Turkey's Volcker Moment

By Klaus Friedrich

Snuffing out structural inflation.

When Paul Volcker became Chairman of the Federal Reserve in August 1979, the United States was suffering from a long bout with stagflation. Consumer prices had increased by levels that had been unheard of for several decades and the economy was stalling. In fact, in the very month Paul Volcker took office, annual inflation stood at nearly 12 percent.

Volcker recognized that the real threat to the independence of a central bank—political interference by more short-term oriented politicians—can ultimately be thwarted only by the bank's determination to succeed in its basic mission, which is monetary stability. By 1979, it was clear that the Fed was failing and that a sharp turn in policy was needed.

Hence, Volcker and his colleagues on the Board of the Federal Reserve Bank took the courageous and controversial step of aggressively raising the so-called federal funds rate. Between August 1979 and June 1981, this rate rose from 11.2 percent to 20 percent. The net effect of this policy was a steady decline in and, more significantly, a lasting containment of inflation.

The Fed's return to positive real interest rates had a decisive impact on lastingly changing U.S. economic fortunes for the better.

Dealing with high inflation had also long been a reality in a number of emerging markets. In earnest, most countries began to tackle this problem

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Turkey's central bank governor **Erdem Basci.**

in the early 1990s through a prudent combination of fiscal and monetary policy.

Turkey provides an interesting example, although it was a relative latecomer to such efforts. At the end of 1979, when Volcker took up his post, Turkey's inflation level stood at 81 percent. Over the next twenty-three years, Turkish inflation would average 63 percent per annum. The economic costs of this near quarter-century of inaction were high. These seemingly never-ending price increases wreaked havoc with the household finances of Turkey's citizens.

Failure in monetary policy to achieve greater price stability also made successive Turkish governments more reluctant to implement economic reforms. Their primary concern was to soften the blow of what is rightfully described as the most brutal tax on the poor. Necessary economic reforms, on the other hand, might have required additional, politically unpopular short-term sacrifices. Together, these two policy failures kept the country from realizing a crucial goal—expanding its middle class.

Starting in 2003, the steady implementation of prudent fiscal and monetary policies finally broke this all-too-familiar pattern. By the end of 2012, the inflation rate in Turkey had come down to a low of 6.2 percent. Economic growth averaged 5.1 percent between 2003 and 2012 and per capita GDP nearly tripled.

Yet, despite all this progress, inflation rates in Turkey remained above levels in the United States and the

U.S. inflation rate (1979–2013)

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European Union. Turkey's economic growth is predominantly driven by domestic consumption. The national savings rate is very low, which contributes to a very large structural current account deficit—estimated at 7.2 percent of GDP in 2013.

Whenever the currency of a country with a large current account deficit declines, this excess of imports over exports leads to spikes in inflation as the higher costs of importing goods in local currency terms are passed on to consumers. In fact, even in good times market participants factor in the risk of higher import costs, leading to structural inflation.

The Fed's tapering over the last few months has caused foreign investors to repatriate capital, which in turn has put downward pressure on the currencies of these countries.

What's a central bank to do under such circumstances? Most of all, it must be realistic about what it can actually achieve. In the U.S. case in the late 1970s, Paul Volcker had no control over oil price hikes, which were the root cause of the double-digit inflation in the United States back then. Likewise, the Turkish central bank can do little about the changes in global market sentiments that may cause global investors to withdraw from emerging markets.

Against that entire backdrop, Turkey's central bank governor Erdem Basci and his team had what, with the benefit of hindsight, may come to be viewed in some years from now as a Volcker moment. On January 28, 2014, faced with the risk of high inflation and low economic growth (their own case of a U.S.-style stagflation, *à la* the late 1970s), the central bank decided to act—and act in a dramatic fashion. It increased its one-week repo rate, now its official policy rate, by 550 basis points, to 10 percent.

The Turkish central bank's policy interest rate is now considerably higher than the increase in the country's CPI, which stood at

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7.3 percent in December of 2013. If resolutely maintained, this interest rate policy has the potential not only to dampen inflation caused by current capital outflows, but to break the back of structural inflation that has existed up until now.

Despite progress, inflation rates in Turkey remained above levels in the United States and the European Union.

Of course, much as was the case with Volcker's courage decades ago, there will be a short-term price to be paid. Growth in Turkey will be lower than expected and consumption will fall.

But it is this shift to lower consumption that will reduce the country's current account deficit. With that, Turkey's vulnerability to sudden shifts in global market sentiment will be lowered. Expressed in technical terms, Turkey will reduce structural inflation in the long term.

Markets may continue to react negatively for a while to the central bank's action. The Turkish lira may still continue to decline. But in the end, the courage of Governor Basci and his team may have succeeded in creating a new and sustainable equilibrium in the Turkish economy.

By snuffing out structural inflation, if the maneuver succeeds, Governor Basci would also accomplish a lot in guaranteeing the independence of the Central Bank of the Republic of Turkey. ◆