

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

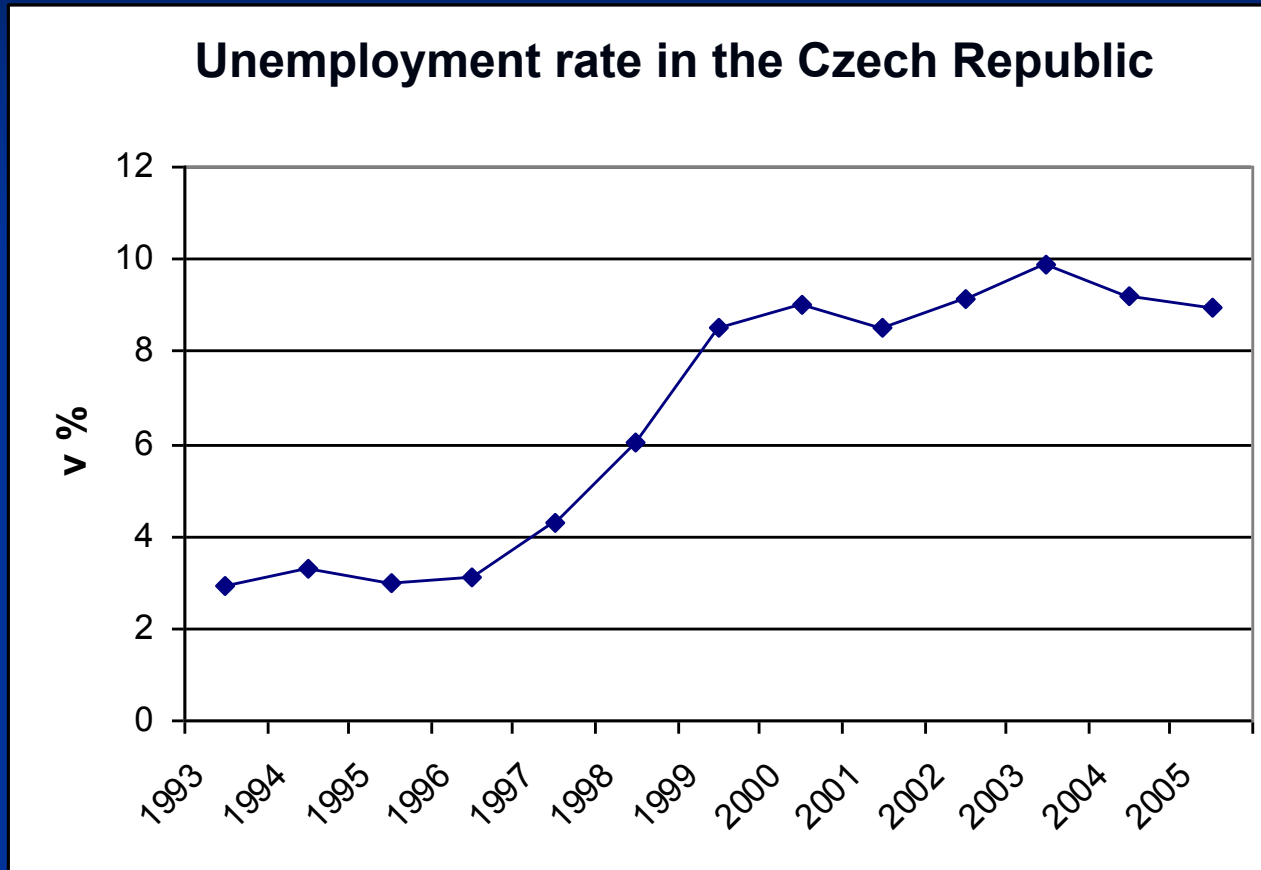
- satisfactory stage of the economic reform
- most basic reform steps were made
- solid economic growth
- low unemployment rate
- good future view of macro aggregates

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?

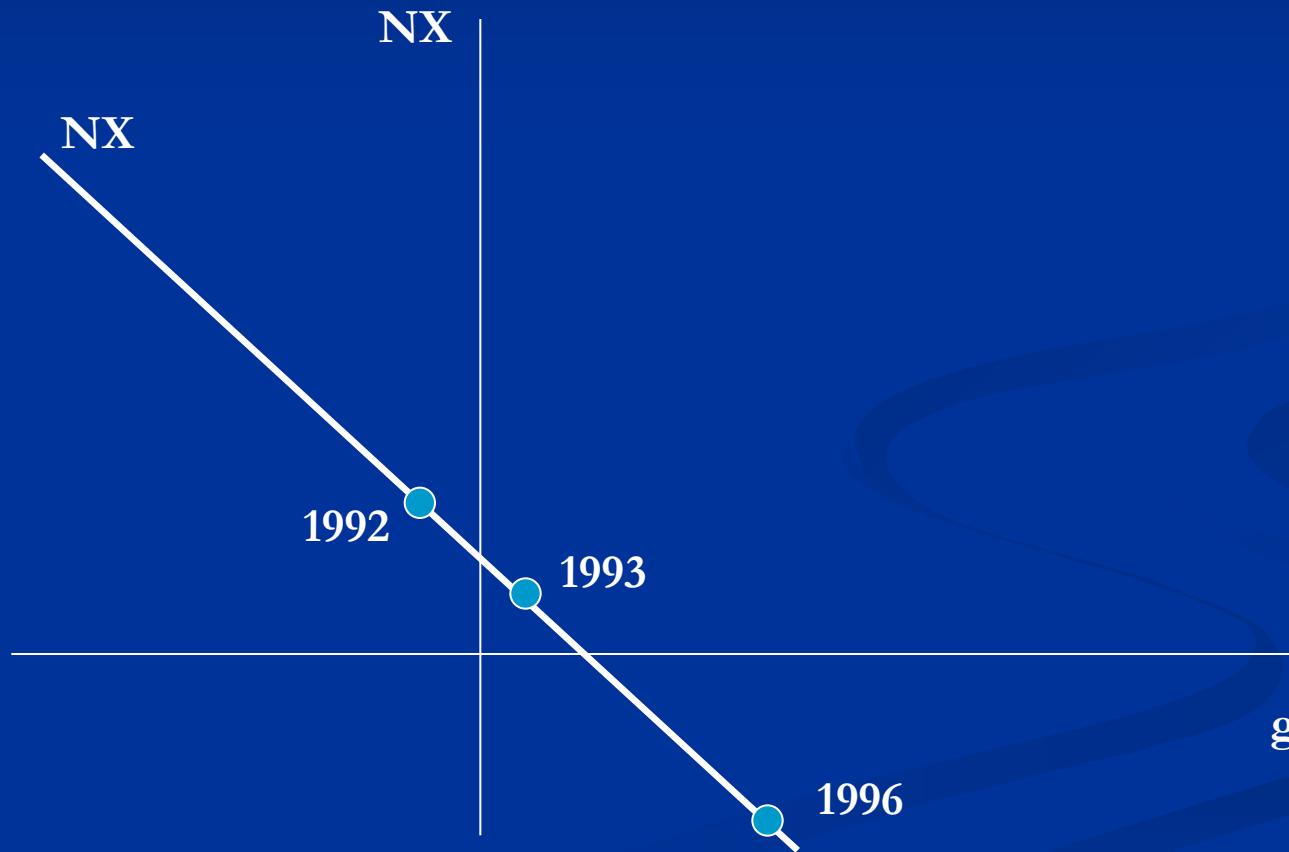
- several causes (factors)
- all of them „worked“ together
- direct relationship between the external imbalance and the Czech koruna exchange rate
- 4 main causes: excessive domestic demand, exchange rate regime, short-term foreign capital influx, monetary policy

1. Overheating of the Czech economy

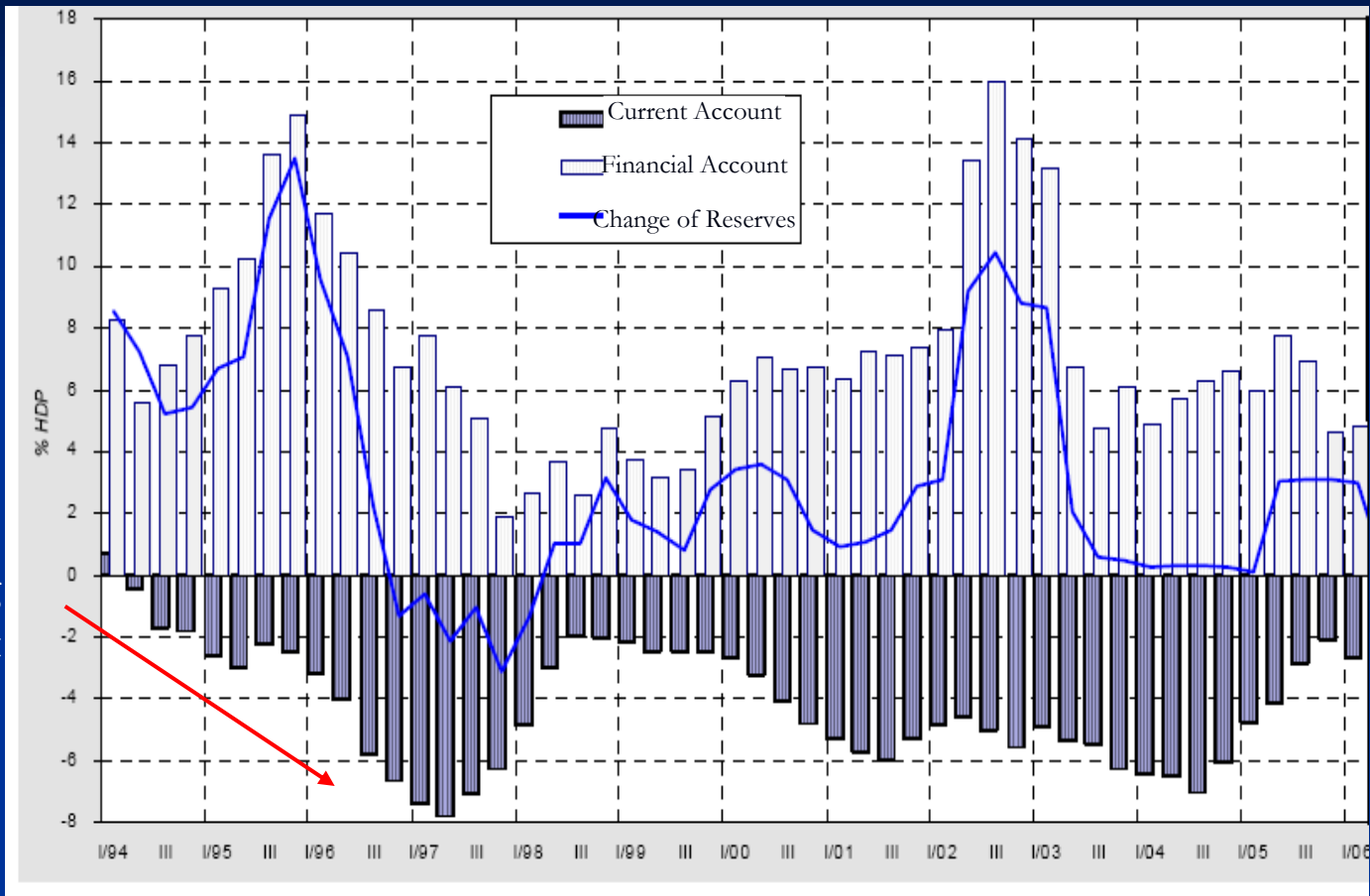
→ excessive domestic demand

- 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

Relationship between GDP growth (g) trade balance (NX)



BP development



Deepening
CA Deficit

Source: Czech Ministry of Finance

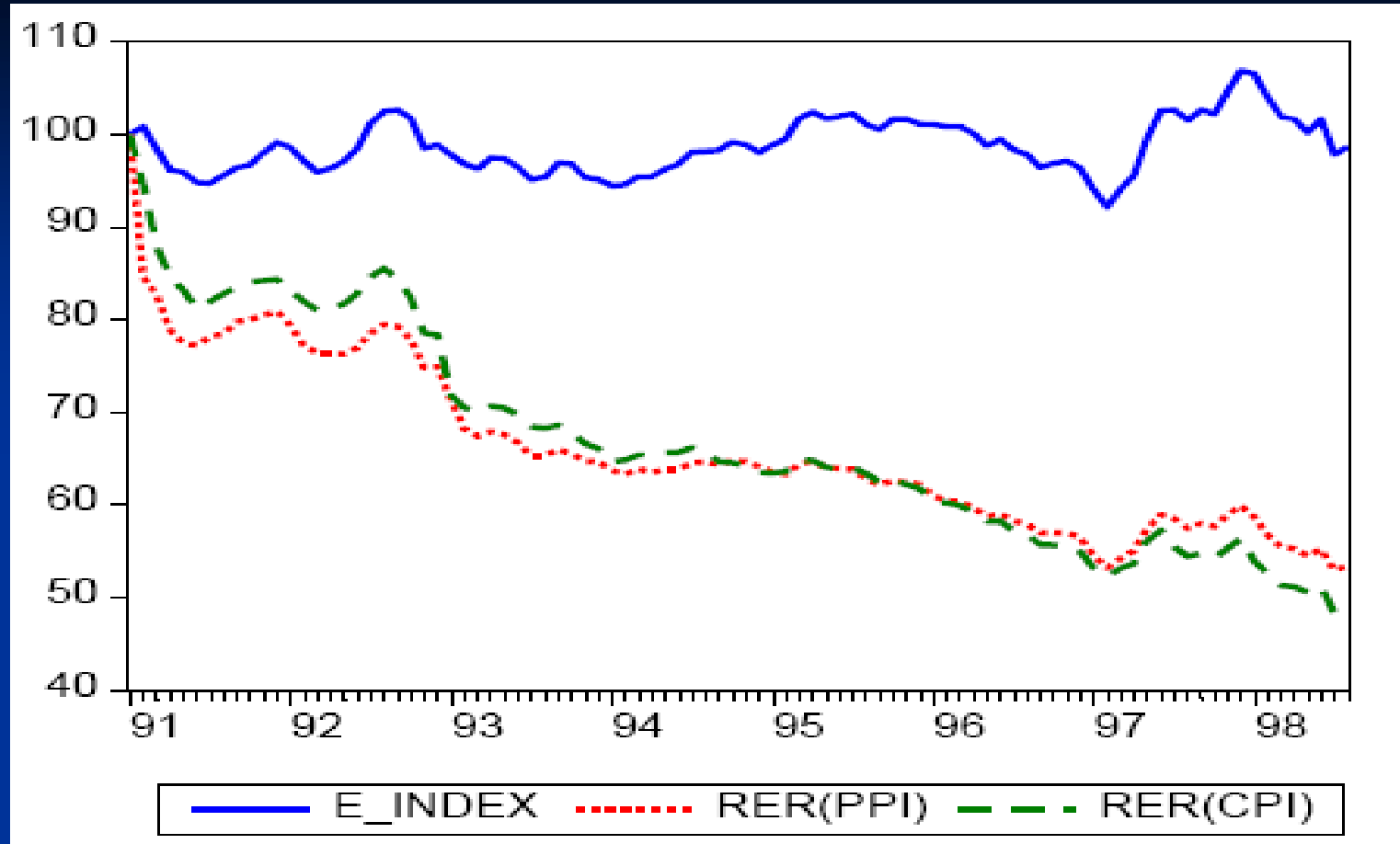
2. Exchange rate regime

- 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

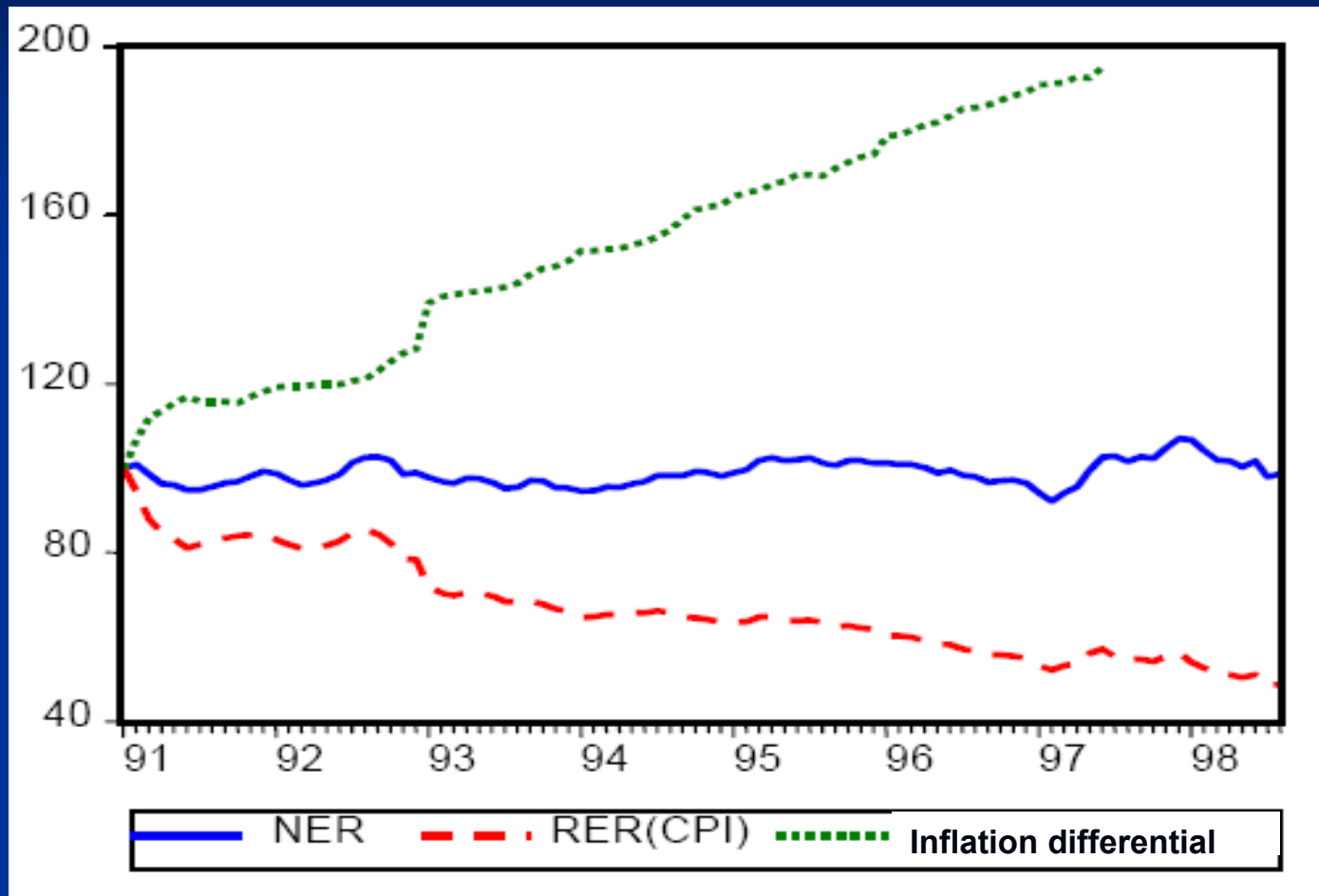


Source: Vencovský, Komárek (1998)

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

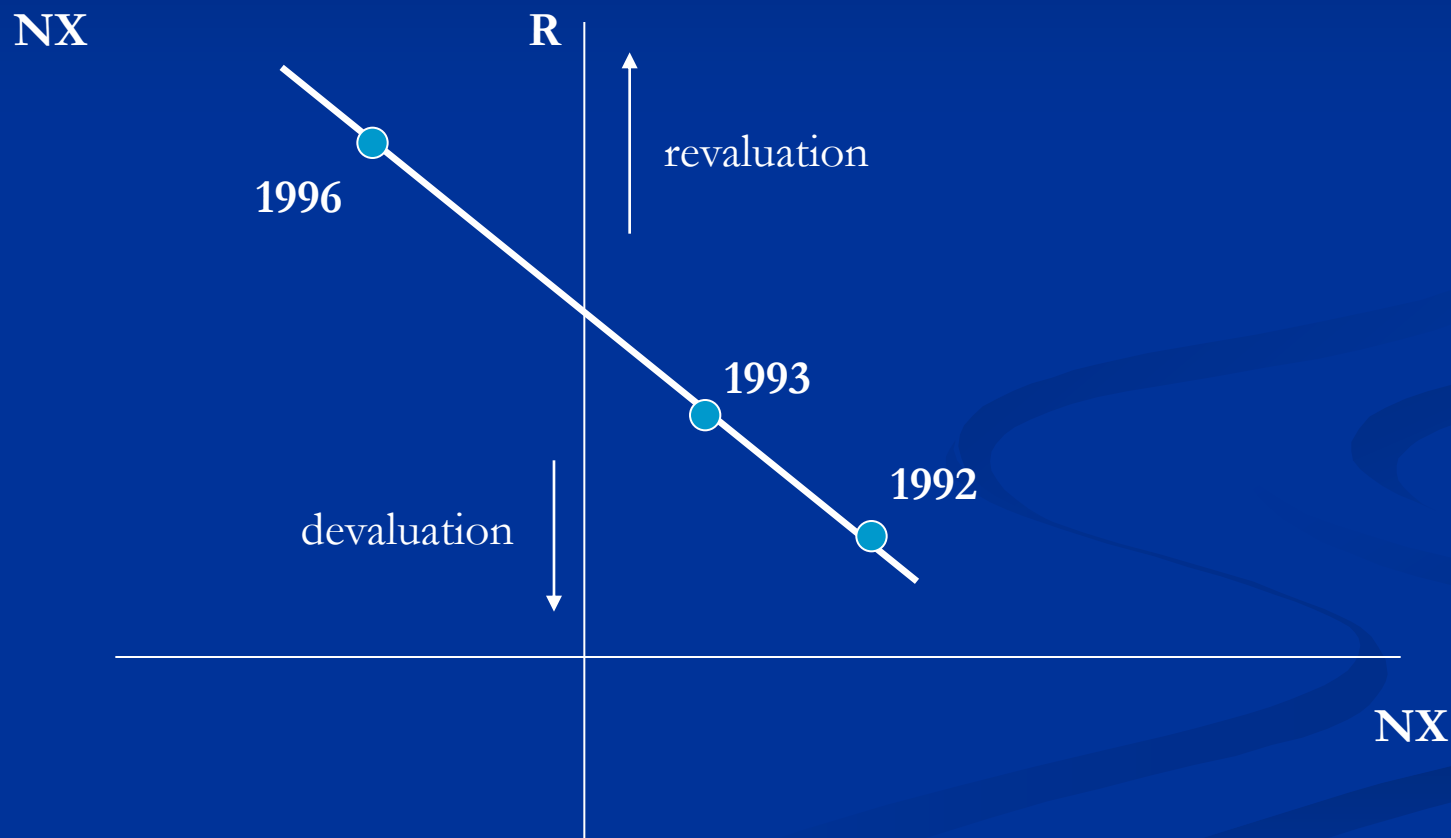
Real CZK exchange rate

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



Source: Vencovský, Komárek (1998)

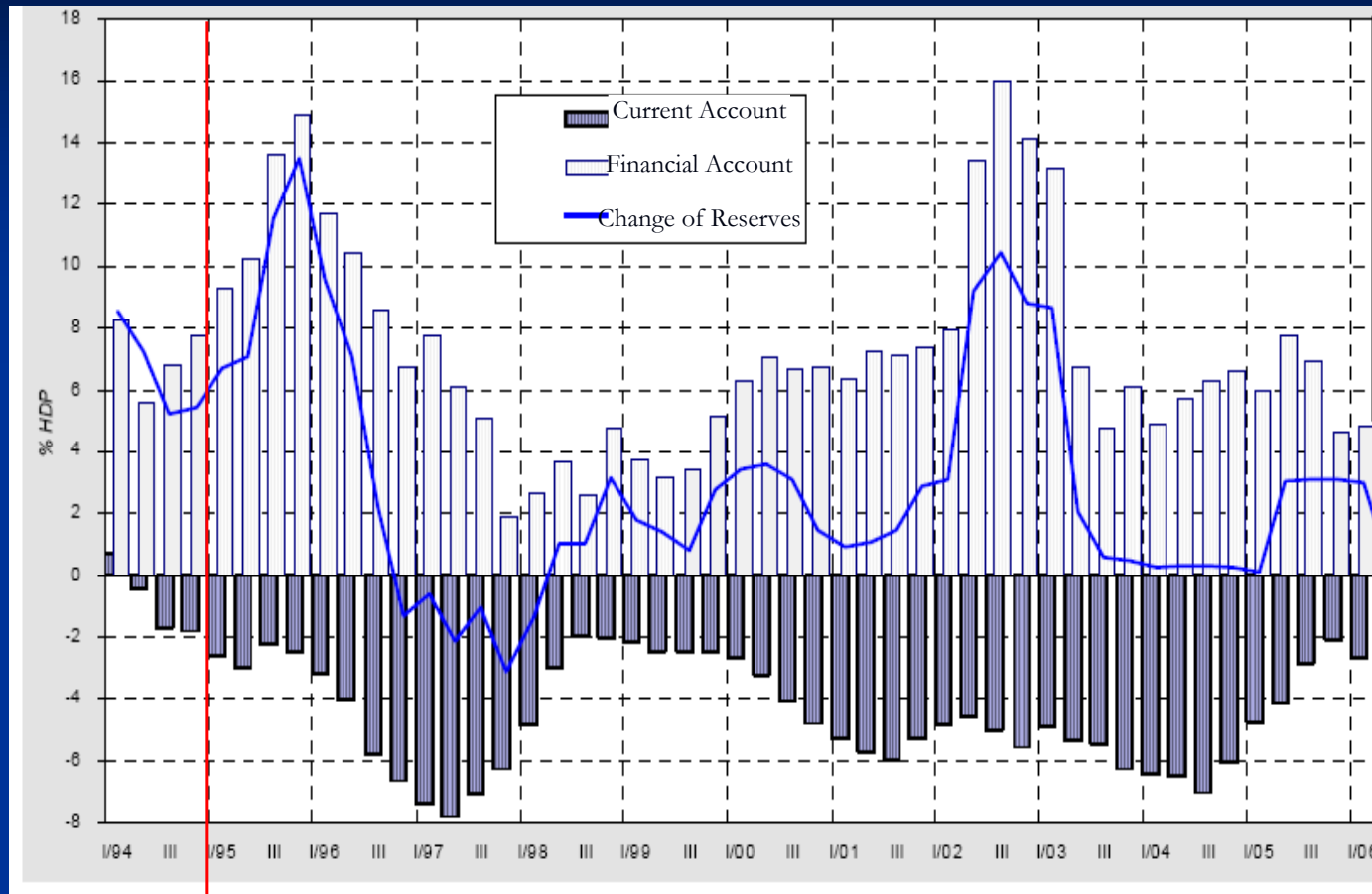
Relationship between real exchange rate (R) and trade balance (NX)



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

BP development



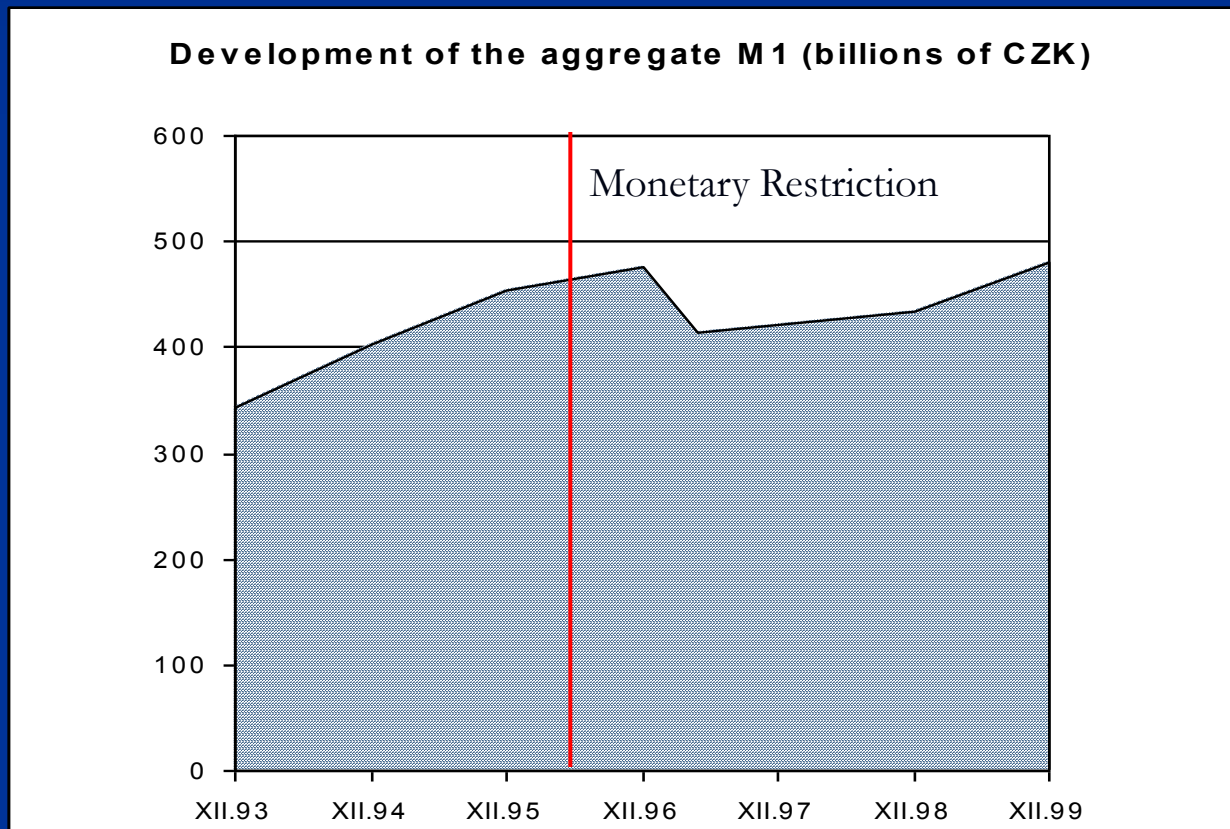
Capital flows
liberalization

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)

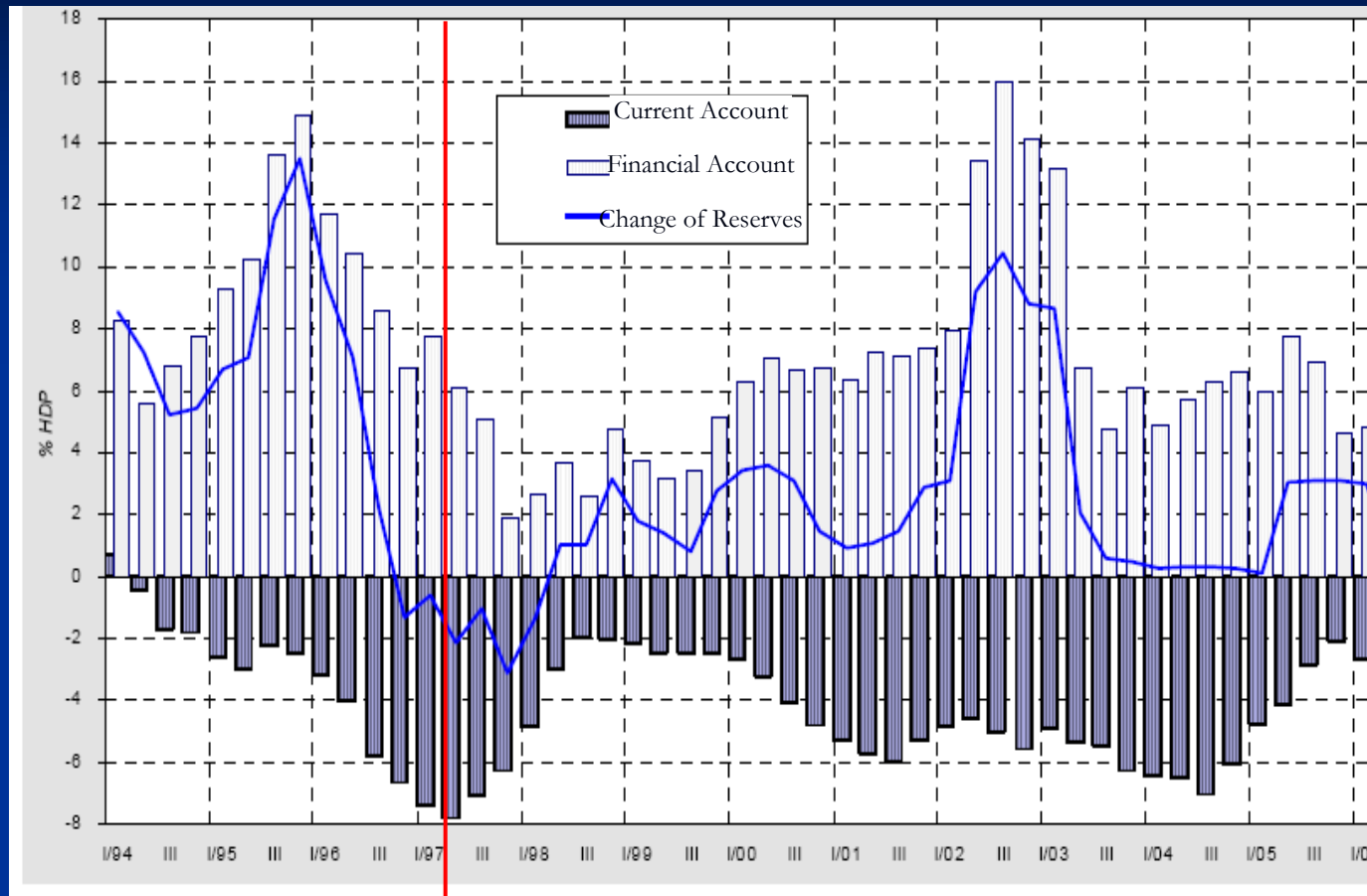
Development of the crisis

- wrong prediction of macroeconomic aggregates for 1997
- April 1997 – state budget deficit (the new phenomenon)
- first „parcel of economic measures“ – cut of SB expenditures by cca 25 billion CZK (cca 5% of total expenditures)
- 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

BP development

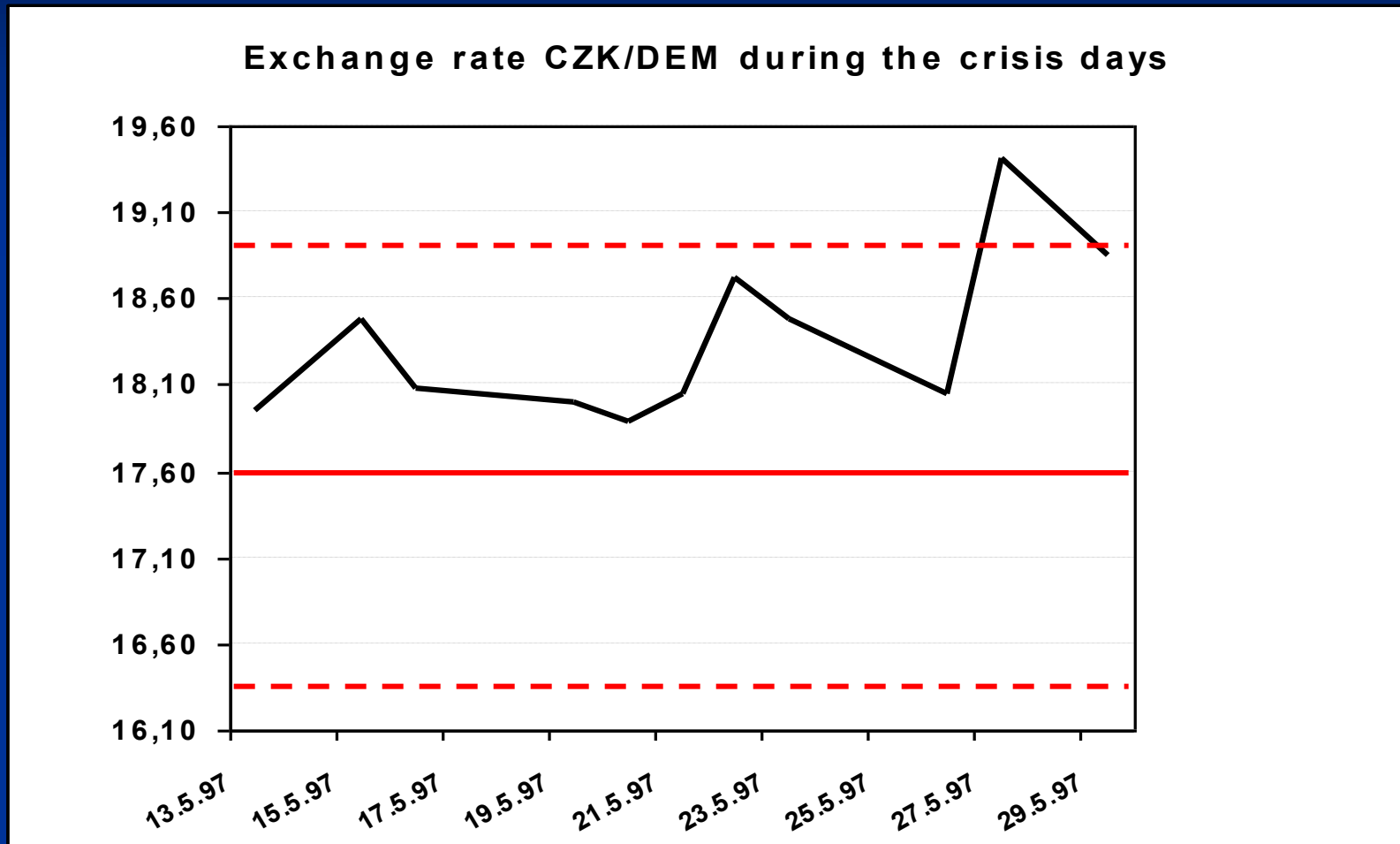


Start of the
Monetary Crisis

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 ⇒ 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