

# Recent Developments in Czechoslovakia

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*Josef Tosovsky*

Allow me to make a few remarks on our approach to the issue of convertibility in Czechoslovakia. Introducing currency convertibility is part of an entire package of monetary reform that I would like to characterize for you. It can be characterized as a return to money, or a monetary renaissance. I think the issues of credibility and confidence, which were raised several times at this conference yesterday, are currently very topical in **Czechoslovakia**. When I am meditating about convertibility and the credibility of exchange rate policy, I am reminded of a joke that seems to me to be appropriate. Two guys meet, and one of **them** asks: "What is the difference between one dollar and one **Czechoslovakian** koruna?" And the other guy answers, "Just one dollar." In fact, the situation is not that bad, and I am not quite that pessimistic.

What are our options? We tried for 40 years to allocate foreign exchange according to a plan. The system failed and we now have two basic options.

One option is to maintain and somehow improve the retention quota system. There are several alternatives available: for example, a retention quota determined for each company or different retention quotas for individual branches of industry or economic sectors or a single, universal, retention quota for the whole economy. A retention quota, which was also discussed by Mr. Baka, might introduce, in my opinion, a split in the economy as only the exporting companies have a direct access to foreign exchange. As a result, there is a great

deal of bargaining among the companies for an access to foreign exchange ("dollarization" of the economy). Moreover, a retention quota system is usually connected with dual exchange rates, namely an official rate and a market-based (auction) rate which has a negative impact on relative price structure. As a result, a retention quota system is not the best solution under the situation we are in today. Hence, after having carefully considered all the advantages and disadvantages of the retention quota approach (which may be described as a gradualist approach), we have rejected it.

Instead, we have chosen the other option and decided in favor of the current account convertibility. It seems to us that to strive for full capital account convertibility could be too risky, especially during the transition period. Exchange rate policy is now very important. In the previous system, the role of the exchange rate was practically negligible. Therefore, our policy is: no gradualism, go straight to convertibility.

Let me now discuss the role of convertibility within the whole economic reform package. I would like to stress two factors. First, we have to be very prudent and very restrictive in monetary and fiscal policy. I think we made a good agreement with the Minister of Finance at the beginning of this year. The budget is in surplus, and monetary policy is very restrictive. In fact, we plan to keep the total volume of credit in the economy between minus two percent and plus one percent this year. During the first half of this year, the increase in credit was approximately zero. I think this is very important for the introduction of convertibility and price liberalization.

In carrying out this policy, we have one big advantage: over the past 20 years our monetary policy, fiscal policy, and foreign exchange policy were very prudent. We are not in a situation like some other countries. For example, our hard currency debt—in gross terms—was \$7 billion at the middle of this year, and our net indebtedness was close to zero. I should mention, however, that on the asset side there are some bad loans, especially to some Arab countries. But the size is less than \$2 billion.

The second factor I would like to stress is price liberalization. We feel that it is not possible to introduce convertibility without simultaneously introducing complete price liberalization. (Prices of a very limited number of goods can, however, be controlled by the state.) That is, convertibility must be accompanied by price liberalization.

Now I would like to discuss the exchange rate and exchange rate policy. The choice of a starting exchange rate is the first point of discussion. Because our exchange rate is not a market exchange rate, only about half of our exports are now profitable. So we will need to devalue our currency. We would like to make a large devaluation and then peg our currency to either the ECU or the deutsche mark. The reason for the deutsche mark is that a unified Germany will probably be our biggest foreign trade partner. In addition, pegging to the deutsche mark seems to me more transparent *than* pegging to a basket of currencies. But there are other reasons, including political ones, for pegging to the ECU.

So our plan is to stabilize the exchange rate, and to create and establish trust and confidence in the convertibility of our currency from the very beginning. In addition to being very important for companies which are domestic residents, currency convertibility is also important for foreign investors, especially since I think that direct investment will be very important for Czechoslovakia.

What can we do? As I have said, the size of devaluation should be quite large, which will have a large impact on inflation. Therefore, if monetary policy is very restrictive, thereby reducing demand in the economy, the size of the devaluation could be somewhat less. There are several things we can do. One is to stabilize savings in banks for a long time. But this is very difficult. It is possible to increase interest rates, to make them positive in real terms. But we are also in a situation of moving from a command economy to a market economy, and so expectations of people and companies are changing. Therefore, a large increase in the interest rate in the current situation may have a different effect than in the standard economic situation.

The second possibility is to establish some new financial instruments and some new possibilities for investment. For example, it is possible to buy bonds and to issue bonds. The first issues were quite successful. Another possibility is to start privatization very quickly so that people would invest their money in the private sector. A third possibility is to take some administrative measures, but I do not want to discuss them since they are obvious.

Even though I do not think our macroeconomic disequilibrium is very bad, our fear is that our internal disequilibrium and excess demand for goods could be easily translated into an excess demand for foreign exchange and a deficit on the current account. We would like to avoid this situation. Unfortunately, we must cut demand in the short term because I do not see how we can change supply in the short term.

The introduction of convertibility will require some financial backing, perhaps a stabilization fund. I do not want to give a specific amount. Instead, I would like only to say that the amount of the stabilization fund must be sufficient to maintain convertibility and to ensure confidence internally and externally. After all, its size will ultimately depend on the success of our restrictive monetary policy and the extent of initial devaluation.

The last thing I would like to mention is the economic situation, and whether it is suitable to introduce convertibility. We are doing many things simultaneously. One very difficult thing is what I would call our internal economic reform, which is a very difficult thing and something we have already discussed. The second important thing that we are doing is the reform of Comecon. Not only will the pattern of trade change, but the price system and the payments system will also change. This will affect all Eastern and Central European countries. The third thing, if Mr. Gerashchenko will allow me, concerns some problems with the Soviet Union. Since we have had close economic ties with them for 40 years, their decisions—such as cutting their exports of power and raw materials—can directly influence the Czechoslovakian economy.

To sum up: the situation confronting Czechoslovakia is far from perfect. There are some unfavorable external as well as internal factors including the political ones which cause us a headache. But, on the other hand, will the economic situation ever be perfect? Hence, we have no other choice but to change the entire economic system.