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Convertibility and the Czech Crown

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Abstract

This paper was written during a visit to Czechoslovakia in August 1990. It discusses basic conceptual issues dealing with currency convertibility in general and the current Czech reform program in particular. One set of issues concerns possible restrictions on parts of the balance of payments, such as the repatriation abroad of profits. Another concerns the best way to set the level of the exchange rate. Recommendations include: no restrictions on current account convertibility, and an exchange rate peg higher than the 1990 official rate but lower than the black market and auction rates. A 1991 addendum notes Czechoslovakia's January move to convertibility.

JEL Classification: 124, 431

I would like to thank my host, Michal Mejstrik of the Institute of Economic Studies of Charles University in Prague, and the many other Czechoslovaks who took the time to talk with me, including Karel Dyba, Jiri Jonas, Ales Bulir, and Livia Klausova.
The term "convertibility" generates controversy. For many in East European countries it seems a far-off goal, the reward to the efforts at economic reform now underway, to come only after other steps are completed. My own feeling, after the short time I have spent in Czechoslovakia studying the question, is that the date of January 1, 1991, that is being discussed for some sort of convertibility, is not too soon. But it is important to note that convertibility is not some magic formula that will solve all the problems of the economy. Most important is liberalization of the domestic economy (including market-setting of prices, and privatization). The institution of international convertibility would be a useful supplement, but it would have to proceed simultaneously to domestic liberalization. There is not much point in the government attempting the former if there is not already a commitment to attempt the latter.

Let us begin by considering the definition of convertibility.¹ I would define it as the ability of private agents to buy freely foreign currency in exchange for domestic at the going price, and to sell foreign currency at the same price. There is some confusion on the definition. Some Western economists (for example, Ron McKinnon of Stanford University) proposed the term "internal convertibility" to refer to reform of the domestic economy in a

country such as the Soviet Union, so that domestic enterprises can convert their domestic currency holdings into domestic goods (also called "commodity convertibility"). The term internal convertibility as I hear it used in Czechoslovakia is confusing to us Western economists. It refers to external convertibility subject to some restrictions. Livia Klausova suggested to me the term "restricted" of "limited" convertibility for domestic residents, which seems to me much clearer.

Beyond the semantic question, there is the more substantive question as to how restrictive is the exchange rate regime that the government puts in place. Everyone says that the regime contemplated to take effect in Czechoslovakia on January 1, 1991, will include the restriction that export enterprises will have to turn their foreign exchange earnings over to the State Bank, as they do now. It seems to me that this might defeat the point of convertibility. Of course, if exchange rate reform is done in the proper way -- and we will discuss below what is the proper way -- then those who earn foreign exchange could very well choose voluntarily to sell it to the state bank rather than on the private market, especially if the private domestic banking system does not develop quickly. But as long as a system is in place under which they are forced to turn over their currency by law, they might fear that in the future they will be forced to do so at less favorable terms. If the move to currency convertibility lacks credibility in this way, it may not be successful. Potential exporters may be reluctant to invest in exporting, and the black market may persist.
I understand that the Czech government is concerned that an early move to full convertibility would lead to a large balance of payments deficit and a rapid depletion of foreign exchange reserves. Such concerns can be addressed by a consideration of the two questions that a country must decide when adopting a convertible currency. The first question is which items in the balance of payments would be fully convertible in an unrestricted way. The second question concerns the determination of the exchange rate.

Many countries have full convertibility for much of the current account. But three kinds of restrictions are particularly common. Each penalizes a particular activity by setting a higher price for the acquisition of foreign exchange for a particular purpose.

Most common are restrictions against the acquisition of foreign assets by domestic residents. Under a dual exchange rate system, domestic residents are charged a higher price to obtain dollars for this purpose than they are charged if they can show that they intend to purchase foreign goods. The goal, of course, is to discourage "capital flight," thereby improving the balance of payments and protecting the central bank's level of international reserves. (There are analogous ways to discourage investment abroad that do not work through the exchange system, such as taxation or outright prohibition of capital outflow.) Such capital controls have an important drawback, in that they are never
airtight. Travelers will smuggle currency out of the country. Companies will overinvoice imports or underinvoice exports; and arrange to lead the time of their payments for imports, or lag the time that they receive payment for exports. But capital controls do have some effect. They prevented international arbitrage of interest rates for Italy, France, Denmark, Spain, and Portugal as recently as the mid-1980s (and continue to do so for Greece and some others). A dual exchange rate would be a perfectly reasonable regime for a country like Czechoslovakia for a transitional period of ten years.

A second possibility is to penalize the acquisition of foreign exchange for the purpose of making interest payments abroad or repatriating profits to foreign investors, by setting a higher exchange rate for these transactions. (Again, this could also be done by taxing or prohibiting outright the repatriation of investment income.) This is what is contemplated for January 1, and is the origin in the Czech context of the term "internal convertibility," meaning "convertibility for domestic citizens only." I personally would not support such restrictions, because foreign investors will be extremely reluctant to invest in Czechoslovakia if they are not assured the ability to repatriate profits. While restrictions on some forms of capital inflow may be necessary for several years (to avoid, for example, the excessive borrowing from banks undertaken by most Latin American countries in the 1970s), foreign direct investment is in my view highly desirable. If foreign firms are allowed to operate in
Czechoslovakia, the domestic economy will benefit from the demonstration effect of seeing how things are done in the West. There will also be an important effect whereby the competition of foreign firms prevents newly-unconstrained domestic enterprises from raising prices out of line with world market conditions. Hopefully, if foreign investors are assured a stable and market-oriented economic system in Czechoslovakia, they will choose voluntarily to reinvest their earnings in the country. But even if a foreign investor started up a profitable enterprise, and then a few years later sold it off to a Czech resident and took his money out of the country, the Czech economy would still have the benefit of a new thriving enterprise.

A third kind of restriction that is common is to penalize the import of luxury consumer goods, by charging a higher exchange rate for them than for basic goods like food, oil and intermediate inputs. (Analogously, tariffs can be applied to such luxury consumer goods.) I personally would be inclined against such restrictions: if it is considered desirable on political or moral grounds to discourage such conspicuous consumption, it would be better to tax the luxury consumer goods (regardless whether produced domestically or abroad), with the revenue going to the government. If it is considered desirable to apply a penalty exchange rate to such goods, I don’t think it would be such a bad idea for several years, provided the gap in rates is not too great (otherwise there will be smuggling and a black market in these goods), and provided there is not a complicated maze of many
different exchange rates, bureaucratic red tape, and corruption. Such trade restrictions could be gradually phased out if Czechoslovakia wants to join the GATT (or, eventually, the EC), and if the central bank’s international reserves hold up.

All three kinds of restrictions might help prevent rapid reserve loss. But the more important instrument to prevent reserve loss is the setting of the level of the exchange rate.

The first decision a country must make in adopting a convertible currency is the choice between a fixed exchange rate regime and a floating rate regime. Under a fixed rate, the central bank stands ready to sell however much foreign currency the public wishes to buy at the announced rate (or buy however much foreign currency the public wishes to sell). Under a floating rate, the central bank is not in the business of buying and selling foreign exchange; instead the exchange rate is set in the private market, adjusting automatically to equilibrate supply and demand. Consider an upward shift in the demand for foreign exchange, which could be due for example to the removal of restrictions on imports. Under a floating rate, the exchange rate will automatically increase to reduce the demand for foreign exchange and increase supply, thereby restoring equilibrium. Under a fixed rate, the central bank must meet the excess demand for foreign exchange out of its reserves.

For a country like Czechoslovakia, without a developed private banking system, a floating exchange rate is not an appropriate choice. (Even in the longer run, when the banking system becomes
more developed, it is likely that Czechoslovakia will want to join the countries of Western Europe in keeping their exchange rates fixed, at least within relatively narrow bands.) Let us proceed on the assumption of a fixed exchange rate.

If the country's overall balance of payments deficit (the excess demand for foreign currency) is too large, it will threaten eventually to use up the central bank's reserves. If a policy response is postponed, eventually there will be a crisis. Thus it is highly desirable for a country that is moving to a convertible currency, to choose from the beginning a level for the exchange rate that is a good guess as to the level that will produce a balance of payments close to zero. Making sure that the exchange rate is high enough is a far better way of preventing rapid reserve loss than are restrictions on imports, repatriation of Profits, etc.

Making sure that the exchange rate is consistent with balance of payments equilibrium involves three questions. (1) What method should be used to choose the initial level of the exchange rate? (2) To what currency or basket of currencies should the exchange rate be pegged? (3) How rapidly should the country move to convertibility?

On the first question, I am told that a Purchasing Power Parity (PPP) calculation which includes the prices of a wide range of Czech goods and services, including those like housing that are not internationally traded, gives a number like 8 CKR/$; and that a calculation that includes only the costs involved in producing
goods that are internationally traded gives a number like the current official exchange rate, 15 CKR/$. It is useful to perform such calculations. But it seems clear that a country like Czechoslovakia should choose a value of the exchange rate that is higher than that given by PPP. The reason is that, in order to pay for imports of oil, the country needs to generate a small trade surplus in manufactures and other goods and services — in the absence of heavy borrowing from abroad. Since Czech goods, for the moment, cannot compete with Western goods on quality, they will have to compete on price. The exchange rate must be high enough to overcome initially the natural inertia facing a people who will be learning the rigors of the international marketplace for the first time.

At the other extreme, the black market rate, currently at 30 CKR/$, and the auction market rate, most recently at 35 CKR/$, give much higher numbers. (The supply of foreign exchange on the auction market was extremely small at first, and the rate accordingly very high. But the supply has been increasing, apparently as enterprises begin to make greater use in this way of their "retention quotas" for foreign exchange earnings, and the auction market rate seems to be converging to the black market rate.) But I do not think that the equilibrium exchange rate chosen for a well-planned move to currency convertibility need necessarily be as high as the current black market or auction market rates, even though a goal of currency convertibility would of course be to eliminate any gap between the official and black market rates. Under a well-
planned move to convertibility, exporters (both those that exist now and those that would come into being) will increase their ability and willingness to supply foreign exchange at any given exchange rate. The reason is that they will no longer have to cope with the risks, inconvenience, and moral taint of dealing with the black market -- the risks that induce many of them to turn in their foreign exchange at the less favorable official rate under the current system. But such an outcome, with the black market rate converging to the new official rate might require, among other things, that exporters be allowed to choose freely whether to sell their foreign exchange earnings to the state bank or to the private market.

The second question is what kind of peg should be adopted. Whether the peg for the exchange rate at the beginning is set in terms of dollars or in terms of marks could make a big difference later, when the mark or dollar appreciates or depreciates against other currencies. The regime for the Czech crown ("koruna") will probably have to be an adjustable peg; the uncertainties involved are too great to warrant a declaration of permanent commitment to a particular exchange rate. Nevertheless, it is desirable that the initial exchange rate be sustainable for as long as possible. To minimize the risk that Czechoslovakia will find in future years that its exports have become uncompetitive because the mark or the dollar appreciated unexpectedly, the crown should be pegged to a basket of trading partners' currencies. The weights in the basket should be unchanging and publically announced, if the central bank
Delors arbitrarily picked 1992 as the date for European economic union, it seemed hopelessly unrealistic. But the concreteness of the date (including the fact that a date does not need to be translated into different languages!) got people talking, and soon created the political momentum necessary to bring the enormous changes about. Businessmen in a typical backwater segment of the European economy stopped talking about how to lobby their national government to protect them from integration, and started talking about how to become more competitive so as to survive when 1992 came. The same principle may hold for pre-announcing the date of convertibility, even if the earliness of the date seems unrealistic.

I can think of three more reasons why early may be better than late. One is to resolve uncertainty, which investors, both foreign and domestic, dislike most of all. Currently many projects are on hold pending resolution of uncertainty regarding the government's reform program. Another is to act before Czechoslovakia loses its monetary virginity. Currently a great advantage that the country has over Poland or the Soviet Union, or Latin America (or, for that matter, most of the countries in the world), is that there is little history over the last 40 years of monetized deficits, inflation (whether overt or suppressed), and devaluation. Other countries are victims of a cycle whereby expectations of inflation and devaluation engender speculation which then brings about the feared inflation and devaluation. Once this cycle gets started, it can be very difficult to stop. Proclamations by government
officials that inflation will fall or that there will be no devaluation are not believed if they have been proven false frequently in the past. Czechoslovakia's monetary virginity is a valuable asset that should not be squandered lightly.

The recent numbers on Czech money growth and government deficits, to the extent that they are meaningful, look favorable to me. But if the transition to privatization is drawn out, then state enterprises may start to take greater advantage of the soft budget constraints, running up large deficits that the government may be forced to accept as its own. This is the advantage of privatizing sooner rather than later. (It is also one of several reasons why it is important, in the case of the many state enterprises that cannot be fully privatized all at the beginning, that managers be given clear instructions as to what is expected of them during the transition, and as to how their performance will be judged when future managerial positions are filled.)

The final reason why liberalization should be instituted sooner rather than later is again political. The alternative to comprehensive reform is not a stable status quo, but rather a gradual deterioration into economic chaos. The current system is rapidly undermining both respect for the law and respect for the market. Those people who are a priori inclined in favor of the market are losing respect for the law, as economic transactions that should be perfectly legitimate are driven underground. At the same time, those people who have a strong a priori commitment to the law are losing respect for the market, as they watch unsavory
types profiting from illegal transactions, and come to associate the market with corruption and dishonesty. The law and the market should work well together, if property rights and the rules of the system are well-specified and enforced, and then the market is allowed to operate.

The model that is to be avoided is the current muddling-through strategy of the Soviet Union. For five years Gorbachev has been talking about perestroika, and the rewards that will come in the future if the public is patient (this to a population that for 70 years was promised future rewards if they sacrificed for the Marxist state). The economic situation has deteriorated sharply, and the public is coming to associate this deterioration with perestroika, notwithstanding the fact that genuine economic liberalization has not yet been tried.

The Czech people will support a program to switch to the economic system of the West, and will even tolerate for awhile the inevitable dislocations that will result. But the Czech government only has one clear shot. If half-hearted and confused reform is attempted, and the economic situation subsequently deteriorates, then when the government in several years announces a more serious reform program, like Gorbachev it will have already lost its credibility with the people. This is why a serious reform should be attempted relatively quickly, and should include not only market-setting of prices, privatization, and guarantees against monetized deficits, but also a movement toward convertibility of the Czech crown.
Addendum, February 1991

In October 1990, Czech Finance Minister Vaclav Klaus, the leader of the faction in favor of rapid economic reform, was elected as the first chairman of Civic Forum, which had previously been supposed to be completely under the sway of President Vaclav Havel. This development seemed to augur well for reforms. Klaus told an audience of American central bankers, "We feel that history will not forgive us if we miss our unique chance. We plan to implement all crucial reform measures at the beginning of 1991."2

Also in October, the Czech crown was devalued by 54.54 percent, from the previous rate of 15.5 crowns to the dollar to 24. (The tourist rate was unchanged at 29.26.)3

On December 29, the State Bank announced a unification of the multiple exchange rates at 28 crowns to the dollar, as had been agreed upon with the IMF. This rate represented a devaluation of 14.25% for the official commercial rate and revaluation upward of 7% for the tourist rate. Thus the attempt to choose an equilibrium rate was consistent with my advice of last August that it should lie somewhere between the existing official rate and the black market rate. The State Bank also announced that from January

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1, 1991, the rate would be set daily using the market value. Between adjustments, the peg is to a weighted average of five currencies: the dollar (31 %), deutschmark (46 %), austria schilling (12 %), pound (4 %) and swiss franc (7 %). 4 Apparently the specific scheme adopted is one of full current account convertibility, again as had been recommended by Western economists.5

At the same time, price controls on most commodities were removed. The first round of auctions to privatize small shops and businesses took place in late January. Deliberations continue on a voucher plan to privatize larger state enterprises. Czechoslovakia may truly be on "the road back from serfdom."

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