



Interest rate illusion

By **Mojmir Hampl**

Vice-Governor of the Czech National Bank

The current financial crisis differs from many in the past in that it has deepened sovereign states' debts up to levels typical for times of war and revolution rather than peace and prosperity. Moreover, this time the crisis has hit advanced economies harder than the poorer ones. Yes, this time around it is more a crisis of the developed world. At what side of this divide do the "emerging economies" of Central, Eastern and South-eastern Europe (CESE) now stand?

Of course, different economies in this heterogeneous region have followed dramatically different trajectories and approaches. While the Polish economy has experienced uninterrupted growth, the Baltics saw GDP slowdowns in the double digits. While the Estonians hurried into the eurozone in bad times, the Czechs are more skeptical about adopting the euro than ever.

Despite these stark differences, certain general lessons can be drawn for domestic economic policies in general and monetary policy in particular. Some of the most important lessons concern the exchange rate regime and the conduct of monetary policy.

One such lesson is implied by the well-known problem of foreign exchange (FX) loans. In Hungary, Poland, Romania and several other countries in the region, large shares of the overall credit extended to companies and households over the past decade have been denominated in foreign currencies. Particularly popular choices were the Swiss franc or the euro, which offered irresistibly low interest rates compared to the domestic interest rates in many CESE countries.

An FX loan implies FX repayments. It thus makes a lot of sense for people – such as Austrians commuting to Switzerland for work – who receive a large part of their income in that particular foreign currency. In all other cases, a household drawing an FX loan burdens its budget with a currency mismatch. No danger provided the exchange rate is stable. But which exchange rate can be expected to be stable for good?

The lesson is that this nominal illusion of lower interest rates in foreign currencies proved to be...well, illusory. Good strategies are not those that work only in good times.

To see the policy lesson, we need to understand that the convergence of emerging economies towards the most advanced ones implies, among other things, real exchange rate appreciation. With a fixed nominal exchange rate, this appreciation will show up in domestic inflation and sometimes domestic interest rates that are higher at home than abroad. So why not think about how to achieve permanently low inflation, low imbalances and low interest rates even in emerging countries? Why not start reviving the idea of a fully autonomous monetary policy and flexible rather than fixed exchange rates once again?

In some respects, the regime of a fixed exchange rate is akin to a monetary union. So another painful lesson for some CESE countries is similar to that for Ireland, Portugal, Spain and Greece. A fixed exchange rate implies that whenever a shock occurs (including convergence as mentioned above), the economy needs to adjust to it without the help of exchange rate movements and without domestic monetary stabilization. Specifically, the economy needs to feature flexible labor and product markets and very healthy public finances ready to react swiftly and in the right direction. Estonia has probably achieved this desired level of flexibility. But is this ideal achievable in the majority of European countries?

One problem in the periphery of the euro area as well as in some CESE economies was that the economies were not flexible enough: wages and prices grew too fast, leading to weakening competitiveness and thus widening trade deficits. Fiscal profligacy made the situation even worse. To get back on track, adjustment was needed. And still is, as the situation in many European countries so painfully proves almost every day. No flexibility? Then in bad times, be prepared for bailouts or defaults.

In sum, recent developments in the CESE region reconfirm the Golden Rule of economic policy: whatever policies we use, we should make sure they are internally consistent and adequate to the state of the individual economy and its stage of development. Membership in any kind of club, be it the EU or the eurozone, is not itself a panacea. The most important thing is to have your homework done. Rather sooner than later.