Central Bank of Turkey set to maintain the pace of hikes

We expect the Central Bank of Turkey to maintain the pace of its rate hikes next week, raising the policy rate by 250bp to 20% and signalling the continuation of further monetary tightening. The bank will also continue to rely on alternative instruments and the gradual unwinding of banking sector regulations

Hafize Gaye Erkan, the Central Bank of Turkey's governor

The Turkish central bank is expected to raise the policy rate (one-week repo rate) by 250bp to 20% at its next meeting on 24 August. Since the start of its ongoing policy shift to a more orthodox approach, the Central Bank of Turkey (CBT) has hiked by 900bp from 8.5% and has taken initial steps to ease “liraisation” targets and security maintenance requirements, but the macro-prudential policy framework still remains largely in place. At this month's Monetary Policy Committee (MPC) meeting, we should begin to see some evidence of the extent to which the appointment of new members supporting the shift will lead to a revision in the pace of tightening.

During the last two meetings chaired by the new governor, Hafize Gaye Erkan, the MPC hiked the policy rate to 17.5% and signalled further tightening steps in a "timely and gradual" manner until significant improvements in the inflation outlook are achieved. It also signalled its intent to “simplify and improve the existing micro and macro-prudential framework” with a gradual approach on this front to be guided by impact analyses.

Accordingly, we saw quantitative tightening with a hike in required reserve ratios for FX-protected deposits to 15%. With this decision, the CBT withdrew more than TRY450bn, creating a liquidity deficit in the banking system. However, the deficit has declined again over recent days, with the net OMO funding barely positive as of 17 August. Given this backdrop, the CBT will likely come up with further liquidity withdrawal via additional quantitative tightening decisions.

We also saw selective moves targeting macro-prudential measures related to banking sector lending:

1. A cut in monthly growth limit for total loans to 2% from 3%.
2. A reduction in the monthly growth limit for TL commercial loans (to 2.5% from 3%) under the securities maintenance practice based on loan growth.
3. Setting the growth limit for vehicle loans at 2% (down from 3%) and keeping the 3% limit for general purpose loans unchanged.
4. A monthly maximum interest rate applied to credit card cash utilisation and overdraft accounts was raised to control inflation and balance domestic demand (export and investment loans, as well as loans for the earthquake zone exempt from all credit restricting measures).
5. The removal of security maintenance requirements for banks to extend FX loans to match the growth in their FX deposits.
6. Additional measures to support exporters' access to financing i.e. regulation changes related to rediscount credits from the CBT.
7. Decisions made by the Banking Regulation and Supervision Agency (BRSA) to impose higher risk weights for retail lending, including credit cards.
8. Removal of the first tier for TL commercial loans – excluding export and investment loans – and application of the interest rate cap as a single tier. The two-tier structure is still in place for consumer loans.

Additional gradual steps to ease liraisation targets and security maintenance requirements are also underway:

1. Reducing the deposit liraisation target to 57% from 60% previously. The CBT simplified targets for monthly and periodic conversions from FX deposits to TRY deposits. The penalty for missing the deposit liraisation target was also lowered to 12% of FX liabilities from 17%. However, the conversion requirements framework is still largely in place.
2. Cutting liability-related security maintenance requirements from 10% to 5%.
3. Signalling new actions to diversify TRY savings and support the deepening of capital markets via new products.

With these moves, deposit rates moved down from close to 42% (with a maturity of one to three months) in the second half of June to around 29% as of 11 August. According to Erkan, deposit rates had been too high relative to inflation expectations. As a result, the central bank targeted the most binding constraint in the current micro and macro-prudential policy framework and eased conversion requirements. On the other hand, lending rates are on the rise on the back of changes in lending caps and other macro-prudential moves. The spread between loans and deposits that were in negative territory has therefore improved significantly in recent weeks.

In addition to this gradual move to a more orthodox approach, the CBT appears to be prioritising reserve building and improvement in external imbalances. The bank has declared its intention to reduce reliance on indirect FX interventions and to provide banks with FX directly if there is demand due to maturing FX-protected accounts. Subsequently, FX reserves have seen some signs of recovery since the elections. Gross FX reserves (including gold) rose by US$17.9bn to 116.3n. Net reserves, on the other hand, improved by $20.2bn to $15.8bn, and net reserves excluding FX swaps increased by $10.0bn to $-50.6bn in the same period.

Regarding the external account, the continued strength seen in economic activity driven by domestic demand pushed imports significantly upwards and weighed on the current account balance, despite the supportive impact of declining energy and commodity prices in addition to supported exports and a sustained recovery in global economic activity. For the rest of 2023, the expectation is that the 12M rolling deficit will likely narrow given TRY weakness following the elections and gradual tightening in monetary and fiscal policies. Measures for limiting the growth rate of retail loans may also slow down domestic demand and lead to a slowdown in import growth. For now, the outlook remains challenging as the decline in global leading activity indicators in the second half of the year increases the risk of a slowdown in exports.

Despite the under-delivery of the consensus in the last two meetings, the Central Bank of Turkey acknowledges inflationary pressures, and attributes the increase in the underlying trend to strong domestic demand, cost pressures related to wages, FX, tax hikes, and a deterioration in pricing behaviour.

The bank envisages a transition heading towards the disinflation and stabilisation period and expects inflation to peak at around 60% in the second quarter of 2024. It then aims to adopt a declining trend thereafter. However, there remains a large gap between the policy rate and both current and expected inflation. With the current pace of hikes, the real policy rate – which is in deep negative territory – will begin declining once again and will likely remain there for longer. This will likely add to pricing pressures on inflation and could potentially weigh on reserves.

Given that the new uptrend in inflation challenges the gradual monetary policy approach, the 24 August MPC meeting with its three newly-appointed members will be an important one to watch.

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