Surprise rate cut from the Central Bank of Turkey

The CBT cut the policy rate by 100bp to 18%, citing transitory factors on inflation and a weakening in corporate lending

The Central Bank of Turkey

With a surprise move in the September rate setting meeting, the CBT cut the policy rate by 100bp to 18% citing a need to revise the policy stance. The market was not expecting a move this month, except for some adjustments in the policy guidance and judging that the bank would wait a few more months despite increasing question marks after the recent shift in rhetoric regarding core inflation.

There are key changes related to the policy guidance:

1) While the market is closely watching the level of real rates after the August inflation exceeded the policy rate, the CBT signalled changes to the statement in recent weeks that “The policy rate (...) to be determined at a level above inflation” with a new emphasis on the growing divergence between the headline inflation and non-food inflation. Now, this sentence was removed from the statement.

2) Regarding the timing of a rate cut, the CBT had reiterated since May that “the current stance will be maintained until the significant fall in the Inflation Report’s forecast path is achieved”. While following a higher path than the inflation report envisaged, base effects that will be in play in the

last two months of the year would likely provide room for the central bank to act in the fourth quarter. However, the CBT made an early move putting forward its inflation assessment and credit developments as the factors requiring a revision in the monetary policy stance and leading to a reduction in the policy rate.

- For inflation, the CBT saw the ongoing uptrend in inflation attributable to pressures from food and import prices, supply constraints and the effects of the reopening as "transitory" and hence downplayed ongoing inflationary challenges.
- Regarding the credit developments, while the bank seemed satisfied with the Banking Regulation and Supervision Agency's latest macro prudential measure limiting the maximum period of consumer loans over TL50,000 to 24 months from 36 month to curb retail lending, it was concerned about "higher than envisaged contractionary effect" (of) "the tightness in monetary stance" on commercial loans.

3) Finally, while the CBT underlined its commitment to "use all available instruments decisively in pursuit of the primary objective of price stability", it added with further specifying that it would do so "until strong indicators point to a permanent fall in inflation and the medium-term 5% target is achieved".

> With the new focus on a relatively benign core inflation in comparison to the headline, the CBT's revised approach should be a signal that it is ready to cut further and seize the opportunity as long as financial stability objectives allow it to, however fragile capital flows, higher risk premium and level of dollarization will remain limiting factors for the central bank. In the near term, the CBT's less restrictive policy stance will likely weigh on the exchange rate outlook, and further deteriorate expectations adding to already high inflationary pressures.

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