TÜRKİYE CUMHURİYET MERKEZ BANKASI

«RBI's Policy Dilemmas – Reconciling Policy Goals in Times of Turbulence»

by Bruno Carrasco & Hiranya Mukhopadhyay

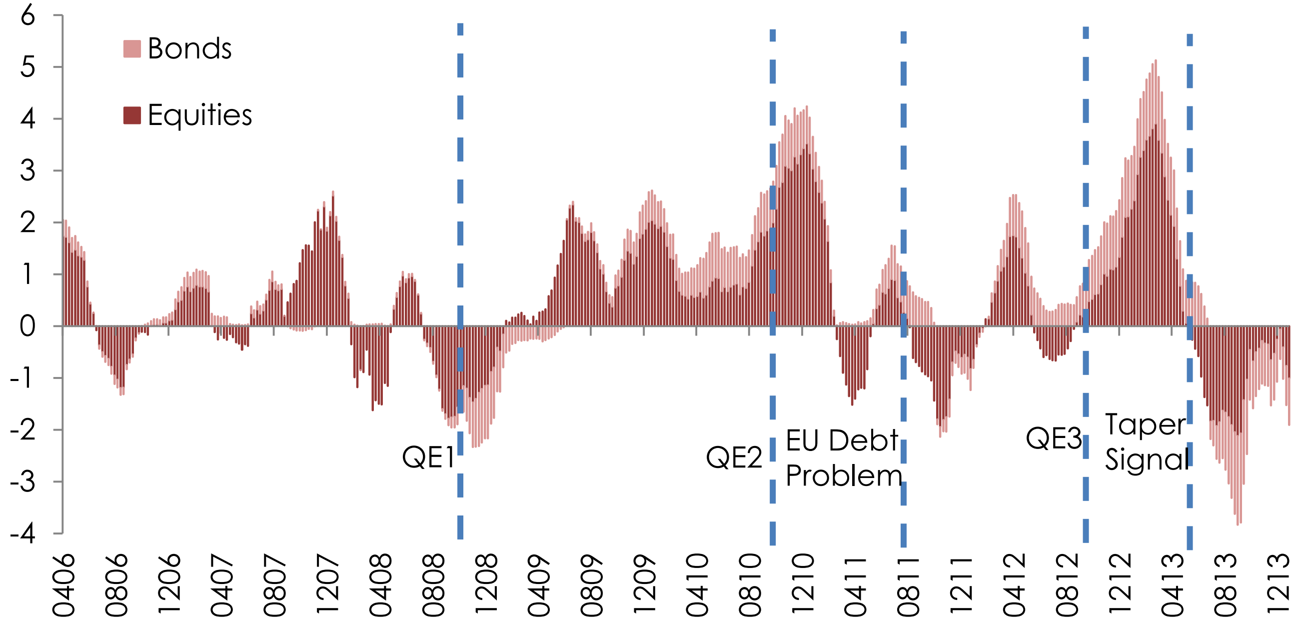
Discussion by
Salih Fendoğlu

ECB-IMF Conference on
"International Dimensions of conventional and unconventional monetary policy"

April 28-29, 2014 – Frankfurt am Main

Interesting how times have changed…

➢ **Emerging Market Annual Fund Flows (13-week moving average, billion USD)**



➢ An amplified cycle of business cycles: accelerated capital flows, higher domestic credit growth, higher non-tradables inflation, currency appreciation, further capital inflows.

The paper

- Assessing the RBI's policy responses in the recent period (2010-):
  1. The weight RBI attaches to inflation and output gap (and perhaps exchange rate) in policy making?
  2. Responding to food price inflation?
  3. Effectiveness of policy responses under different credit market conditions?

The paper
(Methodology)

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1. The weight RBI attaches to inflation and output gap (and perhaps exchange rate) in policy making?

   → estimating a Taylor-type rule

2. Responding to food price inflation?

   → link between food price inflation and core inflation?

3. Effectiveness of policy responses under different credit market conditions?

   → estimating the credit regime (demand or supply constrained?)

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     (demand or supply constrained?)

- The paper does a good job in addressing these questions.

1. The weight RBI attaches to different objectives in policy making

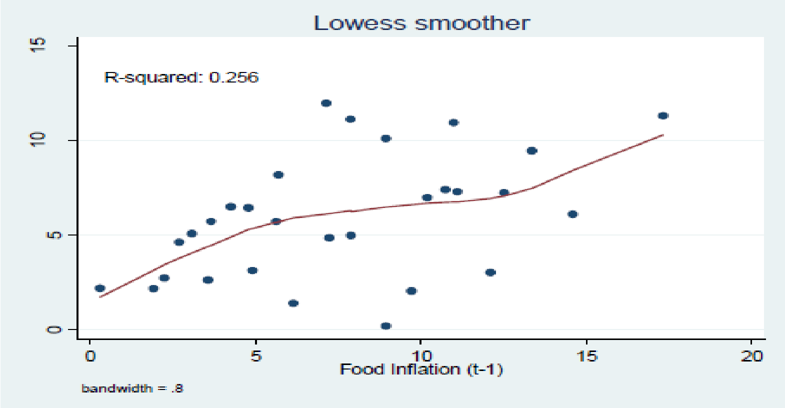
- Estimate a Taylor-type rule (2000Q1-2012Q4):

$$i_t = [0.04,0.05]\ i_{t-1} + [0.13,0.16]\ \text{Inflation} + ..$$

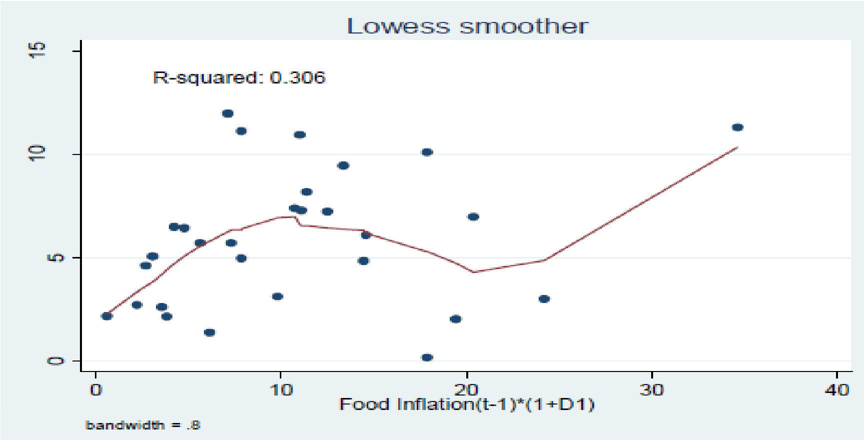
$$+ [0.04,0.05]\ \text{Output Gap} + \cancel{[0.13,0.16]}\ \Delta ER$$

- Results:
  - A good approximation of actual policy making, and interest rate is not too high or too low:
    - actual and predicted interest rates are fairly close.
  - Inflation stability remains the main goal.
    - despite much criticism that RBI is too easily swayed by growth considerations.
  - No direct reaction to ER movements.

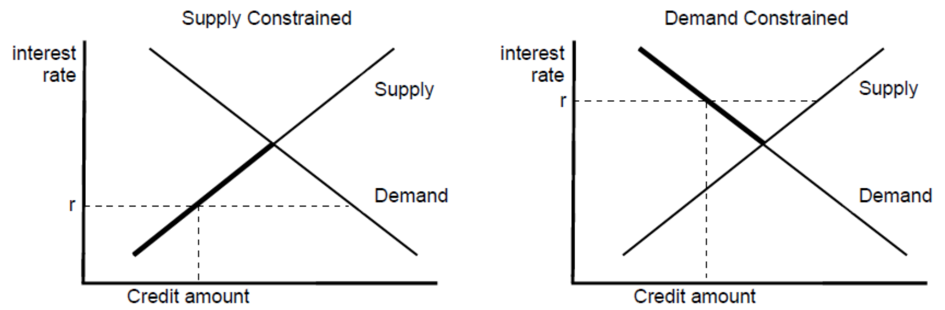
- Significant link between food price inflation and future core inflation:



- Lack of full credibility (higher R^2):

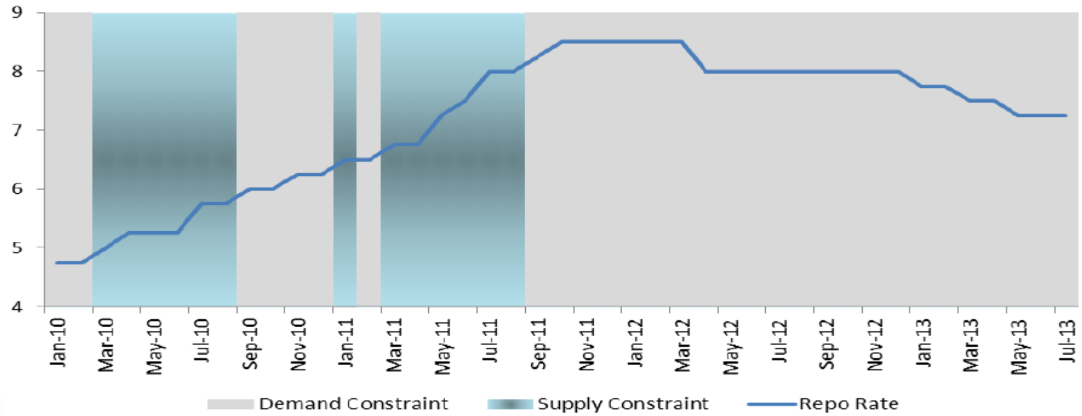


- Policy is effective only if credit conditions are demand constrained:



  - Demand for credit: expected level (*GIIP*) and volatility (*RISK*) of industrial growth rate.
  - Supply of credit: deposit base (*GLOANF*).

- Using estimated parameters, estimate GCREDIT = f(Z).



Comments

- Robustness of the interest rate rule specification? Forward-looking behavior? The degree of forward-looking? Additional variables? The targets? e.g. Patra and Kapur (2012, IMFWP).
- Concluding policy rate too high or too low?
  - From historical perspective: Comparison with a whole-sample fitted rule is biased (in-sample overfitting) → rolling $i_t - E[\, i_t \mid I_t \,]$.
  - From optimal point of view: Solving Ramsey DSGE model and study decentralized eq. that replicates the Ramsey welfare as close as possible (SGU, 2004; Fendoglu, 2014).
- Does higher φ_π imply a stronger preference for inflation (than output gap)?

Comments

- Lack of full credibility?
  - may refer to the large literature on CB transparency / independency (e.g. Dincer & Eichengreen, IJCB).
- For validation/robustness, going beyond identifying the credit market regimes (demand- or supply-constrained) is important.
  - a ‘direct’ test of policy effectiveness on e.g. domestic credit growth under the two regimes would be informative. Lower effectiveness under the ‘identified’ supply regimes?
- Given multiple objectives, any role for other policy tools besides the policy rate?
  - Reserve requirement ratios, etc., other tools for financial stability.
  - More clear picture on the (in)effectiveness of policy rate.

Turkish Case – Financial Stability as a supplementary objective

	Old Approach	New Approach
Objectives	Price Stability	Price Stability Financial Stability
Policy Tools	Policy Rate	Structural Tools Cyclical Tools

- Structural Tools:
  - **Maturity-based and Leverage-based Reserve Requirements**
  - **Reserve Option Mechanism**
- Cyclical Tools:
  - Policy Rate
  - **Interest Rate Corridor**
  - TL and FX Liquidity Management
- Further financial stability measures (micro-prudential policies by the BRSA)
  - e.g. Restrictions on FX lending, loan-to-value ceilings, high risk weight for consumer loans, sectoral measures for provisions, restrictions on installment sale for credit cards.

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higher maturity → lower RR

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higher leverage ratio → higher RR

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an option to fulfill domestic RRs with dollar/Euro or gold

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managed uncertainty about money market rates to discourage/encourage short-term flows

Final Remarks

- Overall, a good and comprehensive analysis to assess the RBI’s policy trade-offs and policy responses.
- Further analyses would shed more light on the results.

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