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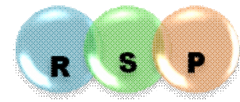

ORIGINAL PAPER

Considerations Regarding the Monetary Policy Strategies Promoted by the Central and East European Countries after the Communism Collapse

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Abstract
As a result of society evolution, monetary policy, as well as the objectives of central banks, have suffered and continue to suffer several changes. The case of Central and East European countries is no different, and most of these countries have changed their monetary policy strategies after the collapse of the communist regime. This article aims to create an overview of the changes that have taken place in terms of monetary policy strategies and objectives in the Centrale and East European Countries, especially in Romania, Hungary, Poland and the Czech Republic. The paper is divided into two parts. The first part provides an overview image of the monetary policy promoted by the central banks immediately after the fall of communism, while the second part presents the main features of the current monetary policy strategies promoted in these countries.

Keywords: *communism, monetary policy, central banks, monetary policy strategies, inflation targeting.*

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Introduction to monetary policy

We can say that the monetary policy is the process of elaborating and implementing a plan of actions which is formulated by a central bank, a currency board or another competent monetary authority, in order to control the money supply existing in the economy. Likewise, trough monetary policy, central banks manage the money supply and achieve their macroeconomic objectives (inflation rate, economic growth, liquidity, etc.). These objectives are achieved by changing the interest rate, selling or buying government bonds, changing the minimum reserves required rate, etc.

Initially, the monetary policy term referred to the actions through which central banks influenced and/or targeted a certain measure regarding the money supply and often the monetary policy definition was focused on the purchasing power of money. Throughout time, there have been many opinions regarding the concept of monetary policy and the responsibilities that a central bank should have. The monetarists (Friedman and Scwartz – 1963; Friedman and Meiselman – 1963; Andersen and Jordan – 1968) considered inflation as a monetary phenomenon and therefor central banks are the ones which should be held accountable for maintaining price stability. The New Classical Theory (Sargent, Wallace, 1975) has introduced in macroeconomics, together with the revolution of rational expectations, the proposal of policy inefficiency, according to which in any macroeconomic model, the assumption of rational expectations would make the inefficiency of the monetary policy to influence the real production. However, further studies (Fischer, 1977; Calvo, 1983; Taylor, 1993) have shown that the interaction between the expectation hypothesis and the perfectly flexible wages and/or prices hypothesis were the ones that generates the proposal of policy inefficiency. This perspective was the result of New Keynesian Theory.

The monetary policy, as well as the objectives of central banks have undergone several changes. Currently, worldwide, central banks have different objectives. For example, in the United States of America, the law that governs the organization of central bank assumes that „the mission of the Federal Reserve System is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.” (Federal Reserve Board, 1994). As far as the main objective of the European Central Bank is concerned, it implies maintaing the price stability. European System of Central Banks supports the general economic policies in the Union with a view to contribution in order to the achievement the objectives of the Union as laid down in Article no. 3 of the Treaty on European Union: „the Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment” (European Institute of Romania, 2005).

However, as a result of the recent financial crisis, central banks have been forced to adopt a number of unconventional monetary policies, which had two major objectives: restoring the functioning of financial markets and ensuring a monetary policy accommodation at a zero-lower bound. The final goal of these types of policies was to ensure macroeconomic stability. Inoue A. și Rossy B. (2018) point out in their paper that „central banks have recently been forced to rely on unconventional monetary policies due to the ineffectiveness of conventional policies at the zero-lower bound. The unconventional policies include altering the size and composition of Central banks' balance sheets (i.e. Large-Scale Asset Purchases programmes, or LSAP) and/or issuing

announcements about the future path of short-term interest rates (i.e. forward guidance)".

Considerations regarding the evolution of monetary policy strategies in Central and East European countries

With the collapse of the communist system, most of the Central and East European countries started to adopt the regime of fixed exchange rates. However, this regime was quickly abandoned due to the fact that these states failed to keep the inflation rate under control, which dropped significantly, leading to a strong deflation. All of these translated into a significant appreciation of the national currency, which led to a balance of payments disequilibrium. Given the forgoing facts, these former communist countries were forced to adopt other monetary policy strategies, and they had to choose between: targeting monetary aggregates, adopting an eclectic monetary policy strategy (similar to the one promoted by FED, some countries adopting various exchange rate regimes, such as controlled or fixed floating, regimes which continued to be used, even after the introduction of inflation targeting), replacing the fixed rate regime with the one promoted by the currency board or the inflation targeting strategy.

According to Frensch R. (2001), „some preliminary results show that the Central and East European countries which are preparing for their accession to the European Monetary Union, are facing a trade-off between exchange rate stability and low inflation". These countries can choose either the first path by targeting low inflation rates combined with a flexible exchange rate system, or the second path by using a stable peg to the euro currency. Currently, most of Central and East European countries which are trying to access the monetary union have adopted the direct inflation targeting regime, except of Bulgaria, which operates under the currency board regime.

Further will be discussed the main strategies and objectives promoted in four Central and East European Countries, member of the European Union and which will have to adopt the unique European currency sooner or later. These states are Poland, the Czech Republic, Hungary and Romania. We chose these countries because they have the same monetary policy objective (price stability), the same monetary strategy (inflation targeting), as well as regimes based on floating or controlled exchange rates.

The monetary policy promoted by National Bank of Poland

During time, Poland has pursued three monetary policy strategies. According to Pruski (2002), „in 1990, at the outset of transition, Poland adopted fixed exchange rate regime with the principal aim to fight hyperinflation. The initial period of stabilization took 18 months. It allowed the zloty to regain its role as a medium of exchange and a store of value in spite of the annual inflation rate still exceeding 40% by the end of 1992." The success of stabilizing the economy, on one hand, and the obvious rigidity of fixed exchange rates, on the other hand, made it necessary to change the monetary policy strategy in 1995. Obviously, at that time Poland was not fulfilling the necessary conditions for adopting the full-fledged inflation targeting and, in general, its economy was much too large and faced with a number o structural problems in order to have a currency board. Therefore, the eclectic approach of monetary policy seemed to be the most appropriate strategy for a country like Poland. The eclectic monetary policy can be considered a success because by using it, the inflation rate was reduced from 1000% to approximatively 10%. However, it led to an inconsistency in simultaneously controlling

the exchange rate, interest rate and monetary growth. Finally, in 1998, the eclectic monetary policy was replaced by the full-fledged inflation targeting.

Looking back, it can be said that the consumer price inflation in Poland followed a downward trend, falling from about 20% in 1996 to about 7% in 1999. This decrease in terms of inflation has stopped in 2000 when, as a result of rising in terms of food, oil and services prices, an inflation rate of 10% has been recorded. Since the beginning of 2004, monetary policy has aimed to reach a medium-term inflation target of 2.5% ± 1%. During 2004-2019, inflation was in the range of 2.50% ± 1% only at the level of 2005, 2007, 2012, 2017 and 2019, and for the rest of the years, the average annual rate of inflation did not fall within the range. The highest level of the inflation rate was recorded in 2008 and 2011. In 2008, the inflation rate registered a value of 4.17%, with about 1.70 pp more than the inflation target, but nonetheless, was the smallest deviation from the inflation target recorded by a country in the inflation target group. According to the National Bank of Poland (2009), this rise in terms of inflation rate was stimulated by a number of factors which were independent of the internal monetary policy, in particular, the high prices registered by food and oil. It is worth of mentioning that, during that period, an increase in inflation could be observed in almost all countries around the world, as a result of the global financial crises. On the other hand, the lowest level of the inflation rate was recorded between 2014 and 2016, when Poland recorded a deflation for a significant period of time. According to the Polish central bank (2016), the main reason for this deflation was the significant drop in terms of commodity prices on global markets. In March 2015, in order to bring the inflation rate to its target as close as possible, the Monetary Policy Council decided to reduce the interest rate by 0.50 pp and also reduce the reference interest rate to 1.50%. As a result of the monetary policy decisions taken by the Council, the inflation rate managed to recover and, by 2019 its value was 2.13%.

During 2019, the Polish Monetary Policy Council chose to maintain its interest rates, as following: the reference rate continued to be 1.50%, Lombard rate (for lending facility) remained 2.50%, the interest rate for deposit facility was 0.50% and the rediscount rate has maintained its value of 1.75%. However, on March 17, 2020, the Council decided to reduce its reference rate with 0.50 pp, to 1.00%, and to make the following changes to the rest of its interest rates: lowering the required minimum reserve rate from 3.50% to 0.50%, reduce its lending facility interest rate from 2.25% to 1.50%, reduce the discount rate from 4.00% (the level of this rate was maintained since 2010) at 1.10% and the rediscount rate from 1.75% to 1.05%. These measures were taken in order to reduce the possible deteriorations in term of global economic outlook, as a result of the restrictions introduced in most of countries in order to prevent the spread of SARS-CoV-2 virus.

The monetary policy strategy of Czech National Bank

Starting with 1998, the Czech National Bank Council, decided to change its monetary policy regime to inflation targeting. The main objective of Czech central bank continued to be price stability and the change was made only in terms of how this objective was achieved. The main characteristic of the direct inflation targeting is that it focuses on the medium-term economic growth. The monetary policy rates, i.e. the rates used by the Czech Monetary Council, consist in the 2-week repo rate, lending facility rate (Lombard) and deposit facility rate (discount). By changing the values of the

monetary policy instruments, the central bank tries to offset excessive inflationary/disinflationary pressures that could deviate from the inflation rate target.

Regarding the inflation targets set by the Czech National Bank, they have undergone a series of changes during the last thirty years, as it follows:

– an inflation target placed between 3% and 5% by January 2002;
– an inflation target placed between 2% and 4% by December 2005;
– an inflation target of 3% (January 2006 – December 2009);
– an inflation target of 2% (starting from January 2010).

At the beginning of 2008, the inflation rate stood at 6.30%, but, as a result of the measures taken by the central bank, more exactly, the decrease in terms of monetary policy rates, it dropped to 0.60% by 2009, but it wasn't still in the established range (3%). In 2010 and 2011, the inflation was at a level close to the one established, but it has increased in 2012 as a result of the increase in terms of value added tax. Between 2014 and 2016, as a result of the significant drop in commodity prices on global markets, the inflation recorded by the Czech Republic was at a very low value, namely 0.40% in 2014, 0.30% in 2015 and 0.60% in 2016. In this regard, the Czech National Bank decided to reduce its monetary policy rate at a level which was very close to zero. This measure has proved to be an effective one, which is why in the following period (2017-2019) the inflation rate was within the range established by the central bank.

In 2019, the Czech monetary policy interest rates were 2% for the 2-week repo interest rate, 3% for the credit facility rate (Lombard) and 1% for de deposit facility rate (discount). They were increased by 0.25 pp in February 2020, and the, due to the COVID-19 pandemic, the Czech Council decided on March 16, to decrease them. Currently, the values of the main interest rates used by the Czech central bank are 1% for the 2-week repo rate, 2% for Lombard rate and 0.05% for discount rate. The minimum reserve ration continued to be 2%.

One thing to note is that the Czech National Bank has also resorted to use some unconventional monetary policies. Between 2007 and 2012, the Czech central bank has reduced its monetary policy rates by about 4% and has introduced a series of repo operation which aimed to provide liquidity in order to prevent some problems that commercial banks might have encountered in terms of liquidity. However, the spilling over effect created as a result of the weakness in the euro area, which translated into low inflation, made the Czech National Bank to progressively lower the policy rate to 0.05% by November 2012. „Under such circumstances, within the forward guidance policy, the Czech National Bank signaled that it was considering using the exchange rate as an additional instrument of monetary policy." (Alichi, A. et. al., 2015). In this regard, in November 2013, the Bank proceeded to make a change by replacing the floating rate regime with an exchange rate floor (CZK27=EUR1), but the target variable continued to remain the inflation rate. According to Franta M. et. al, (2014), „the use of the exchange rate as an instrument at the zero-lower bound can be defined as an approach where the central bank chooses – and possibly also publicly declares – the specific exchange rate level it wants to attain and is prepared to intervene in the foreign exchange market in unspecified and unlimited amounts to attain that level". McCallum`s study (2000) shows that, at a negative interest rate, central banks from open economies can devalue their domestic currency in order to stabilize the inflation rate and, implicitly, the real economy. More recent studies made by Stone M. et. al (2011) and Borio C. and Disyatat P. (2010) shows that the exchange rate policy can be used as a potential unconventional monetary policy at a zero-lower bound.

Monetary policy in Hungary

The monetary policy practiced by the Hungarian economy until 2000 can be characterized as unstable, the macroeconomic situation of Hungary being critical, and the vast majority of indicators suffering rapid deterioration. According to Golinelli R. and Rovelli R. (2001) depending on the exchange rates applied, the monetary policy in Hungary between 1991-1999 can be divided into two phases:

– „ the first phase, from January 1991 to March 1995, was an adjustable peg;

– the second phase was a pre-announced crawling peg with daily devaluations."

In the first phase, between 1991 and 1995, the macroeconomic situation of Hungary was unfavorable, the gross domestic product has registered a continuous decrease, the annual rate has varied between -1% and -5%, while the budget deficit was 6-7%. In this phase „the exchange rate was the fulcrum of two conflicting central bank objectives: to promote external competitiveness and to provide a nominal anchor for price stability" (Szapary and Jakab, 1998). During this period, targeting inflation was not the first or only objective of the central bank, since the monetary authorities were clearly concerned about the possible costs that deflation could bring. The result was not as expected: the forint was devalued 22 times, on a discretionary basis between 1990 and 1995, which led to an increased speculation against the currency and undermined the credibility of the central bank. Under these circumstances, the Hungarian government have introduced a package of stabilizing measures in March 1995, including spending cuts, tax increases, imposing an import surcharge, liberalization of capital transactions, etc. As a result, in 1996 the deficit was reduced to 4% and there was an economic growth of 4.5%. Regarding the inflation rate, it registered a value of 10% at the end of 1999.

The month of June 2001 marked the introduction of inflation targeting in Hungary. This measure was taken as a response to the countless unsuccessful attempts made by the National Bank of Hungary which wanted to use other nominal anchors in order to control inflation. Regarding the implementation of this objective, considering that at the beginning of 2001 the inflation rate was around 10%, it was proposed that the inflation had to reach the level of 7% by the end of 2001. Starting from 2005, the inflation target had continued to be 3%. However, the National Bank of Hungary has not consistently been able to reach an inflation rate as close to this target as possible. The years in which the inflation rate registered in Hungary approached the target set by the central bank were: 2003, 2005, 2006, 2011, 2017, 2018 and 2019. In these years the following inflation rates were recorded: 4.67% (inflation target - 4%), 3.58% (inflation target - 3%), 3.92%, 3.94%, 2.40%, 2.90%, respectively, 3.40%. For the rest of the years, the National Bank of Hungary has failed to keep the inflation rate under control. In 2004, there was a substantial increase in inflation, which reached a level of 6.75% as a result of the increase in indirect taxes. The same unfavorable tendencies were registered in 2007 (the average annual inflation rate being 7.98%), when there was a globally fast increase in the price of oil and food. As a result of the decisions taken by the Monetary Council of the National Bank of Hungary, there has been registered a decrease in terms of inflation, which brought the rate closer to the target range, but this trend has not been maintained for a very long time because the inflation rate has seen a strong appreciation at the level of 2012, reaching 5.68%. Considering these aspects, the central bank proceeded to tighten the monetary policy, and as a result, a decrease in the inflation rate occurred. This decrease continued, and by the time of 2014, Hungary

registered deflation, the inflation rate reaching - 0.21%. The same trend was maintained in 2015, when the average annual inflation rate was - 0.06%. In this regard, the Monetary Council opted for a relaxation in terms of monetary policy, and it reduced the bank reference rates, more precisely, it reduced the interest rate on the lending facility and the interest rate on monetary policy to 0.90 % and decreased the interest rate on the deposit facility to - 0.15%. As a result of these measures taken by the National Bank, in 2016, Hungary emerged from the deflationary trend and registered an inflation rate of 0.41%. Between 2017-2019 the inflation rate remained within the inflation target set by the central bank (3 ± 1%).

During 2019 the National Bank of Hungary has maintained its monetary policy rate at 0.90%, like it was established in May 2016. Also, the interest rate on the credit facility was maintained at 0.90%, while the interest rate on the deposit facility has changed from - 0.15% to - 0.05% (March 2019), but nonetheless has remained in the negative area. The inflation target continued to be 3 ± 1%, while the minimum reserve ratio remained at theier level set in December 2016 (1%). In the first part of 2020 (25 March), the National Bank of Hungary decided to keep its rates at the same level as they were in 2019, even though most European countries have made major changes in order to prevent a new financial crises as a result of the COVID-19 pandemic.

An important aspect concerning the National Bank of Hungary is the following: as a result of the rate cut cycle started in 2012, the key monetary policy rate went from 7% to 0,9%. Due to the fact that, under these circumstances, the conventional monetary policy instruments reached their limits, the Hungarian National Bank began to implement a series of unconventional monetary policy instruments affecting short-term yields. Following the introduction of these instruments, the Hungarian National Bank was able to reconstruct the transmission of monetary policy, which was damaged by the crisis. Additionally, the financial stability was consolidated and the real economy was stimulated.

Analysis of the monetary policy promoted by the National Bank of Romania

In May 1991, the National Bank of Romania went through a reorganization, being assigned with monetary authority functions. With the reorganization that took place in early 1991, or in other words, after the fall of the communist regime, the National Bank of Romania implemented several monetary policy strategies. This post-communist era can be divided into three periods characterized by significant changes in terms of monetary policy, as it follows:

– 1991-1997 - characterized by an alternation of restrictive policy measures with accommodative policy measures. Between 1991-1993 National Bank of Romania used credit ceilings (credit planning in a modified form). After 1993, the monetary policy promoted by the central bank aimed at targeting the monetary aggregates, together with an implicit targeting of the exchange rate, but which was abandoned in 1995;

– 1997-2005 - during this period, the economic reforms were emphasized, and the independence and credibility of the National Bank has increased. Regarding the monetary policy strategy used, it continued to be based on the targeting the monetary base, as provided in the economic program concluded in 1997 with the International Monetary Fund;

– 2005-present - with the accession to the European Union, the National Bank of Romania has changed its monetary policy strategy, adopting inflation targeting, in order

to a better comply with the criteria laid down in the Maastricht Treaty, with a view to a possible adoption of the single European currency.

In view of the above, it can be considered that the main monetary policy strategies used by the National Bank of Romania were the monetary aggregates targeting and the inflation targeting. It is difficult to establish which of the two approaches was more efficient and more suitable for the Romanian economy. Both strategies have more or less achieved their objectives, given the economic conditions (the implementation of the strategy in a period characterized by uncertainty, volatility and very high inflation rates, as well as the outbreak of the global financial crisis).

During the period when the central bank has approached the money supply targeting, the inflation rate was reduced from very high and unstable levels, over 55%, to a relatively lower level, somewhere around 10%. In 2000, the National Bank of Romania had an inflation target of 27% but, due to some exogenous shocks, this objective could not be met, and Romania has registered an inflation of 40.7% by the month of December of the same year. In 2004, as a result of the negotiations carried out by Romania in order to accede to the European Union, the monetary policy was designed so as to be in line with the commitments made by the national authorities. In this respect, an inflation target of 9% has been set, an objective that the National Bank has managed to reach, registering an inflation rate of 9.3%.

As is well known, starting with 2005, the monetary objective of Romanian central bank has been price stability and its strategy continued to be direct inflation targeting. According to the National Bank of Romania, Inflation targets are formulated in terms of the annual change in the consumer price index and are set as midpoints within a target band of ±1 percentage points The inflation rate targeted by the National Bank of Romania gradually decreased, from a value of 8% in 2005 (with a range of ± 1%), to a value of 2.50% (with a range of ± 1). %) from 2013 until now. Regarding the inflation rate actually registered by Romania during 2005 and 2019, there were few situations in which the inflation rate was not the range established by the National Bank of Romania. In 2008, the National Bank of Romania set an inflation target of 3.80%, with a range of ± 1%. However, as a result of the excess demand, together with the increase of wages and the worsening inflationary expectations, led to an inflation rate of 7.80%. A similar but at the same time opposite situation was registered at the level of 2016, when the inflation target of the central bank was 2.50%, with a variation interval of ± 1%, while the inflation rate registered in 2016 was -1.50%. According to the National Bank of Romania (2016), this evolution reflected the overlap of two important changes in the indirect tax regime: extending the reduced value added tax rate at 9% to all foodstuffs in June 2015 and reducing the standard value added tax rate from 24 to 20% in January 2016. Other factors that contributed to this decline were: imported inflation, evolution of foreign prices and evolution of the exchange rate.

In the second half of 2019, the National Bank of Romania maintained its monetary policy interest rate at 2.50%, while the interest rate on the deposit facility remained 1.50% and the Lombard rate continued to be 3.50%. Even though the rates of minimum reserves remained at 8% in 2019, for both the liabilities denominated in RON and for the foreign currency-denominated ones, starting from the 24th of February 2020, the central bank decided to lower de minimum reserve rate for the latter at 6%. This measure was taken as a result of the evolution of foreign currency-denominated credit, as well as a result of the attempt of National Bank to continue its process of harmonizing its minimum reserve ratios with European practices and standards. Likewise, on 23rd of

March 2020, the central bank decided to reduce its monetary policy by 0.50%, reaching 2%. With this action, National Bank also decided to decrease its Lombard rate to 2.5%. These measures were taken to ensure a better stability of exchange rate in order to prevent an economic crisis that could arise as a result of the protection measures taken by the governments worldwide in order to prevent the spreading of the coronavirus.

Conclusions

In this paper we tried to present the main evolutions in terms of monetary policy strategy registered by the Central and East European countries after the collapse of the communist system, as well as the evolutions generated by these changes in terms of inflation rate. As we could see from the information presented above, these countries have made several changes regarding the monetary policy strategies and monetary objectives, but, by 2005 all of them had the same objective (i.e. price stability) and the same strategy (i.e. direct inflation targeting). It is difficult to decide which of these monetary policy approaches were more effective because they have certain limits, which have been very well highlighted with the onset of the global financial crisis, when central banks were forced to rethink the interaction between the financial economy and the real economy, and they began to use a series of monetary policies that were considered unconventional.

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