Turkey's central bank to stay on hold... this time

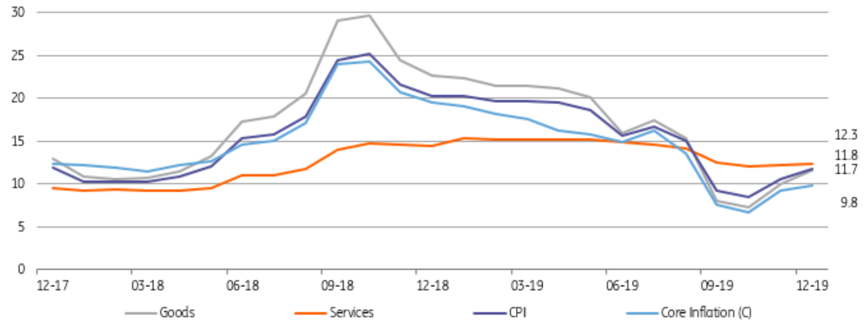
The central bank of Turkey is likely to remain on hold at the upcoming meeting as the decline in (ex-post) real policy rate with large rate cuts and the recent rise in inflation entails a risk to TRY stability. But a measured cut cannot be completely ruled out given the ongoing growth priority

Source: Shutterstock

Following the aggressive easing since July amounting to a substantial 1200 basis point reduction in the one-week repo rate, we expect the central bank of Turkey to discontinue the cycle and keep the policy rate unchanged at 12% in the upcoming meeting on 16 January.

Sensitivity to geopolitical risks as observed by the latest developments between US and Iran, stickier inflation readings with less supportive base as observed in December with reviving pressure on food prices, and low ex-post real policy rate are all reasons why the central bank might remain on hold.

Inflation Outlook (%)



Source: TurkStat, ING

On the inflation side, headline and core numbers in December were above consensus expectations with the former closing the year at 11.8% vs the central bank's 12% estimate released with the October inflation report, while the former stood just below of the 10% threshold as services inflation remained sticky with a slight increase to 12.3%.

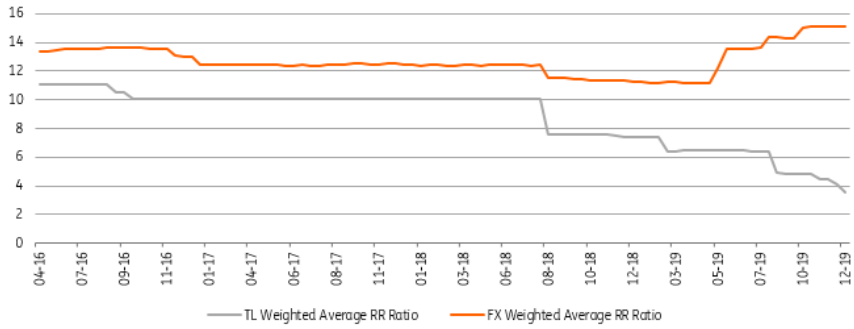
In the breakdown, the increase in inflation was driven by higher fuel and clothing prices along with reviving pressure on food prices. Given that benign food inflation has contributed markedly to the disinflation process last year, likely reversion in unprocessed food inflation towards the long term average, inertia in services inflation along with still elevated forward-looking expectations despite some improvement in recent months can be risk factors for the central bank to attain 8.2% forecast in 2020.

Last month, the CBT has taken some actions as:

1) Adjustment in policy linking reserve requirements to credit growth: In August, the CBT linked required reserve ratios (RRRs) and remunerations to credit growth given private banks' hesitancy to expand lending. The macro-prudential tool to incentivize lending was based on TL loan growth (not the FX part) and came with a cap of 20% (beyond this level no preferential treatment for banks). In early December, the CBT revised 10-20% band for nominal annual loan growth rate to a 5-15% real annual volume expansion. Given that the inflation is at 11.8% at the end of 2019, the real band should translate into a nominal band of 16.8-26.8%, higher than the previous one. The adjusted framework also supports longer maturity commercial and housing loans and favours retail lending growth less.

2) The CBT further refined policy of using reserve requirements to incentivise TRY lending and hiked FX RRR by 200bp while keeping it unchanged for banks that comply with the TRY real loan growth conditions to ensure that these banks are not affected by this increase. The move is also expected to shore up the FX reserves by an estimated US$2.9 billion.

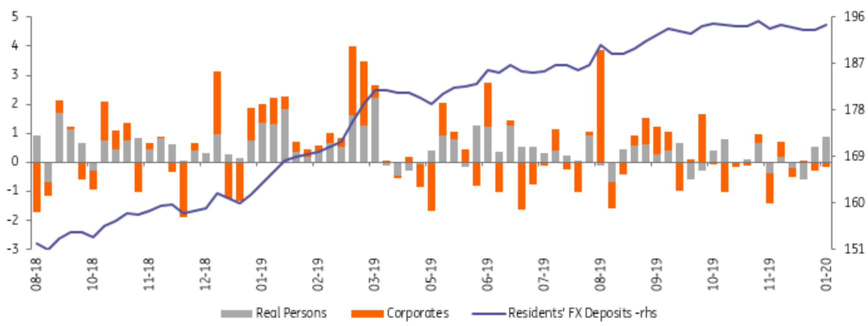
Reserve Requirement Ratios (%)



Source: CBT, ING

3) Finally, according to the local media though not confirmed officially yet, the CBT is about to impose fee on FX RRR balances, aiming to incentivise de-dollarization in the banking system. The move, if materializes, will be just like the one we saw in Jan-15. At that time, the CBT decided to apply annual commission (to be charged on daily account balances and collected on a monthly basis) on RRs denominated in Euro held by banks by “taking into consideration the expectations that the ECB’s implementation of negative deposit rate”. This would be the latest of the CBT actions to make FX holdings less attractive for households by pushing FX deposit rates lower and transactions costs higher.

Residents’ FX Deposits (US$ billion)



Source: CBT, ING

So, the central bank is using not only other means to ease the policy other than rate reductions given weak domestic demand, stable currency and improving price pressures but also has been taking further steps to disincentivise dollarisation and support FX reserves to maintain currency stability.

However, the decline in (ex-post) real policy rate with large rate cuts and the recent rise in inflation entails a risk to TRY stability while sensitivity to geo-political developments will also be among factors will likely make the central bank more cautious in the near term. But risks are on the downside, as depending on the performance of the TRY, further easing cannot be ruled out given the bank’s ongoing growth priority.

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