

# A Monetary Disequilibrium Model for Turkey: Investigation of a Disinflationary Fiscal Rule and its Implications for Monetary Policy

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## Abstract

In this paper we estimate a monetary disequilibrium model for Turkey based on Khan and Knight's [Khan, M. S., & Knight, M. D. (1981). Stabilization programs in developing countries: a formal framework. *IMF Staff Papers*, 28, 1–53] framework. Our results show the importance of fiscal discipline in achieving sustainable disinflation. In the long term, however, we conclude that tight fiscal policies should be mixed with monetary and debt management policies to avoid excessive monetary contraction as the real demand for broad money increases with the disinflation process.

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## 1. Introduction

In this paper we present a monetary disequilibrium model for Turkey based on Khan and Knight's (1981) framework. The focus of interest is on the fiscal side of the economy. Our argument is that tight fiscal discipline, together with an independent central bank and restructuring the banking sector, are the most important ingredients of the current stabilization program, which was introduced in 2001. However, our simulations suggest that simple fiscal stabilization programmes

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can prove overly restrictive in terms of their long run properties. What appears to be needed is a combination of fiscal stabilization, monetary policy and debt management policy if a desirable long run equilibrium is to be achieved.

Monetary disequilibrium models have proved useful in describing economies where monetary shocks are the major source of disturbance to the economy. With these models it is possible to track the effects of monetary policy on the economy. In particular, monetary disequilibrium models can be useful tools to understand the link between financial instability, monetary policy and real economic activity. Financial instability is created by the need for sustained borrowing by individual sectors within the economy. This provides the root source of undesired monetary expansion and associated inflation when combined with accommodative monetary policies. As a result there emerges a link between financial instability and monetary disequilibrium in the money market, which is likely to be transmitted to the real economy through the impact of credit expansion on aggregate demand, eventually leading to a financial crisis if the authorities do not address its source. Many central banks now publish ‘Financial Stability Reports’ to monitor the risks for their inflation targets arising from financial markets. Monetary disequilibrium models, therefore, offer a potential solution to the questions of how to incorporate these risks into their macroeconomic models.

The earliest versions of this kind of model can be traced to [Blejer \(1977\)](#) and to [Blejer and Leiderman \(1981\)](#). Their model is basically concerned with the short run analysis of the implications of the monetary approach to the balance of payments with only two adjustment channels, price and balance of payments adjustment. Fiscal policy, which can be an important source of monetary expansion, has only an implicit role and they ignore the potential effect of monetary disequilibrium on real income. The version developed by [Khan and Knight \(1981\)](#) is seminal in giving an explicit role to the link between fiscal policy and the money supply and also in recognizing the output effects of monetary disequilibrium.

Work since Khan and Knight has extended the model in a number of ways. [Lipschitz \(1984\)](#) includes explicit export and import functions in a model for the Korean economy. [Sundararajan \(1986\)](#) and [Millack \(2004\)](#) estimate similar models for the Indian economy. [Agenor \(1990\)](#) and [Ozatay \(2000\)](#) extend the monetary disequilibrium model by recognizing the currency substitution effect on real money demand. Ozatay’s model is particularly interesting in that he uses it to analyze the credibility issues of alternative stabilization programs for Turkey. Monetary disequilibrium models have also been applied to developed economies by [Sassanpour and Sheen \(1984\)](#) who extend the model by including an augmented Phillips equation to capture price adjustment in which monetary disequilibrium is related to expected inflation.

The plan of this paper is as follows. In Section 2 we set out the theoretical model and discuss how it relates to the existing literature. This is followed in Section 3 by empirical estimates of the model and a discussion of its empirical fit. Section 4 presents a number of policy related simulations of the model which demonstrate the importance of fiscal discipline for the long run properties of the solution. Finally, in Section 5 we discuss the implications of our model and present our conclusions.

## 2. The model

Our model follows the basic structure common to the monetary disequilibrium literature. It consists of six behavioural relationships and two identities that define the broad money supply. The basic structure of the model is one which disequilibrium in the monetary sector drives price

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