Inflation in the Nineties: The Case of Visegrad CPEs

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Based on a paper:
Stepanek, P.-Zamrazilova, E.: The impacts of initial conditions and different ways to price stabilizations in Visegrad countries (forthcoming)

EABH, Prague, May 15, 2015
The „original sin“ – no market institutions (central banks, financial system, property rights), non-market price systems, distorted price structures was common for CPEs, but

- Differences in the scope of centralization and the scope of price distortions at the start of transformation
  - CR and SK - full centralization, all prices set administratively
  - HU - more than half of the consumer prices was free of control
  - PL - liberalization of prices started in the 80s
- Differences in the importance of foreign trade for the economy
  - In CR and HU the role of foreign trade higher than in PL and SK
- Different strategies of individual countries
- Dilemma: „Gradualism or big bang“?
First stage of liberalization, 1990 - 1992

<table>
<thead>
<tr>
<th>ER Regime</th>
<th>Czechoslovakia</th>
<th>Hungary</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-1992</td>
<td>Fixed ER with fluctuation band +/- 1 %</td>
<td>Fixed ER with fluctuation band +/- 1 %</td>
<td>crawling peg with changes of parity</td>
</tr>
<tr>
<td></td>
<td>10/90 -35 % devaluation, 12/90 - 15 % dev.</td>
<td>1/91 - 15 % devaluation</td>
<td>Q1/90 - initial devaluations</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>CPI (%)</th>
<th>Czechoslovakia</th>
<th>Hungary</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>9.7</td>
<td>28.9</td>
<td>585.8</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>56.6</td>
<td>35.2</td>
<td>76.1</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>11.2</td>
<td>23.7</td>
<td>46.3</td>
<td></td>
</tr>
</tbody>
</table>

- Poland: the leader in almost complete price liberalization (1989 - 1990)
- Czechoslovakia: price liberalization in 1991
- Hungary: gradualist program in 1991
- In CZ and PL, the initial price shock turned out much larger than expected (in CZ 30 % expected) in PL due to monetary overhang, in CZ due to devaluation mostly
- In CZ prices relatively stabilized by mid 1991
After initial stabilization, inflation remained stubbornly high:

- Above 20% level in PL and HU driven by inflationary expectations, emergence of spirals (price/wage and price/exchange rate), declining to around 10% at the end of decade.
- Close to 10% level in SK and CZ (CZ was the first CPE to reach low levels of inflation comparable to developed peers).

Differences in inflation:

- Economic policy?
- Historical track record?
- Others?
Different ER and MP strategies

„Corner solution“: fixed pegs, currency boards versus free floating
• From hard pegs (controlling hyper inflation) to more flexible ER regimes and back to hard pegs...
• Pegged regimes have undergone changes (anchor currency/ies, moves from fix to crawling pegs, widening of band,...

Hungary
• March 2005 crawling peg with preannounced rate of future devaluation (ER as an intermediate target of monetary policy)
• Inflation targeting 2001

Poland
• May 1995 crawling band (+/- 7.5 %) gradual extension to (+/- 15 %), of fluctuation band – free floating as of 2000
• Inflation targeting 1998

Czech Republic
• Until May 1997 mixed scheme of MP (M2 under fixed ER), followed by monetary crisis
• First to admit with Gerald Bouey: „We did not abandon monetary targets, they abandoned us“ ...
• Inflation targeting 1998 (December 1997)
• First CPE to adopt new MP regime – a key to final desinflation?
Czech monetary crisis (May 1997)

Pegged exchange rate regimes are a very dangerous strategy for EMEs and can make financial crises more likely…(Mishkin, 1999)

- Fixed ER & liberalization of financial account promoted the short-term capital inflow
- Signs of overheating visible as of 1996, CNB tightened monetary policy H2/96
- Speculative attack on CZK (partly triggered by Asian contagion)
- Crisis revealed the weaknesses of monetary policy regime – two goals (M2 and ER)
- Managed floating introduced (end of May 1997)
- Introduction of Inflation targeting at the end of 1997
Balassa-Samuelsson effect (survey of studies)

<table>
<thead>
<tr>
<th>Contribution to CPI average in p.p.</th>
<th>CZ</th>
<th>SK</th>
<th>PL</th>
<th>HU</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conventional methods (OLS, etc.)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Backé et al., 2003</td>
<td>0,8</td>
<td></td>
<td>9,8</td>
<td>4,9</td>
</tr>
<tr>
<td>Golinelli and Orsi, 2002</td>
<td>4,5</td>
<td>5,3</td>
<td>2,3</td>
<td></td>
</tr>
<tr>
<td>Lojschová, 2003</td>
<td>1,9</td>
<td>2,5</td>
<td>3,4</td>
<td>2,8</td>
</tr>
<tr>
<td>Roseti, 2002</td>
<td>1,4</td>
<td></td>
<td>4,6</td>
<td>4,3</td>
</tr>
<tr>
<td>Sinn and Reutter, 2001</td>
<td>3,1</td>
<td></td>
<td>4,4</td>
<td>7,1</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>2,3</td>
<td>2,5</td>
<td>5,5</td>
<td>4,3</td>
</tr>
<tr>
<td><strong>More sophisticated methods</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Égert, 2002</td>
<td>0,6</td>
<td>-0,4</td>
<td>2,3</td>
<td>1,8</td>
</tr>
<tr>
<td>Égert et al., 2003</td>
<td></td>
<td>1,3</td>
<td>2,1</td>
<td>1,2</td>
</tr>
<tr>
<td>Mihaljek and Klau, 2004</td>
<td>0,7</td>
<td>1,5</td>
<td>1,6</td>
<td></td>
</tr>
<tr>
<td>Wagner and Hlouskova, 2004</td>
<td>0,6</td>
<td>0,2</td>
<td>1,1</td>
<td>1,1</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>0,4</td>
<td>0,4</td>
<td>1,7</td>
<td>1,7</td>
</tr>
</tbody>
</table>

- Modern methods (cointegration, etc) provide lower estimates of B-S effect
- Almost all studies show lower B-S effect in CR and SK in comparison with HU and PL (however being also very low)
- Which B-S assumptions were violated?
Economic development level and comparative price level

Long-term discrepancy between EDL and CPL in the CR was mostly a consequence of continuing price distortions (delayed price liberalization in housing, health care, education) – corresponding to minor B-S effect
To sum up: lessons learned

- Gradualism does not represent protection against economic and social shocks
- The optimal ER regimes vary over time
- Crawling pegs (as disinflation tool) work until around 10% inflation
- Dual regimes of monetary policy do not work in the longer term – a choice between money supply and ER targeting should have to be done (the Czech case could serve as an example)
- Liberalization of capital flows under fixed exchange rate (erratic capital movements) - proper timing?
- „Protective“ stance of monetary policy does not work indefinitely if not accompanied by structural reforms – may be even counter-productive


Thank you for attention

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