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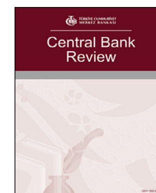
Central Bank Review xxx (2016) 1–8

Contents lists available at ScienceDirect

Central Bank Review

journal homepage: http://www.journals.elsevier.com/central-bank-review/



A brief assessment of Turkey's macroprudential policy approach: 2011–2015[☆]

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ARTICLE INFO

Article history:
Received 29 July 2016
Accepted 8 August 2016
Available online xxx

JEL Classifications:
E32
E44
E51
E52
E58
G18
G28

Keywords:
Macroprudential policy
Monetary policy
Capital flows
Credit growth
Emerging markets

ABSTRACT

The predominant role of cross border financial flows for macroeconomic and financial stability has imposed complex policy trade-offs for emerging economies, especially after the global financial crisis. This note provides a brief account of the macroprudential policy approach adopted in Turkey between the years 2011 and 2015, a period when global capital flows exhibited unprecedented volatility. Special emphasis is put on the use of monetary policy tools for macroprudential purposes. We first highlight the particular role of external flows and the associated tradeoffs in designing the monetary policy and macroprudential policy framework. Next, we describe the policy implementation by the central bank and the regulatory authorities, and evaluate the consequent outcomes. Our analysis suggests that macroprudential policies have improved external balances, dampened financial amplification channels, and reduced the sensitivity of the Turkish economy to capital flows.

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1. Introduction

The global financial crisis has led to a reassessment of macroeconomic policy formulation across the globe. Countries have expanded their policy toolkits with macroprudential policies in recent years to deal with macro financial risks.[1] The heightened volatility in capital flows during the post-crisis period has led to significant challenges especially for emerging economies by worsening policy trade-offs. Such an environment made additional tools of macroeconomic and financial policy more valuable.[2]

Against this backdrop, Turkey has taken a number of steps towards building an institutional setup for implementing explicit macroprudential policies since 2011. To this end, the Central Bank of the Republic of Turkey (CBRT) modified the inflation targeting framework by incorporating financial stability as a supplementary objective. Moreover, a formal Financial Stability Committee (FSC) was founded to respond to macro-financial risks in a more systematic and coordinated fashion. Through the recommendations of the FSC, the Banking Regulation and Supervision Agency has taken a comprehensive set of measures to contain excessive leverage and to improve households' financial position. This study conducts a broad evaluation of the macroprudential policy implementation in Turkey during this process and draws some policy implications.

How to design and implement macroprudential policies has been of great interest to both policy institutions and academia after the global financial crisis. The renewed interest in conducting macroprudential policy yielded a substantial amount of research in recent years. New theoretical results and empirical findings triggered attempts to streamline and standardise the conduct of macroprudential policy.[3] Although these efforts have tremendously

☆ The views expressed in this paper are those of the authors' and do not necessarily represent the official views of the Central Bank of the Republic of Turkey. I would like to thank Koray Alper, Uğur Çıplak, Deren Ünalmış, Pınar Özlü, Faruk Aydın, and Canan Yüksel for useful contributions.

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Peer review under responsibility of the Central Bank of the Republic of Turkey.

[1] For an overview of macroprudential policy measures across advanced and emerging economies see, eg, Lim et al. (2011), Tovar et al. (2012), Ostry et al. (2012), Claessens and Ghosh (2013), Claessens et al. (2013), Claessens (2014), Galati and Moessner (2013, 2014), Bruno and Shin (2014) and Akıncı and Olmstead-Rumsey (2015), among others.

[2] See Obstfeld (2015).

[3] See IMF (2013, 2015) and Schoenmaker (2014), among others.

http://dx.doi.org/10.1016/j.cbrev.2016.08.001
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Please cite this article in press as: Kara, H., A brief assessment of Turkey's macroprudential policy approach: 2011–2015, Central Bank Review (2016), http://dx.doi.org/10.1016/j.cbrev.2016.08.001

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contributed to our understanding of macroprudential policy, they are mostly based on theoretical results or cross-country evidences with limited attention to country-specific characteristics. Given the complexity of instruments, long lags with which they affect the final policy objectives, and the short size of the data, the existing theoretical and empirical literature may still have to be complemented by case studies. In that sense, we believe that individual country experiences may provide valuable insights for the design and conduct of macroprudential policies.

Macroprudential policy experience of Turkey may yield contributions for the current debate at least for two reasons: first, Turkey has been quite active on the macroprudential front in recent years, using a wide range of tools imposed through restrictions on both borrowers and financial institutions; second, design and implementation of macroprudential policy framework in Turkey reflects a purely emerging economy perspective, where special emphasis has been given to the role of capital flows. Understanding this approach may yield particularly valuable insights, because recent studies have mostly focused on advanced economy settings. The central role of capital flows in driving business cycles and macro-financial risks in emerging economies may have different implications for the conduct of macroprudential policies as well as for the interaction between monetary and macroprudential policies.

The design and implementation of macroprudential policies are largely country-specific, depending on the initial cyclical and structural characteristics of the economy as well as the institutional background. Therefore, we proceed by describing the initial conditions and the background for the Turkish case.

2. Background

Turkey faced rapid credit growth during the past decade on the back of improved economic fundamentals after the 2001 crisis and easy global liquidity conditions. The 2001 crisis, which was a home-made event consisting of a mixture of banking, fiscal, and balance of payment crises, incorporated many features of the conventional crisis literature. The response to such a devastating crisis was strong. Several structural adjustments took place on fiscal, monetary and prudential dimensions. The new Central Bank law, introduction of a floating exchange rate regime along with inflation targeting, consolidation and strengthening of the banking system and fiscal balances, and foundation of a new banking regulatory and supervisory agency have made Turkey an attractive destination for capital flows. Fuelled by ample global liquidity and also supported by demographic factors, Turkey faced rapid credit growth during the 2000s, as private credit to GDP ratio rose sharply (Fig. 1).

Perhaps paradoxically, rapid credit growth during the past decade coincided with a considerably tight bank regulation and supervision. Prudential policies in Turkey are traditionally implemented through the banking system, as Turkish financial intermediation is dominated by banks.[4] Reflecting the bitter experience of the past financial crises, bank regulation and supervision has been unambiguously prudent during the past decade. For example, banks were not allowed to have currency mismatches, foreign currency loans to consumers were prohibited, and there were restrictions on foreign currency lending to non-financial firms. Tight restrictions were imposed on distributing bank dividends, new bank entry, branch openings etc. Moreover, Banking Regulation and Supervision Agency (BRSA) imposed significantly higher minimum capital adequacy and liquidity coverage ratios than required by international standards. Reflecting the cautious prudential framework, banks have maintained ample capital and liquidity buffers during this period.[5]

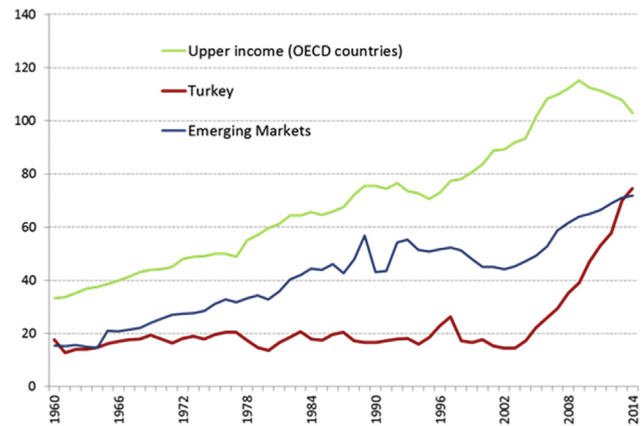

Fig. 1. Private Credit/GDP ratio. Source: World Bank.

Although many of these prudential features had macro implications, a formal macroprudential perspective was lacking during the 2000s. BRSA had a microprudential mandate, mostly focussing on the health of individual banks. CBRT published a financial stability report with a macro perspective, but monetary policy was conducted under a conventional inflation targeting regime, with no explicit mandate or tool(s) for responding to macro-financial risks.

The quantitative easing by advanced economies and the surge of capital flows to emerging economies after the global financial crisis further highlighted the need to adopt an explicit macro approach to financial stability. The underlying trend of private credit growth rate climbed to 40% at the end of 2010. Meanwhile, Turkish lira appreciated rapidly in real terms. These developments were accompanied by an overheating in the economy and a sharp widening in the current account deficit. Perhaps more importantly, the quality of external finance deteriorated sharply. By the end of 2010, almost all the current account deficit was financed by either short-term or portfolio flows, leaving the economy susceptible to sudden reversals in global sentiment (Fig. 2).

The large external financing needs and the deterioration in the quality of inflows in 2010 have increased the so called "sudden stop" risks for the Turkish economy. Historically, capital outflows have been the main trigger of output losses across emerging economies[6] and Turkey has been no exception in this regard. Turkish business cycles were dominated by boom-bust episodes, which were amplified by sudden movements in capital flows. The massive economic contractions in 1994, 2001, and 2009 reflected such episodes. Each recession was accompanied by a net capital outflow (sudden stop) and a disruption in the financial system. Given such an historical background, the sharp deterioration in the current account balance and the quality of external financing by the end of 2010 called for a timely response, once again highlighting the need to adopt a macro approach to financial stability.[7]

Although the build-up of macro-financial risks in 2010 required a prompt policy response, it was not clear *who* should react and *how* the response would be executed in practice. Given the dominant role

[4] As of September 2015, 92.3% of the financial liabilities of households are to banks (see Central Bank of the Republic of Turkey Financial Stability Report, November 2015, Table II.1.2).

[5] For example, the capital adequacy ratio of the system was above 16% throughout the period of 2002–10.

[6] See Claessens and Ghosh (2013) for some evidence.

[7] See Başçı and Kara (2011) for more details on the rationale behind the change in the policy approach.

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