Macro note – MPC Rate Decision

CBRT cuts policy rate by 250 basis points to 45% in line with expectations. Emphasis placed on the rigidity in services inflation, commitment to price stability and additional sterilization tools for liquidity conditions.

Abdulkadir DOGAN
Chief Economist
adogan@sekeryatirim.com.tr
(+90) 212 334 33 33/313

The CBRT's Monetary Policy Committee (MPC) cut the policy rate by 250 basis points to 45% at this month's meeting, in line with expectations. The CBRT opted for a tone in the policy statement matching December's, with some minor changes. Chief among these was the emphasis on services inflation and the ongoing inflation rigidity due to backward indexation. Core goods inflation, on the other hand, remains low. Another important change was made in the closely monitored indicator for the monetary policy stance. For a long time, the threshold for a tight monetary stance had been "until monthly inflation has been permanently and significantly reduced." In the new text, this has been changed to "permanent disinflation and price stability." From this point of view, we understand that interest rates can be cut even in periods of high monthly volatility and that the general trend will be taken into account. The last important change is that additional measures may be taken to sterilize liquidity. In this context, we expect a period in which macroprudential policies will be used more effectively. Apart from these fundamental changes, the policy text contains similar emphasis to the previous text. The importance of the coordination of fiscal policy is reiterated and the contribution of fiscal discipline to price stability is underlined. It is reemphasized that the policy rate will be adjusted so as to ensure that inflation realizations, the underlying trend and expectations support disinflation. Although inflation expectations have improved, they remain a risk factor. In case of a deterioration in the inflation outlook, it was reemphasized that monetary policy tools would be used effectively instead of monetary tightening. We observe that the overall tone of the decision text was in line with December's message. Despite the rate cut, it was declared that the tight stance would be maintained and price stability would not be compromised. The verbal guidance mechanism was actively transformed into a monetary policy tool and it was reiterated that the policy rate would be adjusted to the extent required by disinflation. Moreover, it was stated that decisions would be taken on a meeting-by-meeting basis, and it was emphasized that price pressures caused by unexpected developments would be evaluated at each meeting. Accordingly, we expect the rate cuts to continue gradually as long as the underlying trend of inflation remains intact.

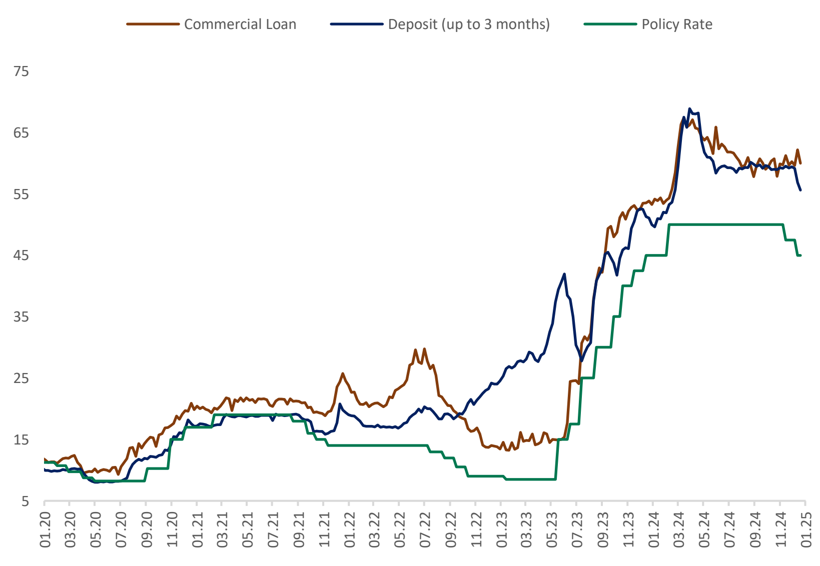
The decision text details the rationale for the tight stance and current developments. Accordingly, "While the underlying trend of inflation receded in December, leading indicators point to an increase in January in line with the projections. This development is mainly driven by services items with a high tendency to time-dependent price setting and indexation to past inflation. Core goods inflation, on the other hand, remains relatively low. Indicators for the last quarter suggest that domestic demand remains supportive of disinflation. Although inflation expectations and pricing behavior have been on an uptrend, they continue to pose risks to the disinflation process." The fact that January inflation was in line with expectations is one of the most important reasons for the interest rate cut. While inflation in core goods remained subdued, the rigidity in services inflation led the CBRT to pursue a cautious rate cut. And while the fight against inflation continues decisively, inertia and indexation keep the risks to the disinflation process alive.

The section on the rationale for the interest rate decision is summarized as follows. "The decisive stance in monetary policy strengthens the disinflation process through stabilization in domestic demand, real appreciation in the Turkish lira and improvement in inflation expectations. Increased coordination of fiscal policy will also contribute significantly to this process. The tight monetary policy stance will be maintained until inflation falls permanently and price stability is achieved. Accordingly, the policy rate will be set in a way to ensure the tightness required by the envisaged disinflation process, taking into account inflation realizations, the underlying trend and expectations. The Committee will take its decisions with a prudent and meeting-based approach focusing on the inflation outlook. In case of a significant and permanent deterioration in inflation, monetary policy tools will be used effectively." The choice of permanent disinflation and price stability over the monthly inflation outlook is important. From this emphasis, we understand that interest rate cuts may continue even if inflation exhibits volatility in some periods. Emphasizing the underlying trend of inflation realization and expectation implies that disinflation will be achieved through more comprehensive and long-term indicators. The inflation-focused and meeting-based approach to the policy rate indicates that the monetary policy stance and the level of tightness will be reconsidered based on monthly developments.

The paragraph on macro financial stability was amended as follows. "In case of unanticipated developments in credit and deposit markets, the monetary transmission mechanism will be supported by additional macroprudential steps. Liquidity conditions will be closely monitored and sterilization tools will continue to be used effectively with additional measures." It was emphasized again that deterioration in the loan and deposit spreads will not be allowed. The introduction of additional measures for sterilization indicates that complementary tools (such as reserve requirements, liquidity management) will be used effectively in addition to the main tool (policy rate).

In summary, in today's interest rate decision, the Central Bank cut the policy rate by 250 basis points to 45% in line with expectations. The message was that both inflation and expectations will be closely monitored until the next meeting and will be reviewed at the March meeting. The emphasis on price stability replaced the monthly inflation developments and a more general framework was drawn. Moreover, the CBRT reemphasized that meeting-based and inflation-focused decisions would be taken and underlined the need for caution regarding interest rate cuts. The rigidity in services inflation seems to be the key obstacle to the CBRT's rate cut pace. We underline here that improvements in this area may prompt interest rate cuts above expectations. The CBRT maintains its resolute stance in the fight against inflation, both by effectively using its main policy tool and by adjusting liquidity through complementary macroprudential measures. In this context, we expect gradual rate cuts to continue in 2025 depending on the course of inflation. We note that the policy rate stance may be revised in case of new supply or demand shocks.

Graph 1: Policy, Loan, and Deposit Rates (%)



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ŞEKER INVEST RESEARCH

Şeker Yatırım Menkul Değerler A.Ş.	TEL:	+90 (212) 334 33 33
Buyukdere Cad. No: 171 Metrocity	Fax:	+90 (212) 334 33 34
A Blok Kat 4-5 34330 SİSLİ /IST	E-mail:	research@sekeryatirim.com
TURKEY	Web:	http://www.sekeryatirim.com/english/index.aspx

For additional information, please contact:

Research

Kadir Tezeller	**Head**	**+90 (212) 334 33 81**	ktezeller@sekeryatirim.com
Burak Demirbilek	**Utilities, Defense Industry**	**+90 (212) 334 33 33-128**	bdemirbilek@sekeryatirim.com
Sevgi Onur	**Banks**	**+90 (212) 334 33 33-150**	sonur@sekeryatirim.com
Engin Değirmenci	**Cement**	**+90 (212) 334 33 33-201**	edegirmenci@sekeryatirim.com
A. Can Tuğlu	**Food & Bev., Retail, Auto, Aviation, Oil&Gas**	**+90 (212) 334 33 33-334**	atuglu@sekeryatirim.com
Esra Uzun Özbaskın	**Telcos, Iron & Steel, Cons. Dur.**	**+90 (212) 334 33 33-245**	euzun@sekeryatirim.com
Başak Kamber	**Glass**	**+90 (212) 334 33 33-251**	bkamber@sekeryatirim.com

Economy & Politics

Abdulkadir Doğan	**Chief Economist**	**+90 (212) 334 91 04**	adogan@sekeryatirim.com

Institutional Sales

Batuhan Alpman	**Head**	**+90 (212) 334 91 01**	balpman@sekeryatirim.com
Deniz Keskin	**Trader**	**+90 (212) 334 33 36**	dkeskin@sekeryatirim.com
Soner Bayram	**Trader**	**+90 (212) 334 33 38**	sbayram@sekeryatirim.com

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