Part II

Managing Economic Convergence and Financial Stability in the EU Accession Countries of Central and Eastern Europe

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Managing Economic Convergence and Financial Stability in the Czech Republic

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1 Introduction

One of the key economic policy issues for countries aspiring to become members of the European Union is that of "real versus nominal convergence". This is indeed a pivotal issue, as it deals with the identification and sequencing of the key decisionmaking priorities for the candidate countries to follow. This problem can be rephrased in simple terms as "Copenhagen versus Maastricht".

Seen from the official point of view, the conclusive and regularly evaluated benchmark for accession to the European Union are the so-called Copenhagen criteria.[1] These criteria, together with political requirements such as the rule of law, stability of democratic institutions and respect for human rights and the rights of minorities, also contain a set of relatively general economic criteria – in particular the requirement for the candidate countries to have a functioning market economy and to be able to withstand competitive pressures and market forces within the Union.[2] On the macroeconomic level, the economic part of the Copenhagen criteria is interpreted in such a way that the top priority must be given to enhancing economic growth and closing the performance gap between the candidate country and the member states of the Union.[3] However no specific numbers are given to indicate the desired speed of economic growth.

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1 The progress of the candidate countries in meeting the Copenhagen criteria is mapped out in regular reports of the European Commission. The fact that domestic politicians closely watch the conclusions of these reports is illustrated by the commotion about the latest report for 2000. This concluded that "the Czech Republic can be regarded as a functioning market economy and should be able to cope with competitive pressure and market forces within the Union in the near term, provided that it keeps up and completes the implementation of structural reforms". This opinion was interpreted as ranking the Czech Republic as a third-wave country. This produced many critical responses, as well as a positive result in the form of redoubled political efforts to remedy the problems found.

2 These requirements entail a large number of mostly microeconomic tasks – completing structural reform and privatisation, improving law enforcement, strengthening the banking sector, developing local financial markets, etc. It is considered a natural consequence that the above tasks, if implemented, will foster economic growth.

3 This is a matter of definition. Given the more or less constant labour force, economic growth is tantamount to an increase in labour productivity.

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Another undeniable fact is that the mandatory focus on fulfilling the Maastricht criteria, which lay down explicit parameters for inflation, long-term interest rates, public budgets and the exchange rate, represents the later stage of preparing for accession to EMU. In fact, there is not much freedom for discretion. By adopting the *Acquis Communautaire* (the entire body of European laws), the candidate countries committed themselves to adopting the single currency. They were denied the so-called opt-out clause, which – as a privilege of some current EU member states – stipulates the right to retain the national currency. By preparing to join the EU, the candidate countries are automatically undertaking to draw up, when they become members, a convergence programme specifying guidelines for the adoption of the euro. The clear progression – "first membership in the EU and then membership in the EMU" – however, creates an obvious sequencing for the official obligations of the Copenhagen and Maastricht criteria.

Many economists believe that this sequencing is right and grounded. They believe that the two sets of criteria – the real convergence of Copenhagen and the nominal convergence of Maastricht – compete with each other to some extent. They are concerned that "exaggerated" ambitions within nominal convergence, i.e. the emphasis on low inflation or low public debt, will hurt real convergence. They argue that a narrow focus on the Maastricht criteria will result in slower growth and that more time is needed to close the performance gap between the accession countries and the EU member states.

There exists, however, an alternative view, highlighting the strong elements of complementarity between the processes of real and nominal convergence. This view has been adopted by the European Central Bank, which maintains that the processes should be followed in parallel. In other words, the fact that the Maastricht criteria are not obligatory for accession to the EU should not prevent the macroeconomic policies of the candidate countries being, in the medium run, consistent with the Eurozone policies.[4]

How might the desired accord be achieved in practice? And how many trade-offs between real and nominal convergence do policymakers have at hand? Each candidate country will have to choose its own path, taking into account its own historical experience and social preferences. This applies equally to the Czech Republic, which in the previous period of economic transformation gathered a large volume of empirical evidence which should now be put to use.

4 European Central Bank (2000).

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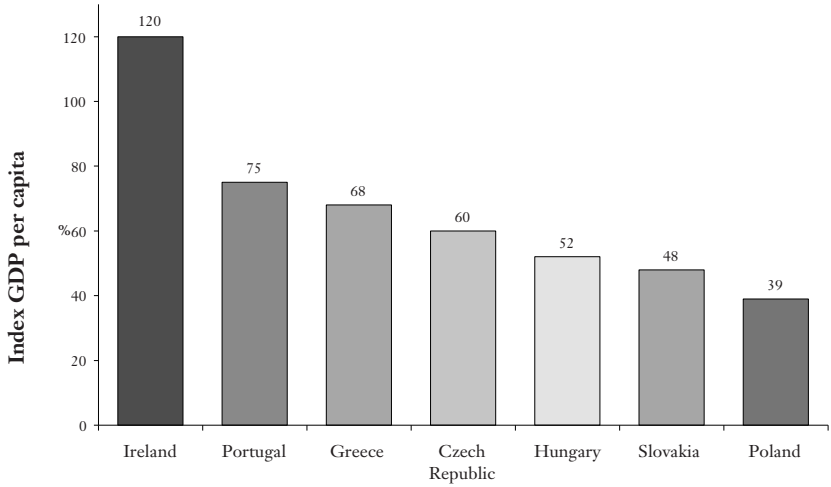
2 A Case Study of Non-Sustainable Growth

The statistics show that in 2000, Czech per capita GDP was approximately 60% of the EU average (see Figure 1). At the same time, the economically weakest EU members recorded higher values: Greece 68% and Portugal 75%. Amongst the candidate countries, the Czech Republic was outperformed by Slovenia (71% of the EU average), but was ahead of Hungary (52%) and Poland (39%).

Figure 1 Comparison of Economic Strength of Selected Countries



Note: GDP per capita in purchasing power parity in 2000; EU average = 100.
Source: OECD (2001).

A more alarming finding than the mere existence of a performance gap at any particular moment is the fact that the gap between the Czech Republic and the EU countries has a widening tendency (see Figure 2).

Whereas in 1990 the Czech Republic's GDP per capita was approximately 69% of the EU average, the following decade of transition saw the gap increasing by almost 10 percentage points. This comparison clearly suffers from many flaws. It ignores the simple truth that the candidate countries have undergone sweeping social changes, accompanied by an inevitable transformation recession. The statistical GDP data are not able to take account of the huge leap from a shortage economy and distorted international trade to market structures where price respects the sovereignty of the consumer and profit is a reflection of business success.

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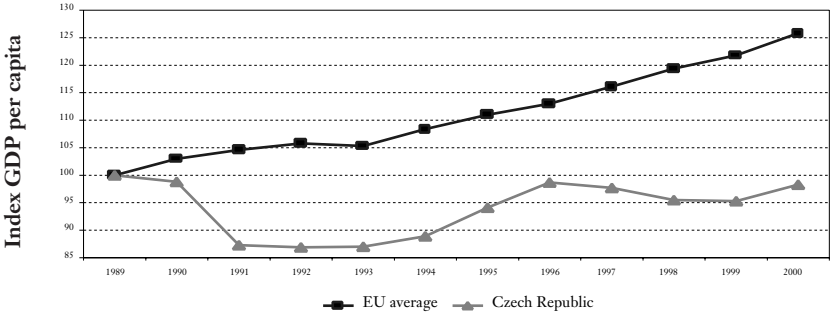
Figure 2 Widening of the Performance Gap Between the EU and the Czech Republic



Note: Fixed prices; 1989 = 100.
Source: Vintrova, R. *et al.* (2001); CNB database.

However, the fact remains that the Czech Republic has fallen back from the EU economic level.[5]

Under these circumstances, the importance of economic growth cannot be overstated. It is evident that a growing economy has higher financial capacity for completion of transformation objectives and adoptions of European legislation. Growth fosters an increase in competitiveness, which in turn is a pre-requisite for prosperity in a club of countries respecting the four fundamental freedoms of free movement of persons, goods, services and capital.

The EU also has a an interest in accelerating growth in the accession countries It does not need weak members depleting structural funds, demanding various waivers, and generating fears of destabilisation of the common labour market without offering offsetting benefits to the others. So, acceleration of real convergence quite rightly becomes the key priority for the economic policies of candidate countries, and will be closely watched by the EU.

In this context one should recall that the Czech economy showed a very promising performance just a few years ago. In 1995 and 1996, economic growth reached levels of 5.9% and 4.8% respectively. In these years, the Czech Republic was dubbed the "Central European tiger" or "the

[5] Revisions to the national account statistics in 1997 showed that the transformation recession in the Czech Republic in the 1990-93 period was smaller than in Hungary or Poland. Prior to the revision, the prevailing opinion had been that the Czech Republic had shown the largest transformation decline. Similarly, the loss of output during the second recession in 1997–98 now looks more benign (up to one percentage point more) following statistical revision in 2001.

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front-runner of the transition economies". In an atmosphere of transformation achievements and strong macroeconomic figures, the restrictions on free movement of capital were largely abolished and the Czech currency became externally convertible. Seen in retrospect, the rate of opening of the economy may appear too fast, but it mirrored the optimism of the times.

The period of boom came to an abrupt end in 1997: a speculative attack on the koruna, austerity packages accompanied by tight fiscal and monetary measures, and a political crisis followed by a protracted period of economic downturn. The country learned the lesson that economic growth must have another important characteristic – it must be sustainable. From this point of view, the macroeconomic performance prior to the monetary turbulence of 1997 exhibited serious flaws. Rising domestic demand was met largely by imports, as the non-restructured domestic supply suffered from many bottlenecks. Current account deficits were to a large extent financed by short-term capital. Real wage growth outpaced labour productivity growth. The misaligned domestic fundamentals were further shaken by volatile global financial markets.[6]

Czech policymakers thus saw with their own eyes that a boom-bust pattern prolongs the process of catching up with the EU and translates into extra costs. Using the terminology of today, we can say that the one-sided preference for real convergence failed.

3 Shadow Importance of the Maastricht Criteria

Now the economic recession has been overcome, the prospects of the Czech economy appear more optimistic. The economy showed the first signs of recovery in the second quarter of 1999, and since then the positive growth trend has continued. Furthermore, inflation has stabilised at a relatively low level, close to the price stability required by the Maastricht criteria.[7] However, it must be admitted that this situation is not fully the result of deliberate policy by the central bank, but of a largely opportunistic exploitation and anchoring of external disinflationary pressures.

The following finding is of even greater significance: although there is no official requirement to meet the Maastricht inflation target, the benefits of low inflation are evident. For example, low inflation has translated into a

6 A more detailed explanation can be found in Dědek (2000).

7 Consumer inflation measured by the year-on-year change in the CPI reached 4.2% in the first half of 2001. "Net inflation" (which excludes changes in indirect taxes and regulated prices) was 3.0% as at the end of 2000.

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low interest rate differential, which is discouraging inflows of speculative capital. At the same time, a stable low-inflation environment encourages FDI. These positive effects of low inflation help to safely finance the current account deficits that are an inherent part of the process of transition. Low inflation also keeps currency appreciation at bay, thus helping to preserve external price competitiveness. Other things being equal, it also puts the state budget under less strain, as it slows down the triggering of various mandatory indexation rules.

There is no obligation to meet the Maastricht interest rate criterion, but nobody has any doubts that a low and stable interest rate contributes significantly to economic growth. Banks can evaluate more projects as less risky and worth financing over a longer period of time. The costs of financing for businesses are lower, households enjoy cheaper mortgages, and interest payments on state debt are less of a burden.

The central banker should continuously emphasise the mutual dependency between the inflation and interest rate criteria. Interest rates can be low only if the inflation rate is low. Pressures on the central bank to follow the reverse trend, i.e. to maintain low interest rates despite high inflation, may lower the credibility of monetary policy and are therefore counterproductive.

As already mentioned, the Czech economy recovered from recession and has embarked on a path of growth, with rather positive market expectations. There are concerns, however, about the danger of twin deficits, i.e. an increase in both the current account and public sector deficits.[8] These risks have been repeatedly pointed out by international institutions – e.g. the conclusions of FSAP mission saw the current trends as contributing to the vulnerability of the economy.[9] Furthermore, it seems that no radical solution is politically feasible. On the income side, it is difficult to envisage an immediate increase in taxation, not to mention that a significant hike in tax rates could also negatively influence both inflation and economic growth. On the expenditure side, there has been a palpable aversion to reducing the current welfare schemes and to taking unpopular

8 The "passive scenario" of the Ministry of Finance, which assumes continuation of the entrenched trends, estimates the public spending deficit in the 2001–03 period at 6-7% of GDP. The dominant course of fiscal consolidation as presented by the government in its Pre-accession Economic Programme is based on a substantial increase in VAT and indirect taxes, which is not likely to be received well in Parliament.

9 The FSAP (Financial Sector Assessment Programme) under the auspices of the IMF and World Bank, an important element of the new financial architecture, strives to improve the quality of financial systems in the member states. The Czech Republic was among the first countries to allow a thorough examination by the project. The Czech Republic is also doing well in the ROSC (Reports on Observance of Standards and Codes), which examine in detail the status of observance of international standards in the financial sector.

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steps, especially before the June 2002 elections.

Again it is proven that although no external authority is pressing on the Czech Republic to meet the Maastricht budgetary requirement, economic reality and macroeconomic prudence are urging for complying with this requirement. A political commitment to the Maastricht criteria would make it easier to consolidate public finance.

Last but not least, there is the Maastricht exchange rate requirement. One can doubt the real benefit of this criterion for exchange rate stability if it stipulates keeping fluctuations within a 30% band. With such a wide band, the Czech koruna would have met the requirement even in times of currency turbulence (see Figure 3).

Figure 3 The Nominal Exchange Rate of the Koruna Inside the Maastricht Band

Note: Range ±15% from the national central parity.
Source: CNB database; own calculation.

The exchange rate criterion is a very soft restriction on those candidate countries that are aware of the benefits of exchange rate stability and would therefore strive to contain fluctuations within a much narrower range than the Maastricht one. Therefore, the only real importance of Maastricht type stability is that it sets out a minimum "quarantine period" of two years in the form of membership in ERM II for each candidate country aspiring to adopt the single currency. It may, however, look strange and unchallenging to require the candidate countries to pass a lengthy exam in external price stability when these countries have the proven ability to maintain a stable exchange rate. But these are rules of the game which the European Union refuses to change with respect to the equal treatment principle.

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The Czech currency is now in a regime of managed floating – with much greater emphasis on "floating" than on "managed". Is this the best arrangement in the pre-accession period, or are there other viable alternatives? The answer is that a higher degree of exchange rate flexibility would better suit the specific features of the pre-accession period, but the benefits of the current regime lie largely in negative delimitation. In other words, any other exchange rate regime based to a greater extent on officially declared stability (a fixed rate, currency board or unilateral "euro-isation"), poses greater risks when one takes into account the degree of openness of the Czech economy with respect to capital flows. This experience was reconfirmed by the series of exchange rate crises in the 1990s, which warn against a combination of pegged rates, liberalised capital flows and inconsistent economic policies.

It is often said in defense of floating that exchange rate flexibility serves as a shock absorber. However, we should not overestimate this role. A number of examples may be found of a liberalised financial account being driven by motives that conflict with concerns regarding the current account, where the former usually prevail over the latter. The dominance of capital flows results in a longer-term trend of nominal exchange rate appreciation, which adds to the real appreciation driven by the higher domestic rate of inflation. This contributed to the widening of the external imbalance in the period prior to the Czech currency turbulence of 1997 and became a risk factor in the recent fragile recovery of the economy.[10] Furthermore, it is evident that the exchange rate fluctuations of the Czech currency are often a result of swings in global currencies. They are not, therefore, generated by domestic economic affairs. Nevertheless, these externally induced events have significant implications for the domestic economy.[11]

The current regime of managed floating is thus the second-best alternative which should not cloud the benefits for a trade-oriented economy deriving from exchange rate stability. But does a first-best solution exist at all and, if so, what is it? On the general level, the adoption of the single currency could be the answer. This will mean that an irrevocably fixed rate will be introduced with respect to the Czech main trading area, which will undoubtedly enhance trade and strengthen competition. The Czech economy

10 These cases are symptoms of a more general problem dubbed by some authors as "fear of floating". See Goldfajn and Olivares (2001) and Krugman (2001).

11 An illustrative example of the negative impact on the exchange rate caused by global currencies was the period of strengthening of the dollar against the euro. The koruna was falling against the dollar and rising against the euro. As key commodities are purchased in dollars, a stronger dollar makes imports more expensive. Most exports on the other hand go to EU member states, so a weaker euro translates into lower export income. The trade balance was thus hampered on both the import and export side.

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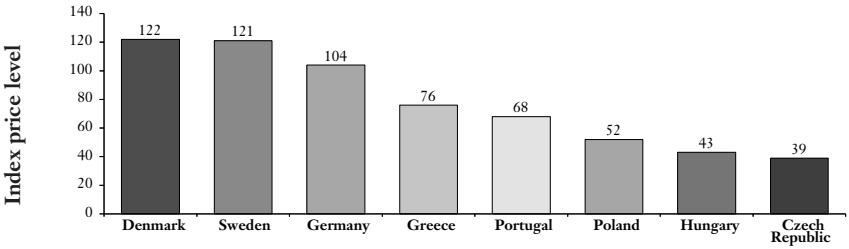
will once and for all escape the threat of a monetary crisis, for where there is no national currency no speculation can be made against it. This will, no doubt, come at the price of new problems, as the winding-up of a national currency is no trivial issue. Notwithstanding these problems, it is still good news for the Czech economy to be able to participate in a joint project responding to the many challenges of worldwide economic globalisation.

4 Closing the Price Gap

The price level problem has become one of the most hotly debated issues under the umbrella of real versus nominal convergence. The basis for the dispute is the "hard" empirical fact that the price levels in the candidate countries are below those in the EU member states. This problem is particularly acute for the Czech Republic, as its price level stands at about 40% of the EU average (see Figure 4).

Figure 4 Comparison of Price Levels



Note: Price levels in purchasing power parity in 2000; EU average = 100.
Source: OECD (2001).

This observation raises a number of questions. Is the Czech economy not committing a fatal mistake, by having a disinflation strategy that focuses on achieving inflation comparable to the EU average? Is such strategy not in fact counterproductive, only postponing the necessary hike in prices to bring them to the same level as in the European Union? Is the central bank not exposing the economy to the danger of a massive price jump upon entry to the EU? There are even doubts about the consistency of the Maastricht criteria per se. How should it be possible to close the price gap, either through higher inflation or through nominal appreciation, when the Maastricht criteria in parallel require price and exchange rate stability?

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The law of one price

The discussions about catching up with the EU price level often confuse two theories – the "law of one price" on one hand and the "Balassa-Samuelson effect" on the other.

The law of one price belongs to the family of models accentuating the aspect of disequilibrium thinking. Its driving force is the alleged disparity of values of products at home and abroad. Pricing arbitrage follows to remedy the pricing anomaly: the demand for cheaper domestic goods drives domestic prices up, thus converging them to those abroad. The outstanding gap between domestic prices and those in the European Union seemingly provides empirical grounds for this theory.[12] But does the statistically determined gap really indicate the extent the prices would have to jump?

Figure 5 has been frequently used as a demonstration of the strong correlation between GDP per capita and the price level. However, if this is a regular pattern, the only correct method for determining the size of the price anomaly is not to measure the distance to the EU average, but to measure the vertical distance to the estimated regression line. In other words, if the regression line slopes at about 45 degrees, then the Czech Republic with its 60% of the EU average GDP has a "legitimate right" to about 60% of EU average prices. The remaining deficit then cannot be linked to the closing of the price gap by way of pricing arbitrage, but to the closing of the average productivity gap with respect to the EU member states. When the price level is only about 40% of the EU average, the space for catching up the gap is not 60% (= 100% - 40%), but only 20% (= 60% - 40%). This "distance" is then a lot shorter, approaching the measurement error.

And there is an additional factor. The size of the price gap cannot be inferred simply from a statistical comparison which does not capture "microeconomic details" such as transportation costs, quality and reputation of goods, varying consumer preferences, and so forth. These factors, if they are the root of the price anomaly, do not themselves pose the risk of a price jump, as entry to the European Union will not bring anything new. Pressure to increase prices may be expected in areas where

12 Figure 4 points to the existence of vast differences in price levels also within the EU. These differences are also changing very slowly. According to the OECD (2001), the difference between Denmark and Portugal reduced by only 11 percentage points during the last decade (in 1990, the two countries stood at 126% and 61% respectively vis-à-vis the EU average, whereas in 2000 the corresponding figures were 122% and 68%). The difference between Spain and Denmark, on the other hand, widened by 4 percentage points during the same period.

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entry to the EU will lead to elimination of trade barriers or implementation of large-scale state aid programs.[13] In other words, if no significant trade barriers exist for a given commodity group, the assumption is that the prices in the given commodity group have already been realigned. This should be the case regardless of any comparative statistical analyses which do not take into account the above microeconomic details.

From the viewpoint of putting monetary policy into practice, the following remark is very relevant – the opinion that the price gap problem will be solved by way of stimulating higher inflation is simply not true. Higher inflation means price increases in general. The price gap, on the other hand, reflects certain disproportions in relative prices. Higher inflation means only that the alignment of relative prices will happen at a higher price level, as the general rise in prices does not itself change the price ratios. And if the higher inflation leads to a weakening of the currency, the price gap will be reproduced with this amount of weakening.

The Balassa-Samuelson Effect

While the adjustment mechanism in the law of one price is put into motion by a state of disequilibrium, the Balassa-Samuelson (BS) effect is based on equilibrium reasoning. The model envisages transmission of a wage increase in a tradable sector with a higher rate of productivity into a non-tradable sector with a lower rate of productivity. The assumption of equalisation of wages in the two sectors drives wages in the non-tradable sector up, causing higher inflation. If we drop the assumption of a fixed exchange rate, the model predicts a real appreciation of the domestic currency against foreign reference currencies.

It should be noted that the logic of the BS model does not mention the need to narrow or close the price gap. It only mentions that higher productivity will lead to a real appreciation of the currency or, if the exchange rate is fixed, to a higher inflation rate. So it also works in reverse – a lower productivity rate vis-à-vis a reference country will be the condition for preserving or even broadening the price gap. In any case, the BS model is, particularly for candidate countries, topical in its message that higher productivity or faster growth will lead to higher inflation. A too

13 Large potential for a price leap exists in the agricultural commodities sector, where price distortions can be attributed to the Common Agricultural Policy. According to a study by Vintrova et al. (2001), joining the CAP could translate into prices of food increasing by 35%–45%. The restrictions in place could also be used to explain why the price of arable land is approximately one tenth of the price in the EU countries neighbouring the Czech Republic. Price gaps may also be attributable to lower indirect taxes and unfinished changes in administered prices.

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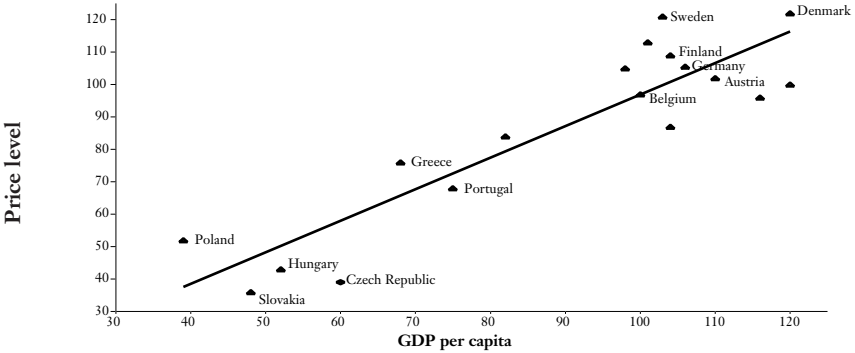
Figure 5 Statistical Interdependency Between the Price and Economic Level



Note: Measured on the basis of PPP; EU = 100.
Sources: OECD (2001); CNB calculations.

ambitious disinflationary policy may thus be viewed as a hindrance to productivity growth, inhibiting real convergence.

We cannot deny the BS effect its logical consistency. However, we should make an assessment of its empirical importance. The estimate of the strength of this effect will determine a lower limit for reducing inflation, which – if not respected – may logically damage productivity growth and the speed of real convergence. The strength of this effect also determines whether any inconsistency really exists in the Maastricht criteria. If this effect is not significant, it could be easily absorbed by the slack permitted by the criteria.[14, 15]

Intuitively, we can envisage a gradual reduction in the significance of this effect. It seems that the traditional way of regarding the service sector as non-tradable is losing its relevance owing to the fact that a great number of non-traded activities are now subject to strong international competition. Globalisation processes driven by technological innovations are leading to a reduction of transaction costs, and subsequently to a reduction of the relative weight of purely non-traded commodities.

Finally, we have to point out that the paradigm of the BS effect shows

14 See Szapáry (2000) for a survey of estimations of this effect from different authors.

15 If the inflation criterion tolerates an excess of up to 1.5 percentage point above the reference level and the exchange rate criterion is a 30% fluctuation range, then a moderate BS real appreciation can easily be split into inflation and nominal exchange rate values which still meet the Maastricht criteria. Furthermore, this kind of decomposition will have to be observed only during membership in ERM II, so the binding period may be only two years.

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one fundamental flaw – abstraction from capital flows, as if the exchange rate and inflation rate were to be judged solely on the basis of the current account. This crucial omission may be fatal, particularly for a small open economy with a high degree of capital mobility.

Once we introduce the capital account into the model, we can see a new set of consequences of a high inflation rate. A wider inflation differential, maybe even caused by the BS effect, tends to be reflected in a comparable interest rate differential. The inflow of short-term capital stimulated by the higher domestic interest rates triggers an exchange rate strengthening, helping to reduce inflation. A stronger exchange rate, other things being equal, translates into slower economic growth, thereby reducing domestic inflation. Adjustment mechanisms carried by the capital flows may, however, cause "overshooting", becoming a trigger of subsequent economic turbulence. A small open economy should avoid situations in which excessive capital flows are about to cause macroeconomic instability.

Last but not least, a model which, in theory, justifies the positive correlation between growth and inflation, should not be used as an alibi for inflation generated by an overheating economy, driven by real wages growing faster than labour productivity, excessive fiscal expansion and mounting government debt. These are intolerable inflation risks which have nothing to do with the BS effect. On the contrary, the model urges an interpretation stressing the strong relationship between convergence of price levels on the one hand and convergence of labour productivity rates and maintenance of macroeconomic stability on the other. The model does not explicitly mention the impact of ignoring this relationship. However, there is a track record of countries stricken by monetary crises.[16]

5 Policy Coordination in the Czech Republic

The policy trade-offs involved in the issue of real versus nominal convergence demand coordination between the government and the central bank. Both these institutions must have a say, as the implications of their policies are crucial for solving the problem. On the other hand, the implications of the two sets of policies are mutually dependent. However, the law requires the central bank to decide independently of the government. An efficient system of coordination is therefore needed, suggesting suitable policy mixes while respecting central bank independence.

16 A warning example of consequences of price and wage catch-up not backed by catch-up in labour productivity is the reunification of Germany, which was made possible only by huge transfers from the old to the new federal states.

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At least two reasons exist for why monetary policy within an inflation targeting regime creates a suitable environment for successful coordination and communication between the government and the central bank. The first important consideration is that the inflation target may become a bridge between government and monetary policies. While respecting the operational independence of the central bank, the government gets an opportunity to be involved in the process of setting the inflation target. The government will thus participate in setting the key parameters for suppressing inflation, such as the speed of disinflation and the definition of price stability. Simultaneously, it is in the interest of the central bank that the government supports the inflation target, as this adds to the credibility of monetary policy. And higher credibility is widely recognised as a vehicle for reducing the cost of meeting the target. Furthermore, the fact that the government accepts the inflation target means that the target will be made part of government economic policy. In other words, on the one hand the government creates better conditions for hitting the inflation target, and, on the other hand, any measures taken by the central bank aimed at achieving the inflation target cannot be interpreted as an act of hostility towards the government.

In what form have the above features been reflected in the practical policies of the Czech authorities? Although the history of inflation targeting in the Czech Republic is still short, we can already distinguish three stages.
Inflation targeting was launched in December 1997, when a short-term target for the end of 1998 and a medium-term target for year 2000 were announced.[17] The concept of "net inflation", which is in fact the consumer price index minus changes to regulated prices and indirect taxes, was chosen as the factor for steering monetary policy.

The first inflation targets were declared unilaterally by the Czech National Bank (CNB). This "self-targeting" approach was occasionally criticised. It must, however, be remembered that at the end of 1997, a new anchor was being sought for monetary policy, as the exchange rate anchor had been lost in the currency turbulence. The country was experiencing a political crisis, so it was very difficult to spend time discussing conceptual issues of monetary policy with the government. The need for a new anchor was further exacerbated by a dramatic rise in inflation expectations. When comparing the actual inflation figures with the 2000 target, it was obvious that the CNB envisaged a moderate disinflation. But events took a different turn, owing in particular to a strong and unexpected influence from external factors such as an extreme drop in oil prices, imports of subsidised agricultural products and aggressive pricing between retail

17 In November 1998, an intermediate target was set for the end of 1999.

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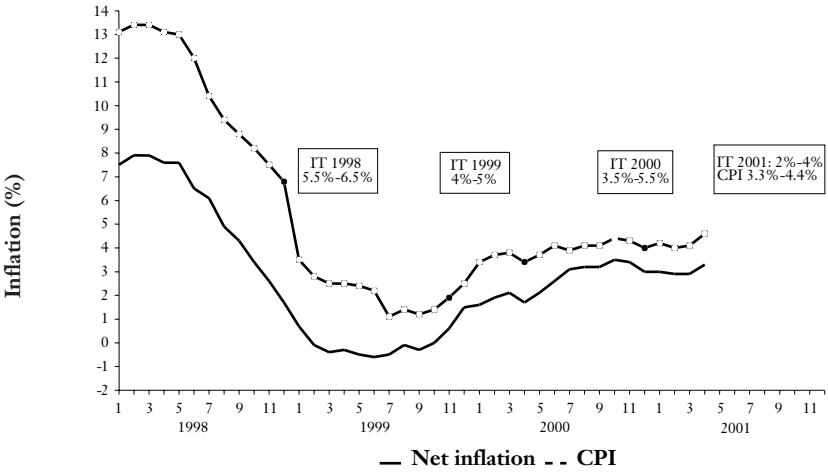
chains. In conjunction with the upcoming economic recession at home, this resulted in faster-than-expected disinflation. Eventually, it all led to an undershooting of the inflation targets and an only gradual return to the originally planned disinflationary trend.

The second stage started with the approval of a document entitled *CNB Monetary Strategy* in March 1999. In this document, the CNB presented a longer-term vision for gradually embracing the European standards for price stability, quantified in the form of a net inflation target of 2%±1 percentage point for the year 2005. However, more importantly, the Bank's strategy was incorporated into a document entitled *Medium-Term Economic Strategy of the Government of the Czech Republic* and subsequently into a document entitled *Joint Assessment of the Economic Policy Priorities of the Czech Republic*, which outlined the Czech Republic's path into the EU.

Figure 6 Confronting Inflation With Inflation Targets



Source: CNB database.

The dealings with the government, and in particular with its economic experts, were no walk in the park. Many an edge had to be softened and many a position clarified. The discussions on the practical implications of the price level issue were the most contentious. The result – in the form of consensus on the joint position of the government and the central bank – was achieved not only on the strength of the individual arguments, but also by the desire to present a consensus on economic issues to the European Commission.

If the consensus was reached under the pressure of reputation risk, one must ask whether the *CNB Monetary Strategy* accepted by the government is not getting obsolete. After all, the turbulent period of 1999-2000 exposed the Czech economy to a negative oil-price shock and the after-effects of recession. In the light of this test, the central bank's vision still seems to be standing its ground. In principle, the longer-term plans are still being met. The sharp disinflation was followed not by a resurgence of inflation, but by an anchoring of inflation expectations at a lower level. The missing of the medium-term inflation target for 2000 by only a narrow margin should, under the given circumstances, be interpreted as an achievement.

At present, inflation targeting is at the start of its third stage. This had a problematic beginning. In January 2001, a controversial amendment to the Czech National Bank Act entered into force. This imposes an explicit obligation on the central bank to consult and reach agreement with the government on the inflation target. This new feature introduced into inflation targeting has met with criticism from the European Commission as an element compromising the independence of the central bank. In the event, this provision was soon abolished by the Constitutional Court, which found it to be a breach of the independent status of the central bank as guaranteed by the Constitution.

However, this episode opened up a debate on how it is that the central bank can have operational independence, but not the sole authority to set targets. Reconciliation of the principle of target dependence, i.e. a form of government involvement in setting inflation targets, with the European legislation thus requires voluntary and not compulsory cooperation. From this point of view, the law did not have to codify the need for cooperation, as inflation target consultations had already become part of the communication between the central bank and the government.

The current stage has also seen the introduction of some technical changes to inflation targeting, such as description of the inflation target in the form of a continuously descending band and a switch to targeting headline inflation as measured by the overall consumer price index.[18] The new concept was approved by the government in April 2001. This motion reflected not only the consensus of the two main policymaking bodies with respect to continuing the disinflationary trend, but also the willingness of the government to put agreement regarding the inflation target on a more long-term footing.

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18 The new inflation target puts annual headline inflation at the level of 2 to 4 percent at the end of 2005. When this plan is compared with the ECB's inflation target of 0 to 2 percent for the harmonised consumer price index, we can intuitively conclude that the CNB inflation policy hopefully leaves sufficient space for the adjustment of relative prices and for the Balassa-Samuelson effect.

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Financial Stability, Monetary Policy and Integration: Policy Choices for Transition Economies

János Vincze

1 Introduction

In the 1990s, emerging markets went trough a number of regional and globalising crises, sometimes quite unexpectedly, that caused great harm. The concurrent reappearance of global financial markets and of a number of financial crises with a clear regional and international dimension prompted both policymakers and academics to reconsider financial liberalisation and international integration.

For transition economies in Eastern Europe (hereinafter referred to as TEs), whose clear political goal is to join the European Union, the recent experiences of emerging markets contain manifold lessons. Other problems are specific to the EU accession process, and may bear likeness to the ERM problems of 1992-93.

In this chapter, I start from the observation that not all financial crises seem to be equally destructive. I make an attempt to distinguish between financial structures and monetary policies that have the potential to amplify real disturbances, and thereby lead to crises *par excellence*, and those where fluctuations have risk-sharing features, and do not aggravate real shocks. Crises in the first category could be defined as "bad", the second as "good" or "acceptable". The construction of a financial architecture should, first of all, serve to avoid destructive or "bad" crises. Such bad crises do not automatically include all serious financial crises. Even large turbulences can be regarded as acceptable and inevitable phenomena. Dampening these turbulences may actually cause social damage, because a better risk-sharing in society would be prevented.

In the central and eastern European countries the main financial policy issue is the preparation for full membership to the EU, which is widely thought to be able to reduce their vulnerability to financial crises. I claim that this is true mostly with respect to "bad" crises. However, being "locked in" by a regional arrangement will not prevent financial crises from happening, as Mexico's crisis after its accession to NAFTA illustrates. Therefore, it is useful to examine whether and how the accession countries

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may become vulnerable to financial crises before and even after joining the EU.

Section 2 elaborates on the idea of distinguishing between bad and acceptable crises. In the following two sections I will focus on identifying harmful financial crises. Section 3 focuses on the domestic financial structure, and Section 4 tries to sort out the role of monetary policy. TEs' experience with financial crises will be analysed in Section 5, which will also look at the direction in which these countries are heading. Monetary policy choices will be addressed in Section 6. Finally, Section 7 comments on desirable policy actions.

2 Distinguishing Between Crises

It is usually believed that financial crises are harmful *per se*, because they cause great trouble in societies. Also, financial crises and vulnerability to crises are deplored because they prevent monetary policy from efficiently managing inflation, either because a crisis makes it impossible, or because vulnerability to crises softens the determination of policymakers. In addition to these general issues, crises in the TEs in the near future could delay accession, or after accession, lead to prolongation of the period before monetary unification. Moreover, it is thought that financial liberalisation and integration, in themselves, increase the likelihood of crises. As TEs do not have very well-developed financial infrastructures, they are especially vulnerable to crises, since the accession process requires total capital account liberalisation and exposes the domestic financial sectors to outside competition. The conclusion is a dilemma: their financial sectors must be improved and stabilised before accession, but liberalisation itself is a dangerous process, in which caution is absolutely necessary.

One may say that the only perfectly safe financial system is no financial system at all. Our understanding of financial intermediation suggests that no system without risks exist, whether it is based on banks or on securities markets. Even complete securities markets would not necessarily put an end to fluctuations. Although intermediaries may improve the allocation of risks and resources, when "open" markets are incomplete, they cannot obtain a first-best allocation.

Can we imagine a world where there are no financial troubles, but where recessions and other types of real disturbances still exist? Indeed, one of the main functions of the financial sector is to provide insurance against risks. However, if risks are real and cannot be eliminated by fiat, then it is reasonable to assume that somebody must at some time suffer,

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and that financial sector problems may indeed be part of a scheme for optimal risks distribution. In this view, crises help to give a state-dependent character to risk allocations, which is indispensable for efficient risk-sharing when non-diversifiable risks exist.[1] This idea does no imply that all banking, debt, asset market or exchange rate crises are optimal, i.e. contingent outcomes constituting part of a first-best social allocation. It only means that they may have a useful function, and that the crises we dislike must be those that aggravate the natural risks of economic life, or those that worsen rather than improve risk-sharing in society. The real problem therefore is not that financial crises occur, but that they may hit the most defenseless with an extraordinary force. And as many recent crisis episodes seemed to possess this unpleasant feature to a large degree, they led to a denouncement of liberalisation. However, we may find recent examples where the financial crisis did not seem to involve much "real" trouble. Then the question is not how to reduce vulnerability to crises in general, but rather, how to create a financial architecture whereby possible financial disturbances belong to a risk-sharing arrangement and may help share real exogenous risks.

Let me give an approximate definition of a "bad" financial crisis. 1. Real shocks are amplified in a "bad" crisis. 2. A "bad" crisis may be caused by shocks that are not related to real economic fundamentals. 3. In a "bad" crisis, losses are not shared and the poor suffer relatively more than the rich. It must be clear that the whole financial architecture, including markets, intermediaries, monetary policies, is responsible for the character of financial crises, and that interaction between the components is crucial.

To illustrate that it is possible to distinguish between "acceptable" and bad crises, I am going to assess some financial crises that occurred during the 1990s. What was the nature of the 1992-93 ERM crisis? For several countries – notably Italy and the United Kingdom – the general opinion was that the crisis did not bring any harm, but rather, the opposite. The crisis had neither real nor inflationary adverse effects. In fact, the devaluations may have contributed in some cases to the recovery. In other words, one can interpret the adjustable and vulnerable ERM as a sort of optimal arrangement in which real disturbances, such as the German unification, resulted in a financial crisis.[2]

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1 In this vein, Allen and Gale (1998a) argue that bank runs may, in some circumstances, be vehicles for achieving first-best allocations. Default risks have been known to improve (see e.g. Obstfeld-Rogoff, 1996, Chapter 6). Also, devaluations and uncertainty about inflation can give a state-dependent character to nominal contracts, making markets "more complete".

2 A less favourable interpretation is, of course, that countries where the crisis had no real causes also suffered, like France. However, was it a great problem for the French economy? There is little evidence that it was.

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In contrast, the Mexican Tequila crisis of 1994-95 may be considered as a harmful crisis. Mexicans suffered acutely for years after the crisis, while US investors were proudly informed by their government that they did not lose any money. This was probably one of the most invidious consequences of the crises in the 1990s.

The Asian crisis of 1997-98 is another crisis that caused great harm. Several East Asian economies went into severe and prolonged recessions, with unjust distributional consequences. It would be very difficult to assign these to existing real shocks that may have preceded the crises.

The financial sectors and monetary policies of both Mexico and the East Asian countries contained some serious flaws that I will analyse in the following sections.

3 Vulnerability and Financial Architecture

The literature gives a number of features of financial systems which could be blamed for the amplification of real disturbances. It appears that the presence of moral hazard, the large fluctuations in asset prices, the existence of financial market linkages and the lack of hedging possibilities are the most common suspects. I will briefly explain each of these features.

Moral hazard is generally regarded as one of the main reasons that a financial accelerator exists. Moral hazard not only has natural (exogenous) causes, but can also be created by policies and institutions (see Eichengreen and Hausmann, 1999). Exchange rate pegging and explicit or implicit government guarantees result in moral hazard.

Large *asset price volatility* and bubbles have characterised many recently liberalised financial markets and banking systems. However, poor quality of supervision, weak regulatory frameworks and inexperience usually lie at the root of these problems.

Financial market linkages have been powerful mechanisms for transmitting disturbances internationally.[3] On the other hand, the work of Allen and Gale (1998b) suggests that such transmitting is, to a large extent, the result of too little liberalisation and that full international integration would contribute to minimising exposure to international spillovers.

The lack of hedging opportunities (Eichengreen and Hausmann, 1999) implies that international investors find their investments in emerging markets too risky. By developing strategies to alleviate this problem, they increase the vulnerability of the countries involved. These strategies

3 See Darvas-Szapáry (2000) on the role of the regional aspect after the Russian crisis of 1998.

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involve, for instance, lending in foreign currency on a short term. Financial market liberalisation and the entry of foreign firms into domestic financial markets can also help to solve these problems, whereas monetary unification can be an even more stable remedy.

Al these features played important roles in the Latin American and Asian crises in the 1990s. Moral hazard via implicit guarantees was a well-documented feature of many Asian economies, and regulation was far less than perfect, resulting in asset price bubbles in Thailand, for instance. Several Latin American countries, suffering from the Tequila crisis, may not have had many currency hedging possibilities. Also, domestic financial markets were usually very poorly integrated with international financial markets, but dominated by government and domestic participation.

From the above, it seems that incomplete liberalisation and restricted foreign entry into domestic financial markets, accompanied by weak supervision, and not liberalisation and integration *per se*, are the things that cause harmful financial disturbances. One objection may be that full liberalisation will increase the potential for foreigners to engage in destabilising speculation in the foreign exchange market. My argument is that there is good reason to believe that foreigners would probably use the access to lending and borrowing in the "domestic" currency for hedging purposes, whereas otherwise they would have to behave in ways (e.g. preferring short-term foreign currency lending) which may cause harmful financial disturbances. The appetite for speculative profits can grow if monetary policies are inappropriate (see next section), but this can be avoided. On the other hand, having foreign lenders expose themselves to genuine exchange rate risks (i.e. risks that have "real" sector origins) provides an important risk-sharing possibility. Foreigners willing to lend in Hungarian forints will share the losses when the forint would depreciate.

Another possible objection is that too much internationalisation may keep the financial sectors of TEs underdeveloped. What are the main arguments for the judgment that the financial sectors in TEs are relatively inefficient? A number of comparable indicators pointing to this inefficiency exist. They include measures of financial depth, interest rate spreads, market capitalisation, etc. However, one should refrain from a hasty interpretation of these indicators.

First, financial depth and the overall size and liquidity of asset markets may be closely related. As a large part of money demand comes from financial transactions demand, small financial markets may in themselves reduce money demand. Second, there may be important offshore markets that take up a large part of financial business for several TE currencies. Third, these countries are usually open, but their foreign trade is not invoiced in their own currency, thereby decreasing money demand.

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Fourth, some countries have an increasing share of multinationals or other groups of firms that conduct much of their business internally, also implying that their activity requires little "domestic" money. Fifth, the leverage of the multinational sector can appear to be too low, despite the fact that parent enterprises may be highly levered. Thus, there must be substantial financial intermediation in foreign markets, resulting in domestic investments. Sixth, to a certain degree foreign banks lend directly to domestic enterprises.

To sum up, several factors suggest that the usual indicators do not show how easily enterprises may have access to financial services, as these financial services have already been integrated into world markets. Domestic interest rate spreads may reflect a worse mixture of borrowers than those who can get credit from some lender. Of course, the indicators also show the consequences of "primeval sins" (domestic money is not used in transactions involving foreigners), and/or those of size effects. Having said that, it remains true that financial development is not very sophisticated in TEs, especially in the household sector. This sector remains vulnerable for financial sector problems, for instance in the case of a real estate price bubble. However, a degree of trust may be placed in the learning capabilities of financial institutions. Even without any specific regulatory effort, too much risk-taking may be avoided by the financial institutions themselves, having learnt from the mistakes of the past decade. Whereas one may have a sober view of the rationality of the market, one may be confident that markets react to recurrent events, even without government intervention.

4 Monetary and Exchange Rate Policy and Financial Stability

Central banks in emerging economies have pursued a style of monetary politics aimed at disinflation that might have had unwelcome effects on financial stability. This strategy involved a heavily managed (almost or practically pegged) exchange rate, coupled with sterilisation, which tried to give a significant positive excess yield (premium) on the home currency.[4]

Table 1 in the Appendix illustrates this traditional *peg cum sterilisation* regime for four countries that practiced it and suffered from an exchange rate crisis. This policy implies that in "tranquil" periods, the excess yield has a significantly positive mean and a relatively small variance. The average premium was as high as 11 percent in Mexico, and ranged from 3

4 We will define $\pi = i - (i^* + ds)$ as the premium on the home currency, where i is the home interest rate, i^* the foreign rate and ds the rate of future devaluation of the home currency.

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to 5 percent in Thailand, Korea and Indonesia. However, there is also some probability that, due to a surprise depreciation, the mean of the excess yield in the whole regime becomes closer to zero, and its distribution has a larger variance and also possesses features of non-normality, such as excess kurtosis and non-zero skewness. For the aforementioned four countries, there is at least a tenfold increase in variance; the skewness becomes large and negative, while excess kurtosis is significant, together indicating "large" negative outliers.

Disinflation under the (adjustable) *peg cum sterilisation* policy was based mainly on the exchange rate anchor, but, as it were, without full confidence. The lack of total confidence explained sterilisation and the resulting positive average yield differential, which was thought to be helpful in defending the peg. This strategy was also believed to be disinflationary, because it gave respectably high real interest rates, for our sample ranging roughly from 4 to 8 percent. In this framework there was a very likely gain for everyone willing to invest in the country's currency, or alternatively, to borrow in foreign currency. It is common knowledge that one type of gambler prefers this type of gamble, tending to neglect small probability events. This gambler is satisfied with even small gains and may forget a large loss might occur when the small probability (unfavourable) outcome is realised. It is widely believed that this policy aggravated the East Asian crises when they came. The mechanism is as follows: there is an implicit, but uncertain, guarantee by the government that it will not devalue, while it keeps the nominal interest rate above the foreign rates.[5] The interest rate differential is high enough for many firms or banks to prefer borrowing in foreign currency, which results in a currency mismatch, making them very vulnerable to adverse shocks.

The apparent failures of these policies have led in two directions. One direction has resulted in stronger rigidity by way of a currency board arrangement, and the other one, recently very popular, involves floating exchange rates. Table 2 in the Appendix shows the corresponding statistics for the four countries in their post-crisis "flexible" regimes. One can see that the practice of flexibility is more diverse than that of pegging. The premium was large and positive in Mexico and Indonesia, while small in Korea and negative in Thailand. In all cases, variances have increased substantially. Real interest rates are again positive but with large differences across countries. In Indonesia it was almost 20 percent on average, whereas in Korea it fell below 3 percent.

It may be too early to assess the performance of the new regimes, or

5 See again Burnside-Eichengreen-Rebelo (1999).

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even to determine what characterises them precisely. From the point of view of engendering financial fragility, one may have suspicions. The countries with large average excess yields may increase their vulnerability, as this may attract speculation in a floating regime, too, by (nearly risk neutral) foreigners, or can result in desperado behaviour by residents. On the other hand Calvo-Reinhart (2000) show that many "nominal" floaters practise exchange rate management, though, in some cases, not so much by direct exchange market intervention, but rather, with the help of nominal interest rates. This in itself may cause disturbances in the financial system.

5 Past and Future Crises in TEs[6]

Several TEs have suffered from some kind of financial crisis in the last decade. In Russia, virtually all types of crises appeared simultaneously in 1998. There was first a stock market crisis with significant real repercussions, then a sharp devaluation with foreign (including private) debt moratorium and with bank runs resulting in a collapse of the payment system. After years of currency instability and banking sector problems, Bulgaria in 1997 witnessed a currency attack that resulted in a full-blown banking crisis with runs. Default was avoided, and there was no stock market crisis, there being no stock market of which to speak. In Romania, a permanent state of banking and currency problems has prevailed. In 1997-98, the foreign exchange situation exhibited the features of a crisis with large depreciation, though no bank runs and no collapse of financial intermediation ensued. The Slovak Republic was able to defend its fixed exchange rate system, despite an attack during the Czech crisis of 1997. However, the Russian crisis of 1998 triggered the collapse of the fixed exchange rate system, leading to a large depreciation of the Slovak koruna.

In all of these examples, fundamental problems produced the crises in the, sometimes, rather simple financial systems. The root of the problems was patently fiscal, though for the Slovak Republic, this statement is not easy to prove by reference to traditional fiscal accounts. Despite the fact that the financial systems were obviously not robust or efficient in these countries, the financial crises were definitely adjunct to the very real troubles that plagued these economies. There seems to be no evidence that the financial sphere made things definitely worse. On the other hand, it is possible that Bulgaria and the Slovak Republic were stimulated by their respective financial crises, and the reform processes gained momentum in their wake. In fact, it may be true for the other two countries as well.

6 This section is, to a large extent, based on Árvai-Vincze (2000).

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The three Baltic countries (Lithuania, Latvia and Estonia) have had different experiences. They all have rigid exchange rate regimes – currency boards in Lithuania and in Estonia, and a strict peg in Latvia. They have liberalised their financial sectors rather boldly, but they have been more exposed to Russian trade than most other TEs. The Russian crisis had a severe impact on Latvia, due to the economy's high exposure to Russian markets, but Latvia did not have to abandon the exchange rate regime. Even though we cannot speak of a full-blown banking crisis, several banks experienced bank runs and liquidity crises after the Russian crisis. There was a modest rise in interest rates, though capital flight was not substantial, as foreign participation in Latvia's capital markets was insignificant. Stock prices had already been declining for several months before the crisis; thus, there was no significant immediate effect on the stock market. Although Lithuania was also vulnerable to contagion from Russia, the currency board arrangement survived the storm and the consequences of the Russian crisis were more substantial in the real economy than in the financial markets. Financial markets basically reacted the same way as in Latvia. Estonia was a similar case as the other two Baltic economies, though with less damaging consequences to the real economy, due to its lower exposure to Russia. Nevertheless the stock market was hit hard by foreign investors' loss of confidence. As an automatic response to the liquidity shortage in a currency board system, there was an immediate rise in interest rates, but capital flight was not substantial.

The three Baltic states represent an interesting experiment inasmuch as liberalisation was coupled to very rigid exchange rate policies. These countries managed to survive the Russian crisis and its aftermath in a relatively intact state, proving that this mix of policies can be effective in avoiding bigger troubles. The Russian crisis was definitely "real" for these economies, and, almost out of necessity, their financial sectors were not as robust as possible. Still there were relatively few disturbances, like those in Latvia, that might have been an indication of a "bad" crisis. Indeed, one may say that these countries were definitely vulnerable to economic crises for real reasons. In this light, the experience of the Baltic states may be seen as a success. An alternative interpretation would be that the troubles after the Russian crisis are attributable to the inflexible exchange rate arrangement. Although this interpretation might make sense, the burden of proof rests with its advocates.

In May 1997, the Czech Republic was the target of speculative attacks which the monetary authorities were not able to withstand, and the fixed exchange rate system had to be relinquished. The repercussions of the currency crisis in the capital market were less severe than expected. Though the currency crisis did not lead to a liquidity crisis in the banking

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system, the serious problems in the Czech banking sector, which had been accumulating for years, became more visible. In my opinion, the Czech crisis was not a bad crisis either, as it inflicted little damage to the economy, at least no additional damage to the real sources of the crisis. This was even though at the time, the Czech economy did not exhibit all the features I recommend in Section 2, and that previous exchange rate policies had belonged to the adjustable *peg cum sterilisation* category.

My view is that the Czech policy regime exhibited the features of an implicit risk-sharing arrangement. It was based on a risky strategy of fast disinflation and quick resumption of growth within a framework where the government's influence was strong via its possession of the banking system. Because things turned out unfavourably, the implied exchange rate regime was able to implement cost sharing via the devaluation that put some of the burden on the shoulders of non-residents investing in koruna denominated assets. The crisis again worked like a catalyst, leading to a policy that, after some years, seems to be producing positive results. Today, the Czech banking sector is in much better shape and, to a large extent, in foreign ownership. Though the crisis caused the abandonment of the exchange-rate-based disinflation strategy, the current monetary policy is reasonable, in that it avoids giving unnecessarily good investment opportunities, and by providing a fundamentally stable nominal exchange rate.

Poland's monetary authorities had widened the fluctuation band in several steps before finally letting the zloty float in April 2000. This move may have been influenced by the desire for an "independent" monetary policy and aimed at pre-empting potential speculative attacks. The Russian crisis had some adverse impacts on exchange rates and asset prices, but Poland may have had some real exposure to Russia. Still, there is little evidence that the post-Russian crisis disturbances were really serious. Poland has put great weight on disinflation, surrendering monetary policy to that goal. (However, in order to cushion the impacts of the Russian crisis, Poland somewhat eased it striving at the end of 1998). It is conceivable that in Poland the adverse effects of a disinflationary strategy based on the interest rate channel might have been instrumental. The mini-crisis at the beginning of 2000 may have been caused by the anti-inflationary zeal that resulted in very high zloty real interest rates and in high premia.

In Hungary, banking problems had been solved via consolidation before 1995, though its costs may have contributed to the recurrent small attacks on the currency during 1994-95. The currency problem was managed via a large devaluation and the implementation of a stabilisation programme. In 1998, after the Russian crisis, stock prices dropped sharply, but had no important real effects. The exchange rate came under some pressure, but was defended almost costlessly.

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In Slovenia, by pursuing extremely cautious macroeconomic policies, all types of crises are avoided, at the cost of maintaining relatively strong capital controls. It has not suffered from any crisis, but it has also seen relatively little liberalisation. This mixture of policies was enabled by good initial conditions, but Slovenia seems to be situated on a dangerous middle ground now, which may be a cause of future troubles, unless a bolder reform of the financial sector materialises.

6 Monetary and Exchange Rate Policies in TEs

TEs have produced a wide variety of exchange rate and monetary policy regimes. Table 3 in the Appendix shows statistics on Hungary, the Czech Republic, Poland, and Estonia in different time periods.

The Czech Republic followed a *peg cum sterilisation*-style policy before its crisis of May 1997. Columns (1) and (2) in Table 3a illustrate this, showing a reduction in the average premium, and a substantial increase in the variance. However, note that the changes between the columns are not as sharp as those between Tables 1a and 1b, as the Czech crisis was a relatively mild one compared to those in East Asia and Mexico. In 1997, Czech monetary policy switched to a floating regime, and column (3) shows that this resulted in a somewhat higher premium, with higher variance and more outliers, as well as in a definitely higher real rate.

From 1993 onward, Poland increased its exchange rate flexibility gradually, starting with a traditional crawling peg, then widening the bandwidth until abolishing it. Splitting the sample into two shows what it has meant. There was an increase across subsamples in both the premium and the real interest rate, and there was an increased variance in the premium, accompanied with somewhat more "normal" higher order moments.

After its mini exchange rate crisis in 1995, Hungary moved from an adjustable peg regime to a crawling band with a ±2.25 bandwidth, retaining to it until April 2001. Because, most of the time, the band was defined for a basket of DM and US dollar, I am reporting statistics for both currencies. Column (3) and (5) in Table 3b show the statistics before the Russian crisis, and column (4) and (6) for the whole period (columns (3) and (4) refer to DM statistics). One can observe here again the features of the *peg cum sterilisation* regimes, but without a proper crisis. The large difference between the premia is attributable to DM/dollar exchange rate changes.

Estonia has been a devoted currency boarder, fixing its krona against the DM from quite early on during transition. Columns (1) and (2) in Table 3b show the small premia in tranquil times, and the somewhat increased

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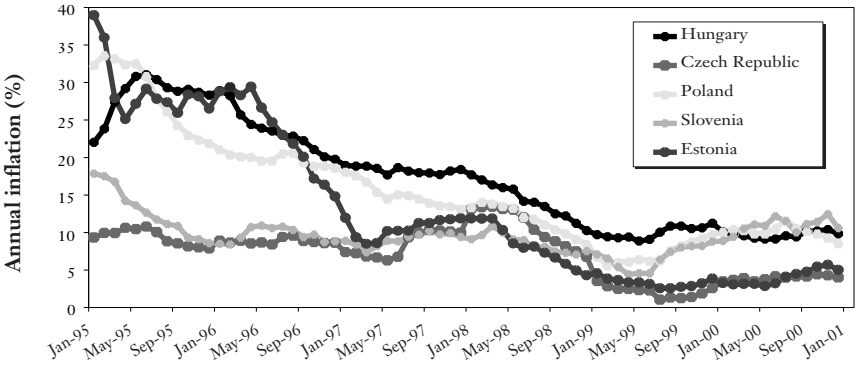
premia, if we include the turbulent periods of the Asian and Russian crises. Non-normality appears even in normal times, but the obvious difference between this and the *peg cum sterilisation* strategy is the size of the premium. Note the large negative average real interest rates.

From the tables, it seems that all countries, except Estonia, had significantly positive real interest rates. One may pose the question whether these were important for inflationary developments. Figure 1 would suggest that this was not so much the case. Estonia had the most spectacular disinflation of the five countries whose inflation rates are displayed, and it has, together with the Czech Republic, recently been a forerunner in the inflation front.

Figure 1 Inflation in TEs, 1995-2001



Indeed, Table 4 can be invoked to give a different explanation for differential inflation developments in the region.

Table 4 Inflation and Exchange Rate Changes
(in percentages)

	Price level change	DM exchange rate change
Czech Republic	45	–2
Slovenia	65	26
Estonia	82	0
Poland	103	33
Hungary	135	85

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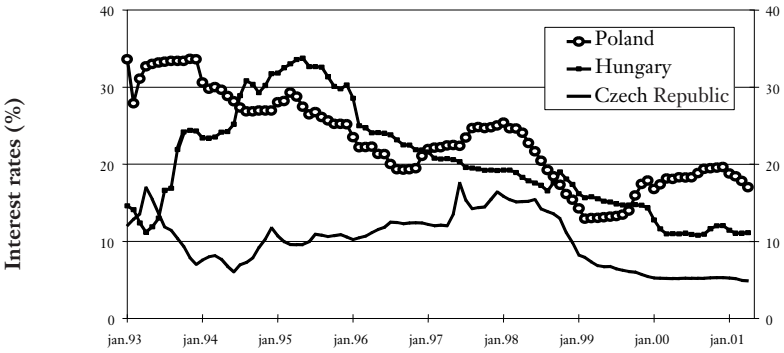
The only change in rankings occurs between Estonia and Slovenia, where Slovenia has the highest per capita GDP, and Estonia, a former Soviet republic, probably has the most distorted price system at the beginning of transition. The above data suggest the following interpretation. Real interest rates have probably played minor roles in inflation developments. The style of monetary policy, or the exchange rate regime, did not really determine inflation either in the short or in the long term. Short-term movements in the rate of inflation were probably due to common causes (oil prices, agricultural shocks), whereas monetary policy mattered for lower frequency price changes, mostly via its relationship with the nominal exchange rate.

What about the relationship between these monetary policies and financial vulnerability? Above we noted the role of *peg cum sterilisation* policies in the Asian and Mexican crises. Again, we find large premia with small variances, which is also suspected to have played a role in the crisis, in the Czech Republic before 1997. In fact, Czech monetary policy has recently moved towards much lower interest rates premia (see Figure 2). Polish interest rates became quite high in the second subperiod, while interest rate volatility has probably been greatest in Poland (see Figure 2). Poland has been struggling with balance of payments problems in recent years, and it is possible that besides fiscal policy, its monetary policy might have contributed to this. Hungary's crawling band system seemed to work reasonably well from the point of view of financial stability, as it had more built-in flexibility than pegs. This policy, however, performed worse than most others in inflationary terms (see Figure 1). On the other hand Estonia's currency board, which performed quite well in terms of inflation, was not a safe haven against the turbulence of international financial markets.

Figure 2 Three-month nominal interest rates in Poland, Hungary and the Czech Republic, January 1993 - April 2001



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This broad menu of monetary policies might have important attraction for investors when there are regional shocks. Providing different exchange rate regimes is apparently tantamount to offering different assets where asset yields have the same regional factor, and these different asset yields react differently to the same source of uncertainty. In other words, countries have provided investors with significant diversification opportunities. This might have contributed to the popularity of the region. Now, is this a stable arrangement and, if not, what would be the consequences of changes thereof?

Hungary's recent switch to floating rates suggests, although it does not necessarily imply, some convergence between exchange rate policy styles. If there is a move towards uniformity, and it will almost necessarily happen if several countries aim at fulfilling the Maastricht criteria simultaneously, then this diversification possibility will pass and capital flows may become either smaller or possibly more volatile. It is not unlikely that uniform policies played important roles not only in the East Asian crises but also in the ERM crisis. Taking this into account, either the sequencing of Monetary Union entry or the changing of the Maastricht criteria might be of some help. As the latter would be very difficult to change, the first solution appears to be more viable. However, it would obviously also trigger political tensions. Thus, there is a distinct feeling that the two pre-euro years may become the most susceptible to capital flow volatility and attacks.

The recent worldwide move towards flexible exchange rates, and the strong emphasis put on the interest rate channel of monetary policy have been motivated by several ideas. One goal certainly was to diminish financial vulnerability, and another was to manage inflation more successfully. The latter goal can be decomposed into two elements. First, countries wish to target low inflation on average, and second, they would like to stabilise inflation. Both ideas are explicit in the Maastricht criteria, and very strongly imbued in EU mentality. If we have reasons to doubt both the necessity of having very low inflation at all times and the desirability of little inflation variability, then *a fortiori* we have a case against the very active use of the interest rate or, the interest rate channel, which is the same, in TEs. In the following, I will develop an argument to this effect.

There are good reasons to believe that the real exchange rate is going to appreciate in the accession countries. Whether this is strictly related to the so-called Balassa-Samuelson effect, or, can be explained by other causes is not important here. Indeed, there might be other factors behind the increase in the price of services relative to that of industrial goods. Real appreciation on a CPI basis seems to be unavoidable, provided that TEs

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fulfil the hopes of faster development and modernisation. Now the question is whether this will be carried out by way of a positive inflation differential or nominal exchange rate appreciation. Thus, in order to attain the EU average, it is almost certain that, aside from temporary manipulation, one would have to resort to nominal appreciation.[7] No one doubts nowadays the advantages of having a low rate of inflation, lower than that prevailing in many TEs at the moment. However, a few percentage points higher inflation than that achieved in Euroland is acceptable. If appreciation requires high average excess yields, then, though potentially helpful against inflation, it may also increase vulnerability by attracting hot money. With very robust financial systems and with very good prudential regulation, the problem may not be very serious. However, it is questionable whether all accession countries would pass this test, on account of the weaknesses of their financial sectors. This is an example of the importance of interactions between monetary policies and financial structures in determining vulnerability.

One might also argue that striving for very little inflation variability can be counterproductive. It is clear that both long-run and short-run relative price changes have occurred and will occur in TEs for good reasons. For instance, there are very good reasons to believe that food prices are much more volatile in TEs than in developed economies. As the share of food prices in the CPI is also higher, this imparts an incipient volatility to the CPI as well. Efforts to stabilise the CPI may cause variations in relative prices that would not make any sense. An active monetary policy implying frequent and possibly large nominal changes would certainly cause additional relative price variation, and therefore allocational distortions.

7 Summary and Policy Conclusions

In this chapter, I distinguished between "acceptable" and "bad" financial crises, seeking to identify the features of financial structures and monetary policies that are most likely to be responsible for the distinction. The analysis of financial crises in TEs has shown that although none of them have exhibited the properties that would make the avoidance of a bad crisis very likely, they have not had any "bad" financial crises in the sense assigned to the term in this study. There are two possible explanations: either this has happened by chance, or their financial infrastructure has been so underdeveloped that it has not had the necessary strength to

7 Nominal appreciation and the concomitant "weighing-in" problem are analysed in Szapáry (2001).

produce a truly bad financial crisis. As the countries under review seem to be intent on developing their financial sectors, they remain or will become vulnerable to bad crises in the future. What then are the best ways to escape from this predicament?

A recurrent topic in Section 2 is that liberalisation and integration are the only safe strategies in the long run. In the case of TEs, there is one reason why caution must not bear enormous weight in the immediate future. The reason is that EU accession will, at any rate, require virtually full liberalisation, and there is some advantage to the idea of starting experimentation with a liberalised system before that date. One important caveat is that the quality of prudential regulation must be improved, as it appears to be a necessary part of any modern financial system. The biggest challenge is how to cope with asset price bubbles. In this respect, recent regulatory experience must be incorporated into the regulatory frameworks as fast as possible. It must be noted, however, that regulators can trust the learning capacity of the private sector.

This leads to another major point: privatisation of the financial sector must proceed quickly, and if it is done fairly and without restrictions, then it will almost necessarily involve a very high foreign ownership share in all TEs. Indeed, in the last few years enormous progress has been made in this field, even in those countries whose bank privatisation used to lag behind. Foreign banks' participation is useful not just because they have experience in general and in particular with recent financial turmoils, but also because this can ameliorate moral hazard, which is potentially the most dangerous factor for financial vulnerability.

A general lesson from the Asian crises appears to be that several of the countries that suffered most from the concatenation of financial sector and currency crises had had a policy of liberalisation oriented toward domestic ownership. Now some of the TEs have not made the mistake of stimulating moral hazard via implicit guarantees. However, it can be an important problem for Slovenia, which appears to have chosen a cautious and protectionist approach so far, that it can run into serious difficulties at the time it would most need some respite. Cleaning up the inevitable mess that accompanies the early stages of transition is an important prerequisite for every country wanting to enter the European Union successfully.

The analysis of monetary and exchange rate policies showed that the relationship between these policies and financial vulnerability is very complex. We have learnt of the dangers inherent in currency pegs, and may have misgivings about actively independent policies in floating regimes. I raised the question, whether the goals of avoiding financial instability and attaining low and stable inflation are fully consistent.

The Central and East European countries have no intention of

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developing financial and/or monetary policy cooperation among themselves. They all look at the European Union individually as the vehicle through which they can eventually enjoy the fruits of large-scale integration. In view of the regional character of some of the recent financial turbulences, this neglect of each other's policies may have repercussions. On the other hand, they all trust that Central and Eastern Europe, as a distinguishable economic region, will soon disappear.

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Appendix

Table 1a Measures of Monetary Policies in the Peg Cum Sterilisation Regime in Tranquil Times

	(1) ME 1991:4 -993:11	(2) TH 1991:4- 1997:3	(3) KO 1991:4-1997:7	(4) IN 1991:4-1997:4
(1) prem	0.1104	0.04	0.052	0.0336
(2) var	0.0016	0.0018	0.006	0.0008
(3) ske	-0.563	0.3038	-0.7545	-0.1443
(4) kurt	0.5311	-0.0851	1.5191	2.1837
(5) rrate	0.05	0.0395	0.0822	0.0377

Table 1b Measures of Monetary Policies in the Peg Cum Sterilisation Regime Including the First Months of the Crisis

	(1) ME 1991:4-1995:2	(2) TH 1991:4- 1997:6	(3) KO 1991:4-1997:10	(4) IN 1991:4-1997:7
(1) prem	0.064	-0.0036	-0.0301	-0.0085
(2) var	0.0172	0.0537	0.2322	0.0534
(3) ske	-3.063	-5.375	-5.97	-5.961
(4) kurt	11.175	31.183	36.817	38.289
(5) rrate	0.054	0.0381	0.08	0.0377

Notes:
ME: Mexico, KO: Korea, TH: Thailand, IN: Indonesia.
prem: the average premium on the US dollar.
var: the empirical variance of the premium.
ske: the empirical skewness of the premium.
kurt: the empirical kurtosis of the premium.
rrate: the 3-month real interest rate on the domestic currency.

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Table 2 Measures of Monetary Policies in the New Floating Regimes

	(1) ME 1997:1-2000:9	(2) TH 1998:3- 2000:9	(3) KO 1999:1-2000:9	(4) IN 1998:5-2000:8
(1) prem	0.10	-0.04	0.0137	0.3368
(2) var	0.0410	0.0556	0.0172	0.6707
(3) ske	-0.379	0.8011	-0.4024	1.1316
(4) kurt	1.1815	0.1909	1.1782	0.5819
(5) rrate	0.076	0.0394	0.0269	0.1939

Note:
The beginning months in this table were chosen so as to exclude the most turbulent periods.

Table 3a Monetary Policy Measures in TEs

	(1) CZ 1993:1-1997:1	(2) CZ 1993:1- 1997:7	(3)CZ 1998:1-2000:9	(4) PO 1993:1-1996:12	(5) PO 1997:1-2000:9
(1) prem	0.0658	0.048	0.0764	0.0624	0.1111
(2) var	0.0077	0.0125	0.018	0.0241	0.0366
(3) ske	0.2708	-0.669	-0.878	-0.954	-0.758
(4) kurt	0.0077	1.226	1.327	1.261	0.5319
(5) rrate	0.0197	0.0197	0.058	0.0326	0.0831

Table 3b Monetary Policy Measures in TEs

	(1) ES 1993:9-1997:9	(2) ES 1993:9-1999:2	(3) HU 1995:10-1998:4	(4) HU 1995:10-2000:9	(5) HU 1995:10-1998:4	(6) HU 1995:10-2000:9
(1) prem	0.0052	0.0258	0.0914	0.075	-0.019	-0.039
(2) var	0.0003	0.0019	0.0045	0.0074	0.0113	0.0188
(3) ske	-1.33	1.249	-0.431	-0.785	-0.749	-0.7435
(4) kurt	8.133	1.306	-0.700	1.76	0.513	0.2431
(5) rrate	-0.172	-0.11	0.0468	0.0495		

Notes:
CZ: Czech Republic, PL: Poland, HU: Hungary, ES: Estonia.
In Table 3 the premium and correlation refer to the Deutsche mark, except in Columns (5) and (6) of Table 3b where they refer the US dollar.

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Comment on Oldřich Dědek and János Vincze

Stephany Griffith-Jones

I will comment on two papers, which are very good, although I have some disagreements with the second paper.

I found Oldřich Dědek's paper very interesting and enjoyed the brief but very thoughtful reflection on the Czech currency crisis. I must say that, Oldřich was among the few Czech economists who also did a good analysis of the potential risks *before* the crisis. Unfortunately, it was a minority of Czech economists who saw the risks in advance. This is a common feature in many such crises, as the "we are different" approach tends to prevail. I also enjoyed the analysis of the possible tensions between the Copenhagen criteria for economic growth and real convergence and the Maastricht criteria. And I enjoyed the analysis of the Balassa-Samuelson effect and the emphasis on lower price levels in the Czech Republic and other transition countries to those in the EU.

There could be a problem in the sense that, because of the Balassa-Samuelson effect, and because of this one-price-effect, once countries like the Czech Republic or Hungary join the EU, they might engage too ambitiously in disinflation policy. This could hinder high growth of both the economy and of productivity, and therefore inhibit the real convergence. Therefore I would agree more with Vincze's paper, that countries like Hungary, which start from a high level of inflation, should perhaps be allowed some flexibility. The policy implication here is not so much for the country but for the Maastricht criteria. They could be modified so that they would allow for higher levels of inflation in this transition period, so that growth is not hindered. Growth is such an important objective. I am not arguing here for very loose macroeconomic policies. I am very aware that the fiscal deficit is large at present in the Czech Republic. I am just arguing for greater flexibility of the inflation level, because the Maastricht criteria are so tight. Many people have argued that even in the West European context they are too tight, but I think this is particularly so in the transition countries.

I also like the link between these factors and the connection with capital flows. And I agree with Oldřich when he says that there should be a policy for prevention of excessive capital flows playing havoc in the moment of accession. But would this also include the possibility of discouraging flows,

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if these were excessive? That is, should the Czech Republic, and other transition countries, keep some instrument for possible discouragement of capital flows à la Chile and Slovenia? And would it be possible given the restrictions that both the EU and the OECD poses. But of course, other policy instruments would be possible if there were capital surges, such as tightening of fiscal policy in a countercyclical way.

My next point is on FDI. Oldřich points to the benefits of inflation as attracting FDI. I agree that FDI has many benefits and is positive. But I think we may have overrated the stability of FDI. There is increasing evidence that, particularly as a crisis approaches, the multinationals make a lot of hedging, especially for FDI that is directed to services or other domestically sold goods, where there is a higher exchange rate risk. This hedging may actually generate quite a lot of pressure on currencies, as has been the case recently in Chile and Brazil. Of course, FDI is more stable than other flows, but it is perhaps not as stable as it was in the past. So this hierarchy of volatility is still valid, but much less so than some time ago.

Finally, Oldřich raises an interesting discussion at the end of his paper about the coordination between the central bank and the government on inflation targeting and about the autonomy of the central bank. I would like to make a comment in general on this issue, not limiting myself to the Czech case.

Table 1 Autonomy and Objectives of Central Banks

Objectives / Autonomy	Only Inflation	Inflation plus others (e.g. Growth)
Yes	I	II
No	III	IV

In Table 1 in the first square, the preference of the central bank is disinflation; there is a sole objective of disinflation and the central bank is totally autonomous. That combination is problematic because it gives too much priority to inflation and not enough priority to growth, wherever there is a trade-off. Therefore, maybe in the future, one should think about either a little bit less autonomy for central banks or greater importance for other objectives. I am thinking about the differences between the US and the European central banks in particular. The US, very clearly in the 1990s, has followed a policy that, more than in Europe, was supporting growth, perhaps because growth and employment are much more explicit

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in the objectives of the Fed. That itself, is not a bad thing. There may be some movement; either towards quadrant II or quadrant III, which may be desirable, especially for transition or developing countries.

I will turn now to János Vincze's paper. I like that he points to the hierarchy in financial systems, between primitive, well-developed and middle systems. He says that the middle systems are prone to crisis. On that, I would put two caveats.

One needs to emphasise that even advanced economies are prone to crises, although for them these may be less costly. Countries like Sweden and Finland have had major crises, because there are imperfections in the financial markets. And I even would argue that the Asian crises are to a certain extent not only the result of mistakes in the policies in the countries, but, as is commonly accepted, also of mistakes in the international capital and lending markets. And what is actually particularly interesting, is that it is not just Keynes and Stiglitz and Wyplosz and these people that are saying it, but increasingly there is a literature among market participants, who say: 'Markets are not efficient, and we should have an alternative behavioural school, that starts assuming imperfections in capital markets, which actually uses this perception of imperfections to try and make money'. So it is also becoming self-fulfilling in that sense. A particularly interesting paper e.g. is Persaud (Persaud, Avinash, 2000), that won last year's price from the Institute for International Finance, the institute of bankers. I just mention it because of the disturbing interaction between herding and market sensitive risk management practices. It argues that the models used by the most sophisticated banks actually accentuate herding and volatility and so on, and therefore create contagion. Therefore, it is a bit worrying that the proposed new Basel Accord relies so heavily on the criteria of the advanced international banks themselves. Relying on banks' own models for capital purposes could make flows even more volatile, more pro-cyclical. Of course, in emerging markets there are more imperfections and weaknesses, but there are quite a lot in developed markets too.

The second issue on this hierarchy in financial systems, which the paper does not really address, is how do you pass from this more primitive financial sector to a fully integrated one? What should be the timing and sequence? What are the lessons for Eastern Europe of the West European experience as described by Wyplosz and others?

Another disagreement I have is that the paper, like quite a bit of the literature, overstresses the issue of moral hazard as a cause of crisis. In financial crises in the past, we did not have the IMF or even lenders of last resort nationally, so I think it is a bit overrated. There is obviously an element of moral hazard but it is a bit exaggerated.

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One of the solutions to the problems of domestic financial systems is the possibility of selling domestic banks to the foreigners. I think that is what is actually happening in these countries. They have a very high proportion of foreign ownership of the banks. About 90 percent of the banks in the Czech Republic and in Hungary are in foreign hands. This may have many benefits, but it also has costs. There has not been a careful assessment of the net balance of all countries; what is the impact of resource allocations, financial efficiency and so on? I know some work that is going on at the World Bank, but I am not sure whether there is enough of that. We should not jump to conclusions; there is a very rapid process of increasing foreign ownership, but I am not sure if that has been carefully assessed.

Another small point is that the author emphasises that investing in the local currency of an emerging country is always a good thing. But I think, as we see from the Czech and the Mexican case, this is not always true. Indeed, the origins of the Mexican peso crisis started with Treasury bonds in local currency, so the key issue remains country risk. That is, in the literature, what people like Hausmann don't really emphasise enough. Even though it may be good to have less foreign exchange exposure, by issuing paper in local currency, this does not necessarily eliminate all the problems.

One of my strong disagreements is the distinction – Oldřich already mentioned that – between good and bad crisis. A maybe more interesting distinction is between developed and emerging market crises, because most emerging market crises are extremely costly. Whereas in developed countries usually, not always, there can be currency crises that do not interact with the banking sector, and which may have positive effects (as some argue when the UK left the ERM). I agree very much with Oldřich that the crisis in the Czech Republic was certainly a bad crisis. GDP growth in the Czech Republic in 1993-96 was beginning to take off at 3-4 percent. Then there are three years of negative growth. In the phase of transition, this is quite serious. Not as dramatic as the Asian crisis and the Mexican peso crisis, but it is quite a loss of output. The rate of unemployment in the Czech Republic was 3.5 percent, which is extremely good. And now it is three times as much, and it is very hard to bring down high levels of unemployment. So these are quite high costs of the crisis.

In advance, you never know if a crisis will be good or bad. So it is much better, of course, to prevent crisis and to try to manage booms, as we talked about in previous FONDAD conferences. You should have some type of mixture of fiscal, regulatory and other measures to discourage excessive inflows. I would like to mention the excellent chapter in BIS Papers, March 2001. It is a very thoughtful analysis of how regulatory mechanisms could be countercyclical to help prevent crisis. This is much healthier than this dramatic effect of discipline through crisis.

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It is a bit strong to say that the best way to prevent capital flows disrupting the pre-accession period of these countries, is to liberalise as much as possible the financial sector, because it could actually make these countries more vulnerable.

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Floor Discussion of "Managing Economic Convergence and Financial Stability in the EU Accession Countries of Central and Eastern Europe"

Commenting on Dědek's paper, Miroslav Hrnčíř wondered whether real and nominal convergence are competing or complementing each other. "On the one hand, there is this extreme idea: forget about controlling inflation, what is important is the growth rate. On the other hand, the accession countries are expected to strive for the EMU membership and thus have to accept the nominal Maastricht convergence criteria. So there are two approaches. One is that you join the EMU as soon as possible, because before the accession you are subject to capital flow volatility and increased capital flows. The other is that it would be wrong to prematurely fix the currency when you are still catching up, because you still need to adjust your price level.

Let me illustrate with the case of the Czech Republic. The Czech GDP per capita is about 60 percent of the EU while our price level is about 40 percent of the EU level. This price level discrepancy is due to domestic economic sectors. From that point of view the Balassa-Samuelson argument is quite valid, that there is wide scope for price increases in the service sector and for a rise in incomes. We should recognise that the catching up of the economy will lead to a rise in price levels that should not be interpreted as genuine inflation. Continuing deregulation, implementation of the EU standards, agriculture policy and environmental standards are all long-term processes leading to price level changes. The changes will take several years, if not a decade.

So if we would take rigidly the present regulations or the Maastricht criteria, the entry into the EMU is going to be a much longer process than currently is expected. My question is: what would be the proper timing and proper process of entry into the EU and into EMU?"

Commenting on Vincze's paper, Hrnčíř argued that the Czech currency turbulence of 1997 was not so bad because it created room for considerable changes in the institutional framework and in policymaking. "I agree that it would have been better to do this without a crisis," he said, "but when the crisis happened, the follow-up developments created the conditions for a more balanced and sustained growth in the Czech Republic, and we see already the first results."

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Daniel Heymann argued that the interpretation of financial crisis as a proper response of the system to a shock is not what in reality happens. "Typically, crises do not happen like well-understood shocks in a system where you have escape clauses that allow you to adjust to those shocks. The point is that in the case of Eastern Europe you might expect to be subject to shocks during the transition, and then the role of flexibility is quite important. Avoiding speculative activity is extremely important in Latin America, we know that. So watching over the system to prevent speculative activity and the outbreak of crises in that respect is quite important."

Brian Kahn compared the discussion about the Maastricht and the Copenhagen criteria to the inflation targeting problem policymakers in South Africa grapple with. "It seems that too much responsibility is placed on monetary policy in this context, while we see very little discussion about complementary policies. We talk about coordination between governments and other organisations, but not very much is said about industrial policy and other policies which might be more important for sustainable growth. That is one issue.

The other issue is full employment. As Stephany argued, you should strive for a central bank that combines autonomy with multiple objectives, such as inflation-plus-growth or inflation-plus-employment objectives."

Leslie Lipschitz was concerned about the way the real convergence was being discussed. "We are talking about real changes and then we are looking for financial instruments. But you cannot do anything with monetary policies to affect these changes in the real economy. If we are talking about real convergence, what do we mean? We mean presumably very large capital inflows, which change capital-labour rates towards West European levels in the Czech Republic, with big productivity gains. Then it is a given that you are going to have big deficits and you are going to be highly subject to any fluctuation in risk premia. So the real question is: how do we get information to the market in a systematic way so we don't have big jumps in risk premia? That is probably impossible.

While we are talking I did a calculation of the magnitudes of the Balassa-Samuelson effects for a stylised Czech Republic that resulted in an equilibrium real appreciation of 7.5 percent a year. Now that is interesting, because I was very struck by János' Table 4, where, if I read it right, it says that in Poland we have a real appreciation of 70 percent and in the Czech Republic some 25 to 50 percent. You have an exchange rate change and a price change, and a huge real appreciation. These might well be equilibrium exchange rate changes.

If that is what is really happening out there – I assume not all of it really is – how do you deal with that through an exchange rate policy? If you

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have fixed your exchange rate and you have huge inflows, your monetary policy is going to be overwhelmed, stabilisation is going to be massively costly, and you are going to have a pre-1997 Czech situation. If you float your exchange rate and try to have interest rate independence, that is, you try to keep your interest rates well above German rates despite the fact that you have a real appreciation, you are going to get an overshoot of your exchange rate to the point where it is expected to be depreciated, which is going to screw your traded goods sector over time. So these are the real problems. It is not at all clear to me how you find a monetary solution to these problems.

On monetary policy, given that you don't have a solution, is there anything one should *not* do? János made the point that there is a moral hazard problem when financial markets think there is an implicit guarantee that the nominal exchange rate is going to be fixed. When people believe that, we get the situation as we had in Asia, in which there are private agents with massive foreign exchange exposure, slowdowns and when you eventually force a change you cripple your real economy."

Heiner Flassbeck had a problem with the way Leslie Lipschitz discussed the mechanics of inflation rate, interest rate and exchange rate. "I think we have a very loose way of talking about risk premia," he said. "You get for a time an inflow of capital, which looks great and which is good for stabilising inflation. However, this will become a big problem later on because the exchange rate depreciation which is necessary in the long run, as we all know, will come up too late because the market is not anticipating it in an orderly way. So there is this dilemma which, in my view, is different from Leslie's interpretation.

To illustrate the dilemma, if you have an inflation rate of 10 percent in all the accession countries – Czech Republic being the exception – and you want to come down to the 2 percent EU level, you need a 20 percent depreciation of the nominal exchange rate in 4 years time, because 8+6+4+2 is 20.

How to get at this 20 percent depreciation? If you fix the exchange rate you have a problem, but if you make it flexible you have, at least in the transition period, also a big problem because it is most probable that you get a nominal appreciation which adds to the real appreciation that you anyway have, due to your high inflation rate. In my view, the only solution would be the middle ground solution, namely to get early accession, not to the EMU but to the EMS system, and to ask for a mechanism which gives you the time to bring about an orderly appreciation of 20 percent and adjust the interest rate in an orderly way. Then you would have an additional and efficient incentive for capital inflows."

Zdeněk Drábek found it a bit ridiculous to talk about hypothetical

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situations. "I would be very interested to hear the actual situation in the Czech Republic and Hungary. On conventional Copenhagen criteria, if you talk about an output gap and if you take your figure of GNP per capita for the Czech Republic of 60 percent of the EU level, surely there must be somewhere in the ballpark the situation that existed in Spain and Portugal when they were acceding the European Union. So why would this be an issue for the Czech Republic of today? I think the issue is that the European Union is very worried about labour mobility and it is very worried about structural funds and their funding. That is one issue.

The other issue is the Maastricht criteria. I thought that the accession to the European Union for us, Central European countries, meant that we accede to the European Monetary Union on day one. I thought that the adoption of the common currency would not be a matter that we could negotiate but a criterion for our accession.

The third issue is the price gap. I think Leslie has been identifying the main problems. If I were a banker and I was certain that there was a price level gap of 40 percent, I would be very worried to negotiate entry. But the problem may not be that serious, partly because, as several of you pointed out, part of the price difference is due to price differences in the non-tradable sector. Therefore, for the central bank the interesting question would be to ask how important the non-tradable sector really is in this example, and therefore, implicitly, what the potential for the Balassa-Samuelson effect to work itself through the system would be? That is the critical issue."

Xavier Cirera drew some lessons from the Spanish case. "How was the situation in Spain or Portugal at the beginning of the transition? In Spain, the income per capita was something like 65 percent of the European Union average. However, the important issue missing in the debate is the time dimension. Spain had a preferential trade agreement with the European Union since the 1970s, entered into the European Union in 1986 and then into the European Monetary Union in 1997. That is a lot of time and that is very important for real convergence. Both for real and nominal convergence you need time.

Another thing is that after the accession to the European Union in 1986, Spain suffered a huge capital inflow partly because of inflationary policy based on high interest rates. This triggered a real worsening of the trade balance. If you add the Balassa-Samuelson effect, you can expect the same for transition economies. So accession has effects on the real sector and on the tradable sector, which are very important.

Also, Spain suffered three devaluations, two in 1992 and one in 1993. So the record of crisis prevention of the European Monetary System is not very good, that is the first point. The second point is that in 1992, there

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was implementation of the Single Act, and there was financial liberalisation in Spain and Portugal. I wouldn't say that financial liberalisation triggered the crisis, but it helped to trigger the crisis.

Finally, I would like to raise a question to Dědek and Vincze. During the negotiations the accession candidates had the possibility to ask for a transition period for implementation of the Single Act, as has been applied to Spain. Why has none of the accession countries asked for this transition period?"

Yung Chul Park addressed the issue of foreign ownership of financial institutions: "Stephany said that one should assess the costs and benefits associated with the foreign ownership of financial institutions. Dědek was suggesting Bill White to undertake a study on the role of foreign banks in emerging market economies at the BIS.

East Asia's experience has been that in most of these crises, in countries like Thailand, Indonesia and Korea, the share of foreign ownership of financial institutions has gone up substantially from almost zero to around 35 percent in Korea and 40 percent in other countries. It is about time to re-examine the behaviour of foreign owned banks in emerging markets. If you think that the banks should take care of those small and medium-sized firms which do not have access to capital markets: These foreign banks don't want to touch small and medium-sized firms at all. They try to develop good relationships with major players, big manufacturers, and the high-income consumers by providing very specific services. They completely ignore the small and medium-sized high-risk borrowers.

Maybe I am exaggerating a little bit, but it is about time to look into the behaviour of foreign banks. The World Bank is doing a big study so they might come up with something interesting, we hope."

Reply by Dědek and Vincze

Oldřich Dědek stressed that a good crisis is the one that did not happen. "There are examples of countries that found themselves in a pre-crisis situation and managed to find a solution, a sort of adjustment without recession. I have in mind particularly, for example, Hungary in 1995. Hungary was on the verge of a crisis and some people thought the Mexican case might repeat, but the Hungarian government was bold enough to go ahead with a package to resolve the situation even though the package was unpopular and trade unions protested. In the Czech Republic something different happened. Our austerity packages were launched after the speculative attack, not before. So the timing of rescue packages is an important factor.

On the Maastricht criteria, I fully agree that the Maastricht criteria are a

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pre-condition for EU entry, but at the same time, transition countries are required to work out pre-accession programmes, and on the entry they are required to follow convergence programmes. As far as the inflation-growth trade-off is concerned, I think it is a true paradigm for a closed economy. For an open economy we should have a triangle: growth, inflation and external imbalance. External imbalance is a sort of inflationary debt as well, because excess demand, if demanded from the domestic market, raises inflation; if it is channelled abroad, it creates a current account deficit. So it is important to have in mind all these components and take this trade-off into account.

Let me answer the question of Xavier Cirera why we did not ask for a transition period like Spain once had. The position of a transitional country is that we have to swallow 40.000 pages of *Acquis Communautaire*. We could apply for transition periods, but there is strong competition among accession countries. Particularly the Baltic Republics are fierce competitors and they are refusing transition periods, spoiling the market for other countries. Countries are afraid that asking too much from bureaucrats in Brussels might frustrate the country's accession to the EU.

My last comment is related to the discussion of the Balassa-Samuelson effect. The model is not complete; it is designed as if the country is only linked abroad by the current account. There is no role for capital flows in the model, so it is not a true model. I think that exchange rate fluctuations are primarily caused by capital flows, not by the Balassa-Samuelson effect."

János Vincze said that the origins of the Czech crisis of 1997 dated back to the period 1993-96, when growth was not based on sound economic principles. "The reason why the Czech growth became negative after 1997 was that it was based mostly on consumption and large real wages increases that exceeded productivity growth. Actually, in those three years the Czechs were somehow happily throwing away the advances they had made around 1993. So the troubles of the late 1990s were created before 1997.

About the exchange rate guarantee, what I hold is that pegging with sterilisation really was more or less what is meant by giving an exchange rate guarantee, but with some important condition. The interest rate is not just the guarantee but also the incentive to dollarise your liability. What is even more important is the interaction between different parts of the financial architecture that complicates this sort of exchange rate regime."

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