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Foreword

The following papers were presented at the Second International Varna Seminar organized within the activities of the ERI Project. Fifty-three participants from West and East exchanged experiences and identified prospects for a further integration of this part of Europe into the world economy. It was concluded that national efforts and international support in introducing early convertibility would have to proceed hand in hand.

I should like to express my sincere thanks to all the scientists and experts who contributed greatly to the success of this Conference. My gratitude belongs to The Bulgarian National Member Organization especially to Professor O. Panov and Professor E. Razvigorova and to the organizers from the Ministry of Foreign Economic Relations, especially to Dr. Ugrinov, for their excellent organization of the Conference and for providing the facilities necessary for the fruitful scientific discussion.

F. Schmidt-Bleek

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Summary

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The rapid changes in Central and Eastern Europe, although very young, already require a major shift towards maturity of the necessary political and economical institutional changes. This has to happen both nationally and internationally if stability and irreversibility of the transition are the percieved goal. The unexpected pace of these developments meant that politicians as well as scientists on both sides were, to a great extent, unprepared. Vigorous political action is accompanied by equally intensive efforts by scholars. National programs for the reforms emerge as a result of cooperation between the West and the East.

One knowledge, that reforms must be of a comprehensive character and include all economic and social institutions, was accepted by the majority of the transforming countries. Hence the necessity of a systematic approach.

Convertibility is one of the key issues in this reform. Its importance may acquire a dramatic character when faced with the accelerated disintegration within the CMEA market. Trade imbalances, raw materials and energy shortages, and changes in the modes of payment on the basis of convertible currencies, may cause mass unemployment, the collapse of enterprises and in the worst scenario of whole industrial branches or even economies. The political consequences are hardly predictable.

New trade and financial relations or a concept for the continuation of the existing ones under the new conditions will have a stabilizing effect not only for the eastern part of Europe. This new pattern requires an elaboration and an institutional network. The main objectives of the Second Varna Seminar were the exchange of views and information about the present economic situation in these countries, to exchange experiences and appraise recent economic policy measures and their impacts on trade balances, price stability and real wages, as well as to shape the auspices of the near future especially about the role and sequencing of convertibility in the reform process.

Another main issue of interest was the present state and the future of trade and financial relations in Eastern Europe. The discussion of that topic could clarify the chances for any individual country in the region to master the reform process by its own efforts.

SESSION I

Session I dealt with the stages in the transition to convertibility, the main idea was to compare the theoretical understanding with practical experience and to make feasible conclusions about the timing of the introduction.

The major theoretical considerations were presented in the paper by *Professor Portes*, followed by an evaluation of the experience of Poland, Yuguslavia and Hungary and the concepts for introduction of convertibility of Bulgaria, Czechoslovakia and Romania. A special case is the transformation in the former GDR as implemented in the Monetary, Social and Economic Union between the two German states.

Following the argumentation of Professor Portes the introduction of convertibility will have several positive impacts. Creditors to Eastern European debtors will see it as a major step towards the normalization of the position of these countries in the world economy, thus facilitating

the debt service. It is regarded by them as a touchstone of virtue. Moreover, the "critical mass" of measures required to achieve credibility may have to contain convertibility. Another positive effect will come from the introduction in the Eastern countries of the so badly needed new price system and competition. Freeing prices in a closed economy establishes only a monopolistically distorted equilibrium. Breaking up national monopolies and cutting hierarchical links between central authorities and enterprises may be a long process. Convertibility, and in this way open-economy equilibrium prices and the introduction of external competition, will give substantial impetus to the system and prevent additional damage.

The approach characterized as the "Big Bang" including in the initial package a total reform current account convertibility for residents is only hypothetical as it is not possible administratively and institutionally to implement all the required reforms at once. Another shortcoming of the prevailing recommendations is the insufficient attention paid to the interaction between the main components of the reform program.

A reasonable sequencing within a given time-schedule seems to be the only feasible solution. Interdependencies have to be known and consequences eventually predicted (e.g., not to blame the failure of a convertibility step on an inadequate supply-side response, which is connected on the other hand to measures of incorporation and privatization of state owned enterprises, prices, taxation, etc.). Such a sequencing must be robust to external shocks and errors and must be credible as to the achievement of its initially announced expected changes. Capital account convertibility has to be followed not only to avoid capital flight, but also to keep control over inward flows.

If preconditions are required it is obvious that macroeconomic stabilization and hard budget constraints have to be mentioned. Solving the stock problem by an initial push in prices, the provision of attractive assets and the creation of employment uncertainties will lead to the reduction of the "monetary overhang", by preserving the encouragement of savings. In this way a confiscatory monetary reform can be avoided. The hard budget constraints on their side do not necessarily eliminate budget deficits and bring to a flow equilibrium. It seems equally important to avoid the "redistribution" of national income through the budget by introducing self-financing economic actors. Current account convertibility at a fixed exchange rate is impossible without the establishment of financial discipline. Until this condition is met also currency auctions make little sense. A strong argument in favor of a single fixed exchange rate is that it will reveal the efficiency of firms and their activities.

All partial measures (a centrally directed "price" reform, enterprise retention as part of their export profits, currency auctions in closed economies, etc.) are intermediate steps going more likely backward than forward. Convertibility is not just a question of microeconomics or a monetary issue. It is central to the process of transformation and has to be situated in the context of every specific country, depending mainly on the possibility to sustain it or not. A forced retreat will have, without doubt, a devastating effect on the credibility of the respective reform program.

Moving to the presentations of the national experiences, the three countries that have introduced convertibility in different degrees until now—Yugoslavia (Nikic), Poland (Lutkowski) and Hungary (Boros) showed definite similarities, and as a whole a divergence from the theoretical hypotheses preconditioning macroeconomic stability for the introduction of convertibility. Especially in the case of Poland and Yugoslavia when all other measures to stabilize the economy failed, convertibility was introduced as a last effort to save the collapsing monetary system and to protect the state from insolvency. At the time of introduction of convertibility, December 1989 for Yugoslavia and January 1990 for Poland, the monetary inflation in those countries was respectively 60% and 79%. The foreign debt was inserviceable in both countries. Introduction of convertibility was supported by international financial institutions. The policies pursued by the respective governments are quite similar and the consequences from the introduction of convertibility also show similar features which are, in fact, essentially divergent from the initial expectations. The experience of Poland and Yugoslavia shows that measures for stabilization

excluding convertibility are inefficient. A short comparison between the two countries supports these statements.

Yugoslavia

(1) Time of introduction of convertibility: December 1989.
(2) Dominant macroeconomic conditions at the time of introduction:

- High inflation - 60% in December 1989.
- Existing currency black market.
- High foreign debt - 15 billion US$.
- Liberalized imports - 85% of total.
- Freedom of economic activity including foreign activity.

(3) Exchange rate-fixed for a period of 6 months according to an agreement with the IMF—overvalued.
(4) Government policy:

- 6 months wage freeze.
- Price control over some inputs (energy, transportation).
- Tight monetary policy.
- Reduction of governments expenditures.
- Arrangement with the IMF for rescheduling of the debt service and a stand-by credit in support of the stabilization program in the context of the reform program.

(5) Consequences of convertibility in the context of the reform program.

- Reduction of inflation - 1,8% in August, 1990.
- Increases in the foreign currency reserves.
- Disappearance of the black market.
- Outflow of capital because of overvaluation.

(6) Main problems:

- Sustaining the present exchange rate.
- Provision of capital resources for the necessary industrial restructuring.

Poland

(1) Time of introduction of convertibility: 1 January, 1990.
(2) Dominant macroeconomic conditions at the time of introduction:

- High inflation - 79% in January 1990
- Currency black market.
- High and inserviceable foreign debt.
- Liberalized prices - over 90%.
- Liberalized imports (except services and capital transfers).
- Low uniform tariffs.
- Freedom of economic activity, including foreign activity.
- Abolished export subsidies and other forms of preferential treatment.
- Gradually devaluated national currency before 1 January 1990.

(3) Exchange rate-fixed for a period of at least 3 months according to an agreement with the IMF—greatly undervalued.
(4) Government policy:

- Budget discipline.
- Tight control over money supply.
- Strict tax-based wage policy.
- Suspended debt servicing received from the Paris club.
- Agreement with the IMF for a stand-by credit in support of the stabilization program.

(5) Consequences of convertibility in the context of the reform program:

- Price level: reduction of inflation to 3% in August 1990.
- Real wages: fall by 40% in the first quarter and by 30% in the second quarter of 1990.
- Production: a decline of 30% in state-owned industry compared with 1989; an increase in the private sector.
- Unemployment: 800,000 in August 1990 (6% of the labor force).
- Trade balance: from a deficit of 0,8 billion US$ in 1989 to a surplus of 1,97 billion US$ for the first 6 months of 1990.
- Foreign exchange reserves grew up until August 1990 by 3 billion US$.
- Rate of exchange: stable and reaching equilibrium after the initial devaluation in the first quarter of 1990.

(6) Main problems:

- Recession.
- Unemployment.
- Decrease in living standards.

Hungary

Hungary is closest to the two states analyzed above concerning convertibility although the approach is a gradual one. Since 1981 one exchange rate has been applied for all transactions and the value of the forint is determined against a statistically weighed basket of convertible currencies. The rate of inflation is considerably lower—25–30%. A two-tier banking system was introduced in 1987. Imports in 1990 were liberalized, some 65–80% in terms of volume. For 1991, a 90% liberalization is perceived. Also the majority of consumer prices (some 85% in 1990) are liberalized. Economic activity (private business activity and the building up of economic associations) is free. Monopoly on foreign trade is eliminated and replaced by a decentralized structure. Foreign direct investment is subject to permission only in cases exceeding 50% of companies' capital. A stock exchange exists. The foreign debt is very high, but serviceable, and an agreement with the IMF is in force.

It is obvious that, by using these countries as examples, the liberalization of the economic life in a previously centralized economy leads to high inflation which is most probably caused by the monopolistic distortions, the closeness of the CMEA system and the deteriorated balance of payments. The introduction of convertibility has a stabilizing effect due to the introduction of an external measure of efficiency—the price system, and due to the reduction of the inflationary pressure on the tradables in the economy by the introduction in the national market of a highly tradable good—the foreign currency. The accompanying effect is high recession and unemployment. The rather strange similarities of the macroeconomic consequences in the case of overvalued (Yugoslavia) and undervalued (Poland) currencies, may be an indicator for the already running process of restructuring between the different industrial sectors of the economy.

Czechoslovakia

Czechoslovakia is the next country closest to the introduction of convertibility. The two papers presented at the seminar *(Klima and Charap)* are unanimous in the conclusion about the maturity of the country for the introduction of convertibility, but propose different strategies.

Charap supports the introduction of a quick convertibility and not only on current, but also on capital accounts. The foreign direct investment will help the country to immediately increase its consumption, now and in the future (a capital account surplus will finance a current account deficit). The recommendation is a quick and comprehensive reform including convertibility.

Klima's paper discloses the reform program of the Czechoslovakian government. For comparability reasons the main subjects will be revealed in the same sequence as for Poland and Yugoslavia, but also includes future prospects:

(1) Time of introduction—1 January, 1991.
(2) Dominant macroeconomic conditions: in the middle of 1990.

- Increase of GNP by 1,3% in 1989.
- Low inflation rate: 2–3% annually.
- Relatively low external debt: 7,9 billion US$ in 1989.
- Relatively small budget deficit 1988/1989.
- Slightly increasing export in convertible currency countries.

(3) Exchange rate—unified, about 24 korun per dollar, or a devaluation of 50%.
(4) Government policy: to be pursued.

- Stabilization policy.
- Tax reform.
- Tight budgetary rules.
- Privatization and demonopolization.
- Liberalization of domestic prices as of 1 January, 1991.
- Liberalization of foreign trade.
- Adequate social safety net.
- Adequate structural policy.

(5) Main priorities:

- Avoid unnecessary high inflation.
- Avoid excessive external debts.
- Avoid the transformation of the internal monetary surplus into an external debt.

Unlike the other countries Czechoslovakia intends to follow a policy of active incentives for stimulation of exports (bonuses) and disincentives for imports (import surcharges, licensing, custom duties, etc.). A next step is intended to be the introduction of a capital account convertibility.

The final aim of the reform program is to achieve the restructuring of the Czechoslovakian economy and its integration into the world economy. This requires much closer contacts and coordination with the international institutions.

The approach of the countries that have not introduced convertibility yet (Bulgaria, Romania and the Soviet Union) was derived from the general concerns characterizing the macroeconomic considerations in the introduction of this step. A great emphasis was put on the preconditions and it was pointed out that their absence was a major obstacle.

Bulgaria

In the keynote presentation of *Professor Valtchev* he declared that it was Bulgaria's aim to follow a policy for the introduction of convertibility in the sense of Article VIII of the IMF Agreement. As we saw in the cases of Yugoslavia and Poland only residents were included, fulfilling in such a way only a part of the requirements of Article VIII. According to Professor Valtchev, the present crisis in the country does not offer favorable conditions for the introduction of a quick convertibility. The economic system is characterized at the moment by:

- An administrative price system.

- An absence of a monetary and capital market.
- An underdeveloped "state" banking system.
- An absence of hard currency reserves.
- A large external debt.
- An initial phase of the economic reform.
- A rate of inflation of about 10% monthly.

These parameters of the system must be changed in order to achieve convertibility. The basic preconditions, defining also the macroeconomic policy that has to be followed include:

- Creation of a market economy.
- Creation of a modern monetary and credit system.
- Reform of the tax and budgetary systems.
- Introduction of unified exchange rate.
- Gradual liberalization of imports, transfer of profits, rights to borrow loans abroad for the firms.
- Measures to stop the "dollarization" of the economy.
- Legal guarantees for foreign direct investment.
- Agreement with the IMF.
- Productivity growth due to economic reform.

This policy has to be achieved in two stages:

The first stage lasting about a year will include the issuing of a package of laws and general measures for economic stabilization.

The second stage will last between 5 and 10 years, depending on the internal and external conditions and will implement the above listed policies and will finish with the introduction of convertibility, at a unified exchange rate. Regular auctions and centralization of all currency receipts at the National Bank together with gradual liberalization of imports will characterize that period.

Romania

The Romanian case (Bran) is characterized by an increase in the money supply of about 15% in July 1990, compared to December 1989 and a level of production of 85% of that recorded one year ago. The introduction of a two-tier banking system was initiated. Prices will be gradually liberalized consisting mainly of three groups—free, controlled and subsidized.

The scenario for the transition to convertibility adopted by the Romanian Government includes the following measures:

- Devaluation of the leu.
- Increase in productivity.
- Limitation of money supply in order to strengthen the purchasing power of the leu.
- Liberalization of payments in leu and currency for non-residents.
- Permission for Romanian citizens to take abroad larger sums of leu.
- Transition to general convertibility.

The fulfillment of this plan will depend on the interaction of real economic factors, monetary and fiscal policies and international support. Only an increase in the labor productivity and in the quality of the exported goods and services can bring the positive effects expected from convertibility. Otherwise an accelerating inflation and a decrease in the foreign exchange reserves will be the outcome.

The former GDR

The case with the former GDR (Peruzzo), although unique, and inappropriate as a direct example, may be very useful for scientific discussion. If we assume that generally, on the way to successful reforms in Eastern Europe, there are the following main obstacles:

- Lack of knowledge about the functioning of the market economy and about the transition process.
- Lack of capital necessary for the reconstruction.
- Lack of stable political forces driving the process.
- Lack of a modern, competitive industrial infrastructure,

In the case of the GDR it was only the inherited industrial structure, that is basically distorted and is a missing part on the way to a market economy.

If we abstract ourselves from the loss of national sovereignity, the reform approach in the GDR is that of total integration into the economic, political, legal and social structure of the FRG. We could call this a "substitution" strategy. The basic principles here are private ownership, rivaling systems of performance, free pricing, freedom of contracts and free movement of labor, capital and services in the whole area. The basic social principles are the freedom of association, works constitutions and collective agreements, co-determination, old age pension and insurance (sickness, accident and unemployment) schemes.

The economic laws of the FRG are adopted and implemented completely and the D-Mark replaces the GDR-Mark.

Basic attention has been paid to the industrial restructuring of the economy. Two major routes are followed:

- Stimulation of new investment through direct financing and government incentives.
- Direct investment in the creation of an appropriate infrastructure, mainly at a municipal level, stimulating the creation of small and medium sized enterprises.

All cases for investment in the previous GDR state industry are treated and authorized by the Trustees Agency. Under the above conditions, although many subsidies were abolished, the cost of living in the GDR one month after the introduction of the Union was 5,5% lower compared to the previous year.

The reform approach applied to the GDR leads us to conclude that the main rationale for the economic reforms in Eastern Europe, besides the institutional changes and the stabilization of the currency, is the industrial restructuring of the economies that will allow them a normal participation in the international division of labor in the world economy. Following a "substitution" strategy allows the quickest transformation but is connected with huge expenditures and requires the application of external administration.

SESSION II

The second Session dealt with problems of the reorganization of the credit and monetary systems and the capital market. The introduction of convertibility requires the establishment of new markets and financial institutions. What is making the present changes in Eastern Europe different from the similar processes after World War II, is the almost complete absence of a market supporting the institutional and legal infrastructure in those countries.

In his paper *Dr. Dimitrov* begins with a statement that convertibility is a market relation and its introduction can not be achieved before market relations become dominant. This applies mainly to the creation of a monetary market.

The economic crisis, the external indebtedness and the deteriorating conditions in CMEA countries are the main obstacles for the introduction of the market economy in Bulgaria. The

positive aspects are the general democratic changes, the relatively small size of the economy, the low rate of inflation until now and the experience gained from the other reforming countries.

On the way to convertibility several measures seem indispensable:

- Equal treatment of all forms of ownership.
- Recognition of the commodity character of the labor force.
- Broader monetarization of the economy by increasing the number of tradables and the power of money.
- Reduction of the monetary overhang.

The approach for the latter is in the privatization of state assets and a consequent cancellation of that money. The deliberate inflation aiming at the devaluation of savings, or a currency reform, are inappropriate because of their social costs.

The actual reforms in the financial sphere have to be included in the budget, the tax system and the banking system. The budget is redistributing now (plan 1990) 90% of the national income. It is characterized by tremendous expenses and taxes on companies' profits reaching up to 80%. The budget system is suffering under a constant deficit—at present 15,5 billion leva. The accumulated internal debt and the practice of financing it through the monetary system are definitely inflationary.

The main changes in this sphere must include:

- Cutting down expenditure.
- Excluding certain activities from the budget.
- Eliminating the direct financing of the deficit.

The main objective of the reforms in the tax system has to be the reduction of the level of levied taxes. This will have both qualitative (by increasing the companies independence) and quantitative (by reducing the inflationary pressure through the passing of the tax burden on to the consumer in a monopolistic economy) effects. VAT has to replace the turnover tax. The system of a general progressive taxation of the population has to be modernized.

The reform of the banking system has to begin with the elimination of the administrative functions. The banks, at the moment, do not offer services, they take decisions and manage the monetary circulation often against the interests of the firms. The payment procedure is very slow and this increases the money demand in the economy. The system for servicing the population is underdeveloped and monopolistic. The low interests for companies' savings at the banks—no more than 1%—are one of the main reasons for the under-monetarization of the economy, for the keeping of overstocks and for the slow introduction of innovations. The fact that the interest rate does not secure a minimum return on the money in the banks in order to compensate for inflation brings about a direct depreciation of the money.

The reform should introduce a two-tier banking system:

- National Bank—independent and pure emission bank.
- Commercial Banks—with universal character. For the size of Bulgaria they should not exceed 15–20.

All functions and activities of the banks and their competence have to be regulated by law. The introduction of the two-tier banking system will facilitate the creation of an interbank money market and also the creation of a market for securities.

Characteristic for the Bulgarian vision was its predominant monetary orientation with a relative underestimation of the problems of the real economy and especially of restructuring.

The main lessons the East European countries could learn from the Japanese experience during the postwar and high growth period, were presented in the paper of *Professor Takenaka*. An agricultural reform, demonopolization of the industry and a selective industrial policy, were the milestones of that period. The strategy of high growth adopted at that time implied, as a major vehicle, a high rate of capital utilization and a high investment replacement ratio. The

policy of "cheap money" followed by the Bank of Japan kept the cost of capital (interest rates) low and the rates of return on capital were kept very high due to the speed by which technology progressed within the industry. At that time Japanese corporations considered capital to be the embodiment of new technology. According to statistics 30–40% of annual growth in Japan appears to be due to technological progress. This lead to dynamic changes in the industrial structure by moving resources to the most efficient industries, spurning even more technological progress. The existence of a plentiful, high quality labor force capable of adopting new technologies positively influenced the success. Extremely high investment rates were achieved accompanied by an aggressive managerial posture adopted by the Japanese corporation which allowed a continuation of the investment replacement ratio at the high level of 12–15%. The high rate of savings represented the source for the invested funds.

During all that period a "cheap exchange rate policy" was followed which allowed an increase in exports and protected fledgling industries. Trade followed a clear pattern of having deficits at growth periods and surpluses during slumps. A unique form of ties developed between government and industry. The creation of the Industrial Structure Council at the Ministry of International Trade and Industry served as a forum where representatives from science, industry and administration discussed the future and worked out a vision of how industrial structure should stand. This represented a guideline for the corporations with a consensus behind it and reduced the uncertainties and risks involved in the individual managerial decisions.

The fruitful interaction of monetary and real economic factors is the decisive condition for the timing of convertibility. In his statement *Dr. Kagalovsky* pointed out the social and political background of the present economic policy in the Soviet Union. The sharp politicization of economic decisions is accompanied by factors such as the revolution of expectations, social unrest and the dominance of populist ideas reflected also in the 500 Day Plan. He pointed out the transparency of the financial policy and especially the drafting of the budget with its deficit. As a way for fighting the hyperinflation he proposed a reconsideration of the objectives against a dollarization of the economy at the initial phase of the reform process.

The strong arguments supporting the early introduction of convertibility represented the core of *Professor Bomhoff's* presentation.

- Introduction of an imported price system correcting distorted domestic relative prices.
- "External financial disciplining", which will be probably impossible to introduce, through domestic political decisions.
- Avoidance of corruption and black market activities.
- Reducing bureaucracy and its bias in favor of big firms as well as bureaucratic allocation of foreign exchange.

The introduction of convertibility, high or stable interest rates, and a secure savings institution are of major importance for economic development as they will secure a high savings rate and will prevent capital flights. A solution with a concentration of foreign exchange in a central state agency will have negative results.

The second major problem is the fixing of the exchange rate. If undervaluated it will stimulate exports, but hamper small firms to buy abroad and, consequently, have a negative effect on the restructuring. The difficulties in defining the proper exchange rate and the general bias against a floating exchange rate will be qualified as a lack of discipline in the monetary and fiscal policy. This supports a solution with an exchange rate fixed for relatively short periods of time but will have this disadvantage, that it will require a very tight monetary policy and hamper the supply of money—economic growth and restructuring will suffer.

Professor Starodubrovsky supports the opinion that early convertibility is not possible and market relations can not be introduced without prior stabilization. The proper timing for the introduction of convertibility will be at the end of the stabilization period and at the beginning of the introduction of the market mechanisms.

SESSION III

The third session dealt with the problems of payment balances and currency reserves, the external debt and the international support in favor of convertibility.

The case of Bulgaria was presented in the keynote paper of *Professor Tzarevski.* He analyzed the present state of the country's foreign debt, the policy justifying borrowing and the necessary measures for restoring the financial health of the country.

The present amount of the debt is about 10,4 billion US$ according to Government information. The country has to pay annual interest of about 700–800 million US$ and must meet annual maturities of about 2 billion US$. The real annual receipts from exports in hard currency amount to about 2 billion US$. The servicing of the debt is not possible at the moment. It grew by 7 billion US$ during the last five years. The receivables of the country, as per June 1990, from credits given to other countries accounted to 2,2 billion US$.

An analysis shows that more than 80% of the loans were used for productive and personal consumption as raw materials, intermediate goods, spare parts or consumer goods. Only 20% of the credits were used for the purchase of equipment and machinery, mainly in not very efficient plants, for heavy machine building, metallurgy or heavy chemistry (which is also due to the basic Marxist concept for the primarily development of heavy investment industry as well as the "dual" character of many industrial enterprises in CMEA countries.—Nikola Totzev). As a result of this inefficient credit policy the loans did not contribute to the creation of competitive productive facilities which could have returned invested currency.

The basic assumption underlying the borrowing in the past was in their profitability by later payments in inflation-caused devaluated currencies. Indeed, the devaluation of the foreign currencies can be favorable for the debtors, provided they are used efficiently and, at the time of devaluation, there is an increase in the prices of the exported products. That is the case normally with technology intensive products. The Bulgarian export goods are not predominantly of that kind, but the share of technology intensive goods is higher by imports. As a consequence the terms of trade deteriorate. The internal measures that have to be undertaken are connected with the overall improvement of the productivity and the growth of the economy. Particularly the debt should not be kept secret any more and all the terms of the particular credits have to be publically announced and controlled.

The restoration of the financial health of the country requires a long-term program including:

- A system for evaluation of the taken credits—shift towards credits with a concrete industrial application.
- Negotiations with foreign monetary institutions for the rescheduling of payments and for new credits.
- Negotiations with CMEA countries on the conditions of trade after January 1, 1991 when payment in convertible currency will be introduced in the CMEA countries. Like some of the other small East European countries Bulgaria is expecting a deterioration of the terms of trade and a general reduction of exports to the Soviet Union and the other CMEA countries. Additional difficulties are connected with the Gulf crisis. The problems can be solved either on a bilateral basis, that will distort further trade in this region, or by a new concept for trade in this part of Europe.

Creation of favorable conditions for foreign direct investment will have, in the long-run, a positive effect on the financial situation of the country. The second keynote paper presented by *Dr. Williamson* dealt with general theoretical problems of foreign exchange constraints in a liberalizing economy. The problem of additional foreign financing if not received as aid or via debt reconstruction has to be considered under the aspect of the national interest in foreign borrowing. Such an assessment has to balance:

- The benefit of relaxing the foreign exchange constraint.
- The benefit of building up reserves.

- The cost of eroding creditworthiness and precipitating a debt crisis.

Expenditure switching or a shift of foreign expenditure towards domestically produced goods is another way of improving the financial situation of the country. Possible sources are:

- Tighter import controls.
- A more competitive real exchange rate.
- Improved non-price competitiveness.

Whereas the first measure can give quick results, in the long-term it has negative impacts by precluding foreign competition, distortion of resource allocation and erosion of the Government's fiscal position. Improving the non-price competitiveness means restructuring of the economy. This is the key to the problem of convertibility, but the process is a very long one, ranging from 2 to 20 years, depending on the industrial sectors involved. The combination of real devaluation and liberalization of import controls will determine the short and medium term policy of these countries. An ultra-competitive exchange rate will be highly recessional if it is not accompanied by a monetary expansion (of Poland) because of the real balance effect and if monetary accommodation is added, the effect will be hyperinflation (e.g., Brazil).

With regard to import liberalization, an absolute abolition (convertibility), promises long run gains at the cost of short term difficulties. There are two problems here: a Government ready to take the risk and a population confident of the irreversibility of this step. Because an incredible convertibility invites an import surge (stocking up of foreign goods by the public as observed in Latin America), which makes the maintenance of convertibility impossible.

The realistic case is that of gradual liberalization of import controls. Domestic import competing enterprises are given the possibility to adapt to the new situation they face, including a large increase in prices of materials, products and energy. Unnecessary social tension and unemployment can be avoided. The gradual liberalization has to be accompanied by the introduction of new tariffs and a following gradual reduction of those tariffs. For example, until the final day when the whole package of measures for the transition to a market economy will come into force.

The third oil shock will have dramatic consequences for Eastern Europe and without foreign aid and debt reconstruction no feasible solution can be achieved. Of course these countries have to accept a lower level of output until such a time as exports rise or the oil prices fall. Independently of the present difficulties, convertibility seems to offer much greater advantages in Eastern Europe today, than it did in Western Europe 40 years ago, where the basic infrastructure of a market economy was already in place and there was no comparable need to import a price structure.

SESSION IV

The new financial institutions and opportunities for economic transition and the future of regional economic cooperation in Eastern Europe concluded the discussions. In his keynote paper *Dr. Richter* characterized the introduction of payments in convertible currencies from 1 January, 1991 as the end of the CMEA era. The consequences for the small East European countries will be huge deficits with the Soviet Union. They will have to compete with Westerners for the Soviet market and often the price will be below the production costs.

The main problem is how to deal with the emerging trade deficits and imbalances in Eastern Europe. Analyzing the idea of an East European Payment Union constituting a multilateral clearing system with financial support from the West, he saw the composition of the Union as a crucial problem. There are three possibilities:

- Hungary, Poland and Czechoslovakia.
- The above countries & Bulgaria and Romania.
- The above countries & Soviet Union.

Supposing the last composition is chosen, it will actually mean financing the Soviet Union's imports from Eastern Europe, because of the lasting Soviet surpluses that are expected. This may be a feasible solution in respect of keeping employment and social stability in the smaller countries, but there will be no positive structural effects because of the fact that the majority of export intensive enterprises in this direction are old fashioned, noncompetitive state enterprises.

Other solutions may include Western support for:

- An ease in the debt service burden.
- The setting up of special funds for the promotion of small and medium sized enterprises.

Any kind of solution has to be oriented around the crucial factor for Eastern Europe—the restructuring of its trade and the increasing part of trade with the West. Under such conditions mutual trade in Eastern Europe, after a temporary reduction, will increase but with a different composition.

The discussion that followed dealt profoundly with options other than the integration of the East European countries in the EFTA or in the EEC. Both possibilities were considered unrealistic because of the uncompetitive industrial structures and performances of the East European countries. Professor Portes warned against exaggerated expectations from trade with the EEC, or, even file applications. He underlined the necessity of a tremendous amount of thinking about the future of Central and Eastern Europe. Professor Schmidt-Bleek raised the idea for the creation of Central European Economic Market comprising 120–150 million people with a dimension large enough to allow competitive industrial structures and an innovative industry.

William Witherell suggested the idea of a Common European Economic Space also as a guarantee for the irreversibility of the process. He stated that the situation in Eastern Europe calls for rapid action by a closely coordinated program. All Western experts but one supported the idea of an early convertibility (including Bulgaria) in the context of the reform program and stated that it has to be supported by a vision about the economic integration in Central and Eastern Europe. The opposing opinion of Valtchev, Dimitrov and Williamson advocated a gradual approach taking into consideration the present economic situation of Bulgaria and its ability to move to convertibility without external support.

In conclusion, it can be stated, that the present changes have a unique character. The Socialist concept of the two world economies failed and two parallel processes were initiated—the one of rapid disintegration of the ex-socialist system and one of an effort for its integration in the world market system.

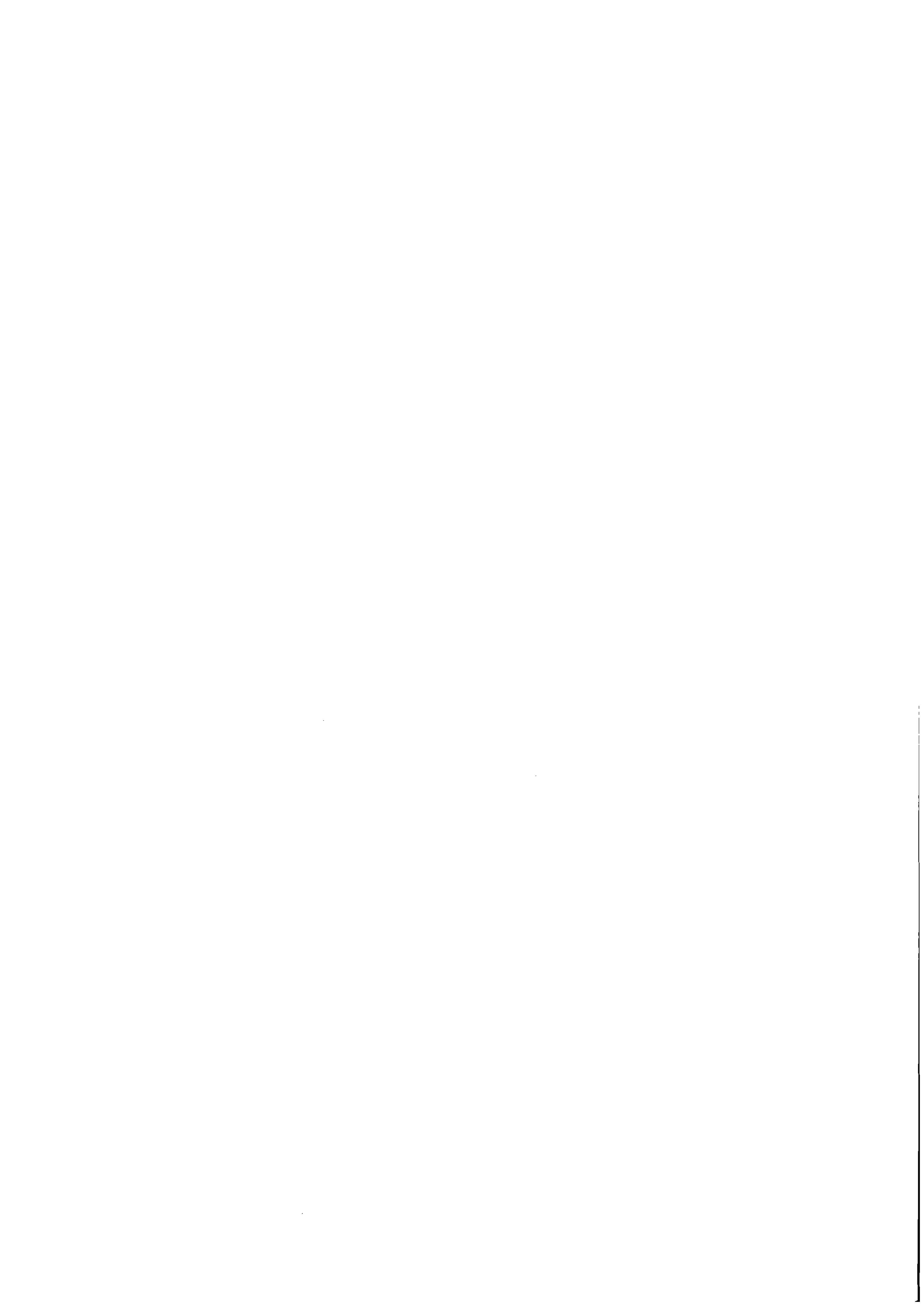
Almost equal economic structures that have existed in the two systems for years now have to be unified on the principle of comparative advantages. Lack of transparency due to generally unstable macroeconomic conditions, bad information and communications systems, and the lack of institutional settings for coordination hamper the process.

A general approach allowing the quick transplantation of overall conditions, principles and institutions from the world marketplace to the transforming countries is the only peaceful way of restoring the equilibrium. Convertibility is a key issue in this effort. A lot of intellectual investment is necessary not only to replace worn out social and economic dogmas, but also to create new visions for the future. This will save a great deal of accompanying additional destruction while having a positive effect on the restructuring of probably underestimated dimensions. Providing that a general framework and conception about the future of Central and Eastern Europe is created, individual businesses will find their ways to cooperate by rationalizing capital investment and fully exploiting existing resources and will achieve restructuring at comparatively low costs.

The choice is still open.

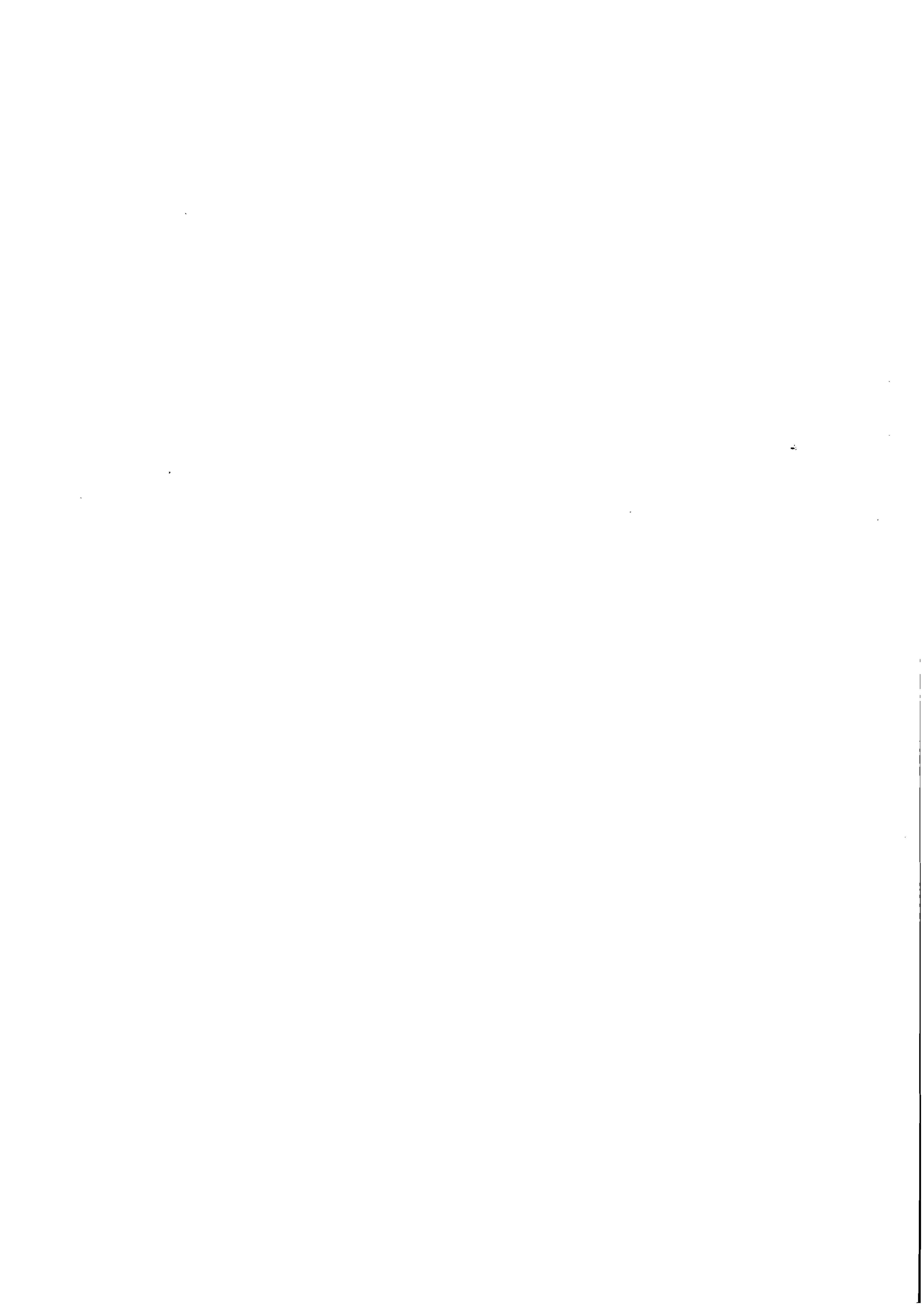
Convertibility in the general framework of national reform programs subject to international support and understanding is no doubt a step in the right direction.

The participants agreed that the third Varna East-West Seminar in 1991 should discuss "The reform of the financial system and new financial institutions in Eastern Europe".



Session I

Stages in the Transition to Convertibility



Conditions and Stages of the Transition to Convertibility of the Bulgarian Lev

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The disappointment from the results of the centralized planning of the economy is so deep that all political parties in Bulgaria declared themselves to stand for a transition to a market economy. They have, of course, different views as to the time limits, the methods and the ultimate goals of the transition. Some of them propose shock measures while others prefer more gradual changes.

The transition to a market economy is organically linked with the problem of convertibility of the Bulgarian lev. The scientists are unanimous when they point out the widely known advantages of convertibility, as it will connect the national economy with the global economy, and will increase the external competition which will force the local producers to improve the quality of their products, to introduce innovations and to lower their production costs. Convertibility will create more attractive conditions for the inflow of foreign capital, new technologies and new products. Investment will be directed to those branches in which the country has certain advantages, and this will gradually lead to a more rational structure of both production and exports.

Convertibility is important also for the ordinary people. After a long period of strict control on the use of foreign currency, when the people were not allowed to keep and to export foreign currency and were held responsible to the law for breaking the regime for foreign currency operations, now they view the convertibility as mainly an opportunity to travel freely to other countries and to buy goods from the Western market.

In this generally favorable psychological environment and in the presence of obvious advantages of convertibility, it is natural that some people look with interest and hope at the ideas of national and foreign economists for an *immediate* transition to convertibility of the Bulgarian lev, using as a basis the rate that has been formed on the "black market" and on the auctions for foreign currency, which is about 10 leva per dollar. Others, however, put forward the objection that the national economy is in a crisis and there are no conditions for convertibility—they have to be created now and this should be done systematically and quickly.

When we analyze the problem it is necessary to first of all make clear what convertibility Bulgaria could aim at now and in the future.

The term convertibility itself has undergone a considerable evolution. Various interpretations of the term exist. Apart from this, it is often used with various modifiers: some speak of full and partial convertibility, others of convertibility for residents and for non-residents, of convertibility in current payments and in capital transfers, etc. After the reforms in Poland and Yugoslavia, the term "internal convertibility" became popular though it is not quite clear what it means. The American economist Richard Cooper prefers to call it "residents' convertibility for current payments".

With this variety of interpretations and terms, it is possible to avoid misunderstanding only if we *accept the term convertibility in the sense in which it is used in the Articles of the IMF Agreement.* The matter is discussed in several texts mainly in Articles VIII and XIV, but also in Articles XIX and VI. These texts and definitions may not be perfect from a strictly scientific point of view, but they are accepted by the largest financial organization in the world and have been applied for several decades now without essential changes.

According to the Articles of the IMF Agreement, currencies are convertible of those countries which have declared that they will stick to the statute of Article VIII, §§2, 3 and 4. "No member shall without the permission of the Fund impose restrictions on the making of payments and transfers for current international transactions". This means that both residents and non-residents may exchange and use freely the respective currency accounts, i.e., for trade, transport, insurance, tourism, personal transfer, etc. Inconvertible are the currencies of those countries which have adopted the statute of Article XIV. The latter allows them to preserve temporarily the existing limitations and control on current payments. As members of the Fund, however, these countries must aim at removing these limitations when the economic conditions, the balance of payment, and the monetary reserves improve to a degree which will make this possible.

According to the Article of the IMF Agreement, for one currency to be convertible it is not necessary that it should by all means be usable also for capital transfers. The member countries "may exercise such controls as are necessary to regulate international capital movements" (Article VI).

In the group of current payments, however, the IMF has included also some transfers which essentially are closer to the international capital movements, for example the "normal short-term banking and credit facilities in connection with foreign trade and payments of moderate amounts for amortization of loans and for depreciation of direct investment" (Article XIX).

Finally it is necessary to mention the fact that the Fund does not allow the countries that have declared their currency convertible to turn back to the statute of Article XIV when steady unbalances and disproportions appear in their economy. They may only temporarily and with the permission of the Fund introduce some control and limitations in the current payments.

If we accept the IMF interpretation of convertibility it becomes clear that with the declaration of the Bulgarian lev for convertible (i.e., with the declaration that Bulgaria accepts the statute of Article VIII) the country will undertake a heavy responsibility. Such a step should not be made lightly and not without the necessary preparation.

In this respect we could draw some lessons from the *history of the convertibility during the postwar period.* We need not recall the crash which Great Britain experienced in 1947 with the hasty attempt to restore the convertibility of the pound. More convincing is the fact that the majority of the IMF member countries took a long time to prepare the convertibility of their currencies. The first ten most developed and largest West European countries made this step only in 1958 and 1961, Spain and Portugal only after their entry into the European Community and Turkey in 1990. It is now more than half a century since the Bretton Woods conference took place and the number of countries with officially convertible currencies is 68. However, if we look more carefully at the actual facts we notice that at least 27 from the developing countries (included in the 68 countries with convertibility), have actually infringed the statute of Article VIII, having imposed, with or without the permission of the Fund, various restrictions on current payments for long periods of time. Such countries are Bolivia, Argentina, Ecuador, etc. This means that the number of the countries with convertible currencies is really about 40. Even now the majority of the IMF member countries have inconvertible currencies. One can assume that they have serious economic reasons not to accept the statute of Article VIII (and that this is due not only to conservatism and love for administration in the monetary field).

The present crisis in the Bulgarian economy does not pose favorable conditions for an immediate transition to convertibility. The major part of the prices for goods and services are determined administratively, and not on the market. There is no money and capital market.

The interest rates are fixed "on the top". The central bank is still strongly dependent on the government and seems to continue to finance the budgetary deficit through money emission. The country has no money market if we do not take into consideration the rare and irregular auctions for foreign currency and the "black market". The monetary coefficients are canceled, but there are still multiple currency practices. The country has no monetary reserves, it has a big external debt and has declared a moratorium on the payment of amortization and interests. The economic reform which must secure the transition to the market economy is only beginning. It is possible to say that the conditions for the introduction of convertibility in Bulgaria are more negative than they are in Hungary, Yugoslavia, Poland, and the ČSFR.

As a country which will probably soon become a member of the IMF, Bulgaria is naturally obliged to stick to the Articles of the IMF Agreement and to do everything possible in order to make its currency convertible. However, taking into consideration the present economic conditions, it would be wiser if Bulgaria chooses, for the time being, the statute of Article XIV. This means that we shall be able to preserve the existing monetary restrictions and controls, but we will not be able to introduce new ones.

It is necessary to bear in mind that the restrictions in Bulgaria are, on the one hand, unnecessarily severe, and on the other hand—they are not sufficient. It is not difficult to cancel or soften the unnecessary restrictions. At the same time, however, we must introduce some additional restrictions which will secure the balance of payments. For example, Poland did so when, parallel with the announcement for "internal convertibility" of the zloty, it increased the customs duties in order to make imports more expensive and to achieve an active trade balance. Apart from customs duties it may prove necessary to also impose other restrictions like import taxes, time deposits in the import of some goods, limits on the sales of currency for private travel, etc.

As to the additional monetary and other restrictions which we could introduce, it is necessary to start consultations with the IMF in order to prevent the danger of going too far in that direction. The IMF will probably be understanding, realizing that this is not a part of a long term policy for protection, but only a necessary step on the road to liberalization.

Liberalization could start almost immediately, for example with regular monetary auctions accessible to all kinds of organizations and persons, or by the liberalization of the imports of consumer goods and by means of production for the private companies, or by allowing the organizations to receive loans from foreign firms and banks for production and export, etc.

All these measures, however, will be only a partial liberalization. It is more important to start systematic preparation by creating the conditions for introducing convertibility of the lev in the spirit of Article VIII of the IMF Articles of Agreement. The measures could cover:

- a market reform, privatization and demonopolization;
- creation of a modern banking system, a money market and capital market;
- balancing the budget and a tax reform;
- introduction of a unified exchange rate and normalization of the monetary regime;
- balancing the balance of payments and re-scheduling the external debt;
- creation of conditions for attracting foreign capital;
- securing international support for the introduction of convertibility, etc.

The first absolutely necessary condition for convertibility *is the creation of a market economy.* In Bulgaria the transition to such an economy is only beginning. The majority of prices are fixed centrally. The prices of basic food stuffs are kept low through subsidies which take 20% of the budgetary expenditures. The means of production are distributed administratively and therefore there is no market for the means of production. The majority of the wages are fixed. The illusion about the worker's self management and that of the resultative nature of the salary are not fully overcome. In spite of the reduction in the volume of output the factories are slow in reducing the labor force. The number of people employed in the administrative and bureaucratic structures is also reduced too slowly.

This shows that there are no conditions for convertibility, as there are no developed market relations. It is not possible to have a normal money market unless the markets for goods, services, labor force and capital are developed at the same time.

The market reform, however, will be barred *if the monopoly structures are not destroyed* by administrative and legal means. There are still whole branches in which there is only one enterprise—dealing with production, purchasing and sales. The *demonopolization* will probably start with separating state monopolies into smaller companies and will continue with the privatization and the revival of private and cooperative organizations.

However, *privatization* in Bulgaria is also just beginning. Indeed a process of spontaneous privatization started, which had some elements of plundering the state property at prices too low by persons connected with the party and the state machine. This process was temporarily stopped, at the request of the democratic opposition in Parliament. A law of privatization is forthcoming, but it will probably provoke long discussions in Parliament. It is planned to transform large enterprises into stock companies, but it is not yet decided in what form they will be privatized later on. The problem of the ownership of the land which has never been nationalized in Bulgaria is extremely difficult. There are different opinions. Some propose that the land should be given back to the former owners or their successors, others recommend that the land should be a collective property and should also be leased to private farmers, and others stick to the principle that the land should belong to those who cultivate it. Probably in the next few years the arable land will not be purchased and sold freely.

Under these circumstances it is obvious that the transition to a market economy in Bulgaria will take a long time. This does not mean, however, that the problem of the convertibility of the national currency must be postponed until the market reform is completed. It will be sufficient if the market reform starts and reaches a certain critical point, when the market relations will have a rather big share. Only then will the first condition for convertibility be available.

The second condition is the creation of a modern *monetary and credit system.* If judged by Western standards, the banking system in Bulgaria is probably one of the most backward spheres. For a long time it has been performing extrinsical functions—on the one hand it used to exercise strict control on the enterprises, depriving them of their initiative, and on the other hand it used to accumulate the free money of the population not so much for financing the production process as for financing the state budget.

One of the first measures in reforming the banking system will be the creation of a bank really independent from the Government central (national) bank as an emission institution responsible for the stability of the national currency and regulating the money supply.

A decision to do this has already been made, but it is not yet realized. Already started, but still in its initial stage, is the process of setting up a system of universal commercial banks and specialized banks (farmers', cooperative, mortgage, etc.) and joint stock companies. It is necessary to also eliminate the monopoly of the State Savings Bank which was, until recently, the only bank authorized to keep the deposits of the population.

The interest rates are still fixed centrally. Due to increased inflation in the last few months they have become negative. In order to stimulate the accumulation of capital and to decrease the inflation pressure of the purchasing power of the population, it is necessary to move to market-fixed interest rates and to their transformation into positive interest rates with the help of their regulation by the National Bank.

The creation of a market of stocks and bonds will take more time. The country has almost no securities. Naturally, there is no stock exchange either. However, a draft law for the stock exchange is in preparation.

The monetary and credit policy and privatization could contribute to the harnessing of inflation which (having been rather moderate until recently—about 5% per year) increases strongly and is now more than 10% per month. The presence of inflation is not an insurmountable barrier against convertibility. However, it is by no means a factor which favors the transition to convertibility.

At the beginning of the year the inflation potential was estimated to be about 15 billion leva (one part of the free savings of the population). It seems however to have increased considerably in the last few months. Until recently its compensation seemed possible through the attraction of free savings in the banks (with the assistance of positive interest rates) and through pumping out a part of the money mass from the population (by selling small pieces of state property—shops, workshops, hotels, land, etc.). With the speeding up of inflation, the task became more complicated and it is possible to expect a currency reform accompanied by temporary freezing or high taxation (confiscation) of a part of the bank notes available in the population. One way or another, the harnessing of the inflation process and the reduction of the inflation rate is badly needed with a view to the future transition to convertibility.

Bulgaria has not yet started the very important reform in the budgetary system and taxation. Presently too large a portion of the national income (almost 90%) is distributed through the budget. Until this percentage is lowered to about 50%, no market processes will be possible as there will not be a terrain for them. In order to decrease the role of the budget, it will be necessary to put an end to the practice of covering the budget liabilities through the emission of money and from savings kept in the State Savings Bank. The budget must be freed from the subsidies that are too large.

Bulgaria is awaiting a tax reform too. Taxes are too high—they exceed 50% and reach 97% of the profit. This prevents the self-financing of enterprises and bars technological innovation and extended reproduction. Laws for introducting VAT and an income tax for the population are under preparation.

In order to create conditions for convertibility, it is necessary to normalize, as soon as possible, the exchange rate and the monetary regime. This does not yet mean convertibility, nor that we have adopted the statute of Article VIII.

Coefficients were removed in Bulgaria, but there are still multiple currency practices. There are three official rates: a basic rate, an exchange rate and a rate used in auctions, and there is also a "black market" rate. The country must accept a unified rate as soon as possible, in any case long before we accept the statute of Article VIII.

There are different opinions as to whether the unified rate should be based on the black market rate or on the auction rate (which are similar), or it should be oriented to the purchasing power parity. It is also argued whether the rate should be fixed or floating, and if it is fixed—to what monetary unit it should be bound (to the dollar, to the ECU or to the DM). There are discussions which reveal some advantages of using the unified rate which is close to the purchasing power parity, with periodical devaluation corresponding to the rate of inflation.

It is impossible to think of convertibility unless some exchange market is created. Such a market does not exist at the moment. It is possible to start with regular auctions accessible for all agents, and to reach at a later stage an interbank money market under the stronger or the weaker control of the National Bank.

It is also necessary to take measures in order to stop the "dollarization" of the economy. The dollar is increasingly coming into the circulation of money and operates as a second, parallel currency. Unless the prestige of the lev is improved (and it is undermined by the presence of a parallel currency) there are no chances for the lev to become convertible. The approaches to the elimination of the parallel currency include increased interest rates of deposits in leva, administrative restrictions on the use of the dollar in internal circulation, anti-inflation policy, creation of a regular money market with relatively steady rates of foreign currency in the Central Bank. This would facilitate the demand for foreign currency for current payments.

For a long time Bulgaria was considered a first class client by Western banks. In the last few years, however, for various reasons which will not be analyzed here, the *current balance of payments* became passive, the *reserves* of foreign currency sharply decreased and the country was forced to declare a *moratorium* and to temporarily stop the payment of interests and amortization on the foreign debt.

The situation became still worse for several reasons: the Kuwait crisis, the increased oil prices, and the transition that as from 1991 payments to the East European countries and the USSR would be in hard currency.

The Kuwait crisis was a great blow to the current balance of payments. Iraq owes Bulgaria a considerable amount (1.2 billion dollars), and according to the agreement this debt had to be paid with deliveries of oil. After Bulgaria joined the international embargo, the oil deliveries were stopped and the country has to purchase these quantities from other sources, at the high current prices.

The decision of the CMEA countries to move, starting from 1991, to trade at global prices in dollars will have a negative effect on Bulgarian exports. Our most important trade partners—the USSR, the former GDR and the other East European countries (whose share in the Bulgarian trade exceeds 90%) will partially orient themselves to other suppliers. The reduction of the Bulgarian exports will force limitations on the imports of raw materials, fuel, machines, equipment and industrial goods from the USSR and the East European countries. Opportunities still exist to reduce this negative effect by concluding multilateral (and more probably bilateral) agreements between the CMEA countries for payments in clearing dollars. The problem, however is not yet settled, though 1991 is at the door.

After the declaration of the moratorium it became practically impossible to obtain new bank and firm credits. For this reason the country is already experiencing a shortage of raw materials and spare parts. Industrial production was lowered by 15% and it seems that the downward tendency will continue, which in turn lowers the export opportunities of the country.

It is absurd under these circumstances—a passive balance of payments, zero reserves and a moratorium on the external debt—to think of moving to convertibility. Efforts must be directed to concluding agreements with the consortium of Western banks for the re-scheduling of the debt. When Bulgaria becomes a member of the IMF and works out a stabilization program complying with their requirements, it is possible to expect the first loan from IMF. This would contribute to a normalization of relations with commercial banks, for reviving their trust in the solvency of Bulgaria, and for obtaining reasonable new loans.

The new loans, together with the growth of production and exports (as a result of the steadily implemented economic reform) would contribute to the balancing of the balance of payments and the servicing of the external debt, and also for the rise in the monetary reserves.

A certain role in this respect is expected from the inflow of foreign direct and portfolio investments, with legal guarantees for the remittance of profits and repatriation of capital.

This would lead to another important condition for the introduction of convertibility.

Finally, it is necessary to provide for *international assistance*. Hungary and Yugoslavia obtained credits from the IMF and from other sources. Poland even created, with Western assistance, a special fund of 1 billion dollars, whose aim is only to guarantee the stability of the new rate of the local currency. Bulgaria has not even started negotiations for such international support without which convertibility is impossible.

The negative general economic conditions and the lack of fundamental conditions determine the *duration, the peculiarities and the stages of the eventual programs for a transition to convertibility of the Bulgarian lev.*

Two stages are expected: institutional preparation and creation of a real market economy.

During the *first stage*, which will last about one year or a little more, a package of laws will be prepared and adopted—of ownership, privatization, banking, taxation, foreign investments, etc. At this stage the necessary minimum steps will be taken for stabilizing the economy—first of all for restricting inflation through the reduction of money emission and increasing salaries, reducting the budgetary deficit, and other similar steps. It is also important to take measures to secure the supply of raw materials for industrial production and for the provision of food stuffs and other necessities. If these stabilization measures are organized in a special program, which should not necessarily be done, its duration should not be more than one year. This short term

stabilization program must be closely linked with the creation of market mechanisms, and it should by no means consolidate the administrative methods for economic management.

The *second stage* covers the process of creating a market economy. It is longer, covering several years, and as already mentioned, includes:

- Full liberalization of prices
- Creation of a modern monetary and banking system
- Balancing the budget and a tax reform, and
- Re-scheduling the debt and balancing the foreign payments

Within the second stage, which will create the framework and the conditions for convertibility, it is necessary to implement *step-by-step* a *policy of liberalization* of the regime for foreign currency. It would be wrong to start with the adoption of the statute of Article VIII or with the introduction of "internal convertibility" of the type of those in Poland and Yugoslavia, as the required conditions are not available. It is impossible, to outline at this moment, the exact sequence of the steps for money liberalization, but one possible arrangement could look like this:

- Regular auctions for foreign currency, hoping to gradually come to the balanced rate, at the start;
- When the auction rate becomes relatively stable (within one or two years), the multiple currency practices are stopped, and it is possible to move to a unified exchange rate;
- In order to create conditions for attracting foreign capital already at this stage, repatriation of profits is guaranteed, however, keeping control on the origin of the leva amounts which are remitted.
- It is desirable that all currency receipts should be centralized in the National Bank, as was done in Hungary, Poland and Yugoslavia, but for a certain period of time the National Bank will have very limited reserves and will not be able to meet the demands for foreign currency for current payments, it would be reasonable to allow the local enterprises to keep for themselves a certain part of their currency receipts from exports. They will have the right to use it for imports and for sales at the auctions, but not to operate with it on the domestic market, which would have a "dollarizing" effect.
- When a relative balance in the current payments is reached and the currency reserves are increased, without unnecessary delay it is possible to introduce "internal convertibility" of the lev, i.e., for residents, for current payments. At this point centralization begins of all currency receipts in the National Bank, and the latter ensures the internal convertibility (i.e., for residents) at the unified rate. For non-residents the limitations for the purchase of currency against leva (with unknown origins) remains. Also limited are the possibilities for non-residents to obtain certain assets (stocks, bonds, real estate) against leva, as the danger of selling out a part of the national wealth at a knock out price exists. This restriction remains in force until the prices of these assets on the domestic market become normal.
- Next come the measures for creating an interbank currency market and for liberalizating the regime for non-residents, with the right to obtain stocks, bonds and real estate against leva.

This actually fulfills the requirements of Article VIII of the Articles of the IMF Agreement. The leva becomes convertible for current payments both for residents and for non-residents.

The duration of the process of liberalization until the adoption of the statute of Article VIII is not possible to be defined in advance. It depends on the success of the economic reform as a whole, and also on the changing external conditions. In case of a favorable development in Bulgaria and in Europe, which is unlikely, the foreign currency sphere in Bulgaria could be liberalized quicker, and the statute of Article VIII could be already adopted in the middle of the 90s.

Stages in the Transition to Convertibility for Eastern Europe and the USSR

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How quickly and by what route should currency convertibility be approached by the economies in the process of transformation from socialist central planning to market capitalism? It is likely that more has been written on this issue than on all others involved in the transition except perhaps for privatization.

There are some obvious reasons. The creditors of the East European debtors see convertibility as a major step towards normalizing the position of these economies in the world economy and thus facilitating debt service. The international financial institutions naturally put the highest priority on one of their own major objectives (Article VIII). Potential investors regard convertibility in general as a touchstone of virtue, though they may not distinguish between its various forms. And for many Eastern economists and policy-makers, convertibility is almost equivalent to legitimacy, a badge that will entitle them to sit at the table with Western finance ministers and central bankers on a par—so to speak—as long as it lasts.

All this may help to explain why some argue there should be *no* stages in the transition to convertibility: that it should come at the *beginning* of a comprehensive reform program, at least in the form of "internal" convertibility (on current account, for residents). This view was not merely implemented in the Polish effort to exit dramatically from hyperinflation, but is also a feature of the radical version of the Czechoslovakian reforms. Many Hungarian economists too want convertibility first, questions later.

A qualified version of this approach is that there is a minimal initial package of reforms necessary to establish a credible change of economic regime, and that this package must include resident convertibility on current account. The strongest version is the extreme "Big Bang": that it is necessary to do almost everything simultaneously, because it is well known in economics that everything depends on everything else. This is after all what we learn in basic general equilibrium theory. Dynamics is difficult, made even more so by the increasingly popular notion that the outcome actually depends on the path (hysteresis). The easiest strategy, it seems, is to ignore it.

Some would do so by saying that if you want to go there, you should not start from here—no path will make it. But these economies are indeed here—burdened with the multiple legacies and distortions of decades of central planning and comprehensive state ownership. The difficulty is that it is impossible to test the hypothesis that a purist "Big Bang" is the most effective road from here to there—an efficient, dynamic market economy with predominantly private ownership.

The hypothesis is not testable simply because it is administratively and institutionally impossible to implement all the required reforms at once. Hence the failure of any program can always be blamed on what it left out or implemented inadequately. If, as in Poland, convertibility is the keystone of the initial package, and even at the macro level that package does

not seem to be delivering on its promises, its architects may claim that this is because a micro level supply-side response was necessary (assumed?), and this required immediate privatization, which the system did not deliver.

There is a weaker version of the assertion that "stages" is just a euphemism for indecision and delay when comprehensive action is required. At recent OECD and IMF seminars, it was concluded that the academic literature on "sequencing" was just that—"academic" in the sense of being an unhelpful intellectual rationalization of the inability to prescribe clear, practical programs for action (IMF *Survey*, August 1990).

I believe, on the contrary, that the notion of "robust sequencing" is not merely relevant but must serve as the organizing framework for any serious, implementable reform program ("Introduction" to *European Economy* 43, March 1990). It is hard to spend more than half an hour analyzing any major component of such a program without asking what must precede it and what other measures it will make possible that would otherwise not work. Indeed, the "Shatalin Plan" may give insufficient attention to the interactions among the main component measures; the sequencing is there, but only temporal, not economic.

The chosen sequence of stages must be *robust* to external shocks and errors in assessing behavioral responses. It must be *credible*—preferably announced ex ante as a comprehensive sequence that clearly changes the economic regime and thereby changes expectations radically. The problem here, as always, is how policy-makers can credibly pre-commit themselves to a time-inconsistent program. Will they really control credit and avoid tax-subsidy concessions if that will cause many bankruptcies? Will they maintain controls on nominal wages regardless of how far real wages fall? Will they stick to their chosen nominal exchange rate if it quickly becomes drastically over-valued and convertibility itself is threatened?

This line of reasoning leads to the conclusion that convertibility should come towards the end of the sequence because it appears that there are so many preconditions for it to succeed. For this very reason, however, a commitment to early convertibility, backed by international institutions and perceived as a key element of the political-economic program, raises the stakes and may itself help to push the "preconditions" through. And the "critical mass" of measures required for credibility may include convertibility, for which the necessary conditions need not be preconditions.

Just as it is impossible to implement all the necessary reforms simultaneously, so I cannot in a brief introduction cover all the relevant issues. We shall discuss exchange-rate policy and debt later in the conference. Maintaining convertibility at the pegged rate requires a realistic choice of exchange rate, adequate reserves, and a sustainable debt burden; and it helps to choose properly the currency (basket) to which to peg. The alternative of floating must be evaluated: My remarks below on the importance of macroeconomic stabilization should not be taken to mean that these countries must achieve (for example) the EC inflation rate (adjusted for differential productivity growth) so as to maintain a fixed parity with the ECU.

I take it as given that commodity convertibility is a prerequisite for current account convertibility, and I do not discuss capital account convertibility. It clearly must come after the freeing of current account transactions, not only to avoid capital flight, but also conversely, to keep control over inward flows. Newly independent domestic firms, households and banks may borrow irresponsibly; excessive capital inflows may not be absorbable and may in the short run lower the price of tradeables and discourage production for export, while in the long run proving unserviceable. It seems unlikely that inconvertibility on capital account will be a significant obstacle to desirable foreign direct investment, as long as current account convertibility guarantees the freedom to remit profits.

Finally, I shall not consider intermediate *forms* of convertibility. There has been much discussion of proposals for an East European Payments Union analogous to the postwar EPU, as a successor to CMEA (ECE, *Economic Survey of Europe* 1989–90; CEPR *Bulletin* 40; P. Bofinger, CEPR Discussion Paper No 458; P. Kenen, IMF). One could envisage a looser, informal pay-

ments union without credit facilities, in which trade surpluses would actually be "transferable" (Nuti).

The issues here are analytically and empirically interesting, but there are limits to the analogy with postwar "gradualists" approaches to convertibility. The multiple legacies of central planning are different from and deeper than those of a war economy, not merely because the former has lasted so much longer. The Eastern countries undergoing transformation need totally new price systems and a massive injection of competition. It is hard to see how to do this quickly except through a radical opening of the economy to trade, which would include current account convertibility at a unified exchange rate. That would overcome some (by no means all) of the inherited distortions.

But this open trade policy is not sustainable without domestic macroeconomic stabilization and substantial price responsiveness of import demand and export supply. Restoring macroeconomic equilibrium is both a stock and a flow problem. The stock dis-equilibrium in most, if not all, of these countries can probably be eliminated without a confiscatory currency reform, through a combination of initially pushing the price level up sharply, providing a reasonable portfolio of assets at attractive returns, and creating sufficient uncertainty about employment prospects to encourage precautionary savings. The flow dis-equilibrium is in most countries due to budget deficits which must be eliminated by quite conventional measures.

It is claimed that imposing financial discipline (a "hard budget constraint") on enterprises is a necessary and/or sufficient condition for macroeconomic equilibrium and hence for convertibility. It is clearly not sufficient, since the government budget can remain in deficit for all sorts of other reasons that keep revenues low and expenditures high. Nor is it necessary: the macroeconomic (strictly, monetary) position in most of these countries was sustainable until the mid-1980s, when it deteriorated sharply in the USSR, Bulgaria and Hungary. Poland has always been more inflationary and had a burst at the beginning of the 1980s, but the slide into hyperinflation did not begin until late 1988 (or even perhaps early 1989).

There is a strong case for the view that the deterioration was due partly to external shocks (especially a rising burden of debt service) and policy aberrations (e.g., the Soviet anti-alcohol campaign that reduced excise revenues), but mainly to partial and inconsistent decentralization, which eroded the enterprise "tax" base and weakened central (and bank) control over enterprise expenditures. If the "soft budget constraint" and all its nefarious consequences had been characteristic of the centrally planned economies from the outset (early postwar), it would be remarkable that the denouement was so long delayed. Moreover, the "levelling" characteristic of the standard, unreformed CPE system of enterprise finance and "taxation" involves not merely subsidizing loss-makers but also siphoning excess (above-plan) profits away from profit-makers. Part of the recent problem comes from giving the enterprises control over those excess profits.

It is nevertheless clear that current account convertibility is not sustainable if enterprises can borrow unlimited amounts of domestic currency at low real interest rates in order to purchase foreign currency, without a credible medium-run solvency constraint. This is also a compelling objection to foreign currency auctions until financial discipline is established; but when it is, there is a strong argument for adopting a single fixed exchange rate that will make it transparently clear which activities and firms are profitable and which are not.

Most of this is consistent with a fairly conventional sequencing (Nuti):

(1) Monetary restraint with budgetary discipline.
(2) Letting prices vary to clear markets.
(3) Establishing competition by breaking up monopolies.
(4) Instituting financial discipline and eliminating "levelling" across enterprises.
(5) Cutting the hierarchical links between central authorities and the enterprises.
(6) Opening to international trade at a unified exchange rate.
(7) Current account convertibility.
(8) Capital account convertibility.

But some of the arguments above suggest a rather different program, in which current account convertibility does indeed come much earlier. Is not the top priority to establish a reasonably rational price structure? Why free prices only to establish a closed-economy, monopolistically distorted equilibrium? How long will it take to break up the monopolies? How much longer thereafter will it take to move from the closed-economy equilibrium to something approximating the open-economy equilibrium, and how much damage will have been done in the meanwhile?

Both views—or at least my own—reject a wide variety of partial measures. Partial, centrally directed price "reform" however much it used "world market prices" as a reference point; enterprise retention of part of their export earnings; restricted and necessarily distorted foreign exchange markets, in particular auctions in the context of a basically closed economy with irrational prices and firms (at least some) not subject to financial discipline; all these would be intermediate steps more likely to go backward than forward.

It is clear that convertibility is for these countries not simply a question of international macroeconomics, not a monetary issue. It is central to the process of transformation and must be situated within that process in a way appropriate to the particular country concerned, which may depend heavily on whether it will be possible to *sustain* convertibility once introduced. Certainly a forced retreat would be devastating to the credibility which is indispensable for any reform program. But sustainability is not merely a matter of *when* convertibility is implemented, but also *how*. There is considerable scope for discussion of this throughout the conference.

Recent Polish Experience in Monetary Convertibility

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On January 1, 1990, a package of new economic legislation came into force in Poland, which represents the basic groundwork for the first stage of the program of monetary stabilization and of long-range institutional change, inaugurated on the same day. The program, known as the "Balcerowicz Plan", was designed to transform Poland into an open modern type market economy and included, from the very beginning, the intent to introduce the convertibility of the Polish zloty to the broadest extent judged warranted under the circumstances of the moment. Thus, the Polish currency has been convertible since the beginning of the year in the sense of Article VIII of the IMF Articles of Agreement (convertibility on current account with some restrictions on services and capital movements) on the basis of the stable and practically uniform rate of exchange of 9500 zloty = 1 dollar.

The purpose of the present paper is, first, to provide a brief outline of the new foreign-exchange mechanism as circumscribed by the foreign exchange law forming part of the aforementioned package, second, to highlight the role ascribed to convertibility in the Balcerowicz Plan and, finally, to make a tentative assessment of the results achieved so far.

The Present Polish Foreign Exchange System

In order to bring out the characteristic features of the new system more clearly, a short reminder of some basic traits of the foreign exchange mechanism typical of the centrally managed economies may be appropriate here. Those traits included: foreign trade and foreign exchange monopoly, quantitative controls, a system of import licensing and foreign exchange permits on the one hand, and differentiated subsidies to export, income tax reliefs, preferential rates of interest on export credits, on the other hand. Rates of exchange, usually fixed at artificial levels, exerted little or no influence on the internal price structure and correspondingly little influence upon the physical volume and structure of trade as independent determining factors. Even though in the wake of successive reform attempts the above mentioned features lost much of their sharpness as mechanisms of control became more flexible (e.g., retention quotas, foreign exchange auctions, greater scope of free decision at the lower levels, more flexible pricing policies), the basic traits such as foreign exchange rationing, direct controls and isolation from the immediate influence of the world market remained in Poland, as more or less everywhere in Central and Eastern Europe, until the collapse of the old system. Obviously, the degree of disarray in Poland was compounded by some additional circumstances like rapid inflation, prolonged stagnation, exceptional degree of social discontent, etc., which seemed to make Poland the least probable candidate for an early introduction of convertibility, at least if one views the problem in a traditional perspective. However, the present reform has taken the plunge in spite of all the uncertainty and risks involved. The structure of the new monetary mechanism is based upon the following fundamental premises:

- Prices of goods constituting 90% of the GNP have been completely liberalized
- All quantitative restrictions on imports as well as almost all on exports have been dismantled
- A pretty uniform tariff has been introduced, kept—with some exceptions—at quite a low level; during the past months custom duties on
  4,500 items have been completely suspended (production inputs) and the remaining items are subject to 5% custom duties on the average, after several successive reductions designed to stimulate import activity
- The principle of a foreign trade monopoly has been abolished and all sectors (state-owned, cooperative and private) have been put on the same footing. No special license to open up a foreign trade enterprise is necessary, merely registering. Access to foreign exchange for import purposes is not subject to any limits on fulfilling the above mentioned condition.

Thus, introducing convertibility has been combined with extremely radical opening in the sphere of trade policy in general and with breaking some long cherished prejudices and monopolies (like the celebrated "foreign trade monopoly"). It should be added, that on the same day all subsidies to export, all tax exemptions and reductions, as well as all preferential treatment of export in the sphere of credit policy, were abolished.

The system of retention quotas has been abolished and all exporting units were obliged to convert their foreign exchange proceeds into national currency. However, the deposits held by the enterprises on January 1, 1990, were freed from obligatory conversion. The enterprises continued to dispose of them freely until their depletion. As a matter of fact, export proceeds are converted automatically by the banks, through which the business is transacted. Contrary to initial fears, automatic conversion turned out to be rather painless to enterprises and one does not hear any complaints, as the rate of exchange has remained stable and enterprises have had no problem of obtaining any amount of foreign exchange they wanted, if they had to make a legitimate payment.

As to services directly connected with foreign trade, they are subject to the same rules as trade in goods, i.e., payments are liberalized. Otherwise, however, services—though forming part of the current account—remain regulated by the system of general and specific permits. Capital transactions are, of course, subject to controls: granting as well as taking credit is regulated on traditional principles. Direct investments and payments connected with them (remittance of profits and salaries) are free within the limits determined by the present legislation on joint ventures. That legislation is now under review and will soon be radically altered: complete freedom to transfer profits and the abolishment of the cumbersome system of licensing will probably become a fact very soon.

In contrast to "economic units", households (private individuals) are allowed to keep foreign exchange deposits with Polish banks and are not obliged to sell foreign currency, which they acquire. Foreign money withdrawn from bank accounts may freely be carried abroad without any limit or permission. Individuals can also purchase foreign currency legally on the parallel market. However, there is a limit on the amount of foreign currency, which one may carry abroad, if the money in question was not taken from the bank account, but acquired in a different way. The limit at present is 500 US dollars. Carrying greater amounts is possible under the permit system. Polish currency may not be used as a means of international payment and carrying it abroad is subject to restrictions. Thus, free convertibility under the present system is, strictly speaking, limited to current account transactions and is of the "internal" or "domestic" type. It must be added, however, that it appears to be working technically very smoothly and I must personally say that in the debate currently going on in the Polish press on many controversial aspects of the government's economic policy I do not recall having encountered any serious complaints about how the system is working. This is in glaring contrast with the period immediately preceding reform, when the fire of criticism was concentrated primarily on that aspect of the new Program. The move to convertibility was commonly judged to be the most risky part of the attempt, deemed to end in disaster very soon. Technically, at least, it turned out to be probably the most successful piece of the reform exercise, although—from a different perspective—one may

always challenge that assertion on other than technical grounds (e.g., by raising the question whether the price paid for the achievement has not been excessive, as some critics maintain—I shall briefly revert to that point later).

The foreign exchange market in Poland is at the moment composed of the unified bank market, through which payments to and from abroad are channeled, insofar as they are connected with foreign trade and other transactions (under the permit system). Up to now, banks are selling foreign exchange at the official rate to "economic units" only for import and related purposes. At present, households may buy foreign currency merely in the counter (parallel) market. The parallel market is allowed to float within the band of 10% in relation to the official rate. However, it has moved merely within the range of 2–3% until now, remaining at first under upward pressure, as a result of the initial sharp devaluation. Thus the rate of exchange, though formally not fully uniform, has in practice stayed virtually uniform, with the central bank intervening marginally on the parallel market at some moments. Splitting the market into two parts (similar to introducing obligatory sale of the currency for export) was initially designed as a safety valve to reduce potential speculative pressures on the zloty. The danger has not materialized up to now and the authorities are considering the idea of unifying the market fully by allowing private individuals not only to sell but also to buy currency in banks. It is worth noting too, that in mid-1990 the "Pewex" (hard currency) shops have started to sell goods to private buyers not only against foreign currency, but also against the Polish zloty.

Of course, the above mentioned liberalizing moves refer to hard currency trade, as the CMEA trade this year is still being conducted through the traditional channels with the rate of the zloty fixed at 2,100 = 1 ruble.

The Role of Convertibility in the Reform Program and the Results Obtained So Far

The shape of the Polish program of reform was strongly influenced by the situation in which it was elaborated—the most serious threat to the nation's economic security at the moment stemmed from the monetary disarray. The country was clearly slipping into hyperinflation and the monetary system was already on the verge of collapse. Thus, monetary stabilization was declared to be the most urgent task and the precondition for more fundamental structural and institutional reforms.

Creating a macroeconomic framework for stability implied imposing severe budget discipline and tight control over the supply of money. That has been the core of the stabilization program. However, a hyperinflationary situation with its strong inertial factors (expectations) made it advisable to provide the stabilization package with "nominal anchors", designed to break the inertia forces at play, which could otherwise transform the initial ("corrective") jump on prices into an explosion of wage-price spiral. In the course of negotiations with the IMF, which offered the possibility of a stand-by credit in support of the stabilization effort, it was decided that there would be two such anchors: a strict tax-based wage policy, and a stable rate of exchange, which should be kept fixed for at least three months.

Thus, from the very start, convertibility at a stable rate of exchange became crucially important, even the central element of reform. On the one hand, it was to act as an important factor of correcting the price structure, thereby laying the foundation of restructuring the economy, and—at the same time—reintegrating the country economically with the outside world. Apart from that long-term task, it had a more immediate, though not less important task in the short-term to perform: to act as a factor strengthening the confidence in the value of the zloty, and to cushion—through imports—the shock of price liberalization. What, I think, distinguishes convertibility at a stable rate of exchange from all other important elements of the stabilization package (such as wage policy, budgetary and monetary policy) is that its powerful psychological impact at the critical moment is *positive* in nature, while all other factors contributing to stabilization have a *negative* psychological effect in the sense of creating hardship and inflicting

pain. If personal experience is of any value as evidence, I would say, that in the early weeks of January, when prices were exploding much more steeply than expected, wages were held down and enterprises watched in horror as the *monthly* rate of interest on credit was being raised to the level of 36%, the free convertibility, its continued stability and the news that exchange reserves are actually growing, not falling, was probably the only glimmer of light over the dark horizon, and the only stable point on which to pin one's hope, that the process of monetary sanation would end in the zloty's recovery.

This should not distract attention from the important fact that the stabilization package forms, and should form, a logical whole, in which all elements depend on each other and are mutually supportive . In that sense, convertibility depended on the other elements and held good because these other elements held good, as well as the other way round, so that it is difficult to say how much praise (or blame) should unequivocally be ascribed to this or that element of the program, as far as the results are concerned. Still, I believe that the introduction of convertibility was most important at the moment, precisely because of the psychological connections which it brought into play at the decisive and extremely risky phase. Of course, the above remark is fully relevant in a hyperinflationary situation only, otherwise it may be subject to debate, although even in different circumstances a case can be made for an early move to convertibility on the grounds of considerations known from textbooks in supply-side economics.

As to the Polish experience, let me add that the move to convertibility was preceded by certain preparatory steps: in the second half of 1989 the zloty was 512 zloty = 1 dollar. In late December 1989 the rate was already
6,500 zloty = 1 dollar, which means the price of the dollar was by then 12 times higher than in January. By comparison, the growth of the price level over that year was "merely" around 600%. However, at the start the zloty was clearly strongly overvalued, although the "parallel" market (already legal but not regulated) vastly exaggerated the zloty's overvaluation—in December the parallel rate was around 12,000 zloty, i.e., it was twice as high as the official rate. On January 1, 1990, the zloty was devaluated from 6,500 zloty = 1 dollar to 9,500 zloty = 1 dollar (that is around half) and became convertible.

Before commenting upon the provisional outcome of the Polish experiment in convertibility, here is some background information on the performance of the Polish economy under the stabilization program up to now:

The Price Level

The initial jump in prices as a result of price liberalization, devaluation and growth in interest rates was much stronger than expected: 79% in January alone, but subsequently fell sharply and reached 3.5% in June. Although the financial policies have been extremely tight, in some respect much tighter than assumed in the Program (with the state budget showing a surplus of 3% GNP instead of 1% GNP deficit in the first half of the year, while the *real* value of the money stock declined almost by half) the inflation path was much higher than aimed at. Over the first half of the year prices rose by 172%, i.e., more than twice as fast as assumed under the program. In July and August inflation stayed around 3% and the situation tended to stabilize.

Real Wages

Fell much more sharply than assumed initially, although the statistical figure is obviously exaggerated, because of imperfection on the price index itself as well as because of limited applicability of the term "real wage" to the situation in which a considerable part of the money stock had no backing in goods. The price shock brought equilibrium to the market, eliminated waiting lines before shops and all other typical traits of the "economy of shortages". Still, statistically, the fall in real wages—because of the tight wage policy and because of "corrective" price shock—was around 40% in the first quarter. In the second, and especially in the third quarter,

wages recovered somewhat so that the present statistical index is closer to 30%, as compared to December 1989.

Production and Employment

Also the decline in production as a result of restrictive monetary policy and tight budget constraints turned out to be much deeper than expected: the value of the production sold by the socialized sector fell by 30%, when compared to the corresponding period of the last year. That index should also be corrected for growth in the private sector activity and in agriculture, although both sectors (agriculture and handicraft) complained most loudly about monetary constraints. The most recent data (for August) indicate that there is a moderate movement upward in the index of production, but it is still too early to judge whether the trend is steady.

In contrast, unemployment grew only slowly at first, then started to soar and is now at the level of 800,000 people (5% of the labor force). To sum up, a sharp reduction of inflation and relative monetary stabilization within the first 7 months of 1990 was achieved, but at a price which turned out to be at least twice as high as expected with respect to the price shock, decline in production (3 times as high) and unemployment. The standard of living of the society suffered pari passu with the drop in the level of production and the divergences in income distribution widened sharply.

And now, here are some basic data most directly connected with the convertibility problem:

Balance of Payments

The strong monetary squeeze and the sudden appearance of the buyer's market combined with deep devaluation induced many enterprises to expand export and reduce import. Here is one of the areas of the economy, where the response to reform has been rapid and unexpectedly strong. In contrast to last year, the balance of trade has shown strong surplus until now. In the first half of the year exports grew by 22% as compared to last year and imports fell by 20%. The trade surplus with the convertible currency area grew from 0.25 billion dollars in 1989 to 1.97 billion dollars in the first half of 1990 alone, and continued to grow, though more slowly, in the third quarter. The current account balance (trade plus services plus unilateral transfers) turned from a deficit of 0.8 billion dollars in 1989 to a surplus of 1.1 billion dollars during that period. Of course, the latest oil shock will certainly modify the final outcome of the year, but still the balance will remain as a substantial surplus for the year as a whole. It is to be noted, however, that Poland enjoyed a period of suspended debt service towards the Paris club members this year, so that the strength of the Polish balance of payments over the past 8 months was probably a passing phenomenon, not to speak about other shocks to come (oil as well as a new system of payments with the CMEA countries). Still, the switch to convertibility at a realistic—if not unquestioned—rate of exchange did produce a powerful and positive effect upon the country's payment position, at least in the short run.

Foreign Exchange Reserves

Foreign exchange reserves grew this year by 3 billion dollars, both because of the trade surplus as well as because many economic units, which found themselves short of cash, had to sell part of their foreign exchange deposits to the banks against zlotys.

Rate of Exchange

The rate of exchange remained stable and the developments on the parallel market indicated that the zloty was somewhat undervalued, at least in the first quarter. In any case, the bank felt confident enough to keep it stable for much longer than required by the agreement with the IMF. On the whole, the mechanism worked surprisingly smoothly. There has been no

moment of nervousness on that front and this certainly contributed to strengthen the confidence in the national currency, so that the trend toward a double-currency system has been reversed. Technically, the stable rate of the zloty with convertibility has probably been the most successful piece of the new economic mechanism in operation. As one of the high-ranking officials from our central bank put it, this is the "jewel in the crown" of our reform.

Concluding Remarks

The question may legitimately be put, of course, whether the "jewel" has not been acquired at an excessive price in terms of output lost, the sharp drop in the standard of living and growing unemployment. Any answer will probably contain an unavoidable element of subjectivity rooted in value judgment. However, I think that there are good reasons to assume that the mechanism was worth having. As to social costs of introducing and maintaining convertibility, it is true that it had to be supported by firm financial policies. However, exorbitant social costs of implementing those austere policies was, I think, connected more with suppressing inflation (hyperinflation) under conditions of highly monopolized economy with state ownership as the dominating form of property, rather than with convertibility as such. Having no such instrument to strengthen confidence ("anchor") the costs of suppressing inflation could be much higher, because the inertial element of inflationary expectations would be stronger. Besides, the zloty might, perhaps, be excessively devalued at the outset, i.e., the initial devaluation was perhaps too deep. That could have strengthened inflationary pressure and the cost of suppressing it was thereby raised. The problem of deciding upon an appropriate size of devaluation is, however, a separate though important question.

All in all, short-term advantages of having an effective nominal anchor in hyperinflationary situations as well as long-term efficiency considerations seem to lend strong support to an early introduction of convertibility in the case of an economy in transition like Poland's economy, all the accompanying difficulties notwithstanding.

Stages in the Transition to Convertibility

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Introduction

The prime concern nowadays in all ex-socialist countries—which includes also my country, is the following—what is the necessary and shortest way of building up market economies, and how can these economies be integrated in the world economy. In building market economies the restoration of convertibility of the national currency seems to be inevitable. This short paper tries to examine how convertibility can be reached; what type of further changes are necessary to happen in the economy soon; whether the modest reforms of the past decades in Hungary, especially those introduced in 1988 and 1989, were useful from the point of view of a future convertible national currency.

The Past Years—Do they help us now?

The past twenty years or more of communism in Hungary were quite different compared to all other Eastern and Central European countries of the Soviet influence area. Those differences were characterized by a number of features including the following:

- Land and agriculture became never fully nationalized. 80–85 per cent of production came from private and cooperative sectors. They were owned and managed by their members. There was a low level of state regulation.
- The majority of residential property was always privately owned: flats, houses, weekend houses, etc.
- The private sector was never completely liquidated in some sectors. However, in services and food processing its importance has been growing since 1968.
- State owned units were given some independence in 1968. This meant that they were allowed to decide on some basic questions of their business activity.
  Changes also took place in the macro financial systems of the country which then became elements of a market economy.
- As of 1968 the country gradually abandoned multiple exchange practices. Since 1968 there are only two rates: one applied for commercial and one for non-commercial transactions vis a vis convertible currencies. Since 1981 only one exchange rate is applied for all transactions.
- Since 1981 the value of the domestic currency is determined against a statistically weighted basket of convertible currencies most frequently used by Hungarian foreign trade and financial transactions.
- Domestic values of the basket are determined by the Government through the Central Bank. Cross rates, however, follow the movement of the world currency markets on a daily ba-

sis. Due to these practices official and black market rates of the currencies are closer than anywhere else in the CMEA States.

- Since 1985 the banks quote forward currency rates for the Hungarian companies, which they can use to eliminate their foreign exchange exposure. Forward rates (swaps) are calculated on the interest rate differentials of the convertible currencies and Hungarian forints. (In the case of Hungarian forints interbank rates are used.)
- The majority of consumer prices are liberalized. (Some 85 percent of the products.) Prices contain VAT type taxes since 1988.
- A growing part of the Hungarian imports (at present some 65–80 per cent on volume terms) is liberalized. Importers of those goods do not need any permit from authorities for imports or the purchase of hard currency.
- From a truly monopolistic foreign trade structure the country is smoothly moving to a decentralized system. According to the law all companies can carry out foreign trade transactions if they can prove their technical capabilities to do so. If technical capabilities are available authorities can not refuse permits.

  The Communist Party postponed bank reform since 1968 several times, but since 1978 a gradual positive change of events has taken place.
- In 1978 the first joint venture type off-shore bank started operation.
- In 1987 the Central Bank delegated all domestic businesses to newly created commercial banks.
- Joint venture banks have full bank license for both domestic and foreign operations since 1987.
- In 1990 twelve commercial banks were licensed for trading related to foreign exchange operations.

During the legislative period between 1985–89, especially in 1988 and 1989, the Parliament has passed very important laws. Based on those laws transformation of the economy could accelerate.

Law of Associations—Year 1988

This law redefines the forms of companies and arranges the basic right for citizens to be members of Associations or to set up companies without any previous permit of the authorities.

Two important forms of companies were redefined in the law. These are:

- Limited liability company (Hungarian abbreviation Kft)
- Share company (Hungarian abbreviation Rt)

The law sets the minimum capital requirement for 1 million HUF in the case of a Co. Ltd. (some 20 000 US$). At least 30 percent should be paid in cash before courts register those companies. Contribution in kind can also be accepted. Companies have to be fully capitalized within three years, either using their profits earned or with additional payments of their shareholders.

Law on Foreign Investment—Year 1988

This law applies the following major regulations:

- Foreigners (companies and individuals) can be partners (shareholders) with Hungarians (companies and individuals) in limited liability and share companies.
- Foreigners are allowed to form fully foreign owned companies in Hungary.
- Only majority foreign owned companies need a permit from authorities. Authorities are obliged by law to answer within 90 days all requests in the case of foreign majority.

- Companies with foreign participation at least 20 percent and a minimum amount of 5 million HUF are entitled a profit tax refund of 20 percent. Those over 30 percent (minimum 5 million HUF) are entitled to a refund of 60 percent in the first five years of operation. In selected branches of the economy companies can enjoy a 100 percent profit tax refund in the first five years, and 60 percent in the next five years.
- Reinvested profits can also be deducted from the tax bill.
- There is no need for a permit to repatriate profits earned.

Commercial banks execute the transfer on the instructions of the customer.

Law on Securities and Securities Trading—Year 1989

This law gives the rules of issuing and trading with securities on the stock exchange. On the basis of that law the Budapest stock exchange was reopened on 21 June, 1990.

Foreign businessmen can also easily participate in stock trading because:

- All stock exchange members can execute their orders.
- Registered shares can be transferred abroad without any limitations.
- Conversion of bearer to registered shares is in the majority of cases in the competence of the management boards of the companies concerned.

The answer to the question whether the past helps the country in achieving the convertibility is affirmative. The critical volume of reforms in the past 20 years makes the concept of convertibility a close and pragmatic goal to be achieved.

Further Necessary Steps. Possible Difficulties. Scheduling

Further measures have to be undertaken on the way to convertibility. Some doubts are also present and some difficulties may appear, which could slow down the process of reform. In the second part of this paper I will try to summarize those factors.

Floating Exchange Rates

The necessary change in the prevailing system is symbolic. Instead of a fixed relationship of the currency basket vis a vis the national currency, the value of the basket would change also the Central Bank's role from a purely bureaucratic one into a market conform one. Instead of the heavy fights Central Bank officers had with the Government, whether and to what extent the basket should be reevaluated, Central Bank would be a natural participant of the market showing its interest through interventions for or against the national currency. With some courage government Central Bank could introduce an exchange rate float soon.

Foreign Exchange (Reserves and Convertibility)

Law level of foreign exchange reserves are very frequently used as an argument against convertibility. It is my very firm belief that a speculation, which is dangerous for reserves, could be cut back substantially by introducing floating rates. Speculators slow down the flow of incoming foreign exchange receivables and accelerate outgoing currency payments on rumors of devaluation as it has also been shown in the last quarter of 1990. Floating exchange rates, however,

give always the chance to Central Banks to disappoint speculators from time to time. Experiences around 1973 before the Smithonion Agreement came into force confirmed the same in the international currency markets. The level of foreign exchange reserves in Hungary really did not change substantially compared to that of a year ago reserves, however, improved substantially. A year ago reserves of the National Bank of Hungary (Central Bank) were nearly fully offset by short term borrowing from foreign banks. Nowadays, nearly all the currency reserves are covered from domestic sources (currency deposits of private individuals and joint venture companies). In a panic situation, which causes a run on currency reserves, the central bank is in a better position to stabilize the domestic sources. In credits, the majority of those foreign exchange reserves are used as collateral for domestic credits guaranteed by the same central bank. Experience gained during 1982 and several times since then, has shown that short term foreign bank debts are the most dangerous for the financial stability of a country. Concerning the necessary minimum level of reserves in the case of convertibility in our case I could recommend the following formula:

Liquid foreign exchange reserves = R
next 3 months outstanding financial payments of the country = F3
expected foreign trade cash flow for the next 3 months = T3

Under liquid foreign exchange reserves to be considered:

- Total foreign exchange account holdings in currency of all Hungarian units including precious metal accounts
- Fixed time deposits of all Hungarian units abroad maturing within the next three months
- Cash and cash type cheque holdings of all banks in Hungary.

$$R = F3 \pm T3$$

The figure (R) floats, however from to time the range can be estimated at 1,200–1,700 million US dollars in the case of Hungary. Fluctuation can be caused by following reasons:

- Exchange rate changes of hard currencies
- Fluctuations in the expected financial and trade cash flows of the country.

As a consequence of the above I see a good change that calculating also a certain level of courage from the government—convertibility is a realistic perspective for Hungary soon.

Convertibility and Trade Within the Ex-Comecon Area

Ex comecon countries start trading in hard currencies form 1991, which automatically increases theri demand for hard reserve currency as a consequence of increased trade volumes (transaction money). Lack of foreign exchange reserves can break down trade flows in the area dramatically with al those well known side effects (fall of production, unemployment, etc.).

Those countries where national currency can be offered as an alternative for trade related invoices and cash flows can get rid of those grave problems easier. Hungary could be in the group of countries standing on the sunny side with its potential to make Forints convertible very soon. Delay in reaching a decisioin to make the currency convertible puts additional pressure on reserves, which can be used as a "brilliant" argument to further delay convertibility for years. The right timing seems to be decisive, which of course depends entirely on courage of government and central bank.

Convertibility: The Yugoslav Experience

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In December 1989, the Yugoslav Federal Government proclaimed the convertibility of the Dinar for all current transactions and pegged it to the Deutsch Mark at the rate of 7 Dinars to 1 Mark. The Government declared its intention to keep this rate unchanged at least for 6 months and backed it with measures such as:

- A 6-months wage-freeze and
- Price control of some inputs (energy, transportation).

It has committed itself to pursue a tight monetary policy and to substantially cut Government expenditures.

Convertibility and the associated measures were proclaimed after nearly a ten year effort to consolidate the domestic economy which had been heavily shaken by foreign liquidity and the debt crisis in the early 80s. At the same time, the successive and profound changes in the institutional framework were enacted to provide a genuine market environment. All restrictions concerning ownership were abolished and in addition to the market of goods and services which, more or less, existed already, conditions for the introduction of a capital and labor market were also established.

After the proclamation of convertibility of the Dinar, the foreign exchange black market has ceased to exist virtually overnight and price inflation dropped from 60% in December 1989, (retail prices, on a monthly basis) to 37% in January, 13% in February, 4% in March and to 1.8% on a monthly average until August 1990. At the same time, foreign exchange reserves have increased from 6,2 billion US$ at the end of 1989 to 8,2 billion US$ at the end of August 1990.

Despite the fact that since the proclamation of convertibility, domestic currency has become increasingly overvalued, the Government commits itself to keep the exchangerate unchanged. Justification for this commitment is based on the fact that foreign exchange reserves keep increasing and that the export performances are still good. The high growth of foreign exchange reserves is rather surprising particularly in the light of overvalued currency. However, it could be explained by a tight monetary policy which has forced the business sector to export to maintain liquidity, by advance payments for exports and credits for imports, by seasonal increase in proceeds from tourism and from sales of foreign exchange by the household sector.

The growing overvaluation of the Dinar along with an easement of the monetary restrictions in July and August 1990, are creating an uneasy concern for of the monetary restrictions, are creating an uneasy concern for the Government's ability to maintain continued price stability, high foreign exchange reserves and a fixed exchange rate. The concern is even greater if one takes into account that considerable problems with the adjustment processes in the basic economic structure are ahead. These processes will be accompanied by a very strong resistance to the restrictive monetary policy. In this paper, however, I will restrict myself more to high-lighting

the main steps which were undertaken and the conditions which were created on the way to convertibility than speculating about future prospects. In addition, I will address three important issues:

(1) Changes in the development strategy.
(2) Problems of the foreign debt and external liquidity.
(3) Changes in the foreign trade and foreign exchange system.

The Yugoslav strategy of development in the postwar period was basically inwardly oriented, with consequent deficits in the balance of payments and net import of capital. Consequently, there was a constant propensity to pursue a policy of overvalued domestic currency and the foreign exchange market was replaced by various arrangements of foreign exchange distribution. Improvement of economic relations with Western market economies in the 60s and 70s resulted in an increase in the surplus on the balance on non-factor services, workers' remittances and unilateral transfers with a simultaneous growth of deficits on the balance of merchandise. Foreign debt outstanding was steadily rising but remained easily serviceable. The problems appeared during the 1976–1980 development plan with extremely ambitious investment undertakings. In 1979 a record postwar deficit in the balance of payments was recorded (3,6 billion US$). Overall foreign debt increased from 6,6 billion US$ at the end of 1975 to 18,9 billion US$ in 1980 and a debt-servicing ratio started rapidly increasing. Foreign debt continued to grow until 1982 to the amount of 21,1 billion US$ mainly due to short-term borrowing. Since the short-term position was not sustainable, Yugoslavia entered that year with an open foreign-liquidity crisis.

After the record balance of payments deficit in 1979, the Government declared that domestic consumption had to be radically curtailed, that exports of goods and services had to be increased and an active exchange rate policy be consequently pursued. The switch from a deficit to a surplus on the balance of payments had become the major goal of the economic policy.

In the following four consecutive years real wages decreased and by 1983 they were 25% below the 1979 level. Financing of investments was under tight scrutiny and a very sharp reduction on imports was introduced. As a result, the growth of GDP decreased and a negative rate was recorded in 1983. A surplus on the balance of payments appeared in this year however, the first one in nearly ten years.

Thus, the problems with the foreign sector were not solved. Deterioration in the overall economic activity diverted a rather considerable part of exports from the convertible to the clearing area while the debt-servicing ratio kept growing. The overall debt-servicing ratio attained 40% and in respect to the convertible exchange proceeds to even 60% in 1983. Problems in the external liquidity have produced at least two severe constraints:

(1) To the full capacity utilization and thus to the growth of GDP, and
(2) To the inflow of capital needed for financing the adjustments in the basic economic structure.

The stand-by arrangement with the IMF was therefore unavoidable, and it was signed in 1983. The next year, 1984, a 3-year agreement was signed with the IMF and with two groups of creditors, a consortium of commercial banks and a group of governments.

These arrangements substantially alleviated foreign liquidity constraints and the economy was on an upswing in 1984. Yet, this upswing produced a false impression that problems were solved and in 1986 the government's economic policy softened its grip over domestic consumption and monetary policy. Acceleration of inflation and the recurrence of foreign liquidity problems (the overall debt which had started to decrease was mounting again) forced the government to resort again to restrictive measures. An additional arrangement with the IMF was signed in 1988 and is still in force. Since 1983 foreign performances have steadily improved. The market-share of Yugoslavia's merchandise exports (which dropped from 0,33% in 1978 to 0,25% in 1981) in OECD countries has increased to 0,43% in 1987, and the market-share in the EZ countries has changed from 0,45% to 0,35% and 0,63% in the respective years (the OECD foreign trade state statistics). In 1988 and 1989, for which OECD data was not available, the overall export of

goods and services to the convertible area increased by 13% and 10% respectively. Consequently, the debt-servicing ratio started to improve and the burden of the foreign debt to diminish.

Due to these results, the Federal Government was getting high marks for its successful execution of austerity measures and for improvement in the foreign liquidity position from the IMF and OECD. However, since the opinion which prevailed in these institutions was that the external debt and liquidity problems were essentially caused by the mismanagement of demand, it seems that they have failed to realize that even after the demand had been put under control and after the balance of payments and foreign liquidity had improved, the basic problem of the socialist economy characterized by a large government sector and soft-budget constraint, still remains—the distorted basic economic structure. In a distorted and heavily paternalized economic structure, adjustments on the demand side do not necessarily result in adjustments on the supply side. Besides, if prices are not kept under tight control inflation may start accelerating. That happened in Yugoslavia. The annual rate of inflation increased from 89% in 1986 to nearly 200% in 1988 and 1.250% in 1989. Yet, acceleration of inflation did not prevent the introduction of convertibility. On the contrary, convertibility has opened the way to price stability. The fact that foreign exchange could have been bought in unlimited quantities at a fixed rate, the only constraint being disposable funds of domestic currency, has practically curtailed further escalation of inflation. At the same time it has become quite clear that the lasting price stability is closely linked to the hard budget constraint. That is something that socialist economies are not used to. However, faced with the need to adjust the basic economic structure in such a way that it becomes more efficient, it is an open question whether monetary expansion can be kept under control and whether convertibility can be sustained if inflation and consequent periodical adjustments in the exchange rate appear again. The question of how to finance and carry out the adjustment process in the basic economic structure is getting highly important. It seems, therefore, that international institutions, particularly the IMF and IBRD, should give equal consideration to the problems of financing adjustments in the basic economic structure, as to the restructuring of demand. Consequently, important questions arise with respect to the collection and distribution of funds needed for the financing of structural adjustment processes and how to condition the use of these funds. This is particularly important in light of the appearance of the world debt crisis, because the flow of capital has reversed and has left the indebted countries without funds to finance adjustments in the basic economic structure. Also, the rapidly increasing debt-servicing ratio has caused a weakening of overall economic performances and has radically reduced domestic savings.

Rescheduling of the Yugoslav foreign debt has become indispensable for keeping the economy running and for making improvements feasible in foreign trade performances. Even so, after rescheduling the debt repayments, the debt-servicing ratio remained high: in 1987 it was 29% (without rescheduling it would have amounted to 42%) and in 1988 and 1989 it only decreased to 24% and 20% (including rescheduling). It is estimated that if the export of goods and services increase by 10% in 1990, the rescheduled debt-servicing ratio may be reduced to roughly 15%.

The improved external liquidity position has opened the possibility of beginning to repurchase the foreign debt on the secondary financial markets, entering into debt-equity swaps and radically diminishing the position of short-term credits. The overall foreign debt thus has been reduced from 21,9 billion US$ in December 1978 to 17,9 billion US$ in September 1989.

Along with the existence of the foreign debt a rather considerable internal debt in foreign currency has also developed. Since the beginning of the 60s, Yugoslavian citizens were allowed to keep foreign exchange accounts with the banks. The sources of foreign exchange which were allowed to be kept in the bank accounts were limited to the workers' remittances and a few other less important sources, but never strictly controlled. Due to the considerable amount of workers' remittances and proceeds from the foreign tourists which have been increasing since the mid-60s, the foreign exchange saving accounts were rising and had reached 19 billion German Marks in 1982. In this year, due to the external liquidity problems, the government limited withdrawals from the foreign exchange saving accounts. In spite of the fact that this restriction

was lifted rather soon, foreign exchange savings with the banks in the subsequent years did not increase any more. As a matter of fact, the level of foreign exchange savings with the banks has remained unchanged, with some fluctuations, until now. But, since there were no external reasons which would influence workers' remittances and proceeds from tourism to diminish, one could speculate that considerable funds of foreign exchange have piled up in the mattresses at homes. At the time of accelerating inflation in 1988 and particularly in 1989, a wide currency substitution, though illegal, has taken place. When convertibility was proclaimed, the amounts of foreign exchange kept at home and planned to be used for purchases of goods and services, were diverted from the black market to the bank counters. It seems that sales and purchases of foreign exchange by private parties have been roughly balanced by now. Anyway, fears that foreign exchange reserves may get depleted after domestic currency is proclaimed convertible, turned out to be groundless.

Along with the introduction of austerity measures, in the early 80s, the political establishment in Yugoslavia started to reconsider the entire economic system. Basic parameters were defined in order to redesign the institutional framework in a way that it would be appropriate to the market conditions of operations. The result was—changes in the Constitution and promulgation of a set of laws covering issues important for the running of the economy. However, changes in the legal regulations of the foreign trade and foreign exchange system (including operations of the foreign exchange market) started much earlier.

The foreign exchange system, which was in operation at the time when the balance of payments and foreign liquidity crisis emerged, contained a provision that exporters were entitled to retain a certain portion of their foreign exchange proceeds in convertible currencies for their own needs. Such an arrangement appears attractive in planned economies when firms are acquiring certain independence as a stimulus to increase exports. In an economy which is burdened with a chronic propensity to overvalue its currency such an arrangement is a kind of reward for exporters and an incentive to continue to export. It is only natural that such a system opens the possibility that foreign exchange appears in commercial transactions not only between domestic and foreign residents but among domestic residents as well. This possibility was not so visible in Yugoslavia at the time prior to the balance of payments and external liquidity crisis. However, after 1980, due to this arrangement, the nature of the existing system gained new characteristics. The right to retain a portion of foreign exchange proceeds turned into the rule that the exports were the condition of imports. As the access to the foreign exchange became more difficult, particularly for non-exporters, the role of foreign currency in dealings among domestic residents in the formal sector increased. Various legal forms of such dealings existed, but as a rule they were on a bilateral basis. Therefore a multiplicity of equilibrium exchange-rates, with a wide range of effective rates, existed parallel to the official "market" exchange rates.

This foreign exchange system clearly illustrated the reality of the existence of two different markets: the official market to which exchange proceeds were surrendered at the official rate (used for repayment of government debts and for some other public needs) and the other market, non-transparent and unorganized at the time with numerous equilibrium exchange rates, which served various needs of the firms. One solution to improve the situation was to organize, in addition to the official market, a second market with a single equilibrium exchange rate. That would mean the existence of double exchange rates as a temporary and transitional solution. However, the idea which prevailed was to establish a limited foreign exchange market immediately with a single exchange rate for all transactions.

In December 1985 a set of new laws were passed regulating external economic relations. They proclaimed free trade as the general basis for the foreign trade and foreign exchange system, and convertibility as the ultimate goal of the new system. Particular attention was paid to the management of demand at the foreign exchange market.

All imports were to be carried out by the authorized firms in accordance with the balance of payments projection for the current year. To keep the demand for foreign exchange within the balance of payments projection, all imports were framed within certain import regimes:

(1) Free imports.
(2) Conditionally free imports.
(3) Quotas.
(4) Imports on a permanent basis.

The regime "conditionally free imports" was a remainder of the former system where imports were conditioned by exports. Initially only approximately 5% of total imports fell within the regime "free imports" and the rest were regulated by the more restrictive regimes. Roughly 45% of total imports were regulated within "quotas" and 45% under "conditionally free imports", while the rest were on the "permit" basis. Along with the improving foreign trade performances and increases in the foreign exchange reserves in 1988 and 1989, the regime "free imports" was encompassing an even greater part of the total imports and at the time of the proclamation of convertibility, around 85% of total imports were free. In August 1990 only 10% of imports were under control, mainly within the "quotas" regime.

Concerning the foreign exchange market, it has been conceived as an integrated whole consisting of three different levels of activity. First, it relates to all foreign exchange transactions between subjects belonging to non-bank sectors and authorized commercial banks. Second, it relates to transactions among authorized commercial banks, and third, to transactions between authorized commercial banks and the Central Bank. The transactions between the authorized commercial banks and the Central Bank take place through regular-interbank meetings which are held every working day.

Banks are obliged to sell the foreign exchange funds needed by the firms and other eligible persons for their legitimate external payments.

In order to keep the foreign exchange market operations under control, all authorized banks are obliged to submit their daily foreign exchange position to the Central Bank. These positions contain data on the working balances held by each authorized bank with their correspondent bank abroad. Each authorized bank is obliged to keep its foreign exchange position within the defined upper and lower levels. These levels are defined according to a formula developed by the Central Bank for each authorized bank. In addition to reporting their foreign exchange positions daily to the Central Bank, all authorized commercial banks must report the amounts of expected inflow payments and planned outflow payments. These reports constitute the basis for daily estimates of the commercial banks' new foreign exchange position.

The relationship between the expected inward and outward foreign exchange payments is such as to bring the foreign exchange position of a certain commercial bank below its lower limit, then such a bank is still allowed to buy the lacking foreign exchange funds (for legitimate orders of its customers) on the exchange market. If, on the other hand, the projection of expected inward and outward payments is such as to bring the position of a particular bank above its upper limit, then such a bank is obliged to sell the exceeding part of available foreign exchange funds to other banks. Finally, if the foreign exchange position of a particular bank remains between the lower and upper limits, the authorized bank is allowed to use all foreign exchange in excess of the minimal level for payments abroad according to the legitimate needs of its clients.

The key obligations of the Central Bank are: to monitor all transactions which pass through the market, to intervene with foreign exchange sales and purchases in order to maintain an equilibrium on the foreign market.

There has been no change in the method of operation of the foreign exchange market since the proclamation of convertibility of domestic currency. However, because the provisions which have accompanied the proclamation of convertibility have substantially liberalized conditions of engaging in foreign trade operations, the range of parties authorized to participate in the foreign exchange market has increased.

Table 1. Balance of payments of Yugoslavia (in millions of US $).

		1976	1979	1980	1981	1982	1983
I.	Receipts	9288	14526	18172	22281	19439	17033
	1. Exp. of merchandise	4878	6794	8978	10929	9914	10254
	2. Exp. of services	4025	7352	8794	10922	8748	6592
	3. Transfers	385	380	400	430	450	527
II.	Outlays	9123	18187	20463	23031	19903	16759
	1. Imp. of merchandise	7367	14019	15064	15757	13334	12154
	2. Imp. of services	1726	4128	5357	7224	6514	4545
	3. Transfers	30	40	42	50	55	60
III.	Current transactions	+165	-3661	-2291	-750	-464	+274
IV.	Net foreign debt	7018	14012	17347	19511	18547	18653
	of which: short-term	100	929	2050	2322	1817	1147

		1984	1985	1986	1987	1988	1989
I.	Receipts	17356	17726	19721	20451	22953	26499
	1. Exp. of merchandise	10254	10622	11084	11425	12779	13560
	2. Exp. of services	6502	6454	7922	8202	9271	11931
	3. Transfers	600	650	715	824	903	1008
II.	Outlays	16852	16893	18621	19203	20466	24072
	1. Imp. of merchandise	11993	12223	13096	12603	13329	15002
	2. Imp. of services	4794	4600	5450	6512	7048	8975
	3. Transfers	65	70	75	88	89	95
III.	Current transactions	+504	+833	+1100	+1248	+2487	+2427
IV.	Net foreign debt	18283	17935	18429	19549	16830	15214
	of which: short-term	1051	1015	1365	1300	1121	795

Source: Bulletin of the National Bank of Yugoslavia, No. 5-6/1980 and 9–10/1989.

Table 2. Main economic indicators (annual indices)

		1976	1977	1978	1979	1980	1981	1982
1.	GDP	103,9	108,0	106,9	107,0	102,3	101,5	100,5
2.	Employment[a]	103,5	104,5	104,6	104,3	103,3	100,9	102,3
3.	Consumers Prices	111,6	116,7	114,3	120,3	129,9	141,0	131,8
4.	Real wages Av	103,2	103,1	105,9	100,0	90,8	95,4	94,1

		1983	1984	1985	1986	1987	1988	1989
1.	GDP	99,0	101,9	100,5	103,5	99,0	98,4	-
2.	Employment[a]	101,9	102,1	102,5	103,1	102,2	100,2	100,0
3.	Consumers Prices	141,1	153,3	173,4	189,0	230,0	296,0	1060,1
4.	Real Wages Av	89,0	93,6	103,4	109,0	93,0	92,0	-

Source: Statistical Yearbook 1979, 1982, 1989, Federal Statistical Bureau, Belgrade

[a]Social sector

Stages Towards Convertibility in Romania

Paul Bran,
Advisor to the Prime Minister, Romania

Introduction

In the context of the transition to a real market economy, money is gradually acquiring the leading part in managing and influencing economic activity. Its functions must be reconsidered both theoretically, penetrating the core of all economic concepts, and in practice, monetary instruments being used, to the full, by macro- and microeconomic policy.

Currency's Function of Conveying Information

In an economy, currency—or, generally speaking, money—is fulfilling a complex function of communication between people, as economic agents, conveying information on the value and utility of various goods and services. On the other hand, the material part of money—the so-called monetary standard—helps to express the significance of value under the form of prices, and, on the other hand, money as a social token, preserves and conveys information in time and space, on the created and distributed economic value.

During all the phases of the communication process through money (or currencies), objective and subjective distortions may appear, altering the quality of economic information, of the monetary mechanism and money itself.

This possibility arises from the specific traits of every phase of the monetary communication process:

(1) Reflection of value
(2) Incorporating the meaning of economic value into money as a symbol
(3) Interpreting (or translating) the respective meaning (sense) by those utilizing money
(4) Regulation of the communication process by credit or by changing the monetary standard.

Any period of social and economic transition, especially in Romania today, is very rich in influences affecting the quality of the monetary communication process.

Changes in the Way of Interpreting the Role of Money

In East European countries, there is a clear necessity to accept the changing character of both economic value and of currency. This new vision of money, rather hard to achieve for those accustomed to fixed prices and a rigid monetary standard, is also leading to a change in economic behavior, implying quick decisions and risk sharing.

At the same time, it is necessary to understand and evaluate the role of money not only on the economic basis of its purchasing power, but also by taking into account multiple influences exerted by social, political, or even military factors.

The penetration of non-economic influences into the core of money is possible or even probable especially in periods of crisis, revolutionary transition or social unrest.

The Situation of Currency in Romania

The December Revolution in 1989 found the Romanian economy in a state full of contradictions. The expected positive effects of the clearing out of Romania's foreign debt were annihilated by the extremely grave state of the economy (obsolete products, technology and information) and of the entire social system (rigid structures, various and deep disequilibrium).

From a monetary point of view, money supply was relatively constant; people's savings were rather high representing about 10% of the social product.

In the first eight months of 1990, economic, social and political events had both an extensive and profound impact on currency circulation:

- The decrease of production and its quality, with ever increasing prices at the same time.
- Many strikes and other forms of social struggle with a view to obtain increases of wages and salaries
- Wage and salary increases accepted by Government and enterprise management in contradiction with the results of production.

In this situation, for example in July 1990, industrial production was only about 85% of its level recorded a year ago while the money supply was forced to increase because of a 4 billion lei rise in wages and salaries over the 1989 level.

Consequently, the present economic reform faces a currency worn-out by various types of inflation (first of all demand-pull and cost-push inflation). Money supply increased by about 15% compared to the end of 1989, while production decreased substantially. As a result, pressure on prices has been quite powerful.

Prerequisites of Implementing Monetary Reform

The first component of the monetary reform that has already been accomplished consisted in reorganizing the banking system. Since September 5, 1989, our National Bank has detached itself from crediting activity, becoming a bank of issue (similar to Western Central Banks).

The credit and discount operations have been taken over by a new bank, called the Romanian Commercial Bank. All the other banks become commercial banks and private or cooperative ones.

A second prerequisite consists in making healthier money circulation by increasing and diversifying the supply of goods and services (from houses and buildings to shares and bonds, plant and equipment).

At the same time, the money supply will be under more rigorous control by trying to achieve a closer correlation between the evolution of wages and salaries and the fulfillment of production norms and quotas (taken into account by future regulation of wages and salaries).

A third condition of monetary stability is the reform of prices by which new real dimensions of the monetary standard should be identified according to the laws of market economy. The prices will be gradually liberalized, in several stages and on different categories of products. In this respect the reform project is taking into consideration three main types of prices:

(1) Free prices for the goods supplied by at least three manufacturers.
(2) Controlled prices by Government for the goods manufactured in the branches of national economy with monopolistic or oligopolistic structure.
(3) Subsidized prices—by Government—for the goods which meet the basic needs of the population.

The above mentioned components of monetary reform will be accompanied by the gradual improvement of the leu/dollar exchange rate, based on several devaluations.

The Scenario of Transition to Convertibility

In the reform scenario, taken into account by the Government, convertibility of our national currency (leu) is to be carried out in several stages as follows:

- Changing the present 21 lei/$ rate in order to bring the official exchange rate as close as possible to the level of the free market rate.
- Strengthening the purchasing power and the exchange rate of the national currency by increasing production and limiting money supply.
- Liberalization of payments in lei and foreign exchange for non-residents (foreign tourists and investors), probably beginning in the first half of 1991.
- Setting up the legal framework for Romanian citizens to take abroad larger sums of lei.
- Passing from limited to general convertibility by liberalizing payments in lei and foreign exchange according to international practice (analogous to neighboring countries which already have convertible currencies, such as Yugoslavia), stage envisaged for 1992.

The fulfillment of this schedule will depend both on the evolution of our country's economic recovery and on the way in which Romania will benefit from monetary and financial assistance from the international and regional specialized institutions.

At the same time, the moment and the quality of reaching the target of convertibility depend on the way in which monetary and "real" factors interact.

Thus, the international experience gained by many countries, with different economic potentials, structures and development levels, proves the existence of complex, sometimes even contradictory, correlations between the exchange rate of convertible currencies and the evolution of balance of payments.

One may consider the following model reflecting the interdependence between convertibility of a certain currency and the situation of the balance of payments:

(1) The effective transition to convertibility is generally favored by the state of equilibrium in the balance of payments.
(2) In its turn, the devaluation (or depreciation) of the national currency contributes to obtaining a surplus in the payment balance which will provide foreign exchange reserves.
(3) This effect will last only if an increase in labor productivity and in the quality of the exported goods and services is achieved.
(4) If the expected action of the economic fundamental factors is missing or delayed, convertibility will lose its beneficial implications and will tend to bring about inflation and a decrease in foreign exchange reserves.

Conclusion

The measures envisaged in our Government's Program are favorable to the recovery of the Romanian currency and to the transition to convertibility. In the view of the Council for Reform, convertibility is both a means of stimulating economic agents to adapt themselves to the market economy's requirements and, in the longer run, a consequence of some favorable economic and monetary conditions.

Monetary, Economic and Social Union

Guido Peruzzo,
Permanent Representative of Germany at the Commission of the European Communities

Basic Elements

Introduction

The treaty concerning the creation of a Monetary, Economic and Social Union between the FRG and the GDR came into force on July 1, 1990. This treaty is *aiming* for the political unification of Germany. It is a kind of a guide to a social market economy for the GDR.

It creates a *homogeneous monetary area* on the territory of the FRG and the GDR with the DM as a common currency. Hereby the GDR resolves a strong and worldwide esteemed currency as a solid basis of a new economic state.

The treaty guarantees a secure legal basis for a social market economy in the GDR and hereby a *homogeneous economic system* in the two German States. The *essential principles* of the economic union are:

- Private ownership
- Rivalling system of performance
- Free Pricing
- Freedom of contracts, and
- Free movement of labor, capital, and services in the total monetary area.

The treaty guarantees the unity between the *Social Union* and the Monetary and Economic Union. It is characterized by a labor law system according to the social market economy and a comprehensive system of social security which is based on justice and equalization of social burdens.

Monetary Union

Regulations concerning the monetary Union are confined in Chapter II of the treaty. The prevailing principle is that *price stability* in the whole monetary area must be guaranteed. Competence and responsibility of the Deutsche Bundesbank covers the whole monetary area.
Modalities of Convertibility/Replacement:

1. 1:1 $\Longrightarrow$ wages, salaries, scholarships, rents, leases, pensions
   2:1 $\Longrightarrow$ other claims and commitments
   1:1 $\Longrightarrow$ persons who are living in the GDR:
   2.000,- $\longrightarrow$ 14 years
   4.000,- $\longrightarrow$ 59 years

6.000,- ⟶ more than 59 years
higher amounts ⟶ 2:1
3:1 ⟹ persons not living in the GDR

2. The treaty also contains regulations against abuses:
   obligatory use of banks, no cash or change
   application, no automatic exchange
   assets younger than 31.12.89 ⟶ 3:1

Economic Union

Chapter III of the treaty describes the shaping of the Economic Union. The GDR guarantees that all economic and financial *measures* taken are in *accordance* with the *social market economy. Prevailing principles* are:

- Stability of prices
- High employment rates
- Balanced external economic equilibrium and
- Self sustaining economic growth.

The GDR adopts and implements all economic laws of the FRG.
Further regulations concern some points of *structural adjustments*:

- External economic relations
- Companies
- Agriculture
- Environment.

The treaty itself does not regulate all necessary measures, but it describes the principles:

- Reliance on validity of contracts in external relations
- Restructuring of companies to new market conditions and
- Quick realization of an environment union.

Social Union

Chapter IV deals with the social union. Here again the FRG system is adopted by the GDR. Basic elements are:

- Freedom of association
- Works constitutive and collective agreements
- Co-determination
- Protection against termination of labor contracts (for the labor law system)
- Old age pension
- Sickness insurance schemes, accident insurance and unemployment insurance (for the social system).

There are temporary exemptions, subsidies to certain insurances or special grants to GDR citizens to eliminate additional burdens by the social union in the starting phase.

First Assessment (Success/Disappointment)

Political Development

On July 1, 1990—the date of coming into force of the treaty concerning the Monetary, Economic and Social Union,—nobody would have thought that a *German Unification Treaty* would come

into force only 3 months later, on October 3, 1990, the reunion-date of the GDR to the FRG. On that day all paralyzing uncertainties associated with the date of accession ended.

From 3 October, the *focal point of future activities* were: a quick set up of an effective administration in the territory of the GDR which is responsible for economic questions and problems. We must speed up bureaucracy to make available land property for industrial use. The GDR needs consultants for administrative problems.

Very important is a quick classification of open *ownership questions*. The principle must be: decision in favor of the investor! Only so can we create new jobs. Problems with ownership rights must not paralyze the reconstruction of the GDR. If there are any doubts left, the badly necessary availability of land property must be reached by ways and means of compensation.

Transition: Plan to Market

The transition from a planned to a market economy is not easy. The introduction of a *market economy at one stroke* is painful. But it is the shortest and most honest and sincere way to new economic perspectives and increasing welfare. Naturally, in the GDR nowadays very hard adjustment processes are going on. It is particularly difficult in industry and agriculture to survive under the new conditions of effectiveness and competition. In the *two treaties*—Monetary, Economic and Social Union and German Unification—we built enough *bridges* to bring the GDR economy on a secure way from the precipice of a planned economy to the safe shores of a market economy.

The Unification Treaty expands our *regional assistance* to the territory of the GDR. Industrial investments can be subsidized up to *23%*. To this amount a further *10%* can be added by investment subsidies without regional bias. To make it very clear: investment subsidies of 10% are not charged to the regional assistance (23% maximum) and are insofar additional investment incentives. Investments in the GDR territory are better promoted than on the traditional FRG territory on the border to the GDR or elsewhere in the FRG. Also investments in economic related municipalities or local *infrastructure* are promoted by grants up to 90% within our regional assistance scheme. And there will be a credit program for *municipal investments* in following the *areas*:

- Development of industrial areas
- Investment in environmental protection
- Energy saving/conservation
- Transport infrastructure
- Urban renewal
- Investments in hospitals

The program will mobilize a credit volume of approximately 10 billion DM. It will help the municipalities to bridge a time of low income. It will support the creation of infrastructure which is very important. During the last months lack of electricity, water or sewage or also transport and communications has prevented the creation of new industries. We must not forget that all municipal activities will promote the regional SME which have been recently created and which depend or orders. Last, but not least, we want to stop the decay of cities and municipalities in the GDR. That is why we are promoting renewal activities in this area.

Apart from the ownership problem the so-called *"inherited burdens"* are important investment barriers, namely the pollution of the environment and the indebtedness of many companies. As far as environment is concerned there are possibilities to be exempt from any liability for inherited burdens.

Many GDR-firms are indebted without any fault of their own only because of the official SED economic policy. These debts shall not impede capital investment of an external partner. Therefore the Unification Treaty allows partly or comprehensive debt release to restore competitiveness. The green light for the debt release only can be given by the so-called "Treuhandanstalt".

There is a *twofold economic task* on the territory of the GDR: to *build up SME* and to *make the industrial basis competitive*. The first is doing well due to assistance to new entrepreneurs. Already before the Economic Union there were 100,000; in July alone, 36,000 additional. Much more difficult is the reconstruction of old industries. State owned enterprises must be privatized as soon as possible. Those which are bankrupt must go into liquidation. To revamp market economy the most inherited burden of the SED-Regime must be abolished: the *intellectual burden*. Readiness to take responsibility and initiative have been suppressed for 40 years. Now they must be the engine for the up-swing in the GDR. We know that this is difficult for many of our compatriots and that it needs time. Still too many people expect too much from their government. On the other hand, the *start* of the GDR *into a market economy* was not bad. The replacement of the GDR-Mark by the DM did not encounter many problems. The DM is stronger than ever before. Though many subsidies have been abolished the cost of living in the GDR did not rise extremely. On the contrary: consumer prices in July were 5.5% lower than a year before.

Financial Aspects

Let me finally touch upon finance. Apart from all national efforts *partners from all over the world* are invited to *invest* in the *GDR* and create new jobs. A lot is already in the pipeline. Many negotiations are nearly finished or are submitted to the Treuhandanstalt for authorization. For example, our French friends have already started more than 60 investment projects. The GDR-market should not be left to German giants! In the interest of competition also *SME* must have the chance to settle down in the GDR. Here the Treuhandanstalt has an important task.

Regarding financial aspects the German *tax payer* is also asked. It was clear from the beginning that German Unification would not cost anything. But as Germany is booming there are additional tax revenues, so nobody has to pay more than before. On the other hand, it is justified to take additional credits to finance the German Unity. For us the German Unification is the most important investment in our history. Insofar it is justified to also make future tax payers pay for the Unity—this is the consequence of additional credits.

A last remark: we can *afford it!* The economic growth in the FRG will be $\approx 4\%$ this year. Our business community is able to invest in the GDR due to excellent profits. *Foreigners* are welcome and should come. Germany is a good location for investment and nobody can afford not to participate in the German reconstruction. Investments in Germany will have their effects in the EG and on Eastern European markets. And where else is there such a potential of good skilled and willing labor as in the GDR?

To conclude: the Monetary, Economic and Social Union was the beginning. German Unity on October 3, 1990 is not the end. A market economy on the territory of the GDR is the aim. We shall reach it!

Session II

Reorganization of the Credit and Monetary System and the Capital Market

Convertibility of the Bulgarian Lev: Economic and Institutional Preparation for Convertibility

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Convertibility is a market relation. It would be a delusion, at least in our country, to expect that convertibility could be reached out of the context of introducing market relations in the national economy. A rather strong economy, with high quality products and advanced technologies, having therefore good opportunities for exports, or an economy which is extremely rich in valuable resources (as is the case of the oil countries) can introduce convertibility applying a centralized, administrative approach. Then the state is able to fulfill the demands of the population and the companies for hard currency. On the other hand, if the population is extremely poor and backward (the case of feudalism), then again the problems would not be quite severe. It is a different matter whether it is at all possible to reach a good level of international competitiveness if market relations are absent. However, in the case of a poor country with a relatively small export to the global (and not to the "socialist") market, in which the internal financial market is not developed and where money constantly lowers its value, it is practically impossible to introduce any form of convertibility whatsoever, except in such a way which will affect quite negatively the interest of the population and of the companies. The only thing Bulgaria could do at the moment is to introduce a market economy and market relations. Is it possible to introduce a free market for currency only, in the absence of other markets (for products, capital and labor)? If the market is left to operate only within this field, it could lead to a certain balance between supply and demand. However, the exchange rate obtained in this way, will certainly be considerably higher for foreign currencies. For these reasons the following assumption seems reasonable: the way to convertibility is via market relations, and the speed of their introduction will determine the rates at which we will be moving towards convertibility. If market relations are dominant, i.e., if the share of these relations exceeds some "critical point", then we could start to introduce some measures aiming at convertibility. The problem, however, can be posed also in a slightly different way. The question could be: Is it possible to obtain convertibility before market relations have become dominant? Here is an answer which I offer for discussion: Not before they have started to dominate, but maybe at the moment when they start to be dominating (the Polish case).

If we start from the assumption that convertibility is a part of the market, then all basic and indispensable elements of the market reform are also indispensable conditions for the introduction of convertibility. Examples are the changes in the forms of ownership, the abolishment of monopolies, agrarian reform, reforms in the tax policy, in the budgetary policy, in the system of pricing, in the labor market, and of course, in the monetary system. Because convertibility is a characteristic of money, the main attention should be directed to the creation of a money market—a real market of money and capital, to the functional and institutional changes, etc. However, this does not mean at all that this can be accomplished without some of the other

basic elements of market reform. The exclusion of even one of them would mean a failure of the whole reform. This also refers to an eventual decision to postpone some of these reforms. In Bulgaria the situation became worse by the following circumstances: first, the deep economic crisis of our economy which requires urgent anti-crisis steps; second, the external debt of the country which lead to suspension of our payment (until recently some people used to declare that we are still first class debtors!); and third, the deteriorating conditions with CMEA.

In this difficult situation our strong points are: first, the democratic changes in the country which open opportunities for taking the road to a market economy; second, the fact that we are a small country; and third, the fact that we do not have galloping inflation yet, and it will not come unless stimulated by the government. Probably there is one more advantage—the opportunity to learn from the experience of other countries—Hungary, Poland, Yugoslavia and thus avoiding negative developments.

The market economy is an organic unity of commodity markets (including those of the means of production which are distributed at the moment in a centralized way), capital markets (of capitals and money) and labor markets.

The principle of equality and equal treatment of all forms of ownership requires that the incomes from capital should by all means be considered rightful, i.e., that the owner of capital should have the right to obtain from his capital such an income that will create his interest to save, in order to be able to reproduce and extend his capital and the assets of the business unit. At the moment this is not allowed by the dominating economic system. In reality not a single form of ownership, not even state ownership allows the formation of income from capital. In this context the declaration about the equality and equal treatment of the various forms of ownership is meaningless because in practice it means that all other forms of ownership will be treated in the same way as state property, and the latter does not create for his owner—the state—any income from capital. In this situation cooperative and private property cannot develop. This means that in the transition period to a market economy, it will be necessary to have preferential treatment for private property which is the basis on which the other forms—cooperative, joint stock, institutional, mixed, etc.,—are formed. On this basis it is possible to create various economic interests in the market agents, and these interests are the essence of market relations.

Another important aspect in the formation of a market and market relations is the assumption that the labor force is a commodity—an assumption which requires social recognition. If the commodity character of the labor force is acknowledged, all discussions about the character of the social system—whether it is capitalism, socialism, etc., becomes meaningless, and many phenomena become their explanation. The recognition of this fact would lead to a general denial of the illusion that the wage is a resultative value, i.e., that the workers should be held financially responsible for the competence of the business manager. The worker must receive payment corresponding to his particular abilities and skills, the price should be paid by the management, and ultimately by the owner. This assumes also the abolition of the thesis of the workers' self-management as it is not in keeping with the market principles and is rather populistic. The interest of the worker is directed to the current, immediate payment, and not to the economic consolidation of the business unit, improvement of its competitive positions on the market, investment and reproduction. This does not exclude the possibility for a real participation of the workers in the ownership in their capacity of rightful owners.

Convertibility is a characteristic of the money, and money is present in all markets. Money is the one side of the commodity market (including the market for services) and the labor market, and it is the two sides of the monetary and capital markets. Therefore, in defining the necessary conditions and changes in the different fields, we shall give special attention to the role of money. The starting point here is the understanding that it is possible to have convertibility only on condition that there is sufficient confidence in the national monetary unit. And this confidence must be not so much quantitative, but mainly qualitative. In other words, confidence must come not so much from the quantity of our money as from the quality. I will come back to this idea

later. When we speak of inflation, or even the rate of inflation, or inflation growth, we think of quantitative differences and quantitative relations. However, when talking about monetization or demonetization of our economy, we have in mind a new quality, i.e., that in our country, for a variety of reasons, it is possible to buy fewer things for money—products, services, land, capital, labor force—than for foreign currency, hard currency in particular. Here it is necessary to accept, as a general principle, the need for monetization of the economy, or—to put it in other words—the need to increase the power of money, however vulgar this may sound. The greater this power is and the higher the level of monetization, i.e., the monetary economy is well developed—something of critical importance for our country from the point of view regarding the stage of development in which we are: the quicker the monetization is, and the more field it covers, the easier it will be to fight the inflation and the number of safety valves accessible for application will increase.

To sum up, market reform creates important conditions for the introduction of convertibility in two ways: first, qualitative conditions—monetization of the economy, increased power of money, extended domain in which they operate, i.e., the economic logic replaces the command relations. Second, quantitative conditions connected with the increased confidence in the national currency. In the first place these are the steps connected with the reduction of the free money, the so-called "wandering-money": the savings of the population and the free money available which account for more than 27 billion leva. What share of this are company assets is not clear. Let us hope that the bank will at last publish information and will thus stop acting as an obstacle to economic studies. From these two aspects it is possible to analyze the separate necessary elements of the forthcoming economic reform.

The Reform in Relation to Property

The reform will have a strong influence on both sides of the relations in question. The accent on the transformation of the state property, on the privatization and enhancement of the private property serves in the first place as a powerful tool for attracting the savings of the population and directing them to business activities. In this field the state is not poor at all. On the contrary—it is extremely rich, having practically almost all the property, including the municipal one, in its hands. This is a very large reserve for sales, and it will not be exhausted in the next decade or so.

It would be most efficient in the second aspect, the qualitative one, to start immediately with the sale of small property: shops, restaurants, small hotels and other facilities in the service sector, work shops, machines, etc. The people will be inclined to buy such property because they can easily work out what profit they could expect. At this stage they will be more inclined to buy a shop than to enter a partnership for the purchase of a chain of shops through stocks. It is in this direction that the fear, constantly instilled by the governmental economists, from an uncontrolled future inflation operates. The people are afraid for their money and would readily invest immediately, and in large amounts in physical property.

The privatization of large firms will act in the same direction. However, its full force should be expected at a later stage of the reform.

In both cases the following principle is valid: the more money the buyer pays in cash, the better for the economy. It is important to understand that the state or the municipality does not loose anything from this sale. There are groundless fears about eventual sales at a knock out price, or about the lack of a methodology for the evaluation of the assets liable for sales. If there is real competition between the potential buyers, the price will be realistic.

The same effect should be expected from an eventual sale of state-owned land to private farmers (for example, the lands of the former state farms which were formed on patches of really nationalized land).

In order to realize the principle of increasing the confidence in our national currency, it is very important to see what will be done with the money obtained from the sales. The best

thing would be to consider this money as a debt of the state to the population, and to put an end to the question by invalidation of the money after the debt is paid. In this way the debt of the state to the population, the deterred consumption, will really disappear. On the contrary, if the state accepts the assumption that this money, should be used for other purposes, i.e., should be reinvested, this will act against the principle of increased confidence in the lev. A compromise could be reached in this case: for example, a part of these incomes, but only a rather small part—not more than 20%—could be used for purposes directly related to privatization: for development of infrastructure, etc.

Is there any danger that the process of privatization could become a new source of inflation, i.e., that it could start to act in the opposite direction? Certainly there is, and it consists of the following: if the approach to privatization that will be chosen relies on allowing bank credits to the buyers and they use them in order to buy out the state property. Of course it is very important here what scheme will be applied for refinancing of the credit banks, but in any case the money obtained by the state will be a source of inflation. Therefore such schemes have to be avoided. When they are really necessary, then crediting should not be directly done by the banks, but by the governmental (municipal) institution that sells the property—i.e., it agrees that the property will be paid in installments within a certain period of time. The money obtained from privatization must be treated correspondingly, i.e., the major part of it has to be cancelled. Now we have production facilities whose value may exceed 100 billion leva—or 50–60 billion leva, to be more realistic. The inflation potential created from the saving of personal money—27 billion leva—is about half of this amount, i.e., it is 12–13 billion leva. This means that with the privatization of only a small part of the common property in the country this inflation potential could be considerably reduced. This is a very important condition for increasing confidence in the lev through the creation of a more normal ratio between goods and money. The other alternatives—the deliberate inflation aiming at devaluation of savings, or a money reform will create so many additional problems that it will hardly be possible to implement a market reform.

From this point of view with respect to quality, privatization is one extremely necessary step. First of all it enlarges the sphere in which money operates, i.e., the monetization of the economy increases through the extension of the markets, and the means of production become a part of the market. And not only that but they go to the market still having a considerably more realistic and normal value than they have had so far. Because the private interest will eliminate the arbitrary pricing. This refers both to the means of production and to the circulating assets.

The reduction of the scope of the present purchasing practices and of the centralization investment process will actively assist for the monetization of the economy.

Reform of the Tax System and the Budget

The fundamental transformation of the tax system and the budget is necessary for the correct functioning of the whole economy on the basis of the market principle both from the point of view of the population, and from the point of view of the companies, but also from the point of view of the role of the state. At the moment the state redistributes through the budget already more than 90% (according to the 1990 plan) of the national income. Even if all subsidies are reduced, the part that is redistributed remains very high—about 67% of the national income. Clearly, with such a strong interference on the part of the state no market reform could be implemented. In Poland for example the part that is redistributed this year was cut down to 30% of the GNP, which means approximately 45–50% of the national income. In order to finance these tremendous expenses the state has to collect money, and it does this from all possible sources, even from sources that the state knows it should not touch. The major part of the budgetary incomes of the state come from the taxes levied on the production units, and a considerably lower part, less than 10%, come from personal income taxes. In practice this means that the enterprises cannot realize their independence with the taxes so high. All kinds of taxes are levied

and money is extracted from them in various ways: through income tax, prices, the system of profit distribution, credits, and deposits. But any taxation acts anti-productively and has no stimulating effect. When this principle is applied, even the principle of equality of the kinds of property does not work, as the property, or the capital does not create income, and without income the property cannot preserve itself, nor can it reproduce and enlarge. The economic stimuli move back, leaving space for the administrative ones. This is the general picture.

For the state in particular the budgetary system is characterized by a constant deficit. The budget deficit as such has not been accounted for many years, i.e., the people have been deceived deliberately in order to draw their attention away from this serious problem. The internal debt accumulated at the moment is a problem whose solution is impossible until the present forms of relations with the National Bank and other financial institutions are preserved. What is dangerous is not the dimension of the internal debt, but the approach to its coverage. Now according to official information from the Ministry of Finance the internal debt is about 15.5 billion leva. However, this is not its real size. It is necessary to add to it the irrevocable credits—about 8 billion leva, and also the potential future obligations of the Ministry of Finance to the Foreign Trade Bank which will emerge because of the difference in the exchange rates. How big will they be? It depends on the system of defining the exchange rate that will be applied in the next few years. If we assume that the exchange rate is fixed at about 8 leva per dollar, this will mean that the budget has to cover the differences of 7 leva to the Foreign Trade Bank for each dollar paid. And every year the budget has to transfer to the bank the amount of 6.5 billion leva for interest amounting to 800 million leva. Where will it find this money? At the moment there is no reasonable answer to this question. The sum becomes terrible, but there is no way out. The practice applied so far for financing the deficit is definitely inflationary, this is an important factor which creates inflation, and unless it is changed, the nature of this influence will be preserved, and this will act against the eventual introduction of convertibility in any form. Furthermore, the accumulated internal debt will continue to act inflationary. It is in this sense that we must consider the possibility for cancellation of the money obtained from privatization. No matter if a balanced budget could be reached within one or two years, the "sins" from the past will always be a potential for inflation.

Of course the main problem of the budget is not only the deficit, but mainly the amount of the income centralized by the state. This amount cannot be easily reduced, but the main barrier here are the expenditures that have to be financed from it. Their sharp reduction will have extremely negative consequences for the national economy. It is also necessary to take into consideration the heavy social problems which this process will create—the least will be the unemployment of a part of the civil servants. There are also the subsidies, premiums, etc., of any kind.

What must be done to the budget system, in order to prepare it for the introduction of convertibility? A number of steps must be undertaken: reducing expenditures, and extracting a number of activities from the budget; eliminating the direct financing of the deficit and the whole debt from the monetary system. The only way out here, apart from privatization, are the state bonds, not only to cover the current deficit, but also to reduce a part of the accumulated debt. This debt, because of the strange conditions in which it has been financed, is constantly creating a great potential for irresponsibility and bad economic management in the whole national economy, as money which is borrowed without interest or at a very low interest, never creates a stimulus for the person who is using it for investment. In this sense the accumulated debt acts in a direction, opposite to convertibility both in terms of quantity and in terms of quality. This refers even more to the debts covered on an anti-economic basis—debts without interest, irrevocable credits and strange methods of covering differences by means of the difference in the exchange rates. Furthermore, it is necessary to make a fundamental reform in the tax system—this will have more qualitative consequences as only this can give real freedom to the market forces. Of course we must avoid the illusion that a tax system can exist that could painlessly finance a budget equal to 90% of the national income and do this in a market environment. This must be understood

as soon as possible by those who wish to make such a reform, or rather who pretend to think about such a reform. The reduction of the taxes levied on the companies is a qualitative step, as it allows the realization of their independence irrespective of the form of ownership, i.e., it allows them to operate on a market. This, however, has also a quantitative side—it allows a reduction of the inflationary pressure, because in such a situation, in which a number of firms are practically monopolies on the market, a liberalization in prices will allow them to pass the tax burden onto their counterparts and ultimately onto the consumers, i.e., this will lead to a growth of inflation as a result only of the irrational tax system.

The tax reform must be directed to reducing the tax burden for firms to a rather acceptable level, the introduction of VAT and a general progressive taxation of the population by signing a tax declaration. In order to observe the principle of equality of the forms of ownership, it is necessary both for the state-owned and for the private firms to apply the same rules for the realization of incomes and reinvestment. To do that, it is necessary to fix a maximum limit of tax on personal incomes which should be in line with the taxation of the companies that are legal persons. What can be expected from such a reform? The effect is a transfer of the tax burden from the firm to the population, as VAT will not only replace the present turnover tax, but it will also take over a part of the burden coming from the taxation of profits; but the main burden will fall on the consumers as ultimate taxpayers.

Reform in the Financial System

The changes in the financial system are closely related to convertibility and this is, for understandable reasons, because convertibility is a quality of money. This does not mean, however, that the changes in this sphere are sufficient for the introduction of convertibility. They have to be considered only as a part, an important part of the formation of the market.

The existing system is rather underdeveloped compared to global standards. There is no other sphere in our economy in which the underdevelopment is so great and clear—not even labor productivity. Here the most important unsolved (or insufficiently solved) problems are the distribution of functions in the banking system and in its relations with the enterprises, the companies and the population, the structure of the banking system itself, the payment mechanism, the relations with the world, the interest rates, the information, etc.

The most serious problem at the moment is the *elimination of the administrative functions* of our banking system. There are no other countries where the banking system performs such functions. This is a quality typical for a system which is moving away, and the longer it stays the more we shall delay the introduction of convertibility. The latter is incompatible with administration on the part of the banks. The present total control by means of the lev presumes a total control on all transactions related to the circulation of money. The bank is now using its privilege to be the only channel for money circulation and not only controls but also decides whether a certain transaction should be made or not. This means that not the company management, but the bank decides what is right and what is not. The banks do not give services, they make decisions and manage, sometimes against the interest of the companies and those of the state, or rather in the interest of the apparatus. The whole process is performed on the level of the low-level bank officials, so the consequences from this "Service" are clear. Instead of being a real partner of the firms as they are in the developed market economies, the banks have become additional administrative units which prevent the companies from taking decisions. Because of this "total control through the lev" the bank bars the monetization of the economy—the funds of the enterprise do not have "internal convertibility", i.e., one lev in one fund is not equal to one lev kept in another fund. In practice the firms cannot dispose of their funds as they wish. Instead of directing its attention to whether a certain payment is consistent with the laws or not, the bank gives an opinion about whether it should be made. This is facilitated by the numerous rules and regulations issued.

Another serious problem is the *slow payment procedures*. Often a payment between two firms takes 15–20 days. The main reason is the accepted form of payment, though here the problems concern money and with money all delays should be paid by somebody. What is funny is that it is the banks that cause the delays. Recently the process began to become still more complicated. With the creation of the system of 70 independent banks the technical difficulties increased. Besides, the trend is not towards the building up of a system of commercial banks with branches in the country.

In the field of *servicing of the population* the problems are not less serious. In most countries the population is the main source of savings. The situation in our country is similar, but the savings are not normal savings. To a large extent they are forced savings, and therefore are a measure of what is called deferred consumption.

From the approximately 20 billion leva accumulated in the State Bank, the population is using about 4 billion leva in the form of various credits (the figures are not exact due to the lack of relevant information). As a rule, all these 20 billion bear an interest of 1%. The interest on the credits given to the population is about 3% (the loans for housing) reaching up to 7% (on the loans for consumption). This is a system introduced in 1974. It was a decision of the Council of Ministers and the interest rate has not changed since. A new project is expected in the near future. Worth mentioning are also more than 1 billion leva installments for the purchase of cars which are kept separately in the State Savings Bank (SSB). The excessive 16 billion in the SSB are oriented along one single channel—they are allowed as a loan to the National Bank of Bulgaria with 2% interest. Thus the profit obtained goes to the state budget. There it is considered a secure and pre-planned income. The low rate makes an inefficient usage possible of these credit resources of the National Bank of Bulgaria. One part of it, in a way which is considered quite natural by all our pseudo-experts, goes directly to financing the deficit in the state budget. Even for many years this financing was calculated in the income part of the budget. In the practice of the developed countries the direct financing of the deficit through the Central Bank is always considered to be generating inflation. Characteristic for the way of thinking of our pseudo-experts on all levels, including those in the highest positions, is the assumption applied in the current law of the budget, that in order to limit the so-called "credit resource", it is best if the excessive money in the National Bank of Bulgaria is used for directly financing the deficit in the state budget! What is more tragic, however, is that these people really mean this! Such an interest significantly harms the basic economic interest of the population and is unacceptable in a market economy.

Of a similar nature is the *policy regarding the companies*. On the one hand, they are oppressed by the total control through the lev, and on the other hand by means of the negative credit policy. The interest is considered first of all as a means for retaining some income for the bank and for passing it through the banks to the budget. It is almost a rule that the company money in our banking system do not bear an interest higher than 1%. Very few are those accountants who are able to open deposits where the interests are higher. The companies cannot keep their money anywhere else. A monopoly position exists, also used by the banking system, and through it by the budget, for exerting tremendous profits. In accordance with this is also the assumption in the Law of the budget for the taxation of profits of companies with 80%! The companies have no interest in keeping money and therefore it is natural that instead of money (which does not bear interest) they prefer to keep large quantities of materials and products, mostly raw materials, which naturally creates a shortage of these materials. While in the developed countries the ratio between the interest received by the companies for their money in the banks and the interest paid with them is about 1:2 or 1:3, in Bulgaria it is 1:50 or even 1:100. This is an abnormal situation—the money does not belong to the state, it is created to serve all agents.

The low interest, the few opportunities for receiving interest at all, including the taxation of interest payments are some of the reasons for the demonetization of our economy, for keeping over-stocks, for the unfinished constructions, for the slow rates on the introduction of new production facilities—in a word, for what is called an anti-economical approach. At the same

time it is also the reason for the lack of economic thinking. This two-way relationship is extremely important because it reproduces itself on all levels.

The interest structure applied in our country, which is a direct consequence of the already rejected but still firmly applied approach from the past, is unprofitable for all agents—both for the population and for the companies. The fact that the interest rate does not secure a minimum return on the money in the banks, in order to compensate the inflation, brings about the direct depreciation of the money. Apart from everything else, this does not help us to solve the other problems of our financial system—for example the reconstruction of the social security activities by basing it on the principle of accumulating funds. It is particularly important for the firms to have various opportunities for keeping money in the banks in various forms—as time deposits, cheque deposits, etc., as they stimulate them to dispose quickly of the finished products, to reduce the stocks, etc. In the developed countries the money available to the companies bears interest even if they are just kept for one single day. In their bank accounts they only keep the money they need for payment during the day and nothing else—the remainder is transferred to those deposits that acquire interest.

For the solution of these serious problems it is necessary to solve the problem of the *redistribution of functions within our banking system.*

The National Bank of Bulgaria must undertake the functions of a pure emission bank, similar to the central banks in the developed countries. It must not serve as a main channel through which the money passes, some of it remaining on the bottom in order to assist the budget. It is also necessary to eliminate the monopoly of the State Savings Bank on the mobilization of personal savings. The servicing of firms and of the population must be taken entirely by the commercial banks and of course by some other specialized financial institutions. The National Bank of Bulgaria must not perform similar functions. The State Savings Bank will thus find itself in competition and will have to increase the interest rates in order to be competitive. This will eliminate the unnecessary segmentation of the financial market—for the firms and for the population.

What should the *National Bank of Bulgaria do?* First of all it must be separated from the Government and from the Party, to which it has been subordinated so long. Even with the amendments in the Constitution this is already a fact. It has to depolitize itself—its President must perform his functions without being connected with any of the political forces. He has to be a person whom the people trust. This is not a formal requirement. The NBB has to undertake its basic function—to fight inflation, even if it will have to constantly oppose the opinion of the Ministry of Finance and even of the Council of Ministers. Its policy, which should by all means be announced in advance, must be something that everybody will have to take into account—this refers to the Government, the syndicates, the companies, etc. The struggle against inflation is fought through the regulation of the money emission and through this the volume of the loans, but only with economic tools, and not through decisions, rules, letters, and other forms of administrative management. The global practice during the last decade and also earlier shows that only through income regulation (regulation of wages in our case) it is impossible to harness the inflation. The solution has to be sought somewhere else—through the direct control of the quantity of money by means of the specific tools that are available for the central banks—the discount rate which corresponds to the reinvestment of the commercial banks in our country by the basic rate—not only marginal reinvestment; the Federal Reserve System, and the most popular tool—the transactions in the open market. The latter is at the moment not possible, as we have not yet the necessary conditions—the bonds and securities are just appearing. The participation of the NBB in the new banks with its capital is not a means for flexible management and influence on our banking system. The most important channel for cutting down the inflation tendencies (if we exclude the direct production of money) is to cut the channels for direct financing of the budget on the part of the National Bank. What can the budget do in this situation—if needed it could issue bonds and sell them at such an interest which will secure real buyers. Finally, it could turn to the commercial banks for loans, but based

on the market principle. The National Bank may participate in this process only for a short time—in order to fulfill the temporary needs of the budget, since the other approaches require more time.

The NBB can really exercise a very strong influence on the national economy. Indeed, in the last couple of years there was a certain movement of the center of central state regulation by the Government to the direction of the Central Bank (in the developed countries). This influence, however, is achieved only with economic means—through the interest rates, the exchange rate and the access to capital. What is most important, however, is to exclude any opportunity for the appearance of unexpected rules, decisions, etc. In order to avoid this, all functions and activities of the banking and financial institutions, including those of the National Bank, should be defined in the law. The laws must be adopted after extensive discussions, taking into account the interests of everybody, if these laws have to work, and not wait for amendments which are made so often nowadays. They must be considered by the companies and by the saving public. As a first step in the elimination of the "information blackening" in this field is to announce all figures and other information regarding the activities of our banking system and to appoint new heads of the National Bank of Bulgaria and the Bulgarian Foreign Trade Bank, who should be persons not involved in political life, however painful this may be. The banks are the last place where political activities should develop.

The creation and maintenance of speedy, efficient and flexible banking procedures is also within the competence of the NBB. It is necessary to overcome as soon as possible and to reject the accepted form of payments, to introduce the cheque form with a perspective for a real future computerization (and not pseudo-computerization as we have now) of the banking process, similar to the practice in the developed countries. The creation of a multi-banking system also requires the introduction of clearing payments among the banks. This is not an easy task for our banking system but it is a necessary one. The separation of our banking practice from the global tendencies is getting bigger and bigger.

An advanced banking system is really an achievement of global civilization, and if we artificially avoid such a system, this will be at the expense of the people. The key place in such a system is occupied by the commercial banks. They are those who have to entirely undertake the servicing of the population and of the companies. Last year there was a very wrong tendency to create as many commercial banks as possible, and this in parallel with the existing structures (the local branches of the national bank). For our country this is not necessary, it is even harmful. This will slow down the process of creation of a real money market considerably. For our scales it will be enough to have 15–20 commercial banks, and even this figure is too high. They have to be universal banks, with the right to accept deposits and to make payments, to trade in securities and currencies (the latter should probably be done only by some of them). It is very important for these banks to have a network of branches all over the country. We must not be afraid that a part of these banks will have 20, 25 or 30 branches. If they have these branches, they will really be able to do their job well. Internal competition among the banks is acceptable only if they are strong, well capitalized and proposing a wide range of services, and of course if they have good relations with the international markets. The current laws set requirements too low for capital that a bank must have (7 million leva). There is nothing worse than weak commercial banks (this includes insufficiently qualified personnel), poorly capitalized (i.e., ready to go bankrupt) and not possessing a good network of branches in the country. Such banks would be unable to act, some of them will yield to the influence of the companies they service, and there are still totalitarian structures—of people and institutions who have nothing to do with banking. Such banks would be in difficulties when they want to act on the market principle, they will slow down the payments and will be dependent on each other. What is to be done in order to move from the present system to the desired one? The answer is not easy, but we must look for it. One year ago things were easier, but the creation of many formally independent commercial banks will prolong the process. The goal should be to turn the commercial

banks into an assistant, a partner and a consultant of the firms, and not as their controller and administrator.

The main problem of the new system is the creation of an inter-bank money market, the NBB being excluded from its role of mediator in the movement of the main financial flows which it plays now. The NBB has to finance our banking system only marginally, interfering in this way and through its intervention also on the dimension of the interest rate and on the income curve. It is not enough to give commercial banks the right to accept deposits from the population or to allow credits. A long time ahead the State Savings Bank will have a priority in this field mainly due to its developed system all over the country—particularly if it has offices in all towns. Therefore it is more important to create a link between the SSB and the commercial banks, with the interest in their credit relations being formed on a competitive basis. Only in this way, and not purely administratively, as some people are trying to do, will it be possible to raise the interest rates of the deposits to an acceptable level. If the interests on the deposits for houses have to be kept low, this has to be done at the expense of the funds centralized in the budget. The main thing here is to allow free formation of the interest rates on the interbank short-term deposits, which must be able to fluctuate quickly according to the changing conditions of the capital market, and all other interest rates of the banks will adapt to it. This rate gives the margin for the deposit rates and the minimum for the rates on the bank loans with regard to the clients of the banking system. The competition between the banks must make the banking services cheaper and more efficient.

In this direction it is necessary to act for the creation of a market of securities in the country. First of all it will be necessary to create the securities. Here too, we are very much behind the others. We must not believe in the illusion that only with the effort of the legislation the problems will be solved automatically. For example, some people want to have a law of the stock exchange at any price. This law can wait. It is more important to move along the path we have chosen. The state and the companies must really issue securities, and not talk about them.

The development of a relevant financial sphere in our country will be a condition for the success of our general market reform. However, convertibility will not be reached only through the financial system. It is the most important element which is indispensable if we want a price reform and free price formation. A commodity market cannot exist, nor can there be market prices, unless there is a rather well developed financial sphere.

There is, however, a very essential point here. What is more tragic and is symptomatic of the period we are in, is that even an elementary financial culture is absent, especially on the highest level—the level of the decision-makers. This explains the majority of the accumulated problems. The lack of this knowledge is also present in those who are employed in the system, who are obliged to do everything possible in order to prevent the mistakes of those who make the decisions for them. This very specific culture is an exception, but not a rule. Contrary to the other spheres, in this field it is possible within a short time to make a rather good advance. All our western partners express a strong wish to assist us with training which will be free for us, in the construction of a fiscal and banking system that will be suitable to our conditions and in the provision of the information infrastructure. There are really good opportunities which we could use, if we wish.

Japanese Economic Development and Policy Framework: An Experience in the Reconstruction and High-Growth Period

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From the postwar II reconstruction period to the 1960s the Japanese economy achieved an average annual growth rate of over 10% which was high not only in comparison to other countries, but historically for Japan as well. It was during this period that the foundation was set for the country to become an economic giant. Inasmuch as some of the most characteristic economic mechanisms of the current Japanese system trace their roots to that period, an understanding of it is therefore indispensable to an understanding of the Japanese economy as it stands today.

This paper outlines how postwar reconstruction was accomplished, and provides an analysis of the mechanisms of the high growth period as they began to surface in the 1960s.

Postwar Reconstruction

The Second World War (the Pacific War) ended for Japan in 1945. The loser in the struggle, the economic toll on the country was enormous. Fully one quarter of all Japanese assets in terms of fixed capital and facilities had disappeared, and eighty percent of its ships had been lost. It was by no means an easy task to live in a country with as little land as Japan and a population of 72 million to feed, and this was no doubt obvious to everybody. Expanded military expenditure during the final periods of the war had caused rampant inflation, and the lack of foreign currency coming in severely limited trade, which in turn resulted in extreme shortages of materials. The desperate state of the economy at the time can be seen clearly from the indexes shown in Table 1.

Table 1. The Japanese Economy before and after the Second World War

	1934-36	1946	1949
Real GNP (*Yen* 1 Trillion)	12.7	7.8	10.4
Private Consumption	7.2	4.5	6.2
GNP Deflator	1.0	45.7	236.1
Private Savings Rate (%)	10.2	- 3.4	- 8.3

Source: National Income Statistics, etc.

Japan's postwar economic reconstruction, then, got off to a miserable start. In spite of this, the period saw many important policies put into effect.

Agricultural Reform. Agricultural reforms brought an end to share-cropping and boosted agricultural incomes. Farmers had more of a desire to raise crops, which caused their productivity to increase (it should be noted, however, that the appearance of a poor, landed peasant class lowered the average cultivable acreage per head, which is one of the reasons Japanese farmers are so inefficient today).

Dismantling the Zaibatsu: Decentralization. Industry was decentralized, with spin-off and newly created corporations bringing about stiffer competition. The heads of zaibatsu-affiliated companies were replaced, and the foundation was laid for more democratic management styles. Opening up of shares for public trading helped democratize ownership, and created the base for today's financial markets.

Employment of Graded Production. Graded production was a policy enacted to deal with the shortage of raw materials and funds that had been caused by severely limited trading. These resources were allocated en masse to industries that were most "important" from a national standpoint. This, in practice, meant that bank loans were concentrated in steel, electric power, chemicals and other industries that formed the basis for industrial development. These sectors were also given favored tax treatment and enjoyed various other policies designed to foster their growth. Graded production was actually only used for a very brief period directly following the end of the war, but the philosophy behind it has made itself felt in later industrial policy.

The postwar policies for the revitalization of industry made an enormous contribution to real economic activation, but they also caused run-away inflation. Excessive government intervention in the private sector caused corporate management to become lax. This in turn prompted a clamp-down on finances in 1949, in which the government unveiled a variety of policies designed to rationalize industrial activity. These policies became known as the "Dodge Line" after the name of an American Minister invited to Japan in the capacity of advisor. Their aims were:

(1) To control fiscal expenditures in order to achieve a "small government"
(2) To review subsidies to corporations, placing more emphasis on market mechanisms and encouraging household savings drawing a clear line between government and private activities, and
(3) To do away with price controls and double-standard foreign exchange, producing a free and competitive domestic market, and making it possible for the Japanese economy to make a comeback.

The "Dodge Line" forced private corporations to take responsibility for themselves in what was now a free, competitive environment. They were given the incentive to rationalize themselves, which was to become one of the deciding factors in the high-growth period that began in the 1960s.

There was another factor that supported the postwar economic recovery—the Korean War that took place in the 1950s. The Dodge Line was an effective policy in terms of holding down inflation and allowing market mechanisms to recover, but it also brought about fears of deflationary pressure due to tightly controlled fiscal policies. With the outbreak of the Korean War, however, America began buying a variety of goods and services from Japan, most notably military-related goods. The "special demand" thus created removed any deflationary effects that the Dodge Line would have had, and helped Japanese economic development to get into its stride smoothly. By 1951, mining and industrial production has recovered to pre-war levels, and 1952 saw consumption rise to a level as high as it had ever been previously. The Japanese Economic Planning Agency published an Annual Economic Report (so-called "Economic White Paper") analyzing economic trends. In 1956, it reported, "We want to emphasize that we are no longer in the postwar era, but have entered a period of new economic growth." and, in fact, in the years that followed, Japan was able to achieve high economic growth on a scale rarely seen in the history of the world.

The Mechanisms behind High Growth: The Shimomura Theory

In 1960, Hayato Ikeda, a member of the Liberal Democratic Party, became Prime Minister and presided over the first Ikeda Cabinet. Ikeda himself had entered politics after years in the Ministry of Finance, and was very well versed in economics. He gave a new direction to Japanese policy, publishing a plan to double the national income in ten years, and setting Japan firmly on the road to high growth. The theoretical support for his plan came from Dr. Osamu Shimomura.

Shimomura is know as the first economist to introduce Keynes' "General theory" to Japan, and was one of the most avid Keynesians the country produced. At the same time, most economists and policy makers predicted that the high growth rate Japan was experiencing would eventually slow down. Shimomura, however, held that the Japanese economy would show extremely high growth which would continue long-term, and that it was quite possible that the national income could double in about ten years.

Shimomura's ideas were widely known in Japan as the "Shimomura theory", though their basic framework came from Harrods' economic growth model (Shimomura, 1961). Let us assume there is proportional relationship between production (Y) and capital stock (K), which we will express as

$$K/Y = C$$

where

$$C = \text{Capital-Output Ratio}$$

The capital output ratio is the inverse of capital productivity. The lower this ratio, the more effectively capital is being put to work. Changes in production are, therefore, proportional to changes in capital stock.

$$\frac{\Delta K}{\Delta Y} = C$$

or

$$\Delta Y = \frac{\Delta K}{C} = \frac{(1-d)Ig}{C}$$

where

$$\begin{aligned} Ig &= \text{Gross Business Fixed Investment} \\ d &= \text{Replacement Investment Ratio} \end{aligned}$$

If $\Delta Y/Y$ and I/Y are replaced by g and r respectively, then we get

$$g = \frac{(1-d)r}{C}$$

where

$$\begin{aligned} g &= \textit{Economic Growth Rate} && (\Delta Y/Y) \\ r &= \textit{Investment Ratio} && (Ig/Y) \\ d &= \textit{Repacement Investment Ratio} && (Ir/Ig) \\ C &= \textit{Captial--Output Ratio} \end{aligned}$$

It is therefore necessary to look closely at variables d, r and C when considering the possibilities for growth of the Japanese economy.

For our purposes, we will start with d. Shimomura forecasted that it would range between 16–19% for the 1960s. The actual value for d between 1951 and 1959 was 11–13%. Based on this information, he predicted that with the rise in income level, the rate at which equipment wore out would increase, and with it the need for replacement investment. Looking at variable r (investment—GNP ratio), Shimomura predicted that the aggressive managerial posture adopted by Japanese corporations would support the continuation of the high 12–15% levels. He believed that the entrepreneurs in Japan had the "animal spirit" talked about by Keynes, and was low enough at 1, emphasizing that if capital utilization were high enough it would make high

economic growth possible. In response, Shimomura (1960) compared and analyzed economic data from other countries and argued that the capital-output ratio rises as economies grow, and because of that, it would be impossible to maintain high growth for very long.

In Table 2, a comparison can be found between the high growth forecasted for Japan by Shimomura, and what actually took place in the 1960s. It can be seen that the Japanese economy was supported by active corporate investment activities and a high degree of investment efficiency. Actual growth figures are extremely close to those predicted, and Shimomura's "1" for the capital-output ratio was right on the mark. This was one of the things most characteristic of the Japanese high growth period.

Table 2. Shimomura's Forecasts and Actual Economic Growth

	1960–65	1966–70
Shimomura's Forecasts		
d	16.0 %	19.0 %
1/C	0.85	0.90
r	15.3 %	12.6 %
g	11.3 %	9.5 %
Actual Figures		
1/C	0.86	0.94
r	14.7 %	16.7 %
g	10.6 %	11.2 %

Source: Takenaka (1984)

Factors Supporting High Growth

The Shimomura theory was based on the Harrod/Domer economic theory of "warranted growth rates", or the maximum growth rate possible when production factors (in this case, capital) are being used fully. In order for economic growth to be possible, based upon the Shimomura theory, however, various conditions needed to be met as well, and we will now take a look at some of the main factors that support the high growth seen by Japan.

The first point to consider is how it was possible to achieve extremely high investment rates. According to Minami (1981), the most important factor in investment decisions by Japanese corporations at that time were the real rates for return on capital, and costs (in terms of real interest rates). The Bank of Japan's cheap money policy helped keep interest rates low, but profitability rates were probably more important in the long run, according to Minami. What made high rates of return on capital possible was the speed at which technology was progressing. In spite of the fact that the period saw slight rises in the share of labor and a tendency for the rate of value added to capital to decrease, the rate of return on capital maintained high levels, forming a favorable environment of corporate investment.

Statistics show just how important technological progress was to the development of the Japanese economy. Analysis using the source approach indicates that almost half of the approximately 10% annual growth can be explained in terms of increased capital spending, but another 30–40% appears to be due to technological progress. Though a late comer to industrialization, Japan was able to bring in state-of-the-art technology and posessed a labor force that was able to deal with it. This made rapid technological progress possible. At the same time, dynamic changes were occurring in the industrial structure. The resources for production were shifting to the most efficient industries, which, from a macroeconomic point of view, spurned even further technological progress. Calculations by Kosai and Ogino (1984) show that approximately one third of the technical progress seen at this time can be explained by the shift to efficient industries.

Another important factor supporting high investment rates was the high rate of savings, which was the source of the funds invested. Fortunately in Japan, there were sufficient national savings to maintain high investment. High-growth tends to level out income distribution and cause a decline in savings, but it is worth pointing out that in spite of that, high savings levels, in macroeconomic terms, were maintained in Japan. Interestingly enough, savings were high despite the fact that the Bank of Japan's cheap money policy kept the interest on them low.

Another characteristic factor in Japan's high economic growth was the low capital-output ratio, which indicates that capital was highly productive. One reason for this, as already stated, was the high rate of technological progress. At that time, Japanese corporations considered capital to be the embodiment of new technology. In fact, according to calculations by Watanabe and Egaitsu (1967), from 1959 to 1962 approximately 70% of all technological progress was indeed embodied in capital.

In this connection, "Capital Stock Vintage" (the average age of capital) is often used as an index of how effective capital is, the higher its quality becomes. As is shown in Table 3, the capital stock vintage in Japan was 10.2 years in 1960. By 1965, however, the figure had been cut to 8.6 years, and by 1970 it had been reduced even further to 7.3 years.

Table 3. Vintage of Capital Stock in Japan (Years)

	1960	1965	1970
All industries	10.2	8.6	7.3
Manufacturing Industries	8.0	6.5	5.9

Source: The Japan Development Bank

There are other factors behind Japan's high growth period which should also be pointed out. First on the list is the existence of plentiful, high-quality labor. Human resources are the main fountain of all economic development. In Japan's case, this was augmented by the fact that labor came from the same cultural stock. The country's homogeneous, high-quality labor resources gave a tremendous boost to economic activities and especially factory production. The second factor to be emphasized is the cheap exchange rate, which helped protect fledgling industries and increase exports. In 1949, shortly after the War, the exchange rate was fixed at Yen 360 to the dollar, a rate which was maintained until 1971. Between 1955 and 1970, wholesale prices in Japan rose only 16%. By contrast, US wholesale prices saw a 25% rise. This means that the real value of the yen against the dollar dropped about 9% during the decade. The exchange rate was raised to Yen 318 to the dollar in 1971, the year President Nixon curtailed the exchange of dollars for gold. The changes in currency valuations were not enough to adjust for the industrial competitiveness between the two countries, however. The yen remained undervalued through the early 1980s.

Economic Structure and Policy during the High Growth Period

In this section the main features of the Japanese economy in the high-growth period of the 1960s and the role economic policy played in their maintenance will be discussed.

Until Japan recorded its first large surplus in 1969, trade followed a clear pattern of having deficits during growth periods and surpluses during slumps. This meant that when trying to expand the economy, for example, using a policy of fiscal and monetary expansion, the limits to what could be accomplished in terms of the international balance (commonly called the "international balance ceiling") soon became apparent, and aggregate demand once again had to be suppressed. The so-called "Stop-and-Go" policy is characteristic of fiscal and monetary policies during that time, but it also indicates some of the structural problems in the Japanese economy, namely, that it had poor foreign currency reserves and was under a certain amount of constraint in terms of its international balance.

Secondly, the period is characterized by vast differences in the productivity and wages paid by large corporations and their smaller counterparts, which caused a kind of "double structure" to appear. In the 1960s, small corporations with between one and forty-nine employees accounted for 49% of all employment. By contrast, this figure was 17% for the United States and 11% for Great Britain. One of the factors was that while large corporations were able to use their credit to obtain bank loans easily, the overall lack of funds made it difficult for smaller businesses to obtain financing. This in turn led to differences in the capital-labor ratio. Large corporations with high capital-labor ratios enjoyed the merits of their scales, and were able to boost their productivity by introducing the latest technological advances. But even under the double structure, small businesses could accumulate capital because of high economic growth. Furthermore, the diversification of people's needs reduced many of the scale merits traditionally enjoyed by large corporations, weakening them into the 1970s.

However, the existence of a double structure in the Japanese economy was later to have a great influence on the country's labor markets. Generally, large corporations had access to modern technology introduced from overseas, but in order to use it to produce goods they had to assure themselves of a skilled labor force. Smaller corporations, by contrast, tended to be tied to older, more traditional technology, and could therefore function even with unskilled labor. Shortages in skilled labor caused polarization to occur, wages rose at plants where skills were in demand and held steady or fell at plants where they were not. When this happened, one of the ways in which major corporations fought back was to put into effect the lifetime employment system. The technological level of smaller corporations eventually rose, and it is possible that this was the reason why the lifetime employment system subsequently gained such popularity.

Another aspects of policy that should be considered are the unique ties that developed between government and industry during the high-growth period. Japanese government/industry relations can generally be thought of in terms of industrial policy. Economists debate just what exactly industrial policy is and whether or not it is very effective, but those arguments will have to be left for another occasion. Suffice it to say that several important policy mechanisms were put into effect in the 1950s and 1960s. One of these was the Industrial Structure Council which the Ministry of International Trade and Industry (MITI) established in the early 1960s. The council is made up of leading figures from academia and business, who exchange opinions on what direction Japanese industry should take in the future, and produce a vision of how the industrial structure should stand. In actual fact, however, it functions as a forum where representatives of industry and government can adjust their opinions and develop a social consensus on the direction in which the country is to head. From the time of its inception to the present day, the council has formed the backbone of MITI's administrative efforts. The vision it produces is, to corporations, a guideline with a consensus behind it, and reduces the uncertainty and risk involved in individual managerial decisions.

In 1953, the Fiscal Investment and Loan Program was introduced, and quickly became a unique system of Japanese public finance. This system is a little complicated, but in a nutshell, funds from the postal savings program (administered nationally by the Ministry of Posts and Telecommunication) were used to make loans and investments in addition to the general budget, which is based only on government tax income. There tended to be a lack of funds in the reconstruction and high-growth periods, so the system allowed the government to adjust their distribution, thereby giving it control over the distribution of the resources necessary for production.

The Development of Industry in the High Growth Period

Finally some mention should be made of trends seen in the industries representative of the postwar reconstruction and high-growth periods. First on the list is steel, which forms the basis

for other industries. By 1953, the industry had recovered from its devastation during the Second World War, topping the 1943 pre-war record for crude steel production. At the time, Japan was producing about 80,000 tons of crude steel a year, while American production stood at 100 million tons. Japan overtook that of Great Britain in 1961, and of West Germany in 1964, placing Japan as the number two steel producer in the world, ranked in the same league as the United States and the Soviet Union.

The home electrical appliance industry is a typical example of high growth in the consumer goods area. Japanese families experienced the "First Home Appliance Boom" in the latter half of the 1950s. Black and white televisions, washing machines and electric refrigerators sold like hot cakes as the country tried to catch up with the standard of living enjoyed in Europe and the United States, and the industry saw yearly growth rates of 48%. The three products were known at the time as the "three essential status symbols" in a phrase that was a play on words about the three divine (Shinto) symbols of the Japanese throne. Televisions had appeared in 37% of all households by 1960, just seven years after broadcasts had begun (1953). Then in the 1960s, there emerged a new impetus. Color televisions, coolers (air-conditioners) and cars became known at the "Three C's" and led the age.

Finally, the automobile industry should be discussed. At the end of the war there were only 110,000 cars in Japan. By 1960, the number had grown to 2.2 million, and by 1970 it had burgeoned to 17.8 million. It should be kept in mind, however, that the production of passenger cars which are the mainstream of today's automobile industry did not overtake that of trucks until the mid 1960s. High growth brought about an increase in personal income, which in turn made it possible for the market for durable goods to expand. The existence of these "trigger industries" made high macroeconomic growth possible.

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Currency Convertibility: When and How?

A contribution to the Bulgarian debate[1]

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Introduction

Economic growth in Bulgaria has been stagnant since 1989, inflation is increasing and the lev is rapidly losing its value in terms of other currencies. In March 1990, the Bulgarian authorities declared a moratorium on the country's external debt. Under these difficult economic circumstances, an intense debate has been engaged about the appropriate future monetary policy of the nation, and many new options are open now that Bulgaria has been accepted in the 1990 annual Meetings as a member of the IMF and the World Bank.

It would be inappropriate for a first time visitor to Bulgaria to offer firm advice on policy for a country on which little research has been published and for which the past, in any event, no longer provides much guidance about the future. Currency convertibility and monetary policy have to be discussed under conditions of great economic and political flux, not only in Bulgaria itself, but also in all of its ex-Comecon trading partners. Nevertheless it may be of some use to recall a number of arguments that are important for deciding upon the *date* of the transition to convertibility as well as the *form* in which convertibility might take place.

Timing of Convertibility

Within one year of the political changes of November 1989, a consensus has formed in Bulgaria that the lev must become a convertible currency. Officially this has been underlined by the acceptance of Bulgaria as a member of the IMF which stipulates in Article VIII of its Articles of Agreement: "no member shall without the permission of the Fund impose restrictions on the making of payments and transfers for current international transactions". However, according to Article XIV member countries may preserve temporarily the existing limitations and controls on current payments. As members of the Fund, however, countries must strive to make the transition to convertibility when economic conditions make this possible.

Bulgarian economists differ about the timing of a move to convertibility. Dimitrov writes: "Different views have been voiced. Some understand convertibility solely as the product of a balanced and strong economy, postponing the problem to the indefinite future. Others plead for

[1] Revised version of a lecture at the second International Varna Seminar On the Way to Convertibility in Central and East European Countries, October 1990. Professor Dr. Todor Valtchev, Dr. Vencislav Dimitrov and Professor Nesho Tzarevski provided useful insights about the Bulgarian economy. John Williamson and other Seminar participants gave stimulating comments. The views in this paper are solely my own.

its immediate introduction, despite existing shortages and imbalances in the economy—seeking convertibility as a means to economic recovery, despite inherent risks".

A realistic debate about the timing of a move to convertibility on current accounts must take into consideration that foreign currency already plays an important role in all Central and Eastern European economies. US Dollars and DMarks are not only widely accepted in urban areas, but may even be the preferred medium of exchange for many residents. This seems to be the essential difference between the situation in Eastern Europe today and, for example, in Western Europe after World War II. The other crucial difference with other times when countries contemplated making their currencies convertible is that in Eastern Europe the transition from a collectivist to a market economy has been agreed in principle but still needs to be implemented. It seems to me that these two factors together make earlier views about the timing of the change to convertibility no longer directly applicable to Eastern Europe today.

Here are some well-known traditional arguments for caution:

- Political uncertainty and the general wish to diversify one's portfolio may induce residents to move part of their savings to foreign countries. With currency convertibility the implicit costs of doing so are much reduced, even if the currency is only convertible for transactions on current accounts. Over-invoicing of imports, under-invoicing of exports and a variety of other legal or illegal means are available once the currency becomes convertible currency for trade and tourism. It may be in the national interest, however, to stimulate domestic savings and to discourage, for at least some time, international diversification of domestic wealth. A non-convertible currency may make it much more costly to transfer part of domestic wealth abroad.
- Tourists going abroad may use valuable foreign currency and, once again, invest their wealth or even their talents in foreign countries. A non-convertible currency allows for political control over outward-bound tourism.

All such arguments against early convertibility involve substantial political control over economic transactions and important limitations on the freedom of contracts between domestic residents and foreigners. Some points associated with postponing the move to convertibility follow:

- If the government has the power to allocate foreign exchange, this will easily become a source of corrupted practice and will involve a bureaucracy that is costly not only in the direct budgetary sense but also because vital imports may be delayed through excessive red tape.
- Domestic entrepreneurs may judge that black market activities and smuggling may offer attractive rewards, but there is a difference between the private and social benefits of such activities.
- Distorted domestic relative prices that are out of line with world prices complicate business life for domestic firms and have social costs. A convertible currency makes distorted domestic prices far more visible and may even prevent continued distortions because of substitution effects both in production and consumption. For instance, in Western Europe the past few years have shown how much discipline is imposed on domestic governments in the area of taxation because of further integration of the financial, labor, and goods markets in the European Community. We observe a clear convergence of Value Added Tax rates as well as of income tax schedules not because the different politicians have come to agree about the optimal structure of taxation, but because their residents will move either their purchases or their work effort abroad if induced to do so by glaring differences in rates of taxation.

Possibly of all these arguments the final argument against postponing the transition to convertibility should dominate. For, the transition to a market economy will suffer if domestic relative prices differ substantially from world prices, or if there is persistent political uncertainty about the continuation or termination of such distortions. To impose domestic relative prices

that are more in agreement with world markets conditions will initially impose heavy adjustment costs on consumers and producers. Families have become used to subsidization of food and some basic commodities. The benefits of more realistic prices do not appear immediately; the costs of reduced subsidies hurt directly. For that reason alone, removal of distortions in relative prices will stimulate strong political opposition on the consumer side. Producers will have to make equally hard adjustments if import relative prices and subsidies change. A very important advantage of currency convertibility is that the speed with which domestic relative prices adjust to conditions in the world market no longer depends on domestic political conditions but is imposed from abroad.

External disciplining has worked well in putting some constraints on taxation policies in the European Community; it may also be the most feasible way to achieve a more sensible structure of relative prices in the economies of Eastern Europe. With a convertible currency the whole world market is on your side if you wish to remove distortions in relative prices. Because future prosperity requires a market economy, and a market economy in turn presupposes realistic relative prices and far fewer distortions, immediate currency convertibility may help to import a relative price structure that could be politically impossible to obtain through individual domestic political decisions.

I should also like to suggest that the bias in favor of large firms and against small firms and new entrepreneurs may be an additional very important argument to remove control over foreign exchange from the central authorities. In my own country, the Netherlands, politicians belonging to the two largest political parties are now actively debating the amount of government support that would be needed to help Philips, the struggling electronic firm. And this within a context of strong economic growth, a very tight labor market and an unsustainable large budget deficit. Government subsidization of Philips implies higher taxes to the detriment of other firms and potential new entrepreneurs. However, in the "market" for political influence large existing companies have a more concentrated power in favor of subsidies than those who eventually pay the budgetary costs. In addition, Professor Hayek's warning that governments have no comparative advantage in guessing which future activities are most promising (and would best be served with foreign exchange) apply with full force. Finally, political control over foreign exchange imposes unavoidable heavy distortions in the domestic credit market. Some companies may find it easy to generate cash flow or to attract capital in order to expand, but they enjoy the political connections that are helpful in obtaining foreign exchange. A "shadow" market in foreign exchange will appear in which firms and individuals will try to obtain licenses to import. However, there will be a varying degree of political control over this "market", leading to an uncertain and inefficient set of constraints on firms' activities.

The Soviet Union and some of the other ex-socialist economies have promoted cooperative forms of organization for smaller enterprises. Some cooperatives are spin-offs of larger state-owned firms; others have arisen to perform tasks that were neglected in the past. As long as domestic relative prices remain grossly distorted, managers of state firms may take a personal pecuniary interest in a new cooperative and deal with these smaller privately-owned satellites in ways that are socially harmful even though individually profitable. For instance, a state firm may sell subsidized inputs to a cooperative which then subsequently sells its output at a realistic price. News reports from Eastern Europe suggest that such practices are strongly disliked by the public, which suspects big-firm managers to have a selfish interest in some cooperatives. By contrast, other cooperatives may be eliminated by state firms that have exclusive rights to foreign exchange or cheap government-provided inputs and compete with the cooperative in consumer markets. It would be regrettable if the transitional phase to a market economy was greatly hampered by these two different types of problems and this may be one additional reason to favor policies such as immediate convertibility of the currency that lead to a realistic relative price structure.

The transition to a market economy will witness the establishment of many small firms which have to survive a symbiosis with a number of extremely large enterprises, either state-owned or

not yet privatized. It is essential that the new firms and cooperatives can compete on equal terms with the state-owned conglomerates. This requires that the so-called soft budget constraint for the state-owned enterprises is replaced by a binding budget constraint. In other words, losses must have consequences also for socialized firms. Additionally, the rule of law obviously must apply not only to the new privatized firms and cooperatives, but also to the state-owned business: bureaucratic favoritism has no place in a true market economy. It would be naive to forget that politicians and bureaucrats have a natural tendency to give more weight to the problems of large existing firms than to the difficulties facing new and unknown enterprises. But, the design of institutions and policies should counter this bias as much as possible. Within this context, an immediate move to convertibility of the currency makes much more sense than continued bureaucratic allocation of foreign exchange to businesses and individuals.

Form of Convertibility

First, a brief review of the different options that are open to a small economy which makes its currency convertible. Table 1 shows four different versions of fixed exchange rates; Table 2 four ways to implement flexible exchange rates.

Table 1: Fixed Rates

1) "Automatic Central Bank" (Hong Kong)
2) Currency Union (Belgium—Luxemburg)
3) Fixed by multinational agreement (E.M.S.)
4) Fixed unilaterally (Austria, Norway)

Table 2: Flexible Rates

1) Almost no interventions (no sterilization)
2) "Leaning against the wind"
3) Wide, secret target zones
4) Crawling peg with very frequent adjustments

Many of the small trading nations of Western Europe have opted for some form of fixed exchange rates. Obviously, these countries have concluded that their national economy is not an optimum currency area and that they should provide their citizens and business firms with a system in which foreign transactions with at least some major trading partners can be conducted with little or no currency risk. Membership of the EMS is increasing, because German dominance has delivered low and stable inflation for many years. If a new member country ties its currency to the DMark in a manner that is viewed as credible by the financial markets, the country "buys" the reputation from the Bundesbank. As long as Germany continues to dominate the system, the reputation of its Central Bank is a public good that can be provided to new members without diminishing its supply to the old members of the EMS.

For new members, the "quality" of the national money may improve through a tie-in with this German dominated system, and credibility may be purchased more cheaply than if the Central Bank had to obtain a strong reputation for anti-inflationary policies on its own.

On the other side of the ledger there are obvious transitional costs as the new EMS-member must adjust to lower inflation. Also, domestic politicians give up the possibility to use the Central Bank for stimulating the economy in an election year. Such misuse of the Central Bank

in order to generate a "political business cycle" is a temptation in all countries that set their own monetary policies. One of the important advantages of a system such as the EMS for the citizens of the participating countries is that the common monetary policy will not be under as much of a threat to play its part in promoting re-election of sitting governments as in the case in which each country implements its own monetary policy.

Given all these advantages of a common monetary policy and a common inflationary path for participating member countries, should one advocate some form of cooperation between the monetary authorities in the small economies of Eastern Europe and the Bundesbank? Note first that countries may unilaterally decide to couple their monetary policies to those of the Bundesbank or the provider of any other major currency. Austria is a good example. The Austrian money market has been integrated for many years with the German money market and the Austrian monetary authorities can conduct open-market operations in DMark. This system does not require any form of approval by the German authorities and has resulted in an exchange rate between the Austrian Schilling and the DMark that is as stable as the exchange rate between the DMark and any of the EMS-partners. Hence, we can discuss whether the economies of Eastern Europe should try to emulate the Austrian example without having to wait for consent by the current membership of the EMS.

Some influential experts have advocated an even stronger form of fixed exchange rates. Professor Allan H. Meltzer[2] has advocated a monetary authority for the Soviet Union along the lines of the Hong Kong Example. He writes:

> "Credibility for the new monetary policy can be achieved most effectively if the new system is seen to be a major departure from the old, and the opportunities for discretion are severely restricted. The public must be convinced that the central bank and government will honor their commitment to avoid inflation. I suggest that this is done most effectively if you restrict the government's monetary role by establishing a monetary authority like the Hong Kong or Singapore Monetary Authority. In such systems the exchange rate is fixed. The authorities are empowered to issue money only if they receive convertible currency, and they must withdraw money when they lose convertible currency. They collect seigniorage, but they have no discretionary authority to change the quantity of money and no legal means of doing so. Money can only be issued to the extent that the country earns convertible currency.
>
> This system has several advantages. Most important is the durability of the commitment. Like Ulysses, in the ancient Greek legend, you will have bound yourself tightly. There are other advantages. Let me spell out a few. First, the system focuses attention on the need to compete in world markets. Efficiency in international markets begets domestic efficiency, and increased domestic efficiency encourages exports. Second, domestic prices would adjust toward world levels. If the exchange rate is fixed on the dollar or the mark, domestic commodity prices will move toward US or German prices for goods of the same quality. Third, interest rates will fall toward the world level. At first there would be a risk premium but the premium would decline as confidence grows that the system will be maintained. Fourth, budget deficits would be limited. All borrowing, whether denominated in domestic or foreign currency, would have to be financed from domestic or foreign saving ... This would be a strong commitment. The closer you come to it, the more it will be believed. A mixed system in which the exchange rate is fixed but adjustable will be less credible. If people doubt your commitment to monetary stability they will charge risk premiums in interest rates and wages to pay for possible inflation."

In this strong form of fixed exchange rates, credibility and stability are purchased and achieved more quickly than under any alternative scheme. However, the fixed exchange rate implies that domestic inflation is influenced by world inflation so that not only domestic relative prices that are imported from abroad—a very desirable matter—but also domestic absolute prices and are no longer under much control by the domestic authorities. For a developed economy with a stable or or at most slowly changing economic system, this may not be a disadvantage. For instance, if there is macroeconomic pressure on average wage costs in industry in the Netherlands to decline relative to production costs in Germany, the magnitude of such a decline will be at most a few percentage points. Given that German wage rates increase at, say,

[2]Monetary Reform in the USSR, Moscow Address, September 17, 1990.

3–5 % per year there is sufficient room to obtain a somewhat lower rate of increase in Dutch wage costs for one or two years and the desired adjustment in relative cost level may be obtained.

In Eastern Europe, the economies are currently engaging in an almost unprecedented economic transformation and it is impossible to predict where cost levels will turn out to be next year, in five years and in ten years time. This uncertainty is starkly reflected by considering current black market exchange rates and relative wages in Eastern Europe, neighboring countries such as Turkey and Greece, and the higher developed economies of Western Europe. At current black market exchange rates it would appear wage costs in Eastern Europe are a small fraction of those in, for instance, Turkey with the differential increasing even further at this time. From a longer term perspective, which would base relative cost levels on fundamental factors such as educational levels of the work force, institutional stability, infrastructure stability, infrastructure, and natural resources, it might be extreme to expect a continuation of the situation in which wage costs in, for instance, Bulgaria are five times lower than in the industrial sector in Turkey. Hence, there cannot but be extreme uncertainty about the proper wage cost levels in the economies of Eastern Europe over the next several years.

Under such circumstances fixing the nominal exchange rate imposes all necessary macroeconomic adjustments on nominal wages. It might be necessary to alter nominal wage levels by very substantial amounts over several consecutive years. This, in my view, will impose great hardship on wage earners and will also make it impossible in the meantime to ask wage earners to engage in longer-term nominal contracts such as home mortgages.[3]

What about fixing the exchange rate for a briefer period and without going to the extreme of the Hong Kong model? Early evaluations of the Polish experiment strongly suggests that fixing the exchange rate for a longer period on the basis of the most recent black market exchange rate results in an initial undervaluation. For, the black market exchange rate was formed in a period of great uncertainty about the future exchange rate regime and possibly during conditions of incipient hyperinflation. Currency substitution will be extremely important under such circumstances and the demand for domestic money very low. In fact, estimates suggested that two thirds of the currency circulating in Poland was foreign currency rather than domestic currency. Additionally, fixing the exchange rate will not reduce domestic inflation as measured in domestic currency to world levels overnight. Probably domestic inflation will continue to be substantially above world inflation and this again will influence the initial setting of the fixed exchange rate. Combining these two factors may well result in a severe undervaluation which is costly because it leads to wrong decisions by producers and consumers and is in itself a source of inflationary pressure. This would suggest great caution in fixing the exchange rate for a longer period of time and not necessarily following the most recent black market rate.

There is an obvious trade-off between attempting to achieve immediate credibility for the monetary authorities through fixing the exchange rage but imposing great costs on the labor market, or opting for a less fixed exchange rate regime which will be easier on wage formation in the labor market but implies that credibility for monetary and exchange rate policy will take longer to achieve.

At the other extreme end of this spectrum would be a purely floating exchange rate. This has not been the institution of choice for the trading nations of Western Europe, the sole exception being Switzerland. In North America, however, Canada has maintained a floating exchange rate with respect to the US, even though the United States is a more dominating trading and

[3]Some form of indexation of savings and mortgages contracts would help: under indexation the real rate of interest is fixed when the claim is bought or sold in the primary market, and additionally inflation is compensated for once or twice a year. It must be possible to combine indexed long-term savings with indexed home mortgages, but it will be difficult for the banks to assume any mismatch of maturities in such an indexed market under a fixed exchange rate with great uncertainty about future rates of inflation. For banks, under a Hong Kong type system, managerial instruments dominate nominal (non-indexed) reserves. It is hard to see how banks could then offer indexed mortgages to new home owners, without some governmental institution providing insurance of all default risk on such assets as well as providing help with any mismatch between indexed savings and indexed mortgages.

investment partner for Canada than any nation in Western Europe with respect to Germany. Hence, a floating exchange rate is a feasible option, but most smaller nations prefer a fixed exchange rate with a major partner or participation in a fixed exchange rate system such as the EMS. For Eastern Europe a pure float would appear to have an overriding disadvantage, namely that it would be viewed as indicating a lack of discipline in the area of fiscal policy. Currently, statistics on budget deficits and the way in which they are financed are scarce and of poor quality so that international financial markets are very uncertain about the fiscal policies being followed. The transition to a market economy generates continuing uncertainty about budgetary policies for many more years: how quickly will subsidies be abolished, how easy will it be for displaced workers to find new employment, how much infrastructure is required to attract foreign direct investment and to make a more attractive home for domestic savings, and finally, how much of the government's expenditures can be covered with domestic taxation? None of these questions will have predictable answers for several years to come.

If the authorities choose a floating exchange rate it will be regarded as a sign that they do not wish to give up the option of covering part of future deficits through money creation with its consequences for the value of the currency. Because the monetary base as a stock is small in respect to the annual uncertainty regarding the government budget deficit, any news about future budget deficits and the extent to which they may be financed through the Central Bank's creation of new money will have a major impact on the market's expectation of the future monetary base. Hence, great uncertainty regarding the exchange rate will result and the foreign value of the currency will fluctuate with each piece of news regarding future budgetary policy. Such uncertainty about exchange rate movements even in the very short run will be costly for businesses and individuals.

Real Rates of Interest

A common policy mistake in many developing countries has been for the authorities to intervene in the credit market and to depress real rates of interest. On the surface, such actions provide borrowers with a reduced cost of capital, but the policy makes no sense because it reduces the amount of savings. Hence, the supply of credit through the official sector of the economy falls so much short of the demand at the government influenced interest rates, that credit rationing becomes a necessity, with all its disadvantages of political bias in favor of large established enterprises and risk of corruption. At the same time, an informal "curb" market for credit will develop in which borrowers who can not be satisfied on the official market will try to attract funds at higher—possibly even illegal—rates of interest. Such a two-tier credit market is hugely inefficient.

The government should not be afraid of a high real rate of interest, because with stable political and legal conditions, the current scarcity of capital should imply a very high marginal real return on new capital and hence, a real rate interest that is high by the standard of the capital-rich industrial countries. Experience in several developing countries has shown that deregulation of the credit market and a move towards higher returns for domestic savers coincided with a take-off of economic growth.

During the transition to a market economy the authorities may wish to either establish a national savings bank or to issue guarantees for the return on savings attracted by the private sector or foreign-owned banks. If there is a national savings bank, the authorities therefore have to set a rate of interest for domestic savings. If the rate of inflation over the relevant horizon is uncertain it may be sensible to offer a guaranteed real rate of return and to compensate the domestic savers afterwards for the actual rate of inflation, using a scheme similar to that of the indexed national savings in the United Kingdom.[4] With a rate of exchange that is fixed for

[4]The real rate of return on indexed retail savings in the UK is very slightly positive; simultaneously the UK authorities have issued indexed government debt since 1981 on which real rates of return have varied from 2% to slightly above 4% per annum.

long periods, domestic short-term interest rates no longer are free policy variables, because the authorities will have to follow a target for the stock of international reserves. To the extent to which the domestic banking system needs to be provided with net foreign assets, solvability of the domestic banks will also constrain the freedom to alter domestic rates of return on savings. With short-term rates needed as instruments to maintain the fixed exchange rate, the authorities will have less chance to follow policies at the long-term end of the yield curve that provide high and stable rates of return to domestic long-term savers.

By contrast, a more flexible rate of exchange allows for far greater freedom in following an interest rate policy that is targeted towards encouraging domestic savings and discouraging currency substitution into foreign currencies or capital flight.[5]

With the resource cost of the Hong Kong type system so much larger, because the country has to borrow to set up its central bank and commercial banking system rather than attract capital for investment in fiscal infrastructure, and given the tremendous uncertainty regarding the medium-term evolvement of real wage costs, a rather more flexible system seems advisable.[6] However, a more flexible exchange rate does not mean that fiscal deficits can conveniently continue to be financed through money creation or that the need to move to a domestic structure of relative prices that conforms better to world market conditions is less urgent.

In my view, the best transitional regime for the countries in Eastern Europe may be a rather flexible fixed rate or a rather fixed flexible rate: either a unilateral fix for a relatively brief period or a crawling peg system with quite frequent adjustments. Under either system the domestic banks can operate with reserves denominated primarily in domestic currency and there is no need for the nation as a whole to allocate foreign reserves to serve as reserves to the banking system. In a Hong Kong type system or in any other version of long-term fixation of the exchange rate and full convertibility on current account, the domestic banks will only be able to grow if a substantial part of their capital and reserves either consists of foreign currency or can be converted into such a little notice and with little cost.

Currency Reform—A Historical Case Study

After World War II the Netherlands regained its freedom in May 1945. A new civilian government came into office at the end of June. Between July and late September a thorough currency reform was enacted. It goes without saying that postwar conditions were in many ways different, both politically and economically, from the situation in which the ex-socialist countries of Eastern Europe find themselves today. But, the currency reform coped with a very substantial "monetary overhang" and was supported democratically. Also, Holland had to rebuild its economy with very little foreign financial assistance while simultaneously facing a drain on resources because of its costly initial resistance to the independence movement in Indonesia, a former Dutch colony.

An authoritative analysis of the 1945 currency reform was published in 1973 by the responsible ex-Minister of Finance, Pieter Lieftinck who, after leaving the Netherlands, had a distinguished career at the IMF and the World Bank.[7] When Lieftinck became Minister of Finance shortly after the war, national income was estimated by the Dutch authorities to be 5 billion guilders, but private sector estimates at that time were seven or eight billion, evidencing

[5]Obviously a devaluating exchange rate leads to higher domestic interest rates, but the "spikes" in interest rates, particularly at the short end, that are so typical for the final stages of a fixed exchange rate that becomes harder and harder to defend can be avoided.

[6]Walters and Hamke have also argued in favor of a Currency Board rather than an independent Central Bank for the ex-socialist countries. Professor Tew pointed out the two problems with such a proposal—how does the Currency Board acquire its foreign assets?; do Commercial Banks also have to own large stocks of foreign assets?—in an intervention in the London "Financial Times" (February 23, 1990).

[7]"The Postwar Financial Rehabilitation of the Netherlands", The Hague, Martinus Nijhoff, 1973.

a substantial uncertainty about the transactions demand for money.[8] The money supply at the war-end amounted to 11 billion guilders, over four times as much as at the start of the war in 1940. With national income in current guilders slightly below the 1938 level obviously the income velocity of money was unsustainably low. At the same time, it was widely felt that much of the increase in the money stock had come into the hands of black market operators or war profiteers, so that a proportional shrinkage of money balances would not be a "just" solution.

Lieftinck writes: "On July 9, 1945, as a first measure against hoarding of money made in the black market, all 100 guilder notes were withdrawn from circulation. Subject to a brief time limit, the facility was opened for holders of such notes, to be credited for the amount on a blocked bank account" (the 100 guilder note was the largest denomination in circulation at the time). On September 26, 1945 the government withdrew all bank notes in circulation and blocked all bank deposits. At the same time the existing bank secrecy law was suspended. "This measure was intended to serve three objectives. The first was to bring into the open all money holdings, in particular those improperly acquired during the years of foreign occupation... The second was to register all liquid assets for the purpose of tax assessment under the existing tax legislation and the special reconstruction taxes that were going to be imposed. The third and most important objective was to re-establish an appropriate relationship between the quantity of goods available and the supply of money in circulation".

During the week following the currency withdrawal and blocking of bank deposits, each citizen received an identical small nominal amount of money and later that same week additional money was released to finance wages earned over the week. In subsequent weeks the government continued to release money for wage payments as well as special releases to meet firms' requirements for working capital. Bank credit remained subject to licensing and often required investigation of all blocked accounts owned by the firm. In Lieftnick's words: "By the end of 1945 the ratio between national income and the amount of money in circulation had almost returned to its pre-war level".
"The government opened different options for the remaining blocked money:

(1) Continuation of these holdings on blocked account in the hope and expectation of future releases.
(2) Transfer of limited amounts to a medium-term savings account.
(3) Use of these holdings for payment of tax arrears incurred during the occupation.
(4) Use of these holdings to fulfill obligations in respect to the new special reconstruction taxes to be imposed.
(5) Subscription to long-term, low interest bearing Government loans."

Because the last three options were most popular, the blocked money became available to the Treasury, "where it was held and only gradually released for public spending according to the growing needs connected with the rehabilitation of the economy".

As a result of these measures, the income velocity of money which had fallen to approximately 0.3 during the war and 0.45 in the summer of 1945, rose to almost 2 (very similar to the 1938 level) in December of 1945 and remained very stable around that level for the next four years. The nominal money supply had been reduced from 11 billion guilders in May 1945 to 4.1 billion guilders at the year-end. "Thereafter it rose steadily and it was practically stabilized at the level of around 7.2 billion guilders in 1948". Wholesale prices increased by 25–30%. Real wages were virtually stable.

I quote from Lieftinck's description of the accompanying tax reform:

> "Since during the war years tax evasion had been practiced on a large scale and tax assessment had run into a backlog, supplementary tax declarations were imposed with respect to all existing direct taxes, and provisional tax assessments were made covering the year 1944 and the first eight months of 1945. In order to speed up the collection of tax arrears and in anticipation of the

[8] In 1938 national income at market prices equaled 5.4 billion guilders; the war had reduced national income to approximately 3 billion guilders in early 1945 (annual rate).

announced reconstruction taxes, a system of voluntary and obligatory tax deposits (advanced payments to the Treasury) was introduced which by the end of 1946 amounted to over 1,800 million guilders. To supplement the revenue from normal taxes, two special reconstruction taxes were imposed:

(1) A so-called capital increase levy on the accrual during the war years of all personal wealth (money holdings and other assets taxable under the existing wealth tax), at a rate of 50 to 90% differentiated on the basis of a propriety test of the nature of the acquisition and the amount of the increase.

(2) A so-called once-for-all capital levy on all personal wealth at the end of the war, at a rate of 4 to 20% by application of a progression scale.

The collection of these special taxes, the total yield of which amounted to over 3,000 million guilders, was spread over a number of years, and to the extent that they were not paid out of blocked accounts these levies contributed considerably to counteracting otherwise generated new inflationary pressures. With a view to making the Government budget a better policy instrument to the circumstances, its structure was for the time being modified. Instead of the traditional division in two parts, a current account and a capital account, the current budget was divided into an ordinary account, an extraordinary account, and a separate budget chapter for the newly established Agricultural Equalization Fund. The ordinary account covered normal recurrent expenditure. The extraordinary account covered all expenditures that were directly connected with those functions of the Government that were undertaken to cope with the dislocation of the economy, including war damages, and, therefore, were considered to be of a temporary character (the administration and liquidation of the war heritage). The budget of the Agricultural Equalization Fund served to give an estimate of the balance of the cost of farm and consumer subsidies and the yield of agricultural export levies, the former being required to ensure a reasonable remuneration to the farmers while at the same time keeping the food bill of the consumers down. Its actual outcome was highly dependent on changes in world market prices; and given the objectives just mentioned, the balance of this account could not be predicted reliably. The capital budget maintained its traditional character of covering expenditures that increased the durable assets of the public domain and the revenues derived from those assets. Particularly the introduction of the extraordinary account in the current budget proved to serve an extremely useful purpose because it avoided the mixing up of recurrent and non-recurrent expenditures, facilitated a special surveillance and an appropriate phasing of the latter, and embodied a constant reminder that those expenditures were temporary and should be abolished as soon as possible".

The Dutch Government was not faced in 1945 with widespread use of foreign currency. Also, convertibility of the guilder was postponed until the next decade. In the 1950s the European Payments Union (EPU) remained the institutional mechanism for international payments until late 1958. The return to convertibility was postponed for so many years in Western Europe because of a perceived "dollar shortage". This term only makes sense if one assumes as general dollar overvaluation of the West European currencies during the immediate postwar years.[9] Because in Eastern Europe unofficial markets provide information about the exchange rate between local money and the DMark or US dollar, there should be no excuse for establishing an exchange rate that would undervalue the DMark or Dollar to such an extent that it would make sense to speak of a DMark or Dollar shortage. Hence, the historical experience in Western Europe with the EPU in the postwar period does not offer many indirect lessons for Eastern Europe today, apart from the obvious one that it is hazardous to fix exchange rates in periods of great economic transition. However, the Dutch experience with a currency reform immediately after the war is of interest as a historical case study of the removal of a monetary overhang larger than a full year's national income in a way that was democratically acceptable.

Need for a Nominal Anchor

During the transition to a market economy forecasts of nominal income at market prices will be subject to large forecast errors. At the same time, the income velocity of money will depend on

[9] See: Peter Bofinger: "A Multilateral Payments Union for Eastern Europe?". Discussion Paper nr. 458, Centre for Economic Policy Research, London 1990.

trends in economic growth and inflation, as well as on the availability of money substitutes, both in the form of domestic saving accounts and in the form of foreign currency. The Polish example has shown already how quickly the importance of foreign currency for domestic transactions can change over time, and this will make estimates of the velocity of money even more hazardous. With both national income and velocity being so hard to forecast, how can the Central Bank provide a nominal anchor for the economy if one rejects the option of fixing the exchange rate for a long period as I have done in this paper?

Perhaps the Dutch example may offer a useful suggestion. Lieftinck suggests in his book that the authorities were able to make continuous estimates of at least a very large proportion of national income by monitoring trends in wages. During the first few months after the current reform the Central Bank apparently set a path for the money stock on the basis of its estimates of wages paid to workers.[10] If indeed the quality of up-to-date statistics on wages is clearly superior to the statistics on output or domestic sales, then it may make sense for a brief period to use estimates on the incomes side for setting monetary policy. Assuming the authorities will continue to determine wages in the socialized sector, it should be possible to allow for free wage formation in the privatized sector of the economy and to free almost all domestic prices whilst maintaining a perspective on nominal developments in the economy by monitoring very closely trends in wages. During this first stage, an anti-inflationary policy would effectively mean a consistent policy on wages in the nationalized sector. In the Dutch case, the income velocity of money became remarkably stable from the end of 1945 onwards, i.e., no more than 8 months after the war. Once velocity has stabilized, the Central Bank could try to target the rate of growth of an appropriate monetary aggregate, using the type of feed-back rule advocated by many monetary economists.[11]

Conclusion

The East European nations are discussing convertibility of their currencies under exciting but very difficult political conditions. The movement towards political and economic freedom should in my view include the transition to a fully convertible currency, and I have tried to provide some arguments in favor of making the currency convertible as soon as it is politically feasible to conduct a fiscal policy that does not require inflationary finance of the budget deficit. Many of the points in this paper were well expressed in a recent conference contribution by Hahn-Been Lee, a former Deputy Prime Minister of South Korea who spoke on "The Change in the East Block".[12]

> "Once the Europeans achieve equalization of domestic prices with external prices, they will gain the confidence of their people, who will then be able to trust their own currency.... Once people begin to have that valuable trust in their own currency, they begin to adopt the habit of saving, making investment possible. Saving is a prerequisite for the privatization of state-owned industries. Only after such successful economic management does popular democracy have a fair chance at stability..."

[10] In addition, as shown in the quotation above, the Central Bank helped to provide credit to enterprises.

[11] See for example: B. McCallum, Monetary Theory, MacMillan, 1989.

[12] Wall Street Journal, July 13, 1990.

Session III

Payment Balance and Currency Reserves—External Debt, International Support in Favor of Convertibility

External Debt Monitoring

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Introduction

The problem of Bulgaria's external debt became particularly important under the conditions prevailing during the economic crisis the country is experiencing at the moment. The debts and receipts to and from other countries are an important factor not only in the search for the road to convertibility of the Bulgarian lev, but also in the search for economic, financial, and political stability.

In order to overcome the economic crisis, it is necessary to seriously consider the financial policy of the country and to take steps to reduce our external debt, to restructure and reschedule the payments, in order to secure the normal servicing of the debt. All this would be impossible to do without the significant support of other countries and assistance of the creditors.

In this short presentation I shall focus on two points:

(1) Analysis of the situation with the external debt, and
(2) Steps to be taken in the credit policy of Bulgaria.

Understandably, more attention will be given to the necessary actions on the part of Bulgaria, hoping that our foreign partners will reveal the forms and the possible scales of the required external assistance.

Analysis of the Situation

It is important to stress at the very beginning that due to the critical level of industrial development and a number of other reasons Bulgaria often used external credits in its past and this is not the first time it bears the burden of these debts. It would be enough to point out the great difficulties from the debts accumulated in the period after the liberation from Turkish domination until the global economic crisis 1929–1933 when, together with a number of other European countries, it became bankrupt.

The Bulgarian economy was quite shattered and very backward immediately after the Second World War. In order to restart its economic development and to restructure the national economy, Bulgaria had to attract additional financial resources from other countries. Being unable to receive considerable external credits from the West in the first postwar decades, Bulgaria directed its efforts in obtaining credits from the USSR and some East European countries, and in this way they played a positive role in our economic development at that stage. The credits were given at favorable terms and were used almost exclusively for investment purposes. They were not sufficient, however, and some of the projects created with their assistance were not on a good technological level. The result of this was that in spite of the accelerated development of the production forces, economic efficiency was considerably low. With full employment of

the whole labor force, the raising of the standard of living went quite slowly, especially in the last two decades. In spite of this, the credits (which were repaid) helped in the creation of considerable production facilities.

Only as late as the 1960s and especially in the 1970s did some opportunities to use credits from Western countries emerge, though they were not always offered at favorable conditions (this refers particularly to the very short repayment periods). Bulgaria began to receive loans from its Western partners, but unfortunately did not work out a clear and scientific concept for the policy to be applied in order to use them efficiently. Loans could be received without a requirement for a maximum efficiency in the investment of the money for building up modern production facilities which match the global standards in the key sectors. Nor was there any consistent structural policy for economic development.

As a result of these circumstances, the loans obtained were used mainly to cover the shortages and the imbalances in the economy created by the centralized administrative system and the unbalanced, in some cases voluntaristic planning. In spite of the large, for the scale of the country, foreign debt, the latter did not create highly efficient and globally competitive production in any of the branches. A significant portion of the loans was used for the construction of prestigious, but not efficient production facilities like the plants for heavy machine building, metallurgy and other large plants. Another part of the loans was used for the import of goods needed to fill the gaps that appeared as a result of the imbalances, the poor planning and the incompetent centralized management of the national economy. Even in the last couple of years Bulgaria became a regular importer of agricultural products, mainly cereals and fodder. Other goods are also imported which could be produced locally if the economy was better structured and the producers were properly stimulated. Unfortunately, it can be concluded, that a part of the resources obtained through loans from other countries were invested in the building-up and equipment of projects which were designed to serve the needs of a limited number of people. Though their amount is not very big, this was lavishness that we should not have afforded. According to official data, more than 80% of the external loans were not used for the creation of production facilities, but for personal and productive consumption. Two thirds of them were directed to productive consumption—import of raw materials, auxiliary materials and spare parts. The personal consumption includes the import of consumer goods, fodder, herbicides, raw materials and intermediate products for the production of consumer goods.

Only about 20% of the loans were used for importing equipment and machinery for production innovation. This amount includes also the 600 million dollars for the financing of our participation in the building up of the "Yamburg—Western USSR border" gas-pipeline which guaranteed the delivery of considerable quantities of gas until the year 2010.

As a result of the inconsistent credit policy, the external loans did not contribute to the creation of modern production facilities which could help the satisfaction of the domestic demand and the increase of exports. This would have increased the hard currency revenues and would have assisted the repayment of the loans and even the formation of small hard currency reserves. The loans were only used for temporarily overcoming the accumulating effect of the negative economic factors and phenomena, but not for their elimination. Thus the negative factors in the economic life, though hidden temporarily, were accumulating all the time. Economic achievements and high rates were widely demonstrated. Statistics did not perform its role either. It used to announce that unlike Poland, the USSR, and other countries, the Bulgarian economy was developing successfully. This was done to show a false level of success by the totalitarian leadership and the administrative system.

This self-deception prevented us from drawing realistic conclusions of the real conditions of the country even in the 1980s, when we could already learn from the lessons of Poland, Romania, Yugoslavia, and other countries in connection with their problems of external debt and the inefficient use of loans.

One of the theoretical justifications of the almost uncontrolled use of the external loans was the presence of inflation of the currencies in which the loans were received. There was an

understanding that it is profitable to receive credits which will be paid later with devaluated dollars, DMs, pounds, etc. The theoretically sound principle that inflation is favorable for the debtors and unfavorable for the creditors was applied to draw a wrong political conclusion. The policy of actively drawing loans was justified in this way, without giving sufficient attention to the effect from each particular loan.

Indeed the devaluation of the foreign currencies can be favorable for the debtors, but only if the loans are used efficiently and—what is very important—if at the same time as the devaluation there is an increase in the prices of our exported products. At the present moment, however, the quickest changes take place in the prices of new products which embody technical progress, but we export very few of them. For that reason in the majority of cases, Bulgaria is not able to sell at high prices on foreign markets. The debts are paid with currencies received from the exports of goods at prices which increase very slowly and even remain unaltered for a long time. In the case of imports the situation is reverse. Importing advanced machinery, equipment and technologies, Bulgaria has to pay rising prices that grow even quicker than the inflation rate. Therefore the terms of trade deteriorate.

Inflation also affects the external loans in another aspects. The higher the inflation rate, the higher the interest rates. The interest rates under conditions of inflation is not only a manifestation of the price of the service. At the same time it also compensates the creditor's loss which results from the depreciation of the real value of the debt. The high interest rates, when the economic conditions are deteriorating, make it still more difficult for Bulgaria to service its debts.

Because for a long time the external debt was kept secret, no full analyses have been published about the terms of our external loans—sources, utilization, interest, due times, structure, etc. No information is available either regarding their efficiency. The official statement was that the external debt is about 10,4 billion dollars. It was also announced that the main part of the external debt was accumulated in the period 1985–1989.

According to information from some external sources and from our press during the last couple of months, Bulgaria's external debt in hard currency has increased since 1970 as shown in Table 1.

Obviously, the debt increased considerably in 1975–1979, then in 1980–84 it fell considerably, and in 1985–89 it strongly increased again. The last sweep upwards is due to the attempts of the totalitarian regime to hide, with the assistance of external loans, the acceleration with which Bulgaria was moving to a serious crisis. The gross debt in 1984 was 2,1 billion dollars and the net debt was only 700 million dollars, which was not so bad. The debt was also rather normal in 1985. Only three and a half years later it grew by 7 billion and thus became an enormous burden to the economy. It might be enough to point out that in 1985–89 the hard currency expenditures of Bulgaria were 23 billion dollars and the revenues were only 15,7 billion dollars.

According to international practice, the acceptable normal level of a foreign debt is when its servicing requires 20–25% of the current receipts of the country. The main source for hard currency for Bulgaria is the export to the developed countries and to some of the developing countries. The exports to industrially developed countries was about 1 billion dollars annually (in the period 1986–89), with a declining tendency in recent years. The exports to developing countries in the same period was around 1,5 billion dollars annually, and a part of it was delivered on credit or paid according to clearing, barter, and other bilateral agreements. In this situation the real annual receipts from exports in hard currency are no more than 2 billion dollars. Even if we accept the criterion for debt servicing with 25% of the hard currency receipts, Bulgaria has about 500 million dollars available for this purpose.

Given the situation of the international financial markets, it is possible to assume that the average interest on the Bulgarian external debt is about 7–8% annually. This means that Bulgaria has to pay 700–800 million leva interest each year, which is about one-third of its total receipts in hard currency. According to our estimates, in the period 1970–1990 the total amount of the interest calculated on its foreign loans is almost equal to the current debt.

Years	Gross Debt	Net Debt
1970	0.7	0.6
1971	0.8	0.7
1972	1.0	0.9
1973	1.1	1.0
1974	1.8	1.4
1975	2.7	2.3
1976	3.3	2.9
1977	3.8	3.3
1978	4.4	3.8
1979	4.6	3.9
1980	3.6	2.9
1981	3.2	2.4
1982	2.8	1.9
1983	2.4	1.2
1984	2.1	0.7
1985	3.5	1.4
1986	6.2	4.8
1988	8.0	–
1989	10.0	–
1990	10.4	–

Source: ECE, 1987–88, N 7, p.3. (O. The data for 1989 and 1990 are from the Bulgarian press.)

Together with the interest, the country must also meet the coming maturities. If we accept the most optimistic version, namely that the average term of payment for the loans is 5 years, then each year we have to meet maturities amounting to about 2 billion dollars. This is an amount equal to the total sum of the average annual receipts from exports of the country in hard currency. The amount payable in 1990 as per March 31, 1990 (before payments were frozen) was 3,4 billion dollars and the amount payable in 1991 is 1,8 billion dollars. Analysis shows that the receipts in hard currency, from exports and from other activities, are not sufficient for servicing the debt. These circumstances forced the government to make a decision in April 1990 to stop payments on the principal of our external debts and to concentrate efforts on the payment of the interest only. The Bulgarian Foreign Trade Bank stopped payments of maturities of all kinds of credits—short-term, import credits, credits for financing of investment projects, and also medium and long-term financial credits. This was a step which undoubtedly shook the reputation of the country as a reliable partner. Problems with imports, and severe difficulties in obtaining new external loans emerged.

The receivables of Bulgaria as per June 30, 1990 from credits given to other countries accounted to 2,2 billion dollars. These are credits to some developing countries, among which Iraq ranks first. The major part of these amounts are not payable.

Bulgaria's main creditors are the FRG, Japan, Austria, the UK, and France.

New Problems Facing the Bulgarian Credit Policy

The need to overcome the crisis situation in the field of foreign debt is an extremely difficult problem for Bulgaria. It will require a long-term program based on a well considered monetary and credit policy. The measures to overcome the debt crisis must be an integral part of the

stabilization program for a long period of time. The core of this program must consist of measures for the systematic increase of hard currency incomes and a considerable limitation of the expenditures, in order to secure a balanced and active balance of payments. It is already necessary in the early years to reach a positive balance in the current payments which will be sufficient for paying the annual interest and will allow us to direct some, though small amounts, towards the repayment of a part of the principal. Thus further growth of the debt will be stopped and it will gradually start to diminish.

Such a turn is not easy for an economy which is undergoing a crisis. It will require a lot of efforts for the successful realization of the economic reform which must be done at a minimum social cost. Realistically speaking, such a turn in the conditions of the balance of payments cannot be reached within one or two years. Undoubtedly, the amount of the debt will continue to increase in the short-term perspective as a result of the unpaid interests and also because of the use of external assistance. The goal is to prepare conditions for barring the growth of the debt further, and later to move to a reduction of its growth and then a gradual reduction of the debt itself, in order to create conditions for its normal monitoring and servicing. A gradual, well considered, transition would be better than shock producing measures, as they might have unpredictable consequences for the economy which is in a difficult situation.

In connection with the development and implementation of a new credit policy, it is fundamentally important to eliminate the unnecessary and harmful practice of considering the public debt a state secret, as this makes it impossible to analyze the economic efficiency and the reasonableness of obtaining external credits. It is quite clear that the credits cannot be a secret for the creditors and their banks. The secret is kept only from the Bulgarian nation. The secrecy allowed opportunities for arbitrary decisions, without the knowledge of the public. It makes it possible to receive loans without assessing the consequences, without analyzing the efficiency of the use of the loans and their terms. If there is a full transparency in the financial and credit policy, the public will always know not only the exact amount of the debt, but also the terms of each particular credit—amount, maturity period, interest, goal, and method of payment. Everybody will be able to judge about the efficiency of each loan. Thus, the poor economic results could not be masked with the assistance of external loans. The publicity increases the public influence on the economic, fiscal, and credit policy of the country. It allows not only the banks and the governmental financial authorities, but also scientific institutes, experts, etc., to assess the efficiency not only of the credits used, but also of the whole economy and economic policy.

There is no doubt, that had the Bulgarian public been regularly informed about the inefficient use of such large external loans, it would have opposed them much earlier and would not have allowed the uncontrolled realization of a thoughtless credit policy which brought the external debt of the country to its present critical level. It is also necessary to eliminate the secrecy of some other information like: inflation and money circulation, balance of payments, hard currency and gold reserves etc., as they are needed for making an analysis of the real economic conditions.

Of great importance for the long-term stabilization program and for the economic reform is the question about the further development of the foreign economic relations of Bulgaria and the conditions for obtaining foreign assistance.

In the first place, at this point in time it would be wrong, in our opinion, to underestimate our economic relations with the USSR and the other CMEA countries which have three quarters of our foreign exchange. It is necessary to preserve the market shares we have gained in these countries in order to be able to satisfy our needs for raw materials, fuel, energy, and consumer goods. A part of the raw and other materials imported from these countries can be, after being processed, exported again bringing in more hard currency.

The Soviet market and the markets of the other CMEA countries are also important for us in connection with the forthcoming introduction of the system of payment in hard currency instead of in transferable rubles. The preservation of our position in our relations with the CMEA countries can open better opportunities for obtaining hard currency which will be an additional

source for repayment of our external debts. At the same time we should not underestimate the danger of a reverse situation. If our balance of payment with the CMEA countries deteriorates, there is a real danger that the debts in convertible currency might seriously increase.

There are reasons to expect that Bulgaria's financial conditions will deteriorate considerably from the transition to payments in hard currencies among the CMEA countries. Negative consequences are expected in two directions:

- Terms of trade will get worse, and
- Exports will be limited.

The deterioration in Bulgaria's terms of trade with the CMEA countries and mainly with the USSR will be manifested when the current international prices start to be applied in the mutual exchange of commodities. Bulgaria's imports from the USSR are dominated by products with high international prices: oil, gas, raw materials, etc. The situation becomes even more complicated now with the new rise in the oil prices in connection with the developments in the Persian Gulf. The major part of Bulgaria's exports to the USSR consists of products which are not competitive and their prices may fall. All this means that we must expect considerable deterioration in the Bulgarian terms of trade with the USSR. The same thing is expected with ČSFR, GDR (which is now part of united Germany), Hungary, and Poland.

Together with the deterioration in the terms of trade, there are reasons to expect a considerable cut down in the Bulgarian trade with the CMEA countries when the payments start to be performed in hard currency. It is quite realistic to expect a reduction in Bulgarian exports.

As a result of these factors, it is obvious that there will be a deterioration in the Bulgarian balance of payments. In order to soften at least partially these consequences, Bulgaria tries to reach an agreement with the separate CMEA countries for a gradual and step-by-step transition to payments in hard currency at current international prices, within a period of 2–3 years. Along with this, other mutually beneficial solutions are considered in order to avoid eventual clashes.

Of great importance for Bulgaria in its attempts to overcome the crisis of the external debt are its relations with the developed industrial countries. The problem of reaching a turn in the tendency of the growing external debt is directly related to Bulgaria's balancing its payments with the industrially developed countries. This requires the inclusion in the long-term program for stabilization of the economy, of efficient steps for strong stimulation of exports and all other activities creating hard currency revenues, as well as a reduction of the expenditures in hard currency.

In spite of everything, in the conditions of a deep economic crisis it would be unrealistic to expect that the problems of Bulgaria's external debt could only be solved through the limitation of the hard currency expenditures and the stimulation of incomes. It would be difficult to activate, restructure, and develop the economy as well as increase its efficiency without considerable assistance from outside. Otherwise the process would be slow and difficult, with heavy social consequences. It is necessary to point out once again that the realization of an efficient program for the strengthening of the economy without serious social clashes will inevitably require, in the first years, new debts and financial assistance, and this will increase the debt still further. This means that the external debt will not only remain very high, but will continue to grow. It is desirable to limit this growth by increasing the efficiency from the use of not only the new credits, but also of all hard currency resources.

According to the available data the major part of the obligations are to banks and are short or medium term. This means that now, and in the next two or three years, the main part of the debt has to be paid which is impossible, as it already became clear. Therefore the first immediate task is to push forward the negotiations for rescheduling the payment and, where possible, for reducing the interest. The negotiations could be held both with the banks and with the governments of individual countries who can contribute in different ways. It would be very helpful if the governments of some countries decide to allow long-term loans to Bulgaria at favorable interest and other terms, and to use the amounts for paying the short-term loans

whose interests are very high. It is very important to negotiate also with the Club of Paris about allowing concessions within the frames of international plans and agreements.

All these steps could only produce a real effect if they secure the rescheduling within a longer period of time at improved terms and interests. What has been done so far will neither assist Bulgaria to overcome the crisis, nor normalize its economic relations with Western countries.

Along with the measures for rescheduling, restructuring, and improving the terms, it is necessary to take immediate steps for obtaining new loans from foreign governments and international organizations, in order to use them for the realization of the economic reform and the stabilization program. In this respect the first task is to arrange the inclusion of Bulgaria in the International Monetary Fund and in the International Bank for Reconstruction and Development. These organizations will not provide us with large financial resources. However, Bulgaria's participation in them will play a positive effect on its international prestige. In the coming years we shall also rely on concrete assistance from these organizations. The preliminary procedures have already been discussed.

Bulgaria is a co-founder also of the European Bank for Reconstruction and Development. From this bank it is possible to expect additional sources for reconstruction and modernization of a number of enterprises, as well as for restructuring the economy.

Apart from the international organizations, additional resources in hard currency can also be requested from the governments of those Western countries who have lively economic relations with Bulgaria. Some countries already declared their readiness to give Bulgaria financial assistance. Very promising is the statement the EC Foreign Ministers gave at the beginning of April 1990, about extending the list of the East European countries which will receive financial assistance, including Bulgaria. Another thing that could be done is to distribute obligation loans through banking consortiums and to use the obtained resources both for paying the short term debts, and for new investments.

It is necessary to use all forms of attracting capital from other countries, for creating joint and other companies, etc., as this would enhance the development of Bulgaria's economic relations with other countries, will increase its economy and its exports, and will contribute to the growth in its hard currency reserves. All this will facilitate the movement away from the economic and financial crisis.

The Foreign Exchange Constraint in a Liberalizing Economy

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Introduction

This paper summarizes standard theory regarding the foreign exchange constraint in a market economy, and then examines the relevance of this theory for the problems confronting the liberalizing economies of Eastern Europe.

The Concept of a Foreign Exchange Constraint

A simple model of the balance of payments on current account may be specified as:

$$B = B(Y/Q, c).Q, \qquad B_1 < 0, B^2 > 0,$$

where

$$\begin{aligned} B &= \text{balance on current account} \\ Y &= \text{real income} \\ Q &= \text{capacity output} \\ c &= \text{competitiveness} \end{aligned}$$

The model is illustrated in Figure 1.

A foreign exchange constraint exists if (with current c and Q) the maximum sum F available to finance a current account deficit is less than $0B^*$. Such a constraint prevents the economy operating at full capacity $0Q$. Output has to be cut by $(1/m)(B^* - F)$, where m is the marginal propensity to import.

A foreign exchange constraint can be relaxed in two ways.

Foreign Finance

Additional foreign financing, an increase in F, has the obvious short-run benefit of diminishing any gap between B^* and F and thus permitting the economy to operate closer to Q. If the increase in finance takes the form of aid or is accomplished via debt reconstruction, it is a pure gain.

Feasible levels of foreign borrowing and aid are constrained by what the rest of the world may be ready to supply. But even within the limits of what the rest of the world may be willing to supply, the national interest in foreign borrowing must be assessed in an intertemporal context. Failure to make such an assessment has frequently led to devastating costs—as in much of Latin America, in Bulgaria, and, the most dramatic case of misuse of the international capital market of all, in Romania under Ceausescu. Such an assessment has to balance:

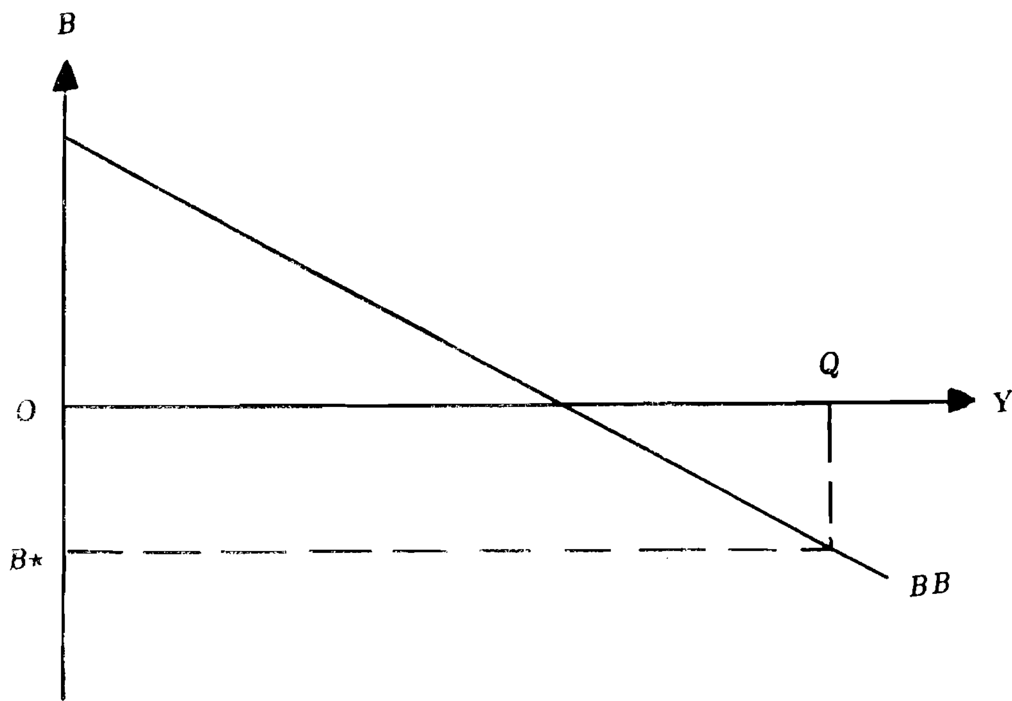

Figure 1. Dependence of Balance of Payments on Current Account

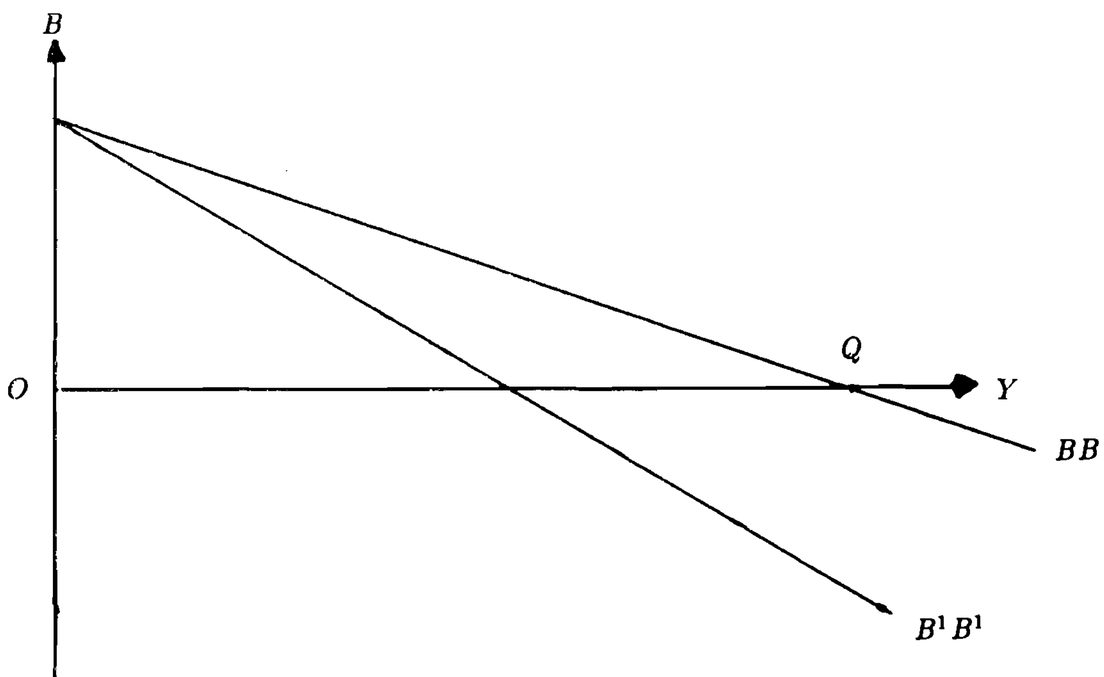

Figure 2. Expenditure Switching

- The benefit of relaxing the foreign exchange constraint (or, if the economy is already operating at full capacity, the rate of return on the additional investment undertaken with the foreign borrowing, as analyzed in the two-gap model)
- The benefit of building up reserves, which should typically be held at about 3 or 4 months' supply of imports, and certainly need to be at such a level prior to any declaration of convertibility
- The cost of eroding creditworthiness and precipitating a debt crisis (something that, according to a traditional rule of thumb that seems to have some empirical support, can happen when the debt/export ratio exceeds 200%).

Expenditure Switching

Expenditure switching means a shift of domestic and/or foreign expenditure toward domestically produced goods. It has the effect of shifting BB up. Possible sources:

- Tighter import controls
- A more competitive real exchange rate[1]
- Improved non-price competitiveness.

Question 1: How do the lags of these three instruments compare?

Import controls can act rapidly. Devaluation requires something like 2 or 3 years, and the full effects may take longer still, until exporters can respond to changed price incentives. Non-price competitiveness depends on restructuring: this is the key to catching up, but the process is very long-term, involving perhaps 2 to 20 years.

Question 2: Can real devaluation fail to eliminate a foreign exchange constraint?

In the short run, the answer is yes, for the reason just given: devaluation takes time to work. In the medium run, there are certain limits on the maximum sum that a country can transfer abroad, but a sufficiently competitive real exchange rate can enable it to approach that limit. The constraint on use of the exchange rate comes from the danger of macroeconomic destabilization. An ultra-competitive exchange rate will be highly recessionary if not accompanied by monetary expansion (cf Poland) because of the real balance effect; but, if there is monetary accommodation as happened in some Latin American countries (cf Brazil), the result can easily be hyperinflation.

Question 3: Can tighter import controls substitute for real devaluation?

In the short run, it is difficult to deny that import controls—such as those resulting from the denial of convertibility—may give a better outcome. In the medium run, import controls are a thoroughly bad idea: they distort resource allocation, they preclude foreign competition, they invite rent-seeking behavior, and they typically erode the government's fiscal position. We are thus confronted by an intertemporal trade-off: abolition of import controls (convertibility) promises long-run gains at the cost of short-run difficulties. But this does not necessarily mean that a government will always be wise to make the courageous decision of abolishing import controls and establishing convertibility immediately. A premature plunge may lack credibility, precisely because the public knows that it can be reversed and that reversal will bring a short-run easing of the situation. An incredible declaration of convertibility invites an import surge (a phenomenon several times witnessed in Latin America) as the public tries to stock up on foreign goods while this remains possible; the import surge may then make the maintenance of convertibility impossible.

Question 4: Is there a case of gradual liberalization of import controls?

In my view the answer is yes. Import-competing enterprises need time to adjust to the new situation they face, including a large increase in the prices of energy and materials to

[1]This is the standard instrument in a market economy. Import controls have already been abandoned, save for the support given to a few industrial cripples like textiles and agriculture, which will not vary one way or the other with the state of the balance of payments. And what should be done has (hopefully) already been done to look after the long-run efficiency of the economy.

world market levels. Some will adjust successfully if given time. Others will not, but even in those cases it makes no sense to drive enterprises out of business so long as they are capable of producing positive value-added at world prices, until the new export industries can absorb the factors they release. An immediate move to near free trade threatens to close down many enterprises simultaneously before their factors can be absorbed elsewhere. The right strategy is to establish convertibility as a part of the coordinated package of measures on "M-Day", the day the economy moves to a market economy, but to accompany convertibility by a tariffication of all import restrictions and then to reduce those tariffs gradually over the next, say, 5 years.

The Third Oil Shock

Suppose that the economy is initially in macroeconomic equilibrium as in Figure 2 when the price of oil rises dramatically. If the economy is heavily dependent on imported oil, as they all are in Eastern Europe excluding the Soviet Union, the effect will be to rotate BB down to B^1B^1. Matters will be more difficult still if the economy was not initially in macro equilibrium, if it loses export markets in Iraq as well, or if it was receiving debt repayments in oil from Iraq.

The optimal response to such a situation in a market economy is to devaluate, to finance any interim deficit that may arise until devaluation can "work" by borrowing from the international capital market (or, if necessary, the IMF), and to let output decline only to the extent that may be needed to make the real devaluation "stick". This reaction presumes that the country is internationally creditworthy or has adequate unused borrowing rights at the IMF, that its enterprises respond to price incentives, and that enterprises that are viable in the long-run but face short-run liquidity problems will be able to borrow from a competitive banking system. Unfortunately all three assumptions seem rather doubtful in the context of the liberalizing economies of Central and Eastern Europe.

Clearly it makes sense in these circumstances to search out all possible sources of aid and to seek a favorable debt reconstruction (in which context it may be worthwhile to revive Bulgaria's pre-war claims on Germany, which were apparently not settled in the London Debt Agreement of 1953). Beyond what can be accomplished there, it may be necessary to accept a lower level of output until such time as exports rise or the oil price falls. The key question is whether it makes sense to abandon the quest for convertibility until the foreign exchange constraint can be mastered, as the West European countries did in comparable circumstances in the 1940s. On that question my mind is still open: convertibility seems to offer much greater advantages in Eastern Europe today than it did in Western Europe 40 years ago, where the basic infrastructure of a market economy was already in place and there was no comparable need to import a price structure (and substantially less threat from corruption).

The Reform and Stabilization Program of the Czechoslovakian Government

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The Czech and Slovak Federal Republic has decided to move to a market oriented economy and to be more closely integrated with the world economy. The analysis of economic and social development and comparisons with the development of neighbors in Europe, which was done after the "velvet revolution" provided a lot of evidence about problems and inefficiencies resulting from past policies. The allocation of resources through central planning rather than the market mechanism that took place during almost all the postwar period has resulted in a long-term decline in productivity, a loss of international competitiveness and also a decline in the standard of living.

There is broad public support for radical reorientation of the economy. At the same time, it might not yet be clear, if there is really a deep and broad understanding about the impact of the transition to a market economy on the economic and social life of the society. Relatively high levels of personal and social consumption have been achieved at the expense of investment.

The starting position for transition to a market economy could be evaluated in comparison with some other CMEA countries as more or less favorable:

- Irrespective of a sustained decline in the growth rate during the last 15 years, there was still an increase of NMP by 1,3% in 1989
- The prudent monetary and fiscal policy, and wages and price policy made it possible to keep a very low inflation rate for a long period of time—some 2–3% annually; this figure does not include "depressed" inflation
- A relatively low external debt—7.9 billion US$ in 1989 with a debt service ratio of 19,4%
- In 1989 there was a slight increase in exports to the countries with convertible currency
- The budget deficit in the fiscal year 1988/89 was relatively small.

The main inherited problems (besides the damaged attitude of people to economic life) could include the following:

- Obsolete industrial assets and a one-sided structural orientation to heavy branches of industry; an undeveloped infrastructure
- Inadequate involvement in the international division of labor and cooperation with developed countries caused by less competitive industrial products
- A complicated environmental situation.

Czechoslovakia was one of the most industrialized countries before World War II and its achievements must be therefore compared with countries such as Austria and Belgium. The forty years of "economic experiment" with the centrally planned management system was unsuccessful.

The more or less favorable initial situation is however now complicated by relevant external events beyond the Government's control such as: the disintegration of the CMEA market; payments in convertible currency (rather than paying in transferable rubles) for foreign trade between CMEA countries at international prices; Middle-East crisis followed by an increase in the price of crude oil.

There is a general understanding in the Government, The Federal Assembly, and the public in general, that the economic reform, being understood as a systemic and institutional reform and fundamental restructuring of the economy, must be promoted as quickly as possible. Although some economic reforms had been initiated earlier, the process of reforms has greatly accelerated since November 1989. In 1990 a significant number of changes, new laws, and regulations have already been introduced. In May 1990 a "concept paper" on all reform issues was prepared; in September the Scenario of the reform was delivered to the Federal Assembly by the Government and approved.

The package of reform measures and policies, that can be implemented to a great extent simultaneously, includes:

(1) The creation of a macroeconomic framework for economic reform—stabilization policy, reform of the tax system, new budget rules.
(2) Changes of ownership in the economy and demonopolization—so-called small privatization and restitution, big privatization, setting up the "State Property Fund".
(3) A major liberalization of domestic prices, liberalization of foreign trade operations, and the opening of the economy.
(4) "Internal convertibility" of the Czechoslovakian currency (Koruna), which includes the liberalization of current account transactions and a unified exchange rate responsive to supply and demand.
(5) The provision of an adequate social safety net.
(6) An adequate structural policy.

The other measures which are to be promoted as part of the above mentioned policies are: promotion of private sector activities, financial sector reform, a program for restructuring state owned enterprises (SOEs) and the privatization of a part of them, changes in the "rights and responsibilities" of the managers of SOEs, and last but not least, the encouragement of foreign direct investments.

An internally consistent macroeconomic framework is understood to be a prerequisite for successful structural adjustment. The reform policy aimed at changing the behavior of consumers, investors, and enterprise managers can only be successful if it takes place in a macroeconomic environment conducive to and supportive of such reforms. Accordingly, the Government has given priority to the elaboration of a macroeconomic framework within which its sectoral reform policies, organizational, institutional, foreign trade, and financial reforms can be successfully unfolded.

The main priority followed is to avoid both inflation and unnecessarily high unemployment. Avoiding excessive external indebtedness is another objective. These objectives should be pursued with a mix of fiscal, monetary, and exchange rate policies.

Overwhelming state ownership on the means of production proved itself ineffective worldwide and will no longer be the only type of property in the country (common with the cooperative property); the constitution was already changed and private property is again allowed in economic life. In the first stage of privatization the majority of the state owned enterprises will be transformed in the form of joint stock companies with the possibility of privatization. The process of privatization and its details are still a matter of consideration, but it is clear that the sectors of retail markets and services might be fully privatized in the near future (in the frame of so-called small privatization).

The foreign capital is needed to participate in the privatization because of a lack of domestic capital and as assistance to revitalize the old-fashioned industrial structure. All rights and

guarantees to the foreign investors are provided in Czechoslovakian legal documents, as well as in international agreements on protecting investors from the respective foreign country. By this agreement the Czechoslovakian side is, in fact, giving a guarantee for free repatriation of the profit share or capital outside the country. Appropriate conditions to attract foreign direct investments are now being elaborated in the field of legislation and by selecting the state enterprises for pilot programs of privatization with foreign capital participation.

The private enterprises without limitations on capital volume or number of employees are now encouraged by law.

A radical approach to the solving of the price-problem has been chosen. The price system based on the domestic costs applied for long periods of time, caused a discord between the internal structure, the level of prices and world market prices. Even more, internal cost-based prices are distorted so that there is no link between "factory gate" (wholesale) prices and retail prices. The price problem is to be solved in two steps:

(1) A centrally controlled price remedy (including taking into account the impact of the transition to a freely convertible currency accounting system between CMEA countries)—the price remedy is already taking place and should be accomplished in the first part of 1991.
(2) Price liberalization on most of the products is also due to take place early in 1991; there is full understanding of the fact that price liberalization must be preceded by demonopolization of the enterprise structure.

A strong obstacle to the price reform, to the opening of the economy and to the country's involvement in the international division of labor, to the attraction of foreign direct investment and to joint ventures, is the domestic currency unconvertibility; therefore a program for reaching the "internal convertibility" of the Czechoslovakian Koruna is prepared and should be implemented early in 1991. The successful run of this program is, of course, preconditioned by an expansion in the volume of foreign trade being carried out in convertible currency, with an appropriate exchange rate policy and also with necessary foreign exchange reserves. It is also desirable to be backed with stand-by convertible currency resources to be able to intervene in the exchange rate level when the demand for convertible currency exceeds the possible supply. A relatively convenient situation has been created by Czechoslovakia's re-entering the world finance institutions (IMF, World Bank, European Bank for Reconstruction and Development).

The Government's long-range goal is to reach the unlimited convertibility by meeting the obligations of the IMF's Article VIII. However, due to the contemporary economic situation it is possible to introduce the current account convertibility only, giving domestic residents the right to buy foreign exchange at the official exchange rate in order to finance current account transactions, i.e., purchase of goods or services from abroad.

The implementation of such a concept of convertibility (called in domestic papers as "internal convertibility") is based upon:

- The compulsory sale of foreign exchange export incomes by the resident economic agents to the banks at the official exchange rate being set up on the basis of demand and supply guaranteed purchase of the foreign exchange resources against domestic currency to cover payments abroad.
- Elimination of the circulation of foreign currencies in the Czechoslovakian economy.
- Setting up the control of the foreign exchange balance through macroeconomic interventions (restrictive budgetary and monetary policies) and with the possible application of incentives stimulating foreign exchange supply and restricting the demand (import surcharge, restriction in the use of the foreign exchange by citizens and to supply the consumer market with imported goods, import licenses for certain commodities, customs duty, export bonuses).
- Intervention of the Central Bank on the foreign exchange market enabling a long-term exchange rate stabilization using central foreign exchange reserves or eventually loans from abroad.

An important issue related to the establishment of the internal convertibility is the specification of the initial level of the exchange rate of the Czechoslovakian Koruna to the convertible currencies, which would ensure the launching of the new system and enable its stability for a long enough period of time. The initial level of the exchange rate must also reflect the feasible impact of the devaluation on the internal prices, which must, from the one side, send the right signals to initiate industrial restructuring according to the relations on the external market; these relations are to be transformed through the exchange rate level into the domestic economy. From the other side, the new internal prices of inputs to the economy derived from the level of the exchange rate must be only just a manageable obstacle for producers in branches already matching the requirements of the competitors' effectiveness. The state of foreign exchange reserves available for foreign exchange market interventions must also be taken into account.

The setting up of the initial level of the exchange rate of the domestic currency is a multi-criterion task, where the particular criteria are of an economical, social, and political nature and some of them are mutually contradicting. Suggestions made for the determination of the initial exchange rate level differ, but the very probable value is about 24 Koruns to one US$, which represents about 50% devaluation of the domestic currency. In the debate about the issue there are voices supporting even higher devaluation. They are motivated by the expected high demand on the foreign exchange if the internal convertibility will be introduced with an overvaluated exchange rate, when there is a lot of domestic money circulating in the economy due to the previous unconstrained monetary policy. However, some economists, from the other side, do recommend to follow the revaluation strategy. Their main concern rises from expectations, that the high devaluation will inflict unmanageable inflation.

The reform of the banking system is already going on, the emission and credit functions of the Central Bank were split between the Central Bank and crediting banks; the Central Bank obtained real control over the amount of money in circulation and over the equilibrium recovery; the reform project supposed that the number of crediting banks will be increased (3–4 banks until now); foreign participation in banking business will be possible in a later stage of the reform.

An important part of the reform program is to work out the legal and organizational framework. In the first half of the year more than 60 decrees and laws have been enacted by the Federal Assembly. The important legislation which creates conditions for commercial activity, for privatization, and for the economic behavior of all (state and privately owned) enterprises, should come into force on January 1, 1991.

Let us mention some of those acts already in force:

(1) Act on joint-stock companies
(2) Act on the state enterprise
(3) Act on the private enterpreneurship of the citizens
(4) Act on foreign economic relations
(5) Act on enterprises with foreign capital participation
(6) Act on foreign exchange
(7) Act on state bank
(8) Act on crediting bank and insurance companies
(9) Act on taxes.

In the final state of preparation are:

(1) Act on securities
(2) Act on budgetary rules
(3) Act on employment
(4) Act on privatization
(5) Act on the land
(6) Act on prices control and on cartels
(7) Act on competition

(8) Act on import duty
(9) Act on collective (triparties') talks.

The complexity of the transition maneuver towards the market economy needs careful control in order to ensure that development will not follow the "crises transition trajectory". In the ČSFR the reform of the management system is deeply interconnected with the urgent issue of restructuring the industry, which was postponed several times in the past. The decision about "correct allocation" of investment for restructuring, which should be done in accordance with the Government's intention to be involved in world economic relations in a more harmonized manner and to move to a far more open economy, needs a great deal of coordination with the outside world.

Such a decision, which is to be taken on the macro- and microeconomic level, would be worked out much more precisely and easily should the developed economies pass through a period of growth. Such a prospect is, however, hardly to be expected within the next 2–3 years, even if the integration of (West) Europe opens a new prospect for growth, thanks to the large-scale economy effect which is expected to take place. At the same time, one must not underestimate the emerging new global destabilization factors like the crisis in the Persian Gulf, or the situation in the Soviet economy, to which the Central and East European countries and Czechoslovakia are especially very sensitive. The program of the stabilization of the economic development, along with the non-crisis trajectory in this context, plays the basic precondition for the success of the reform as a whole.

The stabilization policy of the Government in context with the measures for an economic reform program is based on:

(1) Macroeconomic restrictions; the goals are stipulated as:
   - Zero increase of volume of money circulated in the economy
   - State budget with a small surplus within the 1–1,5% range of budget expenditures
   - Possible range for credit loans stipulated as minus 2% to plus 1% of the 1989 level.

   In 1991, when most of the prices will be liberalized, internal convertibility will be introduced and many import restrictions relaxed, the macroeconomic restrictions will, from the one side, be even stronger than in the year 1990 (the danger for transformation of the internal money surplus to the external debt will be higher) but on the other side, monetary and financial policies will be much more flexible to encourage the necessary restructuring. The State budget will be created with a surplus 2–2,5% of total expenditure.

   Despite all these restrictions, the state budget will provide the resources needed as a social guarantee connected with the valorization of pensions, with re-qualification and unemployment.
(2) The reform of the tax system will start to play a stabilization role. The reform will proceed in a number of stages. The final market compatible shape of the tax system will be in the year 1992. The basic role in the system will be played by the value added tax and the other taxes, like consumer tax, import tax, and corporate tax.

   In 1990, the turnover tax rates will be mostly unified (there will be 4 basic turnover tax rates instead of an individual one for each group of products).

   In 1991 the number of profit tax rates will be reduced from four (75%, 65%, 55% and 50%) to two (50% and 55%).

   In 1992 the necessary legislation will be adopted so that the new tax system will come into force on January 1, 1993.
(3) In connection with the "pruning down" of the state budget (in some cases up to 90% of profit was taxed and the huge budgetary means were consequently redistributed in an administrative manner) the role of local budgets will be increased. The new budgetary rules will ensure the local budget "self service" and will define the financial relation between republics.
(4) Further suggestions on stabilization measures for the period 1991-92 will be derived from the progress made in an adaptation of the economy to the market place conditions, especially

to internal convertibility and eventual devaluation of the domestic currency with an impact on the prices of inputs, on an increase in crude oil prices, and progress in the restructuring program.

(5) The realization of the program of restructuring will inflict a growth in unemployment. The Government is taking measures to alleviate the impact by

- Revitalizing the private sector and small businesses, especially in the service sector; it is expected that by the first half of 1991 some 300–400 thousand new jobs could be created.
- Developing the social safety net.

The success of the economic reform will be highly influenced by the political development in the country. Democratization of life in our society is still revealing new phenomenon and it is therefore difficult to make a precise prognosis.

Session IV

On New Financial Institutions and Opportunities for Economic Transition

The Plan of the East European Payments Union and the Future of Regional Economic Cooperation in Eastern Europe

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On 1 January 1991 the most important specifics of the CMEA ceased to exist. The three decades of cooperation based on detailed state level coordination of mutual deliveries, artificially created prices, bilateral clearings settled in transferable rubles is over. What comes next?

Differentiation gains momentum in the European CMEA area. The GDR disappeared in October 1990. Poland, Czechoslovakia and Hungary opted for a determined transition to market economy, quick privatization, and intended to apply for full membership in the EC. The governments of Bulgaria and Romania could not really decide to what extent they should introduce elements of western type democracy and market economy. The Soviet Union tries to tackle with its aggravating political and economic crisis without any special emphasis on maintaining the volume of trade with its former allies.

In the last decades there has been inter-industry type trade between the individual East European economies and the Soviet Union. East European countries delivered mainly manufactured products in exchange for mainly primary energy and raw materials. East European manufactured products have been overpriced and a substantial part of them cannot be marketed outside the CMEA region. The shift to hard currency settlement of payments will, most probably, lead to huge deficits in the "small" East European countries' trade with the Soviet Union. The Soviet surplus in 1991 alone was expected to amount to 10–15 billion US$ still before the Gulf crisis. High oil prices will bring about additional burdens for the East European countries and additional incomes for the Soviet Union.

As the burdens of transition to hard currency settlement of payments became obvious for a wider circle of western experts the idea of calling into being a regional payments union was raised. This institution, called Central European Payments Union (CEPU), would be a multiclearing system, similar to the European Payments Union (EPU) that was organized after World War II in Western Europe. The EPU had been supported financially by the USA in the framework of the Marshall Plan. The CEPU is also designed to generate external financing, namely the support of the industrialized countries of the world. The core of the idea is to hinder a dramatic decline of mutual trade among the members of the dying CMEA and to give impetus to trade creation within the region wherever it is possible. The center of the multiclearing system, most probably located somewhere in West Europe, would make efforts to smooth away trade imbalances, creating in this way the presumed preconditions for a higher level of intra-regional trade.

Before going into details of the CEPU a crucial question, namely which countries would be members of the multiclearing system, must be answered. The narrowest circle would comprise

the radically reforming countries: Hungary, Czechoslovakia, and Poland. A wider version would include Romania and Bulgaria as well. According to the broadest version the CEPU would include the five countries mentioned and the Soviet Union. The composition of the CEPU is the critical point of the construction. The CEPU with the Soviet Union is a completely different organization than without it.

Trade between the "small" East European countries is typically intra-industry trade where mostly manufactured products are exchanged. Trade imbalances are traditionally low. According to ECE data total imbalances in mutual trade of Czechoslovakia, Hungary, the GDR and Poland amounted to 288 million US$ in 1989 with a total trade volume of approximately 7.7 billion US$.[2] Respective data for these countries without the GDR but including Romania and Bulgaria may not be substantially different. As Table 1 demonstrates, the share of the "small" East European countries in each other's foreign trade is surprisingly low. Taking these low trade shares, the rather similar composition of exports and imports, and finally the traditionally balanced mutual trade, I see no reason for anxiety about menacing with imbalances after the shift to hard currency settlement of payments *within* this group of countries. After the shift to hard currency settlement trade volumes may decline but imbalances can not be expected to grow. Furthermore, the experience of regional integrations in Latin America demonstrate that an increase of mutual trade between countries at a medium level of development is not usual, even if it is encouraged. Thus, we can raise the question whether it is really worth setting up an international organization to smooth away trade inbalances of the expected magnitude?

After the introduction of hard currency payments lasting Soviet trade surpluses are expected. Thus the CEPU with the Soviet Union's membership would help the East European countries to maintain their imports from the Soviet Union. The East European countries would pay for the commodities imported from the Soviet Union in clearing money. The Soviet Union could spend these incomes only within the clearing circle, namely in the East European countries. However, multilateral clearing can not cope with a long lasting one-sided imbalances where deficit and surplus, respectively emerges always with the same countries. When the initial fund is expended the system ceases to function.

Is it good to give a helping hand to the East European countries so that they can carry on their exports to the Soviet Union? (As long as the reserves of the clearing center last.) On the one hand, the answer is yes. A lower level of unemployment and less under-utilized capacities will be the result. On the other hand, most of the enterprises in East Europe that have specialized in the Soviet market are big, inefficient, uncompetitive state owned enterprises. The danger would be imminent that the most uncompetitive economic agents of the region will be encouraged by western financial assistance to avoid adjustment by preserving their comfortable market.

Is the financing of the CEPU the most effective way of western support? Most probably not. The *economies* of East Europe should survive the coming critical years and not the less efficient segment of their state owned industry. (An illustration from Hungary: in the first six months of 1990 the production of enterprises employing more than 300 people declined by 12%, whereas the production by economic agents employing less than 50 people increased by 150%).

A more efficient way of western support could be:

- Easing the debt service burdens
- Setting up special funds to help privatization
- Setting up funds to promote the export of medium-sized and small enterprises.

Participation in the CEPU belongs to the competence of the governments. But how could the domestic regulation of trade be solved? If hard currency imports will be liberalized in the countries concerned, why would any importer buy, let us say a more expensive Polish computer instead of a South Korean one, only because the former is "cheaper" at the macro-economic level? Are there market mechanisms to tackle this problem?

[2]Economic Survey of Europe 1988–1990, UN New York, p. 3–76.

Without the CEPU, East European products will have to be priced according to their price/performance ratio from 1 January 1991. They will compete with western supply, mainly in the Soviet market. The Soviet Union will be willing to buy goods of inferior quality only at an appropriate low price. With most East European commodities this "equilibrium" price will not cover production costs. Economic agents in East Europe will have the option to go to third markets but certainly the adjustment to western quality standards and the reduction of costs can not be saved this way, either. Taking into consideration the present chaotic circumstances in the Soviet Union a diversification of sales (as well as purchases) of East European enterprises that are too dependent on the Soviet market seems to be rational. Even the best company adjustment program may prove to be a failure if it is based solely on the fragile Soviet market.

For East Europe an increase in exports to the west is the crucial factor. The war against the CMEA legacy can only be won in the battlefields of the OECD markets. After a temporary reduction, mutual trade may increase, moderately, again, but its composition will hopefully be completely different from that today.

If not the CEPU, then what else? Is there still a way for intra-regional economic cooperation? There are alternative ways for the diversion/creation of trade. Technically the most logical solution could be the creation of a provisional East European customs union with a high initial discrimination towards non-members. High tariffs should gradually be diminished according to a schedule set up before the customs union starts its operation. However, at the present level of mutual distrust it would be absurd to propose this solution. The creation of a free trade area (EFTA) seems to be more feasible.

There are western fears regarding the future of East Europe. One or more economies of the region may collapse and then social tensions may lead to an uncomfortable level of instability in the region and the West can not be indifferent to this, particularly Europe. Rising oil prices increased the probability of this scenario. Even more important is that Western support, if any, be targeted to areas where it can be best used. According to my view, it is not the CEPU. There may be another reason for Western concern, namely the vision about some East European countries aggressively penetrating the OECD markets by artificially low priced commodities. First, the region's countries do not have any means to finance such "cheap" exports by subsidies. Secondly, even if the "small" East European countries wanted to earn all the dollars in the OECD area, what they need to buy is Soviet oil, the necessary "penetration" would be "peanuts" compared to total OECD imports. Furthermore an export drive targeted at the West would also induce massive imports from the West.

Table 1. Share[1] of individual countries and groups of countries in total trade of countries observed

Exports								
		Total	ČSFR	POL	HUN	ROM	BG	USSR
ČSFR	(1989)	100	-	8.5	4.0	1.8	2.3	30.5
POL	(1989)	100	5.4	-	1.6	1.1	1.6	20.5
HUN	(1989)	100	5.1	3.2	-	1.5	0.7	25.1
ROM	(1985)	100	2.6	3.5	2.4	-	1.7	21.4
BG	(1989)	100	4.4	3.9	1.4	2.1	-	65.8
USSR	(1989)	100	9.1	8.4	6.1	3.9	9.0	-

		Group A	Group B	Group C
ČSFR	(1989)	12.4	16.6	47.1
POL	(1989)	7.0	9.7	30.2
HUN	(1989)	8.2	10.4	35.6
ROM	(1985)	8.5	10.2	31.6
BG	(1989)	9.7	11.7	77.5
USSR	(1989)	23.6	36.5	36.5

Imports								
		Total	ČSFR	POL	HUN	ROM	BG	USSR
ČSFR	(1989)	100	-	8.6	4.8	1.7	2.2	29.7
POL	(1989)	100	5.6	-	1.6	1.0	1.2	17.9
HUN	(1989)	100	5.2	3.3	-	1.6	0.9	22.1
ROM	(1985)	100	3.3	5.5	2.8	-	3.0	22.4
BG	(1989)	100	5.0	4.8	1.4	1.9	-	53.6
USSR	(1989)	100	9.2	10.3	6.7	3.4	10.1	-

		Group A	Group B	Group C
ČSFR	(1989)	13.4	17.3	47.0
POL	(1989)	7.2	9.4	27.3
HUN	(1989)	8.4	10.9	33.0
ROM	(1985)	11.6	14.6	37.0
BG	(1989)	11.2	13.1	66.7
USSR	(1989)	26.1	39.7	39.7

Group A: ČSFR, POL, HUN
Group B: Group A + BG, ROM
Group C: Group B + USSR

[1] Based on national currency

Source: National Statistics

AGENDA

Second International Varna Seminar
On the Way to Convertibility in Central and East European Countries

Jointly organized by the

International Institute for Applied Systems Analysis

and the

Institute of Management and Administration of the Council of Ministers of Bulgaria

September 30 - October 3, 1990
Golden Sands, Bulgaria

September 30, 1990

OPENING STATEMENTS

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September 30, 1990

SESSION I: STAGES IN THE TRANSITION TO CONVERTIBILITY

Chairman: O. Panov

1. Keynote speaker: T. Valtchev
2. Keynote speaker: R. Portes

October 1, 1990

SESSION I: STAGES IN THE TRANSITION TO CONVERTIBILITY (Continued)

Chairman: K-E. Schenk

3. National experiences:
   - Poland: K. Lutkowski
   - Hungary: I. Boros
   - Yugoslavia: G. Nikic
   - Czechoslovakia: J. Charap
   - Romania: P. Bran
4. Expectations, Successes and Disappointments with the Monetary, Economic and Social Union Between the FRG and the GDR — G. Peruzzo

October 1, 1990

SESSION II: REORGANIZATION OF THE CREDIT AND MONETARY SYSTEM AND THE CAPITAL MARKET

Chairman: R. Hashiyama

1. Keynote speaker: V. Dimitrov
2. Japanese Economic Development and Policy Framework: An Experience During the Reconstruction and High Growth Period — H. Takenaka
3. The Soviet Union Reforms: K. Kagalovsky

October 2, 1990

SESSION II: REORGANIZATION OF THE CREDIT AND MONETARY SYSTEM AND THE CAPITAL MARKET
(Continued)

4. Monetary Reform:
The Choice Between Fixed and Flexible Exchange Rates —
E.J. Bomhoff

5. Prerequisites of Convertibility in the Context of
Economic Reforms — V.G. Starodubrovsky

October 2, 1990

SESSION III: PAYMENT BALANCE AND CURRENCY RESERVES - EXTERNAL DEBT, INTERNATIONAL SUPPORT IN FAVOR OF CONVERTIBILITY

Chairman: M. Lavigne

1. Keynote speaker: N. Tzarevski

2. Keynote speaker: J. Williamson

3. The Stabilization Program of the Czechoslovakian Government —
P. Klima

October 2, 1990

SESSION IV: ON NEW FINANCIAL INSTITUTIONS AND OPPORTUNITIES FOR ECONOMIC TRANSITION

Chairman: W. Witherell

1. **The East European Payment Union and the Future of Regional Economic Cooperation in Eastern Europe — S. Richter**
2. Concluding Discussions

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