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Payments and Finance Problems in the Commonwealth of Independent States

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Solving payments problems that have recently constrained interstate trade among member countries of the Commonwealth of Independent States (CIS) requires stabilization measures that improve the prospects of currency convertibility among CIS countries and stronger institutional arrangements, to permit payments and settlements through correspondent bank accounts.

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Summary findings

Payments problems constrained interstate trade among the CIS countries in 1992–95, especially during the prolonged demise of the ruble zone. Two kinds of solution should be sought: more effective stabilization measures to improve the prospects of currency convertibility among CIS countries, and strengthening of institutional arrangements to permit payments and settlements through correspondent bank accounts.

Strengthening institutions will require not only strengthening commercial banks but liberalizing foreign exchange markets and promoting the use of letters of credit and other mechanisms to increase the security of trade transactions.

A multilateral clearing arrangement operated among central banks would have been a useful alternative to the chaotic payments prevailing earlier, but such arrangements are no longer needed as considerable progress has been made toward convertibility. Nor is a payments union desirable.

Trade deficits are likely to persist in such countries as Belarus and Ukraine. Surplus countries such as Russia and Turkmenistan must develop transparent means of trade financing that take into account the recipient countries' ability to pay.

External financing will remain important for practically all CIS countries. The best way to mobilize private financing will be to establish macroeconomic stability and stable, transparent rules on private capital inflows. Improving the flow of public resources requires improving countries' capacity to quickly absorb the large amounts already committed. Donors need to expedite procurement and other procedures and recipient countries must address governance problems and institutional weaknesses that delay disbursements.

Certain smaller CIS countries face significant debt servicing problems and often the creditors are other CIS countries that themselves need additional financing. The smaller countries need debt relief on concessional terms, possible only if external assistance allows local creditors to offer such relief.

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Payments and Finance Problems in the CIS

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This paper was prepared as part of an ongoing research on trade and payments issues in the former Soviet Union. The paper will appear as part of a *festschrift* to Peter Kenen. It is based in part on work that I have undertaken in collaboration with David Tarr to whom I am also grateful for comments on the present draft

PAYMENTS AND FINANCE PROBLEMS IN THE CIS

A. INTRODUCTION

Integration of the previously centrally planned countries into the international economy has presented some of the most difficult challenges of transition to the market. State control of trade and foreign exchange, vastly distorted prices and insufficiently developed financial institutions left countries in Eastern Europe and the former Soviet Union ill prepared to participate and benefit from international trade and finance. At the same time their governments realized that without integration into the international economy, the transition to a market system would never be complete or successful.

In 1990, Peter Kenen prepared a report for the IMF which focused on the implications of price liberalization and moving to international prices and convertible currencies for trade and financial relationships among the countries of Eastern Europe which were members of the soon to be defunct CMEA [Kenen, 1991]. He concluded that the needed economic reforms will worsen these countries' terms of trade and drive them into a current account deficit with the USSR. He recommended the extension of medium-term financing from the USSR to individual countries and additional external financing from the international community to cope with the terms of trade shock.[1]

In 1992, the USSR itself collapsed and in its place fifteen new countries emerged, all proceeding with price liberalization and moving to international prices and convertibility at a different pace. The problems of economic relations between Eastern Europe and the USSR were quickly overshadowed by the problems of the countries in the former Soviet Union itself: Inadequate payments arrangements and a poorly functioning banking system constrained trade and payments with the rest of the world but especially with each other. Price liberalization resulted in a severe terms of trade shock for energy importers within the former USSR such as the Baltics, Ukraine and Belarus, and contributed to the emergence of large intra-FSU balance of payments disequilibria. With the exception of the Baltics, monetary instability combined with institutional weaknesses have impeded countries' efforts to cope with these financing difficulties.

Since then, Eastern Europe has dealt remarkably well with international trade problems arising in the context of transition: There were few financing difficulties with the USSR in part because of supply declines in Russian and other FSU exportables, and in part because of a rapid reorientation of Eastern Europe's trade to the OECD. Additional international financing, as suggested by Kenen, also became available to most countries [Bosworth and Ofer, 1995].

The situation in many of the FSU countries, however, continues to be a source of concern: Four years after independence, some progress in strengthening financial institutions has been achieved. Stabilization has been attained in several countries and significant efforts are underway in others. Yet, trade among these countries is but a fraction of previous levels and a substantial share of it is conducted under barter arrangements. Payments problems appear to still plague trade in many countries with the exception of the Baltics; and no solution is in sight for the financing problems large imbalances in intra-FSU trade have created in countries like Belarus, Ukraine or Georgia.

The purpose of this paper is threefold: (a) to analyze the impact of payments problems on trade among the FSU countries, using a framework similar to the one Kenen used in the context of the Eastern European countries; (b) to review and analyze alternative solutions to these problems; and (c) recommend appropriate institutional and policy reforms, including ways to deal with the intractable intra-FSU financing difficulties. The focus is on the members of the Commonwealth of Independent States (CIS), i.e., all FSU countries except the Baltics. The reason is that the Baltics, soon after the dissolution of the Soviet Union, took steps to introduce convertible currencies and thus avoided the bulk of the payments problems discussed here. The following section reviews trends in trade and in the evolution of payments mechanisms. Section C discusses the issue of financial imbalances. Section D discusses proposals for institutional reform including the establishment of multilateral clearing and payments arrangements. The final section contains conclusions and recommendations.

B. TRENDS IN TRADE AND PAYMENTS

1. The trade decline

In the aftermath of independence, trade of the new independent states of the FSU with the rest of the world declined but trade with each other apparently collapsed. Official estimates using market exchange rates show a decline in exports to the rest of the world of 14% between 1991 and 1994; and a drop of 87% in exports to other FSU countries (Table 1). Russia is by far the largest trading country in absolute terms with its trade accounting for over 50% of the total, with Ukraine at 19% a distant second. There are many problems with these estimates: First, they clearly overstate the actual decline in 1992 because the exchange rate used to convert rubles to dollars in 1991 was substantially overvalued. On the other hand, in subsequent years the ruble and some of the other new currencies were substantially undervalued using purchasing power parity and wages-in-dollars comparisons [Michalopoulos and Tarr 1994a]. Second, there is evidence that the actual exchange rates used in the conduct of intra-FSU trade in the period 1992-1994 involved a much smaller ruble devaluation vis-a-vis the dollar. Third, throughout the period there were significant amounts of trade conducted through barter. While the statistical agencies tried to adjust for it, it is doubtful that the adjustments made captured all the amounts involved.

Data on intra-FSU trade (called hereafter "interstate trade") published by individual countries are incomplete and contradictory. The constant price series presented in Table 2 is based in part on World Bank and IMF estimates. They show a somewhat smaller decline for intra-FSU trade than the series in US dollars, which however, remains substantial. In most countries exports fell by 70% to 90%. Even Russia and Turkmenistan, which suffered the smallest declines over the proiod, still experienced drops of 67% and 52%, respectively. The fact that intra-FSU trade declined substantially is also corroborated by firm level surveys [Bull,1994].

TABLE 1. Foreign Trade of the New Independent States of the former Soviet Union, 1991-94

(millions of current U.S. dollars at market exchange rates)

	1991		*1992*		*1993*		*1994*	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
Trade with the rest of the world *								
Armenia	70	830	40	95	29	188	42	110
Azerbaijan	487	1,248	754	333	351	241	360	275
Belarus	1,661	1,957	1,061	755	737	777	1,053	690
Estonia	50	204	242	254	461	618	730	1,251
Georgia	30	480	161	269	222	460	86	189
Kazakhstan	1,183	2,546	1,489	961	1,529	1,269	1,327	1,694
Kyrgyzstan	23	785	77	71	112	112	112	88
Latvia	125	478	429	423	460	339	524	581
Lithuania	345	475	557	342	696	486	855	1,063
Moldova	180	656	157	170	174	210	121	134
Russia	53,100	45,100	41,600	37,200	43,900	33,100	46,974	35,100
Tajikistan	424	706	111	132	263	374	319	306
Turkmenistan	146	618	1,145	543	1,156	749	371	298
Ukraine	8,500	11,300	6,000	5,500	6,300	4,700	4,648	4,347
Uzbekistan	1,257	2,048	869	929	1,466	1,280	912	1,106
Former Soviet Union	67,581	69,431	54,691	47,977	57,857	44,903	58,433	47,233
Trade with countries of the former Soviet Union								
Armenia	3,823	4,686	243	292	124	159	215	359
Azerbaijan	9,091	7,013	521	434	629	461	398	612
Belarus	23,151	20,375	1,939	2,128	3,092	3,348	2,085	2,990
Estonia	3,836	2,996	147	146	341	326	574	405
Georgia	5,594	4,806	144	224	295	433	156	280
Kazakhstan	14,285	16,949	2,141	2,463	3,126	3,576	1,958	2,476
Kyrgyzstan	5,163	4,293	236	344	282	378	325	402
Latvia	5,920	4,365	451	472	587	649	503	652
Lithuania	9,268	6,251	505	624	929	1,111	1,160	1,276
Moldova	6,190	5,525	244	377	636	743	406	449
Russia	108,571	83,333	12,300 **	6,200 **	15,752	10,546	17,700	15,000
Tajikistan	3,456	4,361	93	172	118	198	170	252
Turkmenistan	6,314	3,684	616	410	1,731	876	1,252	313
Ukraine	49,598	61,217	5,262	6,425	5,669	9,185	5,543	7,593
Uzbekistan	13,761	14,100	628	827	2,085	2,225	1,408	1,086
Former Soviet Union	268,022	243,954	25,470	21,537	35,396	34,211	33,853	34,145

** The rest of the world refers to countries outside the former Soviet Union.*

*** These recent estimates differ from data in Dikhanov, 1995 which shows exports of 10,954 million and imports of 9,246 million. These later estimates are thought to underestimate imports and may well be subject to further revision.*

Source: National official statistics and IMF.

TABLE 2. Volume of Interstate Trade, 1991-94
(1991=100)

	1992		1993		1994	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
	Based on data in constant 1990 rubles					
Armenia	70.5	35.3	30.2	25.8	19.9	18.2
Azerbaijan	50.7	46.6	24.6	23.4	10.8	18.4
Belarus	77.8	76.1	59.2	61.8	42.0	45.3
Estonia	37.9	38.7	21.5	17.6	13.2	18.8
Georgia	24.3	37.5	22.7	33.0	11.1	13.8
Kazakhstan	95.8	110.1	63.8	72.3	32.4	30.8
Kyrgyzstan	45.8	56.1	22.8	31.5	18.5	21.5
Latvia	79.6	80.4	23.5	25.1	17.0	23.1
Lithuania	48.2	71.1	28.9	28.3	14.5	18.5
Moldova	52.1	61.3	45.9	46.9	28.5	27.0
Russia	72.2	86.2	46.7	54.2	32.5	44.9
Tajikistan	26.1	32.2	15.1	16.2	16.5	13.4
Turkmenistan	95.5	114.7	54.5	100.0	48.2	23.0
Ukraine	64.8	79.3	39.8	56.5	24.9	26.3
Uzbekistan	45.0	49.4	43.3	43.6	28.9	18.2
Former Soviet Union	67.4	77.4	43.7	52.1	29.0	32.7

Source: 1992-1993: Michalopoulos and Tarr, 1994a.
1994: World Bank staff estimates.

Trade with the rest of world declined much less, and in some countries not at all since 1992. In part this was because most countries pursued a conscious policy to shift energy and raw material exports to the OECD in order to earn hard currency and avoid payments problems associated with FSU trade. In the CIS this shift was virtually always undertaken within an overall trade regime that restrained exports which itself had significant adverse effects on output and welfare [Gros, 1994a].

There is a question as to whether the decline in interstate trade should be of concern. This is an issue because there is strong evidence that under central planning, the FSU countries--then simply regions of the Soviet Union--traded excessively with each other. Trade with the "rest of the world", i.e., foreign trade of the Soviet Union, was totally controlled. Under central planning "imports were a necessary evil--the source of last resort for basic raw materials and other inputs that could not be produced at home in quantities sufficient to meet domestic needs. Exports were needed to pay for imports, but they were released reluctantly, because of domestic shortages" [Kenen, 1991, p.246]. Moreover, production was highly concentrated, with some goods produced by a single or very few producers.

Consequently, trade among the then Republics absorbed an unusually high proportion of total trade.[2] At 61% of total trade, Russia had the lowest dependence on trade with the other republics in 1991; for the others, such trade amounted to between 82 and 93% of the total (Table 3).

TABLE 3. Distribution of Interstate Trade, 1991-94

(percent)

	1991		*1992*		*1993*		*1994*	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
Country share of total interstate trade								
Armenia	1.4	1.9	1.0	1.4	0.3	0.5	0.6	1.1
Azerbaijan	3.4	2.9	2.0	2.0	1.8	1.3	1.2	1.8
Belarus	8.6	8.4	7.6	9.9	8.7	9.8	6.2	8.8
Estonia	1.4	1.2	0.6	0.7	1.0	1.0	1.7	1.2
Georgia	2.1	2.0	0.6	1.0	0.8	1.3	0.5	0.8
Kazakhstan	5.3	6.9	8.4	11.4	8.8	10.5	5.8	7.3
Kyrgyzstan	1.9	1.8	0.9	1.6	0.8	1.1	1.0	1.2
Latvia	2.2	1.8	1.8	2.2	1.7	1.9	1.5	1.9
Lithuania	3.5	2.6	2.0	2.9	2.6	3.2	3.4	3.7
Moldova	2.3	2.3	1.0	1.8	1.8	2.2	1.2	1.3
Russia	40.5	34.2	48.3	28.8	44.5	30.8	52.3	43.9
Tajikistan	1.3	1.8	0.4	0.8	0.3	0.6	0.5	0.7
Turkmenistan	2.4	1.5	2.4	1.9	4.9	2.6	3.7	0.9
Ukraine	18.5	25.1	20.7	29.8	16.0	26.8	16.4	22.2
Uzbekistan	5.1	5.8	2.5	3.8	5.9	6.5	4.2	3.2
Former Soviet Union	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Trade with the rest of the world as a share of total trade								
Armenia	1.8	15.0	14.1	24.6	19.2	54.2	16.3	23.5
Azerbaijan	5.1	15.1	59.1	43.4	35.8	34.3	47.5	31.0
Belarus	6.7	8.8	35.4	26.2	19.2	18.8	33.6	18.8
Estonia	1.3	6.4	62.2	63.5	57.5	65.5	56.0	75.5
Georgia	0.5	9.1	52.8	54.5	43.0	51.5	35.4	40.3
Kazakhstan	7.6	13.1	41.0	28.1	32.8	26.2	40.4	40.6
Kyrgyzstan	0.4	15.5	24.5	17.0	28.4	22.9	25.6	18.0
Latvia	2.1	9.9	48.8	47.2	43.9	34.3	51.0	47.1
Lithuania	3.6	7.1	52.5	35.4	42.8	30.4	42.4	45.4
Moldova	2.8	10.6	39.1	31.1	21.5	22.0	22.9	23.0
Russia	32.8	35.1	77.2	85.7	73.6	75.8	72.6	70.1
Tajikistan	10.9	13.9	54.3	43.5	69.0	65.4	65.2	54.9
Turkmenistan	2.3	14.4	65.0	57.0	40.0	46.1	22.8	48.8
Ukraine	14.6	15.6	53.3	46.1	52.6	33.9	45.6	36.4
Uzbekistan	8.4	12.7	58.1	52.9	41.3	36.5	39.3	50.5
Former Soviet Union	20.1	22.2	68.2	69.0	62.0	56.8	63.3	58.0

Source: Shares based upon data in current dollars in Table 1.

There is no consistent detailed information on the evolution of the commodity composition of this trade after independence. The information available (presented in Table 4) suggests the following general pattern: Energy in the form of oil and gas exports was a large part of Russia's exports; Ukraine exports primarily semifinished industrial products (steel) and processed agricultural commodities; Uzbekistan and Kazakstan exports are dominated by raw materials; Belarus and the smaller countries tend to export a variety of manufactured commodities.

Part of the patterns of trade that had developed reflected natural resource endowment. But part of the trade, especially in manufactures, was the result of decisions to locate production on the basis of political or other considerations unrelated to economic efficiency. Some other part of trade involved simply inefficient production that could not be expected to meet international competition once a market system was adopted. Losing this trade could be welfare enhancing rather than welfare reducing.

Gravity models suggest that in the long run, following market reforms, the share of total trade accounted for by FSU interregional trade would decline to about 15-30% of the total, depending on the country [Kaminski et. al. 1995]. In practice, the share seems to have fallen more or less about what would have been predicted. However, the shift has occurred very rapidly and within the context of substantial declines in total trade. Not all of this decline resulted in welfare reductions: Some resulted simply in reduced waste and better allocation of resources.

ıle 4: Commodity Composition of Interstate Trade of Selected FSU Countries, 1993

:cent of total exports/imports)

	Russia	Ukraine	Belarus	Kazakhstan	Uzbekistan	Turkmenistan
al exports	100.0	100.0	100.0	100.0	100.0	100.0
and gas	37.4	0.5	8.7	19.9	42.5	78.5
al and other fuels	0.5	1.5	..	21.1	7.7	..
v materials	15.2	35.6	25.6	42.4	41.0	..
riculture and food	4.4	22.6	5.3	11.2	..	..
nufactured goods and other	42.4	39.8	60.5	5.4	8.9	21.5
tal imports	100.0	100.0	100.0	100.0	100.0	100.0
and gas	2.5	58.1	59.6	31.4	32.4	..
al and other fuels	1.5	1.1	1.6	4.9	3.0	..
w materials	31.6	15.7	24.9	28.5	0.0	..
riculture and food	12.6	3.5	9.0	7.8	14.6	..
nufactured goods and other	51.7	21.6	5.0	27.4	50.0	..

ırce: World Bank staff estimates.

Interstate trade, however, declined significantly both in countries which implemented extensive market reforms such as the Baltics as well as in slow reformers such as Ukraine; in countries that consciously reoriented exports and in countries that did not. Thus, it can be argued that the rapid decline in interstate trade had an impact on output because of the highly interlinked production structure of the former Soviet Union. Failure to supply needed inputs in interstate trade led to the reduction of output in downstream industries. And this output decline led to further declines in trade due to the reduction in the production of exportables.

The decline in trade was compounded by a very adverse terms-of-trade shock for the energy and raw material importing states [Tarr,1994]. During 1992-1994 the major energy exporters, Russia and Turkmenistan, raised previously heavily subsidized prices for interstate shipments of oil and natural gas to close to world levels. Table 5 presents estimates of the terms-of-trade change on interstate trade. The first column shows what was the hypothetical change in the terms of trade that would have occurred if prices moved to international levels based on the 1990 trade pattern. The second column provides estimates of terms of trade changes actually experienced by 1994.

The worst losers were the Baltic states, Belarus and Moldova, which were estimated to experience a loss on their terms of trade of between 20 and 40%. The table shows that what actually happened was pretty close to what had been predicted; and that most of the terms-of-trade changes had been completed by end-1994. The table also shows that the terms-of-trade shock experienced by some of the energy importers was larger than the terms-of-

Table 5: Terms-of-Trade in Interstate Trade, 1994

(1990=100)

	Hypothetical changes in moving to world prices (1)	Actual changes (2)
Armenia	68.3	75.6
Azerbaijan	73.9	88.8
Belarus	80.1	86.2
Estonia	68.2	83.2
Georgia	55.2	64.3
Kazakhstan	98.5	94.8
Kyrgyzstan	87.3	81.1
Latvia	75.7	80.0
Lithuania	65.2	77.8
Moldova	46.6	56.2
Russia	137.6	118.9
Tajikistan	75.3	77.1
Turkmenistan	134.7	139.5
Ukraine	86.2	93.0
Uzbekistan	91.0	90.9

Source: Column 1: Tarr, 1994.
Column 2: Dikhanov, 1995.

trade shock that Kenen estimated for Eastern Europe and substantially larger than that experienced by oil-importing countries after the oil shock of 1973.

2. Payments problems

Payments problems, with economic agents either unwilling or unable to use the banking system to pay for goods and services from other countries may well have been the most serious impediment to interstate trade. Two distinct subperiods can be identified: First, the two-year period from independence in late-1991 to late-1993 through early-1994 by which time almost all FSU countries had established their own currencies; second, the two-year period from beginning-1994 to the present (beginning-1996).

The first two-year period was truly chaotic. There were three sets of interrelated problems: (a) Correspondent accounts between commercial banks in each of these countries could not be used to handle interstate trade transactions, because there were disincentives or restrictions in their use and because of technical shortcomings and delays in making cross border payments; at the same time enterprises did not wish to pay for imports from other FSU countries with scarce hard currencies, and thus were unwilling to use foreign correspondent banks for interstate trade; (b) the attempt to operate a common ruble zone failed (see below) and foreign exchange markets in the new currencies issued by new independent states took some time to be established; and (c) in the interim, the Central Bank clearing and payments system, established by the Central Bank of Russia (CBR) to control unlimited financing of bilateral trade deficits imposed further uncertainties and constraints on the trading system [Michalopoulos and Tarr 1992a and 1994a].

In market economies, the existence of an effective banking system and the operation of foreign exchange markets gives enterprises access to the currencies through which they can make/receive payments to and from enterprises in trading partner countries. At the time of the break-up of the Soviet Union and the establishment of fifteen new independent states such a system for making decentralized payments across borders did not exist. The ruble was the common currency but losing value rapidly on account of high inflation, leading to the introduction of many quasi currencies, e.g., in Ukraine. Payments took a lot of time to complete, were not always final and were made without regard as to whether the payer had sufficient funds.

In February 1992, in an effort to monitor and facilitate interstate payments, the CBR and the other central banks established a system of official correspondent accounts through which payments were to be channeled. During this period Russia alone could create cash rubles, but the central banks of the other independent FSU states could expand the aggregate money supply by creating credit in rubles. This led to the emergence of different so-called "non cash rubles" in different countries with different exchange rates between them and the Russian ruble. In the absence of monetary coordination among the central banks, governments saw no value in exporting in the ruble zone. All they gained for the exports were ruble credits in their banking system, something their central banks could create independently and they had too much of in any case. Governments, including the Baltics, quickly responded by imposing export licensing requirements on interstate trade which were typically more severe than in their trade outside the FSU [Michalopoulos and Tarr, 1994a].

The payments situation deteriorated further after July 1992. Russia began to accumulate large surpluses on its bilateral trade balances with most of the new independent states. To avoid unlimited financing of these trade surpluses and stem the outflow of goods, Russia imposed credit limits on the central bank correspondent accounts of these countries. When correspondent balances with the CBR were exhausted, they were either replenished by borrowing in the form of so-called "technical credits" or the CBR suspended payments by the central bank that had run out of ruble balances. Also, because the accounts at the CBR were bilateral, it was not possible to offset deficits with surpluses generated with other FSU countries. The system was still plagued by huge uncertainties and long delays (about three months) in a highly inflationary environment. Since the CBR could refuse to clear the payments orders of enterprises in a country that exceeded its limit, this meant that Russian exporters would not be paid for the goods they shipped, even if the importer had funds in its commercial bank to cover the payments order.

In early 1993, the Russian authorities decided to curb further financing of the other FSU states through the CBR and informed them that after the bilateral credits already negotiated were exhausted, they would have to obtain loans through the budget. This was followed in June 1993 by a resolution of the Supreme Soviet formally discontinuing access to other FSU countries to financing from the CBR and the demonetization of the pre-1993 ruble soon thereafter. The latter formally put an end to the ruble zone and forced the remaining non-Russian members (Armenia, Azerbaijan, Belarus, Georgia, Kazakstan, Moldova, Turkmenistan, Tajikistan and Uzbekistan) into a dilemma: introduce their own currencies or accept monetary union with Russia, with monetary policy largely determined by the CBR.

All these countries but Tajikistan had introduced their own currencies by early 1994; the latter did so in 1995. These countries had stayed in the ruble zone essentially for two reasons: First, and perhaps most important, there was the expectation that membership would provide them with easy sources of financing. Second, for political reasons they did not want to "offend" Russia on which they depended in a variety of ways, not the least of which was access to energy and raw material imports on, hopefully, subsidized terms. When it appeared that financing on easy terms would no longer be available, that energy imports would become more expensive over time, that monetary instability in Russia continued and that they would not face political sanctions, they opted out of the zone. In so doing, they joined the Baltics, the Kyrgyz Republic and Ukraine which had launched their own currencies in 1992 and 1993, respectively.[3]

During this two-year period of unsettled monetary and exchange policy, the decentralization of payments through correspondent banks was hindered in a variety of ways: Processing of payments by the central banks was being done at a more appreciated exchange rate between the Russian ruble and the "national non-cash rubles" than was usually available to commercial banks. In addition, between August 1992 and July 1993, the CBR did not permit the opening of new accounts for correspondent banks in countries that did not have national currencies. Russian banks, facing both credit and exchange risk were not interested in holding balances in other countries using the ruble; on the other hand, banks from other FSU countries wanted to build precautionary balances in accounts they had in Russia--a practice which some states prohibited in order to stem the outflow of capital to Russia.

The disarray in payments during this period had a devastating impact on interstate trade. Some large enterprises, especially in Russia, were able to continue to do business in other FSU countries partly using rubles and partly hard currency. In 1992 and 1993 financial firms in several CIS member countries were offering to intermediate payments in other CIS members for fees ranging up to 20-30% of the value of the transactions [Gros,1994a]. But most enterprises either stopped trading or resorted to barter.

In the beginning of 1994, the start of the second period, the introduction of new currencies and the progressive elimination of controls on correspondent bank accounts, improved the opportunities for decentralized financing of trade. Countries no longer had to fear that direct trade between enterprises facilitated through the commercial banking system would result in trade surpluses that had no value. A growing network of correspondent accounts among commercial banks spread through some countries (Russia and Ukraine), providing potentially fast turnaround on payments.

While this network started to facilitate some trade, a host of new issues emerged: First, the new currencies, with few exceptions (the Baltics, Kyrgyz

Republic), were not fully convertible. The markets for these currencies were not developed and could not be used in trade. Trade between Russia and the CIS countries was usually denominated in rubles; but this entailed considerable foreign exchange risk because of the ruble's instability. Use of correspondent accounts was further constrained by the general weaknesses of the commercial banking system. Many countries were also facing a serious foreign exchange shortage and were unwilling to use foreign exchange for the denomination or settlement of interstate trade transactions.

As of early 1996 the payments situation had improved; but the improvements were uneven and much remained to be done in many countries. The banking system and payments were functioning best in the Baltics and to a lesser extent in Russia. Correspondent banks were being used for the conduct of trade in practically all countries without significant restrictions; but there were considerable weaknesses: clearances could take as long as fifteen days, there was no trade finance and importers usually had to make payments in advance in full; and letters of credit were not being used to finance interstate trade transactions. While foreign exchange markets were operating in practically all countries, there were continued restrictions (for example significant surrender requirements) in several countries, notably Ukraine and Uzbekistan. As a result barter continued to be an important instrument of trade among most of the new states. While estimates of the total share of barter transactions are difficult to determine, countries (with the exception of the Baltics) report that in 1995 about a quarter to a third of total interstate transactions occur through barter; slightly less in trade with Russia and slightly more in trade among the other countries.

C. FINANCING CONSTRAINTS

The information on the amount of financing made available in support of interstate trade is quite incomplete. It is not possible to develop information on what has happened in the provision of financing for interstate trade on an annual basis and for all the countries. The information that is available is the amount of outstanding ex post credits that were provided primarily by Russia to the other countries--except the Baltics. In some of the cases (and especially for the most important creditors and debtors) it is possible to confirm the information by obtaining data both from the creditors and the debtors. In other cases no information is available.

Table 6 presents the information that we have been able to piece together. The first column shows the cumulative deficit/surplus countries have had on interstate trade in the period 1992-1994. The remaining data show the total amount of outstanding credits that exist, mostly as of mid-1995, between these countries.[4]

Despite the incompleteness of the data, the table brings out the salient characteristics of financing of interstate trade in the last four years. First, it shows quite clearly that Russia and Turkmenistan are the main creditors, while Ukraine and Belarus are the main debtors in absolute terms. Relative to the size of their economy however, Tajikistan and Georgia also have accumulated a large amount of debt in interstate trade.

Table 6: Interstate Trade Balances and Financing in the CIS Members, 1992-1994

(million US dollars)

	Cumulative trade balance, 1992-1994	Cumulative known net financing, 1992-1994 *	Cumulative Credits from Russia				Cumulative Credits		
			Total	technical credits, 1992-1993	state credits, 1993-mid-1995	for natural gas deliveries	From Turkmenistan	From Kazakhstan	From Uzbekistan
Armenia	-229	138	86	45	41	..	51	..	..
Azerbaijan	42	148	82	82	..	..	66	..	..
Belarus	-1,350	925	925	385	81	459	..	..	..
Georgia	-342	662	150	135	12	3	489	22	..
Kazakhstan	-1,290	1,154	1,320	1,250	68	2	..	..	..
Kyrgyzstan	-280	434	390	113	21	256	..	28	16
Moldova	-283	122	122	89	33	..	..	..	..
Russia	14,007	-8,977	..	..	..	..	..	..	..
Tajikistan	-240	471	254	127	127	..	..	18	199
Turkmenistan	2,000	-1,390	134	134	..	..	..	..	23
Ukraine	-6,728	5,922	4,981	2,500	204	2,277	940	1	..
Uzbekistan	-16	390	533	418	115	..	..	96	..
Total			8,977	5,278	702	2,997	1,547	166	39

* Includes some financing for 1995.

Sources:
Data on trade balances for 1992-1994 are from Table 1. Data on financing are World Bank staff estimates, based on information supplied by member countries

As with other aspects of the trade and payments situation during this period, financing was also quite chaotic. The bulk of financing, approximately 80%, was forced, in the sense that it did not result from a contractual arrangement by individual countries to seek or provide credit. Instead it was either the result of arrears (usually for natural gas shipments by Turkmenistan and Russia) which were subsequently consolidated or it was the result of the provision of overdraft facilities or "technical" credits by the CBR which were subsequently formalized in the form of a credit usually denominated in dollars at a LIBOR linked interest rate and with a variety of maturities. Several of the consolidated credits especially between Turkmenistan and Ukraine and some of the other small gas importers also involve repayments in kind or in the form of equity participations in the debtor's enterprises. Some of the credits outstanding (e.g., from Russia to Tajikistan) are not, strictly speaking, financing for trade but have been incurred for the provision of currency by Russia.

The interest rates and amortization periods on which the forced financing has been consolidated are close to commercial. They have generally been extended without an assessment of the countries' creditworthiness. A number of countries in the region (the Kyrgyz Republic, Tajikistan) have found it difficult to meet these obligations and have sought rescheduling.

Beyond this forced financing which occurred largely in 1992-1993 and in the case of Turkmenistan also in 1994, few new credits are known to have been extended during this period, perhaps no more than $700 million. These were provided by Russia, e.g., to Belarus, Kazakstan and the Kyrgyz

Republic. In addition to these credits, there has been some $250 million of net financing by Russian enterprises directly to enterprises in the rest of the FSU in the form of excess of receivables over payables. A few of the main credit and financing arrangements related to interstate trade and payments of the past few years are worth noting:

- By far the largest amounts involve Russia providing financing to Ukraine. The total of almost $5 billion is almost 50% of the total financing obtained by the 10 net debtor countries. There are two major components to this debt, that related to CBR overdrafts and technical credits and that related to debt linked to shipments of natural gas by the Russian monopoly Gazprom (which is now a private company). Separate agreements have been signed for servicing each component of this debt.
- Turkmenistan's forced financing of natural gas exports accounts for the bulk of the remaining known financing. Turkmenistan has reached agreements for the servicing of this debt (involving essentially consolidating of arrears) with most of its debtors, the most important of which are Ukraine and Georgia.
- Ukraine and to a much less extent Belarus and Kazakstan obtained the bulk of the financing and are the largest debtors. Ukraine is likely to have provided some credits to a number of the smaller FSU countries on which however, there is no information.
- In addition to Ukraine and Belarus, Tajikistan and Georgia are major debtors that are likely to require extensive rescheduling of their debt on concessional terms--which has not formally happened yet.

- Kazakstan and Uzbekistan appear to have been in a net debtor position with Russia but net creditors with other Central Asian economies.

This information with regard to the financing made available on interstate trade can be compared to the total amount of financing provided to these countries in the 1992-1994 period (Table 7). The table shows that the official development finance (which includes official grants as well loans on both concessional and commercial terms) made available to these countries from the rest of the world were substantially more in the aggregate than the amount of new financing extended inside the FSU, primarily by Russia and Turkmenistan. Upon closer examination however, it is important to note that the bulk of the assistance recorded here involves grants given to Russia by Germany to deal with the costs of relocation of Russian troops. If one excludes this financing, the remaining amounts provided to the whole FSU actually fall far short of the amounts of internal financing provided by Russia and Turkmenistan. Moreover, most of the new external credits from the rest of the world went to Russia. In addition of course, Russia received very substantial financing in the form of deferral of its own debt payments, while it extended an unknown amount of defacto deferrals on interest and principal to developing countries which have not been servicing fully their obligations to the FSU.[5] All of this financing also is substantially less than the capital flight that has occurred from most FSU countries in this period and which has variously been estimated at $20-40 billion.

Table 7: Aggregate Net Resource Flows to the CIS Members, 1992-94
(million US dollars)

	Total CIS	Russia	Ukraine, Belarus, and Moldova	Transcaucasus	Central Asia
Official development finance	16,871.0	12,146.3	2,360.4	590.9	1,773.4
Official development assistance	11,252.0	9,214.8	1,468.9	192.8	375.5
Official grants	10,125.8	8,700.0	1,187.1	154.9	83.8
Official concessionary loans (net)	1,126.2	514.8	281.8	37.9	291.7
Bilateral	944.4	454.0	252.1	5.1	233.2
Multilateral	181.8	60.8	29.7	32.8	58.5
Official non-concessionary loans (net)	5,619.0	2,931.5	891.5	398.1	1,397.9
Bilateral	3,389.3	1,810.9	368.9	179.8	1,029.7
Multilateral	2,229.7	1,120.6	522.6	218.3	368.2
Private flows	18,609.6	14,186.3	2,647.4	34.3	1,741.6
Private loans (net)	13,387.3	11,584.0	1,207.4	34.3	561.6
Foreign direct investment	5,020.0	2,400.0	1,440.0	0.0	1,180.0
Portfolio equity investment	202.3	202.3	0.0	0.0	0.0
Memorandum item:					
Net use of IMF credit	5,096.3	4,062.7	613.7	63.9	356.0
Interstate known financing	10,547.0	..	6,969.8	947.4	2,629.9

Sources:
World Bank debtor reporting system and Table 6

D. ALTERNATIVE SOLUTIONS

Following independence many believed it worthwhile to try to preserve, as much as possible of the previously integrated monetary and trade system of the Soviet Union. Divergent political and economic interests however, made this impossible. From the very beginning the Baltic countries made it very clear that they wished to introduce market-based reforms quickly and to reorient their economies away from the FSU. Ukraine, primarily for political reasons, also declared early on its intention to issue its own currency and pursue an independent monetary and economic policy. Attitudes in the other CIS countries ranged from the desire to collaborate closely with Russia (Belarus) to the more independent--yet cautious--policies of some of the countries in Central Asia and the Caucasus.

The lack of monetary co-operation throughout 1992 and the likely unraveling of the ruble zone, with the resulting adverse effects on trade, led many analysts to recommend the establishment of a clearing and/or payments union [Dornbush 1992, van Brabant 1991]. The same arguments that were used in the context of Eastern Europe a few years earlier and the parallel with the European Payments Union were again presented in support of the establishment of a clearing and/or payments union for the CIS members (i.e., excluding the Baltics, especially Estonia and Latvia which moved quickly in the course of 1992 to establish convertible currencies).

Indeed throughout this period the CIS countries agreed to implement a number of co-operative arrangements in the field of trade and payments, ranging from complete monetary union to a multilateral clearing arrangement to a customs union [Gros,1994a]. At present a customs union among Russia, Belarus and Kazakstan is in the process of implementation. No region-wide arrangements have been put in place so far. In the payments field the closest anything came to be implemented was the establishment of a multilateral clearing arrangement under the Interstate Bank. Ten countries actually ratified the treaty for the establishment of this Bank in 1993. But in the end, the Bank (and multilateral clearing) did not get established, for reasons discussed below.

The question nonetheless remains as to whether a clearing and/or payments union would have been useful in addressing the payments and financing problems that impeded interstate trade at the time or, for that matter, whether such arrangements would be useful at present.

1. Convertibility and trade

Enterprise-to-enterprise trade and payments are facilitated in a single currency area, and there is a large literature discussing the requirements and conditions for establishing optimum currency areas [Goldberg, 1995]. This literature stresses the benefits resulting from reduced transactions costs of trade within an optimum currency area compared with the potential costs in terms of macroeconomic adjustment that could result from the lack of exchange rate policy within the area. Whatever this balance may be, an essential precondition for any currency area is control over aggregate money creation within the area.

In the context of the break-up of the former Soviet Union the strong forces of devolution of political and economic power to the individual states and the lack of co-ordination and free-rider problems that led to the break-up of the ruble zone in 1993 suggest that it was not practical then and is not practical now to aim for a re-establishment of an area-wide single currency arrangement. This does not mean however, that there may not be isolated cases where countries might find it advantageous to seek to establish very close monetary co-ordination or even a monetary union. Indeed, there have been numerous discussions aiming at the establishment of a monetary union between Belarus and Russia, but so far no agreement has been reached on the variety of issues that would have to be addressed in this context.

If there are different currencies, convertibility of these currencies, especially for current account transactions, is the policy that would best facilitate trade. The examples of Estonia and Latvia and more recently the Kyrgyz Republic, Lithuania and Russia suggest that currency convertibility is feasible both for small countries and large, for countries with significant foreign exchange reserves and without; and that it can be achieved through the use of a fixed exchange rate system, a freely floating one or even a managed float, such as the one used by Russia at present.

Even when currencies are not convertible, trade need not be impeded if commercial banks establish correspondent accounts in hard currency in banks in developed market economies and trade is denominated and settled in hard currency. Such arrangements indeed were made by commercial banks in all FSU countries early on, and in some cases even before independence. These arrangements however, have not been fully utilized to support interstate trade. The most serious impediment to hard currency-based transactions has been the limitations on access to hard currency. Auctions or markets for hard currencies have existed in many countries, but the supply of hard currency in the past--and in some still at present--was limited because of taxes, exchange surrender requirements, and the general incentive of enterprises that earn foreign exchange to hold on to it as a store of value and hedge against inflation or use it in transactions with the hard currency areas. Moreover, governments have imposed constraints on access to these markets that limit the convertibility of domestic currencies into dollars for the purpose of conducting trade. While the situation is improving in this respect, such restraints continue to exist, e.g., in Georgia, Turkmenistan and Uzbekistan.

Moreover, the conduct of trade in hard currencies through a network of correspondent accounts is not costless: First, banks will need to accumulate hard currency balances to satisfy the transactions demand for hard currency trade. There is an interest cost for maintaining these deposits that is equal to the difference between the interest earned on the accounts and the opportunity cost of these funds. For countries or banks whose cost of borrowing dollars on international markets is quite high, these costs may be substantial. Second, fees must be paid to commercial banks in developed market economies for processing the transactions.

2. Clearing arrangements and the Interstate Bank

Despite the examples of Estonia and Latvia, there was considerable doubt throughout 1992-1993 whether convertibility was achievable for most of the countries in the former ruble zone. It was also felt that hard currency shortages, and weaknesses in the commercial banking system made it desirable to consider the establishment of a Central bank-based multilateral clearing arrangement, especially since the alternatives appeared to be either bilateral clearing or barter.

The main objective of multilateral clearing through Central Banks would be to facilitate trade by providing efficient and secure settlement of payments for enterprise-to-enterprise transactions on a multilateral basis; a secondary objective could be savings in the use of scarce hard currency resources and overcoming the problems that scarcity of foreign exchange and ineffective or constrained foreign exchange markets pose for international trade.

In the context of the turbulent situation prevailing in 1992-1993 and perhaps through 1994 such an arrangement made a lot of sense: Unlike the situation in Eastern Europe, trade among the states involved was a very substantial portion of total trade, currencies were inconvertible, clearing was inefficient and bilateral and there was general hard currency scarcity. A multilateral clearing arrangement through the Central Banks would also have permitted the clearing of a much larger volume of transactions than was feasible through the correspondent bank accounts. It has been estimated that the reductions on trade that would have been needed solely to achieve bilateral trade balance--and by inference the gains from multilateral clearing--amounted to 5-6% of incomes for CIS countries other than Russia. This would have been a benefit several times larger than the benefits from multilateral clearing that accrued to the countries of the European communities in 1958 [Gros, 1994b].

Such a multilateral clearing arrangement came very close to becoming operative in late-1993. An agreement to establish an Interstate Bank for mutilateral clearing and settlements among ten CIS countries was actually reached in January 1993; and it was actually ratified by the parliaments of most countries (with the notable exception of Ukraine).

The agreement was intended to be implemented by the CBR using a multilateral payments mechanism on the basis of the Russian ruble for clearance of trade transactions among the member states' central banks. The CBR would inform the Interstate Bank each day of the amount of imports from the other states that they wanted to pay for. The Interstate Bank would provide a multilateral clearing service and inform member states of their cumulative debtor or creditor position. A two-week settlement period was established with full settlement of all outstanding balances to be made in rubles or hard currency.

The system was to run on an initial credit line from the Central Bank of Russia (fixed at 300 billion rubles), but there was to be no additional credit, except interim finance amounting to one-month's exports. Central banks running up against their debt limit were expected to hold the amounts of imports they wanted to pay through the system to the exports declared by the other partner countries (or face expulsion). Thus the Interstate Bank was explicitly designed not to address the financing problems of major FSU debtor countries. It was explicitly foreseen that the Interstate Bank would operate in parallel to the commercial banking system and would never be made obligatory (See Gros, 1994 for details).

Following the January 1993 agreement, little happened to implement it as the Bank's future became tangled up in the uncertainty over the evolution of the ruble zone. After that issue was resolved in the summer of 1993, an effort to put the Bank in place was re-initiated in December 1993 with a meeting of the Central Bank presidents. At the time, it was anticipated that the Bank would operate as a clearing mechanism for the emerging new--but not yet fully convertible currencies. Following that meeting however, no additional steps were taken and the Interstate Bank never became operational.

The demise of the Bank occurred essentially for political economy reasons: Russia did not want the institution because it had a convertible currency and was in a trade surplus position with practically all other CIS countries. It felt that it had no trouble in conducting trade in rubles and was afraid that the clearing arrangement would be used to perpetuate its financing of the deficits of the other member countries of the Bank; i.e., that the Bank would become a payments union with Russia the main creditor. The others had a free rider problem: No individual country had a large enough incentive to invest the political capital needed to push for the Interstate Bank, since the institution would work only if everybody participated and the benefits would accrue to all.

While a clearing arrangement such as that under the proposed Interstate Bank may have been desirable at that time, the question is whether it would be useful to deal with the continuing problems faced by countries in interstate trade at present (1996). The main difference in the last two years is that more countries have made progress towards establishing currency convertibility and the commercial banking system, while not fully effective, has also been strengthened. Trying to establish an new multilateral arrangement carries risks: One risk is that it could distract from efforts to promote convertibility, as well as efforts to strengthen clearing and settlements through correspondent bank arrangements. Moreover, the political economy reasons that prevented the establishment of the Interstate Bank are just as much present today as they were two years earlier. Thus, the time for a clearing arrangement has passed. The best course is to push ahead with convertibility and take all possible steps to facilitate the use of correspondent commercial banks to facilitate payments.

There is a lot that needs to be done in that regard: Commercial banks in countries introducing new currencies have opened correspondent ruble accounts in Russia, and Russian commercial banks maintain correspondent ruble accounts in those countries. These types of arrangements have been used to conduct some of the trade between Russia and the other FSU countries for some time now; they are less used in trade among the other countries. In the context of such trade Russian firms have been insisting on receiving payments in rubles or hard currencies. Denominating trade in rubles poses a number of difficulties for some of the other countries

The most important problem is the continuing high rate of inflation in Russia, which discourages exporters from accepting payment in rubles.[6] An additional risk involves ruble-denominated payments for contracts in the future. The absence of effective futures markets in most of the CIS makes it difficult for traders to hedge against an adverse movement in the exchange rate on futures contracts even in dollar-denominated contracts. The recent establishment of a band for the ruble has obviously helped the situation, but the absence of a well functioning futures market is still a problem that needs to be addressed.

Another problem that has plagued interstate trade is the absence of mechanisms to deal with risks of nonpayment by buyers and nonperformance by sellers. Such risks are typically handled through insurance services, trade contract enforcement, and appropriate methods of payments (notably letters of credit), mechanisms that are not available in Russia and most of the other states of the former Soviet Union. Letters of credit guaranteed by Western banks for dollar-denominated transactions are available, however, and this mechanism is already used to guarantee payment for imports from Western countries. On the other hand, traders that use the ruble as the basis of interstate payments through commercial bank correspondent accounts in the former Soviet Union take risks that can be avoided if the dollar and Western banks are employed. Development of similar mechanisms to deal with ruble denominated trade through the commercial banks is another area which needs to be addressed. More broadly, institutions need to be developed to facilitate direct trade among individual agents without government foreign exchange rationing.

Barter, which is intrinsically less efficient, will be abandoned in interstate trade only if a well-functioning payments system is established. Although state trading barter arrangements should be discouraged, privately arranged barter or payments arrangements during the interim should not be discouraged. Provided the barter deal is arranged by individual agents acting on the basis of market signals, private barter trade reflects the fact that the individual agents find barter more efficient than the banking system; moreover, private barter should respond to the principles of comparative advantage. Thus, regulations prohibiting private barter do not attack the cause of the problem, which is macroeconomic instability and payments difficulties.

3. Payments unions and financing

All of the measures discussed above could help facilitate trade and payments. But they would not deal with the fundamental financing problems that have emerged in interstate trade. The establishment of a payments union had been proposed early on--especially as the demise of the ruble zone appeared inevitable--in order to address the emerging financing problems that were perceived to hamper interstate trade.

The main difference between a strictly multilateral clearing arrangement such as the Interstate Bank and a payments union is the provision of more extensive financing for deficits arising in interstate trade, based on some prearranged rules. Proponents of the establishment of a payments union in the FSU--just as they did in the case of Eastern Europe a few years earlier--have based their arguments on the successful contribution of the European Payments Union in revitalizing intra-European trade in the 1950s [van Brabant,1991].

In a payments union, only part of the multilateral balance needs to be paid until a country exhausts its credit limit. A payments union in the FSU was recommended in the hope that it would accomplish one or more of the following objectives: provide an incentive for regional trade, establish a payments facility among countries with inconvertible currencies, or provide financing and balance of payments support [Williamson, 1992]. The establishment of a payments union has actually been agreed in principle by CIS members in late-1994; and all twelve CIS members agreed to establish an Interstate Currency Committee in May 1995 as a first step in implementing a payments union--although not much has happened since then.

The basic problem with a payments union is that superior policy instruments are available to meet each of these objectives: And it is well established in economic theory that it is preferable to use the instrument that most directly attacks the problem at hand.[7] If the problem impeding trade is making payments in the context of inconvertible currencies, a multilateral clearing arrangement would suffice; the additional financing provided by the payments union would not be necessary to deal with the problem.

Assuming that clearing arrangements are in place, trade incentives can be provided less costly and more effectively to intra-regional trade by preferential treatment through tariffs and related trade measures than through the provision of aggregate balance of payments financing to countries with an overall debtor position on intra-regional trade. This is because the relative "softness" of payments to countries within the union (i.e., the availability of financing) is perceived by the central bank of government authorities but is not internalized in the decision making of importing enterprises unless the central bank imposes foreign exchange rationing or other trade diverting controls on payments outside the union. But in these circumstances, preferential trade arrangements are the most direct and transparent means of stimulating trade with partner countries. This is not the place to discuss in detail the advantages and disadvantages of trade preferences for FSU countries. Suffice it to say that such arrangements may be beneficial or harmful to some or all of the countries in the region, depending on their design; and a number of preferential arrangements are already in place--which however, do not meet the standard conditions for efficient customs unions or free trade areas. The only point that needs to be emphasized here is that a payments union is not the preferred approach to provide preferential trade treatment [Michalopoulos and Tarr, 1994b]

This leaves the question of whether establishing a payments union which would provide a certain amount of financing for intra-union payments imbalances would have been at some time or is at present a useful policy approach to dealing with the financing problems facing some countries on interstate trade. In addressing this question the first issue that needs to be considered is the expected creditor/debtor position of the various countries that might participate in a potential arrangement. For the purposes of this discussion we need to look solely at the CIS countries, i.e., excluding the Baltics. They have neither the political interest nor the economic need to involve themselves in a payments arrangement with the former Soviet Union countries.

Based on the trade patterns of the last several years (see Table 6) it would appear that Russia and Turkmenistan would emerge as major creditors, Uzbekistan a creditor--but not for significant amounts--and Ukraine and Belarus as the major debtors in absolute terms, but with a number of the other smaller CIS countries, e.g., Georgia, Tajikistan showing relatively smaller deficits in absolute terms but large relative to their total trade. The remaining countries would also likely be in deficit for interstate trade but not in large absolute or relative terms.

The question would then arise as to whether Russia and Turkmenistan, the likely persistent creditors in a payments union with the rest of the FSU, would be willing to provide the necessary credit. Notwithstanding the 1994 agreement to establish a CIS wide payments union, there is little evidence that they would: Russia has had persistent balance of payments difficulties and has been unable to service its external debt without extensive debt rescheduling. Its attitude during the discussions of the Interstate Bank clearly showed that it had no interest in providing significant financing for interstate trade, especially if it were to be of the automatic unconditional variety likely to be needed for a payments union. Turkmenistan is a poor country with very large energy potential which is keen on utilizing its foreign exchange earning capacity to modernize and develop its economy; again it is highly unlikely that it would voluntarily enter an understanding in which it would provide external financing for an indefinite period to other FSU countries. Both Russia and Turkmenistan are indeed trying to reduce the arrears owed to them by other FSU countries.

In light of the difficulties Russia and Turkmenistan may face in providing credit in general or within a payments union, should donor nations or multilateral institutions step in to provide the credit? And if so, should they do so in the context of a payments union or bilaterally and in the context of agreed programs of reform supported by the IMF and the World Bank?

The problem of providing external financial support through a payments union is that the rules of payments unions typically allow access to credit unconditionally and on the basis of predetermined credit limits. Under these circumstances countries that are pursuing the worst macroeconomic policies may run the largest deficits and draw most heavily on the credit. Should a payments union have been concluded, let us say in 1992-1993, among the CIS countries, the bulk of the benefits would have accrued to Ukraine and Belarus, arguably two of the countries that have been among the slowest to reform [DeMelo et.al.1995]. Perversely, balance of payments support would have gone to the countries whose adjustment programs are least worthy of support. In this way, a payments union may prolong inappropriate macroeconomic policies; in particular, it may prolong the period during which the country operates without a convertible currency. While it is conceivable that conditionality regarding macro-economic adjustment could have been introduced through a hypothetical payments union, it is highly unlikely that such conditionality would have been more effective in stimulating the introduction of macro-economic adjustment than the direct involvement of the IMF with each of the countries.

Moreover, some of the potential participants, e.g., Uzbekistan, had a greater need for balance of payments support to finance imports from outside the payments union, but the credit provided to the payments union is restricted to balance of payments support within the region. While a payments union was not and is not the answer to the financing problems of some of the countries of the region, the financing needs of these countries are quite real and need to be addressed. Outside Russia very little external financing has been directed to these countries in the aggregate. At the same time, the reform process in some of them (Ukraine, Uzbekistan) only started in earnest in 1994; others continued to be plagued by war and insurrection through most of the period (Tajikistan, Georgia, Azerbaijan, Armenia). Thus it is hard to make judgements as to whether additional financing should have been made available during this period--or if it had been made available that it would have been utilized effectively.

As of the beginning of 1996, however, IMF-supported stabilization programs had been put in place in practically all the countries. Similarly the World Bank and many bilateral donors were providing a variety of assistance programs in support of reforms in all countries. The key issues arising regarding financing were as follows:

- Many countries were not in position to receive export credit financing because of the absence of "cover" from main OECD export credit agencies.
- Some bilateral financing, e.g., balance of payments funding from the European Union, which was urgently needed in deficit countries (e.g., Ukraine), was conditioned on non-economic issues (e.g., action on shutting down nuclear reactors) which was difficult to implement in the short run.
- There was urgent need for the provision of debt relief for two of the poorer of the FSU countries which have a large amount of intra-FSU debt: Georgia and Tajikistan. Given the financing problems faced by these two countries, long term and concessionary debt relief is needed. Yet the creditors themselves (e.g., Kazakstan, Uzbekistan) have financing problems. Their ability to provide concessional financing depends to some extent on the amount of financing they are able to obtain from sources outside the FSU.
- Russia and Turkmenistan are likely to continue to be major creditors within the FSU while net debtors with the rest of the world. Both countries need to develop a suitable financing strategy as well as transparent credit facilities for the financing that they are likely to continue to extend to FSU countries. The latter needs to take into account the creditworthiness of the recipient so as to ensure that repayment will be made and there will not be a need to reschedule soon after the credits are extended.

- All countries need to take steps to increase their capacity to absorb foreign assistance more effectively. At present, the World Bank, by far the region's largest provider of public financing has a portfolio of committed but undisbursed assistance amounting to more than $6 billion of which $4 billion alone is in Russia.

E. CONCLUSIONS AND RECOMMENDATIONS

Payments problems constrained interstate trade among the CIS countries over the period 1992-1995, and especially during the long drawn out demise of the ruble zone. The solution to these problems should be sought in two general directions: More effective stabilization measures that would enhance the prospects of convertibility for the countries in the region; and strengthening of the institutional arrangements that would permit payments and settlements through correspondent bank accounts. The latter involves strengthening of the commercial banks themselves, liberalizing foreign exchange markets and promoting the use of letters of credit and other mechanisms that increase the security of trade transactions.

While a multilateral clearing arrangement operated among Central Banks would have been a useful alternative to the chaotic payments conditions prevailing in the earlier part of the period, such arrangements are no longer needed because there has been considerable progress towards convertibility. A payments union was not desirable earlier or at present to deal with continuing financing problems prevailing in some of the countries especially energy importers.

Financing problems faced by some of the countries could be eased by their pursuit of more effective adjustment policies. For example domestic energy prices in some energy importers such as Ukraine continue to be below world prices. This would imply that balance of payments requirements could be eased through measures that will reduce the demand for energy imports. Notwithstanding such measures, countries like Ukraine and Belarus are likely to continue to run significant deficits on interstate trade. Surplus countries, such as Russia and Turkmenistan need to develop transparent means for trade financing which take into account the capacity of the recipient to repay.

External financing will continue to be an important source of financing for practically all countries in the region. The most effective means of mobilizing private financing is the establishment of macro-economic stability and transparent and stable rules regarding inflow of private capital. For public resource flows the key challenges revolve around improving the absorptive capacity of countries to absorb quickly large amounts of already committed finance. This would require action both by donors to expedite procurement and other administrative procedures and on the parts of recipients to address the problems of governance and institutional weaknesses that delay the disbursement of committed funding.

Certain of the smaller CIS countries face significant debt servicing difficulties; their creditors are frequently other CIS countries, which themselves require additional financing. Debt relief to these countries is needed on concessional terms. Provision of such relief however, needs to be supported by further external assistance to enable the creditors in the region to provide relief on such terms.

ENDNOTES

1. I had reached similar conclusions in my paper with David Tarr [Michalopoulos and Tarr 1992a].

2. It was a high proportion of GDP, but the estimates are somewhat distorted by the artificial exchange rate used to value international trade

3. The IMF early on had supported the notion of a ruble-based monetary union. It abandoned the idea as soon as it became apparent in early 1992 that monetary co-ordination among the Central Banks was impossible. Thereafter, both the IMF and the World Bank, the sources of most of the external financial support to these countries over this period, were keen to promote stabilization policies in these countries and felt that such policies had a better chance of succeeding if they were in a position to pursue an independent monetary policy.

4. In interpreting the table please note that trade and current account imbalances in intra-FSU transactions can be quite different than intra-FSU financing, as imbalances in these transactions may be financed by extra-FSU credits.

5. Russia took over under the "zero" option all of the old obligations and assets of the FSU. Unlike the predictions made early on, Russia also now has a debt amounting to about $25 billion to former CMEA countries. This was the result of the fact that despite a substantial terms of trade of improvement with the rest of the CMEA countries--as Kenen had predicted--the volume of Russia's exports in 1991-1992 declined substantially whereas shipment of the former CMEA countries did not.

6. The monthly rate of inflation of the Russian ruble was 18% as of January 1995 (almost 800% annually), but declined to about 4% by the end of the year.

7. This has been developed by a number of authors, most notably Jagdish Bhagwati, Harry Johnson, V. Ramaswami, and T. N. Srinivasan. See, for example, Jagdish Bhagwati (1971).

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