Turkey's central bank hints that rate cuts are on the way, possibly in July

The Central Bank of Turkey kept its policy and interest rates unchanged in the June meeting. But the forward guidance shows that it dropped its tightening bias and has now opened the door for a July rate cut

CBT Governor Fatih Karahan

In its June rate-setting meeting, the Central Bank of Turkey (CBT) has kept the policy rate (1-week repo rate) flat at 46%, as expected, following its recent reduction in the effective cost of funding. The interest rate corridor has also remained unchanged in its asymmetrical form, for now. This decision confirms the bank's prudent approach in the face of geopolitical uncertainty increasing upside risks to the inflation outlook.

Ahead of the MPC meeting, May's better-than-expected inflation data, combined with stabilising market conditions and the resumption of reserve accumulation, allowed the CBT to shift its funding toward one-week repo auctions from the upper band of the interest rate corridor. This has led to a lower effective funding rate that aligns with the policy rate. Given such a large 300bp easing, the CBT appears to be moving cautiously, refraining from making changes in the June meeting.

One option for the Bank was to cut the overnight lending rate (from 49% to 47.5%) and remove the asymmetry in the corridor. It opted to retain the flexibility of re-raising the effective cost of funding in the face of potential new shocks, given ongoing global uncertainties. The central bank also refrained from sending any dovish signals in an environment of higher geopolitical tension. This cautious stance is also evident in the liquidity management after the volatility seen in March, and in the CBT's decision to differentiate the reserve requirement ratios for short-term Turkish lira-denominated funding obtained from abroad across maturities.

Currently, the CBT employs macroprudential measures and relies on the policy rate and credit caps to control both the price and volume of credit. Deputy Governor Cevdet Akcay stated in late May that the bank has two options: 1) lowering rates if conditions permit, while maintaining macroprudential measures, or 2) keeping the policy rate high while gradually removing volume restrictions. In the June rate setting note, the Bank's message stated that "in case of unanticipated developments in credit and deposit markets, the monetary transmission mechanism will be supported via additional macroprudential measures." This implies that it does not have any intention of easing lending restrictions at this stage.

The market was also heavily focused on whether or not we'd see revisions in the forward guidance and any signals of a July rate cut. In its statement, the CBT dropped previous references to tightening its monetary policy stance in case of a significant and persistent deterioration in inflation. It returned to the message we saw in early March, stating that "all monetary policy tools will be used effectively in case a significant and persistent deterioration in inflation is foreseen." So, the central bank has dropped its tightening bias and opened the door for a July cut.

In the statement, the CBT acknowledged the improvement in the underlying inflation trend in May. It also sounded quite positive regarding the June data, as leading indicators suggest the decline in the underlying trend should continue, as well as noting that the second quarter data points to a slowdown in domestic demand. Finally, the Bank adopted a cautious tone about recent external developments, remaining in wait-and-see mode without discussing any possible positive or negative impacts.

> All in all, although real rates reached historically high levels following April's hike, recent data releases suggest that there's room for policy easing. This comes down to improvements in inflation expectations, signals of a more significant slowdown in the second quarter, the resumption of foreign flows and easing FX demand among residents supporting the CBT's FX reserves. We currently expect a 350bp cut to 42.50%, and a return to pre-March levels in July, versus survey participants' expectations of a 300bp cut to 43.00%. The CBT could prefer to start rate cuts with a smaller move, given that the current level of geopolitical risks will likely add weight to the Bank's already cautious approach.

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

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