

# Turkey: The CBRT stays on hold & Lira depreciates

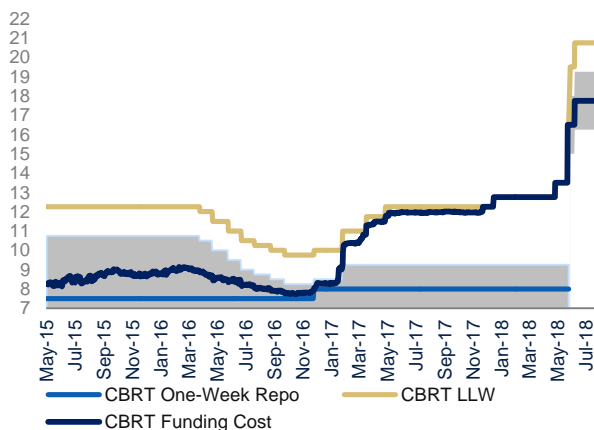
Adem Ileri / Serkan Kocabas / Alvaro Ortiz

The Central Bank (CBRT) decided to maintain the policy rate unchanged (17.75%) despite the market expectations (including ours) of 100 bps tightening. After the decision, the market reacted very sharply and the Turkish Lira depreciated by 3.5%. While the CBRT recognized that “elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior”, it decided to maintain (and not increase) the tight stance and continue to monitor “Inflation expectations, pricing behavior, lagged impact of recent monetary policy decisions, contribution of fiscal policy to rebalancing process and other factors affecting inflation, if needed, further monetary tightening will be delivered”. Today’s decision is a risky one as some of the reactions by markets, rating agencies, households and corporates could be self-fulfilling. In any case, the communication process should be clearly enhanced. We expect the CBRT will have to tighten later, maybe tighter depending on the degree of fiscal consolidation and currency volatility.

## Inflation & expectations still high despite the economic rebalancing

After the highest realization of inflation (15.4%) in June since December 2003, inflation expectations (one year ahead inflation increased from 10.44 to 11.07% in July) increased accordingly due to deterioration in pricing behavior and ongoing cost push factor on the back of negative currency shocks. According to the statement, the CBRT envisages that the economic adjustment is already underway. Hence, CBRT decided to keep the policy rate unchanged and will closely monitor the inflation expectations, pricing behaviors, the lagged effect of the tight monetary policy and the contribution of fiscal policy to rebalancing and the other factors affecting inflation. Depending on the correction in food prices and the likely removal of the adjustment in fuel prices, inflation could experience the peak level in July, reaching 16% or higher. From now onwards, the disinflation path will also depend on the fiscal consolidation included in the New Medium Term Program.

Chart 1 CBRT Interest Rates



Source: BBVA Research Turkey, CBRT

Chart 2 12-month Inflation Expectation & Core Inflation



Source: BBVA Research Turkey, CBRT, TURSKTAT

## The ball is now on the Fiscal side...

Today’s CBRT decision disappointed the market and there is a risk that the decision could feed further inflation expectations and inertia, maintaining high levels of inflation. Looking ahead, today’s decision redirects the focus on fiscal policy which will have to show a clear commitment in the fight against inflation. Fiscal measures will be now monitored very closely.

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## BBVA Research Turkey Unit

### Chief Economist for Turkey, China and Big Data Unit

Álvaro Ortiz  
alvaro.ortiz@bbva.com

Adem Ileri  
ademil@bbva.com

Ali Batuhan Barlas  
albari@bbva.com

Deniz Ergun  
denizer@bbva.com

Seda Guler Mert  
sedagul@bbva.com

Serkan Kocabas  
serkankoc@bbva.com

Yigit Engin  
yigite@bbva.com

Pelin Ayranci  
pelinayr@bbva.com

## BBVA Research

Chief Economist BBVA Group  
Jorge Sicilia Serrano

### Macroeconomic Analysis

Rafael Doménech  
r.domenech@bbva.com

#### Digital Economy

Alejandro Neut  
robertoalejandro.neut@bbva.com

#### Global Macroeconomic Scenarios

Miguel Jiménez  
mjimenezg@bbva.com

#### Global Financial Markets

Sonsoles Castillo  
s.castillo@bbva.com

#### Long-Term Global Modelling and Analysis

Julián Cubero  
juan.cubero@bbva.com

### Innovation and Processes

Oscar de las Peñas  
oscar.delaspenas@bbva.com

### Financial Systems and Regulation

Santiago Fernández de Lis  
sfernandezdelis@bbva.com

#### Digital Regulation and Trends

Álvaro Martín  
alvaro.martin@bbva.com

#### Regulation

Ana Rubio  
arubiog@bbva.com

#### Financial Systems

Olga Cerqueira  
olga.gouveia@bbva.com

### Spain and Portugal

Miguel Cardoso  
miguel.cardoso@bbva.com

#### United States

Nathaniel Karp  
nathaniel.Karp@bbva.com

#### Mexico

Carlos Serrano  
carlos.serranoh@bbva.com

#### Middle East, Asia and Big Data

Álvaro Ortiz  
alvaro.ortiz@bbva.com

#### Turkey

Álvaro Ortiz  
alvaro.ortiz@bbva.com

#### Asia

Le Xia  
le.xia@bbva.com

### South America

Juan Manuel Ruiz  
juan.ruiz@bbva.com

#### Argentina

Gloria Sorensen  
gsorensen@bbva.com

#### Chile

Jorge Selaive  
jselaive@bbva.com

#### Colombia

Juana Téllez  
juana.tellez@bbva.com

#### Peru

Hugo Perea  
hperea@bbva.com

#### Venezuela

Julio Pineda  
juliocesar.pineda@bbva.com

### CONTACT DETAILS:

BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain). Tel.: +34 91 374 60 00 and +34 91 537 70 00 / Fax: +34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com