FOR AGENDA

0450

SM/90/214

November 7, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Currency Convertibility and the Transformation of Centrally Planned Economies

Attached for consideration by the Executive Directors is a paper on currency convertibility and the transformation of centrally planned economies, which is tentatively scheduled for discussion on Monday, December 17, 1990. A summary and questions for discussion appear on pages 24-26.

Mr. Isard (ext. 6640) or Mr. Greene (ext. 7440) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Currency Convertibility and the Transformation of Centrally Planned Economies

Prepared by the Research Department

(In consultation with other departments)

Approved by Jacob A. Frenkel

November 6, 1990

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I. Introduction

Many countries that have had centrally planned economies are now undergoing economic transformation. As a result, far-reaching reforms aimed at making these economies more market-oriented are contemplated or underway, including an extensive overhaul of the institutions and mechanisms for implementing monetary and fiscal objectives. At the policy level, the reforms include the restoration of macroeconomic stability, major price liberalization, the restructuring of firms and industries, the creation of new tax and budgetary systems, and the establishment of commercial banking activities. 1/

High among the policy reforms of interest is the establishment of currency convertibility. In their discussion of the Work Program in May 1990, Executive Directors suggested that a paper be prepared on currency convertibility in the context of the integration of Eastern Europe into the international monetary system. 2/ In September the Interim Committee also expressed interest in this topic. 3/

Long dismissed in centrally planned economies as unnecessary or a threat to the availability of foreign reserves for industrialization and development targets, convertibility has acquired new significance in the context of economic transformation. Convertibility for current account transactions, along with measures to liberalize trade and payments generally, is now advocated as a source of competitive discipline that can play a major role in guiding domestic enterprises toward efficient production and investment decisions. Convertibility for certain types of capital account transactions is seen as helping attract foreign investment inflows and associated managerial resources and transfers of technology, which can have major importance for the transformation process. Internal convertibility is viewed as a way of making domestic holdings of foreign currencies available to banks or other intermediaries, thereby easing a country's foreign exchange constraint. In general, establishing convertibility is considered a way of reducing the costs associated with the administrative allocation of foreign exchange. Convertibility has also become a key symbol of openness and economic freedom that may be important for the acceptability and credibility of difficult reform programs.

Questions still remain, however, about the risks of establishing convertibility, particularly early in the transformation process. At this point the economic incentives and legal provisions may not yet be in place

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1/ For general discussions of the issues that arise in market-oriented reforms, see SM/89/202, "Market Oriented Reform in Planned Economies;" and Wolf (1990).

2/ The Secretary's Department, "Executive Board Meeting 90/84, May 30, 1990, p.m.," (June 11, 1990), p. 2.

3/ "Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund" (September 24, 1990), para. 4.

for markets and macroeconomic stabilization mechanisms to function properly. Domestic industries may not yet be internationally competitive, and foreign exchange reserves may be limited.

This paper addresses the main issues related to currency convertibility, with special regard to the problems of establishing convertibility in the process of transforming centrally planned economies into market-oriented ones. Currency convertibility--which concerns the freedom to buy or sell foreign exchange, generally in connection with making payments related to international flows of goods, services, and financial assets--is traditionally analyzed separately from restrictions on trade and capital flows. A major reason is that limitations on currency convertibility and restrictions on trade and capital flows have often evolved independently and for different reasons. Economically, however, the two types of restrictions have similar effects. Moreover, the role of the payments system in influencing the expansion of world trade is recognized explicitly in Article I(iv) of the Fund's Articles of Agreement, which states that one of the purposes of the Fund is to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade."

In recognition of the links between the payments system and the system of trade and capital flows, the case for eliminating restrictions on currency convertibility is analyzed in this paper as part of the larger issue of removing restrictions on international transactions generally. Complete liberalization of current and capital account flows requires currency convertibility, and restrictions on trade and capital flows can dilute the benefits from convertibility. Because there appears to be widespread agreement among economists that convertibility is desirable as a long-run objective, along with the general liberalization of trade and capital flows, much of the discussion concerns how rapidly convertibility should be established during the transformation process.

The paper is organized as follows. Section II defines several different aspects of convertibility, distinguishing in particular among current account convertibility, capital account convertibility, and internal convertibility. Section III then analyzes the effects of current and capital account convertibility, focusing on how convertibility affects a country's production sector and macroeconomic stability. Section IV addresses the issue of when to introduce current account convertibility, emphasizing that success depends on establishing several general preconditions at or before the move to current account convertibility. This section also discusses transitional arrangements countries may wish to consider in establishing convertibility. Section V discusses issues related to internal currency convertibility. Section VI provides a summary and offers questions for discussion by Directors. Some historical experiences with establishing convertibility are reviewed in the Appendix,

which focuses on three groups of countries: 1/ the Western European countries that were members of the European Payments Union (EPU) during the 1950s; the newly industrializing economies (NIEs) of Eastern Asia; and two transforming economies--Poland and Yugoslavia--that have already gone a long way toward establishing current account convertibility.

II. Definitions

The meaning of "convertibility" has changed over time as the international monetary system has evolved. 2/ Before the 1930s, convertibility was generally defined as the right to convert a currency freely into gold at a fixed exchange rate. Today, a currency can be regarded as "fully convertible" when any holder is free to convert it at market exchange rates--fixed or flexible--into one of the major international reserve currencies.

Discussions of convertibility have been clouded by two types of semantic problems. Confusion sometimes arises from failure to recognize that currency convertibility implies the absence of restrictions on foreign exchange transactions, but not necessarily the absence of restrictions on international trade or capital flows. Problems may also arise from confusing different forms of limited currency convertibility. Thus, it is worth noting how the right to convert domestic into foreign currency is commonly restricted.

Some restrictions on convertibility are based on the purpose for which currency conversion is desired. These restrictions often distinguish between conversions associated with current account transactions and conversions for other purposes. Indeed, this distinction is embodied in the Fund's Articles of Agreement. The postwar international monetary arrangements that emerged from the Bretton Woods Conference required members of the Fund to move toward the restoration of current account convertibility, while authorizing members to restrict convertibility for capital transactions. 3/ The obligations of convertibility that Fund members are required to undertake are defined by Article VIII, Sections 2, 3, and 4. Under Section 2(a), members may not, without the approval of the Fund, impose restrictions on the making of payments and transfers for

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1/ As used in this paper the term "country" does not in all cases refer to a territorial entity as understood by international law and practice. The term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate, independent basis.

2/ Haberler (1954) provides an informative discussion.

3/ Gold (1971), p. 4, and Kindleberger (1984), p. 428. See also Article VI, Section 3.

current international transactions, 1/ subject to the transitional provisions of Article XIV, which allow countries to maintain those restrictions on current payments and transfers that were in effect when they joined the Fund. Under Section 3, members may not engage in discriminatory currency arrangements or multiple currency practices that are not authorized under the Articles or approved by the Fund. 2/ Sections 2(a) and 3 prohibit restrictions on (or discriminatory practices governing) the availability or use of foreign exchange as such. They do not prevent members from imposing restrictions on merchandise trade, 3/ nor do they exclude surrender requirements that compel residents to turn over accruals of foreign exchange to their monetary authorities. 4/

Other restrictions on convertibility are based on the origin of the currency balances. Such restrictions have distinguished between "old" and "new" balances, meaning balances accumulated before or after some particular date. For example, when sterling was briefly restored to convertibility in July 1947, the intention was to limit convertibility to newly acquired sterling balances. Thus, the United Kingdom attempted (albeit unsuccessfully) to make arrangements so that, except for agreed amounts, outstanding balances of "old" sterling would remain inconvertible. 5/

Still other restrictions on convertibility are based on who holds the currency balances, 6/ or on where the balances are held. Discussions of such restrictions often refer to "internal convertibility," and different meanings have been attached to this term. As defined in this paper, internal convertibility means that residents are free to maintain domestic

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1/ As defined in Article XXX(d), current transactions can include certain transactions of a capital nature--in particular, "payments of moderate amount for amortization of loans or for depreciation of direct investments."

2/ Section 4 requires, subject to a list of exceptions, that: "Each member shall buy balances of its currency held by another member if the latter, in requesting the purchase, represents: (i) that the balances to be bought have been recently acquired as a result of current transactions; or (ii) that their conversion is needed for making payments for current transactions." For a discussion of the guiding principles for interpreting these provisions, see "Article VIII and Article XIV," in Selected Decisions, International Monetary Fund, Fifteenth Issue, 1990, pp. 326-9.

3/ "Thus, although a measure formulated as a quantitative limitation on imports will have the indirect effect of limiting payments, it is not for that reason a restriction on payments within the meaning of the provision. . . . Restrictions on trade do not become restrictions on payments within the meaning of Article VIII, Section 2(a), because they are imposed for balance of payments reasons." Gold (1971), pp. 9-10.

4/ Gold (1971), pp. 7-8.

5/ Hinshaw (1958), p. 10.

6/ These restrictions generally distinguish between residents and nonresidents, and sometimes among different classes of residents (such as the monetary authorities, households, and enterprises).

holdings of certain assets (e.g., bank deposits) denominated in foreign currencies, and thus to convert domestic currency internally into foreign currency assets. 1/ Such freedom to hold and intermediate foreign exchange domestically, however, is not tantamount to permission to make payments abroad, nor to hold assets located in foreign countries. Nor does it necessarily permit residents to hold any financial assets, other than foreign currencies, that represent claims against nonresidents. 2/ Countries concerned to protect their official reserve holdings have sometimes met their international obligations by making their currencies convertible for nonresidents while simultaneously prohibiting private residents from holding international reserve assets. Before August 1971, for example, the United States stood ready to buy and sell gold freely for the settlement of international transactions, 3/ thus providing external convertibility of dollars into gold. It did not permit private U.S. residents to hold gold, however, thereby prohibiting internal convertibility into gold. By contrast, in countries whose residents already have significant holdings of foreign currencies, the establishment of internal convertibility is of interest as a possible way of channeling foreign exchange resources into the banking system.

III. The Effects of Current and Capital Account Convertibility

Establishing convertibility for international transactions has a variety of implications for an economy. By exposing the economy to the pressures of foreign competition, current account convertibility, along with the removal of trade restrictions, offers substantial benefits for a country's supply side. It also poses certain risks, particularly in the short run, for domestic employment and real income levels, and for macroeconomic instability arising from the possibility of greater or more frequent current account imbalances. Creating convertibility for capital transactions likewise can have good and bad repercussions for a country's external capital flows, inviting inflows of long-term investment capital

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1/ This appears to be a relatively common usage of the term today. However, internal convertibility has sometimes been used to refer to the right to exchange money for goods, particularly in countries such as the Soviet Union, in which there are restrictions on converting certain forms of money into goods. The term has also sometimes been used synonymously with convertibility for current account transactions, particularly in Czechoslovakia.

2/ Although in principle a country can establish internal convertibility separately from convertibility for international transactions, once its residents are allowed to purchase and hold foreign currency without limit, the country may have great difficulty in preventing currency conversions associated with payments for international transactions.

3/ By so doing the United States fulfilled its exchange rate obligations in (the then prevailing version of) Article IV, Section 4(b) of the Fund's Articles of Agreement.

while opening the doors for capital flight. Both current and capital account convertibility also have implications for a country's balance of payments, requiring more attention in the development and implementation of monetary, fiscal, and exchange rate policies.

1. Convertibility and the supply side of the economy

a. Current account convertibility

Establishing current account convertibility within an environment of liberal trade regulations can introduce a new degree of freedom into the economy, particularly in countries that have been characterized by central planning. In the absence of prohibitive quantitative restrictions on imports, current account convertibility can afford individuals a much greater choice of consumption items by simplifying and expanding the opportunity to purchase goods and services from abroad. This can lead to significant increases in consumption and consumer satisfaction in the short-run, particularly where the output of domestic industries has in the past been unable to satisfy consumer demands. It may also promote domestic production by easing access to imported capital and intermediate goods.

These direct benefits, however, have traditionally been considered less critical than the indirect benefits that current account convertibility can help generate over the medium-term by creating a competitive environment and thereby contributing to comparatively advantageous choices about domestic production and investment. The transformation of centrally planned into market-oriented economies involves substantial decentralization of production and investment decisions and reliance on market prices to coordinate the behavior of many separate economic units. Success depends on the quality of information that guides decision-makers, and on how well the price-adjustment mechanism functions in equilibrating supply and demand. From this perspective, it is important for domestic producers to operate in a competitive environment.

Current account convertibility can help create such an environment insofar as it exposes domestic producers to competition from abroad and helps introduce the relative prices for different commodities prevailing on world markets. The strength of this competition depends not only on whether domestic currency is convertible for current account transactions, but more broadly on the overall scope and nature of trade restrictions.

A competitive environment provides strong incentives for producers to use resources efficiently, thereby freeing resources to produce additional output. Exposing the economy to international competition also reduces the market power of domestic monopolies and oligopolies, which have been a common feature in many centrally planned economies. In small economies, such as those in Eastern Europe, domestic markets in many industries may be too thin to support a large number of producers. Imports may thus be a particularly important source of competitive pressure. The opportunity to

export, which expands the size of the market that domestic producers can reach, also promotes competition by strengthening the incentives for more enterprises to produce any particular good or service.

Over the longer run, import competition is likely to promote innovation and quality improvements in domestic industry. Domestic enterprises will need to adjust product lines and styles, and to introduce new technologies, to keep their products competitive with goods available from abroad. More generally, an environment of international competition induces domestic producers, whose objectives are to maximize their own financial performance, to allocate resources in ways that tend to exploit the country's comparative advantage. This is particularly true to the extent that greater international competition, fostered by current account convertibility, helps domestic firms adjust to the relative prices prevailing on world markets. In such an environment, investment tends to take place in activities that offer relatively attractive prospects for expanding domestic production and exports and for raising living standards over time.

While these beneficial effects of international competition provide strong arguments in favor of current account convertibility, there are also risks involved. Substantial unemployment and idle capacity can result in the short run if the products of domestic enterprises are extensively abandoned in favor 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 if imports become readily available, particularly if the quality of domestic output is much poorer than that of competing foreign products. In either case, the purchasing power of domestic incomes can decline substantially, 1/ with reinforcing multiplier effects on domestic output. If the environment for domestic enterprises grows too harsh, the strains imposed on the population can become unsustainable, thereby undermining political support for a reform program.

The nature of the environment facing domestic enterprises, and their ability to compete with imported goods and services, depends critically on the level of the exchange rate. The adverse effects on employment and real wages (measured in domestic terms) can be limited if current account convertibility--and other measures to expose the economy to international competition--are introduced at an exchange rate that makes imports

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1/ As Lipton and Sachs (1990) emphasize, however, the reduction in real incomes, as traditionally measured, may well overstate the fall in living standards in an economy characterized initially by extensive shortages and rapid inflation.

sufficiently expensive. 1/ An exchange rate sufficiently depreciated to allow domestic producers to survive the early stages of reform can make all imports costly for consumers and producers, however, including imports of essential intermediate goods and investment goods critical for the country's development efforts. This can bias production and investment decisions against the technologies and products that are most efficient over the medium term. Countries may thus be inclined to set their foreign exchange policies to meet objectives other than the early introduction of complete current account convertibility. Historically, countries with uncompetitive industries and foreign exchange shortages have generally sought to restrict the convertibility of their currencies, or to maintain other forms of import restrictions, rather than to rely on a heavily depreciated exchange rate for attaining a sustainable current account position. Such an approach, however, invites the maintenance of distortions and imbalances in the domestic economy.

b. Capital account convertibility

One of the key issues faced by reforming economies is how to attract capital and other productive resources from abroad. To the extent that official grants, loans, and technical assistance are limited, the success of the transformation process may depend crucially on attracting inflows of private capital and expertise.

The introduction of capital account convertibility--or, at least, convertibility for certain types of capital flows--can help attract resources from abroad. 2/ In addition to factors determining the attractiveness of individual projects, the willingness of foreigners to move capital into a country depends heavily on whether interest, after-tax profits, and initial capital investments (investment principal) can be

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1/ Of course, if at world prices the value of a firm's output is less than the cost of its inputs of tradable goods, no exchange rate will make the firm competitive (in the absence of trade restrictions). Similarly, if the costs of labor and other nontradable inputs cannot be prevented from rising in parallel with the prices of tradable goods, exchange rate depreciation cannot raise the value of a firm's output relative to the cost of its inputs.

2/ Capital account convertibility may also enable residents to obtain higher risk-adjusted rates of return in the short-run, and to hold internationally diversified investment portfolios, thereby cushioning the real value of their savings against various shocks to the domestic economy.

repatriated. This is true for virtually all forms of direct investment flows and portfolio capital flows. 1/

Where foreign investors assume large ownership positions in domestic enterprises, capital inflows can lead to new and possibly better management. Foreign management is likely to bring more complete information about production techniques used and marketing opportunities available outside the country. It may also contribute in other ways to expanding the country's access to improved technology from abroad and to foreign markets, thereby leading to more efficient production methods.

The effectiveness of convertibility in attracting private capital inflows will depend crucially on the country's economic and legal environment, both currently and prospectively. Macroeconomic stability and the credibility of continuing stability are central considerations in evaluating whether specific domestic investment opportunities compare favorably with investment opportunities elsewhere. As emphasized by Corbo and Fischer (1990, p. 27), "investment requires an appropriate and credible economic environment .... [and] does not respond well when investors, foreign and domestic, doubt that the government will sustain its reforms ...." Other important considerations include the legal system and the nature of the investment code; the quality of the physical and electronic infrastructure, including the transportation system and the communications network; human capital and natural resources; perceived political stability; and the size of the markets to which there is access domestically and in neighboring countries.

The negative side of establishing capital account convertibility involves mainly the risks of capital flight and greater volatility in exchange rates, external reserves, or interest rates. 2/ An increased ability to send savings abroad could on balance reduce the funds available for domestic investment, particularly where the reform process has not progressed sufficiently to dampen uncertainties about macroeconomic

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1/ Capital account convertibility is not the only way to attract private capital from abroad. Although foreigners may need reasons to believe they will eventually be able to repatriate earnings, various forms of tax concessions and subsidies may in the short run substitute for capital account convertibility as an inducement for private capital inflows. Such inducements, however, are likely to be considered inequitable, because they discriminate between foreign and domestic investors. In addition, they may have adverse fiscal implications and often prove inefficient in terms of the new income generated relative to the revenues foregone and expenditures involved. Accordingly, economists generally advise caution about using such measures to encourage foreign investment.

2/ There is also the risk that lack of oversight and coordination at the macroeconomic level may allow capital inflows to exceed the socially optimum level, resulting in an excessive debt burden if the inflows represent mostly borrowed funds. See Aizenman and Isard (1990).

stability and the competitiveness of domestic enterprises. Until there is widespread confidence that the reform program will succeed, changes in the perceived likelihood of success could, under capital account convertibility, generate strong exchange rate pressures. These exchange rate pressures in turn could greatly complicate the task of macroeconomic stabilization. Perhaps because of these risks, most countries have maintained restrictions on various types of capital flows until their economies were well advanced, usually some time after the introduction of current account convertibility. Implicitly, these countries have viewed the risks associated with full capital account convertibility as more costly than the distortions introduced when convertibility is limited to the current account (plus selected types of capital flows). 1/ In assessing this trade-off, however, authorities should recognize that restrictions on external capital transfers have become increasingly difficult to enforce as advances in information and transactions technologies have increased the integration of international capital markets. Thus, capital flight has sometimes occurred on a large scale even in the absence of capital account convertibility. This issue is discussed further in Section IV.

2. Convertibility and macroeconomic stability

Both current account convertibility and capital account convertibility can complicate the task of macroeconomic policymaking, largely because convertibility allows greater movements--including trends--in the current or capital accounts of the balance of payments. Under a fixed exchange rate system, persistent external imbalances can drain a country's international reserve holdings, thereby creating pressure to adjust either its exchange rate or the settings of other policy instruments. Adjustments may also be needed when international reserves are accumulating, to avoid the adverse consequences of failing to slow the domestic money creation that typically accompanies reserve inflows. Under a flexible exchange rate system, incipient trends in the balance of payments typically lead either to exchange rate movements or to adjustments in the settings of other policy instruments. In turn, these changes in exchange rates or other policy instruments have repercussions on domestic prices and incomes and may compromise the ability of policymakers to achieve the ultimate objective of sustained noninflationary growth.

Whether current account convertibility leads to persistent external imbalances in a fixed exchange rate system, or to more direct pressures for adjustment in a flexible rate system, depends on the exchange rate at which convertibility is established, together with the stance of fiscal and monetary policy. For economies undertaking substantial reforms of the environment in which domestic producers must operate, the real exchange rate

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1/ Current account convertibility without capital account convertibility is essentially equivalent to a dual exchange rate system. See Adams and Greenwood (1985) for a discussion of the equivalence and the distortions induced; see also Kiguel and Lizondo (1990).

at which domestic enterprises are competitive in the short run may differ considerably from the rate at which they are competitive over the longer run. The establishment of current account convertibility may thus imply a need for gradual exchange rate adjustment if large external imbalances are to be avoided.

Whether this rate adjustment can be achieved smoothly over time once current account convertibility has been established is an open issue in today's environment. Historical experience from the period before 1973, by which point most industrial countries had established current account convertibility, is not a useful guide for two reasons: the international environment has since become much more conducive to transmitting speculative pressures; and policies in the period before 1973 were oriented toward keeping exchange rates fixed rather than toward achieving smooth adjustment over time. Most of the countries that have maintained current account convertibility throughout the past two decades have also imposed few, if any, restrictions on capital flows. Experience suggests that, in a world of highly integrated capital markets and technologies for making financial transactions rapidly, once convertibility is extended to the capital account strong pressures on exchange rates are likely to develop periodically in response to changes in the economic or political outlook. In the absence of adjustments in interest rates or other policy instruments in response to these changes in outlook, full convertibility can allow large swings in exchange rates. The accepted wisdom in this context is that it is impossible for a country simultaneously to enjoy a stable exchange rate, unrestricted capital mobility, and independent control over interest rates or other instruments of monetary policy.

Even with convertibility limited to the current account, speculative pressures can be transmitted to exchange rates through advanced and postponed shipments of durable goods, and through leads and lags in payments and currency conversions. Thus, it may be difficult for a country simultaneously to enjoy both exchange rate stability and the absence of current account restrictions, unless it is willing to limit its ability to keep its major policy instruments focused on domestic economic performance. 1/

Countries must therefore weigh the benefits of removing current account restrictions against the advantages of exchange rate stability and greater monetary independence. The relative importance of these three objectives may change as countries move through different stages of economic development and transformation. In the early stages of reform, some

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1/ Some have argued that sacrificing policy flexibility may have benefits for a country embarking on a comprehensive reform program by imposing discipline and thereby enhancing the credibility and effectiveness of the program. However, credibility can easily be lost when policymakers tie their hands in ways that generate more austerity or volatility than the populace is willing to accept.

countries may consider it particularly important to keep interest rates and credit policies stable and to avoid sharp fluctuations in exchange rates. These countries might thus find it desirable temporarily to retain some current account restrictions (along with restrictions on certain capital account transactions), in addition to pursuing appropriately tight macroeconomic policies, as a way of controlling external payments imbalances. As is discussed later, mechanisms that enable the authorities to control the total resources available for imports, while allowing market participants to bid openly for those resources in an environment of liberal trade regulations, may be particularly attractive in this context. Such mechanisms may not be very effective, however, in the absence of sound macroeconomic policies and attractive economic prospects, without which the incentives to evade controls are likely to be strong.

IV. When to Introduce Convertibility

The appropriate time to introduce convertibility will normally depend on the implementation of other measures in a country's reform program. As indicated in this section, macroeconomic stability and appropriate microeconomic incentives are critical to the success of convertibility, which implies that certain conditions must be established before, or at the same time that, convertibility is introduced. Given the major benefits that convertibility can provide, countries should move as quickly as possible to establish the preconditions necessary for convertibility to succeed. Moreover, there is a strong case for the rapid introduction of at least current account convertibility once these preconditions are established. Nevertheless, some countries may wish to move more gradually to establish convertibility, in which case certain transitional arrangements may be of particular interest.

1. General preconditions for current account convertibility

In discussing the issue of currency convertibility, economists have traditionally identified certain preconditions that must be present for its successful implementation. 1/ Although the characterization of these preconditions has changed over time with the evolution of both the concept of convertibility and prevailing views on macroeconomics, the basic requirements are: (1) an appropriate exchange rate; (2) an adequate level of international liquidity; (3) sound macroeconomic policies; and (4) incentives for economic agents to respond to market prices, which in turn should be free of major distortions. 2/ The same preconditions apply to the elimination of trade restrictions generally.

1/ See, for example, Jacobsson (1954) and Gilman (1990).

2/ Strictly speaking, no major distortions should remain once convertibility is established.

As the discussion below will clarify, the first three of these conditions can be regarded as necessary to ensure that the introduction of current account convertibility does not generate macroeconomic instability, while the fourth condition is needed to ensure that convertibility delivers the intended economic benefits. For countries undertaking the transformation from central planning to a market-oriented economic system, the third and fourth conditions will require major institutional reforms. Whether to move to convertibility straightaway or in stages may thus depend on whether there is strong political support for a comprehensive and rapid approach to reform.

a. Appropriate exchange rate

The first precondition for the establishment of current account convertibility--an appropriate exchange rate--is easy to comprehend. Unless the exchange rate is broadly consistent with equilibrium in the balance of payments, introducing convertibility will generate large imbalances. These imbalances, in turn, will generally have destabilizing effects on the domestic economy, whether the authorities choose to let the external imbalances persist or decide to cool or stimulate the economy through domestic policy measures.

As indicated earlier, the exchange rate consistent with balance of payments equilibrium in transforming economies is likely to change over time with developments in the competitiveness of the country's productive sector, including both export and import substitution industries. The real exchange rate needed if convertibility restrictions are removed early in the transformation process may well be more depreciated than the rate appropriate if these restrictions are removed at a later stage, when the country's industries are more competitive and better able to respond to market forces. 1/ Accordingly, it may be useful to envision an exchange rate path identifying levels of the real exchange rate consistent with current account sustainability at different points in the transformation process. The expectation would be that, other things equal, there should be some appreciation in the equilibrium real exchange rate as the underlying competitiveness of the country's productive sector improved. In the short-run, however, countries should aim for an exchange rate that will yield a sustainable current account balance in the light of the reforms introduced. Too appreciated a rate can create difficulties in attaining current account balance, while an overly depreciated rate, as noted earlier, can bias

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1/ The resulting degree of initial depreciation may also be greater the smaller is the extent of the private sector's holdings of foreign currencies, as this will heighten the role of supply responses (which can be expected to be weaker in the short run) in determining the equilibrium exchange rate.

production and investment decisions by making all imports very expensive for enterprises and households. 1/

b. Adequate international liquidity

Even with the exchange rate on a path broadly consistent with current account balance, an adequate level of international liquidity, comprising mainly foreign exchange reserves and access to foreign financing, 2/ is essential for a country to withstand cyclical shortfalls in its balance of payments or temporary terms of trade shocks, such as the mid-1990 rise in petroleum prices. Without adequate international liquidity, countries would find it difficult to maintain a stable macroeconomic environment for domestic producers and consumers, since it would be difficult to stabilize both the exchange rate and interest rates in the face of adverse short-term disturbances to the volumes or prices of exports or imports. Moreover, adequate international liquidity is necessary for the credibility of a country's overall adjustment efforts. Without such liquidity, observers might consider the country vulnerable to unforseen external developments, thereby providing incentives to take speculative action against its currency. As described further in the Appendix, insufficient liquidity was a major reason why the industrial countries of Western Europe chose to create a central payments union as a transitional arrangement, and to move only gradually toward liberalizing trade and establishing convertibility between 1946 and the late 1950s, when fixed exchange rates and reliance on reserves were the norm.

What constitutes adequate international liquidity for supporting current account convertibility is a complicated issue. The answer depends partly on the degree of exchange rate flexibility that the country desires. Given the limited access of many developing countries to international credit markets, a number of these countries have been encouraged in recent years to accumulate foreign reserves amounting to at least three months' imports, c.i.f., although in some cases (e.g., Nigeria) countries adopting a floating rate system have successfully eliminated exchange and trade restrictions with a smaller level of reserves. As this standard has applied to many countries with inconvertible currencies, arguably a larger amount of cover might be advised for non-OECD countries establishing convertible currencies. It may be instructive to note that Poland, which moved a long way toward current account convertibility at the start of its present reform program in January 1990, had reserves and external lines of credit totalling at that time about US$2.5 billion, equivalent to about 4.5 months of imports, c.i.f.

1/ The extent to which such decisions were biased would depend, of course, on the degree to which decisionmakers accurately anticipated movements in the real exchange rate over time.

2/ Some countries may also have significant amounts of international liquidity in the form of private resident holdings of foreign currency assets.

c. Sound macroeconomic policies

The third precondition for introducing current account convertibility--sound macroeconomic policies--involves policies sufficient, at a minimum, to maintain a sustainable current account balance. How strong macroeconomic control and discipline must be to attain this objective is difficult to say. What is clear is that strong fiscal and monetary control are needed to create an environment of general macroeconomic stability conducive to a successful reform program. This is all the more true because external payments imbalances can create unsustainable speculative pressures when prospects for general macroeconomic stability, including in particular price stability, are clouded by doubts about the authorities' willingness or ability to exercise firm macroeconomic control. It is also clear that countries moving from central planning to reliance on market forces must undertake comprehensive institutional reforms so that macroeconomic stabilization can be achieved through indirect means--such as open market operations--rather than relying on direct controls. 1/

Historical experience shows the central role of strong fiscal control in reform programs. 2/ Strong and credible fiscal discipline generally requires budgetary processes for controlling fiscal deficits, including ways to limit the automatic financing of loss-making enterprises and subsidized activities. In addition, as Blejer and Szapary (1989) and McKinnon (1990a) have emphasized, it is essential to replace the implicit tax systems of centrally planned economies with explicit systems under which tax revenues expand elastically as public enterprises are divested or become managed under new incentives, and as the economy grows. 3/

The importance of firm monetary control in stabilization efforts is also well documented. Strong monetary control in a market-oriented economy requires a central banking system with the ability to stabilize the economy indirectly by adjusting interest rates or other policy instruments. Establishing such an institution is especially critical in economies that have had central planning, where controls over production and resource

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1/ See Szapary and Wolf (1989) and Wolf (1990).

2/ After analyzing the relevance of financial structure and policies to economic growth in Hong Kong, Korea, Singapore, and Taiwan Province of China, Fry (1985) concluded that the differences in financial structures and policies were more prominent than the similarities, but that two common characteristics stood out: the absence of pressure for monetary expansion to finance large and continuous fiscal deficits; and the fact that none of the four countries allowed its currency to appreciate in real terms solely as a result of inflationary monetary expansion. The critical role of strong fiscal discipline in reestablishing macroeconomic stability has also been emphasized by Sargent (1982) in his study of ending hyperinflation.

3/ Tax policies and fiscal expenditures must also be conducive to encouraging the kind of investment needed to promote and maintain the competitiveness of domestic industry.

allocation and the absence of commercial banking activities may have obscured the importance of a strong monetary authority.

The establishment of monetary control also requires the elimination of any "monetary overhang" that a country initially confronts. 1/ Monetary policy must be capable of maintaining a reasonable degree of stability in both the price level and the macroeconomic environment. This is impossible in the face of a monetary overhang, under which large increases in consumer spending (including imports) can arise from the liquidation of outstanding monetary balances. Monetary overhangs can be eliminated through currency reforms, or perhaps through the sale of state-owned assets (such as the housing stock), together with setting interest rates at positive real levels. If restrictions on trade and currency convertibility are removed before the monetary overhang is eliminated, however, the opportunity to use domestic money balances to purchase imported goods will drain foreign exchange reserves and put strong pressures on exchange rates and interest rates.

d. Incentives to respond to market prices

The fourth precondition for introducing current account convertibility--that economic agents have incentives to respond to market prices, which in turn should be free of major distortions (other than those that will disappear when convertibility is introduced)--also presents a major challenge for economies in which well-functioning market price mechanisms have not yet been established. Under central planning, prices often bear no relationship to production costs or relative consumer values. Price reform is thus an essential part of the transformation process. As in all countries, the goal of such reform is to insure that prices correctly indicate relative scarcity values and the marginal returns from alternative economic activities. In this context, there is broad agreement that, as a first approximation, the prices prevailing on world markets provide the best indication of relative scarcity values for tradable goods and services, which in turn will affect the appropriate prices for nontradables. 2/

As noted earlier, the benefits from establishing current account convertibility--once major cost/price distortions have been removed and market price mechanisms are functioning--come from exposing domestic producers to import competition and creating an environment in which domestic production, investment, and consumption decisions are guided by the relative prices that prevail on world markets. Import competition forces

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1/ Even though most transforming economies start from a position where shortages of goods have been pervasive, in some cases, such as Poland, the counterpart "monetary overhang" may have been substantially reduced through inflation.

2/ The appropriate prices of nontradable goods and services should reflect the scarcity values that would emerge from competitive domestic markets for these commodities, including labor.

domestic producers to be efficient and reduces the market power of domestic monopolists and oligopolists. By basing decisions on relative world prices, moreover, domestic investors will allocate resources to areas consistent with the country's comparative advantages in the world economy.

Unless domestic producers and households have incentives to increase supplies and reduce demands in response to increases in prices, however, market price mechanisms will not function appropriately, and the elimination of exchange and trade restrictions will not have beneficial effects on the efficiency of production and investment. The reform of enterprise incentives is thus a critical step along the road to establishing current account convertibility. In this context, it should be emphasized that market price mechanisms do not function appropriately when producers are not subject to "the discipline of the bottom line." 1/ In centrally planned economies, the bulk of production has taken place in enterprises operating with "soft budget constraints," 2/ under which financial losses have been routinely covered or disguised by subsidies, tax concessions, or automatic credits from the state. Producers at such enterprises have thus lacked incentives to respond appropriately to price signals. At the macroeconomic level, soft budget constraints have been a breeding ground for fiscal budget deficits and inflation. Accordingly, the hardening of budget constraints and, more broadly, the introduction or strengthening of incentives for producers and consumers to respond appropriately to market price signals, should precede or accompany the establishment of current account convertibility. In the case of producers, this may involve privatization, although other reforms may also encourage enterprises to aim at maximizing net returns.

2. Should convertibility be established quickly?

Whether countries can move successfully to current account convertibility early in the reform process depends basically on how quickly they can establish the preconditions just described. This, in turn, may depend not only on the speed with which resources can be reallocated across sectors to reflect the new environment, but also on whether there is ample popular support for rapid and comprehensive reform. This last condition may turn on the initial amount of macroeconomic instability and the initial extent of distortions.

As described further in the Appendix, several countries facing hyperinflation have moved rapidly to establish strong fiscal control and to cut back sharply on the state's provision of credit to enterprises. They have also depreciated their exchange rates to realistic levels, substantially reduced monetary growth, and gone a long way toward establishing current account convertibility. In designing their reform programs, these countries have recognized the reinforcing nature of

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1/ Fischer and Gelb (1990).

2/ The term "soft budget constraints" is attributed to Kornai (1979).

comprehensive reforms. In particular, stabilizing prices, and introducing strong incentives for enterprises to become more responsive to market prices, have helped to establish the preconditions for current account convertibility. At the same time, the early introduction of convertibility may have helped create an environment in which there are strong pressures to maintain sound macroeconomic policies and to move rapidly in implementing structural reforms. 1/ Whether such strong and comprehensive reform programs and the resulting severe austerity would have been politically feasible in the absence of strong and widespread discontent with the initial macroeconomic situation is uncertain.

In countries where extensive economic controls have led to superficial macroeconomic stability, the prospect of heavy dislocation costs may discourage popular support for large-scale and rapid structural reforms. This may be particularly true in countries starting the reform process with modest levels of inflation but sizable price controls, soft budget constraints on enterprises, and the like. Although the major benefits stemming from convertibility argue strongly for introducing it as quickly as possible, in countries that lack popular support for implementing strong adjustment and comprehensive reforms, the preconditions for current account convertibility may take some time to establish.

Once the preconditions for current account convertibility have been established, there are strong reasons for moving quickly to introduce it. With an appropriate exchange rate, sufficient international liquidity, and supporting macroeconomic policies, convertibility should not lead to unsustainable pressures on exchange rates or the current account balance. Thus, with the reform of enterprise incentives and the elimination of domestic price distortions, the benefits of moving to convertibility should far outweigh the risks.

Nevertheless, countries like the transforming centrally planned economies that have not had much experience with a liberal trade environment may be anxious about establishing current account convertibility even after

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1/ The credibility and success of a reform program depend critically on the difficult process of carrying out more fundamental structural reforms. These are likely to take some time, as they involve restructuring production enterprises and the banking sector and creating the infrastructure necessary for private direct investment flows and financial intermediation activities to emerge. The emergence of private direct investment and financial intermediation flows, in turn, is likely to depend on a host of factors. These include the laws defining bankruptcy provisions, the investment code, and property rights in general; the quality of the physical and electronic infrastructure, including the transportation system and the communications network; and the availability, transparency, and accuracy of information relevant to direct investment and credit extension decisions, which depends on having reasonably well developed accounting, auditing, and disclosure standards.

the preconditions outlined earlier have been established. There may be concern, for example, that without restrictions on the total volume of imports, convertibility will lead to large current account imbalances or major swings in exchange rates, particularly during periods of economic uncertainty, such as after a large oil price shock. As described in the next section, transitional arrangements in approaching convertibility are available that can allay many of these concerns while providing the key benefits to be derived from convertibility--namely, a competitive environment and a rational set of relative prices. Such arrangements, which involve the introduction of exchange and trade reforms that will support current account convertibility once it is introduced, can be designed to satisfy members' obligations under the Fund's Articles of Agreement and could involve either fixed or flexible exchange rates.

However long countries may take in going all the way to establishing current account convertibility, there is widespread agreement that a unified exchange rate for current account transactions and certain types of trade policy reforms should be adopted as soon as possible. A unified exchange rate is one of the obligations that countries must meet under the Articles. The harmful effects arising from multiple currency practices are widely recognized. 1/ Multiple exchange rate systems involve discrimination among different exporters and importers, which can be harmful to other countries as well as to residents. They can also require large amounts of time for making transactions and administering the systems, while generally providing strong incentives for evasion. Prolonged reliance on such systems can distort the allocation of resources and retard the adoption of appropriate balance of payments adjustment measures.

With regard to trade policy reforms, there are two elements that seem to matter most. As summarized by the World Bank (1987, p. 9):

> The first is the move from quantitative restrictions to tariffs. This links domestic prices to foreign prices. The second is the reduction of the variation in rates of protection alongside reductions in its overall level. 2/

3. Transitional arrangements in approaching convertibility

Despite the benefits of moving quickly to establish current account convertibility, some countries may find it attractive to do so more

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1/ See IMF (1985).

2/ The Bank also mentions as a third element: "the direct promotion of exports to offset the bias resulting from import tariffs." However, it adds the following note of caution: "Specific measures to promote exports risk acquiring a permanent status ... and often lead to the postponement of more fundamental changes relating to the exchange rate. They may also contravene the General Agreement on Tariffs and Trade (GATT), create lobbies that will oppose their removal, and risk countervailing duty actions from importers."

gradually, through the use of transitional arrangements. One type of arrangement that may be of interest would involve establishing a system of trade and payments regulations that provides much of the free access to foreign exchange that would arise under convertibility, while enabling the authorities to maintain control over the total volume of resources available for imports. Such a system can be designed in a variety of ways, depending on the institutional arrangements and preferences of individual countries, and recognizing members' obligations under the Fund's Articles of Agreement. For example, open markets can be established either for foreign exchange, general import licenses, or for foreign exchange certificates with which import licenses can be obtained automatically. Such systems can be financed by foreign exchange surrender requirements for exporters, with the total resources for imports limited to available export earnings over the relevant time period, less amounts set aside for anticipated service payments and any desired increase in external reserves. Although in the past some versions of these systems (e.g., exchange certificates) have been used to restrict transactions, their creation as a transitional measure toward current account convertibility can be designed to involve low administrative and transactions costs, particularly compared to systems using an administrative allocation of foreign exchange. Moreover, although such systems give rise to multiple currency practices, the Fund in the past has accepted certain multiple currency practices as transitional arrangements. This type of arrangement provides a unified and transparent exchange rate for those exporters and importers included in the system. 1/ At the same time, this type of foreign exchange allocation, in which virtually all external transactions are channeled through a market monitored by the authorities, provides a mechanism for limiting imports financed with foreign-currency debt and for maintaining close control over the current account balance.

Such transitional arrangements for current account transactions can involve either fixed or floating exchange rates. 2/ As discussed in the Appendix, such arrangements were introduced by Taiwan Province of China in the late 1950s and by Korea in the mid-1960s. The exchange rate system now

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1/ This rate--which the authorities can stabilize if they wish--reflects the market-clearing price of foreign exchange, import licenses, or foreign exchange certificates.

2/ Quirk et al. (1987), who refer to such floating rate arrangements as "auction markets" (as distinguished in practice from "interbank markets"), discuss the experiences with these systems in developing countries.

operating in Poland, which is also discussed in the Appendix, provides another example of such a transitional arrangement. 1/

Another transitional approach that may be of interest involves using a set of temporary import tariffs to regulate the current account deficit during the early period of convertibility (McKinnon, 1990b). Under this approach, countries would immediately introduce current account convertibility, unify the exchange rate for current account transactions, and remove all quantitative trade restrictions, while establishing a set of temporary tariffs on goods to limit the short-term rise in imports. Tariffs would initially be set high, to protect domestic firms from foreign competition during the period needed to restructure and undertake new investment. These tariffs would then diminish at a pre-announced pace and eventually be replaced by a fairly low customs duty, thereby signaling domestic firms that they have only a limited time to become competitive. Such a system was used in Chile to establish current account convertibility during the 1970s.

One advantage of this proposal is that countries would immediately eliminate the types of current account restrictions precluded under Article VIII. This proposal would also require less government regulation of international transactions than would be needed under a system establishing formal limits on the volume of imports, although differential tariffs on different classes of goods would mean a slower movement toward world relative prices. One danger with this proposal is that domestic enterprises, once under the protection of high tariff barriers, might resist the implementation of scheduled reductions in tariff rates. Another risk is that establishing even temporary import barriers in countries where they were not previously in existence could violate the rules of the General Agreement on Tariffs and Trade (GATT), although the GATT might be willing to grant an exception in view of the special circumstances surrounding these tariffs.

For capital account transactions, inflows of direct investment capital and associated managerial and technological resources are widely

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1/ In Poland, households are free to make foreign exchange transactions in private markets, but enterprises are required to obtain foreign exchange in an official market and to surrender foreign exchange receipts to the monetary authorities. Moreover, official foreign exchange is not provided freely for capital account transactions, reflecting "concern on the part of the ... [authorities] regarding the defensibility of a fixed parity, given the uncertainty surrounding the launching of the stabilization program" (Lipton and Sachs, 1990, p. 113). While such a system involves multiple currency practices, the authorities' intention to prevent the divergence between the parallel rate and the official rate from becoming significant has made it a system that the Fund has been prepared to approve as a transitional arrangement; see, e.g., Poland--Review Under Stand-By Arrangement, EBS/90/77 (April 23, 1990), p. 17.

acknowledged as critical for the transformation process. At the same time, it is generally agreed that countries should move to encourage long-term capital inflows while limiting the possibilities for capital flight and volatile, short-term capital flows. To support these objectives, countries could enact rules guaranteeing nonresidents the right to repatriate assets, investment earnings, and compensation (including pension earnings) from employment in domestic enterprises. These changes could be part of more general investment code reforms allowing nonresidents to own, manage, and exercise control over domestic enterprises. Measures such as these would encourage long-term capital inflows by providing safeguards for repatriation and future transfers for nonresidents. At the same time, but subject to the provisions of Article VI, Section 3, restrictions limiting capital transfers by domestic residents could remain, as could limitations on short-term capital inflows that could create instability in domestic financial markets. However, such restrictions on capital flows should only be maintained if there is strong justification. In particular, restrictions on capital outflows can only be justified if the social costs of capital flight outweigh the costs of requiring residents to forego the opportunity for international portfolio diversification. 1/ In practice, the case for restricting capital outflows also depends on how well the restrictions can be enforced. As noted earlier, past experience has shown that controls are generally ineffective when a country's macroeconomic policies and prospects are poor.

V. The Issue of Internal Convertibility

The previous section has focused on the issues of convertibility for current and capital account transactions. This section turns briefly to the issue of internal convertibility--here defined as the legal right of residents to acquire and maintain domestic holdings of certain assets (e.g., currency and bank deposits) denominated in foreign currencies. 2/

1/ In general, capital outflows are motivated by the pursuit of higher expected yields and by desires to diversify asset portfolios in the presence of various types of risk. Any justification for restricting residents from pursuing these benefits must be based on arguments that capital flight generates negative externalities. To the extent that the success of a reform program depends critically on the strength of domestic investment, it can be argued that the residents of a country undertaking reforms may well be better off individually when they are collectively prevented from moving capital abroad. In the presence of effective controls and sound policies, the reform program may succeed, thereby benefitting all residents substantially. In the absence of controls, however, risk-averse residents could individually have strong incentives to send capital abroad, even in the presence of sound macroeconomic policies. Collectively, the resulting capital outflows could undermine the reform program.

2/ Although the definition is common in parts of Eastern Europe today, the term also has other connotations as noted in Section II.

Residents of countries with inconvertible currencies have traditionally favored the right to hold foreign currency as a hedge against domestic inflation. 1/ In many of the transforming economies, such holdings have also been encouraged because they provided access to special state stores offering goods available for sale only in so-called "hard" foreign currencies.

Countries may, of course, limit the extent to which internal convertibility is permitted. In Poland, for example, households are essentially unrestricted in their ability to obtain foreign exchange and in the range of foreign-currency denominated assets they may hold domestically, while enterprises must surrender fully all export proceeds.

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 quantitative limits on trade, since with internal convertibility residents will have the foreign exchange needed to make payments for imported goods and services. Moreover, internal convertibility may make it very difficult to maintain any effective restrictions on capital outflows, which can be much more difficult to detect than outflows through the current account.

Historically, countries have sometimes chosen to maintain restrictions on internal convertibility after establishing convertibility for current account transactions. In general, the intent has been to limit the scope for capital outflows, or to limit flows of official gold or foreign exchange holdings into the portfolios of private domestic residents.

The motivation for introducing internal convertibility differs from that for establishing current account convertibility. One reason is to induce residents to sell or deposit their existing cash holdings of foreign currency, thereby channeling foreign exchange resources into the banking system. A second reason is to integrate black markets into the formal economy, which can lower transactions costs and lead to greater uniformity in exchange rates. 2/ These potential benefits must be weighed against the potential costs, however. In the absence of sound macroeconomic policies and attractive prospects, internal convertibility can lead to large-scale substitution out of domestic currency into foreign currency, which can deplete official foreign exchange holdings. In general, moreover, large resident holdings of foreign exchange deposits can create difficulties for monetary policy.

1/ Freedom to hold and intermediate foreign exchange internally, however, is not tantamount to permission to make payments or hold assets abroad.

2/ In addition, the legalization of transactions that previously occurred in black markets frees resources that would otherwise be used for enforcement by the authorities and evasion by participants in the black markets.

The preconditions for introducing internal convertibility are the same as the first three preconditions for current account convertibility, namely: (1) an appropriate exchange rate, (2) adequate international liquidity, and (3) sound macroeconomic policies. Sound macroeconomic policies are needed to make it attractive to hold assets denominated in the domestic currency unit and thus to discourage substitution out of domestic currency. This implies policies that yield price stability and competitive returns on domestic currency holdings. To limit speculative pressures, and to insulate the domestic economy from small waves of currency substitution, a realistic exchange rate and adequate international liquidity are also needed.

VI. Summary and Questions for Discussion

This paper has analyzed the establishment of currency convertibility in transforming economies, focusing mainly on current account convertibility, with some discussion of capital account convertibility and internal convertibility. Current account convertibility must be addressed in the context of systemic reforms underway in these countries and as part of the larger issue of removing restrictions on current account transactions generally. Widespread agreement that convertibility is desirable as a long-run objective implies that the main issues concern the speed with which convertibility should be introduced.

Current account convertibility can bring both benefits and risks to an economy. Among the benefits are the direct gains in consumer welfare that result from easing the import process and broadening the array of imported goods and services. The major benefits of convertibility are indirect, however, resulting from the effects of import competition on the efficiency of domestic production and the guidance that relative prices on world markets can provide for the allocation of investment. Convertibility also poses two notable risks. One is that a rapid move to convertibility requires the real exchange rate in the short run to be more depreciated than its longer-term equilibrium level. This can have distorting effects on resource allocation by raising the relative price of imports, including important inputs to production and capital goods. The second risk is that maintaining current account balance, once convertibility is established, implies either greater exchange rate instability or greater pressures on the authorities to direct policy instruments toward external stability rather than internal stability. Historically, most countries have moved gradually to establish current account convertibility and have restricted convertibility for many types of capital flows until later in their development.

The analysis of when to introduce convertibility indicates that the success of convertibility will generally require macroeconomic stability and appropriate microeconomic incentives, which implies that certain conditions must be established before, or at the same time that, convertibility is introduced. Four general preconditions can be identified: (1) an

appropriate exchange rate; (2) adequate international liquidity (meaning reserves and foreign financing); (3) sound macroeconomic policies; and (4) incentives for economic agents to respond to market prices, which must in turn be free of major distortions (other than those that will disappear when convertibility is introduced). The first three are required to limit the risks of severe macroeconomic instability, while the fourth is needed to insure that convertibility delivers its principal benefits. For countries undertaking the transformation from centrally planned economies to market-oriented systems, the third and fourth preconditions require major institutional reforms.

The political feasibility of moving quickly and firmly to establish the preconditions for current account convertibility may require widespread and deep popular discontent with the initial macroeconomic situation; otherwise the population may not be willing to accept the degree of initial austerity implied by highly restrictive policies and enterprise reforms. Thus, for centrally planned economies that are not starting from a position of severe macroeconomic instability, a rapid move to convertibility may not succeed.

However long it takes countries to move all the way to establishing current account convertibility, there is general agreement that countries should move as quickly as possible to unify the exchange rate for current account transactions and to liberalize trade policies by removing quantitative restrictions and rationalizing the system of import tariffs. In addition, once the preconditions for current account convertibility have been established, there are strong reasons for moving rapidly to introduce it. Countries that nevertheless wish to move more gradually to complete current account convertibility, or that have not yet established the preconditions for convertibility, may find it attractive to introduce a transitional system, consistent with members' obligations under the Articles, in which the authorities can maintain control over the total volume of resources available for imports, while allowing households and enterprises to bid openly for these resources. Such a system can allow considerable import competition and effectively permit a market allocation of foreign exchange while limiting imports financed by private borrowing abroad. At the same time, it can enable the authorities to maintain close control over the current account balance and, if desired, to manage the exchange rate.

On issues relating to capital account convertibility, many economists and policymakers have traditionally argued that, apart from moving to promote investment-related inflows (which may require channels for certain types of capital outflows), countries should not rush to liberalize restrictions on international capital movements. From this perspective, efforts should focus in the short run on fostering long-term capital inflows while limiting the possibilities for capital flight and volatile, short-term capital inflows. At the same time, however, the authorities should recognize that controls on capital outflows may not be effective in the absence of sound macroeconomic policies and attractive economic prospects.

As regards internal convertibility, making it legal to hold foreign-currency denominated assets can help to channel existing but hidden private holdings of foreign exchange into the banking system, although this risks substitution out of domestic currency holdings into foreign currency. Accordingly, internal convertibility should not be introduced in the absence of an appropriate exchange rate, adequate international liquidity, and sound macroeconomic policies.

The issues raised in this paper suggest the following key questions on which Directors may wish to concentrate their discussion:

1. Is there agreement that the major benefits of current account convertibility result from the effects of import competition on the efficiency of domestic production and the guidance that relative prices on world markets can provide for the allocation of investment? Is it further agreed that convertibility can pose significant risks insofar as it requires a substantially depreciated exchange rate in the short run and also requires the authorities to direct policy instruments toward external stability rather than internal stability?

2. Is there agreement that an appropriate exchange rate, adequate international liquidity, sound macroeconomic policies, and incentives for economic agents to respond to market prices must be established at or before the introduction of current account convertibility?

3. How quickly should the transforming economies undertake the reforms needed to establish the preconditions for current account convertibility? At what stage in the reform process should these economies introduce important concomitants of current account convertibility, in particular, unifying the exchange rate for current account transactions, removing quantitative restrictions on trade, and rationalizing the system of import tariffs?

4. Once the preconditions have been established, what are the benefits and costs of a transitional approach to current account convertibility as opposed to its rapid and complete implementation?

5. What are the benefits and costs of maintaining restrictions on capital account convertibility once convertibility for current transactions is established? To what extent does the answer turn on the difficulties of restricting capital outflows in the absence of sound macroeconomic policies and attractive economic prospects?

6. Does the introduction of internal convertibility involve any special considerations that are not applicable to the establishment of current or capital account convertibility?

Historical Experience in Establishing Convertibility

Historical experience indicates that most countries have introduced current account convertibility rather late in their development process, usually after the start of industrial reforms and trade liberalization. Thus, many developing countries have not had convertible currencies. In Africa, for example, only the 13 African countries in currency zones pegged to the French franc have had convertible currencies, and even for these countries convertibility has been limited to the French franc. Among industrial countries, convertibility has generally been acknowledged as a main policy objective. Introducing convertibility, however, has depended largely on economic circumstances, with most countries waiting to establish current account convertibility until they had secured what appeared to be a competitive industrial structure and an adequate level of international reserves. In addition, most countries have postponed introducing capital account convertibility until fairly late in their economic development, in the belief that capital account convertibility has involved even greater risk of external instability.

1. Postwar Western Europe

With the outbreak of World War II, normal international financial arrangements had come to an end. To conserve foreign exchange--mainly U.S. dollars--direct controls over trade and payments had been greatly extended and, for the same reason, the currencies of most countries ceased to be convertible into dollars, except at administrative discretion, for both residents and nonresidents. Immediately after the war, only the United States and Switzerland had currencies that were convertible for current account transactions.

Throughout Western Europe, which had suffered heavy damage, most countries had adopted extensive sets of bilateral trade agreements to conduct trading operations. Although there was general agreement that reestablishing convertibility was desirable, the uncertainty of trade prospects and concerns about lack of competitiveness vis-à-vis the United States led most countries not to do so. Moreover, the one attempt to establish current account convertibility soon after World War II--by the United Kingdom, in 1947--was considered by leading observers as "a colossal failure" 1/ or a "disaster of the first magnitude," 2/ largely because of the failure to establish the first three preconditions for convertibility

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1/ Haberler (1954), p. 16.
2/ Hinshaw (1958), p. 11.

discussed in Section IV. 1/ During this attempt, the United Kingdom received a US$3.75 billion loan from the United States in support of implementing provisions to make sterling fully convertible for "current transactions." The loan, authorized under the Anglo-American Loan Agreement signed in December 1945 and ratified by the U.S. Congress in July 1946, became fully effective on July 15, 1947. 2/ One month later, the loan was virtually exhausted, and on August 20 convertibility was again suspended.

In the light of the British experience, but recognizing that bilateral trade agreements and the accompanying trade restrictions were strongly hampering trade and the growth of their economies, the leading Western European countries established a central payments and clearing union as a way of promoting trade among themselves and encouraging the elimination of trade restrictions. Under the resulting European Payments Union (EPU), created in 1950, member countries succeeded in eliminating most quantitative trade restrictions and in achieving substantial increases in both the volume of intra-European trade and the level of international reserves during a period when fixed exchange rates were the norm. 3/ Not until the end of 1958, however, did the member countries decide it was possible to terminate the EPU and declare current account convertibility, 4/ and most of the former EPU members actually waited until 1961 to accept the obligations of the Fund's Article VIII. Establishing capital account convertibility took

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1/ As noted by Haberler (1954, p. 17), the attempt to restore convertibility started from a position of repressed inflation (e.g., "price controls, rationing, subsidies and similar devices") with "large, insufficiently blocked sterling balances owned by foreigners ready to seize their opportunity when exchange control was relaxed." Although convertibility by nonresidents was to be limited to "new" sterling balances acquired through current account transactions, the formal and informal arrangements to ensure the inconvertibility of "old" sterling balances held outside the United Kingdom (which were estimated to be $14.9 billion at the end of 1946) obviously proved ineffective in an environment in which it was also estimated that "new" sterling was flowing from the Sterling Area to the outside world--through the current account--at an annual rate of about $5 billion; see Hinshaw (1958), pp. 10-11.

2/ It may be noted that Keynes, who led the loan negotiations on the British side, felt that the target date stipulated by the United States was much too ambitious and negotiated an escape clause under which the British were entitled to request a postponement if conditions warranted. Keynes died in April 1946 and the British decided not to exercise the escape option.

3/ See Kaplan and Schleiminger (1989) for an extensive history of the EPU and the political and economic circumstances surrounding the move to currency convertibility in Western Europe.

4/ During 1952-53 the authorities of the United Kingdom unsuccessfully sought international support for a "collective approach" to restore sterling convertibility based on a floating exchange rate. See Kaplan and Schleiminger (1989), pp. 164-84.

even longer for most countries. France and Italy, for example, abolished the last of their major restrictions on capital transactions only during the latter 1980s.

2. The newly industrializing Asian economies

The newly industrializing Asian economies (NIEs)--Hong Kong, Korea, Singapore, and Taiwan Province of China--have achieved remarkable economic transformations over the past three decades based on outward-oriented development strategies. The experiences of these countries have received considerable attention, 1/ as have the factors that generally contribute to the success of outward-oriented development strategies. 2/

The four NIEs have chosen very different speeds for accepting the obligations of Article VIII. Hong Kong, as a nonmetropolitan British territory, moved to Article VIII status with the United Kingdom in 1961, and Singapore followed in 1968. By contrast, Taiwan Province of China had not accepted Article VIII status as of April 1980, when it ceased to represent China in the Fund, and Korea did not accept Article VIII status until 1988, after more than two decades of rapid growth and successful industrialization. 3/ Most of the Asian countries that have moved to Article VIII status have still retained important restrictions on capital account transactions, however. Even Japan, which accepted Article VIII status in 1964, eliminated its remaining major capital account restrictions only during the 1980s.

Despite the different speeds with which they accepted Article VIII status, however, each of the NIEs took early measures to achieve the major concomitants of current account convertibility. Taiwan Province of China moved in the late 1950s to unify its exchange rate (for most transactions), and to remove quota restrictions on imports (except for imports of certain luxury goods). 4/ An administrative foreign exchange allocation system was replaced by a system of continuous acceptance of import licenses supported by a foreign exchange surrender requirement for exporters. Thereafter, most exchange transactions took place at a fluctuating exchange certificate rate that the authorities stabilized, and import licenses for most goods were approved automatically when accompanied by exchange certificates. Korea moved to a substantially unified exchange rate in 1965 and, apart from promoting certain infant industries selected for development, adopted a system for encouraging exports through measures aimed at achieving the allocation of resources to export industries that would

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1/ For example, see Corbo et al. (1985).

2/ See Krueger (1985) and World Bank (1987).

3/ Among other Asian economies that have developed rapidly, Malaysia moved to Article VIII status in 1968, while Indonesia did so in May 1988 and Thailand, only in May 1990.

4/ Tsiang (1985), p. 37, and IMF (1960, 1961).

emerge under free trade. 1/ An exchange certificate market was created, similar to the system in Taiwan Province of China, and procedures for obtaining import licenses were simplified. 2/

While the measures taken to liberalize exchange and trade restrictions may have contributed importantly to the remarkable growth experiences of the NIEs, the Korean case also illustrates the risks of such measures under nonsupporting policies. 3/ In particular, following the domestic financial reform and the related high interest rate policy adopted in 1965, Korea experienced an "explosive inflow of short- and intermediate-term private capital [that] began in late 1966." 4/ The authorities chose to maintain exchange rate stability, to avoid taking direct measures to restrict capital inflows, and instead to accept a rapid accumulation of international reserves and external obligations, along with substantial monetary expansion. This led to higher inflation and, eventually, a shift in speculative pressures that led to a major devaluation of the won in June 1971.

3. Poland and Yugoslavia

During the past year, two transforming Eastern European economies--Poland and Yugoslavia--have gone a long way toward establishing current account convertibility. The two, however, represent somewhat different examples of how transforming economies have introduced convertibility during the reform process.

Following a change in government in late 1989, Poland embarked on a far-reaching program of economic reform and structural change effective January 1, 1990. 5/ Simultaneously, the exchange rate was depreciated to a level considerably below that in the parallel market during mid-December 1989; stringent fiscal and monetary policies were imposed; prices were liberalized and interest rates raised; and major changes in enterprise management and financing were begun, including a sharp reduction in credit

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1/ Kim (1985), pp. 59-60; Westphal (1990), p. 44; and IMF (1966).

2/ The percentage of imports for which licenses were automatically approved rose from 30 percent in 1964 to about 87 percent by the first half of 1967, although the automatic approval list in early 1967 still covered mainly capital and intermediate goods; see Kanesa-Thasan (1969), p. 18.

3/ See McKinnon (1973), pp. 161-66.

4/ Ibid., p. 163.

5/ For details of the Polish reform program, see "Poland--Request for Stand-By Arrangement--Letter of Intent," EBS/90/3 (1/3/90); "Poland--Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement," EBS/90/11 (1/18/90); "Poland--Review under Stand-By Arrangement," EBS/90/77 (4/23/90) and Supplement 1 (5/9/90) and Supplement 2 (5/11/90); "Poland--Review Under Stand-By Arrangement," EBS/90/153 (8/21/90) and Supplement 1 (9/6/90) and Supplement 2 (9/13/90); and Lipton and Sachs (1990).

provision and government subsidies for loss-making firms. As part of the reforms the zloty was made convertible for virtually all merchandise trade transactions, 1/ most quantitative import restrictions were removed, and the tariff system was rationalized. This followed steps taken in March 1989 to establish internal convertibility by making it legal for households to hold foreign assets and to purchase foreign exchange from dealers (the so-called "kantor" market).

Data for the first eight months after the start of the program indicate that external performance has been considerably better than anticipated. With both increases in export earnings and a sharp decline in imports, the current account registered a surplus of more than US$1 billion during January-June 1990. Reflecting substantial debt relief, the overall balance of payments registered an even larger surplus, and gross official reserves rose by more than US$1.3 billion over this period. In addition, the introduction of limited internal convertibility has not led to significant currency substitution into foreign assets, partly reflecting the relatively high real interest rates paid on domestic assets during the first few months of the new program, which have made these assets competitive with assets denominated in foreign currency. 2/

There has been no indication of the type of external instability that could in theory arise from the introduction of current account convertibility. This may be a consequence of the strong policies used to stabilize the economy. Specifically, the exchange rate was set at a very depreciated level that reflected "the almost total absence of domestic stores of value". 3/ Simultaneously, macroeconomic policies were tightened sharply, contributing in part to significant declines in production and employment. Together, as Lipton and Sachs (1990, p. 96) have emphasized, a sufficiently large depreciation and tightening of aggregate demand can eliminate excess import demand and thus sustain current account convertibility. Since such policies appeared necessary to stabilize the economy and to provide strong incentives for enterprises to become responsive to market prices, it can be argued that there was little risk in also moving most of the way toward establishing current account convertibility at the same time. As time proceeds, however, the difficulties of stabilizing exchange rates and interest rates simultaneously may increase, particularly if speculative pressures on exchange rates arise as perceptions about Poland's macroeconomic prospects change (whether for better or for worse).

1/ Convertibility restrictions still apply to a number of services transactions.

2/ Indeed, the share of foreign currency deposits in the money stock declined from 63 percent at the beginning of 1990 to 42 percent at end June.

3/ See comments by Stanley Fischer, appended to Lipton and Sachs (1990), p. 135.

The case of Yugoslavia is different from Poland in that the move toward current account convertibility took place only after several years of economic reform and adjustment. Since the early 1980s, Yugoslavia has been implementing economic adjustment programs with Fund support--first under stand-by operations, then under the enhanced surveillance procedure from mid-1986 to mid-1988, and since then under stand-by arrangements. 1/ Following a large balance of payments deficit in 1987, external performance improved substantially in 1988 after the initiation of a stand-by. By the end of 1989, gross reserves reached the level of about 8 months' imports from convertible currency areas. This improvement permitted most quantitative restrictions on imports to be removed during 1989. To stem hyperinflation, however, a new and comprehensive stabilization program was introduced in late December 1989 involving the introduction of a fixed exchange rate, stringent macroeconomic policies, and a temporary freeze on wages and certain prices. Soon thereafter, as of January 1, 1990, domestic residents were permitted to freely convert dinars into foreign exchange.

Data through August 1990 indicate that the Yugoslav program has succeeded in reducing inflation dramatically, while the balance of payments has continued to be in surplus. The adoption late in 1989 of tight macroeconomic policies aimed at reducing inflation and strengthening incentives for enterprises to respond to market prices had the effect, as in Poland, of introducing conditions that would also sustain the introduction of current account convertibility. Unlike in Poland, a significant start toward trade liberalization had already occurred before the new stabilization plan and convertibility were introduced. Whether Yugoslavia's introduction of convertibility could have been sustained in the absence of a new stabilization plan is unclear.

1/ See "Yugoslavia--Request for Stand-By Arrangement--Letter of Intent," EBS/90/35 (2/23/90); "Yugoslavia--Request for Stand-By Arrangement," EBS/90/35, Supplement 1 (3/2/90); and "Yugoslavia--Stand-By Arrangement," EBS/90/35, Supplement 2 (3/20/90).

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