Partial Adjustment without Tears: A Tale for the Tolar*

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Abstract. The design of monetary system in Slovenia was influenced by the heritage of persistent shortages of foreign exchange. This and other considerations prompted a decision that a new currency – Tolar was to float on two separate foreign exchange markets: a market for current account transactions, and a market for capital account transactions. Actual developments differed considerably from forecasts; an abundance prevailed, and the Tolar remained remarkably strong. The aim of the paper is to present, estimate and test a simple model describing the behaviour of the Tolar in the first period of high uncertainty; and to assess its relevance for the real world. Exchange-rate movements are analyzed as if they were adjusting to the expected price level. The results imply that the dealers do not wait for new data on prices to be disclosed; they, however, try and anticipate the likely effects of inflation on the exchange rate. It is shown that interventions by the Central Bank did not affect the SIT/DM exchange rate appreciably. The answer to the question whether other Eastern European countries could have benefitted from “the short-run story of the tolar”, is inconclusive, if not negative.

Key words: Exchange rate, expectations, open market operations

JEL Codes: E58, F31

I. Introduction

The creation of the Slovene monetary system dates to October 1991; at the time it was the only East-European example of full domestic convertibility on current-account transactions. It would thus seem appropriate to closely examine and digest the first lessons to be learnt from that experiment in its initial, highly uncertain period.

As early as mid 1990, the threatening political and economic collapse of former Yugoslavia forced the Slovene authorities to look for a new institutional setting for the republic, so as to insulate the economy from the shocks characterizing the rest of the Federation, and to accelerate the transition towards a free-market system. The political development which followed concentrated these efforts on a search for suitable institutions for the newly born country.
The institutional steps which have led to the introduction of the Slovene Tolar (SIT) have already been described and discussed elsewhere (Mencinger, 1993). In short, existing dinar balances in the Republic were exchanged at a 1:1 ratio to keep the process as simple as possible, and the nominal exchange rate was allowed to float freely, starting from a rather arbitrary 32 SIT for the DM. The rejection of a fixed exchange-rate regime was justified on four grounds. First, the Central Bank of Slovenia could not command the amount of reserves necessary to defend a fixed rate against possible attacks. Second, information about the structural features – both real and monetary – of the newly-born economy were lacking to allow any kind of attempt at fixing the rate or at guessing the equilibrium rate. Thirdly, a choice in favour of a fixed exchange rate would have required an initially very weak tolar in real terms, so as to cope with the existing high inflation rate, which could not be expected to be reduced to OECD levels in a matter of weeks. But the initially very weak tolar would itself stimulate inflation: for in a small, open country a rise in the price of tradeables has important consequences on the general price level and may even lead to the dollarization (in Deutsche Mark) of the economy, thereby making a fixed-exchange-rate regime unsustainable. Finally, there was the awareness that the transition and the disappearance of what used to be a domestic Yugoslav market necessarily imply continuous changes in the equilibrium real exchange rate, which can hardly be accommodated by a fixed rate when domestic prices are sticky downwards.

At the same time, foreign-exchange transactions on the current account were kept separate from those on the capital account. In addition, forward exchange market transactions were prohibited, to minimize random exchange-rate fluctuation and to deter possible speculative attacks on the tolar.

It is known that during its first year the tolar has been remarkably strong; actually much stronger than forecast. The nominal exchange rate on current-account transaction rose sharply twice; just after the birth of the SIT (from 32 up to 42 SIT per DM) and in January 1992 (to slightly above 50 SIT per DM), but it then declined very slowly. As a consequence, given the constant rise in the price level – at a decreasing rate – the real exchange rate initially increased (i.e. weakened), but then was already significantly stronger by the first half of 1992.

This behaviour seems contrary to common sense and gloomy predictions. Indeed, it is widely accepted in the literature that in the absence of stabilization funds, a high-inflation economy undergoing a transition process is bound to face sizable and continuous increases in its nominal exchange rate, thereby nullifying the efforts to stabilize, and/or requiring the introduction of foreign-exchange restrictions. In fact, none of this happened in the case of Slovenia, where the Central Bank was even forced to sell tolars, to forestall an appreciation in nominal terms. Finally, in August 1992, the Bank of Slovenia deliberately let the tolar depreciate by increasing the demand for foreign exchange, accumulating reserves and trying to sterilize, or at least postpone, the ensuing monetary effects by means of open-market operations.