Erdem Başçi: Latest economic outlook and macroeconomic developments in Turkey

Panel speech by Mr Erdem Başçi, Governor of the Central Bank of the Republic of Turkey, at the Conference on "Policy responses to commodity price movements", Istanbul, 7 April 2012.

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Distinguished Guests,

The global economic developments observed during the last decade are influential on the commodity prices. Some of these developments were real factors directly affecting the supply and demand of these commodities. On the demand side, significant growth in demand for energy, food and raw materials of developing countries, led by China and India, became an important factor in commodity markets in recent years. Likewise, the discrepancy between the paces of recovery of developed and developing countries in the aftermath of the global crisis and the global monetary expansion are observed to have reflections on the demand for commodities.

The increasing income in developing countries enjoying robust growth broadly decreases the price sensitivity of commodity demand. As a result of production capacity shortfalls of exporting countries in the short run and these countries' reluctance to increase their production capacity, prices sometimes display excessive increases in the event of a setback in supply.

On the other hand, the robust economic growth potential of developing countries implies that the demand for raw materials will continue to be strong also in the medium term. The key solution for imports-dependent countries due to having little natural resources lies in increasing the productivity in agriculture and energy sectors. Increases in productivity especially in the agricultural sector are of vital importance and thus call for prompt action for the developing countries that are witnessing a shift in employment from agriculture to non-agriculture sectors. In a similar sense, measures for achieving more effective use of energy by companies and households, and for increasing the use alternative energy sources, especially renewable energy, should be the another issue among the priorities on the part of both advanced and developing countries, dependent on imported energy inputs.

Esteemed Participants,

A comprehensive literature has been guiding central bankers as to the type of monetary policy responses to be given to commodity price changes. The central banks following to the widely accepted advice put forth by this literature endeavor to contain the second-round effects of the commodity price increases, rather than the first-round effects. It is inevitable for commodity price increases to be reflected directly on prices, because of the high weight of goods linked to energy and other commodities in consumer price indices. That is why the first-round effects cause fluctuations in inflation. Nevertheless, temporary movements in commodity prices, unless they affect the general pricing behavior, do not affect the medium-term outlook, but just remain as relative price changes. That is why those central banks pursuing monetary policy with a medium-term perspective prefer to refrain from sharp policy responses to the abovementioned first-round effects.

Understanding the sources of the price fluctuations prior to making decisions is a prerequisite for policy makers. Commodity price changes with relatively more of a permanent nature may distort the general pricing behavior and initiate a wage-price cycle. This may entail prolonged upward movement in inflation in general and, accordingly, the high costs associated with this. Therefore, to be able to contain the potential second-round effects due rises in commodity prices, it is important for central bankers to pay close attention to core inflation indicators and inflation expectations, and shape their communication policy in this direction.

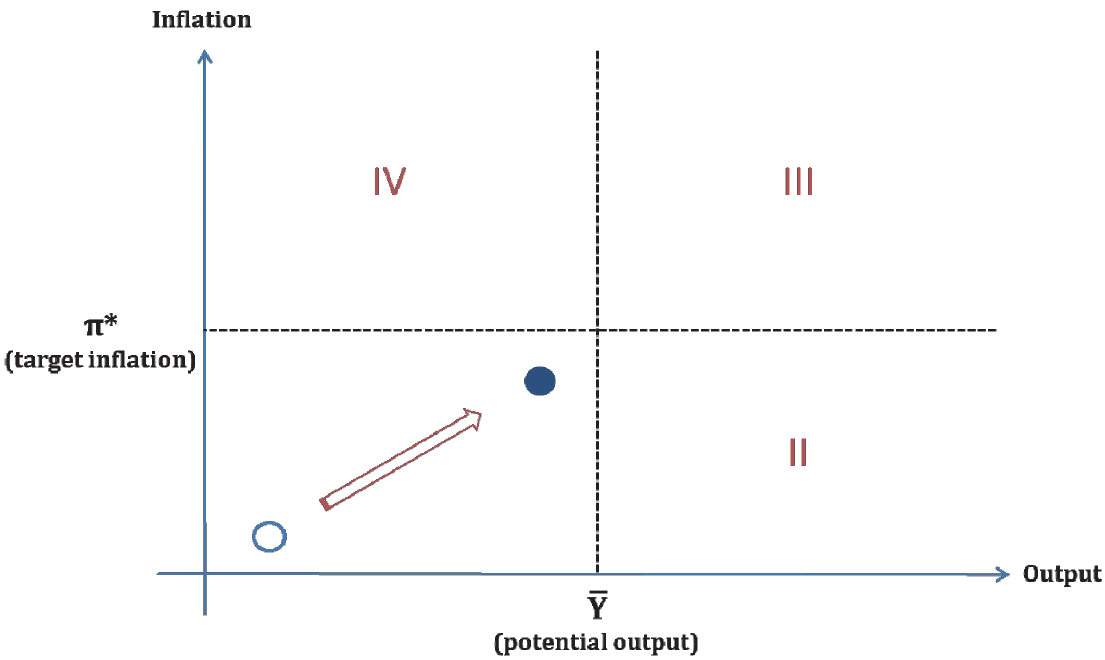
We, as the Central Bank of the Republic of Turkey (CBRT), are also in the position to carry out the abovementioned analyses. As a matter of fact, in our Inflation reports as well as the Summary of the Monetary Policy Committee (MPC) meetings, we share with the public, our assessment of the nature of commodity price changes.

In the Inflation Report published in January 2012, we made the following assessment on oil prices:

“Another risk factor in the forthcoming period is the uncertainty regarding oil prices. Although the weak course of the global economy dampens commodity prices, recent manifesting problems regarding oil supply pose upside risk to energy prices. Should such a risk materialize, the CBRT will not react to temporary price movements, yet the Bank will not tolerate any deterioration in expectations.”

Likewise, at the Monetary Policy Committee meeting held on 27 March; after pointing out that “uncertainties in oil prices pose upside risks to the inflation outlook”, we underscored “[…] we will continue to closely monitor supply-side developments and we will not tolerate any deterioration in inflation expectations”.

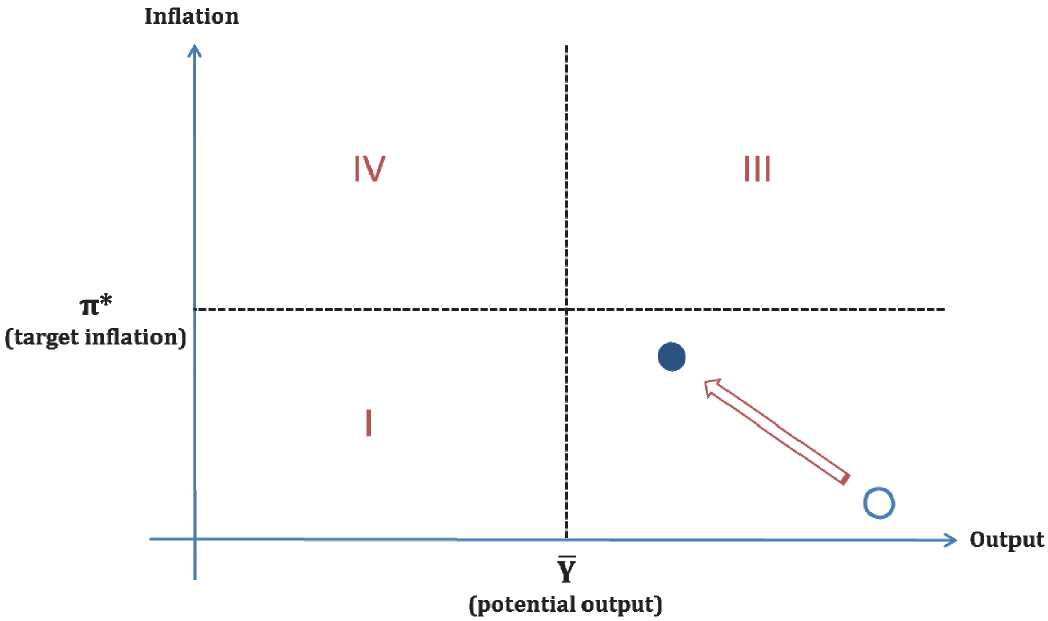
In view of the current level of inflation, I would like to re-underline on this occasion that it is essential to eliminate upside risks. To this end, last month, we implemented a “strong, effective and temporary” monetary tightening in order to eliminate the impact of recent cost developments on inflation expectations. We will closely monitor factors affecting inflation in the forthcoming period and additional monetary tightening (AMT) will be repeated when deemed necessary.



Dear Participants,

At this point, I would like to give you a quick overview on the monetary, financial and fiscal policies that Turkey has implemented for economic stability. The global demand shock that came after Lehman crisis brought steep declines in commodity prices with it. In response, expansionary monetary policy as well as supportive fiscal and financial policies were implemented at the same time. In terms of monetary policy, interest rate cuts and injection of liquidity into the markets, and in terms of fiscal policy, temporary cuts in consumption taxes could be mentioned as examples of the overall accommodative policy stance in Turkey in 2009[1].

With the help of these policies, the dynamics of the economy in Turkey turned to positive in 2010; however, the increase in foreign capital inflows due to the exceptionally loose monetary policies by the advanced economies led to an excessive credit growth and an appreciation pressure on the Turkish currency, widening the external deficit. In response to these developments that have repercussions on the current account and the financial stability, CBRT responded by widening the overnight interest rate corridor with the aim of deterring short-term foreign capital inflows. Additionally, as part of the restrictive fiscal and financial policies, macroprudential measures were implemented in collaboration with other regulatory institutions and fiscal discipline was strengthened through tax hikes.



When we come to 2011, Euro area debt crisis took over the markets; however, commodity prices displayed an upward trend as the global monetary expansion and its effects on the markets still continued. Decreasing risk appetite led to capital outflows from developing economies. As the increasing energy prices and the pass-through from the depreciating currency started to put excess pressure on the consumer price inflation, CBRT responded this time with AMT complemented with measures relaxing the financial markets' liquidity needs. On the fiscal front, cuts in wage and corporate income taxes differentiated across regions have been put in place last week to support the economy that is already growing at a moderate pace.

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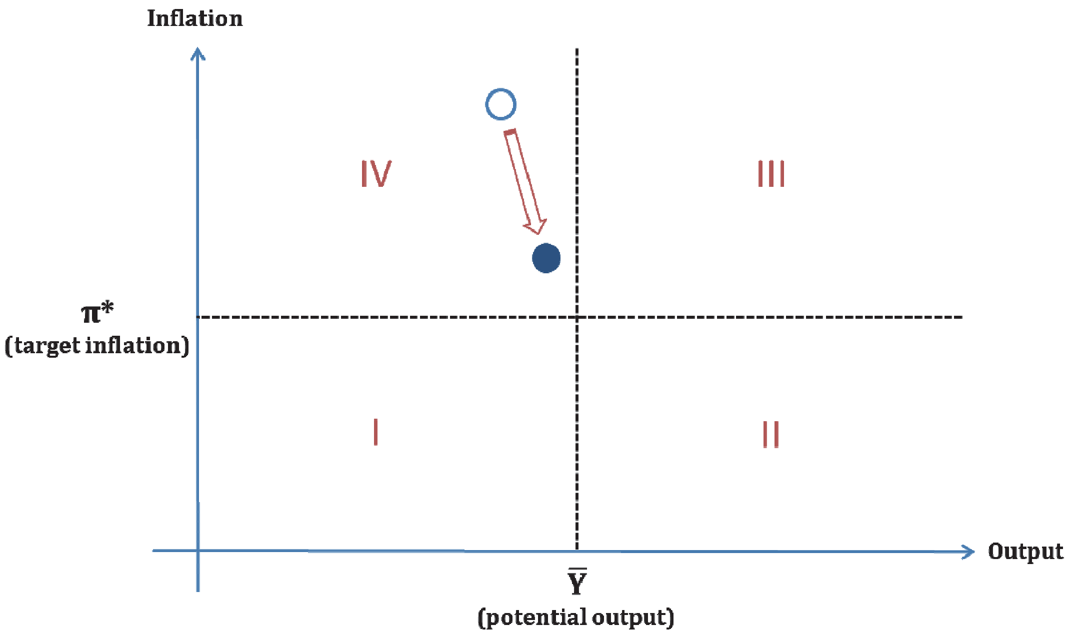
1 On March 15, 2009 Special Consumption Tax (SCT) rates were decreased on vehicles to %18 from %37, and on durable goods and other electrical household appliances to %0 from %6.7. These rates were increased on vehicles to %28, on durable goods to %2 and on other electrical household appliances to %6.7 on 16 June, 2009. By October 1, 2009, SCT rates were brought back to the levels before March 2009. Similarly, Value Added Tax (VAT) rates on furniture and IT products were slashed to %8 on March 30, 2009, before being raised back to the initial rate of %18 on October 1, 2009.



Dear Participants,

So far I have touched on the impacts of movements in commodity prices on inflation and economic growth. Now I will talk about the impact of fluctuations in commodity prices on foreign trade balances. The dependency of the Turkish economy on energy imports makes the current accounts balance more sensitive to changes in commodity prices. Uncertainties regarding the global economy in recent years and the exceptionally loose monetary policies adopted by advanced economies, such as the United States, Japan and the Euro Area, foreshadow the high probability of continued excess volatility in commodity prices.

In the face of these developments, we welcome the recent concrete steps, as part of the medium term program in Turkey, towards reducing the dependence on energy imports by shifting to domestically produced and renewable energy sources. These measures will hopefully ease the susceptibility of the current account to commodity prices in the long run.

The key question in the short-run is how to smooth out the impact of the 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. In Turkey, ex-refinery fuel prices, in addition to the 18 percent-Value Added Tax (VAT), are also subject to the Special Consumption Tax (SCT). Special Consumption Tax, which is not only a fixed tax but also comprises a major part of the final prices of fuel products, helps to smooth out significant fluctuations in crude oil import prices. Thus, consumers are less affected by such fluctuations.

Esteemed Guests,

It seems that uncertainties regarding commodity prices will continue to be an important factor to be considered carefully in policy implementations in the forthcoming period, too. I believe that the papers presented in this conference will guide us in overcoming the policy challenges we will face along the road. Thank you very much for your interest and participation.