Turkey's central bank to maintain dovish bias

We expect the Central Bank of Turkey to reduce the policy rate by 75 basis points to 9% at the April meeting. A supportive shift in global policies and widening output gap- which is weighing on inflation- provides room to act

Source: iStock

At an unscheduled meeting last month, the CBT cut the policy rate into single digit figures for the first time since mid-2018. We now expect the Bank to reduce the policy rate (1-week repo rate) by 75bp to 9% at the April meeting. The bank seems determined to mitigate the downside risks to growth, and a supportive shift in global policies, as well as the local inflation backdrop, which is being weighed down by a widening output gap, provides room to act.

Given the extent of the global growth impact from the pandemic and local lockdown, which is pressuring the Turkish macro outlook, we have further revised our 2020 growth forecast from 0.6% to -1.5%. We envisage:

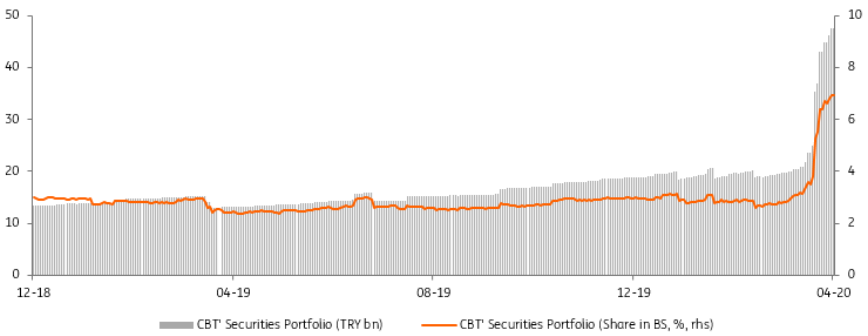
- A sharp contraction in 2Q compared with the 1Q09 performance during the global financial crisis

- A mild consumption-driven recovery in 3Q, though the impact on tourism will be a limiting factor
- A return to expansion in 4Q

The government has already announced a TRY100 billion (around 2% of GDP) package of support including tax breaks and financial support for firms, and social safety nets to protect the unemployed and vulnerable segments of society. We have also seen additional actions with wage subsidies for employees of affected businesses and the self-employed, while the government is also working on legislation to ban layoffs for three months and envisages meeting a portion of the employment costs.

The CBT, meanwhile, has already delivered a 100 basis point emergency rate cut and announced a series of measures aimed at providing liquidity to banks, supporting exporting firms (through arrangements on the rediscount credits) and securing the flow of credit to the corporate sector. At the end of March, with an objective of strengthening the monetary transmission mechanism by boosting the liquidity of government debt securities, the bank also introduced additional measures, including an expansion of the collateral pool and an increase in the size of its government securities. Accordingly, the CBT's securities portfolio, which stood at around TRY20 billion in mid-March, rose to TRY47.4 billion as of 15 April. So the bank has put forward a series of measures aimed at alleviating the adverse impact of the pandemic on the economy and stands ready to deliver further action, including additional rate cut(s).

Securities Portfolio

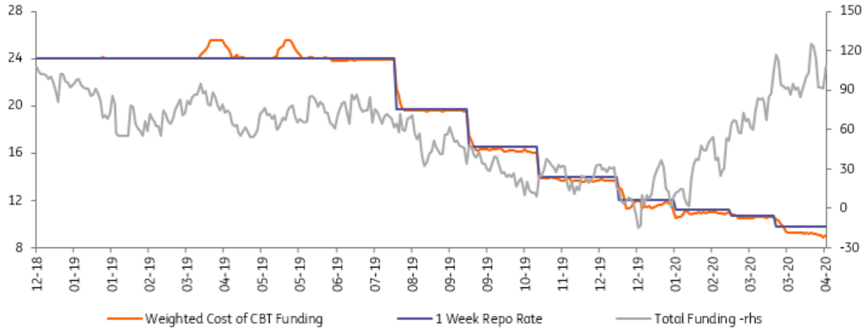


Source: CBT, ING

As for the inflation outlook, the CBT has pointed to growing downside risks due to weakening demand conditions from the coronavirus outbreak. We think that the exchange rate performance will remain the key variable, as we have already seen the impact on last month's data, though FX pass-through should be limited during the slowdown. Accordingly, we expect annual inflation to be at 8.7% by the end of this year, allowing for further policy easing. In addition, with the latest inflation data, the ex-post real rate (based on the effective cost of funding rate) went down further to -2.8%, the lowest since mid-2013. However, the CBT continues to focus on the ex-ante real rate to guide its policy decisions.

Of course, the CBT may opt not to make any changes, as it has room to drive the effective cost of funding down further without any more policy rate cuts. After the March MPC, the CBT introduced a new liquidity facility for banks with an interest rate 150 basis points lower than the 1-week repo rate, to be provided via longer term repo auctions. It also started TRY currency swap auctions with a maturity of one year so as to maintain lending to corporates. The maximum amount of funds that a bank may receive from this new facility will be linked to the amount of credit that it has already provided, or will provide for the corporate sector. Accordingly, the CBT has already provided TRY40.5 billion (almost 45% of the total funding provided to the banking system) via 90-day repo auctions, pulling the effective cost of funding to 9.0% as of 16 April vs the policy rate of 9.75%. So, it is possible that the bank can reduce the effective cost of funding further with the targeted additional liquidity facilities without changing the policy rate.

CBT Funding (Rates in %, Funding in TRY billion)



Source: CBT, ING

> Many emerging market economies have reduced their policy interest rates to support growth in recent months, including Turkey, and going forward, additional moves should not be ruled out given the effects of the coronavirus pandemic. We expect another cut from the CBT this month, while TRY volatility remains a key risk.

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