Monetary and exchange rate policies in the Central and Eastern Europe: lessons and challenges

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Successful transition to low inflation amid changing institutional set-up

**Fixers to floaters:** Czech Republic, Hungary, Poland and Romania
- Fixed (basket) exchange rate (ER) regime as a key tool for initial disinflation
- Disinflation reconciled with real convergence; transition to explicit Direct Inflation Targeting (DIT) gradual
- DIT was a successful response to massive capital inflows (EU accession) and outflows in 2008-2009
- Euro adoption looks far away

**Fixers forever:** Bulgaria, Estonia, Latvia, Lithuania
- Currency board and fixed ER regime helped borrow anti-inflationary credibility (ER as an anchor)
- More susceptible to asset bubbles (Baltics)
- Greater output volatility in the aftermath of global financial crisis though ER regimes remained resilient
- Euro adoption motivated by both economic and political considerations (exception: Bulgaria)

**Temporary floater:** Slovakia
- Successful passage through ERM II with implicit DIT and wide fluctuation band (+/- 15%)
- Passage marked with a bit of luck (large productivity increases amid labour market slack)...
- ... and a bit of unluck (overvalued conversion rate in 2009)

**Fixers and floaters:**
- Regardless of the ER regime chosen, medium-term price stability has been achieved (in some countries very recently), reinforced by central bank independence
- Large external imbalances (especially in Baltics) were not avoided, but ER regimes remained essentially resilient to currency crises
The case of Poland: global risk aversion as a key driver of exchange rate

- 2009: massive PLN depreciation despite rising short-term interest rate disparity
- 2012-2013: large capital inflow to bond market provides EURPLN stability amid falling short-term interest rate disparity
- 2014: continuous EURPLN stability amid falling short-term interest rate disparity
- ER channel looks more theoretical rather than effective monetary transmission conduit
- Czech experience: ER channel can be reactivated under the zero bound

Source: Reuters
Direct Inflation Targeting in CE-4: has monetary policy lost its edge?

Poland

Czech Republic

Hungary

Romania

3Y rolling standard deviation of YoY GDP growth rate (lhs) 3Y rolling standard deviation of domestic FX rate against EUR (rhs)

Source: Reuters
Conclusions and policy implications

- ER regimes and their evolution in the CEEC supported successful disinflation
- Fixers will remain fixers, floaters will remain floaters - corner solutions are strongly preferred
- ERM II episode in Slovakia enforced by the EU Treaty, otherwise would have been avoided
- The Japanese-style stagnation in the Eurozone suggests low likelihood of floaters joining the euro soon
- Over more than a decade, in Czech Republic, Poland and Romania the drop in ER volatility has been accompanied by stable or increasing output volatility
- Limited ER channel effectiveness suggests a greater interest rate volatility
- The ER channel effectiveness may be increased under the zero bound
- The importance of financial stability considerations (risk of asset bubbles) has increased
- The reduced effectiveness of ER channel suggests lower costs of monetary integration for DIT countries
Thank you for your attention