Turkey: Central bank on hold amid inflation risks

The Central Bank of Turkey has turned more cautious lately, signalling a gradual shift towards policy normalisation

The Turkish Central Bank in Ankara

Following the end of its long rate cutting cycle last month, the CBT remained on hold and kept the policy rate (one-week repo rate) at 8.25% at the July rate setting meeting, in line with expectations. The CBT has adopted a more cautious stance lately, which is likely attributable to the recent deterioration in the inflation outlook, including an increase in core indicators and the fact that the cost of funding is already aligned with the CBT's own inflation forecast of 7.4%. Initial signs of a rebound in economic activity from the bottom in April should also come as a relief, given policy efforts to limit the downside in activity.

The MPC statement has remained broadly unchanged, though the CBT seemed to 1) acknowledge rising risks on the inflation outlook and 2) have a more optimistic view on economic activity.

On the former, the CBT reiterated the deterioration in core indicators, citing the "pandemic-related rise in unit costs" as a key reason, even though demand conditions are keeping a lid on price pressures. Seasonal factors and pandemic-driven effects on food inflation also pushed the headline CPI higher. The bank also maintained its view that demand-driven disinflation will be more evident in the second half of the year, however it is more concerned about upside risks following stronger-than-expected inflation readings recently.

On the latter, the CBT is more optimistic that the recovery, which started in May with the reopening of the economy, is gaining momentum. Monetary and fiscal measures introduced with the pandemic continue to limit the downside in activity and are contributing not only to the recovery but also to financial stability.

In the remainder of the statement, the CBT commented that it sees a partial global recovery in the third quarter, as several countries emerge from lockdown measures. The bank continued to emphasise a high degree of uncertainty in the global economic outlook and the expansionary measures of global central banks. It also noted that it expects a recovery in exports and benign energy prices, which will be supportive to the current account balance in the period ahead while easing travel restrictions should be supportive for tourism revenues and hence external balances.

Overall, the CBT has turned more cautious with a gradual shift towards policy normalisation, as implied by the recent statement on a hike in the FX reserve requirement. This shifting stance is likely attributable to its focus on financial stability against a backdrop of the widening external deficit, already low real rates and rising money supply, while risks on the inflation outlook are another factor. Signs of a faster economic recovery, on the other hand, should some as a relief.

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