Commentary: Currency Convertibility in Eastern Europe

Some Messages from Latin America

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The reason for my personal presence on this panel is not at all clear to me. Some 35 years ago, my professional life began to focus on the problems of different Latin American countries, and, though my interests have ranged widely, they have never strayed for very long from the fascinating sets of issues that sprang from the kaleidoscope of Latin American economics. Then, last November, I was asked by my government to join in a brief official mission to Poland. I somehow cannot believe that I am here because of those few days of firsthand apprenticeship in Eastern Europe. So I conclude I must have been invited in order to bring to this group some messages, or "lessons of experience," from Latin America. This is how I interpret my task—to transmit messages that I know to be true in their original Latin American context, and that I believe to be'relevant for at least some Eastern European countries. Others besides myself will have to judge the extent of relevance, and the range of countries to which any one of these messages may apply.

Before turning to the specific messages, let me quickly review how the main points made by Fred Bergsten and John Williamson stand up when viewed against a Latin American backdrop. First, the idea that the opening of the current account has a certain natural priority over the opening of the capital account comes off with good marks.

By this I mean that the preconditions for opening the current account are fewer and less stringent than those for opening the capital account, so that it is easy for a country to have the first without the second. I have observed healthy and useful parallel markets in action under such circumstances, demonstrating that capital does in fact move even though not quite so freely as with a fully open capital market. What the parallel market does is partially insulate the country from the large drains of international reserves that might occur under a fully open capital market in a fixed exchange rate system. Alternatively, with a flexible rate, it helps insulate the trade rate from fluctuations that often have little to do with the middle-to-long-term allocation of resources as between tradable and non-tradable goods, which is the main function of the rate for export and import transactions.

I can also give the blessing of Latin American experience to Bergsten and Williamson's second point, that the convertibility of currencies into gold is not an issue on a par with the others we are discussing. Uruguay is an interesting test case. There, in spite of the country's possessing what may be the world's highest monetary gold stock (in per capita terms), there is no serious thought of a return to the gold standard.

Bergsten and Williamson's third point—that currency auctions may be a good idea—strikes me as particularly promising for the newly-emerging market economies of Eastern Europe. I draw the analogy here from major trade liberalizations that have taken place in Latin America and elsewhere. Those who have studied such liberalization processes most carefully have come to the conclusion that three years is a very short—perhaps too short—time to move from a system with very large and pervasive trade distortions to one with only modest interferences with trade. Likewise, they concluded that seven years is a long—perhaps too long—time to accomplish the transition. The main point is that the transition is too arduous to be carried out in one big step, yet it is too important—too vital—to be stretched out indefinitely.

My own perception is that the economies of Eastern Europe have adapted to a set of prices that is tremendously different from the one that will prevail when linkage to the world market is complete. The task facing these economies is thus quite closely analogous to that facing highly trade-distorted economies at the beginning of major liberalization efforts. A well-designed auction system is one way for such economies to replicate the successive steps of a comprehensive liberalization plan.

The idea is that, initially, the whole price system is out of tune with world markets. To shift all at once to world market prices would render nonviable any number—unfortunately an unknown, undetermined number—of activities. Allowing firms to have access to foreign exchange for imported raw materials, parts, and capital goods—at a substantial premium over the nominal exchange rate—constitutes the first important step toward harmonization with the world market. As I see it, the premium in the auction market might start at, say, 100 percent over the regular exchange rate. Then, it could move down by steps to, say, 80 percent, then 60 percent, then 40 percent, and then 20 percent, and so forth. The timing of each step could be determined in advance, or made contingent on the consequences of the previous step being adequately "digested." The important thing is that the interval between steps should not be so long as to extend unduly the process of full integration with the world market. It is my impression that some elements of this system have in fact played a role in the recent adaptive efforts of both Poland and Czechoslovakia.

On Bergsten and Williamson's critical choice between big bang and gradualism, I surprised even myself by, after considerable thought, coming out in favor of both. My main point is that big bang is one scenario and gradualism is another, and that there are circumstances in which one might be called for and quite different circumstances that point to the other. I should emphasize here that I am talking about a country's using these strategies to overcome major distortions. And, coming from my Latin American background, I tend to think of inflation as being a core component of the initial distortion package. The main message is that for a big bang to work, the fiscal and quasi-fiscal sources of inflation should already have been stopped. If major fiscal reform is part of the big bang package, I prefer to see its full effects first, and only then take a step like moving to a fixed exchange rate. Fiscal reforms usually take much longer than planned, and rarely reach their full revenue targets. This double slippage has caused the failure of countless reform packages. This is why I feel prudence dictates opposing a big bang when major fiscal reforms are part of the package.

On the other hand, where there is no major fiscal problem, including cases where an earlier such problem has by now been solved, my major reason for opposing a big bang no longer exists, and I might readily turn out, after studying the details of a case, to favor one.

Latin American experience lies behind these judgments. Later I will mention some failures, but for now let me note several cases where very successful stabilization programs were implemented following the gradualist route. These include (a) Chile, 1975-81, where a 400 percent inflation was brought down to less than 10 percent over a six-year period. The exchange rate was fixed only in 1979. (b) Brazil, 1964-73. This was the period in which the Brazilian miracle got underway. After major policy reforms during 1964-67, there were six years of real growth averaging more than 10 percent per year. At no point in this process did the inflation rate get below 15 percent per year, and the normal exchange rate continued to depreciate as the "miracle" proceeded. (c) Mexico today. The present Mexican reforms and stabilization program are a true economic policy landmark. Spanning the last years of the de la Madrid presidency, together with the Salinas presidency to date, it has covered virtually every area of economic policy, yet without a discernible big bang.

The moral of the story is not only that economic reform can be achieved by way of decisive programs spanning several years, but also that we have on record numerous actual such cases. The economic transformations of Taiwan, Korea, Spain, Greece, and Indonesia also fit this mold.

I now turn to some specific messages drawn from Latin American experience. These are really more than messages—they are genuine lessons of experience in the Latin American setting that spawned them. But for Eastern Europe I would say they are just messages until their relevance has been established, their applicability confirmed. In the main, these messages deal with the situation of an ongoing inflationary process that we want somehow to bring under control.

(1) The fiscal deficit must be the centerpiece of any inflation control program. One cannot stabilize while having to print large quantities of money to cover the fiscal deficit.

(2) It is the overall public-sector fiscal deficit that matters, not just that of the central government. Many countries—notably the Dominican Republic—have managed to keep tight reins on their central government's deficit, only to have a major inflation spring from the deficits of their autonomous agencies and state-owned enterprises.

(3) Most particularly, one must avoid resorting to tricks to hide the deficit: several Latin American governments have developed real skill in hiding deficits by artful maneuvers. The latest trick—of major importance in Costa Rica, Honduras, and Guatemala—consists of transforming into central bank losses what would otherwise be a fiscal deficit. From our point of view, this makes no difference at all. Both end up being covered by the printing of money.

(4) One must take care to avoid seriously squeezing the private sector as a counterpoise to financing government deficits. The Echeverria government in Mexico was a prime violator of this precept: in its first three years it lifted the government's share of consolidated banking system credit from 30 percent to nearly 70 percent. Private-sector credit obviously had to bear each successive blow. At the time, I noted it was "highly unlikely" that in the next three years the government's share of credit would go from 70 percent to 110 percent. Instead, a rampant inflation broke out. But more importantly, think of the burden placed on later, more responsible governments. They are saddled with the need to run vast fiscal

surpluses, simply to bring private-sector credit back to its original 70 percent share.

(5) Do not rely on seigniorage as a way of bringing about the absorption of fiscal deficits by the banking system. This was the theory behind the ill-fated Austral and Cruzado plans in Argentina and Brazil, respectively. The "dream" in each case was that, with stabilization, people would want to hold more real cash balances. So if one could make the people "believe in" stabilization sufficiently, they would willingly hold enough extra money so that the banking system could finance the remaining deficit. This "dream" did not work. The fiscal deficit remained unsolved, the inflation continued, and people soon reverted to their old habits of holding low real cash balances in an inflationary situation. Prudence calls for not basing a major stabilization effort on such ingenuous "dreams." The right way to go is to attack the fiscal deficit directly, and first—by raising taxes and/or reducing expenditures. Leave out of the mainline stabilization program once-and-for-all bonanzas like an increment in seigniorage. Welcome the bonanzas when they come, but use them, then, for some once-and-for-all purpose. For example, reduce the debt of the government to the general public or open up a new tranche of credit to the private sector. Or buy more foreign exchange reserves if they are needed. But do not—please do not—go through elaborate promises of stability in order to talk the people into holding more cash, only then to defraud them by failing to come through with the government's main part of the bargain—solving the fiscal deficit.

(6) The above points, taken together, imply that the pace of disinflation must be linked to the pace at which the fiscal deficit and related gaps are first reduced, then finally, one hopes, closed.

(7) This means, in turn, that the fixing of the exchange rate must wait until we no longer observe excessive monetary expansion.

(8) Even if the problem of inflation has been overcome, the choice of an exchange rate system should be conditioned on the likelihood of a need for real exchange rate adjustment. Many factors—notably commodity price changes, trade liberalizations, and major capital

flows into or out of the country—can alter the equilibrium real exchange rate. To give some examples of the power of capital flows to influence the real exchange rate, all the major debt-crisis countries of Latin America—Argentina, Brazil, Chile, Mexico, Peru, Venezuela, and Uruguay—experienced major real exchange rate appreciations when the big inflows occurred, and all had to suffer massive real exchange rate depreciations when the crunch came and the inflows stopped. Each of these countries ended up experiencing a swing of a factor of two or more in the real exchange rate, over a period of just two or three years.

(9) One must bear in mind that a major function of the real exchange rate is to guide the allocation of resources among industries and activities producing importable, exportable, and nontradable goods and services. In the Latin American experience, economies that have become grossly distorted also have histories of erratic movements in the real exchange rate. Nobody confides in the signals it gives. When this is the case it adds a new challenge to economic policy—not only to see to it that the real exchange rate signals received by the public are good ones (reflecting fundamental market forces) but also establishing enough credibility so that economic agents are willing to commit their capital for five, 10, 15, even 20 years in response to these real exchange rate signals.

(10) This leads to policies in which the authorities try to keep the real exchange rate on a track that gives sound signals for the medium and long run. The champion in this regard is Brazil from 1968 to 1979 (a much better era than the present one). During that period, the Brazilian real exchange rate (as defined and measured by the authorities) was kept virtually constant, staying in a range of plus or minus 5 percent. This is the closest example that I know of, of a country following a "clean crawling peg" policy. More common is a "dirty crawling peg" policy in which the authorities set an initial target range for the real exchange rate, but then allow that range to be modified as events unfold. The simplest basis of modification is that when international reserves accumulate too much or too fast, the real exchange rate is allowed to appreciate, and that when major reserve drains start to occur it is allowed to depreciate. This type of

policy has been followed with great success in Chile since 1985, in Colombia for many years, and also, I understand, in Korea.

(11) Obviously, one cannot pursue a policy in which the real exchange rate is to some degree a target variable unless one has some additional policy instrument to use as a balance wheel. When the Brazilians instituted their real exchange rate policy, they set the rate at a level which would stimulate exports. Then, as reserves began to accumulate, they liberalized imports in successive steps, to the applause of most economists. There was much less applause later when, after the 1973-74 oil crisis, they put import restrictions back on in order to avoid a loss of reserves.

Thus, one balance-wheel instrument has been import restrictions. Another can be—and was in the Brazilian case for a time—international reserves themselves. When large increments of reserves are desired, and at the same time a steady real exchange rate signal is wanted for exports, one can set the real exchange rate target with export stimulation in mind, and then accept a varying pace of reserve accumulation, depending on the shifts and swings of the underlying supply and demand for foreign exchange.

A third way of maintaining the real exchange rate within a desired band is to vary the rate at which foreign debt is being paid (or repurchased). This is the device used by Chile in the last several years. The amount of private foreign debt which was allowed to be repatriated in any given period was determined in such a way as to keep the equilibrium exchange rate in the desired range. (Repatriation rights were allocated by periodic auctions.) Repayment of the foreign debt of the government can also be used as the balance wheel, with debt repayment being speeded up when reserves tend to accumulate and slowed down when reserves begin to fall. Here one must be careful to see to it that the money to buy the dollars for debt repayment comes from some "real" source, like taxes or public utility rates, and is not just newly printed for the purpose of buying dollars.

(12) The preceding points give some of the reasons why long-term observers of the Latin American scene tend to think in terms of a

sort of hierarchy of exchange rate systems. In this hierarchy, the system one chooses is contingent upon the underlying circumstances. A country with zero or negative reserves usually has little choice beyond a fairly clean float. With relatively modest reserves, a dirty float is possible, entailing intervention to smooth out extreme fluctuations stemming from causes known to be transitory. With a still higher level of reserves, it is possible to contemplate a dirty crawling peg, as pursued in Colombia and Chile (see point 11). An even higher level of reserves is in general necessary to maintain in working order a successful fixed exchange rate system. Note that this hierarchy does not imply a normative ordering; it simply delineates the circumstances in which it makes sense to contemplate implementing one or another system.

(13) In particular, I have a strong affinity for a fixed exchange rate system, so long as the country in question has the capability of implementing it and meets its other preconditions. The Central American countries as a whole were virtual models of fixed exchange rate management during the 1960s and early 1970s; they also enjoyed great economic progress during this period. Mexico in the period from 1955 to 1970 or so was another model worthy of emulation.

(14) In conclusion, I must emphasize that in none of the above discussion of exchange rate issues have I broached the issue of nonconvertibility for current account transactions. Latin American experience leads me to believe that there is always available an exchange rate system that will permit such convertibility. I believe the lesson from the Latin American experience is that maintaining convertibility (at least on current account) should take precedence over loyalty to any given exchange rate system.