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Kieler Diskussionsbeiträge, No. 189

Provided in cooperation with:
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Suggested citation: Schmieding, Holger (1992) : No need for a monetary halfway house: Lessons from the European Payments Union for post-Soviet currency arrangements, Kieler Diskussionsbeiträge, No. 189, http://hdl.handle.net/10419/48095

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No Need for a Monetary Halfway House

Lessons from the European Payments Union for Post-Soviet Currency Arrangements

by Holger Schmieding

Ag 2942 192 Weltwirtschaft Kiel

CONTENTS

- The Soviet ruble has become the common currency for 14 independent states with their own policies on credit expansion and budget deficits. The built-in inflationary bias of the present arrangement can be redressed if the common ruble makes way for separate currencies. However, if major successor states of the Soviet Union switch to their own monies, trade between the former Soviet republics may be further disrupted as long as the new currencies are not convertible for current transactions.
- The European Payments Union (EPU) of the 1950s is often presented as a model for the successor states of the Soviet Union with separate currencies. However, the EPU clearing mechanism and its facility for soft credits were mere second-best devices to mitigate the harm that was caused by the inconvertibility and the collective overvaluation of the West European currencies against the dollar. In the 1950s, a sufficient devaluation of West European currencies would have removed the rationale for restrictions on trade and payments and would thus have made the EPU obsolete. Today, the former Soviet republics need not waste their time in a payments union, i.e. in a halfway house on the road to convertibility, unless they opted for a gross overvaluation of their currencies.
- In recent years, Poland, Hungary and Czechoslovakia have made their currencies convertible at least for most current transactions of their residents. This minimum convertibility has promoted their integration into the worldwide division of labour; it has been maintained because exchange rate policy has not led to a sustained misalignment. Instead of copying Western Europe's post-war mistake, the post-Soviet republics should follow the example of the East-Central European countries and make their currencies convertible at realistic and sufficiently flexible exchange rates.
- Regardless of their currency arrangements, the successor states of the Soviet Union have to transform their banking systems and establish an efficient system to clear payments between banks. Technical help from abroad could promote this process. However, the states need no mechanism that discriminates between interstate payments and payments between the states and third countries.
- Proponents of a special post-Soviet payments arrangement sometimes argue that such an institution would promote the cooperation between the successor states of the Soviet Union; it would thus be politically useful regardless of economic considerations. However, the strained political relations between many post-Soviet countries suggest that the readiness for a reliable cooperation is limited. Hence, special arrangements that inflate rather than economize on the need for cooperation are likely to be unstable.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · AUGUST 1992

ISSN 0455-0420

Contents

I. Introduction 3

II. The General Rationale for a Payments Union 4

III. The Experience of the European Payments Union 5

1. The Overvaluation of West European Currencies 6

2. The Functions of the EPU 7

3. The Evolution of the EPU 9

4. Evaluation 11

a. Expansion of Trade 11

b. Trade Liberalisation and Currency Convertibility 11

IV. A Post-Soviet Payments Union? 12

1. Is Convertibility Infeasible? 13

2. The Examples of Poland, Hungary and Czechoslovakia 16

3. Are the Ex-Soviet Republics Special Cases? 19

V. A Mixed Payments Union? 21

VI. A Payments Mechanism for Convertible Currencies? 23

VII. The Politics of Payments Arrangements 24

VIII. Recommendations 26

Bibliography 27

Deutsche Bibliothek - Cataloguing-in-Publication Data

Schmieding, Holger:
No need for a monetary halfway house : lessons from the European Payments Union for post-soviet currency arrangements / by Holger Schmieding. Institut für Weltwirtschaft Kiel. - Kiel : Inst. für Weltwirtschaft, 1992
(Kiel discussion papers ; 189)
ISBN 3-89456-028-2
NE: Kieler Diskussionsbeiträge

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ISSN 0455 - 0420

Bibliothek des Instituts
für Weltwirtschaft Kiel

I. Introduction

With the peaceful collapse of the Soviet empire and the concurrent dissolution of the Soviet central bank, the ruble turned into the common currency of 15 independent successor states with their own central banks. Only Estonia has so far cut the links to the ruble and introduced its own separate money. On the macroeconomic level, even the most stability-oriented successor states are hard put to resist the temptation to join the inflation race and expand the central-bank-financed deficits of their state budgets and state firms beyond any reasonable limits. Although the erosion of the ruble as a medium of exchange and store of value harms all its users, the biggest chunk of the inflation tax accrues to the republic which boosts the money supply most. On the microeconomic level, the old mechanism to guarantee, clear and settle ruble payments has vanished with the central Soviet institutions. The resulting uncertainties and delays are already contributing to the rapid decline in the division of labour within and among the independent successor states of the Soviet Union ("republics" for short). According to Russian estimates, Russian deliveries to other republics in January 1992, for instance, fell 25–30 per cent short of their January 1991 levels [IMF, 1992, p. 7].

The way to stop the competition for the ruble inflation tax is obvious: The common currency has to be abolished if an effective re-centralisation of monetary policy is impossible or politically undesirable. As soon as major successor states follow the Estonian example and replace the Soviet ruble by their own monies however, the microeconomic problem may become even far more acute. In the worst-case scenario, trade among the republics may shrink substantially in the absence of any new method to settle inter-republican payments. If, for instance, each republic tried to balance bilateral trade flows at the lower side of the bilateral exports or imports, the volume of inter-republican trade would decline to 44 per cent of its previous value.[1] Even worse, such bilateral trade restrictions could induce a chain reaction of mutual retaliation and thus a further reduction in inter-republican exchanges [Dornbusch, 1992]. This would be all the more unfortunate as all successor states are heavily dependent on their mutual trade, the huge and oil-rich Russian Federation less so than the smaller republics.

To avoid such a dismal outcome, various authors have proposed to establish a payments union among the ex-Soviet republics. Even the European Bank for Reconstruction and Development has joined the chorus. This paper examines whether the successor states of the Soviet Union should indeed enter into special payments arrangements. It assumes the likely case that major republics such as the Ukraine introduce their own monies.

The paper is organised as follows. First, the general rationale for a payments union, the oft-cited example of the European Payments Union (EPU) of the 1950s and the arguments for and against a post-Soviet payments union along the lines of the EPU are analysed (Sections II, III and IV respectively). Thereafter, the possible rationale for a payments union among republics with very different degrees of third-money convertibility and for a payments mechanism for republics whose currencies are already convertible on current account are examined (Sections V and VI). The subsequent section (VII) evaluates the

[1] Fischer [1992, p. 34]; the calculation is based on 1988 trade data.

claim that a payments union is politically desirable. The major recommendations are summarised at the end.

II. The General Rationale for a Payments Union

On the most fundamental level, the rationale for a payments union (PU) reflects the advantages of money in general. In a non-money world, only a small volume of mutually beneficial trade can be conducted. Economic exchanges take the form of primitive barter. The introduction of money as a fungible medium of exchange and store of value reduces transaction costs; money allows economic agents to advance to a complex division of labour in space and time according to their static and dynamic comparative advantages, i.e. to exchanges which are multilateral and need not be balanced at any point in time.

Similar considerations apply to cross-border transactions. Assume that, for whatever reason, a group of countries had currencies which are not convertible into other monies. Assume further that households and firms in these countries are willing to spend their local money on imports from other members of the group; however, they are not willing or able to spend a fully convertible foreign exchange (say dollars) on these imports because, at the official exchange rate, dollars are too scarce to be used for this purpose. In the absence of any further provision, trade flows among these countries would have to be balanced in each period, either via private barter deals between individual economic units in the countries or, typically, via state interventions which ensure that imports from each country equal the corresponding level of exports in each period. The need to balance exports and imports bilaterally in each period implies an encompassing system of state control over foreign trade. It substantially curtails the volume of possible transactions as exchanges are restricted by the shorter side of the bilateral balance of desired exports and imports.

With a regional payments union the member currencies become convertible into each other while they remain inconvertible into external currencies such as the dollar.[2] A PU is thus a partial and discriminatory step towards convertibility. More precisely, a PU has two major features: a regional clearing mechanism and a facility for limited balance-of-payments credits. The **clearing arrangement** enables the members to run offsetting bilateral imbalances; the **credit facility** creates the scope to run imbalances with the union as long as they are roughly offsetting over the course of time. Only "structural" imbalances with the union as a whole, i.e. persistent overall deficits or surplusses, would have to be settled in scarce foreign exchange. Both aspects of a payments union help member countries with otherwise inconvertible currencies to economize on scarce foreign exchange; a payments union weakens the need to maintain severe trade restrictions for balance-of-payments reasons among members and thus promotes intra-union trade.

Within a payments union, cross-border exchanges are typically settled along the following lines: Upon presenting documentary evidence that a transaction has occurred, the importer pays the respective price in

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2 Naturally, any agreement on a payments union needs to specify which transactions are covered by the arrangement.

his local currency to his central bank whereas the exporter receives the equivalent amount, calculated at the official exchange rate, in her local currency from her central bank. The central bank of the exporting country thus grants a short-term credit to its counterpart in the importing country. At the end of the month, each central bank informs the common clearing agent of the payments union about the bilateral net balances with all other participating central banks. The clearing agents calculates the overall monthly balance of each participant by offsetting the bilateral claims as much as possible [see, e.g., Gros, 1992, p. 43]. The remaining monthly balance of each country vis-à-vis the union as a whole is settled partly by credit and partly in convertible foreign exchange. The share of hard currency settlement may depend on the cumulative imbalance which the country has incurred since the creation of the mechanism and thus on the amount of credit which the country has already received or extended (see Section III); beyond a pre-determined limit, all further imbalances have to be settled exclusively in convertible foreign exchange. Excessive deficits may also be covered by special credits which the union may extend if the deficit country agrees to change its economic policy in order to avoid further imbalances.

The treatment of cross-border transactions in a payments union differs from that between economic agents whose local monies are convertible. In the latter case, the money is usually transferred between commercial banks. The bank of the buyer or the seller converts his or her local money into the desired foreign money on the market at the going exchange rate. Because each bank is eager to save transaction costs and to economize on non-interest bearing cash or highly liquid low-interest deposits, the banks themselves have a strong interest to participate in the existing mechanisms for an efficient intra- and international clearing among banks. By its very nature, the clearing involves automatic short-term credits among the commercial banks.

III. The Experience of the European Payments Union

Proponents of a Post-Soviet or an East European Payments Union usually cite the example of the European Payments Union (EPU) as one of their main arguments.[3] The EPU lasted from mid-1950 to the end of 1958. The Preamble of the EPU Agreement had laid down four major objectives [EPU, 1951]: (i) the removal of quantitative trade restrictions on the basis of non-discrimination within Europe, (ii) further moves towards full convertibility, (iii) increases in foreign exchange reserves, and (iv) the attainment of independence from US aid. In terms of these objectives, the EPU members made remarkable progress during the years in which the system operated.[4] At the same time, intra-European trade expanded rapidly. On December 27, 1958, the EPU was dissolved and the currencies of member countries became freely convertible

[3] See, e.g., van Brabant [1990; 1991a; 1991b] and Buchheim [1990b] for an East European PU. The idea of an East European PU has received scant attention recently. The payments union idea has been revived for the ex-Soviet republics by, e.g., Havrylyshyn and Williamson [1991], Gros [1992], Dornbusch [1992], and Bofinger and Gros [1992].

[4] The discussion of the EPU draws on Schmieding [1987; 1989].

into the US dollar for current transactions. Although the transition to this kind of convertibility had taken considerably longer than anticipated in 1950, the fact that it actually happened can be interpreted as a noteworthy achievement. Yet, a look at the special circumstances of the postwar period is warranted before we pass a judgement on the EPU.

1. The Overvaluation of West European Currencies

In the aftermath of World War II, no major currency but the US dollar was fully convertible. Cross-border transactions in Europe and elsewhere outside the dollar area were hampered by a shortage of international liquidity, i.e. a lack of dollars. Economically, the much deplored "dollar gap" is easy to explain. Trade and payments figures, the fashionable "dollar shortage" talk and the rates at which major West European currencies were traded on the free market in Switzerland [see Giersch et al., 1992, p. 93] point to a gross undervaluation of the dollar in the post-war period. This had three major negative consequences:

— At the official rates, no other major currency looked sound enough to be trustworthy or even be credited with some expected revaluation. Every country thus had an incentive to refuse to accept any currency but dollars in exchange for its goods. **Payments** among currency areas were therefore subject to severe restrictions.

— Owing to the shortage of money that could be used as a store of value and medium of exchange in transactions among currency areas, the world outside the dollar area turned to **barter trade**, i.e. to a network of bilateral agreements specifying in detail the quantities and values of goods to be exchanged.[5] These encompassing trade restrictions were to make sure that no partner ended up with a deficit that would have to be settled in scarce dollars, or at least with no bilateral deficit exceeding a fixed limit called "swing." As a consequence, the volume of intra-European trade in the late 1940s remained far below its pre-war level; the resumption of trade links proceeded even less rapidly than the recovery of domestic production.

— The overvaluation turned Western Europe into an expensive and thus unattractive site of production; it also entailed the risk of future devaluations. Hence, American and other foreign **investors** shunned Western Europe which had to rely almost exclusively on domestic savings (buttressed by some foreign aid) to finance the reconstruction and expansion of its capital stock.

In principle, the underlying economic distortion could have been righted rather easily. As all major West European currencies were grossly overvalued against the dollar while the intra-European exchange rates were far less out of line, a hefty revaluation of the dollar in terms of gold or a corresponding devaluation of European currencies in terms of dollars would have been the obvious remedy. Unfortunately, the govern-

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[5] Such bilateral agreements had played a major role in international trade since the Great Depression of the late 1920s.

ments of both the US and the European countries were reluctant to change the parities sufficiently.[6] Since the traumatic — though misinterpreted — experience with the currency instabilities of the interwar period, a stable external value of one's money in nominal terms was widely regarded as being highly desirable per se. Furthermore, a kind of "elasticity pessimism" prevailed among academics and politicians, i.e. the belief that trade volumes would react only slowly to price signals: after a devaluation, the desired improvement of Europe's aggregate trade balance vis-à-vis the US would come about only with a long and sustained J-curve type delay - if it were to happen at all.

The transatlantic currency misalignment was exacerbated by a peculiar asymmetry in the pace of Western Europe's economic reconstruction. Before the war, Germany had been the dominant supplier of capital goods in Europe. After the war, (West) Germany's economic recovery lagged far behind those of other countries. While industrial production in the rest of Western Europe already exceeded its 1938 level by 7 per cent in 1947, West Germany's factories still churned out no more than 34 per cent of their prewar output [Economic Cooperation Administration, 1951, p. 98]. Because of the ill-considered Allied occupation policy, West Germany was virtually absent from the European trade and payments circuits until the end of 1949. To rebuild and augment the war-damaged capital stock, Western Europe hence needed to import far more capital goods from the US than would have been the case if these goods could have been purchased in Germany, the traditional supplier.

2. The Functions of the EPU

Shocked by the European balance-of-payments crisis of 1947, the US, the only country capable of shaping the international economic order, changed tack. With the European Recovery Program (ERP) which Secretary of State George Marshall announced on 3 June 1947, the Americans made it plain how they intended to help Western Europe along. They decided to replace the previous short-run relief efforts by medium-term aid for reconstruction, to provide Europe with some liquidity necessary for the conduct of intra-European trade on a multilateral basis and to push for the removal of restrictions on intra-European exchanges.

The Organisation for European Economic Co-operation, OEEC, the collective body of Marshall Plan recipients, turned into a quite effective instrument of trade liberalization.[7] Immediately after the US Marshall Plan administrator, Paul Hoffman, had urged Western Europe to make rapid progress in early

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[6] Although the devaluation of most West European currencies against the dollar in late 1949 helped to mitigate the problem, the adjustment fell far short of the necessary magnitude.

[7] The OEEC did not become the powerful supranational predecessor of a European Economic Union as the US had envisaged [see Milward, 1984, pp. 90-125]. Note that West Germany was included in the OEEC from the very beginning. This constituted the first step towards a rehabilitation of the country on the international level. Whereas the US had invited all European countries besides Spain to participate, Eastern Europe had to abstain because of a veto by Stalin. To compensate his satellite states in Central and Eastern Europe, Stalin founded the Council for Mutual Economic Assistance (CMEA) in 1949.

November 1949, the OEEC Council of Ministers decided to abolish quantitative restrictions on 50 per cent of intra-OEEC trade within six weeks. The liberalisation requirement was raised stepwise to 90 per cent by early 1955 [see Ehmann, 1958, pp. 23–52]. A few months after the removal of quantitative import restrictions in Western Europe had begun in earnest, the first and rather futile steps towards a multilateral settlement of intra-OEEC payments imbalances were replaced by the much more comprehensive European Payments Union (EPU) in mid-1950.[8]

As a supplement to the OEEC the EPU was designed to advance European economic integration in two ways:[9] (i) under the EPU regime, all intra-EPU payments were to be settled monthly on a strictly multilateral basis; (ii) the EPU was to provide for the automatic extension of limited balance-of-payments credits from countries with net surpluses in intra-EPU exchanges to net debtors.[10] The credit mechanism was backed up by an initial infusion of US$ 350 million of Marshall Plan aid as working capital.[11] The US used further bilateral payments to induce countries such as Belgium, who expected to end up as structural creditors to the EPU, to participate in the scheme.

The **clearing mechanism** reduced the overall need for transaction balances in transferable currencies (i.e. in dollar) and removed the rationale for a bilateral balancing of trade in the area covered by the EPU agreement. The **credit mechanism** created the scope to run payments imbalances with the union over time as long as the cumulative imbalance did not surpass a certain limit called "quota". Cumulative net imbalances amounting to 20 per cent of these EPU quotas were a pure credit; beyond this initial credit tranche, **surplus countries** received half of their additional surplus in dollar and granted the remainder as credit. The dollar share in the settlement for **debtor countries** increased with the size of the net deficit relative to their quota [see EPU, 1959, p. 19]. Imbalances surpassing a country's quota had to be settled entirely in dollars at the end of each month.[12] Via the EPU mechanism, surplus countries in intra-EPU exchanges thus granted a limited amount of revolving short-term credits to the corresponding deficit countries. The rising share of dollars in debt settlements provided debtor countries with an incentive to correct the imbalance even before they exhausted their quota.

The EPU was more than a European organisation. The mechanism encompassed payments balances with the entire monetary areas of the OEEC countries, including overseas territories and all members of the sterling area such as India, Pakistan and South Africa. In 1950, intra-EPU trade accounted for roughly 60 per cent of world exports and imports. The actual clearing was handled by the Bank for International Set-

[8] For an assessment of the pre-EPU arrangements, see Triffin [1957].

[9] The EPU was largely the brainchild of the U.S. Economic Co-operation Administration (ECA). It had initially been opposed by the U.S. Treasury, which had advocated a strengthening of the International Monetary Fund (IMF).

[10] Bofinger [1990] has emphasised a third function of the EPU, namely that of coordinating the transition to full current-account convertibility.

[11] As is turned out, this sum was equivalent to 30 per cent of the total net imbalances which the EPU members incurred in the first year in which the EPU operated [EPU, 1959, p. 36]. Some working capital was needed as the dollar shares in the settlement of deficits and of the corresponding surplusses were not necessarily identical.

[12] In a payments union, even those members who have exhausted their quota and thus have no further access to credits benefit from the multilateral clearing of mutual claims; see Dornbusch [1992, p. 13].

tlements (BIS) in Basle while the administration of the EPU was laid into the hands of a Paris-based managing board which operated under the supervision of the OEEC Council.[13]

3. The Evolution of the EPU

The establishment of the EPU coincided with the onset of the Korean war which spurred a run on imports in Western Europe. In November 1950, i.e. within less than five months of EPU clearing, West Germany had already exhausted its quota. In conjunction with the OEEC, the EPU granted West Germany a conditional balance-of-payments credit which was explicitly linked to a programme of monetary and fiscal restriction. When West Germany temporarily suspended its previous relaxation of import quotas in February 1951, the OEEC approved this measure so that no OEEC member could legally retaliate against West German exports. Within a few months, West Germany's payments situation improved dramatically; the country repaid the special assistance credit in May 1951, i.e. five months ahead of schedule, and lifted the re-imposed import quotas in January 1952.[14]

The handling of the "German crisis" and the rapid improvement in the West German payments position greatly enhanced the prestige of the EPU and the OEEC. The measures adopted by West Germany and the EPU set a precedent for further crises to come. By extending temporary and conditional balance-of-payments credits, the EPU and the OEEC council tried to entice those debtor countries which were about to exceed their EPU quotas to adopt more restrictive monetary and fiscal policies and to relax any reimposed import control within a short period of time. As negotiations over the terms of renewal of the EPU were held every year since the initial agreement on each country's financial obligations to the EPU had expired in 1952, creditor countries had some leverage to nudge debtors towards less expansionary demand policies and a more liberal trade and payments regime. Moreover, countries accumulating claims on the union in excess of their quotas (notably West Germany from 1953 onwards) were themselves urged by the OEEC to liberalise their imports further.

The EPU mechanism enabled its participants to relax restrictions on the convertibility of their currencies among each other sooner than vis-a-vis the dollar. This progress went along with a liberalisation of trade among the participants under the auspices of the OEEC that outpaced the removal of import barriers against the dollar area.

Over the course of reconstruction in the 1950s, the real overvaluation of West European currencies gradually corrected itself. West Germany's internal economic reforms of June 1948 had paved the way for its famous "economic miracle." With its subsequent reintegration into European and world trade, West Germany re-emerged as a major supplier of capital goods. Europe's special postwar needs to import machinery (and food) from the U.S. thus abated over the course of time. Roughly in line with this development, West European countries eased their restrictions on trade and money flows with third countries.

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[13] For details of the EPU and its evolution see Kaplan and Schleiminger [1989].

[14] On the "German crisis" see Giersch et al. [1992, pp. 101-105] and Kaplan and Schleiminger [1989, Chapter 6].

From 1954 onwards, a stepwise hardening of the terms of bilateral trade and payments arrangements with non-EPU countries and a hardening of the EPU agreement[15] itself made the discrimination against countries with convertible currencies, i.e. the dollar area, increasingly obsolete.

From 1955 onwards the EPU turned into an almost bilateral affair. Low inflation West Germany accumulated high surpluses in excess of its quota, forfeiting dollar payments it would have been entitled to receive from the union [see Table 1]. Via the EPU mechanism, West Germany granted credits to high inflation France, whose position with the EPU deteriorated rapidly. Without West Germany's politically motivated generosity, the EPU would probably have collapsed by late 1955 or 1956. The maintenance of the EPU for the benefit of France (and some minor debtors) prevented the other EPU members from taking the final steps towards the current account convertibility of their currencies at that time.

In the late 1950s, a radical change in French economic policy paved the way for the dissolution of the EPU. The French franc was twice devalued in 1957 and 1958; and after de Gaulle's rise to power in 1958, France adopted a drastic austerity programme which had been approved by the OEEC and the IMF. Upon implementing the "Plan Rueff", France finally agreed to dissolve the EPU as of 27 December 1958. With the exception of Greece (who followed in May 1959), Iceland, and Turkey, all OEEC members restored external convertibility of their currencies into dollars for current transactions on this day.[16]

Table 1 — Prices and Payments Positions of Major EPU Members

	Price[a] increase 1950–58 (percent)	Relative payments position with the EPU[b]	Cumulative balance with EPU 12/58 (US$ mil.)	EPU quotas (late 1951) (US$ mil.)
Switzerland	11.9	0.1	+20	250
Belgium	17.5	3.6	+1192	331
West Germany	22.5	8.9	+4473	500
Denmark	29.8	–1.3	–255	195
Netherlands	31.3	1.6	+557	355
Italy	35.6	–2	–420	205
United Kingdom[c]	46.3	–1.3	–1396	1060
Norway	47.5	–1.7	–342	200
Sweden	52.2	0.5	+137	260
Austria[d]	52.2	–0.9	–61	70
France	62.9	–4.7	–2900	620

[a]Consumer price index. — [b]Cumulative balance 12/58 divided by the respective EPU quota. — [c] Payments figures understate the British balance-of-payments problems due to the partial inclusion of the Sterling area in these figures. — [d]Devaluation of 18 per cent in 1953.

Source: EPU [1951-1959]; BIS [1951-1959]; own calculations.

[15] For details, see the annual reports of the EPU, especially EPU [1959, pp. 17-26].

[16] West Germany went one important step further and removed most of the remaining restrictions on capital flows in late 1958 and early 1959.

4. Evaluation

a. *Expansion of Trade*

In terms of trade creation, the EPU seems to have been a success, at least at first glance. The shares of the EPU countries (excluding overseas territories) in both world imports and world exports rose significantly in the years 1950–1958, from 35.3 to 41.8 per cent for exports and from 41.8 to 43.6 per cent for imports respectively [Schmieding, 1987, Table 4]. The figures point to a considerable reduction of the combined trade deficit of the EPU countries and to a rapid increase in the volume of trade at the same time. However, Western Europe's enhanced position on the world market can be attributed to one single and rather special factor: the re-emergence of West Germany. The Federal Republic took 7.5 per cent of world imports in 1958 compared to 4.6 per cent eight years earlier and increased her exports from 3.6 to 9.4 per cent of world exports at the same time, almost attaining the shares held by the much larger German Reich in 1937 (8.2 per cent for imports and 9.8 per cent for exports respectively). The other EPU countries barely increased their slice of world exports (32.6 per cent in 1958 as opposed to 31.7 per cent in 1950 and 32.6 per cent in 1937), while their share of world imports declined from 37.1 to 36.2 per cent (1937: 43.8 per cent).

Although the EPU mechanism may initially have facilitated West Germany's re-integration into the world trading system and may have given the West Germans the chance to promote their trade via export credits to France and others, the EPU can hardly be credited with the West German success.[17] West Germany gained market shares overseas while other EPU-members became slightly more dependent on intra-European exchanges in the 1950–1958 period. Note that West Germany's external trade continued to increase at high rates even after West Germany had surpassed the position on the world market which the Western parts of the German Reich had held before the war. With less inflation, a relatively far-reaching and rapid liberalisation of imports and a faster growth of productivity than in most other EPU countries, West Germany outperformed its West European competitors.

b. *Trade Liberalisation and Currency Convertibility*

By the end of 1958, i.e. more than eight years after the establishment of the EPU as a regionally discriminatory interim solution, Western Europe had finally returned to fairly liberal and non-discriminatory trade and payments arrangements. At first glance, the EPU seems to deserve a positive verdict:

- Both the credit and the clearing mechanism of the EPU had helped Western Europe to economize on scarce dollars.
- The credit facility had partly compensated the West European countries for the lack of a developed international market for private capital.

Yet, the very facts that the transatlantic capital market was underdeveloped in the aftermath of World War II and that convertible foreign exchange was extraordinarily scarce in Western Europe reflected the over-

[17] For an analysis of West Germany's postwar growth spurt, see Giersch et al. [1992].

valuation of West European currencies, not any inherent deficiency of the capital market or any incorrigible dollar shortage.

Interestingly, the major beneficiaries of Marshall Plan aid in absolute terms, namely Britain and France, were exactly the two countries which went through recurrent balance-of-payments crises in the 1950s [Kostrzewa et al., 1990]. West Germany however — which had suffered a net outflow of resources in the post-war period if war reparations and the costs of military occupation are deducted from the Marshall Plan payments and the other aid receipts — experienced an unprecedented export boom, outstandingly high rates of economic growth and a rapid accumulation of foreign reserves.[18]

All in all, Western Europe had taken the long road to multilateral trade and currency convertibility. Due to a reluctance on both sides of the Atlantic to revalue the dollar or to devalue European currencies respectively, the lack of international liquidity had retarded the removal of barriers to trade and payments for more than a decade. The Marshall Plan and the EPU were mere second bests; they served as — albeit successful — means to limit the damage of a misguided transatlantic exchange rate policy on intra-European exchanges. Because the EPU made the maintenance of overvalued currencies and regional discrimination against exchanges with the dollar area more bearable, the EPU even reduced the adjustment pressure on high-inflation countries such as France. It may thus have delayed the correction of real exchange rate misalignments and the introduction of current-account convertibility.

Unfortunately, the short way to currency convertibility, i.e. the option of genuinely flexible or at least readily adjustable exchange rates, was hardly considered at all by policy-makers in the late 1940s and early 1950s. Lower exchange rates vis-à-vis the dollar, be they determined by the market or be they the result of a devaluation in a regime of otherwise fixed parities, would have made Europe attractive for foreign investors. Provided that restrictions on the free flow of capital had been relaxed accordingly, this inflow of capital would have shortened the time needed for reconstruction and the partial catching up with the U.S. At the same time, a dearer dollar would have subjected the American economy to more competitive pressure. Under such a regime, productivity might have increased at an even more rapid rate on both sides of the Atlantic.

IV. A Post-Soviet Payments Union?

All in all, the verdict on the European Payments Union of the 1950s is negative rather than positive; it was a time-consuming detour rather than a necessary halfway-house step on the road towards the convertibility of West European currencies. The role which a special post-Soviet payments arrangement could play today depends on the degree of convertibility of the participating currencies into fully convertible third monies such as the dollar, the ECU or the D-Mark. A payments arrangement may be devised

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[18] For a detailed comparison of inflows and outflows, see Buchheim [1990a].

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— to introduce a regionally limited convertibility among republics whose currencies are not convertible into third monies (a genuine payments union along the lines of the EPU);
— to cater for republics with different degrees of third-money convertibility (a mixed payments union); or
— to ease the settlement of exchanges among republics with convertible currencies.

The discussion in this chapter concentrates on the first case, the remaining two cases being taken up in the subsequent sections.

1. Is Convertibility Infeasible?

Many supporters of a payments union readily acknowledge that such a mechanism would be a temporary second-best solution [see, e.g., Dornbusch, 1992]. Yet, why should a republic pause at this halfway house instead of moving on to the first-best option of currency convertibility at the very beginning? To investigate this question, a brief look at key concepts and key arguments of the general debate on convertibility is warranted.

In the most narrow sense of the term, a currency can be labelled convertible if it can be freely exchanged into other monies. To be economically meaningful however, convertibility must also encompass the freedom to conduct the underlying cross-border transactions which give rise to cross-border payments. For instance, the permission to acquire foreign exchange to pay for imports is of limited use if the imports are illegal or subject to restrictive quotas or almost prohibitive tariffs. Convertibility and the liberalisation of cross-border transactions are two sides of the same coin. Unless stated otherwise, the term convertibility in this paper always refers to both payments and the underlying transactions.

The advantages of convertibility-cum-liberalisation are well known. With **current account convertibility** for resident enterprises, a country

— imports the world market structure of relative prices for tradables and thus makes the allocation of resources more efficient,
— subjects domestic producers of tradables to competitive pressure and thus spurs economic growth,
— curtails the scope for excessive price increases which domestic monopoly suppliers of tradables may otherwise have had,
— enhances its attractiveness for foreign investors and suppliers of advanced technology who can repatriate their profits and royalties.

Full current-account convertibility further promotes the well-being of domestic citizens who can freely acquire foreign exchange to travel abroad. As the purposes for which the citizens actually use the foreign exchange can hardly be controlled, full current-account convertibility comes close to a de facto permission to export capital. In addition, formal **capital-account convertibility**

— subjects the economic policy of the country to the regular verdict of domestic and international asset holders,
— signals the commitment of the government and the central bank to sound and sustainable macroeconomic policies,
— widens the opportunities for domestic investors and the government to finance suitable projects and a sustainable budget deficit by foreign savings, i.e. an inflow of capital from abroad,
— removes the suspicion that the country could be a trap for capital as investors can freely move not only the profits and interest receipts but also the principal at any point in time.

With full convertibility, a country thus participates fully in the worldwide competition for mobile resources. Of course, convertibility per se is no guarantee for a net inflow of resources which will only happen if other conditions such as political stability, macroeconomic conservatism and unit labour costs make the country an attractive location for investors.

Upon the collapse of communism, the countries in Central and Eastern Europe including the successor states of the Soviet Union are in a position which differs from that of Western Europe after World War II in three major respects which are relevant for the convertibility issue:

— the structure of **relative prices** is more distorted,
— the production **technology** is more outdated, and
— the need to augment the existing **capital stock** by new investments is more pronounced.

For these reasons, current-account convertibility and conditions which are conducive to an inflow of capital, skills and technology are far more important for todays newly emerging market economies than they were for Western Europe some 40 years ago.

Although the general merits of convertibility are rarely disputed, opinions differ widely on the appropriate timing of its introduction. Opponents of early convertibility argue

(1) that current-account convertibility and trade liberalisation would subject the economy to excessive competitive pressure and push even ultimately viable producers of tradable goods into bankruptcy,
(2) that the abrupt switch from the trading practices of socialist times to settlement in convertible currency would harm even mutually beneficial exchanges among producers in different ex-Soviet republics in the same way as the end of the trade and payments provisions of the Council for Mutual Economic Assistance (CMEA) is said to have harmed intra-CMEA trade from the beginning of 1991 onwards, and
(3) that capital-account convertibility, and those aspects of current-account convertibility which de facto ease capital movements, could magnify the effects of residual economic distortions and make the currency prone to destabilising speculation and runs; this in turn may force the government to abrogate convertibility; the government would thus lose credibility because an unsustained commitment to immediate convertibility is more harmful than a delayed introduction of convertibility.

On theoretical grounds, the above arguments are largely invalid:

(1) On the macroeconomic level, the extent to which the average domestic producer is subjected to competitive pressure depends on the exchange rate. With an appropriate parity, the liberalisation-induced adjustment pressure on least efficient producers is compensated by additional export opportunities for the most efficient suppliers. On the microeconomic level, it may well be true that even ultimately viable ventures are forced into bankruptcy for lack of credits to cover temporary losses. However, no pattern of trade protection could compensate for the general deficiencies of the capital market; most proposals which have been advanced in the literature would, if implemented, tend to exacerbate rather than mitigate the problem. Instead, only a rapid transformation of the financial sector, notably the privatisation of existing banks, the unrestricted admission of foreign banks and the adoption of a time-tested regulatory system from the West, could help to overcome the present capital market deficiencies [Schmieding, 1991b].

(2) The switch from soft to hard-currency settlement puts an end to a previous market segmentation; like the removal of any distortion, it will indeed harm some firms who had been shielded from third-country competition on the republican markets. At the same time however, the switch benefits other firms who have easier access to inputs and machinery of suitable quality from the West. Special soft-currency arrangements such as a payments union would artificially promote exchanges of sub-standard consumer goods for equally sub-standard capital goods; such arrangements would thus tend to retard the modernisation of the capital stock in the successor states of the Soviet Union.

(3) In theory, the hazard of runs on currency reserves and large sudden outflows (or inflows) of short-term capital is per se no argument against full convertibility.[19] At a flexible exchange rate, the foreign exchange market could always clear without any intervention, be it sales or purchases of foreign currency by the domestic central bank or be it changes in the degree of convertibility. Yet, because the financial markets are thin and underdeveloped in Central and Eastern Europe and especially in the successor states of the Soviet Union, small political and economic shocks may well cause larger fluctuations in the exchange rate than they would in well-established market economies. Furthermore, risk-averse economic agents can hardly hedge themselves against such fluctuations initially for lack of suitable instruments. This constitutes one of the reasons why Central and East European governments have been reluctant to extend convertibility to capital account.

An exhaustive treatment of the arguments for and against immediate convertibility on capital account is beyond the scope of this paper. How sustainable a full capital convertibility would be depends largely on the soundness of macroeconomic policy and the readiness of the government and/or the central bank to ac-

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[19] Furthermore, the supposed potential for immiserizing growth is sometimes brought forward as an argument against a simultaneous liberalisation of the trade and the capital account. If asset markets react faster to the liberalisation than goods markets, assets are traded as the present values of still distorted income streams. Hence, existing distortions may be magnified by capital inflows [Frenkel et al., 1983]. However, this assumes that even foreign investors who should know better do not make their investment decisions on the basis of world prices. This assumption is reasonable only if the trade reforms are not credible in the first place [Buch, forthcoming].

cept the verdict of the foreign exchange market on the value of the local money.[20] For the settlement of inter-republican and other international trade, a minimum convertibility in the sense of current-account convertibility for resident enterprises would suffice.

2. The Examples of Poland, Hungary and Czechoslovakia

On an empirical level, the experiences of the three most advanced countries of East-Central Europe shed light on the feasibility and the effects of such a minimum convertibility. Since 1 January 1990, the Polish zloty has been convertible for trade transactions of domestic enterprises at the official exchange rate; almost all import and export quotas have been removed; individuals can trade freely in currencies at numerous special exchange shops where the flexible rates deviate slightly from the official parities; since mid-1991, foreign investors can freely repatriate their profits. Since 1 January 1991, the Czechoslovakian crown has been almost as convertible as the Polish zloty; like the zloty, the crown is convertible for current-account purposes of domestic firms, the differences being that Czechoslovakia restricts the amount of crowns which individuals may legally change into a foreign money to 7500 crowns per year and that imports are slightly less liberalised than in Poland. The Hungarian forint is de facto convertible for almost all current-account transactions of domestic firms (only 10 per cent of all imports were still subject to licensing in 1991), households may purchase up to the equivalent of US$ 350 in foreign currency per year for tourist purposes, non-residents can freely repatriate their forint earnings on direct and portfolio investments. Abstracting from a few details, all three currencies thus meet the minimum-convertibility norm described above. The three countries have also liberalised their foreign trade substantially in recent years, with at least Poland and Czechoslovakia being more open to imports than, say, the European Community.

Poland, Hungary and Czechoslovakia have so far demonstrated that such minimum convertibility can be easily sustained even during grave economic turbulences. They have adopted an exchange rate policy which roughly maintains the external competitiveness of domestic producers; since 1990, all three countries have recorded a rapid rise in exports to the West, notably the EC. Because of their internal progress on the road from plan to market, their realistic exchange rate policies[21] and their enhanced access to the EC market, all three countries have found their way into Western markets far more rapidly than expected [see Table 2]. In 1991, only Poland registered a significant trade deficit with the West. Once Poland had begun to correct the overvaluation which had emerged in late 1990 and early 1991, the Polish deficit narrowed again in late 1991 and early 1992.

[20] If a country is ready to de facto adopt a Western currency via some sort of currency board [see, e.g., Hanke and Schuler, 1991; Schmieding, 1991a; Rostowski, 1992], full convertibility would be sustainable beyond any reasonable doubt.

[21] This statement needs to be qualified somewhat in the case of Poland. With its attempt to use the nominal exchange rate as a nominal anchor while inflation continued, the zloty exchange rate went through an unfortunate up and down, namely an excessive undervaluation in early 1990 and a temporary overvaluation in early 1991. Since April 1991, the zloty exchange rate has been adjusted several times.

Table 2 — The Growth of Trade between East-Central Europe and the West

	1989			1990			1991[a]		
	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Imports	Trade balance
a. Trade with the OECD									
Poland									
– in dollars[b]	512	517	–5	743	643	100	801	1009	–208
– in % of all OECD trade	.28	.29		.35	.31		.38	.49	
Hungary									
– in dollars[b]	378	390	–12	478	454	22	533	537	–4
– in % of all OECD trade	.20	.22		.22	.22		.25	.26	
Czechoslovakia									
– in dollars[b]	347	306	41	408	406	2	507	479	28
– in % of all OECD trade	.19	.17		.19	.20		.24	.23	
b. Trade with OECD Europe									
Poland									
– in dollars[b]	461	453	8	686	578	108	749	935	–185
– in % of all OECD-E trade	.40	.41		.49	.43		.54	.72	
Hungary									
– in dollars[b]	334	370	–36	431	428	3	486	495	–9
– in % of all OECD-E trade	.29	.33		.31	.32		.35	.38	
Czechoslovakia									
– in dollars[b]	320	290	30	382	389	–7	479	461	18
– in % of all OECD-E trade	.28	.26		.27	.29		.34	.35	
c. Trade with Germany[c]									
Poland									
– in dollars[b]	159	198	–29	269	245	24	365	427	–62
– in % of all German trade	.71	.70		.94	.74		1.12	1.27	
Hungary									
– in dollars[b]	119	162	–43	169	174	–5	215	212	3
– in % of all German trade	.53	.57		.59	.52		.66	.63	
Czechoslovakia									
– in dollars[b]	111	122	–11	140	161	–21	256	250	6
– in % of all German trade	.49	.43		.49	.48		.79	.75	

[a]First three quarters only. — [b]Monthly average at current prices. — [c]Excluding East Germany until the end of 1990.

Source: OECD [b]; own calculations.

Admittedly, the stunning redirection of trade from the East to the West also reflects a decline in trade among the ex-CMEA countries. The decline is often attributed to the switch from the old CMEA-trading practices to settlement in hard currency at world market prices. From January 1991 onwards, new trade contracts were concluded in convertible currency; only some contracts which had not yet been fulfilled

were still settled in transfer rubles. With the sudden switch to world market prices, the generous subsidies which the Soviet Union had implicitly disbursed to the CMEA purchasers of its underpriced oil and raw materials were terminated.

A closer look reveals that the post-CMEA experience provides no argument against currency convertibility and a change in trading and payments practices from barter arrangements to hard-currency settlement:

- The rise in the price for Soviet oil did indeed harm the other ex-CMEA countries. This change in the terms of trade is, however, logically distinct from the switch to convertible currencies; the Soviet Union could have demanded a corresponding change even if intergovernmental barter and settlement in largely infungible transfer rubles had been continued.
- The collapse in the overall level of East-East trade is largely attributable to two special factors, namely the sudden redirection of East German imports towards the West after the introduction of the D-Mark in East Germany at an unrealistic conversion rate and the implosion of the Soviet economy.
- The trade among Poland, Hungary and Czechoslovakia, whose currencies are largely convertible for current-account purposes, has held up far better than other cross-border exchanges within the former CMEA region. According to Polish statistics, Polish exports to Czechoslovakia grew by 22.4 per cent between 1990 and 1991 (January to November), i.e. even **considerably faster than Poland's overall exports** (plus 8.3 per cent); and whereas Polish exports to Hungary were down by 19.4 per cent, imports were up by 12.3 per cent in nominal zloty terms. Because of the concurrent devaluation of the Polish currency, zloty figures exceed the respective dollar figures by roughly 10 per cent.[22]

Note that the development of East-East trade over time is not the relevant criterion. CMEA members had used the special CMEA arrangements to dump sub-standard goods on their partner countries at least as readily as they supplied their domestic consumers with such goods. Furthermore, the switch from plan to market and the corresponding disruptions of accustomed patterns of economic behaviour have affected transactions within and among the formerly planned economies. Hence, trade among the emerging market economies was bound to shrink roughly in line with the internal production of tradable goods anyhow, that is, even in the absence of any specific payments problems. Only a far more pronounced collapse of sales to other ex-CMEA members could be interpreted as an indicator that these cross-border exchanges are affected by a specific problem such as a gravely deficient payments mechanism. Yet, the Polish statistics on trade among the westernmost EMEs appear even more satisfactory if they are contrasted with the concurrent declines in industrial production in these countries (–12 per cent in Poland, –19 per cent in Hungary and –22 per cent in the CSFR). Of course, these numbers are not fully conclusive, inter alia because the trade data are supplied in nominal zloty or dollar terms, not in real terms. All in all, the available recent statistics on trade among the westernmost EMEs are neither fully consistent nor, in many cases, compara-

[22] Information provided by the Polish Development Bank.

ble to earlier data, for instance because of changes in the method of data collection. Taken together, the figures tentatively corroborate the hypothesis that the drastic change in the trade and payments regime within Eastern Europe has by itself not posed insurmountable problems for those three westernmost EMEs whose currencies are largely convertible for trade transactions. The post-CMEA experience of these countries is thus no convincing argument against convertibility for the successor states of the Soviet Union.

3. Are the Ex-Soviet Republics Special Cases?

Of course, the above conclusion may appear to be premature as two special factors apply in the case of the ex-Soviet republics:

(1) Trade among the republics accounted for a far greater share of their GDP than CMEA-trade did for Poland, Hungary and Czechoslovakia in the late 1980s (see Table 3). However, the paramount importance of inter-republican trade is no reason against convertibility of a republican currency as long as the exchange rate is realistic; only in the case that a dominant neighbour keeps an inconvertible currency and discriminates against convertible-currency trade may the importance of inter-republican trade be an argument for special payments arrangements among republics with widely different degrees of convertibility (this issue is taken up in Section V below).

Table 3 — a. Trade of Ex-Soviet Republics, 1988[a]

	Exports			Trade balance		
	inter-republican	abroad	total	inter-republican	abroad	total
	(As percent of GDP)					
USSR	21.1	5.4	26.5	–	–5.8	–5.8
	(As percent of net material product)					
USSR	29.3	7.5	36.8	–	–8.0	–8.0
RSFSR	18.0	8.6	26.6	0.1	–8.7	–8.6
Ukraine	39.1	6.7	45.8	3.5	–6.4	–2.9
Belorussia	69.6	6.5	76.1	15.5	–7.5	7.9
Estonia	66.5	7.4	73.9	–8.2	–10.2	–18.4
Latvia	64.1	5.7	69.8	–1.7	–8.2	–9.9
Lithuania	60.9	5.9	66.9	–9.1	–8.1	–17.2
Moldavia	62.1	3.4	65.5	–2.4	–10.8	–13.2
Georgia	53.7	3.9	57.6	2.8	–8.6	–5.8
Armenia	63.7	1.4	65.1	–5.8	–13.4	–19.2
Azerbaidzhan	58.7	3.7	62.3	19.2	–9.1	10.2
Kazakhstan	30.9	3.0	33.8	–19.9	–7.1	–27.0
Turkmenistan	50.7	4.2	54.9	–2.0	–3.9	–6.0
Uzbekistan	43.2	7.4	50.5	–8.0	–0.8	–8.9
Tadzhikistan	41.8	6.9	48.7	–20.8	–2.8	–23.7
Kirgizia	50.2	1.2	51.4	–8.7	–14.3	–23.1

Table 3 — b. Trade of East-Central European Countries

	Exports			Trade balance		
	intra-CMEA	world market	total	intra-CMEA	world market	total
	(As percent of GDP)					
Hungary (1990)	6.2	26.4	32.6	0.8	2.0	2.8
Poland (1989)	6.9	13.5	20.5	2.0	2.3	4.3
CSFR (1989)	15.7[b]	10.1[c]	25.8[d]	0.5[b]	1.2[c]	1.7[d]

[a]In domestic prices, excluding "non-productive" services. — [b]Includes all socialist states. — [c]OECD only. — [d]Excluding non-socialist developing countries.

Source: IMF et al. [1991, Table 26]; EIU [Quarterly Country Report, Poland 1/1992; Hungary 2/1992]; OECD [a, p. 141].

(2) The banking system in the republics is even more underdeveloped than it was in East-Central Europe two years ago. The transfer of money via banks may easily take three months within Russia. The sorry state of the banking system affects all transactions, not only cross-border exchanges. Separate republican currencies would, of course, complicate the clearing among banks in different successor states of the Soviet Union. While this argument is relevant for the discussion whether individual republics should or should not introduce their own monies, it constitutes no case against convertibility once republican currencies have been introduced. Instead, the opposite holds true: the clearing among convertible currencies is easier than among inconvertible separate monies.

(3) Unlike Poland, the successor states of the Soviet Union have not yet managed to return from double-digit rates of monthly inflation to a more modest pace of price increases. While this is lamentable, it need not deter the republics from facilitating mutually beneficial trade. Current-account convertibility can well be maintained at high rates of inflation; it would be unsustainable only if the republics made the ultimately futile and costly attempt to fix the nominal parities of their currencies. Incidentally, the past and present restrictions on ruble convertibility have not been able to prevent a substantial exodus of capital from the ruble zone (which some estimates have put at roughly US$ 14 billion in 1991). With convertible currencies at realistic exchange rates, the republics would be less prone to the clandestine export of investible resources.

To sum up, the economic arguments against the first-best solution of current-account convertibility for the successor states of the Soviet Union are unconvincing. Neither the paramount importance of inter-republican trade nor the underdeveloped state of the banking system are per se obstacles against curent-account convertibility. Economically, there is no need for the second-best option of a genuine payments union. Roughly two years ago, the merits or drawbacks of a payments union for Central and Eastern Europe had been heatedly discussed in academia. In his summary of the debate, Kenen [1991] passed the verdict that a payments union may be a solution in search of a problem. Although the case of the ex-Soviet

republics is not fully identical to that of post-CMEA Central and Eastern Europe, the overall judgement still applies.

V. A Mixed Payments Union?

The above discussion has been based on the assumption that all members of a post-Soviet payments union would keep their currencies inconvertible for the time being. Yet, a PU need not encompass only countries with similar degrees of convertibility. Instead it is logically possible that a payments union clears transactions among countries with convertible and inconvertible monies. Hence, the desire to introduce convertibility need not prevent potential members from participating in a PU.[23]

A payments union is an awkward option for a country with a convertible currency, though. It constitutes a step back from convertibility and a multilateral settlement of cross-country exchanges. Net balances in transactions with the PU are cleared and settled in a different way than those with third countries; the net balances cannot be used to offset balances vis-à-vis third countries; the international fungibility of the country's money is restricted.

For this reason, actual transactions among countries with highly different degrees of currency convertibility are usually conducted in a convertible currency. However, the country with the inconvertible currency may control trade heavily to avoid large deficits and thus an outflow of scarce foreign exchange. Hence, some opportunities for mutually beneficial transactions remain unexploited. When confronted with the proposal to establish or join a discriminatory payments arrangement, the country with a convertible currency thus faces a trade-off between the reduced fungibility of its own money and the hazard that the insistence on hard-currency settlements with soft-currency countries may harm foreign trade. In some important historical cases, special payments arrangements have been devised for dealings among such countries. Some of these examples merit a brief exposition because they shed light on the reasons why countries may agree to such practices.

Switzerland and the EPU, 1950–1958

Strictly speaking, even the EPU had been a mixed payments union because it included Switzerland. Unlike the currencies of all other European countries, the Swiss franc was convertible into dollars in the late 1940s and early 1950s. Because its trade with other West European countries was of such paramount importance for tiny Switzerland, it agreed to participate in the European Payments Union. Otherwise, the EPU mem-

[23] This point has been stressed by John Williamson in a discussion at the European Bank for Reconstruction and Development on 26-27 March 1992.

bers might have discriminated against Swiss exports in the same way as they discriminated against trade with the dollar area.[24]

Finland and the Soviet Union, 1945–1990

After World War II, Finland found itself in a peculiar situation: While the Soviet influence on Finnish policy was strong, Finland remained a democracy, kept a market economy and could gradually develop links with major economic institutions of Western Europe. Whereas Finland's trade with the world market was governed by standard market economy practices, the country also participated in the East European state trading system based on bilateral barter trade and inconvertible currencies [Oblath and Pete, 1985]. In accordance with the Finnish-Soviet trade agreements, the Finnish authorities issued licences to domestic firms to import from or to export to the Soviet Union. Payments between the two countries were settled bilaterally via two clearing accounts; net deficits or surplusses were turned into credits between the two central banks. Finnish exporters, however, could obtain the export proceeds in dollar from their central bank. As the official exchange rate overstated the value of the ruble, the Finnish central bank thus de facto subsidised exports into the Soviet Union. As a consequence of this practice, and despite the license system, the Finnish central bank accumulated a non-interest bearing surplus and hence a claim on the Soviet Union.

As in the case of Switzerland in the 1950s, tiny Finland had agreed to participate in a special trade and payments arrangement in order to secure its access to a major adjacent market. Even more importantly, Finland had political reasons to accept the Soviet practices. In fact, the Finnish readiness to conduct its Eastern trade by Soviet rules helped Finland to obtain the Soviet permission to become first an associate member of EFTA in 1961 and a full member in 1985.[25]

The above examples[26] show that a mixed payments union can be feasible in the presence of special economic or political factors which prompt the countries with a convertible currency to agree to such an arrangement, i.e. to partly foresake their claim on payment in hard currency. If major successor states of the

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24 The British and the American zones of occupation in Germany are sometimes cited as examples for the damage which the insistence on hard-currency settlement may do in a region governed by inconvertibility and bilateral trade practices. At the end of the war, the victors had decreed that the heavily controlled foreign trade of their occupation zones should be conducted in convertible dollars [see i.a. the decree No. 1, 1947, of the Joint Export and Import Agency of the Anglo-American Bi-zone]. This dollar clause was one of the elements which retarded the resumption of West Germany's foreign trade [Buchheim, 1990a]. At the given and fixed prices and exchange rates, West German goods could not compete with goods from the dollar area. West European countries thus preferred to spend the few dollars they had on imports from the US. As in the case of Switzerland, the Western occupation zones of Germany finally adopted the practices of their major trading partners. The first bilateral trade agreements between the Western zones of occupation and West European countries were concluded in 1947 and 1948 [see Erhard, 1954, p. 85].

25 For a brief exposition, see also Kostrzewa and Schmieding [1992].

26 Incidentally, the settlement of intra-German trade between 1951 and early 1990 can be counted as a further example. Special political motives had induced West Germany to accept a bilateral clearing of German-German trade at soft payments terms, notably a permanent interest-free credit-line. As West Germany ran a trade surplus with East Germany almost all the time, the swing was used almost exclusively by East Germany.

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Soviet Union maintained inconvertible currencies, it may indeed be advantageous for their smaller neighbours to join such a mixed payments union if their own monies are convertible. More precisely, if the dominant country of the present ruble zone, the Russian Federation, were to delay current account convertibility for more than a transitional period while the smaller republics introduce separate and convertible monies, a mixed payments union might make economic sense. So far, however, Russia has been more eager to go for current-account convertibility than other republics, save Estonia.

VI. A Payments Mechanism for Convertible Currencies?

A mixed payments union is of course inferior to convertibility for all republican currencies. In theory, a special and discriminatory payments arrangement could also be construed for participants with convertible currencies. Such a mechanism would make only very limited sense, though. A convertible currency can be readily exchanged into another money; the very essence of convertibility is that it makes little difference whether an economic transaction is settled in one currency or another, at least as long as the terms of payment reflect the expectations on the evolution of the relative values of the currencies involved.

For two reasons, such a mechanism would be neither necessary nor warranted:

(1) If the republican currencies are convertible at suitable exchange rates, the premium on foreign exchange would disappear; hence there would be no longer any special need to economize on foreign exchange as opposed to the general desideratum of economizing on all holdings of any non-interest bearing money, be it the domestic or a foreign one.

(2) The nascent banking systems in the successor states of the Soviet Union need working balances of foreign exchange and lines for short-term credits in foreign exchange to make sure that credit constraints do not force them to restrict cross-border trade to bilaterally balanced exchanges. Yet, this applies to trade among the republics as much as to trade with third countries; there is no need for a mechanism which artificially differentiates between these two kinds of international transactions. An initial endowment of foreign exchange could be easily provided to the respective central banks by suitable international institutions such as the IMF. Additional lines for short-term credits could be obtained from the usual sources, i.e. private banks or international institutions. There is no reason why such credit lines should be supplied by the central banks of other ex-Soviet republics rather than by the world capital market [see Schmieding, 1991b] or an international institution such as the IMF.

Of course, even republics with convertible currencies need an efficient clearing mechanism. For this purpose, no special payments mechanism has to be created among the successor states of the Soviet Union. Instead, they could benefit hugely from technical help in establishing and perfecting clearing arrangements for banks within the republics, among the republics and between the republics and the outside world. Efficient clearing reduces the need for working balances in any convertible currency, be it the domestic or a

foreign one. An international agent such as the Bank for International Settlements may provide technical help in the clearing operations among banks. It is ultimately a semantic issue whether such technical assistance warrants the grandiose name of a Payments Union or a Payments Mechanism.

Furthermore, inter-republican trade could be advanced by guarantees that trade credits are indeed honoured. A private or public international organisation could offer to ensure the credits, charging a fee in return for a guarantee to the exporter that the import will actually be paid for. Foreign assistance could also be used as a carrot to induce the republics to actually serve and repay any short-term debt which may arise in the settlement of transactions with other successor states of the Soviet Union or with third countries. Such assistance need not be tied to any regionally discriminatory payments arrangement.

In addition, the successor states of the Soviet Union need — and to some extent already receive — technical assistance for the restructuring and privatisation of their banking systems, i.e. for the creation of profit-oriented private banks which, in their own self interest, will try to keep non-interest bearing working balances as low as possible by an efficient clearing of interbank transactions. At present, the clearing of standard non-cash transactions in the ruble zone is very cumbersome. Even most payments within a single country, say Russia, have to be settled via the respective central bank.

VII. The Politics of Payments Arrangements

The above discussion has so far neglected three further arguments for a special payments arrangement: A Post-Soviet Payments Union or Payments Mechanism may serve

- as a macroeconomic surveillance mechanism for the republics [van Brabant, 1991b, Chapter 6],
- as a convenient means to channel external assistance to the republics, and
- as an instrument to promote the future economic and political collaboration among the republics.

In the 1950s, the EPU and the OEEC had played all three roles to some extent for the countries of Western Europe. At that time, the International Monetary Fund was still in its infancy. By now, the IMF has turned into an influential intergovernmental organisation which can draw on substantial experience in macroeconomic stabilisation and microeconomic liberalisation. As a neutral outside arbiter, the IMF is far better posed to disburse conditional external assistance than any new organisation to be established by the post-Soviet republics whose political relations with each other are often rather strained. The conditions to which external assistance should be tied include

- decisive moves towards macroeconomic stabilisation, including a strict control of credit to state-owned enterprises, the reduction of explicit or implicit subsidies and an increase in tax revenues,
- current-account convertibility at a realistically valued and sufficiently flexible exchange rate,
- the elimination of barriers to trade among the republics,

— the explicit agreement to take responsibility for a share of the external debt of the former Soviet Union,
— a cooperative approach to the introduction of separate currencies so that replaced ruble notes are returned to the central bank in Moscow and thus cannot be used for purchases in Russia which would swell the Russian money supply.[27]

Politically, transnational institutional arrangements such as a payments union which do not obviously benefit each participant at any point in time are fragile creatures. In the 1950s, two special political factors enhanced the feasibility and stability of the EPU. After World War II, the United States exercised sufficient hegemonic power and provided sufficient financial incentives to West European countries to overcome objections against an EPU. The US could impose a fair degree of economic and political co-operation on countries which had been fighting each other until recently. The generous American payments to France and Britain made it easier for these countries to accept the politically contentious (re-)introduction of West Germany into the politics, the trade circuits and the institutions of Western Europe. Thereafter, the cooperation was sustained and yielded tangible results largely because, in the most troublesome intra-European political relation, that between defeated Germany and its Western neighbours, West Germany was rather prepared to yield in order to re-gain a semblance of political respectability in the international arena.

Today, no such easy and amicable resolution of political differences between, for instance, Russia on the one hand and the Ukraine and the Baltic republics on the other hand seems likely. Instead, Russia and the Ukraine are arguing fiercely about the Crimean peninsula; some ex-Soviet republics are even engaged in armed conflicts against each other (Armenia vs. Azerbaijan; Moldova vs. some Russian troops in break-away Transnistria).

Furthermore, the incentive for Russian politicians to enter into a payments union, be it a mixed or a genuine one, is rather weak to begin with. As a major exporter of presently still underpriced oil and raw materials to other republics, Russia can expect to become and remain a structural creditor to the payments union. Via an EPU-style payments union, Russia would thus have to extend a permanent credit on soft terms to other republics. As the largest and economically dominant successor state of the Soviet Union, Russia is far less dependent on the inter-republican division of labour. Because of this asymmetry Russia may expect to be able to force its terms of settlements on the smaller republics in the absence of a payments union.

Even if it were politically desirable to install a mechanism like a payments union which requires the continuous cooperation of the republics, the arrangement could be rather unstable. It may need a substantial political effort and the promise of some Western aid to induce the republics to participate in such a mechanism. Instead, the designers of institutional arrangements for the ex-Soviet republics should economise most on what seems to be scarcest: the commitment to a reliable cooperation among the successor states of the Soviet Union. Hence, a minimum agreement on some technical aspects of international clear-

[27] Such a provision is included in the Code of Conduct for the introduction of republican currencies which Russian and Ukrainian officials have endorsed at a conference in Brussels on 17 February 1992.

ing is likely to be more feasible, stable and useful than more grandiose schemes such as a payments union into which the republics would have to invest more of their scarce political goodwill towards other successor states of the former Soviet empire.

VIII. Recommendations

The major recommendations which emanate from the above discussion can be summarised in six points:

(1) The successor states of the Soviet Union should make their currencies, be it the ruble or be it new republican monies, at least as convertible as those of Poland, Hungary or Czechoslovakia.

(2) No payments union is warranted or needed as a halfway house towards current-account convertibility for the republican currencies.

(3) In the 1950s, the EPU and the Marshall Plan were valuable second-best devices to mitigate the harm which was caused by the inconvertibility and the collective overvaluation of West European currencies against the dollar. A sufficient devaluation would have removed the rationale for restrictions on trade and payments and would have made the EPU obsolete. Today, the ex-Soviet republics should avoid the West European mistake. They should opt for realistic exchange rates for their monies instead.

(4) Western advice and Western financial assistance should be used to promote at least a minimum currency convertibility; the West should not try to coax the republics into special inter-republican arrangements which some republics and notably Russia may accept only grudgingly and which may hence be very unstable.

(5) Western technical assistance should, e.g., focus on the transformation of the banking system and on suitable arrangements for inter-bank clearing, be it the clearing within a republic, among republics or between the republics and the outside world.

6) Under specific circumstances, a payments union may serve as a second-best interim solution. If the Russian government were to back away from its oft-repeated commitment to make the ruble convertible for current-account transactions soon, a special clearing and arrangements for trade among the ex-Soviet republics could be warranted. If, however, the economically dominant and centrally located Russian Federation will indeed introduce a minimum convertibility for the ruble, the other republics will be under strong pressure to follow Russia's good example and make their currencies sufficiently convertible as well. The interdependence between Russia and the smaller ex-Soviet republics is asymmetric. In other words, if Russia went ahead and if the incentive for others to follow suit is not diluted by a payments union, the competition between institutional arrangements is likely to promote the first-best outcome of early convertibility on current account.

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