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

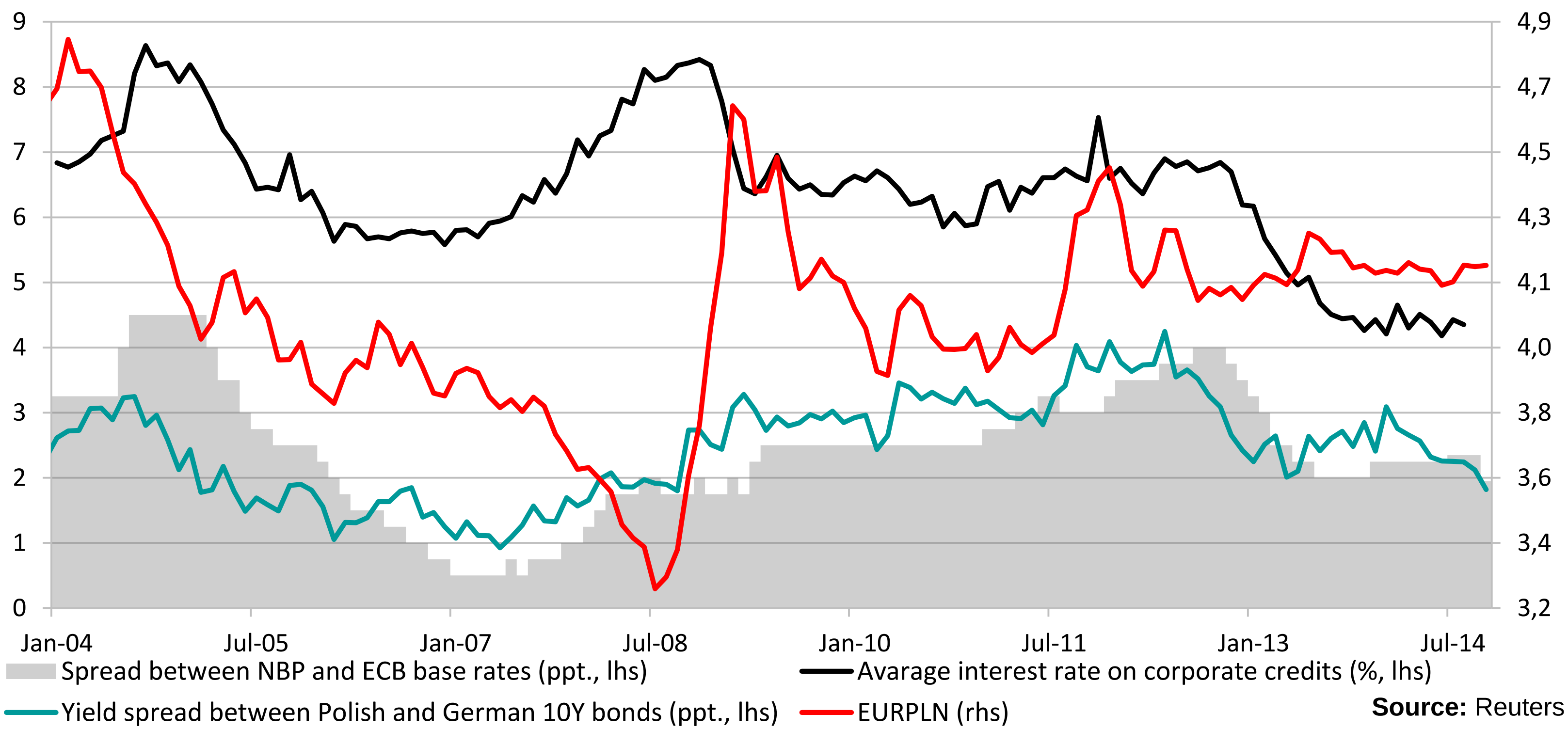
- **Fixers to floaters:** Czech Republic, Hungary, Poland and Romania
- Fixed (basket) exchange rate (ER) regime as a key tool for initial disinflation
- Disinflation reconciled with real convergence; transition to explicit Direct Inflation Targeting (DIT) gradual
- DIT was a successful response to massive 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

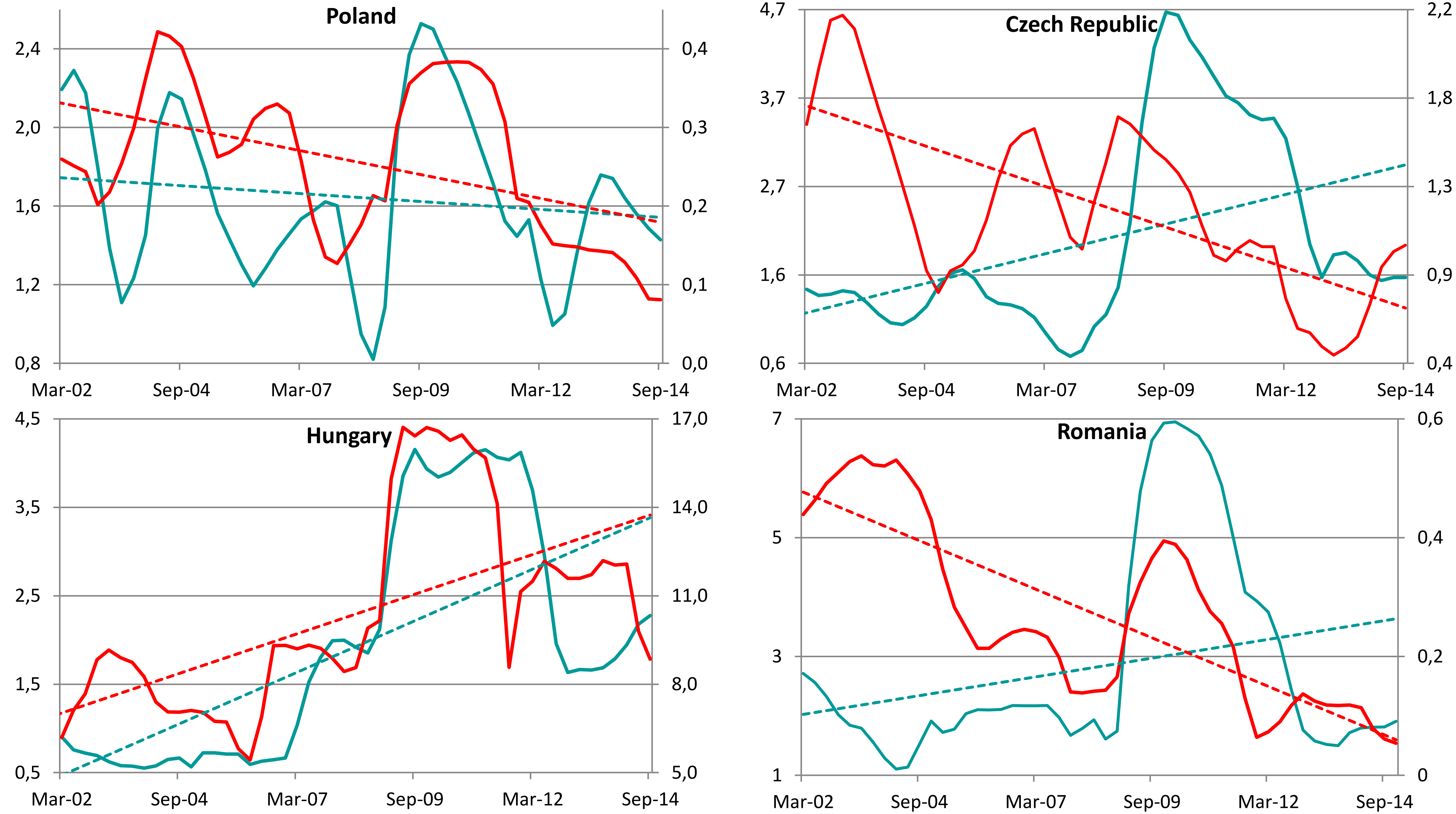
The case of Poland: global risk aversion as a key driver of exchange rate



Source: Reuters

- 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: continous 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

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



Source: Reuters

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

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