


## Chapter 21

# Testing the Validity of Taylor's Rule on Developing Countries for Effective Financial Marketing

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### ABSTRACT

*This chapter examines whether the central bank policy behaviors of E-7 countries are valid by using a Taylor type monetary policy response function. In this context, the policy response function of banks is analyzed by using monthly data for the 2008-2018 period. Then, unit root tests of ADF (Augmented Dickey Fuller), PP (Philips Perron), IPS (Im Peseran Shin) and LLC (Levin Lin Chu) were performed and analyzed by using Dumitrescu-Hurlin methodology. As a result of the analyses conducted using inflationary data, it was observed that short-term interest rates of the central bank affect price stability by causing inflation, but inflation rates did not cause an increase or decrease in short-term interest rates. According to the findings, although inflation does not cause interest rates to change in E7 countries, a causality relationship has emerged from interest rates to inflation rates. These results indicate that the monetary policies implemented in these countries are not carried out in accordance with the Taylor rule.*

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## **INTRODUCTION**

Today, the central banks have tried to fulfill the most important function of monetary policy by focusing on the objective of achieving price stability as a result of many studies showing that the uncertainties experienced in increasing inflation due to new developments in financial markets and high inflation rates negatively affect sustainable economic growth. In line with a target of inflation rates with monetary policy instruments, it tries to achieve the inflation target by aiming at reaching a numerically proportional rate determined in a certain period in order to achieve price stability, which is the central bank's target (Aguiar-Conraria et al., 2018; Dinçer et al., 2019a,b). Although the objectives of monetary policy and economic / economic policy are the same in many aspects, there are differences. Benjamin Friedman (2000) described monetary policy as one of two methods used to regularly influence the direction and speed of economic activities, including financial factors such as the rate of change in prices in the free market economy, as well as non-financial factors such as output and employment. Full employment, price stability, financial stability, economic development, fair income distribution and closing the balance of payments deficits are the objectives of monetary policy (Ince et al., 2016; Yüksel and Özsarı, 2017).

Full Employment means that all production factors in the economy can be fully and effectively exploited. In the narrow definition of monetary policy, full employment means the full and effective use of labor among production factors (Dinçer et al., 2016). The aim of full employment for monetary policy is defined as the elimination or prevention of unemployment. However, because of the fact that seasonal and incidental unemployment constitutes the natural unemployment rate in economies, an unemployment rate of 3-5% is accepted as natural unemployment rate in all current economies (Morley et al., 2018).

Price stability is the most important one of the objectives of monetary policy and the absence of phenomena such as deflation, inflation, slumpflation and stagflation in an economy, and maintaining the balance of the general level of prices. If the general level of prices goes below or exceeds a certain level, this results in the occurrence of one of the aforementioned phenomena by disturbing price stability. It is not possible to talk about price stability in these economies. Inflation refers to the continuous increase in prices at the general level. Every price increase is not inflation. Deflation is a continuous and rapid decrease in prices at the general level. Slump inflation is the situation of inflation in an economy while shrinking / shrinking in that economy (Caporale et al., 2018).

Stagflation is the simultaneous stagnation of the economy while inflation continues (stagnation in inflation). In cases where price stability cannot be achieved, individual decision-makers cannot make a rational decision by looking at economic activities such as savings, spending and investment with risk, prices cannot easily distinguish the changes and do not have the necessary / sufficient information. In cases where price stability cannot be achieved, political power cannot implement a more comprehensive economic policy since confidence in the policies implemented is diminished. For such reasons, providing price stability is the most important objective of monetary policy. Price stability is shown as the indispensable objective of monetary policies (Beckmann et al., 2017).

Financial stability, directing capital mobility in open economies is directly related to stability in financial markets. In a financial market where there is no stability, capital outflows are experienced even though there is no capital inflow, and on the contrary, stability and confidence in the market attract capital mobility (Wang et al., 2019; Dinçer and Yüksel, 2018). In today's conditions where globalization is gradually increasing, the increase in international trade and capital mobility creates significant changes in money and financial markets (Dinçer et al., 2018a,b; Kim et al., 2015). Savers can transfer their resources to international markets, which will provide higher returns than domestic markets. When

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