Turkish central bank to stay on hold amid inflation risks

We think the Central Bank of Turkey will signal a wait-and-see period at its forthcoming meeting, with no imminent rate changes in the near term due to rising risks on the inflation outlook and signs of economic recovery

The Turkish Central Bank in Ankara

Following a surprising end to its long rate cutting cycle, which started in mid-2019 with the objective of lowering the cost of funding for banks, we expect the Central Bank of Turkey to remain on hold and keep the policy rate (1-week repo rate) at 8.25% in July. This is due to a recent deterioration in inflation and a cost of funding which is already aligned with the CBT's own inflation forecast. Initial signs of a rebound in economic activity from the bottom in April should also come as a relief.

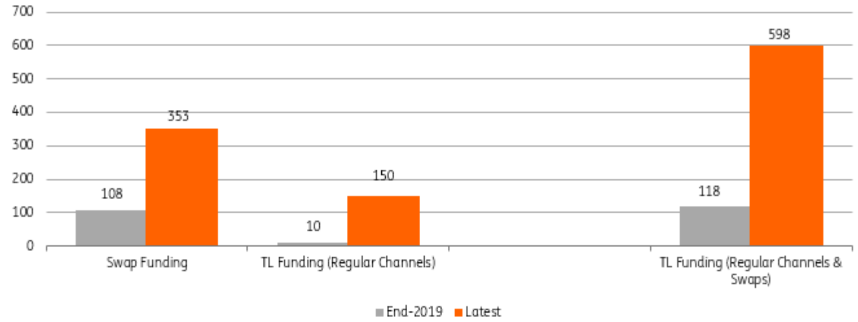
- On inflation, we saw a broad-based increase in price pressures in June with a) a continuing upward move in oil prices adding to transportation inflation, b) elevated food inflation due to higher fresh food prices, c) higher clothing prices and d) price adjustments in restaurants and hotels due to transitory conditions arising from the pandemic. The last inflation reading suggests that reaching the CBT's latest end-2020 estimate may be difficult, though the bank expects that supply side factors, which have prevailed in recent months as a result of pandemic-related restrictions, will phase out and demand-driven disinflationary effects will prevail in the second half of the year. Exchange rate developments and the impact from increasingly supportive economic policies, as well as consequent signs of a rebound recently, point to challenges to the inflation outlook in the remainder of the year, in our view. This is the backdrop against which the CBT will likely stay on hold in the near term. We also note that at the last policy meeting, the bank omitted a sentence which stated that the inflation outlook was considered to be in line with inflation projections. This likely indicates that the CBT is not as confident as before about its inflation projections and could revise these up in its next report to be released at the end of this month.

- Ex-post real rates in Turkey are currently among the lowest in the emerging markets, while the ex-ante real funding rate, based on the bank's inflation forecast for this year at 7.4%, is barely positive as the CBT has already pulled the effective cost of funding below the policy rate, with new funding alternatives introduced at the breakout of the pandemic. So, the CBT has already provided TRY70.9 billion (close to half of the total funding provided to the banking system) via 90-day repo auctions, pulling the effective cost of funding to 7.4% as of 17 July. An assessment of the level of the real policy rate suggests that the June decision is likely the end of the easing cycle and there will be no further move in July.
- The CBT sees that the economic recovery started as of May following gradual steps towards normalisation, as recent data releases show a strong recovery in business and consumer sentiment while the latest industrial production figures recorded a rebound, as expected, with easing lockdown measures and the reopening of the economy. Given that the improvement in confidence and activity is stronger compared to many of its peer countries, signalling a sharp improvement in the growth outlook, the CBT will likely feel less pressure to ease.

Following last month's hawkish surprise, the question is whether this is a pause or stop. In addition to what the close-to-zero real cost of funding rate implies, we think the latest reserve requirement decision could be another indication of the shifting CBT stance. After an across-the-board cut in FX reserve requirement ratios (RRRs) for banks meeting real credit growth conditions by 500bp, the bank decided to hike FX RRRs by 300bp, which will likely lead to the withdrawal of US$9.2 billion of FX and gold liquidity from the market. The impact of the decision on the CBT's gross reserves is quite tricky to gauge given that banks may opt 1) to use their swaps with the CBT to meet increasing RRRs or 2) to utilise other FX resources. While the second option will support the CBT's gross FX reserves and won't cause any change to Turkish lira liquidity in the market, the first option will keep the CBT reserves flat and be contractionary for available TRY liquidity.

Given that the total swap size of banks with the CBT, according to our calculations, is already high, at more than US$65 billion lately, the actual impact should be between the two alternatives, and cause some tightening in TRY liquidity, in our view. So, the CBT has likely finished the rate cutting cycle due to the still relatively high risk premium of the country compared with other EM peers and the low level of reserves, and will likely be more cautious in the period ahead with a gradual shift towards normalisation.

Total CBT Funding (incl. swaps, TRY bn)



Source: CBT, ING

> All in all, we think the CBT should signal a wait-and-see period with no imminent rate changes in the near term due to rising risks on the inflation outlook and signs of economic recovery. The focus on financial stability against a backdrop of a wider external deficit, already low real rates and rising money supply, should also be drivers.

Author

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

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