

CREATING A STABLE MONETARY ORDER

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A Precondition for Monetary Order

A stable monetary order is for me both a goal and an instrument for achieving other goals. My crucial message is the following: a basic precondition for creating a stable monetary order goes beyond technicalities. This is something I would like to stress very much. In my understanding, there is no technical, organizational, or institutional device that could potentially make up for the lack of political responsibility, for the lack of political and social consensus, in a country that wants to have a stable monetary order. Political and social consensus is for me a crucial precondition, and I spend most of my time trying to maintain and establish exactly that precondition in my own country.

It seems to me wrong to suggest alternative institutional arrangements, such as currency boards, to compensate for the lack of political responsibility or to compensate for the incapability of politicians to establish and maintain basic support for rational economic policy. I have to advocate standard institutional arrangements, even if they may not be intellectually challenging. We are not interested in any new social experiments. We enjoyed 40 years of living in a traumatic social experiment; it was more than enough. Therefore, we are very conservative.

The Conduct of Monetary Policy

Standard institutional arrangements mean, for me, the creation of a two-tiered banking system and the independence of the central

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bank. What are the policy prescriptions we have to follow? In principle, I favor rules—but rules understood as clear, transparent concepts, not as rigid technical prescriptions. Rational monetary policy needs clearly defined goals and priorities, and there is no more important goal than price stability.

I view monetarism as an inspiration, not as dogma about technical details. My problem, and not only mine, is the question of how to conduct monetary policy in a situation of extreme fluctuations in economic performance during economic transition. This is a crucial question. All the well-known textbook prescriptions are extremely useful as a basic orientation, but one has to add something to that. At the end of the 1990s, all of us will have perfect time series to analyze our mistakes, but we do not have such time series now, and we have to act. We have to conduct monetary policy with all the uncertainties we face. There is no simple advice, but I have two suggestions.

First, in the early stages of the transformation process, we must conduct a very restrictive monetary policy. Second, the traumatic decline in production observed during the transition is not a standard depression. Thus, there is no expansionary policy that can cure that decline or prevent unemployment from arising. It is more proper to say that the existing output decline is the result of the transformation shakeout, that is, the shakeout of irrational economic activities. The faster such economic activities die, the better.

Very often I have to face arguments in my own country—and, I am very sorry to say, in the West as well—that there is a depression or crisis in Czechoslovakia, Hungary, and Poland, and that this crisis requires expansionary economic policies. That is a very dangerous misinterpretation. I have made no optimistic assumptions about the elasticity of the aggregate supply curve of an economy under transition, and I am pretty sure that expansionary policy would bring inflation and nothing else. The question is when to make a policy switch to a less-restrictive monetary policy. It is quite clear in a country like Czechoslovakia that it must be done after price deregulation. (Today 95 percent of all prices are free to move, which is more than in most Western European countries 10 years ago and probably more than in some Western European countries even today.) A switch to a less-restrictive monetary policy must occur after price deregulation, trade deregulation, and privatization of an important segment of the economy. But this policy is still no real answer.

To my great regret we do not live in an easy world of homogeneity. We live in a heterogeneous world. We live in a mixed world with a growing private sector, which reacts to market signals, and a shrinking, but still huge, state-owned sector that does not react to market

signals. The state-owned firms are in a state of preprivatization agony. One of your businessmen recently made a very good analogy. He said that state-owned firms in Czechoslovakia behave like they are in a freezer. They are frozen, they do not smell, they do not move, they do not react. We live in such a complicated world, and to discover the proper moment to make monetary policy less restrictive is for me a task we have to solve now.

There are some additional analytical issues in the field of monetary policy that are my current headaches. Our basic analytical frame of reference is the quantity theory of money with its equation of exchange, $MV = PT$. We think in terms of the famous four variables and implicitly use them to analyze our economic situation, our economic policy.

The Unreliability of Official Data

The problem of the unreliability of data on prices and output is well known. During the old system, economic data favored the communist regime. During the transition to a market economy, however, the official statistical data help to discredit the reform efforts. Because there are many unreported economic activities in the mushrooming private sector, statistical offices are unable to analyze and take into consideration all the economic data. In my country, the official data really fail to show the fluctuations in output due to the privatization of small-scale businesses. For example, our statistical office publishes retail trade data only for firms with more than 100 employees. In November 1991, retail trade for those firms had declined by some 35 percent. While such information would be extremely relevant for any standard and stable economy, and especially for a centrally planned economy where all retail firms have more than 100 employees, it is now absolutely irrelevant. Nevertheless, the decline in that measure of retail trade made the headlines in Czechoslovakia and in the *New York Times* as well. The unreliability of data on prices and quantities is, therefore, a crucial issue.

Is Monetary Policy Overly Restrictive?

But this is not the main problem we face. I am afraid that our monetary policy may be too restrictive. My hypothesis is that in a country moving from a centrally planned economy to a market economy, transactions grow much faster than current output. So if monetary policy focuses on increasing the money supply in line with current output, monetary policy will be overly restrictive. For that reason I have some doubts about our monetary policy.

Why is it that transactions grow faster than output? There may be at least three reasons. The first is that in the past we have had only current output transactions, whereas, in the transformation period, we have huge property transfers. The differences between current output transactions and property transactions are large in a newly emerging market economy. As such, a simple quantity of money equation, which relies on current output, will underestimate the demand for money. This is a serious concern.

Second, in the world of central planning we had only real transactions, payments for the delivery of goods and services. There was no financial sector. However, in the transition to a market system, financial transactions become important and add to the demand for money.

Finally, there is another important reason for a dramatic increase in transactions in economies making the transition to a market system, namely, the enormous multiplication of the number of economic agents as markets widen. In the past, economic transactions were very often done administratively inside large enterprises without the intermediation of money. But today there are many new economic agents and numerous exchanges among thousands of firms instead of movements of goods inside large firms. This institutional change is another reason for the enormous increase in the demand for money and why it is so difficult to measure the demand for money in such a situation.

Monetary policy may also be overly restrictive because of the conservative nature of our commercial banks. At present, we have two different patterns of commercial-bank behavior in Central Europe. We have the behavior of commercial banks in countries like Poland and in the former Soviet Union, where the situation is such that commercial banks grant credits very easily. And we have the behavior of commercial banks in Czechoslovakia, where the newly born independent banks try to play a very conservative role and are probably overcautious. (They have their new general directors with their cigars à la Paul Volcker, and when a newly born entrepreneur comes to ask for a loan, the bank directors tell them, "You don't look sufficiently promising.") The difference probably reflects the different mentalities in various countries of Eastern and Central Europe. We were always overcautious in the past in Czechoslovakia, and the overly conservative behavior of our commercial banks creates an additional problem that we have to solve. There is no reason to try to force the banks to grant more credits, but we are afraid that maybe they are too risk-averse.

Other Issues in Creating a Monetary Order

There are three final issues, which I will just mention. First, there is the issue of whether one country should try to enter the global economy alone or whether it should try to organize a regional monetary arrangement as a way to integrate itself with the global economy. My answer is straightforward. There is no reason to create sophisticated, complicated, and artificial monetary arrangements. To create, as I like to call them, "poor man's clubs" is a safe way to block our fast entry into the world economy.

The second issue is whether we should keep restricting currency convertibility to current account convertibility or whether we should jump immediately into the world of capital account convertibility. I have nothing against full convertibility, but for practical reasons it seems that current account convertibility is sufficient for us now. It is sufficient because it opens the country to the rest of the world. We do not intend to centrally plan the introduction of competition at home. For us the best way to liquidate domestic monopolies is to introduce international competition, and this is exactly what current account convertibility accomplishes.

The third issue is whether to have fixed or flexible exchange rates. I was horrified at the very beginning with the idea of having fixed exchange rates. I remember at the same time that the IMF was shocked when I suggested a flexible exchange-rate regime. I was really afraid that announcing a fixed, highly devalued exchange rate three days before the introduction of price liberalization could create a vicious inflationary spiral. I wanted to let the exchange rate be free to move for sometime and maybe only then introduce a fixed exchange rate. I am glad that I was wrong in this respect. Nothing happened with the preannounced fixed exchange rate, and it seems to me that to use the exchange rate as an anchor for all other monetary variables in the economy is a good policy.