

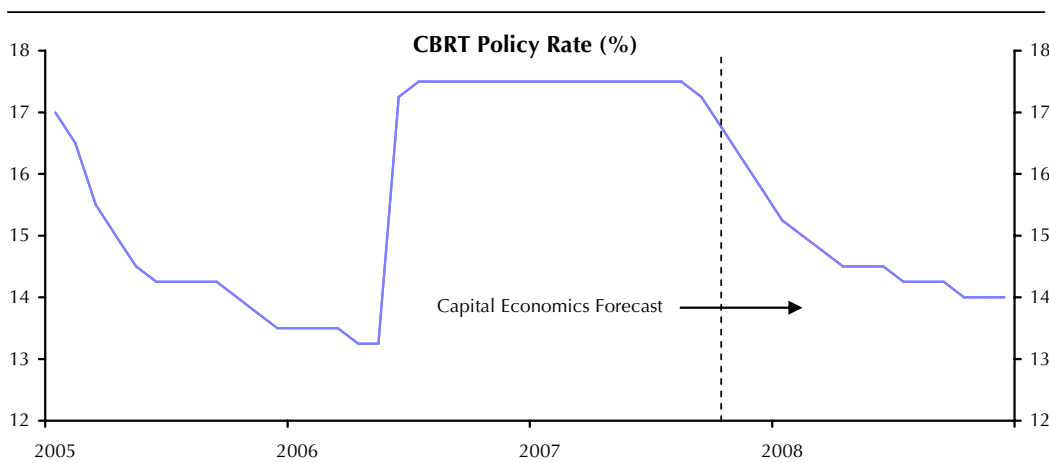
EMERGING EUROPE UPDATE

14th Nov. 2007



Turkey: Surprise move points to front-loading of rate cuts

- This evening's decision by the Central Bank of Turkey (CBRT) to cut interest rates by 50bps to 16.25% came as something of a surprise – the consensus was expecting a cut of just 25bps. But with the medium-term inflation outlook improving, the CBRT appears intent on front-loading future rate cuts. Accordingly, we expect rates to fall by a further 150bps by the end of Q1 of next year and by as much as 225bps by the end of 2008.
- Although the size of today's cut in rates came as a surprise, further policy easing can be expected over the coming months. Admittedly, the near-term inflation outlook has deteriorated recently and inflation did pick up to 7.7% y/y in October, from 7.1% in September. But this was driven by a sharp rise in food prices and does not seem to have caused concern amongst policy makers. Indeed, while the CBRT's latest inflation report forecast further rises in inflation this year on the back of higher food prices and indirect tax hikes, it noted that such effects should prove to be short-lived.
- What's more, the Bank envisages a much more benign inflation environment over the medium-term. Crucially, while headline inflation rose last month, its preferred measure of core inflation fell slightly to 6% from 6.1% in September. The latest inflation report sees further falls ahead.
- For a start, the Bank believes (and we agree) that the lagged effects of monetary tightening in the middle of last year are still being felt. Furthermore, inflation expectations appear to remain well anchored and the recent appreciation of the lira should start to have an impact on domestic prices by the start of next year.
- Of course, risks to the outlook still exist. While the Bank currently views high food and oil prices as a temporary phenomenon, it will be on the lookout for any signs of a pass-through to core inflation. More importantly, the presence of a large current account deficit makes the lira vulnerable to a dip in global risk appetite and a sharp drop in the currency cannot be ruled out.
- The CBRT sees inflation at 4.1% by the end of next year, just above its central target of 4% but well within the +/- 2% tolerance range. We think that downside risks to the currency mean that inflation will end next year at closer to 5%. Either way, more rate cuts are likely. Coming on top of last month's surprise decision to cut rates by more than the market was expecting, today's move suggests that the CBRT is intent on front loading policy easing. Accordingly, we expect rates to fall by 150bps to 14.75% by the end of Q1 next year and as far as 14% by the end of Q4. (See Chart.)



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