Turkey: The CBRT tightens but lower than expected

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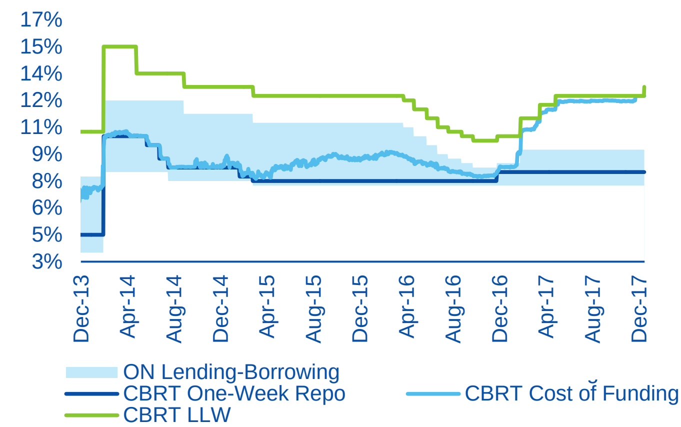
The Central Bank (CBRT) hiked the recent de-facto policy rate (late liquidity window, LLW) by only 50bps to 12.75%, disappointing the market call between 75-100bps and our call of 125bps in the average funding rate. The Bank acknowledges increasing risks on inflation expectations and pricing behavior once again so further tightening cannot be ruled out. The first reaction of the market was a sell-off and the TL depreciated around 2%. We expect inflation to fall slightly below 12% in December thanks to favorable base effects following its recent 13% level on exchange rate pass-through, second round price effects and excess demand. The base effects will be favorable until 2Q18, but beyond this, there is a risk on inflation to navigate near two digits until 4Q18, given the recent depreciation feeding inflation expectations and inertia, and positive output gap. The last expectations survey of the CBRT shows that market expects 9.3% inflation at the end of 2018 which in our opinion should have been prompted by a tigher reaction. The incoming inflation data will be the key input to know whether the CBRT opted today for a gradualist approach or just a wait-and-see attitude.

Inflation expectations deteriorate rapidly

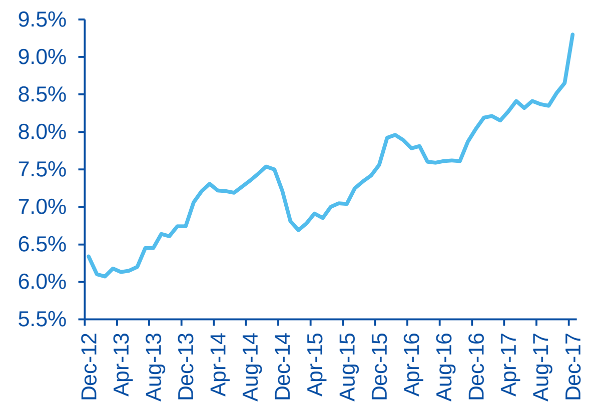
Despite the recent relief, TL is still implying a high depreciation level compared to summer months, which will be easily passing-through over core prices with a lag next year. Second, increasing energy prices will be another factor that will fuel cost push factors more and result in further second round price effects. Third, overheating in the economy may last long and keep core inflation high. After a robust growth rate in 2017 (our expectation is around 7%), we forecast that economic activity may continue to perform well around 4.5% levels next year before 2019's election cycle. Last but not the least, even though global factors seem to remain dovish over still weak global inflation dynamics, recently calmed local factors may reverse easily. All in all, this would require the Central Bank to preserve its tight stance longer than we had initially expected.

Figure 1 CBRT Interest Rate Corridor



Source: CBRT, Garanti Research

Figure 2 Inflation Expectation (12-month ahead)



Source: TURKSTAT, Garanti Research

Looking Ahead: Tighter for longer

Deteriorated inflation path and excess demand will require monetary policy remain tight (or even tighter) for a longer period than initially expected. Incoming data will be key to know whether today's decision was the "final act" of the renewed tightening cycle or just an intermediate step for further actions. In any case, inflation outlook remains gloomy.

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