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ABSTRACT
This paper examines the interplay between exchange rate regimes and policies and commercial policy in six transition economies. In all these economies the rate of protection afforded domestic industry by the exchange rate has been eroded by high rates of inflation and insufficient growth in productivity. As a result, there has been pressure on governments to increase trade barriers and each country examined has had recourse to various means of restricting imports. We argue that more flexible management of the nominal exchange rate would be a preferable way of dealing with the real appreciation of these countries’ currencies.

Key Words: exchange rates, trade policy, transition economies

JEL Classification Nos. [P33]; [F13]; [F33]
1. Introduction.

The effectiveness of different exchange rate system in promoting competitiveness in international trade and their impact on macroeconomic stability have been discussed by Wickham (1985), Sachs (1996), Frenkel (1996) and others as part of an ongoing scholarly debate. Most recently, this discussion has focused on the appropriate choice of exchange rate regime for transition economies. In this paper, we consider an aspect of exchange rate policies that has so far escaped much attention in the literature, the impact of different exchange rate regimes on the stability of trade policy. Stable trade policies are extremely important both for the economic welfare of the countries concerned and for the preservation of the multilateral trading system.

Unfortunately, there is reason to believe that the liberalization measures adopted by many countries, but especially by the transition economies, remain extremely fragile. For example, the Balance of Payments Committee of the World Trade Organization (WTO) has reviewed 39 requests from member countries for derogations from their international obligations and for a temporary increase in temporary protection. Moreover, several South East Asian countries, such as Malaysia, have recently increased tariffs in response to financial crises, even though the higher rates remain below the rates these countries bound in the WTO.

In this paper, we examine whether transition economies may be using changes in commercial policy as a substitute for exchange rate adjustments or for changes in monetary and fiscal policy in dealing with balance of payments disequilibria. Such use of commercial policy would not be new, as one of the objectives of the Bretton Woods System was to outlaw such practices, which had been widely employed in the pre-World War II period. For the transition economies, the use of commercial policies to ameliorate balance of payments policies is attractive on a number of grounds: it answers domestic and foreign investors’ demands for protection; it raises revenue; and it allows governments to target protection so as to benefit some tradables more than others in a way that changes in a unified exchange rate or changes in macroeconomic policy can not. Nevertheless, such a policy is likely to cause considerable harm to countries whose prices have for so long differed from world market prices and whose economies are, as a result, badly in need of restructuring.
2. Theoretical Issues.

Economic theory provides a relatively little guidance on the relationship between exchange rate and commercial policies. Nevertheless, there are several strands in the literature that shed some light on this relationship, and we review these in this section. The first of these themes concerns the similar nature of trade and exchange rate policies. Trade and exchange rate policies have a common denominator in that they provide a certain degree of protection or support to domestic industries. There will always be a change in the level of the exchange rate that will, at the margin, increase the return to certain exporting or import-competing activities. These marginal activities can be equally promoted or protected by tariffs or subsidies, implying that a certain level of the exchange rate will correspond in the above sense to a given level of the tariff. However, there are important differences between the economic consequences of these two policy instruments. A unified exchange rate implies a non-uniform protection of firms only if these firms operate with different costs of production. Also, protection under a unified exchange rate does not discriminate between domestic and foreign firms while a tariff does. It follows that a change in the real effective exchange rate, which is the exchange rate that matters, will also affect the degree of protection of firms and of their exposure to foreign competition. As a result, firms that receive insufficient protection from the existing exchange rate may press for an increase in tariffs to protect their industries. Such pressure for protection is as likely to come from exporters facing an appreciating exchange rate as it is from firms in import-competing sectors.

A. Sources of Pressure for Protection

When the exchange rate is used to provide protection to domestic firms, it is through undervaluation, the analysis of which owes a great deal to Dornbusch’s (1976) theory of overshooting. An undervalued exchange rate protects domestic firms from imports and gives domestic firms greater incentives to export. Conceptually, we could think of this as equivalent to extra protection from imports through tariffs. Similarly, an undervalued exchange rate could be compared to an export subsidy. Thus, balance of payments equilibrium can be achieved through any number of combinations of tariff protection and
exchange rate, and whether a currency is undervalued or not depends in large part on whether external equilibrium can be achieved given existing tariff levels.

The determination of equilibrium conditions is not straightforward since the very concept of equilibrium is ambiguous. In this respect, it is possible to consider at least three different concepts of equilibrium. The first concept focuses on the current account balance. This concept is suitable under conditions of limited currency convertibility. The second concept refers to balance on the overall balance of payments, and it is applicable in situations characterized by open capital accounts. In this respect, a stable balance of payments implies stable capital flows. Finally, the third concept of equilibrium refers to what we call political-economy-based equilibrium. This refers to a policy equilibrium in the presence of various lobbies and interests who press for changes in either the tariff regime or in the exchange rate. The question then is how economic equilibrium can be disturbed, through what channels will calls for protection emerge, and what form they will take.

As Mussa (1984) pointed out, the key issue of exchange rate policy is to set relative prices between tradables and nontradables, and there are three important instruments through which government policies can affect domestic relative prices. The first method is through a system of multiple exchange rates that corresponds to a system of export and import taxes and subsidies. The second method arises from the existence of market imperfections, which cause rigidities in the nominal prices of goods entering into international trade, and of stickiness of returns to factors employed in the production of these goods. Consequently, the relative protection afforded various industries may differ depending on the nature of market imperfections. In such a case, the domestic currency costs of earning a unit of foreign exchange or of replacing a unit of foreign currency spent on imports will differ among industries as they do in a multiple exchange rate regime. The third method is government influence over the distribution of expenditures among goods or the level of spending relative to income. This amounts to the conduct of macroeconomic policies. In addition to these channels, we must add, of course, the conduct of exchange rate policy, which is self-evident. Through any of these methods, the government may affect domestic relative prices and, therefore, the competitiveness of domestic industries.
At first glance, one is tempted to argue that stable exchange rates are a precondition for stable trade policies. However, this need not be the case. There are three ways in which we can view the impact of exchange rate regimes on the stability of trade policy. The first link concerns the direct effect of exchange rate policies on trade flows and, consequently, on the introduction of commercial policies to modify these flows, usually by means of commodity-specific tariffs and subsidies. The second link has its origin in the direct impact of exchange rate policy on the balance of payments more generally. The third link comes from indirect effects of exchange rate policies on domestic growth and inflation. We shall now turn to each of these aspects in turn.

If we disregard the first link, the tariff-cum-subsidy, as infeasible in the present day of liberal economic policies and postpone the discussion of the third, we can easily see that the level of the nominal exchange rate plays an important role in explaining the instability of trade policy. A change in the nominal exchange rate will affect marginal exporters or producers of import-competing goods who, in turn, may put pressure on the government to increase protection of their industries. However, this is only a part of the story. Governments themselves may be inclined to increase protection because neither the nominal exchange rate nor existing import restrictions may be adequate to maintain the current account in equilibrium. This is so because the current account is not determined by the level of the nominal exchange rate but by the real effective exchange rate (REER), which determines the relative prices of tradables in terms of non-tradeables. As Krueger (1997) and Corden (1991) have shown, a desired level of the current account balance is linked to a particular level of real domestic expenditures and of the real effective exchange rate. This means that, under certain circumstances, the level of the nominal exchange rate may provide inadequate protection to domestic industries, resulting in a deterioration in the current account imbalance. This is also the reason why both Krueger and Corden warn of the dangers of a trade liberalization that is not accompanied by rational exchange rate policies, that is, by devaluation.4

When most of the arguments regarding the choice of exchange rate regime and the level of the exchange rate of transition economies were originally put forward, the great majority of these countries maintained various payments restrictions that precluded a flexible management of the balance of payments.
Capital flows were restricted, and governments could not rely on capital inflows to finance current account deficits. Once these restrictions were liberalized, the governments’ options widened. When access to foreign capital improved, it became tempting to disregard the level of the current account imbalance on the assumption that access to foreign capital would remain unimpeded. The fact that this might not necessarily be the case is by now quite evident. The real question has become whether capital flows are stable or not, and what role should be played under such circumstances by the exchange rate.

The second transmission channel to trade policy is thus through pressures generated by autonomous changes in capital inflows. Because current account deficits are not necessarily undesirable, the question in the absence of capital restrictions is whether capital flows can be sustained. The instability of capital inflows should not necessarily be understood in terms of fluctuations of capital flows as such but rather in terms of fluctuations from the level required to finance the equilibrium current account deficits. In general, this is a topic that remains a part of the ongoing theoretical discussions about bubbles and crises in foreign exchange markets. This discussion is noteworthy for the lack of agreement among participants (Frenkel 1996, pp.153-54). Nevertheless, the discussion of the effectiveness of taxation of capital flows and the extent to which capital taxation can affect real exchange rates seems to have reached a relative consensus following the pioneering work of Mussa (1984), who argued that capital controls have only a limited capacity to affect the long-run level of the real exchange rate. Their principal effect is to influence the responsiveness of the real exchange rate to various forms of economic disturbances.

The third type of protectionist pressures may arise from the perception of poor macroeconomic performance. Given the link between exchange rate policies on the one hand and the domestic growth of output and inflation on the other, exchange rate policies have been the cause of protectionist pressures. The pressures have come from the business sector and also from the government, concerned not only about the deteriorating balance of payments but also about other variables such as the level of unemployment.

B. Choice of exchange rate regimes.

The choice of exchange rate regime also remains highly controversial. Neither the theoretical nor the empirical literature has been able to rank exchange rate regimes in terms of their effectiveness in
minimizing the rise of protectionism.⁵ One influential approach to the question of which exchange rate regime is more conducive stable commercial policies was provided by McKinnon (1986) as part of the discussions about the appreciation of the United States dollar in the first half of the 1980's. McKinnon made a strong case against a flexible exchange rate because it "looses its usefulness and becomes highly disruptive. (Moreover), macroeconomic instability and incentives for protection are aggravated" (our italics). The fundamental assumptions of his argument are that there is a scope for financial arbitrage and relatively free trade. The reasons for the emergence of protectionist pressures in an open economy is the appreciation of the nominal exchange rate resulting from a large inflow of foreign capital attracted by high interest rates needed to finance the fiscal deficit. We know that a solution to this problem is a restriction in domestic spending and, in particular, a reduction in the fiscal deficit to lower interest rates and reduce the incentives for capital inflows, but this does not alter the fact that increased protection is often seen as the remedy to a problem originating elsewhere.

Fixed exchange rate are not necessarily a better alternative. Whenever exchange rates are fixed and the domestic and foreign inflation rates differ, the real effective exchange rate (REER) changes. Unless the appreciation in the REER is matched by the growth of productivity in the tradeable goods sector, the fixed exchange rate will eventually expose domestic industries to excessive competition from imports, and exports will become increasingly less competitive. This is one of the reasons why Krueger (1997) criticizes the use of the nominal exchange rate as an anchor in stabilization programs. In addition, higher domestic rates of inflation necessitate higher domestic rates of interest. The latter will stimulate the inflow of foreign capital, which will increase the inflationary pressures and thus accelerate the appreciation of the REER. This is precisely what recently happened in the Czech Republic. The inflation differential of about 8 percentage points against Germany, the main market for Czech exports, the level of nominal interest rates two to three times as high as that in Germany and the pre-announced commitment of the Czech authorities to maintain the existing exchange rate parity encouraged a strong inflow of foreign capital starting in 1995.⁶ The bubble burst in the late spring of 1997 when an attack against the Czech currency forced the authorities both to devalue and to abandon a fixed nominal exchange rate regime.
Inflation is, therefore, undesirable because it can be the origin of protectionist pressures in the absence of appropriate exchange rate adjustments. Clearly, whenever domestic inflation is in excess of inflation rates elsewhere, the exchange rate must be depreciated or commercial policy must be changed. This is not only because of the need to maintain the competitiveness of domestic industry and to maintain an external equilibrium but also due to the growing strength of protectionist lobbies as the result of deteriorating competitiveness of domestic industries.

Another alternative is a crawling peg that maintains the real effective exchange rate yet imposes some discipline on domestic monetary policy. However, the experience with crawling pegs is also not entirely without problems. The crawling pegs may not be flexible enough to completely eliminate the problems of fixed exchange rates in an inflationary environment. For example, Obstfeld (1984) argues, using the example of Argentina, Chile and Uruguay, that the choice of the crawling-peg exchange rate regime in these countries was not effective because it produced dramatic, and ultimately unsustainable, current account imbalances and real exchange rate appreciation. One reason was slow labor market adjustments. Thus, once imperfections are introduced into the functioning of product or factor markets, policy prescriptions become more complex. Another problem with crawling-peg regimes has been the selection of currency baskets, which introduces an element of arbitrariness into the process of setting the level of exchange rate. For peggers, the choice of a reference basket of currencies involves decisions that are dependent on trade concentration, the degree of market openness, the size of the country and various other indicators.

The literature on the choice of exchange rate regimes provides more guidance regard to the choice of exchange rate regime in the context of macroeconomic policies, although it touches the relationship between exchange rate regimes and commercial policies only indirectly. We can identify two aspects of macroeconomic policy making that lead to increased pressures for protection. These include government policies leading to slow economic growth and rising unemployment and those policies relating to inflation.

There has been a growing interest in the profession regarding choice of the exchange rate regime as an instrument of growth-promoting policies. Most recently, the discussion has focused on the role of
exchange rate policies in transition and, more specifically, on the role of these policies in stimulating the growth of domestic demand and of exports. It appears that a consensus is being reached that transition economies with stable exchange rates have arrested and reversed output declines much more quickly than did those countries that pursued policies of flexible exchange rates. However, and equally important, stable exchange rate policies have turned out to be detrimental to the growth of output on a sustained basis. Both of these points have been made forcefully by Sachs (1996), who explains the impediments to economic growth generated by pegged exchange rates as stemming from various market rigidities in the transition economies that preclude a flexible domestic response to changes in relative prices.\footnote{8}

Pegged exchange rates also have tended to stimulate domestic demand for consumer goods and thus contributed to overheating, which itself may have had different origins. For example, the growth of domestic demand in the Czech Republic accelerated in the early 1990's following a rapid rise in wages. However, the concurrent sharp appreciation in the real effective exchange rate has added considerably to the growth of domestic demand for imported consumer goods. Moreover, the pegged exchange rate combined with inflation higher than abroad has forced up the level of interest rates, thus attracting foreign capital, which also stimulated the growth of domestic aggregate demand.

None, of this, of course, tells us anything directly about changes in commercial policy. It does say, however, that exchange rate policy can stimulate or retard domestic growth and thus affect the intensity of protectionists pressures. Rapid growth of domestic output is likely to reduce calls for extra protection while slow growth is likely to stimulate them. If growth is not accompanied by balance of payments difficulties or with a rise in unemployment, protectionist pressures are likely to be relatively small.

There is also a growing consensus that stable exchange rates have performed an extremely useful role in stabilizing transition economies (Sachs 1996), although the evidence is not conclusive. The inability to suppress inflation to the level of West Europe and, as a result, the inability to lower the level of interest rates and to reduce foreign capital inflows have intensified inflationary pressures in some transition economies. At the same time, high interest rates have facilitated the financing of current account deficits.
Thus, the pressures for additional protection from a more flexible exchange rate policy have been relatively mild. This has tended to delay important policy decisions.

Finally, other factors also play a role. For example, Ades et al. (1993) argue that the initial rate of inflation matters. They find that exchange rate-based stabilizations have been relatively less successful in high-inflation countries where initial booms have been followed by severe recessions. The impact has been the opposite in low inflation countries that started with recessions but were able to recover later. In either case, exchange-rate-based stabilizations have been associated with recessions and thus with increased calls for protection.9

3. Empirical Evidence

While the potential sample of transition economies is quite large, we focus our analysis on six countries. Four of these, the Czech Republic, Hungary, Poland and Slovankia have been among the better performers in terms of economic liberalization and stabilization. The remaining two, Bulgaria and Romania, illustrate the experience of countries less successful along these lines. The former four countries are considered to have a trade regime based on “standards and performance norms of advanced industrialized countries.”10 For this sample of countries, we seek to show to what extent commercial policy changes, particularly in the form of increased protectionism, have been used as a substitute for exchange rate realignment. We do not expect a one-to-one correspondence between exchange rate appreciation and a tightening of commercial policy. Rather, we expect that only when and if appreciation of the exchange rate results in the deterioration of trade performance will authorities be tempted, or pressured, to consider a revision of commercial policy. The mirror image of increased protection through higher tariffs is a change in the exchange rate policy. An increased REER will reduce domestic protection and reduced REER will increase it. It follows, therefore, that devaluation of the nominal exchange rate will increase domestic protection.

Before turning to the empirical findings, the remaining issue to be addressed is the question what kind of REER is relevant for our comparisons. REER can be computed with either producer prices or
consumer prices in the denominator. If both price indices moved more or less in parallel, the issue would moot. However, this is often not the case, and the discrepancies are usually very large in the transition economies.\textsuperscript{11} For this reason we use both measures. We have chosen 1992 as the base period to measure the changes in REER. The reason for not selecting an earlier year is that many price liberalization measures were not completed until the end of 1991. Using the earlier years, therefore, would be meaningless. In order to demonstrate the emergence of protectionist pressures, however, we do report some measures taken by these countries already during 1990-1992.

It should be also noted that we avoid as much as possible any exchange rates as undervalued or overvalued. Undervaluation and overvaluation remain a theoretical concept that is approximated in practice almost exclusively by considering the deviations of actual exchange rates from purchasing power parity. The relevance of the latter as a yardstick for equilibrium is highly dubious. The evidence regarding the validity of PPP as a standard of equilibrium in the external balance shows that deviations of actual exchange rates from PPP-based rates are more the exception than the rule.\textsuperscript{1} Alternative measures such as changes in REER are partial-equilibrium concepts that are fully suitable for our purposes.

Real exchange rates for the sample countries are reported in Table 1. The Czech Republic provides a particularly dramatic example of the effects of an excessively rigid exchange rate policy. Between 1992 and 1997, the REER appreciated by 36 percent on the basis of producer prices and by 54 percent on the basis of consumer prices. This means that the protection to Czech industries provided by exchange rate policy declined by the corresponding amounts during the period under consideration, assuming that was no commensurate improvement in fundamentals in particular through the growth of productivity. The latter has not been the case, (Begg, 1998).\textsuperscript{13} Thus, our conclusion is that Czech exchange rate policy led to a substantial decline in the protection afforded the country's industries.

A similar pattern can be observed for the other countries in our sample. Each has seen its REER appreciate. Using the producer price-based indices, the most serious appreciation has taken place in Slovakia followed by Romania and Bulgaria. In contrast, both Poland and Hungary have experienced a relatively mild appreciation of their REER.\textsuperscript{14} The main reason for the relatively better performance of the
REER in Poland and Hungary is that their exchange rate policies have reflected, to a greater extent, domestic rates of inflation. This contrasts not only with the performance of the other countries but also, in the case of Poland, with the policies pursued during 1990-1992 when a significant appreciation of the REER took place.\textsuperscript{15} Using the consumer price-based indices, the most serious appreciation of REER took place in Bulgaria and Romania, with Slovakia a close third. Once again, both Poland and Hungary have experienced more modest appreciation.

Thus, protection of industries afforded by the level of the exchange rate declined dramatically in the Czech Republic, Slovakia, Bulgaria and Romania in the brief period following the reforms of the early 1990's. The question is whether this has been reflected in worsening trade performance or in attempts by these countries to offset the effect of their exchange rate policies through changes in commercial policies.

Trade performance as measured by the changes in the trade balance is as expected, with a dramatic deterioration in the trade balance, particularly in the countries with the sharpest appreciation in the REER. Following a brief period of relatively balanced trade, the Czech Republic experienced a sharp deterioration in its trade balance in 1994 that continued until the end of 1996. A similar pattern can be observed for Poland. Slovakia maintained a relative trade balance until the end of 1995 when a trade deficit began to emerge and then deteriorated further in 1997. Romania's trade position also deteriorated sharply in the course of 1996, and, by mid-1997, the country was running a large and growing trade deficit. Hungary has maintained a fairly stable trade deficit throughout the most recent period with a slight improvement at the end of the period. Bulgaria's trade balance has been considerably influenced by the financial crisis of the second half of 1996, which lead to a collapse of imports. By the end of the first quarter of 1997, the annualized import level declined by almost 27 per cent in current dollar terms.

The link between changes in REER and trade performance is very tight in some countries including the Czech Republic and Slovakia; in others the relationship is more tenuous. Because the impact of exchange rate changes on trade flows is felt with a time lag, the imprecise nature of the relationship is not surprising. Moreover, the relationship was probably also influenced by the speed with which competitiveness was lost in individual countries, and this, in turn, was also a function of productivity
improvements, which depended crucially on the success of industrial restructuring. This point is particularly evident in the performance of Hungary. The relatively stable REER in Hungary has been associated with a fairly constant level of trade (im)balance and, most recently, with some improvement in the trade balance. This improvement is particularly impressive in the light of the fact that the initial devaluation in Hungary was the least dramatic in the whole region. The case of Poland is somewhat puzzling; the deterioration in the trade balance has been associated with a fairly constant level of the REER measured by producer prices, although the REER measured by consumer prices has been sharply rising, perhaps suggesting that the latter should have been the basis for the crawling peg mechanism if a stable trade balance was the policy objective.

Initial devaluations have not been decisive in maintaining a sustainable trade balance. The sharpest devaluations took place in the Czech Republic and Slovakia and in Poland between 1989 and the end of 1991. Their currencies were devalued by about 43 percent and by 50 percent respectively. Hungary devalued by only 11 percent during the same period. While these devaluations were clearly helpful in the early phase of the reform by stimulating trade reorientation, the competitive advantage they conferred was quickly lost because they were not supported by measures leading to a rapid improvements in productivity. In sum, exchange rate policy has influenced trade performance. A loss of competitiveness caused by an appreciation in REER is associated with a deterioration in the trade balance. The appreciation in REER was to some extent offset by improvements in productivity but only partially.

In order to see the countries' responses to the deteriorations of their trade performance, we turn to their trade policies. The most salient features of the policies are summarized in Table 2. We can see from the table that all of these countries have experienced not only instability in their exchange rate policies but also an instability in commercial policy. In the case of the Czech Republic, the appreciating REER has contributed to the emergence of a rapidly deteriorating trade and current account imbalance and to the need for an introduction of import restrictions in April, 1997. These restrictions took the form of foreign exchange deposits amounting to 20 percent. Under pressure from the European Union and from other WTO member countries, the Czech government eliminated the deposits starting from September 1997. In the
meantime, the Czech crown was devalued, and this relieved the competitive pressures on Czech industry. By July 1997, the REER had dropped by 10 percent from its peak in March 1997, moving it back to the level of about July 1996.

The experience of other countries is very similar. Bulgaria introduced an import surcharge in June 1996, and Romania has maintained an import surcharge since May 1992. The Slovak Republic introduced a 10 percent import surcharge in March 1994 that it eliminated by June 1996, but it re-introduced the surcharge, amounting to 7 percent, in July 1997. Hungary and Poland did not avoid these additional import restrictions either; Hungary introduced an import surcharge in March 1995 and Poland in December 1992. Poland eliminated the surcharge by January 1997 and Hungary by July 1997. With the exception of the Czech Republic, over time, each of these countries has also introduced measures affecting particular industries. For example, Slovakia introduced so-called quality certificates and import deposits, and Poland adopted measures to protect its car industry. Poland and Hungary also introduced measures to protect agriculture. Hungary has global quota on consumer goods imports, and Poland introduced import quotas on certain electronic products. Romania introduced a system of reference prices for six products in 1994 to protect domestic producers. These were abolished in July 1995 when a new tariff was introduced.

We do not claim to demonstrate a causal relationship between the introduction of the protectionist measures and exchange rate policies. Nevertheless, the timing of the protectionist measures described in Table 2 is more than coincidental. As Chart 2 shows, the import-restrictive measures were introduced in all transition economies at the time when the trade deficit increased to levels that were menacing. At the same time, the deteriorating trade imbalance was also closely connected to appreciating real effective exchange rates, as noted above. In these cases, the countries' international competitiveness had suffered, causing increasing pressures for an increase in import restrictions.

4. **The Czech Case**

It follows from the previous discussion that protectionist pressures arise from three aspects of exchange rate policies; from an appreciating exchange rate that is not offset by an increase in productivity,
from a level of the exchange rate that is neither conducive to international competitiveness nor to economic growth; and from a rigid exchange rate policy that encourages speculative inflows of foreign capital. Empirical assessments of the appropriate level of the exchange rate are always difficult to make, but there is a growing consensus among domestic and foreign observers that Czech exchange rate policy has failed on all three accounts. This represents a dramatic switch in the opinion of the majority of economists who until recently have praised the Czech experience as an example of a well-managed system.16

(i) The Exchange Rate Level. There has been a great deal of interest in the literature and in policy circles whether the exchange rate of the Czech Republic has been undervalued or overvalued.17 The empirical questions remain, of course, speculative since the existence of differences between the actual exchange rate and the equilibrium exchange rate cannot be demonstrated conclusively.18

(ii) However, an answer can be provided by looking at the performance of the current account, and the figures have been quite revealing, a dramatic deterioration in both the trade and current account between 1994 and 1997.

Despite the conceptual problems involved, some observers have attempted to calculate the distortion of the actual exchange rate. The conclusions are virtually the same for all of these studies, a significant undervaluation of the exchange rate in the early 1990's and an equally significant loss of this advantage over time.19 By 1997, some economists have indicated that the exchange rate began to be overvalued.20 Given the large current account deficit at the end of 1996, above 10 percent of GDP, a functional overvaluation of the exchange rate was possible.21 The devaluation of May and June 1997 moved the level of REER down somewhat but only to the level of mid-1996. Perhaps this was not sufficient because the 1996 level may have left Czech industry highly exposed to foreign competition.

(ii) Rigidity of the Exchange Rate Regime. There are reasons to believe that the exchange rate regime of the Czech Republic had been pegged inflexibly for too long. As we have noted above, fixed exchange rates stimulate capital inflows while more flexible exchange rates regimes tend to discourage them. A fixed nominal rate proved to be useful in the early stage of the stabilization program, but the insistence on a pegged exchange rate eventually became counterproductive. A credible pegged exchange rate regime
encouraged strong capital inflows, which proved difficult for the monetary authorities to control. In addition, the exchange rate regime encouraged inflows of short-term and speculative capital seeking to profit from interest rate arbitrage (Cihák, 1997). It was only once the bands around the exchange rate parity were expanded that the capital inflows slowed down.22

(iii) Appreciation of Real Effective Exchange Rate. While there may be disagreements about the degree of distortions of the actual exchange rate from equilibrium rate, there is no disagreement about the evolution of the REER. All studies that we have been able to review clearly show that REER has significantly appreciated irrespective of the method of calculation.23 The only disagreement is about the magnitude. The evolution of the REER has been primarily the outcome of official policy. In the Czech Republic, as elsewhere in the region, views about the appropriate level of the nominal exchange rate were divided. One group of economists pushed for an undervalued exchange rate in order to provide sufficient protection to the tradable sector. Another group of economists argued against undervaluation partly on the grounds of the high costs of such a policy.24 Moreover, they argued in favor of a strong currency in order to increase the competitive pressures on domestic industry to restructure. The official Czech policy initially supported the soft currency policy, but this policy was subsequently abandoned. The result of this decision and of a relatively slow growth of factor productivity was the appreciation of the REER.

The policy of undervaluation was also defended in a number of other countries.25 What made the difference in the Czech experience was the desire to maintain a stable nominal exchange rate so as to improve the country’s standing in international capital markets. Ironically, this improvement, combined with an unwillingness to devalue, caused capital inflows that effectively undermined the policies that brought them about.

(iv) The Impact on Commercial Policies. Czech exchange rate policy has not been neutral for the conduct of commercial policies. Given the undervaluation of the exchange rate in 1990-91, profitability in the tradables sector remained relatively high for several years. However, the appreciation of the REER eventually began to be reflected in the performance of the tradable sector. Initially, the government avoided protectionist measures by adopting measures directed towards liberalization of the capital account (Dedek
1997), which it hoped would moderate capital inflows. An adjustment of the nominal exchange rate was also avoided. The relaxation of restrictions on foreign currency transactions was introduced at the time when monetary policy was already under severe pressure from the surge in capital inflows. It was these pressures rather than the deteriorating trade and current account imbalance that led to the decision to liberalize capital outflows with the view of offsetting the pressures of capital inflows. The measures were only marginally effective, and it was not long before protectionist pressures reappeared.

The empirical evidence of the impact of the exchange rate policy is limited but instructive. One of the more comprehensive studies is de Menil (1994) who compared the trade performance of different transition economies. He found that the insistence on nominal anchors has been one of the major factors behind a relative deterioration in trade balances of the countries concerned, largely due to unsatisfactory export performance. This conclusion has been challenged by Bruinshoofd (1997) on the grounds of an improvement in trade imbalance in 1997 in the Czech Republic and the increase in Czech exports. However, this improvement could be attributed to the devaluation of the koruna in Spring 1997 and to the slowdown in domestic growth.

Conclusions

Inappropriate exchange rate policies have led to protectionist pressures in transition economies surveyed in this paper. The pressures emanating from such exchange rate policies vary from time to time depending on the changes in domestic fundamentals. As a result, protectionist pressures can be cyclical, and this appears to have been the case in the transition economies under consideration because they experienced several shifts in commercial policy over this relatively short period of time. Because the competitiveness of domestic firms was adversely affected by a rising real effective exchange rate, appropriate nominal exchange rate adjustments would have gone a long way toward mitigating the calls for protection. At the same time, exchange rate policies cannot be blamed for all the loss of competitiveness of domestic industries in the Czech Republic or in other transition economies. Other factors, including market imperfections, inflexible management of currency baskets, and, in general, factors that determine the
domestic growth of output and inflation, have also played a role. Moreover, the rise of protectionist lobbies also has been instrumental in increasing the pressure on governments to raise protection. Sound macroeconomic policies, institutional changes addressing market imperfections, and other pro-growth domestic policies are also crucial. Hungary, which has been more successful in restructuring its industries than other countries has demonstrated that a relatively overvalued exchange can be offset by measures to encourage the growth of productivity. The pursuit of nominal-anchor exchange-rate policies has been based, \textit{inter alia}, on the belief that a stable nominal exchange rate would provide consistent signals to investors, both domestic and foreign, about the comparative advantages of the country. This belief has clearly turned out to be wrong. Whether comparative advantage remains stable is determined not by the level of the nominal exchange rate but by the level of real effective exchange rate, and the latter has changed dramatically in many transition economies over the last few years. Moreover, this change has been quite rapid, indicating that the authorities will find it difficult to stick to their nominal anchor policies or that they will face increasingly intense protectionist pressures.
REFERENCES


Begg, David, “Pegging Out: Lessons from the Czech Exchange Rate Crisis.” *Journal of Comparative Economics* (this issue-ed. please supply page nos., etc.)


Table 1: CEEC Exchange Rate Instability: Movements of the Real Effective Exchange Rate, (1992-1997).

<table>
<thead>
<tr>
<th></th>
<th>REER (PP)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>100</td>
<td>117.1</td>
<td>98.9</td>
<td>109.4</td>
<td>103.3</td>
<td>114.6</td>
</tr>
<tr>
<td>Czech</td>
<td>100</td>
<td>117.9</td>
<td>122.0</td>
<td>125.4</td>
<td>132.6</td>
<td>136.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>100</td>
<td>105.9</td>
<td>100.6</td>
<td>96.0</td>
<td>98.9</td>
<td>108.9</td>
</tr>
<tr>
<td>Poland</td>
<td>100</td>
<td>107.4</td>
<td>103.1</td>
<td>107.4</td>
<td>111.4</td>
<td>109.2</td>
</tr>
<tr>
<td>Romania</td>
<td>100</td>
<td>106.7</td>
<td>115.8</td>
<td>115.3</td>
<td>114.4</td>
<td>123.5</td>
</tr>
<tr>
<td>Slovakia</td>
<td>100</td>
<td>116.7</td>
<td>119.1</td>
<td>123.4</td>
<td>128.6</td>
<td>136.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>REER (CP)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>100</td>
<td>154.8</td>
<td>146.9</td>
<td>174.1</td>
<td>156.2</td>
<td>188.1</td>
</tr>
<tr>
<td>Czech</td>
<td>100</td>
<td>122.3</td>
<td>130.4</td>
<td>136.4</td>
<td>147.4</td>
<td>153.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>100</td>
<td>110.5</td>
<td>109.7</td>
<td>104.6</td>
<td>107.6</td>
<td>115.7</td>
</tr>
<tr>
<td>Poland</td>
<td>100</td>
<td>107.6</td>
<td>108.0</td>
<td>114.9</td>
<td>125.5</td>
<td>130.5</td>
</tr>
<tr>
<td>Romania</td>
<td>100</td>
<td>141.2</td>
<td>151.9</td>
<td>149.3</td>
<td>135.3</td>
<td>146.6</td>
</tr>
<tr>
<td>Slovakia</td>
<td>100</td>
<td>118.9</td>
<td>123.6</td>
<td>129.5</td>
<td>134.8</td>
<td>144.1</td>
</tr>
</tbody>
</table>

Notes:
1. Trade-weighted indices 1992=100, vis-à-vis 21 industrial countries, based on industrial producer prices (PP) and consumer prices (CP).
2. Cumulative data from January up to latest observation (September 1997).

Table 2: CEEC - Import Restrictive Measures 1992-1997

<table>
<thead>
<tr>
<th>Country</th>
<th>Trade Policy Measures in Central and Eastern Europe (1992-97)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bulgaria</strong></td>
<td>1) Import Surcharge</td>
</tr>
<tr>
<td></td>
<td>- On 1 August 1993, Bulgaria introduced a temporary 3% import surcharge. The surcharge was lowered to 2% in 1994, and further reduced to 1% in 1995, before being eliminated on 1 January 1996.</td>
</tr>
<tr>
<td></td>
<td>- On 4 June 1996, Bulgaria re-introduced a temporary 5% import surcharge. The surcharge was lowered to 4% on 1 July 1997, and is to be reduced in steps over the next three years to 2% in 1998, 1% in 1999, and eliminated by the year 2000.</td>
</tr>
<tr>
<td></td>
<td>2) Other measures</td>
</tr>
<tr>
<td></td>
<td>- On 1 July 1992, Bulgaria re-introduced an import tax for a limited number of products including meat, poultry, dairy products, and some fruits and vegetables. In 1991, a 15% import tax was applied in addition to the import duty. The tax was later abolished with the introduction of a new import tariffs. In 1993, the import tax was eliminated or incorporated in customs tariff in the case of a few agricultural items.</td>
</tr>
<tr>
<td></td>
<td>- On 6 June 1994, Bulgaria applied quantitative restrictions on imports of ice cream. The quota was eliminated on 1 January 1997.</td>
</tr>
<tr>
<td></td>
<td>- In January 1995, higher fees were charged for foreign trade licensing and registration.</td>
</tr>
<tr>
<td></td>
<td>- In April 1995, higher duties are levied on sugar imports to support local industry. That same month, the customs clearance fee of goods was raised from a lev equivalent of 100 US $ to that of 1000 US $.</td>
</tr>
<tr>
<td></td>
<td>- Between June and September 1995, higher duties are imposed on dairy imports to curb the import of cheap low-quality products.</td>
</tr>
<tr>
<td></td>
<td>- In September 1995, customs imposed strict control over carriers of items liable to payment of excise duties, mainly cigarettes and spirits.</td>
</tr>
<tr>
<td></td>
<td>- In September 1995, four institutions, the Ministries of Finance, Health and Agriculture, and the Standardisation Committee and Meteorological Committee, are taking the control on the quality of imported goods. The purpose is to set up a solid barrier to sub-standard imported products. It is required that all imports have labels in Bulgarian, and that certain goods be subjected to phytosanitary control.</td>
</tr>
<tr>
<td></td>
<td>- On 21 April 1997, the Czech Republic introduced a temporary 20% import deposit. The measure was abolished 4 months later, on 21 August 1997.</td>
</tr>
<tr>
<td></td>
<td>3) Export Barriers</td>
</tr>
<tr>
<td></td>
<td>- In November 1993, temporary export taxes were levied on 11 groups of products, mainly foodstuffs.</td>
</tr>
<tr>
<td></td>
<td>- In mid-1994, export taxes on wheat and sunflower oil were raised substantially.</td>
</tr>
<tr>
<td><strong>Czech</strong></td>
<td>Republic</td>
</tr>
<tr>
<td></td>
<td>1) Import Surcharge</td>
</tr>
<tr>
<td></td>
<td>- On 17 December 1990, the Czech and Slovak Federal Republic introduced a temporary 20% import surcharge. The surcharge was reduced to 15% in June 1991, and by mid-1992, it was lowered to 10%. The measure was eliminated on 31 December 1992, prior to the CSFR’s dissolution on 1 January 1993.</td>
</tr>
<tr>
<td></td>
<td>2) Import Deposit</td>
</tr>
<tr>
<td></td>
<td>- On 21 April 1997, the Czech Republic introduced a temporary 20% import deposit. The measure was abolished 4 months later, on 21 August 1997.</td>
</tr>
<tr>
<td></td>
<td>3) Other measures</td>
</tr>
<tr>
<td></td>
<td>- In January 1992, variable import levies were applied on some agricultural products (meat dairy products, potatoes, oilseeds, sugar, wine, alcohol, and starch). These levies were eliminated and replaced with tariffs or tariff quotas as a result of the tariffication provision of the WTO Agreement on Agriculture.</td>
</tr>
<tr>
<td></td>
<td>- At present, there are no countervailing duty or safeguard legislation although the parliament passed an anti-dumping law to protect producers from cheap imports in May 1997.</td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td>1) Import Surcharge</td>
</tr>
<tr>
<td></td>
<td>- On 21 March 1995, Hungary introduced an 8% import surcharge. The surcharge was applied on all goods except energy and machinery for investments. The surcharge was lowered to 7% in July 1996, and to 6% in October of that same year. In March 1997, the surcharge was further reduced to 4% and to 3% in May. The measure was eliminated on 1 July 1997.</td>
</tr>
<tr>
<td></td>
<td>2) Other measures</td>
</tr>
<tr>
<td></td>
<td>- In March 1992, Hungary decided to put up trade barriers against steel imports in the latest concession to industries and joint ventures demanding protection. Quotas on imports of 15 steel products were introduced. Hungary also reduced its quotas on car imports and raised tariffs on televisions to 25%.</td>
</tr>
<tr>
<td></td>
<td>- In May 1992, western vehicle companies accused Hungary of violating international trade agreements by giving customs preferences to Ford as a reward for making investments in Hungary. The protest followed a government decree which set an 18% tariff on imported vans with exception for vehicles with specifications that in practice are met only by Ford Transit models. Hungarian customs officials settled the controversy in July of that year.</td>
</tr>
<tr>
<td></td>
<td>- In April 1993, Hungary banned certain imports in retaliation for the EC’s one month blanket ban on imports of live animals, meat milk and dairy products from Eastern Europe due to foot and mouth disease.</td>
</tr>
<tr>
<td></td>
<td>- On 1 November 1994, Hungary temporarily raised import duties on certain foods and agricultural products. The increased duties were formally applied until 31 December 1994 before being replaced by new tariffs that result from the Uruguay Round negotiations. The measure, however, raised average import tariffs from average rates of 22-24% for farm and food products to 45%.</td>
</tr>
<tr>
<td></td>
<td>- On 1 January 1996, current exemption from customs duties for imports of certain capital goods are removed.</td>
</tr>
<tr>
<td></td>
<td>- To date Hungary has made no recourse to anti-dumping or countervailing duty actions.</td>
</tr>
</tbody>
</table>

Table 2: CEEC - Import Restrictive Measures 1992-1997 (Cntd)
<table>
<thead>
<tr>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1) Import Surcharges</strong></td>
</tr>
<tr>
<td>- On December 1992, Poland introduced a 5% import surcharge. The surcharge was lowered to 3% on January 1996 and abolished by 1 January 1997.</td>
</tr>
<tr>
<td><strong>2) Other measures</strong></td>
</tr>
<tr>
<td>- On 1 January 1992, Poland increased its import duties to 35% on passenger cars, buses and trucks, and introduced specific minimum duties.</td>
</tr>
<tr>
<td>- Early 1992, tariff rates on computers increased from 5% to 20%, while duties on cigarettes were raised from 40% to 90%, and tariffs on consumer electronics increased to 30%.</td>
</tr>
<tr>
<td>- In April 1992, Poland toughened its regulations on trade involving liquor, tobacco, and fuels. Special license requirements were needed for those who wanted to trade in liquor, tobacco, and fuels. The decision was justified on the basis of existing loopholes in border controls that allowed dishonest dealers to make fortunes.</td>
</tr>
<tr>
<td>- In October 1992, Poland introduced temporary variable levies on some agricultural goods and duty free tariff quotas for several grains and animal feed. Customs duties on imported eggs and sugar were raised.</td>
</tr>
<tr>
<td>- In February 1993, Poland announced the use of import quotas on certain consumer electronics such as microcomputers, microprocessors, and other components.</td>
</tr>
<tr>
<td>- On 21 June 1994, temporary variable import levies were introduced on a number of food and agricultural products. This measure sought to increase protection for domestic producers of 8 groups of products, pork meat, poultry, milk, cream, cucumber, flour, vegetable oils, and processed tomatoes.</td>
</tr>
<tr>
<td>- In late 1994, import duties on consumer electronics were affected by a 6% surcharge tax.</td>
</tr>
<tr>
<td>- In July 1995, higher tariff rates were levied on imported foodstuffs and agricultural products in connection with Poland’s membership in the WTO. The higher tariffs replaced all previous non-tariff measures applied to food and farm products, 19% of goods faced higher tariffs, including beef, some processed food products, yeast, sauces, alcohol, tobacco, and tobacco products. The government, in early 1996, approved possible additional duties on certain food products to guard against import surges.</td>
</tr>
<tr>
<td>- In March 1997, Poland re-introduced a 10% customs duty on certain grain imports. These imports had been subject to a 20% import duty that was suspended in November 1996 until June 1997. Polish farmers had complained that there was an excess reserve of fodder grains and that the continuation of duty-free imports was exacerbating the situation. The duty was applied on grains used as fodder, while imports of wheat, corn, and soybeans for human consumption remain duty-free.</td>
</tr>
<tr>
<td>- On 1 June 1997, the import duty on barley was raised from 10 to 20%, and on 1 July 1997, a 20% import tariff on wheat came into effect. The government announced the wheat tariff in January when it imposed a 10% tariff on other grains.</td>
</tr>
<tr>
<td>- Mid-November 1997, Poland decided to ban imports of Belgian beef cattle and related products due to mad cow disease. Poland also won the right to maintain tariffs at 9% in order to protect its restructuring of steel industry, even though under an agreement signed a few years ago, Poland was due to reduce its tariffs on steel from 9% to 6% in 1997, and to 3% in 1998.</td>
</tr>
<tr>
<td>- In December 1997, Poland approved of a package of anti-dumping measures effective on 1 January 1998. Since 1992, Poland has made no recourse to countervailing duty actions; in early 1991, Poland initiated two anti-dumping investigations on imports of animal and vegetable fats and oils, and beef. The procedures were terminated due to lack of evidence.</td>
</tr>
<tr>
<td>- As of 1 January 1998, Poland introduced a 20% tariff on Hungarian corn and raised the import tariffs on Hungarian tomato puree from 11% to 60%. Poland took action under pressure from Polish farmers following a sharp increase in Hungarian corn imports during the months of November-December 1997.</td>
</tr>
<tr>
<td>- As of 1 January 1998, waivers of safety certification rules for imported goods are terminated. A new system of mandatory safety and products standards was introduced in 1996 that, although not discriminatory, appears to act as a barrier to imports. However, certain waivers were in effect allowing foreign companies to continue selling products without Polish safety certifications, provided the application has been made before hand. The Polish government decided in December 1997 not to extend such waivers and as a result, all products that require safety certification must complete the certification process and receive “B” safety marks before they may be sold on the Polish market. Poland currently does not accept the EU “CE” mark, or any other international safety certificates.</td>
</tr>
<tr>
<td>- Poland has used its sanitary and phytosanitary regulations to prevent, for &quot;economic reasons&quot;, the increase of imports of certain agricultural products from the new States of the former Soviet Union.</td>
</tr>
<tr>
<td><strong>3) Export Barriers</strong></td>
</tr>
<tr>
<td>- In early 1992, export prohibitions were extended to cover live poultry and turkey.</td>
</tr>
<tr>
<td>- In October 1992, due to damage caused by severe drought, a temporary export ban on feed-grains and oil seeds was introduced. The measure was effective until 31 March 1993. Export licensing was also introduced for certain grains and animal feeds. The licensing obligation remained in effect until the end of June 1993.</td>
</tr>
</tbody>
</table>
Table 2: CEEC- Import Restrictive Measures 1992-1997 (Cntd)

<table>
<thead>
<tr>
<th>Country</th>
<th>1) Import Surcharge</th>
<th>2) Other measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>- On 1 May 1992, Romania introduced a 30% import surcharge levied on certain alcoholic beverages, perfumes, electronic appliances and motor vehicles. The measure was suspended later that year.</td>
<td>- Between May and October 1993, a 30% anti-dumping duty on alcohol, vehicles, televisions, and video recorders was introduced. - On 19 November 1993, the government decided to impose, or increase, excise duties on imports of audio and video equipment, household appliances, cosmetics, cigarettes and liquor. - On 24 June 1994, the Ministry of Agriculture established reference prices for 6 products, poultry, meat, sunflower oil, potatoes, tomatoes, wheat and barley. This measure was introduced on a temporary basis to protect domestic producers from unfair competition. This temporary measure was abolished on 1 July 1995, when a new tariff on agricultural products was introduced. - In July 1995, trade weighted tariffs on agricultural products were raised from 25% to 75% following the Uruguay Round Agreements. All non-tariff barriers on agriculture were converted into tariffs and ceilings on tariff levels for commodities not subject to tariff bindings were established with little relation to previous levels of protection. As a consequence, Romania now has one of the highest agricultural tariff bindings of any country in Europe. Up until 1996, very high tariffs remained for most agricultural products, on average about 110%. However, such tariffs have since been adjusted to &quot;internationally accepted levels&quot;. - In mid-1996, a 0.5% customs service fee levied on the value of the imported good was introduced. - On 19 November 1997, the Romanian government imposed new standards requirements for imports of certain goods that must now be accompanied by a certification of conformity issued in the country of origin, stating that the product meets standards covering environmental, public safety, and public health concerns. Although the standards are identical to those required by the EU for imports and are consistent with the WTO Standards for Environment, Public Health, and Safety, there have been cases where Romanian requirements have been stricter than international standards (e.g., wheat imports must be of particularly high quality because of rather old technology employed in domestic bakeries). - Romania has introduced anti-dumping and countervailing legislation but, as yet, no actions have been initiated.</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>- On 17 December 1990, the Czech and Slovak Federal Republic introduced a temporary 20% import surcharge. The surcharge was reduced to 15% in June 1991, and by mid-1992, it was lowered to 10%. The measure was eliminated on 31 December 1992, prior to the CSFR dissolution on 1 January 1993. - In August 1994, the Slovak Republic introduced a temporary 10% import surcharge. The surcharge was lowered to 7.5% on 1 July 1996, and abolished on 1 January 1997.</td>
<td>- In November 1993, the government decided to impose, or increase, excise duties on imports of audio and video equipment, household appliances, cosmetics, cigarettes and liquor. - In February 1993, a temporary export ban on exports of power, gas, iron ore and several key foods was in effect.</td>
</tr>
<tr>
<td></td>
<td>3) Export Barriers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- In 1992, a temporary export ban was applied to important agricultural inputs and wood products (for which domestic supply is constrained and due to environmental concerns). - In February 1993, a temporary export ban on exports of power, gas, iron ore and several key foods was in effect.</td>
<td></td>
</tr>
</tbody>
</table>

Sources:
- Bulgarian Business News.
- Bureau of National Affairs: Eastern Europe Review.
- Financial Times.
- The Hungarian Economy: a Quarterly Economic and Business Review.
- Romania Economic Newsletter: Reporting and Analysing Economic Development.
Chart 1: CEEC - Trade Imbalances and Recent Changes in Commercial Policies.

**Bulgaria**

[Graph showing the REER index and trade balance for Bulgaria, with key dates and events marked on the graph, such as 14 June 1996 where a 5% import surcharge was introduced, and 1 January 1996 when a 1% import surcharge was eliminated.]

- 1992 REER = 100
- Millions of US$
The Impact of Exchange Rate Regimes on the Stability of Trade Policy

**Czech Republic**

- **REER (cp)**
- **REER (pp)**
- **Trade Balance**

**Key Dates:**
- 21 April 1997: 20% Import Deposit Introduced
- 21 August 1997: Import Deposit Eliminated
The Impact of Exchange Rate Regimes on the Stability of Trade Policy

Hungary

REER 1992=10

1 October 1996
Import Surcharge Reduced to 6%

1 July 1996
Import Surcharge Reduced to 7%

15 May 1997
Import Surcharge Reduced to 3%

21 March 1995
8% Import Surcharge Introduced

Trade Balance

REER (cp)
REER (pp)

Millions US$
Poland

The Impact of Exchange Rate Regimes on the Stability of Trade Policy

REER
1992=100

Millions of US$

1 January 1996
Import Surcharge Reduced to 3%

1 January 1997
3% Import Surcharge Eliminated
Slovak Republic

ENDNOTES

1 We are indebted to David Begg, Ali Kutan, Jan Svejnar and Michael Wyzan for comments on an earlier version of this paper. Any errors and all conclusions are solely the personal responsibility of the authors and should not be attributed to their employers or sponsors. Brada acknowledges the financial support of the National Council for Eurasian Research.

2 We are aware that our use of the word protection has a very different meaning from the common usage in the trade literature. This will become evident from the discussion further in the text below.

3 See also Dornbusch (1984) for an elaboration of this method.

4 Both Krueger and Corden call for devaluations in countries that have liberalized their trade regimes in order to maintain both the internal balance and the initial current account balance. See Corden (1991), pp. 229-230.

5 The literature on the choice of exchange rate regime is vast but, once again, its treatment of the relationship between different regimes of exchange rate and commercial policy is sporadic. For some empirical evidence see Brada and Mendez (1988).

6 In 1995, the total balance on the capital account amounted to US$ 8.2 billion and the corresponding figure for 1996 was US$ 4.3 billion. In 1997, the total capital inflows are estimated to have been halved. The magnitude of capital inflows can be also seen from the following figures: the share of foreign capital in domestic savings represented 84 percent in 1995, and foreign capital accounted for 51 percent of domestic money supply (M1). For more details, see Drabek (forthcoming).

7 See, Wickham (1985) for a review of the relevant literature.

8 The issue may not be as straightforward as suggested by Sachs. For example, it is imperative to consider various conditions under which supply responds. If the supply response is slow because of slow reactions of firms, rather than because of poor policies or price rigidities, the deterioration in the current account position will not require a change in policies. See Roldos (1995) as well as Flood and Mussa (1994), Rebelo and Vegh (1995) and other papers presented at the Roundtable on the Use of Exchange Rate Anchors in Adjustment Programs, 9 October 1995, IMF, Washington, DC.

9 Edwards (1993) also casts doubt on the effectiveness of fixed nominal anchors arguing that inflationary expectations may be strong in countries with a history of rapid and/or unstable inflation even in the presence of nominal anchors. The argument of Krueger (1997) also supports this view.


11 We can only speculate why the differences exist between changes in consumer prices and those in producer prices. One of the main reasons is that price liberalization has typically affected the enterprise sector almost instantaneously while prices of many important consumer goods and services have been liberalized more slowly. In the Czech Republic, for example, the prices of electricity, rents, heating, water, certain municipal services and even some foodstuffs have been deregulated in a staggered fashion and they are not full liberalized to date.

Alternatively, it may be that the more rapid increase in the consumer price index may reflect not inflation but rather the inability of the price to capture improvements in the retail distribution network.

12 See, for example, the recent tests of Koch (1997). He based his tests a cross-country sample of 80 countries and showed that the coefficient associated with GDP per capita valued at PPP is substantially less than one. Also see Dornbusch (1982).

13 According to the official data provided by the Ministry of Trade and Industry, the average annual productivity growth was in the range of 2-3 percent during 1992-1997. These data were provided by the First Deputy Minister of Trade and Industry at his presentation in the Trade Committee of the Economic Commission for Europe, Geneva, 8 December, 1997.

14 The empirical findings in the literature differ for various reasons. This may be due to different choices of indices or due to the choice of the base period. Some studies have relied on data with 1990 as the base period showing fundamentally different results. See, for example, Carlin and Landesmann (1997), pp. 80-81.

15 See, for example, Koch (1997).
It was as late as December 1995 that a group of distinguished economists assembled at an European Policy Institute workshop in Prague to appraise the exchange rate policies in Central and Eastern Europe and argue that it is safe to say that the Czech Republic's approach (to the exchange rate management) was the most successful. See CEPR/Institute for EastWest Studies Brief, No.2, November 1996, p.1. The Central Bank, too, has been very pleased with its policy of a nominal anchor as reflected in the statements of its adviser Dedek (forthcoming). This self-satisfaction and rigid pursuit of this policy at the root of subsequent problems.

A historical account of the choices considered by the government is provided in Hrn. (1997).

Virtually all empirical evidence has so far been provided in the form of deviations of the nominal exchange rate from that calculated on the basis of the purchasing power parity. However, the PPP-based estimates are highly ambiguous and partial. Moreover, more sophisticated approaches have so far led to no major improvements in this respect. For example, as Frenkel (1996) pointed out, econometric research has failed to explain most exchange rates movements by changes in the underlying fundamentals, especially on a short-term basis.


This conclusion is not always supported by the empirical evidence provided by writers trying to estimate the deviation of the actual from the equilibrium rate. For example, Carlin and Landesmann (1997) argue that the Czech koruna, together with the Slovak koruna, has remained the most undervalued currency throughout the whole period. As most observers, they have relied on their estimates of the deviations of the actual exchange rate from that calculated with the help of the purchasing power parity.

While the Czech experience is by now fairly well understood, the experience among other transition was not necessarily as negative. For example, Savalainen (1995) argues that, in the light of the Baltic experience, credibility of stabilization policies has been of greater importance than the choice of exchange rate regime per se. However, a more general study by Sahay and Vegh (1995) covering a spectrum of transition economies is consistent with the Czech story.

See, for example, BIS estimates in their Monthly Indicators. Other estimates can be found in the publications of the Economic Institute of the Czech National Bank.

Kaminski et al. (1995) find undervalued exchange rates too costly and, therefore, highly unsuitable for transition economies. This position was defended in the Czech Republic primarily by economists associated with the opposition Social Democratic Party, but it was later adopted by the majority of economists in the country.

See, for example, Rosati (1997) who argues the same for Poland and transition economies in general.