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MONETARY POLICY OPTIONS FOR TRANSITION ECONOMIES

Moguće vrste monetarnih režima za zemlje u tranziciji

Abstract

Implementation of an adequate monetary policy regime in transition economies has provoked an active debate in the past decades. There was a tendency to try to reach a "one-size-fits-all" solution. However, differences in macroeconomic performances and institutional development have led to different choices in terms of applied monetary regimes. This debate is ongoing since none of the monetary regimes is ideal. If there are reasonable doubts whether the choice of monetary regime a transition economy has made was optimal, it is eligible to reconsider available alternatives. This paper is a contribution to this ongoing debate. A lot of emphasis is sometimes given to the role of monetary policy in transition economies, with high expectations in terms of the capacity of the right choice of monetary regime to generate high levels of economic growth. However, institutional development substantially overshadows the importance of the choice of monetary regimes for economic success of transition economies.

Key words: *monetary policy, exchange rate, transition economies, inflation targeting*

Sažetak

Debata o izboru adekvatnog režima monetarne politike za zemlje u tranziciji aktuelna je već dugi niz godina. Postojala je tendencija da se dođe do idelanog monetarnog režima koji bi odgovarao svim zemljama u tranziciji. Ipak, različite makroekonomske performase i razvijenost političkih, monetarnih i finansijskih institucija vodile su različitim izborima monetarnin režima. Debata o adekvatnom monetarnom režimu i dalje je aktivna jer ni jedan model nije idealan. Ako postoje sumnje da li je neki monetarni režim ispunio očekivanja u pojedinim zemljama u tranziciji, legitimno se mogu razmotriti raspoložive alternative. Ovaj rad je doprinos toj javnoj debati. Monetarnoj politici se često pridaje veliki značaj i pred nju se postavljaju velika očekivanja u vezi s tim da pravilan izbor monetarnog režima može da kreira visoke stope privrednog rasta. Ipak, za ekonomski uspeh zemalja u tranziciji znatno je važniji stepen izgrađenosti i kapacitet institucija sistema u odnosu na izbog monetarnog režima.

Ključne reči: *monetarna politika, devizni kurs, zemlje u tranziciji, ciljanje inflacije*

Introduction

Monetary policy regimes have been developing throughout the past centuries in a way that has been evolutionary and gradual. Developed nations have led the path, and developing nations have been following. It was not a rear occasion that developing nations did not have necessary prerequisites for the implementation of developed nations' experiences. However, a lot has been learned and lots of improvements have been achieved in monetary policy conduct. Certain monetary regimes have been widely accepted for a period of time, but have completely gone out of fashion in the years and decades to follow. An active debate has been going on in the past couple of decades concerning the appropriate choice of monetary policy for transition countries. However, it is not clear what would monetary policy experience and "state of the art" of monetary economics suggest the transition economies should do. What monetary policy regime is

an adequate one for a specific transition country, for its level of development and for its type of macroeconomic challenges? Various transition countries have opted for very different choices. And every country had strong arguments for their specific choice. What choices do transition countries actually have?

Discretionary monetary policy

Discretionary monetary policy is a non-rule based, no clear goal *ad hoc* monetary policy in which the government via central bank can implement a wide set of unclear, frequently and as a rule, politically influenced goals with a short run approach to monetary policy conduct. Such monetary policy has been widely in place for decades back in various developing nations with similar outcomes. Discretion of monetary authorities was frequently abused by political interest producing policies such as monetization of public debt, dual and multiple exchange rates, excessive monetary expansion, discretionary lines of credits to favored real and financial sector entities etc. Monetary policy was frequently misused by political elites in the name of development policies but rather for particular individual and group interests. In such a framework and in those times, credibility of monetary policy was heavily compromised in many developing countries. We have seen quite a number of episodes of very high inflation, massive capital flight, destructive financial crises with depressions and prolonged periods of low growth.

From 2000 to 2006 (formally 2008), Serbia was *de facto* in a regime of discretionary or *ad hoc* monetary policy with unclear goals. In practice, however, predominantly exchange rate was a target. Throughout this period, exchange rate was relatively stable with relatively high internally generated inflation. The consequence of these circumstances was a substantial real appreciation of the Dinar (especially in a period from 2000 to 2003). At the same time, and in the years to follow, the country has not experienced any significant increase in productivity. This has led to deterioration in country's competitiveness and to growing current account deficits (CAD), swiftly reaching unsustainable levels. Serbia entered double digit CAD as soon as 2004, reaching 21.7% CAD to GDP in 2008. In addition, these levels of CAD were mainly based on imports of consumption goods i.e. investment contribution to CAD was relatively low. Clearly, such policies were leading to declining rates of growth with an increase of public and private debt. Both consequences were clearly visible from 2009. Global economic crises has just accelerated and emphasized the negative consequences of inadequate economic policies and inappropriate structure of GDP growth from previous years.

In spite of Serbian experience with formally relatively high level of institutional independence of the Serbian central bank, discretionary monetary policy from 2000 to 2008 produced high real appreciation of the Dinar and dramatic increase in euroization of Serbian financial system, with detrimental consequences for both macroeconomic and financial stability of the country. So, even in the case of Serbia from 2000 to 2008, discretionary monetary policy was not able to resist politically influenced goals with a short-run and short-sited approach to monetary policy conduct.

If a country wants to move away from discretionary monetary policy, the key challenge and a prior question is whether transition countries are capable of setting up an institutional framework that will prove to be effective and efficient in constraining the discretion of their monetary authorities. As an alternative to discretionary monetary policy, central banks need to be fully and realistically independent from political influences and with a clear goal as a strong and effective "nominal anchor". Nominal anchor is a nominal variable used by monetary authorities to control inflationary expectations and for reduction and stabilization of inflation.

Legitimate nominal anchors are: exchange rate level, monetary aggregate level (level of money), and inflation level. Therefore, monetary policy regimes can basically be: exchange rate targeting, monetary targeting and inflation targeting.

Still, more as a theoretical concept, nominal anchor can also be a specific level of certain chosen prices. However, research suggests that tying monetary policy to a specific level of prices suggests a rather rigid rule, and a mechanism that might promote less output stability i.e. less stable GDP growth. This comes from the fact that in

such a monetary regime price shocks are not treated as bygones by monetary policy, but rather as shocks that need to be reacted upon. Therefore, a more restrictive monetary policy response to bring back the specific prices to their targeted level [7] as a byproduct generates larger economic contraction then necessary under inflation targeting. There are really no available recent global experiences with this monetary regime. The only one available is that of Sweden in the 1930s [2] that proved to have been rather successful. Some recent research suggests that price level targeting has certain advantages over inflation targeting [15]. And even more recently, certain central banks of developed nations debate about implementation of price level targeting as an answer to relative ineffectiveness of inflation targeting to deflation challenge [1].

Therefore, transition countries are left with a choice that some see as a choice between fixed versus flexible exchange rates. More precisely, the choice is weather nominal anchor is an exchange rate (with hard pegs and soft pegs options) – exchange rate targeting, level of monetary aggregates (i.e. money) – monetary targeting, or level of inflation – inflation targeting.

Exchange rate as an anchor

Exchange rate targeting, based on exchange rate as an anchor, can have several forms. Broadly, we can divide them in two categories: soft exchange rate pegs, and hard exchange rate pegs [9, p. 356].

Soft exchange rate pegs can also be called fixed but adjustable pegs. This means that these monetary regimes allow occasional devaluations. Fixed exchange rate pegs allow for unannounced relatively large devaluations with different magnitudes, depending on stability and level of current account imbalances. In some cases, these devaluations are forced by the markets and come as a consequence of rapid FX reserves depletion. In some cases, the governments revert to devaluations as a preemptive measure to preserve the FX reserves and relative competitiveness of the national economy. There are situations in which devaluation is *de facto* a prelude to introduction of a flexible exchange rate. However, if the government has a long-run record of relatively low

level of budget deficit and public debt with an economy that produces low levels of inflation and current account deficit, with sufficient FX reserves, fixed exchange rate may operate without devaluations for a long period of time.

Crawling exchange rate pegs allow for announced and predetermined relatively small devaluations in specific time frames. They can take various forms, but broadly they can take the form of crawling pegs – with fixed exchange for a predetermined time horizon, and crawling bands – with a small flexibility of exchange rate movements within a predetermined fluctuation band around central level of exchange rate that is occasionally reset. The magnitude of exchange rate devaluations in a crawling regime can be based on levels of inflation, current account deficit, FX reserves etc. and can be with different frequencies within a year

Soft exchange rate pegs leave little room for independent monetary policy to react to domestic and imported macroeconomic shocks [14]. At the same time, they are incapable of delivering a nominal anchor that keeps inflationary expectations under control. In addition, they cannot eliminate the currency risk component as long as devaluations are possible. They are incapable of preventing monetary policy misconduct if central bank is not really independent of political influences. In addition, crawling pegs and bands with their adjusting devaluations based on differences in various variables compared to the anchor country, with forward looking or backward looking calculations of potential devaluations can prove to be complicated for the general public to understand and follow [6].

If the economy has high levels of current account deficits, fixed exchange rate can waste FX reserves of the country and encourage speculative attacks on local currency with possible massive devaluation with overshooting effects that can initiate widespread bankruptcies of households, corporates, banks and the government [10].

Hard pegs can essentially take two forms: currency board and full dollarization. Both, if operating properly, can provide a strong nominal anchor that can keep inflationary expectations low, and can eliminate currency risk. They are simple, easy to understand, and eliminate the risk of public debt monetization or excessive monetary

expansion. However, they leave no scope for domestic monetary policy and therefore it is impossible to react to domestic shocks that are independent of those in an anchor country. Devaluations and depreciations of exchange rate are excluded as a tool for improvement of competitiveness of local economy. Therefore, internal devaluation in terms of downward wage corrections remains the only realistic way of improving competitiveness in the short run. Similarly, external shocks may have a more direct and severe impact on GDP growth than in the case of exchange rate flexibility and independence of monetary policy.

Despite all of the disadvantages of exchange rate pegs, if a country does not have a developed political and financial institutional framework, capable of credible use of monetary sovereignty, so to have an independent and efficient monetary policy, transparent hard pegs may prove to have more benefits then shortfalls for a transition economy [11, p. 599].

Level of monetary aggregates as an anchor

A credible nominal anchor can be level of monetary aggregates, i.e. level of money [10]. If by monetary targeting a country wants to control inflation, it has to focus on three relevant elements: First, reliance on the level of monetary aggregates to conduct monetary policy. Second, public announcement of monetary targets, so to anchor inflationary expectations. Third, an accountability mechanism that does not allow substantial deviations from targeted monetary aggregates by the central bank.

Germany and Switzerland have been implementing monetary targeting with great success since the early 1970s for more than 20 years. It has strong advocates and still is an element of monetary policy of the ECB. It has been a monetary regime of choice for many countries in the 1970s and 1980s. It has enabled the central bank to aim inflation which is different than in other countries, and it has allowed a certain level of independence in terms of monetary policy to deal with internal and external shocks.

However, some countries have not been as successful, since this monetary regime is heavily reliant on constant velocity of money. If the velocity of money is relatively volatile, even relatively constant and well-targeted monetary aggregates can produce inflationary pressures beyond the desired level of inflation. This risk can undermine the credibility of the central bank and therefore the monetary targeting as a regime may prove to be less effective than necessary.

Transition countries that have higher level of dollarization (or euroization) may be exposed to high levels of volatility in velocity of money, especially in times of uncertainty. Therefore, reliance on monetary aggregates as a nominal anchor can prove to be insufficient bringing inflation down and for keeping inflationary expectations under control. Problems that this monetary regime may bring upon central banks in terms of their credibility, in countries that have relatively young central banks with unproven positive track record, can make this monetary regime incompatible with transition economies requirements.

If the country does not have a central bank with established credibility, and if the velocity of money tends to be volatile, this monetary regime can hardly be perceived as an optimal choice.

Even if some developing countries have publicly stated that they have adopted monetary targeting as a monetary regime, in practice they have not fully complied with strict definition of this monetary regime. Even the Bundesbank, as a famous monetary targeting central bank, in its monetary policy conduct in certain points in time has been behaving as inflation targeting central bank [3].

Additional problem of making this policy effective in transition economies is the fact that most of them are relatively small, with important amount of capital inflows and lack of effective monetary instruments capable of precise and affective corrections of monetary aggregates in short and medium term.

Level of inflation as an anchor

Declaring the targeted level of inflation and using it as a nominal anchor lies in the essence of inflation targeting. Inflation targeting, as was the case with monetary targeting, allows for independence of monetary policy and flexibility of exchange rate. Inflation targeting relies on five basic elements:

First, public announcement of mid-term numerical target for inflation. Second, central banks institutional devotion to price stability as a primary goal to which all other goals are of the second order. Third, monetary policy strategy that takes into account movement in monetary aggregates, exchange rate and other important variables in making decisions concerning monetary policy instruments. Forth, transparency of monetary policy and communication of the central bank with financial markets and the general public about plans, goals and decisions. Fifth, increase in central bank credibility concerning fulfillment of inflation goals, and mechanism of central bank accountability [12].

However this regime requires certain preconditions to be implemented in transition economies.

Primary precondition for inflation targeting to be successful is full institutional central bank independence. In addition, successful implementation of inflation targeting in transition economies calls for some additional requirements.

First, introduction of inflation targeting yields much better results after succesfull inflation reduction to relatively low levels. In other words, inflation targeting has much better chance of being successful if implemented on relatively stable single digit inflation levels with a several years of track record [4].

Second, lack of fiscal discipline is incompatible with inflation targeting. High budget deficits lead to public debt crises or pressures for monetization of public debt with pressure on exchange rate and increase in inflationary expectations. Therefore, absence of fiscal dominance over macroeconomic environment and institutional development to ensure fiscal discipline is a must for inflation targeting to have a chance to succeed [13].

Third, local currency must be in dominant use. Basic inflation targeting policy instrument is a local currency interest rate. This interest rate should influence savings, consumption and investments. If transition economy uses other currencies (dollars, euros) in a significant portion of financial transactions, reference rate of the central bank loses much of its influence over financial transactions, and therefore, loses much of its impact on aggregate demand and inflation.

Inflation targeting is not ideal. When targeting monetary aggregates or exchange rate, central bank can directly influence these variables. When targeting inflation, central bank influence is indirect and with a significant time lag, i.e. with monetary policy transmission lags. These lags can significantly vary from one country to another. So the conduct of the inflation targeting regime is more complex and therefore may pose a risk to credibility of a central bank, especially in transition economies. In addition, inflation targeting alone, cannot override the dominance of fiscal policy over macroeconomic variables. In addition to that flexibility of exchange rate movements associated with inflation targeting can cause financial stability risks and decrease the stability of business environment in the country.

Conclusion

In a variety of potential monetary regimes for transition economies, it is not clear what type of monetary regime should be appropriate for every transition country. It is not just the macroeconomic performance of a country that can influence the right choice. Of course, it is important to take into account the level and stability of inflation, of current account deficit, of budget deficit and the public debt. But even more than this, the right choice of monetary regime must take into account the capacity and the level of development of political and financial institutions in a specific transition economy. Is it possible to have not just "paper based" but "real life based" independence of the central bank? Is it possible to establish a nominal anchor that will be supported by the political institutions? Can a country have a credible and competent central bank responsible for implementation of a monetary policy regime? Does the financial system dominantly operate within a local currency upon which a central bank implements its monetary policy? Despite strong argumentation for advantage of monetary regimes based on flexible exchange rates and independent monetary policy, if the country does not have a developed political and financial institutional framework, capable of credible use of monetary sovereignty, transparent hard pegs may

prove to have more benefits then shortfalls for certain transition economies.

In the end, it should be clearly said that any monetary policy regime alone cannot solve economic problems of any transition country. If the economy is balanced and with developed political and financial institutions, it is far less important whether it has a fixed or a flexible exchange rate. For economic success of transition economies, choice of monetary regime is of second-order importance to development of credible political, financial and monetary institutions.

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