Durmuş Yilmaz: Expectations in global economy

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the Leaders of Change Summit, Istanbul, 15 March 2011.

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Distinguished Guests,

It is a great pleasure to speak here at the Leaders of Change Summit that has gathered politicians, decision makers, journalists, economists and bureaucrats who have played prominent roles in their fields and inspired societies across the world.

Today, I will share my thoughts regarding the outlook of the global economy and the challenges faced by the emerging market economies in the aftermath of the crisis. Then, I will discuss the role of central banks in this new era. Finally, I will conclude my remarks with the experience of the Turkish economy and the response of the monetary policy.

Distinguished Guests,

More than two years after the collapse of Lehman Brothers, the dust over international financial system seems somewhat abated. Unprecedented measures taken by central banks and fiscal authorities have put financial markets back on a relatively steady course by late 2009. As economic activity has started to gain pace, risk perceptions gradually improved, notwithstanding heightened sovereign risk in the Euro area, concerns over housing and labor markets in the United States, uncertainty regarding the health of financial institutions in advanced economies, huge influx of capital flows and associated risks in emerging market economies, and last but not least, questions surrounding the pace of demand rotation in the global economy. A long list of lessons on financial stability has emerged, though how to put them in practice is subject to an intense debate. The cooperation at a global scale is the key to solve current problems and addressing the future ones, but to maintain the spirit of cooperation among nations is getting more challenging as the memory of the crisis starts to fade away.

Outlook for emerging market economies

As we all know, capital flows to emerging market economies have intensified recently thanks to better growth prospects, interest rate differentials, and relative stability of financial institutions in these countries that proved their strength and flexibility to extreme shocks. As liquidity in the global financial system increases thanks to rapid expansion of high powered money in major currency countries, central banks of small open economies face the risk of losing control over monetary conditions. Policy rate hikes to contain inflationary pressures and restrain credit expansion are likely to lead further widening in interest rate differentials, thereby fueling even more capital inflows, more borrowing, higher asset prices and inflation. As a result, emerging market economies today face a growing risk of asset bubbles, excessive borrowing and inflationary pressures – all of which are threatening the financial stability. The problems facing countries with current account deficits are much challenging than the surplus ones, since they have to deal with both financial stability problems arising from the strength of capital flows and the risk of sudden stops.

Assessing whether capital flows to emerging market economies are permanent or transitory is a challenging task. The current wave of capital inflows reflects both global push factors (including ample liquidity and low interest rates across advanced economies) as well as country-specific pull factors (including buoyant growth prospects, relatively sound fiscal positions, and decreasing country risk perceptions). Over the medium term the pull factors are likely to remain complacent, as relative to advanced economies, emerging markets are expected to grow faster, which would put upward pressure on interest and exchange rates, perpetuating their attractiveness for international capital. Although it is far from certain whether quantitative easing in several advanced economies would persist in the medium term, monetary authorities in these countries are likely to maintain their accommodative stance in the near future as well. All in all, the current outlook suggests that capital flows to emerging market economies may be a permanent phenomenon, while its magnitude is subject to change in risk perceptions.

While tools to manage large capital inflows are well known, the appropriate policy mix depends on country-specific circumstances. Fiscal policy, monetary policy, exchange rate policy, foreign exchange market intervention, macro-prudential tools, and capital controls could be used to cope with the inflows, but each of them entails some tradeoffs, which are likely to be quite costly for emerging deficit countries in particular. Some countries have opted for various forms of capital control, although their effectiveness needs to be evaluated based on the objective of imposing them at the first place. Some studies find that capital controls have some compositional effect and could alter the maturity of new investments. So far as reducing the volume of flows, the empirical evidence is inconclusive. Unless the authorities have full control over capital accounts, partial restrictions are unlikely to offset the impact of flows, prevent appreciation of local currency and provide more space for independent monetary policy.

In principle, flow of capital from advance economies to emerging ones and appreciation of the currencies of the latter over time is a mutually beneficial secular trend, as long as it is supported by strong fundamentals, better growth prospects, and high productivity differentials. Rather than fighting against this trend through over restrictive capital controls or excessive reserve accumulation, there is strong legitimacy in using macro-prudential policies to mitigate the adverse effects of volatility in capital flows, especially those with speculative nature, over financial stability. Several emerging economies have started implementing such measures to limit the credit growth and asset price bubbles. These measures include raising reserve requirement ratios, requiring higher income- and deposit-to-loan ratios, tightening capital adequacy requirements and liquidity ratios, introducing transaction taxes, fees etc. The adequacy of such measures has yet to be seen, but the swift and proactive response of policy makers is a positive step forward, as the most recent events have clearly demonstrated that it is likely to cost less to undertake preventive measures prior to a crisis than to clean up in its aftermath.

Of course, economic conditions and institutions differ across countries. An effective macro prudential tool in one country might not work in another country. Therefore, policy makers need to take country specific factors into account in designing their own framework. It is also imperative for the academic community and international organizations to focus on this issue and develop a set of concrete policy tools that national authorities, at their own discretion, can use to identify, assess and manage systemic risks.

Financial stability and central banks

The critical importance of financial stability from a central bank's perspective is not new. Smooth functioning of the financial system and payment mechanism has been a concern of central banks since their foundation. In fact, that is the reason they are called as "the bank of banks" or "the lender of last resort" for financial institutions. However, over time as the financial system gets more complicated and expanded exponentially, its supervision and regulation has been partially transferred to other institutions. The challenge faced by central banks is to establish a framework that combines both price and financial stability as primary mandates and identify the policy instruments to target both, even at times they seem to conflict with each other.

Central banks have typically calibrated short-term interest rates as their primary policy instrument to determine their monetary stance. Since policy rates are too blunt instruments that affect the entire economy, using them to achieve both of these targets may lead to unintended consequences. The level of interest rate required to ensure price stability can differ from an interest rate needed to preserve financial stability. For example, during boom periods driven by productivity and financial innovation shocks, a low policy rate would suffice to contain inflation; yet the very same level of interest rate may still lead to accumulation of financial risks. Moreover, during boom periods, emerging markets typically attract large capital inflows even with reasonably low level of interest rates. In such periods, the external and internal equilibrium requires different interest rates and monetary policy has to use more than one instrument. The “Tinbergen Rule” suggests that one instrument could be employed to achieve only one target, which in our case is conventionally recognized as price stability. There is clearly a need for a second set of policy tools. This second instrument, in my opinion, may be in the form of macro prudential tools that directly address financial activities.

Should all authority and responsibility related to financial stability be centralized and vested in central banks? On the one hand, the benefit of vesting the decision making power and responsibility under one institution, which happens to be the central bank, is clear: no coordination problem, more effective communication under one voice, and swift response to emergencies.

There are also downsides to such approach. The distinction between “goal independence” and “instrument independence” lies at the foundation of what we call central bank independence today. If central banks assume all regulatory and supervisory activities regarding the financial system and becomes the only authority responsible for its oversight, the instruments needed to achieve that goal may reach to a point where the principles of democracy necessitates a much closer coordination and cooperation with the government, blurring the central bank’s independence. Expanding the role of central banks in the economy has the potential to create a strong and out of the ordinary entity in a democracy that emphasizes accountability and the responsibility of elected officials.

Central banks played a vital role in maintaining financial stability in the past and they are likely to do so in the future. The optimal use of policy rates and macro-prudential tools to achieve both the price and financial stability would define the criteria for assessing the success of central banks in the post crisis era. During the crisis, new monetary tools have been explored by the central banks. Now, in addition to continuing to explore such monetary policy tools, policy makers would have to elaborate on the uses of regulatory rules for limiting the risks threatening financial stability and designing the optimal institutional structure for that purpose that finds the perfect balance between the risk of losing central bank independence and the risk of creating coordination problems (between the central bank and the regulatory and supervisory agency).

Financial stability in Turkey and the monetary policy

In the second part of my speech, let me turn to financial stability in Turkey and the monetary policy we have started to implement in the aftermath of the global financial crisis.

Turkey used to be among emerging economies with high volatility and particularly sensitive to global risk perceptions throughout the 1990s and early 2000s. However, this time the headwinds from the global crisis has remained relatively subdued thanks to the resilience of the financial system and prudent macro policies. Of course, the growth rate of the economy has dropped sharply, but neither price nor financial stability has been seriously jeopardized. In fact, Turkey was one of the few emerging countries that ended up with higher credit rating than pre-crisis level.

A combination of several factors made the difference, but lack of excessive borrowing turned out to be the key. Unlike its peers, the leverage ratios in Turkey stayed at moderate levels during the period of excess global liquidity, thanks to prudent policies of the Banking Regulatory and Supervision Agency and the Central Bank of Turkey. In fact most of those policies implemented in Turkey since 2002 are incorporated into the Basel III principles, such as countercyclical buffers (banks in Turkey are not permitted to expand unless their ratio is at least four percentage points above the legal minimum) and liquidity ratios (both in local and foreign currency). Debt level of the public sector was also reduced significantly thanks to a quite ambitious fiscal discipline. The real strength of the economy, however, came from the management of foreign exchange risks, which is the most critical aspect of a small, open economy. Thanks to prudent regulations and oversight, the overall FX position of the Turkish banking sector was balanced. Households carried a long position in FX, limiting their exposure to curreny shocks. Although the corporate sector carried a significant FX position, their debt was mainly in long term.

All these factors contributed to the resilience of the Turkish economy to the global crisis, which in turn provided ample space to the Central Bank of Turkey to implement front-loaded and aggressive monetary easing without compromising price stability objective. No rescue package was needed to support the banking system. Thus, the government was able to enact modest but still quite effective counter-cyclical fiscal policies in the midst of global turmoil.

Since early 2010, due to anemic growth in external demand, current account balance has been deteriorating rapidly, whereas core inflation remains subdued and output gap persists. Recent surge in capital flows toward emerging markets, including Turkey, has the potential to exacerbate the divergence between the pace of recovery in the domestic and external demand. If this pattern of growth coexists with rapid credit expansion and deterioration in the current account balance, it may lead to financial stability concerns. These developments make it essential to effectively utilize policy instruments other than policy rates. Consequently, in today's challenging financial environment, which is likely to persist in the foreseeable future, the Central Bank of Turkey underscored four basic principles upon which the monetary policies would be built to maintain financial stability.

The first one is to discourage excessive leverage and keeping the debt ratios of banks and the corporate sector at modest levels. The second principle is extending the duration of borrowing for private and public sector, as well as household deposits. The third principle is strengthening the FX position of both the public and private sector, which is usually the Achilles' heel for emerging economies with sizable current account deficit. The fourth principle is better management of foreign currency risk by the corporate sector through instruments like the Turkish Derivative Exchange.

In November 2010, we have started quantitative tightening to deal with rapidly increasing macro imbalances driven by short term capital inflows and acceleration in credit growth. To that end we have raised required reserve ratios to control the rapid credit expansion by restricting the supply of loanable funds. Another issue we considered is lengthening the maturity of capital inflows. This is important for improving the quality of capital account, limiting maturity mismatches, and avoiding exchange rate misalignments. To this end, we lowered the policy rate and widened the corridor between overnight borrowing and lending rates so as to create some extra volatility in the short-term interest rates.

Although it looks quite complicated at first sight, the framework we adopt in spirit is not significantly different from the conventional inflation targeting framework. The only difference is that, previously our policy instrument was the one week repo rate, but now our instrument is a "policy mix"—which consists of a combination of short term interest rates, reserve requirement ratios and interest corridor. We seek to use these instruments in right combination in order to cope with both inflation and macro-financial risks. The monetary policy stance in this framework is not only determined by the path of policy rates, but as a mixture of all policy instruments outlined above. Just like the conventional inflation targeting framework, the policy is forward looking and contingent on the economic outlook. The exact setting of the policy mix depends on the factors affecting price stability and financial stability. Although it is too early to assess the success of these policies, initial impact so far seems promising.

Conclusion

The recent crisis put front and center the rising economic power of emerging countries. It has also demonstrated the vulnerabilities within the global system, especially across financial markets. Financial stability becomes a major concern for policy makers, which has the potential to reshape the monetary policy framework of central banks. Significant steps have been undertaken, but significant progress is still needed to tackle global imbalances. That involves not only revisiting economic policies, but also economic and institutional infrastructure that shapes them. As the quest for a new global order continues both in theoretical and practical levels; the predictability, balance and sustainability of the new global order will depend on the cooperative and coordinated efforts to establish a well-represented infrastructure.

Thank you for your attention.