Economic Watch

Turkey: The CBRT stays tight with deeds and words

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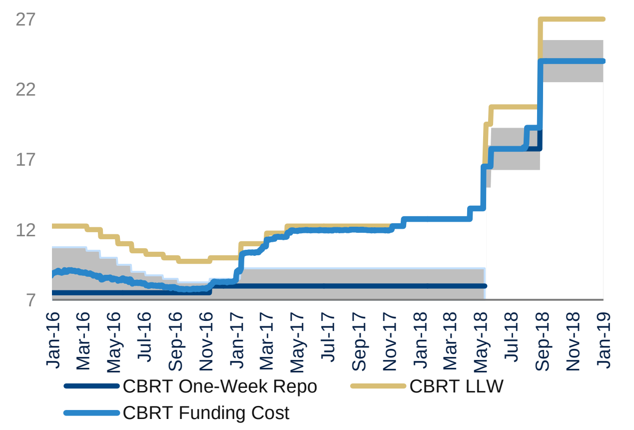
The Central Bank (CBRT) kept its policy rate (one-week repo, 24%) unchanged in line with expectations. The statement on the decision is almost the same with the previous one, but strengthens the policy tone (as seen in our Big Data CBRT sentiment index) by repeating "risks on price stability continue to prevail despite the recent improvement in inflation outlook". The stabilization of the currency and lower oil prices in 4Q18, utility price reductions and the extension of tax incentives all led to a downward shift on the expected inflation path mainly for 1Q19. Though, likely outrageous food inflation in January, higher-than-expected increase in minimum wage, recent tax hike in tobacco and volatile financial markets still pose upside risks on inflation, keeping inflation expectations far from anchored. Hence, the message "if needed, further monetary tightening will be delivered" remains in place preserving the tight stance. We consider the decision as the right one as it supports the disinflation path and reinforces credibility. In our view, the CBRT should wait for June (when the recovery in inflation becomes more obvious) to start an easing cycle.

Still uncertainties on inflation outlook should keep the CBRT alert…

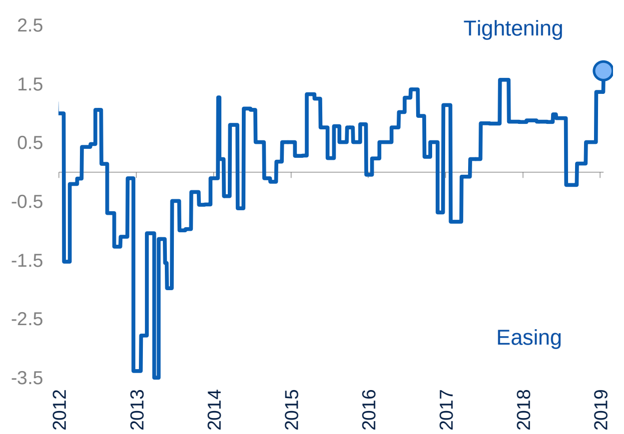
After the downside inflation surprises in the last two months of 2018 and the downward shift of the expected path for inflation on cyclical factors, the CBRT maintains its strong stance as the inflation outlook is still not promising. High volatility in the markets, uncertainties over the pricing behavior and cost push factors (fueled by higher-than-expected increase in minimum wage), and likely upside risks on food inflation and tobacco prices will probably keep inflation increasing in 1Q (but to a lower extent, by around 1-2pp), which is an adequate reason for the CBRT to stay on hold. We estimate that the headline inflation could stay above 20% in the first half of the year, before decelerating much faster afterwards on base effects and lagged effects of the deeper negative output gap. We think that the CBRT should wait to achieve a sizable improvement in inflation outlook and inflation expectations as they are still above the CBRT's interim targets. Despite the recent limited decline in medium term expectations, one-year ahead inflation expectation stays near 16% and two-year at 12% (vs. the CBRT's own targets of 15.2% and 9.3%). Thus, the CBRT also opted to reinforce its tight stance (as seen in our Big Data sentiment index in Chart 2), which will help to restore credibility and make it easier to manage the medium term expectations with more clarity and predictability in time.

Chart 1 CBRT Interest Rates, %



Source: BBVA Research Turkey, CBRT

Chart 2 CBRT Monetary Policy Statement Index



Source: BBVA Research Turkey

…and wait to start a gradual easing cycle for at least June

Despite the downward shift in the expected path of inflation for especially 1Q19, uncertainties over the pricing behavior still prevail. We think that the Central Bank should wait for June, when the negative output gap and diminishing exchange rate pass-thru might result in a deeper decline in the headline inflation, to start a gradual easing cycle. This could provide some buffer against unexpected negative inflation shocks.

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