Currency Convertibility and the Transformation of Centrally Planned Economies

by Joshua E. Greene and Peter Isard
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 and independent basis.
Preface

This study was prepared in the Research Department of the International Monetary Fund. Its authors are Peter Isard, Advisor, and Joshua E. Greene, Senior Economist in the Developing Country Studies Division.

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I Introduction

Many countries that have had centrally planned economies are now undergoing a dramatic transformation aimed at making their economies more market oriented. Far-reaching reforms are contemplated or under way, 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.

Among the reforms attracting major attention is the establishment of currency convertibility—the freedom to buy or sell foreign exchange, generally for payments related to international flows of goods, services, and financial assets. 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 and appropriate price signals that can play a vital role in guiding domestic enterprises toward efficient production and investment decisions. Convertibility for certain types of capital account transactions is seen as helping to attract foreign investment inflows and associated managerial resources and transfers of technology, which can significantly affect 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 seen as 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 in gaining acceptance for difficult reform programs.

Questions still remain, however, about the risks of establishing convertibility, particularly early in the transformation process, when economic incentives and legal provisions may not yet be in place to enable 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 relating to currency convertibility, with special regard to the problems of establishing convertibility in countries undergoing the transformation to market-oriented economies. Limitations on currency convertibility have traditionally been analyzed separately from restrictions on trade and capital flows, perhaps because they 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 IMF'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, this paper analyzes the case for eliminating restrictions on currency convertibility 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 its benefits. Because most economists agree that convertibility is desirable as a long-run objective, along with the general liberalization of trade and capital flows, much of the analysis 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, capital account, and internal convertibility. Section III then analyzes how current and capital account convertibility affect a country's production...
sector and macroeconomic stability. Section IV discusses when a country should introduce current account convertibility, emphasizing that success depends on establishing several preconditions at or before the move to current account convertibility. This section also discusses transitional arrangements countries may wish to consider in establishing convertibility. Sections V and VI discuss issues related to capital account convertibility and internal convertibility, respectively. Section VII provides a summary and conclusions. The Appendix reviews some historical experiences with establishing convertibility, focusing on two groups of countries: the Western European countries that were members of the European Payments Union during the 1950s; and the newly industrializing economies of Eastern Asia.
II Definitions

The meaning of "convertibility" has changed over time as the international monetary system has evolved (Haberler (1954)). 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 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. Such 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 IMF gradually to restore current account convertibility while authorizing them to restrict convertibility for capital transactions (Gold (1971), pp. 4; Kindleberger (1984), p. 428; and Article VI, Section 3). The obligations of convertibility that IMF 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 IMF, impose restrictions on the making of payments and transfers for current international transactions, 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 in multiple currency practices that are not authorized under the Articles or approved by the Fund. 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:

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).

Nor do the Articles exclude surrender requirements that compel residents to turn over accruals of foreign exchange to their monetary authorities (Gold (1971), pp. 7-8).

Other restrictions on convertibility are based on the origin of the currency balances. Such restrictions have distinguished between "old" and "new" balances, meaning those accumulated before and after a particular date. For example, when the U.K. authorities briefly restored sterling to convertibility in July 1947, their 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 inaccessible (Hinshaw (1958), p. 10).

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."
Still other restrictions on convertibility are based on who holds the currency balances, or on where the balances are held. These restrictions generally distinguish between residents and nonresidents, and sometimes among different classes of residents (such as the monetary authorities, households, and enterprises). 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 holdings of certain assets (for example, bank deposits) denominated in foreign currencies, and thus to convert domestic currency internally into foreign currency assets. Such freedom to hold and intermediate foreign exchange domestically, however, is not tantamount to permission to make payments abroad or to hold assets located in foreign countries. Nor does it necessarily permit residents to hold any financial assets, other than foreign currencies, that represent claims against nonresidents. Countries concerned with protecting 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, thus providing external convertibility of dollars into gold. However, it did not permit private U.S. residents to hold gold, thereby prohibiting internal convertibility into gold. In contrast, in countries whose residents already have significant holdings of foreign currencies, internal convertibility could serve to channel foreign exchange resources into the banking system.

3This 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 U.S.S.R., where 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.

4Although, 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.

5By so doing, the United States fulfilled its exchange rate obligations in (the then prevailing version of) Article IV, Section 4(b) of the IMF's Articles of Agreement.
III 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 resulting from the possibility of greater or more frequent current account imbalances or exchange rate pressures. Creating convertibility for capital transactions can likewise have both good and bad repercussions for a country’s external capital flows, inviting inflows of long-term investment capital 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.

Convertibility and the Supply Side of the Economy

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 allow 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 domestic demands. It may also promote domestic output by improving access to production inputs and modern technology.

These direct benefits, however, have traditionally been considered less important than the indirect benefits that current account convertibility can provide by creating a more competitive environment and promoting production and investment decisions consistent with the country’s comparative advantage. 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 goods 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 enabling them 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
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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 and a liberal trade environment, 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 the beneficial effects from increased competition argue strongly for 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, 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 sufficiently expensive. However, an exchange rate sufficiently depreciated to allow domestic producers to survive the early stages of reform can make all imports appear costly for consumers and producers, including imports of essential intermediate goods and investment goods critical for the country’s development efforts. 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 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, tends to maintain distortions and imbalances in the economy.

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 these countries’ transformations may depend crucially on their ability to attract 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. 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 repatriated, and on the attractiveness of individual projects. This is true for virtually all forms of direct investment flows and portfolio capital flows.

Where foreign investors assume large ownership positions in domestic enterprises, capital inflows can lead to new and possibly better management,
with more complete information about production techniques used and marketing opportunities available outside the country. Direct investment may also contribute in other ways in expanding the country’s access to 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 current and prospective economic and legal environment. Whether macroeconomic stability can be achieved and maintained is a central consideration 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. Although the success of economic transformation may hinge crucially on attracting capital inflows, a country that establishes capital account convertibility also runs the risk of capital flight and greater volatility in exchange rates, external reserves, or interest rates. Greater ability to send savings abroad could, on balance, reduce the country’s funds available for domestic investment, particularly where the reform process has not progressed enough to dampen uncertainties about macroeconomic stability and the competitiveness of domestic enterprises. Until there is widespread confidence that a country’s reform program will succeed, changes in the perceived likelihood of success could, under capital account convertibility, generate strong pressure on the exchange rate, which, 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. Delaying the introduction of capital account convertibility implies a judgment that the risks associated with full capital account convertibility outweigh the distortions introduced when convertibility is limited to the current account (plus selected types of capital flows). In assessing this trade-off, however, authorities should recognize that current account convertibility without capital account convertibility is essentially equivalent to a dual exchange rate system (Adams and Greenwood (1985) and Kiguel and Lizondo (1990)), and that restrictions on external capital transfers have become harder 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 V.

### 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. These changes, in turn, affect 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 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 real exchange rates to adjust over time if large external imbalances are to be avoided.

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10. 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).
Whether this rate adjustment can be achieved smoothly over time once current account convertibility has been established is an open question in today's environment. Historical experience 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 before 1973 were oriented toward keeping exchange rates fixed, with occasional discrete realignments, 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 regarding this situation is that a country cannot simultaneously 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, a country may not be able to enjoy both exchange rate stability and the absence of current account restrictions without limiting its ability to focus macroeconomic policy instruments on domestic economic performance. 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 countries may consider it particularly important to keep interest rates and credit policies stable and to avoid sharp fluctuations in exchange rates. They might thus find it desirable to retain some current account restrictions temporarily (along with certain restrictions on capital account transactions), in addition to pursuing appropriately tight macroeconomic policies, as a way of controlling external payments imbalances. As is discussed later, transitional arrangements 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 arrangements 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.

\[11\] This limitation is not necessarily undesirable. 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.
IV When to Introduce Current Account Convertibility

The appropriate time to introduce current account 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 rapidly moving most of the way to current account convertibility once these preconditions are established. Nevertheless, some countries may wish to introduce or maintain transitional arrangements, either to enhance their ability to stabilize the current account or to allow a phased intensification of import competition that places strong pressure on domestic enterprises to adjust while providing a reasonable but limited time in which to do so. In certain circumstances, such transitional arrangements can strengthen the transformation process, provided there is a credible system for limiting their duration.

General Preconditions

Economists have traditionally identified certain preconditions that must prevail if currency convertibility is to be implemented successfully (for example, Jacobsson (1954) and Gilman (1990)). These preconditions have changed somewhat as the concept of convertibility and prevailing views on macroeconomics have evolved, and the basic requirements are now (1) an appropriate exchange rate; (2) an adequate level of international liquidity; (3) sound macroeconomic policies, including the elimination of any monetary overhang; and (4) an environment in which economic agents have both the incentives and the ability to respond to market prices, from which all major distortions should have been eliminated. The same preconditions apply to the elimination of trade restrictions generally.

As the discussion below will clarify, the first three of these conditions are seen as necessary to ensure that the introduction of current account convertibility does not generate macroeconomic instability, while the fourth condition is necessary 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 preconditions 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.

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 path that identifies 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 being equal, there should be some appreciation in the equilibrium real exchange rate as the underlying competitiveness of the country’s productive sector improves.

In the short run, however, countries should aim for an exchange rate that will yield a sustainable current account balance. Too appreciated a rate may make it difficult for a country to attain current account balance while an overly depreciated rate can bias production and investment decisions by making all imports appear very expensive for enterprises and households and by making exports appear too profitable for domestic producers and too inexpensive for nonresidents. The extent to which such decisions are biased would depend, of course, on the degree to which decision makers accurately anticipated movements in the real exchange rate over time.

**Adequate International Liquidity**

Even if its exchange rate is on a path broadly consistent with current account balance, a country must have an adequate level of international liquidity—comprising foreign exchange reserves, access to foreign financing, and, in some cases, holdings of foreign currency and foreign-currency-denominated assets by private residents—to withstand cyclical shortfalls in its balance of payments, such as those coming from an unexpected change in petroleum prices. Without adequate international liquidity, a country might be unable to maintain a stable macroeconomic environment for domestic producers and consumers, because of the difficulty of stabilizing 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 effort. Without sufficient liquidity, the country might be perceived as vulnerable to unforeseen external developments, thereby encouraging 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.

The amount of international liquidity a country needs to support current account convertibility depends partly on the degree of exchange rate flexibility that it desires. Given the limited access of many developing countries to international credit markets, a number have been encouraged in recent years to accumulate foreign reserves amounting to at least three months of imports, e.g., although some countries (for example, Nigeria) that have adopted a floating rate system have successfully eliminated exchange and trade restrictions with a lower level of reserves. As this standard has applied to many countries with inconvertible currencies, arguably a larger amount of cover might be advised for countries when establishing a convertible currency. Poland, for example, which moved a long way toward establishing current account convertibility at the start of its present reform program in January 1990, had reserves and external lines of credit totaling at that time about $2.5 billion, equivalent to about 4.5 months of imports, e.g.

**Sound Macroeconomic Policies**

The third precondition for introducing current account convertibility—sound macroeconomic policies—involves policies that will, at a minimum, maintain a sustainable current account balance. What this entails will vary from country to country. However, fiscal and monetary policies must be strong enough to create an environment of general macroeconomic stability conducive to a successful reform program. 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, external payments imbalances can lead to unsustainable speculative pressures. In this regard, the authorities should be cognizant of the key role that expectations can play (Calvo and Frenkel (1991)).

Countries moving from central planning to reliance on market forces must reform their monetary and fiscal policy institutions. In addition, they must introduce market mechanisms for transmitting excess demand or supply pressures to prices, wages, and interest rates, so that they can achieve macroeconomic stabilization through indirect means—such as open market operations—rather than relying on direct controls (Szapary and Wolf (1989) and Wolf (1990)).

Historical experience bears out the central role played by strong fiscal control in reform programs.12

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12 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 outweighed 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. Sargent (1982), in his study of ending hyperinflation, also stressed the critical role of strong fiscal discipline in re-establishing macroeconomic stability.
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 others (1991) and McKinnon (1990a) have emphasized, the implicit tax systems of centrally planned economies must be replaced by explicit systems under which tax revenues expand elastically as public enterprises are divested or become managed under new incentives, and as the economy grows. At the same time, tax policies and fiscal expenditures must be conducive to encouraging the kind of investment needed to promote and maintain the competitiveness of domestic industry.

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

If monetary control is to be established, any “monetary overhang” must be eliminated to prevent the possibility of large increases in consumer spending (and imports) from the liquidation of outstanding monetary balances. Only then can monetary policy maintain a reasonable degree of stability in both the price level and the macroeconomic environment. 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 pressure on exchange rates and interest rates.

Monetary overhangs can be eliminated through currency reform, price liberalization, or perhaps through the sale of state-owned assets (such as the housing stock). Excess liquidity can also be reduced by setting interest rates at positive real levels, although the latter may raise government expenditure if most interest-bearing instruments are claims against the government (Calvo and Frenkel (1991)).

13 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.

14 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.
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Privatization may also be important for strengthening both the incentives and, by eliminating entrenched bureaucracies, the ability of production units to respond to market prices (Borensztein and Kumar (1991) and Lipton and Sachs (1990b)). Where privatization takes time, however, other measures must be given priority in the short run.

In general, market price mechanisms do not function appropriately when producers are not subject to “the discipline of the bottom line” (Fischer and Gelb (1990)). In centrally planned economies, the bulk of production has taken place in enterprises operating with “soft budget constraints” (Kornai (1979)), 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 frequently led to fiscal budget deficits and inflation. Accordingly, the hardening of budget constraints is a particularly important step that should precede or accompany the establishment of current account convertibility.  

Privatization, of course, can be one way to harden budget constraints, by eliminating the automatic access of firms to budgetary subsidies.

Should Convertibility Be Established Quickly?

Whether a country can move successfully to current account convertibility early in the reform process depends largely on how fast it 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. The latter condition may hinge on the extent of the country’s initial macroeconomic instability and distortions.

Poland provides one example of the rapid approach to convertibility. Under conditions of hyperinflation and widespread popular discontent with the macroeconomic situation, and following a change in government in late 1989, Poland embarked on its bold program of economic reform and structural change on January 1, 1990. 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 provision and government subsidies for loss-making firms. As part of the reforms, the zloty was made convertible for virtually all merchandize trade transactions (although convertibility restrictions were retained for a number of service transactions), most quantitative import restrictions were removed, and the tariff system was rationalized. These measures followed steps the authorities took in March 1989 to establish internal convertibility for households by making it legal for them to hold foreign assets and to purchase foreign exchange from dealers (the so-called kantor market).

Yugoslavia illustrates a somewhat different approach in that it introduced convertibility after easing trade restrictions and accumulating significant external reserves under a succession of prior adjustment programs. Since the early 1980s, Yugoslavia has been implementing economic adjustment programs with IMF support—first under stand-by arrangements, then under the enhanced surveillance procedure from mid-1986 to mid-1988, and subsequently again under stand-by arrangements. Although a large balance of payments deficit occurred in 1987, Yugoslavia’s external performance improved substantially in 1988 after the initiation of a new stand-by arrangement, which significantly improved external reserves and allowed the lifting of most quantitative import restrictions by 1989. Resulting hyperinflation led to a new and comprehensive stabilization program late in 1989 that involved a fixed exchange rate, stringent macroeconomic policies, and a temporary freeze on wages and certain prices. As part of the program, the dinar was made fully convertible, as of January 1, 1990, for both current and capital account transactions by residents and in the case of enterprises, for current account transactions and debt-service payments. Thus, as in Poland, convertibility was introduced at the start of a new adjustment program. In this case, however, the development of a strong reserve and balance of payments position and the lifting of import restrictions preceded convertibility and facilitated its introduction.

The Polish and Yugoslav experiences have demonstrated the reinforcing nature of comprehensive reforms. In particular, stabilizing prices and introducing strong incentives for enterprises to become more responsive to market prices helped create the preconditions for current account convertibility. Because strong stabilization measures followed by a period of austerity appeared necessary to end hyperinflation in both countries, it can be argued that

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15 Since the hardening of budget constraints curtails credit availability from the state, measures to facilitate the emergence of private credit markets—including the introduction of accounting standards and auditing and disclosure procedures—can play an important role in reducing the strains on potentially profitable enterprises.
these countries risked little in simultaneously moving most of the way toward establishing current account convertibility. Indeed, their decision to do so may have strengthened the incentives to maintain sound macroeconomic policies and move rapidly in implementing institutional changes and other structural reforms.

As a rule, a country is unlikely to succeed in implementing a strong and comprehensive reform program without broad popular support. Success in eliciting and sustaining such support depends not only on the degree of discontent with the initial economic situation but also on the extent and duration of the hardship resulting from the reform program. The latter, in turn, will depend on the country's ability to implement, quickly and effectively, key structural reforms aimed at reorganizing production enterprises and the banking sector and creating the infrastructure needed to generate private direct investment flows and financial intermediation.\(^\text{16}\) Although many of these changes take time to implement, they are essential for any economic transformation program that aims to improve productivity and lay the foundation for higher output and living standards.

In deciding whether to introduce current account convertibility quickly, countries should consider not only how rapidly they can establish the economic preconditions, but also how quickly they can implement supporting institutional changes and other structural reforms. Ideally, the move to convertibility should wait until the preconditions have been firmly established and national authorities are confident that the remaining reforms will succeed. Nevertheless, countries in which initial macroeconomic instability and popular discontent are high may feel compelled to move more rapidly toward introducing the main elements of current account convertibility, even with some risk of harming particular sectors and thereby decreasing popular support for the reform program.

In countries where extensive economic controls have led to superficial macroeconomic stability, the prospect of heavy dislocation costs may limit popular support for large-scale and rapid structural reforms. This may be particularly true in countries that start the reform process with modest levels of inflation but serious distortions arising from widespread price controls and soft budget constraints on enterprises. Although there are strong arguments for introducing convertibility as quickly as possible, the necessary preconditions may take some time to establish in countries that lack broad support for implementing strong adjustment and comprehensive reforms.

Even after the preconditions have been established, countries unaccustomed to a liberal external environment may be reluctant to remove all restrictions on current account transactions, fearing that without constraints on the total volume of imports, convertibility will lead to large current account imbalances or major swings in exchange rates, or cause large declines in output and employment. In the past, such concerns have led many countries to move toward current account convertibility in stages. The next section examines various transitional arrangements that can allay these concerns while enabling countries to move a long way initially toward providing the key benefits of convertibility.

No matter how long a country takes to establish complete current account convertibility—that is, to eliminate all exchange restrictions on current account transactions—there is widespread agreement that it should adopt a unified exchange rate for current account transactions and certain types of trade policy reforms as soon as possible. The harmful effects arising from multiple currency practices are widely recognized (IMF [1985]); indeed, member countries of the IMF are obliged to adopt a unified exchange rate under its Articles of Agreement. Multiple exchange rate systems discriminate among different exporters and importers, which can be harmful to other countries as well as to residents. They can also involve heavy administrative costs and generally provide 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, two elements 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.\(^\text{17}\)

\(^\text{16}\)As noted earlier, the emergence of private direct investment and financial intermediation flows is likely to depend on many considerations. 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 depend in turn on having reasonably well-developed accounting, auditing, and disclosure standards.

\(^\text{17}\)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, create lobbies that will oppose their removal, and risk countervailing duty actions from importers.”
IV WHEN TO INTRODUCE CURRENT ACCOUNT CONVERTIBILITY

Transitional Arrangements

History provides few examples of countries that have eliminated all exchange restrictions on current account transactions in a single stroke. As noted in the Appendix, the moves to current account convertibility in postwar Europe and in the newly industrializing Asian economies occurred in stages. Moreover, although the steps taken by Czechoslovakia, Poland, and Yugoslavia over the past several years have gone a long way toward establishing current account convertibility, they have stopped short of removing all exchange restrictions on current transactions.

As discussed earlier, the reluctance to eliminate all restrictions on current account transactions is based on the belief that convertibility poses serious risks for macroeconomic stability and the supply side of the economy. Thus, in seeking transitional arrangements to mitigate these risks, countries typically focus on one or more of the following objectives: retaining mechanisms for controlling the current account balance; stabilizing the exchange rate and thus providing a nominal anchor; and limiting the negative impact of import competition on output and employment in the short run.

Two kinds of transitional arrangement have been proposed for meeting these objectives while still going far to provide the key benefits that current account convertibility is intended to deliver: namely, competitive discipline and appropriate relative price signals. One type of arrangement relies on a limited extent on exchange restrictions. The other permits complete current account convertibility but involves import protection in the form of tariff barriers. Both present the danger that, in the absence of a preannounced timetable and a credible process for eliminating the restrictions over time, the transitional arrangements may become permanent and severely weaken or undermine economic transformation and growth over the long run.

The first kind of transitional arrangement provides much of the free access to foreign exchange that would arise under unrestricted convertibility, while enabling the authorities to maintain control over the total volume of resources available for imports. Such a system can be designed to accord with the institutional structures and preferences of individual countries. For example, open markets can be established for either foreign exchange, general import licenses, or foreign exchange certificates with which import licenses can be obtained automatically. These 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 (for example, exchange certificates) have been used to restrict transactions, they can be specifically designed, as a transitional measure toward current account convertibility, to involve low administrative and transaction costs, particularly compared with systems based on an administrative allocation of foreign exchange. Moreover, although such systems can lead to multiple currency practices in the form of parallel markets, the Fund has accepted such multiple currency practices as transitional arrangements in some cases, such as the 1990-91 stand-by arrangement with Poland.

This type of transitional arrangement, which can involve either fixed or floating exchange rates, provides a unified and transparent exchange rate for those exporters and importers included in the system. This rate—which the authorities can stabilize if they wish—reflects the market-clearing price of foreign exchange, import licenses, or foreign exchange certificates. Because virtually all external transactions are channeled through a market monitored by the authorities, this type of arrangement provides a mechanism for limiting imports financed by foreign-currency debt and for maintaining close control over the current account balance. 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 operating in Poland provides another example of this type of arrangement.

18A third possible transitional arrangement for Eastern European countries would be to establish a payments union analogous to the type of institution created by the Western European countries in 1950; see the discussion in the Appendix. Kenen (1991) and Polak (1991) argue strongly against this approach. A fourth approach would be to subsidize domestic production temporarily, for example, through employment subsidies, as has been proposed in the case of the former German Democratic Republic (Akerlof and others (1991)).

19Quirk and others (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.

20In 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 (1990a), p. 113). Although 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 made it a system that the Fund was prepared to approve as a transitional arrangement.
A second kind of transitional arrangement that may be of interest uses 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. The tariff rates would initially be set high, to protect domestic firms from foreign competition during the period needed to restructure and undertake new investment. These rates would then decrease at a preannounced pace and would eventually be replaced by a fairly low and uniform customs duty, thereby signaling that domestic firms have only a limited time to become competitive. Such a system was used in Chile to establish current account convertibility during the 1970s (Edwards and Edwards (1987)).

On the one hand, the use of temporary import tariffs offers certain benefits. Current account restrictions precluded under Article VIII of the IMF’s Articles of Agreement would be eliminated immediately, and less government regulation of international transactions would be needed than under a system that established formal limits on the volume of imports. On the other hand, the use of high import tariffs would inhibit the introduction of more competition to domestic industries (although this may be part of the rationale for tariffs in the short run). In addition, any use of differential tariffs would preclude the full adjustment of domestic relative prices to those prevailing in world markets, thereby distorting domestic production and investment decisions.

If tariffs are used as a stabilizing measure, they would tend to keep the exchange rate more appreciated in the short run. This would provide less stimulus to exports but would also prevent the emergence of an overdepreciated exchange rate, with its associated problems. There is the risk, however, that domestic enterprises, once under the protection of high tariff barriers, might resist the implementation of scheduled reductions in tariff rates. Furthermore, establishing even temporary import barriers in countries where they did not previously exist 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.

Auctioning foreign exchange or foreign exchange certificates may avoid some of the adverse consequences of using import tariff barriers as a transitional arrangement, by facilitating the introduction of relative world prices and by allowing a greater depreciation of the exchange rate. However, in addition to being more likely to encourage variability in exchange rates or in international reserves, this approach imposes more administrative restrictions on the allocation of foreign exchange and prevents countries from moving immediately to Article VIII status.

Whatever set of transitional arrangements they adopt, countries should be aware of their limits. Such arrangements cannot stabilize both the external current account and the exchange rate: any move to reduce imports will automatically encourage some appreciation in the exchange rate, while efforts to stabilize the exchange rate will encourage more imports than would be likely at a more depreciated rate. Moreover, efforts to stabilize the exchange rate through transitional arrangements will be unlikely to succeed if inappropriate macroeconomic policies lead to a significant divergence between exchange rates on the official and parallel markets.
Discussions of capital account convertibility center on three issues: (1) whether capital account convertibility should be delayed until late in the transformation process or introduced simultaneously with current account convertibility; (2) whether restrictions on capital account convertibility are likely to be effective once current account restrictions have been removed; and (3) if capital account convertibility is delayed, what types of capital account restrictions should still be removed in the short run.

A decision to delay the introduction of capital account convertibility depends ultimately on a determination that the risks involved in unrestricted capital movements would outweigh the benefits. These benefits include the likelihood of greater inflows of direct investment capital and associated managerial and technological resources, which are widely acknowledged as critical for the transformation process, and the opportunity for residents, via capital outflows, to pursue higher expected yields and to diversify their asset portfolios in the presence of various types of uncertainty.

One major risk of eliminating all restrictions on capital flows is the possibility of extensive capital flight, which is widely believed to generate large negative externalities. To the extent that the success of a reform program depends critically on the strength of domestic investment, the residents of a country undertaking reforms may well be better off individually when they are collectively prevented from moving capital abroad. Effective controls on capital outflows may thus be essential for the reform program to succeed. Without such controls, risk-averse residents could have strong incentives to send capital abroad, even in the presence of sound macroeconomic policies, and the resulting capital outflows could undermine the reform program.

Another risk of allowing unrestricted capital flows is the possibility of greater macroeconomic instability arising from the volatility of short-term capital movements. Such movements can intensify any macroeconomic difficulties that develop during the implementation of a reform program. At the same time, the threat of volatile capital flows can be a source of policy discipline, heightening the authorities' concern to keep their macroeconomic policies sound.

Whether restrictions on capital flows are likely to be effective once current account restrictions have been removed is unclear. To some extent, these restrictions can be circumvented through leads and lags in the timing, or distortions in the invoicing, of current account payments. Whether they are effective, therefore, is likely to depend on the strength of the incentives for circumvention. Past experience has shown that controls are generally ineffective when a country's macroeconomic policies and prospects are poor.

Countries that choose to delay the introduction of capital account convertibility, primarily to limit the risks of capital flight and volatile, short-term capital flows, may nevertheless want to modify some restrictions to encourage long-term capital inflows. 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—reforms now under way in a number of Eastern European countries. Such measures 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 of the IMF's Articles of Agreement, restrictions limiting capital transfers by domestic residents could remain, as could limitations on short-term capital inflows that might create instability in domestic financial markets.
The previous sections have focused on 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 (for example, currency and bank deposits) denominated in foreign currencies. Residents of countries with inconvertible currencies have traditionally favored the right to hold foreign currency as a hedge against domestic inflation. Freedom to hold and intermediate foreign exchange internally, however, is not tantamount to permission to make payments or hold assets abroad. In many of the transforming economies, holdings of foreign currency have also been encouraged because they have provided access to special state stores offering goods for sale only in so-called hard 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, because 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 effective restrictions on capital outflows, which can be much harder 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, thereby lowering transaction costs and encouraging greater uniformity in exchange rates. 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, in turn, can deplete official foreign exchange holdings. In addition, large resident holdings of foreign exchange deposits can complicate monetary policymaking.

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, including the elimination of any monetary overhang. Sound macroeconomic policies—policies that yield price stability and competitive returns on domestic currency holdings—are needed to make it attractive to hold assets denominated in domestic currency and thus discourage large-scale currency substitution. To limit speculative pressures and to insulate the domestic economy from smaller waves of currency substitution, a realistic exchange rate and adequate international liquidity are also needed.

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

In addition, legalizing 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.

This did not happen in Poland, partly because of the relatively high real interest rates paid on domestic assets during the first few months of the new program, which made these assets competitive with those denominated in foreign currency. Indeed, the share of foreign currency deposits in the money stock declined from 63 percent at the beginning of 1990 to 42 percent at the end of June 1990.
VII Summary and Conclusions

This paper has analyzed the establishment of currency convertibility in transforming centrally planned economies, focusing mainly on current account convertibility, with some discussion of capital account convertibility and internal convertibility. It has addressed current account convertibility in the context of the systemic reforms under way in these countries and as part of the larger issue of removing restrictions on current account transactions generally. In view of the widespread agreement that convertibility is desirable as a long-run objective, the paper has focused on the speed with which it should be introduced.

Current account convertibility in a liberal trade environment 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. However, the major benefits are indirect, 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. First, a rapid move to convertibility is likely to require the real exchange rate in the short run to be more depreciated than its longer-term equilibrium level. This raises the relative price of imports, including important inputs to production and capital goods, and can have distorting effects on resource allocation if investors do not accurately anticipate movements in the real exchange rate over time. Second, maintaining current account balance, once convertibility is established, implies either greater exchange rate instability or greater pressure on the authorities to direct policy instruments toward external 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 current account convertibility indicates that the success of convertibility will generally require macroeconomic stability and appropriate microeconomic incentives, implying that certain conditions must be established before, or at the time that, convertibility is introduced. The paper has identified four such preconditions: (1) an appropriate exchange rate; (2) adequate international liquidity (meaning reserves and foreign financing); (3) sound macroeconomic policies, including the elimination of any monetary overhang; and (4) an environment in which economic agents have both the incentive and the ability to respond to market prices. The first three preconditions are required to limit the risks of severe macroeconomic instability, while the fourth is needed to ensure that current account 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 feasibility of moving quickly and firmly to establish the preconditions for current account convertibility may depend on the depth and breadth of popular discontent with the initial macroeconomic situation. Where discontent is not strong, the population may be reluctant 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 lack strong popular support. However, if such countries choose to move gradually toward current account convertibility, they risk prolonging the period in which there is no efficient guide for production and investment decisions. Moving gradually can also make it hard to maintain sound macroeconomic policies.

However long it takes for countries to establish full current account convertibility—that is, to eliminate all exchange restrictions on current account transactions—there is broad agreement that they should move as quickly as possible to unify the exchange rate for current transactions and to liberalize trade policies by removing quantitative restrictions and rationalizing the system of import tariffs.
Moreover, once they have established the preconditions for current account convertibility, countries should move rapidly to secure the key benefits of convertibility, namely, introducing import competition and the relative price signals that world markets provide.

History provides few examples of countries that have eliminated all restrictions on current account transactions in a single stroke. Some countries have found it attractive to introduce transitional arrangements in which controls are placed on the total volume of resources available for imports through official channels while still allowing households and enterprises to bid openly for these resources. This approach permits considerable import competition and effectively permits a market allocation of foreign exchange while limiting imports financed by private borrowing abroad. At the same time, it enables the authorities to maintain close control over the current account balance or, alternatively, to stabilize the exchange rate. It should be recognized, however, that such arrangements involve inherent multiple currency practices that are unlikely to lead to successful macroeconomic performance, or be acceptable to the IMF, unless they are accompanied by appropriate macroeconomic policies that will prevent significant divergence between the exchange rates on the official and parallel markets.

Another set of transitional arrangements involves eliminating all exchange restrictions on current account transactions while relying on temporary import tariffs to stabilize the current account. Although this approach protects domestic output and employment in the short run, limiting the strength of import competition also undercuts one of the key benefits that convertibility is intended to provide. Moreover, to the extent that this approach relies on differential tariffs, it prevents domestic relative prices from adjusting all the way to world levels and can thereby distort domestic production and investment decisions. It also tends to keep the foreign exchange value of domestic currency above the level that would otherwise prevail in the short run, thus providing less stimulus to exports.

While history suggests that few countries have moved quickly to eliminate all restrictions on current account transactions, it also illustrates the dangers of allowing such restrictions to persist. In the absence of a well-defined and credible timetable for phasing out restrictions, the process of economic transformation and growth may be seriously weakened or undermined.

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 in the short run should focus 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, allowing citizens 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 be introduced only in the context of an appropriate exchange rate, adequate international liquidity, and sound macroeconomic policies.
Appendix  Historical Experience in Establishing Convertibility

Historically, most countries have introduced current account convertibility rather late in their development process, usually after initiating industrial reforms and trade liberalization. Thus, few developing countries have had convertible currencies. In Africa, for example, only the 13 African countries whose currencies are 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 establishing current account convertibility only after securing 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 it would involve even greater risk of external instability.

Postwar Western Europe

During World War II, normal international financial arrangements broke down. To conserve foreign exchange—mainly U.S. dollars—direct controls over trade and payments were 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 currencies of Switzerland and the United States were convertible for current account transactions.

Throughout Western Europe, which had suffered heavy damage, most countries adopted extensive sets of bilateral trade agreements to conduct trading operations. Although there was general agreement that re-establishing convertibility was desirable, the uncertainty of trade prospects and concerns about lack of competitiveness vis-à-vis the United States kept most countries from doing 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" (Haberler (1954), p. 16) or a "disaster of the first magnitude" (Hinshaw (1958), p. 11), largely because the first three preconditions for convertibility discussed in Section IV had not been established. During this attempt, the United Kingdom received a $3.75 billion loan from the United States to help it implement 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. One month later, the loan was virtually exhausted, and on August 20 convertibility was again suspended.

In 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 to promote trade among themselves and encourage 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.\(^{26}\) Not until the end of 1958, however, did the member countries decide it was possible to terminate the EPU and declare current account convertibility,\(^{27}\) and most of the former EPU members actually waited until 1961 to accept the obligations of the IMF's Article VIII. Establishing capital account convertibility generally took even longer. France and Italy, for example, abolished the last of their major restrictions on capital transactions only during the late 1980s.

**Newly Industrializing Asian Economies**

The newly industrializing Asian economies—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 (for example, Corbo and others (1985)), as have the factors that generally contribute to the success of outward-oriented development strategies (Krueger (1985) and World Bank (1987)).

The four Asian economies have followed very different timetables for accepting the obligations of Article VIII. Hong Kong, as a nonmetropolitan U.K. 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.\(^{28}\) Most of the Asian countries that had accepted Article VIII status continued to retain 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, all of the newly industrializing economies took early measures to achieve the major concomitants of current account convertibility. In the late 1950s, Taiwan Province of China unified its exchange rate for most transactions and removed quota restrictions on imports, except for imports of certain luxury goods (Tsiang (1985), p. 37, and IMF (1960 and 1961)). It replaced an administrative foreign exchange allocation system with 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 emerge under free trade (Kim (1985), pp. 59-60; Westphal (1990), p. 44; and IMF (1966)). An exchange certificate market was created, similar to the system adopted in Taiwan Province of China, and procedures for obtaining import licenses were simplified.\(^{29}\)

While the measures taken to liberalize exchange and trade restrictions may have contributed importantly to the remarkable growth experiences of the newly industrializing economies, the Korean case also illustrates the risks of such measures under nonsupporting policies. 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" (McKinnon (1973), p. 163). The authorities chose to maintain exchange rate stability and to avoid taking direct measures to restrict capital inflows, and instead accepted a rapid accumulation of international reserves and external obligations, along with substantial monetary expansion. This led to higher inflation and, eventually, to a shift in speculative pressures that led to a major devaluation of the won in June 1971.

\(^{26}\) 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.

\(^{27}\) 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).

\(^{28}\) 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.

\(^{29}\) Thus, 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 (Kanesa-Thasan (1969), p. 18).
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