Monetary and Exchange Rate Regimes in Central and Eastern Europe: Past and Future

Johannes Wiegand, IMF

CEEI Conference, Austrian National Bank, November 2019

Based on: IMF European Department Paper 16/3 &
IMF WP 18/58

The View Expressed are Those of the Author,
Should Not be Attributed to the IMF

CEE Economies Are (Broadly) on the Same Monetary Journey…

Starting point: transition from centrally controlled economies to market economies from the late 1980s/early 1990s

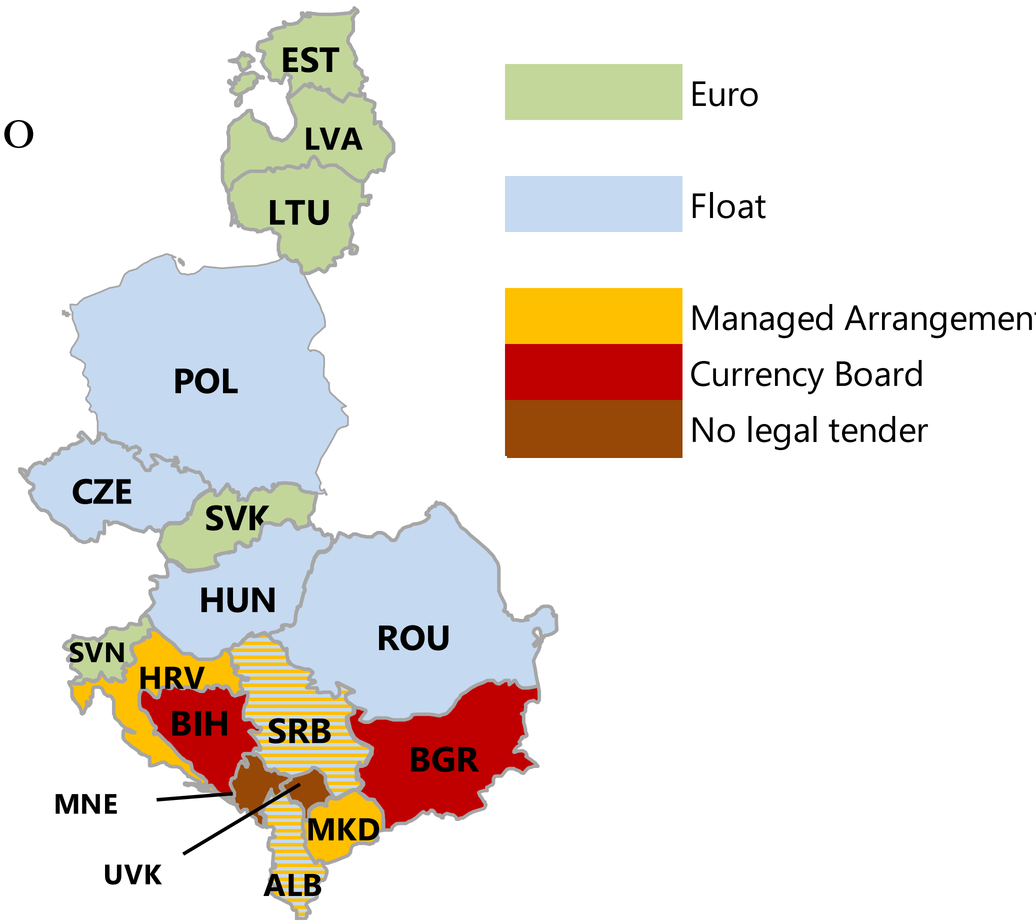
End point (at least in principle): **euro adoption.**

- Some CEE countries are already euro area members
- Others have committed to adopting the euro in their accession treaties
- Again others are negotiating/seeking to negotiate similar treaties.

... but Have Adopted Vastly Different Monetary and Exchange Rate Regimes

Questions:

- Why are the regimes so different?
- Is the diversity of regimes a good outcome?
- What can we say about euro adoption (timing/circum-stances)?



1

Why are Monetary and Exchange Rate Regimes in CEE so Different?

Key is Uneven Stabilization in the 1990s

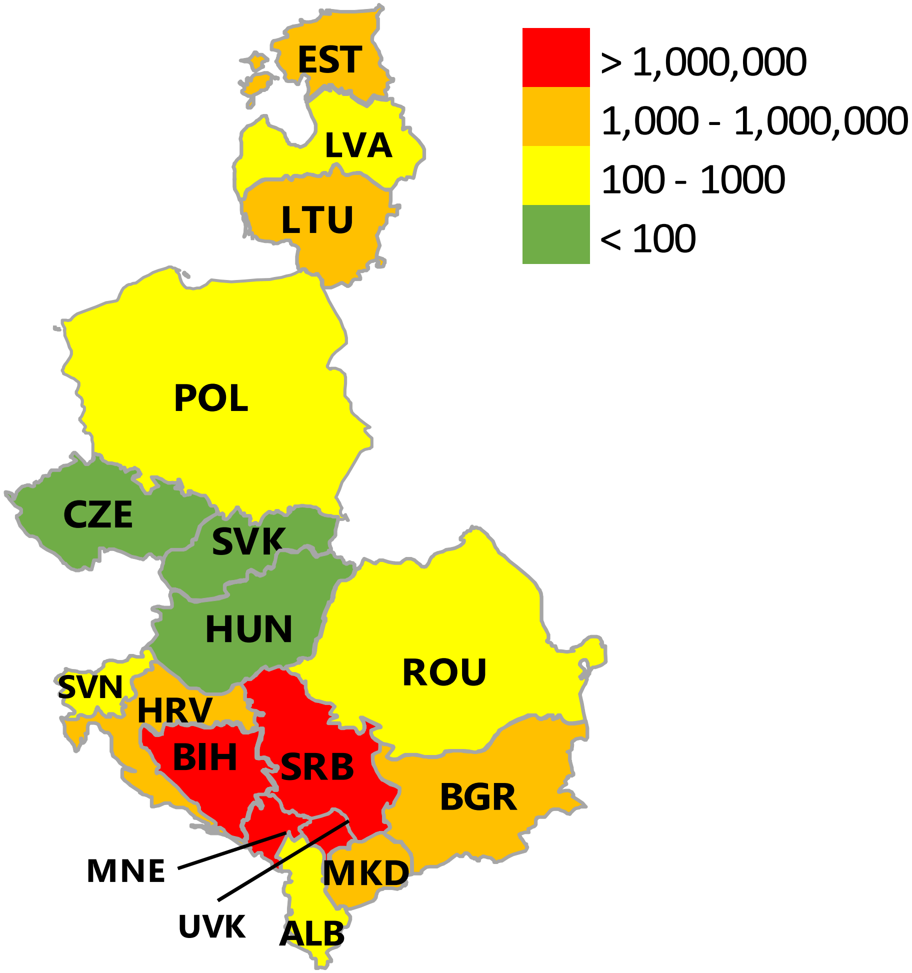
All CEE economies struggle with inflation in the 1990s, but to different degrees:

- **Modest (double-digit) inflation in Central Europe,** rapid exchange-rate based stabilization. With inflation defeated, countries switch to flexible exchange rates/inflation targeting from the late 1990s
- **Hyperinflation (1000 percent plus)** in the Baltics (1992/93), much of former Yugoslavia (1992-94, civil war), Bulgaria (1996/97).

  The higher inflation during transition, **the more rigid and durable the fixed rate regime** to bring it down:

  - Currency boards in Bosnia & Herzegovina, Bulgaria, Estonia, Lithuania
  - Unilateral adoption of the euro in Kosovo, Montenegro

Peak Annual Inflation During Transition

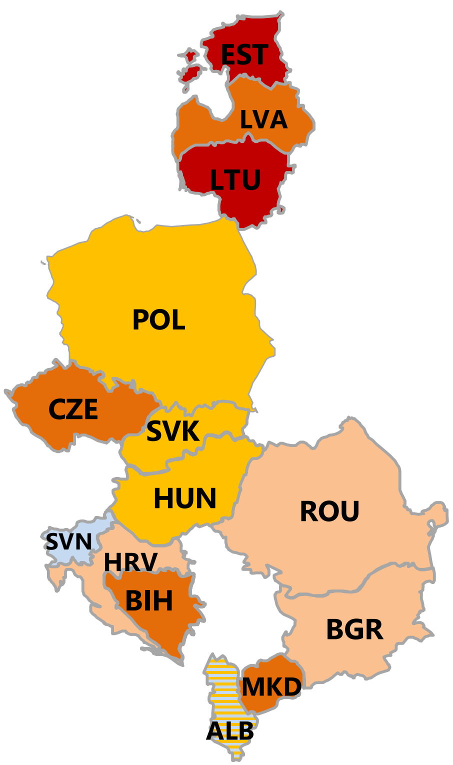


Evolution of Exchange Rate Regimes

(IMF Classification with Amends for Effective Exchange Rate Flexibility)

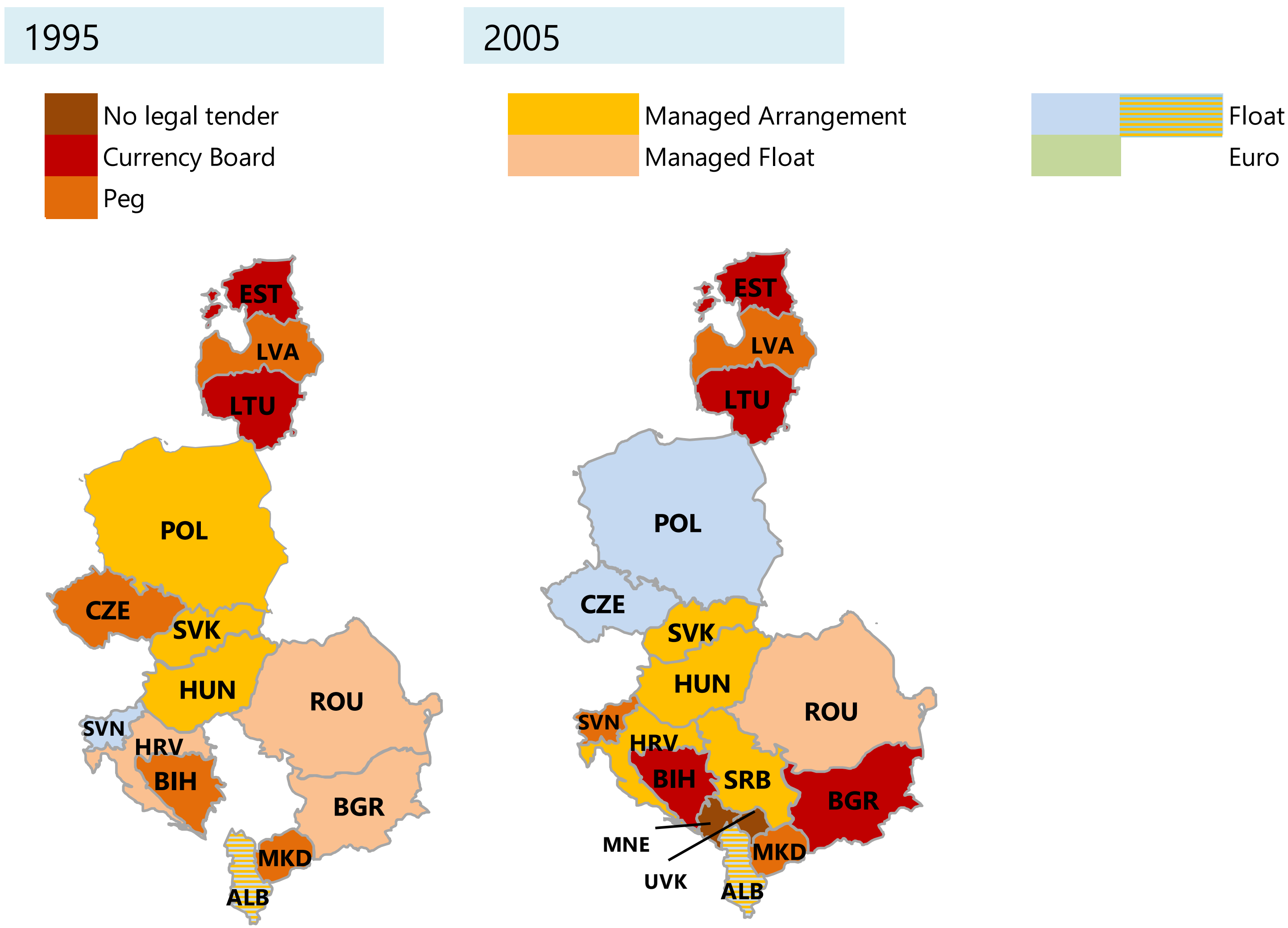
1995

No legal tender
Currency Board
Peg
Managed Arrangement
Managed Float
Float
Euro



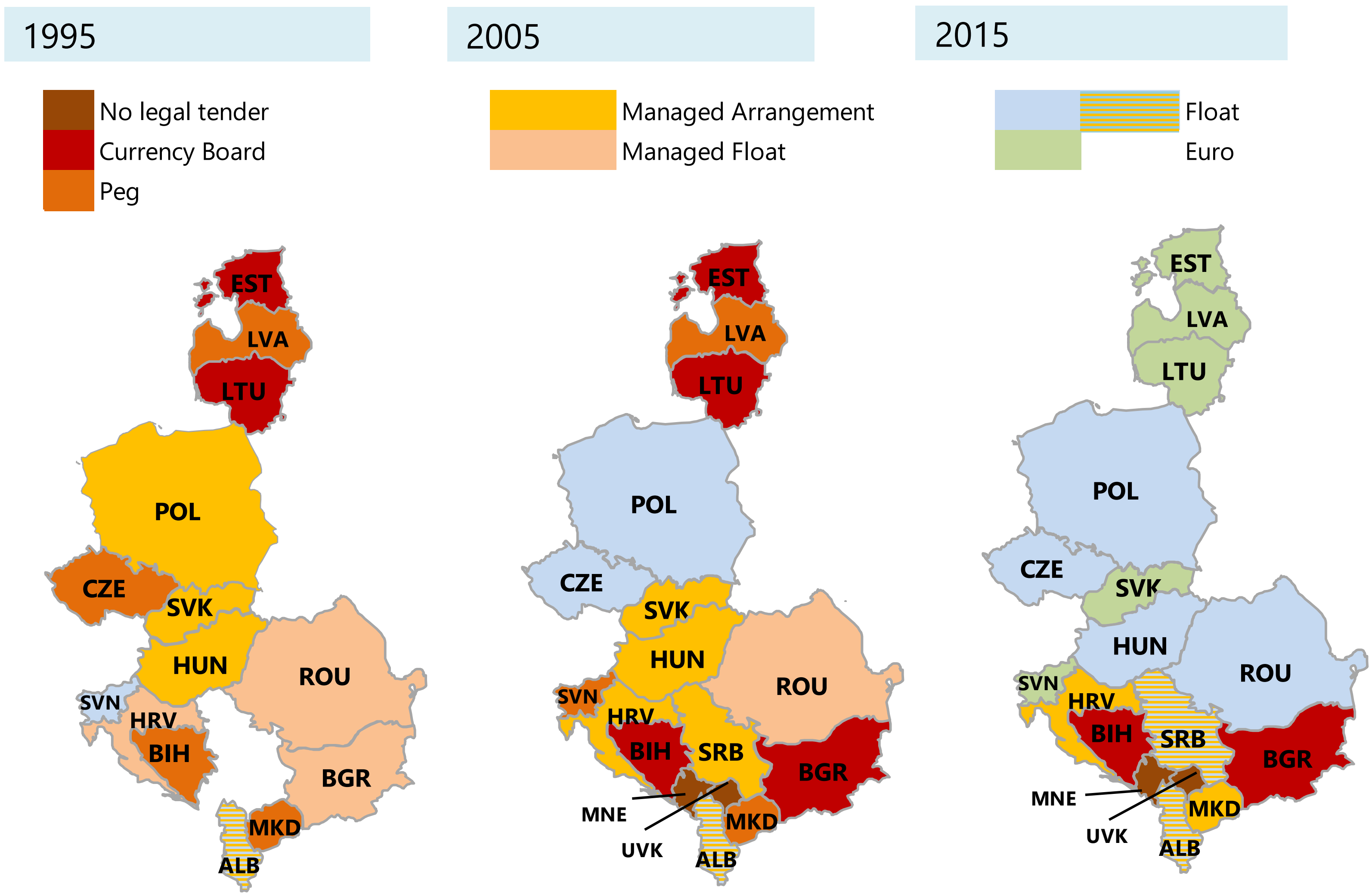
Evolution of Exchange Rate Regimes

(IMF Classification with Amends for Effective Exchange Rate Flexibility)



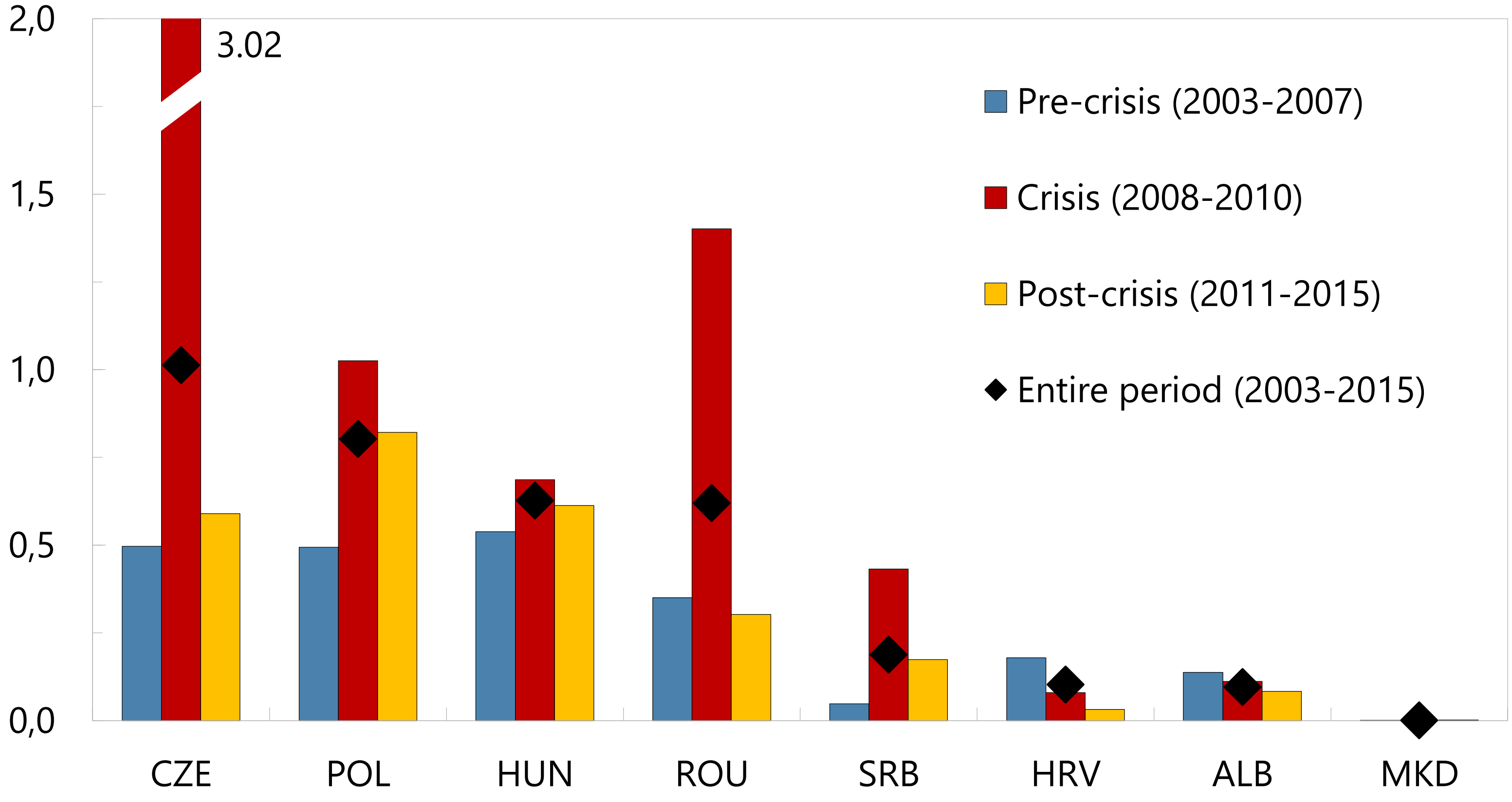
Evolution of Exchange Rate Regimes

(IMF Classification with Amends for Effective Exchange Rate Flexibility)



Effective Exchange Rate Flexibility

Calvo-Reinhardt "Fear of Floating" Index, 2003-15
(average over quarterly values)



Hyperinflation's Legacy: Deep-Seated Distrust in the Domestic Currency

- Countries that suffered hyperinflation tend to have high deposit euroization to this day (Geng et al., 2017)
- Survey-based results show persistent inflation and devaluation expectations, even in countries with currency boards (!, Brown and Stix, 2015)
- <u>Forces (quasi-)fixed exchange rates,</u> as depreciation can be perceived as signal that inflation is resurging → risk of capital flight
  (common phenomenon in EMs, not just CEE)

2

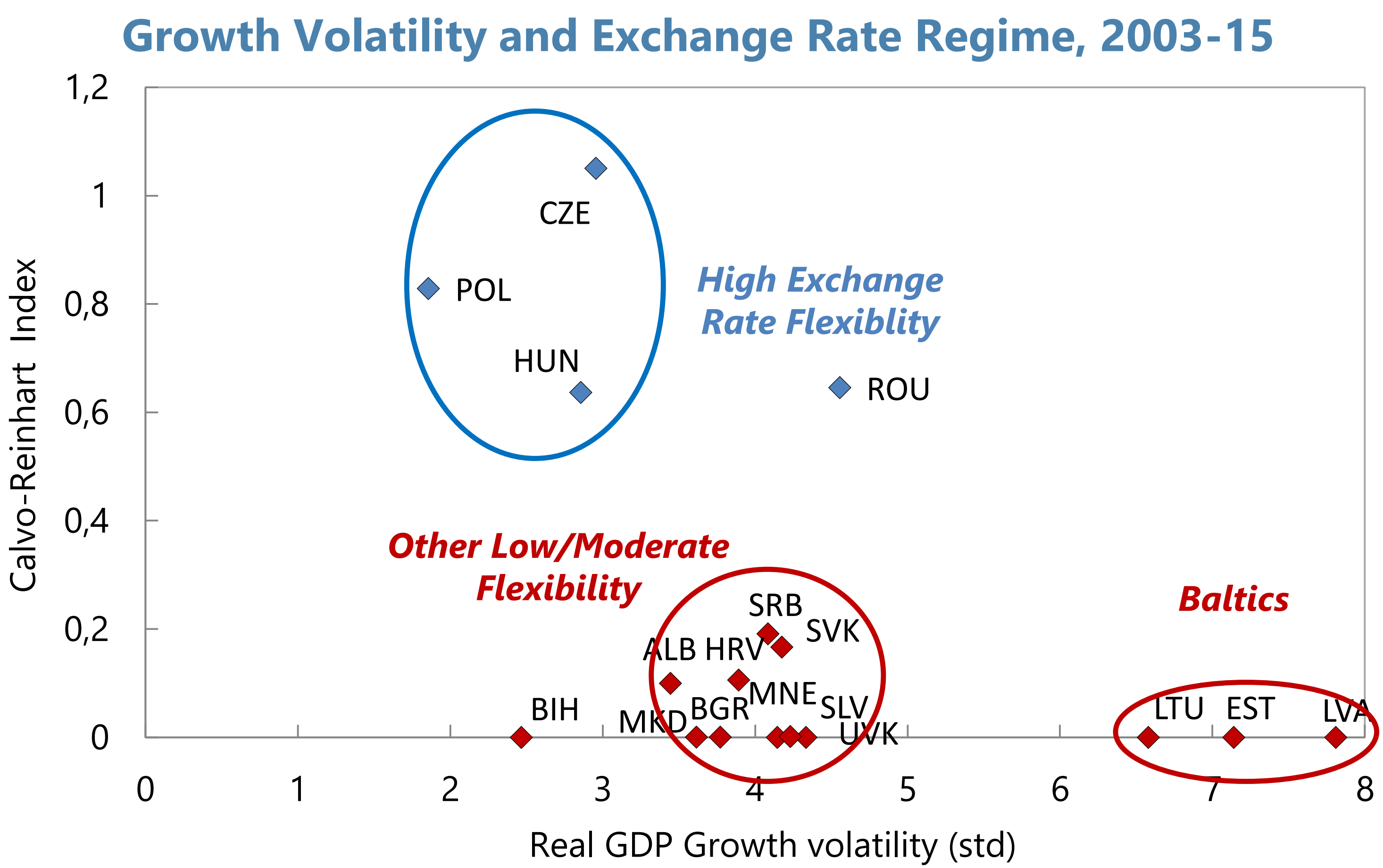
Is the Diversity of Monetary and Exchange Rate Regimes a Good Outcome?

With Stabilization Achieved, the Main Monetary Task is Managing Convergence

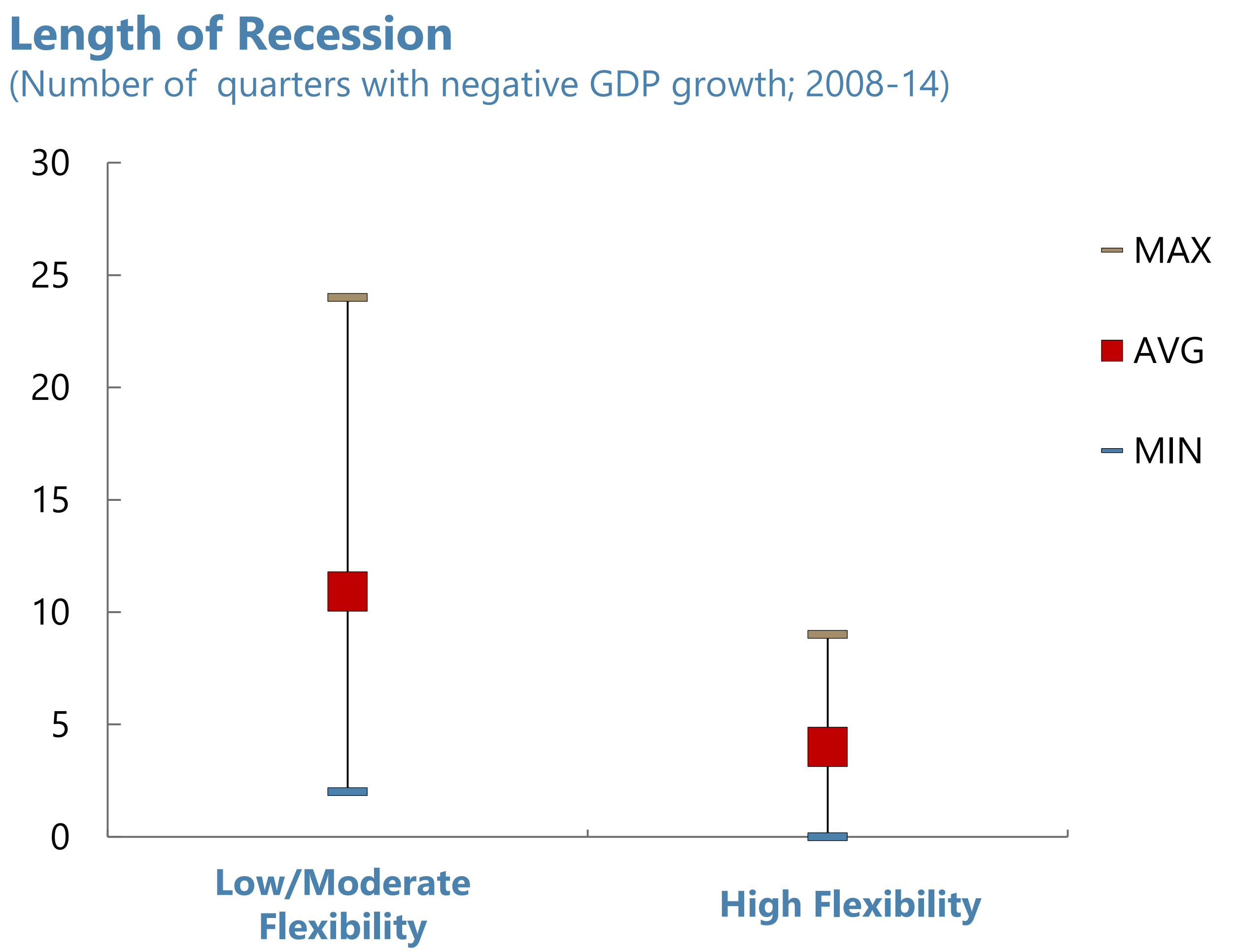
***… and for this monetary autonomy is helpful*:**

- Converging economies grow faster, hence their natural rate of interest is higher
- With a flexible exchange rate/monetary autonomy, central banks can align the monetary policy stance with the natural rate. Permits low inflation, *convergence through nominal exchange rate appreciation*.
- Fixed exchange rate: monetary stance is misaligned by construction, and normally too loose
  - *Convergence through inflation differentials*
  - Inflation depresses real interest rates - risks excessive debt accumulation, boom-bust growth pattern (Backé and Wójcik, 2008).

Convergence is a Bumpy Ride for Countries with Fixed/Quasi-Fixed Exchange Rates …



… with More Pronounced Booms and Deeper and Longer Recessions (IMF, 2015)



Bottom Line: Regimes Reflect Constraints that Formed in the 1990s

- *Unconstrained* economies tend to have flexible exchange rates/ inflation targeting. Good outcome: well suited for convergence.
- Most countries with fixed rate regimes are *constrained* by the traumatic hyperinflation experience of the 1990s.
  - *Conditional on that constraint*, pegging is the right regime: prioritizes monetary stability.
  - But there is a cost: the convergence process is bumpier and more prone to dislocations.

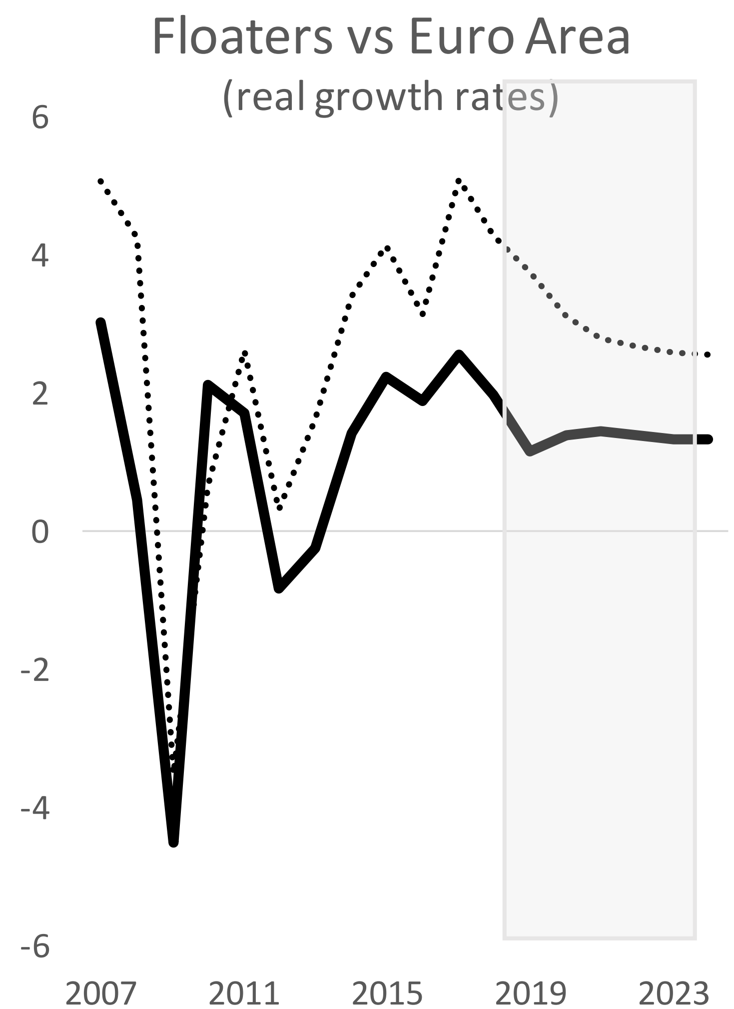
3:

What Can we Say About Euro Adoption?

Countries with Flexible Exchange Rates

<u>Convergence is still ongoing</u>

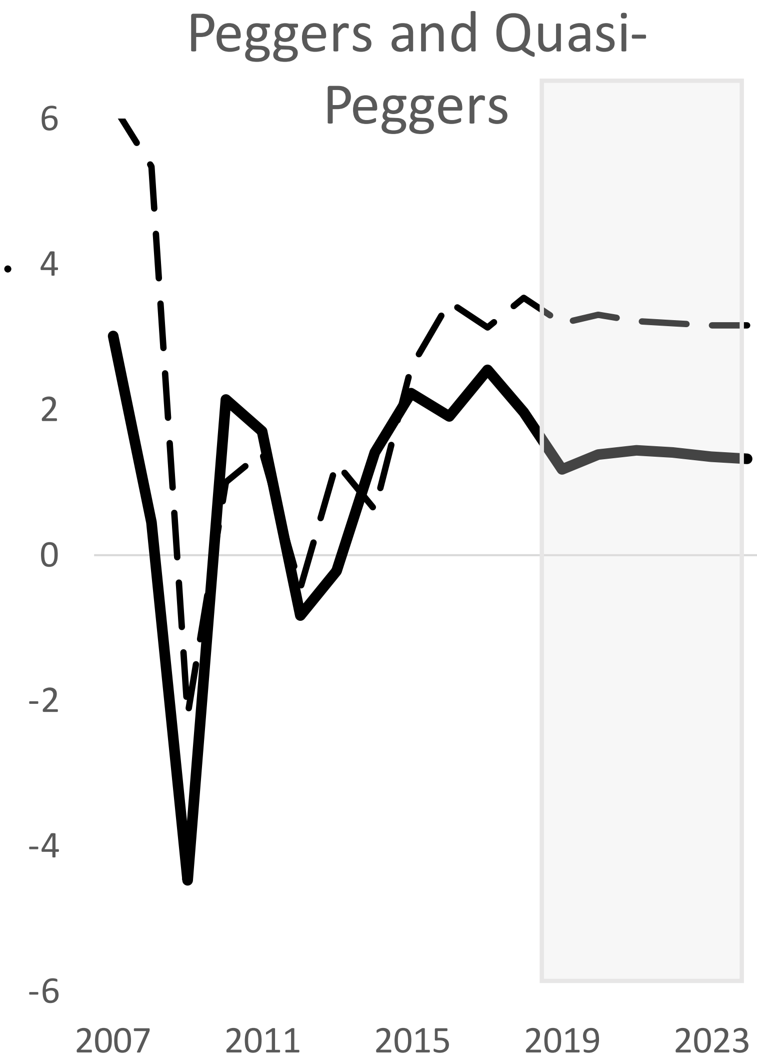
- Monetary autonomy remains a plus.
- Solid economic rationale for remaining outside the euro area, for now.



Countries with Fixed/Quasi-Fixed Exchange Rates

<u>Convergence is also still ongoing</u>…

… but there is much more interest in adopting the euro.



Is Euro Adoption Without Convergence a Good Idea?

Argument in favor:

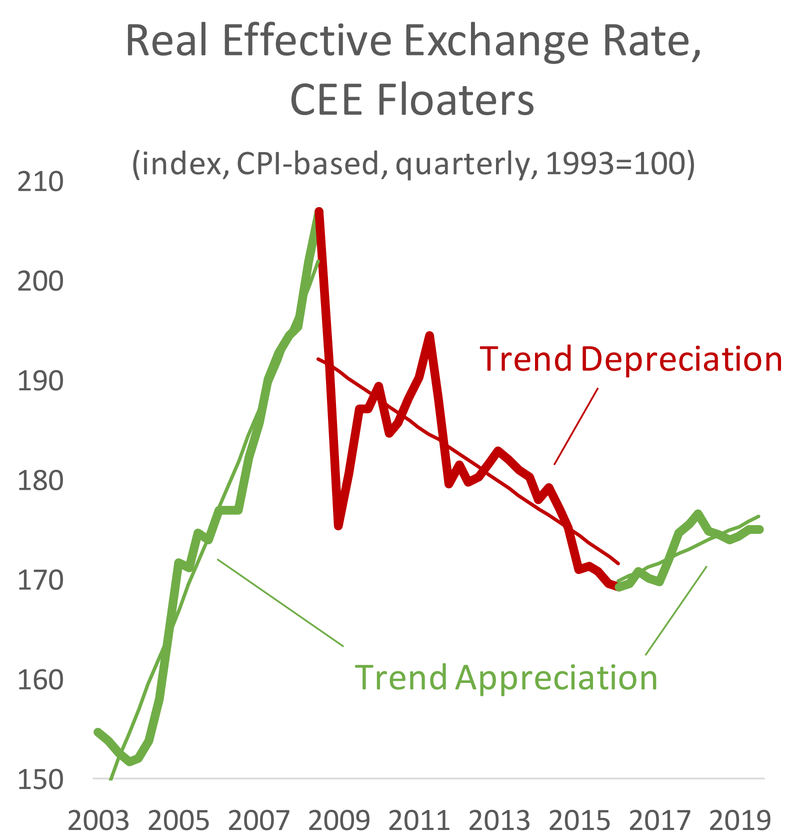
- *There is no monetary autonomy to give up or preserve*.
- With the euro, countries *obtain a trusted currency.* Greatly facilitates macroeconomic management: no more deposits in FX, no need to hold reserves, institutionalized access to euro liquidity

Argument for caution:

- Euro adoption is irreversible.

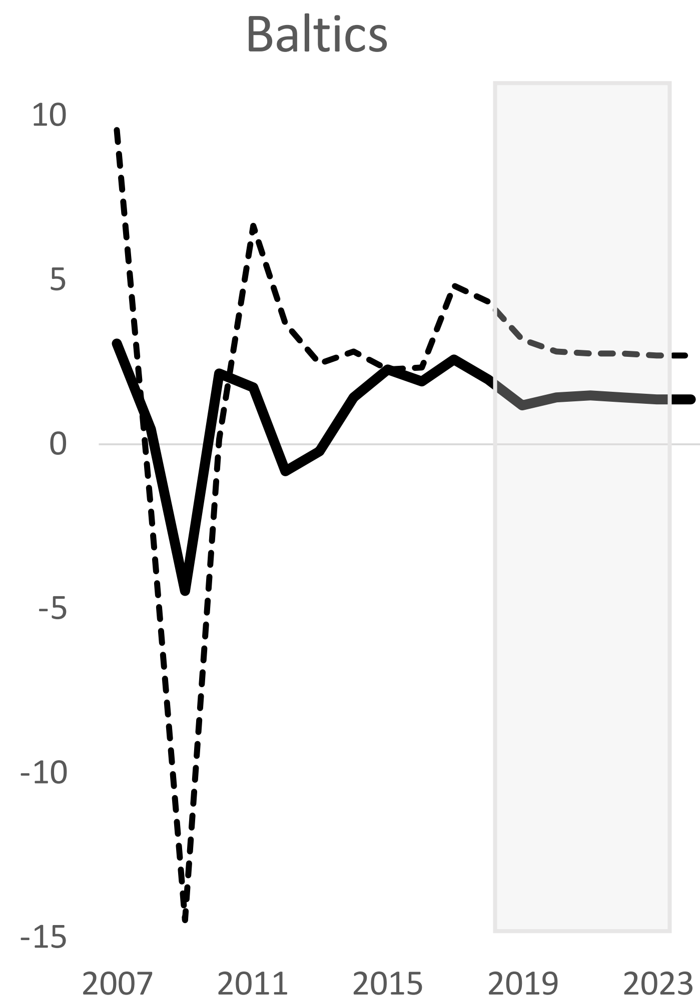
… or Should Countries Aim for (More) Exchange Rate Flexibility Going Forward?

- *Hyperinflation legacy* has not disappeared….
- … but experience from elsewhere (Latin America) suggests that it takes 20-30 years for the grip of past hyperinflation to loosen.
- Resumption of convergence/ *ap*preciation expectations should help.
- Some economies may be too small to make floating worthwhile.



Note: The Baltics Adopted the Euro without Having Floated

- … even though convergence is still ongoing also there.
- So far so good:
  - ➢ While wage and price pressures have returned (→ convergence with a fixed exchange rate)
  - ➢ … financial imbalances have not (yet) reemerged.
  - ➢ Lesson from the crisis: strong macro-prudential frameworks.



Thank you