Inflation dynamics when the anchor is lost: evidence from Turkey

A. Hakan Kara

Bilkent University

IT in Emerging Economies, November 26\textsuperscript{th}, 2021
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

2001-2010 (% change in real exchange rate)

2011-2021 (% change in the real exchange rate)
Terms of CBRT governors (years)

- Gazi: 4.89 years
- Süreyya: 5.00 years
- Durmuş: 4.99 years
- Erdem: 5.02 years
- Murat Başçı: 3.21 years
- Murat Çetinkaya: 1.34 years
- Naci Ağbal: 0.20 years
- Şahap Kavcıoğlu: 0.07 years

Average: 2.6 years
Inflation has moved to double digits since 2017

2006-16 Average: 8.3%
2017-2021 Average: 14.3%
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

\[ y = 0.1895x + 0.0009 \]
\[ R^2 = 0.2116 \]

2017-2021

\[ y = 0.507x - 0.0032 \]
\[ R^2 = 0.4097 \]
How anchored are expectations?

Sensitivity of 1-year ahead Inflation Expectations to Exchange Rates

2006-2016

\[ y = 0.0129x - 0.0037 \]

\[ R^2 = 0.0306 \]

2017-2021

\[ y = 0.0709x - 0.0242 \]

\[ R^2 = 0.2753 \]
Inflation target no longer serves as an anchor.

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.

Source: Bloomberg, CBRT

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...