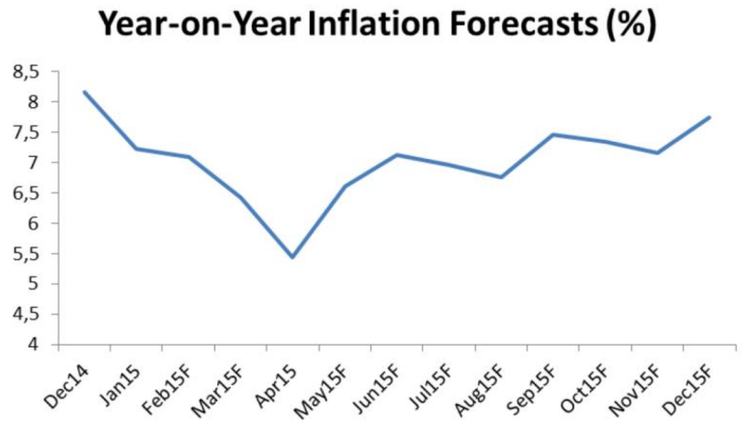
The Central Bank of Turkey resists back down to political pressure

While remembering how USD/TRY parity lost 5 per cent in just 10 days between 21st and 30th January 21, today (24th Feb) was the regular monetary policy meeting for the Central Bank Turkey (CBT). The previous meeting was on January 21st and there was increasing pressure from the Turkish government towards the CBT to lower the interest rates by a considerable margin.

At that time, the CBT kept its 'cautious' stance and cut only the policy rate by 50 basis points to 7.75 per cent. This was not found to be adequate by the government. The Governor Basci made an unfortunate comment in Inflation Report meeting, that they can reconvene on February 4th extraordinarily to reconsider further rate cuts! The Turkish lira lost 5 per cent within this time and weakened to 2.45 from 2.32 against US Dollar. Since then the currency did not recover, it hit 2.50 against US Dollar when President Erdogan publicly criticized the CBT on February 11 for not doing its job properly!

The lira was trading around 2.47 against US Dollar today ahead of the regular CBT monetary policy meeting. Some market players were not expecting a rate cut because of the weakened currency. We were expecting a 50 basis cut in the upper bound of the interest rate corridor and 25 basis points in the policy rate because of the political pressures and the decline in the loan growth rates. The upper bound of the interest rate corridor, which is the marginal funding rate, directly affects the business loan rates, especially the SME's.
The annual growth rates in loans and the SME loans declined considerably in the last six months and for this reason we saw some room for ease in the upper bound of the interest rate corridor. On the other side, the CBT should have kept the symmetry of the interest rate corridor, it could not just cut the policy rate to 7.50 per cent and leave it at the same level of the borrowing rate (of the lower bound in the corridor). We believe the cut in the lower bound of the interest rate corridor has been taken to make the corridor more symmetric.

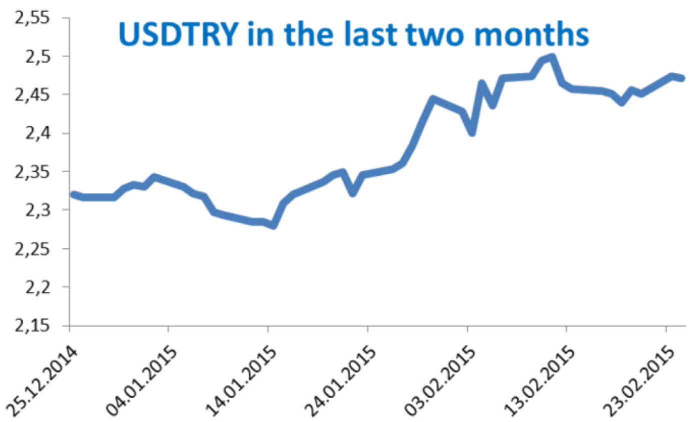
The inflation data in the coming months would support the decision of the CBT because there is a very good base effect in the inflation figures in February and March (see the graph below).



The annual inflation will move around the territory 5-6 per cent thanks to the favorable base effect in these months. But the real factor would likely reappear in June once the statements coming from the Federal Reserve harms the markets. The end-year inflation expectation of the CBT is 5.5 per cent. The bank would be obliged to hike interest rates again once Fed starts tightening and the favorable base effects for inflation disappears in the last quarter of the year.

Market reaction

The extent of the rate cuts were within the market expectations. This is why the Turkish lira did not depreciate further above 2.47. The psychological USDTRY level for the market players, 2.50, is important. USDTRY parity did not yet surpass the level of 2.50. However, our calculations show that the parity will end the year at around the 2.60 level. The market players should be cautious for further depreciations in the days ahead.



The next monetary policy meeting of the Central Bank of Turkey is on 17th of March.