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**CURRENCY CONVERTIBILITY IN THE LIBERALIZATION PROCESS OF
THE FOREIGN SECTOR : THE CASE OF THE RUSSIAN FEDERATION**

by

NATHALIE POIRIER, B.A.

**A thesis submitted to
the Faculty of Graduate Studies and Research
in partial fulfilment of
the requirements for the degree of**

Master of Arts

Department of Economics

Carleton University

Ottawa, Ontario

May 12, 1993

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THE FOREIGN SECTOR : THE CASE OF THE RUSSIAN FEDERATION

submitted by Nathalie Poirier, B.A.

in partial fulfilment of the requirements for
the degree of Master of Arts

Thesis Supervisor

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Carleton University

12 May 1993

à mes parents,

à Jérôme,

ABSTRACT

Discussion of convertibility generally boils down to the choice of a realistic exchange rate, a well defined exchange regime and a developed internal exchange market. In the case of the Federation of Russia, the achievement of a convertible system, even limited, is a matter of removing all the distortions inherent to a centrally planned economy. However, the process of implementing a market in Russia is presently facing many formidable obstacles. In the context of a deep economic crisis, the feasibility of full current account convertibility is questionable. Any partial versions of current account convertibility should only be viewed as a form of redistribution of foreign currency in the domestic economy, that is, a first major step to free the market for foreign exchange.

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INTRODUCTION

The opening up of a centrally planned economy (CPE) to the world economy that implies the liberalization of foreign trade involves far reaching changes at all levels. Never before, in other countries' experiences - for instance, the well known case of Latin American countries - has the process of liberalization involved such large scale economic, structural and institutional transformations.

The reason is quite clear : the integration into the world economy of planned economies is unique because the willingness to integrate into the world economy is first of all fuelled by the willingness to accomplish a transition from a CPE to a market economy.

As opposed to some Latin American countries, the process of transition in the former CPE has more dimensions, even though we believe that at certain levels of broad generalization, some lessons can be learned from Latin American experience. The aim is not only to stabilize and deregulate the economy, but also to introduce basic institutional and systemic changes.

Hence, prior to any liberalization attempt, the old legal and institutional structures of centralism must be dismantled so as to allow the implementation of an efficient market type economic framework and functioning mechanisms.

Given that in a CPE one of the main instruments for restricting trade was the denial of foreign exchange except for approved purposes, reinforced by the inconvertibility of the domestic currency, the crucial step in liberalizing the foreign trade sector, besides dismantling the traditional institutional monopoly of foreign trade and providing enterprise autonomy in foreign markets, has to be the establishment of convertibility.

The concept of convertibility is multifaceted. Taken in its broadest sense, it includes currency convertibility, the exchange rate regime and liberalization of foreign trade. An understanding of the concept of convertibility, as well as the related concept of limited convertibility, is essential to fully grasp the issues raised. Hence, in part one, an important initial task will be to establish a precise definition of currency convertibility.

In a sub-part, we shall stress the nature of inconvertibility as well as review the main consequences of financial controls and restrictions on current transactions. Given their distorting nature, the achievement of a convertible system should be regarded as a necessity (at least in the longer term) and as a useful instrument for any economy aiming at full integration into the world economy.

In this perspective, the core of our discussion in part two will address the following points :

- at which phase of the transformation process is it best to establish convertibility?
- are there any advantages to establishing a limited degree of convertibility during the early stage of the transition before achieving full convertibility ?
- what are the pre-conditions necessary prior to convertibility ?
- in light of two Latin American countries' experience, Chile and Argentina, in which order must the process of integration be achieved : current account liberalization first followed by capital account liberalization or vice versa ?
- what lessons can we draw from the experience of these two countries ?

This second part will deal with the process of liberalization toward an unrestricted convertible system in general and in the particular context of a CPE. To be even more concrete, we have chosen to illustrate our discussion in part three with a case study.

Until the late 1980s, the Soviet Union possessed all the features of a CPE.

The process of economic and political reforms toward decentralization initiated thereafter modified many of these characteristics. A few market type elements were introduced, such as greater enterprise autonomy and encouragement of

various forms of private enterprise. Nevertheless, the system of planning and management was still functioning according to a classic CPE. The August 1991 attempted "coup d'Etat", however, marked the turning point. With the dislocation of the Soviet State, political and economic transformation has become an urgent reality. The successor countries, which formed the Commonwealth of Independent States (CIS) have thus begun their transition to market economies, or at least seek to build modern market institutions as their basic economic structures. They have inherited economies which are very diverse, reflecting their disparate origins and economic conditions before and during the existence of the USSR.

For the purpose of this paper, we shall concentrate on only one of them : the Federation of Russia. Four reasons motivated our choice. First, Russia is the legal successor of the Soviet Union. Second, it is the first of the successor States to attempt serious economic reforms and to have some sort of global plan. The third factor is related to the second one : the state of the reforms is more advanced and as a result, its "economic structures" are relatively better organized. Fourth, the Russian Federation accounts for more than half of the economic weight of the region.

In light of our findings in the first two parts, we shall be able to evaluate the state of advancement of the transformations undertaken in the Russian economy.

At the same time, we shall clarify the often raised question as to whether a move toward convertibility and external liberalization has been achieved in the Federation of Russia. If yes, is it viable ?

We shall show that, at the present time (November 1992), the Russian authorities have not, in practice, satisfied the necessary pre-conditions for introducing even a limited degree of convertibility.

Given the complexity of the whole liberalization process and the high degree of interdependence between the various economic elements involved in that process, the reader must not expect an exhaustive treatment of all the reforms, mostly in the internal sector, which need to be undertaken prior to currency convertibility. In this regard, we intend to provide a reasonable (but not exhaustive) insight into those pre-conditions, at least satisfactory enough to provide the basis for a meaningful analysis.

<<For the East European countries undergoing radical transformations, convertibility is not simply a question of international economics, nor a monetary issue. It is central to the process of transformation and must be situated within that process in a way appropriate to the particular country concerned.>> [Portes (1991)]

PART ONE

DEFINITIONS OF CONCEPTS

A\ The Concept of Convertibility

i. General Definition

"Convertibility" is a word with several meanings.

In practice, the "convertibility" of a currency is a relative concept with different degrees. It can be assessed in relation to an abstract norm of freedom to use or exchange any amounts of the currency at some defined rate of exchange.

Traditionally, the concept was derived from the possibility of converting paper money into gold at a parity guaranteed by the emitting institution. [Van Brabant, (1991, p.56)] Today, gold is an irrelevance and convertibility means the right to exchange domestic currency into convertible foreign currencies ("hard currencies").

Early definitions therefore attached an official obligation to maintain a par value in the rate of exchange between domestic currency and foreign currency.

In particular, the domestic currency balances of non-residents were to be redeemed at a known parity. [McKinnon, (1979, p.6)]

In contrast 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 just at an unofficial or parallel rate (normally depreciated).

Apart from the standard definition, three other concepts of convertibility merit mention.

Since the Second World War, convertibility has been virtually limited to payments of current account transactions (that is, the purchase of goods and services from abroad). Such "current account convertibility" requires that no restrictions be placed on obtaining currency for current account transactions, including tourism and the repatriation of foreign investment incomes. It is the concept of convertibility used by the International Monetary Fund (IMF), and it will be further discussed in the next section.

The second concept is "unrestricted convertibility" (or "full convertibility").

One speaks of unrestricted convertibility if a currency can be exchanged into a foreign currency freely, for any purpose (including the purchase of foreign assets) at the legal exchange rate. A currency becomes convertible in this sense only when exchange restrictions on capital exports are abolished, so that residents have the right to export capital in unlimited quantities at the official exchange rate. In simple words, it means that a currency is convertible for both current and capital account transactions.

The third concept is "commodity convertibility". While financial convertibility is identified with the possibility of changing a currency into any other at the

exchange rate prevailing in the market, commodity convertibility means, according to Van Brabant (1991, p.57), <<that the holder of a currency is entitled to purchase any desired goods or services at [the] prevailing price in the currency's home market.>> Commodity inconvertibility also means in the context of high inflation that money has no purchasing power to buy the commodities in the domestic economy. Commodity inconvertibility is generally related to the phenomenon known as "flight from the domestic currency". Alternatively, in the context of a shortage economy, it can mean that since there is nothing to buy, money is inconvertible into goods.

Discussions in the context of East European economies typically use two other concepts, namely "internal" (applying to domestic residents only) and "external" (applying to foreign residents only) convertibility rather than the traditional distinction between "unrestricted" and "current account" convertibility.

This distinction relates to who should be allowed to exchange domestic for foreign currency, rather than the purpose for which such exchange should be allowed.

More precisely, "internal" convertibility relates to the right of domestic residents <<to sell freely domestic currency at a single but possibly variable rate in exchange for foreign currency in order to finance the importation of goods and services on current account, or to remit profits to a foreign firm without any need for administrative permission>>. [Havrylyshyn and Williamson, (1991, p.44)]

<< Such freedom to acquire and maintain domestic holdings of foreign exchange, however, is not tantamount to permission to make payments abroad or to hold assets located in foreign countries. Nor does it necessarily permit residents to hold any financial assets, other than foreign currencies.>> [Greene and Isard, (1991, p.4)]

On the other hand, "external" convertibility relates to the right for non-residents to make exchange operations. It implies that the national monetary authority is obligated to repurchase domestic currency balances (arising from authorized current-account transactions) from foreigners at a parity within the official margins either with convertible foreign exchange or with the foreigners' own currency. Foreigners would be allowed to sell their domestic balances in a unified open market for foreign exchange or, of course, to use those balances to make payments for other current transactions. [McKinnon, (1979, p.48)]

Note that this form of convertibility is narrower than the IMF's concept of convertibility, as stated in Article VIII.

ii. The IMF's Definition

The traditional alternative to "unrestricted convertibility" is "current account convertibility". As was mentioned, this is the concept used by the IMF.

According to this definition, a currency is considered convertible without limitation if it meets three criteria :

- i) usability : if it can be used without restrictions of a currency character for any reason whatsoever;
- ii) exchangeability : if it can be exchanged for any other currency without restrictions of a currency character;
- iii) exchange value : if it can be used or exchanged at its par value, or at a rate of exchange based on the par value, or at some legal rate of exchange defined in any other way considered desirable.

If these three criteria are not wholly satisfied, the currency may still be called convertible for some purposes or under some legal provisions, but the convertibility falls short of the theoretical maximum. [Gold, (1971, p.1-2)]

More specifically, according to a still commonly accepted definition derived from section 2 of Article VIII (of the Articles of Agreement) of the IMF,

<<no member shall, without the approval of the Fund , impose restrictions on the making of payments and transfers for current international transactions>>.

By "payments for current transactions" is meant payments which are not

<<for the purpose of transferring capital and includes, without limitation :

- all payments due in connection with foreign trade and normal short-term banking and credit facilities;
 - payments due as interest on loans and as net income from other investments
- (...)>> (from Article XIX)

The distinction between current international transactions and capital transfers is a very important one. In order for the Fund to assist in the establishment of a multilateral system of payments in respect of current transactions and in the elimination of foreign exchange restrictions which affects the growth of world trade, <<members may exercise controls of capital transfers as are necessary to regulate international capital movements. but no member may exercise these controls in a manner which will unduly delay transfers of funds >> in settlement of current transactions. (from Article VI, section 3)

It is, therefore, not part of the obligations of convertibility that members must refrain from discriminatory capital controls. [Gold, (1971, p.4)]

Note that this definition of convertibility implies an absence of discrimination, for instance as would be the case with administrative controls and multiple exchange rates. Convertibility, however, does not mean free trade. Though it excludes the use of administrative controls, it is consistent with protection through price-mechanism devices.

As Gold points out, although restrictions on merchandise trade will have the direct effect of limiting payments, it is not for that reason a restriction on payments within the meaning of Article VIII, section 2(a), because they are imposed for balance of payments reasons.

There are two other major concepts of convertibility in the Fund, the first being the current account convertibility embodied in Article VIII.

The second is a form of convertibility into gold. A member that freely buys and sells gold for its own currency without any exchange restrictions of any kind, within the prescribed margins of par, with the monetary authorities of other members for the settlement of international transactions is deemed to be fulfilling the exchange rate obligations of the Articles. The underlying theory seems to be that the member maintains the par value of its own currency in terms of gold by standing ready to engage in gold transactions for its currency with other members. [from Article IV, section 4(b)]. In some important respects, the former convertibility is more rigorous. First, a member is not freely buying and selling gold within the meaning of Article IV, if it has restrictions on the making of payments and transfers for current international transactions. A currency continues to be convertible under Article VIII even if it is subject to such restrictions.

Second, the free transaction of gold means that the member has no restrictions on capital transactions. It has been seen that the obligations of Article VIII do not prevent a member from restricting capital transfers. [Gold, (1971, p.36)]

The last major concept is the concept of "currency convertible in fact" which is associated with the Special Drawing Rights (SDR). As is explained in Article XXXII, this form of convertibility applies only to currency obtained in transactions involving special drawing rights and not to balances obtained in other operations or transactions. One condition that a participant's currency must satisfy in order to be a currency convertible in fact is that the currency be convertible under Article VIII or that the participant is freely buying and selling gold within the meaning of Article IV, section 4(b). However, we shall not discuss the complex characteristics of this third concept further.

While the traditional definition of convertibility extends only to "current" transactions, as long as the operations are related to commercial transactions, capital account transactions may be considered current for the purposes of satisfying Article VIII. Non-resident inconvertibility on capital account would therefore apply to any restrictions on capital inflows or outflows such as the purchase or selling of foreign exchange and securities other than suppliers'

commercial credits (which are normally granted by exporters or received by importers), to the extent that they are not conforming to normal commercial practices. [McKinnon, (1979, p.5-6)]

In summary, under Article VIII of the IMF's Articles of Agreement, member countries are obliged to avoid restrictions on current international transactions, multiple currency practice and discriminatory currency arrangements (except as authorized by the Articles or approved by the Fund). Moreover, the monetary authorities of a member country must convert balances of their currency when those balances are presented for conversion by the monetary authority of another member.

B.\ The Nature of Currency Inconvertibility

Inconvertibility develops in situations where the demand for foreign currencies exceeds the available supply (at the prevailing exchange rate) from exports, foreign exchange reserves, credits, or other capital inflows. When this situation occurs, the country has to ration the insufficient supply of foreign exchange among domestic and foreign economic agents. The larger the excess demand for hard currencies, the more inconvertible will be the domestic currency and the greater the degree of rationing of foreign exchange that is required.

Nations with overvalued exchange rates tend to have current account deficits. If persistent, these often lead to inconvertibility, as foreign exchange reserves are exhausted and additional credit becomes unavailable or too expensive.

C.\ Various Forms of Restrictions on Current and Capital Transactions or "restricted convertibility"

In the previous section, we discussed convertibility, with an emphasis on the IMF's definitions of this term. In reality, once the member country has accepted the obligations of Article VIII, derogatory norms can be introduced, and the member may impose, as an alternative to a change in parity (for instance, a devaluation), temporary restrictions of several kinds on its current account transactions in response to correct a payments deficit. It follows that various degrees of limited convertibility can be identified by the effectiveness of exchange controls and restrictions, quantitative and financial barriers to external transactions, etc.

i. Financial Controls

a) Exchange Control :

An important means by which the authorities in a deficit country (for example)

may attempt to restore equilibrium to the balance of payments is the restriction of payments to other countries by means of exchange control.

Under a system of controlled exchange rates, a central authority supersedes the market place by becoming the sole buyer and seller of foreign exchange. The exchange rate at which such transactions take place is no longer determined by the interaction of supply and demand forces but it is rather set by the authorities. In so doing, the control agency rationing supersedes the allocating function of the exchange market. In that sense, the currency is inconvertible.

Exchange rate control also appears to be an indispensable tool for managing economies in which there already prevails a limited degree of currency convertibility. An exchange control regime exists because the supply of foreign exchange at the prevailing price is less than the amount demanded. At this controlled (overvalued) exchange rate, the control authority will choke off the excess demand for foreign exchange by rationing market demand. It therefore provides an efficient way of restricting the use of foreign currency reserves, without altering the trade liberalization process.

For a system of exchange control to operate effectively, it is necessary that the purchase and sale of foreign exchange by the residents of a country using exchange controls be made illegal except through a State central authority. Every

resident in the country concerned who desires to make a payment in foreign currency must purchase that foreign currency (at the official exchange rate) from the central agent and from no other source. In turn, every resident who has acquired foreign currency must sell it at the official exchange rate to the exchange-control authority and must dispose of it in no other way.

By doing so, a country can directly control and effectively maintain equilibrium in the country's balance of payments with the rest of the world by rationing foreign currency to those who wish to make payments abroad and thereby restricting the demand for foreign currency to the amount currently received from current transactions, that is to an amount necessary to keep the balance of payments in equilibrium.

It is not our purpose to discuss in detail the technical problems involved in making effective any system of exchange control. Such a system to be effective does, however, require well developed bureaucratic regulations [Meade, (1951, p.264-266)]. That being said, an extensive use of foreign exchange controls amounts to a very low degree of convertibility. In fact, in such a case we should rather talk of "inconvertibility".

b) Multiple Exchange Rates :

An exchange-control authority may use its monopoly power to control, as we have seen, the rationing of the available foreign exchange at a single official rate of exchange. But as an alternative approach to allocating scarce foreign exchange resources, it can also use its monopoly power in a rather different way by no longer operating on the basis of one single official exchange rate.

Multiple exchange rates therefore result from official action when the authorities control foreign exchange payments in such a way as to create different exchange rates for different types of transaction, transactor, or currency. These practices fall into three main categories :

1) a dual or multiple exchange market system applying to broad categories of goods.

Multiple markets usually comprise an official market in which the supply and demand for foreign exchange are controlled and a free financial market that handles all other transactions. The free rate is almost always more depreciated than the official rate. In general, under that system, current account items are subject to a commercial exchange rate, and capital account items are to be settled at a (depreciated) financial exchange rate. Multiple markets typically penalize broad categories of suppliers of foreign exchange to the official market, typically

exporters, and subsidize groups of purchasers. As a result, the authorities control the transactions channelled into the official market.

2) fixed exchange rate on given transactions (a separate exchange rate for a limited number of specified transactions)

Specific foreign exchange transactions can either be subsidized or penalized by the authorities, forcing the purchase or sale of exchange at an over- or undervalued rate for the local currency. This practice is often used to hold down official expenditures on the servicing of government guaranteed debt, to encourage migrant labour to repatriate foreign earnings, or to penalize profit remittances abroad by foreign companies or payments abroad by residents.

By discriminating among various types of transactions, the central authority is thus able to alleviate the pressure on scarce foreign exchange resources by charging increasingly higher exchange rates corresponding to imports transactions of decreasing necessity to economic growth and welfare in general.

3) taxes (or subsidies) that accrue to (or are paid by) the monetary authorities on the value of some exchange transactions.

Similar in impact to fixing the exchange rate for given transactions and equally selective, these practices typically target current account transactions.

By using taxes and subsidies, a country can influence the various items in its balance of payments. The clearest examples of such fiscal controls are the imposition of import duties in order to reduce the amount of foreign products purchased and so to decrease the total expenditure in foreign currency upon them, and the imposition of an export subsidy, in order to increase the total receipts of foreign exchange from the exports concerned. Other examples apart from export bonuses or subsidies include mandatory advance import deposits (which pay no interest), taxes on remittances abroad, and taxes on sales of exchange by commercial banks. [IMF, (1989, p.13-14) and Meade, (1951, p.272)]

Why set multiple exchange rates? What are the aims?

It has been observed in most countries with multiple exchange rates that multiple rate systems are costly in terms of efficiency and resource allocation and they have not proven conducive to medium-term balance of payments adjustments. In that case why do the authorities have recourse to that system?

Most countries that have adopted multiple currency practices did so at a time of external payments difficulties. The underlying reason for a country to avoid the uniform exchange rate change - normally a devaluation - that would be part of a systematic approach to solving the problems is usually the belief that it will be politically and socially costly. Some countries believe a uniform devaluation would undermine growth prospects and complicate economic management by causing inflation; others believe that it would undermine social priorities by raising the cost

of essential food imports; and yet others believe that development prospects would be endangered by higher costs for imported inputs for certain industries. Multiple rates are thus used to address payments difficulties by attempting to relieve the pressure on different elements of the external accounts, generally imports and some important invisible payments, or to provide additional incentives for exports.

In some instances, using a dual rate as a temporary device to find a realistic level for a proposed unified exchange rate has been an effective transitional policy tool. In several member countries of the IMF, dual markets were established when the authorities intended to unify the fixed official rate with various other rates, official and unofficial, that existed but were uncertain about the correct level for the new rate. [IMF, (1989, p.13-14)]

ii. Commercial Controls

The total payments or receipts in a country's balance of payments may be influenced by commercial measures which set a limitation upon the amount (or the value) of a particular commodity which may be imported or exported. From general observation, such controls are maintained to offset excess demand for imports at an overvalued exchange rate or to increase export earnings.

a) Quantitative Restrictions (QRs):

A great variety of instruments may be employed in administering QR regimes, including : guarantee deposits, tariffs and surcharges, licensing, regulations and prohibitive lists, restrictions on the repatriation of profits and dividends of foreign owned firms, low interest loans for certain category of transactions, etc.

1) export incentives :

As the need for additional foreign exchange becomes pressing, governments introduce varieties of export incentives, which constitute a main source of foreign exchange earnings.

* export subsidy

An export subsidy is a payment made to exporters : it typically takes the form of a payment of a certain proportion of the value of the goods exported. Payment of such a subsidy increases the internal price of tradable goods, so that goods are exported at prices below the domestic price.

* rebate on duties

paid on imported inputs for the production of exportables.

*** granting of credit**

to finance either export transactions or the purchase of needed factors of production.

2) limitations on imports :

A quantitative restriction on the imports of a particular commodity may be fixed in terms of a maximum volume or in terms of a maximum value of the commodity which is to be permitted into the country. This reduces the deficit in the balance of payments.

*** quota and license**

The import restriction may be enforced by means of a global quota or by means of the issue of import licences to individual traders. With the quota, imports are allowed into the importing country on the principle of "first come, first served" until the permitted amount or value of the import has entered. The frontier is then closed to all further imports of the commodity concerned for the rest of the quota period. With the granting of licences to individuals which permit them to import given quantities or values of the commodity, the sum of all the individual licences adds up to the total quantity or value which is permitted to enter the country. Such restrictions, as we have said, limit the volume or value of imports.

They can also be used for the purpose of limiting the administrative allocation of foreign exchange, countertrade, prohibitions and other discretionary actions.

* tariff quota

Similar results can be obtained by means of a tariff quota, by which a certain restricted quantity of the commodity may be imported without duty or on the payment of only a low import duty, while additional quantities can be imported but only on payment of a much higher import duty. Therefore an ordinary QR on imports may be viewed as a tariff quota in which the duty on additional imports is prohibitively high.

* tariff

The imposition of a tariff on imports is equivalent to imposing a tax on importers. It directly raises the value of transactions (in the short-run) and lowers the volume of importables (in the longer run).

* advance import deposits

Under advance deposit schemes, usually in local currency, the authorities require importers to deposit with the monetary authorities or commercial banks a specified proportion of the value of an import transaction. In an environment of credit rationing, prior deposits are costly to importers in terms of foregone interest or profits on other uses of scarce capital. The cost of a guarantee deposit can be

translated into a tax equivalent for the importer. This type of control has been introduced to reduce import demand directly and, in most cases, indirectly, by restraining liquidity creation, which has often been excessive in some countries.

Many of these restrictions constitute outright bans and are maintained more or less permanently for health or security reasons. Otherwise, the maintenance or intensification of QRs on imports reflects the desire of government to protect particular industries, or even enterprises, or to conserve foreign exchange reserves.

For the IMF, QRs on imports and other trade restrictions are subject to surveillance because of their implications for exchange rate policies under Article IV, section 2 of the Articles of Agreement. The nature and especially the extent of trade restrictions can alter relative prices between sectors, leading to distortions in resource allocation and influencing the market-clearing functions of exchange rates.

iii. State Trading Monopolies :

Again, similar results to those obtained by QRs through the issue of a limited quantity of import or export licenses can also be obtained through a State trading monopoly. The State trading organization can now restrict the total quantity of the product which it imports as a means of reducing the value of the countries'

commodity imports and so diminishing the deficit on the balance of payments. And analogously, a State export monopoly can purchase a restricted amount of the product for export and dispose of it at a scarcity price to the foreign country, absorbing itself the monopoly profits on such restricted trade. State trading organizations can also be used for the purpose of expanding import or export trade in the same way which would result from the payment of import or export subsidy.

D. \ Consequences of financial controls and current transactions' restrictions:

The potential restrictions on payments and transfers for international transactions emanating from the proliferation of exchange controls and QRs practices are detrimental to the transferability of payments between trading partners, and thus to the promotion of a full convertible system. To the extent that <<greater realism to the integration policies to a multilateral system can be achieved if there are a gradual superimposition of transferability and later, of convertibility>> [Van Brabant, (1991, p.51)], these restrictions are also detrimental to the IMF's policy promotion of a multilateral system of international trade and payments.

Widespread trade restrictions and foreign exchange control as described in the previous section are widely recognized to create incentives for compensatory

arrangements, illegal transactions, as well as capital flight which all result in inefficient resource allocation. The present section will focus on these consequences.

i. Compensatory arrangements and Countertrade Transactions :

a) Compensatory Arrangements

1) definition

In the broadest sense, compensatory arrangements refer to a whole range of business arrangements whereby an exporter commits himself contractually to cause or generate desired benefits such as revenues for the importer and resource transfers. Under such arrangements, acceptance on the part of the exporter is imposed by the importer as a condition to import. Thus, a main goal of compensatory arrangements is to reduce or eliminate the net outflow of foreign exchange for importers.

2) reasons

Exporters in western countries are now actively promoting this type of arrangement as a means of circumventing payment restrictions on foreign exchange by many developing countries. Some countries will therefore simply engage in compensatory arrangements because it allows them to make sales which, because of the foreign exchange shortage, might otherwise be lost.

At the same time, an increasing number of developing countries are using compensatory arrangements as a means of dealing with balance of payments problems and financing difficulties because it permits nations to sustain their importing activities without depleting foreign exchange reserves or by guaranteeing the replacement of hard currency within a relatively short period of time.

Consequently, these nations are relieved of the burdens of additional international borrowing or restrictive internal economic measures. As these economic pressures become more severe, compensation is becoming an especially important tool in assisting the economic survival of developing and developed nations.

In most cases, compensatory arrangements are imposed by nations as a mechanism to assist in expanding their exports and in generating sufficient amounts of hard currency to finance their import transactions. In most cases, these arrangements are imposed by nations which are experiencing shortages in

foreign exchange reserves or situations by which the other party considers the goods in question to be more valuable than currency. [Fischer and Harte (1985)]

The motivation for seeking compensation deals may also be found elsewhere : notably, in uncertainty brought about by wide-swinging fluctuations in exchange rates, overvalued exchange rates, inflation or in a desire to avoid local foreign exchange controls. In broader terms, uncertainty or lack of confidence in relying solely on market demand and availability of markets may lead to arrangements through which specific imports can be assured and export markets realized.

That being said, it could be added that compensatory arrangements can be transacted under contract between two commercial enterprises, either on their own initiative or in accordance with official directives, or they may be conducted under government to government bilateral agreements. When compensatory arrangements result in exchange of goods and services between two parties in different countries, the transactions are known as countertrade or barter, respectively according to whether financial counterflows are involved or not.

b) Countertrade**1) definition**

As a general definition, countertrade is a practice in international trade in which two parties link an import transaction and an export transaction in a reciprocal fashion. In most instances, a private firm agrees to sell certain goods to another firm or a sovereign nation and simultaneously agrees to purchase from that other party certain goods in a parallel transaction. If the firm does not agree to export the given amount of products from the nation, the importing nation may not purchase the goods from the private firm. [Fisher and Harte (1985), p.9]

2) reasons

The motivation behind countertrade may be the importer's urge to market abroad goods in low demand or goods for which no adequate marketing support is available. In essence, the nation uses its purchases from a private firm and to force that private firm to accept the responsibility (and risk) of marketing the nation's marginally undesirable goods in the world marketplace.

Other reasons may include the need to finance imports or the desire to utilize excess production capacity under long-term export contracts.

3) types of countertrade

Countertrade exists in a variety of forms. The most common types are known as indirect compensation or counterpurchase, direct compensation or buy-back and clearing agreements.

* counterpurchase

In a counterpurchase arrangement, one party sells goods to a second party and simultaneously agrees to purchase from its customer goods which are unrelated to the items it is selling equal in value to a stated percentage of the good sold. The goods which the nation will be offering for the counterpurchase will often be of low quality or overpriced.

* compensation

In a compensation transaction, one party will sell equipment, technology and/or an entire turnkey plant to the second party and agree to purchase a portion of the output produced from the use of the equipment or technology.

Unlike counterpurchase transactions, the products that the private firm purchases

in compensation trade are frequently of marketable quality and in demand in the international marketplace. In addition, compensation transactions are generally of larger dollar value than counterpurchase transactions.

c) Barter

Countertrade is frequently confused with the concept of barter. Barter transaction is the straight exchange of goods having offsetting values effectuated without the use of currency. As mentioned above, countertrade is most frequently used to refer to two reciprocal sales transactions in which each party is paid in currency. to some extent, barter transactions can be considered as a subcategory of countertrade, especially in cases in which barter requirements are imposed by nations in a coercive fashion for purposes of disposing of goods which they cannot otherwise sell. Barter can also be used as a means of liberating blocked currencies or to circumvent foreign exchange controls. [Fisher and Harte (1985), p.10,16)]

d) Bilateral clearing agreements and switch

While countertrade is conducted most frequently between a sovereign nation and a private firm, clearing arrangements occur between sovereign nations. In general, these bilateral alliances occur between countries which do not have a strong

currencies and which lack the equilibrium mechanisms that allow for adjustments of the balance of payments. Under bilateral clearing agreements, nations agree to purchase equal values of each other's products over an agreed period of time. Under such a reciprocal trading arrangement, exporters are paid by a designated domestic bank in a clearing currency that can be used only to buy goods in the importers' country. The value of the goods traded under the agreement is denominated in clearing accounting units expressed in major currencies, i.e. dollars, or in intra-CAEM trade, transferable roubles. The participants frequently open reciprocal lines of credit and exchange quantities of goods during a predetermined "clearing period", at the end of which the nations must balance the accounts. Trade imbalances at the end of the clearing period have to be settled in cash in the specified currency, or the volume of trade must be rectified to restore balance. When an imbalance develops in an account which a nation cannot rectify, such as a credit arising because there are no more goods available in which the nation is interested, private firms known as "switch trading" firms step in to assist a recalcitrant nation in disposing of the goods which it is required to purchase. This third party will purchase the clearing dollars (or credit) from the nation having a clearing-account surplus and use the credit to pay for exports from the other party. In other words, the recalcitrant nation substitutes this third party's purchase of goods for its own. The practice of switching leaves to the third party the obligation of rectifying imbalances in bilateral trade. Bilateral clearing agreements are most common among Third World and intra-CAEM trade.

e) Bilateral trade agreements

One of the main consequences of inconvertibility is the large amount of trade that takes place on the basis of bilateral agreements. This type of compensatory arrangement involves the exchange of goods characterized by parallel and separate cash flows for imports and exports. Bilateral agreements are often tied to western countries' credit lines and are intended to preserve or enhance the countries' share of each other's markets in one or several economic sectors or to support the development of a major industrial project in the developing country. [Verzariu (1985), p.35]

f) Special practices

As hard-currency credit is becoming constrained in trade with developing countries, special practices provide ways which could make use of soft currencies obtained in payment for Western exports. Because of exchange restrictions imposed by many developing countries and the unwillingness of many western banks to accept soft currencies, the value of any soft-currency payments translates into hard currency only to the degree that it is possible, through an intermediary, to obtain goods and services in the developing country and market them in hard-currency countries - i.e. in exchange for convertible currencies. [Verzariu, (1985), p.40]

ii. Illegal transactions :

The control of the foreign trade sector through QRs, capital flow restrictions or exchange controls, create strong incentives for avoiding transactions through the official channels.

a) Establishment of a "Black Market" in Foreign Exchange :

Because importers and residents of the exchange-control country are not legally permitted to acquire currency notes at the official rate, it is most likely that the residents will be willing to offer a higher price in the black market in terms of domestic currency for the foreign currency they desire to obtain. In other words, this means that it is more profitable for foreigners to deal in the black market than at the official rate with the exchange-control authority, because they can exchange foreign currency for the restricted currency at a more favourable rate [Meade, (1951, p.266)]. In the presence of a black market, there are now two exchange rates : the official rate and the black market rate.

Different views exist regarding the determination of the black market exchange rate.

1) Approach based on current transactions :

Under an exchange control system the government is assumed to ban all capital outflows and distribute whatever foreign exchange supplies are available to demanders of foreign exchange for current account transactions at an official rate. The unsatisfied demand for foreign exchange may seek out another source of supply. One obvious source is a black market for foreign exchange, which arises due to an unsatisfied demand for foreign currencies on the official market.

On the supply side, the supply of foreign currencies on the official market is negatively related to the rate prevailing on the black market. As the black market rate rises, given the official rate, exporters will be tempted to divert more and more of their foreign exchange earnings from the official to the black market. In turn, the supply of foreign exchange on the black market is a function of the black market rate given the official rate, of the risks involved with transacting on illegal markets and of the extent of overinvoicing imports (due to overvaluation). Because of these risks involved, the exporters are assumed to add these risks as a further cost of supplying exports and hence export less at a given black market rate. It is precisely because of these risks that the exchange rate on the black market are always higher than the equilibrium rate - defined as the rate at which foreign exchange market is cleared without any exchange control nor intervention by the government.

2) Approach based on capital account transactions :

Under this alternative approach, foreign exchange is bought and sold in the black market because the public desires to alter the composition of its portfolio of financial assets and not for the purpose of carrying out international sales and purchases of commodities. The supply of foreign currencies on the black market is a function of the ratio between the black market rate and the official rate.

As Blejer (1978) puts it, the main sources of foreign exchange supply to the black market are receipts from the overinvoicing of imports and the underinvoicing of exports. The main incentive for engaging in over- and under-invoicing is provided by the requirement for exporters to surrender the declared value of exports and importers to receive foreign exchange equal to the declared value of imports.

Importers who overinvoice will need to get rid of an illegal amount of foreign exchange equal to the difference between the declared and the actual value of their shipment. Given the prospects of profits provided by the differential existing between the official and the black market rates, the importer will have the incentive to deal on the black market. Similarly, exporters who underinvoice will possess illegally earned foreign exchange which they will be willing to sell (with profits) on the black market.

On the other hand, the demand for foreign exchange is a function of the difference existing between the expected rate of return on foreign assets (which is determined by foreign nominal interest rates and the expected rate of depreciation of the black market rate) and the rate of return derived from holding alternative assets, that is domestic assets (which is determined by domestic nominal interest rates and inflation rate). The official rate is administratively determined by the government. For example, the latter could use some reaction function that is aimed at maximizing the government's utility function. According to Blejer (1978), such a reaction function could relate the official rate to deviations from the black market rate. Given these assumptions, the black market exchange rate may be expressed as a function of the relationship between domestic monetary disequilibrium and the world rate of inflation. << It will depreciate faster the higher the rate of domestic credit expansion relative to the increases in the demand for domestic real balances and it will depreciate more slowly the higher is the world rate of inflation.>> [Blejer (1978), p.123]

b) "Smuggling" or illegal trade flows :

QRs, such as the imposition of a tariff on imports over some commodity, for example, by raising the domestic price over the world price, create incentives for some to take that good across the borders without declaring it to the official authorities or to a lesser extent, lying about the actual value of the good in

question ("smuggling"), so as to avoid payment of trade taxes. If the tariff exceeds the costs involved with smuggling (i.e. for example, the risks of being caught, fines, etc), then illegal trade will take place. Illegal transactions may also be regarded in terms of incentives to misrecord commodities transactions and faked invoicing.

Black-market for goods may also be accentuated by shortages, misallocations due to distorted trade, etc.

What is the link between smuggling and the black market for the exchange rate ?

The black market for foreign exchange may also be considered to reflect the demand for foreign exchange to purchase illegal imports (as a result of underinvoicing imports), while the supply of foreign exchange is derived from illegal exports (for instance, stimulated by underinvoicing exports). Importers who underinvoice in order to avoid tariffs will need to obtain illegally an amount of foreign exchange equal to the difference between the actual and the declared value of their shipments. Exporters who underinvoice to avoid export taxes will possess illegally earned foreign exchange which they will be willing to sell.

Under this approach, the determination of the black market exchange rate does not depend on assumptions concerning the form of rationing as what was described above, since black market will exist only to finance illegal trade.

Instead, it appears to be a function of import tariffs and export taxes, to the extent that they stimulate smuggling behaviour. In general, an increase in the import tariff increases import smuggling as well as the black market rate of

exchange. An increase in the export tax also results in an increase in the level of smuggling but decreases the relative black market rate of exchange.

iii. Capital flight and limited capital inflows

a) Capital Flight (or illegal capital flows)

1) definition

Broadly defined, capital flight refers to the << gross value of all capital exports from an economy, regardless of whether they reflect the purchase of foreign financial assets or real assets or direct foreign investment by domestic residents.>> [Cuddington (1986), p.2] Typically, however, capital flight refers to short-run speculative capital outflows, which respond to various factors such as tightening of exchange rate controls, major devaluation of the domestic currency, etc. In the context of an exchange control regimes, for instance, residents may choose to invest abroad in order to obtain or place their financial assets, and earnings on those assets, beyond the control of domestic authorities.

Short-run capital flight can be executed not only by shifts in portfolio composition toward foreign assets but also by changes in trade credit. For example, domestic firms may want to get rid of their borrowing denominated in foreign currencies.

According to Bhagwati (1978), this phenomenon represents a demand for illegal foreign exchange that is fed by the supply created by such phenomena as underinvoicing exports and overinvoicing imports. In that case, the difference between the declared and the actual value represents a capital flow. As was mentioned in the previous section, exchange control regimes and QRs all provide strong incentives for evasion and false invoicing or misclassifying transactions. When there are controls on the amount of funds that can be repatriated legally, foreign firms have an incentive to transfer their profits through overinvoicing imports from their parent firms and underinvoicing exports so as to keep part of their foreign currency proceeds. [Krueger (1978), p.165-166]

Capital flight therefore appears to be defined as that part of the stock of external claims that yields no recorded investment income to the creditor country. It seems reasonable to assume that this income is not reported in balance of payments data.

2) reasons

Exchange control regimes create strong incentives for holding foreign exchange in excess of what is legally available thereby leading to high import premia. As Bhagwati [(1978), p.164] points out, the high premium attached to the access to foreign exchange creates an inducement to hold portfolio investments in the form

of illegal foreign exchange that would not be obtained equally under an alternative system with ready legal access to foreign exchange.

In addition, since an exchange control regime, most of the time, translates into an overvalued domestic currency, the prospects of a stabilizing policy such as a currency devaluation can contribute to the shift of domestic wealth into foreign assets.

3) Determinants of net international capital movements

In explaining the international movement of capital, economists have typically emphasized the role of interest rates. In this section, we will examine alternative theories of its determinants.

****the flow theory :**

According to this theory, the relationship between the "flow" of capital and the level of interest rates is a function of interest rate yield differentials.

More specifically, the inflow of capital depends positively on the domestic nominal interest rate and negatively on the foreign interest rate. Note that this specification is dependent on the assumption that the exchange rate is fixed and expected to remain so. With a flexible exchange rate, investors are not interested

in the comparison between the nominal domestic interest rate and the foreign interest rate, but rather in the comparison between their yields, including the expected rate of depreciation of one in terms of the other. This is nothing else than the Fisher hypothesis applied to an open economy. Hence, if the domestic rate of inflation increases, the resulting overvaluation of the domestic currency will cause a current account deficit, and thus the anticipation of depreciation of the exchange rate is likely to have negative effects on capital flows.

****the stock theory or "portfolio-adjustment" approach :**

The basic idea of the portfolio approach is that financial investors seek to distribute their wealth between the various assets available, in such a way as to maximize their utility. In order to make his decision, the investor will need to take into account both expected returns and risks, and his preferences with respect to the trade-off between them. The demand for a particular asset will depend positively on the expected yield and negatively on its risk as perceived by investors. One implication of this "stock theory" is that a rise in the domestic rate of return will only provoke a one-time capital inflow, as investors adjust their portfolios to include more of the domestic assets. This contrasts the "flow theory" which assumes that a given interest rate differential maintained through time will cause a continuing constant capital flow. Hence, under the portfolio-adjustment approach, in order to attract capital inflows, a continuing increase in the domestic interest

rate would be required, rather than the maintenance of a constant interest rate differential. In applying the portfolio model to the context of international capital flows, the idea of risk can be translated into a country's creditworthiness.

****empirical evidence**

Evidence from empirical work has allowed us to distinguish among several determinants of capital flight. Capital flight can be explained by differences in risk perceived by residents and non-residents in holding claims on residents of a given country, that is the risks associated with domestic investments. The emphasis on the idea that residents and non-residents do face different risks results from the fact that residents, as opposed to non-resident investors, are exposed to taxation of income derived from domestic investments, and in many cases they are not fully protected against domestic inflation and exchange rate depreciation. Any shock to the domestic economy, that increases government expenditures or reduces revenues raises the possibility that new sources of revenues will be needed. According to Dooley (1988), the risk premium, which measures non-residents' perception of the risk of being "taxed" their money balances through inflation and money creation by the government of the country in question is an important determinant of capital flight (because of the uncertainty it attaches to the return on domestic assets). Dooley showed the existence of a positive relationship between capital flight and domestic inflation.

It indicates that where the authorities are taxing domestic money balances through inflation, residents prefer to hold a larger share of their financial assets in a form that is outside the control of the domestic authorities. Some empirical work has also shown that there exists a positive relationship between capital flight and financial repression (that keeps domestic interest rates from rising far above those prevailing abroad to compensate for expected currency depreciation). It suggests that residents acquire foreign assets in cases where the yield on domestic currency time deposits is less than short-term rates in international markets (adjusted for exchange rate changes). In some cases this may reflect controls on domestic interest rates, or it may simply reflect relatively slow adjustments of domestic interest rates to rapidly changing economic conditions.

b) Limited inflows

In assessing the consequences of QRs and exchange control regime on foreign capital, it is necessary, as Bhagwati (1978) has pointed out, to distinguish between official and private (long term) capital flows. With exchange control regimes leading to sheltered markets - or to some protected industries- it is evident that private investment could become profitable. For instance, "tariff-jumping" investment is among the best known forms of private foreign investment. Foreign direct investment may well be attracted into exporting industries, essentially to benefit from cost-reducing advantages abroad such as the presence of cheaper

factors of production. On the other hand, as compared to an equilibrated exchange rate system, exchange control systems may be considered to be less effective as an inducement to invest. The repatriation of profits and the principal may be suspended, and this risk may be perceived greater than the risk of exchange depreciation. The general trend resulting from empirical studies [see Bhagwati (1978), p.162-164] indicates that exchange control regimes limit capital inflows. This phenomena is explained by the uncertainty due to the perception of an unfavourable investment climate.

iv. Effects on saving (domestic and foreign)

Empirical evidence [Bhagwati (1978), Krueger (1978)] demonstrate that exchange control regimes are not likely to contribute to increased domestic saving and augmented capital formation. The link of saving in an economy to its foreign trade regime can be explained :

a) via the income distribution

One approach is to assume with the Cambridge school that saving is exclusively a function of wages and profits and that the marginal propensity to save out of capital (profits) is greater than the saving propensity out of wage income.

If income distribution favours more profits than wages, then saving formation will

be increased. The consequence of control regimes on saving can therefore be a function of the income distributional impact of the regime.

There are also a number of hypotheses that link the overall saving of the economy to the sectorial composition. The overall saving propensity is a weighted sum of the sectorial saving propensities. Some economists have argued that the relative growth of the export sector is conducive to greater saving [Bhagwati (1978), p. 131]. This relationship is based on two underlying functions. One relates exports to taxation and hence to public saving, while the other links exports to higher corporate saving via the higher propensity to save of the corporations in the export sector. If as a result of an overvalued exchange rate regime, we observe a relative overexpansion of the importable sector and underexpansion of the exportable sector, then it will indicate that exchange controls adversely affect the saving generated in the economy. A third linkage exists between domestic saving and the foreign trade regime through the relative size of the corporate sector. To the extent that the foreign trade regime affects the distribution of resources, savings increase since the corporate sector's propensity to save is high.

b) via tax revenues

This approach is based on the assumption that governmental saving is positively related to government tax revenues (fiscal policy) and that the restrictive exchange

control regime influences the division of resources between the private sector and the government, the latter being considered to have a higher saving propensity. If exchange restrictions reduce in any possible way the government's revenues - for example, through an excessive reliance on QRs which would reduce the volume of foreign trade, a relatively easy source of tax revenue - then the public saving will be reduced.

c) via export expansion or foreign aid

This type of argument, inspired by Harrod-Domar type growth models, refers to the fact that the ability to raise saving ex-post depends critically on the capacity to transform ex-ante saving into investment. Literature on the "foreign exchange gap" has applied this argument to the context of an open economy. The idea is that because the foreign exchange market is not in equilibrium, in the sense that there is an excess demand for foreign currencies, it becomes impossible to finance investments. In the presence of such a foreign exchange constraint, increased availability of foreign exchange, via export expansion or foreign aid, enables ex-ante saving to be translated into ex-post saving. But so does any policy that reduces the imports required to sustain any given amount of investment or income. In consequence, an exchange control regime may - for example, by increasing capacity underutilization- increase rather than reduce the import requirement and hence retard the growth of ex-post saving.

d) via the effect on real interest rates

This last approach is drawn on McKinnon-Shaw discussion [McKinnon (1973)]. In an inflationary context and assuming that nominal interest rates tend to be sticky in developing countries, the higher the inflation rate, the lower will the real interest rates be. If then saving is positively correlated with real interest rates, the use of exchange controls to suppress the balance of payments deficit that would accompany internal inflation would lower saving formation in the economy.

e) domestic saving as a function of capital inflows

It is often postulated that domestic saving is a positive function of foreign capital inflow. The underlying rationale for this hypothesis is that, as an economy gets more foreign capital, this supplements its available domestic resources, so that it is reasonable to assume that part of this will be expended on increasing current consumption. In a first instance, with current consumption rising, at given income, current domestic saving efforts would then fall. But this aspect is only part of the overall impact. Indeed, part of capital inflow is also expended on increasing future consumption. At given income, it will increase investment and future income, and hence saving on that account. Evidences of a relationship between exchange controls, capital inflows and saving have been extensively discussed by Bhagwati [(1978), chap.6]

v. Allocative inefficiency :

There is widespread agreement among economists on the proposition that the free movement of long term international capital, just like the free movement of commodities, is highly desirable since it contributes to a more efficient use of resources. If the above proposition is true, it can then be claimed that exchange control regimes have adverse effects on the efficiency of an economic system.

a) inefficiencies resulting from the misallocation of consumption and the creation of excess capacity

Commercial policies have resulted in distortions which have opened a wedge between the domestic and foreign prices of traded goods. The change in relative prices will immediately shift resources out of the sector whose relative price has declined and into the expanding sector. In the case of the imposition of a tariff on imports, resources will flow into the import-substituting sector and away from the exportables sector.

In addition, the imposition of a tariff, may create the incentive to postpone consumption in a later period, causing underconsumption of the importable good and excess saving, and overproduction.

b) inefficiencies resulting from the misallocation of investments

As a result of capital controls, the domestic loan rate may be above the world market interest rate. The high loan rate discourages the accumulation of physical capital and therefore, introduces a distortion in investment, or equivalently, an intertemporal misallocation of production.

PART TWO

**THE PROCESS OF LIBERALIZATION TOWARD UNRESTRICTED
CONVERTIBILITY IN A CENTRALLY PLANNED ECONOMY**

In the context of the transition of a centrally planned economy to a market economy, the opening up to the rest of the world is widely recognized to be an essential element in making the market mechanisms function efficiently.

Integration in the world economy, however, is not an easy task. It is rather a complex process which involves several economic notions.

Indeed, the removal of trade and payments controls that unrestricted convertibility requires, and the gradual reduction in protection with which its introduction is associated on the one hand, and the removal of restrictions on domestic financial markets together with the adoption of consistent macroeconomic policies on the other hand, constitute the key elements of the entire process of opening up.

What are the effects and the interrelations between those elements ? What is the place of convertibility in the transformation process ?

After having briefly outlined the characteristics of a planned economy such as the ones prevailing in the former Soviet Union, we shall identify in section B the costs and benefits of convertibility. In view of two Latin American countries' past experiences, we shall in the next section discuss the preferred order of liberalization and draw some lessons from stabilization programs and external liberalization. We may then ask at what stage in the reform process would

convertibility be appropriately introduced ? This question raises the much controversial notion of sequencing and timing. This will lead us to discuss the meaning of "convertibility" in the particular context of an economy where the legacy of centralism has not entirely vanished yet. In section E, we shall set out the macro- and microeconomic pre-conditions necessary in order to make the introduction of convertibility sustainable and credible in a CPE in transition. We cannot discuss the issue of convertibility without devoting a section to the exchange rate regime. If convertibility is to be established, which exchange rate regime would be best suitable ? Without going in depth, we shall review, in section F, the main arguments for and against a floating regime and its alternative. Finally, in section G, we shall examine the role of accompanying policies. We shall therefore raise the question as to whether or not the costs associated with the liberalization process can be alleviated by accompanying policies during the transition period?

A.\ The Economic Legacy of Centralism :

The main characteristics of a CPE revolved around the following two ideas : first, most means of production belonged to the State; second, all decisions related to production's objectives, allocation of inputs and the allocation of the product between consumption and investment were taken within the context of a quantity-oriented global plan. By doing so, central planners minimized the

dependence on outside suppliers. Given the predominance of the plan, CPE did not need to rely on instruments such as fiscal and monetary policies.

It is worth noting that we do not intend in this section to review extensively all of the characteristics of a planned economy. Rather, the objective of this section is to give a better insight of the main aspects of such an economy, and of the current trends and policies which must be undertaken by a reforming government, in order for the reader to better understand the context in which the process of liberalization takes place.

i. inelastic aggregate supply, administered prices and subsidies :

The importance assigned to the plan had two immediate consequences for the organization of the economy. First, an equilibrating mechanism was not needed in order to equilibrate the demand and supply of inputs in the production process. Second, aggregate supply was rigid. Prices therefore did not act as market signals to ensure market equilibrium and they did not necessarily reflect relative scarcities as in a properly functioning market economy. Instead, prices were fixed by the administration for a more or less extended period at a level below that required for macroeconomic equilibrium. Prices, which were set essentially for accountability purposes, played only a limited role in resource allocation. Differences between prices and costs resulting from the distorted price structure

had to be compensated for. Consequently, subsidies were the main instruments for government's intervention in resource allocation and income distribution.

<<On the production side, [the role of subsidies was to] replace imperative planning with pseudo monetary incentives for fulfilling policy objectives; on the consumption side, they served to shield the consumer against inflationary pressures and to cover financial gaps resulting from a distorted price system>>. [Holzmann (1991), p.9] Many subsidies existed. Beside explicit subsidies, there were many implicit subsidies, in the sense they were not budgetized. These resulted from non-market clearing interest rate levels and various tax preferences.

Tax preference was a useful instrument to control relative prices of products and factors as well as to support specific production sector of the economy.

Price-equalization procedure was another implicit subsidy, which was used to compensate for the differences between world prices and administered domestic prices. This latter procedure allowed the structure of domestic prices and costs to diverge sharply from that of foreign trade. This procedure allowed domestic prices to be insulated from changes taking place on the external market, but on the other hand it was the cause of important time lags in the transmission of world market signals.

ii. Low productivity

For at least the last decade, the growth rate of real output in most CPEs has been slowing down. One reason for this development is the low and declining productivity of capital. While investment rates have traditionally been high, the return on capital has declined. Many reasons can be found. Among them, the technology which is becoming obsolete. Hinds (1990) also argues that the absence of property rights on the capital stocks leads to inefficient investment projects since the benefits to sound decisions do not accrue to the managers.

iii. Excess demand

Up until the beginning of market oriented reforms, open inflation did not exist in CPEs : it was repressed, in the sense that absolute prices were too low to clear the overall market. Price controls prevented markets from reaching their equilibrium levels. It created a situation where, at official prices, aggregate demand exceeded aggregate supply. Normally, this situation would lead to an increase in the price level, but because of controls, it did not. Price pressures created by excess demand manifested itself in terms of generalized shortages of goods and informal rationing by queues on the one hand, and by the expansion of a secondary economy (black market) on the other. As controls were loosened, open inflation emerged.

iv. Monetary overhang and shortages

The presence of a "monetary overhang" in CPEs is a very debated issue. [see Cottarelli and Blejer (1991), Carson (1992), Cochrane and Ickes (1991)] For those who believe in its existence, a monetary overhang, in the sense that the increase in households' wealth took the form of excessive holdings of monetary balances, is the financial counterpart of consumer goods shortages.

The availability of goods in the official market is constrained because prices are fixed below market clearing levels.¹ As a result, households' level of actual consumption is below their desired level. Given the limited variety of financial instruments in CPEs, households' savings could be mostly accumulated in the form of liquid assets (cash and saving deposits). This accumulation led to an excess holding of monetary balance, or "monetary overhang". This represented forced saving (or involuntary) since, at the prevailing official prices, these households would have chosen to consume more if the goods had been available. There are reasons, however, to question whether a monetary overhang could have been accumulated to a very significant extent in CPEs. These have been discussed by Borenzstein and Montiel (1991) among others. To begin with, much of the monetary accumulation that took place may have been the outcome of voluntary behaviour, for several reasons. First, the existence of excess demand for some

¹ As Carson [(1992), p.229] points out, a disequilibrium exists because, in addition to the existence of formal quantity constraints, the price actually paid by the household is assumed to be insensitive to changes in demand.

goods does not imply a state of generalized excess demand for goods, as spillover effects are felt in markets that are not in excess demand. Second, the existence of black markets implies that price controls could be evaded. More specifically, opponents to the monetary overhang theory argue that <<all CPEs have significant second economy markets. Thus consumers always face an operational decision : hold money (and defer purchases), or spend it on goods in the second economy. At any moment, consumers can dissave and buy black market goods.>> [Cochrane and Ickes (1991), p.102] A typical household must choose between what it is willing to pay and what it must pay (in money and in efforts) to obtain a good on the official market. If that cost is too high, then it will choose to defer its consumption. In that case, saving is voluntary. Hence, as Carson [(1992), p.228] notes, <<if we look at the prices the household is willing to pay, ...no monetary overhang exists>>. Moreover, it is believed that, in the second economy, prices tend to be high enough to eliminate any excess liquidity.

To defend their view, believers in the monetary overhang have therefore made restrictions regarding the well functioning of parallel markets. As Cottarelli and Blejer [(1991), p.3] put it, they assume that <<parallel markets may not be wide enough to supply most of the relevant goods and they may tend to be largely concentrated geographically. Access to these markets...may be highly discouraged by penal sanctions and by non-competitive practices.>>

v. an implicit taxation system

The traditional CPE tax-collecting system mechanism was largely implicit.

The State raised revenues by appropriating the State owned enterprises' economic surpluses. The enterprises' "profits" margin was automatically deposited with the State bank and became revenue that could be used by the government. This arrangement was obviously harmful for incentives, but it did have the advantage of giving the State sufficient revenues to keep the budget close to balance, at least in principle. This would have been true provided that the budget deficit is small and that enterprises are required to remit a large proportion of their cash flow.²

Hence, the traditional CPE tax-collecting system mechanism was not sufficient any more to cover budgetary expenditures. That being said, no personal income tax was necessary either because almost all workers were employed by the State; by keeping wages low, the government implicitly withheld a tax at the source.

vi. a restricted role for money, weak financial discipline and the lack of an efficient domestic financial market

² Holzmann [(1991), p.5] points out that toward the end of the 1980s, this requirement was relaxed. As a result, chronic budget deficits surged owing largely to the monetization of these deficits; excess liquidity in the economy exacerbated the existing imbalances in the product and factor markets, which in turn, increased pressure to provide more subsidies. As Holzmann notes, overruns in direct and indirect subsidies during budgetary execution were often the main cause of the budgetary deficits that occasionally emerged. [ibid, p.1]

Money was primarily an instrument of accounting and control. It was the means of keeping account of economic activity and effecting transactions. Money was not a store of purchasing power and there was no mechanism for accumulating it.

In the traditional monetary system, households and enterprise sectors operated on two distinct monetary circuits. Financial flows were indeed compartmentalized between firms and households, with a bank money circuit for inter-firms transactions, and cash for transactions involving households as buyers or sellers. More explicitly, under that system, cash was not used as legal tender for inter-enterprises' transactions and the banks could not freely convert money into bank balances and vice versa. Interenterprise accounts were settled directly among the banks servicing the enterprises and when the latter needed cash they obtained it from a separate account. As the major function of financial institutions was to help implement the production plan, these financial flows were adjusted passively to planned physical flows by a single State Bank which served as a combined central bank, issuing currency, and a clearing system for payments to and by enterprises. As we can see, the banking system was highly controlled and centralized. It is clear that financial operations could not impede the execution of the plan. Monetary policy was the passive outcome of the financial deficits run by the government and enterprises, not an active policy.

Long term investment was provided by allocations from specialized banks which received their funds from the central government budget while finance was provided automatically, interest free from the state budget. None of the financial institutions acted as independent financial intermediaries, but as administrative agencies of the central government. State banks advanced credit for planned activities on advantageous terms and routinely covered losses.

Financial repression is another legacy of the traditional CPE system. Financially repressed economies are economies in which there are relatively few types of assets available to economic agents and in which interest rates are controlled or at least strongly influenced by the government. More specifically, in those economies, deposit rates and official loan rates can be artificially low relative to the world market interest rate.

A consequence of financial repression is the unimportance of the interest rate mechanism in allocating financial resources. Credit is mostly short-term, and is automatically available to finance the firms' requirements necessary to fulfil their planned tasks, or more likely these last years to cushion the effects of higher prices for energy, capital inputs and more generally, to avoid the pain of adjustment to a rapidly changing environment; it was granted by the central bank at a zero or minimal nominal interest rate designed to cover administrative costs. As a result, financial deficits were automatically monetized.

In Kornai's terminology, firms and banks (and even the Central budget) faced a "soft budget constraint" by virtue of the fact that a failure to cover costs could always be offset by additional subsidies or borrowing through the State Bank (and its relevant intermediaries) rather than posing a threat of bankruptcy. [Kornai (1990)] Rarely has rationing been enforced quantitatively to maintain control over the money supply.

The financial sector was rudimentary and was structured to avoid any competition. The lack of a capital market was related to the minuscule (if not absent) size of the private sector and to the absence of clearly defined property rights of the economies' capital stocks. Household's savings could take the form of only a small limited range of financial instruments. Firms could only use finance for purposes specified in the plan.

Because a significant bond market hardly existed, the State's fiscal deficits were largely financed by monetary emission. Excess liquidity in the monetary system due to an uncontrolled and accommodating money creation often characterized a CPE. The resulting limitation of the purchasing power of money - an essential attribute on which is based economic agents' desire to hold money - contributed to shortage and rationing in terms of consumer goods on the internal market (i.e. "commodity inconvertibility").

vii. Monopoly of external trade and inconvertibility:

On the external side, central planning necessitated a strict control over external transactions. By means of exchange controls and State trading monopoly, virtually all domestic production was insulated from outside influences and foreign competition. Without such strict controls, the authorities' ability to arbitrarily fix prices would have been limited. Moreover, domestic enterprises could have dealt directly with non-residents and imported their inputs from cheaper suppliers and thus behaved against the authorities' will.

Through State trading monopoly, the central authorities controlled the flow and the geographic allocation of imports and exports. According to standard theory, the level of trade of a planned economy was mainly determined by import requirements : exports were considered as a necessity to finance imports. In other words, the State would plan to export an amount sufficiently large so as to earn the foreign exchange needed to pay for the planned imports. The system offered few incentives to boost exports and to rationalize imports. Imports depended not only on domestic demand, but also on the degree of priority given to the product in question.

All in all, foreign trade transactions were administratively determined and no automatic mechanism transmitted to producers signalled trade opportunities or

induced them to take advantage of any such opportunities. Enterprises did not have the right to initiate export or import transactions on their own but were obliged to require official approval and use the services of the State foreign trade organization. The situation began to change in the 1980s with the commitment to make the transition to market economies and integrate them into the world economy.

A large part of production was subject to direct controls. Although there were no formal tariffs or quota restrictions, the implicit rate of protection was very high.

Informal quota restrictions on both imports and exports proliferated.

The fact that the domestic currency is inconvertible into foreign exchange on current account creates a price wedge (i.e. domestic prices are higher than their foreign counterparts) that is similar to the effect of a high tariff on competing imports. At the same time, exports (which are the residual remaining after domestic needs have been satisfied) were heavily subsidized by being sold abroad at a higher price than domestically. The effect was similar to imposing an export tax that drives the domestic effective price below that paid by foreigners. For finished goods, as was mentioned earlier, exchange controls and State trading agency provided absolute protection for competing manufactured imports.

In the context of centrally planned economies, domestic currency inconvertibility by residents into foreign exchange is in part a reaction to an overvaluation of their

domestic currency, to the lack of sufficient foreign exchange reserves and to balance of payments pressures. Given the irrationality of internal prices, resident convertibility cannot be allowed because it would lead to large scale imports which have relatively high prices but which could have been more cheaply produced at home. On the other hand, because domestic goods are sold at a low price (due to subsidies and low cost), non-residents must be prevented from domestic markets. They must have restrictions on the convertibility of their earnings into foreign exchange or gold. [Bornstein, (1979, p.261-278)]

A much more severe form of inconvertibility occurring in CPE is related to the fact that the domestic currency is inconvertible into goods for transactions outside the consumer sphere. Enterprises operated with blocked cash balances even in the conduct of domestic trade. That is to say, enterprises had to negotiate with the central planning authorities before money could be spent to buy from domestic as well as from foreign sources of supply. If an enterprise acquired inputs it was because it had been allocated that resource by the plan, not because it had bank balances.

viii. the absence of an exchange market and a system of multiple exchange rates

In general, the Soviet authorities did not intervene to support an official parity in the foreign exchange market. The official exchange rate was set administratively

with little or no regard to market forces. The only function exercised by the exchange rate was that of converting prices in foreign currencies into domestic prices for balance of payments purposes. Hence, its role was purely one of accounting.

In addition, because the State monopoly was further reinforced by the external inconvertibility of the currency and by the fact that foreign currencies could not be held or transacted by residents, the role of the money was limited to a purely domestic currency, even though, in many respects, it was not even fully convertible into goods. The domestic and foreign prices of traded commodities were strictly partitioned through a system of multiple exchange rates. As was mentioned earlier, the domestic currency did not link domestic to world prices, which were rather fixed administratively, and costs diverged sharply from that of foreign trade prices. As a result, foreign exchange resources which were controlled by the authorities, were only partially allocated through the market.

The absence of an exchange market and the existence of an administratively determined system of multiple exchange rates constitute a substantial obstacle to payments compensations.

B.\ The Convertibility of the National Currency:**a Necessary Element in the Process of External Liberalization**

If currency convertibility symbolizes integration into the world economy, it should not be considered as an end in itself, but rather as an efficient means (together with domestic price reform) to enable domestic enterprises to trade freely at world prices. For this to be possible, domestic relative prices must be linked to world market prices. That in turn entails the establishment of a correct price level on the one hand, and on the upholding of an appropriate system of relative prices on the other.

Experience shows that trade and payments go hand in hand and that the liberalization of trade is enhanced by the possibility of transferring funds freely from one country to another. In discussing this question, it is necessary not to separate the two aspects - payments and transactions. Both need to be addressed to establish a meaningful degree of convertibility. If convertibility for international transactions is to be economically meaningful, holders of domestic currency must not only be able to freely pay for foreign goods and services, but also be able to freely import those in the first place. Thus, it appears that trade liberalization is directly related to the existence of a convertible national currency - at least partially.

By delaying the elimination of direct trade controls one would be attempting to achieve domestic equilibrium with distorted domestic prices. This is because the trade controls would block international commodity arbitrage, which is the mechanism by which domestic and world market relative prices are equalized.

Integration of a country's goods market into the world economy therefore requires that there be no trade restrictions and that its currency be convertible for current account transactions.

On the other hand, integration of national financial markets requires not just current account convertibility but unrestricted convertibility. But the literature on the optimal sequencing of economic reforms argues that this is a distinctly less urgent priority. This last aspect will be further discussed in section C. In the meantime, in order to identify the position of convertibility in the sequencing of reforms, we shall, in the following section, analyze the advantages and the disadvantages of convertibility.

i. Benefits of Convertibility

a) the role of current account convertibility in an emergent market economy.

Let us examine the reasons why convertibility is needed. Kenen (1991), Bofinger (1991), Polak (1991) and other authors evoke several reasons for the introduction of convertibility as a component of a foreign economic policy of liberalization.

First, many believe that, in addition to dismantling the State monopolistic structures, convertibility constitutes an economic operator which allows the producers to be kept informed by a set of decentralized agents of the scarcity of goods and to determine the social demand of both domestic and foreign goods by confronting in permanence domestic prices to competitive foreign prices. Convertibility therefore helps introduce a price-adjustment mechanism by "importing" a rational price system from the world economy through trade liberalization so as to eliminate the inherited price distortions existing between internal and foreign prices and to favour resource allocation according to the economy's comparative advantage. Either current account convertibility or internal convertibility will serve this purpose. Indeed, in order to import world prices, it is necessary to conduct current account transactions in convertible currencies. In other words, it is necessary to dispose of the necessary foreign currencies in order to purchase foreign products.

A second reason for current account convertibility is of course to build foreign investors' confidence by guaranteeing them easy repatriation of earnings. That in turn attracts foreign direct investment. Encouraging the flow of capital (profits, dividends and interest) does not require right away unrestricted convertibility (i.e. capital account liberalization). But current account convertibility alone may not be sufficient to attract foreign direct investment. Local laws on foreign investment protection might be necessary to build foreign businesses' confidence. For example, local laws could guarantee foreign investors the right to repatriate capital freely or to exchange freely their profits (held in local currency) into foreign currency for transfer abroad. In addition, local laws could also specify that foreign investment will be free of any form of administrative confiscation. These items are considered to be current account transactions and therefore are compatible with the IMF's definition of current account convertibility. Note however that internal convertibility does not provide for the right to remit earnings of foreign investment : that requires external convertibility.

Third, convertibility promotes domestic economic performance and macroeconomic stability, two conditions for successful and meaningful reforms. In addition to reducing the power of domestic monopolies, the central purpose of convertibility in an emergent market economy is to facilitate the establishment of a competitive environment by exposing local producers to international competition and promoting production and investment decisions consistently with

the country's comparative advantage. By providing market price signals, convertibility increases the information available for private and foreign investors. In the absence of QR on imports, greater international competition and a liberal trade environment, fostered by current account convertibility, may promote domestic output by improving access to production inputs and modern technology. Also, a competitive environment provides strong incentives for producers to use resources efficiently, thereby enabling them to produce additional output. The ability to trade brings a country into contact with superior technology, know-how and potentially, foreign markets access. In turn, over the long term, import competition is likely to promote innovation and quality improvement in domestic industry in order to keep their products competitive with goods available from abroad.

Other arguments include the fact that convertibility will make hard currency available to all enterprises, and not only to those exporting on hard-currency markets.

Convertibility can also provide an instrument for influencing the level of exports and imports : by devaluing even a partly convertible currency, a country can encourage exports and discourage imports thus allowing for the gradual liberalization of foreign trade through the removal or reduction of tariffs, QRs etc.

b) the role of capital account convertibility

An opening of the capital account gives residents and non-residents the opportunity to diversify their portfolios internationally in a legal manner, and by this means, to maximize their utility. Indeed, to the extent that capital controls were effective prior to their removal, residents would presumably not have been able to attain their desired net foreign asset position nor would non-residents have been able to acquire either their desired holdings of domestic assets or borrowing from domestic lenders. Moreover, in principle, it permits unrestricted foreign borrowing. Therefore, investors are able to enjoy the benefits of access to foreign savings in supplementing domestic with foreign savings when interest rates are lower abroad. By the same token, net capital inflows can result from the removal of capital controls. The reverse is also true : there could potentially be a net capital outflow.

ii. Problems of Convertibility

While the benefits of convertibility are widely recognized, it is essential not to overlook the risks that are associated with an opening of national markets to the world economy.

a) current account convertibility

At the macroeconomic level, convertibility is likely to require the real exchange rate in the short term to be more depreciated than its longer term equilibrium level. This raises the relative price of imports and can have a distorting effect on resource allocation if investors do not accurately anticipate movements in the real exchange rate over time.

Second, because convertibility largely allows greater movements in the current account of the balance of payments, convertibility often imply unsustainable current-account deficits . Under a fixed exchange rate regime, persistent external imbalances can drain a country's international reserves holdings. Alternatively, under a flexible exchange rate regime, disequilibrium in the balance of payments may lead to exchange rate instability. This disequilibrium may affect domestic prices and incomes and may compromise, as Greene and Isard (1991) puts it, <<the ability of policy makers to achieve the ultimate objective of sustained, non inflationary growth>>. The maintenance of current account balance therefore implies greater pressure on the authorities to direct policy instruments toward external stability rather than internal stability.

Greene and Isard (1991) identified several other risks involved with convertibility. The introduction of currency convertibility and the exposure of the reforming

country to international competition can be risky for many firms whose competitiveness often has deteriorated considerably. Increased competition brought by current account convertibility can result in the short term in substantial unemployment, declining production and idle capacity. This may occur if the products of domestic enterprises are extensively abandoned in favour of imported goods and services. Alternatively, substantial reductions in real wages (after adjustment for exchange rate changes) may be required to keep domestic products competitive, particularly if the quality of domestic goods is poorer than that of the competing foreign products. In either case, the purchasing power of domestic income can decline substantially.

In addition, the increased degree of openness induced by convertibility exposes the domestic economy to shocks from the international markets. The possibility of speculation on international markets, in the case of a fixed exchange rate system cannot be ruled out. [Daviddi (1989)]

b) capital account convertibility

A country that establishes capital account convertibility runs the risk of capital flight. This could lead to a sharp change in the country's foreign exchange reserves or contribute to excess exchange rate volatility. A second risk associated with the removal of capital controls has to do with the greater ability to send

savings abroad. The depletion of a country's savings reduces the country's funds available for domestic investment, when one of the key issues faced by reforming economies is precisely to attract capital from abroad.

Capital account convertibility can deprive the country of important tax revenues. Since domestic residents naturally have an incentive to shift some portion of their financial activities and portfolio holding abroad to avoid these taxes, the authorities' ability to tax financial activities, income and wealth would be reduced. Another drawback of capital account convertibility is also the possibility of speculation on international markets.

C.\ The Order of Liberalization

In an ideal world without market imperfections or externalities, all markets are best liberalized simultaneously. In the less than perfect real world, however, simultaneous liberalization is mostly infeasible (from the point of view of the ensuing effects on various domestic macroeconomic variables). Governments cannot and perhaps should not undertake all liberalizing measures simultaneously. Instead, as McKinnon (1991) puts it, there is an "optimal" order of economic liberalization. Indeed, although different orders or strategies may yield similar results in the long term, during the transition the behaviour of the main

macroeconomic variables may be quite different. We may therefore ask whether the trade account or external capital account should be liberalized first ? Moreover, what is the relationship between the order of liberalization and macroeconomic management ?

Experience shows that the negative aspects associated with opening up can be minimized by an appropriate sequencing of policies. How fiscal, monetary and foreign exchange policies are sequenced is of critical importance.. In other words, depending on which reform policy comes first, it is possible to smooth the transition process toward an unrestricted convertible market, that is to reduce the adjustment costs associated with the liberalization process. The choice between strategies would naturally have to depend on the government's objectives (internal vs. external balance), on the state of the economy prior to transformation, on the tolerance of the population for the disruptions that are sure to accompany the reform process and on the political situation.

The experiences of some developing countries (especially the Southern Cone countries of Latin America) with vigorous attempts at economic liberalization have raised the issue of the preferred order of liberalization. While some may argue that their experience is only partially relevant for the problems faced by countries in transition from a CPE to a market system, we believe that at a certain level of broad generalization, some lesson, as to how to stabilize and liberalize, using

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PRECISIONSM RESOLUTION TARGETS

monetary and fiscal policies in a time of rapid inflation and underdeveloped market institutions and structures, can be learned from Latin America. For the purpose of our analysis, we shall focus on the experiences of Chile and Argentina so that we shall have a better insight into the possible problems which might be encountered during the liberalization process toward a market-type economy. This can also provide useful clues of what to do, or what not to do, in a similarly comprehensive trade liberalization program in an emerging market economy.

Certain rules of thumb have emerged. For instance, when inflation is rapid, domestic macroeconomic stabilization is needed before reforms that change relative prices are undertaken; and the capital account should generally be opened after the current account.

This section focuses on the optimal sequence of external liberalization, presuming that domestic financial and fiscal equilibria have already been secured and that commodity prices in domestic markets have been largely freed.

i. Liberalization in a perfect world without distortions :

Simultaneous removal of commercial and financial restrictions

(assuming no domestic financial repression, no fiscal deficit)

*** Simultaneous tariff reduction and free capital flows**

Since, in the real world, financial markets adjust faster than goods markets, the impact effect of the simultaneous liberalization is dominated by an inflow of capital and its consequences (still assuming domestic interest rates are initially above the foreign rate).

-effect on exchange rates :

As a result of capital inflows, the real exchange rate will initially appreciate.

-effect on price and interest rate :

As capital inflows slowly decline toward their new long run level, and as goods markets start to adjust, the results of the tariff elimination are felt. The price of imports is lowered by the amount of the reduction in the tariff rate. The change in relative prices leads to a transfer of resources toward the production of non-tradable and exportables goods and, at the same time, divert demand from these two sectors toward the market for importables. As a result of this transfer, an excess supply of non-tradable goods is created, which causes a decline in the price of non-tradables and the overall price level. In other words, the resulting shift in the pattern of demand and production caused by the change in relative prices

tends to exert downward pressure on the general price level. Meanwhile the money supply is increasing owing to the inflow of international capital, and the nominal demand for money starts to fall because of the drop in the price level resulting from trade liberalization. There is a larger excess supply of money than when the two policies are undertaken separately, which causes the price level and the interest rate to fall even more.

- effect on the balance of payments :

The combination of the change in relative prices and the excess money supply results in current account deficit. The deterioration caused by the opening-up of the capital account is reinforced by the removal of trade restrictions.

The capital inflows generated by the removal of financial controls may not be sufficient to cover the current account deficit so that, in a fixed exchange rate regime, the country will lose international reserves. As reserves are depleted, the money supply is reduced if the country does not undertake sterilization (an assumption of the monetary approach to the balance of payments). In the long run, this causes aggregate demand to contract and prices to drop.

- effect on external indebtedness :

As capital flows in, external debt increases. But as the interest rate falls, so do the interest payments on foreign debt. The net effect on the foreign debt is therefore ambiguous. [Khan and Zahler (1985)]

* Simultaneous tariff reduction and unification of exchange rates

The implications are that there will be a larger deflationary effect. On the other hand, the impact on the balance of payments is ambiguous because the effect of financial liberalization is to generate a capital account surplus, whereas the effect of commercial liberalization is to generate a current account deficit in the very short-run. But in the long-run, commercial liberalization could generate a surplus.

ii. External Liberalization based on the experiences of Latin American countries :
a Brief Review

a) removal of trade restrictions followed by capital account liberalization

Several authors have advocated a Chile-type "current account first" order of liberalization.

In a context of high inflation, Chile underwent a simultaneous trade liberalization and stabilization program in the early 1970s. In 1973, Chile had some very high formal tariffs protecting finished goods, as well as non-tariff barriers (quota restrictions, restrictions on exports). In addition, the government was directing the allocation of foreign exchange for imports only to the extent that it suited its immediate social objectives. Multiple exchange rates were also set across different categories of imports and exports.

In the domestic economy, the government budget deficit was out of control and had become fully monetized. Credit was provided easily. The domestic financial market was repressed, with negative real interest rates. An organized capital market was virtually non-existent. In view of this economic chaos, foreign capital was unavailable to Chilean economic agents.

In 1973, the government moved toward a stabilization program based on tight fiscal and monetary policies. Equally important, the government undertook measures to liberalize the domestic financial system (i.e. eliminate domestic financial repression) by removing interest rate ceilings. Interest rates rose sharply from negative to high positive levels, thus creating a competitive market for deposits and loans.

In the foreign sector, the first step toward liberalization was to unify the exchange rate, then to convert all implicit protection by direct controls, such as the quota restrictions, into some explicit price control, such as a cascading tariff.

The third step was to move to foreign exchange convertibility on current account.

The net effect of these first steps was to convert implicit direct control protection into explicit tariff protection. Once that transformation was achieved, the government proceeded to reduce the explicit protection gradually. Ultimately, Chile had reduced tariffs on imports to a low uniform level and had removed all controls and taxes on exports.

A decade later, even though the government budget was under control and price inflation had been successfully reduced, compared to the high levels reached at the beginning of the 1970s, the attempted reforms had failed. For many economists, the exchange rate policy - the failure to stabilize the real exchange rate - and the excessive recourse to external debt finance of the current account deficit are at the centre of the explanation. What did actually happen ?

At the beginning of 1978, the government changed its monetary and exchange rate policies. The approach followed by Chile in order to stabilize inflation entailed securing control over the domestic money supply by relying on very high nominal and real interest rates, by revoking exchange controls on capital account, and by adopting a downward crawling peg of the exchange rate.

In order to curb domestic inflation, the nominal exchange rate was depreciated below the differential between domestic and world inflation. The apparent real interest costs of foreign borrowing fell below those prevailing in domestic financial markets. With an open capital account, the falsely high structure of domestic interest rates exacerbated the excessive absorption of foreign capital. Hence, one problem was excessive capital inflows. These forced an appreciation in the real exchange rate [Corbo (1987)].

Despite efforts to cut down the rate of inflation, domestic prices were pushed up relative to world prices of imports and exports. Growing overvaluation had an expansionary effect on aggregate demand. Consumption rose sharply, as did investment and the budget deficit. Once the short run expansionary effects had passed, the overvaluation led to a change in the composition of spending which shifted demand from domestically produced goods toward imports. Domestic output and employment fell. The fall in income led to a further increase in the budget deficit. Accordingly, the real exchange rate overvaluation resulted in a deterioration of the external balance, where the current account deficit represented levels of spending and resource absorption in excess of current income. One further factor was the effect of adverse world economic conditions in the early 1980s - namely the increased real interest rates in the world market. For a

debtor country, this implied a deterioration in the terms of trade, and hence an adverse real income effect, which further worsened the current account and external indebtedness situation.

Overall, Chile's trade liberalization alone has been successfully sustained. The one major mistake was to impose tight monetary policy while leaving extremely high nominal interest rates on loans and deposits. These caused excessive capital inflows, which threatened a loss of monetary control and forced a severe overvaluation of the domestic currency, causing widespread bankruptcy in the newly opened tradable goods sectors. By reducing the inflows of foreign capital, the program for stabilizing the domestic price level would have been strengthened. Chile should have scaled down her interest rates and tightened domestic credit more. She should have relied less on the exchange rate as a lever to secure the price level [McKinnon (1991), p.81].

b) removal of capital restrictions followed by trade liberalization :

An opposite point of view, based on Argentina's experience, indicates that unrestricted currency convertibility should be restored (that is, the external capital account should be liberalized) before external trade reform. Convertibility took the form of a convertibility at a fixed rate against the dollar.

In the case of Argentina, external indebtedness primarily financed capital flight, not current account imbalances. Unlike Chile, increased investment played absolutely no role in the current account deterioration. Rather, political instability, combined with the maintenance of a high degree of commercial protection and a complete liberalization of international capital flows, created a climate of exchange rate instability and deteriorating expected returns on domestic assets. For these reasons, purchases of external assets rather than increased imports were the obvious way to escape from uncertainty and expected depreciation. In an effort to stabilize inflation, the Argentinean authorities maintained an overvalued exchange rate. Despite the anticipated collapse of the exchange rate, domestic interest rates rose in the short run, in order to attract foreign capital.

Overvaluation combined with high interest rates contributed to the slowdown of productive investment. As a result, firms started speculating and borrowing at prohibitive rates to acquire dollars. Hence, financial convertibility did not solve the problem of money creation. A balance of payments deficit followed.

Domestic financial instability derived from the inability to bring the fiscal deficit under control and stop the inflationary process. This soon led to the anticipation of a real depreciation. With no limitation on capital movements, massive capital outflows occurred. The currency collapsed, which triggered hyperinflation, a recession, and a serious foreign debt crisis.

iii. Lessons from Chile's and Argentina's Experiences

Emergent market economies which must face major decisions on how to achieve both stabilization and liberalization are sometimes regarded as groping in the dark. But in fact, the recent stabilization experiences, such as those of Chile and Argentina, are very useful to understanding the options and the potential outcomes faced by those economies.

What should be learned from these experiences ?

The first lesson to be drawn from these liberalization attempts (and attempts in other developing countries) is that macroeconomic stability is a prerequisite for liberalization. This conclusion is based on the fact that liberalization will aggravate certain distortions in the economy if excess demand is allowed to persist. Excess demand pressures need to be brought down to moderate levels by the appropriate policies. In this regard, it is imperative that the fiscal deficit be brought under control. In Argentina, since the financing of deficits is a fundamental source of inflationary pressure, the resulting real exchange rate appreciation created an unsustainable current account position. Although Chile ran a budget surplus toward the end of the 1970s, the problems created for its current account position by the real exchange rate appreciation were exacerbated by a system of backward wage indexing, which adjusted wages to reflect past

rather than current rates of inflation. With inflation (slowly) declining, the backward indexation of wages raised real wages. A proper wage control policy is therefore a necessary element during a stabilization program. Another reason why excess demand pressures need to be controlled is that high inflation reduces the information content in prices because of the difficulty of determining relative prices from information about absolute prices when the latter are constantly changing. In turn, because prices cannot convey information satisfactorily under conditions of inflation, the efficient allocation of resources is impeded.

Furthermore, in the short-run, economic reform, by itself, inevitably tends to generate inflationary pressures, because it requires relative price adjustments involving reduction in subsidies, strong upward pressure on wages, depreciation of the exchange rate and inflationary expectations, all of which in practice mean that average prices are certain to rise. Inflation might also cause excess demand for imports, reductions in exports, increased trading risks, lost confidence in the domestic currency (hence capital flight and inability to maintain a reasonably stable exchange rates, all of which will reduce the credibility of the liberalization measures). The control of inflation is therefore vital, not just because a low inflation would make the reform program more credible, but also because without it, other elements of the program will be directly undermined.

The second main conclusion is that liberalization in goods markets should precede liberalization in financial markets. The reason is twofold : first, asset prices would be distorted if they were determined in an economy with distorted prices of goods. The other reason relates to liberalizing the external capital account (that is, restoring unrestricted currency convertibility) only after restrictions on the current account, as well as restrictions in the domestic financial sector, have been removed. This constitutes a more prudent strategy, given the differential speeds at which the goods and capital markets adjust and the adverse effects of trade liberalization on the adjustment costs of tradable sector.

Since the purpose of the reforms is to improve the allocation of domestic resources, it is of course necessary to first remove any existing obstacles to such movements.

The Chilean success in strictly liberalizing her foreign trade sector allows us to conclude that one of the first things to be done in the transformation process is to remove domestic price distortions. Then a devaluation is necessary to improve the relative price of tradable goods, and selective tariffs may be applied to facilitate industrial restructuring.

Another important conclusion that may be drawn from the subsequent stages of the Chilean liberalization process is that during or prior to deregulation of the

domestic financial market, a banking reform which restricts bank credit should be put in place. According to McKinnon (1991), failure to recognize the need for official action to limit bank lending rates was in part responsible for the failure of reforms in the early 1980s.

That being said, it is also generally accepted that in an inflationary environment, the domestic financial market should be deregulated only after the fiscal deficit has been controlled, in order to avoid out of control credit and indebtedness.

Note that when trade reform occurs in the context of a partial currency convertibility [see Bhandari's analysis (1989) in section G, part II], the "current-account first" sequence is preferable only if the policymakers' preference function is limited to domestic price and national income/output targets. Given the recession prevailing in the Russian Federation, this strategy might be a good approach toward liberalization of the foreign sector.

Another argument supporting this sequence can be attributed to the increased competitiveness of domestically produced exportable goods and the contraction of the demand for importable goods due to the real exchange rate depreciation (resulting from current account liberalization). If this devaluation is precluded by an opening of the capital account (which, on the contrary leads to a real appreciation), the transition in the goods sector from a protected to a freer

relative price structure will be more costly in terms of lost output and revenues. Indeed, the real appreciation caused by the capital account liberalization will turn against exporters and firms competing with imports. It will result in a loss of international competitiveness.

By contrast, if targets were defined in terms of "terms of trade" (as measured by the real exchange rate), then the "capital account first" scenario should be chosen. The real appreciation resulting from capital inflows lowers the relative price of imports and consequently improves the terms of trade.

Based on Argentina's experience, it has been suggested that the opening of the capital account will result in the short run in large "destabilizing" capital flows. [McKinnon (1991)] Before allowing domestic economic agents to borrow freely from or to deposit in international markets, the domestic capital market should be fully liberalized, which in turn depends on stabilization of the domestic price level. If the capital account is opened when the domestic financial market is still repressed, with interest rates fixed at artificially low levels, massive capital outflows will take place, and the real exchange rate will be highly volatile after this account is liberalized.

Alternatively, assuming that the fiscal deficit has been controlled and the domestic financial market liberalized, the opening of the capital account may result instead in large capital inflows of foreign capital, triggered by substantial interest rate differentials. [McKinnon (1973)]

This inflow of capital can be related to the market response in a country undertaking a liberalization program. << Once a country undertakes a stabilization cum liberalization program, where the profitability of the economy suddenly rises, then there is a once for all attempt by foreign lenders to take advantage of the situation by inundating with foreign capital the newly liberalized economy. This inundation with foreign capital is possible even in the case of a pure trade liberalization, where there is no major financial stabilization occurring at the same time. But if there is a major financial stabilization in which the country moves interest rates from low to high levels, then the inflow of capital is greatly exaggerated...[the problem here is that] people look at profitability myopically as individual lenders and borrowers, not taking into account what will happen [to exchange rates] if they all transfer foreign capital simultaneously.>> [McKinnon, (1991), p.115]

An economy that liberalizes its foreign trade should therefore avoid massive injection of foreign capital. Until the adjustment costs of trade liberalization are almost absorbed, it is necessary to maintain some form of capital control. This

negative impact of capital flows also reinforces the view that the capital account be opened only after the domestic capital market has been liberalized and domestic interest rates have been raised.

On theoretical grounds, this widely recognized conclusion is viable. In effect, when the capital account is liberalized first, the rate of interest initially declines, but then the fall is accelerated as tariffs are removed. This is so because the excess supply of money generated by the fall in prices owing to the reduction in tariffs is assumed greater than the excess supply of money created by the capital inflow. A worsening of the current account is also normally observed. The removal of tariffs pushes the trade balance and the current account into further deficit. As capital restrictions are removed, there is an immediate inflow of capital, and both reserves and the stock of foreign debt rise. However, as the tariff reduction lowers the demand for money, which further reduces the interest rate, the process is temporarily reversed, and both the stock of foreign reserves and debt fall.

Also based on Argentina's experience, it was found that the decline in interest rates, the deterioration of the current account and the loss of foreign reserves are initially less if capital flows are liberalized before any trade reform takes place. On the other hand, the stock of external debt will be smaller in the long run if the trade account is liberalized first. A main concern with the liberalization of the

capital account is therefore the prospect of a foreign debt crisis. This line of argument thus supports the "current account first" approach.

It is important that these lessons be retained when reform programs are developed for the CPE.

D.\ Speed of Reform (gradualism versus shock therapy) :

Given the potential contribution of a convertible currency, currency convertibility figures high on the agenda of reforming economies, although there is absolutely no consensus view about when it should come about.

Should the transition to currency convertibility be gradual or "shock therapy" ? In particular, should we introduce convertibility at the very beginning of the transition process without waiting for some pre-conditions to be fulfilled or should we wait for these to be well established in order to guarantee sustainability of convertibility ?

The appropriate speed and timing of reforms in general is the source of many disagreements. Not enough experience has been amassed to be able to generalize about the appropriate speed of reform, especially because it is not a question of

completing first one reform and then another, but rather of advancing on several fronts at the same time.

Gradualism may sometimes be justified when reform faces large economic uncertainties. In an economy with structural distortions that prevent optimal adjustments, shock therapy may have perverse effects. A slow but steady reform may reduce the overall cost of adjustment by spreading out the adjustment over time. That being said, by their nature, some reforms take longer than others : price reforms can be done quickly, but new institutions (creation of a capital market and privatization for instance) take time to develop.

When reforms lack credibility or when inefficiencies prevent the market from adjusting at a socially optimal rate, adjustment may be too slow from a social perspective. For adherents of heterodox approaches [Lipton and Sachs], the optimal policy is to implement the program rapidly so that the welfare gain is achieved as quickly as possible. But gradualists [McKinnon, Levick, Kornai, Nuti among others] argue that precipitate haste will inevitably be costly in terms of economic disruption.

In terms of the timing of convertibility, the opponents of shock therapy (that is, the simultaneous introduction of reforms) claim that a quick introduction of convertibility and liberalization of foreign trade would be potentially disruptive for

the economy. An early transition to convertibility will result in either exchange rate or exchange reserve problems and may generate too much inflationary cost-push and terms-of-trade losses. Instead, the government should give priority to domestic liberalization and structural reforms, and proceed with the loosening of the restrictions in the external sector step by step, within a time horizon of a several years. The introduction of currency convertibility in that case belongs to a later stage of the transformation process.

Krueger (1978) and Bhagwati (1978) have defined five phases in the process of foreign trade liberalization based on an empirical study of ten less developed countries. The first two phases correspond to periods of severe exchange controls. This would correspond to the initial situation in a CPE. Phase III corresponds to a major devaluation to increase the export orientation of the economy and a relaxation of exchange controls. In the next phase, QRs are replaced by formal tariffs to give some protection to domestic industry. Full current account convertibility is achieved only in phase V. During that phase, an exchange rate policy (pegged exchange rate) and a monetary and fiscal policies are jointly employed to maintain external balance. QRs on foreign trade are eliminated. In the process of economic development, full (unrestricted) currency convertibility - the elimination of capital controls - comes last. In order to give time to the economy to restructure itself, Krueger and Bhagwati advocate a gradual loosening of exchange restrictions rather than a quick introduction of convertibility.

Levcik (1991), another supporter of gradualism, believes that the introduction of current account convertibility should come only after foreign trade and especially imports have been liberalized to a substantial degree.

In turn, the liberalization of foreign trade should not be attempted before certain preliminary measures are undertaken : << one must have at one's disposal the essential macroeconomic tools to operate a prudent anti-inflationary fiscal and monetary policy, as well as to implement a social policy that will soften the impact of the opening of the economy (...) To make all these tools available to the authorities, extensive legislation will have to be undertaken. In the meantime, privatization should be already near completion to ensure a sufficient number of decentralized economic agents capable of operating and of competing on the market ... [and] the domestic price structure ought also to be liberalized.>>

[Levcik (1991), p.43] Among gradualists, Levcik favours a longer period adjustment than McKinnon and Williamson do.

Some members of the IMF have also remarked that a country which lacks the experience of market mechanisms risks being submerged by the short term effects of rapid convertibility. It is necessary to look after the external balance.

At the same time, however, the currency depreciation necessary to maintain competitiveness may cause a substantial backward movement of real incomes.

Yet another approach to gradualism is the one put forward by McKinnon (1991), who argues that the faster the rush to convertibility, the higher the cost. This argument was also emphasized by Nuti (1991). The rapidity of introduction of convertibility depends on how high an adjustment cost the authorities and the public are willing to accept. A relatively rapid move to convertibility increases the share of low-positive-value-added activities that have to be run down. Hence, the faster the move to convertibility prior to satisfaction of some conditions, the greater the domestic currency undervaluation necessary to maintain confidence, given the need to secure a viable balance of payments position and to check a surge of imports caused by the fear that convertibility may be temporary. Currency undervaluation is stagflationary, at least in the short-run, until exports have had time to respond.

For those who support a rapid passage to convertibility, the early implementation of the "rules of the game" of the market and external liberalization are essential to make sure that stabilization measures actually take hold. The concept of convertibility (on current account) is more a policy instrument to stimulate the desired changes in the economy than an economic objective used to accelerate certain structural changes seen as necessary to increase overall efficiency. This argument is also based on the fact that many countries do not have the "luxury" of waiting, given the general climate of instability and popular discontent : in view of the inherited rigidities and the distorted price and allocation of resources in the

domestic economy, the bringing of domestic prices closer to foreign prices, the unifying of the exchange rate and the reallocating of resources was likely to be at best a rather long process unless there is also a credible currency convertibility to influence the behaviour of economic agents. That being said, in the case of disintegrated economies, it is believed that only stabilization through a shock (i.e. on a broad based front) can create credibility for future government actions. Given the essential role of relative prices, an early move to convertibility is therefore not an option, but rather a necessity, precisely because of the existing rigidities.

In addition, adherents of shock therapy doubt the capacity of any central government to administer gradual reforms of any sort under the given post-socialist context. That is another reason why convertibility is seen as an urgent issue.

That being said, both options evidently have their own benefits and costs.

What ought to be remembered is that an early establishment of current account convertibility is crucial, in the sense that there is a pressing need to subject domestic producers to competitive pressures from abroad and, in the process, to import a rational system of pricing. However, we share the view that one could

not introduce convertibility before deregulating domestic prices, before budget constraints have been hardened, before commodity convertibility has been achieved and before the macroeconomy is in reasonable balance.

The answer to this dilemma rests on the type or degree of convertibility that will be established at different moments in time. This means the adoption of more and more developed forms of convertibility as the transition progresses, starting with a limited form.

Thus, in terms of the timing of full convertibility (that is, the elimination of all exchange restrictions), the country's ability to make a quick move will depend on how fast it takes to meet some given pre-conditions and how quickly economic agents can adapt.

Of course, ideally, the move to convertibility should wait until key structural reforms and other institutional changes have been firmly established.

Unfortunately, some of these necessary pre-conditions are time consuming and the waiting cannot be afforded [Lipton and Sachs (1990)].

As an alternative view, one should seek to identify "the smallest package of measures" [Williamson (1991)] that is needed to make the transition from an inconvertible system to a convertible one. Many of the things should indeed be

done gradually, but nevertheless, we share the view that there is a core of measures that would seem to be best undertaken simultaneously. A lot of reforms would remain to be executed : privatization and demonopolization cannot be accomplished overnight; trade protection should be phased out over several years to give import competing enterprises a chance to adjust.

According to Nuti (1991), who puts primary emphasis on stabilization, three pre-conditions must be satisfied. First there must be market clearing prices (no shortages, no commodity inconvertibility); second, there must be no generalized subsidies on tradables, and third, there must be significant price elasticities of demand and supply, necessary for currency devaluation in order to improve the trade balance (under conditions in which world demand for domestic export is not perfectly elastic). The underlying philosophy of Nuti's strategy is that competitive conditions on domestic markets must be established before substantial liberalization of external trade. In that context, convertibility can be introduced as fast as the three pre-conditions listed above can be met. The first two can be implemented quickly through a stabilization program; the third one can be enhanced by privatization programs and by enterprise restructuring but these are part of the time consuming endeavors mentioned earlier.

No matter how long a country takes to establish complete current account convertibility, there is widespread agreement that it should adopt a unified exchange rate for current account transactions as soon as possible, in order to promote increased pressures from foreign competition while giving domestic enterprises improved access to the foreign markets. For this reason, economists have proposed limited forms of convertibility mainly on the current account.

But what form should this limited current account convertibility take ? Should attention be paid first to the advancement toward internal convertibility or to external convertibility ?

Under the external convertibility approach, as mentioned in an earlier section, the logic of the transition to a market economy rests on an inflow of Western capital and technology. The shortest way by which convertibility can contribute to a revival of the economy is through stimulating foreign business activities by means of easier repatriation of profits. Second, there is reason to believe that a limited degree of external convertibility produces a less destabilizing effect on the domestic economy than a comparable degree of partial internal convertibility, if one compares the amount of domestic currency which can be exchanged by residents and non-residents. In the first case, this is potentially the whole money stock in the economy, while in the second, it is only the sums servicing external operations related to current account transactions. At this stage it is out of

question to allow two-way capital flows. We therefore are in presence of some type of dual organization of the economy : an open foreign sector which can intermediate foreign currencies and an unreformed domestic sector which cannot.

Alternatively, some authors believe that it is internal convertibility for current account transactions that should be given primary importance.

Internal convertibility, implying precisely the needed enforcement of a unified exchange rate, should be introduced as early as possible in the reform package - i.e., as soon as some minimum pre-conditions are satisfied.

Internal convertibility is based on the assumption that the contribution of foreign capital, even though important, is not a determining factor. Instead, the advocates of internal convertibility believe that without market clearing prices, markets cannot operate. What matters is to reestablish the correspondence between domestic and world prices. By allowing some form of limited capital movement such as under external convertibility, erratic capital movements might destabilize the exchange rate and consequently the level and structure of domestic prices.

Aganbegyan (1988) speaks of internal convertibility as the <<establishment of a single rate for the rouble and other currencies according to which enterprises and other organizations could exchange the rouble for foreign currency, and some currency earned from the export of goods and services could be exchanged into roubles.>>

Internal convertibility therefore rests on three aspects of the reforms : greater enterprise autonomy, adequate price signals and correspondence with the world economy. << Internal convertibility actually requires a radical, once-for-all shift away from the administered economy>> [Asselain, (1991), p.221] In this sense, although progress toward real internal convertibility is much more complicated to attain than external convertibility (in terms of pre-conditions to be satisfied), it might be preferable.

A minimum package of pre-conditions would most likely include a microeconomic measure (commodity convertibility), as well as a component of macroeconomic stabilization, combined with price liberalization to accompany the first stage of external opening. In this manner, we would avoid an inflationary spiral and economic agents would be given a chance for restructuring. Furthermore, it would provide without delay an additional macroeconomic tool to the country in its process of economic transformation.

This package of measures or pre-conditions needed for internal convertibility is less binding than the one needed for a complete current account convertibility and thus, would be quicker to establish. Countries can permit internal convertibility while maintaining extensive controls on current account transactions. To be effective however, such controls may have to take the form of restrictive tariffs or QRs on trade, because with internal convertibility, residents will have the foreign exchange needed to make payments for their imports. We shall discuss this issue in a next section.

That being said, we might add that the motivation for introducing internal convertibility differs from that for establishing full current account convertibility. According to Greene and Isard, the principal reason is to induce residents to sell or deposit their foreign exchange holdings, thereby channelling foreign exchange into the banking system.

E.\ Pre-conditions to Convertibility and Opening of Trade in a Centrally Planned Economy in Transition:

In the previous sections, we asked whether the satisfaction of a set of pre-conditions was required prior to the introduction of convertibility or whether

there was a case for introducing convertibility at an early stage of the reforms.

We also examined the issue of a preferred sequencing of liberalization measures.

In the light of our findings, we share the view that a "current account first" scenario could be less costly provided that some conditions are satisfied first.

We also found that a limited degree of current account convertibility (i.e. internal convertibility) could be introduced relatively rapidly, at least in principle.

Whether or not a country can move successfully to complete current account convertibility rapidly in the reform process depends largely on how fast it can satisfy a more complete set of necessary pre-conditions.

According to the well known pattern of Latin American countries such as Chile and Argentina, establishing convertibility in an inflationist environment without macroeconomic stabilization could entail the dollarization of the economy and massive adverse capital flows.

Based on these broad lessons, we shall make a case for a reform strategy adapted to the particular features of a CPE : discussions of convertibility focus on various essential elements : a realistic exchange rate, a well defined exchange regime, a strong exchange authority and a developed internal exchange market. But in a wider sense, convertibility requires an environment of general macroeconomic

stability conducive to a successful reform program. To serve that purpose, the country must establish the basis for an efficient internal market as well as put in place the necessary instruments to conduct macroeconomic policies in order to stabilize the exchange rate. This involves institution building reforms and a considerable reduction in the role of government.

More explicitly, the IMF recommends that strict monetary and fiscal policies be put in place in order to create an anti-inflationary climate and to avoid the apparition of unsustainable external imbalances after the liberalization of prices and trade have occurred.

The purpose of this section will be to identify precisely the pre-conditions and the transformations required in a CPE in order to achieve, on the one hand, a sufficient degree of convertibility for the reformed system to function and, on the other, to make that commitment sustainable.

As the process of privatization is at best a medium term task, we shall not include it in the set of minimum pre-conditions, even though it is a very important aspect of the transformation process. Note that one school of thought believes that one can relegate privatization to a later period, after the establishment of free prices and current account convertibility. And for those who seek to speed up privatization, meaningful change in this direction can be brought about only by an

efficient enterprise sector and a properly functioning capital market, which takes time to establish.

i. Macroeconomic pre-conditions

a) stabilize inflation and domestic demand

Stability here means balancing total domestic demand with total domestic production. This entails the elimination of the disparity existing between excess real balances and the shortage of goods, so that on the one hand price distortions be eliminated enabling prices to act as effective market signals, and on the other hand, the country need not borrow from abroad beyond its future capacity to service its debt. In the meantime, this disparity can be mitigated by an increase in aggregate supply. It is therefore necessary that free competition be allowed as soon as prices are freed. Lack of adjustment may result in higher inflation, an overvalued exchange rate and a balance of payments crisis.

Integration to the world economy can succeed only if inflation has been controlled.

In the case of the CPE, the argument for anti-inflationary orientations ensues from the presence of growing open inflation. It is worth to mention that even

countries that do not inherit a large repressed inflation must face the possibility that significant inflationary pressures will be generated by the policies that are necessary during the transition.

1) Monetary stabilization : eliminate excess liquidities

*** a restrictive monetary policy**

A tight monetary policy is essential to the maintenance of relative stability in both the price level and the macroeconomic environment. Such a deflationary environment can be achieved by limiting the quantity of real balances in circulation. In order to achieve this goal, a restrictive monetary policy based on credit rationing and on the control of the money supply is necessary.

*** financial discipline**

Excess liquidity can be eliminated by putting an end to the systematic monetization of deficits. Actually, a monetary system such as the one prevailing in a CPE, which is tied down to accommodate debtors and provide a perfectly elastic supply of money, can neither exert a direct control over the quantity of circulating money nor exert an indirect control by the mean of nominal interest rates. The ending of systematic monetization of the deficit, however, involves more than

just cutting budget deficits, or a change of attitude on the part of the monetary authorities. Achievement of tight financial policies at the macroeconomic level critically depends on whether financial discipline has been imposed at the microeconomic level. Essential institutional changes are necessary. These include reduction in the possibilities for bargaining over financial reliefs and preferential credits and the enforcement of bankruptcy laws. In other words, it requires a modification of attitude from the part of economic agents. Otherwise, as was mentioned earlier, if price controls were to be removed in a world of enterprises with soft budget constraints, the traditionally passive monetary system would be likely to accommodate increases in prices without any well defined upper limit. For the firms, it will mean the establishment of "hard" budget constraints in order to eliminate the automatic monetization of deficits and weed out those that will be insolvent at realistic prices. This measure would provide an incentive for enterprises to react properly to market price signals and at the same time reduce their costs by economizing on inputs. In other words, firms must be responsible for their own destiny rather than leaving them as agents of the State subject to direction by the planners. Financial discipline is not something that can be achieved in the very short term. It depends on how quickly individual's behaviours are changing.

*** deregulation of the financial sector**

Excess liquidity can also be reduced by increasing the attractiveness of domestic liquid assets through a rise in the rate of interest paid on domestic currency deposits. Raising domestic interest rates at positive real levels, however, may have adverse implications on the government budget. In CPEs where the banking system is "owned" to a large extent by the government, a rise in the interest rate paid by banks will need to be financed through taxes. From this perspective, a rise in interest rates is a drain on the budget. This argument has been pointed out by Calvo and Frenkel (1991). That being said, the deregulation of domestic financial market can be helpful in stabilizing the value of currency. Indeed, as a result of monetary authorities' accommodating behaviour, there are inflationist pressures and a lack of confidence in the domestic currency, which in turn exacerbate the tendency of enterprises to hold excess inventory. McKinnon (1991) points out that with hidden price inflation and without an attractive real rate of return being paid on enterprises' deposits at the State bank, enterprises will opt to hold excess inventories of all kind as a substitute monetary store of value, thus destabilizing the value of currency.

*** eliminate the monetary overhang**

If monetary control is to be established, any "monetary overhang" must be

eliminated to prevent the possibility of large increases in consumer spending (and imports) from the liquidation of outstanding monetary balances.

Monetary overhang can be eliminated through a price liberalization which would bring about a once-and-for-all general price increase. The underlying idea is that as prices are freed, households will try to reduce their money balances by exchanging money for goods, thereby creating an excess demand for consumer goods. This will lead to a large rise in the price level. Provided that the government budget is balanced and tough credit controls are in place, the price shock itself will eliminate the monetary overhang.³ But this is not the only conceivable way of absorbing a monetary overhang. A second alternative to deal with the monetary overhang is through a currency reform. Essentially, this means that the existing money supply is called in and new money is issued in return, with balances in excess of some maximum level being cancelled. The sale of state-owned real and financial assets (such as land, buildings, enterprises, stocks, bonds) constitutes the third alternative. On the one hand, this scheme would allow a redistribution of already existing capital into households' and private

³ Actually, there is a debate regarding the price effect of a decontrol of prices. In opposition to the common view that a liberalization of prices leads to a one-time price jump, some economists argue that as prices are liberalized, the large rise in the price level sets off a wage-price spiral, which ignites inflation. Carson [(1992, p.228)] further argues that as prices are freed, <<we can identify a type of household whose living standard will fall as a result of the price shock, unless it receives an explicit subsidy to replace the implicit subsidy, in the form of better access to goods...Continuing creation of new money may then be necessary to finance these subsidies. In this way, elimination of the monetary overhang can lead to budgetization of deficits and to on-going inflation.>>

entrepreneurs' hands, which is essential for improving productivity and for creating economic growth. On the other hand, the sale of state assets would provide a major source of income for the State budget. By selling State assets, the authorities thereby initiate a more rapid strategy for privatization. Indeed, to the extent that this approach could involve the sale of existing State-owned enterprises into private hands, this alternative is consistent with the goal of strengthening the small-scale private sector. In this sense, the advantages are closely related to those of a privatization. Several issues are worth mentioning. First, as compared to the first method, the sale of State assets is a non-inflationary solution. Second, to the extent that foreign investors can also buy domestic assets, there is a possibility that the domestic productive capital gets out of the control of domestic entities. Hence, it might be necessary to restrict foreign ownership.

The counter-argument is based on the foreign exchange receipts that would be generated by sales of domestic State assets to foreign investors. Another argument is based on management expertise, access to new technologies and know-how. [Kornai (1990), chap.1] The third issue worth mentioning is related to the consequences of income distribution, in the sense that not everybody is able to afford to buy shares of enterprises. The sale of State assets therefore entails the creation of a capitalist base in the country. From a strict welfare standpoint, this uneven distribution could be viewed as undesirable. On the other hand, the

creation of a capitalist base would contribute to the creation of a market economy middle-class (consisting of managers, accountants etc.) that make the economy work in the West.

Besides putting a serious constraint on domestic price reform, the overhang poses a constraint on the introduction of external convertibility. If restrictions on trade and currency convertibility are removed before the monetary overhang is eliminated, the opportunity to use domestic money balance to purchase imported goods will drain foreign exchange reserves and put strong pressures on the exchange rate and the interest rate.

*** Reform of the banking system : mobilizing savings and improved financial intermediation**

Strong monetary control in a market oriented economy requires a central banking system able to stabilize the economy indirectly by adjusting interest rates or other policy instruments. The absence in most CPEs of a well-developed capital market, based on market determined interest rates, limited the instruments of monetary policy to credit controls and interest rate ceilings. The excess demand pressures coming from excess liquidity could be eased by introducing more attractive non liquid monetary savings vehicles, with higher interest rates. In that context, the need for fundamental reform of the entire financial system and especially of

banking becomes self-evident. The credibility of the reform process is essential to the success of the liberalization of the domestic financial market.

As pointed out by Brainard (1990), banks will play a central role during the first stages of transition to a market economy. This role is enhanced by the virtual absence of a capital market that normally provides an important alternative source of investment funds and increase the efficiency of the financial sector. A capital market will develop, but this takes time. Privatization will necessarily create a stock market, which in principle can also play a key role in mobilizing saving and in enhancing the efficiency of resource allocation, but this will also take time. Hence, during the early period of transition when a capital market does not yet exist, banks will be the only economic agents able to ensure an efficient allocation of resources, move investment decisions away from government control, mobilize and optimally allocate domestic saving and thus improve the productivity of investment, provide payments mechanisms and facilitate the implementation of monetary policy. Improving financial intermediation is therefore crucial.

In order for the market to function, and only once some degree of macroeconomic stability (essentially the control of inflation) has been achieved, is it possible to move from a passive State-owned banking system to a hardened system of money and credit. For that to occur, we must develop at least a rudimentary financial market (including intermediaries) that can effectively limit credit and channel

domestic saving efficiently into needed investments projects according to the profitability criteria (with a corresponding reduction in the role of the State budget), i.e. banks must be able to enforce the "hard budget constraint".

This can be achieved through the creation of a decentralized banking system composed of market-oriented commercial banks performing as profit-maximizing banks and competing for clients. These banks would be indirectly controlled by an independent central bank, whose mission would be to effectively control the money supply, to establish confidence in the currency, and to create alternative financial assets which could be freely transacted. The idea of an independent central bank offers many advantages. First, a central bank should have independence from political influence in order to facilitate longer-term monetary policy decisions. An important facet of formal monetary policy independence is the extent of legal constraints on central bank funding ability of the government. By setting strict limits on central bank credit to government (and the national banking system), the central bank gains control over the asset side of its balance sheet. Second, the case for central bank independence in monetary policy is based on the view that the monetary policy would be more credible, thus improving its effectiveness in fighting inflation. The view that such independence is desirable is far from universal. In particular, Swinburne and Castello-Branco (1991) point out the conflicts which might arise between an independent central bank's monetary policy and government's fiscal policy. Such a lack of coordination

may generate uncertainty for private agents which undermines the credibility of the government's macroeconomic program as a whole, because eventually either fiscal or monetary policy has to give way. <<The central bank's duty to conduct policy at least in consultation with the political authorities is for that reason widely acknowledged, but within that, varying degrees of independence for the central bank are possible>> [Swinburne and Castello-Branco (1991), p.20]. That being said, the desired degree of independence is likely to depend on a number of country specific factors such as the state of development of financial markets and money market instruments, and the central bank budgetary independence.

2) fiscal discipline : balancing the budget

A restrictive monetary policy is not sufficient. A large budget deficit resulting from the revenue losses due to the decline in economic activity and the pervasive lack of financial control was also responsible for the high rate of money creation which fuelled hyper-inflation. In the long run, monetary stabilization will depend on the establishment and maintenance of fiscal discipline. This is particularly true in an economy where there are no mechanisms of financing a deficit other than by monetizing it (or foreign borrowing which we want to avoid) since financial assets are almost non-existent. Through its negative effects on aggregate demand and

aggregate spending, the adoption of a restrictive fiscal policy would have a deflationary effect. In addition, it would also temporarily stimulate saving (to the extent that what is not consumed is saved).

Budget control will generally require a substantial reduction of budgetary subsidies. Besides reducing the level of government spending, this will eliminate the distortion in relative prices and promote the development of efficient markets. Among others, many price subsidies especially on the tradable sector would need to be eliminated, because subsidies lead to a transfer of domestic resources abroad through the export of subsidizing goods.

However, as noted before, besides explicit subsidies, there exist numerous implicit subsidies. As discussed by Holzmann (1991), some of these implicit subsidies will disappear during the reform process while new explicit budgetary subsidies - such as the provisions for a social safety net and for enterprise restructuring- will become necessary as a result of other reform measures and lobbying pressures. Indeed, the elimination of implicit subsidies threatens redistribution away from those elements which were most heavily protected under central planning. These elements will try to preserve their status and lobby to this end. As a general rule, lobbying pressures are proportional to sunk costs in physical and human capital. [Becker (1983)] Consequently, <<total budgetary subsidies may even rise during the initial phase of transition, although overall economic subsidies are substantially

decreasing. >> [Holzmann (1991), p.24] <<A successful subsidy-reduction program must be accompanied by an adjustment in relative prices through price liberalization, the emergence of positive real interest rates, and an appropriate exchange rate policy>> [ibid, p.18]. Until distortions prevailing in CPEs are eliminated, various subsidies will continue to exist.

The protection of sunk capital, which has increasingly to be financed by monetary expansion, generates inflation. To help limit the excess issue of money, major reform in enterprise and personal income taxation are needed. This involves the replacement of the old implicit revenue system with a comprehensive and uniform system of explicit business and personal income taxes which will encourage saving and investment and discourage consumption. The new taxation system must therefore shift taxation away from capital toward labour and value-added. Moreover, the liberalizing government must quickly develop a regularized tax system for retrieving the revenues lost from giving up ownership of the means of production. For satisfying the need of an efficient fiscal system, one that does not penalize economic performance, McKinnon (1989) has suggested that a value-added tax (VAT) would be the best suited form of enterprise taxation for an economy in transition to the extent that it is a uniform tax easy to administer. On the household side, a broadly based personal income tax would also raised much needed revenues and contribute to the eventual balancing of the budget.

In summary, the implementation of policies (and the implementation of the minimal structures to support them) that will yield price stability and competitive returns on domestic currency holdings are needed to make it attractive to hold assets denominated in domestic currency. In the absence of sound macroeconomic policies, the demand for imports will be so high and currency substitution will be on such a large scale as to threaten the sustainability of convertibility (both internal and complete current account convertibility).

b) a manageable foreign exchange position and a viable balance of payments position

The general macroeconomic measures just described are needed to create the foundation of a market economy in which currency convertibility can be contemplated. But the attainment of convertibility will also require some improvement in the foreign exchange sector.

1) develop an exchange market

The creation of a foreign exchange market has two main objectives : first, transactions in foreign currencies will be easier to handle for both exporters and

importers. Second, useful information will be obtained both with respect to trends in the exchange rate market and with respect to the distribution of foreign exchange resources.

The existence of a short run interest rate, which would correctly reflect the domestic demand for credit, is an imperative condition for an exchange market to function. Indeed, in order for the exchange market to achieve properly its role, that is to establish a unified exchange rate and allow for forward cover of trade transactions, there must exist some arbitrators. It is up to the commercial banks to act as arbitrators. Their role would consist in grouping their clients' buying and selling orders for each term and transmit those orders on the spot market when the time comes. This action would determine an aggregate supply and demand for foreign currency against the national currency, and as a result it would secure a sufficient level of foreign reserves.

An exchange market system based on auction's principle might be the solution. It would play a useful transitional role in providing the authorities as well as enterprises information regarding the true valuation of foreign currency in the domestic economy, and as a basis for eventual unification of exchange rates at a realistic level. The usefulness of such markets in determining an appropriate unified exchange rate will depend however on their size and the extent to which they are free to reflect market forces.

At this stage, the reform will involve removing interest rate ceilings to achieve positive and meaningful real rates of interest, that is, which reflect the shortage existing on the monetary and capital markets. Of course, real positive interest rates presuppose positive returns and yields on investments. All in all, a positive rate would permit an efficient allocation of financial resources. Macroeconomic stability and strong bank supervision both need to be in place before deregulating the domestic financial sector.

2) establish an appropriate exchange rate

The fourth pre-condition for introducing both internal and complete current account convertibility involves a realistic exchange rate that will reconcile internal and external balances in the medium term. In the short-run however, it will have, at a minimum, to maintain a sustainable current account balance because << unless the exchange rate is broadly consistent with equilibrium in the balance of payments, introducing convertibility will generate large imbalances >> [Greene and Isard (1991), p.9]

Hence, trade liberalization requires as a prerequisite the adoption of a unified (for all types of external operations) and realistic exchange rate necessary to re-establish the correspondence between domestic and world prices. In turn, for any exchange rate policy to be effective, Nuti's three pre-conditions must be satisfied.

Let us repeat briefly those pre-conditions : the existence of market-clearing prices, significant price elasticity of demand and supply, and the absence of subsidies on the tradable sector. [see part II (section C)] It is evident that the choice of an initial exchange rate parity is extremely difficult under the condition of economic transformation.

Given the overvaluation of the exchange rate prevailing in most CPE, a depreciation of the exchange rate, in real terms, is expected to occur during the transition toward a market economy. Under the conditions prevailing in the economy during the early stage of transformation, a market clearing exchange rate will tend to assign a rather low value to the domestic currency, relative to both purchasing power parity and the prevailing official exchange rate. Such large deviations are due to various factors such as increased demand for foreign goods by domestic economic agents, capital flight due to economic uncertainties during the transition, increased demand for hard currency, weak competitiveness of the export sector combined with the growing demand for import.

One traditional approach rests on seeking purchasing power parity. Due to the highly distorted pre-liberalization price structure and the uncertainty about inflation during the transition, this approach is bound to be misleading.

Alternatively, the competitive approach is based on the estimation of an equilibrium exchange rate (which in practice invariably means devaluation) that will achieve a competitive exchange rate.

In determining the level of the appropriate foreign exchange rate, the aim of the authorities must be to avoid both undervaluation, which would imply short term stagflation and overvaluation, which would result in an intolerable balance of payments deficit and successive devaluations.

As McKinnon (1991) has shown, the lack of a hard budget constraint in the enterprise sector leads to an "overbidding" for foreign exchange and to an exchange rate which undervalues the domestic currency.

A domestic price reform, by reducing the distorted structure of domestic relative prices, should help establish a meaningful value for the exchange rate, once the inflationary pressures have been weakened. That supposes an initial devaluation of the domestic currency to more realistic levels.

The introduction of convertibility prior to reasonable satisfaction of macroeconomic stabilization will require a highly undervalued currency to maintain confidence.

In the short term, this may constitute a serious threat to the success of reforms. The need for an appropriate exchange rate policy will be discussed in a later section.

3) ensure an adequate stock of liquidity

A country must have an adequate level of international liquidity to maintain a stable macroeconomic environment for domestic producers and consumers. More specifically, an adequate level allows a country to maintain balance of payments equilibrium and to defend its exchange rate if it is fixed.

Without sufficient liquidity, the country might be perceived as vulnerable to external shocks, thereby encouraging speculation on its currency.

The amount of liquidity a country needs to support current account convertibility depends largely on the degree of exchange rate flexibility it desires. [Greene and Isard (1991)]

That being said, of course, the balance of payments matters only if a country has a fixed exchange rate system. If the exchange rate is freely flexible, an inflationary monetary policy or a domestic inconvertibility could not have repercussions on the central bank's foreign reserves. Instead, they would lead to a devaluation of the

domestic currency. In this context, the convertibility problem manifests itself not as a balance of payments problem but as an exchange rate problem.

[Bofinger (1991)]

In summary, a realistic exchange rate and adequate international liquidity are needed to limit speculative pressures and to insulate the domestic economy from small scale currency substitution. In the absence of those conditions, any commitment to convertibility, both internal and complete current account convertibility, is unlikely to carry credibility. Any failure to establish credibility would in turn be detrimental to sustainability.

ii. Microeconomic Conditions

a) commodity convertibility

As long as the domestic currency does not fulfil the basic functions of money even in internal transactions, it certainly cannot fulfil those functions in foreign trade. Therefore, current account convertibility requires guaranteed domestic commodity convertibility into goods and services as well.

The introduction of a meaningful form of currency convertibility is subordinate to establishing real domestic convertibility of money into goods (i.e. commodity

convertibility), both in the enterprise and in the consumer sector. This means that enterprises should be able to respond to market type incentives such as productivity and profits. They should be granted the right to spend money balances as they see fit without permission and they should have a hard budget constraint. That implies that the domestic currency must be stabilized so that it becomes attractive to hold.

Complete current account convertibility hardly makes sense until commodity convertibility exists, since that would give enterprises the ability to buy abroad freely while denying them the right to buy at home without the permission of the authorities. Without a stable currency in terms of internal purchasing power, commodity convertibility, domestic rationing could indeed be easily circumvented by importing foreign goods, as all unsatisfied demands would be concentrated on the foreign sector. This would add to the demand for imports.

The restructuring of the price system and the determination of a correct exchange rate (the proper rate of devaluation) are the key to achieving real commodity convertibility. The decentralization of import and export decisions at the level of enterprises without price reform would lead to massive exports of underpriced goods. Moreover, no rationalization of the price structure can take place with an

arbitrary exchange rate because it would imply a false valuation of imported inputs. On the other hand, no correct exchange rate can be determined on the basis of a distorted price system either.

Note that this microeconomic condition is a necessary pre-condition for full current account convertibility. It is not part of the minimum set of pre-conditions required to achieve internal convertibility.

b) create a market competition environment

1) enterprise restructuring

Restructuring is needed to fill the gaps between current performance and what is required to become competitive internationally. It has to take place if firms are to respond appropriately to price signals. In more general terms, an environment in which economic agents have both the incentives and the ability to respond to market prices, from which all major distortions should have been eliminated, must be created. It is needed because in most CPEs products and technologies are many years behind internationally competitive standards; because resources were wasted; and because management skills, cost and quality controls, marketing were

almost inexistent. In addition, enterprises lacked competitive incentives because the survival of producers was assured by various soft budget mechanisms and implicit and explicit subsidies.

Restructuring involves the break-up of many enterprises, which were typically too large and inefficient, the creation of private property rights in the means of production, and further hardening of the budget constraint. To begin with, it implies institutional and complementary reforms. Legal, regulatory, accounting and audit systems are needed, respectively, to support markets in order to enforce contracts and protect private property rights, to regulate commercial relations and to organize and monitor information. Complementing reforms are needed investments in human capital and bank inspection. Management skills have to be developed especially in the areas of finance and marketing. The development of market-economy skills and infrastructures, however, are lengthy processes which pose a constraint on the efficiency and speed of reforms. [Fischer and Gelb (1990)]

2) price liberalization

The need to free administered prices and eliminate subsidies is by now widely recognized. Price reform is the cornerstone of all internal reforms. It should at a minimum accompany a move to currency convertibility, and at best should precede

it by a short interval. Only market-clearing prices provide the scarcity signals that allow an economy to work properly. Price liberalization is also necessary for the credible hardening of budget constraints. Fischer and Gelb [(1990), p.21] have noted that << until prices are rational, profits and losses are not necessarily good indicators of efficiency, and are therefore not a good guide to decisions on which firms should be closed and should obtain financing for increased investment.>> Moreover, if prices for a large set of goods remain fixed, for whatever reason, the other elements of the reform package will not make much sense. It is worth emphasizing that the price of certain essential goods should not be liberalized too soon. It should also be mentioned that price reform cannot produce the desired effects - relative prices that reflect scarcity - unless firms face "hard budget constraints". Without that financial discipline and a bankruptcy legislation, firms will be encouraged to compensate for price increases by raising wages, thus triggering an inflationary spiral. The inflationary impact of price liberalization has already been discussed in an earlier section. We might add, in this regard, that the sequencing of reforms - whether institutional and behavioral changes fostering the imposition of financial discipline have effectively preceded, or at least occurred simultaneously with, the liberalization of prices - is critical.

F.\ Foreign Exchange Rate Regime:

Most observers agree that the system to strive for is one where domestic relative prices are linked to world market prices through an open non-distorted trade system. The price level would be tied down either by the adoption of a fixed nominal exchange rate or by a flexible nominal exchange rate accompanied by monetary and fiscal policy pursuing a domestic inflation target independently of the rest of the world. In that latter case, it is the money supply which would serve as the nominal anchor as opposed to the exchange rate.

Hence, beyond the creation of an exchange market, the problem of choosing a proper exchange rate regime must be solved. Would emergent market economies be best served by a fixed or a floating nominal exchange rate?

The degree of flexibility for the exchange rate becomes a crucial decision as soon as some degree of current account convertibility has been established. The free floating option has gained little support in comparison to a fixed regime.

i. the case for a fixed exchange rate

The strategy of an exchange rate pegged to a stable monetary unit is suggested above all by the literature on exchange rate policies for developing countries.

Past experience shows very few example of developing countries that have floated successfully their currency on a sustained basis.

That being said, there are several powerful arguments against floating in the emergent market economies of East Europe.

The first, is the difficulty of interpreting the 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 needed with a floating rate. This argument was stressed by Bofinger (1990). A floating exchange rate needs to be accompanied by an autonomous monetary policy based on well defined principles, such as seeking a steady growth of the money supply or of nominal income. Such a monetary policy is impracticable when variables such as the demand for money or the propensity to save are liable to change unpredictably as a result of fundamental changes in the economic organization.

The failure of a strategy of flexible rates in the context of developing countries is commonly attributed to the inadequate development of domestic financial markets and their lack of integration with world markets. When financial market are poorly developed, temporary balance of payments disturbances can lead to high exchange rate volatility. A floating rate can be expected to function efficiently only in the presence of a well developed domestic capital market, which can allow

shocks to be absorbed through changes in asset positions [Williamson (1991)]. In this respect, financial markets in a former centrally planned country are not very different from those in developing countries.

Third, given the risk of exchange rate volatility due to inflation, a floating regime would be unstable. Williamson [(1991), p.42] evokes 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.>>

In connection with the argument of volatility, the theory stipulates that in a freely fluctuating regime, unexpected changes in the exchange rate increases the exchange rate risk - the possibility that a contract specified in a foreign currency will yield less than expected when payment is made because the exchange rate has fallen - while in a fixed exchange rate regime with capital controls, there is likely to be less variability in the exchange rate in the short run.

Some authors advocate a fixed regime as an anchor for expectations and thus helping to control inflation. The nominal anchor role of a fixed nominal exchange

rate excludes any kind of crawling peg, which could be made identical with a real exchange rate target. This strategy can only be used as an instrument of domestic macroeconomic stabilization if restrictions on foreign trade are abolished.

Thus, the strategy crucially depends on establishing complete current account convertibility. [Bofinger (1990)]

Last, some economists argue that the instability of the exchange rate inherent in a floating rate regime would undermine the main aim of currency convertibility.

That is to import rational price ratios. According to Kenen (1991), the exchange rate must be fixed or pegged in order to instil respect of world prices. That would not be possible if these prices were fluctuating because of variations in the exchange rate.

ii. the case for a permanently fixed exchange rate

The literature on optimum currency areas [McKinnon (1963)] provides another important argument against flexible rates : in a small economy, variations in a flexible rate lead to relatively large fluctuation in the domestic price of tradable and in the overall price level. Because the central bank can control only the price of domestically produced good, the larger the size of the tradable sector, the more directly are variations in a flexible rate transmitted in the form of fluctuations in the price level. This instability of the price level reduces the store of value and

the standard of value functions of the domestic currency ; in the case of a very strong depreciation, even the means of exchange function can be impaired.

Countries characterized by small open economies (in terms of the ratio of tradable to non-tradable in its output) should therefore peg their currency in order to secure the monetary value of their currency. A permanently fixed exchange rate offers several advantages. These include reduced transaction costs and the elimination of exchange rate uncertainty due to devaluation or appreciation of the fixed exchange rate.

iii. the case for complete flexibility

At the other end of the spectrum, there are three main arguments advanced to support floating against pegging. One is that governments lack the knowledge to pick the right exchange rate and thus would lack credibility in defending the pegged rate. Second, some authors argue that a market equilibrates itself; thus, the best way to determine the "right" value of a currency is to let the exchange rate freely float. Third, assuming that the exchange rate is not allowed to float, the maintenance of convertibility requires both an adequate stock of foreign exchange reserves and a satisfactory flow balance of payments position. The latter needs a competitive exchange rate as well as control over domestic demand; hence, any excess liquidities must have been resorbed. In the absence of a firm monetary and fiscal policy, demand for imports will inevitably be so high as to

threaten the sustainability of convertibility. The second argument is strengthened by the fact that a government without reserves cannot defend a fixed (nominal) exchange rate away from its equilibrium value determined by market forces.

iv. the case for an intermediate regime

Permanent fixity of the exchange rate requires the willingness to allow the money supply to be determined endogenously by the state of the balance of payments : a payments deficit must be allowed to reduce the money supply and raise interest rates, so as to cure the deficit without a change in the exchange rate.

Disequilibrium of the external balance can encourage speculative attacks on the currency; whether a currency succumbs to such attacks is unpredictable. As a result, in the long term, exchange rate risk may be higher in a fixed rate regime than if floating is allowed. In countries where capital markets are underdeveloped, a fixed exchange rate regime therefore appears questionable.

<<For these reasons it would seem prudent for the emerging market economies to contemplate intermediate exchange rate regimes and to distinguish between the short run when the economy is first opened and during the whole period of stabilization, and the longer run.>> [Williamson (1991), p.44]

According to Williamson, an emerging market economy should aim at holding its exchange rate fixed in the short-run after first liberalizing prices. As was

mentioned in a previous section, the prices inherited from the CPE system bears no relation to scarcity, and a main purpose of establishing convertibility is to permit the importation of a price system from abroad. This process will be facilitated by the existence of a fixed exchange rate to provide an anchor for the new price structure. In a liberalization context when inflation is still present, a fixed exchange rate tends to stabilize the inflationist anticipations and reinforces the credibility of the internal monetary policy. The case for seeking to preserve a fixed exchange rate in the long run is much less compelling. We will not extend the discussion on this subject as the present work is mostly concerned with the transition aspects of the market-oriented reforms.

That being said, if a former CPE wants to initiate a process of economic integration with the world economy, raise external trade, opt for an export oriented boom, and attract foreign investment, it must guarantee stability and it must reduce uncertainty about the exchange rate. Since export promotion requires not just a competitive exchange rate but the assurance that the exchange rate is going to remain competitive in the future, this requires a willingness to devalue when needed to offset differential inflation. Furthermore, in order to protect the competitive position of the export sector, it is also necessary to maintain the real exchange rate at a predictable level. Given the pros and cons cited above, a fixed but adjustable exchange rate ("crawling peg") could be an interesting alternative.

Let us define the real exchange rate as $\epsilon = eP^*/P$ where e is the nominal exchange rate, P^* and P are the foreign and domestic prices respectively. Hence, for a given world price P^* , any domestic inflationary pressure could be offset by a depreciation of the domestic currency (i.e. a rise in e).

<<In the presence of a continuing and independently determined inflation, a [continual] indexing [cf the real exchange rate] implies a passive, but variable, downward crawl in the nominal exchange rate>> [McKinnon (1991), p.107].

The management of an indexed exchange rate must be supported by exchange controls on capital account if we want to avoid currency substitution and most important, if the exchange rate commitment is not to be undermined by speculative flows resulting from uncertainties during the transition. Otherwise, because economic agents would have unrestricted access to foreign currency, the demand for domestic money would fall in favour of foreign exchange assets.

Another intermediate regime between fixed and flexible rates, that is a dual rate system is also often suggested. In such a system, current account transactions can be conducted at the fixed exchange rate, while the capital transactions would be conducted at a freely flexible (or managed) exchange rate so as to attain a target level for the capital account. The underlying aim of a dual rate system is to shelter the domestic real economy from external and domestic financial shocks. In effect, the burden of adjustment to financial shocks is redirected from the domestic interest rate to the financial exchange rate. The current account

exchange rate can be kept fixed thereby maintaining a stability for the relative prices of goods and services. Greenwood [(1985), p.56] argued that the adoption of a dual exchange rate system was equivalent to levying a tariff on financial transactions with the rest of the world. Furthermore, he argued that a dual system was economically equivalent to a fixed exchange rate with capital controls, or alternatively, that a dual exchange rate system is equivalent to current account convertibility with capital account inconvertibility, in the same sense that a tariff is said to be equivalent to a quota. A regime of this sort reduces the substitutability between domestic and external assets without erecting any barriers to capital flows. It should however be strictly temporary.

G.\ Transitional Measures

We have shown that in the short term, only a limited degree of convertibility should be adopted by the reforming authorities. Only once the pre-conditions are firmly established is it suggested to remove all restrictions on current account transactions. We shall show in the following section that, in order to reduce adjustment costs during the transition toward the unrestricted convertible system, some accompanying measures are needed. But first, let us examine the short term effects of current and capital account liberalization. By doing so, we shall be in a better position to discuss the role of accompanying policies.

i. Short-term effects of external liberalization

a) short term effects of the (complete) current account liberalization :

Current account liberalization could be defined as the elimination of commercial restrictions, for example the removal of a nominal tariff on domestic imports.

* Assume that commercial restrictions, such as a nominal tariff on imports, are eliminated while inconvertibility on foreign assets is maintained by means of strict capital controls.

-effects on price :

A gradual liberalization of trade, such as the elimination of the tariff on imports, leads to a fall in prices, as a consequence of the drop in price of importable goods, and therefore diverts demand toward the market for importable (exports are assumed to react with a lag). As a result of this transfer, an excess supply on the domestic market is likely to occur, which causes a decline in the price of domestic goods and the overall price level.

-effect on welfare :

The decline in prices is likely to induce more consumption. In that case, trade liberalization worsens the intertemporal allocation of consumption by reducing further saving and thus investment.

-effects on interest rates :

The fall in prices lowers national income which by lowering the demand for money, creates an excess supply of money that manifests itself both in the financial sector and in expenditures. The nominal rate of interest drops temporarily (the "liquidity effect") and stabilizes itself at its initial level as the monetary disequilibrium is eliminated.

-effect on exchange rates :

The deflation combined with the trade balance deficit and the consequent loss of international reserves resulting from the removal of trade restrictions will lead under a fixed exchange rate regime to a real depreciation of the domestic currency. Under a flexible regime, both the nominal and the real exchange rates will depreciate.

-effects on balance of payments:

The combination of the excess supply of money and the associated lower interest rate, combined with the change in relative prices results in a current account deficit. [Khan and Zahler (1983)]

*** Assume instead that trade restrictions are removed but that financial restrictions on the external capital account take the form of a multiple exchange rate system. More specifically, the limited degree of convertibility on foreign assets is imposed by the use of an official dual exchange rate system. The central authorities intervene continuously to defend a specific commercial (official) exchange rate. Meanwhile, the financial (parallel) exchange rate is permitted to float freely.**

- effect on price :

According to Bhandari (1989), a decrease of the domestic tariff rate implies a lower price level of financially settled imports.

- effect on balance of payments and exchange rates :

The reduction in the tariff rate, through its impact on the price level, leads to increased domestic demand for financially settled imports, and therefore

stimulates domestic aggregate demand. In order to restore the resulting financially settled trade balance deficit, the real exchange rate must depreciate. Given the tariff reduction, the elimination of the current account pressure induces the expectation of a nominal financial exchange rate appreciation, coupled with price deflation, which in turn will stimulate output. Because the commercial exchange rate is fixed, price deflation leads to a commercial real exchange rate depreciation.⁴

- effect on the interest rate :

In addition, because output is stimulated, the demand for money is increased; as a result, the domestic interest rate rises to ensure the continued maintenance of money market equilibrium. [Bhandari (1989)]

Thus, in the short-run, the financial rate will appreciate, undershooting its long run value. The effect of commercial liberalization is also to generate a current account deficit. This result contrasts with the conventional analysis for flexible exchange rate, where it is shown that a current account deficit is accompanied by a depreciation of the exchange rate. The different correlations among exchange rate and the current account reflect the underlying differences between the two

⁴ As argued by Greenwood (1985), a government levying a tariff on imports so as to achieve some import goal is equivalent to the government levying a tax on private financial transactions undertaken with the rest of the world.

exchange rate regimes. According to Aizenman [(1985), p.251], the explication lies in the fact that << under a flexible rate regime, a current account deficit reduces holding of foreign assets by the private sector, leaving holdings of money balances intact. Under a multiple rate system, a current account deficit reduces holdings of money balances, leaving holdings of foreign assets in the hand of the private sector intact. To regain asset composition equilibrium, we need an appreciation. >>

b) Short term effects of the capital account liberalization :

External capital account liberalization could be defined as the complete removal of the existing restrictions on international capital flows [for example see Khan and Zahler (1983)]. It is also possible to view external financial repression as the result of the imposition of a multiple exchange rate system [as in Bhandari(1989)]. The unification of exchange rates could therefore constitute another form of external capital account liberalization. For the purpose of our analysis, let us assume that capital controls take the form of capital flows restrictions.

The immediate effect of removing restrictions on the capital account is an inflow of capital as the domestic interest rate is above the foreign interest rate (given our assumption about domestic financial markets).

-effect on welfare :

Relaxing capital controls, for example by lowering the loan rate below the world interest rate, would increase investment.

-effects on balance of payments:

Conform to the monetary approach to the balance of payments, by which balance of payments disequilibria result in changes in the money supply, the inflow of capital creates a surplus of the balance of payments, thus raising the stock of international reserves. The supply of money being equal to the stock of international reserves and the level of domestic credit, the inflow of capital creates an excess supply of money. That in turn, has an expansionary effect on aggregate demand, which is reflected by an initial rise in prices. Assuming sticky prices, the real money supply is greater than before. Increased demand pressures lead to a worsening of the trade balance (in the short-term). Note that in the long-term, prices will rise in proportion to increase in the money supply. The real money supply will therefore be the same as at the start.

-effect on interest rate :

The excess supply of money, as expected, also temporarily lowers the nominal domestic interest rates. Later, as prices increase, the real money supply will shrink back, and the interest rate will rise. From this it follows that interest rates, in the long-term, will also be the same as before.

-effects on real and nominal exchange rates :

According to the asset-market approach, exchange rates will change when interest rate differentials change or when expectations about future exchange rates change. Hence, the inflation resulting from capital inflows will lead, under a fixed exchange rate regime, to a real appreciation of the exchange rate. Under a flexible regime, the capital inflows will result in an appreciation of the nominal exchange rate which, combined with inflation, leads to an appreciation of the real exchange rate, too. In both case, the short-term real appreciation "undershoots" the long-term appreciation. What has happen ? Since investors are assumed to have rational expectations, they know that prices will eventually rise to the full extent of the change in the money supply and that the exchange rate must depreciate from its starting point. Because of that expected depreciation, investors will require higher interest rates to persuade them to carry on holding domestic assets. But as explained above, short-term interest rates are lower than their initial level. To

restore equilibrium, the exchange rate must depreciate to less than its long-term value, that is to a point from which it is expected to appreciate and compensate for the period of low interest rates. In this sense, the short-term exchange rate is said to "undershoot" its long-term value. [Dornbush (1976)]

-effects on external indebtedness :

In addition, as long as there exists a positive interest rate differential in favour of the domestic economy, foreign debt (the accumulation of capital flows) increases. In order to generate resources to cover rising interest payments on the external debt, the economy must depress aggregate demand so as to generate trade surpluses. The current account being defined as the difference between exports and imports less the interest payments on the foreign debt, the rising interest payments creates a current account deficit. [Khan and Zahler (1983)] The current account deficit is financed by increases in foreign debt rather than by a fall in international reserves, as was the case with trade liberalization.

We just said that the liberalization of the capital account increases external indebtedness. To the extent that many developing countries are already in a debt crisis situation and therefore facing temporary credit rationing in the international

capital market, it is very possible that the removal of capital account restrictions may instead result in capital outflows, depending on the country's approach to solve its debt problem.

Table 1: Summary of the Short-Term Effects of Current and Capital Account Liberalization

Effects on	Current Account Liberalization			Capital Account Liberalization	
	capital controls		multiple rate system	commercial restrictions	
	fixed	flexible		fixed	flexible
PRICE	-		-	+	
OUTPUT	-		+	+	
MONEY DEMAND	-		+	-	
INTEREST RATE (nominal)	-		+	-	
CURRENT ACCOUNT	deficit		deficit	deficit	
RESERVES	-	n/a		+	n/a
REAL RATE of EXCHANGE	+	+	+	-	-
	deprec	deprec.	deprec.	apprec.	apprec.
NOMINAL EXCHANGE RATE	fixed	+	-	fixed	-
		deprec.	apprec.		apprec.
CAPITAL FLOWS	n/a	n/a	inflows	inflows	
EXTERNAL DEBT	-			+	

note : assuming no financial repression
 assuming that each account liberalization takes place while the other account is still restricted.

Unlike trade liberalization, capital account liberalization does not significantly affect relative prices nor the level of domestic prices, nor is there a significant loss of international reserves; but there is rather an initial gain. There is however, a process of growing indebtedness that involves a persistent current account deficit that is due to the need to make interest payments on the foreign debt. Finally, there is a temporary decline in the rate of interest.

ii. A Role for Accompanying Measures

The analysis in the previous section showed that the liberalization process adversely affects the balance of payments situation no matter which order of liberalization is chosen. Given the Latin American countries' experience, it may be more prudent to delay (complete) current account convertibility until the foreign exchange constraint has been mastered.

The theory shows that, in the meantime, the authorities could reduce the adverse effects on the current account by providing transitional protection. Other policies could be used to restore a satisfactory macroeconomic equilibrium, notably fiscal and monetary policies and an appropriate exchange rate management. Choosing the appropriate mix will not be part of our analysis since there exists as many

combination as there are country specific circumstances. In what follows, we have chosen to limit our discussion to the role of an exchange rate policy and of trade protection during the transition period.

a) Exchange rate policy

Countries with regulated foreign trade and domestic finance sectors have generally sought to impose exchange controls on outflows and inflows of capital and to keep their real exchange rate fairly constant (by adjusting the nominal exchange rate) in order to avoid the adverse effects of inflationary pressures. However, with the passage to convertibility and the deregulation of domestic financial markets, the risks of macroeconomic instability can be mitigated by using an appropriate exchange rate policy.⁵ A passive indexing of the exchange rate and the control of capital flows become less desirable. Moreover, the significance of a commitment to convertibility depends on a country's exchange rate policy. Given those two factors, the difficult task of choosing the appropriate exchange rate is therefore a crucial issue.

In setting an exchange rate policy, the key is, as pointed out by Williamson (1991), to make sure that the real exchange rate is sufficiently competitive to support and

⁵ We have shown in section F that those risks could also be mitigated by choosing the appropriate exchange rate regime. While experiences of developing countries have given support for a fixed exchange rate, we have suggested that a crawling peg could be a well advised compromise during the transition period.

to nurture the long-term restructuring toward the expansion of the export sector, as well as to avoid the emergence of balance of payments difficulties. Export promotion requires not just a competitive exchange rate, but the assurance that the rate is going to remain competitive in the future so that firms will want to invest more to expand their export capacity. The maintenance of a competitive rate requires a willingness to devalue when needed to offset differential inflation such as to reduce net incentives for import substitution but it should not be devalued more than for achieving that purpose. Excessive devaluation is costly since it aggravates short-run stagflation : the price rise induced by the devaluation cuts the real value of money balances, and in the short-run this effect outweighs the positive effects on demand from export expansion. Correcting external imbalances generally requires adjusting the exchange rate toward its equilibrium level to redirect resources to the tradable goods sector and to reduce spending. In order to offset domestic inflation and protect the competitive position of the export sector, a fixed but adjustable exchange rate as mentioned in a previous section would therefore be desirable.

Countries that have allowed their real exchange rate to become overvalued have experienced both a slowing of the expansion of their export sector and capital flight. Exchange rate overvaluation retards growth and contributes to the deterioration of the terms of trade. [see IMF (1992)]

Alternatively, if we define the current account deficit in terms of three variables : saving (S), investment (I) and budget deficit (BD), the following relationship is established :

$$\begin{array}{l} \text{decline in} \\ \text{aggregate net} \\ \text{foreign assets} \end{array} = \begin{array}{l} \text{Current} \\ \text{account} \\ \text{deficit} \end{array} = (I-S) + \text{BD}$$

According to Dornbush (1984), there are several channels through which an appropriate exchange rate policy could reduce the current account deficit.

via an increase in saving

-A transitory real depreciation or an undervalued exchange rate, would encourage saving.

via a reduction in investment

In the context of an open economy, movements in real exchange rates affect investment due to adjustment costs and the high import factor content.

-A transitory real appreciation or equivalently an overvalued real exchange rate leads to an accumulation of capital because overvaluation implies a low real price of imported goods (and factor of production). For those investments that have an

import content, the overvaluation in fact constitutes an investment subsidy and tends to promote investment. The expectation of a real depreciation, by creating the anticipation of a future rise of the real price of imports in terms of domestic goods, acts as an investment stimulus. Once the real depreciation does actually take place, the accumulation behaviour is reversed.

via the reduction in the government budget deficit

The linkages between exchange rate and government budget is given by a trade off existing between international competitiveness and budget balance. <<First, to the extent that there is an external public debt, a real depreciation raises the real value of debt service in terms of domestic output and hence is likely to increase the budget deficit. Second, if the government has fixed the exchange rate at a given level, but has since found it necessary to depreciate, then the resulting exchange rate subsidy will deteriorate the budget.>> [Dornbush (1984), p.13]

A way to minimize debt finance is therefore to seek overvaluation of the exchange rate. That being said, a restrictive fiscal policy remains the most direct way to minimize the government budget deficit. However, if the chosen liberalization sequence chosen has an adverse effect on national output and unemployment, such a policy would only exacerbate the disequilibrium.

As indicated by Greene and Isard [(1991), p.9], << it may be useful to envision an exchange rate path that identifies levels of the real exchange rate consistent with current account sustainability at different points in the reform process....There should be some appreciation in the equilibrium real exchange rate as the underlying competitiveness of the country's productive sector, including both export and import substitution industries, improves.>>

In summary, even though there is a role for exchange rate policy, successful adjustment to free trade is not just a question of getting the exchange rate "right". A real depreciation would encourage saving and reduce investment, both of which help reduce the current account deficit. But a real depreciation also increases the budget deficit which on the contrary worsens the external balance. We might add that an exchange rate sufficiently depreciated to allow domestic producers to survive increased foreign competition during the early stage of reform can, on the other hand, make all imports appear costly for consumers and producers, including imports of essential intermediate goods and investment goods critical for the country's development efforts.

That is why some authors have suggested instead to rely on temporary trade protection measures during the transition period.

b) Temporary trade protectionism

Full integration into the world trading system requires a convertible currency. But convertibility does not necessarily mean free trade right away. The reluctance to eliminate all-at-once the restrictions on current account transactions is based on the infant industry argument for protecting domestic producers who are just starting on their "learning curve" from foreign competition. This is consistent with the belief that a rapid adoption of world prices and convertibility may generate current account imbalance, exchange rate instability, rising competition of imports and unemployment in the short term. Thus, alongside the establishment of internal convertibility, several kinds of transitional arrangements have been proposed in order to smooth the transition process. Such arrangements would be compatible with the Articles of Agreement of the IMF despite the impact that trade restrictions have on payments. According to established practice, measures of trade regulation are not considered restrictions on payments as long as they are temporary.

moving from implicit to explicit tariff protection

The most serious case against moving to immediate free trade has been made by McKinnon (1991). Before him, Krueger and Bhagwati (1978) had also evoked that idea but in a less developed manner. His main argument is that because of

the rationalization of prices induced by convertibility, enterprises are confronted with substantial adjustment costs such as an increase in their input prices and are vulnerable to import competition and thus more likely to be subject to bankruptcy if no transitional protection is provided to them during the period of adaptation to the new prices.

The choice of a commercial policy in the course of trade liberalization depends heavily on the pre-existing system of protection. In a CPE, << the highly cascaded structure of implicit tariffs raised the level of effective protection in finished goods to the point where most manufacturing exhibited negative (or very low) value added at world market prices.>> [McKinnon (1991), p.9] In such circumstances, a devaluation coupled with trade liberalization would lead to further welfare losses as the cost of tradable inputs increases even further. <<Such a precipitate move to free trade could provoke the collapse of most domestic manufacturing industries no matter at what level the exchange rate is set. >> [McKinnon (1991), p.9]] The solution is temporary protection through tariffs.

Only when the balance of payment is under control, should QRs be abandoned. In the meantime, it is necessary to impose a tariff system on imports as an indirect way of regulating imports and stimulating exports and of closing the gap between internal and foreign trade prices.

After the price of inputs increases to world levels, explicit tariff protection from competing imports of finished goods need to be at least as high as the old implicit rate if the given industry is to survive.

The tariff rates would initially be set high, to protect domestic enterprises from foreign competition during the period needed to restructure and undertake new investments. A "cascading" tariff adjusted downward from very high levels protecting domestic finished goods, to lower levels for raw material. McKinnon's objective is to give temporary but substantial protection to the industries that previously got the greatest implicit protection through low input costs. These rates would gradually be decreased at preannounced pace until all rates have converged to some low uniform level.

On the one hand, the use of a temporary import tariff has certain advantages in terms of the infant-industry argument as described above. On the other hand, it limits competition in the domestic economy, when during the first stage of the transition, it is precisely the contrary one is looking for. If competition from imports is effectively excluded by high tariffs, the domestic producers face little incentive to keep down prices or to pursue efficiency in production. Other reasons for which a competitive environment is needed were discussed in part II (section B, i, 1). Overall however, it has been argued that a temporary tariff protection is preferable to a quota or a large devaluation. First, tariffs improve

the country's fiscal situation by raising revenues accruing to the government. With quota, this is not, in general, the case. It is only if the government sells import licenses instead of distributing them free. Second, a tariff is preferable to a devaluation because devaluing is stagflationary. Williamson (1991) has suggested another reason : a devaluation pushes up the price of all goods whereas McKinnon-type tariffs are concentrated on basic commodities such as food and raw materials.

export levy

Other Western proposal for reform, notably the Houston Summit Report [IMF et al (1990)] have accepted that there is a case for some transitional protection but have proposed to provide much of it through a temporary export levy on energy and perhaps on a few other input materials that were very underpriced under the central system of the former Soviet Union.

The disadvantage of this approach is that it does not give enterprises an incentive to economize on the use of energy and so delays the releasing of resources for exports.

subsidize temporarily domestic production

There are strong arguments against this form of temporary protection. First, subsidies go against the trend of eliminating price distortions and promoting allocative efficiency. In the context of a CPE in transition to a market economy, it would only retard the establishment of market mechanisms. Second, subsidies weaken the fiscal position and therefore, would destabilize further an already fragile economy.

In summary :

Whatever set of transitional protection is chosen, it must be noted that such arrangements cannot stabilize both the external current account and the exchange rate. Any move to reduce imports will tend to keep the exchange rate more appreciated in the short term. Any effort to stabilize the exchange rate will encourage imports.

**"The convertible ruble
Is simply about
How the Market is in
And how Planning is out"**

**(extract from "To an Inconvertible Friend")
- Joe Berliner, poet**

PART THREE

AN ASSESSMENT OF THE RUSSIAN MOVE TOWARD CONVERTIBILITY AND EXTERNAL LIBERALIZATION

In its "Memorandum on the Economic Policy of the Russian Federation" adopted by the government of Boris Yeltsin on February 27, 1992, the Russian government reaffirmed its commitment to move rapidly toward a unified fixed exchange rate as soon as possible and to achieve full convertibility for the ruble.

Given the state of the Russian economy and the progress of the transformation into a market economy, is this last objective realistic ? Are the necessary economic conditions in place ?

Given what has been said in the part two - in terms of preconditions and sequencing - it seems unlikely that full ruble convertibility can be envisaged in a short or medium term. Despite some efforts, in practice, no meaningful comprehensive reform has succeeded at stabilizing the domestic economy : the money supply seems to be out of control; hyperinflation is looming; no hard budget constraint has been introduced. In fact, the strongest political coalition seems to have a soft-budget constraint as their main platform.

This part provides an account of the principal macroeconomic developments in the Federation of Russia and discusses the prospects for establishing current account convertibility. The first section describes the economic situation prevailing in the eve of the dissolution of the Soviet Union. The next section reviews the

main elements of the package of Decrees (those relevant to our analysis) undertaken by the Russian government in its effort to move toward a market economy. In section C, we shall evaluate the results of these reforms in light of the necessary pre-conditions needed for the establishment of sustainable and credible currency convertibility.

A \ An Overview of the Inherited Economic Situation in 1991

In comparison to the traditional features of a CPE, the economic situation inherited by the new economic policy makers was significantly modified during the years of Perestroika. The economic reforms undertaken in the second half of the 1980s did little to address the deep seated economic problems of the USSR. The partial nature of reforms introduced new distortions, as the increasing economic freedoms tended to undermine the central planning mechanism. The Union witnessed the emergence of a steepening decline in activity and growing financial imbalances. All in all, the situation was characterized as unfavourable.

The deterioration in the economy of the Russian Federation that took place in the late 1980s and in 1990 became more pronounced in 1991 with the falling apart of the Union. The decline in domestic output accelerated while inflationary pressures mounted as the budget deficit increased and bank credit to enterprises grew. Damaging effects also came from the disorder in the financial and credit

system. Implementing a stabilization program in such a recessionary climate was not an easy task for reformers. Table 2 shows some selected economic indicators of the Russian Federation in 1991. It should be remembered that these data suffer from some degree of distortion as there exists a serious index numbers bias, especially in evaluating output decreases and price increases (inflation). There are good reasons to believe that both are overstated by official statistics.⁶ However, even if these figures are distorted, they reflect fairly closely the trends found in statistical series from other sources.

Table 2: Selected Economic Indicators for the Russian Federation in 1991 (changes in %)

real GDP	-9
industrial output	-8
oil production	-11
consumer price index	90.4
industrial wholesale prices	138
employment	-1.1
current account (in %GDP)	0.7
total exports	-30
oil exports	-42
total imports	-46
money supply M2	77
total domestic credit	93
bank domestic credit	127

source: IMF (1992)

⁶ For more details on these specific methodological problems, the reader can refer to Osband (1991)

i. Internal Imbalances

Fiscal and monetary policies were in disarray in 1991, and the crisis of the financial and monetary systems had deepened.

a) Declining Output

According to the IMF, the Russian GDP (in real terms) was estimated to have fallen by 9 per cent in 1991. [source: RFE/RL Report vol. 1 No. 36, 11 September 1992] A number of factors contributed to the sharp output decline in 1991. Most of them were attributable to disruptions on the supply side : falling exports to Western markets, which reduced the hard currency resources available to import industrial inputs and spare parts; the further disintegration of the system of central planning and traditional enterprise links, and an accelerated decline in investment. As a result, industrial output fell by 8 per cent for the year. In the energy sector, whose exports provide an important source of hard currency earnings, crude oil production dropped by 11 per cent, due to a lack of equipment.

b) Price Increase

Inflation accelerated markedly in 1991. Industrial wholesale prices rose by 138 per cent compared with 1990 and retail prices by 90 per cent. Two key sources initiated these rapid price increases. The first was the combined effect of a severe fiscal imbalance and an irresponsible monetary policy (further discussed below). Partial liberalization measures (April 1991) combined with administered price increases represented the second major inflationary forces. The April 1991 price reform was supposed to restore equilibrium of the domestic market and reduce shortages. However, due to accelerating disposable income rises and falling supply of consumer goods, it did not. Product shortages have persisted and households' actual level of consumption was below their desired level. Some empirical estimates of the undesired accumulation of monetary balances in the former Soviet Union were presented by Cottarelli and Blejer (1991). These authors concluded that as monetary balances in that country are the main form in which households can accumulate wealth, a monetary overhang, close to 20 per cent of GDP at the end of 1990, did exist. It started to take sizeable proportions toward the end of the 1980s when enterprise reforms raised significantly the volume of profits that could be retained by the enterprises and used without restrictions. <<[This increased liquidity,] together with the relaxation of wages constraints, led to an unprecedented growth in wages and a major acceleration on households' income growth, fuelling, in the absence of adequate increases in

consumer goods, the growth of households' monetary holdings at increasingly high rates. >> [ibid, p.9] The inflationary impact of a monetary overhang has been fully discussed in part II, section E.i, footnote 3. As a result of inflation, reliance on barter and other non-monetary forms of trade rose and flight from the ruble increased. Toward the end of the year, the announcement of further price liberalization measures coupled with the gradual loss of effective control over State regulated prices led to a sharp acceleration of inflation.

Figure 1 : Price Developments (until end of 1991)

c) Budget Deficit

The fiscal position of the Russian Federation substantially deteriorated over 1990-1991. The accounts of the central Russian government indicated a deficit representing 14 per cent of GDP.[source: Goskomstat] Initially, the increasing deficits that emerged in the beginning of the 1980s reflected the expansion of bank credit to the government and to enterprises, as a consequence of the preeminence given in the Plan to investment over consumption and soft-budget constraint. Then, the reduction in tax revenues on sale of alcohol as a result of the anti-alcohol campaign of 1985-1986 contributed to the further deterioration of the budget. In 1987-1988, a new Law on State Enterprises, which attempted to give some autonomy to enterprises (including financial autonomy) led to a further contraction in government revenues. The requirement to hand nearly all profits over to the State was replaced by a profits tax.

Thus, the growth of the budgetary deficit was mainly due to the lower than expected revenues, which were constrained by the declining fiscal authority of the central government and by the virtual absence of an effective revenue collection mechanism, once ministerial control over State enterprises had waned. In addition to the foregone profit taxes, on the expenditure side, subsidies of various kinds continued at high levels to compensate for the April 1991 price increases.

d) Expansion of Money and Credit

Monetary and credit policy was another source of inflationary pressures. Total domestic credit of the Russian banking system grew by 93 per cent in 1991 [source: IMF (1992)], with a ceiling of 25 per cent on the commercial bank lending rates (which was well below inflation). Credit for the economy as a whole grew by 127 per cent in 1991. The increase was concentrated in short term credit to enterprises, which rose by 175 per cent. The expansion of the money supply has been largely the result of bank crediting to enterprises and the passive accommodation of a series of large State budget deficit over the last years by the Central bank (Gosbank).

In 1991, money was still largely passive. The rapid monetary growth led to a worsening of the monetary overhang. Despite the recession, broad money grew by 77 per cent in 1991. In addressing that issue, the Soviet Union undertook a partial confiscatory monetary reform in January 1991 which consisted of the withdrawal from circulation of large denomination bills. The reform failed, however, to reduce the amount of cash in circulation by a sufficiently large volume. The breakdown of monetary control in 1991 further eroded the role of the ruble as a medium of exchange, which contributed to a marked increase in barter transactions. Besides the problem of substantial cash holdings, there is also a "saving overhang" in terms of forced savings due to the absence of consumer

goods in the legal market - black market prices being prohibitive. The lack of monetary control was also reflected in a high rate of short-term credit expansion to enterprises and the government sector. The annual increase of total credit of the banking system has been 140 per cent during 1991. That increase was mostly concentrated in short term credit to enterprises which rose by 175 per cent. With that, interest rates on loans from the banking system remained well below the rate of inflation in 1991.

e) The Lack of Financial Discipline

Another consequence of the new liberties accorded to enterprises was to create improved market-oriented incentives by, among others, granting them the right to keep a greater proportion of their profits. Incentives to obey to a hard-budget constraints were introduced in principle. But in practice, budget constraints remained soft. As the government was unable (due to the absence of a bankruptcy law) nor did it have the political will, to credibly threaten not to bail-out loss-makers, enterprises continued to expect the covering of their losses through implicit and explicit subsidies, and resources continued to be inefficiently allocated. Cheap bank credit was still available to enterprises. As a general rule, the institutional and structural reforms needed to enforce and control a hard-budget constraint were absent.

f) Dismantling of the Monobank System

The economic reforms under way in the former USSR have led to a radical change in the country's banking sector. Originally, the State Bank (Gosbank) together with its subsidiaries, as well as the Foreign Trade Bank (Vnechtorgbank) and the Bank for Financing Capital Investments (Stroybank) the only Soviet banks.

Up until 1988, Gosbank provided both the usual functions of a Central Bank (such as the management of the currency issue, the participation in clearing and settlement systems, the functions of bankers' bank and government's bank), in addition to the commercial banking needs of enterprises. It was in practice a monobank because it exerted a quasi-monopoly on all monetary credit and payments operations, according to Gosplan's and the Ministry of Finance's instructions. The activities of Vnechtorgbank and of Stroybank were limited to an administrative role in the foreign sector and in granting credits to the construction industry, respectively. A network of specialized banks accountable to Gosbank was established in order to facilitate the distribution of financial resources to most productive sectors of the economy.

Beginning in 1988, the basis of a two-tier banking system was therefore introduced. Five new state owned banks were created to take over all commercial

banking functions (i.e. long-term credit distribution) for a particular sector, while Gosbank retained short-term credit allocation function and traditional central banking functions. The five new sectoral banks were the Bank for Construction and Industry (Promstroibank), the Bank for Agro-industry (Agropombank), the Bank for Housing and communal services (Zhilsotsbank), the Saving Bank (Sberbank) and the Bank for Economic Foreign Affairs (Vneshnekonombank) which replaced the former Vnechtorgbank. Despite some decentralization efforts, the financial system remained largely uncompetitive, since each the banks were not allowed to deal with enterprises other than those assigned to them. In fact, interest rates played only a very little regulatory role in the allocation of credits which were instead allocated according to economic objectives set by Central planners. Later in 1988, the reform allowed cooperatives and state enterprises to establish their own banks. It brought an element of competition in the banking system as these were initially free to set the interest rate they charged. However, not long after their creation, the government introduced some regulations to restrict interest rates from being too low as compared to those charged by State banks and by the same token, to channel credit through the State owned banking sector. In practice, there was therefore still little or no competition for deposit and loans.

With the establishment of a two-tier banking system in December 1990, the Central Bank was divested of its commercial banking operations.

The Banking Law enacted by the Soviet Parliament in December 1990 therefore suggested that the Soviet Union had acquired a market type banking system with its Central Bank (a branch of Gosbank) and new commercial banks proliferating. These had been set up mostly by enterprises as a vehicle for inter-enterprise financing independently of government restrictions. As a rule, they were small and undercapitalized. From mid-1990, commercial banks were granted foreign exchange licenses, which allowed the banks to open foreign exchange deposits, to hold deposits with foreign banks and to deal in foreign exchange. Until then, these transactions had been carried out solely by Vneshnekonombank. The former large specialized banks, which used to service specific economic industries, were transformed into new banking institutions allowed to conduct unrestricted commercial banking activities, while Agropombank and Zhilsotsbank were liquidated in the course of 1991. That being said, in practice, the system remained passive, and competition between small commercial banks and former specialized banks remained nonexistent. Indeed, in reality, these new state-owned banking institutions continued to carry the same range of banking functions as they kept their former clients and continued to control the bulk of the financial transactions of the enterprise sector. In other words, they remained more or less "specialized". In the absence of a bankruptcy law for lost making firms and of a tight supervision system, and tight credit conditions based on market criteria, banks did not enforce the hard budget constraint. As stressed by Brainard (1991), these banks (formerly specialized) were created by transferring existing loans from the portfolio of the

Central bank to the new institutions. Thus the banks perpetuated the accumulation of "bad" loans in their portfolio. <<In extending new loans, therefore, the bank is not putting its own capital resources at risk, since any potential losses will accrue in one way or another to the Central bank...This in turn implies an accumulation of contingent liabilities on the account of the government's fiscal budget.>> [ibid, p.54] Unless the government is willing to throw a firm into bankruptcy, the bank cannot pursue an active credit policy. More generally, the banking system could not well function as long as rules for such basic principles as collateral on loans, a system of deposit insurance or a reliable mechanism for reporting bank operation, do not exist.

With respect to the Russian banking system itself, it began to act independently of the USSR structure only in 1991. In particular, the Central Bank of Russia, which served previously as a branch of Gosbank, was given added power. Thus, from early 1991, the Central Bank of Russia was free to conduct its own monetary policy, while Gosbank continued to control currency emission. On November 1991, Gosbank was taken over by the Central Bank of Russia, including all ruble printing presses.

ii. Foreign Exchange Restrictions and Enfeebled External Position

a) Exchange Rate Developments and Foreign Exchange Arrangements

Figure 2 : Exchange Rate Developments (January 1991-March 1992)

3 of/de 3

PM-1 3½"x4" PHOTOGRAPHIC MICROCOPY TARGET
NBS 1010a ANSI/ISO #2 EQUIVALENT

PRECISIONSM RESOLUTION TARGETS

During 1991, the ruble had multiple exchange rates against convertible currencies.

A "commercial exchange rate", which was fixed in terms of a basket of five currencies, fluctuated between rub 1.6 and rub 1.8 = \$1 during 1991. It applied to all capital flows, centralized imports and the foreign exchange surrendered by export enterprises. An "official rate", which had ceased to be used for current transactions, was still used for statistical purposes and the denomination of external claims. This rate was also pegged to the basket of five currencies; during 1991, it fluctuated between rub 0.55 and 0.60 = \$1. The "tourist rate" (which was called the "special rate" until April 1991 and then the "market rate" up to July 1991 when it was renamed the "tourist rate") was set far lower. It averaged rub 40 = \$1, until December 1991, when it was allowed to float. [source : IMF]

A (very thin) free interbank market for foreign exchange, the Currency Exchange, held weekly under the auspices of the Gosbank, had been created in April 1991 to break the state monopoly on foreign exchange transactions. It replaced the foreign exchange auctions previously held by the Vneshnekonombank. The interbank market was organized as a joint stock company. Only a limited number of members could participate in the auctions. Beginning in August 1991, foreign currency auctions were also held in the Russian Exchange Bank. In parallel, commercial banks were allowed to register foreign exchange transactions between enterprises.

Exchange arrangements under the earlier Soviet policy in 1991 were also based on a 80-90 per cent foreign exchange surrender requirement to the Vneshnekonombank (the Bank for Foreign Trade). The remainder was deposited with the newly established banks authorized to deal in foreign exchange operations

b) Declining Foreign Trade and Foreign Exchange Reserves

Important changes in the organization of foreign trade have been carried out in recent years. Greater enterprise autonomy, encouragement of various forms of private enterprises and more generally the reorganization of the foreign trade sector, had granted some enterprises (whose output was competitive enough on the foreign market) the right to operate directly on the foreign market without having to pass by the Ministry of Foreign Trade and Foreign Trade Organizations. To conduct trade, a license was needed. Their proceeds were to be held in foreign currency deposit at the State Foreign Trade Bank. By the end of 1991, in principle, all enterprises had been given the right to participate in foreign trade, although indirect controls (by quota allocation and licensing) had replaced the earlier rigid administrative controls. They were still given targets for hard currency earnings, but they were accorded some freedom as to how they achieved these targets. They were also allowed to retain a proportion of these earnings to use as they saw fit.

In 1991, the external policies pursued in Russia were predominantly those laid down by the Union government and Gosbank. An overvalued exchange rate ⁷ impeded the expansion of exports. In addition, exports were regulated through a system of licensing and quotas, which were set so as to protect the supply of goods for the domestic market, which was facing growing shortages. Imports were mainly constrained by the availability of foreign exchange. Total exports declined by 30 per cent. This situation was the result of the weakness of the country's export base, basically consisting of raw materials and energy; fuel (and other sources of energy) accounting for more than half of all exports. The fall in oil extraction in recent years entailed a steep reduction in the export of oil and oil products, which declined by 42 per cent in 1991. Imports declined by 46 per cent (all in US dollars). In spite of this deterioration of the external foreign trade position, the trade balance of Russia was estimated to have improved to a surplus of \$ 12 billion in 1991. However, by the end of 1991, the Central Bank of Russia had depleted most of its foreign exchange reserves.

In summary, at the end of 1991, shortly after the dissolution of the Soviet Union, the economic situation was marked by a deep depression which is believed to have gotten under way when the command economy had started to be dismantled but

⁷ The exchange rate was overvalued if we compare it to the market clearing exchange rate which would have prevailed if domestic prices had not been controlled and had not been compensated for by implicit subsidies. If we look at the black market exchange rate, which is recognized to better reflect the market forces, we observe that the official rate (rub = 1\$) was much lower than the one prevailing on parallel markets.

had still not been replaced by market mechanisms or institutions. According to Goskomstat, the official estimate of Soviet inflation in 1991 was 141 per cent. The budget deficit and extensive shortages were severe throughout 1991. Bank lending rose substantially. On the official Moscow auction/interbank foreign exchange market, the external value of the currency collapsed as the ruble lost 86 per cent of its value against the dollar. The only positive note was in the foreign sector where a trade surplus was registered. At the end of 1991, the base for the creation of an effective market economy was lacking : there was no well developed firmly established private sector, nor was there a competitive demonopolized market environment or a system of financial institutions to ensure the effective redistribution of resources. Russia did have its own banking and monetary system. But in spite of reforms, the banking system remained passive and uncompetitive.

B.\ Transformation of the Russian Economy since the Attempted August 1991 Coup

i. Stabilization of the Internal Sector

Under the current Russian conditions prevailing at the time, the credibility of the government was so limited and the disintegration of the market so overwhelming, that there was hardly any alternative to shock therapy, so says Sachs. The Russian

authorities opted for this "big bang" approach rather than a more gradual one. We shall evaluate the merits and demerits of both approaches (applied to the Russian context) later on, in part III (section C, ii).

Thus, some three months after the failure of the August coup, the Russian government took in hand a reform program (known as Gaidar's reforms) aimed at the liberalization of the economy and its financial stabilization. The main elements of the stabilization package included : reducing the budget deficit, cutting sharply the money supply and the volume of credit, and stabilizing the ruble's exchange rate. The decontrol of prices and the launching of a privatization program completed the package.

a) The Liberalization of Prices

The liberalization of prices was from the beginning a key element of the Russian government's program. On January 1992, the authorities implemented a comprehensive price liberalization which caused an initial price shock of at least 600 per cent during the following two months and converted into hyperinflation during 1992. In principle, virtually all prices were freed from central government control : about 80 per cent of wholesale and 90 per cent of retail prices were freed. Temporary exceptions were made in the case of industrial inputs, energy, and essential consumer goods which remained under government price control in

order to protect the most vulnerable groups of the population and enterprises through the first stage of price liberalization. The authorities noted their intentions to eliminate all remaining administered retail prices by the end of the first quarter of 1992.

b) Fiscal Balance

The achievement of fiscal balance in the first quarter of 1992 was another key target of the Russian government's stabilization package. Much effort was devoted to balancing the budget by sweeping reductions in expenditures and the implementation of an entirely new tax system. The major reductions in budget expenditures concerned large cuts in defense, investment and subsidies of all kinds although immediately following liberalization, it became clear that, given the large price jumps in almost all markets, the maintenance of regulated prices would require substantial budgetary resources. The chief components of the new tax system were the creation of a value-added tax (VAT) set at a uniform rate of 28 per cent, excise taxes on a wide range of consumer goods, a progressive personal income tax, a corporate tax and export tariffs.

c) Tightening of Credit

The Central Bank of Russia indicated its intention to tighten credit. Given that the Russian banking system was not yet at a stage of development where exclusive reliance for monetary control could be placed on market based instruments, ceilings on Central Bank credit expansion to the commercial banks were to be the main instrument of credit control. In pursuing this policy of credit control, the central bank aims at preventing non-price discrimination in the allocation of credit among enterprises and across sectors. In other words, it is a means to limit direct allocation of credit. By such centralization of credit allocation, one might question how much is this system different from the one prevailing under central planning. Although credit was to be tight, it would be allowed to grow enough to provide enterprises the means with which to respond to the new price structure and market incentives. The Central Bank was also committed to raise its bank rate to a positive real level as soon as possible. Its general policy was to help ensure that the entire range of interest rates, both on deposits and on loans, would become positive in real terms.

d) Small Scale Privatization

At the end of November 1991, a series of decrees and laws on privatization was adopted by the Russian government. It also created an administrative apparatus for privatization and began implementing a radical privatization program .

ii. Reforms in the External Sector

In addition to the stabilization package indicated above, the package of decrees outlined steps to be taken toward the opening of the Russian economy to the outside and toward the legal establishment of an internally convertible currency and the abolition of import restrictions.

As of January 1992, the international trade system was liberalized in principle. All import restrictions were suspended, and Russia was declared opened to foreign investments and trade. In practice however, the authorities maintained exchange restrictions.

a) Restrictions on Export Proceeds and on Import Payments

All firms were free to engage in international trade. In practice, however, this was less than complete liberalization. For instance, the old system of registration for

firms wishing to participate in foreign currency transactions was retained.

Centralized imports continued to be allocated at a non-market rate of exchange.

A system of issuing licenses for imports and exports and of determining quotas and tariffs was introduced to regulate international trade. Amazingly, the system was designed to restrict exports and encourage imports. That was logical in a shortage economy where central planners were concerned about the export of limited and strategic industrial inputs needed for domestic production. It should be remembered that CPEs were import-oriented and used protection (and exchange rate policy) to subsidize imports. In a transition economy, exports should instead be encouraged to generate hard currency revenues, favour a competitive environment and growth, while the tariff protects the infant-industries. Actually, imports were almost completely liberalized at the beginning of 1992 while heavy export duties on a variety of goods amounting to a high percentage of export prices were established, the purpose of which was primarily one of currency regulation. As of July 1, some of the quota and licenses restricting exports were eliminated. Exports of energy remained restricted.

Despite calls for the elimination of surrender requirements for local enterprises, in practice, foreign exchange movements were still regulated via the maintenance of a mandatory surrender of hard currency export earnings, which were channelled to the State. A new surrender requirement of 40 per cent of foreign exchange earnings was applied to exporters of raw materials at a "special commercial

exchange rate" (more depreciated than the old commercial rate of rub 1.8 = \$1), while a new 10 per cent mandatory exchange requirement, payable by all exporters alike at a rate less detrimental to exports, was introduced to form a stabilization fund for the ruble market exchange rate (that is, to support official intervention in the interbank market). The remaining 50 per cent of hard currency proceeds could be used for needed imports or sold in the foreign exchange market. The retention quota system had been eliminated (under the old system, exporters could keep just a fraction of hard currency even after the 40 per cent exchange). That measure encouraged enterprises to pay greater attention to their foreign trade performances. The fact that exporters were allowed to retain part of their foreign exchange receipts provided a source of hard currency income to enterprises, most of which are entitled to conduct foreign transactions. From these, they could pay for their imports at their own discretion. Together with export tariff, the mandatory sale of hard currency aimed at restricting export proceeds.

Although Russian authorities did not impose formal restrictions on import payments, a number of technical obstacles to such payments arose in connection with the illiquidity of Vneshnekonombank which in July 1992 still held an estimated 90 per cent of local hard currency accounts funds and which found itself unable to fulfil payment orders on behalf of local depositors.

The foreign trade bank that exerted a strict control over all foreign exchange operations in the past had given up its monopoly as new commercial banks were established to finance trade and enterprises. These new banks have also received the right to carry out convertible currency transactions.

b) Exchange Rate Policy

On November 1991, Boris Yeltsin signed a Decree on the Liberalization of foreign Economic Activities, setting out the basic principles of the international trade and payments system for the Russian federation. Radical changes in the foreign exchange system were to be introduced.

This new system was designed to expand the role of market forces gradually in order to determine a unified flexible exchange rate for the ruble. This rate was to replace the three exchange rates that existed previously under the Union, namely the official rate of Gosbank, the commercial rate and the tourist exchange rate.

The distortions in the exchange rates were reduced through a substantial devaluation of the rates for commercial operations. However, several exchange rates remained in place. Not only did unification of the ruble exchange rate prove impossible, but the Russian authorities actually introduced additional rates.

A system of dual exchange rates applying to commercial operations was in effect. Centralized imports were allocated by the State to organizations at an exchange rate different from the market rate. An administrative rate of rub 5.4 = \$ 1 was to apply to the so-called centralized imports operations and to expenditures related to service payments and to imports of basic necessities. For exporters, a system of retention quotas continued to operate.

A (fixed) "quasi-market exchange rate" of the Central Bank of Russia was initially applied to government trade transactions and to the 10 per cent surrender requirement introduced for export earnings. This rate was to be quoted weekly by the Central Bank of Russia. Initially, it was quoted at rub 110 = \$ 1 (compared to the commercial rate of (average) rub 1.75 = \$ 1 in 1991), after taking into account the interbank rate. Another rate called the "special commercial rate" pegged at 50 per cent of the quasi-market rate (rub 55 = \$ 1 since December 1991) was applied to the 40 per cent mandatory exchange of hard currency earnings. This special commercial rate is used for the purchase of foreign exchange by the government in order to build deposits in the "Hard Currency Reserve of the Russian Federation". The funds in this Reserve provided for payments of external debt service of the Russian Federation and for the so-called centralized imports of basic necessities. In January 1992, an exchange rate of rub 5.4 = \$ 1 was created to apply to centralized import operations. The foreign exchange retained by exporters may be used to finance their own imports or to

sell on the exchange market at a market determined rate. A "freely floating inter-bank market rate" for all non government foreign exchange transactions determined on the Moscow Interbank Currency Exchange market (MICE) was even more depreciated ($140 + 160 \text{ rub} = \1). Finally, a tourist rate used by Western businesses and travellers was pegged to the interbank market rate. Until the end of June 1992, it was fluctuating between $\text{rub } 100 - 125 = \1 . Commercial banks were free to determine the tourist rate. A wholly artificial "official" rate at about $\text{rub } 0.6 = \$1$ (not listed by the Central Bank of Russia) inherited from the command economy continued to be in place for the valuation of external assets and for statistical purposes.

By a decree of June 14, 1992, the artificially low special commercial exchange rate was abolished in a first step to unify the ruble rate. This initiative ended the system of dual exchange rates.

With stage two of Gaidar's Reform, the Central bank of Russia unified the exchange rates for the ruble into a single floating rate set by the MICE market. On July 1, the official rate was set at $\text{rub } 125.6 = \$1$, which represented a weighted average of the rates used in transactions on the foreign currency exchange market in June.

The retention of foreign currency earnings was maintained. However, the situation for exporters was improved as the whole 50 per cent had to be sold to the State at the "market rate" - 30 per cent of foreign exchange earnings were to be sold to the central bank of Russia's hard currency reserve, and the remaining 20 per cent were to be sold directly on the domestic hard currency market.⁸

Furthermore, exporters were given the right to sell the balance of their foreign exchange earnings to Russian banks at the market rate or to hold it in a hard currency account with Russian banks.

During the first part of 1992, the Russian authorities sought to make the ruble a convertible currency at a uniform and stable exchange rate. For this purpose, the black market exchange rate was legalized and hard currency restrictions were removed, as the Russian banks were given the permission to freely sell hard currency to the public in exchange for rubles at the market exchange rate. At the enterprise level, enterprises were free to buy and sell foreign exchange for purposes of foreign trade at the market foreign exchange rate. [see appendix A.1]

⁸ In 1991, 80-90 per cent of foreign currency earnings had to be surrendered by export enterprises at an average "commercial exchange rate" of rub 1.7 = \$1. Clearly, with the new arrangements, exports incentives are higher as the surrender requirement is less in terms of percentage of hard currency earnings and in terms of the exchange rate at which these earnings must be sold.

With respect to profit repatriation, according to regulations, it is possible for non-resident enterprises and joint ventures to buy hard currency at the interbank market exchange rate for profit repatriation purposes.

With respect to foreign currency held locally, under the former Union, non-residents faced a very restrictive régime. In addition, non-residents were not allowed to own or operate ordinary current deposit bank accounts in rubles, except for very specific purposes. Even with those rubles that they could hold legally, they could not do much : non-resident enterprises were traditionally required to pay in hard currency. Since then, restrictions have been relaxed in Russia. Non-residents may hold local foreign currency accounts without restrictions. Foreigners' access to local currency accounts has also been liberalized to some extent. As of April 1992, non-residents may also open ruble accounts (referred to as type "R" account) and sell foreign exchange for rubles to cover operating costs of their representative offices in the territory of Russia.

c) Development of an Exchange Market

At the beginning of 1992, the Moscow Interbank Currency Exchange (MICE) was created. It met twice a week, and replaced the former Gosbank hard currency exchange. As opposed to the former USSR State Bank's foreign currency

exchange joint stock company, the MICE is not a state organization, although the founders do include the Central Bank of Russia, something that will allow the Central bank to conduct an active policy in the foreign currency market and to influence the ruble exchange rate if it chooses to do so. A second difference is that, given that there are more members, the foreign currency market is guaranteed to be more stable. This will rule out any jumps in the exchange rate associated with speculative operations of any individual bank by reducing the influence of any bank on the market exchange rate. With respect to the functioning of the MICE, it works as follows. Authorized traders and commercial banks entitled to act as agents on behalf of enterprises in trading sessions buy and sell foreign exchange. The market forces determine the balance of supply and demand, and ultimately the market exchange rate. Since July 1, 1992, the Central Bank of Russia uses the rate determined on the MICE's latest trading session as a signal to quote the official exchange rate for the ruble vis-à-vis the U.S. dollar. From time to time, the Central Bank of Russia intervenes to support the ruble by selling hard currency to equilibrate demand and supply.

Since July 1992, the Central Bank of Russia has permitted authorized banks to sell hard currency to individuals without restrictions and without documentation. This marks another step toward legalizing and expanding the circulation of hard currency in Russia.

C.\ Evaluation of the Stabilization and Liberalization Program

By mid-1992, of all Republics of the CIS, only Russia had some sort of global plan to reform the economy. In spite of its efforts in implementing a stabilization program, the Russian government did not succeed.

The State Statistical Committee's (Goskomstat) mid-year report noted that attempts at macroeconomic stabilization, which began in January, failed to translate into output recovery, mainly because of the excessive monopolization of the Russian economy.

In terms of the pre-conditions discussed in part two, we observe that there has been some movement in the right direction, but not enough. We believe that besides the softness of the budget constraint, this is mainly caused by the fact that the institutional and structural changes implemented were too few and too feeble. Thus, they failed to establish a properly functioning market framework, which is necessary for the reforms to be effective. Hence, many aspects of the economy were reformed in principle; in practice, the implementation of some reforms has been several times postponed so that the situation today is little better than before.

In what follows, we shall take each pre-condition one by one and evaluate the achievements of the Russian government. In other words, we shall examine whether or not these pre-requisites for full current account convertibility have been satisfied.

i. Evaluation in Terms of "Economic Pre-conditions"

a) Stabilization of Domestic Prices and Domestic Demand

Midyear figures of 1992 show that price indices have increased dramatically. The IMF estimated that retail prices in Russia rose by 875 per cent during the first eight months of 1992. [source: RFE/RL Report vol 1. No 36, 11 September 1992, p.68]. Since the end of the first quarter, the monthly rate was about 20 per cent. By the end of 1992, it was approaching 50 per cent per month. According to Goskomstat, consumer prices increased ten-fold between December 1991 and June 1992; wholesale prices rose 15 times. The latest figures for the third quarter do not show improvement. Price liberalization did not lead to the virtual elimination of shortages. Instead, given that the country was already in a deep depression, the liberalization of prices led to a large initial increase in prices. Because of the overhang of previously accumulated monetary balances, the liberalization of prices created a favourable environment for a rapid open

inflation.⁹ As a result of this surge of inflation, the ruble ceased to be a viable medium for domestic economic transactions. Consumer goods (i.e. barter) remain one of the dominant medium of exchange, together with the dollarization. As McKinnon (1990) explained, the monetary overhang is an impediment to implementing price reform that would otherwise be welfare improving. The liberalization of prices also did created a favourable environment for inflation because it took place under quasi-monopolistic market conditions, in an economy still dominated by State enterprises characterized by non-market behaviours. Also, the relaxation of central control has given a stimulus to "mafiya" elements whose presence is a powerful entry barrier. These elements sustain monopolies in the same way that the mafia sustains high prices for illegal goods and services in the West. The facts that it was not accompanied by a wage increase control policy to ensure that nominal income rose relatively less than prices was another contributing factor. In addition, monetary policy was marked by negative real interest rates and the fiscal policy, by a budget deficit. Under these conditions, the Russian stabilization program could not succeed.

In addition, in reaction to rising prices (including wages), the domestic real economy was destabilized further. In an economy already in a depression, enterprises did not react to shifts in production costs by cutting those as one would expect. Instead, enterprises tried to protect their employees by raising their

⁹ For an explanation, the reader should refer to footnote 3 in part II (section E.i.a.1)

wages and by keeping them employed. Enterprises passed their growing costs on to consumers by raising consumer prices, and they reduced output. The price elasticity of supply remains very low.

b) Monetary Stabilization and Elimination of Excess Liquidity

In terms of monetary stabilization, intended to end the shortages of goods and the end of inflation, the Russian authorities have failed. Inflation is high and shortages remain, although, according to Yavlinsky (1992), these have been reduced. According to the IMF (1992), the households' excess holdings of monetary balances has been substantially reduced by the January price liberalization. On the other hand, the non-enforcement of the hard budget constraint at all levels of the economy permitted a huge expansion of the money supply. The economy is still characterized by an excess liquidity. Owing to the lack of efficient monetary and fiscal controls, the IMF believes that there is a serious risk of further intensification of inflationary pressures in Russia.

Furthermore, the end of the monetization of the budget deficit has not occurred either, in spite of the government's acknowledgement that any ruble stabilization is bound to fail unless inflation is checked and budgets balanced.

Money is still largely passive. Since the beginning of market reforms, the former highly controlled and centralized banking system has undergone substantial changes. The problem is that it has undergone considerable decentralization without becoming financially accountable. Indeed, the soft budget constraint has been maintained as the proliferating new commercial banks have continued to supply their enterprises (some of them heavily indebted) with cheap credit which they obtained from the Central Bank. The Central Bank of Russia, fearing the collapse of the banking system, initiated the automatic crediting of commercial bank deficits. Evidently, financial stabilization, which was another key objective of the reform, has proved to be a failure.

With a dominant state sector still run largely along administrative lines (where goods are still largely administratively allocated), and the lack of a sizable private sector able to respond to market signals, monetary and fiscal policies were ineffective. In fact, the institutions inherited by Russia from the USSR were unsuitable for implementing a classical monetary stabilization policy. In that context, monetary stabilization had little chance of success.

The growing demand in nominal terms for money resulting from the rapid increase in prices has greatly exceeded the quantities supplied. There resulted a shortage of cash which, despite the introduction of new 200, 500 and 5,000 ruble notes, the authorities controlled with difficulty. This phenomenon contributed in

turn to the growing problem of interenterprise debt. Indeed, the constraint on the demand for money resulting from the State's inability to print enough currency to cover the economy's transactions has forced enterprises to give one another credit by simply not paying for goods and services delivered. This growing interenterprise indebtedness has exacerbated the already fragile Russian financial system. << Having gotten rid of the monetary overhang, we have received a debt overhang >>[Khandruev, vice chairman of Central Bank of Russia, cited in Makarov] But the final outcome is the same : debt overhang defeats any hard monetary policy because ultimately it will be monetized.

Moreover, the lobby pressures from the militaro-industrial complex have forced the budgetization of subsidies, making the hardening of the budget constraint even more difficult. Under these pressures, the government, despite its commitment to a tight credit policy, has been forced to make some concessions by expanding new credits to industry, and has thus injected more inflationary pressure into the economy. Given the serious structural distortions of the Russian economy, any relaxation of the government's commitment to a tight monetary policy would lead to another "round" of inflation. In addition, the government has been unable to implement a positive real interest rate policy, in spite of the government's recognition of the importance of positive real interest rates (that is, of setting nominal rates above the rate of inflation) in order to prevent inflation and the hoarding of stocks by enterprises, an interest rate policy was still non-existent in

the Russian stabilization plan. As this contradicts the government's intended tight monetary policy and anti-inflationary measures, the central bank did raise nominal interest rates from 20 to 80 per cent [source:EIU No3 1992], but they were still very negative in real terms. As a result, it seems that Russia has become a net exporter of capital and on the internal side, it is providing the incentive to hoard.

c) Balancing the Budget

The inability to balance the budget made stabilization impossible. In the first six months of the year, the budget deficit has been completely out of control at 17 per cent of GDP. [source: EIU No. 3] The problems come from the fact that the authorities have been counting too heavily on the ability of the Russian financial system to collect enough of the hard currency earnings of the Russian exporters (through high export duties) to build up reserves and on the capacity of its tax collection system to raise targeted revenues. For instance, there was inadequate preparation on the part of both the government and the enterprise sector to collect and remit the VAT introduced earlier. The problems therefore resulted from developments on both the income and the expenditure sides. In addition to the two factors already mentioned, the main problems lay in the decline in economic activity and in the financial bankruptcy of many enterprises (which caused a shrinking of the tax base), as well as in the substantial reduction of imports and exports.

d) Establishment of Market Clearing Prices

The liberalization of markets is still far from complete. As we have seen, alongside price liberalization, some categories of goods remained regulated by State price control. In this regard, the economist G. Yavlinsky has offered some serious criticisms. In his opinion, there was no liberalization of price formation; it turned out to be a decentralization. Prices are still not free. Local authorities and monopolies are setting them instead of the government. The government's Memorandum included a commitment to free the prices of oil (and of other fuels) and electricity, which has always been heavily subsidized. (This contributed to one of the most severe distortions of the former Soviet economy.) Gradually, all prices were going to be freed to increase to world market levels. But on April 1992, the government backed out from its earlier commitment and approved instead the imposition of a tax on oil producers that charged higher prices than permitted. In this manner, energy prices were to be kept down. At present, since late September, the government has increased energy prices significantly (while still maintaining a ceiling). Oil prices have doubled, but have still not reached world levels. In fact, Russian oil still costs only about a sixth of the world market price charged in dollars. Progress on energy price rises has been slower than planned and as long as there exists a discrepancy with world price levels, low oil prices will remain a source of inflationary pressure.

e) Establishment of Commodity Convertibility

In principle, enterprises no longer have to go through the planning hierarchy and obtain clearance prior to being granted the right to obtain and use money balance in order to acquire goods and services on both the local and foreign markets. In practice however, enterprises are still constrained by cash shortages, prohibitive prices and duties etc. At the household level, consumers are constrained by prohibitive prices (prices rise relatively faster than wage income). In other words, in the wake of the steep price rises, the ruble has lost its purchasing power. As a result, there has been a shift to barter and to dollars, and a flight from the ruble. Moreover, persistent shortages of consumer goods also limit households in their ability to convert their monetary balances into desired goods. The ruble is not yet fully convertible into goods.

f) A Viable Balance of Payments Position

In terms of achieving external balance, liberalization has also failed. The Russian government has been unable to accompany its stabilization program with a liberalization of foreign trade as outlined in the government's Memorandum. In fact, foreign exchange rate controls and trade restrictions, although they were relaxed to a certain extent, were maintained. This prevented exports from

growing and thus, it deprived the authorities of a much needed source of hard currency revenues.

Falling exports of Russia's principal convertible currency earners (such as oil, natural gas, military equipment, machinery and gold) was another factor contributing to the reduction of foreign currency earnings. Goskomstat reported an 18 per cent decline in oil exports due to a decline in production in the first 6 months of 1992. Oil and gas, which were the principal export products (accounting for 48 per cent of exports), led the overall 35 per cent fall in exports observed during the first half of 1992. [source: I. Zhagel, Izvestia, July 20].

Energy exports have been falling, because they are much needed inside Russia and production has dropped. With respect to the sale of military equipment, the defense industry is constrained by the commitment to demilitarization. With respect to machinery exports, as these were mainly directed to former Eastern block trade partners who paid in soft currency and since Russia is demanding more and more hard currency payments, these traditional customers are now favouring higher quality products from more advanced industrial countries. The falling exports have, in turn, had an adverse effect on imports and external indebtedness. All in all, despite a mid-year positive trade balance ¹⁰, the volume

¹⁰ According to recent figures, it seems that the trade surplus has turned into a deficit. But this did not suffice to cover Russia's foreign debt.

of foreign trade has been declining and the official external debt has risen, leading to a major exacerbation of the foreign currency crisis.

g) Adequate Foreign Exchange Reserves

Despite a slight increase at the beginning of 1992, holdings of foreign exchange reserves of the Central Bank of Russia, have been depleted very rapidly.

Several factors were responsible, among them it is worth to mention the practice of hard currency interventions by the Central Bank to support the ruble, the growing foreign debt, and the poor performance in generating hard currency revenues. Besides the falling exports of Russia's principal hard currency earners, conditions of growing inflation together with Central Bank's instruction in the sphere of currency regulation - which prescribed the mandatory selling of 20 per cent of exporters' hard currency earnings - encouraged exporters to shelter their currency abroad.

h) Stabilization of the Ruble

The government hoped that following the floating of the ruble in July, the exchange rate would have settled at about rub 80 = \$1 (+/- 7.5 per cent). This rate was considered to realistically reflect the value of the domestic currency, at which the authorities hoped to fix the newly unified ruble. But the monetary

conditions, in particular the credit and financial policies, necessary to sustain this rate were not met. The supply exceeded the demand for hard currency on the Moscow Interbank Currency Market (MICE). Therefore, a lower rate of rub 134 = \$1 was instead prevailing on July 2.

Until July, the Central Bank of Russia had an interventionist policy on the exchange market to support the ruble. [see appendix A.2] Over the period, it spent about \$500 million to prevent destabilizing fluctuations in the exchange rate. As mentioned before, with the nomination of a new chairman of the Central Bank of Russia in July 1992, the exchange rate policy changed direction, so that by the end of the third quarter of 1992, the exchange rate had slipped to an even more depreciated rate exceeding rub 200 = \$1. The CBR << is not giving up the practice of hard currency intervention [to support the ruble], but it can run out of currency reserves at any moments >> [acting chairman of the Central bank of Russia, 2 September 1992, quoted from RFE/RL Report vol.11 No.36, 11 September 1992] In that context, it has become more and more difficult to intervene on the interbank currency market to back up the exchange rate, which could collapse at any time due to high inflation and rising inflationary expectations. The acute shortage of foreign exchange necessitated sharp depreciations of the new market determined exchange rate, adding to inflationary pressures. The problem of stabilization of the ruble is exacerbated by the lack of

an active currency policy of the Central Bank of Russia which has adopted a wait-and-see position, trying to minimize its currency expenditures.

With the prevailing hyperinflation and the loosening of credit policy, this depreciation of the ruble prevented neither the flight from the ruble nor the dollarization of the economy - despite the fact that since May 1992 the ruble has been declared the << sole legal tender in any settlements >> within the territory of Russia [article 4, Law on the Monetary System of the Russian Federation]. Nevertheless, much business is still conducted in hard currency, thus making the overall stabilization of the economy even more difficult.

ii. Evaluation in Terms of "Sequencing"

From the strict standpoint of economic theory without any considerations for political and social obstacles, the failure of the stabilization program arises from an improper sequencing in the policies pursued so far.

As a general rule, prices were liberalized too soon. By this statement, we mean that the freeing of most prices have been allowed before institutional, attitudinal and structural changes could take place. These changes include the development of legal, informational and administrative infrastructures. As stressed in part II, these changes are pre-conditions to price liberalization and enterprise

restructuring, the heart of reform. They foster the strengthening of competition and financial discipline. For this reason, we can say that the "big bang" approach followed by the Russian government is mainly responsible for the hyper-inflationary process which has developed in the recent months. Let us examine more specifically where the authorities went wrong.

First of all, price reform is only meaningful if firms are sensitive to costs (including interest rates), or a "hard budget constraint" is achieved. That being said, the major price liberalization of January 1992 has not been accompanied, in practice, by financial discipline on the part of both the firms and the banks. The price increase of January 1992 indirectly led to an uncontrolled growth of domestic credit to enterprises and the government, which partly offset the monetary stabilization efforts undertaken by the government. In addition, the monetary policy of the Central Bank of Russia lacks credibility because it is not independent from political influences and industrial sector's lobby pressures.

Liberalization attempts in Latin American and other developing countries have demonstrated the importance of macroeconomic stability as a prerequisite for liberalization. Excess demand pressures need to be brought down to moderate levels. Excess liquidities were not eliminated prior to the price liberalization. As noted previously, even though the monetary overhang was reduced following the price jump of January 1992, excess liquidity in the economy remained a

problem as household excess holdings of monetary balances is just a part of the problem. Monetization of the budget deficit is still a common practice. Price liberalization was not accompanied by a wage-increase control policy (so that wages rose less rapidly than prices) to prevent a wage-price inflationary spiral. Kornai (1990) had already mentioned the need for administrative controls over wages during the stabilization program.

In Russia, price liberalization has not been accompanied by credible efforts to balance the budget. Indeed, one cannot hope to balance the budget until enterprises have hardened their budget constraints and the burden of providing subsidies has been removed. For example, subsidies which hold down prices (especially energy prices), subsidies on domestic production and implicit subsidies such as tax preferences to enterprises and low interest rates had not been removed. Furthermore, the adjustment in prices has entailed the budgetization of previous implicit subsidies, in particular with respect to enterprise restructuring and the social safety net. Substantial and sustainable subsidy reduction requires complementary economic and institutional reform measures, some of which again were absent. These reform include a tax reform (which would eliminate the remaining tax reliefs), tight credit and monetary policies and the deregulation of the financial sector.

The January 1992 price liberalization has not been accompanied by the unification of the exchange rate, despite the government's early commitment to abolishing the system of multiple exchange rates. Indeed, up until their unification in July 1992, several exchange rates were still existing.

More fundamentally, decision making has been decentralized before proper fiscal and monetary control over the economy was secured. As a related matter, we might add that the economic policy of the Russian government has not had a conception of massive institutional transformations. Achievements in this field are modest.

The decentralization of the banking system was undertaken prematurely. Commercial banks were lending to enterprises despite the latter's soft budget practices. The consequent loss of control over the flow of credit contributed to the upsurge in inflationary pressures that seriously undermined the efforts to stabilize the economy.

With respect to the liberalization of the financial sector, the move in this direction has not been preceded, or at least accompanied, by the hardening of budget constraints both at the enterprise level and at the commercial bank level. These continue to follow soft credit practices. In facts, they are not set up to evaluate the commercial viability of loans they extend. In other words, banking

decentralization and the deregulation of financial markets have not been supported by a reliable system of bank supervision.

The bottom line to this "wrong" order of liberalization has to do with the fact that the Gaidar's reforms have attempted simultaneously to decontrol prices and to impose financial stabilization. Most importantly, substantial liberalization of markets was implemented before institutional groundwork had been laid down. In particular, we refer to the absence of financial discipline. That requires the political will at the highest levels and the development of market-oriented skills (which includes the retraining of managers and workers to operate the new institutions), both of which were insufficient.

In summary :

A comparison with economic developments in 1991 reveals that the liberalization program has achieved some results, but still has a long way to go. For instance, centralized state control over prices has been largely abolished; the large jump in prices caused by the price liberalization of January 1992 exhausted much of the monetary overhang that had been accumulating since the 1980s. Despite its small size, the private sector is growing.

That being said, in spite of its efforts, the program adopted by the Russian authorities in January 1992 has failed to stabilize the monetary economy, due to

an insufficiently tight credit and monetary policy, and it destabilized the real economy. The corrective inflation induced by the large price jump in January 1992 degenerated into an inflationary spiral. Investment collapsed and State monopolies continue to be strong. Russian industry remains largely state owned and managed. Moreover, the government continues to impose limitations on enterprises regarding their choice of suppliers and to maintain a ceiling on their prices. Local authorities continue to maintain the system of so-called state orders which account for 10-15 per cent of total output.

Given the deep roots of the underlying imbalances, there are no grounds for believing that stabilization policy will be successful quickly. Now, as mentioned in part II (section E), the essential conditions for a meaningful and lasting convertibility are precisely control of the money supply and reduction of exchange-rate volatility. This does not necessarily mean that a nominal anchor is desirable for the exchange rate. An adjustable exchange rate could also fulfil this function. The government had hoped to have a comprehensive reform plan consistent with its February 1992 Memorandum in place by the end of the year 1992, but it is unlikely that these objectives will be met. The stabilization phase of the transition to a market economy is a more complicated and slower process than expected, given the dimensions of the existing distortions, the severe macroeconomic disequilibrium, the lack of well functioning market institutions and infrastructures, and given the opposition of powerful groups faced by reformers. Several years

will be needed before stabilization and the removal of inefficiencies are achieved. As might be expected, the non-satisfaction of the minimum set of pre-conditions for convertibility (as discussed in part II section E) has serious implications for the sustainability and the credibility of even a limited degree of currency convertibility.

D.\ Convertibility of the Ruble : A Long Term Prospect ?

Without doubts, the unification of exchange rates on July 1, 1992 marked a decisive step toward ruble convertibility.

From our findings on the state of the Russian economy, in both the internal and the external sector, and given the lessons from Latin American countries, we agree with the common view that, at present, extending unrestricted ruble convertibility to the capital account (that is abolishing exchange controls on the capital account) is undesirable. Neither can it be seen as a short-term prospect. On the one hand, it would invite massive capital flight. On the other hand, because of the high wedge between domestic and foreign interest rates, domestic agents might overborrow on international capital markets. In fact, it should come much later in the transition, when the current account has been completely liberalized.

With respect to full current account convertibility, this is best postponed until the domestic economy is stabilized and the exchange rate is stabilized to a more realistic level.

Nevertheless, in view of its recent admission to the IMF on June 1, 1992, the Russian government must ensure that the reforms will remain on track to attain its objectives. Even though temporary derogatory norms can be maintained during the transition period, under Article VIII of the Articles of Agreement, convertibility in the IMF's sense (that is for purpose of current account transactions) and the elimination of foreign exchange restrictions constitute an obligation of the Fund's member countries. As we mentioned in part one of this paper, upon joining the IMF, each country must refrain from imposing restrictions on the exchange of national currency for other countries' currencies which may impede the growth of world trade and the establishment of a multilateral system of payments between member countries with regard to current transactions.

Although unrestricted convertibility is not within reach, some limited form could be envisaged. In what follows, we shall examine the so-called internal and external convertibility.

In principle, as stipulated by the "Law on Currency Regulation and Currency Control" (July 1992), residents now have the right to buy and sell foreign currency

on the domestic market [see appendix 1]. Residents can also conduct current currency operations without restrictions.

According to our definition, a currency is internally convertible if residents can freely make current foreign exchange transactions at a single exchange rate.

According to that definition, the "Law on Currency Regulation" does not guarantee internal convertibility; it only guarantees the freedom of making such transactions. To the extent that the "official" market rate and the recently legalized black market rate are not aligned, it could be argued that there does not exist a single rate at which foreign exchange transactions can be conducted.

Appendix 2 shows the significant differential existing between the official interbank market rate and the legalized black market rate. Thus, the spread of exchange rates is not as much a result of multiple official rates as a result of the existence of "free markets" or what is sometimes referred as "parallel markets" (black market, interbank markets, auctions). Hence, according to our definition, the ruble is not yet internally convertible.

On the other hand, if internal convertibility boils down to the fact that << on the market today, at the rate at which that floating rate has settled, everyone, both private individuals and enterprises can exchange money>>, then according to first vice premier of Russian government V. Shumeyko [quoted in FBIS Daily report July 2] internal convertibility of the ruble has been established. More specifically,

this means that legally any enterprise can buy foreign currency through the currency exchange, and any citizen can obtain foreign currency at banks authorized to conduct foreign currency operations.¹¹

However, we express some concerns about the viability of this so-called internal convertibility. Even though domestic residents legally have the freedom to make currency exchange transactions, in practice, the public and enterprises might not always be able to do so everywhere on the Russian territory, since the infrastructures (i.e. such as an integrated commercial bank network over all the Russian territory) to support convertibility are missing. Assuming we agree with the second definition, we could therefore argue that the ruble is convertible, both in principle and in practice, in large cities such as Moscow or St. Petersburg. But in remote centers, commercial banks authorized in carrying foreign exchange transactions may not have continuously at their disposal the hard currency necessary to carry such transactions; or simply there may be no authorized agents at all. A serious limitation is therefore the volume of hard currency the banks can afford to sell, given the short supply of foreign exchange currency.

¹¹ As can be seen, all is a matter of definition. The second definition is obviously less constraining than the first one. For this reason, it is also debatable. For the remainder of the discussion, we shall use this second definition (after all, there is no point in debating the issue further if we opt for the former definition).

Hence, assuming one accepts the second definition, at present, in Russia, there is in principle a limited convertibility for purposes of current account transactions falling short of the theoretical maximum in terms of IMF convertibility criteria, namely usability, exchangeability and exchange value [see part one (section A,ii)]. It is limited in the sense that only residents within the territory of the Russian Federation are free to make exchange transactions. Non-residents outside the country, however, cannot buy rubles and they are not permitted to sell rubles except to repatriate profits. At best, they have been authorized to open bank accounts on the territory of Russia. In other words, complete external convertibility has not been achieved.¹²

Theoretically, internal convertibility possesses many virtues in a context of hyperinflation such as the one prevailing in Russia. As mentioned in part two, an unconditional convertibility within the territory of Russia, at a fixed and stable rate, can restore confidence in the ruble and interrupt inflationary expectations. In addition, import competition can provide a nominal anchor, which is a good thing during the price liberalization period.

That being said, the ruble may well have been declared internally convertible for current transactions. However, the conditions (as discussed in part II) required to achieve its sustainability have not been met. Indeed, if Russia is to establish a

¹² The repatriation of profits and the right to participate in joint ventures can be viewed as a limited form of non-resident external convertibility.

convertible and stable ruble, at least two conditions must be fulfilled: first, the hyperinflationary process should be halted (by a strict tightening of credit and by balancing the budget, among other policies) and second, the foreign exchange policy should be made credible (by stabilizing the exchange rate and by having a sufficient level of hard currency reserve).

In the context of the deep crisis faced by the Russian Federation, the implementation of the first condition is questionable. Indeed, a deflationary policy supposes the adoption by all the Republics of the CIS of a coordinated economic strategy, in particular of monetary policy. However, the other Republics' central banks are able to issue new ruble credits. In the absence of any centralized coordination, this capacity will increasingly come to undermine the Russian Central Bank's control over the ruble area monetary policy. A workable deflationary policy also implies an infrastructure (demonopolization of the economy, a controlled banking system, an efficient system of tax collection) which is still missing. But mostly, such a policy would also have recessionary effects which would be a threat to political stability. In terms of the second condition as regard the viability of convertibility, in particular the adequate level of foreign exchange reserve, the establishment of internal convertibility is also questionable. To the extent that hard currency reserves are low and the borrowing potential on international markets is limited, and that at the same time foreign investment and the import of new technologies are much needed in Russia, heavy demands of

foreign exchange should be rationed, either implicitly or explicitly. Hence, in the short-term, we could argue that only a limited degree of internal convertibility should be allowed in order to lock in domestic savings. The prioritization in the use of foreign exchange would permit the re-orientation of scarce foreign exchange toward investments in both physical and human capital (that is, those areas which an efficient market economy requires). Structural reforms has to, at least, be moving forward, with solid progress already apparent and the promise of more to come evident, before anything like a free foreign exchange market can be expected within Russia. Without the stabilization of the domestic economy, we believe that exchange rate "unification" is vain. The unification of the exchange rate presupposes that the authorities will retain the lowest rate, that is a rate close to the one prevailing on parallel markets, in order to discourage expectations of depreciation. Until the change of direction of the Central Bank of Russia, the Russian authorities refused to let the ruble depreciate itself. This position was justified by the expectations of increased foreign investment. In fact, since the beginning of reforms in January 1992, the monetary authorities have tried to invert the depreciating tendency of the ruble on the exchange market by regular adjustment of the official rate and by intervention on the MICE. Although the several interventions of the Central Bank of Russia have turned out to be insufficient to strengthen and to keep the exchange rate stable, this costly policy has achieved a partial success to the extent that the free market rate was maintained around $\text{rub } 140 = \$1$ the day the newly unified rate was introduced.

Note however, that at this rate, the Russian authorities were far from their objective of rub 80 = \$1. Exchange rate policy is even insufficient to guarantee the rate of rub 125.26 = \$1 at which the exchange rate has been unified.

With the change in direction of the exchange rate policy at the end of July 1992, the ruble is now allowed to slide. This policy is justified by expectations that the worsening exchange rate will stimulate Russian exports, thereby improving the country's balance of payments position and earning Russia much-needed hard currency.

At present the ruble is undervalued in a purchasing power parity sense (above rub 300 = \$1 at the end of the third quarter of 1992) on the Moscow Interbank Foreign Currency Exchange. Domestic prices of traded goods in Russia are, at the existing market exchange rate, substantially lower than world prices. Maintaining ruble convertible at this extremely unrealistic low internal market rate creates strong inflationary pressures.

Moreover, hard currency exchange is not completely liberalized. Enterprises must sell 50 per cent of their hard currency earnings at the new market rate. Even though less penalizing than the former arrangement, this system still provides an incentive to capital flight. It also contributes to the devaluation of the ruble on the free exchange market.

In our opinion, from what we have said above and in previous sections, the conditions for the development of a convertible system, even limited, are far from being satisfied. Internal convertibility may well have been declared, but the reality is quite different. In practice, given the low level of foreign exchange reserves, hyperinflation, financial instability and the lack of efficient market-type infrastructures, internal convertibility is neither sustainable nor credible. The Russian economy is still substantially insulated from the outside world.

We also believe that lowering the external value of the ruble is a necessity. However, we believe that it should not be lowered "artificially" by interventions of the Central Bank of Russia. Besides, Russia lacks the funds to back up convertibility at significantly higher rates. Instead, we believe that the value of the ruble must be lowered by the forces of the market. In other words, the Russian authorities must put in place the necessary policies so that the currency exchange market will reflect the improvement observed in the domestic economy. By improvement we refer to a healthy economy in which the fiscal situation and inflationary pressures are under control. Gradually, the interbank exchange market and the black market would converge into a single rate.

According to many, the granting of the \$ 6 billion IMF Stabilization Fund should permit the exchange rate to rise, and thus, it should permit the ruble to become convertible at a pegged exchange rate. In our opinion, the existence of such a

Fund would not be sufficient to support the exchange rate. A stabilization fund should have a strictly psychological role. It should be used only to guarantee the exchange rate in case of strong downward pressures. In any other cases, it should not be used or it will provoke downward speculation. In other words, the existence of a stabilization fund cannot compensate for the absence of an austerity policy and the absence of a credible exchange rate policy.

That being said, even though it has been approved in principle, the granting of the \$ 6 billion IMF financial package is contingent upon the condition that Russia will adhere to its stabilization policies and will continue to carry out market economic reforms. Even the \$1 billion IMF fund made available on demand (August 1992) should not be viewed as a solution.

Until major progress is made, only a very limited form of currency convertibility will prevail in Russia. The main problem neglected by those favouring the introduction of various partial versions of convertibility [Portes (1991)] is that these are dangerous levers in the hands of the bureaucracy which will produce just one thing for sure : misallocation of scarce foreign exchange.

One might wonder then how matters are different from the situation prevailing under the centrally planned system. In our opinion, the difference is that now the context has changed : the process of transition has begun its way toward

decentralization and liberalization. The remaining foreign exchange controls, whose elimination would entail further destabilization in an already fragile economy, should be viewed in the context of that emerging market system as transitional policy tools to correct external payments difficulties and whose gradual liberalization will constitute the transition to convertibility. We therefore conclude that what has been qualified of internal convertibility (according to the second definition) should instead be viewed as a first major step to free the market for foreign exchange.

CONCLUSION

Opening up to the outside world generally implies setting a competitive exchange rate, making the currency convertible on current account, eliminating non-tariff barriers to imports, setting a non-prohibitive tariff schedule and welcoming foreign direct investment.

In this paper, we have focussed our attention on one condition for external liberalization, namely the issue of convertibility.

More specifically, we have attempted to determine the viability of an early introduction of currency convertibility in the context of a CPE in transition. For this purpose, we have chosen to study the case of the Federation of Russia.

Discussion of convertibility generally boils down to the choice of a realistic exchange rate, a well defined exchange regime and a developed internal exchange market. But starting from the assumption that convertibility is an element of the move to a market economy, then all the basic and indispensable elements of market reform will also be indispensable conditions for the shift to convertibility.

We have found that for Russia, solving the convertibility problem indeed amounts to solving the problem of how to reform the economy in general. In other words, the path to convertibility is a matter of removing all deficiencies and obstacles to the development of the country and of fundamentally transforming the economy. This issue is a complex one which involves the satisfaction of several interdependent economic pre-conditions. These include the achievement of macroeconomic stability, the liberalization of domestic prices and the reform of the financial system. There must also be a reasonable balance in foreign trade flows and in foreign exchange payments, as well as a sufficient level of foreign reserves. It would be an illusion to believe that convertibility could be introduced outside the context of introducing market institutions and relations throughout the economy.

The speed at which these are introduced will determine the speed with which Russia will move in the direction of a credible and sustainable convertibility.

Although no consensus has been reached on the optimal sequencing of reforms, the importance of a firm monetary and fiscal framework at a very early stage of the process is well acknowledged. On the external front, convertibility must accompany the process of integration of the economy into international trade and capital flows. Thus, sound management of the balance of payments is crucial both for the adoption of convertibility and for the continued credibility of a convertible currency. Only by means of a tough stabilization program will the ruble become convertible, first into goods and later into other currencies.

We have found that, at present, most of the things that should precede or compose the "minimum package" of reforms are not firmly established. This means that the pre-conditions for even a limited degree of convertibility, are not met. Essentially, this is because the process of implementing a market is presently facing many formidable obstacles. In addition, foreign currency reserves have been depleted, the situation of the balance of payments is very weak, and the monetary and fiscal targets have been missed. As a result, the feasibility of full current account convertibility is questionable. Making the currency convertible in the IMF's sense in such a context would indeed confront the economy with the choice between a severe deflation of output and an extremely undervalued currency. Both outcomes are highly undesirable.

Given our assumption that currency convertibility and the liberalization of trade are necessary conditions to world economic integration, then the postponing of convertibility means that the integration is most likely to be delayed. Although it is widely believed that the system to strive for, in the long-term, is one where domestic relative prices are linked to world market prices through an open non-distorted trade system, one cannot open the economy to trade under conditions of macroeconomic instability, since that would guarantee a massive external deficit. In terms of sequencing, this entails adjusting first to domestic market clearing prices and subsequently to world prices, while maintaining fairly rigorous control over international trade for some time. The Russian domestic market being large, there is hope both of building up domestic competition and using the domestic market to gain experience economies. But according to some authors [Williamson (1991), Fischer and Gelb (1990)], whose views we share, one cannot safely liberalize prices (the cornerstone of all internal reforms) without introducing some degree of external competition. One solution to this dilemma consists in adopting McKinnon's proposal of a tariff protection for domestic goods ¹³ and maintain some capital controls for purpose of current account transactions (for example, restrictions of travel allowance).

¹³ Even though there already exists a system of tariffs on imports in Russia, we share the view that there is still room for more protection. Among other reasons, Russia needs foreign competition in order to learn new technologies to increase its productivity. But because it is advantageously endowed with natural resources, Russia runs a high risk of ending up supplying raw material and other low-value exports if it allows unrestricted trade. To ensure that this does not happen and to ensure the long-term growth of its economy, Russia must turn toward higher-value exports. For this to occur, it must protect its domestic industry during the "learning period". Opening up to foreign trade does not necessarily mean free trade.

This approach would be consistent with the IMF's Article of Agreements to which the Russian Federation has recently adhered.

The fact that some Russian government officials say the ruble has been made internally convertible, while the acting chairman of the Central Bank of Russia keeps saying that << convertibility is a pretty fairy tale told by the government >> creates confusion [cited in Leontyev (1992)]. In our opinion, these contradictory statements stem from the variety of definitions existing for the concept of convertibility. Actually, what has been called "internal convertibility" for current account transactions is only a limited degree of internal convertibility taken in a very narrow sense. It is based on a loose use of the term, which has been reduced to the fact that Russian entities and individuals can freely buy and sell hard currency at a market determined exchange rate. The reason why we believe that its credibility is questionable is the following: in spite of the "unification" of the exchange rates on July 1, 1992, domestic residents and enterprises can still conduct their foreign exchange transactions at more than one legal rate. Second, it is a fact that the satisfaction of foreign demand for hard currency cannot be fully guaranteed due to the low foreign exchange liquidities.

Although this enlarges the participation in exchange operations, it does not yet constitute a real internal convertibility, but rather a form of redistribution of foreign currency in the domestic economy. In other words, it should be viewed as

a major step to free the market for foreign exchange. It has become clear that, in terms of the timing of convertibility, the measures adopted so far by the Russian government constitute an evolutionary way of developing ruble convertibility, which corresponds to the strategy of a gradual transition to a market economy.

With respect to external convertibility, some progress has been achieved, since ruble profits may be exchanged into foreign currency at the interbank market exchange rate for transfer abroad.

That being said, the problem of introducing convertibility into Russia is somewhat further complicated by the fact that the Russian ruble is still the currency of most other Republics of the former Soviet Union. Since the breakup of the Union, most of the former Republics have expressed a strong desire to introduce their own currency. Quite obviously, an uncoordinated breakup of the ruble area would produce an influx of rubles into the Russian economy, increasing the money supply inside that country and hence, temporarily undermining the anti-inflationary efforts. That would delay further the satisfaction of the necessary pre-conditions with regards to price stabilization.

Appendix A.1 : The Law on Currency Regulation (July 14, 1992)

Section I. GENERAL PROVISIONS

Article 1. Basic concepts

The concepts used in the present law mean the following:

1. "Currency of the Russian Federation"

a) rubles in circulation and also confiscated and withdrawn from circulation but subject to exchange, in the form of banknotes of the Central Bank of the Russian Federation and coins;

b) ruble funds in bank accounts and other credit institutions outside the Russian Federation on the basis of an agreement concluded between the Government of the Russian Federation and the Central Bank of the Russian Federation with the corresponding organs of the foreign state for the use of currency of the Russian Federation as a legal means of payment on the territory of the corresponding state.

2. "Securities in the currency of the Russian Federation": payment documents (checks, drafts, letters of credit, and so forth), capital assets (shares, bonds), and other promissory notes expressed in rubles.

3. "Foreign currency"

a) monetary bills in the form of banknotes, treasury notes, and coins which are in circulation and are a legal means of payment in the corresponding foreign state or group of states, and also monetary bills that have been confiscated or withdrawn from circulation but are subject to exchange;

b) funds in accounts in monetary units of foreign states and international monetary or payment units.

4. "Currency values"

a) foreign currency;

b) securities in foreign currency—payment documents (checks, drafts, letters of credit, and so forth), capital assets (shares, bonds) and other promissory notes expressed in the foreign currency;

c) precious metals—gold, silver, platinum, and metals of the platinum group (palladium, iridium, rhodium, ruthenium, and osmium) in any form and condition with the exception of jewelry and other consumer items and also scraps from these items;

d) natural precious stones—diamonds, rubies, emeralds, sapphires, and alexandrites in crude or processed form, and also pearls, with the exception of jewelry and other consumer items made from these stones or scraps from them.

The Government of the Russian Federation categorizes items made of precious metals and natural precious stones as jewelry or other consumer items and scraps from them.

5. "Residents"

a) individual persons with permanent residence in the Russian Federation, including those temporarily staying outside the Russian Federation;

b) legal entities created in keeping with legislation of the Russian Federation and located in the Russian Federation;

c) enterprises and organizations that are not legal entities created in keeping with legislation of the Russian Federation and located in the Russian Federation;

d) diplomatic and other official representatives of the Russian Federation located outside the Russian Federation;

e) branches and resident representatives indicated in subpoints "b" and "c" of the present point located outside the Russian Federation.

6. "Nonresidents"

a) individual persons with permanent residence outside the Russian Federation, including those temporarily staying in the Russian Federation;

b) legal entities created in keeping with legislation of foreign states with locations outside the Russian Federation;

c) enterprises and organizations that are not legal entities created in keeping with legislation of foreign states with locations outside the Russian Federation;

d) foreign diplomats and other official representatives and also international organizations and their branches and representatives located in the Russian Federation;

e) branches and representatives of nonresidents indicated in subpoints "b" and "c" of the present point.

7. "Currency operations"

a) operations related to the transfer of property rights and other rights to currency assets, including operations using foreign currency and payment documents in foreign currency as a means of payment;

b) importation and remittance of currency assets to the Russian Federation and also their exportation and remittance out of the Russian Federation;

c) international monetary transfers.

8. Operations with foreign currency and securities in foreign currency are divided into current currency operations and currency operations involving the movement of capital.

9. "Current currency operations"

a) transfer of foreign currency to the Russian Federation and from the Russian Federation to settle accounts for exports and imports of goods, work, and services and also to settle accounts related to credit for export-import operations for a period of no more than 180 days;

b) receipt and granting of financial credit for a period of no more than 180 days;

c) transfers to the Russian Federation and from the Russian Federation of interest, dividends, and other incomes on deposits, investments, credit, and other operations involving the movement of capital;

d) transfers of a noncommercial nature to the Russian Federation and from the Russian Federation, including transfers of sums of wages, pensions, alimony, inheritances, and also other similar operations.

10. "Currency operations involving the movement of capital":

a) direct investments, that is, invested in the charter capital of the enterprises for the purpose of earning income and gaining the right to participate in the administration of the enterprise;

b) portfolio investments, that is, the acquisition of securities;

c) transfers in payment for buildings, structures, and other property, including land and minerals categorized according to legislation where it is located as real estate and also other real estate rights;

d) granting and receiving of payment deferments for periods of more than 180 days for exports and imports of goods, work, and services;

e) granting and receiving of financial credit for periods of more than 180 days;

f) all other currency operations that are not current currency operations.

11. "Authorized banks"—banks and other credit institutions that have received licenses from the Central Bank of the Russian Federation for conducting currency operations.

Section II. CURRENCY REGULATION

Article 2. Protection of the currency of the Russian Federation

1. Settlements among residents are carried out in the currency of the Russian Federation without restrictions.

2. The procedure for the acquisition and use in the Russian Federation of currency of the Russian Federation by nonresidents is established by the Central Bank of the Russian Federation.

3. The exportation and remittance from the Russian Federation of currency of the Russian Federation and securities expressed in the currency of the Russian Federation and also the importation and remittance to the Russian Federation of currency of the Russian Federation and securities expressed in the currency of the Russian Federation are carried out by residents and nonresidents according to the procedure established by the Central Bank of the Russian Federation in conjunction with the State Customs Committee of the Russian Federation.

4. Transactions concluded in violation of the provisions of the present law are invalid. Individuals concluding such transactions bear criminal and administrative liability in keeping with legislation of the RSFSR.

Article 3. The right to ownership of currency assets

1. Currency assets in the Russian Federation can be owned by both residents and nonresidents.

In the Russian Federation the right to ownership of currency assets is protected by the state along with the right to ownership of other objects of ownership.

Kinds of currency payments to the state are determined by laws of the Russian Federation. All other payments and mandatory withholdings are prohibited and are not subject to mandatory execution.

2. The procedure for completing transactions with precious metals and natural precious stones in the Russian Federation is established by the Government of the Russian Federation.

Article 4. The domestic currency market of the Russian Federation

1. Residents have the right to buy foreign currency on the domestic currency market of the Russian Federation according to the procedure and for purposes determined by the Central Bank of the Russian Federation.

2. The purchase and sale of foreign currency in the Russian Federation are conducted through authorized banks according to the procedure established by the Central Bank of the Russian Federation.

Transactions for purchase and sale of foreign currency may be conducted directly through authorized banks and also through currency exchanges operating according to the procedure and under conditions established by the Central Bank of the Russian Federation.

The purchase and sale of foreign currency bypassing authorized banks is not allowed.

3. Transactions for purchase and sale of foreign currency concluded in violation of Points 1 and 2 of the present law are invalid.

4. The Central Bank of the Russian Federation may conduct operations for buying and selling foreign currency in order to regulate the domestic currency market of the Russian Federation.

Article 5. Residents' accounts in foreign currency

1. Residents may have accounts in foreign currency in authorized banks.

2. Residents may have accounts in foreign currency in banks outside the Russian Federation in cases and under conditions established by the Central Bank of the Russian Federation.

3. The procedure whereby authorized banks open and keep residents' accounts in foreign currency is established by the Central Bank of the Russian Federation.

Article 6. Residents' currency operations in the Russian Federation

1. Residents conduct current currency operations without restriction.

2. Residents conduct currency operations involving the movement of capital according to the procedure established by the Central Bank of the Russian Federation.

3. Residents have the right to transfer, import, and remit currency assets to the Russian Federation with the observance of customs rules.

The procedure for mandatory transfer, importation, and remittance to the Russian Federation of foreign currency

assets were previously transferred, imported, or remitted to the Russian Federation or acquired in the Russian Federation on the bases indicated in Point 2 of the present article, and in other cases in keeping with legislation of the Russian Federation.

4. The procedure whereby nonresidents export, transfer, and remit currency assets from the Russian Federation, with the exception of cases indicated in Point 3 of the present article, is established by the Central Bank of the Russian Federation in conjunction with the State Customs Committee of the Russian Federation.

Article 9. The Central Bank of the Russian Federation as an organ for currency regulation

1. The Central Bank of the Russian Federation is the main organ for currency regulation in the Russian Federation.

2. The Central Bank of the Russian Federation within the framework of the present law:

a) defines the sphere and policy for the circulation in the Russian Federation of foreign currency and securities in foreign currency;

b) conducts all kinds of currency operations;

c) establishes the rules by which residents and nonresidents in the Russian Federation conduct operations with foreign currency and securities in foreign currency and also the rules whereby nonresidents in the Russian Federation conduct operations with currency of the Russian Federation and securities in currency of the Russian Federation;

d) establishes the procedure for mandatory transfer, importation, and remittance to the Russian Federation of foreign currency and securities in foreign currency belonging to residents and also the cases and conditions whereby residents open accounts in foreign currency in banks outside the Russian Federation;

e) establishes the general rules for issuing licenses to banks and other credit institutions for conducting currency operations and issues these licenses;

f) publishes normative acts that are compulsory for execution by residents and nonresidents in the Russian Federation;

g) establishes standard forms for accounting, reporting, documentation, and statistics of currency operations, including by authorized banks, and also the procedure and deadlines for submitting them;

h) prepares and publishes statistics of currency operations of the Russian Federation in keeping with accepted international standards;

i) performs other functions specified by the present law.

Section III. CURRENCY CONTROL

Article 10. The purpose and areas of currency control

1. The purpose of currency control is to ensure the observance of currency legislation in the execution of currency operations.

2. The main areas of currency control are:

a) determination of whether currency operations that are conducted are in keeping with legislation in effect and that the necessary licenses and permits have been obtained;

b) verification of fulfillment by residents of obligations to the state in foreign currency and also obligations for the sale of currency on the domestic currency market of the Russian Federation;

c) verification of the justification for payments in foreign currency;

d) verification of the completeness and objectivity of accounts and reports in currency of the Russian Federation.

Article 11. Organs and agents for currency control

1. Currency control in the Russian Federation is provided by currency control organs and their agents.

Currency control organs in the Russian Federation are the Central Bank of the Russian Federation, the State Customs Committee of the Russian Federation, the Ministry of Finance of the Russian Federation, and the Currency Control Inspectorate under the government of the Russian Federation.

2. Currency control agents are organizations to which currency control organs delegate currency control functions.

3. Authorized banks are currency control agents under the jurisdiction of the Central Bank of the Russian Federation.

Article 12. Authority of currency control organs and agents

1. Currency control organs within the limits of their authority:

a) monitor the correctness of currency operations conducted in the Russian Federation by residents and nonresidents, the correspondence of these operations to the conditions of licenses and permits, and also their observance of normative acts of currency control organs.

b) conduct inspections of foreign economic activity of residents and also the activity of nonresidents in the Russian Federation;

c) establish the procedure and forms of accounting, reporting, and documentation for currency operations of residents and nonresidents and also foreign economic activity.

Article 13. Rights and responsibilities of residents and nonresidents

1. Residents and nonresidents conducting currency operations in the Russian Federation and also nonresidents conducting operations with currency of the Russian Federation and securities in the currency of the Russian Federation have the right:

a) to study the documents from inspections conducted by currency control organs and agents;

b) to appeal actions of currency control agents to the corresponding currency control organs and also actions of currency control organs according to the procedure established by legislation of the Russian Federation;

c) to exercise other rights established by the present law and other legislative acts of the Russian Federation.

2. Residents and nonresidents conducting currency operations in the Russian Federation and also nonresidents conducting operations with currency of the Russian Federation and securities in the currency of the Russian Federation must:

a) submit to currency control organs and agents documents and information confirming the correctness of the currency operations that are conducted and those necessary for their performance of their currency control functions;

b) give explanations to currency control organs and agents during the course of their inspections and also concerning their results;

c) in the event of disagreement with the facts presented in the document of the inspection conducted by currency control organs and agents, submit written explanations of the reasons for refusing to sign this document;

d) keep accounts and submit reports on currency operations they have conducted, providing for keeping them for no less than five years;

e) fulfill the requirements (instructions) of currency control organs for eliminating the violations that are revealed;

f) perform other duties established by legislation of the Russian Federation.

Article 14. Responsibility for violation of currency legislation

1. Residents, including authorized banks, and nonresidents who have violated the provisions of Articles 2-8 of the present law, bear responsibility in the form of:

a) payment to state revenues of everything received from transactions that are invalid because of the present law;

b) payment to state revenues of everything unjustifiably acquired not in a transaction but as a result of illegal actions.

2. Residents, including authorized banks, and nonresidents, for failing to account for currency operations, accounting for currency operations in violation of the established procedure, and failing to submit documents and information to currency control organs and agents in keeping with Point 2 of Article 13 of the present law or submitting them late bear liability in keeping with the policy established by the Currency Control Inspectorate in conjunction with the Central Bank of the Russian Federation.

3. With repeated violations of the provisions mentioned in the present article and also failure to fulfill or improper fulfillment of the instructions of the currency control organs, residents, including authorized banks, and nonresidents bear liability in the form of:

a) payment to state revenues of sums indicated in Points 1 and 2 of the present article and a fine in the amount of five times these sums or a fine in an amount determined by the Russian Federation currency control inspectorate in conjunction with the Central Bank of the Russian Federation;

b) suspension or revocation of licenses and permits issued by currency control organs to residents, including authorized banks, or nonresidents;

c) other sanctions established by legislation of the Russian Federation.

4. The collection of the sums of fines and other sanctions mentioned in the present article is handled by currency control organs, including, at the request of currency control agents, from legal entities—with compulsory payment, and from individual persons—through the courts.

5. Officials of legal entities that are residents, including authorized banks, and of legal entities that are nonresidents, and also individual persons guilty of violating currency legislation bear criminal, administrative, and civil-legal liability in keeping with legislation of the Russian Federation.

Article 15. Rights and responsibilities of currency control officials, organs, and agents. Appealing the actions of currency control officials

1. Officials of currency control organs and agents, within the limits of the authority of these organs, have the right:

a) to check all documents related to their performance of currency control functions, to obtain the necessary clarifications, references, and information on questions

arising during inspections, and also to confiscate documents showing violations in the sphere of currency legislation;

b) to suspend operations in accounts in authorized banks in the event of the failure to present the documents and information mentioned in the present article;

c) to suspend or revoke permits and licenses for the right to conduct foreign economic activity and currency operations issued to residents, including authorized banks, and nonresidents;

d) other rights specified by legislation of the Russian Federation.

2. Currency control organs and agents and their officials must protect the trade secrets of residents and nonresidents which they have learned in the performance of their functions.

3. Currency control organs and their officials, in the event of improper performance of the duties assigned to them, are held liable according to the procedure specified by legislation of the Russian Federation.

Source: Foreign Broadcasting Information Service, Daily Report
Central Eurasia, 4 August 1992, p.32-37

Appendix A.2 : Foreign Exchange Rate Developments in 1992 (rub/\$)

Date	Interbank rate (MICE)	Average black market rate	Moscow black market rate	CBR intervention (billion rub)
03 Jan	150.0			
28 Apr	143.6			
06 May	128.5			
08 May	128.0	121.36	120	29.98
12 May	127.6			3.5
14 May	127.4	119.41	120	7
19 May	126.6			4
21 May	123.0	120.53	120	6
26 May	118.0			25
28 May	113.0	120.61	118	28
02 Jun	112.6			13
04 Jun	112.5		122	14
09 Jun	112.4			40
11 Jun	112.3	126.58	125	30
16 Jun	129.0			20
18 Jun	118.5			6
23 Jun	146.0			
25 Jun	146.6	138.71	135	
30 Jun	144.0			
02 Jul	134.8	138.84	135	
07 Jul	130.5			15
09 Jul	130.3	139.44	138	15
14 Jul	130.2			15
16 Jul	135.4	145.13	144	15
21 Jul	151.1			20
23 Jul	155.7	147.45	145	20
28 Jul	161.1			
30 Jul	161.2		160	0
04 Aug	161.4			
06 Aug	161.5	163.07	160	0
11 Aug	161.7			
13 Aug	162.5	176.85	175	0.2
25 Aug	168.1			
27 Aug	205.0	194.43	200	0.2
01 Sep	210.5			
03 Sep	210.5	220.58	220	0.23
08 Sep	207.9			
10 Sep	203.0	220.94	215	
15 Sep	204.0			
17 Sep	205.5	219.71	215	
06 Oct	342.0			
08 Oct	334.0	305.11	295	

Source: Kommersant, various issues (Jan. 1992-Nov. 1992)

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