Deciphering Turkish Monetary Policy in a Time of Crisis

(“Toto, I've a feeling we're not in Kansas anymore”)

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Outline

Like the little girl Dorothy in the Wizard of Oz story, I think Turkish monetary policy went over the rainbow recently.

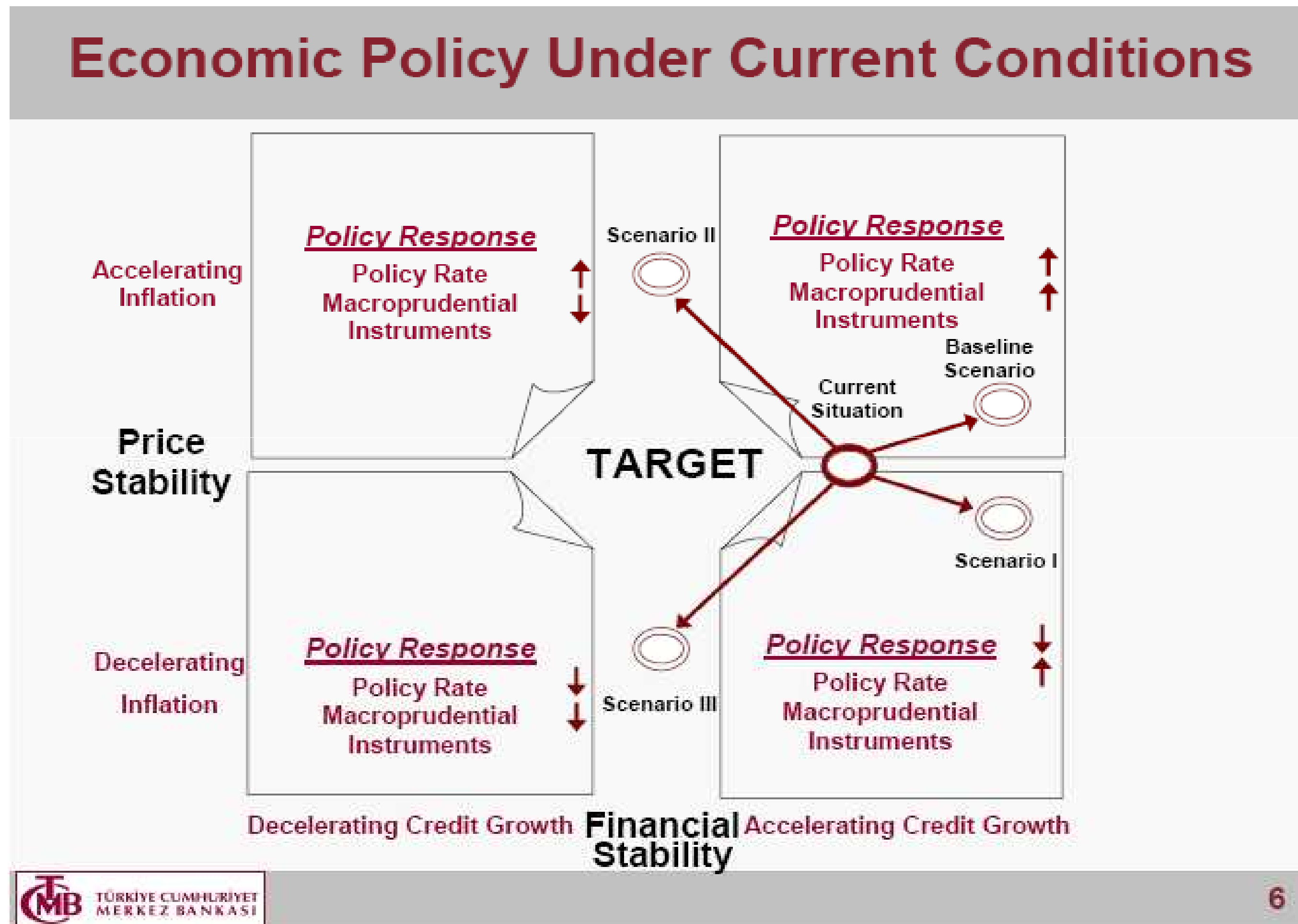
In an effort to put this in some context, I will argue:

- There has been a clear paradigm change in the monetary policy framework since late 2010.
- The CBT should be commended for seeing the current account problem in a timely way, but I remain confused, and to some extent in disagreement with, some of the things that are being done.
- As far as I can see, the bottom line is that we seem to have 'switched corners' around the famous monetary policy trilemma without naming it as such.
- We could follow a simpler, more transparent route by sticking to plain vanilla Inflation Targeting while trying to tame the current account deficit (CAD), but this would be politically impossible and had no public support anyway.
- However, what is being done is not risk-free, either. One of the key risks is that expectations as to what monetary/exchange rate policy is capable of, has been elevated in the public eye.

What Happened? A Little Background

- The Turkish economy experienced a very strong and quick recovery in 2010. Ample external financing and expansionary monetary and fiscal policies were the key drivers.
- The resulting credit growth, running at an annualized pace of 35%-40% in late 2010 and sharp lira appreciation led to an unsustainable increase in the CAD.
- By late 2010, the CBT saw this and decided to act upon it through a novel "monetary policy mix". Basically, the Bank moved to a 2x2 framework where it had 2 goals (price stability and financial stability) and 2 instruments (the policy rate and prudential tools).
- This is a commendable move and a rare public policy quality in this country – that of foreseeing trouble, and trying to 'remove the punchbowl as the party is still going'.
- But the rest is more complicated: What the Bank did was somewhat confusing and objectionable in my view, on both technical and philosophical grounds.

The Paradigm Change



Source: Erdem Basci presentation of December 11, 2010.

I was a bit confused, because…

- First, what was meant by prudential policy was somewhat incomplete
  - Macro prudential policy fundamentally falls in the BRSA territory, but the BRSA did not do much until this summer. A tool the Bank itself can alter directly -- the required reserve ratio -- became the most active instrument.
  - But because the RRR also works through the base money, combined with lowering of the policy rate, a somewhat awkward situation emerged where it looked like the Bank was trying to set both the price and quantity of liquidity.
  - The Bank targeted a ‘threshold level’, but for commercial banks to adjust to the new state at the higher RRR without requiring CBT funding, arithmetically speaking, deposit base would have to shrink.
- Second, inflation problem, *de facto*, was assumed away
  - Both inflation itself and expectations were still off-target; plus, heavy imports and strong lira had artificially suppressed inflation
  - Also, the Bank argued there was no ‘overheating’ mainly because external demand was weak; but external demand was partly ‘endogenous’ to the expansionary policies of 2010.

Moreover…

- There was no need for 'unorthodoxy' or novelty in our case, because there was nothing new in what we were faced with: a "classic capital inflows problem" and a "fear of floating" syndrome. Growth was too strong and had to be slowed down with all policies at our disposal working in the same direction.
- In other words, while an intellectual 'rethink of central banking in advanced countries' after the global crisis is perhaps needed, I don't think that's what we had here.
- Despite the fact that the Bank sounded content, monetary policy did not get enough support from other policy areas when the experiment started.
- Contrary to the common perception, fiscal policy was quite lax, once we consider the strength of the cycle and the country's chronic saving shortfall. Macro prudential policy was somewhat timid and lagged. On reforms, Ankara was piecemeal in its approach and lacked a well-prioritized framework…
- But an impression has been created that monetary policy alone can pull this off, or that the CBT figured a way to crack the so-called 'Impossible Trinity' so that we could have the best of two worlds: inflation could be contained and competitiveness restored, with minimal help from other policy areas.

Has the Bank Solved the ‘Impossible Trinity’?

- I don’t think so…
- One of the rare principles that almost always works in economics is that in an open capital account regime, we cannot control both inflation (have independent monetary policy) and the exchange rate (target competitiveness/growth).
- Central banks are very powerful, but this rule tends to be more powerful than the central banks.
- Despite the fact that the Bank said nothing to this effect, a ‘proof of the pudding in the eating’ approach suggests that we basically switched corners around the Impossible Trinity.
- That is, we stuck to full capital account mobility, but moved, *de facto*, from a regime of Inflation Targeting (with a more or less floating exchange rate) to a regime of exchange rate targeting because gaining competitiveness took priority over achieving low single digit inflation.
- This found popular support for lots of reasons…

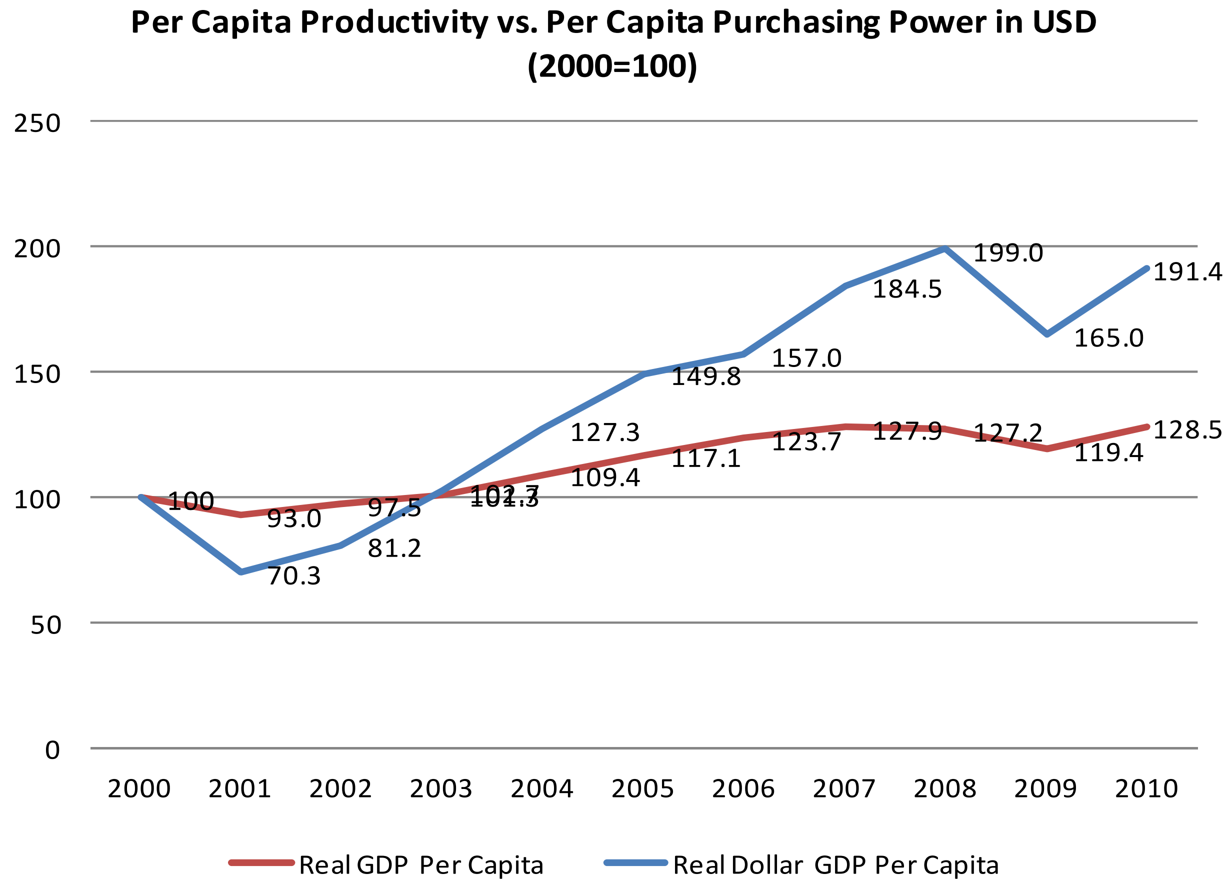
What Would the Textbook (from the mid-1990s) Say?

- Stick to Inflation Targeting because monetary policy is best at achieving price stability and this is how it could provide the best support to grander economic objectives like productivity growth.
- Tighten fiscal policy to curb demand, limit appreciation pressures, increase savings, help with the cost of sterilization, create fiscal space for later (for a possible 'sudden stop'), and make room for easier monetary policy.
- Use macro prudential policy to slow credit growth; try not to hike policy rates because that could be counter-productive but do not reduce it, either, unless it is unduly high; build reserves aggressively through sterilized interventions.
- Focus the debate toward accelerating structural reforms, as the only (longer term) way out of the 'capital inflows problem'.
- Consider capital controls, but as a last resort because they tend to be distortionary and are no panacea.
- But this route was politically impossible, nor did it have much popular support. To the contrary, the public has been led to believe by opinion leaders that monetary policy (read: a weaker exchange rate) could do wonders…

Could It?

- It could, if weaker exchange rate leads to a very strong – a Rodrik-esque – “supply response” through expanding the tradable sector and increasing productivity.
- But it is hard to bet on it in Turkey’s circumstances because Turkey is relatively rich (moving to higher end products probably requires deeper thinking and reforms than a weaker currency alone)…
- …‘depreciation-inflation-depreciation’ spiral is a non-trivial possibility, as we should not be misled by reduced pass-through effects of recent years
- …and corporate sector carries a large ‘currency mismatch’ on its balance sheet, the consequences of which we do not yet fully know.
- Also, the risk of further market volatility/instability should not be underestimated, as the level of our F/X reserves as percent of our short-term obligations and large CAD is not that strong.

The Ultimate Challenge (So That We Won't Lose Sight): Aligning Our Global Purchasing Power With Our Global Capabilities



Conclusion

- The CBT has done a brave thing, but I am yet to fully understand its workings. To me, it seems like the CBT switched corners around the famous trilemma, while keeping interest rates as low as possible to support growth.
- But support from other policy areas has not been adequate or timely, and monetary policy appeared overburdened as a result.
- The main risk we are facing is that, without a tighter policy framework, exchange rate policy alone cannot do the trick, and while chasing down multiple objectives, we may end up with more inferior macro outcomes at the end.
- As a side, “zero real interest rate” climate is risky for a country with a chronic CAD problem. Since Turkey’s real ‘neutral’ interest rate is unlikely to be zero, low interest rates, among other side effects, could delay reforms further.
- Ultimately, our modern sector has to go high tech and the informal sector has to acquire skills that are globally demanded. Politicians and the public should be made aware that monetary policy can’t do this.
- In sum, it is probably in our best interest, if Dorothy went back home to Kansas, i.e. if monetary policy irrevocably and transparently returned to its core function, that of achieving price stability.

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