Inflation Targeting: Five Years From The Inside

Central banks' main role is to create and manage money, which performs as unit of account, medium of exchange, and store of value. Managing money of an economy involves protecting and stabilizing its value. Monetary policy can choose, which value it wants to focus on. It can be its external value, that is the exchange rate, or its internal value, that is inflation.

Magyar Nemzeti Bank decided to focus on the internal value of money, and introduced inflation targeting almost six years ago. The new regime had a special purpose beyond the usual objective to achieve price stability. It was about bringing down double-digit inflation to low single digits, as it was one of the criteria to meet in order to introduce the unified currency not later than January 1st, 2007, that is exactly eighteen days ago. The project as such has failed, but not for monetary policy. The inconsistency of economic policy, and the lack of political will and, importantly, the missing social consensus doomed the project to be a failure but we can still say that inflation targeting is successful in Hungary. During the course of the past five or six years dynamics of economic variables and the behavior of economic agents have changed. One-off price shocks can be managed without serious spill-over effects, expectations are well-anchored, and policymakers have finally recognized the role of central banking in the management of economic policy.

Financial markets have accommodated the central bank's dedication to control the change in consumer prices, usually properly pricing in the monetary authorities bias towards tightening or easing monetary conditions. Inflation targeting has made Magyar Nemzeti Bank more open and transparent, which helps analysts, asset managers and the various financial intermediaries to properly focus monetary policy actions. This predictable behavior decreases the costs of active monetary policy by smoothing out fluctuations in the level of interest rates, and by pricing in easing or tightening biases in the forward curve, financial markets can send delicate signals to fiscal policy on the potential path of interest rates in the future.

External Factors To Inflation Targeting

Hungary is a small, open economy where real and nominal variables are functions of external developments at least as much, as they are functions of the actions of domestic economic policy. When we assess either the feasibility or the success of inflation targeting, we should not forget all the external factors which help or hamper the attainment of policy targets. Nowadays we live the times of the so-called 'Great Moderation'. This concept refers to the historically low volatility of economic growth and inflation both in the developed and the developing world. The standard deviation of output and inflation in OECD countries fell by more than fifty percent during the past twenty-something years compared to the previous quarter of a century. The reason behind are manifold: structural changes, technological innovation, globalization, better economic management, international division of labor, lower consumption of energy per unit of output and probably pure luck are all equally important factors in this process.

Low volatility of inflation on the one hand is a natural consequence of reduced variations in output, but on the other hand it is also attributable to better monetary policy. Economic policy, just like investment strategies, clothing or pop-music, is pretty much a fashion thing. Sometimes one school becomes trendy, sometimes another. Inflation targeting is definitely a fashion, and we can say that it is a very successful fashion. Many central banks have adopted this style of policy making, and many other monetary authorities behave as if they had a formal inflation target. In this regime the target is more important than the tools to achieve them, which helps central banks to apply all available techniques to fulfill their duty as guardians of stable prices. This flexibility is a very important feature, as the innovation in financial engineering makes other techniques, such as controlling the monetary aggregates, basically inefficient. Commitment to inflation as opposed to other economic variables have earned credibility to central banks, which has brought down risk premia on the required returns on long-term investments. Smarter governments quickly recognized that increased central bank credibility is something that they can easily monetize through lower interest rates, which helps them lower taxes and/or spend the extra money on other purposes. It is by no coincidence that almost all governments have recognized the importance of the independence of the central banks, and it is only the countries of deep structural problems and/or dictatorial leadership which consider the curbing of this independence to be a viable solution to anything.

This benign external environment is optimal for central banks to formerly adopt an inflation targeting. It can even work in such small open economies as Hungary, despite the fact that in these kinds of countries excess demand rather translates into a higher current account deficit than higher prices. When international inflation is low, the domestic monetary policy can easily import price stability, if it convinces economic agents that inflation, sometimes generated by governments themselves, is not a serious risk to consider. When this conviction is strong, risk premia in the price components of real economy contracts go to zero, even in times when the currency, which is supposed to be highly correlated with domestic prices, fluctuates.

There is one more factor, however, that we need to consider when evaluating the external environment in respect of domestic monetary developments. This is the international shadow monetary system, which Deutsche Bank economists simply call Bretton-Woods II. In Bretton Woods II „peripheral” countries of rapid economic development pursue a strategy of export-led growth supported by undervalued exchange rates, capital controls and official capital outflows in the form of accumulation of reserve asset claims on a center country, that is the

United States. The center country acts as an ultimate buyer of products and services, and is willing to run a current account deficit by selling claims on its assets.

The success of this strategy in fostering economic growth allows the periphery to graduate to the center. During this process, an accumulation of capital takes place, and due to modernization, technological transfer total factor productivity goes up keeping inflation low in the periphery despite the rapid economic growth. This was the strategy of Europe and Japan after World War Two, and obviously this is the strategy of East Asia today.

At the same time the United States ceases to be a big close economy and turns to be big open economy, where excess demand also translates into a current account deficit as opposed to higher inflation. The external imbalance is then financed by official flows of the periphery, where monetary aggregates are hard to control as well. The result is an environment, where inflation is low due to international division of labor and the rapid increase in global total factor productivity, and risk premiums contract due to the overwhelming official flows of the Bretton Woods II countries.

What Are The Consequences Of All Of This To Hungary's Past Five Years?

First of all, the feasibility inflation targeting in a small open economy is always subject to academic and professional debates. It is obvious though, that targets of low inflation and/or price stability are easier to meet in an open economy when global inflation is low. Inflation targeting, notwithstanding the obvious differences in the economic systems of then and now, could not have been so successful in the 1980's, when global inflation was rampant.

Secondly, Hungary was free-riding on Bretton Woods II and acted as a center country. It run and has been running a high current account deficit and accumulated no reserves, but sold claims on itself to countries with overflow of reserves. The government of Singapore's interest in the local bond market is an obvious example of this. The unsustainable policy mix has never been really punished, leaving Hungary, as one of the local asset manager calls it, a "country of unfinished crises". The grace period, that we live in, has prevented financial markets to send signals to policy makers about the unsustainability of the path of economic policy, which ultimately has led to consecutive postponements of the county's Eurozone accession. The accession has bleaker prospects then ever before, exposing the currency to shifts in sentiments when the Bretton Woods framework finally cease to work.

Further Consequences Of Ultra-low Risk Premia: The Tošovsky Dilemma

The tools of the central bank in a small open economy to target inflation is not as obvious as it first seems. Tightening monetary conditions through higher-then-neutral interest rates are not always an option when domestic inflation is high. This, what we sometimes call Tošovsky-dilemma, is the result of the multiple equilibria of real interest rates we may have in small, open, economies with low level of capital stock. First of all, equilibrium real interest rates in the real economy should equal the marginal return on capital. In case of a still-emerging market country this marginal return is high, as the volume of the capital sock is lower than that of the most of developed countries.

At the same time, equilibrium real interest rate on the financial markets is simply determined by the uncovered interest rate parity criterion, which imply that local interest rates should equal the international real interest rates, increased by the expected depreciation of the real exchange rate plus the amount of risk premia. The problem with this measure is that expectations regarding the changes in the real exchange rate and the level of risk premiums are highly correlated. When the outlook is bright, the currency is expected to appreciate and risk premiums decrease. In this rosy scenario the money market equilibrium of the real interest rate is too low, and the central bank cannot hike rates without risking an excessive inflow of foreign portfolio capital.

When, on the other hand, for whatever reasons, the market is pessimistic, the exchange rate is not expected to appreciate anymore, while risk premiums skyrocket. The result is such a high equilibrium interest rate, which may hold back domestic growth and/or forces domestic consumers and enterprises to flee into euro or any other hard currency for credit. The ever-changing mood on international financial markets makes the equilibrium of the money market interest very volatile, and limits the central bank’s ability to calibrate monetary conditions. If domestic interest rates are aggressively increased to mitigate inflationary pressures would only result in attracting unnecessary capital and an expansion of the domestic money stock. As a result, the focus of the central banks has to be measures other than just hiking interest rates. It is important to note, that the “benchmark” or “neutral” interest rate is changing according to the variations in risk appetite, which can trigger harsh monetary policy reactions of both directions. This elicits criticism of the central bank, which actually does nothing more than maintains a certain level of interest rates compared to the actual neutral rate. It is important note here, that volatile risk premiums and hence volatile monetary policy actions can be the consequence of both internal and external developments.

Although this not directly related to the multiple equilibria of real interest rates, the currency can also have more than one equilibrium level. These equilibriums have the same relations to each other, that is one of them is stable and linked to the economic structure of the country, while the other is more volatile and is determined by the actual supply and demand conditions on the financial markets. The currency of a small open economy is like a small boat on the big ocean of global financial markets, where huge ships create waves which these small boats need to weather.

The central bank is in an extremely difficult situation, as major swings in the currency do have an effect on domestic prices. The multiple equilibria on the currency market means that if the exchange rate leaves one equilibrium level, it may not swing back as a pendulum, but rather finds a different at a much weaker level, making the attainability of the inflation target completely impossible.

To picture this, the currency can look like a ball in a double-bottom ditch: if it swings from one groove to the interim top, it can either roll back to its original level or roll over and may not come back ever. Central banks in this case may want to overreact with their interest rates to be sure that the ball comes back where it used to be as opposed to losing more of its value and transporting the inflation target to the thrash can of economic policy. It is also to be noted, that this state of multiple equilibria is more likely in those countries, which need to rely on a huge amount of external borrowing to finance their current account deficits or their redeeming debt. In these situations the currency is much more exposed to the risk appetite of the international financial markets, making the case for more than one equilibrium.

An Inflation Targeting Central Bank As An Institute Of Democratic Control

There is another, non-economic aspect to a central bank targeting inflation exclusively. We all know that politicians and policy-makers are not solely act on the long-term benefit of their voters. Many times the need to maximize votes in the short term triggers actions which conflict the longer run interest of the public. Formal institutions of democratic control ensure that politicians are subject to professional scrutiny beyond the regular control of civil organizations or of the media. In democracies voters have the ultimate say in evaluating politicians and their policies, but the control institutions provide more in-depth, more thorough assessment of the performance of the decision makers. These institutions also limit the freedom of governments to exercise their powers during the electoral cycle. The Constitutional Court controls the judiciary; the State Audit Office carries out financial supervision of budgetary institutions; the Competition Office monitors markets and fosters fair competition on the marketplace, and so on. Although we usually consider central banks simply to be a unit in economic decision making and management, a monetary authority does have a control function in parliamentary regimes.

When maximizing and/or optimizing votes, policy makers carry out actions which usually redistribute incomes between groups of economic agents. This redistribution of income mainly benefits subgroups of voters, the preferences of whom have a significant effect on the outcome of the next election. As everything, it also comes at a price. Somebody has to pay. In order to avoid handicapping other groups of voters, it is always compelling to spread out the costs on the whole society in the form of higher increase in the level of consumer prices. This is less of a viable policy option in case of an inflation targeting monetary policy, because if a the central bank controls inflation so aggressively, that it even disregards short term volatility in aggregate output, it also detains governments from pursuing short-sighted, irresponsible economic policy. To put it bluntly: if a government follows an unsustainable economic policy, which leads to a higher-than-desired inflation, then the central bank has right, the means, and also the obligation to even drive the economy to a complete halt to meet the inflation target. We all know what it means if the economy slows down: our neighbor loses his or her job. We all know as well, what it means if there is a recession: we lose our jobs. In this case we and many other do not vote for the government and they lose the election. It's consequence is that all governments under a regime of explicit inflation targets should be aware of the ultimate limitations of their policies. An inflation targeting central bank acts as an institution of democratic control when it limits the deviation of inflation from the prearranged target, and helps guarantee that the political parties on power do not completely lose sight of the long-term interests of the society.

This aspect of central banking is not widely debated in economic literature or political science, but helps explain why a central banker is different from other units economic policy.

Outlook For Inflation Targeting

As it follows from all this, targeting inflation is a feasible to exercise in a small open economy, if global inflation is under control and the international financial system is stable. Although we should expect no major changes in the external environment, we have to keep in mind that nothing lasts forever. Bretton Woods II will cease to exit in its current form one day, making the external environment for importing price stability more difficult or even impossible. The current international financial system does have some tensions within, which will transform the current low inflation, low volatility and low risk premia into world something different. Recession plus deflation or runaway inflation are all possible, just like controlled reflation. In those cases inflation targeting may still be a valid strategy to follow, but the target should be carefully chosen.

We also need to consider the ever faster changing nature of the financial industry. Financial engineering are creating new and new products, leaving regulators, auditors, risk managers and market analysts unaware of the risks inherent in the financial system. It may be still years or even decades away when the complexity of the industry gets to a tipping point, from where the mightiness of the financial system will be more of a course than blessing. If the system of financial intermediation comes under stress, it may have overwhelming consequences to the global economy and to individual countries.

Finally, we should not forget either, why inflation targeting was introduced five and half years ago. At that Hungary aimed to be the member of the innermost circle of the European Union, the Eurozone. By the time inflation targeting gets 10 years old, we will most likely be still out of the monetary union. Magyar Nemzeti Bank has still some work to do.

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