Economic Watch

Turkey: The CBRT softens its policy tone

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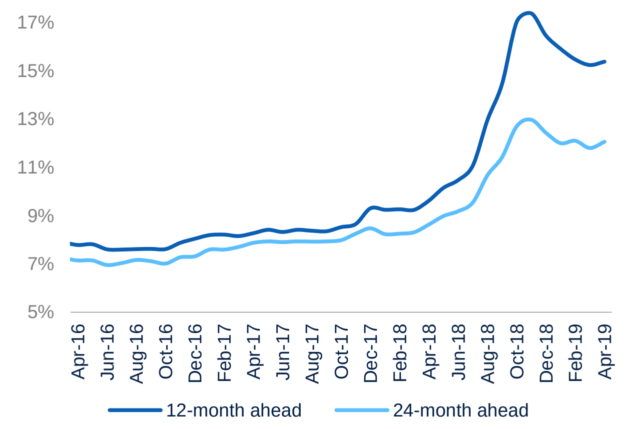
The Central Bank (CBRT) maintained the monetary policy rate unchanged (one-week repo, 24%) in line with expectations. The policy statement was slightly different and the drop of the sentence in the statement "if needed, further monetary tightening will be delivered" triggered a negative market reaction resulting in a lira depreciation by 1.2% against the USD. We expect that the CBRT will wait to start the easing cycle and the process of reduction of interest rates should start after the summer (i.e October) when inflation should be significantly lower. Despite the real rates remain high, the new round of market, political and geopolitical uncertainties and their potential effects on pricing behavior should be closely monitored and inflation expectations should be more anchored before letting the interest rates to drop. We believe that the Central Bank will maintain the tight stance with deeds and words (maybe reinforced in the next inflation report presentation) and we stress our view that they should stay tight for longer given the new round of uncertainties. Beyond this, the policy framework should be comprehensive and the fiscal policy should enhance efforts as the risk of missing targets is also alive.

Inflation expectations support prudence…

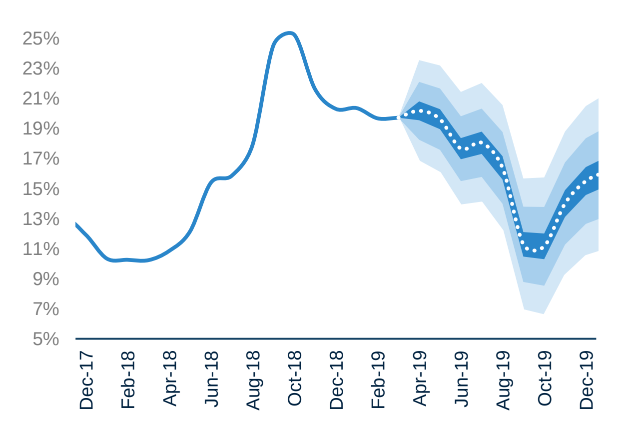
Despite the slight recovery in inflation thanks to the extended tax incentives, some stabilization in exchange rate and lower demand, annual inflation remained at near 20% in the 1Q due to high inertia, cost-push factors and high food inflation. According to our estimates, the underlying trend that eliminates the temporary effects in inflation is still hovering around 14%, which should support our expectations of monetary policy to remain on hold in the short term. The recent currency volatility stemming from both political and geopolitical uncertainty and volatile food prices has hit inflation expectations as 12-month and 24-month ahead annual inflation expectations lifted up from 15.2% to 15.4% and from 11.8% to 12.06% respectively. Still alive cost push factors (PPI is near 30%), the still uncertain outlook on political and geopolitical and the potential effects (in prices and quantities) of the removal of US waivers to Iran crude oil import overcome the negative output gap and diminishing pass-thru as a result of low demand. Hence, the CBRT should maintain its tight stance to increase confidence in order to anchor inflation expectations.

Chart 1 Inflation Expectations (YoY)



Source: BBVA Research Turkey, CBRT

Chart 2 BBVA Inflation Forecast (YoY)



Source: BBVA Research Turkey

…and require the Central Bank to stay tight for longer

We expect that annual inflation will stay close to 20% until June and near 15.5% at the end of the year. There are some upside risks on price stability (signaled also by the CBRT) that could create further deterioration in inflation expectations. Thus, we think that the CBRT should wait until October when the recovery in inflation will become more obvious to initiate easing cycle in monetary policy.

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