A Symposium Sponsored By
The Federal Reserve Bank of Kansas City

CENTRAL BANKING ISSUES IN EMERGING MARKET-ORIENTED ECONOMIES

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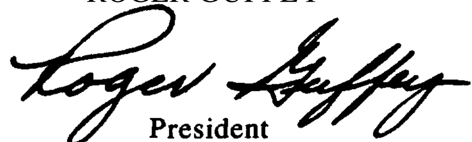
Foreword

Within the past year, a number of countries in Central and Eastern Europe have indicated their intent to move toward market-oriented economic systems. As part of the transition process, these countries are considering comprehensive economic reforms including the creation of independent central banks and the development of new financial markets and institutions.

Central banks will play a crucial role in the ongoing transformation process. Through the conduct of monetary policy, central banks can promote the creation of a noninflationary macroeconomic environment. Central banks can also assist in the development of a stable financial system and support expanded international trade through the maintenance of currency convertibility.

To assist policymakers in these countries, the Federal Reserve Bank of Kansas City sponsored this symposium as a means to encourage an exchange of views on the role of central banks during and after the transition to market-oriented economies.

ROGER GUFFEY



President
Federal Reserve Bank of Kansas City

The Contributors

Wladyslaw Baka, ***President, National Bank of Poland***

Mr. Baka was reappointed to a second term as president of the National Bank of Poland in September 1989. His first appointment to the post came in 1985, following five years in which he served as secretary, then vice chairman, of the government's commission for economic reform. Educated at Warsaw University, he began his career there in 1959 as a researcher and later, as a professor of economic sciences and a member of the Polish Academy of Sciences. As president of his nation's central bank, Mr. Baka represents Poland in the World Bank. He has chaired the Polish delegation at a number of international councils.

C. Fred Bergsten, ***Director, Institute for International Economics***

Mr. Bergsten has been director of the Institute for International Economics since its creation in 1981. He was assistant secretary of the U.S. Treasury for international affairs from 1977 to 1981, and also served as undersecretary for monetary affairs during 1980-81. Earlier, he was a senior fellow at the Brookings Institution and on the senior staff of the National Security Council where he was assistant for international economic affairs. He is a widely published author and testifies frequently before Congressional committees.

Richard N. Cooper, ***Professor of International Economics, Harvard University***

Mr. Cooper has been at Harvard since 1981. He sewed as under-secretary for economic affairs in the U.S. State Department during

the Carter Administration, and was a provost and professor of international economics at Yale University. From 1961 to 1963, he was a senior staff economist for President Kennedy's Council of Economic Advisers. Mr. Cooper is chairman of the board of directors of the Federal Reserve Bank of Boston, and holds other leadership positions with the Institute for International Economics, the Chief of Naval Operations, and the Committee for Economic Development. He also belongs to the Trilateral Commission and the Council on Foreign Relations.

E. Gerald Corrigan, ***President, Federal Reserve Bank of New York***

Mr. Corrigan was named to his present position in 1985. He began his career at the New York Fed in 1968 as an economist in the domestic research division and held a variety of staff and official positions before being named special assistant to Federal Reserve Board Chairman Paul Volcker in 1979. Mr. Corrigan became president of the Federal Reserve Bank of Minneapolis in 1980 and served four and a half years there before returning to New York. He is a member of the Council on Foreign Relations and the Trilateral Commission.

Andrew D. Crockett, ***Executive Director, Bank of England***

Mr. Crockett first joined the Bank of England in 1966, serving in the Economic Intelligence and Cashiers Departments. He was named personal assistant to the managing director of the International Monetary Fund in 1972 and later became chief of the Fund's Special Studies Division, assistant director of the Middle East Department, and deputy director of the Research Department with primary responsibility for the World Economic Outlook project. Mr. Crockett rejoined the Bank of England in March 1989 as executive director for Overseas Affairs.

John W. Crow, ***Governor, Bank of Canada***

Mr. Crow was appointed governor of the Bank of Canada in 1987. He joined the Research Department of the bank in 1973 and subsequently served as adviser to the governor, deputy governor, and senior deputy governor. Before going to the Bank of Canada, he worked at the International Monetary Fund from 1961 to 1973. Mr.

Crow is a member of the board of directors of the Federal Business Development Bank and the Canada Deposit Insurance Corporation.

Ivan Dragnevski, ***President, National Bank of Bulgaria***
Mr. Dragnevski became president of the National Bank of Bulgaria in 1989. He began his professional career with an appointment there in 1964. He represented the Bulgarian Foreign Trade Bank in London during the mid-1970s. He was named director general of the Bulgarian Foreign Trade Bank in 1977 and president in 1980. He continued in that position until receiving his present appointment.

Martin Feldstein, ***President, National Bureau of Economic Research***
Mr. Feldstein is professor of economics at Harvard University as well as president of the National Bureau of Economic Research. Since joining the Harvard faculty in 1967, his research and teaching have focused on problems of the U.S. economy and the economics of the public sector. From 1982 through 1984, he was chairman of President Reagan's Council of Economic Advisers. He is a fellow of the Econometric Society and the National Association of Business Economists, and belongs to the Trilateral Commission, the Council on Foreign Relations, and the American Academy of Arts and Sciences.

Jacob A. Frenkel, ***Economic Counselor and Director of Research, International Monetary Fund***
Mr. Frenkel was appointed to his current position in 1987. Before joining the International Monetary Fund, he was the David Rockefeller Professor of International Economics at the University of Chicago. He is a research associate of the National Bureau of Economic Research, a fellow of the Econometric Society, a member of the Group of Thirty, and a member of the advisory committee for the Institute for International Economics.

Mitja Gaspari, ***Deputy Governor, National Bank of Yugoslavia***
Mr. Gaspari came to the National Bank of Yugoslavia in November 1988, after serving a number of years with the National Bank of Slovenia. He joined the National Bank of Slovenia as an analyst in the research center in 1975 and became the center's director in 1981.

He was named vice governor of the National Bank of Slovenia in 1987 and deputy governor in June 1988. In his present post, he also serves on the Federal Economics Council at the Federal Executive Council and as a member of the working group for monetary and banking reform.

Victor V. Gerashchenko, ***Chairman, State Bank of the U.S.S.R.***
Mr. Gerashchenko was appointed to his present position in 1989. He began his career with the U.S.S.R. Bank for Foreign Trade. He served as director of the Moscow Narodny Bank Ltd. in London, and was governor of both the Beirut and Singapore branches. He was also chairman of the Ost-West Handelsbank in Frankfurt. In 1982, Mr. Gerashchenko returned to the U.S.S.R. Bank for Foreign Trade as managing director of the Foreign Exchange Department. In 1983, he was named deputy chairman of the Bank for Foreign Trade and served in that capacity until assuming his present position.

Leonhard Gleske, ***Former Member of the Directorate, Deutsche Bundesbank***
Mr. Gleske was a member of the Directorate of the Deutsche Bundesbank from 1976 to 1989. During that period, he was involved with international monetary issues and served on the Central Bank Council. He is presently serving a second term as a director of the Bank for International Settlements. Earlier in his career, Mr. Gleske spent 12 years as president of the Land Central Bank in Bremen and served on the Commission of the European Economic Community.

Jean Godeaux, ***Former Governor, National Bank of Belgium***
Mr. Godeaux was governor of the National Bank of Belgium between 1982 and 1989. During that time, he was president of the Bank for International Settlements and chairman of the Committee of Governors of the Central Banks of the Member States of the European Economic Community. Previously, he was president of the Banking Commission and chairman of the Belgian Bankers Association. Mr. Godeaux spent 20 years with the Lambert Bank of Brussels as manager, managing partner, and president. He is now president of the Rediscount and Guarantee Institute and a director of the Bank for International Settlements.

Alan Greenspan, ***Chairman, Board of Governors of the Federal Reserve System***

Mr. Greenspan began his four-year term as chairman of the Federal Reserve Board in August 1987. Previously, he was chairman and president of the New York economic consulting firm of Townsend-Greenspan & Co., Inc., chairman of President Ford's Council of Economic Advisers, chairman of the National Commission on Social Security Reform, and a member of President Reagan's Economic Policy Advisory Board. He was also senior adviser to the Brookings Institution's Panel on Economic Activity, consultant to the Congressional Budget Office, and past president and fellow of the National Association of Business Economists.

Arnold C. Harberger, ***Professor of Economics, University of California at Los Angeles***

Mr. Harberger has been a professor at UCLA since 1984. He is also a Gustavus F. and Ann M. Swift Distinguished Service Professor at the University of Chicago, where he was a member of the faculty since 1953. He is a past or current consultant to a number of foreign ministries, primarily in South America and Asia, and to such international organizations as the World Bank, the International Monetary Fund, and the Organization of American States.

Mugur Isarescu, ***First Secretary for Economic and Monetary Affairs, Embassy of Romania***

Mr. Isarescu was assigned to the Romanian Embassy in Washington, D.C., in March 1990, shortly after joining the Ministry of Foreign Affairs of Romania. His professional career spans 20 years during which he was a senior fellow and a department head at the Institute for World Economy at the Academy for Economic Studies in Bucharest. He has specialized in exchange rate policies and participated in a number of international conferences and seminars.

Mervyn A. King, ***Professor of Economics, London School of Economics***

Mr. King joined the London School of Economics in 1984, after prior appointments at Cambridge and Birmingham Universities and visiting terms at Harvard and MIT. He directs the LSE Financial

Markets Group, is a member of the City Capital Markets Committee, is a non-executive director of the Bank of England, and is a trustee of the Kennedy Memorial Trust. Mr. King will spend the fall term in the United States teaching at Harvard and working as Senior Olin Fellow at the National Bureau of Economic Research.

Vaclav Klaus, Minister of Finance, Czechoslovakia
Mr. Klaus was appointed to his present position in 1989. He began his career as a researcher in the Institute of Economics of the Czechoslovak Academy of Sciences. Subsequently, he held various positions in the Czechoslovak State Bank. In 1986, he returned to the Academy of Sciences as head of the Department for Macroeconomic Policy in the newly-formed Institute of Forecasting. Today, as minister of finance, he is involved in transforming a centrally planned economic system to a market economy and with problems of macroeconomic stabilization policies.

Lawrence A. Kudlow, Chief Economist and Senior Managing Director, Bear, Steams & Co., Inc.
Before accepting his present position, Mr. Kudlow was a private economic consultant in Washington, D.C. where he served on both the Federal Home Loan Bank Board's Federal Savings and Loan Advisory Council and the Federal Home Loan Mortgage Corporation's Advisory Committee. During the first term of the Reagan Administration, he was associate director for economics and planning in the Office of Management and Budget and chaired or served on a number of sub-cabinet committees. He was chief economist for Bear, **Stearns** and for Paine Webber investment firms in the 1970s. Earlier, he was a staff economist at the Federal Reserve Bank of New York. Mr. Kudlow is a frequent commentator on CNN and network programs dealing with business and economic issues.

Philippe Lagayette, First Deputy Governor, Bank of France
Mr. Lagayette joined the Bank of France in 1984 as deputy governor and became first deputy governor in 1990. He was a member of the European Economic Community's monetary committee in 1984. Earlier he was with the Ministry of Finance, serving as inspector of finance, deputy director, and head of staff to Finance Minister Jacques Delors.

Allan Meltzer, Professor of Political Economy and Public Policy, Camegie-Mellon University

Mr. Meltzer has been at Carnegie-Mellon University since 1964. His work in the field of money and capital markets has brought frequent consulting assignments with Congressional committees, the U.S. Treasury Department, the Board of Governors of the Federal Reserve System, foreign governments, and central banks. At present, he is honorary adviser to the Institute for Monetary and Economic Studies of the Bank of Japan and a member of the President's Economic Policy Advisory Board. Mr. Meltzer is a founder and **co-chairman** of the Shadow Open Market Committee and a fellow of the National Association of Business Economists.

Georg Rich, Director, Economics Division, Swiss National Bank

Mr. Rich has held his present position with the Swiss National Bank since 1979. Before joining the bank in 1977, he taught economics at **Carleton** University in Canada for 10 years. He received his doctoral degree from Brown University and was a postdoctoral fellow at Yale and a visiting professor at the Graduate Institute of International Studies in Geneva. He was also a visiting scholar at Carnegie-Mellon University in 1989. His present responsibilities with the bank include economic studies and research, banking studies, and statistics.

Gordon Richardson, ***Chairman,*** Morgan Stanley ***International***

Lord Richardson was governor of the Bank of England from 1973 to 1983. He was named to the Privy Council in 1976 and received a Life Peerage and knighthood in 1983. Today, in addition to being chairman of Morgan Stanley International, Lord Richardson is a director of the Bank for International Settlements and the Saudi International Bank. He also is chairman of the Group of Thirty and a member of the Consultative Group on International Economic and Monetary Affairs.

Imre Tarafas, First ***Deputy*** President, National Bank of Hungary

Mr. Tarafas was named to his present post in October 1988, after serving two years as director general of the National Planning **Office.** He began his career in 1969 at the Institute of Economics at the Hungarian Academy of Sciences in Budapest. In 1973, he joined

the National Bank of Hungary where he served as head of the division in charge of exchange rate policy and as general manager in the Department of Economics.

Niels Thygesen, ***Professor of Economics, University of Copenhagen***

Mr. Thygesen has been in his present position since 1971. He is a senior research fellow at the Center for European Policy Studies in Brussels and a visiting professor at the Institute for Political Studies in Paris. Mr. Thygesen has served with several groups dealing with monetary integration and cooperation in the European Communities, most recently the Committee for Monetary Union in Europe. He has also been a visiting scholar at the Brookings Institution, head of the Monetary Division of the OECD, economic adviser to the finance minister of Malaysia, and adviser to Danrnarks Nationalbank.

Josef Tosovsky, ***President, National Bank of Czechoslovakia***

Mr. Tosovsky was named to his present post in December 1989. Previously, he was deputy branch manager of the London Branch of the Zivnostenska Bank. He was chief economist at the Zivnostenska Bank from 1984 to 1985. He first joined the National Bank of Czechoslovakia in 1973, became deputy manager in 1978, and served as adviser to the president in 1982 and from 1986-89.

Decebal Urdea, ***Governor, National Bank of Romania***

Mr. Urdea was appointed governor of the National Bank of Romania in April 1989. Before becoming governor, he was president of the State Committee for Prices from October 1987 through March 1989. Earlier, he was with the Ministry of Finance for 32 years where he served as economist, senior economist, head of section, manager, and deputy minister.

Paul A. Volcker, ***Former Chairman, Board of Governors of the Federal Reserve System***

Mr. Volcker is chairman of James D. Wolfensohn, Inc. and professor of economic policy at Princeton University. He was first named chairman of the Board of Governors of the Federal Reserve System in 1979 and reappointed to a second four-year term in 1983.

He was president of the Federal Reserve Bank of New York from 1975 to 1979. Mr. Volcker was undersecretary for monetary affairs in the U.S. Treasury Department from 1969 to 1974.

John Williamson, ***Senior Fellow, Institute for International Economics***

Mr. Williamson has been in his present position since 1981. He has taught at universities in Brazil, England, and the United States. He is a former economic consultant to the U.K. Treasury where he worked on a range of international financial issues. He is a former adviser to the International Monetary Fund on questions of monetary reform related to the work of the Committee of Twenty. His most recent study, "Latin American Adjustment: How Much Has Happened?" was published this year by the Institute for International Economics.

Symposium Summary

Gordon H. Sellon, Jr.

Within the past year, the Soviet Union and other countries in Eastern Europe have begun a radical transformation from centrally planned to market-oriented economies. As part of this process, these countries have initiated comprehensive economic reforms, including the development of new financial markets and institutions and the creation of independent central banks.

To assist policymakers in these countries, the Federal Reserve Bank of Kansas City sponsored a symposium on "Central Banking Issues in Emerging Market-Oriented Economies," at Jackson Hole, Wyoming, on August 23-25, 1990. At the conference, officials from the Soviet Union, Poland, Czechoslovakia, Hungary, Yugoslavia, Bulgaria, and Romania exchanged views with Western experts on the role of central banks during and after the transition to market-oriented economies.

This introduction highlights the issues raised at the symposium. The first section provides an overview of the challenges facing policymakers in the newly liberalized economies and identifies the main issues discussed at the conference. The following four sections summarize the viewpoints of the program participants and their policy recommendations.

Gordon H. Sellon, Jr., is an assistant vice president and economist at the Federal Reserve Bank of Kansas City.

Gordon H. Sellon, Jr.

Overview

The purpose of the Bank's symposium was to open a dialogue between policymakers in the East and West. As part of the exchange of information and ideas, policymakers in the Soviet Union and Eastern Europe described economic and financial reforms currently under way in their countries and identified problems to be overcome. In response, Western experts discussed the role of central banks in market-oriented economies and suggested possible solutions to these problems.

Challenges in emerging market-oriented economies

Policymakers in the Soviet Union and Eastern Europe have a common goal—to transform their economies from a system in which resources are allocated by central planning to a system in which resources are allocated by prices established in competitive markets. Reaching this goal will require considerable institutional changes. Legal systems will have to be altered to establish individual property rights, state ownership of resources will have to be transformed into private ownership, and accounting systems will have to be introduced to accurately determine the financial status of business. Most important, households and firms will have to adapt to a world in which they gain the economic freedom to choose but lose the protection of the state against job loss and bankruptcy.

A key element of the reform process in each of these countries is the development of financial markets and institutions. Under central planning, commercial banks and other private financial intermediaries played no role in the allocation of savings and investment. Moreover, the state or central bank served only to channel funds to state-owned enterprises according to the central plan and to finance state deficits by printing money. Currently the Soviet Union and countries of Eastern Europe are in the process of establishing a commercial banking system, money markets, and capital markets. These countries are also attempting to establish central banks separate from the commercial banking system and independent of the financing operations of the government.

In each of these countries, serious roadblocks lie in the path of economic reform. While some of the obstacles are political, many are economic. In several of the countries, deficit spending financed by money creation has led to a severe problem of inflation. In these countries, restrictive policy measures to curb inflation add to the economic costs of reform.

A related problem in some countries is the so-called monetary overhang, the accumulation by households of large currency balances that could not be spent because of shortages of consumer goods. Unless neutralized, these balances could cause an upsurge in domestic inflation or an increase in imported goods that would drain foreign exchange reserves.

Finally, some of the countries have severe external and internal debt problems that may hinder the reform process. Those countries with large foreign debts are faced with diverting resources from domestic development to repay these loans. Other countries have firms and financial institutions that, because of past losses, are technically insolvent. These institutions either must be closed or recapitalized if they are to play a role in a market-oriented economy.

Central banks and economic reform

At the symposium, Western experts stressed that central banks can play a key role in the reform process currently under way in the Soviet Union and Eastern Europe. In the course of the discussion, broad agreement emerged on three issues: first, the primary focus of central banks should be to maintain price stability; second, central banks should play a role in developing and supervising new financial markets and institutions; and third, central banks should support the establishment of currency convertibility early in the reform process.

Many participants viewed inflation as a serious threat to the reform effort. A burst of inflation early in the reform process could undermine the credibility of the program. Moreover, without overall price stability, firms and households would have difficulty responding correctly to relative price signals. In this situation, newly developed markets might not allocate resources efficiently.

Government deficits and the monetary overhang were seen as the biggest obstacles to price stability. Western experts agreed that budget deficits in the Soviet Union and other countries should be reduced or eliminated. They also stressed that central banks should have a degree of independence from the treasury or finance ministry so that deficits would not continue to be monetized. To reduce the inflationary potential of the monetary overhang, Western authorities suggested a variety of solutions including the sale of state assets as part of a privatization process, the creation of new savings instruments, and currency reform.

Central bankers from Western countries also focused on the difficulties of conducting monetary policy in the transition period. Without financial markets and with only a rudimentary banking system in the emerging market-oriented economies, the traditional channels of monetary policy are not operational. Moreover, because of the difficulty of defining and measuring monetary aggregates, central banks may not have short-run guides to the effectiveness of policy. In these circumstances, many participants felt central banks would have to rely on quantitative credit controls and discount window credit to conduct policy. To implement a restrictive monetary policy, some participants suggested controlling the total amount of central bank credit. Others advocated pegging the exchange rate to a country with a low inflation rate as a method of importing a restrictive monetary policy.

Western experts also agreed that central banks could play a leading role in developing new financial markets and institutions in the Soviet Union and other emerging market-oriented economies. They stressed the importance of establishing stable, safe, and efficient systems of monetary payments and financial intermediation. To this end, central banks should develop money and capital markets and create a modem payments system. More important, central banks should develop a system of prudential supervision and regulation that encourages financial intermediaries to make fair and accurate judgments about the creditworthiness of firms and households.

There was also a broad consensus reached at the symposium on the issue of currency convertibility. Participants agreed that current

account convertibility should be established relatively early in the reform process. Opening up domestic markets to foreign goods has several benefits for the emerging market-oriented economies. First, convertibility provides a benchmark for market prices of goods that is missing in centrally planned economies. That is, convertibility provides the guidance of prices already established on world markets. Second, convertibility introduces the discipline of world competition, forcing domestic producers to become more efficient or fail. Third, convertibility provides consumer goods to households previously accustomed to shortages and rationing. In addition, with the appropriate exchange rate, convertibility may boost exports, providing both a stimulus to the domestic economy and increased foreign currency reserves. Most participants felt, however, that because of the danger of capital flight, full currency convertibility should be postponed until later in the reform process.

Despite broad agreement on these three issues, significant differences of opinion emerged in other areas. One controversial issue was the choice of a fixed or flexible exchange rate system. Supporters of fixed rates cited the monetary policy advantages of pegging the domestic currency to that of a country with a strong commitment to price stability. They also emphasized the use of foreign prices as a benchmark for establishing a domestic price system. Proponents of flexible rates focused on the large resource adjustments that would take place in the reform process. In their view, a fixed nominal exchange rate placed too much of the adjustment burden on real exchange rates and on the prices of domestic, non-traded goods. In addition; if a country had too few foreign exchange reserves, it would be difficult to set and maintain a credible fixed exchange rate.

Differences of opinion also surfaced on the speed of the reform process and the sequencing of reforms. For example, a number of participants argued that the creation of money and capital markets should occur early in the reform process. Other participants suggested that banking reform should have priority. While there were a number of proponents of the rapid or "big bang" approach to reform such as occurred in Poland, other attendees favored a more gradual reform process. However, most participants felt that the

timing and sequencing of reforms would probably differ from country to country depending on the severity of current economic problems and on the degree of domestic political consensus.

Issues and Options

Four presentations at the symposium surveyed the major issues and outlined the policy options for central banks in emerging market-oriented economies. In his keynote address, Paul Volcker provided an overview of the role that central banks play in a market economy. John Crow then examined the difficulties of maintaining price stability and monetary confidence during the transition to a market economy. E. Gerald Corrigan focused on the role of central banks in establishing an efficient, safe, and sound financial system. In the final presentation, C. Fred Bergsten and John Williamson explored the issues of currency convertibility and the choice of an exchange rate system.

The role of central banks

Although central banks can play a variety of roles in a market economy, Paul Volcker emphasized the importance of price stability to the reform efforts under way in the Soviet Union and Eastern Europe. While noting that central banks are not the only way to maintain price stability, he felt the establishment of a strong, independent central bank was likely to enhance the credibility of the reform effort.

Volcker also identified other responsibilities of a central bank. Central banks can promote the stability of the financial system through supervision and the provision of liquidity facilities. Central banks are also a natural focus for efforts to improve the payments system. Given the enormous need for economic training in these countries, Volcker suggested that the central bank could provide technical expertise and act as a focal point for international contact and interaction.

In Volcker's opinion, the transition from central planning to a market-oriented economy poses especially difficult problems for

monetary policy. Because of problems in interpreting interest rates, prices, and monetary aggregates, central banks might not be able to implement discretionary policies. In this event, he suggested that a convertible currency and a fixed exchange rate system might be a useful way to anchor expectations about price stability.

Monetary policy and the control of inflation

While price stability is an important goal in mature market economies, John Crow emphasized that it is an equally important objective in the reform process under way in the Soviet Union and other countries in Eastern Europe. Without overall price stability, he argued, it is difficult for firms and households to correctly interpret market price signals. Thus, in his opinion, price stability and monetary confidence are central to the reform process.

According to Crow, there are three basic ways the central bank might establish price stability: a fixed exchange rate system, a restrictive policy guided by domestic indicators, and a wage or incomes policy. In Crow's opinion, each option has some limitations. A fixed exchange rate system promises to enhance domestic credibility only if people believe there is a long-term commitment to the system. This commitment may be difficult to maintain because of the large resource adjustments required during the reform process. Monetary aggregates and other domestic economic indicators used by Western central banks may be unreliable because of institutional changes during the reform process. Wage or incomes policies may serve to anchor the inflation rate in the short run but are inconsistent with market-determined prices over the longer run.

Crow also stressed the importance of building financial markets and institutions so that central banks can conduct policy through market-based means. The central bank may want to take a lead role in establishing a money market similar to what occurred in Canada. The development of a money market would not only open channels for monetary policy, but would also allow government deficits to be financed without money creation. Because weak financial institutions can pose a constraint on monetary policy, Crow also argued for a system of prudential supervision.

According to Crow, the newly emerging market economies face three immediate challenges to establishing price stability and monetary confidence. First, fiscal reform is necessary to remove the inflationary force of budget deficits. Second, a privatization program, currency reform, or other means must reduce the inflationary consequences of the monetary overhang. Finally, positive real interest rates must be established to provide incentives for saving and to allow credits to be differentiated on the basis of risk.

Central banks and the financial system

In his presentation, Gerald Corrigan advocated that central banks play a key role in developing financial markets and institutions. In Corrigan's view, stability of the banking and financial system is crucial to the stability of the overall economy. Financial stability, in turn, requires public confidence in both the banking system and the central bank.

The banking and financial system has two important functions: to mobilize and channel savings to productive investments and to provide a safe and reliable payments mechanism. According to Corrigan, the central bank can improve the efficiency of the financial intermediation process and promote public confidence through a system of prudential supervision and through active involvement in the development of the payments mechanism.

In the reform process, Corrigan suggested giving priority to the development of the banking system. In his view, policymakers need to ensure that the banking system is independent from both the government and central bank. This implies that the banking system should be privately owned or, at the minimum, privately managed. In addition, the central bank should be independent of government financing operations and should not be required to subsidize inefficient financial or nonfinancial enterprises.

Once the banking system is established, Corrigan would give priority to developing a government securities market. This market would assist in government financing operations, open a channel for monetary policy, and could also serve as a model or catalyst for the

development of capital markets.

Currency convertibility in Eastern Europe

As the Soviet Union and other countries in Eastern and Central Europe move toward freer markets, currency convertibility and exchange rate systems will become important policy issues. In their symposium presentation, C. Fred Bergsten and John Williamson examined convertibility options open to policymakers, the selection of an exchange rate system, and the pace of currency and exchange rate reform.

Bergsten and Williamson favored introducing current account convertibility early in the reform process. In their view, current account convertibility is necessary to integrate the domestic economy into the world trading system. Convertibility also allows world prices to be used as a benchmark for developing a domestic price system. Because of the danger of capital flight, however, the authors suggested that capital account convertibility be deferred. They also argued that convertibility should be established with other currencies rather than with gold.

In the early stages of the reform process, Bergsten and Williamson advocated the use of a fixed exchange rate system with domestic currencies pegged to those of major Western trading partners. They argued that in the transition period it will be difficult to conduct monetary policy under a flexible exchange rate system. They also believed floating rate systems can become severely misaligned. At the same time, they recognized that changes in par values will be necessary over a longer period as markets and industries are restructured. As to the problem of choosing an initial exchange rate, the authors recommended the domestic currency be devalued to the extent necessary to stimulate a competitive export sector.

Bergsten and Williamson also examined the appropriate speed of currency and exchange rate reform. They noted that, historically, gradual approaches to convertibility have been favored in Western Europe and elsewhere. Given the serious economic problems in the Soviet Union and some other countries, however, the authors sug-

gested a more rapid approach may be preferred.

Policymakers from Eastern Europe and the Soviet Union

Policymakers from Czechoslovakia, Poland, Bulgaria, Yugoslavia, the Soviet Union, Romania, and Hungary outlined economic reform programs in their countries and discussed the role of central banks in the restructuring process.

Recent developments in Czechoslovakia

In his luncheon address, Vaclav Klaus discussed the current status of reforms in Czechoslovakia and examined political obstacles to reform. According to Klaus, a number of institutional and economic policy changes were made in the first eight months of 1990. Important measures included: abolishing state planning agencies, creating a two-tier banking system, adopting restrictive monetary and fiscal policies, devaluating the currency and liberalizing trade, reducing subsidies to consumers and producers, and enacting legislation to support the creation of a private sector. At the beginning of 1991, the government plans to introduce a privatization program, price reform, and currency convertibility.

In Klaus' view, there are many political obstacles to the reform movement in Czechoslovakia. Some groups in Czechoslovakia are hesitant to embrace a pure market economy. Other groups continue to believe in a modified planned economy. Thus, debate continues over the extent and pace of economic reform.

Josef Tosovsky provided a more detailed look at currency convertibility in the Czechoslovakian reform program. According to Tosovsky, policymakers favor a rapid implementation of current account convertibility once two preconditions are met. First, a restrictive monetary and fiscal policy must be firmly in place to curtail inflationary pressures. Second, the domestic price system must be liberalized parallel to the introduction of convertibility. When convertibility is introduced in 1991, policymakers plan to devalue the currency and maintain a fixed rate with either the deutsche mark or the ECU.

Recent developments in Poland

Poland has moved very rapidly along the reform path. As described by Wladyslaw Baka, the Polish program has two objectives: to curb inflationary pressures and eliminate goods shortages, and to make the institutional changes necessary to create a market economy. To accomplish the first goal, policymakers introduced restrictive monetary and fiscal policies, curbed wage increases, adopted currency convertibility and a fixed exchange rate, and liberalized domestic prices. As a result of these measures, inflation has fallen dramatically and a growing trade surplus has increased foreign exchange reserves. At the same time, however, production, consumption, and employment have declined much more than anticipated.

In addition to monetary policy, the National Bank of Poland is involved in restructuring the banking system and in creating new financial markets. According to Baka, commercial banking functions have been separated from the central bank. Privatization of the large, state-owned commercial banks is handicapped, however, by a lack of capital. The central bank is also involved in developing a modem payments system, in creating a money market, and in establishing new accounting and supervisory standards. According to the new banking law, the central bank in Poland is prohibited from financing budget deficits of the state or state enterprises.

Recent developments in Bulgaria

Ivan Dragnevski discussed financial and banking reforms in Bulgaria and examined some of the problems facing policymakers during the transition period. According to Dragnevski, the first steps toward banking reform were taken in 1989 with the creation of a two-tier banking system. Fifty-nine new commercial banks were created from branches of the national bank. These banks are permitted to make business and mortgage loans and to accept deposits from individuals. However, these institutions continue to be owned by the state and must compete with larger state-owned financial institutions.

Dragnevski also described policy measures to promote price stability. To reduce inflationary consequences of a large monetary overhang, he suggested that interest rate ceilings will have to be removed. In addition, since the beginning of the year, a system of credit restraints has limited lending activities of commercial banks.

Recent developments in Yugoslavia

According to Mitja Gaspari, policymakers in Yugoslavia have concentrated on halting inflation as a prerequisite for undertaking fundamental structural changes in the economy. Emergency measures to curb accelerating inflation include: restrictive monetary and fiscal policies, currency reform, an incomes freeze, elimination of indexation, and currency convertibility.

Thus far, the Yugoslavian program has had mixed results. On the positive side, inflation has come down dramatically, and a large trade surplus has led to increased foreign exchange reserves. However, industrial production has fallen sharply. In addition, wage growth continues to be strong, and a lack of federal control over republic spending raises prospects of renewed budget deficits.

Gaspari also described some of the structural reforms under way in Yugoslavia, including the transformation of banks and other firms to profit-oriented entities. In his view, the large amount of nonperforming loans on bank balance sheets is a serious constraint on the reform process.

Recent developments in the Soviet Union

Victor Gerashchenko viewed inflation as a serious impediment to the development of a market-oriented economy in the Soviet Union. Part of the inflationary pressures are due to the accumulation of large state deficits in recent years. According to Gerashchenko, there are also "price push" pressures on prices. The decentralization of industrial decisionmaking has allowed some enterprises with monopoly power to raise prices considerably.

To deal with the monetary overhang in the Soviet Union, Gerash-

chenko advocated increased production of consumer goods, housing reform, and an expansion of investment opportunities for consumers. In his opinion, liberalizing interest rates to permit positive real rates is a necessary step to get households to increase savings voluntarily. He also stressed that the central bank must be freed of responsibilities for financing the government deficit if it is to pursue a successful anti-inflation program.

Recent developments in Romania

Mugur Isarescu described the reform process in Romania. In his view, the transition from central planning to a market-oriented economy in Romania involved three steps: dismantling central planning institutions and creating market institutions, converting property from state to private ownership, and establishing a social safety net. Under new legislation, three quarters of state enterprises have been transformed into commercial companies and are to become fully privatized over time. Other bills encourage private entrepreneurship and relax regulations on foreign investment. Legislation is currently being drafted to restructure the banking system.

On the issue of currency convertibility, Isarescu characterized Romanian policy as "rapid gradualism." That is, convertibility is to be introduced in stages starting with exporters being able to retain an increasing fraction of their foreign exchange earnings. A system of foreign exchange auctions will then permit companies to trade foreign exchange. The intent is to raise the retention rate over time until full current account convertibility is achieved.

Recent developments in Hungary

Imre Tarafas commented on the difficulty of conducting monetary policy during the transition to a market economy. In Hungary, two factors limiting the effectiveness of monetary policy are the underdeveloped banking system and the lack of financial discipline at firms. The latter problem has made it difficult for the central bank to implement an anti-inflation program. Without hard budget constraints, firms continue to spend when policy is tightened and so place upward pressure on prices.

According to Tarafas, monetary policy in Hungary is currently focused on the current account. Restrictive policy has led to a sizable improvement in the trade balance and foreign exchange earnings over the past year. Because of the price pressures stemming from firms, the central bank has had to devalue the currency. For this reason, Tarafas suggests that a fixed exchange rate system is not feasible for Hungary in the transition period.

Western discussants

Western experts examined central banking issues in the reform process in the Soviet Union and Eastern Europe and proposed solutions to some of the problems identified by policymakers in these countries.

Monetary policy and the control of inflation

Martin Feldstein focused his remarks on the problem of controlling inflation in the Soviet Union. According to Feldstein, a prerequisite to market reform in the Soviet Union is a sound monetary and fiscal program aimed at eliminating budget deficits and absorbing the rouble overhang. Principal methods of cutting the budget deficit include: increased tax revenues, lowered subsidies, and reduced spending on heavy investment and the military. To reduce the rouble overhang, Feldstein preferred voluntary approaches, such as the creation of attractive savings instruments for consumers.

Lawrence Kudlow described some of the problems hindering the movement of Western capital into Eastern Europe. Kudlow argued that currency risk must be reduced before Western investors will be willing to commit funds. Thus, he emphasized the need for currency convertibility and the use of fixed exchange rates or other methods of reducing exchange rate risk. He also noted that bureaucracy and excessive state regulation made it difficult for Western investors to function in Eastern Europe.

Allan Meltzer emphasized the importance of price stability in the reform process. He argued that overall price stability is necessary if relative prices are to act correctly as signals for resource allocation.

Price stability, in turn, requires fiscal and price reforms. The central bank will not be able to establish credibility in its commitment to price stability unless it is free of requirements to finance deficits of the state and state enterprises. In addition, an efficient market economy requires price flexibility. Thus, Meltzer cautioned that once market prices are established, governments must resist pressures to cushion the impact of wage and price changes.

Georg Rich also saw price stability as important for newly developed markets to play their proper allocative role. To maintain price stability, Rich suggested the central bank choose a monetary anchor at the beginning of the reform process. This step is necessary to create stable price expectations and to ensure that the central bank is removed from deficit financing requirements. Rich indicated a fixed exchange rate might provide a useful short-run monetary anchor. Over the longer term, however, he thought the central bank might switch to a domestic monetary or credit aggregate to allow the exchange rate to shield the economy from external shocks.

Niels Thygesen commented on the merits of fixed exchange rate systems for promoting price stability. In his view, the European Monetary System provided a useful guide to central banks in Eastern Europe. According to Thygesen, the EMS has led to convergence toward lower inflation rates within the European Economic Community. Thus, he suggested that Eastern European countries should consider fixed rate systems with their main trading partners in Western Europe.

Central banks and the financial system

Andrew Crockett argued that reform of the financial system in Eastern Europe and the Soviet Union is crucial to the success of the overall reform effort. Specifically, a reliable payments system is central to the development of an efficient system of resource allocation. And, an effective system of financial intermediation is essential for savings to be allocated to the most productive investment opportunities. Crockett identified four steps toward financial reform. First, commercial banking activities must be removed from the central bank to create a decentralized, competitive banking system.

Second, effective settlement and clearing systems must be introduced. Third, reforms must extend beyond the banking system to the development of money markets. Finally, the central bank must develop a system of prudential supervision and regulation.

Mervyn King emphasized the responsibility of the central bank for ensuring financial stability. He noted that, in the West, central banks emerged after the development of financial markets. Their primary responsibility was to provide stability and prevent financial crises. In Eastern Europe, the challenge is reversed—how to create a system of privately owned commercial banks from a centralized system. According to King, central banks in these countries will be faced with the conflicting responsibilities of promoting competition while maintaining safety and stability.

Philippe Lagayette suggested there are important linkages between central bank responsibilities for monetary policy and financial stability. Because central banks must move interest rates to conduct monetary policy, the financial system must be strong enough so that financial crises do not result when policy is changed. To ensure financial stability, Lagayette argued that the central bank must have responsibilities for supervision and regulation.

Currency convertibility in Eastern Europe

Richard Cooper focused on the role of currency convertibility in the Soviet Union. In his view, current account convertibility would have a number of beneficial effects including: introducing effective competition, aligning Soviet prices with world prices, providing more consumer goods, and stimulating export industries. As preconditions for convertibility, Cooper emphasized that enterprises must have hard budgets and that an anti-inflationary macroeconomic policy must be in place. In these circumstances, he favored establishing convertibility at a fixed exchange rate.

Jacob Frenkel also emphasized the importance of current account convertibility. For convertibility to be successful, however, Frenkel argued that four preconditions must be met. First, an appropriate exchange rate must be in place. Second, adequate international

reserves must be available. Third, macroeconomic stability must be established, including the elimination of budget deficits and the monetary overhang. Finally, the price system must be reformed and state enterprises must be privatized or become profit-oriented.

Arnold Harberger viewed currency reform in Eastern Europe from the perspective of similar reforms in Latin America. While favoring current account convertibility and fixed exchange rates, Harberger noted that the speed of reform and the choice of exchange rate systems depends upon a country's economic situation. Thus, in some circumstances in Latin America, gradual movements to convertibility using currency auctions have been quite successful. For a rapid or "big bang" approach to work, Harberger argued that macroeconomic stability must be established prior to convertibility.

Overview panelists

In his summary of the issues raised at the symposium, Leonhard Gleske emphasized the importance of price stability and currency convertibility to the reform programs in Eastern Europe and the Soviet Union. According to Gleske, monetary stability is vital if market prices are to provide correct signals for resource allocation. Domestic monetary stability is also a prerequisite for establishing current account convertibility.

Gleske also observed that monetary stability is not sufficient to ensure real growth in these economies over the longer term. Equally important are structural policies aimed at increasing the supplies of goods and services. To be effective, Gleske argued that structural policies must change both institutions and attitudes. By improving the supply response of the economy, structural policies will promote price stability.

In his closing remarks, Alan Greenspan examined the differences in the roles played by financial institutions in centrally planned and market-oriented economies. He noted that the key function of commercial banks in a market economy is the reduction of financial risk through diversification. If successful, banks can reduce real interest rates, increase investment, improve productivity, and raise stand-

ards of living. Central banks can assist in this effort by providing liquidity facilities, supervision, and payments system services.

Conclusion

The process of economic reform is well under way in Eastern Europe and the Soviet Union. The move from a centrally planned to a market-oriented economy requires fundamental changes in the legal, economic, and financial systems of these countries.

Participants at the Federal Reserve Bank of Kansas City's 1990 symposium agreed that central banks can make important contributions to the reform efforts. Central banks can promote a stable macroeconomic environment and can play a role in developing new financial markets and institutions. By supporting the establishment of currency convertibility, central banks can also assist in the integration of these countries into the world economic system.

The Role of Central Banks

Paul A. Volcker

I must say that it is a pleasure to be back with this group after a lapse of eight years. The scenery remains superb, the fishing is still good, and the company is stimulating. In my former position, I must confess I had some difficulty in squaring all this with my personal idea of what a true-blue central banker should do. You know: austerity, discipline, restraint, hard work, pinstripes, and all of that. I do not notice any of that in this company. But I do think it is important that our Central and Eastern European central banking friends do understand one thing that is symbolized by this conference. The simple empirical fact is that central bankers—and I include finance ministers for this purpose as well—have always found the most agreeable places to meet. I think it is all justified under the general rubric of promoting international financial cooperation. Who can protest such a cause as that?

I am free of all official responsibilities these days, but I am supposed to say something profound and provocative in these 15 minutes. And I have to tell you, I find that more difficult after having left government. Somehow the thoughts and ideas seem to have come easier when I could call on good colleagues and superb staff for their participation—and, not unimportantly, for a few facts. These days, I sit in a lovely office on the 40th floor, with a nice view, way above the steamy streets of New York. But I am in intellectual isolation, at least about central banking. For all the glories of my investment banking friends, I have to tell you they are not very big on the role of central banking in emerging market economies, which is what I

am asked to talk about today. In fact, when I mentioned to one of them that I was supposed to talk about central banks in emerging market economies, they told me that was an antithesis in terms. Central banks are not exactly the harbingers of free market economies.

As I thought about this subject, I had a little difficulty. I do not question the emphasis that has been placed upon central banks and central banking in Central Europe and Eastern Europe. And not just there, but also certainly in China where I spent a week last January, and in Latin America—which has many similar problems to those of Central and Eastern Europe. In all of these places, there is a tremendous interest in central banks, in encouraging central banks, and in strengthening central banks. And it does not, of course, stop there. The same process seems to be under way in the U.S.S.R. itself. And what interests me is that Mr. Yeltsin apparently wants a central bank in Russia and I guess the Lithuanians want a central bank, and the Kazaks want a central bank. Every province in China, I can tell you, wants its own central bank, too. I began wondering why. What is this all about?

There are obviously a lot of priorities that these countries face in moving to a market-oriented economy. They face the challenge of inoculating the basic idea of markets, the basic idea of private property in their economic systems. They have that enormous challenge of privatization. They have to introduce accounting systems, commercial law, and financial instruments. You can go on and on. Where does central banking rank in that hierarchy of priorities?

And as I began wondering and looking at central banks in the Western world, I realized they were not at the cutting edge of a market economy; they were Johnny-come-latelies. With a few notable exceptions—like the Bank of England and the Bank of Sweden, which go back some 300 years—central banking is almost entirely a phenomenon of the twentieth century. And there were market economies long before the twentieth century. Indeed, to some extent, central banks were looked upon and created as a means of financing the government, which I do not think people have in mind when thinking about central banking today. The Federal Reserve

itself was not established until 1913; the Bank of Italy, later than that; the Bank of Switzerland, not much before that; the Bank of Canada, in the 1930s. (I would get all these facts right if I were still in the Federal Reserve System, but I think they are roughly right.) Similarly, the central banks of Australia and New Zealand were also creations of the last 50 years. And if you say a central bank is essential to a market economy, I have to ask you about Hong Kong, which has no central bank at all in the absolute epitome of a free market economy. Yet it does quite well in terms of economic growth and stability. So the question remained in my mind.

And it also occurred to me that we forgot until quite recently, and even today, how much central banks in the rest of the world rely upon direct administrative and selective measures to control money and credit. Total bank credit ceilings were not exactly an unknown technique, even in Western Europe's central banks, as recently as 10 or 15 years ago. Administrative guidance and selective credit controls are still not unknown—even in the United States from time to time. It is only in the past couple of decades that interest rate ceilings, formal or informal, have gone by the boards, and they are not entirely by the boards even today. Now, all of that has changed with the integration of capital markets internationally and with a worldwide move to deregulation that goes far beyond financial markets and central banks. But my point is that these are quite recent developments. They did not lead market economies; they followed.

And I also might mention that for all the talk about central banks today, I think it is fair to say that the authority and prestige of central banks in the industrialized world, though fairly high now, has not always been so high. A lot of de facto authority was lost in the 1930s and 1940s in the midst of depression and war; and a lot of central banks lost their statutory independence as well in that period. Only in the past decade or so has monetary policy again been at the cutting edge of national policy.

Well, if all of that is true, what is driving all this interest in central banking? What critical role does it have in these emerging market economies? Well, the answer that kind of leaps to mind automatically, at least to the mind of a central banker I suppose, runs

something like this: the transition to a market economy from a centrally controlled command economy is going to be fraught with a lot of problems, but one of the central problems will be inflationary dangers; inflation is bad and destabilizing and threatening; central banks are against inflation; Q.E.D. We had better hurry and create a good central bank to deal with the potential inflationary problem. But even then I have to say, wait a minute.

There are other potentially more effective ways to get a handle on inflation than a central bank. And I do not have to cite any greater authority in this room than Wayne Angell. When he went off to Russia, he did not recommend the creation of a new Federal Reserve System. Rather he said, "Go on the gold standard." Alternatively, one might say "adopt convertibility." Or one might say, as Alan Walters seems to be saying these days, "have some kind of a currency board" for emerging economies. A central bank might be attractive to those here, many of whom are central bankers. But it is not the only way you can deal with inflation. In fact, as you well know, a central bank can become an engine of inflation rather than the reverse.

I have to point out that historically, until the past 10 or 15 years, socialist economies, though having many other deficiencies, did not have a bad record on inflation. They did not have a central bank in the Western style, but they disliked inflation. I sometimes wish Keynes had said as much about the evils of inflation as Lenin did. We would all be better off if he had. But in fact socialist economies were pretty sensitive to the inflation problem. Mr. Alkhimov, a predecessor of Mr. Gerashchenko at the Gosbank, told me 10 or 15 years ago, "You know, we deal with this monetary problem psychologically in quite the opposite way that you Westerners do. You are always worried about inflation and creating too much money, so you talk about the importance of an independent central bank. I have to tell you that the people who run the U.S.S.R. are very suspicious that those of us in the Gosbank will create too much money. So, we have to get permission from the Politburo once a quarter to agree to a proposed increase in the money supply that we think is appropriate."

It brought a vision in my mind somehow of the Open Market Committee meeting last Tuesday, looking at M2 and all the rest and looking at the economy, deciding maybe the money supply ought to be increased a little bit in terms of everything going on. But having to say, no we cannot make that decision right away. Mr. Greenspan will have to ask for an appointment with the President and go over and see Mr. Bush, maybe with Mr. Brady and Mr. Boskin in the background, and say, "Please Mr. President, the Open Market Committee has come to the conclusion that we would like to increase the money supply a little bit. Would that be acceptable to you in the Administration?" only to find a little growling on the other side! It is quite a different way of looking at things.

Well, inflation is part of the story, but it seems to me there is something else going on here. And the reason there is so much talk about central banking is that it is very much tied up with ideas of sovereignty, of autonomy, of discretion, and of economic policy-making. And here I guess I would cite no less an authority than Margaret Thatcher. She is not, I think, protesting entry into the European Monetary System—which might mean in some sense the dissolution of an independent Bank of England—because she thinks a Bundesbank-led consortium is going to create more inflationary problems than they already have in the U.K. No, she is worried about Queen and sovereignty and parliament and whether she is in control of things. And I think that is probably what Mr. Yeltsin thinks of when he talks about a central bank for Russia. And I think that is what a lot of people think of when they are talking about a central bank. It is not that Mr. Yeltsin wants a more solid rouble than the U.S.S.R. rouble. Rather, he wants some control over the destiny of his particular republic. So the essence of a central bank seems to be a little bit ambiguous. Sure, it deals with inflation, but it also has the authority to inflate. The very discretion implied by that term creates some ambiguity.

There are clearly some more mundane, more concrete reasons why nations want a central bank. These emerging market economies are going to want competitive financial systems, effective financial systems—that certainly go hand-in-hand with a market economy. They need some kind of a banking system. They had a banking

system, but it was not suitable for a market economy. But rather than starting from scratch, they took the big banks they had, broke them up, and created some commercial banks. And it is quite natural then to say that somebody has to supervise those commercial banks. We will take part of that old machinery and make a central bank out of it, and it has clearly got a role as a supervisor, a regulator, a lender of last resort. And I think starting from scratch in that particular case, the central bank may also have a self-interest in promoting and facilitating a market system in the financial world so that it itself can operate.

I think it is also true—a very much related matter—that there is a need for a more efficient payments system in the economies of Eastern and Central Europe. The central bank is a natural focus for achieving that objective. It is not the only focus you can think of, but it is a natural focus for improving the payments system. I think those things are true and they are all important. But again, I do not think they account for the urgency of all the talk about central banking in these economies. All those things I am talking about—supervision, regulation, payments system—lie somewhere in importance I suppose between a new telecommunications system and a new steel plant. They are very interesting and very important, but one would hardly have a conference attracting all you people to Jackson Hole to discuss them.

There is another much more subtle reason for central banks, a reason which may be on nobody's mind except mine. But let me just mention it because I think it grows out of observation of the experience of a good many countries. And it is a point that is seldom explicitly discussed. But I do not think it is just a figment of my imagination. Central banks around the world share certain common characteristics. They have a continuity of policy and staff and some degree of insulation—greater in some countries than in others—from the political process. It seems to me they are typically centers of economic professionalism and training within governments and sometimes within countries. And partly because of those qualities, they are a natural focal point for international contact and interaction—away from the political forums like summits and G7 meetings. All those things are quite important for the world at large and for

individual countries. I think it obviously varies a lot from country to country, but they can provide a very unique and valuable resource for a country, and I think particularly for a country in the midst of development and arrival on the world scene.

1 would just give you two examples of the kind of thing I have in mind. One is south of us in Mexico, a developing country where the Bank of Mexico has clearly been a center of professionalism and education and responsibility for many decades—indeed, less so now because they have been so successful. The Bank of Mexico has supplied most of the talent to economic parts of the rest of the government. And I think another example on the continent of Europe is Italy. The Bank of Italy is not independent in any formal or legal sense. But in a country that has had a government that has not been characterized by an enormous amount of continuity, the Bank of Italy has provided a continuing focal point for effective and successful economic policy.

Well, none of that tells us precisely what a central bank ought to do about its primary job in an emerging market economy, which is something about economic policy. I am not going to get very complicated about that because I do not think it is really a very complicated question. I do not think there is any cookbook that supplies the answers to all of these countries across the board. I think judgments necessarily have to take account of political as well as economic factors. These factors have to be judged by the people there on the scene, people who are part of that political process, part of that economy.

But I think what can be said with some certainty is that given the kind of inflationary pressures inherent in the transition, if these central banks are going to be successful and if their countries are going to be successful in the transition, they are going to be tough. They are going to have to be tough—tough in the sense of keeping some kind of limits on the growth of money and credit sufficient to keep inflation under control. It seems to me that if price stability is not attained rather early in this process, establishing credibility and stability later on will become progressively more difficult, which could jeopardize the successful transition to a market system. There

are a lot of horror stories, particularly in Latin America, that I could cite to reinforce that point.

I do not think achieving that rather simple, direct, brutal, and maybe difficult purpose requires a lot of fancy tools. I would not counsel a lot of preoccupation with developing liquid government securities markets, futures markets, forward and options markets, or an efficient stock market. In fact, small countries may never have terribly effective markets in all those respects. I think there are positive advantages in fact, at this stage, in keeping as much of the intermediation as possible inside the banking system. You do not have to force feed financial market development. It will come naturally enough from abroad and from within. But I think there is going to be a lot of effort on training bankers and getting the commercial banking system to operate more effectively, in line with the needs of a market system. I also think interest rates are going to be very difficult to interpret and that money supply data are going to be difficult to interpret. This is not an area in which you are going to have much opportunity for successful fine tuning.

These are all considerations that point toward what may be thought of as fairly crude tools like convertibility and a par value system so it can act as an anchor to expectations. This kind of anchor would be a great help in making the point that stability is going to be maintained even if those particular techniques seem to diminish the discretion and policy role of the central bank. In fact they may provide the most practical guide to policies in the short run.

In conclusion, I think what all this talk about central banks ought to boil down to is this: It is crucially important to get the message through to the public and the political leaders that restoration of a sense of price stability is indeed vital to the success of this great experiment in moving toward a market economy. As a practical matter, it is true that building the independence and the stature of the central bank may be the best way to make that very simple point. That is the fundamental issue in talking about the role of central banking in these emerging market economies.

Monetary Policy and the Control of Inflation

John W. Crow

As presenter for this session of the symposium I see my task as more to indicate than to prescribe. There are other reasons as well for a cautious approach. Even if one could claim to have a good understanding of the common features of the economies in question, the differences among them are also very important. It is therefore unlikely that any single prescription could satisfy all cases. And while I can claim a background in central banking, I can only claim a very great interest in the financial and economic transformations taking place across Central and Eastern Europe and the conditions under which central banks have to operate and establish a place for monetary policy.

Some overlap with other parts of the symposium is unavoidable. For example, we need to assume that in this morning's first session, on the role of central banks, it was accepted that central banks will be provided with the tools necessary to conduct monetary policy in a way that (of course) gives central attention to monetary stability. Monetary stability can also be described as price stability or, in the possibly less demanding terms chosen for this session, as inflation control.

It is also worth highlighting at the outset the particular relevance of the fact that we are discussing monetary policy against the backdrop of "emerging market-oriented economies"—that is, economies emerging from the system of "material balancing,"

under which quantities of inputs are made available administratively on the basis of estimated needs for fulfilling the production targets stemming from a central plan, and moving toward one where the price mechanism and competition in private markets play a major role in resource allocation.

In a market economy, monetary policy is transmitted above all through changing yields in financial markets. Until the transmission linkages—from the instruments of monetary policy to financial markets, and from financial markets to the rest of the economy—have developed, monetary policy as it is generally perceived is unlikely to be very effective. Conversely, while the general range of market reforms or creations under way are hardly being undertaken in order to improve the playing field for monetary policy, the better financial markets function, and the better they become linked to the market decisions of consumers and investors, the more effective monetary policy will be in getting macroeconomic results.

Another reason for emphasizing the shift toward market economies is that while inflation is bad news under any economic system, it is particularly bad for a decentralized, that is market, system. For this system, with its reliance on the price mechanism and monetary exchange, monetary stability is essential if market signals are going to be interpreted efficiently. In other words, to function well, a market economy depends on confidence in the money that is being used.

Broad approaches to establishing monetary confidence

This section reviews the main ways in which monetary policy might be anchored so as to secure the credible performance necessary for monetary confidence.

Bearing in mind perhaps the debates in Western Europe over the exchange rate system, consideration needs to be given in this session to the merits of a fixed exchange rate as the anchor for monetary stability. Such an approach would also entail an early decision to make the currency convertible in the foreign exchange market (at least for current if not right away for capital account transactions).

Currency convertibility will also get a discussion all to itself later at this symposium.

For monetary policy, the crucial value of relying on a fixed exchange rate anchor is that it promises to deliver early credibility. It does this through explicitly locking onto a currency that already enjoys a good reputation for preserving its purchasing power. Credibility would be enhanced if it is likely that strong trading links will develop with the economy using the currency in question. In this context, the European Monetary System could be an obvious pole of attraction—either in the collective currency bundle, the ECU, or, conceivably, through its strongest constituent currency.

Still, arguments for not betting monetary policy on the exchange rate have considerable weight.

Reliance on the exchange rate (in effect on someone else's monetary policy) for monetary discipline, and therefore for confidence, means commitment to a fixed exchange rate that must be seen as unwavering if it is to be credible enough to shape price and cost decisions. Simply pegging the exchange rate may not by itself provide the necessary demonstration of commitment. Indeed, can anything less than some sort of monetary union be seen as "unwavering?" And practically speaking, monetary unions or EMS-type arrangements for monetary policy convergence look a fair way off at this point.

Fixing the exchange rate means that the discipline on domestic costs that is imposed by an unyielding exchange rate dominates other considerations regarding the role of the exchange rate—particularly the role of shifts in the nominal exchange rate in facilitating shifts in the real exchange rate (the exchange rate adjusted for relative rates of inflation) as a way of getting the economy to adjust efficiently to real economic changes.

As an illustration of the above point, it may be presumed that the terms of trade will shift as CMEA trade declines and new trading patterns emerge. More generally, relative prices will move, probably a great deal, under the impact of market transformation. It

follows that the real exchange rate will likely have to move as part of the general process of relative price adjustment. Without some flexibility in the nominal exchange rate, it may well not be possible to get anything approximating the necessary exchange rate shifts in real terms except at great economic cost in terms of foregone output and increased unemployment.

What about domestic indicators, guides, and anchors?

In this area it does not seem likely that any clear-cut option would be available. One common approach from the domestic angle is to use monetary or credit aggregates as a way of plotting a path for monetary policy. However, in view of the economic and institutional transformations taking place, it seems unlikely that stable relationships to either spending or interest rates will be forthcoming any time soon.

Accordingly, the authorities might be well-advised to adopt an eclectic approach to the use of domestic guides. An initial focus on an IMF-styled measure of maximum domestic credit expansion, grounded in the central bank's balance sheet, may well be called for. Whatever other monetary management decisions are implemented, in the prevailing economic and institutional flux the central bank will want to keep a close eye on the pace at which its own assets are expanding (more on this below).

The authorities will in any event want to monitor movements in any relatively broad indicators of prices that are available, as a gauge by which to adjust the thrust of monetary expansion. At the same time, in this period of structural change relative prices will be changing a great deal in all markets, and it may be difficult indeed in the shorter run to separate out the impact on the price level of changes in relative prices, from the impact originating in a process of general domestic cost and/or price inflation. How well relative cost or price changes can be distinguished from general movements in costs or prices will of course depend in part upon the quality of the cost and price measures. Developing satisfactory measures will therefore be a priority.

Even if monetary policy is not fully geared to the exchange rate, the balance of payments outturn in general, and exchange rate pressures in particular, can obviously also play a role in gauging the degree of demand and inflation pressure, and therefore in indicating a need to adjust the thrust of monetary policy. However, as in the case of price movements, in this area also it will be important to make distinctions—between on the one hand the effects of demand on the balance of payments and the exchange rate, and on the other the effects of influences of a structural nature.

The pace of increase of the general level of money incomes (conventionally called the money wage rate) is clearly of great relevance in terms of the possibilities for inflation control. However, it may be relevant not so much because of its sensitivity to demand pressures, but more especially because of its cost and price push features in a particular institutional context. These features could call for other forms of restraint as a complement to monetary restraint—not as a way of life in a market-based economy but in the initial stages of economic stabilization. In this way the money wage rate could act as a temporary nominal anchor alongside any available guides that are more directly linked to the monetary process. In this context, the Polish experience to date will be of interest. There, wages (on the basis of a tax-based incomes policy) apparently serve as the nominal anchor, reinforced to some degree by a fixed exchange rate.

Building the foundations

Evidently, a great deal of institution building (beyond the questions relating to central bank structure and powers that were presumably covered earlier this morning) will have to occur before the economies in question can use monetary policy in the market-based way that is available elsewhere.

No doubt a major priority at the start is to establish a market-oriented system of deposit gathering and commercial credit extensions—the traditional field of commercial banking. But also, more generally, the authorities will wish to encourage greater competition in the financial markets, to channel savings to their most productive uses. Within the OECD this objective has been met both by systems

in which banks play a dominant role (the continental European model), and by systems in which marketable securities are also very important (the North American-U.K. model). Markets for short-term funds are, in either case, of particular interest to central banks, given the fact that their policy actions are transmitted through such markets into the rest of the financial sector and into the non-financial sector.

Sometimes appropriate market structures have developed only after central banks and governments have taken the lead. For example, the Bank of Canada realized quite early in its existence that a well functioning money market—dealing in treasury bills, commercial paper, overnight funds, and the like—would assist the implementation of monetary policy as well as the overall efficiency of the economy. But although the banking system as such had been well developed for many decades, an active money market emerged only after a series of Bank of Canada initiatives in 1953-54. (These are documented in the appendix.)

From the viewpoint of monetary control, and therefore inflation control, the development of the Canadian money market had two particularly desirable features.

In the first place, the Canadian money market's development provided an avenue for increased reliance on price-related methods of monetary management—broadly speaking, open market operations. And in this process, reliance on jawboning and on bank liquidity ratios to influence commercial banks' extension of credit became less and less—to the point that these features now have no role in Canada.

Secondly, the broadening of outlets for the placement of government debt—to include the money market as well as the bond market—helped to provide a first line of assurance that government deficit financing would not impinge upon monetary control. In general, in the absence of broad and resilient financial markets through which to absorb financing demands, the central bank would find it very difficult to deflect direct pressure from government

deficits on its balance sheet and therefore on inflation of the monetary base.

To deflect the pressure by, for example, imposing higher bank reserve requirements in cash, or in government securities, is not an adequate solution. At the very least it causes problems for the efficiency and competitiveness of the deposit-taking part of the financial system. A better solution would be for the government to pay an interest rate sufficiently high that it attracts willing lenders, and without pumping up the money supply. In general, if credit of various kinds really has to be subsidized or channelled preferentially, the subsidy should be out in the open and not financed through what is in effect a *tax* (and therefore fiscal, not monetary, policy) on the intermediation of savings through the banking system.

A related issue with implications for controlling inflation is the importance of developing at an early stage a workable system of prudential oversight for financial institutions, including determining which institutions will have access to the lender-of-last-resort facility for liquidity purposes. This, too, is a separate topic of discussion in a later session. Its importance for inflation control is to remove a potential constraint on the conduct of monetary policy. The presence of distressed institutions may inhibit monetary discipline, for fear of precipitating a crisis in the financial system or of disrupting the flow of investment finance to the non-financial sector,

The immediate challenges

Building institutions and building confidence takes time, and meanwhile monetary policy has to do what it can with what is available, keeping its eye fixed firmly on inflation control.

It cannot be emphasized too strongly that central to any prospect of overall monetary control is the absence of pressure on the central bank to inflate its balance sheet (simply put, to print money) because of budget deficit financing needs. Depending of course on each country's circumstances, some fiscal reining in, even fiscal reform, is therefore probably implied. This does not necessarily mean that deficit financing would not be available at all from the central bank.

But such financing would have to be budgeted for in the framework of an overall monetary financing plan that reflected the needs of monetary control and not whatever size the deficit happened to be.

There may be a large monetary "overhang"—a form of forced savings—as a legacy from the previous system of passive credit creation and price control. The consequence may be an extreme burst of spending and inflation when prices are decontrolled. This carries the threat of derailing the process of building monetary confidence before it even gets started.

Here, the challenge clearly is to eliminate this burden as quickly as possible. One way of absorbing the overhang is the privatization of existing government assets. This is a delicate problem, given the natural concerns about selling at (possibly) fire sale prices, especially to foreigners. Nevertheless, asset sales will be a useful safety valve. The housing stock in particular is a prime candidate for privatization, and one that in the hands of individuals would greatly increase their stake in the market economy. At the same time the disposition of state assets, for which the true market value of many is far from clear, will raise important prudential questions. If such sales are made on credit to domestic residents or firms it is critical that this not lead to an extension of the safety net of lender of last resort to insolvent financial or non-financial firms. It is also possible that an upward price level shift (for example through an increase in the relative price of food to stimulate production) could absorb some or all of any overhang of real balances. Currency reform, to eliminate excess balances, clearly has a place on the list of potential measures, but if it does not give every appearance of being definitive and final it will surely have serious after-effects on confidence in the monetary system. Therefore, currency reform looks more like a constituent measure of a broader stabilization package, most likely in the context of associated deficit-reducing fiscal measures to remove a systemic cause of inflation, rather than a self-contained step.

Another crucial challenge will be to ensure that "real" interest rates on both loans and deposits are positive. This will help to ensure a proper incentive for voluntary savings, and that there is room to

differentiate credits on the basis of risk. It will also help to diminish any monetary overhang to the extent that real yields on these "overhang" balances were formerly negative.

In a period when rapid structural, and therefore relative price, changes are occurring, and barring a fixed exchange rate solution that can be seen as definitive, the monetary authorities will have even greater difficulties than usual in determining what rate of monetary expansion is consistent with inflation control. Control over the central bank's assets (the ultimate lever of monetary policy) would likely need to be closely managed—so as to limit the pace of central bank credit expansion to one consistent with the authorities' best estimates of the flow of resources accruing to the central bank through the growth of the liability side of its balance sheet (for example, from bank notes issued, increases in commercial banks' reserves) in a noninflationary environment. There will be distinct merit in conservative estimates because confidence, once lost, is not easily regained. Such a "domestic credit expansion" approach has the virtue of safety first, being both a potentially useful brake on excessive monetary expansion and protective of the overall balance of payments.[1]

End Notes

[1]See for example, Manuel Guitian, "Credit Versus Money as an Instrument of Control," International Monetary Fund, *Staff Papers* (November *1973).*

Appendix
Establishing the Canadian Money Market

Before 1953 there was no organized short-term money market in Canada. Business had few options other than the chartered banks for short-term financing or money placement, at sticky interest rates set by the banks. "Call loans" of the banks to money market dealers were then quite illiquid and priced on the basis of the prime loan rate. Treasury bills and commercial paper were typically held to maturity. The banking system relied heavily on New York for short-term liquidity adjustments.

The lack of flexibility and competition in the domestic market for short-term funds was clearly detrimental to the efficient provision of financial services and the allocation of savings. Moreover, from its establishment in the mid-1930s, the Bank of Canada had been aware that its operations were hampered by the lack of a money market. In the absence of active markets for bills and overnight funds, the banks would allow their excess cash reserves to fluctuate over a fairly wide range. This meant that the central bank did not have reliable leverage over short-term monetary conditions, even though it could set the supply of cash to the banking system with some precision (through open-market operations).[1] The banks tended to react sluggishly to reserve tightening or easing. The Bank thought that the establishment of an active money market would induce the banks to manage their cash more finely and so provide a more effective channel for the transmission of monetary policy. However, any plans that the Bank may have wished to pursue in this respect had to be put off because of World War II and its economic aftermath.

By the early 1950s conditions in Canada were in principle favorable for the formation of a money market: official controls imposed during the war had been dismantled, and the central bank no longer attempted to hold down market interest rates; savings and investment had expanded strongly; the banks, trust companies, and insurance companies formed a core of large and sophisticated intermediaries; and since bond and equity markets were thriving, there were plenty of securities firms with the resources to be money market

dealers. Yet the overt encouragement of such a development by the Bank of Canada met with little success until various concrete initiatives were taken:

1953 The Bank of Canada offered a line for short-term financing —purchase and resale agreements (PRA)—to a group of 13 investment dealers, known as "jobbers." Under this facility, inventories of treasury bills and short-term Government of Canada bonds could be temporarily financed at the central bank. Each jobber was given a specific limit on its access to PRA; the total value of the available lines was initially about as large as the eligible inventory held by the jobber group. Auctions of treasury bills were changed from a fortnightly to a weekly cycle, and amounts auctioned were increased.

Since the charge for PRA was substantially less than the prime rate, the jobbers quickly switched to central bank financing for most of their needs, going to the limit of their PRA lines. The Bank urged the chartered banks to provide day loans to the dealers at rates in line with money market yields, but the banks initially showed no interest in such an innovation.

1954 The Bank Act Revision introduced reserve averaging. Since statutory cash requirements would now apply to average reserve positions over a calendar month, the banks could make sizable economies on excess cash. This led to a more stable demand for bank reserves, and to prompter system responses to changes in policy settings.

It was decided that credits to chartered bank reserve accounts for Bank of Canada security purchases would be subject to a settlement delay of at least two days. In contrast, settlement at the Bank for the proceeds of day loans that chartered banks had called from investment dealers would be booked next day. This difference in the speed of settlement greatly enhanced the relative position of day loans for liquidity adjustments by the banking system.

The chartered banks now agreed to provide day loans, at rates near those on treasury bills, up to the limit of unused PRA lines. This

allowed the central bank to confine itself once again to last resort lending.

The banks also agreed to reduce charges for intra-day (daylight) overdrafts of the investment dealers.[2]

The Bank provided wire facilities across the country for the transfer of government securities.

These measures achieved their objectives. By 1958 an active money market provided the channel for the transmission of monetary policy that the Bank had sought. In 1962 the central bank allowed bankers' acceptances to be eligible for PRA to assist their introduction in Canada, phasing out this support, later when the BA became well established. By this point the money market was going ahead under its own steam; and the rapid expansion of recent decades has been propelled by profit opportunities, competition and new technology rather than by policy measures. Indeed, the contribution of the authorities in the latter period has been more to liberate market forces than to undertake new measures of support.

This experience would suggest that the central bank can make a useful contribution to structural change in the financial sector. In the right environment, such as Canada's money market in the 1950s, a few key policy actions can propel rapid modernization. In turn, a well-functioning money market has proved of great value in improving the competitive efficiency of the financial market and in the implementation and transmission of monetary policy.

End Notes

[1]"Cash" in this context refers to the deposit claims of banks on the Bank of Canada. These claims serve as reserves, for which there have been legal minimum requirements in Canada as elsewhere, and as settlement balances in the payments system.

[2]The fee of a bank for a daylight overdraft is called "over-certification." Such overdrafts are necessary to dealers in securities because of technical lags in delivery and settlement.

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Central Banks and the Financial System

E. Gerald Corrigan

I am pleased to appear before you to discuss the role of central banks and the financial system in the specific context of the recent efforts on the part of a number of Eastern European countries and the Soviet Union to shift their economies toward more market-oriented and competitive systems. I am especially pleased to have the opportunity to discuss these issues in the presence of the distinguished group of central bank governors from those nations who are gathered with us today.

For the sake of emphasis, let me begin my remarks by citing several propositions which, in my judgment, are central to the discussion as a whole. These propositions are:

First, the stability of the banking and financial system is an absolute. prerequisite for the growth and stability of the economy at large.

Second, 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.

Third, while the development of capital markets—especially an efficient market and secondary market for national government securities—clearly is important, the highest priority should be

placed on the reform and adaptation of the commercial banking system.

Fourth, successful reform of the commercial banking system presupposes parallel reform in the central banking system. At a minimum, this reform should take central banks out of the business of directly financing government deficits and provide mechanisms through which central banks can increase or decrease liquidity in the economy without allocating credit for specific purposes or functions.

Finally, and most important, at the end of the day, commercial banks and central banks have only one asset that really matters and that asset is public confidence. Accordingly, the task of reform—in all of its detail—must be approached with enormous weight given to this overriding consideration. Indeed, the confidence factor will become all the more important over time as the ownership of banking and financial institutions shifts to private hands. The crucial question is not whether particular reforms will work as a matter of theory or abstraction, nor even a matter of whether a particular approach has worked in other countries. Rather, the bottom line is the issue of whether specific reforms are likely to work and will build confidence in the specific context in which they are applied.

Before discussing these issues in greater detail, two important qualifications should be made: first, my own thinking about these very difficult issues is naturally conditioned by my own experience and environment. Thus, much of what I have to say reflects how things have—and have not—worked here in the United States and in other Western industrial countries. I say this because I am acutely mindful—in part from my association with reform efforts in developing countries in Latin America and elsewhere—that successful elements of structural economic reform cannot be insensitive to traditions, customs, cultures and histories in the reforming countries. On the other hand, there are certain basics—even when considered in the light of national histories and cultures—that are essential in virtually any setting.

The second qualification follows from the first: namely, I do not consider myself an expert on the details of the commercial or central banking systems in any of the countries whose officials are gathered here today. But, I do know enough about each and enough about reforms already under way to know that much of what I have to say will not apply equally in all cases and in some may apply in only limited ways. However, even where the latter is the case, I am quite convinced that there is value and discipline to be gained in going back to basics.

Against that background, I believe it is fair to say that it is universally recognized that a particularly important function of a banking and financial system in a market economy is to help mobilize a society's savings and to rigorously and impartially channel those savings into the most efficient and effective uses or investments. That process is, of course, the very lifeblood of economic development and rising standards of living. As a corollary, it is also universally recognized that the banking and financial system must provide the vehicles through which payments for goods and services can be made quickly, efficiently, and safely in a context in which both the seller and the buyer of such goods and services have confidence that instruments used to make such payments will be honored and accepted by all parties to that transaction and to subsequent transactions. Without that confidence, the system simply cannot work. Stated differently, these crucial economic functions of mobilizing savings and making payments are often taken for granted. In reality, however, it is very difficult to forge a set of legal and institutional arrangements within which these functions are performed consistent with the often conflicting goals of free choice, economic efficiency, and safety and stability.

Indeed, economic history tells us in wholly unmistakable terms that no society has found it easy to forge its financial institutions in a way that these goals are appropriately balanced. Even today, within and among the most successful of the industrialized countries of the world, there is great debate as to how best to go about that task. Certainly, that is true here in the United States. The reasons for the inherent difficulties in this area are an almost classic blend of political and economic considerations that have their roots in the

crucial functions the banking system must perform in a market economy.

To illustrate this, take the example of the typical household. Clearly a society's long-term economic prospects are best served when such households make the decision to freely save some of their current income. But that's not enough since there must also be a way in which those savings can be mobilized and put to work in productive investments. That, of course, means that the household must see not only an inducement to freely save but it must also see an inducement to entrust those savings to someone or something else that can directly or indirectly put those savings to work in sound and productive investments. Under any circumstance, the household will see some risk in parting with its savings and it will expect to be compensated accordingly. But, and this is a very large but, under ***any*** circumstances, ***any*** household in ***any*** society will also want to maintain some fraction of its savings in the form of highly liquid assets, including assets which can easily be used to finance day-to-day and week-to-week transactions needs.

For that reason a household's willingness to entrust its savings—especially its highly liquid savings—to some institution presupposes that it has confidence in the financial integrity of that institution. If that confidence is not there in the first instance, the society's ability to mobilize its savings will be compromised and its ability to reap the benefits of economic specialization in the production and distribution of goods and services will be undercut. similarly, if that confidence is lost, households will simply rush to redeploy their savings, raising the specter of a flight to cash and/or to hard goods with all of its implications for inflation and destabilizing runs on banks.

This, of course, is why confidence in banks is so crucial and this single factor goes a very long way in explaining why banking institutions and banking instruments have evolved in the way that they have over centuries. What this says, of course, is that no matter what the precise legal and institutional financial framework in a particular country, there are certain preconditions that must exist if the financial system is to be able to perform its essential tasks of

mobilizing and allocating savings and facilitating day-to-day transactions. Thus, there must be a class of financial institutions and financial instruments that the public views as safe and convenient outlets for their savings where at least some fraction of those savings is highly liquid ***and*** can be used to make payments. The problem, of course, is that any institution that provides the public with access to financial instruments having those characteristics must be one that invests the public's savings carefully and prudently, but also invests those savings in a way that promotes economic efficiency and growth.

In virtually all countries, the single, dominant class of institution that has emerged to play this crucial role as both the repository of a large fraction of the society's liquid savings and the entity through which payments are made is the commercial bank. Indeed, even in mature industrial countries with highly developed capital markets—such as the United States—the commercial banking system is still the most important single element of the financial system, especially when it is kept in mind that the capital markets rely very heavily on the banking system for day-to-day and standby financing facilities. But, from the earliest days of commercial banking, experience has repeatedly shown that the ***combination*** of functions typically provided by such institutions carries with it the unique risk that a loss of confidence in individual institutions can spread to the system as a whole. This, of course, is the so-called systemic risk phenomenon. And, as the broad sweep of history tells us, there are many instances in which the loss of confidence in financial institutions has caused major damage to the real economy. In other words, systemic risk is not an abstraction; it can be quite real.

It has long been recognized by all governments that banking and financial institutions must be subject to at least some form of regulation or official oversight because the functions they provide are indispensable to economic success, even though these same functions—by their very nature—introduce potential risks that are capable of undermining the prospects for such economic success. I am fond of pointing out—and I will do it again in this context—that Adam Smith forcefully took this position in the ***Wealth of Nations.***

In most countries there is either an explicit or a tacit recognition that one of the crucial functions of the central bank is to help preserve and enhance the stability of the banking and financial system. Indeed, while the primary task of most contemporary central banks is viewed as the conduct of monetary policy, many central banks—certainly including the Federal Reserve—were established largely with a view toward preventing or at least containing financial shocks and disruptions.

My own vision of the role of the contemporary central bank—framed by a sense of history, by my experience in the United States, and by my utter conviction as to the importance of the efficiency and stability of the financial system—is one in which the central bank houses a trilogy of functions. At the center of the trilogy is, of course, monetary policy. But there are two other crucial functions of the contemporary central bank that are closely related to monetary policy and constitute a single theme. These other two functions are the broad oversight of the financial system, and the oversight of and/or the direct participation in selective aspects of the operation of payment systems. These are the functions, but the single theme is stability—stability in the purchasing power of the currency of the country and stability in the workings of the financial system including the payments system. This single theme of stability is a package deal in that each of the parts is mutually dependent on the other parts.

But if it is appropriate to think of the role of the central bank in the context of this trilogy of functions, and if it is fair to suggest that financial stability is a necessary—but not sufficient—condition for economic growth and stability, then it must follow that the structure and workings of the banking system are of great importance to this process as a whole. Looked at in this broad light, the challenge of reforming the banking system is formidable indeed, especially since the paths chosen to effect such reform cannot be viewed in isolation from reforms of the central bank. Neither can they be viewed independently of emerging developments of capital markets, in particular the need to develop mechanisms whereby central governments can more effectively finance budget deficits in a manner that does not constrain the monetary policy process. None of this is easy but the greatest challenge may lie in forging the individual pieces of

the reform effort in such a way that they fit together into a cohesive whole that will serve the dictates of stability, growth, and confidence. From this perspective, it seems clear to me that the first priority is the mobilization of private savings.

This, in turn, brings one's attention immediately to the liability side of the balance sheet of the major financial intermediaries—the commercial banks. Indeed, in the short run, I would argue that the design of the transactions-like and savings-like liability instruments of the banks is more important than the design of the overall structure of the system. And, it's not simply the design of the instruments that is important but also the design and workings of the broad infrastructure that goes with such instruments. For example, for transactions-type accounts and especially for inter-bank movements of funds, efficient, safe, and speedy collection and payments systems are a must if confidence is to be built and maintained. Indeed, banking instruments and institutions are only as good as the infrastructure which supports them. The ability of the banking system to mobilize savings by attracting deposits is one thing. But, its ability to retain such deposits and to put them to good use is quite another which, of course, brings me to the asset side of the balance sheet. The bank's choice of its assets is crucial for two reasons:

> First, if the bank is careless in the credit it extends, it will incur losses and will not be able to honor its obligations to its depositors. If its ability to honor its deposit obligations is in question, the bank will always be subject to the risk of deposit runs. This is the subtle genius of the banking system for it is a key feature of the banking system which creates the incentive for the bank to extend credit wisely, judiciously, and impartially.
>
> Second, even where capital markets are well developed, the credit decisions of the banking system remain the single most important element which determines how the society's savings are deployed. Those credit decisions therefore determine which firms, which farms, and which entrepreneurs will receive the credit and which will not. If the system is working correctly, those who receive credit will be the most efficient,

> the most competitive, and the most profitable. Therefore, they will be the most capable of producing the stream of goods and services which will permit the economy to grow and standards of living to rise.

It should be clear that the objectivity and impartiality of the credit decision making process are absolutely indispensable features of an efficient and market-oriented banking system. Partly because of the obvious problems of political pressures, but for other reasons as well, the government or the state is not well equipped to make these decisions. To be sure, the state can establish tax or other incentives for certain activities—something we see in all societies—but the decision as to who gets credit and who does not must be left to private initiative in a context in which those making the decisions have a major stake—their own economic livelihood—in the credit decisions they make.

This is also one of the more fundamental reasons why the development of sound and internationally acceptable accounting systems in emerging market economies is so vitally important. Accounting systems serve a variety of purposes but none is more important than their role in helping creditors make the rigorous decisions as to which enterprises can meet the market test of efficiency, competitiveness, and profitability which will permit those enterprises to meet their obligations and, in turn, permit their creditors to meet their obligations.

Another subject of importance in regard to the structure of banking institutions is the size and composition of the bank's capital account. The capital account, representing the ownership interests in the bank, serves two obvious purposes: first, it is a source of permanent funding and second, it provides a cushion for absorbing losses. But the capital base also serves another more subtle function: namely, it creates a constituent group of individuals or institutions who have a direct interest in the profitability of the bank which, in turn, should strongly reinforce the impartiality of the credit decision making process.

For these reasons, it should be obvious that private ownership of banks is the preferred arrangement. Having said that, it is also true that government ownership of commercial banks is quite common in developing nations and, in fact, is also to be found in some major industrial countries. Also, in virtually all countries—the United States included—special purpose banking organizations entailing government ownership, guarantees, or sponsorship are not uncommon. I mention this only because the drive for private ownership of banks may—particularly in the short to intermediate run—have to be tempered with some realism as to what kinds of arrangements are workable. Thus, some or all of the initial capital stock of commercial banks may have to come from the government—an outcome that can be acceptable if three conditions are also met. Those conditions are:

> First, the management of the bank is independent of the government such that the government does not direct credit decisions and allocation. In other words, government ownership must not preclude competition.
>
> Second, having provided the initial capital, the government is not responsible for the overall funding of the bank.
>
> *Third,* the government's ownership interests are structured such that at some later date they can be easily sold to private interests.

While individual countries have considerable latitude with regard to the precise legal and organizational structure of their commercial banking system, the basic functions are common to all countries. And, by their very nature, those functions entail risk-taking on the part of individual institutions and the system as a whole. In the face of that risk-taking and the need to maintain public confidence in the banking system, banking in all countries is subject to a higher degree of official oversight and regulation than is the case for most other forms of private enterprise. As an extension of that, all countries have put in place some form of a so-called safety net that is associated with the operation of the banking and financial system.

In practice, the specific form of the safety net—in both de jure and de facto terms—can differ appreciably from one country to the next. In generic terms, however, the safety net is usually designed to provide the following functions: first, the regulation of the affairs of banking institutions, usually including the inspection and examination of such institutions; second, some form of protection against loss on the part of at least small depositors and investors; third, some form of emergency liquidity facility: and finally, some form of official regulation of or participation in the workings of the payments system.

In virtually all countries, the central bank plays a direct or indirect role in the operation of one or more of these central features of the safety net. For example, the emergency liquidity facility is almost always the discount window of the central bank. In many countries—including the United States—the central bank also plays an important role in both the supervision of banking institutions and in either or both the regulation and operation of the payments system. Given the concept mentioned earlier of the trilogy of central bank functions, it will come as no surprise when I say that I strongly believe that central banks should play an important role in both of these areas. In this regard, I would place a particularly high priority on the need to develop a strong program of bank supervision, especially in the early phases of the changing role of the commercial banks. Similarly, the central bank can also play a highly valuable role in the early development of critical aspects of the payments system, such as the inter-bank deposit market and the emerging markets for government securities.

Regardless of how broadly or narrowly, how explicitly or implicitly the legal mandate of the central bank is drawn, it seems to me inevitable that the central bank will always have an important role in helping to build and maintain confidence in the underlying stability of the banking and financial system. In turn, that necessarily implies that there must be a high degree of public confidence in the central bank itself. Achieving and maintaining that public confidence is, in the first instance, squarely related to the success the central bank has in the discharge of its monetary policy responsibilities. That is why monetary policy stands at the center of the trilogy of central bank

functions. It is also the reason why central banks must have special status within the governments they serve. At the very least, that special status implies that central banks should not be expected to directly finance the budgetary deficits of governments. It also implies that the central bank normally should not be responsible for the direct financing of other types of enterprise. Indeed, such arrangements run the clear risk that the central bank's balance sheet can become weighed down with low quality assets. In such circumstances, confidence in the financial integrity of the central bank can only suffer.

Having said that central banks should not be responsible for the direct financing of government deficits, it is also true that central banks typically are major holders of government debt but in the ideal order, its holdings of such government debt should arise in connection with its orderly efforts to supply liquidity to the economy as a whole through open market operations or other suitable vehicles. This is one of the many reasons why the development of a market for government securities—including a viable secondary market for such securities—is such a high priority. Indeed, a well functioning government securities market will serve three vital purposes: first, it will provide a more market-oriented way to finance budget deficits; second, it will facilitate a more effective approach to monetary policy and the strengthening of the balance sheet of the central bank; and third, it will provide the foundation upon which other elements of capital markets can be developed. But, as with all markets, the development of a smoothly functioning government securities market presupposes that there is a complete infrastructure that will support an emerging secondary market for such securities that, at the least, provides the liquidity whereby such securities can be readily bought and sold by the central bank and other market participants. Without that infrastructure and liquidity, it will be very difficult to design government debt instruments that institutions and individuals will find attractive as investments and it will be equally difficult to free the monetary policy process from the need to either directly finance government deficits or to engage in various forms of credit allocation, or both.

I said at the outset that the task of reforming the banking and financial system was one of the most important tasks facing the countries of Eastern Europe and the Soviet Union. It is also one of the most difficult. In part those difficulties are technical, in part they are economic, and in part they are political. But most fundamentally, these difficulties arise from the fact the reform of the banking system must come to grips with that great intangible—public confidence. It is in this area in particular that the role of the central bank is vitally important not only in the context of its monetary policy responsibilities but also with regard to the inherent responsibility of the central bank to help ensure the essential stability and viability of financial institutions and markets.

Currency Convertibility in Eastern Europe

C. Fred Bergsten and John Williamson

A part of the process of transforming a centrally planned economy into a market economy is, it is generally agreed, the establishment of currency convertibility. Views differ, however, on the strategy by which convertibility should be established. This paper aims to identify the key issues in the debate about convertibility. We offer answers on two of the questions at issue, and leave the remaining three open.

The standard definition, which we adopt, is that a currency is convertible if it "is freely exchangeable for another currency, or for gold" (Pearce 1981, p. 82). In contradiction to earlier usage, convertibility does not today generally imply the right to convert at a fixed exchange rate, but it does imply the right to convert at the legal exchange rate, rather than at an unofficial or parallel (normally depreciated) rate.

Current account versus unrestricted convertibility

When Yugoslavia established convertibility in December 1989 and Poland followed suit at the beginning of this year, they gave domestic residents the right to buy foreign exchange at the official exchange rate in order to finance current account transactions, that is, purchase of goods or services from abroad. Such ***current account convertibility*** is the concept of convertibility called for in the IMF's Articles of Agreement ("no member shall, without the approval of the Fund,

impose restrictions on the making of payments and transfers for current international transactions," Article VIII, Section 2(a)). Current account convertibility has often been abridged by limiting the foreign exchange that can be purchased for. tourist expenditures, in order to minimize the evasion of exchange controls intended to prevent capital outflows. We accept that such limitations on tourist allowances are likely to be needed for as long as convertibility is restricted to the current account.

It is of course true that the substance of current account convertibility could be denied de facto if the relaxation of exchange controls was negated by an intensification of trade restrictions. Hence it is important to bear in mind that it is the joint product of trade restrictions and exchange controls on current account transactions that determines how fully a country's goods markets are integrated into the world economy.

A currency enjoys ***unrestricted convertibility*** if there are no restrictions on its exchange into a foreign currency for any purpose; including the purchase of foreign assets (capital export). Currencies become convertible in this sense when exchange restrictions on capital exports are abolished, so that residents have the right to export capital at the official exchange rate. Nowadays parallel markets through which capital can be exported even in the absence of unrestricted convertibility seem to be universal (although they were not ubiquitous in Western Europe in the early postwar period); even though neither Poland nor Yugoslavia has adopted unrestricted convertibility, in both cases the dollar stands at only a modest premium in the parallel market.

The first key issue is whether the medium-term objective should be current account convertibility or unrestricted convertibility. Current account convertibility is a necessary condition for a country to be integrated efficiently into the world trading system. It ensures that international relative prices will prevail in the domestic economy, give or take a margin for trade restrictions, transport costs and the imperfections of arbitrage. Assuming that tariffs and other trade restrictions are not unreasonably severe, this in turn ensures that enterprises which face hard budget constraints[1] will encounter incen-

tives to produce, export and import in accordance with comparative advantage. Of course, it is also necessary that the exchange rate be appropriately valued: if the domestic currency were overvalued, for example, too many firms would wish to import and too few to export, resulting in an unsustainable current account deficit.

Centrally planned economies deliberately avoided currency convertibility. A part of the central plan consisted of determining which goods could be in excess supply and should be exported, and which were in excess demand and should be imported. A centralized state trading agency bought domestic goods in the former category to sell abroad at whatever price happened to prevail on the world market, and bought goods in the latter category abroad, with no concern for the profits or losses that might be involved. Currency convertibility would have allowed enterprises and households to use their cash balances to buy abroad those goods that were cheaper on the world market than on the domestic market, thus subverting the planners' priorities.

Indeed, central planning was characterized not just by currency inconvertibility but also by "commodity inconvertibility." This means that an enterprise was not allowed to use its cash balances to purchase goods or services at its own discretion, but was constrained by the central plan (rather than, as in a market economy, being rationed by a budget constraint). Any cash shortage that jeopardized plan fulfillment could be compensated by borrowing from the state bank at a low rate of interest (and with no threat of bankruptcy to limit further borrowing if the loan could not be serviced). Given that prices did not reflect scarcity, it was of course logical to prevent enterprises trading freely to maximize their profits.

Commodity convertibility would give enterprises the right to decide for themselves whether and how to spend their cash balances. Doing this before budget constraints are hardened (as has to some extent happened in the Soviet Union) is a formula for losing control over demand. In fact, hard budget constraints, commodity convertibility, and prices that reflect scarcity, are the three changes that jointly define the move from a planned to a market economy. Privatization, though a natural complement, is less urgent.

Currency convertibility, even on current account, hardly makes sense until commodity convertibility exists, since that would give enterprises the ability to buy abroad freely while forbidding them to buy at home. But a good case might be made for introducing both commodity and current account convertibility simultaneously, since current account convertibility can supply a country with a relative price structure (enforced by potential competition) that reflects scarcity.

Is unrestricted convertibility, the addition of the right to export capital freely, an equally urgent priority? Surely not. It is not necessary for encouraging the *import* of capital, something which can of course be important to a country engaged in extensive modernization of its capital stock. What matters for that purpose is that foreign lenders or capitalists should have the right to remit their profits into foreign currency, and that requirement is satisfied by current account convertibility. Unrestricted convertibility enables capital to flee from where it is needed, which is at home during the period of economic reconstruction that lies ahead. (The three major cases of capital flight in Latin America all involved countries that had abolished controls on the export of capital.) Nor is there a strong case on grounds of civil liberties for demanding that households be free to export capital: the Western European democracies imposed such restrictions for years (in the case of Italy, the restrictions have only been abolished in the last few months), without any widespread complaint that this infringed personal liberty.

We conclude that Eastern European countries would be well advised to focus their efforts on the achievement of current account convertibility, and to treat unrestricted convertibility as a luxury to be delayed until reconstruction has been achieved.[2]

Gold convertibility

Angell (1989) and Wanniski (1989) have suggested that the Soviet authorities should make the rouble convertible into gold at a fixed price. Since gold can be sold for hard currency, this would provide indirect convertibility into dollars or other hard currencies, but at an exchange rate that would vary with the dollar price of gold.

The argument in favor of gold convertibility is that this commitment will provide a constraint on inflationary policies, which will enhance confidence and hence make rouble-denominated financial instruments more desirable savings vehicles, and provide assurance that any one-time upward price pressure resulting from the release of pent-up consumer demand would be perceived as temporary (Angell 1989, p. 12).

We see three powerful arguments against the proposal. The first is that it is not at all clear that a promise of gold convertibility can transform expectations in the way that is postulated. If the gold content of the rouble were pitched sufficiently low to ensure initial credibility, it would not be much of a constraint on deficit financing. But if it were pitched high enough to constrain deficit financing, the absence of a past track record justifying credibility would suggest the danger of a run from roubles into gold. A system of commodity money is inherently unstable unless it is backed 100 percent (Friedman 1951).

The second argument against a gold-convertible rouble stems from the fact that the rouble/dollar exchange rate would vary directly with the dollar price of gold, which is a highly volatile price. Unless the gold price is far more stable than in the past, periodic severe misalignments of the rouble would be guaranteed.

Third, even if it is true that gold-backed rouble bonds could be sold at a low interest rate, one must doubt whether the Soviet Union would be well advised to borrow in this way. If the gold price were to rise, the cost of such borrowing could be very high, as it certainly was the last time a major country decided to try and reduce its interest bill this way. In 1973 Giscard d'Estaing launched Fr. fr. 6.5 billion of bonds indexed to the gold price with a 7 percent interest rate (some 1 percent below the market rate). Fifteen years later the French Treasury had to reimburse holders Fr. fr. 55 billion, that is, 8.5 times the sum subscribed, having in the interim paid Fr. fr. 35 billion in interest rather than the forecast Fr. fr. 6.8 billion. (In constant 1988 prices, repayment of principal went from 24 billion to 55 billion francs and interest from an expected 10 billion to 35 billion francs. All statistics from *Le* Monde, 16 Jan. 1988, p. 28.)

We conclude that a declaration of gold convertibility for the rouble would be distinctly imprudent.

Exchange rate policy

Before discussing the alternative strategies by which convertibility could be achieved, it may be useful to outline the exchange rate arrangements that would seem the appropriate complement to currency convertibility in the East European context.

The first issue is whether the exchange rate,should float or be pegged. We see two powerful arguments against floating. The first was invoked by Paul Volcker at this conference and echoed subsequently by other speakers: the difficulty of interpreting traditional monetary indicators during the transition to a market economy which deprives the central bank of the possibility of conducting an informed autonomous monetary policy such as is needed with a floating rate. The second stems from the unsatisfactory record of floating even in countries that have had an adequate basis for conducting monetary policy: notably, the demonstrated propensity of floating rates to generate periodic severe misalignments that produce large trade imbalances and consequent distortions in the economy. In view of this evidence it is naive to imagine that one can rely on the market to compensate for the ignorance of the authorities as to what the "right" exchange rate is.

If one wishes to peg the exchange rate, the next issue is to what should it be pegged? Except for the Soviet Union, the convertible currency trade of the countries of East and Central Europe is predominately with Western Europe: on technical grounds either the deutsche mark or the ECU would offer a suitable peg. Since the deutsche mark is likely to encounter resistance in some countries on political grounds, the ECU is the natural candidate. The fact that it may be marginally more inflation-prone than the deutsche mark hardly seems a serious drawback: the countries of Eastern Europe will be able to feel proud of their accomplishment if they succeed in keeping their inflation down to the average ECU rate in the coming years.

Should the peg remain fixed, or should it be adjusted at times? The discussion on the transition to a market economy has added an important extra argument for a fixed exchange rate. The prices inherited from a regime of central planning typically bear no relation to scarcity, and a major purpose of establishing convertibility is to permit the importation of an appropriate set of relative prices from abroad. This process will be facilitated by the existence of a fixed exchange rate to provide the anchor for the new price structure. We thus believe that any country establishing a market economy should aim to hold its exchange rate fixed for a year or so after any "big bang."

The case for seeking to preserve a fixed exchange rate in the long run is less compelling, at least until such time as these countries may wish to consolidate future membership in the European Community and its prospective monetary union. Real shocks may arise that require a real exchange rate adjustment, a process that can usually be facilitated by changes in the nominal exchange rate. One can hope that these countries will find that they can live comfortably with the ECU rate of inflation. If that proves too optimistic, however, it would be far better for them to devalue gradually and routinely to offset differential inflation, rather than repeat the perennial error of averring an unwavering commitment to a fixed exchange rate which they rely on as a nominal anchor despite its inconsistency with their demand management policies until the currency is finally devalued in the midst of a crisis that leaves governmental credibility in shreds.

So long as convertibility is restricted to current account transactions, a parallel market will exist. This should be tolerated, and the size of the ECU premium on the parallel market exploited as a useful indicator. A substantial and prolonged premium is a symptom of lack of confidence that should be addressed by policy changes. (Inconvertibility on capital account can still provide a useful shock absorber.)

There remains one last issue: how to pick the exchange rate at which to peg. The criterion—to reconcile internal and external balance in the medium term—is clear enough. How to apply that criterion is, unfortunately, more difficult. One traditional approach,

that of seeking purchasing power parity (PPP), is prone to be even more misleading than usual, due to the highly distorted pre-liberalization price structure and the uncertainty as to how large the corrective inflation that occurs on liberalization will prove to be. The competitive approach, that of seeking a fundamental equilibrium exchange rate (FEER), relies on some form of macroeconometric model to calculate the real exchange rate that will reconcile internal and external balance in the medium term (Williamson 1985); any such models that may have existed are likely to become redundant as a result of liberalization. Since it is crucial to achieve a competitive exchange rate to allow long-term restructuring but only important to avoid over-devaluation (which aggravates stagflation in the short term), the best advice is to devalue enough to ensure a substantial competitive export sector, but no more than can be relied on to achieve that purpose.

The form of gradualism

Until rather recently it was generally taken for granted that the establishment of convertibility would necessarily be a distinctly gradual process, just as it was in Western Europe and Japan after World War II and has been subsequently in most developing countries that have made their currencies convertible. There are, however, different methods of pursuing a gradualist strategy. At least three partially distinct alternatives can be discerned.

Standard approach. The standard gradualist strategy is that adopted in Western Europe and Japan after World War II, in which a comprehensive system of import controls was progressively relaxed by transferring more import goods to the open license category, which implied that foreign exchange would automatically be made available to any importer who showed the documentation establishing his purchase. Severe payments difficulties were met by suspending or even temporarily reversing the process of liberalization, but export growth was over the years strong enough to permit continuing relaxation (the differential timing of which provided an extremely effective mechanism of payments adjustment). In the European case the process of intra-area liberalization was more rapid than that of liberalization from outside the area, being backed up by

the European Payments Union (EPU). But by 1955 current account convertibility was largely established de facto; at the end of 1958 it was publicly announced, and in 1961 the European countries formally assumed the obligations of the IMF's Article VIII. Convertibility was the final stage of liberalization, which ensured that consumers could achieve the maximum satisfaction from the output being produced by the reconstructed productive system by being able to trade at world prices.

Payments union. A variant on the standard approach which, as noted above, was employed in Western Europe after World War II, involves the creation of a payments union during the transitional period before full convertibility is established. Intra-trade among the East European countries has in the past been conducted in "transferable roubles."[3] If in the future it is settled in hard currency, then no question of the convertibility of the resulting balances arises. However, a switch to hard-currency trading will preempt scarce stocks of Western currencies, and each East European country might find an incentive to curtail its imports from partner countries more severely than makes collective sense. Hence the question is posed as to whether it might not be worth creating a payments union within the region, in which the currency of one member earned by another would be settled through a clearing system, and the resulting multilateral (within-region) balances would be settled in a mix of hard currency and credits. If the payments union is provided with a stock of hard currency by an outside benefactor, like the EPU was, then the hard-currency component can be larger for creditors than for debtors. Within-region convertibility is ensured even before general convertibility is achieved. A lively discussion on the merits of a payments union has developed in recent months: see UN Economic Commission for Europe (1990 ch. 3.4), van Brabant (1990), Bofinger (1990a), and Lavigne (1990).

Currency auctions. A number of developing countries have in the past auctioned off a portion of their foreign exchange receipts, and the Soviet Union has in recent years adopted a similar practice. Enterprises have been given a statutory right to retain a specified percentage of their export proceeds. They can use this to import for the enterprise's own needs, or alternatively they can sell the proceeds

of their retention quota in an auction market that is held periodically. This gives enterprises without foreign exchange earnings of their own the ability to import foreign goods for which they perceive a particularly pressing need, either for resale to the public or as input to their own productive process. When the system started, the retention quota was small and the premium on the dollar in the auction market was correspondingly large. A gradualist strategy for approaching convertibility could consist of gradually enlarging the retention quota, thus putting downward pressure on the auction-market value of the dollar, as Romania has announced it plans to do. When the retention ratio reached 100 percent, all imports would be paid for at the auction rate, the official value of the local currency would disappear, and it would be convertible on current account.

Big bang versus gradualism

Perhaps the most hotly-debated issue regarding convertibility concerns the merits of a "big bang," meaning a sudden declaration of convertibility such as that of Britain in 1947, or Poland and Yugoslavia at the turn of the year, versus the gradual and cautious approach practiced by Western Europe after the failure of sterling convertibility in 1947.

The question is a part of the wider debate on the optimal sequencing of economic reform. We have already argued that commodity convertibility is a precondition for current account convertibility, and that unrestricted convertibility is a lower priority than current account convertibility. Can one supplement those conclusions by endorsing, or ruling out, a big bang, or by identifying the additional conditions that must be satisfied for a big bang to be desirable?

The elements of the Polish "big bang" adopted on January 1, 1990 were as follows (Lipton and Sachs 1990) :

- fiscal and monetary austerity, in conjunction with a currency devaluation, designed to eliminate excess demand;

- establishment of a stable (in terms of the dollar) and convertible currency;

— creation of market competition, based on the deregulation of prices, free trade, full liberalization of the private sector, and demonopolization of the state sector; and

— labor market reforms including unemployment insurance, job retraining, and credit allocation to individuals to start small businesses.

The Polish big bang was courageous, and has opened a debate that was undreamt of a year ago, but the jury is still out on its success. On the positive side, inflation has fallen, queues have vanished, and the balance of payments is in surplus. On the negative side, inflation has still not vanished, output has fallen more than anticipated (at least according to the official measures), and the rise in exports is distinctly modest. Opinion seems divided over whether the failures can be explained by minor errors in execution, notably the excessive devaluation of the zloty, or whether it is a fundamental design flaw to attempt a wide-ranging liberalization before supply-side reforms have created institutions that can be relied on to respond to changed incentives.

Another economist who argues that convertibility should be established rapidly, as soon as certain preconditions have been satisfied, is Kornai (1990, pp. 155-58). His list of preconditions is as follows:

— a hardening of budget constraints, to prevent state enterprises from demanding unlimited quantities of foreign exchange;

— the strict application of wage discipline as one aspect of macroeconomic stabilization, including also the absorption of any liquidity overhang;

— adequate foreign currency reserves; and

— a uniform realistic market-clearing exchange rate.

It may also be argued that a big bang, including convertibility, can make sense under certain conditions but not under others. Both

Poland and Yugoslavia were facing hyperinflation when they took the plunge: hyperinflation is a problem that does not admit of a gradualist solution, and the desperation that it breeds may nurture a willingness to accept the risks and hardships implied by a set of dramatic, sudden changes whose consequences are not readily foreseeable. Hungary's position is not nearly so desperate, and hence the gradualist strategy which it is following may also have been a rational choice. Perhaps the experiences of Poland and Yugoslavia will provide a basis for deciding whether a big bang should be reserved as a fallback position for dealing with desperate situations, or whether the risks and hardships have been overestimated and more countries should be encouraged to take the plunge.

ESCB support

A radical suggestion has recently been made for consolidating a "big bang" approach to convertibility. Bofinger (1990b) proposes that the East European countries should join the projected European System of Central Banks (ESCB).

Bofinger argues that price stabilization is a necessary complement to economic liberalization, but that its achievement is jeopardized by both technical and credibility problems. The technical problems arise from the inevitability of a measure of corrective inflation during the liberalization program, especially where a monetary overhang has been inherited from the past, and likely instability in the monetary relationships that provide the basis for traditional central bank policies of monetary targeting or interest rate stabilization. These technical problems could be resolved by pegging to an outside currency, for which role the ECU is the natural candidate. The problem with this solution is that a unilateral ECU peg will have low credibility, especially in countries with a history of inflation and a tradition of soft budget constraints. Lack of credibility increases the output cost of stabilization, for the customary reasons.

It is to address this credibility problem that Bofinger argues the case for association with the ESCB. Membership in the exchange rate mechanism of the EMS would provide credit facilities that would help the East Europeans to buffer speculative attacks, as well

as allowing currency realignments only subject to international agreement, both of which features would enhance the credibility of a stabilization commitment. But the disadvantage of this solution is that the liquidity effects of intervention by the present EMS members to support the East European currencies could conceivably threaten their own price stability. It is to counter that disadvantage that Bofinger envisages the possibility of the East Europeans joining the ESCB, a step that would deprive them of monetary autonomy. One can think of this as applying the East German solution to the rest of Eastern Europe.

Conclusion

We have argued in this paper that the establishment of current account convertibility is an essential component of the process of changing the East European economies from the autarkic, centrally planned model to market economies efficiently integrated into the global economy. Capital account convertibility does not, however, merit a similar priority. Gold convertibility would be imprudent.

When it first became clear that Eastern Europe as a region was intent on liberalizing its economic system, many economists recalled the precedent of EPU and wondered whether interim arrangements might not be called for to prevent destruction of the relatively high level of intra-trade in the region. That debate is not yet resolved, nor is that on the merits of gradually increasing the share of foreign exchange that is auctioned as opposed to progressively transferring goods to open import licensing. Nevertheless, the drift of opinion has clearly been away from all such gradualist solutions toward endorsement of a "big bang" on the heroic Polish model. This allows a country to import a price system to replace the relative prices inherited from the era of central planning, which bore no relationship to scarcity. It is increasingly argued that gradualist solutions adopted in earlier experiences were motivated by a reluctance to devalue or a lack of commitment to the market economy that are absent from Eastern Europe today.

Continuing nervousness about endorsing the big bang stems from two sources. One is the lack of consensus on the list of conditions

(or preconditions?) needed to support a quick move to convertibility. The other is the lack of an institutional mechanism to provide credibility to stabilization efforts. It has been suggested that the EC as a whole could do that by welcoming serious East European reformers into the ESCB, thus providing the same sort of support that the Federal Republic has provided to the GDR through German monetary union. That is a political tall order, but there is no point in raising it with the politicians until central bankers and economists have decided whether it makes economic sense.

End Notes

[1]Enterprises in centrally planned economies were confronted by "soft budget constraints," meaning that a failure to cover costs could always be offset by additional borrowing rather than raising the threat of bankruptcy. Conversely, a hard budget restraint is one which does limit the enterprise's purchases, ultimately by the sanction of bankruptcy.

[2]There is a large literature on the sequencing of economic liberalization, one of the few conclusions of which is that liberalization of the capital account should not be a priority (Edwards 1984, Krueger 1984). However, although its conclusion is the same, the logic is quite different from that which we have argued applies to Eastern Europe. The proposition for LDCs was developed on the basis of models which assumed that liberalization of the capital account would cause an influx of capital, as foreign investors sought to profit from the high returns available in an economy that had previously refused to borrow abroad and therefore had a low capital-labor ratio. The logic was that a capital inflow would cause a real appreciation which would throttle the development of nontraditional export industries. Furthermore, until the current account had been liberalized capital might well flow into industries where protection was giving a distorted signal of the desirability of investment, and where the country could therefore lose from new investment ("imrniserizing growth").

[3]It is well known that the term "transferable rouble" (TR) was a misnomer, since it was not multilaterally transferable. The TR was credit which could subsequently be spent in the particular country where it had been earned, when the planners found a commodity available in the debtor country that was wanted in the surplus country. Holzman (1979. p. 156) suggests that the TR was more like a ration card than a currency.

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Policy Dilemmas of Eastern European Reforms: Notes of an Insider

Vaclav Klaus

It is becoming more and more clear to all East Europeans, and to Czechs and Slovaks in particular, that the only practical and realistic way to improve their living standards is the total abolition of institutions of central planning, the dismantling of price and wage, exchange rate and foreign trade controls, and the radical transformation of existing property rights. This approach represents the "hard core" of the reform project of Czechoslovak economists and politicians which is currently under discussion and preparation.

We have to face, however, many obstacles (see for more detail, Klaus, 1990b) while trying to realize such an ambitious reform goal in a very short period of time. There are many serious technical issues which must be solved,, but the most pressing obstacle is the ideological prejudice against the market and its side effects, the dreams of "muddling through" based on minor improvements of the existing system, and rational or irrational fears of crossing the tolerance limits of the population or, better to say, of some powerful organized groups with their well-defined vested interests.

We have to argue with 1968's reformers who believed then, and still believe now, it is possible to improve the performance of our inefficient economy by introducing some minor elements of the market into it, and who explicitly or implicitly consider the market to be an overcome, obsolete, and inefficient economic coordination

mechanism. They are supported by Western intellectuals who visit our countries nowadays and who preach obsolete, long forgotten ideologies they are not able to sell at home.

We have to fight quasi-radical antibureaucratism whose adherents do not criticize the system of central planning as such, but particular people in it. It unfortunately becomes an extremely unproductive and nihilistic approach which blocks any far-reaching and deeply rooted social change.

At the same time we have to oppose the arguments of very loud and very self-confident technocrats who stress the superiority of technical knowledge, who do not understand the systemic explanation of social events, and who believe in social engineering and in "rationalistic constructivism."

We have, therefore, an enormous task to explain the advantages of the "invisible hand of the market" as well as its accompanying effects and to sell these ideas to the public and to the newly-born politicians. It takes time which is necessary for the search for difficult solutions of pressing economic issues of the reform and its sequencing.

Historic events are unfolding before our eyes and with all necessary fears and risks, we have to move forward very quickly. In Czechoslovakia in the first eight months of 1990, we proceeded in a parallel fashion with institutional restructuring, with legislative measures, and with changes in economic policy:

(1) the monobank was dismantled and the two-tier banking system was introduced;

(2) several institutions, so characteristic for the traditional command economy, like the State Planning Commission and the State Price Board, were abolished;

(3) new legislation, supporting the private sector and defining the rules of the game, was initiated;

(4) restrictive monetary policy was implemented with the target for the rate of growth of the money supply in 1990 around zero;

(5) fiscal policy goes together with monetary policy and the state budget was transformed from deficit to surplus;

(6) the Czechoslovak crown was significantly devalued (not to the equilibrium level, but the change was in the right direction);

(7) subsidies both to consumers and producers were cut, and especially food prices were increased when the "negative turnover tax" was abolished;

(8) foreign trade was to some degree liberalized.

On the other hand, the parliament has not yet discussed the so-called "Transformation Act" which provides an original scheme for rapid and widespread privatization. The prices (and foreign trade and exchange rate) have not yet been liberalized. We know that we have to act rapidly because gradual reform provides a convenient excuse to the vested interests, to monopolists of all kinds, to all beneficiaries of paternalistic socialism, to change nothing at all. We are well aware of the fact that losing time means losing everything. Losing time means falling into the "reform trap" of high inflation and economic, social, and political disintegration we see in some other countries. We feel that history will not forgive us if we miss our unique chance. We plan to implement all crucial reform measures at the beginning of 1991.

The microeconomic restructuring (privatization and price liberalization) has its macroeconomic aspect, which is—at least in Czechoslovakia—fiercely debated under the title "restrictive versus expansionary macroeconomic policy." The reformers stress the need for restrictive policy (see Klaus, 1990a) because

— they are afraid of inflation and its debilitating impacts upon economic decision making and resource allocation;

— they are very pessimistic about the short-term growth potential of the unreformed economy as well as about the rapidity of the supply response in a reforming economy;

— they want to squeeze out the most inefficient parts of the economy as soon as possible, which is not possible to achieve with excess demand and easy sales of any products;

— they want to start the real restructuring without being tied up with a burden of repayment of a "reform neutral" foreign debt.

The anti-reformers, on the contrary, criticize the restrictive policy and call for expansionary policy because

— either they are principally against the reform or they do not believe the reform can bring about an improvement of the situation in the foreseeable future;

— they believe in the efficiency of interventionistic industrial policy, in the ability of the government to orchestrate science and large-scale innovation, to organize foreign assistance, and to coordinate all kinds of "progressive solutions;"

— they are more optimistic about the blocking effects of various structural constraints on economic growth because they underestimate how structurally deficient the economy really is and will be when the oil crises will be felt;

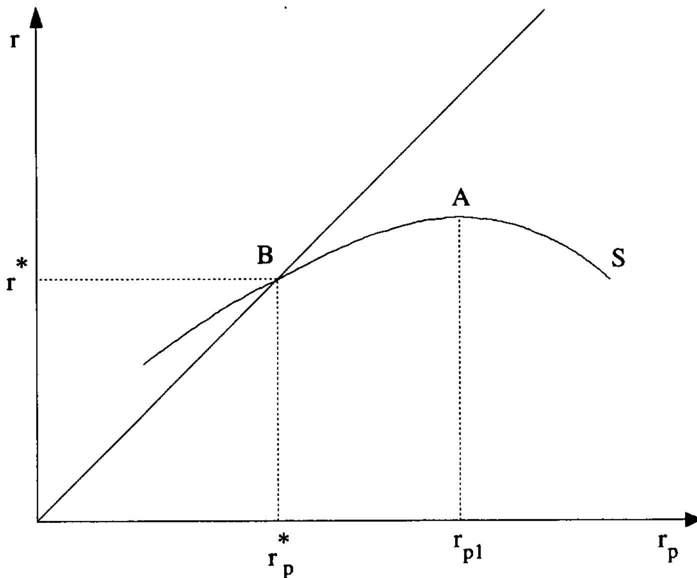
— they do not want, in principle, to stop unprofitable business activities because they want to give everybody another chance.

We can demonstrate this issue with the help of the following diagram, depicting the so-called S-curve which is a locus of feasible combinations of planned, intended rate (r_p) of economic growth and of real rate (r) of growth. (See Ickes, 1990.)

The position and the shape of the S-curve depend on

— the growth potential of the economy at the aggregate level;
– structural defects, non-homogeneity of the economy, and bottlenecks.

The critical point is that the second factor is closely related to the quality of the economic systems, to the type of its coordinating mechanism, to its incentive structure, and so forth.



The diagram suggests that only at point B, both rates equal, is the economy in macroeconomic equilibrium. Slightly higher r_p than r_p^* still accelerates growth (with accelerating inflation), but after reaching point A, the real rate of growth goes down and inflation accelerates even further. The economic strategy, therefore, depends crucially on the assumptions about the position and shape of the S-curve, especially about the location of point A.

The implicit assumptions of the Czechoslovak government economists can be summarized as follows:

(1) the prevailing long-run tendency in our economy was and still is $r_p > r_p^*$ with the secular open, hidden, and repressed inflation as a result;

(2) r_p^* is permanently—because of deep structural defects, price rigidities, and low supply response—lower than the natural rate of growth based on aggregate input data. This is documented by declining total productivity (according to standard growth accounting methodology) in the past two decades;

(3) short-run effects—both from abroad (collapse of Comecon and current oil crises) and from inside (uncertainties connected with systemic transformation)—shift the S-curve lower than it used to be in past years.

We do not possess sufficient data for drawing the S-curve, but our analysis shows that the short-run r_p^* is probably very close to zero if not below. We are aware of the fact that macroeconomic mistakes would be extremely costly. Even if the major challenges for the reform process are microeconomic in nature, sound macroeconomic policy is essential if the reform process is to succeed. We are, therefore, convinced that restrictive, and not expansionary, monetary and fiscal policies are the precondition for any successful economic reform. In a structurally rigid and deficient economy, expansionary policy cannot provoke a positive supply response.

The pursuit of our monetary and fiscal targets is difficult now and will prove to be even more difficult in the near future, but we cannot afford the risks of entering the forthcoming intricate reform phase with a large monetary latitude and excessive aggregate demand. The initial transitory costs of such a policy will be nontrivial, but the benefits to be gained will be well worth the effort.

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Recent Developments in Poland

Wladyslaw Baka

I would like to make some comments on the new economic program in Poland. Poland started to implement reforms at the beginning of this year. There are two principal goals of this program. The first goal is to curb the inflationary process quickly and permanently, and eliminate a shortage of goods in the market. The second goal is to transform the economic system into a market economy, which requires ownership changes, privatization, demonopolization, and other institutional changes.

During the first months of this year, many steps were undertaken to curb inflation and to start the process of transformation of the economy. The main points of the reform package implemented since the beginning of 1990 are:

— liberalization of all prices;

— rapid elimination of the budget deficit;

— restrictions on wage increases;

— tax measures;

— unification and stabilization of the exchange rate, along with the partial convertibility of the domestic currency;

— consistent anti-inflationary monetary policy, including

higher interest rates to limit credit demand and to create incentives for savings (introducing the principle that interest rates remain positive in real terms);

— introduction of money and capital market instruments and institutions;

— the introduction of an anti-monopoly policy involving the promotion and the formation of new economic units, stressing changes of ownership through privatization of state-owned firms and companies; and

— lowering of restrictions on imports from Western countries.

What are the results through the first half of the year? First, the monthly inflation rate went down from about 80 percent in January to 3.5 percent in June and July, and we expect further declines. In the fourth quarter of this year, according to our forecasts, the rate of inflation should be about 1 percent per month. Second, the internal market situation has been improved, and demand and supply relationships are now in balance. *Third,* exports have gone up by more than 20 percent in real terms, and imports have gone down by more than 20 percent. The surplus in the trade balance has resulted in increasing foreign exchange reserves. The exchange rate has been stable, and there has been no limit on the access of economic units or of the people to foreign exchange.

In introducing fundamental changes in the economic system, we expected production and consumption would decrease. However, the decrease is greater than had been estimated. Output has fallen by 30 percent—especially in consumer goods production, which has fallen by 40 percent. Total employment has decreased significantly, and real household income has gone down 30 percent. But real incomes cannot be cut further. Instead, future progress toward price stability must be achieved by raising the level of economic activity. So, we think that conditions are now right to proceed to the next stage of the overall transformation of our economy—that is, institutional transformation and structural changes in the economy. This new stage requires stable economic growth.

The National Bank of Poland, in its role as a central bank, will play an important role of guiding the transformation of the Polish economy. What are the main responsibilities? First, the central bank of Poland is responsible for setting the exchange rate and controlling capital movements. It is also responsible for controlling the total volume of domestic bank credit, which is closely connected with the balance of payments. In regulating the volume of credit, the central bank of course has to take into account the monetary impact of Treasury policy and the actions of nonbanking credit institutions. The central bank is also responsible to some extent for the distribution of bank credit among different economic activities, especially the distribution among the public and private sectors. The final major responsibility of the Bank of Poland is the formulation of policies dealing with interest rates and their effects on the types and volume of savings and credit.

Of course, traditionally it is quite evident that the National Bank of Poland is responsible for managing the payments system in the country. And during the period of transition, the need for action by the National Bank of Poland is greater than in normal times because there is a lack of financial institutions and capital markets—and of course there is the additional problem of developing a banking system. In this period, we have to perform functions normally performed by such institutions.

We face major problems in the conduct of monetary policy. Based on the experience of advanced countries, we believe that monetary policy is but one of the alternatives for general economic policies, but that the primary goal of monetary policy should be domestic price stability. So we have oriented our monetary policy toward achieving this goal. The first element of interest rate policy was to assure confidence in the banking system by introducing a positive interest rate. At the beginning of this year, we implemented a program to link interest rates to the rate of inflation. I think that we can say that this strategy has been very successful. The propensity to save has increased, and we have begun the process of stabilizing the economy. Confidence in the zloty, the Polish internal currency, has grown. This increased confidence is a very important factor for future policy.

That has raised another point of interest rate policy and inflation policy. It is necessary to treat inflation policy as a function also of interest rate policy. And we have decided to take account of the decrease of inflationary expectations in setting our interest rate policy. So I think that we now have created more stable conditions to promote economic activity. Doing so was necessary because in the first part of the year the decline in production was very significant, about 30 percent. I think that as a result of the measures that were taken, the economy has begun to recover in recent months. It is not only economically but also politically a very essential point.

We are convinced that in transforming our economy from a centrally planned to a free market economy, transforming the banking system must play a key role. I am convinced that the main problem in our situation is to create and maintain confidence in the banking system. Without such confidence, it would be absolutely impossible for the banking system to fulfill its direct role in the transformation from a centrally planned economy to a market-oriented economy.

And after our initial experience in the transformation of the Polish economy and the development of the Polish banking system, we feel also that the three functions of a banking system discussed by President Corrigan—involving the development and stabilization of the working of the financial system, including the payments system—are very important. The development of effective supervision of the banking system is also very important. The quality and efficiency of monetary policy depends on a safe and efficient banking system.

The reform of the Polish banking system started in 1989 when, under the new banking law, a two-tier structure of banking was introduced involving the central bank—the National Bank of Poland—as well as commercial banks. The function of the central bank was separated from the commercial banking function. The NBP—National Bank of Poland—now acts as a central bank like those in Western countries.

Under the new banking law, nine commercial banks were estab-

lished to replace the former regional branches of the NBP. By July 1990 the NBP granted about 60 licenses for the establishment of commercial banks. Many of them are private banks, as well as some banks with foreign capital participation. So we have changed fundamentally the structure of the banking sector. All these banks function as typical commercial banks. Because the biggest banks are still the state-owned banks, there is a problem with privatization of these banks. We have prepared a privatization program, but there is a lack of capital. So we have invited foreign banks to participate in the implementation of this program. Of course, in reorganizing the banking sector, a great deal should be done with the modernization of banking infrastructure—banking management techniques, data transmission, and introduction of modern bank accounting. We have organized a banking school with the participation of foreign banks to teach the new techniques, so that our bankers can adopt modem banking methods.

The problem of banking supervision now is becoming very important because in the situation where new banking institutions are being established, there are very new problems connected with unsound banks. This year, a system of banking supervision has been established, and before the end of the year we intend to have in place prudential regulation dealing with loan quality, capital adequacy, and foreign exchange exposure. A first step in this process will be the introduction of revised accounting procedures to become effective by November 1990. Full audits and comprehensive diagnostic studies of the banks are also under way to provide a basis for institutional strengthening. So this project is very ambitious. We are looking for an efficient system of banking supervision; and I think that if we use the experience of our Western colleagues, this task will be completed efficiently and soon.

We will expedite the development of money markets, too, through a regular auction of National Bank of Poland bills starting in July. Now under preparation is the system of Treasury bills and other institutions. Pending the introduction of a completely new domestic payments system, internal improvement will be made in the second half of this year to speed up the execution of payments through the banking system. It is a very essential factor for confidence in the

banking system. We have benefited from help—especially from the Federal Reserve, the Bank of France, and the Bank of England—in creating an efficient payments system.

I would like to add that in the shaping of our banking system, we are carefully monitoring changes in Western Europe. I think that the reunification of Europe will help shape the transformation of our banking system as well. This transformation, we hope, will contribute to the very important goal of European integration of economic as well as other aspects of social and political life.

I think that our experience with exchange rate policies is also very instructive. As you know, we introduced so-called internal convertibility of our currency at the beginning of the year, and we freed the exchange rate. Over the past seven months, there were no problems with maintaining stable exchange rates; nor were there problems with assuring access to foreign currency. I would like to emphasize that we designed this policy at the end of last year because we had made a series of devaluations of the zloty. And we deliberately overshot the equilibrium exchange rate at the beginning of this year. Last year, prices increased about twelvefold, and the rate of exchange increased nineteenfold. So at the beginning of this year, the rate of exchange was 9,521 zloty to one dollar. In the first seven months of this year, the rate of inflation was 180 per cent, yet we have not further devalued the zloty. As a result, in the internal market in Poland, the dollar has lost about 60 per cent of its value. However, there is no problem for the future because our international reserves have grown very significantly. This policy was very effective in establishing confidence in the Polish currency. And I think that it was a very good choice in our priorities.

The central problem for the central bank in our country—a problem that also exists in other countries—is the relation between the government and the central bank. In the Western world, the degree of autonomy the central bank enjoys varies from country to country. There is no single model. We have chosen the model of very great autonomy for the central bank because our experience so far—with monetary policy, inflationary pressure, and the attitude of government officials regarding their preeminent role—convinced us of the

need to fundamentally alter the relation between the government and the central bank. And according to the new banking law, the central bank enjoys independence. The National Bank of Poland is expressly prohibited from financing the budget deficit. Also, the central bank may not finance state enterprises. Finally, the program of monetary and credit policy is directly presented by the central bank to parliament. Of course, the government presents its opinion, but parliament has to decide in the case of differences of opinion what should be the choice.

However, it is also quite evident that for the stabilization of prices, a mix of policies is necessary. So there must be some collaboration between the government and the central bank. And I think that this idea, which is developed in the practice of the Federal Reserve—the independence of a central bank within the government—is a very good idea. But this idea should be adapted to each concrete condition. In Poland, we are looking for a way to make this idea concrete in our situation. As an example, the president of the National Bank of Poland is appointed by parliament upon recommendation by the president, as is the prime minister. At the moment, this system is very efficient; but I think that it depends very deeply on how much weight the government places on restraining inflation.

Recent Developments in Bulgaria

Ivan Dragnevski

It is a great pleasure for me to participate in the present discussion on central banks and the financial system in the framework of the symposium on central banking issues in emerging market-oriented economies. The change from a centrally planned to a market-oriented economy involves changing attitudes, institutions, and organizations. In this respect, the overall objective of the reform is to base the economy on the newly functioning market system. I am not going to follow up all the ways the reforms should be defined.

It is important, however, that the transition occurs along with the establishment of active financial markets. But since it will take a long time to establish them, the setting up of a competitive two-tier banking system would be an important complement. Foreign banks and the use of foreign banking expertise should be encouraged. The government or some other central institution may have to assume the responsibility for bank liabilities that could no longer be serviced, and for nonperforrning loans. The central bank should be independent and would need to develop the requisite skills for implementing monetary policies and for supervising the banking system after the banking statistics are available. Let me brief you on the existing structure of the banking system in our country and elaborate on the problems we are facing during the transition period.

Today the banking system consists of the National Bank, the Bulgarian Foreign Trade Bank, the State Savings Banks, eight older commercial banks, and 59 new commercial banks that until 1990

were branches of the national bank. Very recently the Bank of Agricultural Credit and the first private bank would give priority in providing services to private sector institutions. Most of the banks are organized as stock companies. Their shares are usually owned by the National Bank, by the Bulgarian Foreign Trade Bank, or by large nonfinancial enterprises.

I would like to mention the important reforms in the banking system that were introduced in 1989 in establishing a two-tier banking system. Those reforms involved, as I already said, the creation of 59 new commercial banks, which resulted from the transformation of the former branches of the National Bank of Bulgaria. This began the process of establishing an independent central bank. Under the new system, all banks are permitted to make both operating and investment loans to any industry or private business. They will also be authorized to receive deposits from individuals and to grant mortgage loans. At the present time, only 10 banks are licensed to deal in foreign exchange.

The present banking system is small in terms of the number of branches and people employed. It is also simple in terms of the types of deposits, liabilities, and financial arrangements. We do realize the need to modernize and restructure the banking system so it can play the important role of helping restructure the economy based on market principles. At the same time, we have already taken steps toward the creation of a financial sector operating on the basis of both market principles and competition. In that respect we are facing two groups of issues. Let me now come to some of the problems and issues related to the structure of the banking system.

First, one of the objectives of the reform is to eliminate the monopoly of the State Savings Banks in dealing with households and, at the same time, to encourage commercial banks to mobilize deposits from households. The other objective is to create conditions for the banking system to provide a wide range of banking services to households and enterprises, including the many private enterprises now being formed.

Second, the equity of the commercial banks is now owned mainly by the National Bank, by the Bulgarian Foreign Trade Bank, and the large nonfinancial enterprises. Arrangements of this type may create serious problems for the banks that are now considering transferring the shares owned by the National Bank to the public and giving preferences in the operations of privatization of the bank to new shareholders who are completely independent from other banks or from large borrowers from the banking sector.

Third, the size of most banks is excessively small. It is well known that small banks have difficulties being efficient. There are different methods of overcoming these difficulties. It seems more appropriate at the present time for our country to follow one of those solutions. Since the National Bank of Bulgaria retains a large participation in the equity of the commercial banks, it can play a decisive role in leading those banks into mergers with each other or into their absorption by the largest commercial banks created in 1987.

A fourth issue is developing efficient payments services, which will be one of the main contributions expected from the modernization and restructuring of the banking sector. The necessity of training the staff for banks in an expanded branch network of the existing banks must not be overlooked. Furthermore, I again stress the necessity of establishing prudential bank supervision, with the primary objective to ensure stability of the financial system through a supervisory process that features on-site examinations and off-site analysis.

The second group of issues we have to deal with are those related to credit and interest rate policies. Needless to say, one of the severe problems is the monetary overhang. At present, the overhang represents about 100 percent of the gross domestic product. It is well known that a monetary overhang will cause inflation to accelerate. In order to reduce inflationary dangers that exist, we are introducing the following policy: an increase in interest rates is forthcoming. It is a fact that the present level of interest rates on deposits and credits is very low. We intend to increase the basic rate from 4½ percent to 10 percent. It is difficult now to envision such interest rate levels because of the budget situation, the maintenance of a number of

controlled prices, and the financial situation of many of the companies. In this respect, we are going to pursue an interest rate policy providing real positive returns on financial savings instruments and involving real positive costs for borrowers.

To prevent the inflationary effects which could result from the expansion of the money supply, at the beginning of this year we introduced a system of credit ceilings. First, the nominal stock of investment credits from each bank cannot until the end of 1990 exceed the level reached at the end of 1989. This means that new investment credit can only be granted by each bank after the repayment of investment credits outstanding. Second, the nominal stock of working capital credit granted by each bank must be reduced by the end of this year to 95 percent of its value at the end of 1989. In introducing these regulations, we know that we might create difficulties for some productive enterprises, which might force the National Bank to lessen the restrictive policy for the expansion of total domestic credit. This could be achieved by following a less restrictive policy on working capital credits to new companies and to existing companies that present a sound program either of producing goods for export or of producing key goods that have to be imported at present.

In order to activate the financial sector we are moving to establish an interbank market. At the same time we are looking to establish both new financial markets and products—for example, a market for government securities so that the government budget deficit can be financed in a less inflationary manner.

Recent Developments in Yugoslavia

Mitja Gaspari

It is very hard to say anything very important from the Yugoslav point of view after hearing the very nice presentation by Mr. Crow. All the things he mentioned are very relevant from the Yugoslav point of view. But anyway, maybe I can give you some examples of implementing the Yugoslav economic reform program and what we learned during the implementation of this program over the last six months.

Since the beginning of 1990, the Yugoslav economy has been suffering from an almost continuously accelerating inflation. The accelerating inflation, budget financing problems, built-in indexation, and strong inflationary expectations have been preventing any successful attempt toward stabilization. The structural problems relating to an inadequate definition of ownership, lack of financial discipline, and unbalanced relative prices in the economy—especially negative real interest rates and subsidized prices of primary products and services—have been creating the institutional and structural preconditions for runaway inflation in the 1990s. As a consequence of that, an efficient program for transforming the Yugoslav economic system into a market economy required a two-stage approach. This is the crucial point.

First, it was necessary to hold down this accelerating inflation as a precondition for further structural changes. The stabilization program launched in mid-December 1989 was a consistent response to these demands. Second, after initiating the stabilization program

over the first six months of this year, the government introduced at the end of June the second package of economic policy measures concerning the ownership program, bank and enterprise restructuring, and the long-term conditions for sustainable economic development in Yugoslavia.

The first program, adopted last December, consists of three sets of measures. Perhaps these measures will provide some answers to questions posed by Mr. Crow. The first set of measures aims at furthering systemic and institutional changes—adopted and initiated earlier—as required for establishing an open, decentralized, and full-fledged market economy. Let me discuss four of them:

(1) the transformation of social ownership—a major problem of the Yugoslav economy—into all possible clear-cut and transparent ownership forms, including privatization;

(2) the transformation of the banking and enterprise sectors into profit-oriented economic entities during capitalization and restructuring, including identifying the deficit in both sectors, as well as financing this deficit from real resources, and, or in some cases, partial shifting to the public sector debt;

(3) reform of the state sector, including a clear definition of public services and their prices, full transparency of budget revenues and expenditures, and elimination of any hidden public debt—a very serious problem of the Yugoslav economy during the 1980s; and

(4) tightening of financial discipline through changes in the accounting system and particularly through the strict interpretation of bankruptcy rules.

This is the core of the program, with its medium-term targets.

The second set of measures concerns the macroeconomic policy tools with the following main features. First, consistent with the anti-inflation program, our restrictive monetary policy was further tightened in both January and February. The reason was to offset the

monetary effects of the larger than expected increase in foreign exchange reserves. Since the beginning of the Yugoslav program, there has been a strong inflow of foreign exchange, mainly from the household sector and in some cases, due to a lagged effect, from the enterprise sector. For example, more than $2 billion came into the central bank during January and February. Second, tight fiscal policy was aimed at generating a surplus of real revenues, with limited possibilities for borrowing by the government. According to the agreement with the IMF, neither the federal nor republican governments are allowed to borrow in the secondary market during the first six months of this year. The third set of measures involves the continued liberalization of imports. It has already proven to be profitable by increasing the foreign exchange inflow. Fourth, the program has forced domestic monopolies to cut their inventories and prices. The last measure is a further liberalization of interest rates on bank deposits and loans. This is a very tricky question.

The interest spread in the Yugoslav banking sector is enormous, more than 20 percentage points. Interest rates on loans are around 40 to 45 percent. Since the inflation rate is almost zero, real rates are also 40 to 45 percent. Interest rates on deposits are between 10 and 15 percent, so you can see what the interest spreads are currently in Yugoslavia. Of course, only enterprises in distress would consider borrowing from such a very expensive source. If banks refuse to fulfill the enterprises' cash needs, the enterprises cannot continue to operate.

The third set of measures presents an emergency anti-inflation program, very similar to the Polish program. It has been influenced by Professor Sachs and some of the people sitting here. First of all, over a period of six months, the exchange rate of the dinar is to be pegged to the German mark at a rate of 7 to 1. Second, average personal incomes were frozen at the November 1989 level through June of this year. Third, there was a currency reform that knocked off four zeros from the dinar—that is, the new dinar is worth 10,000 old dinars. Widespread indexation was also abolished, especially for interest rates and the accounting system. Fourth, prices were liberalized, and this is more in accordance with the Bolivian program than with the Israeli program. There was no general price freeze, except

for the prices of coal, oil, steel, nonferrous metals, railroad transport, public utilities, and drugs. These sectors account for only 15 to 20 percent of the industrial sector. Fifth, the dinar was made convertible in current account transactions. Whereas enterprises already enjoyed completely free access to foreign exchange since mid-1988, citizens are now allowed to make almost unlimited purchases and sales of foreign exchange.

This was a short description of the main idea of the two-stage program. It may be interesting to say something about the results of this program during its first six months, and the role of the National Bank of Yugoslavia in the whole program.

We currently have a very strong foreign exchange position, with more than $9.8 billion of foreign exchange reserves. We also have more or less stable prices. In June, inflation was -1.2 percent; in July, the inflation rate was 2.2 percent. The July inflation rate, in large part, was due to the liberalization of frozen prices at the end of June. Monetary policy until the end of June was very restrictive. We implemented very firmly this currency board approach. During the first six months, the National Bank of Yugoslavia withdrew a substantial amount of liquidity to decrease in nominal terms the domestic credit activity of banks. Between February and April, we also implemented credit ceilings as an emergency measure.

On the other hand, there are several very unpleasant developments. First, industrial production (not seasonally adjusted) is declining at a 10 to 15 percent annual rate; on a seasonally adjusted basis, the rate of decline is almost 40 percent. We may be reaching the social limit of the program if you consider the recessionary movements in industrial production. The second very important feature is that wages and salaries are not very much under control, which is I suppose the main problem in socialist countries. The only available policy instrument which is very effective is in my view illiquidity in the enterprise sector. Any other measure is very short-term oriented, and people are not very much aware of profits in the enterprise. So I think that in Yugoslavia during the first six months, only illiquidity of the enterprise sector has done much to keep down wages and salaries in that sector. Yet a very dangerous situation

could develop in the next few months if the National Bank of Yugoslavia does not stay very firmly on a restrictive monetary policy.

The next point which is very important is public sector expenditures. Yugoslavia may be a little bit different from other countries because of our multinational structure and multinational expenditures also. The federal budget accounts for only 15 to 20 percent of total public sector expenditures. A lot is due to republics and provinces. There is no Yugoslav law which allows the central government to restrict expenditures by republics and provinces. So a very heavy burden is on the federal budget to compensate for the excessive republican and provincial expenditures. Anyway, it is my personal view that federal budget expenditures are also too high right now. In summary, then, the primary threats to achieving economic stability are public expenditures and excessive increases in wages and salaries.

Just a few final remarks on the restructuring of the banking and enterprise sectors, which are important from our point of view and may be interesting for my colleagues in other countries. We know that without substantial restructuring in the banking sector, we will not be able to reduce the excessive interest spread. Yet we must do so because business investment will suffer since no enterprise can pay 45 percent in real terms. There are several activities which are under way and some of them are under negotiation right now with the World Bank. First of all, we implemented some changes in the legal framework. We are also adopting several changes in the institutional framework and we are preparing special restructuring programs for banks.

Let me give you a few figures to show the magnitude of the problem. In our banking sector, at least 35 to 40 percent of total banking assets are more or less nonperforming. In absolute terms, this means that at least $8 billion to $10 billion of assets compared to the total GDP of $55 billion to $60 billion may soon be in default. So it is quite obvious, given that the capital of the banks in Yugoslavia is not more than $3 billion to $3.5 billion, that the banking system

in Yugoslavia is, on average, insolvent. So we need strong measures against this problem.

First, we need to establish a special agency on the federal level which is authorized to write off part of these bad loans, to recapitalize these banks, and later on to sell the banks to the highest bidder. In the enterprise sector, we are planning to start the procedure of privatization, selling enterprises to special agencies on the level of republics and provinces, and special mutual funds will be established at the level of republics. Enterprises which are eligible for bankruptcy procedures according to the law will be under the control of these special agencies, and a trigger mechanism is under way to implement these activities for privatization of these enterprises. Enterprises have not yet taken advantage of this program, but it now appears that at least 100 big and medium-sized enterprises will be eligible for this program either this year or over the next three years.

Recent Developments in the Soviet Union

Victor V. Gerashchenko

I would like to discuss the monetary and banking situation in my country. The last few years have witnessed quite a number of sweeping changes in the Soviet economy. These changes, including the decentralization of decision making, have substantially contributed to inflationary pressure. According to estimates by the State Statistical Bureau, inflation was 7½ percent last year. This figure includes both the actual price rise and a computed element measured by shortages of consumer goods in the shops (so-called "suppressed inflation"). One can expect that the trend will accelerate in the year to come, given the reforms which have to be introduced within the plans of transition to a market-oriented economy. In this context the necessity of enhanced power for the State Bank becomes exceptionally vital to influence these developments. Adapting to market conditions makes it inevitable to elaborate and monitor a new type of monetary policy.

For many years the Soviet economy was not affected by inflation, at least not by the open increases of prices, because all prices were fixed by the government. Such a phenomenon as price elasticity was virtually unknown in the centrally planned economy. Any disequilibrium between supply and demand used to take the shape of commodity scarcity. So whenever inflationary factors were at work, they were predominantly of a "demand-pull" character. "Cost-push" factors emerged in the Soviet economy when economic entities got more freedom in the decision-making process, particu-

larly in setting wages and salary levels. In previous years, due to the very strict limitation over the level of salaries and total payroll, control over inflation through administrative measures worked satisfactorily. During the last two years as economic liberalization started evolving, the average level of salaries has gone up more than 13 percent. Coupled with stagnation (and even decline) of production, the scarcity of consumer goods increased and an inflationary trend was ignited. Monopolism of enterprises that produce many kinds of goods and the absence of competition in many industries account for the fact that production lags far behind private incomes. Therefore a sensible price control mechanism is unavoidable in my country unless proper measures to demonopolize industries and increase competition can be put into effect.

No matter what future steps the government takes, it will face the problem of a so-called "monetary overhang." This problem is widely discussed in the national press and abroad. From my point of view, it is grossly misinterpreted. The figures of estimated surplus demand are sometimes fantastic, having nothing to do with realities. According to our calculations, unsatisfied consumer demand, expressed in money terms, stands at about 100 billion roubles, a figure equal to one-ninth of the annual GNP, or one-quarter of the annual turnover in the consumer market.

There are several solutions to the problem. One is just the simple increase of production of quality goods and services to households, Conversion of defense industries, which is now under way, can substantially contribute to the solution of the problem of the consumer goods' productive capacities.

Another way is to provide investment opportunities for the population. These opportunities should, first of all, be linked to housing policy. The rental rate in my country for housing in the cities was fixed in 1927 and has not been revised since. This rate does not even cover maintenance costs today. The new rental rate should encourage households to invest in property.

If the government succeeds in encouraging private investment in housing, that will ameliorate public finance. The buying out of flats

from the state will drastically reduce the government debt. At the beginning of 1990, that debt was 400 billion roubles. The estimated value of the housing stock in cities is 364 billion roubles. If sold to inhabitants, the proceeds could thus be used to pay off most of the government debt, and the existing monetary overhang could also be absorbed in this fashion.

Reforming the price-setting mechanism is the next acute and vital problem for my country. Unless it is done, it will be impossible for the banking system to introduce sensible interest rate policies. If an enterprise makes no profit because prices for its products are deliberately fixed by the government, it cannot afford to tap credits at market rates. It needs subsidized money, that is, soft loans. On the other hand, the general level of interest rates in my country will become economically rational when savings banks start to pay the population a fair rate of interest compatible with the current rate of inflation instead of the 2 to 3 percent paid out now. It is important that households have confidence in their financial wealth in an inflationary environment.

The main source of the inflationary pressure over the past four years was the budget deficit. We quite realize the necessity of controlling inflation through cutting the budget deficit, primarily through squeezing centralized investment spending. We have made certain progress in this respect lately. For example, the current budget deficit for the last six months has been below the projected figure of 60 billion roubles for all of 1990. What is also important is the fact that the U.S.S.R. Ministry of Finance intends to borrow this amount entirely from enterprises and the population through different types of bonds. So far it has issued Treasury obligations with a 5 percent interest rate and redemption dates between 1996 and 2000. I am not sure that this type of bond will work. I think the interest rate needs to be higher and the maturity shorter for the issues to succeed.

We have to transform the historic relationship between the government and the monetary system. At the moment, the State Bank of the U.S.S.R. automatically has to credit the government budget deficit, execute every order of the government to cover the financial

loopholes in the budget with additional credit, and issue fiduciary means of payment. The same principles govern our interest rate policies where Ministry of Finance considerations about the debt-servicing costs dominate, rather than an anti-inflationary spirit.

In the subordination of the central bank to the government's search for funds, there is always a temptation for the latter to finance economic and social programs through the "printing machine." The draft law on the State Bank of the U.S.S.R. now under consideration in the Supreme Soviet is likely to stop this inflationary bias.

At the same time, we understand that the independence of the central bank from the government is not a solution in itself. Along with the development of a full-fledged market in the U.S.S.R., the role and responsibility of the State Bank in maintaining the stability of the national monetary system will unavoidably grow. This will require a close relationship between the central bank and the government in pursuing coordinated economic and monetary policies.

Recent Developments in Romania

Mugur Isarescu

First of all, allow Mr. Urdea and me to extend our sense of gratitude and thanks to the Federal Reserve Bank of Kansas City for this great opportunity. Just last summer at this time, our participation in an international conference discussing radical reform of the economic and banking system of Romania was not only beyond our means, but frankly was beyond our dreams.

The program topic we are discussing now is very complex and I cannot afford to give a comprehensive treatment. I prefer instead to present to you some personal ideas on our concept of convertibility. And at the same time I will try to start with reforming the economic and banking system, not only in Romania but also in other Eastern European countries. We share the view that the different economic and political situations in Central and Eastern European countries require different approaches. Regarding the Romanian situation, we think that the only practical way for real transition from a command to a market economy should contain three cornerstones. First, we must dismantle the central planning institutions and their rigid control on prices, wages, and other economic variables, and put in their place the proper market institutions. In this respect, the radical reform of the banking system is essential in our view. Second, we must convert property and promote the private sector. Here the essential process is, in our opinion, the transformation of the state enterprise. Third, we must construct the social security safety net appropriate to a market economy mechanism. For Romania this is a particularly important point because the Romanian population suf-

fered too much, especially during the last decade—the decade of madness—and we are very sure that any successful transition to a market economy depends on avoiding new suffering for the population of Romania. Regarding covertibility, we totally accept the concept presented by Mr. Bergsten and Mr. Williamson of current account convertibility and the importance of currency convertibility for the emerging Eastern European market economies. A good point made by the authors is that central planning was dharacterized not just by currency inconvertibility but also by commodity inconvertibility. I should add that in Romania this inconvertibility reached a real peak in the last couple of years of the former regime. Bank notes became more and more lottery notes. With luck and long lines, they were supposed to buy some goods—many times not exactly the wanted ones.

Our approach to convertibility is correlated with the general sequencing of economic and banking reform in Romania. I prefer the sequencing approach to either the big bang or the gradualism approach. For this, we must take account of Romanian priorities. Romania was the last Eastern European country, except Albania, to move toward democracy and a market economy. We started in December of 1989 with the most centralized and rigid economic system and with a real dictatorship. We then had a bloody revolution, which unfortunately was followed by six months of a political vacuum and social unrest. On the positive side of the Romanian revolution, I discovered that the disappearance of the Communist Party during the hottest day of December eliminated all the ideological obstacles we fought. There is a national consensus for democracy and a market economy. The new elected government is deeply committed to move rapidly in this direction.

What have we already done up to this moment? The State Enterprise Conversion Act was debated and passed months ago by the new Romanian Parliament. Accordingly, three quarters of the state enterprise became commercial companies, which are supposed to become fully privatized over a longer period of time starting perhaps this fall. The last quarter of the state enterprises, mainly the public utilities, became autonomous state-owned companies. Earlier, in March of this year, two other major bills were passed by the

provisional government. One permitted and promoted the setting up of new private entrepreneurships and the other relaxed tremendously the regulations on foreign investment in Romania.

What lies ahead in the near future? We are drafting bills regarding radical reform of the Romanian banking system—we put the assistance of the World Bank and the IMF in this field. We hope that the banking reform bills will be passed by the parliament no later than the end of this year. We are also drafting the bills on the social security safety net. Achieving current account convertibility of the Romanian currency is seen in this context of internal economic and banking reform. The specific institutions and the legal framework for convertibility will be created mainly by banking reform.

Additionally, we share Mr. Bergsten's and Mr. Williamson's view that introducing both commodity and current account convertibility in a related manner is a good idea. That is the reason we consider the State Enterprise Conversion Act to be critical. Our approach to convertibility, "rapid gradualism,." is based on currency auctions and retention accounts. The legal framework for establishing retention accounts was already put in place by the State Enterprise Conversion Act and the Private Entrepreneurship Act. Under these laws, Romanian companies are allowed to retain 30 percent of foreign exchange earnings, and 50 percent as of next February. Perhaps we still need some technical qualifications this very moment. We are preparing the legal framework for foreign exchange auctions that we plan to hold twice a month starting in October of this year. Romanian companies that need hard currency will buy from those who have it. The exchange rate at the auction, in our opinion, will not affect (and we try not to affect) the official exchange rate or other commercial transactions.

Let me elaborate a little bit on that particular point, which was much debated by Romanian economists and benefited from IMF advice. In our opinion, both of these instruments have the potential, if utilized properly and on a temporary basis, for introducing a significant degree of liberalization in the trade and exchange system, paving the way for current account convertibility. I consider the following conditions necessary in order to realize this potential:

For retention accounts:

(1) to provide a substantial retention level, at least 30 percent or perhaps 50 percent (this was a debated point);

(2) to be nondiscriminatory, that is to apply equally across different branches of the economy; and

(3) to exempt from the licensing requirements those imports that are financed by drawdowns from these accounts.

For the foreign exchange auctions:

(1) to be considered a necessary complement to the retention accounts in assuring a more rational allocation of the scarce foreign exchange;

(2) to avoid administrative restrictions on demand (for example, by limiting who can bid or the amounts of the bids), thus avoiding corruption;

(3) to narrow the gap between the official and the auction exchange rates; and

(4) to expand the auctions as quickly as possible with a view to using them as a key source of information for the establishment of a unified exchange rate.

Of course to achieve convertibility for the Romanian national currency, we need to continue what we already have started at the beginning of this year—that is, correction of substantial overvaluation of the national currency. We devalued tremendously one time, and perhaps we will devalue again this fall. At the same time, we need to establish an appropriate exchange rate regime. In my opinion, my personal opinion—this is debated up to now in Romania—this can be done by pegging to a basket of currencies, but I mean a very flexible pegging.

Recent Developments in Hungary

Imre Tarafas

Mr. Chairman, ladies and gentlemen. If we had not had the coffee break, I would have kept my remarks very short, agreeing with all the points in Governor Crow's paper that are applicable to Hungary. I feel that the Hungarian experience confirms his conclusions. But now that I am not under the pressure of an imminent coffee break, my comments will be a bit longer.

I will start with what Governor Crow started with, the issue of tying the exchange rate to a basket of currencies or to the currency of a dominant trading partner. Anchoring monetary policy to a fixed exchange rate is, I think, a good idea in the long run for most of us with small and open economies. But I agree with him that, in the transitional period toward a market economy, such an approach is not applicable. One of the most important reasons is that in the transitional phase, monetary policy is considerably less effective in controlling aggregate demand than it is in market economies. For one thing, banking systems are usually underdeveloped. For another, as Mr. Gaspari hinted at, financial discipline is generally weak at the enterprise level.

These two factors reduce the effectiveness of monetary policy. When policy is tightened, enterprises do not adjust their spending behavior. They continue to buy from and sell to each other, even if payment does not take place. Payment arrears—that is, involuntary credit—are accumulated among enterprises, and these increasing payment arrears keep demand artificially high despite the tight

monetary policy. Because of the artificially high demand, in turn, prices continue to climb, and eventually the exchange rate must be adjusted to avoid appreciation of the real exchange rate.

I believe Governor Crow makes a reference to this point in his paper, arguing that in such economies one cannot anchor monetary policy to the quantity of money or credit. For that matter, neither can one anchor policy to a fixed exchange rate, for the same reason. What we can do in such a situation, and here I agree once again with Governor Crow, is to follow an approach which he calls "eclectic," and I would call "pragmatic." Under the present circumstances in Hungary, that means to watch the evolution of the current account and adjust monetary policy if the current account does not move as desired.

Why focus on the current account rather than inflation? First, achieving the current account target is a top priority in Hungary. Second, our recent experience suggests that monetary policy in Hungary has been much more effective in helping to shape the current account than in containing inflation. As an example, I would point to the import-liberalization program that we initiated two years ago. Beginning in January 1989, enterprises have no longer been required to apply for a prior import license on a set of imported goods that accounted for about 40 percent of total imports in 1989, and for more than 70 percent this year, and the intention is to increase the share of liberalized imports to somewhere between 80 and 90 percent next year. Liberalization here means, as I have just said, the absence of any licensing procedure—in fact, it is de facto convertibility for the largest of current account transactions, trade.

At the same time, there has been sustained improvement in the trade balance: in 1987 we had a trade deficit exceeding $300 million, but last year we had a surplus of about $550 million, and this year the surplus will probably be around $1 billion or more (for total exports of about $7 billion). Most analysts attribute this improvement, to a very large extent, to an appropriately tight monetary policy, supplemented from time to time by moderate devaluations.

However, Hungarian monetary policy has been much less effective in containing inflation. From year to year, almost irrespective of how tight monetary policy has been, inflation has turned out to be very close to what one would expect by just adding up cost-push factors. Fortunately, that situation is slowly changing. Over the course of this year, we have observed a strengthening in financial discipline at the enterprise level—sellers are not delivering to, and are initiating bankruptcy proceedings against, enterprises that are unable to make normal payment. Indeed, enterprises are accumulating money balances to avoid insolvency. This firming of the demand for money at the enterprise level has already enabled us to avoid disturbingly large devaluations and to improve the outlook for our current account this year.

I think the main reason for this change in the behavior at the enterprise level is the political change. With government bailouts now a thing of the past, enterprises now take much more seriously the need to be solvent at each moment and the need to subordinate other decisions to maintain liquidity. I used to say half jokingly that for a macroeconomist and a central banker, the largest benefit of the recent political change is that it has made market-based instruments of economic policy more efficient because they have become more credible. If this is so, and if it continues, I hope we will achieve a breakthrough in the efficiency of monetary policy in controlling inflation. But that is still down the road. I think that for the foreseeable future we will have to remain very pragmatic in our monetary policy. So I think it would be wise to maintain maximum rigidity in determination, but maximum flexibility in implementation.

Recent Developments in Czechoslovakia

Josef Tosovsky

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Commentary: Monetary Policy and the Control of Inflation

Martin Feldstein

Governor Crow has given us an excellent summary of the issues and options in controlling inflation. I will focus my remarks on the application of the points that he made to the case of the Soviet Union, which I do in part because I've thought more about the Soviet Union than about the inflation problems elsewhere in Eastern Europe, but also because I think that perhaps it is in the Soviet Union that the problem of inflation is most critical at this time to the general subject of economic reform.

The potential inflationary pressures and the current pace of inflation in the Soviet Union are serious impediments to the more fundamental market reforms that are needed. The key reform in shifting to a market economy has to be price liberalization and an end to centralized planning and price setting. Free prices are the essence of a market system. But if prices were decontrolled now, Soviet economists and Western experts who look at the Soviet economy say that there would be an explosion of the Soviet price level because of the overhang of previously accumulated roubles. That rouble overhang is a reflection of the forced saving by the population of a monetized series of very large budget deficits over the last several years. In a market economy, those monetized budget deficits would have simply led to an increase in the price level, which kept the real value of those balances under control. But with prices frozen in the Soviet Union, the monetized deficits have created the

dramatic shortages that we have all heard about and that some of us have seen and, at the same time, along with those shortages of goods on the shelves, have created the accumulation of substantial money balances.

The problem of dealing with this situation is certainly not just a central bank problem. And indeed, until the Soviet Union has created a government bond market at least, there are few instruments that could be used for central banking policy. I am not going to try to distinguish between what the central bank needs to do and what government policy needs to do more generally. Although the distinction is somewhat artificial, I think it is worth distinguishing between the problem of eliminating the current budget deficit—which at least until this year has been running at about 10 percent of GNP and, as I said, being essentially fully monetized—and the problem of dealing with the rouble overhang, the accumulation of past budget deficits.

Let me start with the notion of eliminating or reducing the deficit of the government budget. Essentially, as we all know in this country, that problem is so difficult not from a technical point of view but because of the politics that are inevitably involved in deficit reduction. And the increased democratization in the Soviet Union has made it that much more difficult for the Soviets to deal with deficit reduction. Any policy that reduces the budget deficit is going to hurt someone who feels it directly, while the advantages of reducing the budget deficit are more diffuse and benefit people indirectly.

What are the options for reducing the budget deficit? One obvious choice is an increase in taxes. Within the Soviet context, that may possibly be done in a way that is less painful than it often appears in the rest of world because of the system of pricing of Soviet goods. Certain consumer goods in the Soviet Union bring with them very large implicit taxes. And so shifting production into those goods that carry very large markups is a way of shrinking the budget deficit. In fact, it was the Soviet program of cutting production of heavily-taxed vodka that was one of the factors that led to the increase in the budget deficit. I'm not suggesting a new increase in vodka production in the Soviet Union, although I gather that's happening, but rather that

there are other kinds of consumer goods the production of which would shrink the budget deficit.

A second option is reducing subsidies, an eventual necessity if the Soviet Union is to move to a system in which prices more accurately reflect costs of production, but again politically very difficult, as Prime Minister Ryzhkov discovered when his suggestions for increasing the price of bread were so soundly rejected.

A third, and I think most important, option is reducing the spending by the government on heavy investment and military acquisitions. After all, military spending in the Soviet Union is still about 15 percent of GNP and it is military spending and heavy capital goods that have a virtual monopoly on what I would call Westem-quality production in the Soviet Union. Shifting some of that production into consumer durables—television sets that work, refrigerators that work, and automobiles—has the potential for substantial implicit tax revenue for the Soviet government.

The more challenging problem, I think, is dealing with the rouble overhang. Gosbank Chairman Gerashchenko gave a very optimistic estimate of about a 100-billion rouble overhang, which is about 25 percent of annual trade and services. I've heard estimates from other economists, both Soviet and Western, of as much as 300 billion to 500 billion roubles. As long as the overhang remains, removing price controls has the risk of very substantial increases in price levels. So what can be done to deal with this problem of a pent-up rouble overhang?

There are basically two different approaches. The first approach is to eliminate the overhang of roubles by making the accumulated roubles worthless. This can be done either by a burst of hyperinflation which reduces the real value of roubles, in other words just taking off the price controls and letting the jump in the price level reduce the real value of existing roubles, or by an explicit currency reform in which new roubles are exchanged for old. The primary difference between those two is essentially distributional. An increase in the price level eliminates wealth proportionately for all nominal wealthholders, while a currency reform would be done

presumably in a redistributional way as it was in the immediate postwar period in the Soviet Union.

Those who advocate one of these two approaches say that much of the accumulated balances in the Soviet Union are the result of illegal activities. These activities are not just illegal in the Soviet sense, in which virtually any kind of market activity until recently was illegal, but illegal also in the Western sense that they reflect theft, extortion, and other things. I'm certainly in no position to judge the truth of that. Opponents, though, of that kind of involuntary elimination of the rouble overhang argue that the criminal component in the accumulation of wealth was really quite small and that eliminating the overhang would certainly be unfair to those who have saved. After all, financial assets are the only kinds of assets that Soviet citizens have been able to accumulate in the past. Consequently, an inflationary increase would wipe out all of their wealth. And, as Governor Crow said, either of these approaches would weaken confidence in the monetary system and, indeed, in capitalism itself. My own sense is that those should be regarded as options of last resort and that it would be far better to try to deal with the rouble overhang without confiscating previous accumulations.

What are the alternatives that I would put under the category of the voluntary absorption of the rouble overhang? The first is to increase the demand for financial assets by making them more attractive. As Mr. Gerashchenko said, Soviet citizens do not currently have a real store of value. They get an interest rate of 2 to 3 percent in an economy in which the inflation rate estimates run from the official 7½ percent to more casual private estimates of significant double-digit inflation. The key, therefore, is to increase the interest rate so that holding roubles becomes attractive. Until now, there has been strong ideological opposition to doing so. I was encouraged by Mr. Gerashchenko's statements that an interest rate increase is now an option that is being considered more seriously. I think it would be very desirable to move toward offering state bonds and longer term time deposits based on a floating interest rate tied to inflation. However, that can only be done after the Soviets have inflation statistics in which the public has some confidence.

But, and this is I think a critical point, if a high enough interest rate could be offered so that financial assets were sufficiently attractive to induce households to hold voluntarily the entire previously accumulated balances, prices could then be decontrolled without any increase in the price level. After that had been accomplished—once the public saw that there were stable decontrolled prices—then the level of interest rates required to sustain those holdings of monetary balances could be reduced. If that could be done, it would certainly be the best approach, and I think it certainly deserves to be a central part of the Soviet strategy.

A second option within this voluntary approach is the sale of government assets, to which both Governor Crow and Mr. Gerashchenko referred. But as Mr. Gerashchenko rightly pointed out, the only way that one can make the sale of apartments attractive is to begin by a radical change in the rents currently being charged for Soviet apartments. I am not very optimistic about either that or the notion of selling shares in Soviet companies. It is not clear what "shares in a company" means to Soviet citizens. How reliable is the notion that they will ever be worth anything? It seems to me the right place to start, if we are going to go down that road at all, is by selling some kind of convertible bond that has a fixed promise to pay, perhaps tied to inflation, with the notion that they might eventually convert into some form of equity ownership.

Finally, there is the option of using foreign resources to absorb the rouble overhang. Those foreign resources could be the result of foreign aid of the sort that the Germans have been providing, or loans from foreign governments, or the receipts from sales of Soviet assets to foreign owners. Those foreign revenues could be used to soak up the existing rouble overhang in two basic ways. One way would be to use foreign revenues to import consumer goods that could be sold at very high rouble prices to Soviet citizens to soak up some of the rouble overhang. Remember, roubles exchange for dollars on the street at roughly 10 or 15 roubles to the dollar so that the total overhang, if Mr. Gerashchenko's 100-billion rouble number is correct, is equivalent to only about $10 'billion. Eliminating that overhang would then permit the freeing up of prices and the moving ahead with economic reform. In addition, if individual entre-

preneurial activity in the Soviet Union is now to be legalized, the Soviet government could also permit those small private entrepreneurs to import equipment and machinery for their private businesses. And that too could absorb substantial amounts of the rouble overhang.

I asked myself, perhaps a little facetiously, what is it that we in the United States produce that has the highest potential value in the Soviet Union relative to our costs of production? What would be the ideal good for making available to the Soviet Union as part of a package of loans or financial assistance to help absorb the overhang? I think the answer to that question is currency—$10 bills. A loan to the Soviet government of $5 billion or a sale by the Soviets of $5 billion worth of assets would permit them to absorb 50 billion to 75 billion roubles. Some of that currency would, of course, be converted by the public into goods and would, therefore, have a real economic cost to the provider—the U.S. or other foreign governments. But much of it would be held as a store of value by the Soviets, withdrawing the equivalent amount of rouble overhang with no real cost to the provider.

Let me conclude by emphasizing that although the fundamental problem in the Soviet economy is a microeconomic problem of creating markets and incentives, a prerequisite to that kind of market reform is a sound monetary and fiscal policy to eliminate the budget deficit and to absorb the rouble overhang.

Commentary: Monetary Policy and the Control of Inflation

Lawrence A. Kudlow

Regrettably, Mike Boskin was not able to join us. He is in Washington puzzling and working through some of the difficult fiscal issues that Marty Feldstein referred to in a more international context. These are, of course, my own views and not Mike Boskin's views.

The first point I want to make is with respect to the discussion on Eastern and Central Europe. I want to try to do this more from a business standpoint. My firm has been active in some of the early business and financial discussions in Central Europe, and I can tell you that we have had a very difficult time of it. So I listened with great interest to some of the remarks of the Central European central bankers.

I would say the most difficult issue we have had to confront in doing business and generating investment interest is the question of currency value, currency reform, and—bringing it all down to the bottom line—currency risk. Currency risk is probably the single largest complaint that I hear in all manner of discussions. Currency reform, including currency convertibility, may not be so easy because the Western currencies themselves have fluctuated in substantial magnitudes in the last five years, or the last 10 years, and, arguably, in the last 20 years, since the breakdown in the early 1970s of the Bretton Woods arrangements. Therefore, I agree that what Paul Volcker called the Bundesbank group, or the EMS group, might

be a useful currency anchor with respect to convertibility—or perhaps the U.S. dollar. But the fact remains that no Western investor or businessman can be entirely assured of currency convertibility unless there is going to be a fixed rate someplace along the line. And since the outlook for fixed rates is not particularly positive at the moment, the question of whether currencies are convertible on the open market remains, so that hedging devices can be brought into play if in fact Central and Eastern European currencies are permitted to fluctuate on a variety of spot and futures exchanges.

Now this may be a more expensive or costly way of dealing with currency risk. But it may also be the only way this can be done. So my principal point is: with respect to a variety of economic and monetary reforms, it would be wise to consider using your currencies—and permitting your currencies to be used—on these various international exchanges so the risk factor can be reduced and various sophisticated, high-tech modem hedging devices can be used.

The second point, though, which we have also found in our experiences, is that currency risk is not the only issue. I give you a specific example: A large investment bank (it was my own investment bank) set up a fund for investing in Hungary. I think we were able to raise on the open market some $80 million. We were able to enter into an arrangement with the Bank of Hungary, which in effect took much of the currency risk out of the investment. We were able to agree on a fixed exchange rate over a period of five to 10 years with various technical provisions—but I am not going to get into that. But the basic issue was, to a substantial degree, that most of the currency risk was removed.

That fund, which was put together with the International Finance Corporation as well as some private investors, today—some eight or nine months later—remains essentially uninvested. It is not, I can assure you, for a lack of trying. It is not for a lack of shoe leather or time spent in various hotels or government halls. It is because so many other issues besides currency risk are still prevalent. I will not say all Western investors, although my sense is that the same themes would crop up whether it be Japan or England or Western Europe for that matter.

If I have one urgent request to my East European colleagues, it involves the degree of state regulation and intervention, which remains a painful barrier and impediment to the basic formation of what we call "deals"—investments, structuring new companies, privatization, strategic acquisition and so forth. In particular, the rules of privatization and other legal uncertainties are a problem. What is meant by privatization? Selling shares to local investors? Employees? Western partners? Basically, what are the rules of the road? Also, the constant need to negotiate all manner of corporate business arrangements—the structuring of boards of directors, the structuring of shareholder rights, the structuring of senior management and middle management, a general lack of sophistication—all these issues create difficult barriers. The time and the cost involved really take their toll. Therefore, although I recognize you cannot reverse 40 or 50 years of history overnight, and I appreciate the length and duration that these reforms will take, it remains true that not much U.S. private investment is likely to come into Eastern and Central Europe until these state interferences are substantially curtailed. And I am not really even speaking of macroeconomic policy—issues of tax incentives or free trade or deregulation of prices and all the rest. 1 am merely saying that there are great markets in Eastern and Central Europe, and do not underestimate the creativity and ingenuity of American businesspeople. Also, do not underestimate the willingness of U.S. businesses and investors to come into your countries. Given half a chance, we can probably create all manner of clever approaches to do business, but we have to be given half a chance. So that is my second principal point.

My third point is as much a domestic U.S. issue, coming back to central banks and their control over inflation. There is a little cottage industry that has grown up in New York, Boston, and Washington in the last year called "giving advice to the East European countries." Giving advice are economists, businesspeople, academicians, and all the rest. Maybe it is not such a small industry anymore! I want to discuss this part of my talk with the greatest degree of humility, because as I listened to some of the discussions this morning, Paul Volcker talked about how central banks are themselves engines of inflation. Mr. Crow talked in broad terms about some of the difficult options and issues of controlling inflation.

I think as we enter the 1990s, there are a number of substantive issues which Western central bankers have not yet resolved. And, therefore, with respect to inflation control, it is awfully hard to give advice in clear, ringing terms and tones to our new colleagues from Eastern and Central Europe.

I certainly agree with the goal of price stability. I like the rhetoric; I like the language; I like the fact that a lot of important central bankers use it as often as possible. But I am not sure, speaking as someone who operates in private markets, that I know exactly what we mean by the term "price stability." For example, what is the benchmark—what is the regulator? Are we talking about producer price indexes? Are we talking about consumer price indexes? Are we talking about other government national income and product indexes? Are we talking about a standard of value, such as real goods produced in the economy? A broad commodity index? A return to some kind of gold exchange such as we had during the Bretton Woods period? Are we talking about currency reforms, exchange rate stability? None of these issues has really been resolved, even though the notion of price stability and the use of that phrase is very widespread.

On the issue of implementing price stability (supposing we knew what we agree upon as the end result), are we talking about a monetarist rule—fixing the quantity of money over the long term or fixing the quantity of bank reserves? Are we talking about interest rate targeting in the United States through the federal funds rate or call money rates in other foreign countries? Are we talking about a price rule where central bankers would use commodities or gold or bonds as a target, as a signal, with respect to managing the money supply? And so forth and so on.

We really have not agreed on any of these issues as we enter the 1990s. Therefore, I believe, looking at it as a market participant, there remains great uncertainty and great unpredictability with respect to monetary policy and the issue of inflation control. And I recognize, as I think you will, that we are still plagued by large swings in the money supply, interest rates, and exchange rates and

that this uncertainty and unpredictability have taken their toll on businesspeople, financial investors, consumers, and families.

One question I would ask, maybe referring back to Paul Volcker's opening remarks: Are we asking central banks to do too much? Can they, in fact, exercise the degree of economic control that we think they can? And, even in the current setting in the United States (and I suspect this is going to be a model worldwide), what is the proper monetary response to budget deficits and different kinds of so-called deals or compromises? Is it a high-tax, high-spend response or a low-tax, low-spend response? Should the Fed ease or tighten, depending on the nature of the so-called fiscal and monetary mix? There is no consensus about this at the present time, and I do not see how we can give advice overseas if we ourselves are still unsure.

In the end is my final thought. I have always believed, both in government and out of government, that markets know more than even the brightest, best-informed, most technically-competent central bankers or government people. I am a strong believer that market mechanisms should play the guiding role in central banking policy and the ultimate goal of inflation control and price stability. Market price targets serve a very, very useful purpose. And I think with respect to the newly developed, newly democratized, newly opened, and newly modernized Eastern and Central European economies and their central banks, casting a sharp eye on the message of markets will do you much good and help you avoid many of the mistakes we have made down through the years. In the end, that is probably the only advice I can give you. And all I can say is: Welcome to the real world. You will have to puzzle it out and fight it out with the rest of us.

Commentary: Monetary Policy and the Control of Inflation

Allan H. Meltzer

Governor Crow touched on most of the major issues one wants to raise, leaving his discussants with little to question. 1 can only echo his comments about the goal of price stability and the critical importance of firmly setting monetary policy on a noninflationary path and keeping it there. Like Governor Crow, I do not believe this objective has much chance of being achieved unless there is some formal understanding that frees the central bank from financing government budget deficits. I would go further. Monetary policy cannot deliver stable prices in Eastern Europe unless there are fiscal and other reforms; the commitment to price stability will be meaningless if most prices remain controlled. These fiscal and price reforms are only part of the economic reform necessary to make monetary policy work effectively.

There are two main points on which I must differ with Governor Crow. First, I believe Governor Crow overemphasizes the importance of interest rates, financial instruments, and well-functioning financial markets in the conduct of monetary policy.

Central bankers in many countries have become so accustomed to conducting open market operations in well-developed money markets that they forget that this has not always been their practice. Central banks used discount rate changes to good effect in an earlier era. If there is no market for financial assets a central bank can hold a daily, weekly or monthly auction of the volume of reserves or base

money it wants to issue. To withdraw base money, the central bank could auction eligible paper.

Monetary policy works by changing asset prices relative to output prices and by changing the composition of asset portfolios. A developed market for short-term financial assets is not necessary for the conduct of monetary policy. Monetary policy can be effective in controlling inflation if relative prices are (1) free to change and (2) act as signals for resource allocation, which is to say that allocation decisions are made in markets not by private or public monopolies.

Second, Governor Crow suggests that if one anchor is good, two may be better. He regards Poland's effort to use tax-based incomes policy to control money wages as an interesting, and probably useful, experiment. Possibly he sees incomes policy as a way to improve the chances of reaching and sustaining price stability.

I am skeptical about the usefulness of centralized wage policies for several reasons. Wage standards tend to become uniform standards, or they sanction uniform rates of change. A problem in many economies that is particularly important in Eastern Europe is to bring relative wages into some relation to relative productivities and relative demands. Wage boards and incomes policies discourage these micro adjustments. Further, I don't believe his proposal can work effectively. If Eastern Europe is to become competitive internationally, it must find ways to get costs of production (including wages) into harmony with international competitors. If the exchange rate is fixed and the money wage is encouraged to conform to some national standard, the principal way to reduce real wages and real costs of production is to devalue the currency, sacrificing the other anchor.

Equally important, the countries of Eastern Europe must learn where to concentrate their productive efforts. If subsidies are reduced or, better, removed, some products previously produced will be imported, and others will be exported in greater or lesser degree. To learn where their comparative advantages lie, these countries must allow relative prices and costs to adjust. Wage stabilization hinders adjustment of this kind.

I can summarize much of the rest of my comment in three words—credibility, flexibility, and applicability. After discussing each of these in turn, I will add a few words about the so-called monetary overhang that is often said to be a problem for the Eastern European economies.

Credibility

One of the most urgent tasks in Eastern Europe is to get people accustomed to using price signals—relative prices changes—to guide resource allocation. The monetary system can best contribute to this task by assuring that the price signals are as clear as they can be. Price stability removes the problem of separating general and relative price changes and reduces the problem of separating temporary and permanent changes in the price level. The signals from demand, cost, or productivity changes are then easier to interpret. The quality of the information provided by the price system is greater. This, in turn, increases efficiency.

In principle, there are several ways in which the monetary authority can maintain price stability. The principal alternatives are either fixing the exchange rate or adopting some fixed or adaptive rule for money growth. Either of these rules will work if the role is consistent with price stability, and the public believes that the central bank will follow the rule. Neither role guarantees success. A fixed exchange rate rule runs the risk that the exchange rate will not be consistent with price stability or, as Chile learned in the 1980s, that the real exchange rate is revalued. A monetary role will have difficulty with velocity changes in a rapidly changing economic system.

Establishing credibility—the belief that the central bank will follow the role—is particularly difficult in Eastern Europe. Under the centralized planning system that was common to these countries, the state bank financed not just the excess of spending over receipts in the government budget but in the budgets of all the enterprises. As we know from experience, if the state bank (or the central bank) continues to finance all budgets on demand, inflation will not be

avoided, and credibility will not be established once prices are decontrolled.

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. Unlike Governor Crow, I would not equip the central bank with the power to choose the money stock or the interest rate. In fact, I would restrict the government's monetary role by establishing a monetary authority like the Hong Kong or Singapore Monetary Authority. 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 additional advantages. Let me spell out a few. First, it focuses attention on the need to compete in world markets. Efficiency in international markets begets domestic efficiency, and increased domestic efficiency encourages exporting. Second, domestic prices would adjust toward world levels. If the exchange rate is fixed to the dollar or the mark, domestic commodity prices will move toward U.S. 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. The market would limit borrowing by raising the interest rate as borrowing increased.

The monetary authority would be limited to a few monetary functions. A banking authority, or financial market authority, would have the important task of developing and supervising a competitive banking and financial system to increase the efficiency with which savings are allocated and investment financed.

Flexibility

Under the system of material balances and central planning, prices had no allocative role. Resource allocation and pricing were unrelated, and prices changed infrequently. In a market economy, prices change frequently and guide the allocation of resources. Price flexibility permits the market to respond to changes in relative demand or relative scarcity.

Flexible costs and prices can reduce fluctuations in employment and output. Developed markets contribute to price flexibility. In Eastern Europe, where price and wage flexibility has been rare for decades, reliance on flexible prices and wages to signal the appropriate reallocation of resources is likely to develop slowly. People must learn to follow the signal. And they must learn that rising prices for the goods or services that they buy is not necessarily a sign of anti-social behavior by the sellers.

We know from our own experience that this is a difficult lesson to learn. Large increases in the prices of consumer goods in the United States often lead to claims that speculators and profiteers are responsible for the rise and to calls for lower prices, controls, or investigations. Large declines in price lead to demands for protection, subsidies or minimum prices. Government responses to these outcries typically reduce price flexibility, thereby making the economy less efficient and less competitive. The information, provided by the price system, to guide resource allocation is suppressed.

Applicability

Monetary reform is a useless gesture unless it is part of an economic reform that allows prices to adjust. Monetary reform and price flexibility should be parts of a comprehensive reform program that includes the establishment of open, competitive markets in a wide range of goods, services, labor, and assets. For it is competition in a market economy that reduces monopoly power and induces self interested individuals to provide the social benefits that free markets generate. And, it is the right to keep the gains and the responsibility to accept losses that induces people to compete. Hence, estab-

lishment of private property and other institutions that sustained the competitive market system, such as accounting and legal systems, must be part of the reform.

The United States and other private property, free market economies have placed many restrictions on property and markets. Some of these are introduced to equate private and social costs, as in the case of pollution, or to protect minors or others. Some are designed to redistribute income. The type of market system that is most likely to endure is a democratic, capitalist system with its tensions between efficiency, growth, and redistribution. Redistribution requires taxes, and high taxes reduce effort or shift activity away from established markets. Heavy intervention and redistribution reduce the likelihood of a successful transition to democratic capitalism.

Those who question the applicability of the market system to Eastern Europe or the Soviet Union typically do not have these restrictions in mind. Those who raise the issue of applicability question whether private property and competitive markets will produce growth, raise living standards, and increase efficiency in their countries.

The argument often made is that experience and the established culture are so different that individuals will not respond to the type of incentives that have worked elsewhere. We know that this cannot be wholly true. People from all of the cultures and countries of the world have responded to market incentives in the United States and there is now additional experience in a wide variety of cultures. And the prevalence of "black markets" and other private arrangements suggests that entrepreneurs are not unknown in Eastern Europe or the Soviet Union. Increased competition is a way to get these entrepreneurs into more productive activities.

I believe that an important distinction is often neglected in discussions of applicability of the price system. Misleading language contributes. We talk about people "working for money," but, money is only a means of buying goods or assets.

People produce and innovate to acquire goods, services and assets. That is why monetary reform alone is not sufficient. It must be part of a social and economic reform that puts toasters, washing machines, dryers, TVs, cars, houses and the like into stores in every city and village and provides an infrastructure that includes roads and electricity to make these durables useful to a large part of the population. The reform produces incentives by providing opportunities for accumulation and for improved living standards.

Monetary overhang

In many countries, there is said to be a "monetary overhang"—forced saving in the form of cash balances that people would spend if more goods and services were available. The concern is that, if prices are decontrolled, prices will rise as people seek to shift from money to goods. The fear that others will behave in this way encourages a flight from money, for the anticipated increase in prices will reduce future purchasing power.

There are two solutions to this problem—increase the supply of goods or reduce the stock of outstanding money. Currently, in most of Eastern Europe, the first requires imports. The second calls on the government to withdraw money from circulation by selling assets, including housing, as Governor Crow suggests, or selling some type of indexed bond that pays a positive real rate of interest. If the country replaces the state bank with a monetary authority, as I have suggested, the bonds should be denominated in the currency to which domestic money is pegged.

I see no reason to choose between these two alternatives. Governments should offer assets, including indexed bonds, to privatize ownership and absorb excess supplies of money. If the monetary authority fixes the exchange rate and maintains convertibility, the public can buy imported goods. Once the public becomes convinced that the exchange rate will remain fixed and prices will remain stable, they will choose to increase cash balances. Thus, credible policies reduce monetary overhang both by withdrawing money and by increasing the demand for money.

Commentary: Monetary Policy and the Control of Inflation

Georg Rich

Well, I guess as one comes toward the end of a session, people always hope that you will not overrun your time. I will try to keep my comments brief. It was only with great reluctance that I accepted the task of commenting on the control of inflation in emerging, market-oriented economies. The reason is very simple. As economists, we are much better equipped to analyze and forecast the impact of shocks, given the institutional setup. But, we have great difficulties in analyzing the effects of institutional change itself. And this is really the problem we face in Eastern Europe today. In my comments, I would like to focus on the problems that these countries face in the transition period, the period when they shift from a centrally planned to a market-oriented economy. But, as I say, I am not sure just how much Western economists can actually contribute to this topic.

As John Crow rightly points out, the principal task of central banks is to provide a stable monetary anchor. The monetary anchor must ensure that prices remain stable. Price stability is an essential ingredient in a market-oriented economy. In such an economy, resources are not allocated according to a central plan, but by the interaction of individual firms and households who are guided by relative prices in making economic decisions. For this reason, and I think many speakers now have emphasized this point, relative prices play an important allocative role in market-oriented economies. To play this role efficiently, relative prices must emit correct signals,to

firms and households. Variable and unpredictable prices are unlikely to prompt firms and households to take correct economic decisions. Since inflation normally implies highly variable and unpredictable movements in prices, it tends to undermine the allocative function of the price system. Thus, price stability is required if relative prices are to play proper allocative roles.

Although the experience of the Western monetary authorities may be useful to the Eastern European countries in search of a monetary anchor, the transition from a centrally planned to a market-oriented economy poses additional problems not normally encountered in the West. The key problem is that in the transition period internal relative prices must be adjusted so that they can start to play an efficient allocative role. Considering the distorted structure of relative prices inherited from the era of central planning, all the Eastern European countries find the required adjustment to be enormous and painful. This leads to a very paradoxical situation. In the transition period, relative prices must be variable if the Eastern European countries are to achieve the reforms that will make the price system work. This may also imply highly unpredictable price movements in the transition period. Yet, price movements in that period should not get completely out of control. The chaos ruling in the transition period should not become a permanent feature of the economy. Rather, out of the chaos in the transition period, monetary stability should emerge and should allow relative prices to play their proper allocative role.

How are the Eastern European countries going to produce this miracle? The answer to this question, I believe, is that the monetary anchor should be chosen at the beginning of the transition period. It should not be chosen at the end. The early choice of an anchor ensures that the price adjustments required during the transition period do not get out of hand. Poland and the German Democratic Republic have clearly perceived the necessity of choosing an anchor early. In Poland, two nominal anchors are currently used—a stable nominal exchange rate and a taxed-based incomes policy. Now, I share some of the ill feelings about the taxed-based incomes policy as Allan Meltzer does. But, as long as this policy is consistent with the nominal exchange rate target, it probably is all right, at least in

the transition period. Poland's use of a fixed exchange rate as a monetary anchor makes sense in the transition period because the purpose of the adjustment is to render the Polish economy competitive on international markets. This, in turn, implies that Polish prices should adjust to those in the rest of the world. Clearly, a fixed exchange rate will help in achieving this objective. The German Democratic Republic has taken an even more drastic course of action. Here, the country simply adopts the monetary standard of another country and, therefore, fixes its exchange rate irrevocably.

The early adoption of a monetary standard is important because, as many speakers have mentioned, in the old central planning system the banking system acted as a residual lender to the government and to state-owned firms. This residual lendership may become very dangerous in the transition period when prices are freed because it may become a source of inflation that has to be controlled.

While a stable exchange rate may be useful in the transition period, I am less sure, and here I share some of John Crow's feelings, whether a fixed exchange rate is also a useful strategy in the longer run. Once the transition period is over, it might be better to adopt a monetary standard based on the growth in some money or credit aggregate than to peg the exchange rate. As a central banker from a small country, I know that you may face shocks coming from abroad that harm the domestic economy. In these situations a flexible exchange rate may be advantageous because it may enable the central bank to insulate the domestic economy from undesirable foreign shocks.

Commentary: Monetary Policy and the Control of Inflation

Niels Thygesen

As the other commentators have said, Governor Crow's paper deals in an appealing and balanced way with most of the issues and options in monetary policy and the control of inflation in emerging market economies. I shall focus my remarks on one central issue on which he invites comments from the panel of East European central bankers and the appointed discussants: namely, the relative merits of external versus domestic objectives in designing a stability-oriented monetary policy. That topic has, of course, also been addressed by several other commentators. But since I am the only discussant from a member state of the European Economic Community, I may be forgiven for referring to the experience of countries in that Community with respect to their efforts to create monetary stability through the exchange rate and, more recently, to move toward economic and monetary union. I also want to come back, at the end of my comments, to the remarks of Governor Crow on the importance of having a diversified range of instruments in each economy.

Governor Crow rightly sees the crucial virtue—in the promise of early credibility—that an external orientation of monetary policy, one with a fixed nominal exchange rate against a major international currency with a good international record, would bring. But it is obvious from the subsequent discussion that he has serious reservations about proposing a policy which has stability, in this sense, as the main focus. So he does not completely, I think as'he said he

intended to, refrain from giving odds for the different horses that he parades in front of us, the external and the internal way of formulating policy.

He asks two critical questions that are obviously relevant to this choice. The first is: would the East Europeans not have to go all the way to a monetary union, participation in an area with a single European currency, to achieve full benefits in terms of disciplining domestic costs and prices? But, as he says, monetary unions—EMS-type arrangements for convergence—look a fair way off at this point. So this is a negative verdict against the external anchor.

The second question is: would the East Europeans not find it potentially very costly, in terms of output and employment losses, to forsake flexibility of the nominal exchange rate at a time when "relative prices will move probably to a great extent under the impact of market transformation requiring real exchange rate changes"?

These two questions are clearly of decisive importance for the weight one can assign, maybe after a short transition period, to pegging the nominal exchange rate as a centerpiece of an anti-inflationary strategy. If the answer to these two questions put by Governor Crow were a confident yes, then the East Europeans would be well advised to proceed to the subsequent parts of his paper and look at the domestic options for a stability-oriented policy. But the answers appear to me to be less unequivocally yes to the two critical questions. And if so, the market-oriented economies in Eastern Europe might, with some benefit, make an explicit commitment to peg the nominal exchange rate a central element in their strategy.

Let me try to take up the two critical questions he raised. In a sense, the first question—whether one has to go to full irrevocably fixed exchange rates or even full monetary union to deliver credibility—captures well the discussion within the European Community in the last couple of years. Full monetary union clearly has a political as well as an economic inspiration. But the major economic argument for full monetary union, moving through fixed rates toward a single currency, is that only the final stage would yield the full benefits in

terms of unification of markets and full credibility of the commitment. It is observed that inflation rates within the European Economic Community have not converged fully, although good progress has been made over the last couple of years. Furthermore, interest rate differentials persist between national markets because the commitment to exchange-rate fixity is not complete. Hence, it is argued there is no substitute for full monetary unification to achieve the full benefits through external credibility.

What this argument overlooks, I think, is the contribution that intermediate types of commitments may make to low inflation performance, and have, indeed, made within Western Europe. The fixed but adjustable rate system that we had operated in the European Monetary System, first with some flexibility from 1979 to 1983 and then with increasing rigidity since 1983, has in fact implied a very considerable degree of inflation control and convergence toward a low level of inflation, such as we have observed in the lowest inflation countries in the Community. And remember, that policy was not explicitly announced.

If one adds to this picture the experience of those countries in Western Europe that did not undertake similar commitments, with their difficulties in controlling the inflation rate, I think one would arrive at a somewhat more favorable verdict on the possibility of achieving a considerable degree of inflation control without full monetary unification.

What about the output and employment costs of a fairly rigid nominal exchange rate? Allan Meltzer and Georg Rich both stress the different ranges of ambition in moving toward monetary union. What Governor Crow dismisses, I take it, is only the full monetary union of the German type that we have just seen. That would indeed require such a large number of very rapid and substantial adjustments as to make it unrealistic for other economies in Central and Eastern Europe. But I trust he would not imply that pegging unilaterally, but firmly, to a currency standard of their main trading partners in Western Europe would in itself be an unfeasible strategy for them, nor that it would not help considerably in achieving inflation control.

It seems to me to be, with currency convertibility for current account transactions, an essential step.

If the recent experience of Western Europe is not seen as sufficiently relevant because these economies have already been closely integrating for a number of years, one might look back to the long period of the 1950s and 1960s in Europe, where exchange rates were stable, and expected to remain so, within the framework of the Bretton Woods System. That also led to a period of fairly stable, and modest, inflation and rapid growth in the Western European economies. If you want to look still further around to evaluate the answer to the second question that Governor Crow raises about the costs of fixed exchange rates, I think his argument may underestimate the degree of flexibility you can have in relative prices and in the real exchange rate without moving the nominal exchange rates. We have examples elsewhere in the world economy: from East Asia and Japan, with long periods of exchange rate stability prior to the 1970s, which nevertheless left very considerable scope for real exchange rate changes—improvements in competitiveness in some periods, real appreciation in others, in their case, as one would hope would be the case for a long time for the Eastern European economies. So I think, on the second point, the costs of fixing exchange rates, as put forth by Governor Crow, may be exaggerated on the negative side.

Let me turn briefly to the other element, namely his emphasis on the range of instruments available. I share fully his views that the development of market-oriented instruments is essential to the success of monetary policy, for the reasons he gives and for the additional reason that they increase the independence of the central bank in managing monetary policy. That applies to the management of government debt, in particular. But I think he may overlook that there are other instruments in monetary policy that could be used profitably which are not quite of the market-oriented type, such as reserve requirement changes and discount rate changes, which Eastern European economies should not easily give up.

Finally, in the context of the discussion of economic and monetary union in the European Communities, the emphasis has been on two

main aspects. First, that the central bank, in a common monetary union, should be devoted to price stability—have that as its overriding objective. And second, that it should be independent of political instructions. I think that there is an interdependence between these two elements. Price stability is difficult to achieve without having considerable independence for the central bank. But independence of the central bank is also difficult to conceive unless one confines the task of the central bank fairly narrowly to that of price stability. If the central bank has to participate in all sorts of government activities—for example, in financing budget deficits, and in the formulation of other policies—then it becomes difficult to avoid the kind of political involvement in monetary policy that we are trying to move out of gradually in the European Communities.

Commentary: Central Banks and the Financial System

Andrew D. Crockett

There can be little doubt that the reform task facing policymakers in Central and Eastern Europe is the most daunting economic challenge faced by any government or central bank in recent years. It goes without saying that to fully understand this challenge requires a familiarity with existing institutional and political realities that few of us in the West can have. For both these reasons, any comments we might make and any advice we might offer to our central banking friends from these countries must be tinged with a considerable dose of humility.

Let me begin by saying that I agree completely with everything Corrigan has to say in his excellent paper. My own comments, which were largely prepared before I had the benefit of reading his paper, will, to a large extent, echo his analysis, but will also develop it in certain directions.

The reform of the financial system is central to the success of reform efforts more generally. Without an effective payments mechanism, the allocation of economic resources will be inefficient. And without an effectively functioning system of financial intermediation—that is, a mechanism for encouraging, gathering, and allocating savings—there can be little hope of mobilizing the real resources needed for the restructuring of the economies of Central and Eastern Europe.

The financial system is a network of institutions and markets that mobilize and allocate financial resources. In Western economies, financial resources are unrestricted claims on real resources. The efficiency of the financial system is therefore central to the successful functioning of the real economy. Financial efficiency is promoted by the market mechanism—with resource allocation guided by prices that move in response to the interplay of decentralized supply and demand decisions.

The starting point for the transformation of the financial system of the formerly centrally planned economies is quite different from this. In these countries, financial resources could not be regarded as unrestricted claims on real resources. The allocation of financial resources has traditionally followed, not preceded, decisions on the allocation of factors of production and of final output.

The transition to a market economy therefore implies very profound changes in the basic raison d'etre of the financial system. I believe that central banks have an important role to play in managing the process of structural transformation. This role encompasses three functions: (1) promoting an efficient and competitive network of financial intermediation; (2) preserving stability in the financial system; and (3) promoting macroeconomic stability and, in particular, a stable price level.

I put price stability third, not because it is least important but because, in the process of financial reform on which the Eastern European countries are embarking, it grows out of the other two objectives. As Scott Pardee hinted in his observation in our opening session, if reform only delivers price stability, and is unable to show tangible benefits in other directions, it is unlikely to be politically durable, let alone economically efficient. And as Paul Volcker remarked yesterday, price stability is something that centrally planned economies have been reasonably good at.

It may be asked what business central banks have promoting the development of the financial sector. Surely their objective should be to assure price stability as the best environment in which the private sector can develop the institutions that promote growth.

But there is an important difference between the environment in which central banks developed in Western economies and the circumstances now faced in Eastern Europe. Most Western central banks emerged in situations where financial markets and institutions were already quite well established. The problem to be faced was one of systemic instability. And the solution to the problem was to give one institution, the central bank, the objective of promoting stability through its capacity to intervene in markets.

In Eastern Europe, reformers have a different starting point. The structure of markets and institutions has to be developed before central banks can perform the stabilizing functions that we in Western countries are accustomed to assign them.

Let me now be more concrete. What needs to be done to move the banking system of Eastern European countries to a level at which they can contribute positively to the economic development of these countries? I will identify four important elements in the process—though these are, of course, not exhaustive.

A *first* step—which has already been taken by many countries—is the separation of commercial banking activity from the central bank. Beyond this, however, an efficient banking system requires decentralization and competition. Monolithic banking systems have to be broken up and the newly created institutions allowed to compete with each other. This means, in particular, that commercial banks must not be assigned specific sectors of the economy in which they are given specific responsibilities and, in consequence, a quasimonopoly position. It also means that the problem of nonperforming assets must be dealt with before commercial banks are set free to operate on commercial terms. Foreign financial institutions also have a role to play in helping promote competition and efficiency.

Second, effective and efficient payment and settlement systems need to be introduced. Payments and clearing mechanisms are the nuts and bolts of the financial system. If they work well, we do not pay much attention to them. But if they do not, the entire machinery can seize up. Central banks have a clear leadership role, in my view,

in developing the payments system in the emerging market economies. Sophisticated, state-of-the-art systems are not required. What is required is a reliable mechanism so that payments and settlements can take place on an assured basis.

Third, efforts should be devoted to the establishment of short-term money markets. The mobilization and allocation of savings cannot be fully effective within the confines of a single financial institution. There must be ways of transferring surplus liquidity between institutions to meet fluctuations in the flows of funds, as well as to put liquidity at the service of other legitimate users, both in the public and the private sectors.

It should also be noted that the short-term money market is the most effective and efficient vehicle for monetary policy implementation. A functioning money market would help resolve the paradox identified yesterday by Bruce MacLaury. For it would no longer be necessary to use nonrnarket techniques of credit control to underpin the stability of market-oriented reforms in the real economy. Market techniques would be available for monetary management also.

Fourth, prudential regulation of the banking system has to be given a major role. I can only underline the points made by Corrigan in this connection. The transition to a market-oriented banking system will place enormous decision making authority in relatively inexperienced hands. We have heard yesterday of the very large nonperforming assets on the balance sheets of the banking systems of the Central and Eastern European countries. These mistakes of credit extension must be avoided in the future, as must the other excesses that are typical in newly emergent banking systems.

But there is another, crucially important, function that can be served by an effective system of bank supervision. This is the development and standardization of accounting and credit appraisal techniques. Such techniques are at the core of the business of banking, and as yet they exist only in rudimentary form in most Central and East European economies. It is an important responsibility of a central bank to see that these basic skills are developed. The organization of training and technical assistance is one means

of doing this. Another is to use the mechanism of supervisory oversight to make sure that appropriate techniques are being applied in the field.

In conclusion, let me note that I have taken a "broad church" view of the role and responsibilities of the central bank in the financial system. This is somewhat at variance with the more restricted view that has become popular in recent years, in which central banks' responsibility has been seen to be increasingly focused on the single goal of price stability. But I believe Corrigan is right to emphasize the wider responsibilities of a central bank. This wider role is certainly very much within the historical tradition of central banks as they emerged in the nineteenth century. And it is fully consistent with the needs of the Central and East European countries as they face the enormous challenges of moving to a market-oriented system.

Commentary: Central Banks and the Financial System

Mervyn A. King

In the process of transition to a market economy, the creation of a financial system that can both mobilize savings for the investment that will be required for 'development and also ensure efficient decisions by private managers is an important first step. But it is unlikely that a new financial system can be successfully put in place without an important role for the central bank in the newly liberalized economies (NLEs). Why do we need a central bank? The answer comes, I believe, from an examination of the history of central banks. Indeed, in thinking about the role of central banks in the NLEs it is more helpful to look back on the evolution of central banks in market economies than to focus on the policy issues that have dominated discussion in the West in the immediate past.

From an examination of the evolution of central banks it becomes clear that Jerry Corrigan has hit the nail on the head when he stresses the role of the central bank in ensuring stability of the financial system. As Sayers (1976) put it in his history of the Bank of England,

> "The complete central bank has to have some care for the health of financial institutions generally, a care that may be no more than that of a watchdog, but can in difficult times develop into a large part of its activity, and branch out beyond the narrowly financial to amount to intervention in the organization of industry and trade." (p. 501).

Most central banking institutions in Europe started life as privately owned commercial banks. The evolution of central banks represented a market demand for such an institution. In times of financial difficulty the need for coordination—and the difficulty of achieving this by cooperation between competitive commercial banks—led to the emergence of a single dominant bank that could play a coordinating role. But the conflict of interest between this quasi-regulatory role and the objectives of a profit-maximizing commercial bank led to the development of non-competitive institutions charged with the responsibility of managing the financial system in times of stress and preventing excessive note issue. The lender of last resort must be above the competitive battle. Even in the twentieth century this theme of evolution can be seen in Australia, where the Reserve Bank was created only in 1960.[1] It is difficult to imagine that a central bank could now retreat from these wider responsibilities. Since major problems in the transition to a market economy are likely to show up first in a financial crisis, central banks in the NLEs face an enormous challenge. The three key areas are likely to be: (1) the relationship between the central bank and the government, (2) management of the stability of the financial system, and (3) the implications of free trade in financial services for stability.

Some important lessons are provided by the "Montagu Norman school of central banking." For some time Montagu Norman has had a bad press. But in many ways he was a model for central bank governors in the 1990s. What are these lessons in the three key areas identified above?

Relationship with government

Montagu Norman believed in the independence of central banks. He had some useful ploys in dealing with government. At difficult moments he was inclined to disappear on long vacations and, since he was known to be willing to overrule his subordinates upon his return, hasty decisions were avoided that might otherwise have been mishandled in the heat of the moment. He once fainted in the arms of the Chancellor of the Exchequer—thus literally disarming his opposition (Boyle, 1967). Central bank independence has been a topical issue in recent policy discussions. The relationship between

the central bank and government varies from one country to another. Attention has focused on differences in the constitution of central banks across countries. But the lesson of Montagu Norman is that this key relationship may be more sensitive to the mandate and constitutional position of elected politicians than to the formal status of the central bank. Central banks in the NLEs may find that there is a tradeoff between the independence granted and range of responsibilities afforded to them.

Financial supervision

As Jerry Corrigan notes in his paper, a central bank is expected to ensure stability of the financial system. In the context of the NLEs the involvement of the central bank with the economy as a whole is not a side issue. There have been times when concern with financial infrastructure has been more to the fore in the mind of the central bank than monetary policy itself. For example, in the 1920s and '30s the Bank of England played a leading role in the restructuring of the cotton and textile industry in Britain. As Sayers puts it, "In the mind of the governor himself, these problems of economic organization perhaps had more attention than the narrower field of monetary policy with which central bankers are conventionally concerned." (p. 502).

The experience of Montagu Norman in the 1920s has direct relevance to Eastern Europe today. The reorganization of industry will alter radically the structure of the asset side of commercial banks' balance sheets. The resulting losses will in many cases threaten the viability of the banks, and raise questions as to how far the central bank should intervene in protecting banks from the consequences of privatization of previously mismanaged state enterprises. The lender of last resort role is likely to be an extraordinarily difficult one in the transition from a centrally planned to a market economy.

It is difficult to imagine that in the NLEs central banks will be able to limit their concern to narrow technical issues of monetary policy. For example, central banks will surely be concerned to ensure the construction of a coherent explicit tax system in order to replace the

revenue lost as a result of privatization. The transfer of state-owned assets to the private sector has in some cases resulted in a substantial loss of revenue. The trading surpluses previously accruing to the state have not been replaced by an explicit tax system. As McKinnon (1990) has pointed out, this loss of revenue has led in the Soviet Union to an erosion in government revenue and substantial budget deficits. The consequent loss of monetary control has led to serious inflationary pressure. In the absence of an effective tax system, the task of monetary control becomes more difficult.

Indeed, it is notable that in the debate on monetary union in the European Community, the report of the Delors Committee—comprised primarily of central bank governors—placed emphasis on the need for coordination of budgetary policies.

The sequencing of liberalization measures will also be of concern to central banks. Selective price de-control, coupled with the absence of hard budget constraints, can imply extremely volatile prices for financial assets, such as foreign exchange. Hence in the context of lender of last resort policies, the structure and sequence of a transition to a market economy must be a matter of concern to central banks.

There are many other areas in which the new central banks will have not only to learn from their counterparts in the West, but also be open to and ready for innovations in the financial system. Banking supervision already faces the challenge of the difficulty of distinguishing between banks and non-banks, and there will be further problems in distinguishing between the financial transactions of financial institutions, on the one hand, and non-financial institutions, on the other. The payments mechanism itself, the protection of which is one of the principal rationales of banking supervision, is subject to major change from innovations in technology. The growth of direct debit mechanisms may remove the granting of credit from the operation of the payments mechanism, hence altering radically the argument for regulation in this area. Central banks in the NLEs might be well advised to push the payments system in a direction that separates as far as possible the granting of credit from the payments system.

The international dimension

The growth of trade and financial services has increased the need for coordination among regulators in the market economies. The proliferation of regulatory bodies within each country has created the need for a "lead regulator" to take initiatives in liaising with their counterparts overseas. The central bank is a natural candidate for this role. The financial system is now more open to international capital flows than it has been for 50 years. This creates restrictions on the ability of any one country to pursue financial stability in isolation. For example, the most recent collapse of an investment bank in the UK—that of British and Commonwealth in 1990—was caused by a failure in a nonfinancial subsidiary in another continent. Domestic regulation of the parent company was insufficient to prevent a run on the bank. In the immediate aftermath of the 1987 stock market crash, coordination among regulatory authorities, and especially central banks, helped to prevent a spread of possible systemic failure. Cooperation among central banks was a major theme of Montagu Norman in the 1920s, and he played a major role in ensuring a successful launch for the Bank for International Settlements. Concerned lest the proposed BIS become dominated by the politics of reparations, he argued that the new institution should be a non-political central bank for central banks. The more rapidly central banks in the NLEs become full members of the international club of central banks and regulators, the greater will be the confidence of overseas investors in direct investment in the NLEs.

I have argued that in the market economies central banks evolved from commercial banks, largely as a result of the perceived market demand for such a coordinating institution. In the NLEs, the challenge is the reverse—how to create a system of privately owned competitive commercial banks from an existing centralized financial system. The principal difficulty that is likely to emerge from this process is that the central bank will be trying to create competitive independent commercial banks at the same time as it retains an overall regulatory responsibility for the financial system as a whole. In a number of market economies, the concern for control over monetary and regulatory policy has inhibited the development of a competitive banking system. This dilemma is likely to face the

central banks of the NLEs in an acute form. They will have to be parents to a new competitive banking system, nourish their off-spring, give them their liberty, and yet try to maintain the stability of the family as a whole.

In tackling the problem of trying to create a competitive banking system while ensuring financial stability at a time of dramatic industrial change, central banks in the NLEs will be a crucial ingredient for a successful transition to a market economy. The governors and the directors of the new central banks will require exceptional qualities—and more than their fair share of luck.

End Notes

[1]For further discussion of this topic, see Goodhart (1988)

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Commentary: Central Banks and the Financial System

Philippe Lagayette

I am not sure whether I can rise to the level of mystique, but I will try nevertheless to echo some of the remarks very correctly made by Jerry Corrigan. It is certainly true that the situations in various countries in Eastern Europe are different and that those situations are very difficult to manage. It is equally true that when you look at Western central banks, you do not see something uniform. Instead, you see very extensive differences in the area of their activities and differences in the ways they act. We are very aware of that in Western Europe because we are now in the process of discussing organization of the future European Monetary Unit (EMU) and a future central banking system for this EMU. This leads us to look very closely at what we are doing, and this creates quite an interesting debate. So I also share the view of Andrew Crockett that we must have an attitude of humility when we look at these questions.

Nevertheless, there are some basic principles on which probably a lot of people would agree now, even if those principles have not developed in history in a very rational and continuous way. It is also true to say that during most of the time since industrial life appeared, there was no key role for central banks. Therefore, we have to focus on the most basic principles which presently justify the utility of central banks and see very pragmatically if they can be useful in Eastern countries. In this spirit, I am going to concentrate my remarks on three points.

First of all, the subject we examine today is very closely related to the subject of yesterday, even if this does not appear so obvious.

There is not a single reason to have a central bank, as Paul Volcker reminded us yesterday. But probably a lot of people could agree with the fact that central banks are a precaution that democratic governments take in order to protect their currency. They admit that management of the currency, which is an activity of collective interest and therefore should normally rest in the competence of the democratically elected government, requires special caution because it requires a very high degree of stability and continuity. The central bank is just the body which is in charge of providing this long-term view of stability. If this is admitted, all the activities of the central bank must be oriented toward stability. In particular, central banks could not accept a financial system and a commercial banking system which would not be stable and firm and would undermine the soundness of the currency.

If you accept that view, there are a lot of consequences. The question of credibility is a question which is common to all activities of a central bank aiming at stability. Credibility cannot be divided. Bad performance, for instance, in supervision of the financial system would weaken the position of the central bank in the field of monetary policy. The same can be said about expertise. Bad expertise in one field would reflect adversely on the central bank's (credibility) in other fields.

Many other links exist between the soundness of the financial system and monetary policy. In monetary policy, a key requirement for a central bank is to be in a position to appreciate what the monetary aggregates are and how they are moving. For that purpose, the central bank must be assured that liquidity is located somewhere precisely, mostly in the commercial banks. That is why it would not be acceptable for a central bank to have a situation in which a substantial part of the liquidity would be located in companies extending liquidity and credit facilities to each other according to imprecise rules. In that field, reforms need to be made in some Eastern countries. For the same reason, an extensive use of barters should also be banned.

The central bank, when it performs monetary policy, must be able to move interest rates. It is one of the most crucial decisions. In order to be able to move interest rates, the central bank must be sure that the financial system can bear it, that is to say there is no weakness of the financial system such that a move of interest rates could have disastrous consequences.

My second point is that in the Eastern European countries, or in the Soviet Union, the reform of the financial system cannot be separated from the reform of the economic system, specifically the reform of industrial companies. Granting credit is certainly the heart of banking activity: the banks are in charge of allocating savings. And only free banks can do a good granting of credit, a good allocation of funds; Jerry Corrigan has very rightly pointed on that. This happens only if funds are channeled to banks. For instance, all systems of barter, all kinds of swaps, are certainly a hamper to normal banking activity. Secondly for this activity of granting credit, commercial banks must be in a position to know the risk—that is to say, to make a judgment on companies. That is why a good accounting system is so important. In that respect, too, I very much agree with what was said by previous speakers. And maybe central banks can provide some services in that area, for instance, to know and aggregate the risks taken by all commercial banks on a given company and to be able to give this information to commercial banks. This service exists in many countries and is certainly a very important basic service for commercial banks.

But also, central banks must be in a position to count on a business attitude on the part of companies, rather than facing companies convinced that receiving credit is just a consequence of other decisions. It is why a lot has to be done in the other fields of reforms, reforms which determine the behavior of nonfinancial companies. Beyond their own merit, such economic reforms are also indispensable for a correct exercise of banking activity.

My third point is that there must be a minimum of supervision and regulation of commercial banks and that the central bank must have it in its hands. Of course, there is a tradeoff between safety and dynamism of the commercial banking system. Too much regulation

certainly kills dynamism, and finally also kills safety because safety comes in a substantial part from profitability. If commercial banks are not in a position to be profitable, there will ultimately be no safety.

Despite this tradeoff, a certain degree of regulation must exist. The first essential area of regulation is for the central bank to be able to license commercial banks individually and to have the final word on who is able to perform a commercial banking activity and who is not. The second thing is to be in a position to ensure a certain degree of competition between commercial banks. On that, I very much agree with Andrew Crockett that it is essential not to have too much specialization for commercial banks because this restricts competition and encourages borrowers to consider banks simply as a window to extend them the funds they think they need. Competition between banks is needed to incite both banks and companies to behave rationally.

There must also be minimum conditions required for accounting regulation of commercial banks so that the central bank can appreciate their situation. We know, in Western countries, how difficult it is to appreciate the situation of commercial banks, so everything must be made to facilitate this appreciation. And of course, a minimum definition of nonperforming assets is a very important element of this accounting regulation. Finally, there must be a minimum of liquidity rules and solvency rules. In that respect, a certain amount of owned funds, of capital, is a key element.

Let me conclude by saying that I have been struck during these two days of discussions by the fact that there are fewer and fewer arguments in favor of gradual solutions. And in that respect, I was very much struck by what Minister Klaus said yesterday. The few remarks I have made tend to the same conclusion: this is a global reshaping both of the financial and the economic system which is needed. Each element of this reshaping is necessary to make the others efficient; it is therefore difficult to imagine a gradual timing.

Comment from **the Floor**

Allan Meltzer

I would like to speak to all of the Eastern Europeans on the panel to say that you are getting well intentioned but bad advice from your Western colleagues. If you read Walter Bagehot, he will tell you to adopt some rules. Allow the market to enforce discipline on your banking system. If you go the way of Western banks, you will try to prevent failure. You will believe that deposit insurance or regulation or supervision are a substitute for market discipline. Here, in the United States, decades of supervision, regulation, and insurance have left us with $150 billion of losses in the thrift industry and a weakened banking and financial system. Do it the way you know will work. Rely on market discipline and market incentives as the core of the supervisory system. Allow the market to direct the way in which your resources will be allocated and then come back here in 10 years and teach your Western colleagues how to run a banking system.

Commentary: Currency Convertibility in Eastern Europe

Richard N. Cooper

Bergsten and Williamson have given us a fine statement of the issues involved in establishing convertibility in emerging market economies. Rather than go through all of the issues point by point, I would like to focus on one country, the Soviet Union, and indicate what I think the appropriate course would be in terms of convertibility. I chose the Soviet Union not because I know a lot about that economy, but I know even less about the other Eastern European economies, and I have had occasion recently to learn a little bit about the Soviet Union.

In making my remarks, I take for granted that the Soviet Union is serious about perestroika. Every country should determine for itself what kind of economic and social system it wants. I am not trying to impose my views, but to take at face value the current statement by the Soviet reformers of their objectives and ask how best to achieve them under the heading of currency convertibility.

By nature and inclination I am a gradualist—especially where, as in the current situation, an enormous amount of institutional development has to take place. The financial and commercial institutions that Western countries take for granted are still in a relatively nascent state in the Soviet Union. But the more I reflected on the issue, the more I disagreed with the approach to currency convertibility that was in last December's plan for economic reform in the Soviet

Union, namely that currency convertibility can be postponed for a decade or more until lots of other reforms take place.

The more I thought about that, the more I thought that postponing convertibility would be a fundamentally wrong approach to economic reform in the Soviet Union. On the contrary, currency convertibility—and here I will mean current account convertibility, with the possible exception of travel—should be an integral, **upfront** part of economic reform in the Soviet Union. There are six reasons why quick movement toward convertibility is desirable. Let me go through them briefly and then address the conditions that are necessary to sustain convertibility.

The first reason is to introduce early a degree of effective competition into the Soviet economy. Political figures in the Soviet Union have come to understand that markets are extremely important in a modern, highly articulated, well functioning economy. But I am not certain that they understand that the key to success in Western economies is not markets; it is *competitive* markets. With some exceptions, businessmen dislike competition. But they are forced by the actions of others to continue to improve in order to stay in business. Constant pressure makes the system vibrant and progressive. The Soviet Union by design has monopolized almost the whole of its industrial sector on the assumption of economies of scale and maximization of central control are desirable. It would be extremely unwise to launch a market-oriented system dominated by these enterprises, whether they are publicly or privately owned. The prospects for introducing effective internal competition into such a system are very limited, at least in the near future. It can be done over time, but it will take at least a decade, probably longer. So I see the introduction of foreign competition at the outset as an extremely important part of introducing effective, competitive markets in the Soviet Union.

The second reason is to align Soviet prices with world prices as rapidly as possible. Such alignment may of course be subject to any conscious tariffs that they want to introduce, but that should be an explicit, consciously chosen policy. To reform the price system intentionally, and then a decade or so from now move to the world

price system, involves essentially two price reforms—and a lot of misallocation of resources in the intervening decade or whatever length of time it is. Moreover, strong vested interests built up in the meantime will try to resist the second reform. The Soviet Union should try to introduce the world price structure early in the process rather than later on.

Third, one of the problems in the Soviet Union today, as I understand it, is motivation of the labor force. Workers get paid in roubles, but as Bergsten and Williamson pointed out, roubles are not always convertible into goods. Yet people consume goods and services, not currency. One reason for introducing current account convertibility early is to offer wage goods in much greater abundance than now exist—necessarily at high prices, but nonetheless available—so that people can see what they can buy and can work and save toward buying those things.

Fourth, as part of a move to convertibility, the Soviet Union would have to decide what kind of tariff system it would like. I favor a relatively low uniform tariff, 10 to 15 percent, with possibly some transitional tariffs to last only a few years. In any case, the new imported wage goods would come in at high rouble prices and would serve to reduce the monetary overhang, if indeed there is an overhang. Parenthetically, I am not knowledgeable enough to have a judgment on the question, but I do wonder whether this much-spoken-of overhang in the Soviet Union is really a serious overhang under the postulated circumstances of a convertible rouble—both in terms of locally-produced commodities, as Williamson and Bergsten have emphasized, and in terms of foreign goods. It is noteworthy that financial assets and household assets in the Soviet Union are very low relative to income levels, compared with Western countries. I could quite well imagine that under altered circumstances households would voluntarily hold not only their existing cash balances but even more. At least I regard it as an open question rather than presume that an overhang exists and is a big problem. Early convertibility would help deal with any overhang, if it exists, by transferring some of it to the government in the form of import duties.

Fifth, by the same token, convertibility would help reduce the budget deficit. There would be explicit tariff revenue. In addition, to avoid some of the most disturbing consequences of early convertibility, necessarily at a heavily depreciated exchange rate, I would put a tax on the exports of oil and gas and a modest subsidy on the imports of grain. A substantial increase in domestic prices of energy is needed in the Soviet Union by all accounts. But the degree of depreciation that would be necessary to make the rouble convertible would probably exceed what is required on efficiency grounds in the first instance. So an export tax would slow the rise of energy prices to the world level. The net effect of these temporary taxes and subsidies would be substantial current revenues for the government.

Finally, convertibility would provide a very strong stimulus to develop export markets. At the exchange rate required to make the rouble convertible, exports would be extremely profitable for newly independent enterprises. Autonomous enterprises would have a strong financial incentive to develop export markets, and that would push them from the beginning to take into account not only the price but also the quality of products that are sold in the world market.

What are the preconditions for making convertibility work? First, enterprises have to be on hard budgets and to be encouraged to maximize profits. Monetary emission should be under control; that is to say macroeconomic stabilization should be achieved. And of course commodity convertibility is a necessary accompaniment of currency convertiblity, but it is automatically brought about by convertibility. If enterprises are to take advantage of the new export opportunities, they have to be able to acquire funds for investment. That raises the question of how savings are mobilized and channeled into enterprises that have sufficient productive opportunities. Some development of the banking system is therefore a necessary precondition for moving to convertibility. But a complete development is not necessary.

A key issue which Williamson raised in his oral remarks is the choice of the exchange rate. Like him, I favor a fixed exchange rate in order to stabilize expectations in this new and highly uncertain environment. I would choose an exchange rate that favors exports—

that is to say, in conventional terms, one that is slightly undervalued. Given the heavily distorted price system that now exists in the Soviet Union, there is no persuasive way to calculate such an exchange rate on a purely technical basis. So what is required is a technically informed political decision on the exchange rate. For the sake of concreteness and to stimulate further work, I suggest five roubles to the SDR as a starting point. I choose the SDR rather than the deutsche mark or the ECU because the Soviet Union for the immediate future will sell heavily into dollar-oriented markets—oil, gold, various minerals, and so forth. So the dollar should be represented in the basket, as it is in the SDR. Five roubles to the SDR is a useful starting point for discussion. At that rate, I would expect the rouble to appreciate in real terms over time as Soviet export industries get the rhythm of exporting, as they learn quality control, marketing techniques, and so forth. There would be upward pressure on the exchange rate over time.

This is all on the presumption of macroeconomic stabilization. Suppose that macroeconomic stabilization is not at first assured. The Soviet Union has a large budget deficit, which I am told is going to be difficult to reduce sharply. Under the circumstances, I would still go for early currency convertibility, but obviously not at a fixed exchange rate. There would have to be a floating exchange rate. But the benefits that would flow from convertibility would still outweigh the disadvantages even in a not completely stable macroeconomic environment.

A disadvantage of a major currency depreciation in many countries is that it gives a big impetus to inflationary expectations. That is the argument against it in many developing countries, for example. Paradoxically, past Soviet policy of closing the economy to the rest of the world turns out to be helpful, enabling the Soviet Union to have a substantial depreciation without creating inflationary expectations. The main impact as far as the man on the street is concerned would be a tremendous increase in the variety of goods available in stores, though at high prices. Imported goods would not generally be directly comparable to the goods he has had available up to now, so the main impression would be one of greater variety rather than higher prices. The two important exceptions to that are energy,

which is an important input to enterprises, and foodgrains. That is why I would have a transitory tax-subsidy scheme on those goods.

Let me now say something about the question of price stability as an objective, which so far has been urged and apparently accepted in this group. At the risk of making myself ***persona non*** grata in a group of central bankers, former central bankers, and fellow travelers, 1 want to make a modest case for modest inflation. I say this against the consensus that seems to be developing here that (1) central banks should be independent and (2) price stability should be the prime objective of central banks. It also relates to what I have been saying under the heading of convertibility.

The first point to note is that when economists and bankers talk about price stability, they are frustratingly unclear and ambiguous about what exactly they mean by price stability. For concreteness, I am going to assume price stability in the consumer price index (CPI) is what is desired. I assume that because that is what the man in the street means by "inflation." He is talking about what he buys, which is roughly captured in the consumer price index, and not the other various ways we measure inflation. That definition is important to what follows.

For good economic performance, a government should try to establish a stable financial environment. Seeking price stability is not the only or even the best way to achieve a state of stable expectations. All countries but the largest face a strategic choice in doing that. They can go for price stability or they can adopt a fixed exchange rate. As between those two, I believe that a fixed exchange rate is the superior alternative for many countries. However, electing a fixed exchange rate means accepting some price instability, if one wants to call it that, or more generally accepting the level of inflation in the rest of the world. A fixed exchange rate is not in general compatible with CPI price stability, unless it happens that the countries to whose currency our currency is fixed achieve CPI price stability.

On top of that, for all middle income developing countries, and I assume also in the future for the emerging market economies, one

has to put what I would call the "development premium" on the CPI. It is a well known characteristic of growing economies that the prices of services rise more rapidly than the average price of goods. Even with price stability in tradable goods, developing countries experience a positive increase in the CPI. The extent of that increase is in fact positively correlated with the extent of economic growth in the country. It is worth recalling that Japan during the 1950s and 1960s had a CPI increase that was over three times the CPI increase in the United States. Korea, also a country that has performed extremely well by the variety of criteria that economists use to measure economic performance, until the mid 1980s had an increase in the consumer price index between 10 and 20 percent a year. Yet the Korean economy did not seem to suffer enormously from this inflation. Emerging market economies that actually succeed in doing well as a result of their economic reforms can expect some inflation arising from what I call the development premium.

Third, there is a public finance case for some inflation in countries that have poorly developed tax systems, and that have great difficulty enforcing the tax systems they have. While in textbooks economist can pretend we have lump sum taxes, in the real world there are always deadweight losses associated with taxes. Any optimal tax system will therefore have at least a modest component of the inflation tax in it. In countries where tax systems are not well developed, and where enforcement is a problem because they do not have a history of enforcement, what happens in practice is that taxes get loaded too heavily on the foreign trade sector and in particular on imports, with undesirable consequences for competition, efficiency, and growth. Under those circumstances, a modest inflation tax can offer an improvement in the tax system and therefore in overall economic performance. Countries at the stage of development I am considering can raise between 1 and 2 percent of GNP annually through the inflation tax. That is not a huge amount, but every bit helps. The deadweight losses from that source, if inflation is under control, will be less than the deadweight losses associated with alternative taxes.

Finally, I come back to the exchange rate. If the procedure has been well managed and the exchange rate is undervalued with a view

to stimulating exports over time, as that stimulation takes place, the real exchange rate of the country must appreciate. Once again the country faces a strategic choice. Does it take that real appreciation by appreciating the nominal exchange rate or by allowing domestic prices to rise with an unchanged nominal rate? That choice need not be made now. But it is not obvious that appreciating the currency is always the superior choice between those two alternatives. There are circumstances in which the expectational environment is better served by keeping the nominal exchange rate fixed and allowing prices to do the adjustment. That indeed is the process we have *within* countries. Massachusetts experienced a relative rise in wages in the 1980s, and in the 1990s, there may have to be a relative decline.

Let me just close by saying that I am not arguing that central bankers should drop their concerns about inflation. On the contrary, they play a vital social role. Every society has many pressures for inflation, and somebody has to take the position of leaning strongly against it. That is preeminently the role of the central bank, and one that central bankers should continue to play. My only plea is that, in pleading for price stability, central bankers not take it too literally.

Commentary: Currency Convertibility in Eastern Europe

Jacob A. Frenkel

Being the seventh speaker in this session on currency convertibility naturally leaves me at something of a disadvantage: we have already heard so much good sense and so many good ideas on the subject, that I now find it all the more difficult to say much that is new. This reminds me of a recent observation of the Princeton economist, Avinash Dixit, that the invention of word processing has lowered the cost of producing words without changing the cost of producing ideas, with predictable results. The lesson I draw from all this is that I should be brief. In their paper for this session, Fred Bergsten and John Williamson have in any case simplified my task: they identified the major issues and covered a lot of ground that I now feel no need to touch on.

I shall focus my remarks mainly on the preconditions for a successful implementation of currency convertibility; but there are a few important points that I should like to emphasize at the outset. Some speak about the adoption of currency convertibility as an act of ***symbolic*** significance—an act that signifies that the country concerned is becoming a "member of the club," as it were. I see that as a mistake. Rather, the adoption of currency convertibility has to be viewed in the context of an ***overall program*** of economic transformation and restructuring; it should be seen as one of the components of such a program. And since there is no single blueprint for economic restructuring applicable to all economies—different strategies will be appropriate to different economies, depending on

their circumstances—it clearly follows that there is no single blueprint for currency convertibility either.

Let me also emphasize that the introduction of convertibility is not an easy task: there are short-term costs, as well as medium-term benefits. The task prior to implementation is to assess the benefits in relation to the costs, and to select a strategy that minimizes the latter in relation to the former. However, there is one general point that was emphasized in the discussion earlier today: this is that it is essential to distinguish between ***current account*** convertibility and ***capital account*** convertibility. There was consensus that capital account convertibility, while it might be on the agenda for eventual implementation, requires a lot of preconditions that in many cases are unlikely to be met in the immediate future. I concur with this consensus, not least because of the problem of capital flight. I shall therefore also focus my own remarks on current account convertibility.

The advantages of adopting current account convertibility seem fairly obvious. On the demand side, the adoption of convertibility will provide consumers with goods they never had (either in terms of desired quantity or even more frequently, in terms of desired quality)—that is, access to new markets. On the supply side, it is useful to think of currency convertibility in the context of broader trade liberalization efforts. When a previously centrally planned economy transforms itself into a market economy, the opening of the economy to world market forces serves two related functions. First, world market prices can provide the most reliable guide for production decisions in the uncharted territory of decentralized decision making. With the guidelines of central planning removed, it is world market prices that can offer the best guidance to producers. In addition, openness to world markets can be the most reliable guarantor of the stimulus of competitive forces, particularly for economies that start from a position in which most major sectors are highly monopolized, and where the scale of the economy is too small to accommodate adequate internal competition in many sectors. Openness to world market prices in fact offers the most appealing means of introducing a competitive market environment into previously centrally planned economies.

But of course there are risks even with current account convertibility—risks that we hear about time and again. There will very likely be unemployment in the beginning, especially as unprofitable enterprises are eliminated. There will be a decline in output, and there may also be a significant decline in real wages. It may therefore become difficult to maintain the domestic political support that is so necessary for the success of the economic transformation. But in reality, there is no alternative, because the starting point is a distorted economy: restructuring necessarily means that many firms will go out of business, and their going out of business is in fact desirable. But there is indeed a problem of how to maintain political support. The best strategy, it seems to me, is to make sure that the aims and means of the program are transparent from the outset, and that there are adequate safety nets. In the latter context, however, I am a little nervous about excessive wage indexation which, as we know from experience, can transform a microeconomic problem into a macroeconomic disaster.

Turning now to preconditions, I would highlight four that seem necessary for a successful adoption of convertibility. First, you must have an appropriate exchange rate in place. Second, there must be adequate international reserves. And third, you must begin from a position in which the course of macroeconomic policies is consistent with stability. These three preconditions are of course frequently mentioned; once you have all three in place, you should be able to move to exchange and trade liberalization without generating macroeconomic instability or a balance of payments (current account) crisis. But there is a fourth precondition that is also important for the countries that we are discussing today; it was less pertinent to the issue of the convertibility of the Western European currencies in the 1940s and 1950s. This fourth precondition is that the price system must be free of major distortions, and must be performing its role as an incentive system. This requires, for a previously centrally planned economy, that state enterprises and the price system are reformed. Without this fourth precondition, the other three preconditions will do little good; they will not yield the results that we are looking for. I shall now elaborate on each of these four preconditions in turn.

First, the exchange rate. Unless the exchange rate is broadly consistent with balance of payments equilibrium, the removal of restrictions will generate large imbalances and will therefore, tend to create difficulties with which we are familiar. However, the "equilibrium" exchange rate is likely to change in the transition. As firms and enterprises become more efficient, and as competitive forces in the economy become stronger, it is quite likely that you will need a less-depreciated currency than was warranted at the beginning of the process. Therefore, if convertibility is adopted relatively early on, it is quite likely that during the transition process the domestic currency will undergo a process of appreciation. Even though, in principle, fixed exchange rates can serve as useful anchors in the anti-inflationary fight, one should not attempt to anchor too many variables during the transition, because there are bound to be shifts in equilibria.

Second, international reserves. Even if the exchange rate is right, there are still going to be unavoidable cyclical disturbances which, though transitory in themselves, can upset macroeconomic stability and confidence, with effects that may be more profoundly damaging. We therefore need a cushion of adequate international reserves. How big is adequate? The answer of course depends on the circumstances, but in the past, the maintenance of reserves equivalent to at least three months' imports seems to have provided a good rule of thumb for countries with pegged exchange rates. As a matter of fact, the lack of such reserves was one of the main reasons why the countries of Western Europe postponed convertibility to the late 1950s. In this context, let me mention a few examples: Korea accepted Article VIII status in the International Monetary Fund in 1988, when its reserves amounted to three months' imports; Thailand adopted Article VIII in 1990, when it had five months' imports; and Poland had reserves and external lines of credit amounting to four-and-a-half months' imports when its currency was made convertible for virtually all current account transactions at the beginning of 1990. Therefore the rough order of magnitude of the required level of reserves seems fairly clear.

Third, sound macroeconomic policies. This is always a nice objective, but here, in the context of currency convertibility, we

really have to mean it. On the fiscal side, perhaps the most crucial element is an adequate tax system. We must have a reliable base for fiscal revenue. It would be a serious mistake to draw up revenue plans on the assumption that there will be a need to resort to inflationary finance, not least because this will tend to mean that the adoption of a proper tax system will be delayed. More broadly, if fiscal deficits are not eliminated to a large extent, then there is unlikely to be much confidence that convertibility will be viable. These considerations have surely provided the rationale for the recent emphasis placed on the need for a restrictive fiscal stance in both Poland and Czechoslovakia.

On the monetary side, much was discussed on the problem of monetary overhang. And indeed the first step in the introduction of monetary control in a previously centrally planned economy must be the elimination of the initial monetary overhang, if such an overhang exists. Unless the monetary overhang is eliminated, convertibility is surely doomed, because if this excess liquidity is unleashed by the liberalization of markets, there will surely be a severe drain on the international reserves. So this is a first priority. But what is the best way to deal with an overhang? Many argue that interest rates must be raised to make the holdings of domestic monetary assets sufficiently attractive. I regard this as very good advice, but unfortunately the requisite hike in domestic interest rates is likely to exacerbate the problem of the budget deficit. This leads me to underscore my earlier point: there had better be an adequate tax system in place prior to the increase in interest rates because otherwise, the moment you make your currency more attractive by raising interest rates, you also, at the same time, say to the public in effect, "We intend to raise taxes," because you are creating a deficit. Furthermore, an excessively high rate of interest may translate itself ultimately into a tight credit crunch which will operate on the economy as a supply shock. Thus, while it is wise to raise interest rates to avoid large negative real rates of interest, excessively high rates may be too costly.

The second means of eliminating the monetary overhang is to sell state enterprises to the public. Again here, there are implications for government revenues and the tax system, since the enterprises, once privatized, will no longer be generating revenues directly for the

government. Furthermore, unless a credible tax system is in place, the (once-and-for-all) proceeds from such sales will be lower than they would otherwise have been, since the sale price will reflect the probability that these enterprises, once sold, might be the target for new taxes which the government, with its revenue needs, will be tempted to levy. So again, the need for an adequate tax system is up front.

Finally, I turn now to the *fourth* precondition—a well functioning system of prices and incentives in the domestic economy. This fourth condition is at least as essential as the other three, because if the external economy is fully liberalized, any significant disequilibrium in the domestic economy which is allowed to remain will spill over into the external economy and threaten a drain on the reserves. A reformed price system which is aligned with world prices, needs to be in place.

As far as this fourth precondition is concerned, the Achilles' heel—as we know from the experience of recent cases—is likely to be the behavior of state enterprises in the early phases of the price reform. If the decision making process in the state enterprises is not guided by considerations of efficiency, the fulfillment of all the other preconditions may not do much good. There has to be a clear perception in each enterprise that its objective is profit maximization: otherwise, the nascent market economy is unlikely to bear the fruit for which it was planted. The exposure to world prices will not do much good unless it guides management in its economic decision making.

Of course, privatization may do the job as the private sector is more likely to aim at profit maximization which in turn will enhance efficiency. But privatization may, at least in some countries, have to be a very long process, and it would be disastrous if we had to wait for this process to be completed before we attained the improvements in efficiency: ways must be found of improving efficiency even while enterprises are still in the hands of the public sector. The aim should be to develop incentive schemes that will yield efficient allocation of resources while allowing for the reality that a diverse pattern of private-public ownership is likely to prevail for several years.

What can we infer from all this about the pace of reform? Well, the appropriate pace must depend on satisfaction of the preconditions. If those preconditions were in place yesterday, then the adoption of currency convertibility could have taken place yesterday. But, if the preconditions are not in place, then we must be aware that premature convertibility may be very costly and failures may discredit the entire reform process. Just as the stabilization of inflation through the adoption of an exchange rate anchor is likely to be successful only if the fundamentals are in place (that is, if it is supported by the appropriate fiscal and monetary policy) so here, convertibility is most likely to be successful if the preconditions are in place.

Of course, one should not allow for an unwarranted delay. There will always be the pressure from anti-reform groups to use the argument that the preconditions are not satisfied in order to stall the reform efforts. Keeping this in mind, however, great efforts must be exerted to address seriously the issue of the preconditions. As far as the debate between gradualism and nongradualism (or "shock treatment") is concerned, I believe that pragmatism is called for. Some actions, by their nature, cannot be taken gradually. Credibility and effectiveness require a decisive move. In many areas, there is no choice between gradualism and nongradualism: what is best is to go at the fastestpossible pace, as long as it isfeasible. At the same time there are other areas which require complex infrastructure which can only be built over time. This may sound like a tautology, but it is not.

It would be a mistake to assume that there is a technically rigid tradeoff that policymakers can choose. Past experience with "tradeoffs" guiding policymakers—the Phillips curve, for example—showed us how illustrativesuch tradeoffscan be. In this context I would take issue with the view that during the process of reform and the adoption of currency convertibility, it may be reasonable to aim for modest inflation. I shall readily admit that modest inflation may well arise in the transition process. But if you start by aiming at modest inflation, it is less likely that you will have it; you are more likely to have significant inflation.

Let me make one final point. In his opening remarks to the conference, Paul Volcker asked: why do we focus on central banking when we analyze the process of economic transformation? In his own remarks, Jerry Corrigan has given some answers, and I will just add that the question brings to my mind the remark of William McChesney Martin, the chairman of the Fed for 20 years from 1951 through 1970. In describing the role of a central bank, he said that a sound central bank must always take away the punchbowl just when the party gets going. Without a strong and independent central bank, there is a great danger that nobody will take away the punchbowl in time. If fact, the political pressures are likely to operate the other way and result in accelerated inflation. And we are all familiar with the many reforms that fell victim to inflation. Thus, it is only natural that in launching a comprehensive program of economic transformation, careful attention should be given to the unique role of the central bank.

Commentary: Currency Convertibility in Eastern Europe

Some Messages from Latin America

Arnold C. Harberger

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

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

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

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

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

My own perception is that the economies of Eastern Europe have adapted to a set of prices that is tremendously different from the one

that will prevail when linkage to the world market is complete. The task facing these economies is thus quite closely analogous to that facing highly trade-distorted economies at the beginning of major liberalization efforts. A well-designed auction system is one way for such economies to replicate the successive steps of a comprehensive liberalization plan.

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

On Bergsten and Williamson's critical choice between big bang and gradualism, I surprised even myself by, after considerable thought, coming out in favor of both. My main point is that big bang is one scenario and gradualism is another, and that there are circumstances in which one might be called for and quite different circumstances that point to the other. I should emphasize here that I am talking about a country's using these strategies to overcome major distortions. And, coming from my Latin American background, I tend to think of inflation as being a core component of the initial distortion package. The main message is that for a big bang to work, the fiscal and quasi-fiscal sources of inflation should already have been stopped. If major fiscal reform is part of the big bang package, I prefer to see its full effects first, and only then take a step

like moving to a fixed exchange rate. Fiscal reforms usually take much longer than planned, and rarely reach their full revenue targets. This double slippage has caused the failure of countless reform packages. This is why I feel prudence dictates opposing a big bang when major fiscal reforms are part of the package.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Overview

Leonhard Gleske

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.

Overview

Alan Greenspan

Being the last one on the program after two days of extended discussions, I am almost inclined to say I agree with everything that has been said and then sit down. However, what I intend to do is basically try to review some of the broader aspects with which we are confronted in this period of transition.

I would like to begin where I think the beginning is, namely to try to get some judgments about the nature of centrally planned economies and their financial structure and how that compares with a financial system that is market based. In one sense, the extreme version of centrally planned economies has no financial system. It has no prices, it has no money, it has no values as such. Therefore, there is no need for any financial structure to implement the allocation of resources.

This theoretical construct is in fact the basis of what we have seen in Eastern Europe over most of the post World War II period. In such an economy, the allocation of resources largely replicates the value systems of the leaders of the society, whether it be through a detailed physical input-output system or in a somewhat arbitrary manner. But in principle, if one is basically constructing a vector of demands that are thought to be the appropriate end result of the choices by leaders, one can mechanically calculate precisely what is required to produce the desired outcome. We need so many tons of heat-treatable aluminum plate, for example, to make so many MIG-29s. Or we need a certain physical amount of steel I-beams to build

certain bridges. But as Andrew Crockett pointed out earlier, in this type of system, finance does not drive the allocation process and indeed it has got very little purpose to it.

Now as a practical matter, it is fairly clear that this pure centrally planned system cannot work, has never worked, and in fact has really never been fully implemented. The obvious reasons are those which would have been discussed in many texts, over many years, and over many generations. Nonetheless, a version of the system with many of its problems has existed in the post World War II period in Eastern Europe, and throughout its history, until very recently, in the U.S.S.R. There are financial institutions, banks and a number of savings associations, and there are quasi-financial organizations. But their essential purpose is not to facilitate the allocation of goods and services that comprise a market economy.

Instead of using a physical materials vector imposed by the leadership of the society, a market economy uses the value preferences of the society to allocate resources. We are, of course, all familiar with how those value preferences, working through the financial system, allocate goods and services in a way which we presume to be optimally efficient.

But this is obviously not the purpose of finance in a centrally planned economy. Basically, the purpose is bookkeeping. The sole purpose of prices and financial claims in many of these societies until recently has been only peripherally to allocate or ration resources. When there are inadequate goods or materials, queueing does the allocation, thereby reconciling the production of goods and services with their consumption. Banks are essentially bookkeeping organizations which accept deposits and extend credit to government enterprises as part of the centrally planned allocation process. Under those conditions, you really do not have any particular purpose for financial institutions other than the types of financial "monobanks" which existed. Merely constructing them in that context adds very little to the system.

As Paul Volcker pointed out yesterday, the centrally planned economies did not until very recently exhibit any significant infla-

tionary processes. As many of the contemporary practitioners are now becoming acutely aware, such a system is biased fundamentally toward inflation since credit is not extended according to productivity criteria in a market sense, and competition is explicitly disallowed in these systems.

You end up with a very clear need for a financial system as you move from central planning to a market system. What we have heard in the last two days from our Western colleagues, our new Eastern colleagues, and those who have been practicing the art for a number of years is a general awareness of how this process is starting to function in practice. What we are observing is the evolution of a market system, as you begin to get the allocation process increasingly moving away from central planning toward market-based processes. As these market-based processes proliferate, the need for financial elements begins to emerge. You will begin to get not only commercial banks but also securities organizations and insurance companies of the Western type. You will also begin to get the whole panoply of various different financial instruments which evolve in our market economies as instruments to assist in the efficiency of the allocation process that a competitive market system tends to generate.

When one looks at this overall process, it becomes increasingly clear why commercial banking arose as market economies themselves evolved. In the contemporary as well as in the ,historic context, banks have a crucial credit rationing and resource allocation role, as Jerry Corrigan pointed out in his very thoughtful paper earlier today.

The crucial question for market economies, and increasingly for the Central and East European economies as well, is how do we know the commercial banks are doing it right? And here, we do have a test. Excluding subsidies to the commercial,banking system, of which regrettably there are many, the ultimate determination of whether or not the commercial banking system is contributing to efficient allocation in a manner which creates wealth is the profitability of the institution. (Remember, I am stipulating there must be adjustment for the various subsidies which are in the system.)' It is clear that in the underlying intermediation process by

commercial banks, what they basically do is to try to augment what the simple market model is producing.

The simple market model is one in which there is no intermediation process, no commercial banks, and no financial intermediaries. All savings go directly into investment, and the savers hold direct claims on those investments. What one finds in that type of activity is a real interest rate that is clearly higher than that which exists in an economy in which significant and effective intermediation exists. And the reason that occurs, of course, is that the commercial bank intermediation process involves the accumulation of a variety of investments in a manner in which diversification reduces the basic risk in the total portfolio relative to the individual items. Accordingly, a claim against that portfolio can be offered to depositors at rates below the average rate on the total investment portfolio. To the extent that the commercial bank is able to do that, it is clearly creating a risk reduction service to the economy as a whole. That service reduces real interest rates, increases investment, improves productivity, and raises standards of living. The crucial question is whether the commercial bank is able to sell claims against its portfolio at interest rates sufficiently below the average yield on the portfolio to cover not only the costs of banking services, but also the imputed cost of equity capital, which is a necessary part of the evaluation.

In theory, I think the issue is very clear cut. If the commercial bank is profitable, it is creating value, it is creating wealth, and it is improving efficiency. If it is not profitable, it basically should be disbanded. The problem here, obviously, is that even in the United States, where we have a generally free banking system, there are still significant subsidies. Those subsidies, which result from our safety net, distort the evaluation process. Much the same is true in Europe and the Far East. And I should hope that our colleagues who are constructing these organizations in the newly-emerging economies try to avoid some of the mistakes that I think we have tended to make. I will come back to this issue in a moment.

As was indicated earlier today, central banking evolved from commercial banking. The basic function that created the potential value of central banks was their ability to assist the commercial banks

in maximizing value added by intermediation, thereby creating wealth. A central bank does this by liquefying illiquid assets of commercial banks, or in certain instances, of other financial institutions. What is happening when we open the discount window and create loans is that we effectively are enabling a commercial bank—or in some rare instances, another type of financial institution—to convert a long-term claim to a demand claim.

The ability to have that service available enables commercial banking to be far more effective. As a result, the service contributed by the central bank has an economic value in the total market system. In some instances, the fee that is charged for that service is close to its implied market value. In others, such as in the United States where our discount rate is below market rates, at least for those individual transactions, there is a subsidy--although there is a long argument that we can make about offsetting elements involved in reserve requirements and the like, which make the net subsidy something less. But the point at issue is that the service of enhancing liquidity is what is crucial to commercial banking and was the major element, and indeed continues to be one of the most important elements, involved in what central banks do.

The issue of the central bank creating inflation, I think, requires breaking down this problem in somewhat more detail. I think it is fairly clear that when we had central banks under a gold standard, the issue of inflation did not come to the fore as a problem. Basically, gold points and a variety of other mechanisms essentially restricted the credit creation of the financial system and regulated through international gold flows the extent to which inflation could take hold. However, with contemporary central banking, domestic currencies are accorded value by fiat. It has thus fallen on central banks to preserve the value of the domestic currency directly rather than being able to look to automatic processes. As Allan Meltzer pointed out yesterday, however, there are innumerable such institutional arrangements throughout the world in which a "gold standard without gold," as he put it, can thoroughly function. And in such instances, I would suspect the inflation problem that we often associate with central banks is not something which we are particularly concerned about.

Obviously, also implicit in the monetary functions of central banks are the supervisory functions and oversight of at least part of the payments system, as well as a number of other collateral functions. The issue, however, that is important for us in the West to communicate to our colleagues in the East is that there is no single Western central bank model that is necessarily the one that we would recommend they follow. More importantly, merely because we have had what by all measures is a successful financial system, we should not presume that, therefore, the process by which the institutions all evolved were ideal and not subject to improvement. In fact, we have constructed innumerable institutions which are less than efficient in the sense of maximizing the value of intermediation. We in the United States have constructed numerous specialized institutions--banks, for example, that are unduly involved in agricultural credit only, or savings and loan institutions whose portfolios have been historically very heavily in fixed-rate mortgages. These specialized institutions essentially violate the principle that what a commercial bank should do is to create diversification and in the process, reduce risk, thereby adding value in the financial services area.

Finally, let me just say that I 'suspect the major problem which confronts our Eastern colleagues in the construction of market economies—and, specifically, of commercial and central banking institutions which are structurally supportive of those economies—is a fundamental issue that I guess one must term ideological. I think it is fairly clear that market economies have created practical success and are by all evidence clearly superior to centrally planned economies. What is not clear is that the value systems of the Eastern European societies have also shifted. Competition, profit, speculation, and entrepreneurship generally are still pejorative terms in the East and, regrettably, also in a number of areas in the West. I think an essential element in the evolution of market economies in the East is going to have to be a major education effort. At lunch yesterday, Vaclav Klaus made it clear that time cannot come too soon.

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