Durmuş Yilmaz: Central banking in emerging economies – the Turkish experience

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the "International Conference on Economics", Ankara, 12 September 2006.

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Dear professors, colleagues, and guests,

I am very pleased to participate in such a conference covering a broad range of economic issues and attended by many distinguished academicians from different countries. It is also a great pleasure to deliver a speech on the topic of central banking in emerging economies and the Turkish experience.

Dear guests,

Given the wide range of issues related to central banking in emerging economies and the limited time available, I have decided to limit the extent of my remarks today. I'd like to talk about the challenges we face as today's central bankers in emerging market countries, mainly in the context of the Turkish experience. However, before embarking on this subject, let me first of all step back and take a look at the evolution of central banking, especially in the recent past.

There is no doubt about that throughout the 20th century, central banking has undergone a tremendous transformation both in numerical terms and institutional aspects.

At the beginning of the last century, for example, there were just 15 central banks in the world. In fact, what is more important than the figures is that central banks were first established mainly as the lender of last resort and banknote issuer, rather than as an institutional body of monetary policy.

Today, there are 160 central banks operating around the world. Some of them are also responsible for supervision and regulation of financial system and have been publishing financial stability reports, and some of them are targeting a certain measure of general price level and have been issuing inflation reports.

Thus, in a broader perspective, the evolution of central banking has followed a course from maintaining liquidity when it is necessary and issuing banknotes, towards keeping inflation low and stable, and preserving stability in financial markets.

In some sense, this evolution process can be characterized as the converging of the objective functions of central banks all around the world.

To be more precise, it is generally accepted that in the case of both industrialized nations and emerging economies, the main contribution that a central bank can make to economic welfare in the long run is achieving and maintaining price stability. Moreover, maintaining price stability is not merely an issue of maximization of economic welfare. It gives people the confidence that money will retain its value over time, ensures that price signals function as a guide for markets to function efficiently and establishes trust in the interaction among economic agents, in property rights, in society and in the future in general[1]. Under this framework, central banks today operate mainly with the overriding objective of price stability either explicitly or implicitly.

Dear guests,

The establishment of the single mandate as price stability has also had significant implications in the institutional design of central banks.

In fact, as is clearly seen especially in emerging market countries, price stability can only be achieved through long term and determined policy implementations. It is at this point that independence, as an assurance given to the public to ensure long-term price stability, comes to the forefront as the crucial feature of institutional design of central banks.

In my view, of all the changes in the face of central banking in the last two decades, the most important one is the increasing emphasis that has been placed on central bank independence.

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[1] Issing, O. (2000). "Should We Have Faith in Central Banks?".

While inflation was falling and independence was becoming an important feature of central banking around the world, Turkey was unable to experience the same process. It was not until 2001 that the Central Bank of Turkey gained independence close to global standards.

In 2001, with the amendments made in its Law, achieving and maintaining price stability was stated as the primary objective, and the Central Bank of Turkey was provided with the direct authority to set monetary policy and choose instruments at its own discretion to achieve price stability. I believe this is one of the major structural reforms in the Turkish economy, especially in terms of its effects on inflation. Of course, independence is not a concept that can be achieved via the implementation of law alone. It is a concept that policy practices have a great influence upon.

Dear participants,

Having mentioned the two milestones in the notion of central banking, I'd now like to continue with the challenges of central banking in emerging economies combined with the Turkish experience in terms of monetary policy implementations.

Although objective functions are similar in financially liberalized and well-functioning market economies, the transmission of monetary policy actions on economies certainly differs between industrialized countries and emerging market economies.

Accordingly, there is a wide range of views among economists on how monetary policy decisions influence economies. If we add the uncertainties faced by the internal dynamics of emerging market economies to the picture, the impact of decisions taken by central banks might differ from one country to another both in terms of the nature and the time and even from one period of time to another for the same country.

First, it is important to note that in the design and implementation of monetary policy, the understanding of structural changes is essential since the impacts of monetary policy decisions in a given economy depend on its structural changes and macroeconomic environment[2]. On the other hand, it is clear that emerging economies like Turkey are subject to structural changes more frequently than any other developed economy. Combining these two facts, central bankers in emerging economies face the challenge of modeling the economy properly and react accordingly.

In addition, I believe it is not an exaggeration to say that subsequent crises and reform processes have largely defined the economic landscape of emerging market economies in the last twenty years. Thus, uncertainty, which naturally exists in every economy, constitutes a real challenge for central bankers in many emerging economies because of their volatile and unpredictable structure.

Dear guests,

What we have been experiencing in the Turkish economy in the last five years can be classified as one of the clear examples of the impact of structural changes on an economy.

First of all, after a thirty-year period of high and chronic inflation, inflation declined from 68.5 percent in 2001 to 10.26 percent in August 2006. This decline in inflation also made it possible to perform the currency reform at the beginning of 2005 and we dropped six zeros from our currency.

Second, we experienced high growth rates while inflation was falling. I can say that the Turkish economy has left behind the boom-bust cycle of growth and has been growing for the last eighteen quarters consecutively. Additionally, the sources of growth have changed, as well.

Third, the declining trend of the ratio of public debt to national income has contributed both to the fight against inflation and the relative stability in financial markets.

All these developments through the decisive implementation of policies have reflected themselves in reducing uncertainty and increasing predictability, strengthening macroeconomic fundamentals, increasing resilience to shocks and changing the dynamics of the economy bringing the private sector to the forefront; rising productivity, changing behaviors and increasing competition. All in all, it is clear that the Turkish economy has been undergoing a structural transformation since 2001.

After going through a deep structural transformation, it is safe to say that the Turkish economy has gradually been normalized. According to our studies, the impact of decisions of short-term interest

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2 BIS. (1998). "The Transmission of Monetary Policy in Emerging Market Economies". BIS Policy Papers No. 3.

rates on inflation and on the economy is observed up to 18 and 9 months respectively in Turkey. We also calculated that the lag has been lengthening as we progress with the structural transformation**.**

Dear participants,

The second challenge of central banks in some emerging economies is dollarization. In fact, the issue of dollarization has become a common characteristic of many emerging markets like Turkey since the beginning of the 1990s.

Both our experience and that of Latin American economies clearly indicate that dollarization increases the fragilities of almost every sector of the economy, namely the real sector, public sector and financial sector.

From the perspective of the real sector, dollarization appears in several respects. First, it affects pricing behaviors. In other words, a high level of dollarization is likely to cause a higher pass-through effect of exchange rates on inflation. Besides, in countries where derivatives markets are not well developed, the balance sheet effect of exchange rate fluctuations on the private sector also has important implications considering the level of exposure to exchange rate risk.

From the perspective of the public sector, a currency mismatch problem arises, given that the greater part of government revenues are denominated in national currency, while the part of liabilities are denominated in foreign currencies.

Regarding the financial sector, we observe similar effects. With negative impacts on the balance sheets of financial intermediaries, dollarization raises the possibility of default risk and liquidity risk in the sector, and then distorts effective credit allocation of available resources.

All these fragilities caused by dollarization heavily affect the way central banks implement their policies by weakening the impact of monetary policy decisions. Besides, dollarization in emerging economies threatens central banking by causing instability and uncertainty in money demand, which in turn makes it hard to predict money supply and control inflation.

Dear guests,

When we look at the Turkish case, we see that dollarization has its roots in macroeconomic instability, inefficient market regulations and lack of credibility of economic policies in one hand; predictable exchange rates in the other hand.

The high and chronic inflation period led economic agents to invest simply in foreign currency, which is the easiest and least costly method of risk aversion. In addition, market regulations such as blanket guarantee on foreign exchange deposits and lack of supervision supported the process of dollarization, as well.

As of 2001, Turkey was one of the most dollarized emerging market economies with a share of 58.2 percent of foreign exchange deposits in total deposits. The same ratio was 49.3 percent in Romania, 46.8 percent in Russia and 47 percent in Peru, which were generally accepted as highly dollarized economies.

Today, looking ahead from the year 2001 we have been experiencing a reverse dollarization for the last four years. As of August 2006, the ratio of foreign exchange deposits to total deposits decreased to 36.7 percent. Similarly, the ratio of investment instruments denominated in domestic currency has pursued an increasing trend, while that of foreign currency has been decreasing accordingly.

I can say that as long as the floating exchange rate regime is implemented properly and inflation is kept under control through credible macroeconomic policies, the floating exchange rate regime along with the inflation-targeting regime has a crucial role in decreasing the level of dollarization.

However, I would like to add that the level of dollarization is not declining fast, and it is still high. Although diminishing to some extent, we are still observing some lingering behaviors inherited from the past inflation period. That is why it is so important to continue with current policies and structural reforms.

Dear participants,

The third factor that stands as a challenge for central banking is sustainability of fiscal discipline in emerging economies.

It is a challenge because of its impacts not only on inflation through aggregate demand, but also on financial stability since concerns about the sustainability of fiscal policy are likely to influence economic variables such as interest rates, exchange rates, and other measures of risk premium.

In this context, what differs in many emerging markets is the role of fiscal dominance, a situation in which fiscal policy ultimately governs price determination in financial markets[3], crowds out available sources, disrupts effective credit allocation in the economy, and impairs the effect of monetary policy on aggregate demand. The high level of fiscal dominance in many emerging market countries is associated with the high level of public sector borrowing requirements.

Additionally, vulnerability in public sectors' balance sheet and debt structure may constitute a barrier to central banks' policy decisions such as those on short-term interest rate hikes.

Such fiscal distortions are rare in industrialized economies and hence, these economies are less susceptible to adverse shocks coming from the fiscal side.

Dear guests,

In addition to the issues that I have mentioned, there are in my opinion two further issues related to fiscal policy and public debt management that cause challenges in many emerging market economies like Turkey.

The first one is the relatively shorter maturity of debt compared to that of developed countries and the other is the "original sin" problem, which is presented in the literature by Eichengreen and Haussmann.[4] In this context, emerging countries are forced to borrow in units of currencies that they are basically unable to issue.

All these concerns have direct impact on the fragility of financial markets. Therefore, any doubt over the sustainability of fiscal discipline causes volatility in financial variables and has a high possibility of endangering central bank goals.

In the case of Turkey, when we look back, we see that the period of high and variable inflation coincides with high public deficit being financed by the Central Bank. An increasing lack of fiscal discipline in public expenditures and further widening of budget deficits caused inflation to get out of control and the public sector borrowing requirement to grow continuously. This structure affected the banking system, as well. The Turkish banking sector was not able to perform its intermediary function effectively. Instead, the sector mostly financed public sector deficits.

Looking to the present, on the other hand, one of the most important changes is that the Central Bank of Turkey no longer extends credits to the Treasury or any other public institution by the amendment made in its Law in 2001. And it is no coincidence that inflation has been on a declining trend since then.

Moreover, tight fiscal policies have been put into practice for the last five years. A very high level of primary surplus, that is 6.5 percent, has been targeted. The positive effect of these measures has started to be observed in several areas.

The ratio of consolidated budget deficit to gross national product turned into surplus of 0.4 percent in the second quarter of 2006. And the ratio of public sector net debt stock to gross national product decreased from 90.5 percent in 2001 to 52.8 percent in the first quarter of 2006. In fact, public sector net debt stock is on a downward path converging towards the Maastricht criterion. And maturities are becoming longer. More importantly, the issue of public debt sustainability is no longer at the top of the agenda, implying decreasing pressure in financial markets.

I want to stress here again that the continuation of tight fiscal policies and high primary surplus is quite important in terms of both the price stability objective and the financial stability issue.

Dear participants,

The last concept in central banking that I want to mention today is the role of expectations management in emerging market economies.

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[3] Moreno, R. (2002). "Fiscal Issues and Central Banking in Emerging Economies: An Overview". Meeting held at the BIS in December 2002.

[4] Eichengreen, B., Haussmann, R. (1999). "Exchange Rates and Financial Fragility". NBER Working Paper 7418.

As economic literature tells us, and you very well know, the management of expectations is of great importance for every central banker. Quoting Michael Woodford[5], *"For successful monetary policy is not so much a matter of effective control of overnight interest rates as it is of shaping market expectations of the way in which interest rates, inflation, and income are likely to evolve over the coming year and later"*.

I believe it is the expectations that form a bridge between short-term interest rates and long-term interest rates. The more the expectations converge to the targets, the greater the likelihood of the success of the policies. Also, the less volatile the expectations are, the more stable and predictable the effect of monetary policy on the economy is.

However, when it comes to emerging market economies, the functioning of expectations differs from developed countries. To be more precise, expectations affect the economy more heavily than other channels in many emerging market countries with a high inflationary past[6].

We at the Central Bank of Turkey are also familiar with this experience. The impact of short-term interest rate decisions is observed within a much shorter period of time through the expectations channel, which has made this channel the most effective one in Turkey so far.

In this context, what I find particularly critical to my experience is that the high inflationary history of emerging market countries stands as a real challenge to expectations management in several respects.

One of the reasons is the lack of credibility resulted from the high and chronic inflation period in emerging economies. Since these periods can be characterized by the monetization of public debts by sources of central banks or central banks having objectives other than and sometimes even contradicting price stability, economic agents tend to have doubts about the credibility of central bank policies. Not to mention that this constitutes a limit to the effectiveness of monetary policies.

The other one is known as "inflationary psychology" or "inflation scare". To be more precise, because of high and volatile inflationary periods, economic agents in emerging economies are more inclined to exaggerate adverse effects than in any other economy that has price stability. Thus, a seasonal rise in inflation may immediately lead to deterioration in inflation expectations and higher prices with little transitional impact on the level of economic activity.

At this point, given the importance of expectations management, a key aspect of the policy framework is transparency and communication. Here, it is impossible not to agree with Paul Volcker, who said; *"I have one lesson indelible in my brain: don't let inflation get ingrained. Once that happens, there's too much agony in stopping the momentum."*[7]

Referring to the Turkish case, I can say that the thirty-year experience of high and chronic inflation has made us face the challenge of convincing both the public and the financial markets that we are committed to bringing inflation down and maintaining price stability. In every platform we participated and in every announcement we made, we emphasized our policy objective, which is to achieve and maintain price stability, the reasons underlying our policy implementations and the importance of having a medium-term vision in terms of lagged effect of policy decisions.

To this end, we try to use communication policy effectively as an important part of the inflation-targeting regime. We base our communication policy on the grounds of trust, transparency, consistency and decisiveness.

I believe this is not peculiar to the Turkish case. Many central bankers in emerging market countries have to deal with the drawbacks of a past of high and chronic inflation and thus incredible policies. And it is by all means clear that designing a communication strategy is not easy under these circumstances.

As you may all agree, the concept of communication itself is a dynamic issue. Therefore, given the importance of effective communication, it is important to note that we at the Central Bank of Turkey have been working continuously on improving our communication policy.

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[5] Woodford, M. (2003). Interest and Prices. Princeton Univesity Press.

[6] BIS. (1998). "The Transmission of Monetary Policy in Emerging Market Economies". BIS Policy Papers No. 3.

[7] Orphanides, A. (2006). "The Road to Price Stability".

Dear guests,

There is no doubt that central banking can be considered as a combination of positive sciences and human psychology, or as you could say, the union of science and art. I can safely say that for a central banker of an emerging market country, managing monetary policy has more qualifications as an art, rather than a science.

As Mervin King, the Governor of the Bank of England, once said, *"I have raised more questions than I have answered, perhaps that is what happens when you become a central banker"*[8]. I hope that you will find some of the answers in the panel.

Thank you.

8 King, M. (2004). "The Institutions of Monetary Policy". Lecture at the American Economic Association Annual Meeting, San Diego, 4 January 2004.