



**TÜRKİYE CUMHURİYET
MERKEZ BANKASI**

Flexibility in Monetary Policy

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**Presentation at ICOPEC Conference
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Outline

- Monetary Policy Consensus Before 2008
- How and Why have Policies Shifted Towards More Flexibility?
- Implications for Monetary Policy in Turkey
- New Policy Framework Designed by the Central Bank of Turkey
- Implementation and outcomes

Consensus during the 'great moderation'

- Focusing price stability is the best CBs can do to contribute welfare
- Monetary policy is too blunt to react to financial stability
- Crisis prevention is costly, so it is better to mop-up afterwards
- Financial intermediation costs should be avoided

Mindset during the 'great moderation'

- This time is different!
- We know how the economy works
- Agents are rational
- Therefore, 'good monetary policy should be boring'
 - Predictable, Transparent and Simple

Conventional Inflation Targeting Framework

- Floating exchange rate regimes
- Taylor rule-like reaction functions
 - Single objective (inflation)
 - Single instrument (short term interest rate)
- New Keynesian models (w/o explicit macro-financial linkages)

Was this framework flexible?

- At first sight seems so, since under a flexible ER regime the CB can react freely to shocks by adjusting short term interest rates
- However, reaction function did not allow much flexibility in practice, because of rule based policy behavior and the scarcity of instruments
- Moreover, it was too costly to deviate from the conventional behavior in a financially integrated world
- Alternative policy options that would surprise financial markets can be risky to implement when consensus is strong
- Paradoxically, monetary policy framework was too rigid while the world was moving towards more flexibility

Shifting Towards More Flexibility

The crisis was a wake-up call



THE NEW YORKER



"Oh my God—I just remembered I can fly."

TUESDAY
MAY 10

The crisis was a wake-up call

- It may be well worth to invest on crisis prevention
- Monetary policy should not disregard financial stability aspects and asset price bubbles
- The assessment of financial risks has to be broadened
- The economy may not be as simple as previously thought

Re-emergence of Flexibility

- Financial stability mandate in itself calls for more flexibility
 - Flexibility in reaction function
 - Flexibility in using alternative instruments
- Thinking out of the box, contemplating richer view of welfare assessment and transmission mechanism
- Search for an alternative policy framework
- Unconventional is the new conventional?

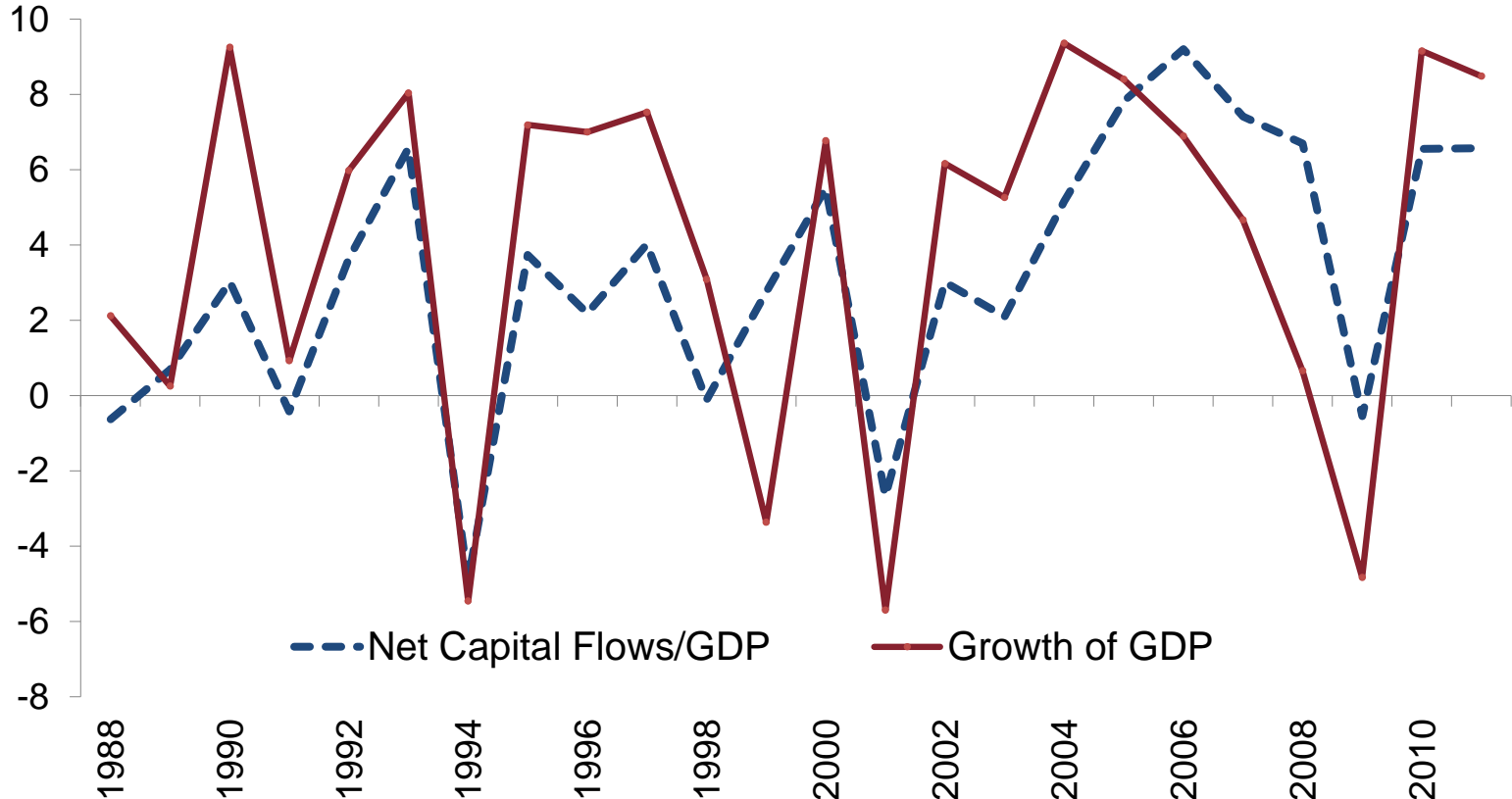
Reflections on the Turkish Monetary Policy

In search of a new policy framework

- Modify the existing inflation targeting regime to incorporate financial stability as a supplementary objective
- But how? Implementation is not trivial.
 - Financial stability is a much broader concept than price stability
 - No past experience or role model
 - Lack of academic guidance

Main issues considered in the design of new policy-1

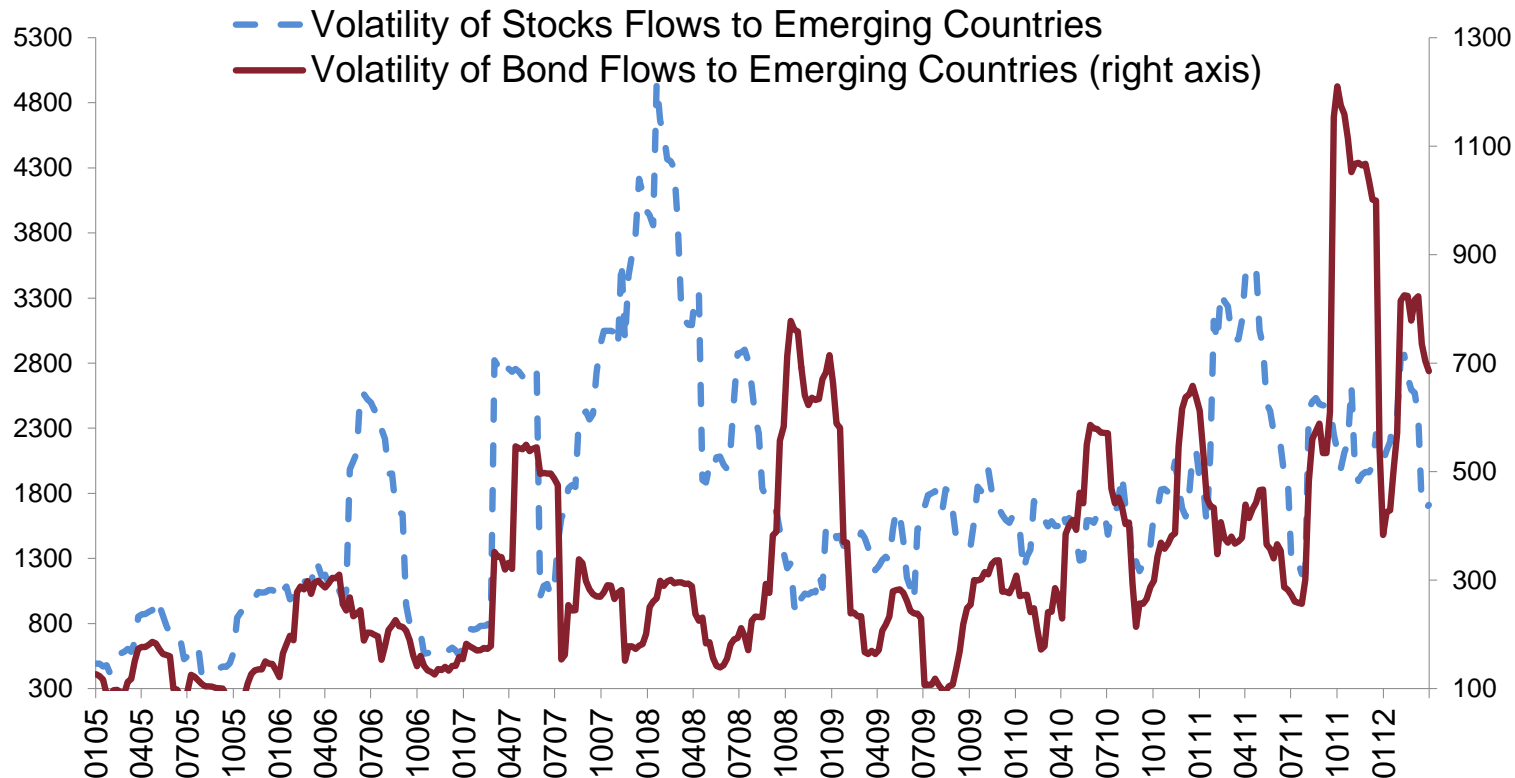
- Observation 1: Historically, Turkey is prone to boom-bust episodes driven by capital flows and excessive credit cycles



- Implication 1: The new policy should aim at alleviating the adverse impact of volatile capital flows and credit cycles on the domestic economy

Main issues considered in the design of new policy-2

- Observation 2: The volatility in cross-border financial flows has been excessively high in recent years (possibly due to QE and global uncertainty)



- Implication 2: The new policy should be flexible enough to address volatile capital flows and sudden reversals in global risk appetite

Flexible Policy Designed by the CBRT

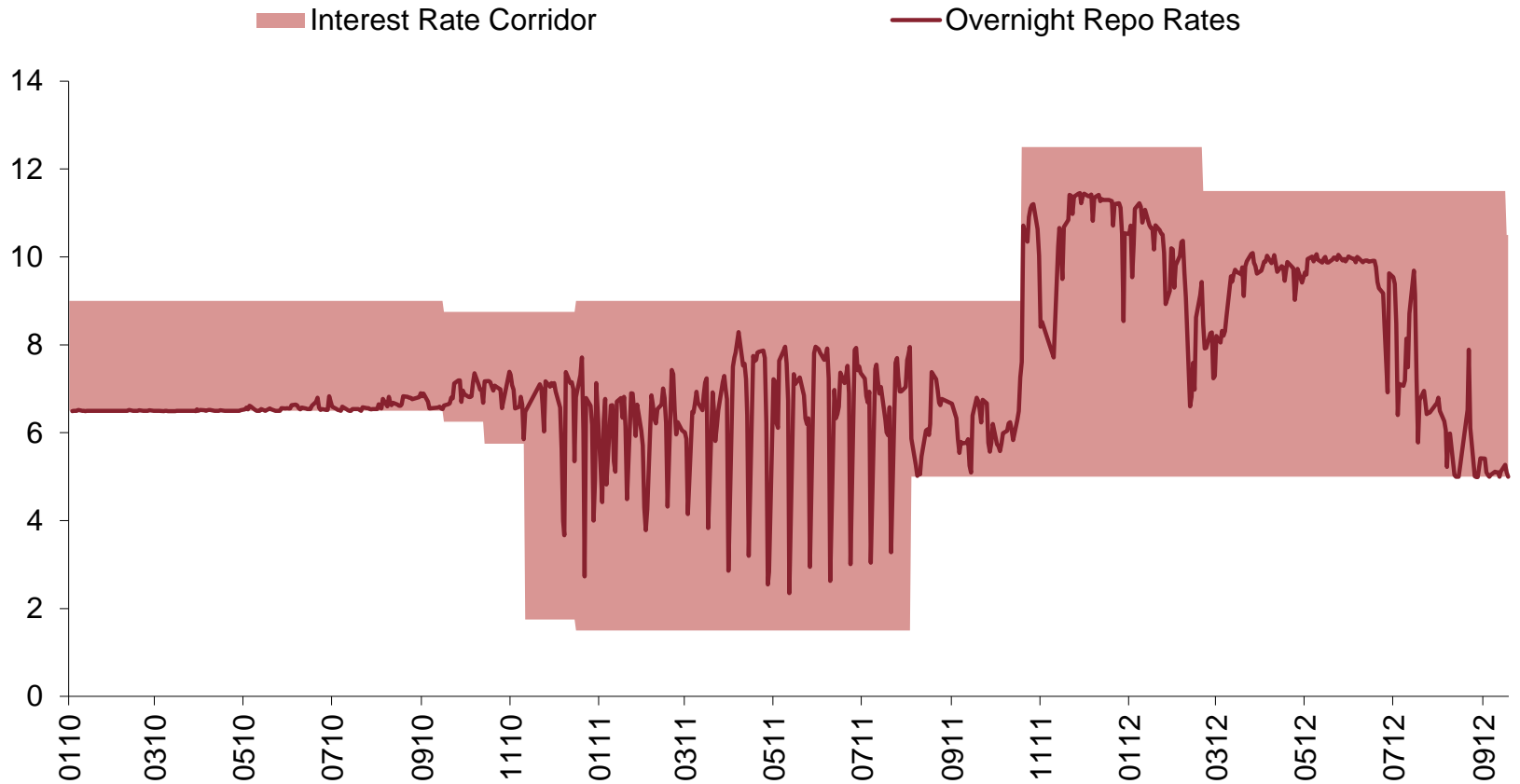
Flexibility in the objectives and instruments

	OLD FRAMEWORK	NEW FRAMEWORK
INSTRUMENTS	Policy Rate	Liquidity Management Interest Rate Corridor Policy rate Reserve Option Coefficients
OBJECTIVES	Price Stability	Price Stability Financial Stability

Flexibility in the reaction function

- Do not commit on a fixed interest rate for a predetermined period.
- Full commitment boosts credibility under normal times, but perhaps not in these days and definitely not in an emerging economy.
- Uncertain global outlook may prompt frequent reversals in policy stance.
- It may be more credible not to promise on something you cannot deliver.
 - Credibility of ability

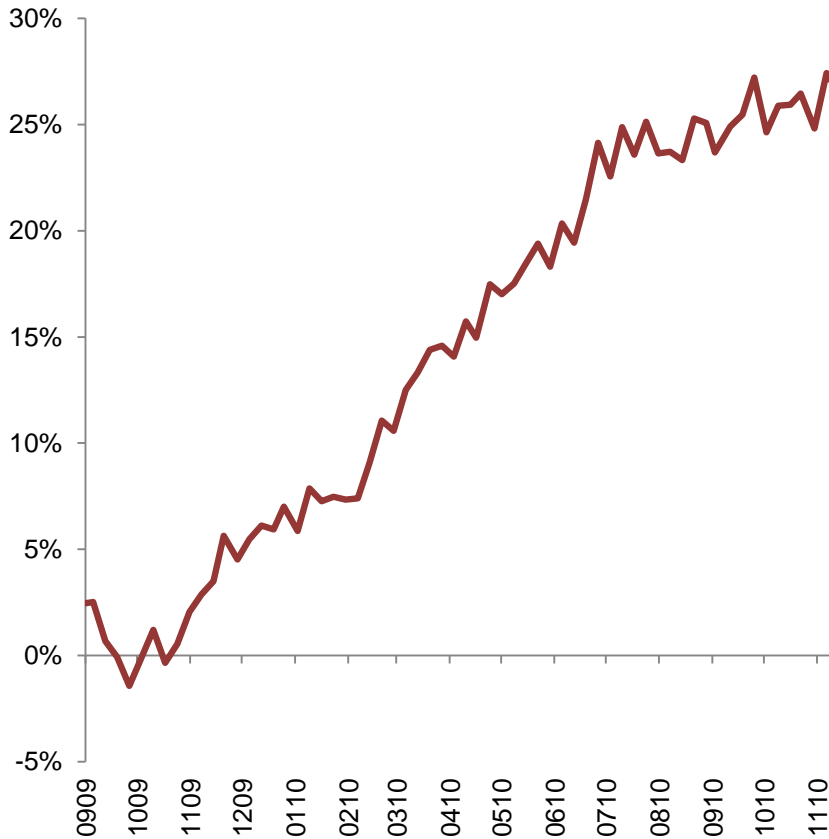
Flexibility in the reaction function: an example



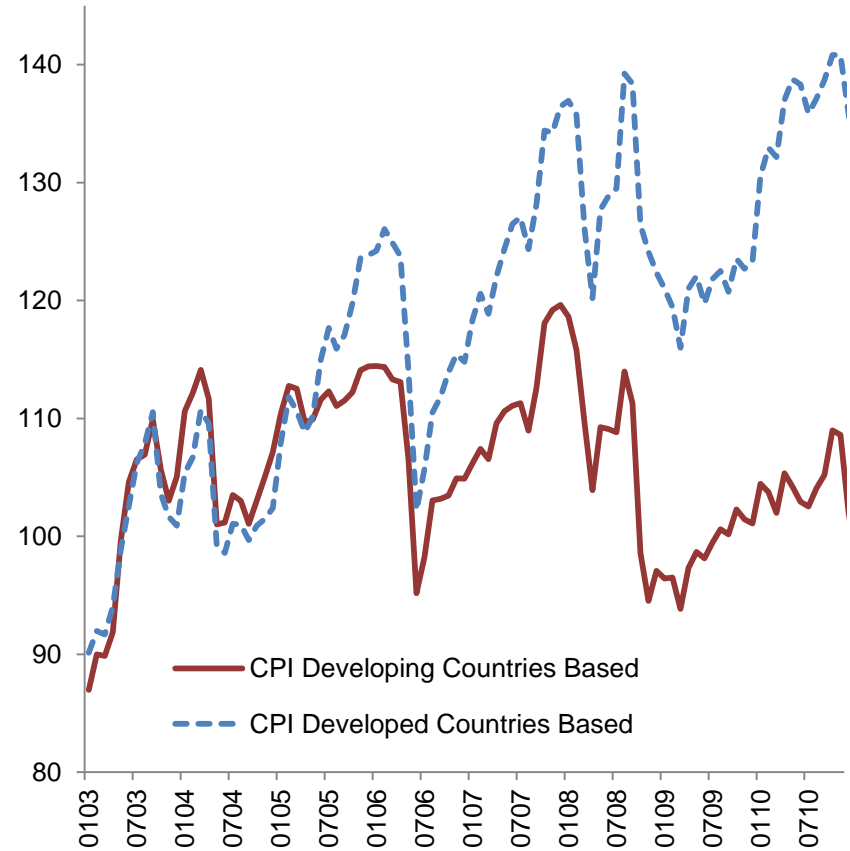
Implementation and Outcomes

Rapid credit growth and excessive currency appreciation by the end of 2010

Total Loan Growth Rates
(Annual Growth, Percent)



Real Exchange Rate
(2003=100)



*Total credit is inclusive of all types of banks (deposit banks, participation banks, and development/investment banks) and credit cards.

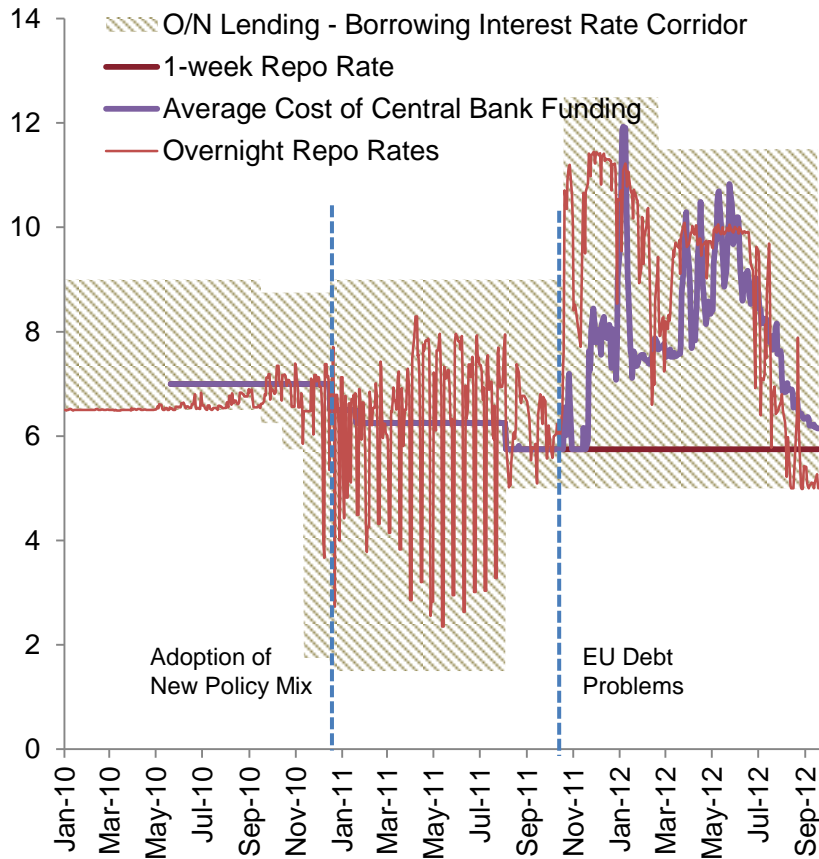
Current account balance by the end of 2010

(Seasonally Adjusted, Quarterly Average, Million USD)

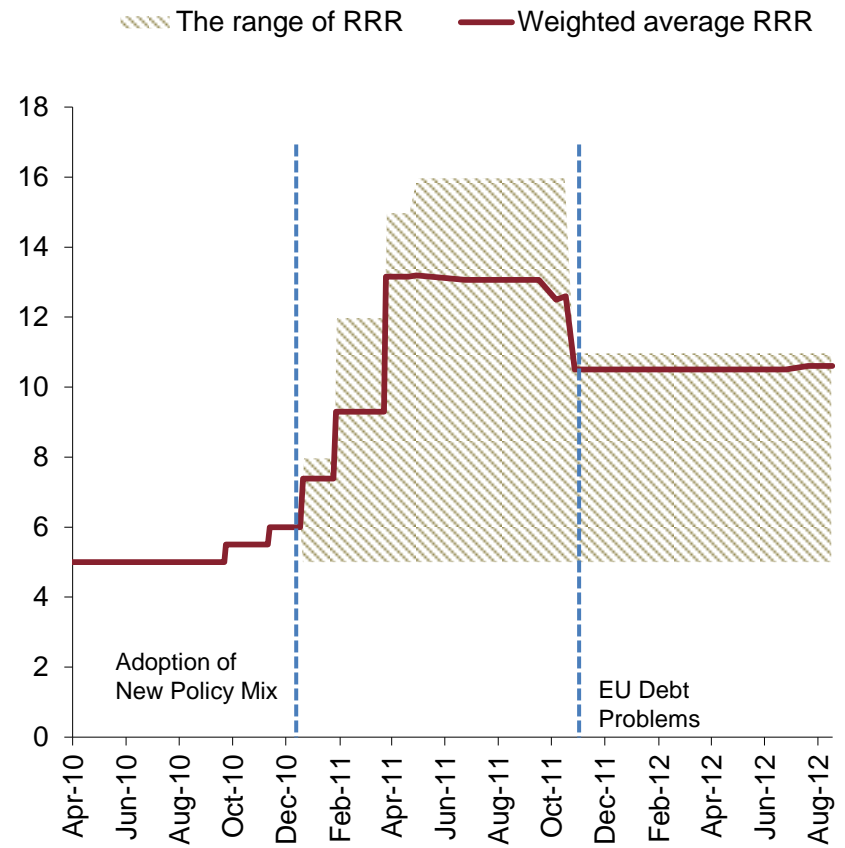


The response of the CBRT

CBT Policy Rates (Percent)

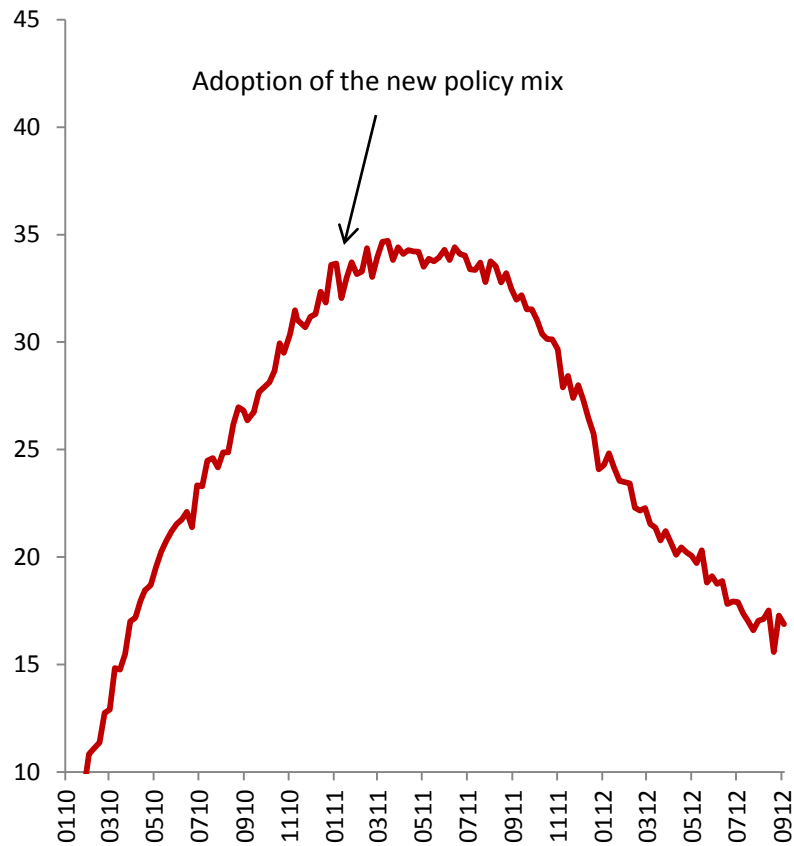


TL Reserve Requirement Ratios (Percent)

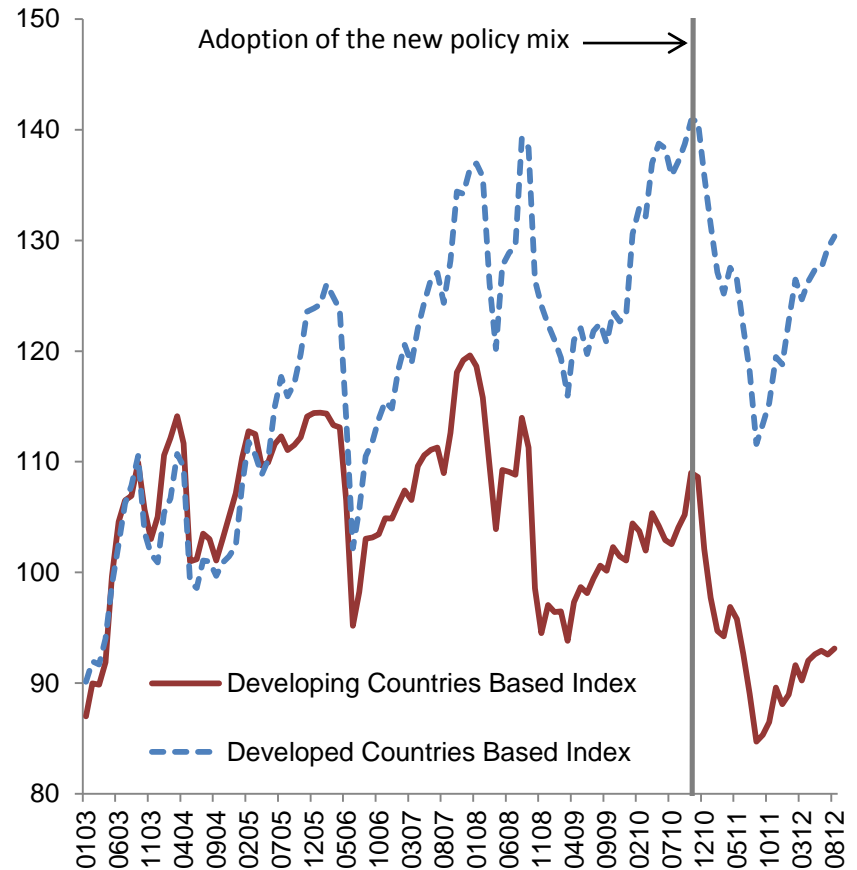


The outcome: credit growth and real exchange rate

Total Loan Growth Rates (Annual Growth, Percent, FX Adjusted)



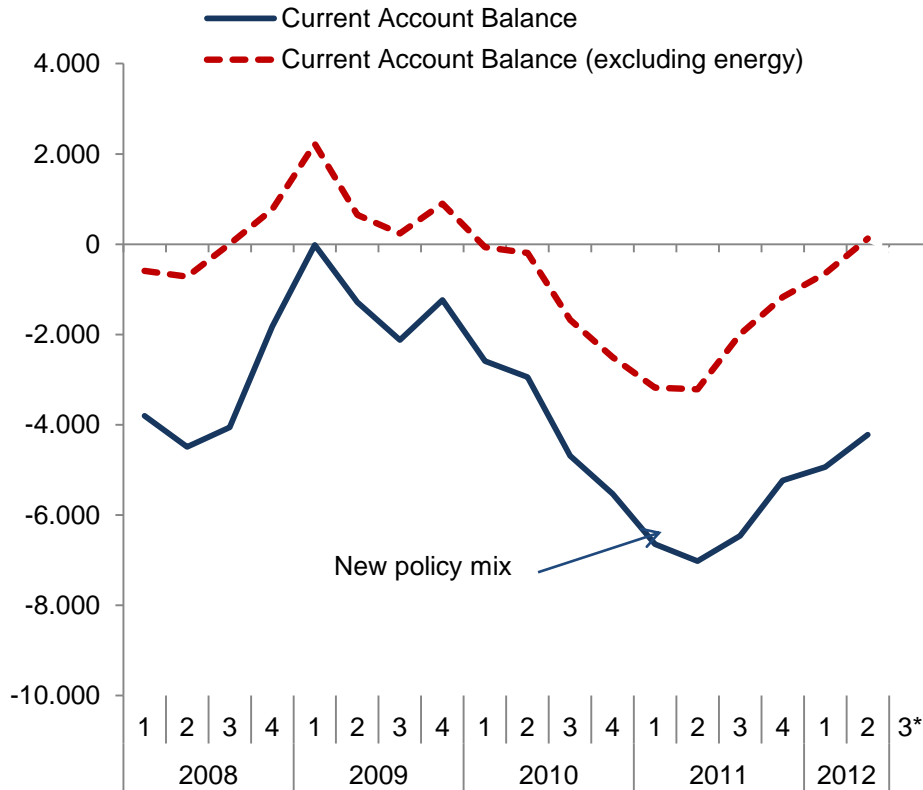
Real Exchange Rate (Annual Growth, Percent)



The outcome: current account and rebalancing

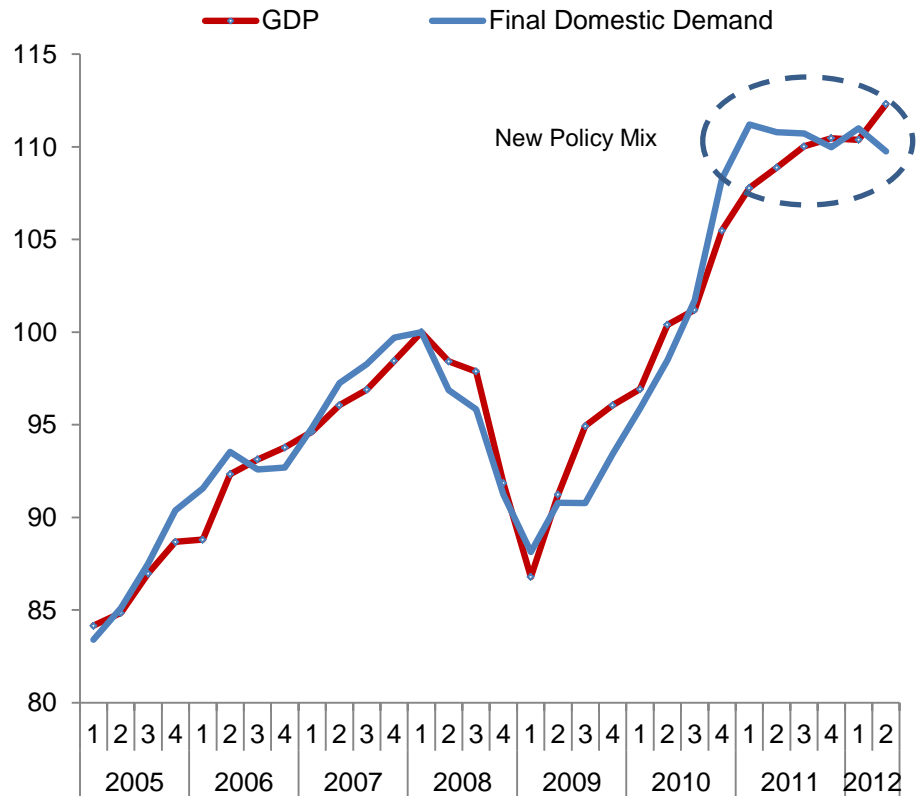
Current Account Balance

(Seasonally Adjusted, Quarterly Average, Million USD)

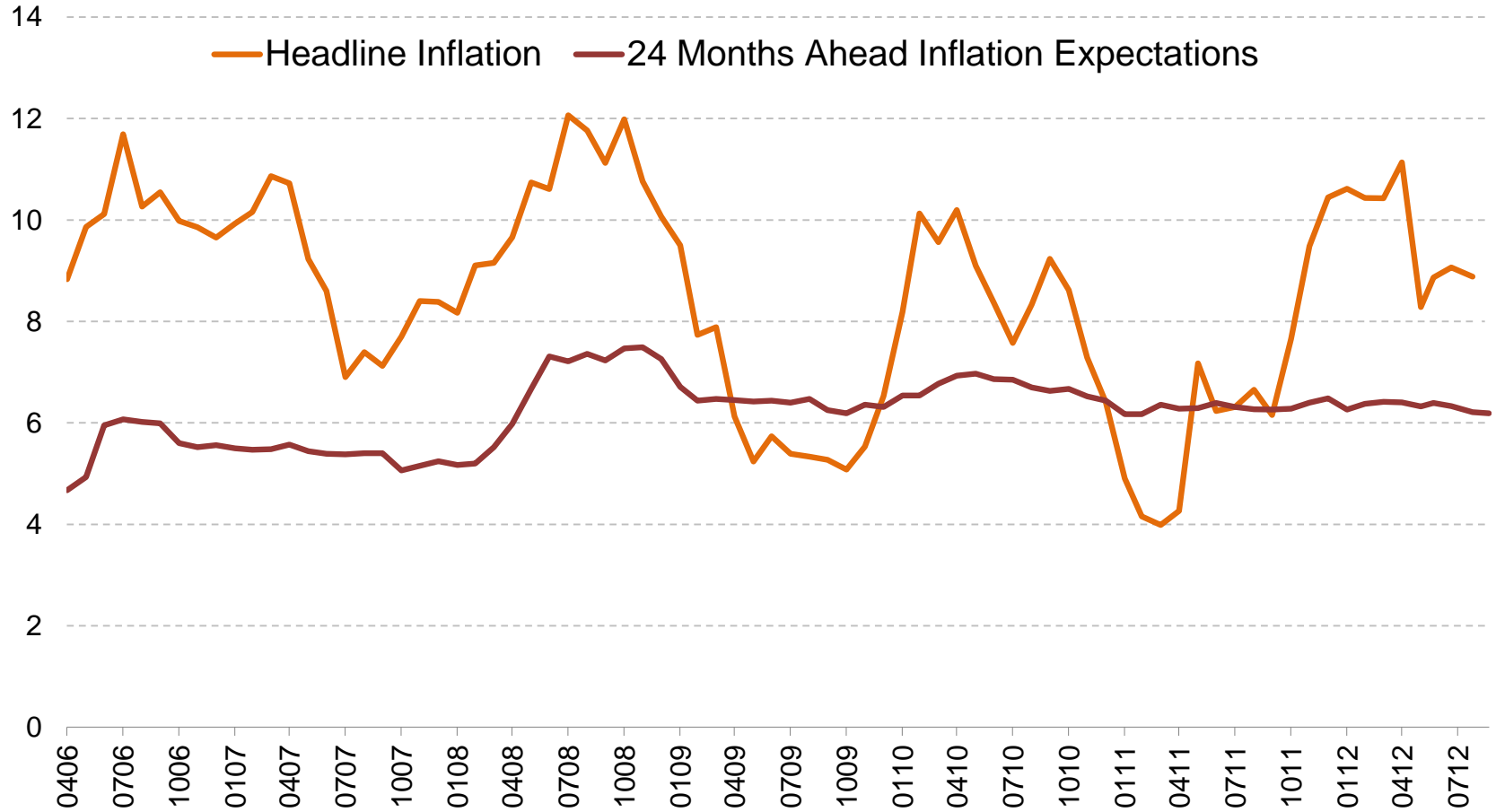


GDP and Final Domestic Demand

(Seasonally Adjusted, 2008Q1=100)



The outcome: inflation and expectations



Concluding Remarks

- The global crisis has dramatically shaken the consensus view in economics in many aspects.
- Monetary policy across the globe has moved towards more flexibility.
- The Central Bank of Turkey has formulated and implemented a more flexible strategy to address challenges posed by heightened global uncertainty and the ensuing volatility in cross border capital flows.
- So far, the new policy mix has been successful in rebalancing the economy without hampering price stability objective.



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