Moderate Inflation and the Problems Connected With It

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President Kraft,
Distinguished Guests,
Ladies and Gentlemen,

I should like to thank the Bank of Estonia for the great honor of being invited to speak at this conference on the occasion of the fifth anniversary of the re-introduction of the Estonian kroon. This is a time for congratulations, to the people of Estonia, to the Estonian Government, and to the Bank of Estonia, on five years of remarkable achievements in transition.

Estonia's economic achievements are many and interrelated: to stabilize output in 1994, and then to begin a process of sustained growth; to reduce inflation to its present level of around 10 percent per annum; to maintain budgetary discipline; to begin the decisive restructuring of the economy; and of course the occasion for this conference -- to maintain the value of the currency and, without any doubts about its continuation, the currency board arrangement.

These are remarkable achievements which as President Meri and President Kraft have both said, have made Estonia one of the leading reformers among the transition countries, a

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[1] First Deputy Managing Director, International Monetary Fund. This is the edited transcript of a presentation made at the conference celebrating the fifth anniversary of the re-introduction of the Estonian kroon, held in Tallinn in June 1997, and hosted by the Bank of Estonia. I am grateful to Owen Evans of the IMF for his assistance.

country whose achievements are widely recognized in Europe and in the international community for the decisive and disciplined way in which it has gone about the transition process.

Many of those who heard about the intention to introduce the currency board in 1992 were doubtful that it could succeed. I personally had long favored the use of the exchange rate as an anchor in reducing high rates of inflation. But it is a long step from maintaining a fixed exchange rate, with the option of changing it, to establishing a currency board with the fixity of the exchange rate which is the fundamental principle of your approach to monetary policy. We knew in 1992 that it could be done but that it requires an exceptionally strong fiscal policy, as well as strong structural policies, to ensure that it can continue. Now as a result in part of what Estonia has done, as a result also of what other countries have achieved under this system, among them Argentina, there is more confidence that a currency board system can bring more rapid stabilization and the continuation of a stable monetary environment than there was in 1992. There is also no question about how demanding this system is and how much has been required to make it succeed.

It is on this basis that the IMF and the rest of the international community congratulates the people, the government, and the central bank of Estonia on the success of the reintroduction of the Estonian kroon and on the maintenance of the rock-like stability of the exchange rate.

Looking ahead, Estonia faces many challenges in seeking to make up for the lost years, and in seeking to attain, eventually, European living standards and full entry into Europe. This includes many structural challenges. We have heard the President of the Estonian Bank, Mr. Kraft, talking about these challenges just now, among them land reform, pension reform, social security reform, the completion of reforms in the industrial system, maintaining Estonia's remarkable record on trade-reform, and continuing to move certain prices to world levels. All these aspects of structural reforms--except perhaps in some aspects of trade reform -- are critical elements of what needs to be done for Estonia to be accepted into Europe.

In addition, there is the challenge of maintaining the macro-economic stability that has been attained in this country since 1992. The challenges of structural and macro-economic reforms are linked because certain elements, particularly the maintenance of balance of payments equilibrium, require both ongoing structural reform and good macro-economic policy.

I shall concentrate on the macro-economic side of the issue. That task can be put very simply. Estonia wants to join the European Union and eventually to join the European Monetary Union, and adopt the Euro as its currency. It needs to get ready. Incidentally, despite all the recent noise and uncertainty, I do not doubt that the Euro will come into existence -- and that at some point thereafter Estonia will want to enter EMU and adopt the Euro. In the meantime Estonia will have to maintain its currency peg against the Deutschemark and then against the Euro. To do that, it will have to get the inflation rate down from the current level of about 10

percent and gradually converge to the European rate of inflation. It will have to do that while maintaining the competitiveness of the Estonian economy.

Earlier, President Kraft gave a list of eight requirements for a competitive economy. We can summarize the essence of these conditions as being that the rate of productivity growth in Estonia should match the rate of wage growth, so that the inflationary impulses that would come from excessive rates of cost increase are absent.

Now, how can the inflation rate be brought down to European levels? That is, of course, a very difficult task, and one might think it impossibly difficult, except that during the past five years Estonia has gone from triple digit inflation to practically single digit inflation and thus is almost there. Now Estonia is dealing with a problem that many other economies have also faced, the problem of so-called moderate inflation by which is meant inflation in the low double digits up to about 30 percent. This problem has been experienced in many Latin American countries, now in many transition economies, in some countries in Africa, and also in Israel, sometimes over a very long period of time.

In the remainder of my presentation on moderate inflation, I draw on a paper, called "Ending Moderate Inflation", co-authored with my IMF colleague, David Burton.

The question we examine in the paper is how countries have reduced inflation from moderate rates to the single digits and eventually to the low rates of around 2-4 percent that we

observe now in Europe and in most advanced economies. We define moderate inflation rates as being in the range of 15 - 30 percent, and say that a country has moderate inflation if it finds itself within that range for at least three years. Actually, Estonia did not stay in that range for three years. So, strictly speaking, you did not quite qualify as a moderate inflation country by this definition.

The first question we examine is what does theory say about how to get out of these inflations? In talking about the theory, I shall also apply the lessons to Estonia. There are some preliminary requirements. The first is that the underlying policies in the economy have to be consistent with low inflation. That sounds very simple and straightforward but it is not. It means in particular that fiscal policy has to be such that the country does not need to rely on revenue from inflation to balance the budget. Estonia does not rely on this mechanism but many other countries do. In this connection, there are many countries which do not explicitly obtain revenue from inflation, in that they do not rely on seignorage to balance the budget. Nonetheless, there may be fiscal factors behind inflation, stemming from so-called quasi-fiscal deficits. For instance, in some countries the government provides credit on favorable terms to particular sectors of the economy, through a development bank or some other quasi-governmental institution.

In addition, in some countries, for instance in Latin America, the financial sector profits from inflation. The banking sector finds itself doing well when the inflation rate is high. To stop inflation, the government will have to fight against the interest groups that benefit from the

continuation of inflation. It has to make sure that the interests of the average consumer are taken into account, not just those who benefit from the continuation of inflation.

What else needs to be done? The need is to create a culture of stability, a culture that will lead to the belief on the part of economic agents in the country that inflation will not be tolerated. This generally requires institutional measures, in the first instance by making the central bank independent and giving it the task of maintaining the value of the currency, that is of preventing inflation. Central bank independence can be legislated but does not exist in a vacuum. Some legally independent central banks do not act independently and continue to succumb to political pressures. Beyond legislation, the political system has to support the central bank's legal independence and not seek to undermine it. That, I believe, is an important part of what has been achieved in this country. Listening to President Meri, it was clear that at the highest levels in Estonia there is full acceptance of the importance of maintaining the stability of the currency.

Often countries that are reducing moderate inflation experience the so-called capital inflows problem. A country which is stabilizing often has to hold interest rates high to try to force inflation down; at the same time many stabilizing countries will fix the exchange rate or limit its flexibility in an attempt tofurther stabilize prices. This combination of high interest rates and a fixed exchange rate presents incentives for large capital inflows. These inflows can have major macroeconomic effects including the widening of the current account deficit.

When faced by capital inflows, the first task is to analyze the source and composition of the flows carefully. If the inflows take the form predominantly of foreign direct investment (FDI), there is less to worry about. Long term investment inflows normally should not reverse quickly and thus should not create major vulnerabilities. Rather, they should add to productive capacity and generate an income flow, part of which can be used to meet the associated stream of payments (interest and dividends) needed to service the debt.

But if the capital inflows are short-term, then there may be a problem. At some point opinions could change and the inflows could reverse. We have seen that recently in Eastern Europe and Southeast Asia. The question is how to minimize vulnerability to a reversal of short-term inflows in a country with a fixed exchange rate and reasonably high interest rates.

The first requirement is to make sure that domestic financial institutions have the capacity to deal with these flows. That means capital adequacy ratios in excess of the Basle standard. Higher reserve requirements, a change made in Estonia recently, can also be an important step. Equally important is the need for a strong supervisory system over banks and other financial institutions to make sure that they are not using short term inflows to finance long term or illiquid investments.

And in the short run, it is often necessary to tighten fiscal policy in this situation. By tightening fiscal policy a country can expect to reduce the current account deficit by raising the national rate of saving. A current account deficit indicates that a country is saving less

than it is investing and the best way we know of increasing national saving is to boost government saving, via fiscal policy. As an aside, let me briefly discuss the Maastricht criteria. These criteria play a very major role in Europe in encouraging fiscal discipline, through the requirement that the government deficit (appropriately defined) should not exceed 3 percent of GDP. But these criteria have the disadvantage of encouraging the belief that a deficit of 3 percent indicates no need for further fiscal adjustment, irrespective of the economic situation. But there are countries for which a 3 percent of GDP deficit is much too large and, indeed, in many countries, a surplus may be called for.

Another important part of the policy response to capital inflows may be sterilization of inflows. That is, the central bank would buy the foreign exchange and then sell government bonds to offset the impact of the foreign exchange on the money supply. This approach is however not consistent with the strict rules of a currency board, and so is less likely to be useful in the case of Estonia.

There is also the question of relative price adjustments. Typically an increase in a relative price takes the form of an absolute price increase. For instance, if the price of energy has to rise by 50 percent to get to world levels, the inflation rate is likely to go up. Now, in principle, it is possible that when one relative price rises, some other prices will go down, so that the inflation rate is unaffected, but in most economies events do not unfold that way. Typically large increases in key relative prices boost the inflation rate. Thus getting moderate

inflation down is difficult in circumstances where relative price adjustments have to be made. And that has certainly been the case in Estonia and other transition economies.

So far, I have dealt with the basic issues that need to be addressed in getting moderate inflation down. The key points are that underlying policies have to be consistent with a low inflation equilibrium; credible institutions are vital and the belief that inflation will not be tolerated needs to be established and reinforced; fiscal policy needs to be consistent with zero seignorage; wages and other costs must rise in line with productivity, the capital inflows problem may have to be dealt with; and necessary relative price adjustments need to have been undertaken.

Now, in the paper with David Burton, we applied this framework to 20 countries, divided into four groups of five countries each. The group of countries that ended moderate inflation comprised Chile, Egypt, Iceland, Kenya, and Paraguay. The group of countries in which moderate inflation continued was made up of Colombia, Costa Rica, Ecuador, Israel and Mexico. The group of moderate inflation transition economies covered Estonia, Hungary, Latvia, Moldova and Poland. And, finally, there is an interesting group of countries which, in the 1990s, succeeded in stabilizing from high inflation right down to single digit inflation rates, without an intervening episode of moderate inflation. These include Argentina, Brazil, Croatia, Peru and Slovenia.

The first and most important conclusion we draw from studying these cases is that moderate inflation can be beaten. However, there is no single formula for doing this. It has been done by countries with fixed exchange rates, by countries with floating exchange rates, and even by countries which tried to operate with a fixed real exchange rate -- the case of Chile.

I would like to briefly explain how Chile was able to reduce inflation while following a real exchange rate rule. Chile has brought inflation down from hyperinflation to 5 ½ percent last year without fixing the nominal exchange rate and without an obvious nominal anchor. It did this by having a nominal magnitude firmly in mind in the running of policy. Chile targeted the inflation rate and was able to keep its real exchange rate broadly constant through a very active and powerful fiscal policy. So, if a country is willing to use fiscal policy to regulate the economy, to run a budget surplus if necessary and take fiscal measures if needed -- and to do all this very actively, including twice a year adjustments in fiscal policy -- then even an approach to disinflation involving a basically fixed real exchange rate seems feasible.

Nevertheless, most of the countries that have succeeded in stabilizing inflation have used a nominal exchange rate anchor. Only a few, such as Estonia and Argentina, have adopted the strongest version of the exchange rate anchor approach which is the currency board.

A second result is that a strong fiscal position is critical. In every case in which a country succeeded in reducing inflation to single digit levels, it tightened fiscal policy. And in countries that have not yet succeeded in reaching single digit inflation, such as Colombia and

Israel, the record shows that when inflation came down, a lack of sufficient fiscal discipline let it creep back up again.

A third conclusion. Often there are only uncomfortable policy choices. If the capital inflows problem develops, the preferred response is fiscal tightening. If that cannot be done, then a combination of measures will need to be undertaken. You may allow the exchange rate to appreciate or undertake sterilized intervention, for example. But each of those measures in turn has its problems.

A fourth conclusion. Many countries took advantage of favorable opportunities, such as a drop in the price of oil or the price of some other imported input. Countries that succeeded in achieving single digit inflation used the opportunities that came along to ratchet inflation down.

A fifth conclusion. Policy-makers need to avoid a significant overvaluation of the currency. In several cases of exchange rate based stabilization, including Mexico, an emerging overvaluation led to a breakdown of the stabilization process. Avoiding this risk means watching the size and the financing of the current account deficit closely and adjusting policy -- including fiscal policy -- should the deficit become too large.

Sixth conclusion. Relative price adjustment has been central to the inflation process in transition economies. Our conclusion is that those countries which pushed these adjustments

through quickly, allowing key prices to move to world market levels early in the transition process, were able to deal with inflation more successfully than others.

The last conclusion--but a very important one. We do not see any impact on growth from these inflation stabilization experiences. Theory generally indicates that bringing inflation down will adversely affect growth. But in our regression analysis, we did not see that connection. So it seems that the fear that bringing down moderate inflation has to entail a loss of output or slower growth in the process may not be well founded. Now, of course, there may be a tradeoff at low inflation rate -- in the single digits. But at higher rates of inflation, a tradeoff does not show up in our study and other regression based studies which have been undertaken.

Let me conclude by briefly summarizing the policy lessons that seem to emerge for Estonia.

- First, the maintenance of a macro-economic situation consistent with low inflation is critical. On the fiscal side, this could even mean the need for fiscal surpluses.

- Second, the nature of capital inflows needs to be watched closely. The financial system has to be strong enough to deal with them. To the extent that these inflows are long term, they should not be a great worry. To the extent that they are short term, attention should be paid to them and efforts made to adjust fiscal policy so as to reduce the current account deficit.

- Third, a critical element in transition economies such as Estonia concerns relative price changes. Major price changes associated with the structure of reforms in the industrial sector and in the energy sector should take place as quickly as possible, if the inflation rate is to come down rapidly towards European levels.

Thank you.