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The Daily Dish

Inflation Fighting, Turkish Style

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Eakinomics doesn’t get out much (some would argue it gets out too much, but let’s not mix the positive and normative analyses). So yesterday’s tour through global central banking yielded this stunner from the *Financial Times*: “Turkey has shocked markets with a 100 basis point interest rate cut despite inflation of nearly 80 per cent….” Yikes!

One would think that this is precisely the wrong thing to do. Lower rates encourage debt-financed spending, raising overall demand and placing upward pressure on prices. The Federal Reserve is engaged in exactly the opposite policy in order to combat U.S. inflation. In addition, lower interest rates make Turkey a less attractive destination for investment capital; the outflows of capital weaken the Turkish lira (“The lira dropped about 1 per cent to as low as 18.14 against the US dollar, the weakest level on an intraday basis since a severe slide late last year”), making imports more expensive and reducing the cost of Turkish exports. These shifts have the effect of further stimulating the demand for Turkish goods and services.

What explains this interest rate cut? FT reports: “?ahap Kavcio?lu, the central bank governor, supports president Recep Tayyip Erdo?an’s unusual theory that high interest rates cause inflation….”

One could leave it at that. Quirky Turks doing eccentric central banking. But there are actually two lessons for the current U.S. policy debate. The first is that once inflation is entrenched (and 80 percent qualifies as “entrenched”), there are no good policy choices. One can live with the inflation, or live with the consequences (slower growth) of policies to fight inflation. The best explanation for Turkey is that with general elections looming next year, the president has chosen the former: Stimulate the economy and live with the inflation. “‘Instructions may have come down for a cut amid signs growth may be slowing,’ said Ceyhun Elgin, a professor of economics at Bo?aziçi University in Istanbul. ‘The aim may be to carry things forward, for better or for worse, until the election.’”

The second lesson is that this lays the groundwork for even bigger problems in the future. Officially, Turkey has an inflation target of 5 percent. The central bank doing a U-turn at this juncture is a recipe to destroy whatever inflation-fighting credibility it retains. At home, the Fed is in a battle to establish its credibility in the fight against inflation. The worst mistake it could make would be to prematurely ease financial conditions and fail to hit its 2 percent target. There will be political pressure to do so, but staying the course will involve some economic pain that has a payoff: An environment of price stability is necessary for sustained high employment and continued growth.