How effective is inflation targeting in Turkey ?
A re-examination of some casual causalities

Mehmet Tuncel (University of Nantes, France) and Ruhi Tuncer (Galatasaray University, Turkey)

JEL Classification: F32, F41, C32
Key words: inflation targeting, balance of payments crises, Turkey, cointegration, structural change.

The Turkish economy has been faced with galloping inflation between 1978 and 2002. In 1989, financial liberalisation has accelerated the inflation of the 1980's because of economic policies aiming at a depreciation of the real exchange rate in order to boost exports. The populist fiscal policies of the 1990's have created a stock of public debt and high real interest rates that have checked growth.The risis of 1994 that has been the direct consequence , has shown that it was no longer possible to follow the cycles of high public debt-high interest rates on the one hand and inflation-depreciation of the Turksh Lira on the other.

The Staff Monitoring Program signed in 1998 has permitted the IMF to intervene in budgetary management, in fixing prices of agricultural produce and public sector salaries. The stand-by program of 1999 is one aiming at price stabilisation through manipulating the exchange rate. It envisaged a strict control of the money supply, adopting the principle of a currency board as it existed in Argentina and being established in countries preparing to join the European Union.

This program has had limited succes in checking inflation. On the other hand, tying the money supply to net assets held by the central bank has been a source of instability for the financial system. In November 2000, the central bank has not been able to provide liquidity to the interbank market. The liquidity crisis of one bank has thus been transformed to a financial crisis, leading to the crisis of February 2001, the severest experienced by Turkey. Floating the Turkish Lira became inevitable and the program of stabilizing prices through exchange rates had to be abandonned.

Structural reforms like the objective of a primary budgetary surplus, strict control of the banking system and the independence of the central bank have, in a way, been the positive consequences of the crisis of February 2001. On the other hand, the independence of the central bank has been interpreted as an obligation to adopt a policy of price stabilization. This dominant discourse is not surprising in itself. Inflation targeting has been implemented in middle sized economies for the last fifteen years at the price of accepting reduced growth, its justification having an ideological character (Pollin and Zhu 2005). It is in this context that the central bank has implemented a policy of strict control of the money supply between 2001 and 2006 and declared that it is adopting the policy of inflation targeting in the beginning of 2006. Since 2002, inflation has certainly lost speed. The modest reduction of nominal interest rates has lifted the real interest rates to a very high level. The Turkish Lira is overvalued, the current account deficit is at around 7% of the GDP.

The central bank presents the reduction of the inflation as a result of the monetary policies implemented since 2002. Price stability is supposed to be a consequence of controlling the money supply. The aim of our study is to re-examine the relations between financial indicators like monetary base, interest rates, exchange rates, inflation, capital entries, yields of financial markets and public bonds. We wish to study the relations of causality between these indicators and to test in what way the changes announced in monetary policy have influenced these relations. One of the hypotheses that we will test is that price stabilization is not the consequence of inflation targeting but it is a result of the appreciation of the Turkish Lira due to short term capital entries attracted by high real interest rates.

We make a time series analysis and construct a VECM model. In such a model, causal relations and adjustment speeds between variables are expressed by cointegration relations. We use tests for structural change in cointegrated systems of Seo (1998) to detect changes in causality and speeds of adjustment between variables. Our empirical covers the period since 1989 that is to say, on the period of financial liberalization.

The first section summarizes financial liberalization since 1989 and the crises of the 1990's. The second section analyses the crisis of February 2001 and the structural reforms that have followed. In the third section we set the monetary policy adopted by the then independent central bank since 2002, in the context of inflation targeting from a theoretical point of view, comparing it with the experiences of other countries. The fourth section is consecrated to econometric tests mentioned above.