# ECONOMIC POLICY

Sponsored by a Grant TÁMOP-4.1.2-08/2/A/KMR-2009-0041

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The project is supported by the European Union.

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June 2011

# Week 10

# Presentations:

# Liquidity trap

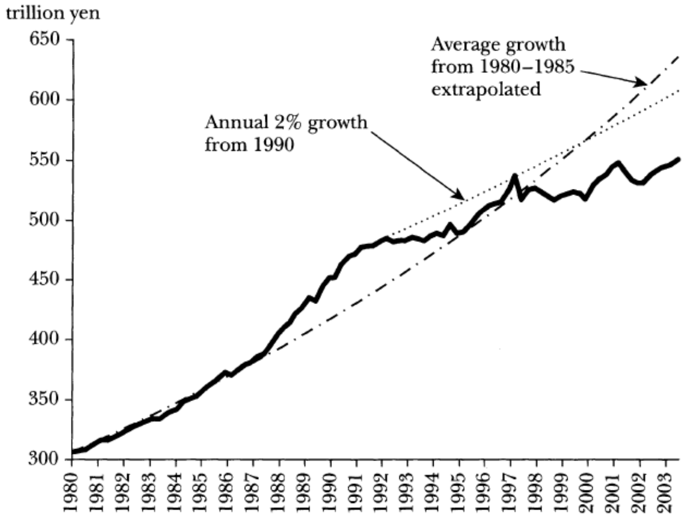
# Exchange rate based stabilization

# Choice of the exchange rate regime

## Presentation 1

- Liquidity trap
- Krugman on Japan: http://web.mit.edu/krugman/www/jpage.html
- Svensson (2003): Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others, The Journal of Economic Perspectives, Vol. 17, No. 4

Real GDP: 1980–2002




*Source:* Japanese SNA (System of National Accounting); ⟨http://www.esri.cao.go.jp/en/sna/menu.html⟩.

# Liquidity trap

- i cannot descend below 0.
- If i=0 portfolio holders are neutral in between holding money and government bills.
- Open market operations cannot have any effect neither on prices, nor on quantities.

# How to avoid liquidity traps?

- There is by and large consensus in the following:
- Explicit, symmetric inflation target (for expample 2%)
- or: determination of the future path of the aggregate price level.

- Various tools are suggested:
    - Announcing one of the two regimes listed above
    - Increasing the monetary base
    - Reducing long term interest rates
    - Devaluation
    - Levy on cash holdings
    - Fiscal expansion

# Inflation target

- Krugman (1998): may not be credible
    - The private sector may not believe the central bank will continue to inflate after the deflationary period is over.
    - Suggestion: the central bank should set inflation targets for several years ahead.
    - A „credible promise to be irresponsible"
    - In Japan: 4% for some 15 years

# Price level path target

- Svensson, Bernanke
- Instead of setting inflation, the central bank should determine price level paths.
- It may start with a drop in the price level.
- Popular in the academic literature but it is not used in the practice.

# An increase in the monetary base

- If i=0 the money is considered to be equivalent to the treasury bills.
- BUT: If the increase is expected to be permanent by the public, then long run expectations are going to change.
- Difficult to find middle ground in between credible easing and hyperinflation.

# Tax on cash holdings

- Requires technical innovation, but it is not impossible.
- If cash is taxed, then the negative return on money can be achieved.
- It is very difficult to communicate and therefore quite unpopular with the public.

# Fiscal expansion

- Expansionary fiscal policy is a natural choice. Its effectiveness still depends on the public's reactions.
  - They may expect higher taxes in the future.
  - Independent central bank may take restrictive monetary actions.
  - Tax policy.

# Presentation 2

- Exchange rate based stabilization
- Case study: the Bokros stabilization
- Antal László: A kiigazítás – ahogy én látom, Közgazdasági Szemle, XLV. évf., 1998.

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- Sebastian Edwards: Exchange rates as nominal anchors, NBER Working Paper, 1992 December
- Kornai János: Kiigazítás recesszió nélkül, Közgazdasági Szemle, XLIII. évf., 1996

# Antecedents

- Mexican crisis in 1994
- Mounting foreign debt
  - Capital reversal due to lack of trust
- Exchange rate regime: adjustable peg
  - Speculation on the foreign exchange market
  - High inflation. In spite of the frequent devaluations, the real exchange rate appreciates

# Features shared with other crisis stricken countries

- Real appreciation. Currency is largely overvalued.
- Small open economies: foreign trade is utterly important.
  - Strong growth in imports relative to exports
- Large deficit in the government budget makes the situation more severe.
- South America: stabilization programs in several countries
  - Some variant of the pegged exchange rate (crawling peg) is introduced)

  - Goal: monetary stability, low level of inflation
- Some succeed, some not
  - In most cases more than one stabilization programs are required.

# Bokros stabilization (1995) Tools

- Introduction of the crawling peg
  - Starting with a one step devaluation
  - Keeping price competitiveness for the Hungarian export goods
    - Trade off between enforcing competitiveness and inflation
- 8 % import surcharge
  - In order to curbe import demand

# Tools

- Freezing nominal wages in the public sector
  - In order to restrict consumption
- Fiscal austerity:
  - Cutting mean based social supports
  - Retirement age is raised
- Public debt was reduced by a large scale privatization program of public assets.

# Results

- Current account stabilized
- Export growth increased significantly signaling an export-led growth path.
- Internal absorption was reduced, share of consumption in GDP declined.
- Labor productivity increased significantly.

# Presentation 3

- Choice of the exchange rate regime
- Literature:
- Obsfeld–Rogoff: The Mirage of Fixed Exchange Rates, 1995, Journal of Economic Perspectives
- Calvo–Mishkin: The Mirage of Exchange Rate Regimes for Emerging Market Countries, 2003, NBER Working Paper

# Questions

- Which regime is more efficient? The pegged, or the floating?
- Which regime improves stability of the financial system and the credibility?
- What are the virtues and the vices of the fixed exchange rate regime?

# Standard theory

Optimal currency areas:

Why do we fix the exchange rate *inside* ***the country***?

- Con: shock affect different regions differently
- Pro: we need money (transaction costs, liquidity)

**The borders of the fixed rate are set by the product of these two factors.**

# Theory and developing countries

- Theoretical propositions:
  - Credible institutions
  - Stable currency
  - Labor and goods markets are emphasized, financial markets are ignored
- Developing countries:
  - Weak institutions
  - Frequent movements in the currency band
  - Capital flight and reversals

# Pegged exchange rate

Pro’s:

- Reduces transaction costs and uncertainty
- Reduces inflation pressure
- Provides nominal anchor

- Con’s:
    - Difficult to sustain
    - Loss of credibility if it is abandoned
    - Invites speculation

# Empirical evidence

- Monetary independence
- Curbing inflation
- Terms of trade
- Gains from foreign trade
- Flexible prices and wages
- Loans in foreign currency (dollarization)
- Foreign exchange reserves
- Lender of Last Resort

# Monetary independence

- Measures treating national problems
- Impossible trinity: floating rate
- Sterilized intervention

But:

- There is no guarantee for monetary independence
- Weak institutions, low efficiency of monetary policy

The main thing is not the regime itself!

# Fighting inflation

- Floating rate: lack of nominal anchor

But:

- Low inflation can be achieved also while having flexible rates (inflation targeting).
- The fixed rate is not a perfect anchor.

# Terms of trade

- The pegged rate is insensitive to terms of trade changes.
- Floating rate: opportunity for nominal correction
- Fiscal devaluation: using taxes and subsidies
- But:
- Ability of unlimited devaluation carries inflation danger.

# Gains from trade

- Pegged rate enhances opens, real integration to the world economy

But:

- More openness – more exposure to capital flight
- If revenues and loans are denominated in foreign currency, then devaluation looses its effect.

# Loans in foreign currency

- Holding on to floating rate is difficult, exchange rate volatility can cause bankruptcies.

But:

- The size of private debt accumulation depends also on the regulation.
- There are facilities to avoid currency risk.