The "East Jour Fixe" of the Oesterreichische Nationalbank

53rd East Jour Fixe

Monetary Policy in New Member States

The East Jour Fixe of the Oesterreichische Nationalbank, a series of meetings initiated in 1991 as a forum in which economists, members of academia, government officials and other experts on Eastern Europe meet to discuss specific transition issues, looks back on a long tradition. On October 29, 2004, this seminar series was continued with the 53rd East Jour Fixe meeting on "Monetary Policy in New Member States," which looked at specific monetary policy issues in the new Member States for the period between EU accession and the eventual adoption of the euro after the fulfillment of the convergence criteria. This topic has drawn a lot of attention from academic researchers and policymakers since the EU enlargement of May 2004.

The 53rd East Jour Fixe meeting was organized in two sessions. The first session was chaired by Doris Ritzberger-Grünwald, Head of the Foreign Research Division of the OeNB, who gave a short overview of the role of inflation targeting as a preferred monetary policy strategy of some countries (for instance, Finland) before joining monetary union and of those countries which are still not participating in ERM II (the U.K. and Sweden). Then, Lucjan Orlowski, Sacred Heart University (U.S.A.), who is currently a visiting research professor at the German Institute for Economic Research in Berlin, presented his recent work on "Targeting Relative Inflation Forecast as a Monetary Policy Framework for Adopting the Euro." He started by describing policy options for the new Member States (NMS) before the adoption of the euro. Various forms of direct inflation targeting have prevailed in several NMS (the Czech Republic, Hungary, Poland) as a superior monetary policy framework compared to monetary base targets or a fixed exchange rate policy. However, the implementation of inflation targeting stirred a heated debate over its timing and format. In particular, the NMS do not satisfy the prerequisites for inflation targeting generally recommended in the literature. These prerequisites comprise first and foremost single-digit inflation, a stable relationship between inflation and policy instruments, and well-defined channels of monetary policy transmission.

Accordingly, in his presentation Orlowski proposed relative inflation forecast targeting as a monetary policy framework conducive to the adoption of the euro in the NMS. In this policy framework, the national monetary authority targets the differential between forecasts of domestic inflation (from the perspective of the NMS) and inflation in the euro area. Given the final objective for the NMS of fulfilling the convergence criteria (including the inflation criterion) and adopting the euro, the difference should diminish as progress in nominal convergence is achieved. However, in the adjustment period, relative inflation forecast targeting can accommodate possible external and domestic shocks better than comparable monetary regimes. This should ensure a higher credibility of this regime and a superior macroeconomic performance than under alternative designs of monetary policy.

The contribution was discussed by Julius Horvath, Central European University (Hungary). He addressed several features of relative inflation forecast targeting and discussed issues of its possible application in the NMS.

The second session addressed several more specific features of monetary policy in new and prospective Member States, including transmission mechanisms and money demand in these countries. The importance of these issues for the conduct of monetary policy was stressed by Peter Backé, European Central Bank (ECB), who chaired this session. He noted that the ECB has a keen interest in analyzing the issues featured in the session, also in the context of the unfolding monetary integration of the NMS.

In the first contribution, Judit Krekó presented the results of her joint research with colleagues at Magyar Nemzeti Bank, Anna Naszódi and Csilla Horváth, on the "Interest Rate Pass-through: The Case of Hungary." The paper estimates error correction models with threshold autoregressive parameters to investigate the pass-through from monthly forint-based money market rates to the interest rates in the Hungarian banking system between 1997 and 2004. The latter approach allows for an analysis of various nonlinearities in the adjustment process of interest rate determination. The paper actually finds several sources of nonlinearities in interest rate behavior in Hungary. In particular, the results suggest that the speed of adjustment of bank rates depends on the size of the original changes in the money market rate and the deviation of the bank rates from their long-term equilibrium levels. Nevertheless, the pass-through in Hungarian corporate loan rates is stronger and faster than in comparable European countries, which may be due to the high degree of competition in the corporate segment of the Hungarian banking sector. The results using data aggregated for the whole banking sector are confirmed by bank-level data over a shorter period (2001–03). However, consumer credit rates in Hungary were found to be rigid in an international comparison, probably reflecting the low interest rate elasticity of loan demand and the high proportion of the risk premium.

Finally, Jarko Fidrmuc, Foreign Research Division (OeNB), presented his joint research with Abdur Chowdhury, United Nations Economic Commission for Europe, on "Money Demand and Disinflation: The Experience of Selected CEECs." At the beginning of his presentation, Fidrmuc presented the process of disinflation in six CEECs (the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia). All selected countries achieved significant progress in disinflation, which was accompanied by a corresponding stabilization of broad money (M2), although the correlation between both variables is weaker in more recent periods of lower inflation. This may indicate an increasing importance of external factors in the determination of money demand in the CEECs. Applying a panel cointegration estimation of a money demand function for the CEECs, external factors (the euro area interest rate and exchange rate) are found to play an important role in the CEECs.

The contributions of the second sessions were discussed by Robert Kunst, University of Vienna, who stressed selected aspects of the econometric techniques employed. The general debate addressed various issues related to parameter stability and data availability as well as policy implications for the NMS.