Durmuş Yılmaz: Food prices and inflation

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the Central Bank of Argentina 2008 Money and Banking Conference "Financial turbulence – impact on developed and emerging economies", Buenos Aires, 1 September 2008.

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Dear Guests,

It is a great pleasure and honor for me to address such a distinguished audience on the issue of "Food Prices and Inflation". The current level of food prices constitutes a major risk to households, in particular those living in developing countries. I'd like to thank the Central Bank of Argentina to organize this conference and dedicate a special session on this issue at this juncture.

Dear Guests,

The second half of 2007 was not an easy period for central bankers – and so far 2008 has been even more challenging.

We are currently facing significant inflationary pressures on a global scale due to record high increases in commodity prices. The surge in inflation rates has become a major challenge that threatens price stability in many countries. Average inflation throughout the world has been rising rapidly. Inflation in developed countries has reached its highest level of the last eighteen years. For the first time in many years, inflation figures of the developing countries are in two digit levels.

Moreover, the financial turbulence that has started in the second half of 2007 and the subsequent credit crunch are adversely affecting economic activities. Growth rates have been slowed in many countries. Some advanced economies are on the brink of recession.

Dear Guests,

This is not the first time the world had experienced supply shocks in commodities. But, these shocks were usually in energy prices and consequently, they had affected advanced economies more severely than the developing ones. The rise in food prices, on the other hand, has led to different repercussions. In comparison to the industrialized world, food expenditures in developing countries constitute a larger share in the basket of consumer prices. That is why increases in food prices typically lead to higher increases in the inflation rates of developing countries.

Food prices have been rising dramatically, particularly since mid-2007. At one point, the inflation of wheat prices reached triple digits. Similar levels were observed in corn, soybean, and rice prices. According to estimates of the International Monetary Fund, food inflation accounted for 44 percent of global inflation in 2007 – up from 27 percent in 2006. In Asian countries, this figure reaches to 68 percent. Food inflation is expected to contribute almost two thirds of increase in inflation rates in Brazil, Chile and Argentina. Despite some relief in the most recent period, they are expected to stay elevated in the near future.

There are both supply and demand pressures behind this dramatic surge in food prices. On the supply side the amount of resources allocated for agricultural production has been stagnant for a while due to rapid urbanization and industrialization. A shift in labor force from agricultural to non-agricultural sectors has been experienced in many developing countries. Rapid productivity gains observed throughout the post-war period, have been slowed in the last decade. Moreover, the recent drought that hit most parts of the world created a supply crisis, aggravating the upward trend in food prices.

On the demand side the huge jump in energy prices and rising environmental and political concerns force developed countries to seek alternative energy sources. The production and

consumption of bio-fuels increased rapidly, particularly after the European Parliament adopted the Common Agricultural Policy reform in 2003 and the US Senate approved the Energy Policy Act of 2005. As a result, prices for commonly used bio-fuel crops, such as corn, wheat, sugar cane and canola, started to climb. During the 2004-2005 period, only 7 percent of total corn production was used to produce bio-fuel, but this share is expected to increase to 17 in 2008 and 31 percent in and 2011. The increase in purchasing power of households in fast growing and emerging economies with large populations also put strong demand pressure on international food prices.

What is the contribution of these factors in food price inflation, especially exogenous ones such as the adverse weather conditions? What is the extent of the role played by factors? Is it possible to control domestic food prices through monetary policies?

It is difficult to give an exact answer to these questions, but recent research conducted by the staff at the Central Bank of Turkey may give us some ideas. Empirical analysis of food prices in Turkey showed that external factors are quite dominant in food inflation. It was estimated that severe drought in Turkey and skyrocketing world food prices were responsible for almost 70 percent of annual inflation in processed food prices in 2007. It was less than 10 percent in 2006. It was also found that aggregate demand conditions, which are mostly within the domain of monetary policy, had a negligible contribution in processed food inflation. These findings show, on balance, that the recent climb in processed food prices was mainly fueled by supply shocks and external factors.

Dear Guests,

In recent months there are signs of some relief in food inflation. Inflationary pressures triggered by severe drought and related crop losses have been waning for some time around the world, including Turkey. Early forecasts for 2008 suggest that the weather will be more accommodating than 2007. As measured by current indicators, grain production will particularly rebound from its year-ago levels. The rate of increase in food prices is likely to decelerate during the second half of 2008.

Yet, despite better prospects on the supply side, food prices are expected to stay elevated in the near future in the medium term as long as the demand pressure from rapidly-growing developing countries continues. Let me give you a few numbers and explain my reasoning.

As I mentioned before, food expenditures in developing countries constitute a larger share in the basket of consumer prices than those on developed countries. It is as low as 15 percent in the U.S., as high as 60 percent in India. Moreover, income elasticity of food is also significantly higher in less developed countries. In Bangladesh, one percent increase in household income leads to 0.73 percent increase in food demand. In the U.S., however, a typical household who receives one extra dollar spends only 10 cents more on food.

What does it mean?

It means that as long as rapid growth rates in developing countries continue, the food demand is also likely to rise rapidly. In the post war period, we did not observe a similar surge in food demand, because the engine of world economy at that time was mainly advanced economies. Today, we face a different picture. Emerging market countries are growing fast. Their share in world consumption is three times higher than what it was in early 80s. More importantly, these countries, like China, India, and Indonesia have huge populations. According to our estimates at the Central Bank of Turkey, the contribution of only two countries (China and India) on food demand growth in the world reached almost 50 percent in 2007 – up from 10 percent in 1980. The growth in global food demand is estimated to exceed the growth in global food supply since early 2000s and it is likely to stay that way in the near future.

In other words, we are facing a gap between food demand and food supply. Prices have to adjust to restore equilibrium. Since the price elasticity of food demand is low as compared to,

say, durable goods, there needs to be a drastic rise in food prices, which is what we are facing today.

Dear Guests,

Until recently, the common view among central banks of developed countries was to give priority to problems in financial markets, ignoring the signs of inflationary pressures. Certainly, there are structural reasons behind the recent run-up in food and energy prices, as I have just briefly discussed. However, it is also undeniable that there are significant demand-driven pressures over commodities. Loose monetary policies adopted at the turn of the century certainly played a key role, together with excess liquidity in the financial system. Fast-forwarding to the recent period, the central banks of developed countries still keep real interest rates negative in the face of financial risks may hamper a correction in commodity prices.

The commonly accepted practice in inflation targeting regime is that monetary policy should not react to supply-driven shocks that are temporary in nature and should allow temporary increases in inflation in the short-term, unless they create deterioration in inflation expectations. Otherwise, undesired fluctuations might arise in economic activity and relative prices. The increase in commodity prices would trigger a self-correcting mechanism. By changing the relative prices, it would provide valuable information on how the resources of the economy should be distributed. While high food and energy prices curb consumption on these products, they would also encourage investment and increase supply in the long-term. In short, the common view is that central banks have nothing to do but wait for the supply-driven shocks to work out their natural course.

However, in the current environment where persistent and rapid increases in food and energy prices have been observed for a considerable period, the prevalence of this view has become questionable – especially in the light of current projections that foresee even higher prices in the near future. As a matter of fact, many countries under inflation targeting regime now project that inflation will converge to the target at the end of 2009 or in 2010, at the earliest.

Going through a long period of high inflation is a serious risk for price stability. First, the general price level may shift upwards at a faster rate, as producers and workers in other sectors ask for higher prices and wages in response to the loss of their real purchasing power. The fall in real interest rates due to deterioration in inflation expectations is another risk, since lower real rates will lead to a faster pace of credit expansion. The common factor of these two risks is that persistent supply shocks may turn into demand shocks after a while.

Thus, at some point, central banks have to decide to what extent they can tolerate the rise in inflation. Advocators of a “wait-and-see” approach in the face of supply shocks are not clear on the question of when the supply shock ends and when demand-driven price increases take its place, in an environment where inflation keeps rising. If this issue is not clarified, any above-target inflation figure or any upward revision in inflation forecasts can easily be attributed to supply-side factors. Clear lines should be drawn as to which economic data would refute this discourse and what would constitute a limit to supply shocks from a central banker’s point of view.

Dear Guests,

In the last part of my speech, I would like to discuss recent developments in the Turkish economy and the monetary policy implemented in this period.

In early 2008 the supply side shocks in food and energy prices started to exert significant inflationary pressures, as they reached unprecedented levels above and beyond expectations. For instance, October 2007 Inflation Report, based on forecasts of international agencies, had foreseen oil prices around USD 70 per barrel in 2008 and a gradual correction in food prices. In other words, it was assumed that supply side shocks would be temporary and that they would lose impact after a while. These forecasts were in line with pricing in

forward and futures markets. However, these expectations did not materialize. Both crude oil prices and agricultural commodity prices continued to rise. The adverse impacts of supply shocks reached unprecedented levels during the first half of 2008.

Under normal circumstances, supply shocks are expected to have a temporary impact on relative prices, not changing the course of medium-term inflation. Nevertheless, the emergence of multiple shocks at the same time and their persistence for a considerable period aggravated the risks on pricing behavior. In fact, the research conducted by the Central Bank staff indicates that economic agents increasingly focus on past inflation while forming their inflation expectations.

After evaluating the said developments, the Central Bank concluded that the increases in food and energy prices in recent years reflect a structural change stemming from the global economic environment. In other words, these shocks are likely to prevail for a longer time period, contrary to previous forecasts. There is no clear evidence at this point that this trend will reverse in the short term. Moreover, our revised projections suggest that even with the maintenance of a cautious monetary policy stance for the foreseeable future, reaching the 4 percent target is going to take an extended period of time.

Dear Guests,

In light of these evaluations, the Central Bank of Turkey announced the framework of its monetary policy for the upcoming period in the April 2008 Inflation Report and in the letter on inflation targets that was sent to the Government on June 3, 2008.

The first pillar of the monetary policy framework is the target revision. The main purpose of the target revision is to create an achievable disinflation path that can be taken as reference by economic agents and that would take us to our price stability objective in the medium term, which is inflation rate of 4 percent. As you may know, Turkey has not witnessed low single-digit inflation figures for nearly half a century. This has adversely affected the expectations for attaining the 4 percent inflation target. Furthermore, overshooting the inflation targets in 2006 and 2007, and recent supply shocks have elevated expectations even further. Hence, the new targets announced on June 3, 2008 aim to create a new anchor for economic agents, that is attainable.

At this point, I would like to emphasize that the nature of these new targets differ remarkably from those set for the 2006-2008 period. The Central Bank will treat the revised targets asymmetrically. In this framework, in the upcoming period, the Central Bank will prefer an inflation that stays below targets. Accordingly, better than expected outcomes in food and energy prices or in other global factors will be perceived as an opportunity to bring down inflation faster than that is implied by the revised target path. Should the upside risks materialize; monetary policy will be conducted so as to minimize any upside deviation of inflation from the revised targets.

Target revision is the solution that is provided by our Bank to the “problem of demarcation”, which is faced by almost all central banks today. However, the revision will work only if necessary policy stance is adopted. For this reason, the second pillar of monetary policy comprises the implementation of a monetary tightening that is consistent with the new inflation targets. Newly set targets are references that would help decision makers in the economy understand the reasoning behind the policy stance, i.e. the factors that have led to monetary tightening and the extent of monetary tightening if and when necessary. In other words, the Central Bank has announced, via the target revision, the limits of its tolerance to the first round impacts of supply side shocks.

While concluding my speech, I would like to extend my thanks to the Central Bank of Argentina, and all other institutions and individuals who contributed to the organization of this significant event.

Thank you.