

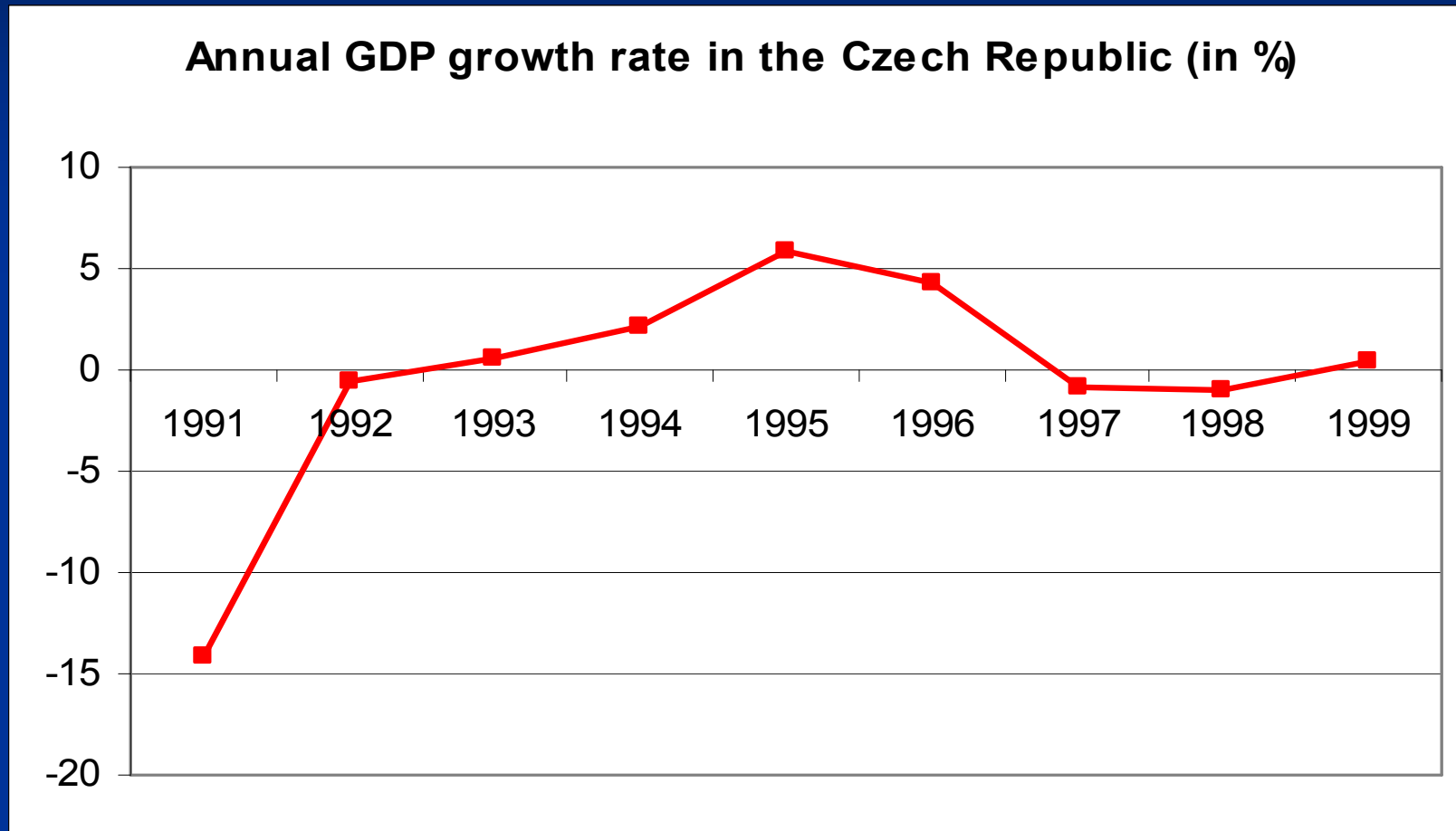
The Causes, Solution and Consequences of the 1997 Monetary Crisis

- Situation of the Czech economy before the crisis
- The 1997 monetary crisis – why did it happen?
- The crisis development
- Consequences of the crisis
- Different crisis explanations
- Presentation availability: in „Study materials“ at is.muni.cz

Czech economy in the middle of the 90's

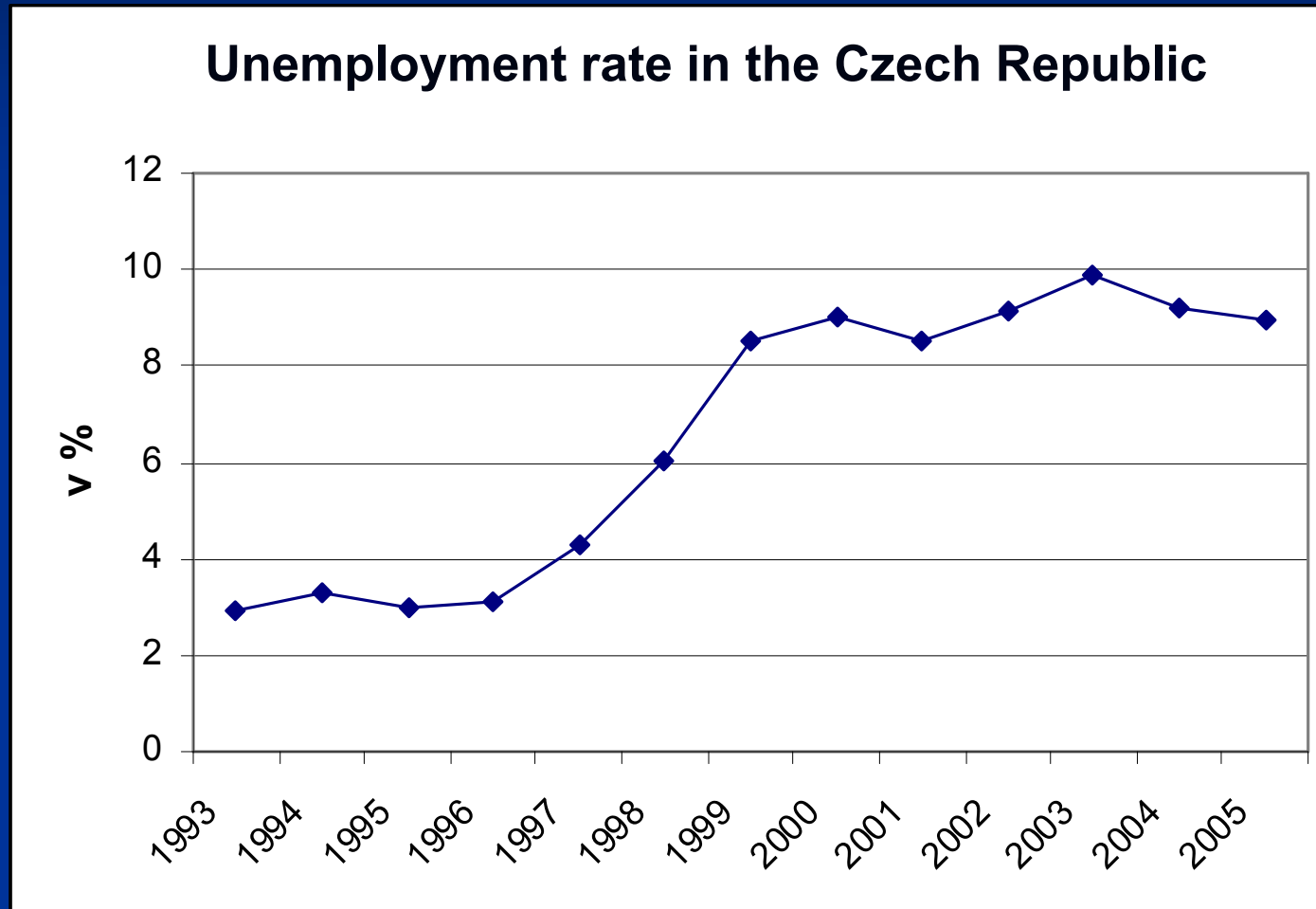
- satisfactory stage of the economic reform
- most basic reform steps were made
- solid economic growth
- low unemployment rate
- good future view of macro aggregates

Czech economy in the middle of the 90's



Source: Czech Statistical Office, www.czso.cz

Czech economy in the middle of the 90's



Source: Czech Statistical Office, www.czso.cz

The 1997 crisis – why did it happen?

- several causes (factors)
- all of them „worked“ together
- direct relationship between the external imbalance and the Czech koruna exchange rate
- 4 main causes: excessive domestic demand, exchange rate regime, short-term foreign capital influx, monetary policy

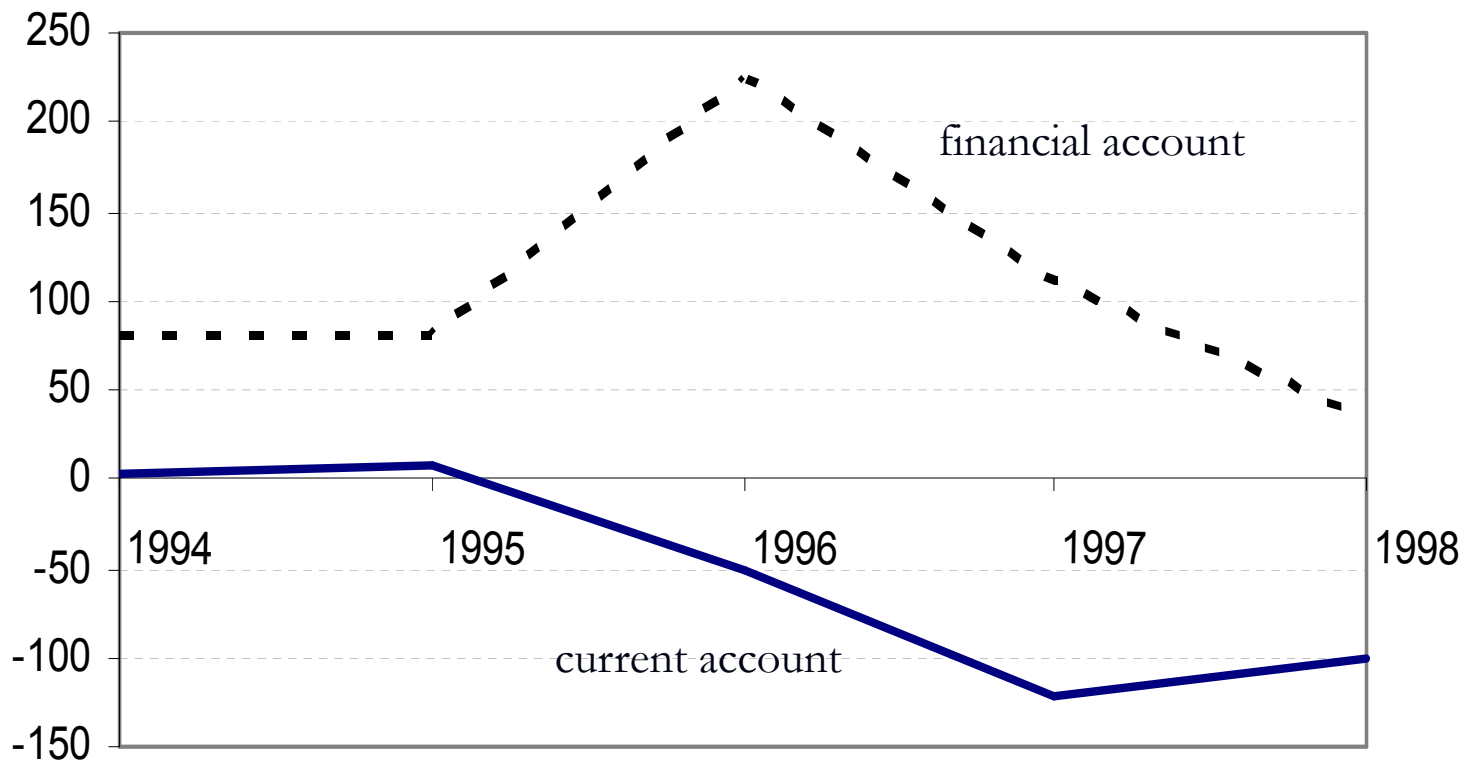
1. Overheating of the Czech economy

→ excessive domestic demand

- 1994-1996 one of the fastest economic growths in Europe
- excessive domestic demand (theory of „transformation wage pillow“)
- insufficient domestic supply
- imports as a natural valve of this imbalance
- huge current account deficits
- pressure on the CZK depreciation

BP development

Balance of payments in the Czech Rep. (billions of CZK)



Source: HOLMAN, R.: Transformace české ekonomiky, CEP 2000.

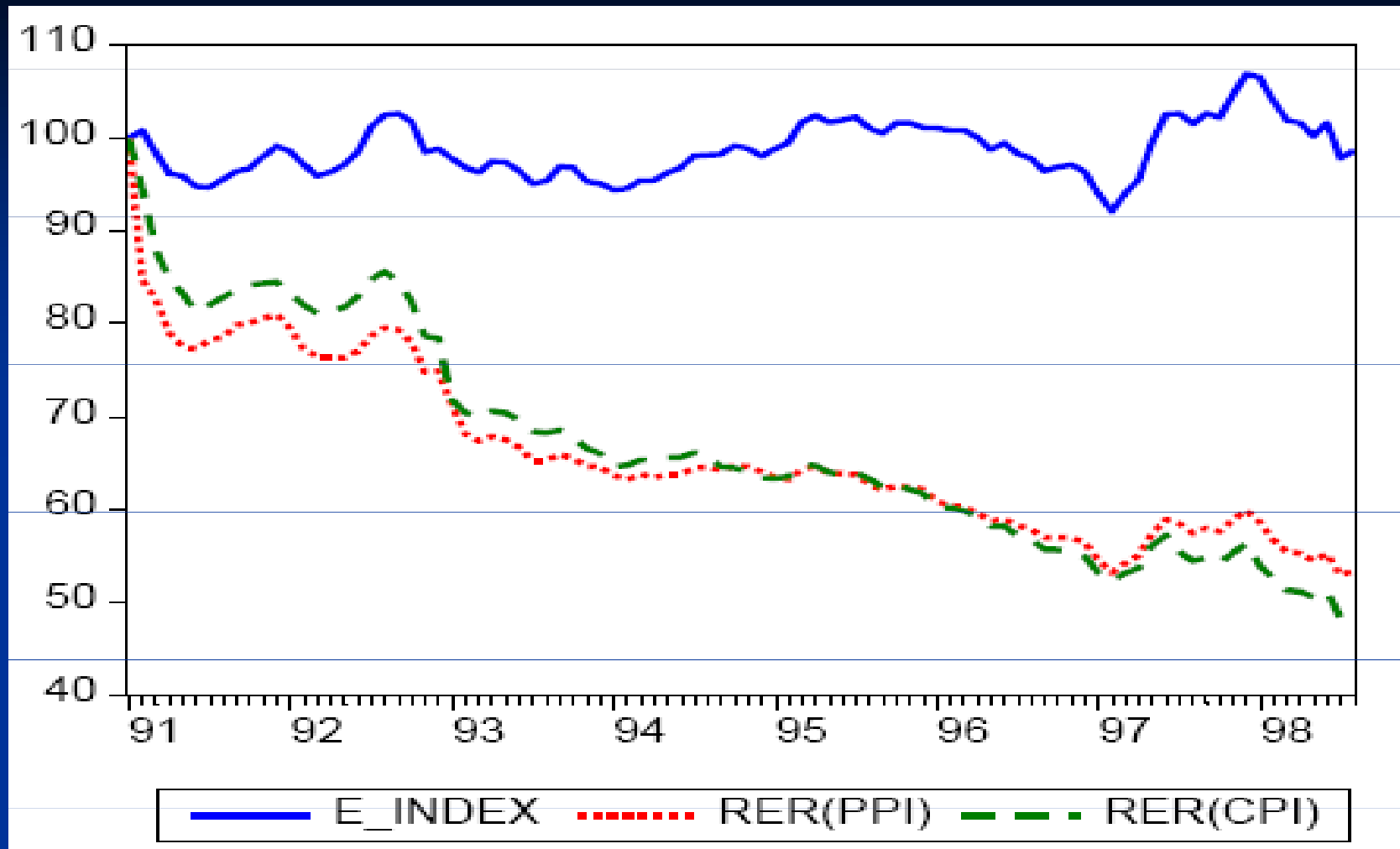
2. Exchange rate regime

- fixed exchange rate regime since the beginning of the transition process
- central parity at 28 CZK/1 USD with $\pm 0,5\%$ fluctuation zone
- undervalued CZK as another „transformation pillow“
- good anti-inflation instrument
- but: real exchange rate problem
- question of „crawling peg“ implementation

Real CZK exchange rate

- $R_{D/F} = E_{D/F} \cdot P_F / P_D$ where:
- $R_{D/F}$...real exchange rate domestic/foreign currency
- $E_{D/F}$...nominal exchange rate domestic/foreign currency
- P_F ...foreign price level, P_D ...domestic price level
- if $R > 1$, domestic goods relatively cheaper \rightarrow to acquire 1 foreign cage of goods you have to offer more than 1 domestic cage of goods
- if $R < 1$, foreign goods relatively cheaper \rightarrow to acquire 1 foreign cage of goods you have to offer less than 1 domestic cage of goods

Real exchange rate CZK/DEM, 1991=100

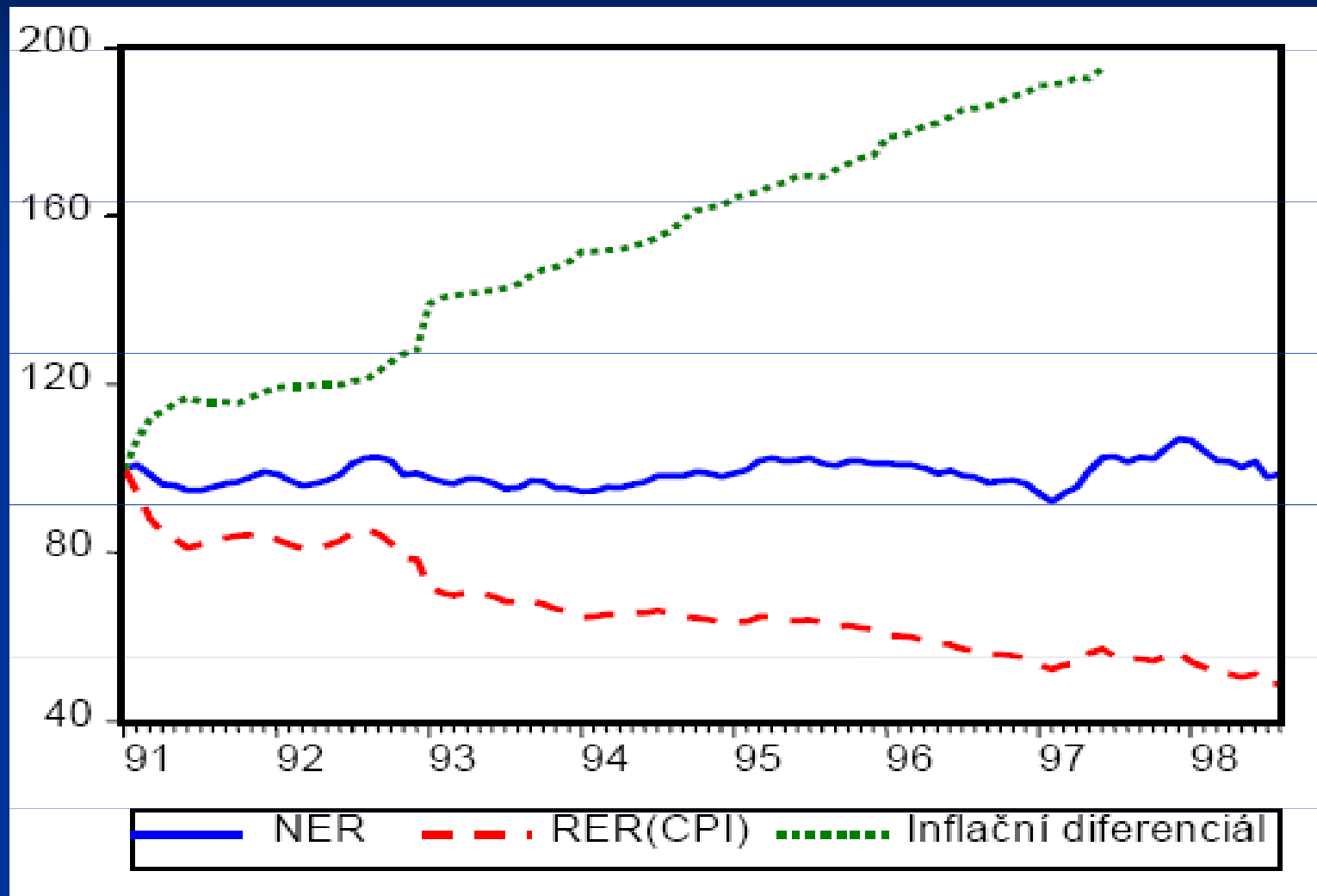


Source: Vencovský, Komárek (1998)

For example: if you got 1 German commodity cage for 500,- CZK in 1991, you could get the same German commodity cage for cca 250,- CZK in 1998 → that's how the real appreciation of CZK worked

Real CZK exchange rate

Exchange rate trends – relation Czech Republic – Germany (1991=100)



Source: Vencovský, Komárek (1998)

3. Influx of short-term foreign capital

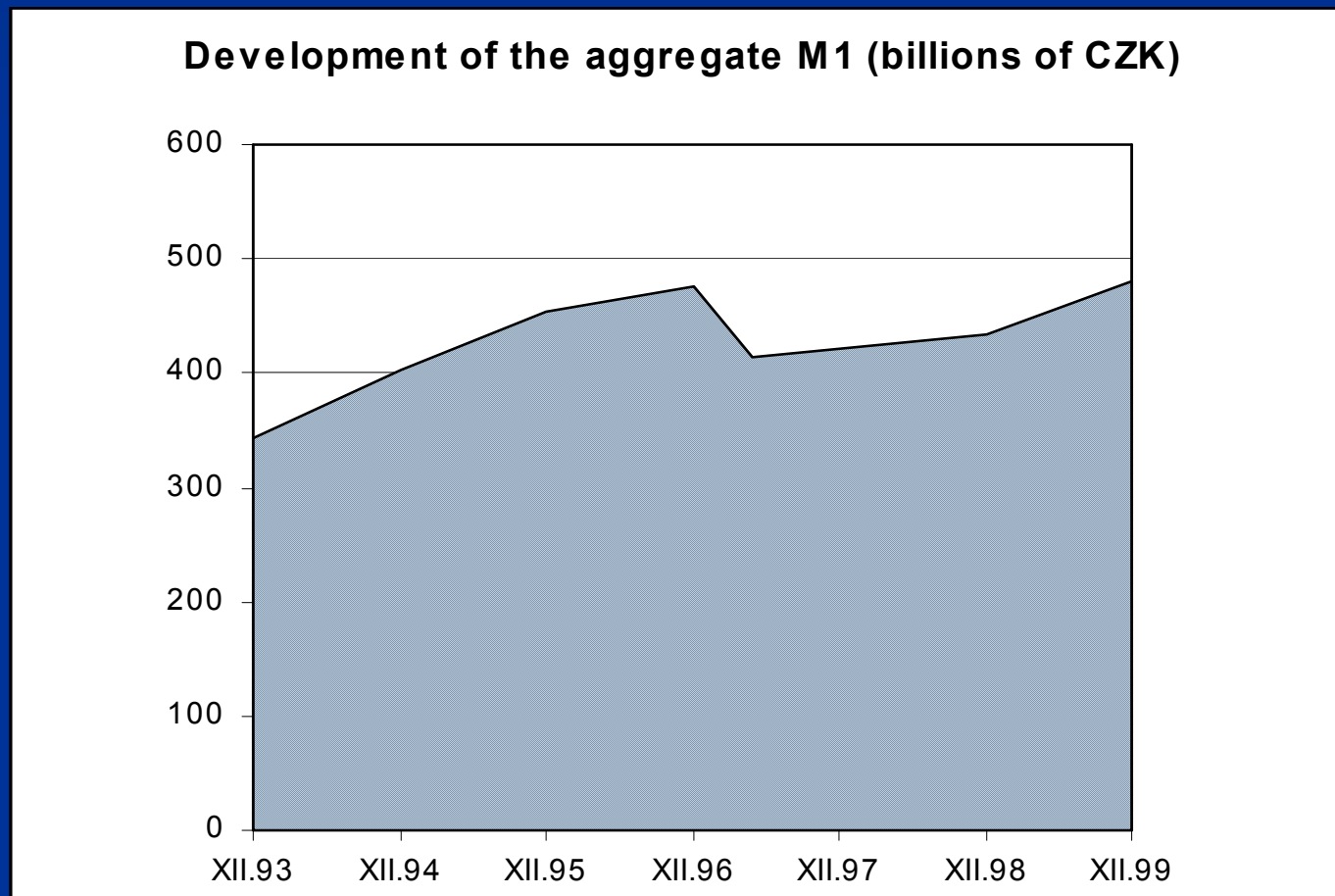
- problem of co-existence of fixed exchange rate regime and liberalized capital flows
- minimal exchange rate risk for foreign capital
- positive interest-rate differential (Czech real interest rates higher than in other transition countries)
- increasing ratio of short-term capital on the financial account
- virtually no problem with current account deficits – CA def. covered by FA surpluses
- but: dangerous structure of BP

4. Monetary policy of Czech National Bank

- restrictive monetary policy in the early 90's – main goal – decrease inflation
- since 1993 – slightly expansionistic – main goal – economic growth
- 1995 – full liberalization of capital flows – since that – increase of short-term capital influx
- February 1996 – widening of fluctuation zone of CZK to $\pm 7,5\%$ - the goal to raise the exchange rate risk
- bond-sales to eliminate the excessive growth of monetary base
- crowding-out effect of bond-sales – another growth of interest rates, and another influx of short-term capital
- in 1996 – the need of restriction – middle 1996 – CNB increased the minimal required reserves rate, and basic interest rates

Monetary policy of Czech National Bank

- 1996 monetary restriction as the brake of economic growth
- slower economic growth – impulse for short-term foreign capital to „cast away“



Source: Centre for Economics and Politics (2000)

Development of the crisis

- wrong prediction of macroeconomic aggregates for 1997
- April 1997 – state budget deficit (the new phenomenon)
- first „parcel of economic measures“ – cut in SB expenditures by cca 25 billion CZK
- inner conflicts in the minority government – political destabilization
- beginning monetary crisis in Southeast Asia

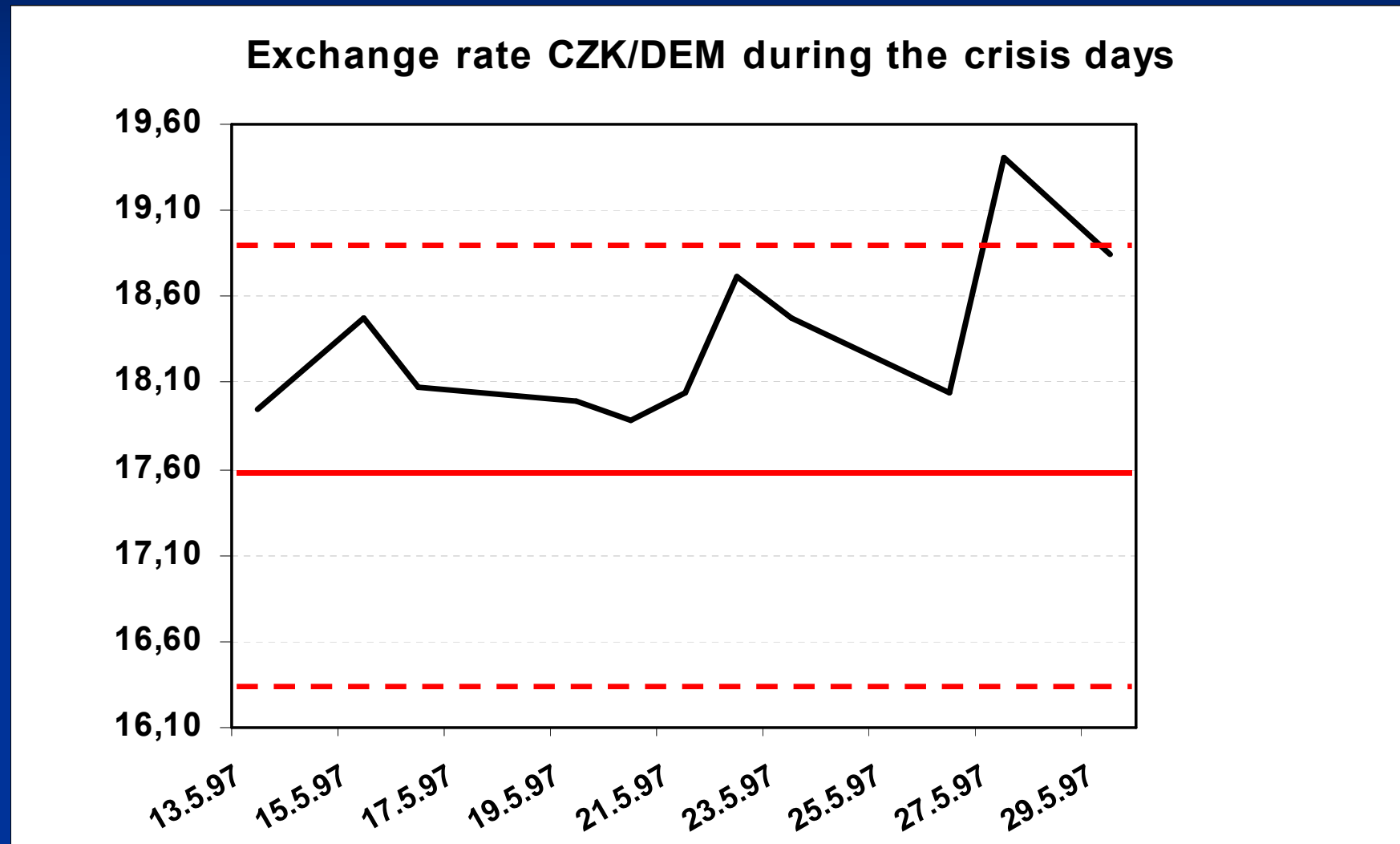
Development of the crisis

- first attack on the CZK: 15th May 1997
- foreign short-term capital started to reflux
- Czech National Bank tried to keep the CZK exchange rate
- unequal „battle“ between the speculates and Czech National Bank

Most important facts of the 2 crisis weeks

| Date | Important facts |
|---------|---|
| 15.5.97 | CZK depreciates by 5 %, first intervention of the central bank |
| 16.5.97 | Pressure on the CZK continues, CNB raises the collateral loan interest rate to 50 % |
| 19.5.97 | Another intervention of CNB, overnight IR rose to 38 % |
| 21.5.97 | CZK under another attack, inter-bank IR rose to 500 % at one moment |
| 22.5.97 | Sharp drop of CZK, CNB disallows foreigners obtaining short-term loans in CZK, firms and people convert deposits to foreign currencies, CNB loses 500 million USD |
| 24.5.97 | Three ministers declare the aim to leave the government |
| 26.5.97 | ER regime changed to “controlled floating”, former fluctuation zone cancelled |
| 27.5.97 | CZK ER overshoots to 19,40/1 DEM |
| 28.5.97 | CZK stabilized, the government introduces a program “the recovery package” of measures, personal changes in the government |
| 29.5.97 | CZK returns to the border of former fluctuation zone, situation calms down |

CZK exchange rate during the crisis



Source: Centre for Economics and Politics (2000)

Main variables before and after the crisis

| | 30.4.1997 | 30.5.1997 |
|---|---|--|
| Overnight interest rate | 10,79 % | 151,88 % |
| Collateral rate | 14 % | 50 % |
| Discount rate | 10,5 % | 13 % |
| Foreign currency reserves of CNB | 11,518 billion USD | 10,025 billion USD |
| Exchange rate CZK/DEM | 17,903 | 19,180 |
| Exchange rate CZK/USD | 31,005 | 32,691 |
| Exchange rate regime | Fixed ER with 15% fluctuation zone | Controlled floating without official fluctuation zone |

Consequences of the crisis

- short-term consequences:
 - personal changes in the minority government
 - governmental breakdown in autumn 1997
 - sharp devaluation of CZK, change of ER regime
- mid-term consequences:
 - premature parliamentary elections in 1998
 - changes in monetary policy
 - economic recession in 1997 and 1998
 - constant unemployment growth since the end of 1997

The two different crisis explanations

- Oldřich Děk – vice governor of CNB
- Václav Klaus – premier in 1997, current president of the Czech Rep.

| Oldřich Děk explanation | Václav Klaus explanation |
|---|---|
| Bad macro- and microeconomic situation | Good situation of the national economy till 1996 |
| No willingness to calm down the economy | Parliamentary elections in 1996 \Rightarrow minority government |
| Expansionistic fiscal policy instead of the restriction | No central bank cooperation |
| No governmental cooperation | Strong monetary restriction in June 1996 |
| Constrained monetary restriction | Insisting on the fixed ER regime |