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Turkey: CBRT overdelivers and maintains its monetary prudence

Development

The Central Bank of Turkey (CBRT) delivered a front-loaded and larger-than-expected 200bps hike to 19.0% in its key policy rate – one week repo rate, receiving a warm reception from global markets. In the statement complementing the rate decision, the monetary policy committee (MPC) maintained its hawkish rhetoric citing elevated inflation (and expectations). Since the turn of the year, the risks to inflation stemming from robust domestic demand conditions, cost-push pressures and high inflation expectations, in conjunction with increasing non-core volatile food and commodity prices has pressured the CBRT to act. Today's hike widens the buffer between the benchmark policy rate and inflation to currently 340bps.

Key data

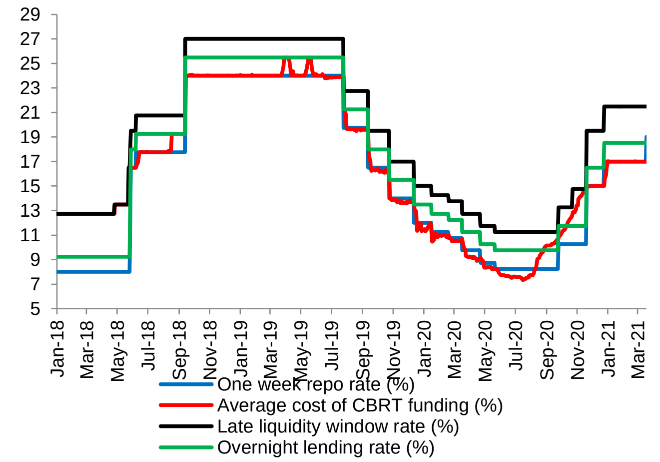
One-week repo rate: 200bp increase to 19.00% (MUFG 18.00%; consensus 18.00%)

Macro

After the CBRT raised its policy rates by a cumulative 675bps to 17% between September and December, we had believed that conventional monetary policy had reach its current cyclical peak. Indeed, since the new economic leadership under Governor Agbal and Finance Minister Elvan came to the scene in Q4 2020, the CRBT has been consistently prudent in its measures which have played a pivotal role in reducing the Turkish risk premium. However, recent global developments (notably the rise in long-term US yields), the upside inflation risks as well as market pressure

CBRT MAINTAINS MONETARY POLICY PRUDENCE

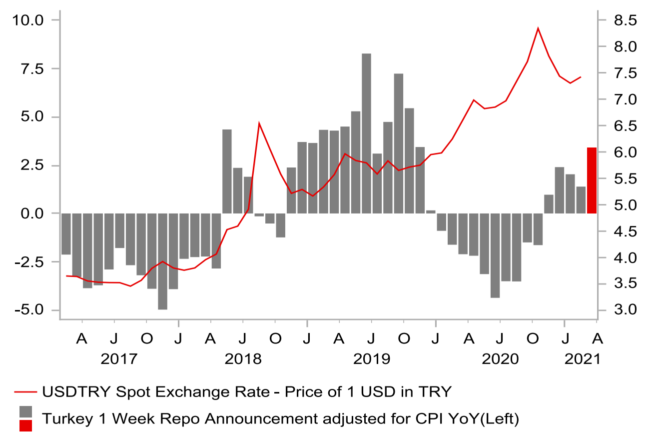
TURKEY BENCHMARK RATES AND EFFECTIVE FUNDING RATE (%)



Source: Bloomberg, CBRT, MUFG Research

HIGHER REAL POLICY RATE SUPPORTING TRY

POLICY RATE DEFLATED BY CPI VS. USD/TRY



Source: Bloomberg, Macrobond & MUFG Research on the TRY had strengthened the case for additional tightening. Heading into the meeting we had believed that these risks crossed the CBRT's threshold to err on the side of caution and act by rising the one-week repo by 100bps to 18.0%. The more aggressive tightening is justified by the prevailing high external financing requirements, the need to strengthen international reserves and need to promote a durable de-dollarisation path.

Looking ahead, we view that sustaining the current positive momentum and restoring macroeconomic stability entails a strong commitment to more orthodox policies, including a rule-based fiscal policy. We still expect the CBRT could look to start easing in the second half of 2021, though the start of the expected easing cycle will be conditional on evidence of weakening demand pressure, diminishing inflationary expectations, a robust pickup in de-dollarisation and TRY stability. Given Turkey's still elevated risk premium and large external financing requirements, progress in circumnavigating challenges pertaining to (i) inflationary pressures; (ii) requirements to bolster reserves and replenish capital inflows; as well as (iii) pivot residents' portfolio choice in favour of TRY-denominated assets to ensure a durable de-dollarisation strategy, will all require not only an appropriate risk adjusted return but also a sustainable track record. This would, in turn necessitate maintaining a conservative monetary policy stance and to provide robust forward guidance to markets on the CBRT's commitment to undertake additional tightening – which given the challenging inflation outlook, which we envisage peaking in March-April at ~16-17% y/y, and only meaningfully declining by the last quarter of this year when base effects take hold – may be required if there are no further meaningful declines in the risk premium over the near-term. What we believe markets would welcome is the further restoration of macroeconomic stability through a carefully calibrated and credible CBRT strategy to bolster FX reserves.

FX

The larger than expected CBRT rate hike has been welcomed by FX market participants. USD/TRY has fallen back below its 200-day moving average at just below 7.4400 for the first time since the start of this month, and moves further below the intra-day high of 7.7839 from 9th March. The CBRT have again shown that they are determined to tighten monetary policy in response to upside risks to the inflation outlook. The real policy rate in Turkey after adjusting for inflation is one of the most attractive in emerging markets. It should continue to favour the relative outperformance of the TRY which remains the one of best performing EM currencies so far this year despite the recent correction lower. The ongoing sharp rise in long-term US yields and USD rebound are though providing a more challenging environment for emerging market currency performance in the near-term. As a result, it is likely to be difficult for USD/TRY to fall back towards the lows from earlier this year at close to the 7.0000-level until the US bond market begins to consolidate at higher levels.

Trading

We had hoped that Turkey would once again over deliver in the tightening and they have very much done so with an aggressive hike. Following Brazil yesterday this is now the second EM central bank that has over delivered in a short space of time following a benign Fed. This bodes very well medium term for high yield EM and we have Turkey front of the pack here. Short term we are a bit more cautious after being nearly 4% up from yesterdays' low with support around 7.3000 and the political noise that caused the weakness yesterday still around. However our outlook is very much selling upticks in USDTRY as we expect inflows to come back with the carry on offer sufficient to offset concerns elsewhere. We also continue to favour longs here vs

ZAR. Key question for us over the medium term is whether this finally will spur domestic investors to convert their USD holdings into local currency. The de-dollarisation ratio will be key to watch.

Treasury

After higher than expected delivery that helped lira instantly, we will monitor the transmission of this rate hike on market funding conditions to loan / deposit markets in coming days. The credit growth remains relatively sluggish since beginning of the year, pressuring nominal lira deposit rates paid to local investors given demand / supply conditions and partially being a factor for slower pace of de-dollarisation in onshore market recently. Separately the withholding tax incentive on TRY deposit will mature as of 31 March and unless not extended WTH tax will be increased from 5% to 15% applicable 1 April. This readjustment on taxation level may offset the positive impact on net return for local depositors and discourage for any extra appetite to convert back to lira. We believe we will see some gradual decrease on dollarisation in coming weeks yet the pace would be depending on deposit market pricing / further extension of incentive that might help lira to take support from onshore as well if net return can increase in parallel to money markets.

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