

Transition, privatization and monetary arrangements in the countries founded on the territory of former Yugoslavia*

Ivan Ribnikar¹, Marko Košak²

Abstract

The aim of our research was to compare the methods of privatization of social ownership and monetary system in the countries of former Yugoslavia with the privatization mode and monetary arrangement that could be considered as optimal. By applying the method of comparative analysis, it has been found out that the way of socially-owned enterprises being privatized and monetary regulations implemented had the crucial impact on the transition in the countries of former Yugoslavia. In fact, the chosen methods of privatization and monetary arrangements applied in these countries have established economies of uncompetitive enterprises. Privatization was either macro-economically harmful for the domestic savings and capital formation and / or unjust for people. In addition, our analyses have proved that the monetary regulation and foreign exchange policy were either not implemented at all or too little to neutralize the negative consequences of selling companies to foreign investors on the foreign exchange rate. The same goes for the combination of monetary policy and foreign exchange rate policy that should have been implemented so as to prevent speculative import and export of short-term capital. For the countries that have not joined the EU yet, it might be helpful to comply with the conclusions of our research and examine their path toward a market economy.

Key words: monetary arrangements, foreign exchange policy, transition, countries on the territory of former Yugoslavia

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¹ Professor Emeritus, Faculty of Economics, University of Ljubljana, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia. Scientific affiliation: monetary economy. Phone: +386 41 795 955. Fax: +386 1 5892 698. E-mail: ivan.ribnikar@ef.uni-lj.si.

² Associate Professor, Faculty of Economics, University of Ljubljana, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia. Scientific affiliation: banking, financial market and financial institutions. Phone: +386 1 5892 400. Fax: +386 1 5892 698. E-mail: marko.kosak@ef.uni-lj.si.

1. Introduction

In the countries that were created on the territory of former Yugoslavia at the beginning of the 1990s the transition meant primarily that previous social ownership of non-financial enterprises had to be abolished and that new monetary arrangements should be introduced. The latter would not have been necessary if these were not newly formed states. By contrast to other countries in which transition commenced in the same period, Yugoslavia did not have a mono-banking or monetary system. Nevertheless, the method of the privatization, i. e. abolishment of the social ownership, together with the chosen monetary arrangement has determined the path of these countries toward market economy. This is why we connect these two issues and in the first two chapters discuss abolishment of social ownership (“privatization”) and monetary systems or arrangements.

In our paper we discuss the problems of generally limited monetary sovereignty in small countries in detail, which is due to the fact that, that in such small countries, there is space for only one of two economic policies we are interested in. One can choose only specific combinations of monetary and exchange rate policy. Our main hypothesis is that monetary policy and exchange rate policy were not used enough to neutralize the negative effects on the exchange rate which originated from the sale of enterprises to foreign investors. In our analysis we rely on relevant literature, historical facts, IMF data and data available from national central banks.

The monetary arrangement chosen, primarily determined by the exchange rate regime, determines the connections of the national economy with the rest of the world. Since this connection is of great significance, we discuss this issue in the fourth chapter. At first we discuss the (monetary) consequences of the sale of enterprises to foreign investors, which has usually been put forward as the model method of establishing private ownership of firms. Then we talk about the so-called sterilization interventions of central banks on the foreign exchange market. These were economically necessary if new ownership of enterprises meant that firms had been sold to foreign investors. In many cases this was economically justified.

In small economies and monetary areas there is even less possibility to talk about monetary sovereignty than in bigger states (Mundell, 2010). If there is a free movement of capital or money cross-border, which sooner or later happened in all of the countries that are dealt with in this paper, and not necessarily because of ideological or foreign-policy reasons, as in the case in the so-called Washington consensus (Berr, 2005), but rather because of the practical impossibility to create an effective control over cross-border flow of money, and there is very little possibility of pursuing an independent monetary or exchange rate policy. There is typically room for only one policy to conduct freely and independently. But when we say there is little possibility, we wish to stress that the countries can choose the specific combination of monetary and exchange rate policy. In this way, countries can

choose a combination of policies that prevents possible negative effects of a full openness. Such negative effects could be in the speculative inflow of money in or out of the country, for instance. We discuss this in the fifth chapter. At the end there are conclusions.

2. Privatization or the abolishment of social ownership of non-financial enterprises

Although in matters of less importance, legal principles were strictly followed, as if Yugoslavia had been a country where the rule of law was obeyed, they were completely disregarded with respect of the most significant issue – ownership of enterprises. And it is surprising, since in Yugoslavia in the case of ownership of enterprises a high degree of consistency and logic was followed – a particular logic, of course. To merely talk about abolishment of social ownership privatization only of non-financial enterprises could be perceived as strange by many. The prevailing opinion was, and still is, that everything was once owned by the state and therefore everything must be privatized. The cause of this was not probably only because of indolence, or the desire for oversimplification, or to resemble other states in Eastern Europe. For instance, that there were other motives behind such opinions are visible from the way the social ownership was abolished, i. e. who benefited the most.

In our case there was no state-ownership of enterprises so there was no need of privatization, which is one of the most widely used words during transition. It was something with which the transition could or should begin. But, for instance, banks had their owners, the so called founders; financial insurance undertakings were mutual, while non-financial enterprises were in social ownership. Thus, banks could not be privatized, except when they came under state ownership because of their rehabilitation. Insurance undertakings could not be privatized, either, but only transformed into stock companies through a well-known process (“demutualisation”). Again, it was not privatization². What inevitably had to be done was to transform non-financial enterprises in social ownership into privately or state-owned enterprises. Only in the case when during the abolishment of social ownership, business enterprises became state-owned, privatization was to be considered. Not immediately but in majority of cases sometimes in the future (Ribnikar, 1998).

If we leave aside non-financial enterprises that turned into state-owned ones, there was a dilemma for most enterprises in social ownership whether to distribute the

² Mutual or cooperative financial institutions, although still present in old market economies, were regarded in our countries as communist heritage. Hence, today there are almost extinct.

shares among citizens in a fair manner (for instance, to each one equal part) or to sell those shares to private investors at the highest possible price. This would be apparently a fair solution as well. Although someone could ask to whom the price should be paid when something socially owned was being sold, no such questions had ever been raised. As it was reiterated many times, everything was at least de facto state-owned so it was logical that all the proceeds from sale should go to the state. But another question that has never been raised is even more significant; and that is how those private investors could afford to buy such valuable properties.

The so-called dilemma about the two ways of abolishing social ownership, both of which were considered to be fair was not a dilemma about two different ways, but rather a dilemma whether to follow a more unfair or more damaging way from the point of view of domestic capital and saving formation. Namely, both ways, come down to the same result (Ribnikar, 1997).

Before we get to the results, however, we should discuss something that no one has taken into account yet. Namely, although in our case there was originally no place for the privatization as there was no state-ownership, nevertheless there had been important cases of privatization (such as in France or England at the beginning of the 1980s) that could be perceived as significant for us as well. This was the experience regarding the way in which the private sectors could buy enterprises that were not sold to them by private owners³. In fact if the sale and/or purchases are between private investors, this is something that is happening almost always and there are no big problems. But if the seller is not the private owner, and it is as well the case of France, England as of Slovenia and other countries of the region abolishing social ownership, then there are the same problems. The problems are how the private sector will be able to buy these enterprises. Our countries were in an even more difficult position, as the volumes of these sales or purchases were much larger.

The experience we have ignored is that private investors cannot buy enterprises which are not sold by other private investors, if the entity acting as the seller does not enable private investors to act as buyers. In the case of France (Durupty, 1988) and Great Britain, it was the state that was selling businesses and at the same time enabling the private sectors to buy enterprises offered to them. This was made possible in such a way that when the state offered shares of enterprises to private investors, at the same time it also bought back its bonds from them. In that way those investors gained the means necessary to buy these enterprises. From a macroeconomic perspective, these transactions resemble a swap contract. As a

³ If the private owners are those who sell, there is only a change in the form of their assets. This is because with the money they receive from their sale they buy some other assets. If it is the state that sells, then the state cannot buy something for that money. In that case state ownership would not be decreased at all.

result the structure of assets held by the private sector changed – instead of government bonds there were now shares of privatized companies. From the perspective of the state, the shares in its ownership decreases and at the same time its debt decreases by the same amount.

In this way those states, non-transition and democratic, have made sure that during privatization there was no space for unfair behaviour (no one became rich because of the fact that the seller was not a private investor) and that there was no space for negative effects on domestic capital or saving formation. So wealthy states were not so rich to allow this to happen.

The poorer transition countries were able to ignore this experience because they were non-democratic. This is the reason why no one raised the question of fairness. Moreover, an example of a widely accepted lie was the supposed truth that privatization could never be fair. As for the negative effects on capital and saving formation, they were disregarded⁴.

All of this could have been avoided⁵, but let us leave it all aside as it has not been relevant for a long time now. In order to find connection with monetary arrangements in the next chapter we have to say a few words about the possible exit from the impasse that privatization is unfair and damaging. It is an exit that was found or that came forward somehow automatically and which can be expressed very simply: business enterprises must be sold to foreigners. This solution was acceptable since foreign consultants wholeheartedly suggested it⁶. In fact this was something that reaffirmed a country's openness. And since the monetary arrangement and the exchange rate regime determine a country's connections with the world – and with its openness, we have in this way already made introduction to our next chapter.

3. The monetary arrangement and the exchange rate regime

Small economies or small monetary areas have limitations and peculiarities irrespective of the fact whether they are transition economies or not, and whether they are newly founded states or not. For these countries the exchange rate and

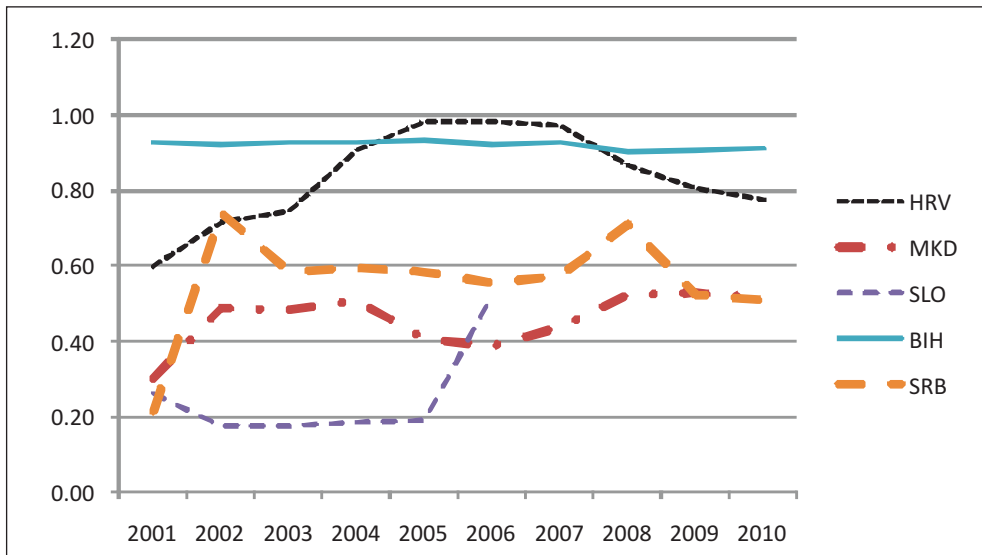
⁴ In many cases they could not think about it at all. Proceeds from privatization were necessary as a mean to survive – to pay wages to employed in public administration and to pay pensions.

⁵ Such is, for instance, the proposal to transfer the ownership of enterprises to pension funds. Why to do this, and how to do it, was the subject of several papers (Ribnikar, 1993; Ribnikar, 1994.).

⁶ No foreign consultant saw a macroeconomic problem if the enterprises are sold to foreigners, although the experience of France and Great Britain that we have mentioned should have been known to them. They also did not deem problematic the fact that in this way these countries will get used to large deficits in the current account.

external liquidity are of vital significance. They cannot implement an exchange rate regime that does not guarantee relative stability of the exchange rate. So the “pure” or “free floating” regimes are not an option for these countries. This is why in these countries the central bank has to hold relatively large amounts of foreign exchange or international monetary reserves.

Graph 1: Base money as a proportion of the foreign currency denominated assets in central banks



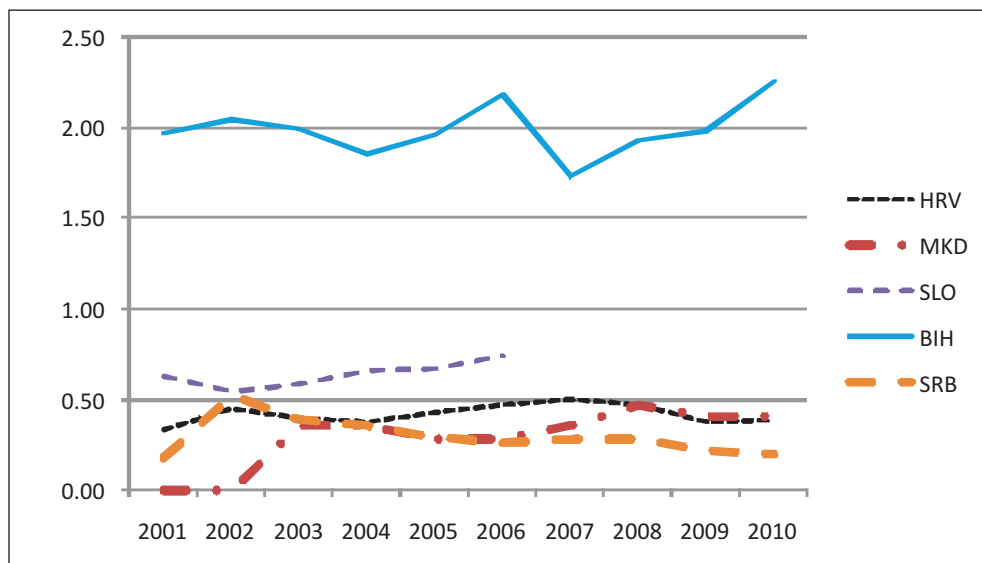
Source: IMF, International Financial Statistics and central banks

The exchange rate regime determines to great extent the monetary arrangement or monetary system. In fact the majority of the monetary aggregate that we call “base money” changes, in small countries, through central bank transactions on the foreign exchange market (graph 1). Not only is there no space to increase the amount of base money through the purchase of government securities in these countries, but also there is almost none available to extend loans to banks although this function is distinctive for the central bank. This is because the central bank often has to buy more foreign currency than the amount of the necessary increase in base money.

In the case of transition economies and newly founded states, the limitations and peculiarities are even more pronounced. The newly introduced money in a newly founded state cannot acquire credibility overnight. There is nothing national euphoria can do in this respect. In addition, the money, which is introduced, is *de facto* temporary – that is until the state adopts the Euro. This is why in these countries the use of parallel currency is inevitably tolerated, at least in the case of

some money functions or of some transactions. And this should not necessarily be regarded as something wrong or that they should try to prohibit it. It would be economically damaging trying to do so. At last, in the period of the “dinar” period not only were bank deposits denominated in German marks and other foreign currencies were allowed (“foreign currency deposits”)⁷, but also the German mark was the unofficial parallel money. It could not have been expected or it cannot be expected that with monetary sovereignty and the introduction of own money (kuna, tolar, denar, etc.) the country will be able to dismiss parallel money. In fact, in the case of such small monetary areas it is the best that the newly introduced money affirms itself in competition with the parallel one. In short, this means that the domestic money should become as good as the Euro, before the Euro’s adoption.

Graph 2: Money in circulation (M1) as a share of the foreign currency denominated assets in the banking sector



Source: IMF, International Financial Statistics and central banks

An additional peculiarity of the monetary arrangements of the newly founded states that we are discussing was that – at the time of their founding, their central banks had no or almost no international monetary reserves. This fact alone has determined with which exchange rate regime and hence, monetary arrangement, these countries will start. Thus, at the beginning an exchange rate regime in which the central bank

⁷ These are deposits in foreign currency not foreign exchange deposits, as had been called and still are being called. In English they have been always correctly denoted as “foreign currency deposits”. But the misnomer “foreign exchange deposits” has prevailed in all countries.

had to sell foreign currency on the foreign exchange market was not an option. But in time, these countries have accumulated and increased their international monetary reserves – through surpluses in the current account of their balance of payments or primarily through foreign borrowing and economic assistance, and so were the possibilities for various monetary arrangements opened.

In this sense already within the Yugoslavia after a certain period, Montenegro begun to gradually introduce the German mark and finally introduced it in November 2000. In the beginning of 2002 the Euro replaced the German mark. Bosnia and Herzegovina, for instance, introduced the currency board in August 1997. The value of the “konvertibilna marka” (MK) was set to 1 German mark, and at the beginning of 2002 it amounted to 0.511292 Euros. Other countries followed the “managed floating” regime, which is the most permissive as to its various varieties. From the de facto fixed exchange rate regime, in the case of Macedonia from 1997/98, to the regime of genuine managed floating that had Slovenia until June 28, 2004 when it joined the ERM 2. In that regime the value of the “tolar” depreciated almost daily against the Euro. As concerns other countries, namely Croatia and Serbia, Croatia opted for the regime very similar to the fixed exchange rate regime and Serbia, a regime where the value of “dinar” nominally depreciates frequently – but not with such frequency as it was in Slovenia. Although all these countries had at the beginning same monetary arrangement, they have decided to follow different monetary arrangements.

Usually countries opt for a currency board when, due to economic, political or other reasons, they cannot come otherwise to the good money and hence cannot achieve monetary and financial stability. This is probably the case with Bosnia and Herzegovina. Montenegro opted for a radical solution – full dollarization (or better said euroization) although they would have been better off if they have opted for a currency board. Both regimes are similar in the sense that in both of them there is no space for independent monetary policy or exchange rate policy, with the difference that in the regime of a currency board the “seigniorage”, which is a monopoly profit from the issuance of money, remains in the hands of the state⁸. Neither of these two regimes guarantees absolute security or credibility to the citizens. They have not been introduced by foreign powers, but rather by the state itself. In addition, in both cases the currency and reserves that the banks hold at the central bank are not exposed to currency risk – in Montenegro this is because the currency is actually the Euro – but this does not apply to bank deposits or bank claims in general, what can be seen from Graph 2. So there is for instance in Bosnia and Herzegovina twice as much of narrow money (M1) as there are foreign exchange reserves the banks and the central bank have.

⁸ The “seigniorage” can amount from 0,5 to 1% of GDP, and in certain circumstances – such as for instance in the case of great monetary expansion, even more.

Following the political, monetary and financial instability in 1996 and 1997, Macedonia succeeded to stabilize. Probably it was because the state decided that it didn't want to incur great costs of stabilization again that the monetary policy has been chosen to act as a guarantee that it will not happen. The central bank has been targeting the stability of the Euro exchange rate on the foreign exchange market. Similarly occurred in Croatia where, after monetary and financial stabilization at the end of 1993 and the beginning of 1994, the Croatian "kuna" was introduced and has completely replaced the Croatian "dinar" by the end of the year. The Euro exchange rate has been used as a target of monetary policy, although not quite so strictly as in Macedonia. We can deduce it at least on the basis of the stability of Euro in both countries.

Slovenia experienced the highest levels of inflation in October 1991 upon the introduction of its own currency, and then the inflation began to lower gradually. In the whole period until June 28, 2004 inflation did not increase so there were no reasons to change monetary and the exchange rate policy. The low nominal depreciation of the "tolar" against the Euro was followed consistently – in a strict accordance with the managed floating regime. In the same period, Serbia experienced very high levels of inflation even hyperinflation, but even after the stabilization the fixed Euro exchange rate (or previously the German mark) wasn't taken as a target of monetary policy. Namely, it is not advisable to opt for such a solution if there is a fair amount of certainty that it won't be possible to be maintained such a regime (Mundell, 2001). We presume that in the case of Serbia, such certainty did not or could not exist.

All considered, there is not one exchange rate regime that can be regarded as superior. There is only an exchange rate regime and a monetary arrangement that in given circumstances may be regarded as the best. Although the regimes we have mentioned in the cases above greatly vary, we cannot say that some of them were completely wrong. Circumstances in different countries varied as well. Nevertheless, we are interested in determining the appropriateness of a specific exchange rate regime and/or monetary arrangement; namely whether it was possible through the regimes to achieve adequate competitiveness of the economy and to prevent negative effects on the exchange rate that resulted from the sale of enterprises to foreign investors. It is generally known that the privatization of companies, especially their sale to foreigners, should improve the performances of privatized businesses. Privatisation cannot be considered as something negative. But we wish to analyse the impact that this process had on the exchange rate and consequently on the competitiveness of domestic businesses.

4. The sale of enterprises to foreigners and the central bank's sterilization intervention on the foreign exchange market

From the aspect of fairness and from the point of economic effects on domestic saving and capital formation, when we wish to abolish social ownership of enterprises, it is irrelevant whether these enterprises are immediately sold to domestic investors or whether their shares are distributed among citizens who sooner or later sell them to domestic investors. Neither of these solutions can be regarded as fair or exempted from negative consequences on capital formation and saving. We can only gain a bit more fairness at the expense of domestic saving and capital formation. Vice versa, we can only gain with respect to national saving and capital formation at the expense of fairness (Ribnikar, 1997).

Such problems are averted if enterprises being sold to foreigners. The great part of companies have been sold to foreigners anyway, although they did not know that by doing so they prevented negative effects on domestic saving and capital formation. Countries were namely selling these enterprises due to fiscal reasons, irrespective of the fact that these funds should not been used for financing current expenditure. But we are going to leave this aside. What we are interested in is the fact that with the sale of enterprises to foreigners another problem emerged. It emerged regardless of the fact whether such transactions were economically justified or not. This problem becomes visible on the foreign exchange market by decrease in the exchange rate and/or on the money market. The quantity of base money increases.

By selling companies to foreigners foreign currency flows to the foreign exchange market and this is why the exchange rate decreases, if the central bank does not do anything about it. The central bank does not do anything about it if there is pure floating exchange rate regime. But this was not the case in any of the countries mentioned above⁹. Central banks typically intervene on the foreign exchange market. A currency board, wrongly named the central bank in the case of Bosnia and Herzegovina, has to buy any amount of euros offered to at an unchanged, i. e. official rate. In this way the money base increases and so does the money supply. In the case of complete euroisation the money supply increases by the amount of money that comes for instance on the accounts of sellers of enterprises. In both cases there is a direct relation between transactions on the foreign exchange market and the money supply. This is actually theoretical model, but in our case it is a reality, which is usually denoted as the monetary approach to the balance of payments (Johnson, 1972 and Johnson, 1977). The connection with the world is complete and direct. But for Bosnia and Herzegovina and for Montenegro this is

⁹ This is how central banks in very large monetary areas function, such as the FED or ECB. They do not intervene on the foreign exchange market. They affect the exchange rate indirectly – through changes in the interest rate.

not entirely true. In the first country we cannot consider its monetary arrangement to be a true “currency board”¹⁰, while the second country is not what we can call as a “true monetary area” (Mundell, 2001). Namely, the money supply in these countries can change regardless of the state of the balance of payments. This is why Graph 1, for instance, states that sterilization should have been impossible if in both countries we had the case of a “true monetary area” – the euro area. But as it is not the case, sterilization is possible but superfluous. Both countries were obliged to finance large current account deficits and so it would be unacceptable that their central banks create and hold foreign reserves created on the basis of sterilization purchases of foreign currency.

In a managed floating regime the central bank can intervene in the foreign exchange market arbitrarily. It also has a large range of intervention, from of leaving of the exchange rate to almost freely fluctuate to preventing any changes in the exchange rate. The latter holds for Macedonia and Croatia, where the central banks have been targeting the unchanged Euro exchange rate. If the stability of the exchange rate is not the central banks’ target but some other thing, the central bank can allow some changes in the exchange rate and at the same time it can intervene on the foreign exchange market. In this case the connection with the world is not direct. The central bank can allow the exchange rate to fluctuate in the range it deems economically justified or appropriate.

But it is not just that the central bank can direct the effects of the foreign money flowing on the foreign exchange market, to changes in the exchange rate or to the changes of the base money if it buys foreign currency. But it can buy foreign currency on the foreign exchange market either in sterilized or in unsterilized way and thus cause or does not cause changes in the base money base or not. If it buys in sterilised way, then there are no changes in the quantity of base or reserve money. In this way the central bank, if there is a managed floating exchange rate regime, acts as a “buffer” in the relations with the world or in this relation it determines independently what will be adjusted – whether the exchange rate or something else. It can be the quantity of base money, but it is not necessarily. If the central bank pursues the policy of a fixed exchange rate in a managed floating exchange rate regime, and this is the case in Macedonia and Croatia, then there are no adjustments through changes in the exchange rate. Something else has to change, and it is not necessarily the quantity of base money base.

¹⁰ Originally the “currency board” issued, meaning that it exchanged for foreign currency (British pounds), only currency and not the other part of base money, it is bank reserves. There was no need for them, as there were no independent banks. For instance, in Mozambique banks were established as branches of London-based banks and so they were not obliged to hold reserves. Nowadays, the “currency board” exchanges foreign currency, Euros, for national currency of which part is transformed in bank reserves. And bank reserves are not “currency”, and therefore the name “currency board” is nowadays not quite appropriate.

And with this we have made an introduction to sterilization interventions, purchases and sales, made by central banks on the foreign exchange market and which are – as we will see – inevitable in a situation where privatization of enterprises is exercised through their sale to foreigners, and if the state wishes to eliminate the negative effects that the increase in the value of the national currency exerts on the competitiveness of companies.

Sterilization interventions have been known since the gold standard, when the central banks wanted to prevent increases of the money supply on the basis of the inflow of gold. Their interventions have compensatory decreased the money supply through their sales of government securities or through decreases of the volume of rediscounts of bills of exchange. Thus, they sterilized the effects that the inflow of gold had on the money supply¹¹. Moreover, we know also for the sterilization interventions of central banks on the foreign exchange market in the period following the World War II, when the fixed exchange rate regimes prevailed. This was an example of sterilization of the effect that the purchases of foreign currency by central banks exerted on the monetary base. But also in a floating exchange rate regime central banks are able to eliminate the undesired monetary effects of their purchases of foreign currencies by doing it in a sterilised way.

But in all the cases we mentioned the intent was to either maintain the exchange rate at an officially determined level – in the case of a fixed exchange rate regime, or to eliminate high exchange rate volatility – in the case of a floating exchange rate regime. All of these central banks' interventions on the foreign exchange market should not have had undesired monetary effects. Although in the case of transition countries that we discuss there are such reasons for sterilization interventions in the foreign exchange market, the main reason for such central bank intervention is another.

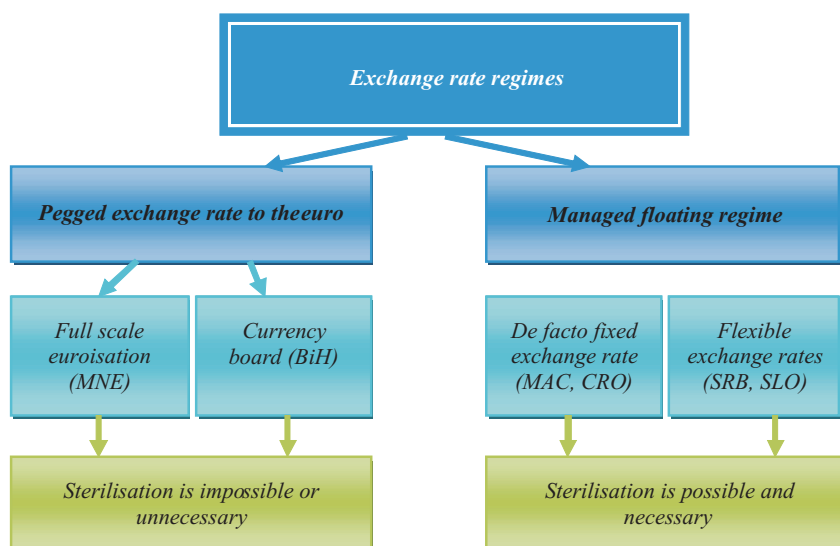
The sale of enterprises to foreigners causes an increase in the supply of foreign currency in the foreign exchange market and pressures on the exchange rate to decrease. As this is a balance of payments item, that can be quantitatively very important for some short period of time, but not something that one can expect to be sustainable in the long run, it is probably not economically justified to let this item determine the level of the exchange rate. The increase in the value of the national currency decreases the competitiveness of domestic businesses; they are forced to leave foreign and domestic markets and thus there is more room for foreign businesses and imported goods. A deteriorated trade balance and the current account deficit are financed abroad – with money entering the country through the sale of enterprises to foreigners. But this cannot go on for a long time. When you

¹¹ This is because money stability – in the sense of its purchasing power, was of utmost importance. Everything was subject to this goal.

sell everything that was possible to sell, then you cannot still face the same deficit in the current account of the balance of payments. As in the meantime many previous enterprises disappeared as uncompetitive, the adjustment to the quite new surrounding must be prolonged and painful.

To avoid this happening, it is economically justified for the central bank to sterilize the amount of foreign currency that flows on the foreign currency market through the sale of enterprises, and in that way to prevent the appreciation of the domestic currency. This is a situation similar to one observed in countries which face large inflows of foreign currency due to oil exports, for instance, and which do not allow that inflow of foreign money to determine the level of the exchange rate. These foreign funds will namely sooner or later disappear. An excellent example of this is Norway and its “oil fund” where money coming from oil export is channelled and invested into shares and bonds of various companies around the world. In this way the oil export does not make damage to other industries; and beside the state has very large foreign currency reserves left aside for the time when the oil sources will be extinguished¹².

Picture 1: Exchange rate regimes and sterilisation



Source: Authors

¹² The Norwegian “oil fund” is just an example of numerous so called “sovereign wealth funds”, managed by countries that have large surpluses on the current account of their balance of payments. In this way these countries impede the appreciation of their own currency; they do not spend much – actually they live below their means, and actually they create reserves for times of duress.

Whether a country follows a fixed exchange rate policy in a managed floating exchange rate regime, or it follows a floating exchange rate regime, in both cases the central bank may through sterilization interventions on the foreign exchange market prevent that extraordinary events such as the inflow of foreign currencies from sales of enterprises to foreigners would push the exchange rate down and/or lead to the monetary expansion (Picture 1). But this is not true if the domestic currency is tightly pegged to the Euro, such as in systems with full euroisation (MNE) and currency board (BiH). If these systems really abide by their definition, then sterilization is not possible. However, in Montenegro and Bosnia and Herzegovina this is not the quite true, as we have already argued. These countries are not part of a “true monetary union”. This is why their monetary authorities may use sterilized purchases of foreign money, but such purchases have been neither necessary nor used. Namely, in these countries the deficit in the current account of the balance of payments is not created through capital imports, because of sale of enterprises for instance, rather capital is imported because of the deficit in the current account of the balance of payments.

Sterilization comes with a price. The cost to the central bank and at the same time to the state, equals the difference between the yield, which could be accrued from some other assets and the yield that the central bank gains for the increased international monetary reserves. Does sterilization increase interest rates or not, it is still unclear, and the answer depends in the first place on which interest rates one has in mind¹³.

Irrespective of the costs mentioned, international monetary reserves that are being increased via sterilization are often under attack. Politicians and their advisers often argue that these reserves should be spent for some useful purposes. If this happens the effects of central bank's sterilization intervention on the foreign exchange market would be annihilated. If countries adhered to this principle and did not allow the inflow of capital resulting from the sale of enterprises to foreigners to affect the exchange rate, less domestic businesses were liquidated. The deficit of the current account of the balance of payments (Graph 3) mirrors the competitiveness of a country's economy, it means that the business enterprises are not competitive.

But foreign currency enters a country not only through the sale of enterprises, but also through foreign borrowing. Should these funds be sterilized through the intervention of central banks? If this would be the case, then countries would never make net imports and exports of capital, and this is something unusual. Foreign net

¹³ There are many studies on the topic of sterilization (Frankel, 1994; Obstfeld, 1982; Rogoff, 1984) and opinions differ, especially regarding the fact how long can the central bank continue with such interventions. As for the interest rate, it would probably decrease if net imports of capital would be allowed, but it would also remain unchanged if this would not happen. And this is precisely the aim of sterilization.

borrowing or lending is something that one finds always. Besides, in contrast to the sale of enterprises that cannot go on for long and must sooner or later stop, borrowing is different. It can go on for a long time, and in addition it can create problems not only to the country, which borrows, but also to the lenders. Namely, it is the lenders who face credit risk and this is why borrowing and debt have their limits, although the Greece financial crisis and the crisis in several other countries show that those limits can often be crossed. Not only because of irresponsible borrowers, but also because of irresponsible lenders. The problem of Greece, Ireland and others, does not lie in their high public debt as can usually be heard, but in their overall foreign debt, which resulted from large and long-lasting deficits in the current account of the balance of payments¹⁴.

Graph 3: Current account balance expressed as percentage of BDP



Note: The data for Serbia is shown on the right side axis

Source: IMF, International Financial Statistics

If we go back to sterilization, we can say that central banks can use sterilization purchases and sales of foreign currency as part of their foreign exchange policy, when they do not want to cause any monetary changes with their interventions on the foreign exchange market. In addition, they should purchase and thus sterilize

¹⁴ The financial crisis in the Eurozone resulted from the fact that many countries lived well beyond their means, which is clearly mirrored in the deficits of their current accounts. This is also true for the countries we are discussing in this paper (Ribnikar and Bole, 2006). Graph 3 sketches these problems. Irrespective of this it is budgetary deficits that face major criticism today. This is probably because budget deficits can be fixed more easily; it is at least prevailing opinion, than to restructure the economy and make business enterprises competitive.

the money that flows into the country from the sale of existing enterprises to foreigners. But this should not be done in the case of the money that flows into the country on the basis of foreign borrowing. However, a problem remains; if the cross-border movement of capital and money is completely free the problem of short-term speculative capital may emerge. We discuss this in the next chapter.

5. How to combine monetary and exchange rate policy

We have argued that it is economically justified, or even necessary, for the central bank to prevent negative effects that the inflow of foreign currency (due to the sale of enterprises to foreigners) may have on the exchange rate. If the central bank wouldn't sterilize but rather buy this huge amount of foreign money in a straight way, control over the money supply would be gone. If it wouldn't buy this money at all, then the domestic currency would appreciate. In addition we have in mind that such central bank interventions are not necessary in the case of foreign borrowing. Further, we must know that central bank's interventions on the foreign exchange market are not instruments of monetary policy¹⁵, although in smaller countries this is the way in which the central bank issues or withdraws the majority of its money. Besides, we are not interested in the instruments of monetary policy and we simply take for granted that the central banks can control money supply by using their instruments of monetary policy.

As interest rates in transition economies are generally very high, and not only because of the lack of savings or funds, but rather because of the lack of confidence in the domestic currency and banks, there may be some investors that find attractive to invest in short-term bank deposits or other short-term financial instruments. Such is the case with speculative or "hot" money, which lowers the exchange rate upon its entry and raises the exchange rate upon its exit from the country, unless the central bank manages to neutralize these effects. The amounts of such money can be very high and therefore it may happen that the central bank cannot buy all of this money through sterilization purchases. Although the decrease in the exchange rate upon the entry of speculative capital in the country could turn to be harmful to speculative investors themselves, and the same can be said for the rise in the exchange rate upon its exit¹⁶; namely such exchange rate volatility would seriously harm the economy. And it would be volatile, if the central banks do not intervene.

¹⁵ We have to make a difference between how the quantity of the central bank money changes or how the central bank money is created, although there is no creativity to these process, and instruments of monetary policy. So for instance in the countries we talk about in this paper the major part of central bank money is not "created" through instruments of monetary policy. This is nothing extraordinary, besides that the so called structural position of the money market is running a large surplus.

¹⁶ It is precisely because of this that developed countries and international monetary institutions, such as the IMF, have suggested to these countries to somehow fix their exchange rates.

In order to prevent this to happen and thus to exempt the central bank of costs associated with additional sterilization and the economy of the costs, which equal the additional earnings of foreign investors, the central bank must combine its monetary (level of interest rate) and foreign exchange policy (the expected rate of the exchange rate changes) in such a way that there are no interests of foreign investors to invest in short term bank deposits or other short-term financial instruments. The central bank can achieve this if it constantly monitors and keeps the so called uncovered interest rate parity (UIRP) (Ribnikar, 2003). As in transition countries the currency and sovereign risks were, and still are, much higher than in countries of the Euro area, it is not a matter of uncovered interest rate parity but rather of the uncovered interest rate imparity that is important. The difference or imparity should be equal to the sum premium for currency and country risk.

If, for instance, the annual interest rate in the Euro area amounts to “ $x\%$ ” and the expected nominal appreciation of the Euro in a transition country amounts to “ $y\%$ ”, the annual interest rate in that transition country has to amount not only to “ $x\% + y\%$ ” but it also has to take into account the annual premium for currency and country risk. The interest rate in foreign countries, in countries of the Euro area, is set. But the risk premium change, and usually lowers gradually, but usually not that much in the short-run. The central bank has to determine such a level of interest rate through monetary policy, that it will equal the sum of the interest rate in the euro area and the expected annual appreciation of the Euro. The latter is determined by exchange rate policy. But this is not enough. There has to be an adequate uncovered interest rate imparity and not parity. Adequate means that the sum of these interest rate or their percentages has to be higher than the interest rate in the Euro area for the amount of the premiums on currency and country risk.

From these arguments stem a number of important facts. When cross border movements of capital are free, and this is something that all world countries have agreed upon, countries cannot conduct a completely independent monetary policy, and separately, an exchange rate policy. Here the type of exchange rate regime does not matter. But if countries did not “tie their hands” additionally through a fixed exchange rate regime or policy, they will at least have the opportunity to choose certain – but not deliberate or any – combinations of monetary and exchange rate policy.

In this way there is a certain “trade-off”. Monetary policy can be changed toward more restrictiveness (the interest rate increases) if simultaneously as concerns the exchange rate the policy increases the level of the nominal appreciation of the Euro. If monetary policy changes toward more expansiveness (the interest rate decreases) the exchange rate policy has to lower the level of the nominal appreciation of the Euro. Only in this way an adequate uncovered interest rate imparity against the Euro area will be maintained. In this sense the absolute level of the exchange rate is not important – what matters is its change in time; namely, the annual rate of

appreciation (or depreciation). And it is, of course, the expected changes and not realized changes.

As regards the international movement of capital, an abrupt and/or unexpected change in exchange rates, or a relatively high depreciation of the national currency for instance, will not *ceteris paribus* affect capital flows – for instance short-term capital. But it will affect foreign trade. Besides, it will increase currency risk and country risk, which are both significant for domestic and foreign investors. For the purpose of our argument we leave aside the fact that an unexpected and high depreciation of the national currency is practically impossible. In all countries the level of euroization is very high, and the majority of bank deposits and loans is protected by a currency clause; in this way countries and their central banks are actually prisoners of this euroization. This is because when it comes to exchange rate policy their hands are tied. What is still available is the possibility of a gradual nominal depreciation of the national currency, which has to be coordinated with the monetary policy.

All things considered then, in the case of transition countries the managed floating regime can be considered as better. A fixed exchange rate regime or managed floating regime with a fixed exchange rate policy precludes devaluation or the necessary depreciation of the national currency. And these options are necessary to all countries if they want to have equilibrium exchange rate. When due to different reasons a fixed exchange rate is inevitable, then everything else in the economy has to adjust to the fact that the domestic currency is *de facto* Euro. And if this is not an option, because it cannot be achieved, the performance of the economy will be permanently below its potential due to overvalued domestic currency.

6. Conclusions

Research results based on the theoretical literature, historical facts, IMF data and the data of the central banks of the former Yugoslavia, confirmed the initial research hypothesis that monetary policy and exchange rate policies were not sufficiently applied in order to neutralize the negative effects on exchange rates, which were the result of the sale of enterprises to foreign investors. In all the countries discussed in this paper, a number of important issues for the introduction of a new economic system were being dealt with in a non-transparent way. However, it is not a mere problem of opacity, but rather what was being hidden. We primarily refer to the curious emergence of unusually wealthy individuals, owners of the companies. Who is the owner and the quality of the owner are of major significance for the efficiency of the economy. These owners have not demonstrated true ownership skills, but this is beyond the point we would like to make. Rather our intentions were to analyse the problems encountered by these countries at the beginning of

transition and how they should have been solving those problems, irrespective of the marvellous creation of new company owners, who were generally privatization-predators, speculators, or nouveau riche.

The first obstacles were encountered already with the abolishment of the social ownership of businesses. This should have been done only in the case of non-financial enterprises. But privatization came as a priority, as if everything until then had been state-owned. Actually we know that this was not the case. In the process of the transformation of ownership there was an apparent dilemma whether to distribute the shares of companies in a fair way among citizens or whether to sell those companies at a market price, which was also seemingly fair. In both cases the outcome is the same. Namely, both are unfair and/or damaging solutions from the macroeconomic aspect – damaging in the sense that through these solutions domestic savings and formation of capital decreased. This did not happen when enterprises were sold to foreign investors – as new owners. This solution was also very popular, in addition to the already mentioned miraculous emergence of domestic wealthy owners.

But with the sale of enterprises to foreign investors the significance of the appropriateness of the chosen monetary arrangement increases, as this arrangement should allow (although not all countries have used this opportunity) to the central bank to neutralize the negative effects that large foreign currency inflows could exert on the exchange rate. Through sterilization purchases of the foreign currency the central bank prevents the real appreciation of the domestic one. In this sense currency board, full euroization or the fixed exchange rate policy are not appropriate monetary arrangements. Besides its advantages (monetary stability) a fixed exchange rate has its own drawbacks – namely, it leads to the appreciation of the domestic currency. However, this policy was necessary in certain countries, and in this sense we must say that it was not wrong.

With full liberalization of cross-border movements of capital and money there is interconnection between monetary policy (the level of interest rate) and the exchange rate policy that has to be acknowledged. It has to be acknowledged if we wish to prevent speculative inflows and/or outflows of short-term capital. Sterilization prevents unjustified and damaging appreciations of the domestic currency, and the maintenance of an adequate uncovered interest rates parity with respect to the Euro prevents damages that the speculative movement of capital can cause.

Thus leaving aside all those things that were done in a non-transparent manner, if we adhere to this trendy term, we can conclude that neither the way in which social ownership was abolished nor monetary arrangements together with exchange rate regimes in the countries we have analysed were appropriate. They were not as they should have been. All of these countries got used to living beyond their means

(Graph 3), but wages and living standards are nevertheless still rather low. This is probably due to other elements as well, not only those that were done in a non-transparent way. In fact, despite the similarities, there are distinct differences among the states, and it is essential that the specificities of individual countries regarding exchange rate regimes and monetary arrangements are the subject of future research.

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Tranzicija, pretvorbe i monetarna uređenja u novonastalim državama na području nekadašnje Jugoslavije

Ivan Ribnikar¹, Marko Košak²

Sažetak

Cilj našeg istraživanja je usporediti način pretvorbe društvenog vlasništva i monetarno uređenje u zemljama nekadašnje Jugoslavije s načinom pretvorbe i monetarnim uređenjem koji bi bili optimalni. Metodom komparativne analize utvrđeno je da su način ukidanja društvenoga vlasništva poduzeća i monetarno uređenje odlučujuće određivali tranziciju u tim zemljama. Rezultati istraživanja pokazali su da zbog načina privatizacije i monetarnih uređenja, koja su se de facto primjenjivala, nastala su gospodarstava s nekonkurentnim poduzećima. Pretvorba je bila makroekonomski za domaću štednju i formiranje kapitala, štetna i/ili za ljude nepravedna. Također, ustanovljeno je da se monetarno uređenje i politika deviznog tečaja uopće nisu koristili, ili su se koristili premalo za neutralizaciju negativnih posljedica prodaje poduzeća strancima. Slično vrijedi i za kombinaciju između monetarne politike i politike deviznog tečaja, da bi se sprječavao špekulativni uvoz i izvoz kratkoročnog kapitala. Za države, koje još nisu ušle u EU, vjerojatno bi bilo korisno da u skladu sa zaključcima naše rasprave preispitaju dosadašnji put prema tržišnoj ekonomiji.

Ključne riječi: monetarno uređenje, politika deviznog tečaja, tranzicija, države na području nekadašnje Jugoslavije

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¹ Profesor Emeritus, Sveučilište u Ljubljani, Ekonomski fakultet, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenija. Znanstveni interes: monetarna ekonomija. Tel.: +386 41 795 955. Fax: +386 1 5892 698. E-mail: ivan.ribnikar@ef.uni-lj.si.

² Izvanredni profesor, Sveučilište u Ljubljani, Ekonomski fakultet, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenija. Znanstveni interes: bankarstvo, financijska tržišta i insitucije. Tel.: +386 1 5892 400. Fax: +386 1 5892 698. E-mail: marko.kosak@ef.uni-lj.si.

