INFLATION TARGETING: REFLECTIONS ON THE FINNISH EXPERIENCE

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In the beginning of 1993 Finland was on the edge of collapse. GDP volume was down by 13 percent, banking sector was faltering, the rate of unemployment had increased fivefold, public debt ratio had increased fourfold, foreign indebtedness had doubled, stock market had declined by 50 percent as were the house prices, the currency had lost one third of its external value, and the foreign exchange reserves of the central bank were depleted. It was in these circumstances in which the bank of Finland decided in February 1993 to adopt a direct inflation targeting strategy.

The strategy proved to be a success. We believe that the adoption of direct inflation targeting, linked with fiscal policy aiming at rapid consolidation, contributed in a decisive way to the rapid recovery of the economy which took place together with the disappearance of inflation and inflation expectations. In 1995 the country was ready to join the EU. All the EMU entry criteria were met in 1997. In the beginning of 1999 Finland joined the EMU together with 10 other Member States of the European Union.

The following is an attempt to describe and interpret the Finnish experience of using direct inflation targeting as monetary policy strategy. In order to make the decision to move to a new strategy understandable it is necessary to describe a little bit of history, i.e. the events that led the country to the most severe peace-time recession during its 75 year old independence. The recession had been preceded by a strong boom fuelled by heavy capital inflows. In a classical manner, the boom ended in the bust.

The choice of direct inflation targeting was an urgent and a pragmatic decision dictated by the circumstances rather than by some doctrine or theory. The paper will explain the mechanics of the strategy, as well as how the strategy was applied in practical monetary policy decisions.

Although the decision to adopt direct inflation targeting took place in rather extraordinary circumstances it worked well also when the circumstances had normalised. Therefore, understanding the Finnish experience may be of some value to those central banks which are applying or contemplating to apply such a strategy in their own countries.

I. HISTORICAL BACKGROUND

From devaluation cycle to deregulation

Most of the post-war economic history of Finland is characterised by high and variable rate of inflation. Of course, inflation was high only in comparison with inflation in Finland's main trading partners. But this sufficed to create severe instability problems from time to time, one manifestation of which was the so-called devaluation cycle. Indeed, throughout the post-war period Finland resorted to devaluations, which occurred at approximately once-in-a-decade frequency. Initially, the large discrete devaluations boosted corporate profitability and investment, which was followed by rapid re-acceleration of inflation with a lag of few years. This, in turn, sowed the seeds for a future devaluation.

As in most other small economies, the exchange rate regime was that of fixed but adjustable exchange rates. There were a number of changes in the mechanics of the regime, such as the shift from dollar peg to the basket peg in early 1970s, and the shift from trade-weighted to ECU basket in 1991. In 1977 the basket peg was supplemented by defining a band of +2 ¼ percent inside which the central bank had the right to adjust the exchange rate. In mid-1980s the exchange rate was allowed to fluctuate within the band implying limited exchange rate uncertainty.

A resort to a devaluation from time to time was an inevitable consequence of conducting economic policies which bring about a rate of inflation that is higher than in the rest of the world. Whatever the reasons for such policies and for the inflation-proneness of a country, the resulting inflation/devaluation cycle became gradually deeply rooted in expectations, which made it even more difficult to get rid of the cycle. Of course, such a regime was sustainable only because both capital movements and domestic financial markets were tightly regulated, as was the case in Finland until the 1980s. It is likely that the inflation/devaluation cycle, linked with regulated markets and the imperfect competition in many areas brought about a rent-sharing equilibrium, which benefited the influential groups of the society. Thus there were no pressures from inside to change this equilibrium.

Circumstances started to change in the course of the 1980s. Capital flows started to play an increasingly important role already in the first half of 1980s, i.e. before the formal liberalisation measures were taken. Interest rate controls were lifted gradually. Operational mechanisms of monetary policies were modernised, which contributed to the emergence of properly functioning and deep money market.

A serious attempt was made in the 1980s to get rid of the devaluation cycle phenomena. The commitment to the fixed exchange rate was tested during the mini-recession of 1986, but this time the attack was repelled. It is likely that the pressure would have re-emerged had the export demand not started to increase rapidly already towards the end of the year. In addition, the consumers benefited from the improved terms of trade. Nevertheless, the successful defense probably raised the credibility of the commitment, which was strengthened also by the developments abroad, especially in the ERM countries

Capital inflows and the boom

This success proved to be a mixed blessing. The years 1987 to 1989 were characterised by heavy capital inflows, which were channeled mainly by commercial banks. The banks borrowed short-term from foreign banks and extended foreign-currency denominated debt to their domestic customers. Relying on the exchange rate or regarding the risk of a devaluation very distant the customers were eager to borrow in foreign currency because the nominal interest rate was lower. The credit expansion fuelled by capital inflows contributed to excessive indebtedness of firms and households as well as to rapid increase of property and housing prices to unsustainable levels. This situation created a classical dilemma for monetary policy: circumstances required monetary tightening which was possible because higher interest rates would have added to capital inflows given the (as yet, credible) commitment to the fixed exchange rate.

The floating exchange rate would probably have prevented some of these excesses to take place. It would, however, have required a clearly defined strategy to stabilise expectations. The alternatives would have been indirect monetary targeting or direct inflation targeting. Although there were some discussion about such alternatives, these were regarded purely academic. The simple fact is that the time was not ripe for such a profound change in policy regime, neither psychologically, institutionally nor politically. Because international benchmarks were lacking, gaining credibility for direct inflation targeting would not in those circumstances have been an easy task. The society would not have accepted a substantial nominal appreciation in 1987-88, which would have been a likely outcome if the currency had floated. In addition, a change in exchange rate regime would have required a change in legislation. Again, an unlikely outcome in those circumstances.

From boom to bust

Exchange rate as an intermediate target apparently was credible for some time-hence the heavy capital inflows. It also seems that the limited exchange rate

uncertainty inside the currency band and the limited room of maneuver of monetary policy provided by the band helped to reduce market pressures and the need for interventions for some time. But the credibility was lost almost overnight when the "rainy days" arrived in 1991. The currency was under the pressure for most of 1991 until it was formally devalued in November. A speculative attack was repeated in April 1992 and again in September, this time with greater force. As a result, the markka was allowed to float in September 1992. After the float decision the markka continued to weaken.

A number of factors can be listed which contributed to the severe recession of the Finnish economy in the early 1990s. The collapse of the exports to the former Soviet Union was one reason, but not a major one. Loss of price competitiveness and weaker demand in some of Finland's main trading partners, notably Sweden and the UK, were contributing factors, but again these were not major reasons. After all, the decline in exports was mild compared with the decline in domestic demand.

The main reasons for the recession were of domestic origin, i.e. excessive lending by banks, excessive indebtedness of the private sector and excessive increase of asset prices. Ultimately the bubble burst with well-known consequences.

The debt deflation initiated by high interest rates and declined asset prices was made worse by the fact that the sharp depreciation of the currency led to a large number of bankruptcies of firms which in earlier years had resorted to foreign currency denominated debt.

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II. DIRECT INFLATION TARGETING

Why inflation targeting?

Direct inflation targeting was adopted in a state of emergency in the beginning of 1993. In those circumstances there was no time and no means to base

a decision on the new monetary policy strategy on thorough theoretical analysis or a detailed study of empirical experiences of other countries. Theoretical literature was not yet written, and the only countries, which had some experience on direct inflation targeting were New Zealand and Canada. The UK had adopted inflation targeting few months earlier in October 1992, and Sweden was contemplating to make a similar move at the same time as Finland.

In the case of Finland, the simple fact was that the strategy of the exchange rate as an intermediate target had wrecked. In addition, the widely-held view was that the nominal exchange rate had overshot the fundamental equilibrium level by a large margin, although nobody knew what the equilibrium would be exactly. Introducing indirect monetary targeting would have been most confusing in Finland, where the whole concept of money supply was unfamiliar to the public at large. In addition, given the state of the economy the stability of the demand for money function could be questioned with good. Reasons.

The remaining two alternatives were to announce an inflation target or to announce nothing. Because the latter choice would have been equal to surrender, inflation target was a natural choice. This does not mean that the choice of direct inflation targeting was chosen only because the circumstances were so extreme. It is likely that the choice would have been the same even if the circumstances had been more normal, although the preparatory work probably would have been longer.

The main strategic reason for the announcement of the inflation target in early 1993, however, was the fact that the initial weakening of the markka after the float decision was considered to be vastly exaggerated. Certainly this was the view of the Bank of Finland. The Bank wanted that the inevitable correction to the real exchange rate, i.e. real appreciation, should take the form of nominal appreciation rather than higher inflation.

Choice of the target

The target that was announced by the Bank of Finland in February 1993 was to achieve 2 percent rate of change in the indicator of underlying inflation by the year 1995 and to maintain the rate at around that level thereafter.

The indicator of underlying inflation was derived from the headline CPI from which the effects of indirect taxes, housing prices and the interest costs of housing loans (capital cost of owner-occupied housing) were eliminated). In 1995 indirect taxes accounted 21 percent of CPI, while the share of capital cost of

housing was around 7 percent. Thus the indicator of underlying inflation covered some 72 percent of the headline CPI.

The purpose of these adjustments was to prevent the economic policy measures to have an impact on monetary policy decisions. Economic policy here refers to both fiscal policy (indirect taxes) and monetary policy (interest costs). The latter followed from the common sense that monetary policy should not react to itself (chase its own tail).

The calculation of the indicator of underlying inflation was commissioned by the Bank of Finland to Statistics Finland, which is the statistical authority of Finland. Outsourcing of the work to the statistical authorities was done in order to avoid any doubts that the measure could be manipulated by the central bank itself.

The 2 percent target was chosen because it was considered to be more or less equal to the implicit or the explicit target announced by other countries aiming at price stability. The expression of the target was deliberately somewhat vague, around 2 percent. There was no indication that the ex post inflation should on the average be exactly 2 percent.

The strategy was from the outset defined in a forward-looking manner and for the medium-term horizon. The initial target was set for 1995 after which date the rate of underlying inflation should remain at around 2 percent level, implying that minor deviations in both directions will be tolerated. It was also understood, although probably not very well communicated, that certain supply side shocks which change the relative price of certain goods, should not as such affect monetary policy, even though it may affect the price index temporarily.

The Bank of Finland announced the inflation target as a single number and not in terms of a target range. It was considered that the target range, or the tolerance range, may be confusing to the markets and to the public at large. Given the inflationary history of Finland it was feared that the public might form their inflation expectations in accordance with the upper limit of the range. Another consideration was that the credibility of the central bank would probably be hurt more if measured inflation overshoots the upper limit of the range than if it just deviates from the medium-term target. Similarly it was feared that there would be a strong pressure for monetary easening if the measured inflation undershoots the lower limit of the range for whatever reason.

Success of the strategy

The measured inflation at the time of the announcement of the direct inflation targeting strategy was around 3 percent, which was not far above the announced target of 2 percent set for 1995. Despite this, the announced target was regarded as ambitious, if not unrealistic, by most observers, especially the academics. Although not clearly documented, it seems that the reasoning of those who regarded the announced target as unrealistic was that they thought the rate of inflation in 1993 to be exceptionally low because of the huge slack of economy. In addition, they probably did not believe in the substantial appreciation of currency in the near-term.

In practical monetary policy making the new strategy was reflected in a series of interest rate cuts. Between February 1993 and summer 1994 the tender rate was cut from 10.5 percent to 5 percent. There were minor fluctuations on the road reflecting the fact that the auctions were based on variable rate tender. The decline of interest rates could have been faster but the Bank of Finland was leaning against the market pressure, because it wanted to restore the foreign exchange reserves which had been depleted during the currency crisis. Another reason for the Bank's caution was the fact that inflation was not expected to decelerate in the near future. All forecasts, including the Bank's own, were unanimous on this.

In retrospect, the strategy produced the desired results sooner than anticipated. The nominal exchange rate appreciated sharply since 1993 and reached a pre-float level in effective terms already in 1995. The Bank of Finland's foreign exchange reserves had been fully restored by the same date. The inflation target of 2 percent, set for 1995, was achieved already in early 1994. Inflation continued to decelerate in the following year to disappear entirely for a couple of years.

The first real test of the new strategy took place in late 1994. Despite high unemployment nominal wage increases for 1995, negotiated at the branch level, were high. In terms of unit labour costs the pay rises probably would have been appropriate for export industry, but they were far too high for the rest of the economy. The asset prices started to pick-up at about the same time, although admittedly from depressed levels. Survey-based measures of inflation expectations were clearly on the rise. As the financial market data gave similar signals the Bank of Finland decided to raise its tender rate in December 1994. This was followed by further rises in spring and summer 1995. These decisions were based on the forward-looking analysis of inflation outlook in the horizon of around 2 years ahead. In order to strengthen the signal value of monetary policy decisions the Bank shifted to fixed-rate tenders in December 1994.

These actions contributed to the disappearance of the newly arisen inflation expectations, although it would be exaggerated to argue that a 100 basis point rise in interest rates between December 1994 and June 1995 alone did the trick. It was important from the very beginning that the price stability objective of the central bank did get support from the Government not only in rhetoric but also in action. Indeed, the Government did announce its support for the inflation target already in spring 1993, but more importantly, it adopted at the same time a programme of sizeable cuts in central government expenditure covering several years. The new Government, which took office in spring 1995, confirmed its support for price stability and, more importantly, announced a front-loaded fiscal consolidation programme covering the entire four-year term of its office. The centralised wage agreement concluded in September 1995 gave a final seal to the sustained calmness of the inflation outlook for more than two-years.

Between October 1995 and October 1996, the Bank of Finland's tender rate was lowered in successive steps by 3 percentage points to 3 percent. The reason was that the Bank's inflation forecast repeatedly pointed to the continuation of low inflation.

As a mater of fact, the rate of increase of the indicator of underlying inflation vastly undershot the target both in 1995 and 1996. The disappearance of inflation in those years was mainly due to the substantial decline of the relative price of food, which took place as a result of Finland's entry to the European Union. This undershooting of the target was no concern for monetary policy. The Bank's view was that this was an anticipated supply-shock, the effects of which should be take the form of absolute declines of the prices of affected products. This was what happened.

The disappearance of inflation led to short-lived debate in Finland on the threat of deflation. The debate, which was inspired by similar debate elsewhere, was largely out of place. Despite measured price stability, there were no signs of generalised decline of prices or depressed demand. Economy was growing fast, domestic demand was recovering, asset prices were on a move up, consumer and business sentiments were high. None of these indicators supported the deflation argument. The conclusion is that observed zero inflation need not be a sign of a disease.

As a part of Finland's preparations for the Economic and monetary Union, the Finnish markka joined the ERM in October 1996. This high-profile move was important politically, but it had little immediate significance from the point of view of practical policy making. Although floating the currency had been comparatively stable for about two years vis a vis the ERM currencies. Inflation targeting was

continued, which was reflected in the monetary policy measures made in the remaining two years during which Finland could continue independent monetary policy.

In 1997 the Bank's inflation forecast was again on the move upwards. The forecast for 1998 exceeded the 2 percent target by a clear margin. The risks surrounding the forecast were considered to be on the upside, owing to continuing rapid growth of output, projected closing of the output gap, effective weakening of the currency and continuing rises in asset prices. The Bank's response was a small increase in the tender rate in September 1997. A further step upwards was made in June 1998. Again, the move was based on the Bank's inflation forecast and the risk assessment surrounding the forecast. This was the last interest rate decision of the Bank of Finland.

Communication issues

A shift to direct inflation targeting did change both the quality and the quantity of the Bank of Finland's communication policy in a number of ways. Perhaps the most important change was the fact that the Bank had to become more open and transparent in order to tell to the market and to the public at large how it sees the future inflation to evolve. For this reason, the strategic importance of the Bank's forecasting activity, and the risk assessment surrounding the forecast, increased.

Although, the Bank did not publish its forecast before the end of the 199s, it became increasingly open to explain in semi-quantitative and sometimes in quantitative language the main elements of the forecast as far as they were considered to be important for future inflation. Unlike some other central banks, the Bank of Finland did not start to publish a separate Inflation Report. Instead, the inflation article, published quarterly in the Bank of Finland Bulletin, was gradually developed in that direction.

III. CONCLUDING REMARKS

The Finnish experience of applying direct inflation targeting was relatively short, which does not allow for any firm conclusions to be drawn. Nevertheless, it is fair to say that the strategy worked well. The initial inflation target was achieved earlier than expected. The currency appreciated in nominal terms, the foreign exchange reserves were restored to acceptable levels in a couple of years, and the interest rates came down substantially.

It is also fair to say that although the initial circumstances were rather extreme, the conditions for price stability were favourable in the coming years were favourable for price stability. There was still significant slack in the economy, the currency was appreciating, and the food prices declined in absolute terms. For a short time it appeared that inflation expectations were again on the rise, which required a pre-emptive monetary policy action.

Announcing the inflation target was instrumental in the stabilisation of the economy and later in the road to recovery. A strong commitment to fiscal consolidation, was the second element of the stabilisation strategy. The increased credibility of the policy mix was reflected in the long-term interest rate differential between Finland and Germany. This data reveals that the credibility was achieved in spring 1995. Various statements and indicators show that price stability had become both accepted and expected by about the same date. This is revealed by wage moderation during the latter half of the decade.

The lessons from the Finnish experience of applying inflation targeting cannot as such be transferred to other countries, who shifted or contemplate to shift to such a strategy in very different circumstances. For example, inflation targeting in Finland was initially an instrument for stabilisation and not for disinflation as such. In later years inflation targeting started to lose significance because of Finland's decision to aim at the EMU in the first group. It is most likely that the Bank of Finland would have continued direct inflation targeting Finland not decided to go to the Economic and Monetary Union among the first countries.