Turkey: An Inflation-Forecast Targeting Regime

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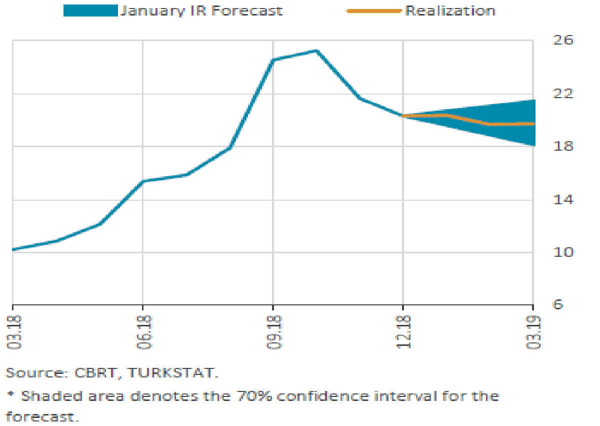
The Central Bank of Turkey (CBRT) published last Tuesday its latest inflation report. As usual, the Governor presented the expected outlook for inflation and answered the questions of economists and journalists. Besides, the Governor commented on the international reserves and downplayed the importance of last week's change in the monetary policy statement, stating that it was a "structural approach" rather than a "short term signal of direction" and even added that "if upward risks to inflation materialize additional tightening can be provided if needed". We believe rather than opening the door to a tighter monetary policy, the CBRT is moving to Inflation Forecast Targeting (IFT) framework. If so, we understand that the CBRT remains confident with the actual inflation outlook and furthermore they will maintain the actual stance (which embeds a consistent policy rate path) as long as the upward/downward risks to the forecasts do not materialize. In absence of shocks, we expect policy rates to be on hold in the short term and to be reduced later (consistently with a decreasing ex-ante real interest rate).

Inflation forecast targeting (IFT): A forward-looking model framework

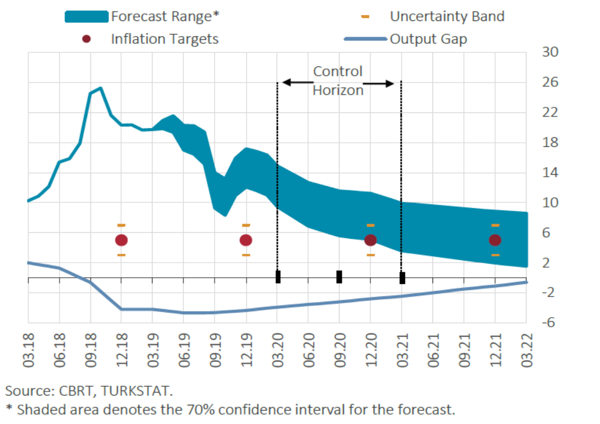
The IFT has been increasingly adopted by several central banks (Canada, Czech Rep., Nordics…). Under the IFT, the central bank's "inflation forecast" represents an "intermediate target" to manage and in the short run communicate about the output-inflation trade-off of the final target (5% of CBRT). A simple Taylor rule could be used but this is a simplistic representation about what the CBs need to do and communicate given the presence of lags, expectations and nonlinearities. The forecast path for the official interest rate is endogenous and will change to achieve the path to a long-run inflation target and to close the output gap. The forecast of the model is a key (but not the only one) input for the MPC decision. As the path for key macroeconomic variables as inflation rate and output gap (in some countries even the interest rate path) are normally disclosed, the rationale for policy decisions and risks can be better explained. The IFT also provides flexibility and enhances transparency. At minimum, the central bank publishes an explicit path for the inflation rate forecast showing how quickly the central bank aims to get inflation back on track over the medium term (the 5% target in 2021 in the case of Turkey) and what this will likely imply for the official rate.

Chart 1 CBRT January inflation forecasts & realization



Source: CBRT

Chart 2 CBRT Inflation & Output Gap forecasts



Source: CBRT

Nominal policy rate on hold in short run but decreasing rates in mid-term

We believe that the CBRT is adopting the IFT, consistent with the removal of the warning in the monetary policy statement and the new warning in the inflation report. Inflation expectations are in line with the previous inflation report (Chart 2). The CBRT considers that some of the risks from March´s FX volatility have normalized (as they also expect the normalization of risk premium in the forecast) but they announce that they are ready to act if upward risks to these forecasts emerge. In the mid-term a decrease in nominal and real interest rates are consistent with the new forecast path of both inflation and the output gap included in the inflation report.

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