

# Exchange rate control in Italy and Bulgaria in the interwar period. History and Perspectives\*

Nikolay Nenovsky  
Bulgarian National Bank, University of Orleans, ICER

Giovani Pavanelli  
Department of Economics "G. Prato" University of Torino

Kalina Dimitrova  
Bulgarian National Bank, Sofia University "St. Kl. Ohridski"

"Il mio sentimento d'amicizia per la Bulgaria è costante, sincero, disinteressato. Questo sentimento è condiviso dalla totalità del popolo italiano. Credo fermamente nell'avvenire politico, economico e morale della Bulgaria. Essa ha il suo compito nei Balcani", Mussolini, B. in Scipocovsky, M., (1927, p.1)

## 1. Introduction

On the 6 of September 1937 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 Law for foreign exchange trade in 1933 and they did it with the knowledge and assistance of the Italian ambassador in Sofia. Camilo Vacaro brought certain amounts of money in Bulgarian currency to the Embassy against which the Ambassador gave him checks denominated in foreign currencies and those checks were sent to Italy by the delegation itself. The Governor asks the Minister of Finance to discuss this delicate affair at the Council of Ministers before BNB Governor brings it to trial for Foreign Exchange Law violation (BNB, 2004, No. 297). The background of this historical detail connecting Italy and Bulgaria<sup>1</sup> is an entire period of restrictions on the trade and foreign currency exchange between the two world wars, in which Bulgaria and Italy are active protagonists (Bulgaria and Italy are allies in WWII and economically belong to the so called clearing block).

The history of the exchange control in Europe in the interwar period provides us with interesting insights of the current development of the European monetary union and of the perspectives of its enlargement, where the exchange rate and monetary regime have a central role. Like in the past, in a different historical context and in different forms of course, Europe today could be also divided into centre, semi-periphery and periphery or, in other words, groups of countries at different stages of economic development. Therefore, we find it challenging to compare the evolution of exchange control (an exchange rate regime) in two countries which were of course characterized by

---

\* A previous version of this paper was presented at the Second Conference of Southeast Europe Monetary History Network (SEEMHN), Vienna, April 2007. We are grateful to Rumen Avramov, Martin Ivanov, Luca Einaudi, Peter Bernholz and Atanas Leonidov for helpful comments and suggestion. The usual disclaimer applies.

<sup>1</sup> In fact, this affair is a typical case of avoiding exchange rate restrictions. According to Charles Kindleberger the ways to circumvent the exchange control are either to bribe an employee at the central bank or to export money with the help of diplomatic representative offices or to involve in smuggling (Kindleberger, 1990, [1984], p. 531).

different economic conditions – Italy being a representative of the semi-periphery and Bulgaria of the peripheral and, at that time, underdeveloped Balkans – but which, as a matter of fact, were both external to the financial and industrial core of Europe.

The introduction of exchange control characterized the general tendency towards a collapse and differentiation of the international monetary system after WWI, which put an end to a period of almost 40 years of considerable economic and financial stability<sup>2</sup>. The world economy suddenly split into several blocks of countries characterized by different economic and monetary behavior. Two major attitudes towards economic policy confronted with each other – the first attitude was shared by people who thought that the return to old semi-automatic regulatory mechanisms of world economy was possible and indeed necessary (viewing the gold standard as an integral part of these mechanisms) and the second (opposite) attitude was supported by people who believed that a new era of economic relationships had come and new rules (in other words, an active governments' interference) were required. This was a time when the world economy was going through a transition process which was extremely unstable and ended with WWII. It led to the creation of the IMF and the World Bank which came to constitute a new type of supranational regulation of the world monetary system.

As predicted by several economists at that time, the exchange control turned out to be an extremely distorting and discriminating form of interference in the 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 blocks of countries managed to preserve their relative shares of world export and member countries of each block tried (and succeeded to some extent) to balance their foreign trade within the group, the division of several isolated blocks resulted in a contraction of the total amount of world trade.

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

	<b>1929</b>	<b>1931</b>	<b>1935</b>	<b>1937</b>
European exchange control countries	23.48	27.19	21.68	22.53
Gold bloc	14.53	15.86	13.41	12.08
Other countries	61.99	56.95	64.91	65.39
	100	100	100	100

*Source: League of Nations (1938).*

Michael Heilperin gives a definition of exchange control, which we can employ as a working definition: “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 about 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 not include them”, (Ellis, 1947, p. 877). Following Ellis, the main instruments of exchange control are: government monopoly of dealing in foreign exchange, government disposition over private holding of foreign exchange and assets, enforcement of an overvalued or undervalued rate of exchange, multiple exchange rates, government permission to export and to 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).

<sup>2</sup> See Fromkin (2004) for a general discussion on the WWI outbreak.

Various combinations of these instruments were implemented to achieve a mix of exchange control purposes either with respect to international economic matters (maintenance of appreciated or depreciated exchange rate, attainment of equilibrium in the balance of payments; trade “to go on” permission without available foreign exchange; securing more favorable “terms of trade”, controlling or enforcing capital movements, and economic welfare) and/or giving priorities to domestic economic issues (to control inflation and deflation; to increase domestic employment; to foster industrialization, etc, i.e. “protection”; to prepare for the war; to provide revenue for the state; and to discriminate favorably or unfavorably with respect to 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 30’s 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 (and in some countries hyperinflation) after WWI, the original motives for exchange control introduction were to defend a particular exchange rate as a measure to control inflation. This exchange control instrument however, did not contribute to the improvement of the balance of payment; therefore additional forms of interferences were put into practice like active measures of export encouragement and import restrictions.

Given the complexity of this topic, we will start with a descriptive approach, making a parallel chronology of events in Italy and Bulgaria supported by empirical facts. The purpose of this paper is to analyze the motives behind governments’ decision to introduce and maintain exchange control, the economic consequences of these measures, the techniques adopted and the chronological order of the events (Ellis, 1947). From a theoretical point of view, we study the exchange rate control in the context of economic and monetary isolation (autarchy). In order to describe the motivation behind the policy decisions adopted at that time we introduce some elements of institutional and political economy approaches wherever we find appropriate. Moreover, we take into account the macro influences of exchange control on real economy. The topic of the balance of payments constraint is considered as a main purpose of our investigations.

The structure of the paper is the following. In the first two sections we describe the history of exchange control in the interwar period in Italy and Bulgaria and illustrate it with data. In the third section, we propose some theoretical reflections and interpretations of exchange control. In the conclusion, we try to formulate some lessons from the exchange control in the 30’s and to draw a parallel with today.

## **I. Italy: Stabilization and Short-lived Exchange Control**

Measures aimed at regulating exchange rates had been introduced in Italy 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 rates 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 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 recapitulate briefly the events<sup>3</sup>. 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 by Italian army in Caporetto, in November 1917. In December the

---

<sup>3</sup> For a reconstruction of economic and institutional events in interwar Italy cf. Toniolo, 1980; Zamagni, 1993.

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. 276-9).

The postwar 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 movements<sup>4</sup>. On June 1921, however, the government decided to lift any restriction 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 budget deficit. Monetary policy, however, was too accommodating and as a consequence inflation increased, reaching 15% in the third quarter of 1925 (Fратиanni-Spinelli, 1997, p. 136). The balance of trade also worsened: nominal exchange rate in terms of dollars fell to 27.5. On 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 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, 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 “defense 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 system<sup>5</sup>. 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 (cf. Barucci, 1981; Bini, 1981; Cohen, 1972; Falco-Storaci, 1977; Marconi, 1982). It would appear that

---

<sup>4</sup> 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 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; cf. Ciocca-Ulizzi, 1991). In 1919 and in the first half of 1920, on the contrary, nominal depreciation was so fast that real exchange rate actually decreased signaling an increase of the competitiveness of Italy (cf. Cotula-Spaventa, 2003, p. 216)

<sup>5</sup> R. Decreto Legge 21/12/1927 n. 2325 “Per la cessazione del corso forzoso e convertibilità in oro dei biglietti della Banca d’Italia”.

political considerations were probably dominant. The middle class, who was the most important constituency of the regime, had been severely hit by postwar inflation and was strongly in favor 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 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-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)<sup>6</sup>. 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)<sup>7</sup>. 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 Bank of Italy, 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. 298-9).

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 US and UK Treasury as a consequence of the arrangements concerning the loans obtained during the war (cf. Hirschman, 1987 [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 import<sup>8</sup>. As a result, between December 1927 and December 1929 the reserves of the Bank of Italy 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 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 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 (figure 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, in 1931-33 trade deficit was lower, in nominal terms, than in the Twenties. 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

---

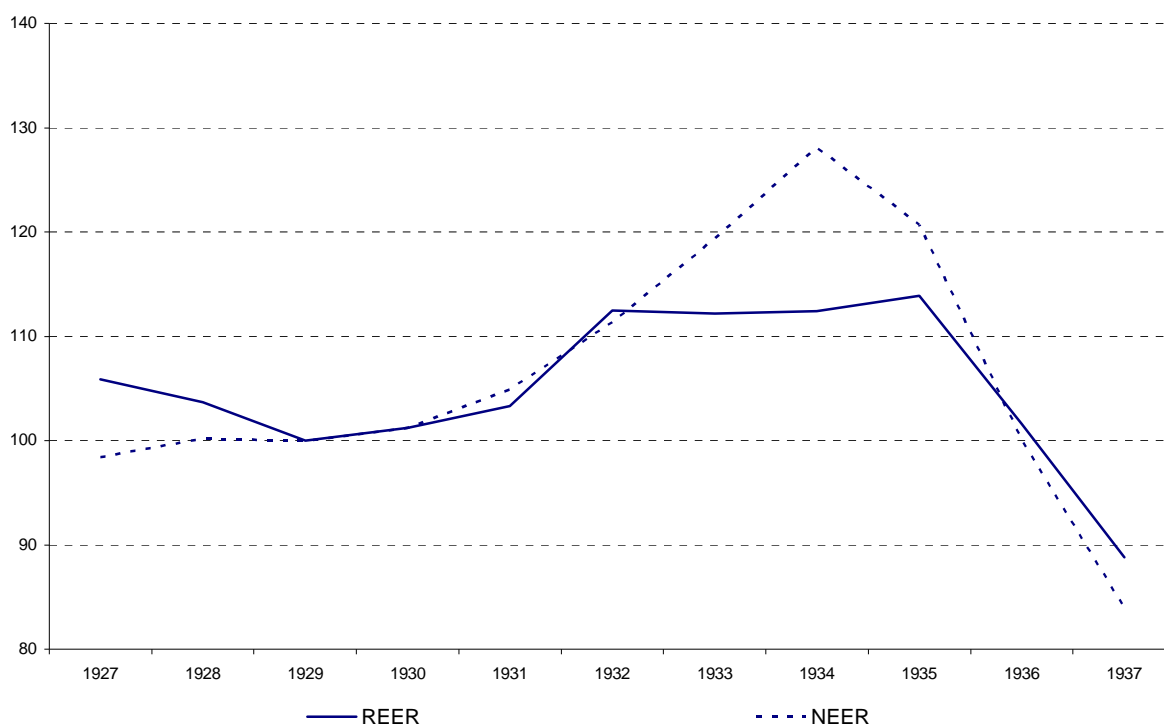
<sup>6</sup> This situation proved to be only temporary; in 1928, following a bad wheat harvest, trade deficit increased to 7.456 millions of lira.

<sup>7</sup> 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.

<sup>8</sup> Net export deficit amounted to 7.476 millions in 1928 and to 6.536 in 1929.

continued also in these years following adverse capital movements [cf. Table 1]. 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.<sup>9</sup>

Figure 1 Effective exchange rates of the Italian lira (index 1929=100)



Source: P. Ciocca, and A. Ulizzi (1990) (the rise of the index means appreciation, the fall means depreciation).

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”<sup>10</sup>. 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 Thirties 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 the Bank of Italy had to increase circulation in order to bail out some leading banks (among

<sup>9</sup> A positive side-effect of these adverse capital movements was that Italy’s external debt substantially decreased (see Banca d’Italia, 1938, p. 114).

<sup>10</sup> 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”.

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 [cfr. Table 1]. 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.

Table 1 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	
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.

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 traveling 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 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 (cf. Banca d'Italia, 1938; Assonime, 1940; Raitano, 1995).

In the years 1935-36 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 Twenties. 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 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 mentioned, starting from 1934-35, the government also introduced severe limitations on import (in the form of licences, 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 Thirties, 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; cf. Tattara, 1991, p. 461). Furthermore, the trade balance was mainly against Italy<sup>11</sup>. 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)<sup>12</sup>”: 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 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 materials<sup>13</sup>. 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

---

<sup>11</sup> “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).

<sup>12</sup> See part III.

<sup>13</sup> 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.



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 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 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 Thirties 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.

## II Bulgaria: Stabilization and Long-maintained Exchange Control

The Balkan wars and the WWI put a severe strain on Bulgarian economy and finance; as laid in the Treaty of Neuilly, Bulgaria had to pay a huge foreign debt (and above all reparations which represented  $\frac{1}{4}$  of the national income of the country)<sup>14</sup>. Inflation ("expensiveness" - the term used by the Bulgarian economists in this time) was very volatile as well as the devaluation of the national currency. The trade balance in the period 1919-1929 was at deficit with the exception of three years the surplus of which was by far not enough to compensate the negative balance in the rest of the period (Svrakov 1941, [1936], p. 300). The stages of the stabilization in Bulgaria follow logically and chronologically the stabilization process in other countries, with the peculiarities of the periphery and developing countries in general (for more details see Koszul, 1932, Ivanov, 2001). Like in others European countries the financial stabilization was conducted in the context of the orthodox monetary ideology according to which stable currency and balanced public finance are the basis of economic development.

Specifically, from its very beginning the stabilization in Bulgaria was accompanied with a number of exchange control forms and restrictions<sup>15</sup>. At the end of 1918 г. (12 of December) a Law was enacted on trade with foreign currencies, foreign currency receivables and credits and a week later (19 of December) the Foreign Exchange Institute (*Kambialen Institut*) was established with the main purpose to concentrate foreign currency inflows in the country and to smooth the high volatility of the exchange rate. After the Foreign Exchange Institute did not manage to improve the situation of the foreign exchange market (where the exchange rate exhibited high volatility in response to many speculations and induced overall economic uncertainty) new forms of exchange control were set into practice. On 12 of December 1923 BNB introduced foreign exchange monopoly by the virtue of the

---

<sup>14</sup> For extensive discussion on Bulgarian economic development during 20<sup>th</sup> century, see Avramov (2000).

<sup>15</sup> A detailed overview of the forms of foreign trade restrictions and exchange control in Bulgaria is provided by Ivanov (2001, chapter. 2).

Law on trade with foreign exchange. The foreign exchange market (forex market) in Sofia was closed and all buying and selling orders were sent to the BNB. A direct reason for this early form of exchange control was that the foreign reserves of the country were depleted by a great amount as a result of the hyperinflation in Germany in 1923 since most of them were denominated in Reichmarks.

In spite of the fact that in August 1925 Bulgaria signed new trade agreements and in 1926 it introduced more protectionist customs tariffs, the balance of payment and foreign currency balances did not improve. The problems with the conventional methods of import restriction and export enforcement were not efficient any longer, which imposes the gradual increase of the exchange control. New steps with view to enforce the exchange control<sup>16</sup> were introduced back in May 1924, logically related with the *de facto* stabilization of the Bulgarian Lev which was constituted in the Law in 1926 where the exchange rate was fixed at 139 Levs per 1 USD as the rate at which BNB bought 1 USD is 137.20 Levs<sup>17</sup>, and the banknotes coverage is set at 1/3). In this case, the exchange control really fostered the launch of the stabilization which demanded foreign reserves (part of which were obtained in the form of Stabilization Loan granted to Bulgaria by the League of Nations) and balanced public finance (in which customs revenues were a major item). On 22 of November 1928 a new Law on BNB was passed designating BNB with functions of an independent monetary institution in the spirit of the international agreements.

Of course, the measures of direct control on the forex market were always accompanied by measures to influence the other two basic macro markets – the import and export markets. For example, with respect to export in the beginning of 1928 there was a law on wine export encouragement, in 1932 grape export encouragement and in 1935 meat export encouragement etc. In 1931 an Export Institute was set up which later in 1940 was transformed into Foreign Trade Institute (*Institut za vanshna targovia*)<sup>18</sup>. In spite of the efforts exerted with respect to export encouragement, the restrictions on import were more often used and were more effective. It is interesting to point out that customs tariffs in that period (1918-1930) were always accompanied by administrative exchange rate manipulations. For instance, the customs exchange coefficient (the rate at which the paper lev was converted into gold backed lev since customs duties were collected in paper money and were announced in gold backed levs) was significantly different from the market exchange rate. According to Toshev by the means of these manipulations the government managed to increase the customs tariffs by 80% only for two years in the period 1926 – 1927.

Table3 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

<sup>16</sup> In June a sharp speculative appreciation of the Lev is recorded (around 200%), see Nenovsky (2006), which has a negative impact on the sales of Bulgarian tobacco abroad (it becomes more expensive when denominated in foreign currency). Two type of levs are introduced – external and internal as the internal levs can become external (to be used for import purposes) only with the permission of the BNB. The system of dual national currency (external and internal) is not Bulgarian invention, see for example about Romania, Royal Institute of International Affaires (1933, p.115).

<sup>17</sup> On 24 of March 1926 the buying rate became 138.80 and on 24 of September 1926 it further decreased to 138.50, thus BNB tried to attract foreign capital by decreasing its own profit margin.

<sup>18</sup> In 1930 “Food Export” (Hranoiznos) was established and entitled with the monopolistic power to buy and trade with cereals (a specific tool against deflation). Because of the negative price scissors between the buying and selling price, losses were accumulated and transferred to the budget. Some part (once 50% and later 25%) of the payments to the farmers were in treasury bonds representing domestic government debt, which amounted to around 400 mill. golden levs (Berov, 1989, p. 465).

## Exchange rate of the paper lev/ customs coefficient

1.20	0.59	0.71	0.83	0.7	0.78	0.67	0.43	0.47	0.46	0.74	1.00
------	------	------	------	-----	------	------	------	------	------	------	------

Source: Toshev (1943, p.67).

In the same direction of impact (towards depreciation of the Bulgarian lev, i.e. “circumventing the fixed exchange rate”, loosening deflation and enhancement of the inflow of convertible gold exchange) but later in 1933, exchange premiums were introduced for private compensational deals and gained considerable scale in 1935. Exchange premiums perform some percentage of depreciation of the officially fixed by the BNB exchange rate. Thus, the exporters have the stimulus to export more at a lower price<sup>19</sup> (see box 1).

**Box 1 Import tariff, exchange rate premium and real exchange rate**

Let consider trade and exchange control together, that take the form of using together import tariff and currency premium. If  $t$  is the tariff and  $\varphi$  is a currency premium (usually  $\varphi \geq 0$ , but it could be  $\varphi < 0$ , in the case of the sperrmark in 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  $e_r$  became:

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

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

$$(1 + \varphi)(1 + t) > 1$$

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

Lets' go back to the international chronology. The efforts for monetary and financial stabilization quickly gave up under the waves of the Great Depression starting in the USA and quickly reaching Europe (first in Austria, then Hungary, Germany and other countries). At that time countries opted for different (independent) strategies how to adapt their economies to the crisis (Eichengreen, 1997, [1996]; Eichengreen and Sachs, 1985)<sup>20</sup>. Three blocks were formed – (i) countries devaluating their currencies (United Kingdom (1931), USA (1933) and Greece in 1932)<sup>21</sup>, (ii) countries maintaining the gold exchange standard (with France at the head) and conducting strict deflationary policy (limiting the growth of wages and prices) and (iii) the group of countries preserving the parity and exercising exchange control (Germany, Italy, Hungary, Austria). Bulgaria joined the third group

<sup>19</sup> There is a thorough description of the mechanism and role of the exchange premiums provided by Christoforoff (1939, 1947). At the beginning, these exchange premiums differed across different foreign currencies which puts them closer to Ellis' definition of multiple exchange rates as an exchange control instrument.

<sup>20</sup> Many Bulgarian authors speak about the *collapse* of the world economy (Svrakov, 1941, [1936], p. 310). Similar overview of the mechanisms of adaptation is given by Einzig (1934), p. 9. In Mises's opinion (1932) “Country whose is 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).

<sup>21</sup> In the end of 1931 16 countries preserved the gold exchange standard, in 12 countries national currencies were under the parity and in another 11 the golden parity was kept by the means of restrictions on foreign exchange trade (Svrakov, 1941, [1936], p. 312).

of countries being skeptic about the application of the measures for foreign trade liberalization recommended at the Conference in Genève in 1927.<sup>22</sup>

In our hypothesis, without pretending to be systematic, the basic reasons underlying the decisions by the Bulgarian government to introduce exchange control and to oppose the other two alternatives (devaluation and deflation<sup>23</sup>) are the following:

First, Bulgaria was a debtor country which considered the issue of debt burden and service a key priority (Leonidoff, 1966, 1969). In fact Bulgaria was an extremely diligent payer who pursued to preserve its reputation in the course of its debt service (Ivanov, 2005). Due to its political isolation after WWI, however, its endeavours as a good payer were not recognized and it had to bears alone the whole responsibility and burden of its liabilities almost without any debt relieves (Ivanov, 2001, 2005)<sup>24</sup>. In his speech marking the BNB's 50th anniversary, the 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' (Lyapchev, 1929, p. 135).”

With respect to its structure, Bulgarian foreign debt was denominated in gold backed levs and dominantly owed by non-devaluating countries<sup>25</sup>. According to the Royal Institute of International Affairs “In Bulgaria it is almost certainly that the transfer question has predominated” (1939, p.98) and the purpose of maintaining the currency on gold basis “has presumably been to avoid and increase in the costs of the foreign debt service” (1939, p.129). Before the start of reparations' payments in October 1923, foreign debt service reached amount of 112 mills gold francs in the period, 1918 – 1922 and represented 16.3% of the budget expenditures. Reparations under the 27 November 1919 Treaty of Neuilly were added to this debt, coming to 2250 mill gold francs at 5 per cent annual interest over 37 years plus occupation expenses representing a quarter of the national wealth of the economy. With the devaluation of the British pound Bulgaria obtained certain alleviations since foreign debt was predominantly denominated in pounds. As a result debt service portion drops to 11% of total budget expenditures while there was no remarkable loss on the assets' side of BNB balance sheets since a comparably small amount of them were denominated in British pounds (Royal Institute of International Affaires, 1939). Summarizing the opinions of many economists at that time a hypothetical devaluation would certainly increase the debt burden of the country while the possible advantages would be marginal if any (Sarailiev, 1937, p. 27).

Second, the constraints in the balance of payments were particularly hard not only in the part of the foreign debt service. The prices of agricultural products, which included the major part of the Bulgarian export<sup>26</sup> fell sharply on the international markets and aggravated terms of trade of agricultural countries. At Stresa conference in September 1932 where the discussion focused on possible mechanisms of assistance to Southern European countries (a major part of the so-called “agrarian block”), it was pointed out that the price drop reached 70% (Bonnet, 1933, p.21). At the conference it was proposed to set a fund concentrating the funds generated from the import of agricultural products to developed countries which would be used for partial debt service of agricultural countries (United Kingdom stood against this proposal).

Third, the systematic exchange control could be interpreted as a defensive reaction in response to the restrictions introduced by the trade partners of Bulgaria. In fact, the price drop was combined

---

<sup>22</sup> In 1926 however, there is some although partial decrease of the restrictions. In spite of the many comments on the decrease of the trade and exchange restrictions, the government headed by Andrey Lypchev actually did not seem to have the will to do it.

<sup>23</sup> Christophoroff also points out that the exchange control is a way “to fight against deflation” (Christophoroff, 1939, p.12)

<sup>24</sup> Bulgaria continued to pay back reparations in 1933 as well.

<sup>25</sup> French claims on Bulgaria were about 26% of overall external Bulgarian debt (next in the creditors' list of Bulgaria were Italy (25%) followed by Greece (12.7%) and Romania (10.55%).

<sup>26</sup> Romania faces similar problems Madgearu, V. (1930, 1939). For overview of the economic situation for all Balkan countries in the 30's see Royal Institute of International Affaires (1936).

with a number of restrictions on the import of agrarian products to Germany and France with the view to protect their own farmers employing economic or political mechanisms (Raupach, 1969). Turkey, an important trade neighbor of Bulgaria, also introduced some limitations on the import of Bulgarian goods. In April 1932 drachma joined the club of *devaluators* (Lazaretou, 2005) and Bulgaria lost its competitive and long-traditional export positions at the Greek market.

The fourth and direct cause for the introduction of the exchange control was the intensified capital outflow from Bulgaria in the end of 1931. Not accidentally it took place soon after the collapse of the fragile monetary and financial stabilization in the late 20's and was marked by the devaluation of the British pound. In addition to this global imbalance, Boshulkov (1927) provides a list of long-term domestic factors like confiscation of capital accumulated during the wars, capital prosecution and political instability, which certainly contribute to decrease the capital accumulation and foreign reserve on Bulgaria.

Table 4 Some macroeconomic indicators of Bulgaria (1927-1939)

Years/indicators	Total reserves (mill of levs)	Coverage ratio (%)	Trade balance (mill of levs)	Years	Budget balance (mill of levs) <sup>1</sup>
1927	13078	28.3	489		
1928	12897	31.2	-810	1928/9	347
1929	8984	42.2	-1928	1929/30	185
1930	9249	37.0	1601	1930/1	1143
1931	8620	36.6	1274	1931/2	-891
1932	7519	35.8	-88	1932/3	-746
1933	7442	36.0	644	1933/4	-233
1934	7278	35.3	287	1934 (9 months)	-246
1935	6549	34.4	244	1935	-278
1936	7158	33.8	729	1936	283
1937	8196	31.9	34	1937	642
1938	8250	31.8	644	1938	510
1939	11677	29.9	868		

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

<sup>1</sup>) Christophoroff, A. (1939), p. 139.

Logically the introduction of the *systematic* exchange control in 1931 in Bulgaria<sup>27</sup> came in force with the Law on trade with foreign currencies dating 15 of October 1931 as well as with Bulgarian National Bank (BNB) Ordinance No. 1 from 20 of October<sup>28</sup>. Together they entitle BNB with strict monopolistic functions in the forex trade. These legislative acts described in very detail the conditions under which the foreign currencies are submitted at the BNB and respectively granted for import purposes. Several lists of luxury goods the import of which was first limited were written and rewritten. With the view to keep foreign capital inside the country and to halt the depletion of foreign reserves, BNB decided to raise the interest rate and in 1933 imposed further import restrictions. Due to the fact that other countries also imposed exchange and trade constraints (among which Greece and Turkey are important trade partners of Bulgaria), the only reasonably way to let foreign trade “go on” was by signing bilateral clearing agreements and even officially conducted barter deals (Ellis, 1947)<sup>29</sup>. In a sense while the exchange control could be interpreted as an *unilateral* act, clearing agreements

<sup>27</sup> In June 1931 the government of the National Block comes into office after the cabinet of the Democratic Alliance.

<sup>28</sup> Followed also by Ordinance N 4.

<sup>29</sup> Similar argument of “go on” is stressed by Jacque Rueff (1966, p. 79).

appear to be an instrument to overcome the disadvantages of the exchange control, and in their nature they were *bilateral* agreements with some perspective to become *multilateral* clearing agreements<sup>30</sup>. In this line of thoughts, the clearing mechanism followed chronologically the unilateral exchange controls as the latter inevitably blocked the international financial and trade relations.

Bulgaria signed several clearing agreements with Austria (in October 1931), Switzerland (April 1932), Germany (June 1932) and with Italy (1933). In its prime, the clearing agreements represented a small share of overall foreign trade but soon they became widely spread and according to Michaely (1962) and Friedman (1976) they occupied 2/3 of the trade turnover in the 30's. Benham (1939) and Neal (1979) argued that Bulgaria together with Hungary were the countries which used the bilateral forms of international trade to their maximum, and at the same time Bulgaria was the only country managing the fixed clearing exchange rate throughout the whole period of restrictions. In Michaely's calculations (Michaely, 1962, p. 691) Bulgaria ranked last in a sample of 60 countries under study as in 1938 bilateralism represents around 87% of its foreign trade compared with an average of 70%. It is interesting to note, that in the successive rankings in 1948, 1954 and 1958 Bulgaria preserved its last position (in the context of the socialist block at that time)<sup>31</sup>.

Many authors like Friedman (1976, p.117) shared the opinion that Germany was the logical partner for clearing and bilateral agreements of Central and southern European countries (table 4) as a natural reaction against the restrictions (tariff and non-tariff ones) imposed on them by UK and France (restrictions under which trade with Bulgaria was bound to foreign debt service<sup>32</sup>). Moreover, these countries did not extend credit line similar to Germany and of course they were not characterized by the same markets and domestic demand. It is natural that the contraction of the trade with France and UK was compensated partially by expansion in the trade with Germany and Austria.

In the system of clearing the importer pays in his national currency depositing the money at the central bank of the importing partner while the exporter gets the money denominated in his national currency from his central bank. The settlement is done at an exchange rate which is a priori agreed upon. At first glance, the country with the strong currency (or appreciated) is losing because it accumulates positive clearing balances which cannot be settled (for details see Neal, 1979). The country with the appreciated currency tries to increase its sales outside the clearing agreements.

The difficulties with the clearing and the need for more flexibility triggered the appearance of a new institutional form of international trade – bilateral private trade with exchange rate premiums (in 1933 compensation offices were established at the trade chambers). Bilateral private compensations were paid directly to the importer in their national currencies.

Table 5 Clearing and non-clearing trade of Bulgaria

Years/shares	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	78.30	48.87	62.43	21.70
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	81.70	66.67	81.58	18.30
1937	65.52	47.11	71.91	34.48	79.90	58.22	72.82	20.10

<sup>30</sup> This was a Nazi project during the war (1940-42) but it was never put systematically into practice. In the case of Bulgaria trilateral agreements were used more after 1935 (see Christoforoff, 1939, p. 36).

<sup>31</sup> Christoforoff (1939) provides his own calculations of this indicator.

<sup>32</sup> See for example Royal Institute of International Affaires (1939, p.131). The differences in the policy towards South Europe between France and Great Britain on one side, and Germany on the other side, are underlined by Heinrich Hunke, chairman of the council for the encouragement of the German economy. In his speech in Sofia in 1942he classifies the economic relations with Germany as salvaging for South Europe and the Balkans (Hunke, p. 16-17).



1938	77.24	58.86	76.21	22.76	74.02	51.43	70.22	25.98
1938a	71.68	51.49	71.78	21.40	74.74	54.10	72.38	25.32
1939a	72.81	59.43	81.63	27.19	80.89	61.04	75.46	19.05

Note and source: a – export/import data refer to the first five/four months of the year. Christophoroff, A. (1939) “The course of the trade cycle in Bulgaria 1934-1939”, p. 46, p.48.

Studying the clearing mechanism in more technical details however, it turns out that there were two forms of payment. The first one implies that the foreign bank (BNB in the example, providing that there is clearing surplus for Bulgaria) has Reichmarks (Sperrmarks) at its disposal and pays to the importing company in levs (i.e. it buys Reichmarks, which were called “blocked marks”), thus increasing the money supply and income in Bulgaria (and consequently the demand for import). In this case the central bank (BNB for instance) support the German Reichmark and do not allowed it to depreciate. The clearing foreign exchange obtained from the clearing here is at the asset side of the balance sheet of the BNB. This form is referred to as the “principle of immediate payment”.

The second form, described as the “principle of delayed payment” implies that the Bulgarian exporter waits for the realization of import of German goods and then buys Reichmarks with his blocked levs<sup>33</sup>. In this case the central bank (BNB) refuses to buy blocked mark until it had received request for the marks from domestic importers of German goods. During this period (until the request of Reichmarks) the exchange rate of the Reichmark is going to depreciate at the domestic (in our case Bulgarian) market. In this case the holding of blocked Reichmarks does not create money being part of the off-balance sheet.

According to the literature dedicated to the subject, the “principle of immediate payment” was advantageous to the depressed Southern Europe because it was widely believed at that time that the expansion of money supply would solve the problem of growing unemployment rather than leading to sharp price rise. According to Neal (Neal, 1979, p. 393) the bigger the clearing surplus together with the higher the exchange rate against the Mark, and the observation of the “principle of immediate payment”, the stronger the expansionary effects of the central banks in Central and South Europe.

Therefore, Hungary for instance which adhered to the “principle of immediate payment” experience economic growth as well as improvement of the trade balance. Romania in contrast exercised the “principle of delayed payment” which did not turn out to be conducive for the economic development (Neal, 1979)<sup>34</sup>. Bulgarian case was similar to the Hungarian one applying the “principle of immediate payment” in its clearing agreements as the effects on money supply expansion could be studied in balance sheets data (table 5). The increasing value of the item “Other foreign currencies” on the asset side of BNB balance sheet was closely related to the received non-gold block foreign currencies from the clearing and other agreements (BNB, 2001). The growth of this item was much faster after 1938 when huge positive balances in the clearing agreements with Germany were recorded.

Table 6 of the BNB balance sheets 1928-1938 (mill of levs)

Assets	1928	1930	1932	1934	1936	1938	1940
Gold and silver holdings <sup>1</sup>	1598	1879	1874	1900	2049	2586	2301
Receivables in gold	2736	481	92	26	0	0	4
foreign currencies (article 10 of BNB Law)							
Other foreign currencies	534	152	116	174	772	1279	2336
Domestic credit <sup>2</sup>	5362	4267	3913	3724	4336	4829	8021

<sup>33</sup> For more details, see Lindert and Kindleberger (1983, [1982]) and Kindleberger (1988, [1973]). Sometimes these two methods of payments are called respectively “financing principle” and “waiting principle”.

<sup>34</sup> As we haven mentioned above Italy alters the principle of delayed payment with the principle of immediate payment at a later stage.

Treasury bonds	0	0	130	310	0	0	0
Other items <sup>3</sup>	164	375	247	252	215	146	557
<b>Total assets</b>	<b>10394</b>	<b>7154</b>	<b>6373</b>	<b>6386</b>	<b>7372</b>	<b>8839</b>	<b>13219</b>
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 <sup>4</sup>	3862	1817	1813	1872	2382	3707	3785
Other liabilities <sup>5</sup>	637	287	203	277	546	443	937
Profit	71	83	32	48	133	202	272
<b>Total liabilities</b>	<b>10393</b>	<b>7154</b>	<b>6373</b>	<b>6386</b>	<b>7372</b>	<b>8839</b>	<b>13219</b>

Note and source: <sup>1</sup>. Gold and silver holdings including gold and silver coins at cash. <sup>2</sup>. Domestic credit comprises of receivables from the government, banks, commercial papers and effects. <sup>3</sup>. Real estates and other assets. <sup>4</sup>. Demand, time and other deposits of government and banks. <sup>5</sup>. Liabilities in gold and other foreign currencies. Original balance sheet data from BNB (2001) 120 Years Bulgarian National Bank, p. 130.

In late 1939 the exchange control was transformed from a stabilization instrument into an instrument for concentration of resources feeding war preparations. Of course, the war logic of the exchange control was apparent much earlier in Germany (and Italy) which in the late 30's subordinated its foreign trade to the tasks of war economy. The final point in the relationships with Bulgaria for instance (and before that with Romania) was the signed intergovernmental clearing agreement in 1940 (in the negotiations BNB did not participate because of its specific position) which was extremely asymmetric in favor of Germany (at a unfavorable for Bulgaria exchange rate against the Reichsmark among other clauses) and allowed Germany to transfer resources from Bulgaria. Since 1934 Bulgarian 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 6)<sup>35</sup>.

Table 7 Share of good categories in total import (%)

Good 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	28.0	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 like in other countries, the exchange control performed another function apart from the above mentioned functions of monetary and financial stabilization and balance of payment restrictions<sup>36</sup>. This function, though considered only as implicit, was getting more important with the time. It regards the use of exchange control with the purpose of stimulating and restricting the development of certain sectors and branches of the economy as according to Paul Einzig, the exchange control became a "weapon for commercial policy", Einzig (1934). Moreover, the League of Nations' report on exchange control, it is said that:

„...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)

<sup>35</sup>Some economists criticize the enhanced dependency of the local industry on foreign (imported) materials.

<sup>36</sup> Ellis (1947) describes the purposes (domestic and external) and the instruments of exchange control in details.



Even though the first reasons behind this kind of industrial policy were with the view to limit the expensive import (for instance BNB argues in favour of the import of commodities and materials rather than of the import of machines because the former were cheaper (BNB, 1934, p. 91), the necessity to protect national industry and decrease unemployment moved with the time to the foreground of argumentation<sup>37</sup>. In other words the exchange control and the foreign trade restrictions in general (quotas and tariffs) obtained dominating domestic functions. Economists often argued that “encouraged industry (*nasarcehna industria*)” and overprotection were to the detriment of consumers and in general to the entrepreneurs (since the protection of domestic production decreases competition and leads to the appearance of domestic industries with monopolistic power)<sup>38</sup>. In Toshev’s opinion “the importance of the international trade agreements was diminishing after 1932 with respect to the domestic industry because there was another very effective instrument which compensated the trade concessions, and namely it was the exchange rate policy of BNB” (Toshev, 1943, p.85).

As a result of the maintained exchange control in the thirties and the intensified trade with Germany, the exchange rate of the Bulgarian lev appreciated gradually during the thirties reaching 18.5% in 1937 in nominal effective terms with respect to the base year 1929 (Ivanov et al., 2007) (figure 2)<sup>39</sup>. The NEER calculated with the implemented exchange rate premiums 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 extract profit from this competitive position given the prevailing restrictions in foreign trade entailed by all countries. Moreover the price drop of agricultural product which dominated Bulgarian export 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 premiums applied to some limited number of private trade deals and estimated at 25% on average for the period 1935-1939<sup>40</sup>, had a smaller effect in real terms (5.7%) and consequently marginal effect on total export development<sup>41</sup> if any.

Figure 2 Effective exchange rates of the Bulgarian Lev (index 1929=100)

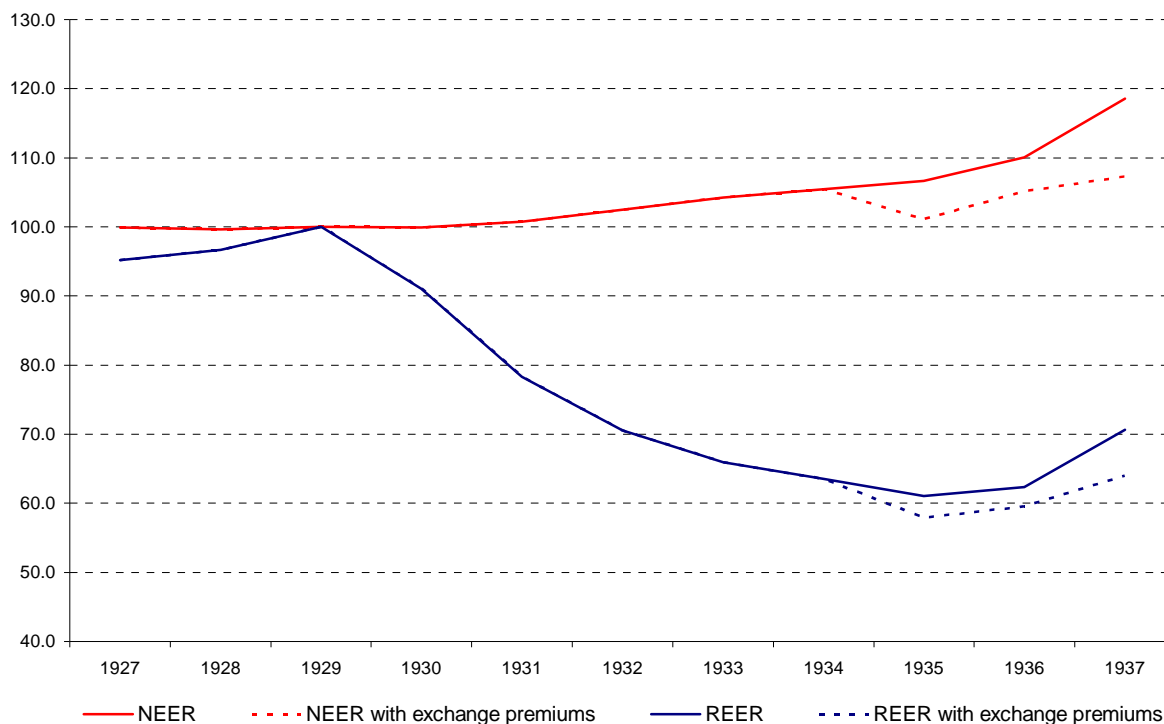
<sup>37</sup> In 1928 a Law for national industry encouragement was passed which provided various advantages and customs alleviations losing its effect partly due to the exchange control introduced in 1931. There was a new Law in 1936 which customs regulations were of particular importance for the protection of old and new industries (details are provided in Toshev, 1943).

<sup>38</sup> It is often addressed that the increasing discrepancies between the development of the industrial and agricultural sectors inevitably translate into price scissors, different income levels and therefore wealth redistribution.

<sup>39</sup> Interestingly, arbitration calculations (across the Romanian Leu) of Christophoroff generate around 20 % appreciation of the Reichsmark against the Bulgarian Lev in the period after 1934, i.e. 1RM = 25 levs while the official exchange rate was 1RM=33levs (Christophoroff, 1939, p. 20)

<sup>40</sup> Data available in the Statistical Yearbooks of the Kingdom of Bulgaria.

<sup>41</sup> As a result the restrictions in general and the exchange rate ones in particular became a subject of conflict of different groups of interests (industrialists, traders, farmers and others). Of course, by following the debate at that time it is clear that little attention was paid to the consumers who found it difficult to realize and defend their interests. A simple evidence of this could be found in the lists of goods subject to import restrictions among which we can notice sole-leather, sugar, cotton, wool and others that were definitely to the prejudice of consumers. Charles Kindleberger, see the textbook by Lindert and Kindleberger, 1983 [1982], develops the idea about the redistributing effect of the trade and foreign exchange restrictions in details.



Source: own calculations. For more details see (Ivanov et al., 2007).

### III Theoretical Reflections and Discussion - the Macroeconomics of Exchange Control

In this part, we intend to develop some macroeconomics of exchange control. Before proceeding with the analysis, it is important to point out that the theoretically postulated relationships that we study are questionable in themselves due to the complexity of the exchange control system. Furthermore, empirical estimations are often far from conclusive, not only because of the lack of consistent disaggregated data but also due to the government's interference at micro level (estimations of centrally planned economies face similar difficulties). The complexity of the exchange control require simplification, therefore the reasoning below is conducted in the framework of an "idealized" model of exchange control.

Both stories of the introduction and practice of exchange control in Italy and Bulgaria are eloquent examples of how serious the **balance of payment constraint** was at that time and how a difficult task was to circumvent it.

Before World War I the balance of payment constraint was overcome by the relatively automatic mechanism of the gold standard and the so-called "rules of the game". Even when the rules of the game were violated, the existence of the London financial centre and the Bank of England as well as the cooperative behavior of the other major central banks allowed for the functioning of the LLR on international scale. The WWI however, destroyed this institutional framework and led to the formation of different political and economic blocs and to the spread of political and economic nationalism. As we pointed out, despite the attempts to restore the pre-war situation, during the twenties many European countries were characterized by severe current account and budget deficits and were following diverging political and economic objectives, independently or within a certain

bloc. Under these new circumstances, the exchange control can be interpreted as an example of the new invading economic paradigm which attributes an active role to the government in the economy. We should remind the reader that before WWI governments' and central banks' discretionary powers with respect to the exchange rate were considerably limited and used with discretion under special extreme conditions, like wars.

The exchange control in Bulgaria and Italy, as well as in other countries like Germany, Austria and Hungary, was a specific alternative both to devaluation and to deflation, which for different reasons were much more costly from an economic and political point of view. In this situation exchange control was a form of isolation which protected domestic capital markets from international capital flows. Devaluation was not acceptable for countries which had experienced inflation and financial crisis, and which had just stabilized their currencies. Furthermore, most of the countries that introduced exchange control (with the exception of Italy) had been defeated in the war and were characterized by considerable external liabilities. These countries were debtors who did not only want to preserve their reputation of good payers but most probably also tried to extract maximum economic profit from their appreciated currencies. When the currencies (pound sterling, USD and French or Swiss Frank), in which foreign liabilities were denominated, devalued, this directly decreased the debt burden by an automatic recalculation of the foreign liabilities of a country<sup>42</sup>. They wanted to preserve their reputation of good payers (Bulgaria) or to preserve their reputation among the electorate (Italy). The balance of payment constraint was of course more binding in Bulgaria than in Italy: in Bulgaria the burden of foreign debt and the constraint of weak foreign reserves<sup>43</sup> were more intense<sup>44</sup>; its government, therefore, had to introduce foreign exchange restrictions considerably earlier<sup>45</sup> and stabilized the lev through administrative exchange measures (an early form of exchange control).

There is no doubt, that the basic question which demands an answer is to what extent the exchange control as a form of governments' interference helps (or harms) macroeconomic stability and economic growth<sup>46</sup>. Before answering this question, however, let's first expose some technical details of the exchange control mechanism which would help us to explain the main macroeconomic interrelations, and particularly the forms of control on the balance of payment as well as the different types of clearing.

The methods of foreign reserves accumulation and exchange rate pegging could be classified in two types of balance of payment control. Type 1, *trade control* includes indirect influence on the forex market through impact on the basic markets determining the demand and supply of foreign currency, i.e. on the import and export markets (of goods, services and capital); Type 2, *exchange control* implies a direct impact on the forex market by determining the volume of traded foreign currencies<sup>47</sup>. In the first type, the volume of foreign currencies depends on the import and export

---

<sup>42</sup> 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".

<sup>43</sup> According to Royal Institute of International Affaires Bulgaria is the country with an extreme lack of capital and investments in Europe (Royal Institute of International Affaires 1936, p. 120).

<sup>44</sup> The choice of the method of exchange control depended on other factors like contracts, political and purely ideological reasons (Heuser, 1939, p. 48).

<sup>45</sup> 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".

<sup>46</sup> Ellis (1940) provides an interesting exposition of the theory and macroeconomic consequences of the exchange control.

<sup>47</sup> Technically the exchange control is a *logical continuation of the tariffs and quotas* at the import market, which cannot fulfill their purposes to improve the trade balance (Kulicher, 2002, [1929] and Kindleberger, 1988, [1973]). The diminishing foreign reserves threaten the stabilized national currencies and the regular foreign debts service). Consequently the trade difficulties lead to the evolution of exchange rate control forms, i.e. from

flows, which are limited or enforced. In the second type we have the opposite logic – there is an *a priori* determined amount of foreign currency, once the sums necessary for the debt servicing have been accounted for, and the import flows are constrained by this amount. The government further interferes directly with the import and export markets to accomplish its goal of foreign reserves accumulation. In spite of the fact that both mechanisms have similar results in the long run (both of them interfere with the efficient allocation of resources), we have to consider that the direct control on the forex market is considerably more complex to enforce and, as a whole, has remarkably adverse effects<sup>48</sup>.

Under the trade control, *de facto* import control, two types of restrictions can be identified, price discrimination (tariffs and customs duties) and volume discrimination (quotas, barter). In the former type the import price is fixed above its equilibrium level by adding customs duties and tariffs and the volume become a function of this fixed price level. In the latter case, the volume is fixed (usually at a lower level than that of equilibrium) and the price is determined accordingly. The historical record proves that the exchange control of the first type not always accomplishes directly the aims pursued at the forex market because of the decentralized behavior of importing and exporting agents.

Under the exchange control the central bank can fix directly the supply of foreign currency. Under these circumstances, if the goal is to increase the foreign exchange supply, the exchange premiums are an appropriate instrument. The exchange premiums are a form of violation of the static foreign exchange monopoly, allowing for some (very limited) flexibility of the exchange rate (fixed by law) with the only purpose to stimulate export. In principle, when the volume of foreign exchange and the exchange rate are given, the next logical step is to control totally (through permissions and licenses) the volumes of import and export, hence the goods markets become function of a predetermined equilibrium at the foreign exchange market. Undoubtedly exchange control is considerably stronger and implies a more substantial violation of the market mechanisms of efficient distribution of scarce resources. It is also more difficult to maintain, as evidenced by the presence of black exchange market, smuggling, corruption and other forms of violation of the law (like the story of the two Italian citizens in Bulgaria).

The other technical detail concerns *the mechanisms of clearing*. Let's take for instance Bulgaria for the interwar period and try to answer the question in a narrower context – what is the role of clearing with Germany for the development of the Bulgarian economy since 1932<sup>49</sup>? There are different opinions about the German impact on South Europe, from the extreme support of clearing methods to the opposite extreme of total denial and accusation of exploitation by Germany.

Here we would like to remind the reader the scheme of clearing (chart 2) which we discussed in section 2 (the method of immediate payment or financing principle, and the method of delay or waiting principle).  $G$  stands for the German central bank,  $B$  – for the BNB,  $X_B$  – Bulgarian export to Germany,  $X_G$  – German export to Bulgaria/or Bulgarian import from Germany, and  $M$  – is an additional monetary flow created by the Bulgarian central bank due to the clearing surplus (in our case 90). In the case of immediate payment (financing principle) applied by Bulgaria (the same story concerns Hungary, and later Italy) as a result of the positive clearing surplus [ $X_B(100) > X_G(10)$ ], domestic money supply automatically expand (the clearing surplus is multiplied by the clearing exchange rate (supposed to be 1, in this case for example  $IRM = 1lev^{50}$ ). In this case (also named financing principle) the central bank buys the receivables from its exporters at the fixed in the clearing exchange rate. In the second case of postponed payments (as we mentioned above Romania employs

---

unilateral to bilateral clearing and later on to private exchange barter and exchange premiums etc (in the case of Bulgaria in 1935) in order to direct trade towards countries with “free currencies”.

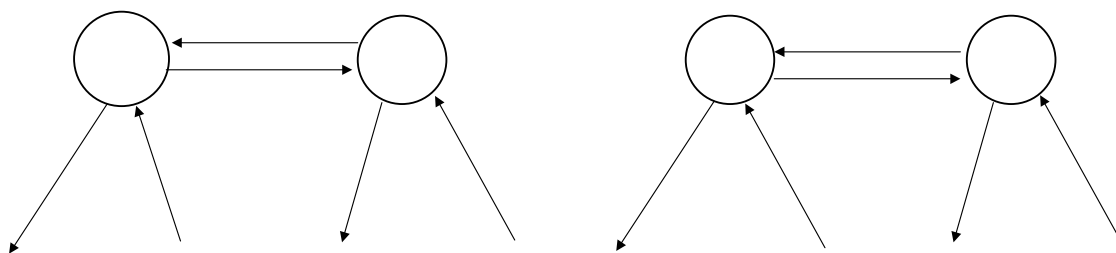
<sup>48</sup> See the textbooks on international trade (for example Vanek, 1962; Lindert and Kindleberger, 1983, [1982]).

<sup>49</sup> Details about the interrelations between the dynamics of the Bulgarian and German economies see Christoforoff (1939) and also Fisher (1939, p. 154)

<sup>50</sup> In the real Bulgarian case the rate was  $IRM=33$  levs).

this method of payment)<sup>51</sup> the central bank waits for the counterparty to settle the clearing balance, hence the positive surplus is not immediately monetized and there is no monetary expansion at home. In the first case the positive surplus appeared as debt/credit respectively at the balance sheet of the German central bank and Bulgarian central bank. In the second case there is not additional monetary creation and the debt/credit position regarding the clearing are not at the balance sheet but under the line (off-balance). In this waiting principle the clearing surplus (90) has depreciating effect on the mark (as mentioned by Larry Neal)<sup>52</sup>.

Chart 1 Two methods of clearing system



First, there is a substantial impact of clearing mechanisms on the money supply and price level. As we pointed out already, due to the specific method of clearing with Germany (in contrast to other countries like Romania for example<sup>53</sup>, Bulgaria maintains the same level of exchange rate in the framework of the clearing (1RM=33 levs). The positive clearing balance, which Bulgaria accumulates, leads 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 during the 30's deflation had severely hurt the agricultural sector<sup>54</sup>. This mechanism of expansion by the means of the method of immediate payment can be accommodated in the overall mechanism of "contagion" of the Bulgarian economic cycle by the German economic cycle described by Christoforoff (1939). As well known when the national socialists come to power in Germany (1933) the economy experience

<sup>51</sup> See for instance Neal (1979).

<sup>52</sup> In this case we could suppose the clearing rate to move from 1RM=1lev, to around 1RM=0.1levs, *ceteris paribus*.

<sup>53</sup> Romania tries several times to renegotiate the exchange rate against the Reichsmark in its clearing agreement with Germany.

<sup>54</sup> Interestingly in the case of financing principle the adjustments are realized by price level, whereas in the waiting principle by the sperrmarks exchange rate fluctuations. For example in the case of Bulgaria this means domestic price level rises (due to the monetary expansion) and a consequent deterioration of the competitiveness of Bulgarian goods in Germany, i.e. reduction of the mark appreciation. In the case of Romania (waiting principle) there was no price rise but sperrmark exchange rate depreciation in Romanian sperrmark market. When the waiting period runs out the exchange rate of the sperrmark rises and approaches its previous level. We could also assume that the financing principle affected the competitiveness of the Bulgarian goods not only at the German market but also at other markets which triggers the introduction of exchange premiums with the view to stimulate the trade with "free currency" countries. According to Neal (1979, p.400) the countries applying the financing principle are in closer political relationship with Germany.

Financing principle

Debt (90)

credit growth, expansion of government spending. This is logically concomitant with the signing of the clearing agreement between Bulgaria and Germany (1932) and consequently by the departure from the strict deflationary policy of the BNB and the introduction of the exchange premiums (in the middle of 1933).

The actual development of the Bulgarian cycle (see Christoforoff, 1939) confirms the above exposed logic of exchange control development. In a comparative perspective, Larry Neal (1979)<sup>55</sup> argues that the different methods of payment explain the higher economic growth of the Hungarian economy in contrast to the difficulties faced by Romania. Paul Einzig (1941) describes different mechanisms through which Germany first exported inflation to South-East Europe and subsequently pursued deflationary policy at home. Germany accumulated positive clearing balances and according to the "financial principle" (followed in Bulgaria and Hungary) led these countries to finance German economy by inflation or devaluation. Therefore Germany does not have interest to introduce German mark into Southeast Europe, because will lose the inflation and devaluation levies. Interestingly some parallels could be drawn with the present refusal of the old Euro zone countries to put the euro into circulation into the new accession countries.

Second, the exchange control (in the case of clearing) influences the real exchange rate and the overall terms of trade of a country. In spite of 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 terms of trade of Germany with South Europe develop unfavorably (i.e. the ratio of export prices to import prices decreases). This is supported also by the overvalued reichsmark at the exchange rate in the clearing system<sup>56</sup>. Under these circumstances the method of immediate payment implying money expansion in the creditor country in the clearing framework (like Bulgaria), helps to postpone the real appreciation of the reichsmark with respect to the lev (and enhance the appreciation of the lev against the reichsmark). In a sense, it functions as a compensating mechanism in the context of the trade flows between Bulgaria and Germany given the fact that both countries opposed a devaluation of their national currencies<sup>57</sup>. As a whole we dare to argue that the exchange control (and clearing in particular) stimulates the Bulgarian economy under the circumstances of global deflation and international trade restrictions. Yet importantly, the exchange control has a considerable impact on the development of national industries, which we will not discuss in details in this paper.

Third, the balance of payment restrictions both in Italy and Bulgaria can be usefully interpreted in the light of the well known equilibrium condition between saving and investment in an open economy. According to this condition, if we assume that private saving is constant, an increase in the budget deficit and/or in private investment has to be reflected in a deterioration of the trade balance. Of course, the aggregate approach presents some methodological and analytical problems. However, it is correct to point out that in both cases trade deficit was caused not only by the price drop of agricultural products in the beginning of the thirties (to a greater extent for Bulgaria than for Italy) but also by the considerable increase of public expenditures in the second half of the same decade in preparation for the war (this aspect was more explicit in Italy than in Bulgaria). The ambitious

---

<sup>55</sup> Friedman (1976) try 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.

<sup>56</sup> The problem of the overvalued Reichmark is solved by private clearing agreements within Germany through the flexible exchange arte of the ASKI marks and through the mechanism of the sperrmarks (see Neal, 1979).

<sup>57</sup> 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 WWII (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.

imperialistic policy of Mussolini's government has been studied at length (cf. among others De Felice, 1981; Miller and Kagan, 1997). Bulgaria also had its ambitions in the Balkans as a perspective ally to Germany. The increasing public expenditures since 1934 however, were counterbalanced with great efforts and resulted in surpluses since 1936 (Christoforoff, 1939, pp. 100-105). According to this line of reasoning, exchange control in Italy and Bulgaria could be interpreted as an instrument of government's interference, nationalization, militarization and economic isolation.

Fourth, interesting parallels can be drawn between the history of the thirties and today's economic situation in Italy and Bulgaria and in the European Union in general.

The First World War caused a sudden collapse of the world economy. Money supply, the structure of relative prices and the structure of the balance of payment irreversibly changed, new social and political subjects appeared whose interests were related to those of debtors and those who opposed deflation. Money became fiduciary, while the capital movements dominated the balance of payment dynamics. The unsuccessful attempts to return to the pre-war situation and the Great Depression accelerated the process of national isolation and preparation for another war. According to this line of reasoning, the exchange control was an organic element of the model of closed economy. At the beginning it was viewed as an alternative to devaluation and deflation, a way to overcome the balance of payment constraint, but with the time it was transformed into an instrument for mobilization of war resources. In this aspect Italy and Bulgaria had similar trajectories – both countries 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 to avoid economic isolation and war conflicts in Europe. In a sense, the balance of payment constraint, which was at a national level, is now partly transferred to a European scale. By adopting the common currency Italy cannot try any more to improve his competitiveness through devaluation, while the currency board arrangement in Bulgaria (Bulgaria is not a member of the euro area yet) commits this country to low inflation and to a restrictive fiscal policy. Today, as during the interwar period, the economies of the European countries can prosper in the long run only by adopting healthy fiscal and monetary policies and by increasing productivity. Although economic isolation and autarky appear unlikely in our century, we should not forget that these pathologies were also unlikely at the beginning of the twentieth century.<sup>58</sup>

#### IV Conclusions

We can now summarize the main results of our study in the following way.

Firstly, exchange control in the interwar period was the result of balance of payment constraints which were particularly severe for peripheral and semi-peripheral countries, given the fact that the world economic and monetary equilibrium had collapsed. During the thirties the relatively automatic mechanism of the gold standard, together with the LLR functions performed by the Bank of England, in cooperation with central banks from the financial core, did not exist any more, whilst the practice and even the idea of a global supranational LLR (like IMF after World War II) was just in its very beginning. The League of Nations lacked the authority both to restore the pre-war world financial relations and to try to implement a new system.

Secondly, peripheral and semi peripheral countries like Bulgaria and Italy, which had a long record of lack of discipline and lack of good tradition in monetary management, preferred to stick to a fixed exchange rate regime which symbolized monetary stability and enhanced credibility. For that purpose they needed foreign reserves which, however, rapidly decreased as a consequence of balance of payments deficits. These were caused mainly by the dramatic drop of agricultural prices, by capital outflows and later, by costly rearmament policies (pursued in particular by Italy). Furthermore, most

---

<sup>58</sup> See Fromkin (2004), Frieden (2006)

of the countries which opted for exchange control (Italy is an exception), had been defeated after WWI and beared a heavy debt burden which had to be repaid.

Thirdly, 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 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.

Fourthly, our study of the exchange control reveals interesting macro interrelations. While there is some obvious macroeconomic asymmetry within the area of 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 as well as the development of the foreign trade. Of course, such processes can be regarded as “optimal” of second order only. No doubt, the exchange control marks a serious interference in the mechanisms of the market. Furthermore, history shows that exchange control is characterized by corruption and political favoritism and leads therefore to strong distorting redistributive effects. In other words, exchange control tends to favor certain groups of interest which one way or another are connected to power. These aspects however, the microeconomics and sociology of exchange rate control, constitute a new chapter of this complex story.

### Bibliography

- Aldcroft, D. (2002). “Currency Stabilisation in the 1920s: Success or Failure?” *Economic Issues*, vol. 7, part 2, pp. 83-102.
- Assonime (1940), *Il controllo dei cambi nei vari paesi*, Quaderni dell’Associazione fra le Società Italiane per Azioni, IX, Tip. Castaldi, Roma.
- Assonime (1942), *Accordi di compensazione*, Quaderni dell’Associazione fra le Società Italiane per Azioni, XII, Roma, Tip. Castaldi.
- Avramov, R. (2001). *Bulgaria’s Economic 20th Century*, Centre for Liberal Strategies, Sofia (in Bulgarian).
- Baffi, P. (1958), “Monetary Developments of Italy from the War Economy to Limited Convertibility (1935-1958)”, *Banca Nazionale del Lavoro Quarterly Review*, vol. XI, 1958, Dec., pp. 399-483.
- Banca d’Italia (1938), *L’ economia italiana nel sessennio 1931-1936*, Roma, Ist. Poligrafico dello Stato.
- Barucci, P. (1981), “Il contributo degli economisti italiani (1921-1936)”, in *Banca e industria fra le due guerre. L’economia e il pensiero economico*, Il Mulino, Bologna, pp. 179-243.
- Benham, F. (1939), *South-eastern Europe: a political and economic survey*, Royal Institute of International Affairs, London.
- Berov, L. (1989), *Bulgarian economy until the Socialist Revolution*, Vol I, Nauka I Izkustvo Publishing House, Sofia (in Bulgarian)
- Berov, L. (1997) *The Bulgarian National Bank at 120*, an unpublished manuscript (in Bulgarian).
- Berahov, R. (1927) *Industrial protectionism at home*, Cooperative Printing House “Napredak”, Sofia (in Bulgarian).
- Bini, P. (1981), “Il dibattito attraverso le riviste di regime”, in *Banca e industria fra le due guerre. L’economia e il pensiero economico*, Il Mulino, Bologna, pp. 246-98.
- BNB (2001) *The Bulgarian National Bank: a Collection of Documents*, The Central Public Record Office., Vol. 3, 1915-1929 (in Bulgarian).



- BNB (2004) *The Bulgarian National Bank: a Collection of Documents*, The Central Public Record Office, Vol. 4, 1930-1947 (in Bulgarian).
- Boshnyakov, D. (1936) *Prices and the Monetary Problem*, Razvitie Printing House, Sofia (in Bulgarian).
- Burilkov, Zh. T. (1928) *The Monetary Reform*, S.M. Staikov Printing House, Sofia (in Bulgarian).
- Chapkunov, A. (1936) *Crises and Foreign Currency*, Hudozhnik Printing House, Sofia (in Bulgarian).
- Christophoroff, A. (1939) "The course of the trade cycle in Bulgaria 1934-1939", Publications of the Statistical Institute for Economic Research, State University of Sofia, No. 1-2.
- Christophoroff, A. (1946) *Central Banks and Contemporary Economic Theories*. Yearbook of the State Higher School of Financial and Administrative Sciences, Sofia, Vol. V, 1945/1946 (in Bulgarian).
- Ciocca, P.-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*, Bari, Laterza, vol. I, pp. 341-68.
- Cohen, J. (1972), "The 1927 Revaluation of Lira: A Study in Political Economy", *The Economic History Review*, pp. 642-54.
- Cotula, F.-L. Spaventa (2003), "La politica monetaria tra le due guerre. 1919-1935", in F. Cotula-M. de Cecco-G. Toniolo, *La Banca d'Italia. Sintesi della ricerca storica, 1893-1960*, Bari, Laterza, pp. 209-310.
- Dam, K. (1982). *The Rules of the Game. Reform and Evolution in the International Monetary System*, The University of Chicago Press, Chicago and London.
- De Cecco, M. (2003), "L'Italia e il sistema finanziario internazionale. 1860-1936", in F. Cotula-M. de Cecco-G. Toniolo, *La Banca d'Italia. Sintesi della ricerca storica, 1893-1960*, Bari, Laterza, pp. 3-58.
- De Felice, R. (1981), *Mussolini il duce*. vol. II. *Lo stato totalitario (1936-1940)*, Einaudi, Torino.
- Demaria, G. (1939), *Cambi manovrati e clearing complementari nella nuova politica autarchica*, Roma, Editoriale del Commercio.
- Demostenov, S. (1937) *The History of the Monetary Theory*, Pridvorna Printing House, Sofia (in Bulgarian).
- Demostenov, S. (1946) *Money, The Essence and Importance of Money*. Shtastie Litography, Sofia (in Bulgarian).
- Demostenov, S. (1991 [1946]) *Theoretical Political Economy*, 7M Publishing House and University Publishing House, Sofia 9in Bulgarian).
- Eichengreen, B. (1997, [1996]). *L'expansion du capital. Une histoire du système monétaire international*, L' Harmattan, Paris
- Eichengreen, B., J. Sachs (1985). "Exchange rates and economic recovery in the 1930s", *The Journal of Economic History*, vol.45, No 4, pp. 925-946.
- Einzig, P. (1934). *Exchange control*, Macmillan, London.
- Einzig, P. (1955). *The Exchange Clearing System*, Macmillan, London.
- Ellis, H. (1940). "The Past and Future of Exchange Control", *The Quarterly Journal of Economics*, vol. 54, No 4, part 2, pp. 159-217.
- Ellis, H. (1942). "The Problem of Exchange Systems in Post-war World", *The American Economic Review*, vol. 32, No 1, part 2, pp.195-205.
- Ellis, H. (1947) "Exchange Control and Discrimination", *The American Economic Review*, Vol. 37, No. 5, pp. 877-888.
- Falco, G.-M. Storaci (1977), "Il ritorno all'oro in Belgio, Francia e Italia", *Italia Contemporanea*, Jan.-Mar.
- Fisher, A. (1939). *The German trade drive in South-Eastern Europe*, Royal Institute of International Affairs, vol. 18, No 2, pp. 143-170.
- Focarile, A. (1929). *Bulgaria d'oggi. Nei suoi aspetti sociali, economici, commerciali e finanziari (con una carta delle ferrovie bulgare)*, Ulrico Hoepli editore, Milano.

- Fратиани, M.–F. Spinelli (1997), *A Monetary History of Italy*, Cambridge, Cambridge University Press.
- Frieden, J. (2006). *Global Capitalism. Its Fall and Rise in the Twentieth Century*, W.W. Norton & Company, New York, London
- Friedman, Ph. (1976). “The welfare costs of bilateralism: German-Hungarian Trade, 1933-1938”, *Explorations in Economic History*, vol. 13, No 1, pp. 113-125
- Friedman, Ph. (1978). “An Econometric Model of National Income, Commercial Policy and the Level of International Trade: The Open Economies of Europe, 1924-1938”, *The Journal of Economic History*, vol. 38, No 1, pp. 148-180.
- Fromkin, D. (2004). *Le dernier été de l'Europe. Qui a provoqué la Première Guerre mondiale?*, Hachette, Pluriel, Paris.
- Goodhart, Ch. (1998). The two concepts of money: implications for the analysis of optimal currency areas, *European Journal of Political Economy*, vol. 14, p. 407-432.
- Guarneri, F. (1988) *Battaglie economiche tra le due guerre*, Bologna, Il Mulino.
- Heilperin, M. (1939). *International monetary economics*, Longman, Green and Co, London
- Heuser, H. (1939), *Control of International Trade*, London, Routledge.
- Hirschman, A. (1939), “Mémoire sur le contrôle des changes en Italie”. Rpt. in *Potenza nazionale e commercio estero. Gli anni trenta, l'Italia e la ricostruzione*, Bologna, Il Mulino, 1988.
- Hunke, H. (1942) *The foundations of the international economic relations in Europe*, Publication of the German-Bulgarian Chamber of Commerce, Sofia (in Bulgarian).
- Ivanov, M (2001) *Political Games with the external Debt. Bulgarian Scenarios of economic Crisis and Upsurge, 1929-1934*, Zlatyo Boyadzhiev Publishing House, Sofia (in Bulgarian).
- Ivanov, M. (2004) *Could we Devaluate? What is there behind the Orthodox Bulgarian Answer to the Great Depression?*, Historical Review No. 3/4 (in Bulgarian).
- Ivanov, M., K. Dimitrova, R. Simeonova-Ganeva (2007) *Effective exchange rates of the Bulgarian Lev 1896-1939*, BNB Discussion paper (forthcoming).
- Leonidoff, A. (1966) *Impact of the external financial debt of Bourgeois' Bulgaria on its balance of payment and currency during the first phase of the general capitalist crisis (1918-1938)*, High economic institute “Karl Marx”, Sofia, book II.
- Leonidoff, A. (1969) “Foreign creditors and Bulgaria after the First World War”, *Historical Review*, Vol. XXV, issue 4, pp.15-37.
- Lindert, P., Ch. Kindleberger (1983, [1982]). *Economie internationale*, 7<sup>e</sup> édition, Economica, Paris.
- Kemilev, A (1936) *Money circulation in Bulgaria*, Journal of Higher school of Commerce Graduates, Varna, year I, book 4, pp. 287-300 (in Bulgarian).
- Kindleberger, Ch. (1988, [1973]). *La grande crise mondiale 1929-1939*, Economica, Paris
- Kindleberger, Ch. (1990, [1984]). *Histoire financière de l'Europe occidentale*, Economica, Paris.
- Koszul, J. (1932) *Les efforts de restauration financière de la Bulgarie (1922-1931)*, Felix Alcan, Paris.
- Kulicher, I. (2002, [1929]). *The main questions of the international trade policy*, Socium, Moscow , (in Russian).
- Machlup, F. (1939). *The Theory of Foreign Exchanges*, Economica, New series, vol. 6, No. 24, pp. 375-397.
- Madgearu, V. (1939). *Le Contrôle des Changes en Roumanie*, International Institute of Intellectual Cooperation, Paris.
- Marconi, M. (1982), *La politica monetaria del fascismo*, Il Mulino, Bologna.
- Michaely, M. (1962). *Multilateral balancing in international trade*, *The American Economic Review*, vol. 52, No 4, pp. 685-702.
- Miller, B., K. Kagan (1997). “The Great Powers and Regional Conflicts: Easterns Europe and the Balkans from the Post-Napoleonic Ear to the Post-Cold War Era”, *International Studies Quarterly*, vol.41, pp. 51-85.
- Monchev, B (1939) *The Monetary problem after the World War*, Sofia (in Bulgarian).

- Neal, L. (1979). "The economic and finance of bilateral clearing agreements: Germany 1934-8", *The Economic History Review*, vol. 32, No3, pp. 391-404.
- Nurkse, R. *L'expérience monétaire internationale. Enseignements de la période d'entre les deux guerres*, Genève, Société des Nations.
- Nedelchev, K. (1940) *Monetary Issues: Bulgaria 1879-1940*, Knipegraph Printing House, Sofia (in Bulgarian).
- Nenovsky, N. (2006) *Exchange rates and inflation: France and Bulgaria in the Interwar Period and the Contribution of Albert Aftalion (1874-1956)*, Bulgarian National Bank publication.
- Nikolov, G. (1927) *Stabilization: Monetary and economic (Thoughts on the monetary and Economic Crisis)*, Elisei Petkov Printing House, Sofia (in Bulgarian).
- Pavanelli, G. (1990), ), "Gli economisti e la politica economica: le svalutazioni degli anni '30 nel dibattito italiano", *Quaderni di Storia dell'Economia Politica*, VIII, 2-3, pp. 321-58.
- Pavanelli, G. (1991) "Il controllo dei cambi negli anni Trenta: il punto di vista degli economisti italiani", *Storia del Pensiero Economico*, 22, pp. 37-62.
- Petkov, J. (1926) *Prix, circulation et change en Bulgarie de 1890 a 1924*, Jouve&Cie Editeurs, Paris.
- Radoslavov, V. (1993 [1923]) *Bulgaria and the World Crisis*, Publishing House of the Bulgarian Academy of Sciences, Sofia (in Bulgarian).
- Raitano, G. (1995), "I provvedimenti sui cambi in Italia nel periodo 1919-36", *Ricerche per la storia della Banca d'Italia*, vol. VI, Bari, Laterza, pp. 265-335.
- Renzi, A. (1943), *Tecnica degli scambi con l'estero*, V ed., Hoepli, Milano.
- Robbins, L. (1935). *The Great Depression*, MacMillan and co., London
- Royal Institute of International Affaire (1933). *Monetary Policy and the Depression, A First report on International Monetary Problems by a Group of the Royal Institute of International Affaire*, Oxford University Press, London: Humphrey Milford
- Royal Institute of International Affaire (1936). *The Balkan States. A Review of the economic and financial development of Albania, Bulgaria, Greece, Romania and Yugoslavia since 1919*, Oxford University Press, London: Humphrey Milford
- Rueff, J. (1966). *Le lancinant problème des balances de paiements*, Payot, Paris.
- Sarailiev, G. (1937) *Monetary devaluations and theory effect at home and abroad*, Sofia 9in Bulgarian).
- Scipcovensky, M., (1927). *Bulgaria. Riesumazioni storiche e considerazioni polutiche ed economico-finanziarie dal 679-1927*, Milano
- Scpissarevski, D. (1930). *Bulgarie au Travail. Cinquante and après (deuxième édition)*, Marseille, Société anonyme du sémaphore de Marseille (ancienne maison Nartatier).
- Svrakoff, G. (1941 [1936]). *Theory of Trade Policy (Foreign Trade)*, Sofia (in Bulgarian).
- Storaci, M. (1989), "Il gold exchange standard in Italia", *Rivista di Storia Economica*, n.s., 6, n. 3, pp. 283-319.
- Stoyanov, N. (1933) *Reparations and Inter-Allied Debts. Bulgaria Government Debts*, Sofia (in Bulgarian).
- Tattara, G. (1991) "Power and Trade: Italy and Germany in the Thirties", *Vierteljahrschrift fur Sozial und Wirtschaftschichte (VSWG)*, pp. 457-500.
- Tolomeo, R. (2002), a cura di, *Tra speranze e delusioni (la Bulgaria a Versailles)*, Lithas editrice, Roma.
- Toshev, D. (1941-2). *Bulgarian Industrial Policy after WWI*. *Journal of Higher school of Commerce Graduates*, Varna, 15, pp. 1-213 (in Bulgarian).
- Toshev, G. (1928) *Foreign Currency and Foreign Currency Policy: A Scientific Inquiry into the Reasons of the Economic Crisis*, Franklin Cooperation Printing House, Sofia (in Bulgarian).
- Totev, T. (1932) *The Money. Coins – Banknotes – Paper Money*, Zdruzhenie Trud Printing House, Sofia (in Bulgarian).
- Triffin, R. (1969, [1968]). *Le système monétaire international*, Firmin-Didot Etude et Éditions CLÉ, Paris

- Vanek, J. (1962). *International Trade. Theory and Economic Policy*, Richard D. Irwin, Homewood, Illinois.
- Vachkov, D., M. Ivanov and Ts. Todorova (2007) The history of Bulgaria's External Government Debt, 1878-2005, BNB Publication (forthcoming, in Bulgarian).
- Yeager, L.R. (1966), *International monetary relations: Theory, History and Policy*, New York, Harper & Row.
- Yurii (1923) Monetary Crisis Liquidation (the appreciation of our lev), Pridvorna Publishing House, Sofia 9in Bulgarian).
- Zamagni, V. (1993), *The Economic History of Italy. 1860-1960*, Oxford, Clarendon.
- Zarin, P. Ch (1947) *Measures against Monetary Inflation*, Hudozhnik Printing House, Sofia (in Bulgarian).