EC330-3-SP – Lecture 8

Convertibility and Exchange Rate Policies

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Plan of talk

- **Introduction**
1. Bloc, or functional, autarky under Comecon
2. Reintegration into the world economy
   - currency convertibility
   - exchange rate regimes
3. Trade-offs b/n float and peg in transition experience
- **Wrap-up**

Aim and learning outcomes

- **aim**: understand
  - the importance of the external sector of the economy in transition reforms
  - the particular choices made in their implementation
- **learning outcomes**
  - explain why post-socialist countries needed reintegration into the world economy
  - classify convertibility according to its degrees
  - discuss the trade-offs between float and peg
  - evaluate transition experience with exchange rate management

"Bloc" autarky under Comecon

- **foreign trade system** of socialist economies before transition
  - *imposed* on the East European countries by the Soviet Union
  - manifestation of the ideology of *self-sufficiency* which dominated Marxist-Leninist economic thought
- **institutional framework** provided by the Council for Mutual Economic Assistance (CMEA), better known as *Comecon*
  - established in 1949
  - dissolved in 1991
  - during its existence, trade with the other **socialist** countries accounted for some 60 to 75% of *total* trade in *each* of the Comecon members, with the biggest part usually trade with the USSR

Functional autarky, not self-sufficiency

- Holzman (1974), *Foreign Trade under Central Planning*
  - trade with **capitalist** economies, generally accounted for b/n 10 and 25% of total trade even under central planning
  - with remaining percentage filled up by **developing** countries
  - **state trading** as the *essential core* of this functional autarky:

    state monopoly in the area of foreign trade corresponded to state ownership over the "means of production" in the entire economy
    - only state *foreign trade organisations (FTOs)* specialised by economic branch or group of products allowed to handle foreign trade relations
    - *introduced in Russia in April 1918*, following the first nationalisations
    - *survived*, in its traditional form, in socialist economies *by the early 1980s*

Socialist FTOs

- **subordinated** to the ministry of trade and/or attached to the relevant branch within the industrial ministry
- acted as **intermediary** b/n foreign partner and domestic enterprise
  - with *capitalist* partners, FTOs dealt on the basis of international prices and in foreign currencies
  - with *socialist* partners, trade was effected according to CMEA prices and settlements were accounted in transferable roubles at the International Bank for Economic Cooperation (IBEC) created together with CMEA for that purpose and based in Moscow
  - with *national* state-owned enterprises (SOEs), transactions were effected in the domestic currency and prices
- **40 to 60** such FTOs in *each* centrally planned economy
- *Soviet* FTOs were very **large and powerful**: *Soyuzneftexport* was the single largest oil exporter in the world

Planning of foreign trade

- foreign trade was planned and coordinated at a national and “bloc” level (CMEA) using *standard* **material balance** *tables*
  - **imports** were required
    - when planned domestic resources were insufficient
    - and when it was not easy to save on domestic uses of a good
  - ways to increase some **exports** had *then* to be found, looking at cases where *curtailing domestic uses* seemed possible
- according to Lavigne (1999), such an approach has **two aspects**
  - foreign trade is treated as an activity *secondary* to domestic trade
  - imports are given *priority* to exports: a country is supposed to export mainly to pay for its imports
- from **“import-led growth”** (Hanson, 1982) until the 1980s to **“export dynamism”** and reforms afterwards

Inconvertibility of socialist currencies

- they **could not be purchased/sold** against other currencies
  - at a *single* exchange rate
  - *without* restrictions
  - and for *all* purposes
- *degrees* of (in)convertibility, **multiple** exchange rate system
- **prohibition** for *households*
  - to maintain foreign currency accounts at banks (domestic or foreign)
  - to effect exchanges of money for any other purpose except tourism
- *FTOs* and *SOEs* **allowed** to maintain accounts in foreign currencies in order to effect payments on their transactions
  - but a huge part of the *proceeds* from exports had to be kept at banks within the *national* territory
  - in particular, on accounts with the specialised *Foreign Trade Bank* that enjoyed the *monopoly on payments abroad* in each of these economies

Types of convertibility

- *IMF* has defined **two** major types of convertibility
  - ***current* account convertibility:** to effect payments on transactions classified in the current account of the BoP, i.e.
    - goods, e.g. imports
    - services, such as transport and travel abroad
  - ***capital* account convertibility:** to effect payments on transactions classified in the capital account of the BoP, i.e.
    - foreign direct investment (FDI), e.g. building a factory abroad
    - portfolio investment, e.g. buying a foreign government or corporate bond
- various **degrees** of convertibility in transition economies
  - *direction* of transaction: internal vs external convertibility
  - *horizon* of investment: LT vs ST capital account convertibility
  - (unlimited) *current* account convertibility has been introduced rather early in the reforms but *capital controls* have been phased out gradually

Convertibility, but which and when?

- arguments in favour of a **quick** *current* account convertibility
    1. importing the *correct relative price structure* from the world economy, thus stimulating local industries with comparative advantage
    2. strengthening the *commitment* of governments *to liberalise domestic prices*, due to arbitrage if internal prices remained centrally imposed
- arguments in favour of a **phased** *capital* account convertibility
    1. newly liberalised currencies remain vulnerable to *speculative attacks* and *capital flight*, the more so with *underdeveloped* domestic financial markets limiting hedging opportunities
    2. *monetary policy* becomes far *less effective* as a tool of macroeconomic policy, hence a huge burden falls on *fiscal* policy

Exchange rate regime

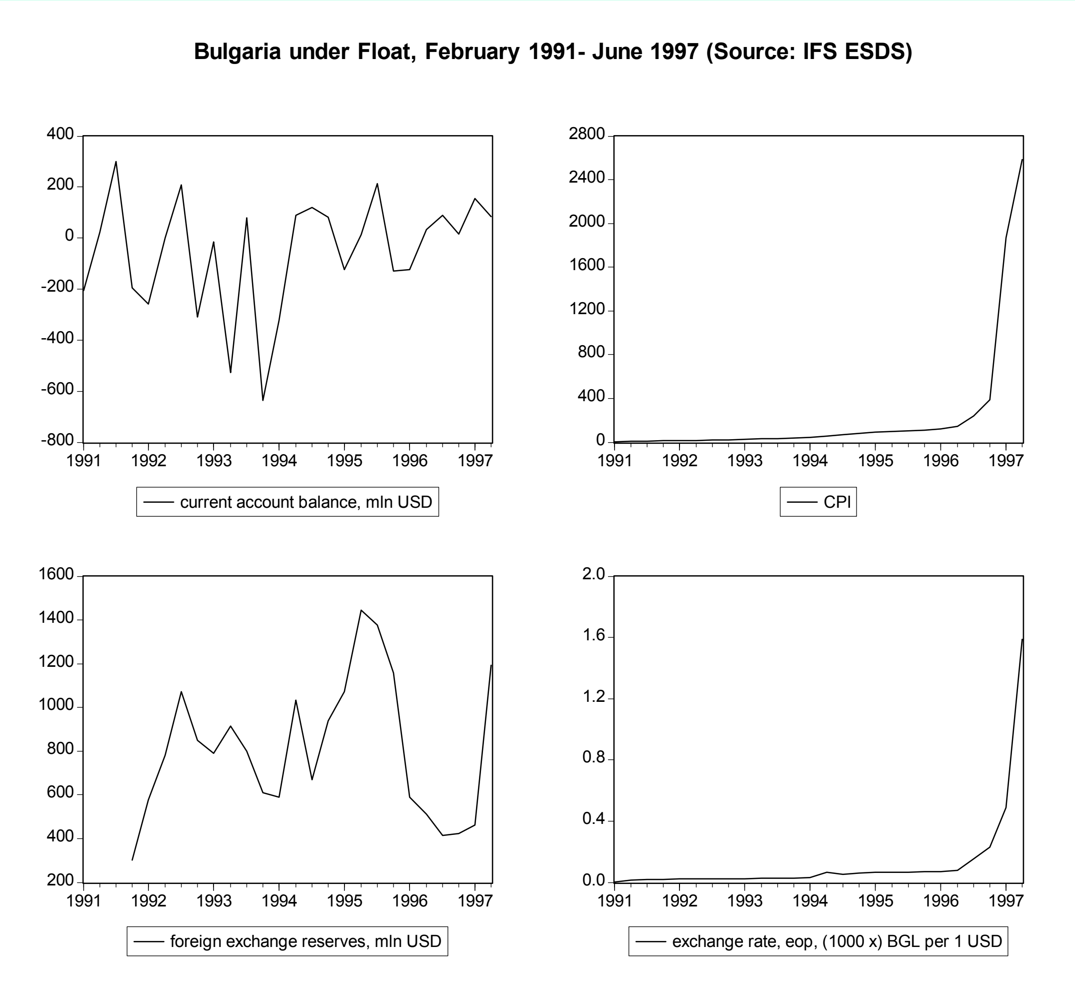
- in **theory**
  - (pure) *float*: the central bank leaves the value of the national currency to be completely determined by the *market*
  - (credible) *peg*: the central bank engages to maintain a *constant* exchange rate against a foreign currency (or a basket of currencies), **possible**
    - only if the central bank has enough foreign exchange *reserves* to intervene
    - and only to certain limits, defined by the underlying *"fundamentals"*
- in **practice**
  - policy makers often adopt neither (pure) float, nor (permanent) peg
    - managed or "dirty" floats
    - adjustable or "crawling" pegs (bands)
  - an *extreme* case of a *peg* that has been popular in transition countries (first Estonia, then Latvia and Bulgaria) is the **currency board**

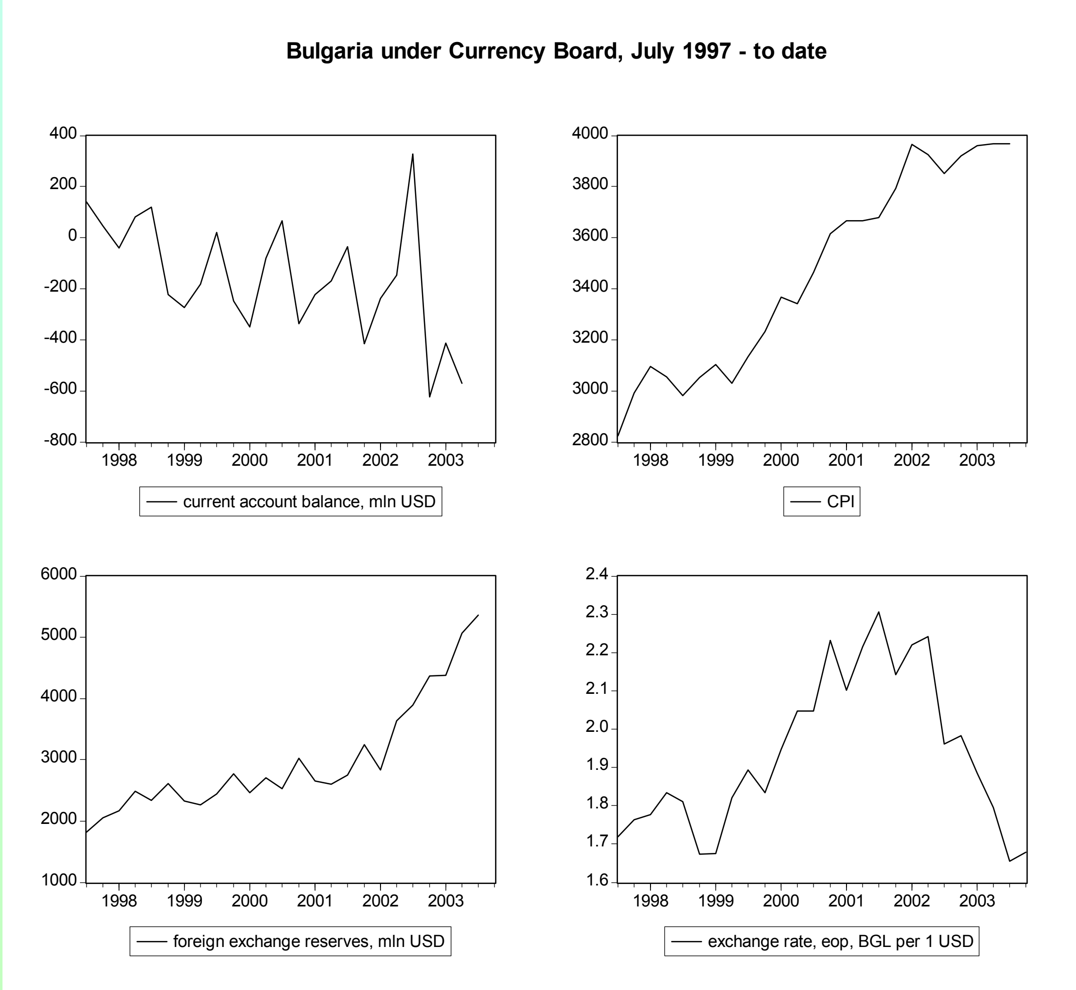
    beyond it, the national currency has to be surrendered
      - monetary union (e.g. the euro in the Euro-zone)
      - "dollarisation" (e.g. Panama)

Trade-offs between peg and float

- **fixed** exchange rate: key *advantages*
  - contributes to less overall macroeconomic uncertainty (volatility)
  - helps fight inflation, and could be used as a "nominal anchor": the monetary authority binds itself not to inflate at a rate higher than world inflation, "importing" policy credibility from a central bank with low-inflation reputation
  - it, however, can also "import" any negative tendencies in the world economy into the domestic economy
- **flexible** exchange rate: key *advantages*
  - allowing adjustment to shocks, ensures automatic equilibrium of the BoP
  - permits autonomous monetary policy
  - "immunises" the domestic economy against "outside" business cycles
- popular *transition* options in the "**intermediate** ground"
  - *crawling* peg, or rather crawling band: in Poland since October 1991 (initially reforms started under a peg)
  - *adjustable* peg: in Hungary until April 1995

Bulgarian transition: float then board





Bulgarian transition: **float** comments

- *initial* **foreign exchange reserves**: no other choice but to introduce a flexible regime for the lev
- lev/dollar (end of period) exchange rate and **CPI**: have tended to broadly move together, but this high correlation does not necessarily mean causation
- **current account**: roughly in balance => may support claims that a float helps the automatic adjustment to external shocks
- *accumulation* of **reserves**: what has been received mostly from the IMF as reform-supporting loans has been lost in the banking crisis of 1996 and the subsequent hyperinflation <=> *dirty* float

Bulgarian transition: **board** comments

- **CPI** has tended to move again roughly with the lev, fixed to the euro and hence following the euro/dollar trends => a credible peg seems to help in containing inflation…
- … but a major trade-off is that, due to some real appreciation, the **current account** has definitely gone into deterioration…
- … the good news is that **reserves** have grown at an impressive rate (not only because of the stable lev, yet to a large extent due to it)
- longer-run **sustainability** – hence, credibility – of the currency board will depend on the extent to which inflows of (non debt-augmenting) capital would compensate for the current account deficits
- a common feature of experience with currency boards during transition, not only in Bulgaria but also in Estonia an Latvia, is that they have tended to help restore (relatively high) **growth** relatively quickly

Concluding wrap-up

- **What have we learnt?**
  - why transition countries needed reintegration
  - which are the major types of convertibility
  - what are the pros and cons of polar exchange rate regimes
  - what choices have transition countries made in their exchange rate policies
- **Where we go next**: to the structural phase of transition reforms, and to privatisation in particular