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Why Turkey's Central Bank will stick with its unorthodox policies

New Governor Basci will defer interest rate hikes when addressing rising inflation

Key Judgments

- The Central Bank of the Republic of Turkey (CBT) has targeted reductions in the growth of bank lending and the current account deficit as the primary goals of its non-orthodox policies.
- The appointment of Erdem Basci as the new CBT Governor to replace Durmus Yilmaz will not bring any change in the central bank's policy orientation, which is to defer any interest rate hikes in favour of tightening via reserve requirement increases and other unconventional measures.
- The evidence does not support the claim that Prime Minister Recep Erdogan has brought pressure on the CBT to lower interest rates in advance of the 12 June parliamentary elections.
- The CBT will not be in a position to declare policy success before the end of this year: higher inflation in the next three-six months will force it to take more aggressive actions to curtail bank lending – but hikes in interest rates are unlikely to be among them.

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Context

The CBT surprised markets last December with a two-pronged policy of cutting interest rates while substantially raising banks' reserve requirements. The financial community, which had expected the CBT to use short-term interest rates as its primary anti-inflation policy tool, greeted the moves with disbelief.

During past periods of rising inflationary pressure market players were accustomed to changes in the CBT's policy rate and regular pronouncements from its Monetary Policy Committee (MPC) pointing out that higher rates were unavoidable. This is why the radical shift in the CBT's policy last December was so unexpected. At two consecutive MPC meetings in December and January, the CBT's policy rate was cut a total of 75 bps and a 600 bps hike in reserve requirement ratios for banks was imposed.

Some observers in the financial markets and the media saw the new policy as misguided, even risky for the financial sector because foreign investors hold an estimated 18 per cent of the government's marketable debt stock. According to this argument, a loss of confidence in the CBT's management of monetary policy could trigger a mass exodus of these investors and force a belated sharp rise in interest rates.

Alongside this harsh criticism, others praised the measures as creative, notably Neil Shearing of Capital Economics, a London-based economic consultancy. Shearing emphasized that in a world awash with liquidity, policies to control lending without pushing up interest rates and fuelling even higher levels of hot money inflows made sense.

Below we argue that it is still too early to say whether the CBT's unorthodox policies will work. We are convinced, however, that the CBT will stick with its current policy mix even if inflation begins trending upwards later this quarter, as we predict it will do. The bottom line for investors is that interest rates will remain low but they should expect monetary tightening to be implemented via new unorthodox measures such as additional reserve requirements, loan controls and increased moral suasion on banks to restrict lending.

The new policies remain controversial

Today, over three months after launching its new policy initiatives, the CBT is still on the receiving end of sharp criticism. For example, the *Financial Times* ran a piece recently that began by asking how long the CBT was going to "stick with its outlandish monetary policies". In the same article JPMorgan's Turkish economist Yarkin Cebeci opined that the recent 9.2 per cent figure for Q4/10 GDP growth supported the case for traditional monetary tightening.

For reasons detailed below, we suggest that investors refrain from such knee-jerk judgments and look instead at the rationale that the CBT has spelled out to explain its monetary policy goals and the means by which it hopes to reach them. We think the evidence is persuasive that the CBT will persist in its current policy orientation, deferring interest rate hikes in favour of tightening via new unorthodox measures until the growth in bank lending and the country's current account deficit fall back into the CBT's "comfort zone".

The CBT wants to slow the growth of bank lending from 35 per cent currently to below 25 per cent. The government's target for the current account deficit as a percentage of GDP is 5.4 for 2011, or roughly US$62 billion. We think the bank probably wants to see the current account deficit move below 6 per cent as the 5.4 per cent target is too ambitious. As long as these two key indicators

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remain above the desired targets we expect the CBT to implement additional tightening measures including further increases in banks' reserve requirements, possibly supplemented by direct controls on bank lending and higher capital requirements for the banks.

The background to the CBT's unorthodox monetary policies

In the MPC minutes and other public pronouncements the CBT has been careful to distinguish what it considers the two primary goals of its monetary policy, namely price stability and financial stability. Deputy Governor (as he then was) Erdem Basci emphasized in a 12 November 2010 presentation that the level of interest rates required for financial stability may differ from the level consistent with price stability. More to the point, he argued that in an economy facing inflationary pressures higher interest rates "could fall short of preventing the occurrence of financial risks". He went on to criticize central banks in developed countries for ignoring financial stability and saw this failure as a cause of the global financial crisis. He concluded that the CBT would not make this mistake. This presentation to a meeting of the EU member states' economic counsellors was little noticed by local market participants.

The policy implication of Basci's argument is that a lower policy rate would be the best way to ensure financial stability while price stability would have to be addressed via other measures such as higher reserve requirement ratios. Although the primary mission of the CBT over the past 20 years has been to achieve and maintain price stability, financial stability had now been raised to equal billing as one of the bank's fundamental goals. The CBT's new policy mix was unveiled the month after Basci's presentation.

The CBT identified the risks to financial stability as a rapidly increasing current account deficit fuelled by short-term capital inflows and a mounting pace of credit growth. The bank's expectation was that lower interest rates would discourage capital inflows while a higher reserve requirement ratio would be the primary tool to slow credit expansion.

Why did the market react negatively?

Local investors were sceptical of the CBT's interpretation of the problems they faced and their proposed solutions; no one bought the bank's reasoning and many looked instead for other explanations of the CBT's actions, especially the reduction of interest rates. We think one reason for the reaction was that markets misread CBT statements prior to the announcement of the new measures. Market participants grumbled that there were significant differences between the CBT's actions and the messages it sent the market before launching the policies. For example, after the January MPC meeting that introduced a further rate cut of 25 bps and a 400 bps hike in reserve requirement ratios media reporting highlighted the significant gap between those actions and hawkish comments by CBT Governor Durmus Yilmaz the previous week.

A second factor behind the reaction was the fear of moving into unknown policy territory. The market found it difficult to forecast the net effect of two seemingly contradictory policy tools. According to simple-minded logic, increases in reserve requirement ratios should come in tandem with higher − not lower − policy rates.

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Third, the decision came at a time when many market participants expected that higher global inflation would sooner or later lead to higher policy rates in major developed countries. The CBT appeared to be risking falling into a very dangerous situation with lower interest rates at home while central bankers all over the world were moving to hike rates.

This is why some suspected that Erdogan was pressuring the CBT to reduce interest rates in order to provide monetary stimulus ahead of the June elections. The existence of a causal relationship between the upcoming elections and monetary policy would of course seriously erode the CBT's credibility. Some even took this speculation to the extreme by linking monetary policy to the Islamic roots of Erdogan's Justice and Development Party (AKP). Islam prohibits the taking or giving of interest (*riba)* regardless of the purpose of the loan.

The speciousness of this argument should be clear:

- Turkey is not an Islamic country.
- It has a liberal financial regime.
- Erdogan himself is a staunch supporter of sound finance and banking.

The emergence of speculation about political influence on CBT policy is mainly associated with the fear of some secularists about the resurgence of Islam in Turkish everyday life. Although the evidence does not support these fears, they are likely to be voiced as long as the AKP remains in power.

Nor have we found evidence that the AKP government has tried to bend economic policy in order to buy votes. Government spending grew by only 3.2 per cent in Q4/10 while private spending rose 9 per cent. In previous elections public spending surges of 9-15 per cent were common. This time around the government seems to be in a very strong position electorally and does not need to boost spending to enhance its popularity. AKP Economy Minister Ali Babacan recently said that the government expects to win the general elections in June and does not want to jeopardize macroeconomic stability by excessive public spending.

Why the CBT's monetary policy "rationale" is rational

The rationale behind the CBT's two-pronged policy mix is obvious even if the bank's choice of policy tools is not. First of all, the CBT is uncomfortable with the country's mushrooming current account deficit and very high share of short-term financing. The deficit last year hit 7 per cent of GDP – one of the highest ratios among major EM economies. As a rule of thumb any ratio above 6 per cent is a cause for concern, particularly if the deficit is mainly financed by short-term capital inflows, as in Turkey's case. Last year more than 40 per cent of the current account deficit was covered by portfolio inflows; these were mostly short term in nature. The share of foreign direct investment in financing was only 16 per cent.

The CBT is concerned that Turkey is particularly vulnerable to a sudden disruption of capital inflows, caused for example by a reversal in global risk appetite. The CBT wants to lessen the economy's dependence on short-term foreign capital and to limit what it sees as a major factor behind excessive expansion of bank credit. In pursuit of its new emphasis on "financial stability" the CBT will restrict credit availability but via higher reserve requirements, not by higher interest rates.

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The decision to reduce the CBT's policy rate is the most controversial aspect of its new policy mix. The stated goal is to weaken the lira and discourage capital inflows. The bank's expectation was that reduced inflows would be associated with a decline in the growth of credit used to finance imports.

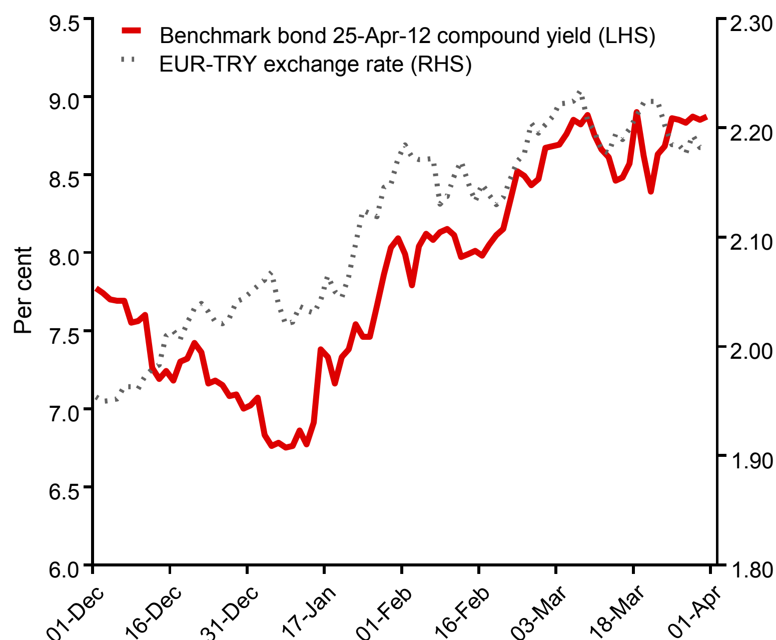
A second factor that argued in favour of cutting the policy rate last December was the Fed's quantitative easing policy. The CBT believed that as long as US rates remained low any rise in Turkish interest rates would simply accelerate the inflow of hot money via carry trades into Turkish fixed income assets funded with dollars. So lower interest rates were designed to discourage such volatile speculative inflows into Turkey.

A third factor was that inflation was relatively "well behaved". Turkish inflation in 2010 came in at 6.4 per cent, slightly below the official 6.5 per cent target. The proven success of the CBT's inflation-targeting regime perhaps gave the bank the confidence to switch its primary focus, at least temporarily, from price stability to financial stability; the priority of the goal to deter hot money inflows was thus elevated and the decision to cut interest rates followed.

The interim results of the new policies

The lira in fact did weaken substantially – by 11 per cent against the euro – and bond yields soared by over 150 bps in market trading. To some extent these developments reflected the widespread confusion immediately after the MPC announcement, but they were also caused by bond sales by banks as they raised liquidity to meet the higher reserve requirements.

Chart 1: TRY exchange rate vs euro and benchmark bond yields, December 2010 to date



Source: Central Bank of Turkey.

Although the policy goal was to dampen foreign capital inflows, preliminary data suggest that such inflows have actually increased in the wake of the new monetary policies. From an outflow of US$500 million in December short-term portfolio inflows soared to US$2.2 billion and US$1.5 billion respectively in January and February. The composition of these inflows also changed, as hot

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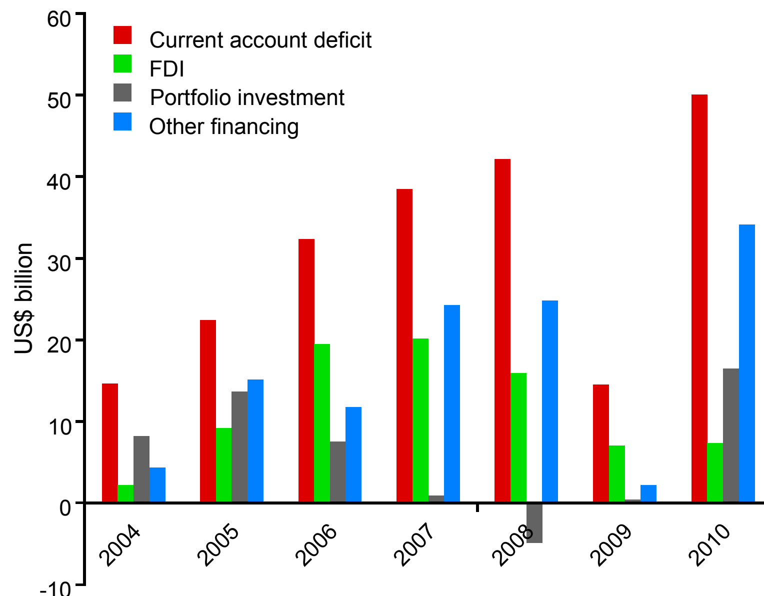
money switched from the equity market into the bond market. This was an unintended consequence of the rise in reserve requirements as higher interest rates attracted new foreign inflows into domestic government bonds.

An additional source of capital inflows – errors and omissions, or unregistered transactions in the balance of payments – hit roughly US$2.5 billion each month following a relatively modest figure of US$580 million in December. These transactions were mainly swap transactions and short-term portfolio inflows that were not market-mediated flows such as portfolio investment. The large size of these inflows highlights the inherent uncertainties of the CBT's new policy initiatives.

Chart 2: Current account deficit and its financing, 2004-10



* Current Account Deficit is shown in positive figures for a better view, in order to facilitate the comparison with financing.

Source: Central Bank of Turkey.

So far no adverse inflationary consequences have followed from the new policies. Indeed, March inflation fell to a record low of 4 per cent, which has created manoeuvring room for the CBT to persist in its current policy line. The fact that the European Central Bank and possibly other developed country central banks are moving to raise their policy rates also creates policy space for the CBT.

We think the impact of the new policies on bank lending is less reassuring. Turkey's use of reserve requirement hikes as a policy instrument is certainly nothing new or surprising; they were used frequently in the late 1980s to fight inflation. The problem with using reserve requirements as an anti-inflation policy tool is that their impact on banks' lending activities takes time, typically 12-18 months. In the short run banks will typically react to higher reserve requirements by restructuring the asset side of their balance sheets, selling less profitable assets (e.g., government bonds) in favour of more profitable assets (e.g., commercial credits). Such adjustments by banks run counter to what the CBT is trying to achieve.

Recent data show that loan growth continues to be strong, especially lending to retail and small and medium enterprises (SMEs). The share of retail lending in total bank loans including credit cards is 30 per cent; last year this category of loans grew 41 per cent. SME lending, which represents 25 per cent of total bank loans, grew even faster at 50 per cent. Chart 3 below shows that bank

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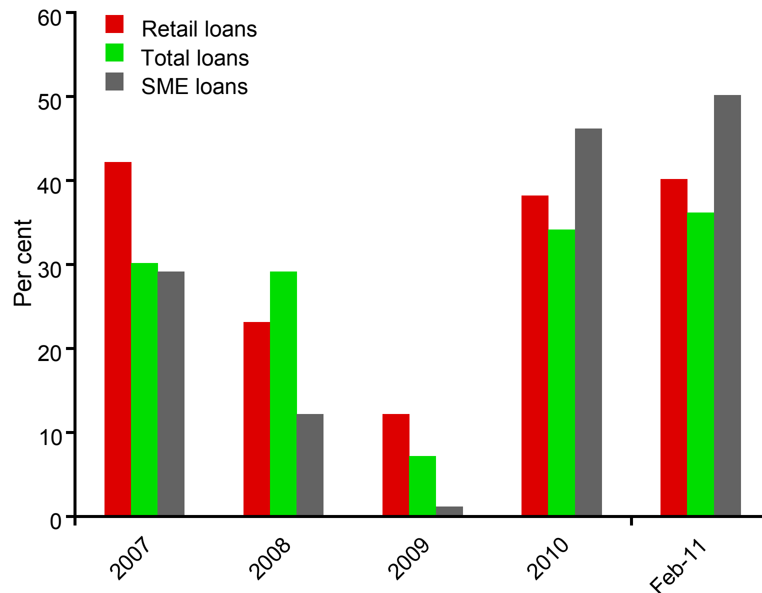
credit expansion has remained robust so far this year. The annual growth rate of bank loans, which was 34 per cent in December, rose to 36 per cent by end February – much higher than the CBT's target of 25 per cent loan growth for the end of 2011.

Chart 3: Growth rates of bank loans, 2007-11



Source: Banking Regulation and Supervisory Agency of Turkey.

In view of these trends the CBT has fallen back on two primary strategies. One is to urge the government to maintain fiscal discipline and the other, less friendly, action is to step up pressure on the major banks to restrict lending.

The minutes of the CBT's MPC meetings constantly reiterate that tight fiscal policies are the sine qua non for success in the country's inflation targeting regime and that the government must be careful about fiscal spending ahead of the June elections. Budget performance has in fact been relatively strong: last year the primary budget balance was 0.8 per cent of GDP. This good performance has further improved so far this year: central government budget revenues rose by 20 per cent while expenditures grew by only 5 per cent in the first two months of the year. These trends are encouraging but it is unrealistic to expect the government to tighten fiscal policy in advance of the June elections.

That leaves moral suasion on the banks as the CBT's primary short-term option to accelerate the reduction of bank lending. We think increased pressure on the banks to rein in lending is inevitable.

The central bank's new Governor will give top priority to maintaining credibility

The Turkish presidency's press bureau confirmed on 14 April that Deputy Governor Erdem Basci has been chosen to replace Governor Yilmaz, who leaves office on 18 April upon completion of his five-year term. Basci was named Deputy Governor in 2003 and was reappointed in 2008. He is an academic and used to be an adviser to Economy Minister Babacan.

The choice of Basci is an important sign of the government's confidence in the

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bank's current policy orientation. Basci brings continuity and strong professional qualifications to the Governor's office. Maintaining the CBT's credibility will undoubtedly be one of his primary goals. This means that there will not be any significant changes in the current direction of monetary policy inasmuch as Basci was its major proponent.

Our scenario for monetary policy

Having identified its two key policy targets – the growth of bank credit and the current account deficit – we think the CBT will stick with its current unorthodox policy mix until both variables come down into the bank's comfort zone. We anticipate that rather than resuming interest rate hikes the CBT will continue raising bank reserve requirements or institute other unorthodox measures, such as direct controls on bank lending or increases in capital requirements. Therefore investors should not expect a quick flip-flop in policy after the June elections.

The CBT still has a long list of possible policy tools that it can deploy by way of hardening its monetary stance. The bank stated in the minutes of its 15 February MPC meeting that additional measures along the same lines will be implemented if necessary. For example, the CBT might directly target specific types of loans such as SME and retail credits. It could also use direct controls on retail lending. Another possible action might be to cease or substantially reduce FX purchase auctions. The CBT typically buys US$50 million every day through FX purchase auctions in the market. The bank could suspend this programme in order to tighten domestic lira liquidity.

The CBT has so far avoided imposing direct controls on capital inflows as Brazil and some other EM countries have done. We think if direct controls are imposed they will fall on bank lending, not capital inflows.

A final word on the outlook for Turkish equities

Although we expect no change in the CBT's policy orientation over the next four-six months prospects for equities should improve as we approach June. History tells us that equity markets typically rise two to three weeks before elections and rally immediately after elections, especially when the outcome is more or less certain – as is the case today.

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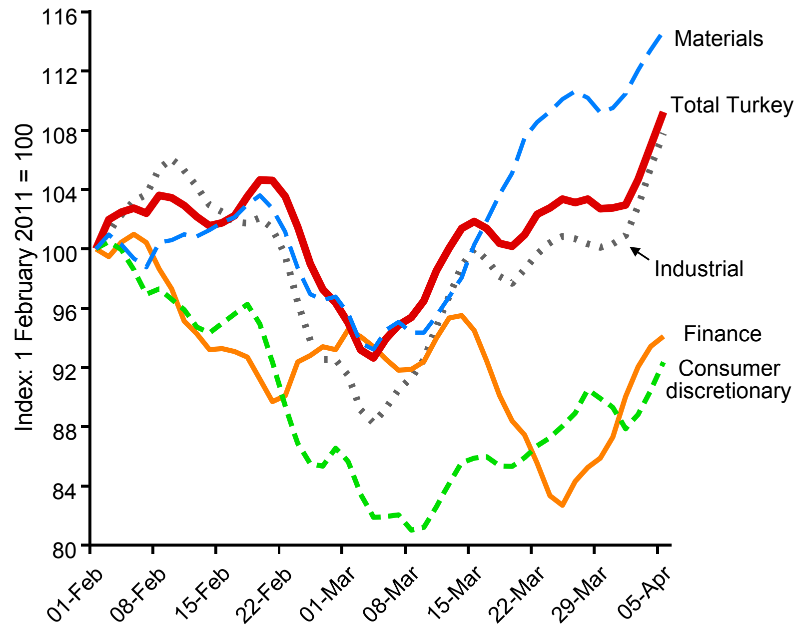
Chart 4: MSCI Turkey Index, performance by sector, 1 February 2011 to date



Source: Bloomberg.

That is why we expect short-term gains in equities through the coming election period. However, sectors that are highly dependent on bank loans – construction, wholesale trade, agriculture and textiles – as well as the banks themselves will continue to be adversely affected by CBT policy (see Chart 4 above). Therefore investors should instead look for opportunities in the energy, communications, transport and tourism sectors.

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