Durmuş Yılmaz: Global challenges and local response – monetary policy in Turkey

Address by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at a congress organised by the Turkish Economic Association and the International Economic Association, Istanbul, 25 June 2008.

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Dear Guests,

First of all, I would like to welcome you all to Turkey. I am delighted to be here to address such a distinguished audience in Istanbul. I would like to thank the Turkish Economic Association and the International Economic Association for organizing this Congress.

Let me start my talk with the words of Josiah Charles Stamp, one of the former governors of the Bank of England in 1920s:

> *"It is easy to dodge our responsibilities, but we cannot dodge the consequences of dodging our responsibilities."*

This quote will also be the theme of my speech today.

Distinguished Guests,

Although globalization had started in the second half of 1980's, it has not yet reached its peak and we are still witnessing its evolution. As Thomas Friedman's once said, globalization is making the world flatter. We witnessed record high growth rates around the world in that period; although there was also notable variation in the growth performances across countries. It will not be wrong to argue that globalization could be a powerful tool that may contribute to sustained development if it is combined with compatible policies.

However, we should also keep in mind that globalization also presents some challenges and thus, it has made the job of policy-makers more difficult.

Firstly, I would like to underline the concept of financial globalization. Thanks to financial liberalization and improvements in information and communication technologies, significant amount of capital has been flowing into developing countries, especially to those that offer high growth potential – helping these countries achieve relatively high growth levels. In the post-war period when globalization was not a popular buzzword, high growth rates were also observed in a number of countries, usually in the South Asia. However, these countries had something in common, which was high rates of savings. In countries like Turkey, where more than half of the population is 30 years old or younger and where savings rates are comparatively low; foreign savings, and therefore capital inflows are needed to maintain high levels of growth. In this respect, financial globalization has contributed to the convergence process among countries.

Financial liberalization has also led to amplification of new and more complex financial products. As a side effect, these financial products have introduced new risks and fragilities to the financial markets. As financial markets have gradually become more integrated, the concept of financial stability has started to receive more attention and become one of the priorities of central banks. Therefore, it is not surprising that the systemic problems that emerged in the US sub-prime housing loans in the second half of 2007 and gradually spilled over to other credit markets have given enormous anxiety to policy makers. In this context, central banks have engaged in closer cooperation and information sharing with each other to address these challenges.

The recent crisis in financial markets is likely to have significant repercussions over the real economy and the most obvious victim is the economic growth. A marked slowdown in

developed countries is expected. Part of the current debate is whether developing countries could escape from a sharp slowdown in the industrialized world. Some argue that they can, thanks to progress in macroeconomic stability and structural reforms in recent years. We still do not know whether they are right.

Another aspect of globalization is the huge volume of international trade, which has led to considerable convergence in business cycles across countries. Integration of previously-closed economies, like China, India and Eastern European, to international markets has led to an economic boom in the world economy, which was mostly anti-inflationary – until most recently. Needless to say, record increases in commodity prices in the last two years have created doubts in our minds about the sustainability of this anti-inflationist growth process in the near future.

Dear Guests,

We are currently facing significant inflationary pressures on a global scale due to record high increases in commodity prices. The surge in inflation rates has become a major challenge that threatens price stability in many countries. I would like to give you a few examples.

Between 2006 and 2008, eighteen developing countries have implemented inflation-targeting regime. In 2006, the end-year inflation was within the target band in twelve of these countries. In 2007, this number dropped to five. By May 2008 only one of these 18 countries (Brazil) has succeeded to keep inflation within the target band. In the remaining 17 countries, including Turkey, inflation is outside the target band. Developed countries are also experiencing a similar problem. By May 2008, only in one of the eight developed countries the inflation rate is still within the band – and that country is Canada, by the way. Average inflation throughout the world has increased one-fold to seven percent over the last 12 months. Inflation in developed countries has reached its highest level of the last eighteen years. For the first time in many years, inflation figures of the developing countries are in two digit levels.

In this period central banks have adopted different approaches for fighting inflation. One reason of this divergence is the difference between the objectives of central banks. For example, the Federal Reserve Bank of the United States, with ultimate goals of price stability, financial stability and full employment, lowered interest rates by 325 basis points between September 2007 and June 2008 due to severe problems in the financial system. The European Central Bank, on the other hand, has followed a more hawkish attitude and focused on attaining its primary objective, which is price stability.

The disparity between the consumption patterns is another factor causing divergence in monetary policies. In comparison to the industrialized world, food expenditures in developing countries constitute a larger share in the basket of consumer prices. That is why increases in food prices typically lead to higher increases in the inflation rates of developing countries. This is one of the reasons why central banks of developing countries focus more on price stability and display a tighter monetary policy stance in recent months. To put it in figures, since mid-2007, policy rates in sixteen major developing countries have increased by 110 basis points on average – in contrast to developed countries where policy rates have been cut by 98 basis points on average.

The exchange rate regime also affects the conduct of monetary policy. As you may all know, many developing countries peg their currencies against the US dollar or the Euro. As the US dollar has lost value against many currencies in recent years, this has led to sharp increases in the inflation rates of those economies whose currencies are pegged to the US dollar. In the period of January 2006 to May 2008, inflation rates of countries whose currencies are pegged to the US dollar have increased three-fold to 15.1 percent from 3.9 percent. Inflation rates of countries whose currencies are pegged to the Euro rose to 10.2 percent from 4.4 percent. In this period, countries that avoid the nominal appreciation of their currencies have only exacerbated the inflationary effects of supply shocks. The necessary adjustments in real exchange rates have taken place through the rise general price level.

Until recently, the common view among central banks of developed countries was to give priority to problems in financial markets in absence of inflationary pressures. However, they have slowly acknowledged the fact that the increase in inflation has reached critical levels. Accordingly, with uncertainties in financial markets diminishing, the FED and the ECB have hinted that they may resort to monetary tightening in the near future in the face of rising inflation.

What should be the best reaction of monetary policy under these circumstances? Although the factors causing higher inflation are presumed to be exogenous and beyond the control of central banks, there is a lot of controversy on this issue.

But before going into detail, let me question the validity of this debate first, because to what extent the increase in commodity prices is supply-driven is questionable in the first place. Certainly, there are structural reasons behind the recent run-up in food and energy prices. However, it is also undeniable that there are significant demand-driven pressures over commodities. Loose monetary policies adopted in early 2000s certainly played a key role, together with excess liquidity in the financial system. Another culprit is high subsidies provided by many governments in the developing world to at least partially protect consumers from the cost of high food and energy prices. Fast-forwarding to the recent period, the observation that the central banks of developed countries still keep real interest rates negative in the face of financial risks may hamper a correction in commodity prices.

On the other hand, many developing countries, mainly China, India, Malaysia, Indonesia, and Egypt have decided to gradually reduce subsidizing energy prices and pass the true cost to consumers. This is a favorable development that will eventually help to control demand pressures on commodities.

Dear Guests,

As you may all know, the commonly accepted practice in inflation targeting regime is that monetary policy should not react to supply-driven shocks that are temporary in nature and should allow temporary increases in inflation in the short-term, unless they create deterioration in inflation expectations. Otherwise, undesired fluctuations might arise in economic activity and relative prices. The increase in commodity prices would trigger a self-correcting mechanism. By changing the relative prices, it would provide valuable information on how the resources of the economy should be distributed. While high food and energy prices curb consumption on these products, they would also encourage investment and increase supply in the long-term. In short, the common view is that central banks have nothing to do but wait for the supply-driven shocks to work out their natural course.

However, in the current environment where persistent and rapid increases in food and energy prices have been observed for a considerable period, the prevalence of this view has become questionable – especially in the light of current projections that foresee even higher prices in the near future. As a matter of fact, many countries under inflation targeting regime now project that inflation will converge to the target at end-2009 or in 2010, at the earliest.

Going through a long period of high inflation is a serious risk for price stability. First, the general price level may shift upwards at a faster rate, as producers and workers in other sectors ask for higher prices and wages in response to the loss of their real purchasing power. The fall in real interest rates due to deterioration in inflation expectations is another risk, since lower real rates will lead to a faster pace of credit expansion. The common factor of these two risks is that persistent supply shocks may turn into demand shocks after a while.

Thus, at some point, central banks have to decide to what extent they can tolerate the rise in inflation.

As the famous philosopher Karl Popper put it while defining the demarcation problem, "*if we do not demarcate a scientific hypothesis, we will be leaving out one of the key steps in verifying the correctness of that hypothesis*"**.** Any theory should be formulated in a way to allow falsification; the circumstances under which the theory fails should be identified.

Advocators of a “wait-and-see” approach in the face of supply shocks are not clear on the question of when the supply shock ends and when demand-driven price increases take its place, in an environment where inflation keeps rising. If this issue is not clarified, any above-target inflation figure or any upward revision in inflation forecasts can easily be attributed to supply-side factors. Clear lines should be drawn as to which economic data would refute this discourse and what would constitute a limit to supply shocks from a central banker’s point of view.

Dear Guests,

In this part of my speech, I would like to discuss recent developments in the Turkish economy and the monetary policy implemented in this period. I believe that starting this evaluation with the developments in 2006 will be more useful in providing a better understanding of the current monetary policy stance.

As you may know, in May 2006 risk perceptions for developing countries changed significantly owing to the deterioration in global liquidity conditions. In the period where the supply-side shocks started to take their toll on inflation, the rapid depreciation of Turkish lira led to a significant deterioration in medium and long-term inflation expectations – giving rise to the risk of potential second-round impacts. The Central Bank of Turkey responded to these developments with a rapid and strong monetary tightening. This strong monetary tightening was a necessary policy stance for keeping inflation expectations in check and making inflation converge to the target in the medium term. Thus, policy rates were raised by a total of 425 basis points in June and July 2006. At the same time, the excessive liquidity in the overnight market was cut down via open market operations and foreign exchange sales.

These measures soon proved to be effective. The acceleration of inflation stopped in the third quarter of 2006, followed by a marked decline in inflation rate starting from the second quarter of 2007. Favorable developments in the services sector, which had recorded significant price rigidities in the past, were particularly noticeable. As you may know, bringing down services inflation takes longer compared to goods inflation, owing to structural factors such as lack of competitive pressures, high share of labor costs in the production function, and backward-looking pricing behavior. Against this background, it is a favorable development that services inflation declined to single digit levels for the first time in mid-2007, after hovering around 14 percent even in the 2004-2005 period where consumer price inflation came down to single-digit figures.

The year 2007 was a time when the effects of unfavorable developments in food and energy prices became visible. Nevertheless, uncertainties over the persistence of supply-side shocks in the future and the marked slowdown in core inflation indicators created a favorable environment for a gradual ease in monetary tightening. In this framework, the Central Bank initiated a measured rate-cut cycle in September 2007 and cut interest rates by a total of 225 basis points within a six-month period. By end-2007, consumer inflation had reached 8.4 percent, exceeding the 4-percent target. However, the fall of core inflation (which excludes items beyond the control of monetary policy such as food and energy) to 4.8 percent confirmed that the monetary tightening implemented in 2006 was the right policy choice. During this period, domestic demand and capacity conditions also continued to support the disinflation process.

In early 2008 the supply side shocks in food and energy prices started to exert significant inflationary pressures, as they reached unprecedented levels above and beyond expectations. For instance, October 2007 Inflation Report, based on forecasts of international agencies, had foreseen oil prices around USD 70 per barrel in 2008 and a gradual correction in food prices. In other words, it was assumed that supply side shocks would be temporary and that they would lose impact after a while. These forecasts were in line with pricing in forward and futures markets. However, these expectations did not materialize. Both crude oil prices and agricultural commodity prices continued to rise. The adverse impacts of supply shocks reached unprecedented levels during the first half of 2008.

Under normal circumstances, supply shocks are expected to have a temporary impact on relative prices, not changing the course of medium-term inflation. Nevertheless, the emergence of multiple shocks at the same time and their persistence for a considerable period aggravated the risks on pricing behavior. In fact, the research conducted by the Central Bank staff indicates that economic agents increasingly focus on past inflation while forming their inflation expectations.

After evaluating the said developments, the Central Bank concluded that the increases in food and energy prices in recent years reflect a structural change stemming from the global economic environment. In other words, these shocks are likely to prevail for a longer time period, contrary to previous forecasts. There is no clear evidence at this point that this trend will reverse in the short term. Moreover, our revised projections suggest that even with the maintenance of a cautious policy stance for the foreseeable future, reaching the 4 percent target is going to take an extended period of time.

Dear Guests,

Under these circumstances, the Central Bank of Turkey had two options. The first one was to stick to the inflation targets, as many central banks do today, but to avoid implementing a monetary policy that is consistent with these targets. In other words, the Central Bank would accept *a priori* that inflation would surpass the target in the foreseeable future. The absence of any policy response would be justified by the presence of supply side shocks. The central banks that adopt this approach are bound to lose their credibility gradually, as long as the inflation continues to remain above the targets.

The second option involves revising inflation targets to an attainable level and implementing a monetary policy that is in line with the new targets without compromise. That would help control economic uncertainties and create a new anchor to be used by economic agents in their decisions.

Dear Guests,

In light of these evaluations, the Central Bank of Turkey announced the framework of its monetary policy for the upcoming period in the April 2008 Inflation Report and in the letter on inflation targets that was sent to the Government on June 3, 2008.

The first pillar of the monetary policy framework is the target revision. The main purpose of the target revision is to create an achievable disinflation path that can be taken as reference by economic agents and that would take us to our price stability objective in the medium term, which is an inflation rate of 4 percent. As you may know, Turkey has not witnessed low single-digit inflation figures for nearly half a century. This has adversely affected the expectations for attaining the 4 percent inflation target. Furthermore, overshooting the inflation targets in 2006 and 2007, and recent supply shocks have elevated expectations even further. Hence, the new targets announced on June 3, 2008 aim to create a new anchor for economic agents, that is attainable.

At this point, I would like to emphasize that the nature of these new targets differ remarkably from those set for the 2006-2008 period. The Central Bank will treat the revised targets asymmetrically. In this framework, in the upcoming period, the Central Bank will prefer an inflation that stays below targets rather than otherwise. Accordingly, better than expected outcomes in food and energy prices or in other global factors will be perceived as an opportunity to bring down inflation faster than that is implied by the revised target path. Should the upside risks materialize; monetary policy will be conducted so as to minimize any upside deviation of inflation from the revised targets.

Target revision is the solution that is provided by our Bank to the aforementioned “problem of demarcation”, which is faced by almost all central banks today. However, the revision will work only if necessary policy stance is adopted. For this reason, the second pillar of monetary policy comprises the implementation of a monetary tightening that is consistent with the new inflation targets. Newly set targets are references that would help decision

makers in the economy understand the reasoning behind the policy stance, i.e. the factors that have led to monetary tightening and the extent of monetary tightening if and when necessary. In other words, the Central Bank has announced, via the target revision, the limits of its tolerance to the first round impacts of supply side shocks.

Dear Guests,

In this part of my speech, I would like to cover the Central Bank's reasons for implementing a measured course of monetary policy tightening, in further detail.

Obviously, interest rate decisions are not taken in order to curbe hikes in food and energy prices. It is not possible to control direct effects of supply side shocks with monetary policy tools. The Central Bank has been implementing a monetary tightening to offset the secondary effects of supply shocks. Since domestic demand is growing at a moderate pace at the moment, it has been curbing the pass through from cost-push factors. As a matter of fact, the prices of products that do not use food or energy as main inputs have been rather well behaved compared to the prices of products that have food or energy as inputs.

However, the fact that first round effects of the supply side shocks have reached unprecedented levels has been affecting inflation expectations adversely. Monetary policy cannot remain indifferent in case of a deterioration in the overall pricing behavior. If supply side shocks last long, their effects will spill over to the other sectors in the economy. A tighter stance is a must in order to control the expectations and to prevent the mutation of supply side shocks into demand shocks. If monetary policy does not react to the disruption in inflation dynamics, supply side price hikes may, after a certain point, easily evolve into a self-feeding vicious circle.

Dear Guests,

Why did the Central Bank not repeat the strong monetary tightening policy that it had implemented in 2006, but instead opted for a measured and gradual increase in interest rates in 2008?

The current conditions differ from the May 2006 fluctuation. Prominent reasons for the disruption in inflation dynamics in May 2006 were the significant depreciation of the Turkish lira due to the deterioration of risk perceptions in an environment where domestic demand was strong and the impact of the exchange rate pass-through on prices as well as increases in non-processed food prices were high. The Central Bank's response was a rapid and strong monetary tightening aimed to overcome the deterioration in inflation expectations in that period – so that economic units would continue to take the inflation target as a reference in their decisions.

Today, the primary cause of the lasting deterioration in inflation outlook is the presence of significant supply side shocks .As I have mentioned previously, the Central Bank's projections suggest that it will not be possible to bring inflation back to 4 percent in the short-term even with a sustained maintenance of the tight monetary policy stance. In this case, a strong reaction by monetary policy, as was the case in 2006, would not ensure the convergence of inflation to 4-percent target in the short-term, but would create undesired fluctuations in economic activity and relative prices.

It should be kept in mind, however, that the inflation expectations will deteriorate further in the absence of a reaction by the Central Bank. The current path of core inflation indicators demonstrates that the sharp increases in food and energy prices have started to adversely effect pricing behavior. The core inflation indicator that excludes food and energy prices rose to 6.3 percent as of May. Put differently, there is the risk that the deterioration in pricing behavior might spread to other sectors of the economy. This situation necessitates a measured, gradual and predictable phase of monetary tightening. The measured and gradual nature of monetary tightening is important in face of an already moderating economic growth while having a monetary tightening that is predictable is important to prevent undesired fluctuations in financial markets.

Dear Guests,

I would like to stress once more. Macro-economic stability is one of the key inputs of sustainable economic growth. Macro-economic stability cannot co-exist with high inflation. Countries that concede higher inflation for the pursuit of economic growth in the short-term are bound to be deprived of both in the medium-term. Policies to attain price stability will entail a cost in the short-term. We need to pay this cost to achieve price stability and ensure sustainable and high growth rates. If we hesitate today and step back from our ultimate target of price stability, we will still face similar problems in the near future, but possibly in worse circumstances.

In conclusion, disinflation in Turkey is an on-going process. The disinflation process was disrupted over the past two years due to the extraordinary effects of supply side shocks and inflation targets were overshot considerably. In this environment, the Central Bank of Turkey has made necessary assessments and reacted accordingly. Within the framework of the monetary policy adopted recently, the target has been revised. This is our response to the question of to what extent the Central Bank of Turkey may allow for supply side shocks. Monetary tightening consistent with the target constitutes the second pillar of this policy. If we foresee any deviation of inflation outlook from the target, the necessary policy action will be taken without any hesitation or delay.

As you remember, I started my speech with the words of Charles Stamp, former Governor of the Bank of England:

> *"It is easy to dodge our responsibilities, but we cannot dodge the consequences of dodging our responsibilities."*

The Central Bank of the Republic of Turkey will not dodge its responsibilities. In this environment of massive global challenges, we perceive the new inflation targets as attainable. All the existing monetary policy tools in hand will be utilized decisively and without any hesitation in order to attain these targets.

While concluding my speech, I would like to extend my thanks to the Turkish Economic Association and the International Economic Association, and all other institutions and individuals who contributed to the organization of this significant event.

Thank you.