Monetary and Fiscal Policy Conflicts in Central Europe: Has the Institutional Framework of Macro Policies Hampered Growth?

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Abstract: This paper explores the conditions of growth in Central Europe (Hungary, Poland, Czech Republic) since the beginning of the 2000s, from the point of view of the evolution of the institutional framework organising the coordination – or the conflict – between monetary and fiscal policies. In a context of disinflation via direct inflation targeting and of preparation for EMU entry, clashes were observed between independent central banks and governments, leading to several conflicts on the policy mix and on the status of the central bank. We first outline the institutional and economic framework of monetary and fiscal policies in Central Europe, then expose the conflicts observed and their impact on growth. Then we try to explain the emergence of these conflicts, first in terms of lack of monetary policy credibility, which is not very convincing, then in terms of the imperfections of the institutional framework governing macro policies, which seems more adequate and highlights how the imperfect coherence of the institutional framework may threaten growth.
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Introduction

This paper proposes to explore the conditions of macroeconomic growth in Central Europe (Hungary, Poland, Czech Republic) since the beginning of the 2000s from the perspective of the institutional framework organising the coordination – or conflict – between monetary policy and fiscal policy. This period is interesting because the main issue in macroeconomic policies slowly shifted from completing the transition to preparing accession to the EU, and in the long-term to EMU, while at the same time the institutional framework governing macro policies was modified. Monetary policy is implemented in these countries since the early 2000s by independent central banks pursuing price stability through a strategy of inflation targeting, while governments implement fiscal policies torn between the new need to respect the European fiscal criteria and the objective of promoting strong growth to foster catching up with the EU 15.

In this context, clashes were observed between independent central banks and governments in all three countries at various dates, leading to several conflicts on the policy mix and on the status of the central bank, and to a certain extent these conflicts have hampered growth in Central Europe. This paper aims to study these conflicts in order to better understand how and why they have arisen, whether they were cumulative, the evolutionary impact they had on growth, and whether they have a chance of continuing in the future or if solutions may be found to defuse them ex ante. The study of these conflicts is also interesting in a comparative perspective because similar tensions were observed in the first years of EMU between the ECB and national governments.

In the first two parts, we shall outline the institutional and economic framework of monetary and fiscal policies in Central Europe. The aim here is to identify institutional constraints weighing on each macro policy, and to point out their often diverging objectives. On one hand, monetary policy is implemented by independent central banks entrusted with the objective of price stability. In order to achieve this objective, all three central banks have adopted direct inflation targeting as a new monetary policy strategy. On the other hand, governments implement fiscal policies in the specific context of the nearly complete transition process, where some large-scale costly reforms are still needed, with a view to pursue growth and development to continue catching up with the EU 15, while at the same time trying to comply with the increasingly constraining European framework on fiscal policies. We shall also document the main monetary and fiscal policy measures implemented since 2000 in these countries, and the issue of the excessive deficit procedure they have all been submitted to in July 2004 by the European Council.

The third part of the paper shall then document the conflicts between central banks and governments, identifying in each country the chronology, the sources and themes of disagreement, and whether the conflict mainly took the form of a conflicting policy mix or attempts by the government to modify the status of the central bank in order to reduce its independence. We shall try here to compare the intensity of the conflict in each country, to expose the arguments of each actor. We shall also discuss the emerging negative consequences of these conflicts for each actor, and to what extent they hampered the emergence of a sound policy mix favouring growth.

The last two parts of the paper explore explanations of these conflicts. In the fourth part, we try to explain their emergence in terms of lack of monetary policy credibility: did the lack of credibility of monetary policy cause these conflicts, as was suggested in the case of conflicts between the new ECB and national governments in the first years of EMU? We
propose a survey of studies relying on different methodologies to approach the degree of credibility of these countries’ monetary policy. It seems that although perfectible, monetary policy credibility was sufficient, and that other explanations must be sought, in relation to lack of credibility of fiscal policies, or in relation to shortcomings of the general institutional framework.

The last part of the paper thus argues that these conflicts are encouraged first by political factors and by the governments’ often excessive fiscal policies in the period, and second by the institutional framework governing macro policies. We argue that the rules on macro policies cannot either attenuate the conflict of objectives between monetary and fiscal policies, either offer devices to resolve them. An interpretation of this conflict in terms of a dynamic “chicken game” shows how the institutional rules give the actors incentives that lead to conflicts.

1. The institutional and economic framework of monetary policy in Central Europe

We expose in the first two parts the institutional rules monetary and fiscal policies are submitted to in the new member states and identify their often diverging objectives. These institutional rules have evolved along with the process of European integration: first loosely submitted to an obligation of compatibility with EU rules during the first years of transition, they were then submitted to stronger constraints during the accession negotiations, and since the 1st of May 2004 they must comply with the entire European institutional framework, except that the SGP is not constraining yet, although it will be when these countries integrate EMU.

In the case of monetary policy, the independent central banks pursue an objective of price stability assigned to them by their statutes, and they pursue this objective all the more thoroughly as it is a prerequisite for EMU accession. We shall study here the degree of independence of these central banks, their inflation targeting strategy, and its efficiency in achieving disinflation.

1.1. Independence of central banks

In all three countries, central banks are highly independent, either since their creation, either since more recent legislation enacted just before the implementation of inflation targeting. Their independence concerns the use of monetary policy instruments as well as the definition of monetary policy objectives.

In Hungary, the two-tier banking system was reinstated on the 1st of January 1987, giving back to the Magyar Nemzeti Bank (MNB) its central bank status. Its independence was laid down in the Act on the MNB in October 1991. In July 2001, a new Act on the MNB was voted to put its status in compliance with EU rules: it aligned the MNB’s independence with EU regulations and made price stability its primary objective. This Act also defined the nomination rules of the members of the Monetary Council, the decision-making organ, who are appointed by the President of the Republic for a six-year term. The Governor of the MNB is also appointed by the President of the Republic for a six-year term, at the proposal of the Prime minister (see www.mnb.hu). Contrarily to ECB practise, the MNB and the government jointly decide of inflation targets since 2001 (see below).

In Poland, the Narodowy Bank Polski (NBP) was reinstated as a central bank in 1989 and was then entrusted with the value of the Polish currency. Its status was modified by the Constitution of 1997 and the Act on the NBP of 1997 which reinforced its independence, created the Monetary Policy Council (MPC) and defined its objective as price stabaility. The MPC defines the objectives of monetary policy and the level of reference interest rates. Its
members are appointed for a six-year term by the President of the Republic, the Sejm (the lower chamber of the Parliament) and the Senate. The President of the NBP is also appointed by the Sejm, for a six-year term, at the request of the President of the Republic (see www.nbp.pl).

In the Czech Republic, the central bank (Ceska Narodni Banka, CNB) was created on the 1st of January 1993, following partition with Slovakia. The Czech Constitution (1992) and the Act on the CNB of 1993 guarantee its independence. The members of the Bank Board, including the Governor, are appointed by the President of the Republic for a six-year term of office. The Bank Board, the decision-making organ, sets its inflation objectives and its monetary policy instruments (see www.cnb.cz).

In all three countries, the decision-making organ decides of the reference interest rates by a simple majority vote, the chairperson having the casting vote in case of a tie. In all three cases, measures have also been taken to improve transparency and accountability of central banks in the 2000s, though there is still progress to be made (Jonas & Mishkin 2003, Jarmuzek et al. 2004, Lyziak et al. 2007). The institutional framework of monetary policy in these countries has therefore evolved since 2000: by reinforcing the independence of central banks and aligning their objectives on those of the ECB (price stability), it has converged with European rules.

1.1. Monetary policy strategy, objectives and instruments

The primary objective of monetary policy defined by the three Acts on the central bank is price stability; without prejudice to this primary objective, the central banks support the general economic policies of the government.

Each central bank defines what it understands by price stability by setting an inflation target. The Czech Republic adopted inflation targeting in January 1998, Poland in January 1999 and Hungary in the summer 2001. The three countries chose a fast path to disinflation due to the objective of EMU accession in a near future. The chosen targets accompanied the disinflation process and converged around 2.5% – 3% (see appendix 1). The preferred monetary policy instrument in the three cases is the two week repo rate. The adoption of the inflation target as a nominal anchor follows (or shortly precedes) the abandon of fixed exchange rates, replaced by a managed float in the Czech Republic since 1997, a float in Poland since 2000, and an exchange rate band of +/-15% in Hungary since September 2001. Even if there is no full float in Hungary, this greater exchange rate flexibility allows more autonomy for monetary policy to pursue disinflation, otherwise constrained by the fixed exchange rate (Mundell triangle).

Inflation targeting involves setting a publicly announced medium-term inflation objective, and short-term yearly objectives. The central bank elaborates regular inflation forecasts, evaluates the risks of non-fulfilment of the target, and decides whether to adjust its reference interest rate. In case of exceptional shocks on inflation steering it away from the target (ex. major variations in oil prices, in agricultural producer prices, administrative changes in tax rules or in regulated prices), the central bank generally decides not to intervene. The Polish and Hungarian central banks will however intervene to prevent “second round effects” on inflation (a build-up of inflationary expectations, a spill-over on wages…). The credibility of monetary policy hinges here on the central bank’s capacity to justify its analysis of the shock and its policy decision.

1.3. Macroeconomic context

In these countries, convergence of inflation to EMU levels is hampered by the Balassa effect linked to catching-up, and by the still-ongoing liberalisation of administered prices,
even though the latter are one-off. Therefore the inflation targets are set slightly higher than the ECB’s objective.

The three countries implemented the following monetary policies. In Poland, monetary policy is considered to have been rather excessively expansive in 1999-2001, excessively restrictive in 2002 and excessively expansive again in 2003-2004 (Lyziak et al. 2007). In the Czech Republic, in 1998 and 1999, monetary policy was generally restrictive, especially in 1998-1999 and in 2003. In Hungary, monetary policy has been rather tight since 2001, the interest rate cuts following declining inflation, except for a loosening in the first half of 2003 following the speculative attacks on the forint in January.

All three countries have achieved disinflation in the period under review. In Poland, the first stabilisation of inflation expectations was recorded in 2000, then disinflation was observed as of 2001, with a high cost in terms of slowing growth (tables 1 and 2). The NBP considers that the disinflationary process has been achieved in 2002 (NBP 2002). In the Czech Republic, disinflation was very swift in 1999, inflation flared up again in 2000-2001 in a context of renewed growth, and disinflation seems durable since 2002, despite transitory increases in inflation expectations in 2000 and 2003 due to a wavering credibility of the 1999 and 2002 disinflation episodes, and despite growing uncertainties on public finances since 2000. In Hungary, disinflation had been pursued since 1995 with the crawling-peg exchange rate regime, but had reached a limit in 1999-2000, inflation remaining around 10% with high inflation expectations (MNB 2001). With the inflation targeting strategy, disinflation resumed in 2001, was interrupted in 2003, and resumed in 2004, upheld by low inflation expectations (MNB 2004).

**Table 1 Inflation (%)**

<table>
<thead>
<tr>
<th></th>
<th>90</th>
<th>91</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>00</th>
<th>01</th>
<th>02</th>
<th>03</th>
<th>04</th>
<th>05</th>
<th>06</th>
</tr>
</thead>
<tbody>
<tr>
<td>H</td>
<td>28.9</td>
<td>35.0</td>
<td>23.0</td>
<td>22.5</td>
<td>18.8</td>
<td>28.2</td>
<td>23.6</td>
<td>18.3</td>
<td>14.3</td>
<td>10.0</td>
<td>9.8</td>
<td>9.2</td>
<td>5.3</td>
<td>4.7</td>
<td>6.8</td>
<td>3.6</td>
<td>4.0</td>
</tr>
<tr>
<td>P</td>
<td>585.8</td>
<td>70.3</td>
<td>43.0</td>
<td>35.3</td>
<td>32.2</td>
<td>27.8</td>
<td>19.9</td>
<td>14.9</td>
<td>11.8</td>
<td>7.3</td>
<td>10.1</td>
<td>5.5</td>
<td>1.9</td>
<td>0.8</td>
<td>3.5</td>
<td>2.1</td>
<td>1.6</td>
</tr>
<tr>
<td>CR</td>
<td>9.7</td>
<td>52.0</td>
<td>11.1</td>
<td>20.8</td>
<td>9.9</td>
<td>9.6</td>
<td>8.9</td>
<td>8.4</td>
<td>10.6</td>
<td>2.1</td>
<td>4.0</td>
<td>4.7</td>
<td>1.8</td>
<td>0.2</td>
<td>2.8</td>
<td>1.9</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Annual average increase in consumer prices. Source: EBRD 2006.

The institutional and macroeconomic framework in Central Europe thus seems to buttress the credibility of monetary policy: central banks are independent, pursue an objective of price stability through a strategy of direct inflation targeting which seems more transparent and more credible even than the double pillar strategy of the ECB, and disinflation seems to have been achieved, at least for the moment.

**2. The institutional and economic framework of fiscal policy in Central Europe**

We shall explain here how the European institutional rules constraining fiscal policies apply to new member states, describe the objectives of fiscal policies and the main measures of fiscal policy pursued in these countries since the beginning of the 2000s.

2.1. New member states and Maastricht criteria

Governments of new member states (NMS) are submitted to EMU-related constraints on fiscal policy, in a specific manner: NMS participate in EMU as of their accession to EU but with a derogation (they do not fulfil the Maastricht criteria). This implies first that they shall integrate EMU when they respect the Maastricht criteria and when they request it, but that they have no opting out clause. Second, they must comply with general provisions of the EU Treaty on economic policy, including the avoidance of excessive deficits (public deficit below 3% of GDP and public debt below 60% of GDP). In case of an excessive deficit, NMS

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2 For criticism of the double pillar strategy of the ECB, see Artus & Wyplosz (2002).
are exposed to recommendations from the Council, but do not risk sanctions in case of non-compliance with these recommendations. However, they risk suspension of all or part of Cohesion Fund assistance (Council Regulation 1084/2006). This is not anecdotal: in the very extreme case when all Cohesion Fund assistance were suspended, this would amount to three times the maximum fine of 0.5% GDP under the SGP sanctions (appendix 2). In the framework of the Pre Accession Economic Programmes (PEP) that they must present annually to the Commission before their accession, then in the framework of the Convergence Programmes (CP) compulsory since 1st May 2004 (and when they enter EMU they will have to submit Stability Programmes), these countries’ governments therefore face institutional change in the form of increasing constraints on their fiscal policies.

Finally, let us note that in addition to these constraints, Polish law includes further constraints on public debt since November 1998. If the ratio of public debt to GDP: (i) is greater than 50% but not greater than 55% in year x, the draft budget for x+2 must stabilise the rate of increase of the debt; (ii) if it is between 55% and 60%, the draft budget for x+2 must reduce the ratio of public debt to GDP to a level lower than in year x; (iii) if it is equal or greater than 60%, the draft budget for x+2 must be balanced, with no deficit.

2.2. Fiscal policy objectives

Central European governments support the central bank’s objective of price stability in the perspective of EMU accession, but they also pursue other, real, objectives: they are much more sensitive to growth, development and catching up with the EU average, and employment. This implies fiscal policies oriented towards structural reforms stimulating growth (ex. infrastructure, education) and competitiveness, but also direct fiscal stimulation. For example, the Hungarian government stated that it “is committed to an economic policy which […] assures the restoration of the equilibrium and the stimulation of growth. Long-term objectives include the strengthening of social and economic cohesion, modernisation, and catching-up with Europe” (Hungarian PEP 2003). The Polish government adopted the following strategic aims in October 2001: “gradual return to the path of GDP growth, improvement in employability of the population and employment growth, effective absorption of European funds” (Polish PEP 2002). The Czech government states that “[its] main economic objectives are to promote growth and employment by stimulating productivity and competitiveness and to get public finances under sustainable development. The aim is to accelerate the process of catching-up with the “old” EU Member States, without neglecting environmental and social issues. […] Fiscal policy must fulfil its macroeconomic stabilisation function and be - at the same time - consistent with other structural policies promoting the competitiveness of the Czech economy on the single market” (Czech CP, 2004). Due to these objectives and to historical specificities, Central European governments therefore still have reasons to have high public spending. Costly structural reforms are needed to complete transition (pension reforms…) and to respect the acquis communautaire.

2.3. Macroeconomic context

The growth path was contrasted in the three countries (table 2). In Hungary, the disinflation process did not greatly hamper economic growth: it has remained above 4% since 1997. In the Czech Republic, disinflation had a modest negative effect on growth: in 1999 it did not prevent economic recovery, and in 2002 it only reduced the growth rate from 2.5% (in 2001) to 1.9%. In Poland, disinflation in 2001 and 2002 was accompanied by a marked slowdown in growth from 4-5% in 1998-2000 to 1.1% in 2001 and 1.4% in 2002. Governments were therefore also tempted, to varying extents, to maintain high public spending in order to mitigate the real costs of the disinflation policy. The following fiscal policies were implemented in the three countries.
In Hungary, a right-wing government was in place from 1998 to 2002, and the socialists have been in power since 2002. After the difficulties related to the beginning of transition, and following an austerity plan in 1995, public finances reached their least imbalanced situation since 1990 in 2000, with a deficit at 2.9% of GDP. This however was short-lived, as fiscal policy reverted to an expansionary stance and deficits have increased since: they have been above 3% of GDP since 2001 and above 6% since 2002.

Table 2 GDP growth and public finances

<table>
<thead>
<tr>
<th>Year</th>
<th>Public deficit</th>
<th>Public debt</th>
<th>GDP growth</th>
<th>Public deficit</th>
<th>Public debt</th>
<th>GDP growth</th>
<th>Public deficit</th>
<th>Public debt</th>
<th>GDP growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>-</td>
<td>71.7</td>
<td>1.3</td>
<td>-4.9</td>
<td>43.4</td>
<td>6.2</td>
<td>-3.3</td>
<td>12.5</td>
<td>4.0</td>
</tr>
<tr>
<td>1997</td>
<td>-5.8</td>
<td>62.3</td>
<td>4.6</td>
<td>-4.6</td>
<td>42.9</td>
<td>7.1</td>
<td>-3.8</td>
<td>13.1</td>
<td>-0.7</td>
</tr>
<tr>
<td>1998</td>
<td>-7.8</td>
<td>60.4</td>
<td>4.9</td>
<td>-4.3</td>
<td>38.9</td>
<td>5.0</td>
<td>-5.0</td>
<td>15.0</td>
<td>-0.8</td>
</tr>
<tr>
<td>1999</td>
<td>-5.3</td>
<td>59.5</td>
<td>4.2</td>
<td>-1.8</td>
<td>39.3</td>
<td>4.5</td>
<td>-3.7</td>
<td>16.4</td>
<td>1.3</td>
</tr>
<tr>
<td>2000</td>
<td>-2.9</td>
<td>54.2</td>
<td>8.1</td>
<td>-1.5</td>
<td>35.9</td>
<td>4.2</td>
<td>-3.7</td>
<td>18.5</td>
<td>3.6</td>
</tr>
<tr>
<td>2001</td>
<td>-4.1</td>
<td>52.1</td>
<td>4.1</td>
<td>-3.7</td>
<td>35.9</td>
<td>1.1</td>
<td>-5.7</td>
<td>25.1</td>
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<tr>
<td>2002</td>
<td>-9.0</td>
<td>55.6</td>
<td>4.3</td>
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<td>-6.8</td>
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</tr>
<tr>
<td>2003</td>
<td>-7.2</td>
<td>58.0</td>
<td>4.1</td>
<td>-4.7</td>
<td>43.9</td>
<td>3.8</td>
<td>-12.6</td>
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<td>3.6</td>
</tr>
<tr>
<td>2004</td>
<td>-6.5</td>
<td>59.4</td>
<td>4.9</td>
<td>-3.9</td>
<td>41.8</td>
<td>5.3</td>
<td>-2.9</td>
<td>30.7</td>
<td>4.2</td>
</tr>
<tr>
<td>2005</td>
<td>-7.8</td>
<td>61.7</td>
<td>4.2</td>
<td>-2.5</td>
<td>42.0</td>
<td>3.5</td>
<td>-3.6</td>
<td>30.4</td>
<td>6.1</td>
</tr>
</tbody>
</table>


In 2001 and 2002, fiscal policy was expansionary to counter deteriorating competitiveness and slower growth due, among other factors, to monetary policy. The Medgyessy government (summer 2002) further loosened fiscal policy, and then again the Gyurcsany government (October 2004).

Although the Medgyessy government committed itself to fiscal restraint (Hungarian PEP 2002), aiming to reduce the budget deficit to 3% in 2004, it appeared quickly that it would not succeed. In the same manner, the fiscal adjustment announced in 2003 (Hungarian PEP 2003) was not achieved because of fiscal expenditure slippage. The government’s concern for growth and competitiveness led it de facto to slow down fiscal adjustments, contrarily to its commitments. Furthermore, it pursued in 2003 a policy in favour of competitiveness at odds with the MNB’s policy, which it criticised for the excessive strengthening of the forint (Hungarian PEP 2003). In order to attenuate this conflict (see below), the government accepted to tighten fiscal policy in 2003 to allow a relaxation of monetary policy, by aiming to restrict demand and reduce the deficit (Hungarian PEP 2003). But ex post, this commitment did not prove credible.

In October 2004, the Gyurcsany government introduced a further shift towards income redistribution and tax reductions without increasing fiscal revenues, implying further deficits. It considered that previous deficits were not the result of government decisions but of market processes (rising interest rates) (Hungarian CP May 2004). So fiscal policy still aimed to restrict demand to restore exports and a balanced growth, but at the same time structural reforms in the social and health systems and in education were launched, raising the target deficit. The reiterated commitment to control expenditures was still not credible. Finally, the re-elected Gyurcsany government (fall 2006) seems to be really committed to turning around public finances. It states that “the credibility of fiscal policy has been considerably
undermined by the frequent modifications of the deficit targets and the failure to achieve the modified targets” and pursues the “restoration of the credibility of fiscal policy” (Hungarian CP, September 2006). To this end, reforms of the rules of public spending and of public administration, health and education systems are necessary. The government thus forecasts a decline in growth in 2006-2009, then lasting growth on more sound bases.

In Poland, following a period of relative fiscal discipline (deficit of 1.5% of GDP in 2000), fiscal policy was rather lax under Miller’s left-wing government (2001-2005), in spite of the ambitious Hausner plan which was not entirely implemented. It remained lax after 2005, and the public deficit has exceeded 3% of GDP since 2001.

In 2001-2003, fiscal policy was expansionary, essentially due to social spending, except in the first half of 2002 when Finance Minister Belka implemented an austerity programme. It was reversed in June 2002 by Finance Minister Kolodko, who nonetheless aimed to reduce the budget deficit, with little success. In January 2004, Finance Minister Hausner launched a Programme for Rationalisation and Reduction of Public Expenditure (“Hausner plan”) to bring the public deficit under 3% of GDP by end 2007 by reducing social and administrative spending, increasing the efficiency of tax administration and increasing the tax base (Polish CP, April 2004). The government further intended to cap the level of the deficit at 30 billion złoty (this was applied for the first time in 2006 by the next government). But despite faster growth, none of the proposed measures, including the Hausner plan, were fully implemented and the deficit continued to rise. Growing political instability in particular delayed the complete vote of the Hausner plan in Parliament.

Fiscal policy was then relaxed in 2005 as the deficit target for 2007 was revised upwards, in spite of strong growth, due to the full inclusion of the costs of the 1999 pension reform in the public deficit in 2007, which increased the deficit by about 1.5 point.

The new right-wing government (November 2005) announced it would seek to improve public finances through performance budgeting and the introduction of three-year budgeting for general government finance planning (Polish CP, January 2006). It further stated that its main objectives were employment and living standards, while respecting fiscal constraints but in the long term: it aims for close to equilibrium public finances (-1% of GDP deficit), in the sense of the SGP, for end 2010 at the earliest (Polish CP, November 2006). But it is a minority government and will have difficulty getting the Parliament to vote its measures.

In the Czech Republic, after the right-wing government’s conservative fiscal policy in 1993-1998 aiming for a balanced budget, in 1998-2006 the successive left-wing governments have been more expansionary and the fiscal deficit has increased (Matalik & Slavík 2003). It exceeds the reference value since 1998, with a worsening of the situation in 2002-03.

The fiscal policy objective in 1998-2002 was to maintain balanced public finances, then the new Prime Minister Spidla, having campaigned in favour of reinforcing the welfare state, switched to an explicit policy of fiscal deficits, and created several off-budgetary institutions to carry out state interventions (Matalik & Slavík 2003). Therefore, he did not aim to reduce the fiscal deficit below 3% of GDP sooner than 2010. In 2003, it reached 12.9% because of the one-off imputation of state guarantees representing 6-7% of GDP to government expenditure in line with ESA95 rules.

Then the Spidla government, spurred by the excessive fiscal deficit procedure (see below) and followed by the Gross government (July 2004), decided to tackle the problem and designed a consolidation plan for public finances which would bring the deficit under 3% in 2008 while avoiding a strong reduction in growth (Czech PEP 2003). This would be achieved by a slightly restrictive fiscal policy and by structural changes in fiscal policy (first changing
the structure of taxes and government expenditure, change in budgetary rules, then introducing tax incentives for growth while maintaining fiscal neutrality). In September 2004 fiscal targeting was also introduced, which includes binding medium-term expenditure ceilings. A deep pension reform is also under discussion (2004-2007). At the end of 2004, it became apparent that these measures would not be sufficient, so the 2005 budget included further discretionary cuts. Fiscal targets seem to have been met in 2004, 2005 and 2006, but fiscal policy was once again loosened in 2006, an election year, so that the 3% deficit target will probably not be met in 2008 as planned (Czech CP, March 2007).

The CNB computes a “fiscal stance”, which is the fiscal effect on the output gap corrected by the business cycle, and confirms that it was expansionary in 1999, tight in 2000 and 2001 when growth picked up, neutral in 2002, tight in 2003 and expansionary in 2004 and 2005 (CNBd 2006).

Fiscal policies in NMS are thus subject to precise rules, which have not proved very effective in curbing fiscal deficits due to their weak credibility (absence of sanctions) and to the real objectives of fiscal policies. All three countries therefore underwent excessive deficit procedures as of May 2004. In July 2004, the European Council recommended they should bring their deficits below 3% in 2007 for Poland and 2008 for Hungary and the Czech Republic. In the Czech case, the Commission concluded in December 2004 that effective action had been taken and that no further steps were necessary. In the Polish case, although the Commission was satisfied in December 2004, it later pointed out that the January 2006 Convergence Programme only aimed to meet the reference value by end 2009, so a new recommendation is expected. The Hungarian disequilibrium is the hardest to absorb: the European Council judged in January 2005 that Hungary had not taken sufficient action and issued a second recommendation in March 2005, followed by a third in October 2006. The situation of Hungarian public finances is considered by European institutions as the worst among new member states.

3. Conflicts between central banks and governments in Central Europe

Given this institutional set up and diverging objectives between central banks and governments, conflicts could be expected between monetary and fiscal policy and have been observed to varying degrees in the three countries since the beginning of the 2000s. They concern the macro policy mix and the status of the central bank. We shall see in each country how the government criticised the speed of disinflation chosen by the central bank, how the central bank criticised the government’s fiscal policy, and what negative consequences this had for both actors and for growth.

3.1. Conflicts in Hungary

A first conflict between monetary and fiscal polices appeared in 2001-2002. While the central bank was implementing a disinflationary policy, the governments slowed down fiscal adjustments and sought interest rates and exchange rates reductions from the MNB. Far from complying, when it appeared that the deficit would actually amount to 9% in 2002 and that fiscal policy was not credible, the MNB tightened its monetary policy in May and July (MNB 2002). Therefore, although 2002 was a year of strong disinflation, the central bank raised interest rates. This conflict is all the more vivid as the MNB and the government had jointly set the inflation objectives in June 2001 for end-2002 and end-2003 (MNB 2002), in the hope this would help the government support monetary policy objectives.

The conflict lessened in the first half of 2003 when the MNB lowered interest rates, not to support growth and competitiveness but to counter speculative attacks on the exchange rate (see Kiss 2005). But combined with an unexpected devaluation of the intervention band,
this caused the exchange rate to drop very strongly, so the MNB increased rates again by six points in the second half of 2003 to maintain the exchange rate and combat inflation. Once again, this put pressure on the government to reduce the deficit and ran counter to its competitiveness policy.

The conflict flared up again in 2004 following the publication of the government’s Convergence Programme in May and the nomination of a new government in October. The MNB criticised the Convergence Programme for relying more on growth than on cuts in public spending to reduce the budget deficit. Furthermore, the new government was very critical of monetary policy, “accusing it of harming the Hungarian economy through inadequate economic policy co-ordination and monetary policy inflexibility” (CNBc 2004). According to the MNB, its rate cuts could have been bolder if fiscal policy had been more restrained (MNB 2005); on the other hand, the government considered that “under the tight monetary conditions, any greater fiscal austerity would jeopardise the strengthening export and investment driven growth” (CP, December 2004). The further slippage in fiscal policy since 2004 has aggravated this conflict: as noted by the European Council, deficit targets have been revised upwards since 2004 while growth has not deteriorated, structural reforms have been delayed, and tax cuts have been granted although the deficit targets were not met, contrary to Council recommendations. Fiscal policy failed to regain credibility in the past few years.

This conflict on the policy mix was paralleled by a conflict on the status of the central bank. In a first episode, after a new Act on the MNB was voted in 2001 to ensure compliance with EU regulations, the government submitted an amendment in June 2002 proposing to set up in the MNB a Board of Supervisors composed of four representatives of political parties appointed by the Parliament and two members appointed by the Minister of Finance. The governor of the MNB Jarai has stated (12 June 2002) that this amendment “infringes on the Bank’s operational independence” and that this type of committee does not exist in other EU countries. However, the amendment was voted and the Board of Supervisors was created in July 2002. Its scope of authority does not extend to the MNB’s definition and implementation of monetary policy (MNB 2002).

In a second episode, the government proposed in 2004 an amendment to the Act on the MNB threatening to undermine its independence. In particular, it proposed to increase the role of the government in the appointment of Monetary Council members: four were to be nominated by the MNB governor with the Prime Minister having a right of veto, the remaining three to five by the President of the Republic upon proposition of the Prime Minister without the governor having a right of veto (CNB 2004c). Despite criticism from the ECB, who considered this to be contradictory with central bank independence, this amendment was voted in December 2004.

Both changes were marginal in regard to the MNB’s independence which was not affected, so their economic impact on the institutional design of macro policies in Hungary was small, but they had a real political impact, as they stemmed from the government’s hostility to the MNB.

3.2. Conflicts in Poland

A conflict between the central bank and the government on macro policies broke out in 1999-2001. Due to a more expansionary than expected fiscal policy, the NBP tightened its monetary policy, regretting that the short-term costs of reducing inflation were higher than they would have been with a tighter fiscal policy: “an overly lax budgetary policy aggravated the unfavourable mix of monetary and fiscal policy” (NBP 2001). Conversely, the government (especially the new government as of October 2001) criticised the scale and
timing of this tightening, considering it unnecessarily reduced growth and it was maintained too long despite falling inflation, so that the 2001 inflation target was undershot (Jonas & Mishkin 2003). The austerity programme at the end of 2001 allowed the NBP to loosen its monetary policy, reducing the conflict and improving the policy mix. However, this conflict resumed in May 2002 when the government enlarged it to a disagreement on the exchange rate: it considered the high level of the parity was detrimental to competitiveness and growth.

The conflict was briefly attenuated in the second half of 2002 as Kolodko replaced Belka as Finance minister: he was more favourable to a fast EMU accession, implying greater support of the NBP’s monetary policy, and the NBP pursued its rate cuts (EIU 4Q2002).

The conflict resumed in 2003 when Kolodko renewed criticism on the NBP’s exchange rate policy and the fiscal deficit continued to rise. This occurred despite the Hausner plan to reduce it because of the political difficulties of its implementation and of the high political cost of fiscal adjustment. Therefore, the NBP considered that fiscal policy was neither sound nor credible, that it threatened price stability, and that it crowded out private investment financing, narrowing the possibilities of further rate cuts. The NBP was particularly sceptical about the Hausner plan: it planned an increase in the fiscal deficit in 2004 before its subsequent decrease, and the far-reaching adjustment was only intended in 2005. It concluded that “the unfavourable combination of fiscal and monetary policies raises the real costs of achieving and maintaining internal and external equilibrium” (NBP 2003). This conflict carried on into 2004 as the deficit continued to rise due to incomplete implementation of the Hausner plan. The NBP also criticised the government’s delay in launching necessary structural reforms, such as property rights protection, labour market and tax reform, development of the financial system, to increase potential GDP. This opposition subsided in 2005 as the deficit turned out to be lower than expected, which allowed further interest cuts, and with the new government’s seemingly firmer commitment to reduce the fiscal deficit (although its minority status poses threats on this).

This conflict spilled over to the status of the NBP. First, at the end of 2001, the government proposed an amendment to the Act on the NBP to harmonise it with the Maastricht Treaty. However, it also aimed to reduce the independence of the NBP as its policy objectives would be fixed by the government (NBP 2002), and would include growth and employment (Jonas & Mishkin 2003). This amendment stood no chance of being voted, as it went against European rules, and was eventually dropped. Second, further amendments to the Act on the NBP were proposed by members of Parliament in 2003, considered unconstitutional and incompatible with EU regulations by the NBP. They were not voted either. These episodes are nonetheless significant of intense political conflicts between the government and the central bank, the government using them – unsuccessfully – to try to bully the NBP into relaxing monetary policy.

3.3. Conflicts in the Czech Republic

The lack of coordination between fiscal and monetary policy in the Czech Republic was noted by observers in 1998-1999 (European Commission 1998). Governments criticised the excessive speed of disinflation (Jonas & Mishkin 2003), deemed too costly in terms of growth, considering the economy was only slowly recovering from the 1997 crisis and the inflation targets were repeatedly undershot. In the following years, the central bank did not criticise so strongly the government’s fiscal policy, it only repeatedly pointed out that it was difficult to predict the size and the timing of the fiscal impulse, making it more difficult to coordinate monetary and fiscal policies (CNBa 2000, 2001, 2002). Conversely, the government strived to restrict fiscal policy as of 2003 to “make room for a more
accommodating monetary policy” (Czech CP, May 2004). The joint setting of the inflation targets for 2001-2005 (see below) also helped to attenuate the conflict.

This conflict led to legislative attempts to restrain the CNB’s independence. The Act on the CNB was amended in 2000 to harmonise it with EU legislation (primary objective of price stability, non financing of public institutions, etc). But some measures threatened the CNB’s independence: the CNB and the government must agree on matters relating to the inflation target and the exchange rate regime, the Bank Board members are to be appointed by the President of the Republic at the proposal of the government. These changes, which entered into force on 1st of January 2001, were considered to be incompatible with EU rules by the European Commission and the ECB. The Czech Constitutional Court considered them to be unconstitutional and repealed them in August 2001. The Constitution was then revised to change the CNB’s primary objective to price stability. In May 2002, a second harmonisation amendment to the Act on the CNB restored the CNB’s independence. In the meantime, the yearly 2001 and the medium-term 2002-2005 inflation targets had been set jointly with the government, and although this was contrary to the CNB’s independence, it recognised that this helped to “boost the credibility and effectiveness of the inflation target, as well as for forming the desired monetary and fiscal policy mix” (CNBe 2000).

Conflicts of various duration and intensity on the policy mix and on the status of the central bank have been observed in the three countries, where governments criticise the speed of disinflation chosen by the central bank whereas the central bank criticises the excessive and often unpredictable fiscal policy of the government, these conflicts being shorter and milder in the Czech Republic. They do not seem to have been very profitable for either actor, as governments did not succeed in convincing the central banks to lower their rates. On the other hand, if governments have seemingly finally started to redress public finances, this was not only due to pressure from central banks but also from European institutions. Furthermore, the central banks sometimes lost popular support when it was perceived as trying to punish the government for its excessive fiscal policy rather than follow its monetary policy objectives, as in Poland in 1999-2001 (Jonas & Mishkin 2003). Globally, these conflicts risk reducing the efficiency of both policies: fiscal policy is hampered by high interest rates, monetary policy is constrained by loss of public support if it aims for too fast a disinflation, and an unsuitable combination of monetary and fiscal policies may prevent the emergence of conditions conducive to stable growth. Therefore, how can they be explained? We shall explore two successive explanations.

4. Can these conflicts be explained by lack of credibility of monetary policy?

Can they be explained, as suggested Creel and Fayolle (2002) in the case of EMU, by the lack of credibility of monetary policy? To explore this, we shall review two ways to evaluate monetary policy credibility: central banks’ ability to meet their targets, and the capacity of private agents to anticipate monetary policy decisions.

4.1. Do central banks meet their targets?

In Hungary, the inflation target was met in 2001 and 2002, overshot in 2003 and 2004, because of unexpected consumption growth related to expansionary fiscal policy in 2003 and due to increases in indirect tax in 2004, then met again in 2005 (MNB, various years). In Poland, the inflation target was first overshot in 1999 and 2000, because of the unexpected fiscal expansion, then undershot in 2001, 2002 and 2003 because of a very restrictive monetary policy (NBP, various years). In the Czech Republic, the target was first undershot in 1998 and 1999, essentially due to external factors such as plummeting raw materials and food prices, appreciation of the exchange rate, and the continued restrictive fiscal policy containing
demand in the wake of the Spring 1997 crisis. The target was met in 2000 and 2001, then undershot again in 2002 and 2003 for the same reasons, and met since (CNBa, various years).

The results are thus mixed. Central banks usually worry more about overshooting than undershooting their objectives. These results point to some target overshooting in Hungary and Poland, but this was related to unexpectedly loose fiscal policy or tax changes, and the target was never overshot in the Czech Republic, which indicates a rather high level of monetary policy credibility measured in terms of its capacity to achieve its objectives. Conversely, target undershooting may contribute to explaining the conflict on the policy mix as its cost is much greater for the government than for the central bank.

4.2. Are monetary policy decisions correctly anticipated?

Another way to evaluate monetary policy credibility is to observe whether private agents anticipate it correctly. One way to measure this is to consider its impact on the yield curve. The idea is that monetary policy credibility reflects its ability to influence private agents’ expectations regarding future inflation and future policy and that these expectations can be approached by observing the yield curve, which relates short-term interest rates, normally directly influenced by monetary policy, and long-term interest rates, which are influenced by monetary policy to the extent it is correctly and credibly anticipated. Short-term interest rates should be smoother than central bank rates as they anticipate them, while long-term rates should not be affected by monetary policy if it is correctly anticipated. Another way to measure how well monetary policy is anticipated is to look at private inflation expectations.

In the Czech Republic, a study of the impact of monetary policy decisions on short-term and long-term interest rates from 1996 to 2002 (Matousek and Taci 2003) shows that transparency of monetary policy has increased after 1997, as short-term interest rates were less “surprised” by monetary policy decisions than before, and that long-term rates indicate monetary policy was credible throughout the period, its credibility increasing after the switch to inflation targeting. Another study on the volatility of forward interest rates on 1999-2005 data (Bruna 2006) qualifies this result by identifying phases of lesser credibility of the CNB, especially after the end of the first phase of disinflation in 2000, when private agents were not sure disinflation was definite.

In Hungary, the MNB claims that the switch to inflation targeting has increased monetary policy credibility measured by its impact on long-term rates (MNB 2001). A study of the impact of monetary policy decisions on short-term and long-term interest rates from 2001 to 2005 (Gabriel & Pinter 2006) qualifies this result: this impact is small for short-term rates (because of “occasional inconsistencies of interest rate decisions and communication”) and more important for long-term rates, implying greater long-term credibility. Furthermore, it seems that monetary policy tightening is more credible than monetary policy easing.

In Poland, we do not dispose of data on yield curves. A study on the comparison between inflation expectations of the private sector (consumers and commercial bank analysts) (Lyziak et al. 2007) and the inflation target shows that monetary policy credibility has increased, especially for bank analysts, except in the period of fast disinflation in 2002-2003 and in 2004 due to EU accession.

These tentative results indicate monetary policies were rather credible in Central Europe in the period under review. This is confirmed by several other studies, which tentatively conclude that the transmission from monetary policy to long-term interest rates is strongest in Poland, weakest in Hungary, with the Czech Republic in between (Crespo-Cuaresma et al. 2004, Arestis et al. 2005). It seems therefore that the explanation of conflicts between central banks and governments by lack of credibility of monetary policies does not hold in this case, and that the source of the problem mainly resides with lack of credibility of
fiscal policies. We now propose to relate this lack of credibility of fiscal policies and the general conflict to the institutional framework governing macro policies in Central Europe.

5. Explaining these conflicts by the institutional framework

5.1. Diverging policy objectives

At a first level, the conflicts between central banks and governments can be explained by their diverging policy objectives. We have seen that central banks pursue price stability to achieve disinflation in the short term and prepare EMU accession in the long term, whereas governments, while also committed to EMU accession, also pursue real objectives such as growth and employment. To a certain extent, this brings us back to two traditional questions of economic policy.

First, the confrontation of these objectives is related to the trade-off between nominal and real objectives: governments contest the speed of disinflation chosen by the central bank because of its negative effect on growth, especially when inflation targets are undershot. In this sense, both authorities support EMU accession as quickly as possible, but have diverging appreciations of what this horizon is. In the absence of an obvious optimal speed of disinflation, and due to differing distributional consequences of different choices, conflicts may be expected on this decision, and are bound to be acute in cases of supply shocks, where prices and activity diverge.

Second, this opposition is related to the debate on economic policy instruments. Central European central banks are much more inclined than governments to consider that macroeconomic policies should be geared towards nominal adjustments, while stabilisation of real variables should be obtained by spontaneous adjustments resulting from supply-side structural polices such as flexibilisation of the labour market, the completion of privatisation, tax reform, competition policy, etc. Governments consider to a larger extent that macro policies can stabilise real variables. These conflicts may therefore be interpreted in terms of the debate on the use of fiscal policy to stabilisation ends.

5.2. Political factors

At a second level, difficulties of coordination fiscal and monetary policies may be political. Whereas in Western Europe, central bankers are generally technocrats, in Eastern Europe they are often former politicians (Balcerowicz, the governor of the NBP from 2001 to 2007, and Jarai, the governor of the MNB from 2000 to 2007, are former Finance Ministers), or technocrats having ventured into politics (Tosovsky, the governor of the CNB, briefly served as Prime Minister before going back to the CNB), which contributes to politicising debates around monetary policy.

Furthermore, in the period under review, the central bankers and the governments were of opposite political obedience: the former were all from or related to right-wing parties, while the latter were left-wing (in Hungary since 2002, in Poland from 2001 to 2005 and in the Czech Republic from 1998 to 2006).

5.3. The “chicken game”

In a more economic framework, this conflict has been interpreted in terms of the “chicken game” (Fitoussi 1999), where each player seeks to convert the other to his own view, or failing that, to punish him and stick to his own convictions in order not to lose face (not to be the “chicken”). In this setting, the policy mix is viewed as a non-cooperative game between the central bank and the government, where each player has a firm conviction on what the optimal policy mix is, and these visions diverge. Thus, the optimal policy mix is a restrained fiscal policy and a neutral or accommodating monetary policy according to the
central bank, as this minimises the costs in terms of growth and employment of a given disinflationary policy; and a neutral or accommodating monetary policy and a neutral or accommodating fiscal policy according to the government, as this allows to pursue disinflation given a growth objective. Fitoussi applied this framework to the conflict between the ECB and national governments in the early years of EMU, and it seems to correspond to the situation of Central European countries: Central European central banks as well as governments state very clearly that they have such a preference on the policy mix.

The confrontation of these diverging conceptions of the optimal policy mix easily leads to a conflict hampering the emergence of either policy mix. The matrix of gains of the chicken game (figure 1) illustrates how if each player pursues its objectives, the worst solution emerges (-1, -1). In dynamics, this situation worsens: monetary policy is all the more restrictive if fiscal policy is too lax, while fiscal policy is all the more lax as monetary policy is deemed too restrictive by the government. If either of the two players give in, both gain, but the one which gives in gains comparatively less. Two preferable equilibria exist (the “conservative” and the “social” solution) but because of non-cooperation and a wish not to loose face, they cannot be attained. This approach explains that in certain circumstances, central banks may have excessively tightened monetary policy in order to force the governments to revert to more fiscal restraint, while governments may have excessively loosed their fiscal policy to more than compensate for the restrictive monetary policy. In all cases, the emergence of a policy mix creating good conditions for growth is hampered.

Figure 1 The matrix of gains of the “chicken game”

<table>
<thead>
<tr>
<th>Central bank</th>
<th>Governments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Restrictive fiscal policy</td>
</tr>
<tr>
<td>Restrictive monetary policy</td>
<td>4 / 2 “Conservative solution”</td>
</tr>
<tr>
<td>Expansionary monetary policy</td>
<td>0 / 0 “Social solution”</td>
</tr>
</tbody>
</table>


5.4. Imperfections of the institutional framework of the policy mix

The chicken game approach usefully explains how the conflict can last but, taking non-cooperation as given, does not explain why the institutional framework of macro policies does not foster cooperation.

The first step to understand this is to go back to the Kydland & Prescott (1977) and Rogoff (1985) models, at the foundations of the independence of central banks. According to these models, the government pursues two partially conflicting objectives, price stability on one hand and growth and employment on the other, which implies a risk on inflation if the government tries to raise the level of output above its natural level to reduce unemployment. In order to render monetary policy credible – to make it able to achieve its objective of price stability and to convince agents of its credibility – the models recommend creating an independent central bank who will pursue the price stability objective while the government will pursue the real objectives. In this set up, there is no possibility of a trade-off between

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3 According to the CNB (1999b), “the general trend should not be one of a tight monetary policy subsequently offsetting or counterbalancing excessively relaxed wage-income or fiscal dimensions. On the contrary, the conditions of the Czech economy should normally require a prudent wage-income policy combined, as far as possible, with a more relaxed monetary policy”. According to the NBP (2004), “the non-optimal macroeconomic policy mix which couples a restrictive monetary policy with a loose fiscal policy, increases the cost of price stability maintenance in the form of lower GDP growth (in relation to the optimal mix)”. For the governments’ preferences, see above (Fiscal policy objectives).
price stability and growth, since both objectives are not pursued by the same entity. It follows from this literature that central banks and governments necessarily have conflicting objectives, as the central bank’s objective was precisely defined in opposition to the government’s.

Furthermore, in the way these theoretical results were applied to EMU, the institutional architecture of EMU gives an explicit preference to the price stability objective. This is illustrated by the Stability and Growth Pact constraints imposed on fiscal policies to prevent them from interfering with the price stability objective. To the extent that Central European countries aim to integrate EMU and are submitted to these constraints, this also applies to them. This means that the fundamental trade-off between price stability and real objectives is no longer possible, the choice has been made once and for all. The choice of independent central banks is therefore much more than a technical choice, it also implies fundamental choices on the possible scope of economic policy objectives.

Even in this framework, conflicts are possible for two reasons. The first one is related to credibility. Creel and Fayolle (2002) suggested that the ECB pursued an excessively restrictive monetary policy in its first years in order to combat inflation and punish lax fiscal policies, thus doubly convincing agents of its determination to pursue price stability, in other words to quickly acquire credibility. But we have seen that in Central Europe, monetary policy seems to have been rather credible, give or take a few exceptions, and if anything the conflicts were rather related to lack of credibility of fiscal policies.

Finally, conflicts may arise because the institutional safeguards intended to submit governments to the primacy of the price stability objective are not sufficient. In the case of EMU, the SGP has shown its limits, was suspended in November 2003 and reformed in March 2005. In the case of Central European countries, the excessive deficit procedure is even less effective because it is not constraining, which has allowed Hungary and Poland to delay the required fiscal adjustments. Therefore, a fundamental source of conflict lies in the imperfect coherence of the institutional architecture of macroeconomic policies, which leads to diverging objectives, the primacy of the central banks’ objective, but more or less equal power of governments and central banks and no complete way to constrain the former to submit to this choice. In evolutionary terms, we could say that a given institutional framework among those possible has been selected (here by selection processes external to the Central European economic and political context) but that it is confronted to inertial forces which have not been accommodated into the framework, whence the imperfect coherence.

A contrario, the choice of the Hungarian and Czech independent central banks to set their inflation targets jointly with the government to make monetary policy more credible and to attenuate the conflict on the policy mix illustrates the fact that the trade-off between price stability and growth cannot without risk be entirely decided ex ante and that it may be helpful to re-examine this trade-off and to reintroduce political responsibility in the decision. However, if cooperation on inflation targets has seemed to work in the sense that this conflict was less severe in the Czech Republic than in the other two countries, it has not entirely solved the problem in Hungary, and it is incompatible with EMU rules and will necessarily cease upon EMU accession, which means that the conflict may be revived then, in parallel to the ECB’s first difficult years.

Conclusion

Important conflicts were observed in Central Europe between monetary and fiscal policies in the 2000s. It seems that lack of coordination between fiscal and monetary policy was less severe in the Czech Republic, where the CNB explicitly cooperated with the government in setting the inflation targets as of 2000, and where fiscal policy was arguably more credible than in the other two countries. In this case, deviance from the inflation target
seems to result more from exogenous factors. On the contrary, this lack of coordination seems more acute in Poland and Hungary, where deviance from the inflation target may be explained more by the unsatisfactory macro policy mix.

These conflicts are related to divergent policy objectives of central banks and governments and to the imperfectly coherent institutional framework of macro policies in the preparation of EMU: central bank independence has not abolished the trade-off between nominal and real objectives, without creating good institutional conditions for this policy choice. As EMU countries themselves went through similar conflicts in the first years of the euro, and as the institutional framework of EMU is also imperfectly coherent, there is no reason to believe that EMU accession would allow the complete disappearance of this conflict, especially in times of slower growth (even more if this is the result of a strict monetary policy), and maybe when more spending-biased left-wing governments are in power.

This conclusion highlights a possible source of limits to growth: the imperfection of the institutional framework of macro policies, and the lack of conflict-solving devices. This opens up interesting normative debates on the improvement of the framework, and these questions are all the more relevant as they concern not only Central European countries, but also EMU countries: the improvement of the framework can only find an answer at the European level. Fitoussi (2002) suggests for example that the European Parliament may determine the inflation target of the ECB. In this regard, the device experimented in Hungary and the Czech Republic might prove interesting: a voluntary decision of the central bank to choose its inflation targets jointly with the government might be helpful in attenuating these conflicts and allowing higher growth, and does not require to rewrite the Treaty (if it is a voluntary choice of the central bank, it is not incompatible with its independence).
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Hungarian Ministry of Finance, Pre-Accession Economic Programme (PEP), various dates, August, Budapest.


Polish Ministry of Finance, *Convergence Programme* (CP), various dates, Warsaw.


Appendix 1 Inflation targets

In italics: medium term inflation targets.

Table 1a Inflation targets in Hungary

<table>
<thead>
<tr>
<th>Date adopted</th>
<th>Reference period</th>
<th>Target rates (consumer price inflation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2001</td>
<td>December 2001</td>
<td>7% ±1 percentage point</td>
</tr>
<tr>
<td>June 2001</td>
<td>December 2002</td>
<td>4.5% ±1 percentage point</td>
</tr>
<tr>
<td>December 2001</td>
<td>December 2003</td>
<td>3.5% ±1 percentage point</td>
</tr>
<tr>
<td>Summer 2002</td>
<td>December 2003</td>
<td>Below 4.5%</td>
</tr>
<tr>
<td>October 2002</td>
<td>December 2004</td>
<td>3.5% ±1 percentage point</td>
</tr>
<tr>
<td>October 2003</td>
<td>December 2005</td>
<td>4% ±1 percentage point</td>
</tr>
<tr>
<td>November 2004</td>
<td>December 2006</td>
<td>3.5% ±1 percentage point</td>
</tr>
<tr>
<td>August 2005</td>
<td>As of January 2007</td>
<td>3% ±1 percentage point</td>
</tr>
<tr>
<td>November 2006</td>
<td>December 2007</td>
<td>3% ±1 percentage point</td>
</tr>
</tbody>
</table>

Continuous inflation target: measured month to the corresponding month of the previous year.

Table 1b Inflation targets in Poland

<table>
<thead>
<tr>
<th>Date adopted</th>
<th>Reference period</th>
<th>Target rates (consumer price inflation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 1996</td>
<td>December 1997</td>
<td>15%</td>
</tr>
<tr>
<td>October 1997</td>
<td>December 1998</td>
<td>9.5%</td>
</tr>
<tr>
<td>October 1998</td>
<td>December 2004</td>
<td>4%</td>
</tr>
<tr>
<td>October 1998</td>
<td>Revised in March 1999</td>
<td>8-8,5%</td>
</tr>
<tr>
<td>October 1999</td>
<td>December 2000</td>
<td>5,4%-6,8%</td>
</tr>
<tr>
<td>October 2000</td>
<td>December 2001</td>
<td>6-8%</td>
</tr>
<tr>
<td>August 2001</td>
<td>Revised June 2002</td>
<td>5% ±1 percentage point</td>
</tr>
<tr>
<td>March 2003</td>
<td>Continuous target</td>
<td>2.5% ±1 percentage point</td>
</tr>
</tbody>
</table>

Continuous inflation target: measured month to the corresponding month of the previous year, until entry into ERM II or the end of term of office of the current Monetary Policy Council.

Table 1c Inflation targets in the Czech Republic

<table>
<thead>
<tr>
<th>Date adopted</th>
<th>Reference period</th>
<th>Target rates (net inflation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1997</td>
<td>December 1998</td>
<td>5,5% - 6,5%</td>
</tr>
<tr>
<td>December 1997</td>
<td>December 2000</td>
<td>3,5% - 5,5%</td>
</tr>
<tr>
<td>November 1998</td>
<td>December 1999</td>
<td>4% - 5%</td>
</tr>
<tr>
<td>April 1999</td>
<td>December 2005</td>
<td>1% - 3%</td>
</tr>
<tr>
<td>April 2000</td>
<td>December 2001</td>
<td>2% - 4%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Target rates (headline consumer price inflation)</td>
</tr>
<tr>
<td>April 2001</td>
<td>January 2002</td>
<td>3% - 5%</td>
</tr>
<tr>
<td>April 2001</td>
<td>December 2005</td>
<td>2% - 4%</td>
</tr>
<tr>
<td>March 2004</td>
<td>As of January 2006</td>
<td>3% ±1 percentage point</td>
</tr>
<tr>
<td>March 2007</td>
<td>As of January 2010</td>
<td>2% ±1 percentage point</td>
</tr>
</tbody>
</table>

Target rates (headline consumer price inflation), permanent target

Net inflation excludes regulated prices.
Appendix 2 Cohesion funds expenditures compared to SGP sanctions

<table>
<thead>
<tr>
<th></th>
<th>(1) GDP 2004 millions of euro</th>
<th>(2) 0.5% GDP millions of euro</th>
<th>(3) Cohesion funds, 2007-2013 millions of euro</th>
<th>(4) Cohesion funds, yearly average millions of euro</th>
<th>Ratio (4)/(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>87 205</td>
<td>436,0</td>
<td>8819</td>
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Source:
- GDP 2004: Eurostat