



MAGYAR NEMZETI BANK



Inflation Targeting in Hungary Lessons and Challenges

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Overview

- Peculiarities of IT
- Performance in 2001-2005
- Major shocks and policy reactions
- Challenges and lessons

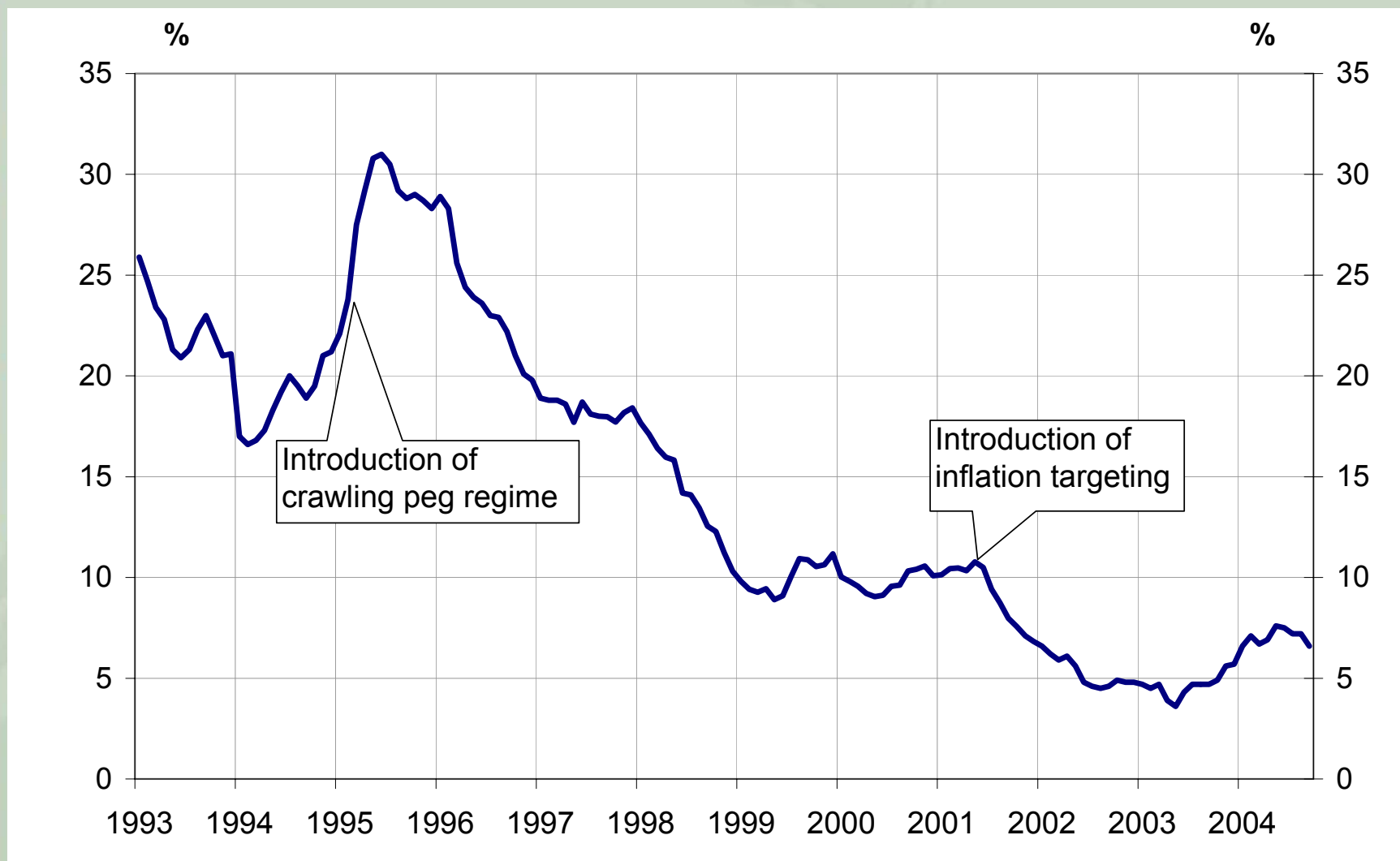


Evolution of the regime

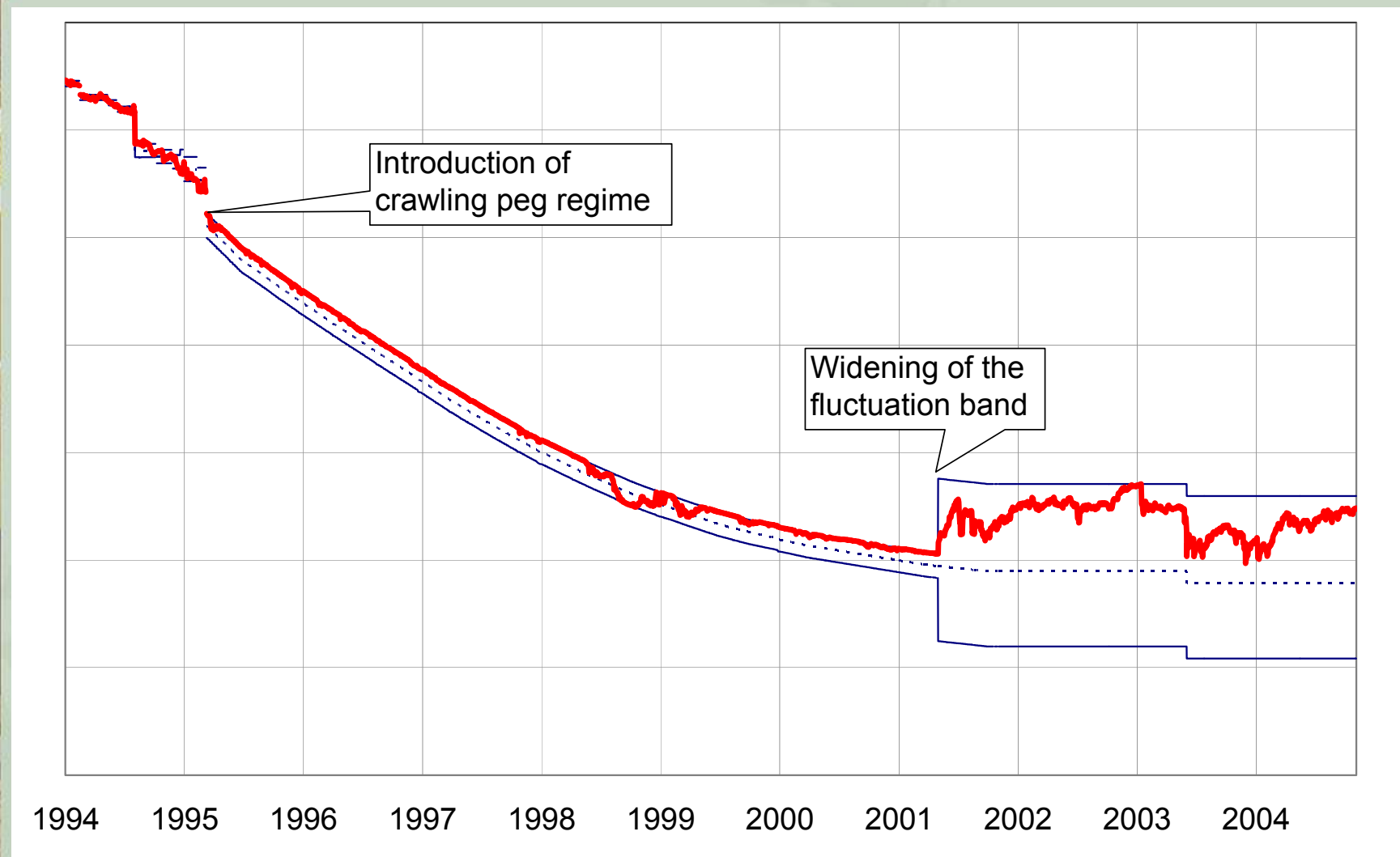
- 1995-2001: crawling peg
- Why to exit:
 - Inflationary inertia (oil prices, food prices)
 - Clear need for monetary contraction
- 2001, May: Widening of the exchange rate band:
 - In 2001 it was considered as a quasi-floating regime, but ERM II compatible at the same time
- Lost nominal anchor
- 2001, Aug.: Inflation targeting




Inflation history



Exchange rate developments



New central bank law, 2001

- 
- Primary goal: price stability
 - Without jeopardising the primary goal, the MNB supports the economic policy of the Government
 - Declared independence from the Government

But:

- The Government, in agreement with the MNB, shall determine the exchange rate regime

Consequences of dual objectives

Inflation targeting within ER band



- limited instrument independence
 - subordinated to ER management at the edges of the band
- limited goal independence?
 - policy coordination required
 - inflation targets: in agreement with the government
 - speed of disinflation depends on:
 - actual room for maneuver of monetary policy
 - fiscal stance
 - in line with convergence program (2006→2007→2008 →2010 →?)

Performance

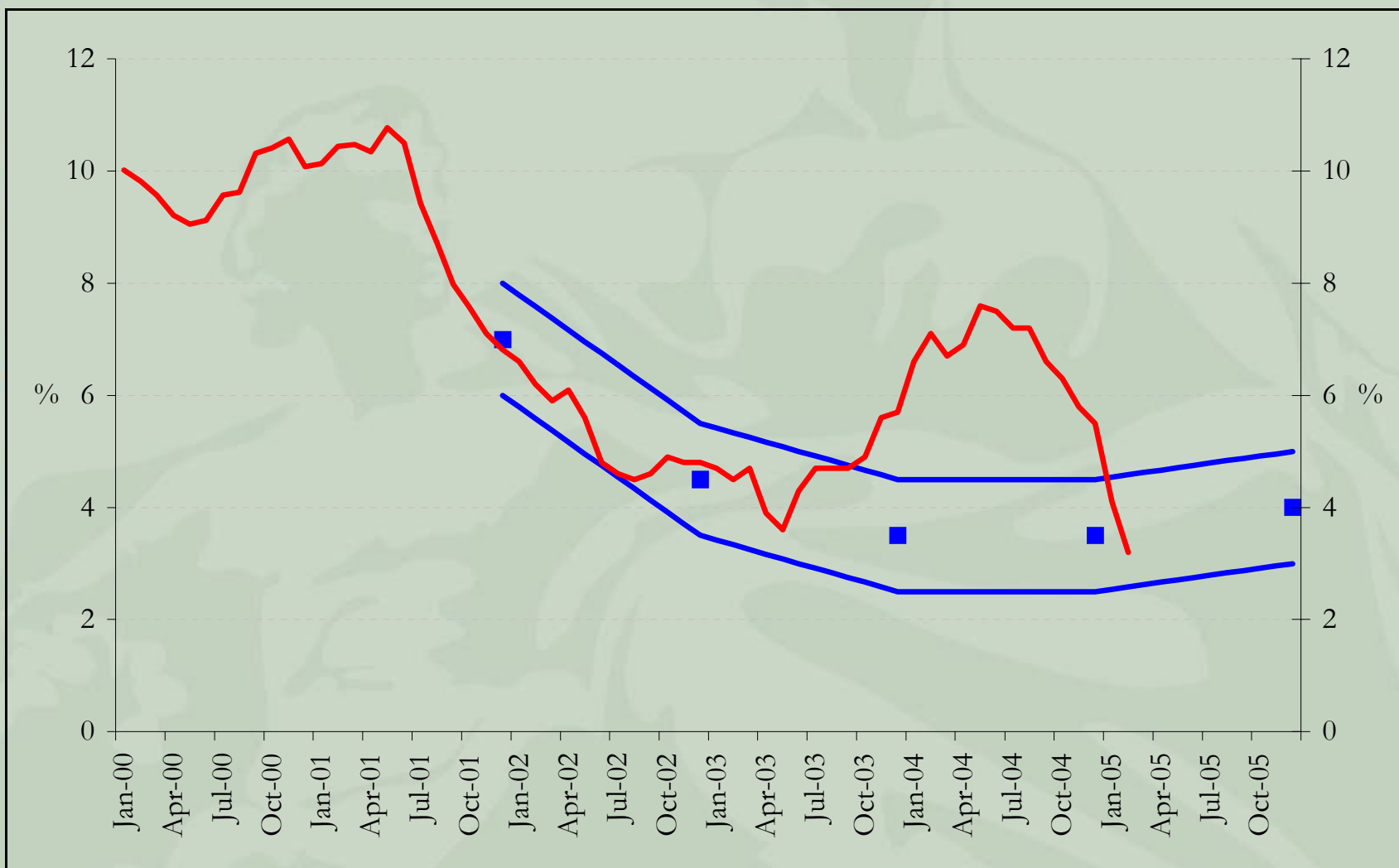
Major tasks:

- break down inflation inertia: $10\% \rightarrow 4\%$
(price stability: 3%)
- smooth output fluctuations: not higher volatility



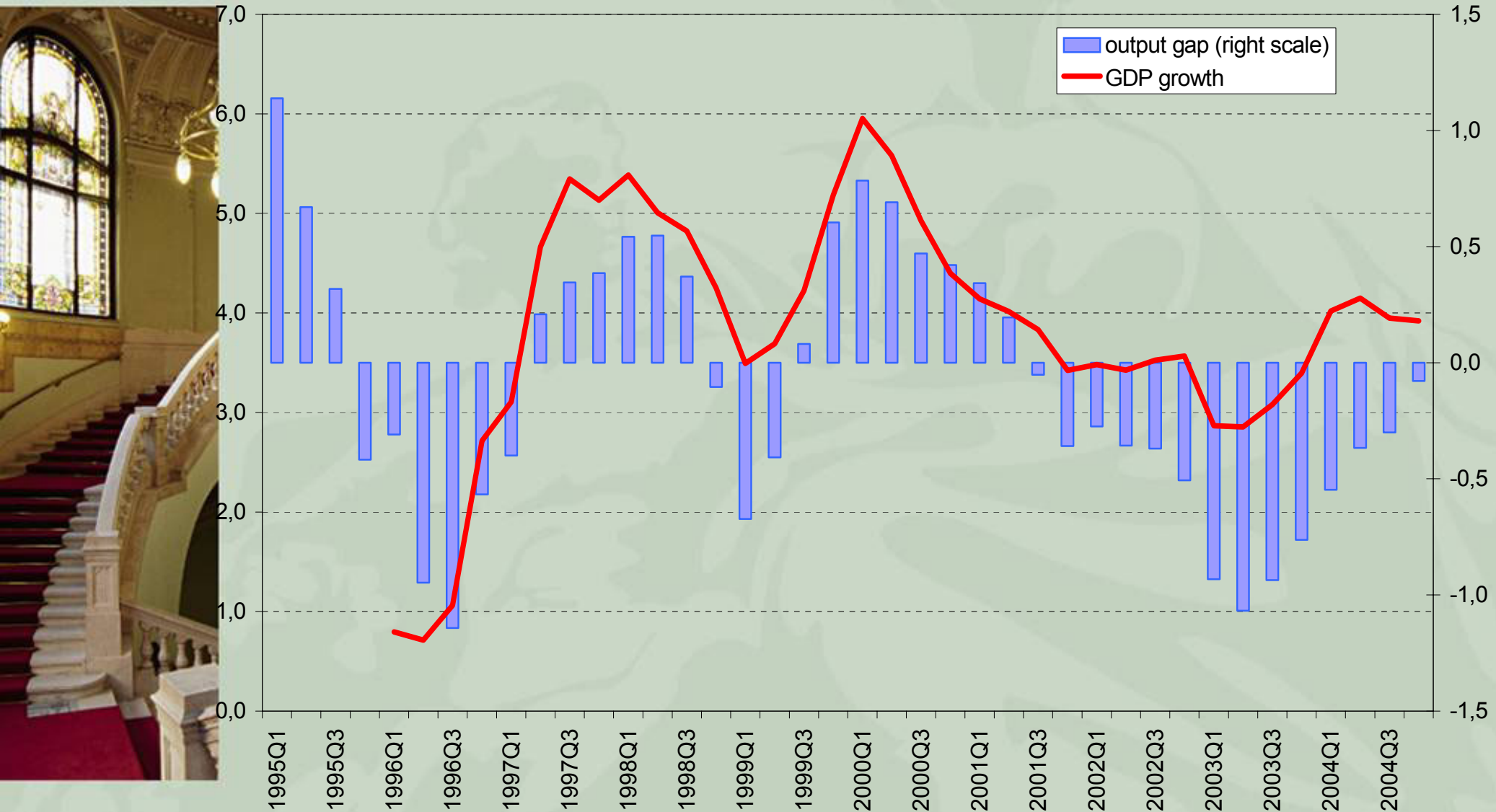
Most targets have been met at moderate costs

CPI and the target band



Most targets have been met at moderate costs

Output gap

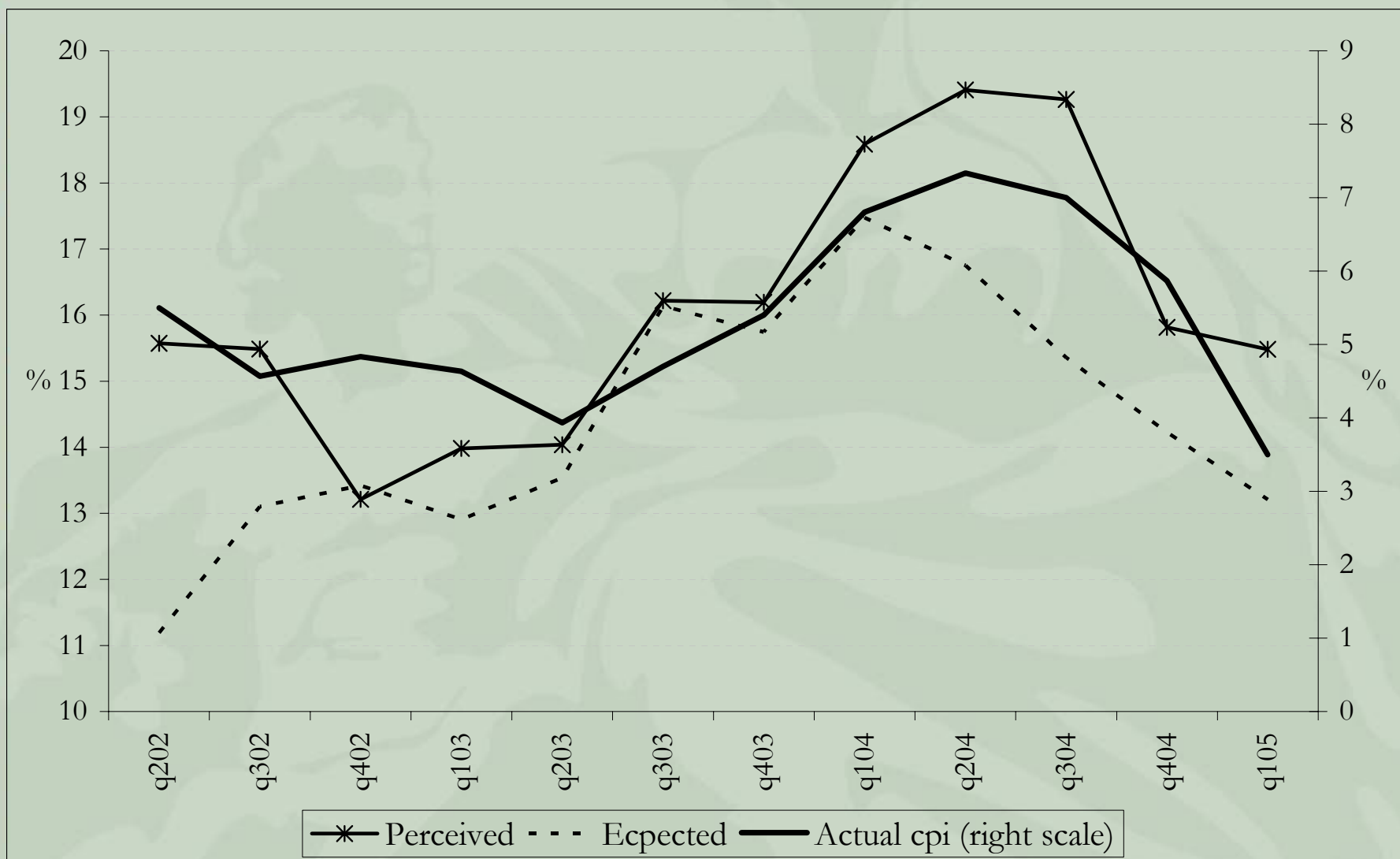


Credibility of monetary policy

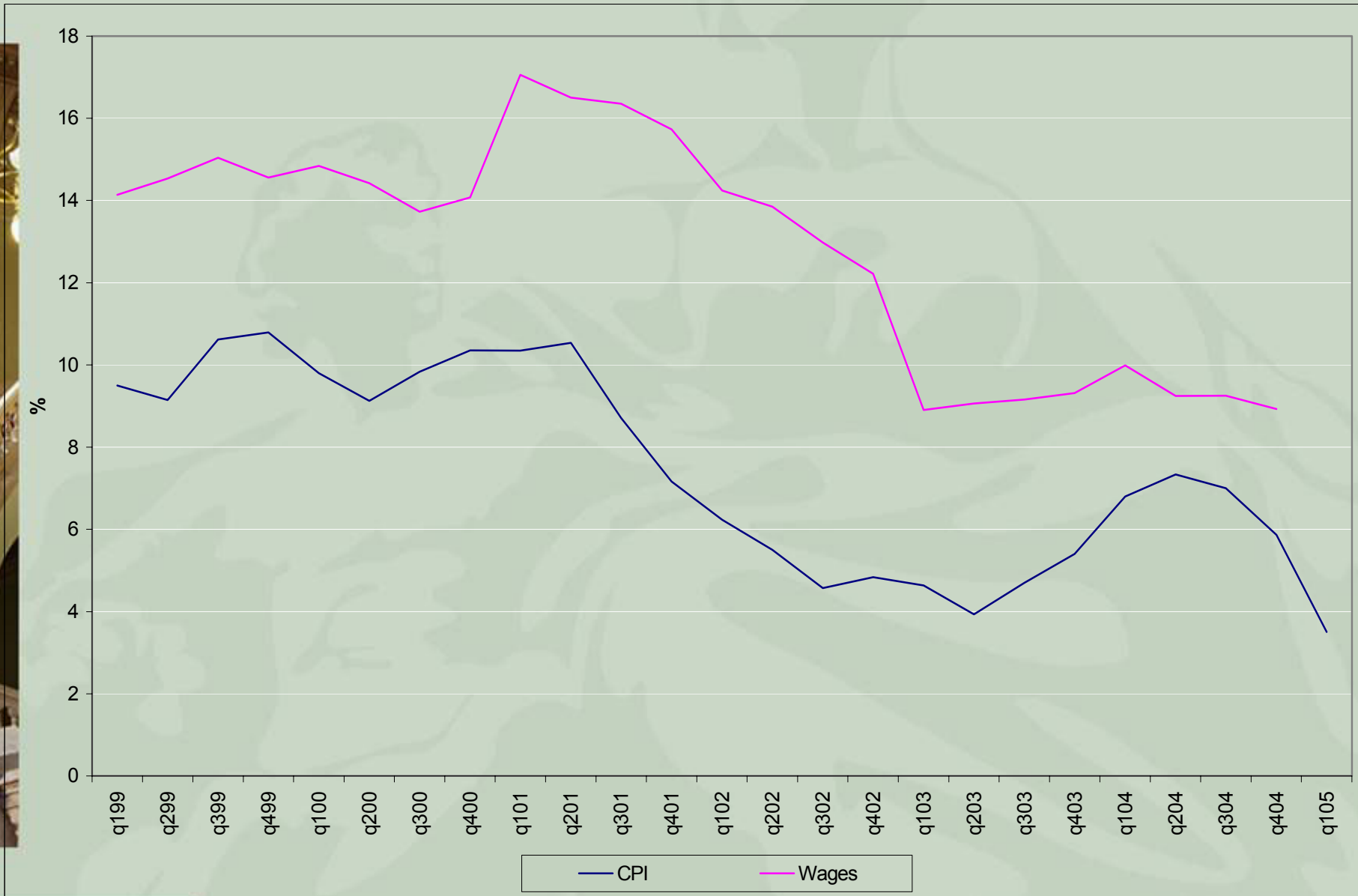
- Long term inflation expectations not yet anchored:
 - Household expectations: still double digit
 - Slow wage adjustment (RER appreciation)
 - High risk premium
- But:
 - Slower exchange rate pass-through
 - Slower pass-through of oil prices
 - Benign reaction to one-off tax increase
- High risk premium: twin deficits



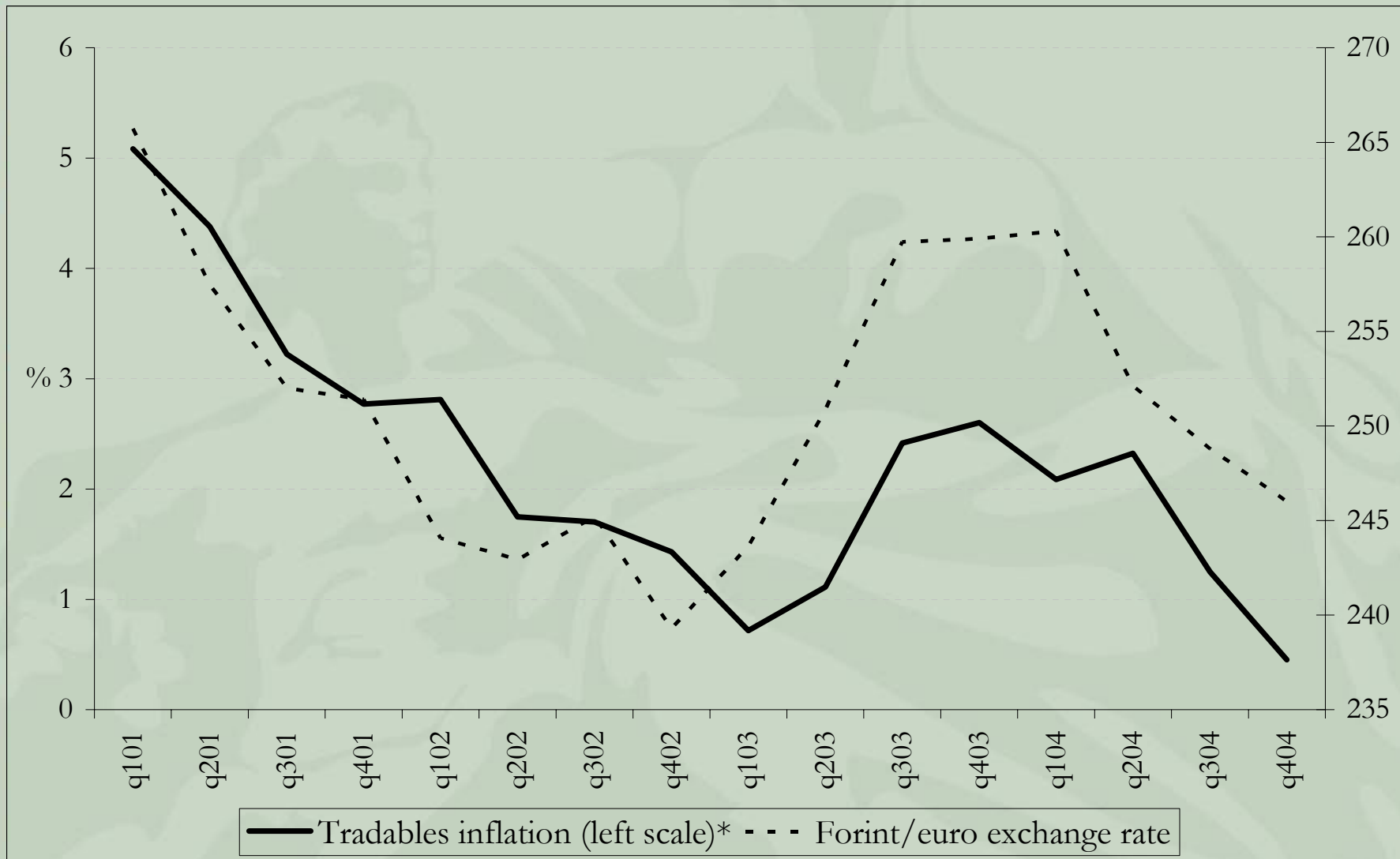
Inflation expectations (Households)



Wage developments

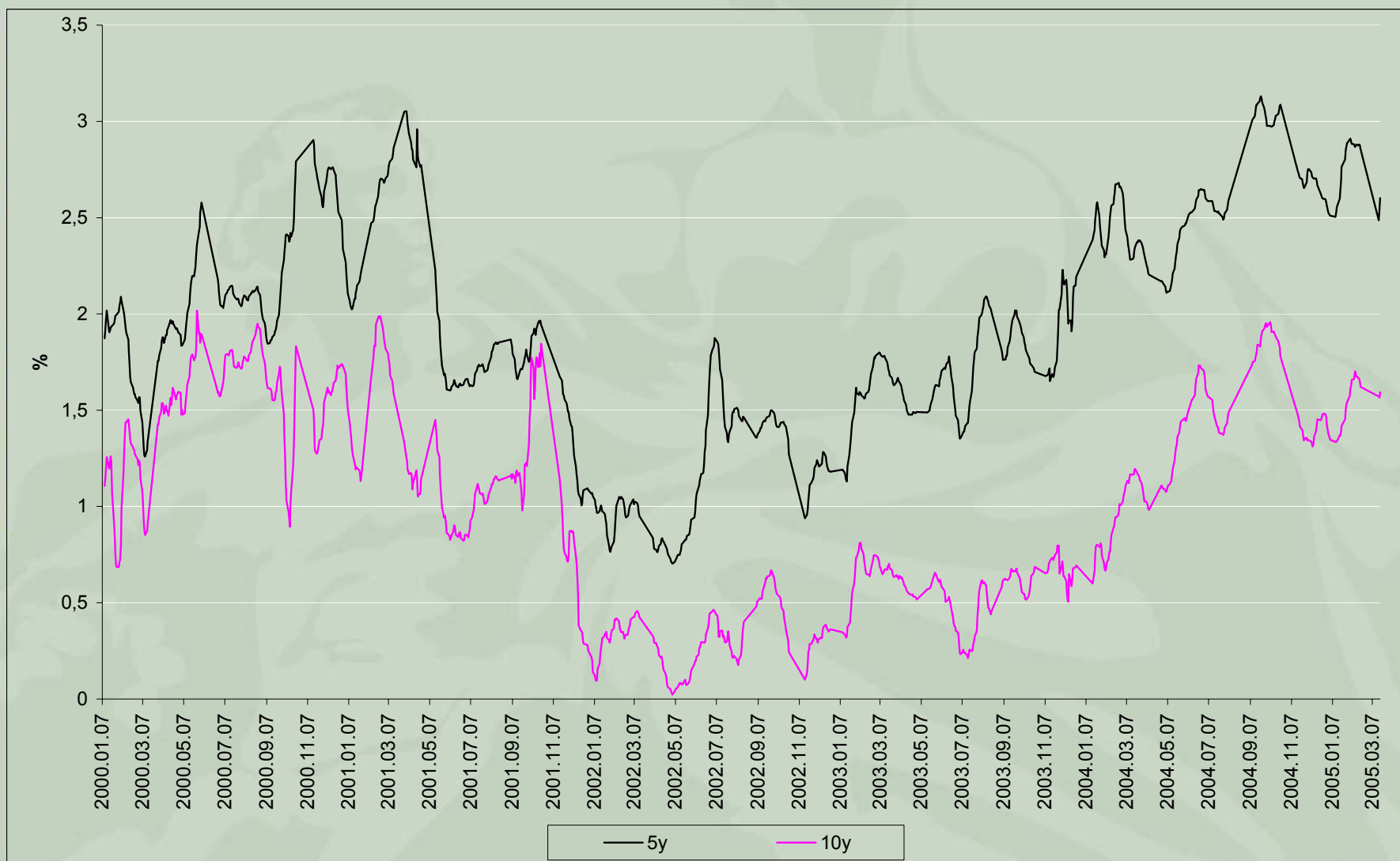


Exchange rate pass-through



Expectations are not well anchored

(5Y and 10Y interest rate differentials)

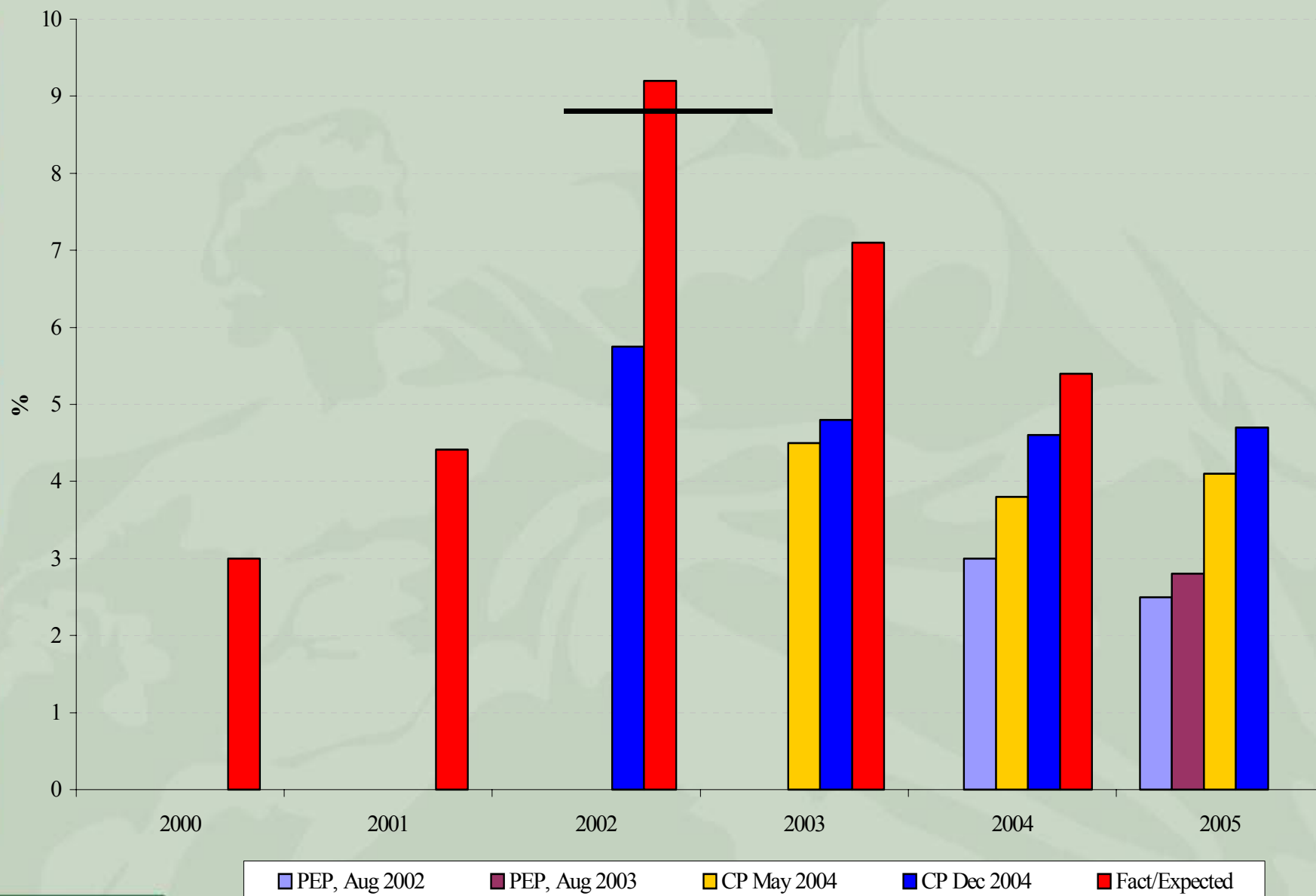


Major shocks, 2001-2005

- Demand:
 - European business cycle
 - Fiscal shocks
 - Financial deepening: consumption + housing boom
- Supply shocks:
 - Oil + USD/EUR
 - Food
 - Increasing competition (EU entry)
 - “Public wages/employment shock”
- Regulated prices + taxes



Fiscal developments: promises and outcomes



Major shocks, 2001-2005

- Risk premium/exchange rate shocks
 - Shifts in convergence expectations
 - Shifts in ERMII central parity expectations
 - Global risk appetite
 - Domestic fundamentals



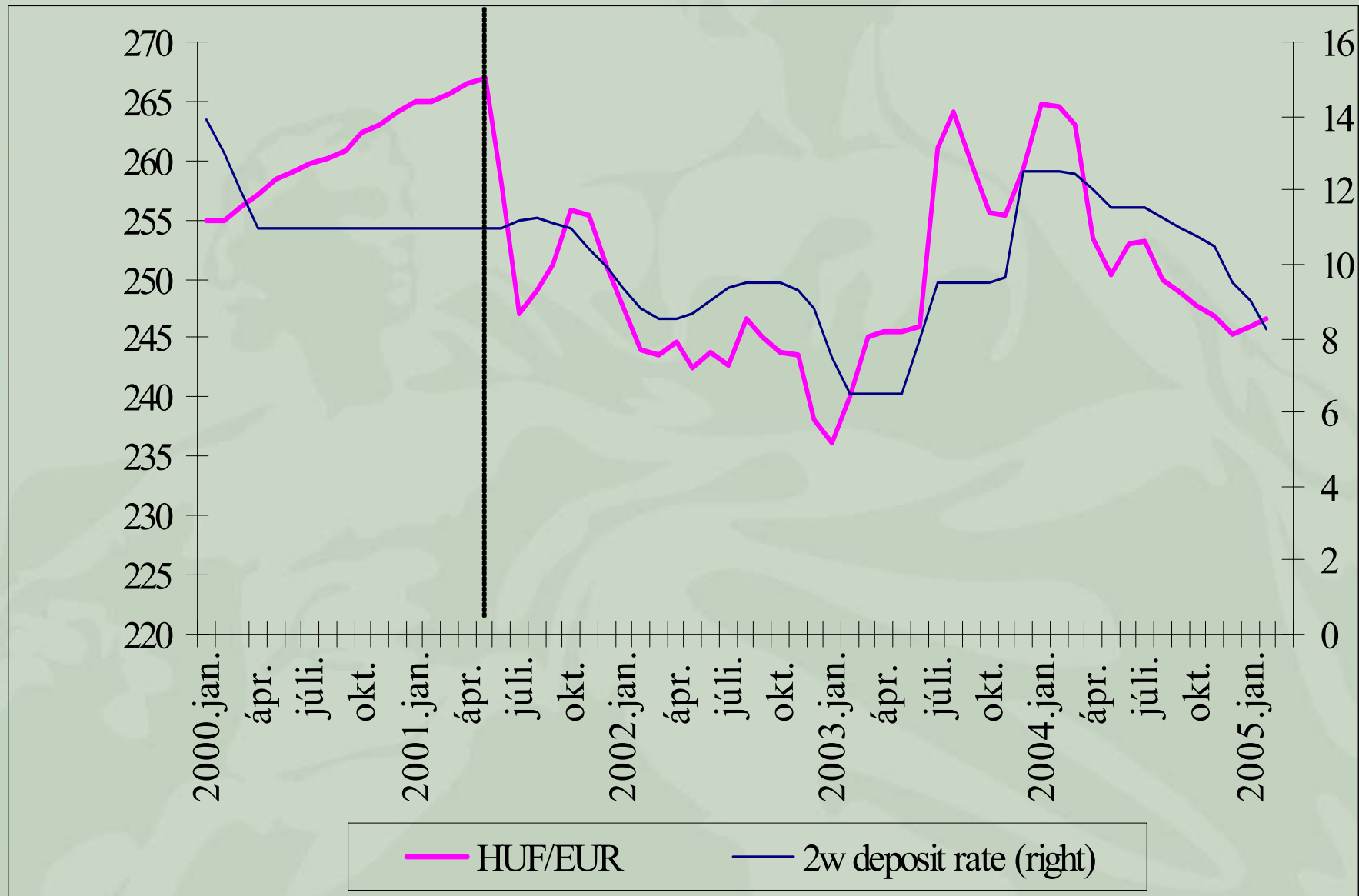
Monetary stance, 2001-2005



- 2001: tighter monetary conditions
- 2001-2004: maintaining tight conditions
 - lots of fluctuations
 - interest rates: smooth exchange rate fluctuations
- 2005: first possibility to ease

Monetary conditions

exchange rate and short term interest rates



Challenges and lessons

- Price stability
- Disinflation path
- Forecasting capacities
- Communicating conditional forecasts
- A perfect nuisance: the exchange rate



Price stability

- Hungary: 3%, Poland: 2.5%
- ECB definition of price stability ($< 2\%$)
- Maastricht criterion on inflation: moving target 1.8% – 3.4%)
- In convergence economies:
 - it can be higher: Balassa-Samuelson
 - it will be higher after eurozone entry



Optimal speed of disinflation

- Earn credibility:
 - Demonstrate determination
 - Meet early targets despite shocks
- Euro – convergence
 - Government reveals preferences: PEP, CP
 - Tight monetary policy can easily lead to overvalued ERM II central parity
 - The sooner inflation convergence, the better: expectations should be well anchored
 - Is ERM II compatible with IT?



Optimal speed of disinflation

- Is there a sustainability constraint?
 - Nominal rigidities
 - Capital inflows (growth potential + convergence speculation + tight monetary conditions)
 - Nominal and/or real appreciation
- ⇒ Potential vulnerabilities



Forecasting capacity



- Knowledge of transmission mechanism: some intuition, not much econometric evidence
- Pluralistic approach: expert view, time series techniques, single equation econometric models, leading indicators. Judgement.
- 2004- : Model-based forecast: for consistency check + simulation only
- Transparency in methodological uncertainty: conditions and assumptions
- Detailed report of forecasting exercise → story based report

Conditional forecast

- Methodological problems:
 - How to define unchanged monetary conditions (fixed interest rate or fixed exchange rate)
- Interpretation problems of the forecasts:
 - Not directly comparable to the analysts' forecasts
 - Guide for monetary decisions
 - Influence expectations? unconditional forecast
- Bias arising from conditionality of fiscal forecasts



Exchange rate

- Strong pass-through inherited (+Exchange rate conditionality)
 - ER major driver of the forecast
 - MPC inclined to smooth ER
- How to communicate?
 - MCI-type communication \Rightarrow speculation
 - or non-transparent
 - or more costly (in the short run)
- Pitfalls:
 - Volatile interest rates
 - Exchange rate as a measure of commitment



Benefits of IT

- More forward-looking approach
 - both central bankers and market participants
- Contained expectations:
 - weakened pass-through
 - lower exposure to external shocks
- Communication, transparency
 - educating markets
- Public support





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Thank you for your attention!

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