Turkish Experience with Inflation Targeting

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Outline

1. Performance under inflation targeting
2. Operational framework for inflation targets
3. Fiscal-Monetary coordination
4. Capital flows and inflation targeting
The evolution of Inflation Targeting regime in Turkey

- 2001 - 2005: Implicit Inflation Targeting (IT)
- 2006 - 2010: Full-fledged IT
- 2011 - 2015: Integrating financial stability into IT
- 2016 to date: Stronger focus on structural factors
Inflation and Targets: 2001-2017

CPI Inflation (y-o-y) (Percent)

- Implicit Inflation Targeting (IT)
- Conventional IT
- Integrating Financial Stability into IT

Strengthened emphasis on structural factors

Implicit Inflation Targeting (IT)

Conventional IT

Integrating Financial Stability into IT

Targets

Inflation


0 10 20 30 40 50 60 70 80

CPI Inflation (y-o-y) (Percent)
Inflation and Targets: 2006-2017

CPI Inflation (y-o-y) (Percent)

Conventional Inflation Targeting (IT)

Integrating Financial Stability into IT framework

Inflation

Targets
Inflation Targets and Expectations (2002-2006)
Operational Framework for Inflation Targeting
Main parameters of the operational framework

- Target level: 5 percent
  - Target variable: end year CPI inflation
- Uncertainty band ± 2 percent
  - Accountability: open letter to the government
- Target horizon: 3 years
- Forecast horizon: 3 years
Why 5 percent?

- Convergence of prices to EU levels
- Structural factors
  - Demographic factors, external balances
- Substitution effect
- Quality improvement and new product bias
Why ±2 percent tolerance band?

- Volatility of unprocessed food prices
- High exchange rate pass-through

Contribution of fresh fruit and vegetables to inflation
(Percentage points)

Pass-through from FX to Inflation in Emerging Countries
(At the end of 12-month period, percent)
Presentation of Inflation Forecast

Forecast Range - Uncertainty Band • Year-End Inflation Targets

Output Gap

Control Horizon
Monetary-Fiscal Policy Coordination

- Ownership/enforcement of the government in achieving targets.
  - Involvement of the government in setting the target
  - Government’s willingness to attain price stability

- Fiscal-monetary coordination is crucial for long-lasting price stability.
  - Also key for managing expectations, easing trade-offs.

- Inflation target should be incorporated as a «hard parameter» in government’s medium term budget plans.
  - Consistency of tax/administered prices and wage setting with the inflation targets.
Some Lessons from Turkey’s IT Experience

- Building credibility (convergence of expectations to target) takes time.
  - «Just do it»
  - Prove that it is not good luck
- Having a convincing track record is a prerequisite to anchor expectations.
- Is it possible to speed up the convergence of expectations to the target?
  - Simple, transparent, and consistent communication
  - Inflation forecast credibility (betting against the market and being vindicated)
  - Government’s endorsement (fiscal-monetary policy coordination)
How much weight should the CB attach to inflation expectations?

12-Month ahead inflation expectations
(Percent)

- Professionals
- Market Based
- Households

Source: CBRT, TURKSTAT.

Last Observation: June, 2017.
May, 2017 for Households.
Capital Flows and Inflation Targeting
The Role of Capital Flows in Amplifying Financial Cycles

- Global Liquidity
- Capital Inflows
- Improved risk perceptions
- Currency Appreciation
- Rapid Credit Growth
- Balance sheet and collateral effects, further credit growth
IT and reaction to capital flows

- Global Liquidity
- Improved risk perceptions
- Flexible Interest Rate Corridor
- Capital Inflows
- Reserve Requirements
- Currency Appreciation
- Rapid Credit Growth
- Balance sheet and collateral effects, further credit growth
IT and reaction to capital flows: An example
The interaction between capital flows, exchange rate and bank loans has been dampened in recent years.

Capital flows, exchange rate, and credit cycles
(HP filtered, standardized)

Source: Kara, Özlü and Ünalmış (2015)
Challenges and Lessons

- Complex transmission mechanism of multiple tools
- Difficulty of linking each tool to objectives (unlike pure IT)
- Overall, it might be wiser to preserve the credibility of monetary policy by avoiding the burden of multiple objectives.
  - Keep close coordination with macroprudential and fiscal policy
  - Address the origin of the problem through deep-seated policies.
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