ECONOMY AND FINANCE • VOL. 9. ISS. 2. • JUNE 2022 • DOI: 10.33908/EF.2022.2.4

TWO SIDES OF A COIN: MONETARY POLICY AND PUBLIC DEBT MANAGEMENT[1]

Judit Neményi[2]

I met *Werner Riecke* at the start of his career at the end of the 1970s. After receiving his degree, he started working for the Department of Econometrics headed by *Mr Szakolczai* (INFELOR System Technology Company). The company was working on assignments by the Central Statistical Office (KSH). We mostly prepared economic calculations for different ministries, and we dealt with SAM-based structural and time-series econometric models and analyses (applied research). We gained a comprehensive economic worldview via macro models of the national economy[3], and breaking them down we progressed towards the details during our career. Although we never worked together in the "INFELOR" years, we talked a lot and found we had similar views on many things. Our friendship can be dated to have started there.

Following the elimination of the Szakolczai Department[4], we worked at various places until the fall of the Socialist regime. After a short stay at the Price Office, Werner worked for the Financial Research Institute, then for different economic policy secretariats (the tax reform by *Kupa,* the economic policy of *Medgyessy)* until he was invited to the National Bank of Hungary (MNB) in 1990 by *György Surányi.* There he was first an advisor to the Governor and then became head of the predecessor of the Department of Monetary Policy. He was appointed managing director of the area of monetary policy in 1995 and Deputy Governor in 1998.

1 Edited version of a talk given at the memorial conference dedicated to Werner Riecke organised at the 'Rajk' Special College on 30 September 2021.

2 *Judit Neményi* is scientific advisor at the Financial Research Institute; she was a member of the Monetary Council of the National Bank of Hungary from 2005 to 2011. E-mail: nemenyij51@gmail.com.

3 Both of us obtained our degrees from the Chair of Economics-Mathematics at the Department of National Economy Planning and Analysis. Later, at the National Bank headed by *György Surányi,* we were categorised "macro experts" versus "finance experts" who were "really into banking affairs" (sic!).

4 All workshops operating well were eliminated in Hungary in the period of Socialism but later on as well. Just think of the elimination of background institutions at around the fall of Communism or, for instance, of the first independent Budgetary Council. Whenever one or another of our workplaces were closed, we had to find a new job. Provided Werner and I had written the story of our job-changes in the '80s, it would have amounted to a complete description of the operation of late Socialism.

I worked for different workshops of the National Planning Office (Department of Modelling, Institute of Planned Economics) and then for GKI Economic Research Co).

Life again brought us close at the time of transition, during the early nineties. As macro-economic time series had broken down and time series econometric modelling had become impossible, I tried a new area, economic policy making for the Department of Money and Capital Markets of the Ministry of Finance established at the time. My task was coordination and cooperation with the National Bank of Hungary and establishing market financing of the budget (setting up the market of government securities). Then I joined MNB in 1995, where I directed economics and research as the chief economist and became a member of the Board of MNB.

Werner and I worked closely together for a decade beginning in 1992 making efforts to promote the establishment of the basic institutions of a market economy in Hungary and help their effective operation. We were dreaming about price- and financial stability. Right from the start, we were aiming at membership in the European Union and the introduction of the common currency. This necessitated cleaning the profiles of key institutions – the central bank and the budget - by getting rid of out-of-place tasks and setting up important institutions to promote the creation and development of key markets that had never existed during Socialism.

I want to recall now two examples of the outcome of our work that have been having an impact to the very day.

1 1992–1996: TRANSFORMATION OF THE NATIONAL BANK OF HUNGARY INTO AN INDEPENDENT CENTRAL BANK

The situation at the fall of Socialism could be described briefly as follows.

- MNB provided unlimited funding to the budget at preferential rates;
- the foreign currency debt of the state was included in the balance sheet of MNB, the Bank took out foreign currency loans on its own behalf;
- the Bank charged the exchange rate loss generated because of the devaluation of HUF to the budget as an interest-free perpetual loan;
- the balance sheet of MNB also included a huge portfolio of refinancing loans at preferential rates;
- and because of all the above, MNB operated with increasing losses. It could not be maintained in an environment of strong inflation, so the budget had to recover the loss.

In other words, there was unlimited monetary funding, refinancing at preferential rates, foreign currency indebtedness of the sovereign Central Bank, but there was no liquid government securities market and there was a shortage of institutional investors.

The law on the Central Bank was adopted at the end of 1991. It stipulated the monetary funding of the budget had to be eliminated gradually, and ordered a step-by-step reduction envisaged for five years. Two Government Decrees were adopted in 1992. One provided to establish which institution held the Hungarian sovereign debt on its balance sheet and what its size was.[5] The other stated the budget deficit could only be financed by marketable government securities beginning from 1993.[6]

On the one hand, one had to transform a monobank of the Socialist economy into an independent Central Bank, and on the other hand, budget funding had to be given market-based foundations, which required the establishment of a government securities market.

We were helped in solving those tasks as we could take part at courses of monetary policy and debt management organised by the IMF and the Bank of England in the first half of the 1990s. We were trying to adapt what we had learnt to the Hungarian environment so that the key institutions of a market economy could be set up and start operation as soon as possible. We were self-educated, we worked in "learning by doing" but we spoke the same language.

The so termed quasi-fiscal (funding and debt management) operation of MNB had to be eliminated to achieve its independence and promote its effectiveness in terms of monetary policy. In addition to gradually eliminating the refinancing of the private sector at preferential rates, the greatest challenge was to eliminate the monetary funding of the budget and the status of MNB as Hungarian sovereign debtor. We succeeded to get rid of direct Central Bank funding gradually, while a debt exchange/credit swap conducted at the end of 1996 put an end to the foreign currency indebtedness of MNB in its own name.

Werner was wrestling with those tasks at the MNB, while I was doing the same at the Ministry of Finance. He represented the aspects of *monetary policy,* I oversaw *debt management* considerations, but both of us had been aware right from the start that we were dealing with *the two sides of the same coin.* We soon discov-

5 The real volume and composition of public debt could only be established by consolidating the balance sheets of MNB and the budget.

6 The law stipulated the full elimination of monetary funding to be reached by 1996. It allowed the increase of the volume of government bonds held with MNB to be progressively reduced year-on-year beginning from 1993.

ered a study by Nobel laureate *Tobin*.[7] It was also clear in practice that monetary policy and debt management affect the whole spectrum of outstanding debt in an economy albeit through different channels, at different intensity and delay.[8]

It was also clear right from the start that the collaboration of the budget was necessary to implement either cost saving financing or disinflation. However, the budget deficit was rocketing as the markets and the economy collapsed, which was further increased by the appearance of market rate interest expenditure, and it could not be curbed in the first half of the decade. Funding demand highly surpassed available sources, which made institutional restructuring quite difficult.[9] Institutional investors were rare on the government securities market and the infrastructure of selling them (primary dealer system) had not yet been created. Therefore, MNB had a dual agency part to play. On the one hand, it arranged auctions of government bonds and on the other hand, since all the announced instruments were not usually sold at the auctions, MNB took them as a "residual buyer" to sell in its network keeping in mind restrictions on monetary funding provided in the law.

In a joint effort with Werner a committee was set up (it would be termed liquidity management committee today). It had weekly meetings to ensure "the coffers" should never be empty and the country should not go in default. In later decades when some politician or expert cried wolf (default) in a demanding situation, I always thought, "you have never seen one like that". We, however, together with Werner and four other knowledgeable colleagues did manage the liquidity of the state on a daily basis for quite a long time (from 1992 to 1994), and sometimes it was a narrow escape to find the funds covering due payments.

In the meantime, we gradually developed the market of HUF-denominated government securities. We arranged auctions starting with discount treasury bills and moving to government bonds of increasingly longer maturity while retail instruments were also issued to a limited extent. The first issuance plans were finalised. Next, we prepared the market to be opened to foreign investors and the plan for the primary deal system had also been drawn up.

7 James Tobin (1963): Fiscal and Debt Management Policies. The Commission on Money and Credit. Prentice-Hall, Inc. Englewood Cliffs, N.J.

8 *„There is no neat way to distinguish monetary policy from debt management, the province of the Federal Reserve from that of the Treasury. Both agencies are engaged in debt management in the broadest sense, and both have powers to influence the whole spectrum of debt."* (James Tobin [1963]: An Essay on Principles of Debt Management. In Tobin (1963:143–219).

9 The problem was solved in spring 1995 by means of a budgetary corrective package introduced by Lajos Bokros, the minister of finance.

We soon realised that *no economic policy could be successful unless monetary and fiscal policies were coordinated,* although a concept growing stronger in the world advised that *"everybody* (i.e., the two main branches of economic policy) *should mind their own business."* Coordination and collaboration were not fashionable. An institutional "separation" of governments and central banks was intended to safeguard the independence of central banks gained recently.[10] The same basic principle was in the background of preparations to join the Euro-zone that started at that time. However, what had been considered best practice in the industrialised world, was not always a winner in the emerging Central and Eastern European countries *en route* to market economies. We could achieve a certain reputation internationally as we were trying to operate our institutions (the Ministry of Finance and MNB) conscientiously and in a coordinated manner. Werner and I were working to that goal, although we were not yet part of decision making at our institutions and often met with a lack of understanding.

We had to fight "at two fronts". Powerful bosses at the Ministry of Finance had trouble understanding that transition to a market economy means the (preferential) interest rate payable on sovereign debt should not and would not be born out of bargains between the two actors (MF and MNB). At the same time, the all-powerful Deputy Governor of MNB found it difficult to understand why it was necessary to establish a government securities market denominated in the local currency, as one could easily go into debt with loans drawn from abroad or from commercial banks.[11]

Werner had been the spiritual father of many ideas, particularly relating to central bank instruments or modes of operation in the first part of the 1990s that allowed MNB to stay firm in the management of the country in a strained financial situation. However, monetary policy could only be effective if MNB were cleaned of its quasi-fiscal functions, and if the markets we were building could transmit the signals from MNB to the financial sector and the economy. MNB withdrawing from its position as sovereign debtor was one of the hardest tasks.

It had become clear by 1993 that the so termed "zero coupon" budgetary loan portfolio held by MNB (bearing zero interest and without maturity), which had

10 Other countries aspiring to join the eurozone were not much ahead of us at the beginning of the '90s in terms of meeting the relevant monetary and fiscal requirements, while the central banks of some of them became independent in the last minute only.

11 Considering that Hungary always honoured its debt service obligations to foreign creditors after the fall of Socialism, there was nothing to prevent the country from taking out further loans. An idea was raised: if we want to go into debt in HUF, why not copy what Austria is doing. They invite six commercial banks and have them underwrite a loan/bonds in private placement. It was difficult to get the importance of market pricing accepted.

been accumulated from devaluation losses generated on foreign currency debt, had to be transformed into interest bearing marketable government securities to ensure efficient monetary operations.[12] The "zero coupon" portfolio had grown so large by 1995 that it made up for about forty percent of the gross government debt measured by the Maastricht rules while its real structure was hidden as the foreign currency debt could be found in the portfolio of MNB- This major problem was solved by a "debt exchange" at the end of 1996. It meant the whole "zero coupon stock" was converted into interest bearing marketable securities after which the Government Debt Management Agency (ÁKK) took out and managed the foreign currency debt of the budget. In that way the monetary and fiscal functions had been finally separated from each other.

2 1995-2001: EFFECTIVE OPERATION OF THE EXCHANGE RATE TARGETING MONETARY SYSTEM

Restructuring budgetary policy and the reduction of the deficit in 1995 paved the way for effective monetary policy and cost saving debt management.

The operation of the *exchange rate targeting monetary system, which applied a pre-announced narrow-band crawling peg as nominal anchor and* was implemented side by side with the large-sized budget adjustment package in 1995, presented new tasks in terms of the transformation of monetary instruments and their application on the one hand, and the renewal of decision making on the other.

In that period the ultimate goal of monetary policy became the mitigation of inflation (two-digit at the time) and achieving price stability; however, the operative target variable was the HUF rate according to the characteristic features of the exchange rate targeting regime. In that system, the Governor of the Central Bank, György Surányi made interest rate decisions, since immediate, fast decisions might be needed because of movements within the exchange rate band. Decisions affecting the monetary system were in the scope of the Central Bank Council.

The Governor of MNB needed a highly structured information system allowing him to respond to market shifts quickly and properly. Its components included monetary guidelines, inflation reports and documents by the operating monetary committee (OMB). Naturally, we also prepared regular macroeconomic forecasts

12 Our experience with the "zero coupon stock" have made us sceptical about non-marketable, zero interest-rate, without maturity instruments, mainly loans, drawing which has also been suggested internationally during the Covid crisis.

every quarter, but MNB did not publish them to curb speculatory movements against the narrow exchange rate band.

After 1995, when I was also working for MNB, we divided tasks with Werner in such a way that he was responsible for monetary instruments and market operations while I headed planning the economic and research tools for decision making. As a member of the Bank Council, Werner also participated in decision making as vice-president beginning from 1998.

The Department of Monetary Policy was charged with[13] drawing up monetary policy guidelines using the forecasts delivered by the Department of Economics. The Department of Economics and Research drafted the documents for decision making, economic analysis and applied research. The inflation report published quarterly from 1998 was the key product of the Department. Monetary policy headed by Werner produced short-term market analyses, documents for the weekly meetings of OMB (Operative Monetary Committee) and was also responsible for developing Central Bank instruments.

Headed by Werner, *the instruments of sterilised intervention policy* were created then. MNB intervened (bought foreign currency) at the strong edge of the exchange rate band operating with lower and lower pre-announced devaluation, and then withdrew the excess liquidity from the system using different means (reverse repo or, when the Bank had no more government securities, by introducing two-week deposits).

Gradual reduction of inflation, which characterised the monetary policy of the second half of the 1990s, was strongly criticised both from outside and inside. However, looking back on it, it can be said to have been clearly successful. Everybody acknowledged it subsequently. The balance of the economy had taken an upward course. The system of crawling peg had run out by the middle of 2000. To reduce inflation further (one-digit but still quite high), one should have had a change in the exchange rate and monetary regimes. A wide-band regime or free-floating would fit better to fight inflation pressure. Offering no acceptable professional justification, the first *Orbán government* torpedoed a change in the exchange rate system including the introduction of a wider band. In retrospect, one may think *Zsigmond Járai* who had been a candidate for the position of Gov-

13 Drawing up the Guidelines was useful for orienting market players and for liaising with the government, since they included the considerations monetary decisions were built on. The Guidelines also included forecasts by MNB. Later, following the implementation of the system of targeting inflation, the inflation reports included the forecasts. The Guidelines were eliminated in 2001 saying they violated the independence of MNB, but it did not prove to be a good decision, as the markets often got worried because of key interpretation and competence issues (when and who should decide the inflationary target, what will the Bank respond to, etc.).

ernor of the National Bank since 2001 "might have wanted to reserve that historic change for himself." The story would not be worth mentioning at all, except for the surprising fact that Werner had also been against widening the band at the meeting of the Monetary Council held at the beginning of July 2000. I could never discover why he changed his mind on such an important question (he had been supporting an early band widening earlier). A year later the new Governor of the National Bank widened the exchange rate band in one of his first measures.

Werner's and my careers diverged after 2001. When we met again, I did not want to burden our friendship by asking him how he could have voted for Járai's over politicised, counter-productive, overstrict monetary policy from the second half of 2002 and all the time in 2003, which hindered the emergence of the country just as much - if not more - [14]as the "fiscal alcoholism" blamed so heavily.

The 1990s had been clearly successful for us. Macroeconomic indicators had improved by 2000, convergence to the EU could have been launched. The growth of the economy, the reduction of inflation, external and internal balances were all fine; public debt was reduced by thirty percentage points of the GDP and approached 50 per cent. Although the option to access the EU was still far away, there was a real chance for the Euro to be introduced by the end of the next decade. You simply had to put your mind to it. But it was not to happen. It was sometimes decided (2002-2006) but nothing serious was done to make it happen. Finally, the plan of Euro was rejected (2010-2021) because decision makers intended to weaken the HUF rate for getting easy financing. Postponing the "Euro-project" under different pretexts was the key sin of Hungarian economic policymakers in the first twenty years of the 2000s, because it has set the country back. Werner and I shared this opinion.

3 NEGLECTED

His assignment as Deputy-Governor of the National Bank expired in 2004 and then Werner was not given a task in the process of shaping economic policy in Hungary. Nevertheless, he did not spend his last 15 years useless. He could give much useful advice in developing countries regarding the establishment of a government securities market or debt management, but he could have and should

14 The most spectacular proof of the botched interest policy became evident in January 2003 when, as a real 'Hungaricum', the strong side of the ±15 per cent-wide band suffered a speculative attack. Then, following a shift in the band, the Monetary Council pushed the spread to above ten percentage points, when there was an excess of liquidity in the world. The rise of interest expenses made fiscal adjustment more difficult.

have served the emergence of this country using his knowledge and experience. Unfortunately, however, he had no more opportunity to turn around erring economic policy decisions. He published articles with his pertinent remarks and proposed improvements.

In retrospect, I think the years with MNB had been the peak of Werner's career. There is no doubt he played a decisive part in shaping its profile as a modern central bank and building its instruments for the market economy. Our great common dreams could not come true. The stabilisation of the country is still uncertain. Turning the economy onto a sustainable growth path is still a challenge although general circumstances are basically different. The introduction of the Euro has moved farther away over the past decade than ever before.