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What You Should and What You Should Not Expect from a Central Bank

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WHAT YOU SHOULD AND WHAT YOU SHOULD NOT EXPECT FROM A CENTRAL BANK

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Central banks are often surrounded by an aura of mystique and the common man on the street seems to have very little understanding not only of what, why, and how exactly a central bank does, but most importantly of how much a central bank actually can do. It is commonly believed that the job of a central bank is to print money, which sounds rather trivial. Yet, at the same time, it is often believed that a central bank can effortlessly push an economy in different directions, and that it controls various powerful economic variables – interest rates, exchange rates, inflation, unemployment, and growth – that affect our everyday lives. The consequence is that the public in general, and politicians in particular, tend to expect a lot from a central bank, and when their expectations are not met, they blame central bankers for not doing their job properly, rather than blaming themselves for expecting too much and possibly doing too little.

Significant changes are envisioned for the National Bank of Georgia as the new government and the parliament take office. The latest proposal put forward by the Georgian government is to move towards an inflation targeting regime, a framework practiced by several central banks around the world (New Zealand, Canada, Euro area, U.K., Sweden, Australia, Iceland) and also being currently put in place in several transitional and developing countries.

In this article, I outline several factors that are likely to create difficulties for the NBG regardless of which monetary framework it adopts. Both policymakers and the general public should be aware of these factors, as they can be avoided as long as there is clear understanding of roles, goals, and possibilities of all the parties involved – the parliament, the government, the central bank, and the business community – and close cooperation between them.

Why Do They Do It?

While macroeconomic stability may mean different things to different people, for a macroeconomist it means a stable growth rate of real GDP and a low rate of inflation. Everything else is seen as a factor that may influence one of these two variables either in the immediate or in the distant future. Hence, unless a central bank is told explicitly to watch out for something specific (e.g. exchange rate in the case of a fixed exchange rate regime), it should be concerned solely with these two variables. For example, movements in the exchange rate matter only as much as they affect inflation (if a country has significant imports, depreciation will fuel inflation) or growth (if a country has significant exports, appreciation will hurt exports and slow down growth). Unemployment does enter the central bank's list of objectives, although implicitly, as a decline in the growth rate is usually coupled with an increase in the rate of unemployment.

Inherent conflict exists between the two objectives of keeping the growth rate high (i.e. keeping the rate of unemployment low) and keeping the rate of inflation low. Whenever unemployment is low, wages rise – reflecting a tight labor market – and prices follow. Similarly, whenever unemployment is high, wages decline – as those looking for jobs are ready to accept lower pay – and prices follow. Hence, whenever policymakers try to decrease unemployment, they face inflationary pressures; and whenever they try to decrease inflation, unemployment is likely to increase.

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Thus, on a day-to-day basis, central banks are constantly balancing the two objectives: they stimulate the economy, fueling inflation; and then battle inflation, reducing economic growth and pushing unemployment up. Accompanying changes in the interest and exchange rates, inflation outlook, and growth perspectives affect the attractiveness of the economy from the point of view foreign investors, who move capital in or out, which can have an impact on the exchange rate, but also on the trade balance, investment, the stock of external debt, and other important macroeconomic indicators.

The main difficulty that a central bank faces is that its ultimate product, money, has three prices, which cannot be controlled altogether at the same time: the interest rate is the price of money today in terms of money tomorrow; the exchange rate is the price of domestic money in terms of foreign money; and the average domestic price level is the price of money in terms of goods. Consequently, whatever a central bank does, it cannot possibly please everybody at the same time. Borrowers want interest rates to be low, while lenders want them to be high. Exporters want domestic currency to be weak, while import-based businesses want it to be strong. Most people want inflation (and unemployment) to be low, but they also want higher wages, which increase both inflation and unemployment. An additional difficulty arises from interactions between these variables: high interest rates tend to appreciate currency and decrease inflation; high inflation tends to depreciate exchange rate and increase interest rates; etc.

In absence of clear goals or guidelines, the central bank is under constant pressure from different lobby groups in the country and, if the central bank is not politically strong enough to pursue what it deems necessary, it may end up accommodating those lobbyists who are strongest at that particular moment. In this case, rather than stabilizing the economy, the central bank may contribute to its destabilization.

Why Could It Be Difficult?

These days it is commonly accepted that central banks can manage the economy only in the medium run, i.e., for a period of five years or so. The only thing a central bank can do in the long run is help in maintaining low inflation by not allowing the supply of money to increase too fast. It is viewed as the government's job to put in place laws and practices that create an environment where long-term growth can be generated. Such laws and practices include the tax regime and social safety net; reforms of the healthcare and educational systems; liberalization of the labor and goods markets; creation of a clear, transparent, and stable business environment, and so on. However, even in the medium run many things can run against a central bank's intentions.

The first and most important factor to guarantee successful monetary policymaking is to ensure *independence of the central bank*. While it is rather easy to make monetary policymaking independent de jure, it turns out to be rather difficult to do the same de facto. Fred Mishkin, a prominent U.S. economist, compares Canada and Argentina to make this point. Although the Bank of Canada is not as independent de jure as the Central Bank of Argentina, pressuring management of the Bank of Canada is unheard of, while in Argentina the government forced a highly respected president of the Central Bank to resign in 2001. Attempts to pressure central banks are very tempting and happen even in developed countries; consider, for example, comments about the strong euro made several times by the French President Nicolas Sarkozy to the president of the European Central Bank, Jean-Claude Trichet. Repercussions of such pressures, however, are likely to be much costlier in a country like Georgia. A paper by Alex Cukierman from the University of Tel Aviv has a simple but telling chart that shows that independent central banks, as a rule, deliver lower inflation rates, while less independent central banks end up delivering higher ones.

The second most important aspect is *coordination between the government and the central bank.* This refers to several things. First, there should be consistency between fiscal and monetary targets. Second, there should be an agreement on proper ways of financing budget deficits, if any occur. Third, there should be close coordination on day-to-day management of the government's cash flows. Finally, there should be close cooperation when it comes to capital flows, whether resulting from privatization, donor aid, or repayment of public debt.

Failure to coordinate in each of these aspects can undermine performance of the central bank. Limiting oneself to simple numeric targets will not be enough and cannot warrant success. Iceland, a country that in the recent years experienced a period of massive capital inflows and rapid growth of its financial sector, had in 2005-6 budget surpluses of more than 5 percent of GDP, yet inflation reaching 8 percent, almost 6 percentage points above its target of 2.5 percent. The failure to ensure coordination between fiscal and monetary policymakers has brought further unpleasant consequences, with the current account deficit reaching 25 percent of GDP in 2006, currency depreciating by 20-30 percent within a week on a couple of occasions, and inflation reaching 12 percent this year.

Success of many monetary frameworks is very much dependent on *credibility of a central bank*, i.e., on the belief that the general public has in the ability of policymakers to evaluate a situation, react to adverse developments, and deliver on their promises. Given the rather short history of the NBG existence, as well as the inflation history of Georgia, the credibility that the NBG currently enjoys may fall short of that needed to implement a framework such as inflation targeting.

The fourth issue is that the *traditional monetary transmission mechanism is not very powerful* in Georgia. The main tool of central banks in developed economies – those practicing inflation targeting and those that do not – is interest rates. In Georgia, as in many emerging and transitional economies, this channel is underdeveloped and the strongest impact on aggregate demand comes from changes in the exchange rate. Given how low the aggregate level of loans is, how small a fraction of borrowers is, and how weak the link between short-term and long-term interest rates is, it is unlikely that changes in interest rate would be very effective in reducing or stimulating domestic demand.

A related concern is that successful monetary policy is impossible without *sufficiently developed financial markets*. The NBG has started developing a market for its short-term financial instruments, but that may not be enough. Large privatization or external borrowing deals could result in a large inflow of foreign currency that may cause either large swings in the exchange rate and/or large changes in money supply that may be difficult for the Georgian economy to absorb.

In order to properly evaluate how the economy would react to changes in policy variables, one would have to rely on a *macroeconomic model for forecasting movements in inflation, GDP, and other variables* over the medium term. Building such a model is extremely difficult, given low quality of existing data, only 15 years of existence of Lari, changes in the monetary regime, and other events that are hard to account for (the Russian default of 1998, the Rose Revolution of 2003, the trade embargo of 2005, and other structural changes in the Georgian economy, including ongoing development of the banking sector). Of particular importance, but also difficulty, is evaluation of excess demand, a rather complex issue even in countries with more stable macroeconomic structures.

A substantial part of the problem is *inflation itself and the fact that few people understand it.* Official numbers do not seem to enjoy much credibility and speculations flourish as to what the actual level of inflation is. Not having reliable inflation numbers naturally hinders any chance of

targeting it. It also prevents the public from forming expectations, which serve as an important input for a central bank. There should be people who can understand what the NBG intends to do, who have reliable numbers to verify its ability to do so, and who can form their own expectations and can inform the NBG of what they believe is likely to happen. Such expectations signal movements in demand, an important piece of information for any central bank.

A more recent concern is that *inflation seems to be on the rise in many countries*, while just a few years ago this seemed to be a forgotten phenomenon. Georgia will not be able to insulate itself from global increases in prices for oil and food. While, in general, central banks can and do fight inflation driven by demand, there is not much they can do when facing inflation caused by supply shocks. Supply shocks are likely to be exacerbated by low levels of competition and the near-monopolistic state of some sectors of Georgian economy, thus contributing to further inflation spikes.

Finally, as recent developments have shown, *political instability* may have implications that go beyond the number of TV stations operating in a country. Trouble, whether internal or external, may scare foreign investors who will not spend their time analyzing what the disputes are about and who is right. Instead these potential investors will look for safer places to put their money. If that were to induce a large outflow of capital, currency could depreciate dramatically leading to a sharp increase in inflation.

What Could Be Suggested?

Given the arguments outlined above, three suggestions should be made.

As discussed earlier, the *key to success of the central bank is its independence*, factual, not just outlined on the paper. For Georgia, this means that the parliament should adopt legislation that would clearly define the goals and instruments of the NBG, as well as ensuring substantial distance between its governing bodies and the country's politicians. In particular, the worst thing that can be done is to make appointment of the NBG leadership part of political bargaining when ministerial and committee chairmanship positions are filled. The central bank should be headed by an independent professional, detached from politics as much as possible.

Given the operational difficulties that the NBG faces, it would be wise to *refrain for the time being from formally adopting inflation targeting*. Initiating this mechanism when the likelihood of its failure is high will only compromise the idea, undermine credibility of the NBG, and thus, make it harder to implement inflation targeting at a later, more appropriate stage. Instead, the NBG can formally make inflation its top priority and subordinate other objectives, while putting the other necessary elements for an inflation targeting policy in place.

Finally, *over-reliance on automatic rules*, such as zero budget deficit or automatic sacking of the NBG leadership, *should be avoided*. These rules will not be sufficient and will not protect Georgia from economic malaise. Automatic firing of the NBG leadership will only lead to frequent rotations at the top of the NBG, interfering with its operations. Instead, constant communication between all involved parties – the NBG, the Finance Ministry, the respective parliamentary committees, and business leaders – should be ensured, to guarantee that all policymakers are working in tandem.