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Monetary Policy, Interest Groups, Financial Crisis

*„We have entered a brave new world.
The economic crisis has put into question many of our beliefs.
We have to accept the intellectual challenge.”*

Olivier Blanchard[†]

SUMMARY: The outbreak of the financial and economic crisis in 2007–2008 put an end to the previous consensus on monetary policy. The effects of monetary policy on redistribution have come to the foreground; the modelling and transparency of central bank decisions now require the development of an interpretive framework that allows the complex interpretation of monetary policy decisions in a social context. This paper uses the example of exchange rate policy to explain the effects of central bank decisions on economic variables, the impact of those effects on institutions, and feedback from interest groups on central bank decision-making. Based on *Woolley's* typology, this paper considers each of the factors within and outside government, as well as structural and less embedded, non-structural factors that may influence central bank decision-making. The paper concludes that interest groups' assertion of their interests is not in conflict with central bank independence; it merely serves to represent the preferences of society concerning monetary policy.*

KEYWORDS: monetary policy, macroeconomics, financial crisis, political economics, institutional economics

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One of the main characteristics of the global financial crisis, starting in 2007–2008 and subsequently evolving into a crisis of the real economy, is that most economists could not foresee the events to come, as a result of which the start, the evolution and persistence of the crisis has taken many by surprise. According to analyses on public policy, such helplessness and lack of direction is typical of periods when a subsystem of public policy is about

to undergo a paradigm shift. In their classic paper, *Howlett and Ramesh* (1995) posit that the stability of a paradigm of economic and public policy will be called into question when the established model and way of thinking are no longer capable of either predicting or subsequently explaining real processes; and although explanations tend to be sought in the old framework for a while, the shift toward a new paradigm will begin in both science and public life.

Undoubtedly, the approach to monetary policy and the search for answers in connection with it have entered this phase.² Pre-crisis consensus on monetary policy is a thing of the past. There has been a quick succession of

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measures and announcements that break away from the mindset of the roughly two decades preceding 2007–2008; suffice it to mention the monetary easing, sovereign debt market interventions and rescue packages applied in the euro area, which had been formerly looked upon as the stronghold of monetary orthodoxy. It is certain that the previous years' consensus³ on monetary policy has been completely overridden by the crisis.⁴ Daily experience shows that flexible inflation targeting has failed to create a strong monetary framework, that the supervisory and macroeconomic aspects of monetary policy cannot be separated, that asset prices cannot be ignored, that the zero floor can indeed present a key problem in monetary policy, and that monetary and fiscal policy need to be managed in combination even in the short term.

Chapter 1 of this paper explains the necessity for a paradigm shift in monetary policy. Chapter 2 locates economic policy in general and monetary and exchange rate policy in particular, in the institutional matrix. Chapter 3 discusses the effects of exchange rate policy decisions on economic variables, and presents feedback from interest groups on central bank decision-making. A summary is provided at the end of the paper.

PARADIGM SHIFT IN MONETARY POLICY

Under the European regulations adopted prior to the crisis, the primary objective of monetary policy was to achieve and maintain price stability; therefore, over the past decade in Europe, monetary policy has been tied to a nominal variable, i.e. changes in the consumer price index. In the simplified approach, interest policy is the only effective instrument to attain that objective. This was the “one objective – one instrument” model, which was both easy to understand and easy to follow.

Owing to the classical dichotomy, monetary policy is unable to exert a permanent influence on real processes and consequently, it can only take into account monetary variables, in particular, consumer price levels, whereas among its instruments, priority needs to be given to the key policy rate as it impacts the economy as a whole.

However, the crisis marks a new era in this regard as well. *Blanchard* (2012b) claims that the model is simplistic and wrong. Indeed, the truth and strength of economic theories is not determined by the beauty of the intellectual architecture of models, although many have been deceived by the elegance of the monetary policy models which have been widely considered valid in recent decades. The crisis has demonstrated the fallacy of this simplistic approach, refuted the assumption that stable inflation is consistent with a stable output gap⁵, and showed that price stability does not mean that all is well in the monetary and financial spheres of the economy⁶.

The failure of the “one objective – one instrument” model has serious implications for political economics. Although the interest policy could certainly have redistributive effects,⁷ on the whole, it could be viewed as a policy that is neutral to sectors and interest groups. In the context of such an interpretation, a well functioning and independent central bank can neither improve, nor worsen the position of specific sectors or (interest) groups of society through interest policy measures. However, the situation will change when optimisation is governed by several criteria and more instruments are available which, according to *Blanchard* (2012b), could also seriously challenge the issue of central bank independence. In addition, *Stiglitz* (2012) argues for the fallacy of the premise of monetary policy. Namely, reducing inflation is not an ultimate objective, but an instrument. The ultimate objective of the

economic policy is an economy that is more stable both in monetary and real terms, one that grows faster in a sustainable way.⁸ Stiglitz also argues that there is no justification for the belief that independent central banks perform better than dependent ones. Therefore, in addition to models, we might have to review our long-established approach to good governance as well, and examine the problem of independence and accountability more thoroughly and more comprehensively.

The consensus before the crisis had assumed the existence of a set of rules that was optimal in social terms and neutral in terms of distribution, the enforcement and application of which had to be ensured by legislation. The models based on the work of *Barro and Gordon* (1983) and *Kydland and Prescott* (1977) specify general rules that are known to everyone and are unanimously accepted, and compliance with such rules requires legal guarantees because voluntary implementation would be too expensive. *Keifman* (2008) rejects this logic claiming that unanimity cannot be assumed either in respect of people's vision or their objectives: individual interests and perceptions on how the world works are different, while monetary policy is not neutral even in terms of redistribution. On the other hand, even if unanimous preferences existed, the Pareto optimum would not always be possible to implement since transfers from winners to losers would either be absent or too costly. Not to mention the fact that, in order for the model to function, all economic actors would need to know, understand and accept the validity of Barro and Gordon's argument. However, as indicated by the different positions discussed above, the intense debate among economists does not appear to suggest that the views on the mechanisms of the economy are consistent. A similar criticism is voiced by Palley (2011), who argues that the previous consensus on central

banks and monetary policy was based on the wrong assumptions. In Barro and Gordon's approach, only an independent central bank can prevent politicians, who think in terms of election cycles, from causing an inflation spiral in the economy, this being the only way to handle the problem of temporal inconsistency. The model is based on the three tenets that (1) the long-term Phillips curve describing the relationship between inflation and unemployment is vertical (i.e. over the long term, employment cannot be improved by driving inflation); (2) even short-term advantages are derived exclusively from the deception of economic actors; and (3) social preferences are constant and consistent. From an institutional perspective, the latter assumption plays a key role. According to Palley (2011), the assumption is not substantiated, which undermines the very foundations of the model.

Practical experience and recent theoretical reflections indicate that the duality of the "one objective – one instrument" concept may be superseded⁹ by a more complex and comprehensive system, which would require the redefinition of the models and interpretive frameworks describing the operation of central banks in terms of political economics and institutions. The clarity and transparency of central bank operations require the availability of descriptive – and hence, not normative but positive – models of interpretation that allow for the mapping, description and analysis of the impact mechanisms of central bank operations. Particularly relevant to this field is the remark by the internationally acclaimed Hungarian economist, *Miklós Káldor*, who argued *that the means of theoretical analysis should be adjusted to the practical problems to be explored*.¹⁰ Since the central bank is also a part of the system of public policy, and central bank decision-makers are exposed to social and political influence as well, there is good

reason to assume that the conduct of monetary policy is also influenced by non-economic (institutional and social) factors. Therefore, it is relevant to examine the institutional framework and political economic constraints that underlie central bank decisions, with special regard to those involving a major redistribution of income.

AN INSTITUTIONAL APPROACH TO ECONOMIC POLICY

In examining the decisions of economic policy, one cannot disregard the social, institutional and public policy environment in which the decision was made, or which it affects (North, 1994). To understand the monetary and exchange rate policy decisions discussed in this paper, it is essential to consider the interest groups that are affected by such decisions, as well as their opportunities to influence the decisions and to pass on the costs incurred from them.

The invisible hand, which constitutes the foundations of the classical liberal approach to economics, may not necessarily work in the field of institutional development. This is because when making decisions regarding the community, decision-makers and those affected by the decisions are separated. Institutional changes affect the community as a whole, yet certain members, groups and representative bodies of the community have more influence on the decisions than others do. This poses a problem because community decisions tend to have strong redistributive effects, i.e. what is gain and progress for some will mean loss and retrogression for others. On this ground, it is easy to see how it is possible to have institutional development that hinders, rather than promotes, the development of the country: some decisions will improve the financial, social and political

situation of certain groups and interest groups of the society, while the country as a whole lags behind (North, 1993). This could be particularly acute in areas less “exposed” to the control of social accountability.

In my approach, economic performance is fundamentally determined by the institutional matrix of the state and society concerned. If institutions are taken to be the set of rules that determine the decisions and behaviour of economic actors, then economic policy itself can be viewed as a part of the institutional matrix. Consequently, monetary policy can be addressed from this perspective.

According to *Shirley* (2003), the most important requirement for the institutional environment is that it should protect proprietary rights and decrease the transaction cost of economic exchanges. In the traditional understanding, monetary policy falls in the latter category, as reduced inflation and price stability help decrease transaction costs by improving predictability. Having said that, recent years have shown that the general cost level of the economy, which affects all transactions, is not exclusively due to price fluctuations but, especially in an environment of relatively low inflation, may also result from the destabilisation of financial markets and the real economy and, implicitly, from the momentary loss of social balance. In the now classic typology of *Rodrik and Subramarian* (2003), monetary and exchange rate policy act as a kind of market stabilising institution, which is expected to ensure a predictable economic environment. The question in this case is what exactly stability is, and how broadly a responsible central bank should interpret it.

Rodrik (2000) argues that since there is no definite recipe for an optimal institutional matrix, political competition is the most effective institutional means of choosing the right path. In this approach, democracy is a

kind of meta-institution intended to ensure that social preferences are manifested in institutions. However, the question remains: what guarantees can be offered in a society that virtually lacks any freedom of institutional regulations? In his analysis of the Argentinian crisis starting in 2001, Keifman (2008) points out that one of the greatest shortcomings of the Barro–Gordon model upon which modern central bank policies rely, is precisely the fact that it excludes monetary policy, one of the key segments of economic policy, from democratic debate. However, particularly without effective social control, the direction of formal institutional development may be determined by influential interest groups whose interests are not necessarily coincide with those of society at large. This does not imply that monetary policy is definitely on the wrong track; it merely suggests that, in the lack of real social control and feedback, there is a greater risk of choosing the wrong path. The particular interests of interest groups cannot be interpreted strictly in financial terms; the cultural and social standing, historical experience, subjective perceptions and ideological convictions of influential interest groups all play a major role in institutional development. In terms of these factors, the social elite and the great masses of society can be characterised by extremely different features. Particularly instructive are the studies that point out that monetary policy-makers tend to come from a very special segment of society: the world of finance. According to *Posen* (1995), central bank independence largely depends on the extent to which the financial sector of the country concerned has been able to enforce its anti-inflationary ideas. *Stiglitz* (2012) argues that independent central banks are institutions that follow the logic of the financial world and are primarily judged by financial market players. Most central bankers come from,

and follow the vision and preferences of, the financial world (*cognitive capture*).¹¹ This view is shared by *Palley* (2011), who warns that central bank operations are distorted by an excessive enforcement of the logic and criteria of financial markets.¹²

Researchers addressing the institutional aspects of monetary policy tend to focus on the role of political and social interest groups in formulating the system of monetary policy and the framework of exchange rate policy; however, such analyses of the decision-making process are much less frequent. *Woolley* (1983) was one of the first authors to deal with this aspect. The interest groups of the private sector apply both direct and indirect channels (lobbying with political leadership, announcements, news and demonstrations) to influence the monetary policy. In a legal sense, central banks are protected against pressure, this being precisely the point in central bank independence; however, it is not evident whether central banks can indeed resist such pressures in practice. According to *Eijffinger* and *De Haan* (1996), the key factors of central bank independence include both economic and political factors. The authors have found significant correlations between central bank independence and (1) the equilibrium level of unemployment, (2) government debt, (3) political instability, (4) the quality of financial supervision, (5) the political influence of the financial sector, and (6) public opposition to inflation. *Weise* (2001) examined the monetary policy decisions of the Federal Reserve in the light of the recommendations and demands for monetary policy made by influential interest groups in American finance and real economy. He found that, although there is no evidence of a systematic correspondence between central bank decisions and the recommendations by the banking sector and other interest groups, the various forms of pressure are clearly apparent.¹³

AN INSTITUTIONAL APPROACH TO MONETARY POLICY LATITUDE

The increased prominence of the factors of political economics¹⁴ is characteristic of the entire process and practice of monetary policy, particularly of exchange rate policy, which has the most significant impact on the redistribution of income. It is by no accident that even in the European practice, which strongly relies on the principle of the independence of monetary policy, setting up the exchange rate policy framework is a joint responsibility of the central bank and the government, whereas in small and open economies, the exchange rate is the only truly effective channel of monetary policy. The exchange rate system is thus a shared responsibility, but the management of the exchange rate policy is the central bank's competence (not irrespective of the fact that the exchange rate policy can never deviate from monetary policy as a whole).

An institutional approach may facilitate the understanding of processes because it admits that regulators, those regulated and other stakeholders all represent different interests and objectives. This does not mean that there are no limits to discretionary policies, but eliminating the opinions of democratically elected bodies poses a threat that monetary policy will be unable to adapt efficiently to changing international and domestic reality. Rules set in stone are always the marks of the enforcement capacity of a given period, which also makes them suitable to conserve the system of power. Institutional inflexibility is also dangerous because the regulations and organisational structure concerned will only change when it would be more expensive to maintain them than to abandon them, which could involve significant social costs.¹⁵

Assuming a small, open and transitional economy, this paper attempts to identify the

institutional, political and economic actors and interest groups which, mostly indirectly, try to influence monetary policy decision-makers. My argument is based on the following premise: if it is possible to detect the influence of a country's interest groups on the establishment of its monetary policy and exchange rate scheme, then the same applies to central bank operations and decision-making despite, and amid, central bank independence. Once we accept such an interpretive framework, it is possible to analyse central bank operations in an institutional and social context.

It follows from the acceptance of the institutional logic that the central bank will formulate its policy by taking into account the effects of its decisions in the broad sense. This is also supported by the fact that in the European approach, the objective of monetary policy is to achieve and maintain price stability, while the central bank also has to support the economic policy of the government to the extent that such support does not jeopardise the fulfilment of its primary objective.¹⁶ The reduction of inflation must be permanent, which means that monetary policy cannot have, even implicitly, any foreseeable consequences that pose a threat to the reduction of inflation either directly or indirectly. The management of the central bank is responsible for determining the level at which this stability should be interpreted and the consequences to be considered for decision-making (in part, this is what signifies central bank independence); however, the regulatory environment also allows for an approach that involves a broad interpretation of both stability and the consequences to be taken into account. Central bank operations are influenced by the surrounding real economy environment, even if the central bank has a legal option to consider inflationary effects only. Assuming rational actors, social and other groups affected by the central

bank's decisions will try to exert pressure on the central bank as long as the expected benefits are higher than the costs of exerting the pressure. In the European model, central bank regulations prohibit central banks from making decisions under external pressure. Obviously, this is not to say that central bankers make their decisions in complete isolation: they, too, live their everyday lives in society. The impulses ultimately influencing decision-making are also independent of what decision-makers consider to be the path to sustainable price stability. It needs to be stressed that stakeholders' attempts to influence monetary decision-makers are not contrary to central bank independence and are not necessarily a problem: even though such attempts may take unacceptable forms, they are in fact a means of social feedback and channelling the views of the community when the laws are observed.

Below I attempt to outline an interpretive framework of the exchange rate policy – a special segment of monetary policy – in the context of institutions and political economics, with special regard to the relationship between exchange rate and trade.¹⁷ Obviously, monetary policy is not covered in its entirety, but as the segment in question is characterised by strong redistributive effects, it may be suitable to illustrate the train of thoughts discussed above. I will not address the debates concerning the central influence on the exchange rate; I recognise that the exchange rate may be diverted, even over the long term, by the instruments at the central bank's disposal. There is a considerable body of literature¹⁸ on the sensitivity of trade processes to exchange rates, and researchers tend to find some kind of relationship between real effective exchange rates and the processes of trade.¹⁹ Below, I will assume that such a relationship exists.

In the neoclassical approach, devaluation has the following macroeconomic effects (the effects are the opposite in the case of revaluation).

▶ *Relative price effect*: devaluation makes domestic products cheaper compared to foreign products. The improved competitiveness of domestic producers will improve the balance of trade if demand for commercial goods is flexible, i.e. the *Marshall–Lerner condition* is satisfied (*expenditure-switching effect*).

▶ *Laursen–Metzler effect* (*Harberger–Laursen–Metzler effect*): devaluation will deteriorate the balance of trade, as it will deteriorate the terms of trade.²⁰ If exports become cheaper in relative terms, imports will become more expensive, as more exports are needed to enable the country to purchase a given quantity of import goods. As the terms of trade deteriorate, real income declines, as a result of which the savings rate (S/Y) will also decline as, following devaluation, economic actors will try to sustain their *ex ante* standard of living. This will lead to increased consumption and absorption, and hence a poorer balance of trade.

▶ *Obstfeld effect*: According to *Obstfeld* (1981), a deterioration in the terms of trade will produce the opposite effect relative to that claimed by *Harberger*, *Laursen* and *Metzler*. *Obstfeld* argues that, in case of an enduring decline in the terms of trade, aggregate spending will fall, which in turn will improve the balance of trade and the current account balance.

▶ *J-curve effect*: the quantitative effects of devaluation are only perceived over time and accordingly, the effects of exchange rate changes may vary depending on the time horizon concerned. Over a longer time horizon, balance-improving effects may dominate.

▶ *Reverse absorption effect*: devaluation may be followed by an increase in domestic and foreign investment, as the country has become a “cheap producer”. Devaluation will deteriorate the balance of trade (and potentially improve the capital account).²¹

▶ *Pass-through*: devaluation will increase the

price level of imported goods and will thus drive inflation. The stronger the pass-through, the less capable exchange rate policy will be of influencing competitiveness.

► *Effect of monetary expansion:* devaluation cannot be independent of monetary developments, i.e. it needs to be preceded, at least indirectly, by monetary expansion and an interest rate cut. This involves a shift in the LM curve in the (r, Y) space. Monetary expansion will increase either income or prices, and the balance of trade will deteriorate in either case.

The above factors indicate that the effects of monetary policy and exchange rate policy are not self-evident; however, redistributive effects are significant in any case. A change in exchange rate will bring about changes in income and consumption, the value of assets, the competitive situation of companies vis-à-vis export markets, the income situation of the parties in foreign currency transactions, and the balance of trade. As a natural consequence, exchange rate policy decisions will divide society, as the same decision will benefit some, and hurt others.²²

Besides economic effects, their spillover effect should also be considered, in particular, the impact of economic changes on interest groups and the influence of interest groups on central bank decision-making. Interest groups judge economic policy decisions based on the change in their own situation, irrespective of macroeconomic effects, and if their influence is strong enough, they may be capable of reverting certain changes despite their potential macroeconomic benefits.

Owing to central bank independence, interest groups will not enforce their interests directly in respect of the monetary policy, as interest groups do not and cannot have any formal influence on decisions. However, interest groups may attempt to put pressure on the central bank through public policy actors or the general public in order to ensure that

the decisions on monetary and exchange rate policy meet their expectations.

In addition to a description of economic effects, in order to outline the interpretive framework, we must define the institutional effects and identify the interest groups that may have a major influence on decision-making. Institutional feedback may have five links to the relationship between exchange rate and trade: absorption (consumption), competitiveness, inflation, nominal exchange rate and the balance of trade.

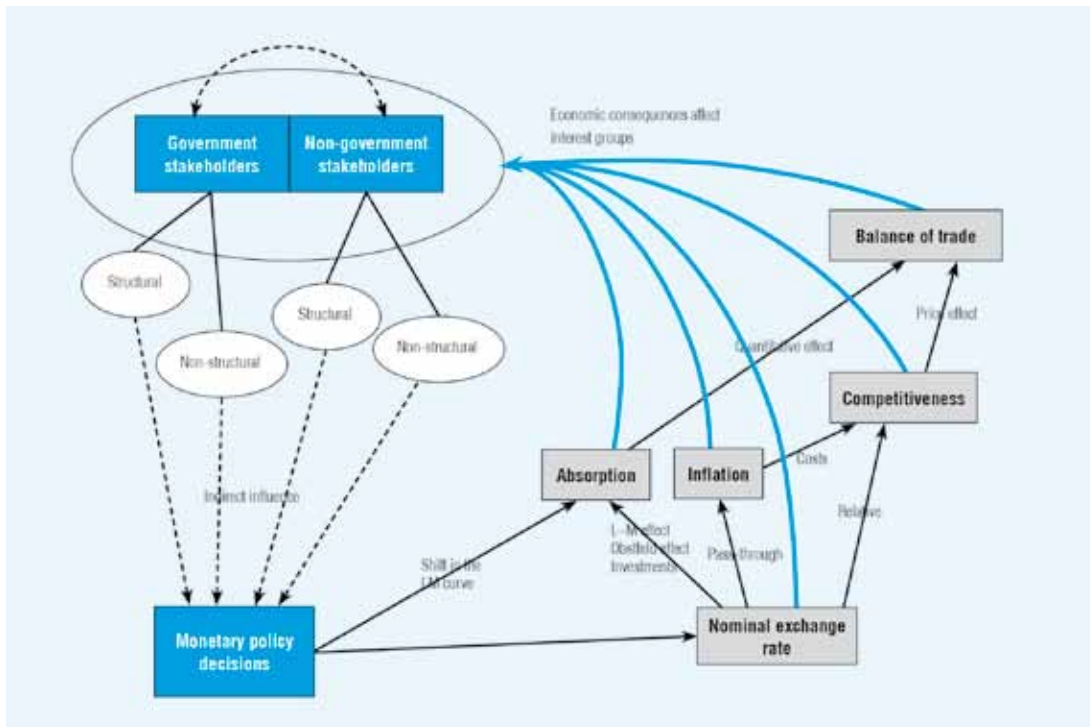
Chart 1 illustrates the effects of exchange rate policy decisions on economic variables, the impact of those effects on institutions, and feedback from interest groups on central bank decision-making.

Based on Woolley's (1983) typology, in analysing the exchange rate policy, special attention should be given to the following political economy and institutional factors: (1) non-structural factors mediated by the government, (2) non-structural factors outside of government, (3) structural factors outside of government, and (4) structural factors related to government.

Non-structural factors mediated by government

Under the European regulatory framework, government is prohibited from instructing central bank managers, and central bank managers are prohibited from taking instructions from government in connection with the monetary policy. This is not to say that government has no means to express an opinion on monetary policy. On the one hand, government also has its own political and social agenda; on the other hand, in democratic states, social preferences are articulated through political competition, and one of the responsibilities of government is

ECONOMIC EFFECTS OF THE EXCHANGE RATE POLICY AND ITS INSTITUTIONAL FEEDBACK MECHANISM



Source: own editing

to enforce those preferences. It also needs to be taken into account that government and the budget (and implicitly the community of taxpayers) are stakeholders in central bank policy both directly and indirectly.²³

Government and other participants of the political competition may connect to the economic impacts through all of the five links. Assuming a small and open economy, participants in the political competition have no interest either in reduced consumption (falling demand, economic downturn, voter dissatisfaction), or deteriorated competitiveness (subdued export sector, decelerating growth), or increased inflation (voter dissatisfaction), or a weakening nominal exchange rate (more expensive imports, deteriorating net foreign currency position), or the deterioration of the balance of trade (increasing financing risk).

These objectives may be in conflict with one another (e.g. competitiveness vs. inflation), while the preferences of political actors will be determined by the developments in social preferences in respect of the above as well.

Political factors mediated by government may comprise the following forms.

1 Government formulates an opinion on central bank policy and communicates that opinion indirectly, mostly through the public, to the central bank.²⁴ Owing to the joint responsibility of the central bank and government for the exchange rate scheme as a whole, this also has formal grounds as regards the exchange rate policy.

2 The central bank is accountable to Parliament, while the legislator is expected to represent voters' intentions, which empowers MPs to form an opinion on monetary policy.

③ As a result of redistributive effects, monetary policy may become a key issue in an election campaign, and certain political parties may use central bank decisions as a campaign theme.²⁵

④ Interest groups that are losers of monetary policy decisions put pressure on government in an attempt to ensure that the government makes the utmost effort to change the central bank's policy.²⁶

Non-structural factors outside of government

Central bank decisions may also be influenced by factors outside of government that directly affect monetary policy decision-makers. This area is less specific than the range of factors mediated by government, but typically, it is also linked to interest groups. The various interest groups of society and other economic and social groups are affected by monetary policy decisions in different ways. Some social groups are more sensitive to inflation than to employment (those with financial savings), while others, on the contrary, are more sensitive to employment than to inflation (employees without financial savings, employers in the real sector, businesses).

According to Woolley (1983), high interest rates tend to face opposition from the producers and distributors of durable goods, as well as employees and consumers, who will thus often attempt to exert pressure to achieve interest rate cuts. Non-structural factors outside of government may comprise the following.

① Dissatisfied interest groups organise street demonstrations. Such demonstrations provide pointers to the central bank even if they are not directly concerned with monetary policy. This factor tends to be related to the nominal exchange rate in the case of

absorption (consumption), inflation and household foreign currency exposure.

② It is also possible for employers and employees to put implicit pressure on central bank policy through collective bargaining, because the development of wages is one of the key drivers of inflation. In this sense, wage increases point to monetary tightening, while more restrained wage agreements could make room for monetary easing.

③ For employees, strikes may be an effective instrument. This may be connected to competitiveness, as employees in the export sector may perceive an excessively strong exchange rate as a threat to their jobs.

④ Developing countries typically have a high external financing requirement, as a result of which foreign investors, and indirectly credit rating agencies, play a key role in the maintenance of economic stability.²⁷ This factor is connected to the (external) balance of trade: according to the assumption applied in the model, foreign investors make their financing decisions based on whether they consider external balance developments sustainable. If not, this will require immediate adjustment on the part of monetary policy.²⁸

⑤ In addition to external financiers' perceptions, the confidence of domestic businesses and consumers may also play an important part; a major shift in confidence indices can efficiently indicate social preferences and opinions to monetary policy decision-makers.

⑥ The revaluation of the national currency is curbed when domestic export companies and companies competing with imports take a stand against the exchange rate policy on account of their own deteriorating situation. The mobilisation of domestic exporters does not require a deteriorating macroeconomic environment (e.g. an increasing trade deficit), it is enough if exporters perceive that their situation has worsened. Owing to the higher interest rate levels brought about by the

revaluation, it is easier for domestic exporters to find influential allies, which might improve their bargaining position (these may include households with foreign currency debts, and the state itself). This is limited primarily by lobbying power, i.e. there is no requirement for the companies concerned to be of outstanding importance either in terms of the performance of the national economy, or of the level of employment.²⁹

Structural factors outside of government

Structural factors outside of government are general, embedded, deeply rooted economic and social factors of a structural character that could influence monetary and exchange rate policy. These factors could be connected to the relationships of exchange rate policy through all of the five links of institutional feedback. Structural factors outside of government may comprise the following.

① Social preferences concerning macro-economic issues, which are often not described explicitly, but which nevertheless exist at the level of social habits. Such factors include Germany's historical aversion to inflation, or France's likewise historically rooted antipathy against the excessive prevalence of market mechanisms. Every country and community has historical experience and memories which could affect their decisions today. These institutional foundations are the most difficult to change, and as they are also the most deeply rooted, they can have a fundamental influence on the final results of economic policy decisions.

② Consumers and households are typically sensitive to inflation. Experience shows that households and the masses of consumers are the least organised of all interest groups. The position of the limit stemming from the sensitivity to inflation is not self-evident and is determined by the unique features, inflation

history, sensitivity and economic specificities of each country and community, as well as their level of confidence in and expectations of government. From an exchange rate policy perspective, reaching the inflation limit may be connected to devaluation: if, as a result of the devaluation of the currency, inflation reaches a certain "critical" level, pressure from the population may force decision-makers to adjust the exchange rate policy.

③ The power and level of organisation of representative bodies, and the potential political affiliation of union, employers' and sectoral movements are also important. The more concentrated and efficient the representation of each particular interest, the more effectively developments and decisions are influenced, and the smaller the extent to which the interest group concerned is forced to bear the explicit or implicit costs of individual decisions on economic policy. The interaction between various groups of various institutional factors is demonstrated by the fact that the outcome of private sector arrangements is also influenced by the power of individual representations. Political affiliation will reduce the ability to enforce interests in some cases, and increase it in others. The influence of well organised interest groups of fewer members tends to exceed that of interest groups of large memberships.³⁰

④ From the perspective of monetary and exchange rate policy, financial markets and financial institutions have a paramount importance. The characteristics of financial markets determine the framework of available techniques and instruments within which central bank policy can be conducted. A more developed, broader and more integrated financial market environment gives more room to the central bank to engage in open-market operations, for instance. The more specialised financial institutions are, the more likely it is that there will be no "buffer

activities” to offset the losses in case of market or regulatory changes, and that the state will need to seek help.

⑤ In the case of high foreign currency exposure³¹, central bank decisions have a significant impact on the social groups, sectors and companies concerned. Both employers and consumers may be affected (primarily in small and open economies where foreign currency lending is prevalent³²). Central bank decisions concerning the exchange rate may come under strong social pressure, which may be accompanied by pressure from the banking sector (the latter stemming from the fact that a depreciating currency may significantly deteriorate the quality of banks’ loan portfolios, and hence their profitability).

⑥ Central banks have a statutory obligation to maintain the stability of financial markets. Consequently, in making decisions, central banks must consider their impact on banks’ profitability, liquidity and balance sheet positions. From this perspective, the exchange rate policy is of key relevance in countries with a high foreign currency exposure.

⑦ The structure of the economy and the level of exposure to interest rate policy and exchange rate change will determine the central bank’s room for manoeuvre. The central bank may decide to take a different course in countries where a large section of the corporate sector is financed through foreign parent companies and is characterised by a high import ratio in addition to exports, or where the corporate sector is typically financed from domestic funds and is comprised of small enterprises with intentions to expand into export markets employing a domestic workforce.³³

⑧ Other factors that may be of significance include the level of paternalism in the social and political system and culture of the country concerned, the extent to which that system is built on personal liability, the share of the grey and black zones within the economy, the

role of foreign currencies, and the scope of monetary policy in general.

⑨ The international integration and interconnection of financial markets are structural features that have a fundamental influence on central bank decision-making. The monetary policy followed in central states and its implicit effects also define central banks’ and interest groups’ room for manoeuvre in peripheral states.³⁴

Structural factors related to government

The fourth group of political factors comprises structural factors related to government and the formal rules of state operations. How strong and influential are the heads of the executive power (i.e. the government) and the legislative power? How intense is political competition? How strong is government bureaucracy? What formal and informal relationships exist between the central bank and government, and between the central bank and other power centres and institutions of public policy; what does the central bank’s accountability mean in practice?

Structural factors related to government may comprise the following.

① The key factor is the legislative regulation of the central bank, with special regard to the constitution and the central bank act. This legislation determines the formal relationship between the central bank and other representatives of the state, as well as the tasks assigned to the central bank by the citizens and the powers with which they entrust the institution for the performance of such tasks.

② To a great extent, decision-making may be influenced by the level of *de facto* independence in addition to the central bank’s *de jure* independence, i.e. the extent to which the central bank’s decision-making is independent of the government’s will.

Obviously, this is not to say that central bank decision-makers cannot make decisions that coincide with the government's will, for making such a decision is also among the rights of an independent central bank.

③ In certain forms of international economic integration, member states undertake to adhere to specific rules concerning monetary policy. Such regulations have been adopted by the European Union, which imposes severe limits on Member States' room for manoeuvre as regards central bank regulations even before accession to the euro area. This gives central banks a high level of independence.

④ Other important factors include the intensity of political competition and the public policy scheme of the country concerned. Fierce competition may necessitate the reinforcement of central bank independence (where there is reason for concern that a potential change in government may also affect monetary policy), and the system of checks and balances may also point to the same direction (where no-one has enough power to exert real and meaningful influence on monetary policy decision-making).

SUMMARY

The economic crisis has undermined the previous tenets of economic policy, and has paved the way for a paradigm shift affecting, among other things, monetary policy. The "one objective – one instrument" model of central banks has become dated, and it needs to be replaced by more complex modelling that covers a wider range of central bank responsibilities and instruments, and fully considers the effects of decisions.

One of the greatest challenges of the post-crisis period is to establish models and interpretive frameworks in order to place economic developments in a social context,

and to adopt models in which economy is no longer a separate segment of social life, but a social subsystem that has a number of links to other subsystems of society. It is a misconception that decisions on monetary policy can and should be made without regard to their implications for the real economy and society; the past few years have clearly revealed the futility of this approach and demonstrated that its consequences pose a fundamental threat to social stability.

Economic policy, and hence, monetary policy, are parts of the institutional matrix. In the institutional approach, the development of social institutions is determined by the ability of various interest groups to enforce their interests, allowing the design and conduct of monetary and exchange rate policy to be addressed from the perspective of political economics. In this approach, decisions on monetary and exchange rate policy affect economic variables, and redistributive implications affect the various interest groups in society which, as a kind of feedback, will attempt – typically indirectly – to shape monetary and exchange rate policy decisions according to their own interests.

This paper identifies each of the governmental, non-governmental, structural and non-structural factors which, when taken into account, may facilitate the understanding and transparency of central bank decision-making. These non-economic factors are inserted into the effect mechanism of exchange rate policy, providing an interpretive framework which allows for a complex interpretation of central bank decisions in a social context.

The integration of institutional factors into a neoclassical approach may improve the explanatory power and practical use of the models significantly. This paper should be considered as the first step in a long-term research effort, and the points raised here should be taken further in subsequent studies.

NOTES

- ¹ Blanchard (2012a)
- ² A clear summary of this is offered by Palley (2011), who makes a distinction between more moderate insider and more radical outsider reform programs.
- ³ For a summary of the consensus, see Blanchard et al. (2012)
- ⁴ Stiglitz (2012)
- ⁵ Olivier Blanchard and Jordi Gali referred to this as “divine coincidence”. It should be noted that whenever the unemployment rate stands at the natural rate, the output gap is zero, i.e. GDP has reached its potential. It also follows from the theory of the modern Phillips curve that if the GDP gap is other than zero, inflation will become unstable, and it will either accelerate or decelerate. Consequently, stable inflation is associated with a zero output gap.
- ⁶ Blanchard (2012b) and Ortiz (2012) share the view that a key consequence of the crisis was that, in addition to price stability, the focus of monetary policy shifted to financial stability. According to Stiglitz (2012), the issue of financial stability is far more important than price stability in more developed countries where inflation is relatively low.
- ⁷ Just consider the impact of an interest rate decision on lenders and borrowers, on the active and inactive segments of the population, on employees and employers, etc.
- ⁸ „The end is a more stable economy – not just price stability, but real stability – and an economy that is growing faster in a sustainable way.”
- ⁹ See IMF position note by Blanchard, Dell’Ariccia and Mauro (2010), which concludes that, although the crisis was not triggered by macroeconomic policy primarily, post-crisis monetary policy will have to be different than that prevailing before the crisis.
- ¹⁰ Káldor (1989), p. 234
- ¹¹ A question to consider is whether the differences between the courses of crisis management can be explained by the fact that the Fed is chaired by macroeconomist Ben Bernanke, an authority on the 1929–1933 crisis, while the European Central Bank was headed, for the most part of the crisis, by the French banker Jean-Claude Trichet followed by the Italian Mario Draghi, himself a banker.
- ¹² One of the most prominent issues in current economics is the distortion of the relationship between regulators and those subject to regulations (regulatory capture), but research tends to focus on the microeconomic aspect of the problem. In the case of central bank policy, the issue at hand is a macroeconomic dimension rather than regulation in the narrow sense; however, as Palley (2011) points out, the latter is clearly evident in the trade-off between inflation and unemployment.
- ¹³ Weise (2001) argues that such groups exert pressure primarily to reinforce their own public policy messages and to demonstrate to their membership and followers that they can influence public policy.
- ¹⁴ Inquiries into the social and political embeddedness of monetary policy are not a recent trend. Studies investigating the political and economic foundations of monetary policy typically address the issues of central bank independence and the exchange rate system. Bernhard, Broz and Clark (2003) provide a summary of such investigations

- ¹⁵ The example of Argentina aptly illustrates the high costs involved at the level of society. See Keifman (2008)
- ¹⁶ According to Article 2 of the Statute of the European System of Central Banks and of the European Central Bank, “the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community”. (ECB)
- ¹⁷ For the foundations of the model explained here, see Kolozsi (2011b)
- ¹⁸ See Kolozsi (2011a)
- ¹⁹ This effect is only relevant in larger economies. According to Eichengreen and Gupta (2012), this relationship is especially significant in the fields of communication, information and computer technology, whereas it is weaker in respect of goods and traditional services (trade, transportation, tourism, financial services and insurance). In their estimate, the effect of the real effective exchange rate is 30 to 50 per cent stronger in the case of modern services than in the area of goods and traditional services. The authors analysed data on 66 countries for the period between 1980 and 2009.
- ²⁰ Terms of trade = export price index/import price index.
- ²¹ The overvaluation of a currency may lead to capital flight, the effect of which on the balance of trade is not self-evident (hollowing-out effect).
- ²² Assuming devaluation, redistribution will typically benefit exporting companies at the expense of other economic actors. The decrease in some individuals’ real income caused by imports becoming more expensive will be reflected as an increase in the real income of exporting companies, since the income of the latter increases with the rising of forint export prices.
- ²³ See Huszti, Kolozsi and Lentner (2012)
- ²⁴ In Hungary, in late 2002 and early 2003, the government disapproved of the strength of the HUF exchange rate. In summer 2003, by way of a joint decision, the central bank and the government devalued the central parity of the exchange rate band, thereby depreciating the Hungarian currency significantly (while also easing monetary conditions).
- ²⁵ In Hungary, one of the central themes of the 2002 elections was the evolution of the HUF exchange rate, with leaders of the subsequent winning party expressing a series of criticism over the central bank’s interest and exchange rate policies, calling for the resignation of the Governor of the Central Bank at the time.
- ²⁶ In 2002 and 2003, leaders of employers’ organisations in Hungary made it clear on several occasions both during the election campaign and following the formation of the new government that they considered the strong HUF exchange rate a risk to the competitiveness of exports. They also proposed the dismissal of the Governor of the Central Bank at the time. After 2010, several employers’ organisations demanded that high central bank base rates be cut claiming that the high rates rendered the survival of Hungarian SMEs impossible. The central bank started to cut rates in the second half of 2012.
- ²⁷ In transitional periods, the external financing limit is particularly important as in such periods there is a significant need for external funds, the mechanisms of the market economy are not yet established, domestic savings are scarce, and

investor confidence is weak. All this implies a high level of exposure to changes in international sentiment.

²⁸ In 1994–1995, Hungary faced a situation in which the occurrence of a twin deficit called for a radical change in the direction of both fiscal and monetary policy (at the level of exchange rate policy, this meant a significant 9 per cent one-off devaluation, and the introduction of the crawling-peg exchange rate system).

²⁹ In certain cases, the reaction of foreign companies also needs to be taken into account. An example of such a situation is the conflict between the American corporate sector and Chinese monetary policy, which also entails a conflict between the government of the two countries.

³⁰ Hungarian economic policy after 2010 offers a counterexample to this assumption: the increased tax burden on banks and large multinationals suggests that well organised and concentrated interest groups have been forced to take a larger share of public dues that previously.

³¹ The limit of foreign currency lending is not a required element of the institutional matrix, as

indebtedness in foreign currencies is the result of a special constellation of economic policy. Namely, an inflation reduction facilitated by exchange rate revaluation entails an increase in interest rates which, together with the continuous revaluation, increases the attractiveness of foreign currency loans offering low interest rates. The disbursement of such loans leads to the build-up of extremely risky foreign currency positions.

³² See Bánfi (2012) on the ballooning of foreign currency loans, and Lentner, Kolozsi and Tóth (2009) on how this limits the room for manoeuvre of economic policy action.

³³ From this perspective, as the economy was liberalised and foreign investments became dominant, the Hungarian central bank's room for manoeuvre underwent a significant transformation as from the early 1990s.

³⁴ A good indication of this is given by Kiss and Kosztópulosz (2012), who argue that the ECB's monetary policy measures between 2002 and 2011 noticeably influenced the day-to-day changes in bond yields and exchange rates in the Czech Republic, Hungary and Poland.

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