Turkey: Signs of prudence

The reshuffling of personnel in both Turkey's central bank and finance ministry has shifted market sentiment. And given the recent developments, we expect the central bank to adjust the policy rate to 15% from 10.25% at the next meeting and start lending from 1-week repo auctions again thereafter

A handout photo made available by Turkish President Press Office shows Turkish President Recep Tayyip Erdogan addressing members of his party

Source: Shutterstock

In addition to the recent personnel changes towards more technocratic leaders at both the central bank and the finance ministry, Turkey's president Recep Erdogan's comments that the new leadership would be supported, even if it requires 'bitter-pill policies', have contributed to expectations of a sizeable policy rate hike and a simplification in the policy framework to provide more transparency and predictability.

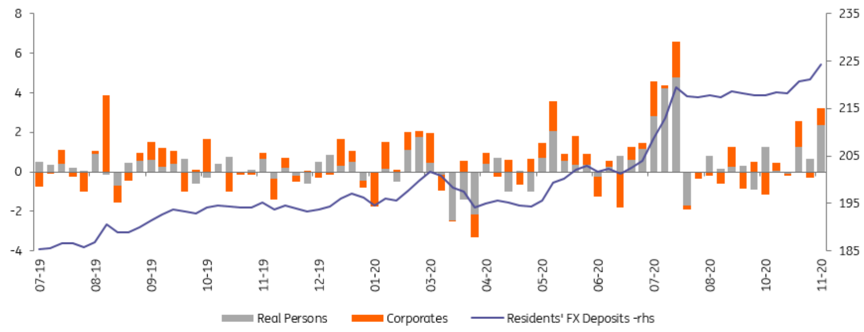
Accordingly, we expect the central bank to adjust the policy rate to 15% from 10.25% at the next meeting on 19 November and start lending from 1-week repo auctions again thereafter.

> *We expect the central bank to adjust the policy rate to 15% from 10.25% at the next meeting*

After the surprising monetary policy committee decision in October to keep the policy rate unchanged but hike in the late liquidity window rate to gain room to manoeuvre in the liquidity tightening process, the Turkish lira depreciated substantially reaching the lowest level in REER terms in the current series going back to mid-90s.

Local FX deposits that were relatively flat since early August also started increasing in the second half of October. Slow adjustment in rates, likely attributable to the lack of banks appetite to compete for deposits in an environment of lending deceleration despite a relatively strong adjustment in the effective cost of funding has kept the real return of TRY deposit holders low and triggered reviving dollarisation.

Residents' FX Dep. (WoW Chg, US$ bn)



Source: CBT, ING

Alongside this backdrop, we have seen unexpected changes in the economy management team.

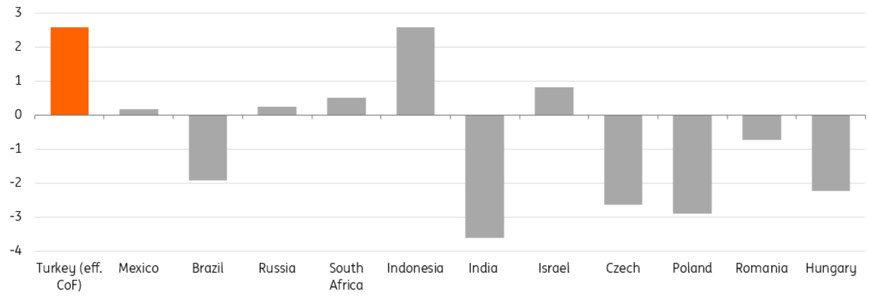
Appointments of Naci Agbal as the new central bank governor and Lutfi Elvan as the new minister of treasury and finance have contributed a significant turn in sentiment. In addition to their respective statements including i) decisive use of all policy tools in pursuit of the price stability objective and ii) enhancing macro stability along with a market-friendly transformation program, President Erdogan's support for the policies implemented by them has increased expectations of a reorientation towards a more prudent framework.

> *While the Turkish lira has shown a strong turnaround, the focus has shifted to the November meeting*

While the Turkish lira has shown a strong turnaround, the focus has shifted to the November meeting and if the central bank will deliver a meaningful adjustment with an outright hike and simplify the policy framework. Given Agbal's pledge to "transparency, accountability and predictability principles", we expect the bank to pull the policy rate from 10.25% to 15%.

Given that the corridor setup has been in place since 2002, though the central bank has been relying on the effective cost of funding as the key rate since 2011, the central bank is likely to keep the corridor scheme and align the cost of funding to the policy rate by shifting all liquidity provision to weekly repo auctions. However, given that the effective funding rate is at 14.46%, the actual adjustment will be around 50 basis points.

Real policy rate (ex-post, %)



Source: Refinitiv, ING

The market is currently pricing around 500bp and such a move by the Bank close to the consensus will not only provide more certainty for policy implementation but also cement the TRY's carry within the emerging market space with the real effective funding rate currently the highest along with INR to go up further.

As was the case after the monetary tightening in September 2018, this restrictive monetary stance and clear central bank communication should help to improve the risk premium of the country.

> The recent reshuffling of personnel and new appointments have shifted market sentiment and sustaining this latest momentum will require maintaining the ongoing change in policy direction by delivering at the November meeting.

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