

VAKIFBANK TURKISH ECONOMY WEEKLY

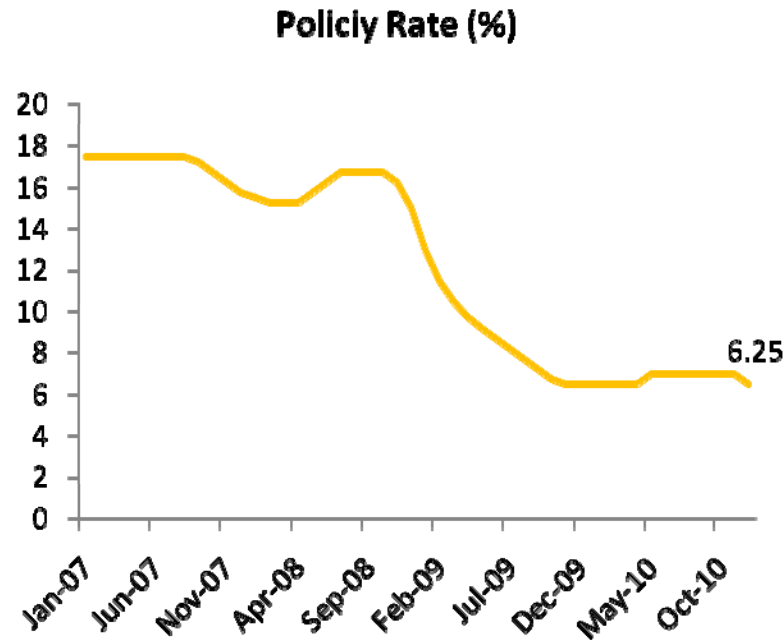
CBRT'S LAST SUPRISE RATE CUT..



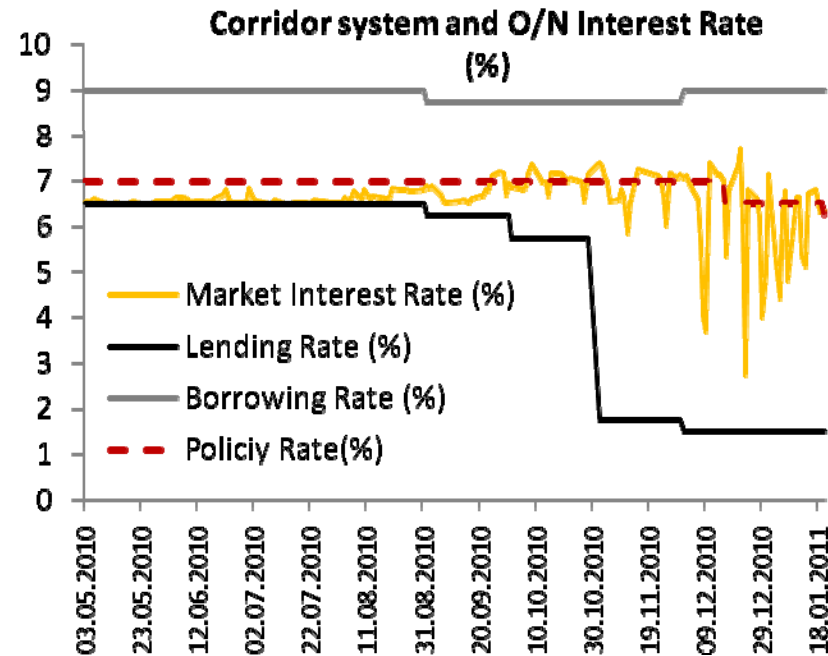
T. Vakıflar Bankası T.A.O





CBRT cuts its policy rate by 25 bp in contrast to market expectations...



Source: CBRT, Bloomberg



Source: CBRT, Reuters

-  Last week at MPC meeting, CBRT cut the policy rate by 25bp and did not change the lending and borrowing rates. On the other hand, CBRT signaled another increase in the reserve requirement ratio for short term deposits.
-  Using a policy mix of a lower policy rate coupled with higher reserve requirements, CRBT aims to preserve both financial stability and price stability.

Risks of recent rate cut...

- The rate cut decision was intended to limit the capital inflows.
- When CBRT cuts policy rate, TRY can weaken through decreasing foreign demand to Turkish assets that leads to narrow Turkey's current account deficit. However, easing policy involves some other risks;

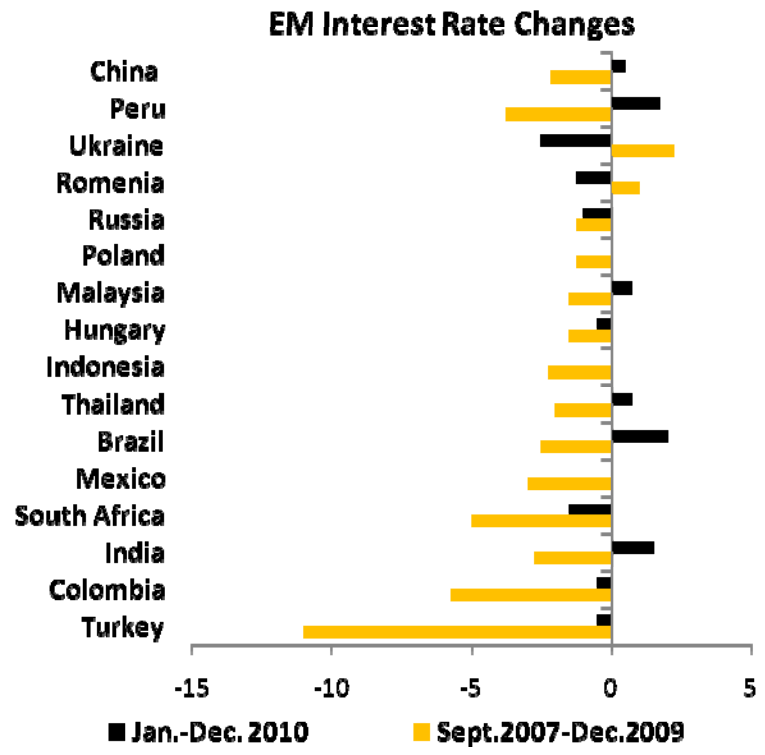


1- Many EM countries have started to raise rates to control inflation. If CBRT continued to reduce policy rate, this would deepen the interest rate difference between Turkey and other EM countries...

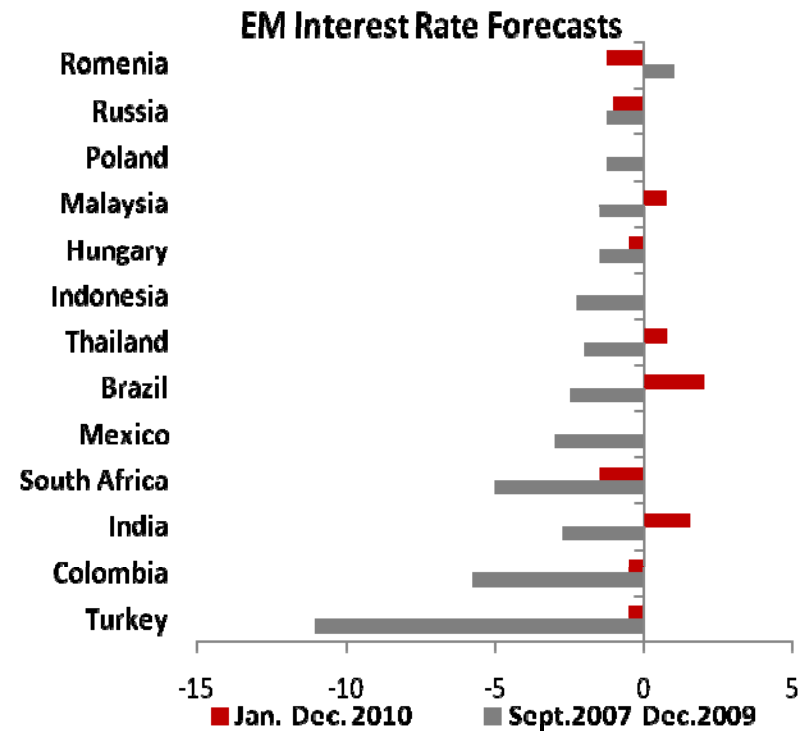
2- Mere rate cut and reserve requirement ratio hikes may not be sufficient enough to narrow current account deficit due to ongoing strong credit demand...

1- Many EM countries have started to raise rates to control inflation. If CBRT continued to reduce policy rate, this would deepen the interest rate difference between Turkey and other EM countries...

As Turkey needs high foreign capital inflows in order to finance its high current account deficit, CBRT has to consider other EM countries' rates together with inflation and growth in its monetary policy. Since high interest rates have attracted short term capital, Turkey should not want to lose its competitiveness by relatively low interest rates.



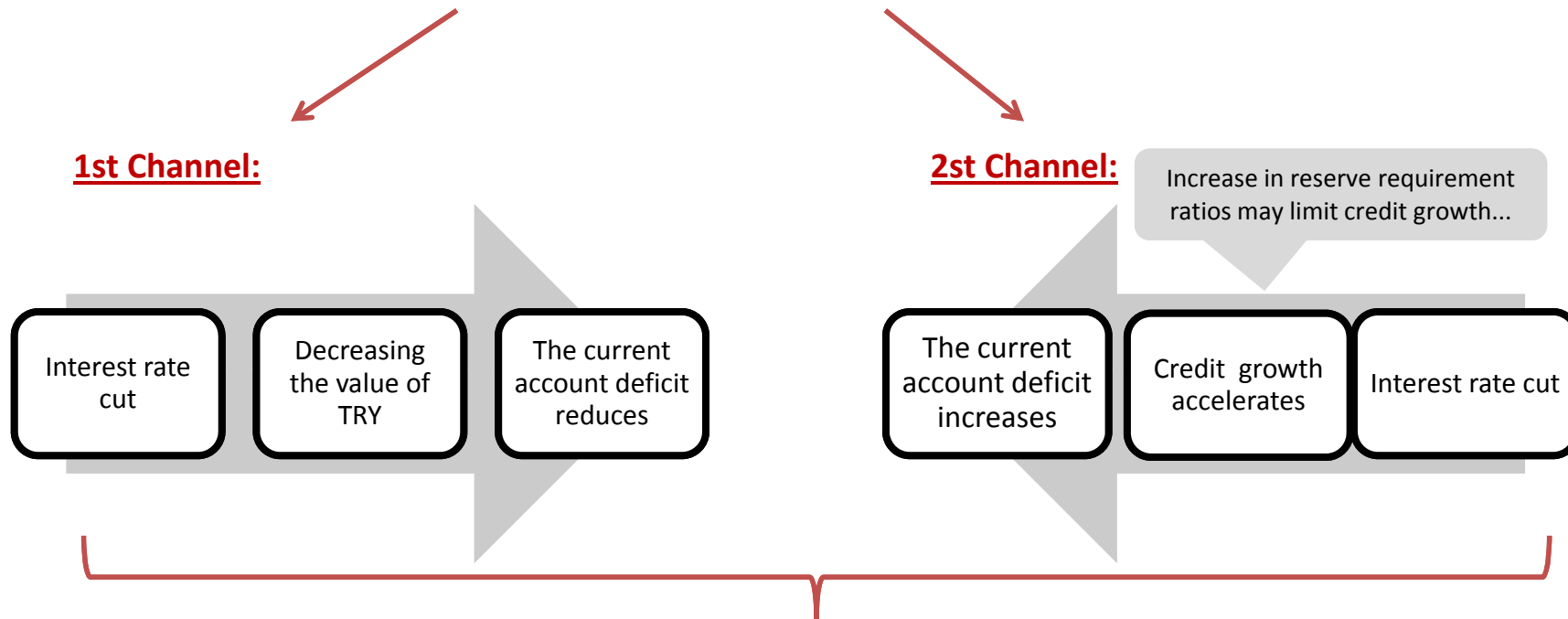
Source: Bloomberg, Reuters



Source: Bloomberg, Reuters

2- Mere rate cut and reserve requirement ratio hikes may not be sufficient enough to narrow current account deficit due to ongoing strong credit demand...

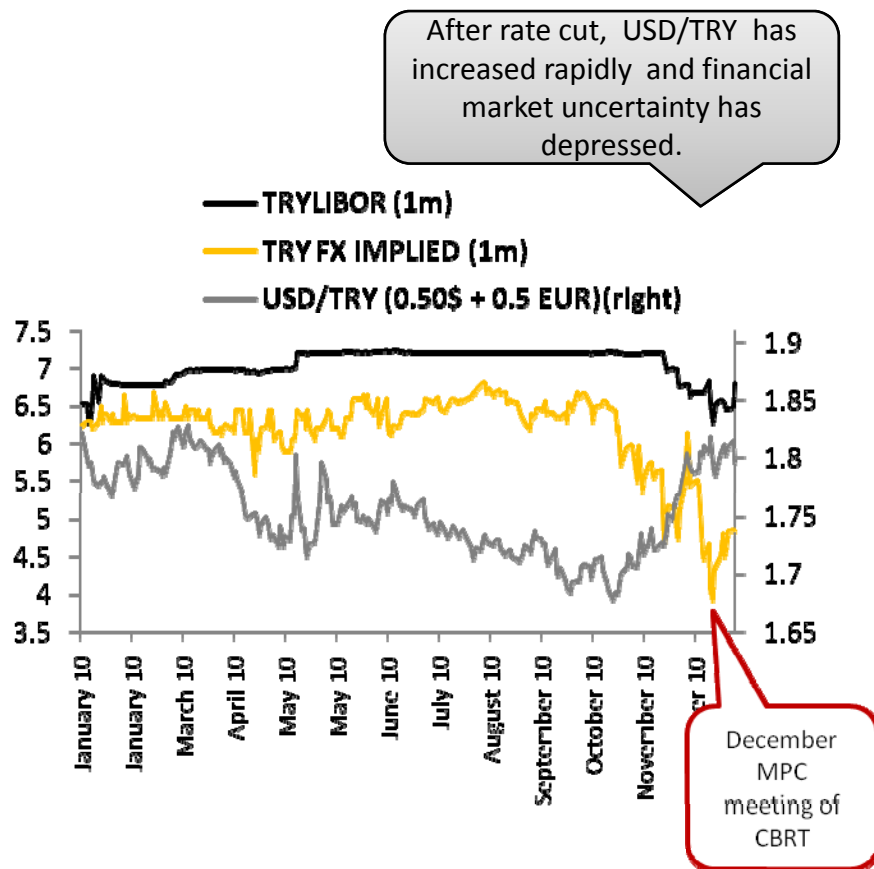
Rate cut decision will affect current account deficit in two different channels.



! This opposite effect makes the net effect more restrictive...

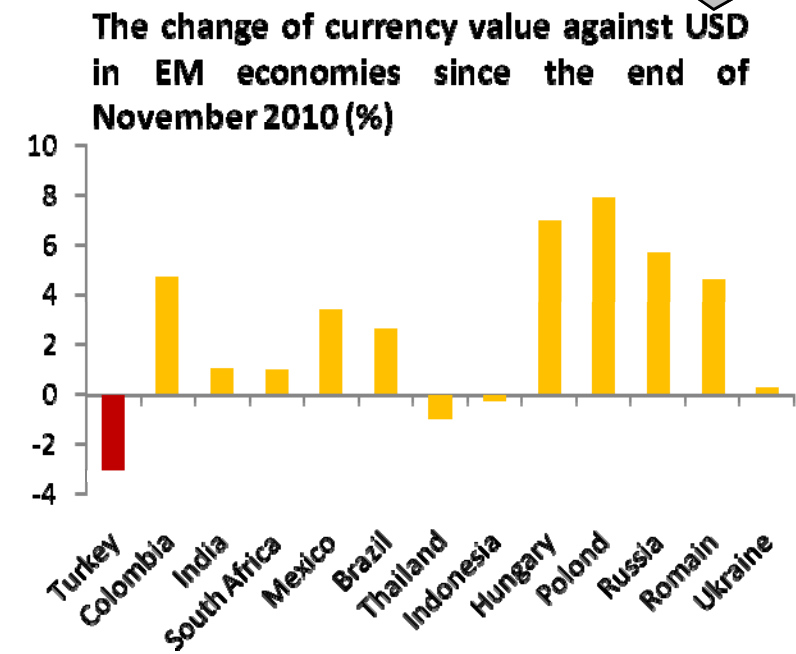
1st Channel: Through foreign exchange rate

Rate cut decision aims to reduce the current account deficit by making weaker TRY. After rate cut in December, USD/TRY has risen parallel to the aim of CBRT but increasing volatility in FX market that increases the uncertainty in financial markets, is remarkable at the same time.



Source: Reuters

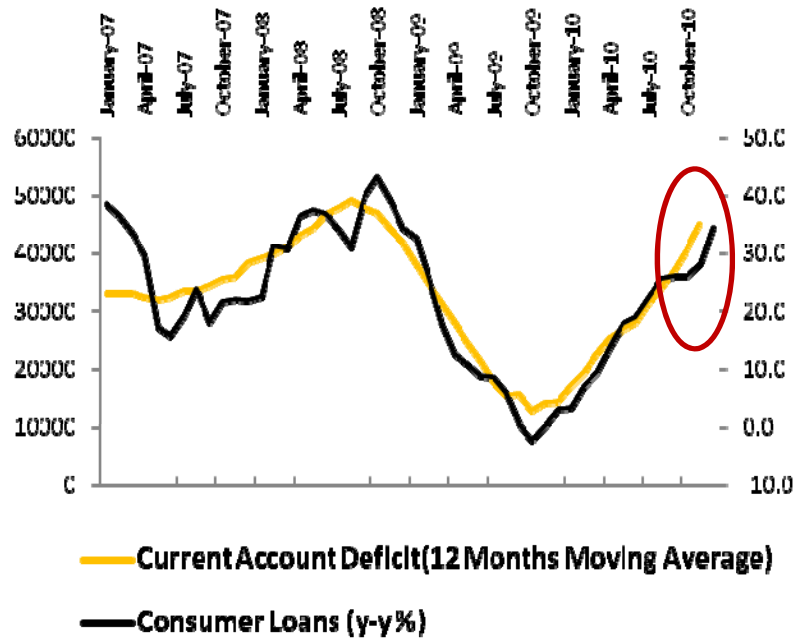
TRY is the currency that has lost the highest value against \$.



Source: Reuters

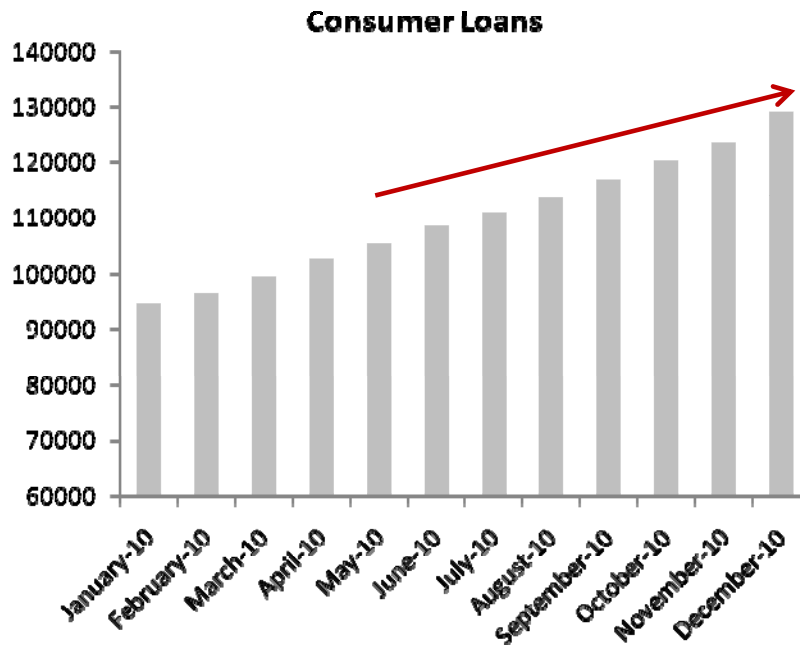
2st Channel: Through Credit

- Rate cut may ultimately lead to more credit demand. Although CBRT tries to curb accretion in credits through reserve requirement hikes, credit growth can expand current account deficit.
- Rate cuts could expand current account deficit through exchange rate channel whereas, rate cuts through credit channel may also lead to increase in the current account deficit.



Source: CBT, BRSA

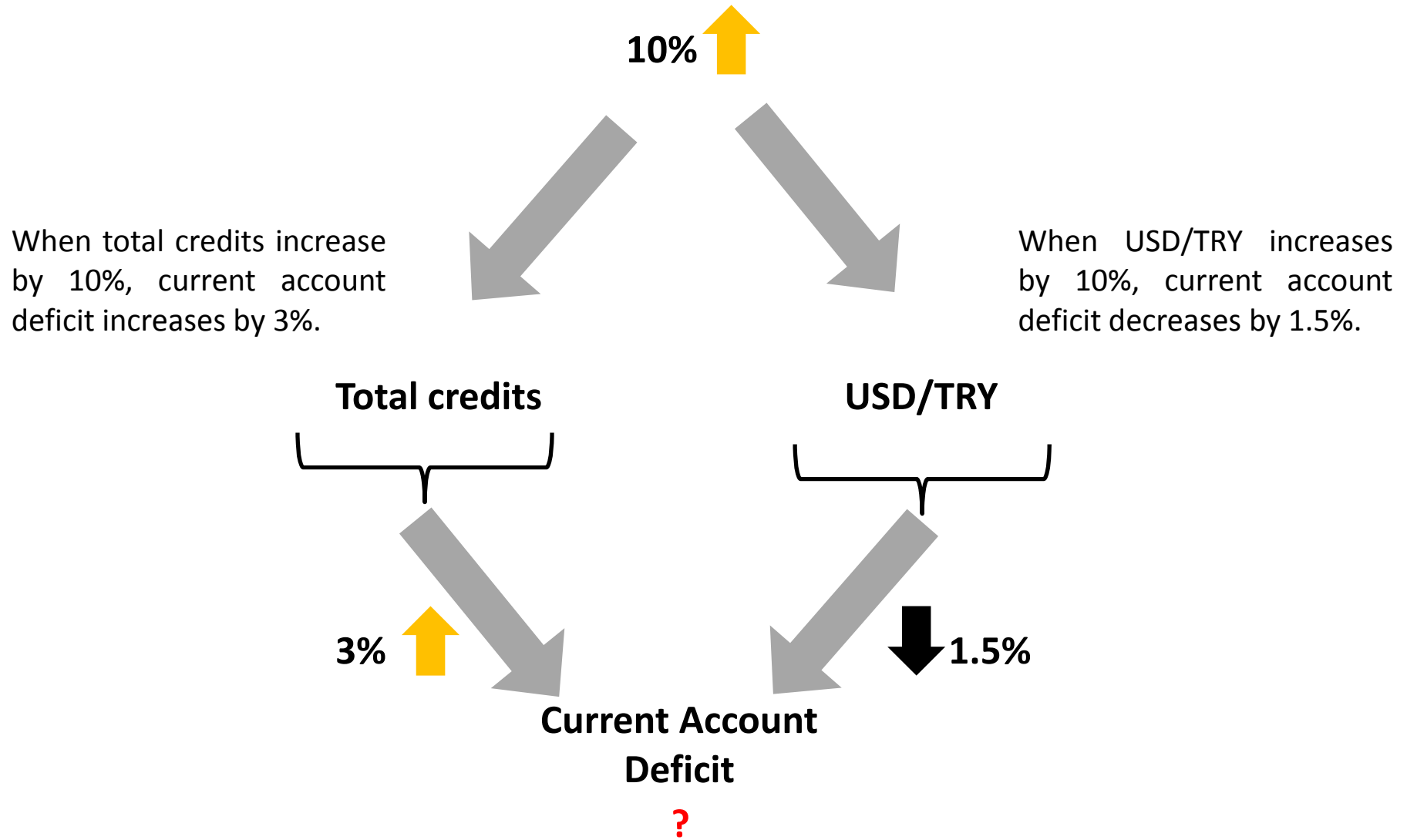
(Million TL)



Source: BRSA

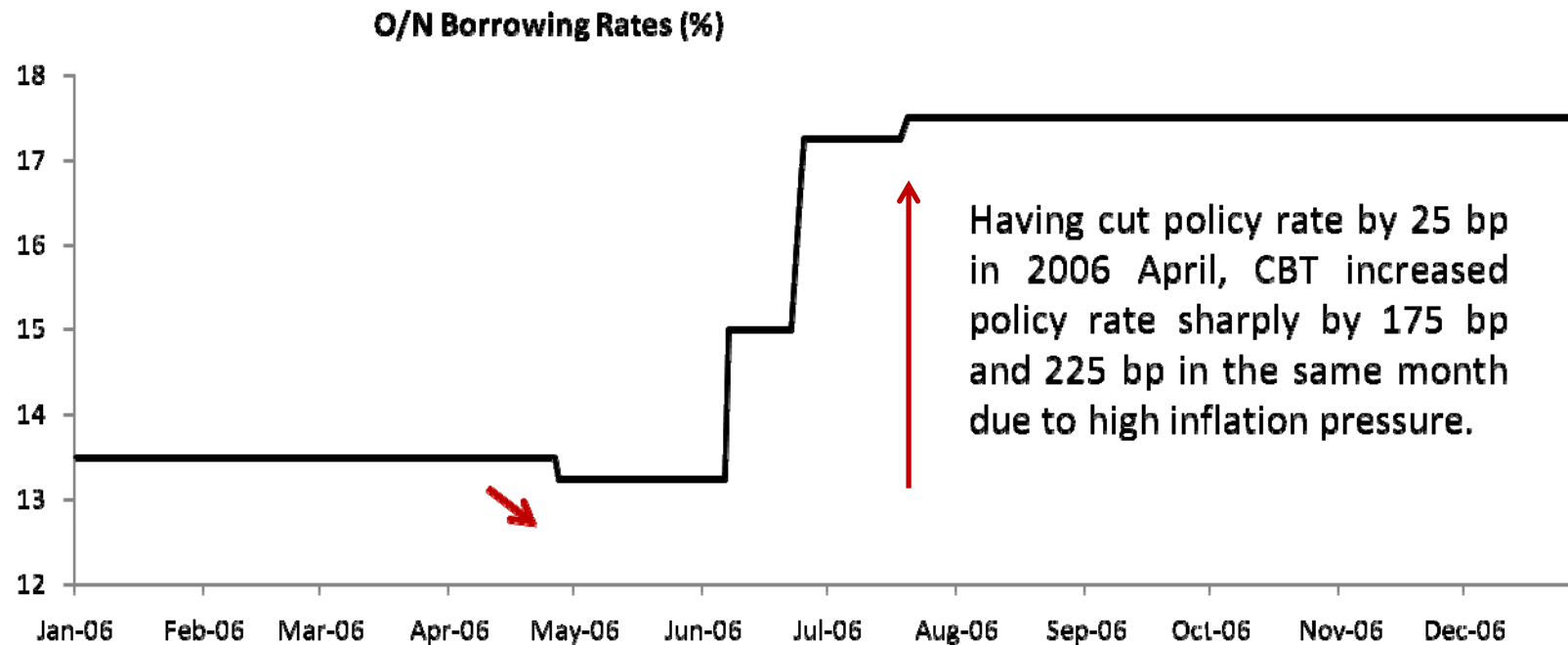
* December 2010 Provisional Data

Model we used in our analysis indicates that total credits growth has more effect on the current account deficit ...



Conclusion: It might be hard for CBRT to keep policy rate at these level due to cost-lead inflation...

Although some Latin American countries introduce tax policies to reduce the capital inflows, CBRT cut interest rates due to low inflationary pressure. However this policy has its risks. Especially, increase in crude oil prices and USD/TRY will lead to an increase in cost-push inflation in the coming months. Hence, sustainability of current levels in policy rate may be questionable in the light of Turkey's experience in 2006.



Source: Bloomberg

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