Monetary policy transmission, interest rate rules and inflation targeting in three transition countries

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Abstract

In 1991, the rate of inflation in the Czech Republic, Hungary and Poland was 57%, 35% and 70%. At the end of 2001, it was everywhere below 8%. We set up a small structural macro model of these three economies to account for the process of disinflation. We show that a simple macro model, with forward-looking inflation and exchange rate expectations, can adequately characterize the relationship between the output gap, inflation, the real interest rate and the exchange rate during this period. This model allows us to assess the relative importance of the interest rate and exchange rate channels in determining the path of disinflation. © 2004 Elsevier B.V. All rights reserved.

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1. Introduction

During the last decade, several economies in transition have achieved both inflation and output stabilization, by pursuing different monetary policy strategies. In this paper, we study the process of disinflation in the Czech Republic, Hungary and Poland (CHP). In the course of one decade, these countries have stabilized inflation and the exchange rate and have resumed output growth, while at the same time maintaining fiscal discipline (see Table 1). In this paper, we interpret and model the process of monetary stabilization; in particular, we want to focus on the role of interest and exchange rates in the transmission of monetary policy impulses.

Modeling the history of disinflation in these countries may seem an adventurous task. Reading the official policy reports of some central banks during the past decade, one often encountered statements implying that: (i) monetary aggregates behaved unpredictably, (ii) the relation between money and growth was unpredictable; (iii) price indexes were unreliable and essentially responded to domestic cost pressures, . . . , (iv) in addition to being heavily distorted by changes in administrative prices; (v) changes in interest rates did not significantly affect in a negative way domestic demand, . . . , (vi) but might instead induce undesirable appreciations of the exchange rate, . . . , (vii) thus fueling into inflation either through the induced currency inflows or through wealth effects and aggregate demand pressures. What might monetary policy have done in such circumstances? To rely on monetary stabilization policies would have seemed a hopeless task. However, in this paper we take a rather different approach. Things were not as bleak as the above statements imply. On the contrary, even through the years of transition, monetary policy has been a relatively powerful and reliable tool for controlling aggregate demand and price pressures. To support this argument, we build an “orthodox” model of monetary policy, focusing in particular on the role of interest and exchange rates in the transmission mechanism. In this model, by appropriately selecting a moderately restrictive path for the nominal and hence for the real interest rate, monetary authorities are able to target the path of the nominal exchange rate and to induce a controlled appreciation of the real exchange rate. In the end, this process gradually steers the economy towards single-digit inflation, while also helping to contain the output costs of stabilization. We will show that such a model adequately characterizes the path of macro variables.
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