Turkey: The CBRT promises tight monetary policy for longer

- Yesterday, the CBRT kept its policy rate unchanged, in line with expectations.
- The Monetary Policy Committee (MPC) promised to maintain tight monetary policy for an extended period of time while explicitly noting that further tightening would be on the table if needed.
- While the Committee maintained its cautious assessment of the inflation outlook, it highlighted its expectation that the inflationary pressures from domestic demand conditions and cost factors could fade due to the monetary policy tightening delivered so far.
- We expect annual inflation to decelerate gradually to 10.8% at the end of this year, after peaking at around 15.5% in April. It could pick up slightly to 11.5% in 2022.
- The CBRT will likely maintain its policy rate at the current level in 1H21. We expect an easing cycle in the second half of the year, which would bring the policy rate to 12% at the end of 2021.

The central bank left its policy rate unchanged at 17%, in line with our forecast and the median market expectation. Given this decision and the post-decision statement, we think the CBRT is adopting a wait-and-see approach to observe the impact of the monetary policy tightening delivered so far.

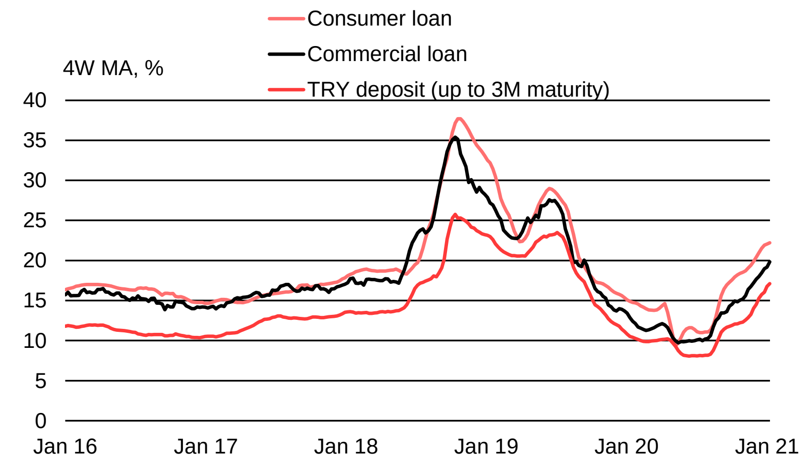
The MPC committed to maintaining its tight monetary policy stance for an extended period. The post-decision statement contained a number of changes from the one in December, particularly with respect to the policy guidance and the MPC's assessment of the inflation outlook. First, the Committee repeated guidance that it would maintain the tight monetary policy until it sees strong signs of a permanent fall in inflation, while adding the phrase "for an extended period". In our view, by adding this phrase, the CBRT aims to reinforce its commitment to a tight monetary policy stance to achieve price stability.

Second, the MPC stated that additional tightening would be delivered if deemed necessary. November and December rate statements did not include such an explicit reference to keep additional monetary tightening on the table.

Third, the MPC repeated its previous assessment that the domestic demand conditions, cost push factors (in particular the exchange rate effects and increasing international food and other commodity prices) and high inflation expectations continued to adversely affect the inflation outlook. However, the Committee added its expectation that the aforementioned adverse effects from domestic demand and cost factors (in this case referring to the exchange rate impact) would fade gradually as a result of the monetary tightening delivered at the November and December meetings.

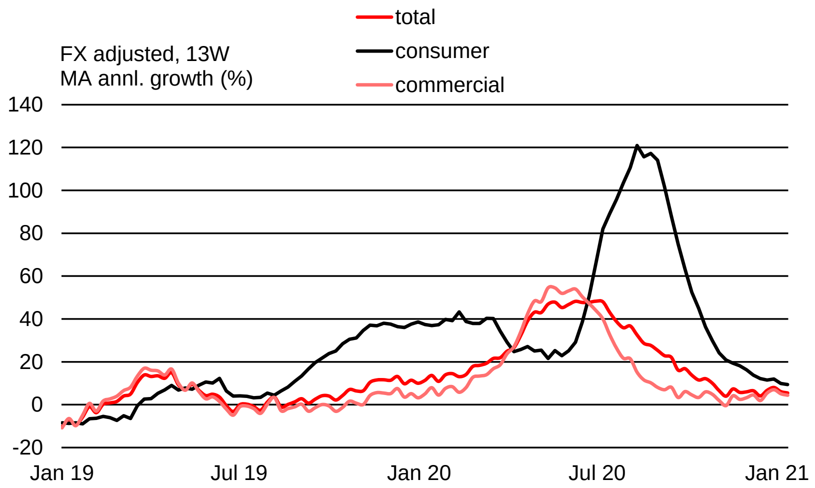
Domestic demand will likely slow down as loan growth decelerates due to the tighter monetary policy stance. Loan and deposit interest rates have been increasing since August, following the upward trend in the average funding cost. With the latter having increased by more than 9pp in the meantime, loan and deposit rates have made their way back to 3Q19 levels (Chart 1). Consequently, growth rates of commercial loans and, more recently, consumer loans have eased to single digits (Chart 2). Given our expectation that the CBRT will keep the monetary policy stance tight in 1H21, lending could remain weak, keeping the sequential credit impulse negative in the coming quarters. We expect domestic demand to weaken further in 1Q21, reflecting the impact of tighter lending conditions. Meanwhile, pandemic-related restrictions will continue to weigh on economic activity. These factors could lead to a GDP contraction of around 3% qoq in 1Q21 (assuming restrictions remain in place for most of this quarter), followed by a partial recovery (1.5% qoq) in 2Q21 if restrictions are gradually lifted. The economy could expand by 2.9% in 2021 and by 4% in 2022, in our view.

CHART 1: INTEREST RATES



Source: CBRT, UniCredit Research

CHART 2: LOAN GROWTH

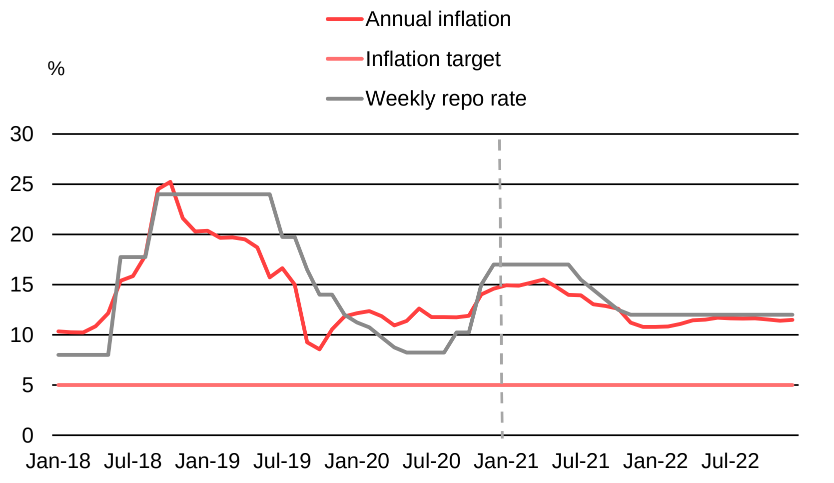


Source: CBRT, UniCredit Research

We will see how the aforementioned assessment on the inflation outlook feeds into the CBRT's projected inflation path when the January Inflation Report is released next Thursday. In the previous report, released at the end of October, the CBRT projected inflation of 9.4% at the end of 2021. The MPC's own assessment of the inflation outlook hints at upward risks for the assumptions underlying this projection. That said, we doubt the CBRT would opt for a sizable upward revision at this stage since the Committee has referred to its 2021 inflation projection as a "forecast target" in its recent communications.

Inflation might peak at around 15.5% in April. Annual inflation increased sharply in 4Q20, primarily due to the sizable pass-through from TRY depreciation and the rise in food prices. Going forward, cost push factors will likely remain inflationary although the recovery of TRY and slower domestic demand could curb some of the inflationary impact. Consequently, annual inflation could reach 15.5% in April, before starting to decelerate gradually, easing to 10.8% by the end of 2021 (Chart 3). We expect a limited rise in inflation to 11.5% next year.

CHART 3: INFLATION AND INTEREST RATE



Source: TurkStat, CBRT, UniCredit Research

The CBRT will likely keep rates unchanged in 1H21. The current policy rate level implies an ex-post real interest rate of slightly above 2pp when calculated with the latest (December) annual inflation figure at 14.6%. While the implied real rate will decline until April, given the aforementioned inflation outlook, it will remain positive, which could suffice for the CBRT to avoid additional tightening. We expect the CBRT to maintain the weekly repo rate at 17% in 1H21, before lowering rates gradually from July onward. The central bank could cut its policy rate to 12% by the end of this year and leave it unchanged next year.

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E 20/1

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