

SPEECHES

Ferenc Karvalits: Challenges of monetary policy – a global perspective and the Hungarian situation

In his speech held at the 46th Economic Conference¹ organized by the Hungarian Economic Association Ferenc Karvalits, Deputy Governor of Magyar Nemzeti Bank discussed the challenges of monetary policy, global financial turbulence and the issue of global price increases. He emphasised that the MNB cannot and does not wish to restrain the change in the relative prices of raw materials and food. It can and does, however, wish to influence the inflationary environment in which these changes take place.



According to Mervyn King, Governor of the Bank of England, monetary policy is considered efficient when it is boring. Today, monetary policy can by no means be called boring. On the contrary, it is quite interesting, fascinating and, above all, difficult. The happy days, as it were, are over. While the past decade was a period of prosperity and price stability, thanks to globalisation and financial integration, growth and inflation currently seem to pose serious risks, while the menace of stagflation seems to threaten numerous large economies. Furthermore, the credit market crisis has put the global financial system at risk.

Besides international events, domestic problems have also focused the spotlight of public opinion on the central bank's activity. Although the perceived controversy regarding monetary policy has numerous aspects to it, the time available here does not make it possible to even touch upon these issues, let alone answer all the related questions. I have, therefore, selected three interrelated and frequently asked questions which I will try to elaborate on:

- To what extent does the evolution of the global financial environment influence Hungarian monetary policy?
- Is it possible or worthwhile to fight the impact of growing commodity prices with monetary instruments?
- How does the exchange rate influence the economy within the framework of domestic monetary policy?

Before addressing these questions, let me briefly explain the principles of monetary policy.

ON THE PRINCIPLES OF MONETARY POLICY

The fundamental principles of monetary policy were formed and bolstered in the debates between theoretical economists and practising central bankers, which had lasted for a decade and which are now the subject of a broad consensus worldwide. As my colleague Judit Neményi mentioned in her article published lately, it would be well worth the effort to encourage the Hungarian public to acknowledge these principles.

Central banks, concurrently with the development of the entire system of financial institutions, have undergone significant changes over the past twenty years. While financial systems have become increasingly open and competitive, central banks have at the same time strengthened their belief that their primary task is to maintain price stability.

¹The speech was delivered on 28 June 2008.

The claim that a central bank is only capable of influencing nominal variables – in other words inflation – is true even in the medium term. It is unable to influence the output of the economy or the level of employment in the long run. Furthermore, no correlation has been established between the level of unemployment and inflation when considering a larger timeframe. On the contrary, international experience has underpinned that low and stable inflation can, through efficient allocation of resources, contribute to economic growth and higher levels of employment. Price stability, therefore, has important welfare-related benefits.

Although it is possible that the economy is temporarily stimulated via the instrument of so-called surprise inflation, this will soon lead to higher inflation. If economic agents do in fact expect higher inflation, it will lose all of its stimulating effects on the economy. Only further surprise inflation could be effective. In reality, such a strategy would not be effective even in the short term as economic agents not only learn from the past, but also formulate expectations regarding anticipated future policy. They optimise their decisions accordingly, using all the information available to them. The primary message of such thinking is that expectations regarding monetary policy have a vital role in the business decisions and the activity of economic agents.

Without strict mechanisms ensuring their commitment, monetary policy makers will always have to face the fact that market participants who expect discretionary measures, i.e. stimulation, will continue to revise up their inflation expectations. Therefore, central banks can only be successful in reaching their inflation goals if they show unquestionable commitment towards curbing inflation and understand that stimulating employment or output beyond the level which is consistent with price stability is an objective they should not strive to achieve. Influencing expectations has, therefore, become a primary aspect of monetary theory and of the practice of monetary policy; it has also provided evidence that a consistent attitude to decision-making dictated by rules leads to a more efficient monetary policy.

In order for price stability to become a viable objective, more and more monetary authorities have been granted independence from the government. The level of independence does, of course, vary from one country to the next, but the guiding principle is identical: the bank's governor or the main decision-making body will set an interest rate policy and the policy rate without any political constraint and free of any political influence. This freedom of decision should also be supported through institutional and financial independence. In Hungary, this framework is ensured by the Central Bank Act. Thus the MNB is an independent institution.

It is also over the past twenty years that the majority of central banks have started to operate within the framework of inflation targeting. Within this, monetary policy regards the explicit inflationary target as the nominal anchor which it commits itself to reaching, thereby striving to influence the expectations of economic agents. Decisions about monetary policy will reflect the deviation of projected inflation from the announced target. In Hungary, an agreement was reached in 2005 between the MNB and the Government, setting the medium-term inflation target at 3 per cent in terms of the headline consumer price index.

The majority of central banks pursue, explicitly or implicitly, an objective function which simultaneously takes into account the deviation of inflation from price stability and the evolution of the real economy, with more emphasis on the former. It is important to note that the evolution of the economy in this case represents deviation of current output from its long-term, potential level. The central bank, as I mentioned earlier, is in no position to influence the latter. This approach is entirely compatible with the forecast-based inflation target system. Besides the evolution of inflation, central banks pursuing an inflation target also take into consideration real economic processes through various channels. Inflation forecasts, serving as the basis of monetary policy decisions, reflect the effect of economic activity on inflation. In the case of an economic slowdown, for example, the output gap will widen and projected inflation will be lower accordingly. Another channel is the specific time horizon assigned to a particular monetary policy: by making decisions which usually focus 1-2 years ahead, central banks setting inflation goals take into account the fact that counterbalancing temporary inflationary shocks in the very short run would result in unnecessarily high real economic sacrifices.

CURRENT CHALLENGES OF MONETARY POLICY

Currently, the world's central banks have to face two serious challenges. One is the sub-prime crisis, which broke out in the US and subsequently spiralled into financial turbulence on a global scale. The other is the significant increase in the prices of food, oil and other raw materials, which has led to a worrying inflationary pressure worldwide.

Global financial turbulence

Without going into details regarding the reasons behind the turbulence, I would like to sum up the ways in which the financial crisis complicates the conduct of monetary policy.

Due to the US sub-prime mortgage crisis, global appetite for risk seems to have fallen. Grave liquidity problems, based in many cases on a mutual lack of trust, have emerged in the financial systems of the (mainly developed) countries affected by this. In larger, more closed economies, downward risks to growth are increasing, feeding on the volatility of the financial system, the tightening of credit standards and, in certain regions, on the correction affecting asset price bubbles. In smaller, more open economies that have not directly been exposed to the effects of the financial turbulence, problems might stem from the fall in global appetite for risk and the slowdown in larger regions of the world economy.

A significant difference compared to previous periods is that a change in investors' risk appetite does not affect emerging markets in the same manner. In so-called safe haven countries, characterised by rapid growth, low inflation and low external debt, a smaller increase in risk premia and a tendency of appreciating nominal exchange rates seem to be continuing. Emerging economies with high external debt and/or signs of overheating fuelled by credit growth and deemed more vulnerable by financial markets are characterised by a larger jump in risk premia and capital outflows.

Although Hungary's vulnerability indicators have improved following measures of budgetary adjustment, the change in external conditions has led markets to increase the yields expected from Hungarian assets, rather than lowering risk premia in response to the results of the fiscal consolidation. There are two reasons why this should not come as a surprise. On the one hand, the budget deficit has significantly shrunk, thereby improving external balance. The growing indebtedness of households has, however, resulted in adverse effects. On the other hand, the composition of external financing has also deteriorated, increasingly involving a shift towards debt-generating inflows. Although other specific effects have also played a part in how that composition has changed, the drop in FDI inflow may be taken as a warning sign, since Hungary has a high net liability position and its image has been further tarnished by worsening expectations regarding its prospects for growth.

A precondition for the improvement in debt and indebtedness indicators, as well as for a decline in the risk premium, is a strict and at the same time growth-friendly fiscal policy. The central bank's responsibility is to contribute to the creation of a more stable economic environment through price stability and by the reduction in uncertainties that stem from inflation.

Global commodity price increases

One of the determining tendencies of the world economy currently is the growing prices of food, oil and other raw materials. What we know for sure is that the prices of these products are increasing relative to that of other products and services that enter into international trade. These commodities are characterised by the fact that they appear directly in the consumer basket, and also serve as input in the production process, especially in the case of oil. There are several, not mutually exclusive explanations that can account for the global increase in the prices of these goods.

These include a temporary spike in prices, long-term structural factors or a global inflationary pressure. One-off factors such as bad weather, temporary capacity limits and speculation have contributed to the former. The sustained change in relative prices may be caused by long-lasting structural factors leading to a shift in demand and/or supply relations. In the case of food prices, these include growing demand in emerging countries and subsidy schemes supporting the production of biofuels. The observed changes in these prices may also reflect a global inflationary pressure. In this case, what we are seeing is not a change in relative prices but the dynamics of food, oil and raw material prices reacting to a positive global output gap, which could be an early symptom of a mounting global inflationary pressure. This is because the price of unprocessed food and crude oil

is typically set on auction-like markets, where prices adjust rapidly and in a more flexible way, whereas the prices of other globally traded goods are more rigid, thus they react more sluggishly.

Today it seems increasingly likely that oil and raw materials will remain more expensive than they were a couple of years, or even months ago. What remains to be seen is whether we are only facing a relative price change or whether this tendency is a harbinger of broader global inflationary pressure affecting the widest range of goods and services.

WHAT CAN BE ACHIEVED THROUGH MONETARY POLICY IN A SMALL, OPEN ECONOMY IN ORDER TO MEET THESE CHALLENGES?

As I mentioned previously, the task of monetary policy-makers is to set an interest rate path which ensures that the inflation target is achieved with the least possible economic sacrifices.

Global financial turbulence has so far caused only limited increase in risk premia in Hungary. The banking system's exposure is not high. Of course, this does not mean that policy makers here can be complacent, as the current global financial turbulence is far from being over. Furthermore, it is still unclear to what extent financial turbulence has set back the growth outlook of our major foreign trading partners. Hungarian monetary policy cannot turn a blind eye to factors such as an increase in risk premia and a deterioration of global growth prospects.

The most urgent problem central banks of small, open economies are facing seems to be imported price pressure. Although these central banks have influence neither on global monetary conditions nor on the global output gap, with a floating exchange rate regime the importing of global oil and commodity price increases is not inevitable. Imported inflationary pressure can be counterbalanced by nominal exchange rate appreciation; this, however, does not constitute a free lunch, as it can temporarily contract activity in the tradable sector.

An appropriate monetary policy response depends on what processes are responsible for global price increases. If the rise in food and oil prices is only a temporary phenomenon, the short-term inflationary effect of the shock can be accommodated. The possible second-round effects and inflation expectations, however, should be closely monitored. The less accumulated credibility monetary policy has, the more likely second round-effects will occur. For a central bank with relatively low credibility, pre-emptive measures may be necessary to stave off second-round effects, even if it does not wish to offset the direct inflationary effects of the external shock.

If the change observed in relative prices is the result of lasting, structural causes, monetary policy will not be able to do anything about it in the long run. If the relative price changes remain permanent their effect will, on the one hand, appear directly in the consumer price index and may, on the other, lead to cost-push inflationary pressure on the relevant monetary policy horizon, due to the fact that the goods affected also serve as production input. Furthermore, the risk of second-round effects will appear. Compared to the transitory case, another difference is that a lasting change in relative prices can also lower potential GDP. Because of this the central bank should, with the instruments at its disposal, strive to ensure that the change in relative prices takes place within the lowest possible inflation environment, and that a lasting inflationary pressure or a price-wage spiral will not occur. Although creating a low inflation environment may entail some sacrifices in the short term, the advantages of maintaining price stability will counterbalance them in the long run.

The rise in prices observed may also signal a global inflationary pressure if the majority of the world's economies grow (or have grown in the recent past) at a faster rate than what is consistent with price stability – i.e. become overheated – over a prolonged period, as a result of loose monetary conditions at the global level. Global inflation can be considered a monetary phenomenon; therefore, in this case there is no need for any adjustment in relative prices. If the global inflationary pressure affects a broad spectrum of globally traded goods (i.e. both on the input and output side of the export sector), then the tightening of domestic monetary conditions via the exchange rate channel will not inflict serious costs on the export sector. In the longer run, the global inflationary pressure may disappear if the major central banks on the global scene start tightening their stance. The question which would then arise is to what extent will a small, open economy assume the cost of higher inflation, and when will it face the economic sacrifices of disinflation. If it swims with the tide, it may later face larger losses of output, as it would simultaneously have to deal with disinflation and lower external demand. If, however, it goes against the grain of global inflation, loss of output will appear sooner, but the cost of enduring inflation and costlier future

disinflation will not have to be paid. In essence, monetary policy decides about which time and output-inflation path to choose for handling the problem.

What Hungary needs to be particularly careful about

In Hungary, special attention must be given to managing the inflationary effects of a global price shock. On the one hand, the accumulated credibility of monetary policy is not yet complete and the stability of inflation expectations is still questionable. Under these circumstances, even partial accommodation of inflationary shocks might be too risky. On the other hand – as I mentioned previously – due to its high external debt, Hungary is vulnerable to the changes in global risk appetite, so if the fight against global inflation becomes more pronounced in the future, the risk premium of Hungarian assets may also increase.

HOW CAN WE INFLUENCE THE ECONOMY WITH THE HELP OF THE EXCHANGE RATE?

The decisions of the central bank, the changes in its main interest rate, affect the economy through various channels. Our research on the monetary transmission mechanism showed that interest rate changes have the strongest impact on inflation through the exchange rate and the expectations channel. In the medium to long run, changes in the stance of monetary policy and the evolution of the exchange rate are linked by the uncovered interest rate parity principle, notwithstanding the fact, that in the short run the exchange rate is influenced by other factors as well. In an international comparison the interest rate channel is relatively weak, which can partially be explained by the large degree of foreign currency indebtedness of domestic agents. It is important to note that, even considering the increase in foreign currency indebtedness, the tightening of monetary conditions has the usual moderating effect on inflation. The exchange rate channel operates efficiently through the price of imported inputs used in the production process and imported consumer goods.

The research mentioned above also indicated, that through the exchange rate channel Hungarian monetary policy can have a relatively strong and fast impact on inflation compared to the international average. However, its capability to stabilise short-term output fluctuations is far more limited. Interest rate increases and the appreciation of the exchange rate are measures that might entail economic sacrifices for net exporters. The more flexible they adjust (restraining wage growth, improving efficiency), the smaller the sacrifices. Due to the typical high ratio of imported inputs in Hungarian exports, the total growth sacrifice is significantly smaller than what would be implied by the decrease in export revenues in itself.

In the medium and long term, the competitiveness of exporters is influenced by the real exchange rate. Although monetary policy cannot influence the real exchange rate in the long run, it is still capable of influencing the extent to which equilibrium real appreciation – stemming from real convergence – should appear in consumer price (or wage) inflation or in the appreciation of the nominal exchange rate. It is in the interest of the whole economy to ensure, that equilibrium real appreciation takes place within the context of steadily low inflation and moderate nominal appreciation.

By influencing the evolution of the exchange rate, the Magyar Nemzeti Bank does have the capability of moderating the domestic inflationary impact of global price pressures. The MNB does not have the capability or the intent to offset the change in the relative price of commodities that took place during the last couple of years, however it can and does intend to influence is the domestic inflation environment in which this process takes place.