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# CURRENCY CONVERTIBILITY AND ECONOMIC TRANSITION IN CENTRAL AND EASTERN EUROPE

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CURRENCY CONVERTIBILITY AND ECONOMIC TRANSITION IN CENTRAL AND EASTERN EUROPE

## 1 Introduction

Reform of the Central and Eastern European economies is closely connected with opening up these economies. The distinctive point about the shift to an outward orientation in these countries is its parallel process of transformation from a planned to a market economy.[1] One of the central elements of the theory of transition from a centrally planned economy to a market economy is therefore currency convertibility.

The convertibility issue is given a high priority everywhere. It is now recognized as an essential component of a comprehensive transformation of the economic system, rather than as an exclusively monetary question. That restoring the convertibility of the currency should be the goal of present economic policy in Central and Eastern Europe is accepted by most economists, whether from East or West European countries. The debate concerns only the way in which to implement this policy and the speed with which to proceed.

Many economists argue that delaying convertibility leads to solutions that are economically irrational and incomplete. International organisations like IMF and World Bank usually support financial packages in countries in Eastern Europe and elsewhere provided that their policies include currency convertibility. At the same time, it is often held that policy credibility will be greatly harmed if convertibility proves not to be sustainable.

In sum, formerly socialist countries are faced with a profound dilemma. On the one hand, convertibility is an important part of the transition to a market economy; on the other, the conditions for convertibility are demanding and require a substantial domestic reform. According to some economists the ideal solution would be a simultaneous approach; several transitional arrangements have been suggested in this context, such as the Payments Union Proposal.

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[1] The main characteristics of the revolution in Eastern Europe from 1989 was a total reversal of economic policy from central planning to a market economy. The experience of many developing countries shows that a process of transition from protection, with usually destabilised economies, to liberalisation is a very important and difficult issue. However, the transition from central planning to a market economy is without any precedents and the issues are even more complicated than in developing countries.

As the task of converting a centrally planned or administrated economy into a market economy of the western model has never been attempted before this would in itself create base for new thinking about both economic theory and policy.

The objective of this study is to address the main issues relating to establishing convertibility in countries undergoing the transformation to market-oriented economies. The results and consequences of an introduction of convertibility in Central and Eastern Europe will be presented and analyzed. Attention will be paid to the link between convertibility, on the one hand, and stabilisation and structural reforms, in particular price and trade liberalisation, on the other. It is evident that one cannot discuss currency convertibility separately from the entirety of the process of the economic opening of these countries.

The issue of convertibility will be discussed with reference to Poland. The objective of this is to analyze the first steps towards convertibility in this country. The aim of analyzing Poland's recent experience is not so much to propagate the Polish model. Rather, the purpose is to see to what extent it was influenced by the specific Polish conditions and how it can be used to help the transition in other countries. The case of Poland is particularly instructive not only because it is the largest economy and most populous country in the region but also because it is the first country to have started the fundamental market reform[2] under a noncommunist government. Though the Polish experience is only two years old, and though it is not yet possible to make definite judgement and draw final lesson for other countries, this early lesson from Polish experience may still be relevant for the other Eastern and Central European countries.

The discussion is centred on the dilemma whether priority should be given to internal or to external convertibility, i.e. in the domestic or in the external market, with the further distinctions between operations made by residents and non-residents. A distinction will be also made between current account and capital account convertibility. The focus will be mainly on current account convertibility, with some attention being paid to capital account convertibility.

The speed and sequencing[3] of reform are controversial issues in discussions of the transition to a market economy.[4] Some authors argue that an early introduction of current account convertibility is an indispensable part of the programme of economic reform, while others are in favour of a gradual approach.

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[2] On 1 January 1990 Poland introduced the economic transformation programme.

[3]The sequencing of reforms usually means the order of liberalisation of different markets. For example, a standard dilemma is whether current account should be liberalised before capital account. The speed of reform refers to the extent of liberalisation over time.

[4]Sequencing and speed of reforms in economic liberalisation programmes is not a completely new issue. In 1970s and early 1980s many developing countries implemented a series of structural adjustment programmes together with macroeconomic stabilisation programmes which emphasis economic liberalisation. The main problem of these countries were distorted markets such as foreign exchange market and some domestic markets - price control, market imperfection.

In view of this, the paper will focus on the appropriate speed at which convertibility should be introduced and will present the gradualist approach and the 'big bang' approach. In this context it will be argued that the question of choosing between immediate convertibility and ultimate convertibility is misleading. The real question should be how to introduce convertibility into the reform process.

Recent literature focuses on the idea of an optimal sequencing of the reform process: all the steps necessary for transition are to be ordered according to the criteria of causality and time and therefore to the question where to place convertibility in it and to which degree to liberalise. The main conclusion is that reform programmes have to include dynamic component by including appropriate speed and sequence of reform not only the economic measures.

Very little theory is available on the topic of sequencing and speed of reforms which implies that one has to concentrate more on countries experience. One may in advance say that it is not easy to generalise this issue.

This paper will analyze the merits of radical reforms at an early stage. At the same time it will discuss the importance of sustained and gradual reform steps to be introduced in the longer run in other to cope with accumulated distortions. It will be argued that high risks are present when liberalising too soon and too extensively. At the same time the idea will be dismissed that convertibility can be a natural product of other structural reforms. This argument can build on the recent Polish experience.

An attempt will be made to show that the appropriate speed of the establishment of convertibility as well as an appropriate speed of the reform itself (these two issues are complementary) depend on the initial conditions and the type of macroeconomic management. Furthermore, it will argue that under certain conditions gradual approach to convertibility (the reform) gives better results than shock therapy approach (Hungarian case) and thus should be preferred. While under other conditions (the Polish case) it may be necessary to apply a quicker approach which may also give positive results.

The tyranny of misleading data, Sachs and Lipton hold, is one of the major problems in analysis of situation in Eastern Europe. The problem is that Western economists, accustomed to Western standard of analysis, sometimes take Eastern European data at face value. It is not only that these data problems pose a serious obstacle to analysis but they, what is even worse, can induce unwarranted pressures on policy makers.

Organisation of the paper will be as follows. The first section will a brief review of the historical experiences with establishing convertibility. The post-war experience of Western Europe will be examined. The description of the basic problems, options and opportunities in creating market economies in Central and Eastern European countries

will be followed by a general discussion of the role of convertibility in the transformation process in Central and Eastern Europe.

The next step will be to define convertibility. The analysis of the problem of convertibility in relation to the transformation process in Central and Eastern European countries will then be discussed in more detail. First, several different concepts of convertibility will be distinguished, in particular current and capital account, and internal and external convertibility. The question which concept to use will be discussed. The emphasis of this paper will be mainly on current account and internal convertibility.

The following section will discuss the moment when a country should introduce current account convertibility. Whether to move to convertibility straight away or in stages is a controversial issue. Two distinct approaches to the convertibility problem will be analyzed: first, the feasibility and consequences of a shock therapy, and secondly, the alternative of gradualism. Attention will be paid to the basic macro and micro requirements for convertibility. The discussion of proposed transitional arrangements in establishing convertibility will follow.

A description the conditions of the Polish economy, the strategy of reform that was adopted in Poland, the early results of the transition programme, and the remaining agenda are main focus of the last section. The initial results and consequences of convertibility will be examined making use of basic statistical and economical indicators, insofar as they are available.

A final section summarizes the policy conclusions suggested by the preceding discussions.

## 2 Historical experience in establishing convertibility

In the past most developed countries have introduced current account convertibility at a rather late stage of their development process. Economic conditions, particularly establishment of a competitive industrial structure and an adequate level of international reserves were the main factors influencing the introduction of convertibility in these countries. The introduction of capital account convertibility was postponed, however, even to the latest stages of the development process because it involved a greater risk of external instability of a country. Some industrial countries like Italy introduced convertibility for capital account transactions, fairly late, actually in 1990 [Cardani and Maggini, 1991:2].

Very few developing countries have established convertibility of their currencies. Only a small number of African countries have established some kind of a limited convertibility, while most of them have had their currencies pegged to the French franc.

In the former centrally planned countries of Central and Eastern Europe an introduction of convertibility was for a long time rejected. These countries were afraid that the introduction of convertibility would influence their process of industrialisation and development through the availability of foreign exchange reserves. Today convertibility has obtained a new dimension in the development process of Eastern European countries especially related to the economic transformation of these economies. Poland and former Yugoslavia introduced internal convertibility for current account transactions.

### 2.1 The evolution of convertibility in the period after the Second World War

This section deals mostly with re-establishing convertibility in the post-war period and especially in the period up to December 1958 when convertibility was reintroduced in most Western European countries. The recent interest in this post-war experience of Western Europe is directly related to the restructuring of Eastern and Central European economies and particularly to establishing convertibility which is considered as the prior goal. Most East and Central European countries are facing somewhat similar problems of dollar shortage and bilateral trading which were the main reasons for the 15 West European countries to form the European Payments Union (EPU) and went through a long period of regional transferability, limited to their mutual relations, until re-establishment of convertibility of their currencies for the US dollar was feasible. The experience gained is considered pretty relevant as some authors propose that Eastern and Central European countries should follow the example of Western European countries and create an Eastern European Payments Union.

The EPU was established in 1950 as a system of West European settlement and it ceased to exist in December 1958 when it was replaced by the adoption of dollar convertibility by the member countries. The collective move towards convertibility in December 1958 was the culmination of a progress from an essentially bilateral international monetary system, to a binary one with parallel arrangements for 'hard' and 'soft' settlements in 1949; and then in December 1958 from a binary system to unified one.

## 2.2 The Road to Convertibility

After the Second World War only the currencies of the United States and Switzerland were convertible for current account transactions. The reason why the currencies of most countries throughout Western Europe ceased to be convertible was the breakdown of international financial arrangements caused by the war. The lack of foreign exchange, especially dollars, had also caused an increase in controls over trade and payments and most of the Western European countries accepted extensive bilateral trade agreements for trade operations.

The period between 1945 and 1949 was characterised by bilateral relations, fixed rates of exchange of most currencies, with the US dollar as the only convertible currency. The arrangements were taking place extensively through clearing and other bilateral accounts without any particular transaction in the open exchange market. Parallel to the bilateral arrangements there were two areas, namely the US dollar and the sterling areas functioning as multilateral mechanism of settlement. The bilaterism began to be called in doubt even before 1949 and various official initiatives were taken, although not successfully, to move from bilaterism to multilateralism; one example is the premature rush to re-establishing sterling convertibility in July 1947.

The crisis of 1947 made it evident that the conditions of political and economic equilibrium which had been anticipated at Bretton Woods were still apparently absent. Although there was a general agreement that re-establishing convertibility was desirable, since bilateral trade agreements and trade restrictions were strongly damaging trade as well as economic growth in general, the uncertainty of trade prospects and concerns about the lack of competitiveness against the United States prevented most countries from doing so.

In the beginning of 1950s this resulted in the more rapid development of sterling arrangements as well as European monetary arrangements and the move from a bilateral international monetary system to a binary one. The prior factor leading up to this event was the devaluation of dollar parity of almost all currencies; especially the devaluation of Sterling in September 1949.

### 2.2.1. Sterling Settlement

In the period between 1952 and 1954 the countries of the Sterling Area succeeded in organising their internal and external monetary policies in order to stop the decline of their gold reserve. Radical import restrictions were adopted and the eventual reestablishment of sterling convertibility was postponed for the future.

### 2.2.2 The European Payments Union

The European Payments Union (EPU) was created as a central payments and clearing union for the promotion of trade and the elimination of trade restrictions among the major Western European countries. The EPU operations were another example of advancement towards international monetary policy within a limited geographical sphere. The multilateral payments system created in 1950s was based to some degree on Keynes' Clearing Union Proposal; under this plan an international institution was expected to grant credits to the member states to finance unfavourable balances of payments.

The mechanism for multilateral settlement between member countries provided by the Union worked as follows [Tew:1977]:

- Each month the EPU took over all bilateral surpluses and deficits of each of the member countries. The sum of all bilateral surpluses of a country with other member countries in a particular month, minus all bilateral deficits were recorded by a central agency, the Bank for International Settlements, as the country's net position for that month.

- All compensable deficits and surpluses between members were simply cancelled.

- The change in a member country's net position had to be settled between the country and the Union. Whether the member had to settle with the Union or vice versa depended on whether a country had a net deficit or net surplus position.

- The procedure established for settling any change in a country's net position did not depend on why that change had occurred. This was not the case prior to the establishment of the EPU because of the strong motivation of countries to prevent an outflow of dollars or gold.

- The principal means of settlements between members and EPU were US dollars or gold and so-called 'credits'.

- The proportion between dollars, gold and 'credit' depended on the quota allocated to each member; the dollar credit proportion to the member's deficits or surpluses was expressed as a percentage of their quotas. The dollar-credit ratio was changed with an increase of the dollar share to credit share in the period up to 1958.

- The last but important point was that the EPU had an initial amount of 350 millions US dollars as a provision when the Union's receipts of dollars fell short of its payments.

In sum, both the establishment of the EPU in 1950 and the development of sterling arrangements provided the countries of Western Europe with the possibility of multilateral settlements. Through exchange controls these two multilateral settlement areas, sterling settlement and EPU, kept apart by exchange controls the dollar area within which arrangements were in US dollars, and the 'soft' settlement area, within which arrangements were mainly in sterling or through the mechanism of the EPU.

The existence of several different methods of arrangements until 1958, suggested the possibility of the existence of discrimination in trade and payments even in these soft settlement areas. This was to some extent in practice until 1958 but it was diminishing towards the end of this period. Therefore, during the period up to 1958 the member countries of EPU succeeded in eliminating most quantitative trade restrictions; under the fixed exchange rates, the volume of the trade among these countries increased as well as the level of international reserves. But it was only at the end of 1958 that member countries decided to bring EPU to an end and to declare current account convertibility.

### 2.3 Introduction of Convertibility - December 1958

In the period between December 1958 and August 1971 Bretton Woods introduced convertibility in the market but also the official convertibility of US dollars into gold. Technically this meant that US authorities were prepared to deal with other central banks in gold. The buying and selling prices were $35 for an ounce. Therefore the US official convertibility related to the exchange of US dollar for gold, and that of the majority of the other countries was limited to the exchange of their own currencies for dollar.

The IMF's Article IV required member countries to settle parities in terms of gold or the US dollar. This could be reconciled with the practice of pegging on dollar parities as long as US officials gave central banks of other

countries the right to officially convert dollars (or gold) at the official price. The price of $35 per ounce was implied by the par value of the dollar agreed by the United States and IMF.

> So far as the foreign exchange markets are concerned, the measures taken in December 1958 have brought unification and at the same time greater freedom of movements for rates. Previously each European currency was traded against the US and Canadian dollars in a separate market, while eleven different European currencies were traded against one another on what was one market, under the arbitrage arrangements introduced in May 1953. At the end of December 1958 these two kinds of market were amalgamated and all the principal European currencies are now freely traded against one other and against US and Canadian dollars in one market [ BIS 29th Annual Report, 1959, p.186 in Tew's The Evolution of the International Monetary System 1945-77].

The simultaneous establishment by thirteen Western European countries of current account convertibility for non-residents was an important achievement in the area of foreign exchange payments. Britain and Germany accepted convertibility of their current payments with all other countries and introduced only one kind of current account for non-residents freely convertible into any foreign currency and freely transferable between all non-residents. The other eleven countries (Austria, Belgium, Denmark, Finland, France, Italy, the Netherlands, Norway, Portugal, Sweden and Switzerland) still maintained a number of bilateral payments agreements, but these comprised only a small part of the foreign trade and therefore of the payment system of each particular country. They also distinguished between countries with which transactions took place on the basis of convertibility and those with which payments were exclusively bilateral.

The convertibility introduced in 1958 has survived until today, though with considerable modifications to changing circumstances.

### 2.3.1 Exchange controls

The introduction of convertibility in 1958 resulted in a widespread abolishment of exchange controls by Western European countries. The major currencies became convertible in the exchange market and the holder of any of these currencies was able to freely convert it in any other by purchasing the one for another in any foreign exchange market. According to the international payments code, member countries were required to allow free transfer and conversion of any holdings of their currencies obtained by non residents through the current trade. In addition, residents were allowed to use foreign exchange freely for imports and other current transactions.

Yet, the dismantling of exchange controls, even for current account payments, remained partial as most of the

countries only in February 1961 accepted the obligations from the IMF's Article VIII[5]. The significance of this was that the currencies of these countries became externally convertible. Technically this meant that IMF accepted these currencies in repayments of drawings that other countries had made with the Fund.

The establishment of capital account convertibility was postponed until even later, for Italy and France not until the late 1980s when they abolished the last remaining restrictions on capital account transactions. Nevertheless, after the introduction of convertibility in December 1958 such restrictions were exceptional.

### 2.3.2 Official management

The commitment to a free market system in 1958 by Western European countries did not include any precisely described official management. It did not settle the question to what extent official transactions should be undertaken to regulate or influence market-determined exchange rates. This was not an issue in 1958 because of the decisions made at the Bretton Woods conference in 1944; in fact it did not receive attention until 1970. In the 1960s most countries were prepared to follow the Bretton Woods decision based on IMF's Articles of Agreement that official transactions were conducted so as to keep market rates very close to official parities and adjust these parities in the case of basic disequilibrium.[6]

However, in the entire post-1958 period exchange markets have always been managed, continuously or intermittently, by official transactions conducted by central banks on their own account or on behalf of a country's monetary authorities (treasury, finance ministry etc.). Sometimes these monetary authorities also undertake transactions with each other and with international institutions such as the IMF. The common name for the different transactions performed by monetary authorities is either 'official settlement transactions' or 'reserve assets

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[5] IMF's Article VIII condemns continual recourse to exchange controls on current transactions. Accordingly, by connection it favours pegging by some kind of official reserve transactions. This is connected with one of the basic rules on exchange rates in the period after 1958 that the market value of each currency should be held within the permitted margin by official transactions (not by recourse to exchange controls).

[6] The theoretical options for official transactions in foreign exchange other than the one adopted in the period till 1970 are as follows. At one extreme there is free floating, with no official transactions at all, at the other extreme is official pegging, at stable officially determined rates of exchange. In between these extremes there is managed floating, with official transactions in foreign exchange but no official target exchange rates, such as has been widely practised by the major powers since 1973; and secondly, official pegging but with adjustable (instead of inflexible) parities.

transactions'. For these transactions the US dollar is used as the intervention currency.

Equally important is the fact that from December 1958 to 1973 most of these countries pegged their currencies to the US dollar. In connection with this pegging convertibility meant on the one hand the right of individuals to enter freely exchange markets anywhere in the world and on the other hand a country's preparedness both to supply the market with dollars against its own currency at fixed exchange rate and its own currency against dollars also at fixed exchange rate. In the 1970s the transition to floating regime retained the first, convertibility in the market, but abandoned the second, official convertibility.

### 2.4 The end of Bretton Woods convertibility

The Bretton Woods system came to an end August 15, 1971; its collapse was the result of the severe imbalance in world payments. The main causes were the continuous deficit of the United States and the continuous surpluses of Germany and Japan. The surplus countries were persistently reluctant to modify their exchange rates and the US could not adjust its rate without jeopardising the operation of the system. The US deficit caused the reduction in the stock of its reserve assets and in particularly gold, while the stock of dollars held by foreign official institutions was growing, causing increasingly difficulties for the US to maintain convertibility.

On 15 August 1971, President Nixon announced a suspension of convertibility of dollar into gold and other assets. The suspension of convertibility was to be temporary but the President did not indicate a time frame. The purpose of this step was to force other countries to unpeg their currencies from a dollar which once made inconvertible into gold became less desirable to hold. The measure was successful and the US regained its exchange-rate autonomy.

### 2.5 The present International Monetary System

Following the spectacular events of 15 August 1971 currencies began to float freely in the foreign exchange market. In 1973 the new exchange system of managed floating replaced the Bretton Woods par value system although it was not legalised until the Jamaica conference in 1976 when the Second Amendment formulated and added to the IMF Articles of Agreement. The main results of this conference were (i) the agreement that member countries were free to adopt the exchange-rate system that fit them best, giving therefore, the same legal position to both pegged and

floating exchange rates[7] and (ii) the elimination of the official price of gold and the suspension of the obligation of using gold in certain transactions between members and the Fund, thus the beginning of gold demonetisation.

The immediate effect of the Second Amendment was the cancellation of all par values that had been established under the Articles of Agreement. Any par value that is retained under its domestic low no longer operates as a par value for the purposes of the Articles. A member may allow its currency to float; it may maintain the value of its currency in terms of the SDR or some other denominator, but not gold [Gold 1978:22].

With the establishment of floating exchange rate regime countries were not obliged any longer to maintain certain par values for their currencies, while their domestic economic and financial policies became more relevant; it was widely believed that the stability of the exchange rates depends on economic and financial steadiness. At the same time countries were advised to avoid the competitive depreciations in order to prevent the gains based on unfair competitive advantages. This created a serious problem in practice. The Fund's second amendment did not define precisely what is meant by unfair competition nor did it define exactly the degree of Fund's surveillance in connection with that.

According to many economists the system of managed flexibility has since its establishment in 1973 not caused a substantive reduction of international imbalances but has allowed serious currency misalignments, especially of the dollar, which was undervaluated until 1970 and overvaluated in the 1980s. The main consequence was distorted international competitiveness of many countries that induced an increase in the trade restrictions.

The failure of floating, however has encouraged the process of economic cooperation which was considered necessary for the balanced functioning of the international monetary system. One example of this necessary cooperation is the European Monetary System (EMS), established in March 1979 by the European Community (EC). Its main objective was to promote monetary stability among European countries and was considered as a necessary step towards the creation of monetary union. The EC created a new reserve asset - the European Currency Unit (ECU) which also functions as an unit of account as well as an official means of payments between central banks. The ECU is a composite of the participating EC currencies. The exchange rate mechanism works on the principle that each member determines a central exchange rate for its currency vis-a-vis the ECU.

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[7] This agreement was relate to a compromise made between France and the United States: "The new regime of managed floating rates reflected a compromise between France (which was seeking a return to adjustable peg) and the United States (which was advocating a totally unrestricted regime of floating exchange rates). This diplomatic compromise was achieved at an economic summit meeting among Britain, France, Germany, Italy, Japan, and the United States at Rambouillet, France, in November 1975" [Chacholiades 1990:501].

## 3 Reforms in Eastern Europe

The revolution in Eastern Europe of the second half of 1989 is one of the most dramatic events of the past decades. After years of trying to reconcile central planning with market incentives, almost all of these countries adopted the principle of the market economy, and the democratic system with large private sectors such as in Western Europe.

After the initial euphoria the newly elected democratic governments of these countries have been faced, in the process of transition to a market economy, with the serious problems concerning the content of the reform, the pace of change, and the sequence of change. The lack of an experience in managing a market economy, unstable political institutions, the resistance against change emanating from the pre-exsisting communist power structure and rising nationalism have made the process of transition even more complex. The worsening of political and economic situation in the former Soviet Union and the end of the Council for Mutual Economic Assistance (CMEA) further worsened the situation in the region.

However, in spite of the problems, there is still a strong desire in most of these countries for the establishment of democracy and moving to a market economy. This desire is on the one hand related to the attractiveness of the Western European example and on the other hand on the aversion for the communist system. However, even with a consensus on the ultimate objective of the reforms, the tactical difficulties of transition to a market economy are still profound as the basic political, and economic changes have to be carried out in the environment of a sever economic crisis.

Finally, the choice of the strategy for transition must extend to consider specific political and economic conditions prevailing in Eastern European countries in 1989, as they constitute the starting point for the transition process. The following section will summarise the prevailing economic (and political) conditions in Eastern Europe before the reform.

### 3.1 The economic situation at the start of reforms in Eastern Europe

The economic situation at the start of reforms in Eastern Europe was extremely unfavourable. The widespread opinion is that the main source of this unfavourable situation was related to the system that prevailed until the revolution of 1989, namely the centrally planned or socialist economy. Attempts to reform an economy in some of the Eastern European countries preceded 1989, but for various reasons most of them failed.

Two different kinds of pre-reform socialist economies could be distinguished. On the one side there was a centrally

planned economy in which decisions were largely based on consideration of quantity (e.g. Bulgaria and Romania); on the other side there were countries like Poland and Hungary that had partially reformed their economies by giving a greater role to market based rules but were still constrained by price controls and the emergence of dual pricing system.

Both regimes were based primarily on the principles on the social ownership of the means of production and socialist planning which established in detail the utilisation of resources and the levels of production. This implied fixing of producer and retail prices for long periods[8], the regulation of foreign trade through state-owned trading companies and undeveloped banking system. As a result unemployment was low and the firms had little intention to improve their performance and balance their budget (soft budget constraint). Therefore, the production structure was neither capable of fulfilling the requirements of producers for inputs nor able to fulfil the households preferences.

Since under the socialist system the main objective was fulfilling the set plan targets there were no incentives to open up new markets, develop new products, continuously modernise factories and equipment or additional training of workers whose employment was dictated by social policy reasons (workers were massively employed by factories even if they were not required). The result was a low productivity of labour particularly when compared to international levels.

Equally low remained the level of economic openness throughout the whole period of communist regime in Eastern Europe, even though some of these countries, for instance Poland, the former Yugoslavia and Hungary, were more exposed to international market forces as their share of manufacturing products trade with Western countries was relatively high.

The emphasis in Eastern European economies was on import substitution strategies. The dominance of the heavy industry and undeveloped services sector were among the main features of socialist economies. Importing and exporting were undertaken by state agencies, which controlled basically all foreign exchange operations. Trade with West was used to fill gaps and compensate for planning mistakes rather than to be based on comparative advantages.

The trade among the former socialist economies was organised through the CMEA and payments imbalances were recorded in the 'transferable ruble' which was, however, not transferable at all. This multilateral clearing remained limited as no debtor country was willing to give up credit it had obtained by running a deficit.

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[8]A politically determined price system did not reveal real conditions of scarcity among goods and factors of production.

The introduction of reforms in Eastern Europe was further complicated by the existence of the monetary overhang and parallel markets. The excess money supply emerged as a consequence of the huge government budget deficits financed by printing money at a pace exceeding the growth in output. The gap between monetary purchasing-power and availability of goods caused the development of a number of black markets.

The effective money supply was further increased by devaluations like in Poland where in 1980s the stock of foreign currency at black market exchange rate was almost as high as the stock of domestic money [Welfens 1991].

Under these circumstances the currencies of these countries lost their function as the means of payments and the store of value. Convertible foreign currencies started functioning as a parallel currency; the parallel currency was used as a mean of payments between private persons as well as for storing value. The German mark and US dollar were the preferred currencies in the process of currency substitution in Eastern Europe.

The consequence was the emergence of hyperinflation, first in Poland and the former Yugoslavia and, more recently in former Soviet Union. The most relevant cause of inflation were budget deficits as they were financing by printing money. The real income decreased dramatically in almost Eastern European countries, shortages and queuing were widespread. Foreign debt was high. Black market exchange rates demonstrated a chronic lack of foreign currencies and a demand for foreign goods.

By 1989 it was clear that the socialist system, even where economic reforms had been undertaken, failed to develop efficient international economic relations and to establish an efficient national economic system. The political revolution of 1989 created the opportunity for the transition from socialism to a market economy and almost all Eastern European countries introduced reform programmes in 1990.

In addition to the unfavourable domestic situation the Eastern European countries were also hit by two major external shocks, in 1990, that have influenced and complicated the process of transition to a market economy. The first shock was self-induced by the decision to dismantle the CMEA by the end of the 1990 and to start conducting trade among themselves at world market prices and settling it in convertible currencies. The collapse of the export demand from the former Soviet Union and East Germany had a strong negative impact on the balance of payments and terms of trade of the other Eastern European countries.

The second shock was related to the sharp rise in oil prices induced by Iraq's invasion of Kuwait. The consequence was the increase in the oil bill of these countries with exception of the former Soviet Union, which was still a net exporter. Poland, together with Bulgaria, Romania and Czechoslovakia, lost the substantial imports of oil from Iraq that they had been receiving in repayments of its debts [Welfens 1991].

The conclusion which follows is, therefore, that the nature and timing of transitions in Eastern and Central European countries have been influenced by their communist past and by the economic crisis facing the new governments.

### 3.2 Reform programmes

In 1990 most of Eastern European countries launched reform programmes whose main objective was the transition to a market economy. The fundamental task of these programmes was to dismantle the old administrated economy and to create a modern market economy as well as to establish stable internal and external financial conditions.

As political and economic situations have differed significantly among Eastern Europe countries the prospects for success differed as well. For instance, countries such as Hungary, Poland and Czecho-Slovakia have appeared to be better prepared for the reform than countries like Bulgaria and Romania where conditions have been less favourable. The former Soviet Union has remained a case by itself.

The key aspects of the transformation process which apply to all these countries were macroeconomic stabilisation which includes measures such as reduction in the budget deficit, elimination of excess money supply; the liberalisation of prices and foreign trade; property reform; and restructuring.

The main objective of monetary, fiscal and income policies have been to create an environment with low inflation and balanced balance of payments. By keeping inflation low and promoting positive real interest rates, monetary policy was meant to establish confidence in the domestic currencies. In some programmes, for instance in the Polish one, the fixed exchange rate was used as a nominal anchor to eliminate inflation expectations.

As the price system of Eastern European economies are severely distorted the reform programmes have emphasised installing an appropriate price structure as quickly as possible. This has included the liberalisation of prices and the end of most subsidies. Specially important has been the establishment of the positive real interest rate in order to correct distortions in the financial markets.

The opening up of these economies and their integrating in the world economy has been widely accepted as the essential step for the efficient functioning of a market economy, i.e. for creating the correct structure of domestic prices and for fulfilling the need for foreign goods and services which had been suppressed for a long time.

In contrast to the policy sequencing adopted in Western Europe in 1950s, currency convertibility has been introduced at the beginning of the transition, rather than being the culmination of the process. Thus the setting of the exchange

rate at an appropriately depreciated level and the need for adequate reserves.

At the micro level these programmes have also attempted to harden the financial constraints for enterprises while measures have also been taken to prevent abuses of the monopoly power. Subsidies and ad hoc changes in tariffs were replaced by a nondiscretionary tax system. The purpose of establishment of a commercial banking system was to assure that credit decisions are made in a commercial way.

The far-reaching measures of systemic and structural reform such as privatisation and the creation of a system of financial markets and institutions, which also include the development of a proper social security system and the investment in infrastructure, will take a considerable time and may be substantially completed only after a decade.

Finally, the strategic decisions implied by to the reform programmes remained the speed at which the transition to a market should proceed, the sequence of the reforms[9], and the combination of internal and external measures needed to create an efficient market economy.

### 3.3 Present situation

In 1990 in all former socialist economies a recession developed. Negative growth rates were recorded in all these countries, output declined and unemployment increased. If this indicates the cost of the reform in Poland, Hungary and Czecho-Slovakia it also indicates the costs of non-reform in the more slowly reforming countries such as former Soviet Union, Bulgaria and Romania.

In 1991 the economic decline in Eastern Europe continued; on average output declined by 10 percent ranging from a fall of 20 percent in Bulgaria to 7 percent in Hungary. Unemployment has increased rapidly in all countries reaching 12 percent in Poland.[10]

Given these problems the costs of the reforms have been more noticeable than the benefits, which remain unpredictable. It is, therefore, widely accepted that the transition process has been full of hardship and risks which

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[9] For a more detailed discussion of this topic see Part 4 of this paper.

[10] As small private industries which are developing quickly in some of these countries, are not yet included, it seems that official data tend to exaggerate the bleakness of the situation. For instance, it has been estimated that in Poland the private sector accounts for about 70% of domestic trade, 44% of output and 20% of output.

far exceed those of Latin America.

Yet, it is generally agreed that in most of Eastern European countries the reform programmes have been relatively successful in the area of macroeconomic stabilisation and price liberalisation. However, it appears that the main bottleneck for growth of these economies remains a lack in structural polices, which implies that it is necessary to speed the structural transformation of these economies.

It is very difficult to predict at this point, the developments in the economies of Eastern Europe. Internal uncertainties and problems together with external factors complicate the transition process and it seems that it will take quite a while for these economies to start growing.

## 4 The issue of convertibility and reforms in Eastern Europe

### 4.1 Introduction

The importance which currency convertibility has acquired today is part of the widespread shift of Eastern and Central European countries to an outward looking strategy of development[11], away from an essentially closed economy approach of the past.

Currency convertibility is the centrepiece of the external aspects of economic policies adopted by these emerging market economies in their economic opening and thus central to this paper. It is held that one cannot really discuss convertibility independently of the other policy questions that arise in opening an economy to the world - hence the more general discussion in this study is required. In that respect attention is also paid to the exchange rate and trade policies.

Convertibility pertains more to microeconomic than to macroeconomic policy. It is closely related to exchange rate policy, but it can also be an important instrument for liberalising economies that used to be centrally led. From the microeconomic perspective the key argument for establishing early convertibility for residents on current account transactions is the liberalisation of the domestic economy by importing competitive pressure and a rational price structure. From the macroeconomic perspective the money supply is not a good target for monetary policy in the case of large and quick shifts of asset stocks and drastic changes in the structure of financial institutions. Therefore, according to this view this policy should take the exchange rate as a nominal target and introduce a realistic, pegged rate (there are strong arguments for pegging rather than floating the exchange rate if the programme includes convertibility) so as to rapidly bring down inflation expectations [Portes 1991:11].

Although there has been a fairly general consensus about the need for the establishment of currency convertibility, different views have emerged as to the type of convertibility to be used, the timing, and the manner of implementation.

In the following sections an attempt will be made to answer two questions. The first question concerns the type and degree of convertibility to be used in the transition process. The second and more controversial question is when and how currency convertibility should be introduced into the reform. The discussions are mainly concentrated on

[11]Parallel transformation from a planned to a market economy is what makes the Eastern and Central European countries's shift to an outward orientation different from the experience of other countries with an outward strategy, for example countries in Latin American. "No reforming developing country has needed to create ex nihilo anything like the full range of institutions of market economy" [Williamson 1991:19].

whether it should be introduced at the beginning of the process of transition, as was done in the Polish case, or whether it should be only a part of the long-term gradual adjustment, as was done in the case of Hungary or the Western European countries in the 1950s.

## 4.2 Alternative concepts of convertibility

### 4.2.1 Definitions

The definition of convertibility has changed with the development of the international monetary system. Today convertibility is defined as the right of any holder of a currency to convert it at the market exchange rate, whether fixed or flexible, into one of the major international reserve currencies. This definition is in contradiction with earlier usage: until the 1930s, currency convertibility was mostly defined as the right to convert a currency freely into gold at fixed exchange rate.

The change in definition of currency convertibility to the standard definition which is currently used was made necessary by the announcement by the President of the United States on August 15, 1971 that US monetary authorities would no longer be committed to converting foreign official holdings of US dollars into gold. This event led to an international agreement on the Second Amendment of the Articles of Agreement of the International Monetary Fund.

Under the Second Amendment the definition of a 'convertible currency' disappeared. Although the obligations of convertibility defined by Article VIII were not annulled, the concept of the 'freely usable currency' was defined "as a member's currency which is widely used to make payments for international transactions, and is widely traded in the principal exchange markets" [Gold 1978:29].

Different types of convertibility are connected with questions who should be allowed to exchange currency and for what purpose. Unrestricted convertibility is defined as a right of anyone to exchange currency for any purpose. In the case of restricted convertibility a distinction can be made between current account and capital account convertibility as well as between resident and non-resident convertibility.

The term convertibility is usually connected with the meaning of restricted convertibility. The reason for this is that in the past most developed countries had some kind of restricted convertibility and it was not until recently that some of them introduced unrestricted convertibility. Also, in the case of Eastern and Central European countries the concept of restricted convertibility is more important and applicable. Many economists hold that at the present stage

of development of these countries as well as in the near future it would be unwise to introduce unrestricted convertibility.

Current account convertibility is traditionally used as an alternative to unrestricted convertibility. In this paper current account convertibility is defined as 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)] This restricted concept of convertibility was adopted and maintained by the majority of West European countries throughout almost the entire period in which their currencies were convertible. According to this definition a domestic importer or a foreign exporter has the right to exchange domestic currency for a foreign one at the official exchange when settling any transaction for the purchase of goods or services from abroad. This convertibility also extends to transactions like payments of interest rates, or the return of profit [Williamson 1991].

In the discussions on Eastern Europe the distinction most usually made is that between internal and external convertibility rather than current account and unrestricted or capital account convertibility. The definition of external and internal convertibility is usually related to the question who is allowed to convert domestic currency for foreign rather than to the purpose of the exchange transactions. Consequently, internal convertibility is defined as the right of residents to hold and exchange foreign exchange domestically while external convertibility is defined as a freedom of non-residents to do the same. The important features of an internally convertible currency is that it does not include permission to make payments abroad or to hold assets in foreign countries. The latter definition is usually related to establishment of a right of foreign investors to repatriate their earnings.

Internal convertibility has been subject to many different interpretations. One of definitions of internal convertibility refers to the right to exchange money for goods; this definition was used particularly for countries with limited possibilities for the exchange of money for goods, as for instance in the former Soviet Union. This type of convertibility, sometimes called commodity convertibility, refers to a right of an enterprise to use money to buy goods without the permission of a planner; a more widespread interpretation includes the possibility of households to use money to obtain goods. The inability to use money balances at the enterprise's own decision is called 'commodity inconvertibility'.

Establishing internal convertibility is also very often considered an initial step in the process towards current account convertibility. That is why in the literature internal convertibility is sometimes used, particularly with respect to Eastern European countries, as a synonym for convertibility for current account transactions.

### 4.2.2 Current account convertibility

The introduction of convertibility for international transactions or current account convertibility has positive and negative implications for an economy. According to Isard and Green, one such positive effect (especially for the supply side) is the exposition of the economy to foreign competition. A negative effect may be the short-run macroeconomic instability caused by persistent current account imbalances or exchange rate tensions. In the short run the introduction of current account convertibility may as well produce a negative impact on employment and real income of the country.

The traditional view (mostly IMF view) is that the introduction of convertibility in the economies of Eastern European countries together with the abolishment of trade restrictions[12] can bring to these countries new opportunities for development and a greater economic freedom. The direct effect should take place on the supply side. With the lowering of quantitative restrictions on imports, convertibility for the current account transactions may cause an increase in the supply of consumption goods. Since centrally planned economies are unable to fulfil demand for consumer goods and services, freedom to import from abroad can in the short run result in the greater satisfaction of consumer demand.

Even more important is considered the indirect impact - creating a more competitive environment - of establishment of the current account convertibility, since it pushes the country to produce and invest according to its comparative advantage. Establishment of current account convertibility can help transforming centrally planned into market-oriented economies as it exposes domestic producers to competition from abroad making possible, the long run improvements in domestic industry, a better allocation of resources, and the application of new technologies.

There are also risks connected with the introduction of current account convertibility, especially in the short run. Shift in demand from domestic products to imported ones can result in unemployment and idle capacity. At the same time the adjustment for changes in exchange rate may reduce real wages substantially in order to keep domestic goods competitive with imports. This can cause a decrease in the available income which, through a multiplier effect, can in turn negatively influence domestic production.

In reality, current account convertibility has often been restricted by placing a ceiling on the sum that individuals are allowed to take out of the country for tourist expenditures. The main reason for imposing these restrictions was

[12]It is important to note that the significance of current account convertibility could be practically denied if an abolition of exchange controls were accompanied by intensification of trade restrictions. Exchange controls and trade restrictions together determine how fully a country's markets are integrated into the world market.

to prevent residents from using the tourist allowance for the export of capital.

### 4.2.3 Capital account convertibility

The question usually asked in debates of capital account convertibility, especially with reference to transforming economies, is whether capital account convertibility should be introduced at the same time as current account convertibility or whether it should be left for later stages of the transformation process. This question is closely connected with the fact that the establishment of convertibility for capital account transactions produces positive and negative effects, just as in the case of current account convertibility. Consequently, the introduction of capital account convertibility depends on whether the risks involved in unrestricted capital movements would be greater than benefits.

The success of the transformation of the Eastern European countries depends for a great deal on the ability of these countries to attract massive capital inflows from the West. It is believed that the introduction of capital account convertibility, even in a limited form, can enable these countries to attract foreign capital as it gives assurance to investors that they would be able to repatriate their profits.

The effectiveness of establishing capital account convertibility depends heavily on the macroeconomic stability of a country. The risk of establishing convertibility of the capital account lies in the extensive capital flight, as well as in more unstable exchange rates and foreign exchange reserves. In order to avoid macroeconomic instability and to protect their economies, most countries have preserved restrictions on many types of capital flows. Therefore, the establishment of full capital account convertibility usually follows some time after the introduction of current account convertibility.

Eastern European countries which choose to postpone the establishment of capital account convertibility in order to prevent extensive capital flight and short-term capital inflow may on the other hand want to encourage long term capital flow as a part of investment reforms now under way in many of these countries. Therefore, to realise that they have to establish measures which guarantee non-residents to repatriate their assets and profits from domestic enterprises. However, limitations on capital transfers by residents as well as on short-term capital inflow may remain in place in order to prevent macroeconomic instability.

### 4.2.4 Internal convertibility

Reasons for establishing internal convertibility are much different from the ones for introducing current account convertibility. The integration of the black market into the formal economy (lowering transaction costs and encouraging greater uniformity in exchange rates) and the channelling of foreign exchange into the banking system are two reasons for establishing internal convertibility. However, there are also some potential risks involved in establishing internal convertibility. One of them is that internal convertibility can lead to an extensive substitution of the domestic currency into foreign currencies, especially in the case of macroeconomic instability, which may in turn cause a decline in the foreign exchange reserves. The other problem related to the introduction of internal convertibility is that large holdings of foreign exchange by residents, as was the practice in most countries, can complicate monetary policy.

This risk of a large substitution of domestic currency into a foreign one can be avoided if one of the conditions for establishing internal convertibility, to be described in more details in next section, namely, sound macroeconomic policies is fulfilled. The policies that yield price stability and competitive returns on domestic currency holdings are needed to make it attractive to hold assets denominated in domestic currency and thus discourage large-scale currency substitution [Green and Isard 1991:17].

In most of the countries in Eastern Europe internal convertibility is defined as a legal right of domestic residents to acquire and maintain domestic holdings of certain assets - currency and bank deposits - denominated in foreign currencies. From this definition follows that internal convertibility comprises several different possibilities such as, (i) the exchange rate may be fixed or floating; (ii) internal convertibility may be introduced as an isolated measure or as part of a monetary stabilisation package; (iii) it may be partial or comprehensive; and (iv) it may be introduced at a single or multiple exchange rate. This explains why in practice many countries introduced different types of internal convertibility.

Many countries limit internal convertibility. For example, households in Poland are free to acquire and hold foreign exchange while enterprises are required to sell their foreign exchange earnings to domestic banks at the market rate of exchange. The other characteristic of the Polish approach is that the rate of exchange at which the zloty is internally convertible has been held almost stable in the period 1990-91. It is an adjustable peg system and it was introduced as a part of a monetary stabilisation package. Introduction of internal convertibility in Poland was also comprehensive and was at a single exchange rate.

The Polish success in the introduction of internal convertibility and in particular the fact that in Poland the introduction of internal convertibility has proved the possibility of transition from a shortage economy with very

high inflation to a demand-constrained economy with lower inflation is the main reason for the present interest in the former Soviet Union for making the rouble internally convertible. In the former Soviet Union (Commonwealth of Independent States) today, internal convertibility is understood as a liberalization of the right of enterprises to import,... "paying for their imports with roubles which are sold by their bank to acquire the necessary foreign exchange, and also the right of joint ventures or entirely foreign owned firms to repatriate their rouble profits in foreign currency purchased at a market rate of exchange" [Ellman 1991:482].

Internal convertibility can be established with maintained restrictions on current account transactions but it is not so easy to establish internal convertibility separately from an external one, i.e. for international transactions, once residents are allowed to purchase and hold foreign currency without limit. In fact, it may be very difficult to prevent them from using their foreign exchange to make payments for imported goods and services. It is even more difficult to prevent and control capital outflows than to prevent outflows through current account once internal convertibility is introduced. In the past some countries have, therefore, chosen to introduce current account convertibility while still maintaining restrictions on internal convertibility to prevent capital outflows or to prevent flows of foreign exchange reserves to residents.

The situation is different when residents already hold a significant amount of foreign currencies. In that case internal convertibility can help to fulfil the important objective of channelling these foreign exchange resources into the banking system. There has been a permanent huge excess demand for foreign exchange in all Eastern and Central European countries, causing an enormous difference between the black market exchange rate and the official rate. "The excess demand for foreign exchange is considered as inherent in central planning, and bound to worsen during the transition phase" [Asselain 1991:221].

### 4.2.5 Which concept to use

Which concept of convertibility to choose is a controversial topic in discussions on reform in Eastern and Central Europe, in particular the choice between current account or internal convertibility. The answer depends to a large extent on the objectives behind the establishment of convertibility and the role it would be expected to play in the reform.

Some economists, for instance Polak, argue that the main objective of establishing convertibility in countries undergoing transformation to market a economy is the introduction of competitive pressure and of a rational price structure from abroad. Import liberalisation together with convertibility is the best way to introduce competitiveness in the export-import sector according to this opinion. If the central objective is to break up monopolies, making

prices free without permitting competitive pressure from abroad gives monopolies a chance to use their power. In this case current account convertibility is needed.

Attraction of foreign direct investment is another widespread objective for establishing convertibility in these countries, since some kind of assurance is required to foreign investors that they will be able to repatriate their earnings. With reference to this external convertibility is to be introduced. This is related to another contradictory issue - external versus internal convertibility.

Asselain argues that a conflict between external and internal convertibility may appear only in so far as unexpected capital movement might destabilise the exchange rate and thereby the level and structure of domestic prices. He also argues that certain guarantees have to be given to foreign investors concerning the repatriation of their earnings, until external convertibility is fully established. What really matters is then the different focus of these two approaches. The main objective of internal convertibility is the remonetisation of the economy and the elimination of the dual structure while the main objective of external convertibility is attraction of foreign investments [Asselain 1991].

Williamson argues in favour of current account convertibility with restrictions on capital account transactions. His argument is that unrestricted convertibility is not necessary for attracting foreign investment because current account convertibility allows the remitting of profits; capital repatriation can be added by giving investors "the right under exchange control regulations to repatriate any capital that was registered with the central bank at the time of its arrival" [Williamson 1991:22].

Internal convertibility, or the right of households to convert their domestic currency into foreign currencies and to maintain foreign exchange accounts, has been accepted by a number of Eastern and Central European countries. Williamson argues that under the enormous uncertainties that these economies face, it would be imprudent to promise such convertibility, because it might be difficult to maintain this right under adverse circumstances. This will make it impossible in practice to eliminate the functioning of a parallel market which therefore should be tolerated together with foreign-currency bank accounts.

Many economists hold that unrestricted convertibility is not advisable for Eastern and Central European countries at this stage of their development as well as in the near future. The reason is that the equivalent of at least five years of domestic savings will be needed for economic reconstruction. Capital controls are, therefore, necessary to prevent

capital outflow[13].

Portes also argues that an early transition to capital account convertibility could create serious confidence problems without contributing very much to the objectives of economic reform, at least as long as current account convertibility guarantees the freedom to remit profits [Portes 1991].

Following Williamson's suggestions, convertibility for Eastern and Central Europe could be regulated as follows:

> Enterprises (including foreign investors) would be allowed to buy foreign exchange at the official rate in order to finance current account transactions; they would also be required to sell their earnings of foreign exchange at the official rate. This would enable them to pay for imports of goods and services and to repatriate profits at the same rate at which they earned foreign exchange through exporting. The export of capital would be subject to exchange controls; permission would be given automatically to repatriate capital upon maturity of a loan or at any time by a direct investor provided that the inflow was registered with the central bank when it arrived, but other capital exports would be prohibited unless authorities saw some particular national advantage accruing from the transaction [Williams 1991:23-24].

### 4.3 Timing of convertibility[14]

The appropriate time to introduce current account convertibility normally depends on the implementation of other measures in a country's reform program. As will be argued in the next section, macroeconomic stability and appropriate microeconomic incentives are traditionally considered critical to the success of convertibility. Many economists hold that the preconditions for the successful establishment of convertibility should be created as quickly as possible considering the major benefits that convertibility can provide. Once these preconditions are established, there is a strong base for countries to move quickly to current account convertibility. Therefore a coherent strategy of transition requires establishment of certain conditions before or during the transition to convertibility.

It is also likely that some countries want to introduce or maintain transitional arrangements in order to stabilise the

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[13] "There is all the difference in the world between tolerating retail use of a parallel market by households wanting to place some of their assets abroad (despite the premium they have to pay for foreign exchange), and facilitating the wholesale export of savings by allowing enterprises and financial intermediaries to buy foreign assets with no financial penalty. Savings are needed at home during the years of economic reconstruction that lie ahead, and capital controls, even if not 100 per cent effective, can help to keep them there. The countries of Eastern Europe would be well advised to delay the abolition of capital controls until reconstruction has been achieved, when such a luxury will be affordable" [Williamson 1991:23].

[14] This section is based mostly on the paper by Williamson.

current account or the exchange rate. One of the reasons for a country to introduce or keep transitional arrangements is to let import competition develop gradually in order to give domestic enterprises time to adjust. Even though in certain situations such transitional arrangements may support the transformation process, the question remains for how long such arrangements should stay in force.

### 4.3.1 Preconditions for convertibility

The preconditions necessary for the establishment of currency convertibility have been extensively discussed in recent years. It has been accepted by most economists that a certain number of preconditions have to be satisfied for convertibility to be established and sustained successfully.

Conditions necessary for establishing convertibility are usually divided into two groups, macroeconomic and microeconomic ones. From the macroeconomic point of view, convertibility requires an adequate stock of reserves and a reasonably satisfactory balance of payments position. The latter requires a competitive exchange rate and control of demand. In respect to the latter monetary overhang has to be eliminated. If these conditions do not hold, demand for imports will rapidly increase, making it difficult to maintain convertibility. The less convertibility is perceived to be sustainable, the stronger will be the demand for imports before the expected reimposition of restrictions. A lack of credibility forces authorities either to abandon convertibility or to deflate demand. "It was precisely the fear of such a choice that made Western European countries so cautious (after the British experience of 1947) in moving to convertibility in the 1950s" [Williamson 1991:25].

The question of how satisfactory the balance of payments position needs to be in order to allow the introduction of convertibility is of a very delicate nature. From the history of convertibility in Western Europe it is obvious that re-establishment of convertibility was postponed until the danger of the balance of payments acting as a constraint on macroeconomic policy had disappeared. Therefore, one can conclude that the balance of payments position has to be satisfactory before a move to convertibility; on the other hand one should also be careful not to go to the other extreme.

The widely accepted basic requirements for the successful establishment of current account convertibility are the ones suggested by Green and Isard: (i) an appropriate exchange rate, (ii) an adequate level of international liquidity, (iii) sound macroeconomic policies, in particular the elimination of any monetary overhang, and (iv) an environment in which economic agents have both the incentives and the ability to respond to market prices, from which all major distortions should have been eliminated.

The first three of these preconditions are essential for maintaining macroeconomic stability after introduction of current account convertibility. The fourth condition on the other hand is required to ensure that convertibility produces economic benefits which are intended to achieve by its establishment. In order to fulfil the third and fourth precondition major institutional reforms are required. These four conditions will be discussed in more detail below.

The introduction of current account convertibility requires an appropriate exchange rate, i.e. an exchange rate which is consistent with balance of payments equilibrium. An important issue related to this is real exchange rate. There is an opinion that the real exchange rate in the case of early introduction of convertibility into transformation process has to be more depreciated than in the case when convertibility is introduced at a later stage when firms are more competitive and better prepared to respond to market pressure. Accurately anticipated movements in the real exchange rate over time are important for making decisions. On the one hand an exchange rate which is excessively appreciated can make difficult achievement of current account balance, while on the other hand too depreciated a rate can make import look too expensive for households and enterprises and export too profitable therefore, in that way influencing the decisions of domestic producers and investors.

An adequate level of international liquidity[15] is the second factor influencing the introduction of current account convertibility. Without an adequate international liquidity no country can face unfavourable short term disturbances such as an eventual change in oil price. Inadequate international liquidity was a primary reason for West European countries to create after the Second World War an European Payment Union as a transitional arrangement in order to liberalize trade and re-establish convertibility gradually when fixed exchange rates and reliance on reserves were the norm. In fact, the level of international liquidity needed for the establishment of current account convertibility depends on flexibility of the exchange rate.

For most of the Eastern and Central European countries access to international credit market is restricted; therefore, their need of foreign exchange reserves is even greater. In the past few years, foreign exchange reserves necessary for the establishment of current account convertibility are equivalent to at least three months of imports. For example, Poland at the beginning of its present reform programme in January 1990, had reserves and external credit of $2.5 billion, which is equivalent to approximately to 4.5 months of imports [Green and Isard 1991:10].

Sound macroeconomic policies as a third precondition for establishing current account convertibility comprise policies that are able to preserve a current account balance with minimum measures. This includes an effective

[15] International liquidity includes foreign exchange reserves, access to foreign financing, and in some cases holdings of foreign currency and foreign-currency-denominated assets by private residents [Green and Isard 1991:10].

monetary and fiscal policy; the type of applied monetary and fiscal policy differs from country to country. Strong monetary control in a market oriented economy requires a central banking system able to stabilize the economy indirectly by adjusting interest rates or other policy instruments. Therefore this implies that transforming countries must also change their monetary and fiscal institutions.

In order to achieve macroeconomic stability these countries also have to stop relying only on direct controls and start to rely more on market operations. Therefore, they have to establish market mechanism which will make prices, wages, and interest rates responsive to supply and demand.

In order to establish monetary control and to avert a huge increase in demand from the liquidation of outstanding monetary balances, any kind of monetary overhang must be eliminated as an increase in demand for imported goods may in turn reduce foreign exchange reserve and put pressure on exchange and interest rates.

Monetary overhang can be eliminated by currency reform and price liberalisation. In the case of most economies, which start their transformation with extensive shortages of goods, monetary overhang may be reduced also through inflation - as in Polish case[16]. Finally, excess liquidity can be reduced by setting interest rates at positive real levels.

The last requirement, the creating of an economic environment, is most difficult to achieve in economies which were centrally planned. The reason for that is that companies in this kind of system had no motivation to act according to price signals because they were functioning in a situation in which financial losses were covered mostly by credits from the state as well as by subsidies and tax concessions. Therefore, enterprise reform is the important step in the process of establishing current account convertibility.

At the macroeconomic level soft budget constraints have regularly caused fiscal budget deficits and an increase in inflation rate. Hardening of budget constraints is, however, considered one of the most important measures in establishing current account convertibility. Privatisation is also seen as a way of eliminating the access of enterprises to the budget subsidies.

The move from a planned to a market economy is the basic microeconomic condition for establishing convertibility in Eastern Europe. According to Williamson essential elements of the shift from a planned to a market economy

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[16]Hyperinflation in spite of the accelerated nominal monetary growth resulted in a decrease in the money stock in real terms.

are: a right of enterprises to spend money balances as they see it or the so-called real or commodity convertibility[17]; a hard budget constraint, which if violated imposes bankruptcy; a freedom of enterprises to set prices for themselves and taking the risk of losing customers if they set prices too high. The purpose of these changes is to make enterprises responsible for their own destiny instead of leaving them to be led by planners -a process that is called de-etatization. Another significant aspect of the shift to a market economy is privatisation.

### 4.3.2 The speed and sequencing

The speed and sequencing of the transition to a market economy is one of the most controversial issues in discussions about reform in Eastern and Central European countries. The position of the transition to convertibility in the sequencing of reforms is of special interest. Portes argues that sequencing and timing are to some extent substitutes; the order does not matter so much if you can do a great deal at once [Portes 1991:6].

There are two widespread and rather divergent approaches to the speed of transformation. A 'shock therapy' or 'big bang' approach is opposed to a step-by-step, gradualistic or evolutionary type of approach. The shock-versus-gradualism controversy centres on the question of " how much the economical and political system can take and implement simultaneously" [Portes 1991:7].

The gradualist approach to the transition to convertibility assumes the ability of policy-makers to adjust the sequence and avoid the inconsistency of partial reforms. Central to this approach, as some economists argue, is the political factor; political constraints imply a need for minimal speed and gradualism in a strategy.

The usual criticism of the gradualist approach are: (i) it does not include a consistent credible model for changing expectations, (ii) it does not create constituencies for reform, (iii) it may require more administrating than a 'big bang', (iv) resistance from the population. The main reason for the lack of credibility of gradualism is that in the past it has failed very often.

The place of convertibility in the sequence is an issue on which economists have different opinions. Some, for instance Portes (1991), Williamson (1991), Asselain (1991) and Bofinger (1991) give high priority to convertibility in the reform while others like Nuti (1991) and Levick (1991) hold that convertibility should be introduced later on

[17]More precisely, introduction of currency convertibility while real or commodity convertibility still does not exist will turn all excess demand towards the foreign sector, which would increase even more the demand for imports. And as long as enterprises are not subject to hard budget constraints, those demands could be unlimited [Williamson 1991:26].

during the reform.

Many economists support rapid transition to convertibility on the basis of the Polish experience. The argument is that there were no reversals in spite of the occurrence of shocks in Polish economy. Instead it seems that creditability has increased.[18] Another argument for fast transition to convertibility is political, namely the establishing of the creditability of policy makers, "by committing them to highly visible and unambiguous target" [Portes 1991:11].

The reason for Eastern European countries to move to convertibility faster than was done in Western Europe in the 1950s is the much-needed transformation to a market economy. Western Europe in the 1950s had a developed market economy with competition and prices that revealed scarcity; "so convertibility was a luxury ... rather than a necessity to give the market economy a chance to get off the ground" [Williamson 1991a:31].

The costs of the rapid transition to convertibility such as a lost in output and an increase in unemployment, are usually used as an argument against the fast move to convertibility. With reference to the costs of a fast transition to convertibility, Williamson argues that while it is right to pay attention to the potential problems of introducing many changes simultaneously, this does not mean that it is impossible to introduce a number of changes at the same time. He suggests introduction of the 'smallest' package of fundamental measures needed to make the transition from a planned to market economy and at the same time preventing problems that may threaten the success of the reform[19]. He also believes that if it is possible the introduction of macroeconomic stabilisation package should preferably precede the move to convertibility.

Portes favours the early establishment of convertibility for residents on current account transactions. This approach is also elaborated by Bofinger and Asselain. Asselain favours early introduction of internal convertibility while Bofinger is more for the early establishment of current account convertibility.

As already seen, the main argument for an early introduction of convertibility in Eastern Europe is import of competitive pressure. The contra argument is that convertibility cannot be introduced before liberalisation of domestic prices. This implies that convertibility cannot be introduced so quickly as it is proposed by some economists.

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[18]Polish experience as an example of the rapid approach in establishing convertibility will be discussed in more detail in the section 5 of this paper.

[19]Williamson calls this a 'minimum bang' [Williamson 1991:31].

The main difference between two extreme positions towards convertibility is that the first approach (Polak) addresses Eastern European countries as if they are less developed countries while in the case of the second approach (Levick) the specific characteristics of the system in these countries are addressed.

Nuti argues that an irreducible difference between these two approaches is based on the costs involved in speeding the process of transition, costs that are neglected by Polak while emphasised by Levick. Rushing to convertibility before the tree main preconditions equilibrium, absence of subsidies on tradable goods and services, a significant price elasticity, are fulfilled includes certain costs, according to Nuti, which cannot be significantly reduced by transitional arrangements such as EPU or parallel currency proposal. "Convertibility, like most reforms, should be thought of as an investment - a good one, but like all investments, in need of finance" [Nuti 1991:48 in Williamson 1991].

The conclusions which arise from the discussions are as follows:

1. There are two widespread opinions on the question how fast convertibility should be introduced. The first opinion is that the establishment of convertibility depends on how fast the preconditions for convertibility can be satisfied. The second is that it depends on how high an adjustment cost is[20]. Therefore, comparing on the one hand, the immediate costs and on the other future benefits of alternative transitional strategies is the main issue behind the transition to convertibility.

2. The assessment of the country experience points out that alternative models of transition are feasible as the Polish and Hungarian experience suggests. The choice tend to depend on each country's specific initial conditions; in particular the existence and degree of macroeconomic instability are important. It is wrong to support 'global shock' or 'gradualism', or any other particular sequence, independent of initial conditions [Portes 1991].

Therefore, initial conditions should be added to the factors that influence decisions about the speed of the transition to convertibility and the position of the transition to convertibility in the reform. Consequently, countries which have to start the reform from economic crisis, such as Poland and the former Soviet Union, are more likely to need a shock therapy than those that have functioning economies like Hungary and particularly Czecho-Slovakia where it was not necessary to eliminate monetary overhang and high inflation and to deal with a huge debt as was the case in Poland.

In sum, the early move to convertibility has its benefits where it is feasible. If country has already introduced many

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[20] "The faster the rush to convertibility, the higher the cost...the faster the move to convertibility, the greater the domestic currency undervaluation necessary to ensure its credibility" [Nuti in Williamson 1991:53].

of the necessary institutional changes and has established definitely its commitment to the transition, a gradual approach is to be preferred to shocks which may destroy nearly as much as they create.

### 4.3.3 Transitional arrangements

This section surveys briefly several transitional arrangements whose purpose it is to enable countries to move toward convertibility without creating negative effects on macroeconomic stability and production. In this respect the main objectives of transitional arrangements are to stabilise exchange rate and hence provide a nominal anchor and to reduce the negative impact of import competition on production and employment in the short term.

The central question related to the establishment of transitional arrangements is whether they could reduce the costs of the rapid establishment of convertibility. No is the answer according to Nuti. Still one should not give up so easily the idea of transitional arrangements.

The first transitional arrangement is the payments union proposal. The widely accepted argument for establishing this kind of arrangement is based on the need for the reduction of the balance of payments problems in the process of transition. The European Payments Union (EPU) and its successful role in easing payments between Western European countries in the period after the Second World War is used as an example. A payments union similar to the EPU, aimed at establishing multilateral payments and trade among the former centrally planned countries, therefore seems a potentially useful strategy[21]. This proposal has been put forward by a number of economists but most intensively by van Brabant, who recommends the establishment of a Central European Payments Union (CEPU).[22]

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[21]The main features of a payments union are: (i) the member countries accept one another's currencies in payments for export, (ii) they also agree to deposit their export earnings with the agent of the union, (iii) they allow the claims to be consolidated and netted out on a multilateral basis, and (iv) their remaining imbalances are settled centrally with the union in a combination of credit and convertible currencies.

A payment union arrangement can be very useful in a situation of severe liquidity shortage as was the case in Western Europe in the postwar period. The objective of a payments union is to eliminate the foreign-exchange constraint and to increase the level of trade between its members. The regime of payments established by a European Payment Union in 1950 enabled a higher liberalisation of trade among the member countries than otherwise would have been feasible. After some time the reserves were restored and the trade with the dollar area was liberalised.

[22]"The other type of payments imbalance emanates from the shift in traditional transferable-ruble trade and payments regime in Eastern Europe and the desire of the reforming countries to divert trade to the West; this shift will be accompanied initially by terms-of-trade losses. To address this type of payments imbalance, I advocate the creation of a payments union..." [Brabant in Williamson 1991:64].

Several economists, for example Polak (1991), Kenen (1991), and Rosati (1991), argue strongly against the payments union proposal. The dominant argument is that there is a distinct contrast between the Western European situation in 1950s and the situation in Eastern Europe today. The main difference is that the economies of Western Europe in the period after the Second World War were market economies with fairly consistent prices. Although these prices were distorted by controls from the war, they could still be used for measuring profitability and for imposing market discipline.

Furthermore, van Brabant's proposal has come too late as Poland and Czecho-Slovakia have already introduced restricted (internal) convertibility. Therefore, in the case of a CEPU these countries would need to reverse their policies. Williamson holds that a series of bilateral agreements between these countries is much more likely and appropriate to the situation than a CEPU. Another major argument against the CEPU is that there is no demand for it as psychologically Eastern European countries are ready to step into the mainstream of the world economy, however dangerous this may be.

Several other economists hold that it would be better to introduce tariff preferences in favour of one another. But this points more to establishment of a customs union or a free trade area rather than a payments union.

A political argument against both the payments and customs union is the so-called 'ghettoization', a term that Flemming uses in his critique of these approaches, under the conditions when countries seek admission to the Western trading system.

Portes and Lavigne argue that the primary problems of Eastern Europe concern structural transformation rather than intraregional payments imbalances. The conclusion which follows is that a payments union proposal is neither politically feasible nor economically justifiable; therefore, it should be rejected.

A second possible transitional arrangement for Eastern European countries would be to establish an exchange rate regime that is compatible with the overall requirements of the transformation process. According to this approach convertibility is seen as an endogenous policy measure, which depends on the use of the optimal foreign-exchange regime in the transition process.

The choice of an exchange rate regime is one of the most complicated issues and its detailed analysis is not the main objective of this paper. However, since it is very closely related to convertibility issue it will be discussed briefly particularly with respect to economies undergoing transformation.

The so-called monetary approach has been developed in detail by Bofinger. He places the convertibility and

payments issue in the context of monetary arrangements needed for the stabilisation of economies undergoing transition to a market economy. He rejects monetary targeting and argues that a fixed nominal exchange rate could provide creditability and an anchor for monetary policy. This is largely based on the assumption that the use of exchange rate as an anchor has always brought benefits to small, open economies and can therefore also be useful in this case.

The most important question concerns the choice between a fixed or floating exchange rate or some other combination. According to Bofinger the choice of the exchange rate regime and the choice of the desired degree of convertibility are interrelated. The basic options for the rate regime include: (i) flexible exchange rates for all the currencies of Eastern Europe against all other currencies; (ii) a fixed exchange rate regime among Eastern European countries, with flexible rates against the rest of the world; and (iii) fixed exchange rates between the Eastern European currencies vis-a-vis ecu [Bofinger 1991:117].

Several arguments against floating exchange rates of the transforming countries can be found in the literature. One of the arguments is that of the difficulty of interpreting traditional monetary indicators with regard to economies which are in the process of transition.

> A floating exchange rate needs to be accompanied by an autonomous monetary policy based on well-defined principles, such as seeking a steady growth of money supply or of nominal income. Such a monetary policy is impracticable or undesirable when such crucial variables as the demand for money or propensity to save are liable to change unpredictably as a result of fundamental changes in economic organisation. In particular, stabilisation of inflation normally induces a desire to build up holdings of domestic money (by a large but uncertain amount), and this should be accompanied rather than allowed to appreciate the currency" [Williamson 1991:41].

Another argument against floating is that for such a policy to function efficiently a developed capital market is required capable of absorbing shocks through changes in asset positions. It is evident that Eastern European countries do not have developed capital markets and that capital account transactions are as yet not liberalized. The past experience with floating it is also not encouraging considering that even countries with well-developed capital market and proper base for managing monetary policy had unsatisfactory results with floating.

In favour of a floating exchange rate are the lack of reliable indicators by which governments can choose the appropriate exchange rate and the lack of reserves necessary to support a fixed exchange rate.

The problem with a fixed exchange rate regime is that it requires the money supply to be determined by the balance of payments. It is also argued that in countries with undeveloped capital markets there is little scope to vary fiscal policy independently of monetary policy, and consequently no domestic stabilisation policy will be applicable.

Therefore, Williamson concludes that for the economies in transition it is more appropriate to investigate exchange rate regimes between the fixed and floating rates making distinction between the short and long run term [Williamson 1991:42].

The argument for fixing the exchange rate in the short run is to provide an anchor for the emerging price structure. Therefore, the widespread opinion (Bofinger, Portes) is that, if the reform programme includes convertibility, pegging the exchange rate is a better option than floating. The question usually asked with respect to this is at what level and for how long the peg should be set. From the Polish experience it could be seen that selecting an appropriate initial level of the exchange rate is particularly important. The serious risk is overshooting - choosing a significantly undervaluated exchange rate. The case of Poland bears this out. There undervaluation was overdone by setting the nominal exchange rate at the level prevailing in the free market. However, the sustainability of that rate in spite of high inflation shows the increase in creditability of convertibility during the 1990.

The danger of the extreme devaluation is cost-pushed inflation and an intensive negative supply shock to import-dependent companies. Thus, one of the most important objectives of convertibility - import of competitive pressure, could in that case be undermined.

A third type of transitional arrangement allows full current account convertibility but includes import protection in the form of tariff barriers. This approach has been developed by McKinnon and it favours the use of a set of temporary import tariffs for regulating the current account deficit during the early period of the transition to convertibility.

According to McKinnon the purpose of a temporary imposition of tariffs is to allow domestic industries with the negative-value-added (at world prices) to restructure by protecting them against competition from abroad. These tariffs should decrease at a predetermined rate and should eventually be replaced by a fairly low and uniform customs duty. The early announcement is needed to make clear that enterprises have only a limited time to become competitive.

Rosati argues that McKinnon's approach suffers from the same weaknesses as the infant-industry argument (in Eastern European case mostly 'senile industry' argument). For instance, how to decide which industry or sector deserves protection and how to guarantee that the tariffs will indeed be reduced in the future. Another important critique of this approach is that the use of high import tariffs would restrain the introduction of more competition to domestic enterprises. This may prevent the full adjustment of domestic relative prices to the world prices and therefore induce distortions in production and investment decisions.

## 5 Country experience: Poland

### 5.1 Introduction

This section analyses the first steps towards convertibility of the currency undertaken in Poland in the past two years. Poland was one of the first Eastern European countries that moved to currency convertibility[23] and substantial free trade with the West. The establishment of currency convertibility was a part of the comprehensive economic reform and the overall strategy of the opening up of the Polish economy.

In an environment of hyperinflation and a large budget deficit the Solidarity-led government opted for a 'shock therapy' approach and on 1 January 1990 this ambitious programme started. The aim of the economic transformation programme of Poland was to transform in a short period of time the Polish economy from a planned into a market economy. The strategy of a transition combined three logically distinct phases: stabilisation, liberalisation and restructuring, including the dismantling of monopolies and privatisation.

The programme consisted of an instant macroeconomic stabilisation package; its purpose was restoring macroeconomic imbalances. The aim of the programme was also the introduction of internal convertibility as a base for the establishment of creditability of the zloty. The long-term objective was the establishment of a stable environment necessary for the development of a market economy. A central objective in this was a continual decrease in inflation over the restructuring period by tight monetary and fiscal policies. The liberalisation of domestic prices and of foreign trade were introduced at once. The privatisation and institutional changes were set to be established over a period of several years.

The achievements and failures of these radical strategy have been used extensively as arguments in the discussions on currency and trade policies in other Eastern and Central European countries. Therefore, a precise assessment of the results of this policies applied in Poland is crucial. The effects were complex and controversial and in that regard literature offers different interpretations of the developments in Poland. This section will attempt to present the different views.

In this paper the recent Polish experience is examined in relation to the legal and institutional mechanism used in the process of currency liberalisation. The timing of its implementation with respect to the overall transition to the market is also analyzed. The stress is put on the problems which have arisen with respect to the new system of

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[23] It is refered to a type of internal convertibility limited to residents convertibility for current account transactions.

currency parities and the new institutional framework. The examination of the basic indicators in the period prior to and after the introduction of currency convertibility is used in as far they were available. The purpose of this examination is to draw some lessons from the first two years of Polish experience in the introduction of currency convertibility with respect to market reactions and macroeconomic developments.

## 5.2 Background to the transition

### 5.2.1 Pre-1989 situation

The pre-1989 Polish reform experience and the fact that Poland started its radical liberalisation in a situation of significant macroeconomic imbalances can help to identify various obstacles on the way to convertibility.

The roots of the imbalances and the main reason for adopting the shock therapy approach to transition instead of the more gradual reform is related to a long experience in this country with ineffective reform efforts, in particular during the 1980s.[24] Instead of a gradual development of market elements, there were constant experiments for reform alternated by measures and developments reversing reform policy. The root of the difficulties was a chronically insufficient export performance and a stagnation of exports, which was largely due to frequent shortages of imported inputs.

The most relevant measures aimed at liberalising trade and freeing activity of enterprises introduced under the previous regime were two laws from 1988: the law on entrepreneurship and the foreign exchange law. The importance of the former law was that state monopoly in the area of foreign trade was abolished and enterprises were allowed to conduct trade independently rather than relying exclusively on large state owned foreign trade organisations. Under the latter law many restrictions on foreign exchange were abolished and the creation of a foreign exchange market was encouraged. The system of administrative allocation of hard currency remained dominant but the first step towards the founding of a foreign exchange market was made.

The important change in the exchange rate system dates from 1982 when a dual exchange rate system was introduced: there was one rate for the hard-currency area and another for the ruble area. The objective of this act was to encourage export by guaranteeing higher profitability. A dual exchange rate system contributed to

[24]The detailed analysis of the attempts to improve the central planning system up to 1989 is beyond the scope of this section. It is, however, generally agreed that there were very few visible positive results of these reforms and that they failed to strengthen the Polish economy.

maintaining a dislocated price system: some prices were linked with the world prices through one or another exchange rate, while the prices of basic products remained isolated by extensive subsidies.

Finally, these policies failed to give an incentive to export growth. In the environment of shortages caused by the macroeconomic imbalances the parallel exchange rate remained many times higher than the official exchange rate throughout the period of depreciation. The establishment of currency convertibility was considered a long-term goal and attempts to reform the exchange system led to a complex and arbitrary multiple exchange system [Lipton and Sachs 1990:108].

### 5.2.2 Polish economy in 1989

The reform attempts during the 1980s made that the Polish economy in 1989 was not a typical centrally planned economy but something between plan and market economy. The consequence was that the economy was in a state of chaos. The main characteristics were a complete breakdown of the financial control of the budget, of the banking system, and a crisis in the balance of payments. The actual debt servicing remained large in spite of the rescheduling of a large part of debt service obligations. As a consequence, and in a situation of unsatisfactory export performance, imports and living standards were cut in order to produce the needed trade surplus.

Two aspects of macroeconomic imbalances from that period were of particular importance for the establishment of convertibility. First, as a result of price controls combined with highly expansionary macroeconomic policies, the overall price level was below the level consistent with macroeconomic balance. This resulted in shortages and is usually referred to as a monetary overhang. The over-expansionary policy includes also a huge fiscal deficit - 8 percent of GDP according to IMF estimates and a wage explosion - real wage in June 1989 was 42.2 percent above the level of two years earlier.

Second, and consistent with monetary overhang, there was a persistent and significant excess demand for foreign exchange at the official exchange rate. Foreign exchange was rationed as the central bank was not able to fulfil needs of importers for the foreign exchange in return for domestic currency at the official exchange rate. This is the situation referred to as currency inconvertibility or, in particular, current-account inconvertibility.

An increase in monetary imbalances was also reflected in the widening of the gap between the official and the free exchange rate. The final consequence was the emergence of hyperinflation the rate of which at the end of 1989 reached 16 000 per cent according to OECD.

It was this rapidly deteriorating macroeconomic situation that formed the backdrop to the economic transformation programme and opened the way to the introduction of convertibility in Poland.

## 5.3 Currency convertibility, stabilisation and reform sequencing in the Polish context

### 5.3.1 Polish economic transformation programme

On 1 January 1990 the Solidarity-led government introduced a comprehensive program whose main objective was the transition to a market economy. It was very difficult for the government, which has come to power only at the end of 1989 to deal with the severely distorted macroeconomic situation and at the same time to start the process of transformation to a market economy without any guidance by existing economic theory. Under these circumstances the government opted to combine simultaneously two radical steps: a strong stabilisation package[25] and immediate liberalisation of prices and international trade and finance. The aim of these radical steps was to stop the financial chaos caused by hyperinflation. Another objective was to introduce competition from abroad as quickly as possible. The structural reforms were left to be implemented over a longer period of time.

The stabilisation programme implemented in Poland was a clear break with the past. As no previous experience was available, it was very difficult to predict the behaviour of the economy and the effects of instant stabilisation and liberalisation measures on the Polish economy.[26]

The measures implemented under this programme were: price liberalisation, a devaluation of zloty by 46 percent - close to the free[27] market rate, the reduction of the budget deficit to 1 percent of national income - finance through bonds and not by new monetary issues, the reduction of money supply, the introduction of a mechanism of partial wage indexation (nominal wages were also fixed in January).

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[25] The stabilisation programe implemented was supported and financialy assisted by the IMF.

[26]Asselain describes the Polish reform initiated in 1990 as a 'leap in the dark',.."since, for the first time, the transition to an open market economy was not approached as a distant goal, subordinate to the previous elimination of existing distortions, but as a direct once-for-all transformation of the economic regime; it had to result from a simultaneous liberalisation of internal and external economic relations, coupled with a macroeconomic stabilisation programme" [Asselain 1991:230].

[27] The black market rate had turned into the free market rate after its legalisation in March 1989.

### 5.3.2 Introduction of currency convertibility

The most important part of the stabilisation programme was the establishment of the convertibility of the zloty after more than 40 years of inconvertibility. According to Sachs the currency was made convertible through a combination of price liberalisation, exchange rate devaluation and tight credit policies. The zloty was made freely exchangeable by residents for almost all current account transactions[28]. The second important role given to the introduction of convertibility of the zloty, in the context of price liberalisation, was to stop the inflationary spiral acting as a nominal anchor[29] and at the same time to restrain the abuses of monopoly positions, through competitive imports [Sachs and Lipton 1990].

The focus of the Polish experience in the establishment of internal convertibility concerns the exchange rate regime, the organisation of foreign exchange operations and the chosen level of the exchange rate. The official rate was depreciated from 6500 to 9500 zloty per dollar and the existing system of multiple exchange rate was replaced by a single, fixed exchange rate for current account transactions. The reason for the undervaluation of the exchange rate was to induce exports and restore the creditability of the zloty. Therefore the creditability of the overall economic stabilisation programme was dependent on it.

Several elements played an important role in determining the exchange rate. Among them were: an expected high inflation in the period January/March 1990 and compensation of exporters for abolishing the remaining export promotion measures. Taking into account these elements the exchange rate eventually established was not significantly higher than the free market rate but was much higher (46 percent) than the official rate at the end of 1989. Important was also the change in exchange rate regime - the zloty was fixed to the dollar. The reason for pegging the zloty to the dollar was mostly psychological as about 50 percent of Polish trade in hard currencies was in dollars; also the dollar was used in foreign-exchange transactions between individuals.

The introduction of the stabilisation program in Poland was not only characterised by this new exchange rate regime but also by other legal and institutional changes affecting foreign trade and financial flows. Among these were the nearly complete deregulation of foreign trade and the freedom of enterprises to trade directly or through foreign trade organisations. At the same time the quantity restrictions on hard currency imports were abolished and the only instrument for import regulation became a system of custom tariffs.

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[28] The so-called internal convertibility.

[29] The stabilisation programme from January 1990 introduced the exchange rate as one of the two nominal anchors of the economy, the other one was wage.

Exporters were asked to surrender receipts from exports to the banking system at a single uniform exchange rate and they were credited with the equivalent amount in zloty. Importers had unrestricted access to foreign currency at the same official rate. Banks were obliged to accept and execute payments for any quantity in convertible currency. However, in spite of the move to hard currency settlements and world market prices in practice trade with former CMEA countries remained regulated by agreements and transitional arrangements, and mostly in the form of barter trade.

### 5.3.3 Sequencing

In the case of Poland the main problem related to the overall reform, and particularly the move to currency convertibility was the sequencing[30] of the various actions, a problem for which no definite solution is suggested by economic theory. The problem of timing of convertibility in the process of reform was interwoven with the problem of a degree of liberalisation as Poland decided that the introduction of internal convertibility should coincide with the shock therapy adopted and implemented in January 1990.[31]

The strategy was that structural reforms and medium-term activities such as privatisation and the development of a banking and financial system as well as the establishment and restructuring of private industrial firms should follow the establishment of currency convertibility and benefit from the competitive effects resulting from the opening of the economy and from the import of a more realistic price structure.

According to Lipton and Sachs, it was vital to achieve convertibility on day one and to move exchange rate to the level necessary to eliminate the excess demand generated by monetary overhang. The main assumption according to them was that the major obstacle to the introduction of convertibility was the macroeconomic (monetary) imbalance rather than a structural problem related to the competitiveness of export industries. Therefore, the

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[30] The discussion about the introduction of currency convertibility in Eastern Europe was from the very beginning centred on the dilemma when and to what extent to implement the move to convertibility. On the one hand, convertibility has been considered as an instrument capable of enhancing the attainment of other goals, and on the other hand structural reforms have been considered necessary prior to any significant currency liberalisation.

[31]In practice the place of internal convertibility in the sequence of the reforms and stabilisation differs from one country to another. In the case of the former Yugoslavia, internal convertibility and the pegged exchange rate of the dinar was used as a crucial part of the stabilisation programe of December 1989. Although at that moment the Yugoslav economy was faced with similar problems like other former socialist countries, it was considered to be better prepared for the achievement of convertibility. The reason was that in the former Yugoslav case the reform was preceded by gradual liberalisation of the currency and the institutional changes such as giving more autonomy to firms. The former Soviet Union case is much more controversial and complicated and cannot be evaluated easily.

elimination of monetary overhang[32] was seen as a necessary and sufficient condition for the establishment of convertibility, provided the exchange rate was properly chosen [Sachs and Lipton 1990].

## 5.4 Assessment of the initial effects of convertibility

The experience of the transition to internal convertibility in Poland can be evaluated with respect to the change of those macroeconomic variables accompanying and at the same time influenced by the introduction of currency convertibility. Two different moments in the macroeconomic performance are especially important for the evaluation, namely the state of the economy when internal convertibility was introduced and the period immediately following the introduction of internal convertibility.[33]

The main difficulty in assessing the impact of currency liberalisation is the fact that in the Polish case internal convertibility was introduced as a part of more comprehensive policy including in particular price and trade reforms. However, some observations can be made from the careful analysis of the figures.

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[32] A monetary overhang exists when nominal aggregate demand exceeds nominal aggregate supply at the administrative controlled price level. In the case of Poland Lipton ans Sachs have argued that the flow factores such as a large budget deficit in 1989, low real interest rates and a sharp rise in real wages in 1987-89, were probably more responsible for the excess demand, than the money stock.

[33] One can add to that the third moment - the medium-long term evolution which also includes the feedbacks of some variables on the exchange rate and on the institutional arrangements themselves. However at this moment it is not possible to include it in the assesment.

**TABLE**

Poland: selected economic indicators, 1990-91

| | Inflation[a] | Output[b] | Unemployment[c] |
|---|---|---|---|
| January 1990 | 79.6 | -31.6 | 0.4 |
| February 1990 | 23.9 | -2.1 | 1.1 |
| March 1990 | 4.3 | 0.9 | 2.0 |
| April 1990 | 7.5 | -1.5 | 2.6 |
| May 1990 | 4.6 | 0.3 | 3.3 |
| Jun 1990 | 3.4 | 4.9 | 4.2 |
| July 1990 | 3.6 | -12.2 | 5.2 |
| August 1990 | 1.8 | 7.6 | 6.1 |
| September 1990 | 4.6 | 8.8 | 6.9 |
| October 1990 | 5.7 | 0.4 | 7.5 |
| November 1990 | 4.9 | 0.0 | 8.1 |
| December 1990 | 5.9 | 3.2 | 8.3 |
| January 1991 | 12.7 | -17.6 | - |
| February 1991 | 6.7 | 0.8 | - |
| March 1991 | 4.5 | 0.1 | - |
| April 1991 | 2.7 | -8.3 | - |
| May 1991 | 2.7 | -1.6 | - |
| Jun 1991 | 4.9 | 2.2 | - |
| July 1991 | 0.1 | -12.1 | - |
| August 1991 | 0.6 | 5.5 | - |
| September 1991 | 4.3 | 3.5 | - |
| October | 3.2 | 1.5 | - |
| November 1991 | 3.2 | 5.5 | - |

a - change from previous month, as measured by the retail price index;

b - change from previous month;

c - as percentage of total employment at the end of 1989, private agriculture excluded

Source: This table is combined from Winiecki (1992) and Olechowski and Oles (1991).

The period immediately after the establishment of convertibility and the implementation of the stabilisation programme was characterised by a sharp fall in the inflation rate which declined from 79.6 percent in January 1990 to 1.8 percent in August of the same year (Table). Positive results were also achieved in the external sector with the stability of the exchange rate, an increase in the stock of official reserves and an improvement in current account. Net official reserves rose by more than 2.2 billion dollars induced by an expansion of exports (43 percent more than in 1989) while at the same time growth of imports was less (+18 percent), due to the recession. The improvement in the current account position was caused by a substantial decrease in demand as a result of a severe pressure on the real side of the system as an outcome of stabilisation. The fall in demand induced a decrease in imports, while devaluation induced a rise in exports.

Convertibility was successfully maintained at a nearly constant nominal exchange rate linked to dollar until May 1991 when the was depreciated by 16.6 percent against the dollar. The adoption of the crawling peg followed in October 1991.

After these initial positive effects of the reform, inflation again started to rise slowly but constantly. In the second half of 1990 the monthly inflation rate rose by 5 percent and at the beginning of 1991 it was already 12.7 percent (Table). The initial forecast for 1991 of a 36 percent rate of inflation had to be revised upward to 55 percent in the course of the year. The main reason for this, aside from the loosening of monetary and fiscal policies, was the process of price liberalisation. However, the increase in inflation resulted in a sharp decline in the foreign exchange reserves.[34]

There were also some negative consequences of the stabilisation program with respect to the real economy. For instance, the result of stabilisation was a dramatically low level of economic activity; GDP declined by 12 percent in 1990, industrial production by 23 percent (at the same time there was an increase in services, mainly through new private firms). This negative trend continued in 1991; during the first half of the year industrial production fell by a further 8.6 percent compared with December 1990. Unemployment rose from neglibile levels at the beginning of 1990 to 1.5 million in June 1991, representing around 8.5 percent of the labour force. In 1991 the rate of unemployment rose to about 12 percent and real consumption declined. In 1991 the Polish economy was also hit by the fall in trade with the former Soviet Union and the need to pay for the import of energy at world prices and in hard currency.

The decrease of production and fall in living standards emphasise the cost of the reform and therefore should not

[34]There is an opinion (Davidi and Espa) that there is an inherent contradiction in the attempt to stabilise the economy and trying at the same time to reach a more meaningful structure of relative prices.

be neglected. Although this issue is the object of different opinions, there is no doubt that the short-term decline in output in Poland has been a result of the stabilisation and rapid liberalisation, further exacerbated by the fall in trade with the former Soviet Union. More controversial is the real extent of this decline. Sachs and Berg argue that this short-term decrease in output has been significantly overestimated. They also argue that decrease in real consumption was much smaller than is generally believed. Their argument is that national statistics inadequately capture the growth of the new private sector. This argument, however, is neither completely confirmed nor disproved by figures presented by these two authors [Sachs and Berg 1991].

The extensive devaluation of the zloty is another and perhaps the most controversial aspect of the Polish programme. The question whether it was excessive at the beginning of the reform is at the centre of discussions. Some economists (Portes) argue that the introduction of internal convertibility on 1 January 1990, which was accompanied by a sharp devaluation of the zloty, resulted in the heavy undervaluation of the zloty against hard currencies through the dollar, to which it was pegged. It is argued that this excessive initial devaluation produced adverse effects on the Polish economy, such as an inflationary impact with its negative effect on competition, removal of the pressure on domestics firms to adjust to the functioning of international market, and sharpening of the initial reduction in real wages.

However, the reasons for choosing such parity was justifiable on account of the desire of monetary authorities to have enough space for defending the parity itself without having to modify the exchange rate as well as the desire to maintain the credibility of the decision to peg the domestic currency and of the overall stabilisation programme.

The major problem in the analysis of the Polish experience is related to the weaknesses of the data used in assessing these issues. How much did output actually fall? What about the standards of living? Did trade liberalisation and strong import competition play a major role in the drop of industrial production? What are the consequence of the collapse of trade with the former Soviet Union? These are the questions, that can only be answered when better data are available.

### 5.5 Present situation and prospects

It is difficult to find examples in economic history where so much has been achieved in a such a short time as has been the case in Poland over the past two years - especially because this was a time when Poland had to deal with large external shocks [OECD 1992:10].

However, in spite of the achievements particularly in the external sector, the present situation is worrying. One of

the major problems at the beginning of 1992 is the decreasing popular support for the reform. The reasons are many but the most important one is the unrealistically optimistic expectations raised at the beginning of the economic reform concerning the speed with which it would enhance production. There is also no doubt that the process of transition has included real social cost, as output has fallen sharply and unemployment has at the same time increased. The decrease in the aggregate consumption over the past two years was less than the decrease in output, but different households and social groups have been affected quite differently. To restore popular support for the next phase of transition priority is given to the stabilisation of the output.

The second problem is a disturbing financial situation caused by an incomplete structural reform, the further deterioration in the financial situation of the state-owned enterprises, the weakening of the banking system caused by a large number of unviable borrowers, and the increase in the budget deficit. Therefore, the relevance given to the solution of these problems in the policies announced by the government for this year.

Clearly, in many aspects the present situation differs sharply from what it was expected or hoped for when the programme was launched. Yet, considering the uncertainties surrounding the estimates of how such unprecedented measures would work, the difference within the results up till now is hardly surprising. It is also clear that new, difficult problems have surfaced.

An issue which will have to be addressed more seriously in the future is the trade with the former CMEA countries. There is an opinion that Polish export to these countries should remain competitive even after the establishment of payments in hard currency because of its lower prices compared to the world prices.

Poland needs tremendous efforts in the months and years ahead to reach the objectives put forward by the reform. The first step is to maintain the achieved results and to stay on course, thus to retain creditability. It is especially important for Poland to go further in the areas of restructuring and to develop better social safety programmes.

The analysis of the Polish experience in the transition to convertibility may be useful to other Eastern and Central European countries embarking on this route. It indicates that currency convertibility can produce a negative effect on economic development, a consideration to be taken into account by other transitional countries.

**6 Conclusion**

To draw conclusions on the basis of discussions on the present experience of establishment of currency convertibility in Central and Eastern Europe for future economic policy is a difficult task. Therefore, the conclusions which will follow here are reflections based on the recent experience in introducing convertibility in these countries rather than a clear road map for policy development.

From the discussions it is clear that no one questions the principle of the need for achieving convertibility in the Eastern European countries. Instead, attention has been focused on the type and timing of convertibility as well as on the kind of accompanying measures to support the establishment of convertibility.

The first issue discussed in this paper is related to the difficulties in defining convertibility; the various Eastern European countries interpret the concept in different ways. It is generally agreed that the type of convertibility that has priority is the one proposed by Williamson. His definition of convertibility is close to both the current account convertibility as defined by the IMF Articles and to the internal convertibility already introduced in some of Eastern European countries, in particular Poland.

There is neither much disagreement on the conditions that are necessary for the successful establishment of convertibility. Among economists there is a consensus that macroeconomic stabilisation is a prerequisite for currency convertibility. As to the conditions needed for the introduction of convertibility, Williamson's argument that some of the conditions, such as price and trade reform, can be introduced simultaneously with the establishment of convertibility and not necessarily in advance. It should be stressed, nevertheless, that the institutional and structural reforms should be started at a very early stage if creditibility and convertibility are to be sustained. Indeed, the introduction of convertibility and structural improvements are mutually supporting.

This is borne out by the example of Poland. Experience with the establishment of convertibility there shows that the issue of currency convertibility should be considered in relation to the price and trade liberalisation. At the same time it makes clear that issues such as industrial and bank restructuring as well as privatisation have to be taken into account. The failure to do so completely in Poland has arguably caused several negative effects in terms of decrease in output and rising unemployment.

Currency convertibility in the countries of Central and Eastern Europe is about opening up the economy to the world market. However, in the very beginning of the reform process, some kind of protection of the economy in transition against market forces is necessary. The type and degree of protection that is required depends largely on the initial conditions of the country concerned and on the specific problems it is facing, for example in the area of foreign

exchange constraints. The present situation in trade shows that unless a certain level of protection is put in place, the economies in transition will have severe competition problems in the international market.

A special issue is the trade among the former members of the CMEA. Since the collapse of CMEA and the introduction of the use of hard currencies in trade relations between the former CMEA member states, trade among them has declined dramatically. The main cause of this is the lack of foreign exchange. This issue has to be addressed quickly. The creation of a CEPU, however, does not seem to provide an adequate solution, both for economic and for political as well as for psychological reasons. In this connection, one may bear in mind that, as Portes argues, the primary problems of Eastern European countries are related to structural transformation at the level of the individual countries and not to intra-regional payments imbalances.

The most controversial issue in the discussions about the introduction of convertibility is the choice between shock therapy and gradualism. Or, in other words, whether currency convertibility should be seen as a precondition and policy instrument or whether it should be looked upon as a final objective of economic policy and a result of a long-term development. In dealing with this question one should distinguish external and internal convertibility. It is clear that external convertibility is the ultimate objective of the transition. At the same time, it is the most challenging and difficult objective to achieve, as is indicated by the experience of many developing countries.

Therefore, external convertibility of the currency should be seen as a final step realised only after an unavoidable and time-consuming process of catching up with more competitive economies. Complete removal of exchange controls would be unwise as long as distortions exist in the domestic financial markets. Unrestricted convertibility is widely accepted not to be required in the early stage of transition. The question is to develop a proper sequencing of unrestricted convertibility and to determine the speed at which restrictions on capital movements are to be lifted.

In the case of restricted convertibility the situation is different. It is necessary to introduce it early in the process of the transition to a market economy. Of course, stabilisation should be the first objective. A possible set of measures includes, apart from stabilisation, a modest, initial opening up to international trade, demonopolisation, privatisation, reform of the banking system and the introduction of current account convertibility. This should be followed by the completion of the restructuring process, the opening up of trade and the introduction of full convertibility. It should be stressed, however, that this general set of possible measures has to be adjusted to the specific situation of the different countries. A flexible approach is needed.

The convertibility issue is so complex that neither shock therapy nor the gradual option offers easy and complete solutions for the present situation of the Central and Eastern European countries. A rigid distinction between shock and gradualism leaves little room for an open-minded assessment of the benefits and limitations of either approach.

Policy makers in the countries concerned should learn from the experience gained in other countries rather than stick to inflexible models. After all, those models lack substantial basis in knowledge of the structure and behaviour of economies in transition and they may therefore easily lead to mistakes that have to be recognised and corrected.

It was therefore probably inevitable that policy errors were made in Poland, both by the Polish national authorities --in particular the overly tight monetary policy -- and by the international community -- especially the undue emphasis on macroeconomic stabilisation and the negligence of structural policies. It is not necessary to get discouraged by such mistakes, however. Rather, one should learn from the Polish case and try to avoid the errors made there in the other Central and Eastern European countries.

The Polish case is often used as evidence that shock therapy leads to high adjustment costs and that therefore gradualism is a better approach. To conclude this on the basis of Poland, however, is wrong: costs are unavoidable. The immediate short-run costs of faster approach are probably higher but they have to be compared with long-term costs of the gradual approach. The costs and benefits of shock therapy and gradualism also depend on the specific characteristics of a country and cannot be generalised so easily. In the case Poland it was necessary move quickly as the economic situation was critical. Other countries may chose to move gradually but they should be aware of the danger of losing creditibility in the case of extreme gradualism.

From the analysis of the literature and from the Polish experience it is clear that a straightforward choice of either shock therapy or gradualism in establishing convertibility would be a too simple and rigid approach. Yet, on the basis of the Polish experience it would seem that the fast approach has several advantages in the present situation. This approach should be used cautiously and should take into account the mistakes made in the Polish reform by the Polish government and international organisations. Another important factor is the initial conditions of the country concerned. Attention should also be paid to reforms of the financial and monetary system, which is closely connected with the successful introduction of currency convertibility. A necessary accompaniment of a fast introduction of convertibility is the creation of a social safety net, so as to avoid the loss of popular support for the reforms.

This paper has shown that the issue of convertibility poses a host of difficult conceptual problems. The mere declaration of convertibility is not enough to make a currency convertible. It is quite clear, as Lavigne says, that there is no master blueprint for convertibility.

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