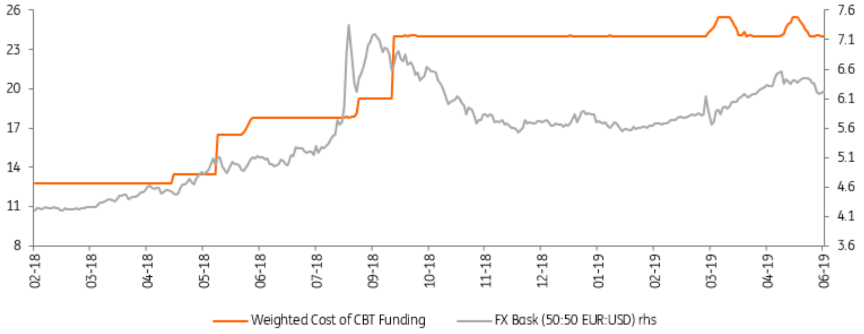
Turkey's central bank to keep policy rate on hold

Despite improving pricing pressures and recent TRY strength, the CBT will likely maintain its current policy stance and avoid any premature policy rate adjustment in order to maintain price and general financial stability

In the June rate-setting meeting this week, we expect the CBT to remain mute again and keep the 1-week repo rate on hold at 24%, despite the swap curve suggesting a modest policy easing in the period ahead.

Cost of CBT Funding vs TRY



Source: CBT, ING Bank

After a short period of funding the banking sector at an expensive ON lending facility at 25.5%, the CBT restarted 1-week repo auctions, implying a fall in the effective funding rate to 24%. Despite an initial negative reaction to the CBT move, the TRY has appreciated significantly in recent days on the back of:

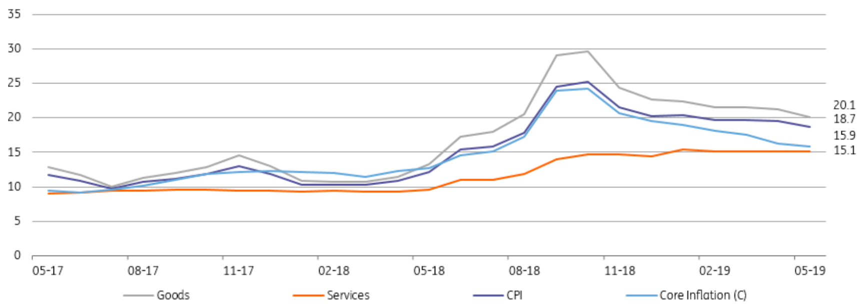
a) A supportive global backdrop: market expectations of Fed rate cuts have risen further given weakening prospects for global trade and global investment

b) Lower oil prices: Brent has declined sharply in recent days amidst global growth concerns, contributing TRY strength and

c) Positive news flows on geopolitics especially in the context of Trump-Erdogan phone call

d) Improving price pressures with a downside surprise in May, reflecting the weakening in domestic demand. The monthly reading pulled annual inflation down to 18.7% from 19.5% a month ago, thanks to lower than expected food, clothing, and home appliances inflation.

Inflation Outlook (%)



Source: TurkStat, ING Bank

Despite the supportive environment, we do not foresee a rate cut, in line with consensus, given:

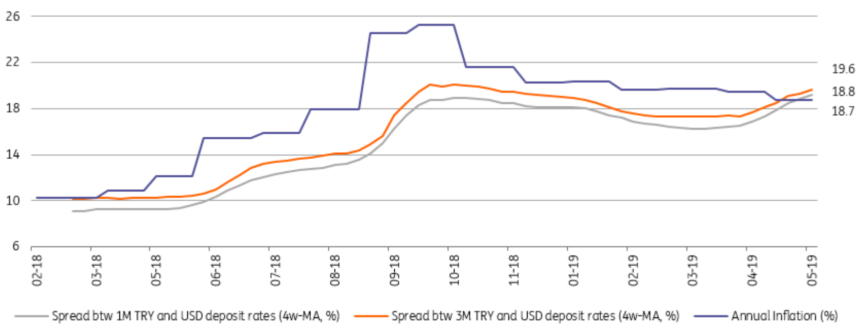
a) A challenging geopolitical backdrop increasing event risks in the near term

b) Despite easing in the headline and core, inflation dynamics have remained difficult as annual services inflation remained unchanged in May at 15.15%, close to the highest level realized for the first time since early 2004, reflecting inertia and relatively high cost factors notwithstanding the weakening in growth momentum

c) A deterioration in the budget performance this year so far on the back of continuing weakness in tax generation and strong growth in primary expenditures. Weak economic activity and spending pressures along with ongoing uptrend in interest expenditures pull 12M rolling budget deficit to the above of the target set for 2019 in New Economy Program

d) The dollarisation trend in deposits: reflecting the impact of elevated inflation and low real return in TL investments (despite recent widening in interest rate differential between FX and TRY deposits), residents have increased their FX deposits by close to US$32 billion since September, mostly driven by households. The trend takes the share of FX deposits to more than 55% of the total in late May.

Interest rate differential btw FX and TRY deposits



Source: TurkStat, CBT, ING Bank

Overall, we expect the CBT to remain cautious on signalling any rate cuts, while the main policy guidance sentence, after the revision in the April MPC, will likely be unchanged. So, despite improving pricing pressure and the recent TRY strength, the CBT will likely maintain the current policy stance and avoid any premature policy rate adjustment to maintain price stability and support financial stability.

We think the CBT will start a gradual cutting cycle in September, with the one-week repo rate reaching 22% at the end of this year. A continuation of a supportive global backdrop with more accommodative global central banks would increase the possibility of an earlier easing move, while reviving currency volatility impacting the disinflation trend would remain a key variable for the CBT in the policy implementation.

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