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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/175

10:00 a.m., December 17, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	L. E. N. Fernando
	G. C. Noonan
Dai Q.	
	S. B. Creane, Temporary
	M. E. Hansen, Temporary
J. de Groote	J. Prader
	G. H. Spencer
R. Filosa	N. Kyriazidis
M. Finaish	
M. Fogelholm	
B. Goos	
J. E. Ismael	T. Sirivedhin
A. Kafka	
J.-P. Landau	J.-L. Menda, Temporary
	O. Kabbaj
	S. Rouai, Temporary
	L. J. Mwananshiku
D. Peretz	P. Wright
G. A. Posthumus	
	Y.-M. T. Koissy
	J.-C. Obame, Temporary
	R. Marino
	M. Galán, Temporary
A. Végh	A. G. Zoccali
K. Yamazaki	K. Ichikawa, Temporary
	M. Nakagawa, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

African Department: G. C. Dahl. Asian Department: T. T. Do, M. J. Fetherston, S. L. Lam. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. I. Blejer. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; H.-M. Flickenshild, M. G. Gilman, A.-M. Gulde, P. J. P. Szymczak. External Relations Department: S. W. Kane, A. Mountford. Fiscal Affairs Department: A. Cheasty, D. Mihaljek. IMF Institute: N. Tith. Legal Department: P. L. Francotte. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; G. Calvo, M. P. Dooley, P. Gajdeczka, P. Isard, M. Schulze-Ghattas, M. P. Taylor. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; O. Roncesvalles. Western Hemisphere Department: P. J. Quirk. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. B. Chatah, A. Gronn, M. J. Mojarrad, F. Moss, A. Raza, B. Szombati. Assistants to Executive Directors: J. R. N. Almeida, B. Bossone, Chen M., J. A. Costa, A. Fanna, B. R. Fuleihan, O. A. Himani, R. Méron, M. Mrakovcic, J. A. K. Munthali, J.-P. Schoder, D. Sparkes, C. M. Towe, S. von Stenglin.

1. CURRENCY CONVERTIBILITY AND THE TRANSFORMATION OF CENTRALLY PLANNED ECONOMIES

The Executive Directors considered a staff paper on currency convertibility and the transformation of centrally planned economies (SM/90/214, 11/7/90).

Mr. de Groote made the following statement:

The paper prepared by the Research Department is very useful and could not be more timely, because convertibility is an essential element of several reform programs now being shaped in countries stepping over to market economy systems, and these programs will soon become candidates for this Board's support. Let me therefore begin by suggesting that we inform member governments of the views prevailing here on this important issue, by formally announcing the conclusions of today's discussion. This could greatly benefit ongoing discussions in several countries that are now examining this very topic.

Today's document very convincingly demonstrates the benefits of introducing convertibility in terms of resource allocation. Although it may seem obvious, it is useful to reaffirm that when enterprises enjoy free access to foreign exchange, the needed competition will operate to promote investment efficiency and the correct satisfaction of consumer needs. It is especially useful to restate these basic views at this particular moment, because in several countries in transit to market economies, a serious controversy is under way over whether it is really necessary to establish convertibility. I am therefore glad to see this very necessity so clearly stressed.

Another virtue of today's document is that it helps clarify a number of definitions. The word "convertibility" always needs to be qualified, especially to avoid the confusion between "internal convertibility" and "current account convertibility." Even though it is hard to imagine one without the other, since the possibility of freely purchasing foreign exchange--that is, internal convertibility--necessarily implies the possibility of making such purchases for current transactions. Still, it is very useful to distinguish between the two notions. "Internal convertibility," on the one hand, is a negative or exclusive concept: its content is defined only by the exclusion of freedom of transactions on the markets, and it does not specify whether it concerns current or capital transactions. Its definition is thus lopsided and incomplete. "Current account convertibility," on the other hand, is a positive or inclusive concept, the content and definition of which are clear, and I strongly recommend that it should be used in every case in which it is truly applicable. I also see very clearly that it would really be more appropriate to use the notion of current account convertibility than the notion of internal convertibility in preparing some of the programs we will soon consider in this Board. I especially have in mind Czechoslovakia, where the term internal convertibility is clearly used in the sense of current account convertibility.

The difficulty I just mentioned of maintaining the distinction between internal and current account convertibility is illustrated by the cases of countries in which the possibility of holding foreign exchange deposits in local banks, with internal convertibility, was introduced far in advance of current account convertibility; indeed, we have seen many cases in which such internal financial convertibility, or "capital account" convertibility, was introduced long before we could even begin discussing current account convertibility. The purpose was to ensure the repatriation of, say, illegal foreign exchange assets, or of any foreign exchange assets that might have been obtained by residents. But the reaction of the business community to these rules led to very large scale substitutions out of domestic, and into foreign, currency, even in the course of internal trading between companies within a country. In some cases, the negative effects of these substitutions greatly outweighed the system's incentive effects or the benefits of any foreign exchange repatriation actually achieved. The solution then generally adopted was to establish full surrender obligations, but with the possibility of keeping foreign exchange deposits in local banks.

Are surrender obligations and the notion of current account convertibility mutually inconsistent? I would say that they are not, and the payments regimes under several programs now being discussed appear to be heading in the direction of a system of surrender combined with current account convertibility. Under such a system, exporters are obliged to remit their export proceeds for conversion into national currency, and will obtain foreign exchange when imports are needed. The advantage for the country is that in the interval between their conversion and reconversion, the export proceeds remain in the reserves of the central bank. Indeed, we need to be very careful with our terminology, and I would be glad to be corrected by the Economic Counsellor if that is needed: in my view, we should not believe that a system of current account convertibility necessarily excludes a system of surrender obligations; rather, to the contrary, there are cases in which the two should go hand in hand.

The main theme of the document is obviously the timing of the introduction of convertibility, and rightly so; nor can the main conclusion on this point be disputed. The appraisal of different countries' chances of successfully introducing convertibility must take into account the stage of the reform process reached by each country, and the progress it has made with its transition to market mechanisms. The correct operation of current account convertibility requires that a high degree of price and import liberalization shall have been attained, and that various prior reforms shall have succeeded in teaching economic agents to respond to economic forces, and it would be futile to introduce convertibility where these prerequisites are absent. In addition, a viable balance of payments position and sustained macroeconomic stability, especially price stability, are also needed if convertibility is to be durable. It is thus understandable that in Central and Eastern Europe there is a great divergence of views about the appropriate timing and the need to announce convertibility in a formal manner. Perhaps the central issue as perceived in some of those countries is the possibility that, if competition among domestic producers becomes very strong, the introduction of convertibility could bring on an acceleration of inflation and a decline in employment and production, at least in the short term.

As regards the external payment situation forecast for next year, it is also the view of some Central and East European authorities that the introduction of convertibility could put a strain on macroeconomic, and especially monetary policy, decisions. Moreover, as very pertinently noted in the document, the introduction of convertibility may also initially require an almost systematic undervaluation of the real exchange rate, the impact of which on price levels is another of the perceived obstacles inclining some of these countries to resist immediate adoption of the decision. This issue also brings us to the need for a sufficient level of reserves.

Restoring an appropriate level of reserves is an explicitly recognized aim of Fund-supported programs, and indeed forms the cornerstone of some of those we are considering today, but this may not be so clearly recognized among all of the other institutions and governments which are interested in re-establishing market mechanisms in Central and Eastern Europe or elsewhere. Outside Fund circles, people are so accustomed to dealing with immediate stabilization issues, to fighting inflation and reducing budgetary deficits and the like, that they seem sometimes to assign a lower priority to the restoration of a desirable level of reserves than the Fund does. The crucial importance of adequate reserve levels needs to be stressed, and this timely document has the great merit of clearly demonstrating that unless sufficient assistance is provided for restoring the appropriate level of reserves, and unless the programs include that among their specific goals, then obviously all the advantages of convertibility in terms of better resource allocation cannot be obtained.

These various considerations shed an interesting light on the reaction of two countries in my constituency to the notion of, and the timing of, convertibility. Hungary has made very considerable progress toward establishing de facto current account convertibility, based on a high degree of trade liberalization and on measures establishing the free repatriation of profits and capital for foreign investors, and the freedom for residents to hold deposits in foreign currency. But the Hungarian authorities generally hold the view that, at this stage, any formal declaration of convertibility would be premature, and that it will still take at least two or three more years to satisfy all the preconditions needed for such a system to exist and to endure. In contrast, in Czechoslovakia, we find a stabilization program which will be virtually centered on the establishment and announcement of current account convertibility. Here I call it by its proper name, and suggest that we not use the name "internal convertibility" any longer. In Czechoslovakia, there are apparently no major macroeconomic imbalances between supply and demand and no monetary overhang. Czechoslovakia thus expects to be able to achieve an overall reform of the system in a single step. The Fund program supporting this process is in fact a contribution to the very goal of establishing current account convertibility, which itself is only one of the elements of the overall passage to a market economy. In Czechoslovakia, it is considered useful and necessary to fully establish this system at the very moment the overall program is announced, and to have available at that time the Fund resources needed for that purpose. The decision to proceed in this manner is expected to yield great advantage in terms of its announcement value.

In sum, it is quite interesting to see that those two countries have in fact responded as suggested by the document before us, using their different individual situations as the basis for their different decisions concerning timing and announcement.

This brings us to one of the more interesting, but at the same time more debatable, conclusions of the document. I quote the assumption expressed in Part 6 of the staff paper: "... political feasibility of moving quickly and firmly to establish the preconditions of current account convertibility may require widespread and deep popular discontent with the initial macroeconomic situation." This statement establishes, as a kind of precondition, popular willingness to accept the austerity implied by the restrictive policies and systemic reforms that accompanies convertibility. It might need to be qualified, to ensure that it is interpreted appropriately. Certainly it cannot be understood to mean that the transition to convertibility should only be implemented by countries so desperately threatened by the prospect of large imbalances and disruptions of the national economies that no other course is open to them. Of course the meaning is very much the opposite: there should be discontent about the functioning of the system, but that system must possess sufficient balance overall to allow convertibility to operate. In other words, for countries still facing a long period of preliminary stabilization to eliminate inflationary pressures and major payments imbalances, the chances of successfully establishing convertibility are much poorer than for countries with more moderate inflation, a better balance of payments position, and no monetary overhang.

A last word on the implication of all this for the roles of the central bank and the treasury in a country that is stepping over to such a new system. The central bank and the ministry of finance in such a country will each find itself in a completely new position. Before the changes, foreign exchange operations were artificially separated from movements in domestic monetary aggregates in a bilateral system of payments which reserved special boxes, so to speak, for each. In such a system, balance of payments effects had little impact on the money stock. In contrast, the interventions needed under the new system will henceforth require much greater flexibility with respect to incomes and expenditures, and will force the country to adopt a completely new approach to the management of macroeconomic policy. One very major consequence of re-establishing convertibility, therefore, is that the authorities must begin to make conscious and direct use of macroeconomic policy instruments.

However, this is easier said than done, since these countries generally lack well-developed money and capital markets, making it difficult for them to do, in terms of sterilization, what can easily be done by countries with well-developed financial and capital markets. We should perhaps devote some attention to the possibility that in the absence of fully developed capital markets, fiscal and monetary policies might become highly volatile in response to this new situation.

Mr. Posthumus made the following statement:

Currency convertibility is a very topical subject indeed, because it is obviously one of the major issues which the Eastern European countries are confronted with. The staff paper and the Board's discussion of it are timely and relevant.

In my view, the discussion is relevant because most, if not all, Eastern European countries have to decide on currency convertibility--whether to introduce it, when to do so, and how--in a very specific situation. Most of these countries are not confronted with the issue of transformation of a centrally planned economy into a market economy. To define their problem in this way would imply that there is a process from the centrally planned economy to a market economy which can be more or less controlled. It also indicates that certain preconditions have to be fulfilled to make currency convertibility possible or desirable.

The Eastern European countries are faced with a situation which can hardly be called a transformation process anymore; their economic predicament can be summarized as follows. First, central planning itself has more or less stopped functioning. There seems to be no longer any guidance to investment and production processes. The collapse of the central planning system means confusion, uncertainty, and a decline in production. We should perhaps look very closely at the experience in the former German Democratic Republic, because it may foreshadow the processes in the other previously centrally planned economies, including the Soviet Union. Second, the energy cost increases compound the problems in these countries, which generally have energy-intensive production processes. Third, most of the smaller members of the Council of Mutual Economic Assistance (CMEA) are affected substantially by the collapse of the planning system in the Soviet Union, their main supplier and market. For the Soviet Union was not just a large partner in a system, but the hub of a nexus of most commercial relations. Fourth, the international market place into which the former centrally planned economies now have to enter is a market place indeed, with fewer restrictions and more competition than ever since World War II.

The formerly centrally planned economies therefore urgently need a new guidance for their production and investment. They have all in principle decided to move to a market economy orientation. The only market available to them is the international market, because all of them are small economies. Relative prices on world markets are therefore indispensable for them, which means that current account convertibility has to be introduced immediately. Delaying current account convertibility and its necessary internal counterpart, price liberalization, would mean continuing a situation in which there is no guidance to production and investment. This can only result in further declines in production and investment. Thus, the introduction of current account convertibility has to take place almost immediately.

The preconditions mentioned in the second key issue for discussion--an appropriate exchange rate, adequate international reserves, sound macroeconomic policies and incentives to respond to market prices--seem to me to be right. The only problem is that they are not fulfilled in most cases. Thus, these policies have to be introduced at the same time as convertibility itself.

But it is clear that such a comprehensive policy package is difficult to introduce and to manage. One issue is which exchange rate should be set initially. In a recent paper, Bergsten and Williamson offered as their best advice to devalue enough, but no more than necessary. Another issue is that establishing sound macroeconomic policies requires quite a lot--experienced and reasonably independent central banks, for example. In other words, the institutions which in centrally planned economies do not exist as such have to be built rather quickly. Incentives to respond to market prices require restructuring of enterprises and banking systems, obviously a difficult and time-consuming task as well. For example--and this was not mentioned in the paper--there is the need to eliminate state monopolies in foreign trade, foreign exchange, and domestic output.

The Eastern European countries can most probably not avoid introducing very comprehensive policy packages, including convertibility. These policies, however, while introduced at the same time, have very different time horizons, and limited progress in one field may threaten the progress made in the others.

The reform process will most likely grind along, perhaps even be a stop-and-go process. This means that the improvement in the economic situation which makes it possible for governments to sustain a reform process may for a long time not be visible to their population. It goes without saying that the political conditions for continued implementation of the comprehensive policies will become very difficult indeed, and may approach what the statement in the paper calls severe macroeconomic instability. The fact that there seems to be no alternative is but a meager consolation.

Mr. Ismael made the following statement:

The lesson to be learned from the very useful staff paper is that currency convertibility can greatly benefit an economy, and should be pursued. At the same time, there are many risks involved, particularly in the short run, and therefore the path toward convertibility must receive careful consideration.

I have little to add to the analysis on the risks and benefits of the various types of convertibility, nor on the prerequisites. My comments will focus first on the question of timing, and second, on the nature of Fund advice to members.

In order to minimize the risks involved in moving to currency convertibility, the first priority for economies that are in the process of transformation should be the attainment of the four prerequisites for current account convertibility, namely, an appropriate exchange rate; adequate international liquidity; sound macroeconomic policies; and incentives for economic agents to respond to market prices. These factors are somewhat interdependent: for example, the first two cannot be sustained without sound macroeconomic policies; and they must go hand in hand. Moreover, it will not usually be possible for structural reforms that are necessary for the implementation of macroeconomic policies or for the encouragement of private initiatives to be implemented very rapidly, and this should be taken into account in the authorities' plans. However, current account convertibility can make a positive contribution to improving incentives for the private sector, and could help reinforce the authorities' other measures. Therefore, it would appear to be useful to introduce at least some current account convertibility simultaneously with other measures to improve market competition. I can understand that in some cases transitional arrangements may be desirable.

Liberalization of trade policies will help reinforce the efficiency of the economy in the long run, but because of possible negative effects on external stability in the short run, some countries may wish to move more gradually, by initially maintaining relatively high tariffs and focusing mainly on dismantling quantitative restrictions, for example. Tariffs can be rationalized once domestic economic units become more confident.

Capital account convertibility should normally also feature later on in the picture. In the short run, attention will need to be given to fostering long-term capital inflows and limiting capital flight. Needless to say, sound macroeconomic policies are a constant requisite throughout the process.

Concerning the role of the Fund and the nature of its advice to member countries with regard to currency convertibility, it is true that Fund members have an obligation under the Articles of Agreement to undertake currency convertibility and eliminate restrictions on current payments or discriminatory currency practices. They should be encouraged to comply with these obligations as soon as it is feasible. At the same time, however, these obligations should not be viewed as an end in themselves, but rather as a means to help achieve the various purposes of the Fund, as set out in Article I, among which is listed "...the promotion and maintenance of high levels of employment and real income and the development of the productive resources of all members as primary objectives of economic policy", and "...to promote exchange stability". Flexibility is provided in the application of Article VIII, Section 2(a), which enables the Fund to approve restrictions where it is considered necessary. For these reasons, I consider it important that the Fund exercise due flexibility in urging members to move toward current account convertibility, so that such movement will be reinforcing, and not damaging to the member's economic stability and its growth prospects. Risks inherent in movement toward convertibility should be fully outlined and discussed with the authorities.

Mr. Landau made the following statement:

Let me commend the staff for the quality and thoroughness of the paper. Obviously, for a Western European, a discussion on convertibility has a special historical significance, since we have a not-too-ancient experience of a very gradual transition to current account convertibility, and a lasting multilateral payments clearing system, through the European Payments Union.

Nevertheless, I would argue that, in the present circumstances, a swift transition to current account convertibility might be the best available strategy for those European countries seeking to establish a market economy. I see many reasons for going that way.

First, as the staff paper clearly points out, current account convertibility is the prerequisite for achieving on the internal market a price structure which reflects the world price and market situation. In the absence of such convertibility, the authorities would resort to a central allocation of foreign currencies, which, even when done through an auction process, is bound to cause some distortions in trade, production, and investment decisions.

The case for a very quick transition is strengthened by the quasi-monopolistic structure of many sectors in formerly centrally planned economies. It might be a long and difficult process to dismantle this structure in an orderly manner. The best way to ensure a sufficient level of competition is therefore an opening to the world market, from which convertibility cannot be disassociated.

The main effect of inconvertibility is to enable the authorities to defend an overvalued exchange rate. But exchange restrictions are not watertight, and experience shows that many leaks are possible, especially on the import side, through parallel markets and black market mechanisms. This means, in practice, that the export sector is bound to suffer disproportionately from the exchange rate situation, whereas imports will not be constrained to the same extent by the central allocation of foreign currency. All in all, inconvertibility appears, in the light of experience, to discriminate heavily against exports.

Alternatives to convertibility are not really attractive. One might wonder, in particular, whether a multilateral payments clearing union, based on the model of the European Payments Union, might be set up for Eastern European countries. There is a big difference between the two historical situations. As experience has shown, West European countries have had much to gain by trading between themselves, which forms a rational basis for a netting out of bilateral imbalances in a multilateral framework. On the contrary, there is no willingness on the part of East European countries to perpetuate trade flows inherited from the period of central international planning, nor is there any economic justification for it. It seems that, for those countries, the best prospect for strong economic growth lies in expanding their trade ties with other industrial countries, mainly in Western Europe, so that they could derive the most benefits from their comparative advantages. An Eastern European payments union would in this regard only serve to perpetuate those trade distortions inherited from the past period, and constitute a strong impediment to structural adjustment and economic growth.

Obviously, there are some preconditions which are to be met before current account convertibility can be established: internal demand has to be brought under control, and the monetary overhang has to be eliminated. Above all, the exchange rate has to be set to at real level that leads to a current account balance compatible with the external financing possibilities. On that point, the staff paper expresses some concerns which I would not fully share--namely, that an initial excessive depreciation would be necessary to accommodate the weak structural competitiveness of those countries' industry; and that, after structural adjustment, some real exchange rate appreciation would have to occur. This seems to be a normal long-term process of economic growth and international adjustment; it should be accomplished progressively over the years; and it certainly should not be taken as an obstacle to current account convertibility. The main problem in setting the proper exchange rate, in my view, is that it might lead to a very sharp nominal depreciation, the inflationary consequences of which might be very difficult to contain and control.

In the process leading to adjustment after the establishment of convertibility, it might be necessary for those countries to obtain temporary protection from external competition through the establishment of import duties. I do not think we should discourage them from doing that, if it is done under proper multilateral supervision. Obviously, a uniform tariff duty operates as an implicit depreciation of the exchange rate, but, contrary to inconvertibility, it discriminates against imports; this might be convenient in the period of transitional difficulties which former centrally planned economies face. Furthermore, some modulation of tariff duties might be appropriate. The essential requirement, in this framework, is that it should be done under multilateral supervision and binding agreements to progressively dismantle protection.

It is clear that the credibility of a quick transition to convertibility rests heavily on those countries' ability to build up a significant amount of international reserves, so as to keep control of their exchange rate strategy, whether fixed or flexible. The preference of this chair for pegging the nominal exchange rate to strong currencies is well known. But even with a flexible exchange rate strategy, those countries operating in such an uncertain environment would need to be able to practice intervention on a significant scale, if they deem it necessary. The creation one year ago of the Polish Stabilization Fund was a first answer to that problem. We welcome the fact that, in those Fund programs presently discussed or approved with those countries, significant frontloaded disbursements, together with resources provided through the new oil compensatory window, will enable the buildup of a significant stock of reserves. This is obviously one of the main responsibilities of this institution in discharging its systemic role.

Even if the argument for current account convertibility is very strong, I see no obvious need to move to it at an early stage. In doing so, Eastern European countries would run a double risk: first, encouraging capital flight, to the extent that present political and economic circumstances would create an environment of uncertainty; second, placing the exchange rate under the influence of portfolio decisions which would, in my view, very much complicate the overall stabilization strategy.

Mr. Filosa made the following statement:

I welcome this important opportunity to discuss currency convertibility and the transformation of the centrally planned economies in light of the significant role that the Fund must play in guiding and supporting present and future economic developments in these countries. I cannot but warmly welcome the stimulating work and reflections made by the staff on these issues. I support Mr. de Groote's suggestion to send the conclusions of our seminar to the Governments of members of the Fund.

Inconvertibility, not surprisingly, was the only possible regime compatible with the whole range of policies followed by centrally planned economies. Indeed, inconvertibility and extensive trade and capital restrictions were established, and long maintained, to insulate the centrally planned economies from international competition, which, otherwise, would have immediately revealed the unsustainability of their policies.

The reorientation of these economies toward market mechanisms requires a sharp, and in my view, a quick, reversal of the previous policies. Currency convertibility and external liberalization are part and parcel of this process, because they reflect the fact that adequate policies have been put in place, and present an internationally visible signal of the commitment to implement them consistently in the future.

This leads me to the conclusion that, today, the real issue for discussion is not convertibility, but rather, the design and the timing of a wide range of policies which are appropriate to permit an orderly and effective transformation of the centrally planned economies into market economies.

The staff paper discusses extensively the costs and benefits of currency convertibility, and the four conditions necessary to successfully establish it. I fully share this analysis and most of the conclusions. I note, however, that the staff stresses the risk that the setting of the exchange rate at the level consistent with currency convertibility might imply inflationary impulses, real wage and output losses, and import costs larger than those implied by a gradual approach to convertibility. To this, one might add that a gradual transition to convertibility could also allow less stringent fiscal and monetary policy, more limited price and trade liberalization, and a bit by bit process of privatization.

A gradual approach to convertibility, while allowing some extra degree of freedom in the policy design, would run the serious risk of replicating the unsuccessful outcomes of previous reform attempts in the centrally planned economies. In my view, this risk is significantly greater than the cost of swiftly introducing convertibility and the policies which are consistent with it, and should therefore be avoided.

In fact, insufficiently restrictive policies would not eliminate excess demand and shortages. In addition, an overvalued exchange rate, together with limited price liberalization, excessive real wages, and extensive subsidies, would maintain productive inefficiency. Excessive demand and lack of external competitiveness would consequently require some forms of foreign exchange rationing. We know that this rationing was implemented in the past through decisions made at the center, in which the beneficiaries of currency allocation were closely involved, and which led to an extremely distorted system of tax exemptions and subsidies. The continuation of such a system would then seriously call into question the very achievement of the reform goals.

An appropriate exchange rate consistent with convertibility would produce two main beneficial effects. First, it would reduce the degree of restraint of financial policies that is required to eliminate excess demand and balance of payments pressures. This is a well-known effect which is valid for all countries. Second, and more important in the specific context of the centrally planned economies, an appropriate exchange rate accompanied by currency convertibility is an essential instrument for eliminating the soft budget constraint at the firm level. In fact, if convertibility is not established, price liberalization, together with the elimination of subsidies and automatic financing, could provide a strong incentive for enterprises to reinstate the soft budget constraint through price increases beyond levels prevailing abroad. If on the contrary convertibility is introduced as a part of the program, then price increases will be limited by foreign competition, and the hard budget constraint could then become effective.

A regime of full and immediate convertibility in Central and Eastern European countries should not be envisaged before the reform process has reached a very advanced stage, with efficient and competitive goods and financial markets in place. In this regard, I found very appropriate the fact that the staff paper dealt separately with current account, capital account, and internal convertibility. Indeed, the lifting of external restrictions and the required policy adjustments differ substantially with respect to real and financial external transactions. I share the view that, while current account convertibility should be introduced at a very early stage of the reform process, implementation of capital account convertibility requires a much greater degree of economic stability, and a significantly more stringent set of policies, and should therefore be introduced at a more mature stage of the transformation process.

With regard to current account convertibility, I however recognize that "full" current account convertibility is not strictly required at an early stage of the reform process. This is because, first, the highest attainable degree of policy restriction, even if accompanied by a substantial devaluation of the exchange rate and sufficient foreign reserves or external credit lines, may not produce a sustainable current account position, even if all restrictions are eliminated; second, because even if a sustainable current account position were achieved, the unavoidable shift out of domestic products in favor of imported goods and services may entail too high transitional costs in terms of output and unemployment. Consequently, countries could in these cases adopt the appropriate transitional arrangements described in the paper in order to reduce the transitional costs of current account convertibility.

Limited current account convertibility could also be accompanied by an appropriate import tariff policy, which, besides linking domestic prices to foreign prices, will also contribute to improve the fiscal position of the country. Tariffs could be set initially to give some temporary protection to domestic enterprises during the period needed to implement structural and institutional measures. In this regard, a differentiated tariff policy that would favor imports of capital and intermediate goods, while restricting imports of consumption goods, and, among the latter, luxury goods even more, could avoid some of the drawbacks of this transitional arrangement. This tariff should, however, be phased out as the economy adjusts.

The temporary retention of restrictions on other items of the current account may also be allowed, in order to contain possible speculative pressures. Tourism, for example, could give rise to hidden capital flight and, if so, could be restricted. In the same vein, leads and lags concerning trade transactions can be easily checked through administrative actions, as the experience of some industrial countries has shown.

With regard to capital account convertibility, I agree with the staff paper that the success of the transformation process may depend crucially on attracting inflows of foreign capital. The establishment of capital account convertibility, however, entails major risks of capital flight and exchange rate instability. The experience of most industrial countries has shown that capital account convertibility was necessarily established only toward the end of a long adjustment process, when efficient and competitive monetary and financial markets were in place. I therefore believe that the recourse to asymmetric capital controls, allowing capital inflows to take place, while constraining capital outflows, should by necessity characterize much of the transitional period.

Finally, the same general considerations apply to the issue of internal convertibility. Usually, planned economies start their transition with an existing stock of domestic holdings of certain assets denominated in foreign currencies. The lifting of restrictions on the current account could therefore exert an undesired pressure on imports, unless the demand for national currency is increased by sound macroeconomic policies. Clearly, if agents were free to substitute domestic currency into foreign currency, the need for appropriate macroeconomic policies would be reinforced, as the situation would not differ substantially from that of capital account convertibility. If, however, internal convertibility were limited to the existing stock of foreign currencies the channels of creation of which were appropriately monitored, substantial information about the appropriateness and credibility of policies could be obtained by the economic authorities. Before the unification of foreign exchange markets, the parallel exchange rate and the composition of the money stock between national and foreign currencies could indeed represent relevant indicators about interest rate policy, inflationary expectations, and the overall credibility of the measures in place. These indicators can be essential in determining the pace and intensity of the adjustment process, providing important insights into the appropriate timing for lifting the transitional arrangements limiting current account convertibility, and, eventually, capital account restrictions.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/174 (12/14/90) and EBM/90/175 (12/17/90).

2. PARAGUAY - TECHNICAL ASSISTANCE

In response to a request from the Paraguayan authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/411 (12/11/90)

Adopted December 14, 1990

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/90/322 (12/13/90) is approved.

APPROVED: September 19, 1991

LEO VAN HOUTVEN
Secretary