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Summary of
WP/92/68

"Interest Rate Policy in Central and Eastern Europe:
The Influence of Monetary Overhangs and Weak Enterprise
Discipline" by Adam Bennett and Susan Schadler

The principal problem addressed in this paper is the effect of raising interest rates in previously centrally planned economies where a large portion of the state industrial sector is not viable but is to remain in operation for the immediate future. When nominal interest rates are raised, the government has no option but to finance the resulting increase in the debt service of these nonviable enterprises. This can be done explicitly through budget subsidies or, as is more common, through bank credit to enterprises. In these circumstances, higher interest rates carry the seeds of higher credit growth and ultimately higher inflation. Moreover, when such a link between interest rates, credit, and inflation is important, the scope for higher interest rates to support the exchange rate is also reduced; if higher interest rates do generate higher inflation, the value of the domestic currency will depreciate.

These observations on interest rate policy are difficult to use operationally in any formulaic or mechanical way. Establishing positive real interest rates is clearly desirable. And to do so when inflation rises, nominal interest rates must be raised. This paper simply argues that this process should not be pursued without careful consideration of the possible side effects on inflation itself. To make a judgment about how far up nominal interest rates should be pushed requires some knowledge of the structure of the economy--specifically, the share of state enterprises that would require financial support if interest rates were raised and the interest sensitivity of the demand for money. The larger the burden of nonviable enterprises and the lower the interest elasticity of the demand for broad money, the greater is the potential for higher interest rates to fuel inflation. By contrast, to the extent that enterprises can be closed down or the government deficit reduced, the raising of interest rates can help reduce inflation through its conventionally recognized role. These considerations are essential to determining the appropriate balance between pushing up interest rates and the longer-term fight against inflation.

The paper spells out the relevant relationships among interest rates, enterprise debt, and inflation and illustrates the effects of raising interest rates by simulations based on plausible parameter values.