Anchoring Inflation in Transition Economies: the Case for a Currency Board Arrangement in Romania

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May 2002
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Acknowledgements

In creating and finishing this project, I owe enormous gratitude to my parents whose constant support has made everything possible. I am very grateful to my advisor, David Holloway, for his words of encouragement, his detailed attention to my work, and his great patience with my schedule (or lack thereof). I am very indebted to Ron Mitchell for his support in the earliest, and most difficult, stage of the project, to Ronald McKinnon, for his inspiring words of praise and support, to Nick Hope, for his great insights into my arguments, and to Alex Cukierman, for a very helpful conversation on currency boards.

Many thanks go to Roxana Ghican of the Romanian Commercial Bank, to Surica Rozentular, of the Romanian National Bank, and to Vasile Puscas, of the Romanian Ministry of European Integration. Without their help, this work would not have been possible.

Finally, thank you to the staff of the IR Office, and especially to Jackie, for giving me the opportunity to finish this project as enthusiastically as I started it.
Chapter 1

Introduction

"Transition is not a one-way process of change from one hegemonic system to another. Rather, transition constitutes a complex reworking of old social relations in the light of processes distinct to one of the boldest projects in contemporary history - the attempts to construct a form of capitalism on and with the ruins of the communist system."

-Adrian Smith

More than a decade after the collapse of communism in Central and Eastern Europe, the former centrally-planned economies of the region (see map on next page) still face many challenges in their transition to modern market systems. Emerging from similar economic regimes, most of these economies started on their path to transition with the same structural imbalances: large declines in output, large fiscal deficits, severe sectoral disproportions, extreme currency inconvertibility, and repressed inflation. Yet, the transition process did not prove similar among these countries as political and institutional differences, along with familiarity of the market mentality, separated the more successful reformers from the laggards. In adapting their isolated economies to open, market-based international trade, the countries of Central and Eastern Europe liberalized prices in order to harmonize their official exchange rate with the market exchange rate. The consequence of this initial stage of market reform was an acute inflation lasting for several years. The more fortunate countries - Poland, Hungary, and the Czech Republic - managed to subdue their elevated inflation by combining price liberalization with strict fiscal and monetary policies. In the absence of such measures, Bulgaria and Romania experienced an inflation rate of triple-digits, while the successor states of the Soviet Union endured an inflation rate of quadruple-digits in 1992. The severity and persistence of inflation in Eastern Europe, specifically in the Balkans, has led these countries to undertake stabilization programs to end high inflation, many of which have had less than satisfactory results.

Although attempts at reform among the transition economies occurred even
before the fall of communism - in the 1950's in Yugoslavia, in 1968 in Hungary, and at various times in the former Soviet Union, of which glasnost and perestroika are examples - the process of transition to a market economy began in 1990 with Poland inaugurating its stabilization program. The difference between this reform process and the earlier attempts is that the latter sought to protect the vitality of the communist regime, while the former sought to deconstruct and rebuild the economic and political systems into democratic, market regimes. Analyses of the transition emphasized reform in six general areas: macroeconomic stabilization; price liberalization; trade liberalization and current account convertibility; reform of state-owned enterprises; the creation of a social safety net; and the development of the institutional and legal framework for a market economy, including the creation of a pluralist democratic regime and a market-based financial system. As a consensus was reached by national policymakers and the Western aid agencies over the reform of these six areas, heated debate emerged over the speed and sequence of reforms and the exact objectives to be pursued in each area.

The debate over the speed of reforms divided the academic world into two schools of thought: the "big bang" - or "shock therapy" - school versus the gradualist school. In practice, only certain areas of reform benefited from shock therapy, while most were better served by a gradualist approach. Yet, this evidence was not available at the time when the decisions on speed of reform were implemented. Consequently, each transition economy adopted different decisions and different policies addressing the six reform areas, and the transition experiences varied from country to country. The focus of this paper is on the macroeconomic stabilization of the transition economy, with a special case study on Romania. As such, reform in the other five areas will be discussed only as they relate to measures or policies of stabilization.

Macroeconomic stabilization refers to the measures taken by the government to

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stabilize any economic variable subject to rapid, and economically debilitating, fluctuations. This area encompasses currency reforms - the creation of one stable currency - in countries which break up from a larger politico-economic area, such as Yugoslavia and the former Soviet Union, and wish to pursue different economic policies; and reform of monetary and fiscal policy with the aim of controlling inflation. The latter objective rests on the argument that inflation is detrimental to an economy for many reasons to be discussed in a later chapter. However, one general a priori argument is that inflation is negatively correlated with economic growth.\(^2\) It is evidenced in a study of functioning market economies that an annual inflation rate of more than forty percent would not allow for sustainable growth.\(^3\) It may, thus, be argued that transition economies cannot yet function as proper market economies due to their lack of structural reforms such as privatization and de-monopolization; as a result, they cannot expect economic growth at more than forty percent annual rates of inflation. Moreover, it is argued that enterprises need access to easy credit if they are to survive during transition, thus suggesting that inflation rates much below ten percent are impossible in a transition economy if it seeks to grow.\(^4\) The inflation objective of macroeconomic stabilization policy forms the focus of this thesis, and it will be discussed in-depth in the case of Romania. In the context of this introduction to the subject, I will present a picture of the stabilization process in the transition economies as a whole, before addressing the narrower topic of Romania’s stabilization (or lack thereof) in recent years.

According to an econometric analysis conducted by Fischer (1993) on data spanning the period from 1989 to 1994, the countries of Central and Eastern Europe are shown to have experienced high levels of inflation fueled by fiscal deficits that accounted


\(^4\)Fischer et al. (1996).
for more than six percent of GDP.\(^5\) This assessment portrays a dismal picture by further showing that real GDP has fallen at a continuous pace since the beginning of reforms. Yet, when including the year of implementation of an inflation stabilization program in the data, it is observed that inflation falls substantially and continuously as fiscal deficits are brought under control. The authors show that output begins to recover soon after the implementation of these programs, validating the a priori argument that curbing inflation is necessary for economic growth. Table 1 presents the data supporting this claim.

<table>
<thead>
<tr>
<th>Country</th>
<th>Stabilization Program Date</th>
<th>Exchange Regime</th>
<th>GNP/capita at PPP (US $ 1985)</th>
<th>Maximum Annual Inflation</th>
<th>Inflation Fell Below 50%</th>
<th>Output Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>February 1991(^a)</td>
<td>Flexible</td>
<td>5968</td>
<td>338.8</td>
<td>-</td>
<td>72.4</td>
</tr>
<tr>
<td>Czech R.</td>
<td>January 1991</td>
<td>Fixed</td>
<td>NA</td>
<td>52.1</td>
<td>1992</td>
<td>21.4</td>
</tr>
<tr>
<td>Estonia</td>
<td>January 1992</td>
<td>Fixed</td>
<td>9078</td>
<td>946.7</td>
<td>1993</td>
<td>34.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>March 1990</td>
<td>Fixed</td>
<td>6569</td>
<td>34.6</td>
<td>-</td>
<td>18.3</td>
</tr>
<tr>
<td>Lithuania</td>
<td>June 1992</td>
<td>Fixed</td>
<td>6816</td>
<td>1162.6</td>
<td>1994</td>
<td>61.1</td>
</tr>
<tr>
<td>Poland</td>
<td>January 1990</td>
<td>Fixed</td>
<td>4941</td>
<td>636.6</td>
<td>1992</td>
<td>17.8</td>
</tr>
<tr>
<td>Romania</td>
<td>October 1993(^c)</td>
<td>Flexible</td>
<td>3722</td>
<td>295.5</td>
<td>-</td>
<td>26.4</td>
</tr>
</tbody>
</table>

\(^a\) These countries had more than one stabilization attempt.  
\(^b\) These countries never had inflation rates below 50% in this time period.  
\(^c\) Hungary had below 50% inflation even before 1989.

Source: Table adapted from Fischer et al. (1993).

The table shows the initial conditions of specific transition countries, allowing us to draw a close parallel between the initial situation in Romania and that in Bulgaria. The two countries both adopted a flexible exchange rate, and experienced similar levels of inflation and output declines in the early years of transition. In contrast, the countries of Central Europe and those in the Baltics exhibited higher GNP per capita at the beginning of reform, and most importantly, they all managed to subdue their inflation to below fifty percent quite soon after their stabilization program was implemented. Romania and Bulgaria can be assumed to have suffered either graver economic imbalances or less-than-credible political will for reform as shown by the fact that they could not curb their inflation.

\(^5\) Ibid.
inflation even after implementing a stabilization program. This paper will take an in-depth look at the reasons for the inability to stabilize in the Balkans, arguing that political motives were central to the creation of a successful reform program. At this point, the most interesting observation which will shape the rest of this study is that fixed (or pegged) exchange rate regimes appear to have been more effective in decreasing inflation, and thus, in increasing growth. From the data and the latter note, Fischer (1993) conclude that the reduction of fiscal deficits and a pegged exchange rate bring about a more rapid and more certain disinflation. Although real GDP growth was negative prior to the implementation of the stabilization program, while inflation and fiscal deficits were very high, all three of these variables stabilized within two years of the program, with GDP growth becoming positive, inflation and fiscal deficits decreasing. Furthermore, the authors advance the argument that stabilization to a monthly inflation rate of below four percent is necessary for sustainable economic growth.

Yet, the overall trend presented appears to be heavily biased toward the performance of the successful transition economies. Although the result shows that an efficient stabilization program decreases inflation, curbs fiscal deficits, and increases GDP growth, not much can be concluded about the performance of the laggard countries, Romania and Bulgaria in this case. These two countries did not perform as well under their first attempted stabilization program, but they were spared the painful outcome experienced by the countries of the former Soviet Union. Figure 1 shows the negative correlation between inflation and growth in 26 transition economies, validating that Central Europe, which subdued inflation to the benefit of GDP growth, was the most successful in economic reform. The positions of Romania and Bulgaria in the Figure further show that these two countries share similar macroeconomic conditions.
Figure 1: Inflation and Growth Correlation (average of 1992 - 1994)

Notes: ALB: Albania; ARM: Armenia; AZE: Azerbaijan; BLR: Belarus; BGR: Bulgaria; HRV: Croatia; CZE: Czech Republic; EST: Estonia; GEO: Georgia; HUN: Hungary; KAZ: Kazakhstan; KGZ: Kyrgyz Republic; LVA: Latvia; LTU: Lithuania; MKD: Macedonia; MDA: Moldova; MNG: Mongolia; POL: Poland; ROM: Romania; RUS: Russia; SVK: Slovak Republic; SVN: Slovenia; TJK: Tajikistan; TKM: Turkmenistan; UKR: Ukraine; UZB: Uzbekistan.

Source: Fischer (1993)

The reforms underlying the results observed in this figure should be very significant lessons for the laggard countries. The correlation suggests that macroeconomic stabilization through the use of a fixed exchange rate proves to be more successful at decreasing inflation and increasing GDP growth. These results suggest that a fixed exchange rate is more likely to address fiscal imbalances, thus emphasizing the importance of the exchange rate regime in successful stabilization programs. The main conclusion from this data is that a fixed exchange rate and reduced fiscal deficits are key to a successful macroeconomic stabilization.

Objective

Starting from a general overview of the transition process in Eastern Europe, this thesis addresses the current problems facing the Romanian economy. Surveying the failure of economic reforms in the country, the inefficient policies adopted in the past
decade, and the escalating rate of inflation, the overarching question I seek to investigate follows: *How would the immediate adoption of a currency board arrangement (CBA) affect the current economic situation in Romania, and, consequently, should Romania adopt such an arrangement?* This study hopes to show the relationship between the independent variable – the CBA monetary arrangement – and the dependent variable – the presently undisciplined economic situation in Romania mirrored in very high levels of inflation. My thesis argues that a currency board arrangement is the optimal stabilization solution for Romania given the constraints it faces at the current time. For a country where inflationary expectations are ingrained in the mentality of all economic agents, which lacks political consensus-building, transparency in governmental operations, credibility in the face of foreign institutions (such as the IMF or the EU), and yet which hopes to accede to the European Union, a currency board is the best policy which attends to the internal reforms of the economy while harmonizing national and foreign policy.

Romania, a formerly socialist country of the Eastern European block, continues to confront a tenacious inflationary cycle. A comparative analysis shows that Romania started onto the path of transition at the same starting point as other Eastern European countries, specifically Bulgaria. Yet, this path seems to be rockier for Romania, for while Bulgaria has stabilized its economy since 1997, Romania continues to endure large-scale currency devaluations. Along with this phenomenon, Romania faces a variety of macroeconomic problems, ranging from large budget deficits to soaring interest rates to a large number of nonperforming bank loans. Additionally, the National Bank of Romania (NBR) does not stand as a fully independent central bank. It continues to be politically influenced by the government, especially at the present time when the Social Democratic Party governs. As a result, subsidies continue to fund inefficient state-owned enterprises at the expense of a more competitive private market, and monetary policy cannot serve its main objective of stabilizing the price level. Most alarmingly, the central bank supplies reserves to inefficient commercial banks which give preferential loans to risky, yet
politically influential, agents, thus harming the already weak stability of the Romanian financial system. The resulting abundance of non-performing bank loans may lead to financial insolvency in the near future as long as moral hazard remains a condition in the banking sector. All of these economic and financial woes, especially the rapidly decreasing value of the national currency, adversely affect the credibility of Romania’s markets. Consequently, foreign and national investment is low, as is the per annum economic growth.

In light of this situation, it is clear that Romania needs a fix - a solution to help the country stabilize its inflation, its national currency, and its exchange rate. Yet, in attempting to stabilize its economy, Romania is not unique. All the elements of financial and economic instability pertaining to Romania have been characteristic of other post-socialist countries on their path of transition to a functioning market economy. Developing a stabilization program for Romania pertains to the larger case of transition economics. Within this framework, the favorable transition experience of other formerly socialist economies, especially the Central European countries, allows for guidelines to success. The case of transition economics calls into use comparative studies more than ever, for these countries emerged from a similar regime with similar initial economic conditions. Thus, comparative study between transition economies is a powerful tool for opening new lines of inquiry.

In developing a stabilization program for Romania, the experience of Bulgaria appears appropriate. Bulgaria - Romania’s neighbor to the southeast - has started its transition at a starting point similar to Romania’s. Plagued by excessively high levels of inflation and other macroeconomic problems, along with an opaque political process, Bulgaria adopted a monetary solution as a stabilization measure and experienced auspicious results. This solution – a currency board arrangement – specifically targets the exchange rate of the national currency and inflation. The arrangement relies on the conversion of the national bank into a fully independent currency board whose principal
operation is issuing the national currency and doing so only to the extent that it is fully backed by foreign reserves. A fundamental part of this arrangement is the pegging of the national currency to a strong and stable reserve currency. Thus, the exchange rate of the national currency can no longer vary. Through the currency board mechanism, inflation and interest rates are expected to decrease, investment is expected to increase, the trade account stands to benefit from a surplus, economic growth is presumably imminent, and investor credibility in the country’s markets increases. Numerous studies attest to the benefits of currency boards on the internal financial and economic situation of the country adopting this arrangement. A look to Bulgaria’s economic state pre- and post-currency board validates the theoretical assertions made of currency board arrangements.

Although a currency board seems to be a favorable monetary arrangement, implementing it may prove inefficient. Not subsidizing certain industries or certain social programs can have destabilizing effects on the economy. More specifically, this arrangement can lead to a lower standard of living for a temporary time period, as it constricts the role of the government in monetary policy and insulates the central bank from the interference of the government authorities. The countries that have successfully implemented a currency board have done so under specific conditions – Estonia, Lithuania and Hong Kong are characterized as very small countries, while Bulgaria and Argentina were on the brink of a financial collapse and any monetary measure might have helped them. Thus, a noteworthy contention is that a currency board may prove successful only under specific conditions. Otherwise, it may do more harm than good to a country’s economy. Previous literature on this topic presents both sides of the debate. This thesis will apply the arguments from the literature to the specific case of Romania, seeking to discover how a CBA would affect Romania’s current economic situation if it were to be implemented immediately. This puzzle encompasses a few narrower questions:

a) *Will the results observed in Bulgaria and Estonia emerge also in Romania?*
b) *If so, should Romania adopt this measure now?*

c) *What is the role of political will in turning this arrangement into a feasible policy?*

d) *How does the goal of European Union accession affect Romania's choice of national economic, and specifically monetary, policy?*

The last two questions are of great significance for the main argument of this thesis. Economic policy has known many instruments for stabilizing the economy, be they implemented in advanced or developing countries. The rationale for choosing a specific instrument with which to conduct economic policy rests on many factors, one of which is the disposition of the policymakers. Yet, in a country such as Romania where democracy is perverted by actions of state-capturing and where the incentives of politicians are dubious at best, we cannot assume that public officials adopt policies to benefit the welfare of the citizens. In the case of Romania, where the current governing party employs members of the former *nomenklatura* who abuse the federal budget and use the central bank as a financing tool, it is particularly false to make this assumption. This thesis argues that the Romanian government and its interference in the transition to a market economy needs to be curbed in order for reform - specifically stabilization - to occur. The adoption of a currency board arrangement will surely insulate monetary policy from Romania's corrupt political process, yet its implementation will surely be blocked by the current governing party benefiting from partial reform. Although this paper will not deconstruct the political process to study the ways to ensure the adoption of a CBA, it will argue that this arrangement will smoothly pave the way to satisfying the Copenhagen and Maastricht criteria for accession to the European Union and the European Monetary Union.
Significance

The significance of this study emerges in the context of finding a solution for Romania's economic distress. Although Romania has, at times, considered adopting a currency board, there has not been any research on this exact monetary fix given the circumstances faced by Romania. Thus, this investigation comes at a crucial time in Romania's development as a modern market economy. Additionally, an assessment of the role of a currency board in Romania's economic development serves not only the internal affairs of the country, but also its external relations with Western Europe. Prime Minister of Romania, Adrian Nastase, has declared the year 2007 as the target date for joining to the EU. Yet, in order to join, Romania must comply with the economic criteria of the June 1993 Copenhagen Summit – namely, that it must have a functioning market economy, characterized by low inflation and high investment. Thus, the adoption of a CBA now may be the solution Romania needs in order to stabilize its macroeconomic factors, gain credibility in its markets, and materialize its adherence to the Union.

In the context of joining the EMU, a currency board seems indispensable for a transition economy, both, as a way to satisfy the pre-requirements to joining, and as an orderly exit strategy. While economic and monetary union is one of the negotiating chapters of the acquis, the EU candidate countries are not expected to become full members of the euro area, to adopt specific exchange regimes, or meet the convergence requirements set out in the Maastricht Treaty on European Monetary Union, as preconditions for EU membership. Even so, one of the negotiating chapters of the acquis communautaire⁶ does focus on economic and monetary union. The European Union has decided that new EU members will be required to join the euro area and, under the acquis, all EU members are to treat their exchange rate policy as a matter of common interest. Thus, the new members must integrate their exchange rates into the financial

⁶Body of laws and regulations each EU member or candidate must abide by.
architecture of the EU and avoid excessive fluctuations of their exchange rates which could endanger the functioning of the EU’s Single Market. Consequently, many candidate countries have implemented exchange rate policies as part of their accession program which are in line with those of the EU. The main target of these exchange rate policies is currency stability. This serves to stabilize the economies-in-transition of these countries, but also to facilitate their accession to the EU and to the euro area.

Although the EU accession process does not set specific requirements for fiscal and monetary policies in the applicant countries, macroeconomic requirements are specified. Under the convergence criteria of the 1993 Maastricht Treaty on European Economic and Monetary Union, countries are required to keep their exchange rates within normal fluctuations margins for at least two years in the exchange rate mechanism (ERM). The second stage of EMU - ERM II - is based on margins of plus or minus fifteen percent against the euro. Additionally, inflation must remain no more that 1.5 percentage points higher than the average of the three lowest inflation rates in EMU member countries, while the fiscal deficit must be below 3 percent of GDP and the government debt must be below 60 percent of GDP. The convergence of the accession countries to these criteria depends on different domestic macroeconomic factors and choices for economic policy. The candidates have thus far employed diverse exchange rate regimes in order to facilitate their convergence.

Given the criteria requirements of EU and EMU, a currency board is a perfect lead-up to Romania’s accession to both unions. This monetary arrangement would not only ensure the stability of the macroeconomic factors, but it would also provide practice in financial discipline for Romania’s highly undisciplined economic, financial, and political arenas. A currency board in the pre-accession period fully fits into the rationale of the appropriate monetary and exchange rate strategies for this transitional period. Specifically, these are strategies of irreversible anchoring of the monetary policy to the exchange rate, and of adoption of increasingly rigid exchange rate arrangements. The
currency board meets both of these conditions.

For the transition economies of Eastern Europe, admittance into the euro area will thus depend upon the degree of convergence that has taken place in their economic spheres in terms of inflation, interest rates, budgetary and debt position, and exchange rates. Real economic performance will also be a considering factor, particularly, economic growth, and trade and current account balances. Although these factors allow entry into the euro area - a goal targeted after the general accession to the EU - they also prepare a candidate country for satisfying the Copenhagen criteria of a functioning market economy.

For a transition economy such as Romania, the adoption of a currency board arrangement now may be the solution it needs in order to stabilize its macroeconomic factors, gain credibility in its markets, and materialize its adherence to the both the European Union and the European Monetary Union.

Plan

In discussing the objectives set above, the thesis will be organized as follows. Chapter 2 presents a literature review on the process of transition in the countries of Central and Eastern Europe. Chapter 3 discusses the opaque political process in these countries and its adverse effect on their economies, specifically on the rate of inflation. Chapter 4 discusses inflation, its causes and effects, with an in-depth analysis of Romania's inflationary process. Chapter 5 presents a theoretical review of economic policy, and particularly of monetary policy. Chapter 6 discusses the option of a currency board arrangement as a way to curb inflation. Chapter 7 discusses the macroeconomic policies adopted by Romania in its years of transition, analyzing the successes and the failures of these policies. Lastly, Chapter 8 discusses the application of a currency board arrangement in Romania as a means to stabilize the internal economy and to facilitate Romania's convergence to the criteria of the European Union.
Chapter 2
Theorizing and Understanding Transition

"Engels . . . does not speak at all in favor of those who think that under socialism existing economic laws can be abolished and new ones created. On the contrary, it demands, not the abolition, but the understanding of economic laws and their intelligent application."

-speech of Josef Stalin to his economists, 1951

The history of Eastern Europe may have been very different if the neo-Stalinists constructing socialism in Brezhnev’s Eastern Europe would have taken heed of Stalin’s own words on successfully running a socialist economy before they rejected the entire notion of economic reform. In warning his economists that their pricing policies were defective as a result of their lack of understanding of the law of value - a standard economic law functioning under both socialism and capitalism albeit in different ways - Stalin ironically explained the deconstruction of the Eastern European socialist system. More than three decades later, the socialist regime came to an end in what proves to be the world’s most important event since the end of the Second World War. For the countries emerging from socialism in Eastern Europe, transformation of their command economy to a new political and economic system has only partly been achieved. In transforming to a radically different regime requiring genuine and complete systematic changes, these countries do not have the benefit of path dependence. Thus, in their pursuit of development without a map, sensible strategies for the future depend crucially on learning the right lessons from what has been done and theorized in the past. Most importantly, these countries and their leaders must acknowledge the veracity of Stalin’s words of caution, for without implementing accurate economic principles those constructing the transition process will suffer the same failures as those who have attempted to construct socialism.

Since the collapse of the old regime, the cold winds of competition - bellum omnium contra omnes - have been blowing throughout Eastern Europe. Dissatisfaction with everything has been on the increase and everyday life has become more insecure in
terms of all economic indicators. The capitalist paradise is nowhere in sight and the deadlines for the miracle to materialize - set and reset by the first (and second and third) team of freely elected, or at least newly emergent, politicians - has repeatedly passed, while targets set for stabilizing the economy have all been largely missed. This spread of disillusion is not the result of the immediate hardship experienced, but rather it springs from the loss of illusions cherished in 1989, from the host of unfulfilled promises, and from the feeling of being taken into a somehow not quite worthy affair. These sentiments, along with the systematic changes occurring now in Eastern Europe, allows for relevant analogies to be drawn from economic history. Although the historical approach to understanding transition may not provide much insight into solving the complex issues facing Eastern European countries today, it does provide important complementary explanations.

It has been argued that the Eastern European revolutions of 1989 most resemble the European revolutions of 1848\(^7\). Indeed, a comparison between the socialist and the feudalist systems does show similarities. Both societies were characterized by an all-encompassing hierarchy, the delegation of partial property rights to a local lord by a sovereign, and the lack of a rule of law. John Stuart Mill writing his famous treatise *On Liberty* argued that the demand for liberalization in the 1840s was a natural response to the inefficient and rudimentary state apparatus. Since little can be entrusted to today’s Eastern European governments, similar demands are raised in the post-socialist world which stand enforced by radical liberal economists.\(^8\) The policy response to the European revolutions of 1848 - much like the current response debated in Eastern Europe - was a mixture of democracy, nationalism, and liberalization. According to Aslund (1992), it

\(^7\)Dahrendorf, R., *Reflections on the revolution in Europe: in a letter intended to have been sent to a gentleman in Warsaw*, Times Books, New York, 1990.

was not by coincidence that a laissez-faire ideology followed upon feudalism. A simple cost-benefit analysis shows that the primitive state hierarchies did not foster the capacity for accurate decision-making because the markets were not fully developed. Yet, by shifting a significant proportion of decision-making to the market and passing laws on the freedom of enterprises resulted in lower transaction costs. Thus, laissez-faire embodied the rational response to the prevailing situation in the mid-1800's much like it should in today's transition process in Eastern Europe.

A further striking comparison of the two different sets of revolutions rests on the changes brought about by these political turning-points. In both cases, a fundamental revolution occurred which brought with it important systemic changes to the political system: it deconstructed the entire former state apparatus by liquidating the old hierarchy. Yet, what Aslund did not make clear (and could not as he was writing in early 1992) was that this deconstruction was by no means a "creative destruction" in Schumpeterian terms, for nothing was constructed in place of the old. For many countries in Eastern Europe, a vacuum remained, void of norms, ethics, laws, institutions, and any relationship between citizens and civil servants. Even more detrimentally, this vacuum was the prime environment for the proliferation of corruption and opaque governance. Thus, the argument that the state should be deprived of as many functions as possible accounts for a liberal argument which is very appropriate for the post-socialist society.

The experience of Central and Eastern Europe after the First World War provides for a second significant analogy to the post-socialist state of affairs. The collapse of the Hapsburg empire during World War I is similar to the collapse of the Soviet empire in the Cold War. The current situation in Eastern Europe is, thus, correctly described as a postwar panorama. Except for Czechoslovakia, the states emerging from the Hapsburg

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10 Ibid.
11 Szamuey, H., *A "coming home" or poisoned chalice?* Centre for Research into Post-Communist
empire - much like those emerging from the Soviet empire and from socialism generally - experienced a high rate of inflation. In the post-war scene, macroeconomic stabilization emerged as a result of independent central banks, separated and stable currencies, and international financial support from the League of Nations\textsuperscript{12}. The favorable experience of Czechoslovakia as an example apart from the rest shows that swift (and early) currency reform together with strict macroeconomic policies provides the greatest opportunity for economic success. The lesson of Czechoslovakia contributes to the study presented here, for reform of the currency coupled with stringent macroeconomic policies (especially, monetary and fiscal) is argued to be the best approach to the process of transition from socialism.

The historical approach allows for some tangencies between the experiences of different countries over time. Yet, this approach does have its limitations especially in applying it to the radical changes occurring in the post-socialist world. The Eastern European countries of today must face economic and political situations marked by an unprecedented degree of uncertainty and chaos. They must navigate uncharted waters toward a destination they know little about, and moreover, with few tools. Thus, the institutional approach better suits the attempt to explain the post-socialist transition. Analytical and structural in nature, this approach draws analogies between different countries in similar stages of their economic and political development. In the process of transition, there are advanced reformers and laggards, and the institutional approach appears to be the best way to see how a similar situation was handled successfully by an advanced reformer in order to apply the lesson to benefit a laggard. This specific approach will prove most useful in the later discussion of a currency board arrangement as a tool for currency reform and macroeconomic stabilization.

Institutionalism concerns the construction of new governance, economic and legal systems to support the transition from a centrally-planned regime, and to build a functioning modern market economy. "Post communist reform is, in this sense, about the reworking of modernity and the reconfiguration of the economic and political institutions and practices put in place (or adapted from pre-communist days) by state socialism."\(^{13}\) In many transition countries, the state-owned enterprise was a social and economic institution during the communist regime: they provide a wide range of services for workers and their families, including healthcare, housing, schooling, and pensions. With the fall of communism, the role of these enterprises became constrained as their funding decreased. Although the state-owned enterprise (SOE) remains a vestige of the centrally-planned system, it no longer provides such a variety of services. When institutions are disintegrated, or if they still exist but only as tools for the politically perverse to benefit personally, the government cannot proceed with successful reforms. Moreover, if the existing institutions are run by individuals with skewed incentives, the government becomes an impediment to economic activity as corruption becomes the norm. This latter case is a good portrayal of the situation in the Eastern Europe, specifically in the Balkans.

Another aspect of institutionalism concerns the development of social networks between economic agents to build trust and efficiency for the creation of functioning market economy. The countries of Eastern Europe exhibit a type of 'crony capitalism' where preferential treatment (ranging from bank loans to Parliamentary positions) benefits a small elite of the population to the detriment of the average citizen. As long as social networks do not exist, this division of the population will lead to greater inequality, poverty, inefficiency in the economy. If access to the credit market is based on an opaque process, the development of the private sector and economic growth are at risk.

Redesigning the social relations fostered by communism and the building of post-communism emphasizes the role of social capital in the process of transition. Francis Fukuyama defines social capital as: “the component of human capital that allows members of a given society to trust one another and cooperate in the formation of new groups and associations.”\(^\text{14}\) The author contends that economic activity is successfully carried out by organizations requiring a high degree of social cooperation, and that societies marked by familism, or, in this case, crony capitalism, are low trust societies. In these societies, the economic sphere depends on relations of kinship or friendship, with the state playing a significant role. Countries such as Romania and Bulgaria are specifically lacking social capital; instead of trust, bribery of public officials is the status quo, which goes to explain the difficulties in establishing a competitive market economy. In contrast, higher trust societies, such as Hungary and Poland, are characterized by large-scale, more productive corporations. The empirical data used by Fukuyama suggests that societies based on familism have lower economic growth (level of GDP) than societies based on professionally-managed businesses. The conclusion emerging from this argument is that familist societies should supervise, in a checks and balances fashion, the intervention of the state in economic affairs in order to ensure a brighter economic future. The school of thought on institutions and social capital is large\(^\text{15}\), but their final argument is clear and well-defined: without the institutions and the social network, the market system, and its building blocks, will collapse. A validation of this contention is Russia’s regression to a barter economy when faced with a severe market inefficiency and an even graver lack of market-supporting institutions.

The institutions fundamental to the private market are the monetary and fiscal institutions. When well-developed, these institutions provide a checks and balances


\(^{15}\)The most prominent supporters are Stiglitz, J. and numerous authors at the World Bank.
approach to the role of the government, through such means as a central bank independent from political influence and a reasonable government expenditure program. In the former centrally-planned economies, these new institutions had to be build from scratch. Monetary institutions had to emerge from monobanks, while fiscal institutions, such as tax administrations, needed financial resources (computers, new staff) and specialized skills (accountants, auditors) which were limited at best.\textsuperscript{16} Moreover, these institutions needed a well-defined legal system to establish their obligations and their strategies, in order to ensure their separation from the inevitable political pressure and to establish a market system governed by the rule of law. Although quasi-independent central banks have been established in most Central and Eastern European economies, with the Baltics transforming their monetary institutions into fully independent currency boards, the formation of fiscal institutions has encountered much difficulty. Even the leaders in transition, Hungary and Poland, have not been able to fully complete the process of establishing new tax systems as a source of government revenue.\textsuperscript{17} The reasons for this failure can be attributed to the lack of financial resources, specialized skills, and the ability or willingness to insulate these systems from political influence. Table 2 shows the developments made in the creation of tax revenue systems, and in general government revenue and grants. The first figures for each country represent the amount of tax revenue received by the government as a percentage of GDP, and the second figures represent the general government revenue and grants.

\textsuperscript{17} ibid.

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The first set of figures show the countries of Central Europe as recording the highest tax revenues. These results complement Table 2 since these countries are also those which have made the most progress in transition. In contrast, the Balkan countries average tax revenues in the high 20’s as a percentage of GDP. This data suggests that the former group of countries has been able to insulate its economic institutions from political interference, while the latter group has not. In circular fashion, this outcome further improves the economic progress of the first group of countries. Similarly, the second set of figures show the Central European countries as having higher general government revenues than the Balkan countries. The lower revenue and more shallow financial markets (as shown by Table 2, last column) suggests that the government spending in the Balkan countries may be more of a burden on the central bank through adjustments in the monetary base. The general observation resulting from this table is that there is a downward trend in both, tax and general government revenues, suggesting that these percentages are not sustainable.

The other side of the fiscal coin is general government expenditure and net
lending. Despite the tax revenues shown above, it does not seem possible to avoid fiscal deficits for the transition countries. The first set of figures in Table 3 shows the developments in general government expenditure and net lending in the period from 1989 to 1998, while the second set shows the overall general government balance in the same time period.

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This table shows that although government expenditure has shown feeble signs of decline, fiscal deficits are still present. The main reason for these deficits is the large role of the state as it engages in far too many activities, such as subsidies to suppliers and consumers. In many cases, these expenditures come at the expense of social programs due to political pressures. The figures for the government expenditure are quite similar to those in advanced industrial nations which can support a welfare state as a result of sound treasuries and deep financial markets. Transition economies, especially the weaker Balkan states, do not have the capacity to sustain such high levels of expenditure since their access to non-inflationary financing of the deficit is limited. Consequently, inflation emerges as the tool for balancing the budget, much to the detriment of the economy. In
the cases of Romania and Bulgaria, the deficits are actually greater since the largest expenditures are observed in quasi-fiscal accounts in the form of credits to SOEs. These accounts are not included in the government’s budget, but they still require financing. As a result, inflation in these countries also exhibits higher levels than in Central Europe. The case of Bulgaria after 1997 is a special one, and it will be treated more in-depth in later chapters. Worth mentioning now is that Bulgaria shows a positive government balance after 1997, the year when it implemented a currency board arrangement. This arrangement emerged as a critical institution for Bulgaria, both monetary and fiscal in nature, which managed to successfully tighten the monetary policy of the country, while also disciplining fiscal policy. The application of such an arrangement in Romania with the goals of curbing inflation and fiscal deficits will form the crux of this thesis.

Thus, the need for institutions in building efficient market systems cannot be underestimated. Stabilization of the transition economies requires sound monetary and fiscal policies, which in turn require well-developed institutions.

Aside from the historical and institutional theories of transition, an understanding of the post-communist sphere generally, and of Romania’s transformation particularly, must start with actual policies implemented and the rationality behind them. In this context, the most subtle, yet most significant aspect of the transition process proved to be the attitude toward change before 1989 and after. While the countries of Central Europe entered the transition process with some experience in the ways of a market economy, the countries in the Balkans, specifically Romania, did not have an encounter with democratic principles or a market ideology prior to 1989. This fact supports the ideational approach by showing that the countries in which leaders were convinced of the superiority of a market system, and committed to implementing reforms towards this end, entered the transition process better equipped for transforming their economies.

The success of Hungary arises from a background of free markets achieved under
communism, during "the unpredictable but accommodating regime" of Janos Kadar.\textsuperscript{18} The "goulash communism" instituted by Kadar consisted of both market and socialist elements that allowed consumer prices in Hungary to parallel those in countries outside the Soviet Bloc. As a result, Hungary was spared the debilitating levels of inflation experienced by other formerly-socialist countries in the years of transition, and consequently, it experienced a mild shock. Furthermore, its financial institution regulation and corporate fraud-control in the post-communist period upgraded it to an investment-grade-rating, meaning that its bonds are safe enough in terms of risk to be eligible for Western universities and pension funds.\textsuperscript{19} Currently, Hungary enjoys substantial foreign investment as a result of its relatively open, market-oriented economy achieved during the pre-democracy period. It also possesses some of the necessary institutions for transition to a competitive market economy, such as market-style legal and regulatory structures characterized by international accounting standards and bankruptcy procedures. These features allow the development of a strong private sector, while minimizing the burden of inefficient state-owned enterprises (which takes the form of financial blockages such as arrears) on the state.

Just like Hungary, Poland enjoyed the same type of political and market freedom before 1989. Lech Walesa was allowed to run for the presidency as a trade-union leader (although unions were illegal), evading the communist regime’s only-one-party rule, and surprisingly, winning the election.\textsuperscript{20} Although the trade union (Solidarity) demanded wage increases and lower prices, the architect of Poland’s shock therapy transition, Balcerowicz, convinced the new government that government wage controls were necessary, while price controls should be abolished. As a result, costs and prices were lowered. Moreover, Balcerowicz stood ready to take on the G-7 creditors to which

\textsuperscript{19} ibid.
\textsuperscript{20} ibid.
Poland was in debt, while tackling the vested *nomenklatura* and diluting the Soviet ideology. Consequently, Poland became the first Central and Eastern European nation to break away from the Soviet block. Michelman (1998) argues that there was no Iron curtain separating the Polish leaders from the Western world, such that Balcerowicz publicly supported institutional economics - by his definition, meaning that one system will perform better than another because of its institutional arrangements (such as state versus private ownership), and not because of an allegiance to utopian principles.

In addition to Hungary and Poland, the Czech Republic also had a smooth transition (and a "velvet" revolution) due to able leadership, Vaclav Klaus, a finance minister turned prime minister, had no prior affiliation with the Communist Party, and was strong in his belief for the free-market ideology. “The less state intervention and subsidies, the better he likes it, although he has pragmatically used the state to hold down inflationary wage-increases, a strategy to which he attributes much of his success.”

The experience of these three countries validates the ideational approach, as it shows that individuals and their ideas matter in national development. As shown by the cases of Hungary, Poland, and the Czech Republic, individuals have the ability shape the policies of their nations, determining the trajectory that these nations will follow in their future development. In contrast to the Central European trio, Romania has lived under a power-obsessed dictator until the last days of December 1989. Ceausescu was a Stalinist figure whose paranoia and delusion (along with his well-armed secret forces) kept the nation bound in a political and economic straitjacket. As a result, the market ideology was not embedded in Romania’s socio-political sphere. Once the revolutionary euphoria faded away, the process of creative destruction failed to occur and an institutional vacuum became the status quo for the first decade of transition. As a consequence of this institutional void, the country went through a moral crisis where individual interests took

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21 Michelman (1998), p. 64.
the form of corruption, and the political process lacked moral legitimacy. In a vicious circle, real institutional change was further blocked, setting Romania apart as a laggard in transition.

Aside from the initial conditions, the laggard countries suffered (and continue to do so) from a misunderstanding and misapplication of economic policy. A victim of poor or biased political and economic policies, the process of transition suffers greatly from misperceptions and distorted expectations of what should be achieved and how. Many erroneous policies resulted from misguided expectations. Against this background, it is only reasonable that in some countries transition policies have not delivered what their designers expected from them on the basis of unsound understanding. The prevailing idea in Eastern Europe seems to have been that, after the victory over the communist political regimes, the post-communist transition was a task to be accomplished by the West and its agencies (the IMF, the World Bank) 22. Romania especially adopted this notion as a result of the popularity received by its December 1989 revolution which was aired on Christmas Eve by all television stations worldwide. Throughout the post-socialist world, the attitude was that by overthrowing the ancien regime the East had done its part and it now expected its reward from the West (generally in the form of assistance to economic development and integration on every level with the outside world). And the Western multilateral agencies stood ready to step in with conventional, neo-liberal policies involving economic liberalization, marketization, and democratization.

Summed up by the “shock therapy” approach, these policies relied on an under-theorized understanding of transformation in Central and Eastern Europe. In contrast, the reality shows that the formerly socialist countries have actually lost a war - the Cold War - and now they are paying the costs of four decades of straying on a road which history finally disproved. Thus, quick improvements to the economic and political situation

cannot, realistically, be accepted. While the breakdown of old inter-linkages was immediate, the emergence of new structures with new institutions is a gradual process which takes time, but which is critical for the success of the transition to a functioning market economy. Yet, in order for this process to get underway, it is crucial that transition countries have knowledge of their own reality and the ability to turn this knowledge into the base of coherent policy toward development. With this self-awareness, and the guidance of the Western world, Central and Eastern European countries can reconfigure the fabric of their societies so as to construct capitalism and create the formal structures and institutions on which liberal democracy can be built.23

The model of transition to be followed by these countries is portrayed in Figure 2.

Figure 2: Model of Transition


As can be seen from the above figure, transition is a complex process which needs time to develop successfully. The early years of the transition, up to seven or eight years into the process, have seen an economic collapse, a large increase in unemployment, along with social and political disorientation, all which resulted in the prosperity of some and the fall of others into abject poverty. The reason behind this dismal start lies in the wrong policy approach. The first phase of transition in Central and Eastern Europe consisted of the simplistic ideology of shock therapy, which dealt the shock but came up empty on the therapy. The words and objectives at the debut of transition were more than axiomatic; they were deemed as sacred for economic change - private property, free enterprise, free market, competition, and so on. This situation was mirrored in the political agenda, where phrases like multiparty system, freedom of expression, free elections, “entering Europe”, had - and continue to have - the same characteristic of infallibility as the basic principles of a new religion. Yet, the new society sought by these countries - tersely termed “capitalism” - comprises a complex structure of a large number of elements,\(^2^4\) which needs to develop the appropriate supporting institutions before the axiomatic terms can have any real meaning. Firstly, the structure is based on the linkage of the different economic subjects in the economy by market relations. Second, for the proper functioning of the market, the economic subjects must be independent, and their independence must be enforced by property rights. Third, the economy must have strong and reliable institutions enforcing the contracts arranged between economic subjects; a legal framework enforcing the institutions is of crucial importance. Fourth, the political system must guarantee in a constitutional format all the above elements. All these elements are interdependent, and they either reinforce or undermine each other. A more in-depth discussion of these four elements brings to light many of the questions facing the former socialist countries, while also elucidating the goal of transition -

and the means to achieve it.

Firstly, market relations of a freed economy - or marketization - are essential for the construction of capitalism. Nevertheless, this represents a foreign concept to those emerging from a command economy. While a market economy grounds itself in real money as a unit of account, a store of value, and a means for transactions, the role of money has been very limited in the socialist economy.\textsuperscript{25} It was mainly a means of control of plan fulfillment, and it circulated in isolated groups. The account money of enterprises was strictly isolated from the cash held by the population. Few financial instruments existed, while the rate of interest, usually very low, was of little relevance to the monetary system. A significant distortion present in the command economy was price discrimination among different customers, with low state prices for the privileged as the rule. A different exchange rate existed for every significant item of foreign trade, and the currency was not convertible. In contrast, a market economy relies on a unified exchange rate and a convertible currency. Given these characteristics of the socialist economy, many questions about the transition to a market economy arise: should the old currency be revived (in the case of newly-independent states from the former Soviet Union) or would a currency reform be favorable? Should the exchange rate be fixed, pegged, or floating? What should serve as the basis of the currency - international financing and a stabilization fund, or a currency board?\textsuperscript{26} An answer to these questions will be attempted later in this paper, where as the myriad of other aspects of the marketization process will only be touched upon as they relate to answering these questions. Other aspects of marketization include the liberalization of prices, internal trade, and production. With these aspects, the main burden is a political one, for in practice it is simply a matter of abolishing regulations and restrictive policies. The main debate of the transition process - that focusing on the sequencing of reforms - revolves around the decision to adopt a

\textsuperscript{25} Askund, A., 1992.
\textsuperscript{26} ibid.
quick or gradual marketization of the economy.

Second, any form of marketization will require macroeconomic stabilization as a balancing force. The focal points of stabilization are monetary and exchange rate policy with the goal of anchoring inflation.

Third, an important dimension of marketization is the requirement of property rights and the rule of law. The optimal functioning of the market economy presupposes private ownership of the means of production, and property rights must necessarily be introduced. One method for bringing about private ownership is through the formation of new privately-owned enterprises. Privatizing formerly state-owned enterprises proves to be a more complex method. In every respect - politically, economically, and legally - privatization has turned out to be the most difficult part of the economic change in transition. The many privatization schemes which have occurred in Eastern Europe were complex endeavors, hard to orchestrate and with disappointing results. Thus, marketization and privatization are both of little consequence in the absence of the rule of law. In addition to drafting and implementing new legislation, law enforcement must exist in a credible and effective form. For the transitional phase, law enforcement is central to the struggle to curb corruption.

These elements broadly outlined by Kornai define capitalism and are essential for its construction. They are the market-building elements each country emerging from socialism struggles to achieve. In ensuring the stability of a system, reinforcement of the ideology of the system is necessary, be it communism or laissez-faire. The main line of causality in any system runs from the “genetic program” - the official ideology - to the economic outcomes resulting from the pursuit of this ideology. In communism, the genetic material was the Marxist ideology which led to great economic inefficiencies (forced growth, chronic shortage economy) through a chain of causality including the

\[\text{27 ibid.}\]
dominant position of the state, its excessive coordination, and its allowance of informal bargaining between the state enterprise directors and the public officials. Figure 3 shows Kornai’s depiction of the building blocks of communism and the interdependent forces between them.

**Figure 3: Building blocks of communism**

![Building blocks of communism diagram]


The figure shows that each aspect, or block, of the system is affected and explained by other blocks, while the main causality of the system runs from block 1 to block 5. Thus, the system’s ideology forms the decisive element determining the lasting economic phenomena. Kornai argues that a radical change in block 1 will affect the entire system, but only when this “genetic program” is fully modified does a deep, radical, and persistent change occur in the entire regime. “An understanding of the state of block 1 provides the most important analytical tool for understanding all the other blocks and revealing the process and the limitations of the reform process.”

This assessment is especially important for the transition economies which have attempted to democratize their political systems, block 1, while retaining properties (such as opaque networks) and members of the former communist system. Specifically in the case of Romania, a radical change needs to be implemented in order to transform the persistently corrupt political process, and allow genuine, lasting reform. A partially reformed political system - as is the case with the Balkan countries, and Romania especially - hampers full economic reform and leads to serious economic imbalances, such as high levels of inflation. The

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The main conclusion emerging here is that isolated changes in some of the blocks of the system will not result in a functional market economy; yet, such isolated changes have, indeed, been attempted in the form of private ownership (changes to block 2), and price liberalization (changes to block 4), which did not result in a solid reform program. Thus, the success of economic policy depends on the institutional context within which it is implemented. By analyzing the current governing ideology in Romania - a type of democracy sprinkled with socialist elements, although some may argue the exact opposite - this paper will portray the limitations of Romanian reforms, and will propose a new plan of action which will fully support the main causality of a functioning capitalist system.

Despite the many changes that occurred in the transition economies, few of them have been truly radical according to Kornai, since elements of the old system are still well engrained in the society. From political liberalization to revival of the private sector to price reforms, no deep, permanent changes have yet occurred. In my mind, the reason for this general disappointment with transition reforms has been the lack of appropriate policies in the appropriate time frame. On the road to capitalism, timing of policies is the key. For what may work well in the advanced reformers, like shock therapy in Poland, may prove disastrous in the laggard countries which do not have the institutions to support such radical change. In the process of transition, time represents the singular element governing the sequence of reforms. In the process of mapping out the successful transformation of a command-economy to a market system, the leading debate occurs between two schools of thought - the supporters of shock therapy versus the advocates of a gradual transition. As previously mentioned, shock therapy policies seem to emerge from undertheorized approaches to transition. As such, they mostly proved beneficial in the transition economies which already had the institutional framework to support such intense approaches, namely the more advanced Central European economies.

The theory of a swift transition focuses most strongly on aspects of stabilization and liberalization. Regarding stabilization, it is generally argued in favor of restrictive
monetary and fiscal policies so as to combat budget deficits. As for liberalization, a core argument supports the rapid elimination of domestic price controls by the state. Among the most common, a broad consensus upholds that macroeconomic stabilization from high inflation could only be achieved through radical measures, extreme enough to curb inflationary expectations and to create credibility in the process of reform. During periods of high inflation, balancing the budget becomes a vital element. As financing is not available on a large scale, drastic cuts in expenditures form the backbone of a balanced budget, especially as tax collection systems function poorly in the phase of transition. To easily cut expenditures, the government usually targets subsidies, the existence and formation of which tend to be products of price regulation under high inflation. Thus, the maneuver of balancing the budget through cutting subsidies requires the liberalization of prices; this deregulation would additionally abolish any expectations of future inflation. Nevertheless, the abolition of subsidies and the deregulation of prices suggest that the population will suffer substantial losses. It is in this respect that shock therapy finds its raison d'etre: it is easier for the political process to adopt all the necessary harsh measures as one package of legal acts issued by the parliament. If a variety of reforms are introduced at the same time, it is more difficult to assess the winner and losers of the reforms, while the formation and encroachment of vested interests in the process will be delayed. A political momentum would be created around the reform program which would be difficult to oppose. Thus, aside from the elementary economic theory, shock therapy is mainly a political decision. A shock treatment is perceived to add to the credibility of the transition strategy in a society which may be skeptical due to its earlier communist reforms. Furthermore, it has been argued that the population, if properly informed, would not contest a democratically adopted harsh stabilization, but would

rather accept it. If convinced of the depth of the crisis, people are willing to undergo substantial suffering in the forms of severe measures with the condition that these measures seem appropriate for bringing the upturn closer. Yet for this conviction to hold, people must trust that the government's reforms are for the benefit of the nation as opposed to personal gain. This last argument may prove quite beneficial for the adoption of a stringent monetary measure to be analyzed later in this paper.

As the environments of the command and the capitalist systems are so alien to each other, in the form of structure and incentives, a rapid transition may seem more appropriate than a gradual adaptation. As no convergence of the two systems has ever been possible, a piecemeal improvement of such elements as the highly distorted old price system proves impossible. A full and rapid liberalization appears to create a smoother transition path as compared to the contradictions, uncertainty, and possible new distortions that can emerge from a gradual process. In my opinion, this is merely an apparition. The gradual process of building market institutions and ensuring long-term reforms cannot be bypassed on the way to a competitive market economy.

A third argument in favor of the shock therapy approach revolves around financial discipline in transition and the imposition of hard budget constraints on state-owned enterprises. As Kornai explains, socialism accustomed state-owned enterprises (SOEs) to a freely flowing supply of money, also known as soft budget constraints. As a result of this feature, many SOEs relied on the government as a lender of last resort, while they mismanaged or ignored their financial health. Thus, resources (including money) were gravely misused in socialism, as their allocation could have been more efficient elsewhere. Even more detrimental, the socialist system was characterized by two types of money: cash - used in consumer and labor transactions - and account money - used in transactions with enterprises. A major flaw emerging under this division of the different forms of money was the divergent value of one unit of the national money in the two different forms. An example of such a case is represented by Russia where in 1989 one
cash ruble was worth three account rubles\textsuperscript{30}. As account rubles were in greater supply, this form of money was marked by repressed inflation. This distortion becomes a grave condition in the process of transformation to a market economy. A market system - with its fundamental definition of money as a unit of account and a store of value - cannot maintain different forms of money as all money circulation is unified. Thus, assuming everything else constant, SOEs would benefit from a larger share of the available amount of goods and services if these enterprises were to exist unreformed in a market economy. The immediate effect of this would be a fall in the standard of living of the population. The argument for a swift reform emerges from the conclusion that state enterprises will hoard final output by raising prices until they are forced to sell due to a shortage of money.\textsuperscript{31} Thus, for the proper functioning of the newly-adopted market economy, SOEs need to face financial discipline and hard budget constraints as early as possible. As hoarding will decline, more goods and services will enter the market and competition will arise between enterprises, thus raising the well-being of the population. Without strict macroeconomic stabilization in the form of hard budget constraints, SOEs will not adapt or restructure their pricing and supply methods. This result suggests that macroeconomic stabilization forms the foundation for microeconomic adjustments.

Other arguments in favor of shock therapy center on quickly abolishing corruption and on building a new political and intellectual climate which proves that the old skills no longer apply in the new environment. Yet, the importance of lag effects in considering shock therapy have been grossly ignored in Eastern Europe. The fact that bankruptcies and unemployment did not occur instantaneously after these severe measures gave the mistaken impression that they will not occur at all. Additionally, many of the advocates of shock therapy based their arguments and convictions on statistics emerging from an inaccurate data-gathering system (possibly intentionally inefficient

\textsuperscript{30} Aslund, 1992.
\textsuperscript{31} Lipton and Sachs, 1992.
under the socialist system of meeting quotas). In many cases, these erroneous figures formed the base of invalid and simplistic recommendations. Coupled with the vague terminology of transition, these easy recipes gave way to a simplistic ideology surrounding the complex process of transition.

This simplistic ideology gave rise and faith in quick fixes as those espoused by shock therapy. In the form of transplanting knowledge available elsewhere, these quick fixes were at the heart of the early post-communist agenda while also being the reason behind its failure. Nevertheless, the sobering experiences of 1990-1992 did create a change of tide from faith in any quick fix. Forecasts of protracted, indefinite depressions, and of endless impoverishment, coupled with uncertainty about the type of economic institutions required and the type of long-term policy priorities, made it clear that neither quick improvements nor an automatic recovery from the crisis could realistically be expected in Eastern Europe.

Nevertheless, no one familiar with the literature on transition would doubt that expectations for quick improvements have been widespread across post-socialist Europe. Not only amateur politicians and commentators, but also respected professional economists fueled such unsound expectations as the existence of regular food supplies, uninterrupted heating, stable currency, job security or the continued provision of social services following the scene prevalent after the communist overthrow - characterized by Szamuely as a lost war. As economic and political failures abounded, the world came to the realization that institution-building along with the creation of private enterprise and market relations need time to develop. The previous one-sided emphasis on the radicality of intentions and projects has been giving way to more circumspect views focusing on the conditions in which a given measure might be implemented. And the early experience of the transition countries seems to show that gradualism fared better as an approach to transition than shock therapy.

Gradualism represents a far more universally employable method than shock
therapy as it allows permanent institutions supporting the market economy to develop. The period of application of shock therapy has to be brief (if at all) because of the social costs that it extracts. An increase of these costs over time may threaten all popular support for the reform process. Thus, the crux of the gradualist argument is the desire to minimize the costs of the systemic changes. These changes take the form of changes in systemic infrastructure - known as transformations in the real sphere - and changes resulting from the replacement of one mechanism with another - referred to as transformations in the institutional sphere. A basic premise of the gradualist, or evolutionary, scenario is that there should not be any contradictions between the changes occurring in these two spheres. Particularly, harmony must be observed in transformations occurring in the economic mechanism, specifically in the relationship between prices, exchange and interest rates. This premise rules out such radical and incomplete measures as the rapid privatization of the economy while leaving in place government-controlled prices, exchange rates, and below-inflation interest rates. The advocates of gradualism contend that the main restriction on the pace of reform lies in the real sphere. This specifically refers to the restructuring of production which is to be the touchstone of the pace of reform in the institutional sphere. Although these principles rule out the transformation of the whole economy in a short period, they do not rule out the transformation of that part of the real sphere which lends itself to complete liberalization in the short term.

While proponents of shock therapy focus on the conditions arising under market equilibrium, gradualists scrutinize the outcomes when market equilibrium is not reached. Most important for the gradualists is their opposition to laissez-faire solutions because of their conviction that well-functioning markets need well-established institutions. Thus, it may be argued that gradualists focus on a different aspect of transition. Instead of debating on the rapid liberalization of prices and the imposition of restrictive monetary and fiscal policy, the advocates of gradualism claim the importance of institutional
guidelines with special consideration for property rights, freedom of contract, and rules of competition. Without these guidelines in place, they correctly argue that shock treatment leads directly to economic decline - a situation observed repeatedly in the early stages of transition. Does this suggest that the supporters of shock therapy have little of value to contribute to the debate on marketization, privatization and institution-building? Since a well-functioning market is the only institution explicitly taken into consideration by most neo-classical shock therapists, they indeed make no valuable contribution in this respect.32 However, in a recent trend, neo-classical economists have been inclined to include institutions into their framework, thus developing a new branch of thought known as neo-institutionalism. These economists focus on the right to use productive resources, suggesting that the establishment of property rights is of crucial importance in the field of transition.

The use of shock therapy throughout Eastern Europe has occurred as a result of political reason without much consideration for the social and economic costs imposed by such a method of transition. The application of quick fixes was generally lacking the necessary theoretical foundation as well as a discussion among specialists of the real transformations needed. The result of this has been profound economic crisis throughout Eastern Europe. Today, more than a decade into the transition, many countries are still suffering from the misuse of shock therapy, but many may still benefit from an adherence to gradualist approaches. Especially concerning the laggards in the process of transition, it has become evident that shock therapy will not produce the expected outcomes in the foreseeable future.

Nevertheless, the 'shock-versus-gradualist' debate does reflect the lack of well-accepted conceptual economic models. The results seen in the transition countries of the Balkans show that "poorly digested, contestable or fully untested macroeconomic

theories were combined with profound disrespect for the peculiar qualities of transforming economies, namely the context, meaning and dynamics of their systemic change. Economic policy is not conducted in a vacuum, and thus, it must incorporate national circumstances and national goals in order to be successful in the long term. In the case of Romania, it is not advisable for the administration to adopt isolated economic policies which do not account for the country’s long term goal of entering the European political and economic union. Doing so leaves the door open to future inconsistency between policies, which can result in significant economic imbalances, undermining the entire progress of reforms. A serious commitment to acceding to the European Union and to the European Monetary Union requires that policies adopted for internal reform be complementary to the foreign policy of adopting the acquis communautaire. Although there exist no clear models of transition, the debate between shock therapy and gradualism sets the stage for discussing the transition strategies in Eastern Europe and in identifying the success stories of this complex process.

Chapter 3

Inflation and the political process

"Men will always turn out badly, unless they are forced to be good."

-Machiavelli, The Prince

The people revolting against the communist regimes in Eastern Europe did so in the name of liberty and democracy. The new governments that came to power were expected to transform the formerly totalitarian system of governing into a democratic process characterized by fair and free elections and the establishment of legal institutions that foster the consolidation of democracy. Yet, many of the new governing groups consisted of former members of the nomenklatura, and they continued to rule based upon the same opaque network which thrived under communism. The nature of the political process became a cleavage separating the countries successful in transition from those lagging behind. The Central European successful trio - Poland, Hungary and the Czech Republic - instituted a pattern of politics which was social democratic in nature, and thus very similar to the process dominant in most of the European Union member countries.\textsuperscript{34} In contrast, the Balkan laggards hardly reformed their political arena. Bulgaria and Romania continued supporting authoritarian governments, albeit under the guise of spontaneously reformed politicians. As Central Europe showed pluralism in its political sphere, the Balkans exhibited a lack of political consensus where the elites in power refused to acknowledge the legitimacy of any opposing views. This rupture of the Central European countries from those in the Balkans was most clearly understood once the winning trio was invited, along with Slovenia, to negotiate its adherence to the European Union.

Aside from hindering future prospects, the perverse political process in the

\textsuperscript{34} Swain, G., and N. Swain, Eastern Europe Since 1945, St. Martin's Press, New York, 1993.
Balkans resulted in a more imminent threat as well. The phenomenon of rent seeking and the distribution of economic rewards for political support carried a hefty cost for the performance of the economy. Due to the significant power of interest groups, the state sector remained unregulated and grossly inefficient. Unlike Central Europe, the Balkans remained plagued by high inflation. Although Romania and Bulgaria both gave way to opposition forces, they continued to suffer from an unchecked political process reflected in inflation and the drastic devaluation of their national currencies. Therefore, unless strict measures are taken to discipline the political process, vested interests will continue controlling the state for their own interests.

Corruption - the foe of transition

The goal of assessing the effects of corruption in the transition economies requires that corruption be defined or, at least, associated with concrete factors. Throughout this work, corruption will assume the definition provided by the World Bank in its 1995 report Anticorruption in Transition. More specifically, corruption will assume two forms: state capture and administrative corruption. The former type refers to the actions of individual, groups, or firms in both the public and the private sector seeking to influence the formation of legislation or governmental policies to their own advantage. Yet, state capture differs from the conventional form of political influence (such as lobbying in the capitalist systems) since it occurs through the illicit provision of private gains to public officials via informal, nontransparent, and highly exclusionary channels. Although forms of state capture vary from direct bribes to informal control rights, all state capture is generally directed toward the extraction of rents from the state by a narrow group through the distortion of the basic legal and regulatory framework of the society. The latter type of corruption refers to the intentional imposition of distortions in the implementation of existing laws or regulations to provide benefits to either state or non-state actors as a result of the illicit and non-transparent provision of private gains to public officials. The
forms of this type of corruption vary from the payment of bribes in order to open a small business to the major misdirection of public funds by state officials to their own advantage. Corruption is, thus, "the privatization of some parts of the government apparatus for the gains of special interest groups or particular individuals."\textsuperscript{35}

Although corruption is a prevalent malady in many countries today, it proves to be a prominent problem in the transition economies. Table 4 presents a corruption perception index in Central and Eastern Europe in 1997.

<table>
<thead>
<tr>
<th>Country</th>
<th>Index value$^*$</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>3.94</td>
<td>1.78</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>5.20</td>
<td>0.22</td>
</tr>
<tr>
<td>Hungary</td>
<td>5.18</td>
<td>1.66</td>
</tr>
<tr>
<td>Poland</td>
<td>5.08</td>
<td>2.13</td>
</tr>
<tr>
<td>Romania</td>
<td>3.44</td>
<td>0.07</td>
</tr>
<tr>
<td>Russia</td>
<td>2.27</td>
<td>0.87</td>
</tr>
</tbody>
</table>

$^*$Index values range from 10 (no corruption) to 0 (maximum corruption)

The above table shows that the countries of Central Europe experience less corruption than the Balkan countries. In explaining this phenomenon, a strong emphasis is placed on the transparency of the political process and the role of the government in public affairs. In the Balkan countries, the political process is captured by interest groups, such as large, inefficient industries (mining and agriculture) or SOEs, while the government acts to impede market activity by refusing to regulate against the extraction of bribes from enterprises and from the private sector.

Corruption is exacerbated in these countries due to the high concentration of economic power across a narrow group of actors; the poorly developed formal channels of political influence and interest intermediation available (such as the intermediation

\textsuperscript{35}Tanzi, V., and G. Tsibouris, 2000.
necessary to resolve the conflict of interest between the state official as political figure and the state official as businessman); and the weak structure of the legal system. Furthermore, the simultaneous process of political and economic reform in these countries has introduced scope for powerful interests to influence the structure of state institutions and the formulation and implementation of economic policy to their own advantage. More specifically, the rewriting of a large number of laws and policies during transition has made political reform very vulnerable to corruption; the redistribution of wealth from the state to the private sector has sparked less-than-honest interest in acquiring the available wealth; the virtual absence of institutions (within or external to the public sector) that could effectively check the abuse of public office allowed corruption to thrive. The corruption prevalent in the judiciary institution - one of the fundamental pillars of a market economy whose role as arbiter of the law encompasses both the formulation and implementation of public policy - shows aspects of both state capture and administrative corruption. In addition to these elements, economies with high levels of natural resources are more likely to generate powerful interests seeking to capture states and lay claim to the concentrated gains stemming from such resources. Russia is a prime example of this, as it represents a country with a great wealth of resources and a very high level of corruption. These conditions are specifically characteristic to the transition countries, and thus, provide a more thorough explanation as to the reason for the high levels of corruption there.

In answering whether corruption is good or bad, it is necessary to ask for whom? Most certainly for the members of the nomenklatura who benefited at the cost of society, corruption conducted in the ‘window of opportunity’ of transition was a once in a lifetime experience. It was for this reason that the Polish political reform included the policy of lustration prohibiting former officials of the internal security apparatus and their informants from accepting public-sector employment; this policy stems from the idea that former Communist appointees who had special privileges as a consequence of their
valued position as Party informants would seek to secure their dominance in the political and economic spheres in order to keep and increase their gains. From a political perspective, Shleifer and Treisman (2000) argue that you cannot simply “teach an old dog new tricks”; former Communist politicians do not understand what is expected of them in the new capitalist system and often fear that they will be outsmarted by competitors. Consequently, their resort to corruption is to be expected. An example of this attitude is presented by the public officials in Russia who often destroy local business through up-front corruption and excessive regulation even before the firm has accumulated any wealth. The likely reason for this is the fact that many Russian officials see a rather short and insecure future for themselves in politics, and thus, they see no access to future profits due to the absence of political security and of corporate governance mechanisms enabling them to just take equity and count on future dividends. Hence, many politicians grab what they can while they can. Thus, for this group of actors, corruption is beneficial in the short run. In the transition countries, the story goes that if you want to live well despite the increasing levels of poverty, you should seek a position in the government; the sad truth is that there now exists an underground market for government posts, with Parliamentary positions in Romania running as high as thirty thousand dollars. Needless to say, this approach to politics can be devastating for growth. At the national level, the connection between public officials and existing firms encourages a lack of competition, barriers to entry and the restriction of the opportunities of competitors to grow. Shleifer and Treisman conclude that the successful transition of the political sphere from a command economy to a market one must ensure that the government does not prey on society through corruptive measures. For if this should be the norm, distrust of the political process will lead to the loss of credibility in the economy as a whole. Table 5

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37 Information from national newspaper, *Romania Libera*. 
shows the obstacle to the development of the private sector in the form of the “bribe tax” imposed on the newly developed small-and-medium-size companies.

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of firms bribing frequently or more</th>
<th>Average bribe tax as percentage of annual firm revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>23.9</td>
<td>3.5</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>26.3</td>
<td>4.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>31.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Poland</td>
<td>32.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Romania</td>
<td>50.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Russia</td>
<td>29.2</td>
<td>4.1</td>
</tr>
</tbody>
</table>


The above table shows that while most countries in Central and Eastern Europe are affected by the bribe tax, Romania stands out. Half of all its firms must pay continuous bribes in order to continue their operations, which accounts for a staggering four percent of their annual revenues. When the needed public institutions, which regulate economic activity, or provide a checks and balances approach to the government, do not exist - or if they do exist but are plagued by perverse incentives for those who run these institutions - the government becomes an impediment to economic activity because it ends up being used by those who control it for their own private gains.\(^{38}\) This result proves detrimental to the health of Romania’s business environment for two main reasons. Firstly, these enterprises could make much better use of these funds if invested in new business opportunities, or in research and development. Secondly, the unregulated business environment in Romania deters many foreign investors from entering the country with business proposals and the much needed capital. Both of these reasons lead to the same result: low or negative economic growth in Romania.

Aside from the concentrated gains of a group of opportunists during the stages of transition (and especially during the early stages) - the so-called ‘winners’ of transition -

corruption had severe economic and social consequences for the rest of the population as well as for the image of the country in the eyes of investors and international organizations. The World Bank Report of 1995 supports a strong correlation between corruption and the increasing levels of poverty and income inequality. Table 6 shows the high levels of income inequality prevalent in Central and Eastern during the transition process.

Table 6: Changes in Income Inequality During Transition

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>23</td>
<td>34</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Hungary</td>
<td>21</td>
<td>23</td>
</tr>
<tr>
<td>Poland</td>
<td>26</td>
<td>28</td>
</tr>
<tr>
<td>Romania</td>
<td>23</td>
<td>29</td>
</tr>
<tr>
<td>Russia</td>
<td>24</td>
<td>48</td>
</tr>
</tbody>
</table>


The Gini coefficients show that inequality has increased in the transition period. As new wage laws had rarely been instated as early as 1993, these figures portray the level of state capture occurring during transition. The result has been the concentration of wealth in the hands of a few, at the expense of the whole population. Some of these new rich individuals also acquired substantial political power, thus perpetuating the process of wealth accumulation by conspicuous means. The deterioration in Gini coefficients also suggests that there has been a fall in income for certain groups, such as pensioners.\(^\text{39}\)

Thus, there has not been an increase in inequality due to people moving up in the income distribution, but because wealth was raided from the government, and many times with the knowledge of the public officials.

The expansion in poverty of many transition economies originated from the initial decline in the GDP, yet it has remained high ever since. Corruption exacerbates poverty

\(^\text{39}\) ibid.
as the lower economic growth rates associated with corruption weaken the main factor that can actually pull people out of poverty. It has, indeed, been suggested by a few economic analysts that the GDP decline in Russia would have been even more drastic if the output of the underground ‘black’ economy were not accounted for; yet, due to the highly uncertain means for measuring the data backing these claims they have remained marginalized. Nevertheless, the living standard of the poor has been directly, and negatively, impacted by corruption. The misdirection of unemployment or disability benefits delays pensions and weakens the provision of basic public services, undermining the entire social safety net. The poor especially suffer from these problems as they are least able to cope in a system requiring bribes for the provision of basic entitlements. Furthermore, the Prague 2000 report *Making the Transition Work for Everyone* shows that inequality within the transition countries has increased dramatically. This can be easily understood in the framework of state capture through which the ‘early winners’ of the transition gained fabulous wealth taking advantage of arbitrage opportunities characterizing partial reforms and claiming state assets at highly undervalued prices. In contrast to this narrow group, the poor gained very little from the redistribution of assets, thus widening the gap between these social groups. Worth mentioning is the effect of asset-stripping from the economic perspective: in the function for output where the two inputs are labor and capital - \( f(L,K) \) - asset-stripping reduces the capital stock, thus causing a reduction in the marginal productivity of labor. This, in turn, leads to unemployment which can further harm the poor and their living standards.

Within the economy, corruption has the same effect as a highly regressive tax. This, in turn, has a negative impact on small and micro enterprises seeking to develop in the private sector. The World Bank (1998) reports that such firms pay on average more than twice as much of their annual revenue in bribes, thus reducing their expenditure on more beneficial factors such as research and development.

As private or foreign investment is dependent on the level of certainty in the
business environment, corruption negatively affects investment as it clouds the business climate. Corruption raises the uncertainty, and thus, raises the effective cost of investment for the firm. Corruption in the legal system denotes that property rights may not be upheld while contracts may not be enforced; this further reduces incentives for investment. In addition to reducing investment, corruption also bears a negative impact on public revenues (although it certainly increases private revenues to public officials). The World Bank report shows that a substantial share of administrative corruption is directed toward tax and custom officials, possibly resulting in lower tax and customs payments by firms. Such corruption represents a substantial indirect private transfer from the national budget to public officials. This reduction of tax revenues, in turn, reduces the funds available for public services, resulting in inferior quality products and services for society. Parts unaccounted for in the federal budget reflect the capture of state, thus leading to the loss of confidence in the political process and in the loss of credibility in the government’s policies and reform platform. The creation of expectations of future corruption has a detrimental effect on the national economy, as these future expectations are figured into calculations of economic variables, most notable of which is the value of the national currency.

The conclusion of the World Bank Report (1998) is that corruption hinders investment, reduces growth, restricts trade, distorts the size and composition of government expenditure and weakens the financial system. These adverse effects have a negative impact on transition. Thus, a significant feature of the development of the transition path must be the rise of effective leaders who are able to implement and sustain policies that are inimical to corruption. Partial political reforms that break with the previous communist system but do not provide new mechanisms of accountability such as political competition or internal checks and balances generate the greatest opportunities for a narrow set of private sector interests to capture the state. The progress of both political and economic reforms is in itself partly an outcome of the level of state
capture in a given country. Those with power and resources to capture the state can have a vested interest in preventing reforms that threaten their influence or eliminate the economic distortions on which their concentrated private gains are based. Thus, the transition of the entire nation is at stake because of corruption.

More specifically, Hellman concludes that the fundamental tenet of the politics of economic reform is to create a constituency of winners with a stake in sustaining and advancing the reform process.\footnote{Hellman, J., "Winners Take All: The Politics of Partial Reform," \textit{World Politics}, Vol. 50, No. 2, 1998.} Thus, the state and the political figures must not be insulated from the pressures of the net losers in the economy; rather, Hellman (1998) stresses through the partial reform model that the concentrated group of winners must be restrained by an increase in competition with other groups or by restricting their ability to veto reform measures unilaterally. The main implication of the partial reform model is that the winners have a veto power over policy resulting in a transition process marked by a partial reform equilibrium that concentrates gains among the winners at a high social cost. The political dilemma presented by Hellman (1998) is not how to sustain reform in the face of opposition from the net losers in the short term (such as the people losing their jobs or facing lower incomes), but how to advance reform in the face of efforts by net winners to preserve the market distortions that produced their gains. Hellman (1998) argues that the winners will proceed to freeze the emerging market economy in some partially reformed state that maximizes the concentration of rents to themselves. Yet the redistribution of rents leads to a misallocation of resources in comparison with a more efficient rationing that might be expected from a fully functioning market, while the incidences of arbitrage (characterizing the partial reform model) and asset-stripping are detrimental to the economy.

A clear example of this political dilemma was the situation in Romania in 1996 where the winners in the transition economy (mostly former members of the
nomenklatura) sought to reverse the reforms toward market liberalization. Ion Iliescu, former Communist leader and president after the 1989 revolution, along with other influential Parliamentarians financed the strikes of the mining sector (which asked that the reforms of price liberalization and tighter budgetary constraints on the mining industry be reversed) in order to promote an economic destabilization under the newly-elected democratic government. Later in the same year - in the events termed the ‘mineriaiele’ - the group financed the violent attacks of the miners on the City Hall of Bucharest. Although this conspiracy was not successful in turning back reforms - for this reason, Romania’s reforms process has been termed “stop-and-go” reform. The apparent lack of consensus-building in Romania led to many years of political turmoil which left a severe imprint on the economy of the country and on its progress in transition. The high levels of inflation suffered in the early years of transition, and again since 1997, directly reflect the loss of credibility in the political process.

**Corruption and economic development**

The breakdown of the political process and the failure to develop a political consensus in the early years of transition meant that there did not exist a system of checks and balances on policymaking. As a consequence, there was no trust in the political authority and this was mirrored in the lack of faith in the national currency. The subsequent pattern of inflation resulting in the Balkans was a result of this political breakdown.41 As different interest groups took over the political process, these countries experienced large and rapid increases in their money supply mainly resulting from government credits to their political supporters or to appease large state-owned enterprises. “Thus the initial price jumps, which were often much larger than economists

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and policy makers had anticipated, reflected not the past "monetary overhang," but rather sudden losses in confidence due to political turmoil."^{42} Moreover, in a self-perpetuating cycle, these countries did not adopt stabilizations programs and lagged behind in their reforms due to this very same breakdown in the political process. In the vacuum left after the fall of communism, rent-seeking elites captured the political process and used government credit to maintain their position of power and entice members of the opposition. As the pro-reform lobby either succumbed or gave up, inflation remained at high levels. And as people lost confidence in the political process and in the national currency, they formed their expectations of the future based upon the dismal conditions they faced in the present. This ensured that high inflation would be curbed only by the adoption of measures stringent enough to inspire credibility and to change people's expectations of the future value of the national money.

Aside from the monetary implications of the political turmoil, Boone and Horder (1998) make the further assessment that the fiscal crises suffered by these countries resulted from the political mismanagement. The total revenues present were high enough to balance the budget, and yet social programs such as pensions and health care were still drastically reduced. The result has been a greater degree of poverty and a much better endowed ruling elite. Boone and Horder's findings suggest that the economic performance of the transition countries is highly influenced by the political decisions dominating that economy, further suggesting that the orthodox view in which structural factors play the determinant role in economic performance may not be as relevant to the transition economies. A crucial prescription emerging from this finding is the creation of a stabilization program which targets political decision-making, ensuring that it is harmonized among different groups in order to establish checks and balances in the political process, while ensuring the market institutions are well-insulated from the

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^42 ibid, p. 47.
inevitable political pressures which may undermine them.
Chapter 4
Inflation: Causes and Effects

"There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

- John Maynard Keynes

Inflation and its causes

Inflation, by definition, is simply an increase in the price level, translated into a decrease in the purchasing power of money. While the process is not as mysterious as Keynes perceived it to be, the social costs that it incurs are just as high as the classical economist assumed them to be. To understand inflation and the causes of this phenomenon (verb) by classical economic theory, an analysis of the relationship between money, the price level, and inflation is necessary. The quantity theory of money contends that the growth in the money supply determines the rate of inflation. This theory is expressed in the following manner:

\[ M \cdot V = P \cdot Y, \]

where \( M \) represents the money supply, \( V \) is the velocity of money measuring the rate at which money circulates in the economy, \( P \) is the price level, and \( Y \) is the level of output. In this framework, \( Y \) is determined by the factors of production and the production function of the economy, and will be treated as exogenous for our purposes. Additionally, the velocity of money is assumed to be fixed to facilitate the discussion of the money supply, especially since such an assumption is a good approximation of reality. Empirical studies show that assuming velocity constant provides a good approximation in many situations (Mankiw, 2000). Given these assumptions, the quantity theory of money implies that the price level is proportional to the money supply. Since the inflation is the

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change in the price level in percentage terms, this theory of the price level also represents a theory of the inflation rate. In terms of percentage-change, equation (1) becomes:

\[ (2) \quad \% \text{ change in } M + \% \text{ change in } V = \% \text{ change in } P + \% \text{ change in } Y. \]

The percentage change in the money supply is determined by the central bank, which controls the money supply. Since we assumed velocity to be fixed, the percentage change in this variable is zero. The percentage change in the price level represents the rate of inflation, which is the variable for which we seek an explanation. And the percentage change in the output level depends on exogenous factors, meaning that we can take the output level as given. The result of this analysis states that the growth in the money supply determines the rate of inflation. Moreover, since the central bank has control over the money supply, this financial institution also has ultimate control over the rate of inflation.

Empirically, this theoretical conclusion clearly holds. In a study conducted by Milton Friedman, together with Anna Schwartz, surveying the average rate of money growth and the average rate of inflation in 34 countries during the 1980s, the positive correlation between the two variables is unambiguous. Figure 4 shows a scatter plot in which the position of each country in the study creates a relationship between money supply and inflation validating the quantity theory of money.
Figure 4: Inflation and Money Growth

Source: Friedman and Schwartz, in Mankiw 2000.

As the figure shows, countries with a high growth rate in their money supply (measured by currency plus demand deposits) have a higher level of inflation.

Aside from the classic explanation for inflation, there exist other causes which lead to an inflationary process and which must be targeted by authorities in their sight against inflation. These causes play an important role in the inflation experienced by the transition countries of Eastern Europe. Continuing to rely on an economic framework, these causes can be separated into two categories: those emanating from the demand side, and those from the supply side.

From the demand side, an economic environment market by structural imbalances leads to inflation. This factor is of specific importance for countries which are adjusting to a market economy from other regimes, especially those built upon central-planning. Thus, the former-communist countries in Eastern Europe have suffered from such imbalances as they started on their transition to the market system, and all have
experienced inflation with the difference being in the degree of severity. These imbalances emerge from the distortionary production and price mechanism existent during the centrally-planned period. In the internal market of the communist regime, overproduction was forced by the central planners as they sought to reach artificially-set quotas without considering a rational allocation of resources; this overproduction emphasized the production of capital goods at the expense of consumer goods. In this effort, the authorities dispersed continuous credit to state-owned enterprises which needed to have a soft budget constraint in order to sustain overproduction. In addition, prices were set artificially without consideration of the demand or the supply of the good in question; as a result, prices failed to function as a signal for economic behavior in the centrally-planned economy.

With the demise of communism and the central plan, the equilibration of the economy meant that production would inevitably decrease in the industries which supplied in excess, while prices would inevitably rise for products in high demand. As consumer products were very high in demand during and after the communist regime, the prices of consumer goods rose drastically for all of the transition countries. Thus, the initial structural imbalances of these countries caused inflation. In some economies, this inflation was aggravated due to the orientation of economic policy at this time.

Related to the factor of structural imbalances, and also having a severe effect on inflation from the demand side, are soft budget constraints. Under the communist ideology, propriety belonged to all, and no one in particular. Consequently, the inefficient administration of the production process in state-owned enterprises had a direct link to the lack of incentives of the appointed directors. As appropriation of profit was prohibited, the only was to ensure production was by setting rigid norms and by pumping credits into these enterprises to counteract against their large inefficiency (which, in turn, caused a dependence on these credits and a further lack of incentive on the part of enterprise directors).
With the end of the communism regime, property still remained in the hands of the state, either directly or indirectly. The large, loss-making enterprises had no chance of being sold, and a very small chance of being privatized. These remain, to the present, under the control of the state which continues to supply with funds both, the enterprise and its workers; a failure to do so would result in social unrest (specifically, workers’ strikes) which clearly would not benefit any political party governing the new economies. In an interesting reversal of roles, the enterprise now functions as an organ of social protection, while the state is the party seeking profit. An additional motivation behind the continued flow of credits is the lack of a bankruptcy law (or a poorly defined one) which did not make it possible for these SOEs to close down. On the other hand, the enterprises which had a profitable dimension were sold through opaque transactions (such as MEBOs) to incumbent directors or to members of influential interest groups in exchange for political support. These newly-privatized enterprises still continue to benefit from government credits, mainly for political reasons.

As a result of these soft budget constraints and the role of social protector played by the enterprises, the costs have exploded, while the quality of production and of the products has continued to deteriorate. This, in turn, leads to lower revenues for the enterprises since they cannot sell what they produce, and thus demanding even more credits. As these less developed countries do not have advanced financial markets, their governments cannot finance these governmental credits from anywhere else but from the central bank. And as explained by the quantity theory of money, the central bank’s subsequent increase in the money supply directly causes an increase in the price level and in the inflation.

A third factor from the demand side related to soft budget constraint is the collapse of trade among the Central and Eastern European countries after the collapse of the communist system. The fall of in their exports proved to be a large shock for these countries. It is argued that the trade which did occur under the communist trade
institutions, such as the CMEA, was based on the underlying ideological motivation fostered by communism, rather than on the economic rational for exporting and importing goods according to one’s comparative advantage in their production. Once these countries decided to end the import of each other’s low-quality goods, the industries which focused on exports experienced a drastic decrease in revenue. Therefore, the costs of these enterprises (largest component being wages) were subsidized by the government in the form of government credits. This added to the long-list of government credits, as well as to the escalating rate of inflation.

The main supply-side factor contributing to the rate of inflation has already been described as the classic factor of excess money supply. A second crucially important supply-side factor is the fiscal and quasi-fiscal deficit. The fiscal, or government, deficit, especially if increasing at a steady rate, will inevitably lead to inflation since the financing of this debt will increase the amount of domestic credit in the economy, thus increasing the money supply. As previously explained, the growth in the money supply equals the increase in the price level. A more indirect, yet just as significant, way to increase the public debt is through quasi-fiscal means. These means specifically refer to the debt accrued by the government to the central bank, which remains uncovered in the accounts of the central bank; the public deficit resulting from foreign debt; and the deficit resulting from arrears and losses of the public sector.

The first quasi-fiscal measure results from the government’s use of central bank funds to pay for certain foreign exchange transactions, or interest rate payments. In cases when the national currency depreciated against foreign ones, these transactions or interest rate payments become more of a financial burden for the state, which appeals to the central bank for funds. Although the state must cover these funds and any net losses at the end of each year, it may run into difficulty doing so, especially in the case of a depreciating national currency. As a result, this unpaid government debit remains as a net loss in the accounts of the central bank.
The second quasi-fiscal feature, the public deficit resulting from external debt, emerges as a problem due to the fluctuations in the exchange rate. The foreign loans borrowed from abroad are used for public expenditures conducted at the exchange rate existent at the time of the financial intermediation. These funds are subject to an interest rate established at the time the funds are borrowed. Yet, when the exchange rate depreciates, the amount spend by the government from the borrowed funds is now greater than the amount borrowed. This sum must be repaid in accordance to the exchange rate established at the time of the initial financial transaction, meaning that the government now must repay more than it would have in the absence of a depreciation, in addition to paying a higher interest on the borrowed funds. This added financial burden on repaying the external debt results in a public deficit, which leads the economy on the familiar path to inflation as previously described.

Lastly, the third quasi-fiscal component of the deficit results from the losses and arrears of the public sector. This situation emerges specifically in the case of state-owned enterprises which are largely inefficient as evidenced by their large losses. These enterprises are subsidized by the government, transforming their losses into a public deficit. In the case that these enterprises are in such a poor financial situation, temporarily or permanently, that they cannot afford to pay their workers or the taxes required by the government, they simply will not make these payments, creating a financial blockage. These unpaid amounts, or arrears, are finally compensated by the government (possibly in the optimistic view that the enterprises are temporarily credit constrained) to return the financial system to its normal flow. As expected, this compensation leaves its imprint on the economy by creating a deficit.

The third supply-side factor contributing to the process of inflation represents the existence of arrears, themselves, as opposed to the deficit created by them. Arrears constitute a way for credit-constrained enterprises incapable of making their necessary payments to continue their business activities. A main detriment of this situation is that
these enterprises fail to restructure themselves, or, at least, they delay this very important process, suggesting that they will continue to rely on arrears in the future. Thus, a form of moral hazard results. These enterprise arrears reach destabilizing levels in an economy only if they are allowed to exist. In the countries of Eastern Europe, the period of transition provided the perfect context for the existence of arrears. The main destabilizing effect of these arrears is an increase in the price level - in inflation - as a result of the increase in the money supply necessary for compensation of the arrears. Additionally, the existence of arrears, their high levels in certain countries, and the ensuing compensation, shows that restructuring of the inefficient enterprises running arrears is not imminent in those countries, that budget constraints remain soft, and that the authorities tolerate financial indiscipline. A further point is that monetary policy, if uncoupled with other policy measures, will float above the real problems of the economy. More specifically, a tight monetary policy will not be successful in stabilizing the economy, if inefficient enterprises duck from the target through the means of arrears.

In addition to all the causes described above, the formerly-communist countries of Eastern Europe experienced a much more pernicious cause of inflation: repressed inflation. This type of inflation directly results from the imbalances fostered by the centrally-planned economy. During the communist regime, the inflation rate for most Eastern European countries was null for many years. Yet, what the communist regime tried to present as a form of economic stability, was, in fact, a sign of the system’s rigidity and its repressed inflation. The manifestation of this form of inflation was more and more difficult to hide in the late 1980’s as stores were mostly empty and the lines were getting longer. Without any other means of illustrating its success, the communist regime permitted the accumulation of money by the population. Yet, this accumulation was merely a form without content, as there was no corresponding increase in the volume of goods and services on the internal market. According to Eugen Radulescu, the monetary authority at the National Bank of Romania, repressed inflation is the worst
form of inflation for an economy. This is because repressed inflation invalidates the use of price as a signal in the economy. Specifically in cases where prices were controlled or frozen for decades, they no longer have any significance. Consequently, the re-stabilization of the economy could only be conducted through an iterative process, the harshness of which is proportional to the initial distortion.

In the transition economies of Eastern Europe, all the above mentioned demand-side and supply-side factors have existed in full force, contributing to high levels of inflation. This end result of these factors was inevitable since inflation is an economy’s mechanism of last resort, making up for losses, economic inefficiency, and political corruption. Yet this resort has a high cost in terms of the performance of the economy, and this cost is mainly borne by the population of a country. Under communism, this cost took the form of consumption rations, empty stores, and forced savings, while in a market economy, it takes the form of inflation, or unemployment, or possibly both.

Inflation and social costs

In The Economic Consequences of the Peace, John Keynes wrote that in a capitalist system, the government can confiscate the wealth of their citizens through the process of inflation. While those in debt may find this process advantageous, many people lose their savings and observe the value of their assets decrease. As inflation continues, and the value of the currency fluctuates greatly even in the short-term, the relationship between lenders and borrowers collapses, and with it goes the foundation of the capitalist system. Therefore, the process of inflation, especially a continuous one, harms not only the economy and the welfare of the people, but also the political system. This conclusion stands as a warning for the transition countries of Eastern Europe whose

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45 Keynes, J. (1920) in Mankiw, 2000.
governments have failed to target inflation as a first priority, and consequently, experienced the waning of the population’s confidence not only in the governing party, but also in democracy and the market system. As a consequence of this loss of trust, people’s expectations adapted so as to embody future inflation. Therefore, the only way to curb inflation in these countries is by changing people’s expectations of the future economic conditions. The way for the government to ensure this change in expectations is by proving their commitment to low inflation through the implementation of a rule-based policy. We will return to the policy aspect in a later section.

The costs of inflation differ based on whether the inflationary process is expected or not. If expected, one of the costs of inflation - the so-called shoeleather cost - results from the fact that money suffers a decrease in purchasing power, and people must hold less money on average to prevent its depreciation. Consequently, they must withdraw money from the bank more frequently, thus wearing out the leather of their shoes, as it were.

The frequent change in prices due to inflation proves costly for many enterprises, in terms of having to inform the consumer of the change in price, and of having to remodel their business plan - this cost is known as the menu cost. Due to this cost, many companies in many industries fail to adjust prices immediately, increasing the variability of relative prices in the economy, and leading to inefficient allocations of resources. Most detrimental for the welfare of the population is the fact that wages - the price of labor - do not adjust immediately. Thus, people face higher price levels with the same income, an unfavorable situation which may lead to great suffering, especially in economies where the labor market is rigid and the wages change with difficulty. This situation is very familiar to the countries of Eastern Europe, where the largest part of the population is either unemployed or working in the same state-owned enterprise as they worked in under communism. Inflation severely affects these already inefficient enterprises since their costs increase; as an increase in government credits (soft budget constraints) for
these enterprises to keep par with inflation is not a priority of the government, the
workers and their wages suffer. The unemployed suffer clearly adverse effects from a
process of inflation. As the transition countries of Eastern Europe have yet to develop
efficient social protection institutions, the population stands in a poor (literally and
figuratively) position to cope with inflation.

An additional cost of inflation is the reduction in government revenues. Since
most tax laws do not take into consideration the effects of inflation, the revenue received
by the government, in real terms, during a period of inflation is smaller. This further
harms any vestige of a social protection plan remaining from under the communist
regime. Despite this effect, inflation also acts, to a greater degree, as a resource for the
government to cover its deficit.

Lastly, a constantly changing price level complicates financial planning at the
individual level. With savings eroded, with their incomes inadequate, individuals must
decide on their consumption patterns for the present and the savings pattern for the
future. Deciding how much to consume and how much to save depends on the price level,
and faced with a constantly changing level of prices, individuals face a complicated
decision. On the one hand, saving for the future may be a good option if inflation is
expected to decrease. On the other hand, if inflation actually increases, the foregone
consumption and the savings were for useless, but painful, efforts.

*Inflation and the interest rate*

The relationship between the rate of inflation and the interest rate serves as
another vehicle through which inflation can have adverse effects. In economic terms, the
nominal interest rate represents the rate given by a commercial bank, while the real
interest rate represents an increase in the purchasing power of money. According to the
Fisher equation, the differential between these two rates equals the rate of inflation, as
shown in the following equation:
(2) \[ r = i - \hat{r}, \]

where \( r \) represents the real interest rate, \( i \) represents the nominal interest rate, and \( \hat{r} \) is the inflation rate. This equation allows for an explanation of the nominal interest rate, the rate affecting the decision to invest. According to the equation - which can also be expressed as \( i = r + \hat{r} \) - an increase in the rate of growth of money causes a proportional increase in the rate of inflation, which in turn causes a proportional increase in the nominal interest rate. Therefore, there exists a linkage between the money supply, the price level, and the interest rate. Table 7 illustrates these relationships.

**Table 7: The Relationship between Money, Prices, and Interest Rates**

Money Supply

\[ \text{Price Level} \rightarrow \text{Inflation Rate} \rightarrow \text{Nominal Interest Rate} \]

Money Demand


As portrayed in the table, changes in the money supply or demand determine the price level; changes in the price level determine the inflation rate; and the inflation rate determines the nominal interest rate. An additional remark which does not emerge from the quantity theory of money is that the nominal interest rate, as the cost of borrowing money, may have a feedback in this system of linkages and effect the money demand. More specifically, the lower the nominal interest rate, the less return received from keeping money in the bank, and thus, the higher the demand for real money balances.

An important conclusion emerging from this analysis is that any policy targeting the inflation rate should also have an effect on the nominal interest rate, and thus, on investment decisions.

*Expectations and rule-based policy*

Expectations serve an important role in bringing down inflation. Therefore, the
population must believe that future inflation will decrease in order for policy to have an impact. As observed in the context of interest rates, a lower expected inflation in the future will decrease current nominal interest rates, thus increasing investment. In the framework of the price level, the Cagan model explains that the current price level depends on the current money supply and on expected future money supplies\textsuperscript{46}. Thus, inflation depends on the current money growth and on the expected future money growth. Consequently, a credible policy for curbing inflation is crucial for changing people's expectations of the future and for achieving the task of anchoring inflation. Expectations depend on credibility, and more specifically, on the belief that the central bank is committed to reducing money growth.

In order to ensure this credibility, monetary and fiscal reform is necessary. In terms of fiscal reform, inefficient spending must decrease, and the central bank must be established as independent from the government. In terms of monetary reform, a rule-based policy needs to be adopted. A rule-based policy means that the authorities announce in advance the way policy will affect different variables in the economy, such as the price level, and then remain committed to this announcement. On the other hand, discretionary policy is conducted by policymakers in ways they see fit at a specific period without any concern of the possible repercussions of their policy choice.

In the case of the transition economies of Eastern Europe, a rule-based policy to curbing inflation is necessary. Since the causes of inflation in this region result from the perversion of the political process, where the government uses policy to achieve its own ends, a credibly, rule-based policy must be implemented in order to change the population's expectation of their government and of the future economic circumstances. A simple announcement of a policy of low inflation is not credible because there is no guarantee that the government will abide by this announcement once people's

\textsuperscript{46} Mankiw 2000, pp.190–192.
expectations have changed. Before a discussion of monetary policy, its role and the means to establishing a credible one, I present the case of a specific transition economy - Romania - whose levels of inflation since the fall of communism have been high, and which would be a prime candidate for the establishment of a credible rule-based policy as opposed to the unsuccessful discretionary policies that its government has adopted over the last ten years.

*A synopsis of the inflationary process in Romania, 1990-2000*

An analysis of the inflationary process in Romania shows the imprint of the political process and its skewed incentives. The evolution of the Romanian exchange rate, starting with 1990, reflects the grave structural dis-equilibrium of the Romanian economy as well as the effects of the politics executed by the authorities for addressing the structural imbalances.

In 1990, the average rate of inflation was moderate: the consumer price index was only 105.1 percent, while the GDP deflator was 113.6 percent. Nevertheless, these figures portrayed an artificial situation, as they referred to a period when prices were yet to be liberalized in the Romanian economy and the external deficit was especially high: net imports accounted for 9.5 percent of GDP, while the deficit of the current account represented 8.7 percent of GDP. The amount of exports to imports illuminates the large external deficit; in 1990, exports covered imports by only 63.3 percent - a clearly unsustainable level. Simply stated, the large external deficit masked the internal imbalance. Once the phenomenon of price liberalization debuted in November of 1990, and the external reserves no longer permitted a continuation of the accumulation of deficit, inflation exploded. In the months of November and December, prices rose by 129.2 percent.

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47 All data was personally gathered from the Romanian National Bank.
Starting with 1991 and continuing for three years, inflation rose. The consumer price index reflected a value of 356 percent, while the GDP deflator recorded values of 327 percent. Additionally, the soft budget constraints permitted abrupt adjustments at every stage of liberalization supervised by the government, up to the maximum level accepted by the government. As a result, the monthly rates of increase of production prices exhibited a spread between 0.2 to 43.7 percent in 1991.

Although the rate of inflation did show a vague decrease in 1994, the last trimester of 1995 exhibited a definite end to this decrease. It is argued that the rate of inflation ceased to decrease after it reached a minimum level for the growth of the consumer price index (as compared to the previous year) recorded at 24.3 percent in September 1995. To maintain or decrease below this level, a significant restructuring of the real sector of the economy would have been necessary. In contrast, the government focused its efforts at this time on increasing production and decreasing unemployment. The economic effects of this political decision were the worsening of the external deficit and the increase of inflation at an alarming rate. For the year 1996, the increase in the consumer price index was of 56.9 percent. For Romania, the warning issued by Michael Bruno became a reality: “A relatively low to moderate rate of inflation (20 - 40 percent) may not necessarily lead immediately to a reduction in economic growth, but it is very probable to lead to a much higher inflation rate. The truly threatening level of inflation appears around and above 40 percent.”

The inflationary process revived in 1996 became much more virulent in the first half of 1997 as a result of a softening of financial policies right before the November 1996 elections, along with the added strain of the liberalization of all other prices which had remained under the control of the authorities. As a result, the month of March 1997 exhibited the highest level for the monthly rate of growth of the consumer price index for

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the entire time period since 1990 - specifically, 30.7 percent. The benefit of coherent policies is highlighted by the fact that harmonized policies followed by the authorities in the aftermath of the March 1997 phenomenon lead to an abrupt decrease in the rate of inflation to the level of 0.7 percent in the month of July. It must be noted that this exceptional decrease in the rate of inflation was achieved by lowering production by 1.8 percent as compared to 1996, and by brutally decreasing real wages by 25 percent as compared to 1996. Thus, the cost of lowering inflation was quite high. This situation weakened the stance toward reform held by the government to the extent where, by August 1997, the new authorities put down their guard in the face of higher wage demands. Even more detrimental proved to be the government’s abandonment of the program for reform as the program was abandoned before it could affect the hard nucleus of the large non-performing state-owned enterprises. Almost immediately, inflation repositioned itself on an ascending path so that the year 1997 exhibited a rise in the consumer price index by 151 percent. In the next three years until 2000, inflation decreased slightly. Figure 5 on the next page shows the inflationary process in Romania from 1989 to 2000.
Figure 5: Inflation in Romania, 1989-2000

Average Annual Value of CPI,
Average Annual Rate of Inflation

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Source: personal calculations from data gathered at the Romanian National Bank
Figure 6: Inflation in Romania, 2000.

Consumer price index and Inflation in year 2000
Although inflation has not reached again the high levels experienced in the early phase of transition, it has not yet dropped under 40 percent. This is alarming since price liberalization has mainly come to an end, suggesting that the causes of inflation are quasi-political. Figure 6 complements Figure 5 by showing the data on the consumer price index for the year 2000.

These tables reflect the quantitative effects of the rise in consumer prices in Romania during transition. The causes of this rise are many, including causes emerging from the demand side of the economy and those resulting from the supply side. A later chapter will discuss the economics of inflation in Romania, analyzing the specific causes driving Romania’s inflationary process. As a framework for this discussion, the next chapter discusses the role of monetary policy in the context of economic policy.
Chapter 5
Monetary Policy in the context of Economic Policy

"In general, haste, lack of experience and intellectual laziness are to blame for the meager results of the first encounter of transforming countries with mainstream economics. That, however, should by no means preclude a second, much longer and better organized, and thus more rewarding attempt, that requires more rather than less attention to the process of applying theories and translating them into practical policy advice."

-Paul Hare

Before applying economic theory to address the problems faced by the transition countries of Central and Eastern Europe, it must be acknowledged that economics is a pluralist science with many schools of thought and many contending views on the accurate economic policy to be used in similar contexts. Mainstream economics, of the nature found in textbooks, consciously assumes away institutional and political factors in the determination of economic models and policy. Yet, institutions do matter, and they vary significantly from country to country, especially in Eastern Europe where only few transition countries have built the institutions necessary for a market economy. “For that reason similar policy advice may result in different outcomes in different institutional settings.”

Thus, careful application of economic policy is crucial for the development of a functioning market economy. As Hare noted above, the choice of economic policy and its manner of application should not be decided hastily for these choice and actions are mirrored in the performance of the economy. In order to set up a clear framework for the discussion of a currency board in Romania, I will not make haste of economic theory
(possibly to the disappointment of the reader), and I will expand on the objectives and the instruments of economic policy, and specifically of monetary policy, which is most relevant for the analysis of a currency board\textsuperscript{50}.

\textit{The objectives of economic policy}

Generally speaking, economic policy represents the measures taken by the national authorities to direct a country’s economy in the ways they believe appropriate. The fundamental objective of economic policy is twofold: it emphasizes the permanent increase in the growth of national production (measured by gross domestic production, GDP) in order to satisfy both, the demand for consumption and the demand for employment. Most countries of the world, developing or industrial, share this objective.

Thus, growth in domestic production - or economic growth - is not an objective coveted, in and of, itself. Rather, it is viewed as a means to satisfying human needs, increasing the quality of life, and the welfare of the citizens. Economic history shows that in the last century, people have benefited from an increase in the standard of living as a direct result of an increase in economic growth\textsuperscript{51}. As an example, in the two centuries spanning the Industrial Revolution from 1750 to 1830, economic growth driven by technological progress changed daily life in Europe more than it had changed in the previous 7,000 years, providing the Europeans with a quality of life incomparably higher.

\textsuperscript{49} Hare, 1999.
than that of traditional societies.\textsuperscript{52} Thus, economic growth has become a target for economic policy. However, political economists contest the consideration of national economic growth as an objective for economic policy due the uneven distribution effects that can emerge from implementing policies targeting this objective. Instead, recent literature concludes that the standard of living of the population is currently viewed as a more suitable objective than the growth of GDP. Closely related with the standard of living of the population is employment, which has become a controversial target of economic policy due to the tradeoffs inherent in a policy targeting full employment, namely inflation. Yet, it is not the elimination of unemployment that is sought by economic policy, but rather the decrease in unemployment to the frictional level. This objective rests on the Beveridge criterion which postulates that the number of vacancies in the labor market available for employment should equal the number of unemployed workers.

The economic turbulence of the last century, especially the later half of the century, has emphasized price stability has as a central objective of economic policy. With inflation (and deflation) leaving such traumatizing imprints on the economies of many countries, special consideration is now given to price stability in the context of economic policy, and specifically, in the context of monetary policy. This thesis will focus on the objective of price stability, arguing that this objective must clearly (and solely) be targeted by Romania's monetary policy if the country wishes to curb its high level of inflation.

Aside from targeting these so-called first-rate objectives, economic policy manages other economic aspects, among which are developments in the external balance

\textsuperscript{52} ibid.
of payments, the equitable distribution of income, and the protection of the environment.

Although the objectives of economic policy are broadly the same internationally, the instruments used to achieve these objectives are far from similar. Based on their social, political, and economic organization, countries support the use of different instruments to achieve these common objectives. For countries which are new to the market system, such as Romania, knowledge of using these instruments is scarce, in addition to the fact that these economies cannot use certain instruments simply because they do not have the supporting institutions, such as developed (or “deep”) financial markets. Prior to 1989, the centrally-planned economies of Eastern Europe reported impressive rates of economic growth, low inflation, and virtually the eradication of unemployment. Nevertheless, since the fall of authoritarian rule, it has been discovered that these countries manipulated statistics in their favor, forced production in order to reach set quotas, and maintained full employment levels by overstocking factories with labor, much of which did not add to the productivity of the enterprise. In fact, the hoarding of labor by these enterprises in order to fulfill centrally-established quotas is now referred to as “unemployment on the job.” Thus, history has shown that totalitarian regimes, be they communist or fascist, are not sustainable politico-economic regimes since they fail to build an economy capable of long-term growth. One of the reasons for this failure is the fact that the instruments used by these economies to affect the economic sphere are either flawed, inappropriate for the given circumstances, or conflicting with one another.

In contrast to the centrally-planned economies, societies based on the mechanism of a market economy have proven to be more successful. At the same time, these
economies are more vulnerable since they function through indirect means that, generally, do not exhibit immediate effects. Despite this vulnerability, these societies have been the only ones to survive change in the evolution of history, while also providing their citizens a high standard of living. Although the market economies of today are a far cry from those described in Adam Smith’s *The Wealth of Nations*, they are the only economies that have survived to the present and have continued to perfect themselves in the process.

*The instruments of economic policy*

The instruments used by public authorities in conducting economic policy are few. These instruments act upon specific variables of the economic sphere, with some degree of interdependence between them. The instrument of fiscal policy acts upon the development of certain sectors of the economy, and specifically upon the distribution of resources through the means of taxes and other government revenues. In mature market economies, fiscal policy represents the principal instrument influencing the direction and the development of the economy. Fiscal policy targets the aggregate demand of the economy as a mechanism for managing the economic arena. Since government expenditure makes up a large part of aggregate demand, fiscal policy largely concentrates on supervising government expenditure giving specific consideration to fiscal deficits. Under exceptional circumstances, public authorities may directly intervene in the economy to affect aggregate demand through the instrument of income policy by regulating wages.

The instrument of monetary policy acts upon aggregate demand through more specific measures than fiscal policy. In recent years, an international consensus has
emerged that the stability of prices should be the sole objective of monetary policy, with all other objectives placed under the auspices of other macroeconomic policies. Closely related to monetary policy is exchange rate policy (although some authors argue that it actually constitutes a component of monetary policy) which seeks to maintain the external balance of payments, and which is, thus, an important policy affecting trade. An example of the role of the exchange rate policy in addressing international trade, and of the interdependence between exchange rate policy and monetary policy, is shown by the Bretton Woods monetary system adopted at the end of World War II as a result of the massive trade distortions caused by the First World War and the collapse of the gold standard. The Allied countries agreed to harmonize their exchange rates by fixing them to a parity of 35 dollars per ounce of gold. Thus, the system was based on the convertibility of the U.S. dollar into gold at the above mentioned parity, making the U.S. dollar the reserve currency in which most international financial transaction were, and continue to be, conducted (albeit, with a current challenge from the euro). Despite the faults of this system – known as the “Unholy Trinity,” the discussion of which is beyond the scope of this paper – it did manage to promote international trade and prosperity after the Second World War through the use of the exchange rate policy as an instrument of economic policy. Also at the interface between the national economy and the international economic sphere rests trade policy. But this instrument is usually subsumed to fiscal policy, and to the industrial policy supported by the public authorities.

Table 8 shows the correlation between the different instruments of political economy and their objectives.
Table 8: The objects and instruments of economic policy

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Instruments</th>
</tr>
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<tbody>
<tr>
<td>Economic growth</td>
<td>Fiscal policy</td>
</tr>
<tr>
<td>Full employment</td>
<td>Monetary policy</td>
</tr>
<tr>
<td>Price stability</td>
<td>Income Policy</td>
</tr>
<tr>
<td>Balance of payments</td>
<td>Exchange rate policy</td>
</tr>
<tr>
<td>Social Safety Net</td>
<td>Trade Policy</td>
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</tbody>
</table>

Economic theory and policy

Economy theory is born out of the evolution of history in a process by which certain events influence the thought of the time, and which, in turn, influences the evolution of history itself. A brief analysis of the economic history of the past two centuries shows that two significant events occurred in economic theory. The importance of mentioning this history is to portray the theoretical environment in which economics and political economy exists today; this will serve as a starting point for the discussion on economic policy in Eastern Europe.

The nineteenth century saw the international affirmation of economic liberalism. The British economy at this time is a prime example of the economic growth and progress that resulted from a liberal economic policy. The leadership of the British in the first Industrial Revolution emerged under a restrained role of the government in economic affairs (shown additionally in its lack of opposition to progress), and an abundance of cheap natural resources53. Despite the restricted role of the state, the efficiency of the market in Great Britain was significantly influenced by the existence of

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53 ibid.
supporting institutions, such as property rights, which allowed for economic growth.\textsuperscript{54} This point re-emphasizes the important role of domestic political institutions as determinants of economic growth, as mentioned in previous chapters. The economic leadership of Great Britain over the European countries on the continent led to the domination of the \textit{laissez-faire} philosophy during the nineteenth century. Soon after France adopted this same philosophy under Napoleon and imposed it in its colonies, the philosophy of a free market characterized by the limited intervention of the state spread internationally, remaining the dominant philosophy for a century. The economic theory underlying this \textit{laissez-faire} philosophy is the classic theory espoused by Adam Smith. The main principles of Smith's classic economic theory state that in an ideal world - in which equilibrium is perpetual, the level of employment is optimal, and the market has the capacity for automatic regulation - there would not be the need for state intervention.

In this time period, monetary policy had not yet been developed as a tool of economic policy. The monetary environment was one in which the national currency was pegged to the stock of gold, an arrangement referred to as a \textit{currency board avant la lettre}. Under this arrangement, the amount of the national currency depended on the stock of gold available at the central bank, and the price level was relatively stable due to the fact that the world economy was growing at a faster rate than the production of the precious metal. The balance of payments was regulated through inflows or outflows of the stock of gold, and not through modifications of the exchange rate.

In the trying times of the Great Depression starting in 1929, economic theory experienced an important change. Marked by episodes of hyperinflation, by the apparition and destruction of the Bretton Woods monetary system, and by the birth of central-planning in the political and economic sphere, this period was dominated by an

economic philosophy which supported a greater role for the state in the regulation of the economy. In this period spanning half a century, government spending increased to finance military expenditure and to stimulate aggregate demand in the face of recession. The experience of the economic crisis, which lasted until 1933, deeply marked the policies implemented by the national authorities of the time. "Keynes was the uncrowned king of the economists, while stimulation of the aggregate demand becomes almost a religion in economic policy." Indeed, fiscal policy at this time was highly expansionary in accord with Keynesian theory, while monetary policy was dominated by the direct control of this expansion - through credit and interest rate limits - and by the added objective of ensuring employment for the work force.

Worth mentioning is the fact that the hyperinflation episodes, as much as the depression itself, were later analyzed as grave errors in monetary policy. The German economist, Ludwig von Mises, notes that the governor of the German central bank did not believe there to be a correlation between the continuous emission of banknotes and the increase in prices, wages, and the depreciation of the exchange rate. The latter adverse effects were believed to be the result of machinations on the part of speculators and enemies of the state. This anecdote shows that the misunderstanding of economic principles and the effect of economic policies (such as monetary expansion) can have significant adverse effects on the economy.

As the Bretton Woods system collapsed in the 1970's, the second significant change in economic theory occurred. The Bretton Woods system, based on the convertibility of the U.S. dollar to gold, functioned as long as the policies of the United States were expansionary to the extent that the supply of dollars in the international financial market was not greater than the demand for liquidity. Yet, the supply of dollars

55 Radulescu, 1999. [translation mine]
became excessive as a result of a growing deficit in the U.S. balance of payments (worsened by America's implication in the Vietnam War), and this supply could no longer be absorbed by the international market. The eventual failure of the Bretton Woods system shows the limitations of a model based on the stimulation of demand and the excessive intervention of the state. The crisis that emerged after the collapse of the Bretton Woods system was aggravated by the first oil shock, and stagflation resulted. The emerging economic concept at this time came from Ronald Reagan in the United States and Margaret Thatcher in Great Britain, and consisted of a fundamentally different emphasis than previous economic thought - the stimulation of the supply side, also known as supply side economics. The deregulation of the market and the distancing of the state from economic activity became the characteristics of a new type of liberalism. I believe that except in the case of a major crisis (such as a world war), this neo-liberal economic thought will be the orthodox philosophy in economics for at least another generation. As such, I believe that it will successfully shape the economic development of the countries in Eastern Europe which are striving to build functioning market economies.

In the context of neo-liberalism (and specifically in contrast with keynesianism), monetary policy is concerned with one unique function: the stability of prices. By ensuring this, monetary policy contributes actively to the long-term growth of the economy and towards the optimal employment of the labor force. The two latter objectives are directly targeted in the short term by fiscal policy and other instruments from the supply side (such as microeconomic policies). Monetary policy under this theoretical paradigm no longer concerns the direct control of credit or interest rates as it did under keynesianism. Additionally, the opening up of national economies and the globalization of capital flows, both increase the importance of the exchange rate in the formulation of monetary policy.

Despite my schematic description of economic policy and theory over time, it is
important to note that economic policy, although largely influenced by a school of thought, will never apply *ad litteram* the theoretical prescription, while at times it may even depart significantly from it. For example, the Reagan administration pursued a restrictive monetary policy oriented towards the control of inflation and the stimulation of the supply side, while pursuing an expansionary fiscal policy dominated by high expenditure on the military. Thus, the policies of the Reagan administration departed from the monetarist prescriptions described above, and, as a result, this combination of policies earned the name of *reaganomics*.

Within the current neo-liberal paradigm, there has been more consideration given to the concepts of confidence building, credibility, stability of expectations and popular perceptions of the economic policy stance.\(^57\) This is especially relevant to the discussion of economic policy in Eastern Europe where credibility is very much an issue of concern. Although these policy aspects tend to be seen as ‘unscientific’ by fans of econometrics, they are nevertheless important aspect shaping the success of implemented policies. As a result of their emergence in academic debate, the disciplines of monetary and theoretical economics both advocate stability in policy perspectives in order for the authorities implementing the policy to win confidence and respectability in the long run.\(^58\) Hare (1999) further specifies that, especially regarding anti-inflation policies, economic agents must be given the opportunity to behave rationally, and investors must have a time-horizon long-enough to advance money for major innovations in technology and organization. This argument suggests that economic policies should not include a large number of specific targets set by the government, but should instead “remain free from recurrent petty interventionism and the concomitant loss of perspective and of orientation.”\(^59\) This line of thought proves specifically appropriate for the countries of

\(^{57}\) Hare, 1999.  
\(^{58}\) ibid.  
\(^{59}\) ibid.
Eastern Europe where economic priorities must be set and maintained independent of the political process, if they are to be successful. This, in turn, proves to be appropriate for the implementation of a currency board since the assumptions of the free competition of ideas, of maintenance of the democratic framework, and of consensus-building, inherent in the above argument are not correct presuppositions for Romania. Thus, it follows that the way to maintain the economic objective of price stability independent from political interference without the proper democratic institutions is through the implementation of a currency board (the in-depth discussion of which is saved for the next chapter).

*The Fundamental Objective of Monetary Policy*

Economic policy is never practiced as literally prescribed by theory, nor is it forever valid. The circumstances of history shape the economic policy of its time, transforming in the process the instruments of economic policy to be used in any specific period. As an economic policy, keynesianism was most relevant at a time of economic crisis when social safety nets and unemployment were of great concern, and when monetary policy was insufficient for addressing the situation. The theory of Keynes came at the right time, and its application led to great success for the developed nations until the early 1970's. The reasons for abandoning keynesianism in the 1970's are multiple, and they have been widely debated in the economic policy literature by critics of Keynes. Still, two main motivations that invalidated this economic theory must be mentioned, for they show how our present economic sphere has changed over time.

First, increased globalization and the interdependence of national economies present a different economic environment than the closed economies prevalent during the height of keynesianism. Economic policy in an open economy is quite different from that in a closed economy, as can be exemplified by the fact that the stimulation of demand in an open economy no longer brings with it economic growth, but only a balance-of-payments deficit. The economic circumstances of France in the 1970's show this exact
dilemma. In an attempt to end recession, the French government decided that starting with June 1975, it would reduce the tax on profits by ten percent of the value of capital goods purchased. By relying on the Keynesian theory, the French sought to stimulate investment, which has a multiplier effect upon the demand, while also reducing government revenue, which further increases demand. Yet, the result was disappointing, since the public sector was the only sector to observe an increase in investment, and even this increase proved to be far from the expected increase possible from the multiplier effect. Even more detrimental to this policy of increasing demand in an open economy was the fact that most of the capital goods (in terms of investment) were purchased from other countries, especially from Germany, which clearly resulted in the failure to increase the national French production, in addition to the creation of a serious balance-of-payments deficit. Consequently, the French government abandoned this economic policy seven months after its instatement.

Secondly, the mechanisms of the market are becoming more and more sophisticated, while the public is becoming better informed. The agents of today’s economic sphere no longer form their expectations in the manner described by Keynes in his theory of liquidity preference. The new way to theorize how agents form their expectations of the market and the implications of these expectations on their behavior form the *rational expectations theory*, which plays an important role in the impact of government policies on the economic arena. In my perspective, this theory plays a specifically important role in the explaining the failure of stabilization programs in the transition economies, and I will revert to it when discussing the implementation of a currency board in Romania.

Thus, the change in historical circumstances led to the decline of keynesianism in the favor of monetarism and neo-liberalism, which emphasizes the supply side and the

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distancing of the state from economic affairs. The success of the United States economy in the last fifteen years attests to the success of this new economic theory. The countries of Latin America, especially Chile, whose economists were strong supporters of the rational expectations theory, recorded economic growth as a direct application of the prescriptions of this new economic inclination.

As economic theory evolved, monetary policy adopted a single focus - the stability of prices. In a more pragmatic manner, the neoclassical, or monetarist, theory supports the principle that one instrument should be used to address one objective in order to ensure efficiency, since the use of the same instrument for working towards two objectives results in incompatibility, and in a loss of credibility, leading to the sacrifice of the sought objectives.

The tracing of the history of economic policy creates the appropriate context for the discussion of the transition economies of Eastern Europe. These countries seek the path to development that will be the most appropriate given the realities of today and the expectations of the future. The application of economic theories and policies that have been invalidated by economic history is both, futile and dangerous. For this reason, the role of monetary policy in the development of the national economy will be analyzed in the context of the current, neo-liberal economic thought which history has proved most successful.

*Intermediate Objectives of Monetary Policy*

In order to achieve the goal of price stability, the monetary authority establishes a set of variables to aim for - the intermediate targets, in the form of monetary aggregates and interest rates (short- and long-term); these targets have a direct effect on the main goal of price stability, but they cannot be directly affected by the tools available to the monetary authority, which traditionally have been open market operations, discount policy, and reserve requirements. Therefore, the monetary authority chooses a set of
variables which are responsive to its policy tools - the operating targets (alternatively called instruments), which take the form of reserve aggregates (reserves, monetary base) and short-term interest rates.

Monetary aggregates as an intermediate objective used to achieve price stability may seem rational, although the use of this objective may prove to be a difficult task. In current economic literature, the definition of inflation is a supply of money exceeding the demand. Yet, this definition is the starting point of a dilemma. Firstly, there is no consensus on which monetary aggregate would be most appropriate for having as a focus of monetary policy. Arguments have been made supporting the use of the monetary base, known as $M_0$, and for $M_1$, which additionally includes currency, demand deposits, and other checkable deposits. These monetary aggregates are the most liquid as their assets can be used directly as a medium of exchange. The second monetary aggregate, $M_2$, adds to $M_1$ other assets that have check-writing features all of which can be turned into cash at little cost. The largest monetary aggregate mentioned here is $M_3$, which adds to $M_2$ large-denomination time deposits, repurchase agreements, Eurodollars, and institutional money market mutual fund share. In deciding which of these aggregates to observe closely in order to track inflation, the idea is to choose the one aggregate which influences and predicts most accurately the future evolution of prices. This proves problematic since it is difficult to trace the evolution of these monetary aggregates over time, especially in transition countries. Empirical studies from countries that have attempted to observe specific monetary aggregates as an intermediate objective of economic policy show inconclusive results. Germany is known to have made public the level of its monetary aggregates, but even in the case of this industrial country, fluctuations observed in the aggregates were not always correlated with inflationary pressures.\footnote{Radulescu, 1999.}

On the other hand, the problem of measuring the demand for money has proven
even more complicated than observing the evolution of the monetary aggregates. The starting point in this endeavor has generally been Fisher's quantity equation of money:

\[ M^s \cdot V = P \cdot T, \]

where \( M^s \) represents the nominal supply of money, \( V \) is the velocity of money, \( P \) is the price level, and \( T \) is the total number of transactions. From this formula, the demand for money, \( M^d \), can be estimated to be:

\[ M^d = \frac{P \cdot T}{V}, \]

at equilibrium. This equation shows that the demand for money is directly proportional with the nominal volume of transactions (as measured by \( P \cdot T \)), and indirectly proportional with the velocity of money. Yet, this equation is so constructed as to lead to the classical equilibrium between the demand and the supply of money, thus, emerging as nothing more than a tautology. Although the equation is helpful in studying very primitive markets, the conclusions which it produces are too fragile for use in the construction of functions for the demand of money. Although complex models for estimating this demand function have been developed, these models fail to be useful in empirical studies seeking to discover the exact relationship between fluctuations in the monetary aggregates, the supply of money, and the inflation.

In an attempt to achieve their goal of price stability, national authorities have attempted to control the evolution of monetary aggregates. For \( M_0 \), the attempt is simpler given that this aggregate is the narrowest measure of money. Yet, starting with \( M_1 \), the situation becomes more opaque, and the influence of the national authorities is offset by the larger scale of this monetary aggregate. In mature market economies with well-developed financial markets, where the relationship between the monetary base and the monetary aggregates has been observed for long periods of time, it is easy to foresee the evolution of each monetary aggregate relative to the monetary base, which is in fact
controlled by the public authorities. However, in countries where financial markets are still in infancy - as is the case with the transition countries - the level of accurate predictability is much lower.

To the degree that the interest rate affects the aggregate demand, it can also serve as an intermediate objective of monetary policy. The relationship between the aggregate demand and the interest rate functions through the element of investment, one of the components of the aggregate demand that is most sensitive to changes in the interest rate. In accord with Keynesian theory, the interest rate - as the cost of borrowing for investment - is indirectly proportional to the level of investment. In addition, expectations of future profit form an equally important element for the decision to invest.

Despite the noted relationship between the interest rate and investment, public authorities have found it difficult to influence the former for the benefit of the latter. In the money market, only short-term transactions - ranging from days to weeks, but not longer than three months - appear to be clearly influenced by the intervention of the authorities. For longer-term transactions, this intervention does not seem to play a role, theoretically as much as empirically. Even so, these interventions do have an effect upon the credibility of the authorities’ economic policy, as it shows their commitment to increase, or at least sustain, investment.

The opening up of national markets and their globalization have given new importance to the exchange rate as an intermediate objective of monetary policy. The stability of the exchange rate has become one of the most important anti-inflation anchors, while also serving as an indicator of economic performance. A stable nominal exchange rate ‘imports’ into the home country the conditions of the foreign economies with which it trades goods and services. In the last few decades, anti-inflationary policy has been the priority of most industrialized countries, to the extent that they created a

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63 ibid.
disinflationary spiral. Yet, the stability of the exchange rate in nominal terms assumes that the inflation in the home country is not higher than that in its partner countries. In the contrary case, the stability of the exchange rate will lead to a decrease in the competitiveness of the products in the home country, which will deteriorate its current account. Consequently, the authorities must either accept the depreciation of the national currency - which would further increase inflation - or they must adopt strict measures to limit the internal inflation. As the first solution would mean the abandonment of the principle of exchange-rate stability, the authorities are indirectly, yet very efficiently, forced to adopt and to maintain long-term anti-inflationary policies. More specifically, the authorities seeking the stability of the exchange rate must assume, explicitly or implicitly, a type of hard budget constraint, which would increase the credibility of this economic policy.

Thus, the more open a national economy, the more serious are the repercussions of the authorities’ choice of exchange-rate policy on the internal market. The band of exchange-rate adjustments available to the monetary authorities narrows as the economy open up. As a result, policies may be less and less discretionary, while the rules of the game must be respected with more scruple. In short, the exchange-rate market disciplines the country’s authorities. In the case of the highly undisciplined authorities of the transition economies, this effect is most appropriate. This paper will discuss the use of the exchange rate as an intermediate objective working to achieve the main objective of price stability for the Romanian case in a later chapter.

In discussing the exchange rate, worth mentioning is the example of the European Union member countries while still under the European Monetary System (EMS). The political decision to protect the parity between their exchange rates stabilized the economic environment in the member countries and stimulated the national authorities to harmonize their other policies with the exchange-rate policy. Yet, in the case of the more fragile economies, the exchange-rate policy was unable to resolve, by itself, the economic
problems. Countries such as Italy, which was under the burden of public debt, and Great Britain, which experienced structural problems and an overvalued parity of the sterling, did not resist in the EMS and abandoned the system. In my view, the transition countries currently seeking to join the European Union must coordinate their exchange rate policy with fiscal policy in order to ensure the stability of prices. In the Romanian case, the issue of credibility must also be addressed if price stabilization is to occur.

*Instruments of Monetary Policy*

From a historical perspective, discounting was the first tool used in monetary policy. The rate for discount operations - the discount rate - was stabilized at the discretion of the authorities, while the volume of credit, or of liquidity, allowed to exist through this mechanism was regulated less than the discount rate. The guiding principle behind discounting was that as long as loans were being made to support the production of goods and services, the provision of reserves to the banking system from the central bank to facilitate these loans was not inflationary. This principle has been discredited, as its implementation did lead to inflation, as is portrayed by the example of the U.S. policy of discounting at the end of World War I.

The mechanism of discounting was used intensely in the *dirigiste* period, when the financial markets were relatively undeveloped, and the volume of government assets was small. Yet, as the financial markets deepened and the monetary emission of the central banks became less important, the limits of the discounting mechanism became evident. An obvious limitation of this mechanism is seen against the backdrop of the computer age and the increase in the price of labor. The operations of discounting involved the transportation of the trade products from the commercial banks to the central bank, where operations of verification were underway, after which the paperwork regarding their value was deposited, and so on. Clearly, this mechanism would be costly and primitive in today's world, and its use does not seem, in my opinion, to be the best
way for conducting monetary policy. Additional arguments convince me of this point.

Aside from above-noted inconvenience, discount policy responds with great difficulty to monetary policy. First of all, discount policy is rigid, as the discount rate cannot be frequently modified. Thus, when the discount rate is smaller relative to the market interest rate, the mechanism runs the risk of generating too much liquidity, as commercial banks would borrow from the central bank’s discount window instead of from the public. The reverse also holds true. Secondly, the discount mechanism induces, by its nature, a pro-cyclical behavior. Liquidity increases in periods of an economic boom and decreases in periods of recession, since the demand on the part of commercial banks tends to be greater in periods of an economic boom when they can obtain a higher margin.

In support of discount operations, they may prove beneficial as they are the window through which the financial market neutralizes monetary policy through interventions opposite to those sought by the authorities. Thus, if the authorities seek to restrict market conditions and to decrease liquidity (through the sale of assets, for example), the natural reaction of the market would be to appeal to a greater degree to discount loans, also known as adjustment credit loans. This reaction would bring liquidity to its initial level.

Additionally, discounting may prove important in preventing financial panics. The central bank generally has a function of lender of last resort (LOLR) which it uses to prevent banks suffering from liquidity problems from emerging insolvent and bankrupt. Discounting is an effective way to provide reserves to the banking system during a banking crisis because reserves are channeled immediately to the troubled banks. In addition to preventing banking crises, the LOLR function aids credit institutions, thus preventing financial crises. However, the cost of this policy is the habituation of the commercial banks to give riskier loans, since they harbor the expectation that the central bank will always bail them out. This moral hazard problem may promote undisciplined
behavior on the part of banks, which may result in a more unstable, and thus weaker, banking system.

For these reasons, I conclude that discount policy is not an instrument of great importance for conducting monetary policy.

In the place of discounting, open market operations have emerged as the principle instrument of monetary policy. The use of this instrument has been favored by the rapid growth of public debt in the main industrial countries, at a time when government assets have become an instrument of high liquidity and minimum risk. In the use of state assets there is almost no transaction cost, and the transfer of funds is instantaneous through electronic means.

The essential characteristic of open market operations is that they occur at an interest rate established by the market, where the central bank acts as any other agent in the market seeking to purchase these assets. The effects on the central bank, however, are different than those on an ordinary agent. When the central bank purchases government assets, the liquidity of the banking system grows, leading to the decrease of the market interest rate and to the growth of liabilities. As a result, the demand for government liabilities increases, leading to the decrease in the interest rate in this market as well. The reduction of the interest rate and the increase in liquidity cause a depreciation of the national currency, and most likely, an increase in the price of stocks on the stock exchange. A sale of government assets by the central bank has the opposite effects.

The intervention on the market of the central bank has a defensive role when it seeks to sterilize the effect of other factors which alter the liquidity in the system, independent of the objectives of monetary policy. For example, in the United States, the interventions in the foreign exchange market are dictated by the Treasury (the Ministry of Finance). When executing these operations, the Federal Reserve System also puts into effect an operation on the money market acting in the opposite direction, in order to maintain the same level of liquidity in the system. Interventions are characterized as
offensive, or dynamic, when they seek to alter the conditions of the market through the increase or the decrease of liquidity.

In countries with evolved financial markets, the impact of central bank intervention can be measured with accuracy. The initial equation is:

\[ M_i = M_o m_i \]

where \( M_i \) is the monetary aggregate targeted (be it, \( M_1, M_2 \), etc.), \( M_o \) is the monetary base, and \( m_i \) is the multiplier of the monetary base. When this latter component is stable, as is generally the case, especially in the short term, the effect of a central bank intervention in the money market on the monetary aggregates - and, implicitly, on the interest rate and the exchange rate - can be evaluated immediately and with precision.

The last instrument used in monetary policy is the reserve requirements. The mechanism of the reserve requirements of the commercial banks to the central bank has a double purpose. The first purpose is prudential in nature since it concerns assuring the public that the banks always have adequate liquidity available in order to cover the demands of the depositors. As previously mentioned, the required reserves are used as a source for discounting between banks to the extent that this occurs through the central bank as an intermediary. The second purpose of the reserve requirement is monetary in nature. It concerns the limitation of the commercial banks in their capacity to multiply the deposits of their clients, and thus, a limitation in their ability to create currency outside the central bank. This concern emerges from the fact that the rate of required reserves is inversely proportional to the multiplier of deposits.

The effect of the reserve requirement upon the liquidity of the system is similar to that produced by open market operations. A rise in reserve requirements causes all commercial banks to keep a larger part of their asset portfolio with the central bank, thus
reducing the amount of deposits that can be supported by a given level of the monetary base, leading to a decrease in the money supply. A decrease in the reserve requirements causes the opposite chain of events. The signal transmitted to the market by the modification of the reserve requirements is much more acute than the signal sent by the intervention of any other instrument. The use of this instrument to control the money supply and the interest rate (by increasing the reserve requirement, for example) can cause immediate liquidity problems for banks with low reserves. Additionally, small changes in the money supply and in the interest rate cannot be engineered by varying the reserve requirements, for this alteration in the requirements usually leads to large changes. In an appropriate analogy, Mishkin (2000) writes that “using reserve requirements to fine-tune the money supply is like trying to use a jackhammer to cut a diamond.”

Thus, the use of this instrument must be very prudent. But even more, it should probably be used quite rarely given its possibly detrimental impact on an economy. The countries of the G-7 group have largely given up on using this instrument of monetary policy, favoring instead the use of open market operations. During the 1990’s, Italy was the only country to have high levels for reserve requirements, mainly in order to finance a part of its large public debt. Due to the fact that reserve requirements usually do not carry an interest rate, and if they do, it is much smaller than the market rate, many countries have established the rate of reserve requirements by law. In this case, reserve requirements lose their function as an instrument of monetary policy. But given the difficulty in using this instrument, this loss does not seem to amount to much.

With the general outlook on economic policy and theory, and a specific analysis of monetary policy - its fundamental objective, its intermediate objectives, its instruments
- we now seek to analyze monetary policy in a special case. In achieving the fundamental objective of price stability, this paper looks at the use of the exchange rate as an intermediate objective, and argues that a fixed exchange rate promotes price stability as compared to any other exchange rate regime. More specifically, the use of a fixed exchange rate will be analyzed in comparison to a floating exchange rate, for the purpose of decreasing inflation and maintaining price stability. The next chapter will present a technical argument in favor of a monetary policy that utilizes the intermediate objective of a fixed exchange rate to stabilize the price level, and suggests the implementation of a specific monetary model – a currency board arrangement - for the purpose of curbing inflation in the case of Romania.
Chapter 6
Fixed exchange rates and the currency board model

"In the beginning God created sterling and franc.  
On the second day He created the currency board and, Lo, money was well managed.  
On the third day God decided that man should have free will and so He created the budget deficit.  
On the fourth day, however, God looked upon his work and was dissatisfied. It was not enough.  
So, on the fifth day God created the central bank to validate the sins of man.  
On the sixth day God completed His work by creating man and giving him dominion over all  
God’s creatures.  
Then, while God rested on the seventh day, man created inflation and the balance-of-payments problem."
- Peter B. Kenen

The model of the fixed exchange rate

In order to discover the implications of a fixed exchange rate regime from a technical perspective, the combination in a log-linear formulation of the three elements comprising the monetary model is required: money market equilibrium, purchasing power parity (PPP), and uncovered interest parity. The expression in log-linear form of these three elements is desirable because the coefficients in log-linear equations are elasticities. As opposed to derivatives, elasticities avoid the use of units of measurement and allow for both cause and effect to be expressed in relative terms.

First, the money market equilibrium shows that real money balances are a function of output and the interest rate. This relationship is expressed in the following equation:

(1) \[ \frac{M}{P} = L(Y, i), \]

where \( \frac{M}{P} \) signifies the real money balances, \( Y \) the output, and \( i \) the interest rate. The log-linear form of this equation represents a specific money demand function, and it is expressed in the following equation:

(2) \[ m - p = \eta y - \lambda i, \]

where the interest rate is the only component not denoted in natural log since it is already

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a percentage. The $\eta$ coefficient is the elasticity of the money demand with respect to $Y$, while $\lambda$ is the semi-elasticity of money demand with respect to the interest rate.

Secondly, the purchasing power parity states that the difference between the price of a good or service in the home country and the price for the same good or service in a foreign country is the exchange rate of the home currency in terms of the foreign currency.

\[(3) \quad P = eP*,\]

where $P$ and $P*$ represent the home and foreign prices, and $e$ represents the exchange rate. In log-linear form:

\[(4) \quad p = \ln ep*\]

According to the absolute PPP equation shown in equation (3), the ratio of the home price to the product of the foreign price and the exchange rate, $P/(eP*)$, equals unity due to arbitrage in the international commodity market. In the same idea, arbitrage in international financial markets brings about an interest parity between the interest rates in the home and foreign country. The theory of interest parity explains the exchange rate in one year's time, yet it does not hold empirically due to factors of uncertainty and risk which may change the exchange rate in this given time period. By instead taking into consideration the expected future spot rate, the equation for the uncovered interest parity is open to uncertainty, and thus, a more realistic expression of interest parity results.

Equation (5) shows the uncovered interest parity:

\[(5) \quad 1 + i = (1 + i^*)(E(e_{t^*})/e_t),\]

where $1 + i$ represents the returns in the home country, $1 + i^*$ represents the returns in the foreign country, and $E(e_{t^*})$ is the expected future exchange rate. Since the interest return depends on the length of time, an equation expressing change over time is shown below:

\[(6) \quad 1 + i^t = (1 + i^*\Delta t)[(E(e_{t^*})/e_t)].\]

In order to portray the interest rate differential between the home and foreign country and its relationship to the exchange rate, the following derivation is necessary:
\( [i - i^*(E(e_{t+1})/e)] / t = [E(e_{t+1})/e] - 1 \)

\( i - i^*(E(e_{t+1})/e) = [E(e_{t+1}) - e]/e)^t \)

The limit of \( t \) converges to 0, and the interest rate differential equals the change in the exchange rates between the two countries:

\( i - i^* = e_i \)

or, in log-linear form,

\( i - i^* = \Delta \ln e. \)

By plugging in the purchasing power parity, Equation (4), and the uncovered interest parity, Equation (10), into the money market Equation (2), the result gives:

\( m = \ln e - \eta \Delta \ln e + (\rho^* + \eta y - \lambda i^*). \)

Disregarding the terms in parenthesis since they are exogenously given, it is clear that a fixed exchange rate requires a particular money supply, while the change in the exchange rate over time, \( \Delta \ln e \), must be zero if the exchange rate is fixed and people believe it to be so. Therefore, in this model a fixed exchange rate implies a fixed money supply according to the equation:

\( m_t = \ln e. \)

As endogenous to the model, the money supply cannot be chosen by the central bank as a tool to affect the economy's level of output, or other factors. With a fixed exchange rate, there no longer exists the freedom to choose the level of the money supply.

It is in respect to the autonomy to change the money supply that a fixed exchange rate regime differs from a floating exchange rate regime. Under a floating rate, the central bank has the liberty to increase or decrease the money supply if it sees this action fit for the economy, and this change would be mirrored by a depreciation or an appreciation, respectively, of the exchange rate. Yet, under a fixed exchange rate regime, the central bank or the government authorities cannot conduct monetary policy since the real money balances, \( M/P \), must be set to the level which maintains the fixed exchange rate. Diagram 1 below presents a clear picture of the implications of a floating versus a fixed exchange
rate for the money supply.

**Diagram 1: Monetary approach**

Analyzing this diagram from the premise of an increase in the money supply in the home country under a floating exchange rate, we observe that the increase in M/P causes a decrease in the home interest rate, which in turn causes a depreciation of the exchange rate measured in terms of the value of the home country's national currency. In the short-run analysis, prices are assumed sticky and thus, adjusting less rapidly than the exchange rate. More importantly, the exchange rate adjusts (depreciates, in this case) due to a change in people's expectations of the future value of their assets denominated in home's currency. With a decrease in the home interest rate, and thus a decrease in their returns on assets denominated in the home currency, people regard foreign-currency-denominated assets as more attractive since they consider the interest rate to be the forward rate. In their efforts to sell the home-currency-denominated assets they possess in order to invest in the more attractive foreign assets, they offer their current assets at lower and lower prices to ensure a sale. This phenomenon translates into a depreciated
exchange rate in terms of the home currency. In the short-run, the exchange rate is higher (more depreciated) than its long-run level due to this phenomenon - an occurrence known as overshooting. The occurrence of overshooting is observed in Diagram 1 in the jump of the exchange rate from point 2 to point 3. Diagram 2 below shows the change in the exchange rate over time:

**Diagram 2: Exchange rate**

As can be seen in this diagram, the short horizon change of the exchange rate is greater than the change in the money supply. Yet, in the long-run, prices start to adjust and people's expectations change, resulting in a change in the exchange rate equivalent to the initial change in the money supply. Diagram 1 shows this development over time. Prices increase by the same percentage that the money supply, $M^s / P$, increased, causing the interest rate to return to its initial value at point 1. As prices and the interest rate increase, people once again consider home-currency-denominated assets as profitable, thus, driving the appreciation of the exchange rate in terms of the value of the home currency to point 4. The main conclusion of Diagram 1 is that a permanent increase in a country's money supply causes a proportional long-run depreciation of its currency against foreign currencies. In this process, the initial increase in the money supply leads to future increases in the price level - due to excess demand for output and labor resulting from the expansionary effect of the increase in the money supply; due to
inflationary expectations of the price level rising in the future; and due to a rise in production costs in the industries where input goods are subject to prices which adjust quickly - thus, leading to inflation in the economy.

The monetary model underlying the above diagrams is inadequate since it considers the output, $Y$, as exogenous. The monetary authority may seek to increase the money supply in order to affect output, and this model does not explain changes in output. Nevertheless, the model presents two clear conclusions. First, the important role of expectations is exemplified by the conclusion that, all else equal, a rise in the expected future exchange rate causes a rise in the current exchange rate, while a fall in the expected future exchange rate causes a fall in the current exchange rate. Secondly, the model concludes that an increase in the money supply causes the depreciation of the exchange rate, thus causing inflation. Table 9 below summarizes the process by which inflation occurs under a floating exchange rate regime.

<table>
<thead>
<tr>
<th>Table 9: Simplified Money Supply Increase in a Central Banking System with a Floating Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equilibrium - assumed at 1 unit of domestic currency = 1 $ US</td>
</tr>
<tr>
<td>Unexpected demand by the central bank to increase monetary base (perhaps by lending to the government)</td>
</tr>
<tr>
<td>Reserves of commercial banks increase</td>
</tr>
<tr>
<td>Loans by commercial banks increase</td>
</tr>
<tr>
<td>Exchange rate of domestic currency depreciates to $1 + X units = 1 $ US</td>
</tr>
</tbody>
</table>

Source: Hanke, S., and K. Schuler (1994)\textsuperscript{66}.

The above table concerns an unexpected increase in the monetary base in order to avoid the complications of a rational expectations argument. The result of this increase is that the domestic currency loses value against foreign currency. If prices are assumed to

be sticky, then the real effects on the economy comprise a depreciation of the real exchange rate, a decrease in the prices of nontradable goods relative to tradeable goods, and an increase in exports, while the real wages and prices will be lower than before this change in the monetary base. An important point worth noting is that the increase in the money supply shown in Table 9 reflects a decision on the part of the central bank, and not an outcome emerging from market forces. This serves as an example of a central bank's ability to use discretionary monetary policy under a floating exchange rate regime. As observed in the Table 9, such discretionary policy conflicts with the goal of maintaining a fixed exchange rate, thus conflicting with the goal of establishing a credible policy beneficial for investors and for micro-security (whereby producers know the price at which their products will sell in the market).

Under a fixed exchange rate, the monetary authority does not face the risk of causing inflation since monetary policy is tied to maintaining the fixed exchange rate. In countries where the central bank is not fully independent and the government controls monetary policy either inadequately - by giving credits to inefficient state-owned enterprises - or selfishly - by increasing the money supply to finance unnecessary expenditure benefiting various rent-seeking groups - it proves best that the exchange rate be fixed in order for the government to not have access to the money supply. In cases where distrust of the government is mirrored by distrust in the national money, and the phenomenon of inflation occurs as a result of a higher risk premium, a fixed exchange rate provides the credibility that both the government and the national currency need in order to stabilize the country's economy. Yet, if a country chooses to adopt a fixed exchange rate regime and the government relies on the central bank to finance its expenditure, a currency crisis is not far ahead.⁶⁷

The main determinant of a currency crisis is a budget deficit financed by the

central bank under a fixed exchange rate regime. Consider the central bank’s balance sheet as shown below:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic credit, BH</td>
<td>Deposits held by private (commercial) banks</td>
</tr>
<tr>
<td>Foreign reserves, BF</td>
<td>Currency in circulation (notes and coins)</td>
</tr>
<tr>
<td>Base money = M</td>
<td>Base money = M</td>
</tr>
</tbody>
</table>

In order to finance its spending spree, the government provides the central bank with bonds in exchange for money. Consequently, the domestic credit expands at an assumed constant rate \( u \). This situation is expressed by the following equation:

\[
(13) \quad \frac{B^H_{t+1} - B^H_t}{B^H_t} = \mu
\]

or in log-linear form,

\[
(14) \quad b^H_{t+1} + b^H_t = \mu
\]

Under a floating exchange rate regime, the increase in domestic credit would be sterilized by an increase in the currency in circulation which would result in inflation. Under a fixed regime, the money supply must remain constant so as to maintain the fixed exchange rate. Consequently, foreign reserves must be sold in order to maintain the exchange rate, but at the cost of losing the credibility of the fixed regime. The working equation for the central bank under this regime is expressed below:

\[
(15) \quad M_t = B^H_t + eB^F_t,
\]

where \( M_t \) and \( e \) are both held constant, and the domestic bonds, \( B^H_t \), increase by the same percentage as the decrease in the foreign bonds, \( B^F_t \).

Given the situation of a fixed exchange rate, a budget deficit financed through increasing domestic credit, and a consequent decrease in the foreign reserves to maintain
the fixed exchange rate, the Krugman model explains that a crisis - a sudden loss of the remaining reserves and the forced flotation of the exchange rate - will occur before the country runs out of its foreign reserves.\(^{68}\) To support his argument, Krugman introduces the concept of the shadow exchange rate, which is the hypothetical market rate existent if the country had no foreign reserves at all. Using the equation expressing the money market equilibrium and the two parities, equation (11), the shadow exchange rate takes the form:

\[
\ln \tilde{e} = m + \lambda \Delta \ln e.
\]

(16) \hspace{1cm} \ln \tilde{e} = m + \lambda \Delta \ln e.

Without foreign reserves, the percentage growth in the money supply equals the percentage growth in domestic credit: \(m_t = b^H_t\). Additionally, the change in the exchange rate (the depreciation, in this case) equals the change in the domestic credit over time (i.e. the increasing money supply): \(\Delta \ln e = \mu_t\). Thus, equation (16) can be transformed as follows:

\[
\ln \tilde{e} = b^H_t + \lambda \mu_t.
\]

(17) \hspace{1cm} \ln \tilde{e} = b^H_t + \lambda \mu_t.

Diagram 3 portrays Krugman's theory of the currency crisis.

Diagram 3: Currency crisis

\(^{68}\) ibid.
According to Kurgman's theory, the exchange rate collapses at time $T$ when the shadow exchange rate intersects the peg. An attack on the currency at an earlier time would lead to an appreciation of the exchange rate, suggesting losses for the attacker since the shadow rate is below the peg in this situation. In contrast, an attack at a later time suggests that the shadow rate would be higher meaning that the attack at this later time is profitable. Yet, speculators acting fast to benefit from this profit drive the time of the attack to point $T$. At time $T$, foreign reserves decrease abruptly, as shown in log-linear form by Figure A of Diagram 4; the money supply suffers a sudden loss corresponding to the loss in the foreign reserves, and then followed by an increase due to the increase in domestic credit as observed in Figure B; and lastly, the interest rate will increase at time $T$ and remain at this higher level as seen in Figure C.

Diagram 4: Implications of the currency crisis

Figure A shows the composition of the money supply. Figure B shows that the money supply before the crisis was characterized by $m_t = \ln \bar{e}$, while after the crisis it is characterized by $m_t = \ln \bar{e} - \lambda \mu$. 
According to the Krugman model, it is possible to forecast a currency crisis in a country which has a fixed exchange rate, and which runs large deficits corresponding to decreasing foreign reserves - or to use Krugman's terminology, a country whose exchange rate is farthest from its shadow rate. Even so, the Krugman model cannot predict currency crises in countries which do not have budget deficits, as was the case with the East Asian crisis in which countries were in fact characterized by budget surpluses. Even so, the example of the East Asian crisis is instrumental because it does show the importance of expectations in determining the exchange rate. Investors entered into the emerging markets of East Asia at a time when interest rates were low in the West and potential returns were higher in Asia. As the mid-1990s saw the transformation of these countries from "developing countries" to "emerging markets," lenders and investors deluded themselves into believing that these countries could participate in the turbulent world economy. Yet, as these investors saw their hopes for inflated returns crash in Thailand in 1997, they expected that all other nations in the same category would also experience the same economic turmoil. These expectations brought about the self-fulfilling prophecy of a financial crisis in all of East Asia, very much in accordance to Krugman and Obstfeld's conclusion that a depreciation in the expected future exchange rate will cause a depreciation in the current exchange rate.

The East Asian crisis also calls attention to the lack of transparency and information disclosure characterizing these emerging market countries. These countries often did not disclose their total reserves or their total liabilities in a regular and up-to-date way (Garten, 1999). As the International Monetary Fund stepped in to East Asia with a rescue package, the issue of moral hazard arose as another fault which led to the crisis in the first place. The notion that a major international actor such as the IMF would bail out these countries, or that national governments would bail out lenders and

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investors, created a habit out of overlending and overinvesting without taking the proper regulatory measures.

In studying the East Asian crisis, three main preventive measures can be drafted which can be applied to strengthen a country's financial architecture in order to avoid such a financial crash. Among the first prescriptions is that of establishing credibility through the establishment of a firm and credible exchange-rate commitment. Secondly, the possession of back-up reserves through the possession of larger currency reserves or credit lines is advisable in order for the country to bolster its position in the face of a possible meltdown. Third, the dependence on IMF bailout rescue packages - or on bailout altogether - needs to be curbed in order for the incentives of investors or lenders to not be distorted. A monetary model which comprises all three of these preventive measures, in addition to insulating the monetary authority from political intervention, and decreasing inflation and interest rates below levels found in countries with a floating exchange rate regime is a currency board model. Three main characteristics define this model: the exchange rate fixed to an ‘anchor currency’, the full-backing of the national currency by foreign reserves and the full convertibility between the two, and an independent central bank which establishes the fixed rate of exchange in the bank law.

Prior to the discussion of the theoretical and empirical aspects of a currency board, a look at central bank independence is appropriate.

The independence of the central bank: an international consensus

"There have been three great inventions since the beginning of time: fire, the wheel, and central banking."

-Will Rogers

On history’s scale, central banks are a relatively new invention. The first central bank was the Bank of England, established in 1694. The initial role of this bank was similar to the role of an ordinary commercial bank, but its functions evolved over time as
it became the center of interbank activities. With the Bank Charter Act of 1844, the bank took on the role of monetary authority, which allowed it to print and disperse banknotes, along with the role of lender of last resort for the banking system, and lastly, the role of administrator of the government’s foreign reserves and of the gold.

Yet, the Bank of England was never an independent central bank, since it remained subordinate to the Treasury and had the role of merely applying monetary policy. Only in the spring on 1997, did the government announce plans to harmonize the Bank of England with the standards of the European continent.

The first independent central bank was the Federal Reserve System which was created in 1913. This independence was mostly a result of the American philosophy on the division of power, rather than the product of economic theory. One of the most noted independent central banks has been the German Bundesbank, which was thus established by military forces occupying Germany after the Second World War who sought to speed up the de-nazification of the country through the means of a bank independent from the political process. The main characteristics of the Bundesbank, and of any credibly independent central bank, are the following: the principal objective of monetary politics must be the stability of the currency; the bank must support the economic policy of the government, unless doing so comes in direct conflict with the function of protecting the country’s monetary stability; in conducting its functions, the bank must be independent from all instructions received from the government, from the Parliament, or from other political institutions; lastly, the persons governing the central bank must have a specified term limit (eight years was the case of the Bundesbank) and cannot be displaced from this function during their term limit.

The successful results achieved by the German economy in the post-war period was a direct result of the independence of its central bank. These results also formed the main argument which led to the construction of the European System of Central Banks
(ESCB) with the same characteristics as the German Bundesbank. As stated in the Maastricht Treaty which outlined the judicial formation of the ESCB: the stability of prices is the essential objective of the European Central Bank (ECB); the bank is independent from instructions received from officials at either the national or the community level; and the organism responsible for the monetary policy cannot be replaced during its specified term limit.

The insulation of the central bank from the political process is of great importance for long-term economic success. In 1993, Helmut Schlesinger, then president of the Bundesbank, affirmed that the success of economic policy, especially of monetary policy, can be observed mostly in the long-term, and thus, central banks must have a long-term perspective. Furthermore, the central banks must decide upon the application of some unpopular measures in the short-term, but which will protect the monetary stability in the long-run. More specifically, the central bank, and monetary policy, must be insulated from the influence of the government authorities who are too familiar with the seductive possibility of covering, without a limit, the government deficit through the increase in the money supply. There is a consensus among economists that inflationary policies are counterproductive for economic growth. Therefore, it is in the interest of every country that monetary policy is protected from the pressures, specifically electoral in nature, of the governing parties.

It must be mentioned that an independent central bank is by no means insulated from public control. The bank must be held accountable for its action by the public (or by an independent agency) to ensure that it carries out its functions to the best of its abilities for the welfare of the country and the citizens. In many countries today, public opinion measures the performance of the central bank in fulfilling its main duty of price stability.

In order to fulfill its essential function, the central bank must have full discretion

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71 Ibid.
over monetary creation. In the case that the central bank has the right, or even the obligation, to cover the public debt through the emission of money, its capacity to conduct an anti-inflationary policy is limited, while the independence of the bank in conducting monetary policy remains merely declamatory. For this reason, the Maastricht model sees to the following principles.72 First, the government, or any related entity, cannot force the central bank to provide it with credits, but the bank may accord these if it feels them to be necessary; thus, the accord of credits by the central bank is fully discretionary in nature. Second, the bank’s open market operations are curbed so that the bank cannot buy government assets on the market; nevertheless, it may purchase these on a secondary market for monetary policy motivations. Third, the national parliaments or any political entity of the European Union cannot have any direct relation with the conduction of monetary policy; additionally, they cannot force the bank to accord credits to any governmental entities. Fourth, there are no limits to the government’s deposits at the central bank, while the bank may act as a fiscal agent; yet, this latter function must be specified in the central bank law as secondary to the principal objective of price stability.

The transition countries of Eastern Europe seeking to join both, the Economic and the Monetary European Union, have adapted their banking legislation to the new social and political conditions, while also taking into consideration current economic thought with respect to the functions and the status of the central bank. Thus, the independence of the central bank is explicitly denoted in the national law of Bulgaria, Estonia, Latvia, Slovakia, Hungary, and the Czech Republic. The role of the government relative to the central bank in these nations range from a consulting role in Estonia and the Czech Republic to a supportive role in Slovakia. In all of the countries of the group mentioned above, the direct financing of the public deficit is clearly limited. This fact is of great importance for these countries - and for transition countries, generally - for two reasons.

First, the financing of the government by the central bank fails to discipline the governmental authorities, and thus, fails to truly manage the problem of the deficit, not to mention the adverse effects that such a decision would have on the country’s inflation. Second, and most importantly, the bank’s failure to finance the government will force the latter to seek other means of financing its expenditure. More specifically, the development of a secondary market for government assets (such as a bond market) will help the government to finance itself, while also accelerating the growth and the deepening of the financial markets of these countries.

However, central bank independence is not sufficient to ameliorate the performance of the economy’s real sector. In order for this to occur, the governing body of the central bank must believe in the capacity of monetary policy for influencing the evolution of the economy. Thus, a crucial dose of credibility that the central bank will conservatively target the stability of prices is necessary for people’s expectations to change and for the economy to see an upturn. An accommodating stance on the part of the central bank toward different, ‘needy’ economic agents, will deteriorate the credibility that the central bank is fulfilling its main duty. A last point on central bank independence calls for other governmental policies to harmonize themselves to the objective of monetary policy. Specifically, fiscal policy and monetary policy must converge toward the objective of restructuring the economy, for otherwise a crisis can occur, along the exact lines of the Krugman crisis model previously explained, regardless of the level of central bank independence.

The specific situation of the transition countries, where the political process does not create a stable environment conducive to investment and economic reform, where the credibility of the government (and even of the central bank) proves doubtful due their manipulation by a multitude of interest groups, where indiscipline and corruption weakens the banking sector, and where the economy suffers from staggering levels of inflation, is prime for the application a specific monetary model - a currency board.
The benefits of a Currency Board Arrangement (CBA)

A currency board arrangement incorporates three main elements - an exchange rate fixed to an 'anchor currency,' the right to exchange the domestic currency at this fixed rate whenever desired, and a commitment to this system reflected directly in the central bank law. Under such a system, the domestic currency can be issued only to the extent that it is fully covered by the central bank's holdings of foreign exchange. This stipulation proves to be a major advantage since the central bank (or the currency board authority) can never run out of foreign exchange reserves in the face of a speculative attack on the exchange rate. Consequently, the main reason for contemplating a currency board is to pursue a visible anti-inflationary policy. In the case that foreign currency backs an equivalent amount of domestic currency bills, the demand for the 'currency board currency' will be higher than for currencies without a guarantee. As the money supply in the currency board country changes, interest rates will change. This mechanism induces profit-maximizing investors to move their funds in order to benefit from greater returns on their investment. The currency board arrangement proves more beneficial in this situation than any other fixed exchange rate system because it implies an exchange rate guarantee. This guarantee ensures that the necessary interest rate changes and the resulting costs to the economy will be lower than those associated with other exchange rate systems.

Economic credibility, low inflation, and lower interest rates seem to be the immediate advantages of a currency board. Highly indebted countries, as well as countries with weak fiscal institutions, usually fall into a low credibility trap. The government loses its credibility in the eyes of the financial markets and is forced to pay a

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risk premium in the form of higher interest rates. Consequently, a higher debt-service burden results. In the case that inflation is kept at low levels, the government will most likely abandon efforts to stabilize the situation and attempt to reduce the real value of the debt through a surprise inflation. This situation leads to a spiral of increasing interest rates since the risk premium demanded by the financial markets further increases. The spiral continues until the government caves in and produces the inflation expected by the market. Countries in such a situation have an interest in using an external anchor such as a currency board arrangement. Since the market knows that the temptation for these countries to inflate public debt away is very strong, these countries would endure extreme inflation rates at the hands of the market. An external anchor would prevent such high rates of inflation from occurring.

Furthermore, a CBA curbs the bailing-out practices of the national central bank which are detrimental to a country's financial system. With a CBA in place, the national central bank can no longer pursue the role of a lender of last resort to inefficient banks in financial trouble. This ensures a better allocation of its loans. Additionally, a CBA requires that the national central bank be independent of the government. This ensures that bank transactions are more transparent. These two factors, along with the sufficient backing of the central bank's entire monetary liabilities by foreign exchange reserves, provide a credible basis for monetary stability and low inflation.

*Empirical evidence in favor of currency boards*

The merits of a currency board arrangement cannot be resolved by theory alone. Ghosh, Gulde, and Wolf (1998) have undertaken an empirical investigation to verify the causality between a CBA and lower inflation rates. By using a data set containing all IMF member countries over more than twenty-five years, the study isolated the inherent effects of a currency board arrangement regardless of the many country-specific challenges facing countries with an implemented CBA. These challenges ranged from
hyperinflation in Argentina, to volatile terms of trade in the Eastern Caribbean Currency Board, to transition to a market economy for Estonia. The results of the study confirm that currency board arrangements have done better at managing inflation than other exchange rate regimes. For example, the presence of a currency board arrangement is found to lower annual inflation by about 3.5 percentage points - the result of what Ghosh et al. label as the "confidence effect" resulting from the credibility of such an arrangement. The lower inflation essentially arises from the faster growth of money demand made possible by the greater institutional certainty associated with a currency board. In contrast to fears raised by opponents of the currency boards, Ghosh, Gulde, and Wolf (1998) did not find that existing currency boards had any negative effects on growth.

Ghosh, Gulde, and Wolf (1999) reached the same conclusions a year later, namely that inflation performance under currency boards has been significantly better than under either pegged or floating regimes. Indeed, it seems natural that CBAs should foster lower inflation since the monetary discipline instilled by the currency board targets this exact factor. Additionally, the higher money demand associated with a more credible system results in lower inflation levels. Most importantly, the 1999 report by Ghosh et al. argued that better inflation performance did not come at the cost of lower growth. Average per capita GDP growth was actually twice as high under currency boards than under either floats or other pegged exchange rate systems. Table 4 shows the performance of different exchange rate regimes as regards inflation and GDP growth per capita. The data, which was presented in the Ghosh et al. report, shows that a currency board achieved the lowest inflation mean and the highest GDP growth per capita when compared with either pegged or floating exchange rate regimes. The data covers all IMF members over the period 1975-1996.
Table 11: Macroeconomic performance under alternative exchange rate regimes

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Source: Gosh et al. 1999.

In the debate about the benefits of a CBA, it can be postulated that transition economies stand to lose from such an arrangement due to their weak institutions in the banking sector. This weakness refers mainly to the abundance of non-performing loans, unsound credit policies to finance consumption, price subsidies, and weaknesses in governance of the banking sector. Yet, it is exactly "countries with such weak institutions that would greatly benefit from the external anchor provided by a CBA."74 Countries with a strong domestic framework characterized by an efficient tax system and little pressure for excessive expenditure (unusual in the transition economies) would enjoy low inflation in any case. Unlike countries with a weak domestic framework, they would have no need for an external anchor.

In line with this argument, the experience of Estonia and Lithuania with currency

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boards proves useful in determining the benefits of a currency board in the context of transition economies. Although both of these Baltic states experienced an initial decline in GDP after the break-up of the former Soviet Union, both have experienced solid economic growth in the past few years\textsuperscript{75}. Indeed, these countries had faster paced reforms compared to other transition economies. Nevertheless, "the currency boards in Estonia and Lithuania have contributed to a drop in 12-month CPI [Consumer Price Index] increases by mid-1999 to well below 3 percent; core inflation was even lower."\textsuperscript{76} As compared to other transition economies, these Baltic States have managed to maintain their low levels of inflation. Furthermore, "the transparency of policies and the policy discipline under the currency boards appear to have supported, rather than hindered, the transformation from centrally planned to market economies, and promoted the nominal and real convergence of their economies toward those of EU members."\textsuperscript{77} Hence, the currency board has served as a tool for promoting the stabilization of these transition economies and for aiding their process of accession to the EU.

\textit{The operating environment}

The operational feasibility of a currency board arrangement depends on whether the attendant legal and institutional issues are effectively addressed. A range of important decisions must be made about its specific nature, including changes needed in the institutional framework for financial management in the economy and, especially, in the legal environment in which central banking is carried out. The basic decisions involved in establishing a currency board arrangement include choosing the peg or anchor currency and determining whether or not to include a safety margin for the financial sector after setting the level of the peg.

\textsuperscript{75} Gulde et al., 2000.
\textsuperscript{76} ibid, p.12.
\textsuperscript{77} ibid, p.15
In choosing an anchor currency, the strength and the international usability of a currency stand as the main factors. In choosing from this field, a country should consider its current and prospective trade flows, as well as other economic links to the country issuing the anchor currency. In a "pure" currency board arrangement, the currency board has no margin to intervene as a lender of last resort on behalf of a bank in difficulties or to engage in open market operations. A country debating the adoption of a CBA may seek a safety margin of some excess coverage, holding reserves of 100+x percent of the monetary base. In this situation, interventions of up to x percent of the base money would be possible without violating the currency board rules. Nevertheless, such a provision may limit the transparency and, thereby, the credibility of the system.

A sound legal system is essential for the success of a currency board arrangement. Much of this arrangement derives its credibility from the changes required in the central bank law concerning exchange rate adjustments. The law must define both the exchange rate and reserves, as well as specify the limited powers of the managing institution under the system. Furthermore, establishment of a CBA requires the redefinition of the financial relationship within the country's government. Most often in the transition economies, the inflationary impetus that the CBA targets was initially created by extensive central bank financing of the government. Rules for a currency board arrangement need to prohibit new central bank loans to the government. These rules laid down in the new central bank law will serve as guideposts for reorganizing the central bank into a currency board.

_The Argentinean Lesson_

The Convertibility Plan introduced in Argentina in 1991 successfully accelerated economic growth and curbed the high rates of inflation which had twice already resulted in hyperinflation. Among other reforms of the Argentinean economy, this Plan reformed the exchange rate regime along with the central bank charter. In the exchange rate reform, the currency - the Argentinean peso - was pegged to the U.S. dollar, the stock of
currency issued was tied to the stock of foreign exchange held by the Central Bank of Argentina, and full convertibility of the peso for both current and capital transactions was established. These monetary and exchange rate arrangements may be described as a currency board arrangement although this is not exactly the case. Unlike in a pure currency board, the stock of monetary liabilities of the Argentine Central Bank could have exceeded the stock of foreign exchange by a maximum of 33 percent (20 percent during 1991-1995). Nevertheless, these steps increased the transparency of the economy, set the exchange rate anchor, and had the effect of sorting out efficient from inefficient enterprises. Additionally, in 1992, the charter of the central bank was rewritten to prohibit the financing of public sector deficits and to remove lender-of-last resort functions in the bank's relations with other commercial banks. According to the 1998 IMF Staff Country Report No. 38, "the exchange rate anchor in Argentina appeared to be strong enough to significantly reduce inflation during the early years of the Plan through 1994."\(^{78}\)

Despite the progress made during the first four years, the crisis triggered by the devaluation of the Mexican peso in December 1994 brought into view the remaining weaknesses of Argentina's banking sector. According to the IMF Report, the stock of problem loans of the banking system still exceeded ten percent of the loan portfolio by 1994, with small private and provincial banks accounting for a disproportionately high share of the total. Despite the nearly three years of high economic activity, the run on deposits caught several banks short of liquid assets. This situation also spread to a number of solvent institutions. Despite sharp interest rate increases, there were large withdrawals of peso deposits. Interestingly enough, while the peso-denominated deposits fell, there was very little net withdrawal of the dollar deposits. This shows that the high investor confidence in the dollar did not result in a run on these deposits. Additionally in Argentina, there was also a shift in the financial sector whereby ten leading banks gained

\(^{78}\) IMF Staff Country Report No. 98/38, p. 8.
a large market share.

It has been postulated that the reason for the banking crisis in Argentina was its quasi-currency board arrangement.\(^7\) Argentina did not implement a "pure," fully credible currency board, while it displayed ambiguity of responsibilities. According to Honohan (1997), the central bank had responsibilities other than protecting the currency and it is for this reason that it and the commercial banks were run. By allowing for higher liquidity margins, the CBA did not present a credible policy which may have maintained investor confidence in the Argentinean peso despite the Mexican devaluation. It is evident from the robustness of the dollar deposits during this time that the crisis was more of a crisis of confidence in the Argentinean peso than in the Argentinean banking system. This suggests that dollarization may be a suitable approach as the dollar is a stable international currency.

The Argentine experience shows some of the main problems with a currency board arrangement - bank failures and the implementation of a quasi-currency board. The currency board regimes inherit unsound banks and bankers unaccustomed to a market economy as a result of socialism, or, in Argentina, an amalgam of populism and mercantilism. Currency board authorities respond to the crises provoked by these unsound financial institutions by lending to the commercial banks, or, in the case of Argentina, by establishing a temporary safety net to redistribute liquidity within the system (among other measures).

Nevertheless, such unfortunate experiences as the one suffered by Argentina are beneficial in weeding out unsound banks and in teaching commercial banks how to fend for themselves.\(^8\) Yet, the rescuing of the financial system by the central bank is itself a


deviation from the standard CBA practices. This example shows the importance of a pure currency board with clear and limited responsibility for monetary matters. It shows that if these limitations are not respected, the outcome can be very unfortunate. But, if not tampered with, this regime could deliver price and exchange rate stability.

The major difficulties faced by Argentina most recently show the main risks associated with currency boards. The dollar appreciation at the end of the 1990s strongly deteriorated Argentinean competitiveness on Latin American markets, particularly with respect to its main trading partner, Brazil. The fall in exports led to an increase in the trade deficit which required external financing. In this environment, investors became increasingly nervous about the possibility of the Argentinean government to service its debt. In June of 2001, the government did manage (with the help of the IMF) to convert some short-term debt into long-term debt, and by July, the peg to the dollar was relaxed, with exporters receiving a subsidy and importers paying a tax. This experience emphasizes that a country takes on major risks from pegging its currency to a country which is not its dominant trading partner.

This aspect of a currency board operation underlies the decision of some transition countries to peg their national currency to the euro, since their trade patterns heavily favor the European Union member countries, and especially due to their prospects of joining the Union's Single Market. Monetary policy as a means of converging to EU criteria will be discussed in the following chapters, in the context of Romania's plans of accession to the European Union. An analysis of the macroeconomic policies pursued by Romania on the path to economic transition is the subject of the next chapter.
Chapter 7

Macroeconomic policy and inflation - the Romanian case

“To get in Paradise, it seems that the Romanians have first to go through Purgatory.”

-Vladimir Pasti

Romania and the rest of the world

In the last few decades, economic policy at the international level has been oriented towards neoliberalism. Essentially, the role of the state has been curbed, as the state has proved to be more inefficient and wasteful than the private sector. Currently, the intervention of the state takes the form of specific economic policy, be it fiscal, monetary, income, trade, or exchange rate policy. The consensus has been that the state should assume a neutral stance, without trying to significantly influence the allocation of resources in the economy (as could be conceived through the use of tariffs or taxes). Thus, the role of monetary policy is of particular importance since its main objective - the stability of prices - serves to establish the price as a signal in the economy so as to facilitate the allocation of resources in various markets.

The success of this neoliberal orientation has not been extraordinary. The periods of keynesian expansionism led to substantial government deficits which currently play an important role in fiscal policy. The objective of decreasing inflation has experienced the greatest success due to the concentration of monetary policy on this single goal, and due to the support of the population in creating a firm anti-inflationary environment. The role of the latter factor in decreasing inflation should not be underestimated, for the expectations of the population are the determining factor in the realization of this goal. The best national performance in the economic arena has been observed in the United States. Decades of a monetary policy supporting a firm anti-inflationary stance, combined with fiscal prudence and an emphasized distancing of the state from the economy (even during the democratic administration), have led to spectacular economic results: 1998
was the seventh consecutive year of sustained growth in the longest period of uninterrupted economic prosperity registered in the last 29 years; the unemployment rate dropped to 4.3 percent; and the inflation rate stabilized at 1.5 percent annually.

The evolution of economic objectives over time and the subsequent economic successes experienced at the international level show how disconnected Romania has been from the international arena during the centrally-planned regime. The reconnection of this country with the Western world - or its ‘return to Europe’ as this operation has been called in national platforms - is an inevitable, but lengthy, process. Romania’s evolution in the first decade since the collapse of communism has been less than satisfactory: fiscal policy has failed to address the excessive fiscal and quasifiscal deficits; trade policy (which will not be discussed in this paper) has varied from protectionism to openness, and emerged highly inconsistent and inefficient in the process; monetary policy has been used to address multiple objectives, some of which (like the financing of agriculture) had no appropriate connection with the normal activities of a central bank.

Under these conditions, it is not surprising that the imbalances created in the communist regime were maintained in the new system, and that a soaring rate of inflation accompanied the first decade of transition. Important to notice is the point highlighted by the director of monetary policy at the Romanian National Bank, Eugen Radulescu, that there has never existed an anti-inflationary mentality in Romania either at the policymaking level, or at the general societal level\textsuperscript{81}. The lack of any episode of inflation in Romania's history and the lack of information about the mechanism of prices in a market economy both created the perfect breeding ground for inflation. This unfortunate outcome shows the importance of training both the politicians and the public in the management of inflation; both parties play a crucial role in curbing inflation, and only by

\textsuperscript{81} Radulescu, 1999.
harmonizing government policies with the public's expectations will the goal of anchoring inflation truly be realized.

Romania's solutions for battling inflation during the last decade (none of which directly targeted inflation, or made it a policy priority) have had serious macroeconomic repercussions, while also proving to be inefficient at the time of their implementation. Despite certain incorrect inflation, and exchange-rate, targets that were set, the indiscipline of the Romanian economy still leads to the accumulation of large fiscal and quasi-fiscal deficits which are financed by central bank credits. Despite the government's current endeavors to restructure loss-making enterprises and to curb inflation by cutting zeros from the end of the banknotes, the inflationary process is still in full force, and, in my opinion, it will soon add those zeros back. This will occur because the current attempts at curbing inflation are not credible enough for people to change the expectations they have harbored for too many years of transition. As the centrally-planned economy collapsed, the institutional void left behind has fostered the attitude of an unstable environment, of a wild capitalism where it is each for himself. Trust of the public authorities who have failed to guide and protect the population on the path of transition will not replace the skepticism unless new credible institutions are constructed in the place of the former state committees who were in charge of the economic plan. Ways to build this social capital will be the focus of the remaining chapters of this paper. However, it is well-acknowledged that there are many interdependencies between the microeconomic structure of the economy, the institutions established, and the overall macroeconomic performance of the economy. A study of comprehensive reform is beyond the scope of this paper. This thesis will specifically address the role that monetary institutions could have in stabilizing the Romanian economy. Before attempting such a discussion, an analysis of Romania's macroeconomic policy during the past decade of transition is necessary, starting with the framework of the Romanian banking system.
Banking System

Although Romania inherited a one-tier banking system from the socialist era (in the form of a monobank), it implemented a two-tier banking system at the end of 1990. The new system consists of a central bank - the National Bank of Romania (BNR) - and commercial banks which serve the traditional role of credit institutions. The former branches of the monobank were transformed into some of the new commercial banks, such as Banca Agricola which only addressed the financial needs of the agricultural sector under the socialist system. In retrospective, it is clear that in the early years of transition these institutions “dramatically” lacked the expertise to grant and manage credits in a decentralized economy\textsuperscript{82}, and that many of the loans were given on a preferential basis without any supervision or monitoring of clients. Non-performing loans, some of which were extended to ghost companies with the full knowledge of the bank directors, allowed the banking system to be a puppet on strings for rent-seekers. Consequently, the banking system became vulnerable and dependent on the central bank for liquidity. Yet, with the central bank as a lender of last resort, the banks and their directors had no incentive to discipline their loan-granting activities, and they continued to engage in risky activities. Thus, moral hazard plagued the banking system.

My perspective on the banking system, shaped by interviews conducted in the summer of 2001 at the Romanian Commercial Bank (BCR) and at the National Bank, is that the system suffered even more acutely from adverse selection. According to the Director of External Affairs at the BCR\textsuperscript{83}, there were prior arrangements made between political figures of consequence and newly appointed bank directors which resulted in significant capital flight outside the country or transfer of money to undisclosed accounts.


\textsuperscript{83}The Director prefers that her name be withheld.
The liquidity burden in this situation fell on the central bank. Thus, due to poor supervision and regulation of the banking system, corrupt individuals were attracted to positions within the bank for their own gain. When asked about the possible implementation of a bank tribunal, due to the high number of failing banks with no records of the outflow of money, the Director responded that such a measure would never be taken in Romania simply because those in control (at the time of the interview, as now, the governing party is the Social Democratic Party) do not want one.

A striking anecdote of the grave indiscipline and acute corruption in Romania’s financial arena is given by the example of the credit institution FNI, the National Investment Fund. The Fund attracted an estimated 164 million dollars from 300,000 citizens (many of which were pensioners living on small pensions) due to the high interest rates it offered. Yet, in the spring of 2000, not long before the fall presidential elections, the Fund announced a moratorium on deposits, meanwhile Maria Vlas, the president of the Fund, was nowhere to be found. All depositors lost their investments, which for many people meant the entire savings they managed to accumulate in the turbulent years of transition. Aside from the social and economic dimensions of this story, the political aspect proves chilling. The main opposition party, PDSR (the Romanian Social Democratic Party, which is now in office) had been accused of trying to subvert the financial system in order to win the fall elections against the governing party at the time, PNTCD (the Christian Democratic Party). Evidence of this rests in the fact that the director of the agency responsible for regulating the capital market, which was thus in charge of supervising the Fund and monitoring its cash flows, did not avert the nation of the cash outflows occurring prior to the moratorium.\(^\text{84}\). Interestingly enough, he was a member of the PDSR Party. In my interview with the Director of the BCR, I inquired about the political implications of the Investment Fund, and she informed me

\(^\text{84}\) Information gathered from national newspapers and the following news website: Central European Review: http://www.ce-review.org
that a substantial number of people retrieved their money, along with the interest, five months before the moratorium. They, too, were all members of the PDSR Party. This example goes to show the extent to which Romanian politics and politicians twist the economic arena to suit their own electoral needs. The level of corruption in this country has become a clear impediment to the proper functioning of the economic and financial markets. In my mind, the insulation of market institutions from the political process is absolutely necessary if reform is to be implemented with long-lasting effects. The Romanian financial market, and especially its banking system, needs credibility in order for investment to grow and for the country to improve its image in front of the outside community and in front of its own citizens. The expectations of the population need to change in order for them to trust the political process, and in order for the market to function. Without this trust, a crisis will always be looming and the market will always be vulnerable.

Weeks after the moratorium was announced by the FNI, depositors of large sums of money at the Romanian Commercial Bank received anonymous telephone calls informing them that the bank will go bankrupt with no insurance for deposits. As a result, mobs of people stormed all local branches of the bank demanding their money. The Minister of Finance at the time (member of the PNTCD) "blamed a group of what he described as behind-the-scenes manipulators for provoking the crisis."85 The bank closed for the day, refusing to honor withdrawal requests, and the situation calmed down in the following days without a financial crisis. Nevertheless, the economist Ionut Balan said to the BBC News team that: "The aim was clear, the idea was to demolish the current government's monetary programme."86 Even more than that, the attacks from the opposition managed to derail, once again, the Romanian political consensus-building

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85 Information gathered from national newspapers and the following website: BBC News Online: http://news6.thdn.bbc.co.uk/low/english/world/europe
86 Ibid.
process by becoming obstacles to democratic party pluralism. Following these attacks the leading candidate for the PNTCD Party in the upcoming fall elections, Emil Constantinescu (President of the country at the time), announced that he refused to be a part of the Romanian political system ever again due to the incomprehensibly high levels of corruption.

**Fiscal Policy**

The main objectives of Romania’s first democratic government elected soon after December 1989 were to distance the state from economic affairs, to redirect incomes and state expenditure in accord with the appropriate levels found in market economies, and to maintain the fiscal deficit at modest levels. Yet, these objectives were not fulfilled.

The levels of income and government expenditure decreased from 43.5 percent and 36 percent, respectively, of the 1989 measure of GDP to levels of 26.8 percent and 31.8 percent, respectively, of the GDP in 1996. Yet, this decrease was not long-lasting as both of these components soon began ascending, the income level increasing to 30.7 percent of the GDP in 1998, and the level of government expenditure increasing to 34.7 percent of the GDP in 1999. Although the figures for the fiscal deficit are lower in Romania than those in other European countries, Radulescu explains that they do not include significant government accounts, specifically the quasi-fiscal accounts. These accounts include the unemployment funds, and the arrears and credits given to state-owned enterprises. In Romania, tax and inter-firm arrears were more than 35 percent of GDP in the year 2000. Inter-firm arrears are transformed into temporary quasi-money when firms use actual liquidity for paying wages or taxes. This method of operation also fuels inflationary expectations.

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87 Radulescu, 1999.
88 ibid.
Analyzing these economic distortions, it seems to me that the economic rationale for subsidies to SOEs is not as strong today as it was in the early years of transition or under the central plan. According to Daianu, increased international openness has allowed foreign suppliers to replace the inefficient domestic firms, while many national private firms (some of which are the product of de-monopolization) have entered the market as strong competitors to the SOEs. Additionally, capital markets have widened and deepened to some extent, providing firms that face temporary problems the needed capital. Whereas each SOE was an integral part of a complex production chain under communism, today their role can be replaced at a relatively low cost, with little or no negative spillover.\textsuperscript{89} Therefore, these inefficient SOEs should not be kept under perfusion if it means an imbalance for the economic sphere. From the above arguments, I take subsidies and any other credits to the state sector to be purely political decisions in the Romanian case. While in more advanced countries, these political decisions may not cause grave distortions in the market (although distortions are created to some extent), the Romanian case is different in the fact that these enterprises are in desperate need of restructuring since they do not provide competitive goods or services. In my view, credit should be used when output is competitive, when companies can ‘run’ faster then the inflation resulting from the financing of the credit they received. The supreme criterion of the market is economic efficiency. As long as SOEs do not have to face the market rules of risk and profit, they cannot be equal partners to private companies, and competition is out of the question. A wrong decision on the part of a private company leads it to bankruptcy, while the SOE faces no such stipulation. In Romania, it always has a guardian angel in the form of the budget that feeds on taxes and duties from the economy and from households. Unless, these enterprises are disciplined (be it by restructuring, privatization, or closing down), the stabilization of the Romanian economy will not
\textsuperscript{89}ibid.
materialize.

Moreover, certain industries - such as agriculture, in the latter half of the last decade, and mining, in the first half – have benefited from preferential treatment in terms of receiving a flow of credits at no interest rate, or free use of utilities, without having their organization and production plans reviewed. The bottom line is that the conservative figures reported by the National Bank ignore significant quasi-fiscal accounts. Upon discounting this selective reporting, the problem of the fiscal deficit emerges greater than previously accounted for. Table 12 shows the severity of quasi-fiscal accounts in Romania, in the period from 1991 to 1998.

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<tr>
<td>Total deficit from external debt</td>
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<td>Percent of GDP</td>
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<td>Stock of gross arrears at Dec. 31</td>
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<tr>
<td>Total deficit from arrears and losses</td>
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<td>Percent of GDP</td>
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<tr>
<td>Total quasifiscal deficit</td>
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<td>Percent of GDP</td>
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Numbers measured in billions of lei.

The problem of fiscal and quasi-fiscal deficit is worsened in Romania due to the decrease in government revenue. Since 1993, Romania has adopted the European mechanism of taxation, the value added tax. Instead of directly taxing the supply side, which discourages production, Romania’s tax policy has gradually shifted towards indirect taxation which targets the consumer. As a result of this shift, direct tax revenues have decreased from 46.4 percent in 1996 to 33.8 percent in 1998 to a low of 25.4 percent
in 1999. The revenue from direct taxes has additionally decreased as a result of the
decrease in income taxes (the principal direct tax); the revenue from income taxes has
fallen from 7.6 percent of GDP in 1991 and 1992 to 3 percent of GDP in 1998. This
decrease in income taxes is the result of a reduction in percentage quotas set for income
taxes and a reduction in the percentage of work force employed. Important components
of the overall decrease in tax revenue are tax evasion - usually in the form of enterprises
adjusting their balance sheets - or tax arrears on the part of inefficient enterprises which
(temporarily) do not have the means to pay. In addition, the budget reserves have been
exhausted year by year due to “inappropriate social protection” and by subsidies to
inefficient state-owned enterprises that proved to be “black holes in the economy.”90 In
an efficient market economy, these enterprises would have increased the budget revenues
due to their efficient production. Yet, in Romania’s case, the state-owned industries
receive substantial subsidies, and the employees are subject to indexation regardless of
their labor productivity.91 Consequently, the burden of the fiscal, and especially the
quasi-fiscal, deficit grows heavier, while the main drivers of efficient economic growth
have yet to be implemented. The primary impact of this deficit is seen on the level of
inflation, which is especially correlated with movements in the quasi-fiscal deficit. Figure
7 shows this positive relationship between the two variables.

90 Isarecu, Mugur, The Romanian Economy in the Perspective of the Year 2000, National Bank of Romania,
November 1999.
91 ibid.
This positive relationship is explained by the fact that many regies autonomes or SOEs produce less output, in terms of revenue, than they require for production, and inflation is their only rescue. On the one hand, the credits they receive are financed by the central bank through monetary emission which spurs inflation. On the other hand, some of these enterprises are monopolies (specifically, legal monopolies emerging from a shrouded political mechanism) which drive up prices as the only source for profit. As a result, the economy continues to suffer in the long run, not only due to the inflation, but because these enterprises will never restructure in order to make efficient their production and finally put an end to their resort to inflation as a mask for inefficiency.

Despite certain modifications over time, the structure of government expenditure in Romania is far from that existing in a functioning market economy. The subsidies accorded by the government to specific industries (agriculture being the most prominent),
along with the opaque transfer of funds to state-owned enterprises, and the arrears emerging from these enterprises and weak newly-privatized companies, have consistently invalidated Romania’s fiscal policy. As the government deficit has continued to grow and the national currency has continued to depreciate, the interest rate payments accumulated on this government debt have increased. As a result, spending on education, healthcare, and pension systems has decreased to a mere 5 percent of the GDP.

This inefficient fiscal policy has fueled the process of inflation. The public debt is financed from the central bank which is not fully independent from the government. In a personal interview with the Vice-Governor of the National Bank, Mihai Bogza, he has stated that the Bank does not, and has not, financed the government, and that contrary to the statement by the Director of the Romanian Commercial Bank, it has not subsidized any of the country’s commercial banks. This statement also contradicts the evidence that the government took over a large amount of bad debts from Bancorex and Banca Agricola (large state-owned banks) which were then financed by the National Bank.92 The authors of the above-mentioned study further conclude that “the Bank systematically bails out banks in financial trouble.”93 Before I was escorted out of the building from the interview with Mr. Bogza, the Vice-Governor informed me that I will receive all the necessary documents in order to draw my own conclusions. And that is the purpose of this thesis.

The first post-communist central bank policy established in 1991, and known as Ordinance 10/1991, states that in exceptional cases, the central bank can legally provide the government with a loan at no interest charge, without this loan exceeding 10 percent of the approved government budget.94 Yet, loose terminology such as “exceptional cases” can be, and has been, easily abused. The Romanian government felt that every situation it

93 ibid.
encountered was exceptional and deserving of central bank assistance, for after all, if transition from a central plan is not exceptional than what is! In many cases, these exceptions were truly unmerited. In a personal interview, Surica Rozentular, the Director of Research at the National Bank, has said that credits were given out from the Bank without ever being replaced since they were mostly going towards the financing of new headquarters for each political party instituted. New banks entered the financial market by first constructing modern headquarters with the money they had received from the Bank for reserve or equity capital purposes. Many of these banks later faced liquidity problems, and were either closed down or privatized. In either case, the initial Bank credits were not repaid.

A more severe impact upon the bank’s financing of debt results from Ordinance 72/1996 which states that the central bank can lend to the government without interest with the stipulation that the loan is no more than double the capital of the central bank and its reserves. This, in my opinion, amounts to an enormous quantity. Even more striking is the fact that, under this Ordinance, the Parliament is no longer required to approve of these central bank loans. Consequently, a large part of the public deficit can be covered by emission from the central bank. This situation has grave effects upon the economy; it opens the way to inflation, and it decreases the incentive of the government authorities to adopt a disciplined budget.

Romania has failed to establish a strategy for conducting fiscal policy. The fiscal policy implemented by the Romanian authorities has been contradictory. It has not followed the rule of law even when it was required to do so. The public deficit has been financed from the central bank in amounts far exceeding the legal norms, and sometimes in opaque transactions. The longer the deficit continues to be financed by monetary emission, the more distant is the stabilization of the Romanian economy.
Monetary Policy

The monetary policy objectives adopted by the Romanian authorities during the last decade of transition have been multiple and inconsistent. Most striking is the growth of the monetary base from 514 billion lei at the end of 1990 to over 90 trillion lei after eight years. This evolution is unambiguously known as soaring inflation, in the ranks of three digit figures. As a result of this inflation, the savings of the population have been drastically eroded from 50 percent of the monetary base in 1990 to only 14.4 percent in 1993 (Radulescu, 1991). As a result of sticky wages and the fact that the government has become a net debtor as opposed to net creditor, the population will undoubtedly feel this loss for years to come. The prospects for the future look grim, especially after the accumulation of large unperforming loans reported by Romania’s main commercial banks in 1997, and the continued flow of funds to the energy and the agriculture sector for political reasons. All this funding from the National Bank, in the form of special credits and commercial bank funds, have clearly undermined the Bank’s task at fighting inflation since these credits were the driving force behind the growing money supply.

Although the national currency, the leu, is the only currency allowed for transactions, Romanian households and firms hold foreign-currency-denominated deposits with commercial banks, and foreign currency as cash. This shows the inherent risk in leu-denominated deposits. As a result of Romania’s continuous inflation, leu denominated deposits are riskier due to the high probability of devaluation. And even if this devaluation will not materialize, the expectations people have of high levels of inflation increase the risk premium of holding deposits denominated in the national currency. Consequently, the Romanian currency functions mainly as a means of exchange, and this simply due to governmental regulation. In the economic activities on

95 Daianu, 2000.
the black market, which form 40 percent of GDP, dollars and foreign currency are usually the currency of choice\textsuperscript{96}. Thus, the population has found different assets to use as a store of value, and other currencies to use as a unit of account. For example, the price for the sale of real estate or land was quoted either in deutch marks (mostly until January 2000) or dollars\textsuperscript{97}. By losing these two important functions – store of value and unit of account – the leu has lost credibility, and thus, purchasing power. This feeds the vigorous inflationary phenomenon. Considering these obstacles, the stabilization of Romania’s economy calls for the insulation of the central bank from political influences, and the harmonization of the main policies acting in the market economy: fiscal and monetary.

\textit{Exchange Rate Policy}

\textit{The early years, 1990 - 1997}

The Romanian exchange rate policy has been labeled a serious failure of grave consequences by many national commentators, especially in the period from 1990 to 1996.\textsuperscript{98} According to Annual Reports issued by the National Bank of Romania, the objective of the policy has been the use of the exchange rate as an anti-inflationary anchor. Indeed, economic theory supports this method of stabilization which has experienced success in other transition economies. Yet, for this method to function properly, economic theory requires for two essential conditions to be met: the initial exchange rate must not be overvalued (it is even recommended that it be undervalued to instill credibility and limit the demand for foreign currency), and the stability of this rate must be supported permanently by the other instruments of monetary policy (even if in relative terms). Unfortunately, in Romania neither of these conditions were met. On the one hand, the exchange rate anchor was based on the overvalued level of the leu which existed under the centrally-planned economy, and which created both, an imbalance in

\textsuperscript{96} ibid.
\textsuperscript{97} Information gathered from different real estate agencies in Romania.
\textsuperscript{98} Conclusion drawn from newspaper articles in this time period; see also Radulescu, 2000.
the foreign exchange market, and the distrust on the part of economic agents of the authorities’ ability to maintain the official exchange rate. On the other hand, the excess of liquidity and the negative real interest rates further discouraged the holders of the national currency which, in turn, discouraged the sustainability of the exchange rate anchor.

According to Radulescu, the “original sin” was the exchange rate established in 1990 by the first post-revolution authorities at 21 lei per dollar. In my opinion, this rate seems to have suffered from very little deliberation, since the exchange rate in 1989 was 24 lei per dollar, while calculations of the equilibrium rate for 1990 suggest the parity to have been at 35 lei per dollar according to the BNR, and, most striking, the rate on the foreign exchange market was of 80 lei per dollar. The exchange rate set at 21 lei per dollar led directly to the dramatic collapse of exports and the growth of imports, which together led to the consumption in totality of Romania’s foreign reserves (of more than 1.5 billion dollars) in less than 6 months.

In September 1990, following this failure, the authorities promoted a dual currency policy by which exporters were allowed to keep a part of their foreign currency revenues (30 percent initially, and 50 percent starting with February 1991), which led to the opening of the interbank foreign exchange market. During this time, the official exchange rate became more and more distant from its market value. While the official rate was 35 lei per dollar in November 1990, and 60 lei per dollar in April 1991, the market value of the leu depreciated continuously reaching 300 lei per dollar in November 1991. At this time, the authorities suggested the unification of the two exchange rates at 180 lei per dollar and the re-establishment of a full surrender system (meaning that exporters were required to give up 100 percent of their foreign earnings). In this market, the rate slowly ascended to the critical value of 226 lei per dollar when the National Bank

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ran out of the adequate foreign reserves needed to sustain this unreal exchange rate. Meanwhile, 200 billion lei entered the national market through the emission of the Bank, the sterilization of which required the Bank to sell approximately one billion dollars. This outcome froze the foreign exchange market and the exchange rate, while the foreign reserves continued to drop since people refused to exchange their foreign currency for lei. This situation had dramatic consequences for the economy, especially when the exchange rate was liberalized again. Moreover, this situation could have led to the inability to honor the external payment, ushering Romania to an economic collapse.

On the eve of such a collapse, the authorities allowed the exchange rate to float freely whereby its value was determined according to the supply and demand of economic agents. Although the theory behind this policy has its benefits, the authorities failed to allow the exchange rate to float freely. Instead, they intervened numerous times ("permanently," according to Radulescu) in order to block the depreciation of the leu, considered excessive by the authorities, which in fact reflected nothing more than the poor performance of the economy. This intervention took the form of 'moral suasion,' as the exchange rate did not reflect an equilibrium of the supply and demand, but rather it was part of an opaque foreign exchange market where the demand was repressed by the authorities and the foreign currency was allocated by undisclosed means.

Under these conditions, multiple exchange rate for the leu existed concurrently: one was the unreal rate, which reflected the wishes of the government more than the performance of the economy, the others were the rates (more or less real) which equilibrated supply and demand on the black market. According to Radulescu, these multiple rate disappeared only in the summer of 1992 and again in 1994, when the economic policies of the government were coherent.

Overall, this exchange rate policy had grave consequences for the economy. First, the overvaluation of the rate stimulated imports and discouraged exports, contributing to the chronic balance of payments deficit. Second, the restructuring of the real sector was
delayed, since the signal sent by international prices proved to be confusing especially as a result of multiple exchange rates. Third, the development of the foreign exchange market, one of the most important markets for an open economy, was hampered since this market was purposely obstructed from finding and maintaining its equilibrium. Fourth, the poor functioning of the foreign exchange market formed a significant obstacle for foreign investment, while sending mixed messages about the policy orientation of the Romanian public authorities.

The later years, 1997 - 2001

The failure of the exchange rate policy implemented in the early years of transition convinced the government installed after the 1996 elections that state intervention in the affairs of the central bank was not a beneficial mode of action. In February of 1997, all commercial banks were re-licensed as dealers in the foreign exchange market, a step which represented the end of administrative restrictions in the operation of the foreign exchange market. The effect of this elimination of government intervention led, as expected, to a "brutal collapse" in the exchange rate of the national currency from 4100 lei per dollar in December 1996 to over 9000 lei per dollar in February 1997.\textsuperscript{100} This jump in the value of the national currency - referred to as the overshooting phenomenon (see Chapter 6) - was temporary, and the value of the leu stabilized for a few months around 7100 lei per dollar aided by restrictive monetary policy and a substantial inflow of capital which supported the supply of foreign currency on the market.

In January 1998, Romania joined the countries that have already applied full convertibility of current account transactions. This has taken a bit of sting away from the much invoked quip that in the winter everything freezes in Romania, including the

\textsuperscript{100} Radulescu, 1999.
reform. The convertibility of the leu seems to have been a well-proposed measure on the path of reform, despite the vulnerabilities that are associated with this measure, since the National Bank experienced in 1999 an increase in foreign exchange reserves up to 2.3 billion dollars from 750 million dollars in 1997, in addition to a gold stock of approximately 1 billion dollars. In March of 1998, Romania has taken on further responsibilities by officially accepting the conditions imposed by the International Monetary Fund, specifically the elimination of restrictions on payments related to current account transactions, thus allowing for an unrestricted opening of the money and capital markets to non-residents. This agreement further specifies that the Romanian authorities will not impose any future restrictions on current account transactions, or discriminatory practices. The foreign exchange market did not experience any changes as a result of this agreement, mainly because it was operating under these conditions de facto before the agreement with the IMF established the requirements de jure. In an ironic way, this shows that the forces of markets - the ‘invisible hand,’ as it were - can be rational without political intervention, although the latter does secure an efficient operation of the market in the future. Nevertheless, the risks associated with convertibility - especially capital account transactions convertibility - can be quite high especially if fiscal deficits remain high. Yet, this measure is a step in the right direction for a competitive market economy.

As of 1998, the leu has remained as a managed float. This shows that while the main instrument of monetary policy in Romania is not the exchange rate (rather, it is the monetary base), the National Bank stands ready to intervene in the foreign exchange market in cases when the national currency is at risk from speculative attacks. One beneficial aspect of this policy is that the segmentation of the foreign exchange market has been dissolved through the disappearance of different exchange rates, especially the difference between the rate offered by banks and that offered by exchange bureaus. Consequently, a greater degree of confidence has replaced part of the uncertainty faced
by economic agents. Yet, stabilization of the Romanian economy is far from being materialized. Despite a lower risk premium associated with the exchange rate, the trade deficit remains high.\textsuperscript{101} Even more disappointing, is the fact that the fiscal and the quasi-fiscal deficits remain high.

Therefore, Romania’s current regime of a managed float is not proving successful. Under this regime, Romania’s exchange rate has suffered a large devaluation. Figure 8 on the next page shows the devaluation of the \textit{leu} in 1998, 1999 and 2000. The figure shows that, in light of Romania’s economic situation in the past few years, this regime may be proving inadequate. As echoed by Daianu and Vranceanu (2001), for the last four years, Romania has again been suffering from severe inflation: 40.6\% in 1998, 55\% in 1999, and 40.7\% in 2000. Additionally, since 1997, Romania has been plagued by negative to low positive growth, -6.1\% in 1997, -5.4\% in 1998, -3.2\% in 1999, 1.6\% in 2000\textsuperscript{102}, making the economic arena grimmer and grimmer. And despite setting inflation targets each year, the targets have been “largely missed.”\textsuperscript{103} Most recently, in 2001, the government’s inflation target was set at 25 to 27 percent\textsuperscript{104}, but annual average inflation in 2001 proved to be 40.5 percent\textsuperscript{105}.

Thus, Romania’s current macroeconomic performance is disappointing. Although there are many factors responsible for this outcome – privatization failures, lack of supporting institutions, firm restructuring, and so on - what seems in my opinion to rest at the core of the country’s inability to stabilize the economy is the central bank’s inability to moderate inflation due to political interference, which has weakened the effectiveness and credibility of the Bank, and which has also resulted in large fiscal and quasi-fiscal deficits throughout the decade of transition. By financing these deficits, the Bank has

\textsuperscript{101} ibid.
\textsuperscript{102} EBRD Report, 2001.
\textsuperscript{103} Ibid, p. 12.
\textsuperscript{104} ibid.
\textsuperscript{105} Data gathered personally from the National Bank.
clearly contradicted its own goal of stabilizing the price level. From this overall picture of the Romanian economy, I argue that reform should consist of a coherent policy mix set
Figure 8: Devaluation of the leu, 1998, 1999, 2000.

Exchange Rate: lei/$

Time: shown as value of leu on the 5th day of every month (January to December) in 1998 (Series 1), 1999 (Series 2), and 2000 (Series 3)

Source: data gathered personally from the National Bank.
up simultaneously which should act to tighten monetary control and streamline public spending. This dual challenge of subduing inflation and lowering the fiscal and quasi-fiscal deficit depends very much on expectations. Fortunately, expectations react to monetary policy changes, suggesting that a credible, rule-based monetary policy must be implemented in order to change expectation and to reform the Romanian economy. Therefore, I argue that the implementation of a currency board arrangement is suitable for resolving Romania’s problems of high inflation, curbing its high fiscal and quasi-fiscal deficits, and most importantly, its lack of credibility.

The Bulgarian experience

The experience of Bulgaria in resolving the same economic problems through the use of a currency board is instrumental for Romania. Much like Romania Bulgaria was also experiencing problems with monetary injections and inflation before adopting a currency board in 1997, although much more severely. The causes of Bulgaria’s rapid acceleration of inflation included support to the country’s weak banking sector, central bank financing of the budget deficit, and a decreased confidence in the lev, Bulgaria’s national currency. Furthermore, the central bank became vulnerable in the process of softening the depreciation of the lev, by depleting its international reserves. At the same time, falling output and tax revenues caused government revenues to decrease substantially from 40 percent of GDP to 14.7 percent in February of 1997. In 1997, inflation soared to 500 percent in January and peaked at over 2000 percent in March. Although the government attempted to finance its deficit through issuing treasury bills, the market was thin and maturities became shorter while interest rates rose until it became unsustainable for the government to service its debt. As a solution, the currency

board was implemented in July 1997, and consequently, inflation fell drastically to less than 1 percent in 1998.\footnote{Daianu, 2001.} Although the final word on Bulgaria's currency board is far from being determined in such a short time frame, Gulde (1999) argues that the currency board has been a crucial factor in Bulgaria's stabilization. Table 13 shows Bulgaria's performance before and after the implementation of a currency board.

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<th>Table 13: Macroeconomic Indicators for Bulgaria</th>
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<tr>
<td>Inflation</td>
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<td>Fiscal Balance (% of GDP)</td>
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<td>Bank financing of fiscal balance</td>
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<td>Nominal interest rate differential\textsuperscript{1}</td>
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<td>Source: Gulde (1999)</td>
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\textsuperscript{1}End-of-year differential between 3-month deposit rates in Bulgaria and Germany.

The above table shows that Bulgaria's inflation decreased dramatically, as did interest rates, the fiscal deficit, and the financing of the deficit from the central bank. Thus, the CBA managed to impose a degree of fiscal discipline, especially as a result of the independence of Bulgaria's National Bank after the implementation of the currency board.

In transition, and especially in the laggard countries, stabilization requires measures to prevent financial indiscipline, reduce the government's overwhelming debt, and increase the attractiveness of the national currency, as well as strong official commitment to reforms. In all these respects, the currency board proved beneficial for Bulgaria. I believe that it will also prove beneficial for Romania. Romania needs a credible, rule-based policy to stabilize its economy due to the decreasing confidence in the Romanian leu, the large fiscal and quasi-fiscal deficit, and the constant resort to the National Bank to finance the deficit through monetary emission. After a decade of transition marked by soaring inflation and by the lack of an appropriate anti-inflationary
mentality, Romania needs a serious arrangement to change people’s expectations. Much like Kornai’s argument mentioned in Chapter 2, the country needs to undergo a radical, deep change in order for a functioning market economy to be established.

Yet, a currency board by itself will not fully stabilize the Romanian economy. Although a crucial element of a stabilization program, the currency board must be implemented along with supporting institutions such as legal and structural measures addressing government expenditure, and the regulation of the banking sector. Currently, Romania’s foreign reserves have been growing from 3 billion dollars in 1995 to approximately 5 billion dollars in year 2000.\(^{108}\) This suggests that in adopting a credible policy such as a CBA, Romania can also credibly protect it from a currency crisis of the type discussed in Chapter 2. Along with the implementation of a new central bank law establishing the National Bank as independent, the currency board can become a credible institution for Romania. A currency board imposes fiscal discipline to the extent that the central bank will no longer finance the fiscal deficit. This does not address the grave problems of arrears in the economy. Thus, a plan to restructure SOEs is necessary if they are to contribute positively to the economy, especially without further credits from the government. Furthermore, ways to finance the government deficit other than resorting to the central bank are necessary. Measures such as the establishment of a bond market in Romania should be researched, for such measures serve very important roles for the Romanian civil society which may be harmed by the strict monetary policy imposed by a currency board.

A currency board for Romania is an appropriate policy in the transitional phase. But even more, it can serve as a long-term strategy for satisfying the Copenhagen and the Maastricht criteria for entering the European Union and the European Monetary Union. Although a currency board can prove to be a good stabilization measure, it is argued that

\(^{108}\) Data gathered from the National Bank.
this arrangement should be abolished (or turned into a floating exchange rate system) soon after stabilization occurs, in order to give the monetary authority more freedom to drive the economy in case of adverse shocks or economic recession. For Romania, I argue that a currency board is the best solution to stabilizing the economy and helping the country accede to the European Union. In this case, the currency board should not be abolished after stabilization, as its implementation and maintenance are necessary for Romania to converge to the criteria imposed by the European Union. Thus, Romania’s implementation of a currency board can help reform the national economy, while also materializing the reforms needed to enter the European Union and the European Monetary Union.

Chapter 8

The European Dimension

"Adhering to the European Union is Romania’s top foreign priority. The country will undertake any measure necessary to strengthen its capacity for taking on the obligations of Union membership." 
-Vasile Puscas, Chief Negotiator to the EU, in a personal interview

The context of EU accession

The Copenhagen criteria requires that the candidate countries develop strategies for fostering both, the creation of a functioning market economy and adherence to the aims of economic and monetary union. Worth noting is the fact that candidate countries are not expected to become full members of the Euro area or meet the convergence requirements set out in the Maastricht Treaty as preconditions for EU membership. Nevertheless, in the Accession Partnerships it has been agreed that candidate countries do start making headway toward convergence with the sound economic conditions prevailing in the Euro area. Thus, EU accession, and subsequent adoption of the euro provide a clear target for the exchange rate of the applicant countries. As the strongest candidates could become EU members in close to five years, “the timetable is thus immediate enough for accession to be a consideration in determining exchange rate regimes, while being far enough away to give countries latitude to adjust their regimes during the interim in a manner that bests serves their transition and macroeconomic policy needs.”

Although candidate countries have the freedom to choose their exchange rate regime in the pre-accession period, the requirement of bringing national institutions and

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economic structures in line with those in the EU will have a bearing on that choice. According to Corker et al. (2000), countries are expected to complete the liberalization of capital accounts, make their central banks fully independent and create efficient, market-oriented financial sectors prior to accession. Upon membership in the EU, exchange rate policy becomes a matter of common interest. Excessive exchange rate fluctuations and competitive devaluations must be avoided as the new members embark on a phased process toward adoption of the euro. Additionally, the national central bank’s statutes must be further adapted with a view to integration into the European System of Central Banks (ESCB).

The first step of the process of adopting the euro post-accession requires participants (those who voluntarily decide to join) to enter the new exchange rate mechanism (ERM2) and to agree an entry exchange rate of their currency against the euro with the European Central Bank, the Commission, and the Council of Ministers. Participants are further required to maintain the exchange rate within a band of plus or minus fifteen percent for at least two years prior to adopting the euro. 111 Corker et al. (2000) argues that “from an economic perspective, a CBA would seem to be consistent with ERM2.” 112 Gulde et al. (2000) agrees that for CBA countries already pegged to the euro the requirements for good economic performance are already very similar to those of EMU participants. Thus, convergence to the EMU criteria and adoption of the Euro should not prove difficult for these countries.

Admittance into the euro area will thus depend upon the degree of convergence that has taken place in terms of inflation, interest rates, budgetary and debt position, and exchange rates. Real economic performance will also be taken into account, particularly, economic growth, unemployment rates, and trade and current account balances. Although

these factors allow entry into the euro area - a goal targeted after the general accession to the EU - they also prepare a candidate country for satisfying the Copenhagen criteria of a functioning market economy. Thus, these common macroeconomic and monetary factors link the separate accessions to the EU and to the EMU.

Romania and EU accession

Professor Tinbergen, a Nobel Prize Laureate in Economics, asserts in Restructuring of the International Order that "integration may be defined as the creation of the most desired world economic structure, through the removal of artificial obstacles from the path of optimal efficiency, and through the deliberate introduction of all the elements necessary for economic coordination and integration." Thus, integration mainly considers the structural changes in the context of an international economy which does not account for national borders and national or international authorities. Integration signifies economic cooperation at an international level with the goal of maximum efficiency. From this perspective, the economic criteria (as opposed to the political criteria) for the candidate countries seeking accession to the EU proves particularly important. Most importantly, the candidate countries do not regard European integration as a goal in itself. Rather, it represents a direct expansion of national interest, corresponding fully to the necessity of strengthening economic (and political) reforms and establishing the market economy for the welfare of each and every citizen. "The goals of accession are similar to the goals of internal reform in Romania," reported Teodor Melescanu, former Minister of State and of Romanian Foreign Affairs, to the

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113 Tinbergen, Restructuring the International Order [title translation mine], Editura Politica, Bucharest, 1978, p.23.
Romania Libera journal. In this context, the process of integration represents for Romania both, a means and a catalyst to speed up economic and political transition.

An analysis of the economic transition of Romania requires a brief look at its initial conditions in order to evaluate its progress and to propose the new reforms needed now as part of the pre-accession strategy. Worth mentioning is the fact that Romania was one of the few CEECs to adopt a completely new constitution (in 1991), thus provoking a drastic change in the organizational behavior of the authorities and making transition an even more difficult project.

As discussed in previous chapters, the December 1989 revolution left Romania in a political and economic collapse, and, most detrimentally, in a moral collapse. Without the communist system's steadfast regulations, the country no longer had a shared system of moral values. The economic transition took place in the absence of legislative and economic measures required by the new organizational and evolutionary context. Thus, the emerging free market did not foster liberty and prosperity, but gangsterism, proliferation of mafiosos, and widespread misery. The transition to the market economy developed only within the gap of the previous structural system, facing the disadvantages of sectoral imbalances. Although different from the previous state of terror under Ceausescu's dictatorship, the new system was still a sort of oppression for the Romanian citizens. The credibility of the people in the new governance was little to none. In the ten years since the revolution, the poverty level increased fivefold, while the GDP annual average decreased at 2.9 percent; the 1998 GDP was 76 percent of the 1989 GDP according to the EBRD Transition Report (1999). Nevertheless, the growth rate of the GDP in 1995 was the highest compared to other countries in the region at this time.

The present situation in Romania does not present a positive outlook toward accession into the EU. Since 1997, Romania's economic situation has been declining,
with output continuing to fall well into 1999, albeit at a slower pace. Foreign Direct Investment (FDI) shows a downward trend, as do exports of goods and services. The country has been suffering from the lack of a political census on reform programs and from the incredible size of the black economy. Capital flight at the hands of corrupted officials is a common occurrence, while the deals of the black market account for 40 percent of the Romanian economy according to the IMF Country Report on Romania (2001). These phenomena have lost the Romanian treasury $1.2 billion in 1996 alone, constituting a threat to national security.

Ever since its application for membership in the EU, Romania has applied with force the regulations outlined in the Europe Agreements. In 1997, it signed as a member of the Central European Free Trade Association (CEFTA), followed a year later by joining the Accession Partnership and presenting its first National Program for the Adoption of the Acquis Communautaire; a second such program was presented in June 1999. In evaluating the economic criteria for accession, the European Commission takes into consideration such areas of economic transformation as liberalization of the price and trade system, stabilization of the economy, structural change, and reform of the financial sector. Towards this end, Emil Constantinescu, former president of Romania, has put into place a radical program of macroeconomic stabilization and structural reform.

Despite the reforms, the Commission has observed the diminishing economic growth (7.1 percent in 1995, 4.1 percent in 1996), accelerating inflation (56.9 percent in 1996) and deteriorating budget and trade deficits. With a population of 22.5 million, the Commission remarked that the GDP per head is only 8 percent of the EU average, while the agricultural sector employs one-third of the working population, contributing 20 percent of the gross value added to the economy. Despite some privatization, there are
still structural problems. Romania trades mostly with Germany in the EU, while its exports to the EU represent 55 percent and imports to the EU represent 52 percent, most of which occurs in the textile industry (38.3 percent of total trade with the EU).

According to the World Bank estimate, the trade openness (calculated as [exports (X) plus imports (M)] divided by GDP) of Romania in 1998 is only 58 percent as compared to other CEECs such as Bulgaria, which has an openness of 91 percent. Although Romania has made considerable progress in the creation of a market economy, the Commission stated in its 2000 Progress Reports on Candidate Countries that "Romania would face serious difficulties in coping with competitive pressure and market forces within the Union in the medium term."

Most destabilizing of Romania's macroeconomic factors is its exchange rate. At present, the Romanian currency is in a free float. In the last months of 1998 and the first months of 1999, the leu has been subject to speculative pressures, losing two-thirds of its value. Such a situation impedes Romania from being anywhere close to complying with the exchange rate criterion of the Maastricht criteria in the medium-run - namely, that no devaluation of the currency should occur two years prior to entering the euro area. The Directorate General for Research concludes in Briefing Paper 38 that "the Romanian leu has undergone continuous and rapid devaluation."115

In the Working Paper "EMU and Enlargement," the Directorate General for Research reports that the National Bank of Romania (BNR) works with an inflation target in order to manage the reduction of inflation by controlling the money base. This target rate embodies a year-on-year inflation of 35 percent. However, the DG has expressed fear that "Romania might fall back into an inflation spiral: both consumer and producer price inflation have increased in recent months [refers to 1999], and the substantial wage

increases accorded in March [of 1999], combined with the depreciation of the currency have revived inflationary expectations.\textsuperscript{116} Thus, the inflation target is proving inadequate for keeping inflation under control. Furthermore, the short-term interest rates remain at high levels, amounting to about eighty percent at the last Treasury bill issue at the end of April 1999. This excessively curbs investment, a crucial element for capital accumulation and future economic growth.

The DG also found that the National Bank Law still permits financing of the budget deficit, while the central bank continues to provide funds to commercial banks and loss-making state-owned enterprises. Furthermore, central bank legislation is not fully compatible with EC legislation since monetary and fiscal policies are not oriented towards stability. According to the IMF Country Report on Romania (2001), the main determinants of inflation in Romania are government expenditure used for subsidizing large, loss-making state-owned enterprises and the use of funds from the National Bank to accommodate large fiscal and quasi-fiscal deficits of the agricultural sector in particular. These factors are very much in contrast to the recommendations implied by the \textit{aquis}, namely central bank independence, coordination of macroeconomic policies, prohibition of direct central bank financing of public sector deficits, and privileged access to financial institutions.

\textit{The prospect of a CBA for Romania}

From the above section, it is clear that Romania needs a visible and credible departure from past policies in order to restore any semblance of normality to the economy. Proponents of a currency board in Romania see this arrangement as a means to cure problems of soft budget constraints, the commercial bank financing that keeps loss-

\textsuperscript{116} Directorate General for Research Working Paper 12, p. 156.
making enterprises afloat, the lack of financial discipline which leads to inflation, large interest rates and exchange rate volatility. Under a CBA, the central bank would lose its discretion to act, and inflation and interest rates would drop toward the levels of those in the country issuing the anchor currency. The more credible policy environment would also provide a better framework for stability and growth.

Under the currency board system, the principle objective of the Romanian National Bank will be the stabilization of the leu. Since Romania's main trading partner is the EU, the anchor currency to be adopted is the euro. There should exist backing of one hundred percent of all leu-denominated liabilities of the Bank of Romania with foreign reserves. For the achievement of the stable liquidity in the commercial banking system, the required reserves should comprise at least ten percent of the loans.

Following the example of the Bulgarian National Bank in its adoption of a CBA, the National Bank of Romania should be reorganized following the Bank of England model into an Issue Department and a Banking Department. The Issue Department is to hold all of BNR’s monetary liabilities, comprising bank notes and coins, deposits from banks and the government. These liabilities are to be backed by assets in foreign exchange and gold. The Issue Department also has the task of investing BNR's foreign assets subject to restrictions in terms of quality and liquidity that must be explicitly delineated in the law of the BNR. The Banking Department is to hold all other assets and claims on the Central Bank, also acting as Romania's fiscal agent with the IMF. This department should also be responsible for enforcing reserve requirements and monitoring developments in the financial markets.

Romania's specific situation requires that the CBA to be implemented deviate from a 'pure' currency board. First of all, because of the fragility of the banking sector (as described in Chapter 7), Romania's CBA should retain some limited traditional central
banking features. The CBA will impose on commercial banks minimum reserve requirements and allow for a limited role of lender of last resort. Thus, the CBA should be established with more foreign reserves than needed to cover the monetary liabilities of the Central Bank. This excess coverage can be used to make loans to commercial banks in cases of an acute liquidity crisis. In light of the Argentinean experience, this approach may render the CBA less credible. Thus, this measure should be used temporarily as the financial sector adjusts to the currency board regime.

Secondly, in view of the magnitude of past fiscal difficulties, the Romanian CBA should include specific budgetary financing features while ensuring fiscal discipline. Hence, BNR law should allow for on-lending of IMF purchases to the budget. Given Romania's various extra-budgetary funds, a Fiscal Reserve Account should be established to enhance fiscal credibility. Such an account would consolidate all central government and major extra-budgetary funds deposits, ensuring their full foreign exchange cover. This account should further add to the credibility and the stability of the government fiscal position.

Expectations and implications of the CBA in the context of the EU

As the current Romanian president, Ion Iliescu, has claimed upon his inauguration, all monetary reforms in Romania will culminate in the process of accession to the EU, and eventually to the euro area. Taking into consideration this claim, the adoption of a currency board regime will facilitate Romania's macroeconomic stabilization and convergence to both the Copenhagen and the Maastricht criteria.

From the theoretical and empirical evidence presented in this report, it is expected that nominal stabilization will be achieved in the monetary sector. Inflation is expected to decrease to about one percent per annum. Confidence in the national currency will
increase, as will national support for the government and its policies. A visible, rule-based system such as the CBA will most certainly increase the credibility of any stabilization attempt made by the government. Interest rates should drop almost immediately. The share of leu-denominated lending should increase, as should lending specifically to the private sector. As a result of the lower interest rates, there will be a decrease in the budget deficit due to lower interest payments on the public debt and higher tax revenues due to increased investment activity. Furthermore, the debt burden would be reduced. In the banking sector, a tangible change should be observed in the behavior of commercial banks as they will most certainly adopt a more conservative stance. The liquidity in the banking system should increase. The presence of foreign banks should also increase, allowing for enhanced credibility and greater liquidity in the banking system. The Romanian international reserves should increase and external debt obligations should be serviced without difficulty. Trade with the European Union issuing the anchor currency should further increase, ameliorating the Romanian trade account deficit.

Upon adoption of such a regime, it is imperative that Romania regards it as a long-term commitment rather than a short-term stabilization device. If the claim of Mr. Iliescu is accurate and Romania's main goal is accession to the EU, then the country would find it an advantage to go the whole path to its EU accession under this monetary arrangement. This argument springs from the fact that a CBA incorporates ex ante major ESCB principles - independence of the national central bank, restricted autonomy in using monetary policy tools, ruling out of any funding of fiscal deficits, which is comparable with the constraints imposed by the Amsterdam Treaty on the EU's own institutions. In this sense, continuous compliance with the CBA principles could be seen as training prior to the institutional accession to the euro area.
The fundamental advantage of a currency board in the pre-accession period is that it fully fits into the rationale of the appropriate monetary and exchange rate strategies for this transitional term. These are strategies of irreversible anchoring of the monetary policy to the exchange rate, and of adoption of increasingly rigid exchange rate arrangements. The CBA meets both these conditions. In the case of Romania, the choice of the euro as a reserve currency even better prepares the economy for its accession to the euro area.

All advantages of the currency board in the pre-accession period should not sidetrack the issue of sequencing of changes in the most sensitive phase - prior to the very adoption of the euro. The only acceptable strategy should be one that leads first the accession to the EU followed by the later accession to the EMU and the adoption of the euro. This strategy also appears to provide an orderly exit scheme for an accession-country operating under a CBA. The most visible conceptual and legal issues for an economy under a CBA would arise in the period between accession to the EU and the adoption of the euro. According to the standard scheme developed by the EU, during this in-between period, pre-in countries will reach compliance with the nominal convergence criteria as presented in the Maastricht Treaty. And before the exchange rate will be irrevocably pegged, these countries will join the ERM2. It is also envisaged that the status of their central bank would have been brought into compliance with the basic requirements ensuing from the Treaty.

Although it is too early a time for any clear-cut solutions to this issue of transition, it seems that the development of really specific approaches for countries with a currency board should be channeled into two directions: finding a form to maintain the pegged exchange rate in the interim period from the accession to the EU to the adoption of the euro, and seeking ways to shorten this interim period. As regards the first option, it
may turn out that there is no solution that is legally compatible with the EU legislation as regards the first option; it may be that an accession country operating under a CBA cannot maintain the CBA throughout the period prior to the lifting of derogation from the euro. The second option, however, seems more plausible. On the one hand, a country with a derogation is allowed to request a report from the Commission and the European Central Bank in order to abrogate the derogation earlier than the standard two year term. On the other hand, a more radical solution for completely omitting the interim phase (respectively the ERM2) could be considered. It appears that a country with a currency board arrangement, which has adopted the acquis communautaire in the monetary area, will be completely ready to adopt the euro from its very accession to the EU. Indeed, Gulde (2000) agrees that "an eventual direct switch to the euro could, in our view, be the first-best solution for accession countries that are able to maintain well-functioning currency boards until EMU membership (Gulde (2000), p. 22)." Additionally, this option will not put at risk the hard-gained macroeconomic stability of the candidate countries. In the final run, the results achieved through a currency board should be identical with the ones expected from ERM2 - namely, to ensure the exchange rate discipline and convergence needed for the economy to comply with the third stage of EMU.

In any case, the adoption of the common European currency is for Romania the ultimate point in joining the European economic area. This act presupposes that the country has gone the whole preliminary way of creating mature market institutions and of ensuring macro-economic policy convergence. In this sense, any monetary union ahead of its time would not be full-fledged. It would not provide all the expected advantages of the common currency and of a full membership in the ESCB. It would mean a 'peg' to the EMU without the required complete freedom of movement for goods, capital and people between the acceding country and the euro area. The country will not be in a position to
avail of the enriched range of monetary policy instruments entailed by ESCB membership.

Nevertheless, it should be remembered that the whole scope of structural reform issues cannot be solved with the tools of monetary policy, even if the latter were an even stronger monetary constraint than the currency board (namely, a monetary union). Rather, the opposite is true. The economy should mature for such a monetary union, and in the meantime the currency board will provide a sufficiently reliable framework of stability that would make the necessary structural reforms possible. Therefore, the goal of entering the two European unions makes the currency board an even more suitable policy to be adopted by Romania. Along with supporting institutions, and other necessary, complementary reforms, such an arrangement proves to be the optimal solution for harmonizing Romania’s national and foreign policies.
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