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Trade and Payments Arrangements in Post-CMEA Eastern and Central Europe

Constantine Michalopoulos
and
David Tarr

Suggestions about how trade and payments can be arranged on an interim basis among the countries of the Council of Mutual Economic Assistance and the USSR now that the CMEA has collapsed.

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The web of trade and payments arrangements binding countries of Eastern and Central Europe under the Council of Mutual Economic Assistance (CMEA) agreements is incompatible with these countries' recent commitments to move toward liberalized trade and currency convertibility.

But the importance to these countries' total trade of their trade with other CMEA members — and the apparent desire of the USSR and others to denominate all future mutual trade at international prices — poses a number of problems of transition for the countries of Eastern and Central Europe.

Michalopoulos and Tarr identify three broad problems in this connection:

• The breakdown of the CMEA arrangements has led to a serious breakdown of trade relations and reduced trade volume among former CMEA members. What interim arrangements can be introduced to facilitate trade?

• Denominating international trade at international prices implies changes in the terms of trade for each country in the system. Terms of trade for the USSR should improve because its main export to the CMEA — energy products — has been undervalued. But if payments are settled in hard currency, other countries of Eastern and Central Europe are going to require more financing at a time when they are already short on foreign exchange.

• All countries may not reach full currency convertibility in the near term, and old CMEA arrangements cannot continue so what interim payment arrangements can be made among these countries and between them and the USSR?

Michalopoulos and Tarr focus on possible interim institutional arrangements for trade and payments among previous members of the CMEA and how such arrangements can help address emerging imbalances in payments. They recommend the following:

• Fundamental trade reforms should allow Eastern and Central European enterprises autonomy to negotiate and conclude contracts directly with foreign firms or agents in the former CMEA countries, to be under no state obligation, and to bear the risk of their contracts. Competition should be encouraged by minimizing or eliminating licensing and price equalization and the monopoly trading privileges of foreign trading organizations. Trade should be at world prices and — until convertibility is achieved — denominated and settled in dollars (convertible currency).

• These countries' commitments to introducing competitive exchange rates and a degree of convertibility should be encouraged. Countries might not achieve convertibility at the same rate; the USSR in particular may lag behind. If so, multilateral clearing arrangements with strictly limited time settlements (no more than three months) may be a useful interim measure and can be established without outside contributions. Short settlement periods are certainly preferable to a system in which bilateral balancing of trade is forced.

• More ambitious payments schemes — patterned after the European Payments Union — are not desirable, as they may retard integration into the international economy and introduce distortions in the pattern of trade and the allocation of financing.

• Providing outside credit to support payments arrangements among Eastern and Central European countries is not recommended — whether such arrangements include or exclude the Soviet Union. Such credit helps countries finance intraregional balances, which have little economic justification and could result primarily from the participants' ineffective macroeconomic policies.

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Trade and Payments Arrangements
in Post-CMEA Eastern and Central Europe

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Trade and Payments Arrangements in East and Central Europe in the Post-CMEA Era

I. Introduction

The web of trade and payments arrangements binding countries of East and Central Europe under the Council of Mutual Economic Assistance (CMEA)[1] agreements is incompatible with these countries' recent commitments to move towards liberalized trade and currency convertibility. The importance of trade with other CMEA members in these countries' total trade however, and the apparent desire of the USSR and others to denominate all future mutual trade at international prices poses a number of problems of transition for the countries of East and Central Europe.

Three broad problems can be identified: First, the breakdown of the CMEA arrangements has led to a serious breakdown of trade relations and reduction of trade volume among former CMEA members. Countries are no longer feeling obliged to abide by CMEA constraints; yet because of currency inconvertibility and the absence of a free market system, trade transactions are hampered. The question then arises as to what interim arrangements can be introduced to facilitate trade *pari passu* with other systemic reforms which are being introduced at a different pace in various countries. Second, denomination of international trade at international prices implies changes in the terms-of-trade for each of the countries in the system. Recent estimates have indicated that in these circumstances, the USSR's terms-of-trade would improve significantly because of

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[1] The CMEA was founded in 1949 by Bulgaria, Romania, Czechoslovakia, Poland, Hungary and the Soviet Union. East Germany joined in 1950, and Albania was a temporary member. Mongolia, Cuba and Vietnam joined in later years.

the relative under-valuation of energy products, its main export to the CMEA.[2] To the extent that payments among these countries (including the USSR) are settled in hard currencies, it is also anticipated, that such a shift will result in raising the financing requirements for countries of East and Central Europe at a time when they already suffer from overall foreign exchange shortages. *Third*, recognizing that full currency convertibility may not be reached for all countries in the near term, but that continuation of the old CMEA arrangements is also impossible, the question is what *interim payments arrangements* among these countries and between them and the USSR are desirable.

The purpose of this paper is to discuss the possible interim institutional arrangements for trade of payments among previous CMEA members and how such arrangements can contribute to addressing the emerging payments imbalances.

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[2] The estimates include Oblath and Tarr (1991), Rosati (1990), Marrese (forthcoming) and Kenen (1990).

II. Trade Arrangements in the Post-CMEA ERA

A. Legacy of Central Planning and CMEA Trading

Trade within the CMEA was historically conducted as an outgrowth of the central planning process. Under the planning mechanism, in East and Central European countries and the Soviet Union, enterprises were given quantity targets, and prices did not play a role in resource allocation. Total imports and exports were coordinated under the plan, since trade according to market forces would be very disruptive to the plan given that prices were so misaligned with world prices. Even when central planning was formally abandoned, as in Hungary in 1968, price controls, price equalization, or other taxes and subsidies also resulted in a seriously misaligned pattern of relative prices. Finally, foreign trade organizations (FTOs) were given a state monopoly on the import and export of goods, which prevented arbitrage on the distorted prices.

The essential feature of trade within the CMEA was the bilateral agreements (or protocols) between the countries that participate in the CMEA. These annually negotiated agreements obligated the two signing governments to export and import to each other specified quantities of particular goods. Enterprises were then required by their government to supply goods for the purpose of meeting the export requirement of the protocol. Upon delivery of the goods, the commercial bank account of the exporting enterprise was credited in domestic currency by its own central bank. Consequently, the customer of the producing enterprise was not a foreign firm, but its own government which both placed the order for the goods and paid the enterprise. Moreover, if the firm was obligated

under the plan to provide goods for export, it felt justified in asking for subsidies if it incurred losses in production.

For trade within the CMEA, the unit of account was the transferable rouble (TR). These TR were, in principle, redeemable for goods from the partner countries; in fact, when denominated in TR, trade was supposed to be bilaterally balanced. In recent years, however, several East European countries have accumulated significant export surpluses in TR. This was due to two types of opportunism in trade. First, countries failed to meet their delivery obligations under the protocols. During 1989 and 1990, the Soviet Union was reducing deliveries as domestic shortages and production problems increased. Another type of opportunism occurred at the transactions level. Since firms received payment from their own government, firms found it in their own interest to export when it was not in the interest of the country. Enterprises often found it more profitable to use resources bargaining with the government than attempting to be a more efficient market oriented enterprise.

B. Desirable Features of a New Trade Regime in East and Central Europe

The ultimate objective of countries in Eastern and Central Europe must be to establish a trading system unfettered by the controls and distortions characterized by the CMEA regime. In such a system, trade policy would rely primarily on tariffs and use of non-tariff barriers to trade would be minimized. Firms will be free to engage in international trade with agents of their choice. Some countries, e.g., Poland, have already more or less reached that objective, regarding trade outside the CMEA. Others are committed to moving rapidly in that direction. The situation in some others, in particular the Soviet Union, is still uncertain and market reforms may take some time to introduce. In this

environment, many questions arise as to what reforms are immediately needed and what interim trade arrangements are required to introduce to facilitate trade with other East and Central European countries and especially the Soviet Union who are lagging in the implementation of market reforms.

As to the reforms needed immediately, the following steps need to be taken. First, of course, it is necessary to undertake wide ranging reforms of the price system. Without such reforms, trade reforms are not likely to be in and of themselves meaningful. Second, the state granted monopoly on trading of the foreign trade organizations in the CMEA area should be liberalized. Otherwise prices to enterprises can be distorted by the FTOs. This has been done in principle in most countries. But in practice oligopolistic structures in trade continue to prevail.

Third, price equalization practices must be abolished. Such practices prevent resource reallocation in accordance with comparative advantage.

Fourth, countries in East and Central Europe should develop the legal basis to impose product specific tariffs or export taxes provided they are not discriminatory and consistent with the GATT. Export taxes are not recommended, but may be necessary in cases where the domestic product is subsidized and the subsidy applies on all production. A prominent case to consider is the case of agricultural production. The price of the export in some countries may be less than the cost of production, leading to welfare reducing exports. The optimal policy is to reduce the subsidy and allow exports; but in the presence of the subsidy, an export tax may be required on all exports (not just CMEA).

Fifth, to encourage product and cost-saving technological development in enterprise decision-making, it is necessary to allow exporting or importing enterprises to deal directly with the agents in the other countries with which

they are buying or selling, to enter into contracts and to bear the risk of their contracts. This can only be accomplished if the governmental obligation to supply to or purchase items from other countries is discontinued. Thus, an essential feature of a desireable trade regime for East and Central Europe is the termination of the state determined quantity or price determination under the framework of the protocols.

Some have suggested that CMEA trade should be reformed by having the governments conduct trade in dollar terms at world market prices. The concept of governments negotiating trade at world market prices is difficult to implement for products that are subject to quality differences. The exporting government will claim that its product is of high quality. Prices in market economies are normally determined through negotiation at the level of the firm, and if the firm does not like the price it is free to seek another offer. Through seeking or obtaining the best offer on world markets, the world market price for products of a particular quality is found. When the government intervenes in decentralized decision-making regarding the nature of the contract (such as steel reference prices or agricultural policies in the European Community) it is usually regarded as a barrier to trade. The essential point is that the government cannot substitute for the market in the determination of market prices. Thus, an essential reform of CMEA should be to remove governments from the process of determining the prices and quantities at which the trade will be conducted. It will then become redundant to suggest that trade be conducted at world market prices.

In the event that partner countries refuse to allow direct negotiation with their enterprises, that should not deter unilateral action by governments who wish to reform their own policies. The argument has been raised that because the

Soviet Union is not moving forcefully to establish a market economy, East and Central European countries cannot allow their own enterprises to negotiate with agents in the USSR such as FTOs. Austria and Finland, however, have shown that small, market oriented countries can successfully trade with centrally oriented economies without introducing central control in their own economies.[3] The USSR presents prices to these countries at which it will sell its exports and buy imports. They, in turn, would maximize their gains from trade with the USSR by allowing their firms to trade with the USSR based on the prices for exports and imports, and the financial arrangements, negotiated with the relevant USSR agent. It does not matter to these countries that the price bid or offered by the USSR may be distorted by central planning.[4]

In the context of discussions on new trade arrangements, some countries, e.g. the Soviet Union, have requested the continuation of intergovernmental protocol lists, which could be used to manage trade as in the past. It is desireable that East and Central European governments agree to nothing more binding than "indicative" lists of products. If a product appears on the indicative list the government only commits to freely allow the import and export of the product. This would involve the removal of the product from licensing requirements or the rapid or routine licensing of products on the lists.

Trade in products that are not on the lists should be permitted to occur, because placing the product on the lists only means a relaxation of licensing and access to foreign exchange for products on the lists, not a restriction of

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[3] See Oblath and Pete (1985).

[4]For example, if the delivered price of Soviet oil to East and Central European countries is low by international standards, their enterprises will attempt to buy it, and it is in the interest of the government to allow them to do so.

licensing for others. It is crucial, however, that the presence of the product on the list should not in any way obligate the government or a particular enterprise to supply the product. An enterprise that wishes to sell a product will need to find a buyer in the other country and enter into a contract. Trade based on indicative lists has been employed in the trade between the Soviet Union and Finland for a number of years.[5]

Finally, true hard currency settlement will be the best mechanism for solving the problem of unredeemable surpluses. Individual enterprises should negotiate the financial arrangements of the transaction with the foreign enterprise and bear the risk. Thus, we recommend that trade be conducted in hard currency and all deficits be settled in hard currency. Due to the possibility of opportunism by foreign governments, the settlement period or credit limit between countries would have to be carefully restricted. An extensive system of bilateral credit arrangements could lead to the proliferation of quantitative restraints on trade such as characterized the trade in Western Europe around 1950 (see below, Section V).

In summary, if these features are implemented East and Central European enterprises will directly conclude contracts with foreign firms (or other authorized agents) in the former CMEA countries, be under no state obligation, and the role of licenses and foreign trading organizations would be minimized. This trading environment would differ from the CMEA arrangements because there would be enterprise autonomy, trade would be conducted according to world prices, and settlements would be made in convertible currency. The principle difference between this approach and trade between firms in market economies would be that

[5]The proposed system is not identical to the Soviet-Finnish system, in which trade was denominated in roubles and no hard currency was exchanged. See Oblath and Pete (1985).

since many of the East and Central European countries do not have convertible currencies, transactions would be denominated and settled in the hard currency of third countries. In effect, this practice is quite common among developing countries.

C. Potential Trade Deficit Problems and Transition Arrangements

In the final months of 1990, it became apparent that switch-over costs to hard currency trade in the former CMEA area may be more severe than previously anticipated. The lack of a decision in the USSR regarding the method by which foreign exchange will be allocated, resulted in the inability of USSR importers to sign contracts with East and Central European exporters, despite "demand" by USSR buyers. It should be emphasized that to the extent that the central authority is losing its control of the USSR economy, it becomes more crucial to convert to hard currency trade and enterprise to enterprise transactions. Otherwise an exporting enterprise in the USSR will be reluctant to export to East and Central Europe, because the payment it receives under an intergovernmental protocol is the delivery of goods through the plan, rather than the immediate and more certain payment of hard currency directly.[6] Thus, many representatives of East and Central European governments are quite concerned about trade deficits, especially a bilateral trade deficit with the Soviet Union, and various transition arrangements have been discussed. The principal proposals have focused on the establishment of a variety of clearing and payments arrangements which are the subject of the remainder of the paper.

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[6]Thus, when production of oil declined in 1990, Soviet deliveries to East and Central Europe declined more than proportionately.

III. Institutional Alternatives for Payments Arrangements

It is widely agreed that the first best arrangement for international payments in the post CMEA era would be for countries to move to full currency convertibility. Recognizing that his might take time to achieve and that the pace of reforms will vary among countries, two basic alternatives for interim monetary cooperation have been suggested: (a) simple clearing arrangements with a relatively short interval between settlement dates (one-three months) and the provision of solely interim finance; (b) payments arrangements, where clearing is supplemented by a facility that provides short (e.g., one-year) or perhaps even medium term credit to the participants -- similar after a fashion to the European Payments Union.[7] For each of these fundamental alternatives there are variations with respect to specific features such as financial contributions of non-participants, the credit terms, the terms of settlement, and the types of transactions covered. The question is what are the potential advantages and disadvantages of such arrangements for trade among former CMEA members.

A clearing arrangement between two or more countries establishes a centralized system of mutually compensated settlements for intra-group transactions, using an agreed upon unit of account. Settlement of net balances arising from transactions (which could include trade in both goods and services) would be made periodically in agreed upon convertible currencies. For example in the Central American Common Market (CACM) clearing arrangement, participants had agreed to extend credit up to $12 million to each participant, with a six month settlement period and settlements made in U.S. dollars. Shorter settlement

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[7]Other arrangements, for example reserve-pooling are also possible, but require a far greater monetary and economic integration that is currently being considered.

periods have been in place in other clearing arrangements among developing countries.

The basic distinction between a payments union and a clearing arrangement is the provision of credit for more than an interim period (i.e., exceeding 3 months). The union could be based on mutual credit extended only among the participating members, or could be financed in part by outside contributors. The European Payments Union was such a mixed arrangement, with the United States contributing $100 million but not otherwise participating in the arrangement. The use of outside assistance allows creditors to be paid in part or in full, with larger credit extended to the debtors than would be otherwise possible [Michalopoulos (1973)].

The apparent success of the EPU has led to repeated efforts to create similar instit tions in other countries. As Kenen (1990) has emphasized, however, the EPU trading region encompassed the entire sterling area, the overseas dependencies of France, Belgium and Portugal, and the Western European members themselves accounted for 35 percent of world exports in 1950, as opposed to less than 4 percent for the CMEA in 1988. Thus, despite the focus on the EPU as a model for an Eastern European Payments Union (EEPU), the more relevant historical experience is from the developing world, where trade within the unions has represented a small portion of world trade. The most successful of these arrangements was the one put in place in Central America in support of the CACM. It functioned, with some outside assistance, for over two decades, until it *de facto* suspended operation in 1987 for reasons to be discussed later. Payments

arrangements have also been in place in francophone Africa as part of the CFA arrangements.[8]

IV. The Role of Clearing Arrangements in Post-CMEA East and Central Europe

Clearing arrangements have been established typically in a regional context, among countries with inconvertible currencies. The clearing arrangement is intended to generate two kinds of benefits to its members. First, there would be some savings in foreign exchange because each country would require fewer liquid foreign exchange reserves to back its trade and because transaction costs arising from payments through third country banks would be reduced. The second and, by far the most important expected benefit is the support of mutual expansion of trade. Clearing can be expected to stimulate intra-group trade if two broad conditions are satisfied: (a) exchange rates are overvalued substantially and in different degrees and can be expected to continue to be so for an indefinite period and, as is typical, there is foreign exchange rationing; (b) trade is hampered by the existence of strictly bilateral arrangements which have led to inconvertible balances. That is, since under the CMEA protocols a surplus earned in trade with one country could not be used to import goods from another CMEA country, trade was bilateral. The question then is what contribution

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[8]A number of earlier proposals in the ESCAP region (which were not implemented) called for a payments union financed without outside credit (although the option of contributions from developed countries was left open), on the basis of initial positions. In a payments union based on initial positions, credit is provided only with respect to increments in trade among member countries. Thus, a country would be asked to participate in the arrangement not with respect to all its trade, but only with respect to changes from the original position. How these original positions are established presumably would be the subject of negotiations among the members [Michalopoulos, (1973)].

clearing arrangements among two or more East and Central Europe countries can make at this point to facilitating mutual trade and payments.

Without doubt a clearing arrangement can provide some very limited foreign exchange savings by reducing transaction costs. The key issue is the relationship between clearing and international trade. At present, trade among CMEA countries in East and Central Europe is hampered by the maze of CMEA bilateral agreements. It is unclear, however, whether these countries now aim or should aim to increase trade with each other. While it is impossible to say for sure because of the price distortions inherent in the CMEA arrangements, it is possible that, if prices and trade among these countries were fully liberalized, they would trade less rather than more with each other. Thus, expansion of mutual trade, a key objective in previous clearing arrangements, is not necessarily present in the former CMEA countries. Instead the main concern is how to cushion the effect of possible <u>reductions</u> in their exports to the Soviet Union and possibly adverse terms-of-trade effects of valuing trade with the latter in international prices.

At the same time, several countries in East and Central Europe have indicated a commitment to take steps to introduce some degree of currency convertibility. Poland has essentially done so already. Hungary is moving in that direction. Czechoslovakia has indicated a desire to achieve substantial convertibility in 1991. Others, most notably the USSR, are lagging. To the extent that these countries introduce more realistic exchange rates and a significant degree of convertibility, the contribution of clearing arrangements would be reduced. For example, if all CMEA countries were to introduce a system of foreign exchange auctions or a variant thereof that would provide firms foreign exchange for the bulk of their foreign trade transactions, it is unclear

why a clearing mechanism for intra-group trade would be necessary:[9] Firms could buy the foreign exchange at the auction and then use it to purchase goods and services denominated in international prices in any market.

Some officials have expressed a preference for a negotiated amount of USSR hard currency purchases of their products. The idea is that an East and Central European country will agree to purchase a specified value of USSR goods and in return the USSR would agree to purchase the same specified value of Hungarian goods. It is important to emphasize that if the country authorities want to negotiate a level of aggregate USSR purchases of the country's exports as a mechanism for ensuring USSR demand, those aggregate hard currency purchases should not limit the autonomy of the country's enterprises in their trade with the Soviet Union. It is also crucial that such USSR hard currency purchases not be targeted in bilateral negotiations toward specific products. The latter would imply protection of specific country exports in the USSR market at the expense of other industries with no such guarantee.

Moreover, if there are bilateral agreements reached on aggregate hard currency trade, it would be desirable to reduce the amount of the agreements over time to avoid a permanent bias in the bilateral aggregate amount of trade. For example, in the initial year the Soviet Union and an East European country might agree to purchase $3 billion worth of goods and services in each other's markets. Trade above this amount would be permitted, but discretionary. That is, the $3 billion would be the minimum amount of trade between the two countries, but there is no guarantee trade above the $3 billion would be balanced. In subsequent years, however, the value of <u>guaranteed</u> hard currency purchases between the

[9]Such arrangements were in place in Poland in 1989 (see Tarr (1990) for a description and quantitative assessment of their consequences), are now in place in Bulgaria and are being considered by the USSR.

countries would be reduced, to say $2.5 billion in the second year and $2 billion in the third year and so on. Total USSR purchases of the country's exports, however, might not decrease in any year if discretionary trade increases. In this manner, the aggregate value of trade with the Soviet Union and the other CMEA countries will become market determined over time, and allow for restructuring of the aggregate amount of trade among the former CMEA countries or toward the West.

Moving beyond such arrangements, a system which allows settlement of balances in hard currency would permit trade to be multilateral. That is, if countries agree to periodically settle their trade balances in convertible currencies, then trade surpluses earned with one country can be used to purchase goods anywhere in the world. Thus, interim arrangements for countries without convertible currencies are possible that permit fully multilateral trade, without the necessity of a clearing or payments union.

Nonetheless, given that currency convertibility is being introduced at a different pace in different countries, and significant foreign exchange controls continue to be in place in most of these countries, clearing arrangements with short settlement periods, i.e., up to three months, in foreign exchange can be useful as a strictly interim measure. They can provide some small foreign exchange savings in transactions costs and a means of monitoring evolving patterns of trade. Their stimulus to trade, as in previous arrangements of this kind can be expected to be small. These arrangements can be phased out as soon as countries achieve a modicum of convertibility. Such arrangements should not be confused with the proposal that some have offered to establish a "clearing dollar." With this proposal trade will be required to be balanced in dollars with the continuation of intergovernmental protocols and state obligations.

Under this proposal essentially nothing would change except that the unit of account in which the trade is conducted is changed to the dollar and prices are renegotiated between the governments at "world market levels." In particular, the problem of how to redeem a TR surplus could potentially be transformed into a problem of how to redeem a clearing dollar surplus, and the many inefficiencies of state trading remain.

It is of course conceivable that clearing arrangements could be considered for an entirely different reason than that considered as their main objective in the past: namely, clearing mechanisms could be used not to expand trade, but rather to regulate its reduction over time and thus to cushion the adjustment of firms previously oriented to CMEA markets. Depending on how it is designed, a bilateral clearing arrangement between any two or more countries, could be used to insulate and protect certain industries in each country from international competition. While such an arrangement could be used to ease transition to international competition, it is clearly an inferior alternative to other means of cushioning the adjustment. Protection through clearing arrangements could involve non-tariff barriers and make the cost of protection non-transparent. Should a need arise to cushion the adjustment of sectors to international competition, interim and declining protection should be provided through tariffs and subsidies.

V. The Role of Enhanced Credit Arrangements: General Considerations

It is widely recognized that simple clearing arrangements, while potentially useful as a transition mechanism, are not by themselves likely to substantially benefit participants or materially affect their trade. Thus proposals for clearing arrangements frequently blend into proposals for enhancing

the arrangements through some type of short-medium term credit characteristic of a payments union. Issues of both feasibility and desirability arise in considering the usefulness of such proposals for countries in East and Central Europe.

A. Mutual Credit

In the case of a payments arrangement with mutual credit, the fundamental problem is to discover countries willing to become creditors within the union in light of the fact that they are typically large debtors in their overall balance of payments. This is precisely the problem in East and Central Europe today.

A country's willingness to participate in a payments scheme as a creditor would depend on the likelihood first, that its position as a creditor within the group might change to debtor and, second, that its trade would expand more rapidly as a result of the union. Unless reversals in imbalances occur as anticipated, there is no incentive for a creditor country to participate.[10]

Unfortunately, it appears that trade-balance reversals are uncommon in trade among countries. In intra-CACM trade there was only one trade-balance reversal among the five countries in the five-year period from 1964 to 1969. There were a number of reversals in the 1970's. But in the 1980's Nicaragua

[10] If all countries have similar probability assessments of which countries will be the likely creditors and debtors, then as long as the likely creditor has some positive probability of becoming a debtor, in principle it is possible to devise complicated credit arrangements (which limit the exposure of the likely creditor), that will provide an incentive for all countries to join. See Ethier (1991) for an elaboration. As mentioned above, however, credit arrangements are very difficult to negotiate, and such complications may aggravate those difficulties.

emerged as a large persistent debtor and Costa Rica and Guatemala as persistent creditors [The World Bank (1989)].

To some extent, reversal in the existing positions can be effected by provisions guiding the extension of credit and repayment. In general, two approaches can be used: Repayments can be based on the reversal of position or on a prearranged time schedule.

The EPU used the first approach. The procedure was broadly as follows: Repayment was made on a monthly basis, partly in cash and partly in the form of credit under a quota system. (Originally, a sliding system of cash and credit was utilized, to be changed later on to a uniform fifty-fifty rate). Any payments in excess of the quota were settled in cash -- with some exceptions relating to extreme debit or credit cases. Under this system, a debtor country could enjoy continued credit for an indefinite period as long as it remained within its quota, and repayment hinged on a reversal of its position.[11] The same applied to creditors. Such a system spreads the onus of adjustment between debtors and creditors, but at the same time the quotas limit to predetermined amounts the credit that is extended to or received by any single country [Michalopoulos (1973)].

The alternative method requires repayments on the basis of a prearranged timetable irrespective of position. A country may end up with large negative balances in intra-group trade because of exchange rate overvaluation or other ineffective macroeconomic policies. A prearranged timetable throws the onus of adjustment more heavily on the debtor, which must either take actions that force

[11]A description of such a settlement scheme for Eastern Europe has been elaborated by W. Ethier (1991).

a reversal within the union or gain a surplus on trade with the rest of the world.

The relative feasibility of these approaches depends on the cooperation prevailing among the members of the union. If there is considerable agreement between debtors and creditors on general economic policy questions assuring that reversals of position will occur, then the former method is preferable. If, on the other hand, such cooperation cannot be assumed, then the generally more demanding terms implicit in the second approach may have to be imposed in order to reduce the amount of credit that would have to be extended by participants to persistent debtors within the union [Michalopoulos (1973)].

Even if policy coordination is undertaken, there is no guarantee that intra-group trade would not leave some countries with large persistent credit or debit positions. It would then make little sense for a country in East and Central Europe to participate in a payments arrangement as a creditor, particularly if such a country, though a creditor in the union, is an overall debtor, requiring foreign transfers to maintain a satisfactory growth performance. Thus, the basic problem of a payments arrangement for intra-group trade and payments is that it focuses on only a segment of the overall balance of trade and payments. Since surpluses within the region may not automatically be converted for the purpose of importing from outside the region, it falls short of multilateral trade. It is for this reason especially that the idea of a payments union was abandoned in ESCAP. It is also the reason for which ultimately the CACM clearing arrangement was de facto suspended. This resulted essentially because Nicaragua, as a consequence of ineffective macroeconomic policies, ran large deficits in intra-group trade, which at the end of 1987 amounted to over $500 million. Costa Rica and Guatemala emerged as persistent

creditors within the CACM at a time when both countries faced severe balance of payments and debt servicing difficulties in their overall international accounts. Guatemala in 1986 and Costa Rica in 1987 suspended operations with the clearing mechanism, which has continued in existence but cleared only 1 percent of intra-regional trade in 1987 [The World Bank (1989)]. The CACM experience is also instructive because it suggests that once a payments arrangement is established, the pressure by debtors to raise credit ceilings increases, as do the requests by the payments union for outside credit to augment available resources.[12]

In order to avoid the problems resulting from large and persistent debtor or credit positions and the need to finance substantial intra-regional, as opposed to global deficits, it has been suggested that payments arrangements be established on the basis of initial positions (see above). The problem is that in East and Central Europe, it is precisely the initial trade positions of members that need to be changed because the price relations on which they are based are distorted. Hence, no payments arrangements based on these initial positions would be desirable.

The prospects for success of a payments union will grow if the creditors anticipate large increases in their exports as a result of the union. For this to occur, however, the payments union must either be tied to an agreement that obligates participants to undertake trade liberalization over time or provide an incentive to undertake trade liberalization. This is a very important condition which, if not fulfilled, is likely to render any payments arrangement

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[12]In response to such requests, the European Commission approved a new credit to the CACM amounting to 120 million ECUs tranched over three years. This credit is intended to support future trade expansion among these countries but not to settle past balances [European Commission (1989)]. As of the fall of 1990, it has not become operative as it requires approval by three of the CACM members which had not yet been obtained.

inoperative. It should be recalled in this context that the EPU which expressly tied to a code of liberalization of intra-European trade to which members had to accede, if they were to participate in the payments arrangements. This code involved commitments to eliminate all quantitative restrictions over a five-year period, as well as other measures facilitating intra-European trade. However, greater trade liberalization within the region than is undertaken externally would induce some costly trade diversion. In addition, given the desire of East and Central European countries to increase their trade integration with the rest of the world, a payments arrangement which focuses on intra-regional trade expansion (diversion) would be moving precisely in the opposite direction.

Perhaps more important than the EPU code itself were the initial conditions that prevailed in Western Europe at the time of its formation. A network of bilateral credit arrangements among Western European countries evolved over time into a situation where most countries were in debt to some countries, but had credit with others. Such a situation provides an incentive for bilateral discrimination in trade. For example, suppose country A is a creditor to country B, but country A is also be a debtor to country C. This situation provides an incentive to country A to impose trade barriers against the imports from country C in favor of imports from country B. Importing from country B allows country A to import at less than the full cost of the goods and services imported by reducing its credits to country B; but importing from country C involves full payment of convertible currency or goods.

Without a network of bilateral credit and debit positions, a country facing a convertible currency deficit gains equally from reducing imports from any country. A dollar's worth of imports from country B is worth the same as a

dollar's worth of imports from country C. It therefore has no incentive to discriminate in its trade barriers. A nonconvertible currency country will in general impose trade barriers including foreign exchange rationing, but there is no marginal gain from rationing against countries in which it runs a bilateral deficit.

The EPU removed the incentive to impose country specific trade barriers because credit or debit positions are defined regionally within the payments union. In East and Central Europe, however, at the beginning of 1991, there is no network of significant debit or credit positions among the countries. Thus, the East and Central European countries have no incentive to bilaterally discriminate in their trade with each other, and the initial conditions which were important to the success of the EPU in reducing trade barriers are absent in East and Central Europe. The Western European experience does indicate, however, that it is important to limit extensive bilateral credit arrangements because they may evolve into an excessively regulated pattern of trade.

B. The Role of Outside Assistance

The usefulness or desirability of outside participation in payments arrangements varies considerably with the nature of the arrangement. In clearing arrangements, strictly defined, foreign participation is not needed; participants can and have easily extended the necessary amount of short term credit. Foreign participation has not been sought for clearing arrangements in the past, nor did its absence appear to be a serious inhibition of the creation of others. However, the situation is quite different with regard to payments unions. Foreign participation has been considered crucial to their establishment and

successful operation. It has often been pointed out that the EPU success was made possible in part because of the original U.S. grant of $100 million, which helped the union to deal with the problem of persistent debtors. Outside aide eases the problem of financing credit positions within the union. Aid funds can pay creditors in part or in full, while a certain amount of credit can be extended to the other participants. The incentive for a creditor to participate would then be the clear benefits that it would derive from potential trade expansion resulting from the union.

A basic issue raised by a payments union with outside credit relates to the criteria for allocating the credit. If there are persistent debtors, then one group of countries enjoys the benefits of the outside credit, implying transfers of resources, while the other group benefits only to the extent that their exports increase as a result of the union. A fundamental problem is whether or not the allocation of aid funds by a payments union is rational. The debtors, whoever they are, get credit automatically according to certain prespecified rules whose stringency can vary with the amount of credit they request. The extension of credit relates to a balance-of-payments position with respect to the region and not to the world as a whole, and yet it is the latter and not the former that should be considered when assistance is extended on balance-of-payments grounds, as it is in the context of an IMF standby or a World Bank structural adjustment loan. More importantly, it may be the case that the use of this credit is the result of inappropriate macroeconomic policies, such as overvalued exchange rates, in which case the aid will go to countries in inverse proportion to desirable reform policies.

VI. Enhanced Credit Arrangements for East and Central Europe

Let us now look at the question of setting up a clearing arrangement with more than interim credit and foreign participation in East and Central Europe. Let us first consider the alternative that the arrangement is limited only to the East and Central European countries (excluding the USSR). Under such circumstances it would appear undesirable to provide external support (from outside the union and in particular from Europe or OECD countries) for a payments arrangement that provides interim credit for trade balances within the region. Indeed, it would be counter-productive, as provision of such credit would reduce the incentive for reorienting trade towards the rest of the world and in any case the beneficiary countries would be chosen arbitrarily irrespective of their economic policies and on the basis of whether or not they have a negative balance within the region -- which in and of itself is of little economic significance.

Suppose however, that the USSR were to participate and provide credit. Again, no external support from outside the group would be justified for the reasons discussed above. The question is whether such an arrangement could nevertheless make a contribution to easing the cost of adjustment in East and Central Europe associated with the anticipated terms-of-trade loss vis-à-vis the USSR resulting from denominating all trade of these countries at international prices.

It should be clear that no concrete proposal to this effect has been made by the USSR. Thus, we are simply considering a hypothetical situation under which the USSR would agree: (a) to participate in a payments arrangement with East and Central European countries; and (b) that if East and Central European countries developed negative balances in intra-group trade, the USSR would agree

to finance these balances on an interim basis, in full or in part, based for example on a quota, as in the EPU.

Clearly, any assistance provided by the USSR to East and Central European countries to ease possible terms-of-trade losses associated with the dissolution of the CMEA could be helpful. From the standpoint of East and Central European countries, such an arrangement could be helpful in financing deficits with the USSR, which are likely to arise in the short run due to the significant terms-of-trade loss they will suffer vis-a-vis the USSR. Since, the USSR is not likely to be willing to finance unlimited deficits, presumably some credit limits (quotas) would need to be imposed. The allocation of credit (from the USSR) would be inefficient as it would again be guided by intra-group payments balances -- which would include, in addition to payments resulting from terms-of-trade losses with the USSR, other factors that affect intra-group trade. On the other hand, Marrese and Vanous (1983) have argued that the USSR had political objectives in East and Central Europe that induced it to subsidize its trade with its East and Central European regional trading partners. It is unclear whether such objectives remain. The desire of the USSR to withdraw from the CMEA framework was in part motivated by its unwillingness to continue to subsidize this trade. Moreover, the Soviet subsidies never bought the political allegiance of the citizens of East and Central Europe.[13] Finally, USSR aid to a payments union would be an inefficient way of obtaining political allegiance relative to bilateral aid.

In sum, a payments arrangement with credit from the USSR could be obviously of assistance in easing the adjustment to a potential terms-of-trade loss; but,

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[13]See Balassa (1990), Oblath and Tarr (1991) and Brada (1988) for elaborations of this argument.

as the multiagency task force study of the USSR has noted [see International Monetary Fund et al. (1991, p.30)], if the USSR is willing to provide such credit, it would be more advantageous to the USSR if it were to provide it directly in the form of an export credit arrangement. Such an arrangement, especially in the area of capital goods, would facilitate its own exports in competition with Western exports.

An alternate arrangement has been elaborated by Ethier (1991). He describes the establishment of a clearing arrangement with credit (either mutual or augmented by outside resources) in which trade with the Soviet Union is included in calculating the settlement balances of East and Central European members but the Soviet Union does not receive or provide credit.

The inclusion of trade with the USSR deals, at least in part, with the criticism that payments arrangements for East and Central Europe that exclude the Soviet Union provide financing for deficits that arise in an extremely small and arbitrarily segmented part of the total trade of the participating countries. Inclusion of USSR trade, however, would still result in the provision of automatic financing of a component of total trade, regardless of the country policies that give rise to the deficit, and as such is subject to the same criticism that the resulting allocation of credit is not efficient.

Inclusion of trade with Soviet Union also gives rise to the question of what would be the ensuing pattern of payments and incentives of different countries in participating. Two alternatives can be envisaged: first, that all the East and Central European countries would end up in a net deficit position; alternatively that some will be creditors and some debtors. If the first outcome obtains (as is widely expected), then the question is why set up such an arrangement in the first place. Provision of outside credit, presumably from

the EC or other donors, would provide for financing of deficits with the Soviet Union with the latter not bearing any of the financing burden. It is argued that if this outcome obtains, the clearing arrangement would permit East and Central European countries to present a united front against the Soviet Union. But, if the objective is to present a united front by East European governments, why cloud the picture by creating an arrangement that includes trade with each other?

In the unlikely event that an East and Central European country is a creditor in such an arrangement, it is argued that it may still find it attractive to join, because the alternative may be a bilateral surplus with the Soviet Union, which would be unacceptable to the Soviet Union. It is assumed, that the Soviet Union would wish to maintain bilaterally balanced trade with all its trade partners and that as result would force a potential surplus country to cut back its exports to the USSR market. A creditor in this arrangement, it is argued, would find it more advantageous to provide such credit to the Union as a whole, because the alternative would be a reduction in its exports and economic activity. The rationale for USSR discrimination is not well elaborated, however, because as argued above, any country, including the Soviet Union, has no incentive to bilaterally balance or bilaterally discriminate in trade before it has developed a network of credit and debit positions. That situation does not presently characterize East and Central European trade.

VII. Conclusions

The analysis leads to the following conclusions about trade and payments arrangements among countries of East and Central Europe in the light of the dissolution of the CMEA.

1. The fundamental reforms recommended for the trade regime would allow East and Central European enterprises autonomy to directly conclude contracts with foreign firms (or other authorized agents) in the former CMEA countries, be under no state obligation, and bear the risk of their contracts. Moreover, the role of licenses and price equalization would be minimized or eliminated and foreign trading organizations would not enjoy monopoly trading privileges. Trade would be conducted according to world prices and denominated and settled in dollars.

2. The commitments of these countries to introduce competitive exchange rates and a degree of convertibility should be strongly encouraged. The achievement of even less than full convertibility will be uneven, and some countries, in particular the USSR may lag behind. In such circumstances, clearing arrangements with short settlement periods, i.e., less than three months, with some of the laggards may be a useful interim measure; and they are to be strongly preferred over a system in which bilateral balancing of trade is forced; but they can be established without outside contributions.

3. Clearing and payments arrangements have been useful in circumstances where there is a network of existing bilateral credit arrangements that have led to bilateral trade discrimination or where the objective of participating countries

is to increase mutual trade. This is not the case in East and Central European countries today where as they emerge from the CMEA they have only small debts to each other and where the focus is on better integration of their economies in the worldwide trading system. Clearing arrangements can also be designed in ways that provide protection. When such interim arrangements in East and Central Europe are concluded, it is important that they do not become vehicles for continued protection.

4. Payments arrangements involving credit face insuperable problems when the credit is to be provided solely by the participating members. Outside credit can be helpful in overcoming some of these problems. But the allocation of such credit is inefficient because it automatically assists countries in the financing of intra-regional balances, which in and of themselves have little economic justification and could result primarily from ineffective macroeconomic policies of participants. On these grounds, provision of outside credit to support payments arrangements among East and Central European countries is not recommended whether such arrangements include or exclude the Soviet Union.

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