**Commentary 2**

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**Article**

**Turkish central bank hikes key interest rate by another 500 bps**

BY DAILY SABAH WITH AGENCIES | ISTANBUL | NOV 23, 2023 - 1:41 PM GMT+3

Türkiye's central bank on Thursday surprised the market with a larger-than-expected interest hike as it lifted its benchmark one-week repo rate by another 500 basis points to 40% in the sixth straight rise under a new governor and the shift in policymaking.

The bank, however, signaled that the pace of monetary tightening will slow down with the tightening cycle to be completed in a short period.

"The current level of monetary tightness is significantly close to the level required to establish the disinflation course," the Central Bank of the Republic of Türkiye (CBRT) said in a statement.

"Accordingly, the pace of monetary tightening will slow down and the tightening cycle will be completed in a short period."

Economists polled by an Anadolu Agency (AA) survey last week expected the bank would deliver a 250 basis points rate hike.

A Reuters poll similarly on Monday showed that the bank is expected to raise its policy rate by 250 basis points to 37.5% this week – according to 21 institutions in the poll. One predicted 300 basis points and another predicted 350.

According to the latest data from the Turkish Statistical Institute (TurkStat), Türkiye's annual inflation eased to 61.36% in October from a nine-month high of 61.53% in September.

"Headline inflation edged down in October and remains in line with the outlook presented in the most recent Inflation Report. The existing level of domestic demand, the stickiness in services inflation and geopolitical risks keep inflation pressures alive. On the other hand, recent indicators suggest that domestic demand has started to moderate as the monetary tightening is reflected in financial conditions," the central bank further said.

The bank, in its last quarterly inflation report of the year earlier this month, revised its year-end inflation forecasts upward for this year and the next.

It expects inflation to rise from around 61.4% last month to peak at 70%-75% in May before dipping to about 36% by the end of next year.

"Getting high and volatile inflation under control will be a long and difficult process. We will continue to use all tools available in a determined way to ensure disinflation," CBRT Governor Hafize Gaye Erkan said at the time.

"Really impressive move by the (central bank) ... getting well ahead of expectations," emerging markets economist Timothy Ash remarked in an emailed note.

The bank's previous policy of cutting interest rates amid high inflation was accompanied by a steep decline in lira in 2021, after which the government introduced a scheme that protects lira deposits from foreign exchange depreciation. The central bank meanwhile initiated a gradual exit from the scheme, also known as KKM, while the shares of Turkish lira deposits began to rise.

Excluding the KKM scheme, the share of lira deposits in the banking system has risen 7 percentage points in the last three months to above 38% amid government efforts to reduce dollarization.

President Recep Tayyip Erdoğan chose former Wall Street banker Erkan as central bank chief after his May reelection.

"To increase the functionality of market mechanisms and strengthen macro-financial stability, the committee continues to simplify and improve the existing micro- and macroprudential framework," the bank said.

"While lending rates are assessed to be in line with the targeted level of financial tightness, the committee evaluates that the regulations to increase the share of Turkish lira deposits and monetary tightening will continue to strengthen the transmission mechanism and to improve the funding composition of the banking system."

The bank has raised its one-week repo rate by 3,150 basis points since June, with 500-point hikes in the previous two months.

**Commentary**

The article concerns Turkey's demand-pull inflation of 61.36% annually due to its previous low interest rate. The government took **intervention** by increasing its interest rate to 40%, trying to lower the pace of inflation.

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| Figure 1: Inflation gap in Turkey |

Normally when the economy is overheating, adjusting interest rates is always an effective **intervention.** However, Turkey’s President, Recep Tayyip Erdogan, decided to instead, flood the economy with cheap money for his presidential election popularity. Due to the low interest rate, households consume rather than save, and firms are more willing to borrow money to invest. Also, to reduce dollarization, they increased the Lira deposit in banks, increasing the money supply. As consumption and investment, which are determinants of aggregate demand (AD), increase, AD shifts to the right, intersecting the SRAS at real output Yinfl higher than Yp, forming an overheating demand-pull inflation.

Unlike in most other countries, Turkey’s central bank is not independent of the government, meaning it is difficult for them to address the problem by adjusting the interest rate. As a result, the economy gradually shifted to an uncontrollable situation – in September 2023, the annual inflation rate reached its nine-month high of 61.53%. To change this severe situation, former Wall Street banker Erkan is chosen by Erdogan after his May reelection as central bank chief.

By November 2023, Turkiye’s central bank had raised the interest rate 6 times to 40% to **intervene** in the overheating inflation.

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| Figure 2: After the imposition of the contractionary monetary policy. |

Since the interest rate is higher, households and firms are likely to be discouraged from borrowing money. At the same time, households may choose to deposit their money into the bank rather than spending considering the high return for saving. The reduction in consumption and investment shifts AD to the left from AD1 to AD2 ideally at its potential output Yp. The inflation in Turkey is expected to decrease to about 36% by the end of 2024.

To evaluate, the monetary policy taken is a flexible **intervention** tool and can be changed often according to its needs. The central bank controlled the current level of monetary tightness very close to the level required to establish the disinflation course. The interest rate can be changed frequently and multiple times. The closest **intervention** taken is the 6th straight rise of 5% in interest rate under the new governor’s management.

Due to inflation, people in Turkey struggle to pay for their fundamental living costs. A successful government intervention may solve the inflation problem and return the price level to its original ideal value. Then people can return to better living conditions. At the same time, the **intervention** reveals that the Turkish government is actively trying to solve the inflation problem instead of overlooking it. Economist Timothy Ash addressed his delight “Really impressive move by the (central bank)… getting well ahead of expectations”. Households' and investors’ confidence can be restored, and they will be more inclined to engage in healthy economic activities, thereby improving the market function ability.

However, the **intervention** to raise interest rates increases the cost of borrowing for individuals and businesses, including those with already existing debts. The debtors may struggle to meet their debt obligations, leading to financial distress and poverty.

Also, as firms face higher borrowing costs, they may scale back production and investment, leading to layoffs and higher unemployment rates. The reduced consumer spending can further contribute to lower revenue and more job losses. This results in a worse living condition, and thus the **intervention**, on the other hand, can lead to widespread poverty and social unrest.

The increase in interest rate may increase income inequality – while wealthy individuals save money in banks and receive higher interest, the poor borrow money from banks and face higher debts, falling into severe poverty. Particularly in Turkey, its central bank is not independent of the government, so people may be unsatisfied with the **intervention** made by the government. The arising public dissatisfaction with the intervention may potentially lead to political pressure onto Turkish government.

Additionally, a 61.36% inflation rate may be too high for the monetary policy to work effectively. Instead of saving in the bank, people may prefer dollar to avoid the extreme inflation. The use of contractionary monetary policy alone to address the problem of an overheated economy may take too long and may need to be complemented by other government **interventions**. For example, fiscal policies such as increases in progressive income tax and business tax can be taken to reduce inequality and the possibility of social unrest.

In conclusion, the former incorrect interest rate set by the Turkish government and its central bank led to severe demand-pull inflation. Their determination to solve the problem is shown by their **intervention** of adding the interest rate to 40% in November 2023. The **intervention** started working gradually and other **interventions** may be taken to accompany it, such as increasing the tax.