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Piotr Matys

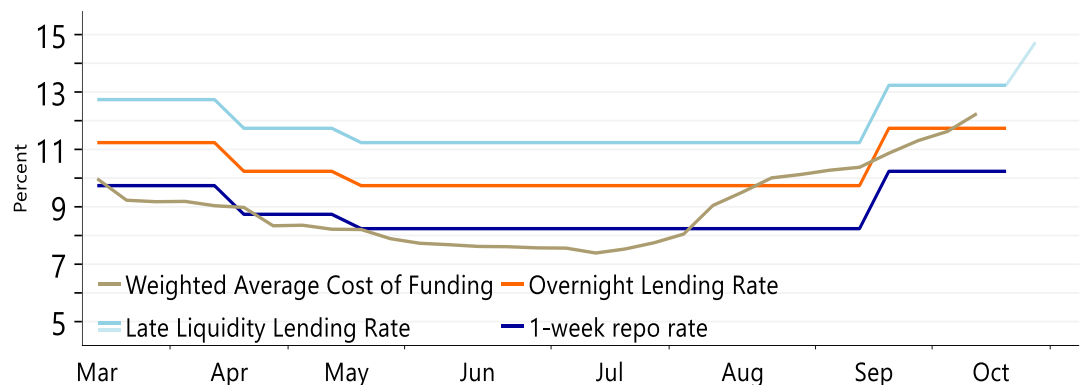
Senior Emerging Markets
FX Strategist
+44 20 7664 9774

The CBRT leaves the market disappointed

EM FX Watch

Turkey's central bank left the market disappointed by keeping the 1-week repo rate unchanged at 10.25% against expectations for another hike following the 200bps move in September. The overnight lending rate was left on hold at 11.75% as well. While the late liquidity lending rate was raised to 14.75% from 13.25%, it proved insufficient to prevent USD/TRY from rising to another record intraday close to the psychological level of 8.00.

Figure 1: The CBRT raised interest rate, but not the one the market expected



Source: Macrobond

The decision implies that the CBRT intends to rely on the interest rate corridor to manage liquidity by potentially directing the average cost of funding towards the late liquidity lending rate at 14.75% (Figure 1).

However, the central bank cannot afford to experiment with the setup of monetary policy as the negative market reaction to its decision clearly indicated. With inflation on track to end this year above 10% and not expected to align with the official 5% target until 2022, an orthodox monetary policy would be more effective in gradually restoring the CBRT's credibility.

Figure 2: USD/TRY was leaning lower in anticipation of a hike only to spike sharply when the CBRT disappointed

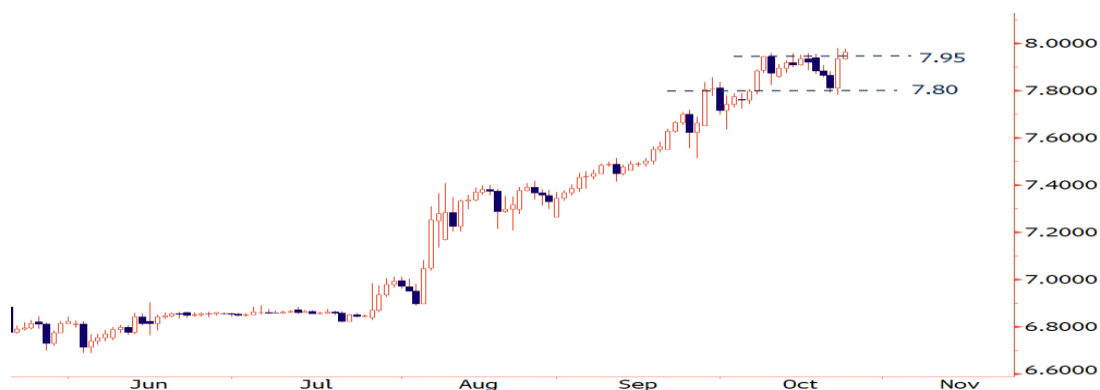


Source: Rabobank/Bloomberg

It is quite disappointing that after making an important step to regain its credibility last month – when the policy rate was hiked by 200bps – the central bank refrained from sending a strong signal of its determination to stabilise the lira. The CBRT may have miscalculated market's tolerance for conducting an unorthodox policy.

The decision to leave the 1-week repo rate on hold at 10.25% could prove costly if former Vice President Biden wins the US presidential election on November 3, as opinion polls currently indicate. The risk that the US may impose sanctions on Turkey for purchasing the Russian S-400s air defence system would increase. While to some extent the prospect of Biden's victory is already in the price, USD/TRY could still extend its already impressive year-to-date gains beyond the psychological level of 8.00.

Figure 3: The outcome of the US presidential election will be crucial for USD/TRY



Source: Rabobank/Bloomberg

The CBRT will hold two more meetings this year on November 19 and December 24. Those meetings will offer an opportunity to make yet another – hopefully much more efficient - attempt to restore credibility which has been undermined by negative real interest rates and spending billions of dollars to slow down the rapid pace of lira's depreciation instead of acting decisively by raising interest rates substantially. As the sharp spike in USD/TRY illustrates, the market has no or very little tolerance for the central bank experimenting with the setup of monetary policy instead of an explicit tightening by raising the 1-week repo rate by a few hundred bps. The CBRT may have to do much more on November 19 compared to what the market anticipated ahead of the October 22 decision, especially if former Vice President Biden wins on November 3.

RaboResearch

Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts

+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Europe

Elwin de Groot

Head of Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman

Senior Market Economist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen

Senior Market Economist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen

Quantitative Analyst
ECB
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Maartje Wijffelaars

Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Erik-Jan van Harn

Economist
Germany, France
+31 6 30 020 936
Erik-Jan.van.Harn@Rabobank.nl

Wim Boonstra

Senior Advisor

+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Americas

Philip Marey

Senior Market Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Hugo Erken

Head of International Economics
United States
+31 88 721 5260
Hugo.Erken@Rabobank.nl

Christian Lawrence

Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une

Senior Strategist
Brazil
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Gabriel Santos

Strategist
Brazil
+55 11 5503 7288
Gabriel.Santos@Rabobank.com

Asia-Pacific

Michael Every

Senior Market Strategist
Asia, Australia, New Zealand

Michael.Every@Rabobank.com

Raphie Hayat

Senior Economist
China, Japan
+31 88 725 3710
Raphie.Hayat@Rabobank.nl

Hugo Erken

Head of International Economics
India
+31 88 721 5260
Hugo.Erken@Rabobank.nl

FX Strategy

Jane Foley

Head of FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Piotr Matys

Senior FX Strategist
Central & Eastern Europe FX
+44 20 7664 9774
Piotr.Matys@Rabobank.com

Christian Lawrence

Senior Cross-Asset Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire

Head of Rates Strategy

+44 20 7664 9730

Richard.McGuire@Rabobank.com

Lyn Graham-Taylor

Senior Rates Strategist

+44 20 7664 9732

Lyn.Graham-Taylor@Rabobank.com

Matt Cairns

Senior SSA Strategist

+44 20 7664 9502

Matt.Cairns@Rabobank.com

Credit Strategy & Regulation

Hyung-Ja de Zeeuw

Senior Strategist

Corporates

+31 30 712 1555

Hyung-Ja.de.Zeeuw@Rabobank.com

Bas van Zanden

Senior Analyst

Pension funds, Regulation

+31 30 712 1869

Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen

Senior Credit Analyst

Financials

+31 88 721 7374

Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema

Analyst

ABS

+31 30 712 1849

Cas.Bonsema@Rabobank.com

Energy & Metals

Ryan Fitzmaurice

Strategist

+1 212 916 7874

Ryan.Fitzmaurice@Rabobank.com

Agri Commodity Markets

Stefan Vogel

Head of ACMR

+44 20 7664 9523

Stefan.Vogel@Rabobank.com

Carlos Mera

Senior Commodity Analyst

+44 20 7664 9512

Carlos.Mera@Rabobank.nl

Michael Magdovitz

Commodity Analyst

+44 20 7664 9969

Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Netherlands	+31 30 216 9045	Hans.Deusing@Rabobank.com
David Kane	Europe	+44 20 7664 9744	David.Kane@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
David Teakle	Australia, New Zealand	+61 2 8115 3101	David.Teakle@Rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Youssef El Mir	Short Term Interest Rates	+31 30 216 9454	Youssef.El.Mir@Rabobank.com
Henk Rozendaal	Interest Rate Derivatives	+31 30 216 9423	Henk.Rozendaal@Rabobank.com
Huib Verbeek	Bonds	+31 30 216 9612	Huib.Verbeek@Rabobank.com
Martijn Sorber	Solutions	+31 30 712 3578	Martijn.Sorber@Rabobank.com

Capital Markets

Herald Top	Global Head of Capital Markets	+31 30 216 9501	Herald.Top@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head of Equity Capital Markets	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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A summary of the methodology can be found on our website www.rabobank.com

© Rabobank London, Thames Court, One Queenhithe, London EC4V 3RL +44(0) 207 809 3000