Macro: Contrary to expectations for a 'hawkish cut', the policy rate down by 300 basis points to 43.0%

The CBRT cut the policy rate by 300 basis points to 43% in July. Our expectation and the average market expectation was that the rate cut process would begin with a cautious and measured step of 250 basis points. Overnight lending and borrowing rates were also reduced by the same amount, to 46.0% and 41.5% respectively, and the width of the asymmetric interest rate corridor was maintained. In August, when there will be no MPC, CBRT has the flexibility to set the effective funding rate at 46% if necessary, as if no interest rate cut had been implemented.

Due to the higher-than-expected cut, the size of cuts at upcoming meetings is becoming important. While no clear guidance has been provided on this issue, it has been stated that a prudent approach will be taken on a meeting-by-meeting basis with a focus on the inflation outlook. We assess the most important message of the decision as 'higher-than-expected dovish cut' rather than 'hawkish communication despite the cut.' Although the CBRT tried to prevent the 300 bps cut from being perceived as a 'standard step size,' it preferred to keep the wording vague in order to maintain flexibility in both directions. The reintroduction of wording implying a negative output gap points to a justification similar to that used in the interest rate cut process initiated last year. We interpret this as an important communication detail regarding the bias toward interest rate cuts. Additionally, we assess the preference for maintaining flexibility rather than adopting a hawkish communication stance that favours 'err on the upside' as the second important detail indicating a bias toward easing.

The depreciation trend shaped by recent reserve and exchange rate policies is making it difficult to reach 24% or remain below 29% by the end of the year for the inflation. The risks to our year-end $/TL assumption of 43.0 are weighted to the upside; the trend over the last three months points to around 44.5 by the end of the year. While inflation is far from the target, the preference for an upward surprise than a downward surprise for the rate cut is an important signal. Together with the reserve/exchange rate policy, we interpret this as a policy approach that tolerates/will tolerate higher inflation to some extent. In summary, based on our reading of the July decision, communication, and policy preference, achieving our year-end inflation forecast, which we updated from 30.0% to 28.5% last month, and keeping inflation within the CBRT target band in December is becoming more challenging.

Our key messages and evaluations are as follows:

MPC Decision:

- ***"The underlying trend of inflation remained flat in June. Leading indicators suggest a temporary rise in monthly inflation in July due to month-specific factors."***
  - In June, monthly consumer inflation was 1.37%, slightly below market expectations (monthly 1.5-1.6%; annual ≈35.3%). According to seasonally adjusted (s.a.) data published by TÜİK, the monthly inflation remained flat at 2.0%. The median and trimmed inflation rates, our own distribution-based trend indicators, improved slightly to 1.9% and 2.0% monthly. At this point, we interpreted the stabilisation of the annual inflation trend below 30% as a sign that monetary policy could be adjusted. (Inflation Developments – June 2025)
  - Based on current data, the median value of our model forecasts for July inflation is 2.5% (s.a. 2.9%, annual 34.1%). We estimate the one-off administered price/tax effects specific to July (natural gas price increase, automatic excise SCT adjustment) to be approximately 1 percentage point. When we exclude this effect, the underlying trend remains below 2%. Therefore, it is possible that we may see a similar picture to the May-June period in the coming months.
- **"Recent data indicate that *~~Data for~~ the ~~second quarter point to a slowdown in domestic~~ disinflationary impact of demand conditions has strengthened."***
  - Our backcast models for the second quarter signal a slowdown in economic activity due to the significant tightening in financial conditions, in line with CBRT forecasts. We expect annual growth to be around 4.5% range (qoq ≈%0) in the second quarter.
  - In the April decision, when interest rates were raised, the emphasis on the 'negative output gap' was reduced, and in the June decision, the reference to it was completely removed from the text. The

reintroduction of wording implying a negative output gap points to a justification similar to that used in the interest rate cut process initiated last year. We interpret this as an important communication detail regarding the bias toward interest rate cuts.

- ***The statement that "Potential effects of the geopolitical developments and the rising trade protectionism on the disinflation process are closely monitored." was retained.***
  - As may be recalled, the CBRT revised its average oil price assumption for 2025 from $76.5 to $65.8 in the Inflation Report. However, following developments in June, the price of a barrel of Brent crude oil has exceeded $75 again. Subsequently, although Brent oil prices fell to the $68-70 range as geopolitical risks subsided, they still point to a higher outcome than the CBRT's forecasts.
  - According to a blog post published by the Central Bank of the Republic of Turkey (TCMB) two weeks ago (link), a 10% increase in crude oil prices raises consumer inflation by 0.8 points in a year. Based on our own analysis, we estimate the same effect to be 1.2 percentage points. In this context, we can say that there are upward risks related to oil prices in the disinflation path forecast by the CBRT in its May inflation report.
- ***"Going forward, ~~increased~~ coordination of fiscal policy will ~~also~~ contribute ~~significantly~~ to this process"***
  - The CBRT softened its statement regarding the contribution of fiscal policy to the disinflation process. Although coordination has been strong so far in terms of incomes policy and energy prices, it is difficult to advocate a full-fledged coordination when considering withholding tax, fuel taxes and changes in special consumption tax on automobiles. While the inflation trend is improving, frequent administered price and tax adjustments are a significant factor preventing us from permanently falling below 2% monthly and breaking inflation rigidity.
  - In terms of macroeconomic policy priorities, the most pressing issue to be resolved is inflation. To achieve this, policy mix must be formulated from a 'general equilibrium' perspective rather than a 'partial equilibrium' approach that focuses solely on budgetary targets.
  - The fiscal stance remained loose in the first half of the year. The trend in the primary balance and the increase in interest payments indicate that the MTP targets will not be met. At this stage, we believe that the most important thing is to exit the high interest rate balance, which is putting a heavy burden on both production and the budget, as soon as possible, even if it means compromising on the budget target, by establishing disinflation urgently rather than gradually.
- ***"The Committee will determine the policy rate by taking into account realized and expected inflation, and its underlying trend in a way to ensure the tightness required by the projected disinflation path. The step size will be reviewed prudently on a meeting-by-meeting basis with a focus on the inflation outlook."***
  - CBRT tried to prevent the 300 bps cut from being perceived as a 'standard step size' and preferred to keep the wording vague in order to maintain flexibility in both directions.
  - We assess the preference for maintaining flexibility rather than adopting a hawkish communication stance that favours 'err on the upside' as the second important detail indicating a bias toward easing.

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