 32.0 from above 32.4 levels.

When we look at the economic and financial developments ahead of the MPC meeting, February data has shown that risks to the inflation outlook have increased significantly. The headline inflation trend (on a seasonally-adjusted basis) has remained elevated at above 4% month-on-month, significantly higher than the CBT's projections, which saw a 3% MoM average rate in the first half of this year excluding January (2.5% MoM in 3Q24 and 1.5% MoM in 4Q24). In addition, there has been some pressure on FX and reserves lately, leading to an increase in the pace of TRY depreciation and a sharp decline in the CBT's net reserve position. In the last one month, the CBT has taken a series of additional tightening measures to strengthen the monetary transmission mechanism. These moves will likely lead to a sharp slowdown in TRY lending with a significant adjustment in lending and deposit rates (around 200-300bp, according to the CBT data in the last two weeks).

Despite a strong non-rate reaction tightening financial conditions and expectations that the CBT would prefer to wait for the March inflation print and the initial impact of the macro-prudential moves, it delivered a 500bp hike "in response to the deterioration in the inflation outlook". In its assessment, the bank acknowledged the i) higher than expected underlying monthly inflation trend ii) resilient domestic demand and reiterated inertia in services inflation, geopolitical risks and food prices as the key drivers of inflation.

Given the ongoing risks to the inflation outlook, the CBT kept its forward guidance unchanged. The bank restated that the "monetary policy stance will be tightened in case a significant and persistent deterioration in inflation outlook is foreseen". This implies that the bank is keeping the door open to additional hikes depending on inflation data. However, given the widening in the interest rate corridor, the bank may initially prefer to utilise the interest corridor and push the effective cost of funding to the upper band. Additionally, the current level of policy interest rate will be maintained as long as needed as the bank reiterated two qualifiers to start cutting: i) a significant and sustained decline in the underlying trend of monthly inflation ii) convergence of inflation expectations to the CBT's projected forecast range. Finally, the CBT reiterated the pledge for further macro-prudential moves "in case of unanticipated developments in credit growth and deposit rates".

Following the tightening deployed, the CBT seems confident that the tight monetary stance will lead to i) a decline in the underlying trend of monthly inflation by moderating domestic demand, ii) real appreciation in TRY, and iii) improvement in inflation expectations. Accordingly, the bank expects that "disinflation will be established in the second half of 2024". Disinflation in line with the CBT's projection will increase the chances of rate cutting towards the end of 2024, in our view.

> Overall, the outlook in key indicators has partially turned less favourable since January given still strong domestic demand, inflation expectations that have not improvede, stagnation in portfolio flows, continuing fiscal pressures, signals of acceleration in lending and a drop in reserves. In response, the CBT delivered on all fronts with an unexpected and strong rate hike, a large set of macro-prudential measures and significant efforts to mop up excess TRY liquidity. These moves will likely further ease concerns about the CBT's plans to bring down inflation, contribute to support both local and foreign investors' confidence in TRY assets and help anchor inflation expectations.

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