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Granger Causality of the Inflation-Growth Mirror in Accession Countries by Max Gillman and Anton Nakov

This paper studies the money-inflation-growth the relationship for two acceding countries: Poland and Hungary, for the period 1986-2004. My comments have to do with the nature of the inflation-growth relationship, which I found to be more of a reduced-form relationship. One of the most important facts in this study is that there were major banking law changes in both Hungary and Poland during the period in question. These changes would tend to affect the demand and supply of credit for consumption and investment directly. The paper captures the impact of such changes in terms of a bank sector productivity parameter $A_{dt}$.

- The impact of bank sector reforms appear as an upward shift in the bank sector productivity parameter $A_{dt}$.

- Downward shifts in bank sector productivity are attributed to a decline in expected inflation variance.

One of the main points of the paper is that bank sector productivity shifts can be used to account for shifts in the velocity of money demand.

- In the model, inflation lowers the growth rate of output by inducing a lower rate of return to human capital.

- Inflation also increases income velocity but changes in the bank productivity parameter can cause shifts in the money/income/velocity relationship.

- More fundamentally, changes in bank deregulation and bank reform most likely had an impact on banking practices. In the paper, this is modelled only as an upward shift in the bank productivity parameter. In a recent CEPR Discussion Paper, Altug and Usman (2004) show that strategic considerations in bank lending decisions in a riskier environment (characterized by high real interest rates, greater project risk, volatility in bank lending capacities) may lead to contractions in bank lending over and above that warranted by fundamentals. This may occur with or without strategic interest rate competition.

- It would have been interesting to describe or analyze the changes that were taking place in Polish and Hungarian banking during the periods of deregulation. Otherwise, the inflation-growth causality relationship appears as bit of a black box.

- For example, how did bank deregulation affect the composition of credit? How did it affect small banks versus large banks? State banks versus private and so on? How did bank deregulation and bank sector reform affect competitive practices in the banking sector? These would have given a better indication of the impact of bank sector changes on output. Hatice Jenkins (2003) has done a study for the Turkish banking system after the financial deregulation of the 1980s that shows how such deregulation affected banking practices, and the volume and composition of credit.
Presumably this is what we are referring in terms of the bank productivity parameter.

- In recent experience in Turkey, the reduction in inflation and nominal interest rates has been accompanied by excessive interest rate cutting and by struggles for market share among banks. This has the potential to lead to credit/consumption booms and busts. Many emerging market financial crises have been accompanied precisely by such booms and busts (see, for example, Calvo and Mendoza 1996 for a discussion of the 1994 Mexican crisis.) Were such effects present in Poland and Hungary?

- The paper by Barrell and Holland (2004) suggest that credit-constrained consumers should be more powerfully affected by changes in interest rates. How would these factors affect the inflation-growth relation?

In concluding, I would also like to offer a comment on the notion of analyzing hyperinflation within an equilibrium model. The paper makes the case that this is a relatively new phenomenon. Typically, hyperinflation was analyzed using a framework such as the Cagan model, which is basically a money demand equation augmented with an expectation-formation mechanism. I would argue that the notion of using an overlapping generations framework such as the one in Marчет and Nicolini (2003) to analyze hyperinflationary phenomena was being thought about much earlier. (See the references to my graduate Macro notes at the end of these comments.) Moreover, researchers were already concerned about changes in the public’s expectations regarding shifts in monetary regimes, at least for the end of hyperinflations. The idea that the increase in money demand observed at the end of the German hyperinflation could be explained by changes in the public’s beliefs about the nature of money supply was in Laura LaHaye’s (1985) JPE paper. Of course, more recent papers have succeeded in introducing more sophisticated schemes with learning and regime shifts.

References

http://home.ku.edu.tr/~saltug Notes on Hyperinflations


Exchange Rate Volatility and Employment Growth: Empirical Evidence from the CEE Countries by Ansgar Belke and Ralph Seltzer

The paper argues that exchange rate volatility can have a different effect in emerging markets compared to developed economies. The reasons have to do with the greater openness of emerging market economies, to market incompleteness and the lack of appropriate hedging instruments, and to the nature of trade arrangements (such as invoicing in dollars). All of these factors tend to make emerging markets more susceptible to exchange rate volatility. The paper relates such exchange rate risk and uncertainty to job creation and job destruction, under the notion that employment possesses irreversibility in the presence of some labor market rigidities. Where do such rigidities reside for CEE countries? In the presence of very high payroll and other taxes, and unemployment protection schemes. Under such conditions, the authors show that exchange rate uncertainty will impede job creation and hasten job destruction. The paper thus argues that monetary union or monetary integration would have tangible real effects on employment performance.

I'd like to comment on this paper by bringing in parallels with the recent Turkish experience. Since the 2000-2001 crisis, Turkey has been following a floating exchange rate regime. In the past year, there has been considerable TL appreciation against the dollar (less against the euro) and more importantly, significant swings in the exchange rate. Much of the manufacturing sector depends on exports, and many exporters have been vocal about the fact that their profit margins have been squeezed, that they are continuing to export as a way of keeping their customer base, and that the TL appreciation creates uncertainty about their future export performance. However, as the Governor of the Central Bank of Turkey recently noted, only the Central Bank appears to be in the market buying dollars. Evidently, neither many Turkish firms nor the majority of banks in Turkey (an exception being UK-owned HSBC bank) have shown much interest or desire to enter into forward contracts to hedge against exchange rate risk. Continuing with the parallels with CEE countries, Turkey also possesses significant labor market rigidities in terms of high payroll taxes and also employment protection. Because of these factors, Turkey has a very large informal sector which some put at 50% of GDP.

The paper is important and interesting for a number of reasons.

• First, it stresses that what appear as a minor form of risk for a developed country, say, the UK, may be much more important for developing countries.

• More generally, the paper argues that transition country and emerging market economies are different from developed country economies in terms of their susceptibility to different forms of risk, in this case, exchange rate risk. This point appears to be highly relevant for policy discussions. In a recent analysis, Kenneth Rogoff and Carmen Reinhart (2004) suggest that emerging market economies (such as Brazil or Turkey) may have a lower tolerance for debt than developed countries. In their analysis, a type of market incompleteness – namely, the inability to borrow due to
serial default – also plays a role. In the paper by Bellie and Setzer, the lower tolerance of exchange rate risk is linked to reduced capacity for job creation, a pressing concern for countries with unequal distribution of income and large populations.

- The paper argues that the model applies to an analysis of the formal sector, since the informal sector or underground economy has, by definition, much lower costs of firing. Nevertheless, one could ask how the paper’s overall policy conclusions would be changed if one took into account the fact that the co-existence in many transition and emerging market economies (including Turkey) of a highly regulated formal sector and a large informal sector. Thus, one could ask what is the overall effect of monetary union on transition or emerging market economies on the outcomes in both formal and informal sectors of the economy. For example, how effective has it been to eliminate exchange rate risk \textit{vis a vis} the euro for the size of the informal sectors in such countries as Greece, Portugal, and Spain? Or, put differently, while exchange rate risk may be important for labor market outcomes, would merely removing it \textit{without} affecting the labor market rigidities merely freeze the existing structure of labor markets in some Accession countries?

Asymmetry of Output Shocks in the European Union: The Difference between Accessing and Current Members by Yuliya Demyanyk and Vadym Volosyvych

This is a potentially interesting paper but I was not sure that it captured the major effects of integration. For example, what are the actual mechanisms for risk sharing? Also I was troubled by the assumption that GDP for the transition countries is modelled as a random walk with drift. Instead, suppose that GDP is a trend-stationary process with structural breaks. (Isn’t transition itself a structural break?) The conclusions of the paper would be significantly affected.

\footnote{In place of debt-GDP ratios of 42\% for Brazil or 55\% for Turkey, Rogoff and Reinhart suggest that sustainable debt-GDP ratios are more in the vicinity of 15\%. See “Serial Default and the ‘Paradox’ of Rich to Poor Capital Flows,” forthcoming American Economic Review. See also The Financial Times, April 21, 2001, page 11.}