

Estimating the fundamental equilibrium exchange rate of Central and Eastern European Countries. The E(M)U Enlargement Prospect

EGERT Balazs, LAHRECHE-REVIL Amina

The ambition of this study is to estimate the equilibrium real and nominal exchange rates for 5 selected Central and Eastern European transition economies, namely for the Czech Republic, Hungary, Poland, Slovakia and Slovenia. For this purpose, a new approach is adopted, which combines the fundamental equilibrium exchange rate (FEER) methodology developed by Williamson (1994) with the behavioural equilibrium exchange rate (BEER) approach advocated by Clark and McDonald (1998). Our investigation, based on the notion of internal and external balances, defined respectively in terms of the relative price of non-tradable goods and the long-run sustainability of the current account position, is carried out in the framework of a VAR-based 3-equation cointegration system. Long-term equilibrium values for relative prices are determined using relative productivity and private consumption, whereas the current account is regressed on terms of trade and the openness ratio. So as to derive the equilibrium real exchange rate and to compute subsequently the extent of misalignment, long-run values for external and internal balances are substituted in the simultaneously estimated cointegration relationships connecting the real effective exchange rate with relative prices and the current account. Assuming that the obtained misalignments can be eliminated with adjustments in nominal exchange rates, the estimated misalignments are used to derive the equilibrium nominal exchange rates against the euro. Finally, the sustainability of an ERM-II-type exchange rate regime is investigated on ex-post data from an EMU enlargement prospect and the credibility problem of fixing the CEECs' currency vis-à-vis the single European currency is analysed.
