

Policy Nexus under Different Exchange Rate Regimes in CESEE countries¹

The main purpose of this note is to shed some light on the macroeconomic performance and mix of policies in CESEE countries² in the period before and after the main wave of the crisis. Special focus is given to differences between the countries with fixed exchange rate regimes (peggers) and countries with floating regimes (floaters). The note aims at highlighting some commonalities and differences between peggers and floaters regarding the macroeconomic performances through visual data inspection and pinpointing some of the challenges that monetary and fiscal policies face with. Hence, the idea is not to draw any firm conclusions on the relations between the exchange rate regime, economic fundamentals and economic developments as averages could mask many issues and could not tell the story about many country-specific factors that might be of crucial importance in driving the economic developments.

The optimal monetary-fiscal nexus has always been a thought-provoking issue. The traditional view on having proper monetary-fiscal coordination, to a large extent has boiled down to a consensus on allowing the monetary policy to focus on inflation and short-term business cycle stabilization and fiscal policy to focus on sustainable government debt and deficit. Expansionary fiscal policy may result in high real interest rates and suboptimal output. Yet, the optimal mix has to be analyzed in the context of the exchange rate regime. Pegged regimes, by their virtues, represent a constraint for the monetary policy especially under high capital mobility. However, the role of fiscal policy in output stabilization becomes also pronounced for flexible regimes under zero lower nominal bound. The recent crisis demonstrated that despite the aggressive monetary measures (including also non-standard measures), the fiscal policy played an important role in counteracting the impact of the financial and economic turmoil. Of course, the crisis emphasized again the critical importance of the initial fiscal space and the capacity for devising credible medium-term exit strategy. Both of them are perceived as critical for policy effectiveness, ensuring favorable expectations and credibility, potentially reducing the sovereign default risk, lowering interest rate, creating wealth effect and improving economic prospects (Agca, Igan, 2013).

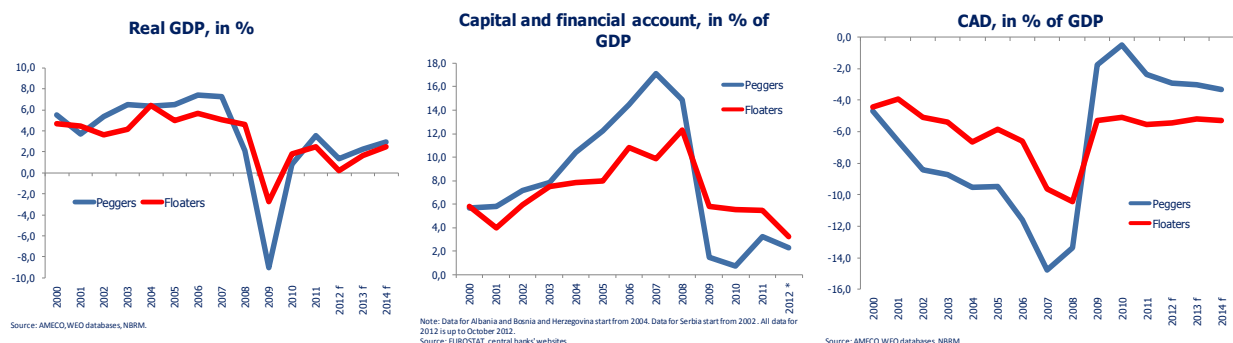
The occurrence of the crisis caught CESEE countries in a mode of solid growth rates amidst ample capital flows and rising vulnerabilities. Strong capital inflows (mainly in the form of external borrowing and FDIs) spurred credit growth that gave strong impulse to the

¹ Mite Miteski and Katerina Suleva from the Research Department also contributed to the note. Special thanks to Dijana Janevska Stefanova, Neda Popovska Kamnar, Egzona Hani and Gani Ramadani for collecting and organizing the data used in the note. The note was prepared as a platform for discussion for the BIS Meeting of the Working Party on Monetary Policy in Central and Eastern Europe, Sofia, Bulgaria on 14-15 March 2013.

² Includes: Macedonia, Serbia, Croatia, Albania, Bosnia and Herzegovina, Baltic States, Poland, Hungary, Czech Republic, Bulgaria and Romania.

domestic demand. During 2004-2007, average growth rate for the whole group of countries amounted to 6.2%. This in particular refers to countries that were undergoing a kind of a convergence phase, where the buoyant capital flows led to a credit boom, which accompanied by strong confidence and high income expectations resulted in strong growth rates. For example, Baltic states in the run up to the crisis had growth rates close to 10%. However, in many cases the capital inflows were not primarily channeled in the tradable sector and resulted in high imports and consumption driven growth. Thus, strong growth rates were accompanied by high current account deficits and elevated external debt i.e., rising external vulnerabilities. Inflationary pressures in particular came to the fore during 2007 and 2008 when the global food and energy price shock was experienced.

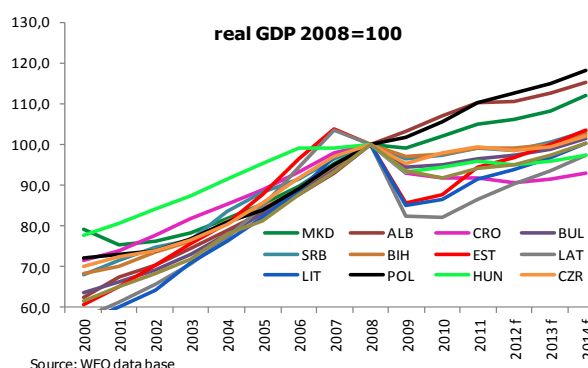
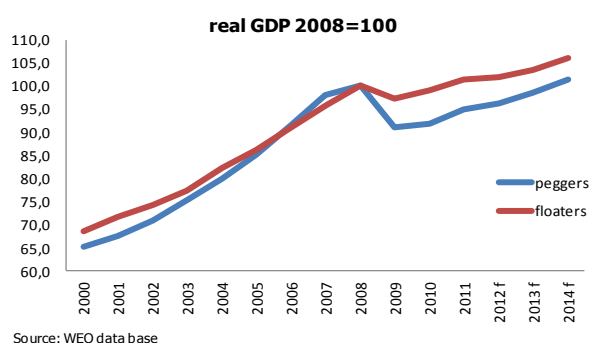
Given the conventional wisdom of exchange rate peg being an efficient tool for disciplining policies, the question is whether those countries entered the recent crisis with more superior initial conditions, both in terms of macroeconomic policies and in terms of their economic fundamentals. Simple visual inspection of the pre-crisis data averages of "peggers" and "floaters", points to some differences in performance between the two groups of countries. On average "peggers" had somewhat higher GDP growth rates (6.9% compared to 5.5% of floaters during 2004-2007), higher capital flows (13.5% compared to 9.2% of GDP of floaters), but also wider current account deficit (about 11.4% compared to 7.2% of floaters) and higher external debt (71.7% compared to 50.5% of floaters).



An inference on the differences between the two groups of countries can be also drawn through the Macro Imbalance Procedure scoreboard of the European Commission (Annex 1). The scrutiny of these indicators reveals that countries with pegs appear to be better off in terms of the lower public deficit and debt. The state of their public finances appears more prudent, with lower **headline and structural fiscal balances**, and lower **public indebtedness**. Yet, dynamically observed, their structural fiscal deficits even before the crisis started to converge to the deficits of the countries with floating exchange rates. It indicated expansionary discretionary fiscal policy, potentially increasing the susceptibility to shocks. At the same time they enjoyed stronger growth rates, but on the back of higher **current account imbalances**, and **higher private sector debt**, domestically and externally financed. Yet, the deterioration in the external position and the credit growth were present and exceeding the thresholds in both groups of countries. Both groups of countries were also exposed to **real appreciation**, but in the run up to the crisis unit labor costs were increasing faster in countries with pegs compared with those in the floating regimes and were above the threshold, indicating larger erosion of competitiveness. Large part of the gap between the floaters and peggers is created by the performance of the Baltic countries. This is expected, as the phenomena of EU prospect driven economic boom was perceived to be much more

pronounced in this group, compared to other CEE countries. If the Baltic States are taken out of the pool, the performance of the peggers and floaters prior to the crisis is more or less similar, and the economic story as explained above still holds for the new group of peggers.

Given that the peg in principle may act as a constraint for utilizing the monetary and fiscal policy in a strong countercyclical manner, the question is then, have these economies suffered much more compared to the "floaters", where the depreciation of the currency took part of the adjustment burden? The data analysis points to the fact that, on average, GDP drop in the acute phase of the crisis is larger in the "peggers" group and almost all countries in this group still haven't reached the pre crisis GDP level. The gaps between the two groups are much milder if the Baltic countries are excluded from the pool. Still, knowing the importance of the stable exchange rate in countries with pegs in determining confidence, and bearing in mind the severity of the externally-provoked crisis, most probably the peg underpinned the confidence and precluded panic, which could have yielded in a more inferior outcome than the actual one. Also, it is very important to note that the averages mask some important differences. For example Macedonia has a peg, but it went through a rather small GDP decline during the crisis (-0.9%) and its GDP is already above the pre-crisis level, explained by strong initial conditions in the run to the crisis and the ongoing structural changes occurring in the economy. Even within the Baltic countries, where strong internal adjustment under currency peg occurred, differences in post-crisis recovery are evident, with Latvia being furthest, and Lithuania being closest to the pre-crisis level. Initial conditions, recovery of the main trading partners, the state of the banking system and institutions in general, i.e., country-specifics are part of the solution of the "divergence puzzle".

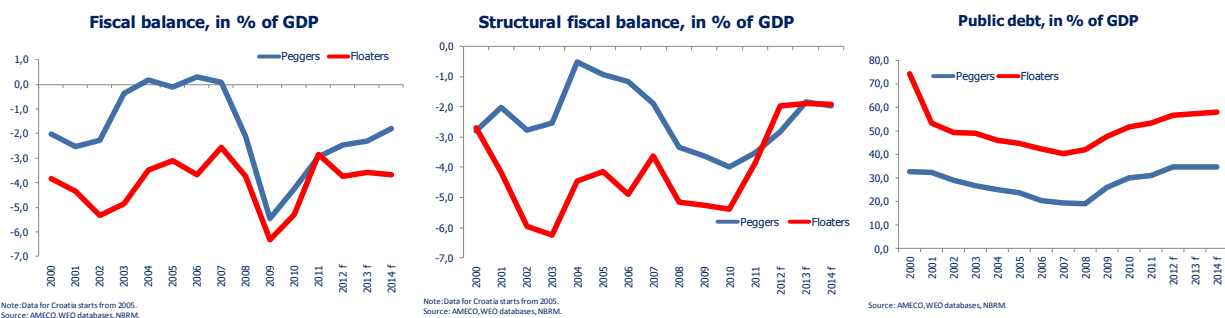


The occurrence of the crisis posed significant challenges for both groups of countries, but also brought to the fore the necessity for some divergence in monetary policy responses, and in some countries in terms of the time sequencing of the fiscal loosening.

Fiscal policy in the crisis period

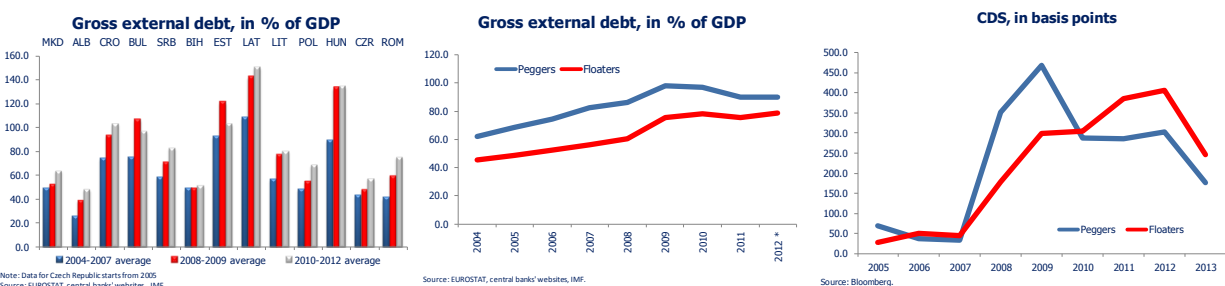
The fall in economic activity and discretionary fiscal measures during 2008-2009 have had a significant impact on government balances and debt in both groups of countries. The average budget deficit in the countries with de facto fixed exchange rate increased from -1% in 2000-2007 to -3.8% in 2008-2009, with the largest deterioration being observed in Latvia, Lithuania and Bosnia and Herzegovina. The countries with flexible exchange rate recorded a smaller increase (though from higher level) in the average budget deficit, from -3.9% in 2000-2007 to -5% in 2008-2009, with the largest deterioration being observed in

Romania, Serbia and Poland. In structural terms, the trend of deteriorating structural balances continued during 2008-2009 for both groups of countries reflecting the discretionary fiscal policy measures, though higher deterioration was observed for peggers.



Rising fiscal deficits lead to a change in the public debt developments for both groups of countries, though more pronounced in the group of the peggers, where the initial debt level was also lower. Namely, the trend of declining public debt as a share of GDP was stopped when the crisis hit and it started rising. The debt accumulation was somewhat higher for the peggers though from significantly lower levels. Depreciation of the domestic currency posed additional pressures for some of the analyzed countries. As higher deficits implied higher external financing, the gross external debt to GDP ratios increased markedly in 2008 and 2009 in both groups of countries, though somewhat more in the case of floaters.

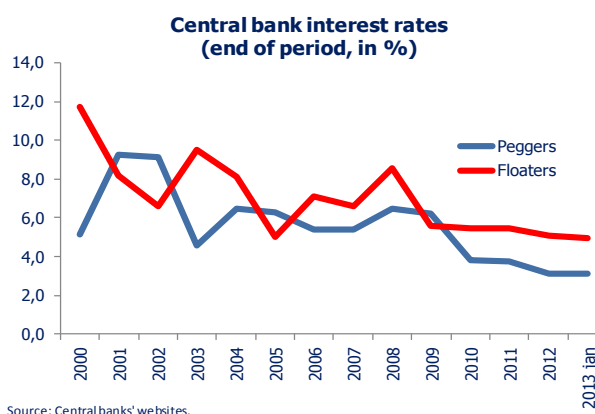
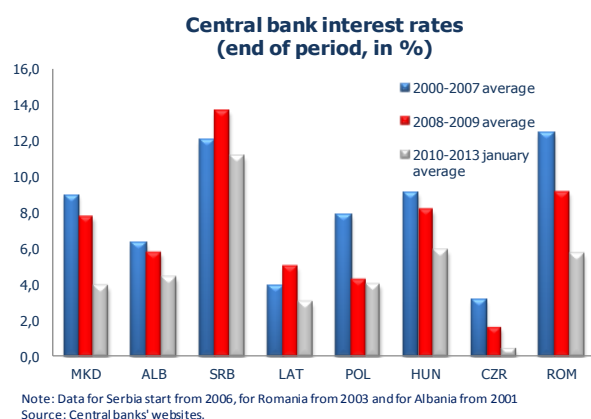
The severe crisis implied a worsening of the financial conditions for CESEE countries, as illustrated by the development of CDS premiums for their government bonds. CDS premiums rapidly increased in 2008 and 2009, but the increase was more pronounced in the countries with fixed exchange rate which generally depend more on external financing. This implies that investors might have perceived peggers as riskier than floaters which resulted in rising financial costs and limited access to the capital market of peggers. However, we should not neglect the fact that within the countries with flexible exchange rate are well-performing countries like Czech Republic or Poland, whose strong underlying economic fundamentals prior to and during the crisis probably had a greater impact on investors' risk perceptions. Nonetheless, some of the countries that required financial support from the IMF, the EU or other financial institutions (Hungary, Latvia, Romania, Serbia, Bosnia) were floaters.



Monetary policy in the crisis period

It appears that stronger countercyclical responses by the central banks were seen in countries with floating exchange rates. When the crisis hit the region, most of the central banks were in a tightening stance of the monetary policy with upward interest rate cycle and

prudential measures. However, when the growth path went downhill and the terms of trade considerably worsened, monetary authorities shifted their focus to a different type of challenge-stabilization of the economic activity. At the same time, they had to prevent excessive depreciation which might have fostered inflationary pressures again and could have adverse effects on financial stability. By the end of 2008 and the beginning of 2009, most of the countries with exchange rate flexibility, like Hungary, Poland and Czech Republic, started a process of monetary easing through a reduction of the key interest rate and use of prudential measures. They were quickly followed by the other floaters like Serbia, Romania and Albania. In some of these countries there were also significant depreciations of the currencies in this period. Bosnia and Herzegovina relaxed the reserve requirement in terms of rate and the basis for calculation and undertook other prudential measures to stimulate credit growth. The monetary policy in Macedonia, however, took an opposite stance at the end of 2008 and in 2009. Against the background of rapid loss of substantial part of the reserves (because of interventions), the Central Bank of Macedonia increased the interest rates, introduced liquidity requirements and raised reserve requirements on bank deposits. In Croatia the authorities also faced with the challenge of mitigating the impact of the crisis while protecting the kuna. In this light, the Central Bank intervened on the foreign exchange market, kept the key interest rate broadly stable and addressed the liquidity requirements by the banks through regulatory measures and repo auctions.



If we look at the timeline of the monetary reactions in the CESEE countries, we see differences in the responses only during the first waves of the crisis, in 2008 and 2009. In this period, the spillover effects from the crisis were to a great extent conditioned on the structures of the different economies, their trade relations, their fundamentals and their accumulated buffers to defend them from shocks. But, as the economic slam deepened and broadened in almost every economy in the world, the hopes for possible recovery by the mid 2010 were quickly substituted with further negative outlooks and it became clear that the main focus of the macroeconomic policies in every country should inevitably be restoring the critical state of the real economy. In this respect, the monetary policies in all the CESEE countries acted in the same manner - towards stimulating the credit growth and thus recovering the real economic activity.

Challenges ahead

The recent crisis challenged the traditional view on the monetary-fiscal nexus, and to a certain extent blurred the boundaries between these two. "Over the past few

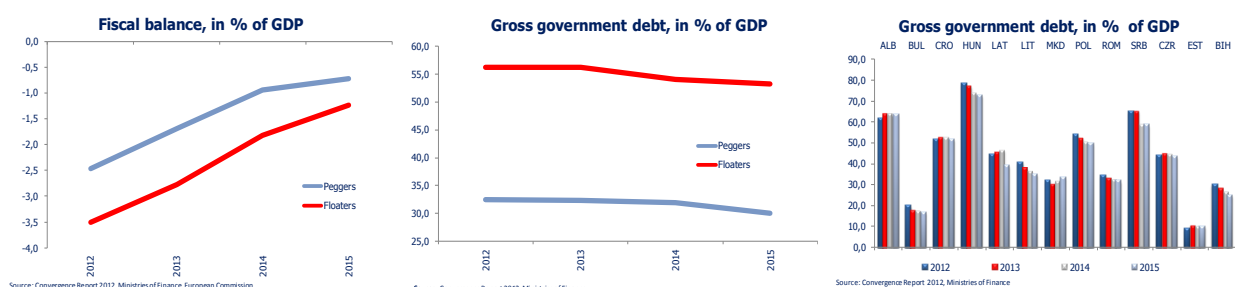
years the combination of financial crisis and sustained fiscal imbalances has led to a substantial breakdown in the institutional framework and accepted barriers between monetary and fiscal policy... This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving its mandate. (Plosser, 2012)". Although the blurred boundaries are more valid for countries outside the analyzed pool, still the statement of the necessary monetary-fiscal coordination and clear mandates for both policy makers should be considered as important, when discussing the future monetary policy challenges. The current experience with the European sovereign debt crisis, which raised issues about the sustainability of the monetary union, is a clear example of how important is the fiscal prudence in hard peg arrangements.

What does MIP Scoreboard tell us about the current level of vulnerabilities in terms of fundamentals and policies? In general, vulnerabilities in terms of fundamentals for both groups of countries declined with peggers undergoing stronger adjustment. After the crisis started, the perception of the investors with respect to the countries with pegged exchange rates worsened much more compared to those with floating regimes. Capital flows reversed and declined more and credit growth slowed down more intensively, which led to a swifter and sharper current account adjustment and improvement in the international investment position. There have been also more pronounced adjustments in unit labor cost developments. So, current account deficit in countries with a peg is not anymore in the vulnerability zone, while floaters on average are still above the threshold. The credit growth went below the threshold in both groups of countries with a sharper adjustment in the group of peggers.

However, fiscal stimuli lead to more vulnerable state of public finances. The estimated share of public debt to GDP at end-2012 is significantly higher compared to the pre-crisis period (15.1 p.p. higher for peggers and 16.4 for floaters). Given the initial lower levels of debt, the peggers currently appear to have lower level (estimated at end 2012 on average 34.6% of GDP compared to 56.6% of GDP of floaters). Some of the floater countries are very close to the Maastricht criterion, or even above it (Serbia, Hungary, Albania).

A couple of aspects of the rising public debt need to be highlighted. Higher debt levels entail *higher financing needs and higher refinancing risk*. In many countries the current state of accommodative monetary policy and the risk-aversion of the investors provide room for the governments **to borrow more extensively on domestic markets** which may act as a potential disincentive for a more rapid fiscal consolidation. Despite the stronger accent placed on the development of domestic securities markets, the **external borrowing** is a key source of financing of the rising budget imbalances. This implies that susceptibility of countries to external financial shocks has increased. If no credible fiscal consolidation is present, a vicious circle might be opened. Foreign investors might "close the gates" or rise the risk premium to finance deficits or roll-over maturing debt (which was the case in the acute phase of the crisis). For the countries with a pegged exchange rate, the closure of the envisaged external borrowing would also entail risk of not accumulating reserves as much as planned, thus creating pressure for the monetary policy for defending the peg. This will consequently lead to higher interest rates and hamper the process of consolidation of public finances. The risk is even more pronounced in countries with less developed financial markets and where the short-term government debt is dominant. Short-term financing means fast translation of rising costs and increased rollover risk.

Hence, probably for all the countries, bringing the public finances on a more sustainable path is the most important challenge, and for the peggers even more so. Medium-term fiscal consolidation seems needed to avoid fiscal dominance and provide a greater room for monetary policy. Large deficits add up to the current level of debt, which even though appears to be relatively moderate compared to other European economies, can be seen as a source of concern given that the sustainability threshold of their public debt is considered to be lower than for the more advanced countries. It is even more pronounced in countries with a pegged currency, as having healthy public finances is an important cornerstone of the monetary and exchange rate policy. A credible fiscal path increases also the probability of lowering the cost of fiscal financing, reducing the long term risk premium and paving the way towards longer-term government financing. In this light, further development of domestic government securities market can help diversify the sources of financing the budget deficit and decrease the rollover risk through extending the maturities. Consolidation plans are already included in the comprehensive medium-term budget frameworks of the governments of all CESEE countries. The reduction of the fiscal deficit should result in lower debt ratios of both peggers and floaters. Yet, this has to be done in a way that does not jeopardize the still anemic recovery of the real sector. The pace of consolidation will depend a lot on the structure of the budget expenditures, i.e., the discretionary spending room. In some cases the consolidation may require deeper reforms of the public spending and of the public finance management system in general.



A challenging task for the monetary policy in the forthcoming macroeconomic constellation will also be combining the traditional monetary policy objective and the financial stability objective. The crisis made clear that "managing inflation is not an end in itself but a means to an end" (Stiglitz, 2011). Namely, the crisis was preceded by so called period of "Great moderation" pinpointing that achievement of price stability is not a guarantee for stable economy and that financial frictions can have a devastating effect on the business cycle. Thus, greater focus on financial stability and better coordination of monetary and macro prudential policy seem inevitable. The new regulatory reforms impose requirements that urge big banks to reshape their balance sheets and thus reduce their risky portfolio, while the sources for further increase in capital are quite limited. While the banks in the CESEE countries were able to remain well capitalized even during and after the crisis, the current balance sheet adjustments of the big European banks, highly present in this region, put significant constraints on the proactive approach in supporting the economic recovery. Even more, the general risk perceptions do not seem to change significantly in the next period, given the rising NPL ratios and decreasing quality of credit demand. In such an environment, the question is whether the policy interest rate, as main traditional instrument may further lose its effectiveness in the period ahead.

The above analysis of the macroeconomic developments and policy mix in the CESEE countries in the period before the occurrence of the crisis, in the acute phase of the crisis and after it,

points to some commonalities and differences between the two groups of countries. Of course, many country specific factors, including pre-crisis fundamentals, openness of the economy, structure of the main trading partners, pace of the structural reforms that increase the competitiveness of the economy, have to be taken into account to get a better and more comprehensive understanding of the different macroeconomic performance between them. In any case, it seems clear that sound policies and fundamentals in the run up to the crisis prevented excessive overheating of the economies and provided buffers for mitigating the shocks, regardless of the chosen exchange rate regime.

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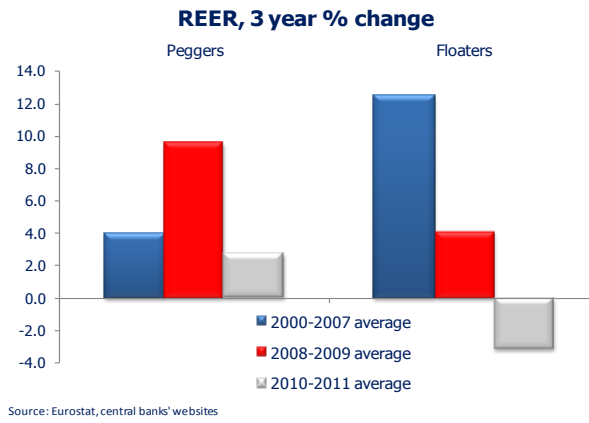
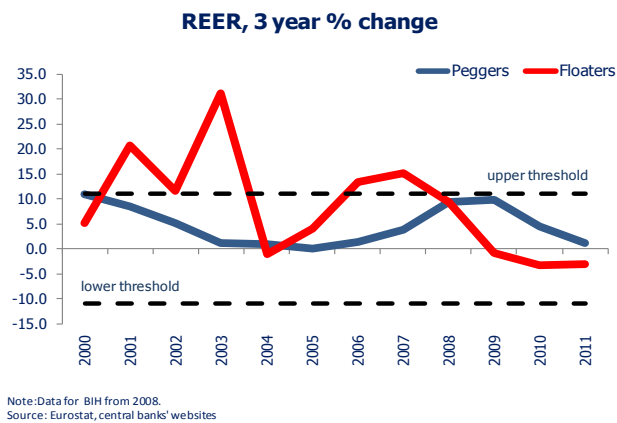
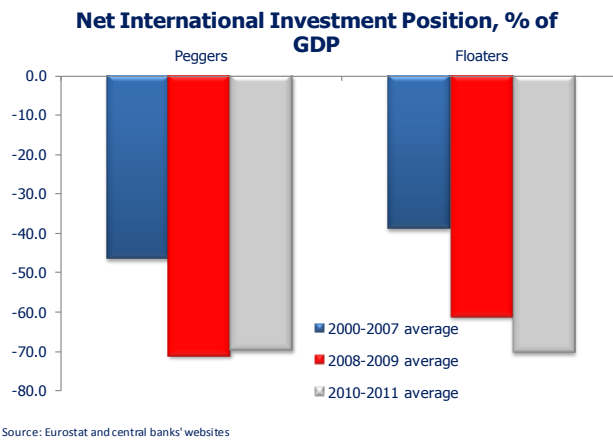
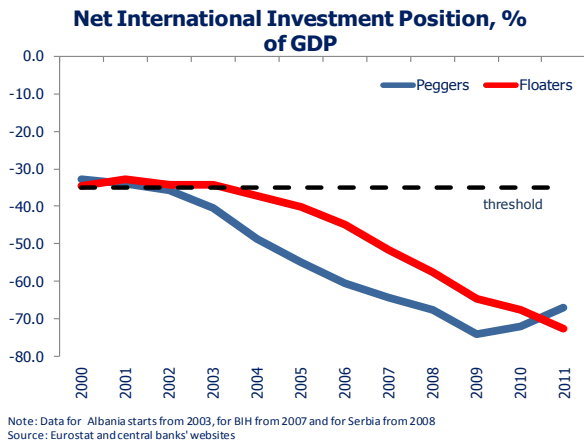
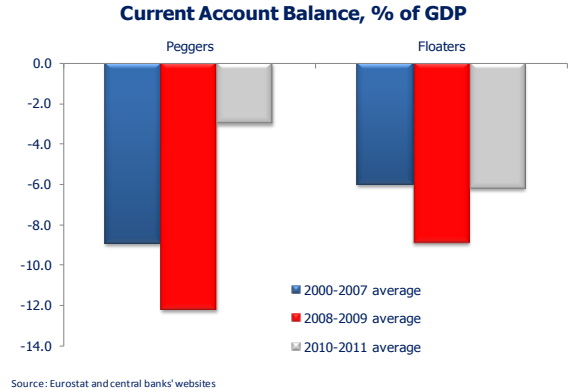
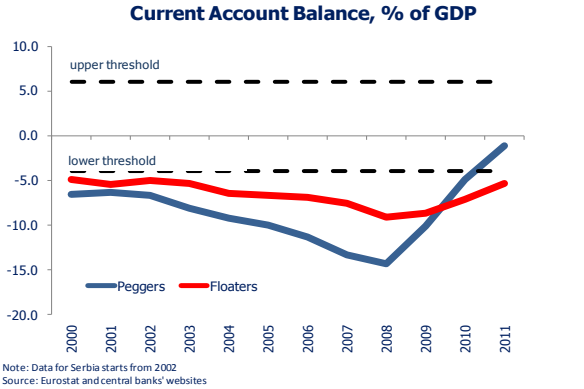
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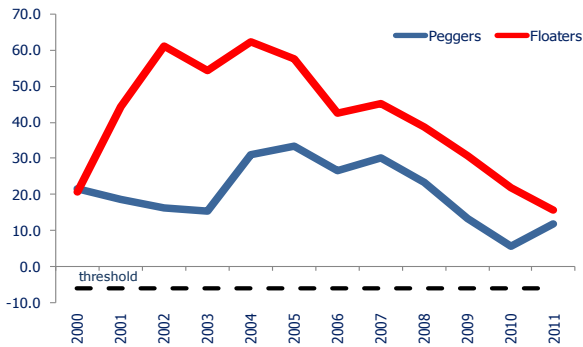
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ANNEX 1

Macro Imbalance Procedure Scoreboard

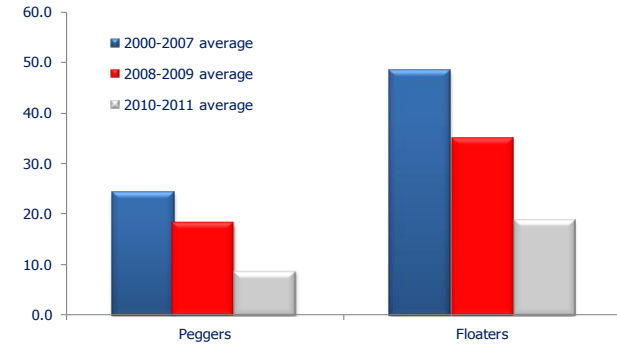


Shares of world exports, 5 year % change



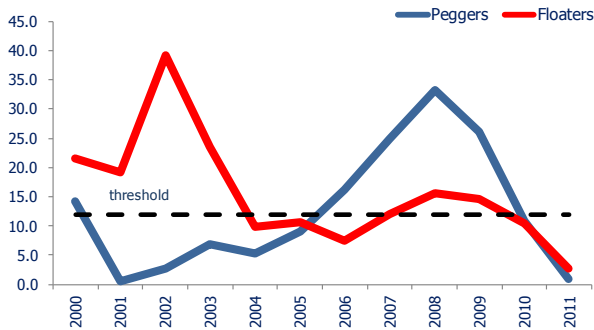
Note: Data for Romania, Croatia and Albania starts from 2001, for Serbia from 2002 and for Macedonia from 2003
Source: Eurostat, central banks' websites and IMF

Shares of world exports, 5 year % change



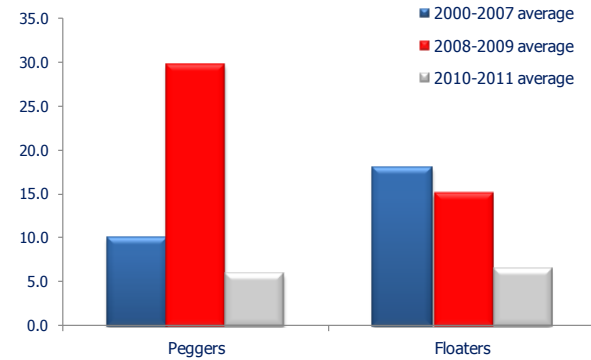
Source: Eurostat, central banks' websites and IMF

Nominal ULC, 3 year % change



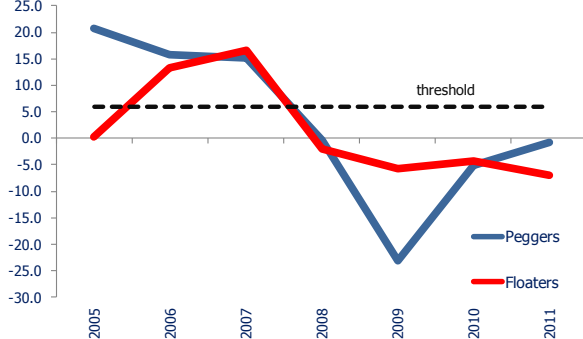
Note: Data for Romania and Macedonia starts from 2002, for Croatia from 2003-2007 and for Albania from 2005.
Source: Eurostat, NBRM, Croatian Bureau of Statistics and Bank of Albania.

Nominal ULC, 3 year % change



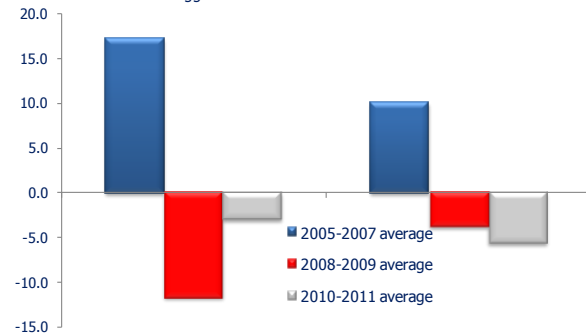
Source: Eurostat, NBRM, Croatian Bureau of Statistics and Bank of Albania.

House price index (y-o-y %, relative to the final consumption)



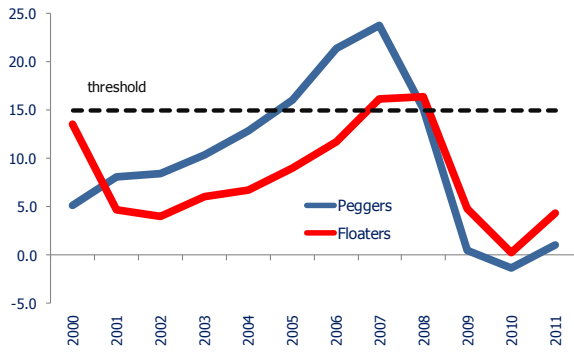
Note: Data for Croatia refer to prices of new dwellings sold, data for Serbia refer to prices of dwellings in new construction. Data for Hungary, Poland and Romania starts from 2006.
Source: ECFIN, Eurostat, NBRM, Croatian Bureau of Statistics and Statistical Office of the Republic of Serbia.

House price index (y-o-y %, relative to the final consumption)



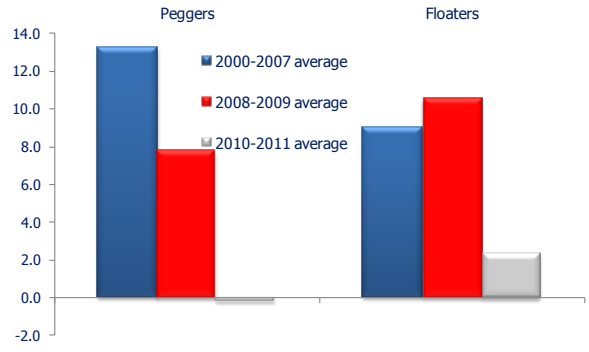
Source: ECFIN, Eurostat, NBRM, Croatian Bureau of Statistics and Statistical Office of the Republic of Serbia.

Private credit flow, in % of GDP



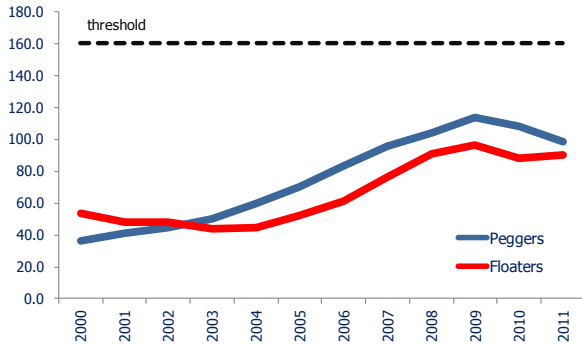
Note: Data for Bulgaria starts from 2001 and for Albania from 2004.
Source: Eurostat and central banks' websites.

Private credit flow, in % of GDP



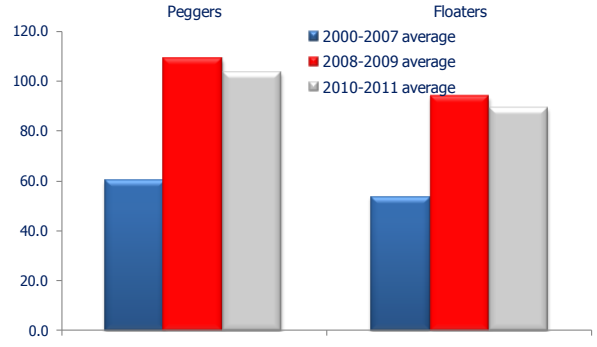
Source: Eurostat and central banks' websites.

Private debt, in % of GDP



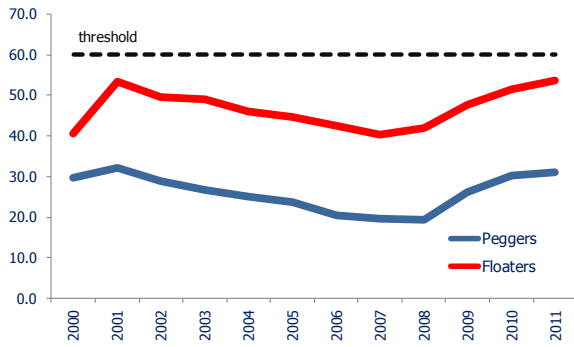
Note: Data for Albania starts from 2003.
Source: Eurostat and central banks' websites.

Private debt, in % of GDP



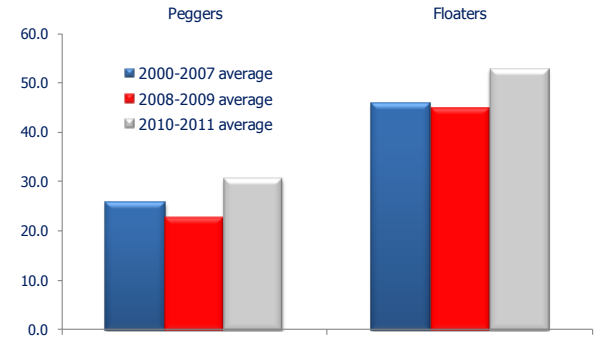
Source: Eurostat and central banks' websites.

General government gross debt, in % of GDP



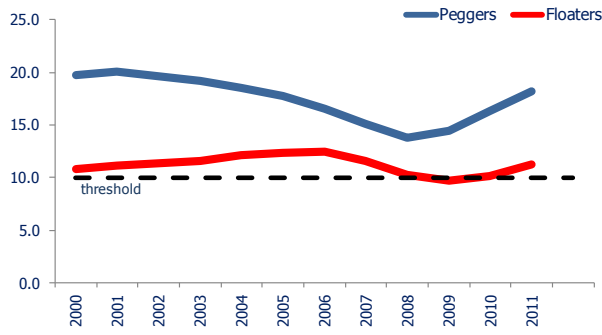
Note: Data for Macedonia and Serbia starts from 2001. Data for Croatia starts from 2002.
Source: Eurostat, National Ministries of Finance and IMF.

General government gross debt, in % of GDP



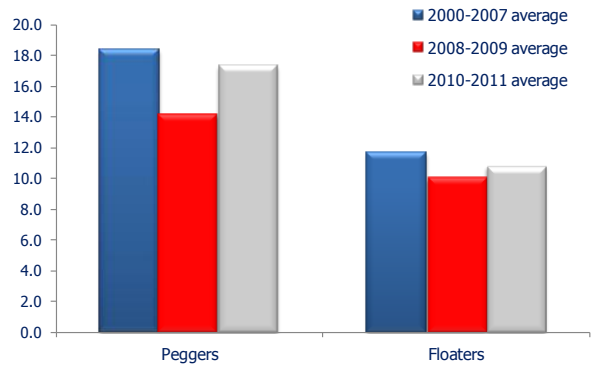
Source: Eurostat, National Ministries of Finance and IMF.

Unemployment rate, 3 year average



Note: Data for Bulgaria starts from 2002.
Source: Eurostat, National statistics and IMF.

Unemployment rate, 3 year average



Source: Eurostat, National statistics and IMF.