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September 23, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Financial Relations Among Countries of the Former Soviet Union

Attached for consideration by the Executive Directors is a paper on financial relations among countries of the former Soviet Union. This paper, together with a companion paper on trade policy reform in the states of the former Soviet Union (SM/93/215, 9/24/93), will be discussed in a seminar on a date to be announced. Issues for discussion appear on page 23.

Mr. Wolf (ext. 37413), Mr. Citrin (ext. 38982), or Ms. Cheasty (ext. 38706) is available to answer technical or factual questions relating to this paper.

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Financial Relations Among Countries of the Former Soviet Union

Prepared by the European II Department
in collaboration with the Monetary and Exchange Affairs
and Policy Development and Review Departments

Approved by John Odling-Smee

September 22, 1993

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I. Introduction and Summary

Since the last paper on this subject prepared for the Executive Board (EBS/92/205, 12/8/92), the financial relations and payments and monetary arrangements among the states of the former Soviet Union (FSU) have continued to evolve. Three closely intertwined, but conceptually separate issues persist. The first is the need to improve further the interstate payments system so as to remove an important impediment to trade. The second issue is the continued uncertainty affecting currency arrangements in many FSU countries and the associated negative impact on domestic monetary control. The third is the very large deficits which most FSU states face in their interstate balance of payments--particularly with Russia--as a result of the reduction in interstate transfers and the terms of trade shock resulting from the movement of interstate trade prices to world levels by end-1994. The deficit countries must undertake a major adjustment effort, which could be spread out over time through the provision of an adequate level of balance of payments support. This paper covers all three issues, but places most emphasis on the third because it is currently the major economic source of tension between these countries, and because EBS/92/205 focused on payments and monetary arrangements.

The resolution of these problems is often complicated by the fact that the three issues of payments, monetary arrangements and financing are so closely inter-related and are frequently confused in the policy debate. For example, the attempt to gain control over effective financing of payments imbalances with other FSU states led the Russian authorities, in mid-1992, to impose limits on central bank correspondent account balances. This in turn led to the emergence of de facto separate non-cash rubles in different states, a development which served as a further stimulus for the introduction of separate currencies.

Various FSU states have introduced changes in their domestic payments mechanisms, and progress has been made toward establishing an Interstate Bank for facilitating multilateral settlements as well as in expanding the scope of decentralized payments arrangements. The main developments in the payments area are summarized in Section II.1 and discussed in greater detail in the Supplement. It should be noted, however, that the financing problem for the FSU states is frequently misconstrued as a payments problem, as the result of the difficulties that emerged in interstate settlements; indeed, arguments are frequently put forth for a payments union for this region with many of the features of the postwar European Payments Union. While payments problems among the countries of the FSU have indeed been serious, and although they have complicated financing arrangements, they are not the source of the severe payments imbalances that have arisen particularly between Russia and most other FSU states.

The continuing disarray in monetary arrangements among many FSU countries has also complicated the financing issue. Many FSU states have temporized on whether to remain in the ruble area or to introduce their own

national currencies. One reason for their hesitation to leave the ruble area has been the expectation that by remaining in a common currency area--regardless of the disarray--they could obtain greater financing from Russia. Some countries also were reluctant to leave the ruble area because they believed that continued use of the ruble would enable them to receive larger subsidies on energy imports from Russia. In many cases, however, this expectation has not been fully realized. Meanwhile, remaining in the ruble area has generally postponed adjustment and made it more difficult to achieve the type of macroeconomic stabilization that has been attained in the Baltic states. Since the Russian currency reform, however, several states have joined together with Russia in an initiative designed to revive the ruble area as a viable monetary union. It would of course be premature to assess how quickly this can be achieved and its likely success, but clearly a considerable effort will be needed before the required instruments for close and sustainable monetary coordination can be put into place. In the interim, those countries intending to join in a revived ruble area must be prepared to take all necessary measures to ensure macroeconomic stabilization and adjustment to the terms of trade shock they are facing. The main developments regarding monetary arrangements are summarized in Section II.2 and a more detailed update, including the aftermath of the currency reform and attempts to revive the ruble area, is contained in the Supplement.

Historically, Russia has provided a net resource flow to many other states of the FSU. Most recently, these flows have been financed mainly by credits from the CBR and a net implicit trade subsidy arising largely from the relative underpricing of Russian energy exports to other FSU states. The Russian authorities intend to raise energy export prices to other FSU states to world levels in 1994, and the amount of explicit financing provided by Russia to these countries is expected to decline sharply from its 1992 level. While the other FSU states will have to adjust to these permanent shocks, it is in the interest of all parties that this adjustment be as orderly as possible. Recent financing developments, an illustrative scenario for 1993-94 and the main issues in this area are discussed in Section III.

That section suggests the broad magnitude of the adjustment which most FSU states will have to undertake in coming years; in the aggregate, the decline in official transfers from Russia and the deterioration in terms of trade will amount to more than US\$15 billion between 1992 and 1994, or about 15 percent of the combined 1994 GDP of the 14 FSU states other than Russia. The experience thus far of the Baltic states suggests that rapid adjustment can significantly bring forward the point in time at which efficient and sustainable economic growth can begin. The task, therefore, is to expedite adjustment but also to ensure that it is orderly.

Orderly and efficient adjustment would be facilitated by: (i) strong macroeconomic policies that provide a stable environment for structural change and encourage official external assistance and private foreign investment; (ii) accelerated structural reforms; (iii) a more active

financing role by Russia, but one which is consistent with its own attainment of macroeconomic stability; and (iv) a more concerted effort of external assistance by the governments of non-FSU countries. External financing, whether from Russia or elsewhere, will help spread out this adjustment over time, but it should also be recognized that the greater the financing, the larger will be the future debt burden on these countries.

While a reconstituted ruble area should not be discouraged if it is based on workable and sustainable policies for monetary coordination, such a monetary union is unlikely, in and of itself, to solve the financing problems of individual FSU states. A payments union, involving significant external financing, is also unlikely to resolve the financing problem and indeed carries with it significant risks. Indeed, a payments system must be put in place which is insulated from financing issues, and any efforts to improve the payments and settlements system (including through the formation of the Interstate Bank) should be clearly separated from attempts to mobilize external financial assistance to facilitate a more orderly adjustment in the FSU states.

Section IV discusses the role that the Fund might usefully play through its policy advice and technical assistance in helping to promote improvements in interstate financial relations, monetary arrangements and payments mechanisms. Part V suggests issues for discussion.

II. Summary of Evolving Institutional Arrangements

1. Payments mechanisms and foreign exchange markets

The payments mechanism inherited by the FSU states from the system of central planning was ill-suited to handle payments between increasingly market-oriented enterprises. Moreover, within a few months after the break-up of the U.S.S.R., Russia began using the payments system as an instrument for monitoring the size of its interstate balance of payments imbalances, and payments problems developed between other FSU states as well. The result was slow and uncertain cross-border payments which reinforced the adverse effects of other factors on interstate trade.

Attempts to reform the payments mechanism have taken place on several levels, including the settlements of central banks and the cross-border payments of commercial banks. Pending the decentralization of payments, the move to full convertibility by the FSU states with national currencies, and the reconstitution of the ruble area for remaining states, the proposed Interstate Bank--as a multilateral clearing and settlements mechanism--can usefully serve to facilitate payments among FSU states.

a. The central bank payments mechanism

In January 1992, the CBR established a system of correspondent accounts for each of the central banks of the FSU states. These accounts replaced

the inter-branch payments mechanism of the U.S.S.R., and permitted the CBR to begin to monitor Russia's interstate payments imbalances on a regular basis. These imbalances grew rapidly during the first half of 1992, however, and in July 1992 the CBR centralized all cross-border payments involving Russian enterprises which were made through the central banks in order to control the amount of credit it extended to other states. Imbalances were either financed through so-called "technical credits" from the CBR or overdrafts on its correspondent accounts, or were limited by the suspension of payments. The limits placed on financing, the uncertainty surrounding the interstate payments mechanism and the cumbersome centralization of payments documents, hampered interstate payments and trade. In addition, the new limits on interstate financing through the payments system led to non-uniform discounts on the non-cash (deposit) rubles of various FSU states, depending on the extent of their excess demand for rubles. While bilateral imbalances between states other than Russia tended to be dwarfed by Russia's surpluses, the absence of a multilateral payments system exacerbated the balance of payments difficulties of many FSU states in 1992 by making it difficult to liquidate bilateral imbalances.

In early 1993, the Russian authorities announced that official financing of interstate imbalances would be shifted from the payments system to intergovernmental credits, and by May 1993, the CBR had virtually ceased processing payments through its correspondent accounts. As a result, a rising share of interstate payments appears to have been made using currency and through commercial banks. Barter and cross-border interenterprise arrears also appear to have increased substantially. Following the Russian currency measures of late July, the CBR reopened its correspondent accounts with the other FSU central banks and announced that all future transactions would be recorded using the exchange rates for non-cash national rubles which it had been formally quoting since mid-July.

b. The Interstate Bank

On January 22, 1993, ten FSU states agreed to establish an Interstate Bank (ISB) designed to facilitate the processing of interstate payments and, through multilateral clearing, to permit participating states to economize on scarce financial resources. As of mid-August, four countries (Belarus, Kazakhstan, Russia, and Turkmenistan) had ratified the agreement and charter of the ISB, and most other states were expected to ratify by mid-September, thereby permitting the ISB to become operational in October 1993 or thereafter. Financing provided by the ISB to member countries would be strictly limited--to one month's payment receipts--and on the principle that the use of the ISB would be voluntary. These provisions were agreed so as to demarcate as clearly as possible the payments mechanism from the provision of interstate credit on the basis of intergovernmental agreements, and to ensure the ISB would not delay the development of decentralized payments and the achievement of currency convertibility. As these developments take place, the role of the ISB would be expected to diminish accordingly.

c. Decentralized payments and foreign exchange markets

In most FSU states, the period 1992-93 has witnessed the development of foreign exchange markets as well as a progressive relaxation of restrictions on the establishment of cross-border correspondent accounts between commercial banks. Both developments have encouraged the decentralization of payments, and provisional data for recent months suggest possibly an increase in the share of interstate payments being carried out on a decentralized basis. At the same time, however, cross-border enterprise arrears continue to hamper interstate trade (see Section III.1 and the Supplement).

The foreign exchange market for convertible currencies in Russia gradually deepened in 1992-93, as additional commercial banks received licenses to deal in foreign exchange and the relaxation on cross-border correspondent accounts between commercial banks gave banks in other FSU states greater access to the Moscow market and new markets in other major Russian cities. Exchange markets have also developed in various FSU states for the new national currencies introduced in the region and for different states' non-cash rubles; in most cases, however, these markets remain relatively undeveloped. Exchange arrangements in many states remain quite complex and multiple currency practices are widespread in those countries in which the ruble is still widely used. While the exchange systems in most FSU states have been significantly liberalized, a number of exchange restrictions continue in effect. All FSU states continue to avail themselves of the transitional arrangements of Article XIV. 1/

2. Monetary arrangements

At the time of the Russian currency reform in late July 1993, five FSU states had already introduced separate national currencies (the three Baltic states, the Kyrgyz Republic and the Ukraine). Ten FSU states, including Russia, nominally remained in the ruble area in the sense that the ruble continued to be used as legal tender, but several of these countries (Azerbaijan, Belarus, Georgia, and Moldova), had introduced coupons which circulated in parallel to the ruble. (Details of FSU currency regimes are provided in the Appendix.)

a. National currencies in FSU states

In the course of 1992, all three Baltic states effectively introduced their own national currencies. Each of these countries has since pursued relatively tight monetary policies, and inflation has declined while their new currencies have remained stable or even appreciated against the U.S. dollar. In November 1992, the coupons circulating as a parallel currency in Ukraine were designated as a transitional national currency. Macroeconomic policy in Ukraine has been highly expansionary relative to that of other FSU

1/ See the Supplement (including Tables 4 and 5) for details.

states, with the result that the new currency, the karbovanets, has depreciated sharply over the past year against the ruble as well as the U.S. dollar. The introduction of the som in the Kyrgyz Republic--in May, 1993--has been accompanied by some tightening of financial policies, with the result that the som has appreciated against the ruble while depreciating against the U.S. dollar.

b. The ruble area before the July 1993 demonetization measures

Despite divergent credit policies, continued loose monetary policy in Russia, and emerging payments restrictions within the ruble area, many FSU states had still not decided at the time of the recent Russian currency reform as to when or even whether to leave the ruble area. There were several reasons for this, including a recognition that a domestic consensus was lacking for strong macroeconomic stabilization policies, technical problems associated with introducing a new currency, and the view in some countries that continued access to financing and subsidized energy imports from Russia might depend on their staying within the ruble area.

While most of these states had been affected by the so-called cash shortage of the first half of 1992, this problem was eliminated in the third quarter of 1992 by the printing of larger denomination notes by the CBR. The CBR now generally provided currency to other ruble area members on demand, but only in the form of bills issued in 1961-1992 with a denomination of less than Rub 10,000; meanwhile a growing share of currency in circulation in Russia consisted of Rub 10,000 notes printed in 1992 and banknotes printed in 1993. With the tightening in net official financing from Russia in 1993, the demand for ruble banknotes as a means to finance imports from Russia rose sharply in a number of other ruble area states. The reflow of rubles to Russia is believed to have been reinforced by the printing of national coupons in several states, which freed up additional ruble banknotes to be used for imports.

c. The July 1993 demonetization and its aftermath

The CBR announced a package of measures on July 24, 1993 which (as amended on July 26) eliminated as legal tender in Russia all pre-1993 notes with a denomination of less than Rub 10,000, thereby de-linking the cash component of the money supply in other ruble area states from that in Russia. ^{1/} The Russian authorities announced that, pending agreement on a viable monetary union with those states wishing to remain in a ruble area, these countries could obtain new rubles on the same terms as non-cash financing, but only within the new limits on state credits (see Section III.1.d). The announcement of the demonetization of old rubles in Russia led to uncertainty and disruptions in the period immediately following the action, both in Russia and other FSU states still using the

^{1/} For a more detailed discussion of the currency reform see the Supplement.

ruble. The main impact of the measure, however, has been to delink the cash component of the money supply of the other ruble area states from that in Russia, and to spur the introduction of separate currencies by some of these countries.

Since the demonetization, Georgia has left the ruble area and Azerbaijan, Moldova, and Turkmenistan have announced their intention to introduce separate national currencies (see the Appendix). Five other countries (Armenia, Belarus, Kazakhstan, Tajikistan, and Uzbekistan) have signed a framework agreement with Russia on the creation of a new ruble area, and all except Kazakhstan have signed detailed bilateral agreements with Russia defining the modalities of their policy coordination. The framework agreement provides for an interim period during which signatories will continue to use their existing monetary units (national currencies, coupons, "old" rubles and, reportedly, stamped 1993 rubles), with an eventual complete shift to "new" rubles. The agreement implies that full unification of currencies would take place after countries have demonstrated their ability to maintain the stability of the exchange rates of their interim currencies vis-à-vis the ruble. Exchange rate stability is to be achieved through the coordination of domestic financial policies, including those governing the money supply, interest rates and the budget deficit. Countries would not become full members of the new ruble area until their parliaments have ratified the agreement and the principle of harmonization of policies. The need to mobilize a domestic political consensus and the difficulties countries are likely to face--given their different adjustment needs--in arriving at mutually acceptable rates of money supply growth are likely to create significant impediments to the full implementation of the new ruble area agreement in the near future. ^{1/}

III. Interstate Financial Relations

1. Financial relations through mid-1993

a. Inter-republican resource flows in the U.S.S.R.

The states of the FSU inherited from the Soviet period a structure of trading relationships that was both highly distorted and characterized by large imbalances. Indeed, trade among the union republics of the U.S.S.R. was carried out at prices that deviated significantly from world market prices, and there was little evident attempt to balance inter-republican trade at these prices. During 1987-89, the latest period for which detailed data are available, Azerbaijan, Belarus, Georgia, Russia, and Ukraine were

^{1/} The recent initiatives to revive the ruble area have also included proposals aimed at a comprehensive economic union. See the accompanying staff paper, "Trade Policy Reform in the States of the Former Soviet Union", (SM/93/215) for a discussion of the issues surrounding the formation of an economic union.

consistently in surplus with the other former union republics as a group, while Kazakhstan and each of the four Central Asian republics were consistently in deficit in intra-U.S.S.R. trade. During this period, Russia's measured trade surplus with the rest of the U.S.S.R. amounted to around 1/2 percent of Russian GDP; trade imbalances for some other states, however, were significantly larger in relation to their own GDP. ^{1/} These trade imbalances were financed by means of automatic transfers through the branches of the State Bank of the U.S.S.R. (Gosbank). Also, Kazakhstan and the Central Asian republics generally were permitted to retain a relatively high proportion of tax revenues generated domestically, and in some cases received grants from the union budget approximating 15 to 20 percent of their GDP.

Russia was a major net exporter of energy products and various raw materials to most of the other former union republics. Since intra-U.S.S.R. trade was characterized by relatively low prices for energy and raw materials by world market standards, this meant that Russia extended a sizable implicit trade subsidy to most other union republics. Using the official exchange rate of the ruble prevailing in 1987, which was likely overvalued, this subsidy has been estimated at around 5 percent of Russian GDP. If the real exchange rate for Russia for mid-1993 were used to value this subsidy, however, it would have amounted to around 15 to 20 percent of Russian GDP in 1987. From the perspective of the smaller recipient republics, the implicit subsidy they received from Russia was, of course, much more significant in relation to GDP. In sum, in the latter years of the U.S.S.R., large resource transfers were made from Russia to most other union republics.

b. 1992

The union republics that became independent states in late 1991 also inherited from the Soviet period a pattern of highly energy intensive agriculture and industry, as well as household consumption. Thus, those which were net energy importers faced a significant terms of trade shock as interstate energy and raw material export prices began to be raised significantly in 1992. In addition, these states lost the fiscal transfers previously received from the union budget of the U.S.S.R.

The changes in relative prices gave rise to significant adjustment by the energy importing states. Import volumes were reduced in a number of states, which contributed to the large contraction of output in most FSU

^{1/} For example, Belarus consistently had a trade surplus equal to about 10 percent of its GDP while Kazakhstan and the four Central Asian union republics together incurred average annual trade deficits amounting to around 12 percent of GDP.

states in 1992. 1/ At the same time, however, the terms of trade shock was partly accommodated through substantial financial transfers extended by Russia. Indeed, preliminary data suggest that Russian financing of the other FSU states amounted to over 10 percent of Russian GDP in 1992 (Table 1). 2/ Most of this financing was provided by the CBR through its correspondent accounts with other FSU central banks or through so-called technical credits which were negotiated beforehand on a bilateral basis. 3/ In addition, for the year as a whole Russian enterprises are estimated to have financed enterprises in other FSU states through the build-up of net arrears claims by an amount equivalent to about 1 percent of Russia's GDP. 4/ Available data suggest that this financing was offset only slightly by net borrowing by Russian commercial banks from commercial banks in other FSU states in 1992 (1/4 percent of GDP), which possibly reflected capital flows associated with stronger stabilization efforts in Russia relative to some other states and the possibility of access to foreign exchange markets in Moscow.

For the other FSU countries (excepting the Baltic states), the financing received from Russia was equivalent to around 20 percent of their combined GDP, and in some cases (Georgia, Tajikistan, Turkmenistan, and Uzbekistan), it amounted to one third or more of estimated GDP (Table 2). 5/ In addition to these financial flows, it is likely that some portion of the cash emission to the other FSU states in 1992--equal to

1/ Deliveries of crude oil and oil products by Russia to other FSU states declined by 43 percent between 1990 and 1992 and are projected to fall by a further 25 percent in 1993 (SM/93/66, Sup. 1, 4/16/93). This drop reflects falling oil production in Russia, an increase in the share of exports sold on non-FSU markets at world market prices, and declining demand in the other states due both to the contraction of domestic output and the deterioration in the terms of trade. The fall in energy deliveries from Russia was partially made up by increased imports from Kazakhstan and Turkmenistan and from non-FSU states.

2/ The precise amount of the net accumulated claims of the CBR is subject to substantial uncertainty, because the staff does not have complete information on the treatment of technical credits, currency, and arrears in the Central Bank of Russia's accounts. All of the estimates of financing in this paper should therefore be considered preliminary.

3/ See Annex I for a more detailed discussion of the correspondent account system in 1992.

4/ For much of 1992, financing on account of arrears was in fact in the other direction, with Russian enterprises tending to incur net arrears with enterprises in other states. Beginning in October 1992, however, the CBR conducted operations to clear the arrears of Russian enterprises with the result that by the end of the year the net position had been reversed.

5/ Payments imbalances existed in bilateral relations between other FSU states as well, but these imbalances are generally not considered to have been large. (Azerbaijan and Turkmenistan, both energy exporters, reportedly ran surpluses with FSU states other than Russia in 1992-93.)

2 1/2 percent of Russian GDP--should also be considered as balance of payments financing, since part of the currency was likely used to purchase imports from Russian enterprises and individuals. Data on interstate currency migration, however, are not available.

Aside from explicit financing of the real resource flow from Russia to the other states, Russia continued in 1992 to extend large implicit trade subsidies despite a probable improvement in Russia's terms of trade with these countries and a general decline in trade volumes of 30 to 35 percent. The Russian authorities have estimated these subsidies at around US\$12 billion, 1/ or 14 percent of Russian GDP at the average exchange rate prevailing in 1992. The estimated magnitude of the subsidy is very sensitive to the exchange rate used, however, and to the extent that the real exchange rate may have depreciated beyond its long-run equilibrium level in 1992, the size of the subsidy in relation to GDP would be exaggerated. For example, at the significantly appreciated real average exchange rate expected to prevail in 1993, the 1992 implicit trade subsidy would have amounted to around US\$10 1/2 billion or about 7 percent of measured 1992 GDP. 2/ Relative to GDP, the size of the implicit trade subsidy for those FSU states that were net energy importers from Russia was of course much larger than for Russia. For the other FSU states as a group, this subsidy is estimated at from 15 to 30 percent of their combined GDP in 1992, depending on the exchange rate used. 3/

c. 1993

At the beginning of 1993, new technical credits were agreed between Russia and all FSU countries other than the Baltic states; limits were set on these credits except in the case of Kazakhstan. The Russian authorities later announced, however, that financing through the payments system essentially would be terminated by mid-April. Moreover, as a condition for

1/ See SM/93/66, Sup. 1 (4/16/93). This subsidy is defined as the difference between the "notional" value of Russia's net exports at world market prices and their actual value in rubles converted into dollars at the prevailing exchange rate. The calculation does not take into account the possible effect that a diversion of trade to the world market (an opportunity assumed to exist for purposes of the calculation) might have on the world market prices used as a benchmark.

2/ While the ratio of the implicit subsidy to GDP is highly sensitive to changes in the real exchange rate, the valuation of the implicit subsidy in terms of U.S. dollars is much less sensitive if the subsidy is large relative to the trade balance denominated in actual ruble prices, which was the case in 1992.

3/ Significant price distortions in most FSU states, including those arising from the implicit trade subsidies, mean that the GDP estimates used in these calculations are also distorted. There has been no attempt to adjust the GDP ratios cited here for these distortions and they should therefore be viewed only as broadly indicative.

agreement on new credits--which would be on the basis of inter-governmental agreements--existing imbalances would be refinanced as interest-bearing state debt indexed to the U.S. dollar or SDR (see following subsection). 1/ Indeed, between end-April and Russia's demonetization measures at end-July, very little interstate financing took place through the accounts of the CBR. 2/

Provisional data for the first six months of 1993 indicate that, excluding currency issue, recorded net financing from Russia to the other states amounted to some 3 1/2 percent of estimated Russian GDP for that period (Table 1), compared with over 10 percent of GDP in 1992. CBR financing on the basis of technical credits amounted to about 3 percent of estimated Russian GDP for that period, while Russian enterprises are estimated to have accumulated further net claims in arrears on enterprises in other states equal to 1 percent of GDP. Meanwhile, Russian commercial banks continued to be a net recipient of financing from other commercial banks, to the tune of almost 3/4 percent of GDP. It is believed that due to the sharp decline in the real level of financing in this period, the demand by other states for cash rubles increased by more than otherwise as cash was increasingly used to import from Russia (see background paper). Although currency issue to the other FSU states declined to around 1 1/2 percent of Russian GDP during this period, it is believed that a larger share of the currency issued was being used directly to finance the flow of real resources from Russia. 3/

d. Interstate debt agreements

To date, Russia has signed agreements with 11 other FSU states 4/ which provide for the repayment of existing CBR claims on the central banks of these countries and involve commitments on new intergovernmental credits for the balance of 1993. The agreements for which information is available provide for the consolidation of Rub 2.3 trillion of accumulated CBR claims and the provision of state credits in the second half of 1993 of Rub 750 billion. The stock of ruble claims has been converted into a U.S. dollar or SDR-denominated stock valued at US\$6 billion on the basis of the average exchange rate during the period in which each country contracted its official liabilities vis-à-vis Russia.

The amount of claims that has been consolidated, as a proportion of the sum of CBR correspondent account financing, currency issue, and interstate interenterprise arrears ranges from around 30 percent in one or two cases,

1/ Up to this point, interest had not been charged on CBR financing to other FSU states.

2/ See the Supplement.

3/ The issue of the extent to which other ruble area countries shared in seigniorage is addressed in the background paper.

4/ Excluding the Baltic states. Details are not yet available on the terms of the agreement with Azerbaijan.

up to 100 percent. Preliminary information suggests that generally this ratio is smaller, the greater the share of currency issue in accumulated claims on a country. 1/ For most countries, the agreements provide for a grace period of 1 or 2 years, 2/ and repayment is typically to be made over 5 to 6 years (i.e., to be completed by the year 2000). Interest is at commercial terms, with the exception of Belarus, Turkmenistan and Uzbekistan, for which an interest rate of zero is specified on the refinanced debt (Table 3). Debt service has been indexed to either the U.S. dollar or SDR.

Most of the debt consolidation agreements are notable by their relatively short maturities and grace periods. While these terms are rather onerous in relation to the medium-term prospects and low per capita income levels of many of the countries involved, they should be viewed in the context of how the debts were generated in the first place, taking into consideration the overall level of resource flows which Russia has been providing in recent years to most other states of the FSU. In this regard, it should be noted that no interest was charged by Russia to the other states on the net liabilities they incurred to the CBR in 1992 and the first half of 1993. Furthermore, as noted earlier, Russia has been providing a large net resource flow to these countries in recent years, including substantial implicit trade subsidies.

Agreed state credits for the balance of 1993 are all on commercial terms, with varying grace periods (Table 4). 3/ Taking the debt conversion and new state credits together, the implied indebtedness by end-1993 would range from the equivalent of 5 to 7 percent of GDP for Belarus, Kazakhstan, the Kyrgyz Republic, Moldova and Turkmenistan, to 13 percent of GDP or more for Ukraine and Uzbekistan (Table 5).

2. Financing and adjustment in 1993-94

The further adjustment of interstate energy export prices toward world market levels along with the reduction in official financing provided by Russia are likely to complicate the economic transition process in the other states of the FSU. In general, the extent to which these shocks will negatively affect output and living standards in the other FSU states will depend on a number of factors: the initial price being paid for energy imports from other FSU states; the amount of private and official financing they are able to obtain from other sources; their initial degree of dependence on imports of energy and other critical inputs and their ability

1/ The treatment of currency in the refinancing agreements has implications for seignorage; for details, see the Supplement, Section III.4.

2/ Exceptions are Kazakhstan, Moldova, Turkmenistan and Ukraine, for which repayments are to begin already in 1994; and Belarus, which is to begin repayment in the year 2000.

3/ Belarus is a clear exception, as it is obligated to begin its repayments only in the year 2001.

to use these inputs more efficiently; and how quickly they can find new export markets both in Russia and in non-FSU countries. On the basis of the financing that can be identified at this point, and given the limits to reorienting production and trade in the short run, it is likely that these shocks will have a substantial adverse impact on both income and spending in 1993 and 1994. Furthermore, it should be noted that the adjustment burden in these years will be exacerbated by the inadequate efforts in most FSU countries to adjust to the changes in economic circumstances in 1992 and prior years.

The staff has prepared an illustrative scenario to indicate the broad order of magnitude of possible outcomes in 1993 and 1994. The scenario has been prepared on the basis of a set of common assumptions and drawing on individual projections for each of the FSU countries. It should be noted, however, that the quantitative results should be interpreted with caution as they are subject to considerable uncertainties related to the quality of trade and payments data thus far in 1993 as well as conflicting information regarding balance of payments trends in certain FSU states.

In the projection (Table 6), it is assumed, in line with the financing envisaged under the STF-supported program with Russia, that official balance of payments financing provided by Russia to other FSU states would fall from US\$7 billion (over 15 percent of the combined GDP of the other FSU states) in 1992 to about US\$2 billion (2 percent of combined GDP) by 1994. 1/ It is also assumed that Russia would raise its prices for energy exports to the rest of the FSU to 80 percent of world prices by the end of 1993 and 100 percent of world prices by the end of 1994. 2/ At the same time, the prices of non-energy products, of which the other FSU states are net exporters vis-à-vis Russia, would increase toward world market levels. On balance, however, (and at 1992 levels of trade) the price increases would imply a further deterioration in the terms of trade of the other FSU states of over 10 percent (following a decline of some 23 percent in 1992) and (if trade volumes remained unchanged) an increase in their net import bill by around US\$10 1/2 billion between 1992 and 1994, equivalent to about 10 percent of the combined GDP of the other FSU states in 1994. On this basis, the combined balance of payments effect of the two shocks for these countries (worsened terms of trade and decline in financing from Russia) would be an estimated US\$15 1/2 billion between 1992 and 1994, or around 15 percent of their combined GDP in 1994 (see tabulation below).

1/ The more than proportionate decline in the ratio of financing to GDP by 1994 reflects the assumption of a substantial real appreciation of the ruble and other FSU currencies as financial stabilization is achieved.

2/ For oil, this would imply average increases of close to 200 percent in 1993 and a further 100 percent in 1994, while for natural gas the price increases would be about 250 percent in 1993 and 100 percent in 1994.

FSU States Excluding Russia: Financing of and
Adjustment to External Shocks, 1993-94 1/

External shocks

Loss in official financial transfers from Russia (between 1992 and 1994)	US\$5 billion
Rise in import bill from terms of trade loss (between 1992 and 1994)	US\$10 1/2 billion
Total shock (between 1992 and 1994)	US\$15 1/2 billion (15 percent of 1994 GDP)

Illustrative scenario

Increase in other financing	US\$3 to US\$6 billion
Projected decline in real GDP:	
1993	-15 to -18 percent
1994	-4 to -5 percent

Source: Staff estimates.

1/ Also excluding Georgia and Tajikistan, for which balance of payments projections were not available.

2/ In percent of the combined GDP of the other FSU states.

At the same time, and in conjunction with substantial progress towards financial stabilization and structural reform, it is assumed that an increase in official financing from non-FSU countries and an improvement in net private capital flows will offset part of these two negative external shocks on the other FSU states. Given the uncertainties noted above, it is difficult to predict the magnitude of these flows with precision. In broad terms, it may be assumed that external assistance from non-FSU official sources (including from the Fund, but net of financing used to build up reserves 1/) would rise from an estimated US\$1 billion in 1992 to around US\$3 1/2 billion to US\$4 1/2 billion by 1994. In addition, it is assumed that the balance on nongovernmental capital flows (including interenterprise trade credits and commercial bank flows from Russia to the other FSU states) would rise significantly in 1993-94, representing a net increase in financing to these states of around US\$1 billion to US\$3 billion by 1994. If it were to materialize, the total increase in these financial flows--of around US\$3 billion to US\$6 billion--would amount to some 20 to 40 percent of the combined effect of the two estimated shocks facing the other FSU states. It should be noted, however, that the magnitude of such flows would depend critically on the strength of adjustment and reform efforts taken by

1/ Annual financing from the Fund to FSU countries other than Russia is assumed to amount to US\$1 billion to US\$2 billion.

these countries themselves, 1/ and that the assumed increase in official financing from non-FSU countries in 1993-94 is very large relative to the levels of financing already attained.

A number of FSU states, in particular the Baltic states, already experienced substantial terms of trade shocks and associated income losses in 1992. The further terms of trade shock and reduced financing from Russia in 1993-94, however, are expected to have significant adverse consequences on the underlying balance of payments situation and economic activity in most of the other FSU states in these years. Although the projection envisages that their exports to non-FSU countries will grow rapidly, and capital inflows from the non-FSU area are expected to rise substantially to finance a sizable widening of the combined current account deficit of these states, considerable adjustment would nevertheless occur through a compression of import volume. Indeed, total import volumes of the other FSU states are projected to fall by an average of 10 to 15 percent over the course of 1993-94.

Data inadequacies in the form of unrecorded transactions may imply that the collapse in financing and trade is not quite as substantial as that envisaged in the scenario. Nevertheless, the import compression in response to the two shocks is likely to remain significant, and to be associated with a further large decline in consumption and investment spending in the other FSU states. Real GDP growth also can be expected to be adversely affected, as the decline in real income induced by the terms of trade loss reduces the demand for domestic goods, and as a drop in imports of raw materials and intermediate inputs constrains production in the short run. 2/

Real GDP in the other FSU states as a group could be expected to fall by 15-18 percent in 1993 under the scenario, and this would be followed by a further output decline of around 5 percent in 1994. These declines would come on top of the average 15 percent fall in real GDP estimated to have occurred in 1992 and would represent a cumulative drop of 40 to 45 percent since 1990, which is comparable to the declines experienced by the Baltic states since 1990. The output declines would be particularly large in 1993 in several states that are large net importers of energy.

Ultimately, it will be necessary for the other FSU states to adjust fully to the lower terms of trade and the reduced level of financial transfers from Russia. To this end, efforts to raise productive efficiency

1/ The strength of these countries' financial policies could be assumed to influence the size of the current account surplus they are able to maintain vis-à-vis non-FSU countries and the magnitude of external financial assistance from the non-FSU area, but also the extent to which the financial resources thereby received would effectively be used to finance net imports from Russia rather than being dissipated in capital flight.

2/ Such imports are estimated to account for about 60 percent of total imports of the other FSU states in 1992.

--particularly with regard to energy use--will be critical. Nonetheless, the illustrative scenario does suggest that the adjustment burden could be very severe in the short term, even if it is assumed that steps toward stabilization would bring forth a substantially higher level of support from non-FSU countries. This burden would be made more manageable if the reform and stabilization efforts in the other FSU states were supported by an adequate level of external assistance from both non-FSU countries and Russia. Indeed, staff analysis suggests that, broadly speaking, every US\$1 billion of additional annual external financing to the other FSU states would, by funding higher domestic expenditures and imports, allow real GDP in these states to be about 1 1/2 percent higher on an annual basis in 1993-94. ^{1/}

3. Policy implications

a. The need for orderly and efficient adjustment

The foregoing illustrative scenario indicates the broad magnitude of the adjustment which most FSU states other than Russia will face as interstate trade prices continue to be brought in line with those on the world market. ^{2/} The resultant terms of trade shock for energy importing countries would be accompanied--on the current policies of the Russian authorities--by a marked reduction in official balance of payments financing from Russia.

The need to adjust to these shocks is inescapable. Indeed, in the case of the Baltic states, much of the adjustment in trade and output has already taken place. What is required now in those countries is to accelerate structural change while preserving macroeconomic stability, so that the needed adjustment can create the conditions for sustained economic growth on the basis of a production structure that is compatible with the needs and incentives of a market economy.

The critical policy challenge at this juncture is to ensure that the necessary adjustment in the other FSU states is not indefinitely postponed--as noted above, the adjustment burden in 1993 and beyond has been amplified

^{1/} It may be noted that the relatively large response of output reflects the large share of energy and other inputs in total imports of most of the other FSU states, and the assumption that higher imports of these inputs may be combined with existing domestic resources to raise output. Furthermore, the increase in output is predicated on the assumption that the corresponding demand would be forthcoming. To the extent that there may be a less than proportionate increase in demand for this domestic output, the additional imports would be accompanied by a smaller expansion in output relative to the baseline.

^{2/} The Baltic states have already been faced with a movement of the prices of their energy imports to world market prices. Azerbaijan and Turkmenistan are--in addition to Russia--net energy exporters.

by inadequate efforts in prior years. At the same time, however, the adjustment process should be as orderly as possible. The illustrative scenario envisages that on present assumptions regarding external financing, the FSU states other than Russia would have to bear 60 to 80 percent of the shocks in 1993-94 in the form of a further substantial fall in real imports, with likely adverse consequences for both income and living standards. Additional external financing could substantially mitigate these effects and allow for a more orderly adjustment, in the sense that it would be spread somewhat beyond 1994. At the same time, however, it should be recognized that the greater the financing, the larger the future debt burden that these countries will face.

Orderly and efficient adjustment would be facilitated by a combination of: (i) strong macroeconomic policies in the affected countries, which would provide a stable environment for needed structural change and encourage both official external assistance and foreign direct investment; (ii) accelerated structural reforms (including those aimed at increasing energy efficiency) to ensure that the costs associated with the cushioning of adjustment are accompanied by an expansion of future productive capacity; (iii) a more active financing role by Russia (but one which is consistent with the achievement of macroeconomic stabilization in that country), in light of its own interest in preventing a major further collapse of output in neighboring states (see Section 3.d.); and (iv) a more concerted effort of external assistance by the governments of non-FSU countries.

b. Implications of evolving monetary arrangements for financing needs

As discussed in Section II.2 (and the Supplement), monetary arrangements among the states of the FSU continue to evolve at a rapid pace. If agreement on a new monetary union among some FSU states is indeed achieved and the necessary measures are taken to ensure the coordination of monetary policy, a reconstituted ruble area could emerge. On the other hand, given the difficulties attendant to implementing the new ruble area agreement, most if not all countries could well have their own national currency within a relatively short period of time.

The precise form of the monetary arrangements which evolves over the next few months is unlikely to have a significant effect on the financing needs of the individual FSU states in 1993-94. This is because pricing policies in interstate trade and the amount of official financing made available by Russia to other FSU states are likely to have more to do with political considerations and with reform and stabilization objectives within Russia itself, than with whether a given state continues to use the ruble as legal tender. ^{1/} This suggests that the needs of individual FSU states for financing from the non-FSU area--given a particular set of macroeconomic

^{1/} It cannot be precluded, however, that non-economic factors related to the nature of monetary arrangements may also influence financing decisions.

objectives in these states--are likely to be essentially invariant with respect to their choice about remaining in the ruble area.

Over time, a country choosing to remain within a reconstituted ruble area may of course benefit from increased nongovernmental capital flows from Russia (e.g., because of the absence of foreign exchange risk) as stabilization proceeds and banking relations are further developed. If these flows were to constitute net additional financing from Russia, this could alleviate somewhat the financing needs of the recipient country vis-à-vis non-FSU countries, but presumably Russia's own financing requirements in respect to the non-FSU would increase *pari passu*.

c. The issue of a payments union

The present system of bilateral central bank correspondent accounts is clearly inadequate as an interstate payments system. As long as payments relations remain bilateral and currency markets remain undeveloped, trading partners find it difficult to liquidate bilateral surpluses in order to pay bilateral debts elsewhere. The system also suffers from extreme uncertainty: since settlement requirements are not well-specified, positions are often known only with a lag, and access to settlement credit is unpredictable, agents submitting payments can never be sure that their payments will be finalized.

As noted in Section II.1.b., the Interstate Bank (ISB) was designed to address these concerns. Balances in the bilateral correspondent accounts would be consolidated through a multilateral clearing mechanism. The ISB would improve the predictability and security of payments by executing a fully automatic non-discretionary settlement procedure, with daily posting of outstanding positions and early-warning signals of possible settlement difficulties, and the imposition of well-specified graduated penalties upon failure to settle. Finally, as a supra-national institution, with no basis for granting financing, the ISB would be insulated from the pressures for financing to which FSU central banks are frequently exposed. With these goals in mind, Fund staff have provided significant technical assistance towards the establishment of the ISB. In the opinion of the staff, the role of the ISB should be limited to multilateral clearing, rather than establishing it as a payments union which would mean augmenting the clearing mechanism with significant quantities of settlement credit provided either by creditor-participants or the international financial community.

Perhaps the main argument for using the payments system to extend credit would be that it would in effect provide financing proportionately to all cross-border traders, thereby avoiding possible difficulties in obtaining commercial bank financing or in the provision of government loans, which may take time to negotiate and presumably would involve strict

limitations on access. 1/ Nonetheless, the staff takes the view that a rapid shift to interstate financing by commercial banks and--to the extent that official financing is involved--through negotiated intergovernmental credits is feasible, and in the interest of all parties. Indeed, any attempt to address the financing problem by means of a payments union would involve a number of risks.

First, there is the risk that a payments union involving the provision of sizable amounts of credit from external sources could easily develop into a forum for intense bargaining over the amounts and terms of credit and disrupt the operation of the multilateral clearing mechanism of the kind that is envisioned with the establishment of the Interstate Bank. Second, the ability to incur external imbalances easily within a payments union could well lead member states to focus their energies on expanding mutual trade at the expense of commerce with the rest of the world at world market prices, and thereby to delay taking those measures which would make their currencies convertible. 2/ Third, the foregoing tendency towards insularity might be reinforced by the institutional arrangements accompanying the establishment of a payments union. In particular, it would almost inevitably involve the creation of a new bureaucracy which--given the traditions of central planning in most FSU states, and the continuing emphasis on intergovernmental agreements on exchanges of certain categories of goods and the reliance on state orders in some countries--could materially slow the progress towards decentralized market relations in interstate trade. Finally, if the FSU states are to achieve successfully the transition to sustainable growth on the basis of market-oriented relations, and thereby become progressively less dependent on official external assistance, it will be important to attach meaningful conditionality (including with respect to currency convertibility) to such assistance. Such monitoring will be most effective if it is carried out on a country-by-country basis by existing international financial institutions--including the Fund--rather than by attempting to apply conditionality indirectly through a totally new regional institution such as a payments union.

1/ In payments system financing, the request for payment identifies the need for credit. This type of financing spreads available financing over all producers of traded goods, and therefore may postpone a decline in output. In direct government financing, credit is allocated administratively or by auction. Since not all existing importers necessarily obtain access to this credit, if distributed efficiently it increases the likelihood that inefficient enterprises would have to shut down, thereby hastening adjustment.

2/ Payments union arrangements have frequently involved exchange restrictions and discriminatory payment practices contrary to the Fund's objectives of establishing a fully functioning multilateral payments system.

d. Sources, terms, and conditions for financial assistance to FSU states

The ultimate objective should be the creation of an environment in the FSU states which will encourage efficient non-governmental capital flows among these states and from the rest of the world. This will involve the reform of the enterprise and financial sectors in these countries, the creation of a transparent and stable environment for foreign direct investment, and the consistent pursuit of financial stabilization.

The various FSU states have quite different medium term prospects due to very different natural resource endowments and restructuring needs. Furthermore, many of the FSU states with sizable financial needs have very low per capita income levels. ^{1/} Moreover, the recent consolidation of CBR financing to the other FSU countries in 1992-93 and the state credits being made available by Russia during the second half of 1993 already have left many of these states with a considerable debt burden (Table 5). The terms and conditions of future assistance to these states from non-FSU governments should take these various factors into account.

Russia, as the single most important past creditor to most other FSU states and with its vast natural resource endowment, should also take into account the foregoing factors in setting the terms and conditions of its lending to these countries. It has a strong interest in the avoidance of disorder in neighboring states and in the maintenance of trade links. It also is a major beneficiary of the terms of trade shock and the reduction in its own financing of other FSU states. The Russian authorities will therefore wish to consider whether Russia might not be able to expand the amount of official financing it could provide to these countries in the immediate future. It would need at the same time to adhere to sound policies aimed at macroeconomic stabilization, and the amount of financing provided by Russia to other FSU states would have to be taken into account in assessing the financing needs of Russia itself. Russia can play an important role in the consultative groups arranged for other FSU states and might usefully be included as an observer at meetings of the Development Assistance Committee of the OECD.

Close coordination among potential creditor countries to the FSU states is to be encouraged, and in this regard the consultative group mechanism has already proved effective and should be used for a larger number of states. The proposal for a special fund for the FSU countries as a group, possibly to be managed by the Fund and through which Fund resources and those of participating non-FSU states could be channelled, is less compelling. It is unclear that such an approach would be more successful than existing mechanisms in raising the requisite amount of external financial assistance.

^{1/} Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan were recently added to the Development Assistance Committee list, and other FSU states are reportedly under consideration.

In any event, it would involve a number of administrative complexities and obstacles, not least the legal requirement that Fund resources can only be made available directly to individual member countries. Moreover, the creation of such a fund could involve some of the same problems mentioned in connection with the proposals to establish a payments union. In particular, the management of the fund would be in the awkward position of having to make direct allocations of a certain pool of credit among the FSU states--which inevitably would be at different stages of stabilization and structural reform--resulting in a potentially contentious process. In the view of the staff, this would be an ineffective approach in light of the need--long emphasized by the Fund--to make conditionality and access decisions on a case-by-case basis taking into account the specific institutional environment and economic situation of individual countries.

IV. Role of the Fund

The Fund has an important role to play in assisting the FSU countries in arranging their mutual financial relations in a way that will promote macroeconomic stabilization, structural reform and financial and economic cooperation in the region. This role is evident in the areas of macroeconomic policy advice, monetary and exchange arrangements, payments reform and statistics.

With respect to macroeconomic policy, and in addition to ongoing work with individual countries on the design of macroeconomic stabilization programs, the Fund staff can assist the FSU states in the following areas pertaining to interstate relations: (i) further development of the analytical and empirical framework for evaluating future balance of payments developments and likely financing needs of the FSU states, in the context of strong adjustment programs; (ii) assistance to the Russian authorities--in the context of macroeconomic program design--in arriving at an appropriate balance between credit provided to domestic entities and financing made available to other FSU states; and (iii) in the event of the formation of a new ruble area, guidance to the authorities of the new monetary union with respect to the institutional arrangements and degree of policy harmonization necessary to ensure effective monetary policy coordination throughout the ruble area.

As to evolving monetary arrangements within the region, the Fund staff will continue to urge the authorities in individual FSU countries to decide as quickly as possible on whether to introduce a separate national currency. To the extent that these authorities believe that macroeconomic stabilization will not be achieved in Russia in the near future, it clearly would be in their interest to introduce national currencies as soon as possible so as to establish at least a necessary condition for domestic monetary control. If these authorities consider that Russia will be successful in its attempts to stabilize, their decision to remain in a well-functioning ruble area would, as a practical matter, mean the subordination of the country's monetary policy and--to some degree--its fiscal policy to

policies being pursued in Russia, and they will need to achieve a domestic consensus in support of this. It is unclear how quickly a well-functioning ruble area can be put into place. In the interim, those countries intending to join in a revived ruble area must be prepared to take all necessary measures to ensure macroeconomic stabilization and adjustment to the terms of trade shock. Countries that decide to introduce separate national currencies will be provided advice--as the Fund staff has already given to several FSU countries and some East European countries--on the appropriate procedures to follow in introducing a new currency and the necessity to accompany this action with suitable financial policies.

With respect to payments arrangements, the ultimate aim should be to decentralize the bulk of payments to the commercial banks. Technical assistance from the Fund (and of the cooperating central banks whose work it is coordinating) in this area will continue to be devoted to: (i) helping the individual FSU central banks develop a strategy for further reforms to the payments system so as to allocate their limited resources in the most effective way; (ii) the training of payments system managers; and (iii) assisting the development of foreign exchange markets for new FSU currencies and the supporting prudential regulations and supervisory systems. Also, in order to support the ongoing reforms of monetary and payment arrangements, further advice on central bank accounting reforms will be needed, including a new chart of accounts which is better suited to a more market-oriented environment. Technical assistance will also continue to be provided to the Interstate Bank, the next step of which will be the organization of a ISB workshop in mid-October.

Technical assistance in statistics is expected to remain an important element in the relations between the Fund and most FSU countries for some time to come, and this will be especially the case in the balance of payments area. Given that the compilation of balance of payments accounts is a new initiative for these countries, progress in setting up data collection systems has been slower than in other statistical areas. Moreover, much of the early work has focused on balance of payments transactions with non-FSU countries, as these are typically easier to measure than intra-FSU transactions. There is also a need for improved monetary statistics which, inter alia, would include expanded information on the intricate and evolving accounting for the correspondent accounts maintained by FSU central banks, and would ensure their consistency with the correspondent accounts maintained by partner countries.

V. Issues for Discussion

In considering the evolving financial relations among FSU states and the role of the Fund in promoting stabilization, reform and cooperation in the region, Executive Directors may wish to address, inter alia, the following issues.

1. While any projection is subject to great uncertainty, the illustrative balance of payments scenario discussed in Section III.2 suggests that the FSU states that are net importers of energy will be subject to both a further terms of trade shock and--on current policies--a sharp reduction in balance of payments financing from Russia in 1993-94. While these countries will ultimately need to adjust to these permanent shocks, and should be encouraged to expedite this adjustment, it is also in the interest of all countries in the region that the adjustment be orderly.

Executive Directors may want to discuss how a satisfactory balance can be found between the need for orderly adjustment in the other FSU states--which will require considerable financing in the short-run from Russia and the rest of the world--and the financial constraints on those providing the assistance. They may also want to discuss the terms and conditions on which external assistance should be provided, taking into account the medium-term prospects and per capita income levels of recipient countries.

2. Regarding institutional arrangements for financing, the staff believes--as discussed in Section III.3.c.--that a payments union would be an inappropriate approach to mobilizing the financing needed to facilitate orderly adjustment by FSU states. The main reason is that it is vitally important to achieve a smoothly functioning interstate payments system and to ensure that it is insulated from the financing of interstate trade. Directors may wish to present their views on the appropriate role for the Interstate Bank in this connection and on whether they share the concerns of the staff regarding a payments union.

In considering the role for external financing, Directors may also want to discuss the need--noted by the staff in Section II.3.d.--to continue to make decisions on conditionality and the amount of assistance on a case-by-case basis rather than establishing a single fund or payments union through which such decisions could easily become contentious and conditionality attenuated.

Directors may also wish to consider what specific policy actions and measures to speed structural reform in these countries would materially contribute to a more stable and transparent environment for foreign direct investment and other nongovernmental capital flows which, over time, will undoubtedly be the most important source of external financing.

3. Executive Directors may also want to discuss the staff's view of the appropriate role of the Fund in the area of interstate relations (see Section IV), as regards both policy advice and technical assistance.

Table 1. Financing of Resource Flows from Russia to Other FSU States--1992 and First Half of 1993

	1992		(1993 Jan.-June)	
	In billions of rubles	In percent of GDP	In billions of rubles	In percent of GDP
Central bank correspondent accounts and technical credits <u>1/</u>	1,677	9.9	1,178	3.1
Government loans	2	--	--	--
Commercial bank correspondent accounts	-30	-0.2	-266	-0.7
Enterprises				
- trade credit	...	...	...	...
- arrears	<u>163</u>	<u>1.0</u>	<u>333</u>	<u>0.9</u>
Total financing	1,812	10.7	1,245	3.3
Memorandum items:				
Currency issue	433	2.5	550	1.4
Implicit trade subsidy				
- at 1992 average exchange rate	2,385	14.0	...	...
- at projected 1993 average exchange rate	...	7.0	...	...
Russian GDP	17,000	...	38,000	...

Source: Russian authorities; and staff estimates.

1/ These are preliminary data and are subject to revision. They may differ from balance of payments figures partly because they include financing provided to Georgia and Tajikistan, and partly because of data inadequacies including with regard to financing between FSU states other than Russia.

Table 2. Central Bank of Russia Financing of Other FSU States in 1992 1/

	End-1992 CBR Correspondent Account Position		End-1992 CBR Position Adjusted to Exclude Currency <u>2/</u>	
	In billions of rubles	In percent of GDP	In billions of rubles	In percent of GDP
Russian Federation	-2,109	-12.4	-1,677	-9.9
Armenia	34	49.0	20	28.6
Azerbaijan	51	25.8	34	17.4
Belarus	102	10.7	69	7.2
Estonia	4	4.0	4	4.0
Georgia	69	51.5	48	36.1
Kazakhstan	407	25.5	266	16.7
Kyrgyz Republic	42	22.9	27	14.5
Latvia	2	1.0	2	1.0
Lithuania	9	3.2	9	3.2
Moldova	27	11.3	18	7.5
Tajikistan	36	90.7	23	58.7
Turkmenistan	172	53.3	111	34.4
Ukraine <u>3/</u>	862	21.7	862	21.7
Uzbekistan	292	69.9	184	44.2
<u>Memorandum items</u> (percent of non-Russian GDP):				
Total correspondent account position		24.3		
Non-cash		19.3		
Currency		4.9		
Other financing <u>4/</u>		1.6		

Source: Russian authorities; and staff estimates.

1/ Preliminary data subject to revision.

2/ Currency deliveries amounted to 2.5 percent of Russian GDP and 4.9 percent of non-Russian GDP. No data are available on how much currency was used for financing Russian exports in 1992.

3/ Includes Rub 408 billion in offset arrears, but excludes swaps of Rub 80 billion.

4/ The table includes a country breakdown for financing through correspondent account overdrafts, technical credits and currency deliveries, but no country breakdown is available for financing in the form of arrears and commercial bank lending. These amounted to 0.8 percent of Russian GDP and 1.6 percent of non-Russian GDP in 1992. See Table 1 for a summary of aggregate data.

Table 3. Agreements with Russia Covering CBR Net Claims
Accumulated during 1992-June, 1993

	In billions of rubles	In millions of dollars	Ruble/US\$ exchange rate <u>1/</u>	Years to maturity	Grace period (years)	Interest rate (In percent)
Armenia						
1992	12	31	390	6.5	2.5	2.5
1993: Jan-June	10	14	699	6.5	2.5	2.5
Azerbaijan						
1992-1993: Jan-June	...	...	...	...	...	...
Belarus						
1992-1993: Jan-June <u>2/</u>	177	385	460	14	7	0
Estonia	...	...	...	...	...	...
Georgia						
1992: July-Dec.	40	135	293	4.5	1.5	LIBOR+0.5
Kazakhstan						
1992-1993: Jan-June	548	1,250	438	7.5	0.5	LIBOR+1
Kyrgyz Republic						
1992-1993: Jan-June	56	115	485	7.5	1.5	LIBOR+1
Latvia	...	...	...	...	...	...
Lithuania	...	...	...	...	...	...
Moldova						
1992-1993: Jan-June	40	89	450	4.5	0.5	LIBOR+1
Tajikistan						
1992-1993: Jan-April	16	42	381	7.5	2.5	LIBOR+0.5
1993: -June	49	85	576	7.5	2.5	LIBOR+0.5
Turkmenistan						
1992:	106	...	...	0.5	0.5	0 <u>3/</u>
1993: Jan-June	30	...	...	1	1	0 <u>3/</u>
Ukraine						
1992-1993: Jan-June	1,050	2,500	420	6.5	0.5	LIBOR+1
Uzbekistan						
1992: July-Dec	57	143	401	9.0	2.0	0
1993: Jan-April	150					
Memorandum item:						
Total debt (agreed) to Russia	2,340	...	...	

Source: Selected national authorities.

1/ The U.S. dollar amounts are reportedly derived by converting ruble claims at the weighted average ruble/dollar exchange rate of the period during which the claims accumulated.

2/ No interest is to be charged on Belarus's 1992-93 debt, unless it becomes overdue, in which case LIBOR+1 will be levied.

3/ LIBOR+2 will be levied on overdue debt.

Table 4. Agreements with Russia on New State
Credits for the Second Half of 1993

	In billions of rubles	Years to maturity	Grace period (years)	Interest rate (In percent)
Armenia	20	7.5	2.5	LIBOR+1
Azerbaijan	...	...	...	...
Belarus	70	15	8	LIBOR+1
Estonia	...	...	...	...
Georgia	10	4.5	1.5	LIBOR+1
Kazakhstan	150	4.5	1.5	LIBOR+1
Kyrgyz Republic <u>1/</u>	15	5.5	0.5	LIBOR+1
Latvia	...	...	...	...
Lithuania	...	...	...	...
Moldova	50	5.5	1.5	LIBOR+1
Tajikistan	60	7.5	2.5	LIBOR+0.5
Turkmenistan	...	...	...	...
Ukraine	250	7.5	1.5	LIBOR+1
Uzbekistan	125	9.0	2.0	LIBOR+1.5
Memorandum item:				
Total debt (agreed) to Russia		750		

Source: Selected national authorities.

1/ Preliminary information.

Table 5. Debt Agreements with Russia, 1992-93 1/

	In billions of rubles (nominal)	In millions of dollars	In billions of rubles (effective) <u>2/</u>	In percent of 1993 GDP
Total	3,090	5,946	5,191	8.1
Armenia	42	65	57	7.9
Azerbaijan	...	...	...	...
Belarus	248	457	399	5.0
Estonia	...	...	...	...
Georgia	50	146	127	7.9
Kazakhstan	698	1,402	1,224	7.1
Kyrgyz Republic	71	130	113	6.3
Latvia	...	...	...	...
Lithuania	...	...	...	...
Moldova	90	140	122	6.5
Tajikistan	125	188	164	...
Turkmenistan	136	242	211	5.5
Ukraine	1,300	2,754	2,404	13.0
Uzbekistan	332	422	368	13.1

Source: Selected national authorities.

1/ Consolidation of accumulated CBR claims (Table 3) and agreements on state credits (Table 4). Debts valued in rubles are converted into dollars either at the exchange rate implied by the terms of the agreement, or (where no information is available on the dollar-equivalent) at the average exchange rate during the period covered by the debt.

2/ At the projected average exchange rate for 1993, Rub 873 per US\$1.

Table 6. Illustrative Balance of Payments for Combined FSU States
Excluding Russia, 1992 and 1994 ^{1/}

	1992	1994	
(In billions of dollars)			
		<u>Lower</u>	<u>Upper</u>
Current account balance	-0.6	-3.5	-6.5
FSU transactions	-2.3	-5.5	-7.5
Non-FSU transactions	1.7	2.0	1.0
Trade balance	-0.6	-4.0	-7.0
FSU transactions	-2.3	-6.0	-8.0
Non-FSU transactions	1.7	2.0	1.0
Exports	26.1	47.0	45.5
FSU transactions	13.3	31.0	30.0
Non-FSU transactions	12.9	16.0	15.5
Imports	26.8	51.0	52.5
FSU transactions	15.6	37.0	38.0
Non-FSU transactions	11.2	14.0	14.5
Capital account	-1.3	4.0	7.0
Governmental	1.1	5.5	6.5
FSU transactions	0.1	2.0	2.0
Non-FSU transactions	1.1	3.5	4.5
Non-governmental	-2.3	-1.5	0.5
FSU transactions	-1.3	...	...
Non-FSU transactions	-1.0	...	...
Errors and Omissions	-3.7	--	--
Overall balance	-5.6	0.5	0.5
Financing	5.6	-0.5	-0.5
of which:			
FSU Central banks	7.0	--	--

Source: Selected national authorities and staff estimates.

^{1/} FSU export and import transactions reflect mutual trade among other FSU states as well as their trade with Russia. Abstracting from cross-country data discrepancies, other FSU transactions shown in the table represent aggregate transactions of the other FSU states with Russia.

Currency Arrangements in the Former Soviet Union as of September 8, 1993

Country	Currency Before Demonetization 1/	Currency Since Demonetization 2/	Current status
Armenia	ruble	ruble	Signed the agreement on the new ruble area; has adopted administrative measures to control ruble reflow.
Azerbaijan	ruble and manat (introduced at fixed parity with the ruble on August 15, 1992) Manat 1 = Rub 10	ruble and manat Manat 1 = Rub 10	No date has been set for the full replacement of the ruble by the manat as legal tender.
Belarus	ruble and rubel (introduced on May 25, 1992) Rubel 0.1 = Rub 1	ruble and rubel <u>non-cash</u> : Brub 230 = US\$1 Brub 2.52 = Rub 1 <u>cash</u> : Rubel 213 = US\$1 Rubel 0.19 = Rub 1	Signed the agreement on the new ruble area; will withdraw rubles on similar terms as in Russia.
Estonia	kroon (introduced on June 20, 1992) EEK 8 = DM 1	kroon EEK 13.7 = US\$1 EEK 1 = Rub 136 EEK 8 = DM 1	Currency board, with peg to DM; current account convertibility. Unaffected by demonetization.
Georgia	ruble, coupon (introduced on April 5, 1993) Coupons 1 = Rub 1	coupon (temporary sole legal tender from August 2, 1993); lari (permanent currency, to be introduced by October 1993) Coupons 7 = Rub 1 Coupons 5,690 = US\$1	
Kazakhstan	ruble	ruble (temporary sole legal tender); 1993 ruble (permanent currency, to be introduced when delivered)	Has signed a framework agreement to establish a new ruble area and intends to withdraw rubles on similar terms as in Russia. However, as of late August 1993, it was still receiving pre-1993 ruble notes from Russia. Technical preparations have been made to introduce a national currency.
Kyrgyz Republic	som (introduced on May 10, 1993) Som 1 = Rub 200 Som 4 = US\$1	som Som 1 = Rub 167 Som 5.9 = US\$1	Floating rate regime. Full convertibility. Unaffected by the demonetization.
Latvia	Latvian ruble (introduced on May 7, 1992; became sole legal tender on July 20, 1992); Lats (replaced the Latvian ruble on June 28, 1993) Ls 1 = Rub 1,661 Ls 0.653 = US\$1	lats Ls 1 = Rub 1,541 Ls 0.638 = US\$1	Floating rate regime. Current account convertibility. Unaffected by the demonetization.

APPENDIX

Country	Currency Before Demonetization <u>1/</u>	Currency Since Demonetization <u>2/</u>	Current status
Lithuania	talonas (introduced on May 1, 1992) became sole legal tender on October 1, 1992; litas (replaced the talonas on June 15, 1993) Llt 1 = talonai 100 Llt 1 = Rub 240 Llt 4.45 = US\$1	litas Llt 1 = Rub 248 Llt 4.25 = US\$1	Floating rate regime. Current account convertibility. Unaffected by the demonetization.
Moldova	ruble and coupons	coupons (temporary sole legal tender from July 27, 1993); Leu (permanent; the authorities intend to introduce it before end-1993) Coupon 1.5 = Rub 1 Coupon 1,282 = US\$ 1	The Trans-Dniester region continues to use rubles.
Russian Federation	ruble	1993 ruble Rub 985 = US\$ 1	1993 rubles are already in circulation. Signed an agreement to establish a new ruble area.
Tajikistan	ruble	ruble (temporary sole legal tender); 1993 ruble (permanent, to be introduced when delivered)	Signed the agreement on the new ruble area; will withdraw old rubles from circulation when expected deliveries of 1993 rubles arrive.
Turkmenistan	ruble	ruble (temporary sole legal tender); manat (to be introduced in November 1993)	Has introduced administrative measures to prevent inflow of rubles.
Ukraine	karbovanets (temporary redefinition of coupons as transitional currency, on November 12, 1992) Krb 1 = Rub 1 Krb 425 = US\$1	karbovanets (temporary sole legal tender); hyrivna (permanent, to be introduced at time of stabilization) Krb 15 = Rub 1 Krb 17,000 = US\$1	Unaffected by demonetization.
Uzbekistan	ruble and coupons.	ruble (temporary sole legal tender); 1993 ruble (permanent currency, to be introduced when delivered)	Signed the agreement establishing a new ruble area; will withdraw rubles on similar terms as in Russia.

1/ Exchange rate (where applicable) at time currency was introduced.

2/ Latest exchange rate (where applicable) available as of August 23, 1993.

