

FALLING INFLATION

Disinflation: Global Lessons & Expert Advice,
An IIF Open Program, November 23, 2004

Lunch & Featured Keynote Address

Dear Guests;

It is my pleasure to be here today and to have this opportunity to tell you about the environment of high and chronic inflation and also the environment of “falling inflation”, their main impacts on economies within the framework of both Turkey’s experiences and that of other countries and finally, the significance of maintaining price stability for the Turkish economy.

First of all, let me begin with harmful consequences of high inflation for countries, especially for Turkey. According to many studies, the three main consequences of high inflation that are most important are: (1) Real growth variability, (2) Inflation uncertainty, and (3) Relative price volatility. Of course, these consequences may turn out to be costly since they reduce economic efficiency and real growth rates; and they deteriorate welfare¹.

As agreed by economic literature in general, high inflation causes real growth rate volatility to increase, and higher volatility of growth rates, in turn, leads economies to produce below their potential.

Additionally, in empirical studies, it has been found that the environment of prolonged high inflation does, in fact, reduces economic growth. The Turkish case is a clear example. Regardless of the reasons behind chronic inflation, the cost of living under such conditions over thirty years has been enormously high for Turkey.

The major impact of high inflation on the Turkish economy was on the growth rates that were lower on average compared with many other emerging market countries and became unpredictable; in other words, the country went through boom and bust growth cycles with high volatility. From 1977 through 1999, the average inflation rate was 61.7 percent, and the average growth rate was only 3.6 percent; when you take the last four years though, you see that the average inflation is down to 32.9 percent, and the average growth rate is up to 4.8 percent, and that despite the major economic crisis and contraction in 2001. The volatility of

¹ Hess, G.D. and Morris, C.S. “*The long-run costs of moderate inflation*”. Economic Review. FED Kansas City. Second Quarter; 1996. pp 71-88.

growth rates which is measured as standard deviation also declined from 4.5 points to 3.5 points as well.

Another effect of high inflation I would like to mention at this point is the rise of inflation uncertainty. Inflation uncertainty is one of the root causes of increase in risk premium, leading thus to high real interest rates. In fact, high real interest rates are not only detrimental to economic activity, but also to consumer welfare. They impose social costs on the public.

Well, the same also goes for Turkey: High inflation uncertainty was certainly one of the reasons behind high real interest rates as well. In the absence of determined economic policies fighting inflation, which resulted in the lack of credibility in economic policies, inflation uncertainty tended to increase through all those years as real interest rates climbed to a higher plateau after every economic crisis. Consequently, high real interest rates reduced spending in interest sensitive sectors of the economy, while development of long-term credit markets, which could be considered as the main source of economic activity and investments, has been delayed all the time.

The last but not the least consequence of high inflation is its impact on relative prices. The price mechanism loses its signaling function due to high inflation. Therefore, neither producers nor consumers can take their economic decisions confidently. In other words, they cannot determine efficiently how much to produce or consume. As a result, the economy as a whole cannot work efficiently.

As we experienced in the Turkish economy in the high inflation environment, it was difficult for a producer to determine whether a price increase of a product was stemming from increase in demand for the product or was simply coming from inflation and relative prices distortion. Therefore, taking decisions in favor of increasing production was not only difficult but also very often very costly for producers. This has been another obstacle for Turkey, as it was not able to achieve sustainable growth rates in the chronic inflation environment.

Among other damages of high inflation, I would like to tell you about another significant impact that it had on the Turkish economy. During the chronic inflation period, the labor market could not work effectively. Because of volatile growth rates, the unskilled part of the labor force were the first to lose their jobs during an economic contraction. Their misfortunes were not only limited with this. They were also the last to regain their jobs when the economy was recovering. Therefore, income inequality has been worsened through all these years and it is evident that one of the main reasons of the many social problems that we have in Turkey

was high and chronic inflation. The cost of high inflation was obviously more felt by deprived groups.

Ladies and Gentlemen,

The achievements obtained on the disinflation front in the last three years under the current program allow us today to speak about a falling inflation environment and price stability.

Now, let me briefly review the point we have reached in the fight against inflation: CPI inflation, which was 68.5 percent at the end of 2001, remained below the targets set in 2002 and 2003 and stands at 9.86 percent as of October 2004. Since 2001, the total decline in inflation is around 60 points, thanks to the continuing determined implementation of the stabilization program, the tight monetary and fiscal policies, effective communication policy, weakening exchange rate pass-through effect, incomes policy more or less in line with inflation target, changes in consumer and producer behaviors etc., some of which I will come back to later. Looking ahead to the remainder of this year, we do not see any serious problem that would prevent us from reaching the 12 percent CPI inflation target for 2004, therefore we will have reached our targets for the third consecutive year.

However, despite the success attained in reducing inflation, I would like to underline the fact that we have not reached our final target yet. Turkey is still one of the very few countries where double-digit inflation is still on the agenda for 2004. As we have mentioned repeatedly in the last three years, our primary objective is to achieve and maintain price stability.

Now let me emphasize once more what price stability stands for.

Within the framework of the well-known definition, price stability means both low actual inflation and, the credible expectation in the minds of financial market participants and the general public that low inflation will persist². Such an inflation rate must be so low that people do not need to take it into account in their investment, consumption and saving decisions.

At present in our disinflation process, it is clear that our economy is no longer in a chronic inflation environment. However, I would like to draw your attention to the fact that we have not yet fully ensured price stability within the context of the definition that I have just given. Therefore, our economy is still in a “falling inflation” environment.

² Broaddus, J. A. Jr. “*Monetary Policy in a Low Inflation Environment*”. Economic Quarterly – FED Richmond; Spring 2003; 89,2.

Honorable guests,

The point we reached in the fight against inflation is remarkable. Both the dynamics of inflation and dynamics of the economy as a whole go through changes as we have now moved from the chronic inflation environment to falling inflation environment.

Looking at all those countries which experienced a similar process, it is clear that the falling inflation environment differs from environments of both chronic inflation and price stability.

The falling inflation environment itself is a transition period. Therefore, features of both the ultimate price stability environment and also the previous high-inflation period can appear together in the economy. This can be explained by the fact that some sectors and economic agents can adapt themselves to the disinflation process relatively fast, while some sectors, failing to adapt to the new environment, take on different expectations and perception of risk factors shaped in the framework of their former habits.

Let me elaborate on this point as it is of great importance with regard to the achievement of price stability.

In relatively fragile economic environments such as the Turkish economy, where price stability has not yet been fully reached and current policies have not yet gained enough credibility, some economic agents may take exchange rates, monetary aggregates, interest rates or similar variables as reference while making their decisions. Therefore, as you will agree with me, expectations and risk perceptions in the economy will change according to the referenced variable.

In the current environment, some of the economic agents that I have mentioned are negatively affected by their referenced aggregates, adopted in accordance with their former habits that contradict with today's economic realities. Moreover, these economic agents tend to put the blame for worsening of their situation on falling inflation. These are the economic agents who resist the most to the fight against inflation. This adaptation problem also prevents these economic agents from seeing the advantages offered by price stability.

In this context, the most important development in the fight against inflation is that together with the increase in the credibility of current policies, the inflation target has increasingly become a more credible nominal anchor for a majority of economic agents in Turkey. In other words, the inflation target is now taken as a reference more extensively. Further developments will facilitate the adaptation of the economy to changing dynamics and support maintenance of the price stability as well.

Distinguished participants,

In this part of my speech, I would like to continue with the three pillars of the change observed in inflation dynamics in the current falling inflation environment.

The first significant change observed in economies in falling inflation environment is the decline in interest rates. If enough credibility has been established during the disinflation process, significant decline is observed both in nominal and real interest rates and this process does not only lead to rise in expenditures but also in investments.

Within this framework, a more detailed examination of the struggle against inflation process in Turkey reveals that decline in inflation also helped mitigate the fluctuations in inflation, and that means less uncertainty and less volatility in the economy. While decreased uncertainty brings along a decline first in risk premium and then in nominal as well as real interest rates, it decreases borrowing costs from consumers' point of view, and opportunity cost of investments from producers' point of view.

At this point, I would like to draw your attention to a risk factor in which the decline in borrowing costs has a significant role. Under chronic and high inflation conditions, consumers tend to renew durable goods such as automobiles, white goods and alike less frequently. However, when a certain point is attained in the process of reducing inflation and increasing credibility, consumers start purchasing their postponed needs. Therefore, pent-up demand for durable goods that the consumers defer tends to increase rapidly in the face of decline in inflation and fall in the borrowing costs in our country.

Meanwhile, there is another point that I would like to emphasize. Similar to other country experiences, in Turkey as well, the positive effects of falling inflation on investments come relatively late compared to other effects such as rise in consumption. That is because it takes time for firms to be convinced that the downward trend in inflation will continue and will be permanent and therefore they can make decisions for new investments. Thus, under falling inflation conditions, it is a natural tendency for firms to make as much investments as they actually could.

In Turkey, though economic recovery has been continuing for three years; investments have only just started to increase in the last few quarters. This is an outcome of the fact that decline in inflation and in inflationary expectations only recently gave confidence to economic agents that stability established in economy may be here to stay.

Consequently, while increase in investment demand is an outcome of the falling inflation, sustainability of this increase depends on attaining price stability.

Distinguished guests,

The second change that came along with the decline in inflation is that as a result of the ease in uncertainties, economic agents are able to foresee longer term and thus financial intermediation is becoming apparent.

Within this framework, when we look back to the chronic inflation period, we regret to see that high inflation along with chronic budget deficits and very high interest rates caused deterioration in the intermediary function of the banking sector and forced the sector to finance public deficits instead. During this period, the financial sector has become very fragile and edged away from its main duty of financing production.

Today, we are happy to see that enhanced competition and economic stability following the decline in inflation and ease of the impact of inflation-led uncertainties on financial markets, the financial intermediation mechanism has started to operate more efficiently. Moreover, serious steps are being taken towards establishment of banking sector-real sector relationship. The ratio of total credits to total deposits, which has been on the rise since 2003, is a clear indicator of this process.

However, let me draw your attention to one point. It is clear that, in order to maintain financial stability in the current environment of relative economic stability, the relationship between the banking sector and the real sector needs to be developed not only for an efficient credit channel, but also with respect to risk evaluation. The progress of risk management in the banking sector will ensure that companies have sounder financial structures, that they develop more transparent financial tables and adopt modern management styles. To express it more openly, the progress of modern risk management in both financial as well as corporate sectors will prevent developments jeopardizing financial stability that may arise out of imbalances between assets and liabilities, stemming from different perceptions in the process of transition to price stability.

Dear participants;

In terms of the structural transformation process, the financial sector, owing to its importance, is the sector that is most and quickly affected from the disinflation process, as well as being the leading sector in terms of supporting the process. Accordingly, further steps need to be taken in this sector in the disinflation process.

Dear guests;

The third factor I will be conveying to you today within the context of the effects of falling inflation on the economy is that, together with falling and foreseeable inflation, prices resume their signaling task in the economy and thus their roles as indicators in the allocation of resources.

Departing from the example of Turkey's past experience of chronic inflation, consumers tended to make less price and quality controls, and attach less significance to diversity in their choices of goods. Producers on the other hand, used to set their profit margins freely to a large extent, paying little attention to their pricing, costs and productivity. They also showed little interest in making investments for increasing the diversity of their products. As a result of this structure, the quality of production declined in time, the global competitiveness of our country weakened and integration with the world economy was delayed.

Nevertheless, with the absolute as well as the relative prices resuming their signaling task following the decline in inflation, the behavior patterns of producers and consumers in Turkey began to change.

At present, producers are in a position to differentiate, to a large extent, whether the increase in prices is attributable to inflation or to an increase in demand, and can take their decisions with regard to increasing production, making investments, etc., within this framework. They now give importance to cost control and productivity increase while determining the profit margins in their pricing policies.

Similarly, consumers have also begun to actively participate in the pricing process, using the advantage of a more competitive environment.

At this point, I wish to emphasize two issues I deem significant. The first one of these, also motivated by the pricing behavior directed to increasing the profit margins, is that inflation falls at a slower pace at some sectors where demand is relatively rigid and competitive

structure is relatively weak, compared to other sectors. This situation is also expressed as rigidity in inflation, and by way of causing differentiation in relative prices, forms an obstacle to prices to carry on their task of signaling information properly. The rigidity in inflation recently observed in Turkey, namely prices of services such as education, rents and hospital services falling at a slower pace compared to the prices of goods, is an example of this. Thus, it is crucial that measures to increase competitiveness and reduce backward indexation in these sectors are taken promptly in order to eliminate this distorted structure and also reduce the risk it constitutes to inflation targets in future.

A second point in connection with this is that; it is inevitable that in time, together with healthier price signals, the resources of our economy will shift to firms and sectors with higher productivity, as was the case in other countries. The firms and sectors that had benefited from the consumption and pricing habits of the chronic inflation environment, but could not work efficiently, will be leaving their places, in this process, to more competitive firms and sectors with higher productivity.

Dear guests;

At this point, I wish to mention an extremely significant issue in terms of its effect on the future course of inflation, regarding the changes in the pricing behavior of producers. This is the process of exchange rate affecting inflation, known also as the pass-through effect. The effect of exchange rate on inflation in Turkey is weakening gradually, due to the changing pricing behavior of producers as a result of the decline in inflation. As observed especially in the recent period, the impact of the movements in exchange rate on inflation is now less than it was in the past and more lagged compared to the past chronic inflation period.

Dear participants;

Lastly, I would like to briefly mention what the economy of our country can gain if the primary objective, which is price stability, is finally accomplished.

First of all, securing price stability will make all that we have gained in the process of the falling inflation, permanent. When price stability is achieved, macroeconomic stability will sustain and efficiency in the economy will increase. It should be remembered that by attaining price stability, a requirement for sustainable growth and employment will be fulfilled.

As a result of all these macroeconomic gains, economic agents will no longer take into consideration an uncertainty like inflation both in their investment and consumption decisions. They will be able to foresee longer term and plan more securely.

Since economic agents, while making decisions, are able to foresee longer term easier under price stability, the labor market will also work more efficiently, and people will be able to find more permanent jobs in this stable environment.

Stable environment achieved with price stability will accelerate the inflow of foreign direct investment and our competitiveness in the international markets will increase.

We should not forget that inflation was not only the most important problem of our country for years but also kept us from seeing the other problems in the society and in the economy. Maintaining price stability will repair the damages in the economy caused by high inflation and will help us see the other problems hiding behind inflation. Structural reforms are the key to erasing the traces of past chronic inflation period and to solving other social and economic problems of our country.

Today, the process of erasing these traces begins with the operation of dropping six zeros off the Turkish lira. I would like to underline that an important issue here. In some countries that had dropped zeros off their currencies, this operation was conducted as part of the disinflation policy. However, in our country it is taking place as a consequence of the successful implementation of the stabilization program that has already reduced inflation considerably.

The New Turkish Lira to be issued as of January 1st, 2005, shows our determination to achieve price stability.

Before I finish, I wish to repeat a remark I made two years ago at the start of the fight against inflation:

“Above all, it is a basic right for people to live in an environment where price stability has been permanently achieved.”

Thank you.