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Monetary Policy in a Centrally Planned Economy
Restructuring Toward a Market-Oriented Socialist System

by Wayne D. Angell

It is a pleasure to be here. I appreciate very much your warm welcome and hospitality. In many respects, the Soviet Union and the United States are entering a new era of partnership. We are both involved in world leadership, we share a quest for better standards of living for our citizens, and we share a desire to promote global harmony and economic wellbeing. We are also geologically very much alike as relatively resource rich countries, although your country is approximately twice as large with correspondingly more resources. So I welcome the opportunity to participate first-hand in discussions about the Soviet economy and learn of your views on its future direction. I also would like to share with you my own thoughts on how monetary policy might be conducted in what I call "market-oriented socialist economy" -- a term that I think captures the spirit of the ideas presently under consideration in the Soviet Union.

These are interesting and exciting times in your country. President Mikhail Gorbachev and the reforms that he has advocated have captured the attention and imagination of the West. In the United States, perestroika and glasnost have become household words. Western economists have become particularly interested in the efforts to restructure the Soviet economy and to increase its interaction with the rest of the world. For Soviet policy makers this restructuring is indeed a daunting task, but one well worth undertaking. Not only can it significantly enhance the material wellbeing of Soviet citizens, it can redound to the benefit and prosperity of the world at large. The U.S.S.R. is a unique and sizable geographic region which can reap substantial benefits from expanding various industries in which it has comparative advantage. This, in turn, can promote global wellbeing through a more efficient allocation of worldwide resources.

I am certainly not an expert on the Soviet economy. Therefore, it might be best if my remarks are understood as pertaining to a hypothetical centrally planned economy in transition toward a market-oriented socialist system. It seems to me that there is more widespread interest in application of the discipline of the market place to realizing the diverse goals of "social" economies. But in the West, the market mechanism is also complemented by appropriate institutional arrangements facilitating the play of market forces. In particular, the role of the monetary system and the framework for the conduct of monetary policy have been crucial.

In my view, regardless of its goals, an economy requires a monetary policy regime that has price stability as its ultimate objective; price stability, in the sense that prices on average are stable while prices of individual goods and services respond freely to reflect relative scarcity. In strictly planned economies, in principle prices are administratively set, so that price movements, relative or general, may not be directly observed. But the phenomena of relative and general price movements manifest themselves in quantity adjustments. Severe shortages of particular commodities and a condition of generalized scarcity are a planned economy's counterpart to relative and general price movements in market economies.

Particular problems with respect to price stability arise in a planned economy restructuring to permit a greater role for market incentives. The bulk of my remarks today will be directed toward achieving that goal in the context of a Soviet economy in which economic agents -- households and enterprises, including farms -- are encouraged to respond to market signals and incentives.

Recent Developments in the Soviet Union

Lively debate continues regarding the various proposals for reform of the Soviet economy and several issues have come to the fore. It is useful to list some that are most significant from my perspective. First is the redirection of production priorities toward socially approved consumer goods. Second is the basic reforms of the price-setting mechanisms, with focus on the increased use of market-like mechanisms and decentralized decision making; that is, an emphasis on profits and other market incentives, self-financing for enterprises, long-term leasing of agricultural land, and greater decentralization of cooperatives. Third is the decision to enter the global arena to reap the benefits of comparative advantage through increased international trade, to utilize world capital markets, and to acquire leading technologies through joint ventures. Fourth is the consideration of ruble auctions and discussions concerning alternative timetables for ruble convertibility.

At the same time, there are concerns about the current macroeconomic environment as a backdrop for microeconomic reform. Particularly worrisome is the existence of a substantial "monetary overhang", reflecting accumulated involuntary savings. Present prospects of an inflationary surge are exacerbated by a significant government budget deficit financed principally by monetary creation. In addition, recent attempts to limit beverage alcohol production seem to have encountered obstacles much like the frustrating efforts to control the flow of illegal drugs in the United States. Both of our countries seem to have found limits as to our ability to make social choices coincide with private wants.

The operative themes in the Soviet economic reform process appear to be modernization, efficiency, and technology. In these respects, it is most useful to look at the experience of the Western market economies. Some of our ways have been highly successful and some have been discarded over time as unworkable. Through it all, we have relied for the most part on a market-based system -- one in which price signals and market incentives direct the allocation of resources. The result is a dynamic, innovative, and constantly evolving economy in which supply and demand for most products self equilibrate.

Furthermore, we have found that the vibrancy and dynamism of the markets lead naturally to greater institutional responsiveness and innovation. Quite often we have to reliberate this process from state bureaucratic tendencies. However, I want to be the first to admit that even in the United States we have sometimes used state intervention rather than relying on market forces. Frankly our experiments in these areas have often engendered waste and fraud. Particularly noteworthy are present inefficiencies in water use that will increasingly call for a change as our scarce water resources approach a crisis stage. Hopefully, the public gains from decontrolling energy prices will encourage the use of market pricing for water resources.

The productive power of a market economy is further enhanced when it is opened to world trade. The additional discipline of world competition promotes further efficiency by preventing the perpetuation of aging, non-competitive industries and domestic monopolies. Without free trade, private gain- seeking may more likely be misdirected away from general economic welfare. In this regard, we in the United States continue to benefit from the competitive vibrancy coming from the prosperity of Japan, West Germany, Taiwan, South Korea, and many others. If the U.S.S.R. fully enters this arena you will both benefit from and contribute to rising wellbeing of the people of the world.

In my experience as a economist, I have had less exposure to economic developments in the Soviet Union than in some other countries such as China, India, and Indonesia. Hence, it is difficult for me to prognosticate with great insight what will be the outcome of the ambitious Soviet reform efforts. However, I would like to address a few issues -- among the many raised by the proposed economic reform -- that I believe are key to the conduct of monetary policy in a market-oriented socialist economy.

The Primary Contribution of Monetary Policy

In a market economy, relative prices provide the information and incentives on which producers and consumers base their decisions. A relative price is defined as the price of one good or service -- be it a factor of production, an intermediate good, or a final product -- relative to that of another. In most economies relative prices are free to change with shifting economic circumstances. This flexibility of relative prices creates prospects for gain, thereby providing incentives for economic agents to respond. As agents act on such incentives, for instance, by supplying more of a certain consumer good, its relative price falls and excess profits are competed away.

But this allocating role of relative prices works efficiently only when agents are not misled by changes in prices that reflect general price pressures rather than fundamental supply and demand conditions. Consequently, it is important to keep the general level of prices steady so that price movements can be interpreted as relative changes. During periods of accelerating inflation, supplying agents may not be motivated to produce more in response to higher prices, as they interpret the higher price as merely a diminution of the purchasing power of money. Such a condition may even lead to socially undesirable behavior as suppliers hoard goods. Similarly, consumers may respond to general higher prices by accelerating their purchases in order to avoid the loss of purchasing power of their money holdings. A rapidly inflating currency mutes the incentive and conservation effects of a market system.

Thus, the primary contribution of monetary policy to increased efficiency is to keep the general price level or the average level of prices stable. I am less optimistic about the benefits of a market system with accelerating inflation. In such an environment, absent monetary restraint, price controls are more likely to be chosen as a policy vehicle. Price controls, of course, prevent allocative efficiency.

While in a market economy changes in relative prices serve as signals for economic adjustment, in a liberalizing socialist economy additional complications arise. The initial structure of prices is more likely to be one which has been determined by social and collective decisions, and hence, is apt to be far removed from the underlying supply and demand conditions. The first step in moving toward market-determined resource allocation then involves a realignment of relative prices to reflect relative scarcities. Such a move may entail rather dramatic price adjustments for many commodities.

How can an economy gain the benefits of flexible relative prices while maintaining general price stability? In market economies, where money serves multiple roles as a unit of account, a medium of exchange, and a store of value, this essentially is the task of monetary policy. General price stability is also essential if money is to perform its multiple functions effectively. But often monetary authorities are tempted to trade off the achievement of the price stability goal against other short-run objectives. In my opinion this is a very unwise course, and would be especially so in any economy for which there is little historical basis for central bank credibility. It could fuel inflationary expectations and result in calls for additional monetary ease. Lack of monetary restraint can lead to accelerating inflation and, therefore, to rising nominal rates of interest. It is a decidedly superior course to exercise monetary restraint yielding, say, 2 percent inflation and a 6 percent nominal rate of interest than to wait until inflation is at 50 percent and nominal interest rates are at 60 or 70 percent to achieve the same constraint on inflation. Raising inflation above expectations stimulates economic growth temporarily because expectations are revised upward, which, in turn, could lead to an upward price spiral. Monetary authorities should never loose site of their main goal -- a zero rate of inflation.

But in planned economies the role of money is more or less confined to that of a unit of account, and central bank functions are primarily focussed on ensuring the legality of various transactions and payments. Money supply provisions are made in line with the production plan, and deviations of actual outcomes from plan result in involuntary accumulation of money balances. Spending opportunities for these balances are limited, thereby preventing money from fully serving its medium of exchange and store of value functions. Clearly, if market-oriented reforms make headway, fundamental changes will be necessary in the Soviet monetary management.

The Need for a Monetary Anchor

In order for monetary policy to hold down the general level of price increases while preserving the flexibility of relative prices, monetary discipline is essential. Some mechanism is required to constrain the expansion of the money supply so that it is consistent with general price stability. I will refer to this as a need for a monetary "anchor". Experience and economic theory suggest several alternatives.

Targeting the rate of growth of one or more monetary aggregates has been a popular choice in the West and has been used with varying degrees of commitment and success in recent years. Much can be said for including money growth rates, at least as an information variable, in monetary policy deliberations. However, it would be necessary to have stable functions, especially for the demand for money, in order to let money growth targets determine monetary policy For a planned economy in transition toward a more market-oriented system, where money does not as yet truly serve as a medium of exchange and a store of value, such targeting would be particularly problematic. If the initial stock of money is inconsistent with a stable price level and there exists a substantial monetary overhang when administered prices are replaced by market prices, then a money growth target would be of little use.

Another alternative that central banks have at times used is to peg the price of gold in terms of their own currency by standing ready to buy or sell gold for a fixed amount of currency. Such a strategy provides strict monetary discipline by requiring the authorities to limit the creation of money to an amount that can be redeemed by drawing down their gold reserves. As long as supply and demand conditions for gold are stable, a gold standard can be expected to produce a reasonable degree of price stability.

Another monetary policy strategy that has been advocated from time to time is that of a commodity standard, that is, pegging the nominal price of a bundle of basic commodities. However, one can imagine a sort of commodity standard in which there was no commitment actually to exchange commodities for money at a set price; rather, the monetary authorities target a certain level of prices for commodities and conduct monetary policy in an effort to hit their target. Such a commodity standard is like a conventional monetary aggregates targeting regime, with commodity prices substituting for the money growth target.

One concern that is often expressed about a commodity standard is that a major change in the price of the bundle of commodities relative to those of other goods and services can create problems of monetary instability and generalized inflation or deflation, if the authorities stick to their target. However, this supposed disadvantage must be weighed against the alternatives, including the damaging runaway inflation that is often observed in the real world.

An advantage of commodity prices over a more general price index as a target is that commodity prices react quickly to changes in the scarcity of money and are immediately observable. I think it is useful to distinguish between commodity standards or commodity price targets and the use of commodity prices as a monetary policy indicator. I have been an advocate -- and a practitioner -- of the use of commodity prices as an indicator of inflationary pressure and of the effective stance of monetary policy in the United States. This approach amounts to taking into account the considerable and timely information conveyed by the "auction markets" on which commodities trade when making decisions regarding monetary growth.[1] It is quite different from a commodity standard or commodity price targeting, and the objective is <u>general</u> price level stability, rather than commodity price stability.

Another potential monetary anchor is a nominal exchange rate or index of nominal exchange rates. If the monetary authorities choose to peg the exchange rate between their currency and some other currency or basket of currencies, they, in effect, are "importing" another country's monetary anchor. Such a policy regime can be called an "external anchor". The resulting inflation rate in the country that imports its monetary anchor is about the same as that in the country exporting the anchor, under certain conditions pertaining to the openness of the economy. Some countries have employed this technique with a degree of success. For example, Austria has pursued for some time now a "hard

1. A detailed presentation of my views is contained in my recent paper presented to the Virginia Association of Economists. Some of the recent research on commodity prices and monetary policy is reported in that paper as well. Two classic references on commodity prices and the nature of "auction markets" are studies by Irving Fisher and Arthur Okun.

schilling" policy in which it pegs its currency (the schilling) to the German mark. Recent experience of France and Germany in the European Monetary System is another example.

Such a monetary policy is not without its potential pitfalls. For one, the "importing" country is at risk should policy in the "exporting" country become unstable and inflationary. In addition, the importing country runs the risk of having an economically unjustified realignment of its real exchange rate vis-a-vis third countries if the exporting country's currency becomes realigned. Furthermore, the uncertainty surrounding a country's long-run commitment to a particular exchange rate peg will be reflected in the interest rate. For instance, Mexico has chosen to let the peso depreciate against the dollar at a rate of 1 peso per day. If this policy is not credible, it may lead to an unnecessarily high interest rate premium.

In light of the uncertainties involved, it is important to have a way of monitoring inflation developments independent of the exchange rate. Very few countries would be willing to fix unalterably their exchange rate to the political winds in another country. But domestic policy flexibility comes at a price, since any explicit acknowledgment of an "escape clause" reduces the credibility of the authorities' commitment to the policy. It is not clear to me that this exchange rate credibility problem is avoidable in any case, since it is difficult to imagine any way of eliminating entirely the authorities' ability to abandon the pegged exchange rate. Some degree of policy discretion would seem to be inherent in the very concept of national sovereignty.

A Monetary Anchor for the Soviet Union

I would like to explore further the potential role for a gold standard in formulating an appropriate monetary policy during a transition period in economic liberalization in the Soviet Union. There would appear to be two unique features of the Soviet situation that might make the gold standard a suitable means of providing monetary discipline. First, the transition from a centrally controlled economy to a market-oriented one would involve a dramatic change in the institutional structure. During this transition, and probably for a considerable time thereafter, there would be a great deal of uncertainty about policy and even about the exact nature of the fundamental economic relationships. A monetary anchor of gold, with its implied discipline and historical association with long-run price stability, might reduce these uncertainties markedly.

During transition, one area of concern to monetary authorities might be the initial strength of demand resulting from any "monetary overhang" and its price level implications. A gold convertible ruble would address these concerns in two ways. First, gold-based rubles and ruble-denominated financial instruments would appear to be desirable savings vehicles, thereby serving to absorb part of the initial monetary overhang and possibly encourage more savings. Second, any one-time upward price pressure resulting from pent-up consumer demand would be less likely to shake market confidence under a gold-ruble standard, as any general upward movement in prices would be perceived as temporary.

The second feature that makes the Soviet situation unique is the country's prominent position in the world gold market in terms of reserves as well as volume of production. This position would seem to impart extra credibility to the ruble-gold convertibility. Moreover, it would be in the country's best interest to seek stability in the world gold market.

Thus, because of the Soviet Union's unique situation, a gold standard could provide credible monetary discipline and ease some of the transition problems I have mentioned. Although, under a gold standard, disruptions in the world gold market could potentially lead to some monetary instability, this would likely be far less than the potential for instability under alternative arrangements.

Under an external peg regime relying on gold as described above the ruble would be immediately convertible, arbitraged by the world dollar gold market. The effective exchange rate would provide relevant price information for the domestic economy. An external anchor and currency convertibility mean that the Soviet monetary authorities would supply only as many rubles as are demanded by the market (foreign and domestic) at the pegged exchange rate. By freely buying and selling gold at the fixed gold-ruble rate, monetary discipline is automatic.

It is important to emphasize that the stage to which economic reform has progressed is crucial to the successful use of an external anchor such as gold to guide monetary policy. Adopting an external anchor requires relative prices that correspond to market conditions; otherwise, goods arbitrage would lead to resource losses as foreigners reap the benefits of domestic subsidies and low prices.

A hard currency and market-determined prices are necessary for making rational economic calculations and decisions. A hard currency confers other benefits as well: monetary discipline and access to world capital markets. In these circumstances, the Soviet authorities might consider the adoption of currency convertibility as soon as possible.

The essential features of a gold standard for the U.S.S.R. imply that the ruble be defined in terms of gold, i.e., that precise unit of account equivalencies be established. These parities would have to be backed by full convertibility, that is, a promise to buy and sell gold at the fixed rate. Full convertibility will require particular care in establishing the initial parity. This implies a transition problem, similar to that faced in adopting an alternative external anchor. If the Soviet Union were to adopt the gold standard or an alternative external anchor it will be necessary to devote careful attention to the criteria for establishing an initial parity.

If the Soviet Union were to adopt a gold standard arrangement, an ancillary feature that would yield benefits to the Soviet Union would be that all U.S.S.R. bonds would be gold bonds, with promise to pay interest and principal in gold. After the gold promise is fully accepted by international capital markets, there would be little to be gained from relying on gold bonds as ruble bonds would be equivalent.

<u>Deficits and Financing</u>

One implication of the gold monetary policy regime that I have described is that government budget deficits would not be financed by money creation. A given budget shortfall would have to be funded by some combination of tax increases, spending cuts, and government borrowing on foreign or domestic financial markets, unless the public's demand for rubles at the pegged gold price or exchange rate increased sufficiently. The Government borrowing option is quite different in an inflationary environment than in a non-inflationary environment.

Another likely implication of the policy regime that I have described, if it were accompanied by liberalized foreign trade and a considerable amount of unsatisfied domestic demand, would be a deficit in the foreign trade balance.

Both the government budget deficit and the country's trade deficit must be financed; how could this be accomplished in a transition period? Fortunately, adoption of a convertible ruble linked credibly to gold and the special circumstances of the Soviet Union could mean, in my opinion, that financing the two deficits would not be difficult.

One would expect that government promises to pay rubles in the future that were fixed in terms of gold would be an attractive savings vehicle (assuming a competitive rate of interest) for the Soviet household and enterprise sectors and even for foreigners. Thus, the anchor for monetary policy that I have sketched here could facilitate the (non-inflationary) financing of the government budget deficit through the issuance of gold bonds. As an added bonus, the probable one-time surge in demand for such bonds following their initial introduction would be an effective way of "sterilizing" some of the accumulated buying power and inflation potential represented by any "monetary overhang". Any remaining "overhang" would be likely to reflect a pent-up demand for traded goods, and probably would result in a trade deficit that would be offset by a capital inflow.

A trade deficit not offset by a service account surplus would reflect capital flows into the Soviet Union. Capital inflows are appropriate for a country undergoing significant economic restructuring. However, capital must be invested productively -- that is, it must be used to finance projects that yield a rate of return well in excess of the cost of capital. The investment must be economically efficient and be able to pass a market test. Inefficient use of foreign capital can lead a country to be impoverished by debt. The objective, however, is productive investment that follows from obtaining funds at the lowest interest rate possible and directing them to projects with the highest rates of return possible. Furthermore, at least in most cases, the foreign capital should be "additional" in the sense that the capital adds to domestic investment and does not just substitute foreign saving for domestic saving at a given level of domestic investment.

How would a restructured centrally planned economy attract capital flows from abroad? Capital can flow into a country in two basic ways: financial investment and direct investment. The latter has the added benefit of being typically accompanied by a transfer of foreign technology and know-how. As I understand the situation at present, steps have been taken toward facilitating direct foreign investment in various joint-venture schemes in the Soviet Union. One impediment to such ventures would be the difficulty of repatriating ruble profits. A convertible ruble, of course, alleviates this impediment and does not put export programs ahead of domestic projects.

Thus, in the regime that I have described, direct investment by residents of other countries probably could be relied on more heavily as a source of external finance. Moreover, as I stated earlier, a ruble convertible at fixed terms into gold would make ruble bonds more attractive to portfolio investors in other countries, thereby increasing the amount of funding to be expected from foreign financial investment also. The better the international standing of the ruble, the lower will be ruble interest rates and the better bargain will be real capital formation. The ruble-gold interest rate should approach a real rate around 2 percent. If so by adopting a gold standard, the Soviet Union will likely attract captial at a most favorable rate.

The special circumstances of the Soviet Union suggest the possible use of an additional enhancement to financial instruments issued by the Soviet Union under a policy regime based on such an anchor: the convertible ruble bonds could be explicitly backed by gold, which the Soviet Union has in ample quantities so that the guarantee would have considerable credibility. I would not be surprised if there were a large latent world market for such gold-backed Soviet "development bonds". Nor would I be surprised if the market rate of interest on such bonds turned out to be quite low.

Concluding Remarks

I have tried in my remarks to be constructively provocative -- not necessarily politically realistic -- in the spirit of *glasnost*! The course of economic liberalization in the Soviet Union is an internal Soviet matter, and, along with its implications for policy management, it must be decided by the Soviet political process.

In my remarks, I have discussed some monetary policy arrangements that I believe could be sensible and responsible methods of conducting monetary policy in a significant transition period. A major theme of my remarks is the necessity of monetary policy discipline. Without monetary discipline, the inevitable result is inflation -- creeping, galloping, or something in between. I have presented some ideas on how the Soviet Union might institute the necessary monetary discipline. While I have made a case for the Soviet Union to adopt a gold standard arrangement as its monetary anchor, other ways might be considered. The essential objective of any alternative selected is to constrain excessive monetary creation -- i.e., monetary discipline.

The Soviet policy process must choose among alternative monetary anchors. But I urge you to make sure that some system for providing monetary discipline is chosen, and that the system decided upon be adequate for the task; otherwise, the full benefits of a restructured economy will not be forthcoming.

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