Proceedings of the 2nd International Conference on Management Research and Economic Development
DOI: 10.54254/2754-1169/86/20240958

Turkey's Monetary Policy in the Post-Covid Era

Peixin Yin[1,a,*]

[1]Beijing-Dublin International College, Beijing University of Technology, Beijing, 100124, China
a. PeixinYin@emails.bjut.edu.cn
**corresponding author*

Abstract: Normally, the key to fighting inflation involves tightening monetary policy, such as raising interest rates. Turkey, however, has moved in the opposite direction. In the high inflation environment, the Turkish government implemented interest rate cuts to deal with the inflation problem, which brought a series of special economic effects. This paper mainly focuses on the reasons for Erdogan government's 2021 Interest Rate Reduction Policy and its positive and negative effects on the economy of Turkey. This paper uses the literature research method to study the above topics. An analysis of the economic consequences of the interest rate policy adopted after the financial crisis in Turkey in 2021 found that although the interest rate reduction policy further worsened inflation, it also promoted the development of the manufacturing industry in the short term, reduced unemployment, and promoted the prosperity of the stock market. These positive results, especially the improvement in employment and the strong performance of the stock market, show persistence over the longer time frame of one year. In the longer term, Turkey faces a brain drain and a widening gap between rich and poor. This unconventional approach in Turkey provides a rare research scenario for studying the economic effects of interest rate adjustments in the context of inflation and contributes a unique case study for other countries in the region.

Keywords: Macroeconomics, Turkey's monetary policy, Interest rate reduction policy

1. Introduction

Turkey is located at the intersection of Europe and Asia, and it is connected by the Bosphorus Strait to the China Sea and the Black Sea, which is the only waterway between the two bodies of water and has extremely important geostrategic significance. According to 2021 data, Turkey's population reached 84.68 million with a per capita GDP of $9,539. In the last quarter of 2021, Turkey's financial crisis became a major focus in the international economic sphere, with widespread media coverage of the country's economic woes. Top of the list is the severe inflation Turkey is facing, with the average consumer price Index (CPI) soaring to 25.76% in the fourth quarter of 2021 and to 36.08% in December. Second, the Turkish lira fell sharply against the US dollar, and by December 17, 2021, it was worth only 42.2% of its peak on February 15 of that year. Inflation has been a chronic problem in Turkey's economic development for many years. Moreover, Turkey's unemployment rate has remained at a relatively high level, between 8% and 15%.

Until the third quarter of 2021, Erdogan's government had largely adopted a counter-cyclical interest rate policy to fight inflation, raising rates when inflation rose and lowering them when inflation was under control. In recent years, however, inflation has repeatedly been tackled. Faced

DOI: 10.54254/2754-1169/86/20240958

with the severe financial situation in the fourth quarter of 2021, the Erdogan government changed its previous strategy, abandoning the traditional countercyclical regulation means of raising interest rates to curb inflation, and instead adopting an unconventional pro-cyclical interest rate policy, that is, lowering interest rates to increase market liquidity, in order to stimulate economic growth. Given the choice between stabilising the situation and stimulating the economy, Mr. Erdogan's government has chosen the latter. This essay mainly focuses on the reasons for Erdogan government's Interest Rate Reduction Policy and its positive and negative effects on the economy of Turkey. This essay uses the literature research method to study the above topics. Studying the causes and consequences of Turkey's extraordinary interest rate cut in 2021 to combat inflation is important for people's understanding of the role and impact of monetary policy in different economic environments and the trade-off between high inflation and growth pressures.

2. Literature Review

Monetary policy affects unemployment and inflation by adjusting the money supply and interest rate, and economists of different schools have different views on this, which can be roughly divided into three schools: Keynesianism, monetarism and rational expectations school.

2.1. Keynesianism

Keynesianism advocates that governments regulate the economy through active fiscal and monetary policies to achieve full employment and economic stability. In Keynesianism, monetary policy affects unemployment and inflation rates primarily by adjusting interest rates and the money supply [1].

In terms of influencing the rate of inflation, Keynesians believe that when the economy is in a boom, the rate of inflation is likely to rise. At this point, the central bank can implement tight monetary policy, raising interest rates and reducing the money supply. Higher interest rates can increase borrowing costs for businesses and individuals, depressing investment and consumption and reducing aggregate demand. Reducing the money supply can limit the flow of funds into the real economy, further depressing economic activity. In this way, as aggregate demand decreases, firms will produce less, thus lowering the rate of inflation [2].

2.2. Monetarism

Monetarism holds that monetary policy can affect unemployment and inflation rates in the short term, but its effects are limited in the long run. In the short term, when unemployment is high, monetarists may support the adoption of expansionary monetary policies, such as lowering interest rates and increasing the money supply, in order to stimulate economic growth and reduce unemployment. Such a policy could lead to an increase in the inflation rate, as more money in circulation could increase aggregate demand in the economy. When inflation is too high for society to accept, monetarists recommend contractionary monetary policies, such as raising interest rates and reducing the money supply, to reduce inflation. That could lead to higher unemployment as economic activity slows.

In the long run, monetarists argue that there is a "natural rate of unemployment," which is the rate at which supply and demand in the labor market are stable. Long-term monetary policy will not change the natural rate of unemployment, but may lead to inflation or deflation. In addition, monetarists emphasize that money is neutral in the long run, meaning that the effects of monetary policy are offset by other factors in the economy and therefore have no lasting impact on real output and employment. At the same time, the monetarist school believes that central banks should not use overly aggressive monetary policy to stimulate aggregate demand, as this could lead to inflation [3].

DOI: 10.54254/2754-1169/86/20240958

2.3. Rational Expectations School

The rational expectations school of thought holds that monetary policy does not affect unemployment in either the short or long run, because people form rational expectations to adjust their behavior.

The rational expectations school emphasizes that people use all available information when making economic decisions and are able to accurately predict the future. This means that when the central bank announces a new monetary policy, people immediately adjust their price and wage expectations to reflect this change. As a result, the effects of monetary policy are offset by rational expectations. In addition, the rational expectations school argues that the traditional Phillips curve, which shows a negative correlation between the unemployment rate and the inflation rate, is invalid. This is because as soon as people anticipate a change in monetary policy, they will immediately adjust prices and wages so that the unemployment rate does not change in response to a change in the inflation rate. In addition, the rational expectations school proposed the concept of the "natural rate of unemployment," that is, the rate of unemployment that the labor market would reach naturally in the absence of monetary interference. They argue that any attempt to push unemployment below the natural rate of unemployment through expansionary monetary policy is ineffective and will only lead to inflation. The rational expectations school, meanwhile, maintains that government monetary policy is ineffective in the long run because people's expectations adjust quickly. Even in the short term, if the public does not understand changes in monetary policy, the policy may have some effect, but this is due to incomplete information, not the power of the policy itself.

3. Analysis of the Results and Causes of Interest Rate Reduction Policy

3.1. The Erdogan Government's Motivation for Countercyclical Monetary Policy

There may be many reasons for the Erdogan government's sudden policy turn and break with mainstream Western economics. In terms of the economy, the previous counter-cyclical "stability" interest rate regulation policy failed to fundamentally solve Turkey's problems, thus giving up "stability" and changing to "development". In the face of Turkey's complex economic situation, interest rate cuts can send a positive signal to the market, boost market confidence, manage market expectations, and be conducive to long-term economic development. The authorities may hope that interest rate cuts can stimulate economic development, improve the structural problems of the Turkish economy, and reverse solve the current inflation. However, the side effect of pro-cyclical rate cuts could make inflation worse in the short term. In terms of politics, Turkey's geographical position is relatively important, and in the tripartite relations between the United States, Russia and the European Union, Turkey needs to maintain a financial environment conducive to the growth momentum of industrial production at a time when international geopolitical risks are escalating. At the same time, Erdogan implemented the new policy at the time of a new round of presidential election, an interest rate reduction policy to stimulate exports, reduce the deficit, promote economic growth and win people's hearts and minds play a certain role.

3.2. The Positive Result of the Policy

3.2.1. The Growth of GDP

By lowering lending rates, the policy has reduced the financial burden on businesses and consumers, thus stimulating consumption and investment. In the short term, this stimulus can raise the level of economic activity and boost GDP growth. Second, interest rate cuts typically reduce the value of a local currency, making exports more competitive in international markets. According to data released by the Turkish Export Association (TIM), in October 2021, Turkey's exports increased by 20%

compared to the same period last year, with exports of automobiles and chemical products increasing by 24% and 39% respectively. This suggests that the policy of cutting interest rates has increased the competitiveness of Turkey's exports through currency depreciation, which in turn has boosted economic growth. In addition, the European Bank for Reconstruction and Development (EBRD) has raised its forecast for Turkey's economic growth in 2021 to 9% and expects the unemployment rate to continue to fall. This is further evidence of the effectiveness of the interest rate reduction policy in boosting economic growth.

3.2.2. Lower Unemployment

Under the stimulus of the interest rate reduction policy, economic production activities have been restored to a certain extent, and the decline in the unemployment rate is not only very significant in the short term. In the longer term, despite two rallies in the first half of 2022 when interest rates remained unchanged, there is still a sustained downward trend until September 2022. In the fourth quarter of 2022, it rebounded again to a level of about 10% and remained stable, but it was still lower than the unemployment rate before the rate reduction policy was adopted (see Figure 1). The decline in the unemployment rate in the short and long term indicates that Erdogan's interest rate reduction policy has a certain stimulus effect on the overall economic development.

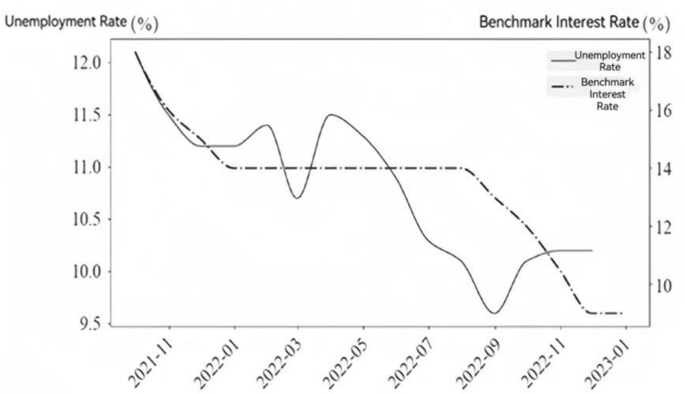

Figure 1: Unemployment rate in Turkey (October 2021-December 2022) [1]

3.3. The Negative Result of the Policy

3.3.1. Worsening of Inflation

Relatively severe inflation has been a persistent problem in Turkey, and mainstream counter-cyclical interest rate controls appear to have only temporarily alleviated the inflation situation. Starting from the end of the third quarter of 2021, the inflation situation deteriorated again, and the Erdogan government gave up counter-cyclical interest rate hike measures to deal with inflation, and tried to take unconventional measures to stimulate economic development by cutting interest rates, ignoring the short-term inflation continued to rise. Figure 2 shows the relationship between Turkey's benchmark interest rate and the inflation rate from the end of the third quarter of 2021, with the CPI rising (from 19.58% at the end of September 2021 to 85.51% in October 2022), although the benchmark interest rate remained stable in the first half of 2022, the inflation rate in the second half of the year increased significantly. However, there is still a downward trend (from 18% at the end of September 2021 to 9% in November 2022). At this stage, the Erdogan government adopted "non-mainstream" inflation response measures, and the change trend of the interest rate level was roughly opposite to inflation. The Pearson correlation coefficient between the two was -0.74, which was highly negative and extremely significant ($p < 0.001$).

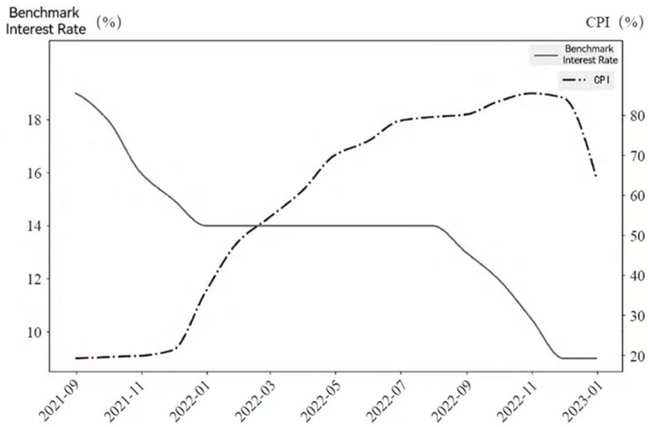

Figure 2: Turkey's benchmark Interest Rate and Inflation Rate (September 2021-December 2022) [1]

3.3.2. Brain Drain and Widening Gap Between Rich and Poor

Turkey's interest rate cut policy could lead to panic spending and investment, mainly due to fears of currency depreciation and inflation. In this case, people may choose to buy more goods and services or invest in various assets to prevent their wealth from shrinking.

First, panic consumption and investment lead to a brain drain. When people feel financially unstable, they may choose to migrate to more stable countries in order to protect their lives and those of their families. In this case, Turkey will lose a large number of highly skilled labor force, which is not good for the country's long-term economic development. About 23,000 entrepreneurs and businessmen have emigrated in the past three years, including more than 10,000 millionaires. About 300,000 highly educated young people leave Turkey for other countries every year. According to a German firm, about 73% of young people in Turkey want to work abroad.

Second, panic consumption and investment may exacerbate the gap between rich and poor [4]. In times of economic instability, the rich have more resources and means to protect their wealth, while the poor fall deeper into poverty. That's because the rich often have more money to invest, while the poor may have to rely on their day jobs to make ends meet. Thus, the policy of cutting interest rates makes the rich richer and the poor poorer.

Finally, panic consumption and investment may lead to a short-term boom in the economy, but this boom is not sustainable. Once people's fear subsides, they will reduce consumption and investment, leading to a recession [5].

3.4. The Causes of the Negative Results

A common indicator of boom or recession in the manufacturing sector is the Purchasing Managers' Index (PMI). A PMI reading of more than 50 indicates that the manufacturing industry is in a state of prosperity, while a reading of less than 50 indicates that the manufacturing industry is in a state of recession. With the help of the PMI index, it is possible to analyze the recent and recent boom or recession of the Turkish manufacturing industry [1]. In the short term, the chart below depicts the movement of Turkey's manufacturing PMI and benchmark interest rates in the fourth quarter of 2021. As seen in Figure 3, from the beginning of October 2021, the PMI of Turkey's manufacturing industry began to decline all the way, and at the end of October, it was close to the boundary between prosperity and recession. At the same time, the Erdogan government has taken measures to cut interest rates for economic regulation, but the impact of regulation measures on the economic situation has a certain lag. The PMI recovered in early November, temporarily removing the risk of recession.

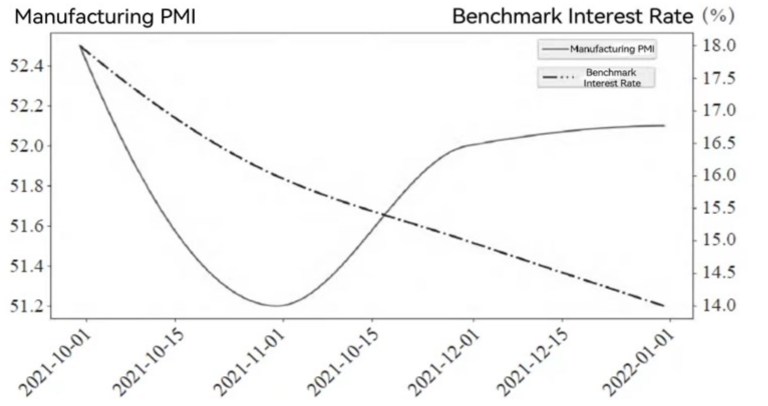

Figure 3: Turkey Manufacturing PMI (October 2021 - December 2021) [1]

The PMI has been declining since December 2021 and fell below the line between boom and recession in mid-February 2022. Although in 2022, the Erdogan government still maintained the policy of interest rate cuts, it failed to prevent the continuous decline of the manufacturing industry, and the few manufacturing PMI recoveries (such as July-August 2022 and November-December 2022) can only persist for about one month. As can be seen from Figure 4, regardless of whether the benchmark interest rate remains stable or continues to decline, Turkey's manufacturing PMI is still mainly in a downward trend, indicating that there are structural problems in the Turkish economy that cannot be saved by short-term monetary policy stimulus.

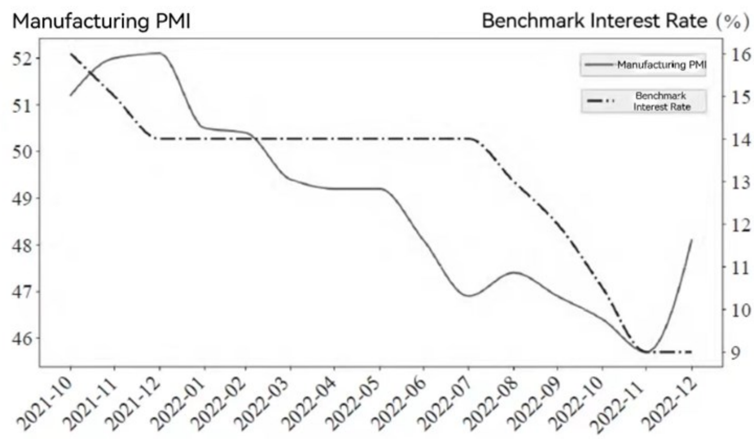

Figure 4: Turkey Manufacturing PMI (October 2021-December 2022) [1]

It can be seen that the temporary recovery of manufacturing PMI brought about by non-mainstream interest rate regulation policies is mainly caused by the reverse expected impact formed by the sudden change of policy. The reduction of interest rate on the financing cost and financing difficulty of manufacturing enterprises has not been smoothly transmitted to the sustained increase of enterprise investment and business activities. On the one hand, because the investment of manufacturing enterprises is usually a long-term investment, the production cost of enterprises will also increase under the expectation of long-term inflation and currency depreciation. Blindly increasing investment will not necessarily bring positive returns in the future [6]. On the other hand, when the market has formed adaptive expectations for the government's new regulatory policies, enterprises will expect lower interest rates, and the short-term stimulus effect of monetary policy will be unsustainable.

DOI: 10.54254/2754-1169/86/20240958

4. Conclusion

This paper analyzes the situation of inflation, employment, and manufacturing in Turkey, and finds some phenomena that have not been noticed in international media reports. First, in terms of macroeconomic control measures to deal with inflation, the Erdogan government in Turkey has announced a plan in 2021 which was cutting interest rates. In view of Turkey's repeated outbreaks of inflation, the Erdogan government's characteristic interest rate control policy is more like a risky experiment in economic, political, and social considerations, and its short-term effect is impressive, but the long-term effect is not stable. Second, under the influence of the Erdogan government's interest rate reduction measures, Turkey has seen a manufacturing boom, a decline in unemployment, a boom in the stock market and GDP in the short term, which indicating that the Erdogan government's interest rate reduction stimulus policy has indeed played a positive role in the real economy and the securities market. Third, in the long run, the short-term prosperity under the interest rate reduction stimulus policy will continue to be affected by the unbalanced structure of Turkey's economy, weak resistance to external shocks, high inflation and the expectation of continued depreciation of the exchange rate, and thus reverse, which is not a sustainable economic prosperity situation. What can be improved in this paper is that econometric methods, such as regression analysis, can be used to evaluate the causal relationship between different policies. Or compare Turkey's economic situation with neighboring countries to understand its impact and trends on a regional and global scale. Future research may focus on the applicability of different types of monetary policies (e.g., expansionary monetary policy, contractionary monetary policy) in different economic situations and how to reform Turkey's financial system to improve its stabsustainability references.

References

[1] *Wang Dehong, Li Shilin. Inflation, currency depreciation and foreign trade balance: A case study on the regulation of Turkey's financial crisis in 2021 [J]. Journal of Regional and Country Studies, 2019,7(06):71-95+156.*

[2] *GÜLER, İlkay. "Asymmetric Relationships Between Natural Gas Price Inflation and Macroeconomic Factors: The Case of Turkey." Fiscaoeconomia, vol. 8, no. 1, 2024, pp. 342–361, https://doi.org/10.25295/fsecon.1365330.*

[3] *Merve, Kocaman. "Asymmetric Effects of Monetary and Fiscal Policies on the Economic Activity: Empirical Evidence from Turkey." Economic Computation and Economic Cybernetics Studies and Research, vol. 56, no. 2/2022, 2022, pp. 307–322, https://doi.org/10.24818/18423264/56.2.22.20.*

[4] *Lin Hongjie, Zheng Liansheng. Turkish lira devaluations of reason and enlightenment [J]. China's foreign exchange, 2023, (18) : 73-75. The DOI: 10.13539 / j.carol carroll nki. 11-5475 / f 2023.18.016.*

[5] *Gungor, Mahmut Sami, and Bülent Güloğlu. "The Effects of Structural Shocks on Macroeconomic Fundamentals under Aggressive Monetary Policy: The Case of Turkey." International Journal of Business and Economic Sciences Applied Research, vol. 12, no. 2, 2019, pp. 7–21, https://doi.org/10.25103/ijbesar.122.01.*

[6] *Bulut, Umit. "The response of monetary policy to the COVID-19 pandemic in Turkey. The path of a credit-based economic recovery." Theoretical and Applied Economics, XXVIII, no. 1, 2021, pp. 231–238, https://go.exlibris.link/WqMv5HWN.*