Overview

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Last year we discussed here in Jackson Hole, at the invitation of the Federal Reserve Bank of Kansas City, "Monetary Policy Issues in the 1990s." Hardly anyone would have imagined at that time that, among these monetary policy issues, the subject we are discussing now would have gained such importance. It seems to me a good sign of flexibility of our host to make "Central Banking Issues in Emerging Market-Oriented Economies" the subject of this year's conference. We are grateful for that.

The economies in Central and Eastern Europe are in the midst of a multi-tier and lengthy process of difficult restructuring. As has been noted recently, the transition from a capitalist to a socialist economic system has been described in many books, but there is no book available that might be used as a guide along the path from a socialist economy to a free market economy. Reading, for instance, Schumpeter's famous book, ***Capitalism, Socialism, and Democracy,*** backwards would perhaps not provide sufficient guidance.

Reforming the monetary and financial systems, and thus also internal and external monetary policies, is an important part of the set of reforms required.

Internal monetary stability is a vital prerequisite for the success of these reforms; the convertibility of currencies must be one of its major goals. The restructuring of the financial and banking system is an important precondition for an efficient conduct of monetary policy and a well-functioning resource allocation. As President Corrigan said this morning, "Of all of the elements of structural reform that are necessary in the transition from a centrally planned and controlled economy to a market economy, none is of greater importance than the reform of the banking and financial system."

In my following remarks, I want to focus first on monetary policy, not so much on its instruments and procedures, but mainly on its main tasks in the restructuring process and on the question that played in yesterday's discussion a certain, but perhaps not the full, role it deserves, namely what should be the relationship between an anti-inflationary policy which is oriented to the short term and structural policy which is geared to the medium and long term?

I am glad that in his luncheon address the Finance Minister of Czechoslovakia, Vaclav Klaus, dealt with this important question.

And secondly, if time allows, I want to add a few remarks as to the convertibility question.

As has already been said in our discussion, prices in a free market economy have the task of coordinating individual economic plans, and thus of steering production and distribution without friction via the market. But prices are only capable of fulfilling this task if they indicate the relative scarcity of resources as precisely as possible. Past experience in many countries has taught us that this is achieved best on the basis of stable overall price levels, but flexible individual prices. Inflationary processes distort the price relationships and call their market steering function into question. They lead to a misallocation of resources and impede the smooth operation of a market economy. I cannot but underline what the Governor of the Bank of Canada, John Crow, said in his presentation: "Monetary stability is essential if market signals are going to be interpreted efficiently."

This is a lesson we should share with our friends from the Central and Eastern European countries' central banks, even if not all of us have resolved our inflation problem. Therefore, I can't go along with the suggestion I understood yesterday in a contribution to our discussion, that Western central bankers should, for this reason, be careful in giving advice for a strong anti-inflationary policy.

The monetary order and thus, of course, also internal and external monetary policies, play a vital role in modern market economies. In the case of centrally planned supplies of goods, by contrast, their importance is minor. In a centrally planned economy, money enters the process only when the actual planning decisions have already been made. Prices are themselves "planned" rather than serving an allocation function. Planned prices are used only to annex a monetary planning system to the system of planned supplies of goods. Wherever economic processes are controlled centrally, the steering functions of monetary policy decisions and the money economy itself are merely subsidiary in character.

The transition from a centrally controlled and administered economy to a system governed by market prices therefore also changes the role played by internal and external monetary policy. The functioning of a free market economy depends quite considerably on the active role played by monetary policy, in particular, a monetary policy oriented to the goal of keeping the value of money stable. The transition from a centrally planned economy to a market economy must therefore be accompanied right from the outset by the will to avoid inflationary processes or to curb them wherever they are a legacy of the past. Internal and external monetary policies—as well as fiscal and economic policies—which are all geared to stability are a vital general prerequisite for the success of the restructuring process.

In the longer run, domestic monetary stability is also a necessary, but not a sufficient, precondition for real growth. This brings me to the other aspect of monetary policy that Central and Eastern European countries are confronted with during the transition period. One can, as one participant in the discussion yesterday did, call it the "microeconomic or supply-side" aspect of inflation. Indeed, a stability-oriented monetary policy faces considerable problems during the transition period.

These problems arise from the fact that the structural reshaping of economies only proceeds slowly. Monetary policy is thus still confronted—in the economy in general, and in the banking sector, its actual field of operations, in particular—with structures and behavior patterns that go back to the time of central planning. This gives rise, as I said before, to the question of what the relationship should be between stabilization policy and structural policy.

Countries that set out along the road from a centrally administered economy to a market economy often learn that prices rise markedly as soon as they are decontrolled and as soon as subsidies are dismantled. It would certainly be wrong to view this exclusively as a monetary problem and to attempt to combat it solely with the aid of a restrictive monetary policy. It is true that the monetary overhang often existing at the beginning of the reform process has adverse effects. In some countries, such as Poland, the inflationary processes initiated in the past have to be brought to a halt. But even at the beginning of the reform process, structural factors have an effect on the supply side because allowing prices to be set freely initiates a process in which the price relations are adjusted, in the long run, to the conditions prevailing in the world markets. For a number of reasons, which are rooted deep in society and historically established behavior patterns, this leads to increases in the level of prices.

The large enterprises still in government ownership are characteristic of many countries with a monopolistic pricing policy; there is a lack of competition. It can often be observed that enterprises continue to adhere to the habit of relying on the government when planning their production and sales, and when calculating their prices; that the government will intervene when losses and unemployment threaten is regarded as certain. In some countries "unholy alliances" have been established in which employees, managers, and local politicians jointly bring pressure to bear to ensure that the government does what it has always done, namely bail out enterprises that get into trouble. This does not necessarily demand efforts of one's own. The population often cannot accept the higher incomes and profits that result from individual efforts and that might increase supply; this has a demotivating effect.

To put it briefly, producing efficiently for a market governed by competition is a matter that is as yet not very well understood; it must still be learned. The avoidance of price increases therefore requires this educational process to be initiated rapidly and then to be accelerated. The battle against inflation may thus not be restricted to monetary measures. Stabilization policy must go hand-in-hand with structural policy measures on which special emphasis must be placed.

In this context, some basic facts about society and industry must be taken into consideration, namely

—the speed at which economic agents are capable of learning differs. In countries in which the population has become used to central planning and which have been strictly isolated from the global economy, competition, behavior patterns oriented to market requirements, and cost-consciousness will probably develop only slowly;

—the countries involved are poor. In particular, there is a lack of capital resources. As a result of unresolved ownership problems and on account of the lack of a properly functioning banking system, the capital formation process, as well as the allocation process, is proceeding only slowly. Foreign capital made available at the terms and conditions granted internationally and under the rules of the international community could fill a gap and have a major impact here. Its provision, however, is often not wanted because there are unfounded fears about "excessive foreign influence" and a "sell-out."

It is quite clear what all this means for structural policy: it must be aimed single-mindedly at improving supplies. If this is done, it also has anti-inflationary effects and thereby eases the pressure on the monetary stabilization policy.

But stabilization policy can influence, even accelerate, the re-education of economic agents. It is capable of imposing sanctions on unwanted behavior. To be sure, when the internal monetary policy pursued is restrictive, high interest rates and a lack of liquidity often mean the end of enterprises which are incapable of supplying the products a market demands at appropriate prices, but they also provide a strong incentive to accelerate the enterprises' adjustment to market conditions and to change their own behavior. In this respect, stabilization policy goes hand-in-hand with a supply-side oriented structural policy.

The question here, however, is how restrictive monetary policy should be in this policy mix. Should it be a shock therapy or rather a step-by-step approach, that is, gradualism? There is no easy answer to this question. Depending on the initial situation, it requires pragmatic solutions that differ from both country to country and time to time. In my view, it is clear, however, that it is vital, especially after the disappointing results achieved in the past, for monetary policy to be geared consistently toward stability at the beginning of the reform process when many old conditions must be destroyed and many traditional behavior patterns must be given up. Or, as Paul Volcker put it in his keynote speech: Given the kind of inflation in the transition period, central banks have to be tough.

Let me now add a few comments on the convertibility of the currencies of the CMEA countries in the former Eastern Bloc.

All the efforts undertaken in the past to make CMEA currencies convertible have always become stuck at the very beginning. In centrally planned and administered economies the centralization of foreign exchange transactions and the inconvertibility of currencies are indissolubly interlinked. "It is quite natural for command economists to oppose convertibility because it would destroy their pre-planned economic programmes."[1]

The economic reforms in the Central and Eastern European countries and the transition envisaged in these reform movements to a free market economy are now also creating better prospects for the implementation of the old goal of convertibility.

I fully agree with Bergsten and Williamson that Eastern and Central European countries would be well advised, in pursuing this old goal of convertibility, to focus their efforts on the achievement of current account convertibility. Combined with a regime of free trade, it would be a decisive step in the opening up of domestic markets to the world market. It would contribute to creating competition in domestic markets as well as to a realistic structure of prices. I also agree that capital account convertibility does not merit a similar priority, but I would not look at this extended convertibility "as a luxury to be delayed until reconstruction has been achieved."

Here I agree fully with Andrew Crockett when he made his comments in the convertibility discussion. At least convertibility for foreign investors should be established much earlier. A spontaneous import of private capital could become a valuable element in the reconstruction of Eastern economies, but would not come about in a sufficient degree as long as foreign investors see the one or the other currency as a mousetrap currency.

Ultimately, however, the convertibility of a currency and its maintenance are the result of domestic monetary, fiscal, and economic policies. In this respect, it makes no big difference whether a country chooses a fixed exchange rate as an anchor of stability or a flexible exchange rate, provided the policy is geared to keep it, at least in real terms, as stable as possible. Convertibility in its widest sense, however, can only be achieved if policies geared primarily to internal stability allow stable balances of payments to be expected.

This does not preclude a wider convertibility also for residents, for instance, on a "free market" that is separate from the official market. President Baka has just explained the Polish experience in which residents may buy and sell foreign exchange on a free market without restrictions. Up to the end of last year, the exchange rates on this free market in Poland were far higher than those officially fixed. Temporarily, they were even a multiple of these official exchange rates, a sign of the lack of confidence in the government's monetary and economic policies. Following a substantial depreciation of the official exchange rate and a stability-oriented monetary policy, the two rates have hardly differed since the beginning of this year. The depreciation expectations resulting from past experience, expectations which are certainly understandable, have disappeared.

A market split in this manner may even be useful because the trend of the free exchange rate and the extent to which it differs from the official exchange rate can be regarded as an indicator both of the credibility of the economic and monetary policies pursued by a country and of the seriousness of its efforts to reform the economy. Split markets can therefore make sense for a transitional period. Domestic economic and monetary policies must ensure, however, that the "free" exchange rates do not diverge too markedly from the official rate. This, too, is an element of building up confidence.

In the long run, however, the goal should be to bring the rates into line with one another, but this presupposes stable balances of payments. It need by no means preclude current account deficits if appropriate spontaneous imports of capital occur, imports on which the Central and Eastern European countries are dependent as a result of the lag in their economic development.

The prerequisites for achieving this must be created. One of the prerequisites is the pursuit of internal economic and monetary policies that also create confidence at home and abroad. Another is ensuring that foreign investors are certain of being able to dispose freely of earnings, profits and capital through unrestricted transfers abroad.

All this must be achieved as soon as possible in conjunction with the payments involved in capital transactions. The balance of payments risks would be limited and tolerable if the prerequisites mentioned earlier, namely economic and financial policies that build up confidence both at home and abroad, are given. This is the task faced by all Central and Eastern European countries.

End Note

[1]See Haberler, p. 26.

Reference

Haberler, G. "Konvertibilitat der Wahrungen" (Convertibility of Currencies) in *Die Konvertibilitat der Europaischen Wahrungen (The Convertibility of European Currencies). A.* Hunold Verlag, ed. Erlenbach/Zurich/Stuttgart, 1954, p. *26*.