Economic Watch

# Türkiye | What to think about the current policy mix?

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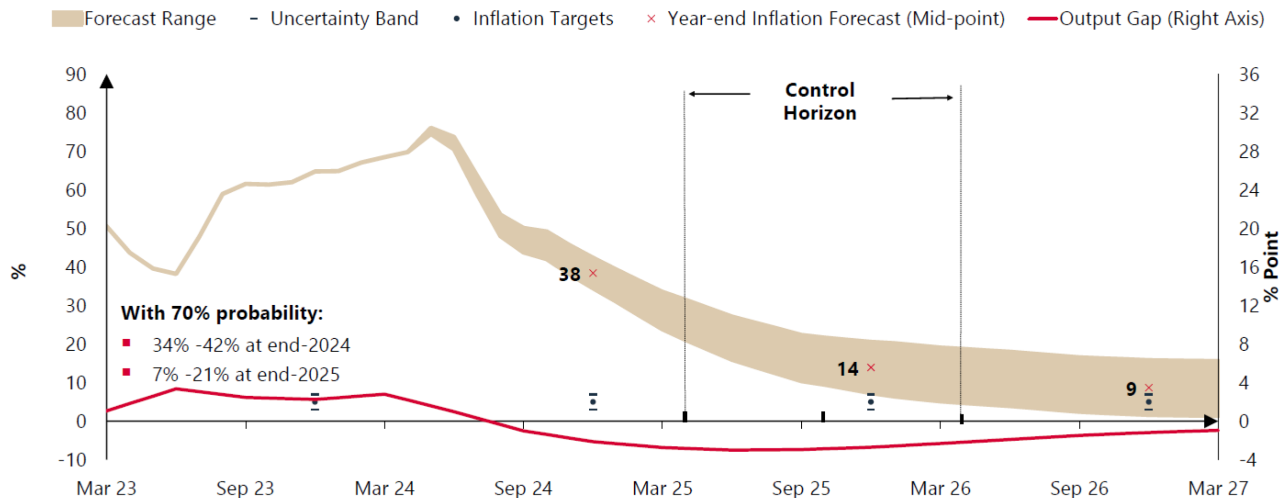
**After the surprising rate hike in March, the Central Bank (CBRT) wants to observe the lagged effects of the tightening on demand conditions and inflation expectations, and consequently on the inflation trend. Yet, stronger balance sheets from the previous financial repression period, wealth effects and continuing availability of card spending still support domestic demand, weakening the monetary transmission mechanism. In this respect, the financial conditions remain tight, however, since counter effects happen at the same time, the overall impact could become less restrictive, regardless of any additional rate hike of the CBRT. On the fiscal policy side, most recently released fiscal savings package indicates a very limited effect of 0.2-0.3% of GDP this year, which would increase in the medium run and start to be more effective on reducing imbalances. Therefore, in order to speed up the disinflation process, other macro-prudential measures aiming to suppress consumption via reducing the availability of spending via cards will also be important in addition to keeping financial conditions tight for longer.**

In the second inflation report of the year, the CBRT revised its 2024 point interim inflation target upward by 2pp to 38% (Figure 1) but did not change the upper bound of their forecasted range as 42% by narrowing down the range to 8pp from the previous 12pp. They maintained next years' targets with 14% for 2025 (with a range of 7-21%) and 9% for 2026. Given their explanation, the stronger than expected inflation by 4pp in the first four months of the year led them to make this revision since they would not be able to compensate the deviation with the additional tightening of March. Therefore, we understand they do not plan any additional tightening for the time being. Instead of pushing for reaching the point target, they target to reduce the year-end inflation within this year's projected inflation range, below 42%, to have a smooth transition without adding any potential financial stability risk and any cost driven inflationary pressure. In this respect, we assess that the CBRT aims to reduce the average cost of TL deposit rates by positively differentiating standard TL deposits with the recent changes on the remuneration of RRs and the elimination of RR implementation due credit growth for small banks in order to support financial stability via lowering the pressure on lending rates. This is important especially for SMEs and the overall impact on production and employment outlook.

### CBRT INFLATION PROJECTIONS (YoY)



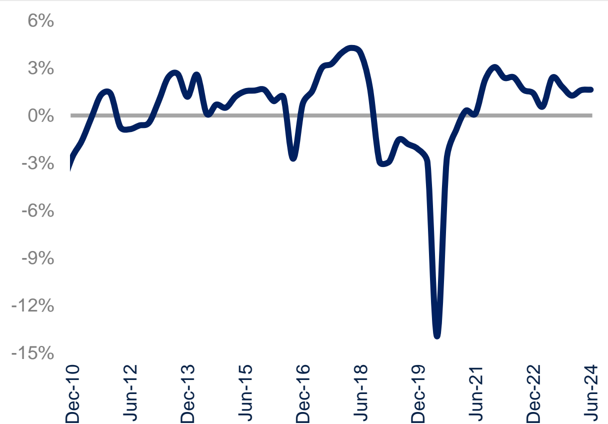
It is also true that economic activity points out a quarterly GDP growth rate of closer to 1% as of early May, resulting in a positive output gap of around 1.5pp for 2Q (Figure 2), which is still driven by mainly private consumption in contrast to more moderate supply levels. The CBRT also revised its 2024 GDP growth assumption to around 3% from the 1.5% previously, showing a fast adjustment in the second half of the year with negative quarterly readings, which we think is not consistent with the smooth transition efforts so far. According to our Financial Conditions Index (FCI), the monetary stance became more restrictive since November, mainly led by lending rates and the negative slope of the yield curve pushed by a tighter monetary policy (Figure 3). Though, real appreciation of the exchange rate, wealth effects stemming from the repercussions from the previous period (stock exchange, higher TL deposit rates depending on the deposit rule attached to KKM accounts and/or deposit volumes etc.) and availability of card spending (card limits, number of installments and standard minimum payment regardless of income levels) prevent a further tightening on financial conditions despite a higher cost of funding than the headline suggests (also due from credit growth caps). It is becoming riskier to stick to a stronger real appreciation trend in order to help disinflation since private consumption remains to be resilient (Figure 4) and inflation expectations significantly diverge to the upside among different agents (professional forecasters' 40-50%, corporates' 50-60% and households' 80-120% for year-end). This is why fiscal policy stance, income policies and other complementary macro-prudential measures gain importance to speed up the disinflation process and start anchoring inflation expectation towards the targeted inflation levels.

Figure 1. **Revisions on CBRT CPI Projections**

| | 2024 |
|---|---|
| Feb24 Inflation Report Forecast | 36% |
| May24 Inflation Report Forecast | 38% |
| **Total Revision (pp)** | **2.0** |
| | |
| **Factors behind the revision (pp)** | |
| Underlying trend of inflation | 1.8 |
| Import prices (TL) | -0.2 |
| Output gap | 0.4 |
| Food prices | 0.2 |
| Administrative prices | -0.2 |
| **Total Revision** | **2.0** |

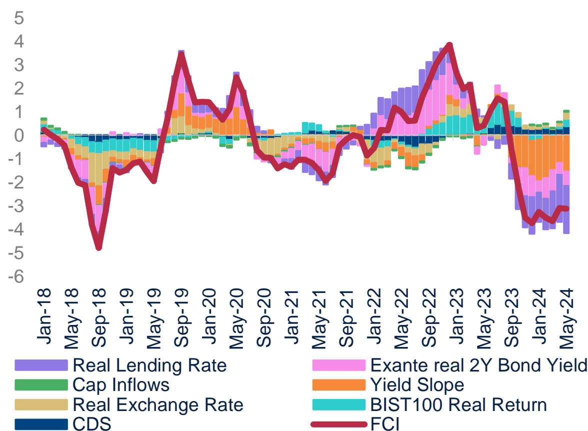
Source: Garanti BBVA Research, TURKSTAT

Figure 2. **Garanti BBVA Output Gap Estimate** (% deviation from potential estimate)



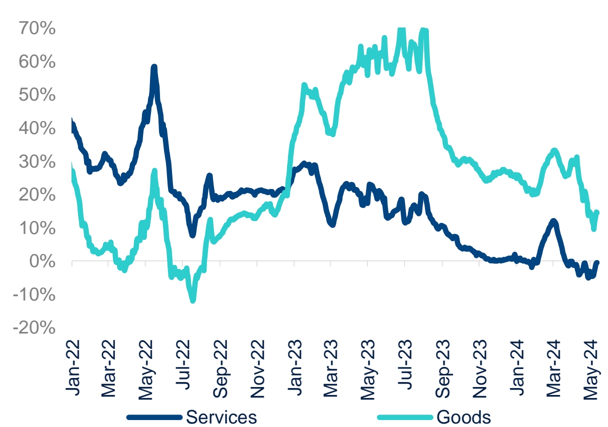

Source: Garanti BBVA Research, TURKSTAT

Chart 3. **Garanti BBVA Financial Conditions Index** (standardized, + easing, - tightening)




Source: Garanti BBVA Research, TURKSTAT, Bloomberg

Chart 4. **Garanti BBVA Big Data Consumption Indicators** (28-day sum, YoY, adjusted by CPI)

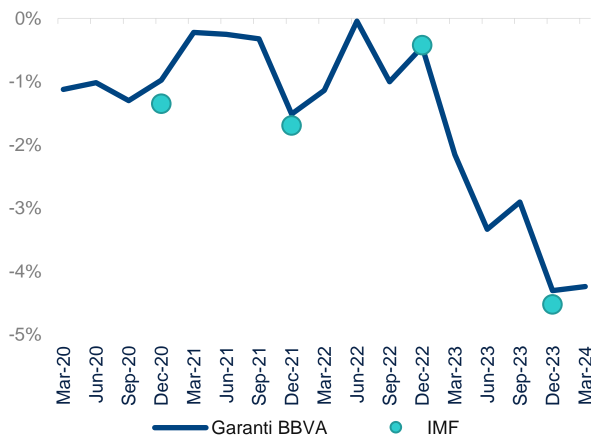



Source: Garanti BBVA Research, TURKSTAT

On the fiscal policy, the government announced a package under three headings: savings in public expenditures, spending discipline and efficiency in investments. In this regard, there will be a 10% cut in goods and services purchases and a 15% cut in investment spending this year, except for those related to the earthquake, corresponding to 0.2-0.3% of GDP. New savings measures will also be taken in the coming period and many of them will be effective in the medium run, which is hard to quantify. On public investment, projects of which above 75% are physically completed, the ones on agriculture, green & digital transformation and railways, and the critically important ones will be prioritized. New projects will not be accepted except in cases of necessity.

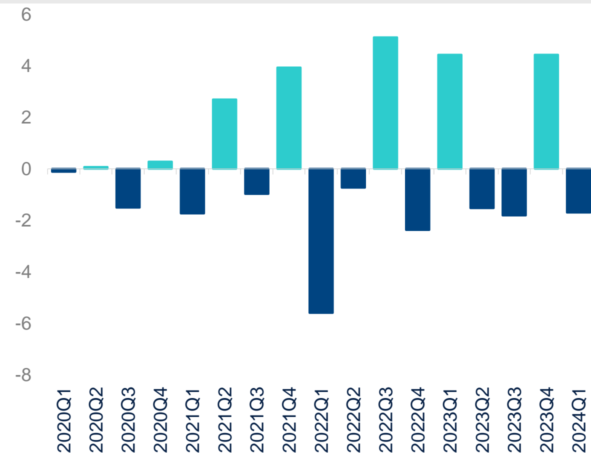
According to our calculations, after the very strong fiscal impulse of the last year (4.3pp in our indicator vs. 4.5pp in IMF's Fiscal Monitor[1]), the fiscal stance was muted in 1Q24 (Figures 5 & 6). Yet, since the lagged effects of the repercussions from the existing fiscal impulse are still in place, new savings measures will be key to help the disinflation process. Additionally, income policies will be on radar to see how wages will be adjusted given the ambitious inflation targets of the next years. Last but not the least, it is still not clear how the subsidies for the households' energy will be reduced in the coming period. In any case, we welcome the remarks of the Vice President Yilmaz indicating that they will aim to reduce the overall budget deficit to below last year's realization of 5.2% of GDP compared to the Medium Term Program forecast of 6.4%. Given the expected clearer deceleration in domestic demand in the second half of the year and increasing interest expenditures in the short term, attaining a primary deficit level of at least below 2% (vs. -2.7% in 2023) will show us how the fiscal policy helps to achieve an effective policy mix for disinflation.

Chart 5. **Fiscal Impulse Indicator** (cyclically adjusted primary balance / potential GDP, annualized sum)




Source: Garanti BBVA Research, TURKSTAT, Ministry of Finance, IMF

Chart 6. **Fiscal Impulse Indicator (**pp, cyclically adjusted primary balance / potential GDP, QoQ)




Source: Garanti BBVA Research, TURKSTAT, Ministry of Finance, IMF

Overall, we evaluate the current policy mix is becoming more comprehensive and starting to move in tandem in the right direction. Since fiscal measures will take more time to be effective, we believe other complementary macro-prudential measures aiming to suppress consumption via reducing the availability of spending via cards and to squeeze wealth effects become essential not to lose time to anchor inflation expectations. Besides, keeping financial conditions tight for longer will be needed to start a sustained path to unwind current regulations (firstly credit growth caps, later deposit rules), in order to strengthen the monetary transmission mechanism. If required, we also do not rule out additional monetary tightening, which we do not assign as a base case. If inflation trend improves to a level that the year-end inflation falls below 42% -upper bound of the CBRT forecast range-, there might be a limited room to start easing with very gradual steps in 4Q24. Yet, lagging fiscal measures & macro-prudential policies on retailer spending availability reduce the likelihood of a cutting cycle sooner. Also, external financial conditions and geopolitical uncertainties will be decisive to provide that room.

[1] Fiscal Policy in the Great Election Year, April 2024

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