Turkey: To cut or not to cut?

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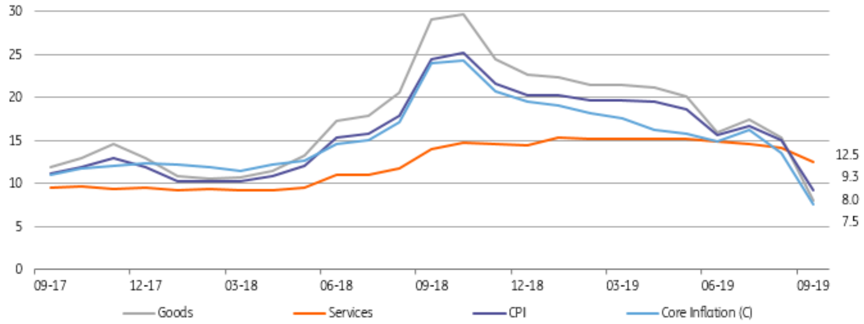
The Turkish Central Bank in Ankara

Following large easing moves in 3Q with the increasingly more accommodative stance of global central banks and improving price pressures, the CBT had signalled a more cautious approach that would be conditional on the inflation path. Given the easing geopolitical tensions and subsequent market rally including an improvement in the currency, with an agreement between the US and Turkey on Northern Syria, the bank will likely consider cutting the policy rate by 100bp to 15.5% in the rate-setting meeting on Thursday, in our view.

Inflation Trend (%)



Source: TurkStat, ING

In recent months, the surprisingly positive inflation releases pulled the annual figure to single-digit territory thanks to still weak domestic demand, moderating pass-through, easing cost-push factors and a favourable base along with further correction in unprocessed food prices despite some administrative price adjustments. Accordingly, the CBT felt more confident about the strength of the ongoing disinflation trend and came up with frontloaded moves in a deep easing cycle amounting to 750 bps in the last two MPC meeting; there was also the contribution of a supportive global backdrop. Regarding the latest interest rate announcement note in September, the CBT seemed confident about its moves as "the current monetary policy stance, to a large part, is considered to be consistent with the projected disinflation path", also signalling more measured pace of easing in the remainder of 2019.

October witnessed significant volatility in local financial markets due to increasing geopolitical concerns. Accordingly, the swap curve in early October, pointing to a large, more than 300bp, easing until the year-end, shifted significantly towards pricing no move by the CBT in the remainder of this year given recent developments and the subsequent rise in the risk premium. However, the agreement between the US and Turkey last week has contributed to a significant drop in risk anticipation with a recovery in market sentiment and consequent strengthening in the exchange rate. This has supported market pricing, currently indicating around a 200bp rate cut in the last two MPC meetings of this year.

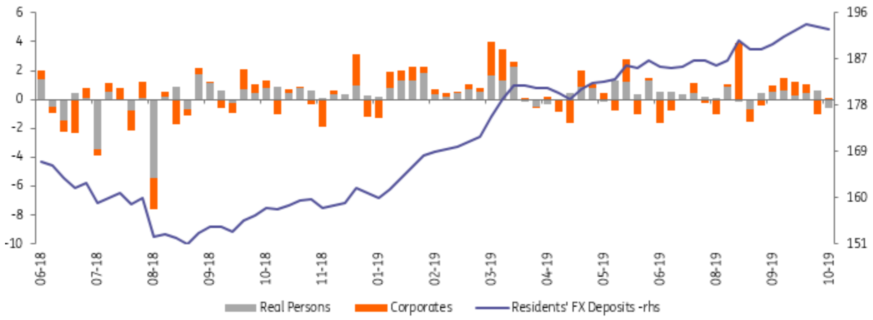
> *The improving geopolitical backdrop should come as a relief to the CBT*

The improving geopolitical backdrop should come as a relief to the CBT and we expect it to continue the easing cycle with a 100bp cut this month. The inflation path should also provide room if we consider the official end-year projection at 12.0% showing the extent of the improvement in the outlook comparing the CBT's 13.9% forecast in July inflation report. We think, it will likely remain in single digits in October and reverse thereafter because of unsupportive base effects, closing the year at 12.8%, though still supporting the case for further monetary easing in the October MPC.

It should also be noted that the risks are on the upside and the CBT may remain mute given:

1. still not well-anchored inflation expectations, high inertia especially in services inflation, and uncertainties surrounding the exchange rate path
2. economic policy uncertainty in the global environment with likely impact of trade tensions on growth prospects, despite the projected easing in global financial conditions
3. challenging macro backdrop with ongoing high dollarisation, subdued capital flow outlook, and close to all-time low consumer confidence levels.

Residents' FX Deposits (US$ billion)



Source: CBT, ING

Overall, we expect the CBT to maintain the easing bias on the back of still weak domestic demand and faster than expected disinflation and to come up with a slower easing pace in comparison to the previous moves. However, the recent acceleration in geopolitical newsflows and subsequent currency volatility weaken the case for further easing as the CBT may opt to be more cautious in an effort to strengthen credibility.

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