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Relative inflation-forecast as monetary policy target for convergence to the euro

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Abstract

A monetary policy framework based on targeting a relative inflation-forecast is proposed for the economies converging to the euro. Such strategy aims at containing the differentials between the domestic and the implicit monetary union inflation-forecasts. Hence, these differentials become a basis for setting an operational policy target. The proposed framework can be viewed as an extension of flexible inflation targeting that prioritizes low and stable inflation over the exchange rate stability. It is believed to be consistent with the Maastricht convergence criteria and can be implemented in concurrence with the exchange rate stability benchmark for the ERM2. Several empirical tests are conducted to determine feasibility of adopting an instrument rule for the proposed policy framework in the three largest inflation-targeting candidates to the euro: the Czech Republic, Hungary and Poland. The stability tests as well as the volatility dynamics tests suggest that adoption of the relative inflation-forecast targeting framework is possible in these countries.

JEL classification: E42; E52; F36; P24

Keywords: Inflation targeting; Exchange rate; Monetary convergence; ERM2; New EU member states; GARCH

1. Introduction

Monetary policy-makers in the new member states (NMS) that joined the European Union (EU) in 2004 and 2007 are facing a challenging task of devising an appropriate policy framework for navigating the path of convergence to the eurozone. The larger NMS countries are now pursuing

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autonomous monetary policies based on direct inflation targeting (DIT)[1] that will, however, have to be modified at the more advanced stage of convergence. These modifications are likely to be based on easing the exclusive targeting of domestic inflation and incorporating the objectives of lowering the spreads between domestic and the eurozone monetary variables for effective implementation of convergence to the euro.The literature pertaining to modern inflation-targeting regimes does not offer much guidance in this respect as it focuses primarily on domestic monetary variables in the context of fully autonomous policy regimes and generally does not take into consideration the issue of monetary convergence to a currency union (Bernanke, Laubach, Mishkin, & Posen, 1999; Faust & Henderson, 2004; Levin, Natalucci, & Piger, 2004; Svensson, 1999). A number of empirical studies addressing the eurozone enlargement tackle various aspects of monetary strategies; however, they generally do not aim at prescribing optimal monetary policy sequencing for transition from the current autonomous policies to the euro via the obligatory interim ERM2 stage (Begg, Eichengreen, Halpern, von Hagen, &Wyplosz, 2003; De Grauwe & Schnabl, 2005; Kočenda, Kutan, & Yigit, 2006). In an attempt to tackle this issue, this paper proposes a modified DIT framework for convergence to the euro.

The proposed monetary policy framework is an extension of current DIT regimes that takes into account the dominant (flexible) inflation target and the exchange rate stability objective. It is based on *relative inflation-forecast targeting* (RIFT). Its key precept is that a dynamic reduction of differentials between the domestic and the implicit monetary union inflation-forecast for a predetermined time-period becomes the main operational goal of monetary policy. In the long run, the inflation target of the converging country becomes fully aligned with the common currency area inflation-forecast. For the euro-candidates, the eurozone inflation-forecast can be formulated on the basis of the Maastricht convergence inflation benchmark that requires the inflation rate of the euro-candidate not to exceed the average inflation of the three lowest EU inflation rates by more than 1.5%. Therefore, the proposed RIFT framework is believed to be consistent with the Maastricht convergence criteria assuming that the officially chosen ERM2 central parity rate does not violate the inflation benchmark.

Implementation of RIFT is based on the policy “instrument dichotomy”, i.e. on changes in the central bank reference interest rate as well as foreign exchange market interventions. Shocks to inflation-forecasts, particularly those perceived as permanent, are countered with increases in interest rates, while shocks to exchange rate stability may be offset with foreign exchange market intervention. A possible currency depreciation shock can be also counteracted with higher interest rates but only if it poses a serious threat to the realization of the inflation target. The instrument dichotomy is unavoidable for alleviating potential conflicts between disinflation and exchange rate stability objectives.

The empirical section of this study is designed to investigate the link between the NMS vis-à-vis eurozone inflation differentials (viewed as the policy target variable), the exchange rate (as a supporting convergence objective) and the candidates’ short-term interest rates (as the policy instrument). If these variables are interdependent, implementation of RIFT will not jeopardize financial stability in these countries. Moreover, policies aimed at prioritizing disinflation are not likely to exacerbate exchange rate volatility beyond the fluctuations band prescribed by the ERM2, providing that the reference exchange rate is set around the long-term market equilibrium rate and

[1] By direct inflation targeting we understand a policy regime that is geared toward achieving a prescribed numerical inflation goal, as oppose to indirect inflation targeting that aims at achieving long-term price stability via alternative targets, such as a stable exchange rate or money growth.