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The Structure and Reform of the Exchange and Payments Systems of Some East European Countries 1/

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I. Introduction and Summary

The holder of money in a centrally planned economy is subject to considerable restrictions on its use. These not only limit the holder's right to exchange his holdings for foreign exchange with which to make payments abroad, but also circumscribe his right to use of his holdings for domestic payments. In this paper it is shown that it was necessary to impose such restrictions to make central planning effective. Since the start of the 1960s, there has been a degree of reform of the economic systems of the countries in question and this has entailed a liberalization of the restrictions on the use and exchange of money. The paper details the connection between the reduction of such restrictions and the transfer of the authority for certain decisions from the central authorities to enterprise managers.

The greater part of payments for transactions between the CMEA member countries are made in transferable rubles on account at the International Bank for Economic Cooperation (IBEC). However, the holder of transferable ruble balances is unable to exchange such balances for other currencies and is subject to considerable limitations on the use he may make of them. This paper shows how these stem from the organization of the CMEA market and its interrelation with the domestic markets of the member countries. The paper surveys various proposals made to increase the role of the transferable ruble and describes recent developments in the organization of the CMEA market.

The first section of the paper gives a theoretical account of the effect of prereform central planning of foreign trade and the role of money in such an economy. Some necessary organizational features of such a planned economy

1/ The paper deals with Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Romania, and the U.S.S.R. This group is not quite coextensive with the members of the Council for Mutual Economic Assistance (CMEA) as this organization includes Cuba and Mongolia.

2/ The author is grateful for comments received on earlier drafts from Akbar Noman, Janos Somogyi, Geoffrey Tyler, and Marcin Wyczalkowski. Such errors as remain are, however, entirely the responsibility of the author.

are described in the next section. In the third part, the paper considers in general terms the contribution that economic reform can make and has made toward removing limitations on the use and exchange of money. The next section examines the use of money in the trade between CMEA member countries and the fifth section examines proposals to extend the usefulness of the transferable ruble. The paper concludes that developments over the last decade have substantially extended the command of money over goods both within the countries in question and on the CMEA market. However, a substantial liberalization of the existing restrictions on nonresident use of the countries' currencies and resident's rights to obtain foreign exchange will require a reform of the price formation mechanism.

II. A Theoretical View of Foreign Trade and Money in a Centrally Planned Economy

1. Foreign trade

A centrally planned economy may be regarded as having two levels. At the top, the planners determine priorities and issue instructions, which are executed by the lower level of managers. The planners' task can be divided into two main parts. Firstly, they must elaborate a coordinated series of balances of resources and uses of products. This is functionally equivalent to constructing an ex-ante input-output model of the entire economy. 1/ Secondly, this model must be translated into compulsory tasks for the individual managers. From the planners' perspective, foreign trade provides a means by which inputs into the production process and goods for final consumption may be obtained. In the main, exports have no utility for the planners other than to create the ability to import. This is in contrast with the situation in a market economy where exports are part of aggregate demand and an important element affecting the level of economic activity. 2/

Since supply and demand in the external world are beyond the planners control, there is a degree of uncertainty in planning for the external sector. Unexpected developments in the rest of the world may disrupt the planned balance of the domestic input-output matrix. 3/ The planners therefore seek to reduce the amount of uncertainty or to insure against various contingencies. To reduce external uncertainty the planners have two main methods at their command. They may attempt to create an autarkic closed economy or they may conclude long-term agreements with foreign trade partners. For that uncertainty which either cannot be eliminated or whose elimination in this way is too costly, there remains insurance. This insurance may consist of stockpiling goods which may be exported if necessary, (or building up gold and foreign exchange reserves), or of contingency plans to divert goods from domestic planned use to export. Such insurance itself has a considerable cost. Stockpiling means foregoing the present use of some resource in order to prevent a future disruption of

1/ See J.M. Montias, "Planning with Material Balances in Soviet-Type Economies," American Economic Review, December 1959, pp. 963-985.

2/ See F.D. Holzman, "Foreign Trade Behavior of Planned Economies" in H. Rosovsky, ed., Industrialization in Two Systems, New York, 1966, p. 240.

3/ Unexpected and uncontrollable developments in agriculture may, of course, have a similar effect.

the input-output system. The costs of diverting goods from one planned use to another may be even larger. Firstly, if the good diverted is part of intermediate demand, its removal may in itself disrupt the current production matrix. If it is part of final demand destined for investment, its diversion may disrupt the long-term production plan. Finally, if it is destined for consumption, its diversion may have a social cost.

As a digression, it may be noted that certain of these problems are intensified when the planners are striving for the maximum growth rate possible. In an effort to mobilize all resources available for investment, the cost of stockpiling, in terms of growth foregone, will be perceived to be high. The domestic availability of consumer goods that may be diverted for export will be low and there will be unwillingness to divert investment goods to export. As a result the foreign trade plan becomes much less flexible.

2. Money

Central planning of an economy is done in physical rather than in money terms. 1/ Tasks are assigned to managers in physical terms and so, in the economy as described so far, money plays no role domestically. In practice, however, it has been found convenient to use money for various functions in centrally planned economies. Firstly, direct distribution of consumer goods from producers to the individual consumer is an inefficient means of satisfying consumer demand. Thus, money is issued in the form of wages, pensions, etc., and used by the recipients to purchase consumer goods and services. The volume of goods and services made available, however, is not here determined by the level of effective demand but by an exogenous decision of the planners. 2/

Quite distinct from this wage-consumer goods sphere of monetary circulation is the use of money by the productive sector. In this sector, money is a means of keeping accounts, whose need stems from the lack of detailed information by the planners or their inability to process information from the production units in the necessary detail. If the manager keeps monetary accounts of his enterprise's activities, the planners can perform simple checks on the internal functioning of the enterprise.

Two varieties of money exist in the centrally planned economy now described. Firstly, there is money that consumers use to purchase goods and services. Secondly, there is enterprise accounting money. The spheres of circulation of these monies are kept separate by the institutional arrangements described in the next section and are each isolated from the world market. A given commodity may have a different price in each sphere

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1/ Similarly, input-output matrices are constructed using physical units.

2/ This applies strictly only at a high level of theoretical abstraction. In real centrally planned economies, in particular since the start of the 1960s, enterprise production patterns show some response to effective demand.

and a further price on the world market. Arbitrage to equate price levels in the three areas is not possible. 1/ All foreign exchange is held by the planners who use it to purchase necessary imports which are then allocated domestically to either the production sector or to consumption. The consumer who holds money may convert this money into those commodities released by the planners but not into foreign exchange or into those goods that are only allocated to the production sector. An enterprise manager holds accounting money in the name of his enterprise. However, since all goods in the production sector have already been allocated by the input-output matrix, he has no freedom to spend this money. This money simply moves from account to account in response to the planned movement of goods within the production sphere. 2/ In general, nonresidents may not hold domestic currency.

III. The Foreign Trade Organization and Money System of the Traditional Centrally Planned Economy

The key feature of the prereform centrally planned economy which is described in this section is the sharp separation of the domestic economy from the external economy and of the domestic consumption sphere from the production sphere. This separation applies to the organizations active in each sphere, the prevailing prices, and the kind of money in circulation.

Foreign trade is a state monopoly in the centrally planned economy and the state alone may hold foreign exchange. Domestic enterprises are only permitted to deal with foreign customers and suppliers via special foreign trade enterprises. When a domestic enterprise produces a good as part of export plan, the good is sold to the foreign trade enterprise at the prevailing domestic wholesale price. The foreign trade enterprise sells the good to the foreign purchaser and receives payment in foreign exchange. This exchange is promptly surrendered to the state bank in return for the domestic currency equivalent at the official exchange rate. The loss or gain of the foreign trade enterprise on the deal is routinely covered by a payment from or to a Price Equalization Fund. 3/ For importing the procedure is similar.

This system serves to isolate the domestic market from the foreign market. Since losses and gains from foreign trade are concentrated in the foreign trade enterprises, which are then directly subsidized or taxed, changes in foreign prices can have no direct effects on the domestic price level or on the activities of domestic enterprises. Since deliveries of domestic enterprises to and from foreign trade enterprises are governed by plan targets, rather than by external market conditions, stimuli from the

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1/ Cf. J.V. Mladek, E. Sturc, and M.R. Wyczalkowski, "The Change in the Yugoslav Economic System," Staff Papers, Vol. II No. 3 (November 1952), pp. 410-416.

2/ In historical centrally planned economies, enterprise managers have always had a small volume of funds which they could dispose of at their discretion for albeit restricted purposes.

3/ See F.L. Pryor, The Communist Foreign Trade System, Cambridge, Mass. 1963, pp. 101-105.

world market are not transmitted to the domestic producer. Another purpose of the system is to control import demand. Managers may apply for imports as substitutes for scarce domestic resources. When the planners press the managers for increased production, this will result in considerably increased import demand. The foreign trade monopoly acts in these circumstances to ration imports. A third function of the system is that the Ministry of Foreign Trade, which controls the foreign trade enterprises, can directly determine the direction of trade. This is useful if the bulk of trade is carried on under trade agreements demanding bilateral balance.

Under this system imports are rationed by the plan so changes in the exchange rate or the application of tariffs do not serve to reduce the demand for imports. 1/ The domestic producer produces for export in order to fulfill a plan assignment rather than in response to foreign market conditions. A foreigner holding a claim on such a country is not free to purchase any good available domestically but may purchase only such goods as the foreign trade enterprises offer. There is no way he may bypass these enterprises and buy directly from a domestic producer, as this might disrupt the domestic supply and demand equilibrium.

As the state foreign trade and foreign exchange monopolies serve to separate the domestic and foreign economies, so the system of cashless payments separates the domestic consumption sphere from the production sphere. This system forbids enterprises to use cash in their transactions with each other. Cash money is only used to pay wages, social security benefits, etc., and by the recipients to purchase consumer goods and services from retail outlets. In the production sphere money, with the exception of the wage fund, only exists on enterprises' accounts at the state bank. In general, the enterprise manager has almost no discretion about how this money is used, but it is transferred from account to account as planned purchases and sales are carried out. 2/

Prices in the production sphere are not set at a level to equilibrate supply and demand but tend to be based on average historical costs. In any case, since supply and demand are regulated by plan, a change in relative prices would not assist in moving the market toward equilibrium. The domestic prices of imports and exports bear no necessary relation to foreign prices; through the operation of the Price Equalization Fund they will be the same as the prices of the equivalent domestic product. Prices in the consumer

1/ In such a system there is no place for the traditional instruments of trade control used in western economies. Tariffs are quite meaningless under a price equalization system since they serve neither to discourage imports nor to raise government revenue. Quotas are built into the centralized foreign trade monopoly system. If the state wishes to reduce a certain import it simply reduces it without having to declare a quota officially. Licensing of individual transactions too is likely to be superfluous when all transactions are registered at the Ministry of Foreign Trade and the National Bank and require their permission.

2/ See G. Grossman, "Gold and the Sword: Money in the Soviet Economy" in H. Rosovsky, ed., Industrialization in Two Systems, New York, 1966, pp. 213-7.

sphere are generally set at approximately market clearing levels. At the point where goods leave the production sphere and enter the consumption sphere, they are subject to a differentiated "turnover tax," which, amongst its other functions, serves to separate the price structure in the two domestic spheres.

IV. The Impact of Economic Reforms

After the Second World War, each country in Eastern Europe adopted an economic system very closely modeled on that of the Soviet Union. This system has been described above as the prereform centrally planned economy. While this system of economic organization contributed to remarkable growth rates for a time, certain problems led to a movement for its reform. Reforms have been initiated in all countries of the region since about 1963 1/ and have significantly modified the functioning of the centrally planned economies. In this section the reasons for the reform of the centrally planned economy are given. Within the length constraint of this paper, it is only possible to sketch the kind of reforms introduced and their impact on foreign trade and the use of money in these countries. 2/

The most important single reason for the introduction of economic reforms was a marked fall in the rate of growth of most of the East European countries after 1960. This fall in growth rates was accompanied by increasingly visible inefficiencies in the economies, for example, rapid inventory accumulation. As the economies developed during the 1950s, the economic system became more rigid. Miscalculations in the plan or other unforeseen occurrences could no longer be righted by mobilizing surplus labor reserves, as these had now been largely absorbed. Instead, it became necessary to devise some mechanism whereby managers could themselves respond to unplanned events. With declining rates of growth, concern grew for more efficient growth. With a smaller growth rate of investment volume it became more important that the most efficient 3/ variant of the investment plan be chosen. The two main goals of the subsequent reforms may be summarized as, firstly, the creation of a framework for a certain amount of decentralized decision making, and secondly, an increase in the efficiency of economic activity. These two goals have been closely interconnected in practice.

1. Internal economic organization

To establish a more efficient and more decentralized system of economic organization, it was necessary to devise a new set of decision-making criteria for management. In general, under the old system of central

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1/ The first country to introduce reforms was Poland in the period 1957-58. Most other countries' reforms date from 1962-63, while Romania's first major reforms were in 1967-68.

2/ For a more detailed summary of the histories of the individual reforms, see M. Gamarnikow, "Balance Sheet on Economic Reforms" in U.S. Congress, Joint Economic Committee, Reorientation and Commercial Relations of the Economies of Eastern Europe, Washington, D.C., 1974, pp. 164-213.

3/ By "efficient" is meant having the highest possible factor productivity.

planning, when a manager had the authority to make a decision, he tried to maximize gross output 1/, since this would lead to the greatest bonus. 2/ This led to considerable inefficiency as it was possible to achieve the gross output target by producing unsalable goods, or goods with a very high material or labor content. Since the introduction of economic reforms, the Eastern European countries have experimented with a variety of criteria for management. 3/ In most countries now, instead of gross output, profitability is the main target, defined as the ratio of profits to some other magnitude such as total costs, fixed capital or fixed plus working capital. A high degree of central control is usually maintained by making the manager responsible for achieving certain targets such as marketed gross output or labor productivity. Thus, the manager's typical objective function in Eastern Europe now reads: (1) achieve certain targets, then (2) maximize profitability.

If decision making is to be decentralized, central control must, to varying degrees, change its nature from direct commands to indirect guidance. In Eastern Europe this has meant increasing use of "economic levers" by the center. While more decisions are made at lower levels, the center actively controls the parameters used in making the decisions, by its price, tax and credit policies. At the same time, if the manager is to be able to make decisions, more resources must be available for him to use at his discretion. To achieve this, a more flexible policy of bank credit has been introduced and the system of enterprise funds 4/ expanded.

All these features of decentralized decision making require the increased use of money. Whereas in the traditional centrally planned economy, most money within the enterprise sphere moved in response to the planned allocation of goods, now decentralization of some decisions means that the manager can use some of his enterprise's money on account at the bank to purchase a variety of goods and services. Money, in the enterprise sphere, has become more active and the holder has been freed from some restrictions on its domestic use.

1/ Gross output includes the value of all material and labor inputs, profits, taxes, and depreciation of equipment.

2/ This is a simplification, since a high output one year, although bringing a large bonus, meant higher plan targets the next year and thus more difficulty in achieving a high bonus in following years. In practice, managers tried to achieve a reasonable overfulfillment of the gross output target.

3/ See M. Kaser and J. Zielinski, Planning in East Europe, London, 1970, pp.131-143.

4/ These funds are financed by earmarking part of receipts or profits and each may be used by the manager for certain broadly specified purposes as, for example, research and development, small-scale mechanization, enterprise expansion, raising foreign trade efficiency, encouraging high labor productivity, and so on.

Two further aspects of the economic reforms have served to increase the command of money over goods and services: the use of inter-enterprise contracts and new methods of price formation. The use of contracts is an attempt to make production more responsive to demand and to decentralize the distribution of intermediate goods. The bargaining which takes place before contracts are signed is not identical to that in a market economy, since sellers and buyers do not choose each other freely, nor are they free to argue about prices: however, in most countries, quantity, quality, and delivery dates are subject to negotiation. Since each side is constrained by the need to fulfill an output or sales target, this limited bargaining encourages the production of goods in demand.

In the prereform centrally-planned economy, prices, other than those on the consumer goods market, had no important economic function so price formation could be essentially arbitrary. In the reformed economy, prices play a more active role. Firstly, managers take decisions on the basis of relative prices. Hence, if the decisions are to be efficient, the prices used cannot ignore the scarcity relations in the economy. Secondly, if managers are to generate sufficient funds to be capable of implementing their decisions, and the central authorities wish to end the indiscriminate subsidization of enterprises, prices must be set at such levels as to make the majority of enterprises working under normal conditions show a profit. Price reforms embodying these principles 1/ have been adopted in most countries of Eastern Europe.

2. Foreign trade organization 2/

Because of the small size of the economies of Eastern Europe, with the exception of the Soviet Union, foreign trade is very important for these countries. Despite considerable participation in foreign trade in the prewar period, the development strategy adopted by these countries in the late 1940s and early 1950s was essentially autarkic. However, when this policy was changed around the middle 1950s, participation in foreign trade grew fast. During the next period from the middle 1950s until the economic reforms of the mid-1960s, foreign trade continued to be carried on using the prereform centrally-planned system discussed above. As has been shown, this system rationed imports and mobilized sufficient exports to pay for them by administrative means.

1/ Logically, use of the one principle as a basis for price formation precludes the use of the other. In practice, the second principle has been of more importance than the first. The principle that normally functioning enterprises should be profitable is interpreted to mean that normally functioning enterprises in each branch of economic activity should be profitable. In a closed economy this interpretation is correct, however, in a more open economy, prices would ideally show which branches a country could profitably specialize in. The use of world market prices in domestic price formation is discussed below.

2/ For a full discussion of recent changes in the organization of foreign trade see UNECE, Economic Bulletin for Europe, Vol.24, No.1, pp.36-49.

While this system permitted foreign trade to operate, it became clear that it was highly inefficient. The two main sources of this inefficiency were an inability to adapt exports to foreign market conditions and the difficulty of discovering the correct trade specialization for the country. The inflexibility of the export system was a consequence of the system of separating specialized exporting foreign trade enterprises from the production units in the economy. The domestic producer sells production at domestic prices to the foreign trade enterprise for export. The producer is thus isolated from price changes and from quality and performance demands on foreign markets. There is also little stimulus to improve quality, since the responsibility for actually selling the goods abroad belongs, not to the producer, but to the foreign trade enterprise.

In addition to the problem of adapting to foreign market conditions is the problem of determining the most efficient structure of production and foreign trade. In the prereform centrally-planned economy, the decision to export is determined centrally on the basis of the availability of goods for export. The arbitrary nature of the domestic price system, its lack of relation to the structure of world market prices, and the absence of an economically-founded exchange rate make comparisons between domestic and foreign costs difficult. Until the late 1950s, no attempt was made to establish the profitability of export. Since then a number of indexes of foreign currency return per unit domestic expenditure have been calculated. 1/ In some countries a minimum acceptable level of foreign currency earned per unit domestic expenditure has been fixed. In its effects, such a minimal level acts as an accounting exchange rate.

A considerable part of the national product of most East European countries enters foreign trade. As the potential gains from more efficient foreign trade were therefore so large, the foreign trade sphere was among the earliest to be reformed. In order to encourage domestic producers to be more responsive to foreign markets, most East European countries 2/ allow major producers to export directly. (Imports, however, apart from a relatively small volume financed by foreign exchange retention quotas, remain strictly controlled by the central authorities). 3/ If a producer is to be encouraged to export when the foreign price for his product is high and discouraged when it is low, the return on foreign sales must be reflected on the enterprise's balance sheet. 4/ Also, if a rational structure of exports is to emerge, the producer should be able to compare the returns from domestic and foreign sales. These require some form of realistic exchange rate to relate domestic and foreign prices. Such a rate or system of rates has been established to varying degrees in most countries in the area.

1/ A. Boltho, Foreign Trade Criteria in Socialist Economies, Cambridge, 1971.

2/ The Soviet Union is a significant exception.

3/ For a discussion see UNCTAD, The Decision-Making Process in Respect of Imports in Selected Socialist Countries of Eastern Europe, New York, 1972: TD/B/341/Rev.1.

4/ Since, in the reformed economy, this will affect profitability and therefore bonuses.

This new exchange rate (usually called a foreign trade coefficient or multiplier) has not fully replaced the older price equalization system of subsidies and taxes on foreign trade. Complete replacement is not possible until the autonomous basis of the domestic price system is abandoned and domestic prices are allowed to reflect the world market price structure. While the domestic price system differs markedly from the foreign price system, enterprises responding to price stimuli might deprive the home market of needed goods or export goods at prices less than the value of their import content. For these reasons attempts have been made in Eastern Europe to reform the system of prices for enterprises so as to reflect foreign prices more closely. This has not proved easy for two reasons. Firstly, as shown above, there are competing requirements for the price system. In most countries it is desired that the price system, besides reflecting foreign prices, should allow most enterprises already existing to show a reasonable profit and should equate supply and demand conditions on the domestic market. Secondly, planning needs a stable environment and the linking of domestic to world market prices is felt to introduce instability and uncertainty.

The economic reforms introduced to date have resulted in some liberalization of the restrictions governing the use of money by enterprises. In the consumer sphere there has been very little liberalization. Nonresidents are only permitted to purchase and hold cash when inside the country in question and this may only be used for the purchase of consumer goods and services. Domestic residents remain subject to restrictions on the exchange of their holdings of cash for foreign currencies. A certain decentralization of decision-making and the freeing of a certain volume of goods from central allocation has allowed the enterprise manager to make wider use of his holdings of enterprise money for purchases domestically. Such purchases are still not permitted to nonresidents. Unless the domestic price system and the exchange rate were brought into closer harmony with foreign prices, such a liberalization could result in a massive arbitrage by foreigners, which could disrupt the planned economy. The same reasoning explains the persistence of strict import and exchange control, for if enterprise managers were given the freedom to convert domestic enterprise money into foreign exchange at a unitary exchange rate before the domestic price system were reformed, their response to the price differentials between domestic and foreign markets could upset the balance of the domestic economy. Although the need to bring prices into a closer relation with foreign prices has been recognized in most countries in the area, the price reforms adopted have not yet resulted in eliminating the incentive for arbitrage.

V. Trade and Payments Within the CMEA

About two-thirds of the foreign trade turnover of the CMEA member countries is with other CMEA members. The organizational features and payments arrangements governing this trade are strongly influenced by the planned character of these economies. Since foreign trade within the CMEA occupies such an important place in the economic activity of most CMEA members, the potential gains from efficient organization of this trade can contribute significantly to the welfare of the participating countries. Concern with improving the organization of CMEA trade and payments has paralleled efforts to reform the organization of the domestic economies.

The present CMEA trade and payments system has evolved from the system of bilateral barter deals of the early 1950s. Most trade takes place in the framework of annual and five-year trade agreements which specify the volume and value of goods to be exchanged. Such agreements facilitate and are facilitated by detailed planning within member countries. Prices governing this trade often differ markedly from those prevailing on western markets and settlements are made in transferable rubles, the accounting unit of the International Bank for Economic Cooperation (IBEC). 1/ For some goods delivered in quantities beyond those specified in the annual trade protocols, and in particular for extra deliveries of raw materials, settlement is in convertible currency.

Prices used in the trade between socialist countries are normally set according to the "Bucharest pricing principle." Such prices are based on "world prices after having neutralized the harmful influence exerted by the interplay of speculative forces on the capitalist market." 2/ The neutralization of "speculative" influence is done by taking average world prices prevailing over some previous period. In practice the prices so derived are not actually used in CMEA trade, but form the starting point for price negotiations during the bilateral meetings to determine the annual and five-year trade protocols. As a result the same good may have different prices in trade between different pairs of partners.

While world prices reflect overall supply and demand conditions outside the socialist countries, the prices used on the socialist international market do not in general reflect scarcities on that market. Most raw materials, some semifabricates and some investment goods of high technological specifications tend to be in short supply on this market. The prices for such goods, when arrived at by the method outlined above, are not high enough to reduce demand. Such goods are generally referred to as "hard" goods. 3/ Similarly, most consumer goods and much machinery and equipment tend to be over-produced and prices are relatively high. These are known as "soft" goods. "Hard" goods are normally easily salable on western markets for convertible currencies, while "soft" goods tend to be marketable solely within the CMEA. 4/

1/ See H. Francuz, "The International Bank for Economic Cooperation," Staff Papers, Vol.XVI, No. 3 (November 1969), pp.489-501; and M. Allen, "The Evolution of the International Bank for Economic Cooperation, 1964-1973," DM/75/12, 2/6/75.

2/ See Council for Mutual Economic Assistance, The Comprehensive Program for the Future Extension and Improvement of Cooperation and the Development of Socialist Economic Integration of the CMEA Member Countries, Section 6, para. 28. Translated in UN,A/C.2/272 (September 17, 1971).

3/ U.S. Congress, Joint Economic Committee, A Foreign Economic Policy for the 1970s: Part 6, East-West Relations, Washington, D.C. 1971, p.1234.

4/ A similar distinction between hard and soft goods existed in trade within Western Europe immediately after the Second World War when most payments were made through bilateral clearing accounts. Hard goods were those which could be easily sold for dollars or which could only be purchased with dollars. See Kyung Mo Huh and Gerard Belanger, "Export Restrictions and International Rules Governing Their Use" (DM forthcoming).

The bilateral payments agreements between each pair of CMEA members were replaced in 1964 by a multilateral clearing scheme at IBEC. The accounting unit, the transferable ruble, can only be held by the Foreign Trade Banks of member countries and by the International Investment Bank on accounts at IBEC. It is not convertible into any western currency (or gold) nor into any domestic CMEA currency. It cannot be used to purchase goods on the domestic market of any CMEA country, but in theory it can be used to purchase goods on the export list of any CMEA country. In practice, owing to the peculiar nature of CMEA price formation and to the exigencies of planning, it only performs this latter function to a limited extent.

As mentioned above, the same product may have different transferable ruble prices within different bilateral transactions. Also, scarce "hard" goods purchased with transferable rubles are considered more valuable than relatively abundant "soft" goods. The countries concerned and the commodities involved play a decisive role in determining the value of a given claim or debt.1/ Thus, the full value of a claim tends to be available only within the bilateral framework. If the claim is transferred to a third country under the multilateral clearing system, the claimant usually loses part of the value of his claim as the third country need only offer the "softest" and least valuable goods against the claim.2/ This leads the countries concerned to minimize the use of money in their mutual transactions and to insist on bilateral balance, not only in overall terms, but by commodity group. In these circumstances, the country holding a transferable ruble generally can only use it within the bilateral relation in which it was earned unless it is prepared to discount its value.

VI. Proposals for Extending the Use of the Transferable Ruble

The system of payments in transferable rubles has been described in outline above. At present restrictions prevent the holding of transferable rubles outside the circuit of CMEA member countries. The currency is not exchangeable for the currencies of members 3/ or of nonmembers. In practice the holder of transferable rubles can only realize their full value within a bilateral framework, and even within this framework they may only be used to purchase similar goods to those from whose sale they were acquired. The problems associated with such a settlement system have given rise to a number of proposals for its improvement, which are outlined below. Finally, certain developments in the system which have taken place in 1975 are described.

1/ A. Laszlo, "Monetary Policy: A Help to Fostering International Cooperation," in W. Schmitz, ed., Convertibility, Multilateralism and Freedom: Essays in Honour of Reinhard Kamitz, Vienna, 1972, p. 129.

2/ See N. Tsarevski, "Problemi na konvertiruemostta na valutite pri sotsializma", Trudove na VII "K.Marx", Sofia, Vol. III, 1973, Sofia, 1974, p. 503.

3/ Except to a limited degreee for noncommercial expenditures.

1. The Polish Proposal of 1965 1/

Under certain conditions, surplus balances earned in transferable rubles should be exchangeable for convertible currency, which would be made available by debtors. The share of the surplus balance liable for conversion should start at the low level of say 10 per cent and be gradually increased until all balances become fully convertible. This proposal can be described as a gradual liberalization of the restrictions on the exchange of transferable rubles.

The rationale of the Polish proposal was that it would stimulate exports and make importers more discriminating. By increasing the desirability of holding transferable rubles by ensuring their ultimate usefulness for the purchase of goods, countries would become willing to run up balance of payments surpluses. On the other hand, an importer, knowing that an import was liable for payment in convertible currency would demand higher standards or reduce his demand. Since intra-CMEA trade is characterized by excess demand for "hard" goods, the Polish scheme would help to create equilibrium on the market 2/ by encouraging exporters to supply goods against money.

The main objection to the proposal was that since the Comecon price structure caused goods to be divided into "hard" and "soft", it would only make bilateralism more rigid. If applied to the whole of the area's trade, the fact that excess imports of "soft" goods might have to be paid for in hard currency, would lead countries to insist on balance in the value of "soft" goods traded. If the proposal was limited to the trade in "hard" goods the result would be the same as under the unreformed system since, even without such a reform, deliveries of "hard" goods above bilaterally-balanced quotas are paid for in convertible currency. 3/ A further objection was that it would need unavailable reserves of currency. 4/ As a result the proposal was rejected by the CMEA.

2. The Polish Proposal of 1968 5/

Whereas the Polish Proposal of 1965 aimed directly at increasing the freedom to exchange the transferable ruble, that of 1968 centered on currency's command over goods. Under the proposal intra-CMEA trade should be divided into liberalized and nonliberalized. The former would consist of multilateral trade in certain specified groups of goods and the latter would be that trade remaining subject to bilateral quotas. Payment for goods in the liberalized category would be in a new socialist currency backed by commodity reserves. Thus claims denominated in this currency would be convertible into "hard" goods and so, from the start, the usefulness of the new currency would be assured. Since the commodity reserves would consist of goods also in demand on western markets, the exchangeability of the new

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1/ J. Wysocinski, Trybuna Ludu (April 27, 1965).
2/ A. Zwass, "Convertibility in the Comecon Region? Proposals and Reverses" Soviet and East European Foreign Trade, Vol. 8, No. 2, (summer 1972), p. 112.
3/ S. Ausch, Theory and Practice of CMEA Cooperation, Budapest, 1972 p. 266.
4/ G. Mazanov, International Affairs (Moscow), No. 4/1969, p.76.
5/ M. Misiak, Polish Perspectives, February 1969.

currency into convertible currencies would be easy to attain. Nonliberalized trade would remain much as at present, with settlement at IBEC in transferable rubles, but its sphere of operation would be steadily reduced. As this happened the transferable ruble would be gradually replaced by the new convertible socialist currency.

3. The Hungarian Proposal of 1969 1/

Hungary has proposed a third scheme, which is fairly similar to the more recent Polish proposal. Here, too, trade would be divided into liberalized and nonliberalized, but payments for both would remain in transferable rubles. Within trade agreements there should be an increasing volume of trade organized on a quota-free basis or in value, rather than physical, quotas. This would gradually make "soft" goods "harder" and increase the monetary functions of the transferable ruble. Finally, the transferable ruble should be linked to other currency systems by means of partial convertibility of the transferable ruble into convertible currency.

This proposal aims firstly at increasing the volume of goods within CMEA trade freely available for transferable rubles. When this has been done to a large extent, it calls for the gradual elimination of restrictions on the exchange of transferable rubles for convertible currency. Both these two proposals (Poland 1968 and Hungary 1969) were influential in the discussions leading to the drafting of the Comprehensive Program of Economic Integration.

4. The Comprehensive Program, 1971

The CMEA member countries adopted the Comprehensive Program in 1971 after two years preparatory work. It contains sections on the improvement of mutual trade and on currency and financial problems and provides a timetable for improvements to be introduced. Very little information on progress in implementing the Program in these areas has been released and it is probable that the initial timetable has been substantially modified. However, it remains the most authoritative proposal for extending the role of money in mutual relations of the countries of Eastern Europe.

If the holder of transferable rubles is to be able to use his balances to purchase the goods he wants where he wants, trade negotiations must cease to be exercises in bilateral barter. The Comprehensive Program envisages two simultaneous approaches to achieve multilateral trade. Firstly, increased multilateral plan coordination both at the national and at the sectoral levels should create multilateral trading patterns. The other solution reflects the recent proposals by Poland and Hungary described above. Within trade agreements, exchange of goods by value quotas rather than physical quotas should be extended. Even more important is that a new category of liberalized

1/ B. Csikos-Nagy, Gospodarka Planowa, August 1969.

nonquota trade is officially sanctioned. 1/ This trade was scheduled to be introduced between interested countries in 1971 on an experimental basis. Prices in both traditional quota and this nonquota trade are to be formed in the same way as hitherto, in other words, systematically deviating from world market prices. Press reports indicate that some experimental nonquota transactions have taken place. 2/

The Comprehensive Program views the question of exchange of the transferable ruble with other currencies as having two parts. On the one hand, there is exchange between the transferable ruble and western currencies and on the other, the exchangeability of the members' domestic currencies with each other and with the transferable ruble. To achieve such exchangeability, the Program divides the problem into two, the question of a justified exchange rate and the mechanism of exchange.

A timetable is provided for working out such exchange rates between the transferable ruble and national currencies of member countries and among the national currencies themselves. The first step to be taken in 1971 was to establish a method for calculating these rates and for deciding when the rates should be changed. Then, between 1972 and 1974 such rates were to be fixed by multilateral agreement. Whether the rates so determined would be used to influence transactions was to be left to the decision of each individual government. Between 1976 and 1979 the countries were to study how to introduce a unified exchange rate for each currency, and finally the decision on whether such a rate be adopted was to be taken in 1980. Since 1971 much research has been done within the CMEA on exchange rates and investment purchasing power parity rates have been determined; however, it appears that the timetable described has been modified.

In detailing the mechanism for introducing exchangeability, the Program distinguishes intra-CMEA exchange from exchange of the transferable ruble with western currencies. In the period 1971 to 1972, CMEA members were to study the measures necessary to realize intra-CMEA exchange and in 1973 to work out the procedure for its introduction. In doing this, they were to consider "questions relating to the correlation between domestic wholesale prices and foreign trade prices." Extensive contact between the pricing authorities of the countries has taken place but no measures to coordinate price systems have been announced. On the question of the exchange of the transferable ruble with convertible currencies, the Comprehensive Program has less to say. It talks of the transferable ruble eventually being used for payments with third countries and the necessity of fixing a realistic exchange rate, but does not call for full convertibility to be introduced.

1/ "The distinction among commodities with physical and money quotas and without quotas corresponds, in fact, to the old domestic practice of centrally-planned economies to distinguish among 'centrally-funded' (i.e. administered by central planning organ), 'resort-funded' (i.e. administered by relevant economic ministry), and 'non-funded' products." F. Pindak, "COMECON's Programme of "Socialist Economic Integration"", Jahrbuch der Wirtschaft Osteuropas, Band 25, Vienna, 1974, pp.446-7.

2/ I. Vincze, Penzugyi Szemle, June 1974, p. 459. I am indebted to Janos Somogyi for this reference.

5. Developments since the Comprehensive Program

The sharp increases in the trade prices of the market economy countries since 1973, and in particular the increase in the world price of petroleum, have had an impact on the pricing system used in intra-CMEA trade. Until 1974, prices in this trade were based on the "Bucharest Principle" described above:1/ average world market prices of one five-year period were applied throughout the succeeding five-year period. The difficulties inherent in such a system of pricing were exacerbated by the sharp increase in prices outside the CMEA and, more particularly, by the abrupt movements in relative prices. CMEA exporters of goods whose relative prices had risen found an incentive to divert exports away from the CMEA market where earlier prices prevailed. Importers of such goods tried to switch their purchases from outside to within the CMEA. The opposite phenomenon occurred for goods whose relative world market prices had fallen.

The CMEA market was consequently strained by world price movements and from the start of 1975 the Bucharest pricing system was modified. Instead of remaining constant for five years, it was decided that new prices should be set annually. The basis for such prices was also changed from a five-year average to a two- to three-year average. A consequence of these changes is likely to be that relative transferable ruble prices will be much closer to relative world market prices. It is also possible that there will be greater uniformity in the contract prices for a given good in the trade between different pairs of CMEA partners. If this happens, CMEA countries will presumably become increasingly willing to hold transferable rubles since their partner countries should become increasingly willing to accept such rubles, as the distinction between "hard" goods and "soft" goods disappears.

The second important development on the CMEA market has been a deepening of the process of plan coordination between the member countries. In previous plan periods such coordination has largely consisted of a dove-tailing of the foreign trade plans of the countries. In preparing their plans for the next five-year period (1976-1980), there has been an increased amount of coordinated planning by industrial sectors. Trade in products of these sectors is increasingly the result of planned specialization patterns and cooperation agreements and is correspondingly less motivated by the emergence of surpluses and gaps in the individual countries' production patterns. The next published Five Year Plan of each CMEA member will include a section on measures to further CMEA integration. The inclusion of such measures among the published Plan targets is intended to raise their status within the hierarchy of Plan targets and reduce the residual character of intra-CMEA trade. The increased emphasis on sectoral plan coordination should strengthen the multilateral element of CMEA trade. This will in its turn extend the use of money in payments for such trade, since net sectoral exports will be increasingly settled in money rather than in other goods.

1/ p.11.

A final development in the use of money between CMEA countries has been certain new regulations for settlements through IBEC. 1/ Hitherto, whenever a country's daily payments through IBEC were greater than its receipts, IBEC automatically issued a credit to that country in transferable rubles, with which it could make payments. Under new regulations promulgated at the start of 1975, such credits will only be issued insofar as the deficit they cover was envisaged in the country's annual bilateral trade protocols. Payments beyond this planned imbalance will have to be made in convertible currency. This measure should serve to hinder the involuntary accumulation of transferable ruble balances.

VII. Concluding Remarks

In a market economy, money actively controls the movement of goods. In a centrally-planned economy, money can only exercise such control to the extent control is not pre-empted by instructions of the planners. Insofar as goods move in direct response to plan commands, money will passively follow such movements. Restrictions on the use of money in the centrally-planned economy serve to delineate the respective areas of control of the plan and the market.

In recent years, decision making has been considerably decentralized in the economies of Eastern Europe and the planning authorities have resorted more to "economic levers" and less to administrative instructions in exercising their control over the economy. Corresponding to these developments, money has assumed a more active role and its command over goods has been substantially extended. Central control over foreign trade has been liberalized to some extent and this development has been accompanied by an increase in the ability of residents to obtain foreign exchange for the national currency. Before restrictions on such exchange by residents, and indirectly by nonresidents, can be fully eliminated, however, domestic prices must be more closely linked to foreign prices. Price reforms reducing the disparity between domestic and foreign relative prices have been introduced or are being introduced in most countries of the area. In only a few, though, has the price formation mechanism been reformed to a sufficient extent to allow a permanent economic link between relative domestic and relative world prices to emerge.

The functions of the CMEA collective currency (the transferable ruble) in many ways parallel those of the domestic currencies. To the extent that trade between the CMEA countries is the result of agreed physical exchanges, the flows of payments between countries merely accommodate these transactions. The holding of money balances does not guarantee that desired goods can be obtained. In recent years, the development of more flexible market instruments and the closer linking of CMEA prices to world prices have served to increase the command of the transferable ruble over goods.

1/ see M. Kaser, "Soviet Trade Turns to Europe", Foreign Policy, (summer 1975,) pp.129-130.

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