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December 8, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Interstate Monetary and Payments Arrangements in the *Former Soviet Union*

There is attached for the information of the Executive Directors a paper on monetary and payments arrangements in the former Soviet Union. This paper also provides background material for the Executive Board discussion of the review of developments under the stand-by arrangement for the Russian Federation (EBS/92/198, 12/1/92), which is tentatively scheduled for discussion on Friday, December 18, 1992.

Mr. Sundararajan (ext. 38573) or Ms. Cheasty (ext. 38706) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

Interstate Monetary and Payments Arrangements in the Former Soviet Union

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Contents

SUMMARY

The purpose of the paper is to present an overview of the nature of the monetary and payments problems in interstate relations, and of the solutions which are being sought.

In the past several months, Estonia, Latvia, Lithuania and Ukraine have left the ruble area and issued their own currencies. Some other states, such as Azerbaijan and Moldova, have announced their intention to introduce a separate currency. However, there is still no single monetary authority for the countries which continue to use the ruble. This has imparted an inflationary bias to the system, because each state has an incentive to expand credit faster than the average. The present system cannot continue, and each country in the area will now have to decide between two clear alternatives: remaining in a single currency area with a common monetary policy, or introducing a separate currency.

Interstate payments are slow and inefficient because of various features of the basic clearing and settlement systems of individual FSU countries and the congestion resulting from the centralization of interstate payments through central banks. In addition, payments restrictions by Russia to limit interstate credit to deficit states have contributed to further payments disruption. Possible solutions to the payments difficulties would involve: (i) the credible separation of interstate payments from interstate credit arrangements; (ii) the reform of the domestic clearing and settlement system of FSU countries; (iii) the decentralization of payments through correspondent banking; and (iv) the development of appropriate means of multilateral settlement between FSU countries, including transitional arrangements.

Since late 1991, Fund management and staff have been involved in a variety of efforts, both bilateral and multilateral, to improve monetary and payments arrangements among the countries of the FSU. The staff has sought to encourage agreement among states of the FSU on monetary and payments issues, and to contribute to the development of an efficient payments system. On the currency issue, the staff has recently been recommending that, while making every effort to make the ruble area work effectively, the case for and against the separate currency option be examined objectively, and preparations to introduce a new currency should be made, at least on a contingency basis. On payments, the staff will continue to:

--encourage the formalization of interstate credit arrangements, and their separation from payments arrangements;

--provide assistance in the setting-up of the interstate bank;

--in collaboration with co-operating central banks and other international organizations, provide technical assistance on the reform of payments systems;

--advise on measures which will lead, in due course, to a greater decentralization of payments through correspondent banking.

I. Introduction

In addition to the extraordinarily difficult policy problems they confront in reforming their own economies, the countries of the former Soviet Union (FSU) have faced serious difficulties in their mutual economic relations. The main issues fall into three areas: monetary and credit policies; the payments system; and interstate trade. The serious problems that emerged in these areas since the breakup of the U.S.S.R., and which remain largely unresolved, are closely interrelated. For example, the inefficiency of the payments system has exacerbated the decline in interstate trade--resulting from the overall decline in economic activity, the demise of central planning and the proliferation of interstate restrictions on trade. Also, the difficulties resulting from the failure to coordinate monetary policy in the ruble area prompted the Central Bank of Russia to impose restrictions on the extension of credit to other central banks in the area. Under the present system, where interstate credit extension and payments processing are closely linked and heavily centralized, this has further disrupted interstate payments, with additional adverse effects on trade.

These problems among states of the FSU have seriously compounded the difficulties faced by policy makers within each country. The absence of an effective system of policy coordination among the newly independent central banks has imparted an inflationary bias to domestic monetary policies in the ruble area. And the continued fall in interstate trade has compounded the drop in domestic production. The uncertainty created by the lack of a single monetary authority also has complicated the negotiation of Fund programs with members of the ruble area. It is now clear that to undertake successful stabilization programs these countries must choose between issuing their own currency or remaining in a unified ruble area with a common monetary policy. Unless a prompt decision is made between these two alternatives, the urgent task of avoiding hyperinflation and stabilizing macroeconomic conditions in the area will be seriously complicated, and the prospect for early agreement with the Fund will be compromised.

This report is intended to inform the Board about the nature and the current status of the monetary and payments problems, to describe current efforts to resolve them, and to delineate possible solutions. 1/ The *staff believes that a workable solution to these problems needs to be found* urgently. While it continues to encourage cooperative solutions and to provide technical assistance, the staff recognizes that its ability to influence issues related to international economic relations among sovereign countries of the FSU is limited. In these circumstances, the views of the Executive Board would be especially valuable in formulating the strategy the Fund staff should pursue over the coming months.

1/ The paper deals predominantly with monetary and payments issues in the ruble area. It does not focus directly on interstate trade or on monetary and exchange policy after the introduction of new currencies.

The report is organized as follows. Section II deals with monetary and credit issues among the states of the FSU. It examines major developments in 1992, including the evolution of credit arrangements among central banks, the ruble currency shortage and the introduction of separate national currencies and/or parallel currencies in certain states. It defines the major problems that must be resolved in the area of interstate monetary cooperation, and proposes possible solutions. Section III deals with interstate payments arrangements in the FSU; it outlines the possible reforms to strengthen such arrangements as part of the overall payment system reforms. Section IV concludes the report and discusses the role that the Fund could play in helping to improve monetary and payments arrangements among countries of the FSU.

II. Monetary Arrangements

1. Recent developments and current situation

In the closing days of the Soviet Union the old Gosbank system was replaced by a more decentralized system in which the main branch of the Gosbank in each of the newly independent states of the FSU was transformed into a central (or national) bank. This led to uncoordinated monetary policy among the states, with each central bank independently extending credit to the Government and to commercial banks, setting reserve requirements, and determining the level of its lending rate, although changes in these policy variables often required approval from Parliament. The room for manoeuver available to the new central banks was initially limited in that the Central Bank of Russia (CBR) took over the sole power of issuing ruble currency, as all the printing presses were located in the territory of the Russian Federation. Nevertheless, the non-Russian central banks were able to finance different rates of domestic credit expansion by borrowing from the CBR, by creating bank reserves or, in some cases, by issuing parallel currencies (coupons).

In attempting to isolate themselves from the relatively tight credit policy of the CBR in the early months of 1992, several of the new central banks adopted divergent credit and interest rate policies. 1/ While a number of central banks pursued a restrained monetary policy in the first half of 1992, others, including the National Bank of Ukraine, expanded domestic credit at a very rapid pace, thus contributing to inflationary pressures in the ruble area as a whole. Over time, most central banks in the ruble area adopted expansionary credit policies to increase their shares of the seignorage and the inflation tax. As previously mentioned, credit expansion in states, other than Russia, was financed in part by borrowing from the CBR, which provided automatic financing of payments imbalances

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1/ By way of example, in July 1992 central bank lending rates (finance rates) ranged from 12 percent per annum in Azerbaijan and Georgia to 80 percent in Russia.

through the correspondent accounts of other central banks with the CBR. At the end of June the CBR had accumulated a net credit balance of rub 316 billion vis-a-vis other states of the FSU (more than 80 percent of CBR credits to Russian commercial banks during January-July). 1/ The underlying payments imbalances of many of these states were boosted during the course of 1992, as Russia raised the prices it charged on oil exports.

In order to insulate monetary conditions in Russia from the actions of other central banks in the ruble area, and limit CBR financing of payments imbalances, the CBR changed the technical arrangements for interstate payments on July 1, 1992, as discussed in Section III of this report. In particular, credit provision to other central banks through the bilateral correspondent accounts was to be tightly limited by the size of "technical" credits specified by the CBR. In spite of these restrictions, credit expansion to other central banks remained substantial: from July 1 to mid-September the CBR extended new technical credits of rub 214 billion to other states and financed overdrafts (beyond the technical credits) of rub 102 billion, bringing Russia's net ruble asset position to rub 632 billion. However, the restrictions were sufficient to constrain the ability of other central banks to finance incipient payments imbalances in full by borrowing from the CBR. Moreover, given the bilateral structure of payments and credit arrangements, deposit ("noncash") rubles earned in one state could not be used to make payments in another state. As a result, the ruble deposits issued by banks in various states are now being exchanged at exchange rates that differ from par, giving rise to a *de facto* segmentation of the market for deposit ("noncash") rubles within the area, 2/ even while the same cash ruble continues to circulate in all countries and to be exchangeable at par for deposit rubles.

While credit policies in various countries, including notably Ukraine, and evolving interstate arrangements have played an important role, monetary conditions and inflationary pressures in the ruble area have been influenced primarily by the stance of monetary policy in Russia. Credit expansion by the CBR was relatively restrained in the first quarter of 1992 and, albeit to a lesser extent, in the second quarter. Moreover, the CBR's finance rate was raised in two steps from 20 percent in March to 80 percent in June. In the third quarter, however, CBR credit expansion accelerated sharply, owing partly to a rise in the financing requirement of the Government, but also to

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1/ Including net claims of rub 159 billion on Ukraine, rub 47 billion on Kazakhstan, rub 20 billion on Belarus, and rub 18 billion on Turkmenistan. These figures include items in transit from the CBR to other central banks, but exclude items in transit from the other states to the CBR. Inclusion of the latter amounts (if they were known) would raise Russia's net credit balances. Also, these net claims exclude the counterpart of ruble currency issued by the CBR to other states in the ruble area.

2/ For example, on November 30 the selling rates quoted by the Bank of Latvia were LR 0.22 for ruble claims on Kazakhstan, LR 0.24 for claims on Ukraine, LR 0.35 for claims on Belarus, and LR 0.4 for claims on Russia.

increased lending to Russian commercial banks and to other central banks in the ruble area. The finance rate of the CBR was kept at 80 percent (a significantly negative level in real terms) and a large share of CBR credit to banks was extended to specific sectors at interest rates that were heavily subsidized by the Government.

The evolution of monetary policy in Russia was reflected in the behavior of inflation and of the exchange rate. Following a surge in January in connection with price liberalization, the monthly rate of increase in Russian consumer prices fell from 27 percent in February to 7 percent in July before rising to around 30 percent in October. The nominal value of the ruble rose from an average of rub 204 per U.S. dollar in January, to rub 122 per U.S. dollar in June, but it has dropped since then to rub 427 per U.S. dollar in November.

Financial conditions in the ruble area were complicated by a number of developments including the shortage of currency and the use of coupons by some countries. The shortage of cash rubles affected all the countries in the area (including Russia), but its intensity varied among countries as the geographic distribution of currency was uneven. 1/ The shortage gave rise to serious difficulties in paying salaries and pensions, given the predominant role of cash in financing household transactions in the countries of the FSU. The currency shortage apparently has all but disappeared in recent months as the Central Bank of Russia began issuing large denomination ruble banknotes in July.

In January 1992 Ukraine introduced multiple use coupons which were allowed to circulate in parallel with ruble currency. Other countries, including Azerbaijan, Belarus, Latvia, Lithuania, and Moldova also introduced coupons or other types of parallel currencies. In general, the rationale for these measures was to mitigate the shortage of cash rubles, although some countries also sought to liberalize prices at a slower pace than in Russia. In some cases, coupons were declared sole legal tender for certain transactions, such as purchases in state stores or transactions in border areas. The unrestrained emission of coupons by some states, exacerbated by restrictions on the use of ruble currency, resulted in the dumping of excess ruble balances in neighboring states to purchase goods, often leading to the imposition of export controls by those states. The influx of rubles from other states also prompted some countries to introduce their own coupons and to consider the option of a separate currency.

1/ For example, Russia's share of ruble currency issued rose from 64 percent in December 1991 to 77 percent in June 1992 while the shares of Belarus and Georgia dropped from more than 3 percent to about 1 1/2 percent. The shares of Ukraine and the Baltic states dropped even more sharply, but these countries were by then supplementing ruble currency by issuing coupons.

In the past several months, a number of states have left the ruble area and introduced their own currency. On June 20, Estonia introduced the *kroon* which was pegged to the deutsche mark in the context of a currency board arrangement. On July 20 the *Latvian ruble*, previously circulating as a supplementary currency, was declared the sole legal tender in Latvia and was allowed to float against other currencies, including the ruble. On October 1, Lithuania declared that previously issued coupons (the *talonas*) would become the sole legal tender pending the introduction of a new currency, the *litas*; the value of the *talonas* is floating in foreign exchange markets. Finally, in November Ukraine declared that the coupon (under the new name of *karbovanets*) would be the sole legal tender and would be exchanged for U.S. dollars on the basis of competitive bidding among commercial banks. The *karbovanets* would be subsequently replaced by a national currency, the *hryvnia*.

Some of the states that remain in the ruble area, such as Azerbaijan and Moldova, have announced their intention to introduce a separate currency. 1/ Several others, while still reserving their positions, are making preparations for a possible departure from the area and, in some cases, have arranged for the printing of a national currency. These countries are weighing up several factors: favoring the separate currency option are concerns about the stability of the ruble, the prospect of an independent monetary and exchange rate policy and the desire for a distinct national symbol; on the other hand the ruble area option is favored (at least as a transitory solution) by the desire to maintain existing interstate arrangements in the areas of trade, credit and energy pricing including in particular the fear that the price charged for oil imports from Russia would increase sharply; and, in some cases, by a perception that it could take some time to create the institutional conditions required to pursue effectively an independent monetary policy.

2. Problems and possible solutions

The central problem has resulted from the continuation of a single currency area *without* a single monetary authority. Since the demise of Gosbank there have been 15 (and more recently 10) independent central banks, all willing and able to issue ruble credits. In such a framework, each state has an incentive to expand credit faster than the average in order to maximize its share of the inflation tax--the so called free-rider problem. Of course, the inflationary consequences of this problem are seriously aggravated if the leading central bank--the CBR--pursues highly expansionary credit policies, as it has since July 1992.

Since the beginning of 1992 there have been several attempts to build a viable framework for monetary management in the ruble area, including the

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1/ Azerbaijan has indicated that the *manat*, introduced as a parallel currency in mid-August, will become the sole legal tender on February 1, 1993.

Fund's initiative for multilateral coordination of monetary policies (presented in May at the Tashkent meeting of the Council of Central Banks), several bilateral agreements negotiated subsequently at the initiative of Russia, and the multilateral agreement reached between Heads of State in Bishkek on October 9 which called for the establishment of an Interstate Bank (ISB). In spite of these attempts, the fundamental problem of monetary policy coordination in the ruble area remains unresolved. In the meantime, credit expansion has been unrestrained, inflation has accelerated sharply, and the value of the ruble in foreign exchange markets has plummeted. In addition, different non-cash rubles have emerged, and interstate trade and payments have been disrupted, as discussed more fully in Section III.

The present situation should not be allowed to continue. Each country in the area should now decide between two clear alternatives: (i) to remain in a single currency area with a common monetary policy; or (ii) to introduce a separate currency. There are no other viable alternatives. Previous attempts to reach agreement on rules to coordinate monetary and credit policies among central banks (for example, along the lines proposed by the Fund staff in Tashkent) have not succeeded. Moreover, a system such as the present one, based on limits on the central banks' correspondent accounts *without* a common and disciplined credit policy, is inherently unsustainable. It does not permit the control of inflation and the stabilization of the currency and inevitably leads to the proliferation of restrictions and the breakdown of trade.

Under the first option, countries would have to agree on clearly defined mechanisms for the pursuit of a *common* monetary policy, with only *one currency* (whether in cash or noncash form) circulating throughout the area. This would require that credit emission be determined by a *single* authority empowered to impose strict limits on credit expansion for the area as a whole. It would also require the harmonization of foreign exchange systems, central bank finance rates and commercial bank reserve requirements and other monetary operations throughout the area. Moreover, a degree of coordination between fiscal policies would be necessary to ensure that budgetary targets were consistent with the approved credit ceilings.

Whether the execution of a unified monetary and credit policy is left to an interstate monetary institution or to the CBR is a political matter to be decided by the sovereign states involved. What is essential for the survival of a single currency area is that the responsibility for a common monetary policy be squarely in the hands of a single authority. This monetary authority should be responsible for providing adequate information to all central banks in the area on all important decisions regarding monetary, credit and exchange rate policy. In addition, as long as it continued to be the only supplier of cash rubles, the Russian Federation would need to provide assurances that the demand for ruble currency in other countries would be satisfied and that the seignorage would be equitably shared.

Under the second option, plans would have to be made to ensure the orderly introduction of new currencies (and the orderly withdrawal of ruble currency) in a way that minimized disruptions to the countries themselves and to their neighbors. Additional efforts also would be necessary to create the institutions and acquire the expertise required to conduct independent monetary and exchange rate policies and to manage international reserves. Important decisions also would need to be made about the exchange regime (whether to allow the new currency to float or to peg the exchange rate, and if so to what currency or group of currencies), and rules would have to be adopted regarding the new currency's convertibility into foreign exchange. Whatever the exchange rate arrangements adopted, the authorities would need to implement rules and procedures necessary for the conduct of an anti-inflationary monetary policy.

Whether or not it remains in the ruble area, each state, including in particular Russia, will have to aim monetary policy (with support from fiscal policy) squarely at the objective of containing inflationary pressures, which have now reached alarming proportions, and then to reduce inflation as rapidly as possible to levels comparable to those prevailing in industrial countries.

III. Payments Arrangements

The current difficulties with the interstate payments systems in the FSU reflect a number of factors. First, Russia, a large structural creditor vis-à-vis other countries, centralized the processing of interstate payments and placed restrictions on payments in order to limit interstate credit to deficit states. This has contributed to a major disruption of interstate trade. Second, the payments system in the FSU was always slow and relatively inefficient as it was mostly based on gross settlement of individual payments designed to monitor each payment or batch of payments rather than facilitate reliable and timely settlements. The growth in the number of banks and the volume of payments, outmoded paper-based methods of transferring funds using mostly postal services, and detailed accounting and reconciliation procedures have slowed the system, causing delays in settlement. Delays have been further compounded by the congestion due to the recent centralization of inter-state payments processing. Third, until mid-1992 the continued acceptance of payment demand orders as the principal payments instrument--request to pay by payees following shipment of goods--which allowed the transmission of payment requests without regard to the financial condition of payers aggravated the buildup of interenterprise arrears, including across borders. The processing of these accumulated payments under a recent scheme to clear interenterprise and interstate arrears has, at least temporarily, further increased congestion and delays in the payments system.

1. Interstate payments arrangements

With the institution by the CBR on January 1, 1992 of correspondent accounts for each central bank in the FSU, the CBR was able to measure for the first time the size of each country's payments imbalance with Russia. 1/ The CBR required that all cross-border payments (including the supply of cash rubles) be made through these accounts. However, Russia's balance of payments with other states remained difficult to monitor closely, because payment centers in some 1,400 sub-branches of the CBR continued to process interstate payments independently and automatically, and the consolidation of accounts from all the sub-branches was subject to delays. 2/

Concerned about the buildup of net claims on other states and the lack of control over its financing, the CBR initially modified the interstate processing system as of April 1, 1992: sub-branches were instructed to send interstate payments--both incoming from other states and outgoing--to the CBR's 82 main branches, which would process them and pass on the funds to ultimate payees in Russia and other states. However, this change increased the volume of payments processed in the main branches, and caused serious backlogs that affected all payments, especially in Moscow and St. Petersburg, as the main branches were not equipped for processing the additional flow of documents. This centralization of interstate payments processing improved the monitoring of the correspondent accounts, but not the control over the financing of the balance of payments. Payments continued to be processed automatically leading to uncontrolled extension of interstate credit.

In order to control the growth of interstate credit through the correspondent accounts, on July 1, 1992, the CBR instructed its main branches to further centralize all interstate payments through one Moscow office, and created a new system of bilateral correspondent accounts under which payments from another state cannot be processed unless that state is either running a payments surplus with Russia or has negotiated a "technical credit" with Russia to finance its payment deficit. This quickly led to blocking of payments from states which had exhausted their credit limits. Most other central banks also similarly set up centralized processing of

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1/ In the USSR payment system, each branch of the Gosbank had correspondent accounts with virtually every other branch, so that it was always possible to know whether a given branch was in deficit or surplus with the rest of the Gosbank. However, the system was not set up to track "regional" balance of payments as opposed to "branch" balance of payments.

2/ The accounts of the sub-branches were consolidated by the CBR only once a month with a lag of two to three weeks. From the point of view of the branches, the new correspondent account system simply meant that accounting had changed, and not the processing of payments.

interstate payments and a set of bilateral payments arrangements emerged. 1/

The blocking of payments based on credit limits in correspondent accounts of central banks arbitrarily restricts interstate payments regardless of whether the underlying transactions are viable. Often, the blocking of payments becomes known only ex post after goods have been shipped. The abrupt stoppages of payments, and the consequent disruption to producers, has deepened tensions between Russia and other states. Also, as noted in Section II, the new procedures failed to curb excessive credit expansion in the ruble area. Technical credits and overdrafts were often granted in an ad hoc manner, to unblock payments in response to short-term political exigencies, rather than as part of a coherent monetary program. Exchanges of non-cash rubles through unorganized markets provided some relief insofar as it created an alternative mechanism for transferring interstate claims to the queuing of payments in the centralized system.

After the July 1, 1992 reform, the CBR Moscow office in charge of interstate payments became overwhelmed by the flow of unfunded payments because of the unwillingness of the central banks with insufficient lines of credit to take responsibility for queuing their own payments. The office also receives continuous requests from Russian payees to give priority to processing their payments when funds become available. 2/ These problems compounded the existing difficulties in the payment system inherited from the Gosbank. The system had been strained in general by the rapid multiplication of banks, growing volume of payments, errors in the processing of payments, and lingering problems of payment fraud to take advantage of the delays between settlement and verification, and poor security standards. The CBR has in recent months brought these problems under some control by mobilizing additional staff and improving transportation arrangements and has been working on a medium-term strategy to automate payments processing. However, payments system initiatives in individual FSU states remain uncoordinated, with potential for difficulties in future interstate payments transactions.

Except for the processing of interstate payments in the Moscow office, where backlogs persist, the payments system within Russia has regained a degree of stability and reliability. Payments in Moscow, which represent 70-80 percent of the value of payments in Russia, settle in no more than two days. Documents between any two main CBR branches travel for no more

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1/ Some other states have also placed limits on the level of claims they are willing to hold on certain deficit states.

2/ Taking into account difficulties in locating these priority payments in a manual processing environment, payments may take several weeks to reach a payee in Russia.

than 72 hours. 1/ The transportation of interstate payments between the central banks, and between a given central bank and the domestic payee, have also been considerably streamlined by the use of dedicated couriers from the military. Despite these improvements, the problems of a large float persist, facilities for large value payments are inadequate, and operating procedures and regulations remain weak. These problems affect the speed and reliability of both domestic and interstate payments, and weaken monetary control. Moreover, restrictions on interstate operations of commercial banks have limited the development of decentralized payments arrangements through correspondent banking.

Further efforts to strengthen the interstate payments system are underway, in the context of defining the objectives and functions of the proposed Interstate Bank. Its primary objectives, which are still under discussion among FSU states, include multilateral clearing facilities for members, some credit arrangements to facilitate settlements, and promotion of an efficient interstate payment system.

2. Possible improvements

Possible solutions to the payments difficulties would involve: (1) the credible separation of interstate payments from interstate credit arrangements; (2) the reform of the domestic clearing and settlement systems of FSU countries; (3) the decentralization of payments through correspondent banking; and (4) the development of appropriate means of multilateral settlement between FSU countries, including transitional arrangements.

a. Credit arrangements

A major problem with the present system is that balance of payments problems are concealed until it is too late to adjust smoothly, and restrictions then have to be imposed. Countries' willingness to adjust would be enhanced if interstate credit arrangements were formalized and separated from payment arrangements, thus making the financing constraint more transparent. The terms of the credit lines currently provided by the CBR through the correspondent accounts are ill-defined: interest rates were initially set at the CBR refinancing rate but were subsequently reduced to zero; repayment dates have been set and reset on an ad hoc basis; and credit limits have been increased frequently, in many instances on political grounds. Procedures need to be developed for the extension of credit to meet chronic balance of payments deficits through channels other than the

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1/ The time between any main branch and any district level branch however depends on local conditions which so far are difficult to assess as there are no data on local payment float.

payments systems. Explicit arrangements for inter-government extensions of credit are clearly desirable in all monetary arrangements. 1/

Under the present unsettled ruble area, the prospects for adjustment could also be improved through other mechanisms:

(1) Arrangements for multilateral clearing of ruble payments through central bank correspondent accounts should be established (for example, through the proposed ISB), and this should be supported by facilities for the transfer of settlement balances and reserve assets among central banks based on agreed interest rates (an inter-central bank credit facility).

(2) Graduated interest rates could be charged on debit balances of central banks in their correspondent accounts as a way to impose financial discipline.

(3) Pressures arising in the correspondent accounts must be allowed to influence quickly and reasonably automatically domestic monetary conditions including through adjustments in central bank discount rates and other monetary operations. For this purpose, various types of early warning arrangements should be devised. Such arrangements include the development of short-term information systems to monitor inter-state monetary and balance of payments developments, and incentives to adjust policy instruments and obtain settlement balances in correspondent accounts based on this information.

b. Reform of the clearing and settlement system

The smooth functioning of the current interstate payments system and the eventual development of decentralized payment arrangements through correspondent banking require that the payments system in each state be strengthened. A good payments system should be reliable and efficient, i.e., it should handle payment transactions rapidly, accurately and in a cost effective manner. Standardization of payment documents and message formats is particularly important in this regard, as it allows more rapid processing and can reduce errors. The system should be based on transparent rules and regulations on access to the system and on the sharing of risks and losses.

In most countries, payments among individuals, enterprises, and government are generally cleared and settled through the commercial banks,

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1/ For example, as a means of encouraging the formalization of inter-government credit facilities, and indeed to put credit decisions on a more rational economic footing, the major creditor states--in particular Russia--should be brought into the international creditor/donor community via the Consultative Group (CG) process. Such a move would help the FSU states to view interstate credit in the same light as external hard currency financing.

often involving a netting of payments through clearing houses. The commercial banks typically have accounts at the central bank which are used for settling their mutual positions. In contrast, in most FSU countries, netting arrangements through clearing houses are underdeveloped, creating congestion at the central bank processing facilities. In addition, in Azerbaijan, day-to-day settlement of mutual positions of banks in the central bank's books has not yet been established, with potential for uncontrolled credit expansion.

The clearing and settlement of foreign exchange transactions in market economies are largely carried out by commercial banks accessing domestic payments systems. For this purpose, each bank must have a branch or correspondent in the country of each currency used for settlement. This traditional international payments system has proved to be very flexible and is able to support different types of exchange regimes and international settlement procedures. However, restrictions on interstate operations of commercial banks in FSU states have limited the development of such arrangements. For example, until recently, banks in the Russian Federation have generally not been allowed to open correspondent accounts with banks in other FSU states, even though they were allowed to operate correspondent accounts in Russia for banks in other states.

Against this background, there are four major areas in which payments system reform needs to be expedited.

(1) Priority should be given to processing large value payments using initially the existing infrastructure, including transfer by telephone with appropriate authentication procedures. Transportation schedules, such as the one already implemented with dedicated couriers from the military, would have to be further streamlined. These reforms would support timely settlements that are needed to foster money and foreign exchange markets, and speed up interstate payments.

(2) Rules and regulations need to be introduced so that participants can focus on the timing of processing and on the associated payment risks. The central banks should introduce availability schedules which reduce payment float by synchronizing the timing of debiting and crediting the banks' reserve accounts. This would, inter alia, facilitate liquidity management for commercial banks, and reduce the size of credit float (amounts debited, but not yet credited). 1/

(3) New procedures for payments, such as netting through the establishment of clearing houses under appropriate supervision, should be introduced, as well as new accounting and reconciliation procedures to manage the risks.

1/ The expansionary effect of the reduction in credit float would have to be offset by other monetary policy instruments.

(4) These urgent reforms should be implemented in the framework of a medium-term strategy for the modernization of national payment systems based on automation and electronic communications, appropriate coordination to ensure interstate compatibility of systems, and a clear specification of user requirements, and of the extent of the operational presence of central banks in the payments process. A National Payments Council, comprising an interdepartmental team of the central bank and a core group of large users, should be established to prepare the introduction of new payment instruments, operating procedures, and document standards; to develop the capability of banks to assess risks; to design systems for managing risks; and to coordinate the automation and modernization of the system.

c. Decentralization of payments

In all monetary arrangements, the functioning of the interstate payments system would be improved through correspondent banking between commercial banks from different FSU states, authorized on a symmetrical basis. This requires elimination of some of the current restrictions on interstate banking. In addition, interbank credits across borders could be encouraged--within prudential limits--by central banks by promoting trade financing instruments. In the case of separate currencies, this decentralization of payments through correspondent banking, supported by the development of exchange markets, would promote the convertibility among FSU currencies and reduce the inefficiency of the current centralized system. However, such decentralized arrangements would require supporting institutional framework and operational facilities, including commercial bank risk management procedures, bank supervision rules to contain interbank and foreign exchange exposures, and a minimal program of strengthening of domestic payments systems, as already discussed.

The above discussion suggests that the development of decentralized arrangements through correspondent banking will not be able to replace in a short time period the existing trade and payments system. First, it will take time to develop the necessary institutional framework and the supporting operational arrangements. Second, for countries remaining in the ruble area, the final settlement of surplus and deficit will continue across the accounts of the central banks of different republics. Uncertainty that these payments could continue to be delayed or blocked could inhibit the development of correspondent banking. Third, even for countries in the FSU with separate currencies, it is unlikely that a large part of transactions could immediately be channeled through a decentralized system. For these reasons, efforts to improve the official clearing and settlement arrangements between central banks of the FSU appear essential while moving ahead with the development of more market oriented arrangements.

d. Multilateral payments arrangements

If countries agree to clearly defined mechanisms for the pursuit of a common monetary policy, with only one currency, all interstate payments could be processed automatically with ex post settlements among central banks. A multilateral clearing arrangement among central banks would therefore not be necessary.

With separate currencies, a multilateral clearing arrangement would also not be necessary if the currencies were convertible and payments took place between commercial banks in different states. And it should be a primary objective to establish current account convertibility for each currency. But, even if convertibility is achieved, a multilateral clearing system through an interstate bank (ISB) would be a useful interim measure until decentralized payment arrangements became more developed.

A multilateral payments arrangement between central banks would improve the efficiency of payments between republics of the FSU, compared to the existing bilateral arrangements, by allowing for multilateral netting of payments. This netting would economize on the size of credit lines or convertible currencies that would be used in final settlement. This would allow some economizing on hard currency reserves and thereby facilitate the establishment of convertibility with non-FSU countries. Multilateral netting can accommodate the use of different national currencies by members of the arrangement, although this would involve exchange rate risks. The main features and experiences with multilateral clearing arrangements are reviewed in the Annex.

Multilateral arrangements have faced a number of common problems which have damaged participants' confidence in the arrangements. These problems include the periodic emergence of arrears, structural balance of payments problems leading to conflicts of interest between members as to the design of the arrangements, and foreign exchange risks. This underscores the importance of speeding up progress in developing efficient payment arrangements through commercial bank correspondent accounts supported by either well functioning foreign exchange markets in the case of FSU countries with separate currencies, or a well functioning common ruble area arrangement. It also shows the applicability in the specific case of multilateral clearing of the general point above about the separation of credit from payments arrangements: the credit limits in a multilateral system should be strictly limited to cover only technical fluctuations in the flows of payments, and balance of payments financing should be managed separately. This would reduce the risk that balance of payments problems were hidden until it was too late for orderly adjustment.

If the monetary system remains unsettled, the potential benefits of multilateral payments arrangements will be only small compared to the current bilateral system. Thus, while necessary, payments system reforms cannot substitute for progress toward a clear definition of monetary arrangements as expeditiously as possible.

IV. Conclusions and Role of the Fund

Since late 1991 Fund management and staff have been involved in a variety of efforts to improve monetary and payments arrangements among the countries of the FSU. Fund staff have participated in a number of conferences and meetings involving official representatives of these countries in which the key problems and possible solutions were discussed. In particular, specific proposals submitted by Fund staff were instrumental in forging a consensus on the appropriate rules to be followed during the introduction of separate currencies. In addition, Fund staff provided considerable technical advice to member countries implementing monetary reforms, notably prior to the introduction of the Estonian kroon and the Latvian ruble. Fund staff also participated in several meetings of the Council of Central Banks. The staff submitted its own proposals for monetary cooperation in the ruble area and commented in detail on several bilateral agreements between Russia and other countries in the area. Recently, Fund staff participated in two interstate meetings of government and central bank experts on the establishment of an Interstate Bank, and contributed to the drafting of a charter setting out the structure and operations of the Bank. Fund staff, with the support of several cooperating central banks and international organizations, also helped to promote interstate coordination of payments initiatives by organizing a training seminar on technical payments issues for senior officials of the FSU.

Throughout this process, the key objectives pursued by the Fund staff have been: (i) to encourage agreement among members of the ruble area on monetary and payments issues, emphasizing that these arrangements should be cooperative, fair and, most importantly, that they should provide a solid basis for an anti-inflationary monetary policy; (ii) to ensure that new currencies are introduced in a way that deals with the legitimate concerns of both the issuing country and other states in the FSU; (iii) to contribute to the development of an efficient interstate payments system by providing technical assistance to strengthen the central banks' monetary and foreign exchange operations, to improve clearing and settlement systems and to establish the prudential controls needed to support direct settlements between commercial banks; and (iv) to promote the ultimate integration of the regional payments system into a fully multilateral international system.

These objectives remain valid. On the currency issue, the staff has emphasized that the choice between remaining in the ruble area and issuing its own currency belongs to each sovereign state. Given the serious inadequacy of existing arrangements, a clear decision between these two options is a precondition for adopting a mechanism of effective monetary control and for the success of macroeconomic stabilization. However, the experience of the past year has underscored the difficulty of agreeing on a cooperative approach to policy coordination in the ruble area. In the light of that experience and continued instability of the ruble, the staff is recommending that, while making every effort to make the ruble area work effectively, the case for and against the separate currency option should be examined objectively, and preparations to introduce a new currency should be made, at least on a contingency basis.

Subject to guidance from the Executive Board, the staff will continue to work, both through its bilateral contacts with individual members and by participating in multilateral meetings, on solutions in the monetary and payments areas. On the currency issue, it will urge early decisions between the two options, taking account of their relative virtues. It will indicate that, whatever the decision, the Fund will continue to assist each country to achieve its economic objectives while contributing to macroeconomic stabilization throughout the area.

The staff will continue to provide assistance in the setting up of the ISB. In that context, the staff will stress that the ISB should initially concentrate on multilateral clearing and settlement issues, that settlements should take place in convertible currency so as to impose a binding budget constraint on the participants, that the participation of commercial banks in channelling payments through the ISB should be voluntary, and that the ability of the ISB to extend settlement credit should be tightly limited. The staff will continue to examine the jurisdictional implications of interstate payments arrangements under the Articles of Agreement.

The staff will continue to encourage the formalization of interstate credit arrangements, and their separation from payments arrangements. This will help to make the balance of payments constraint more transparent and thus encourage adjustment before the constraint becomes binding and resort is taken to restrictions.

The staff will advise on measures which will lead, in due course, to a greater decentralization of payments through correspondent banking.

Finally, the staff--in collaboration with cooperating central banks and other international organizations--will continue to provide technical assistance on the reform of payments systems, including systems for large value transfers, improved transportation and availability schedules, new payments procedures and regulations, and a medium-term strategy for modernizing national payments systems.

Experiences with Multilateral Clearing Arrangements

The FSU states are considering the establishment of an Interstate Bank, whose functions would include multilateral clearing of interstate payments. While the detailed operational arrangements for such clearing are still being discussed, as background, this annex summarizes the main characteristics and experiences with official regional arrangements for multilateral clearing.

Most of the official regional arrangements handle a relatively small volume of total payments reflecting, inter alia, limited trade within the region, exclusion of certain traded goods from the arrangements, liquidity problems of less developed members reflected in external payments arrears, and the limited advantages compared to commercial arrangements. However, in some cases, the percentage of regional trade that passes through the multilateral clearing house is quite high. 1/

A summary of regional payments arrangements is provided in Table 1. These arrangements have a number of common features. Typically, current account transactions are considered to be eligible for settlement through the clearing house except for goods originating outside the region. Each member's credit or debit position is cleared at the end of a transaction period (which varies from one month to one year), with the net positions between members settled in convertible currencies. Members are granted credit lines within each transaction period, but there are limits on these credit lines. If a member fails to settle its net debt position at the end of a transaction period penalty interest is levied; the interest rates charged on balances during a transaction period are generally below market rates and, no interest is applied in about half of the existing multilateral clearing arrangements.

While most arrangements do not require member countries to make payments during each transaction period, most involve an extraordinary settlement system. Each member's net position is calculated at the end of an accounting period, which is shorter than the transactions period. If a country's net creditor/debtor position exceeds its limit at that point, there may be an immediate extraordinary settlement of the excess amount; this settlement is generally compulsory for debtors which exceed the limit.

An accounting unit is established for the purpose of calculating each member's credit or debit position, which is pegged to a convertible currency or a basket of currencies (frequently the U.S. dollar or the SDR). Each member communicates its official exchange rate against the intervention currency, so that the clearing house can calculate an exchange rate for each member's currency in terms of the account unit. The balances of operating

1/ For example 40 percent of trade between the members of the Asian Clearing Union (ACU) is processed through the ACU.

arrangements are convertible in the sense that they can be converted into fully convertible currencies within one to three months.

Regional arrangements have a number of common problems. First, over the past decade most regional systems have been affected by the emergence of arrears in payments that have caused them to break down periodically. This arrears-driven loss of regional convertibility proved particularly damaging to participants' confidence in the arrangements and has retarded development of significant clearing volumes.

Second, there is the problem of the sustainability of the arrangements when members have had structural balance of payments problems. In order to sustain the arrangements, debtors may have to restrict fiscal and monetary policies; as a last resort, provisions have been made for the possible suspension of the debtor's membership. The existence of structural debtor and creditor countries has also led to conflicts concerning the length of the transaction period and the interest rates on net balances. Debtor countries usually prefer a longer period and low interest rates, while the structural creditor countries tend to insist on shorter periods and high interest rates because of the fear of possible liquidity problems, exchange rate risk (particularly where the unit of account is not a strong currency), default risk and loss of interest income.

Third, the major benefit of these arrangements--the reduction of needed foreign exchange working balances--is higher the longer the clearing period and the smaller the balances which have had to be settled. However, where payments imbalances were large relative to the credit lines, or where settlement of net positions in full occurred frequently, the benefit of the arrangements was not significant.

Fourth, the payments arrangements have involved foreign exchange risk. The exchange rate applicable to individual payments is that prevailing at the time the payments are made; however, this may differ from the rate used at the time of settlement of the clearing account, thus exchange risks arise. These risks have been borne by member central banks, in particular, by the creditors whose currencies tend to appreciate against debtor currencies. These risks have been reduced when all member countries have pegged their exchange rates to the same currency or basket of currencies and cross exchange rates between members have been changed infrequently, or if the debit/credit balances in terms of the accounting unit are calculated daily based on the prevailing exchange rate.

A fifth prevalent problem has been delays in the transmission of payments instructions, at the level of commercial banks and the clearing houses. The reason for delays at the level of commercial banks include relative unfamiliarity with the mechanisms of the clearing system, the more cumbersome procedures relative to commercial arrangements, and the small number of transactions, as commercial banks have tended to accumulate transactions before acting on them. Delays at the level of clearing houses have been attributed mainly to difficulties in regional communications. 1/

Finally, the treatment of default risk has to be considered. Several arrangements to distribute the burden of default are possible, including an *ex post facto* assessment among member countries, establishment of an insurance fund, and capitalization of the clearing house. Determination of each member's share in the cost associated with these schemes is another potential source of controversy.

1/ Telex and telephone contacts are more reliable to Europe or the United States than directly between member countries within the region, resulting in a disincentive to use the regional clearing facility.

Table 1. Multilateral Clearing Arrangements: Main Features

	Summary	Multilateral Clearing Unions 1/								
		EPU	CARICOM	CACH	LAIA	WACH	RCD	CEPGL	ACU	PTA
Unit of Account	Most unions use US$ or SDR as their unit of account or peg their own unit to one of them. The EPU used a gold volume which was equivalent to US$1 at that time.	Gold	US$	$CA 2/	US$	WAUA 3/	US$	SDR	AMU 3/	UAPTA 3/
Eligible Transactions	Typically, current and capital transactions, not including transit trade, are eligible. Capital, invisibles, border trade(BT), petroleum and its products(PP), etc. are excluded in a few unions. Regarding LAIA, all payments among members must be made through the clearing system.	Current & capital transactions ex. BT(CACH)			All	Cur. 4/	Visible ex. PP	Cur. & cap.	Current & capital ex. PP and BT(PTA)	
Clearing Arrangements	All unions conduct multilateral settlement and mostly operate multilateral clearing(MC). A few unions perform bilateral clearing(BC).	MC	MC	MC	BC	MC	BC	BC	MC	MC
Transaction Period (month)	Transaction period ranges from 1 to 12 months. Most unions have an accounting period which is shorter than the transaction period (typically 1 week), and calculate each member's net position at the end of the period in order to settle positions which exceed credit/debit limits.	1	6	6	4	1	12	3	1	2
Settlement Currencies	Generally, any convertible currencies (CC) may be used, however, unions of Central American countries use/used local currencies(LC) and/or US$. The EPU also used gold.	Gold or CC	US$	LC or US$	US$	CC	CC	CC	CC	CC
Internal Credit/debit Limits	All unions except the EPU impose internal credit/debit limits. Some are uniform fixed amounts, while others set different and variable limits on each member depending on its trade value.	No	Uniform fixed amounts			% of trade value	Uniform fixed amounts	---	% of trade value	
Interest Rate	Some unions charge interest on the internal daily balances. 5/	No	Yes	Yes	Yes	No	No	---	Yes	No
Additional Credit Arrangements	Only EPU and CARICOM provided a deferred payment system in which members could settle partly by credit. Other unions charge higher interest rate in case of delay of payments. CACH and LAIA have an agreement for assistance under payment difficulties, and WACH has a ad hoc arrangements.	Deferred Payment		Agreement for financial assistance		Ad hoc	---	---	Higher interest rate	

1/ See Table 2 for the list of clearing unions.
2/ $CA(=Central American Peso) is pegged to the US dollar.
3/ WAUA(=West African Unit of Account), AMU(=Asian Monetary Unit), and UAPTA(=Unit of Account of the PTA) are pegged to SDR.
4/ WACH excludes transactions among the members of the West African Monetary Union which have a common currency (CFA franc).
5/ CARICOM=2 fixed rates, CACH=combination of a fixed rate and a variable rate, LAIA and ACU=a variable rate

Table 2. Participants of Multilateral Clearing Unions

Name of Organization	Year of Establishment	Participants
European Payments Union (EPU)	1950 (- 1958)	Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Italy, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, Sterling Area other than Ireland
Carribean Common Market (CARICOM)	1977 (- 1983) 1/	Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St.Kitts and Nevis, St.Lucia, St.Vincent and the Grenadines, Trinidad and Tobago
Central American Clearing House (CACH)	1961	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
Latin American Integration Association (LAIA)	1980	Argentina, Bolivia, Brazil, Chile, Colombia, the Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela
West African Clearing House (WACH)	1975	The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Nigeria, Sierra Leone, Senegal*, Benin*, Burkina Faso*, Ivory Coast*, Niger*, Togo* 2/
Regional Cooperation for Development Union for Multilateral Payments Arrangement (RCD) 3/	1964 (- 1990)	Iran, Pakistan, Turkey
Economic Community of the Great Lakes Countries (CPGEL)	1976	Burundi, Rwanda, Zaïre
Asian Clearing Union (ACU)	1974	Bangladesh, India, Iran, Myanmar, Nepal, Pakistan, Sri Lanka
The Preferencial Trade Area for Eastern and Southern African States (PTA)	1984	Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Somalia, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe

1/ CARICOM suspended its clearing system in 1983 because of exhaustion of the credit facility.

2/ Countries with * are members of the West African Monetary Union.

3/ In 1985, RCD was replaced by the Economic Cooperation Organization (ECO). The payments agreement was terminated at the end of 1990.