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"Monetary Instruments and Their Use During the Transition from a Centrally Planned to a Market Economy" by Paul Hilbers

There is a consensus among economists that industrial countries with well-developed financial markets should rely on indirect, market-based instruments of monetary control rather than on direct instruments. The basic argument is that indirect measures, which allow the markets to distribute and allocate credit, promote a more efficient allocation of financial resources. For the same reason, developing countries that aim at establishing a more market-oriented economy tend to substitute indirect instruments for direct controls as part of a financial sector reform process.

Although formerly centrally planned economies share many characteristics with traditional developing countries, there are also a number of clear differences, in particular with regard to the functioning of the financial system. Some financial characteristics that are typical of the former are a segmented, two-tier banking sector; separate financial circuits for the household sector and enterprises; fluctuating inter-enterprise credits and arrears; soft budget constraints for state enterprises; and a lack of commercial banking and liquidity management skills in the banking sector. In the conditions prevailing in these economies, indirect instruments may have been unable to operate properly. Therefore, the value of immediately introducing indirect monetary controls into such economies is questionable.

This paper examines the choice of monetary instruments for countries that are moving from a centrally planned to a market economy. The main features of their financial systems are analyzed, and the different arguments in favor of indirect instruments are tested. The paper argues that in some cases the advantages of direct instruments in controlling overall monetary developments during the earlier transitional stages seem to surpass their drawbacks in other areas, especially because direct instruments can be modified to allow a greater role for markets.

Monetary instruments in emerging market economies must be effective in controlling overall monetary developments and must promote, or at least allow, the establishment of a more market-oriented financial system. In general, the instruments should be compatible with the financial system within which they will operate. During the typically gradual transition from a state-controlled to a market economy, a correspondingly gradual replacement of relatively direct by more indirect instruments seems the best way to support the development of a market-oriented financial sector while maintaining overall monetary control.