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Focus notes: **Turkey**

Turkey's central bank keeps its key policy rate stable, implements second step of technical rate adjustment

Turkey's central bank kept its key policy rate, the 1-week repo rate, stable at 7.00% at its MPC meeting on September 16, in line with market expectations. Yet, in a broadly unexpected move, the Committee decided to implement the second step of a technical rate adjustment, which constitutes part of the Bank's exit strategy from stimulus measures. Specifically, the CBRT lowered the overnight borrowing and lending rates by 25bps each to 6.25% and 8.75%, respectively. The first step was implemented in May when the central bank decided to switch its key policy rate to the 1-week repo from the overnight borrowing rate previously.

The cut in the overnight borrowing and lending rates should not be perceived as a change in the CBRT's stance. Notably, the central bank re-emphasized its confidence on disinflation, repeating that although inflation would temporarily spike in the short-term, the uptrend was expected to reverse in Q4 2010. It also reiterated that core inflation is expected to remain consistent with the medium-term targets. Moreover, the accompanying statement read, once more, that "it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period", signaling that, at present, the bank has no intension to change its key policy rate. In its "Monetary Policy Exit Strategy" announced in April, the CBRT had stated that should liquidity conditions permit the bank would proceed to the second phase of the technical rate adjustment by widening the spread between the 1-week repo and the overnight borrowing rates. The difference between the two interest rates could be changed by either increasing the 1-week repo rate or by decreasing the overnight borrowing and lending rates. Raising the 1-week repo, the bank's basic funding instrument, would have implied monetary tightening, which would have been rather unsuitable at this stage. The reduction in the overnight borrowing and lending rates should not be translated as monetary loosening, in our view, but, rather as a step towards stimulating interbank lending (see our Focus Notes no Turkey released on May 25, 2010, and New Europe Economics and Strategy May 2010 reports).

The rest of the accompanying policy statement was broadly similar to the one in August. The bank highlighted that the recovery in the domestic economy is slowing down following strong growth in Q2 2010, reiterating

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that uncertainty over external demand lingers. A notable difference was that the Committee stated it would implement further measures as envisaged in the exit strategy by the end of the year. In our view, this suggests imminent (gradual) increases of the TRY and FX reserve requirements ratios, which presently stand at respective levels of 5% and 10%, having been cut from 6% and 11% in order to provide the banking system with additional liquidity during the crisis.

In all, yesterday's MPC meeting does not change our view that the CBRT will stay put on rates in the coming months and deliver some 150bps of rate hikes in H2 2011. In line with the CBRT we see the recent spike in consumer inflation as temporary, attributed to seasonal factors and continue to anticipate a slowdown thereafter with headline CPI easing towards 7.1%yoy by year-end, slightly above the 6.5% central bank target for this year. We envisage a further slowdown to just below 7.0%yoy by December 2011, above the 5.5% target for that year. Upside risks to our policy rate and inflation forecasts lie in the face of a stronger-than-expected rebound in the domestic economy and fiscal slippages, especially in view of the upcoming the July 2011 general elections.

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