KENNESAW STATE UNIVERSITY
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Commentary

Title:

"Why Turkey's Lowering of the Interest Rate is the Wrong Monetary Policy Tool to Fight Spiraling Inflation"

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Bcack `cp 2021

This commentary will analyze whether in its bid to increase aggregate demand, output, and low unemployment, Turkey's decision to lower interest rate is the most favorable move to fight off the spiraling inflation affecting the country.

To begin with, it is essential to underscore that any nation's monetary policies should ideally serve as stabilizers for its economy. If the economy is slowing down due to recession and unemployment, it is expected that the central bank will choose to increase the money supply with an aim at increasing aggregate demand and thereby employ resources that are sitting idle. The central bank does so by either buying securities, lowering the reserve ratio, or lowering the discount rate. The objective of such *expansionary monetary policy* is to make bank loans less costly and easily accessible to businesses and the masses, and through this manner, increase aggregate demand, production, and employment. Alternatively, if the economy is experiencing an inflationary spiral due to excessive spending, the central bank must attempt to decrease aggregate demand by contracting the money supply. This is accomplished by way of selling securities, increasing the reserve ratio, or raising the discount rate. These *contractionary monetary policy* actions are meant to reduce the money supply with a purpose of reducing spending and controlling inflation.

While central banks around the world (e.g., the U.S. Federal Reserve, the Bank of England, and the Central Bank of the Republic of Turkey) have some similarities and characteristic differences, their main goal is to oversee the monetary system and policy of a nation by regulating its money supply, often by setting interest rates. Interest rates are a vital medium on which monetary policy influences the macroeconomy since interest rates impact the economy by influencing bond and stock interest rates, business and consumer spending, and ultimately macroeconomic outcomes like the unemployment rate, GDP growth rate, and inflation rate.

Turkey's current economic crisis is likely caused by a combination of: the Turkish economy's disproportionate current trade deficit (with large amounts of private foreign-currency denominated debt) and dependency on foreign direct investment; President Recep Tayyip Erdogan's increasing autocratic leadership and his fundamental monetary policy nonlinearities linked to the level of interest rates; and worldwide price pressures owing to supply-chain holdups and scarcities of raw materials. The currency – Turkish Lira – has lost more than 40 percent of its value against the U.S. dollar, reaching its lowest currency value of 13.47 to the dollar, on November 30, 2021.[1] For comparison, the Turkish Lira was trading at roughly 5.6 to the dollar in 2019 and 3.5 to the dollar in mid-2017.

According to Erdogan, higher interest rates will result in higher prices because companies have no choice but to pass increased costs on to their consumers. His strong and long-held belief is that higher interest rates cause inflation, rather than bring it down. Erdogan has unswervingly declined to raise interest rates to control Turkey's rising double-digit inflation, saying, "Interest rates are the reason; inflation is the result. My argument hasn't changed, I still defend it, believe in it."[2] As a result, the Turkish lira has plunged in value largely because of his position in lowering interest rates. Inflation in Turkey is approaching 20% (Figure 1).

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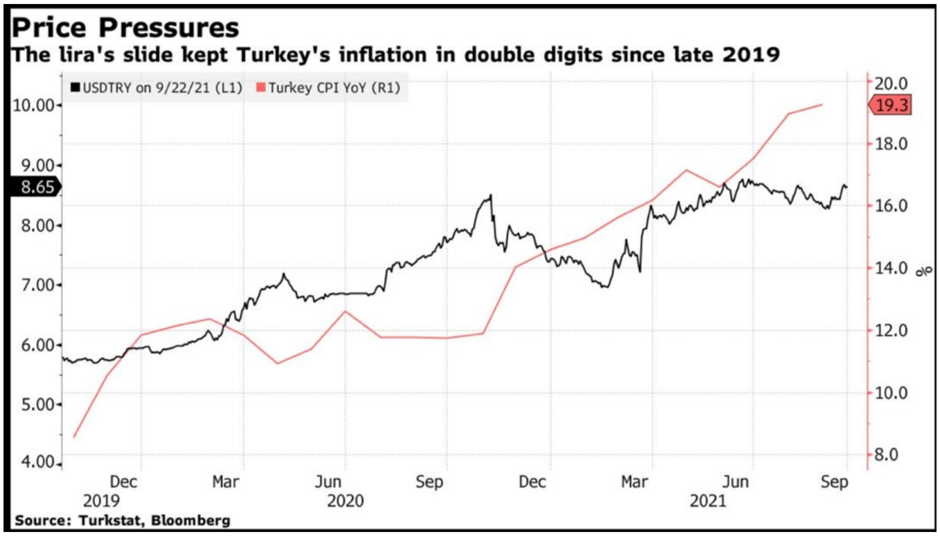
[1] See *https://www.cnbc.com/2021/11/30/turkish-lira-slides-after-erdogan-doubles-down-on-rates-policy-.html*.

[2] Ibid.

Figure 1[3]



The swift downward slide of the economy has shepherded in an uncommon intrusion by the Central Bank of the Republic of Turkey due to an upsurge of people hoarding dollars, as well rare sighting of crowds taking to the streets in protest to President Recep Tayyip Erdogan's management of the economy. It is interesting that in March 2021, the Central Bank of the Republic of Turkey in fact raised interest rates to control inflation following *The Taylor Rule* (a central bank should raise interest rates when inflation is above the target level and should lower interest rates when inflation is below the target level). While other emerging countries like South Korea, Russia, Brazil, Mexico, and Hungary have also all raised interest rates in an attempt to combat inflation, Turkey has now cut interest rates as an answer to inflation due to the Turkish President's misguided monetary policy view.

Evidence abounds that a central bank's independence is better at promoting stable economic growth and maintaining the value of a country's currency, since it is less vulnerable to short-term political pressures. Remarkably, it is widely accepted in Turkey that President Erdogan's autocratic behavior is the norm, thus, instead of accepting the independence of the central bank, Erdogan in fact has sole power over the central bank's monetary policy decisions. This wearing down of the central bank's independence does little to inspire foreign and domestic investment, since it creates the perception that Turkey's interest rate policy is shaped by a political agenda instead of economic fundamentals. Brian Jacobsen (senior investment strategist, multi-asset solutions at Allspring Global Investments) observed, "Investors are getting more and more nervous…It's a toxic brew."[4]

It is ironic that before Erdogan squashed Turkey's central bank independence, Naci Agbal (the last central bank governor who was at the helm for only four months and shown the door in March 2021) administered a succession of interest rate hikes that helped shore up the value of the lira. Sound monetary policy recommends that a rise in interest rates is in keeping with tight monetary policy (*contractionary monetary policy*), meant to reduce the money supply for the

[3] Figure 1 is from Turkstat, Bloomberg.

[4] See: https://www.reuters.com/markets/rates-bonds/turkish-lira-slides-16-towards-record-dollar-low-2021-11-30/.

purpose of reducing spending and controlling inflation. Nonetheless, instead of raising interest rates as inflation continues spiraling, Erdogan has decided to buck accepted monetary policy and lower interest rates instead.

This move is counterproductive, because it is accomplishing the opposite of what Erdogan is attempting to achieve. His first aim is to make money less costly so as to inspire buyers to borrow more, and in so doing, purchase extra goods and services. The idea is also to inspire businesses to make more loans so as to enlarge operations, invest in new equipment and technologies, and hire new workers. Secondly, Erdogan's notion of lowering interest rates is to make exports more affordable and competitive to other nations, thereby increasing Turkish exports. This strategy would not be such a bad move if inflation were low and the country was attempting to kick start the economy. But the country is experiencing just the opposite – inflation is high.

Furthermore, Turkish firms that rely on imported goods are confronted with the difficulty of having to deal with higher costs since the lira's purchasing power has lost much of its value. Faced with higher input costs, businesses pass this onto consumers in the form of higher prices. Turkish households, especially lower-income ones, are left to grapple with higher prices for goods – including essentials like food and energy. And if this weren't hardship enough, Turks are also seeing their savings and incomes eroded by the lira's free fall. Moreover, because Turkey's economy is very reliant on external financing, businesses that made loans in U.S. dollars are now finding it difficult to make repayments as the lira continues to lose value against the dollar.

In summary, it is our assessment that Turkey's lowering of the interest rate is clearly the wrong monetary policy tool to fight spiraling inflation. If the country was not facing runaway inflation, most of, if not all of Erdogan's goals could possibly be attained. Namely, inspire buyers to purchase more goods and services by making money less costly to borrow, encourage businesses to make more loans in a bid to enlarge operations, invest in new equipment and technologies, hire new workers, and increase exports through competitive and affordable Turkish goods.

We instead suggest that Erdogan employ a tried-and-true monetary policy to achieve all his perceived goals – raise interest rates. If Erdogan continues this path of eroding the independence of the central bank, not only do domestic or foreign investors become reluctant to spend money in Turkey, but it is possible that they become increasingly convinced monetary policy in Turkey will be shaped by a political agenda instead of economic fundamentals. Thus, Turkey runs the risk of continuing to have its domestic businesses (that depend on imported goods) face higher costs as the lira's purchasing power loses its value and consumers, particularly those of lower income, cope with higher prices for goods, including essentials like food and energy. Likewise, it is possible that Turks will continue to see their savings and incomes decline as a result of the lost in value of the lira. Lastly, as the lira continues to lose value against the dollar, Turkey's reliance on external financing has made it difficult for businesses to repay loans made in U.S. dollars.