Monetary policy frameworks – experiences and perspectives

(by Ewald Nowotny)

Any introduction of Governor ***Ewald Nowotny*** *must note the wealth of positions his career has spanned. Mr Nowotny was a full professor (1981 – 2008) and Vice Rector (2003 – 2004) of Financial Affairs at the Vienna University of Economics and Business Administration. He was also a member of the Austrian Parliament (1979 – 1999) and chairman of the Finance Committee of the Austrian Parliament (1985 – 1999). In the framework of his business activities, he was member and later on president of the governing board of the Oesterreichische Postsparkasse in Vienna (1971 – 1979), vice president and member of the executive board of the European Investment Bank in Luxembourg (1999 – 2003) and chief executive officer at BAWAG P.S.K. Bank fuer Arbeit und Wirtschaft und Oesterreichische Postsparkasse AG (2006 – 2007). On 1 September 2008 Mr Nowotny was appointed Governor of the Oesterreichische Nationalbank.*

Monetary policy in transition: different paths

Governor Nowotny linked his speech to those of the previous speakers. Transition was the first topic – namely the situation of transition as such and, next, the experience of economic crises, since these two overlap.

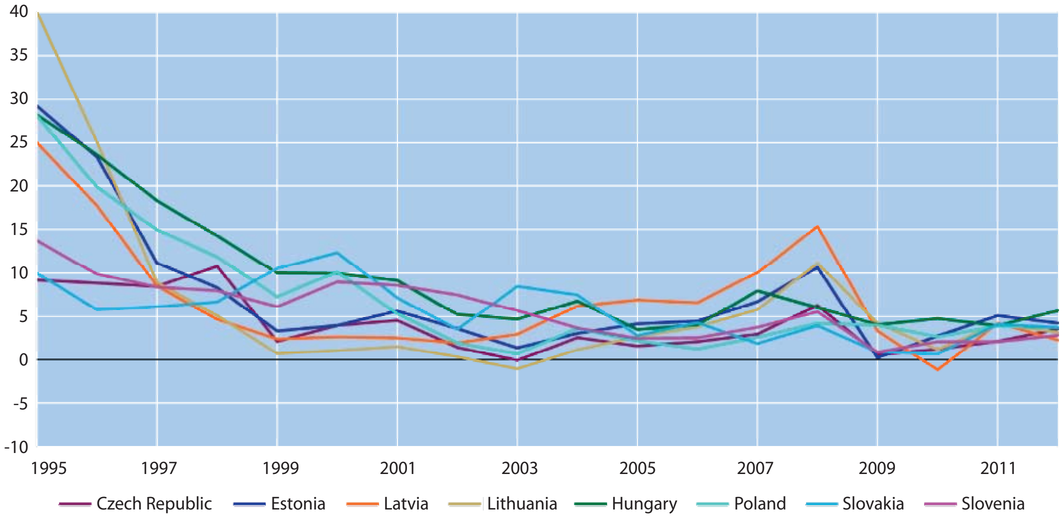
Monetary policy in transition can be characterised by the very different approaches and different paths in the case of the Central, Eastern and South Eastern Europe (CESEE) European Union (EU) member states, which employed a wide range of monetary and exchange-rate regimes during the transition period. At the beginning of the transition process most CESEE countries started with some kind of peg and anchored their domestic currencies to the Deutsche mark and/or to the US dollar in order to be able to counteract inflation. In Central Europe a variety of adjustable or crawling pegs were used, in the Baltic States hard pegs and in South Eastern Europe adjustable pegs with frequent devaluations in most countries.

The initial choice of regime was followed by diverse developments during the transition process. More or less all countries, apart from the Baltics, frequently altered these strategies, also depending on the stage of the capital account liberalisation process. Therefore, movements were observed during the transition period, which were largely attributable to increased capital mobility and financial integration. Some countries headed for fixed exchange-rate regimes, others for exchange rate flexibility. The countries that kept the peg progressively aligned themselves to the euro, while others moved to managed or free floats cum inflation-targeting frameworks. Relative country size played a role in the choice of regime. Very small and small economies opted for pegs or hard pegs, whilst larger ones preferred inflation targeting. The usual trade-offs regarding exchange-rate regimes also emerged in CESEE (e.g. the confidence and stability-enhancing effect of hard pegs versus the external adjustment channel of floats). In addition, exchange rate policy was constrained in many (but not all) countries by high degrees of asset and liability euroisation.

Empirical studies suggest that in many countries, exchange rate policy has displayed only limited effectiveness as a stabilization instrument in CESEE. It appears, that the exchange rate acted as a shock absorber only in Poland, which is larger and less open than other countries in the region. Moreover, there are very strong short-term links between exchange rate dynamics and price stability, as there is a rather fast pass-through of exchange rate developments. This is an indication that role of the exchange rate in this region tends to be a rather limited one.

The different paths taken by CESEE countries led to success in stabilising inflation. These countries proved to be able to manage inflation, bringing it down from three- or four-digit rates, in particular at the earlier stages of transition, to intermediate and in some cases low single-digit rates. This can be seen as a success story in the CESEE region and it supports the view that if there

Fig. 1 Customer price inflation (in % year on year)



Source: WIIW.

Note: Inflation was more persistent and also more volatile in Bulgaria and Romania. Bulgaria experienoed a spike of hyperinflation in 1997 before reducing inflation substantially under a currency board regime, while Romania's disinformation was more gradual (with single digit inflation rate recorded from 2004 onwards).

is a consistent policy it is possible to overcome a high inflation rate.

Monetary policy during the financial crisis

An important factor is that banks in several CESEE countries have large parts of both sides of their balance sheets in foreign currency. Although in some countries there was the attitude that the euro was not considered a foreign currency, based on the thinking that "soon we will have the euro", this was in fact an illusion. There are a number of countries where foreign-currency-denominated lending, led to increased risks.

During the crises the central banks applied a wide range of instruments in order to cope with the financial crisis both internally and externally: interest rates; supporting interbank liquidity; foreign exchange swaps – unfortunately the ECB did barely use this interesting instrument in the CESEE region up to now; and foreign exchange market interventions (used for the first time in Poland since 1998).

Currency and banking crises were avoided, in some cases with international support. Several countries agreed on IMF programs and received EU balance of payments support. The Vienna Initiative also played an important stabilizing role in the CESEE region. It is necessary to emphasise, that it made sense to use these instruments. At the same time, pegs were sustained and adjustment was working and, therefore, there was substantial improvement in the external position of many CESEE countries.

At the same time it is necessary to mention, that monetary policy is only one pillar of economic policy. In a stressed economic environment a sound overall economic policy is strongly recommended and remains the key to success. This means stability-oriented fiscal policy, structural reforms and macroprudential policy measures – particularly in boom times – are definitely needed in order to avoid an overburdening of monetary policy.

The path to the euro

One long-term issue for the whole region is, of course, the path to adopting the euro. This is embedded in the European treaties, with only two exceptions (neither of them for the CESEE region), and it is a given task with many hurdles to overcome. First of all, following accession to the EU each country is required to enter ERM II, and stay within this mechanism for at least two years without experiencing major exchange rate pressure before adopting the euro. However there are a number of countries that have not yet entered ERM II (Bulgaria, Czech Republic, Hungary, Poland, and Romania). Before a formal decision on euro area entry is taken, the European Commission and the ECB conduct convergence assessments. Three CESEE countries, i.e. Estonia, Slovakia and Slovenia, already adopted the euro.

It is important to mention that there are discussions on convergence criteria. These are, of course, widely known, but the crucial point is sustainability. The question of whether a country can sustainably continue to comply with the criteria was previously neglected or, at least underestimated.

From the monetary and exchange-rate policy points of view the challenges are to keep inflation at low levels on a sustained basis and to maintain a sound external position. For those countries that have not entered ERM II yet, it is important that they time their entry appropriately. Mention should also be made of the need for readiness in terms of correcting major imbalances and taking

Fig. 2 Euro results in lower inflation in Austria (Annual change in Harmonised Index of Customer Prices (HICP) in %)

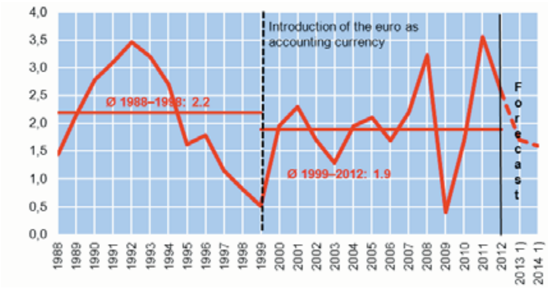


Fig. 4 GDP per capita: Austria ranks fourtf in the euro area (euro area average: 27.1) (per 1,000 purchasing power parities, 2011)

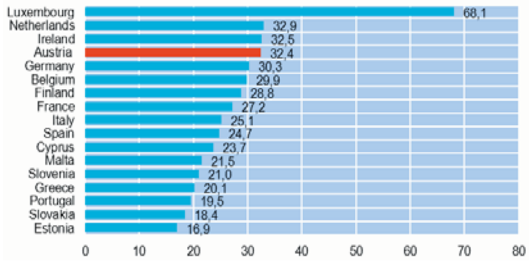


Fig. 3 Interest rate on corporate loans (in % p.a.)

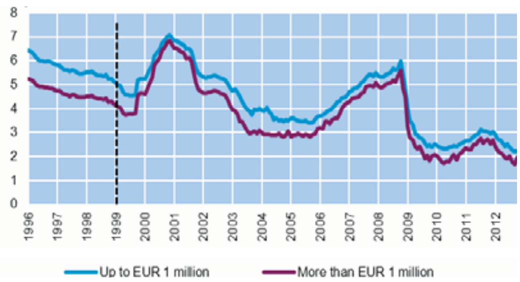
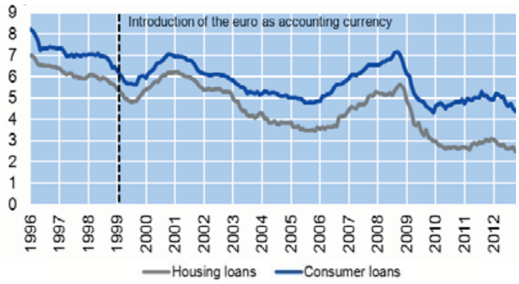


Fig. 5 Interest rate on loans to households (in % p.a.)



Source: Statistics Austria, OeNB, Eurostat.
1) OeNB economic outlook for Austria of December 2012, Eurostat, ECB.

a case-by-case approach depending on the nominal, real and structural characteristics of the particular member state. Choosing an appropriate initial ERM II central rate is also of critical importance. It is essential to take into consideration the best possible assessment of the equilibrium exchange rate at the time of entry, based on a broad range of economic indicators and developments, while also taking into account the market rate.

As regards Austria, which is a small open economy, a number of interesting effects were seen in some indicators. The country profited from lower inflation – of course, this encompasses a number of elements. Also the lowering of interest rates had a positive effect, as it was used for productive investments. Since the euro's introduction Austria has run a current-account surplus, which is an indication that for a small country being a member of the euro area increases stability, while reducing risks especially for export-oriented small and medium enterprises. Of course, this point concerns mainly the state of the real economy.

Challenges arising from accommodative monetary policy in advanced economies

Before the crisis, FDI and long-term other investments were the main external financing source in CESEE. Since 2009, a shift to capital flows of shorter-term nature has been seen. And this is something that has to be observed very closely, since if there is an upward move in interest rates in advanced economies or if there is a massive change in non-standard measures, this might affect these capital flows quite strongly. It is necessary to bear in mind, that the state of the economy in such situations is important. Since the Asian crisis was connected with short-term capital flows, this is an area in which the central bank should monitor developments cautiously and strategically.

Concluding remarks

CESEE central banks employed a wide range of monetary and exchange-rate regimes during the transition period and managed to stabilise inflation under a variety of regimes. During the recent distinct crisis period, currency crises were avoided in this region, partly with international support from IMF and EU. At the same time the overall policy mix rather than a particular regime choice in one policy area was, and still is, crucial to sustaining successful economic performance. Different CESEE EU member states took different approaches on the path to adopting the euro, and this proved highly appropriate. It is also important to consider the convergence assessment, with increased focus on sustainability. Nonetheless challenges still lie ahead for the CESEE countries.

(Compiled by Mariana Kollárová)