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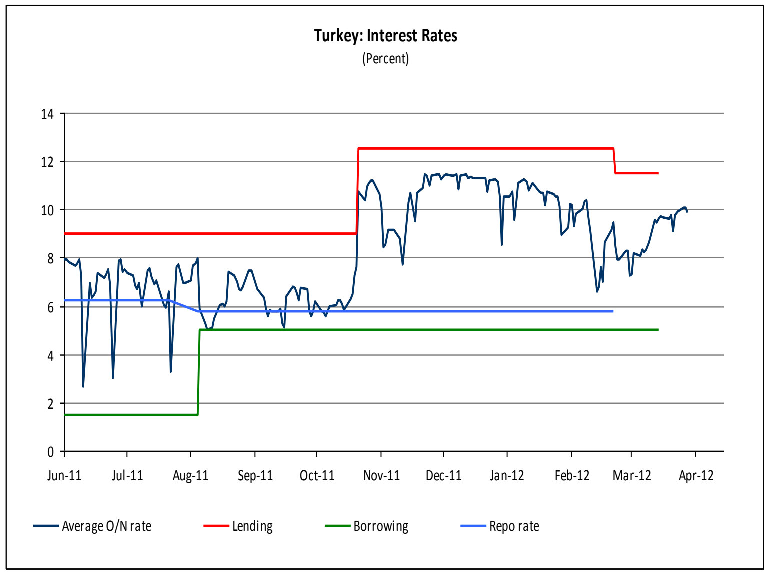
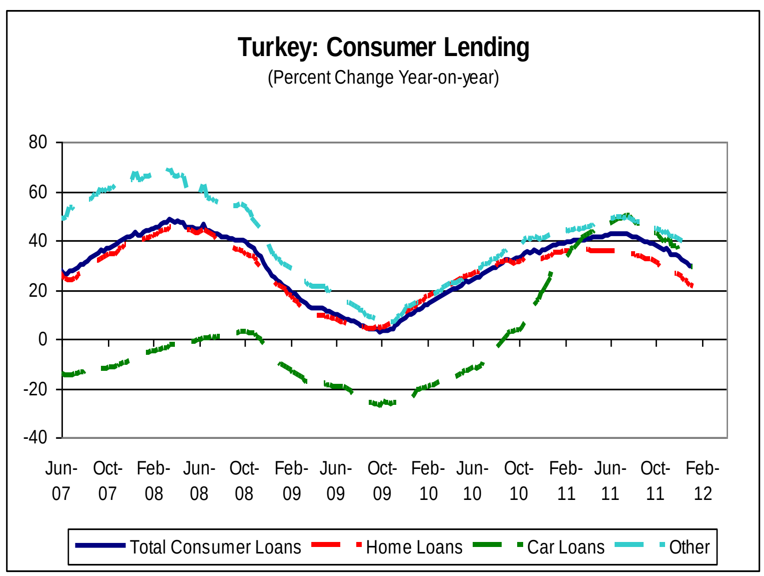
Turkey's Central Bank: Tightening or Easing?

Turkey's central bank policymakers appear torn between conflicting goals that exert a pull of almost identical force at this moment. In one direction: year-on-year inflation has jumped into double-digits again, with oil prices a potential accelerator; the current account, although apparently stabilizing, remains high. In the opposite direction: all signs point to a continuing—in fact, intensifying—deceleration of economic activity.



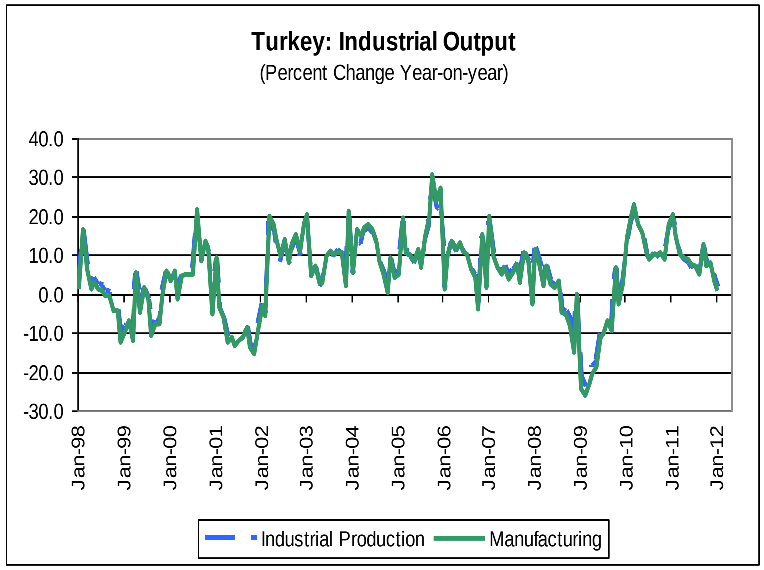


In response to this dilemma, the TCB has very recently issued seemingly contradictory signals as to their outlook and strategy: a sharp increase of the upper interest-rate ceiling at the end of October; a reduction at the end of February; since then, statements that suggested further easing, along with others that warned about the need to maintain a tight stance and highlighted the danger of inflation.

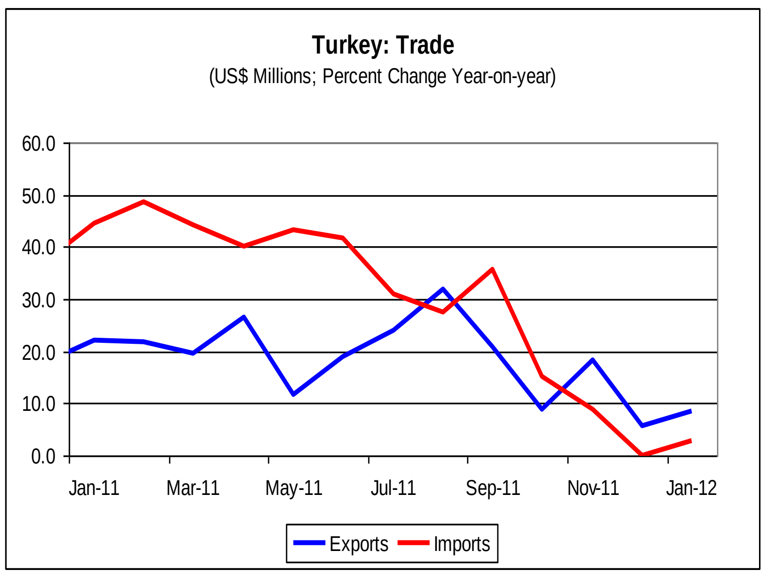
Against that background, yesterday's decision and the content of the official communiqué is less surprising: the bank decided to keep the interest rate corridor unchanged (5%-to-11.5%) but pushed borrowing costs higher by reducing the funds that they make available to the repo market at 5.75%. The rationale: to *"eliminate the impact of recent cost developments on inflation expectations"*—a likely reference to energy prices—despite the recent (mild) deceleration of inflation that has occurred in early 2012, which has been *"in line with the path projected in the January Inflation Report."*

From a practical standpoint, however, what should be noted is that: (a) borrowing costs have declined since early January on a slide that lowered them sharply from around 11% to below 8%; since the beginning of March the bank has managed to contain the downward movement of rates; yesterday's steps have pushed rates up only marginally; (b) foreseeable conditions in the economy are such that the TCB will probably have no choice but to move further in the direction of easing, albeit in the irregular fashion that has characterized them in recent months.

First and foremost, economic activity is clearly decelerating—it has been since early 2012, although from a very fast peak; it has probably entered a phase of only modest expansion, as evidenced not only by a minimal growth in industrial production, but by signs of cooling of domestic consumption, including a very noticeable slowing of household borrowing and of imports—which are, outside of oil, actually diminishing.



In fact, exports—which have also decelerated, but much less dramatically—are already outpacing imports. This is important because it affects in a constructive manner a second area of concern for the central bank: the current account deficit, thus gradually eroding another rationale for higher interest rates.



An unknown is whether inflation, which appears to have stabilized, will continue to decline. Persistently high inflation would evidently complicate matters for the TCB, especially if the risk of recession is not sufficiently obvious to force their hand in the direction of easing. From present perspective, however, it appears that the relative optimism of bank policymakers could be vindicated. Prices are moving at an annualized rate close to 8% in early 2012 (on current trends, DE's estimate puts annual CPI inflation in the 6.5%-to-7.5% range by the end of the year)

The bottom line: despite the tactical tightening move by the TCB, the framework for policy easing is intact, and the current direction of the key variables suggests that policymakers will, in a stop-and-go and irregular fashion, end up moving borrowing costs lower in the Turkish economy.