Macro note – MPC Rate Decision

The Central Bank of the Republic of Türkiye cut its policy rate by 100 basis points to 37%, below expectations. A cautious cut is chosen, highlighting the rise in inflation led by food prices in January.

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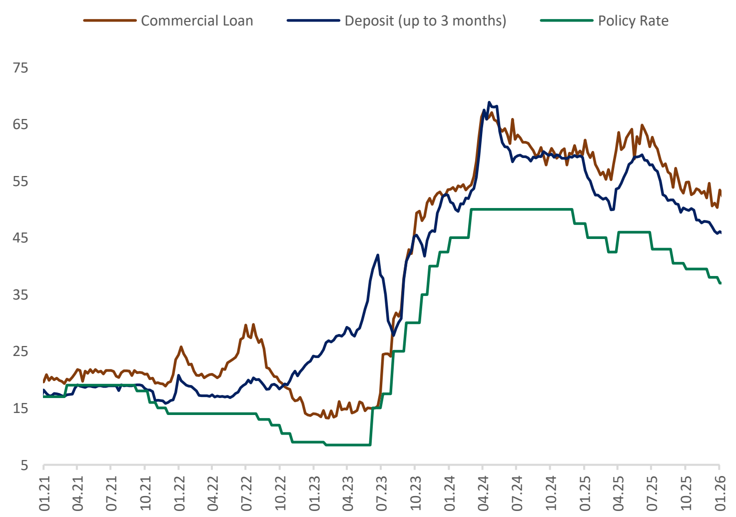
The Central Bank of the Republic of Türkiye (CBRT) Monetary Policy Committee (MPC) cut the policy rate by 100 basis points below market expectations (150 basis points) to 37% at its meeting this month. Market and our expectations were that the MPC could be more flexible in its rate cut, taking into account the inflation outcome for December. When the details of the decision and the size of the cut are considered together, a 'hawkish stance' stands out. And although the decision text is largely similar to previous ones, limited changes have been made. The first notable section points to consumer inflation rising in January, led by food prices. The contribution of food inflation was significant in the marked slowdown in inflation over the last three months and at the end of the year. However, the CBRT has long been highlighting the risks in food inflation and the inertia in service inflation. Therefore, we can say that the most important factor in the limited nature of the cut was that food prices did not stabilize at the targeted level. The continuation of the main trend at a limited level then provides the rationale for implementing a limited rate cut rather than skipping it altogether. In other words, there is no deterioration in the main trend or disinflation that would necessitate a tighter stance. The main trend in inflation is an indicator we monitor closely, as it reflects the underlying trend rather than short-term fluctuations. Therefore, a cut was made, but a cautious approach was preferred. The emphasis, which also concerns future interest rate decisions, relates to developments in the last quarter. The communication chosen is that demand conditions continue to contribute to disinflation at a declining rate. The important point here is that although demand inflation is largely under control, the slowdown in the rate of decline in these prices indicates that the fight against inflation will be protracted. The output gap is not in line with the CBRT's targets, and the composition of growth expenditure is pushing the output gap closer to positive territory. If this trend continues, the CBRT may maintain its tight monetary policy for a long time to come. This is because the baseline scenario is based on the output gap being negative, demand-driven inflation being brought under control, and the disinflation process being completed with an improvement in expectations. A factor that is part of the monetary transmission mechanism and the forward guidance channel is the persistence of inflation expectations and pricing behavior, which have been recurring for a long time. As backward-looking indexation and inertia affect future pricing behavior and expectations, this area is critical for the CBRT's intermediate targets. Although the effective functioning of the transmission mechanism requires a more pronounced decline in inflation in the expectations channel, 12–24-month inflation expectations have not retreated to the targeted level. We believe that structural breaks are necessary for market, household and real sector expectations to be consistent with the CBRT's intermediate targets. While other channels (consumption/demand, exchange rate and asset prices) have retreated significantly, risks in expectations are pushing future inflation outcomes above the targeted levels. Looking at the end of 2025, both the recent main trend and year-end closings are in line with the intermediate target. On the other hand, fiscal policy and the budget deficit are in more positive alignment than expected. In this case, the inflationary impact of administered/guided prices will remain limited or will be offset by other monetary policy instruments. To ensure that disinflation progresses in line with targets, it is crucial to avoid moves that would ease demand conditions and to manage the expectations channel more effectively.

The rationale for maintaining a firm stance and current developments is detailed in the decision text. Accordingly, "The underlying trend in inflation declined in December. Leading indicators point to an increase in monthly consumer inflation in January, led by food, while the increase in the underlying trend is limited. Indicators for the last quarter suggest that demand conditions continue to support the disinflation process, despite a decline in this support. Inflation expectations and pricing behavior show signs of improvement but remain a risk factor for the disinflation process. The tight monetary policy stance, which will be maintained until price stability is achieved, will strengthen the disinflation process through demand, exchange rate and expectation channels. The Committee will determine the steps to be taken regarding the policy rate in a manner consistent with the intermediate targets, taking into account inflation outcomes, the underlying trend and expectations, to ensure the tightness required for disinflation. The magnitude of the steps is being reviewed with an inflation outlook-focused, meeting-based and cautious approach. If the inflation outlook deviates significantly from the intermediate targets, the monetary policy stance will be tightened. Should developments in the credit and deposit markets deviate from expectations, the monetary transmission mechanism will be supported by additional macroprudential measures. Liquidity conditions will remain closely monitored and liquidity management tools will continue to be used effectively."

In summary, in today's interest rate decision, the Central Bank reduced the policy rate by 100 basis points below expectations to 37%. A cautious reduction was preferred due to the seasonal increase in inflation and the limited rise in the main trend. Attention was drawn to recent demand developments and risks in expectations/pricing behavior. Furthermore, it was reiterated that decisions would be meeting-based and inflation-focused, implying that market volatility would not be tolerated. Global market uncertainty may disrupt the CBRT's disinflation targets for a while. We would like to emphasize that improvements in this area could lead to interest rate cuts exceeding expectations. The CBRT, which effectively uses its primary policy tool and adjusts liquidity with complementary macroprudential measures, maintains its determined stance in the fight against inflation. In this context, we anticipate that cautious and gradual interest rate cuts will continue until the end of the year, barring any additional shocks in local and global markets. We would like to emphasize that in the event of new supply- or demand-side shocks, the policy rate stance may be subject to further adjustments.

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



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