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The State Planning Organization has inquired with the Central Bank of Turkey (CBT), through an official letter dated 22 May 2008, that there is a need to determine the inflation path within the framework of the "Medium Term Program". Inflation figures that will appear in the Program are also going to be used as official inflation targets during the 2009-2011 budget preparations. In accordance with Article 42 of the Central Bank Law, inflation targets are to be determined jointly with the Government. This open letter extends our proposal for setting the official inflation targets throughout the years 2009 to 2011.

Recent studies have been increasingly supporting the view that rising food and energy prices may reflect a structural change in global economic environment rather than temporary cyclical factors. Projections made by the international institutions also suggest that food and energy prices may continue to follow an unfavorable course in the forthcoming period.

In the open latter dated April 30, 2008 we have already stated that reaching the 4 percent target could take more time than originally envisaged. Related to this issue, the April Inflation Report presented three different projections constructed under alternative scenarios.

Our main policy document, published in December 2005 on the general framework of the inflation targeting regime, stated that inflation targets would be changed only if inflation was expected to stay away from the target for a considerably long period of time due to factors beyond the control of the monetary policy and consequently official inflation targets ceased to be an anchor. Our assessments based on recent developments suggest that, even under the maintenance of a cautious policy stance, reaching the 4 percent target is likely to take an extended period. Under these conditions, a revision in inflation targets has become a technical necessity.

In fact, the Summary of the April 2008 Monetary Policy Committee Meeting has included the following paragraph:

'Since inflation is seen above the medium term target for a considerable period, the meeting agenda also covered the issue of target revision. Committee members indicated that changing the target for end-2008 would not be appropriate, since doing so would be a clear violation of the accountability principle in practice. Regarding targets for 2009 and afterwards, the Committee assessed that, given the uncertainty surrounding the food and energy prices as well as the global economy, it would be wiser to reconsider the issue towards the end of this year in tandem with the budget preparations. Accordingly, we envisage a framework in which forecasts serve as intermediate anchors while the medium term is anchored by the 4 percent target. The Committee therefore noted that extending the forecast horizon in the Inflation Report to three years would enhance the efficiency of the overall strategy of monetary policy.'

Medium Term Inflation Targets

Food and energy prices continue to pose risks to the medium term inflation outlook and there is no clear evidence that this trend will reverse in the short term. Under these circumstances, we think that it would be appropriate to factor in the possibility of further supply side shocks; and thus to design the target path so as to minimize the risk of a second revision in the inflation target path. Accordingly, we envisage a target path with a more gradual convergence towards 4 percent inflation.

Considering these assessments together with the three alternative projections presented in the April Inflation Report, we propose to revise the targets for 2009 and 2010 to 7.5 and 6.5 percent, respectively; and to set the target for the year 2011 at 5.5 percent.

Upward revision in the target path does not necessarily mean that monetary policy will be looser in the forthcoming period. On the contrary, our forecasts presented in the April Inflation Report are based on a tighter monetary policy stance than earlier envisaged, indicating the maintenance of a cautious policy for an extended period.

The CBT will treat the revised targets asymmetrically in order to contain the inflation expectations. In this respect monetary policy will aim to keep inflation below the revised target path, by staying close to the baseline forecasts presented in the April Inflation Report. 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 the deviation of inflation from the revised targets.

Recent research conducted by the CBT staff on the formation of inflation expectations shows that the weight attached by economic agents to past inflation has recently been increasing, suggesting that the current inflation target has become a weaker anchor in shaping inflation expectations. Breaching the targets by a large margin since 2006 may explain this behavioral change in inflation expectations formation process. If the past inflation becomes a reference point in the wage and price setting process, this could increase the costs associated with disinflation. Revising the target path by incorporating the impact of the prolonged shocks will also help to re-anchor inflation expectations.

The Target and Accountability for Year 2008

According to Article 42 of the Central Bank Law, breaching the target by a significant margin requires the CBT to write an open letter to the Government, explaining the reasons for the breach and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits. This framework facilitates the implementation of the accountability principle, which is one of the fundamental principles of the inflation targeting regime.

Changing the target for the year 2008 – a relatively short period compared to the long monetary transmission horizon – would in practice be equivalent to violating the accountability principle. A challenging but more beneficial approach is to keep the target and explain the reasons for missing the target. Accordingly, we believe that, for accountability purposes, it is more appropriate to keep the original target path for the year 2008, which was announced through the main policy document published at the end of 2007. Given that our inflation reports provide an extensive account for the inflation developments, focusing more on inflation reports for the rest of the year will facilitate the communication of monetary policy. In this context, open letters that are likely to be written for the rest of the year will be shorter and refer largely to the corresponding inflation reports.

Conclusion

Inflation targets have been breached by a significant margin in the past two years as a result of exceptionally persistent supply shocks and there is a considerable chance that, contrary to the initial views, the impact of these shocks will continue for a prolonged period. Besides, the ongoing uncertainty resulting from the global economy has been increasing the risks on the inflation outlook. Our revised projections incorporating the latest developments suggest that it will take a relatively long time for inflation to reach 4 percent level. Even more importantly, current inflation target no longer seems to serve as a nominal anchor in the short term. Therefore, we would like to extend a proposal to your consideration to revise the targets for 2009 and 2010 to 7.5 and 6.5 percent, respectively; and to set the target for the year 2011 at 5.5 percent.

Yours Sincerely,

CENTRAL BANK OF TURKEY
Head Office

Durmuş Yılmaz
Governor

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