Turkey: Outright hike instead of changing the rate corridor

Given continuing financial and price stability concerns, the Central Bank of Turkey brought its policy rate into double digits again, despite market expectations of a flat policy rate and wider interest rate corridor

The Turkish Central Bank in Ankara

In a surprise move at the September MPC, the CBT hiked the policy rate (1-week repo rate) by 200 basis points to 10.25%. Accordingly, the entire corridor setup has shifted upwards with the overnight borrowing rate now at 8.25%, the overnight lending rate at 11.75% and the late liquidity window rate at 13.25%. Given the challenging inflation outlook, increasing dollarisation and ongoing deterioration in the external deficit, requiring normalisation in the policies employed since the breakout of pandemic, the CBT showed a decisive response and came out with a formal hike.

Additionally, having been using:

- newly introduced 1-month repo auctions (interest rate being determined by the liquidity conditions and standing above 11.5% in the last two days),
- the upper band of the rate corridor (at 9.75%) and
- the late liquidity window (at 11.25%) to provide liquidity to the banking system since late

July...

the CBT hiked the effective cost of funding by more than 300bp to 10.65% currently, leaving relatively small room for further tightening via liquidity measures. In this regard, the latest MPC decision will provide additional flexibility to further tighten liquidity and to raise its effective funding rate, if needed.

Also, any adjustment to the upper band of the rate corridor (overnight lending rate) and late liquidity window rate would mean a departure from the symmetric and modestly wide corridor setup, determined in mid-2018. The CBT has only been announcing the 1-week repo since then, seeking to reduce unorthodoxy and uncertainty. The latest move indicates that the CBT does not prefer a wide and asymmetrical corridor and will continue with the current corridor framework.

In the statement, the CBT acknowledges that despite earlier expectations of fading pandemic-related pricing pressures after the reopening of the economy and the supportive impact of weak demand outlook, inflation has remained elevated on the back of rapidly improving economic activity amid large credit stimulus and exchange rate developments. This backdrop, requiring the reinforcement of tightening steps in place since early August, is the major driver of the policy rate hike, according to the Bank.

There are also some other minor modifications in the MPC statement:

- the CBT shared its view on the third quarter economic activity, "recovering markedly" thanks to normalisation and strong credit expansion.
- for the credit stimulus, the bank reiterates a loss of momentum in corporate loans, while it also sees the same normalisation trend in consumer loans.

Overall, given continuing financial and price stability concerns, the CBT brought its policy rate into double digits once again. This decision reduces the gap between the policy rate and actual or expected inflation rates in an environment where the outlook for inflation is challenging, portfolio preferences of residents are shifting to foreign currency and capital flows are weak while also providing additional flexibility if the bank opts to tighten with liquidity measures. Exchange rate developments will likely remain one of the key determinants of the CBT's policy in the period ahead, though the hike should support the Turkish lira in the near term.

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