



EUROPEAN CENTER

Newsletter 2001/1

Introduction

The European Center of the International Center for Economic Growth (ICEG) will release periodically its Newsletter, in which we would like to inform the recipients about the latest research outcomes, new research and country programs, upcoming events organized by the center. More information about the activities, including most of the research output in downloadable format can be obtained from our web-site at www.icegec.org.

We would be pleased to receive comments on the newsletter, the web-site and especially on the programs and their outputs. In case you would like to write to us on these issues, please send the technical information to the web-master at webmaster@icegec.org, while the remarks, notes and questions to the office address at office@icegec.org.

Conference Report

Alternatives for Exchange Rate Regime in Pre-Accession Economies

The final meeting within the research program ‘Alternatives of Exchange Rate Arrangements for Advanced Transition Economies’ funded by the PHARE-ACE Program of the European Union took place on September 20-21 in Vienna at the Institute for Advanced Studies (IHS). The meeting was a conference allowing the partners to present their final research findings in their project discussing the major underlying exchange rate policy issues and expected challenges by the advanced pre-accession economies.

Éva Várhegyi described in her presentation the evolution of the Hungarian exchange rate policy under the pre-announced crawling peg regime and the recent

developments following the shift towards managed floating. In analyzing the costs and benefits of the crawling peg regime, she pointed to the role the crawl played in strengthening the credibility of monetary policy, increasing fiscal discipline, and in allowing the central bank to fight simultaneously against inflation and improve the competitiveness of tradable goods sector. At the same time the crawling peg regime contributed to the emergence of strong backward looking expectations, inertial price increases, sizeable speculative capital inflows, which hampered disinflation and increased its costs. The shift to managed float was in line with the experience of other advanced transition economies and was expected to allow more room for monetary policy and support the convergence of inflation towards the EU levels.

Miroslav Beblavy analyzed the evolution of the Slovak exchange rate regime. In his contribution he pointed to the stages of macroeconomic and exchange rate developments before the currency crisis of September 1998, which was mostly a home made crisis according to the author. The currency crisis resulted however in the shift of the exchange rate regime from the earlier peg to managed float. This shift was also accompanied by strong macroeconomic adjustment centered around fiscal and incomes policies with the aim of improving the unsustainable current account and fiscal balances. Mr. Beblavy described the evolution of the exchange rate regime, the changes in monetary arrangement from monetary to inflation targeting and its impact on central bank policies.

Pawel. Kowalewski presented a paper on the Polish exchange rate problems with a critical approach towards the current policy of appreciating Zloty. In his contribution Mr. Kowalewski described the evolution of the Polish exchange rate arrangement since the first stabilization policies. He mentioned that the gradual increase of flexibility was a necessary measure, as the country had to proceed with disinflation and to cope with high current account deficit, coupled with net capital inflows. He questioned, however, whether the shift to the managed float regime was a good decision and whether the costs weren't too high, as the policy of letting the Zloty appreciate contributes to the slow-down of export growth, may have adverse impact on the current account balance and spill-over to the economic growth, which will be the lowest this year in the last 8 years.

Vladimir Lavrac evaluated the experiences of Slovenia with exchange rate regime, which have been special, as it has adopted since the beginning of transition managed floating. Mr. Lavrac's presentation discussed in detail the lessons the monetary authorities have accumulated

with the use of managed floating, mentioning that both the macroeconomic record and the evolution of exchange rate indicators have justified the initial choice and later reliance of monetary authorities. While the central bank may keep this arrangement till the expected EU and later ERM-II membership, Mr. Lavrac pointed to the difficulties stemming from the liberalization of capital flows, the slow-down in disinflation process, and the high exposure to exogenous shocks, which is unavoidable, given the size of the economy.

Urmas Sepp and Matt Randveer elaborated the Estonian experiences, trying to assess the performance of the currency board arrangement in Estonia and to determine how post-shock adjustments work in such an economy. In their presentation they described the rationale for choosing currency board and the macroeconomic performance under it. They have analyzed the transmission channels and concluded that the interest rate channel is more influential, than the exchange rate one. They have simulated the adjustment of the CBA to an exogenous shock and then described the actual performance of the economy under the major shock it was hit, the Russian currency crisis. Finally, the presentation discussed in the light of legal and institutional aspects of expected EMU membership and the conflicts between the nominal and real convergence, the options available for policy makers in Estonia. The conclusion was that Estonia should keep the currency board arrangement until her full membership in the EMU, as this is acceptable on legal grounds and feasible on economic one.

Peter Backé contributed with a paper discussing the price developments and their influence on exchange rate policies in pre-accession economies. He mentioned, that the process of price convergence is strong, and it has exposed the economies in question to different extent. Mr. Backé

determined three major sources of price convergence. The first is a transitional one, related to the changes in the administrative prices and liberalization of remaining regulated ones. The another source is related to the process of catching up and is associated with the Balassa-Samuelson-impact. The last major source of price increases is linked to the integration process of these economies to the European Union and is associated with the increase of agricultural prices, fiscal expenditures related to the integration.

Cezary Wójcik presented a paper dealing with the issue of Euroisation in general, and then addressing the feasibility and desirability of its adoption for Poland. The first part of his presentation emphasized the major costs and benefits stemming from giving up ones national currency and surrendering its own monetary policy. The presentation emphasized that benefits accrue from greater financial integration, decline of interest rates and transactions costs, but these benefits are outweighed by the costs in the form of loss of seignorage and lender of last resort, increased exposure to exogenous shocks, the lack of adjustment possibility after giving up ones national currency. The final conclusion of the author was therefore that Poland should avoid euroising its currency as a mean of promoting the accession to the European Monetary Union.

Pál Gáspár presented a paper assessing the relationship between real and nominal convergence in these economies and their impact on the choice of the exchange rate regime. In the process of catching up there are three different convergence trends: the real convergence, which means the narrowing of differences in price and wage levels, per capital incomes, actual and equilibrium exchange rate levels, the nominal one presented in meeting the Maastricht criteria and the structural one most closely related to the meeting of the OCA criteria. He showed that while real

and nominal convergence may stimulate each other, in several aspects there are trade-offs between the two. Based on them the presentation assessed the viability of three alternative exchange rate arrangements prior to the EMU membership (hard peg, soft peg and floating) and concluded that the more flexible arrangements can help in mitigating these trade offs and promote better both real and nominal convergence.

Andreas Freytag described in his presentation the exchange rate alternatives available for these economies and the link between exchange rate regime and monetary arrangement. His presentation emphasized that the choice of the exchange rate regime plays an important, but not exclusive role in the policy mix of applicant economies. The theoretical considerations and the empirical evidence suggest that legal monetary commitments and the institutional framework and the match between them are equally important. Based on this, any choice of the exchange rate regime should be built on the analysis of this relationship and the presenter argued for considering another option for the applicant economies: a common strategy with a floating or fixed exchange rate towards the Euro, a strategy similar to the EMS II.

In his second contribution *Miroslav Beblavy* described the foreign exchange rate policies and their outcomes in 4 pre-accession economies as a part of monetary policy framework. His empirical assessment contradicted to the hollowing out hypothesis as these economies have consistently pursued intermediate foreign exchange rate regimes. The major reason behind this choice is related to the role exchange rate regimes played in the process of disinflation and preserving external competitiveness. The empirical part of the paper found that there has been an overall trend real appreciation, but on the other hand the short-term volatility of

the nominal exchange rate could not be attributed to any particular exchange rate regime.

In closing the conference *Paweł Kowalewski* and *Pál Gáspár* gave a summary presentation of the major findings of the research program. They describe the major stages of the evolution in the exchange rate arrangements of these economies starting from the preference towards pegged regimes at the beginning of transition and describing how these initial arrangements have been flexibilised in the majority of applicant economies. The major factors behind this shift to more flexible arrangements stem from increased capital inflows and financial integration, the simultaneous need to proceed with disinflation and maintain external competitiveness, from trend real exchange rate appreciation and changes in relative

price structures. The presentation then described the major factors that affect the choice of exchange rate arrangement for pre-accession economies, including the management of nominal and real convergence, the incorporation of trend appreciation and of the Balassa-Samuelson-effect. Considering the costs and benefits of alternative arrangements the presentation concluded that the preference for more flexible arrangements is justified.

You may find more on this project at our web-site www.icegec.org/Research/ACE. The papers prepared within this project can be downloaded from the web-site. The revised and finalized version of several papers will be available soon as Occasional Papers too.

Conference Announcement

Our center is organizing an international conference within its research program Managing capital Flows in Eastern Europe. The conference will take place on 19-20 October, 2001 in Hotel Inter-Continental in Budapest and will close the research program funded by Ford Foundation. The first conference within that program took place in May, when the initial versions of the studies were presented (more on that at www.icegec.org/Research/Ford).

This final conference is a broader meeting involving besides the contributors several distinguished academic researchers, policy-makers, representatives of international financial institutions. At this meeting the findings of the research project would be discussed in three panels. One panel will discuss the experiences with capital flows in Eastern Europe, analyzing separately the developments in Central Europe and in South-Eastern Europe and in

the countries of former CIS. The second panel would compare the Eastern European experiences the East Asian and Latin American ones, presented at the conference by a senior economist representing each of the regions. The last panel would discuss the issues related to the management of capital flows in a broader and forward looking perspective, focusing on the relationship between capital flows, exchange rate regime, regulation of capital movements and the evolution of the international financial architecture.

More information about the program of the meeting, the list of attendees is available from our web-site. The papers will be downloadable from October 10, 2001 from www.icegec.org/Research/Ford/papers.htm

If you wish to attend the meeting, please e-mail your request to Maria Thuma on

icegec@matavnet.hu e-mail address or send a fax to (+36)-1-248-1161.

Annul Report on Macroeconomic Developments in Eastern Europe

The European Center is preparing its first overview of macroeconomic developments in Eastern Europe under its Macroeconomic Monitoring program. The Macroeconomic Monitors provide a periodical overview of the major macroeconomic developments in the individual Eastern and Central European economies and the region in general. The recent one provides an assessment of the underlying trends in 2001 and gives a brief forecast for 2002. The report presents the

13 country analyses in unified format, so the major trends are comparable across the individual economies, while the regional overview determines those region wide trends that shape the macroeconomic developments of these economies in general.

The report will be released in mid October, and its full content, and the attached database will be downloadable from October 24 from our web-site at www.icegec.org/Monitoring.

For more information on our studies please contact either our web-site or the office at icegec@matavnet.hu or office@icegec.org.

For additional information on the activities of ICEG European Center please contact Pál Gáspár, the Regional Director at pgaspar@icegec.org