

Turkey Macro Flash

CBT cuts rates as expected but its narrative remains a hard sell

- In line with the consensus, the CBT cut the one-week repo rate by 50bp to 8.25%, while also reducing the borrowing rate to 7.50% from 8.0% at July MPC meeting. Moreover, as was expected, the CBT kept the upper-band at 12%, which, according to the Bank, provides flexibility to respond to adverse shocks.
- The CBT argues that today's cut is justified by the improvement in global liquidity conditions in recent months and the subsiding effect of the lira depreciation on inflation. Not surprisingly, the Bank blames high food prices as the key factor hampering the disinflation process. Looking ahead, the CBT underlines that tight monetary policy stance will be maintained through keeping the yield curve flat until there is a noticeable improvement in the inflation outlook.
- In our view, there are at least two shortcomings associated with the Bank's current stance and narrative. *First*, we believe that the presence of the upper band (12%) provides a false sense of security. Previous lira sell-off episodes suggest to us that re-establishing currency stability isn't as easy as the CBT seems to envision. As the saying among traders suggests "*exchange rates go up by the stairs and down by the elevator*". *Second*, without going into a normative discussion as to why the yield curve may not be a good indicator of monetary policy stance in the first place, we note that the signals from Turkey's yield curve are not reliable due to poor liquidity conditions and the presence of a highly fragmented market (the long-end is dominated by foreign investors). Consequently, the CBT's emphasis on the yield curve as a robust indicator of its policy stance should be taken with a grain of salt.
- All in all, as we discuss in this note, the CBT hasn't made a convincing case for its rate cuts since May. Nonetheless, it looks like the CBT will maintain its dovish stance and carry out additional easing (e.g. another 50bp cut at the August meeting) if the lira and global markets permit. However, the fact that external factors can easily become less benign (coupled with the risks that we highlight in this note) leads us to believe that the CBT risks repeating past mistakes.

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Figure 1. CBT's Policy Rates (%)

July 2014	Actual	Citi Forecast	Market Forecast	Previous Release
Lending rate (%)	12.00	12.00	12.00	12.00
One week repo rate (%)	8.25	8.25	8.25	8.75
Borrowing rate (%)	7.50	8.00	7.50	8.00

Source: Bloomberg and Citi Research

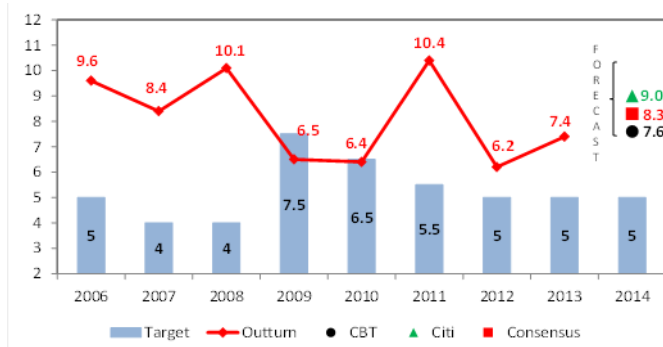
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Forecast Implications

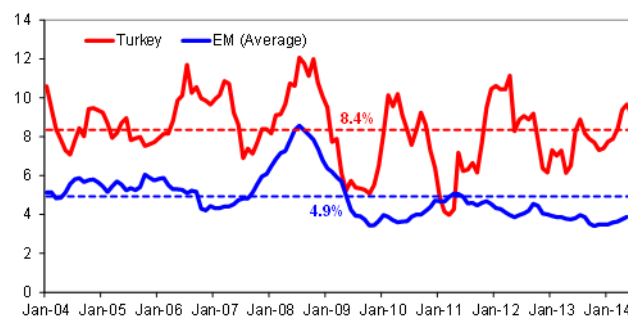
Our analysis suggests that inflation has probably peaked in May at 9.7%YoY and is on track to ease during the summer months on the back of favorable base effects. However, we think that inflation will likely remain elevated owing to the recent deterioration in inflation expectations, delayed effects of pass-through, and the likely energy price hikes later in the year. We believe that the possibility of a relatively poor harvest year further complicates the outlook. Against this backdrop, we believe that year-end inflation is likely to be around 9.0%.

Figure 2. Inflation: Target vs. Outturn



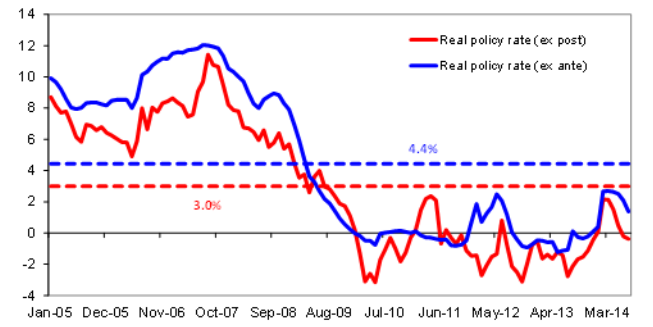
Source: CBT and Citi Research

Figure 3. Inflation: Turkey vs. EM (%YoY)



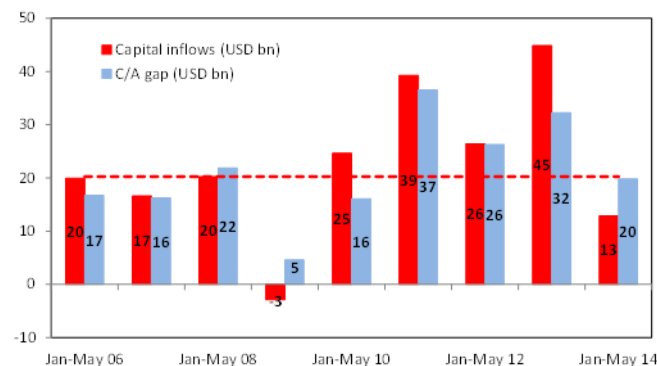
Source: Haver and Citi Research

Figure 4. Real Policy Rate (%)



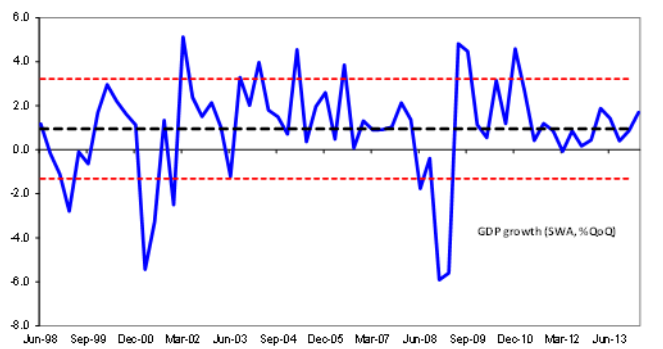
Source: CBT, Haver and Citi Research

Figure 5. Capital Inflows vs. C/A Deficit (US\$bn)



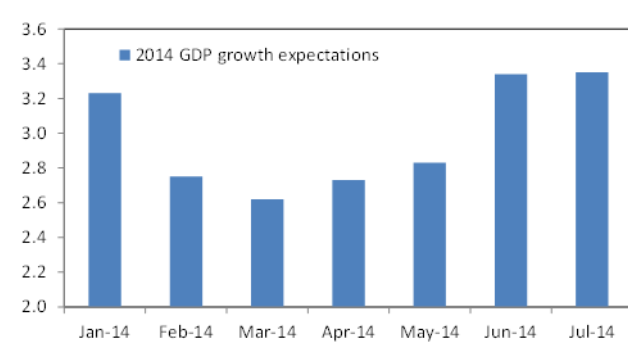
Source: Haver and Citi Research

Figure 6. GDP Growth (%QoQ, SWA)



Source: Haver and Citi Research

Figure 7. Year-end GDP Growth Expectations (%)



Source: CBT and Citi Research

Policy Implications

It is true that the CBT's 50bp easing at the July MPC meeting was widely expected. However, we continue to struggle to follow the CBT rationale behind its rate cuts since May for at least three reasons:

- With year-end inflation expectations standing at 8.3%, which is above the upper limit of the uncertainty band (7%) and the CBT's latest year-end inflation forecast (7.6%), it is hard to make a case for the recent rate cuts if the CBT is still targeting inflation. In our view, markets should be concerned with the CBT's poor track record (Figure 1) — particularly the country's inflation performance with respect to its peers in the EM space (Figure 2) — and low real rates (Figure 3).
- The available evidence suggests that, despite the recovery of the lira and the marked rally in the bond market, inflows have so far been unimpressive (Figure 5). Given investors' valuation concerns ([Turkey Macro Flash - Trip Notes: Investors wait for better levels to add exposure](#)), we believe lower yields are unlikely to make Turkish assets more attractive, particularly if one considers uncertainties associated with the domestic political outlook ([Economics Presentation - Turkey: Monetary policy is testing its outer limits, again](#), page 11) and geopolitical risks.
- The available evidence to date — including the 1Q GDP growth outturn and the evolution of 2014 growth expectations — suggests to us that economic activity is not particularly weak (Figures 6 and 7). By contrast, standing at 1.7%QoQ (SWA), GDP growth in 1Q seems to have gained momentum when compared with 4Q 2013 (0.9%QoQ) and 3Q 2013 (0.4%QoQ). The absence of a large negative output gap makes it difficult to put forward a credible case for monetary policy easing.

In light of the above, we believe that the CBT's rate cuts since May are premature and run the risk of reversing the salutary impact of the January rate hike in stabilizing the lira and bolstering investor sentiment. Looking ahead, we don't rule out additional easing — e.g. another 50bp cut at the August meeting — if the lira and global markets permit. However, the fact that external factors can easily become less benign — coupled with the above-noted risks — leads us to believe that the CBT risks repeating past mistakes.

Appendix A-1

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