Box 1.1

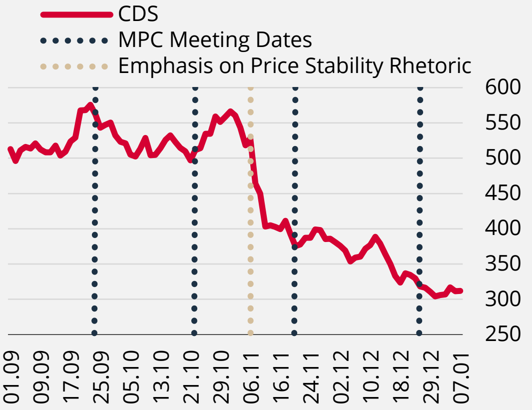
Recent Monetary Policy Decisions and Their Effects on Financial Indicators

This box examines the effects of monetary policy decisions in the September-December period on inflation compensation, the CDS premium and long-term interest rates. Under an inflation targeting regime, central banks tighten monetary stance by raising the short-term policy interest rates in case of deterioration in the inflation outlook. Monetary tightening is expected to slow down economic activity by reducing aggregate demand in the short term.

Saving and investment decisions depend heavily on long-term interest rates. Therefore, achieving permanent decline in inflation and price stability will enhance production capacity in the economy as it will bring low interest rates and a predictable investment environment. In times of high and volatile inflation, tight monetary policy practices aiming at price stability can reduce long-term interest rates by lowering inflation expectations and country risk premium.

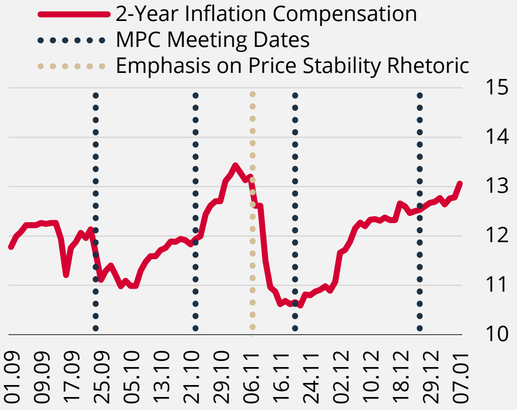
The vigorous recovery achieved in the economy with the rapid expansion in monetary aggregates and credits led to a deterioration in the external balance and inflation outlook. Accordingly, the CBRT increased the policy rate by 200 basis points at the MPC Meeting on September 24, 2020. After the decision, the risk premium of Turkey began to decline and 2-year inflation compensation, which can be described as a measure of inflation expectations derived from market rates, decreased by almost 1 percentage point (Charts 1 and 2). Thus, while short-term market rates increased in line with the policy rate, long-term market rates declined significantly (Chart 3). Therefore, this monetary policy step can be evaluated as an "expansionary tightening".

Chart 1: Turkey's 5-Year CDS Premium
(Basis Points)



Source: Bloomberg.

Chart 2: 2-Year Inflation Compensation
(%)



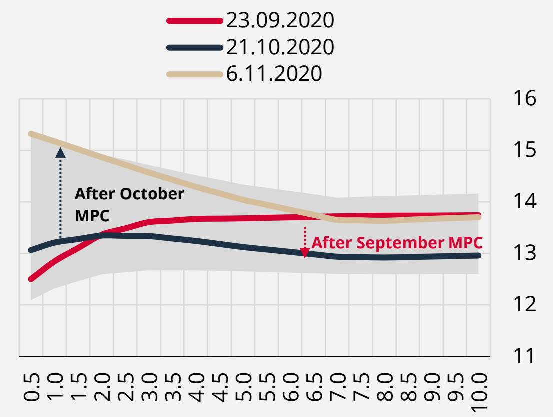
Source: Bloomberg.

Contrary to the rate hike predicted in the surveys conducted by various institutions prior to the MPC meeting in October, the CBRT left the interest rates unchanged and signaled that the additional monetary tightening that may be required would be carried out through liquidity management. After the decision, the country risk premium rose to the levels before the September MPC Meeting, while the inflation compensation also displayed a rapid upward trend. Similar to the increase in the risk premium, long-term interest rates also increased to pre-September MPC meeting levels, while short-term interest rates rose significantly owing to the additional tightening through liquidity management. The upsurge in interest rates across all maturities through inflation expectations and risk premium channels indicates a limiting effect of the October MPC decision on economic activity unlike the September decision.

In November, the country risk premium and inflation expectations decreased notably with the CBRT's adoption of a simple monetary policy framework accompanied by a rhetoric that prioritizes price stability. As a result, market rates fell by almost 1 percentage point in short terms and 2 percentage points in long terms in November (Chart 4). While the decline in the country risk premium continued, inflation compensation remained flat due to the implementation of a simple operational framework at the November MPC Meeting and the hike in the policy rate to converge to the actual money market interest rates. In the ensuing period, inflation compensation increased slightly due to the rapid increase in headline inflation. This increase was also reflected in market rates.

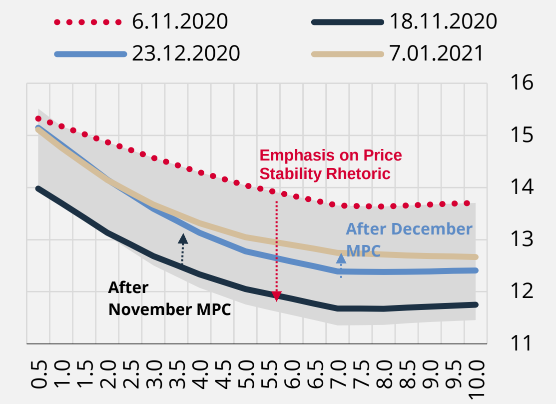
In order to limit the risks to the inflation outlook, the CBRT increased the policy rate by another 200 basis points at the MPC meeting in December. The country risk premium responded positively to this decision, but the increase in inflation expectations continued, albeit limited. While this increase was partially reflected on long-term market rates, interest rates remained flat in the short and medium terms.

Chart 3: Treasury Yield Curve
(%, 1 Sep.– 6 Nov. 2020 Period)



Sources: Bloomberg, CBRT.
* Shaded region represents the lowest and highest yields for the period between 1 September and 6 November 2020.

Chart 4: Treasury Yield Curve
(%, 6 Nov. 2020 – 7 Jan. 2021 Period)



Sources: Bloomberg, CBRT.
* Shaded region represents the lowest and highest yields for the period between 6 November 2020 and 7 January 2021.

Considering the response lag, the decisive monetary policy stance is expected to alleviate the headline inflation in the upcoming period, which in turn improves the inflation outlook. In fact, the decline in the country risk premium by more than 200 basis points since the beginning of November indicates that the belief in economic stability has strengthened. Establishing a low inflation environment permanently will support the decrease in the country risk premium and long-term interest rates and will positively affect economic activity.