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

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Turkey: Inflation in retrospect...
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...................................................... $\sqrt{\text{But...}}$
Fulfillment of preconditions of IT?

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

<table>
<thead>
<tr>
<th>Year</th>
<th>External</th>
<th>Domestic</th>
<th>Total Public Debt Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>30%</td>
<td>25%</td>
<td>55,3%</td>
</tr>
<tr>
<td>2001</td>
<td>25%</td>
<td>30%</td>
<td>90,4%</td>
</tr>
<tr>
<td>2002</td>
<td>20%</td>
<td>25%</td>
<td>80%</td>
</tr>
<tr>
<td>2003</td>
<td>15%</td>
<td>20%</td>
<td>78,4%</td>
</tr>
<tr>
<td>2004</td>
<td>10%</td>
<td>15%</td>
<td>70,3%</td>
</tr>
<tr>
<td>2005</td>
<td>5%</td>
<td>10%</td>
<td>64,0%</td>
</tr>
</tbody>
</table>

[Graph showing the percentage changes from year to year]
Independence from exchange rate considerations...

Asset dollarization index
Low levels of inflation and macroeconomic stability...

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

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target</td>
<td>35</td>
<td>20</td>
<td>12</td>
<td>8</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Actual</td>
<td>29,7</td>
<td>18,4</td>
<td>9,3</td>
<td>7,7</td>
<td>9,7</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Difference</td>
<td>5,3</td>
<td>1,6</td>
<td>2,7</td>
<td>0,3</td>
<td>-4,7</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>-7.5</td>
</tr>
<tr>
<td>2002</td>
<td>7.9</td>
</tr>
<tr>
<td>2003</td>
<td>5.8</td>
</tr>
<tr>
<td>2004</td>
<td>8.9</td>
</tr>
<tr>
<td>2005</td>
<td>7.4</td>
</tr>
</tbody>
</table>
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...

CPI (Yearly)
- Path consistent with end-year target
- Uncertainty Band
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

- Output gap
- +/-2 uncertainty band
- Forecast range
- End-year target
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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