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Currency Arrangements in Countries of the Former Ruble Area and Conditions for Sound Monetary Policy

by

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Abstract

This paper explores the general economic considerations that have guided thinking with respect to monetary union among the countries of the former ruble area. In light of these considerations, the paper discusses the dissolution of the ruble area in the course of 1992-93. This experience suggests that if national authorities are going to seek financial stability through membership in a monetary union, the common currency area must be credible in the sense of being economically sustainable and institutionally workable, and the authorities in the country with de facto monetary authority will need to have sufficient political support to pursue an effective anti-inflationary policy.

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Contents

I. Introduction

Striking changes have taken place since the dissolution of the former Soviet Union (FSU) only two and a half years ago. Insofar as monetary affairs are concerned, what was once a common currency area within the FSU has evolved, over time, into a situation in which all but one of the fifteen former ruble area members, Tajikistan, now has its own separate currency. 1/ The demise of the ruble area, rather than occurring overnight or being carried out according to a deliberate plan, was a spasmodic process, and itself gave rise to significant uncertainties and loss of monetary control in those countries that remained in the area. Even among those countries that left the ruble area some time ago, the record has been mixed as to how successfully monetary control has been established. Some of these differences are highlighted in other contributions to this volume.

This paper explores in section II the general economic considerations that have guided thinking on whether to try to retain the ruble area or to attempt to establish a new monetary union among some of the former member states in the future. In section III, and in the light of these considerations, the dissolution of the ruble area in the course of 1992-93 is discussed. Some lessons are considered in section IV about the conditions required for sound monetary policy in the former ruble area countries.

1/ On April 12, 1994, Russia and Belarus signed an agreement on monetary union which over the next several months was intended to make the Russian ruble the common currency in both countries.

II. Prerequisites for a Viable Monetary Union

It is useful to distinguish among three different issues bearing on the viability of a monetary union among former ruble area members: (i) the well-known underlying economic requirements for an optimal currency area, (ii) the financial sustainability of the monetary union should the foregoing requirements not be met, and (iii) the day-to-day "workability" of the union in the sense of being able to achieve monetary stability throughout the common currency area.

1. Conditions for an optimal currency area

These conditions are well-known, and will only be briefly referred to here. 1/ It is generally agreed that on strictly economic grounds, a monetary union will only be sustainable in the absence of an organized system of financial transfers among members if one or more of the following is fulfilled: (1) the member countries have generally similar economic structures, (2) each has downwardly flexible real wages, and/or (3) labor and capital are able to move relatively freely among member states. Satisfaction of at least one of these conditions will ensure that the members will be able to adapt to exogenous real shocks (such as a deterioration in the terms of trade) without undergoing significant declines in real output and employment, thereby allowing the central monetary authority to maintain an appropriately tight, anti-inflationary policy for the area as a whole without having to be concerned with unacceptable real consequences in any of the constituent member states.

1/ For a fuller discussion of this subject, see Masson and Taylor (1993).

If we were to imagine Russia as the main pillar of some future common currency area involving several other states, it would be difficult to see how any of the foregoing conditions could be expected to be met in the near future. It may be objected, however, that this hypothetical monetary union is in this way being held to a higher standard--in terms of the underlying fundamentals--than many existing common currency areas, such as the United States or various West European countries with sizable regional disparities.

2. Financial sustainability in the absence of economic fundamentals

To the extent the fundamentals are not fully met, these common currency areas are generally sustained through a relatively stable system of financial transfers from one or more sub-regions to others. This suggests, however, that lacking the economic requirements for an optimal currency area, the sustainability of a monetary union will depend upon a high degree of political cohesion and acceptance of significant fiscal responsibilities by at least some members of the union towards the others.

In the case of the former members of the ruble area, one could therefore imagine a situation in which--while generally moving towards the elimination of subsidies--the prices of key inputs such as energy might still be kept below world market prices within the monetary union, thereby maintaining implicit fiscal transfers through trade subsidies to energy importers. 1/ This could reduce the degree of asymmetrical terms of trade

1/ Such an arrangement, for example, has been sought by the Belarussian authorities in their ongoing discussions with Russia on a possible monetary union between the two countries.

shocks within the region and the need for explicit financial transfers from Russia to energy importing countries. 1/ Such an approach, however, would perpetuate price distortions and the wrong signals for resource allocation.

Rather than maintain implicit trade subsidies, a more efficient means to ensure sustainability of such a common currency area would be to provide for explicit intergovernmental transfers that would, in effect finance the intra-union balance of payments deficits of member states. As noted, however, the sustainability of such transfers for an indefinite future period would depend on a long-term political commitment by the donor country, presumably in this case Russia.

3. Workability

Assuming that the viability of the monetary union were to be assured either by the economic fundamentals or a system of financial transfers, the issue which would still arise--and which was signaled as so crucial during the demise of the ruble area in 1992-93--is whether the union would be workable in the sense that there is put in place a set of institutions, rules and policies which would permit the union to operate smoothly and its authorities to achieve monetary stability and thereby low inflation.

In the course of discussions on preserving or reviving the ruble area, at least three possible models were suggested to ensure a clear set of institutions and rules for decision-making within a monetary union. These included: (1) a cooperative, rule-based system; (2) the creation of a

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1/ In 1992, implicit trade subsidies from Russia to other former ruble area states as a whole were estimated to range from 10 to 25 percent of these countries' combined GDP, depending on the ruble/dollar exchange rate used to evaluate these subsidies. See IMF (1994).

separate central monetary authority, possibly established as an international organization, in which each member state would be represented on the basis of a pre-agreed formula but in which Russia--by virtue of its size--would play the dominant role; and (3) the Central Bank of Russia (CBR) itself as the central monetary authority which, in some degree of consultation with other central banks, would decide on the main parameters of monetary policy. Ever since several states attempted in September 1993 to revive the ruble area, the last model has served as the basis for discussions. Bilateral negotiations between Russia and Armenia, Kazakhstan and Uzbekistan on a new ruble area foundered in November 1993, while discussions between Russia and Belarus and Tajikistan have continued (see section III).

The key requirements for a workable monetary union involving Russia and one or more other states, assuming market-oriented economic systems in each member country, would include:

(1) Reaching agreement among the respective governments and central banks on decision-making responsibilities as well as on procedures for reaching and implementing decisions. In effect, there would need to be a clear definition of the central monetary authority (CMA) of the union. Moreover, the agreement establishing the common currency area should specify a system for monitoring financial and economic data in each member country, and provide for the enforcement of corrective policy actions, all on a timely basis.

(2) The CMA would need to establish and enforce ceilings on the growth of central bank credit in each member country. However, as interstate money markets evolve, enterprise budget constraints are hardened, and bank supervision and prudential regulations are improved, the CMA could simply establish a uniform rate of growth of central bank credit for the currency area as a whole.

(3) In support of limits on the overall growth of central bank credit in each member country, it would be particularly important that ceilings on central bank lending to government in each country be specified. It would also be very important for there to be agreement on the ceiling on the overall deficit of the government in each country.

(4) The agreement on monetary union would need to specify a mechanism for determining interest rate policy. A broadly uniform level of interest rates across the union would be encouraged by setting uniform central bank refinance rates. Also, if the full benefits of monetary union are to be realized, there should be no restrictions on cross-border lending between enterprises, banks or individuals, or on cross-border investments.

(5) There should also be a consistent policy among member states on so-called directed credits (i.e., the allocation of central bank credits at subsidized rates to commercial banks for on-lending on the basis of priority sectors or regions).

(6) To avoid distortions in the interest rate structure, the member central banks should have a common policy on the reserve requirements of commercial banks.

(7) Currency should be provided on demand in each member state. The growth in currency demand in each country would be constrained by the limits on the growth of central bank credit and other factors affecting the demand for currency.

(8) All foreign exchange reserves of the monetary union would be held by the CMA, with national governments only holding working balances. Each government should have free access to reserves (in exchange for rubles at the market rate of exchange) held by the CMA, as needed. Foreign exchange regulations should be uniform across the currency area. Intervention in the exchange market aimed at affecting the level of the exchange rate should only be conducted by the CMA.

(9) There should be a well-functioning payments system both within and between member states, so as to avoid an excessive amount of float or fluctuations in float which could complicate the conduct of monetary policy.

(10) Each member state should evolve a similar system of bank supervision and prudential regulations; and

(11) Clearly defined exit rules should be established which govern the possible withdrawal of a member state from the monetary union. These rules should cover the withdrawal of rubles from circulation, the distribution of the foreign exchange reserves of

the union, and the disposition of any other assets and liabilities of the institutions of the monetary union.

III. Evolving Currency Arrangements Among FSU States

1. The ruble area until July 1993

The issues of economic and financial sustainability as well as the workability of the ruble area quickly came to the fore as the dissolution of the FSU accelerated after the abortive coup of August 1991. In the autumn of 1991, the authorities in many of the emerging states began to view the introduction of a national currency both as a symbol of their independence and a means to establish monetary autonomy. At the same time, many of the emerging states continued negotiations on the outlines of a possible banking union to replace the ruble area under the control of the former State Bank of the U.S.S.R. (Gosbank). The main sticking point in these negotiations appeared to be the first requirement noted above under workability, namely the distribution of decision-making power among the different states and in particular whether Russia would have voting power commensurate with its relative size or on the basis of one state, one vote. In the event, the ruble area states did not come to agreement on a banking union and indeed never did manage to agree--on either a multilateral basis or bilaterally with Russia--on an institutional structure and rules for monetary coordination.

Once Russia announced its intention to embark on its own reform program and to move to world market prices in trade with other members of the ruble area states, 1/ the issue of sustainability of the ruble area also gained prominence. With most other states being net energy importers from Russia--at highly subsidized prices--and given the unwillingness of most of these countries to face major short-term adjustment to the expected terms of trade shock, 2/ the economic fundamentals for an optimal currency area were generally viewed as lacking and the question of sustainability of the ruble area--through some combination of continued implicit trade subsidies and explicit financial transfers from Russia--began to share the spotlight with the workability issue.

Although the Russian authorities were unable to come to a unified view on the desirability of maintaining the ruble area, many officials had become alarmed already in late 1991/early 1992 by both the workability and sustainability issues. In particular, it began to be recognized that unless the new CBR gained control over currency issue to the other states and credit emission by these countries, Russia was likely to sustain the ruble area by de facto balance of payments financing through the CBR's accounts with the other new central banks, while at the same time only exacerbating inflationary pressures in Russia. In late November 1991, the CBR was authorized by the Russian Supreme Soviet to take over Gosbank (as of January 1, 1992), including its currency issuance functions, and in January 1992 the CBR established a system of correspondent accounts with each of the

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1/ See President Yeltsin's speech to the Congress of People's Deputies of the RSFSR on October 28, 1991.
2/ The Baltic states may be seen as exceptions in this regard, although they appear to have been given little choice. Actually, the Baltic states had already made it clear before formal dissolution of the FSU that they wished to leave the ruble area.

other central banks designed to monitor payments flows. Over the next year and a half, the CBR introduced additional modifications in the payments system which, while tending to give it more control over financing, frequently contributed to serious delays in interstate payments. 1/ Moreover, the imposition of limits on CBR interstate lending in July 1992 led to the emergence of de facto separate "noncash" rubles in the other states (i.e., they generally traded at different discounts vis-à-vis Russian deposit rubles depending on the interstate financing needs of the different countries). Although this ended the common currency area, strictly speaking, the CBR continued to emit cash rubles to other members of the ruble area.

Meanwhile, discussions had been continuing among a number of the ruble area members on how monetary policies might be effectively coordinated. On March 30, 1992, seven members of the Commonwealth of Independent States (CIS), including Russia, signed a protocol establishing an Inter-Bank Coordinating Council (ICC) as a first step towards the coordination of monetary policy. While the Russian authorities initially noted their agreement with a set of guidelines for multilateral monetary cooperation discussed at a meeting of the ICC in Tashkent in May 1992, they later indicated their intention to negotiate bilaterally with other states and to press them to choose, by October 1, 1992, between leaving the ruble area or remaining, in the latter case agreeing to accept the monetary policy specified by the CBR.

1/ For more detail, see IMF (1994), Annex 1.

In the meantime, several states had introduced coupons and finally, separate currencies, initially in an attempt to resolve the "cash shortage" that had arisen due to the inability of the printing presses in Russia to keep up with the demand for currency in the highly inflationary environment, and later so as to insulate these economies from high inflation in Russia and the rest of the ruble area. 1/ Estonia introduced the kroon in June 1992, under a currency board arrangement. Latvia, which had introduced a parallel currency, the Latvian ruble, in May 1992, declared this currency to be its sole legal tender in July 1992. The talonas, which had been introduced by Lithuania as a parallel currency in May 1992, was declared sole legal tender in October 1992. 2/ The coupon introduced by Ukraine prior to the dissolution of the U.S.S.R., the karbovanets, was designated as a transitional national currency in November 1992. 3/ (The Kyrgyz Republic introduced its separate currency, the siam, in May 1993 in conjunction with a macroeconomic stabilization program.)

The CBR was able to eliminate the cash shortage in the ruble area in the course of the third quarter of 1992 by the printing of larger denomination bank notes. While the other remaining members of the ruble area were issued 1992 bills with a denomination less than Rub 10,000, currency emission within Russia itself increasingly consisted of new

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1/ For a more detailed chronology of the introduction of new currencies, see IMF (1994), Annex 2. Also see Hernández-Catá (1993).
2/ The Latvian ruble and the talonas of Lithuania were replaced, respectively, by the lats and litas as permanent currencies beginning in June 1993.
3/ Ukraine initially introduced these coupons as a rationing device to stem the siphoning-off of goods to other union republics of the FSU in which administered price increases or the liberalization of prices had proceeded to a greater extent.

Rub 10,000 notes and, beginning in 1993, with new large denomination 1993 banknotes.

Despite the deadline for decision on ruble area membership set by Russia, bilateral discussions proceeded without result. This was very much due to continuing ambiguity about whether and to what extent Russia would be willing to sustain monetary union through a combination of implicit trade subsidies and financial transfers. A new initiative, led by Kazakhstan, resulted in a multilateral declaration at the Heads of State summit in Bishkek in October 1992 which called for coordination of policies in the ruble area. While this meeting led to later agreement--in January 1993--on an Interstate Bank for multilateral settlements, 1/ it did not result in any strengthening of monetary coordination among those states remaining in the ruble area.

In early 1993, the Russian authorities announced that interstate balance of payments financing would no longer be undertaken by the CBR. Henceforth, and only after agreement was reached with Russia on the consolidation of interstate debts arising in 1992 and early 1993, financing would be provided through intergovernmental credits on market terms. This appears to have led to an increased demand for cash rubles by other ruble area states to finance their continuing deficits with Russia. In order to insulate the Russian monetary system from the inflow of cash rubles, the CBR carried out a currency conversion beginning on July 26, 1993. Following amendments to the initial regulations which were designed to remove any

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1/ This agreement was also signed by one country that was no longer a member of the ruble area, Ukraine. For details, see IMF (1994).

confiscatory element, Russians were permitted to exchange--for 1993 rubles--up to Rub 100,000 of pre-1992 banknotes with a denomination less than Rub 10,000 and to exchange 1992 Rub 10,000 bills in unlimited amounts. Other members of the ruble area were left, in effect, with ruble currency which no longer was legal tender in Russia. 1/

2. Post-demonetization developments (August 1993-present)

Following the demonetization of "old" rubles in Russia, some of the states using old rubles decided to push ahead with the introduction of their own currencies while others attempted--for a brief period--to agree with Russia on a new ruble area.

Georgia, in which a coupon had been circulating in parallel with the ruble since April 1993, declared the coupon to be sole legal tender in early August and announced its intention to introduce a new currency, the lyra. Introduction of the lyra has been postponed, however, pending major progress towards political and economic stabilization in that country. Azerbaijan, which had introduced the manat on August 15, 1992 as a parallel currency, declared it to be sole legal tender on January 1, 1994. Turkmenistan introduced its own manat on November 1, 1993 as sole legal tender.

On September 7, 1993 the remaining members of the former ruble area (Armenia, Belarus, Kazakhstan, Russia, Tajikistan and Uzbekistan) entered into a framework agreement which envisaged a revived ruble area after a transition period during which countries other than Russia would continue to

1/ Nonresidents were permitted to convert with the Russian banking system only up to Rub 15,000 in pre-1993 banknotes.

use either old rubles or existing currencies, 1/ or would introduce new, temporary currencies so as to attempt to achieve monetary control pending unification. Within several weeks Russia had signed bilateral agreements with each of the other countries which emphasized issues of workability. The agreements called for the alignment of existing monetary institutions and relevant legislation with those in Russia and the convergence, prior to monetary union, of various monetary and fiscal indicators. Each of these agreements envisaged the CBR as the de facto monetary authority in a new ruble area. The question of sustainability, however, was left open.

Those countries that had signed bilateral agreements with Russia faced considerable uncertainties during this interim period. First, there was the possibility of destabilizing cross-border flows of "old" rubles from other states in the short run. At the same time, but only seemingly paradoxically, they envisioned the possibility of a shortage of old rubles after a few months given their high rates of inflation and the limited supply of recalled old rubles available for reissuance by the CBR. As a result, they pressed for rapid monetary unification so as to insulate themselves from the sea of old rubles surrounding them while ensuring adequate supplies of new, Russian rubles. The terms on which Russia was willing to provide new rubles to these countries 2/ turned out to be unacceptable to Armenia, Kazakhstan and Uzbekistan, and they proceeded,

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1/ Belarus had already introduced the rubel, in May 1992, as a parallel currency.
2/ Belarus was in less of a hurry for monetary unification, since it already had in circulation the rubel.

during November 1993, to introduce their own currencies, respectively the dram, the tenge and the sum-coupon. 1/

Tajikistan, by contrast, stayed with the old ruble, with which it was being inundated with resulting heightened inflationary pressures. In late 1993 it reached agreement with Russia on the shipment of Russian rubles (in return for incurring a collaterized debt to Russia) and continued in early 1994 to negotiate on monetary unification. Belarus effectively has a separate currency but on April 12, 1994 signed an agreement which provided for possible future monetary unification with Russia.

IV. Conditions for Sound Monetary Policy

The evolving currency arrangements and stabilization experience of the former ruble area states over the past 2 1/2 years suggest some important lessons about the necessary and sufficient conditions for establishing monetary control. First, if national authorities are going to seek financial stability through membership in a monetary union, the latter should be credible in several respects:

(1) The common currency area must be sustainable, either on the basis of the economic fundamentals noted in section II(1) or through a stable system of implicit or explicit resource transfers from one or more members to the others. In the case of the former ruble area, the degree of commitment to its sustainability on the part of Russia remained ambiguous for a very long time and has been an important issue during the negotiations

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1/ The Uzbek authorities replaced the sum-coupon with a permanent currency, the sum, in mid-1994.

leading to the recent agreement between Russia and Belarus on monetary union;

(2) The monetary union must be workable. While this was viewed as a central issue by many ruble area states already in late 1991, very little progress was made towards agreeing on the necessary institutional requirements for workability until Russia effectively terminated the old ruble area in July 1993 and entered thereafter into bilateral negotiations with some states on a possible revived ruble area. The recent agreement between Russia and Belarus designates the CBR as the central monetary authority in their proposed monetary union; and

(3) Even with a sustainable and workable monetary union, it would make little sense for a country to join unless there is a strong likelihood that the authorities in the country with de facto monetary authority will have sufficient political support to pursue an effective anti-inflationary policy.

With respect to all three of these considerations, remaining in the ruble area presumably gave little comfort to former ruble area states during 1992-93, at least from the standpoint of achieving price stability. Why then did so many of these states wait so long to introduce national currencies? One reason was that each was only newly independent at the outset, and had inherited a common currency from the FSU. While the former union republic branches of Gosbank had formally become republican "central banks" in August 1990, 1/ and had begun to show increasing independence from Gosbank during the following 12 months, at the time of dissolution of

1/ See IMF (April 1992).

the U.S.S.R. most of them still did not yet possess the capacity to function fully as independent central banks in an increasingly market-oriented environment. Thus, although a number of these states were already debating the pros and cons of separate currencies in late 1991, while continuing to negotiate on a possible post-Soviet "banking union", there was a general awareness that it would take a considerable amount of institution building, technical assistance and policy advice from outside experts before a central bank could assure the orderly introduction of a new currency and the maintenance of its credibility through strong financial policies. There were also limits on how quickly national currencies which could not be easily counterfeited could be designed, printed and delivered. It is significant, in this connection, that even the Baltic states--which from the outset were determined to leave the ruble area--did not introduce new, sole legal tender until mid-1992.

A second reason for delay relates to the above-noted prolonged climate of ambiguity about whether a country continuing in monetary union with Russia would be sustained by Russian transfers. The lack of transparency in interstate balance of payments financing--particularly in 1992--also enabled many of these states to delay needed adjustment to terms of trade shocks. The economic issues appear to have been complicated by a number of geopolitical concerns, including the status of Russian minorities in many of the other countries. All these considerations made it difficult for many countries to come to a definitive conclusion about remaining in the ruble area. With the benefit of hindsight, one might conclude that given the turmoil associated with the ruble area during 1992-93, and to the extent that price stability was a major goal, national authorities probably should have moved as quickly as possible (taking into account the mentioned institutional weaknesses) to introduce a separate currency. But in reality, for most of these states, during much of this period the costs and benefits of such an approach were simply not that clear.

Finally, a word should be said about the introduction of a national currency as a guarantor of domestic monetary control. The experiences of those former ruble area countries which have now had a separate currency for about a year or more have been mixed. The three Baltic states, of course, combined their introduction of national currencies with tight monetary and fiscal policies and managed to bring down inflation sharply. Moreover, these stabilization efforts have been sustained, and the decline in output has been reversed. Stabilization has proceeded more slowly in the Kyrgyz Republic, although inflation has recently been declining. Ukraine, by contrast, recorded the most rapid inflation among former ruble area states in 1992-93 (see table). (It is too early to evaluate adequately the performance of some of the other recent adherents to national currencies.) What these experiences do suggest is that given the circumstances prevailing in the ruble area in 1992-93, the introduction of a separate currency may well have been a necessary condition for domestic monetary stability. It was, however, by no means a sufficient condition. As usual, there is no substitute for a strong central bank and sound financial policies, a subject which is dealt with at length in other papers in this volume.

FSU States: Percentage Change in
Consumer Price Index and Real GDP, 1992-93

Country	Consumer Prices		Real GDP	
	1992	1993 1/	1992	1993 1/
Estonia	1,069	89	-19.3	-3.3
Latvia	951	109	-33.8	-10.0
Lithuania	1,021	410	-38.0	-16.0
Armenia	724	...	-52.0	-28.1
Azerbaijan	616	833	-22.6	-13.0
Belarus	969	1,188	-11.0	-11.7
Georgia	888	...	-43.4 2/	-40.0 2/
Kazakhstan	1,381	1,557	-14.0	-12.0
Kyrgyz Republic	854	1,209	-18.0	-16.0
Moldova	1,276	1,968 3/	-21.4	-15.0
Russian Federation	1,353	896	-19.0	-12.0
Tajikistan	1,157	2,195	-30.0	-27.6
Turkmenistan	493	3,103	-5.0	-7.6
Ukraine	1,210	4,735	-17.0	-14.0
Uzbekistan	528	851	-9.5	-2.4

1/ Preliminary staff estimates. Unless otherwise noted, consumer price changes refer to the period average.
2/ Percentage change in real NMP.
3/ December 1993 over December 1992.

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