



**TÜRKİYE CUMHURİYET
MERKEZ BANKASI**

Capital Flows, Financial Stability, and Monetary Policy

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Central Bank of Turkey**

**National Seminar on Developing a Programme for the
Implementation of the 2008 SNA and Supporting Statistics in Turkey**

**10 September 2013
Ankara, Turkey**

Outline

1. Monetary Policy since 2001
2. Capital Flows and Implications for Monetary Policy
3. New Monetary Policy Framework
4. New Policy Instruments
5. Evidence and Conclusion

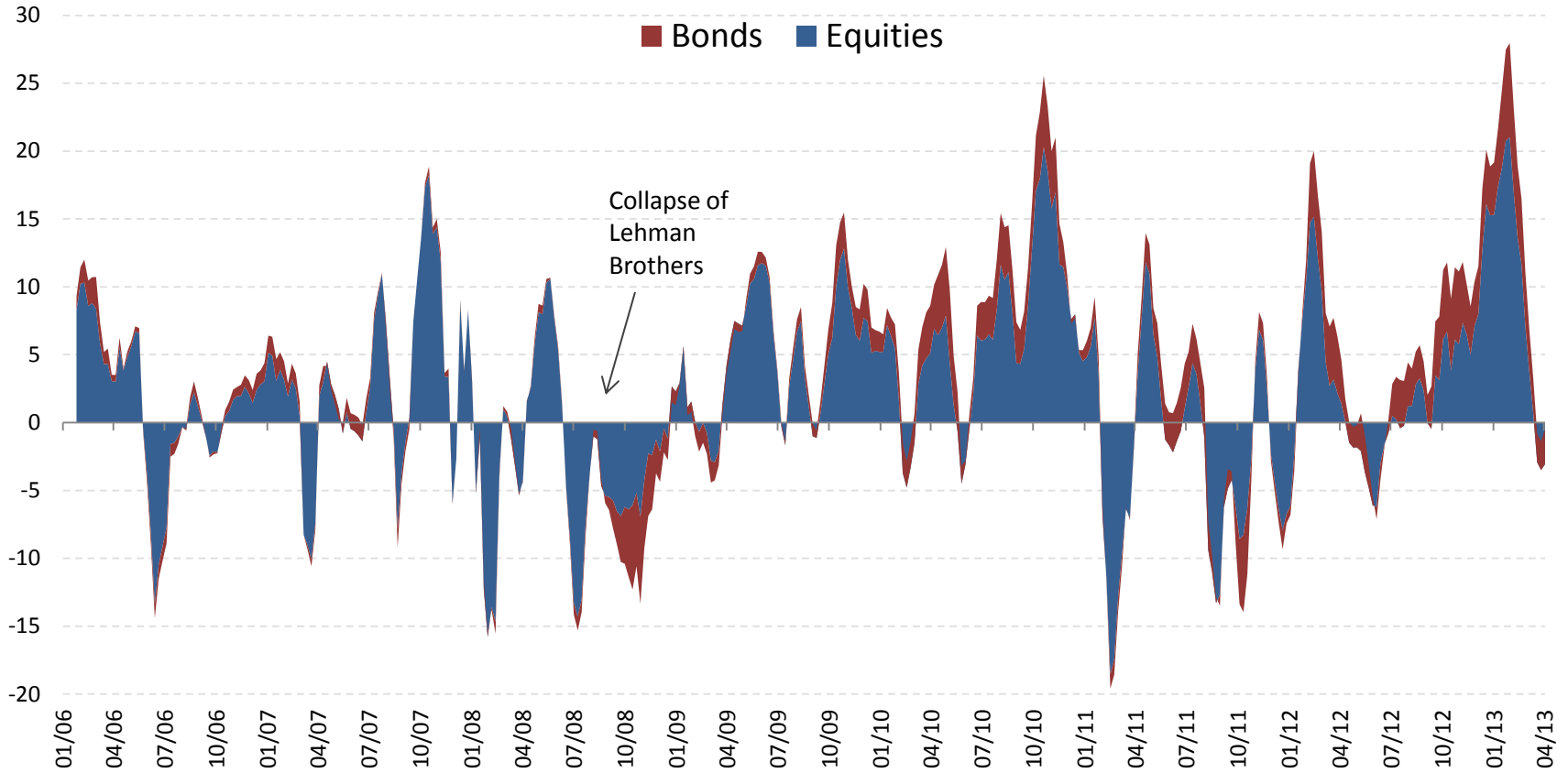
Monetary Policy Since 2001

- 2001-2006: Implicit Inflation Targeting (IT)
- 2006-2008: Full-fledged conventional IT
- 2009-2010: Adjusting to the post crisis conditions
- *Late 2010-to date: Incorporating Financial Stability Objective into the Inflation Targeting Framework*
(with special emphasis on capital flows)

Capital Flows and Implications for Monetary Policy

Portfolio Flows to Emerging Economies

Equity and Bond Flows to Emerging Market Economies (4-Week Moving Sum, Billion USD)

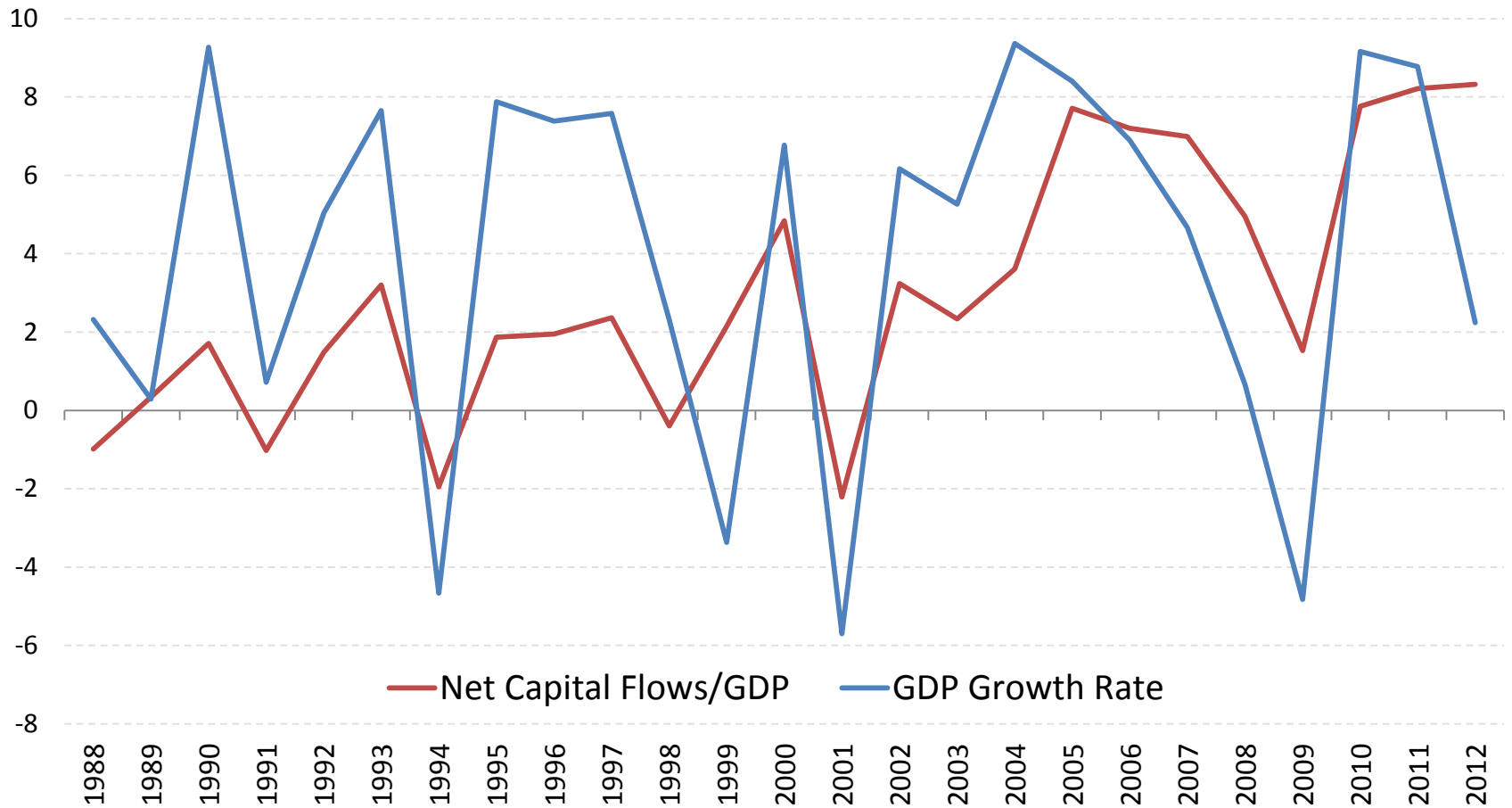


Source: Emerging Portfolio Fund Research (EPFR)

Capital flows: challenges

- Capital flows may have important benefits, but they pose big challenges for macroeconomic policy as well:
- Sudden reversals (stops) can have very large adverse effects on real and/or financial sector.
- Procyclical flows amplify macro-financial fluctuations, rather than dampening them.

Capital Flows and GDP Growth in Turkey



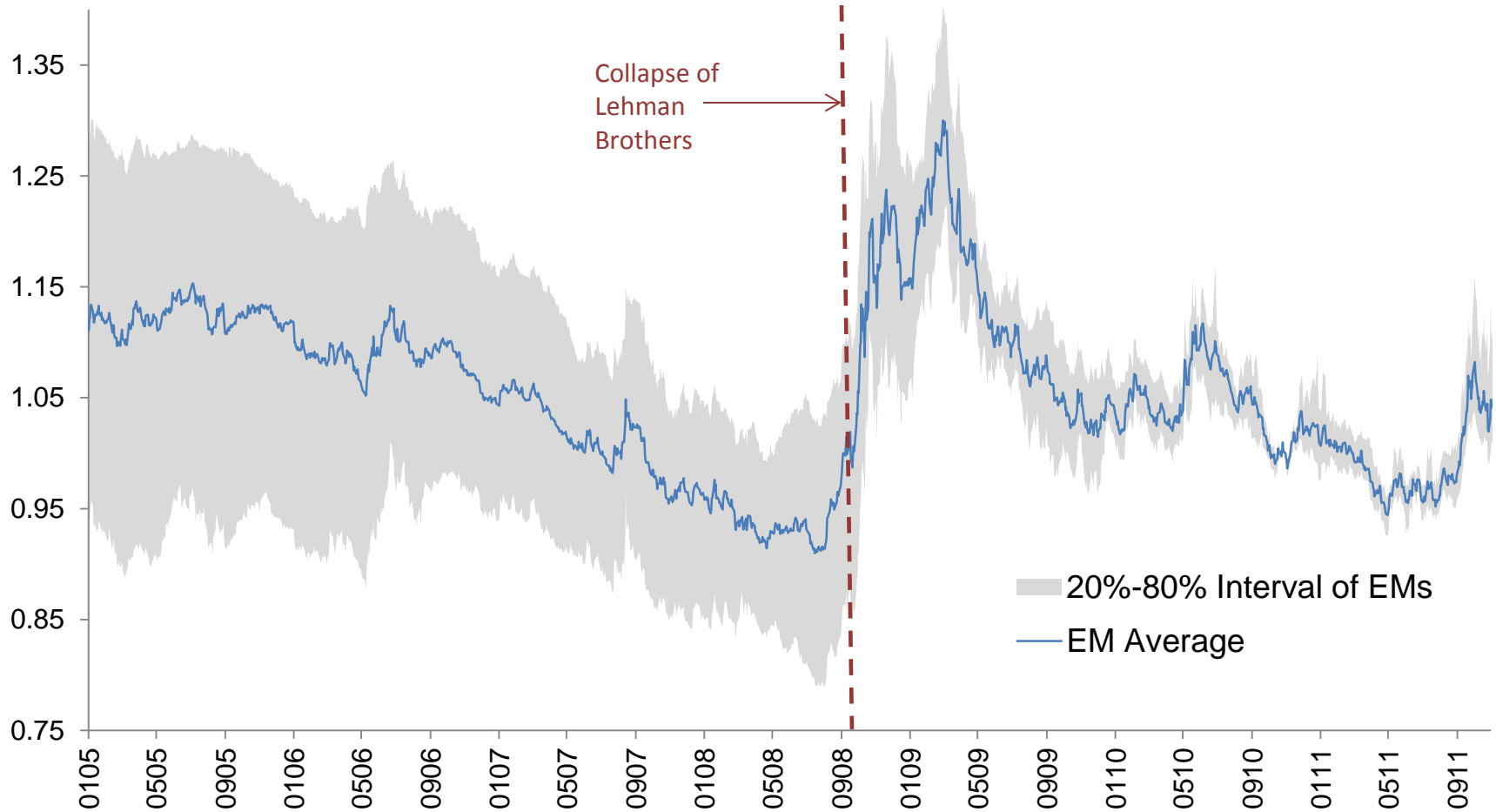
Source: CBRT

Capital flows: why bother now?

Historically the main source of volatility in Turkey has been cross border capital flows, why bother now?

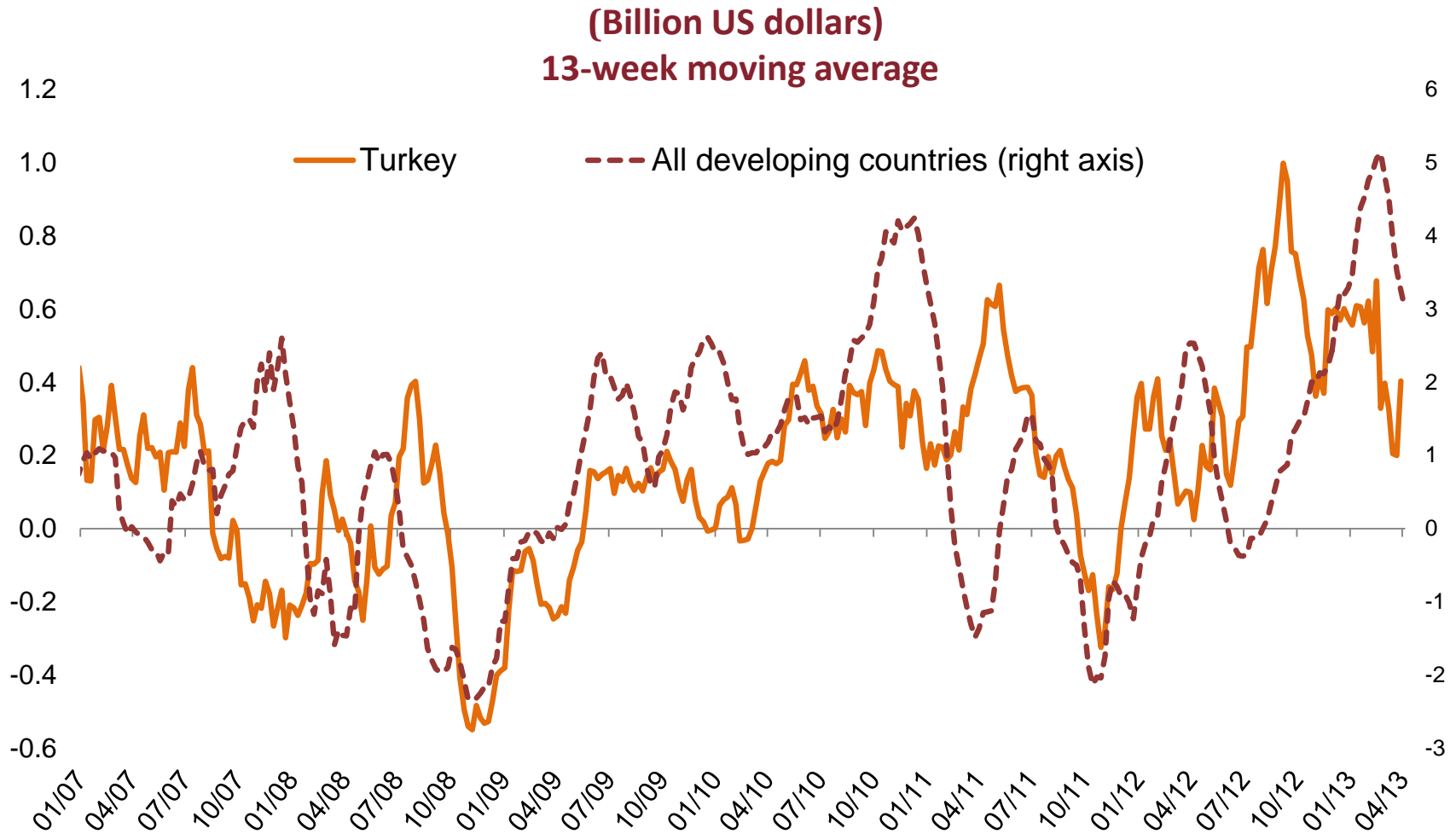
- Size and volatility of capital flows have increased even more during the post-crisis period
- **More importantly, it is mainly driven by global factors.**
 - Less related to domestic fundamentals
 - Inefficient and distortionary

Emerging Market Currencies Against USD*



Emerging Economies: Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Philippines, Poland, Romania, South Africa, Korea.

Portfolio Flows: Turkey vs. Developing Countries

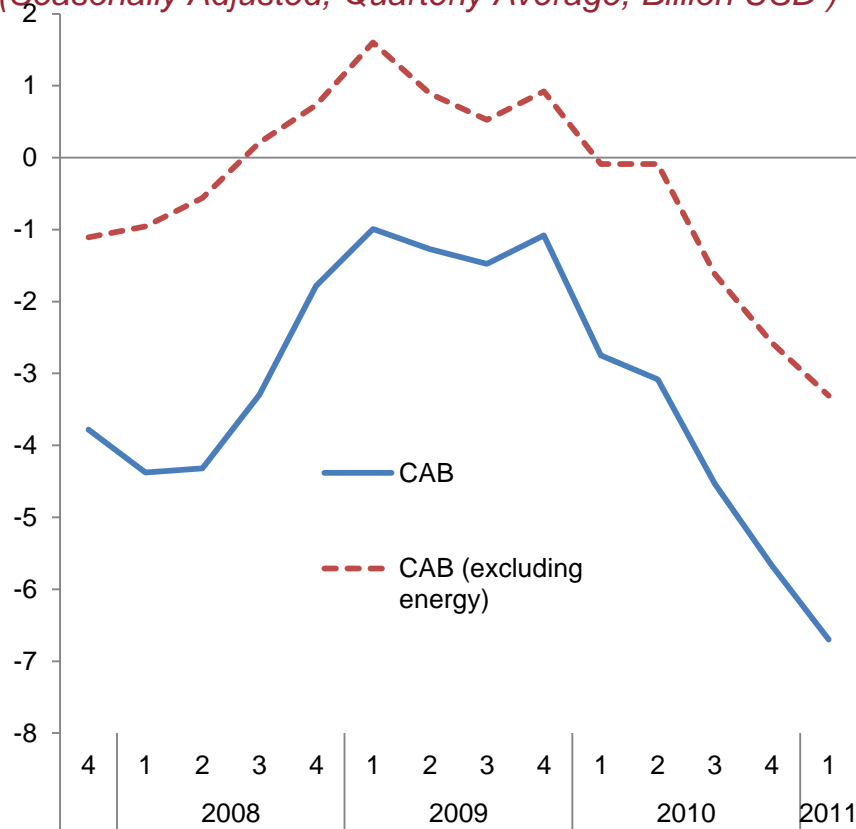


Source: EPFR, CBRT.

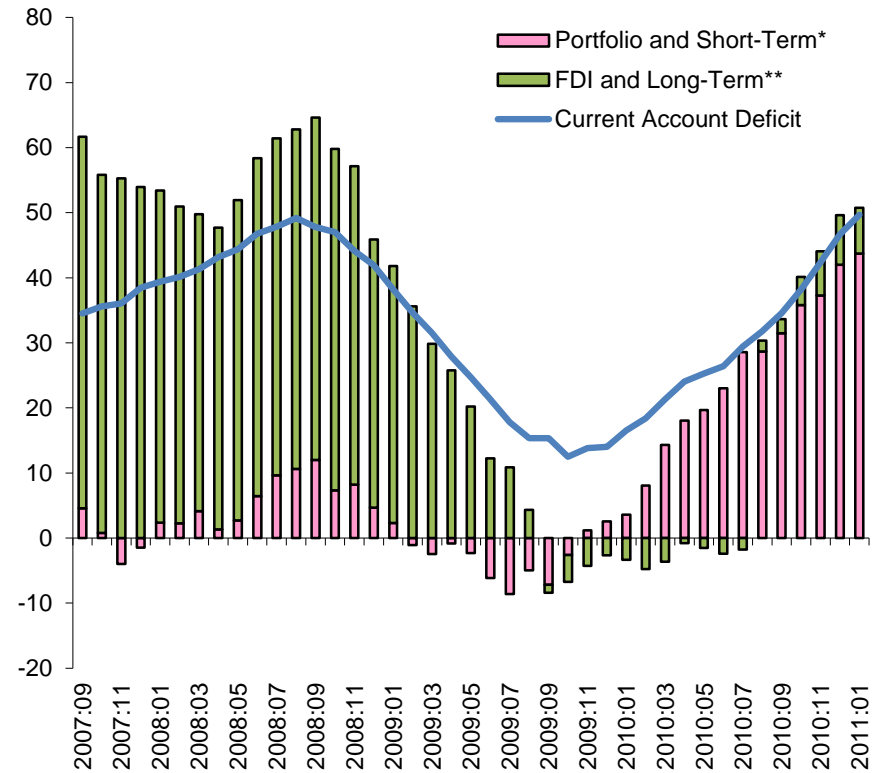
Capital Flows and Macro-Financial Risks: Turkish economy as of late 2010

Turkish Economy as of late 2010: Sharp Increase in the Current Account Deficit, Financed with Short-term Inflows

Current Account Balance
(Seasonally Adjusted, Quarterly Average, Billion USD)



Main Sources of External Financing*
(12-months Cumulative, Billion USD)



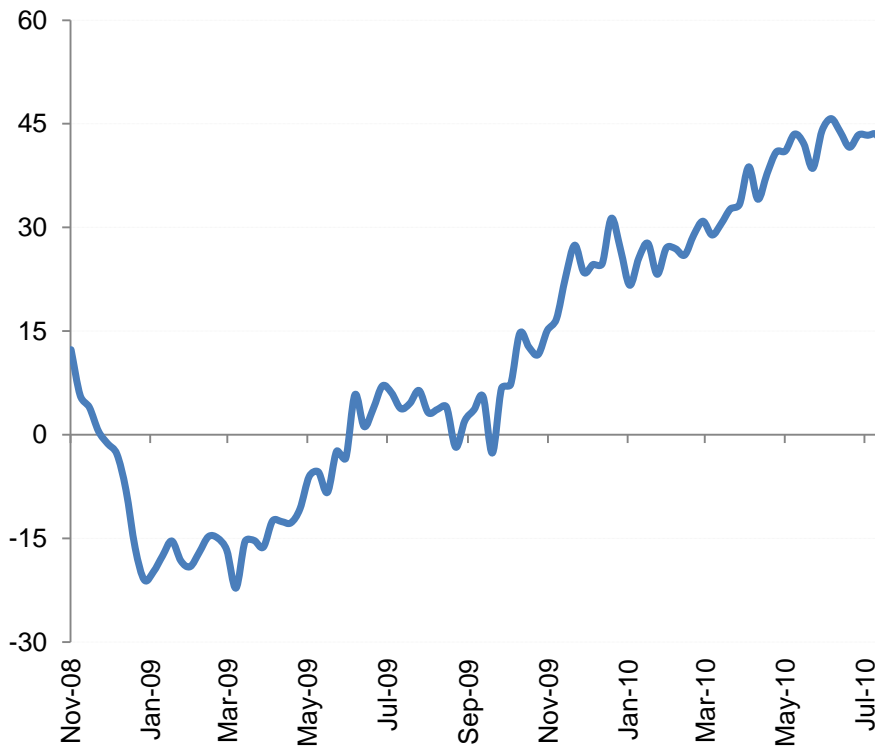
*Short-term capital movements are sum of banking and real sectors' short term net credit and deposits in banks. Long-term capital movements are sum of banking and real sectors' long term net credit and bonds issued by banks and the Treasury.

Source: CBRT.

Source: TURKSTAT, CBRT.

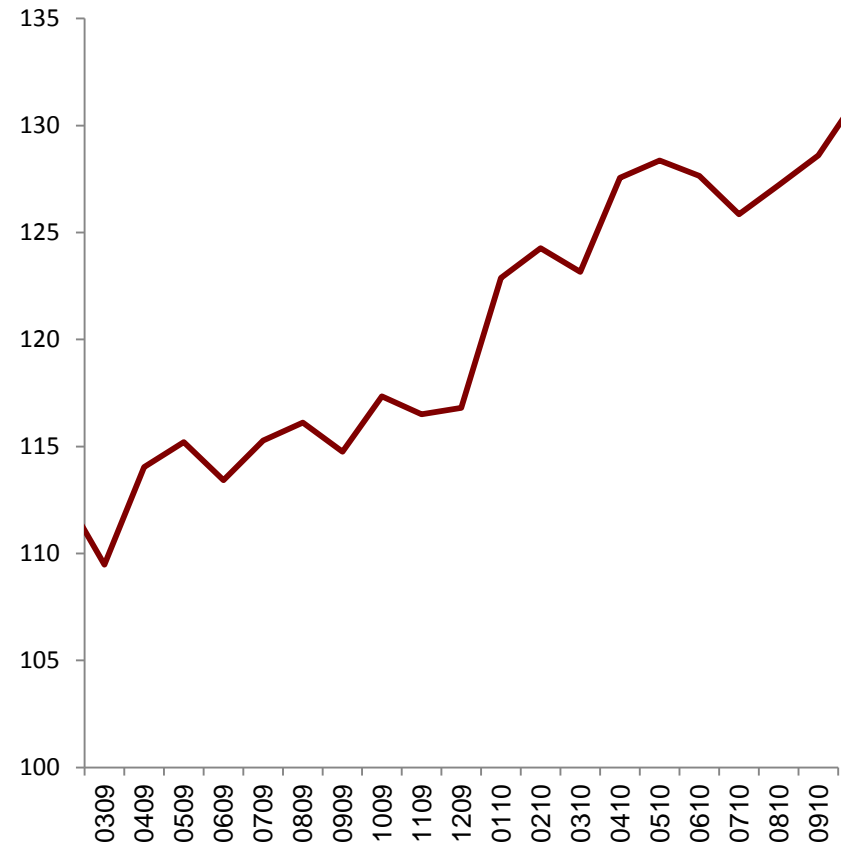
Turkish Economy as of late-2010: Rapid Credit Growth, and Sharp Appreciation of Domestic Currency

Total Loan Growth Rates
(13 Weeks Moving Average,
Annualized, FX Adjusted, Percent)



Source: CBRT

Real Exchange Rate (2003=100)



Searching for a new policy framework

MAIN GOAL:

Design a new framework to

- correct the cyclical part of the current account deficit, by reducing overborrowing and overvaluation,
- alleviate the impact of excessive volatility in capital flows on the domestic economy,
- reduce the sensitivity of credit and exchange rate cycles to capital flows,
- without jeopardizing price stability objective.

Can we do it with conventional Inflation Targeting?

- When global liquidity shocks dominate, using single instrument under IT may exacerbate the trade-offs
- For example, during capital inflows there are two options:
 - $i \uparrow \Rightarrow$ further appreciation \Rightarrow wider CA deficit, sudden stop risks increase
 - $i \downarrow \Rightarrow$ overheating \Rightarrow higher inflation
- Multiple objectives, multiple instruments are needed.

The New Policy Framework

Policy Framework

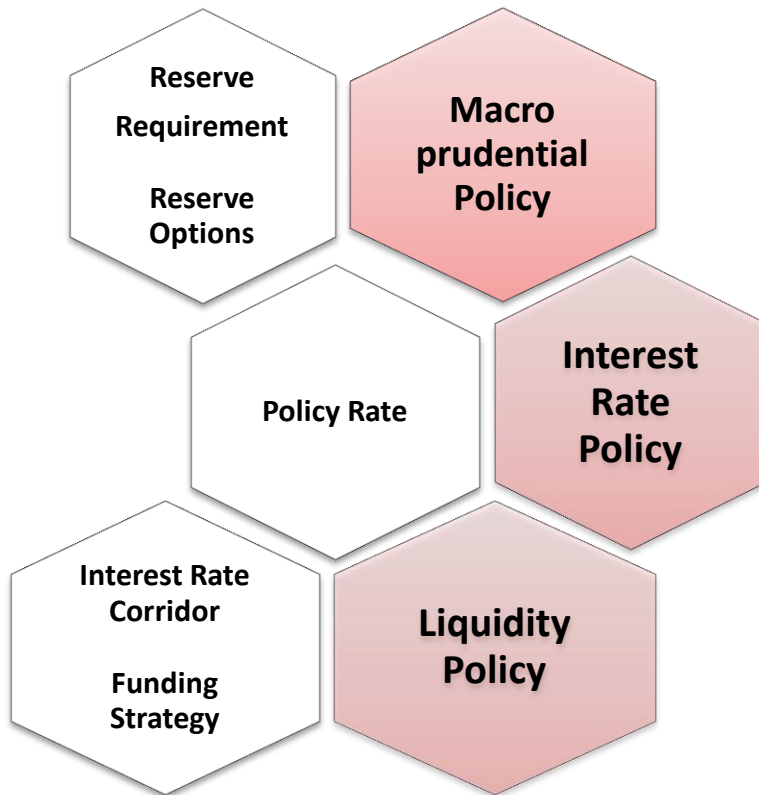
	Old Approach	New Approach
Objectives	Price Stability	Price Stability Financial Stability
Policy Tools	Policy Rate	Interest Rate Corridor Reserve Options Policy Rate, etc...

Financial Stability: How can Monetary Policy Contribute?

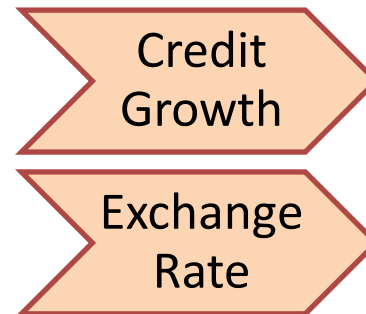
- Monetary policy can contribute to financial stability by reducing the probability of a sudden stop,
- and by dampening the amplification mechanisms triggered by capital flows.
 - smoothing credit and exchange rate cycles

Transmission Mechanism

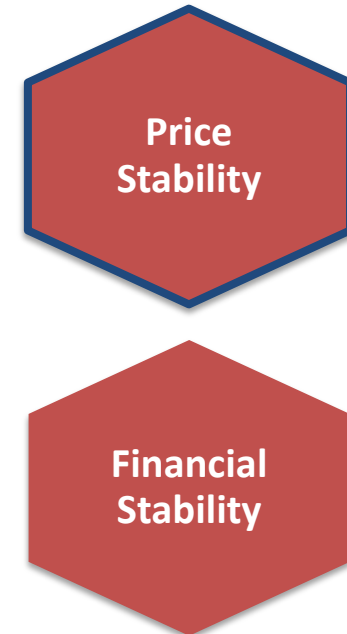
INSTRUMENTS



REFERENCE INDICATORS



OBJECTIVES



The link between credit, exchange rate, and final objectives

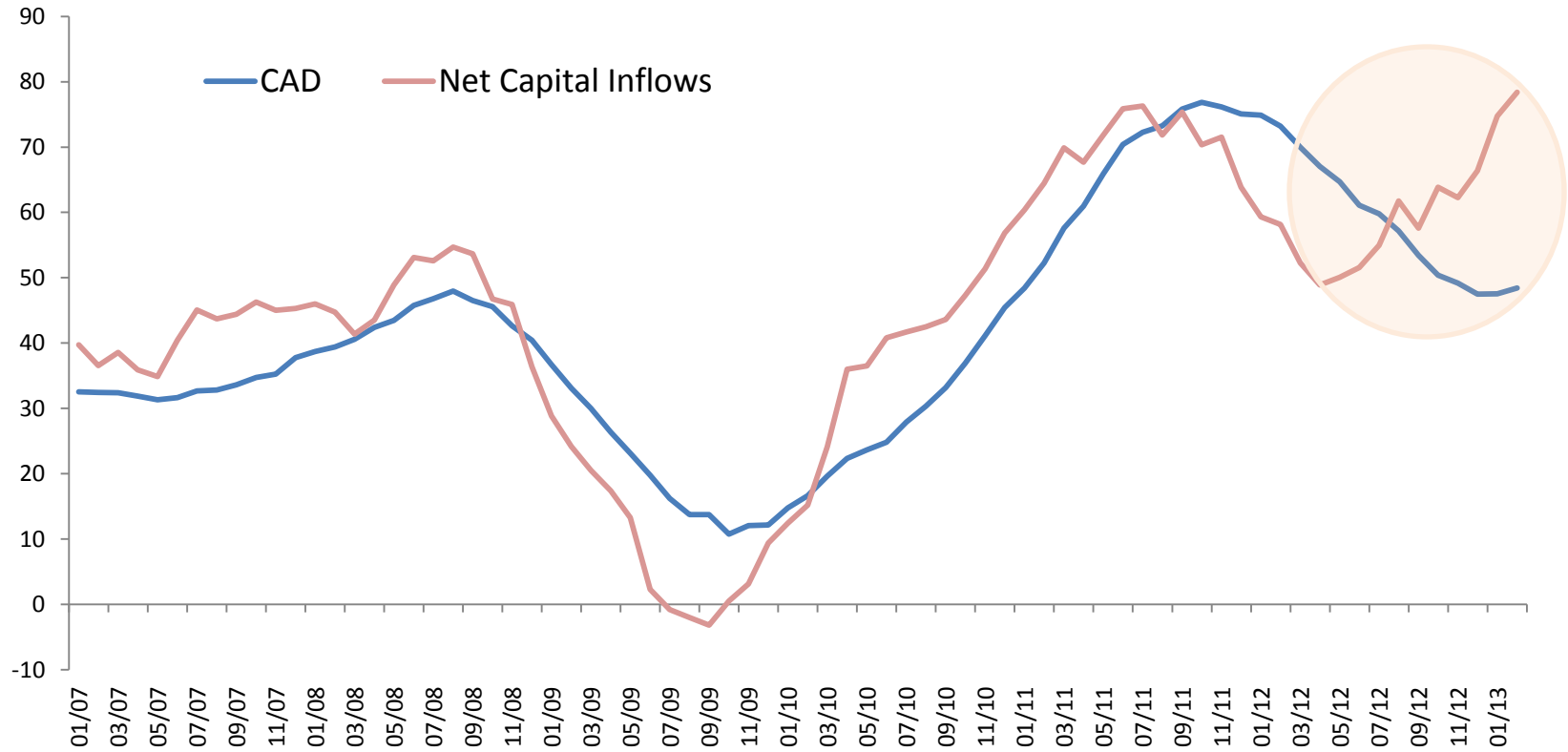
Smoothing credit and exchange rate cycles

- supports financial stability by dampening the leverage cycles and lowering the probability of a sudden stop,
- helps price stability through lower inflation volatility, given the high exchange rate pass-through in Turkey,
- and implies a more balanced growth path.

Have new instruments weakened the impact of capital flows to domestic macroeconomic variables?

Current Account and Capital Flows

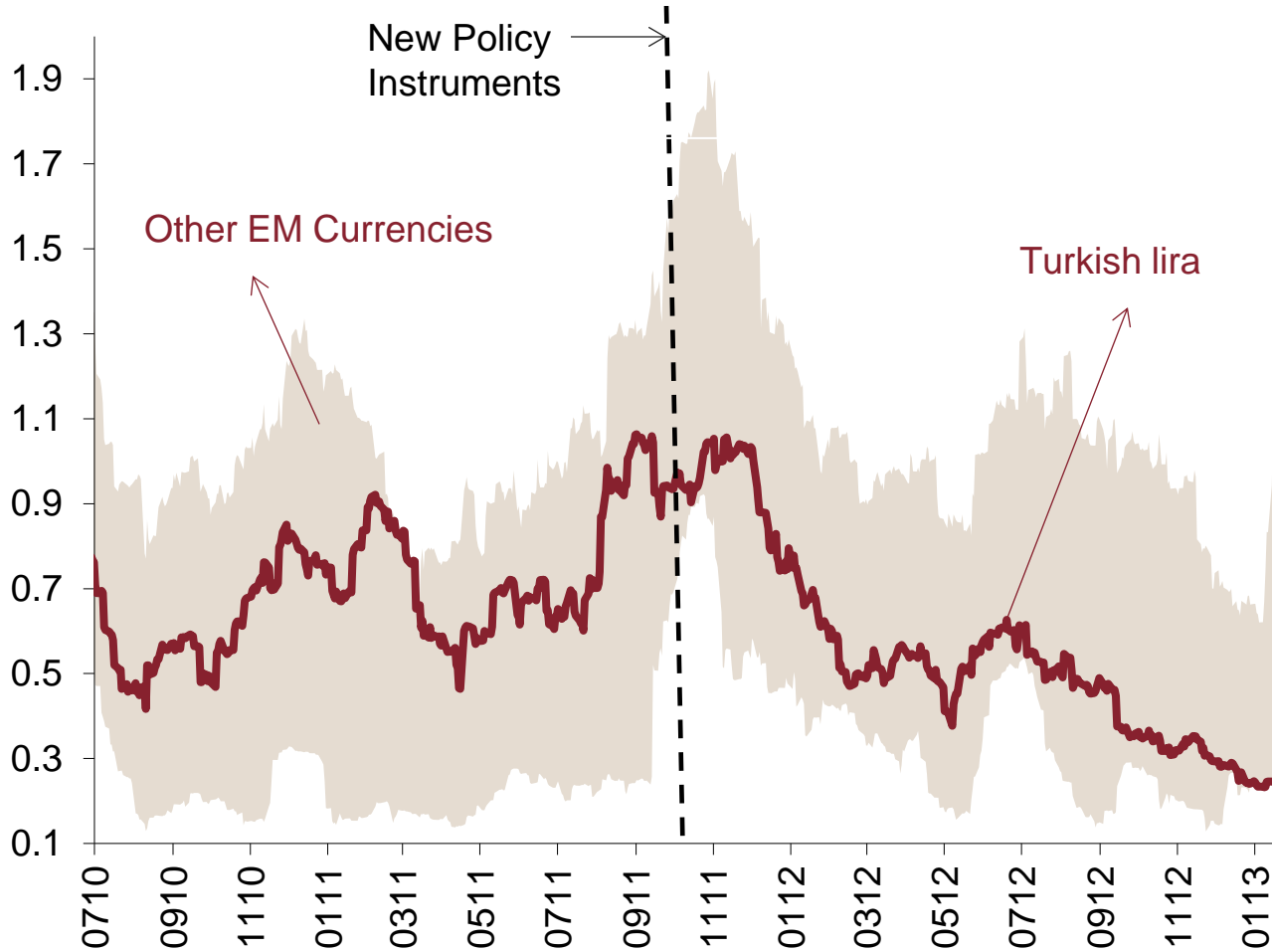
Current Account Deficit and Net Capital Inflows (12 Month Cumulative, Billion USD)



Source: CBRT.

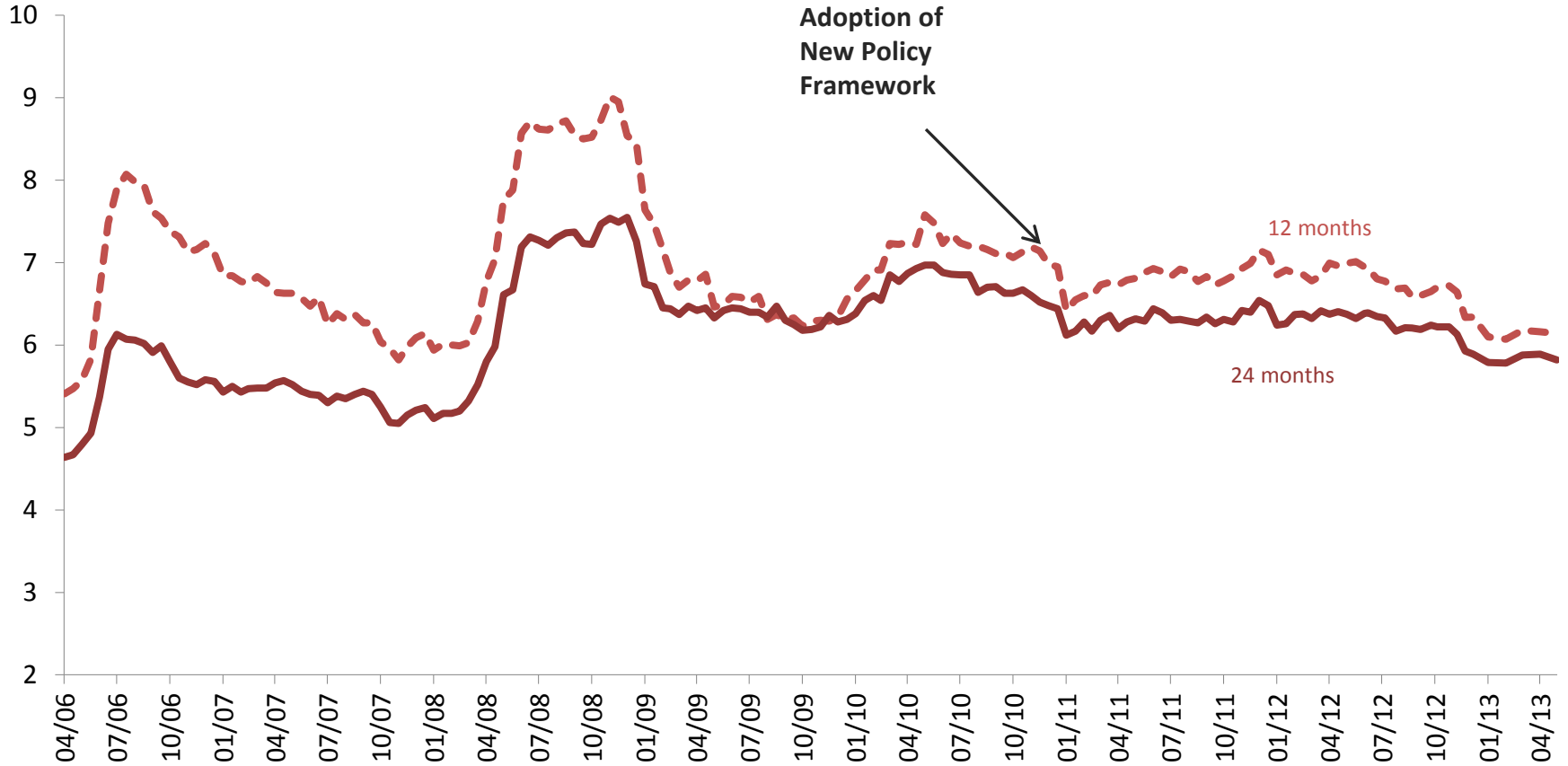
Last Observation: February 2013.

Volatility of the Turkish lira and other EM currencies against USD (30 days moving average)



* Countries with current account deficits are Brazil, Chile, Columbia, Czech Republic, Hungary, Indonesia, Mexico, Poland, Romania, South Africa, and Turkey.

Inflation Expectations



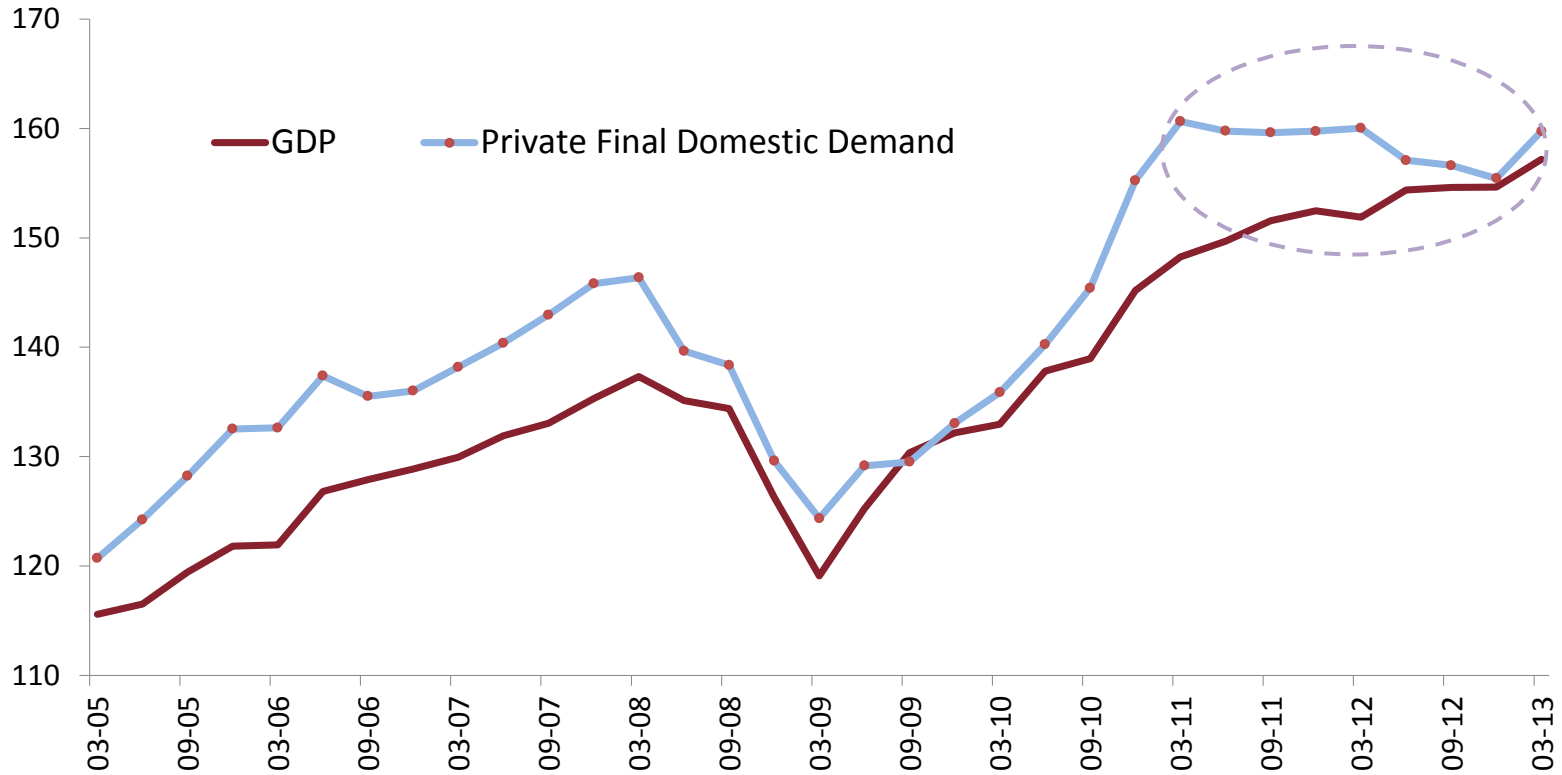
Source: CBRT.

Last Observation: May 2013.

Macroeconomic Outcomes of the New Monetary Policy Framework

Economic Activity

Gross Domestic Product and Private Final Domestic Demand
(Seasonally Adjusted, 2003=100)

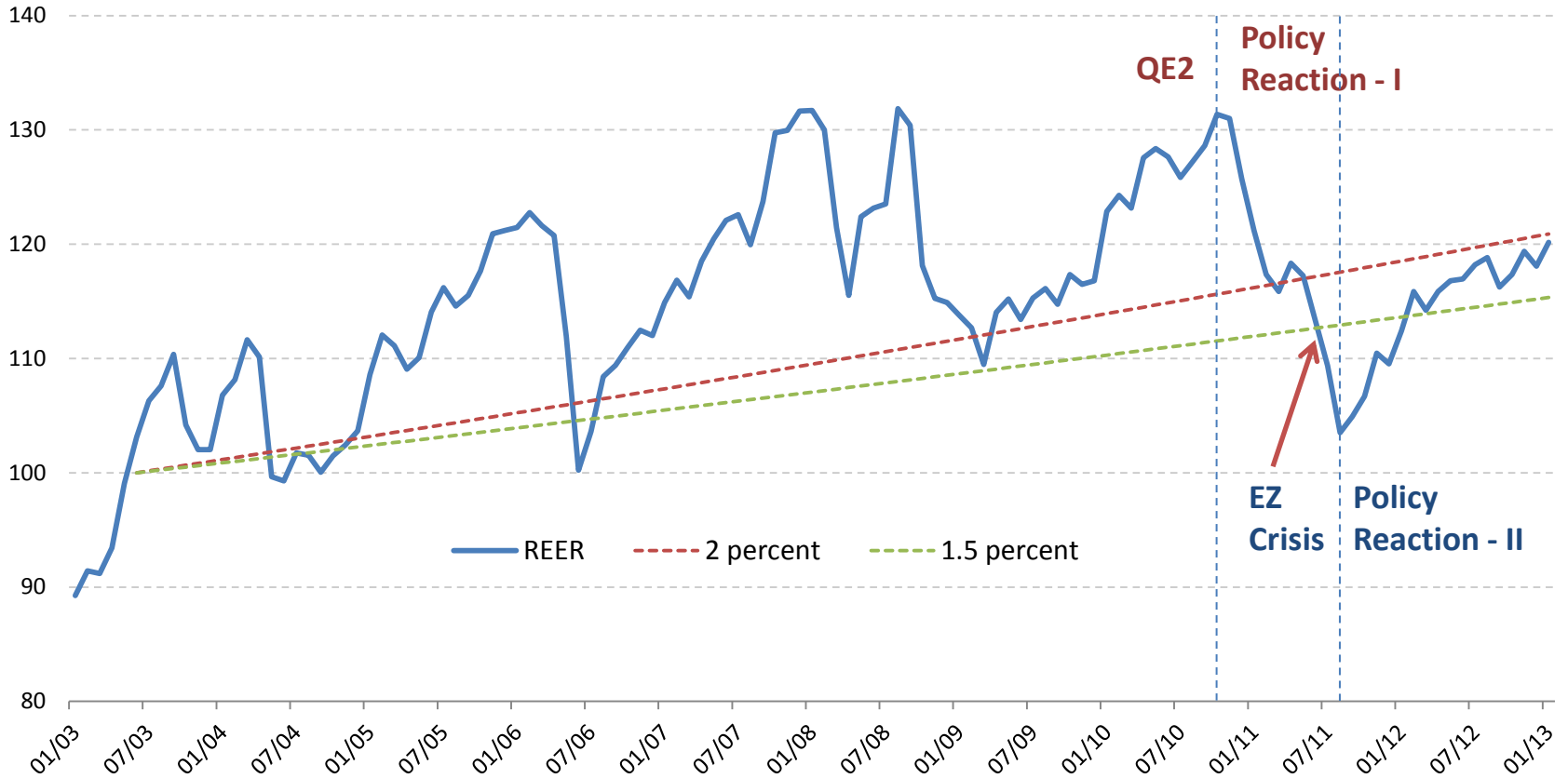


Source: TURKSTAT, CBRT.

Last Observation: 2013Q1

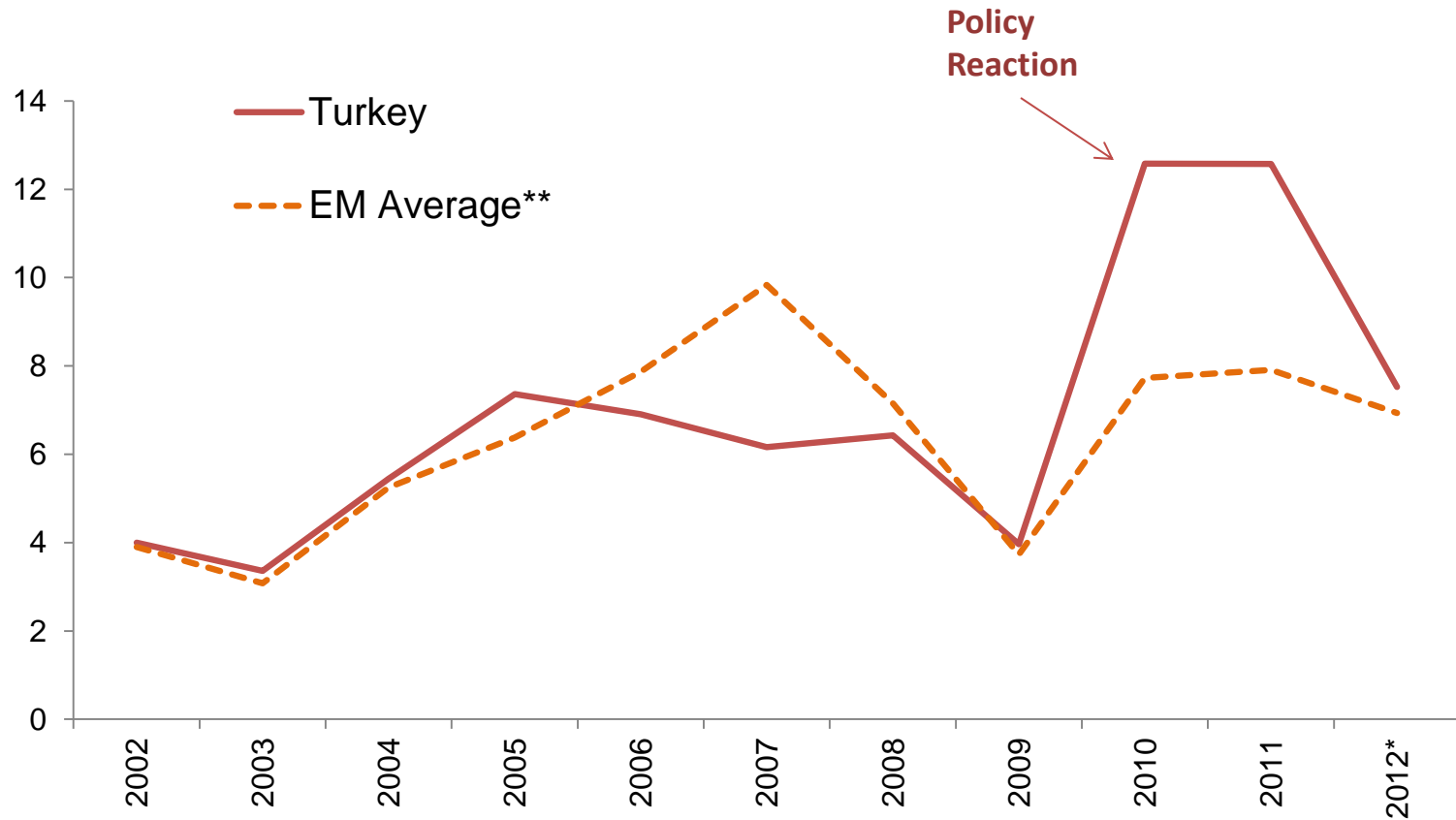
Real Exchange Rate

CPI Based REER (Base year: 2003)



Source: CBRT.

Change in Credit Stock /GDP



* Forecast for 2012.

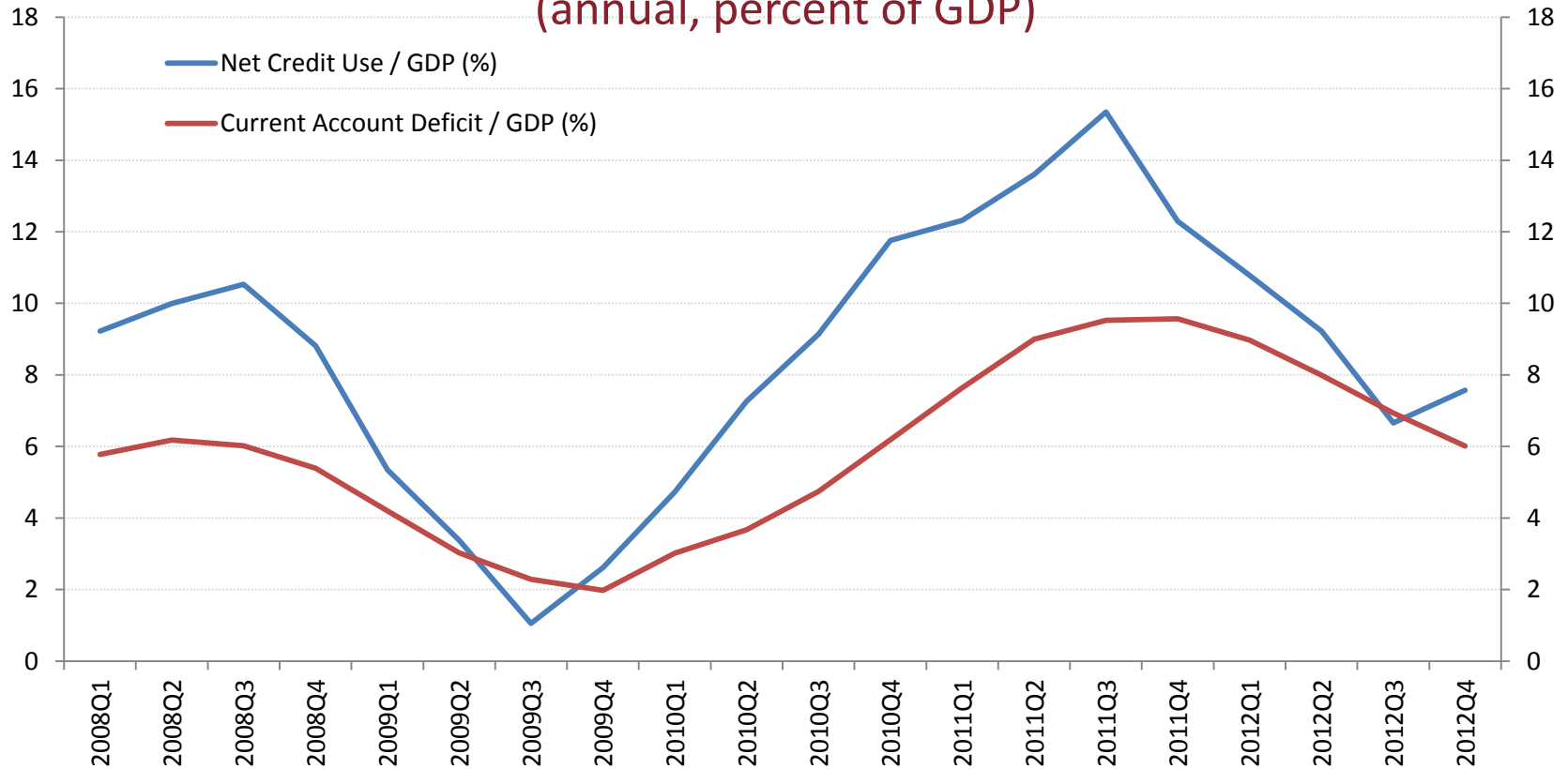
** Emerging market countries included in the average are: Argentina, Bolivia, Brazil, Chile, China, Colombia, India, Indonesia, Malaysia, Mexico, Paraguay, Peru, Philippines, Poland, Russian Federation, Slovenia, South Africa, Thailand, Turkey and Uruguay.

Source: World Bank..

Credit and Current Account

Net Credit Use and Current Account Deficit

(annual, percent of GDP)



Source: CBRT.

Net credit use is annual change in total credit stock.
Current account is in annual terms.

Conclusion

- Heightened volatility in cross-border flows have prompted Central Bank of Turkey (CBT) to change its policy framework by incorporating financial stability into the inflation targeting regime.
- The new policy set-up and the tools developed by the CBT have eased the trade-offs posed by cross border capital flows.
- New policy framework has been effective in reducing macro financial risks in Turkey without hampering inflation objective.



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