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Creating A Money Economy:
Eastern Europe's Crucial Challenge

The following remarks have been excerpted from University of Zurich Professor Willy Linder's "Monetary Aspects of Recent Developments in Eastern Europe," which he presented at Progress Foundation's 3rd International Monetary Conference in Zurich, Switzerland, on June 11, 1990. According to his analysis, a major task confronting the centrally planned economies of Eastern Europe is the creation of a money economy in countries that have been predominantly based on a de facto barter system. To achieve monetary stability, the "remonetization" of such economies demands not only the establishment of freely convertible currencies, but also a fundamental restructuring of socialist monetary, financial, and banking practices. The possibility that any or all of the prerequisites for such a reform can be accomplished without severe disruptions, if they can be accomplished at all, at this time seems remote.*

The centrally planned economies (CPE) of the former socialist countries shared a common trait: they were predominantly based on a *barter, i.e., nonmonetary system.* Production planning — which goods have to be manufactured in which quantities? — was made by means of the so-called *balance-sheet method* that pitted real goods against one another not according to market criteria but according to which production factors are available and which ones are required in order to attain a specific supply target. In the final analysis, every economic system has to cope with optimal procedures to overcome shortages of certain goods. For this very reason, the economic system must be capable of signaling or visualizing such shortages. The *shortage concept* underlying the functionality of the CPEs refers to balances or "balance sheets" indicating the difference between available and required production factors. The system is in a state of *equilibrium* whenever the *balance sheets* do not show any *excess balances, i.e.*, when they are perfectly balanced. If such an economic order is implemented in its "pure form," it practically *would not need any monetary sector.* Monetary values or figures are not intended to exercise any effect or influence on the overall planning of the economy. Money, *i.e.*, means of payment in general, has the sole purpose of rendering possible economic transactions, which in their turn reflect planning priorities; the monetary sector in a CPE thus to a large extent plays a *passive role.*

In the voluminous works of Karl Marx, this basic idea is expressed in several passages in a *close to visionary form.* He wrote: "When there is a socialist mode of production, the monetary capital is eliminated. Society at large distributes labour and means of production on the various business lines. In my opinion, the producers...may receive allocations permitting them to withdraw from the stocks of goods for consumption a certain quantity equal to their work." Or in another passage: "The workers get allocations as evidence of the work they did perform and as entitlement to obtain goods for consumption." These two quotations lead to the conclusion that in a *communist economy* the distribution of goods on the basis of pecuniary income and of prices would not in any way be *justified.* Markets as the institutional embodiment of a specific economic control and steering principle — where the monetary sector is assigned an *active part* — are instead replaced by a system of *overall economic planning.*

In spite of Marx's haziness and imprecision, the basic content of such observations can be interpreted as advocating the introduction of a *rationalization and allotment system* and simultaneously of a *nonmonetary economy* — a procedure certainly in tune with the functional logic of a centrally planned system which might also be defined as an *allotment economy* or *allocation economy.* In such areas, where this principle has not yet been fully implemented, failures and disruptions must therefore occur. As an example, this is indeed the case with distribution of consumer goods by means of "administrative" prices, which necessarily deviate from prices determined by an equilibrated market and which can be readily identified as a major cause of the disequilibrium prevailing in the markets for consumer goods (queues, black markets, the underground economy, etc.). Substitution of these "administrative" prices by *direct allotment* of goods would certainly have corresponded far better to the economic system's inherent logic. The socialist literature specializing in the CPE-theory qualifies such shortcomings, *i.e.*, incompatibilities, as necessary drawbacks during a *transitory period* of coexistence between socialist and "capitalist" elements in the economic framework; these drawbacks have to be tolerated until full implementation of the communist social system is achieved.

Well, this vision has not been realized, as everyone knows (or ought to know). It is clear that the monetary sector has been *very much restricted*, depriving it at the same time — not entirely, but to a large extent — of its economic functions. To be sure, this sector continued to play some part in the economy, although often an unpleasant one for being extraneous to the system itself.

For example, centrally planned economies often established monetary targets formally resembling those of a market economy, but with an entirely different overall economic background and intent. These included:

— *Stable evolution of monetary income* accruing to private households.
— *Stable value of money*, determined by the domestic purchasing power of the monetary unit on the national market as well as of its external value, *i.e.*, stable exchange-rate relations.
— Stable *money circulation.*
— Institutional management of these monetary targets by means of *a banking sector of monopolistic structure.*

* Minor editorial changes have been made for clarity of presentation. The complete text, including references, of Professor Linder's presentation will be included in the *Proceedings* of the conference, forthcoming in AIER's ***Economic Education Bulletin*** series.

Unlike in market economies, however, in socialist societies, monetary stability is a prerequisite not for efficient market operations but for medium- and longer-term planning, a fact realized by Lenin.

Once reforms thoroughly oriented toward a free-market economy or at least market-related economic systems are initiated, a policy which we might term *economic remonetization* becomes a *foremost task*. What problems will arise in this context? The following discussion will not fully clarify the totality of all problems involved, but it may at least elucidate some key aspects.

The Necessity of Currency Reforms

As regards countries with a significant excess money supply (suppressed inflation), monetary reform is unavoidable if the key aim of reforms is a genuinely fresh start toward a reshaped economy. Most countries of Central and Eastern Europe are afflicted by a phenomenon termed *suppressed (or repressed) inflation* in the relevant literature. This is an exclusively *monetary phenomenon* evidencing quite clearly that the unfinished, *i.e.*, hybrid form of the CPE, as it developed under the existing "real" socialism, underwent certain monetary influences in spite of its basically nonmonetary nature. A situation of suppressed inflation is assumed to exist when an excess liquidity develops in the form of money issued by the central bank or by way of bank deposits or money deposited with other paying agents. Goods offered to the market are insufficient to absorb the demand embodied by the excess liquidity. The manifest symptoms of such a situation are queues, black markets, an underground economy and compulsory saving.

Virtually all of the former socialist countries are afflicted by this ailment. The mechanism provoking suppressed inflation is more or less the same one in all of the involved countries: budget deficits are "monetarized" by casting the central bank in the role of "financier." Excess money supply is additionally triggered by *inaccurate planning of the monetary income* earned by private households. The latter should not be allowed to grow faster than the supply of goods (national product). However, in the socialist countries, special systems of incentive premiums have been practised, which caused a disproportionate increase of monetary income when compared to the improved performance which allegedly should have been brought about by them. Formation of savings has therefore increased greatly.

Implementation of a *meaningful price reform* (abolition of subsidized consumer goods and introduction of freely fluctuating prices) is thus made very difficult if not impossible, because after deregulation the single prices would most probably skyrocket wildly, with their thrust derived from distorted markets and a giant excess demand.

If under such conditions prices were to be suddenly deregulated (shock therapy), *serious social unrest* would be a distinct threat, and this would rather mean an adverse influence on the general reform atmosphere. This is why the question looms large: *how to neutralize* the excess money supply? In this respect, three options exist: (1) Absorption of excess liquidity through the *issue of government securities*; (2) to *sell public property to private parties* (reprivatization); and (3) as probably the most realistic variant, a *currency reform, i.e.*, a *currency cut* annihilating a part of the excess demand.

Such a passage even under these relatively favourable circumstances would still prove to be rather painful, amounting to a kind of drastic purge. In addition, currency reform requires from its subjects payment of a high social price. But it is safe to say that this sacrifice cannot be avoided — if the reform is to succeed.

New Monetary and Financial Policies are Required

Remonetization requires the former socialist countries to adopt a modern monetary and financial policy, aiming first of all at stability. However, a fact of considerable significance for problems connected with introducing such reforms consists in the *complete lack of experience* of CPE-functionaries in charge of economic planning with respect to using tools and instruments required for the economic policy of a free-market economy. Therefore, these countries continue to face the danger of lapsing again into *interventionist economic measures*. Moreover, a predominantly technical problem has to be solved, *i.e.*, to find out which *monetary aggregate* (definition of money supply) *corresponds best* to which *national-product aggregate* in order to serve as reference value for the purposes of a stability policy. It can safely be assumed that the rather precarious condition of statistics in the former socialist countries will hardly make clarification of this question a pleasant experience.

The complex pattern comprising currency, monetary and credit policy needs a further complement: *financial policy*. In a system whose assets are predominantly owned by the state and which assigns top priority to planning, the governmental budget and the financial policy act as central *redistribution tools* in order to implement what could be termed *planned redistribution* of resources between regional authorities and bodies, sectors and geographic areas and/or between consumption and investments, between the private and the collective economic segments. This task specification regarding public households or the financial policy is, of course, not justified in a free-market system, as the allocation of production factors — in conjunction with primary income distribution — is arranged by market factors. Above all due to the theories of Keynes, even Western industrial nations admittedly have developed into *income distribution pumps* (transfer households) of considerable size.

An optimal stability policy should use its key tools, *i.e.*, the monetary and the financial policy, so that results complement one another instead of reciprocal contradiction, as often happens. The inherent drawbacks of this procedure consist in monetary policy being the province of an independent central bank, which may shape it autonomously in accordance with legal provisions, whereas the financial policy normally has to be subjected to the whims of parliamentary process. This is why a true-to-theory implementation of these policies is more the result of a lucky coincidence than the result of accurately targeted policy measures. But there is hardly a chance that the former socialist countries will succeed in implementing speedily an optimal monetary and financial policy.

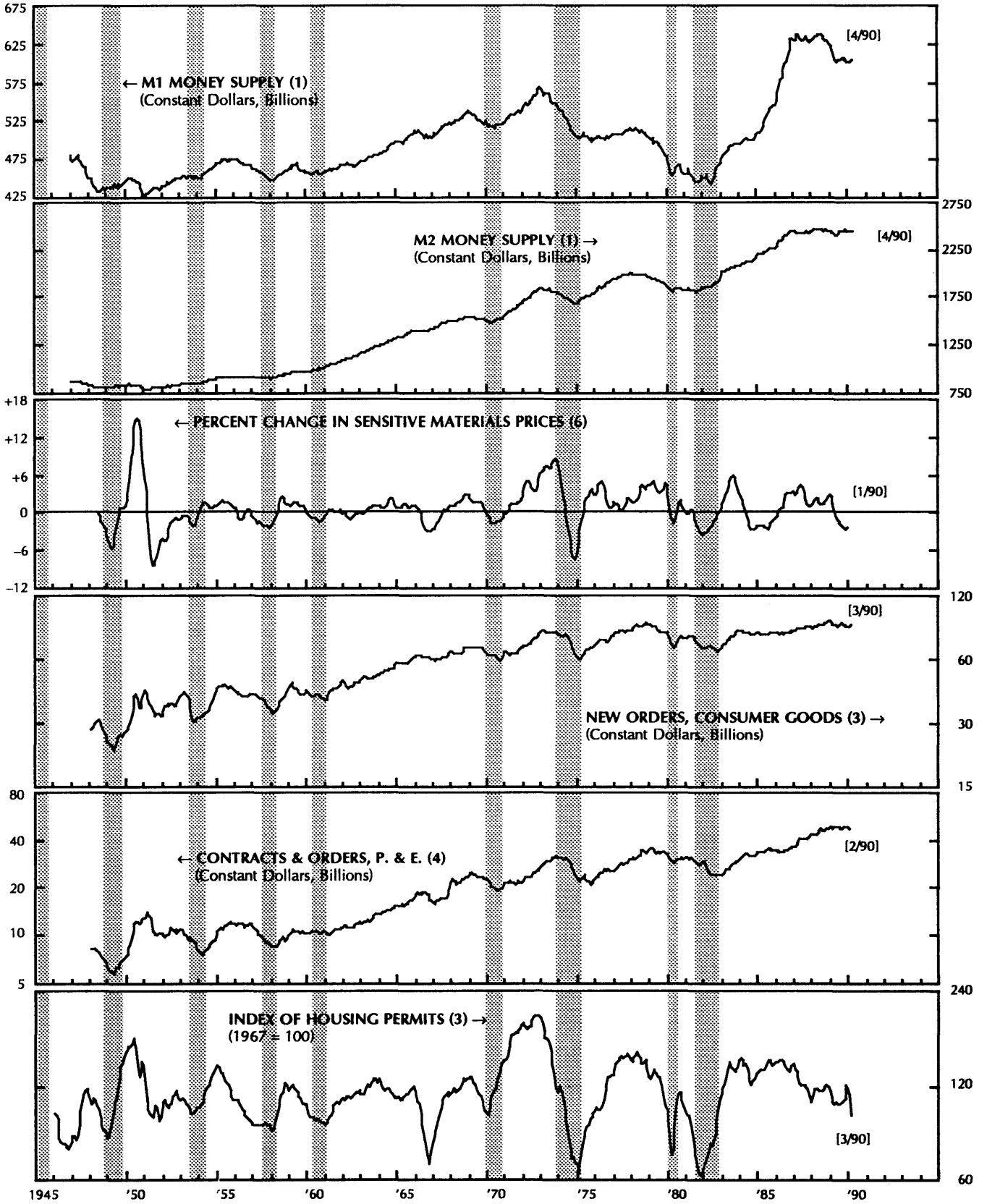
Convertible Currencies?

A freely convertible currency is an absolutely vital component of every well-functioning free-market economy. Only a freely convertible currency offers a chance that economic relations with foreign countries may continuously adjust to the scale of economic-optimality criteria. At the same time, the domestic economy's efficiency is confronted with a permanent challenge, as its performance capability must continuously keep up with the international competition.

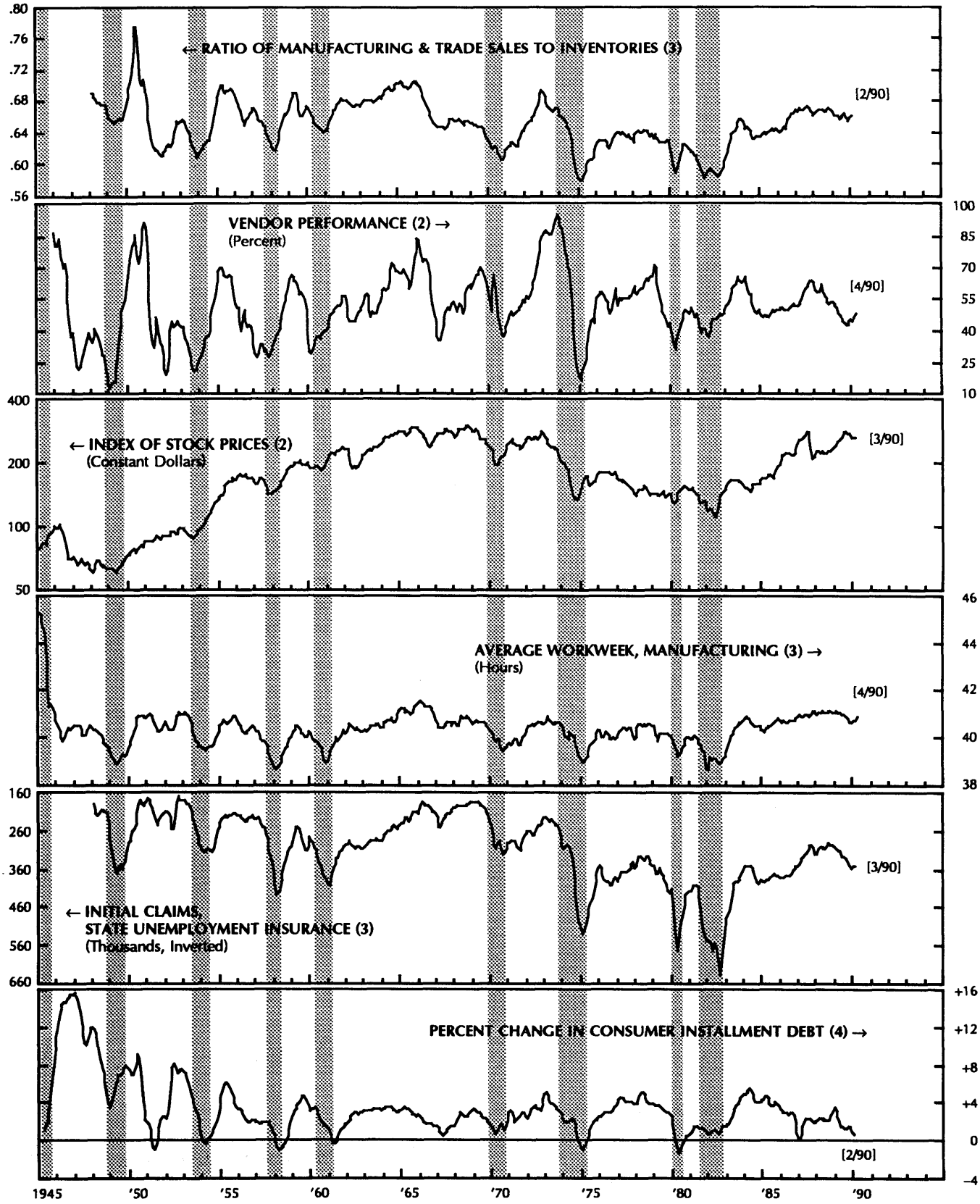
In socialist countries, discussions have been going on for *a long time* as to whether *partly or fully convertible currencies* should some day be introduced. But until the recent movements toward reform, nothing at all happened in this area. There is an obvious reason for this failure to do something: the prerequisites absolutely necessary for the introduction of freely convertible currencies would have implied a complete *abolition of the basic principles underlying a CPE*, requiring that the system actually be changed. For example, exchange rates that make economic sense are governed over the medium and long term by purchasing-power parities and can only develop in countries with a *predominantly free-market pricing system*. Thus, a prerequisite for the introduction of convertibility is a

PRIMARY LEADING INDICATORS

Most of these series are well below their peaks for this business-cycle expansion. Recently, however, some series — including vendor performance, the average workweek in manufacturing, and the sales-to-inventories ratio — have increased.



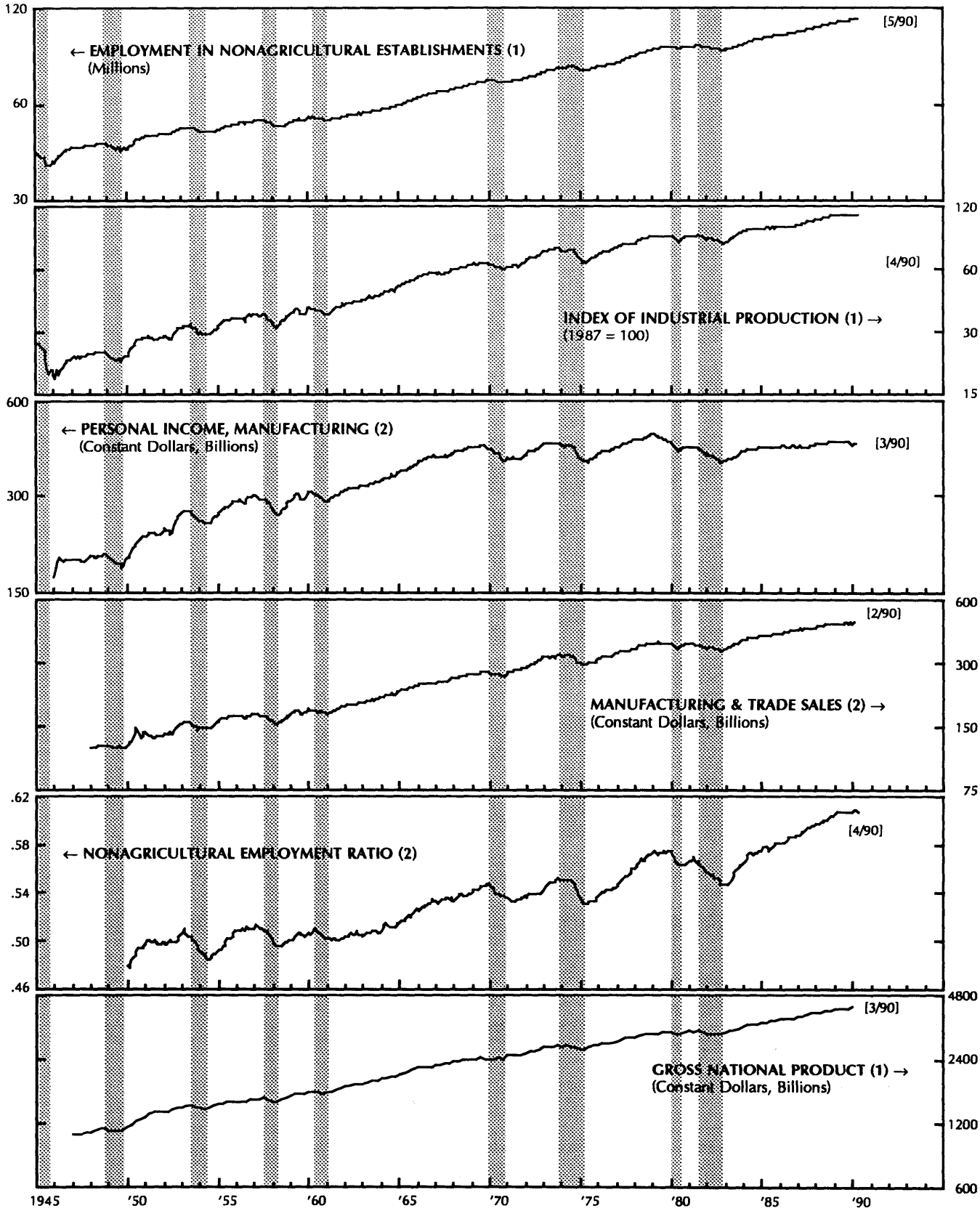
PRIMARY LEADING INDICATORS (Continued)



Note: The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data. The number in brackets is the latest month for which the moving average is plotted.

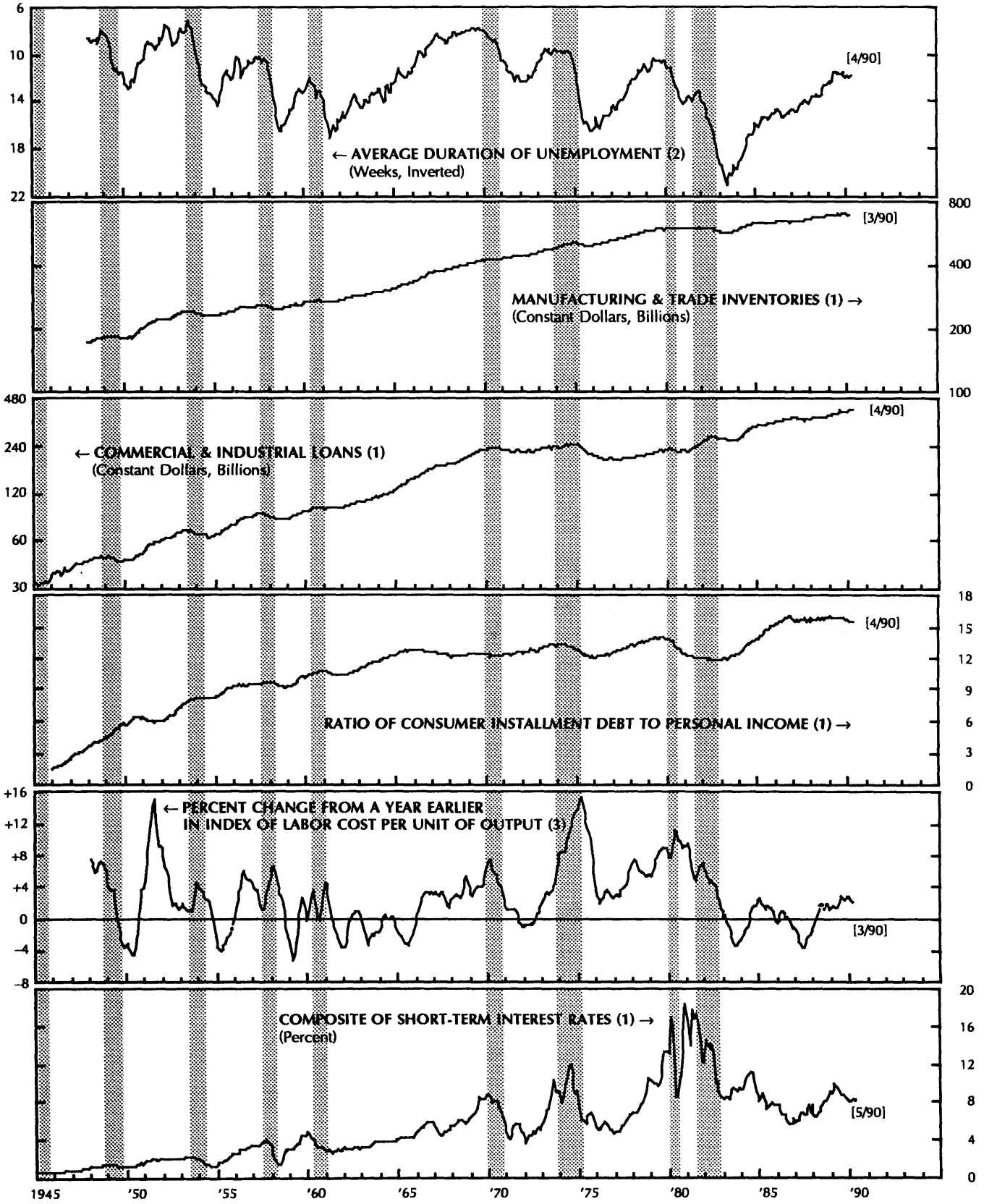
PRIMARY ROUGHLY COINCIDENT INDICATORS

Peaks in these series typically mark the onset of a recession. Currently, most of the coinciders are at or close to their highs for this cycle. During the entire expansion, the rates of growth of most of the coinciders have been somewhat below their long-term trends.



PRIMARY LAGGING INDICATORS

These series usually peak well after a recession begins. Rapid increases in the laggers when the coinciders are "flat," however, can indicate growing imbalances in the economy. In this respect, recent decreases in many of the series are favorable.



change of the pricing system (abandonment of administrative price formation). The passage to free convertibility also presupposes the *abolition* of central planning in the area of foreign trade, replacing it by a decentralized foreign-trade responsibility (authority on company level).

On the institutional level, it will be necessary to set up a *foreign-exchange market*, meaning that the central bank has to set up foreign-exchange reserves. Furthermore, a banking system — largely independent from the central bank (abolition of the monopolistic banking structure) — has to be established. This implies a very thorough *reform of the banking system.*

It is unlikely that the countries on the road to reforms will be able to achieve all these objectives in a short-term perspective. First of all, these nations for many years will continue *to excessively favour importations*, whereas they will only slowly be able to improve their highly *insufficient competitiveness* on the Western markets. Otherwise expressed: they continue to be permanently threatened by balance-of-payment deficits, entailing a permanent *devaluation risk*. And what is more, a well-functioning foreign-exchange market can thrive only in the set of macroeconomic conditions achieved when monetary and financial practices are compatible. To be sure, no miracles can be expected in this area.

Reform the Banking System

A remonetization of the economies of Central and Eastern Europe thus is necessarily linked to a fundamental restructuring of the banking system. An optimal utilization of scarce financial resources is only possible by means of a money and capital market run by a banking system that is institutionally independent of the state.

In a centrally planned economy, the banking system acts merely as a *helpman* in implementing and monitoring governmental plans. For this very reason, it has failed miserably to keep up with the dizzying development of Western money and capital markets. Both its infrastructure and its performance standards are of an alarmingly low quality.

CPE banking reforms *have* focused on setting up a banking structure that is fully independent of the state and on developing training facilities for banking personnel. However, few attempts have been made to restructure banking according to free-market standards and, as of now, an independent banking system still seems a long way off. So far, the reforms have yielded merely organizational changes (new patterning of the division of labour), but have not abolished the monopolistic character of the economic system itself. Under such conditions, *no* genuine money and capital market is likely to develop, *i.e.*, a market capable of transferring funds toward more efficient purposes.

BUSINESS-CYCLE CONDITIONS

The leaders have improved somewhat since last month but they still indicate that slow growth and probably outright recession lie ahead. The absence of a clear trend in many series suggests that conditions are unlikely either to improve or to deteriorate sharply in the near future. At the same time, there is little evidence of the economic imbalances that have preceded past recessions. For the time being, the economic expansion, which is now 91 months old, continues.

Among the primary leading indicators of business activity, the cyclical statuses of ten series now are in doubt to one degree or another. On the favorable side, these include a number of manufacturing series that recently have improved. Higher sales and lower inventories contributed to an increase in the March *ratio of manufacturing and trade sales to inventories*, bringing the series 2 months from its most recent trough. (This and all other dollar-denominated series are adjusted for inflation.) *New orders for consumer goods* and the 3-month *percent change in sensitive materials prices* also increased and also are 2 months from their recent lows. These increases were sufficient to upgrade our appraisals of all three series from clearly contracting to probably contracting. *Vendor performance*, a diffusion index of slower deliveries, increased as well, and is now probably expanding. The recent upticks in these series can be seen in the full set of charts that accompanies this report. Clearly, their duration and magnitude do not offset earlier decreases.

The two labor series also have improved from lows reached a few months back. Revisions to the *average workweek in manufacturing* reveal that this series hit its low in January rather than March, as reported earlier. In May, the base series (from which we calculate a 3-month moving average) jumped above 41 hours for the first time since September. The increase is partly due to automobile manufacturers expanding production, after responding to weak sales last fall and winter by cutting production and laying off workers. Sales are still relatively soft, but automakers reportedly are trying to build up inventories in the event that workers go on strike later this year, when their contracts expire. The 3-month moving average of (inverted) *initial claims for unemployment insurance* also increased, for the second consecutive month. The increases in both series raised doubts about their underlying trends, and they now are appraised as probably, rather than clearly, contracting.

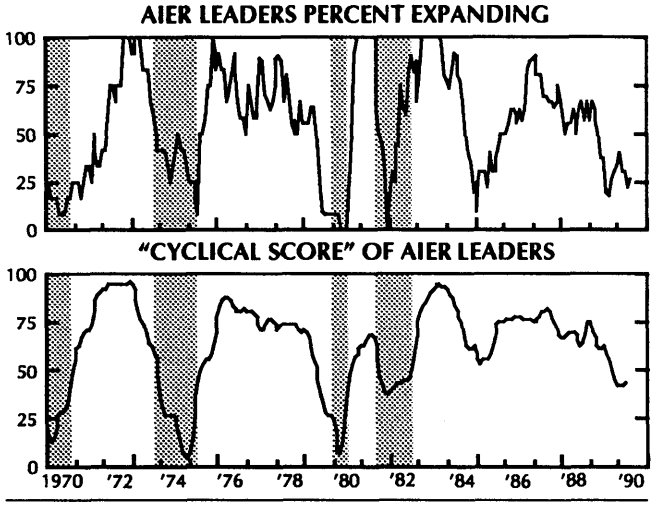
Not all the leaders strengthened this month. *Contracts and orders for plant and equipment* hit a new low (after a hitting a new high last month). The decrease was sufficient to downgrade the series' status to probably expanding. The 3-month *rate of change in consumer installment debt* also decreased,

THE STATISTICAL INDICATORS

	Direction of Change in Base Data				Cyclical Status		
Primary Leading	Feb.	Mar.	Apr.	May	4/90	5/90	6/90
M1 money supply†	+	–	+		–?	–?	?
M2 money supply†	+	–	+		+	+	+?
Chg. in sensitive mat. prices	+	+	+		–	–	–?
New orders, cons. goods†	+	+	–		–	–	–?
Contracts & orders, p. & e.†	–	+	–		+?	+	+?
Housing permits	–	–	–		+?	?	–
Mfg. & trade sales/inv.†	+	+			–	–	–?
Vendor performance	–	+	+	+	?	?	+?
Stock prices†	–	+	–		–?	–?	–?
Average workweek, mfg.	nc	+r	–	+	–?	–	–?
Initial claims, unempl. ins.*	+	+	–		–	–	–?
Chg. in cons. instal. debt	–	–	–		?	?	–
Percent expanding cyclically					**30**	**22**	**27**
Primary Roughly Coincident							
Nonagr. employment	+	+	–r	+	+	+	+
Industrial production	+	+	–		+?	+	+
Personal income, mfg.†	+	+	–		–	–?	–?
Mfg. & trade sales†	+	+			?	?	?
Nonagr. employment ratio	+	+	–	–	+?	+?	+?
Gross National Product†q	+	+			+	+	+
Percent expanding cyclically					**80**	**80**	**80**
Primary Lagging							
Avg. duration of unempl.*	+	–	–	+	?	?	?
Mfg. & trade inventories†	–	–			–?	–	–
Com'l. & industrial loans†	+	+	–		?	+	+
Cons. instal. debt/pers. inc.	–	–	–		–	–	–
Chg. in labor cost/output	–	–	+		+	+?	+?
Short-term interest rates	+	+	+	–	?	?	?
Percent expanding cyclically					**33**	**50**	**50**

† In constant dollars. * Inverted. q Quarterly. nc No change. r Revised.

Under "Direction of Change," plus and minus signs indicate, respectively, increases or decreases in monthly or quarterly data from the previous month or quarter, blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign or indeterminate status when standing alone.



hitting its lowest level in 3 years. Cyclically indeterminate last month, it is now clearly contracting.

The *index of housing permits* plunged to its lowest level since the 1981-82 recession. Just over a year ago, a limited revival in housing construction was helping to keep the economy out of recession (even though activity remained well below the boom levels of the mid-80's). In the past 4 months, however, activity has slowed dramatically. In addition, sales of new single-family homes hit an 8-year low in April. There is an 8.2-month supply of unsold new homes and a 7.5-month supply of existing homes. Unless mortgage rates or home prices decrease further, residential construction will be a drag on the economy for months to come (along with nonresidential construction, which is competing with an excess of existing vacant office buildings).

The Federal Reserve's monetary policy continues to be one of the most important keys to how the economy will perform in the near future. Thus far Fed officials have not eased their restrictive policy, although analysts have predicted for months that they were about to do so to avert a recession. In nominal terms, the *M1 money supply* and the broader *M2 money supply* have decreased since mid-April.* In constant-dollar terms, however, *M1* has increased slightly since January. Previously appraised as probably contracting, its status now is cyclically indeterminate. The almost imperceptible increase in constant-dollar *M2* since February stands in contrast to its accelerated increase in preceding months, and raises doubts about its underlying trend. It now is appraised as probably expanding.

Most of the reappraisals of the leaders this month reflect further weakening in earlier trends rather than clear reversals. Consequently, the net effect on the percentage expanding of leaders for which a trend is apparent is minimal. As a result of the upgrading of the vendor performance series, the percentage increased to 27 (three out of eleven) from 22 (two out of nine) last month. So long as the percentage is below 50 a recession is statistically more probable than not. AIER's experimental "cyclical score," which is based on a separate statistical evaluation of the leaders, also continues to signal recession. The score increased this month, to 43 from a revised 42, but it is only slightly higher than it was 4 months ago (see chart).

Among the roughly coincident indicators, *Gross National Product* increased at an annual rate of only 1.3 percent in the first quarter, according to revised data. The downward revision from the 2.1 percent increase reported last month was chiefly due to a large decrease in business inventories. Again, this decrease reflects producers' quick response to slow sales, and plainly has a "down side" in reduced output, jobs cuts and decreased income. The hope is making such adjustments now will enable business to reduce imbalances enough to avoid larger cutbacks — and recession — later. The 1.3 percent increase in GNP was only slightly higher than the 1.1 percent rate of growth in the fourth quarter of 1989, and much lower than the 3.7 percent rate posted over the same period a year ago.

The slow growth of production is also evident in the weaker pace of job creation. Recent new highs in *nonagricultural employment* are somewhat misleading, since the hiring of temporary Census workers accounts for nearly half the new jobs created since January. Even so, employment increased at a monthly rate of only 70,000 in April and May, compared to 285,000 per month in the first quarter. Without the Census jobs, total employment would have *decreased* recently.

Changes in the other coinciders were insufficient to alter their appraisals. Among the series for which a trend is evident, the percent expanding remains unchanged at 80 (four out of five).

Favorable Changes in the Laggers

Among the primary lagging indicators, there are still few signs of the bottlenecks that have choked off past expansions. *Manufacturing and trade inventories* hit a new low and the series is clearly contracting. The 12-month *change in unit labor costs* continues to moderate after surging during 1989. The series is still close to its peak, however, and remains appraised as probably expanding. The *composite of short-term interest rates* continues to fluctuate with no apparent trend and is cyclically indeterminate. The *ratio of consumer installment debt to personal income* hit a new low and is clearly contracting. Overall, 50 percent of the laggers for which a trend is evident are expanding, the same as last month.

The ratio of the Commerce Department's coincident index to its lagging index is another measure of the production imbalances that typically precede recession. Based on many of the same series followed by AIER, it is widely viewed as a leading indicator. Downturns in the ratio indicate that the rate of increase in key lagging series that affect production costs and consumer demand — interest rates, labor costs, outstanding debt, etc. — is increasing faster than the rate of economic activity (as measured by the coinciders). Eventually, these rapid increases can negatively affect leading indicators (new business investment, new credit, etc.), leading in turn to a general slowdown.

The ratio of coinciders to laggers has sent few false signals. One of these was in 1984-86. Economic activity slowed nearly to the point of recession (GNP actually decreased in 1 quarter of 1986), but just missed being classified as such. Furthermore, the ratio has never failed to signal a recession. It contracted prior to and during each of the seven recessions that have occurred since 1950.

During the past year the ratio of coinciders to laggers has increased slightly. This suggests the economy may yet avoid a full-fledged recession. If this is to happen, however, we would expect to see further improvements in the leaders, and soon.

PRICE OF GOLD

	1989	*1990*	
	Jun. 15	*Jun. 7*	*Jun. 14*
Final fixing in London	$361.50	$352.80	$345.85

* *M1* consists of currency, travelers' checks, bank and thrift demand deposits, and other checkable deposits; *M2* includes M1 plus savings deposits, small time deposits, money market funds and overnight balances.

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