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MONETARY POLICY IN TRANSITION ECONOMIES: A CASE STUDY FOR CZECH REPUBLIC, HUNGARY AND POLAND

Abstract

In the past two decades there was an apparent effort of a number of East and Central European countries to stabilize their economies toward establishing a market economy and achieve sustainable economic growth. This paper is aimed to review and analyze the monetary policy and its effects on sustainable growth. In particular, it will examine the implementation of the monetary policy in three transition economies, namely Czech Republic, Hungary and Poland and its effects focusing on sustainable growth.

Key words:

Monetary policy, inflation, transition economies, convergence, stabilisation, liberalisation, sustainable growth.

1. Introduction

Macroeconomic stability is one of the most important socio-economic factors which determines the achievement of sustainable growth. The macroeconomic policy is the main tool for transition economies to succeed, to «catch-up» and to upgrade their economies. The main targets of the macroeconomic policy are to stabilize the economy and to converge mainly towards the accession to the European Union. The experience of transition economies in achieving this status teaches valuable lessons on the effects of macroeconomic and monetary policies and especially for the transition economies.

The economies of the former Socialist nations face problems of low production incentives and inefficient resource allocation, mainly because controls of their economies remain. Production incentives are higher under private ownership than under public or state ownership and controls.

An important goal for the transition economies was to stabilize the economy and moreover to create a capital market which required to create a liberal banking-system out of

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the former socialist state bank. The socialist banking-system consisted of a state bank that not only controlled all the functions of a state bank but also issued all short-term credits to the private business sector. Transition economies are likely to attract capital inflows, as investors anticipate the convergence of interest rates and the appreciation of their exchange rates.

This paper analyses the monetary policy and its effects and implications. It also focuses on the experience of three transition economies, namely the Chezh Republic, Hungary and Poland. The economic performance of these countries, either measured by the level of inflation or by stabilization and liberalization of markets, or even by their economic growth, places them among the first on the list of «successful» transition economies.

2. The background of macroeconomic policy

The economic and social conditions, policies adopted, and priorities of the three countries' transition economies are quite different. However, there are a lot of similarities in stabilization and liberalization programs and in the background of their monetary policy.

During the last two decades the emerging markets of transition economies faced a lot of problems. Many firms have reduced their output, while investments have been decreased in many industries, especially in manufacture. On the other hand, the high inflation, the instability and fragmented markets, in conjunction with large debts, were threatened the liquidity of new created commercial banks.

The initial objectives of macroeconomic and monetary policy were the domestic prices, the exchange rates and curbing high inflation. Monetary policy was aimed at stabilization and liberalization of the market.

Table 1, Table 2 and Table 3 show the structure of the main factors for the three transition economies. Table 1 illustrates the real GDP, percentage changes from the previous period. Table 2 shows the real private consumption expenditure, percentage changes from the previous period.

Finally, Table 3 depicts the real public consumption expenditure, percentage changes from the previous period.

Table 1: **Real GDP, percentage change from previous period**

	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	2.6	5.9	3.8	0.3	–2.3	–0.2	1.4	2.3
Hungary	2.9	1.5	1.3	4.6	4.9	4.5	5.2	5.0
Poland	5.2	7.0	6.0	6.8	4.8	4.0	5.0	4.8
European Union	2.7	2.4	1.6	2.5	2.7	2.3	3.4	3.1
Total OECD	3.1	2.5	3.2	3.4	2.4	3.0	4.0	3.1

Source: OECD, Economic Outlook, June 2000, Paris, France.

Table 2: **Real private consumption expenditure, percentage change from previous period**

	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	5.3	5.9	6.9	2.1	–2.8	1.2	0.8	0.8
Hungary	0.2	–7.1	–4.3	1.9	4.8	5.1	5.2	5.0
Poland	4.3	3.3	8.3	6.9	4.7	5.0	4.6	4.0
European Union	1.6	1.8	1.9	2.0	3.0	2.8	2.8	2.9
Total OECD	2.7	2.3	2.9	2.8	2.8	3.7	3.8	2.9

Source: OECD, Economic Outlook, June 2000, Paris, France.

Table 3: **Real public consumption expenditure, (%) change from previous period**

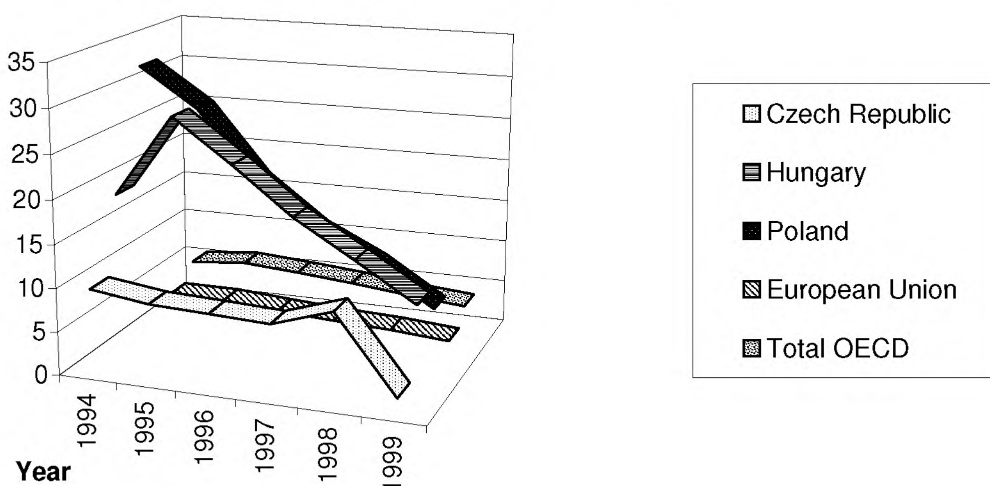
	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	–2.3	–4.2	–1.2	3.6	0.6	–0.1	0.2	2.0
Hungary	–7.4	–5.7	–1.9	3.1	2.8	2.5	2.0	1.5
Poland	2.2	2.9	3.4	3.1	1.6	4.5	2.1	2.0
European Union	2.6	3.5	2.3	3.2	5.9	5.0	4.8	4.4
Total OECD	4.5	3.4	6.9	5.5	4.9	5.0	6.0	4.5

Source: OECD, Economic Outlook, June 2000, Paris, France.

In the first half of 1999, inflation seemed to have fallen toward a single digit-level in these three transition economies. In the Czech Republic, the monthly rate of inflation as measured by consumer price index fell to 6.8 percent in January 1999, while in Hungary and in Poland these figures were 10.5 percent and 8.6 percent respectively. Figure 1 illustrates the percentage changes for consumer prices for the three transition economies, Czech Republic, Hungary, Poland, and also the European Union and Total OECD for a period 1994–1999.

The three transition economies, namely the Chezh Republic, Hungary and Poland, followed a gradual macroeconomic policy that sought to balance the desire to reduce the inflation with the need to control the government deficit, to service the large external debt, promote privatization, liberalize the market, and finally to stabilize the economy and; therefore, to be able to achieve a sustainable growth. For three transition economies the policy orientation, and implementation of macroeconomic programs and monetary issues have common characteristics that have been focused on the following points.

Figure 1: **Consumer prices (percentage changes from previous year)**



The Czech Republic

In Czechoslovakia, after the fall of communist regime, the socialist central bank was broken into two banking systems. In 1993, when Czechoslovakia split into two independent countries, the Czech republic and the Slovak Republic, the number of active banks in each country declined and each country tried to found its own central bank on the basis of the former Czechoslovakia National Bank. In addition, Czech commercial banks held bad loans that had been made to state-owned firms during the socialist period. The Czech Republic employed the monetary policy based on preserving the nominal exchange rate of the national currency (the koruna). The objective of monetary policy was to fight inflation and fix the prices of foreign goods, to stabilize the economy, and also to liberalize the market and to attract the foreign capital through foreign direct investment. Privatization had a major impact on the Czech banking sector. In the banking sector there was a lack of competition, where the government remained the primary owner of each of the major banks and the market was dominated by a few large banks. Although commercial banks had to increase their capitalization over time, it was difficult for the government to find foreign investors to take over the majority of shares in Czech commercial banks. Fiscal policy was underutilized as a policy tool to achieve a lower inflation rate, and thus the fiscal surplus turned to a deficit over the years, and this implied that the monetary policy had to become increasingly tight in order to reduce the rate of inflation.

Hungary

Prior to the beginning of the transition in 1987, in Hungary the state bank was transformed into a two-part banking system in an effort to decentralize the economy and to achieve the sustained economic growth. The new banking system consisted of the National Bank of Hungary as a central bank and of five newly-founded commercial banks. Three of those commercial banks dominated in various sectors of the economy. The Budapest Bank dominated in industry, Magyar Hitel Bank dominated in agricultural sector, and Kerezkedelmi Bank dominated in small business and public utilities. The privatization of the banking sector was mainly focused on sales to foreign investors who exercised control and could transfer additional funds to the banks. By 1991, about half of the commercial banks' loans could be classified as non-performing. During the transition period Hungarian banks were not so effective in terms of savings to the corporate sector. Because of the liberalization problems and unlike Czech Republic and Poland, Hungarian economy experienced quite high inflation rates. In particular, during the period of 1987 and 1988, inflation, as measured by consumer price index, increased approximately by 15 percent and 30 percent, respectively. At the same period, the government's budget deficit remained unacceptably high and the current account deficit reached over 9 percent of GDP. Financing of this deficit required monetary expansion and high interest rates so that the commercial banks were able to attract government securities and savings, but this process has induced rapidly the inflation. In 1995, Hungarian government applied a stabilization macroeconomic program in order to reduce inflation through the high reduction of government expenditures and the gradual increase of taxes. The result of this particular macroeconomic policy was the reduction of the fiscal deficit from 9.6 percent of GDP in 1994 to 7.3 percent in 1995 and 4.6 percent in 1996, respectively.

Poland

After the socialist government, the banking system in Poland consisted of four state banks that specialized in foreign trade, household savings, and so on; all these turned into commercial banks over time. In particular, the National Bank of Poland turned into nine commercial banks; in addition, some small and foreign banks were established. The privatization program foresaw the sales of stock both to domestic owners and foreign strategic investors, but the whole process has been delayed. The macroeconomic program was aimed to attract foreign investors in an effort to strengthen the industrial sector. The stabilization of the economy started in much less favorable conditions than those of Hungary and Czech Republic. In 1989, inflation figure was running at about 55 percent per month, while the government deficit was nearly 8 percent of GDP. The recession deepened in 1991, when the fiscal deficit increased and high inflation rate reduced the competitiveness of Polish markets, products and exports. Policy priorities gradually shifted from stabilization to stimulating growth. The fiscal deficit declined by about 6 percent of GDP in 1992 and by about 2.8 percent in 1993. Poland had the highest rate of inflation of the three transition economies throughout the 1990s, but it also has the fastest growth of aggregate output. Recently, the output growth has slowed due to financial crisis and decline in exports to Russia and Ukraine. However, macroeconomic policy allowed to stabilize the economy and liberalize the market with positive effects. All this attributed to the process of removing the barriers and joining the European Union.

3. The effects of macroeconomic policy

Monetary policy directly affects activity and ultimately inflation through its influence on interest rates and hence on the demand for goods by households and firms. However, monetary policy can also influence the behavior activity through its impact on the value of assets that, in turn, will influence the behavior of

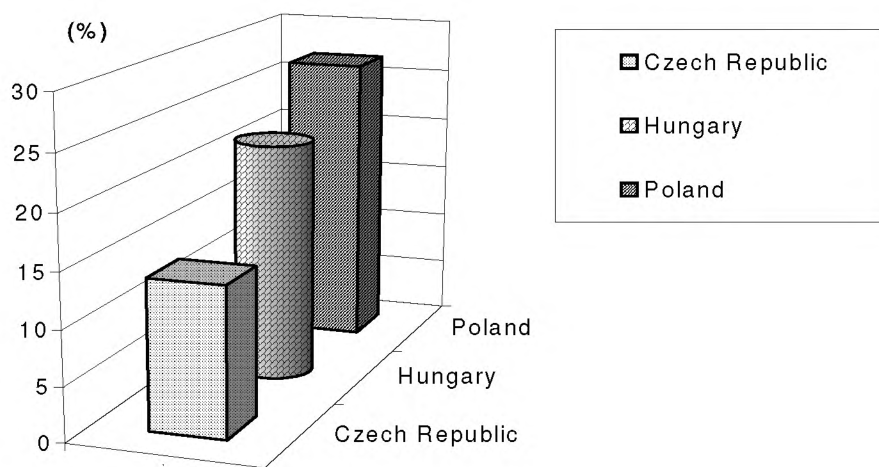
households and firms. Recent financial market developments may have made these effects of monetary policy more important but, at the same time, less easy to predict. In particular, the size of increasingly important financial markets has risen as well as other financial assets. Table 4 shows the short-term interest rates for three transition countries, Czech Republic, Hungary and Poland, and also for Euro-area countries for the period 1993–2001. Figure 2 illustrates the average annual percentage change of inflation for the three transition economies for the period 1990–1998.

Table 4: **Short-term interest rates**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	13.1	9.1	10.9	12.0	15.9	14.3	6.9	5.6	6.8
Hungary	17.2	26.9	32.0	24.0	20.1	18.0	14.7	11.1	10.6
Poland	33.2	28.8	25.6	20.3	21.6	19.1	13.1	16.0	14.0
Euro Area	8.6	6.3	6.5	4.8	4.2	3.9	3.0	4.3	5.1

Source: OECD, Economic Outlook, June 2000, Paris, France.

Figure 2: **Average Annual rate of Inflation, 1990-1998**



The modern and capital markets of transition economies are still in primitive stage and less efficient than those of the European Union countries. We can compare the financial intermediation (namely, the bank assets plus the stock market capitalization plus the bond market capitalization) to GDP (Gross Domestic Product) ratio for the three transition economies, namely the Chezh Republic, Hungary and Poland to the average of the European Union. According to this ratio the figure for the European Union was approx. 288 percent, while the figures for the Czech Republic was 162 percent, 86 percent for Hungary, and about 64 percent for Poland, respectively. Figure 3 illustrates the external debt as a percentage of GNP for the three transition economies.

Monetary policy had the following objectives:

- to make stabilization credible;
- to facilitate the reorientation of trade to the West;
- to create a liberal trade regime;
- to reduce inflation to low single-digit levels.

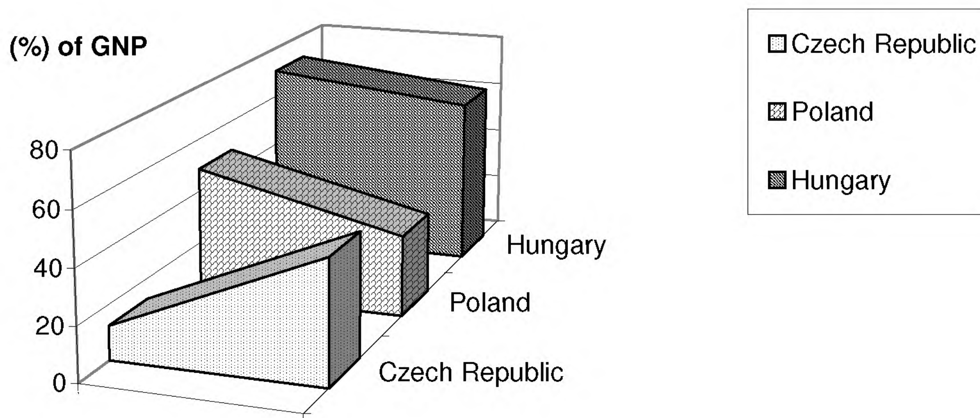
Under the new monetary policy and macroeconomic programs, it was expected that domestic inflation would cause real exchange rate appreciation and will lead to more realistic exchange rates, as these countries came closer to join the European Union. Over time, the output recovered and the inflation declined, though this level was quite below that of the West European levels. Table 5 summarizes the magnitudes of average annual rate of inflation, GNP per capita annual growth rate, and also the external debt as a percentage of GNP for three transition countries, Czech Republic, Hungary and Poland.

Table 5: **Average annual rate of inflation, GNP per capita annual growth rate and external debt as (%) of GNP: (as percentage)**

	Average annual rate of inflation (%)		GNP per capita annual growth rate (%)		External Debt as (%) of GNP	
	1990–1998	1998	1975–1990	1990–1998	1985	1998
Czech Republic	13.7	11.0	–	–1.6	12.5	45.5
Hungary	22.0	14.2	1.8	0.2	70.6	62.2
Poland	26.9	12.0	–	3.7	48.7	30.4

Source: U. N., Human Development Index Report 2000.

Figure 3: **External debt as (%) of GNP**



Under different conditions and with different starting dates of stabilization programs, the results of monetary policy in the three transition economies were quite apparent and they have stabilized inflation at moderate levels and succeeded in generating sustained growth and converging their economies.

In these three transition economies the efforts were exerted through the monetary policy, in terms of disinflation, as measured by consumer price index, to converge with other European member states and so to be able to join the European Union in the future. The success of this process depends on the following three factors:

- The efficiency of this process depends whether the tendency and monetary policy will be supported by the appropriate fiscal policy. The fiscal policy will affect directly the domestic market and also the whole economy with exports, imports and the restriction of fiscal deficits.
- The «international environment» is another important factor that affects this process favourably. Under «international environment» we mean international prices and prices on imports in first inputs such as raw materials and fuels. The «international environment» also directly affects agricultural prices and, furthermore, determines the FDI, Foreign Direct Investment.
- The third main factor which affects and determines this process is whether the monetary policy targeted at inflation is effective or not. The success on inflation targeting in the monetary policy depends whether the central banks of these countries, and also the institutional and policy environment, have the autonomy and are efficient in order to carry out a policy to curb inflation. Inflation targeting had some advantages, provided the monetary policy is supported with a nominal price level. The transparent policy, which government can understand and observe, can also increase the central bank's credibility. Finally, the central banks that follow inflation targeting should avoid other nominal targets.

The real exchange rates of transition economies, as measured by the consumer

process index, will appreciate during the transition period. This process is likely to take several years. In order for these countries to remain competitive and skillfully balance the payment problems, they must apply extensively the «Balassa-Samuelson effect». According to the «Balassa-Samuelson effect», the productivity growth differs among sectors, while wages tend to be less differentiated. Productivity growth is faster in the traded goods sector than in the non-traded goods sector, and this is pushing the wages in all sectors and; consequently, the prices of non-traded goods relative to those of traded goods will rise inferring that the consumer price index will rise faster. The stability objective would be best served by a fixed-rate regime. The implementation of this policy will allow the transition economies to become members of the European Economic and Monetary Union.

3. Conclusions

Transition economies, namely of the Chezh Republic, Hungary and Poland, so far faced many serious problems because of stabilization and liberalization process and also due to underdevelopment of capital markets. Monetary policy is the main tool for macroeconomic planning and to foster the socio-economic growth. Monetary policy is aimed to reduce inflation in these moderate level countries to a single digit level and; therefore, be prepared to enter into the European Union.

The significant development and growth of financial markets relative to GDP is likely to have changed the way monetary policy affects real activity and ultimately inflation. Monetary policy may be more powerful through its effect on asset values which reinforce the traditional direct impact of interest rates on demand. However, monetary policy may take longer to influence the economy, as wealth and balance sheet effects take longer to play out.

The Chezh Republic, Hungary and Poland had applied a macroeconomic stabilization program and have made considerable progress in stabilization and liberalization of their economies. The monetary policy was the main tool of this program and it contributed much to stabilise especially financial institutions and markets of those countries.

It is highly important for all these «transition economies», namely the Chezh Republic, Hungary and Poland, to continue their efforts to reinforce the capital market and to pursue more active fiscal policy and; therefore, in order to support the monetary policy and through this to contribute substantially the convergence and augment socio-economic growth of those countries. The transition economies are integrated into a global financial system with much less restrictions in capital flows. These countries effected relative price adjustments, beyond the «Balassa-Samuelson effect», and also carried out structural reforms to liberalize telecommunications, energy, transportation and health.

The transition economies have made serious efforts creating a banking system that corresponds to the needs of a market economy with the central bank independent from government influence, in controlling inflation and strengthening the national currency. Meanwhile, the role of commercial banks is quite insignificant in financing the investment activities.

While the accession of Central and Eastern European transition countries to the European and Monetary Union is still several years away, it is close enough to take decisions in regards of the monetary policy, such as of what type of enhance rate regime will serve their economic development and ensure their transition to the European Economic and Monetary Union membership. The creation of the European Economic and Monetary Union opened a new chapter in the debate for the transition economies. The transition economies have a strong interest in joining the euro-zone, which will offer them a number of economic advantages including lower risk premiums, interest rates and transaction costs. Macroeconomic and monetary policy is aimed to remove economic barriers, stabilize the economy and liberalize the markets, and consequently, to speed up the entrance to the European Economic and Monetary Union.

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