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**THE RESTRUCTURING OF THE MONETARY SYSTEM
IN CENTRAL AND EASTERN EUROPE
A PANEL DISCUSSION**

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I. THE OBJECTIVES OF THE RESTRUCTURING

1. The definition of a monetary system

Basically, there are two main components of a modern monetary system.

Firstly, there is a product, "money". The economic function of money stems from its ability to act as a store of value and as a medium of exchange between agents who do not necessarily have direct knowledge about each other's solvency.

Secondly, there are the producers of money. These include the central bank, which has a monopoly of the issue of legal tender and a comparative advantage in evaluating the soundness of commercial banks, the primary recipients of its credit. Commercial banks themselves are producers of money, since they issue liquid liabilities ("bank money"). In turn, they have a comparative advantage in evaluating the solvency of enterprises and households through their daily lending activity.

A more detailed analysis shows that the prerequisites for a modern monetary system are somewhat more complex. A monetary system is, in fact, a mechanism designed to lower transaction, information and wealth-holding costs in a setting characterized by a multitude of economic relationships between individuals and enterprises that cooperate and compete with one another, that is, in a market economy.

Moreover, ever since the abandonment of commodity money and, later, of specie convertibility, trust has been the pillar supporting the entire structure. In orderly monetary systems, money is accepted and used thanks to the public's trust in those who produce it; the definition commonly used to distinguish modern monetary standards,

"fiduciary money", recalls this basic element. Trust, in turn, is based largely on the quality of the assets held by the producers of money, i.e. on their lending activity and ability to evaluate the creditworthiness of prospective borrowers.

This brief analysis is sufficient to show that the proper assessment of money-creating institutions' lending operations is essential to the working of a monetary system. It is, moreover, exactly this feature that allows the system to perform its basic function of allocating financial resources efficiently between different economic uses.

2. Monetary systems in command economies

The monetary structures of the regimes that existed until recently in Central and Eastern Europe did not correspond to the above basic assumptions. At the cost of some simplification, one could say that it was only in transactions involving households that "money" performed a function comparable to its role in the West. Only for households did the availability of money signal the existence of accumulated, transferable financial wealth and consequently involve an element of trust.

For firms and financial intermediaries, "money" naturally served as a medium of exchange. But their public ownership meant there was no element of trust in the monetary system. For firms, the availability of funds and/or credit was not a signal of financial solvency; it only reflected a decision made by the planning authority. For banks, the granting of credit was not the result of an internal economic decision; it was simply the implementation of the plan. Moreover, since the monetary system lacked screening procedures, the definition of money was itself blurred: as far as trust was concerned, the liabilities of firms were on a par with those issued by banks, and by the central bank itself; there was no possibility of ranking assets according

to risk, which is one of the features of a modern monetary system.

The limits inherent in a command economy have now become all too clear; in the first place, it is impossible to evaluate firms properly and concentrate resources on the most efficient. Interest rates are set by decree and often kept artificially low; consequently, they are of no help in ranking prospective investment opportunities.

From these considerations I draw the conclusion that restructuring the monetary systems in Central and Eastern European countries means, above all, restructuring the credit operations of financial intermediaries. It is not money as a medium of exchange that needs to be created, but a screening system, based on the fiduciary component that government planning is unable to provide.

3. The first objective

The first objective in restructuring the financial and monetary system is therefore to develop markets and intermediaries able to evaluate the creditworthiness of potential borrowers and thus perform the functions of allocating financial resources and monitoring their use. This is a crucial component of the institutional arrangements underlying a market economy. It naturally involves a dramatic change in the relationship between banks, firms and the public administration. Interference by the state bureaucracy in microeconomic decisions has to be replaced with a system in which each party takes on well-defined risks and responsibilities and is rewarded or penalized accordingly.

4. The second objective

The second objective must be to provide adequate incentives for private saving. This was never a priority for centrally planned economies, in view of their suspicion of

unearned income and consequent reliance on public saving to finance high rates of (inefficient) accumulation. In the present phase, however, the Central and Eastern European countries need large investment flows to reduce the productivity gap compared with Western economies. They will have to use their human capital more efficiently so as to ensure the formation of adequate private and public savings. There is ample evidence that only countries that generate a substantial proportion of the resources they need internally, through appropriate policies, can expect to receive large and stable flows of foreign capital. This consideration is reinforced by the current state of the world economy, characterized by insufficient overall saving and high interest rates.

The far-reaching structural transformation of the Central and Eastern European economies and the high cost of the associated adjustment make it difficult to predict saving behaviour, particularly during the initial phase of transition. As market forces come to play a growing role in regulating these economies, the authorities will need to rely increasingly on market-based policy instruments to stimulate private saving. This objective should be prominent in designing the reform of tax and social welfare systems and the restructuring of financial and monetary sectors.

A number of policy measures, which some countries have already adopted, have an immediate impact by removing the most obvious disincentives to saving for both households and firms: setting positive real rates of return on financial assets that respond to economic conditions; introducing a wider range of financial instruments; replacing discretionary and sometimes confiscatory tax rates on profits with a clearly defined, uniform tax; and removing legal restrictions on the ownership and profitable use of real assets.

5. The third objective

The third objective of the restructuring is to create conditions ensuring macroeconomic stability. As the experience of countries that have already started the transition to a market economy clearly shows, the control of aggregate demand is of crucial importance, particularly in the initial phase. First of all, generalized excess demand or pent up inflation should be avoided when prices are liberalized. An inflation explosion would of course interfere with the process of allowing seriously distorted relative prices to move towards their equilibrium levels and would introduce new distorting influences. Secondly, the liberalization of foreign trade should not lead to unsustainable external deficits. Thirdly, monetary stability can increase the predictability of real rates of return on financial assets, thus helping to stimulate domestic saving. Finally, a restrictive aggregate demand policy should drive home to domestic producers the fundamental shift from an economy dominated by supply rationing to one where the demand constraint becomes binding, thereby encouraging competitive behaviour and greater efficiency.

The restoration of monetary stability has been made a high priority in recent reform and adjustment efforts, especially in countries that experienced a surge in inflation as a consequence of earlier liberalization attempts.

II. METHODS AND INSTRUMENTS

1. An overview

The Central and Eastern European countries are all taking steps to redefine the roles of the various categories of economic operator. As part of this process, central and commercial banking functions are being separated; prices and interest rates liberalized or set at more realistic levels; legislation adopted introducing basic property rights together with procedures for the privatization of state assets and the winding up of insolvent firms.

However, much remains to be done to complete these institutional reforms and make them effective. The commercial banks inherited large uncollectable loans and for some time may be unable to play a fully autonomous role in enforcing financial discipline on their customers, as is demonstrated in some countries by the rapid growth of inter-firm credit in parallel with bank credit.

Regulatory changes and the strengthening of prudential supervision over financial institutions are necessary, but by no means sufficient, conditions for the successful implementation of a new monetary system. The roles of financial intermediaries, including the central bank, must be completely reversed: from executors entrusted with the task of implementing the Plan, they must evolve into decision-making centers with direct responsibilities. The same applies to firms.

It will take much longer for this reversal of roles to take root than to approve the relevant legislation. New relationships will have to be established, new skills learned. In the financial sector investment in human capital will be at least as important as investment in new technology.

In the meantime the functioning of market mechanisms may remain imperfect and distortions in relative prices may

persist. But this should not be construed as justifying continued discretionary interference by the state.

2. The dilemma facing monetary authorities

While this gradual process to a market economy advances, monetary authorities will not be able to count on predictable responses by economic agents to market-based policy instruments. Some important markets do not yet exist and those that do may not be sufficiently developed. Accordingly there is the risk that wrong decisions will jeopardize the authorities' ability to control monetary variables and the stability of intermediaries. The most dangerous potential consequence would be the loss of confidence by economic agents, which could undermine the very essence of a properly working monetary system.

In the initial period, therefore, the still limited effectiveness of market-based policy instruments and the difficulty of ensuring that firms behave in conformity with market discipline may require the traditional monetary and fiscal policy tools to be supplemented by direct controls; for instance, on international capital flows, bank lending and interest rates.

However, such administrative controls on banking and other sectors, may seriously impede the development of market mechanisms and delay the adjustment process. Financial intermediaries have to develop new skills, but if the authorities continue to choose in their place they may fail to do so. This is a vicious circle that must be broken.

3. What can be learned from the Italian experience

The dilemma confronting the monetary authorities of the formerly planned economies presents some analogies with that faced by the Italian authorities in the seventies.

Following the breakdown of the Bretton Woods system of fixed exchange rates and the first oil shock, Italy entered a period of rapid inflation and severe instability. The entire economy was affected, but the principal victims were the market components of the financial system, which had failed to grow in parallel with the real economy. Both the stock exchange and the bond market came under such pressure that their macroeconomic role was sharply curtailed. Banks' liabilities came to account for the bulk of households' financial assets and bank credit for most of firms' external finance.

In these circumstances, monetary management had to rely on the direct control of intermediaries. However, awareness of the inefficiency of these methods and of their ineffectiveness in the longer run led the authorities to embark on reforms designed to develop and strengthen the financial system, in particular the sectors most responsive to central bank intervention, with the aim of gradually replacing administrative controls with market-based mechanisms.

In addition, action was taken on two other fronts as part of the sustained effort to restore monetary stability: the division of responsibilities between monetary and fiscal policy was more clearly defined and Italy participated in the European Monetary System.

It is, I think, worth examining some of the lessons provided by Italy's efforts to establish an efficient and effective stability-oriented monetary policy.

In the first place, they show the importance of establishing an adequate analytical framework based on simplified flow-of-funds accounts to determine the quantity of money and credit required. The need to control credit creation as well as the money supply arises when countries are confronted, as Italy was, with severe balance-of-payments problems. The domestic credit approach to monetary policy that Italy and the United Kingdom adopted in the seventies in connection with IMF stand-by arrangements could well prove

helpful in organizing monetary control in Central and Eastern European countries.¹

Secondly, there was the gradual development of indirect instruments with which to maintain overall financial-monetary control, primarily by influencing interest rates and liquidity, and then the resources available to the banking system for lending. Liquidity must be understood in a broad sense to include not only the primary liquidity provided by the central bank and that supplied by commercial banks, but also that generated by other financial institutions and, through the issue of short-term paper, by the Government.

The third lesson is a corollary of the second: direct controls should never be allowed to lull the central bank into complacency about liquidity creation and the management of interest rates. They can be used to smooth and accelerate the adjustment to changes in liquidity and interest rates; under no circumstances should they be a substitute for them.

4. Some specific proposals

The analogy with the Italian case should not be carried too far, nor can we claim to have been entirely successful in achieving our aims. However, it is difficult to imagine a strategy for the countries of Central and Eastern Europe that does not involve the use of crude, direct instruments of monetary control in the early stages and a prolonged and far-reaching reform effort.

Accordingly, a few concrete suggestions can be made regarding the instruments to be employed to ensure monetary stability in the early phase of the transformation process.

First, the establishment of a market, no matter how unsophisticated, for short-term government securities, in

1. It is in fact being introduced in some of them as part of IMF-supported stabilization programs.

which the public sector can finance itself without recourse to monetary creation and in which the Central Bank can operate to regulate liquidity.

Second, a system of compulsory bank reserves may be helpful until the fulcrum of monetary control becomes the creation of money and credit. The case for reserve requirements is still debated in academic and central bank circles. However, in a simple financial system, where the grip of the central bank has to be ensured, compulsory reserves can be effective in helping to keep liquidity and interest rates on course.

Third, the establishment of a flexible system for central bank refinancing of commercial banks; the design of the facilities must, however, ensure that both the volume and the cost of such refinancing are firmly under the control of the central bank.

At the institutional level, responsibility for monetary policy must be separated from that of the Government for economic policy in general. The autonomy of the central bank and a ban on the monetary financing of budget deficits are basic elements of this separation. The plans being drawn up within the EEC to amend the Treaty of Rome and establish a European Central Bank can serve as a useful model.

Finally, once trade and other current transactions have been liberalized, a nominal external anchor is likely to prove extremely valuable in maintaining stable economic conditions and can be achieved by pegging the currency to that of a country or group of countries enjoying monetary stability. One possibility in this respect would be a link with the European Monetary System.