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FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Research Brief #9

Global Constraints on Central Banking: The Case of Turkey

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I. Introduction

In the period before the global economic crisis, many developing countries adopted inflation targeting as their monetary policy regime. Turkey joined this group in 2002 by adopting implicit inflation targeting. But by 2006 it had adopted full-fledged targeting. However, in the aftermath of the 2008 crisis, inflation targeting regimes lost their attractions throughout the world, paving the way for more complex monetary policy regimes.

Developing countries focused on shielding their economies against the spillovers of external financial developments. In this regard, Turkey emerged as one of the most experimental countries: its monetary authorities focused on developing new policy tools in order to ensure stability of its financial system and secure its economy against external financial shocks.

This Research Brief #9 for Work Package #6 draws on FESSUD Working Paper #143, "Financialisation, Uneven Development and Faltering Governance: The Case of Turkey" as well as Benlialper, A. and Cömert, H. (2015), FESSUD Working Paper #111. It will briefly analyze the evolution of central bank policies in Turkey after 2002. Its main findings are summarized here.

First, central banking in Turkey has changed significantly in the aftermath of the 2008-9 crisis. The Central Bank of the Republic of Turkey (CBRT) has adopted a much more careful stance in addressing developments in financial markets. Even though it has formally retained inflation targeting as its monetary policy regime, its new framework is fundamentally different from "pure" inflation targeting.

Second, both descriptive statistics and some econometric analysis suggest that there are major obstacles to the effectiveness of monetary policy in Turkey. Because of the direct impact of international financial flows on key macroeconomic variables, control over intermediate monetary variables such as interest rates now seems to be problematic.

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Thus, the existing policy framework, in which financial stability is a priority, is likely to be unsuccessful. Moreover, financial flows are shaped mainly by global risk appetite rather than domestic conditions. Thus, such flows are effectively beyond the control of domestic monetary policy. Hence, new policies are needed in order to address the problems emanating from international financial flows.

II. Policy Shifts in the Post Crisis Period

After the first shock of the 2008-9 crisis abated, advanced countries resorted to unconventional monetary policy measures in order to recapitalize their financial markets. As an example, they pumped liquidity into financial markets. This action resulted, in turn, in a global scramble for higher yields, which triggered greater capital flows to developing countries where financial returns were higher.

Thus, such countries faced new challenges. Instead of facing illiquidity problems, they were subject to the vagaries of volatile capital flows. Hence, they have begun to keep a watchful eye on cross-border financial flows. In response, developing-country central banks have been obliged to use a new range of policy tools in order to reach multiple targets in their pursuit of financial stability. In this process, CBRT has embraced five pillars in its struggle to preserve financial stability: a one-week repo rate, an interest-rate corridor, liquidity management, required reserve ratios and a reserve option mechanism.

Interest-Rate Corridor

For example, one-week repo rates, which are used for liquidity management, were substituted for overnight interest rates after 2010. In addition, instead of waiting for the next Monetary Board decision, which is conducted on a "monthly" basis, the CBRT has used an interest-rate corridor in order to change short-term interest rates much more frequently.

Since shocks emanating from external financial flows can affect domestic financial conditions very rapidly, the corridor has provided the Bank with an opportunity to quickly respond to changing conditions. In fact, market interest rates have tended to fluctuate within this band, indicating that the corridor policy has had some success.

The interest rate corridor has been deployed mainly as a response to the changing nature of capital flows. When capital inflows have been strong, the lower bound of the corridor has been reduced in order to create uncertainty about the lowest value of short-term interest rates. This uncertainty has tended to discourage greater short-term capital inflows. However, in the case of financial outflows (such as in 2011), the Bank has raised the upper bound of the corridor in order to attract more financial inflows.

However, such policies have created a policy dilemma since lower interest rates would tend to ease the pressure on the Lira to appreciate. But such an outcome would fuel domestic credit growth. Hence, the CBRT has had to alter required reserve ratios frequently in order to influence the growth of credit.

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Reserve Option Mechanism

The CBRT has also taken measures to contain the foreign-exchange exposure of the banking system and thereby reduce exchange-rate volatility. Most notably, it has introduced the Reserve Option Mechanism (ROM), which has allowed banks to hold a portion of their reserve requirement as foreign currency or gold.

When capital inflows are strong, banks are expected to use the ROM facility more. This is expected, in turn, to ease appreciation pressures and provide buffers of foreign-exchange liquidity that could be used in the event of capital outflows.

Similarly, in the case of economic downturns, banks in need of foreign currency are allowed to utilize the foreign exchange reserves that they are required to hold. Thus, it is expected that ROM should provide a stabilizing mechanism that can moderate the impact of capital flows on Turkey's exchange rate and the foreign-exchange liquidity of its financial system.

III. The Performance of the CBRT after 2002

The overall performance of the Bank appears, however, to have been weak. For example, the Turkish economy experienced a rapid disinflation after 2002. In response, the CBRT was successful in hitting its monetary targets most of the time before the 2008 crisis. However, when the crisis turned the tide, its inflation targets were missed for many years.

Also, Turkey's relatively good growth performance has not resulted in a corresponding increase in job opportunities. In fact, there was a dramatic increase during 2002-2014 in the level of unemployment, as it peaked at 10.6%. This level compares unfavorably to its performance during 1987-2001, when unemployment peaked at only 7.9%. Although Turkey's economy has suffered from chronic high unemployment for more than a decade, the CBRT does not seem, unfortunately, to be overly concerned about such an outcome.

Another major concern has been Turkey's high current-account deficits since they can signal underlying structural problems in the economy. After 2002, Turkey's economy witnessed a gradual increase in its current-account deficit, leading eventually to unprecedentedly wide levels. Although the 2008 financial crisis halted this trend temporarily, its deficit worsened again after 2010. The performance of the Turkish economy on this front has been one of the worst, in fact, among comparable countries (Benlialper et. al, 2016).

Capital Inflows and External Debt

Chronically wide current-account deficits during 2002-2008 were financed by massive net financial inflows, which increased to an average of 5 percent of GDP. When capital inflows to developing countries began to soar in 2010, Turkey's economy ended up attracting capital that was equivalent, on average, to 8 percent of GDP during 2010-2014. This performance surpassed that of many other comparable developing countries (Benlialper et. al, 2016).

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Benefiting from the enormous size of capital inflows, the CBRT increased its foreign exchange reserves between 2002 and 2014. However, given the huge level of Turkey's external debt, the ratio of reserves to external debt has, in fact, remained low compared to the levels achieved by comparable developing countries. The ratio of short-term capital flows to total capital flows has also increased, especially after 2010. As a result, the share of net foreign direct investment in total capital inflows declined, unfortunately, from 30 percent during 2002-2008 to 15 percent during 2010-2014.

Hence, the overall evidence is mixed with regard to the performance of the CBRT. There have been achievements on some fronts (such as inflation and economic growth), when outcomes are compared to historical averages. However, the Turkish economy certainly has a chronic unemployment problem. Moreover, the economy appears to have become more fragile, especially in its ability to respond effectively to changing global conditions, and to capital flows in particular.

IV. Global Constraints on the Effectiveness of the CBRT

Following its new policy framework, which it had developed after the global crisis, the CBRT keeps a watchful eye on key macroeconomic variables such as inflation, the exchange rate and credit growth. However, its ability to affect these variables seems to be significantly constrained by variable cross-border capital flows.

Credit growth has an important effect on inflation, economic growth and financial stability through various channels. Hence, the CBRT has placed a special emphasis on managing credit growth and has declared a 15 percent annual growth target. However, since external financing can substitute for domestic credit, this factor restricts the impact of the bank's policy tools (such as its required reserve ratio and its liquidity policies).

There is, in fact, a close relationship between international financial flows and credit growth. Similarly, boom and bust cycles are strongly associated with movements in such capital flows (Benlialper and Cömert, 2015).

Financial flows have also had a pronounced impact on exchange rates. The value of Turkey's exchange rate, together with international commodity prices, has been the most important determinants of inflation. Especially during the steady depreciation trend of the Turkish Lira after May 2013, inflation has worsened. And this effect has restricted, in turn, the Bank's ability to hit its inflation targets through using conventional monetary policy tools.

Global Risk Appetite

Although domestic factors play some role in explaining the direction of movement and the magnitude of capital flows, the main factors for countries similar to Turkey are global risk perceptions, which, in turn, determine global liquidity conditions.

In fact, there seems to be a high correlation (in absolute terms) between VIX (a well-known indicator of global risk perception) and capital flows to Turkey (Benlialper and Cömert, 2015). Since capital flows are mostly determined by global risk appetite rather than individual countries' domestic conditions, an independent monetary policy becomes a daunting task for central banks (Rey, 2013).

Moreover, as Rey 2013 shows, the VIX indicator appears to be quite sensitive to changes in the US Federal Reserve's interest rate. Thus, it is likely that developing-country central banks (such as the CBRT) are obliged to move their policy rates in line with the interest rate decisions of major advanced countries' central banks (such as the Fed or ECB).

In fact, using econometric analysis, Benlialper and Cömert (2015) demonstrate that the ECB and the Fed interest rates are the most important variables that explain the variation of the policy interest rate of the CBRT. Thus, the interest rate decisions of major advanced countries play a crucial determining role in the interest rate decisions of the CBRT as well as other developing-country central banks, and thereby undermine the basis for any independent monetary policy.

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