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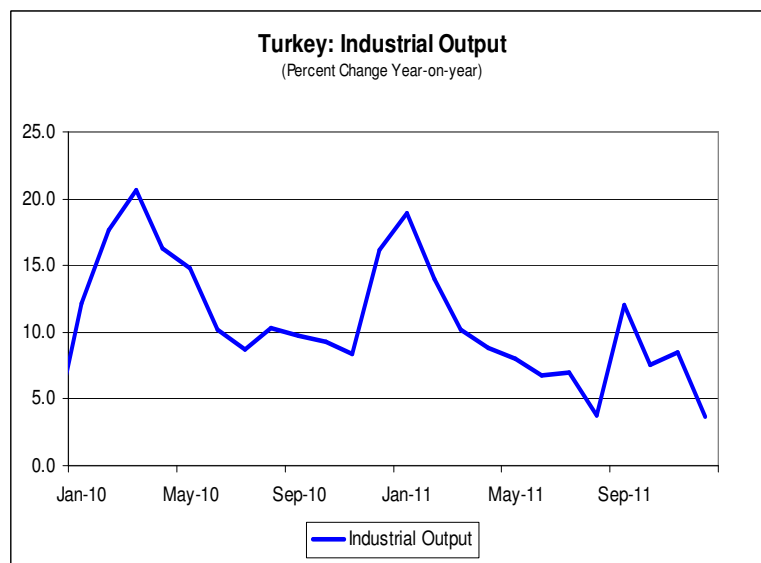
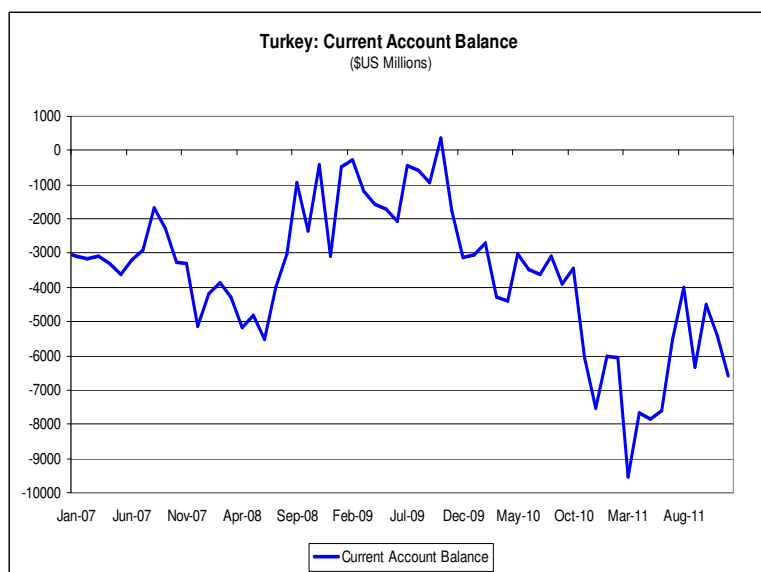
Turkey: Monetary Policy Easing?

Turkey's central bank policymakers seem to be moving in the direction of an easier-money stance. The TCB has just reduced the upper ceiling of its overnight-interest rate corridor from 12% to 11%, leaving, however, the lower boundary of the corridor unchanged at 5% and the one-week repo rate also unchanged at 5.75%.

From a practical standpoint, the move does not affect the current cost of borrowing for Turkey's banks, which has recently hovered around 8%.

But as a signal, it clearly indicates that policymakers foresee a less acute risk of inflation ahead, and also a more favorable trend regarding the current account deficit. The latter exploded in 2010-11 and prompted an intense policy debate followed by the adoption of a heterodox strategy in which interest rates were cut/kept low to weaken the lira and thus stem the widening of the external shortfall. This policy course seemed exhausted in the third quarter of 2011, as the current account deficit proved resilient and consumer price inflation—which had been low—jumped again into double-digit territory.

Now conditions seem to be somewhat, but not drastically, different: the current account deficit has begun to shrink, and inflation has stabilized in early 2012--although it remains in double digits. The government has seized on these seemingly emerging trends to justify their earlier

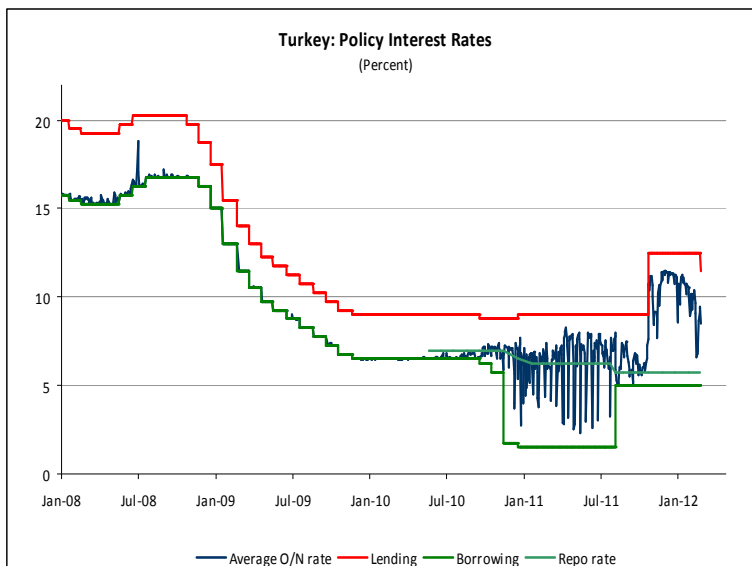


pressures on the central bank and against what Prime Minister Erdogan had called “the interest rate lobby”. Policymakers get the room to make a low-cost concession that puts them on the good side of the political leadership.

The outcome, a gradual shift to a less hawkish stance, might prove to be reasonably adequate to manage a soft-landing of the economy—given the apparent cooling underway and the lingering risks from the euro-zone—*provided* that the stabilization trend of the current account and of consumer price inflation continues.

But there is still a significant risk that inflation will not descend back into single-digits, possibly even accelerating on the back of oil prices.

For the time being, the central bank seems firmly in the inflation-optimist camp, which suggests that borrowing costs may follow a downward short-term trajectory unless new data force a policy reversal. The official rationale is provided in the February 22nd TCB policy statement:



...“the rebalancing between the domestic and external demand is ongoing as envisaged. Final domestic demand is decelerating while the contribution of net external demand to growth is increasing. Accordingly, the rebalancing process and the improvement in the current account deficit will continue in the forthcoming period. Starting from February, core inflation indicators are expected to follow a downward path due to favorable cost factors.”