Commentary: Currency Convertibility in Eastern Europe

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Being the seventh speaker in this session on currency convertibility naturally leaves me at something of a disadvantage: we have already heard so much good sense and so many good ideas on the subject, that I now find it all the more difficult to say much that is new. This reminds me of a recent observation of the Princeton economist, Avinash Dixit, that the invention of word processing has lowered the cost of producing words without changing the cost of producing ideas, with predictable results. The lesson I draw from all this is that I should be brief. In their paper for this session, Fred Bergsten and John Williamson have in any case simplified my task: they identified the major issues and covered a lot of ground that I now feel no need to touch on.

I shall focus my remarks mainly on the preconditions for a successful implementation of currency convertibility; but there are a few important points that I should like to emphasize at the outset. Some speak about the adoption of currency convertibility as an act of ***symbolic*** significance—an act that signifies that the country concerned is becoming a "member of the club," as it were. I see that as a mistake. Rather, the adoption of currency convertibility has to be viewed in the context of an ***overall program*** of economic transformation and restructuring; it should be seen as one of the components of such a program. And since there is no single blueprint for economic restructuring applicable to all economies—different strategies will be appropriate to different economies, depending on their circumstances—it clearly follows that there is no single blueprint for currency convertibility either.

Let me also emphasize that the introduction of convertibility is not an easy task: there are short-term costs, as well as medium-term benefits. The task prior to implementation is to assess the benefits in relation to the costs, and to select a strategy that minimizes the latter in relation to the former. However, there is one general point that was emphasized in the discussion earlier today: this is that it is essential to distinguish between ***current account*** convertibility and ***capital account*** convertibility. There was consensus that capital account convertibility, while it might be on the agenda for eventual implementation, requires a lot of preconditions that in many cases are unlikely to be met in the immediate future. I concur with this consensus, not least because of the problem of capital flight. I shall therefore also focus my own remarks on current account convertibility.

The advantages of adopting current account convertibility seem fairly obvious. On the demand side, the adoption of convertibility will provide consumers with goods they never had (either in terms of desired quantity or even more frequently, in terms of desired quality)—that is, access to new markets. On the supply side, it is useful to think of currency convertibility in the context of broader trade liberalization efforts. When a previously centrally planned economy transforms itself into a market economy, the opening of the economy to world market forces serves two related functions. First, world market prices can provide the most reliable guide for production decisions in the uncharted territory of decentralized decision making. With the guidelines of central planning removed, it is world market prices that can offer the best guidance to producers. In addition, openness to world markets can be the most reliable guarantor of the stimulus of competitive forces, particularly for economies that start from a position in which most major sectors are highly monopolized, and where the scale of the economy is too small to accommodate adequate internal competition in many sectors. Openness to world market prices in fact offers the most appealing means of introducing a competitive market environment into previously centrally planned economies.

But of course there are risks even with current account convertibility—risks that we hear about time and again. There will very likely be unemployment in the beginning, especially as unprofitable enterprises are eliminated. There will be a decline in output, and there may also be a significant decline in real wages. It may therefore become difficult to maintain the domestic political support that is so necessary for the success of the economic transformation. But in reality, there is no alternative, because the starting point is a distorted economy: restructuring necessarily means that many firms will go out of business, and their going out of business is in fact desirable. But there is indeed a problem of how to maintain political support. The best strategy, it seems to me, is to make sure that the aims and means of the program are transparent from the outset, and that there are adequate safety nets. In the latter context, however, I am a little nervous about excessive wage indexation which, as we know from experience, can transform a microeconomic problem into a macroeconomic disaster.

Turning now to preconditions, I would highlight four that seem necessary for a successful adoption of convertibility. First, you must have an appropriate exchange rate in place. Second, there must be adequate international reserves. And third, you must begin from a position in which the course of macroeconomic policies is consistent with stability. These three preconditions are of course frequently mentioned; once you have all three in place, you should be able to move to exchange and trade liberalization without generating macroeconomic instability or a balance of payments (current account) crisis. But there is a fourth precondition that is also important for the countries that we are discussing today; it was less pertinent to the issue of the convertibility of the Western European currencies in the 1940s and 1950s. This fourth precondition is that the price system must be free of major distortions, and must be performing its role as an incentive system. This requires, for a previously centrally planned economy, that state enterprises and the price system are reformed. Without this fourth precondition, the other three preconditions will do little good; they will not yield the results that we are looking for. I shall now elaborate on each of these four preconditions in turn.

First, the exchange rate. Unless the exchange rate is broadly consistent with balance of payments equilibrium, the removal of restrictions will generate large imbalances and will therefore, tend to create difficulties with which we are familiar. However, the "equilibrium" exchange rate is likely to change in the transition. As firms and enterprises become more efficient, and as competitive forces in the economy become stronger, it is quite likely that you will need a less-depreciated currency than was warranted at the beginning of the process. Therefore, if convertibility is adopted relatively early on, it is quite likely that during the transition process the domestic currency will undergo a process of appreciation. Even though, in principle, fixed exchange rates can serve as useful anchors in the anti-inflationary fight, one should not attempt to anchor too many variables during the transition, because there are bound to be shifts in equilibria.

Second, international reserves. Even if the exchange rate is right, there are still going to be unavoidable cyclical disturbances which, though transitory in themselves, can upset macroeconomic stability and confidence, with effects that may be more profoundly damaging. We therefore need a cushion of adequate international reserves. How big is adequate? The answer of course depends on the circumstances, but in the past, the maintenance of reserves equivalent to at least three months' imports seems to have provided a good rule of thumb for countries with pegged exchange rates. As a matter of fact, the lack of such reserves was one of the main reasons why the countries of Western Europe postponed convertibility to the late 1950s. In this context, let me mention a few examples: Korea accepted Article VIII status in the International Monetary Fund in 1988, when its reserves amounted to three months' imports; Thailand adopted Article VIII in 1990, when it had five months' imports; and Poland had reserves and external lines of credit amounting to four-and-a-half months' imports when its currency was made convertible for virtually all current account transactions at the beginning of 1990. Therefore the rough order of magnitude of the required level of reserves seems fairly clear.

Third, sound macroeconomic policies. This is always a nice objective, but here, in the context of currency convertibility, we really have to mean it. On the fiscal side, perhaps the most crucial element is an adequate tax system. We must have a reliable base for fiscal revenue. It would be a serious mistake to draw up revenue plans on the assumption that there will be a need to resort to inflationary finance, not least because this will tend to mean that the adoption of a proper tax system will be delayed. More broadly, if fiscal deficits are not eliminated to a large extent, then there is unlikely to be much confidence that convertibility will be viable. These considerations have surely provided the rationale for the recent emphasis placed on the need for a restrictive fiscal stance in both Poland and Czechoslovakia.

On the monetary side, much was discussed on the problem of monetary overhang. And indeed the first step in the introduction of monetary control in a previously centrally planned economy must be the elimination of the initial monetary overhang, if such an overhang exists. Unless the monetary overhang is eliminated, convertibility is surely doomed, because if this excess liquidity is unleashed by the liberalization of markets, there will surely be a severe drain on the international reserves. So this is a first priority. But what is the best way to deal with an overhang? Many argue that interest rates must be raised to make the holdings of domestic monetary assets sufficiently attractive. I regard this as very good advice, but unfortunately the requisite hike in domestic interest rates is likely to exacerbate the problem of the budget deficit. This leads me to underscore my earlier point: there had better be an adequate tax system in place prior to the increase in interest rates because otherwise, the moment you make your currency more attractive by raising interest rates, you also, at the same time, say to the public in effect, "We intend to raise taxes," because you are creating a deficit. Furthermore, an excessively high rate of interest may translate itself ultimately into a tight credit crunch which will operate on the economy as a supply shock. Thus, while it is wise to raise interest rates to avoid large negative real rates of interest, excessively high rates may be too costly.

The second means of eliminating the monetary overhang is to sell state enterprises to the public. Again here, there are implications for government revenues and the tax system, since the enterprises, once privatized, will no longer be generating revenues directly for the government. Furthermore, unless a credible tax system is in place, the (once-and-for-all) proceeds from such sales will be lower than they would otherwise have been, since the sale price will reflect the probability that these enterprises, once sold, might be the target for new taxes which the government, with its revenue needs, will be tempted to levy. So again, the need for an adequate tax system is up front.

Finally, I turn now to the ***fourth*** precondition—a well functioning system of prices and incentives in the domestic economy. This fourth condition is at least as essential as the other three, because if the external economy is fully liberalized, any significant disequilibrium in the domestic economy which is allowed to remain will spill over into the external economy and threaten a drain on the reserves. A reformed price system which is aligned with world prices, needs to be in place.

As far as this fourth precondition is concerned, the Achilles' heel—as we know from the experience of recent cases—is likely to be the behavior of state enterprises in the early phases of the price reform. If the decision making process in the state enterprises is not guided by considerations of efficiency, the fulfillment of all the other preconditions may not do much good. There has to be a clear perception in each enterprise that its objective is profit maximization: otherwise, the nascent market economy is unlikely to bear the fruit for which it was planted. The exposure to world prices will not do much good unless it guides management in its economic decision making.

Of course, privatization may do the job as the private sector is more likely to aim at profit maximization which in turn will enhance efficiency. But privatization may, at least in some countries, have to be a very long process, and it would be disastrous if we had to wait for this process to be completed before we attained the improvements in efficiency: ways must be found of improving efficiency even while enterprises are still in the hands of the public sector. The aim should be to develop incentive schemes that will yield efficient allocation of resources while allowing for the reality that a diverse pattern of private-public ownership is likely to prevail for several years.

What can we infer from all this about the pace of reform? Well, the appropriate pace must depend on satisfaction of the preconditions. If those preconditions were in place yesterday, then the adoption of currency convertibility could have taken place yesterday. But, if the preconditions are not in place, then we must be aware that premature convertibility may be very costly and failures may discredit the entire reform process. Just as the stabilization of inflation through the adoption of an exchange rate anchor is likely to be successful only if the fundamentals are in place (that is, if it is supported by the appropriate fiscal and monetary policy) so here, convertibility is most likely to be successful if the preconditions are in place.

Of course, one should not allow for an unwarranted delay. There will always be the pressure from anti-reform groups to use the argument that the preconditions are not satisfied in order to stall the reform efforts. Keeping this in mind, however, great efforts must be exerted to address seriously the issue of the preconditions. As far as the debate between gradualism and nongradualism (or "shock treatment") is concerned, I believe that pragmatism is called for. Some actions, by their nature, cannot be taken gradually. Credibility and effectiveness require a decisive move. In many areas, there is no choice between gradualism and nongradualism: what is best is to go at the fastest possible pace, as long as it is feasible. At the same time there are other areas which require complex infrastructure which can only be built over time. This may sound like a tautology, but it is not.

It would be a mistake to assume that there is a technically rigid tradeoff that policymakers can choose. Past experience with "tradeoffs" guiding policymakers—the Phillips curve, for example—showed us how illustrative such tradeoffs can be. In this context I would take issue with the view that during the process of reform and the adoption of currency convertibility, it may be reasonable to aim for modest inflation. I shall readily admit that modest inflation may well arise in the transition process. But if you start by aiming at modest inflation, it is less likely that you will have it; you are more likely to have significant inflation.

Let me make one final point. In his opening remarks to the conference, Paul Volcker asked: why do we focus on central banking when we analyze the process of economic transformation? In his own remarks, Jerry Corrigan has given some answers, and I will just add that the question brings to my mind the remark of William McChesney Martin, the chairman of the Fed for 20 years from 1951 through 1970. In describing the role of a central bank, he said that a sound central bank must always take away the punchbowl just when the party gets going. Without a strong and independent central bank, there is a great danger that nobody will take away the punchbowl in time. If fact, the political pressures are likely to operate the other way and result in accelerated inflation. And we are all familiar with the many reforms that fell victim to inflation. Thus, it is only natural that in launching a comprehensive program of economic transformation, careful attention should be given to the unique role of the central bank.