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Focus notes: **Turkey**

Turkey's Central Bank keeps its key policy rate stable and cuts its overnight borrowing rate to facilitate interbank lending.

The Central Bank of Turkey kept its key policy rate, the 1-week repo rate, stable at 7.00% at its MPC meeting on October 14, in line with market expectations. The Committee also decided to reduce the overnight borrowing rate by 50bps to 5.75% and left the overnight lending rate unchanged at 8.75%. In effect this increases the spread between the overnight borrowing and 1-week repo rates - in line with the second phase of the technical rate adjustment process - and is aimed at stimulating interbank lending by reducing commercial banks' incentive to deposit excess liquidity at the CBRT. The market's consensus was for a cut in both the overnight borrowing and lending rates by 25bps. It is worth noting that the CBRT implemented the first step of the technical rate adjustment in May, when it decided to switch its key policy rate to the 1-week repo from the overnight borrowing rate previously, while the second step was put into practice at the last MPC meeting, in September, when the overnight borrowing and lending rates were cut by 25bps each.

At its accompanying statement the Bank adopted a more positive tone regarding its outlook on the economy noting that "economic activity continues to recover" and "domestic demand displays a relatively stronger outlook" compared with "economic activity is on a milder recovery path following a strong growth in the second quarter" and "domestic demand displays a relatively stable outlook" in the prior statement. The CBRT reiterated that uncertainty over external demand lingers, while it will take some time before industrial capacity utilization returns to pre-crisis levels and that, albeit employment conditions continue to improve, the rate of unemployment remains at elevated levels. The Committee reaffirmed its earlier view that inflation would remain on a downtrend in the period ahead and that core inflation is expected to remain consistent with the medium-term targets. Furthermore, the statement repeated 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", confirming our view that the bank has no intension to change its key policy rate in the imminent future. As part of its exit strategy measures the CBRT also decided to cancel its 3-month repo auctions, which were introduced back in June 2009 to boost longer term liquidity to the market, and clearly signaled it plans to continue gradually implementing further measures as envisaged in its exit strategy programme by the end of the year. On the latter, we believe

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that the next step to be employed is likely to be a 50bps increase on the TRY reserve requirements ratio to pre-crisis levels of 6% aimed at curbing TRY liquidity, a possibility also voiced by the CBRT a day after the meeting. Note that in September the CBRT raised its reserve requirement ratio for commercial banks to 11% from 10% for FX and to 5.5% from 5.0% for TRY deposits as part of reversing stimulus measures introduced during the financial crisis.

In all, we maintain our earlier view that the CBRT will stay put on rates in the coming months and incept its monetary policy tightening cycle in H2 2011, after it assesses the impact of the July 2011 general elections on the domestic economy. We continue to expect 150bps of rate hikes to be delivered by the end of next year.

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