MPC PREVIEW February 2013

Three-way Betting

The second Monetary Policy Committee (MPC) meeting of 2013 will be held on Tuesday, February 19. While we will be providing our views as to potential decisions by the MPC at this meeting in the following paragraphs of this note, we first need to underline that the recent emphasis by the CBT on **monetary policy decisions being "data-dependent" has increased the uncertainty compared to before**, thereby **raising the possibility of a surprise decision** by the monetary authority. This is because data are objective, while analyses are subjective, and differences in interpretation among market players and the CBT might prove more substantive than ever.

Let us remind investors of **key messages provided by the CBT** at the January MPC meeting and the subsequent Inflation Report (IR): "*Inflation forecasts assume that monetary policy decisions are data dependent. In other words, it is envisaged that credit and exchange rates follow a stable course and aggregate demand conditions are kept at levels that do not exert upside pressure on inflation. Accordingly, in response to incoming information regarding price stability and financial stability; short term interest rates, liquidity instruments, and macroprudential measures are set in a flexible and coordinated way. Therefore, the forecasts envisage an outlook where macro financial risks arising from the recent surge in capital inflows risks are contained. Forecasts are based on the assumption that annual loan growth rate will hover at around 15% and there will be no significant change in the real effective exchange rate. (...) Financial conditions index has continued to ease with rapid capital inflows, improving credit supply conditions, and accommodative liquidity policy. These developments point to the* ***risk of further acceleration in credit and domestic demand for the forthcoming period,*** *necessitating a cautious stance against macro financial risks. Therefore, in its first monthly meeting of 2013, the Committee highlighted the faster-than- expected credit growth and signalled that* ***macroprudential measures might be continued should this trend persist*****.**"

Under the light of these principal messages and despite the absence of any hints by the MPC at the January meeting, expectations of a "measured adjustment to the interest rate corridor" and continuation of RR hikes do seem reasonable, in our view, considering recent data flow and most notably changes in the real effective exchange rate (REER) -- a closely followed intermediate variable by the CBT -- and loans.

On the other hand, looking at the same data juxtaposed against the macro setting, and also considering Governor Basci's remarks following the issuance of the IR, a **wait-and-see approach by the MPC also seems somewhat plausible**. Investors might recall that in the Q&A session of the IR meeting, Basci had stated that the measures taken so far on the RRR

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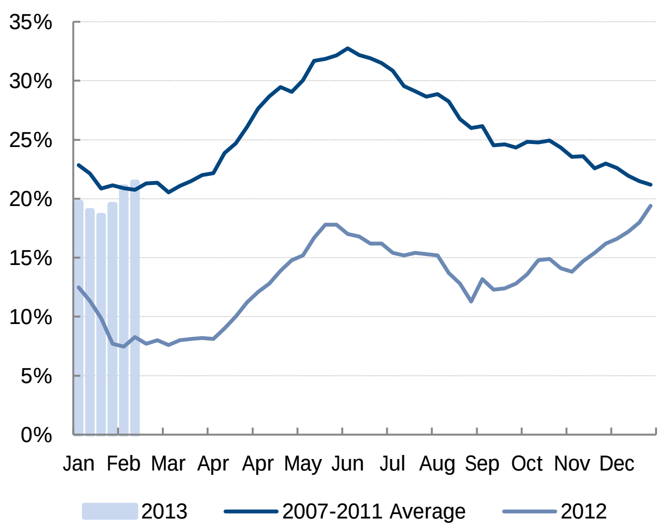
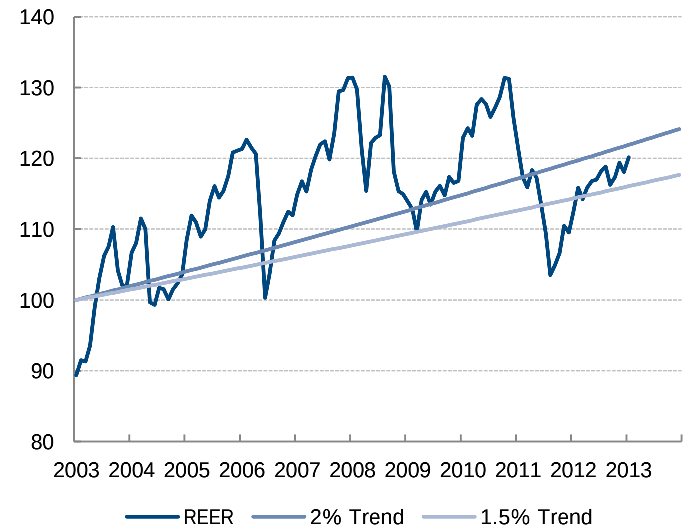
Exhibit 1: Consumer Loans, 13w moving average, annualised



Source: CBT, Burgan Securities

Exhibit 2: Real Effective Exchange Rate, 2003=100



Source: CBT, Burgan Securities

seemed sufficient to rein in loan growth at this stage, adding that the loan growth target was not too rigid. On the other hand, the REER had exceeded the "overvalued" threshold of 120 identified by the CBT in January, backing the monetary authority's last action of a 25bp cut at the lower band of the interest rate corridor. **Month-to-date in February, the REER continues to hover at about the January level, still within the CBT's tolerance interval, as projected through 1.5-2.0% real appreciation annually.** Based on our inflation forecast, the REER is likely to fluctuate at around the 120 mark in February, unless the TRL weakens to beyond 2.065 against the currency basket through the reminder of the month.

Finally, from today's vantage point, neither the overshoot in inflation nor the undershoot in growth is expected to trigger a change in the CBT's policy stance. Monetary policy is currently being shaped by the real performance of the TRL and the course of loan growth. Note that a cut at the lower band is aimed solely at deterring capital inflows, and is not expected to provide any additional stimulus to economic activity. Otherwise, we expect the CBT to maintain the policy rate at the current level.

Therefore, **we think the following three courses of action lie before the CBT**: **i)** Actions similar to January MPC meeting resolutions; i.e. shifting lower the interest rate corridor in a measured way, and implementing minor hikes in TRL/FX RRRs; **ii)** Maintaining the status quo, but providing the message that they stand ready to act, if need be; **iii)** A symbolic tightening in RRRs. **We attach slightly higher probability to the second option**, **while acknowledging that a symbolic tightening in RRRs per se would strengthen the cautious stance regarding financial stability.**

Last but not least, we attach significant importance to press reports claiming a lack of coordination between the CBT and the Banking Regulation and Supervision Agency (BRSA) and the subsequent joint denial by the institutions. Actually, we had emphasized the significance of coordination in our earlier assessment: *"…The reserve requirement hikes* *introduced by the CBT within the first half of 2011 had not proved that effective in tempering loan growth; rather, loan growth was restrained eventually thanks to the measures adopted by the BRSA in June. While it might behoove the BRSA to act in a similar way in the coming months, we reckon the lesson hopefully drawn from the 2011 experience might lead to improved coordination among relevant institutions…."* In this sense, the following **joint statement by the CBT and the BRSA is relieving**, in our view: *"…Regulations that are relevant to more than one institution are discussed at the Financial Stability Committee level and any decision is made following mutual exchange of opinion. Our institutions will continue their works, as before, on the basis of rapport and mutual cooperation."*

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