

WP/01/101

IMF Working Paper

The IMF and the Ruble Area, 1991–93

John Odling-Smee and Gonzalo Pastor

IMF Working Paper

European II Department

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Prepared by John Odling-Smee and Gonzalo Pastor

August 2001

Abstract

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper summarizes the IMF advice on the ruble area as it was presented to the national authorities in Russia, the Baltic countries, and other states of the former Soviet Union in 1991-93. In the course of doing so, the paper corrects some misperceptions that have arisen about the IMF's role. The evidence presented in the paper suggests that (i) the balance of arguments on the ruble area (and national currencies) changed over time, and hence so did the IMF's advice, and (ii) from the beginning, the IMF staff concentrated on pointing out the pros and cons of alternative monetary arrangements, without strongly advocating a particular one, emphasizing that it was the authorities' decision to stay in or leave the ruble area. Fund advice on how to introduce national currencies was made readily available to the various national authorities as early as January 1992.

JEL Classification Numbers: E52, F33, F42, P24

Keywords: Monetary policy, ruble area, national currencies

Author's E-Mail Address: jodlingsmee@imf.org, gpastor@imf.org

¹ The authors would like to thank Oleh Havrylyshyn, Ernesto Hernández-Catá, and Tom Wolf for their helpful input and encouragement throughout the preparation of the paper. Useful comments were also received from Charles Adams, Hrant Bagratian, Gerard Bélanger, Jack Boorman, Eduard Brau, Stanley Fischer, Peter Hole, Ishan Kapur, Adalbert Knöbl, and Michael Mussa. The authors alone are responsible for the judgements in the paper and for any errors.

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I. INTRODUCTION

1. The break-up of the Soviet Union at the end of 1991 into fifteen separate countries, some of which had already declared their independence, was not followed immediately by the introduction of separate national currencies. Some countries moved quickly to introduce their own currencies; the Baltic countries were in the lead, with the ruble being withdrawn around the middle of 1992.² Most of the others did not withdraw the ruble until 1993, many of them late in the year. But by the end of November 1993, only Tajikistan retained the ruble; it introduced its own currency in May 1995 (Figure 1).

2. During the two-year period that the ruble area was losing members and operating with decreasing efficiency, there was much discussion both in the member countries and outside about the best course of action for individual countries. The IMF became involved in the discussions from its first contacts with the countries in late 1991 and early 1992. The purpose of this paper is to set out the record of the IMF's policy advice to the fifteen countries on the ruble area. In the course of doing so, the paper corrects some misconceptions that have arisen about the IMF's role.

3. Section II provides a short history of the dissolution of the ruble area. Section III sets out the IMF's policy advice. Finally, Section IV summarizes the IMF's role, and takes a brief excursion to consider what might have happened if the IMF had pushed in the middle of 1992 for an early break-up of the ruble area.

II. THE DISSOLUTION OF THE RUBLE AREA

4. After the failed coup of August 1991, President Gorbachev persisted in his efforts to keep the Soviet Union together as an economic and monetary union, albeit with an increasing decentralization of powers. In the economic area, he attempted to put in place interrepublican agreements on an Economic Community Treaty and supplementary treaties on, among other things, a banking union, fiscal and budgetary coordination, and external debt servicing. However, in the last three months of 1991, the union government rapidly lost much of its influence while progress in settling interrepublican relations was very slow. There was considerable mistrust among republics, and the main economic areas of disagreement involved the division of power (e.g., voting rights in the banking union) and of the union's assets and liabilities. The discussions on these issues were overtaken by the creation of the CIS on December 8, 1991, and the formal dissolution of the Soviet Union on December 26, 1991.

5. The creation of fifteen new sovereign states on the territory of the former USSR was not initially accompanied by any formal changes in monetary arrangements. The Central Bank of Russia (CBR), which in late November 1991 was authorized by the Russian

² Estonia in June, Latvia in July, and Lithuania in October.

Figure 1. Timeline of Fund Relations with BRO Countries, 1992-96

	Fund Membership	Introduction of National Currency	First Fund Arrangement
1992			
<i>Apr</i>	LTU		
<i>May</i>	ARM, EST, GEO, KGZ, LVA		
<i>Jun</i>	RUS	EST	
<i>Jul</i>	BLR, KAZ	LVA	
<i>Aug</i>	MDA		RUS
<i>Sep</i>	AZR, TKM, UKR, UZB		LVA, EST
<i>Oct</i>		LTU	LTU
<i>Nov</i>		UKR	
1993			
<i>Apr</i>	TJK		
<i>May</i>		KGZ	KGZ
<i>Jul</i>		MDA	BLR, KAZ
<i>Aug</i>		GEO	
<i>Sep</i>		BLR	
<i>Nov</i>		ARM, KAZ, TKM, UZB	MDA 1/
<i>Dec</i>		AZR	
1994			
<i>Oct</i>			UKR
<i>Dec</i>			ARM, GEO
1995			
<i>Jan</i>			UZB
<i>Apr</i>			AZE
<i>May</i>		TJK	
1996			
<i>May</i>			TJK

Sources: Table 1 and International Monetary Fund.

1/ On February 3, 1993, the Executive Board approved IMF financing for SDR 13.5 million to Moldova under the compensatory and contingency facility (CCFF). The credit was approved to help defray the excess cost of cereal imports for the 12 months ending June 1993.

List of Acronyms:

Armenia -- ARM	Kazakhstan -- KAZ	Russian Federation -- RUS
Azerbaijan -- AZR	Kyrgyz Republic -- KGZ	Tajikistan -- TJK
Belarus -- BLR	Latvia -- LVA	Turkmenistan -- TKM
Estonia -- EST	Lithuania -- LTU	Ukraine -- UKR
Georgia -- GEO	Moldova -- MDA	Uzbekistan -- UZB

parliament to take over the State Bank of the USSR (Gosbank) as of January 1, 1992, continued to ship USSR ruble notes and coins to the central banks of the other fourteen countries which had formerly been the main branches of Gosbank in the union republics.³ The central banks continued the practices of the final year or two of the Soviet Union when the Gosbank branches, notably the embryo Central Bank of Russia, financed different rates of credit expansion through running up debits to the Gosbank interbranch payments system. The CBR attempted to limit the credit expansion in the other fourteen countries, and the growing payments imbalances between them and Russia, by introducing a system of central bank correspondent accounts in early January 1992.⁴ However, the system did not initially have the desired effect because transactions with other members of the ruble area were being *automatically* credited (debited) to (with) the Russian banking system, and the CBR management was only being informed *ex post* about Russia's net claims on other states. The other countries also employed other techniques that allowed them to have different money and credit growth from Russia's, including setting their own reserve requirements and refinance rates and, in some cases, issuing parallel currencies (coupons).

6. Views about the desirability of retaining the ruble area or introducing national currencies differed between and within the fifteen new countries. The Baltic countries (Estonia, Latvia, Lithuania) and Ukraine sought complete control over their own monetary policy and announced before or just after the break-up of the Soviet Union that they would leave the ruble area as soon as possible. In Russia itself, some people, including many reformers in the government and their foreign advisors, favored the early introduction of a Russian ruble.⁵ Other countries would then be forced to introduce their own currencies and

³ All the presses for printing USSR banknotes were located on the territory of the Russian Federation.

⁴ The system of (bilateral) correspondent accounts between the CBR and the other central banks in the ruble area replaced the interbranch system mechanism used by Gosbank under the system of central planning. In the U.S.S.R. payments system, each branch of Gosbank had correspondent accounts with virtually every other branch, so that it was possible to know whether a given branch was in deficit or surplus with the rest of Gosbank. However, the system was not set up to track "regional" balance of payments as opposed to "branch" balance of payments. The CBR's correspondent accounts, in contrast, allowed central banks to begin monitoring payment imbalances vis-à-vis Russia on a regular basis.

⁵ See, for example, Lipton and Sachs (1992) and Ulyukaev (1996), pages 20–30. According to Ulyukaev, the First Program of Russian Economic Reforms prepared in September–October 1991 by Yegor Gaidar and associates directly linked the success of early macroeconomic stabilization with the simultaneous introduction of a Russian national currency. By end-November 1991, however, the proposal for an early introduction of a national currency had been rejected due to pressures on the Russian government from leaders of other republics, and representatives of the Russian bureaucracy and enterprise directors connected with them. According to the author, technical factors connected with the time

(continued)

could no longer undermine monetary stability in Russia. However, this path was not taken because of (i) concerns about the response of other countries, with implications for the fate of millions of Russians living in other states once separate currencies were introduced; and (ii) pressures from political and business leaders in Russia itself who felt that the preservation of a unified ruble zone would help Russian enterprises and maintain at least one element of the former empire.

7. Other countries temporized about whether to remain in the ruble area or to introduce their own national currencies. On the one hand, they hesitated to leave the ruble area because of fears of political retribution by Russia, worries about being locked out of the interstate payment mechanisms, and the expectation that, by remaining in the ruble area, they could obtain greater financing from Russia (subsidies for energy imports and credits to finance trade) and run expansionary credit policies whose consequences in terms of inflation would be borne by the entire ruble area and not by them alone (the “free rider” problem). On the other hand, they were interested in exploring the possibility of introducing their own national currencies, not only for nationalistic reasons, but also because of: (i) concerns about Russia’s ability to achieve price stability in the face of multiple pressures on the budget for social safety nets and subsidies to uncompetitive industries; (ii) fears about large inflows of rubles from Ukraine following the expected introduction of its national currency in early 1992; and, most importantly, (iii) severe and recurrent shortages of ruble banknotes supplied by the CBR to the other states, which had made it difficult to increase domestic wages and pensions to compensate for inflation.

8. Attempts were made in the early months of 1992 to bring some order into the chaotic ruble area arrangements. An Interbank Coordinating Council of Heads of Central Banks (ICC) was created and began meeting regularly to discuss the coordination of monetary and credit policies and other matters of mutual interest. At its meeting in Tashkent on May 21-22, 1992, the ICC came very close to agreeing on a set of operational guidelines for monetary coordination based on the setting of mutually agreed credit ceilings for each participant central bank in the ruble area and calling for a fair distribution of credit, cash, and seignorage among participant central banks.⁶ The guidelines were agreed in principle, indicating that the agreement among central banks would need to be submitted to their respective governments for approval. However, the communiqué that was approved during the meeting was not issued, although according to some reports it was signed by the delegations.

9. In the weeks following the Tashkent meeting, the Russian authorities indicated that they did not favor the multilateral approach to running the ruble area, thereby effectively

required to separate the bank accounts of the former union republics also played a role in the decision to abandon the program’s original objectives.

⁶ The IMF prepared draft guidelines for the meeting (see Section III).

ruling it out. Instead they offered other countries the choice between issuing their national currencies or staying in the ruble area, but they insisted that it could only be a Russian ruble area with the CBR being the only emission center and monetary policy authority. They invited the other countries to make their choices by October 1, 1992, and they said that they were willing to enter into bilateral negotiations with each country. This represented a victory for the time being for those in the Russian government who favored the early introduction of the Russian ruble over those in the government and the CBR, probably including its chairman Mr. Matiukhin, who favored the continuation of the old ruble area.⁷

10. Meanwhile, some countries were already leaving the ruble area. Estonia was the first to introduce its national currency in late June 1992, followed by Latvia in July. Preparations were also advanced in Lithuania, which introduced its currency in October. Elsewhere outside Russia the authorities continued to hope that cooperative ruble area arrangements could be made to work, despite Russia's apparent opposition.

11. In the middle of 1992 Russia attempted to impose greater monetary discipline on the other countries. In May and June the shortages of ruble banknotes became more acute, although printing capacity limits as well as Russian policy were responsible. As a result, some more countries, namely Belarus, Moldova, and Azerbaijan, issued coupons. In all three cases, multi-purpose coupons circulated alongside the ruble and were issued in response to acute cash shortages stemming from high inflation, lack of cash substitutes, and repeated problems with cash deliveries from the Central Bank of Russia. In Belarus, for example, the introduction of coupons complemented a number of policy measures that limited cash payments for wages, issued checkbooks to higher income earners, made the use of checks mandatory for large purchases, and reduced requirements on the cash balances of enterprises.

12. With effect from July 1, 1992, the CBR modified its system of central bank correspondent accounts and established that financing to other central banks would be limited by the size of "technical credits" specified in advance by the CBR. In principle, under this new system each central bank knew the maximum amount of debt it could accumulate with the CBR/Russia and therefore should have taken measures to reduce its payments deficit with Russia when it came close to the limit. In practice, the limits were not taken seriously and within two or three months, many members of the ruble area (particularly Ukraine) had already reached their credit line limits and/or were running overdrafts on their credit lines. At that point, the CBR took a further step to stop the use of the payments system for balance of payments financing. For each central bank that had exhausted its credit line the CBR

⁷ The Tashkent meeting was the turning point. Mr. Matiukhin, leader of the Russian delegation, appeared to favor the multilateral approach but on the second day of the meeting he flew back to Moscow amid reports that he was being "retired," while Mr. Ignatiev, who was close to those who favored a Russian ruble, assumed the leadership of the Russian delegation. The Russian position hardened, which is the main reason why the communiqué was not issued.

processed each day only an amount of payments for imports equal to the amount of the payment orders for exports to that country. The imposition of limits on CBR interstate lending in July 1992 led to the emergence of de facto separate noncash (deposit) rubles in other ruble area states (i.e., they generally traded at different discounts vis-à-vis Russian deposit rubles depending on the interstate financing needs of the different countries). Although this ended the common currency area, strictly speaking, the CBR continued to emit cash rubles to other members of the ruble area. Significant differences in interest rates and exchange arrangements between ruble area countries continued.

13. Little progress was made by October 1, 1992 in the bilateral negotiations between Russia and the countries that wished to remain in the ruble area. The main sticking point was the reluctance of the latter to accept that Russia would make all the key monetary policy decisions. New hopes were raised that an initiative launched by Kazakhstan to set up an Interstate Bank (ISB) would produce new operational arrangements or institutions for the conduct of monetary policy in the ruble area. But the ISB that was announced at the Bishkek meeting of CIS Heads of State on October 9, 1992 was limited to being a clearing house for managing interstate payments and settlements. In reality it never even reached the stage where it could do this.

14. The Russian attempt to make other countries choose between national currencies and a Russian ruble area did not lead to any formal bilateral agreements about the latter, even after October 1. National currencies were introduced by Lithuania in October 1992, Ukraine in November 1992, and the Kyrgyz Republic in May 1993. Others continued to be nominally part of the ruble area, although de facto there was no longer parity between non-cash rubles in the different countries, and many countries had introduced parallel currencies. Ruble area countries sought special privileges from Russia, such as increased supplies of ruble banknotes or larger loans for balance of payments financing. Different Russian officials sent conflicting signals about whether Russia wanted them to remain in the ruble area and whether preferential energy prices and balance of payments financing would be tied to ruble area membership. Some government and CBR officials continued to push the position that was dominant in mid-1992 that Russia should not share its currency with other countries, others sought ways to preserve the ruble area.⁸ At the beginning of 1993, the Russian authorities shifted the responsibility for interstate financing away from the CBR and announced that, following the draw down of existing technical credits, all further financing would be extended in the form of interstate credits (i.e., government-to-government loans) at market interest rates. Also, existing debits in the other central banks' correspondent accounts with the CBR were transformed into interest-bearing official debts and indexed to the U.S. dollar or the SDR.⁹

⁸ See Hernández-Catá (1993).

⁹ Up to that point, interest had not been charged on CBR financing of other states of the former Soviet Union. For most countries, interstate agreements provided for a grace period of
(continued)

15. The final chapter in the demise of the ruble area started in late July 1993, when the Russian authorities announced the demonetization of pre-1993 rubles in Russia. According to the announcement, pre-1993 ruble banknotes would cease to be legal tender in Russia from September 1993 and the CBR would only deliver new ruble banknotes to those members of the ruble area which subordinated their monetary and fiscal policies to those of Russia by agreeing to the rules of a "new" ruble area. At the time of the July 1993 demonetization, the ruble area consisted of ten countries: Russia, Armenia, Azerbaijan, Belarus, Georgia, Moldova, Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan. They were still using the ruble as a legal tender, although in several of them (Azerbaijan, Belarus, Georgia, and Moldova) coupons circulated in parallel with the ruble (Table 1).¹⁰ The Russian announcement was intended to bring about what had not been achieved in 1992, namely a clear separation between national currencies and a Russia-dominated ruble area.

16. In response to the demonetization of pre-1993 rubles in Russia, four countries (Georgia, Azerbaijan, Turkmenistan, and Moldova) announced their departure from the ruble area, while five others (Armenia, Belarus, Kazakhstan, Tajikistan, and Uzbekistan) initially declared their intention to join the new ruble area. On September 7, 1993, this latter group of countries entered into a framework agreement with Russia that envisaged a revived ruble area after a transition period during which countries other than Russia would continue to use either old rubles or existing currencies,¹¹ or would introduce new, temporary currencies so as to attempt to achieve monetary control pending unification. However, when these countries realized the possibility of destabilizing cross-border flows of old rubles from other states and Russia's unwillingness to speed up monetary unification and provide them with new rubles, all, except for Tajikistan, introduced national currencies by November 1993. Tajikistan, which signed a protocol to receive delivery of new Russian rubles only in November 1993, was hit by severe inflation in late 1993 as a result of large inflows of old rubles as they were withdrawn from circulation in other countries.¹² It introduced its own currency only in May 1995 (Figure 1 and Table 1).

one or two years and repayment was typically to be made over five to six years. Interest was at commercial terms, except for Belarus, Turkmenistan, and Uzbekistan, for which an interest rate of zero was specified on the interstate credits provided.

¹⁰ Georgia introduced coupons in April 1993.

¹¹ Belarus had already introduced the rubel, in May 1992, as a parallel currency or coupon.

¹² The exchange rate of old rubles per dollar in Tajikistan dropped from Rub 3,000 at the beginning of November to Rub 12,000 in early December 1993.

Table 1. Introduction of National Currencies in the Baltics, Russia, and other Former Soviet Union Countries

Country	Month of Currency Introduction, Currency Name	Month of Pre-1993 Rubles Withdrawn	Month of New Currency Becoming the sole Legal Tender	Note
Estonia	June 1992, Kroon	June 1992	June 1992	
Latvia	May 1992, Latvian ruble (interim currency)	July 1992	July 1992	The Lats, a new national currency, was introduced in March 1993.
Lithuania	May 1992, Talonas (coupon)	October 1992	October 1992	The Litas, a new national currency, was introduced in June 1993.
Ukraine	November 1992, Karbovanets	November 1992	November 1992	The coupon system implemented on January 10, 1992, made coupons legal tender in state stores and confined the use of rubles to the payment of rent services, etc; and for the purchase of goods in "private" markets. The hryvnia was introduced in September 1996.
Kyrgyz Republic	May 1993, Som	May 1993	May 1993	
Moldova	June 1992, Moldovan coupon	July 1993	July 1993	The Moldovan coupon became a de facto national currency in July 1993; the Leu was introduced as sole legal tender in November 1993.
Russia	July 1993, 1993 Russian ruble	July-August 1993	July 1993	Pre-1993 rubles were converted at par to 1993 Russian rubles.
Georgia	April 1993, Georgian coupon	August 1993	August 1993	The Lari, a new national currency, was introduced in September 1995 and became sole legal tender in October 1995.
Belarus	May 1992, Belarussian rubel (coupon)	July 1993	September 1993	On 9/3/93, Belarus signed a bilateral monetary and economic unification agreement with Russia. The agreement stated the conversion of Belarussian into Russian rubles at par. A new agreement was signed on 4/12/94 replacing the 1:1 conversion factor with one linked to market developments.
Armenia	November 1993, Dram	November 1993	November 1993	Small denomination notes of the pre-1993 ruble remained legal tender on an interim basis until March 1994.
Kazakhstan	November 1993, Tenge	November 1993	November 1993	
Turkmenistan	November 1993, Manat	November 1993	November 1993	
Uzbekistan	November 1993, Sum coupon	November 1993	November 1993	The Sum was introduced in July 1994.
Azerbaijan	August 1992, Manat	July-August 1993	December 1993	Small denomination notes of the pre-1993 ruble remained in circulation until December 1993.
Tajikistan	May 1995, Tajik ruble	January 1994	May 1995	1993 Russian rubles were used as a legal tender between January 1994 and May 1995.

Sources: Various IMF Economic Reviews.

III. IMF ADVICE ON THE RUBLE AREA

17. The IMF began its association with the former Soviet Union in 1990 when it prepared the first comprehensive international study of the Soviet economy in cooperation with the World Bank, OECD, and EBRD.¹³ Subsequently, informal contacts were maintained with the Soviet government and, in October 1991, the Managing Director visited Moscow and, with President Gorbachev, signed an agreement establishing a special association between the Soviet Union and the IMF. By mid-April 1992, all the 15 states of the former U.S.S.R. had applied for membership and the staff had prepared a pre-membership economic review paper for each state on the basis of missions to all states in late 1991 and early 1992.¹⁴ In tandem, the IMF fielded missions to Russia, the Baltic countries, and other states of the former U.S.S.R. to begin discussing programs of stabilization and reform, that could be supported by Fund resources.¹⁵ Between April and September 1992, all states except Tajikistan signed the Articles of Agreement and became members of the IMF, following approval of their corresponding membership resolutions by the IMF Board of Governors and the issuance of all necessary domestic legislation governing relations with the IMF (Figure 1). Russia signed the Articles of Agreement on June 1, 1992. Financial assistance from the IMF was not possible before membership. Russia was the first country to borrow when the IMF approved a first credit tranche arrangement in August 1992.¹⁶ The three Baltic countries entered into

¹³ IMF (1991).

¹⁴ Each Economic Review paper summarized economic developments, provided background information on institutional and economic policy making structures, discussed the economic and financial policy stance of each state, and contained a staff appraisal. The papers were considered in IMF Executive Board discussions in late March/early April, at several of which representatives of the states were present and addressed the Board on their countries' economic policies and outlook. The papers were subsequently published (see IMF (1992a) for the one on Russia). The Board discussions were concluded by means of summings-up by the Chairman, which were transmitted to the national authorities concerned, in a manner similar to that for Article IV consultations with regular members.

¹⁵ Discussions with the Russian authorities progressed quickly and by end-February the Russian government, together with the CBR, had already approved and presented to the IMF a Memorandum of Economic Policies (MEP) describing its program of stabilization and reform for the remainder of 1992. The Russian MEP was discussed by the IMF Executive Board jointly with the staff report on the pre-membership economic review of Russia on March 30, 1992. (The main elements of the Russian MEP were published in IMF (1992a), pp. 25–35.) Following the Board meeting, a staff mission to the Russian Federation in April 1992 began discussions with the authorities regarding a possible IMF-supported program after membership.

¹⁶ The Fund's financial resources are made available to members from the General Resources Account under a number of policies, some of which are usually referred to as arrangements
(continued)

stand-by arrangements in September and October 1992. The same four countries borrowed again from the IMF in 1993, as also did Belarus, Kazakhstan, the Kyrgyz Republic, and Moldova. Financial assistance to the remaining countries began in 1994-96, except Turkmenistan which has not yet borrowed from the IMF.

18. In the period up to the middle of 1992, the IMF's policy advice on the ruble area focused on helping countries both choose the currency regime that best suited their needs and implement the regimes they had chosen. There were three main options for the currency regime: a cooperative ruble area arrangement in which all participating central banks would have a say in credit and monetary policy for the ruble area; national currencies; and a Russia-dominated ruble area in which the CBR would be solely responsible for monetary and exchange rate issues.

19. Countries' positions on the choice of currency regime were mainly determined by sovereignty considerations. These were what caused the Baltic countries and Ukraine to declare early on their intention to introduce national currencies, which they—and only they—did in 1992. These considerations were also the reason for the widespread rejection of the option of a Russia-dominated ruble area.

20. In discussions with the ten countries (other than Russia) that did not declare early on for national currencies, the IMF staff explained the economic advantages and disadvantages of the national currency and the cooperative ruble area options. In favor of national currencies was the difficulty of operating a cooperative ruble area arrangement that could deliver low inflation. In favor of the retention of the ruble area were doubts about the ability of fledgling central banks to operate independent monetary policies, and the benefits for trade of a common currency area. Also relevant to the choice between the two regimes was an assessment of which would be more likely to deliver monetary stability. These arguments are discussed in turn.¹⁷

21. A cooperative ruble area arrangement that could deliver low inflation would require arrangements for setting monetary and exchange rate policy parameters (e.g., money growth targets, the exchange rate regime and central bank discount rates) at the level of the ruble

or facilities. In particular, the Fund provides financial assistance to a member by temporarily selling SDRs or the currencies of other members in exchange for the member's own currency. A *first credit tranche* arrangement (or purchase) is defined as one that raises the Fund's holdings of the purchasing member's currency to no more than 25 percent of quota. The IMF adopts a liberal attitude in making resources available in the first credit tranche, provided that the member is making reasonable efforts to solve its balance of payments problems.

¹⁷ Fischer (1992) provided an early summary of the arguments for and against national currencies.

area as a whole, and rules for the behavior of the monetary authorities in each country that were consistent with the area-wide arrangements and parameters. In the absence of non-monetary sources of budget deficit financing, a fairly high degree of harmonization of fiscal policies would also be required. While such a system could be readily designed on paper, a high degree of cooperation was required to make it operate successfully. The experience of 1991 and the early part of 1992 showed, however, that countries were well aware of the advantages of simultaneously supporting a cooperative arrangement that was intended to produce low inflation and themselves breaking the rules by allowing faster-than-permitted monetary expansion (and larger fiscal or quasi-fiscal deficits).¹⁸ This free-rider problem was especially difficult to overcome in 1992 when widespread price liberalization, the collapse of output, the termination of large budgetary transfers from the former U.S.S.R. to some of the former republics, and sharp increases in the prices of imported energy put enormous strains on monetary and fiscal policies.¹⁹ Many observers concluded that there was no possibility of creating a successful cooperative ruble area arrangement in these circumstances, and therefore, whatever its potential advantages, there was no realistic alternative to the introduction of national currencies.²⁰ At the time, however, many countries expressed an interest in a cooperative arrangement.

22. To have a successful national currency, central banks should ideally be independent to enable them to stick to monetary objectives in the face of political pressures to pursue other objectives. They had to develop expertise in managing a whole range of activities such as money market and foreign exchange market regulation and management, banking supervision, accounting, research, and monetary policy analysis, although the requirements for a currency board were less demanding. In early 1992, these institutional requirements were very far from being met in most ruble area member countries.

¹⁸ The IMF staff also explained the consequences of not abiding by the rules of a cooperative arrangement on many occasions, including in the introduction to the draft guidelines on coordination it presented to the Tashkent meeting in May 1992 (see Attachment I). The IMF was represented in Tashkent by Charles Adams, Warren Coats, Ernesto Hernández-Catá, Ishan Kapur and John Olding-Smee.

¹⁹ Additional strains were created by civil conflicts, especially in Armenia, Azerbaijan, Georgia, Moldova, and Tajikistan.

²⁰ Havrylyshyn and Williamson (1991) provide one the earliest analytical accounts of the incentive for each republic of the U.S.S.R. to run the largest possible budget deficit in those days. On the same subject, see Havrylyshyn (1992) and Wagener and van Selm (1993). Lipton and Sachs (1992) emphasized the difficulties of making a cooperative ruble area arrangement work in 1992. There was a considerable debate within the IMF staff in the first half of 1992, with some people being convinced that a cooperative arrangement could never work.

23. As the collapse of trade and payments between the countries of the former U.S.S.R. was a dramatic component of the general decline in economic activity, priority was placed by the authorities of many countries and foreign governments and advisors on finding ways of restoring trade links. The maintenance of a common currency area would have simplified the task of rebuilding inter-regional trade and payments. It would also have helped to discourage the proliferation of barter trade agreements between pairs of countries, which was harmful for trade restructuring, competition, and economic efficiency.²¹

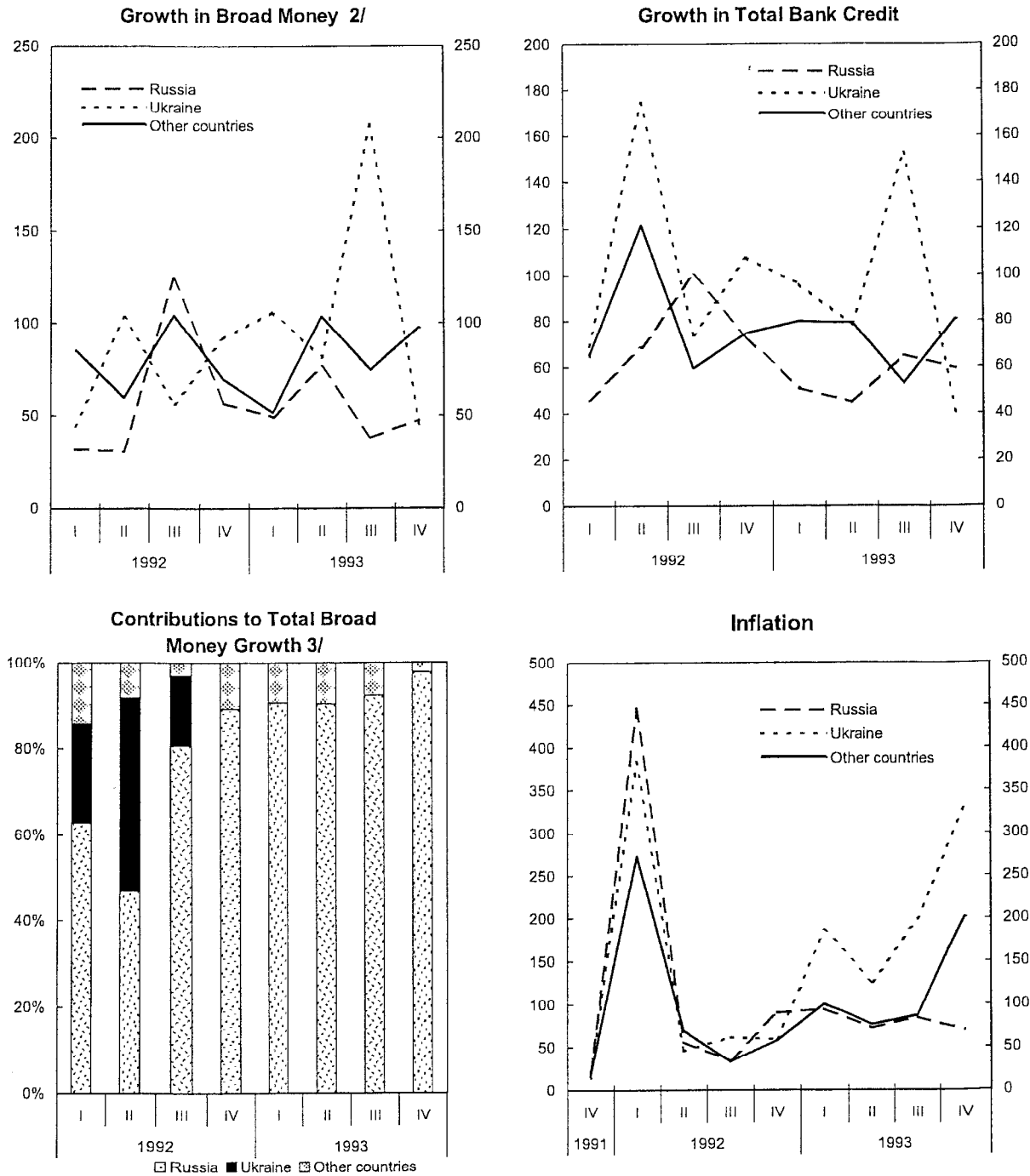
24. Early in 1992, there appeared to be a good chance that the Russian authorities could stabilize the monetary situation within Russia. The government appeared ready to take the necessary measures and the Memorandum of Economic Policies (MEP) agreed with IMF staff in late February committed Russia to a sharp tightening of macroeconomic policies to (i) prevent the transformation of the price liberalization burst of January 2 into a price-wage spiral and (ii) reduce inflation to 1 percent a month by the fourth quarter of 1992. Although the MEP did not include a fully-quantified financial framework because of uncertainties about the monetary data and the effects of systemic changes, and the commitment of the CBR was uncertain, the authorities' policy commitments were quite bold.²²

25. At that time there seemed to be little or no commitment to aim for monetary stability in the other countries, with the exception of the Baltic countries which were working toward the early introduction of national currencies. Ukraine, in particular, pursued destabilizing policies: in early 1992, there was no coherent program in sight, there was no wage policy, the fiscal stance was very expansionary (the IMF staff estimated that, in the absence of corrective measures, the fiscal deficit for 1992 could go higher than 15 percent of GDP), and credit to state enterprises and the population was growing faster than elsewhere in the ruble area (Figure 2). The resulting inflationary pressures were exported to other members of the ruble area, including Russia. The problem was compounded by the badly flawed system of

²¹ One of the main reasons why the governments of some of the major IMF members favored the preservation of the ruble area was that they believed that a functioning ruble area would help sustain trade within the area and reduce pressures for balance of payments support from outside the area.

²² The MEP also summarized the principles governing Russia's relations with other former U.S.S.R. countries. In particular, the Russian government noted its readiness to agree on a common monetary and exchange rate policy with other central banks of the ruble area. In the case of those former republics that chose to introduce coupons or an alternative currency, the CBR was ready to agree with them on the orderly withdrawal of rubles so as to maintain the consistency of the inflation targets mentioned in the MEP with the CBR's own credit program.

Figure 2. Ruble Area Countries: Selected Economic Indicators, 1992-93 1/
(Percent change from previous quarter unless otherwise indicated)



Sources: IMF staff estimates.

1/ Excluding the Baltic countries.

2/ Excluding foreign currency deposits.

3/ In percent of total change of Ruble Broad Money during period.

consumption vouchers (coupons) introduced in January 1992, which resulted in a dumping of rubles in neighboring states.²³

26. In view of the size of Russia and its commitment to seek macroeconomic stability, and the absence of similar commitments elsewhere, it seemed in the first half of 1992 that a cooperative ruble area arrangement in which Russia would de facto provide the nominal anchor would be more likely to produce macroeconomic stability in most countries in the region than a system of national currencies.²⁴

27. The IMF staff discussed these economic arguments with the authorities in all countries and encouraged them to decide whether to pursue national currencies or a cooperative ruble area arrangement. In the case of those countries interested in pursuing national currencies, the staff provided extensive technical advice on the orderly steps for the introduction of a national currency. This work began in 1991 with the U.S.S.R. authorities: at the request of Mr. Yavlinsky, Deputy Chairman of the Committee for the Management of the National Economy of the U.S.S.R., a mission to the Soviet Union in late October 1991 left with the authorities a paper on the pros and cons of introducing national currencies (see Attachment II for a one page executive summary of the paper.) It continued at the beginning of 1992 with the newly independent countries. A conference in Brussels on *Codes of Conduct for Interstate Economic Relations* (Brussels, February 15–17) was probably the earliest high-level multicountry forum in which Fund staff presented the basic principles regarding the introduction of national currencies (Attachment III and Hernández-Catá (1992)).²⁵ The IMF's technical advice, backed up by the promise of financial assistance, was

²³ The Ukrainian coupon system introduced on January 10, 1992, made coupons legal tender in state stores and confined the use of rubles to the payment of rents, transport fares, utilities, other services, and for the purchase of goods in private markets. The problem with the system was that there was no correspondence between, on the one hand, the relative quantities of coupons and rubles in circulation, and on the other hand, the importance of state stores, where coupons had to be used, relative to private markets, where only rubles were accepted. There was a shortage of coupons and an excess of rubles, with the latter driving up prices in neighboring countries and causing tensions with them.

²⁴ In 1989–91 the Russian economy was 63 percent of the whole ruble area economy (excluding the Baltics) and Ukraine was about 17 percent. None of the other countries exceeded 5 percent.

²⁵ The conference was organized by the London School of Economics and the Centre for European Policy Studies, in collaboration with the Soros Foundation, and sponsored by the European Commission. The conference was attended by senior representatives of all the states of the former U.S.S.R. except Azerbaijan, Georgia, and the Kyrgyz Republic, and by representatives of several western governments and international organizations. The objective of the conference was to help establish codes of conduct in three key areas: interstate trade; the introduction of new currencies; and monetary relations in the ruble area.

intensive in the build-up to the introduction of national currencies in the Baltic States in 1992 and the Kyrgyz Republic in May 1993.²⁶ Further detail on Estonia is provided in Box 1. In addition, the staff discussed policies for departing from the ruble area with the Russian authorities, who committed themselves in the MEP of February 1992 to working out with departing countries ways of ensuring the orderly withdrawal of rubles.²⁷

28. For countries wishing to remain in the ruble area, the IMF staff prepared draft guidelines for the conduct of monetary policy (Attachment I) and presented them at the Tashkent meeting of central banks in May 1992. Following discussions with the staff, the Russian authorities had earlier pledged in the MEP to agree with other countries wishing to remain within the ruble area on transparent rules for coordinating monetary and exchange rate policy. In the absence of an agreement about a cooperative ruble area arrangement, whether along the lines of the draft guidelines presented at Tashkent or some other arrangement, the staff encouraged countries to align their interest and exchange rate policies with those of Russia and implement credit policies consistent with the inflation targets in the Russian MEP. The staff took a similar position with countries that were still preparing to introduce their own currencies. For example, the staff urged the Ukrainian authorities in July 1992 to design and implement a macroeconomic stabilization program without delay, stop

²⁶ The role of the IMF in the introduction of new currencies is documented in various IMF documents and external publications covering the demise of the ruble area. See, for example Bank of Estonia (1992), Kallas (1993), Shen (1994), Dreifelds (1996), and Haavisto (1997) on currency reforms in Estonia, Latvia, and Lithuania; and articles on the introduction of the som in Kyrgyz Republic, such as IMF (1993), Lloyd (1993, 1993a); "Kirgizstan: The Reliable Referendum, in *The Economist*, October 1994; "Kirgizstan: The Invalid Responds to Treatment," in *The Economist*, December 1994; Abdoulkadyrov (1995), and Dabrowski et. al. (1995).

²⁷ The IMF staff also contributed to a discussion in February 1992 between senior Russian and Ukrainian officials, including Deputy Chairman of the Russian parliament Mr. Vladimir Shumeiko, and First Deputy Chairman of the Committee of Foreign Economic Relations, Mr. Sergei Y. Glaziev on the Russian side, and Deputy President of the Ukrainian parliament, Mr. Volodymir Hrynov and other Ukrainian members of parliament, of the outline of an interstate protocol on the terms of Ukraine's departure from the ruble area. The outline of the interstate protocol was issued at the conclusion of the Brussels conference (February 15–17, 1992). It drew heavily on the basic principles contained in a paper presented by the IMF staff: (i) complete withdrawal of the ruble currency exchanged for the hryvnia and its remittance to the CBR; (ii) fair and nondiscriminatory treatment of residents of both countries; and (iii) Ukraine's obligation to inform states in the ruble area about the broad features of its conversion program. Although the protocol was never implemented, it represented an early signal of the realization among officials in the region of the need for interstate cooperation on the disposal of rubles acquired in exchange for new currencies.

Box 1. Estonia: Currency Reform

On June 20, 1992, Estonia introduced its new currency, the kroon, and replaced the ruble as legal tender in its territory. The kroon was backed by gold and foreign exchange and operated according to the principles of a currency board. The conversion of existing rubles into kroon proceeded smoothly and the Bank of Estonia took a number of administrative and policy measures consistent with the currency board. In addition, the government introduced a strong package of fiscal adjustment measures just prior to the currency reform.

The IMF staff began serious discussions with the Estonian authorities on currency reform in January 1992 and initiated negotiations on a possible stand-by arrangement (SBA) in early April. From the beginning, the staff explained the main elements and prerequisites for a successful currency reform. It also suggested that the reform would gain credibility from a concurrent conclusion of discussions on a SBA, but the authorities decided to introduce the kroon before the SBA negotiations were completed. The IMF staff worked closely with the Bank of Estonia on a general policy framework, as well as on all aspects of the currency reform right up to the date the kroon was introduced. Although the negotiations had not yet been concluded, the Managing Director, judging that the elements for a successful reform which could be supported by a SBA were in place, took the rare step of issuing a press release jointly with the Estonian government in support of the kroon on the eve of the reform. The governor of the Bank of Estonia at that time has acknowledged the positive role of the IMF in the Estonian currency reform (Bank of Estonia (1992) and Kallas (1993)).

exporting inflation to the rest of the ruble area, and coordinate monetary policy with other countries while it remained in the ruble area.

29. While encouraging countries to make the choice between national currencies and a cooperative ruble area arrangement, and explaining the arguments on both sides, the IMF was formally neutral between the two options. It recognized that the choice had a large political as well as an economic element. In the politically highly-charged world of relations between the new post-Soviet states, there was a tendency, at least in the early years, to try to classify third parties as either for or against Russia. The IMF sought to persuade the countries in the region that it was working in the interests of all countries, and did not take sides. Had it openly favored a cooperative ruble area arrangement, it would have been seen by the Russians, especially after the Tashkent meeting in May 1992, as siding with the other CIS countries. Had it openly favored national currencies, *a fortiori* if it had advocated a Russia-denominated ruble area, many other CIS countries would have concluded it was

acting on Russia's behalf.²⁸ By remaining formally neutral while setting out the economic arguments on both sides, the IMF hoped to retain the confidence of all countries in the impartiality of its advice. While doubts were expressed from time to time by both Russia and other countries, by and large they all accepted that the IMF was not taking sides.

30. As regards the purely economic arguments summarized above, the official IMF line in the first half of 1992 was that either option could be made to work, in the sense of delivering monetary stability and a satisfactory payments system, provided that the rules of the game were observed.²⁹ Critics have argued that the IMF failed to recognize that the free rider problem meant that the cooperative ruble area arrangement was not a viable option.³⁰ The IMF certainly realized that this option's chances of success were not great after the Russian position hardened following Tashkent. But in the summer of 1992 it felt that it could not rule it out so long as a number of CIS countries believed that they could persuade Russia to adopt it, and major member countries attached importance to preserving the ruble area. Of course, subsequent events showed that the barriers to establishing the cooperative ruble area could not be surmounted.

31. In contrast to the neutral position that the IMF held with respect to the two options, there has been a widespread view that the IMF opposed national currencies and sought to maintain the ruble area.³¹ The source of this view is not clear. It may well have been born out of the frustration that the Russian authorities and their foreign advisors felt because the IMF did not actively push other countries out of the ruble area, and then limited the scale of its

²⁸ The Russian government in the spring and summer of 1992 would have liked the IMF to press the other countries to introduce their own currencies, so that Russia's relations with the others would be less damaged than if Russia itself ejected them from the ruble area. The IMF was very wary about being seen to be acting primarily on behalf of Russia. However, in the summer of 1992 it did ask Lithuania to leave the ruble area before a Stand-By Arrangement could be put in place; and this is what happened in October 1992 (Figure 1).

²⁹ As already noted, there were different views within the IMF. Some staff members believed that a cooperative arrangement could never work, while others—and Executive Directors representing some major countries—believed that the importance of the ruble area for regional trade and payments flows was such that every effort should be made to make it work.

³⁰ For example, Gaidar (1997) called this the “most serious technical mistake made by the IMF during all its work with Russia.” Gomulka (1995) called it a “policy mistake that betrayed a technocratic bias and political naiveté or insensitivity.”

³¹ Among the more influential exponents of this view were Lipton and Sachs (1992), Hansson and Sachs (1992), Gomulka (1995), Aslund (1995), and Gaidar (1997 and 1999).

lending to Russia because the authorities did not have full control over monetary policy.³² It may also have reflected the fact that the staff's proposals at the Tashkent meeting became well known, whereas its assistance to countries introducing national currencies remained fairly private.³³ Whatever the original source, it seems likely that the view quickly became conventional wisdom and, in the absence of corrections, was repeated by others who had no independent knowledge of the facts.

32. As 1992 wore on, the balance of the economic arguments for and against national currencies and a cooperative ruble area arrangement shifted. The case for separate currencies became stronger because: macroeconomic stabilization in Russia proved harder to achieve than initially expected; Russia rejected the cooperative approach to running the ruble area; and progress was being made in several countries in strengthening the institutional capacity for sound monetary policy making. Although the IMF retained a public posture of neutrality, by the time of the Annual Meetings of the IMF and World Bank in September 1992, it was privately advising delegates from countries still in the ruble area that the balance of the economic arguments now favored national currencies. This argument fell on increasingly receptive ears.³⁴ It was pressed most urgently in the case of Ukraine, which continued to add

³² At their meeting in Washington on June 17–18, 1992, the Managing Director and Mr. Gaidar agreed that financial assistance from the IMF to Russia would proceed in three stages. The first would not require the resolution of the ruble area issue. The second, which would give Russia access to more finance (in the upper credit tranches), would follow only after Russia had obtained full control over monetary policy. The third would be a currency stabilization fund. See IMF (1992b) for a summary of the three stages.

³³ But see Odling-Smee (1993) for a summary of the IMF's advice to Estonia; this was written to correct Hansson and Sachs (1992) who understated the IMF's role.

³⁴ For example, senior Armenian government officials agreed with the staff that the balance of arguments had shifted in the last few months in the direction of leaving the ruble area. They noted that a decision in principle had been made to introduce an Armenian national currency but not immediately, partly because of the weak state of the economy (badly hurt by the Nagorno-Karabakh conflict), but, most importantly, because of Armenia's dependence on external financing from Russia provided through the correspondent account of the National Bank of Armenia with the CBR. Similar concerns were mentioned by the Georgian authorities, including President Shevardnadze, in discussions with an IMF mission that visited Tbilisi in late November 1992. In particular, while aware of the costs associated with remaining in the ruble area in an inflationary environment, the Georgian authorities emphasized that, in addition to the risk of a cutoff in credit by Russia, a possible departure from the ruble area would have to be considered in light of Georgia's overall political/military relationship with Russia, especially the Abkhazia conflict. (Political and military factors with Russia also influenced the Armenian authorities in their decisions regarding ruble area membership.)

to ruble instability. An additional reason in this case was the staff's view that the sooner Ukraine was responsible for its own currency, the earlier it would be faced with the need to rein in its inflationary policies. Ukraine did eventually withdraw from the ruble area on November 12, 1992.

33. With nearly all ruble area countries becoming IMF members by October 1992 and most of them seeking financial support, a new element came into play. The IMF decided that it could not lend to a country unless either it had its own currency or monetary policy in the ruble area was governed by clear and stable institutional arrangements.³⁵ This position was set out in a letter sent in mid-November to the central bank governors and governments of countries still using the ruble (Attachment IV). The letters urged them to come to an early decision on whether to: (i) remain in the ruble area with a common monetary policy; or (ii) introduce separate currencies. They noted that previous attempts to reach agreement on rules to coordinate monetary and credit policies among central banks had not succeeded; and that a monetary system such as the one in place—based on limits on the central banks' (bilateral) correspondent accounts *without* a common and disciplined credit policy—was causing interruptions to trade and payments and would not permit the control of inflation and the stabilization of the ruble. Without effective monetary control, the staff would not find it possible to agree with a ruble area member country on an economic program and make available the IMF's financial support. Under the national currency option, in which countries introduced their own currencies, many decisions had to be made to ensure the stability of the new currency and minimize disruptions to the domestic and neighboring economies resulting from the currency reform. Under the cooperative ruble area option, what was essential for the survival of a single currency area was that the responsibility for a common credit policy be squarely in the hands of a single authority (be it an interstate monetary institution or the CBR). Although there was no immediate policy response to these letters, they may have helped to crystallize issues in the minds of policy makers, and perhaps tilted the balance of arguments in some countries towards the national currency option.

34. From November 1992 onwards, the IMF Executive Board, as well as Fund management and staff, consistently stressed to the various national authorities, in the context of Article IV consultations, staff visits to countries, and other contacts with top country officials, that the balance of arguments had shifted in favor of countries proceeding firmly to monetary independence, unless they could make the ruble area work.³⁶ For countries engaged

³⁵ Unlike at the Tashkent meeting, the IMF did not exclude the possibility that monetary policy would be set exclusively by the CBR. This was partly because Russia had made clear its support for a CBR-dominated system and its opposition to a cooperative arrangement, and partly because the staff expected those countries that did not choose separate currencies would be less hostile toward a CBR-run policy than the original ruble area members.

³⁶ The first Article IV consultation discussions with Armenia, Belarus, and Kazakhstan took place in December 1992, and May and July 1993, respectively. A number of visits by Fund
(continued)

in program negotiations with the IMF, the staff made clear to them that workable monetary arrangements would need to be in place, whether the country stayed in the ruble area or introduced a separate currency, before the IMF Executive Board would be prepared to approve a program with them. These countries included Belarus, Kazakhstan, the Kyrgyz Republic, and Moldova. Of these, only the Kyrgyz Republic had the clear intention of introducing its own currency, which it did in May 1993. The others, together with Armenia, Azerbaijan, Georgia, Tajikistan, Turkmenistan, and Uzbekistan, procrastinated, hoping that developments in the ruble area and bilateral relations with Russia would clarify the choice. The situation was made easier for them by the introduction of the IMF's new Systemic Transformation Facility (STF) in April, 1993. This enabled the IMF to make loans even though monetary arrangements had not been definitively settled. Credits under the STF were agreed by the Executive Board to Belarus (July 1993), Kazakhstan (July 1993), and Moldova (September 1993) (Figure 1).

35. The IMF was not consulted about the demonetization of pre-1993 rubles in Russia in July 1993. However, the Russian action, although it created uncertainty, had the effect of pushing the other countries into making the choice between monetary regimes that the IMF had been urging for nearly a year. At the Annual Meetings of the IMF and World Bank in September 1993, the IMF gave a note to the five countries that had signed a framework agreement with Russia on a new ruble area. While acknowledging that it was the sovereign right of any state to enter into a monetary union, the note raised serious concerns about whether a new monetary union would be workable and ultimately sustainable. These concerns related to: (i) the poor track record of monetary cooperation among these countries; (ii) whether other ruble area states would realistically be willing to accept limitations by Russia on their sovereignty in the monetary area; (iii) the inadvisability of attempting to achieve monetary union in a highly inflationary environment; and (iv) doubts about the economic sustainability of such a union in the absence of significant financial transfers from Russia, which appeared not to be forthcoming (Attachment V). These arguments reflected a further evolution of the staff's views towards rejecting a monetary union, informed by the accumulated experience of the difficulty the countries had in cooperating.

36. Moreover, the staff was concerned about the ability of these countries—which were faced with a potential inundation from other FSU states of old rubles that were no longer legal tender in Russia—to exert domestic monetary control pending a revived currency union. It therefore advised these countries to differentiate their currencies in the interim, preferably by introducing a full-fledged national currency but, if necessary, by creating a *de facto* separate currency through, for example, the stamping of old ruble banknotes. As negotiations with Russia failed to make much progress, four of the five countries which signed the framework agreement with Russia took steps to separate their currencies and did, in effect,

management, senior staff and missions to Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, and Uzbekistan also took place between October 1992 and July 1993.

introduce national currencies in November 1993. Tajikistan was slow to follow, and therefore experienced the massive inflow of old rubles that the staff had warned against.

IV. SUMMARY AND CONCLUSIONS

37. This paper has summarized the IMF advice on the ruble area as it was presented to the national authorities in Russia, the Baltic countries, and other states of the former Soviet Union in 1991–93.

38. In early 1992 the authorities in the ruble area countries were confronted with basically three alternative courses of action on what to do with the monetary system inherited from the U.S.S.R.. The options were: (i) to establish a cooperative ruble area arrangement in which all participating central banks would have a say in credit and monetary policy for the ruble area; (ii) to introduce national currencies in countries wishing to pursue an independent monetary policy, especially if they wanted a more ambitious disinflationary policy than that in the ruble area; and (iii) to establish a Russia-dominated ruble area in which the CBR would be solely responsible for monetary and exchange rate issues for the area as a whole.

39. A Russia-denominated ruble area did not seem to be a viable option in the early months of 1992 because of the opposition of most of the other countries. For similar reasons of sovereignty, the Baltic countries made preparations, with assistance from the IMF, to introduce their own currencies as soon as possible. The IMF explained to the other countries the advantages and disadvantages of the cooperative ruble area arrangement and national currencies, and encouraged them to choose between them. It was formally neutral between the two options. This was partly because the IMF was concerned not to appear to take sides between Russia on the one hand and the other countries on the other hand in what the countries saw as essentially a political rather than an economic decision. Moreover, the economic arguments in early 1992 did not point clearly in one direction or the other: while the difficulty of aligning monetary and fiscal policies argued against a cooperative ruble area arrangement, the disadvantages of national currencies—weak, almost non-existent central banks and the risk of disrupting trade and payments still further—were also serious. In addition, there seemed to be a chance that Russia, which prepared a very promising Memorandum of Economic Policies in February 1992, would be able to stabilize its own monetary situation and thereby provide the anchor for the ruble area.

40. As events in 1992 and 1993 unfolded, the balance of the economic arguments shifted towards national currencies. First, Russia indicated in the middle of 1992 that it would not accept a cooperative ruble area arrangement, leaving the other countries with a choice between national currencies and a Russia-denominated ruble area. Second, Russia failed to stabilize its own monetary situation, experiencing very rapid credit expansion in the third quarter of 1992 (Figure 2). Third, the embryo central banks were developing rapidly into institutions that had a good chance of operating an independent monetary policy. Responding to these shifts, the IMF became gradually less neutral and gave increasing emphasis to national currencies than to the continuation of the ruble area. While its recommendations at the time of the September 1992 Annual Meetings of the IMF and the World Bank were

delivered orally and privately, by the time of the subsequent Annual Meetings in September 1993, the note that it presented to the countries that were still contemplating a Russia-denominated ruble area argued that such a regime was unlikely to be sustainable.

41. In addition to explaining the choices open to countries, and urging them to make a clear decision one way or the other, the IMF also assisted countries to implement whatever decision they made. Thus it provided technical and financial assistance to the countries that introduced national currencies (Estonia, Latvia, and Lithuania in 1992, and the Kyrgyz Republic in 1993). And it presented a draft scheme for operating a cooperative ruble area arrangement to a meeting of central banks of ruble area countries in Tashkent in May 1992.

42. This paper has been limited to what actually happened. There are many interesting questions that could be asked about what might have happened if something had turned out differently. Would the ruble area have staggered on beyond two years had the IMF (especially after mid-1992) not guided countries toward separate currencies? If so, what would the costs have been in postponed stabilization? On the other hand, should the IMF have pushed for an earlier break-up of the area? Was it naive to believe that the will to cooperate over monetary policy could ever exist? What would have happened if countries which were not ready—institutionally, politically or psychologically—for a national currency had been forced to leave the ruble area by mid-1992?

43. Most of these and other possible counter-factual questions call for papers in their own right. Nevertheless, we allow ourselves the following summary remarks on what would have happened if the IMF had pushed for an earlier break-up of the ruble area. We do this because it is often suggested that the failure to break up the ruble area by the summer of 1992 was a factor contributing to the broader failure of the reform program in Russia initiated by Yegor Gaidar's government.³⁷ It is said that, had the ruble area been dissolved, it would have been easier to control inflation in Russia, and the IMF could have been in a position to lend much more money than it did, thus assisting the reform process.

44. We have doubts about this argument.³⁸ First, only a part of Russia's inflation in 1992 was due to the ruble area and excessive monetary expansion in the other countries. The bulk of it was attributable to the expansionary monetary policies of the CBR although Ukraine's contribution in the second quarter (45 percent of total ruble monetary growth) was high

³⁷ See, for example, Gaidar (1997).

³⁸ We focus here on what might have happened in Russia if the IMF had pushed harder for an earlier break-up of the ruble area. One could also ask what would have happened in the other countries. Many of them were ill-prepared to conduct an independent monetary policy. Also, as noted above, they might have interpreted the IMF's advice as being pro-Russia, with implications for the IMF's subsequent influence.

(Figure 2).³⁹ Second, the IMF might not have been able to cause the dissolution of the ruble area, even if it had tried. Ukraine, which was already committed to introducing its own currency, was in too much political disarray—which is what lay behind its expansionary policies—to implement the new currency much before it did in November 1992; also, the IMF's influence at this stage, especially before Ukraine became a member in early September 1992, was minimal. Many of the other countries, including the larger ones (Belarus, Kazakhstan, and Uzbekistan), clung onto the ruble for as long as they could, for political reasons and in the vain hope that to do so would lead to special financial favors from Russia. This was in the face of advice from the IMF from September 1992 onwards that they would be better off with separate currencies. It should also be noted that the IMF could not apply pressure in the form of conditionality until countries had become members and entered negotiations about an economic policy program that the IMF could support financially. Very few countries were in this position in the summer of 1992. Ukraine, for example, did not agree on a program with the IMF until 1994, despite the persistent efforts of the IMF and other foreign advisors (Figure 1). Third, even assuming that the ruble area had been dissolved by the middle of 1992, and the IMF had been prepared to lend a much larger amount to Russia than the \$1 billion it did in fact lend, what would have been the fate of reforms in Russia? We do not try to answer this large question here, but would point out that the forces that were undermining Gaidar and his government's program were growing in strength throughout 1992.⁴⁰ While the stabilization of inflation and strong financial support from the international community would have been significant counterweights, it is not obvious that they would have been sufficient to overcome the growing domestic reaction against reforms.

45. Although the focus of this paper is the role of the IMF in the dissolution of the ruble area, it is obvious from the facts and arguments presented here that other factors were much more important in explaining when and how the ruble area broke up. The critical elements were the political and, to a lesser extent, economic judgments of the key actors in all the ruble area countries, judgments that mostly rested on analyses and world views that the IMF had little ability to influence. Nevertheless, it will be important that the full story of the dissolution of the ruble area, when it comes to be written, portrays the IMF's specific role accurately. We hope that this paper will contribute to this.

³⁹ This point was made many years ago by Gros and Steinherr (1995, pp. 382–395).

⁴⁰ Gaidar (1997) wrote that “the political price for the conflicting policy of the first months of reforms (introduction of 28 percent value added tax, a reduction in weapons purchases to one third of previous levels, a sharp cut of agricultural subsidies, etc.) was high; internal support for stabilization reforms was lost.” In the same paragraph he comments on the “bureaucratic obstacles to cooperation between Russia and the IMF,” meaning the procedures leading up to Russia joining the IMF on June 1 and the Executive Board meeting on August 5 that approved the first loan. Given these, large scale financial support from the IMF could not have come before June, whatever had happened to the ruble area.

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Monetary Policy in the Ruble Area

(Note presented by the IMF Staff at the meeting of the Interbank Coordinating Council of Heads of Central Banks (ICC) in Tashkent on May 21-22, 1992))

I. THE COORDINATION OF MONETARY POLICY IN THE RUBLE AREA

Several of the independent states of the former U.S.S.R., including Ukraine, the Baltic countries, and Moldova have announced their intention to issue their own national currency. Most of the states, however, have indicated that they intend to remain in the ruble area, at least for some time. The heads of central banks in the area have been meeting periodically to exchange information on matters of common interest and, recently in Minsk, they agreed to create an Inter-Bank Coordination Council for the purpose of working out coordinated solutions in key areas of monetary and credit policy. So far, however, there is no comprehensive agreement among these countries on how to conduct monetary policy in a way that contributes to stabilization for the ruble area as a whole.

The need for coordination

The key objective of bringing down inflation in Russia and in the ruble area as a whole requires first and foremost an appropriately restrained credit policy by the Central Bank of Russia (CBR). However, action by the CBR alone will not be sufficient unless it is supported by adequate policies by other central banks in the ruble area. At present, these central banks are in a position to extend credit in rubles to their national governments and domestic enterprises. Moreover, the interest rates charged on central bank credits and the reserve requirements imposed on commercial bank deposit liabilities differ widely among states. Therefore, the extent to which a given increase in base money leads to a multiple expansion of bank deposits and total bank credit can differ considerably among states. In this environment, each national central bank has an incentive to extend as much credit as possible to its own government and enterprises, in the expectation that the inflation this would generate would be borne not just by itself but also by other states in the ruble area.

To some extent, monetary expansion in the various states has been constrained by insufficient deliveries of ruble banknotes by Russia, the state where all the printing presses in the ruble area are located. But this has led to serious difficulties (including delays in the payment of wages and pensions), particularly as transactions involving individuals are conducted overwhelmingly on the basis of currency. These problems have encouraged some states to resort to multiple-use coupons. And this, in turn, has raised further difficulties, including the tendency by the countries issuing the coupons to dump rubles in other states, thus providing incentives for retaliatory export restrictions by those states. The currency shortages also have prompted several states to give serious consideration to the option of a separate currency.

The current situation is clearly not sustainable. Unless the current system is reformed and a cooperative solution is found, the task of bringing down inflation in the ruble area will be

made considerably more difficult. Eventually, states could be forced to introduce their own currencies before they were adequately prepared to conduct an independent monetary policy. This would also mean that the banking systems of the states in the ruble area would be segmented, with adverse consequences for interstate payments and, possibly, for trade and output. There is therefore an urgent need to build upon the recent efforts at cooperation among central banks and to reach an interstate agreement on monetary and credit policy that should last as long as some of the states wish to remain in the ruble area.

A central monetary agency

There are in principle many possible forms of monetary policy cooperation in the ruble area. One would be to establish a central monetary agency in which each of all the central banks in the ruble area would be represented, and which would be empowered to conduct monetary and credit policy for the area as a whole. That agency would also centralize foreign exchange reserves for the ruble area and would be solely responsible for intervention in the foreign exchange market. This is an option that is worth pursuing for the longer term. At present, however, it seems unlikely that a system of this kind could form the basis of an agreement that was politically acceptable to all the states in the ruble area.

A rule-based system of coordination

An alternative form of cooperation for the near term would be for all the central banks in the area to agree on a number of rules regarding the conduct of monetary policy. These rules should provide a basis for effective control of monetary and credit expansion in the ruble area while avoiding the surrender of sovereignty by individual states. The Fund staff has developed a set of rules that would achieve these objectives. The key elements of the proposed framework, which is specified in some detail in the attached paper on "Guidelines for the Conduct of Monetary Policy in the Ruble Area," would be the following:

First, each republican central bank would agree to set a limit on the expansion of its net domestic assets. The limits would be such that the maximum expansion of net domestic assets for the ruble area as a whole would be consistent with the objective of reducing the growth of the area-wide money supply so as to bring down inflation as planned. The ceilings would also be consistent with the aim of building up an adequate level of official international reserves for the ruble area as a whole (and for Russia in particular) in order to defend the external value of the ruble in foreign exchange markets.

Second, the monetary authorities in all states would agree to set uniform central bank lending rates and reserve requirements; to establish a common, unified exchange system; and to facilitate the settlement and clearance of payments throughout the ruble area, including among central banks.

Third, the CBR would agree to provide a certain amount of currency—specified according to a mutually agreed rule—to the other central banks in the form of an interest-free credit. Currency in excess of this amount would be supplied on demand, but would be in the form of

an interest-bearing credit. The CBR would also continue to provide credit to the other central banks through their other (trade-related) correspondent accounts at an interest rate no higher than the rate it charges commercial banks in Russia. However, total net credit extended by the CBR to other central banks—including those credits associated with currency issue—would be subject to an overall limit to avoid excessive credit expansion by these central banks.

If all the participating states agreed to abide by the rules specified in the guidelines, the proposed framework would help to ensure that inflation was reduced as planned, and that states in the ruble area, particularly the Russian Federation, would build up an adequate reserve of foreign currencies. On both counts, the framework would help to stabilize the value of the ruble in foreign exchange markets. It would do so while relieving the present shortage of currency and providing for a fair distribution of the seignorage.

The framework would also provide certain safeguards that would apply in a situation in which some states failed to abide by the rules. For example, in the event of excessive borrowing by certain central banks, the CBR would be in a position to restrict such borrowing, for example by imposing penalty interest rates. In the case of more serious transgressions, including large, sustained deviations from credit ceilings or persistent failure to abide by the rules regarding central bank lending rates and the foreign exchange system, action could be taken to limit or to suspend the right of the states in question to obtain ruble currency, other credits from the CBR (and other central banks in the area), and to access foreign exchange markets in other states.

It is expected that these guidelines and the associated understandings among central banks would be revised as necessary, in consultation with the Fund, on the basis of practical experience with the conduct of monetary policy in the ruble area.

II. GUIDELINES FOR THE CONDUCT OF MONETARY POLICY IN THE RUBLE AREA

The following guidelines are submitted by the staff of the International Monetary Fund to the central banks, or national banks, of the former U.S.S.R. republics. They are intended as a basis for discussion toward reaching understandings among central banks on monetary cooperation in the ruble area. These understandings would complement and reinforce the agreements concluded on March 30, 1992 in Minsk and on May 6-7, 1992 in Bishkek among the heads of central banks.

1. All central banks in the ruble area will cooperate in the pursuit of a monetary policy aimed at reducing the monthly rate of price inflation to low, single digit levels by the end of 1992, and at achieving further reduction in inflation beyond 1992.
2. To this end, effective coordination of the instruments of monetary policy by all central banks in the ruble area will be needed. Specific requirements will include:

- (i) that all central banks agree to set their lending rates (including their finance rates and the rates they charge on overdrafts) at mutually agreed common levels, with perhaps a pre-specified range of permissible variation to allow individual central banks to deal with financial market conditions that differ from those prevailing elsewhere in the ruble area;
 - (ii) that all central banks, including the Central Bank of Russia, establish ceilings on the expansion of their net domestic assets.⁴¹ These ceilings should be consistent with the objective of reducing the rate of growth of the money supply in order to bring down inflation as planned. (Separate sub-ceilings on net credit expansion to the government also should be specified for each central bank.) Initially, the setting of ceilings on net domestic assets for each of the central banks could be determined according to a mutually agreed rule.⁴² As states in the ruble area enter into arrangements with the International Monetary Fund, specific credit ceilings will be defined as part of these programs, and the Fund will endeavor to ensure that these ceilings are consistent with the overall inflation, output and balance of payments objectives for the ruble area as a whole. In order to achieve the objectives of these arrangements, credit ceilings and other targets in each state may need to be revised, in consultation with the Fund, in response to unanticipated economic developments.
 - (iii) that all central banks enforce reserve requirements on the deposit liabilities of all commercial banks in their territories at the rates common in the ruble area as a whole.
3. The Central Bank of Russia will agree to provide enough ruble currency to the central banks of other states in the ruble area to satisfy the demand for currency in these states. (Of course, such demand will be limited given the credit ceilings on the net domestic assets of each central bank and on the CBR's lending to other central banks referred to in paragraph 2 and 7, respectively). To this end, the Russian authorities will make appropriate plans to produce the required amount of currency. Each central

⁴¹ Net domestic assets of the central bank are defined as credit to all levels of government (net of government deposits) plus credit to domestic banks plus credit to domestic enterprises (if any) plus other net assets. Net domestic assets include claims of the central bank on residents of other states in the ruble area excluding other central banks.

⁴² For example, the percentage change in net domestic assets of each central bank could be limited to the same maximum percentage increase specified for the ruble area as a whole. Alternatively, the maximum credit expansion by each central bank could be distributed according to the ratio of GDP in the corresponding state to the GDP of the entire ruble area.

bank should receive from the CBR a certain amount of ruble currency in the form of an interest free credit (although deliveries would continue to be subject to a fee to cover production and shipping costs). This provision will provide a way to share the seignorage. The amount received by each central bank would be determined by a mutually agreed formula that could involve the same weights used in calculating the ceilings for net domestic assets in the various states ⁴³ (see paragraph 2(ii)). Each central bank would be allowed to buy ruble currency from the CBR over and above its initial allocation, subject to the limitations specified in paragraph 7.

4. The Central Bank of Russia will agree to continue to provide credit to other central banks, including in particular through its correspondent accounts. If the CBR has a net creditor position with other central banks (measured from January 1, 1992) it will charge these central banks the same interest rate it charges to banks in the Russian Federation. This provision will not apply to the portion of the currency issue which will take the form of an interest-free credit as indicated in paragraph 3. The CBR also will agree to pay interest at the agreed rate to those central banks which have a net creditor position in their correspondent accounts (excluding currency issue) with the CBR. Credit from the CBR to other central banks, other than through the net balance on the correspondent accounts (and other prearranged credit facilities, if any) will be extended only under extraordinary circumstances and on a temporary basis.
5. All central banks will act as rapidly as possible to set the level of their lending rates in line with the interest rates prevailing in the interbank market in order to influence the growth in money and credit in the ruble area to desired levels and to allocate central bank credit according to market conditions. In this context, the central banks will endeavor to keep their lending rates above the planned rate of inflation. The level of these rates will need to be reviewed regularly to take into account changes in financial market conditions.
6. All states in the ruble area should move as quickly as possible to liberalize the rates charged by commercial banks on their loans. The states should also reach agreement on measures to liberalize the interest rates paid by banks on their deposits liabilities, and to eliminate regulatory differences between savings banks and other banks.
7. The central banks in the ruble area will agree to implement ceilings on the net position of their correspondent accounts with the CBR, including credits associated with currency issue and with the balance on other correspondent accounts. These ceilings would generally not be binding when central banks are adhering to their respective ceilings on net domestic assets. Debit balances in excess of these ceilings could result in the imposition of penalty interest rates on its net lending to those

⁴³ Any issue of coupons or national rubles by an individual central bank would be deducted from the amount of currency it receives from the CBR as an interest-free credit.

central banks that exceed their ceilings. If substantial excessive borrowing by an individual central bank persists in spite of these penalties, quantitative restrictions would be imposed on such net borrowing, including limitations on the provision of currency.

8. All central banks in the ruble area will work to develop a common payment system, facilitating the exchange of checks, payments orders and order requirements and freely across the ruble area, and bringing about uniform rules for interbank settlements of large value transfers. Initiatives concerning the payments clearing and settlement system will be coordinated to ensure common document standards and message formats.
9. Central banks will coordinate regulations affecting money markets to ensure freedom for commercial banks to participate in money and interbank market activities anywhere in the ruble area. The Central Bank of Russia will agree to set up facilities for prompt settlement of the transfer of ruble funds among central banks at market rates in their correspondent accounts with the CBR.
10. In order to establish the conditions for convertibility of the ruble, each of the states in the area should move as quickly as possible to unify its exchange system and to provide access to its foreign exchange markets to all residents in the ruble area. Until these objectives are reached, all states should agree on a uniform exchange system and a uniform system of surrender requirements.
11. All central banks in the ruble area will agree to buy and sell foreign exchange from each other at market exchange rates within pre-specified limits.⁴⁴ All central banks will be authorized to hold foreign exchange reserves and to intervene to counter disorderly market conditions in the short run. For practical reasons, however, foreign exchange market intervention aimed specifically at affecting the external value of the ruble will be conducted by the Central Bank of Russia. The CBR will inform other central banks on a timely basis about its objectives concerning foreign exchange market intervention and the external value of the ruble.
12. The credit ceilings referred to in paragraphs 2 and 6 will be specified so as to allow for an adequate build-up of net international reserves in foreign currencies for the ruble area as a whole. To this end, credit programs in Fund arrangements will specify a floor on the level of net international reserves for the CBR and, perhaps, for other central banks. (The provisions of this paragraph will apply to all institutions legally authorized to hold foreign exchange reserves, including central banks and the Vneshekonombank.)

⁴⁴ One possibility would be for these transactions to be conducted in the context of arrangements among central banks involving pre-specified swap lines.

13. If individual states wish to introduce coupons for the purpose of dealing with the physical shortage of ruble banknotes they should do so in a way that avoids distorting trade between the state and private retail sectors and that does not result in the dumping of ruble currency on other states. The monetary authorities should ensure that:
- (i) both rubles and coupons are declared legal tender and that both are generally accepted as means of payments in state stores as well as in private markets;
 - (ii) the central bank commits itself to buy and sell coupons for rubles on a one-for-one basis;
 - (iii) sales of coupons are open to all holders of rubles, foreign as well as nationals. In exchanging coupons for hard currency, the exchange rate should be exactly the same as for rubles; and
 - (iv) the issue of coupons is not used to finance the expansion of net domestic assets by the central bank above its ceiling.

The provision of this paragraph would also apply to the introduction of national rubles by individual states.

14. In accordance with the agreement reached in Bishkek on May 6-7, the central banks will exchange information on monetary and credit developments, including in particular data on domestic credit and balances on correspondent accounts, not less than once a month. An agency, such as The Working Group of the Coordination Council referred to in Article 2 of the Minsk Agreement, would be designated to collect and centralize the information and make it available to all central banks and to the Fund on a timely basis. All central banks would agree to consult with other central banks, for example, in the context of the regular meetings of the Inter-Bank Coordination Council, prior to any significant change in the instruments of monetary policy, including especially refinance rates and reserve requirements, or any modification in the exchange system. Central banks would also consult with other central banks prior to the introduction of national rubles, coupons, or a national currency.
15. For all member states of the ruble area, the privileges defined in paragraphs 3 (regarding the right to obtain ruble currency), 4 (with respect to obtaining credit through the correspondent accounts) and 11 (concerning the right to buy and sell foreign exchange) are contingent upon the introduction of the measures specified in these guidelines, and particularly specified in paragraphs 2 and 10. Adherence to the present guidelines is needed to create the conditions for an effective monetary policy in the ruble area. Therefore, the measures and policies specified in these guidelines

will need to be agreed and substantially put in place before a country that is a member of the ruble area can enter into an arrangement with the International Monetary Fund.

THE INTRODUCTION OF NATIONAL CURRENCIES

(Executive Summary of a paper submitted by the IMF staff to Deputy Chairman of the Committee for the Management of the National Economy of the U.S.S.R., Gregory Yavlinsky, in October 1991)

1. A monetary system must, above all, be conducive to the firm control of the supply of money, with a view to maintaining a low and stable inflation rate.
2. In a currency union, the maintenance of monetary control requires that interest rate, credit and exchange rate policies are applied uniformly throughout the union. There is no scope for independent monetary policies by participating countries. It may also be necessary to make the central monetary institution constitutionally independent from governments and to limit lending between member governments.
3. The main advantage of a currency union, provided that monetary control is maintained, is that it minimizes the costs of trading between participating countries. The main advantage of a system of separate currencies is that it allows countries to set monetary policy according to their particular economic circumstances and to pursue more ambitious objectives—including lower inflation—than their neighbors.
4. The adverse effects on trade between countries of introducing national currencies would be minimized by making these currencies convertible as quickly as possible.
5. Whichever system is chosen, government budget deficits that are financed by money creation should be eliminated without delay.
6. If countries wish to introduce their own national currencies, they should do so with due consideration for the costs that such a step can impose on their partners in the currency union. They should exchange the new currency for the old, and remove the withdrawn amounts from circulation. The settlement of financial claims and liabilities would be a matter for negotiation between the affected countries.
7. Symbolic national currencies could be introduced alongside a common currency provided that the central monetary authority controlled their supply and stood ready to buy and sell the national currency for the common currency at a pre-determined exchange rate.

<p align="center">Conference on Codes of Conduct for Inter-State Economic Relations sponsored by the European Commission organized by LSE and CEPS with the collaboration of The Soros Foundations and ICRET</p> <p align="center">Brussels, 15-17 February 1992</p> <p align="center">List of participants</p>	
Mr. Isaakian I. Abasovich President Central Bank of Armenia	Mr. Nikolai A. Domanov Central Bank of Russia
Mr. Habib Abdulaev, Advisor Ministry of Economics Uzbekistan	Mr. U.A. Dzhandosov, Advisor Council of Economic Advisors to the President, Kazakhstan
Mr. Gulyam Zh. Babaev First Deputy Minister of Finance Tajikistan	Mr. Elissalt, DG I Commission of the EC
Ms. Roza Baidshapovna Central Bank of Kazakhstan	Mr. John Flemming Chief Economist, EBRD
Mr. Levon Barkhoudarian Vice Minister of Finance Republic of Armenia	Mr. Sergei Y. Glaziev First Deputy Chairman, Committee of Foreign Economic Relations, Russia
Mr. Yuri D. Bershachevski Chief Advisor to the Deputy Chairman of the Supreme Soviet, Russia	Mr. Daniel Gros Senior Research Fellow CEPS
Mr. Igor Blinov Private Bank Russia	Mr. Maurice Guyader Commission of the EC
Mr. Stanislav A. Bogdankevich Chairman Central Bank of Belarus	Mr. Detlev Hammann Bundesministerium der Finanzen
Mr. Henning Christophersen Vice President Commission of the EC	Mr. Oleh Havrylyshyn Advisor to the President of Ukraine
Ms. Rose De Terville Research Secretary, CEPS	Mr. Ernesto Hernández-Catá Deputy Director, IMF
Mr. Peter Dittus OECD	Mr. Volodymyr Hrynov Deputy President Parliament of Ukraine

Mr. B. Izteleulov Deputy Chairman, Council of Economic Advisors to the President Kazakhstan	Ms. Tania Normak Centre for Economic Performance London School of Economics
Mr. Jaime Jaramillo Exchange and Trade Relations Department IMF	Mr. Domenico Mario Nuti DG II, Commission of the EC
Ms. Filomena Jaseviciene Deputy Minister of Economics Lithuania	Mr. Papadopoulos DG II, Commission of the EC
Peter Kenen Princeton University	Ms. Joan Pearce DG II, Commission of the EC
Ms. Susanna Khavul Programme Officer Soros Foundation	Mr. Andrey V. Pecherov Ministry of Finance, Ukraine
Mr. Anton Kozhinov Centre for Economic Performance London School of Economics	Mr. Jean Pisani-Ferry DG II, Commission of the EC
Mr. Karel Lannoo Programme Officer, CEPS	Mr. Jean-Francois Pons DG II, Commission of the EC
Mr. Ake Linden Special Advisor to the Director General GATT	Mr. Lionel Price Head of Economic Division Bank of England
Ms. Anne McGuirk Exchange and Trade Division Department IMF	Mr. Volodymir Pylypchuk Chairman, Permanent Commission of Economic Reform, Council of Ukraine
Mr. Constantin Michaelopoulos Senior Advisor World Bank	Mr. Ratkebecius Vice President, Central Bank of Lithuania
Mr. Knud Munk DG II, Commission of the EC	Mr. Einars Repse President, Central Bank of Latvia
Mr. Vytas Navikas Deputy Minister of Economics Republic of Lithuania	Mr. Häik Sarkissian Vice Minister, Republic of Armenia
Mr. Yuri Nechaev Senior Advisor Ukrainian Parliament	Mr. André Sapir Commission of the EC
Mr. Klaus Schneider Commission of the EC	Mrs. Tatiana Valovaya Economic Affairs Russian Mission to the EC

Ms. Florence Silve Commission of the EC	Mr. Patrice Vial Directeur de la Prévision Ministère des Finances
Mr. Vladimir Ph. Shumeiko Deputy Chairman, Supreme Soviet Russia	Mr. Francis Wöhring Commission of the EC
Mr. André Sikkal Minister of Foreign Trade Estonia	Mr. Stepan Yanchuk Minister of Finance, Belarus
Mr. Boris Sobolev Deputy Minister for Foreign Economic Relations, Ukraine	Mr. Mark I. Yanovsky Head of Credit and Monetary Management, Russia
Mr. Claus Sorensen Cabinet of Mr. Christophersen Commission of the EC	Mr. Evgeny Yasin Committee of Economic Policy, League of Scientific and Industrial Associations Russia
Mr. George Soros The Soros Foundation	Mr. George D. Yurchyshyn Deputy Governor, Central Bank of Ukraine
Mr. Ivan Szegvari EBRD	Mr. V. Yu Zorin Member of the Supreme Soviet Uzbekistan
Mr. Leonid P. Talmach President National Bank of Moldova	Mr. John Williamson Senior Fellow Institute of International Economics
Mr. Pavel Teplukhin Centre for Economic Performance London School of Economics	Mr. Rutger Wissels DG II, Commission of the EC
Mr. Philip Turner BIS	



November 16, 1992

Mr. Alexander Shokhin
Deputy Prime Minister
Government of the Russian Federation
Staraya Ploshad 4
Moscow, Russia

Dear Mr. Shokhin,

As you well know, we in the Fund have been concerned for some time about the lack of coordination of monetary and credit policies in the ruble area, and its consequences for inflation and for trade and payments between ruble area countries. We believe that the present situation must not be allowed to continue, and that each country in the ruble area must decide between either remaining in the area, and agreeing to mechanisms for a common monetary policy, or introducing a separate national currency. I have therefore written the attached letter to the chairmen of the central banks of ruble area states, including Mr. Gerashchenko, urging them to come to an early decision on this.

The letter also emphasizes the need to negotiate credit agreements between governments which have clearly defined terms and conditions, and to keep these credit arrangements separate from the correspondent accounts among central banks. This is a point which I have already made to you in my letter of November 2.

We would hope that the Russian Federation would use its influence to bring about an early resolution of these unsettled questions.

Yours sincerely,

/s/

John Odling-Smee
Director
European II Department

Attachment



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INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

ATTACHMENT IV

CABLE ADDRESS
INTERFUND

November 16, 1992

Mr. Viktor Gerashchenko
Acting Chairman
Central Bank of
the Russian Federation
Ul. Zhitnaya 12
117049 Moscow, Russian Federation

Dear Mr. Gerashchenko:

As you well know, we in the Fund have been concerned for some time about the lack of coordination of monetary and credit policies in the ruble area, and its consequences for inflation and for trade and payments between ruble area countries. Despite several bilateral agreements and the multilateral agreement reached between Heads of State in Bishkek on October 9, the fundamental problem of monetary policy coordination in the ruble area remains unresolved. In the meantime, credit expansion has been unrestrained, inflation has accelerated sharply, and the value of the ruble in foreign exchange markets has fallen. In addition, different non-cash rubles have emerged, and trade and payments between ruble area countries have been damaged.

We believe that the present situation must not be allowed to continue. As we see it, each country in the area must now decide between two clear alternatives: (i) to remain in a single currency area with a common monetary policy; or (ii) to introduce a separate, national currency. There are no other viable alternatives. Previous attempts to reach agreement on rules to coordinate monetary and credit policies among central banks (for example, along the lines proposed by the Fund staff in Tashkent) have not succeeded. Moreover, we firmly believe that a system such as the present one, based on limits on the central banks' correspondent accounts without a common and disciplined credit policy, will not permit the control of inflation and stabilization of the currency. Without these, as we have indicated to you on other occasions, we will not find it possible to agree with a member country on an economic program and hence to make available the Fund's financial resources through an upper credit tranche arrangement.

Under the first option, countries will have to agree on clearly defined mechanisms for the pursuit of a common monetary policy, with only one currency (whether in cash or noncash forms) circulating throughout the area. This will require that credit emission be determined by a single authority (which could be collectively directed) empowered to impose strict limits on credit expansion for the area as a whole and for each central bank individually. It will also require the harmonization of foreign exchange systems, central bank finance rates, commercial bank reserve requirements and other monetary operations throughout the area, and the coordination of fiscal

policies to ensure that budgetary targets are consistent with the approved credit ceilings. Whether the execution of monetary and credit policy is left to an interstate monetary institution or to the Central Bank of Russia is a political matter to be decided by the sovereign states involved. What is essential for the survival of a single currency area is that the responsibility for a common monetary policy be squarely in the hands of a single authority empowered to make decisions about credit emission for the whole area. This monetary authority will be responsible for providing adequate information to all central banks in the area on all important decisions regarding monetary and credit policy. In addition, as long as it continues to produce all new cash rubles, the Russian Federation will need to provide assurances that the other countries' demand for cash rubles will be satisfied and that the profits derived from the issue of ruble currency will be equitably shared.

On the second option, we have indicated on several occasions that the Fund stands ready to provide technical assistance to any member country that wishes to introduce its own currency. Our assistance will aim at ensuring the orderly introduction of the new currency in a way that minimizes disruptions to the country itself and to its neighbors, and at helping to create the institutions and the expertise required to conduct an independent monetary policy.

There is a second crucial issue which I would like to raise now. In addition to resolving the problem of monetary policy, the states of the former Soviet Union (and the Baltic countries) will need to make important decisions regarding balance of payments financing among themselves. So far this year countries such as Russia, whose exports to other countries in the area have exceeded their imports, have extended credits to the countries with trade deficits. But the size, duration and terms of those credits have been uncertain, and borrowing countries have not taken adequate steps to avoid running into credit limits, thereby producing interruptions to trade and payments for all countries involved. It is important that governments agree on the extent to which they are willing to finance payments imbalances by extending credit to one another. These credits should be negotiated among governments and granted for a specified period and with clearly defined terms, for example as regards interest rates and the currency of settlement. Moreover, these credit arrangements should be kept separate from the correspondent accounts among central banks or other normal payments arrangements that might be introduced, for example in the context of the Interstate Bank. In a well functioning ruble area with single monetary and exchange policy and fiscal policy coordination (including interstate credit arrangements), any credit or debit positions emerging in central bank correspondent accounts would be automatically accommodated, without disrupting the payment system. In the case of separate currencies, it would be clear that any potential payments imbalance that could not be financed through interstate credit arrangements would have to be avoided by adjusting fiscal and monetary policy, including through exchange rate adjustments.

I hope that you will agree that progress in these two areas is urgent, and that you will find the preceding observations useful. Fund staff from this department will be ready to discuss them more fully at your convenience. These issues will no doubt be raised at the Experts' Meeting which is taking place in Moscow on November 16-18, where the Fund will be represented. More generally, we stand ready to provide any assistance that you or other central banks in

the area might request to help you resolve as rapidly as possible the important problems that you are confronting in the area of interstate monetary and payments relations.

I am sending similar letters to those central bank governors listed on the attached page, and to the governments concerned; and I am sending a copy of this letter to Mr. Shokhin. I am also informing the Governors of the Banks of Estonia, Lithuania, Latvia and Ukraine and the governments of these countries about the letter.

With best regards.

Yours sincerely,

/s/

John-Odling-Smee
Director
European II Department

Attachment

CENTRAL BANK GOVERNORS

Mr. I.A. Isaakian
President
National Bank of Armenia
Nalbandiama Street 6
Yerevan 375010, Armenia

Mr. Calib A. Agaev
President
National Bank of
Azerbaijan
Kirov Avenue 19
370070 Baku, Azerbaijan

Mr. S.A. Bogdankevich
Chairman
National Bank of Belarus
Lenin Avenue, 20
220008 Minsk, Belarus

Mr ' Nodar Kakulia
President
National Bank of Georgia
Leonidze Street 3/5
Tbilisi 380027, Georgia

Mr. Galyn Bainazarov
Chairman
National Bank of
Kazakhstan
21, Koktem-3
480070 Alma Ata, Kazakhstan

Mr. Kemelbeck Nanaev
Chairman
National Bank of
Kyrghyzstan
Sverdlov Street 101
720876 Bishkek, Kyrghyzstan

Mr. L.P. Talmaci
Chairman
National Bank of Moldova
7, Renasterei Boulevard
Chiisinau, Moldova 277006

Mr. Viktor Gerashchenko
Acting Chairman
Central Bank of
the Russian Federation
Ul. Zhitnaya 12
117049 Moscow, Russian Federation

Mr. Kayum Kavmiddinov
Chairman
National Bank of
Tajikistan
2322 ul. Lenina
734620 Dushanbe, Tajikistan

Mr. N. Saparov
Chairman
State Bank of
Turkmenistan
22 ul. Cogola
Ashkabad 744000, Turkmenistan

Mr. Fauzulla Mulladzhonov
Chairman
State Bank of Uzbekistan
6 Uzbekistanskiy prospekt
700001 Tashkent, Uzbekistan

The New Ruble Area: Policy Issues and the Use of Fund Resources

(Position paper prepared by the IMF Staff; distributed to relevant country delegations attending the 1993 Annual Meetings)

The Fund staff welcomes recent initiatives for expanded economic and financial cooperation among the states of the former Soviet Union (FSU). In this connection, it has noted the framework agreement signed on September 7, 1993 by Armenia, Belarus, Kazakhstan, Russia, Tajikistan and Uzbekistan to create a new ruble area, and the bilateral agreements subsequently signed with Russia by the five other states. The Fund staff recognizes the laudable objectives of monetary union, and it is of course the sovereign right of any state to enter into a common monetary system. It will be important, however, to ensure that the monetary union will be workable and, ultimately, sustainable. Moreover, in the meantime before establishment of the union, it will be important to minimize the uncertainties that preparing for it may create with respect to the conduct of an appropriate macroeconomic policy in the signatory countries. This note briefly explains these concerns, and sets forth the view of the Fund staff on the implications of a possible new ruble area for access to the financial resources of the Fund, both during the interim period before monetary unification and once a monetary union is established.

Policy concerns

The Fund staff has four major concerns regarding the establishment of a new ruble area. First, it is widely acknowledged that the record of cooperation within the former ruble area over the past two years has been unsatisfactory. The recent agreements providing for a new ruble area call for a very substantial degree of harmonization of the economic and financial legislation, institutions, and policies of the signatory countries, which is considered necessary to establish the basis for monetary unification. Experience suggests that the detailed agreements that are required on the basic institutions and policies necessary for monetary union are unlikely to be reached quickly or, more importantly, implemented at an early date.

Second, a key element for the successful functioning of a new ruble area will be the establishment of an adequate institutional basis for close policy coordination, a key element which was lacking under the old ruble area. As we understand it, the new ruble area would be predicated on each of the national banks pursuing a credit policy within limits approved by the Central Bank of Russia. There is a question as to whether it will be possible for each country to accept those limitations on the flexibility of the national authorities in making both monetary and fiscal policy which are envisaged in the agreement.

A third concern relates to the advisability, at a time when inflationary pressures are still so strong in most FSU states, of the authorities of any one country seeking to tie their monetary policy to that of another member of the new ruble area. While the Fund staff is confident that, with appropriate macroeconomic policies, each of the potential members of a new ruble area can achieve price stability, it also believes that a track record of low inflation in each member country should precede the establishment of a monetary union.

Finally, once the monetary union is established, there will still be doubts about its sustainability. It should be clearly recognized that the establishment of a market-based **economic union** of FSU states, aimed as well at intensified integration with the larger world economy, does not require the same degree of integration as a **monetary union** in which effectively one currency is used. Setting aside political considerations, the sustainability of a monetary union among several FSU states is likely to be a major issue, at least in the next few years. This is partly because, as a result of the envisaged movement of interstate energy and other prices to world levels, the net energy importing states face a considerable term of trade shock. Even if monetary union were achieved, its sustainability would be seriously open to question due to the constraints on labor mobility among member states and doubts about Russia's willingness to finance indefinitely the terms of trade loss of the other countries. A monetary union in no way is a prerequisite for achieving the benefits of some form of economic union, and indeed the attempt to maintain monetary union in the face of considerable economic diversity across members could lead to strains that could threaten cooperation in other areas.

In sum, the Fund staff has serious reservations about the ease with which a monetary union among FSU states can be achieved and, if it can be achieved, doubts about its sustainability in the medium term. We have set them out here so that all participants will be fully aware of the difficulties and can take the appropriate steps to overcome them in advance.

The Fund staff is also concerned that the very process of seeking to align each country's legislation, institutions and policies could result in considerable uncertainty that could threaten the attainment of the monetary control necessary for price stabilization, and which also may jeopardize access to needed external financing. Each of the prospective participants in the new ruble area, other than Russia and Belarus, now faces the threat of an inundation of "old" rubles from other FSU states. The Fund staff therefore views it as imperative—so as to ensure policy independence and, in particular, domestic monetary control—for each of these countries to introduce a separate currency during the interim period pending establishment of a monetary union. Even if it is only a de facto separate currency, this would be preferable to imposing restrictions or border controls, which are unlikely to be fully effective in any case. (The staff has noted with interest that the framework agreement of September 7 actually provides for the introduction of separate currencies during the interim period "in case of necessity".) Moreover, each country should move as quickly as possible to currency convertibility—which will require strong macroeconomic policies as well as the establishment of a functioning foreign exchange market—so as to avoid an unnecessary restriction of trade with other FSU states as well as the outside world.

Use of Fund Resources

Insofar as the possible use of Fund resources by any member is concerned, the Fund must be confident that the monetary authorities have sufficient control to ensure that the financial objectives of a Fund-supported program can be met. As noted above, most of the prospective participants in the new ruble area currently do not have a basis for such control. Therefore, agreement with a prospective member of the new ruble area on a program that could be

supported by a standby arrangement or purchases under the STF facility during the period prior to monetary unification would depend, inter alia, on the prior activation—in one form or another—of a separate currency as well as a functioning foreign exchange market. Regardless of the form of Fund support, there would need to be an understanding with the authorities about the extent to which various institutions, policy rules and parameters (such as tax rates and bank reserve requirements) might be modified during this period as part of the alignment called for in the bilateral agreements with Russia. A program agreed with the Fund would have to clearly take account of any such changes. Since the responsibility for monetary policy would at the time of monetary unification shift to the authorities of the monetary union, at this point an existing Fund-supported program would have to be revised or a new program discussed.

In the even of a request for the use of Fund resources in the context of a monetary union the Fund staff would need to evaluate the likely viability of the common monetary system for the duration of the program period. Moreover, the staff would need to agree—most likely in the context of a Fund-supported program for Russia as well—with the authorities of the monetary union on an appropriate set of financial policies for the union as a whole.