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The Exchange Rate Regime and Economic Recovery

Introduction

In 1992, the key issues facing Czechoslovakia[1], as well as some of the other transition economies in Central Europe, was the **initiation of economic recovery**. Given the degree of openness to the outside world already achieved and the perceived desire to continue this process, any recovery of domestic activity can be made sustainable only if **the growth of export potential matches the increase in imports over the mediumterm.**

In this context, the paper examines the role of the exchange rate and the choice of exchange rate regime.

1 Exchange rate options

Despite significant progress towards a market economy framework accomplished within a relatively short time span, the transition economies of Central Europe are still far from being homogeneous enough to react sensitively to developments in prices and foreign exchange rates. It is therefore claimed that the exchange rate and the exchange rate regime must be of less significance than for market economies. "In the dislocated economies of Eastern Europe, the exchange rate is far from the pervasive price that it is thought to be in the West.... In other words, the exchange rate can hardly be relied upon to anchor an economy in which competition is limited, marketing nonexistent and communications appalling." (Fry, 1992).

On the other hand, however, merely the transition itself makes the present stage of specific importance: **the "code of behaviour" of newly created and restructured agents, including private and privatised firms, trade unions, and government authorities is being forged and "built in".** Alternative exchange rate regimes obviously differ in terms of requirements and signals sent to economic agents. And given that Czechoslovakia is a small economy increasingly open to the outside world, the current exchange rate regime is likely to be a factor determining **the expectations and behaviour of economic agents, at least in the medium term.**

[1] At the beginning of 1993, Czechoslovakia was divided into two separate entities, the Czech and Slovak republics. This paper, which was written in the autumn of 1992 and refers to then Czechoslovakia, addresses issues relevant to both the newly created national states.

1.1 Changing approaches in the postwar world economy

Neither the experience from the development of market economies nor the theory on optimal exchange rate systems can suggest an unambiguous answer to what would be the appropriate exchange rate regime for the transition economies. However, both experience from elsewhere and theoretical writings on exchange rate systems, particularly those based on the "optimal currency area" argument (Mundell, 1961; McKinnon, 1964), do provide useful guidance and lessons.

Since World War Two, economic development have been dominated quite different exchange rate systems: successive stages of the world, the adjustable peg system of the Bretton Woods' framework, implying relatively firmly fixed rates (except for the case of fundamental disequilibrium; Nurkse, 1945), was replaced by mostly floating rates for major currencies in the 1970s. The 1980s saw a resurgence of interest in fixed exchange rate options and in international policy coordination, with special emphasis on the role of fixed exchange rates in the disinflation process. **The disciplining** effects of fixed rates, together with the concepts of **credibility and reputation**, came to the fore with the revival of the ERM and EMS, and with the plans for EMU and a single common European currency in particular.

The different stages mentioned above and the regimes associated with them have often been evaluated by observers in a diametric fashion way: some argue that the Bretton Woods' system functioned quite satisfactorily for a period; others, by contrast stress that it was doomed to collapse. Freely floating rates provided a solution at the time, but they accentuated, undesirable volatility and misalignments in the foreign exchange sphere and, consequently in the entire world economy. In a sense this regime failed in the same way as the Bretton Woods' arrangement. Quite recently the controversial aspects of the ERM and EMS have become hot political and economic issues.

The experience gained from a particular type of exchange rate arrangement also differs widely across individual countries. For example in the case of currency pegs, which is the arrangement relevant to small transition economies, Austria was quite successful in pegging its currency to a basket and later to the deutschmark for two decades (Hochreiter and Knöbl, 1991), whereas the experience of other economies was considerably less satisfactory. Finland, for example was forced to abandon the peg times for an indefinite period in 1992 (Leppänen, 1992).

Summarizing the experience from the postwar developments in the world economy, two alternative strategies for exchange rate policy can be distinguished:

(a) External balance and the employment-oriented concept of the exchange rate

In this case the exchange rate is assigned the role of an instrument securing the competitiveness of domestic industries on the world markets, the aim being to maintain both employment and external balance in the national economy. Its level is adjusted accordingly, either through floating or by discrete changes. This concept of exchange rate policy reflects the "conventional wisdom", which traditionally associates preservation of competitiveness with adjustments of the

exchange rate itself, i.e. as a rule through (competitive) depreciation of the domestic currency.

(b) The stability-oriented concept of the exchange rate

In this approach the exchange rate is expected to be an instrument contributing primarily towards stability and low inflation in the domestic sector, and only via this also to external balance. This option, a "hard currency policy", implies a fixed exchange rate pegged to a stable currency. The disciplining and credibility effects of this type of foreign exchange rate regime, i.e. of a nominal anchor, should provide a basis for maintaining its competitive level vis-á-vis other countries.

The alternative regimes identified above differ in their priorities and aims and, consequently, in their impact on the behaviour and expectations of economic agents.

1.2 Arguments in the choice of exchange rate regime

Though the literature on optimum currency areas cannot give any definite answer as regards the exact type of exchange rate regime that should be applied (e.g. Wihlborg and Willett, 1992), it does provide a number of relevant arguments and guidance for the discussion of the issue.

It suggests that there is always a **trade-off between the macroeconomic advantages of flexible exchange rates and the microeconomic advantages of fixed rates.** The relative costs and benefits of fixed versus flexible exchange rates vary across countries, depending on their size, structural and institutional characteristics, the nature and source of shocks they face, their objectives and current economic situation. Other dimensions given, the case for a fixed exchange rate regime in a transition economy is evidently much stronger for a smaller country with a higher share of export and import flows in its economic activity. (In an extreme case, with only a few non-traded goods and services, the impact of exchange rate changes would be more or less confined to the changes in the domestic price level).

1.3 The case for "simple rules" or a "managed" type of exchange rates

The "simple rule" alternative comprises two extreme options: a freely floating rate or a firmly fixed rate. This does not, however, appear to be a viable solution. In contemporary economies divergent objectives are as a rule aimed at, which different weights attached to them across countries and periods. Moreover, various shocks, external as well as domestic, have to be coped with.

Experience also suggests that exchange rates tend to be mostly managed in the present world economy. After the collapse of the gold standard there were only a few cases of entirely fixed rates in the long run; free floating was also mostly confined to several episodes.

In the conditions of transition economies

(a) the free floating option

has sometimes been suggested as a reasonable approach to establishing a proper initial value for the currency after the breakdown of the former centrally planned economy framework.

There are, however, severe constraints on its potential value in the environment of the transition economies: rather thin currency markets, underdeveloped institutions, as well as lack of forward foreign exchange markets and of short-term "arbitrage" and speculative capital flows which could under certain conditions work towards stabilizing the exchange rate (Williamson, 1991).

Consequently, the extent of misalignments and exchange rate volatility would evidently be much greater than in consolidated market economies of a similar type. And even in those stabilized economies the experience with free floating has not been particulary encouraging. This type of solution therefore seems **unsuited for the environment and objectives aimed at in Czechoslovakia;**

(b) irrevocably fixed exchange rates

The comparison with developed open market economies seems again to suggest non-viability of this solution for transition economies. Given the profound changes – including institutional – uncertainties and shocks involved in the transition process, it appears **unrealistic to attempt to fix an "equilibrium rate" for the long term.** Moreover, apart from the question as to what level to initially set the exchange rate, even greater problems appear to be involved in making the adopted rate **reasonably sustainable in the long run,** without inflicting unbearable costs on the economy.

Consequently it follows that **neither free floating nor irrevocably fixed rate options seem to be realistic for transition economies,** however attractive the simple rule approach might be given the many complexities involved in the transition. Some type of compromise "managed" solution, involving more or less of discretion, therefore appears to be appropriate.

1.4 The "managed" option as applied in transition economies

In Czechoslovakia, a version of the adjustable peg system seems to have been applied. While maintaining a fixed parity with respect to the basket, the authorities have made no commitments as to its duration, thus not excluding its possible adjustment.

In Hungary, a broadly similar arrangement has been adopted. The discrete adjustments made in the forint's exchange rate have aimed at keeping the real rate more or less stable.

By contrast in the Polish case, a crawling peg system was adopted in 1992 to cope with the inflation differential.

A crawling peg implies that the exchange rate is adjusted by small changes at regular intervals (daily, weekly or monthly); in the case of Polish zloty the daily base was chosen.

The apparent advantage of such an arrangement is that it seeks to avoid abrupt changes in the real exchange rate, which certainly has some merits in the still relatively inflationary Polish economy. On the other hand, there is an implied danger of embedded inflationary expectations. The crawling peg arrangement may then turn out to be an additional source of the inflation differential rather than a way of coping with it.

Though operating in a different way, the "managed" exchange rate alternatives in Hungary and Poland have recently tended to adjust by and large to differences in relative price performance vis-à-vis their partners. The policy has thus – at least to some extent – been developing towards **the real exchange rate anchor concept** suggested for transition economies by Nuti (1991) and Fry and Nuti (1992).

The concept of the real exchange rate anchor certainly has some advantages, given the environment of the transition economies with a "positive" inflation differential. It tends to provide relatively stable conditions vis-à-vis the outside world for investors and traders, which may have a positive effect on their activities and expectations. Assuming that the starting point is chosen correctly, it can be expected to lead to a balanced current account in the medium term.

However, there are some constraints implied as well. Data on price level developments are available with lags only. Applying them means that the real exchange rate only accommodates the price differential ex post, without exercising any disciplining effect on economic agents. To establish, instead, a real "anchor" ex ante would require some kind of forecast or targeted data on relative inflation rates, which is by itself open to a considerable margin of misassessment.

Managed-type exchange rates appear to be the only feasible option for the transition economies. The policy of a stable real rate, while accommodating the ensuing inflation differential, is likely to work towards balancing foreign exchange accounts and at the same time to provide a stable parameter in real terms for investment and trade activities with respect to the outside.

On the other hand, however, this type of solution **is not particularly helpful as regards restructuring in the microsphere and exercising a disciplining role on the behaviour and performance of economic agents.** Without doubt, it is just these microeconomic dimensions which are of key importance, conditioning in fact any economic recovery and revival of sustainable growth in transition economies.

2 The case for an export-led recovery

Viewed from the demand side, the recovery of transition economies could be fostered either through the expansion of domestic demand components or through expanding foreign demand. **While the possibilities of an across-the-board promotion of domestic demand appear to be rather constrained in the current circumstances, the prospects for expansion of foreign demand seem to be more promising.** In the case of Czechoslovakia there is certainly scope for the revival of trade in the region, and with Hungary and Poland in particular. At the same time, unexploited opportunities still exist to expand "non-sensitive" exports to the OECD area, especially when the present recession in the major OECD countries is over.

It follows, that a continuation of the recent trend towards an export surplus, developing into a type of export-led recovery, might be a feasible way out of the current structural depression.

This proposition appears, however, to be ruled out by standard macroeconomic reasoning. The macroeconomic identities suggest that an export-led recovery implies "by definition" exports of domestic savings. As the transition economies seem to be clear examples of countries suffering from capital deficiency, just the opposite trend, i.e. a net inflow of savings, is considered desirable.

The static and dynamic considerations of the issue should be distinguished, however. It could be argued that:

- given the constraints on the promotion of domestic demand, an expansion of export demand would be a feasible way to boost domestic investment, thereby generating increasing domestic savings. The point is that the recovery of economic growth would become sustainable only if a **domestic investment-saving mechanism is set in to motion,**

- an export surplus signals a trend towards a strong and stable currency. This would contribute to policy credibility and to **changing expectations among domestic and foreign investors alike.** It is precisely this shift in expectations which is so crucial for reversing the present economic downturn. Without it, any promotion of aggregate demand is likely to be mostly translated into import and price increases.

It may also be argued that the real impact of relevant macro-variables is conditioned by their composition, which is not, however, identifiable in terms of macroeconomic identities. The recent surpluses on Czechoslovakia's current account were matched by repayment of short-term bank liabilities, apart from an increase in foreign exchange reserves. At the same time, a growing inflow of long-term capital, foreign direct investment in particular, outweighed the surplus on current account. A net increase in savings "earmarked" for productive use could thus be achieved, despite a current account surplus.

2.1 "Wrong" type of exports?

In reality, however, the impact of the export surplus appears to have been diminished somewhat by its composition. Czechoslovak exports to world markets increasingly shifted towards relatively lower value-added products. This trend gained momentum from the early seventies onwards, under the re-imposed centrally planned economy framework; it has, however, continued during transition as well.

As shown by Bohatá and Fisher (1992) while the total volume of exports fell in 1990 and 1991, the exports of the iron-metallurgy and basic chemicals industries stabilized or even increased. This was so, despite their rather high energy and material inputs, the supply of which, moreover, was subject to increasing uncertainties and constraints.

These industries also ranked at the top in terms of relative export performance expressed as the volume of exports per employee and/or firm.

Table 1. **The relative export performance of selected industries in 1991**

Industry	Average export performance	
	a) per enterprise (mill CSK)	b) per employee ('000CSK)
Iron-metallurgy	1962.8	272.1
Chemical ind.	466.9	255.1
Engineering	189.2	121.9
Electrotechnics	75.3	63.0
Glass and porcelain	179.7	144.5
Shoe and leather	352.6	126.9

Source: Bohatá and Fischer, 1992

2.2 The role of the exchange rate regime

The three consecutive devaluations of the CSK in 1990 aimed at creating conditions for sustainable trade liberalization and limited currency convertibility by providing a "flat" basis for export expansion.

The devaluation-type approach is expected to lead to an improvement in price and cost competitiveness, given satisfactory price elasticities and provided that the effects of devaluation are not quickly eroded by subsequent increases in incomes.

Apart from the qualification that these conditions need not be a priori satisfied, the export stimulus of devaluation applies to those items where the cost and price dimensions of competition are substantial, if not dominant. Non-price factors, on the other hand, tend to be more important for non-homogeneous products, i.e.

more sophisticated and higher value-added products for which goodwill, reliability, advertising and marketing, prompt delivery, after-sales service and meeting of individual customer needs are crucial.

This qualification concerning the export stimulus of devaluation appears to be relevant in the conditions of transition economies. The legacy of past developments and the rigidities of existing markets, of labour and financial markets in particular, severely constrain the reallocation of resources and the supply response to changing price and exchange rate ratios. Even more important, the lack of established contacts with world markets, the lack of distribution networks, underdeveloped marketing and deficient related services substantially diminish the impact of the price advantages implied by devaluation, in particular in the sphere of non-homogeneous, higher value-added products.

Consequently, as might be expected, the short-run response to the devaluations effected in Czechoslovakia in 1990 was rather unequal across individual industries. As a rule, though with some notable exceptions, new export markets could be found relatively more easily for raw materials, intermediate products and construction materials[2].

The ensuing shifts in the export pattern have evidently contributed to the divergent performance of individual industries. Those hardest hit by the present recession were mostly manufacturing ones, while in the heavy industries the drop experienced was only modest. The energy and fuel industries were even able to maintain the their former levels of output.

2.3 Short-term gains vs medium- and long-term costs of the devaluation-type approach

In the environment created by the devaluations at the start of transition, the implied comparative advantages of Czechoslovak exporters were increasingly based on cost advantages, conditioned particularly by the depreciated labour costs in foreign exchange terms.

The impact of this type of development appears rather controversial. On the positive side, it could be claimed that it secured:

(i) trade balance and current account surplus in conditions where

- internal convertibility on current account and trade liberalization were being implemented,
- foreign exchange reserves were rather low, and
- sustained export growth to convertible-currency markets was crucial in order to offset at least partially the sharp contraction of trade to the former CMEA,

[2] An export "boom" in steel and rolled material to the EC markets led to countermeasures by the EC countries, involving anti-dumping action.

(ii) more attractive conditions for foreign investors who were ready to exploit the opportunities provided by low labour costs (particularly since the labour force is relatively well educated and qualified), along with prospective capital gains.

On the other hand, however, the implied consequences in the medium- and long-run are hardly favourable:

(i) data on recent trends seem to confirm that the incentives derived from an undervalued currency and "cheap labour" fostered a further shift towards lower value-added branches, and within branches to relatively less sophisticated products, thus accentuating long-run trends towards "regressive specialization",

(ii) the negative implications of moving to lower value-added products include the risk of

- a brain drain and of an increasing gap in relation to technological standards in the world economy. By contrast, the successful examples of revitalization elsewhere were based on the narrowing of this gap,

- an increasing cost disadvantage compared to the parallel products of low-income countries, as well as the risk of continued clashes of interest in the "sensitive sectors" with the EC countries,

(iii) in the conditions of transition economies the "soft" exchange rate regime is particularly apt to contribute to vicious circles of devaluation, inflation and a lowering in the degree of value-added in production, as:

- to reverse the inertia of past trends, enterprises must be induced to make every effort to innovate, to develop and to market new products of a higher quality and technical standard, to catch up in marketing and sales services. As enterprises are accustomed to rely more on "outside" help and expost corrections in the rules rather than on their own internal adjustment, "devaluation-type" policies in fact provide for a continuation of the "traditional" behaviour pattern and expectations,

- given the underdeveloped financial and labour markets and existing institutional rigidities, there is implied inertia in the "given" allocation of resources. While in the past preferences were mostly given to heavy industry branches, the devaluation-type policies boosted their comparatively high "profitability" and "export orientation". As a result, a biased picture of comparative advantages, favouring material- and energy-intensive branches, is being built into resource allocation.

From this it follows that the "devaluation-type" approach was able to the secure the competitiveness of Czechoslovak exports in the short run. At the same time, however, **it actually worked against their competitiveness in the medium and long run as a result of both the type of signals to economic agents and to the pattern of resource allocation generated.**

3 An alternative exchange rate regime for Czechoslovakia?

The challenge facing Czechoslovakia's development in the medium run is **to reverse the trend towards downgrading of its production and export structures** which has dominated in the past.

If this trend continues in the medium and long run, a vicious circle is likely to develop. Under the conditions of an open economy, an increasing productivity gap with respect to trade partners further diminishes gains from trade and leads to repeated waves of inflation and devaluation. Instead, any sustained recovery and revival of economic growth requires **moving upwards on the value-added scale.**

3.1 Policies to cope with microeconomic and structural defects

An alternative to exchange rate policies accommodating ex-post to domestic cost and price increases via repeated devaluations, is the "**hard currency" option.** It implies the adoption of a nominal exchange rate as a policy target. Its most demanding version is an **irrevocably fixed nominal rate**, pegged to a low-inflation "pilot" national or composite (ECU) currency.

The main argument for fixing the nominal exchange rate is the traditional one: **the disciplining effects** on economic agents. In the case of Czechoslovakia, these effects should contribute to the desired, complete **overhaul and reorientation of the behavioural pattern and expectations of economic agents.** It does not follow, however, that the nominal exchange rate anchor alone would be powerful enough for this purpose; other instruments must be applied in a consistent and comprehensive way to make the regime changes in the microsphere effective (Portes, 1990).

Once the policy of a nominal exchange rate target is made credible (i.e. after the authorities have passed several "tests" of their policies and proceeded differently from what might otherwise be expected), and enterprises have learned that they can no longer rely on "traditional" depreciation of the domestic currency as a way out of the recurrent pressures of inflating domestic costs, the microeconomic advantages of the fixed exchange rate approach should begin to materialize. The experience from elsewhere, notably Austria, seems to support this assumption (Marin, 1985).

In the case of Czechoslovakia a wide margin for productivity increases exists provided the changed regime and re-oriented incentives and expectations begin to bite. As a legacy of the past, there is an accumulated potential of efficiency gains in the existing wasteful methods of using inputs and equipment, "organizational slack", overstaffing and outmoded routines. Even more important are the potential gains to be had in a dynamic setting, as the centralized framework failed particularly in regard to the introduction of new products and technologies.

Along with the microeconomic impact, the policies adopted should be capable of coping with the **structural defects** of the Czechoslovak economy. As argued in section 2, the rather unequal starting conditions across branches and

industries were due to past development. Consequently, a policy relying only on a unified exchange rate and changes therein and aiming at an "equal footing" works in a **discriminatory way** in reality. As a rule, it favours the heavy industry branches preferred in the past, at the expense of most manufacturing ones.

To correct for this and to achieve a real "levelling of the ground" would require a **transitional arrangement, combining exchange rate policies with promotion schemes for those "disfavoured", i.e. for industries with higher value-added products.**

Consequently, there seems to be a **legitimate case for "industrial policies"** which, not attempting to pick winners and losers, would contribute to the development of infrastructure, telecommunications, business, trade and banking services, to the increased mobility of labour and to the upgrading of human capital. It is flaws precisely in these areas which have placed firms in sophisticated manufacturing branches at a disadvantage with respect to both foreign competitors and domestic producers of basic, low value-added products.

In a similar way, **export promotion schemes** appear to be warranted to correct for the implied disadvantages of domestic exporters of products with higher value-added. These schemes should:

- enable the costs of export reallocation and penetration of world markets (the extra cost of developing marketing, goodwill, distributional networks, the additional risk implied) to be borne, and

- provide a "breathing space" for adjustment and restructuring for those who are likely to be viable producers and exporters in the medium run.

These arguments, developed in line with **infant industry reasoning** and which could be termed **"revitalizing industries" arguments** given their prior existence in the Czechoslovak case, appear to be fairly powerful ones. It could be claimed that it would be necessary to resort to them, if the implied disadvantages inherited mainly from the centrally planned economy – of branches and products where non-price factors of competition dominate are to be corrected within a reasonable "transitory" period.

There are, of course, well-known qualifications and difficulties with the infant-industry argument for protection (Baldwin, 1969, and Hillman, 1991). In the context of transition economies, several issues appear to be especially relevant:

- is the protection once extended likely to remain only temporary,

- as the whole manufacturing sector cannot be protected for the purposes of revitalization, the selection implies a moral hazard problem,

- even if only temporary, protection incurs costs,

- protection of infant industries may virtually eliminate foreign competition, which, given the absence of domestic competition, is only the source capable of providing effective incentives for restructuring. "Revitalizing" protection may operate in just the opposite direction to the desired disciplining effects of a fixed exchange rate.

3.2 The potential role of foreign competition

It is true that in the transition scenarios the incentive and disciplining impact of foreign competition was attributed a key role in developing the competitive environment. It was recognized that the reforming countries of Central and Eastern Europe, unlike e.g. Japan, could rely on "workable" and "contestable" competition to be created within the domestic economy only.

However persuasive and unambiguous this claim may appear, the "revitalizing" effects of foreign competition on domestic firms in the Czechoslovak case have, up till now, fallen far short of expectations and have, moreover, turned out to be controversial (Hrnčíř, 1992).

At the start of the transition, the substantial devaluations effectively eliminated foreign competition for most Czechoslovak industries. The only exceptions were the least efficient branches, including consumer electronics, which for the most part could not survive the competitive pressure even at a sharply depreciated exchange rate.

A dilemma is faced in the existing conditions. On the one hand, greater exposure to foreign competition would be highly desirable as a driving force for the restructuring of domestic firms. On the other hand, however, any significant increase in exposure to foreign competition is likely to threaten the very existence of sophisticated, relatively higher value-added branches, while leaving material- and energyintensive basic industries largely unaffected.

Unlike the policies adopted at the start of transition, the strategy combining the fixed exchange rate target concept with industrial policies and export promotion schemes could also allow for a more **intensive role for foreign competition.**

Under the hard currency approach, the pressure of foreign competition would tend to squeeze profits across all industries. In contrast to the past, however, support via industrial policy and export promotion schemes would **compensate manufacturing branches for their relative disadvantages,** enabling those viable in the medium run to survive and expand.

Export promotion schemes, oriented towards the higher valueadded branches, should be based on ex ante established rules in order to avoid administrative discretion and moral hazard problems as far as possible: support is extended only to those who qualify. The experience from elsewhere (including countries in Far East Asia) suggests the feasibility of such schemes, rewarding volume and/or increasing rates of export sales. Unlike in the past, support in promotion schemes of this type is focused on the relatively successful and potentially successful industries. Consequently, there is a greater chance that it will serve only as a temporary device.

To conclude: while the case for a fixed exchange rate to be preferred to commercial policy measures holds as a general proposition, under the given distorted conditions a transitory "corrective" departure appears to be desirable. Applying similar reasoning, McKinnon argued for "cascading" tariffs rather than a lower exchange rate (McKinnon, 1991).

3.3 Conditions for a fixed exchange rate regime to be viable

The microeconomic advantages of the fixed nominal exchange rate policy must, however, be compared with the macroeconomic constraints and costs implied. However attractive its disciplining and behavioural effects might be in the environment of transition economies, it does not follow that the "hard currency" policy of a fixed exchange rate might be reasonably resorted to under **any conditions and at any time.** It would be neither feasible nor sensible, if its costs in terms of lost output, increased unemployment and social hardship were likely to outweigh the microeconomic and structural benefits.

In the postwar period, a number of European economies (e.g. the Nordic countries) adopted a different strategy: promoting macroeconomic developments via low interest rates, while repeated adjustments of exchange rates were used to accommodate domestic cost pressures and to re-establish a strong competitive position. And only at a more mature and stabilized phase did they, for the most part, shift to the fixed rate policy.

If in a "strict" version, i.e. when irrevocably fixed, the exchange rate is "lost" as a policy instrument, this implies that other instruments must be used, and must be capable of securing competitiveness.

In the medium and long run, maintaining competitiveness is an **issue of fundamentals:** they must converge with those of the anchor currency's country (countries). At the same time, however, **cyclical changes and various external and domestic shocks** arise in the course of time which must be accommodated as well. It follows that the policy of a fixed exchange rate places heavy demands on the mechanisms of domestic adjustment: they must be sufficiently effective and flexible both as for secular and short-run developments.

When assessing the chances of pursuing a fixed exchange rate policy in a transition economy, what matters most is potential **movements in the real exchange rate.** Providing that the prospective inflation differential with respect to the anchor country is either zero or negative, the given nominal exchange rate is likely to be sustained.

Changes in the real exchange rate are related to changes in the nominal exchange rate and to relative changes in wage levels, in profits and in productivity with respect to the anchor countries. The **key variable appears to be the relative change in productivity.** If favourable, i.e. higher or at least matching the increases in partner countries, wages and profits may rise accordingly, without causing real exchange rate appreciation. This type of favourable constellation materialized e.g. in postwar Germany. It may also be a challenge for transition economies: could they exploit the chance of starting at a rather low level to achieve relatively higher productivity increases while catching up?

The **structural and institutional properties** of the economy in question are evidently decisive in this respect, particularly the **degree of efficiency and flexibility in the functioning of labour and financial markets.** It matters whether disposable savings are increasingly channelled to the "right" users. Likewise, a flexibly functioning labour market is likely to be crucial, if competitiveness is to be maintained via domestic adjustments instead of nominal exchange rate changes. The positive experience of **social corporatism and voluntary incomes policies** in a number of small European economies at earlier

stage of their development (Pekkarinen, Pohjola and Rowthorn, 1992) could be a good example to follow in the Czechoslovak case.

However, even with an appreciating real exchange rate, it might be possible to successfully maintain the given nominal rate, provided **there are counterbalancing effects deriving from an improvement in non-price factors of competition.** It is particularly these effects that it is hoped would arise from a hard currency policy; in the Czechoslovak conditions they would be of vital importance[3]. The Austrian example suggests the feasibility of their materialization.

[3] "Austria increased her real market share in the OECD area form 0.9 per cent in 1970 to 1.08 per cent in 1980. This 20 per cent increase in Austrian market share took place despite an 18 per cent revaluation of the real exchange rate of the schilling vis-à-vis her trading partners in the same period" (Marin, 1985, p.479).

4 Concluding remarks

However unrealistic the fixed exchange rate regime might appear under the present conditions of the transition economies, we suggest that its benefits and costs should be seriously scrutinized, taking into account the specific conditions of individual countries. In the Czechoslovak case, we believe it could be a desirable option in the future.

There are contradictory factors at work as regards the time horizon for its possible adoption. It is evidently not viable over the next 1–2 years, taking into account all the forthcoming institutional changes and uncertainties involved.

On the other hand, a number of factors call for the implementation of the policy shift without delay:

- one of the lessons from the development of open market economies is that it **takes time to build the credibility of the strategy opted for,** and it must be "earned" (Hochreiter and Knöbl, 1991). The policy shift becomes increasingly more demanding, the more are opposite expectations embedded in the behaviour of firms, trade unions and various pressure groups. A comparison between Austria and Nordic countries is of particular interest in this respect. By this reasoning, there is a considerable difference between forward- and backward-looking expectations in inflationary tendencies (Barro, 1983), and in the chances of coping with a fixed exchange rate regime,

- as long as capital account flows remain mostly regulated, the "complicating" role of interest rate parity and of speculative capital flows is substantially diminished, if not eliminated. It seems therefore advantageous to go through the process of learning in conditions where the "fundamentals matter".

A reasonably early adoption of a policy of a nominal exchange rate anchor could therefore create a more favourable environment for the future stages of development.

Despite all the handicaps, Czechoslovakia ought to have relatively good chances of succeeding with the fixed exchange rate strategy. In addition to the comprehensive privatization programme and inflow of foreign direct investment, there is a tradition of industrial development and, moreover, of prudent monetary and fiscal policies aiming at a stabilized currency. This tradition dates back to the period after World War I, when the newly created Czechoslovak republic adopted conservative fiscal and monetary policies and, as a result, avoided the hyperinflation experienced by all its neighbours, including Germany, Austria, Hungary and Poland (Sargent, 1986).

The hypothesis is that under the given conditions, the policy of a hard currency – rather than devaluations as implied by the conventional wisdom – should lead to a sustained, export-led recovery of the Czechoslovak economy in the medium run.

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