Inflation and Central Bank Independence - The Case of Türkiye

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The world is currently in the midst of a severe inflation crisis, with many countries experiencing the highest inflation rates seen in decades. As is conventional in contemporary economic practice, this has prompted many central banks to increase the interest rates in order to quell the increase in the price level, by tampering the demand for consumer goods and making borrowing more expensive as a way to cool down the overheating economy.[1] One nation however is taking a different route from all these other countries. The Republic of Türkiye has over the past few months continuously displayed some of the highest inflation rates in the world and is refusing to increase the interest rates, in fact doing the opposite and continuing to decrease them. The country reported an inflation rate of 85.5% for the month of October 2022, which corresponds to the highest level in more than a quarter century and represents a 400% increase since January 2022.[2] This rate has since dipped again to approximately 65%, a rate which remains unnaturally elevated.[3] This corresponds to a 9-month low and may signal a recovery for the price levels in the country or simply the result of a favorable base effect. In any case the current situation deserves close attention. The following graph depicts the aggressive increase of inflation over the last 3 years.[4]

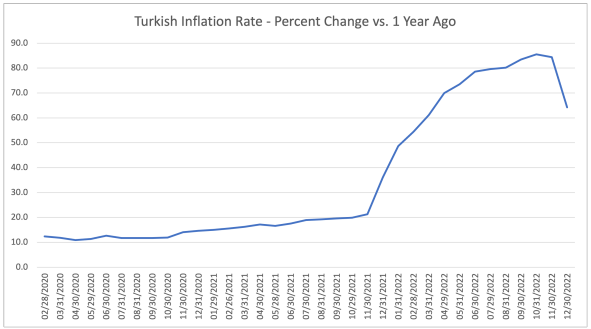

Figure 1: Turkish Inflation over the past 3 years on a monthly basis. Source Factset

A common consensus among economists today, introduced by Milton Friedman as the so-called k% rule, is that the money supply growth, i.e. defined by Friedman as the inflation rate, should be equal to the growth rate of domestic product each year, thereby setting the benchmark for yearly inflation to be around 2 – 5%.[5] The levels of inflation recorded in Türkiye exceeds this recommended benchmark by a significant margin and pose a significant threat to the Turkish economy. However, according to the Turkish president Erdogan, this inflation does not pose an "insurmountable economic threat".[6] The President of Türkiye and his finance minister Nureddin Nebati, looking to reassure their citizens and foreign investors, claimed that inflation levels had reached their climax and would fall back to "appropriate" rates by February or March of next year, in addition to championing their current GDP levels which have reached 7.6% growth level in the second quarter of 2022. As stated by Erdoğan: "Currently, Türkiye's growth rate is 7.6%. We are currently in second place in the world in growth. And that shows something,".[7] The following graph depicts the seasonally adjusted GDP levels of Türkiye in billions of lira over the past few years.[8]

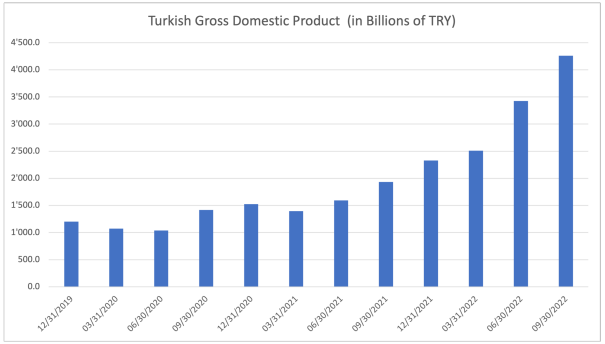

Figure 2: Turkish GDP Growth measured as the percent change vs. 1 period ago. Source Factset

This growth in GDP can in the short-run pri-

[1] Calvo, G. A., & Végh, C. A. (1995). Fighting Inflation with High Interest Rates: The Small Open Economy Case under Flexible Prices. *Journal of Money, Credit and Banking*, 27(1)

[2] Turak, N. (November 3, 2022) Turkey's inflation tops 85 per as Erdogan continues to rule out interest rate hikes. *CNBC*.

[3] Kucukgocmen A., and Erkoyun E. (January 19, 2022) Turkey cenbank holds rate at 9%, inflation to dip from 64%. *Reuters*.

[4] Factset. Economics. Consumer Prices – Turkey

[5] Kilponen, J., & Leitemo, K. (2008). Model Uncertainty and Delegation: A Case for Friedman's k-Percent Money Growth Rule? *Journal of Money, Credit and Banking*, Vol. 40(2/3), pp. 547-556

[6] Daily Sabah with Agencies. (September 20, 2022) Inflation not 'insurmountable economic threat': Erdoğan. *Daily Sabah*.

[7] Daily Sabah with Agencies. (September 20, 2022) Inflation not 'insurmountable economic threat': Erdoğan. *Daily Sabah*.

[8] Factset. Economics. GDP by Industry - Turkey

marily be explained by the revival of the Turkish tourist economy which has rebounded after 2020. In addition the continuous long run efforts by the Turkish central bank over the past several years to slash interest rates, in order to incentivize borrowing and spending by the population, have contributed in sustaining the growth levels above those of its neighbors. The reduction in the key interest rate has continued despite the country's inflation worries with the Central Bank implementing cut of 150 basis points in October 2022, from 12% to 10.5%, despite inflation reaching 83%.[9] Currently the interest rate lies at 9% for the month of January, 2023.[10] The current situation in Türkiye is therefore extremely interesting as it provides an example in which GDP growth and inflation not only coexist but relate to one another. One of the main economic theories finds a positive correlation between GDP growth and inflation, i.e. that a high economic growth would lead to an increase in inflation. The reasoning behind this theory is that through economic growth, which supersedes the long run sustainable growth level, aggregate demand of the population increases faster than aggregate supply, leading to an upward pressure on price levels.[11] This model of inflation, denoted as the Demand-Pull inflation, occurs when an increase in consumer demand for goods and services supersedes the current level of supply, thereby leading firms and businesses to increase prices in order to balance out the shortage of supply. Additionally companies will, through labor unions, be forced to raise wages due to the tightening of the labor market, which once again increases the price levels, as companies pass on said increase to consumers in the form of higher prices in order to keep profits more or less equal.[12] This is mirrored in the situation in Türkiye, where the government has continuously increased the gross minimum wage over the last six month as depicted in the following graph.[13]

Figure 3: Increase in Gross Minimum Wage in Turkey since 2017. Source Take-Profit.org

President Erdogan announced that the gross minimum salary for the first month of 2023 would be an astounding 10,008 lira (535.98 dollars), which corresponds approximately to a net minimum salary of 8'500 lira. This corresponds to a 50% increase to the level determined by the government in July and a 94% increase since January 2021.[14] As opposed to other states around the world, for which the current inflation rates can primarily be explained by the substantial recovery and stimulus packages passed by their governments, the inflation in Türkiye has a much more institutional and far-reaching component, which is not only limited to the last 2 years. Erdogan is known for putting a lot of emphasis on the unorthodox belief that raising the interest rate in fact leads to an increase in inflation, stating that doing so constitutes the "mother of all evil".[15] Therefore, the continuous efforts by the Turkish Central Bank over the past several years to repeatably cut interest rates in favor of economic growth as well as a complete halt in economic activity for almost 2 years due to the Covid-19 pandemic, have weakened the lira and made it vulnerable to short-term outside shocks. Over the last year the Lira has lost more than 50% of its value against the U.S. dollar.[16] Türkiye has to a certain degree attempted to capitalize on its weakening currency as exports become more attractive to its trading partners. However the fear of recession in Europe, Türkiye's main export partners, may lead to a decrease in exports regardless thereby counteracting one of the only positive effects of having a weak currency.

With countless economists and experts around the world pointing to the gravity of the situation combined with Erdogan's vocal and determined position on increasing interest rates this has naturally raised doubts about the independence of the central bank. What defines whether a central bank is independent is its ability to set interest rates and/or increase the money supply by buying bonds and printing money without the interference from

[9] Turak, Natasha. (October 20, 2022) Turkey slashes interest rates by 150 basis points despite inflation at 83%. *CNBC*.

[10] Trading Economics. Turkey Interest Rate.

[11] Machlup, F. (1960). Another View of Cost-Push and Demand-Pull Inflation. *The Review of Economics and Statistics*, 42(2), pp. 125–139.

[12] Barnes, R. (2021) The Importance of Inflation and GDP. *Investopedia*.

[13] Take-Profit.org. Turkey Wages: Minimum and Average

[14] Trading Economics. Turkey Gross Minimum Monthly Wage

[15] Turak, Natasha. (October 20, 2022) Turkey slashes interest rates by 150 basis points despite inflation at 83%. *CNBC*.

[16] Akman, Beril (October 27, 2022) Turkey Gets to Rewrite Inflation Forecasts Again After Rate Cuts. *Bloomberg*.

elected officials or the private sector. This independence is largely regarded as essential not only for a functioning economy but also democracy and has been a precondition for the entry into the European Union as well as a criterion for evaluating the risk of internationally traded government bonds.[17] The independence of the Turkish central bank has recently been called into question after the dismissal of Naci Agbal in March 2022, after he had attempted to bring the high inflation rates under control by increasing the interest rates. Naci Agbal was replaced by Sahap Kavcioglu, who has since continued decreasing the interest rates within the country, which have plateaued at 9%.[18] The Republic of Türkiye has now seen four central bank governors come and go in the span of two years, indicating a high level of involvement by the political branch of government.[19] The case for central bank independence, whose roots stem from the early 1970's, has been continuously strengthened by empirical evidence. The main theoretical framework supporting the concept of central bank independence relates to the inflation bias and its mitigation. According to scholars, the inflation bias is the inherent outcome of discretionary monetary policy, which describes an economic policy for which policymakers make ad hoc judgements rather than according to predetermined rules.[20] In such a system, where certain policymakers may be motivated by short-term election results, the central bank may be influenced in setting an objective for which real output is above the economy's natural equilibrium levels or in which unemployment rests below the natural equilibrium. If real output (unemployment) is set above (below) its natural level, this places an upward pressure on prices as well as wages, leading to an increase in inflation.[21] In addition, and under rational expectations, the public will anticipate this increase in inflation and create new expectations, which will in turn also lead to higher inflation. Therefore the mere suggestion to the rational public that elected officials, whose motives may differ from the well-being of the economy, have an influence on the central bank objectives, can lead to higher inflation levels.[22] Therefore, regardless of whether or not a government such as that of Türkiye's is in fact involved in the policy setting of its central bank, the indication of such, for example through media attention, can already have negative effects on inflation.

Türkiye consequently stands at a pivotal point in its contemporary history. A long-term trend of GDP growth has lifted a large portion of the country out of poverty, but recent global political and economic developments paired with doubts on the governments implications into monetary policy may lead to the negation of said efforts.

[17] Şahin, S. B. (2012). Central bank independence in Turkey: A neo-Gramscian analysis. *Cooperation and Conflict*, 47(1), 106–123

[18] Kucukgocmen A., and Erkoyun E. (January 19, 2022) Turkey cenbank holds rate at 9%, inflation to dip from 64%. *Reuters*.

[19] Monitors Editorial Board. (March 22, 2021) Turkey shows why Central Bank independence is central. *The CSMonitor*.

[20] Fischer, S. (1995). Central-Bank Independence Revisited. *The American Economic Review*, 85(2), 201–206.

[21] Walsh, C.E. (2010). Central Bank Independence. In: Durlauf, S.N., Blume, L.E. (eds) Monetary Economics. The New Palgrave Economics Collection. Palgrave Macmillan, London

[22] Garman, D. M., and Richards, D. J. (1989). Policy Rules, Inflationary Bias, and Cyclical Stability. *Journal of Money, Credit and Banking*, 21(4), 409–421