Central Bank of the Republic of Turkey

In Search of an Appropriate Policy Mix for Emerging Economies: Monetary Policy in Turkey in the aftermath of the Global Financial Crisis

Durmuş Yılmaz

Governor

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Dear Guests,

During the global financial crisis, almost all countries focused on containing potential adverse effects of the crisis on domestic economy; Turkey was not an exception. Following the intensification of the crisis, the Central Bank of Turkey (CBT) delivered sizeable and front-loaded cuts in policy rates, reaching 1025 basis points from November 2008 to November 2009. During this period the CBT not only cut policy rates rapidly, but also pursued a counter-cyclical liquidity policy to support the functioning of money and credit markets, thereby strengthen the impact of the rate reductions on economic activity.

These efforts were successful in bringing back Turkey on a strong recovery track. The healthy household balance sheets and solid banking system allowed a rapid rebound in domestic demand. Starting from mid-2009, the Turkish economy has been facing a domestic demand driven rapid recovery. Meanwhile, strengthening capital inflows has further exacerbated the divergence between the domestic and external demand, creating new policy challenges. Rapidly widening current account deficit coupled with short term capital inflows and exchange rate appreciation called for a different approach to monetary policy.

In order to cope with this new situation, we have slightly modified our existing framework of inflation targeting by explicitly highlighting the increasing role of financial stability in our objective function. Accordingly, first we have announced the details of our exit strategy from crisis measures in April 2010. As a first step, we have normalized the liquidity support facilities and brought back the TRY reserve requirement ratios to pre-crisis levels of 6 percent. Second, we started to highlight the macro financial risks and contingent policy responses. For example, we have stated through our policy documents that, if divergence in growth rates between domestic and external demand continues in the forthcoming period, and if this pattern of growth coexists with rapid credit expansion and deterioration in the current account balance, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity management facilities more effectively.

The primary objective of the CBT is to achieve and maintain price stability. However, the recent crisis has taught us that this single objective may not be enough for attaining macroeconomic and financial stability. In this respect, we reminded the public that financial stability is one of the fundamental duties of the CBT as stipulated in our Law, and we approach financial stability from a macroeconomic perspective.

From an emerging market point of view, the concept of "macroprudential" measures may not be the same as it is perceived in advanced economies. It is important to note that each country has its own characteristics and every country has to design the policy framework according to its own needs. From the Turkish perspective, financial stability risks under the current conditions are most evident as the rapidly increasing current account deficit fueled by short-term capital inflows. The divergence between domestic and foreign demand growth coupled with a rapid credit expansion is increasing the current account deficit, thereby raising financial stability concerns. Moreover, the recent developments and related policy decisions in the European and US economies have been exacerbating these risks, necessitating a different domestic policy mix than we have implemented in the past.

What do we mean by policy mix? When the external and internal equilibrium requires different interest rates, monetary policy has to use more than one instrument. In our case we utilized two more instruments to limit the macro-financial risks associated with short term capital inflows coupled with appreciating currency and rising current account deficit. Let me explain these extra tools in turn.

In order to curb the domestic demand and widening current account deficit, our first aim was to control the rapid credit expansion. Therefore, we have made it clear that one of the goals of our current policy mix should be reducing the pace of credit growth. To this end, we stated that reserve requirement ratios should be used as an active monetary policy tool. Moreover, to use the required reserve ratios as one of the policy tools to mitigate the macroeconomic and financial risks more actively in the future, the remuneration of Turkish lira required reserves is also terminated.

We have been very open with the public regarding these measures. We stated that the measures implemented by the CBT are necessary but not alone sufficient to safeguard financial stability. We underscored the crucial role of coordination across all institutions. To this end, I should mention that, as a support to our policies, the Banking Regulation and Supervision Agency (BRSA) has taken a set of measures to (such as restricting loan to value ratios for certain segments of bank credits, increasing the minimum payments on credit cards) in order to contain the credit supply. BRSA eliminated the ban designed to safeguard investor demand for government debt, and permitted Turkish Banks to sell TRY denominated securities starting from October 2010. Finally, the government also supported our efforts by saving most of the extra revenues acquired by the faster-than-expected pickup in economic activity. In addition, government raised Resource Usage Support Fund (KKDF) deductions on consumer loans to roll back measures taken during the global crisis.

Another issue we considered while formulating current policy mix is lengthening the maturity of capital inflows. This is important for improving the quality of the capital account and avoiding exchange rate misalignments. We decided to adopt a policy mix to deal with this situation. We lowered the policy rate and widened the corridor between overnight borrowing and lending rates so as to allow fluctuations in the short-term interest rates, when needed. This policy so far has been quite effective. We observed a significant drop in the short term speculative inflows. In addition, we differentiated Turkish lira required reserve ratios according to the maturity structure of deposits in order to lengthen the maturity structure of liabilities and reduce the maturity mismatch.

Of course, one crucial communication issue not to be neglected during this process is convincing the public that these measures do not mean giving up on our primary mandate, which is price stability. Accordingly, we used a cautious tone for the inflation outlook. We have explicitly stated that, given the rapid pace of domestic demand and rising commodity prices, general price setting behavior should be closely monitored. In this respect we have forcefully signaled that the net impact of the macroprudential policy package implemented—and to be implemented—both by the CBT and other institutions should be on the tightening side.

We anticipate the hikes in required reserve ratios to curb the credit growth through the cost and liquidity channels. Needless to say, there is a lot of uncertainty regarding the timing and the extent of the impact of our measures. In order to overcome the possible communication problems associated with this uncertainty, we have announced that we will monitor the effects of our decisions from both price stability and financial stability perspectives, and do not hesitate to implement additional measures if necessary.

Although it looks quite complicated at first sight, the framework we adopt in spirit is not significantly different from the conventional inflation targeting framework. The only difference is that, previously our policy instrument was the one week repo rate, but now our instrument is a "policy mix"—which consists of a combination of short term interest rates, reserve requirement ratios and interest rate corridor. We seek to use these instruments in the right combination in order to cope with both inflation and macro-financial risks. The monetary policy stance in this framework is not only determined by the path of policy rates, but as a mixture of all the policy instruments, as I just mentioned. Just like the conventional inflation targeting framework, the policy is forward looking and contingent on economic outlook. The course of the policy mix in the forthcoming period will depend on the factors affecting price stability and financial stability.

In sum, we are going through a period in which central banks policies have to be creative in dealing with the "new normal". However, it is also important to consider country specific features in designing these strategies. In our part, we believe that a lower policy rate and a wider interest rate corridor combined with higher required reserve ratios may serve as an effective policy mix in dealing with rapidly increasing macro imbalances driven by short term capital inflows.

Thank you.