Is Turkey Winning the Fight Against Inflation?

Dani Rodrik
September 13, 2000
Inflation since the early 1980s
**Annual inflation rates in 1999**

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>294%</td>
</tr>
<tr>
<td>Angola</td>
<td>248</td>
</tr>
<tr>
<td>Congo, Dem. Rep.</td>
<td>200</td>
</tr>
<tr>
<td>Russia</td>
<td>86</td>
</tr>
<tr>
<td><strong>Turkey</strong></td>
<td><strong>65</strong></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>60</td>
</tr>
<tr>
<td>Ecuador</td>
<td>55</td>
</tr>
</tbody>
</table>
Inflation and Deficits

- operational deficit
- inflation
Inertial Inflation

\[ \pi_t = \alpha \pi_{t-1} + \beta y_t \]

\[ \alpha \text{ large} \]

\[ \beta \text{ small} \]
Determinants of price movements in inertial inflation:

\[ \pi_t = \alpha \pi_{t-1} + \gamma \hat{e}_t + \text{seas. effects} \]

<table>
<thead>
<tr>
<th></th>
<th>wpi</th>
<th>cpi</th>
<th>wpi-priv</th>
<th>wpi-priv. man.</th>
</tr>
</thead>
<tbody>
<tr>
<td>alpha</td>
<td>0.61*</td>
<td>0.53*</td>
<td>0.73*</td>
<td>0.56*</td>
</tr>
<tr>
<td>gamma</td>
<td>0.33**</td>
<td>0.26***</td>
<td>0.20</td>
<td>0.41*</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.79</td>
<td>0.79</td>
<td>0.86</td>
<td>0.90</td>
</tr>
</tbody>
</table>
Inflation persistence coefficient over time
(with 95 percent confidence interval)
WPI
Predicted and actual inflation, January 1997-August 2000
(based on 1997:1-1999:12 sample)
WPI - Private manufacturing
Predicted and actual inflation, January 1997- August 2000
(based on 1997:1-1999:12 sample)
CPI
Predicted and actual inflation, January 1997 - August 2000
(based on 1997:1-1999:12 sample)
WPI: Inflation forecast and exchange-rate path
(Jan-Aug 2000: realized inflation)

- ER depreciation
- inflation (realized)
- inflation forecast (from vantage of 1999:12)
- inflation forecast (assuming no regime change)
- inflation forecast (assuming inertia is halved)

Cumulative inflation forecast for 2000:
- Assuming no regime change: 33.6%
- Assuming inertia is halved: 26.3%
CPI: Inflation forecast and exchange-rate path
(Jan-Aug 2000: realized inflation)

cumulative inflation forecast for 2000
assuming no regime change: 45.2%
assuming inertia is halved: 31.9%
Relationship between firm concentration and price increases
(by 4-digit private manufacturing industries)
Comparative Disinflation Experience (WPI)

(WPI inflation (percent per month))

(T-1 refers to the average inflation in the 12-month period preceding the onset of the disinflation program)
Comparative Disinflation Experience (CPI)

CPI inflation (percent per month)

- Mexico
- Israel
- Turkey

month relative to start of disinflation program
(T-1 refers to the average inflation in the 12-month period preceding the onset of the disinflation program)
Bottom line on disinflation:

- Outcomes favorable, despite negative shocks (oil prices; $ appreciation)
- Behavior of CPI or WPI-Pman not “unusual”
- Do not over-analyze each month’s outcomes
- Be patient and hold the line
Determinants of the trade and current account balances:

Trade balance = f (real exchange rate, econ. activity, oil prices, seas. effects)

CA balance = g (real exchange rate, econ. activity, oil prices, seas. effects)
CAB projections

- Actual
- Predicted, with realized values
- Baseline (no change in inertia, industrial output up by 3.7%, and oil price same as in 2000:I)
- Industrial output up by 10%
- 10% fall in price of oil

Cumulative CA projections for 2000
(1999 = -$1.4 bn; 1998 = +$2.0 bn; 1997 = -$2.6 bn)

Baseline: -$8.1 bn.
Industrial output up 10%: -$9.7 bn
Price of oil down 10%: -$7.1 bn
Trade deficit projections

- Actual
- Predicted, with realized values
- Baseline (no change in inertia, industrial output up by 3.7%, and poil same as in 2000:I)
- Industrial output up by 10%
- Price inertia halved
- 10% fall in price of oil

Cumulative trade deficit projections for 2000:
- 1999 = $10.5 bn; 1998 = $14.2 bn; 1997 = $15.4 bn

Baseline: $18.1 bn.
Industrial output up 10%: $19.9 bn
Why the consumption boom?

**Interest-rate arbitrage**

\[ i = i^* + E\hat{e} + \rho \]

domestic interest rate = foreign interest rate + expected rate of currency depreciation + risk premium
CA deficit large, but possibly manageable on current trends until mid-2001

- Make more reasonable forecasts of the CA deficit
- Watch closely the financing of the CA deficit
- Do not promise a quick growth payoff
- Plan for preventive measures in the fall if CA deficit widens beyond forecast
  - raise consumption taxes on durables
  - discourage bank credit boom
  - tax short-term capital inflows
Wider incomes policies

• Their absence the weakest link in the program
• Incomes policies extending to private sector employers and employees, and negotiated under government leadership, may be a crucial confidence-boosting step to ensure the “exit strategy” works smoothly.