Challenges to Central Banking from Globalized Financial Systems

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Mr. Jerzy Pruski, Member of the Monetary Policy Council, National Bank of Poland

"Poland as an Example of Successful Transition From Inflation Targeting Lite to Fully Fledged Inflation Targeting"

(Comments on Mark Stone's Paper "Inflation Targeting Lite")

Introduction

I am very honoured having opportunity to speak in front of so distinguished audience. The organisers of the seminar asked me to make comments on the Mark Stone's paper "Inflation Targeting Lite". I would like to discuss this interesting paper from the perspective of the Polish economy. There are three arguments justifying such approach. In the late 1990's Poland could have been classified as inflation targeting lite country. Moreover the shape of monetary policy and the experience of the economy provide very good illustration of numerous points presented by M. Stone. And finally, the evolution of monetary policy in Poland constitutes an accurate example of successful transition from ITL to FFIT.

I will also shortly discuss the problems of transparency of objectives as well as transparency of operational targets and instruments under the ITL regime. However, I skip the discussion on the appropriate method of classification of the different types of monetary policies adopted by individual countries. The limited period of time makes it hardly possible. But more importantly I understand that the main reason for M. Stone paper was the identification of the most serious challenges faced by the emerging countries. For various reasons this group of countries can not adopt monetary policy based on one nominal anchor and do not have sufficient credibility to duplicate the ECB or FED monetary policies.

ITL in Poland

In the last decade Poland followed three different strategies of monetary policy. In 1990, at the outset of transition Poland adopted fixed exchange rate regime with the principal aim to fight hyperinflation. The initial period of stabilisation took 18 months. It allowed the zloty to regain its role as a medium of exchange and a store of value in spite of the annual inflation rate still exceeding 40 per cent by the end of 1992. Contrary to the prevailing role of the foreign currencies in 1989 three years later almost all transactions were denominated in the Polish currency (except the real estate market) and the share of foreign denominated deposits of the banking sector decreased from 80 per cent to 40 per cent. At the same time the trade liberalisation and significant changes in the geographical structure of trade situated domestic producers in a new, partially globalized market environment. Therefore, in order to prevent the real exchange rate from excessive appreciation and preserve the foreign competitiveness the system of fixed exchange was transformed into crawling peg regime. The success in stabilization of the economy and on the other hand, evident rigidities of the fixed exchange rate made it possible and necessary to change the strategy of monetary policy in 1995. Obviously, at that time Poland did not meet the required conditions for FFIT or VIT and generally speaking its economy was too large and faced too many structural problems to adopt CBA. Therefore "the eclectic approach" to monetary policy or using the expression of M. Stone, ITL, appeared to be something like natural strategy for a country such as Poland. Eventually, four years later this strategy was replaced by FFIT in 1998.

As it was correctly described in M. Stone's paper, ITL or eclectic monetary policy in Poland also focused on multiple objectives. It attempted both to meet forecasted and sometimes targeted numerically expressed inflation as well as to avoid excessive deterioration of current account simultaneously maintaining the financial stability. In order to fulfil this bundle of objectives the monetary policy used a large bag of different instruments. However a certain degree of operational transparency existed. Mainly the exchange rate policy was directed to prevent worsening of the current account. But interestingly, in practice the central bank controlled informal exchange rate band of ± 2.5 per cent within the officially introduced crawling band of ± 7 per cent and permanently intervened within this narrower band.

Remaining bundle of instruments were aimed at disinflation. The National Bank of Poland used different and changing combination of these instruments contingent on their expected efficiency. For example, central bank trying to limit demand pressure in the economy used interest rates of maturities from 7 to 270 days, thus exerted influence on relatively large segment of the yield curve. Sometimes it endeavoured to control monetary aggregates, like base money or M2. When the above actions appeared to be insufficiently effective cure for still high inflation the central bank added another instruments, such as obligatory reserves or even sporadically it began to accept the term deposits from individual clients.

The multiplicity of objectives and the large scope of ambiguity of operational targets and instruments induced relatively low accountability of the central bank. Among others the central bank delivered insufficient explanations for deviations between actual and forecasted or targeted macroeconomic variables. For example the substantial deviations of targeted monetary aggregates from actual values, sometimes in the range of 40 per cent, were usually explained simply by the rise of the monetization of the economy. Moreover the central bank did not provide explanations for the changes of monetary policy instruments. Consequently the monetary policy under ITL was characterised by weak communications with markets.

M. Stone raised the question about the advantages of higher central bank transparency in terms of objectives and operational instruments under the ITL regime. The full transparency of objectives requires precise disclosure of all goals, disclosure of the hierarchy among individual goals and numerical quantification of objectives. However full transparency of objectives is inconsistent, by definition, with the ITL framework and consequently some lack of transparency is inevitable for ITL. Therefore the so-called optimal degree of transparency of objectives under ITL should be considered and adjusted to country specific circumstances, which changed with the lapse of time.

With respect to transparency of operational targets and instruments, monetary policy in Poland achieved some degree of transparency – mostly it was clear declaration on the part of the central bank that exchange rate policy was aimed at preventing excessive deterioration of the current account. At the same time the exchange rate was the most effective channel of monetary transmission mechanism influencing inflation. Thus the decisions which should hypothetically improve the current account deficit also deteriorated the path of disinflation. Therefore the central bank maintained the rate of crawl for the long time unchanged and intervened within the narrower informal exchange rate band in the attempt to keep foreign competitiveness and simultaneously increased interest rates and the rate of obligatory reserves to fight inflation. In that way the inconsistency between the central bank objectives led to the inconsistency and weak transparency of its instruments. As a result the unavoidable inconsistency of objectives under ITL and the need for large scope of discretion on the part of central bank made higher degree of operational transparency hardly possible, at least in Poland.

During the ITL regime the Polish economy carried out deep structural changes. The most important are: the liberalisation of current and capital accounts, rapid development and privatisation of banking sector and other financial institutions, formation of legal and institutional framework for sound banking system and building and deepening of all segments of financial markets. The central bank played important role in that process. Mainly the central bank established efficient banking supervision and payment system. It also promoted the development of financial and money markets. Generally speaking the series of structural reforms paved the way for the more mature monetary policy in future.

However with the lapse of time ITL in Poland revealed its diminishing efficiency. Poland experienced constant disinflation but it was slow as compared to other transition countries. Accordingly both firms and households held inert inflationary expectations. The monetary policy faced increasing pressure coming from poor knowledge of the monetary transmission mechanism. Moreover, despite the exchange rate control the external disequilibrium seriously deteriorated. The multiplicity of objectives was one of the most important reasons of significant overliquidity of the banking sector with its negative impact on the efficiency of the monetary transmission mechanism and the profit of the central bank. And the most important, with the passage of time, ITL in Poland resulted in raising inconsistency between the central bank multiple objective and instruments.

The achieved progress in the field of structural and institutional reforms and the level of macroeconomic development were reflected, one can say paradoxically, in diminishing efficiency and increasing inconsistency of this eclectic monetary policy. The newly established strong independence of the National Bank of Poland in terms of both goals and instruments additionally emphasized the need for transition from ITL to the more mature monetary policy based on single nominal anchor. The eclectic approach to the monetary policy in Poland simply reached its limits on the turn of 1997. Under existing strategy of monetary policy the huge inflow of portfolio capital at the beginning of 1998 and the relative inability of monetary policy to cope with that problem were excellent examples of the constraints faced by policymakers. The disadvantages of the ITL clearly outstripped its benefits. In such circumstances, very soon after its establishment, the Monetary Policy Council decided to implement the FFIT. Taking into account the lack of adequate prerequisites for the VIT, the choice of direct inflation targeting seemed to be the proper solution for Poland.

The implementation and the results of FFIT

The implementation of the FFIT in 1998 overcame the lack of transparency and low accountability inherently present in the ITL system. By announcement of the short term (one year) and medium term (six year) inflation goals and introduction of main instrument of monetary policy (short term interest rate) monetary policy became subordinated to the famous principle: one instrument – one goal. It is worth stressing that from the very beginning the Monetary Policy Council declared to gradually move from crawling band to pure floating exchange rate which was finally introduced in April 2000. And that was reached by means of lowering the rate of crawl and expanding the range of the exchange rate band, Since then the central bank has not intervened on the foreign exchange market. The transparency of both objectives and monetary policy instruments was enhanced by the better communication with the market mainly through press conferences, publication of inflationary reports and written justification of the interest rates changes.

It goes beyond the space constraints of this comment to provide detailed analysis of the FFIT in Poland and therefore its results will be discussed very shortly. The initial macroeconomic conditions for introducing the FFIT were not unduly favourable. At the end of 1997 the inflation was above 13 per cent, the current account deficit deteriorated sharply to above 8 per cent in the first quarter of 2000 and the need for consolidation of public finances became increasingly evident. Additionally, Poland as other countries suffered from the Russian crises and the increase of oil prices.

Nevertheless the results of the FFIT seem to be very positive. Poland experienced strong disinflation accompanied by the decrease of inflationary expectations. The low inflation along with higher transparency and accountability of the central bank contributed to the decrease in the long term interest rates. The current account deficit significantly improved to below 4 per cent of GDP. The introduction of pure floating reduced the exchange rate fluctuations compared to crawling band system. At the same time the FFIT was conducive to the deepening of financial markets and better understanding of the monetary transmission mechanism.

Concluding remarks

During the last decade the monetary policy in Poland evolved smoothly from the fixed exchange rate regime to ITL and finally to FFIT. The gradual transition from the system of one nominal anchor, fixed exchange rate to another one the FFIT embodied the transitory period of the ITL. This intermediary stage in the evolution of monetary policy was characterised by increasing inconsistency of the multiple objectives and monetary policy instruments. That is why the ITL in Poland was named the eclectic monetary policy. It allowed for more flexible monetary policy and what is more important it ensured necessary time to carry out structural and institutional reforms. With the passage of time the ITL in Poland became increasingly incompatible with the more mature market economy. Its diminishing efficiency and increasing inconsistency led to the implementation of the FFIT in Poland in 1998.