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Gábor Oblath

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Institute for Economies in Transition, BOFIT

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Bank of Finland
Institute for Economies in Transition (BOFIT)

PO Box 160
FIN-00101 Helsinki
Phone: +358 9 183 2268
Fax: +358 9 183 2294
bofit@bof.fi
www.bof.fi/bofit

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1 Introduction

Since the declaration of the (resident) convertibility of the Polish zloty in early 1990, the convertibility of the national currencies of former socialist economies of Central and East Europe (CEE), now in transition, has become both a highly esteemed policy objective and a controversial academic issue. However, as observed by Thompson (1990), "the rhetorical use of the word 'convertibility' has increased to the point that its relevance to the concrete problems faced by countries in transition has been obscured". Indeed, the more one reads and hears about convertibility in transition economies, the more obvious it becomes that much confusion surrounds the use of this term.

The purpose of the present paper is to clarify some concepts and issues involved in discussions on currency convertibility in CEE. As indicated in the title, these questions are treated from a "Hungarian perspective"; therefore it may be useful to state clearly at the outset just what is and is not entailed in this particular perspective.

First, and most importantly, in no sense are we referring to any official Hungarian conception as to either the interpretation of convertibility or the prospects of introducing the convertibility of the Hungarian currency. Though it should become evident to the reader, it is worth stressing that the views presented are strictly nonofficial. Second, the "Hungarian perspective" does not imply an attempt to form judgements on other CEE countries that have taken a different approach to convertibility. What this perspective does involve is an attempt to analyze some of the conceptual and policy-related issues of implementing currency convertibility within the specific context of the Hungarian economy. Nevertheless, this effort may draw a wider audience than just those who have a special interest in the Hungarian economy. This is the case because Hungary is treated here as an example wherein a conceptual and analytical framework is applied in order to clarify some important issues of currency convertibility in CEE. This choice may be supported by three observations. First, among the countries of CEE, it is perhaps in Hungary where the discrepancy between de jure convertibility and de facto convertibility, two of the key concepts treated in the paper, is the widest. This means that although this country has not yet declared its currency convertible, it has liberalized foreign economic transactions to a

[1] The paper was written while the author worked as a visiting scholar with the Bank of Finland. I acknowledge the useful comments of the members of the Bank's Unit for East European Economies, Glen Harma's help in the language edition and Tiina Saajasto's technical assistance. The views expressed are those of the author, not the views of the Bank of Finland.

significant extent. Second, because of its so-called gradual approach, the problems associated with the sequencing of foreign economic liberalization, the relevant issue behind the term "convertibility", can be analyzed in a more straightforward manner in this country. Third and more generally, the Hungarian case may command a wider interest for reasons similar to those that explain the international relevance of the Polish experience. The latter has come to be considered as an example of the radical (or "shock") approach to opening up the economy, and tends to be treated as a model case with lessons and implications reaching far beyond the context of the Polish economy[2]. The Hungarian case, in turn, may be regarded as an example of the less radical, gradualist approach to foreign economic liberalization and currency convertibility[3]. Although the evidence regarding this approach is far from conclusive, the experiences and especially the policy dilemmas in Hungary may offer useful lessons for other countries of the region, in particular for those that have yet to face the larger-scale opening up of their economies.

The main thrust of this paper, however, is a conceptual and analytical clarification, which would serve as a basis for characterizing the present stage of the liberalization process in Hungary and for discussing possible strategies for moving on to further stages of de facto convertibility. This clarification may help to avoid some of the misunderstandings that have arisen in the interpretation of "currency convertibility" in other East European countries as well[4].

[2] See in particular Berg-Sachs (1992), Rosati (1992) and Gomulka (1992).

[3] Levcik (1991) analysed the Hungarian experiences in this vein.

[4] Since 1990, several publications have treated issues related to currency convertibility in Eastern Europe. See e.g. Daviddi et all. (1992), Dornbusch (1990), Greene-Isard (1991), Sachs (1991), Thompson (1990), Williamson (1991). On some specific questions of convertibility in Hungary, see Blue Ribbon Comission (1992), Köves-Oblath (1992) and Oblath (1991/b and 1991/c).

2 Concepts of Convertibility

In the legal sense, "convertibility" means the free use and exchangeability of a currency. For practical purposes, it can be defined as the freedom of economic agents to carry out transactions involving foreign exchange. Thus, the "inconvertibility" of a currency implies controls on transactions involving foreign exchange. Since foreign exchange is, by definition, the money of countries other than one's own (i.e. the domestic currency is foreign exchange from the point of view of residents of all other countries) and since the extent of freedom to use and exchange a currency may vary for different types of transactions, convertibility and inconvertibility are not clear-cut concepts. As a point of departure, it is useful to consider both concepts as extreme points on a scale leading from total control to complete liberalization of transactions involving foreign exchange. One end of this scale would correspond to total inconvertibility (controls on all related transactions) and the other to full convertibility (complete liberalization). In what follows it should become clear that, both conceptually and empirically, it is more appropriate to measure convertibility/ inconvertibility not on a one dimensional scale but rather in a multidimensional space.

Next, consider the concept of **de facto** convertibility. This is meant to express the actual extent of liberalization of foreign transactions. De jure convertibility, on the other hand results from an official declaration that the currency is convertible. By international convention, a currency is considered convertible when the country‘s foreign exchange regulations meet the criteria set out in article VIII of the IMF Articles of Agreement (discussed below). However, a declaration of convertibility may actually correspond to different forms and "levels" of de facto convertibility.

The possible forms of convertibility can be distinguished according to the following criteria: who are the agents for whom transactions involving foreign exchange are liberalized/controlled (residents and/or non-residents; if residents, are they companies, banks and/or households); what type of transactions are liberalized/controlled (current or capital account transactions). If residents are free to conduct transactions involving foreign exchange, we speak of **resident** (or internal) convertibility[5]. If nonresidents are authorized to freely use and exchange the domestic currency (implying the transferability of the domestic money abroad), we speak of **external** convertibility. Depending on whether the liberalization covers only current transactions or encompasses capital transactions as well, we speak of current or capital account convertibility, respectively. A currency is generally considered fully convertible if it can be freely used and exchanged by both residents and nonresidents for both current and capital account transactions.

Thus, de facto convertibility is a multidimensional concept. Most currencies are de facto convertible in some respects, and de facto inconvertible in others. Moreover, it is worth keeping in mind that although convertibility in the strict sense refers to the liberalization of foreign exchange transactions, the latter is

[5] Note that in the recent literature a distinction is sometimes made between "resident" and "internal" convertibility, the latter referring to the authorization of foreign exchange accounts for residents. We do not consider this convertibility and shall use the terms "resident convertibility and internal convertibility" interchangeably.

meaningless if the underlying real transactions are not liberalized. This sometimes leads to a further dimension (distinction) in the interpretation of convertibility. On these lines, frequently, though somewhat misleadingly, "commodity" and "financial" convertibility are distinguished. For example, if a significant part of imports is strictly controlled (rationed), or travel abroad is subject to (domestic) restrictions, then the currency cannot be considered as de facto convertible, even in the absence of explicit foreign exchange controls. As a matter of fact, foreign exchange controls and restrictions on the underlying real transactions, respectively, may be substitutable means of achieving the same goal: limiting the freedom of economic agents to engage in foreign transactions. Therefore, de facto convertibility should be interpreted as a concept involving both the liberalization of foreign exchange transactions and the freedom to carry out the underlying real transactions (e.g. importing goods and services).

Until recently, the interpretation of **de jure** convertibility was straightforward. According to international conventions, de jure convertibility was understood as a country's official declaration that its foreign exchange regulations comply with the requirements of Article VIII of the Articles of Agreement of the IMF. According to this article, a currency is regarded as convertible if

a) it is convertible for all current account transactions,

b) for both residents and non-residents.

Thus, de jure convertibility of a currency used to be associated with the "Article VIII status" of the country concerned, involving an official **declaration** that its currency was both externally and internally convertible in connection with all items in the current account of the balance of payments. (It is worth noting that "Article VIII status" does not require the removal of controls on capital account transactions).

Recently, however, a broader, or more precisely, a different interpretation of de jure convertibility has become widespread: the simple **declaration** of a country that its national currency is convertible. This new interpretation has arisen because several East European countries declared their currencies convertible without meeting the requirements of Article VIII and, by implication, without having gained "Article VIII" status with the IMF. This recent practice seems to have resulted in the recognition, or at least tacit acceptance, of the broader interpretation. We shall certainly not try to settle this definitional matter; but one should keep in mind that one of the current interpretations of "de jure convertibility" is simply an official declaration of convertibility. International experience, to be discussed later, shows that after having reached some level of de facto convertibility, a country can chose the time for announcing the de jure convertibility of its currency in accord with economic policy considerations.

3 Implementing Convertibility in Hungary: Policy Issues

Having clarified some of the basic concepts, let us proceed to clarify a non-issue. The immediate introduction and declaration of full currency convertibility in Hungary is not recommended by relevant persons or institutions either in Hungary or abroad[6]. On the other hand, there is a wide consensus that the Hungarian currency, the forint, should eventually (i.e. in the longer run) become fully convertible. Full convertibility, as described above, means the complete liberalization of both current and capital account transactions and the removal of all foreign exchange controls.

The real issues can be summarized in two questions.

* First, what is the appropriate timing and phasing (sequencing) of the process leading to full convertibility? Alternatively stated: what are the main "building blocks" (i.e. main steps, conditions and stages) in establishing the full convertibility of the forint?

* Second, at what stage of the process towards full convertibility should the currency be declared de jure convertible?

Although the two questions are interrelated, the answers are not closely correlated. To see this, consider the extreme cases.

At one extreme, it could be argued that only actions (i.e. actual steps in the liberalization process) matter; declarations and announcements concerning convertibility are irrelevant.

According to the other extreme view, the announcement of convertibility is the significant factor; thus it does not matter much what type and level of de facto convertibility is actually "behind" the declaration.

It is not suggested that either of these two views is explicitly held. The point is that both of the above questions are relevant, and an answer to one does not determine the answer to the other.

The failure to explicitly treat both of the above questions seems to be a significant source of misunderstanding. Some experts recommended the rapid introduction of forint convertibility. This recommendation, however, is open to different interpretations. It could mean

- a rapid movement towards full de facto convertibility and a declaration of de jure convertibility as soon as possible; or

[6] There are some experts, e.g. Dornbusch (1990), who set out recommendations involving immediate full convertibility of Eastern European currencies, but these did not relate specifically to Hungary, and this view was not accepted by the majority the profession. However, when discussing the possible ways of approaching full convertibility, we shall refer to the hypothetical option of "doing everything in one step".

- gradual movement towards de facto convertibility with an early announcement of de jure convertibility. (The third possibility is rapid movement to de facto convertibility without declaration).

On the other hand, critics of rapid convertibility have not been sufficiently explicit on whether they are against

- rapid movement towards full convertibility (swift liberalization); or
- in case of a slower approach, the early announcement of convertibility; or
- both rapid movement and early announcement of convertibility.

The answer to the **first** question - as to the phasing and timing of the steps leading to full de facto convertibility - involves judgements on the following interrelated issues:

- the extent of actual external liberalization (de facto convertibility);
- the actual and prospective macro- and microeconomic as well as institutional factors present in the economy (this issue is not discussed in detail for Hungary and is only briefly mentioned in section 5.3);
- the sequencing of the stages leading to further liberalization (i.e. the "building blocks of full convertibility - e. g. first external than internal, or vice versa; for which type of transitions earlier, for which later etc.)
- the necessary conditions that have to be met before moving to a further stage of liberalization;
- the time needed for establishing the necessary conditions for each stage (i.e. speed of the movement to convertibility).

Judgements on these issues must be based on an evaluation of the costs and benefits of removing certain controls and on the sustainability of the next stage of de facto convertibility.

The **second** question – as to the timing of the declaration of de jure convertibility – cannot be answered on purely economic grounds. Announcements of this sort are much in the realm of public relations, often motivated by the impression the government wants to make at home and/or abroad regarding its policies. Although not a purely economic issue, both the declaration and its timing may have economic effects through their influence on the attitudes of domestic and foreign economic agents. A well-timed announcement based on credible and sustainable policies may be an important means of achieving the goals of economic policy. However, an announcement that lacks credibility, is irrelevant or is seen by the public as misleading or inaccurate may very easily backfire. The same holds for announcements of policies that turn out to be unsustainable. Once deceived, the public is much more sceptical the next time around.

Turning to the case in point, the announcement of convertibility, there are no strict requirements or guidelines beyond the above, admittedly very general, considerations. Although article VIII of the Articles of Agreement of the IMF, as already mentioned, requires the removal of foreign exchange controls for both residents and nonresidents on current account transactions as the condition of de jure convertibility, experiences in regard to the declaration of convertibility are quite diverse. The standard reference is Western Europe. Most countries in this region declared convertibility in the late fifties or early sixties, more or less at the time, or somewhat after, they had met the IMF's requirements. However, there are different experiences as well. A case in point is Finland, a country that adopted Article VIII status, i.e. declared de jure convertibility, only in 1979, long after having liberalized current account transactions in line with IMF stipulations. Some NICS, such as Korea and Taiwan have taken a similar route. These countries have already established de facto convertibility by liberalizing current account foreign exchange transactions, but Korea announced convertibility only in the late 1980s and Taiwan has still not declared de jure convertibility of its currency.

Recent experiences in Eastern Europe, as pointed out, offer examples of a different attitude to announcing convertibility. Several countries in this region declared their currencies convertible without approaching the conditions met by Western European countries when they announced de jure convertibility. All of these Eastern European countries announced internal (resident) convertibility. They removed some or more of the controls on international transactions for residents, but they did not establish the type of external convertibility required by Article VIII of the IMF. (To recall: the latter was the important stage before declaring convertibility in Western European countries.)

But there are also significant differences among the Eastern European countries that have declared convertibility, concerning the extent of de facto convertibility at the time of the declaration. These differences relate partly to the type of agents entitled to freely buy (use) foreign currency. In two countries, Poland and the former Yugoslavia, both companies and households were given the right, at the time convertibility was dedared, to purchase foreign exchange legally. In Czechoslovakia and Bulgaria, "convertibility" essentially meant an easing of the trade and foreign exchange regulations with respect to companies. Romania was an intermediate case: limited liberalization for companies and more far-reaching liberalization for individuals (households) – legalizing the parallel market – with a multiple exchange rate system. Although there is no question that in all of these countries very significant liberalization measures were taken, it is far from clear on what grounds they determined that their currencies were ripe for declaring convertibility.

4 De Facto Convertibility in Hungary

By applying the conceptual framework presented above, it is possible to describe the degree and type of the de facto convertibility – and by implication, de facto inconvertibility – of the Hungarian currency[7].

We shall consider the extent of liberalization (or the nature and restrictiveness of existing controls) with respect to the following categories of agents and transactions:

a) types of agents: nonresidents, residents;(among residents) business sector, household sector.

b) types of transactions: current account(trade and trade-related services, travel, factor incomes) capital account(portfolio and foreign direct investments).

Combining the above categories, the degree of de facto convertibility / inconvertibility of the forint can be characterized as follows.

- The forint is **externally inconvertible**. Although nonresidents (e.g. foreign exporters to Hungary) may accept forint payments, they cannot legally transfer or hold forints abroad. They may keep forint accounts in Hungary, exchange their forints to convertible currencies (which, in turn, may be transferred abroad) or spend their forints in Hungary. The Hungarian currency, therefore, is not usable and exchangeable in international trade and service transactions. Tourists may exchange forints for convertible currencies only in the amount of their official purchase of forints. Forint incomes (profits) on foreign investments may be repatriated by the investors after converting them to foreign currencies.

- **Internally**, the forint is **partially de facto convertible** for the business sector in terms of international trade and related services. Although foreign exchange earned by exporters of goods and services has to be offered for sale at the official exchange rate, for most imports foreign exchange is readily available. In 1992, as a result of a process started in 1989, more than 90 per cent of imports has been liberalized. This means that enterprises may buy foreign exchange to pay for the liberalized imports without facing administrative controls. The non-liberalized part – consisting mainly of foodstuffs, agricultural products and consumer goods – is subject to licensing or global quotas.

Enterprises are also free to buy currency for many types of trade-related services (i.e. shipment, insurance). There are, however, some limitations on trade-related travel expenditures and banking services. Foreign investments of Hungarian

[7] This description refers to the state of affairs in the second half of 1992. Beginning in 1993, a new foreign exchange code into force, involving some changes in the regulations discussed in the paper.

companies are controlled; the limited de facto resident convertibility of the forint does not apply to capital account transactions.

– The forint is **internally inconvertible for households.** Private persons may legally buy no more than 300 dollars annually (the amount was increased from 50 dollars in mid-1992). A parallel (nonofficial) market for foreign exchange exists, which is illegal but tolerated by the authorities. The parallel market rate does not differ significantly from the official exchange rate.

Hungarian citizens are entitled to hold foreign exchange accounts with Hungarian commercial banks, without indicating the source of the foreign exchange. As a matter of fact, the Hungarian foreign exchange regulations for households are rather hypocritical. Private persons are not permitted to freely buy foreign currency (i.e. more than 300 dollars per year), but they are entitled to place any amount in interest bearing accounts. Moreover, they are allowed to withdraw and take out of the country any amount of foreign exchange from their accounts. These latter aspects of the Hungarian foreign exchange regime have little to do with convertibility.

To sum up: the Hungarian currency is de facto convertible for the domestic business sectors with respect to a significant part of current account transactions, but it is not convertible for households (private persons). The forint is de facto convertible from the point of view of foreign investors, but it is externally inconvertible.

How should one evaluate and interpret the present degree of de facto convertibility of the forint? The answer depends on the points of reference and basis of comparison. On the one hand, the currency's degree of convertibility is still rather far below that of contemporary industrial countries' currencies; it does not even approach the level Western European countries had reached by the time they declared de jure convertibility. On the other hand, looking at East European countries that declared convertibility in 1990 and 1991, the Hungarian de facto convertibility is at least as extensive as that in Czechoslovakia, Bulgaria and Romania. The convertibility of the Polish zloty is more advanced in one important respect, already referred to above. Namely, the Polish currency is internally fully convertible for current account transactions, not only for the business sector but also for households. There is no point in comparison with the system that prevailed in the former Yugoslavia, where internal convertibility, similar to the Polish one, had to be given up in late 1990 – mainly for economic reasons, before the outbreak of the civil war.

5 Sequencing and Timing: Alternative Options

Starting from the existing level of de facto convertibility, alternative paths (involving diverse stages and timing) leading to further de facto (and finally to full) convertibility can be charted. The differences between alternative programmes may be traced to the answers to the following questions:

1) what type of convertibility should the subsequent stages of the programme focus on, i.e. what sectors and transactions should the immediate and later liberalizing measures by aimed at?

2) how rapidly should the succeeding stages follow each other?

3) what are the macroeconomic and institutional constraints; how to address those aspects of the macroeconomic environment and the foreign exchange regime that are not related to convertibility proper but indirectly influence the scope and effects of de facto convertibility (e.g. foreign exchange accounts of households; foreign exchange holdings of companies)?

4) should the programme include firm commitments concerning timing and sequencing, i.e. should there be a strict timetable for the steps leading to full convertibility?

Answers to the first question should define the building blocks of convertibility; the second question concerns the speed with which the blocks are assembled. The implications of the analogy are straightforward: if the blocks do not fit, the construction may turn out to be unstable; it they are placed upon each other too hastily, the whole construction could topple, destroying even the already existing parts of the building.

Leaving the analogy aside, let us consider the possible answers to the above questions and then turn to the conditions, costs and benefits of some of the options.

5.1 Sequencing

Sequencing the process towards full(er) convertibility involves judgement on the type of agents and transactions to be involved at earlier and later stages of the liberalization process. Four possible approaches are presented:

a) first, widen the scope of resident convertibility, achieve full de facto resident convertibility for current account transactions, continue with external de facto convertibility, and at the final stage, extend resident and nonresident convertibility to capital transactions.

b) first liberalize forint transactions for nonresidents; next introduce external convertibility for current transactions in line with Article VIII of the Articles of Agreement of the IMF; continue with resident convertibility for current transactions; finally extend convertibility to capital transactions.

c) increase the scope of resident convertibility and remove restrictions on the forint holdings of nonresidents. Move towards external and resident current account convertibility more or less simultaneously. At the final stage, liberalize capital transactions.

d) after a preparatory phase, remove controls on foreign exchange transactions for both residents and nonresidents on both current and capital transactions. This implies introducing full convertibility in one step.

The first option (a) implies the continuation of the liberalization process in Hungary, which was started in 1989. The remaining restrictions on trade would have to be removed or, when and where necessary, tariffied. The only controls that would be kept in place would be those relating to transactions that are, by international custom, generally subject to licensing (e.g. drugs, armaments etc.). Controls on trade-related services would also be removed. Next, the purchase of foreign currencies by households for tourism would have to be liberalized. Although the further liberalization of trade might raise some problems, as the removal of administrative controls has been done quite rapidly with neither compensating devaluations nor transitory tariffications[8], the more serious issue seems to be related to the liberalization households' purchases of foreign exchange. We shall return to these problems later.

The second option (b) would mean a departure from the ongoing liberalization process. It implies changing the existing priorities: rather than extending resident convertibility, it involves steps towards external convertibility in the next stages of foreign economic liberalization. According to this strategy, the use and transferability of forint accounts for foreigners would be liberalized; this could be followed by implementing full external convertibility for current account transactions. In this case, the steps related to extending internal (and finally full) convertibility would follow the achievement of external convertibility.

The third option (c), which involves simultaneous steps towards both external and internal convertibility, means not only a break from the present practice and "philosophy" of liberalization in Hungary but also offers an alternative to the strategies chosen by other East European countries. This strategy does not consider internal convertibility as a top priority but rather focuses on pragmatic steps to liberalize foreign exchange transactions for residents and nonresidents gradually, as conditions (to be discussed below) become ripe for lifting controls on both residents and/or nonresidents for current and capital foreign exchange transactions.

The fourth option (d) involves the introduction of full convertibility in one step. Since, as already mentioned, there is a more or less general consensus on the need to sequence the path towards convertibility and, furthermore, most experts agree that an early move to capital account convertibility might have undesirable

[8] See Oblath (1991a) on this point.

side effects (suchas legalizing capital flight), this option is considered as an extreme one; its details and consequences are not treated below. However, the arguments to be presented concerning the risks, costs and benefits of alternative solutions apply to this option as well.

5.2 Timing and Speed

As for the speed of the subsequent steps on the path towards convertibility, three options are considered:

a) move gradually toward each step; first, establish all the preconditions, and only then introduce the next stage of convertibility.

b) proceed through the stages of convertibility as rapidly as possible. This view is often rationalized with the argument that the more time it takes to introduce the next step, the more resistance policymakers will have to face in continuing the liberalization process.

c) do everything in one step; all conditions can never be met; if every step awaits some other step, there will be no advance towards convertibility. (This view clearly corresponds to option d) in section 5.1.)

From the above options on sequencing and timing, several combinations emerge, each of which may correspond to a particular programme for moving towards convertibility.

However, not all of the possible combinations are feasible; and some of the feasible, combinations may be unstable (unsustainable). Moreover, considering the constraints and costs, some of the feasible options may turn out to be undesirable. Therefore, we should now consider the constraints.

5.3 Constraints: The Macroeconomic Situation and Domestic Foreign Exchange Accounts

Both macroeconomic, and institutional constraints may hinder some of the conceivable steps towards convertibility. If these constraints are not observed, the costs of moving to convertibility could be unnecessarily high.

In Hungary, the economic situation is generally considered to be more favourable than that in many of the other countries in Eastern Europe. Hungary's external performance is presently relatively satisfactory. But uncertainties surrounding future prospects place a constraint on the extension of convertibility. The current account now shows a significant surplus, but this is partly due to the severe domestic recession (lower imports, higher exports than otherwise) and partly a result of increments in the foreign exchange deposits of households; this should, if correctly accounted for constitute a capital account item. The overall balance of payments is even more favourable, as there is a significant inflow of foreign capital. How long the inflow will continue is, however, even less certain than are the net revenues in the current account[9]).

Meanwhile, the domestic inflation rate is still high by European standards (20 %), the budget deficit is increasing (8 % of the GDP), production and consumption continue to dedine and unemployment is growing. The burden of external debt service has diminished in the last year but is still rather high (some 40 % of exports). Therefore, Hungary's present relatively favourable international economic position is not based on sufficiently solid grounds; unexpected shocks, either internal or external, may result in destabilizing expectations.

A suitable programme for introducing convertibility must also deal explicitly with those aspects of foreign exchange regulations that are only indirectly related to convertibility. These include the treatment of households' foreign exchange accounts and the possible authorization of foreign exchange accounts for business firms and banks. Strategies that consider resident convertibility as the top priority – especially that which aims at the rapid introduction of full current account resident convertibility – have to face the constraints presented by the existence of **foreign currency accounts of households.**

If the present regulation were maintained, any additional amount of foreign exchange offered for sale to households could be purchased for deposit in these bank accounts. (More dangerously, any amount can be legally withdrawn from these accounts and taken out of the country). A stricter regulation on the use of the **stock** of funds in these accounts (which amounts to some USD 1.9 billion) might seem to be called for in the context of liberalizing the **flows** related to the sale of foreign exchange for tourism. But it should be clear that any additional controls on foreign currency accounts would undermine confidence and thus induce the capital flight which such measures would be supposed to prevent.

This points to a more general problem regarding households' foreign exchange accounts. Given the authorization to take any amount from these accounts abroad, resident convertibility for households would actually amount to legalizing totally free capital mobility. The liberalization of short term capital movements, however, is far down on the agenda of all relevant strategies of moving towards convertibility. Therefore, in Hungary, given the institutional background and the aforementioned dangers of changing the regulation of households' foreign exchange accounts, liberalizing the legal possibilities of private persons to purchase foreign exchange would not simply mean liberalizing a current account (flow) item of the balance of payments. It would also mean the liberalization of short term capital (i.e. hot money), with potentially destabilizing implications in an unstable macroeconomic environment.

Liberalizing the holding of foreign exchange by the **business sector** is a seemingly natural step toward further liberalization, but it involves risk. This solution might lead to the emergence of a dual currency system ("dollarization"), especially in a period of domestic instability, as it did in several Latin American countries and in Poland and Yugoslavia in the 1980s. Therefore, it should be stated clearly that extending the right to hold foreign currency accounts to the business sector does not represent a movement towards convertibility; in an unstable macroeconomic environment it might easily mean the opposite - i.e. a drift away from the relatively free use and exchangeability of the domestic

[9] See Oblath (1993).

currency. This is not to say that authorizing companies to hold foreign exchange necessarily conflicts with convertibility. The issue is rather at what point and under what conditions should this particular step be taken.

The Foreign exchange holdings and transactions of commercial **banks** is a different matter. Since the decentralization of foreign exchange dealings is a necessary step in the reform of the financial and banking system and, furthermore, keeping foreign exchange within the banking system can be managed relatively easily, liberalization of foreign exchange transactions of commercial banks does not involve the type of macroeconomic risks that might result from the wide-scale authorization of companies to hold foreign exchange accounts. The actual solution chosen in Hungary was indeed the liberalization of foreign exchange transactions for banks; the foreign exchange market, instituted in mid-1992 is a limited inter-bank market under the close surveillance of the HNB.

As to **foreigners**, the authorization of forint transfers abroad is considered a potential source of problems because, in case of a speculative attack, it may be both difficult and costly to defend the currency. The decision on when to authorize forint transfers of nonresidents must be based on an evaluation of economic conditions. It is the freedom to transfer the Hungarian currency abroad which would reduce nonresidents' risk in holding forint accounts; but this would certainly increase the risk of a larger scale speculation against the currency abroad.

5.4 Firm Commitments?

Should the measures and steps leading to convertibility be announced in advance and entail firm commitments on the part of the government? On the one hand, it may be argued that the programme is more credible and the possibilities for various interest groups unfavourably effected by further liberalization to block the implementation is smaller if the programme rests on strong commitments involving specific measures and dates. On the other hand, there are risks in undertaking very firm commitments in a fluid situation characterized by much uncertainty as to the economic outlook. If, for reasons beyond the government's control the early commitments cannot be adhered to, credibility might be totally lost. Moreover, the Hungarian public had many unfavourable experiences with firm commitments that have not been taken seriously by the government. Therefore, a looser schedule indicating the main objectives, the steps leading to them and the approximate time needed for the implementation of the programme – entailing a pragmatic approach – might be more credible in Hungary and better suited to the present and prospective economic environment.

6 Benefits, Conditions and Risks

The benefits of moving towards "higher levels" of de facto convertibility, i.e. a more liberal foreign trade and exchange regime, are straightforward and well known from the literature. More competition, more efficient allocation of resources and less distortion in the goods and capital markets. These statements can be formulated in terms of deceasing costs as well: the costs due to protection, monopolization of industries and lack of competition are certain to decrease as a result of a more open trade and exchange regime.

These benefits, however, can be attained only if certain conditions are met; otherwise the risks and costs of a more liberal regime might not match the advantages expected from the further opening up of the economy.

Since, as discussed above, a certain degree of de facto convertibility already exists in Hungary, the relevant questions concern the necessary conditions for achieving further stages of liberalization. The major conditions of full current account resident convertibility, with the institution of households' foreign currency accounts remaining intact, are the achievement of domestic and external economic stability and the accumulation sufficient international reserves. Domestic stability implies an inflation rate much closer to the international (West European) rate, or at least the expectation of significantly lower inflation. External balance means that the current account is balanced or a sufficient inflow of foreign funds and/or foreign direct investment makes up for the deficit.

Some of the risks of moving too fast have already been mentioned, but it is important to recall that the major risk of an early movement towards convertibility is that the liberalization measures related to a particular stage cannot be sustained. If liberalization has to be given up at some point, it will be extremely difficult to persuade the public to believe the authorities the next time. This is a serious danger, as attested to by the Yugoslavian experience, where convertibility had to be abandoned at the end of 1990.

As for the possible **costs** of moving towards convertibility without having achieved the necessary conditions, the excessive devaluation or depreciation of the domestic currency should be the most serious concern. In Eastern Europe large devaluations seem to have not just powerful inflationary, but also contractionary, effects. Such was the case in Poland, but it could be repeated in any country wishing to establish convertibility in a state of external and internal instability[10].

On declaring convertibility, it might be useful to keep three considerations in mind. The first has been touched on: only a firmly sustainable convertibility should be announced. Second, the international interest in announcements and declarations on convertibility seems to have diminished substantially. Third, in order not to deceive the public at home, it would be advisable to announce convertibility only when the currency becomes de facto convertible for households to an extent similar to that in West European countries. For Hungary, a plausible

[10] The claim that excessive devaluations have unfavourable effects and should be avoided if possible does not, of course, imply that devaluations themeselves are to be avoided. On the contrary, if the domestic inflation rate is significantly higher than that of the trading partners, the real appreciation of the currency may be evaded by continuous small devaluations of the exchange rate. For more on this in the CEE context, see Oblath, 1993.

option would be to declare de jure convertibility after having met the requirements of Article VIII of the IMF.

7 Concluding Remarks

Although this paper has treated various aspects of currency convertibility in general, as well as questions related to the prospects and conditions of the convertibility of the Hungarian currency in particular, it does not offer any direct answers to the question as to how and when to introduce convertibility either in Hungary or elsewhere. This is no coincidence. The main point of the paper can be stated simply: the excessive interest devoted to currency convertibility in Eastern Europe may have distracted attention from many of the relevant questions; precisely in what manner, how and when should the liberalization of individual countries' external economic relations be carried out, given their particular conditions and constraints. The conceptual framework presented in the paper and applied in highlighting some of the policy issues and dilemmas in Hungary may be applied to other East European countries as well. This exercise should reveal that the real issues are beyond the over-politicized question of currency convertibility.

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