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Turkey's Central Bank: Further Easing

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Turkey's central bank cut their policy rate (the one-week repo) by 50 basis points, to 5.75 percent. This is the third interest rate reduction since December 2010, for a cumulative 125 basis points. A stark contrast with monetary policy elsewhere, the continued easing is part of a strategy that aims to deal with the most visible vulnerability in Turkey's economy, a very large current account deficit, by inducing a weaker Lira. In this framework, inflation has been seen as a problem of a distant second-order, although policymakers have raised bank reserve requirements to slow lending growth, both to prevent *eventual* overheating and bubbles and the concomitant risks to financial-sector health.

Whether this approach can be called a success thus far is debatable: the Lira has, in effect weakened, but the current account deficit has not narrowed; inflation has moved up, but just slightly. Be that as it may, the most likely 12-month scenario for Turkey includes—barring a sudden collapse of activity—some monetary tightening, as the TCB's strategy is likely, on present trends, to reach a natural limit.

Up until now, for example, inflation has remained well-behaved relative to history and to the central bank's expectations, although a step up has been noticed in the past few months, nonetheless without evident upward dynamism. Meanwhile, the economy's pace of activity has surprised, with GDP in the first quarter jumping 11% year-on-year. Should such pace of expansion be maintained it would almost undoubtedly translate rather soon into a change of conditions enough to force the central bank's hand near-term.

That, however, may not be occurring. To be sure, import activity suggests that domestic demand has continued to expand at a very strong pace; there was only a slight reduction in the annual rate of imports in the three months to June (41.6% year-on-year), versus the first quarter (45.6% year-on-year). But industrial production has slowed more noticeably, from 14.1% year-on-year in the first quarter to 8.4% in the two months for which data are available in the second.

Also important from the standpoint of central bank policymaking is that the data now show a reduction of the pace of consumer lending during the past five weeks, prominently in mortgage and car financing. All of this against the background of still-considerable slack in manufacturing: capacity utilization has continued to rise, but at a slower pace, and it remains well below the pre-crisis norm. And for the central bank—as mentioned in their post-meeting communiqué--against a background of increasing external risks that warranted their move to ease to-- in their words--"reduce the risk of a domestic recession that may be caused by the heightened problems in the global economy".

Should those risks not materialize, however, the current trajectory of the Turkish economy, particularly given the boost of low borrowing costs, is likely to lead to a more significant rebound of inflation within a 12-month horizon, fueled by strong demand and by a weak lira (now close to a historic low).

The bottom line is that the current policy has not aggravated the inflation problem, but has failed to remedy the risk posed by a widening external shortfall, and unless the trend changes abruptly on account of global forces, monetary policy will likely have to take a different course over the next few months, with interest rate increases likely perhaps as early as the first few months of next year.