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Turkey: There goes the simplification

The TCMB warned that if it deems it necessary, it will underfund the banking system through its usual O/N lending facilities, forcing the banks to use its late liquidity window, where the cost of funding is 10%. This would effectively raise the ceiling of the interest rate corridor to 10% on days of the TCMB's choosing. We think this spells the end of policy simplification rhetoric, as forcing banks into the stigma-attached late liquidity window is even more unorthodox than the Basci term policies. That the TCMB is willing to take such unconventional steps within the existing interest rate set, suggests it is very reluctant to hike formally and transparently. In our view, potentially intermittent tightening via obscure lending windows is not the way to reassure investors.

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Research analysts

EEMEA Research

Inan Demir - NIplc
inan.demir@nomura.com
+44 (0) 20 710 29978

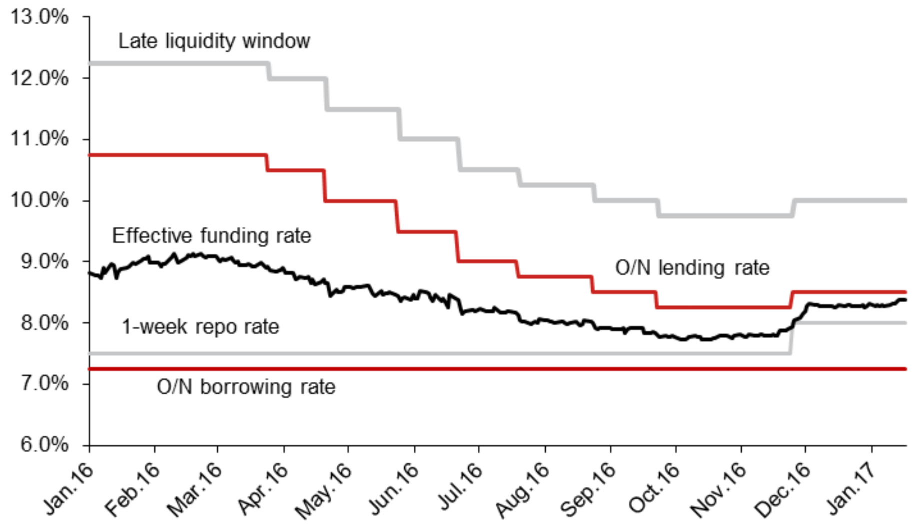
TCMB reverts to unconventional tightening

On Friday, the TCMB announced two further measures to prop up TRY. First, it reduced its lending limit to local banks via the interbank market to TRY11 billion from the TRY22 billion cap that it introduced earlier in the week. The second measure is a warning that it could also limit its lending via the BorsaIstanbul repo market – the other window where it funds the banks on an O/N basis.

Together, these two announcements suggests that the TCMB may deliberately underfund the banking system through its usual lending mechanisms, forcing the banks into its lender of the last resort facility – the late liquidity window – where the cost of funding is 10%.

We think the implications of this announcement are threefold: First, on days that the TCMB deems necessary, the banks' access to 1-week repo funding (which costs 8%) and O/N funding (which costs 8.5%) will be limited and they will be forced to borrow at 10% cost from the late liquidity window. So, on days of the TCMB's choosing, the ceiling of the interest rate corridor will be 10%, rather than 8.5%.

Fig. 1: Policy rates



Source: TCMB

The second implication is the shelving of the policy simplification process. Current TCMB Governor Cetinkaya had been a strong advocate of simplifying the policy framework and

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unifying the various funding rates at a single policy rate, presumably the 1-week repo rate. However, less than a year into his term, faced with market pressure, Mr Cetinkaya had to abandon the policy simplification and reintroduce the wide interest rate corridor.

In fact, what the TCMB currently intends to do is even more unorthodox than the Basci term policies. Using the late liquidity window has been extremely rare; data going back to 1990 show that there have been only nine instances of late liquidity window borrowing over the past 27 years. This is understandable because the late liquidity window is for banks that mismanage their intraday liquidity or face funding pressures, and there is a stigma attached to using it. Now, the TCMB itself forcing the banks to this stigma-attached facility is a big departure from conventional monetary policy, to say the least.

The third implication is an extension of this last point: The TCMB is clearly willing to go to extremes within the current interest rate set, which also means it is not willing (or able) to change the existing interest rates. Forcing the banks to the late liquidity window is a signal of reduced likelihood of a formal and transparent rate hike, in our view.

This brings us to the question of whether this measure will be enough to stem the TRY sell-off. In our view, success is conditional on persistent usage of the 10% facility and a benign global backdrop.

If these conditions are in place, we might see near-term stabilisation in TRY. But even then, we do not expect this to lend sustained support to the currency. First, as we argued before, the size of hike needed to offset the inflationary impact of currency weakness is in the region of 350-400bp and the cost of late liquidity funding falls short of this.

Second, with its large external financing requirement Turkey is prone to higher core rates and is also subject to elevated domestic political risks. Against these, what will reassure investors is not potentially intermittent tightening via usage of obscure policy tools. What is needed is a sizable, formal hike in policy rates to unambiguously improve the risk-reward profile for TRY. To the extent that usage of late liquidity window shows an inability to hike rates, it will be a negative for the currency.

We used the phrase "potentially intermittent tightening" for a reason. It remains to be seen whether the TCMB will be using the 10% funding cost in a persistent manner, because this would lead to higher deposit rates for the banks which would drive loan rates higher. Unorthodox it may be, but this would still be a rate hike, and followers of Turkey do not need any reminders that this is anathema to President Erdogan. So we will be following how often the TCMB uses this tool starting from today.

Appendix A-1

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