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Turkey: CBRT credibility under strain with a surprise rate cut

Development

In an unexpected move, the Central Bank of Turkey (CBRT) cut the policy rate by 100bp to 18%, against our (and consensus) expectations, at the September MPC today. In the statement accompanying the rate decision, the CBRT defended its decision by stressing the temporary nature of the recent increase in inflation and a higher-than-expected contractionary impact of its tight policy stance on commercial loans. While reiterating a pledge to achieve price stability, Governor Kavcioglu removed his commitment to maintain the policy rate above inflation – the rate cuts pushes real rates now in deeper negative territory (-1.25%), with headline inflation at 19.25% y/y as of August. There is now an increasing likelihood that Turkey begins to decouple for its emerging market peers as real rates go further into negative territory and inflation expectations risk becoming unanchored.

Key data

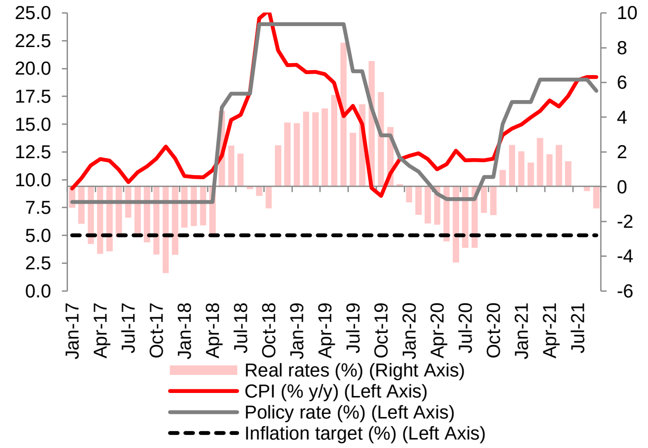
One-week repo rate: 100bp cuts to 18.00% (MUFG 19.00%; consensus 19.00%)

Macro

Heading into the meeting, our expectations was that the performance and potential reaction of the Turkish Lira (TRY) would be a key driver of the monetary policy decision and that the CBRT would not want to disappoint the market with a premature cut. Indeed, lower reserve buffers, alongside a more challenging

CBRT COMMENCES ITS EASING CYCLE WITH REAL RATES NOW DEEPER INTO NEGATIVE TERRIOTRY

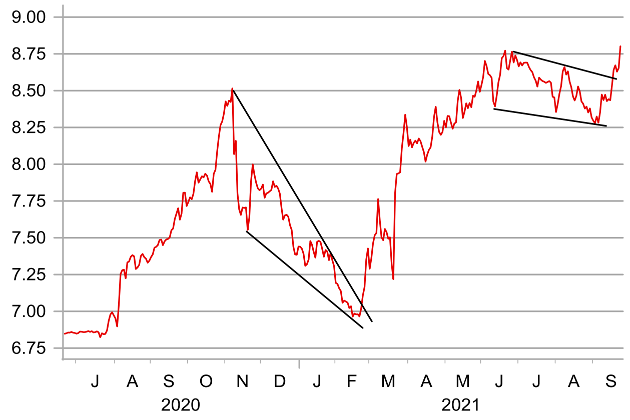
TURKEY NOMINAL AND REAL RATES (%) VS. INFLATION (% Y/Y)



Source: Bloomberg, CBRT, MUFG Research

USD/TRY IS BREAKING HIGHER AGAIN

USD/TRY SPOT RATE



Source: Bloomberg, Macrobond & MUFG Research macroeconomic backdrop (notably higher inflation and increased dollarisation), were signalling that the possible adverse consequences of a premature easing (or refraining from tightening if needed) are likely to be greater currently, as compared with similar episodes in the past. Having said that, we had catalogued (see here) that expectations of a rate cut have been rising given the CBRT's recent pivot towards focusing more on core inflation and supply shocks, especially given the recent stability of the TRY.

Going forward, the direction of CBRT policy is clear with today's move opening the floor for further easing. Before the meeting, our base case was for a cumulative 200bp in cuts before year-end. Whilst we maintain this magnitude of easing, we believe risks are skewed for more cuts, especially given base effects are set to ebb out of headline inflation in November and December.

Overall, the "credit-fuelled, economic growth at all costs" strategy of the authorities had signalled that rate cuts were always on the table. Today's action validates this positon. The policy priority is evidently now firmly on boosting economic activity with an eye on the 2023 elections, with price and financial stability now playing second fiddle. With this, the unorthodox argument that low interest rates causes low inflation dubbed the "neo-Fisherite Rebellion" will increasingly come front of mind in the months ahead, which could bring into question the CBRT's credibility, and ultimately weaken Turkish credit metrics and risk assets.

FX

The CBRT's surprise rate cut has hit the TRY hard as it quickly fell to a new record low against the USD. USD/TRY rose sharply above the highs from June hitting an intra-day high of 8.8017. TRY outperformance over the summer has quickly reversed. We expect the TRY to remain under selling pressure going forward. The earlier than expected CBRT rate hike has brought forward our forecasts (click here) for further TRY weakness. Our year end forecast of 8.6500 has already been exceeded with USD/TRY likely to hit our Q2 2022 forecast of 9.2500 much sooner now. The CBRT's decision to begin lowering rates when the headline inflation rate is still elevated at 19.25% has cast fresh doubt on monetary policy credibility in Turkey amidst President Erdogan's continued calls for lower rates. A more deeply negative real policy rate leaves the TRY vulnerable to further weakness especially at a time when the environment for capital flows to emerging market has become more challenging driven by building concerns over the growth outlook in China and the Fed's ongoing steps towards tighter monetary policy. Further TRY weakness will also act to keep inflation higher for longer reinforcing doubts over CBRT policy.

Treasury

We saw surprising action from CBRT with Mr. Kavcioglu finally delivering his first rate cut after waiting for it for six months. There were some signals for potential cut given the change in the rhetoric about commitment to pay positive real return on investor call scheduled earlier this month, however markets were yet still betting for inaction in this meeting specific given the latest inflation announced at highest for last 1.5years above 19.00%, taking real return to negative territory first time since November 2020. Despite the expected drop in inflation by last quarter due to favourable base effect in last two months, there are still some risk related increasing energy prices to limit the expected downside trend on last quarter as one of the important reason for markets to forecast hold decision this time. Following this surprising decision, the foreign investor appetite which was gradually recovering during summer months is expected to shrink again given the remembrance of idiosyncratic risks over monetary policy making, whereas local residents' strong demand for hard currency savings is also likely to continue with fears lingering for a deeper negative real return amid dovish policy prospects due to surging political pressure. With the expected drop in foreign investor appetite, the lower pricing in the offshore forward market which was observed since last June is expected to reverse with forward points to surge above onshore market traded levels. In line with low likelihood for supportive capital inflows under this environment, we expect lira to remain weak in coming weeks given foreign currency demand/supply conditions amid lower prospect for tourism revenues as high season and high trend in commodity prices both negative for external balances with fresh record lows are likely in case EM appetite sours.

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