CENTRAL BANK OF THE REPUBLIC OF TURKEY

Price Stability

Erdem Başçı, Deputy Governor

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Distinguished Guests,

Before I begin my presentation, I would like to thank the Organization Committee for inviting me to this Conference. It is a great pleasure for me to address such a distinguished audience.

I assume in the period we are going through it is of no surprise that my speech is about price stability. Everyone in Turkey knows very well the meaning and importance of “price stability” after having experienced 35 years of high and unstable inflation.

During the period preceding the 2001 financial crisis, inflation used to be depicted as a grotesque “inflation monster”. The reason for this representation, which was popular with the public, is not hard to understand when we consider the fact that annual inflation remained at chronically high levels for 35 years in a row. The high public deficit, problematic fiscal policies, shallow financial markets and poor financial sector policies are other reminiscences that characterized the pre-2001 crisis period. In the light of these observations, we can affirm that the effort to achieve price stability in Turkey is, at the same time, an effort to turn over a new leaf for Turkey.

Although low inflation rates were achieved in the world a long time ago and have, since then, been maintained currently heated debates are held again on the meaning and merits of price stability in order to re-define it. Today, the clear and present danger the world faces is the constant decline in the prices of goods and services, namely “deflation”.

Annual consumer price inflation has already seen negative figures in Japan, China and the United States. In the European Union, it is expected that average consumer prices inflation would also continue to fall in the upcoming months to reach negative levels themselves.

The mentioned development is not a desirable one because it stems from a sudden drop in the demand in the goods and services market. Sudden drops in demand might rapidly erode the profit margins of companies and push them to the negative territory. This would lead to layoffs, a rise in unemployment, a decline in

disposable incomes, an increase in precautionary savings and finally would culminate in a further decline in the demand for goods and services. This deviation from equilibrium is a self-feeding vicious cycle and an important example of instability. Deflation is only one of the many symptoms of an acute economic disease.

The unconventional monetary policy and fiscal policy measures taken to offset the deflation risk raise a different instability concern and that is the fear of inflation. Contrary to the former concern, the fear of inflation is the resumption of a rise in the prices of goods and services to be followed by its acceleration, ending with the prices getting out of control.

Nowadays, it is observed that economists voice their concerns over either deflation accompanied by a rise in unemployment or the comeback of high inflation. These two opposing views share a single common element; that is, price stability is everyone's wish and the state that everyone wants to return to. The risk that is of concern is the possibility of any upward or downward deviations from price stability.

So what is price stability? Price stability is an inflation level so low that economic agents can ignore while making their consumption or investment decisions. In developed economies, this description refers to the targeting of an inflation rate of 2 - 2.5 percent. Likewise, in developing countries an inflation rate that is a few percentage points above this target is accepted to be consistent with price stability and stands as a target.

Distinguished Guests,

In the following part of my speech, I would like to deal with the relationship between price stability and financial stability from a holistic view.

Let me start by reminding you that stability is a dynamic concept. Stability is the ability of a system to return to a targeted state in the aftermath of temporary shocks. Economic theory and experience tell us that the market mechanism alone can remedy deviations from a targeted stable equilibrium in face of small-scale shocks, however in cases of bigger shocks, a stabilizing public intervention might be necessary.

Financial stability on the other hand can be described as a state where the credit volume displays a desirable and balanced growth. I would like to draw your attention to the parallels between this definition and that of price stability. Just as price stability is defined as the low single-digit growth rate in the prices of goods and services, financial stability can be defined as the growth of credits at a reasonable and sound pace. Credit growth at extreme paces or a credit squeeze is sign of financial instability.

The second point that I would like to underline is that the concept of stability should be considered from a holistic view. Attaining stability in several markets requires the stability of each single market concurrently with the others. The Walras Law, underlying the general equilibrium theory, asserts that the absence of equilibrium in any one of the markets inevitably leads to a disequilibrium in at least one other market. It is therefore not possible to talk about partial stability in that sense. Accordingly, it can be stated that price stability and financial stability are co-requisites.

It is of no surprise then to observe in the period before any crisis, either one of excessively loose fiscal policies, excessively loose monetary policies, excessively loose financial sector policies or any combination of these three.

Excessively loose monetary policy creates imbalances in the goods and services markets. This, in turn, leads to an overheating in the economy after a certain point, together with a surge in inflation, and finally resulting in the loss of price stability. Rising inflation, coupled with the inflation risk premium, further pushes up nominal interest rates and threatens financial stability. The result is the most undesirable case: High inflation coupled with unemployment. This was the case with the developed countries in late 1970's.

In cases where an extremely loose monetary policy is financed by borrowing instead of monetary expansion, the rapid growth of the public debt burden may, after a while, impair financial stability by raising interest rates in financial markets via the risk premium channel. The deterioration of financial stability leads to unemployment and further instability in the goods markets as witnessed by developed countries in the 1980's and some emerging economies during the1990's.

Excessively loose financial sector policies in contrast may result in an uncontrollably rapid rise of private sector indebtedness, thus eventually leading to inflation due to the overheating of the economy after a certain point. Rising inflation and market interest rates, coupled with repayment problems may rapidly evolve into financial instability. And financial instability, in turn, may transform into a sharp credit crunch, a contraction of demand and early deflationary dynamics. Such a situation has been experienced on a global scale in the post-2000 period and still prevails nowadays.

As a matter of fact, Turkey's recent experience can be considered an example of favorable policy responses against these findings.

The stabilization program implemented in the post-2001 crisis period was built on the easing of public debt burden primarily by means of tight fiscal policy. Consequently, the vulnerabilities of Turkish economy were largely subdued and the creditworthiness of Turkey improved rapidly.

Room for maneuver of monetary policy has expanded significantly in response to favorable developments in fiscal policy. Monetization of budget deficits was prevented with the abolition of short-term advances to the Treasury. These developments highlight the significance of the right decision of recognizing the Central Bank's independence as a prerequisite.

Inflation targeting has been adopted as a monetary policy regime, and price stability has been set as the primary objective of the Central Bank of the Republic of Turkey. In this framework, the management of expectations has become the main axis of monetary policy.

It should be noted that the Central Bank introduced the inflation-targeting regime under a freely floating exchange rate system. I would like to emphasize that this means the exchange rate is not a policy instrument. On the contrary, the value of the exchange rate is determined under the market conditions that reflect not only the effects of fiscal and monetary policies but also to a large extent international developments, economic fundamentals and expectations about the future. It is particularly worth noting that under floating rate regime, it is crucial for markets to be aware of the risks related to the exchange rates.

Effective regulation and supervision of the banking sector has also played an important role in the establishment of macroeconomic stability. These efforts aimed the limitation of moral hazard and curbing of excessive borrowing tendencies. In this context, the establishment and activation of the Bank Regulation and Supervision Agency (BRSA), successful implementation of the banking restructuring program and the reflection of best practices of the global economic experience on our system via the New Banking Law assume great importance. Moreover, I would also like to underline the effective cooperation among the Central Bank, the BRSA, the Treasury, the Capital Markets Board and other public authorities along with the representatives of the private sector.

Distinguished Guests,

The policy preferences I have mentioned so far have made an indisputable contribution to limiting and diminishing the fragilities of Turkish economy. In fact, the accuracy of our assertion relating to the decline in fragilities was tested for the first time in the first half of 2006, during which international capital conditions had changed and many countries including Turkey had experienced capital outflows. In that period of strong domestic and foreign demand, the Central Bank adopted a strategy of tightening the monetary policy along with further measures of Turkish lira and foreign exchange liquidity. Although the gap between the inflation expectations and targets widened in the said period, expectations were taken under control to a great extent. The monetary policy response of the time could overcome the effects of the large exogenous shock appropriately.

We are currently undergoing a second major test. Since the third quarter of 2008, the global financial crisis has had a spillover effect throughout the world and no country has been immune to the effects of this worldwide crisis. On the other hand, not all the countries are affected in the same way; the size and cost of the impact differ from country to country. At this point, I would like to share some of my basic observations.

While many countries had to opt for tremendous capital injections into their financial systems, Turkey had no such need, which thus confirmed the safe and sound structure of the Turkish banking sector. It is also observed that the risk

premium of the Turkish economy has resisted the deterioration in global risk perceptions more than implied by its credit rating. Therefore, countries that observed a relative decline in their risk premia, as in the case of Turkey, also had more room for policy rate cuts. I believe that all these can be interpreted as adequate evidence of improved financial stability in Turkey.

Parallel to the easing import prices and waning demand conditions, inflation outlook improved in November, which can also be traced by expectations. This improvement in inflation outlook allowed the Central Bank to implement a rapid policy rate cut cycle.

As a result, on back of the safe prospects for price stability and financial stability in Turkey, the Central Bank is able to act in a counter-cyclical fashion against global shocks.

Esteemed guests,

Recent data point to a recovery in private consumption demand, albeit limited, as of the second quarter of the year. Though some of the problems in the international credit markets have been solved, the remaining unsolved problems still stand out as an evident and determining factor. The signs of recovery in goods and services markets are still sluggish. Meanwhile, the weak course of domestic investment demand and the foreign demand still persists. It can be said in the light of these developments that an improvement in the global economic activity and employment is still far beyond the horizon. On the other hand, downward pressures on inflation are likely to persist for a while.

I would like to once more emphasize that the current monetary policy stance endeavors to eliminate the risk of inflation to fall too much below the medium-term targets. The tightness in financial conditions also supports the decision of the Central Bank to maintain a loosening bias in its monetary policy for a considerable period of time. I would like to end my remarks by stating that the measures taken by the Central Bank aims at containing the adverse effects of the global financial crisis on Turkey. I wish to extend my regards to all participants.

Thank you very much.