Currency Convertibility in Eastern Europe

C. Fred Bergsten and John Williamson

A part of the process of transforming a centrally planned economy into a market economy is, it is generally agreed, the establishment of currency convertibility. Views differ, however, on the strategy by which convertibility should be established. This paper aims to identify the key issues in the debate about convertibility. We offer answers on two of the questions at issue, and leave the remaining three open.

The standard definition, which we adopt, is that a currency is convertible if it "is freely exchangeable for another currency, or for gold" (Pearce 1981, p. 82). In contradiction to earlier usage, convertibility does not today generally imply the right to convert at a fixed exchange rate, but it does imply the right to convert at the legal exchange rate, rather than at an unofficial or parallel (normally depreciated) rate.

Current account versus unrestricted convertibility

When Yugoslavia established convertibility in December 1989 and Poland followed suit at the beginning of this year, they gave domestic residents the right to buy foreign exchange at the official exchange rate in order to finance current account transactions, that is, purchase of goods or services from abroad. Such ***current account convertibility*** is the concept of convertibility called for in the IMF's Articles of Agreement ("no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions," Article VIII, Section 2(a)). Current account convertibility has often been abridged by limiting the foreign exchange that can be purchased for tourist expenditures, in order to minimize the evasion of exchange controls intended to prevent capital outflows. We accept that such limitations on tourist allowances are likely to be needed for as long as convertibility is restricted to the current account.

It is of course true that the substance of current account convertibility could be denied de facto if the relaxation of exchange controls was negated by an intensification of trade restrictions. Hence it is important to bear in mind that it is the joint product of trade restrictions and exchange controls on current account transactions that determines how fully a country's goods markets are integrated into the world economy.

A currency enjoys ***unrestricted convertibility*** if there are no restrictions on its exchange into a foreign currency for any purpose; including the purchase of foreign assets (capital export). Currencies become convertible in this sense when exchange restrictions on capital exports are abolished, so that residents have the right to export capital at the official exchange rate. Nowadays parallel markets through which capital can be exported even in the absence of unrestricted convertibility seem to be universal (although they were not ubiquitous in Western Europe in the early postwar period); even though neither Poland nor Yugoslavia has adopted unrestricted convertibility, in both cases the dollar stands at only a modest premium in the parallel market.

The first key issue is whether the medium-term objective should be current account convertibility or unrestricted convertibility. Current account convertibility is a necessary condition for a country to be integrated efficiently into the world trading system. It ensures that international relative prices will prevail in the domestic economy, give or take a margin for trade restrictions, transport costs and the imperfections of arbitrage. Assuming that tariffs and other trade restrictions are not unreasonably severe, this in turn ensures that enterprises which face hard budget constraints[1] will encounter incentives to produce, export and import in accordance with comparative advantage. Of course, it is also necessary that the exchange rate be appropriately valued: if the domestic currency were overvalued, for example, too many firms would wish to import and too few to export, resulting in an unsustainable current account deficit.

Centrally planned economies deliberately avoided currency convertibility. A part of the central plan consisted of determining which goods could be in excess supply and should be exported, and which were in excess demand and should be imported. A centralized state trading agency bought domestic goods in the former category to sell abroad at whatever price happened to prevail on the world market, and bought goods in the latter category abroad, with no concern for the profits or losses that might be involved. Currency convertibility would have allowed enterprises and households to use their cash balances to buy abroad those goods that were cheaper on the world market than on the domestic market, thus subverting the planners' priorities.

Indeed, central planning was characterized not just by currency inconvertibility but also by "commodity inconvertibility." This means that an enterprise was not allowed to use its cash balances to purchase goods or services at its own discretion, but was constrained by the central plan (rather than, as in a market economy, being rationed by a budget constraint). Any cash shortage that jeopardized plan fulfillment could be compensated by borrowing from the state bank at a low rate of interest (and with no threat of bankruptcy to limit further borrowing if the loan could not be serviced). Given that prices did not reflect scarcity, it was of course logical to prevent enterprises trading freely to maximize their profits.

Commodity convertibility would give enterprises the right to decide for themselves whether and how to spend their cash balances. Doing this before budget constraints are hardened (as has to some extent happened in the Soviet Union) is a formula for losing control over demand. In fact, hard budget constraints, commodity convertibility, and prices that reflect scarcity, are the three changes that jointly define the move from a planned to a market economy. Privatization, though a natural complement, is less urgent.

Currency convertibility, even on current account, hardly makes sense until commodity convertibility exists, since that would give enterprises the ability to buy abroad freely while forbidding them to buy at home. But a good case might be made for introducing both commodity and current account convertibility simultaneously, since current account convertibility can supply a country with a relative price structure (enforced by potential competition) that reflects scarcity.

Is unrestricted convertibility, the addition of the right to export capital freely, an equally urgent priority? Surely not. It is not necessary for encouraging the *import* of capital, something which can of course be important to a country engaged in extensive modernization of its capital stock. What matters for that purpose is that foreign lenders or capitalists should have the right to remit their profits into foreign currency, and that requirement is satisfied by current account convertibility. Unrestricted convertibility enables capital to flee from where it is needed, which is at home during the period of economic reconstruction that lies ahead. (The three major cases of capital flight in Latin America all involved countries that had abolished controls on the export of capital.) Nor is there a strong case on grounds of civil liberties for demanding that households be free to export capital: the Western European democracies imposed such restrictions for years (in the case of Italy, the restrictions have only been abolished in the last few months), without any widespread complaint that this infringed personal liberty.

We conclude that Eastern European countries would be well advised to focus their efforts on the achievement of current account convertibility, and to treat unrestricted convertibility as a luxury to be delayed until reconstruction has been achieved.[2]

Gold convertibility

Angell (1989) and Wanniski (1989) have suggested that the Soviet authorities should make the rouble convertible into gold at a fixed price. Since gold can be sold for hard currency, this would provide indirect convertibility into dollars or other hard currencies, but at an exchange rate that would vary with the dollar price of gold.

The argument in favor of gold convertibility is that this commitment will provide a constraint on inflationary policies, which will enhance confidence and hence make rouble-denominated financial instruments more desirable savings vehicles, and provide assurance that any one-time upward price pressure resulting from the release of pent-up consumer demand would be perceived as temporary (Angell 1989, p. 12).

We see three powerful arguments against the proposal. The first is that it is not at all clear that a promise of gold convertibility can transform expectations in the way that is postulated. If the gold content of the rouble were pitched sufficiently low to ensure initial credibility, it would not be much of a constraint on deficit financing. But if it were pitched high enough to constrain deficit financing, the absence of a past track record justifying credibility would suggest the danger of a run from roubles into gold. A system of commodity money is inherently unstable unless it is backed 100 percent (Friedman 1951).

The second argument against a gold-convertible rouble stems from the fact that the rouble/dollar exchange rate would vary directly with the dollar price of gold, which is a highly volatile price. Unless the gold price is far more stable than in the past, periodic severe misalignments of the rouble would be guaranteed.

Third, even if it is true that gold-backed rouble bonds could be sold at a low interest rate, one must doubt whether the Soviet Union would be well advised to borrow in this way. If the gold price were to rise, the cost of such borrowing could be very high, as it certainly was the last time a major country decided to try and reduce its interest bill this way. In 1973 Giscard d'Estaing launched Fr. fr. 6.5 billion of bonds indexed to the gold price with a 7 percent interest rate (some 1 percent below the market rate). Fifteen years later the French Treasury had to reimburse holders Fr. fr. 55 billion, that is, 8.5 times the sum subscribed, having in the interim paid Fr. fr. 35 billion in interest rather than the forecast Fr. fr. 6.8 billion. (In constant 1988 prices, repayment of principal went from 24 billion to 55 billion francs and interest from an expected 10 billion to 35 billion francs. All statistics from *Le Monde*, 16 Jan. 1988, p. 28.)

We conclude that a declaration of gold convertibility for the rouble would be distinctly imprudent.

Exchange rate policy

Before discussing the alternative strategies by which convertibility could be achieved, it may be useful to outline the exchange rate arrangements that would seem the appropriate complement to currency convertibility in the East European context.

The first issue is whether the exchange rate,should float or be pegged. We see two powerful arguments against floating. The first was invoked by Paul Volcker at this conference and echoed subsequently by other speakers: the difficulty of interpreting traditional monetary indicators during the transition to a market economy which deprives the central bank of the possibility of conducting an informed autonomous monetary policy such as is needed with a floating rate. The second stems from the unsatisfactory record of floating even in countries that have had an adequate basis for conducting monetary policy: notably, the demonstrated propensity of floating rates to generate periodic severe misalignments that produce large trade imbalances and consequent distortions in the economy. In view of this evidence it is naive to imagine that one can rely on the market to compensate for the ignorance of the authorities as to what the "right" exchange rate is.

If one wishes to peg the exchange rate, the next issue is to what should it be pegged? Except for the Soviet Union, the convertible currency trade of the countries of East and Central Europe is predominately with Western Europe: on technical grounds either the deutsche mark or the ECU would offer a suitable peg. Since the deutsche mark is likely to encounter resistance in some countries on political grounds, the ECU is the natural candidate. The fact that it may be marginally more inflation-prone than the deutsche mark hardly seems a serious drawback: the countries of Eastern Europe will be able to feel proud of their accomplishment if they succeed in keeping their inflation down to the average ECU rate in the coming years.

Should the peg remain fixed, or should it be adjusted at times? The discussion on the transition to a market economy has added an important extra argument for a fixed exchange rate. The prices inherited from a regime of central planning typically bear no relation to scarcity, and a major purpose of establishing convertibility is to permit the importation of an appropriate set of relative prices from abroad. This process will be facilitated by the existence of a fixed exchange rate to provide the anchor for the new price structure. We thus believe that any country establishing a market economy should aim to hold its exchange rate fixed for a year or so after any "big bang."

The case for seeking to preserve a fixed exchange rate in the long run is less compelling, at least until such time as these countries may wish to consolidate future membership in the European Community and its prospective monetary union. Real shocks may arise that require a real exchange rate adjustment, a process that can usually be facilitated by changes in the nominal exchange rate. One can hope that these countries will find that they can live comfortably with the ECU rate of inflation. If that proves too optimistic, however, it would be far better for them to devalue gradually and routinely to offset differential inflation, rather than repeat the perennial error of averring an unwavering commitment to a fixed exchange rate which they rely on as a nominal anchor despite its inconsistency with their demand management policies until the currency is finally devalued in the midst of a crisis that leaves governmental credibility in shreds.

So long as convertibility is restricted to current account transactions, a parallel market will exist. This should be tolerated, and the size of the ECU premium on the parallel market exploited as a useful indicator. A substantial and prolonged premium is a symptom of lack of confidence that should be addressed by policy changes. (Inconvertibility on capital account can still provide a useful shock absorber.)

There remains one last issue: how to pick the exchange rate at which to peg. The criterion—to reconcile internal and external balance in the medium term—is clear enough. How to apply that criterion is, unfortunately, more difficult. One traditional approach, that of seeking purchasing power parity (PPP), is prone to be even more misleading than usual, due to the highly distorted pre-liberalization price structure and the uncertainty as to how large the corrective inflation that occurs on liberalization will prove to be. The competitive approach, that of seeking a fundamental equilibrium exchange rate (FEER), relies on some form of macroeconometric model to calculate the real exchange rate that will reconcile internal and external balance in the medium term (Williamson 1985); any such models that may have existed are likely to become redundant as a result of liberalization. Since it is crucial to achieve a competitive exchange rate to allow long-term restructuring but only important to avoid over-devaluation (which aggravates stagflation in the short term), the best advice is to devalue enough to ensure a substantial competitive export sector, but no more than can be relied on to achieve that purpose.

The form of gradualism

Until rather recently it was generally taken for granted that the establishment of convertibility would necessarily be a distinctly gradual process, just as it was in Western Europe and Japan after World War II and has been subsequently in most developing countries that have made their currencies convertible. There are, however, different methods of pursuing a gradualist strategy. At least three partially distinct alternatives can be discerned.

Standard approach. The standard gradualist strategy is that adopted in Western Europe and Japan after World War II, in which a comprehensive system of import controls was progressively relaxed by transferring more import goods to the open license category, which implied that foreign exchange would automatically be made available to any importer who showed the documentation establishing his purchase. Severe payments difficulties were met by suspending or even temporarily reversing the process of liberalization, but export growth was over the years strong enough to permit continuing relaxation (the differential timing of which provided an extremely effective mechanism of payments adjustment). In the European case the process of intra-area liberalization was more rapid than that of liberalization from outside the area, being backed up by the European Payments Union (EPU). But by 1955 current account convertibility was largely established de facto; at the end of 1958 it was publicly announced, and in 1961 the European countries formally assumed the obligations of the IMF's Article VIII. Convertibility was the final stage of liberalization, which ensured that consumers could achieve the maximum satisfaction from the output being produced by the reconstructed productive system by being able to trade at world prices.

Payments union. A variant on the standard approach which, as noted above, was employed in Western Europe after World War II, involves the creation of a payments union during the transitional period before full convertibility is established. Intra-trade among the East European countries has in the past been conducted in "transferable roubles."[3] If in the future it is settled in hard currency, then no question of the convertibility of the resulting balances arises. However, a switch to hard-currency trading will preempt scarce stocks of Western currencies, and each East European country might find an incentive to curtail its imports from partner countries more severely than makes collective sense. Hence the question is posed as to whether it might not be worth creating a payments union within the region, in which the currency of one member earned by another would be settled through a clearing system, and the resulting multilateral (within-region) balances would be settled in a mix of hard currency and credits. If the payments union is provided with a stock of hard currency by an outside benefactor, like the EPU was, then the hard-currency component can be larger for creditors than for debtors. Within-region convertibility is ensured even before general convertibility is achieved. A lively discussion on the merits of a payments union has developed in recent months: see UN Economic Commission for Europe (1990 ch. 3.4), van Brabant (1990), Bofinger (1990a), and Lavigne (1990).

Currency auctions. A number of developing countries have in the past auctioned off a portion of their foreign exchange receipts, and the Soviet Union has in recent years adopted a similar practice. Enterprises have been given a statutory right to retain a specified percentage of their export proceeds. They can use this to import for the enterprise's own needs, or alternatively they can sell the proceeds of their retention quota in an auction market that is held periodically. This gives enterprises without foreign exchange earnings of their own the ability to import foreign goods for which they perceive a particularly pressing need, either for resale to the public or as input to their own productive process. When the system started, the retention quota was small and the premium on the dollar in the auction market was correspondingly large. A gradualist strategy for approaching convertibility could consist of gradually enlarging the retention quota, thus putting downward pressure on the auction-market value of the dollar, as Romania has announced it plans to do. When the retention ratio reached 100 percent, all imports would be paid for at the auction rate, the official value of the local currency would disappear, and it would be convertible on current account.

Big bang versus gradualism

Perhaps the most hotly-debated issue regarding convertibility concerns the merits of a "big bang," meaning a sudden declaration of convertibility such as that of Britain in 1947, or Poland and Yugoslavia at the turn of the year, versus the gradual and cautious approach practiced by Western Europe after the failure of sterling convertibility in 1947.

The question is a part of the wider debate on the optimal sequencing of economic reform. We have already argued that commodity convertibility is a precondition for current account convertibility, and that unrestricted convertibility is a lower priority than current account convertibility. Can one supplement those conclusions by endorsing, or ruling out, a big bang, or by identifying the additional conditions that must be satisfied for a big bang to be desirable?

The elements of the Polish "big bang" adopted on January 1, 1990 were as follows (Lipton and Sachs 1990) :

— fiscal and monetary austerity, in conjunction with a currency devaluation, designed to eliminate excess demand;

— establishment of a stable (in terms of the dollar) and convertible currency;

— creation of market competition, based on the deregulation of prices, free trade, full liberalization of the private sector, and demonopolization of the state sector; and

— labor market reforms including unemployment insurance, job retraining, and credit allocation to individuals to start small businesses.

The Polish big bang was courageous, and has opened a debate that was undreamt of a year ago, but the jury is still out on its success. On the positive side, inflation has fallen, queues have vanished, and the balance of payments is in surplus. On the negative side, inflation has still not vanished, output has fallen more than anticipated (at least according to the official measures), and the rise in exports is distinctly modest. Opinion seems divided over whether the failures can be explained by minor errors in execution, notably the excessive devaluation of the zloty, or whether it is a fundamental design flaw to attempt a wide-ranging liberalization before supply-side reforms have created institutions that can be relied on to respond to changed incentives.

Another economist who argues that convertibility should be established rapidly, as soon as certain preconditions have been satisfied, is Kornai (1990, pp. 155-58). His list of preconditions is as follows:

— a hardening of budget constraints, to prevent state enterprises from demanding unlimited quantities of foreign exchange;

— the strict application of wage discipline as one aspect of macroeconomic stabilization, including also the absorption of any liquidity overhang;

— adequate foreign currency reserves; and

— a uniform realistic market-clearing exchange rate.

It may also be argued that a big bang, including convertibility, can make sense under certain conditions but not under others. Both

Poland and Yugoslavia were facing hyperinflation when they took the plunge: hyperinflation is a problem that does not admit of a gradualist solution, and the desperation that it breeds may nurture a willingness to accept the risks and hardships implied by a set of dramatic, sudden changes whose consequences are not readily foreseeable. Hungary's position is not nearly so desperate, and hence the gradualist strategy which it is following may also have been a rational choice. Perhaps the experiences of Poland and Yugoslavia will provide a basis for deciding whether a big bang should be reserved as a fallback position for dealing with desperate situations, or whether the risks and hardships have been overestimated and more countries should be encouraged to take the plunge.

ESCB support

A radical suggestion has recently been made for consolidating a "big bang" approach to convertibility. Bofinger (1990b) proposes that the East European countries should join the projected European System of Central Banks (ESCB).

Bofinger argues that price stabilization is a necessary complement to economic liberalization, but that its achievement is jeopardized by both technical and credibility problems. The technical problems arise from the inevitability of a measure of corrective inflation during the liberalization program, especially where a monetary overhang has been inherited from the past, and likely instability in the monetary relationships that provide the basis for traditional central bank policies of monetary targeting or interest rate stabilization. These technical problems could be resolved by pegging to an outside currency, for which role the ECU is the natural candidate. The problem with this solution is that a unilateral ECU peg will have low credibility, especially in countries with a history of inflation and a tradition of soft budget constraints. Lack of credibility increases the output cost of stabilization, for the customary reasons.

It is to address this credibility problem that Bofinger argues the case for association with the ESCB. Membership in the exchange rate mechanism of the EMS would provide credit facilities that would help the East Europeans to buffer speculative attacks, as well as allowing currency realignments only subject to international agreement, both of which features would enhance the credibility of a stabilization commitment. But the disadvantage of this solution is that the liquidity effects of intervention by the present EMS members to support the East European currencies could conceivably threaten their own price stability. It is to counter that disadvantage that Bofinger envisages the possibility of the East Europeans joining the ESCB, a step that would deprive them of monetary autonomy. One can think of this as applying the East German solution to the rest of Eastern Europe.

Conclusion

We have argued in this paper that the establishment of current account convertibility is an essential component of the process of changing the East European economies from the autarkic, centrally planned model to market economies efficiently integrated into the global economy. Capital account convertibility does not, however, merit a similar priority. Gold convertibility would be imprudent.

When it first became clear that Eastern Europe as a region was intent on liberalizing its economic system, many economists recalled the precedent of EPU and wondered whether interim arrangements might not be called for to prevent destruction of the relatively high level of intra-trade in the region. That debate is not yet resolved, nor is that on the merits of gradually increasing the share of foreign exchange that is auctioned as opposed to progressively transferring goods to open import licensing. Nevertheless, the drift of opinion has clearly been away from all such gradualist solutions toward endorsement of a "big bang" on the heroic Polish model. This allows a country to import a price system to replace the relative prices inherited from the era of central planning, which bore no relationship to scarcity. It is increasingly argued that gradualist solutions adopted in earlier experiences were motivated by a reluctance to devalue or a lack of commitment to the market economy that are absent from Eastern Europe today.

Continuing nervousness about endorsing the big bang stems from two sources. One is the lack of consensus on the list of conditions (or preconditions?) needed to support a quick move to convertibility. The other is the lack of an institutional mechanism to provide credibility to stabilization efforts. It has been suggested that the EC as a whole could do that by welcoming serious East European reformers into the ESCB, thus providing the same sort of support that the Federal Republic has provided to the GDR through German monetary union. That is a political tall order, but there is no point in raising it with the politicians until central bankers and economists have decided whether it makes economic sense.

End Notes

[1]Enterprises in centrally planned economies were confronted by "soft budget constraints," meaning that a failure to cover costs could always be offset by additional borrowing rather than raising the threat of bankruptcy. Conversely, a hard budget restraint is one which does limit the enterprise's purchases, ultimately by the sanction of bankruptcy.

[2]There is a large literature on the sequencing of economic liberalization, one of the few conclusions of which is that liberalization of the capital account should not be a priority (Edwards 1984, Krueger 1984). However, although its conclusion is the same, the logic is quite different from that which we have argued applies to Eastern Europe. The proposition for LDCs was developed on the basis of models which assumed that liberalization of the capital account would cause an influx of capital, as foreign investors sought to profit from the high returns available in an economy that had previously refused to borrow abroad and therefore had a low capital-labor ratio. The logic was that a capital inflow would cause a real appreciation which would throttle the development of nontraditional export industries. Furthermore, until the current account had been liberalized capital might well flow into industries where protection was giving a distorted signal of the desirability of investment, and where the country could therefore lose from new investment ("imrniserizing growth").

[3]It is well known that the term "transferable rouble" (TR) was a misnomer, since it was not multilaterally transferable. The TR was credit which could subsequently be spent in the particular country where it had been earned, when the planners found a commodity available in the debtor country that was wanted in the surplus country. Holzman (1979. p. 156) suggests that the TR was more like a ration card than a currency.

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