Insight Turkey

Monetary Policy of Central Bank of the Republic of Turkey after Global Financial Crisis

ERDEM BAŞÇI*

ABSTRACT

The recent global financial crisis presented substantial challenges and lessons for all economic agents. One of the most important lessons learned was the indispensability of financial stability for the smooth functioning of the economy as a whole. The Central Bank of the Republic of Turkey (CBRT), being aware of the conditions that new global economic conjuncture necessitates, decided to modify its existing framework of inflation targeting by adopting a new policy by using required reserve ratios and interest rate corridor. The new policy mix approach preserves the main objective of achieving and maintaining price stability while safeguarding financial stability as a supporting objective.

The expansionary monetary policies, which were adopted by central banks of developed countries in the aftermath of the global financial turmoil with the aim of containing the impact of the global crisis, had significant implications for developing economies and Turkey was no exception.[1] During this period, the availability of ample and low-cost short-term foreign financing led to a rapid credit expansion and appreciation pressure on the Turkish lira. This brought the accumulation of macro-financial risks and rising external imbalances as of the second half of 2010.[2] As escalating risks pertaining to financial stability have the potential to hamper price stability over the medium term, different approaches for incorporating financial stability into the monetary policy framework started to be discussed in the academic literature and policy institutions.[3]

* Governor, The Central Bank of the Republic of Turkey (CBRT), erdem.basci@tcmb.gov.tr

Insight Turkey Vol. 14 / No. 2 / 2012
pp. 23-26

Photo: REUTERS, Adrees Latif

An Occupy Wall Street protester sits near makeshift signs in New York's Union Square.

The Central Bank Law, which was amended in 2001, gives responsibility the Bank with taking necessary measures to contribute financial stability alongside its primary mandate of achieving and maintaining price stability. Accordingly, in order to contain macro-financial risks in the domestic economy posed by the global imbalances, the CBRT designed and launched a new policy strategy by the end of 2010. The new strategy preserves the main objective of achieving and maintaining price stability while safeguarding financial stability as a supporting objective. In this context, in addition to the policy rate, complementary tools such as reserve requirement ratios and the interest rate corridor are also used in order to cope with financial imbalances. These policies aim to ensure sounder economic growth in a gradual way without hampering the medium-term inflation outlook. Accordingly, policies are pursued to prevent excessive deviation of the exchange rate from economic fundamentals, while the necessary measures are taken in collaboration with other regulatory institutions, to avoid excessive credit growth.[4]

The New Policy Mix

In the period between November 2010 - when the new policy strategy was introduced - and August 2011, which was marked by escalating uncertainties in the European economy, the monetary policy strategy was shaped around two axes. First, channeling capital inflows towards long-term investments and preventing the over-appreciation of the Turkish lira was targeted. And the second goal was a more controlled growth in domestic loans and domestic demand while rebalancing domestic and external demand. During this period, the interest rate corridor was widened to the south due to the strong risk appetite and intense short-term capital inflows. Hence, overnight interest rates were allowed to occasionally fall below the policy rate so that short term carry trade was discouraged. Also during the same period, reserve requirement ratios were significantly increased with the goal of preventing excessive credit growth and controlling domestic demand. Moreover, foreign exchange buying auctions were held regularly to take advantage of strong capital inflows in reserve build-up. These measures made a significant contribution in mitigating excessive appreciation pressures on the Turkish lira.[5] Meanwhile, a notable deceleration was observed in loan growth after mid-2011 owing also to the measures taken by other public authorities, especially those taken by the Banking Regulation and Supervision Agency. As a consequence, the composition of aggregate demand and the quality of capital inflows started to improve, allowing the Turkish economy to follow a rebalancing path as of mid-2011.

Policy After August 2011 – Sovereign Debt Problems in Eurozone

Due to mounting concerns over the global growth outlook and sovereign debt problems in some European economies, as of August 2011, global risk aversion escalated and volatility in risk appetite reached historic highs.[6] As capital outflows from developing countries accelerated in this period, the CBRT used the same policy tools but in the opposite direction than during the period of rapid capital inflows. The interest rate corridor was narrowed through raising overnight borrowing rates and Turkish lira reserve requirements were revised to decrease the liquidity requirement of the banking sector. Moreover, a series of liquidity measures were introduced to contain fluctuations in the foreign exchange market.

However, the rise in inflation was higher than expected due to the excessive depreciation of the Turkish lira stemming from the deterioration of the global risk appetite since August 2011 and adjustments in administered goods prices in the final quarter. In order to contain the adverse effects on the medium-term inflation expectations and outlook, the CBRT raised overnight lending rates in October 2011 and widened the interest rate corridor upwards. Thus, overnight lending rates were permitted to materialize above the policy rate through adjustments to the funding provided to the market. In the meantime, reserve requirement ratios were reduced in order to prevent an undesirable tightening in liquidity conditions driven by the increase in overnight interest rates.

Accordingly, the measures taken since August 2011 have significantly contributed to alleviate the adverse effects of global problems on the Turkish economy. The CBRT's measures regarding the foreign exchange market and decisions related to the interest rate corridor in August and October 2011 reduced the degree of fluctuations in the exchange rate compared to that of other emerging market economies. Meanwhile, the monetary tightening implemented since October 2011 has also contributed to moderating the excessive credit growth.

Conclusion

As was the case in 2011, the CBRT will continue to safeguard the flexibility of the monetary policy in line with changing global conditions, and ensure predictability through effective communication. The monetary policy will continue to contribute to the sustainable growth prospects of the Turkish economy in the context of price stability.

Endnotes

1. For global financial crisis, see: Reinhart, C. and Rogoff, K. "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises". *NBER Working Paper*, No. 13882, (2008).

2. Çınar, B., Erdoğan, Ö., Gürgür, T. ve Polat, T. "Küresel Kriz Etkileşim Kanalları ve Türkiye Ekonomisi". *TCMB Ekonomi Notları*, No. 10/07, (2010).

3. Goodhart, C. "The Changing Roleof Central Banks". *BIS Working Papers*, No. 326, (2010); Borio, C. "Central Banking Post-Crisis: What Compass for Uncharted Waters?" *BIS Working Papers*, No. 353, (2011).

4. For the effects of over borrowing, see: Cecchetti, S., Mohanty, M. S., and Zampolli, F. "The Real Effects of Debt". *BIS Working Papers*, No. 352, (2011).

5. Başçı, E. and Kara, H. "Finansal İstikrar ve Para Politikası". *İktisat, İşletme ve Finans*, Vol. 26, No. 302, (2011).

6. Eichengreen, Barry; Mohamed El-Erian, Arminio Fraga, Takatoshi Ito, Jean Pisani-Ferry, Eswar Prasad, Raghuram Rajan, Maria Ramos, Carmen Reinhart, Hélène Rey, Dani Rodrik, Kenneth Rogoff, Hyun Song Shin, Andres Velasco, Beatrice Weder di Mauro ve Yongding Yu: Committee on International Economicand Policy Reform (2011). "Rethinking Central Banking". *Brookings and Alfred P. Sloan Foundation e-Book*. http://www.brookings.edu/reports/2011/09_ciepr_central_banking.aspx; For the effects of uncertainty shocks, see: Bloom, Nicholas. "The Impact of Uncertainty Shocks". *Econometrica*, 77 (3) (2009) p. 623-685.