A MONETARY CONSTITUTION
FOR
EX-COMMUNIST COUNTRIES

Antonio Martino

The importance of monetary stability derives from the significant independent influence of monetary change on the subsequent course of economic activity. If money did not matter at all or were of only secondary importance in affecting the flow of spending, income, and prices, monetary stability would be of little relevance.

—Michael D. Bordo and Anna J. Schwartz

The Case for a Monetary Constitution

After the interlude of the Keynesian revolution, monetary stability has been restored to its status as an important policy goal (Dorn 1987). The experience of the 1970s and 1980s and the theoretical works that have accompanied it have helped dispose of most Keynesian ideas on money and monetary policy. From the point of view of its importance, price stability has reacquired the position it held in pre-Keynesian times, when it was believed that a stable purchasing power of money was a necessary precondition for a free and prosperous economy.

In a Keynesian world, price stability is not necessarily desirable. Most Keynesians were convinced that inflation was the unavoidable price of economic growth, that there was a stable trade-off between inflation and unemployment, that it was possible to reduce interest rates through monetary expansion, and that the time horizon for monetary policy decisions had to be dictated by the needs of short-term stabilization policies. All of these views have succumbed to

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the empirical evidence and the theoretical analyses of the last 20 years.

There is no evidence that economic growth inevitably involves price inflation. On the contrary, there are good reasons to believe that monetary instability hinders long-term projects and makes economic growth more difficult, as evidenced by the experience of a number of Latin American countries.

The idea of a stable trade-off between inflation and unemployment is thoroughly discredited: an unexpected acceleration of inflation may temporarily reduce unemployment below its "natural rate," but this effect is short-lived. Only an accelerating inflation could keep unemployment below its "natural rate," but even that unappetizing possibility is dubious (Friedman 1968, 1975, 1977; Bordo and Schwartz 1983).

Manipulation of monetary aggregates can influence interest rates only temporarily: as soon as inflationary expectations catch up with reality, the Keynesian "liquidity effect" is replaced by the "Fisher effect," which will more than offset the initial impact of the unexpected change in monetary policy (Thornton 1988). Nominal interest rates tend to be higher, not lower, when monetary policy is loose.

As for stabilization policies, it is now largely (though certainly not unanimously) agreed that our insufficient knowledge, unreliable short-run macroeconomic forecasts, and variable time lags in the impact of monetary policy decisions make it likely that policies aimed at stabilizing the short run may end up being pro-cyclical rather than counter-cyclical. Attempts at fine-tuning the economy often result in additional, avoidable instability (Friedman 1951, 1953, 1962, 1969; Haberler 1974; Meltzer 1991).2

For these reasons, the old pre-Keynesian wisdom that monetary stability is a necessary (though by no means sufficient) condition for economic progress has again acquired widespread popularity. Price stability may not be a cure-all, but, while there is no long-lasting benefit to be gained from the instability of the price level, this may in itself be the cause of serious economic problems.

In other words, the post-Keynesian "counter-revolution" has resulted in the abandonment of money as an instrument of (discretionary) policy, limiting its role to its three traditional functions as unit of account, medium of exchange, and store of value or "temporary abode of purchasing power," to use Milton Friedman's felicitous expression.

2"Monetarists ... favor stable policy rules that reduce variability and uncertainty for private decision-makers. They argue that government serves the economy best by enhancing stability and acting predictably, not by trying to engineer carefully timed changes in policy actions which are frequently destabilizing" (Meltzer 1991, p. 31).
I mention these well-known facts because if monetary stability were not desirable, if discretionary (and erratic) monetary policy were advantageous, the whole subject of a monetary constitution would lose its meaning. It can be argued that monetary stability is even more important for a country in transition from central planning to the market. In such a country, the amount of long-term investment projects is unusually large: infrastructures need to be built, obsolete plants and equipment need to be replaced by economically viable ones, and the remains of the follies of planning must be removed to make room for the new structures (Jordan 1991, Hanke and Schuler 1991). Building a market economy from scratch requires confidence in the future and long-term investment plans; both need a stable money. All the more so since the reconstruction will inevitably need the participation of foreign investors, who are certainly not encouraged by countries with dismal records of monetary performance.

The lesson for policymakers in ex-communist countries (ECCs) is simple enough: money must be regarded as an integral part of the institutional framework—monetary stability being one of the rules of the game—and not as an instrument of policy. The transition involves transferring from the arbitrary decisions of authorities to the market the most fundamental task of any economic system: that of directing resources to their most productive uses. However, for the price system to perform that task satisfactorily, prices must not send wrong signals; that is, inflationary “static” must not interfere with the working of prices. That is why price stability, always a precious commodity, is of paramount importance for the transition process of ECCs.

Finally, it is not enough for prices to be stable; their stability must also be regarded as long lasting, not as a transient and accidental phenomenon. When people plan for the distant future, the expected behavior of prices matters more than past behavior (Leijonhufvud 1987). The argument for price stability, in other words, must be complemented with the case for the credibility of a policy of stability. It is not enough that prices are stable; they must also be expected to remain stable. It is here that the need for a monetary constitution comes in. The monetary constitution must not be designed for the transition, must not be intended to last only for a limited time, but it must explicitly aim at guaranteeing price stability for an indefinite duration. There is no need, in other words, for special monetary arrangements aimed at easing the transition process and destined to be replaced by other rules once the transition is completed. The commitment to monetary stability must be intended and interpreted...
to be a permanent one, so as to encourage long-term projects and
earn the confidence of domestic and foreign investors.

That a monetary arrangement guaranteeing price stability for the
indefinite future should be the ultimate aim of reformers in ECCs can
be more easily agreed upon than what the transitional path to stability
should be. It has been argued that a disinflationary policy adopted
before the privatization of the economy has been completed could
have serious drawbacks and be doomed to fail. If a monetary squeeze
replaces present inflationary tendencies, the effect on the reallocation
of resources may not be as successful as it would be in a market
economy. In a country where resources are privately owned and
markets are allowed to operate, the slowdown induced by a monetary
squeeze is likely to be temporary and its effects to be compensated by
efficiency gains as resources are more rationally allocated. In a still
collectivized economy, it can be argued that such a reallocation of
resources is unlikely to take place, so that the monetary squeeze will
affect "most the smaller and more privatized entities . . . rather than
the politically protected large state owned enterprises" (Walters 1991,
p. 41). Rather than moving resources toward more productive uses,
the disinflation would hurt the small productive units and discourage
new initiatives. Furthermore, as Alan Walters notes, "the squeeze
devastates the SOEs [state owned enterprises] profits and since much
of central government revenue is derived from the surpluses, there is
a catastrophic fall in government revenue, which ... will induce
monetary expansion to fill the gaps ... which in turn generates a new
wave of inflation."

Such an analysis is probably too catastrophic. Taken literally, it
would appear to suggest that an inflationary monetary policy, by
inflating the SOEs' profits and hence the government revenue, would
be a precondition for a reduction in the government deficit and a
slower rate of monetary expansion. In order to bring the inflation
down, one must first conduct an inflationary policy! Aside from this
paradox, the fact remains that if the economy is not privatized there
is no transition. As long as there is no market, the problem is that of
defining the ideal monetary policy for a command economy. Further-
more, even assuming that the pessimistic evaluation is justified, what
is the alternative? The continuation of the old inflationary policy
would not make the transition simpler, it would solve no problem, and
it would add difficulties of its own making to an already tragic
situation. This is why in what follows I shall assume that we are talking
about countries that are really moving from plan to market, where
privatization is being achieved on a large scale, new markets are
continuously coming into existence, and prices are freed from
administrative control. If, on the other hand, aside from market-talk, nothing is being done in the real economy to allow the price system to work, markets to be formed, and private property to be securely established, monetary arrangements become secondary: there are no monetary gimmicks that can make a semi-paralyzed, near-command economy prosperous and successful.

I shall not, therefore, make any distinction between monetary arrangements for the initial stages of the transition and those for the final steps. My point is that discretionary monetary policy is seldom useful and often harmful, and this is true in a market economy, in an economy in transition from plan to market, and even in a planned economy. What we have learned in the past 20 years is that manipulating monetary aggregates on a daily or weekly basis will solve no problem and it might add to the overall instability of the economy. From an a priori point of view, the ideal rate of inflation may not be zero, but nobody has suggested a better number yet.3

What Kind of Monetary Constitution?

The argument in favor of a monetary constitution in general and for ECCs in particular leaves us with the problem of choosing the specific set of rules to be adopted.4 Now, it is indeed more important to agree on the need for rigid rules that to agree on the particular rule to adopt (see Buchanan 1983, p. 144). However, as long as supporters of monetary constitutions widely disagree on what kind of rules must replace the present discretionary conduct of monetary policy, they are unlikely to make theirs a convincing case. I shall, therefore, look at some of the monetary constitutions that have been tried or proposed and attempt to single out their advantages and drawbacks, in the effort of finding an arrangement suitable for ECCs.

Gold

The oldest form of monetary constitution is the gold standard, which can still count on many advocates. Supporters of gold believe that a gold-backed currency would severely limit the discretion of

3"Proposals for monetary reform usually assume that the public prefers a noninflationary rate of monetary growth. This may be true, but it has not been demonstrated. Nor has it been shown that the rate of inflation that maximizes wealth, or the utility of wealth and private consumption, is identically zero" (Meltzer 1983, 1987 p. 204).

4"Unless we can get an effective change in monetary regimes, we cannot expect our politicians or our central bankers to resolve the incipient stagflation dilemma. Until and unless we begin to take the long-term perspective in our private and in our public capacities, including the adoption of new and binding constitutional constraints on the fiscal and monetary powers of government, we are doomed to remain mired in the muck of modern politics" (Buchanan 1983, pp. 145-46). Also, see Simons (1936).
monetary authorities and the power of government to debauch the currency for political purposes. On the other hand, critics of the gold standard maintain that historically its performance was not as good as its supporters claim.\(^5\)

The trouble with gold, as emphasized by Milton Friedman (1961), is that there is an enormous difference between a 100 percent gold standard—a “real” gold standard in which gold is used as money—and a “pseudo” gold standard, in which money is linked to gold through government fixing of its price.

According to Friedman (1987, p. 373), only a real gold standard “would constitute an improvement rather than a deterioration in our monetary arrangements.” Furthermore, if a 100 percent gold standard is destined to evolve into a fractional reserve system (Meiselman 1983), then it is fair to conclude that the monetary arrangement that would result from adopting the gold anchor would be exposed to the kind of monetary instability that has been typical of fractional reserve systems, with bank panics and the like (Cagan 1987).

However, the historical evidence on the performance of gold is mixed and far from conclusive. For example, Italian history from 1845 to 1915 seems to support the case for gold. The gold standard was the ruling monetary system from the beginning of “Risorgimento”—the process by which Italy became unified and the pre-unitarian states were dissolved—until World War I erupted. Those were years of great transformations, comparable in scope, even though not in direction, to what is going on in the ECCs. It may be more than a historical curiosity to see how this early type of monetary constitution performed.

From 1845 to 1915, the nominal price of gold was not perfectly stable, but it fluctuated year in and year out, periods of stability being followed by sharp decreases or increases (see Figure 1). Moreover, the real price of gold fluctuated along a declining trend until the unification was completed (1871), and it continued to swing along a fairly stable trend until the start of World War I (see Figure 2). During those 70 years, consumer prices were not stable: the unification was accompanied by inflation, followed by deflation, then stability, and finally moderate inflation in the first decade and a half of the 20th century (see Figure 3).

However, if one looks at the gold standard years in a historical perspective, there is no question that in terms of price stability those were years of unrivaled success (Figure 4). If the yardstick by which one measures the success of a monetary standard is price-level

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\(^5\)For a vigorous debate on the pros and cons of a return to gold, see Meltzer and Reynolds (1982).
FIGURE 1
ITALY: THE PRICE OF GOLD, 1845–1915

Source: Banca d’Italia.

FIGURE 2
ITALY: REAL PRICE OF GOLD, 1845–1915

Source: Banca d’Italia.
FIGURE 3
ITALY: CONSUMER PRICE INDEX, 1845–1915

Source: ISTAT, Banca d'Italia.

FIGURE 4
ITALY: CONSUMER PRICE INDEX, 1845–1990

Source: ISTAT, Banca d'Italia.
stability, the gold standard period, on the basis of this circumstantial evidence, was superior to any other time in Italy’s history. One can question whether this outcome is entirely attributable to the gold anchor or not, but it is a fact that those were the most stable in the past 145 years of Italian history.

The obvious answer to the apparent contradiction in the evaluation of the performance of gold is that it is better to have some kind of monetary constitution limiting the discretionary powers of monetary authorities, no matter how imperfect, than to have no constitution at all. The gold standard was far from perfect, and it is doubtful whether it could provide us with an answer to today’s problems, but it has proven, at least in the case of Italy, to be better than a purely discretionary regime.

Currency Competition

Following a famous proposal by Friedrich A. Hayek (1976), a more radical kind of monetary reform has received considerable attention: the privatization of money. Different monetary instruments would be offered by competitive suppliers, and, if the rates at which they would be exchanged for one another were flexible and continuously determined by the market, a virtual circle would be established by a Gresham’s law in reverse, which would lead to the elimination of the less-stable currencies in favor of the more-stable ones.

It is beyond the scope of this paper to go into the details of the various proposals. I shall limit myself to looking at competing currencies as a monetary constitution that could be adopted by ECCs. Let me make it clear that I am convinced that choice in currency is an important component of freedom in general and a desirable feature of a truly free society (Friedman 1991). However, I believe that there are various reasons, aside from political feasibility, that make private competitive currencies unsuited as a monetary constitution for ECCs.

The first, and possibly most important, function of money is to be a unit of account, allowing prices to be expressed in a single measuring unit. The simplification money introduces in economic

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6For a comprehensive analysis of Italy’s monetary history, see Spinelli and Fratianni (1991).

7Almost all academic economists are convinced that the gold standard does not provide an answer to today’s problems. Gottfried Haberler (1974, p. 162), for example, states: “The gold standard broke down with the outbreak of war in 1914. It was superficially restored in the early 1920s but was definitively swept away and abandoned in the Great Depression. There is now no chance that it will be resurrected.”

8For an excellent presentation of the argument for competing currencies, see Vaubel (1986).
calculations is enormous.\textsuperscript{9} Money prices transmit information (Friedman 1984) and allow markets to perform their function of information retrieval systems (Hayek 1945). As such, money resembles language: it conveys information. As in the case of language—most people are proficient in only one language—we tend to think in terms of one unit of account (Cagan 1986). Whenever we are abroad, in a country using a different currency, we experience, at least at the beginning, a marked difficulty in understanding the meaning of prices expressed in the foreign currency. It would be costly to think in terms of two or more currencies all the time, especially if—as required by the logic of competition—their exchange rate would vary continuously.\textsuperscript{10} People are much better off with one yardstick, one unit of measurement—in fact that is the very reason why they have a unit of measurement in the first place. Converting all the time from meters and centimeters to feet and inches gets to be annoying, useless, and time consuming. In all likelihood, therefore, most people would prefer thinking in terms of only one currency, and competition between currencies would be severely limited. On a priori grounds, this objection would seem to carry particular weight in countries where people have very limited experience with the working of prices and markets.

Second, according to the logic of competing currencies, competition favors the most stable one, thereby creating an incentive for the money suppliers to make sure their currency is not rejected because of its instability. Yet, stability does not seem to be the only criterion for success in currency competition: the U.S. dollar is not the most stable currency in the world, yet most international transactions are conducted in dollars. Other factors play a role in the competition of currencies. One of the most important factors is the size of the domestic market. Like language, whose usefulness increases with the number of people speaking it, the importance of a given currency increases with the number of people using it. Its acceptability tends to be self-reinforcing: the greater the number of people who already use it, the more likely it is that it will become acceptable to others, largely without regard to its past performance. The Swiss franc may be more stable than the U.S. dollar, but the fact that the number of

\textsuperscript{9}Instead of having $n$ prices for $n$ commodities, without money the number of prices would be $T = 0.5n(n-1)$. In a world of 1,000 commodities, instead of 1,000 money prices there would be 499,500 “real” prices (Mundell 1968, pp. 45–46).

\textsuperscript{10}“If the money issued by different banks competed freely in the market, the result would be either the emergence of a private monopoly or oligopoly of money creation, or the circulation, side by side, of several kinds of money with fluctuating exchange rates between them. Either one of these outcomes would be intolerable. The immediate result would be to bring the government back into the business of money creation” (Haberler 1987, p. 80).
people using the Swiss franc is smaller makes people prefer to use the dollar. In short, currency competition is likely to be imperfect and unlikely to act as a filter mechanism in favor of the most stable currency.

Finally, as in the case of language, in the choice and use of money there is a considerable amount of inertia (Bordo and Schwartz 1983): people do not ask themselves which is the most effective language for communicating with others, they just pick up the language spoken in the area where they grow up. And, once they have learned it, they continue to use it. This is because in most cases the cost of learning another language outweighs the benefits. Thus, people normally stick to the language they already know. The same is true of money: the dollar may be a monetary instrument superior to the Italian lira, but when I am in the United States I always translate prices from dollars into lire to understand their real meaning. Currency competition is more a notion for theoretical economists than a realistic proposal for monetary reform, especially in countries where monetary sophistication is limited.

A Monetary Growth Rule

The third kind of monetary constitution is the well-known one of a constant monetary growth rule (Friedman 1959, 1969). The logic of this proposal is well known and it need not be repeated here. In one form or another, it is accepted by nearly all monetarists.

I am still convinced that Friedman's monetary rule would offer a superior monetary arrangement in most circumstances. However, we must acknowledge the fact that (at least in a legislated form) it has never really been tried and that, in Friedman's (1987, p. 368) own words, even in the United States "the Fed has been unable or unwilling to achieve such a target, even when it sets it itself, and that it has been able to plead inability and thereby avoid accountability." This poses a major problem to supporters of this type of monetary constitution: if even the monetary authorities of the country where the case for Friedman's rule is known best (the United States) have been unable or unwilling to enforce it, what likelihood is there that it might be given a chance in countries where its significance is less understood and appreciated?

11 I have argued that a monetary growth rule would be the ideal arrangement for Europe should the European Economic Community (EEC) adopt a common currency (Martino 1990).

12 Friedman (1987, p. 369) has been forced to acknowledge: "I remain persuaded that a monetary rule that leads to a predictable long-run path of a specified monetary aggregate is a highly desirable goal—superior either to discretionary control of the quantity of money by a set of monetary authorities or to a commodity standard. However, I am no longer so optimistic as I once was that it can be effected by either persuading the monetary authorities to follow it or legislating its adoption."
The unpleasant conclusion of the previous considerations is that, for one reason or another, none of the major types to monetary constitutions that have so far been proposed appears immune to criticism. The gold standard would have the advantage of simplicity and credibility, but in its fractional version it would be exposed to crisis, it would not necessarily guarantee economic stability, and it would not be self-enforcing; monetary authorities might decide to go off gold whenever they deemed it necessary. A monetary constitution based on competing currencies has the enormous advantage of not being dependent on the goodwill of authorities for its existence: it is self-enforcing. However, it is doubtful that it would work, and even more doubtful that it could be an appropriate solution for countries that lack sophisticated knowledge of prices and markets. The monetary growth rule would be ideal if authorities would allow it to work, but the empirical evidence available so far suggests that, even if formally adopted, it would not be carried out. It would seem that monetary economists have no workable rule to prescribe. We agree on the need for a monetary constitution, but we have not devised one that is likely to be appropriate for ECCs, acceptable to its rulers, and likely to deliver monetary stability.

A Modest Proposal

The problems faced by ECCs in their attempt to go from a centrally planned to a market economy are enormous. To a large

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13In the case of gold there is an additional difficulty. While a gold-backed currency would be ideal in terms of its credibility for countries that are beginning to try to come out of the communist mess, and despite the enormous mining potentialities of the former Soviet Union, gold reserves, according to the latest figures, are not adequate. According to The Economist (1992, p. 73), the “former Soviet Union ... has reserves of only 240 tonnes, a tenth of what most western analysts had long reckoned it had.” Therefore, a gold standard must be ruled out, or, as one of its supporters, Robert Mundell, reluctantly concludes: “Gold can no longer be the solution” (1991).

14After the first draft of this paper was written, I came across a very interesting proposal by Hanke and Schuler (1991b, 1992). The currency board plan they support is extremely elegant in its simplicity, but it leaves two questions unanswered. First of all, aside from all the well-known objections to fixed exchange rates, how are we to find out which exchange rate between the foreign reserve currency and the domestic currency is “appropriate” (1991b, p.23)? A short period of floating would allow us to single out the rate appropriate for present circumstances, but how do we know whether the same rate would be appropriate in the future, given the tremendous changes that are likely to take place? Second, the “real” money supply now in circulation in ECCs, notably the former Soviet Union, is as small as the authors claim for the obvious reason that those countries are undergoing very rapid inflation. If, accepting the authors’ proposal (1991b, p. 25), we move from the present arrangement to the one proposed, freezing the “real” money supply at its present, low level, the inevitable outcome would a dramatic, disastrous deflation and depression.
extent, they are also unprecedented, so that the literature on how to go from plan to market is virtually nonexistent. Furthermore, each of the former communist countries is different from all others because of its history, culture, and degree of economic performance. The idea of a general prescription for success valid for all countries is, therefore, quixotic at best. And, as for a monetary constitution, it is hard to believe that countries in a state of institutional disarray may succeed where our “free” countries have egregiously failed for so long, despite the determined efforts of monetary economists and public choice theorists. Finally, as I have tried to show, economic theory does not offer a foolproof recipe for monetary stability, one that is definitely going to be accepted by the relevant authorities, sure to be implemented once accepted, and certain to deliver monetary stability if implemented.

Yet, before succumbing to defeatism, it is worth remembering that there are no irreversible historical processes and that there is no reason why ECCs could not succeed where others have failed. In fact, if it is true that they are today in a precarious, if not desperate, economic predicament, it is also true that for them the stakes are higher than they would be for any of our “free” countries. We can endure a moderate amount of instability; in their case monetary instability might frustrate their aspirations of prosperity and their hopes for freedom.

What follows has neither ambition of precision nor claim of originality: most of the reflections that follow are well known, and they are all of questionable validity. But, I feel entitled to take refuge in Harold Adams Innis’ observation: “The answer to those who demand answers is that there are no answers” (quoted by Johnson 1975, p. xii).

15 John G. Greenwood (1990) lists five preconditions (he calls them “fragile foundations”) for a successful economy that should be adopted by ECCs: (1) the rule of law, (2) a relatively incorrupt bureaucracy and independent judiciary, (3) predominantly private ownership of property, (4) free market prices, and (5) a stable monetary system. According to Meltzer (1991, p. 276): “To work efficiently, the market requires institutions and structure. Private property, accounting and legal systems, and a monetary framework must be put in place.” However, he acknowledges that “Economic theory does not provide a blueprint for the transition from socialism to a market economy.” To the above preconditions, Niskanen (1991) adds the “cultural attitudes” that are essential for the proper functioning of a market economy. There is little doubt that all of these are necessary (though it is doubtful that they are sufficient) ingredients for the transition. One moment’s reflection on their extraordinary scope and importance will make one wonder if the chances of success in ECCs are as good as we all hope. Nutter’s (1989) analysis of the differences in the organization of a communist society as contrasted to a free society gives a vivid illustration of the breadth of the transformation.
Some Preconditions: Privatization

As previously mentioned, a monetary constitution's main purpose is that of allowing the price system to work effectively in allocating resources and in facilitating long-term investment decisions. It is a device for reducing uncertainty and favoring the risk-taking choices that are essential to economic progress. However, in order for the price system to work, people must respond to the incentives that are implicit in price changes. This poses no problem on the demand side: buyers are likely to economize on items affected by a price increase, and vice versa. But, as long as production is in the hands of "public" entities, it is far from certain that price signals will produce the necessary reaction on the supply side. In other words, for the price system to work, supply must be decentralized and the economy must be privatized. Extensive privatization of the economy is far more important than stability for the success of the transformation. And, it is doubtful that ECCs would be interested in the stability offered by a stagnating economy. As long as the size of government remains overbearing, there is little hope for prosperity and economic growth.

A Fiscal Constitution

The second fundamental precondition for a successful monetary constitution concerns again the size of government: the level of spending, taxation, and the deficit. It is generally recognized that fiscal and monetary rules are strictly connected (Meltzer 1987, 1991; Jordan 1991). This is fairly obvious: monetary instability is often the result of budget deficits, inflation being instrumental to the financing of government spending. Of the two main causes of instability—mistakes in the conduct of monetary policy and "artless budget deficits," as Machlup used to call them—the second has always been prevalent, and it seems the more relevant for ECCs.

Here again the experience of our "free" countries is not particularly encouraging: despite the declared best intentions of governments, spending, taxation, and borrowing have continued to grow unrestrained in many countries. The explanation of the contrast between the good intentions and the appalling results is simple: the growth of government is not a managerial problem; it cannot be solved by changing the managers. It is a problem of rules: without an effective set of constitutional constraints, political
incentives will always and everywhere result in the uninterrupted
growth of spending and taxation (Martino 1989, 1990). It is absolutely indispensable, therefore, that the monetary constitution be accompanied by a fiscal constitution, limiting government spending and taxation and mandating a balanced budget. On this last issue, I must make clear that I am aware that an annually balanced budget is not necessarily the best prescription from a stabilization point of view. A policy that would balance the budget over the cycle would be superior. However, the experience of several countries suggests that the growth of government spending is facilitated by the possibility of running a deficit. Furthermore, once the limitation of an annually balanced budget is removed, there are powerful incentives that push in the direction of increasing deficits. Such, for example, has been the experience of Italy since 1961 (Martino 1989, 1991).

In some cases, it might be difficult to achieve a balanced budget in a relatively short time. Also, the attempt could be very costly from a political point of view. For example, the consolidated budget deficit of the republics of the new Commonwealth of Independent States (CIS) is estimated to run in excess of 20 percent of GNP (Sachs 1991). It would be nearly impossible to eliminate a deficit of that size overnight. What the fiscal constitution could and should mandate is an obligatory tendency toward a balanced budget: all new or greater expenses should be financed exclusively out of tax revenue or by the reduction of other expenditures (Martino 1982). In any case, debt monetization should be forbidden: the government should be prohibited from borrowing from the central bank.

Federalism and Reverse Revenue Sharing

A budget balanced on an annual basis would be desirable only insofar as it would be implemented at a “low” level of government spending: the Swedish prescription of a nearly balanced budget with spending in excess of 60 percent of GNP is not what I would recommend as a model for ECCs. A mandatory balanced budget combined with a tax limitation provision could be an effective way to achieve a ceiling on government spending (Friedman and Friedman, 1979).

16"There will be no escape from the protectionist-mercantilist regime that now threatens to be characteristic of the post-socialist politics in both Western and Eastern countries so long as we allow the ordinary or natural outcomes of majoritarian democratic processes to operate without adequate constitutional constraints" (Buchanan 1989, p. 8).

17An interesting historical illustration of the political cost of pursuing a determined policy of balancing the budget is offered by Italy from unification in 1871 to 1876, see Martino (1991).

18For an excellent analysis of Sweden’s present predicament, see Stein and Dörfer (1991).
The constitutional solution should also address the problem of the relationship between the various levels of government. Federalism, which is today advocated as the appropriate solution for the peaceful coexistence of different geographic, ethnic, or linguistic groups within the same country, also offers an indication for a constitutional solution to the problem of taxation. What I have in mind is a system of "reverse revenue sharing" as suggested by Dwight Lee (1985). Under such an arrangement, all taxing authority would reside in the local units of government (at the level that best suits the history of the country), and each local unit would be required to give the central government some proportion of the tax revenue it raises, with this proportion being uniform over all local units of government.

The advantages of such an arrangement would be numerous (Lee 1985). First of all, it would establish some kind of fiscal competition among the different local governments, because excessively oppressive local tax systems would drive taxpayers away toward more favorable tax environments. No local unit would therefore abuse its taxing authority, and an automatic constraint on taxation would become effective. Furthermore, if the proportion of tax revenue to be given to the center is, say, 50 percent, for every dollar the local unit spent, it would have to extract two dollars from its citizens in taxes. Obviously, the local units should also be subject to a balanced budget constraint. The combination of a balanced budget at both the central and local level and of the automatic constraint on taxation produced by reverse revenue sharing would result in a powerful disincentive to the growth of total government spending, and one that would need no policing to be enforced.

Apart from the fiscal constitution, the decentralization of government seems to offer the kind of flexible structure needed to accommodate regional diversities within the country. Federalism also allows policy competition and experimentation: the debate on public policy problems can then leave the abstract and dogmatic domain of ideological confrontation and be based on the more pragmatic and potentially fruitful approach of comparing the concrete results of the various policy solutions. Since there is ample room for legitimate disagreement on what the ideal tax structure should be, the experimentation made possible by federalism and fiscal competition could provide the "discovery procedure" needed to arrive at a more meaningful understanding of the problem and of its possible solutions. Federalism could also offer a healthy check on total government power and on its tendency to grow over time: it is no accident that federal structures, like those of Switzerland or the United States, have often been more successful in containing the growth of government
than nonfederal ones. Finally, the ideals of federalism can be betrayed and corrupted, witness present tendencies in the United States or the growth of euro-dirigisme in the EEC. There clearly is the additional task of devising constitutional constraints on the central powers in federal structures to prevent them from evolving into the kind of centralized Leviathan they were supposed to replace. While reverse revenue sharing would represent a first important step in the right direction, more needs to be done. This last problem, while strictly connected with that of a monetary/fiscal constitution, obviously lies outside the scope of this paper.

A False Problem: the Monetary Overhang

One of the monetary problems of the transition that has received considerable attention is that of the so-called monetary overhang, the idea that citizens of ECCs hold more cash than they really want because there is nothing they can spend it on (Walters 1991, Sachs 1991). The existence of this large amount of unspent cash balances in the hands of the public has led to speculation on how to prevent it from creating an inflationary bubble: should the government mop up these balances with a large issue of bonds, use them as the counterpart in the privatization program, or inflate them away? A conceivable solution could have been offered by monetary reform, a change in the monetary unit, the conversion of the excess supply of the old currency into the new currency at a noninflationary rate. In short, the solution to the monetary overhang should have received high priority in the transition to a stable monetary system.

There are good reasons to believe that the problem will disappear with the liberalization of prices: once goods become available, there is no reason to suppose that people will be holding more cash than they really want. If prices are liberalized, the overhang will wither away. Discussion of a monetary constitution for ECCs can proceed as if the overhang never existed.

Should the Existing Currency Be Replaced by a New One?

An important question is whether the introduction of a monetary constitution should be accompanied by the adoption of a new monetary unit. On the one hand, it could be argued that changing the currency would make it evident that the authorities were seriously committed to a policy of monetary stability. On the other, what has been said before about the inertia in the use of money on the part of most people would suggest the opposite conclusion: a change in the monetary unit might add to the general climate of uncertainty and make matters worse. There is no general answer
to this question, and in most cases the problem is already solving itself. Those countries where the transition is well under way without hyperinflation will not need to change the currency. But those countries that do not succeed in avoiding hyperinflation—by the time they decide on a new monetary constitution will need introduce a new currency.19

The Isolated Country Case

As previously mentioned, ECCs are not homogeneous. The monetary constitution, therefore, will be different depending on the country's characteristics. For a country that has avoided hyperinflation in the initial stages of the transition and wants to retain total independence and national monetary sovereignty, the adoption of a fiscal constitution of the kind outlined above plus a monetary growth rule should take care of most of the problems.20

If the country is large enough to afford it, flexible exchange rates should also provide the solution for its international monetary relations (Friedman 1950, 1953). Full convertibility and freedom of foreign exchange markets would also guarantee a modicum of currency competition: if they so choose, people would be allowed to hold foreign exchange (or gold) as a more reliable store of value than nominal assets denominated in the country's currency. Distrust of the stability of the national currency would lead people to take refuge in foreign currencies (and/or gold) and give the authorities a signal of their incipient failure.

19Gordon Tullock (1991) has suggested that ECCs "should start with two currencies—the one which they now have, and which is inflating and which should be managed in such a way that it continues inflating at whatever the rate it has right now, and a new one which would be held stable. All existing contracts would be in terms of the currency in which they were made, i.e. the existing currency, and people would be free to make future contracts in either one. I would assume that this system would lead rather quickly to the extinction of the existing currency and the substitution of the new one. No one should get particularly hurt provided the monetary authorities can guarantee both stability for the new currency and that the old currency will inflate at its historic rate."

20Two crucial aspects of the monetary growth rule that I have not dealt with here are (1) the precise numerical value of the rate of growth of the money supply, and (2) the choice of the monetary aggregate for targeting. The reason for the omission is fairly obvious: the choice of the monetary aggregate depends on the institutional framework of the country in question. A particular aggregate might be suitable in one country, and totally meaningless in another. No monetary theorist I know has ever claimed that there is only one monetary aggregate meaningful for all countries. In general, the monetary base is now the favorite choice of many monetarists, but even that preference is not absolute. As for the rate of growth, its precise numerical value has always been considered by proponents of a monetary growth rule as less important than the fact that it is maintained for a long period of time with little or no variability. A "steady and known rate of increase in the quantity of money is more important than the precise numerical value of the rate of increase" (Friedman 1969, p. 48).
MONETARY CONSTITUTION

If, on the other hand, the country is too small to afford a flexible rate regime, it could peg its currency to that of a larger country. However, historical evidence on this arrangement is contradictory: it seems to have worked well in the case of Hong Kong, but it contributed to the Chilean recession in the early 1980s. The moral of the story is that in some circumstances a small open economy cannot afford complete monetary sovereignty and may be forced to give up the use of its own currency.

The Commonwealth of Independent States

The formation of the CIS offers the former Soviet Union a chance to develop an effective confederation, in which the center would supply a few genuine “public goods” (like common foreign defense and control of nuclear armaments) and the independent states would take on the other legitimate functions of government. Assuming that the initiative is successful, it would provide a framework for a monetary constitution different in one respect from the one outlined above for a single isolated country.

The ongoing debate on whether each republic should be allowed to have its own currency or remain within the ruble area—that is, continue to use the Russian currency—could be solved by having the CIS adopt a “dual-currency system.” The CIS as such would continue to use the ruble, and each republic would be allowed to have its own currency provided it accepted the rules suggested above for a fiscal constitution and constant monetary growth. This arrangement could play an important role in the enforcement of the individual republics’ monetary constitutions.

As previously mentioned, experience suggests that formal acceptance of a monetary growth rule does not automatically guarantee its implementation. This poses the problem of policing the enforcement of the rule. One could think of the introduction of a structure of incentives and disincentives aimed at making sure that monetary authorities do not, intentionally or unintentionally, depart from the target rate of growth of the money supply. The central bankers’ salaries could be tied to their performance in implementing the monetary rule, and they could be fired if they fail.21

However, these arrangements are elaborate and they can always be circumvented by an implicit agreement between political and monetary authorities. When, let us say, it is in the interest of the government to follow a path of monetary expansion in excess of what the rule dictates, it is not difficult to envision a connivance between the government and the central bank aimed at violating the rule. In other words, ideally there should be an automatic mechanism

21 Something along these lines has been done in New Zealand.
guaranteeing the enforcement of the rule. It is here, I believe, that the very valuable idea of competing currencies could be applied to the concept of a monetary constitution.

Under a dual-currency system, the CIS currency would compete with the currencies of the independent states or republics in a fashion similar to that which has been suggested for a parallel European currency (Vaubel 1979). Each republic's currency would be freely convertible into the CIS currency. Whenever inflationary expectations for a single republic's currency would increase, people would convert the national currency into the CIS currency. The CIS would then demand the conversion of its excess holdings of the republic's currency into rubles from the republic's monetary authorities, which would be forced to revert to a less-inflationary policy. A mechanism of competition between currencies would thus be established, and it would act as an automatic mechanism of enforcement of the individual republics' monetary rules. The CIS currency would not only provide an alternative to "national" currencies, it would also act as a check on the inflationary propensities of republican governments. Finally, all national currencies should be freely convertible: foreign exchange markets should be completely private, and anybody should be allowed to buy or sell foreign exchange at market prices. This again would reinforce the filter mechanism outlined above, increasing the range of alternatives to national money holdings and extending the competition among currencies.

Conclusion

The suggestions made above are merely an exercise in intellectual speculation and, as previously mentioned, have neither ambition of precision nor claim of originality. In the field of monetary policy more than in that of theory, we must never forget the idiosyncratic nature of most of our recommendations. Institutional factors are extremely important, and they should be taken into account whenever one engages in the unrewarding game of suggesting policy rules. One thing we know for sure: if ECCs really intend to complete their transition from communist planning to market freedom, they will need a currency that is capable of performing its traditional functions adequately (Hanke and Schuler 1991a). We also know that if we entrust the stability of the currency to the discretionary power of monetary authorities, money could become an autonomous, potent source of instability. Hence, the superiority of rules. Which specific type of rule to adopt is in this respect less important than accepting
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the need for monetary rules. Ultimately, the choice of the constitutional setting can only be made in the light of the peculiarities of the relevant country.

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