POLICY PULSE

Turkey: The fine tuning is reaching its limits

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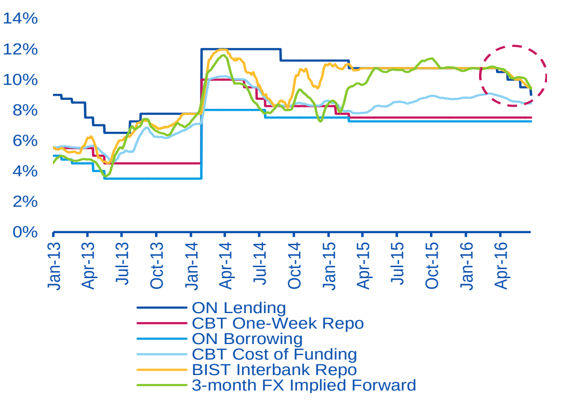
The Central Bank of Republic of Turkey (CBRT) reduced the upper bound of its interest rate corridor (marginal funding rate) 50bps further to 9%, and kept the lower bound of the interest rate corridor and the one-week repo rate constant at 7.25% and 7.50%, respectively. This movement will reduce the average funding rate by another 20bps according to our estimations. The marked fall in inflation was once again the main argument behind the easing while the recent decrease in the core inflation was also added this time. However, the sticky services inflation and the strong rise in unit labor costs preserve the necessity of a tight liquidity stance.

Retreat in core inflation was encouraging but services inflation remains sticky

Unlike the previous rate decisions (where justifications of then easing cycle relied mostly on food prices and global factors) the CBRT mentioned today the improvement in the core inflation as an additional argument to support its upper bound interest rate reduction. The 0.6pp fall in the CBRT core inflation indicator (core-I) in May seems to reinforce the CBRT to continue to ease monetary policy. The cumulated reduction of the upper bound interest rate (175bps) has been translated to near 40bps reduction in the average funding rate since the beginning of the year. Besides, it has placed the corridor at its narrowest since this monetary framework was introduced.

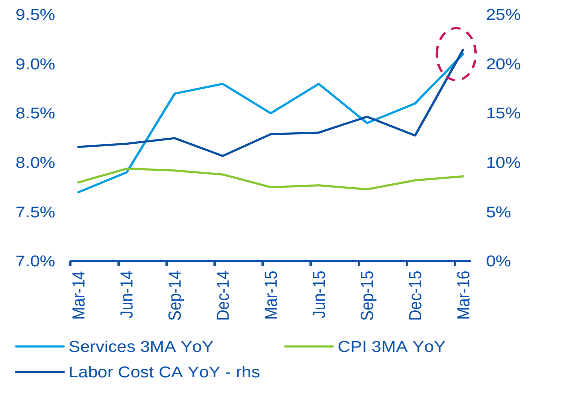
However, core-I is still too high at 8.8%, for any measure in our view, as the inflation target remains at 5%. Besides, we do not foresee a meaningful fall in core indicators in the medium term, as the sticky services inflation (9.1%) and impact of the minimum wage increase (reflected in the surge in unit labor cost of 21.5% YoY in 1Q2016) will remain as two important underlying inflationary factors. In this regard, the developments in services inflation and unit labor cost should be taken as a supporting argument for a prudent monetary policy in the following months.

Figure 1
Turkey: Interest Rate Corridor



Source: BBVA Research

Figure 2
Turkey: Inflation and Hourly Labor Cost



Source: Garanti Research, Bloomberg, CBT

What is next?

Keeping the current funding decomposition constant the average funding rate should fall from current 8.4% towards 8.2% in the next few weeks. Going forward, we think the margin for maneuver for the Central Bank is narrowing as the closing output gap, the sticky services inflation and surging unit labor costs will prevent any remarkable deceleration in core inflation. Thus, we think that the CBRT will continue to manage the monetary policy prudently, either through reducing the average funding rate with a minor upper bound interest rate reduction or stop to wait inflation data to give a further respite. In any case, the margin for fine tuning is reaching to an end.

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