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Focus notes: **Turkey**

Central Bank of Turkey maintains key policy rate unchanged at 6.50%, implements first step of technical interest rate adjustment

On May 18, Turkey's Central Bank kept its key policy rate, the overnight borrowing rate, at its record low level of 6.50%, in line with market expectations. Overall, the Central Bank's assessment on the domestic economy was largely in line with that in April's statement. It reiterated that policy rates are likely to be maintained at low levels for a long period of time as core inflation is expected in the remainder of 2010 to remain below the year-end target of 6.50%. Main differences compared to the MPC meeting in April were that May's statement read that "domestic demand is following a stable growth trend", rather than "gradual". On the other hand, the CBRT highlighted concerns about uncertainties surrounding external demand.

Nevertheless, the most important aspect of the meeting was that the Committee decided to put into practice the first step of the technical interest rate adjustment process outlined in its exit strategy report published on April 14. The Central Bank changed its key policy rate from the overnight borrowing rate to the 1-week repo rate. This was done in order to signal its intension to start implementing its exit strategy measures, reign over excess liquidity provided in view of the global financial crisis and boost policy credibility. The 1-week repo rate was set 50bps above the overnight borrowing rate, i.e. at 7.00%, and the CBRT will now base its repo auctions on the amount with a fixed interest rate and not on the interest rate as was practiced before. This effectively implies that the bids that commercial banks place from now on in 1-week repo tenders will be based on the amount they want to borrow via a specified interest rate. According to the traditional auction procedure banks used to bid on the interest rate they were willing to borrow at. The Bank will continue providing the markets with additional liquidity, however, in relatively decreasing amounts. As liquidity provision slows down in line with the Bank's expectations, the CBRT will eventually initiate the second step of the technical interest rate adjustment process, which includes a widening of the spread between the 1-week repo and the overnight borrowing rates. The difference between the two interest rates will be changed either by increasing the 1-week repo rate or by decreasing the overnight borrowing and lending rates, with the latter employed in the event that the Committee does not want to change its key policy rate. The increase of the spread is expected, inter alia, to stimulate interbank lending.

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In all, the Bank's decision to proceed with the technical interest rate adjustment does not indicate a change in the CBRT's stance. In view of tightened liquidity conditions fanned through the global financial crisis, the Central Bank had become a net lender in money markets in recent months, which deemed the overnight borrowing rate less credible as a policy rate. The 1-week repo rate had become the CBRT's basic funding instrument and had recently stabilized around levels of 7.00% (the latest such auction - ahead of May's MPC meeting – rendered an average simple interest rate of 7.06%).

In view of rising inflation pressures against a background of unfavorable base effects, higher commodity prices, regulated price hikes and growing likelihood for second round effects, we continue to expect 150bps of rate hikes by the end of the year, which, if delivered, will push the new policy rate to 8.50% by year-end. Note that CPI stood at 10.19%yoy in April, its highest level since November 2008. Meanwhile, the CBRT had clearly signaled its intention to gradually embark on a monetary tightening cycle as of the last quarter of the year in order to contain inflation pressures, which the first step of the technical interest rate adjustment does appear to negate. Risks to our forecast are on the upside and lie in the face of further upward surprises in the domestic economic recovery, prolonged bouts of political instability and renewed signs of fiscal slippage. On the other hand, lingering uncertainties over the global economy may contain external demand for Turkish products and thus put a lid on price pressures from abroad. In that case, interest rates may remain stable for a longer-than-previously expected period.

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