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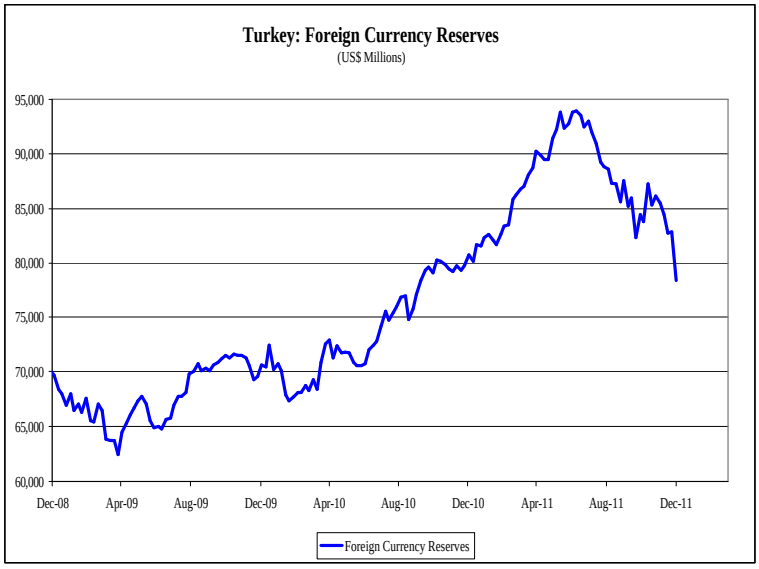
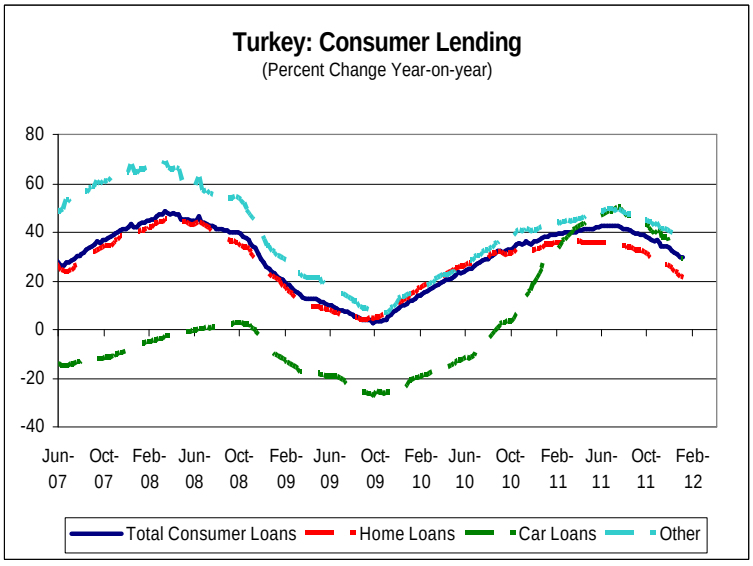
Turkey: How Vulnerable?

The debate regarding monetary policy has turned political in Turkey, with the prime minister warning that the central bank must not give into the demands of what he calls "the interest rate lobby".



The Turkish central bank has maintained its benchmark repo rate stable but let the cost of overnight borrowing to move up sharply since mid-October. There has been *some* downward movement in the overnight rate in recent days. While there were external reasons for such drop (an improvement of financial sentiment in the Eurozone) the decline of the overnight rate coincided with the Erdogan's "offensive", and this has left markets with reasonable doubts as to the central bank's present--and most importantly, future--independence.



Overt political intromission adds to the complexity of monetary policy-making at a time when the TCB appears to be conflicted about its strategy, given both internal conditions (the rebound of inflation and a large and resilient current account deficit) and external uncertainties and risks related to Europe's troubled economy.

Since the last quarter of 2010, facing declining inflation and a widening current account deficit (approximately 10% of GDP, above the historical norm, which is closer to 7%) the central bank adopted the unconventional approach of lowering rates in the midst of an accelerating expansion, with the aim of weakening the lira. Lira adjustment would lead to a narrowing of

the current account shortfall, identified back then as the most important threat to the economy's stability. Within the strategy, money creation would be slowed by increasing bank reserve requirements.

One year later, though, a strong consumption-led expansion has impeded progress on the current-account front, precisely at a time when the risk of financing the external shortfall has risen as a consequence of recessionary conditions in much of Europe. Meanwhile, consumer price inflation is back into double-digits, a development which at least some policymakers attribute to the "success" of earlier policy in helping lower the value of the lira.

Hence the policy dilemma: to tighten money now, for the purpose of containing domestic demand and slowing the pace of imports, as well as to reduce inflation, means to accept a high risk that such policy would be intensifying the *cooling* already underway to the point of recession; to keep policy loose for the purpose of protecting against mounting risks to growth means, probably, additional weakening of the lira (especially as foreign reserves become less abundant) and faster double-digit inflation down the road, making a sharp policy turnaround inevitable at some point.

Either of these choices carries potentially high costs. Political intervention seems to be pushing the central bank into the second approach, on the expectation that it would be less disruptive of growth. There is a significant question mark around this expectation, however, as monetary policy becomes a more evident concern for the markets, and because of Turkey's substantial trade exposure to Europe. The bottom line is that the near-term growth outlook for Turkey seems increasingly challenging, with likely growth in the low single-digits and broad room for a downside surprise.