Erdem Başçi: Commodity price volatility

Speech by Mr Erdem Başçi, Governor of the Central Bank of the Republic of Turkey, at the "G-20 Commodity Price Volatility Conference", Istanbul, 13 September 2011.

*   *   *

Dear Colleagues and Distinguished Guests,

Today I will discuss commodity price volatility, a topic which has vital importance for the global economy and thus for policy makers. In my speech, I would first like to discuss the possible sources of commodity price movements and then elaborate on the approach of the Central Bank of Turkey in dealing with commodity price changes in the past few years.

Commodity markets cover a wide range of raw materials such as oil, metal and agricultural products. These commodities have different characteristics not only in terms of trade volume, supply and demand structure but also in terms of their exposure to financial market transactions. Understanding the sources of the volatility in prices is essential in order to give appropriate policy response. The challenges posed by high and volatile commodity prices are important worldwide, yet they are more immediate for emerging markets. For instance, the share of food in the typical consumption basket is higher in these economies than in advanced economies. The average weights of food in the consumer price index in emerging market countries and in developed countries are around 30% and 13% respectively. Besides, especially for the net importers of commodities, high and volatile prices pose significant risks on balance of payments and sustainability of growth in developing countries.

There are nominal and real factors that affect commodity price developments. The most important real factor is due to the low price elasticity of not only supply of but also demand for these items. Because of low elasticity, a minor change in supply has the potential to affect market prices significantly. Likewise, a minor change in future real growth prospects has the effect of shifting the demand with a potential of large market price changes. This explains the real sources of commodity price volatility which is recently observed. Regarding nominal sources of volatility, most commonly cited explanations are related to monetary policies of major central banks and the structure of financial markets in commodities.

I will elaborate more on real factors that is the lack of sufficient real supply increase in order to meet booming real demand from the developing world. The high growth potential in developing countries suggests that demand pressures are likely to stay with us over the years to come. Combined with the massive financial flows fueled by the exceptionally loose monetary policies, commodity price volatility will probably remain as a major challenge in the years ahead. I believe the key solution here lies in productivity increases in agriculture and energy in the medium term. Regarding agriculture, this necessity is much more evident in emerging markets – in order to keep up with the demand growth, considering the higher share of food in the consumption basket. Rapid employment shift from agriculture to manufacturing & services, and the labor-intensive structure of production necessitates a reformation in this sector.

Likewise, a similar productivity improvement is inevitable for energy both in emerging and developed economies. However, given the limited supply of resources, efficient energy use gains a crucial role at this point. According to the International Energy Agency, improved energy efficiency in buildings, industrial processes and transportation could reduce the world's energy needs in 2050 by one third (Sophie Hebden: "Invest in clean technology says IEA report", 2006). In this context, energy efficiency together with renewable energy, energy obtained from natural resources, are said to be the *twin pillars* of sustainable energy policy.

Dear participants,

Against this backdrop, in the remaining part of my speech, I would like to share our experience in dealing with commodity price volatility, especially in the context of monetary and fiscal policy. Volatility in oil and other commodity prices has both direct and indirect effects on inflation. In this manner, there is a debate in the literature on how a central bank should respond to the changes in commodity prices. Since oil and other commodity-based products are an important component of consumption basket, it is impossible to avoid the so called “firstround effects” of commodity prices, which in turn translates itself into inflation volatility. However, temporary movements in commodity prices do not affect the medium-term inflation trend, as long as they do not disrupt the general pricing behavior. Therefore, central banks acting on a medium-term perspective, typically do not give sharp policy responses to these primary effects as doing so may have strong negative impacts on the social welfare.

On the other hand, a persistent increase in commodity prices may adversely affect inflation expectations and therefore pricing behavior of economic agents. This may entail prolonged increases in general price level and, accordingly, high costs associated with increasing inflation. Therefore, it is important for central banks to pay close attention to the evolution of inflation and inflation expectations in order to contain the second-round effects of the increases in commodity prices. At the Central Bank of Turkey, we frequently state that we will not react to the first round effects of the increases in oil and other commodity prices. However, it is emphasized that second round effects will be closely monitored and deterioration in inflation outlook will not be tolerated.

At this point, I would like to share our experiences in coping with global inflationary pressures in 2007–2008 period when commodity prices were increasing at a rapid pace. During 2007, there was a marked increase in inflation across the world, including Turkey. The sharp surges in oil and other international commodity prices were the major factors driving inflationary pressures.

During this episode, our first line of defense was to pursue an effective communication strategy by underscoring core inflation indicators. Accordingly, we emphasized that there was no significant pressure on core indicators and overall pricing behavior, despite the upward trend in headline inflation. Initially, this strategy worked well and medium term inflation expectations were anchored despite the surge in headline inflation. Later, however, the uptrend in commodity prices turned out to be more persistent than anticipated, leading inflation to exceed the targets for two consecutive years by a significant margin, primarily due to the sharp increases in commodity prices.

In response, we decided to set the inflation targets by mid-2008 for the following three years on a declining path. In this context, the inflation targets were set as 7.5, 6.5, and 5.5 percent, for the years 2009, 2010, and 2011 respectively. Later on, the inflation target for year 2012 was set at 5% in year 2009 and was kept at 5% for the following year 2013.

These targets allowed us to accommodate relative price changes driven by global developments, which itself is the optimal response from a welfare perspective. Second, we wanted to anchor inflation expectations by setting a feasible and credible path for the medium term rather than leaving this job to central bankers’ own inflation forecasts in the interim period. The plan worked reasonably well. The deterioration in inflation expectations stopped right after announcing these targets and the targets were undershot in 2009 and 2010. During this period, many other central banks opted for changing their forecasts significantly above their target for a prolonged period of time. We believe that our approach of setting the targets and forecasts rather than forecasts alone on a declining path involves a firmer commitment on behalf of the central bank; therefore it is more transparent and more effective in anchoring inflation expectations.

Dear guests,

Being a central banker, I have mostly focused on inflation and monetary policy dimension of commodity price movements. Needless to say, the course of commodity prices has implications on many other key macro variables. For example, as a net energy-commodity importer, Turkey's dependence on energy imports makes the current account balance more sensitive to volatility in commodity prices. Recent uncertainty surrounding the energy market is not comparable to any other period in the near history. Moreover, there is a significant risk that commodity prices stay volatile due to uncertainties regarding global economy and the exceptionally loose monetary policies across the globe. Therefore, medium-term outlook for commodity prices is unusually hard to predict.

In the long term, supply conditions and structural policies should adjust to stabilize the energy and other commodity prices. The recent concrete steps as part of the medium term programs in Turkey, aiming at curtailing the dependence on energy imports by switching towards domestically produced and renewable energy sources, have important implications also for decreasing the sensitivity of current account balances to international price movements.

The key question here is how to smooth out the impact of the volatility in energy and other commodity prices on the domestic economy in the short to medium term, while there is a heightened degree of uncertainty regarding financial and real factors. Introducing a fixed element into the sales tax on gasoline or other energy prices might be an effective method in dealing with this issue. In the case of Turkey, for example, there are two types of taxes on the retail gasoline prices. The first one is the VAT that is proportional to the price; the second one is the Special Consumption Tax (SCT) that is a fixed tax. The SCT forms a significant portion of the retail gasoline prices and attenuate the volatility of final prices that consumers face, since it is not a proportional tax. This tax structure not only smooths out the fluctuations in retail gasoline prices but also avoids the need for subsidies, discretionary choices and associated fiscal costs. This conference serves as a perfect platform to discuss alternative methodologies on these issues.

Once again I would like to welcome you all to Istanbul and hope that we will address some of the challenges regarding commodity prices and the global economy in this meeting.

Thank you.