Süreyya Serdengeçti: Inflation targeting – performance and challenges

Opening speech by Mr Süreyya Serdengeçti, Governor of the Central Bank of the Republic of Turkey, at the Conference on Inflation Targeting: Performance and Challenges, Istanbul, 19 January 2006.

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Ladies and gentlemen,

I would like to welcome you all. It is a great honor for me to open this conference entitled *"Inflation Targeting: Performance and Challenges".* I am very pleased to host such distinguished guests and I'd like to thank you all for joining us here in Istanbul and share your knowledge and experience on inflation targeting.

The inflation targeting regime has been adopted by a growing number of countries, especially by emerging market countries, in the last fifteen years. As economic and political conditions of emerging market countries have generally been considered as vulnerable and unstable, these countries perceive inflation targeting as a credible and a safe "way out", after the successful experiences of industrialized countries. Turkey is now the newest member of the club. We have studied the experiences of more than 20 industrialized and emerging market countries as we were working on the general framework of the inflation targeting regime for Turkey. Along with these experiences, historical, socio-political and economic dynamics of the Turkish economy have been taken into account to create a model that is specific to Turkey. I believe that those countries who will adopt this regime in the future will benefit from our experience as we did from others. With this motivation, I would like to talk now about the main characteristics of the period of transition to inflation targeting regime in this country, a period that indeed lasted longer than planned, and about the main issues that we have faced during this period. I am strongly convinced that there are important lessons that can be drawn from the Turkish experience.

Distinguished guests,

The Turkish economy has lived through 30 years of high and volatile inflation rates and massive dollarization together with financial sector instability, high public sector debt burden and unstable and low growth rates. Living with such weaknesses for such a long period of time has created a strong inertia in inflation dynamics. Besides, in the latter half of that period, the currency crisis of 1994, contagion effects of Asian and Russian crises in 1997 and in 1998, and finally our own financial crisis in 2001 have been among the many events that increased the vulnerability of the economy. All these developments that negatively affected economic and social life, highlighted more and more the importance of price stability as the primary goal of monetary policy and made all of us realize the importance of a transparent framework for monetary policy that has a clear nominal anchor.

Accordingly, the macroeconomic policy framework has undergone major changes and some institutional arrangements have been introduced after and since the financial crisis in 2001. In this context, the floating exchange rate regime was introduced; the Central Bank Law has been amended and the primary objective of the Central Bank has been, for the first time in its history, defined as achieving and maintaining price stability. Together with these changes, a new economic program entitled "Strengthening the Turkish Economy-Turkey's Transition Program" was launched in May 2001. This new program addressed the two main issues of chronic inflation and high public debt with tight monetary and fiscal policies backed up by structural reforms.

In this environment, the Central Bank needed to introduce a transparent monetary policy regime with a clear nominal anchor to shape inflation expectations, as inflation inertia was the biggest problem and authorities lacked credibility. The choice of the exchange rate as a nominal anchor again was out of question: The exchange rate based stabilization program had been abandoned in total loss of confidence.

The other option then could be to use monetary aggregates as a nominal anchor. However, they too were not good candidates for a couple of reasons: One, monetary targeting implicitly incorporates the inflation target as the ultimate objective of monetary policy and relies on a forward looking assessment when responding to shocks; the pure form of this regime considers only money and ignores the potential information contained in non-monetary variables. Two, the success of the monetary targeting regime relies on the two assumptions that the velocity of money is entirely predictable and inflation is solely determined by money growth. Unfortunately, here in Turkey we did not live in such an environment. It was very difficult to predict money demand under a chronically high inflation environment as it was unstable. Moreover, the link between inflation and monetary aggregates was not stable neither.

The final alternative was the choice of the inflation itself as the nominal anchor and that obviously refers to the "inflation targeting regime". In addition to having an anchor, which is highly transparent, inflation targeting was viewed to be superior to all other monetary policy regimes because all available information is used in the monetary policy decision making process. Besides these features, Fred Mishkin (2000) for instance addresses the following favorable aspects of the inflation-targeting regime:

> "*Because an explicit numerical target for inflation increases the accountability of the central bank, inflation targeting also has the potential to reduce the likelihood that the central bank will fall into the time – inconsistency trap. Moreover, since the source of time inconsistency is often found in political pressures on the central bank to undertake overly expansionary monetary policy, inflation targeting has the advantage of focusing the political debate on what a central bank can do in the long run."*

On the other hand, as it is widely discussed in the literature, the success of the regime depends on the fulfillment of the necessary preconditions such as central bank independence, sound and well-developed financial sector and absence of fiscal dominance. At that time, the long "fiscal dominance" history of the Turkish economy that severely restricted the efficiency of monetary policy and shallow financial markets that were not well developed were the primary characteristics of the Turkish economy. All these limited the economy's room for maneuver on the eve of the adoption of the new monetary policy regime. Independence of the Central Bank of Turkey that came in 2001, was almost the only institutional factor in hand at that time on the way towards the ultimate objective of price stability.

Given this overall framework and conditions, the Central Bank of Turkey preferred a smooth transition towards inflation targeting whereby it would wait until all these factors that restrict the efficiency of monetary policy would weaken. In early 2002 following the achievement of relative stability in financial markets after the 2001 Crisis, the Bank announced its new monetary policy regime in a public statement as *implicit inflation targeting.* As it was emphasized in the same now historical statement, the final aim was to adopt the full-fledged inflation targeting regime, once the preconditions were met.

This 'new' regime was defined as inflation targeting since the central bank announced a numeric target for annual inflation jointly set by the government according to its law and price stability was now its primary objective. Furthermore, it was similar to inflation targeting in the sense that the decision making process was shaped in a forward looking manner by exploiting the broadest set of information available. However, the inflation targeting regime was also "implicit" rather than "full-fledged", reflecting the fact that the preconditions such as a strong fiscal position of the government and further stability in the financial markets were not yet fulfilled.

During the last four years, sound monetary and fiscal policies together with structural reforms, changes in the institutional framework and adaptation of the economy to floating exchange rates, however painful this might have been, have resulted in remarkable achievements on the way to price stability. During this period, the monetary policy of the Central Bank put greater and greater emphasis on ensuring the credibility of inflation targets. To this end, the Central Bank has often publicly stressed the importance of continuing with a tight fiscal policy and completing structural reforms without delay or compromise.

As a result, inflation targets have been reached for four years in a row, significantly enhancing the credibility of the monetary policy. I am so glad to be able to say that today inflation is at its lowest level in thirty-seven years. Annual CPI inflation, which was 73.2 percent as recently as January 2002, is now down to single digit figures; it stands at 7.72 percent as of end of 2005.

This performance in disinflation has obviously positively affected the economy. First of all, economic growth rates have been positive again in the last four years. Not only they have been positive, but very high levels have been attained. Total growth in real terms since 2001 is 31 percent. Furthermore the pattern of economic growth has changed. Today, the main sources of growth are the improvement in productivity and increasing export performance. In addition to this, the role of the private sector in economic growth has increased considerably in the last few years. Recent Turkish experience showed that tight and prudent fiscal policy is not necessarily contractionary, especially if and when an economy is facing fiscal dominance. The economy is expected to keep its growing trend in 2006 and onward and the aim obviously is to achieve sustainable growth rates at high levels.

Secondly, substantial progress in financial stability has been achieved with the help of the restructuring of the banking sector. Financial markets are now deeper and much less fragile. Parallel to these achievements, both nominal and real interest rates have declined significantly. The average maturity of the Treasury issues increased considerably and Turkish Eurobond spreads, used as a proxy for the country risk premium, have dropped significantly since 2001. Volatility in exchange rates has gradually decreased thanks to the transparent and consistent operation of the floating exchange rate regime. All these together triggered the reverse-dollarization process: Though the process has been interrupted from time to time and more progress is necessary, the weight of Turkish lira denominated investments in portfolio preferences is now on an upward path.

And finally, integration of the Turkish economy with the world has increased, leading to a more competitive environment in the real sector. This process together with macroeconomic stability has made it possible to sustain large current account deficits. Moreover, the quality of the financing has improved considerably as the composition of the capital account is now changing in favor of long term capital inflows and foreign direct investment.

At this point, I would like to reemphasize the support of the fiscal policy as an important factor contributing to this achievement. The involvement of the government in the process first came from the fact that inflation targets have been set jointly by the Government and the Central Bank. The government's pricing, tax and income policies have been carried out in tandem with inflation targets. Another crucial factor has been the fiscal discipline: Very high levels of primary surplus have been maintained all over the years. Thus concerns over the sustainability of the public debt stock have faded away, helping inflation expectations to be consistent with the targets, maintaining confidence in the economy and thus reducing the risk premium. The continuity of fiscal discipline and tight fiscal policies consistent with targets are critical for the credibility of the inflation-targeting regime. Thus, the support from the fiscal side is still an indispensable part of the economic program.

Dear Guests,

Central bank independence generally implies the ability to act free of direct political pressures when taking and implementing decisions concerning monetary policy. Parallel to this, central bank independence takes the first place in monetary policy debates especially in developing countries where lack of sustained fiscal discipline and higher inflation rates have been common. Both country experiences and economic literature have proven that there is a direct relationship between central bank independence and inflation. That is, the more independent and thus the more insulated from political pressures a central bank is, the better the country performs in terms of reducing the inflation level.

The first thing that the independence of a central bank then evokes is *de jure* independence. Within this context, factors such as goal independence, instrument independence, rules for the appointment, term of office and discharge of high level officers, central banks' control of their own budgets and provisions on their staff are among the important issues that can be addressed in central banks' law.

In fact, what I find particularly critical based on my experience is that independence is not a concept that can be simply achieved by legal independence. I believe achieving central bank independence is a process you live through on a daily basis and is closely related to central bankers' stand on economic policies and stability.

The new Law on the Central Bank, enacted in May 2001 in line with EU norms and central banking practices in the world, has been the most important step strengthening our Central Bank's operational independence. By this Law, as I mentioned before, the main objective of the Bank is stated as to achieve and maintain price stability. Furthermore, the Bank is the only body responsible for conducting monetary policy. In addition, credits extended to the Treasury and other public institutions are now illegal and the Bank shall not purchase debt instruments issued by the Treasury or by public establishments and institutions in the primary market. Amendments to the Central Bank Law constitute an important institutional step taken on our way to the European Union.

All of these mean the Bank determines the monetary policy and the policy instruments to be used at its own discretion. As a natural consequence of this discretion, the Bank is also required to establish the highest possible level of accountability and transparency.

According to its Law, each year in April and in October the Governor appears before the Council of Ministers to explain monetary policy and operations. We also make presentations to the Parliament twice a year. Similarly, the Central Bank gives utmost importance to transparency.

Evidently, transparency and accountability cannot be considered separately from the communication policy. Good communication appears to be an unquestionable condition for the effectiveness of monetary policy. Only in that way, the Central Bank can manage to be correctly understood by economic agents and shape expectations the way it desires. Besides, good communication plays an important role in reducing uncertainties and enhancing confidence by rendering the Central Bank's policies more understandable and predictable. The insulation of the public communication from political pressures constitutes one of the most important aspects of good communication. In this context, the Central Bank's informing the public about the economic situation and risks, using various communication channels, must be viewed as a significant part of its independence.

In the last four years, our Central Bank has experienced a historical transformation in terms of its communication policy. It all started with carrying out a new organizational arrangement within the Bank, founding a separate department. This department has the responsibility of preparing documents and booklets, and organizing meetings and conferences to explain monetary policy as well as improving the information set provided through the web page of the Bank. What we have achieved next was to elucidate the newly established conceptual framework of monetary policy. To this aim, we have tried to explain to the public concepts such as 'inflation targeting', 'price stability', 'floating exchange rate regime', 'good governance', and 'sustainable growth', standard elements of textbooks and generally known only in academic circles. To make economic agents familiar with these concepts, the communication policy of the Central Bank has effectively been used on every occasion through lectures and speeches across the country. Now, we know that these concepts are much better understood by the public.

I truly believe that this good communication has played a very important role in the performance of the Central Bank in bringing down inflation.

Dear Guests,

Two important developments and their possible effects on the economy made us decide the year 2005 as a transition period and adopt full-fledged inflation targeting regime in 2006.

First: As of January 1, 2005 we dropped six zeros from the Turkish lira. Thiswas an important development for the economy as a whole.

Second: The Turkish Statistical Institution announced a change in the calculation methodology of the price indices including CPI, starting from January 2005.

During 2005, in addition to these two developments, further steps were taken in order to improve conditions before starting full-fledged inflation targeting regime. We continued to develop our decision-making process towards more transparent and efficient policymaking.

So, though the Monetary Policy Committee continued to be an advisory body in making policy decisions, it began to meet regularly on the pre-announced days to discuss developments on inflation and economy in 2005. Decisions on short-term interest rates of the Central Bank were made public on the following business day taking the evaluations during the meeting into account. Following the announcement of policy decisions, a report on inflation and outlook, which would include the reasoning of the decision and the views of the Committee members together with the signals on how the decisions on interest rates would evolve in the future, has been made public.

Another step was the reorganization of the Research Department to fit the needs of policy design and analysis under the full fledged inflation targeting regime.

Besides, the information set that we use to forecast future inflation was further enlarged; forecast models for inflation were improved and sophisticated.

Now, let me proceed with some of the key elements of full-fledged inflation targeting regime that became effective in 2006.

We decided to target the Consumer Price Index (CPI). It is an indicator easily followed by all economic agents and is an effective way of accurately measuring the cost of daily life. However, we also announced that because the CPI is affected easily by several disturbances that are not under the control of monetary policy, several core inflation indicators will also be monitored closely.

We set the inflation target as a "point target" and at the same time, we set a three-year time horizon for year-end targets. The year-end targets for 2006, 2007 and 2008 are 5 percent, 4 percent and 4 percent, respectively. Bearing in mind the transition from 2006 onwards to a three-year government budget practice, the announcement of a three-year target path is expected to increase the internal consistency of inflation targets and their harmony with other macroeconomic projections.

We defined plus and minus two-percentage points around the target as an uncertainty interval. We thought that measured by a comprehensive index such as the CPI on one side and data and model uncertainty in the economy on the other side, it is not possible for the Central Bank of Turkey to ensure that inflation will not deviate more or less from the point targets. And, according to the 42nd Article of the Central Bank Law, we are accountable to communicate with the Government and the public if inflation deviates more than two percentage points on each side: *"The Bank shall submit information to the Government in writing and inform the public disclosing the reasons of incapability to achieve the determined targets in due time published or the occurrence of the possibility of not achieving and the measures to be taken thereof."*

Unlike in the last four years, the Central Bank will from now on assess upward or downward deviations from the target on equal balance. This also means that an explanation will be made to the public in both substantial upward and downward deviations of inflation from the target.

Indeed, as we look at other countries' experiences, economies that have already maintained price stability, it can be considered as a poor policy management if inflation remains systematically below the target. However, for countries who aim to bring inflation down from very high levels, remaining below targets all the time can be regarded as a positive signal of the commitment to price stability for economic agents. In fact, in the last four years in the Turkish economy, keeping year-end inflation figure below the target played important role in building-up credibility of the government and the Central Bank of Turkey, considering thirty years of high inflation.

Regarding changes in the decision-making process, it is important to note that the Monetary Policy Committee is now assuming a "decision-maker" role instead of an "advisory" role. Decisions regarding short-term interest rates will be subject to voting in the Monetary Policy Committee meetings in 2006.

Furthermore, in line with the principle of transparency, the meeting dates of the Committee are now announced a year in advance and arranged by taking into account the data flow schedule in a month.

Another important development is that the "Inflation Report" will be the main communication instrument of monetary policy. The most significant change in the report will be the inclusion of inflation forecasts of the Central Bank. Moreover, the report will also contain signals of likely policy changes in the future along with a general evaluation of the factors influencing inflation and an in-depth discussion of general macroeconomic developments.

Along with the Inflation Report, summaries of the Committee meetings will also be an important tool of communication policy.

Distinguished guests,

As final words, I would like to mention that the inflation targeting regime is not an end in terms of monetary policy, but on the contrary, a component of an uninterrupted "evolution" process. So far, we have tried to strengthen the economy with the help of fiscal discipline and ongoing structural reforms. I believe the independence of the Central Bank and the enhanced transparency and accountability will be the main tools to cope with challenges as they were in the previous period. I want to conclude by repeating my warm welcome to you all. I hope that you enjoy both the conference and your stay in Istanbul.

Thank you very much.