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Türkiye | The Hawk That Dove: Surprising hurry of the CBRT to ease

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- The Central Bank of the Republic of Türkiye (CBRT) lowered the policy rate by 300bps to 43%, higher than the consensus of 250 bps, with also a similar size of cuts in the corridor (41.5%-46%).
- Compared to June MPC, the overall tone seems to become dovish, despite challenges on both price and financial stability. The CBRT shows complacency about both the disinflation trajectory by stating a *temporary* rise in July CPI due to month-specific factors, and also highlighting the strengthening *negative* impact of demand conditions on inflation; which we think is a little bit early to be sure at the time of the renewed monetary easing.
- Additionally, the CBRT removes the expression on its decisiveness regarding the tight monetary stance with all policy tools. Instead, it refers to only a tight monetary policy stance, which will be maintained until price stability is achieved.
- According to our calculations, administered price adjustments could contribute approximately 1pp to headline inflation, bringing the monthly figure close to 2.5% in July. Excluding those one-off effects, the underlying trend can still decelerate; yet keeping uncertainties for further improvement. Second, given the latest shocks and additional financial tightening thereafter, demand conditions have become more restrictive to support disinflation; but with inadequate composition to reach inflation targets where inflation expectations remain unanchored.
- On financial stability, although dollarization tendency of residents has eased somewhat, it remains persistent, especially seen in inflows to foreign currency investment funds most recently. After the recent increase in withholding tax on TL deposits and funds, it will be key to ensure attractiveness for TL savings, while also sterilizing excess TL liquidity during the accumulation of reserves not to allow a fast decline in ON TL rates.
- The communication of the CBRT, *the step size will be reviewed prudently on a meeting-by-meeting basis with a focus on the inflation outlook*, signals continued cuts in every meeting going ahead, where we evaluate the size of the cuts will likely be reduced after September MPC. We still expect 36% policy rate by end 2025, with reduced cuts to 200bps in October and December.

No room for complacency on inflation with inadequate fiscal support

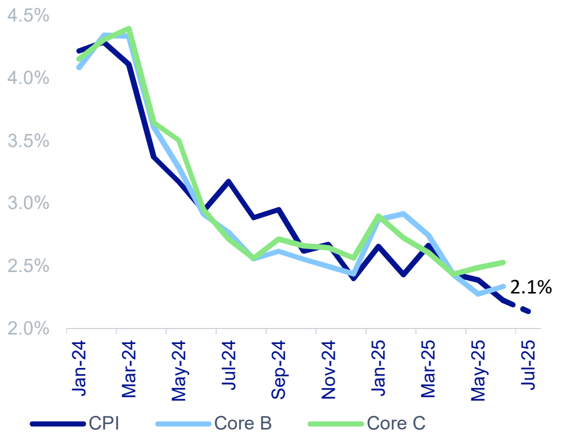
Despite the cautious June MPC decision and the subsequent hawkish communication thereafter, the CBRT surprised the markets with a rate cut exceeding expectations. The latest positive surprises on inflation prints and a shift in demand conditions towards a more disinflationary stance appear to have prompted the CBRT to proceed with a higher pace of easing. Nevertheless, inflation expectations,-although showing some improvement- remain elevated, while global tariff tensions and (geo)political risks persist. In this context, maintaining a similar asymmetric interest rate corridor might provide buffer for risks on both sides. Yet, starting with a more dovish step in the easing cycle and signaling continued cuts going ahead would weaken such buffer, where the opportunity window for the CBRT to reduce inflation within the forecast range this year, might be missed.

In May and June, seasonally adjusted monthly inflation stayed at around 2%, and the 3-month average trend declined to 2.2%. Administered price adjustments—24.6% increase in natural gas price, as well as fuel and alcohol-tobacco tax hikes- are expected to add approximately 1pp to inflation in July, bringing monthly CPI to 2.5% and its seasonally adjusted figure to about 2.3%, suggesting —as emphasized by the Central Bank—a temporary uptick. Assuming tight monetary stance and further moderation in domestic demand, we could see a renewed improvement in the inflation trend starting from August. Nevertheless, risks to the disinflation path persist as inflation expectations remain well above the CBRT's forecast range. Market participants' year-end inflation expectations for 2025 and 2026 stood at 29.7% and 20.4% (vs. 29% and 18% of the upper bound, respectively). Additionally, expectations among households and firms for 12 months ahead remain high at 53% and 40%, respectively. Moreover, services inflation rose primarily in June due to backward-looking pricing, which we may continue to see in the coming months. Meanwhile, global trade tensions remain unresolved, and geopolitical risks persist. Although some food items have seen price declines due to excess supply, the delayed effects of frost-related disruptions may begin to appear later in the summer, keeping uncertainty on food inflation. Finally, the impact of administered price adjustments and weaker-than-expected fiscal discipline so far suggest that the support to disinflation may be limited. Notably, the CBRT's most recent policy statement omitted its previous emphasis on "increased coordination" with fiscal policy. All in all, persistent uncertainty around the disinflation path and unanchored inflation expectations leave no room for complacency. Based on the latest inflation realizations and the assumption of tight monetary stance, we have revised our year-end inflation forecast marginally to 30% from 31%, where we still keep our prudence. The third inflation report of the year, to be released on August 14, could shed more light on monetary stance and inflation outlook, while medium term plan which would be released later in early September could be key to understand the effectiveness of the policy mix to overcome bottlenecks on disinflation outlook.

On financial stability, in the case of dollarization and flow of reserves, we evaluate a very delicate balance of risks due to weaker than expected accumulation so far despite recovering tourism inflows. The level of net international reserves excluding swaps stood at $US48bn as of yesterday, improving from $US12.9bn on April 28th, but still remaining below $US66bn on March 18th (just before the domestic political shock). We observe a greater tendency towards TL assets, yet with also a faster inflow to FC funds. In fact, the exit from KKM has slowed down and a higher FC demand in favor of FC funds than the KKM exit has started to be seen after March shock, showing us dollarization risks are well alive and highlighting the need to keep TL savings as attractive as possible to allow a gradual dollarization pace.

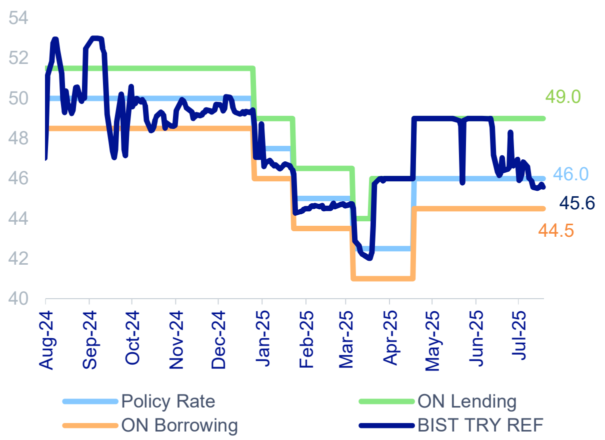
In conclusion, both domestic and external uncertainties continue to pose challenges to the inflation outlook. That said, we find today's communication turning to be dovish compared to June. In particular, the renewed easing cycle more aggressively than expected appears somewhat inconsistent with the previous hawkish communication, especially at a time when fiscal savings remain limited. Depending on the improvement in inflation dynamics, we do not rule out a similar 300bps cut in the September MPC meeting after today's decision. We still expect 36% policy rate by end 2025, with reduced cuts to 200bps in October and December. However, today's decision also introduces a downward bias to our year-end policy rate forecast, which we need to confirm with the near term communication of the CBRT. While the rate cutting cycle continues, monetary restrictiveness might be shaped by other tools, particularly the credit growth caps.

Figure 1. Consumer Inflation Indicators* (seasonal adj., 3-month average)



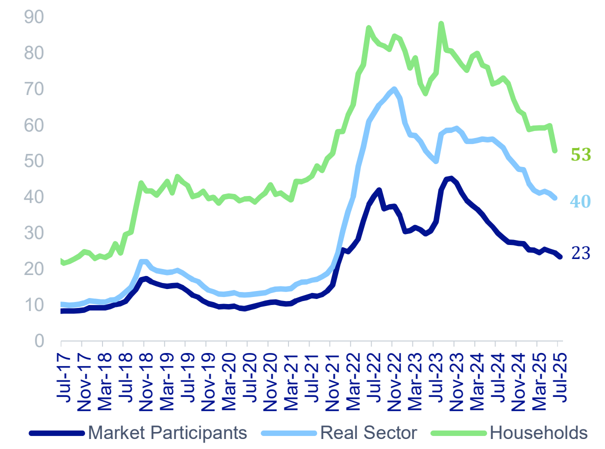
Source: Garanti BBVA Research, TURKSTAT

Figure 2. CBRT Funding Rate & BIST TL REF Rate (%, simple)



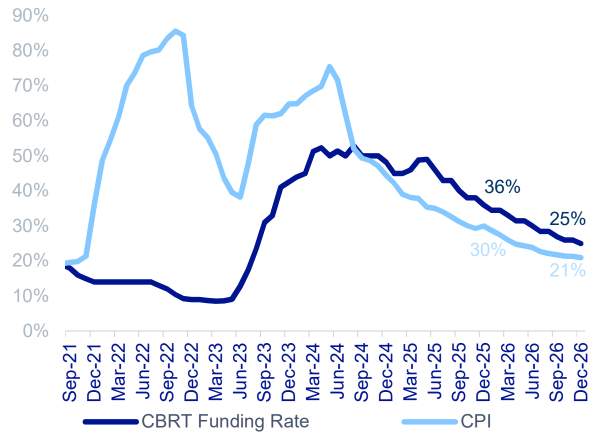
Source: Garanti BBVA Research, CBRT

Figure 3. CBRT Survey One-Year Ahead Inflation Expectations (%)



Source: Garanti BBVA Research, CBRT

Figure 4. Garanti BBVA CBRT Funding Rate & CPI Forecasts (%)



Source: Garanti BBVA Research, TURKSTAT, CBRT

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