Working Paper

INTERNATIONAL MONETARY FUND

IMF WORKING PAPER

WP/96/86

INTERNATIONAL MONETARY FUND

Research Department

Capital Flows in a Transitional Economy and the Sterilization Dilemma: The Hungarian Case

Prepared by Pierre L. Siklos 1/

Authorized for distribution by Peter Wickham

August 1996

Abstract

This paper compares Hungary's experience with sterilization with that of other capital inflow episodes. The study focuses on the short-run impact of sterilization on monetary policy. The empirical data indicate that sterilized interventions by the National Bank of Hungary (NBH) were not significant until mid-1994, sometime after the return to power of the former Communist leaders. Thus, in the second half of 1994, the NBH began to demonstrate more firmly its independence by tightening monetary policy. By the beginning of 1995, the direction of fiscal policy had begun to show consonance with the overall aims of monetary policy.

JEL Classification Numbers:
E58, F32

1/ The author is a Professor in the Department of Economics, Wilfrid Laurier University, Waterloo, Ontario, Canada N2L 3C5. He is grateful to the International Monetary Fund, where portions of this paper were prepared during a stay as Visiting Scholar in August 1995. He is also grateful to Peter Dittus, Edi Hochreiter and Werner Riecke of the National Bank of Hungary for useful conversations about the issues covered in the paper. An earlier version of this paper was invited for presentation at the Association for Comparative Economic Studies Conference, San Francisco, January 5-7, 1996. Comments by Ronald McKinnon on a previous draft are appreciated. All remaining errors are the author's responsibility.

Contents

Summary

This paper considers the performance of monetary policy in Hungary during the 1990s, particularly attempts by the National Bank of Hungary (NBH) to sterilize capital inflows. The results of the analysis suggest that only during the second half of 1994 did the NBH successfully sterilize capital inflows in order to pursue its objective of targeting the real exchange rate of the forint.

No sterilization effect could be detected when a subsample, which excluded the period when the former Communists returned to power, was considered. The same result held true when the real exchange rate was measured with consumer prices rather than producer prices, or when domestic credit was used to proxy monetary policy actions. Nevertheless, other more descriptive and anecdotal evidence suggests that a policy change did take place sometime during 1994 when the NBH moderated growth of the monetary base via sterilization, in line with its more restrictive monetary policy but contrary to the intended policy of the newly elected government in May 1994.