Turkish Central Bank: All rates to stay flat

Today's meeting should see all rates remain on hold until inflation outlook improves

Source: istock

The Central Bank of Turkey (CBT) is unlikely to make any changes in its policy direction in today's rate setting meeting.

Given that elevated inflation expectations will continue as well as ongoing geopolitical issues and a risky scenario of policy tightening by major central banks, we expect the bank to remain cautious on monetary policy.

1 Inflation

Annual inflation has returned to double digits, though with a sharper increase than envisaged earlier, attributable to a reversal in goods inflation, while services remained practically unchanged.

The Food Committee's decision to adjust taxation to bring down the cost of meat production and ongoing Turkish lira (TRY) strength is likely to be supportive, though the current outlook remains a major concern, given continuing producer-driven cost pressures and further deterioration in core indicators.

Inflation expectations

Regarding inflation expectations, both 12-month and 24-month forecasts have moved higher from the beginning of last year, until April this year. We saw some stabilisation in recent months, though strengthening price pressures and a more elevated inflation path are to contribute to stickiness in inflation expectations.

3 Economic growth

Economic growth remains strong, with fiscal policy support including increases in public investment and consumption. The growth outlook is comforting to the central bank with no imminent need to give any additional lift to activity via monetary policy. However, external imbalances will continue to be watched closely.

This year, the current account deficit has followed a gradual and fluctuating uptrend with ongoing mean-reversion to a structural deficit in the gold balance and an expanding energy bill. Also, at -50.6% of GDP as of 2Q17, the net international investment position (NIIP - the difference between external assets and liabilities) remains significant vs peer countries and significantly worse than the -41.1% at the end of 2016, mainly driven by an increase in direct and portfolio investments.

4 Short-term external funding

Moreover, given the high share of short-term funding and reliance of banks and corporates on short-term external funding, annual external financing needs are c.25% of GDP, leaving the country vulnerable to shifts in global financial conditions. Accordingly, a risk of deterioration in sentiment towards EMs, though less likely in the near term, could be a source of concern for the central bank and should make any early easing decisions quite difficult.

5 Rate cut

Markets have currently been pricing a 100bp cut with close to 100% probability until the end of the first quarter of 2018, despite the bank noting the possibility of further tightening, if necessary.

We expect any easing is likely to come initially via gradual rises in the lira's liquidity, while the policy rate, upper and lower bands of the interest corridor, and the late liquidity window rate should remain unchanged until year-end. In other words, a change in the central bank's policy will likely entail liquidity easing first and then resume simplification of the rate corridor system with reversal of previous LLW hikes.

Overall, we expect all rates to remain flat at today's MPC and keep monetary conditions tight with the effective rate close to current levels at 12% and to reiterate its commitment to a tight stance until there is a marked improvement in the inflation outlook.

In other words, still elevated headline and inflation expectations, ongoing geopolitical issues and a risky scenario of policy tightening by major central banks via rate hikes or tapering should keep the central bank of Turkey cautious on monetary policy.

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