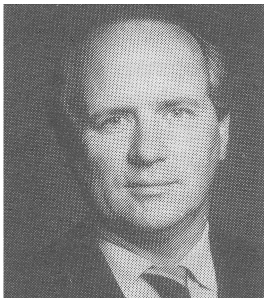
Editorial



Dr. Heiner Flassbeck,
head of the "Business Cycle" department,

"... on an Encounter of the Third Kind"

The other day, in a country of the former Soviet Bloc, I met one of those smart economists from the staff of one of the big international organisations in the United States which give aid and advice to such countries. We quickly started a discussion concerning the overwhelming economic problems prevailing in that region of the world. The country we both were visiting had just experienced a huge drop in overall output, enormous hidden unemployment, was faced with an inflation of inter-enterprise debt, real interest rates of at least 50% and a current account deficit. But my complaints about all the evils that were afflicting the unfortunate population went unheard. My counterpart pointed to very positive developments that should not be forgotten: the inflation rate had come down from 40% per month a year ago to 2% now, nominal exchange rates were more or less constant, there was a remarkable real appreciation vis à vis the US-dollar and the Russian rouble and, although understated in the statistics, a recent stabilisation in output and preliminary indications of enterprise restructuring.

While accepting these facts, I tried to make my point again. Is it surprising, I asked, that nominal short-term interest rates far in excess of the inflation rate for nearly a year and a 50% drop in output in two years bring about a certain stabilisation of prices and some inflow of capital? At this stage of our talk I expected an exchange of arguments on the merits of a restrictive monetary policy and the price to be paid for hyperinflation in different countries. But my opponent jumped up: "Do you really believe", he shouted, "that monetary policy can exert any influence on real *interest rates?" and he looked at me as if I were the last of the dinosaurs. I retreated, my response was extremely cautious. "Don't you think", I argued, "that the Federal Reserve System of the United States has some influence, not only on nominal, but also on real rates? Was it not the intention of the Fed to moderate US economic growth by raising interest rates in seven steps since February of 1994? Isn't there widespread agreement that the Fed is in a position to do just that and isn't there some widely accepted evidence that the US economy has recently been running out of steam?"*

He looked at me suspiciously. "Are you going to compare the United States with a country of the CIS group?" A striking argument! "No," I answered, "but if you're right, doesn't your statement imply, in theoretical terms, more rationality in expectations, i.e. a better knowledge of the relevant model of monetary theory, in our host-country than in the United States – after 70 years of communism?"

He couldn't answer. His mobile phone rang and he quickly responded in Russian. He had to leave. It was the Central Bank. They were asking for his advice.