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Is Hungary ready for inflation targeting?

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Abstract

This paper considers whether the adoption of inflation targets for Hungary, an emerging market economy, is a desirable option. We consider the qualitative and quantitative pre-conditions required for the successful adoption of inflation control objectives. Although it is found that the National Bank of Hungary appears to possess a reaction function with some of the main features found in those estimated for industrial economies, there remain certain aspects of the relationship between the government and the central bank that require clarification and further evolution.
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1. Introduction

Following experimentation with a variety of monetary policies over the past four decades or more, several industrialized economies have opted for a form of inflation targeting (Siklos, 2002; Mahadeva and Sterne, 2000). Other monetary policy strategies, notably money supply targets and exchange rate pegging, were implemented, but mostly found wanting.[1] In some countries the target is quantified and is ordinarily a joint initiative of the government and the central bank (e.g. Canada and New Zealand). In others, the goal is more implicit as

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[1] It should be noted that one of the “pillars” of the European Central Bank’s strategy includes concern for money supply growth (see ECB, 1998), though this approach has been deemed inappropriate by at least one critic (Svensson, 1999). The debate for or against fixed exchange rates seemingly is a never ending one (e.g. see Bank of Canada, 2001).

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in Germany or the US.[2] However, there is a tacit, if not formal, understanding nowadays that central banks ought to promote a form of price stability with some numerical value possibly attached to that condition. The apparent popularity of inflation targeting is due, in large part, to the success of these policies in reducing inflation and in anchoring inflationary expectations (Bernanke et al., 1999). However, it has been noted that the disinflation of the 1990s is a worldwide phenomenon (e.g. Siklos, 1999a) and it is therefore difficult to ascertain how much of the improvement in the record of inflation is attributable by itself to the adoption of the policy.[3]

Nevertheless, since inflation targeting represents a "framework" for the conduct of monetary policy, there has been keen interest in the applicability of such a policy regime to emerging market economies. The IMF (Masson et al., 1997; Blejer et al., 2000; Coats, 2000) has gone so far as to explore the record of inflation targeting in industrial and some emerging market economies (including Brazil, Chile, Israel, and Mexico) in order to provide some lessons for other countries seeking to go down that route. Taylor (2000) and Mishkin (2000) have also joined the chorus of those in favor of some form of inflation targeting in emerging market economies.

The present paper considers the case of Hungary, which is regarded as being among the most mature of the so-called emerging market economies.[4] The country has experienced almost a decade of relative economic stability and has largely completed its transition to a market-based economy.[5] Hungary neared a cross-roads of sorts by 2001, as the crawling pegged exchange rate system adopted in 1995 (see, inter alia, Siklos, 2000; Szapáry and Jakab, 2000; Neményi, 1997, and Kornai, 1997) reached the point where changes in the pre-announced exchange rate were close to zero.[6] Indeed, on 4 May 2001, the fluctuation band for the Hungarian forint (HUF) was widened to ±15% from ±2.25%. On 24 August 2001, it was announced that the crawling peg would cease to exist 1 October 2001. Consequently, the exchange rate no longer served a useful function as a focal point for inflationary expectations.

As one of the candidates for accession to an enlarged European Union (EU) and, someday, into the European Monetary Union (EMU), it is appropriate to ask whether the inflation targeting framework is a sensible choice for Hungary under these circumstances.[7] The press

[2] Hence, in the case of Germany, the inflation objective was achieved via the announcement of monetary targets. The Bundesbank, of course, ceded control over key monetary decisions in 1999 to the European Central Bank.

[3] Siklos (2002), however, presents evidence for 20 OECD economies to the effect that inflation targeting countries have reduced nominal interest rates by more than non-inflation targeting countries.

[4] Research for this paper was completed prior to the official announcement of imminent inflation targets in Hungary. However, as will be seen below, a number of outstanding issues remain so the question whether Hungary is ready for inflation targeting remains relevant.

[5] Falcetti et al. (2000) claim that, by 1998, Hungary enjoyed 8 years of macroeconomic stability. Further, they construct a reform index ranging from 0 to 4 and report that Hungary reached the maximum index value by 1997.

[6] By April 2001, the daily rate of depreciation was only 0.0066% which translates to an annual depreciation of approximately 2.4%.

[7] The present paper is primarily concerned with the conditions that would ensure a successful transition to an inflation targeting regime. Krzak and Ettl (1999) outline the inflation targeting approaches used in the Czech Republic and Poland but are unable to present empirical evidence ostensibly owing to the scarcity of relevant data for these two countries. Also, see Šmídkova and Hrnír (2000), Czech National Bank (2000), Jonáš (2000); IMF (2000), and Christofferson and Westcott (1999).

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