Turkey's central bank announces further macroprudential and liquidity tightening

While the Turkish central bank left its policy rate unchanged at 50% as expected, it also announced macroprudential and liquidity tightening moves following the recent developments in credit growth and deposits and to mop up excess liquidity in the system

The Central Bank of Turkey in Istanbul

At the May rate-setting meeting, the Central Bank of Turkey kept the policy rate flat at 50%, in line with the consensus and our call. In the statement, the bank cited the lagged effects of monetary tightening, though it dropped the reference to "a significant tightening in financial conditions". It also maintained the tightening bias, still leaving the door open for further hikes if required by the inflation outlook, and restated that the MPC remains highly attentive to inflation risks.

The forward guidance was unchanged as the CBT, in addition to the continuing tightening bias, pledged to keep the current level of policy interest rate as long as needed and reiterated two qualifiers to start cutting:

1. A significant and sustained decline in the underlying trend of monthly inflation
2. A convergence of inflation expectations to the CBT's projected forecast range.

In the inflation report published in early May, the 2024 CPI inflation forecast was raised to 38.0% while the 2025 forecast was kept at 14.0%. According to the market participants' survey in May, the expectations for 2024 and 2025 recorded a slight decline to 43.6% and 25.6%, respectively. Expectations for the next 12 and 24 months, on the other hand, improved to 33.2% and 21.3%.

Since the beginning of April, thanks to strengthening expectations that the tight policies implemented after the elections would continue, the supply of FX has increased rapidly amid:

- The downward trend in residents' FX deposits, which are down by US$13.2bn since the end of March until May 10, exceeding the US$10.4bn cumulative increase in the three weeks prior to the March hike in rates
- Increased foreign inflows, with bond and stock purchases at US$5.8bn between end-March and the first 10 days of May. Accordingly, we have seen a notable increase in the CBT's FX purchases during this period exceeding US$50bn.

The key outcome of the improvement in the CBT's FX reserves has been an increase in the banking system's TRY liquidity. The bank's net OMO funding has turned more negative, paving the way for a decline in ON rate from 53% to around 47% in recent days. Given this backdrop and the focus on keeping deposit rates supported, the CBT announced a number of measures including:

- Higher reserve requirements on TRY deposits and FX-protected deposits
- Adjustments in reserve requirement remuneration rates, conversion and renewal target FX-protected deposits
- Excluded corporates' FX-protected deposits from the target calculations. Given prospects for further reserve accumulation, these moves will likely help to keep TRY deposit rates elevated and sterilise excess TRY liquidity in the banking system.

While TRY loan growth decelerated as a result of the tightening in rates and monthly growth caps, FX lending continued to gain momentum, recording a more than US$15bn increase on a year-to-date basis, translating to close to 12% year-to-date after a long period of contraction. This weighs on the effectiveness of the monetary transmission mechanism and leads to gradual currency risk accumulation in the corporate sector. Accordingly, the CBT extended the 2% monthly growth cap on TRY loans to FX loans and decided that for the amount of the loan exceeding the limit, banks would hold TRY-denominated required reserves for one year. The move will likely further contribute to a moderation in the banking sector credit growth in the period ahead.

Regarding the macro outlook, the MPC stated that domestic demand slowed down but imports of consumption goods remained high. Going forward, the CBT's stance with the additional tightening moves announced today will contribute to a return to the disinflation path, while support from the fiscal policy will likely be limited given the relatively small size of the recently announced package of measures, which include cutting purchases of goods and services and investment spending to control the widening in the budget deficit. Assuming the currency follows a more stable course for the rest of the year with the continuation of the tight monetary stance, we expect inflation to be in the CBT's forecast range with the central bank keeping the policy rate on hold at 50% for longer. We factor in a small cut by end-2024.

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