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

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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.

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

1. Introduction

On 6 September 1937, Balgarska Narodna Banka’s (BNB) governor Dobri Bozhilov sent a confidential message No. 166 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 brought certain amounts of money in Bulgarian currency to the Embassy against which the Ambassador gave him cheques denominated in foreign currencies. These cheques then were sent to Italy

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by the legation itself. The Governor was asking the Minister of Finance to raise this delicate affair at the Council of Ministers before the BNB governor brought a prosecution under the Foreign Exchange Act (BNB, 2004, No 297). The background of this historical detail 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 (the two countries were allies in the Second World War and economically belonged to the so-called Clearing Bloc).

The history of Interwar exchange controls in Europe provides us with interesting insights into the current development of the European Monetary Union and into the prospects for its enlargement, where 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 also divided into a centre, part-periphery and periphery: groups of countries at different stages of economic development. Therefore, we find it challenging to compare the evolution of exchange controls in two countries characterized by different economic conditions. Italy was representative of the semi-periphery and Bulgaria of the peripheral and then underdeveloped Balkans: both were external to the financial and industrial core of Europe.

The introduction of exchange controls 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, and who viewed the gold standard as an integral part of these mechanisms. The second attitude was held by those who believed that a new era of economic relationships had come and hence new rules (active government interference) were required. This was a time when the world economy was going through a transition which was extremely unstable and which ended in 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 that 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 –

² In fact, the affair was rather a typical case of avoiding exchange restrictions. According to Charles Kindleberger the ways to circumvent exchange controls are to bribe a central bank employee, 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.

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 of world export and members of each bloc tried (and succeeded to some extent) 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

	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

Note: European exchange control countries include Austria, Bulgaria, Czechoslovakia, Denmark, Estonia, Germany, Greece, Hungary, Italy, Latvia, Lithuania, Poland, Portugal, Romania, Turkey and Yugoslavia. Gold bloc countries are represented by France, Belgium, Netherlands and Switzerland.

Source: League of Nations (1938, pp. 29–30).

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 point but does not include them” (Ellis, 1947, p. 877). According to Ellis, the main instruments of exchange control are: a government monopoly in foreign exchange dealing, 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 controls either with respect 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 persons 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 depreciation 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 exchange control instrument did not contribute to improving the balance of payments, other interference included active export encouragement and import restriction.

Given the complexity of this topic, we start with a description, drawing up a parallel chronology of events in Italy and Bulgaria supported by facts. The purpose of this paper is to analyze the motives behind governments' decisions to introduce and maintain exchange controls, the economic consequences of these decisions, the techniques adopted, and the order of events (Ellis, 1947). From a theoretical standpoint, we study exchange control in the context of economic and monetary isolation (autarchy). To describe the motivation behind policy decisions, we introduce appropriate elements of institutional and political economy. We also take into account the macro influences of exchange controls on the real economy. Our investigation considers balance of payments constraints as a main purpose.

In the first two sections of the paper we describe the history of exchange controls in Italy and Bulgaria in the interwar period, illustrating it with data. In the third section, we propose some theoretical reflections and interpretations of exchange controls. In the conclusion, we try to formulate some lessons from Thirties' exchange controls and draw parallels with today.

2. Italy: Stabilisation and Short-lived Exchange Control

Measures aimed at regulating exchange rates had been introduced in Italy in 1917, during First World War. After 1921, however, most of the restrictions were lifted and it was only in the years 1934/35 that systematic exchange rate control was enforced as a consequence of protracted balance of payments deficits, in a context characterized by the so-called “quota novanta”, the stabilization level chosen in December 1927 when the gold exchange standard was officially re-established and which the government had decided to defend at all costs. It soon became a means 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 import 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 and this tendency was reinforced by speculative attacks following a major defeat of the Italian army in Caporetto, in November 1917. In December the government reacted by creating 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 of the foreign exchange market. 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. 276–279).

The post-war period was characterized in Italy by severe monetary and financial instability; between 1919 and 1921 the nominal exchange rate further depreciated as a consequence of current account deficits and speculative capital movements⁵. On 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, in a situation characterized by political and social turmoil, Mussolini was appointed prime minister. Before long the new government proceeded to restrict political freedom but adopted, at least initially, a *laissez-faire* approach in economy policy and adhered to financial orthodoxy. The Minister of Finance, Alberto De’ Stefani, severely cut public expenditure in order to reduce the budget deficit. Monetary policy, however, was too accommodating and as a consequence inflation increased, reaching 15% in the third quarter of 1925 (Fратиanni and Spinelli, 1997, p. 136). The balance of trade also worsened: the nominal exchange rate in terms of dollars fell to 27.5. In February 1925, therefore, De’ Stefani had to reintroduce some limitations in the transactions in the foreign exchange market and entrusted INCE with the task of gathering information on the

⁴ For a reconstruction of economic and institutional events in interwar Italy see Toniolo, 1980; Zamagni, 1993.

⁵ Between 1913 and 1921 the value of the lira in terms of the dollar decreased from 5.27 (lit/USD) 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 of that, 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; Ciocca and Ulizzi, 1990). In 1919 and in the first half of 1920, on the contrary, nominal depreciation was so fast that real exchange rate actually decreased signalling an increase of the competitiveness of Italy (Cotula and Spaventa, 2003, p. 216).

amount of foreign credits and debts held by financial institutions and professional brokers (Raitano, 1995, pp. 296–297). In the second half of 1925 further measures aimed at curbing speculative capital movements were introduced by the new Minister of finance, Giuseppe Volpi, as a preliminary step for the stabilization of the lira (Guarneri, 1988, p. 210; De Cecco, 2003). In November Volpi was able to reach a settlement of the war debts with the United States and UK. This move, by removing legal obstacles to international loans, was 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: during 1926 the nominal exchange rate of the lira had fallen 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, on 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 of the country) and by severe credit restrictions. Nominal wages and some retail prices were also cut by 20% by 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 put at 7.918 grams per 100 lira; this implied a nominal exchange rate at 90 lire per pound and at 19 lire per dollar.

The reasons underlying Mussolini’s decision to proceed to a sharp revaluation of the lira and the consequence of this measure on the Italian economy were debated by contemporary commentators and have also been explored at length by economic historians and historians of economic thought (see Barucci, 1981; Bini, 1981; Cohen, 1972; Falco and Storaci, 1977; Marconi, 1982). It would appear that political considerations were probably dominant. The middle class, who was the most important constituency of the regime, had been 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 had taken the power, enabling him to declare that, contrary to 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

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”.

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, export decreased from 18.170 in 1925 to 15.519 million lira in 1927; during the same year, however, import decreased even more (from 25.879 to 20.375 million) and the result was a short run reduction of the trade deficit (from 7.335 to 4.856 million)⁷. The situation therefore appeared not particularly worrying, if we consider the fact that from the very beginning of the industrial take-off, at the end of the nineteenth century, Italy had to face a structural imbalance of her net exports, which were compensated by other components of her current account, especially remittances from his emigrants and tourism (Falco, 1995)⁸. During the Twenties remittances from emigrants actually decreased, but were counterbalanced by capital inflows resulting from loans contracted in the US financial market by Italian firms and municipalities. This implied an increase of Italy's foreign debt to a level which was considered excessive by the governor of the Banca d'Italia, Bonaldo Stringher. Therefore, already in 1927 new measures were enacted which requested the government's authorization as a precondition to take out new loans abroad (Storaci, 1989, pp. 298–299).

Already by 1928/29 circumstances changed: 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, American investors were more and more reluctant to subscribe 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 the 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 export and a slight increase in import⁹. As a result, between December 1927 and December 1929 the reserves of the Banca d'Italia decreased from 12,105.9 million lira (in gold and convertible currencies) to 10,795.4. In spite of that, in March 1930 the Ministry of Finance was bold enough to officially

⁷ This situation proved to be only temporary; in 1928, following a bad wheat harvest, trade deficit increased to 7.456 millions of lira.

⁸ It is important to note that revaluation had serious consequences on financial stability of the 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 7.476 millions in 1928 and to 6.536 in 1929.

abolish every form of control in the exchange rate market (Guarneri, 1988, pp. 262–263).

The onset of the Great Depression, together with the protectionist measures adopted by several countries, brought to a collapse the international trade; besides that, Italian competitiveness was severely compromised 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 (chart 1). Not surprisingly, in 1933 the nominal value of export was roughly one third of that in 1927. Import also shrank as a consequence of the recession and, as a matter of fact, between 1931 and 1933 trade deficit was lower, in nominal terms, than in the 1920s. Taking into account net transfers, current account was actually in surplus (Banca d'Italia, 1938, p. 114). However, the drain of the reserves of the Bank of Italy continued also in these years following adverse capital movements (table 2). Once more, these were mainly due to 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 and which guaranteed a high yield in dollars.¹⁰

Chart 1: Effective Exchange Rates of the Italian Lira (Index 1929=100)



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

Source: Ciocca and Ulizzi (1990).

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

Even in this unfavourable situation the Italian government was resolute to defend the stabilization level decided in 1927. At the end of the London Conference in 1933, the Italian Ministry of Finance Guido Jung adhered to the Gold bloc by subscribing, together with the representatives of France, Switzerland, Belgium, the Netherlands and Poland, a pledge to defend the gold standard at the existing parities. Italy, declared Guido Jung on that occasion, “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 enforced 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 Italian economy: many firms were unable to reduce their production costs in the same proportion of their revenues and had to face serious losses, whilst the burden of their debt increased in real terms, threatening their stability. Already in 1933, Banca d’Italia had 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 the incomes of the farmers. In 1934, furthermore, the balance of trade abruptly worsened as a consequence of an increase in imports and a further reduction of exports. The ensuing deficit (2.6 billion lira) had to be cleared utilizing the already depleted reserves of the Central Bank (table 2). Since foreign exchange holdings had been exhausted, its governor, Vincenzo Azzolini, had to mobilize for the first time the stock of gold kept in the vaults of the bank (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.

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 had to be sold to the Istituto Nazionale Cambi con l’Estero. Besides that, banks and firms had to offer to 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 the government to take complete control of the exchange market. In particular, on 20 May 1935 a new department was created to coordinate and

¹¹ Quoted in Cotula–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”.

regulate, under the direct supervision of the Prime minister, 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 (Banca d’Italia, 1938; Assonime, 1940; Raitano, 1995).

Table 2: Reserves of the Bank of Italy and Reserve Ratios (million of lira)

Years	Reserves in gold	Foreign exchange	Total	Coverage ratio (%)
1927	4,547.1	7,558.8	12,105.9	55.5
1928	5,051.9	6,018.9	11,070.8	55.8
1929	5,190.1	5,151.2	10,341.3	55.1
1930	5,296.8	4,327.5	9,624.3	53.2
1931	5,626.3	2,170.2	7,796.5	47.6
1932	5,839.5	1,304.5	7,144.0	46.7
1933	7,091.7	305.0	7,396.7	49.9
1934	5,811.5	71.7	5,883.2	41.2
1935	3,027.2	367.4	3,394.6	19.5
1936a	2,338.5	37.1	2,375.6	x
1936b	3,958.8	62.8	4,021.6	22.4

Note: 1936a: lira 1927; 1936b: lira 1936, after devaluation.

Source: Banca d’Italia, Relazioni del Governatore, Tipografia della Banca d’Italia, Roma, 1927–1937.

In the years 1935 and 1936, these measures were confirmed and even reinforced in the face of an international policy decision whose ultimate result was 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 meant at first a considerable increase in public expenditure and in internal demand which led to a considerable reduction of unemployment, whilst the reserves of the Bank of Italy were subjected to a further 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 to 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, it was transformed into a Ministry. Exchange rate control, writes Paolo Baffi, “became one of the main tools in the mobilisation

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 mentioned, starting from 1934/35, the government also introduced severe limitations on import (in the form of licenses, quotas etc.). Similarly to other countries, furthermore, it increasingly utilized bilateral clearing agreements as a device for circumventing the restrictive effects on international trade of quotas and exchange rate controls. The technique was 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, again in local currency, the exporters (Assonime, 1942; Renzi, 1943). A key aspect was the choice of the exchange rate to be used in computing the value of trade in each country.). The first agreements were stipulated by the Italian authorities in 1932 and included countries which 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 a limited one: to defreeze the credits accumulated in the 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 that with Germany. Already at the end of the nineteenth century this country was a key trading partner for Italy, providing 12,2% of the latter’s total import and absorbing 16% of total export; Italy, on the contrary, played only a secondary role for Germany (the data are in this case 3,2 and 2,5 respectively; Tattara, 1991, p. 461). Furthermore, the trade balance was mainly against Italy¹². On October 1934, two years after the initial agreement mentioned earlier, a new and more comprehensive agreement was signed by the representatives of the two countries. 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 the 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 became quickly by large the most important export and import market for Italy. In the years from 1935 to 1939 it

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 part 3.

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, conversely, Italy continued to play only 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 could ensue (Demaria, 1939; Assonime, 1942; Tattara, 1991). Indeed, after 1936/37, Germany, whose economy was the strongest in continental Europe, managed successfully 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 balances 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 order to help the Italian exporters who otherwise had to wait several months before getting their payments, INCE was authorized to emit warrants for the amounts due which could circulate as credit instruments. Therefore the principle of "immediate payment" (financing principle) was introduced, which had positive effects on internal economic conditions.

On 5 October 1936, following the collapse of the Gold bloc, the government devalued the lira by 40,93%, the same percentage adopted in 1933 by the US authorities. As a result, export increased substantially relaxing, albeit only in the short run, Italy's external constraint (Pavanelli, 1990). To check inflation some measures were adopted to put under control prices and rents and a 15% duty on import, introduced in 1931, was abolished.

Any hope of restoring the 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.

From a macroeconomic point of view, 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

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.

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. Under the Treaty of Neuilly, Bulgaria had to pay a huge foreign debt and above all reparations which came to a quarter of the national income¹⁵.

Inflation (“expensiveness” – the term used by the Bulgarian economists at that time to describe price increases) was very high and also devalued the national currency. 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). The stages of Bulgarian stabilisation followed the stabilisation processes in other countries logically and chronologically, featuring the peculiarities of the periphery and of developing countries in general (for details, see Koszul, 1932 and Ivanov, 2001). 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 controls and restrictions¹⁶. The Foreign Currency, Foreign Currency Receivables and Credit Trading Act was enacted on 12 December 1918. A week later, on 19 December, the Foreign Exchange Institute (*Kambialen institut*) was established with the main purpose of concentrating foreign currency inflows into the country and smoothing the very volatile exchange rate. The *Kambialen institut* having failed to improve the foreign exchange market (the exchange rate was subject to speculation and induced overall economic uncertainty), new exchange controls were put into practice. On 12 December 1923 the Foreign Exchange Act gave the BNB a foreign exchange monopoly. The foreign exchange market in Sofia closed and all bids and offers were directed at the BNB. The direct reason for this early form of exchange control was the depletion of foreign reserves, mostly denominated in Reichsmarks, by German hyperinflation in 1923.

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 exchange controls in Bulgaria is provided by Ivanov, 2001, chapter 2.

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.

New measures enforcing the exchange control¹⁷ were introduced in May 1924, logically related with the *de facto* stabilisation of the Bulgarian lev. A 1926 law fixed the exchange rate at 139 leva to the U.S. dollar (the BNB bought a dollar for 137.20 leva¹⁸) and banknote cover was set at a third. In this case, exchange control genuinely fostered stabilisation which demanded foreign reserves (obtained in the form of a League of Nations' Stabilisation Loan) and balanced public finances with customs revenue a major item. A law of 22 November 1928 designated the BNB an independent monetary institution in the spirit of the international agreements.

Direct exchange market control invariably accompanied manipulation of the other two basic macro markets: imports and exports. Thus followed the 1928 Wine Export Promotion Act, the 1932 Grape Export Promotion Act and the 1935 Meat Export Promotion Act. In 1931, an Export Institute was set up, transformed in 1940 into the Foreign Trade Institute (*Institut za vunshna turgovia*)¹⁹. Alongside export encouragement, import restrictions were more often and more effectively used. It is interesting to point out that customs tariffs between 1918 and 1930 always involved administrative exchange rate manipulations. The customs exchange coefficient (the rate at which paper leva were converted into gold leva for the purposes of customs duties) was significantly different from the market rate. According to Toshev government managed to increase tariffs by 80% over just two years (1926 and 1927) through such manipulation.

¹⁷ A sharp speculative doubling of the lev was recorded in June (Nenovsky, 2006) which hit Bulgarian tobacco sales abroad. Two type of lev were introduced – home and foreign – with the home lev becoming foreign (and usable to pay for imports) only with BNB leave. This dual national currency was not a Bulgarian invention as can be seen from the example of Romania (Royal Institute of International Affairs, 1933, p.115).

¹⁸ 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.

¹⁹ In 1930 the Hranoiznos (Food export agency) was established and vested 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).

Table 3: Bulgaria: Customs (Import) Coefficients and Official Exchange Rate of the Paper Lev (1918–1930)

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 (1943, p. 67).

Exchange premia, introduced for a limited number of private deals in 1933 and broadening considerably by 1935, acted in the same direction of depreciating the lev, ‘circumventing the fixed exchange rate,’ loosening deflation, and enhancing the inflow of convertible gold exchange. By performing a ‘market-determined’ depreciation of the official BNB rate, exchange premia gave exporters the stimulus to export more at lower prices²⁰ (see box 1).

Box 1: Import Tariffs, Exchange Rate Premia and the Real Exchange Rate

Let us consider trade and exchange controls together, taking into account import tariffs and currency premia. If t is the tariff and φ is the currency premium (usually $\varphi \geq 0$, but it could be $\varphi < 0$, in the case of the Sperrmark in the Bulgarian private compensation market after 1935, for example), and considering the tariff as an addition to the foreign price level P^* (P is domestic price level), and the currency premium as an addition to the nominal exchange rate level e , the well-known formula for the real exchange rate e_r becomes:

$$e_r = \frac{e(1 + \varphi) / P}{1 / P^* (1 + t)} = \frac{eP^* (1 + \varphi)(1 + t)}{P}$$

The condition for real depreciation of the national currency (competitiveness gain) is:

$$(1 + \varphi)(1 + t) > 1 \quad \text{or} \quad t > \frac{-\varphi}{1 + \varphi}.$$

²⁰ Christophoroff (1939, 1947) provides a thorough description of the mechanism and role of the exchange premia. At the beginning they differed across currencies which put them closer to Ellis’ definition of multiple exchange rates as an exchange control instrument.

Returning to the international scene, efforts at monetary and financial stabilisation quickly yielded to the Great Depression which started in the USA and quickly reached Europe (first Austria, then Hungary, Germany and other countries). At that time countries used independent strategies to adapt to the crisis (Eichengreen, 1997, [1996]; Eichengreen and Sachs, 1985)²¹. Three blocks were formed: i) countries devaluating their currencies (United Kingdom (1931), the USA (1933), and Greece (1932)²²; ii) countries maintaining the gold standard, with France in the lead, and conducting strict deflationary policy to limit wages and prices 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 Conference²³. It is our general assumption that the reasons for Bulgaria's introducing exchange control and opposing devaluation and deflation²⁴ were as set out below:

First, 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)²⁵. 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 quite such exacerbated circumstances as ours these past fifty years, yet one which can boast that it has ever occupied the position of an exemplary payer to its foreign creditors" (BNB, 2001, p. 135).

With respect to structure, Bulgaria's debt was denominated in gold backed leva and was mostly owed to non-devaluing countries²⁶. According to the Royal Institute of International Affairs (RIIA), "in Bulgaria it is almost certain that the

²¹ Many Bulgarian authors speak of a *collapse* of the world economy (Svrakoff, 1941, [1936], p. 310). A similar overview of the mechanisms of adaptation is given by Einzig: "Countries who do not resort to inflation ...do not put themselves in a position where it might appear advisable to have recourse to those measures comprised under the term Foreign Exchange Control" (Einzig, 1934, p. 9).

²² In late 1931, 16 countries preserved the gold standard, 12 had currency parity, and another 11 kept gold parity by restrictions on trading foreign exchange (Svrakoff, 1941, [1936], p. 312).

²³ In 1926, however, there was a partial reduction of restrictions. In spite of much comment on the decrease of trade and exchange restrictions, the Andrey Lyapchev government did not have the political will to act.

²⁴ Christophoroff also points out that exchange control is a way of "fighting deflation" (Christophoroff, 1939, p.12)

²⁵ Bulgaria continued to pay reparations in 1933.

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

transfer question has predominated” (1936, p.98) and the purpose of maintaining the currency on a gold basis “has presumably been to avoid an increase in the costs of the foreign debt service” (RIIA, 1936, p.129). Even before reparation payments began in October 1923, foreign debt service reached the amount of 112 million gold francs in 1918 to 1922: 16.3% of budget expenditure. Reparations under the 27 November 1919 Treaty of Neuilly were added to this, coming to 2,250 million gold francs at 5% annual interest over 37 years, plus occupation expenses. This represented a quarter of the national wealth. Sterling devaluation offered some relief to Bulgaria since its debt was predominantly in pounds. Debt service now accounted for 11% of budget expenditure; there was no great BNB asset loss since a comparably small amount of assets was denominated in Sterling (the Royal Institute of International Affairs, 1936). Summarising the opinions of many economists at the time, a hypothetical devaluation would certainly increase national debt burden, while any possible advantages would be marginal (Sarailiev, 1937, p. 27).

Second, the balance of payments constraints were particularly tight, and not only as regards foreign debt service. The prices of agricultural products, which accounted for the major part of Bulgarian exports²⁷, fell sharply on international markets and aggravated terms of trade. The September 1932 Stresa Conference which focused on possible assistance to Southern European countries (a major part of the so-called Agrarian Bloc) noted that the price drop reached 70% (Bonnet, 1933, p.21). A fund concentrating revenue from the sale of agricultural products to developed countries was proposed to be used as partial debt service (the United Kingdom vetoed it).

Third, systematic exchange control could be interpreted as a defence against restrictions introduced by Bulgaria’s trading partners. The farming price drop was combined with a number of restrictions on the import of agrarian products to Germany and France with a view to protecting indigenous farmers through economic and political means (Raupach, 1969). Turkey, an important 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.

The fourth and direct cause of exchange control was the intensification of capital outflow from Bulgaria at the end of 1931. This followed the collapse of the fragile monetary and financial stabilisation of the late 1920s and Sterling devaluation. In addition to this global imbalance, Boshulkov (1927) provides a list of long-term domestic factors like the purge and confiscation of capital claimed to be illegally accumulated during the Wars, and political instability, which certainly contributed to decrease Bulgarian capital accumulation and foreign reserves.

²⁷ Romania faces similar problems: Madgearu (1939). For an overview of the economic situation for the Balkans in 1930s, see Royal Institute of International Affairs (1936).

Table 4: Selected Bulgarian Macroeconomic Indicators, 1927–1939

Years	Total reserves (mill of leva)	Coverage ratio (%)	Trade balance (mill of leva)	Budget balance (mill of leva) ¹	Years
1927	13,078	28.3	489		
1928	12,897	31.2	-810	347	1928/9
1929	8,984	42.2	-1,928	185	1929/30
1930	9,249	37	1,601	1143	1930/1
1931	8,620	36.6	1,274	-891	1931/2
1932	7,519	35.8	-88	-746	1932/3
1933	7,442	36	644	-233	1933/4
1934	7,278	35.3	287	-246	1934 (9 months)
1935	6,549	34.4	244	-278	1935
1936	7,158	33.8	729	283	1936
1937	8,196	31.9	34	642	1937
1938	8,250	31.8	644	510	1938
1939	11,677	29.9	868		

Note: ¹ Christophoroff (1939), p. 139.

Source: Statistical Yearbooks of the Kingdom of Bulgaria, (1934, 1937, 1941).

Systematic exchange control came into force in Bulgaria²⁸ with the 15 October 1931 Foreign Exchange Trading Act and BNB Ordinance No. 1 of 20 October²⁹. 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 imports. Lists of luxuries whose import was limited began to be compiled and amended. To keep foreign capital in Bulgaria and halt depletion of foreign reserves, the BNB raised interest rates, in 1933 imposing further import restrictions. As other countries (including major trade partners Greece and Turkey) imposed exchange and trade constraints, the only reasonable way of letting foreign trade ‘go on’ was through bilateral clearing and even officially conducted barter (Ellis, 1947)³⁰. In a sense, exchange control was *unilateral*, while clearing – an instrument to overcome the disadvantages of exchange control – was *bilateral* with

²⁸ In June 1931 the Narodni Blok government came into office after the Demokratischen Sgovor.

²⁹ Also followed by Ordinance 4.

³⁰ A similar *going on* argument is stressed by Jacque Rueff (1966, p. 79).

some prospects of becoming *multilateral*³¹. Thus clearing followed exchange control as the latter inevitably hampered international finance and trade.

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 soon became widespread and according to Michaely (1962) and Friedman (1976) occupied two thirds of trade turnover in the Thirties. Benham (1939) and Neal (1979) argue that Bulgaria, together with Hungary, was the country which used 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 the last position, this time in the context of the Eastern bloc³².

Many authors like Friedman (1976, p. 117) shared the opinion that Germany was the logical clearing and bilateral partner for Central and Southern European countries (table 4) as a natural reaction against British and French tariff and non-tariff restrictions under which trade with Bulgaria was bound with foreign debt service³³. Moreover, Britain and France did not extend credit lines as did Germany and did not have similar markets and domestic demand. It was natural for the contraction of trade with France and Britain to be compensated partially 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. At first glance, the country with a stronger or appreciating currency loses out by accumulating positive clearing balances which cannot be settled (for details see Neal, 1979) and thus attempts to increase trade outside clearing agreements.

The difficulties of clearing and the need for more flexibility prompted the appearance of a new institutional form of international trade: bilateral private trading with exchange rate premia; in 1933 compensation offices were established at chambers of trade. Bilateral private compensations were paid directly to importers in their national currencies.

³¹ This Nazi wartime project (1940–1942) was never put systematically into practice. In the case of Bulgaria trilateral agreements were used more after 1935 (see Christophoroff, 1939, p. 36).

³² Christophoroff (1939) provides his own calculations of this indicator.

³³ See for example the Royal Institute of International Affairs (1936, p.131). Heinrich Hunke, chairman of the Council for German Economic Encouragement underlined the differences between French/British and German Southern European policy in a 1942 Sofia speech which stated that trading with Germany had saved Southern Europe and the Balkans (Hunke, 1942, p. 16–17).

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

Source: Christophoroff (1939, p. 46., p.48).

Studying the clearing mechanism in more technical detail, however, reveals two forms of payment. The first implies that the foreign bank (the BNB in this case, providing there was a clearing surplus for Bulgaria) had Reichsmarks (Sperrmarks) at its disposal and paid to the importer in leva (*i. e.*, it bought Reichsmarks, called ‘blocked marks’), thus increasing Bulgarian money supply and income and hence driving up import demand. In this case the BNB supported the Reichsmark by not allowing it to depreciate. The clearing foreign exchange obtained from clearing here was on the asset side of BNB books. This was *the principle of immediate payment*.

The second form, described as the *principle of delayed payment* implied that Bulgarian exporters waited for the sale of German goods and then bought Reichsmarks with their blocked leva³⁴. In this case the BNB refused to buy blocked marks until they had been requested by importers of German goods. Until such request the Reichsmark depreciated on the Bulgarian market. In this case the holding of blocked Reichsmarks did not create money, being off-balance sheet.

According to the literature dedicated to the subject, the principle of immediate payment was advantageous to depressed Southern Europe 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 under the principle of immediate payment, the stronger the expansionary effect for Central and South European central banks. Thus Hungary, which adhered to the principle of immediate payment, experienced economic growth and an improving balance of trade. Romania, in contrast,

³⁴ For more details see Lindert and Kindleberger (1983, [1982]) and Kindleberger (1988, [1973]). Sometimes the two methods are termed the financing and waiting principles.

exercised the principle of delayed payment which impacted its economic development (Neal, 1979)³⁵. Bulgaria, as Hungary, applied the principle of immediate payment in clearing, and the effects on money supply expansion can be studied in balance sheet data (table 6). The increasing value of Other Foreign Currencies on the asset side of BNB books closely followed receipts of non-gold bloc foreign exchange from clearing and other agreements (BNB, 1999). The growth of this item was much faster after 1938 when huge positive balances in German clearing were recorded.

Table 6: BNB Balance Sheets 1928–1938 (Leva Millions)

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 (article 10 of BNB Law)	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: ¹ Gold and silver holdings including coins. ² Domestic credit comprises receivables from government, banks, commercial paper, and effects. ³ Property and other assets. ⁴ Demand, time and other deposits by government and banks. ⁵ Liabilities in gold and other foreign currencies.

Source: Original balance sheet data from BNB (1999) *120 Years Bulgarian National Bank*, p. 130.

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 apparent much earlier in Germany and Italy which in the late 1930s subordinated foreign trade to war needs. The final point in the relationships with Bulgaria for instance (and before that with Romania) was the 1940 clearing agreement (the BNB did not participate in negotiations because of its specific position) which was extremely slanted in favour of Germany (the Reichsmark rate was unfavourable, for one thing) allowing it to transfer resources from Bulgaria.

³⁵ As mentioned above, Italy later altered the delayed payment principle by immediate payment.

Since 1934, Bulgaria had scored positive clearing balances which were not covered either by import of machines and goods, nor by capital inflow from Germany. In principle Bulgaria exported agricultural products and imported commodities and industrial materials (table 7)³⁶.

Table 7: Share of Good Categories in Total Import (%)

Goods' categories	1921	1923	1927	1929	1931	1933	1935	1936
Commodities and raw materials (incl. fuels)	38.5	50.2	54.3	56.4	58.9	70.2	63.4	63.8
Final manufactured goods	59.6	48.1	43.3	41.1	39.2	28	34.9	34.4
Food and drinks	1.9	1.7	2.4	2.5	1.9	1.8	1.7	1.8

Source: Toshev (1943, p. 90).

In Bulgaria, as elsewhere, exchange control performed another function alongside monetary and financial stabilisation and balance of payments restrictions³⁷. 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 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 (thus the BNB argued in favour of importing commodities and materials rather than machines because the former were cheaper; BNB, 2004, p. 91), the necessity of protecting indigenous industry and cutting unemployment in time moved to the fore³⁸. 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

³⁶ Some economists criticise increased dependence on imported materials.

³⁷ Ellis (1947) describes the purposes (domestic and external) and instruments of exchange control in detail.

³⁸ 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).

domestic production hampered competition and led to the rise of monopolistic domestic industries³⁹. 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 BNB exchange rate policy" (Toshev, 1943, p. 85).

As a result of exchange control maintained throughout the Thirties, and of intensified trade with Germany, the lev rate appreciated gradually during the 1930s reaching 18.5% in 1937 in nominal effective terms with respect to the base year 1929 (Ivanov *et al.*, 2007) (chart 2)⁴⁰. The nominal effective exchange rate (NEER) calculated with exchange rate premia illustrates the path of an alternative devaluation or the market determined path of exchange rate development. Bulgarian exporters however, faced stimulating development of the real effective exchange rate which starts to devalue since 1930 due to the diverging inflation differential of the lower price level in Bulgaria with respect to the weighted price level of its main trading partners. Nevertheless, Bulgaria was unable to benefit from this competitive position due to universal foreign trade restrictions. 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 1939⁴¹ had a smaller real effect (5.7%) and a very marginal effect on total exports⁴² development, if any.

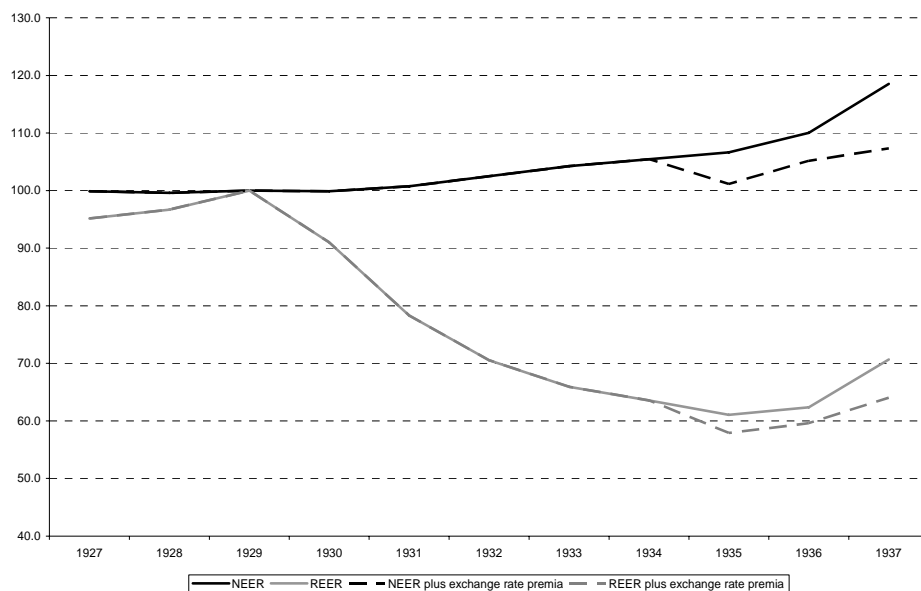
³⁹ It is often said that increasing discrepancy between industrial and agricultural development translate into price scissors, different income levels, and hence wealth redistribution.

⁴⁰ Interestingly, arbitration calculations (across the Romanian leu) of Christophoroff generated some 20% appreciation of the Reichsmark against the Bulgarian lev after 1934, *i.e.* a mark was worth 25 leva while the official exchange rate was 33 leva (Christophoroff, 1939, p. 20).

⁴¹ Data available in the Statistical Yearbooks of the Kingdom of Bulgaria.

⁴² As a result general and particularly exchange restrictions became a focus of conflict between interest groups (industrialists, merchants, farmers). The course of the debate shows that little attention was paid to consumers. Simple evidence of this is the lists of goods subject to import restrictions, among which cobbling leather, sugar, cotton, wool, and others of definite interest to consumers. Charles Kindleberger (see textbook by Lindert and Kindleberger, 1983 [1982]), develops the idea of the redistributing effect of trade and exchange restrictions in detail.

Chart 2: *Effective Exchange Rates of the Bulgarian Lev (Index 1929=100)*



Source: Authors' estimates. For more details see Ivanov et al., 2007.

4. Theoretical Reflections and Discussion: the Macroeconomics of Exchange Control

Before proceeding with the analysis, it is important to point out that the theoretically postulated relationships we study are questionable in themselves due to the complexity of exchange controls. 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 (estimates of centrally planned economies are similarly inconclusive). The complexity of exchange controls requires simplification; therefore the reasoning below addresses 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.

Before 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 pointed out, despite attempts to restore the pre-war situation, during the 1920s many European countries had severe current account and budget deficits and followed diverging political and economic objectives, independently or within a bloc. Under these new circumstances, exchange control can be interpreted as an example of the new economic paradigm which attributed an active role to government in the economy. We should remind the reader that before the War governments' and central banks' discretionary powers with respect to the exchange rate were rather limited and used under set extreme conditions, like wars.

Exchange control in Bulgaria and Italy, as well as in countries like Germany, Austria, and Hungary, was a specific alternative both to devaluation and to deflation, which for various reasons were much more economically and politically costly. In this context exchange control was a form of isolationism which protected domestic capital markets from international capital flows. Devaluation was unacceptable to countries which had experienced inflation and 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 preserve their reputation as good payers but most probably also tried to extract maximum profit from their appreciated currencies. As currencies in which foreign liabilities were denominated (the pound Sterling, dollar, and French or Swiss franc) devalued, they decreased debt burden directly by automatic recalculation of foreign liabilities⁴³. Debtor nations wanted to preserve their reputation as good payers (Bulgaria) or among the electorate (Italy).

The balance of payments constraint was of course more binding in Bulgaria than in Italy. In Bulgaria the burden of foreign debt and the constraint of weak foreign reserves⁴⁴ were more intense⁴⁵. Its government, therefore, had to introduce

⁴³ In Heuser (1939, p. 26–27) “Although in general import restrictions are determined by necessity to defend the stabilized national currencies, the reasons slightly differ between debtor and creditor countries. 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”.

⁴⁴ According to Royal Institute of International Affairs Bulgaria was the country with the most extreme lack of capital and investment in Europe (Royal Institute of International Affairs 1936, p. 120).

⁴⁵ The choice of exchange control methods depended on other factors like contracts, political, and purely ideological reasons (Heuser, 1939, p. 48).

foreign exchange restrictions considerably earlier⁴⁶ and stabilized the lev administratively: an early form of exchange control.

There is no doubt that the basic question is, to what extent exchange control as a form of government interference helps or harms macroeconomic stability and economic growth⁴⁷. Before answering it, however, let us first address some technical details of the exchange control mechanism which would help us to explain the main macroeconomic interrelations, 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, trade control, involves indirect influence on the forex market through the basic markets determining foreign currency supply and demand, *i. e.* 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 currencies⁴⁸. 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 that 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 run 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 effects⁴⁹.

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

⁴⁶ 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."

⁴⁷ Ellis (1940) provides an interesting exposition of exchange control theory and macroeconomic consequences.

⁴⁸ 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 (Kulich, 2002, [1929] and Kindleberger, 1988, [1973]). Diminishing foreign reserves threaten stabilised national currencies and regular foreign debt service. Consequently, trade difficulties lead to the evolution of exchange controls from unilateral to bilateral clearing and on to private exchange barter and exchange premium (in the case of Bulgaria in 1935) in order to direct trade towards free currency countries.

⁴⁹ See international trade textbooks (for example Vanek, 1962; Lindert and Kindleberger, 1983, [1982]).

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 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 export. 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 a 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. We shall take the example of Interwar Bulgaria and try to narrow things down to the role of clearing with Germany in the development of the Bulgarian economy after 1932⁵⁰. 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 exploitation.

Here we would like to remind the reader the scheme of clearing (chart 2) which we discussed in section 2 (the immediate payment or financing principle, and the delayed payment or waiting principle). G stands for the German central bank, B is the BNB, X_B is Bulgarian export to Germany, X_G is German export to Bulgaria or Bulgarian import from Germany, and M is additional monetary flow created by the Bulgarian central bank due to the clearing surplus (in our case 90). In the case of immediate payment (the financing principle) applied in Bulgaria (the same as in Hungary and later in Italy) as a result of the positive clearing surplus [X_B (100) > X_G (10)], domestic money supply automatically expands (the clearing surplus is multiplied by the clearing exchange rate (assumed at unity⁵¹).

Under this financing principle the central bank bought the receivables from its exporters at the fixed clearing exchange rate. Under the other postponed payments principle (as employed in Romania)⁵² the central bank waited for the counterparty to settle the clearing balance, hence the positive surplus was not immediately

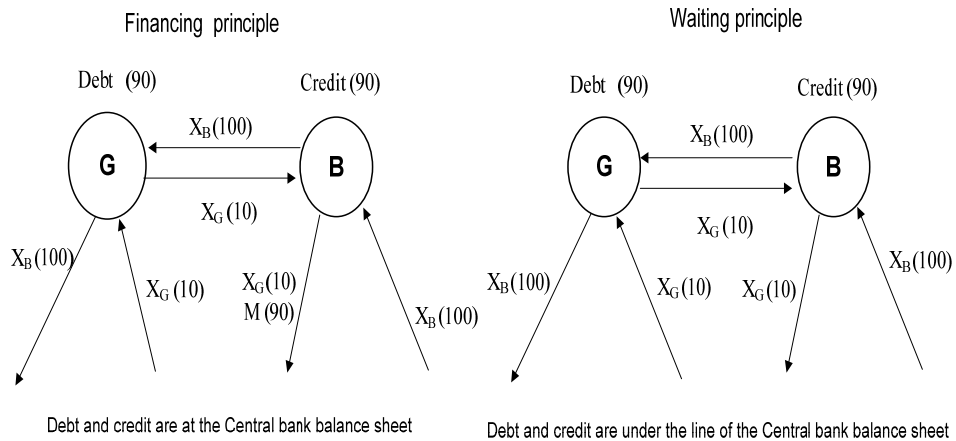
⁵⁰ Details about the interrelations between the dynamics of the Bulgarian and German economies see Christophoroff (1939) and also Fisher (1939, p. 154).

⁵¹ In the real Bulgarian case the rate was 1RM = 33 leva).

⁵² See for instance Neal (1979).

monetised and there was no monetary expansion at home. In the first case, the positive surplus appeared as debt/credit respectively on the books of the German central bank and the BNB. In the second case there was no additional monetary creation and the clearing debt/credit position was not on the books but below the line (off-balance sheet). In this waiting principle the clearing surplus (90) had a depreciating effect on the mark (as mentioned by Larry Neal)⁵³.

Chart 3: Two Methods of Clearing



First, we note that clearing substantially impacted money supply and price levels. As noted above, due to the specific method of clearing with Germany (in contrast with, say, Romania)⁵⁴, Bulgaria maintained a flat clearing rate of 33 leva to the mark. 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 positive features given the fact that the 1930s deflation had severely hurt agriculture⁵⁵. This expansion through the

⁵³ In this case we could assume the clearing rate to move from 1 to around 0.1, *ceteris paribus*.

⁵⁴ Romania tried several times to renegotiate its clearing rate with Germany.

⁵⁵ Interestingly, in the financing principle adjustments are realised by price levels, whereas in the delay principle by the fluctuating Sperrmark rate. Thus in Bulgaria domestic price rises due to monetary expansion cut Bulgarian competitiveness in Germany, *i. e.* they reduced mark appreciation. In Romania there were no price rises but the Sperrmark depreciated in the Romanian market. When the waiting period ended the Sperrmark rose

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 strict deflationary policy and the introduction of exchange premia in mid-1933.

The actual development of the Bulgarian cycle (see Christophoroff, 1939) confirms the above logic of exchange control development. In a comparative perspective, Larry Neal (1979)⁵⁶ argues that the different methods of payment explain higher Hungarian growth in contrast with the difficulties faced by Romania. Paul Einzig (1955) describes the different mechanisms by which Germany first exported inflation to Southeastern Europe and then pursued deflation at home. Germany accumulated positive clearing balances and used the financing principle nations (Bulgaria and Hungary) to finance German economy by inflation or devaluation. Therefore it was against the German interest to introduce the mark into Southeastern Europe as this would deny it the inflation/devaluation levers. (Interesting parallels could be drawn with the present refusal of older eurozone countries to put the euro into circulation in new accession states.)

Second, we note that exchange control in clearing influenced the real exchange rate and overall national terms of trade. Despite 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 for Southern Europe (*i. e.*, the ratio of export prices to import prices fell). This is supported by the overvaluation of the Reichsmark in clearing exchange rates⁵⁷. Under these circumstances immediate payment and hence money expansion in clearing creditor countries (*e. g.* Bulgaria) postponed real Reichsmark appreciation against the lev and boosted lev appreciation against the Reichsmark. In a sense, this was a compensating

to approach its previous level. We could also assume that the financing principle affected Bulgarian competitiveness not only in Germany but also elsewhere, prompting exchange premia to stimulate trade with free currency countries. Neal (1979, p. 400) saw financing principle countries as being politically closer to Germany.

⁵⁶ 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.

⁵⁷ The problem of the overvalued Reichsmark was solved by private clearing agreements within Germany through the flexible exchange rate of the ASKI marks and through the mechanism of Sperrmarks (see Neal, 1979).

mechanism in the context of trade flows between Bulgaria and Germany given the fact that both sides opposed devaluation⁵⁸.

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. Importantly, exchange control was also significant for national industrial development which falls outside the scope of this paper.

Third, we note that 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 (more for Bulgaria than Italy) but also by the considerable increase of public expenditures later in the decade in preparation for war (more for Italy than for Bulgaria). Mussolini's ambitious imperialism has been studied at length (cf. among others De Felice, 1981; Miller and Kagan, 1997); 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 note interesting parallels between the 1930s and today's Italian and Bulgarian economies and that of the European Union.

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 shows exchange control as an organic element of the closed economy. At the beginning it was viewed as an alternative to

⁵⁸ It is interesting to note that the main principles of proposed clearing system as a general form of building the international financial relations is later on again put forward by Keynes (even if not explicitly stressed by him) as a part of his plan for reforming the international financial system after the Second World War (Dam, 1982, Triffin, 1969, [1968]). In his plan Keynes explicitly shares his conviction that a balancing mechanism is feasible in the frameworks of a global clearing, and his wish for this mechanism to be relatively symmetric (in contrast to the Gold standard). This means part of the burden to be spread among the creditor. In a sense, Keynes proposal is confirmed that the exchange control is a weapon used by debtors, regardless of whether they are producers, consumers or whole countries.

devaluation and deflation and a way of overcoming the balance of payments constraint; in time it became an instrument for mobilising war resources. In this aspect 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 (theoretically), 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 scale. By adopting the common currency Italy cannot any longer improve its competitiveness through devaluation, while the currency board in Bulgaria (which is not a euro area member yet) commits it to low inflation and restrictive fiscal policy. Today as in the Interwar, 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 were also unlikely at the beginning of the twentieth century.⁵⁹

5. Conclusions

We can summarise the main results of our study: first, the 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 symbolised 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 farming prices, 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 laboured under 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 at the head), 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

⁵⁹ See Fromkin (2004), Frieden (2006).

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 with respect 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 chapter of this complex story.

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