

Inflation in the Nineties: The Case of Visegrad CPEs

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

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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“ ?

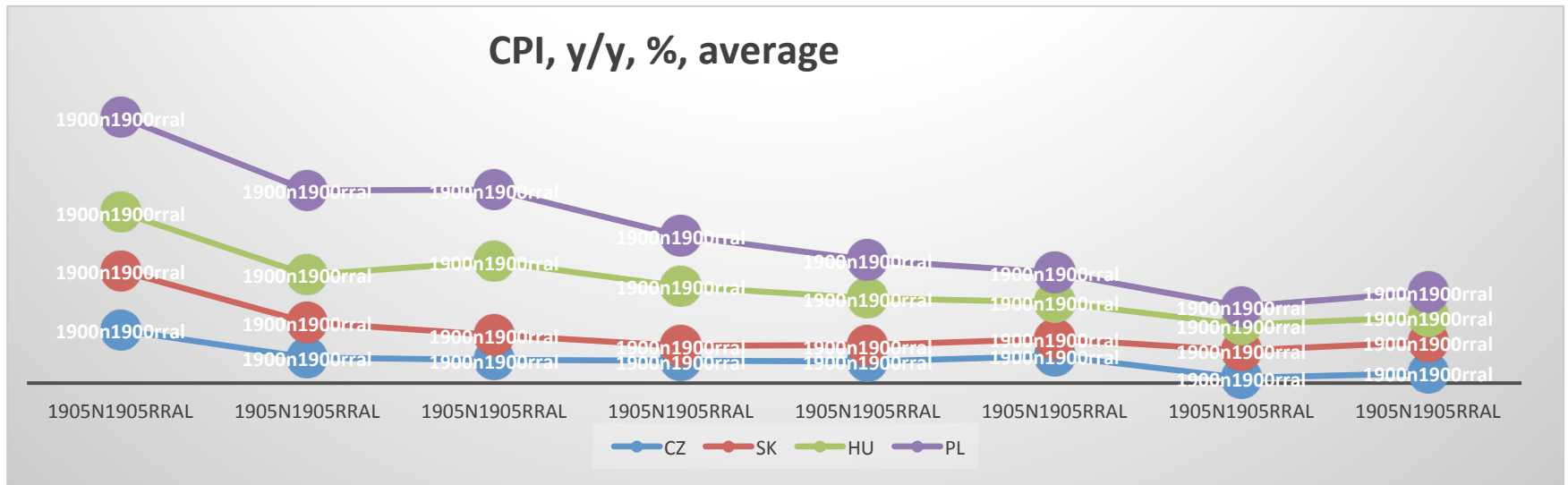
First stage of liberalization, 1990 - 1992

| ER Regime | Czechoslovakia | Hungary | Poland |
|-----------|---|---|---|
| 1990-1992 | Fixed ER with fluctuation band +/- 1 % 10/90 -35 % devaluation, 12/90 - 15 % dev. | Fixed ER with fluctuation band +/- 1 % 1/91 - 15 % devaluation | crawling peg with changes of parity Q1/90 - initial devaluations |

| CPI (%) | Czechoslovakia | Hungary | Poland |
|---------|----------------|---------|--------|
| 1990 | 9.7 | 28.9 | 585.8 |
| 1991 | 56.6 | 35.2 | 76.1 |
| 1992 | 11.2 | 23.7 | 46.3 |

- 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

Struggle for disinflation



- 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

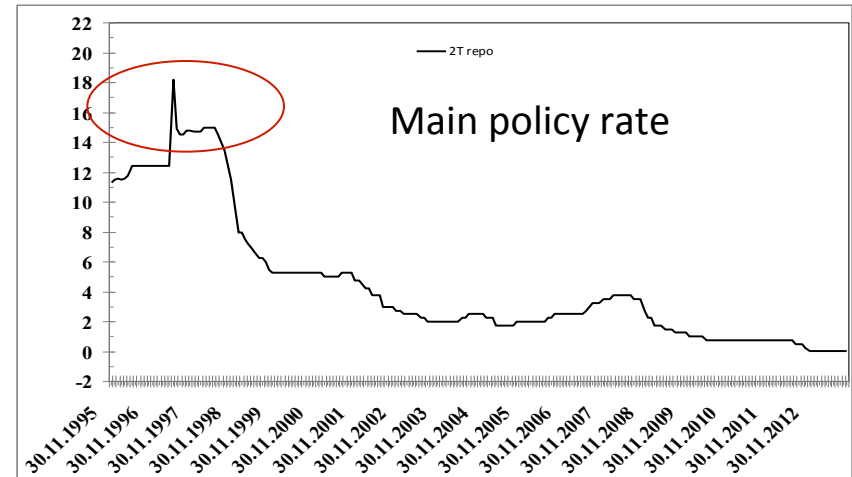
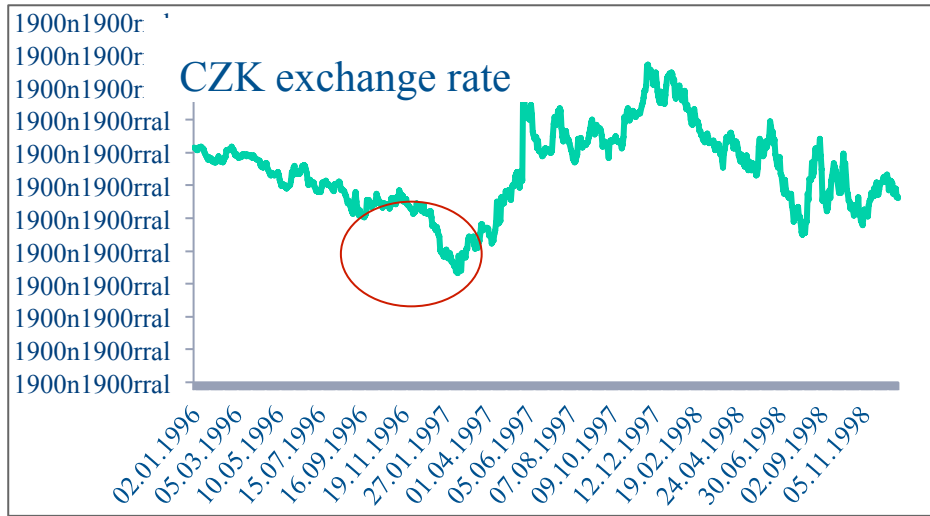
- May 1995 crawling band (+/- 7.5 %) gradual extension to (+/- 15 %), of fluctuation band – free floating as of 2000
- **Inflation targeting 1998**

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)



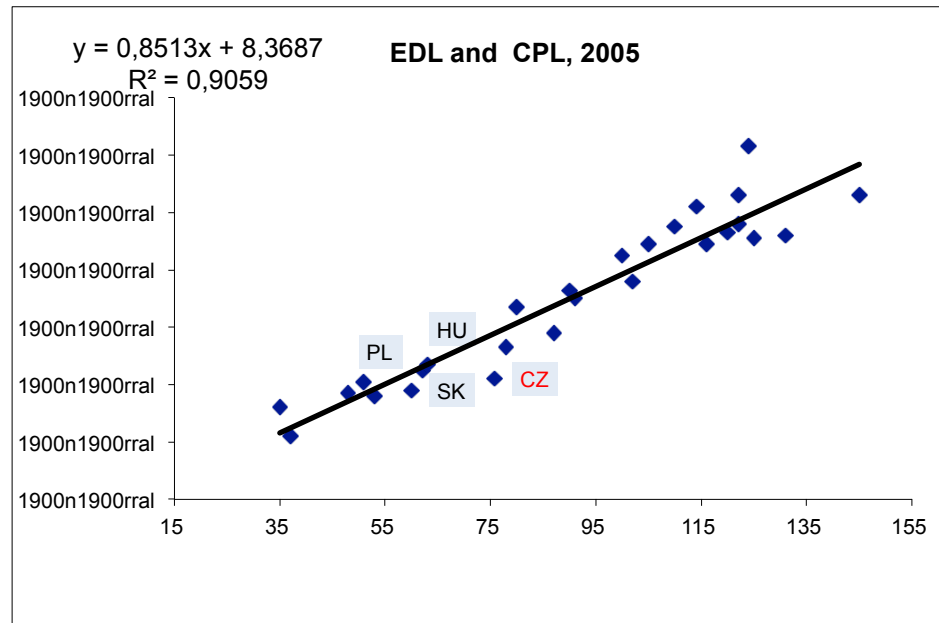
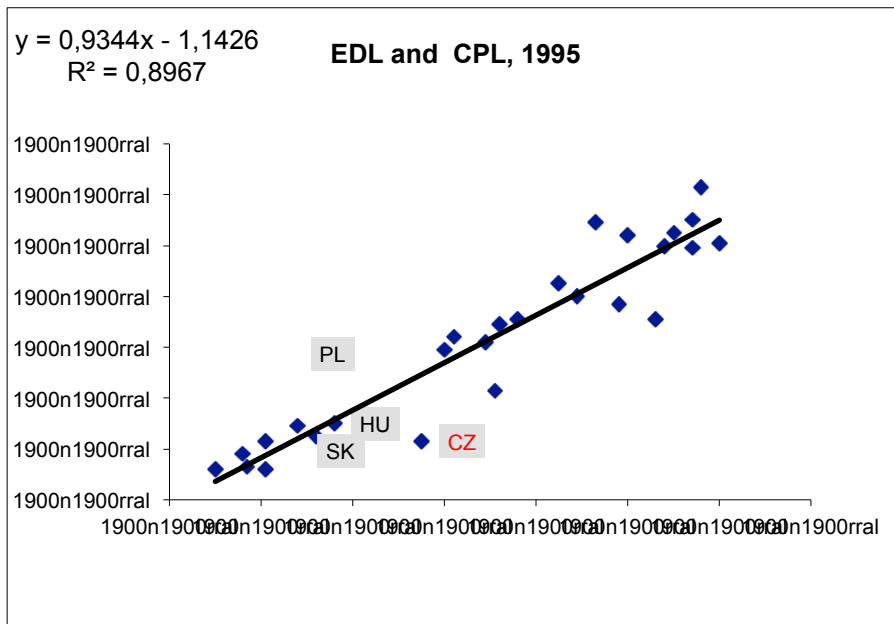
- Fixed ER & liberalization of financial account promoted the short-term capital inflow
- Signs of overheating visible as of 1996, CNB tightened monetary policy H2/96
- Speculative attack on CZK (partly triggered by Asian contagion)
- Crisis revealed the weaknesses of monetary policy regime – two goals (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)

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

- 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

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Thank you for attention

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