

Commentary: Currency Convertibility in Eastern Europe

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Bergsten and Williamson have given us a fine statement of the issues involved in establishing convertibility in emerging market economies. Rather than go through all of the issues point by point, I would like to focus on one country, the Soviet Union, and indicate what I think the appropriate course would be in terms of convertibility. I chose the Soviet Union not because I know a lot about that economy, but I know even less about the other Eastern European economies, and I have had occasion recently to learn a little bit about the Soviet Union.

In making my remarks, I take for granted that the Soviet Union is serious about perestroika. Every country should determine for itself what kind of economic and social system it wants. I am not trying to impose my views, but to take at face value the current statement by the Soviet reformers of their objectives and ask how best to achieve them under the heading of currency convertibility.

By nature and inclination I am a gradualist—especially where, as in the current situation, an enormous amount of institutional development has to take place. The financial and commercial institutions that Western countries take for granted are still in a relatively nascent state in the Soviet Union. But the more I reflected on the issue, the more I disagreed with the approach to currency convertibility that was in last December's plan for economic reform in the Soviet

Union, namely that currency convertibility can be postponed for a decade or more until lots of other reforms take place.

The more I thought about that, the more I thought that postponing convertibility would be a fundamentally wrong approach to economic reform in the Soviet Union. On the contrary, currency convertibility—and here I will mean current account convertibility, with the possible exception of travel—should be an integral, **upfront** part of economic reform in the Soviet Union. There are six reasons why quick movement toward convertibility is desirable. Let me go through them briefly and then address the conditions that are necessary to sustain convertibility.

The first reason is to introduce early a degree of effective competition into the Soviet economy. Political figures in the Soviet Union have come to understand that markets are extremely important in a modern, highly articulated, well functioning economy. But I am not certain that they understand that the key to success in Western economies is not markets; it is **competitive** markets. With some exceptions, businessmen dislike competition. But they are forced by the actions of others to continue to improve in order to stay in business. Constant pressure makes the system vibrant and progressive. The Soviet Union by design has monopolized almost the whole of its industrial sector on the assumption of economies of scale and maximization of central control are desirable. It would be extremely unwise to launch a market-oriented system dominated by these enterprises, whether they are publicly or privately owned. The prospects for introducing effective internal competition into such a system are very limited, at least in the near future. It can be done over time, but it will take at least a decade, probably longer. So I see the introduction of foreign competition at the outset as an extremely important part of introducing effective, competitive markets in the Soviet Union.

The second reason is to align Soviet prices with world prices as rapidly as possible. Such alignment may of course be subject to any conscious tariffs that they want to introduce, but that should be an explicit, consciously chosen policy. To reform the price system intentionally, and then a decade or so from now move to the world

price system, involves essentially two price reforms—and a lot of misallocation of resources in the intervening decade or whatever length of time it is. Moreover, strong vested interests built up in the meantime will try to resist the second reform. The Soviet Union should try to introduce the world price structure early in the process rather than later on.

Third, one of the problems in the Soviet Union today, as I understand it, is motivation of the labor force. Workers get paid in roubles, but as **Bergsten** and Williamson pointed out, roubles are not always convertible into goods. Yet people consume goods and services, not currency. One reason for introducing current account convertibility early is to offer wage goods in much greater abundance than now exist—necessarily at high prices, but nonetheless available—so that people can see what they can buy and can work and save toward buying those things.

Fourth, as part of a move to convertibility, the Soviet Union would have to decide what kind of tariff system it would like. I favor a relatively low uniform tariff, 10 to 15 percent, with possibly some transitional tariffs to last only a few years. In any case, the new imported wage goods would come in at high rouble prices and would serve to reduce the monetary overhang, if indeed there is an overhang. Parenthetically, I am not knowledgeable enough to have a judgment on the question, but I do wonder whether this much-spoken-of overhang in the Soviet Union is really a serious overhang under the postulated circumstances of a convertible rouble—both in terms of locally-produced commodities, as Williamson and **Bergsten** have emphasized, and in terms of foreign goods. It is noteworthy that financial assets and household assets in the Soviet Union are very low relative to income levels, compared with Western countries. I could quite well imagine that under altered circumstances households would voluntarily hold not only their existing cash balances but even more. At least I regard it as an open question rather than presume that an overhang exists and is a big problem. Early convertibility would help deal with any overhang, if it exists, by transferring some of it to the government in the form of import duties.

Fifth, by the same token, convertibility would help reduce the budget deficit. There would be explicit tariff revenue. In addition, to avoid some of the most disturbing consequences of early convertibility, necessarily at a heavily depreciated exchange rate, I would put a tax on the exports of oil and gas and a modest subsidy on the imports of grain. A substantial increase in domestic prices of energy is needed in the Soviet Union by all accounts. But the degree of depreciation that would be necessary to make the rouble convertible would probably exceed what is required on efficiency grounds in the first instance. So an export tax would slow the rise of energy prices to the world level. The net effect of these temporary taxes and subsidies would be substantial current revenues for the government.

Finally, convertibility would provide a very strong stimulus to develop export markets. At the exchange rate required to make the rouble convertible, exports would be extremely profitable for newly independent enterprises. Autonomous enterprises would have a strong financial incentive to develop export markets, and that would push them from the beginning to take into account not only the price but also the quality of products that are sold in the world market.

What are the preconditions for making convertibility work? First, enterprises have to be on hard budgets and to be encouraged to maximize profits. Monetary emission should be under control; that is to say macroeconomic stabilization should be achieved. And of course commodity convertibility is a necessary accompaniment of currency convertibility, but it is automatically brought about by convertibility. If enterprises are to take advantage of the new export opportunities, they have to be able to acquire funds for investment. That raises the question of how savings are mobilized and channeled into enterprises that have sufficient productive opportunities. Some development of the banking system is therefore a necessary precondition for moving to convertibility. But a complete development is not necessary.

A key issue which Williamson raised in his oral remarks is the choice of the exchange rate. Like him, I favor a fixed exchange rate in order to stabilize expectations in this new and highly uncertain environment. I would choose an exchange rate that favors exports—

that is to say, in conventional terms, one that is slightly undervalued. Given the heavily distorted price system that now exists in the Soviet Union, there is no persuasive way to calculate such an exchange rate on a purely technical basis. So what is required is a technically informed political decision on the exchange rate. For the sake of concreteness and to stimulate further work, I suggest five roubles to the SDR as a starting point. I choose the SDR rather than the deutsche mark or the ECU because the Soviet Union for the immediate future will sell heavily into dollar-oriented markets—oil, gold, various minerals, and so forth. So the dollar should be represented in the basket, as it is in the SDR. Five roubles to the SDR is a useful starting point for discussion. At that rate, I would expect the rouble to appreciate in real terms over time as Soviet export industries get the rhythm of exporting, as they learn quality control, marketing techniques, and so forth. There would be upward pressure on the exchange rate over time.

This is all on the presumption of macroeconomic stabilization. Suppose that macroeconomic stabilization is not at first assured. The Soviet Union has a large budget deficit, which I am told is going to be difficult to reduce sharply. Under the circumstances, I would still go for early currency convertibility, but obviously not at a fixed exchange rate. There would have to be a floating exchange rate. But the benefits that would flow from convertibility would still outweigh the disadvantages even in a not completely stable macroeconomic environment.

A disadvantage of a major currency depreciation in many countries is that it gives a big impetus to inflationary expectations. That is the argument against it in many developing countries, for example. Paradoxically, past Soviet policy of closing the economy to the rest of the world **turns out** to be helpful, enabling the Soviet Union to have a substantial depreciation without creating inflationary expectations. The main impact as far as the man on the street is concerned would be a tremendous increase in the variety of goods available in stores, though at high prices. Imported goods would not generally be directly comparable to the goods he has had available up to now, so the main impression would be one of greater variety rather than higher prices. The two important exceptions to that are energy,

which is an important input to enterprises, and foodgrains. That is why I would have a transitory tax-subsidy scheme on those goods.

Let me now say something about the question of price stability as an objective, which so far has been urged and apparently accepted in this group. At the risk of making myself *persona non grata* in a group of central bankers, former central bankers, and fellow travelers, I want to make a modest case for modest inflation. I say this against the consensus that seems to be developing here that (1) central banks should be independent and (2) price stability should be the prime objective of central banks. It also relates to what I have been saying under the heading of convertibility.

The first point to note is that when economists and bankers talk about price stability, they are frustratingly unclear and ambiguous about what exactly they mean by price stability. For concreteness, I am going to assume price stability in the consumer price index (CPI) is what is desired. I assume that because that is what the man in the street means by "inflation." He is talking about what **he buys**, which is roughly captured in the consumer price index, and not the other various ways we measure inflation. That definition is important to what follows.

For good economic performance, a government should try to establish a stable financial environment. Seeking price stability is not the only or even the best way to achieve a state of stable expectations. All countries but the largest face a strategic choice in doing that. They can go for price stability or they can adopt a fixed exchange rate. As between those two, I believe that a fixed exchange rate is the superior alternative for many countries. However, electing a fixed exchange rate means accepting some price instability, if one wants to call it that, or more generally accepting the level of inflation in the rest of the world. A fixed exchange rate is not in general compatible with CPI price stability, unless it happens that the countries to whose currency our currency is fixed achieve CPI price stability.

On top of that, for all middle income developing countries, and I assume also in the future for the emerging market economies, one

has to put what I would call the "development premium" on the CPI. It is a well known characteristic of growing economies that the prices of services rise more rapidly than the average price of goods. Even with price stability in tradable goods, developing countries experience a positive increase in the CPI. The extent of that increase is in fact positively correlated with the extent of economic growth in the country. It is worth recalling that Japan during the 1950s and 1960s had a CPI increase that was over three times the CPI increase in the United States. Korea, also a country that has performed extremely well by the variety of criteria that economists use to measure economic performance, until the mid 1980s had an increase in the consumer price index between 10 and 20 percent a year. Yet the Korean economy did not seem to suffer enormously from this inflation. Emerging market economies that actually succeed in doing well as a result of their economic reforms can expect some inflation arising from what I call the development premium.

Third, there is a public finance case for some inflation in countries that have poorly developed tax systems, and that have great difficulty enforcing the tax systems they have. While in textbooks economist can pretend we have lump sum taxes, in the real world there are always deadweight losses associated with taxes. Any optimal tax system will therefore have at least a modest component of the inflation tax in it. In countries where tax systems are not well developed, and where enforcement is a problem because they do not have a history of enforcement, what happens in practice is that taxes get loaded too heavily on the foreign trade sector and in particular on imports, with undesirable consequences for competition, efficiency, and growth. Under those circumstances, a modest inflation tax can offer an improvement in the tax system and therefore in overall economic performance. Countries at the stage of development I am considering can raise between 1 and 2 percent of GNP annually through the inflation tax. That is not a huge amount, but every bit helps. The deadweight losses from that source, if inflation is under control, will be less than the deadweight losses associated with alternative taxes.

Finally, I come back to the exchange rate. If the procedure has been well managed and the exchange rate is undervalued with a view

to stimulating exports over time, as that stimulation takes place, the real exchange rate of the country must appreciate. Once again the country faces a strategic choice. Does it take that real appreciation by appreciating the nominal exchange rate or by allowing domestic prices to rise with an unchanged nominal rate? That choice need not be made now. But it is not obvious that appreciating the currency is always the superior choice between those two alternatives. There are circumstances in which the expectational environment is better served by keeping the nominal exchange rate fixed and allowing prices to do the adjustment. That indeed is the process we have *within* countries. Massachusetts experienced a relative rise in wages in the 1980s, and in the 1990s, there may have to be a relative decline.

Let me just close by saying that I am not arguing that central bankers should drop their concerns about inflation. On the contrary, they play a vital social role. Every society has many pressures for inflation, and somebody has to take the position of leaning strongly against it. That is preeminently the role of the central bank, and one that central bankers should continue to play. My only plea is that, in pleading for price stability, central bankers not take it too literally.