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Exchange Control in Italy and Bulgaria in the Interwar Period: History and Perspectives¹

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Summary:

This paper analyses exchange control in Italy and Bulgaria during the interwar period. Starting with the chronology of events, the study provides a detailed account of the institutional and economic framework in which these measures were enforced and interprets them by exploring various sources of information and data. Moreover, it suggests a theoretical interpretation of exchange control measures stressing that these policies were a serious interference in market mechanisms. A further point is that exchange control in both countries was an eloquent example of how serious the balance of payments constraint was at that time and how difficult it was to circumvent it. Subject to discussion, the paper derives some lessons for today's economies.

Key words: exchange control, clearing trade, international monetary relations.

JEL Classification: N24

Il mio sentimento d'amicizia per la Bulgaria è costante, sincero, disinteressato. Questo sentimento è condiviso della totalità del popolo italiano. Credo fermamente nell'avvenire politico, economico e morale della Bulgaria. Essa ha il suo compito nei Balcani.

(Benito Mussolini, in Scipcovensky, M., (1927, p.1)

1. Introduction

On the 6th September 1937, the BNB governor Dobri Bozhilov sent a confidential message to the Minister of Finance informing him that two Italians, Costantino and Camillo Vacaro, had violated the Foreign Exchange Act in 1933 and had done so with the knowledge and assistance of the Italian ambassador in Sofia. Camillo Vacaro had brought certain amounts of Bulgarian currency to the Embassy, for which the Ambassador had given him cheques denominated in foreign currencies; those cheques had then been sent to Italy by the legation itself. The BNB governor asked the Minister of Finance to refer this delicate affair to the Council of Ministers before he brought a prosecution under the Foreign Exchange Act (BNB, 2004, p. 564). The background of this historical detail

¹ We are grateful to Roumen Dobrinsky (UNECE) for providing us with League of Nations' reports and Rumen Avramov (Centre for Liberal Strategies-Sofia, Martin Ivanov (Bulgarian Academy of Science, Institute of History), Luca Einaudi (Cabinet of the Italian Prime Minister), Peter Bernholz (University of Basle), and Atanas Leonidoff (Bulgarian Academy of Science, Institute of Economics) for helpful comments and suggestions.

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connecting Italy and Bulgaria² was formed by a lengthy period of restrictions on trade and foreign currency exchange between the wars, in which Bulgaria and Italy were active protagonists practicing exchange control.

The history of interwar exchange control in Europe provides us with interesting insights into the current development of the European Monetary Union and into the prospects for its enlargement, in which the exchange rate and monetary policy play central roles. As in the past, albeit in a different historical context and in different forms, Europe today could be divided into groups of countries at different stages of economic development: centre, semi-periphery and periphery. Therefore, we find it challenging to compare the evolution of exchange control in two countries which, though characterized by different economic conditions (Italy was representative of the semi-periphery and Bulgaria of the peripheral and then underdeveloped Balkans), did not belong to the financial and industrial core of Europe.

The introduction of exchange control typified the general collapse and fragmentation of the international monetary system, after the First World War put an end to almost 40 years of considerable economic and financial stability³. The world economy suddenly split into blocs of countries with different economic and monetary behaviours. Two major attitudes towards economic policy confronted each other. The first was held by those who thought

that a return to the old semi-automatic regulatory mechanisms was possible and indeed necessary, viewing the Gold Standard as an integral part of these mechanisms. The second view was held by those who believed that a new era of economic relationships had come, which required new rules (for active government interference). This was a time when the world economy was going through an extremely unstable transition that ended with the Second World War. It led to the creation of the IMF and the World Bank as new supranational regulators of the world monetary system.

As predicted by several economists at the time, exchange control turned out to be an extremely distorting and discriminating form of interference in monetary relations. According to Lionel Robbins, "Tariffs, exchange restrictions, quotas, import prohibitions, barter trade agreements, central trade-clearing arrangements – all the fusty relics of medieval trade regulation, discredited through five hundred years of theory and hard experience, were dragged out of the lumber-rooms and hailed as the products of the latest enlightenment" (Robbins, 1935, p. 114). From a global perspective, while the different blocs managed to preserve their relative shares in world export and the members of each bloc tried (and to some extent succeeded) to balance their foreign trade within the group, the emergence of isolated blocs resulted in a contraction in the amount of world trade.

Table 1. Percentage share of certain groups of countries in gold value of world exports, excluding the United States

Groups of contries	1929	1931	1935	1937
European exchange control countries	23.48	27.19	21.68	22.53
Gold bloc	14.53	15.86	13.41	12.01
Other countries	61.99	56.95	64.91	65.39

Source: League of Nations, (1938). *A Report on Exchange Control*, p.30.

² In fact, the affair was rather a typical case of avoiding exchange restrictions. According to Charles Kindleberger the ways to circumvent exchange control are to bribe a central bank employee, to export money with the help of diplomatic offices, or to smuggle (Kindleberger, 1990 [1984], p. 531).

³ See Fromkin (2004) for a general discussion on the outbreak of the First World War.

Michael Heilperin gives a working definition of exchange control: "Exchange control," he writes, "consists in the centralization of all dealings in foreign exchange in the hands of a public authority (treasury, central bank, or an institution created *ad hoc*)" (Heilperin, 1939, p. 238). Howard Ellis (1940, 1947) provides an extensive discussion of the instruments and forms of exchange control. He stresses the fact that exchange control "is not generally taken to include the following: tariffs, quotas, prohibitions and embargoes, subsidies, state trading and commercial agreements and treaties. It impinges upon these at points but does not include them" (Ellis, 1947, p. 877). According to Ellis, the main instruments of exchange control are: government monopoly in foreign exchange dealings, government disposition over private holdings of foreign exchange and assets, enforcement of an overvalued or undervalued rate of exchange, multiple exchange rates, government licence to export and import, government disposition over the proceeds of exports, government allocation of exchange to imports, officially conducted bilateral clearing and officially conducted barter (Ellis, 1947, p. 877).

Various combinations of these instruments were used to achieve a mix of exchange control either with regard to international economic matters (maintaining appreciated or depreciated exchange rates, attaining equilibrium in the balance of payments, allowing trade to go on without available foreign exchange, securing more favourable terms of trade, controlling or enforcing capital movement, and economic welfare) or to domestic economic priorities (controlling inflation and deflation, increasing domestic employment, fostering industrialisation and other protectionist measures, preparing for war, providing revenue for the state, and discriminating for or against certain people or classes within the domestic economy). According to Ellis' classification, the most common and widely implemented exchange

control instrument in Europe in the 1930s was the enforcement of overvalued rates of exchange as a device to avoid devaluation which would have ensued because of the withdrawal or flight of capital from debtor countries (Ellis, 1947, p. 878-879). Given the European experience of high inflation (hyperinflation in some countries) after the First World War, the original motive for exchange control was to defend a particular exchange rate as a counter inflationary measure. Since this policy did not contribute to improve the balance of payments, other interference included active export encouragement and import restrictions.

Given the complexity of this topic, we will start drawing up a parallel chronology of events in Italy and Bulgaria supported by statistical data. The purpose of this paper is to analyze the logics behind governments' decisions to introduce and maintain exchange control, the different techniques adopted and the economic consequences of these decisions (Ellis, 1947). From a theoretical standpoint, we will study exchange control in the context of economic and monetary isolation (autarchy). To describe the motivation behind policy decisions, we are going to introduce appropriate elements of institutional and political economy. We will also take into account the macro influences of exchange control on the real economy.

In the first two sections of the paper we will describe the history of exchange control in Italy and Bulgaria in the interwar period, illustrating it with data. In the third section, we will suggest some theoretical reflections and interpretations of exchange control. In the conclusion, we will try to derive some lessons from the exchange control in the 1930s and draw parallels with today.

2. Italy: from stabilisation to systematic exchange control

Measures aimed at regulating exchange rates were introduced in Italy back in 1917

during World War I. After 1921, however, most of the restrictions were lifted and it was only in the years 1934-35 that systematic exchange control was introduced as a consequence of long due deficits in the balance of payments, in a context characterized by the so-called "quota novanta", which refers to the stabilization level chosen in December 1927, when the Gold Exchange Standard was officially re-established and which the government decided to defend at all costs. It soon became a tool to promote reflationary monetary policies and to divert scarce resources towards sectors which appeared to be strategic in view of the war.

Let us briefly recapitulate the events⁴. During the First World War Italy had to face large current account deficits (from 1915 to 1918 imports nearly tripled whilst export stagnated), which stemmed from huge capital disruptions caused by the conflict. As a consequence, the nominal exchange rate of the lira rapidly depreciated. This declining trend was reinforced by speculative attacks following a major defeat by the Italian army in Caporetto in November 1917. In December, the government responded to the attack by setting up a new authority, the "Istituto Nazionale per i Cambi con l'Estero" (INCE, National Institute for Foreign Exchange) and by empowering it to impose a temporary monopoly over the foreign exchange market. The INCE was meant to offset speculation and to ensure that foreign currencies were primarily used to import raw materials and equipment needed by the military sectors (Raitano, 1995, pp. 276-9; Ufficio Italiano Cambi, 1996).

The post-war period in Italy was characterized by severe monetary and financial instability; the nominal exchange rate further depreciated between 1919 and 1921 as a consequence of current account deficits and speculative capital movements⁵. In June 1921, however, the government decided to lift all restrictions in the foreign exchange market. The INCE was kept in existence but its role was restricted to a limited set of operations.

At the end of 1922, Mussolini was appointed prime minister in a situation characterized by political and social turmoil. Before long the new government proceeded to restrict political freedom but adopted, at least initially, a *laissez-faire* approach to economic policy and adhered to financial orthodoxy. The Minister of Finance, Alberto De' Stefani, severely trimmed public expenditure in order to reduce the budget deficit. The monetary policy, however, was too accommodating and, as a result, inflation soared, reaching 15% in the third quarter of 1925 (Fратиanni and Spinelli, 1997, p. 136). The balance of trade also worsened: nominal exchange rate in terms of dollars fell to 27.5. In February 1925, therefore, De' Stefani had to reintroduce some limitations on transactions in the foreign exchange market and entrusted the INCE with the task of gathering information on the amount of foreign credits and debts held by financial institutions and professional brokers (Raitano, 1995, pp. 296-7). In the second half of 1925 further measures aimed at curbing speculative capital movements were introduced by the new Minister of Finance,

⁴ For a reconstruction of economic and institutional events in interwar Italy see Ciocca and Toniolo, 1976; Toniolo, 1980; Zalmagni, 1993. For an overview of exchange control in Italy cf. De Cecco, 1996.

⁵ Between 1913 and 1921 the value of the lira in terms of the dollar decreased from 5.27 (Lit/\$) to 23.46; in terms of the pound from 25.71 to 90.17. For most of this period, however, the nominal depreciation of the lira was insufficient to offset the loss in competitiveness caused by the differentials in inflation between Italy and its trading partners (in particular, United States and Great Britain). As a consequence, between 1915 and 1918 and between 1920 and 1922 the real effective exchange rate of the lira actually increased (from 101.2 to 130, base year 1900, and from 74 to 96.6, base year 1929, respectively; cf. Ciocca and Ulizzi, 1990). In 1919 and in the first half of 1920, on the contrary, nominal depreciation was so fast that the real exchange rate actually decreased signalling an increase of the competitiveness of Italy (see Cotula and Spaventa, 2003, p. 216).

Giuseppe Volpi, as a preliminary step for the stabilization of the lira (Guarneri, 1988, p. 210; De Cecco, 2003, p. 45). In November, Volpi was able to reach a settlement of the war debts with the United States and UK. This move removed the legal obstacles to international loans, and was accordingly followed by large inflows of foreign capital.

In the short run, however, following the collapse of the French franc, the lira was targeted by speculative attacks: throughout 1926, the lira's nominal exchange rate plummeted to 153 relative to the pound and to 31.5 relative to the dollar, raising widespread concern among small savers in Italy and financial circles abroad. In a highly publicized speech delivered in Pesaro, in August 1926, Mussolini committed his government to an outright "defence of the lira". This statement was followed by a centralization of issuing (the Bank of Italy was to become officially the only bank of issue in the country) and by severe credit restrictions. Nominal wages and some retail prices were also cut by 20% by virtue of a decree. This determined a change of expectations and, in the following months, the nominal exchange rate between the lira and the pound rapidly decreased to 88-90. On 21 December 1927, the government officially pegged the lira to gold thereby adhering, similarly to most other European countries, to a Gold Exchange Standard system⁶. The "gold content" of the currency was fixed at 7.918 grams per 100 lira; this implied a nominal exchange rate at 90 lire per pound and at 19 lire per dollar (Baffi, 1973, pp. 101-22; Marconi, 1982, pp. 50-71).

The reasons underlying Mussolini's decision to resort to a sharp revaluation of the lira and the impact this measure had on the Italian economy have been debated by

contemporary analysts and have also been explored at length by economic historians and historians of economic thought (Barucci, 1981; Bini, 1981; Cohen, 1972; Falco and Storaci, 1977; Marconi, 1982). It would appear that political considerations were probably dominant. The middle class which was the most important constituency of the regime was severely hit by post-war inflation and was strongly in favour of any measure aimed at increasing the internal as well as the external value of the currency. Sheer prestige also played an important role: the exchange rate adopted in 1927 was roughly the same as that which had prevailed in 1922, when Mussolini rose to power, enabling him to declare that, unlike previous governments, his regime had been successful in defending the currency. The industrialists, especially those operating in the export sectors, were of course against "quota 90": indeed, they actively lobbied to stabilize the currency at a higher nominal rate (120 lire per pound). They were however partially compensated by cuts in wages and taxes and by the introduction of import duties.

As predictable, in spite of all the efforts made by the government to cut wages and prices, the Italian economy had to face a remarkable reduction of its competitiveness: between 1926 and 1927 the real effective exchange rate of the lira increased from 95.5 to 105.9 (Ciocca and Ulizzi, 1990, p. 367). As a consequence, exports dropped from 18170 million lira in 1925 to 15519 in 1927; during the same year, however, imports showed an even sharper decrease (from 26200 to 20375 million). As a result there was a short-term reduction of the trade deficit (from 8030 to 4856 million)⁷. Hence the situation did not appear to be particularly worrying, considering

⁶ R. Decreto Legge 21/12/1927 n. 2325 "Per la cessazione del corso forzoso e convertibilità in oro dei biglietti della Banca d'Italia".

⁷ Cf. Istat, 1958, p. 152. This situation proved to be only temporary; in 1928, following a bad wheat harvest, trade deficit increased to 7456 millions of lira.

that from the very beginning of the industrial take-off at the end of the nineteenth century, Italy faced a structural imbalance of its net exports, which were compensated by other components of its current account, especially remittances from emigrants and tourism (Falco, 1995)⁸. During the 1920s, remittances from emigrants actually decreased, but were offset by capital inflows resulting from loans contracted in the US financial market by Italian firms and municipalities. This implied an increase in Italy's foreign debt to a level which was considered excessive by the governor of the Bank of Italy, Bonaldo Stringher. Therefore, already in 1927 new measures were introduced whereby the government's authorization was a precondition to take out new loans abroad (Storaci, 1989, pp. 298-9).

Circumstances had already changed by 1928-29: attracted by stock market speculation and by a remarkable increase in interest rates as a result of a restrictive policy inaugurated by the Federal Reserve, US investors were more and more reluctant to subscribe to new loans abroad and indeed withdrew part of the funds previously invested in Europe. Some Italian investors, on the contrary, found it profitable to buy back the bonds in dollars issued by Italian authorities. Furthermore, one has to consider the flow of sums paid by the Italian government to US and UK Treasury as a consequence of the arrangements concerning the loans obtained during the war (Hirschman, (1939), p. 166). Therefore, capital account turned negative, whilst at the same time trade deficit worsened, following a further reduction in exports and a slight increase in imports⁹. As a result, between December 1927 and December 1929 the reserves of the Bank of

Italy decreased from 12105,9 million lira (in gold and convertible currencies) to 10795,4. In spite of this, in March 1930 Antonio Mosconi, who succeeded Volpi as minister of Finance, was bold enough to officially abolish every form of control in the exchange rate market (Guarneri, 1988, pp. 262-3).

The onset of the Great Depression, together with the protectionist measures adopted by several countries, brought the international trade to a collapse; besides that, Italian competitiveness was severely undermined by the devaluation of the pound in 1931 and by that of the dollar in 1933: the real effective exchange rate of the lira went up from 101.2 in 1930 to 112.4 in 1934 (figure 1). It came as no surprise that in 1933, the nominal value of export was roughly one third of that in 1927. Imports also contracted as a consequence of the recession and, as a matter of fact, the trade deficit was lower, in nominal terms, in 1931-33 than in the Twenties. Taking into consideration the net transfers, the current account was actually in surplus (Banca d'Italia, 1938, p. 114). However, the drain of the reserves of the Bank of Italy further continued in these years following adverse capital movements (see Table 2). Yet again, this was mainly due to the purchases of Italian bonds issued abroad: the market price of these securities had decreased remarkably and it became even more profitable for Italian investors to buy securities characterized by a very low risk of default that guaranteed a high yield in dollars.¹⁰

Even in this unfavourable situation the Italian government showed strong resolve to defend the stabilization level decided in 1927. At the end of the London Conference in 1933, the new Italian Minister

⁸ It is important to note that revaluation had serious consequences on the financial stability of firms: their debts increased in real terms and the value of their stocks decreased. As a result, their financial strength was compromised well before the onset of the Great Depression.

⁹ Net export deficit amounted to 7476 millions in 1928 and to 6536 in 1929 (Cf. Istat, 1958).

¹⁰ A positive side-effect of these adverse capital movements was that Italy's external debt substantially decreased (Banca d'Italia, 1938, p. 114).

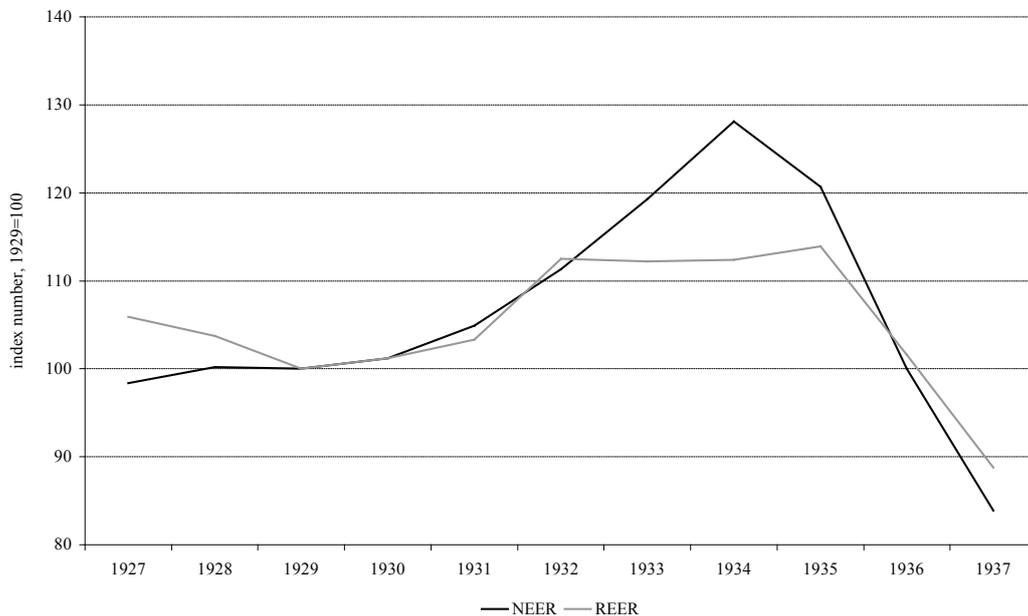


Fig. 1. Effective exchange rates of the Italian lira

Note: The rising of the index means appreciation, the fall means depreciation.

Source: P. Ciocca, and A. Ulizzi (1990) *Tassi di cambio nominali e reali dell'Italia dall'Unità nazionale al Sistema monetario europeo (1861-1979)*. In: *Ricerche per la storia della Banca d'Italia*, vol. I, Laterza, Bari, pp. 341-68.

of Finance Guido Jung adhered to the Gold bloc by subscribing, together with the representatives of France, Switzerland, Belgium, the Netherlands and Poland, to a pledge to defend the gold standard at the existing parities. Italy, declared Guido Jung on that occasion, had "stabilized its currency to gold since December 1927 and [was] firm in defending the fixed exchange rate established at that time"¹¹. In order to improve competitiveness, the regime introduced two consecutive cuts in nominal wages in 1930 and 1934. In September 1931, after the devaluation of the pound, it imposed a 15% import duty.

It soon became clear, however, that further deflation had excessive economic and political costs. The fall of prices during

the early 1930s had severely hit the Italian economy: many firms were unable to reduce their production costs in the same proportion as their revenues and suffered serious losses, whilst the burden of their debt increased in real terms, threatening the firms' stability. Back in 1933, the Bank of Italy was forced to increase circulation in order to bail out some leading banks (among them, Banca Commerciale and Credito Italiano), which in the previous decades had invested heavily in the industrial sector. The drop in prices had been particularly severe in agriculture, squeezing farmers' incomes. What is more, in 1934, the balance of trade abruptly worsened as a consequence of an increase in imports and a further reduction of exports. The resultant deficit (2.6 billion

¹¹ Quoted in Cotula and Spaventa (2003, p. 300) "The Italian government", added Jung in his speech, "maintains that wages and savings are sacred and that these are the only sound means to ensure economic growth".

lira) had to be cleared utilizing the already depleted reserves of the Central Bank (Table 2). Since foreign exchange holdings had been exhausted, Governor Vincenzo Azzolini, had to mobilize for the first time the stock of gold kept in the central bank's vaults (Hirschman, 1939, p. 167). This proved to be a turning point and the government quickly reacted by imposing both systematic exchange rate control and quantitative import restrictions.

the government to take complete control over the exchange market. In particular, on 20 May 1935, a new department was created to coordinate and regulate, under the Prime Minister's direct supervision, the distribution of foreign exchange between firms ("Sovrintendenza allo scambio delle valute"). The new institution was directed by Felice Guarneri, former head of the economic research department of the Italian manufacturers association (see Banca

Table 2. Reserves of the Bank of Italy and reserve ratio (to be inserted here)

Years	Reserves in Gold	Foreign exchange	Total	Coverage ratio (%)
1927	4547.1	7558.8	12105.9	55.5
1928	5051.9	6018.9	11070.8	55.8
1929	5190.1	5151.2	10341.3	55.1
1930	5296.8	4327.5	9624.3	53.2
1931	5626.3	2170.2	7796.5	47.6
1932	5839.5	1304.5	7144.0	46.7
1933	7091.7	305.0	7396.7	49.9
1934	5811.5	71.7	5883.2	41.2
1935	3027.2	367.4	3394.6	19.5
1936a	2338.5	37.1	2375.6	
1936b	3958.8	62.8	4021.6	22.4

Note: all data is expressed in million of lira; 1936a: lira 1927; 1936b: lira 1936, after devaluation.

Source: Banca d'Italia, *Relazioni del Governatore*, Tipografia della Banca d'Italia, Roma, 1927-1937.

On 26 May 1934, a decree by the Ministry of Finance prohibited any transaction in foreign exchange except for the purpose of financing effective trade and industry requirements or for travelling abroad. Any purchase by Italian investors of stocks and bonds issued abroad, as well as export of banknotes and cheques, were also prohibited. In December, a further decree prescribed that foreign exchange obtained in payment for goods and services previously exported should be sold to the Istituto Nazionale Cambi con l'Estero. Besides that, banks and firms were bound to offer the INCE and, once requested, sell to it, all foreign credits and assets in their possession. In the following months other measures were enacted, which enabled

d'Italia, 1938, pp. 115-18; Assonime, 1940, pp. 104-8; Carli, 1955, pp. 257-73; Raitano, 1995, pp. 322-32).

In the years 1935-36, these measures were confirmed and even reinforced in the face of an foreign policy decision that ultimately brought about the disruption of the financial stability Italy had reached during the 1920s. In October 1935, after several months of preparation, Mussolini attacked Ethiopia. For the Italian economy this initially meant a considerable increase in public expenditure and in domestic demand, which in turn led to a considerable reduction of unemployment, whilst the reserves of the Bank of Italy were subjected to yet another drain. Shortly after the war began, Italy was declared an aggressor

country by the League of Nations and was subjected to sanctions which restricted substantially its ability to export and import goods. This implied a further tightening of exchange control. On 29 December 1935, the Department directed by Guarneri, now denominated "Sottosegretariato di Stato per gli Scambi e le Valute", took control of the INCE and of the "Istituto Nazionale Fascista per il Commercio Estero" (an authority whose aim was to promote Italian export) becoming *de facto* the leading centre for economic policy decisions. In 1937, the structure was transformed into a Ministry. Exchange control, writes Paolo Baffi, "became one of the main tools in the mobilization of resources to which the Italian economy was subjected for a whole decade (October 1935 to April 1945) by virtue of almost continuous involvement in military activities of greater or lesser importance" (Baffi, 1958, pp. 399-400).

As aforementioned, the government also introduced severe restrictions on imports that became effective in 1934-35 (in the form of licenses, quotas etc.). Furthermore, similarly to other countries, it increasingly utilized bilateral clearing agreements as a tool to circumvent the restrictive effects of quotas and exchange control on international trade. The tool comprised the following: in each country, importers of goods made payments in local currency to an agency (in Italy the INCE). These sums were used to pay exporters, again in local currency (Assonime, 1942; Renzi, 1943). A key issue at stake was how to determine the exchange rate to be used in computing the value of trade in each country. The first agreements were signed by the Italian authorities in 1932 and included countries that had imposed a strict exchange control: Austria, Germany, Bulgaria, Hungary, Yugoslavia, Romania,

Chile, Argentina (Guarneri, 1988, p. 355). At the beginning their aim was quite limited: to defreeze credits accumulated in previous years by Italian exporters. In the second half of the 1930s, however, when the external constraint became more binding, an increasing proportion of international trade started to be regulated by bilateral clearing: in 1939 over 50% of Italy's import and export was settled in this way (Tattara, 1991, p. 463). The most important agreement was the one with Germany. At the end of the nineteenth century, this country had already become a key trading partner for Italy, providing 12.2% of the latter's total import and absorbing 16% of its total export; Italy, on the contrary, played only a secondary role as a trade partner of Germany's (the data are in this case 3.2 and 2.5 respectively; Tattara, 1991, p. 461). Furthermore, the trade balance was mainly against Italy¹². In October 1934, two years after the initial agreement mentioned earlier, a new and more comprehensive agreement was signed by the two countries' representatives. It presented two innovative points: i) invisible items, particularly tourism and workers' remittances, were included in the clearing as a measure to balance the structural deficit of Italy's net export of goods; ii) 10% of the total value of German export to Italy had to be settled in hard currency paid to the Reichsbank. Similarly to other deals concluded by Italy in this period, the 1934 agreement was based on the principle of "delayed payment" (waiting principle)¹³: Italian exporters obtained the payment of goods sold to Germany "within the availability of the remittances [...] arriving from the sale of German goods in Italy" (Tattara, 1991, p. 474).

After the 1934 agreement, Germany quickly became by far the most important export and import market for Italy. In the

¹² „From the beginning of the century to 1930, the ratio of German imports to German exports had varied from 0.65 to 0.80" (Tattara, 1991, p. 475).

¹³ See section IV.

years 1935-39, it supplied nearly a quarter of the goods imported by Italy and bought 17.7% of the latter's export. During and after the Ethiopian war Germany became a key source of coal (30% of total import) and other raw materials¹⁴. In the same years, Italy conversely continued to play a secondary role for Germany, providing only 2.5% of its imports and acquiring only 4.9% of its exports. This disparity had serious consequences: as observed by several economists, when the trading partners in a clearing agreement are characterized by different economic strength and bargaining power, economic dependence and exploitation can ensue (Demaria, 1939; Assonime, 1942; Tattara, 1991). Indeed, after 1936/37, Germany, which had the strongest economy in continental Europe, successfully managed to buy from the latter more than it exported to it. In this way German authorities were able to obtain two results: i) they borrowed precious resources which they needed for the war: "clearing balance claims", observes Yeager, "as long as they went unspent, represented forced loans to Germany from countries poorer than itself" (Yeager, 1966, p. 325); ii) by diverting Italy's purchases towards Germany's products, they increased the economic and political dependence of the former country. In January 1937, in order to help the Italian exporters who otherwise had to wait several months before getting their payments, the INCE was authorized to emit warrants for the amounts due which could circulate as credit instruments (Renzi, 1943, pp. 252-60). Therefore the principle of "immediate payment" (financing principle) was introduced, which had positive effects on internal economic conditions.

In the wake of the collapse of the Gold bloc, on 5 October 1936, the government devalued the lira by 40.93%, which was the same percentage adopted in 1933 by the US authorities. As a result export

increased, substantially relaxing Italy's external constraint, albeit only in the short run (Pavanelli, 1990). Some measures were adopted to check inflation, putting under control prices and rents and abolishing a 15% duty on import, introduced in 1931.

Any hope of restoring external and internal stability was however compromised by the increasingly aggressive international stance adopted by the regime between 1937 and 1939; this included participation in the Spanish Civil War, the annexation of Albania, heavy rearmament. Predictably, this resulted in huge budget deficits, which were financed partly by issuing Treasury bonds and partly by an increase in monetary base.

Provided that household savings remained substantially the same, the logical consequence of the increase in public expenditure and in private investments in the military sectors was a substantial worsening of the deficit in net exports. Given the political and military situation, however, no foreign country or international institution was ready to lend the resources Italy needed. Italy, furthermore, lacked the bargaining power necessary to exploit clearing agreements in its own interest. At the same time the reserves of the central bank had already been depleted in the first part of the 1930s and during the Ethiopian war. Even if all available foreign currency was diverted, through exchange rate control, to buy the raw materials and goods needed to fight the war, external constraint posed an ultimate check on the military and political ambitions of the fascist regime and paved the way for its defeat.

3. Bulgaria: stabilization and long-lasting exchange control

The Balkan Wars and the First World War put a severe strain on Bulgarian economy and finance. Bulgaria had to pay

¹⁴ The import of manufactured goods from Germany, on the contrary, declined partly as a consequence of the "autarky", the program of national self-sufficiency promoted by Mussolini.

a huge foreign debt and war reparations (Treaty of Neuilly, 27 November 1919), reaching 2250 million gold francs at a 5% annual interest over 37 years (see also: Andreev, 2016, p. 185). Together with the occupation expenses, Bulgaria's foreign liabilities account for a quarter of the national income¹⁵. Debt service was bound with export performance; hence positive trade balance was essential for both debt repayment and reserves accumulation.

The stages of Bulgarian stabilisation logically and chronologically followed the stabilisation processes in other countries, presenting the peculiarities of the periphery and of developing countries in general (see Koszul, 1932, and Nenovsky, 2006). As in other European countries, financial stabilisation was conducted in the context of orthodox monetary ideology which saw a stable currency and balanced public finances as the bases of economic development.

From its very beginning Bulgarian stabilisation was accompanied by a number of exchange market regulations and restrictions¹⁶. A week after the enactment of the Foreign Exchange Act on 12 December 1918, the "Kambialen Institut" (the Foreign Exchange Institute) was established with the main purpose of concentrating foreign currency inflows into the country and smoothing the highly volatile exchange rate. Despite the functioning of the Kambialen Institut, the exchange rate of the Bulgarian lev was very unstable, subject to speculations and induced overall economic uncertainty after the wars. As a result of the German hyperinflation in 1923, BNB lost a certain amount of its foreign reserves which were deposited in blocked accounts and

were denominated in Reichsmarks. Having failed to improve the foreign exchange market, new measures regulating the foreign exchange market were put into practice. An amendment of the Foreign Exchange Act in December 1923 gave the BNB a monopolistic power in the foreign exchange trade. The foreign exchange market in Sofia closed and all bids and offers were directed to and executed by the BNB.

The collapsed free international trade after the First World War put a severe constraint on the balance of payments. The trade balance between 1919 and 1929 was at a deficit except for three years, with the surpluses far too small to make up for the negative balance in the rest of the period (Svrakoff, 1941 [1936], p. 300). Despite signing new trade agreements in August 1925 and introducing more protectionist tariffs in 1926, Bulgaria's balance of payments and foreign currency balances did not improve. The conventional methods of restricting imports and promoting exports were no longer efficient.

After a sharp speculative appreciation of the Bulgarian lev in June 1923 which hit Bulgarian tobacco sales abroad, new measures enforcing the *de facto* stabilisation of the Bulgarian lev (Nenovsky, 2006). A law in 1926 fixed the exchange rate at 139 leva to the dollar (the BNB bought a dollar for 137.20 leva¹⁷) and the banknote cover was set at a third. The stabilisation process was accomplished with balancing the public finances with customs revenue being a major item and obtaining the League of Nations' Stabilisation Loan in November 1928 which build the necessary foreign reserves. A law of 22 November 1928 designated the BNB as an independent monetary institution in

¹⁵ For an extensive discussion on Bulgarian economic development in the 20th Century see Avramov (2001).

¹⁶ A detailed overview of the various foreign trade restrictions and administrative exchange measures in Bulgaria is provided by Ivanov, 2001, Chapter 2 and Dimitrov, Chapter 5.

¹⁷ On 24 March 1926 the bid rate became 138.80, falling to 138.50 on 24 September 1926 as the BNB tried to attract foreign capital by cutting margins.

the spirit of the international agreements.

Maintaining the stable exchange rate inevitably involved enforced control of the foreign exchange market which was accompanied by interferences on the import and export markets. Thus, the "Institut za vunshna turgovia" (Foreign Trade Institute) was established in 1931 with the main purpose to observe the compliance of the 1928 Wine Export Promotion Act, the 1932 Grape Export Promotion Act and the 1935 Meat Export Promotion Act. Alongside export encouragement, import restrictions were more often and more effectively used. Moreover, administrative exchange rate manipulations were also involved in customs tariffs calculations between 1918 and 1930 (Toshev, 1943). The customs exchange coefficient (the rate at which paper lev were converted into gold lev for the purposes of customs duties) was significantly different

threatened by the forthcoming Great Depression. At the lack of international cooperation and given the big economic and financial differences across Europe, countries opted for individual strategies to face the crisis (Eichengreen, 1997 [1996]; Eichengreen and Sachs, 1985). Three blocks were formed: i) countries devaluing their currencies (United Kingdom (1931) the USA (1933)); ii) countries maintaining the Gold Standard, with France in the lead, and conducting a strict deflationary policy to limit wage and price growth; and iii) countries preserving parity and exercising exchange control (Germany, Italy, Hungary, Austria). Bulgaria joined the third group, being sceptical of the foreign trade liberalisation measures recommended by the 1927 Geneva Conference¹⁸.

Systematic exchange control came into force in Bulgaria with the 15 October

Table 3. Customs (import) coefficient and exchange rate of the paper lev

1918	1919			1920		1921		1922		1928	1930
15 XI	1 VII	15 VIII	1 XI	1 I	1 VII	1 I	12 X	1 VII	30 X	26 VII	3 VI
Customs coefficient											
2	2.5	3	5	6	7	9	12	14	15	20	27
Exchange rate of the paper lev											
1.66	4.22	4.22	6.05	8.2	8.96	13.5	28.2	29.94	32.3	27	27
Exchange rate of the paper lev/ customs coefficient											
1.2	0.59	0.71	0.83	0.7	0.78	0.67	0.43	0.47	0.46	0.74	1

Source: Toshev, D. (1943) *Bulgarian industrial policy after the First World War*, p.67.

from the market rate. Thanks to these manipulations the government managed to increase tariffs by 80% over 1926 and 1927 (Toshev, 1943).

As a result of the non-coordinated economic and financial efforts, the weak stabilization throughout Europe was shortly

1931 Foreign Exchange Trading Act and the BNB Ordinance of 20 October. These instruments gave the BNB a strict foreign exchange monopoly, defining in great detail how foreign exchange was to be submitted to the BNB and how it could be dispensed for import purposes. Lists of luxuries the import

¹⁸ In 1926, however, there was a partial reduction of restrictions on international scale. In spite of much public debate in favour of the decrease of trade and exchange restrictions, the Andrey Lyapchev government did not have the political will to act (Ivanov, 2001).

of which was limited began to be compiled and amended (BNB, 2004). To keep foreign capital in Bulgaria and halt the decrease of foreign reserves closely following the pound Sterling devaluation in September the same year, the BNB raised interest rates. In addition to this global imbalance, Boshulkov (1927) provides a list of long-term domestic factors such as the purge and confiscation of capital claimed to be illegally accumulated during the wars, and political instability, which certainly hamper Bulgarian capital accumulation and foreign reserves¹⁹.

There is a strong economic rationale behind Bulgaria's decision to join the Exchange Control bloc as a way to oppose devaluation and deflation at the same time²⁰. Bulgaria was a debtor country which considered debt service a key priority (Leonidoff, 1966, 1969). In fact Bulgaria

was an extremely diligent payer who pursued to preserve its reputation through debt service (Ivanov, 2004). Due to its political isolation after the First World War, however, its endeavours as a good payer were not recognised and it had to shoulder its liabilities with almost no relief (Ivanov, 2001, 2004)²¹. In his speech marking the BNB's 50th anniversary, then-prime minister Andrey Lyapchev said, "one would be hard put to find quite such a young nation in such exacerbated circumstances as ours these past fifty years, yet which can boast that it has always occupied the position of an exemplary payer to its foreign creditors" (BNB, 2001, p. 135).

Given the fact that Bulgaria had no bargaining power, its foreign debt had a 'gold clause' and was predominantly owed to non-devaluing countries²². According to the Royal Institute of International Affairs, "in Bulgaria

Table 4. Selected Bulgarian macroeconomic indicators

Years	Total reserves	Coverage ratio (%)	Trade balance	Budget balance	Years (for Budget balance)
1927	13078	28.3	489		
1928	12897	31.2	-810	347	1928/9
1929	8984	42.2	-1928	185	1929/30
1930	9249	37	1601	1143	1930/1
1931	8620	36.6	1274	-891	1931/2
1932	7519	35.8	-88	-746	1932/3
1933	7442	36	644	-233	1933/4
1934	7278	35.3	287	-246	1934*
1935	6549	34.4	244	-278	1935
1936	7158	33.8	729	283	1936
1937	8196	31.9	34	642	1937
1938	8250	31.8	644	510	1938
1939	11677	29.9	868		

Note: absolute numbers are expressed in million of leva; *) data refers to the first nine months of the year.

Source: Statistical Yearbooks of the Kingdom of Bulgaria, (1934, 1937, 1941); Christophoroff, A. (1939)

The course of the trade cycle in Bulgaria 1934-1939, p. 139.

¹⁹ In June 1931 the government of the Narodnen Bloc took office after the Demokratischen Sgovor.

²⁰ For a detailed study of the economic motives behind the government decision to opt for the exchange control in Bulgaria see Nenovsky and Dimitrova (2007).

²¹ Bulgaria continued to pay reparations in 1933.

²² French claims on Bulgaria were about 26% of the overall Bulgarian debt. Next in the creditors' list were Italy at 25%, Greece at 12.7% and Romania at 10.55%.

it is almost certain that the transfer question has predominated" (1936, p.98) and the purpose of maintaining the Bulgaria lev on a gold basis "has presumably been to avoid an increase in the costs of the foreign debt service" (1936, p.129). Even before reparation payments began in October 1923, the foreign debt service had reached the amount of 112 million gold francs between 1918 and 1922, representing 16.3% of the budget expenditures. The Sterling devaluation in 1931 offered some relief to Bulgaria by decreasing the value of the debt denominated in pound Sterling as debt service accounted then for 11% of the budget expenditures. At the same time there was no great loss on the BNB asset side, suggesting even a positive net result, since a comparably small amount of assets was denominated in pound Sterling (the Royal Institute of International Affairs, 1936). Summarising the opinions of the economists at the time, a hypothetical devaluation would have certainly increased the national debt burden, while any possible advantages would have been marginal (Sarailiev, 1937, p. 27).

Balance of payments constraint was particularly tight not only with regard to foreign debt service. The prices of agricultural products, which accounted for most of the Bulgarian exports, fell sharply on international markets and aggravated terms of trade (Royal Institute of International Affairs, 1936). The September 1932 Stresa Conference which focused on the economic development of Southern European countries (a major part of the so-called Agrarian bloc) provided an estimate of the price drop of around 70% (Bonnet, 1933, p.21). The farming price drop was further combined with a number of restrictions on the import of agrarian products to core European countries to protect local farmers by economic and political means (Raupach, 1969). Turkey, a traditional Bulgarian

trading neighbour, also introduced some limitations on Bulgarian imports. In April 1932 the drachma joined the devaluers' club (Lazaretou, 2005) and Bulgaria lost its competitive and long-standing positions on the Greek market. Therefore, the only reasonable way of letting foreign trade 'go on' was through bilateral clearing and even officially conducted barter (Ellis, 1947).²³

Bulgaria signed clearing agreements with Austria (October 1931), Switzerland (April 1932), Germany (June 1932), and Italy (1933). At first clearing covered a small share of foreign trade but it soon became widespread and according to Michaely (1962) and Friedman (1976) occupied two thirds of trade turnover in the 1930s. Benham (Royal Institute of International Affairs, 1939) and Neal (1979) argue that Bulgaria, like Hungary, used the bilateral forms of international trade to their utmost, while being the sole country managing a fixed clearing exchange rate for the entire period of restrictions. In Michaely's calculations (Michaely, 1962, p. 691) Bulgaria ranked last in a sample of 60 countries, with bilateralism representing some 87 % of its foreign trade in 1938 compared with an average of 70 %. It is interesting to note that in successive rankings for 1948, 1954, and 1958, Bulgaria kept its position, this time in the context of the Socialist bloc.

Many authors like Friedman (1976, p. 117) shared the opinion that Germany was the logical clearing and bilateral partner for Central and South-Eastern European countries, and for Bulgaria in particular (Table 5). It was a natural reaction against British and French tariff and non-tariff restrictions under which trade with Bulgaria was bound to foreign debt service (Royal Institute of International Affairs, 1936, p.131). Unlike Britain and France, German economy had an increasing domestic demand and

²³ A similar 'going on' argument is stressed by Jacque Rueff (Rueff, 1966, p. 79).

Table 5. Bulgarian clearing and non-clearing trade

Years	Export (shares, %)				Import (shares, %)			
	Clearing in total export	Germany in total export	Germany in total clearing	Non-clearing in total export	Clearing in total import	Germany in total in total import	Germany in total clearing	Non-clearing in total import
1934	78.97	48.05	60.84	21.03	78.3	48.87	62.43	21.7
1935	77.25	49.48	68.09	22.75	80.19	59.82	75.11	19.81
1936	69.44	50.53	72.78	30.56	81.7	66.67	81.58	18.3
1937	65.52	47.11	71.91	34.48	79.9	58.22	72.82	20.1
1938	77.24	58.86	76.21	22.76	74.02	51.43	70.22	25.98
1938a)	71.68	51.49	71.78	21.4	74.74	54.1	72.38	25.32
1939a)	72.81	59.43	81.63	27.19	80.89	61.04	75.46	19.05

Note: Superscript: a) export/import data refer to the first five/four months of the year.

Source: Christophoroff, A. (1939) *The course of the trade cycle in Bulgaria 1934-1939*, p. 46, p.48.

extended credit lines which had saved Southern Europe and the Balkans (Hunke, 1942, p. 16-17). Therefore, it was logical to partially compensate for the contraction of trade with France and Britain by expanding trade with Germany and Austria.

Under clearing importers pay in their national currencies, depositing money with their central banks, while exporters get paid in their national currencies by their central banks. Settlement is at an exchange rate agreed in advance (see Lindert and Kindleberger (1983 [1982]) and Kindleberger (1988 [1973])). Bulgaria like Hungary applied the principle of immediate payment from the very beginning in the clearing trade with Germany in its attempt to avoid deflation (Neal, 1979)²⁴. The effect was money supply expansion which can be studied in the balance sheet data (Table 6). The increasing value of 'Other foreign

currencies' on the asset side of the BNB books closely followed receipts of non-Gold bloc foreign currencies from clearing and other agreements (Avramov, 1999). Since 1934 Bulgaria had positive clearing balances which were partially settled by import of machines and goods or capital inflow from Germany. The growth of this item was much faster after 1938 when Bulgaria scored huge trade surpluses in its clearing trade with Germany.

The great dependence on the clearing with Germany and the need for greater flexibility prompted the appearance of a new institutional form of international trade: bilateral private compensation deals and exchange rate premia (Christophoroff, 1939). Bilateral private compensations invented to 'circumvent the fixed exchange rate' were paid directly to importers in their national currencies at the compensation offices

²⁴ For more details see section IV.

Table 6. BNB balance sheet items

Assets	1928	1930	1932	1934	1936	1938	1940
Gold and silver holdings ¹	1598	1879	1874	1900	2049	2586	2301
Receivables in gold foreign currencies	2736	481	92	26	0	0	4
Other foreign currencies	534	152	116	174	772	1279	2336
Domestic credit ²	5362	4267	3913	3724	4336	4829	8021
Treasury bonds	0	0	130	310	0	0	0
Other items ³	164	375	247	252	215	146	557
Total assets	10394	7154	6373	6386	7372	8839	13219
Liabilities							
Capital	500	500	500	500	500	500	500
Reserve funds	1149	1169	1191	1240	1241	1188	1207
Banknotes in circulation	4173	3296	2635	2449	2571	2800	6518
Deposits ⁴	3862	1817	1813	1872	2382	3707	3785
Other liabilities ⁵	637	287	203	277	546	443	937
Profit	71	83	32	48	133	202	272
Total liabilities	10393	7154	6373	6386	7372	8839	13219

Note: all numbers are expressed in million of leva; Superscripts: 1) Gold and silver holdings including gold and silver coins at cash; 2) Domestic credit comprises of receivables from the government, banks, commercial papers and effects; 3) Real estates and other assets; 4) Demand, time and other deposits of government and banks; 5) Liabilities in gold and other foreign currencies.

Source: Disaggregated balance sheet data is taken from Avramov, R. (ed.) (1999) *120 Years Bulgarian National Bank*, p. 130.

established at chambers of trade in 1933 for that purpose. Exchange premia, introduced for a limited number of private deals in 1933 and considerably spread by 1935, acted in the same direction of depreciating the lev and enhancing the inflow of convertible Gold bloc currencies (Boshnyakov, 1936). By performing a 'market-determined' depreciation of the officially maintained exchange rate, exchange premia were aimed at stimulating exporters to sell at lower prices. At the beginning they differed across currencies which put them closer to Ellis' definition of multiple exchange rates as an exchange control instrument (Ellis, 1947).

In late 1939 exchange control was transformed from an instrument of stabilisation into a lever for marshalling war resources. The military logic of exchange control was apparently much earlier in Germany and Italy, which in the late 1930s subordinated foreign trade to war needs. The amendment of the clearing agreement

between Bulgaria and Germany in 1940 was extremely slanted in favour of Germany, allowing it to transfer resources from Bulgaria (Svrakoff, 1941 [1936]). In principle Bulgaria exported predominantly agricultural products and imported commodities and industrial materials. Hence, some economists criticises the dominant role of Germany in Bulgaria's foreign trade satisfying German war needs rather than looking for a more balanced foreign trade position (Toshev, 1943, Berov, 1989)

In Bulgaria, as elsewhere, exchange control performed another function alongside monetary and financial stabilisation and balance of payment restrictions²⁵. Though considered only implicitly, this function was growing in importance. It entailed using exchange control to stimulate or restrict sectors and branches of the economy; according to Paul Einzig exchange control became a "weapon of commercial policy" (Einzig, 1934). Moreover, the League of

²⁵ Ellis (1947) describes the purposes (domestic and external) and instruments of exchange control in detail.

Nations' report on exchange control noted:

"... the control is now applied as an active instrument of commercial policy and for the further purpose of placing a barrier between world and domestic prices, so that monetary and general economic policies could be chosen and executed without regard to their effects on the balance of payments" (League of Nations, 1938, p. 22)

Though the initial reason for this kind of industrial policy was to limit expensive imports (BNB argued in favour of importing commodities and materials rather than machines because the former were cheaper; BNB, 2004, p. 491), in time the necessity of protecting the indigenous industry and cutting unemployment moved to the fore²⁶. In other words, exchange control and foreign trade restrictions in general (quotas and tariffs) obtained predominantly domestic functions. Economists often argued that 'encouraged industry' (*nasarchena industria*) and overprotection hit consumers and general entrepreneurship since protecting domestic production hampered competition and led to the rise of monopolistic domestic industries. In Toshev's opinion "the importance of international trade agreements was diminishing after 1932 with respect to domestic industry since another very effective instrument compensated for trade concessions, and namely the BNB exchange rate policy" (Toshev, 1943, p.85).

The increasing discrepancy between industrial and agricultural development inevitably translates into price scissors, different income levels, and hence wealth redistribution (Lindert and Kindleberger, 1983 [1982]). In 1930 the "Hranozinos" (Food Export Agency) was established and invested with monopoly powers to buy and

trade cereals as a specific tool against deflation. Because of the negative price scissors between buying and selling prices, losses were accumulated and transferred to the budget. Initially half and then a quarter of the payments to farmers were in treasury bonds representing domestic government debt, which amounted to around 400 million gold leva (Berov, 1989, p. 465).

The complex trade and exchange restrictions became a focus of conflict between different interest groups (industrialists, merchants, farmers). The course of the debate shows that little attention was paid to consumers; hence exchange control was discriminative not only in international aspect, but also against different social groups within an economy (Ellis, 1947). Simple evidence could be found in the lists of goods subject to import restrictions, among which cobbling leather, sugar, cotton, wool, and others of definite interest to consumers (BNB, 2004) which prices inevitably increased under the lack of competitive pressures.

As a result of the exchange control maintained throughout the 1930s and the intensified trade with Germany, the lev rate appreciated gradually reaching 18.5% in 1937 in nominal effective terms compared with the base year 1929 (Dimitrova et al., 2008) (Figure 2)²⁷. The nominal effective exchange rate (NEER) calculated with exchange rate premia illustrates the path of a market determined exchange rate development or the path of an alternative devaluation. Bulgarian exporters however, faced stimulating development of the real effective exchange rate which had started to devalue since 1930 due to the diverging inflation differential of the lower price level

²⁶ The 1928 National Industrial Promotion Act provided various encouragements and duty waivers before losing effect partly due to exchange control in 1931. A new 1936 Act made customs regulations particularly important for protecting industry (for details see Toshev, 1943).

²⁷ Interestingly, arbitration calculations (across the Romanian leu) by Christophoroff generated some 20 % appreciation of the mark against the Bulgarian lev after 1934 (Christophoroff, 1939, p. 20).



Fig. 2. Effective exchange rates of the Bulgarian lev

Note: authors' calculations. For methodological details see Dimitrova, K., Ivanov, M. and R. Simenova-Ganeva (2008) "Effective exchange rates of the Bulgarian lev 1896-1939". Bulgarian National Bank, Discussion paper.

in Bulgaria compared to the weighted price level of its main trading partners.

Nevertheless, Bulgaria was unable to benefit from this competitive position due to the foreign trade restrictions imposed by most of its trading partners. Moreover, the agricultural price drop was so sharp and sudden that the increasing volume of export did not result in an increase of the value of total export. Therefore, the exchange rate premia applied to a limited number of private deals and, estimated at a quarter depreciation of the officially maintained nominal exchange rate on average between 1935 and 1939 (Christophoroff, 1939) had a smaller effect (5.7%) in real terms. Provided that the share of clearing trade was around 73% in total export, the number of the bilateral private deals allowed to apply the

exchange premia was very small; hence, the effect on total export development as marginal, if any.

4. Theoretical implications of exchange control

Before proceeding with our analysis, it is important to point out that the theoretically postulated relationships under investigation are questionable in themselves due to the complexity of exchange control. Moreover, empirical estimates are often far from conclusive, not only because of the lack of consistent disaggregated data, but also due to government interference at the micro level and the income redistribution effects. Therefore, the complexity of exchange control requires simplification and the reasoning below pertains to an 'idealised' exchange control model.

The studies of how exchange control was introduced and practiced in Italy and Bulgaria are eloquent examples of how serious the balance of payments constraint was at the time and how difficult it was to circumvent it.

Prior to the First World War, the balance of payments constraint was overcome by the relatively automatic mechanism of the Gold Standard and the so-called 'rules of the game.' Even when these rules were violated, the London financial centre and the Bank of England with other major central banks, allowed for the functioning of the Lender of Last Resort (LLR) on an international scale. The war, however, destroyed this institutional framework and led to the formation of different political and economic blocs and the spread of political and economic nationalism. As was already pointed out, despite attempts to restore the pre-war situation, in the 1920s many European countries had severe current account and budget deficits and followed diverging political and economic objectives, whether independently or within a bloc. Under these new circumstances, exchange control can be interpreted as an example of the new economic paradigm that assigned the government an active role in the economy. We should remind the reader that before the war, the discretionary powers of both governments and central banks with regard to the exchange rate were rather limited and used only under a set of extreme conditions, such as wars.

The choice of exchange control methods depended on other factors such as contracts or political and purely ideological reasons (Heuser, 1939, p. 48). Exchange control in Bulgaria and Italy, as well as in countries like

Germany, Austria, and Hungary, was a specific alternative to both devaluation and deflation, which for various reasons were much more costly in both economic and political terms. In this context exchange control was a form of isolationism that protected domestic capital markets from international capital flows. Devaluation was unacceptable to countries which had experienced inflation and had gone through financial crisis, and which had just stabilised their currencies. What is more, most countries with exchange control (except Italy) had been defeated in the War and had considerable external liabilities. They were debtors who not only wanted to relieve the burden of their foreign debt but most probably also tried to gain maximum profit from their appreciated currencies. As currencies in which foreign liabilities were denominated (the pound Sterling, the U.S. dollar, and the French or Swiss francs) devalued, their debt burden automatically decreased.

Although the trade and exchange restrictions were determined by the necessity to defend the stabilized national currencies, the reasons slightly differ between debtor and creditor countries. Debtor nations wanted to preserve their reputation among financial circles (Bulgaria) or among their electorate (Italy). The balance of payments constraint was of course more binding in Bulgaria than in Italy²⁸. In Bulgaria the burden of foreign debt and the constraint of weak foreign reserves were more intense²⁹. Its government, therefore, had to introduce foreign exchange restrictions considerably earlier and stabilize the lev administratively: an early form of exchange control³⁰.

There is no doubt that the basic question is to what extent exchange control as a form

²⁸ In Heuser (1939, p. 26-27) "For instance for debtor countries like Bulgaria, Greece, Romania and Estonia the constraint on the balance of payment is dominating, while there are also other reasons as important as the deterioration of the foreign trade balance in creditor countries".

²⁹ According to the Royal Institute of International Affairs, Bulgaria was the country with the greatest lack of capital and investment in Europe (Royal Institute of International Affairs 1936, p. 120).

³⁰ As pointed out in Heuser (1939, p. 41) "... in the case of Bulgaria the chief control of imports has from the beginning been part of the general system of exchange control."

of government interference helps or harms macroeconomic stability and economic growth³¹. Before answering it, however, let us first address some technical details of the exchange control mechanism which could help us explain the main macroeconomic correlations, and particularly the forms of control over the balance of payments and different types of clearing.

The methods of foreign reserve accumulation and exchange rate pegging could be classified into two types of balance of payments control. The first type, trade control, involves indirect influence on the foreign exchange market through the basic markets determining foreign currency supply and demand, that is, import and export markets for goods, services, and capital. The second, exchange control, involves direct control of the foreign exchange market by determining the volume of traded foreign currencies³². In the first type, the volume of foreign currencies depends on import and export flows which are limited or enforced. In the second type we have the opposite: there is an *a priori* determined amount of foreign currency, once what is necessary for debt servicing has been earmarked, and imports are constrained by this amount. The government further interferes directly on import and export markets to accomplish its goal of foreign reserve accumulation. Despite the fact that both mechanisms give similar long term results (both interfere with the efficient allocation of resources), we have to consider that direct control of the foreign exchange market is considerably more complex to enforce and has remarkably adverse overall effects³³.

Under trade control, *de facto* import control, two types of restrictions can be identified: price discrimination (tariffs and customs duties) and

volume discrimination (quotas and barter). The former type fixes import prices above their equilibrium level by adding customs duties and tariffs and the volume becomes a function of this fixed price level. The latter fixes the volume (usually at a level lower than equilibrium) and the price follows accordingly. The historical record proves that exchange control of the first type has not always accomplished its foreign exchange market aims because of the decentralized behaviour of importers and exporters.

Under exchange control the central bank can fix the supply of foreign currency directly. Thereafter, if the goal is to boost the foreign exchange supply, exchange premiums are an appropriate instrument. A violation of the static foreign exchange monopoly, they allow for some very limited flexibility of the legally fixed exchange rate with the sole purpose of stimulating export³⁴. In principle, once the volume of foreign exchange and the exchange rate are given, the next logical step is to control imports and exports totally through leaves and licenses; hence goods markets become a function of predetermined foreign exchange market equilibrium. There is little doubt that this form of exchange control is considerably stronger and entails a more substantial violation of the market mechanisms for the efficient distribution of scarce resources. It is also more difficult to maintain, as evidenced by the black market in currency, smuggling, corruption, and other forms of lawbreaking exemplified by the case of the two Italians in Bulgaria.

The other technical detail concerns clearing trade system which was introduced as an auxiliary exchange control instrument to overcome trade restrictions imposed by most of the European countries and to circumvent the balance of payments constraint without

³¹ Ellis (1940) provides an interesting exposition of the exchange control theory and its macroeconomic consequences.

³² Technically, exchange control is a logical continuation of import tariffs and quotas which have failed to fulfil their purpose of improving the balance of trade (Kulicher, 2002 [1929] and Kindleberger, 1988 [1973]).

³³ See textbooks in international economics (Vanek, 1962; Lindert and Kindleberger, 1983 [1982]).

³⁴ Bulgaria implemented various forms of trade and exchange restrictions in the 1930's; see Christophoroff (1939).

devaluation (Ellis, 1947). In a sense, we could argue that the decision to maintain an overvalued exchange rate by the means of foreign exchange monopoly was a *unilateral* act, while clearing trade was *bilateral* agreement with some prospects of becoming *multilateral*.³⁵ The main principles of the proposed clearing system as a general form of building the international financial relations was later on again put forward by Keynes as a part of his plan for reforming the international financial system after the Second World War (Dam, 1982, Triffin, 1969, [1968]).³⁶

There are different opinions about the German impact on Southern Europe, from unqualified support of clearing to the opposite extreme of its total denigration alongside accusations of German exploitation³⁷. As a result of the strong demand of raw materials and agricultural products from German productive sectors, Germany's clearing

partners recorded trade surpluses (Neal, 1979). A detailed analysis of the clearing mechanism, however, reveals two forms of payment (Chart 1).

The first one implies that the foreign bank paid its exporters in national currency in exchange of their claims, thus increasing the money supply, national income and consequently driving up the demand for import. This form of clearing is referred to as the "principle of immediate payment" or financing principle (see Lindert and Kindleberger (1983 [1982]) and Kindleberger (1988 [1973])). The second form, described as 'the principle of delayed payment' or 'waiting principle', implied that exporters waited for the sale of import and then obtained national currency from their central banks.

According to the literature on the subject, the principle of immediate payment was advantageous to depressed Southern Europe

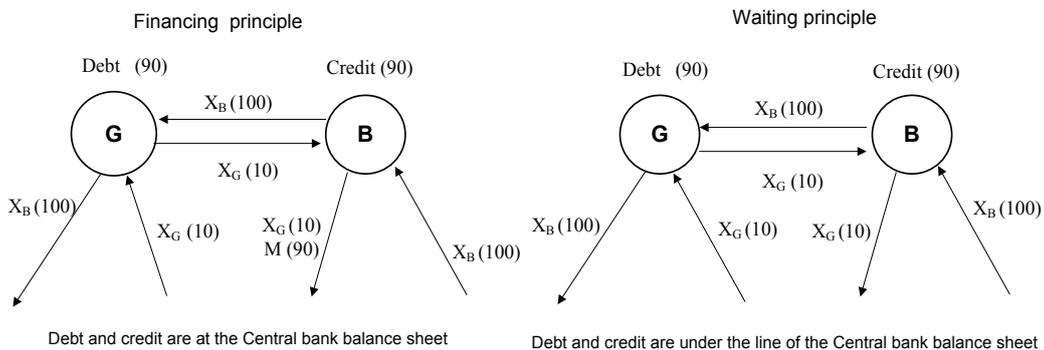


Chart 1. Two methods of clearing

Note: We take as example the trade between two countries, where G stands for Germany (clearing deficit), B stands Bulgaria - country with clearing surplus, X_B is the Bulgarian export to Germany, X_G is the German export to Bulgaria, M is the additional monetary flow created by the Bulgarian National Bank due to the clearing surplus [$M(90) = X_B(100) - X_G(10)$].

³⁵ In Bulgaria for instance trilateral agreements were used more after 1935 (Christophoroff, 1939, p. 36).

³⁶ In his plan Keynes explicitly shares his conviction that a balancing mechanism is feasible in the frameworks of a global clearing and that it could be relatively symmetric in contrast to the Gold Standard, where a smaller part of the burden was spread among creditors. In a sense, Keynes's proposal confirms that exchange control was a weapon used by debtors, regardless of whether they are producers, consumers or entire countries.

³⁷ For more details about economic interrelations between the Bulgarian and German economies see Christophoroff (1939) and Fisher (1939), and between Italy and Germany see Tattara, 1991.

because it was widely believed that expanding money supply would cut unemployment rather than lead to sharp price rises. According to Neal (Neal, 1979, p. 393), the bigger the clearing surplus and the higher the mark rate were under the principle of immediate payment, the stronger the expansionary effect for Central and South European economies³⁸.

Under the method of immediate payment, the adjustment leads to price level increases, while in the alternative method – to exchange rate fluctuations. Consequently, in the former case, countries experienced inflation due to the monetary expansion which inevitably resulted in real appreciation of their currencies and worsened their competitiveness. In the case of delayed payment, there were no price rises but deflation.

First, we should consider that clearing trade substantially impacted money supply and price levels. As noted above, due to the financing method of clearing with Germany, Bulgaria maintained a flat clearing rate of 33 leva to the mark³⁹. The positive clearing balance Bulgaria accumulated led to the expansion of money supply and inevitably to price and income increases, and consequently to economic expansion. This scenario has some positive features given the fact that deflation in the 1930s had severely damaged the agricultural sector. The financing principle, however, affected Bulgarian competitiveness not only in Germany but most probably also elsewhere prompting exchange premia to stimulate trade with free currency countries.

This expansion through the immediate payment method can be accommodated within the overall German ‘contagion’ of the

Bulgarian economic cycle as described by Christophoroff (1939). As the National Socialists came to power in Germany in 1933, the economy was experiencing credit growth and expansion of government spending. This logically followed the 1932 clearing agreement between Bulgaria and Germany and the consequent BNB departure from a strict deflationary policy and the introduction of exchange premia in mid-1933. Moreover, it has been summarised that financing principle countries were politically closer to Germany (Neal, 1979, p. 400).

As mentioned earlier, the principle of immediate payment was also introduced in Italy starting from January 1937. In this case, however, this measure had been preceded by a substantial devaluation of the lira: in the short run, therefore, this policy mix lead actually to an improvement in competitiveness of Italy’s export sectors, which however was bound to be eroded in the following years as a consequence of price level increases.

In a comparative perspective, Larry Neal argues that the different methods of payment explain higher Hungarian growth in contrast with the difficulties faced by Romania (Neal, 1979)⁴⁰. Paul Einzig (1955) describes the different mechanisms by which Germany exported inflation to South-Eastern Europe. Germany accumulated large clearing debts and used the financing principle nations to finance German economy. Therefore, it was against the German interest to introduce the mark into South-Eastern Europe as this would deny the inflation/devaluation levers⁴¹.

Second, we note that exchange control in clearing influenced the real exchange rate and overall national terms of trade. Despite

³⁸ Hungary was an eloquent example of a country practicing the principle of immediate payment and recording high economic growth, while Romania was just the opposite among other Central and South-Eastern European countries (Neal, 1979).

³⁹ Romania was practicing the waiting principle and renegotiated its clearing rate with Germany several times (Neal, 1979).

⁴⁰ Friedman (1976) tries to measure the welfare benefits and the losses for Hungary clearing with Germany, comparing the term of trade in the clearing area and outside the clearing area and comparing the deferent export elasticity for the two areas.

⁴¹ Interesting parallels could be drawn with the present unwillingness of older eurozone countries to put the euro into circulation in new accession states.

the many difficulties in calculating terms of trade in the framework of clearing and exchange control (see Neal, 1979, Friedman, 1976, and Tattara, 1991), there is consensus among researchers that German terms of trade developed unfavourably with respect to Southern Europe (*i. e.*, the ratio of export prices to import prices fell). The overvalued Reichsmark was solved through the flexible exchange rates of the Askri mark and through the mechanism of the Sperrmark (Neal, 1979). Under these circumstances immediate payment and hence money expansion in clearing creditor countries were aimed at postponing real mark appreciation by keeping their domestic currencies from rising relative to the mark. In a sense, this was a compensating mechanism in the context of trade flows between Bulgaria and Germany given the fact that both sides opposed devaluation. As a whole we dare argue that exchange control and clearing in particular stimulated the Bulgarian economy under the circumstances of global deflation and international trade restrictions.

Third, we note that the Italian and Bulgarian balance of payments restrictions could be interpreted in the light of the well known saving/investment equilibrium in an open economy. If we assume that private saving is constant, an increase in the budget deficit and/or private investment has to worsen the balance of trade. Naturally, the aggregate approach presents some methodological and analytical problems. However, it is correct to point out that both countries' trade deficits were caused not only by the price drop of agricultural products in the early 1930s (which in any case played an important role especially in Bulgaria) but also by the considerable increase of public expenditures later in the decade in preparation for war (this was particularly the case of Italy). Mussolini's ambitious imperialism has been studied at length (see De Felice, 1981; Miller and

Kagan, 1997 among others); Bulgaria also had its Balkan ambitions as a prospective German ally. Increasing public expenditures since 1934, however, were counterbalanced by great efforts to attain surpluses from 1936 (Christophoroff, 1939, pp. 100-105). This line of reasoning shows Italian and Bulgarian exchange control as an instrument of government interference, nationalisation, militarisation, and economic isolation.

Fourth, we can draw some interesting parallels between the Italian and Bulgarian economies in the 1930's and today, with respect to the European Union and the enlarging euro zone. The First World War caused a sudden collapse of the world economy. Money supply, relative prices, and the structure of the balance of payments irreversibly changed. New social and political subjects appeared whose interests were related to those of the debtors and those who opposed deflation. Money became fiduciary, while capital movements dominated the balance of payments. Failure to revive the pre-war situation and the Great Depression accelerated national isolation and war preparations. This line of reasoning interprets exchange control as a structural element of a closed economy. At the beginning it was viewed as an alternative to devaluation and deflation and a way of overcoming the balance of payments constraint; in time it became an instrument for mobilising war resources. From this point of view, Italy and Bulgaria followed similar trajectories: both were forced to opt for isolation and exchange control as an alternative to devaluation and deflation.

Today Italy and Bulgaria are members of the EU which, at least in principle, is a framework for avoiding economic isolation and war in Europe. In a sense, the balance of payments constraint, which was felt at the national level, is now partly transferred to the European level. By adopting the common currency Italy can no longer improve its competitiveness

through devaluation, while the currency board in Bulgaria (which is not a eurozone member yet) commits it to low inflation and a restrictive fiscal policy. Today as in the interwar period, European economies can prosper in the long run only by adopting healthy fiscal and monetary policies and increasing productivity. Yet, unlikely as economic isolation and autarchy may appear, we should remember that these pathologies appeared unlikely also at the beginning of the Twentieth Century.⁴²

5. Conclusions

We can thus summarise the main results of our study: first, interwar exchange control resulted from balance of payments constraints which were particularly severe for peripheral and semi-peripheral countries given the collapse of the world economic and monetary equilibrium. During the 1930s the relatively automatic mechanism of the Gold Standard and the LLR functions performed by the Bank of England and central banks in the financial core no longer existed, while ideas of a global LLR like today's IMF were nascent. The League of Nations lacked the authority to restore pre-war financial relations and implement a new system.

Second, peripheral and semi peripheral countries like Bulgaria and Italy, which had a long record of poor discipline and lacked good monetary management traditions, preferred fixed exchange rates which symbolized monetary stability and enhanced credibility. For this they needed foreign reserves which, however, rapidly decreased through balance of payments deficits. The latter were caused mainly by dramatic drops in the prices of agricultural products, by capital outflows, and later by costly rearmament (in particular in Italy). Moreover, most countries opting for exchange control (Italy was an exception) had been defeated in the war and were oppressed by a heavy debt burden.

Third, the Exchange Control bloc included countries with similar problems, similar preferences and characteristics. Together with the Sterling bloc (which included Great Britain and its colonial system) and the Gold bloc (with France in the lead), the Exchange Control bloc, with Germany at the centre, had its own basic equalizing mechanism. From a technical point of view the exchange control can be seen as an alternative strategy to devaluation (pursued by the Sterling bloc) and to deflation and wage decreases (pursued by the Gold bloc). At a more disaggregate level, when we study the techniques of the exchange control, we find several details (like exchange premiums for example) which are *de facto* in conflict with the fixed exchange rate principles.

Fourth, our study of exchange control reveals interesting macro interrelations. While there is some obvious macroeconomic asymmetry within exchange control countries (in fact there was a similar asymmetry during the pre-war classical Gold Standard), we observe certain equilibrating processes in relation to the main macroeconomic parameters and in foreign trade. Of course, such processes could only be regarded as secondary. There is no doubt that exchange control was a serious interference in market mechanisms. Furthermore, history shows that exchange control was characterized by corruption and political favouritism and had strong distorting redistribution effects: it tended to favour certain groups which were connected to the authorities in one way or another. These microeconomics and sociological aspects, however, constitute a new and different chapter in this complex story.

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⁴² See Fromkin (2004), Frieden (2006)

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