

Taking Stock of Monetary and Exchange Rate Regimes in Emerging Europe

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Based on EUR Departmental Paper 03/16,
<https://www.imf.org/external/pubs/ft/dp/2016/eur1603.pdf>

International Monetary Fund
March 2017

Almost any Monetary and Exchange Rate Regime can be Found in CESEE

- **Unilateral use of the euro:** Kosovo, Montenegro
- **Currency boards:** Bosnia & Herzegovina, Bulgaria
- **Managed arrangements:** Croatia, Macedonia
- **Inflation targeting and floating:** Albania, Czech Republic, Hungary, Poland, Romania, Serbia
... but with different degrees of effective exchange rate flexibility (see below)
- **Euro area membership:** Estonia, Latvia, Lithuania, Slovak Republic, Slovenia

A Good Quarter Century After Transition, Time to Take Stock

Questions:

- Why do countries have the Monetary and Exchange Rate Regimes (MEERs) they have?
- Have they fulfilled their objectives?
- Looking ahead, how can monetary regimes assist in addressing the challenges countries are likely to face?
- If a regime looks sub-optimal, could a country switch, and how?

Debate in CESEE is Different from Western Europe

Broad topic is “**fixed vs. floating**” - discussed in Western Europe for the past 40 years (since end of Bretton Woods).

But: **additional factors in Eastern Europe** influence and complicate policy choices.

- Regimes have been shaped by countries' experiences during ***transition from socialism*** in the 1990s.
- Most CESEE economies are ***emerging economies***: often lack (elements of) the institutional setting that is, for the most part, taken for granted in Western Europe.

Geographical Scope

- Countries that are part of the European integration process: EU members, accession/pre-accession countries
- Not CIS
- Also not Turkey – while an accession country, its historical path and current constellation are quite different.

Themes

Stock taking:

- How did MERRs evolve since transition?
- How did MERRs perform?
- What is the rationale behind fixed rate regimes?

Forward looking:

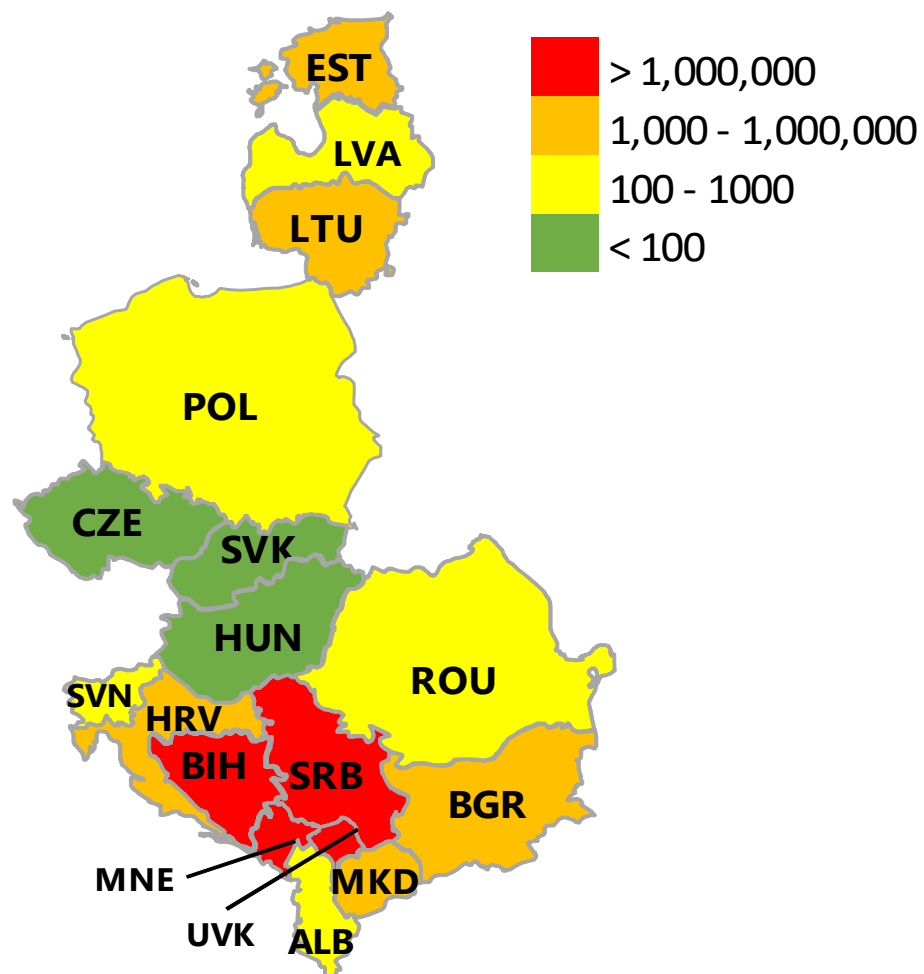
- Monetary strategies going forward

The Past is Critical to Understand the Present

- **Transition and price liberalization in the early 1990s:** all CESEE countries struggle with inflation, and some with hyperinflation: Baltics (1992), former Yugoslavia (1993/94), Bulgaria (1996/97)
- **Exchange rate based stabilization.** Fairly rapid in Baltics/CEE, less rapid in the Balkans
- **Gradual switch to more flexible regimes** starts with the Czech move to inflation targeting in 1997
- **MERRs mostly settled by the early 2000s.** Slovenia (2007), Slovak R. (2009), Baltics (2011-15) adopt the euro

Inflation during Transition

Maximum Annual Inflation During Transition
(percent)

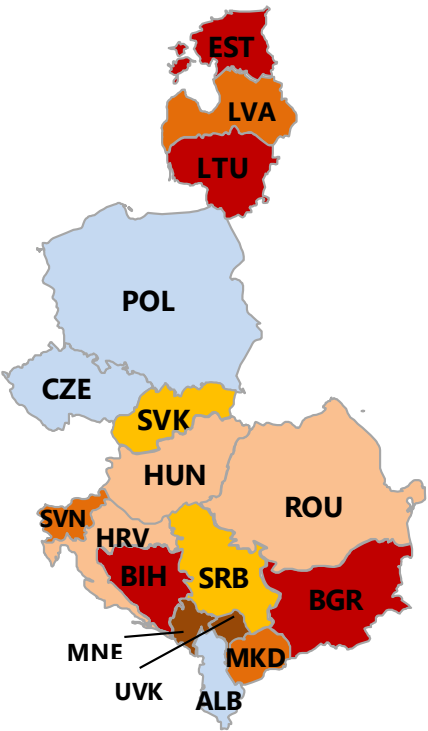
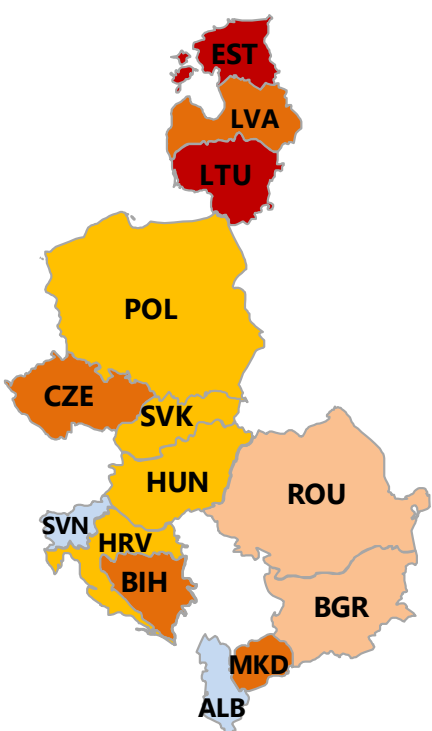
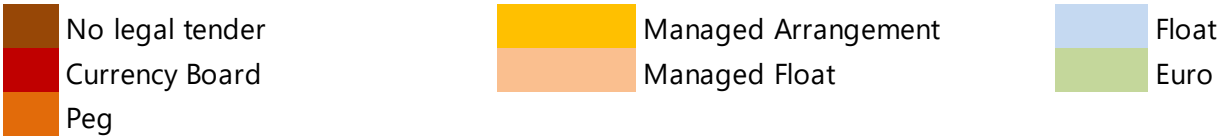


MEERs: IMF Classification

1995

2005

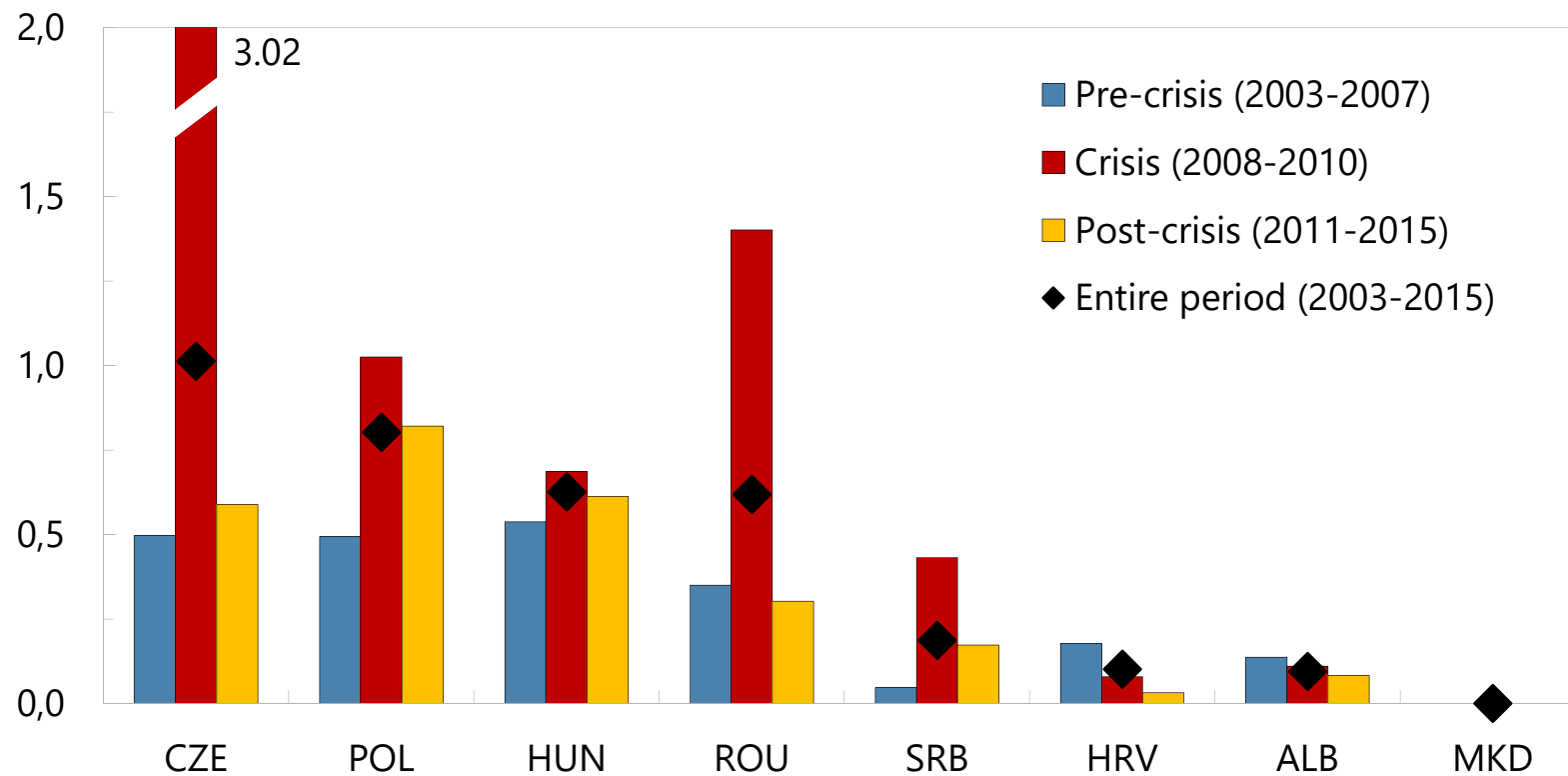
2015



Effective Exchange Rate Flexibility Differs within Floaters

Effective Exchange Rate Flexibility, 2003-15

(Calvo-Reinhart "Fear of Floating" index, average over quarterly values)



Themes

Stock taking:

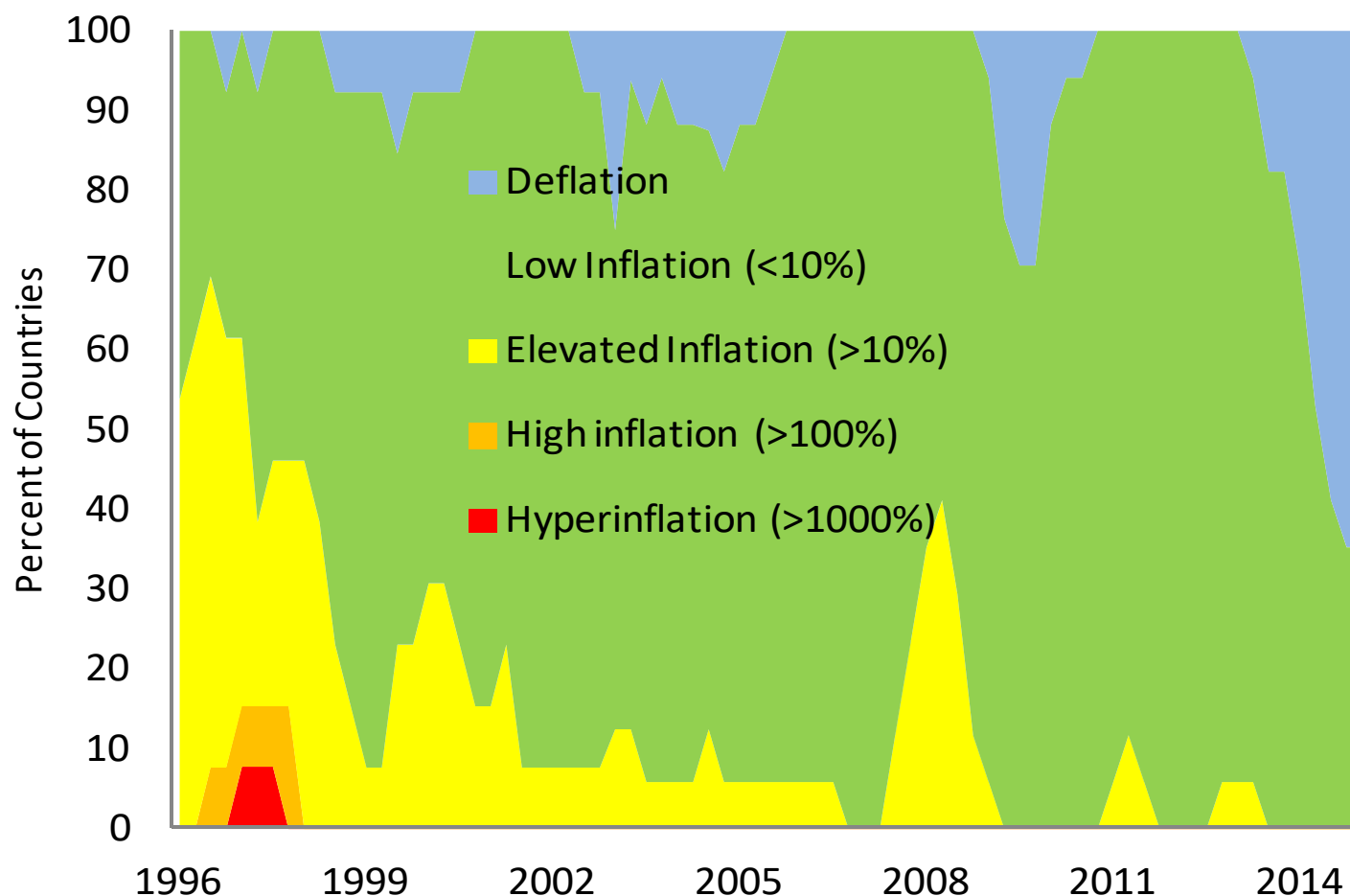
- How did MERRs evolve since transition?
- **How did MERRs perform?**
- What is the rationale behind fixed exchange rate regimes?

Forward looking:

- Monetary strategies going forward

(i) Monetary Stability: Achieved since the late 1990s - with all MERRs

Distribution of Inflation Outcomes, 1996-2015



(ii) Alignment of Monetary Conditions

Focus on 2003-2015/16:

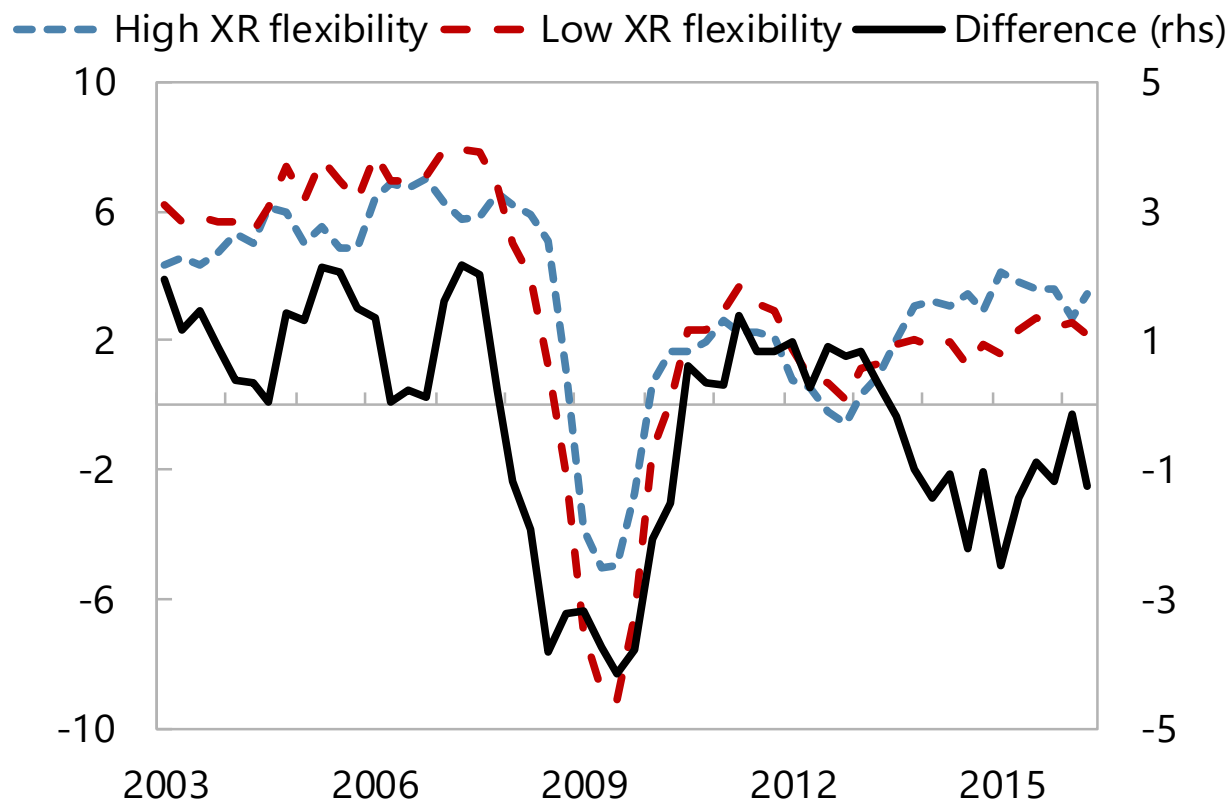
MERRs well established by early 2000s – no more major regime changes other than euro adoption.

Turbulent period that tests MERRs:

- rapid growth and convergence to Western European income levels until 2007/08
- global financial crisis in 2008/09 hits the region hard
- deep recession, gradual recovery thereafter

Boom-and-Bust Growth Pattern More Pronounced with Fixed Rates...

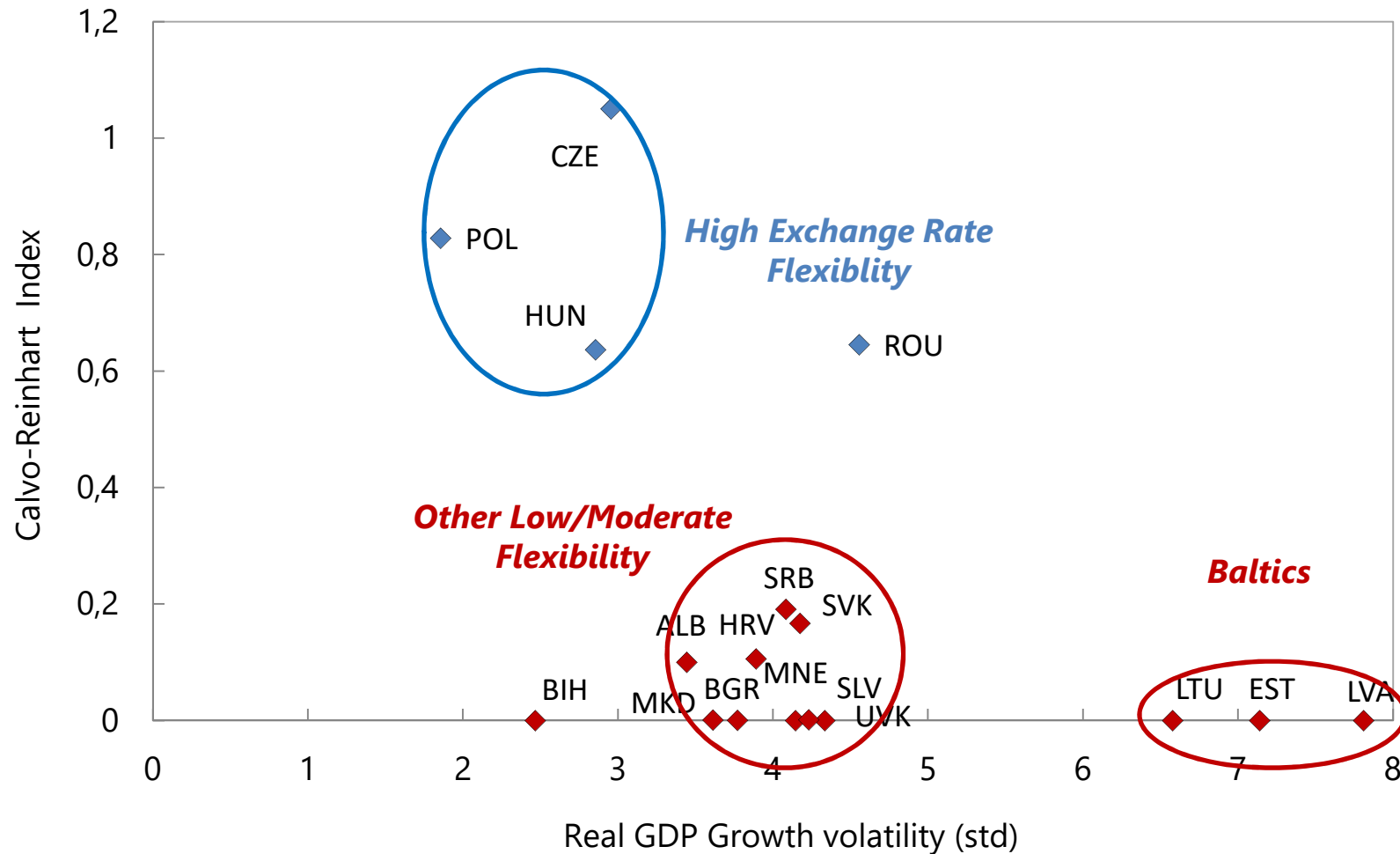
Real GDP Growth, 2003–16



Sources: Haver Analytics; and IMF staff calculations.

... Resulting in *More Volatile Growth*...

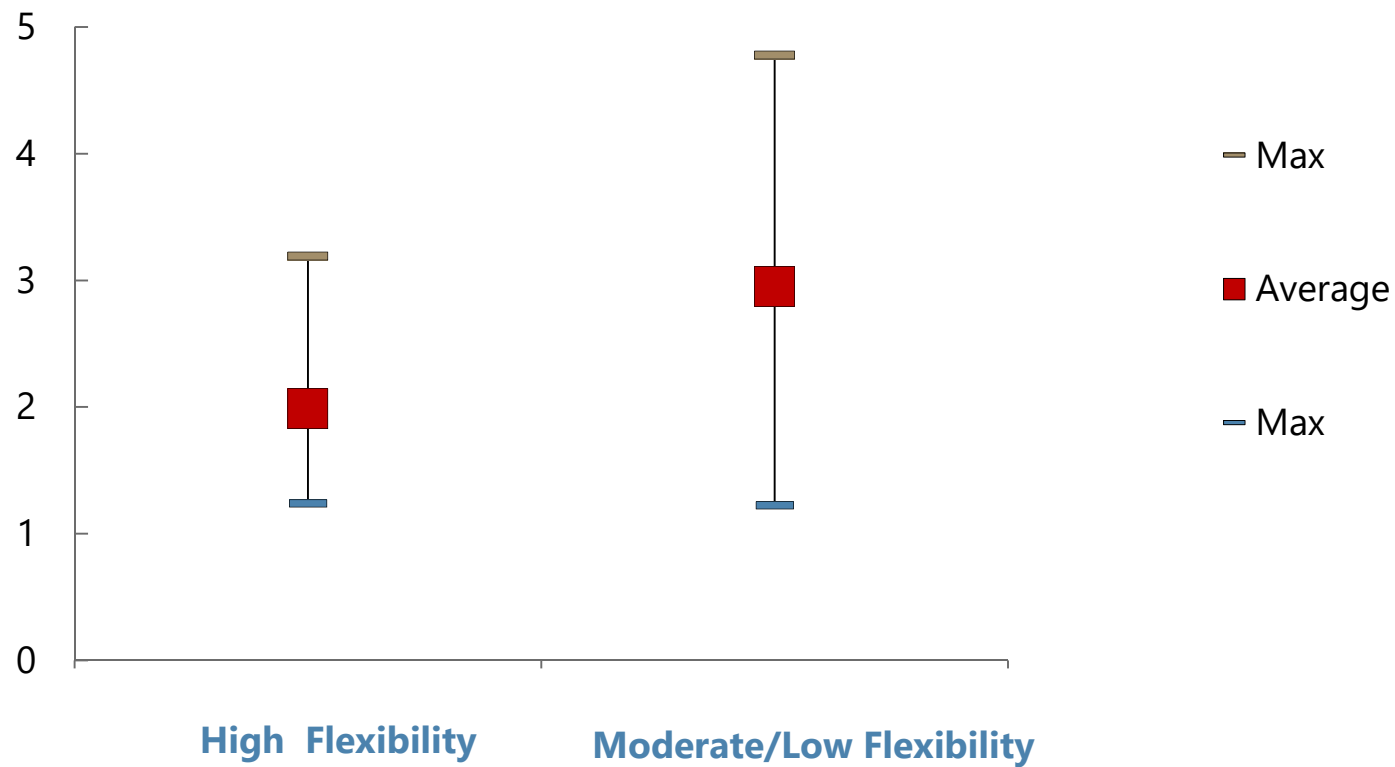
Growth Volatility and Exchange Rate Regime, 2003-15



... and *More Volatile Inflation*.

Inflation Volatility and Exchange Rate Flexibility

(Standard Deviation, 2003-15)



Volatility: a Monetary Interpretation

Transmission mechanism goes through *inflation* and *real interest rates*.

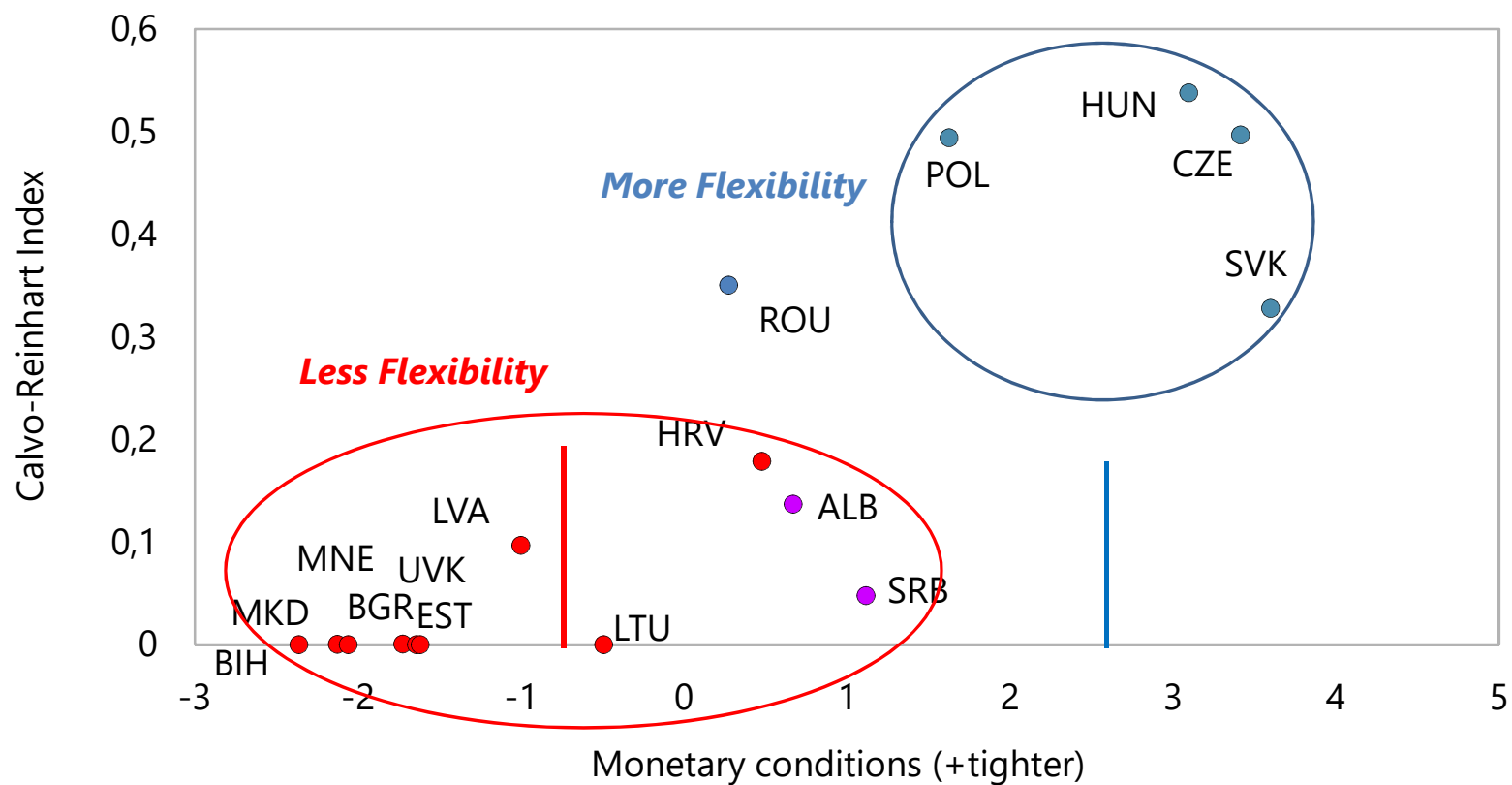
(i) **Floaters:** in boom, nominal exchange rate appreciation keeps inflation low and therefore real interest rates high. Reverse mechanism during the bust.

(ii) **Peggers:** in boom, real appreciation through inflation - reduces interest rates and boosts demand for credit. In bust: deflation pressures *increase* real interest rates.

Note: even limited exchange rate flexibility has been helpful in containing volatility (Albania, Serbia)

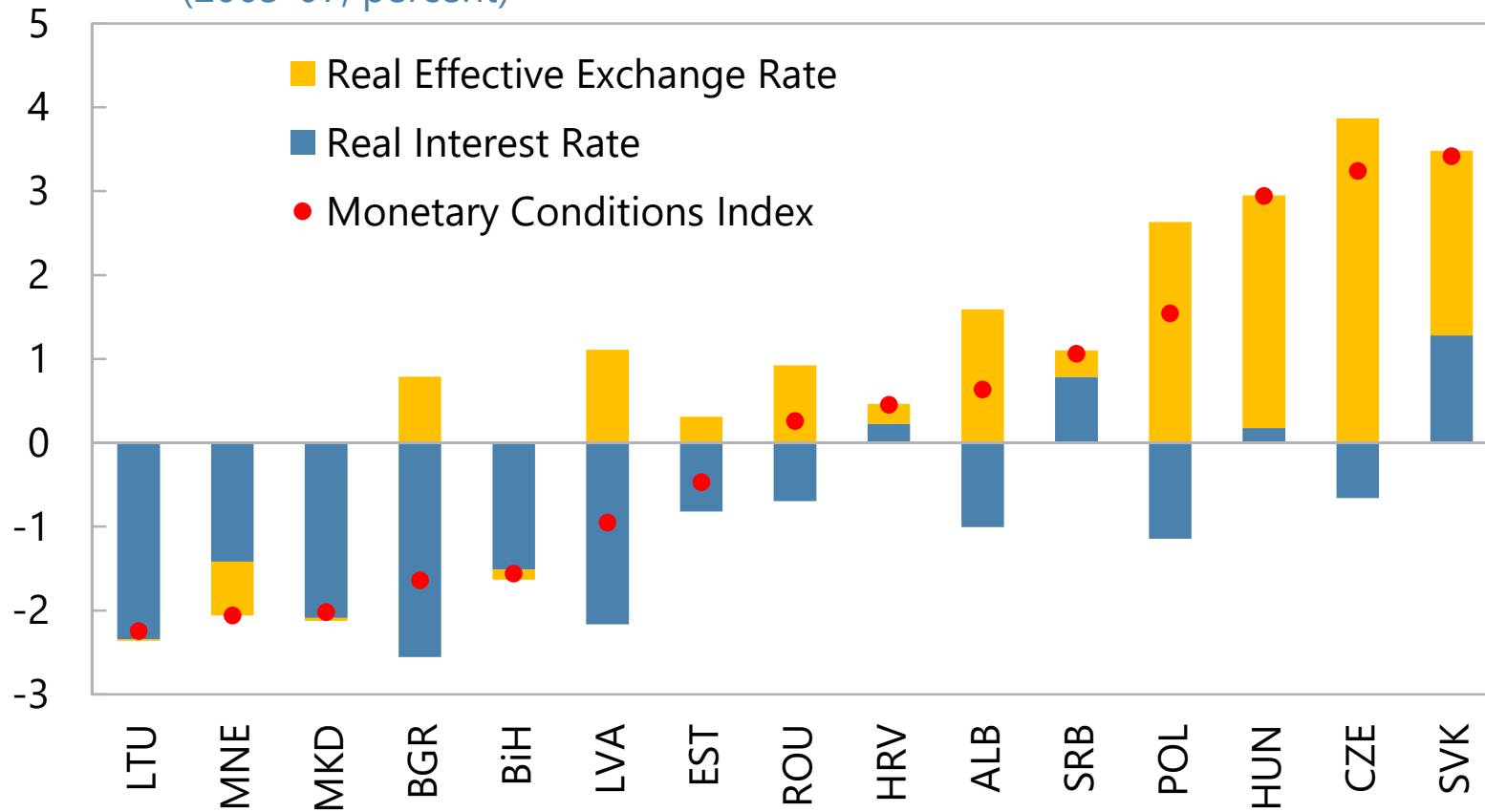
Boom 2003-07: Monetary Conditions for Floaters Tighten...

Effective Exchange Rate Flexibility and Real Monetary Conditions, 2003-07 (average; percent)



...as Exrate Appreciation Keeps Inflation Low and Real Interest Rates High...

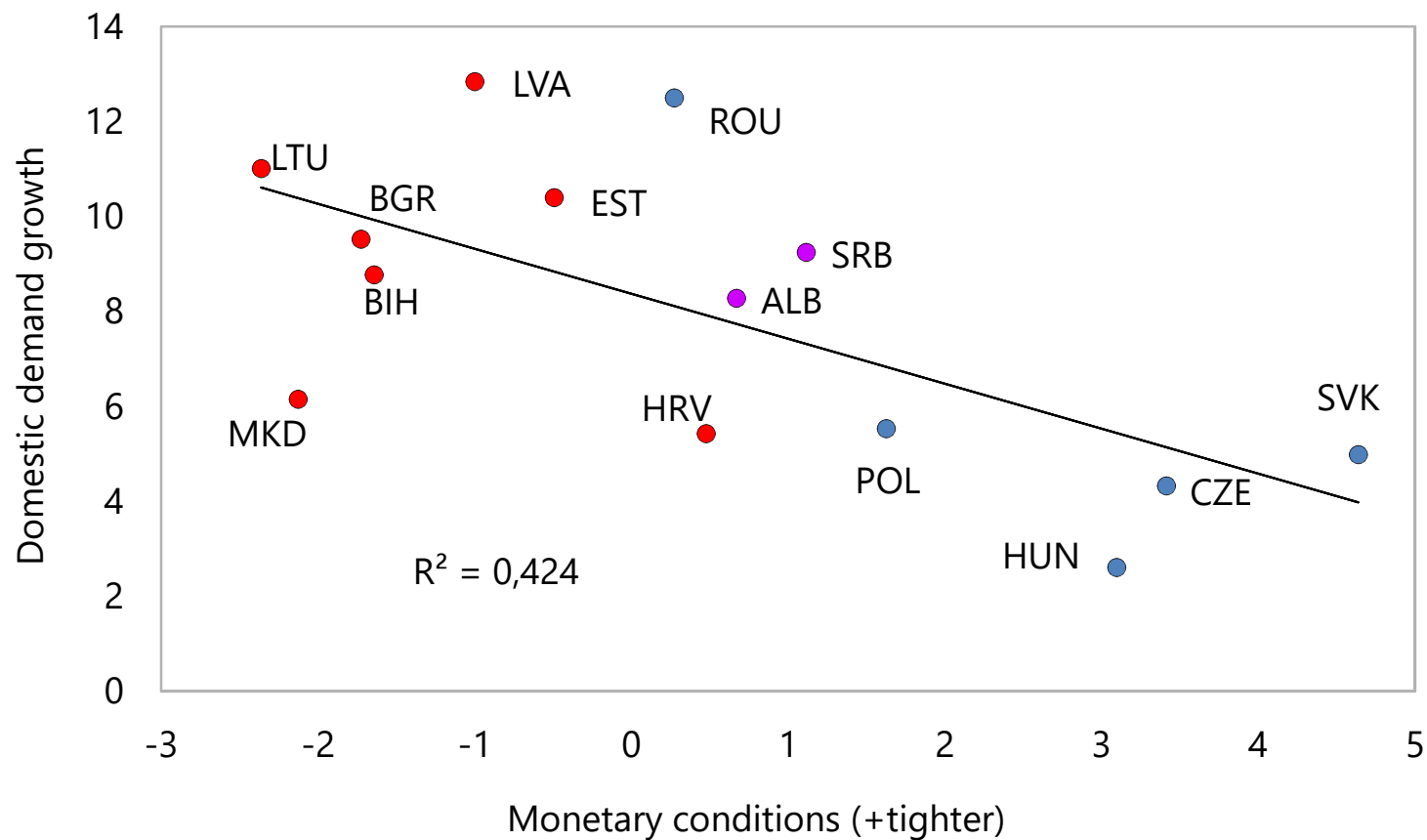
Contributions to Monetary Conditions
(2003-07; percent)



.... thus Containing Credit and Growth Imbalances.

Financial Conditions and Domestic Demand Growth

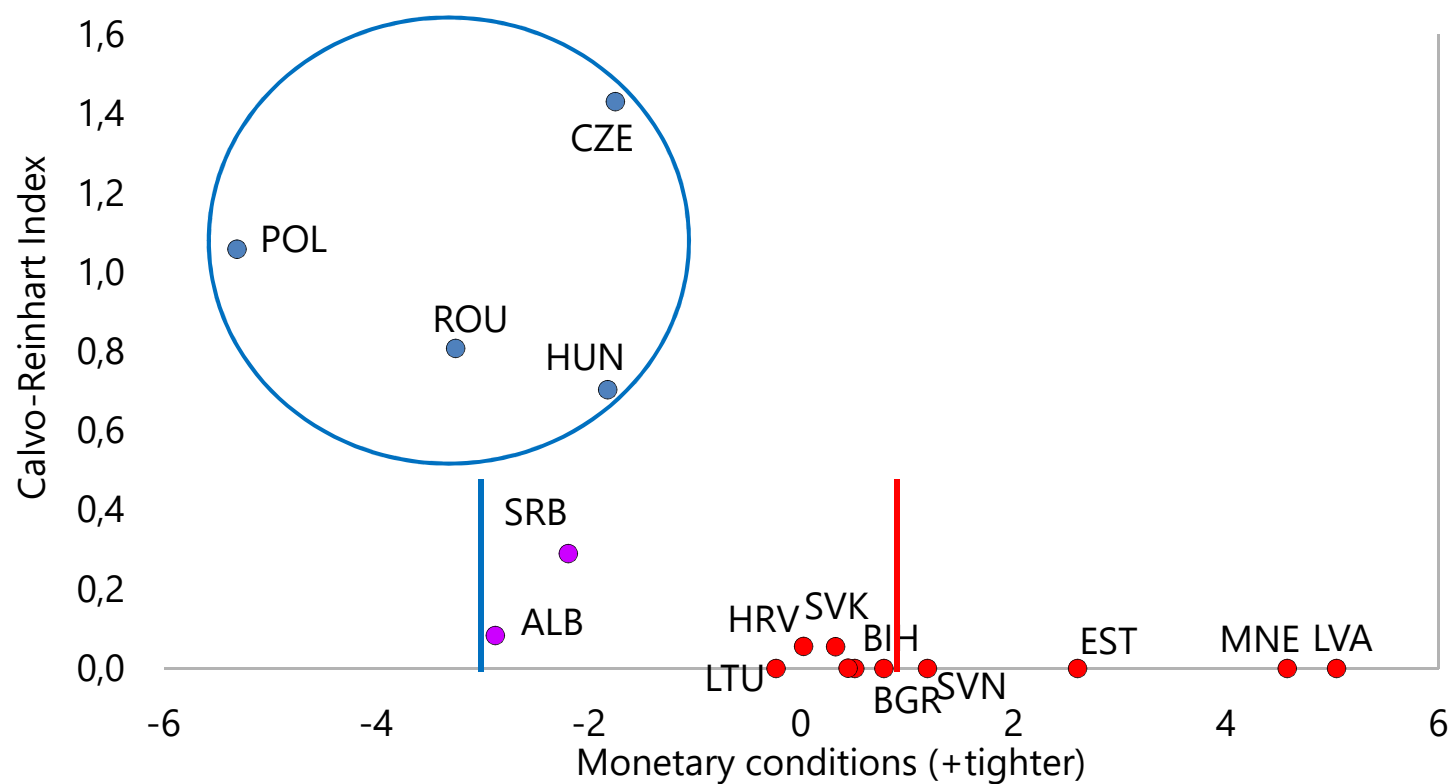
(2003-07 average; percent; low C/R labeled red)



2008-14: Nominal Depreciation Boosts Inflation and Lowers Real Interest Rates

Exchange Rate Regime and Real Monetary Conditions

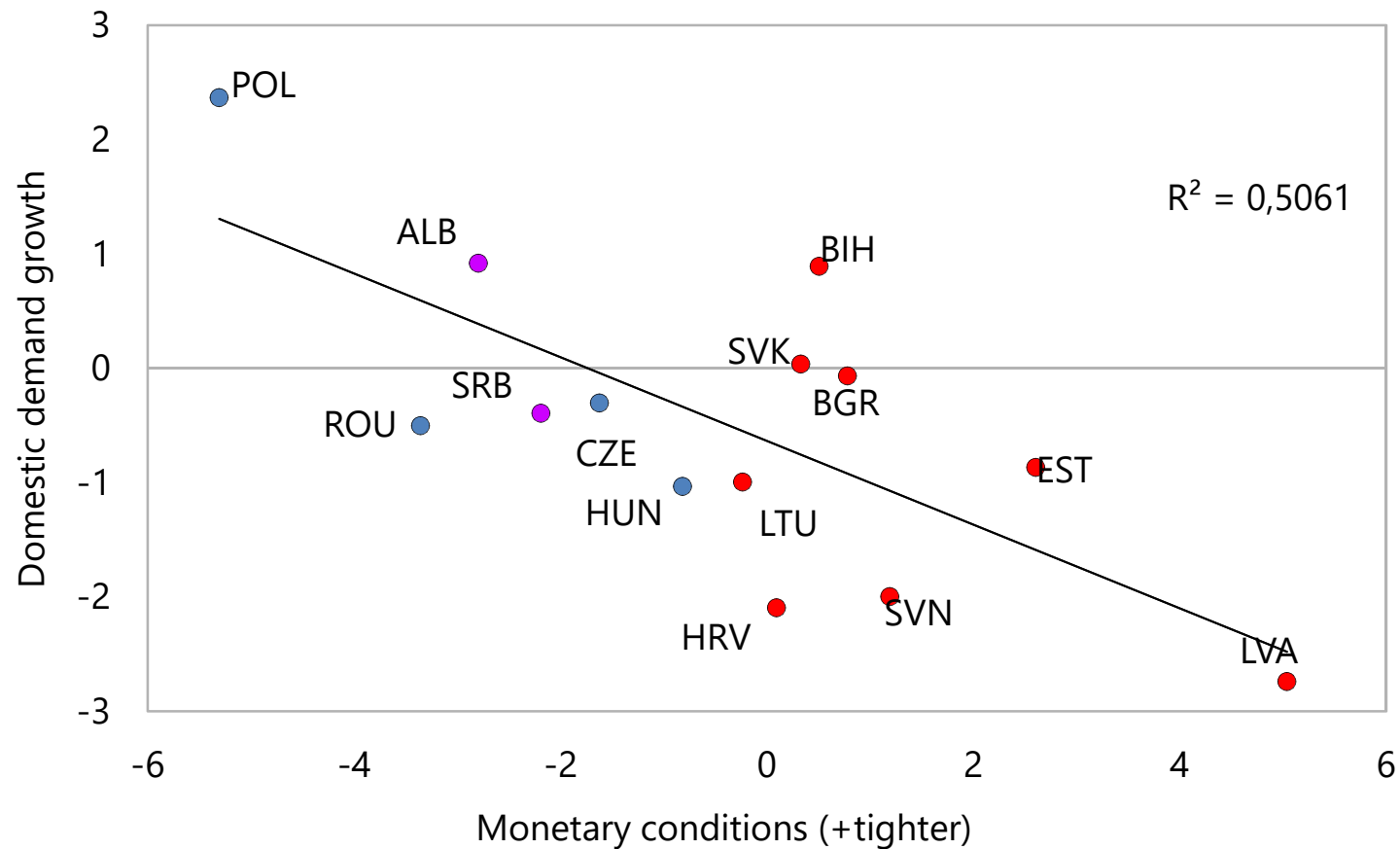
(2008-14 average; percent)



... thus Supporting Demand ...

Monetary Conditions and Domestic Demand Growth

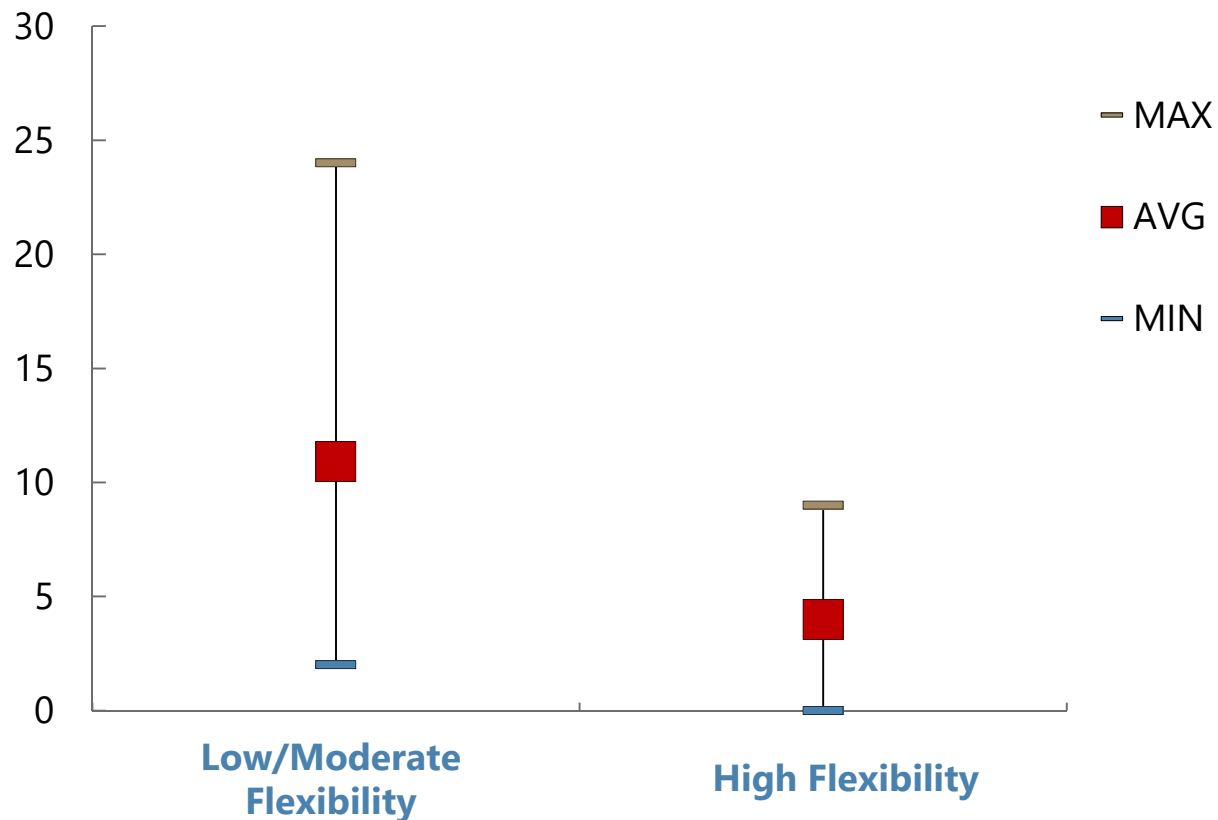
(2008-14 average; percent; low C/R labeled red)



... and Contributing to a Faster Recovery.

Length of Recession

(Number of quarters with negative GDP growth; 2008-14)



We Checked Alternative Explanations for Differences in Macro-Volatility

Cross-country differences are not explained by

- Size
- Quality of institutions
- Fiscal stance
- Macro-prudential policies
- Size and composition of capital inflows.

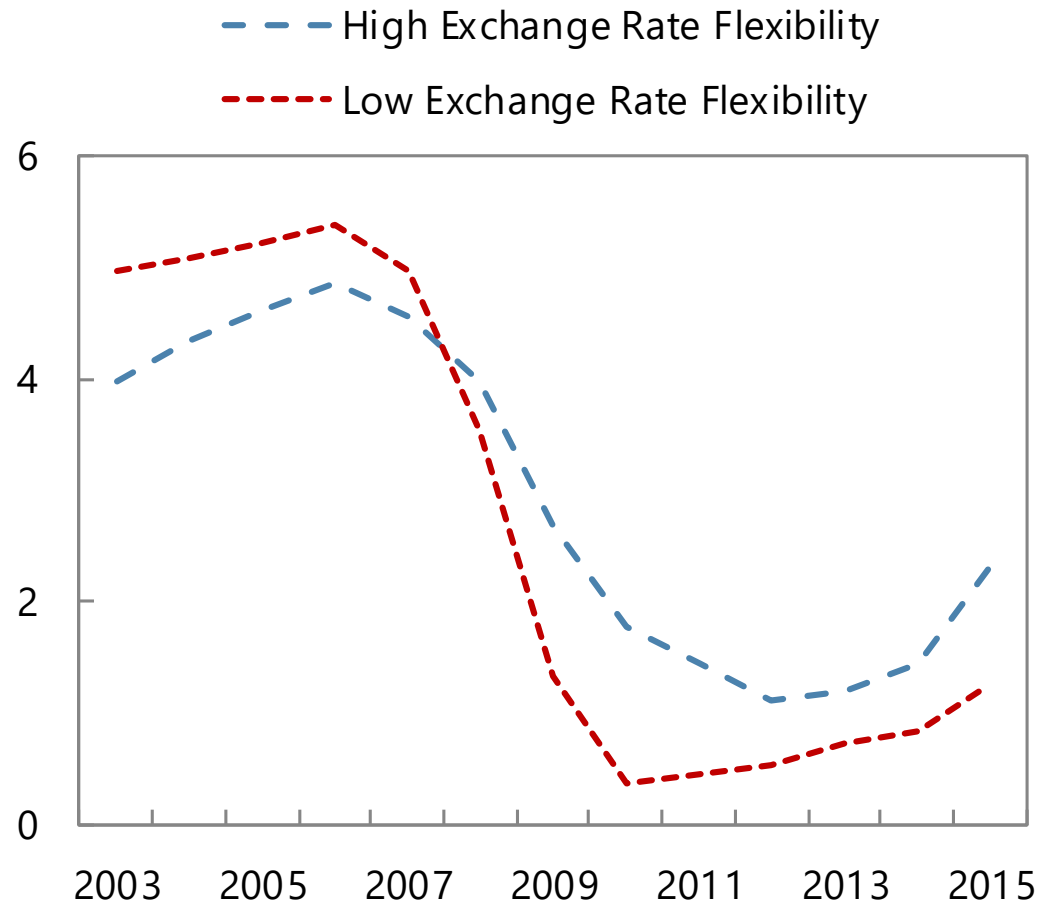
These factors account for some variation *within* groups (floaters / peggers), but not *between* groups.

Boom-Bust Growth Pattern Has a Potentially Long-Lasting Impact

Potential growth on average lower in countries with fixed exchange rates.

Key reason: low investment – which, in turn, owes to debt overhang.

Real Potential Real GDP Growth (Percent)



(iii) Non-Monetary Objectives

The Argument:

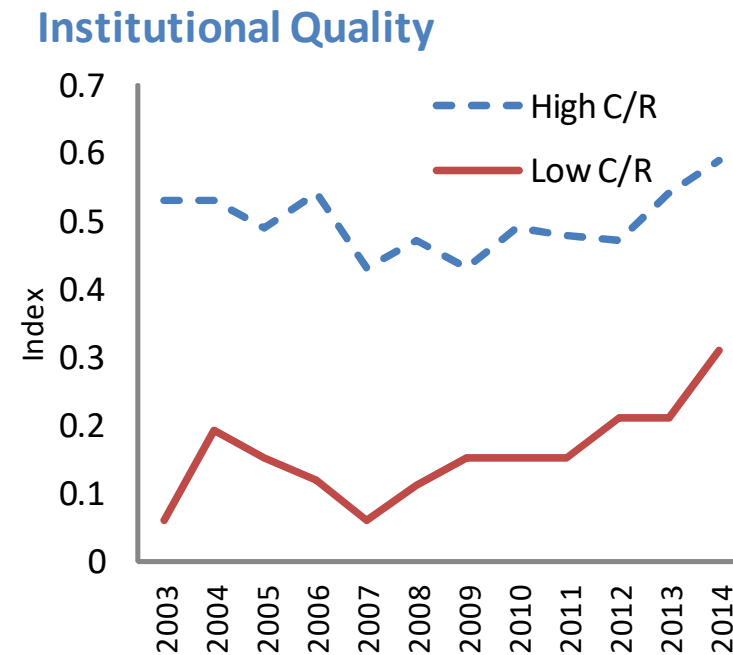
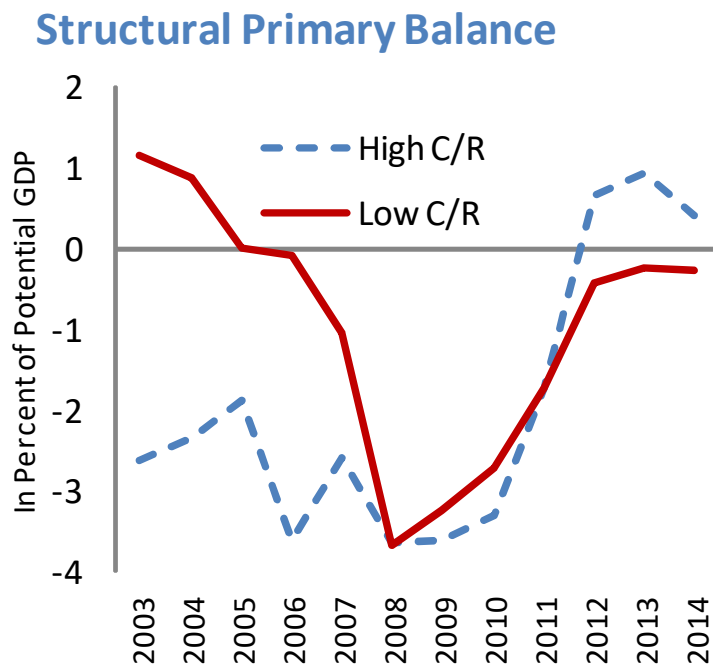
Fixed exchange rate regimes introduce more volatility, and eliminate the ability of monetary policy to support demand.

-> This *forces fiscal/structural policies to be of higher quality*

(and institutional quality is what ultimately matters)

Evidence is Mixed

- Fiscal balances were stronger among peggers pre-crisis, but not post-crisis
- Institutional quality is better (on average) among floaters, but peggers have been catching up



Key Issues

Stock taking:

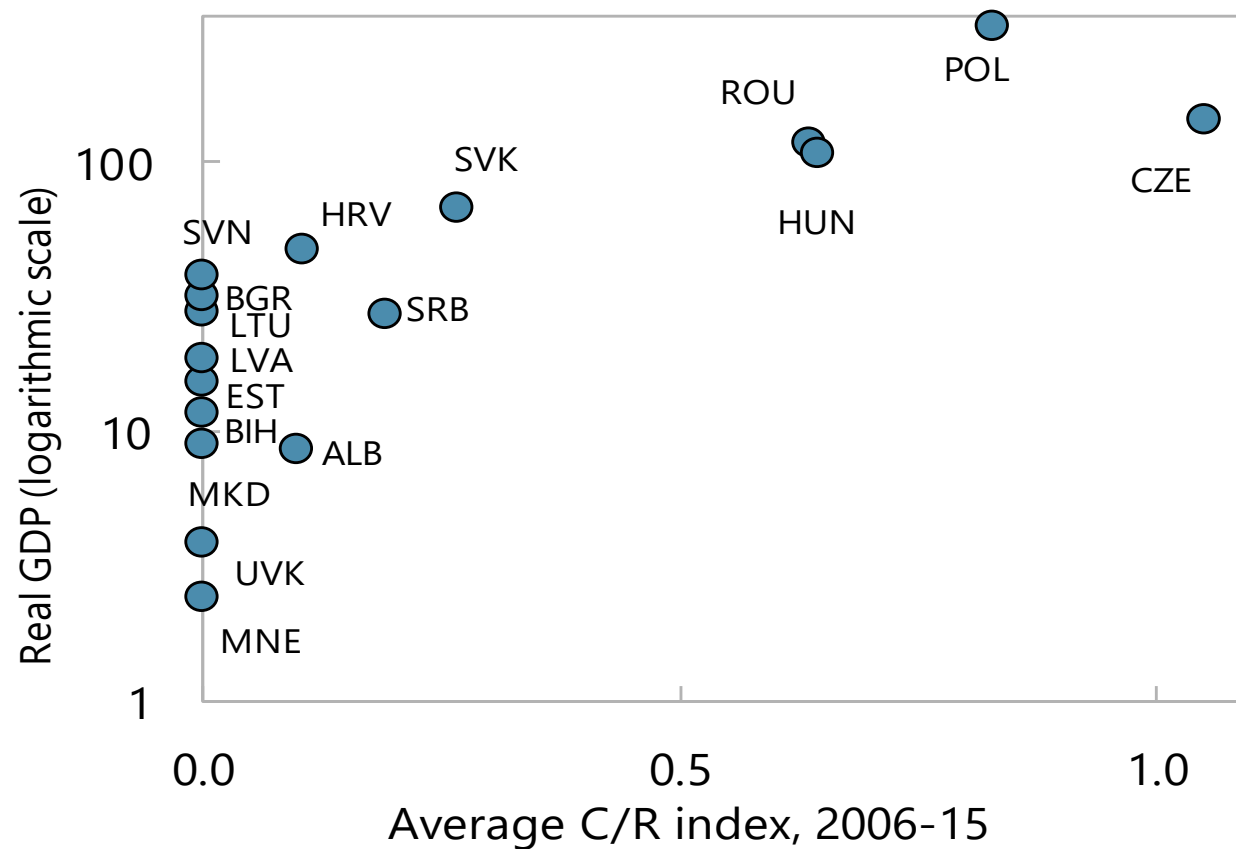
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- **What rationale is behind fixed exchange rate regimes?**

Forward looking:

- Monetary strategies going forward

Factor I: Size

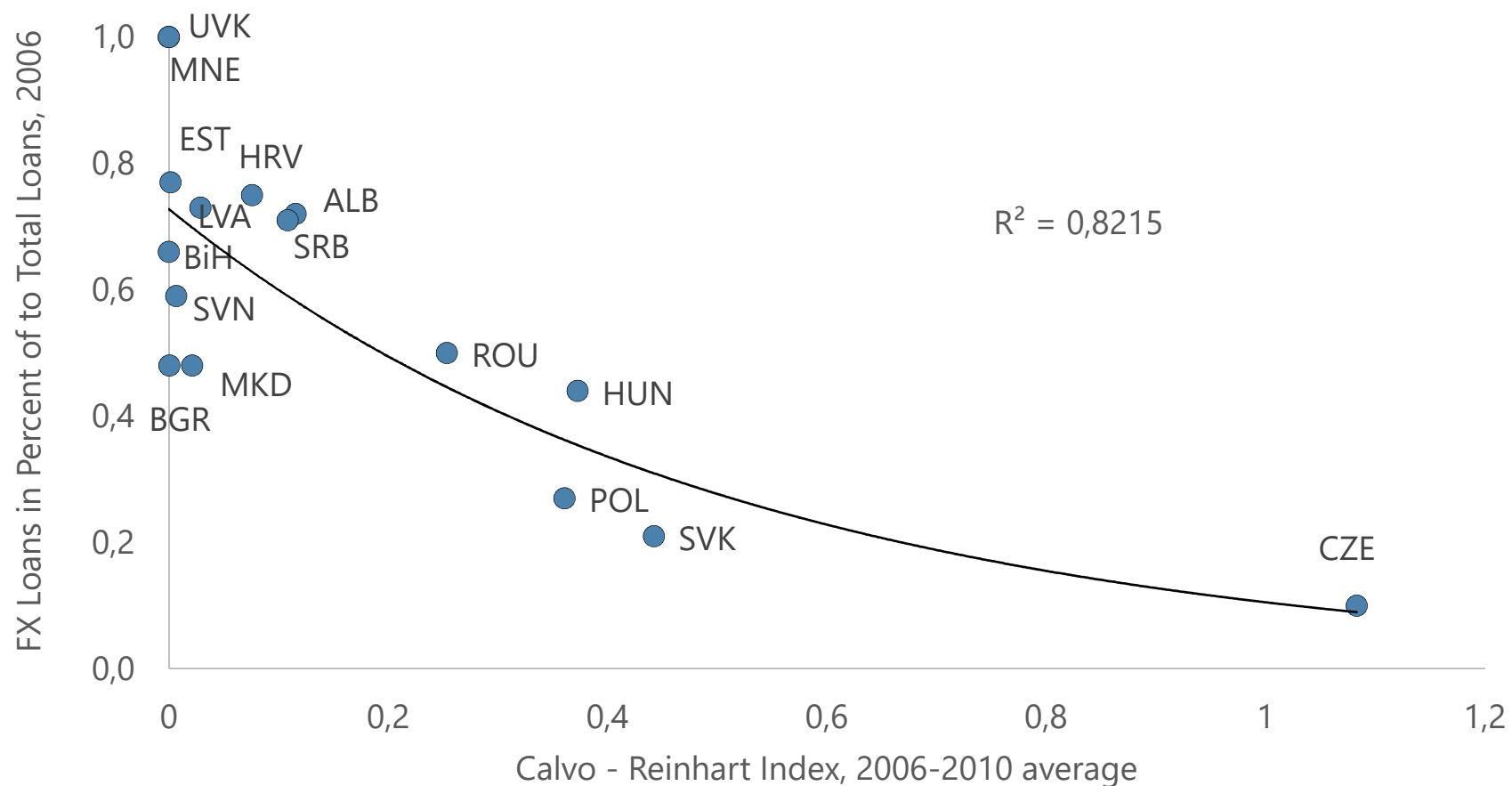
Exchange Rate Flexibility and Size



Sources: Haver Analytics; World Bank, WDI; and IMF staff calculations.

Factor II: “Fear of Floating” - Loan Euroization

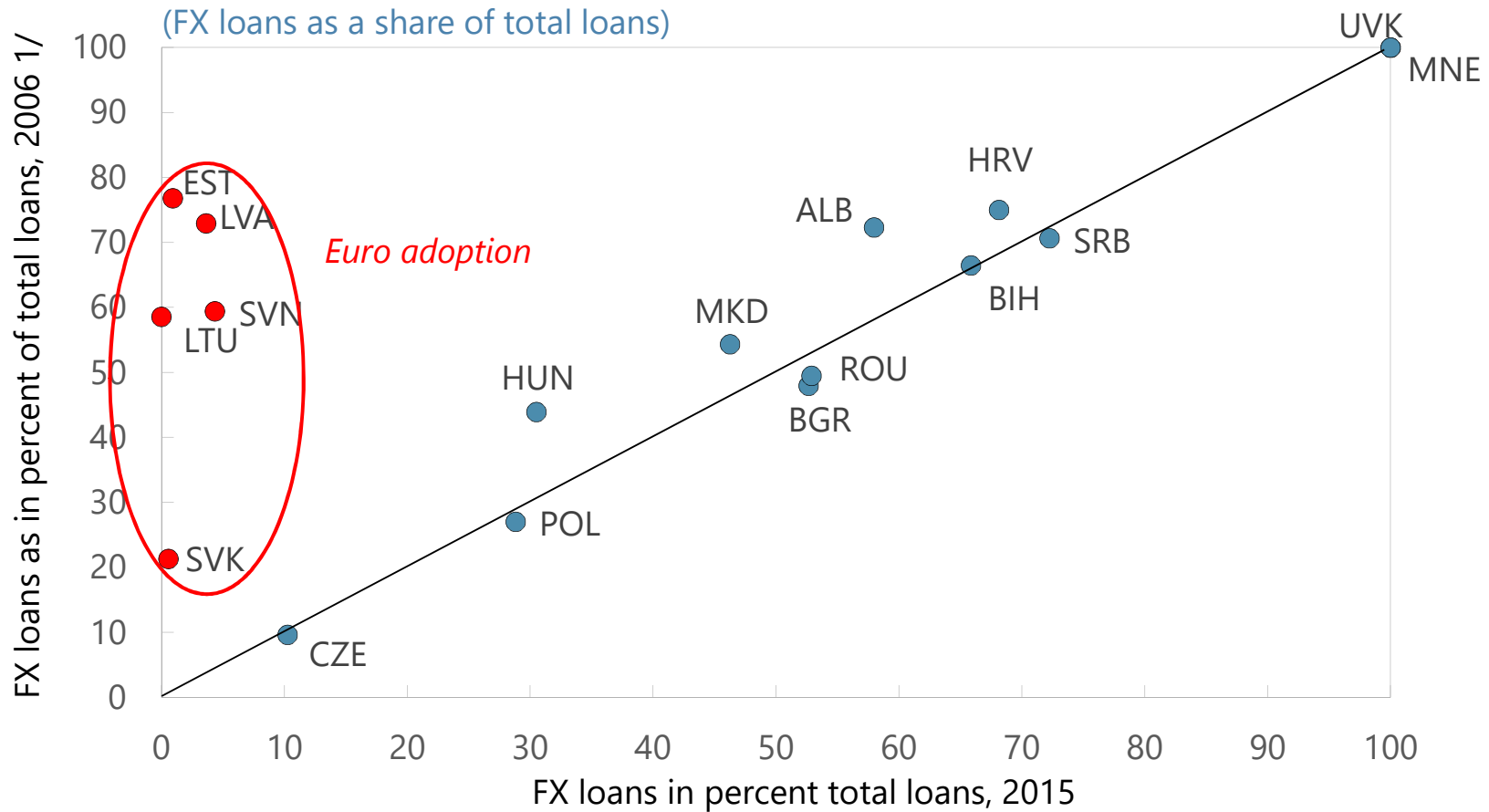
Exchange Rate Flexibility and Loan Euroization



Loan Euroization Is Very Persistent

Loan Euroization, 2006 vs. 2015

(FX loans as a share of total loans)



1/ 2008 for SRB and 2007 for ALB, BGR and ROM.

Why are Loans Euroized?

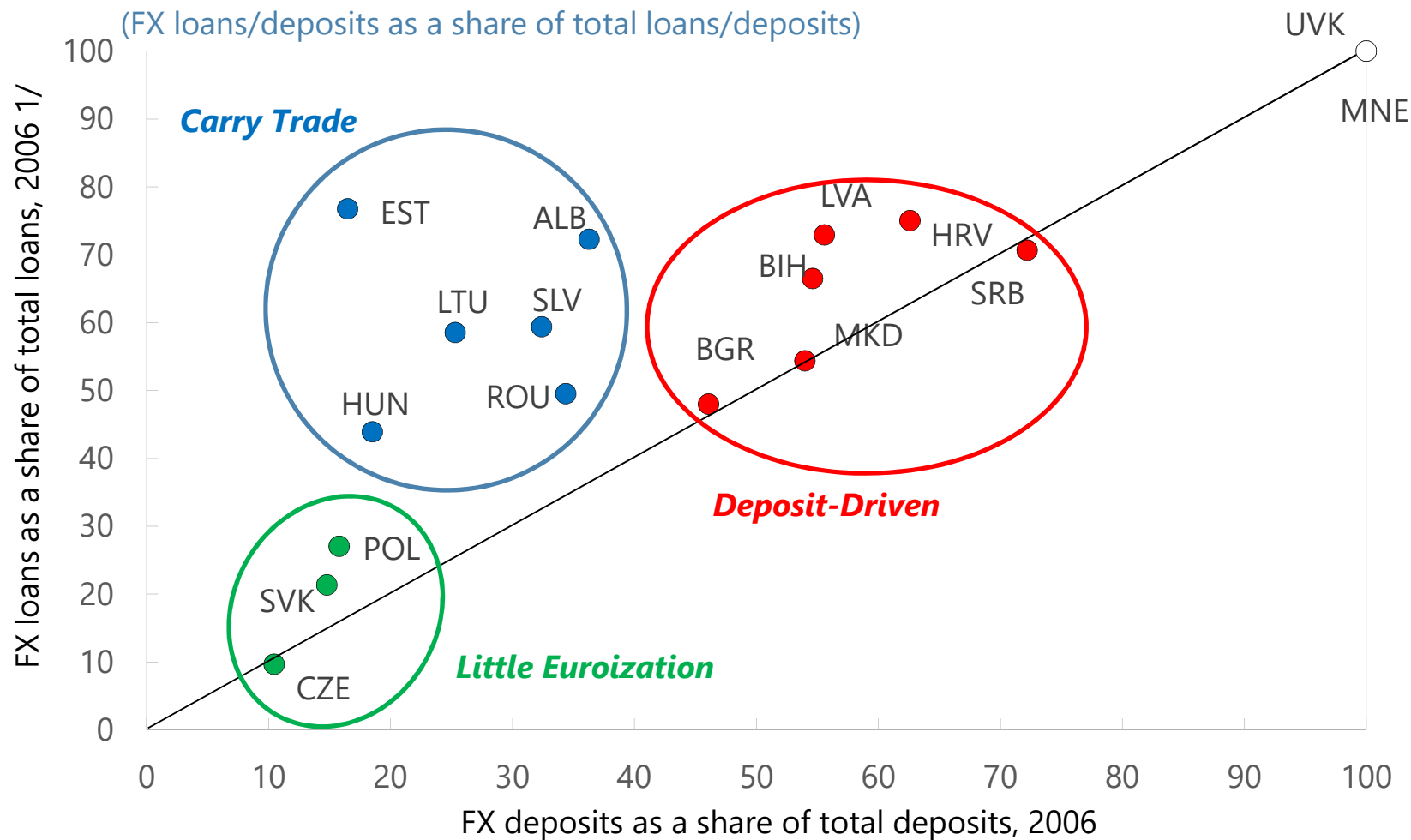
Two forces triggering loan euroization:

- ***Carry trade.*** Loans are in foreign but deposits in domestic currency: borrowers exploit interest rate differentials. Prevalent in central Europe and in the Baltics before the global financial crisis.
- ***Deposit-driven.*** *Deposits* are in foreign currency, reflecting distrust in the domestic currency as savings vehicle. Banks hedge by extending loans in FX. Prevalent in the Balkans.

Carry Trade vs. Hedging

Loan and Deposit Euroization, 2006

(FX loans/deposits as a share of total loans/deposits)

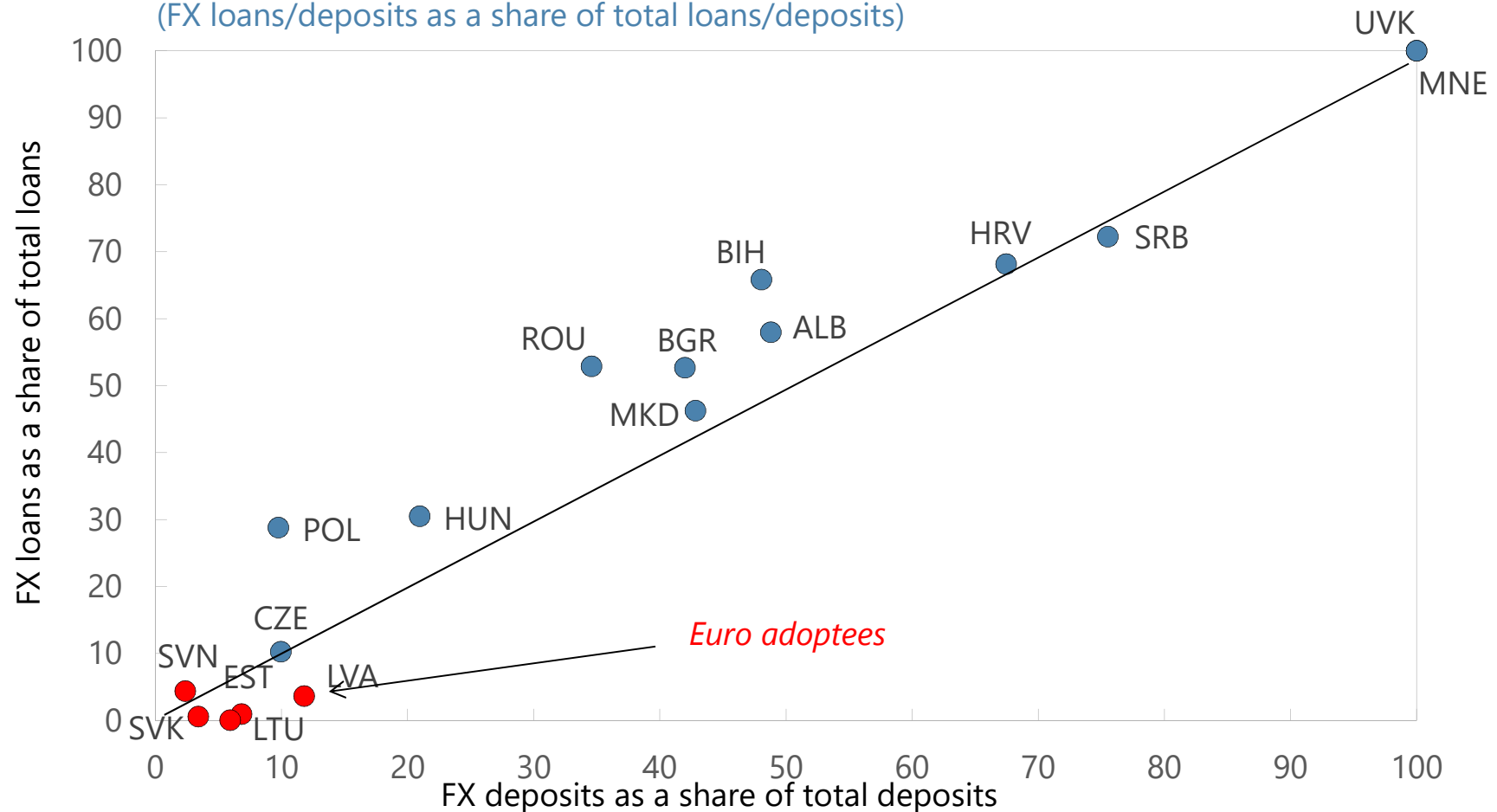


1/ 2008 for SRB and 2007 for ALB, BGR and ROU.

Carry Trade Euroization has Mostly Disappeared in the Wake of the Crisis

Loan and Deposit Euroization, 2015

(FX loans/deposits as a share of total loans/deposits)



Hence, Deposit Euroization is the Main Remaining Issue

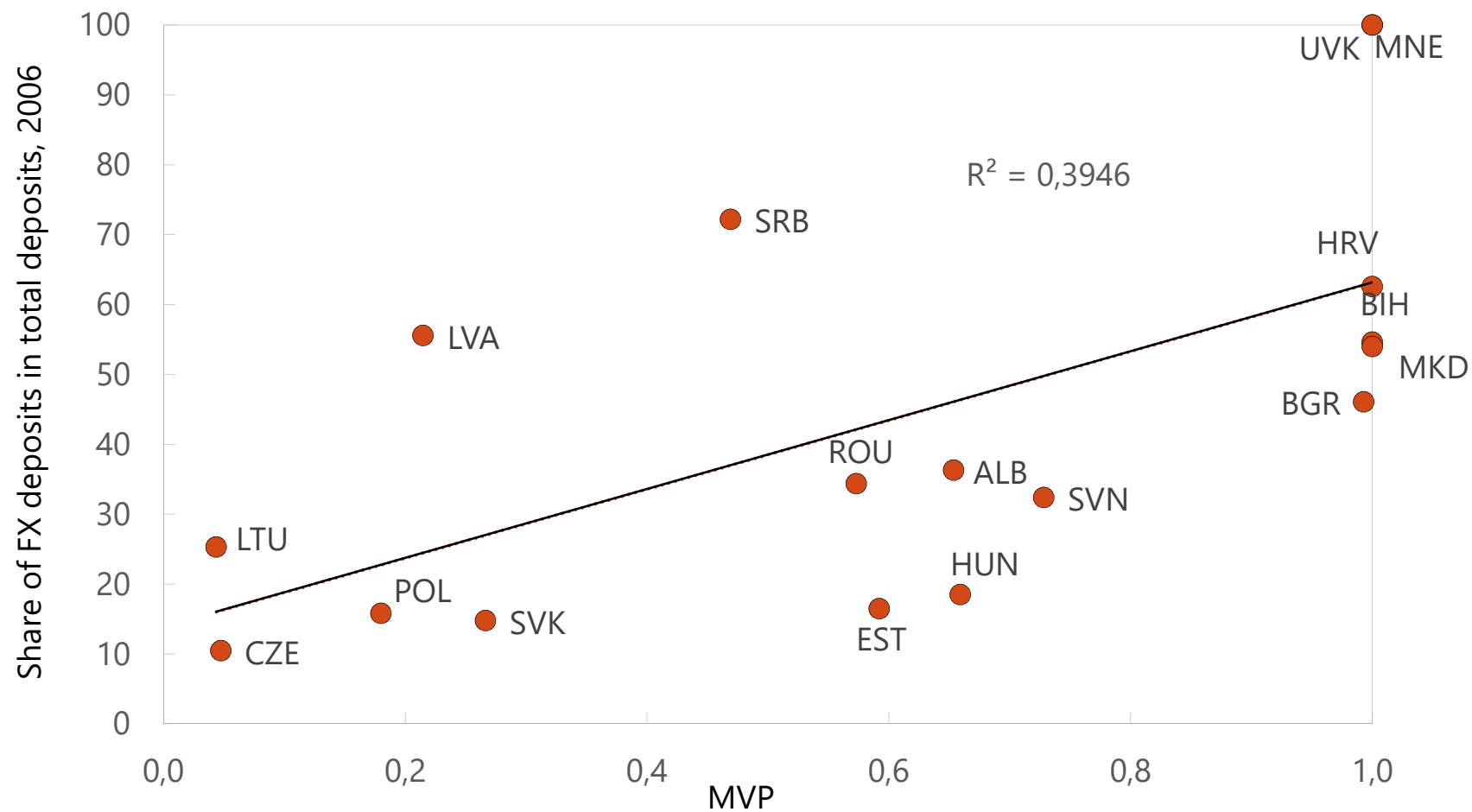
Minimum variance portfolio (MVP): standard model for deposit euroization. Predicts that euroization is high when the volatility of inflation is high relative to the volatility of the exchange rate.

In CESEE: MVP-approach does not work with recent data. Only works if data are being stretched back to the early 1990s. Results improve further when including a control for hyperinflation during transition.

-> *transition experience still determines deposit euroization, 20+ years later!*

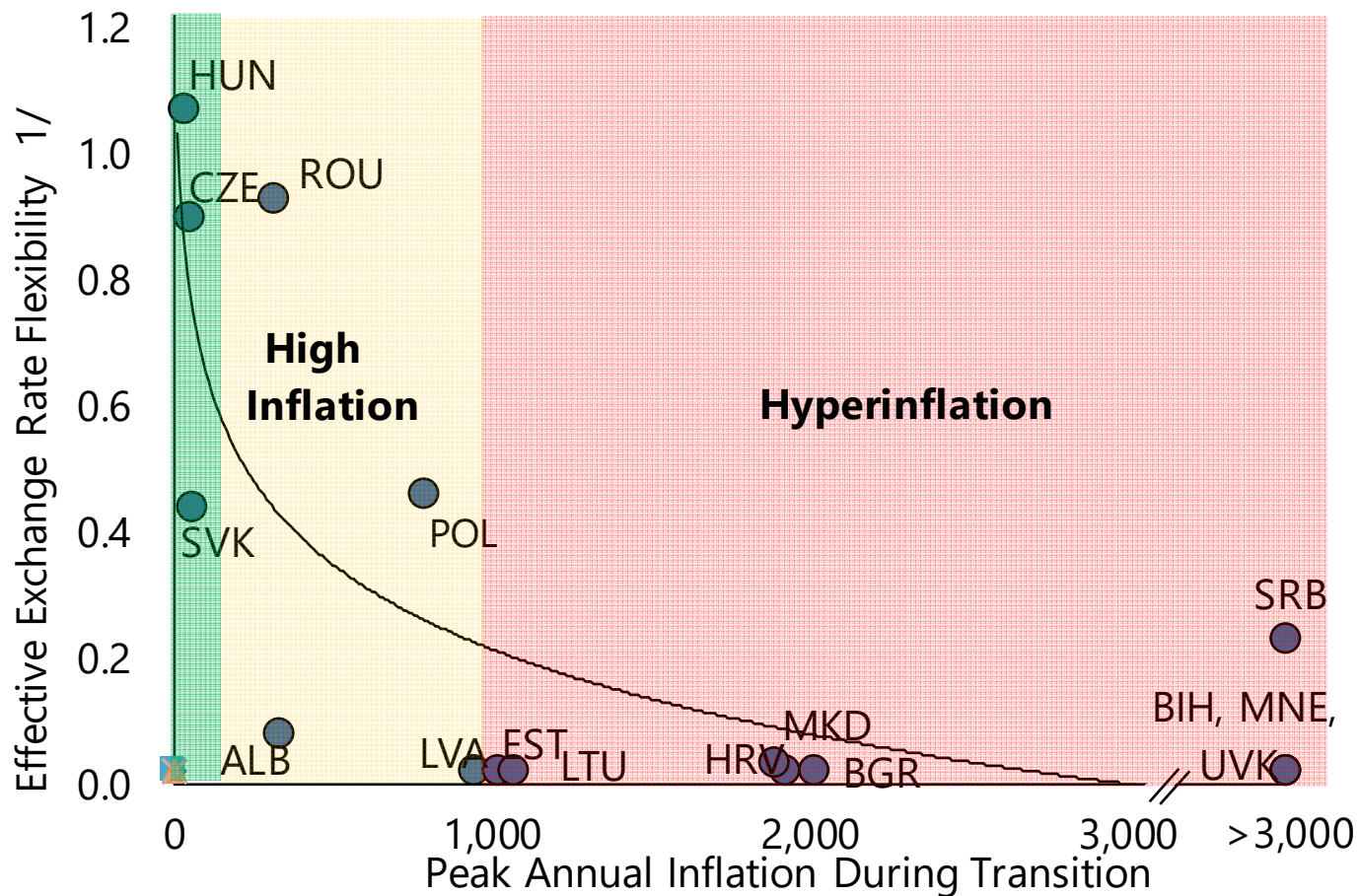
Minimum Variance Portfolio

Minimum Variance Portfolio and Deposit Euroization



The Long Shadow of Hyperinflation

Hyperinflation Legacy and Exchange Rate Flexibility



1/ Calvo-Reinhart "Fear of Floating" Index, average for 2006-08
(before the first CESEE economies adopted the euro)

Themes

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Forward looking:

- **Monetary strategies going forward**

Purpose of this Section: Outline Strategic Options

... and discuss their feasibility, pros and cons. The section is not prescriptive.

For countries with flexible exchange rates: little reason for strategic re-orientation
(as regards the monetary and exchange rate regime!)

For countries with fixed/quasi-fixed exchange rates?

Two Strategies: Stick or Move?

(i) *Stick to fixed exchange rate.* Avoids financial stability risks by sticking to tried and tested regime.

Adopt euro once the opportunity arises, until then, employ other policies than monetary policy to limit macro-volatility.

(ii) *Move to a flexible exchange rate regime.* Holds the prospect of more balanced and less volatile growth.

But: the transition is risky, requires *inter alia* dealing simultaneously with *euroization*.

Bottom line: neither option is easy.

Stick: How Can Fixed Rate Regimes be Made to Work Better?

- ***Strong countercyclical fiscal policy*** - difficult for emerging economies (financial and political economy constraints, small multipliers)
- ***Macro-prudential policies*** to manage credit growth. Work *better* in EMs than in AEs: harder to circumvent bank lending regulations.
But: only strong measures help. In the EU, circumvention via direct cross-border lending (single EU passport)
- ***Labor market flexibility***: “micro” (reallocation of workforce) and “macro” (wage flexibility)

“Stick” Got the Baltics Into the Euro

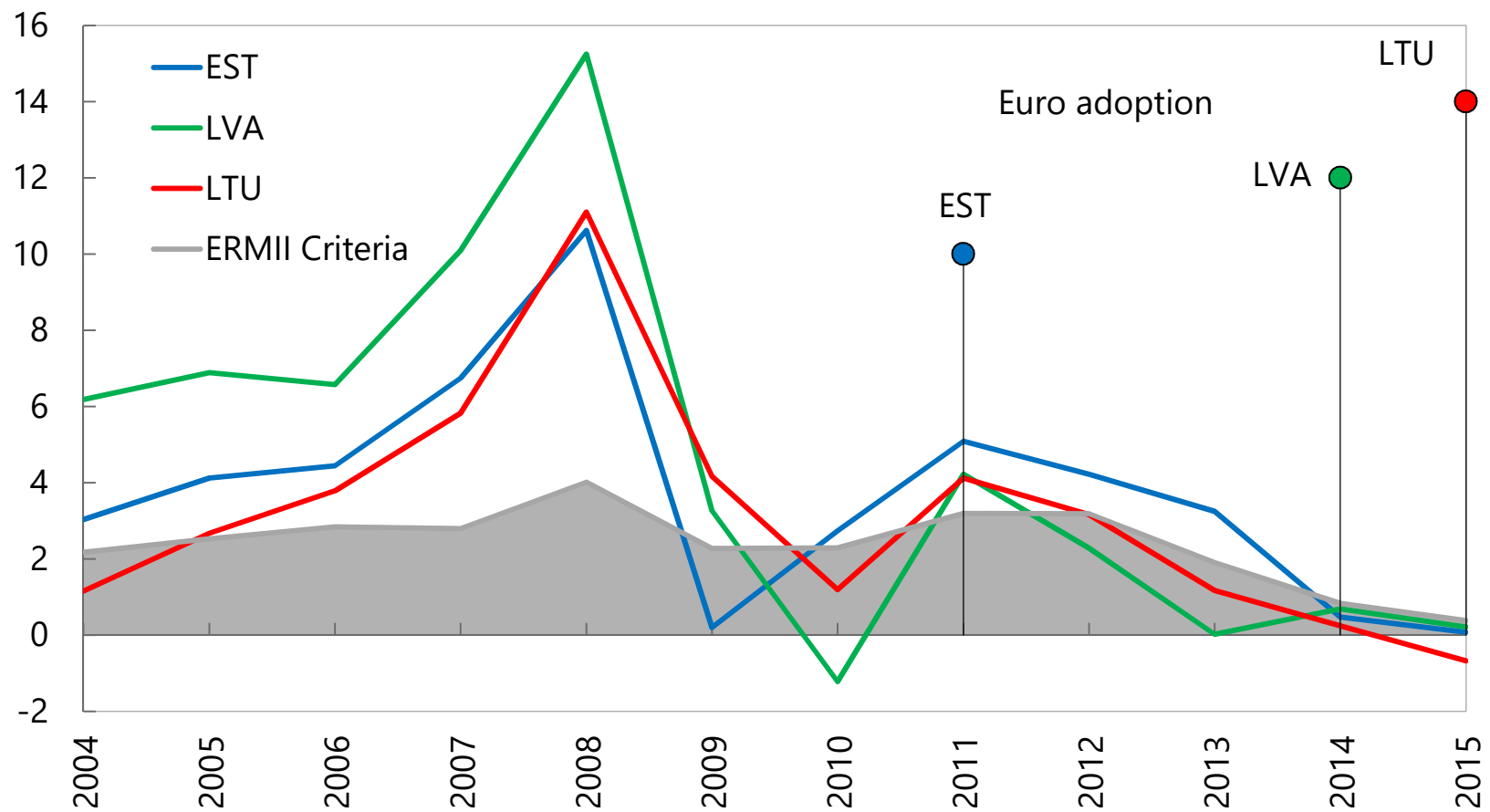
... but can this be reproduced elsewhere?

Three caveats:

- Most CESEE countries would likely need to *stay on the “Baltic path” for longer than the Baltics*
- *Baltics met macro-volatility* with strong institutions, strong fiscal positions, rapid wage adjustment, high productivity growth – difficult to reproduce elsewhere
- Still, *a crisis and recession were needed* to get inflation down to levels required for passing ERM2

The Baltics' Path into the Euro

HICP Inflation, 2004-2015
(Percent)



Moving to More Exchange Rate Flexibility – What Does it Take?

Review of experiences suggests that 3 conditions are key:

- **Disinflation & stable macroeconomic environment.**
Crucial element: stability-oriented fiscal policy that eliminates the need for monetary financing of the budget. **Mostly achieved in CESEE**
- **Establish a credible domestic monetary anchor**
- **Supportive regulatory and structural policies** that encourage the use of the domestic currency.

Establish a Credible Domestic Monetary Anchor (1)

- **Ideal: gradual, carefully planned transition**

Grants time to HHs/corps/banks to get used to flexibility, and to monetary/supervisory authorities to build technical capacities.

May take 10-20 years.

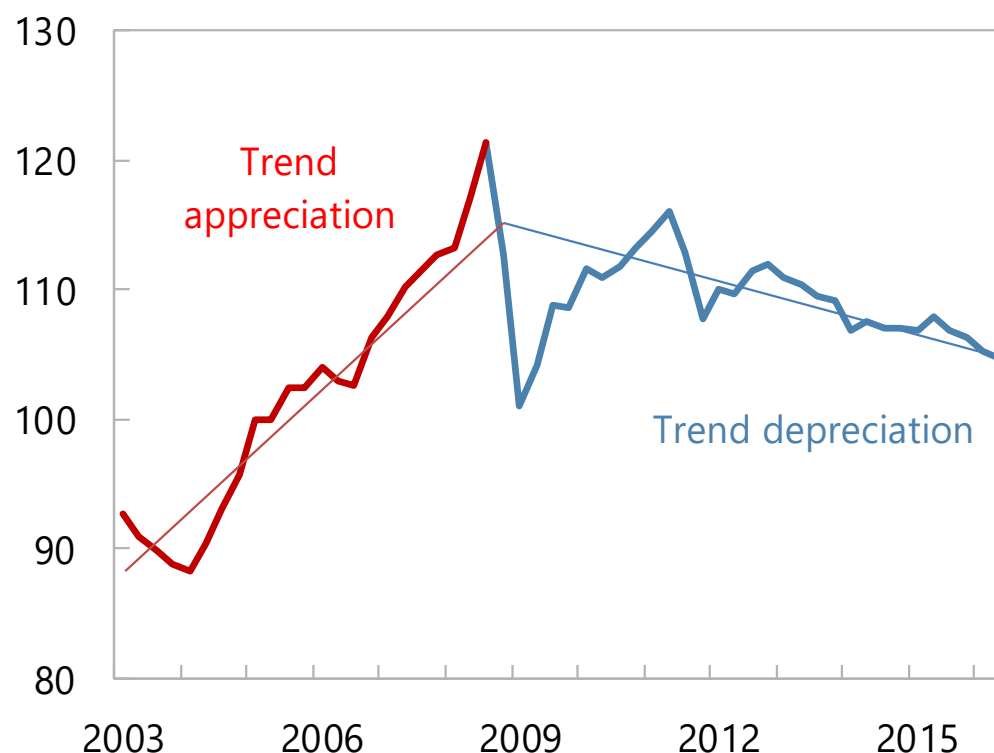
- **Expectations of *exchange rate appreciation*** facilitate the initial move to more flexibility: gives savers financial incentive to hold deposits in domestic currency.

-> *The last 7-8 years were the wrong time for switching*

-> *But: real appreciation expectations should return once convergence resumes*

Establish a Credible Domestic Monetary Anchor (2)

**Real Effective Exchange Rate, Floaters 1/
(CPI based, index, 2000 = 100)**



Sources: Haver Analytics; and IMF staff calculations.

1/ Simple average for the Czech Republic, Hungary, Poland, and Romania.

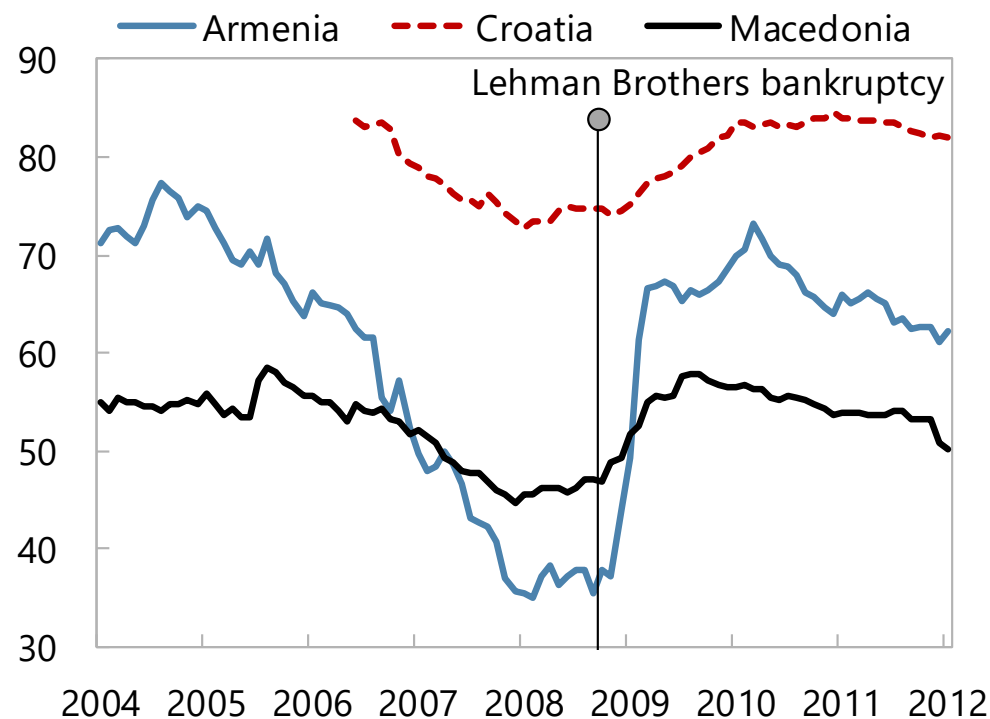
Establish a Credible Domestic Monetary Anchor (3)

Complication: keep euroization low in times of financial stress - savers fear return to depreciation/inflation Spiral. Example: GFC

An external anchor could help.

Deposit Dollarization/Euroization in Selected Countries, 2004–12

(Percent)



Source: National central banks.

Regulatory and Structural Policies (1)

What has worked?

- **Deposit-side regulations:**

- (i) *higher reserve requirements* for FX deposits

- (ii) *higher remuneration* for required reserves in LC, or *required reserves* for FX deposits in LC,

- (iii) charge *higher risk premia* for FX deposits covered by the deposit guarantee fund,

- (iv) *mandatory holding periods* for FX deposits.

- **Lending-side regulations:**

- capital surcharges / higher risk weights for FX loans

But: latent conflict with EU's "free movement of capital" provision

Regulatory and Structural Policies (2)

- **Develop domestic securities markets** to provide alternative savings vehicles to FX deposits, for example inflation indexed bonds

What has not worked?

- **Heavy handed regulation/coercive measures.**

For example, forced conversion of FX deposits into local currency - or of FX loans in the context of deposit-driven euroization - has often provoked financial disintermediation, inciting depositors to withdraw their savings from banks

Main Takeaways (1)

- **Floating has tended to come with better alignment of monetary conditions with CESEE economies' needs.**

Results: lower macro-economic volatility, better medium-term growth prospects

- **But this does *not* mean peggers simply got the exchange rate regime wrong.**

Pegging is (mostly) born out of necessity, reflects distrust of populations burned by hyperinflation in a domestic monetary anchor.

Main Takeaways (2)

Policy options:

- **Stay with peg** -> avoids financial stability risks. But countries will likely have to live with elevated macrovolatility – options to deal with this are limited. Can complicate development prospects.
- **Transition to floating:** should *not* be attempted without a coherent strategy -> risks financial instability. Resumption of growth convergence may provide an opportunity for some countries.
- **European institutions can help**