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Monetary and macro-prudential policies in Turkey

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Thank you for inviting me to this excellent Forum and for giving me the opportunity to talk about monetary and macro-prudential policies in Turkey.

The main problem in the Turkish economy since the global financial crisis has been rapid credit growth. With reference to what Lars Svennson said this morning, if we have to tighten, we should use monetary policy or macro-prudential policy. We have used both of these as the circumstances have warranted.

I will start my talk by mentioning a structural change which I think has happened since the global financial crisis. The Fisher curve has not only shifted downward, but also its slope has come down since the crisis. This has many explanations. Before the Lehman crisis the reaction of the interest rate to inflation changes in Turkey was quite strong. It was actually more than one to one – the coefficient was around 1.5. More specifically, if inflation went up by one percentage point we would hike the rates by 1.5 percentage points. By inflation I refer to actual inflation, not to expected inflation. This approach was extremely hawkish in order to gain some credibility and to lay the groundwork for full-fledged inflation targeting.

Right after the Lehman crisis, the output gap widened and the Treasury's benchmark interest rate fell, together with some policy rate cuts. Interest rates descended to unprecedentedly low levels. Then we experienced a sharp recovery, but afterwards the recovery benchmark interest rates still remained at these relatively low levels compared to pre-Lehman periods. This case is not specific to Turkey; rather it is a global phenomenon. Indeed, real interest rates dropped significantly across all emerging market economies. In Turkey, the slope of the Fisher curve came down and the coefficient declined to 0.37. This was partly due to the flexible inflation targeting and the credibility that had been built while reacting to actual as well as expected inflation. Moreover, the use of macro-prudential measures also had an impact on the decline of the slope. Without the macro-prudential measures we would not have been able to keep the rates as stable and as low as they are right now.

Turkey has been experiencing a disinflation process since 2002. The Turkish Government changed the law in 2001 after the country's financial crisis and the Central Bank was given legal independence. Moreover, the Government started producing quite significant primary budget surpluses. First, we had implicit inflation targeting between 2002 and 2005. The inflation rate came down along with the target rate. In 2006 we began full-fledged inflation targeting and since then year-end inflation has remained in single figures for all but two years. The average inflation rate has been around 8% and the target average has been approximately 6% throughout the full-fledged inflation targeting period. Currently the target inflation rate is 5% and the year-end inflation rate was 7.4% last year.

Inflation fluctuations are high in Turkey. These fluctuations are largely due to the volatility of international capital flows. The exchange rate impact on inflation is relatively high. The exchange rate pass-through to inflation has been estimated to be between 10% and 15%. Therefore, when there is a sharp depreciation in the domestic currency, then we do feel the effects on inflation. Basically, this is one of the reasons why we deviated from the target recently. However, economic agents have understood that this is temporary and hence long-term inflation expectations are following a more stable course.

As for the real side of the economy, the post-Lehman recovery in Turkey has been quite remarkable. During the initial phase, the recovery featured double-digit growth, at 11%. This was unsustainable. The world is not growing fast, thus external demand was weak. If you grow fast as a result of domestic demand only, you have to run an external deficit. The external deficit reached 10% of GDP in 2011, and was around 6% of GDP before the global crisis, so we started to tighten mostly by using macro-prudential instruments. Furthermore, we used monetary policy occasionally, as well. As a consequence of conducting the macro-prudential measures we will be able to bring the deficit down to around 5% or 6% of GDP by the end of this year. This has not been easy. A global environment of low interest rates has reduced savings. We have an open capital account and chose not to use any capital flow measures. The only instrument employed besides monetary policy has been macro-prudential policy.

Another main determinant of inflation volatility is the credit cycle. The credit cycle has also been quite volatile. Before the Lehman crisis and during the post-Lehman recovery we have seen a peak credit growth rate of 40% for consumer loans. We have taken two rounds of macro-prudential measures which were coordinated by the Undersecretariat of Treasury and the Central Bank in coordination with the Capital Markets Board, the Banking Regulation and Supervision Agency and the Savings Deposit Insurance Fund. These institutions form the Financial Stability Committee, which is quite similar in structure to the Mexican Financial Stability Council. The Financial Stability Committee is chaired by the Deputy Prime Minister in our case because of the fiscal aspects of macro-prudential policy. All in all, we undertook two rounds of macro-prudential tightening measures. The first round basically had an impact on all types of loans without any distinction. However, the second round of measures which was quite recent, effectively implemented in February of this year, targeted credit cards and consumer loans only. These measures worked. This is the first time that the speed of consumer loan growth in Turkey has been below the growth rate of business or commercial loans. We are quite happy with this result, because it helps disinflation and at the same time it helps the external balance.

Consequently, inflation expectations remain quite stable but the problem is that inflation expectations for 12 months ahead and 24 months ahead are 2 and 1.5 percentage points above the target respectively. Nevertheless, people do believe in disinflation and expectations for 24 months ahead are always below the expectations for 12 months ahead. So the Central Bank has some credibility there, but we are not at the target yet. So we have to show that we can achieve a rate of 5% in 2015 and keep inflation at around that level afterwards.

The interest rate dilemma makes macro-prudential measures necessary. To achieve price stability you have to have currency stability and credit stability to some extent. For currency stability in the current global environment we need rates that are compatible with low global interest rates, while credit stability requires higher domestic rates than global interest rates. How do you resolve this dilemma? The resolution in the Turkish case is to keep interest rates lower than they would otherwise be and to keep macro-prudential policy tighter than it would otherwise be. So our macro-prudential stance is much tighter than the international minimum standards. At the same time, interest rates are relatively low compared to the closed economy equilibrium.

Real interest rates for two-year Treasury bonds have come down from more than 10% during the pre-Lehman period to below 2% recently. Excessively rapid credit growth was curbed by using only one instrument, the nominal interest rate, before the Lehman crisis. After using all these macro-prudential measures we have been able to keep interest rates low, fluctuating around 2% in real terms. So we can keep them at this level, still continue with internal balance and continue to move towards external balance.

The macro-prudential measures we used include loan-to-value measures, loan-to-income restrictions, higher risk weight and levies on consumer loans, general provisioning requirements and reserve requirements.

The loan-to-value ratio for housing loans is 75% in Turkey. Although it is quite strict compared with many European countries, it is not as strict as in many Asian countries. Singapore, for instance, imposes 20% loan-to-value restrictions on households' third property.

Loan-to-income restrictions have recently been implemented for credit cards. The credit card debt balance must not exceed four months' worth of income of the card holder. This measure started to be implemented in February of this year. It is very effective. Since February, the net credit card debt balance has come down.

The bank regulator applies higher risk weights on consumer loans vis-à-vis business loans. They are around 150%-200% depending on the maturity, while loans to small and medium-sized enterprises have a risk weight of 75% and housing loans have a risk weight of 50%. In this respect, Turkey's approach is somewhat tighter than the minimum standard approach of applying a 35% risk weight on mortgages. The Ministry of Finance has also increased the levy on consumer loans.

General provisioning requirements is another macro-prudential measure in our toolset. The IMF asked for this to be doubled from 0.5% to 1% before Turkey graduated from the Fund's programmes in 2008. Recently, the bank regulator raised the general provisioning requirement to 4%.

In order to use reserve requirements as a macro-prudential instrument we have stopped remunerating reserves so as to increase effectiveness and have also hiked the reserve requirements of banks quite significantly to 10%.

Since then, the Central Bank has used reserve requirements mainly as a structural instrument for the following purposes. In order to increase the maturity of deposits, we have used maturity-based reserve requirements. Likewise, to reduce liability dollarisation, we have used currency-based reserve requirements. Moreover, to improve the banks' risk indicators, we have recently started to use leverage-based reserve requirements. We have also introduced the Reserve Options Mechanism (ROM), which enables banks to hold their domestic currency reserve requirements at the central bank in the form of foreign currency. This is an automatic stabiliser of international capital flows, especially debt flows.

Aside from the ROM, we have also used monetary policy instruments as cyclical stabilisers. The previous macro-prudential tools were basically structural, automatic stabiliser measures. We have also used some discretionary instruments. These discretionary tools are the policy rate (one-week repo rate), the interest rate corridor, Turkish lira liquidity management and foreign currency liquidity management. These instruments have been used in addition to macro-prudential policy tools.

The Central Bank has used the interest rate corridor and Turkish lira liquidity policy by taking the internal and external conditions into consideration. This is in line with the advice of Professor Charles Goodhart:

"But even when interest rates are above the zero bound, there is a range of freedom to operate liquidity management independently. This margin of freedom may now, perhaps, be greatly augmented by the generalized adoption of the "corridor" system for managing short-term interest rates. In principle at least, the corridor system could be so managed that liquidity policy and interest rate policy could be varied in a largely independent fashion. Thus, for example, official interest rates could be raised to counter speculative attacks on the exchange rate, while at the same time the liquidity of the domestic financial system could be maintained, or even enhanced, leaving market rates at the lower edge of the corridor."[1]

[1] Goodhart, C. (2010), "The Changing Role of Central Banks", *BIS Working Paper Series*, No 326, November.

He also suggests that "treating these parameters as a constant would be a waste of a good instrument."[2]

When we need to tighten, we widen the corridor to the north and accompany this with a temporarily tighter liquidity policy. When we want an expansionary phase, then we widen it to the south. Both of these actions work through the exchange rate in particular. When we widen the corridor to the north and tighten liquidity policy, it helps stabilise the currency and also it makes a noticeable contribution to slowing down credit growth. For example, after the announcement of "tapering" by the Federal Reserve System's Federal Open Market Committee we tightened via liquidity policy. Then after the beginning of tapering in the December-January period, which coincided with some political uncertainties in Turkey, we also hiked the one-week repo rate quite significantly.

All in all, our policy measures are working to stabilise credit growth, currency developments and inflation expectations.

[2] Goodhart, C. (2009), "Liquidity Management", *Financial Stability and Macroeconomic Policy – Federal Reserve Bank of Kansas City Economic Policy Symposium 20-22 August 2009*, Jackson Hole, Wyoming, November.