



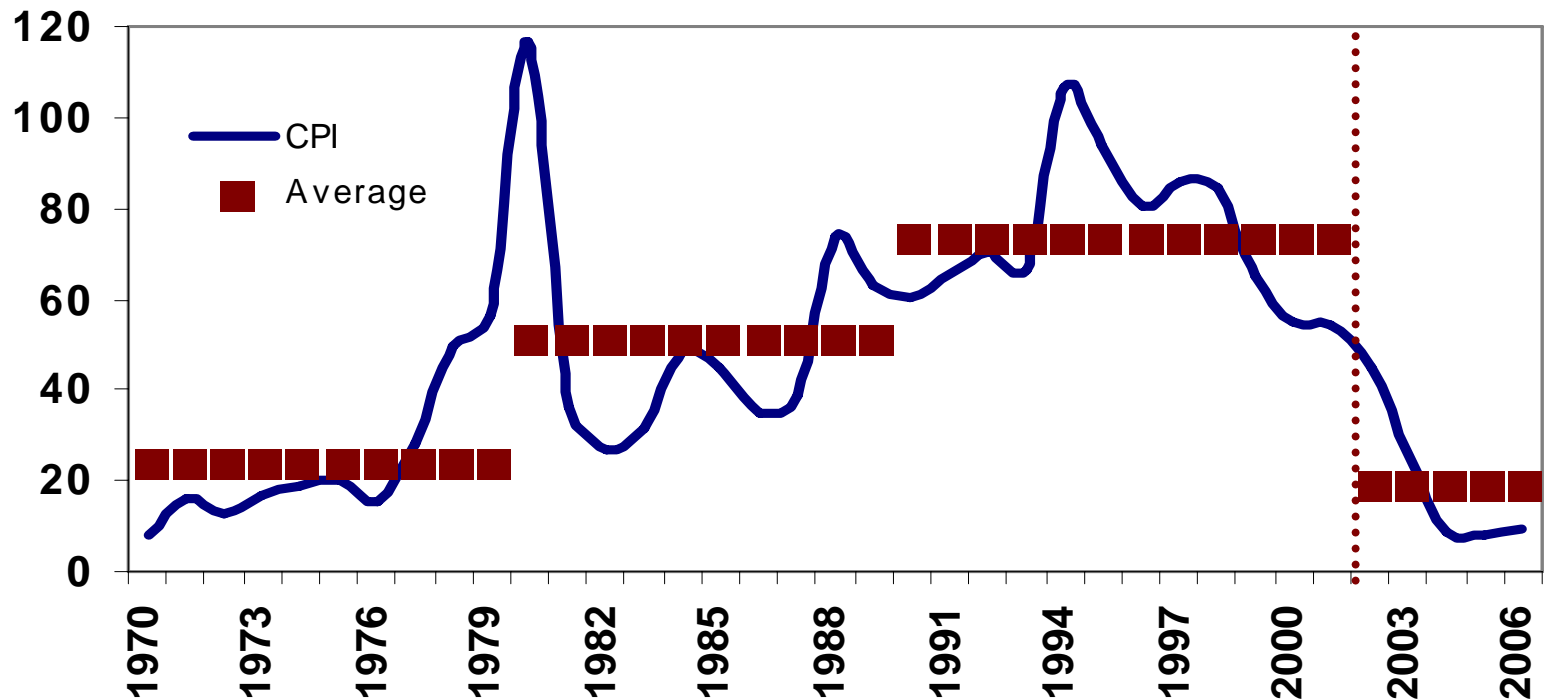
# From Exchange Rate Stabilization to Inflation Targeting: The Case of Turkey

Gulbin Sahinbeyoglu  
**Central Bank of Turkey**

February, 2007  
**Monetary Policy in Emerging Markets**  
organized by  
**OECD & Bank of England**

# Turkey: Inflation in retrospect...

CPI, y-o-y percentage change



# Outline of the presentation

- ◆ **4-year experience of implicit inflation targeting**
  - Preconditions for the successful implementation of IT
    - How did they evolve in Turkey between 2002-2005?
- ◆ **2006: First year in full-fledged IT**
  - Performance
  - Risks ahead

# In the aftermath of the 2001 crisis...

- ◆ **Floating exchange rate regime was introduced.**
- ◆ **Central Bank Law was amended.**
  - Primary objective of the Central Bank defined as achieving and maintaining price stability.
  - Credit extended to the public institutions was eliminated.
- ◆ **“Strengthening the Turkish Economy-Turkey’s Transition Program” was launched.**
  - Addressed two main issues: Chronic inflation and high public debt.

# Monetary policy choice providing a credible nominal anchor..

- ◆ Exchange rate.....  $\chi$
- ◆ Monetary aggregates.....  $\chi$
- ◆ Inflation.....  $\surd$  **But...**

# Fulfillment of preconditions of IT?

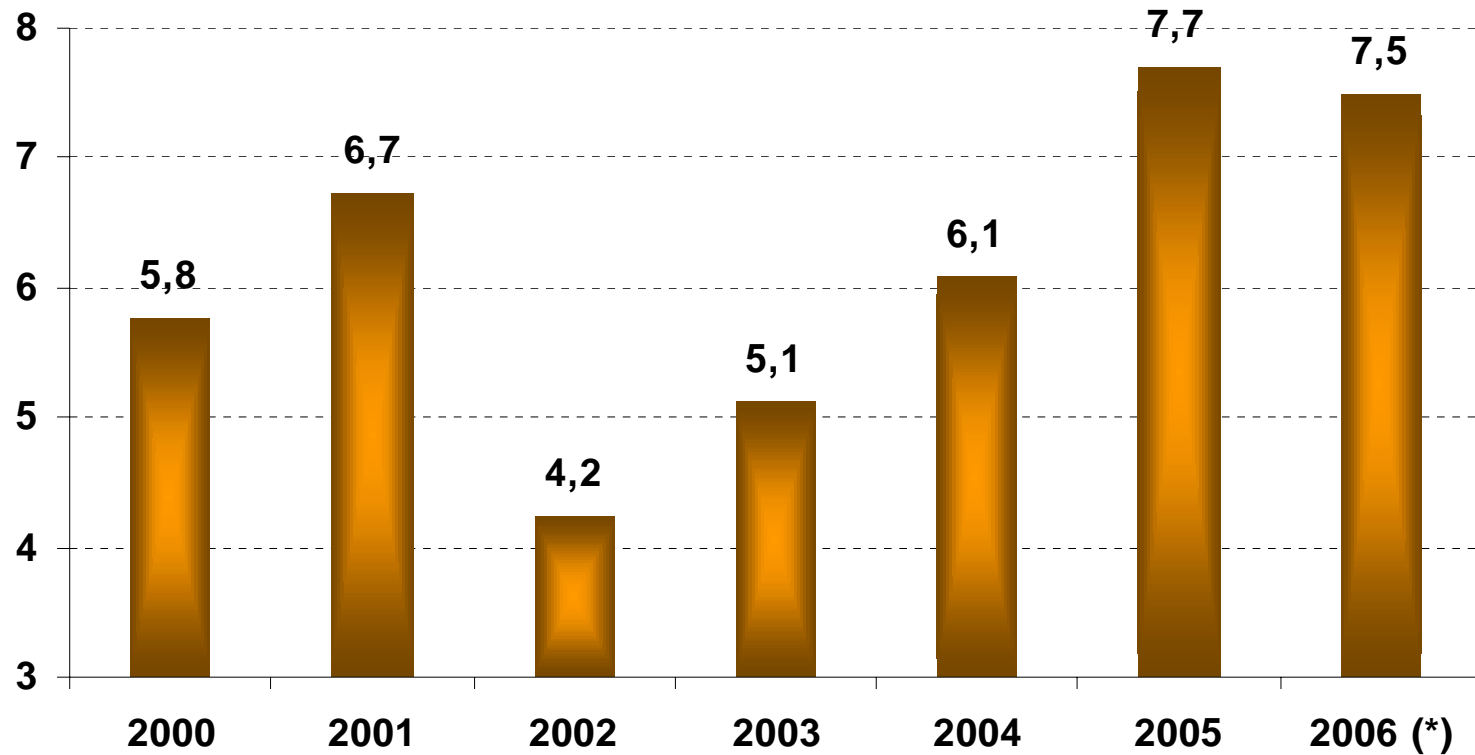
- ◆ Central bank independence..... ✓
- ◆ Floating exchange rate regime..... ✓
- ◆ Absence of fiscal dominance..... ✗
- ◆ Full independence from exchange rate considerations..... ✗
- ◆ Low levels of inflation and macroeconomic stability..... ✗
- ◆ Development of reliable inflation forecasting system..... ✗

# CBT announced *implicit* inflation targeting...

- ◆ Defined as “*inflation targeting*”, because:
  - Price stability as primary objective
  - A unique numeric target for annual inflation
  - Short-term interest rate as policy instrument
- ◆ It was also “*implicit*”, because:
  - Preconditions were not yet fulfilled
  - Base money used as temporary anchor

# Absence of fiscal dominance...

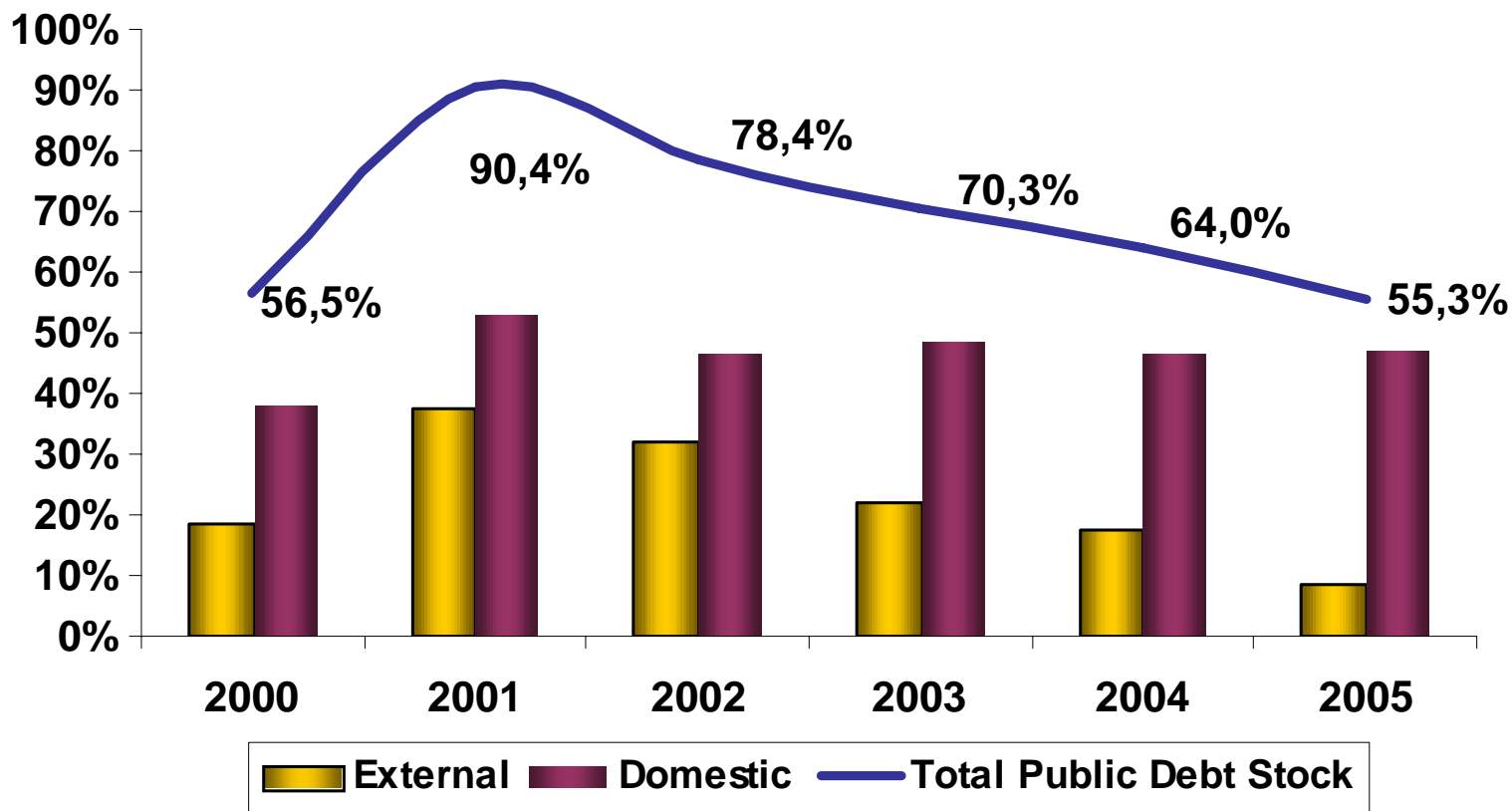
Public sector primary surplus / GNP



(\*) Provisional.

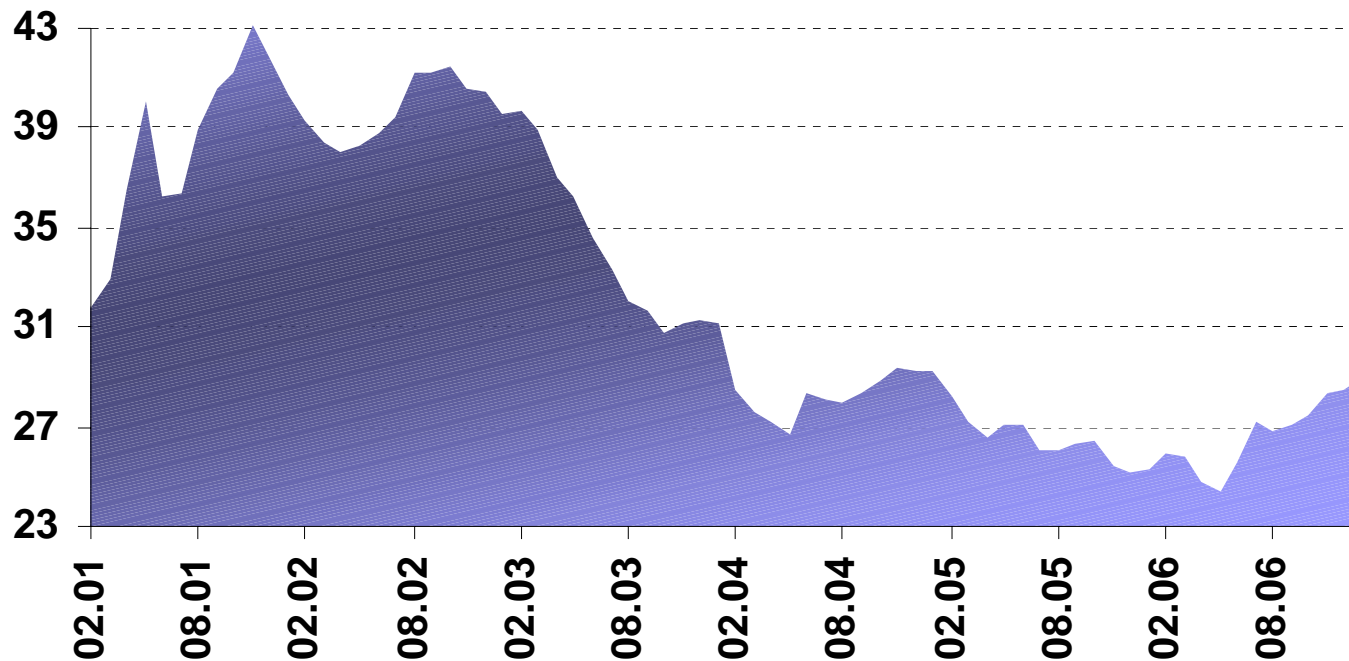
# Absence of fiscal dominance...

Net public debt stock / GNP



# Independence from exchange rate considerations...

Asset dollarization index



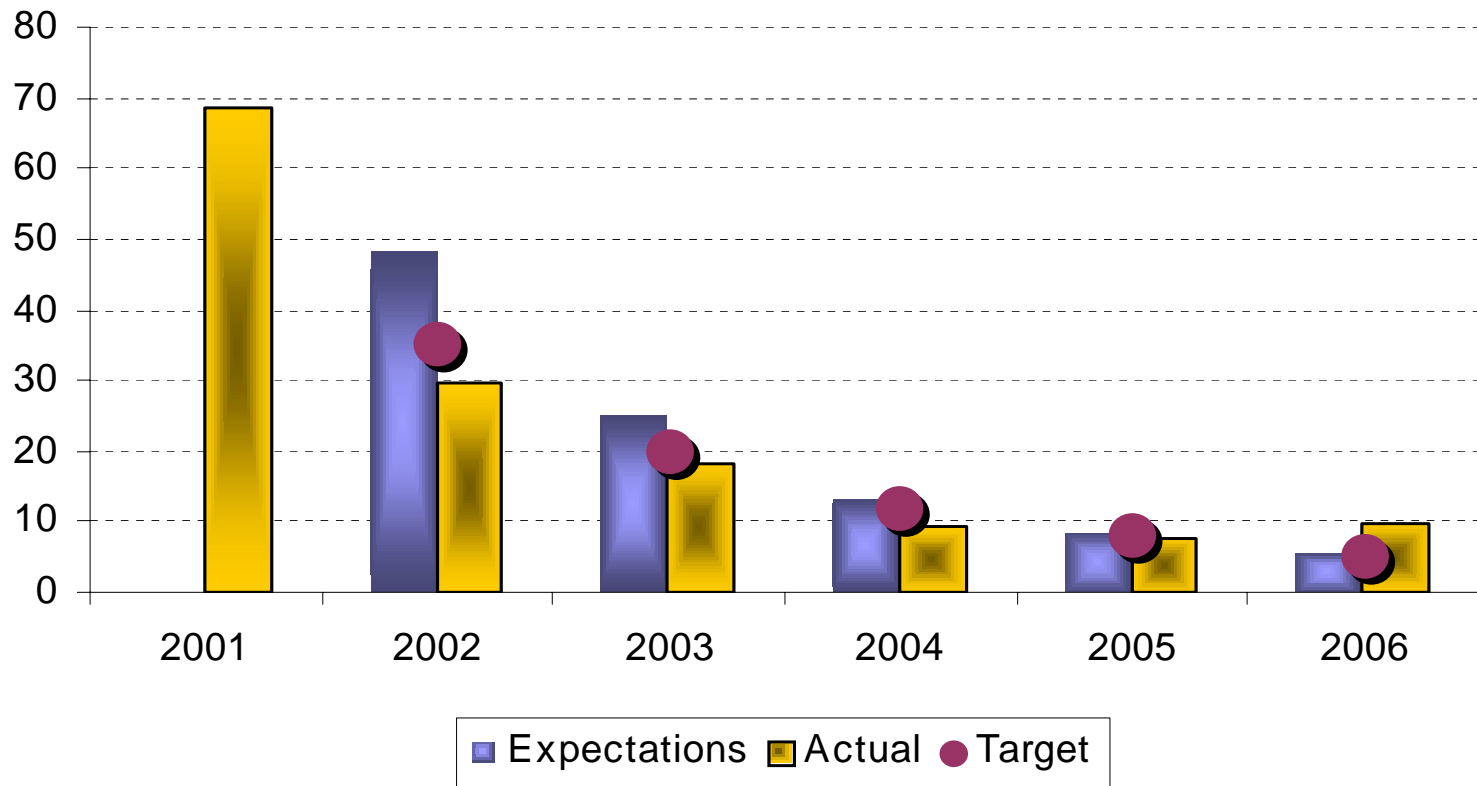
# Low levels of inflation and macroeconomic stability...

Inflation rates (CPI, y-o-y percentage change)

	2002	2003	2004	2005	2006	2007	2008	2009
Target	35	20	12	8	5	4	4	4
Actual	29,7	18,4	9,3	7,7	9,7	-	-	-
Difference	5,3	1,6	2,7	0,3	-4,7	-	-	-

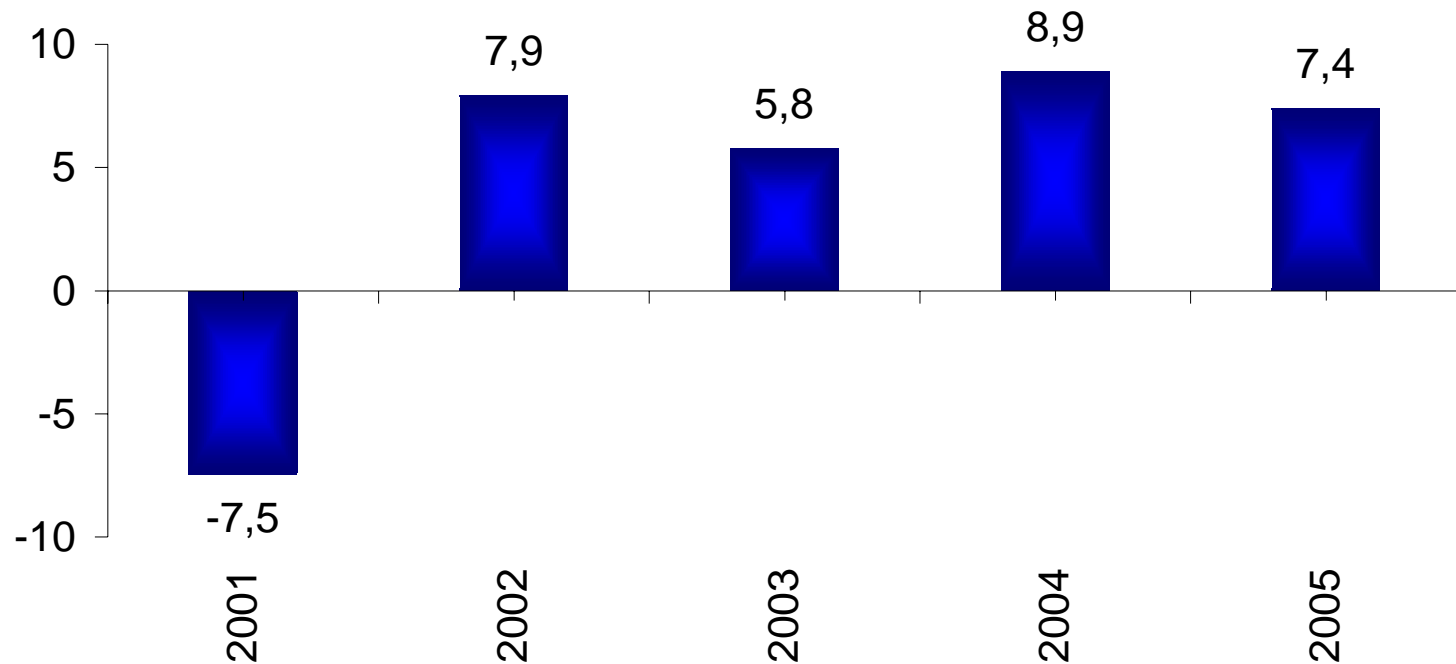
# Low levels of inflation and macroeconomic stability...

Inflation rates, y-o-y percentage change



# Low levels of inflation and macroeconomic stability...

Growth rate, y-o-y percentage change



# 2005: Transition year

- ◆ **Introduction of new price indices**
- ◆ **Introduction of YTL: Currency reform**
- ◆ **CBT's preparations:**
  - Further institutionalization of monetary policy
    - Pre-announced MPC meetings
      - ◆ Public announcements on MPC decisions
  - Improving technical capabilities at the CBT
  - Restructuring of Research (and Monetary Policy) Department: Key unit in monetary policy decision making process
  - Improving the efficiency of communication policy

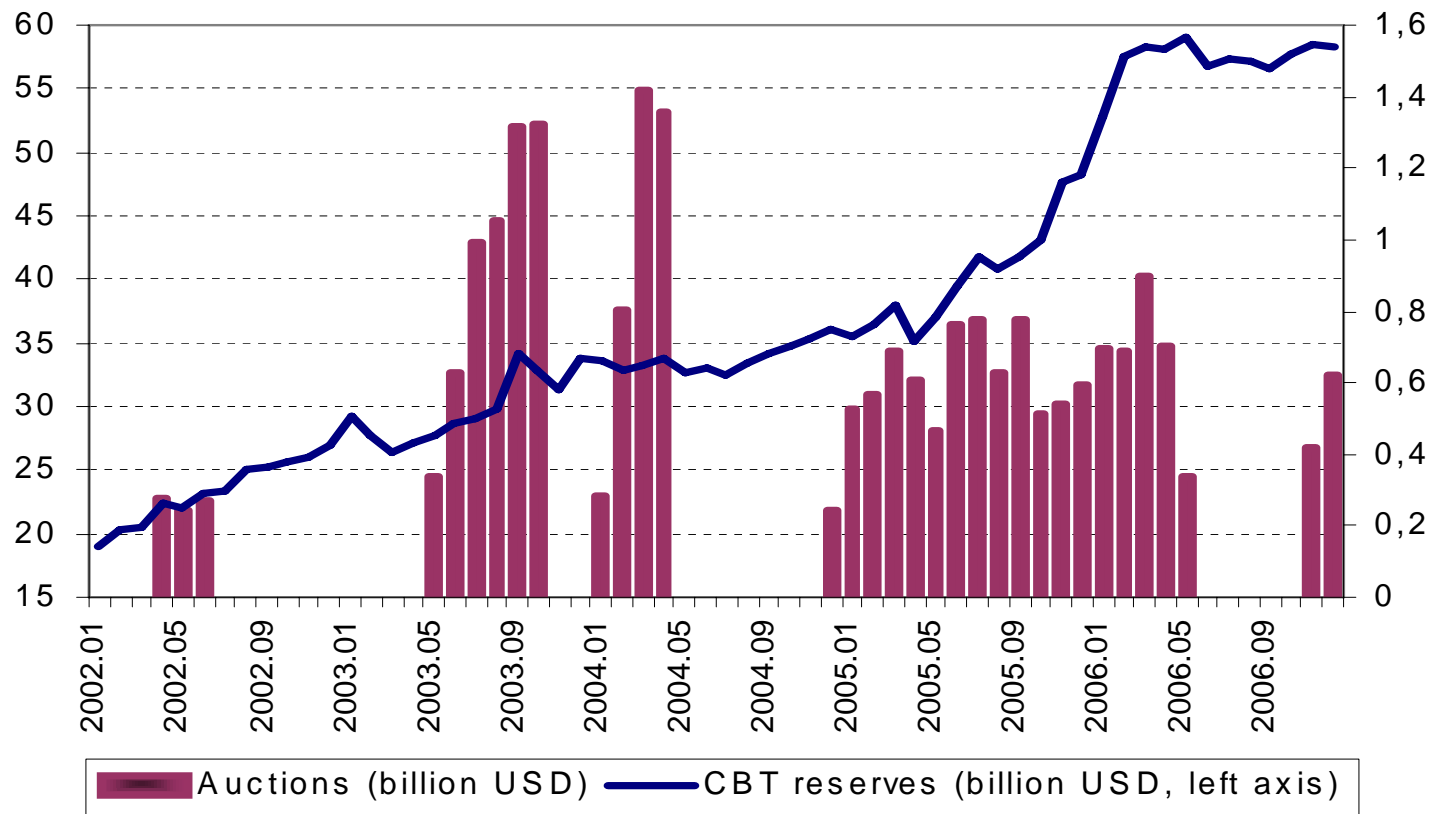
# 2006: Launch of formal IT

- ◆ Point Target: End-year CPI
- ◆ Uncertainty Bands: +/- 2 percentage points
- ◆ Target Horizon: 3-year horizon
  - %5 for 2006, %4 for 2007 and 2008
- ◆ Forecast Horizon: 6 quarters
- ◆ Policy Instrument: O/N rate
- ◆ Decision Making Body: MPC
  - Pre-announced monthly meetings
- ◆ Main Communication Tool : Inflation Report
- ◆ IMF conditionality : Inflation performance-  
NIR floor

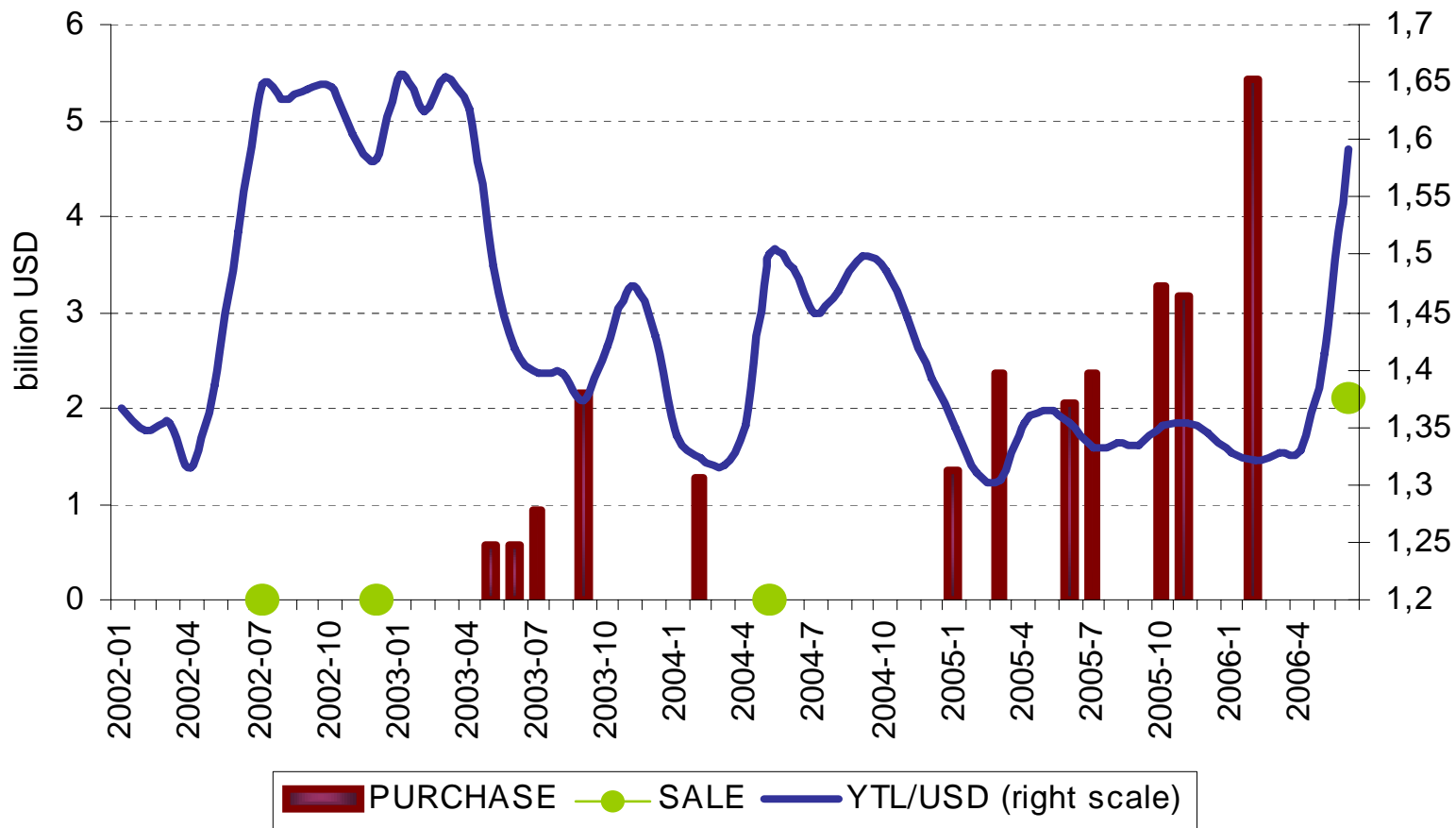
# Foreign exchange rate policy

- ◆ CBT is committed to the floating exchange rate regime, **except:**
- ◆ Smoothing intervention
  - Discretionary interventions to prevent excessive volatility on either side
- ◆ Purchase auctions to build-up reserves
  - Transparent methods with pre-announced purchase auctions
    - Conditional on strength of the balance of payments position and reverse currency substitution
    - No aim to affect the level of the exchange rate; mechanism consistent with the floating exchange rate regime

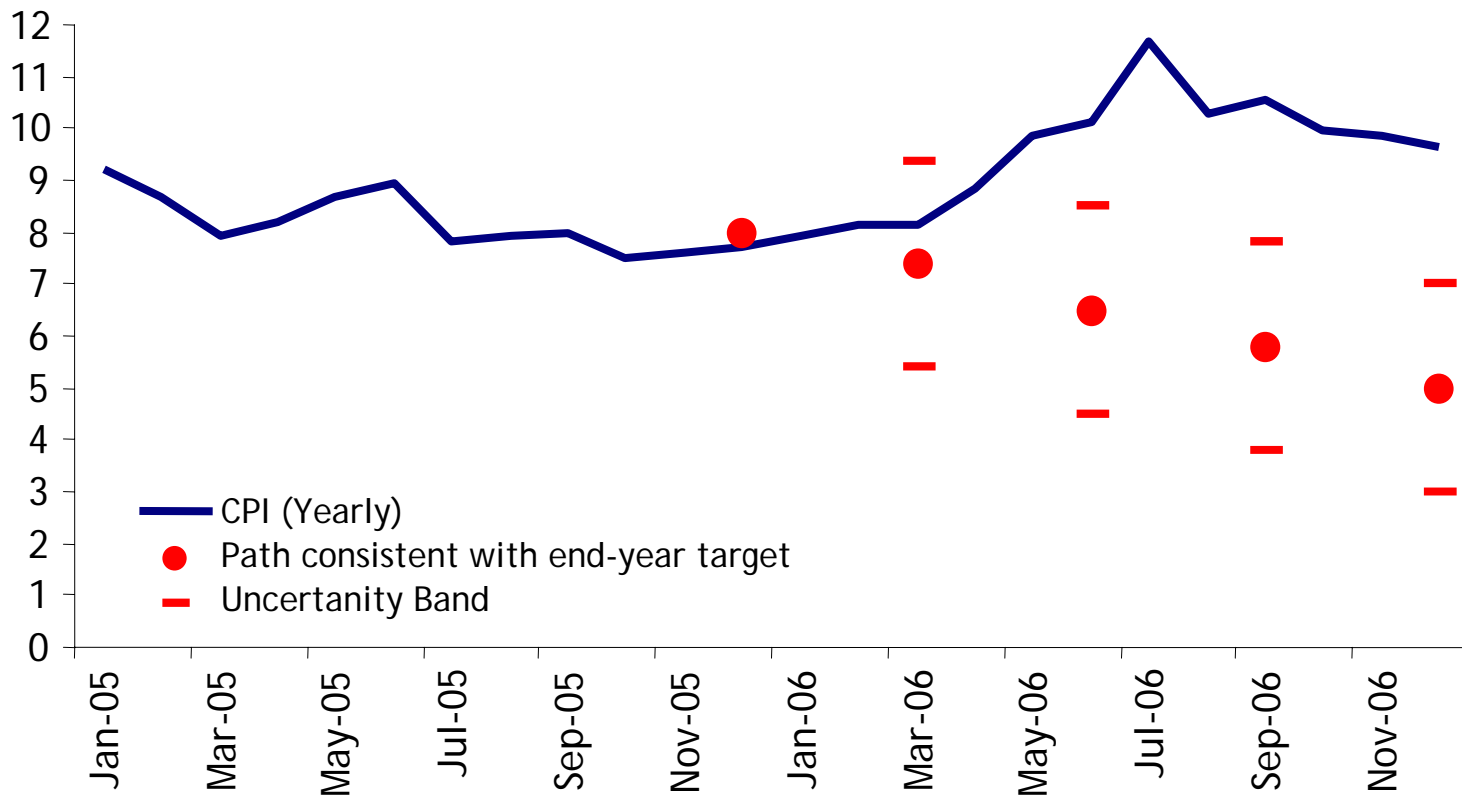
# Purchase auctions vs CBT reserves



# Interventions vs YTL / USD



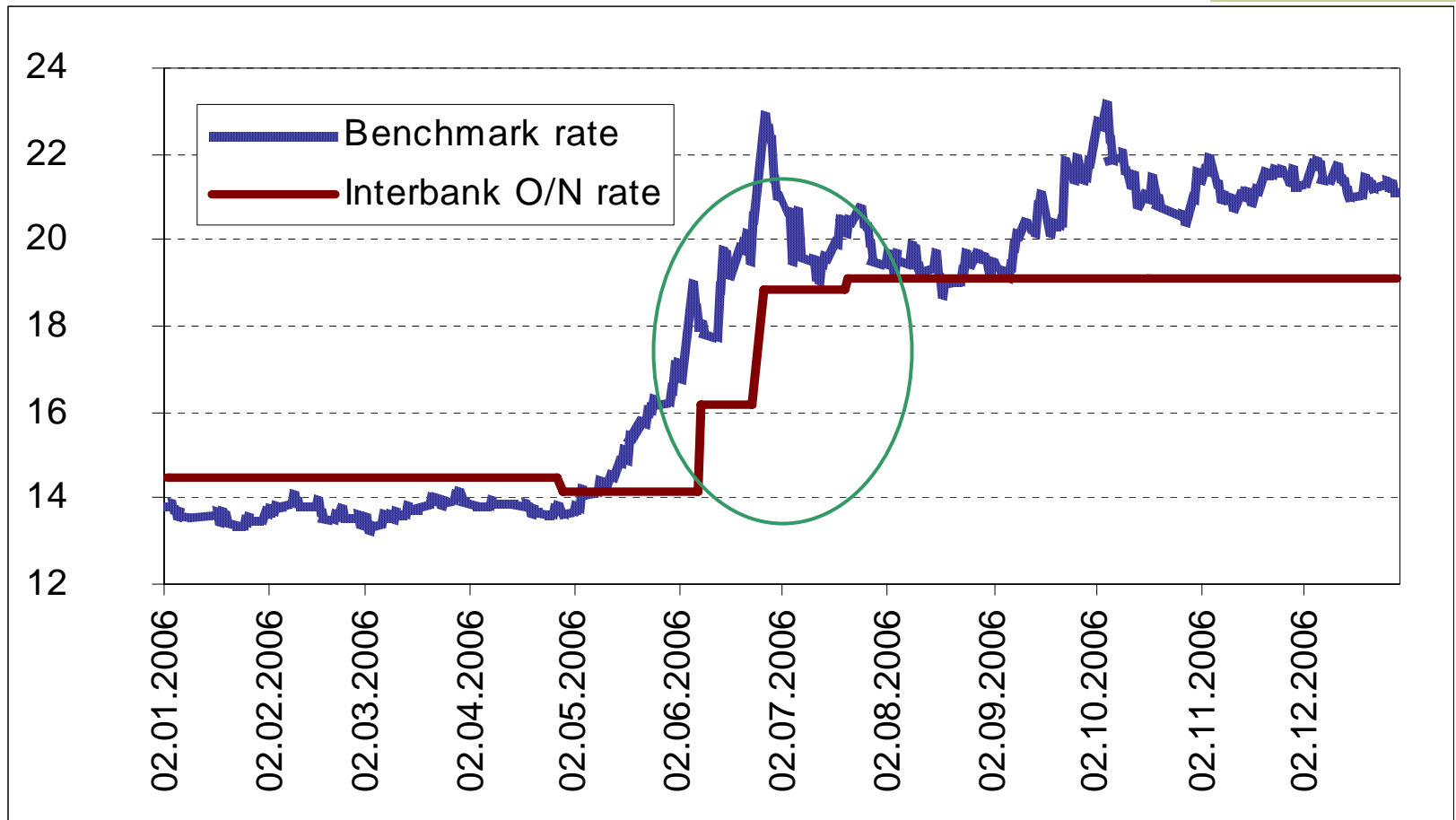
# Performance of in 2006...



# Reasons are...

- ◆ Supply side shocks
  - Increase in oil and gold prices in international markets
  - Increase in prices of tobacco and unprocessed food
- ◆ Stickiness in service sector prices
- ◆ Financial market turbulence in May-June
  - Capital outflows originated from the deterioration of global liquidity conditions and depreciation of YTL

# ...and the response



# Then after...

Tight monetary  
policy

&

Favourable  
international  
developments



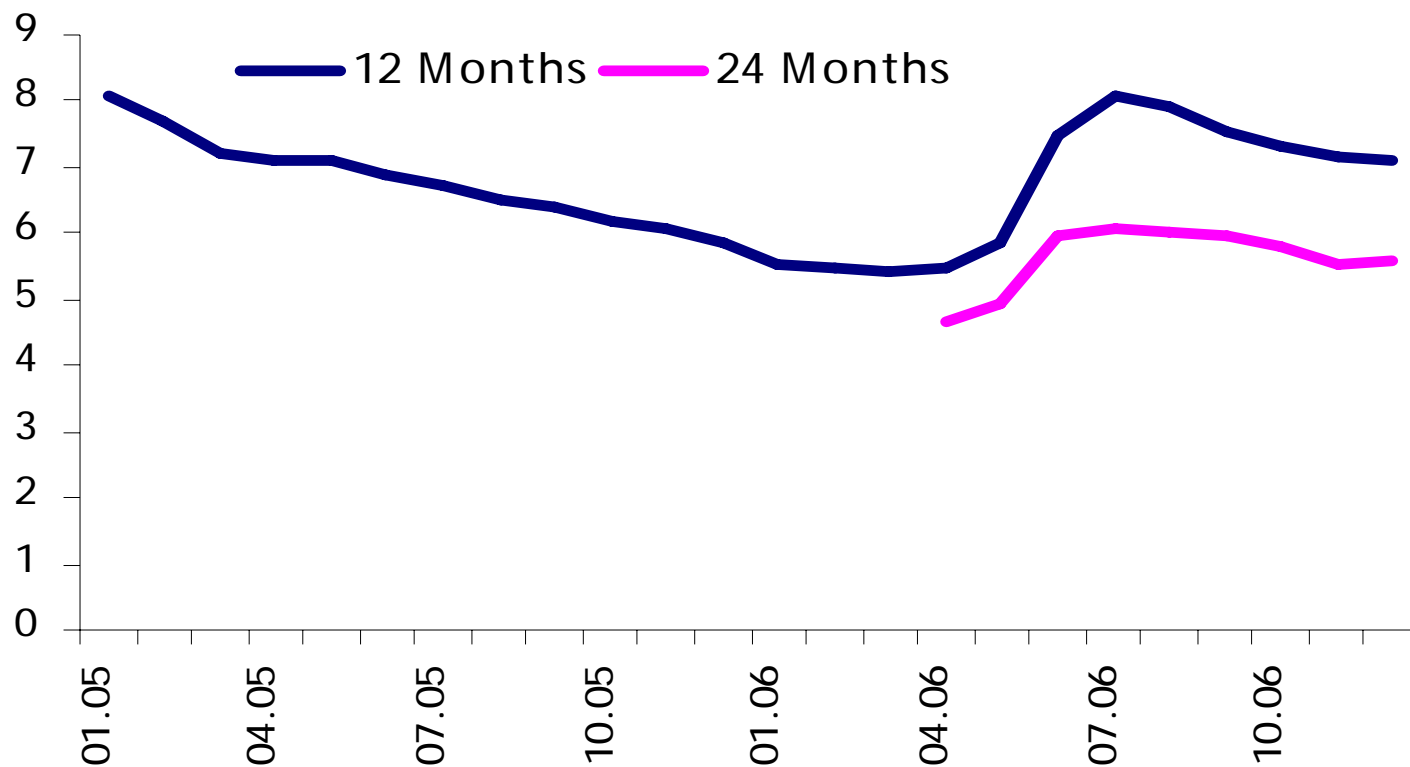
Improvement in  
medium term  
inflation  
expectations

&

inflation outlook

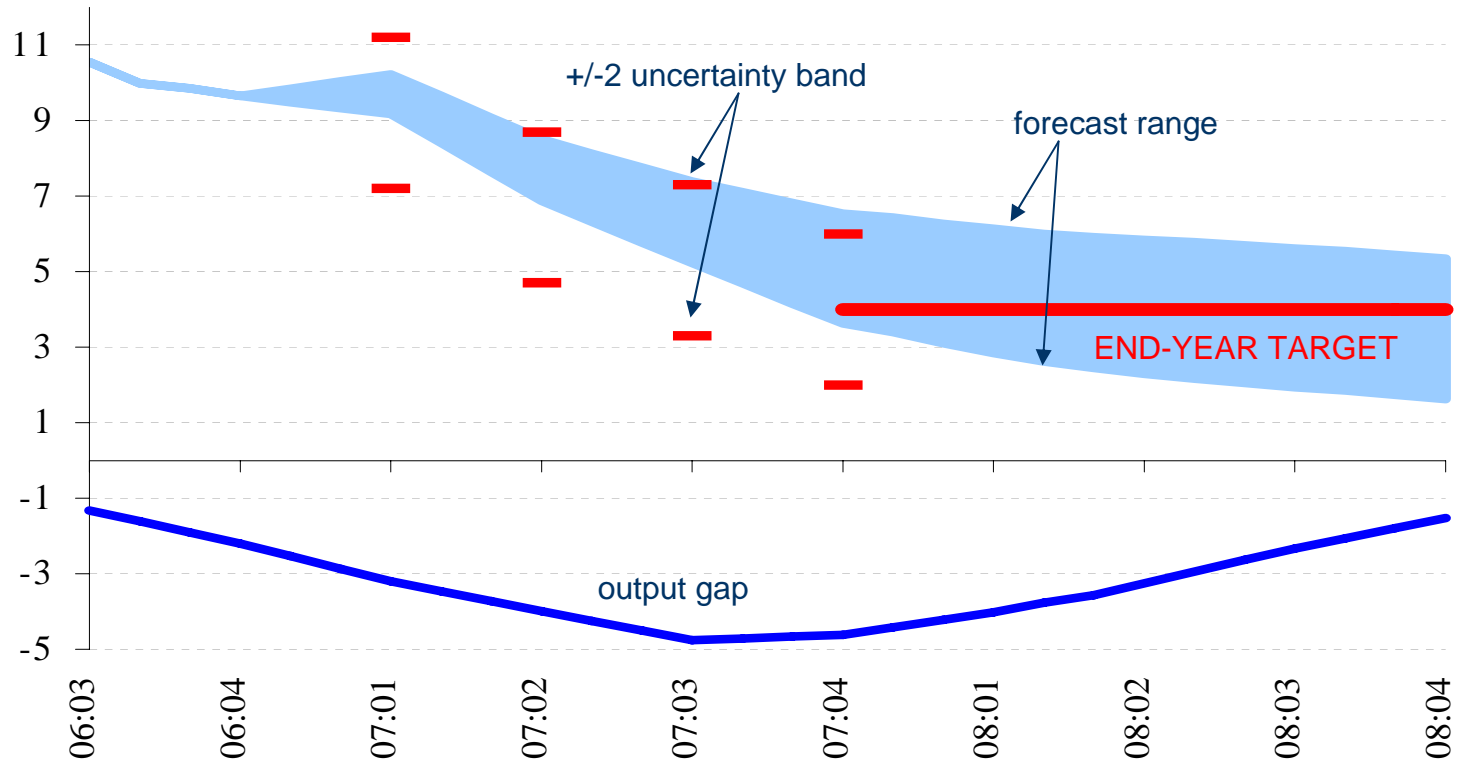
# Expectations partly improved...

CPI expectations for the next 12 and 24 months



# Inflation Report: January 2007

## Inflation and output gap estimations



# Risks ahead...

- ◆ Price rigidities in services sector
- ◆ Abandoning fiscal discipline
- ◆ Staggering structural reforms
- ◆ External shocks
  - Oil prices
  - Change in global risk perception
- ◆ Interruption of accession and convergence process to the EU



**Main tools to cope with challenges  
were (*and will be*):**



- ◆ **Independence of the Central Bank, and**
- ◆ **Enhanced transparency and accountability.**



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