THOUGHTS ON TURKISH MONETARY POLICY

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Central Banking Dogma

- Policymakers should target inflation, using a single instrument--a short-term interest rate

- Inflation target should be low, and hitting the target takes precedence over stabilizing output

- Monetary policy should not target asset prices or exchange rates, or try to contain credit bubbles

Historical experience, especially since 2008, suggests shortcomings of this approach. As a result, Central Bank of Turkey has deviated from the dogma.

Turkish Policy: A Possible Interpretation

Three instruments help policymakers hit three targets:

- One-week repo rate –> aggregate demand –> output and inflation
- Interest rate corridor –> capital flows –> exchange rate
- Reserve requirements –> credit growth

How does the interest rate corridor work?

- Corridor defined by CB borrowing and lending rates
- CB moves market rate within corridor by varying quantities in repo auctions
- Capital flows influenced by both level of market rate and uncertainty about market rate
- In March, CB reduces upper bound on corridor to allow greater capital inflows (?)

IMF advocates return to more traditional inflation targeting... new framework "weakens monetary transmission mechanism" (?) and raises inflation expectations (?)

My tentative view is that the new framework is worth a try, given the problems with traditional policy.

There probably is scope for simplifying the framework. The most “rich” set of instruments is not necessarily desirable. Complexity of current approach includes...

- Width of interest-rate corridor vs. asymmetry around one-week repo rate?

- Level of reserve requirements vs. Reserve Option Mechanism?

In any case, the Central Bank should explain their policy approach as clearly as possible. What is the underlying model of the economy, and what are the roles of each instrument?

Another deviation from traditional policy: Central bank appears to accept less-than-perfect inflation outcomes rather than curtailing growth. Inflation is running near top of 3-7% range.

My tentative view is that this policy is wise.

- Many central banks have overemphasized success in hitting inflation targets relative to output and employment outcomes.

- Many central banks have pushed inflation targets too low, resulting in liquidity traps.

- Turkey has room for strong growth. Unemployment rate is around 10%, similar to level over 2002-2007 and well above 7% of late 1990s.

- “Pro-growth bias” and comments by Prime Minister are not necessarily bad.