Turkey’s central bank announces surprise rate hike

The Central Bank of Turkey (CBT) has surprised markets by hiking the policy rate by 7.5ppt to 25% versus the consensus of 20%

Former Wall Street Banker Hafize Gaye Erkan was appointed Turkey's new central bank governor in June

Turkey’s central bank has hiked interest rates by more than expected to 25%, up from 17.5% previously.

The forward guidance related to monetary policy tightening remains unchanged. This suggests that today's hike is attributable to the recent appointment of three new Monetary Policy Committee members.

The lira has been boosted following the CBT's policy rate hike and signals that interest rate hikes will continue.

In the note explaining the rate decision, the CBT acknowledged the inflationary pressures by pointing out the increase in the underlying trend attributable to “the strong course of domestic demand, cost pressures stemming from wages and exchange rates, stickiness of services inflation and tax regulations”. The bank foresees that inflation can reach the upper band of its end-of-year inflation forecast in 2023 of 62%, not only because of the above mentioned factors but also due to the recent rise in oil prices, significant deterioration in inflation expectations and pricing behaviour.

According to the CBT's latest August Market Participants Survey, the 2023 inflation forecast was 59.5%, and expectations for the next 12 months and 24 months were 42.0% and 22.5%, respectively. Therefore, further deterioration in the inflation outlook was the key reason for the CBT to come up with a strong rate response this month.

In its note explaining the rate decision, the CBT also reiterated its guidance that:

- "Monetary tightening will be further strengthened as much as needed in a timely and gradual manner until a significant improvement in the inflation outlook is achieved."
- "Guided by impact analyses, the simplification process will be gradual”.

Thus, while hiking more than expected in August, the CBT has kept to its message that the pace of hikes will remain on a gradual path in the upcoming rate-setting meetings, and also emphasised that it will continue to take selective credit and quantitative tightening decisions to support.

In this regard, the CBT already announced a number of new regulations at the end of last week, and abolished some of the old ones:

- The target for conversion from FX deposits to FX-protected deposits was terminated.
- The old ceiling on commercial loan rates was removed and the new ceiling will likely be announced at a later date.
- There will be a new framework that will facilitate a switch from FX-protected deposits that constitute more than a quarter of the deposit base to TRY deposits
- FX reserve requirement ratios have increased in order to prepare FX liquidity for the part that may turn to FX deposits instead of TRY deposits.

With these moves, deposit rates that dropped from close to 42% to 29% since the second half of June will start increasing again. In terms of the extent to which this increase will reach, the CBT's new commercial loan interest rate ceiling will also be a critical determinant. The expectation is that the spread between loans and deposits that were in negative territory before the elections and has improved significantly in recent weeks will likely remain this way in the months ahead.

Overall, the latest rate action is significant and will raise expectations for the final policy rate. Given the need for rebalancing to control inflation and reduce external imbalances, the CBT’s move and the likely impact of this move on deposit and loan rates will be an important step towards tightening financial conditions and controlling domestic demand.

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr