Post-Transition Monetary and Exchange Rate Policies:
Dilemmas on Eurozone membership in terms of Global Recession

Gordana Kordić
University of Zagreb, Faculty of Economics & Business, Croatia
gkordic@efzg.hr

Abstract. When the transition process started 25 years ago, one of the most important dilemmas was the choice of exchange rate arrangement and, consequently, national monetary policy. During the transition, countries used arrangements from all three major groups (fixed, intermediate and floating), primarily trying to keep control of inflation, preparing for Eurozone membership. Despite the positive aspects, there have been difficulties and negative side effects as well, such as high levels of euroisation and “fear of floating” deviations from officially announced regimes towards de facto hard pegs, resulting in real appreciations with negative consequences on international competitiveness. Still, in terms of asymmetric economic shocks resulting from the global crisis there is a changed perspective on the Eurozone membership, challenging the ideas on more active use of national monetary sovereignty. Consequently, there are permanent dilemmas on monetary and exchange rate policies for national authorities: redefining monetary policy goals while there are still disposable instruments for more active policy (including de-euroisation) or continuing the accession process for Eurozone membership. At the same time, there are also the European semester and Macroeconomic Imbalance Procedures that are generally seen as an informal criterion for entering the European Exchange Mechanism II, supplementing the Maastricht criterion.

Analyses in the paper are based on exchange rate regime strategies and comparison of macroeconomic indicators for selected post-transition countries that are grouped as eurozone members and EU members outside the eurozone. In the aftermath of the crisis, with doubts on the future of European economic and monetary integrations (including unclear procedures for leaving and/or changing the status into the Eurozone), sovereign national monetary frameworks enable more or less active policy. Paper discusses the pros and cons of different policy choices, focusing on the possibility of wider sovereignty use during the crisis.

Keywords: monetary policy, exchange rate policy, Eurozone, Global Recession

1 Introduction

Since monetary policy is between the basic instruments of macroeconomic strategy, at the beginning of transition 25 years ago one of the central tasks was to develop a monetary framework that would contribute to the necessary reforms. Important part of the monetary reform was the development of a sustainable exchange rate regime, including also the definition of the main policy goals. After “big-bang” transition in majority of centrally-planned economies in the early 1990s followed by the period of stability and economic growth, European Union has been strongly affected with the Global Recession. From 2008 on, the Union is struggling with economic problems that have shown imperfections in its
structure endangering the stability both of the common currency and other aspects of the unification, decreasing investors’ confidence and forcing the international financial institutions on numerous attempts for its’ stabilization. The EU authorities also introduced some new procedures, such are European semester and Macroeconomic Imbalance Procedures, in order to achieve and maintain macroeconomic stability. Still, besides doubts and negative effects of crisis that raised discussions on costs and benefits of euro introduction, it should be remembered that the new European Union members do not have the “opt-out” clause like some of the old ones. In practice, they have to adopt the euro at some point in the future. Furthermore, the legal procedures for exit from the European Union and Eurozone are not clearly defined. The consequences of Global Recession have postponed the accession process and opened the discussions on more active use of monetary sovereignty. The Baltics entered the Eurozone despite the crisis, but their monetary sovereignty during the previous period was limited with the rules of currency board regime and fixed exchange rate.

The consequences of the Great Recession are analyzed from the perspective of post-transition countries that are European Union members, distinguishing whether they are also Eurozone members or not. Focus of the paper is on the post-transition countries, covering two groups of former centrally-planned economies: those that entered the Eurozone before and during the Great Recession (consists of Estonia, Latvia, Lithuania, Slovak Republic and Slovenia) and those that are still outside the Eurozone (group includes Czech Republic, Hungary, Poland and Croatia). Apart from the prerequisite of the accession process to stay in Exchange Rate Mechanism II for at least two years and fulfill the Maastricht criterions, there is also a set of new unofficial goals provided in Macroeconomic Imbalance Procedures that should also be considered during the process of euro introduction.

The paper is organized as follows. The introduction is followed by theoretical background and literature review, including analyses of the historical perspective (second chapter). Third chapter of the paper is focused on the challenges for monetary and exchange rate policies in post-transition countries. The final chapter concludes.

2 Theoretical Backgrounds and Literature Review

Transition was a multilevel process with complex tasks and little or no previous similar experiences, partly because of its big bang approach (instead of slower, gradual as its opposite) and the uncertainty of the final success. Former centrally-planned economies had to change the way of functioning, in terms of changed/developing goals, policies, instruments and institutions, trying to develop market based system and its institutions in a short period of time. On the other side there was the strengthening European integration process that at the time was in its final phase of monetary unification and successful single currency adoption. European Union and Eurozone accession process implied a long term period of negotiations - the obligatory formal criterions were those of nominal convergence and a minimum two-year period in Exchange Rate Mechanism II. But, the instabilities of global economy in 2008 that soon developed into a Great Recession put additional pressures on both sides. Still, the accession process was finished for some countries despite the turbulences (Estonia, Latvia, Lithuania), but the characteristics of their monetary regimes (based on exchange rate anchor, whether as a currency board arrangement or a conventional peg) did not leave much
maneuver space anyway. Furthermore, they have chosen not to externally devalue their currencies on the peak of the crisis, but to use policy of internal devaluation, maintaining the settings of monetary system, despite the negative consequences. But, there are more dilemmas for the remaining countries of the sample observed. For national authorities there is a dilemma on pros and cons of euro adoption, regarding also the Maastricht criteria, in unstable conditions while they still might use their monetary sovereignty and exchange rate as an instrument for shock adjustments.

2.1 Post-transition monetary policy and exchange rate regimes - historical review for selected countries

In this paper selected post-transition countries are divided in two groups based on the criterion whether they still retain national monetary sovereignty or not. On one side, those with monetary autonomy still have an open possibility for wider use of monetary policy, changing the goals and instruments, thus contributing to external competitiveness of national economy. But, they are still limited both by the European Commission requirements internal constraints (mostly high level of unofficial euroisation, especially in terms of credit risks connected with Swiss franc loan indexation).

The data presented in Table 1 refer to the Eurozone path of European Unions’ new member states. The euro was adopted mostly by smaller states, or those that were strongly linked to it (regimes based on the hard pegs, whether having official or quasi currency boards). Countries (from the sample observed) outside the Eurozone use inflation targeting, based on floating regimes. Croatia has also been included in the sample, with a regime defined as IMF’s de facto soft-peg (crown-like arrangement) to euro. In some observations, Croatian system is described as quasi currency board (Lovrinović et. al. 2009), because of its high level of euroisation, FX transactions as main channel of money creation and determination on price stability as a final goal of its central bank.

Table 1: IMF’s exchange rate regime classification and earlier regimes, respectively, selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>EU Accession</th>
<th>Currency</th>
<th>Exchange rate regime classification</th>
<th>Earlier regimes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>2004</td>
<td>Koruna</td>
<td>Other managed arrangement</td>
<td>until 1997 peg to dollar/ currency basket until 2013 inflation targeting, free float</td>
</tr>
<tr>
<td>Hungary</td>
<td>2004</td>
<td>Forint</td>
<td>Floating – inflation targeting</td>
<td>until 2008 various regimes based on pegs/crawling pegs with wide bands (15% in period 2001-2008)</td>
</tr>
<tr>
<td>Poland</td>
<td>2004</td>
<td>Zloty</td>
<td>Free floating-inflation targeting</td>
<td>until 2000 various regimes based on pegs/crawling pegs</td>
</tr>
<tr>
<td>Estonia</td>
<td>2004</td>
<td>Euro (2011)</td>
<td>-</td>
<td>until 2011 currency board regime pegged to deutsche mark/ euro</td>
</tr>
</tbody>
</table>

1 Our sample does not cover all new member states, there are still Bulgaria (currency board to euro) and Romania (floating – inflation targeting regime).
### Table 1: Exchange Rate Arrangements in Transition Economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Year 1</th>
<th>Currency (Year 2)</th>
<th>Exchange Rate Regime</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td>2013</td>
<td>Kuna</td>
<td>Soft peg-crowl like arrangement</td>
<td>until 1994 Croatian dinar, hyperinflation Soft peg to deutsche mark/ euro</td>
</tr>
</tbody>
</table>

Adapted from International Monetary Fund (2015, 6)

(Renewed) monetary sovereignty in the early stages of transition was oriented towards generating monetary stability so the rare countries used (freely) floating regimes, with limited success. But, later developments included inflation targeting regimes and, consequently, more active use of exchange rate arrangements.

### 2.2 Exchange rate policy choices and consequences

Reforms in the former centrally-planned countries in the early 1990s were strongly connected with the choice of monetary stabilization strategy. During the pre-crisis period that was characterized with an optimistic external environment, the economic growth in transition countries was strong, benefiting from the market reforms and restructuring of national economy, fueled by the encouraging conditions on global market during the 2003-2007 period, but also the positive perspectives of European integration process. Still, the consequences of Great Recession changed the perspective, revealing the vulnerabilities of the system and making the future prospective significantly more challenging and uncertain. (Dabrowski 2014).

Although the monetary and exchange rate regime strategies differed for sample countries during the period observed, their initial goals were similar and, despite the regime used, aimed to stabilize national monetary system, benefiting from positive influence on inflation expectations. Another important question was the choice of a particular national policy that would positively contribute to the adjustments on (especially external and asymmetric) shocks. During the transition, there have been two common target variable choices: nominal exchange rate or inflation, resulting in fixed (anchored regimes, hard pegs) or (managed, soft

---

2 There has been some discussions on the *de facto* exchange rate regime in Latvia, since it has never formally confirmed its currency board system, so according to some classifications (for example IMF's Annual Report on Exchange Rate Arrangements) it is classified as a „conventional peg“, while according to some other sources (see Friedman, et. al. 2011., pp 1329) it is classified as a currency board since the Bank of Latvia officially stated that their exchange rate policy is similar to that of the currency board, and monetary base is almost fully backed by gold and foreign currency reserves (for a discussion also see Dale, R., 1997.).

3 Official exchange rate regime in Croatia is floating, without pre-determined bands.
pegs or free) floating exchange rate regime. Monetary and exchange rate regimes differ significantly under these two systems, including exchange rate variability, inflation stability and growth potentials. Floating exchange rates (*de jure* usually entitled as free floating, but *de facto* classified in different categories of soft pegs), besides the sovereignty of national monetary authorities, are considered more sensitive to speculative attacks and that is why they are not recommended for stabilization arrangements. Still, they are a better choice in case of real asymmetric shocks. On the other side, hard pegs decrease uncertainty and positively contribute to the economic growth. Still, national authorities need a certain level of FX reserves to maintain the fixed exchange rate, especially in terms of currency board arrangement. Following the International Monetary Fund assistance, the majority of countries started with pegging their exchange rates, mostly using exchange rate as an anchor. Despite the formally declared monetary sovereignty, the post-transition countries are facing obstacles that limit the possible choices for national authorities. Considering *de jure* exchange rate arrangement, there are (certain levels of) deviations from official policy, in literature described as hidden pegs (Chong, et. al. 2015).

While the exchange rate target has proven success in lowering the inflation rate, providing an easy-to-understand signal of stability, there have also been disadvantages of its use in transition countries. Literature provides a list of arguments. First, there is a problem of determining the equilibrium exchange rate that serves as a target to the regime. The facts that there is no unique methodology for determining the “correct” equilibrium rate, but also that it is not possible to make later adjustments, generate risks of under- or over-valued exchange rate. Consequently, in longer term there is a negative impact on balance-of-payment and the economy is more sensitive to speculative attacks. Furthermore, it generates a problem of national currency real appreciation, based on higher inflation or weaker productivity that would negatively contribute to the export competitiveness. The implicit promise of exchange rate stability in combination with higher risk premiums and interest rates result in capital inflows causing inflationary pressures. Other disadvantages of the regime are connected with inflation stabilization, resulting in imported inflation (import prices growth) and variability of relative prices. (Jonáš 2000).

There is a discussion on the relationship between exchange rate volatility (over- and undervaluation) and economic growth, with arguments on the positive contribution of undervaluation on economic growth for developing countries (Rodrik, D. 2008). There is a positive relationship between real exchange rate undervaluation and economic growth, including the dividing the sample of countries by a development criterion. Undervalued RER is more competitive and positively correlated with economic growth in developing countries. (Rapetti, M., et. al. 2012)

In many analyses, inflation targeting regimes are proved to be connected with the stronger growth. Still, Chong, et. al. (2015) used a *de facto* classification method on a sample covering nearly 200 countries⁴ in a period 1974-2009, analyzing the differences in percentage growth between the regimes based on the exchange rate arrangements and inflation targeting. Their research resulted in data of lower inflation and inflation volatility (on average, even after removing the high inflation observations). However, the authors warned that there is a cost of

---

⁴ From a whole sample of 228 countries, 186 have been classified at least for one period (Chong et. al. 2015. 5)
higher nominal exchange rate volatility, especially comparing with the exchange rate targeting strategy. Based on their estimations, inflation targeting countries performed better in terms of economic growth, demonstrating between 0,8% and 1,1% faster growth annually.

Since adopting the euro in practice means targeting the exchange rate regime (including the minimum two years in ERM II), International Monetary Fund has analyzed the motivation and trade-offs for euro adoption back in 2004 and in its recent study from 2014. (IMF 2014) In the previous similar study that covered the period till 2004, the IMF has highlighted the costs of euro adoption as losing monetary autonomy, including the possibility to use exchange rate as shock absorber. (Schadler et. al. 2005). Their research concluded that since the growth volatility was low then, in combination with countercyclical fiscal policies and wages/prices flexible enough it might substitute the national monetary policy. But, according to the study, risks included large and volatile capital inflows, lending booms and higher inflation (resulting from the Balassa-Samuelson effect). Research (originated in 2004, see IMF 2014) emphasized benefits from introducing the euro in terms of higher growth and decreasing country risk but later developments proved these expectations to be over optimistic.

In table 2 economic indicators of convergence are presented (as of 2014) proving the problems that European Union members have. Furthermore, none of the observed countries is participating in ERM II, but three of them are in excessive deficit procedure.

Table 2: Economic Indicators of Convergence

<table>
<thead>
<tr>
<th>Country</th>
<th>HICP</th>
<th>Government budgetary position</th>
<th>Exchange Rate</th>
<th>Long-term interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>0,9</td>
<td>Yes</td>
<td>No</td>
<td>-5,6</td>
</tr>
<tr>
<td>Croatia</td>
<td>1,1</td>
<td>Yes</td>
<td>No</td>
<td>-0,8</td>
</tr>
<tr>
<td>Hungary</td>
<td>1,0</td>
<td>No</td>
<td>No</td>
<td>-3,6</td>
</tr>
<tr>
<td>Poland</td>
<td>0,6</td>
<td>Yes</td>
<td>No</td>
<td>0,3</td>
</tr>
<tr>
<td>Reference value</td>
<td>1,7%</td>
<td>-3,0%</td>
<td>60,0%</td>
<td>6,2%</td>
</tr>
</tbody>
</table>

Adapted from ECB (2014)

Results of transition process in majority of central and eastern European economies differ in many criterions, determined not only by a choice of exchange rate regime but, expectedly, nationally determined factors. Although euro introduction was their final goal, share of post-
transition countries in Eurozone is still rather small. It consists mostly of smaller economies, including also the Baltics that previously used the arrangements based on hard peg (as formal or informal, *quasi* currency board regimes) so eurozone membership for them was a rather easy transition from national currency. Besides the criterions of nominal and real convergence, EU member countries also need to prove their stable macroeconomic stance based on the European semester requirements and Macroeconomic Imbalance Procedures (MIP) that are divided into six categories (as presented in Table 3.).

<table>
<thead>
<tr>
<th>Stage</th>
<th>MIP categories</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No imbalance</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>Imbalances, which require monitoring and policy action</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>Imbalances, which require monitoring and decisive policy action</td>
<td>HU</td>
<td>HU</td>
</tr>
<tr>
<td>4</td>
<td>Imbalances, which require specific monitoring and decisive policy action</td>
<td>ES</td>
<td>ES, SI</td>
</tr>
<tr>
<td>5</td>
<td>Excessive imbalances, which require specific monitoring and decisive policy action</td>
<td>HR, SI</td>
<td>HR</td>
</tr>
<tr>
<td>6</td>
<td>Excessive imbalances, which require decisive policy action and the activation of the Excessive Imbalance Procedure</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Adapted from European Commission, 2015

As stated before, the implementation of the MIP recommendations is not a formal requirement for euro introduction. Still, it is a sign of national economy’s imbalances and future policy actions requirements.

3 Challenges for monetary and exchange rate policies in post-transition countries

Strengthening national currencies and developing institutions were some of the main goals for transition countries. Apart from the official statistics, there are factors that *de facto* limit their sovereignty. There is a significant level of unofficial euroisation, including the unhedged loans indexed in foreign currency.

3.1 Unofficial euroisation

The choice of stability emerged from the fears of inflationary spiral and limited instruments of monetary demand control. Paradoxically, these countries obtained inflation stability, but the inherited level of euroisation did not decrease significantly. The reasons are several, resulting in *de facto* limited sovereignty. Optimistic Eurozone membership perspective, in combination with the complexity of the transition process and historical facts resulted in high rates of unofficial euroisation in some accession countries. Although it is hard to make an exact measure of its real share in national economy, there are useful data on the euro use in terms of bank loans.
The data on the Graph 1 clarify the prevailing role of euro (as a percentage of foreign currency deposits) in selected countries.

Graph 1: Outstanding euro-denominated bank deposits in selected countries

Adapted from (ECB 2014)

The results indicate high level of dollarization in Croatia, but much less in other countries. This is hardly surprising, because of the Croatian rather rigid monetary system that relies on de facto fixed exchange rate, while central bank regulates monetary base using exchange interventions exclusively. But, the more significant problem is the share of foreign currency loans as a percentage of total loans to non-banking sector in Europe, especially for those indexed in Swiss francs.

Euroisation problem is mostly inherited but is also amplified with commercial banks’ protective measures against exchange rate risks. The trends reversed during the crisis: deleveraging and de-dollarization prevailed. Some of the factors that contributed to the trend of de-dollarization are recognized in decreasing interest rate differentials, higher foreign currency lending standards for unhedged borrowers (Poland), continued deleveraging provided greater reliance on domestic funding and government subsided lending programs (Hungary, zero-interest Central bank funding to banks for small and medium-sized enterprises) (EBRD 2014).

3.2 Inflation control – fulfilling the price stability goal

Inflation control traditionally is one of the major goals of economy programs during the period observed, defined also in “maintaining price stability” as the main goal of national central banks’ especially for the regimes based on the hard fix.

One of the main reasons for limiting the monetary sovereignty with exchange rate anchor was its potential success in inflation control. One of the Maastricht criterions is oriented towards price stability. Graph 2. presents the inflation volatility, based on the Harmonized Index of Consumer Prices.
The Graph 2 presents periods of inflation volatility in countries observed and the later stabilization of the inflation rate (even turning into a deflationary pressure in the 2014). Although the fixed regimes are connected with inflation stabilization, they were not resistant to the external crisis shock (especially critical was the 2008), on the contrary. Still, the shock did not result in monetary policy and/or exchange rate regime switch, since measures of internal, besides external devaluation were chosen for crisis strategies. On the other hand, the inflation rate for countries outside the Eurozone, after initial stabilization, remained under 10% during the period, while the crisis disturbance was weaker in percentage terms. Consequently, the inflation was not endangering (besides a peak in 2008 (especially high in Latvia) that was a result of the external crisis shock and soon stabilized) and the trend soon reversed, causing fears of deflation and ESB reaction at the beginning of 2015. Deflationary pressures in the Eurozone forced the European Central Bank to take determined measures for reversing the trend and create positive expectations on economic growth, export competitiveness and solving the crisis.

### 3.3 Exchange Rate Dynamics

Stabilization of exchange rate volatility should prepare the country for monetary union and a single monetary policy. Exchange rate manipulations then do not exist as a tool in terms of crisis or for support of national goals. There is a confirmed positive impact of currency undervaluation on economic growth but in terms of monetary union members might use only internal devaluation, primary in austerity measures.

The exchange rates volatility during the crisis indicates the level of its’ use as a mechanism for moderating the impact of external shock on national economy.
Graph 3: Nominal effective exchange rate post-transition countries, 1997-2014 (2005=100)

Note: positive value of the index means strengthening of currency

Nominal effective exchange rate (NEER) represents changes of a particular currency exchange rate with its 37 trading partners (2005=100). Countries outside the eurozone experienced stronger exchange rate volatility during the crisis than the member countries, excluding Slovakia.

Graph 4: Real effective exchange rate (2005=100), deflator: unit labor costs in the total economy, 1997-2014

Note: a rise in the index means loss of competitiveness

Real effective exchange rate (REER) is a measure of competitiveness, calculated as NEER corrected with consumer price indices (CPI) or unit labor costs in total economy (ULCT) as deflators. Data for the Eurozone member countries suggest a stronger loss of competitiveness than in those outside the Eurozone. Countries outside the Eurozone (especially Hungary and Poland) used monetary policy to support the crisis defense measures with the real depreciation.
The countries that entered the Eurozone did not have the possibility to use exchange rate policy to minimize the effects of external shock. Furthermore, their loss of competitiveness was stronger than in those countries that might manipulate with their exchange rates. Still, questions on the optimal level of national exchange rate remain open, determined partly by the exchange regime rules.

4 Conclusion

The focus of this paper is on performance of two groups of post-transition countries (EU members that are Eurozone members and those that are not) in terms of euroisation, inflation volatility and exchange rate dynamics, considering the period before and during the crisis. Post-transition countries, 25 years later, are now European Union/ Eurozone members confronting with the consequences of the Global Recession and accession process. Still, the Eurozone membership is still determined with the (in)ability to fulfill criterions of the nominal convergence. The eurozone perspective, from the point of view of the post-transition countries, is much less attractive than before the Global Recession.

References


