

Inflation dynamics when the anchor is lost: evidence from Turkey

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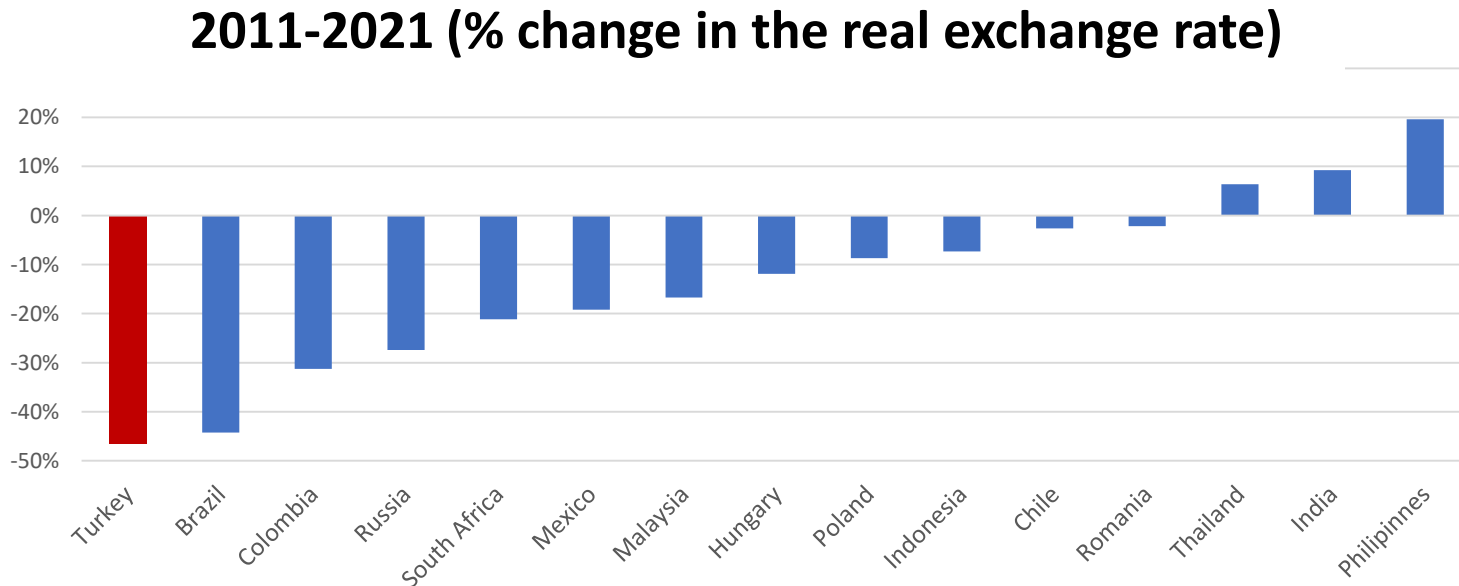
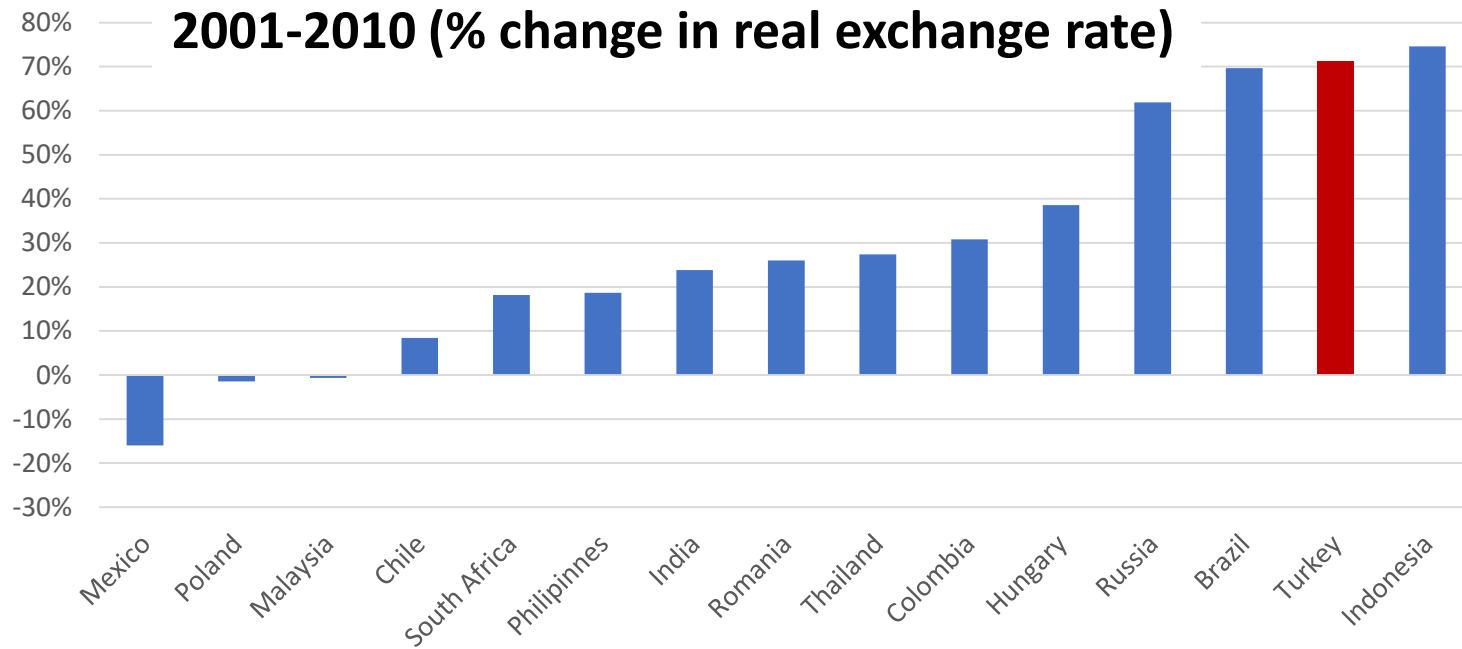
Outline

- Evolution of the monetary policy in Turkey
- Behavioral shift in inflation expectations
- Changing inflation dynamics
- Recent developments

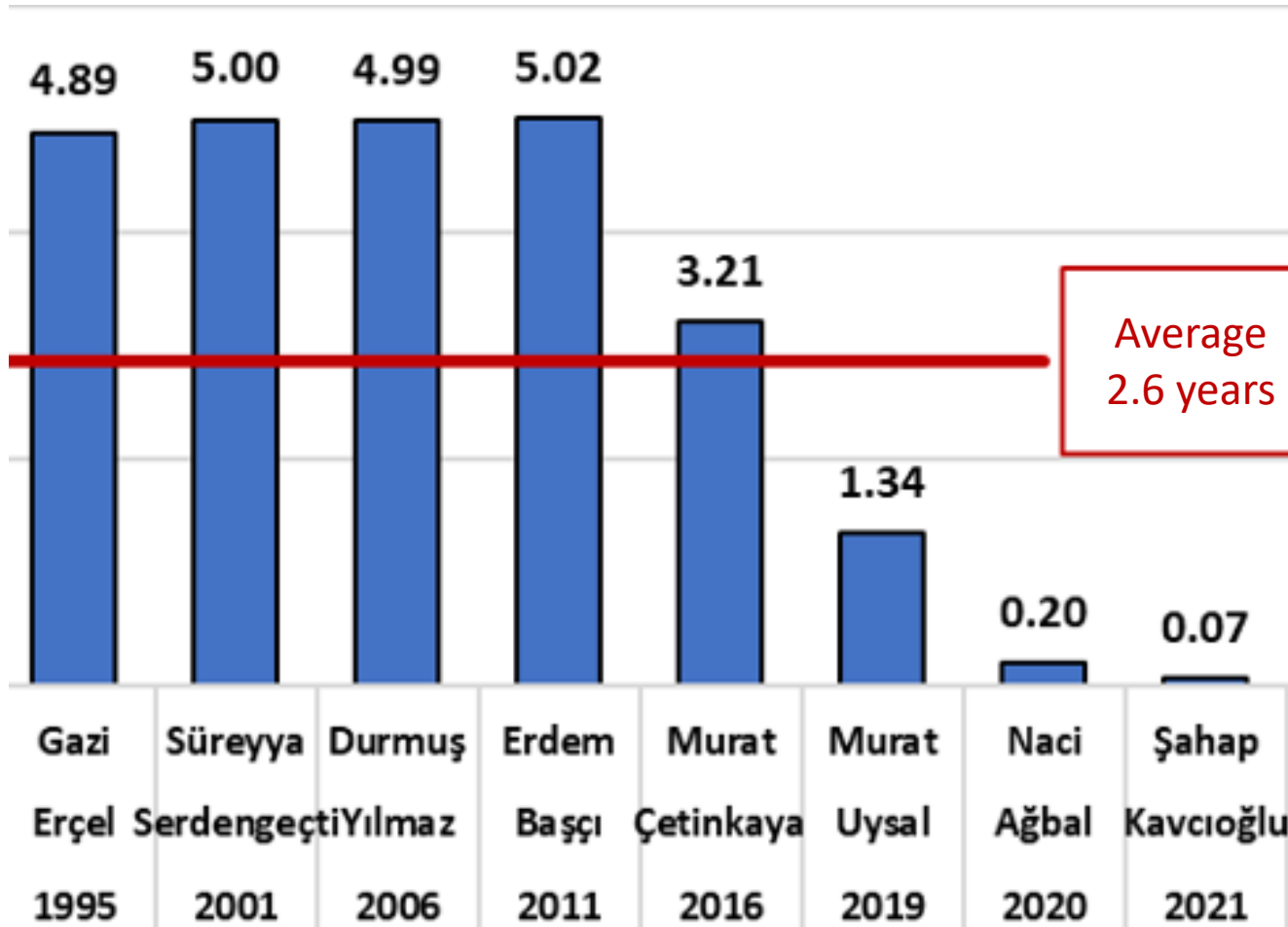
Evolution of monetary policy in Turkey

- “Implicit” inflation targeting: 2001-2005
- Full-fledged inflation targeting (IT): 2006-2010
- Incorporating financial stability into IT: 2011-2021
 - Multiple tools and targets, MaP: 2011-2016
 - Credit and exchange rate as intermediate tools
 - “Competitive exchange rate”: 2017-2021
 - Emphasis shifted to growth and external balance

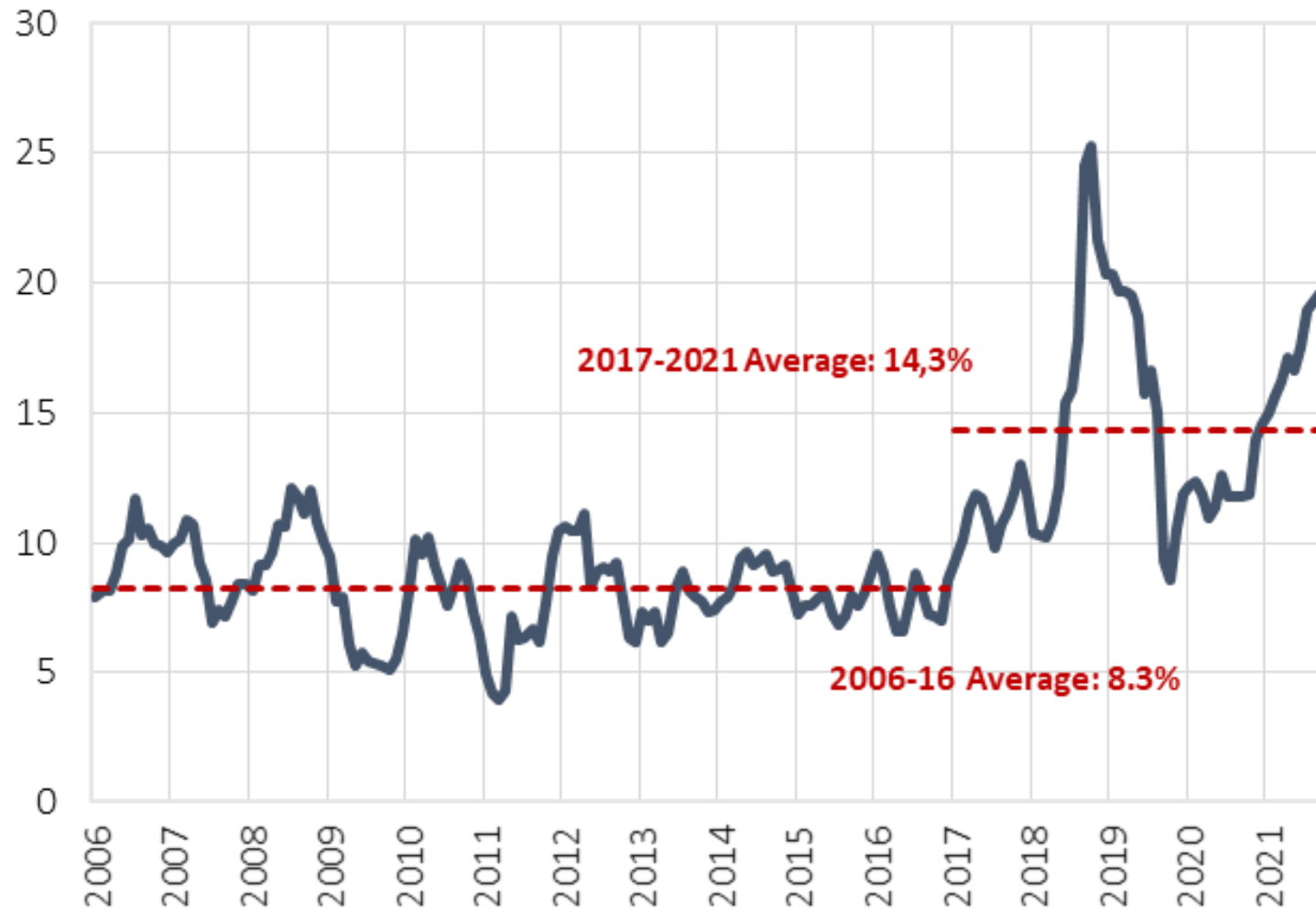
Real exchange rate: comparison with peer EMs



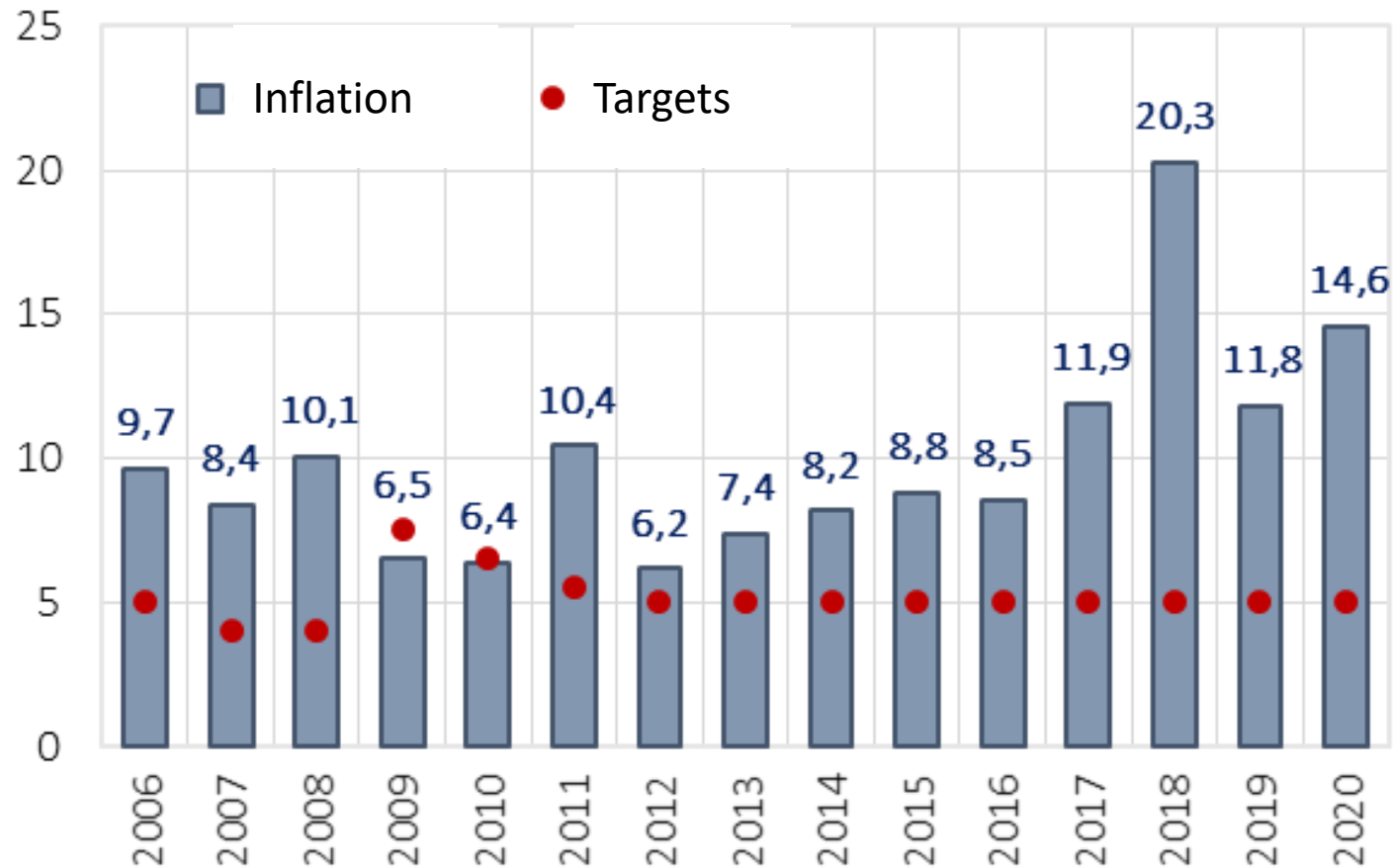
Terms of CBRT governors (years)



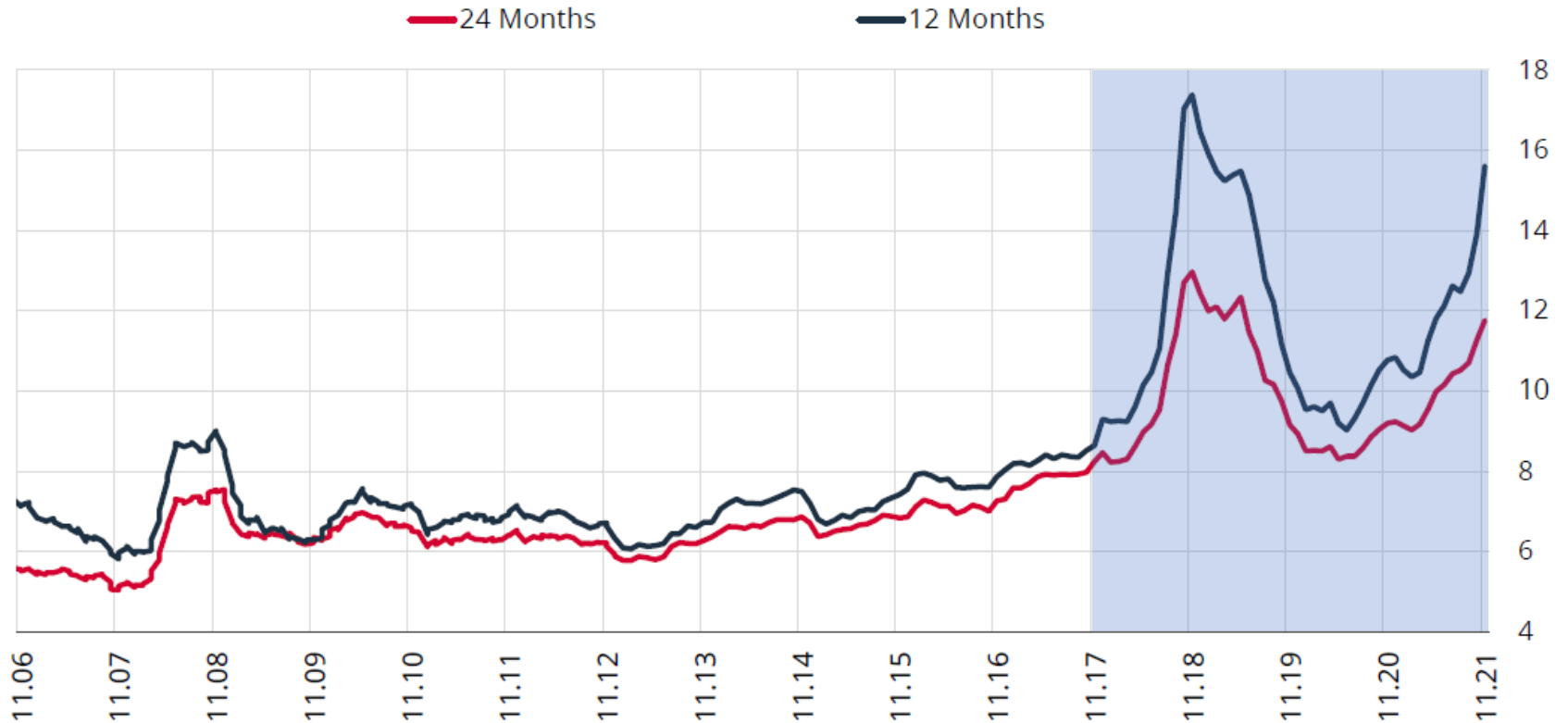
Inflation has moved to double digits since 2017



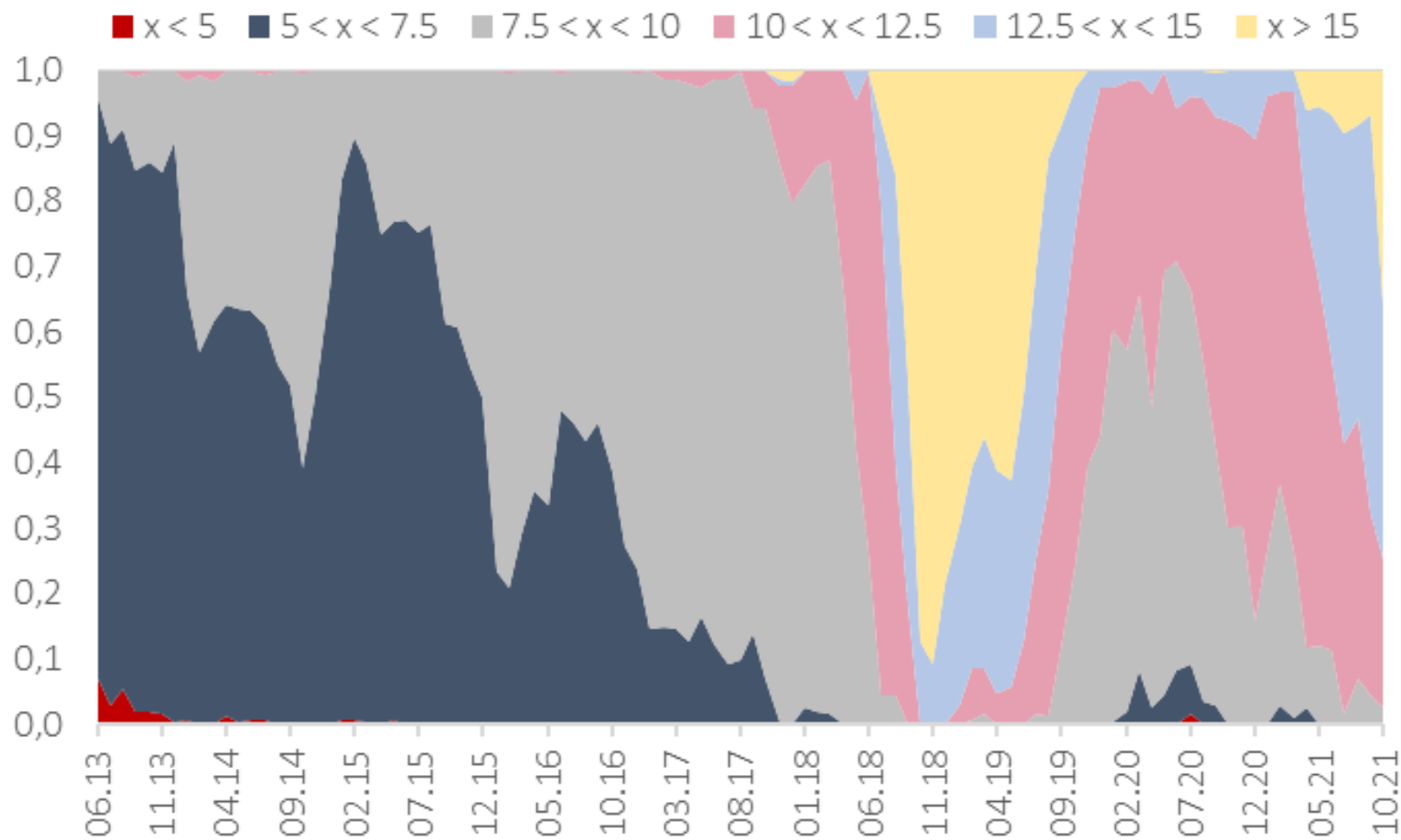
Targets have been breached by a large margin during the past decade.



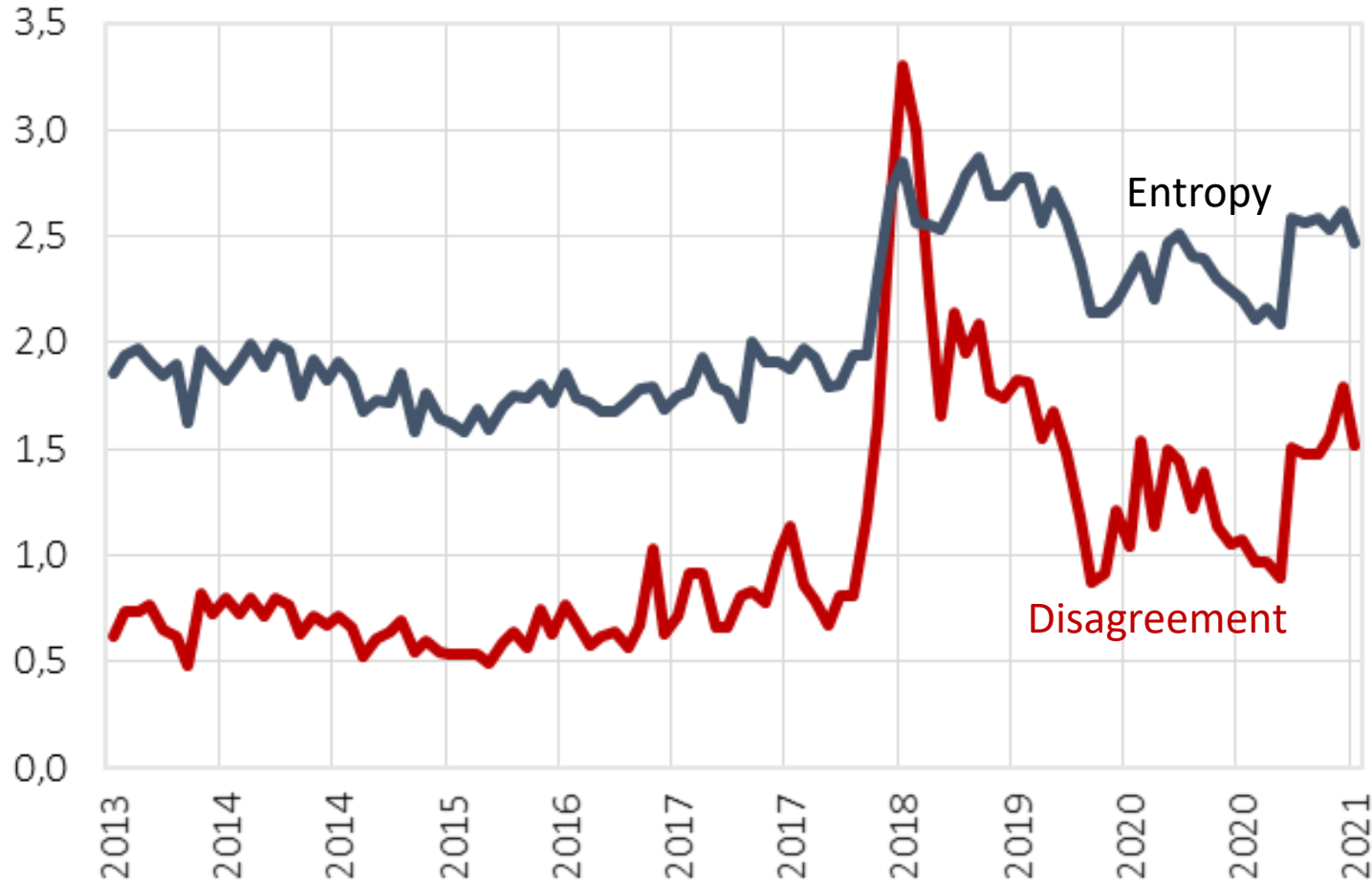
Inflation Expectations (survey based)



Distribution of Inflation Expectations



Inflation uncertainty has increased in recent years.



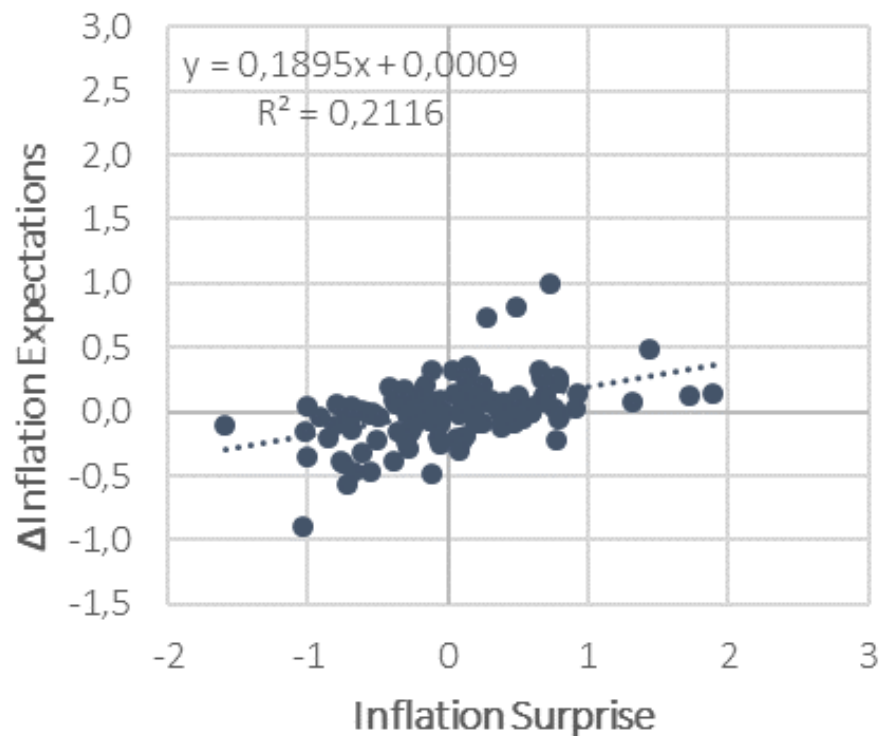
Source: Gülşen and Kara (2019)

Changing Expectation Dynamics

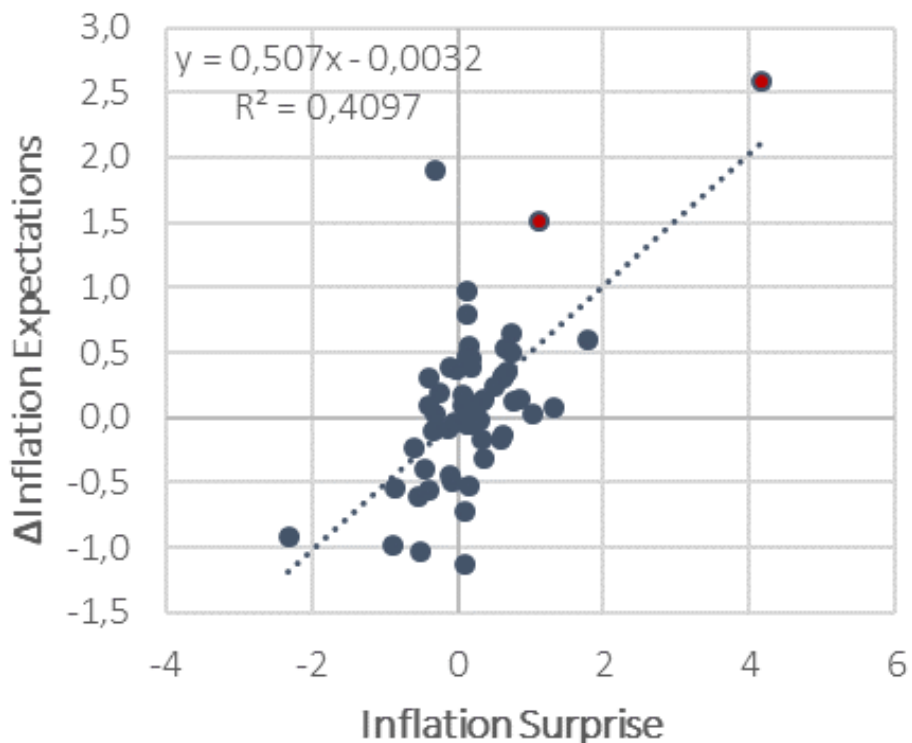
How anchored are expectations?

Sensitivity of 1-year ahead Inflation Expectations to **Inflation Surprises**

2006-2016



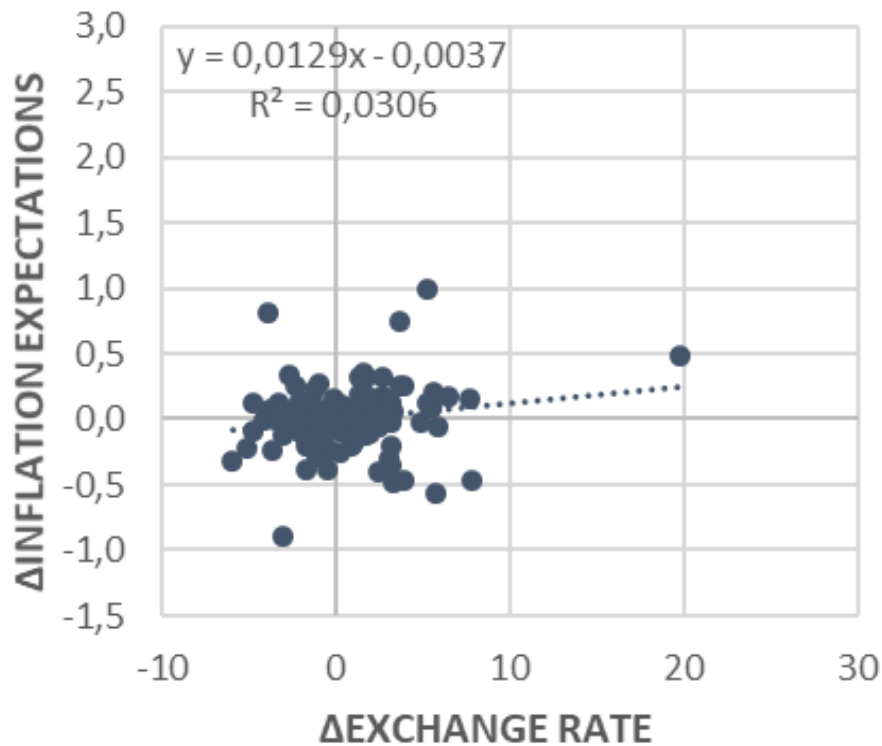
2017-2021



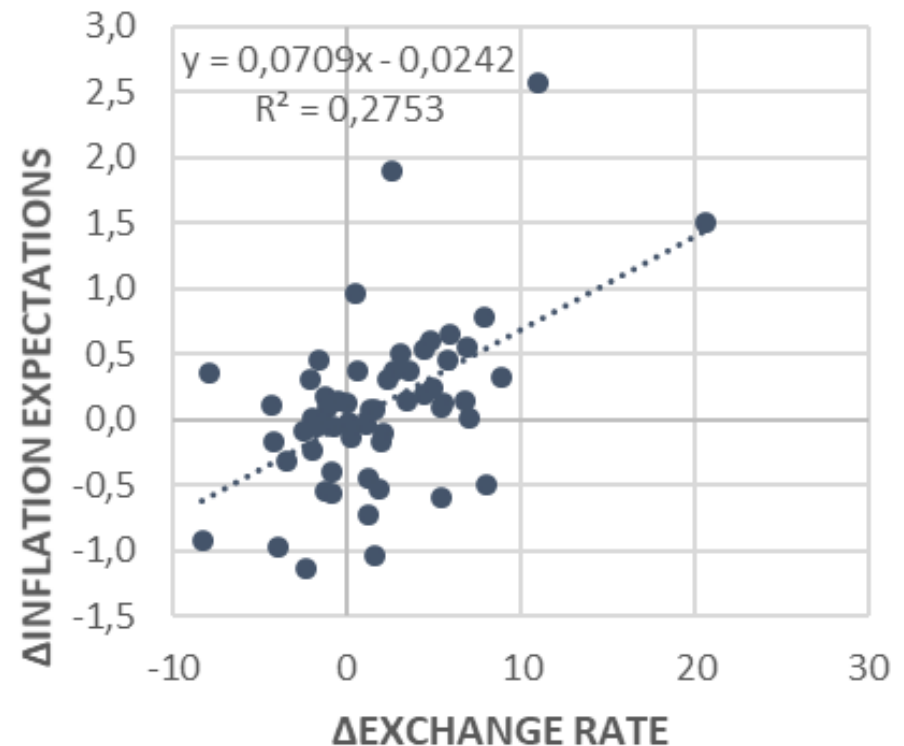
How anchored are expectations?

Sensitivity of 1-year ahead Inflation Expectations to **Exchange Rates**

2006-2016

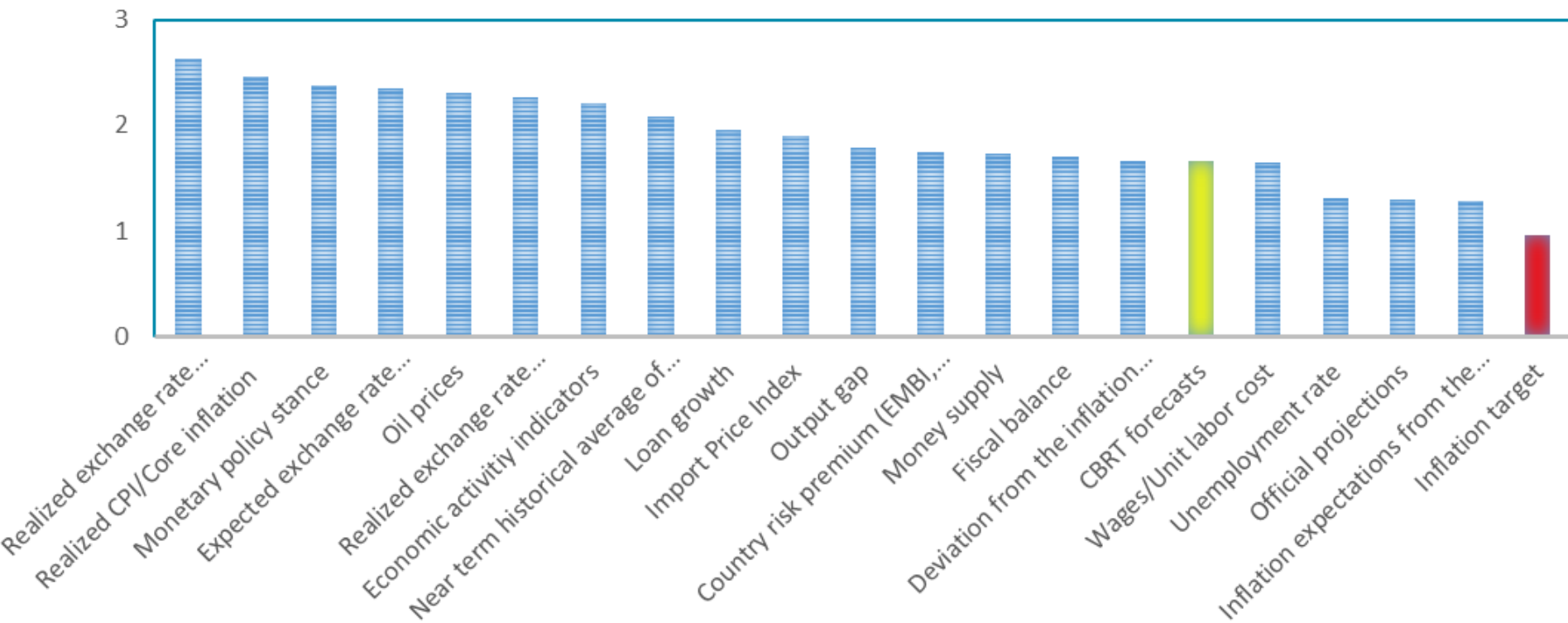


2017-2021



Inflation target no longer serves as an anchor.

DRIVERS OF PRIVATE INFLATION FORECASTS

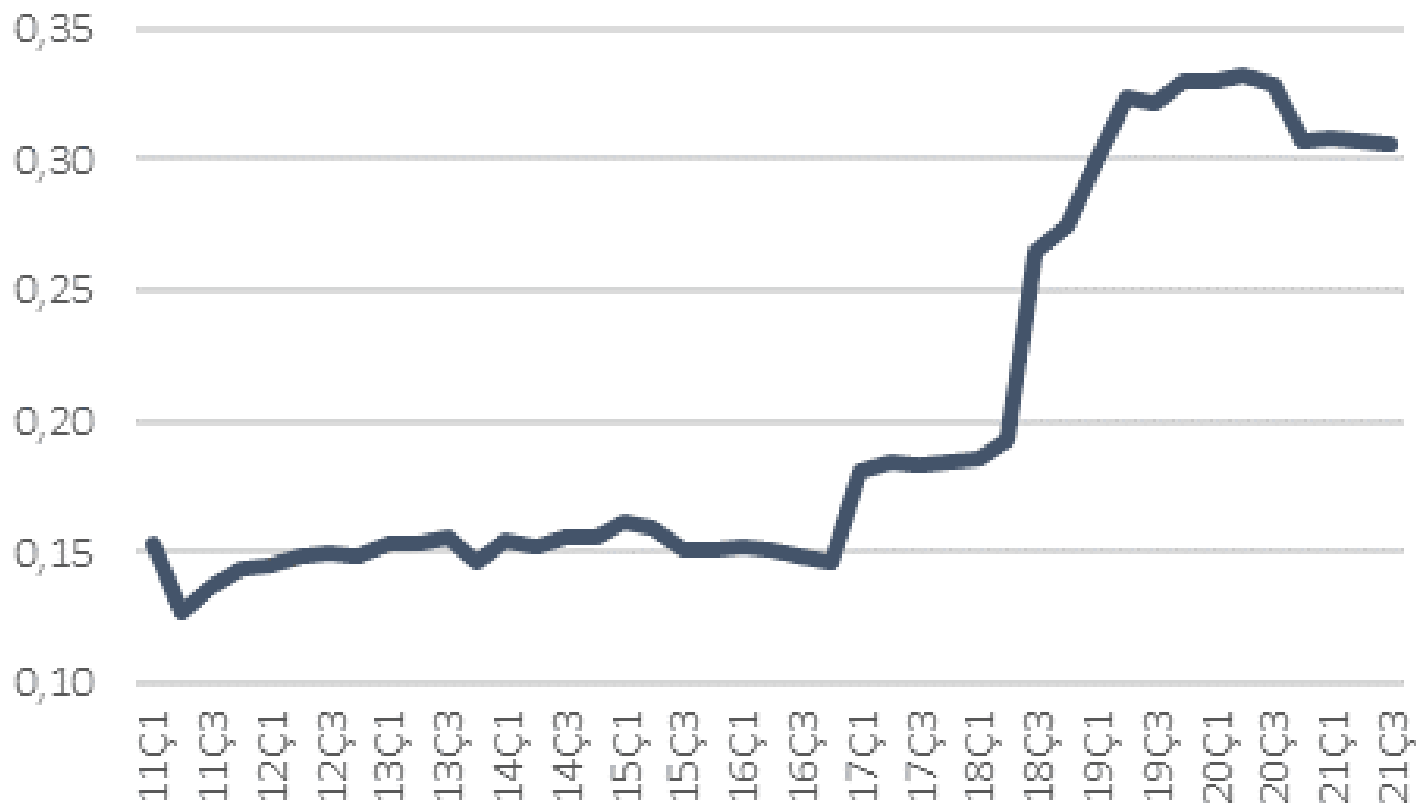


Source: Based on a Survey conducted in Gülşen and Kara (2021)

Changing inflation dynamics

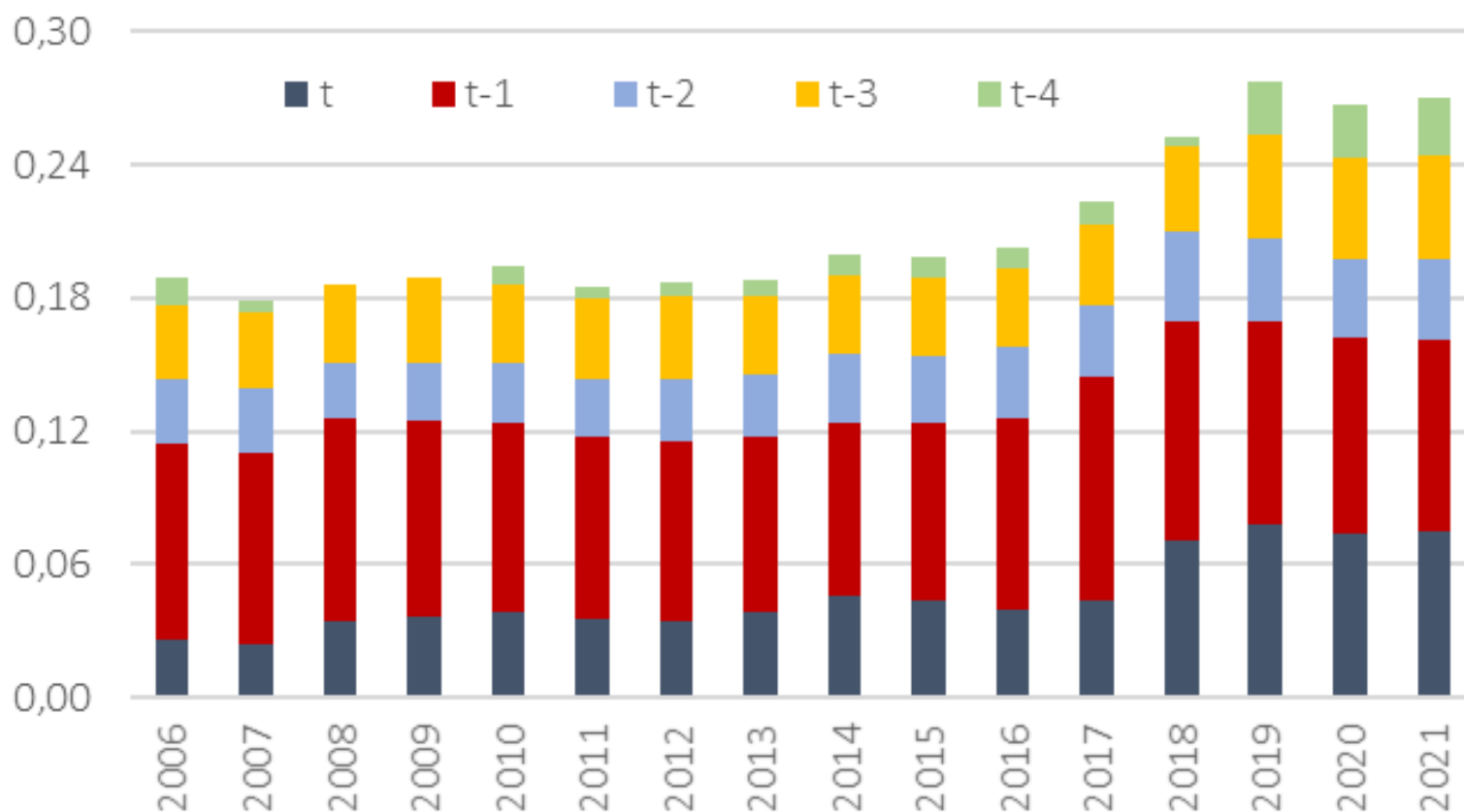
FX passthrough has doubled in recent years.

Impact of a 1% change in the exchange rate on domestic inflation in one year (TVP Phillips curve estimates)



FX passthrough has doubled in recent years.

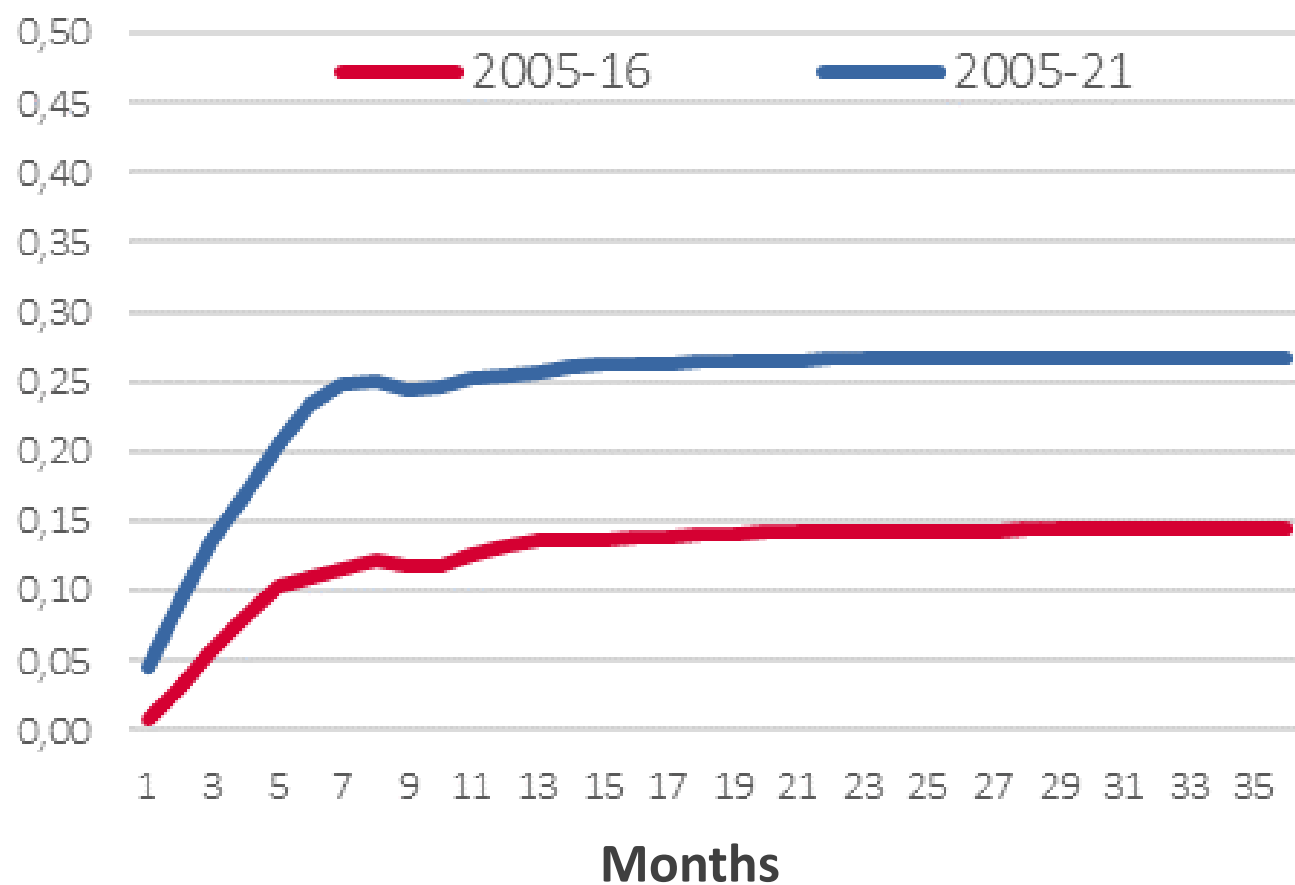
Impact of a 1% change in the exchange rate on domestic inflation (TVP Phillips curve estimates, t denotes quarter)



Source: Kara and Sarikaya (2021)

SVAR models confirm higher FX pass-through.

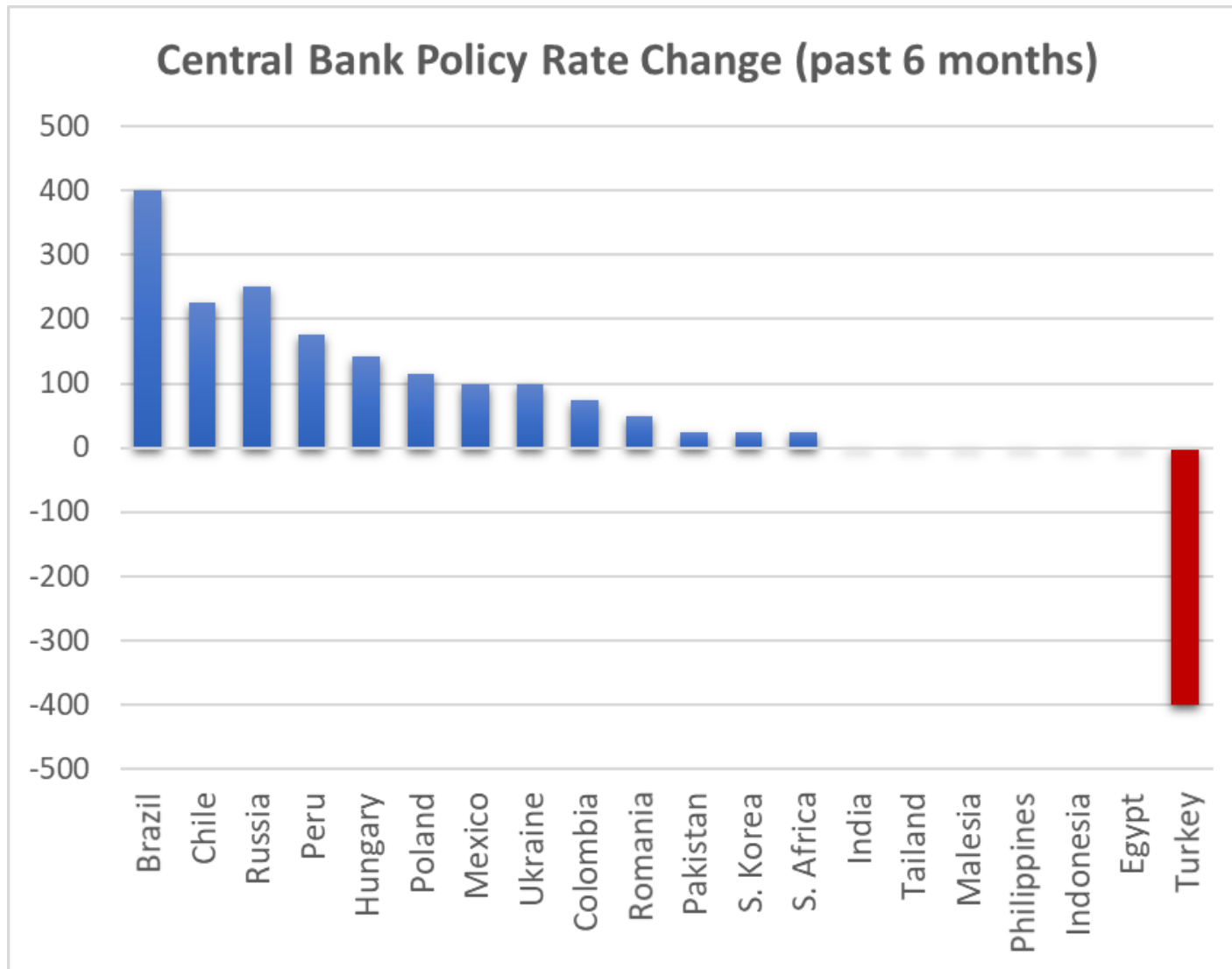
Response of inflation to 1% shock to the exchange rate



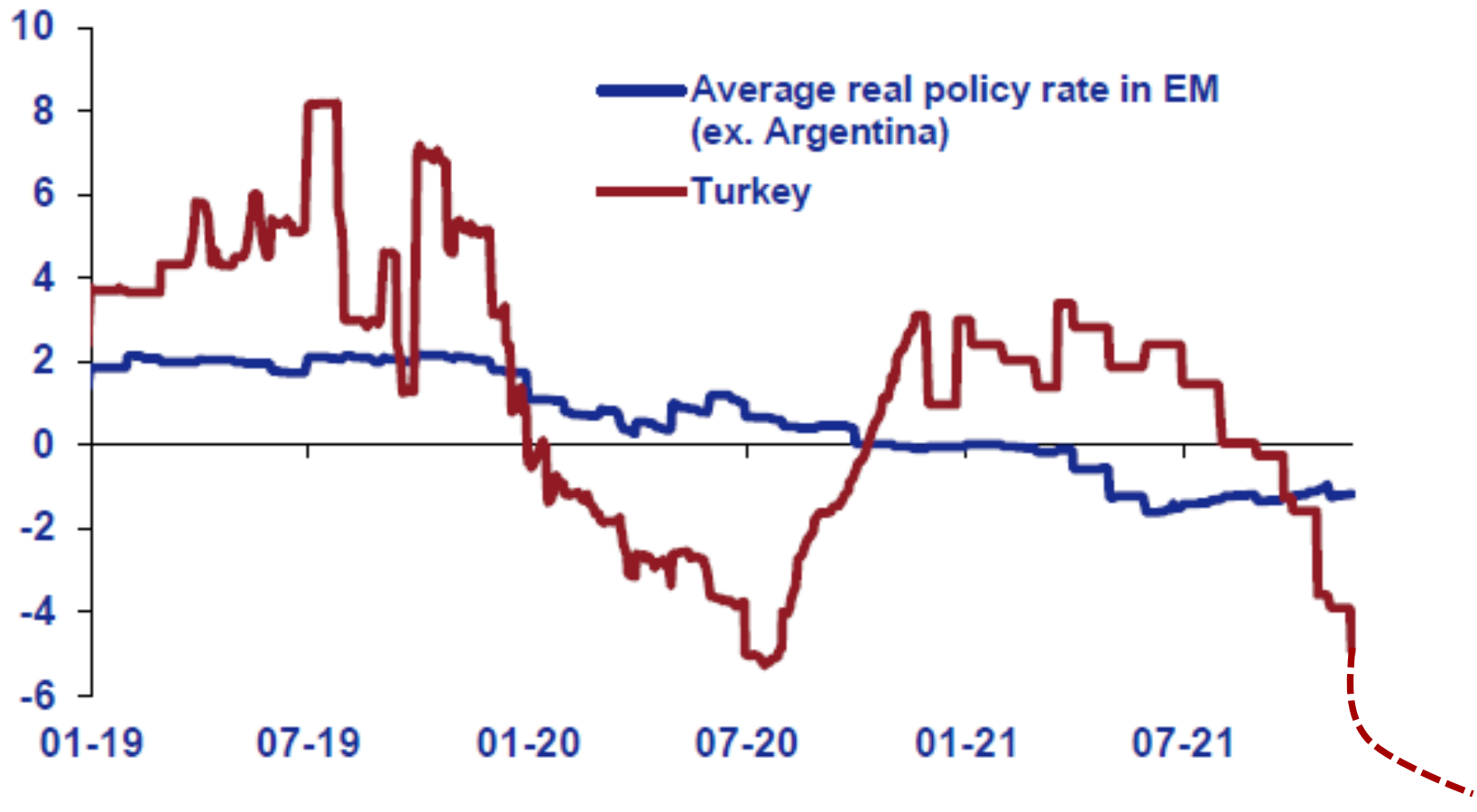
Source: Kara and Sarıkaya (2021)

Most Recent developments

Turkey is now the only EM economy with an easing cycle.

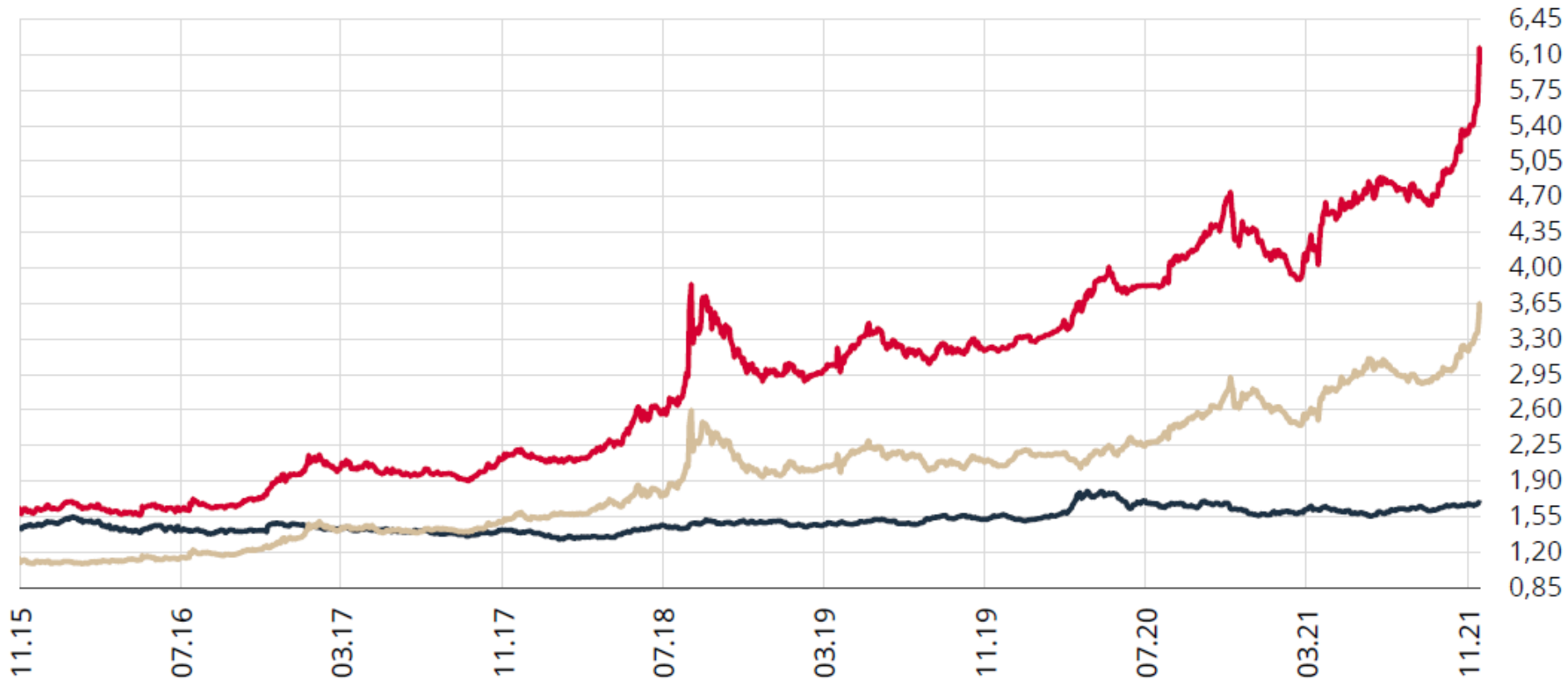


Real policy rate may go deeper in the upcoming period.



Turkish lira depreciated sharply after the rate cuts.

— Turkey — Average of Emerging Economies — Turkey/Emerging Countries



Source: Bloomberg, CBRT

Observation Date: November 18, 2021

Emerging market currencies include Brazil, Chile, Colombia, Hungary, Malaysia, Mexico, Poland, Philippines, South Africa, Indonesia, Romania against USD.

Concluding remarks

- Turkish experience demonstrates how the inflation process can shift quickly if the central bank credibility is damaged.
- The loss of a nominal anchor leads behavioural changes in expectations and inflation dynamics.
- **The credibility is a precious asset: take good care of it!**

Inflation is taxation without legislation.

Milton Friedman

Thank you for your kind attention...