Turkey: Gradual approach in policy normalisation

The Central Bank of Turkey hiked rates less than expected at the June rate-setting meeting and signalled that it would tighten monetary policy at a gradual pace going forward while the macro-prudential framework will also be gradually simplified based on its impact analysis

The Central Bank of Turkey in Istanbul

Amid rising expectations of a rate hike and monetary policy normalisation, Turkey's new central bank governor, Gaye Erkan, raised interest rates less than expected on Thursday. The CBT raised the policy rate to 15% from 8.5% vs widely dispersed market expectations ranging from the low double digits to 40%, with an average of around 20%. As signalled earlier, the decision and the statement show that the switch to orthodoxy will be gradual, but more so than envisaged earlier.

On the inflation front, as of May, the headline CPI and core inflation were at 39.6% and 46.6% year-on-year, respectively, implying a significant gap with the policy rate even after the MPC's decision. Considering that inflation expectations based on the CBT's Market Participants survey stand at 30.65% for the 12 months ahead, and at 18.12% for 24 months ahead, it will take time to reach a policy rate level that is more consistent with the objective of re-establishing price stability.

The reason for the gradual approach seems to be the continuing political cycle. With upcoming municipal elections in March next year, a substantial loss of momentum in economic activity and possible strains in the labour market in the near term would not be a welcome development. Policymakers have also been cautious about the implications of a quick adjustment in rates on credit card and SME borrowing, as such borrowers have relied heavily on low real interest rates in the last few years. So managing risks related to corporate and banking sector balance sheets is also likely to be a reason for this gradual approach.

Despite the under-delivery vs the consensus, the CBT's statement recognised the deterioration in the inflation outlook by pointing to the increase in the underlying trend as well as the "strong course of domestic demand, cost pressures and the stickiness of services inflation" as major drivers. Its guidance also noted that "monetary tightening will be further strengthened as much as needed in a timely and gradual manner until a significant improvement in the inflation outlook is achieved".

The bank also revised its other forward guidance stating that "indicators of inflation and the underlying inflation trend will be closely monitored and (it) will continue to decisively use all the tools at its disposal in line with its main objective of price stability." However, there was no clarity on a likely move at the July MPC meeting at this point. Whether the CBT adheres to the normalisation process and brings the policy rate up to a level consistent with achieving sustainable disinflation will be closely followed by the markets going forward.

In line with expectations, the CBT signalled that it would "simplify and improve the existing micro- and macro-prudential framework". Again, the approach here will be gradual as the bank stated that it would be "guided by impact analyses" and "the simplification process will be gradual". Accordingly, alternative instruments, i.e the long list of regulatory measures as well as the FX-protected deposit scheme, will likely continue for a while, though to a lesser extent than before.

> While the width of the rate corridor has been unchanged, the effective cost of funding via open market operations will likely remain around the policy rate.

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