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

Annual GDP growth rate in the Czech Republic (in %)

Czech economy in the middle of the 90’s

Unemployment rate in the Czech Republic

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

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 +- 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

- \( R_{D/F} = E_{D/F} \cdot \frac{P_F}{P_D} \)  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 → 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 → to acquire 1 foreign cage of goods you have to offer less than 1 domestic cage of goods
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

*Source: Vencovský, Komárek (1998)*
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
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 +-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

<table>
<thead>
<tr>
<th>Date</th>
<th>Important facts</th>
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<tbody>
<tr>
<td>15.5.97</td>
<td>CZK depreciates by 5 %, first intervention of the central bank</td>
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<tr>
<td>16.5.97</td>
<td>Pressure on the CZK continues, CNB raises the collateral loan interest rate to 50 %</td>
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<td>19.5.97</td>
<td>Another intervention of CNB, overnight IR rose to 38 %</td>
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<tr>
<td>21.5.97</td>
<td>CZK under another attack, inter-bank IR rose to 500 % at one moment</td>
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<td>22.5.97</td>
<td>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</td>
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<td>24.5.97</td>
<td>Three ministers declare the aim to leave the government</td>
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<td>26.5.97</td>
<td>ER regime changed to “controlled floating”, former fluctuation zone cancelled</td>
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<td>27.5.97</td>
<td>CZK ER overshoots to 19,40/1 DEM</td>
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<td>28.5.97</td>
<td>CZK stabilized, the government introduces a program “the recovery package” of measures, personal changes in the government</td>
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<td>29.5.97</td>
<td>CZK returns to the border of former fluctuation zone, situation calms down</td>
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</table>
CZK exchange rate during the crisis

Source: Centre for Economics and Politics (2000)
Main variables before and after the crisis

<table>
<thead>
<tr>
<th></th>
<th>30.4.1997</th>
<th>30.5.1997</th>
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<tr>
<td>Overnight interest rate</td>
<td>10,79 %</td>
<td>151,88 %</td>
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<td>Collateral rate</td>
<td>14 %</td>
<td>50 %</td>
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<td>Discount rate</td>
<td>10,5 %</td>
<td>13 %</td>
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<td>Foreign currency reserves of CNB</td>
<td>11,518 billion USD</td>
<td>10,025 billion USD</td>
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<td>Exchange rate CZK/DEM</td>
<td>17,903</td>
<td>19,180</td>
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<td>Exchange rate CZK/USD</td>
<td>31,005</td>
<td>32,691</td>
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<td>Exchange rate regime</td>
<td>Fixed ER with 15% fluctuation zone</td>
<td>Controlled floating without official fluctuation zone</td>
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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 Dědek – vice governor of CNB

<table>
<thead>
<tr>
<th>Oldřich Dědek explanation</th>
<th>Václav Klaus explanation</th>
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<tbody>
<tr>
<td>Bad macro- and microeconomic situation</td>
<td>Good situation of the national economy till 1996</td>
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<td>No willingness to calm down the economy</td>
<td>Parliamentary elections in 1996 ⇒ minority government</td>
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<td>Expansionistic fiscal policy instead of the restriction</td>
<td>No central bank cooperation</td>
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<td>No governmental cooperation</td>
<td>Strong monetary restriction in June 1996</td>
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<td>Constrained monetary restriction</td>
<td>Insisting on the fixed ER regime</td>
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