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Transitional Arrangements for Trade and Payments
Among the CMEA Countries

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Abstract

Trade among the CMEA countries will soon be conducted at world prices and in convertible currencies. These are crucial steps in economic reform but will worsen Eastern Europe's terms of trade and drive it into current account deficit with the USSR. Proposals have been made for a payments union, resembling the European Payments Union of 1950-1958, to ease the transition. But it would not be very helpful if confined to the countries of Eastern Europe and would not function well if it included the USSR, which would be a persistent creditor. Other ways must be found to deal with the transition.

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Summary

The framework for trade in Eastern Europe is collapsing. It has been rejected by the governments of Eastern Europe and by the USSR, for somewhat different reasons. All these governments want to move to trade at world prices and to use convertible currencies. This sort of regime would support and accelerate economic reform in Eastern Europe, which could "import" world prices and world markets to help build market economies. There is concern in Eastern Europe, however, about the costs of moving quickly to the new regime.

A shift to trade at world prices will worsen Eastern Europe's terms of trade and lead to big trade-balance changes. If it had occurred in 1989, the benchmark year in this study, the terms-of-trade deterioration for trade within the region would have been nearly 37 percent for Hungary and nearly 30 percent for Czechoslovakia, and the trade-balance deterioration would have been close to \$2.1 billion for Hungary and close to \$3.6 billion for Czechoslovakia. The shift will cause Eastern Europe to run current-account deficits with the USSR, and these will have to be settled in convertible currencies.

Transitional arrangements have been proposed, modeled on the European Payments Union, which helped the countries of Western Europe to move from bilateral trade before 1950 to current-account convertibility in 1958. The analogy is intriguing but deeply flawed because of the differences between the postwar situation in Western Europe and the present situation in Eastern Europe. An extensive restructuring of output will be needed. For this and other reasons, an Eastern European Payments Union may not be as useful as the European Payments Union was to Western Europe.

Discussion of this issue, however, should not be allowed to divert attention from the basic problem posed by the impending shift to trade at world prices. Eastern Europe is likely to run large balance of payments deficits. The magnitude of the problem will depend in part on the speed with which the shift takes place--whether it occurs abruptly or is phased in gradually--and on the willingness of the USSR to lend to Eastern Europe on an ad hoc basis (something it might be prepared to do even if it did not want to join an Eastern European Payments Union). Whatever the size and timing of the problem, however, Eastern Europe will need help with it--financing for adjustment to the terms of trade shock and for long-term industrial restructuring.

I. Introduction

The framework for trade in Eastern Europe is collapsing. It has been decisively rejected by the governments of Eastern Europe and by the USSR, for somewhat different reasons. But no one knows what will replace it.

All of the governments concerned want to move to trading arrangements that emulate those in the rest of the world. Trade would take place between individual enterprises, not be monopolized by governmental entities. More importantly, trade would be conducted at world prices, and payments would be made in convertible currencies (which means that imbalances would normally be settled in those currencies). There was agreement in principle on these objectives in January 1990, at the Sofia meeting of the Council on Mutual Economic Assistance (CMEA), and the USSR has sought to implement it fully by the beginning of 1991. There is growing concern in Eastern Europe, however, and among Western observers, about the costs of moving quickly to the new regime.

A shift to trade at world prices will worsen Eastern Europe's terms of trade and will drive it into current-account deficit with the USSR. (It has been in surplus for the last two years.) Under the new regime, moreover, a current-account deficit with the USSR will have to be settled in convertible currencies, and this will be difficult. Eastern Europe cannot readily earn or borrow more from the West. In fact, the countries of Eastern Europe must increase their spending in the West to import the capital goods they need for economic modernization.

Some of the countries of Eastern Europe have made short-term bargains with the USSR to finance their prospective current-account deficits. Thus, Czechoslovakia and Hungary expect to draw down credit balances built up when they were running current-account surpluses. The balances are denominated in transferable rubles (TR) but will be converted to US dollars at exchange rates reported to approximate \$0.90 per TR. (Therefore, the two countries will receive fewer dollars than they would at the official exchange rate, which is about \$1.60 per TR, but more than they would realize at prevailing cross rates, which averaged about \$0.55 per TR in 1989.)

Some observers believe, however, that longer-term arrangements will be needed. These might be modeled on the European Payments Union (EPU), which helped the countries of Western Europe to move from bilateral trade before 1950 to current-account convertibility in 1958. The suggestion has been made by a number of individuals and organizations, including the Economic Commission for Europe, in its Economic Survey of Europe 1989-90.

The analogy is intriguing but may be deeply flawed. There are large differences between the postwar situation in Western Europe and the present situation in Eastern Europe. They are reviewed in this paper, which reaches the conclusion that an Eastern European Payments Union (EEMU) may not be a good way to manage the transition to the new trading and payments regime:

(1) An EEPU that excluded the USSR might not be very useful, as there may be far less scope for trade expansion in Eastern Europe than there was in Western Europe after the Second World War. Trade and payments have been conducted bilaterally in the CMEA area, but that has not been the principal reason for the low level of trade among the countries of Eastern Europe. In Western Europe, by contrast, bilateral payments arrangements depressed trade significantly in the late 1940s, and the multilateralization achieved with the help of the EPU helped to foster liberalization, regionally and globally.

(2) An EEPU that included the USSR might not work very well, as the USSR would be a "structural creditor" in the years ahead and would have to lend to Eastern Europe via the EEPU. The EPU had structural creditors too, but Marshall Plan money was used to indemnify them for the dollars they sacrificed by lending to their partners. The same point can be made more vividly. As the United States was not a member of the EPU, the "dollar shortage" faced by Western Europe was financed outside it. If the USSR is a member of an EEPU, the "ruble shortage" facing Eastern Europe will be financed automatically within it.

This paper has four parts. The first describes the old framework for trade and payments among the CMEA countries and the actual trade pattern. The next part reviews the main objections to that framework viewed from the perspectives of the USSR and of the Eastern European countries--Bulgaria, Czechoslovakia, Hungary, Poland, and Romania, denoted here as the CMEA5. 1/ It also examines the outlook for CMEA trade, focusing on the effects of shifting to world prices and the use of convertible currencies. The third part of the paper describes the EPU and assesses its success. The final part of the paper shows how an EEPU might work, with and without the USSR. It is, on balance, critical of proposals to create an EEPU, but it stresses the need for balance-of-payments financing of one sort or another to help the CMEA5 adjust to the impending shift in the terms of trade and the switch to payments in convertible currencies.

II. CMEA Trade and Payments

1. The CMEA System

For more than forty years, most of the trade among the CMEA countries was conducted on a government-to-government basis. The framework for trade between each pair of countries were defined by five-year agreements, which

1/ The German Democratic Republic (GDR) is excluded from most of the discussion and, where possible, the data, because it now uses a convertible currency and would not be a candidate for membership in an EEPU. When the GDR is included, reference will be made to the CMEA6.

were supplemented by annual protocols fixing the quantities and prices of the products to be traded. 1/

The prices of primary commodities, most notably exports of oil and gas from the USSR, were based on world prices but tended to lag behind them; under the so-called Bucharest formula, adopted in 1975, a five-year moving average of world prices was used to obtain a dollar price, and it was then converted to TR at the official rate (about \$1.60 per TR). The prices of other goods, however, were negotiated individually. The prices used in CMEA trade, moreover, were not linked closely to home prices--those received by producers of exports and those paid by purchasers of imports. Trade flows were taxed or subsidized in opaque and complex ways. But prices received by exporters and those paid by importers did not reflect opportunity costs, and there is no way of knowing whether the implicit trade taxes and subsidies compounded or reduced the distortions in real resource allocation.

After 1964, most of the payments between CMEA countries took place in transferable rubles, on the books of the International Bank for Economic Cooperation (IBEC) in Moscow. Exporters were paid in their countries' own currencies, and importers made their payments in their national currencies, but the corresponding payments between CMEA countries were made in TR, by crediting and debiting IBEC accounts. The transferable ruble, however, was not truly transferable, let alone convertible. If Poland built up a credit balance with IBEC by running a trade surplus with Hungary, it could not use it to finance a deficit with Bulgaria. For this and other reasons, each CMEA country sought to balance its trade bilaterally with every other CMEA country. This was, indeed, the normal expectation, even when a country had a credit balance with another. It could draw down that balance if it ran an unexpected deficit with its partner but could not normally plan to run one. In brief, bygones were bygones for planning and bargaining purposes. 2/

The transferable ruble was supposed to become transferable, as its name implies, and plans to make it so surfaced periodically, but they were never implemented. This record raises an interesting question. Was the bilateral character of CMEA trade due to the nontransferability of the TR, or was it the reflection of more basic obstacles to the multilateralization of that trade? Without answering this question, it is hard to forecast the short-run and long-run effects of changing the CMEA payments system. To answer it carefully, however, one must first examine the actual pattern of trade among the CMEA countries.

1/ For more on the CMEA system, see Wolf (1988), Schrenk (1990a) and the sources cited in those works. The CMEA sponsored other forms of economic cooperation, but they lie beyond the scope of this paper (and more efforts of this sort are not likely to occur).

2/ Bilateral balancing was carried even further. Attempts were made to balance trade in certain types of goods, to conserve scarce supplies for domestic use or for export to Western countries in exchange for convertible currencies. Furthermore, separate accounts and exchange rates were used for commercial and noncommercial transactions. For a detailed account of the CMEA payments system, see Brabant (1987).

2. The Structure of CMEA Trade

Central planning tends to be biased against foreign trade. Planners crave certainty, and foreign trade involves uncertainty, even when it takes place between planned economies. It is hard to plan production, harder still to plan consumption, and very hard to plan the differences between them. To take account of trade between two countries, moreover, planners have to match the two countries' differences, so that more uncertainty attaches to each country's plan.

Nevertheless, the countries of Eastern Europe are heavily dependent on foreign trade. Numbers for Hungary and Poland are shown in Table 1, along with those for three other European countries. Hungary and Portugal are similar in size; so are Poland and Spain. But Hungarian exports are larger than Portuguese exports, relative to output, and Polish exports are larger than Spanish exports, although incomes are lower in Hungary and Poland--far lower in Hungary than Spain. 1/ Comparable data are not available for other CMEA countries, but the per capita imports of Bulgaria, Czechoslovakia, and Romania, shown in Table 2, do not differ greatly from those of the countries in Table 1. The USSR is the only CMEA country with very low imports per capita.

Exports account for large shares of output in some of the countries' key industries. In Bulgaria, for instance, exports accounted for 60 percent of total machinery output in 1987 and for 30 percent of the output of manufactured consumer goods. In Poland, they accounted for 27 percent of machinery output and for 31 percent of the output of building materials. 2/

Nevertheless, the CMEA countries trade less with the outside world and more with each other than one would expect, given their small share of world trade (less than 4 percent of world exports in 1988). The distribution of their trade is shown in Table 3, and bilateral trade flows are shown in Table 4. Three features stand out immediately:

(1) The shares of intra-CMEA trade are very high but differ from country to country. They range from 81 percent of total Bulgarian exports and 74 percent of Bulgarian imports to just 41 percent of total Polish exports and 41 percent of Polish imports.

(2) Trade with the USSR dominates intra-CMEA trade. Its shares in its partners' trade are uniformly high, going from 77 percent of total

1/ The economic statistics of the CMEA countries are not as reliable as those of many other countries, because prices are not very meaningful. This caveat applies with particular force to comparisons like those in Table 1, but must also be borne in mind when reading other tables in this paper. Trade data are particularly hard to compare, because each CMEA country uses a different exchange rate between the TR and the dollar.

2/ Output and trade data from PlanEcon Report, Vol. V, 1989, 27-28, 36-37, and 42-43.

Table 1. Openness, Income, and Size of Selected European Countries

Country	Exports as Percentage of GDP	Income Per Capita (US dollars)	Population	
			Total in millions	Per sq.km.
Poland	22.8	1,930	37.9	121
Hungary	37.6	2,240	10.6	114
Portugal	33.5	2,830	10.4	113
Greece	24.2	4,020	10.0	76
Spain	19.5	6,010	39.0	77

Source: International Monetary Fund, International Financial Statistics, and World Bank, World Development Report 1989. Export and GDP data refer to 1988 (except those for Austria, which refer to 1987); all other data refer to 1987.

Table 2. Imports Per Capita, 1987 (in dollars)

Country	Imports
Bulgaria	1,155
Czechoslovakia	975
Hungary	935
Poland	300
Romania	455
USSR	135
Portugal	940
Greece	655
Spain	875

Source: International Monetary Fund, Direction of Trade Statistics and International Financial Statistics, and national statistics. Figures for the CMEA5 reflect the use of national exchange rates to convert CMEA trade from TR to dollars; the figure for the USSR reflects the use of the official exchange rate between the ruble and the dollar. (If exchange rates similar to those of the CMEA5 were used instead, the figure for the USSR would be even lower.)

Table 3. Trade Among the CMEA Countries, 1988

Country	Exports		Imports	
	CMEA as Percent of Total	USSR as Percent of CMEA	CMEA as Percent of Total	USSR as Percent of CMEA
Bulgaria	80.9	77.6	73.8	72.8
Czechoslovakia	73.0	59.0	72.6	55.5
Hungary	44.6	63.1	43.7	57.2
Poland	40.7	60.2	40.6	57.6
Romania	40.8	58.8	48.6	49.4

Source: World Bank, Socialist Economies in Transition, April 1990. Data include exports to and imports from Bulgaria, Czechoslovakia, the GDR, Hungary, Poland, Romania, and the USSR.

Table 4. Bilateral Trade in the CMEA Area, 1988
(Percentages of Exporter's Total Exports to the CMEA5 and USSR)

Exporter	Importer					
	Bulgaria	Czecho- slovakia	Hungary	Poland	Romania	USSR
Bulgaria	---	7.2	2.5	6.8	5.0	78.5
Czechoslovakia	5.5	---	7.5	15.1	4.5	67.5
Hungary	3.6	14.0	---	8.0	4.1	70.2
Poland	5.2	13.3	4.3	---	8.6	68.5
Romania	4.5	6.8	3.1	11.7	---	73.9
USSR	25.5	21.4	10.6	28.7	13.8	---

Source: International Monetary Fund, Direction of Trade Statistics, and national statistics. Entries are averages of percentages computed from the exporting countries' trade data and percentages computed from the partner countries' data. Therefore, individual entries will not agree exactly with those obtained from any single country's data. Figures differ from those in Table 3 because the GDR is included in Table 3 and CMEA trade is valued there at the official exchange rate between the TR and the dollar.

Bulgarian exports to CMEA countries and 73 percent of Bulgarian imports to 59 percent of Romanian exports and 49 percent of Romanian imports.

(3) The other bilateral trade flows are rather small. The largest numbers in Table 4 are for Czechoslovakia's exports to Poland, which account for 15 percent of total Czechoslovak exports to CMEA countries, and for Hungarian and Polish exports to Czechoslovakia, which account for 14 and 13 percent, respectively, of those countries' exports to their CMEA partners. (One should remember, moreover, that Hungarian and Polish exports to the CMEA countries account for comparatively small shares of those countries' total exports.)

Concerns have been expressed about the possibility of a sharp fall in the volume of intra-CMEA trade, due to reductions in output in some CMEA countries and an impending shift in demand to imports from the outside world. These matters are discussed below. Note for now, however, that this trade is rather small, apart from trade with the USSR.

There has also been discussion of prospects for expanding the volume of trade among the CMEA5. The commodity composition of that trade, however, causes one to doubt that it will grow rapidly. The economies of the CMEA5 are complementary to the Soviet economy; they export machinery and other manufactured goods and import primary products from the USSR. But they are competitive with each other; they export similar goods and thus export small amounts.

This is, of course, the answer to the question posed at the end of the previous section. The nontransferability of the TR was not the main reason for the bilateral trade pattern displayed by the CMEA countries or for the low level of trade within Eastern Europe. That pattern was the result of the "socialist division of labor" imposed by the USSR in the early years of the CMEA, which created the complementarities between the economies of Eastern Europe and that of the USSR, promoting bilateral trade with the USSR but limiting specialization within Eastern Europe. Bilateral bargaining on a government-to-government basis also helped the USSR to use its monopoly power in the postwar period. 1/ As a practical matter, moreover, it would have been very difficult to conduct multilateral bargaining on the product-by-product basis that typified transactions among CMEA countries. 2/

1/ The USSR was not alone in using bilateral arrangements to maximize bargaining power. Kaplan and Schleiminger (1989, chs. 3-4) note that the United Kingdom opposed the creation of the EPU partly because it wanted to promote the international use of sterling but also because its bilateral payments arrangements gave it more bargaining power.

2/ It is worth remembering that the early GATT rounds of tariff cuts involved product-by-product bargaining, and it was conducted bilaterally; "principal suppliers" of particular commodities swapped concessions with each other, then extended those concessions to the other participants via the most favored nation clause.

In brief, there was not much interest in making the TR transferable because bilateralism was deeply rooted in the industrial structure of the CMEA area and in its trade policies and practices, and there was little interest in multilateralism.

Tables 5a and 5b document some of the statements made above concerning the pattern of CMEA trade and the basic causes of bilateralism. 1/ Note first that exports to socialist countries are much more sharply concentrated than exports to nonsocialist countries. In the case of Czechoslovakia, for instance, exports of machinery and transport equipment account for nearly 60 percent of total exports to socialist countries but for only 21 percent of exports to other countries. Conversely, exports of other manufactured goods account for only 29 percent of exports to socialist countries but for 42 percent of exports to other countries. Similarly, exports of investment goods account for a full 65 percent of total Bulgarian exports to socialist countries but for only 24 percent of exports to other countries.

The CMEA5 buy most of their oil and other fuel imports from the USSR but buy most of their food and agricultural imports from nonsocialist countries. Their imports of machinery and other manufactures, however, come from both socialist and nonsocialist countries (and they account for similar percentages of their total imports from each country group).

Detailed data for Hungary and Poland, shown in Table 6, say more about these patterns. Both countries export machinery and other manufactured goods to the USSR and the rest of Eastern Europe, but they buy much less of them from the USSR; their manufactured imports from socialist countries come mainly from their partners in Eastern Europe.

Can the CMEA5 expand their trade with each other? Can they perhaps promote intra-industry trade in machinery and other manufactures? Hardt (1990) and Lavigne (1990), among others, are optimistic on this score, but they may be too optimistic. The Economic Commission for Europe has tried to measure the technological intensity of trade in engineering goods, and some of its results are shown in Table 7. The exports and imports of Eastern Europe and of the USSR are far lower in technological intensity than those of most other countries. These results would seem to say that they can meet their partners' needs--that each of them can export more low-tech goods. To raise their productivity, however, they need goods of higher technological intensity. Therefore, they must import less from their CMEA and partners and more from the rest of the world.

There may be some scope for expanding trade within Eastern Europe, but not by more intensive intra-industry specialization in machinery. On the contrary, the CMEA5 should probably aim at making their trade with each other more like their trade with the outside world--more broadly diversified across product categories rather than more concentrated on the narrow range

1/ Two tables are needed because Czechoslovakia, Hungary, and Poland use the Standard International Trade Classification (SITC) to organize their trade statistics, but Bulgaria and Romania have not yet shifted to it.

Table 5a. The Commodity Composition of CMEA Trade
(Percentages of Total Exports or Imports)

Commodity Class (SITC Code)	Trade with Nonsocialist Countries			Trade with Socialist Countries		
	Czecho- slovakia	Hungary	Poland	Czecho- slovakia	Hungary	Poland
	<u>Exports</u>					
Food etc. (0,1,4)	10.7	17.7	15.9	1.5	17.6	3.2
Crude materials exc. fuels (2)	6.1	6.4	9.4	2.1	4.1	2.7
Fuels (3)	9.1	5.7	11.7	2.7	3.2	8.5
Chemicals (5)	11.2	15.7	8.3	5.2	12.2	7.6
Machinery and trans. equip. (7)	20.9	22.5	15.7	59.5	35.9	53.6
Other manufactures etc. (6,8,9)	41.9	31.9	39.0	28.9	27.0	24.4
<u>Imports</u>						
Food etc. (0,1,4)	13.4	9.6	20.8	4.7	3.3	4.3
Crude materials exc. fuels (2)	13.5	7.2	12.7	5.9	6.7	6.2
Fuels (3)	2.6	3.4	5.2	26.1	31.9	25.2
Chemicals (5)	16.5	20.1	15.9	5.0	8.1	5.8
Machinery and trans. equip. (7)	35.8	31.4	25.4	37.6	31.4	38.8
Other manufactures etc. (6,8,9)	18.2	28.4	20.0	20.4	19.5	19.1

Source: National trade statistics. Czechoslovak data for 1989; Hungarian data for 1987; Polish data for 1988. Detail may not add to total because of rounding.

Table 5b. The Commodity Composition of CMEA Trade
(Percentages of Total Exports or Imports)

Commodity Class	Trade with Nonsocialist		Trade with Socialist	
	Countries		Countries	
	Bulgaria	Romania	Bulgaria	Romania
<u>Exports</u>				
Food and agricul- tural goods	17.1	4.3	13.3	5.7
Minerals and fuels	32.9	42.1	3.4	9.7
Other raw materials	7.8	5.5	nss	1.9
Chemicals	7.3	14.6	2.8	4.8
Investment goods	24.2	11.2	65.4	58.0
Consumer goods	7.6	18.6	11.7	17.4
Other	3.0	3.7	3.4	2.5
<u>Imports</u>				
Food and agricul- tural goods	12.4	4.1	2.3	3.4
Minerals and fuels	32.2	73.9	36.1	40.2
Other raw materials	12.1	5.8	3.0	4.2
Chemicals	9.8	7.8	3.4	5.2
Investment goods	25.2	5.6	48.5	34.4
Consumer goods	6.4	1.2	4.8	6.5
Other	2.0	1.6	1.9	6.1

Source: National trade statistics. Bulgarian data for 1989; Romanian data for 1988. Detail may not add to total because of rounding.

nss: not shown separately.

Table 6. The Commodity Composition of Hungarian
and Polish Trade with CMEA Countries
(Percentages of Total Exports or Imports)

Commodity Class (SITC Code)	<u>Hungary with</u>		<u>Poland with</u>	
	USSR	Other CMEA5	USSR	Other CMEA5
<u>Exports</u>				
Food etc. (0,1,4)	20.8	10.4	4.4	3.3
Crude materials				
exc. fuels (2)	1.7	2.3	3.1	4.2
Fuels (3)	0.5	0.9	11.9	7.5
Chemicals (5)	8.3	10.7	10.7	3.7
Machinery and trans. equip. (7)	47.4	51.9	46.0	52.7
Other manufactures etc. (6,8,9)	21.3	23.8	23.9	28.5
<u>Imports</u>				
Food etc. (0,1,4)	1.2	5.8	1.3	5.1
Crude materials				
exc. fuels (2)	8.4	3.1	9.4	2.7
Fuels (3)	50.7	6.3	59.7	2.2
Chemicals (5)	7.4	7.9	3.3	7.5
Machinery and trans. equip. (7)	18.8	49.4	17.4	58.3
Other manufactures etc. (6,8,9)	13.5	27.5	8.9	24.2

Source: National trade statistics. All data for 1987. Detail may not add to total because of rounding.

Table 7. Exports and Imports of Engineering Goods by
Technological Intensity, 1987
(Percentages of Total Exports or Imports)

Country or Country Group	Technological Intensity			
	High	Advanced	Middle	Low
United States:				
Exports	43.7	17.0	19.2	20.0
Imports	24.7	11.8	43.3	20.1
Japan:				
Exports	25.5	12.3	40.6	21.5
Imports	41.1	19.6	15.3	24.0
Republic of Korea:				
Exports	31.6	4.8	35.1	28.5
Imports	32.1	22.0	8.7	37.1
Taiwan:				
Exports	34.9	11.7	17.0	36.4
Imports	33.6	17.4	10.8	38.2
Eastern Europe:				
Exports	7.6	18.3	19.5	54.3
Imports	8.3	23.8	9.5	55.6
Soviet Union:				
Exports	8.4	11.6	49.4	30.5
Imports	6.0	23.5	5.3	60.6

Source: ECE (1990), Tables 7.8 and 7.9. Figures do not always add to 100 percent because some goods in the totals have not been classified.

of goods that they have been trading with each other. This is the most sensible interpretation that can be attached to the view expressed by the Economic Commission for Europe, which argues that "there are significant comparative advantages embodied in the resource endowments of the individual economies that, with the proper institutions and policies, could be exploited more fully to the benefit of welfare levels in the region and elsewhere" (ECE, 1990, p. 3-72).

III. Objectives and Effects of Economic Reform

1. The Changing Role of Foreign Trade

For reasons already mentioned, central planners tend to be strongly trade averse. Imports are a necessary evil--the source of last resort for basic raw materials and other inputs that cannot be produced at home in quantities sufficient to meet domestic needs. Exports are needed to pay for imports, but they are released reluctantly, because of domestic shortages.

Western views are different. Trade is admired as an "engine of growth" and international competition is regarded as a powerful antidote to domestic inefficiency. The appeal of these views is so strong that protectionists have had to recast their arguments. Tariffs and other trade barriers, they say, should be used strategically to open other countries' markets--to promote competition rather than restrict it--and to offset the "unfair" trade practices of others that use them to appropriate the gains from trade.

Current views in Eastern Europe may be said to lie between these two extremes, even in countries strongly committed to building market economies. The need for more imports is readily acknowledged. Imported capital goods embody the technologies that Eastern Europe needs to raise productivity; imported consumer goods widen workers' choices, raising real incomes and strengthening incentives. The need for more exports is also acknowledged, not only to pay for more imports but also to win large markets in which to exploit economies of scale. The domestic dimensions of reform, however, have attracted more attention than the external dimensions, although Poland and Hungary have acted boldly to liberalize their trade and payments. 1/

The focus on domestic aspects is understandable. The challenges are enormous and are greatly complicated in some countries by huge macroeconomic problems. More attention to the external side, moreover, would require faster action on the macroeconomic side. Otherwise, the liberalization of trade and payments would allow excess domestic demand to produce current-account deficits, and an attempt to limit them by devaluation would increase inflationary pressures at home.

1/ Wolf (1990) examines the problems and progress of trade reform in the CMEA countries; Daviddi and Espa (1989) describe recent developments in the USSR.

CMEA area would have ranged from \$2.8 billion for Czechoslovakia to \$1.0 billion for Bulgaria. 1/

These estimates are not forecasts for 1990 or 1991 (when the shift to world prices is likely to take place). They ask how the shift to world prices would have affected each country's terms of trade and trade balance if it had taken place in 1989, and they make no allowance for compensating changes in the quantities of exports and imports or for changes in earnings from services. Nor do they allow for many other factors that are likely to affect the underlying trade flows, including the output and exchange-rate changes that have occurred in 1990 and the worsening of economic conditions in the Soviet Union, which may dominate the rest. 2/

As the USSR can expect to run current-account surpluses with Eastern Europe, it has an obvious reason for wanting to use convertible currencies for settling CMEA payments; it could use its surpluses with Eastern Europe to cover its deficits with the rest of the world. That is why the USSR is willing to countenance the demise of the transferable ruble. The interests and objectives of the CMEA5 are less clear. They want to denominate their payments in convertible currencies but not necessarily to make settlements in them. In other words, they are eager to replace the TR with a truly transferable means of payment but reluctant to shift immediately to a fully convertible means of payment.

This distinction between transferability and convertibility is a matter of degree. When a particular means of payment can be transferred freely to any entity in any country, in exchange for goods or services, financial

1/ The figures in Tables 8 and 9 are not very sensitive to small changes in the assumptions about the prospective price changes. The computations were repeated on more pessimistic assumptions: that energy prices rise by 250 percent, the prices of other raw materials rise by 200 percent, and the prices of chemicals rise by 100 percent, while the prices of machinery and transport equipment fall by 30 percent and the prices of other manufactures fall by 15 percent (rather than being unchanged). Here are the terms-of-trade and trade-balance changes for the countries that report trade data on the SITC basis:

	Czecho- slovakia	Hungary	Poland
Terms of trade (percent)	-35.5	-39.3	-25.0
Trade balance (\$ billion)	-3.9	-2.2	-1.6

The terms of trade deteriorate more sharply and the trade-balance effects are bigger, but the changes are not very different from those in Table 8.

2/ It should be noted, however, that cuts in Soviet exports of the sort that occurred in July 1990 will not reduce the balance-of-payments problems facing the CMEA5. Those countries will have to buy more oil on the world market, so that their total imports will not fall, and they will experience reductions in their exports if the USSR cuts back its imports because of its own balance-of-payments problem.

assets, or another means of payment, it is fully convertible. But the difference of degree is crucial to the subject of this paper, to distinguish between an external means of payment that can be transferred freely among the CMEA countries to pay for goods and services traded by those countries and one that can be swapped for fully convertible currencies and thus used for purchases from the outside world. (It is also important to distinguish between the use of a convertible currency for making external settlements and the convertibility of the domestic currency. Convertible currencies can be used for external settlements without making the domestic currency convertible in any meaningful way. The countries of Western Europe made external settlements in convertible currencies, among themselves and with other countries, long before they made their currencies convertible, even for current-account transactions.)

Because the TR was not transferable, the CMEA countries could not make multilateral settlements, and bilateral balancing was inevitable. If the TR was replaced by a transferable means of payment, multilateral settlements would be possible and bilateral balancing would not be necessary. The CMEA countries would have no incentive to cut their exports to countries with which they have surpluses or to raise them to countries with which they have deficits. 1/ They would still have an incentive, however, to export as little as possible to other CMEA countries and to import as much as possible from them, so as to keep goods at home for domestic consumption or sell them to outsiders for convertible currencies. If the TR was replaced by a fully convertible means of payment, by contrast, there would no incentive to discriminate between trade with the other CMEA countries and trade with the outside world.

The conventional assessment of postwar experience in Western Europe, reviewed later in this paper, would lead one to recommend an immediate move to transferability. The bilateral balancing of trade in Western Europe was viewed as a major obstacle to economic recovery, and the multilateralization of trade that followed the advent of transferability under the aegis of the EPU was viewed at the time--and thereafter--as making a major contribution to trade liberalization and thus to the rapid recovery of trade that took place in the 1950s. Analogies are dangerous, however, and three caveats are in order:

1/ Instances of this sort occurred in 1989; see ECE (1990), p. 3-70, and Lavigne (1990), p. 14. It should be noted that bilateralism can induce many forms of discrimination. A country that anticipates a surplus with one of its partners (or is a cumulative creditor under a bilateral payments arrangement) might seek to raise its imports rather than reduce its exports; conversely, a country that anticipates a deficit with one of its partners (or is a cumulative debtor) might seek to reduce its imports rather than raise its exports. All of these possibilities distort trade, but some of them do not reduce it. The trade-reducing tendencies may dominate, however, when countries face excess domestic demand or current-account deficits with the outside world. It is hard for deficit countries to increase their exports and thus hard for surplus countries to increase their imports.

(1) The coverage of transferability was much larger in the case of Western Europe than it would be in the case of Eastern Europe. The EPU included the entire sterling area and the overseas dependencies of France, Belgium, and Portugal. Therefore, it covered most of Africa and Asia, as well as bits of the Western Hemisphere. ^{1/} The metropolitan members, moreover, were much larger economically than the CMEA countries are today. They accounted for 35 percent of world exports in 1950, while the CMEA countries accounted for less than four percent in 1988.

(2) Transferability by itself should eliminate discrimination in intra-CMEA trade, but it may not contribute greatly to trade liberalization. No CMEA country will want to run a current-account surplus with the rest, even as a group, if it has a deficit with the outside world. By implication, the size and automaticity of future credit arrangements may have more influence on the process of trade liberalization than the shift to transferability itself. The importance of this point is underscored by the EPU experience. The credit arrangements of the EPU were much harder to negotiate than the clearing arrangements, and it might have been impossible to reach agreement on them if the United States had not used Marshall Plan money to make "side payments" to countries such as Belgium that expected to be creditors in the EPU.

(3) Even if transferability leads to trade liberalization, there may not be a rapid increase in the volume of trade among the CMEA5. There are opportunities for trade expansion, along lines mentioned earlier, but it may take a long time to exploit them. An extensive restructuring of output will be needed, at a time when the countries of Eastern Europe are more urgently concerned to acquire Western markets, for political as well as economic reasons.

IV. The European Payments Union

1. The Economic Environment

The currencies of Western Europe were not convertible in 1950, not even for current-account purposes, and transferability was strictly limited outside the sterling area and similar zones. Payments for trade in Western Europe took place through a network of bilateral agreements having built-in credit lines. Payments for imports were centralized at the central-bank level and were cleared at the end of each month by netting credits against debits. Balances were settled bilaterally by building up creditor and debtor positions until the limits of the credit lines were reached. After that, the deficit country had to pay gold or dollars to the surplus country. In 1948 and 1949, attempts were made to multilateralize these arrangements,

^{1/} This point is stressed by Tew (1988), who describes the global economy of the 1950s as a "binary world" comprising the dollar area and the EPU area. (Japan did not belong to either but was not a major trading country in the early 1950s.)

using small amounts of Marshall Plan money, but those attempts were not successful. ^{1/}

Industrial production had recovered handsomely in Western Europe and was above its prewar level in 1950, except in Germany, but the growth of output was slowing down. Furthermore, the volume of trade was far below its prewar level, and trade liberalization was widely viewed as a precondition to the further growth of output. But trade could not be liberalized easily unless payments were liberalized too, and the EPU was organized for this purpose.

2. The Structure and Functioning of the EPU

The design of the EPU was influenced by the bilateral arrangements it replaced. Importers of goods from other EPU countries continued to make payments in their own countries' currencies, and bilateral balances were built up at each country's central bank. At the end of each month, however, the Bank for International Settlements (BIS), which served as agent for the EPU, collected and consolidated all of those balances and converted them into a single number for each member country--its surplus or deficit for that month vis a vis the EPU. (The surpluses and deficits were expressed in gold, but that was not different from expressing them in dollars, as the dollar price of gold was fixed.) This multilateral clearing of bilateral balances obviated the need for each country to make a separate settlement with every other country. It had merely to settle its surplus or deficit with the EPU.

The form of the monthly settlement depended on the country's balance for the current month and on its cumulative position relative to the size of its EPU quota. Its cumulative position was the sum of its monthly surpluses and deficits from the first month on, not what it had lent or borrowed in the course of settling them. If a country had a cumulative deficit, it would receive or make gold payments, depending on the sign of its balance for the current month, in keeping with the schedule for cumulative deficits shown in Table 10, and would settle the rest of its monthly balance by granting or receiving credit on the books of the EPU. If a country had a cumulative surplus, it would receive or make gold payments in keeping with the schedule for cumulative surpluses.

When a country had a cumulative deficit and went on running deficits, it had to make larger gold payments to the EPU and received less credit from it; when the country's cumulative deficit was equal to its EPU quota, it ran out of credit and had to settle completely in gold. But the rules for countries with cumulative surpluses were less clear. When a country's cumulative surplus was equal to its quota, it could not count on earning gold in an amount equal to its subsequent surplus, because it could be asked

^{1/} They are described in Kaplan and Schleiminger (1989) and Triffin (1957), the main sources used in this and the next section.

Table 10. Initial Schedule of Settlements in the EPU
(percent of current deficit or surplus)

Cumulative Surplus or Deficit as Percentage of EPU Quota	Country with <u>Cumulative Deficit</u>		Country with <u>Cumulative Surplus</u>	
	Gold	Credit	Gold	Credit
From 0 to 20 percent	0	100	0	100
From 20 to 40 percent	20	80	50	50
From 40 to 60 percent	40	60	50	50
From 60 to 80 percent	60	40	50	50
From 80 to 100 percent	80	20	50	50
Overall percentage	40	60	40	60

Note: Starting in July 1952, countries having cumulative deficits in the 10-20 percent quota range were required to make gold payments equal to 20 percent of their monthly deficits and those in the 20-40 percent range had to make gold payments equal to 30 percent of their monthly deficits, but downward adjustments were made for countries with cumulative deficits in the 60-80 and 80-100 percent ranges to keep the members' credit lines at 40 percent of their quotas.

to give more credit to the EPU. (The additional credits are the so-called rallonges that appear in subsequent tables.)

This open-ended obligation helped to protect the liquidity of the EPU. Nevertheless, the EPU could expect to experience gold losses from time to time because of asymmetries built into the system. The EPU would experience a gold loss if countries having deficits in the current month were at the low end of the schedule for cumulative deficits shown in Table 10. Their gold payments would be small compared to the payments that the EPU would have to make to the corresponding surplus countries. The same thing could happen if the countries running deficits had large quotas and the countries running surpluses had small quotas (unless the surplus countries granted extra credits). To deal with gold losses of this sort, the United States put \$350 million of Marshall Plan money into the EPU, and it proved to be sufficient for the purpose.

The EPU agreement was renewed periodically, and major changes in the schedules were made on two occasions. In July 1954, the schedules for cumulative surpluses and deficits were unified, using a flat 50 percent gold ratio for all quota ranges; in August 1955, the uniform ratio was raised to 75 percent. These changes "hardened" EPU settlements. They reduced the gap between the terms for settling surpluses and deficits within Western Europe and the terms for settling them with the dollar area--the convertible-currency countries of that era.

The operations of the EPU are summarized in Table 11, which shows the grand total of bilateral balances that were reported to the BIS, those that were settled multilaterally, those that were reversed as countries that ran deficits offset them with surpluses, and those that had to be settled with the EPU itself, by gold and dollar payments and EPU credits. The credit figure is very small but understates the role of credit in the EPU system. It shows what was outstanding when the EPU was terminated, not what was extended from month to month or year to year. ^{1/} The importance of EPU credit can be appreciated fully by comparing the numbers in Table 11 with those in Table 12, which deals with one of the busier years. Over the whole life of the EPU, net credits accounted for 16 percent of net settlements; in 1951-52, however, they accounted for 44 percent.

3. The Contribution of the EPU

Western Europe made remarkable progress during the EPU years. Trade was liberalized rapidly, and the volume of trade expanded hugely. In 1950, 44 percent of private trade in Western Europe was subject to quantitative controls, along with 89 percent of trade between Western Europe and the

^{1/} Some of the credits were reversed automatically, as members shifted from deficit to surplus; some of them were amortized under arrangements negotiated periodically, when the EPU agreement was renewed.

Table 11. EPU Settlements, 1950-1958 (billions of dollars)

Item	Amount
Total bilateral positions (deficits plus surpluses)	46.4
Compensations:	
Multilateral	20.0
Through time	12.6
Special settlements and adjustments	0.4
Balance to be settled	13.4
Settled in gold and dollars	10.7
Settled in credit	2.7

Source: Kaplan and Schleiminger (1989), Table 10.

Table 12. EPU Settlements, 1951-52 (millions of dollars)

Item	Amount
Total bilateral positions	8,675
Compensations:	
Multilateral	3,460
Over time	2,971
Special settlements and adjustments	217
Balance to be settled	2,028
Settled in gold and dollars	1,141
Within quotas and rallonges	799
Full settlements beyond quota	66
Amortization	276
Settled in credit	888
Current settlements	1,164
Amortization	-276

Source: Adapted from Triffin (1957), Table 26. Detail may not add to total because of rounding.

dollar area; by 1959, the figures had fallen to 11 percent for trade in Western Europe and to 28 percent for trade with the dollar area. 1/ Intra-European imports grew from \$10.1 billion in 1950 to \$23.3 billion in 1959, and imports from North America grew from \$3.9 billion to \$6.1 billion. Industrial production rose by 65 percent during that same nine-year period. (Data from Kaplan and Schleiminger, 1989, Table 8.) In 1958, moreover, the major countries of Western Europe made their currencies convertible for current-account purposes, and the EPU was terminated. It is hard, however, to assess precisely what the EPU contributed to these results.

There can be no doubt about its contribution to the multilateralization of settlements within Western Europe and to the conservation of official reserves. Under the interim arrangements of 1948 and 1949, bilateral balances totalled \$4.4 billion, of which \$1.3 billion was settled in gold and dollars, \$3.0 billion was financed with bilateral credit, and only \$0.1 billion was offset multilaterally (Triffin, 1957, pp. 156-57). In the first year of the EPU, by contrast, bilateral balances totalled \$6.0 billion after applying Marshall Plan aid, of which only \$0.8 billion was settled in gold and dollars, \$2.2 billion was financed with EPU credit, and \$3.0 billion was offset multilaterally (Triffin, 1957, Table 26).

Furthermore, Kaplan and Schleiminger (1989) argue convincingly that the Managing Board of the EPU contributed importantly to the solution of major balance-of-payments problems, including the German crisis of 1951, which erupted right after the EPU began to operate. The Board made supplementary credit available to countries that had exhausted their EPU credit lines, and it monitored their domestic policies closely--more closely and intrusively than the Fund does today. 2/

Finally, the EPU helped to keep the European countries "on track" as they moved toward convertibility. The hardening of settlements within the EPU, described in the previous section, diminished the practical distinction between transferability and convertibility, because gold and dollars became more important in EPU settlements. Furthermore, discussion in the EPU Board

1/ The liberalization of trade with the dollar area deserves particular attention. Most discussions of the EPU (e.g., Triffin, 1957, pp. 203 ff) say that the United States accepted more discrimination against it as the price it had to pay for the closer integration of Western Europe--one of the main objectives of the Marshall Plan. An intensification of discrimination occurred in the early years of the EPU, when liberalization within Europe took place more rapidly than liberalization with the dollar area. The latter was more dramatic in the end, however, and reduced discrimination against the United States.

2/ The Fund itself did not have much influence on European policies in the early years of the EPU, partly because it had decided that countries receiving Marshall Plan aid should draw on the Fund only in "exceptional circumstances" so that its resources would be available intact after the Marshall Plan had ended. On relations between the IMF and the EPU, see de Vries (1969).

helped the governments to formulate a common approach to the problem of reaching convertibility.

The multilateralization of payments and the credit arrangements of the EPU were viewed at the time--and probably were--as preconditions for the liberalization of trade within Western Europe, and the hardening of EPU settlements probably encouraged trade liberalization with the dollar area. It is essential, however, to distinguish between necessary and sufficient preconditions. Trade liberalization was achieved during the life of the EPU, but it was monitored separately by the Organization for European Economic Cooperation (OEEC). There was an agreed schedule for the removal of quantitative trade controls, and strong pressure was brought to bear on governments that fell behind. Liberalization was deemed to be part of the larger process of European integration, which was strongly supported in Washington as well as in Europe. If European governments had not been agreed on the need for trade liberalization per se and not been prodded by Washington when their own energies flagged, the payments arrangements provided by the EPU might not have done the job. The timid might have held back the rest, slowing the pace of liberalization.

One more point should be made. The circumstances and intellectual environment of the 1950s worked to rule out a "dash for convertibility" by Western Europe. The British thought briefly about floating the pound and making it convertible unilaterally, but Washington opposed the plan, because it favored pegged exchange rates rather than floating rates, was reluctant to ask Congress for the credits that the British wanted, and opposed the delay of trade liberalization on which the plan was predicated (Kaplan and Schleiminger, 1989, ch. 10). Therefore, the contributions of the EPU should be appraised as they were above, by comparing the payments regime of the 1950s with the bilateral regime that preceded it. A different frame of reference is needed, however, to assess the potential contributions of an EEPU. The CMEA system is disintegrating, and the TR is defunct. Hence, an EEPU should be compared with some form of "modified bilateralism" (Schrenk, 1990b) or with the use of convertible currencies for CMEA settlements. 1/

V. An Eastern European Payments Union

1. The Functioning of an EEPU

A payments union for the CMEA countries could follow the basic design of the EPU. Each country would have a quota, based on its trade with the others, and its rights and obligations would be defined by its cumulative surplus or deficit compared to its quota. The workings of an EEPU can be illustrated by a simple numerical example. In this particular example, 50 percent of each member's surplus or deficit is settled by giving or getting credit, and the other 50 percent is settled in convertible currency, the

1/ This point must be borne in mind when appraising proposals such as those of Daviddi and Espa (1989) that were drafted before the Sofia meeting of the CMEA.

formula adopted by the EPU in 1954 in place of the graduated scale for countries with cumulative deficits.

Consider a hypothetical EEPU comprising four countries, Czechoslovakia, Hungary, Poland, and the USSR, and these bilateral balances:

Reporting Country	Partner Country				Total
	Czecho- slovakia	Hungary	Poland	USSR	
Czechoslovakia	--	+300	-50	-200	+50
Hungary	-300	--	+200	0	-100
Poland	+50	-200	--	-150	-300
USSR	+200	0	+150	--	+350

The balances are expressed in millions of dollars, and the description that follows assumes that payments and credits are expressed in dollars, but other convertible currencies could be used instead. (It would also be possible to use the SDR or ECU as the unit of account.) Begin with the case in which the countries' cumulative surpluses and deficits are smaller than their quotas, so that the countries with surpluses during the current month will give credit to the EEPU and the countries with deficits will get credit from it.

Under the old CMEA system, bilateral balances like those shown above would have appeared and remained on the books of IBEC (and would have been expressed in TR rather than dollars). Czechoslovakia would have built up its credit balance with Hungary or run down its debit balance, and so on. With settlements in convertible currencies, by contrast, Czechoslovakia would receive \$300 million from Hungary but would pay \$50 million to Poland and \$200 million to the USSR, so its total dollar holdings would rise by \$50 million. With an EEPU, bilateral balances would be consolidated, so that Czechoslovakia would have a \$50 million surplus. It would therefore receive \$25 million in dollars from the EEPU--half of its monthly surplus--and extend \$25 million in credit to the EEPU. Poland, by contrast, would have a \$300 million deficit, would pay \$150 million to the EEPU, and would receive \$150 million in credit.

This process would go on, month after month, unless one of the members reached its credit ceiling. If that country had a cumulative surplus, its subsequent monthly surpluses would be settled entirely by dollar payments from the EEPU, and the EEPU could thus experience a net outflow of dollars; if it had a cumulative deficit, its subsequent deficits would be settled entirely by dollar payments to the EEPU, and the EEPU could experience a net inflow of dollars.

An EEPU might seem to be disadvantageous for Czechoslovakia and the USSR--the surplus countries in this hypothetical example. If settlements were made entirely in convertible currencies, Czechoslovakia would earn \$50 million from its partners, rather than \$25 million from the EEPU, and could use the extra dollars to increase its imports from the outside world. If it expected to run such surpluses steadily--to be a "structural creditor" in the EEPU--it might not want to join. If it did not join, however, some of its partners may have to cut down their imports from it, in order to reduce their dollar losses. Furthermore, surpluses do not always last. A country that runs surpluses this year may run deficits next year, and the credit facilities of the EEPU would reduce the dollar losses resulting from those deficits. 1/

2. Membership, Quotas, and Capital

Who would belong to an EEPU? How big should the quotas be? How much capital would be needed?

It would be hard to include the GDR in an EEPU, because it now uses a convertible currency. There would be enormous technical difficulties, as the trade and payments of the GDR would have to be segregated from those of the Federal Republic (and those of the rest of the European Community), in order to measure and settle its monthly balance with the CMEA countries. German unification and the resulting inclusion of the GDR in the EC may cause grave problems for some CMEA countries, and transitional arrangements may be needed, including perhaps medium-term credits to avoid a sharp fall in GDR imports from the CMEA countries. It may be best to handle these matters bilaterally, however, between the whole of Germany on the one hand and the individual CMEA countries on the other. Therefore, the discussion that follows, dealing with EEPU quotas and capital, will concentrate on two possibilities: a "large" EEPU comprising the CMEA5 and the USSR, and a "small" EEPU confined to the CMEA5.

1/ Ethier (1990) proposes an interesting variant on the conventional arrangement outlined in the text. His scheme would be open-ended in two respects: (1) new members could be added without affecting the formal rights and obligations of existing members; (2) members could use it to clear their payments with nonmembers, but net balances with nonmembers would be excluded from the credit-granting aspect of the plan. Each member's obligation to make convertible-currency payments to the union would depend on its deficit with the union, defined to include its deficit or surplus with nonmembers covered by the clearings through the union. Suppose that Czechoslovakia, Hungary, and Poland formed a union and used it to clear their deficits and surpluses with the USSR, as well as their mutual deficits and surpluses. In the particular instance discussed in the text, the outcome would be more attractive to Czechoslovakia, which has a large deficit with the USSR, and less attractive to Hungary and Poland, which would have to pay convertible currencies to the union because of Czechoslovakia's deficit with the USSR.

When the EPU was being negotiated in 1950, a benchmark was needed to bargain about quotas. With two exceptions (Belgium and Switzerland), quotas were set at 15 percent of each member's visible and service trade (the sum of its exports and imports) with the rest of the EPU area in 1949. It is hard to apply this formula to an EEPU, because there are gaps in the data on trade in services. As an approximation, suppose that quotas were set at 20 percent of each member's visible trade with the others in 1988. 1/

The schedule of quotas for a large EEPU, including the USSR, would look like this (in millions of US dollars):

Bulgaria	2,430
Czechoslovakia	2,880
Hungary	1,485
Poland	3,285
Romania	1,950
USSR	9,090
Total	21,120

The corresponding schedule for a small EEPU, excluding the USSR, would look like this (in millions of US dollars):

Bulgaria	460
Czechoslovakia	980
Hungary	460
Poland	975
Romania	640
Total	3,515

What do these numbers say about the capitalization of an EEPU? How many dollars would it have to hold to honor its obligations fully? Its exposure to net dollar payments can be measured by asking what would happen if the member with the largest quota ran a long string of deficits, the one with the smallest quota ran a long string of surpluses, and no other country had a surplus or deficit. This pattern of imbalances would minimize the dollar receipts of the EEPU and maximize its dollar payments. A large EEPU would have to start out holding \$3.8 billion (half of the difference between the quotas of the USSR and Hungary), and this amount would equal 18 percent of total quotas. A small EEPU would have to start with only \$260 million, and this amount would equal 7 percent of total quotas. (Recall that the EPU

1/ In the case of Czechoslovakia, service exports to the whole CMEA area (including the GDR) amounted to 14 percent of merchandise exports in 1988, and service imports amounted to 5 percent of merchandise imports. Thus, the 20 percent figure used instead of the 15 percent EPU figure may make an overly generous allowance for the omission of services. It should be noted, however, that the 20 percent figure makes no allowance for the effects of shifting trade to world prices. The underlying trade statistics are those that were used to construct Table 4.

began with \$350 million, an amount equal to 9 percent of total quotas.) But the big figure for the large EEPU is based on an unrealistic supposition; the USSR is likely to run surpluses, not deficits (which means that the EEPU would gain dollars rather than lose them).

The members of an EEPU might be willing to provide some of the capital, but most of it might have to come from Western governments or international institutions.

3. Benefits and Costs of an EEPU

What would an EEPU accomplish? It would, of course, facilitate the multilateralization of CMEA payments and thus encourage a more efficient pattern of specialization and trade among the CMEA countries. But so would convertible-currency settlements. The case for an EEPU, then, must stand or fall on the contribution it might make to liberalizing trade and payments or, defensively, what it could do to keep trade from contracting in the face of impending balance-of-payments pressures.

Two potential costs of an EEPU must be borne in mind, even though they cannot be quantified.

First, the creation of an EEPU would interfere with the relaxation of exchange controls. A country participating in a payments union is obliged to centralize its payments to its partners; the central bank has to record them on its books in order to report them to the agent for the union. That is, of course, the way in which the CMEA countries managed their accounts with IBEC. But some of the countries of Eastern Europe have moved away from this sort of centralization. Exporters are paid in foreign currency and sell it to the central bank, unless they are authorized to retain and use it; importers buy foreign currency from the central bank, directly or by way of the foreign-exchange market. (To this extent, of course, convertible-currency settlements occur automatically; there is no need to arrange them on a government-to-government basis.) Creation of an EEPU, then, would require a step backward--the recentralization of transactions with the other members.

Second, the creation of an EEPU might encourage the CMEA countries to liberalize their trade with each other at the expense of trade with the rest of the world, as imbalances within the CMEA area could be financed partially with EEPU credit but imbalances with the rest of the world could not. An intensification or prolongation of discrimination against the rest of the world would be unfortunate, because it would interfere with domestic reform in Eastern Europe. Recall the argument made earlier, that Eastern Europe should "import" world markets and world prices in order to accelerate the process of reform.

This second cost could be far higher than the first and much harder to control. Discrimination against goods from the outside world is, of course, the counterpart of preferential treatment for goods produced in Eastern

Europe--the treatment that some experts recommend explicitly to prevent a contraction of trade in the CMEA area and the corresponding cuts in output and employment. There was an intensification of discrimination against the dollar area in the early years of the EPU, but it was reversed thereafter. The reversal, however, reflected the commitment to trade liberalization by the governments of Western Europe, as well as occasional prodding by the United States.

Participation in an EEPU would not require the CMEA countries to move together, in strict lock step, to liberalize trade in Eastern Europe or with the outside world. The EPU countries did not do so in the 1950s. Market economies, moreover, have traded extensively with planned economies without planning or controlling their own trade heavily. The bilateral arrangement between Finland, a market economy, and the USSR, a planned economy, worked well for many years without forcing Finland to control the operations of Finnish firms trading with the USSR (see Oblath and Pete, 1985). Yet a common approach to trade liberalization would perhaps be needed to keep an EEPU from discouraging trade with the outside world, and an attempt to formulate a common approach could conceivably slow down trade reform in countries such as Hungary and Poland, that have moved faster than the rest.

Turning from potential costs to potential benefits, a small EEPU would not be very powerful in promoting trade among its members. It would not be able to promise much financing, compared to the balance-of-payments needs of its members, as the level of EEPU lending would be tied mechanically to the level of imbalances among the CMEA5, and these are not likely to be large compared to prospective imbalances with the USSR or the rest of the world. (The balance-of-payments effects of the "defection" of the GDR may be much larger than the effects of liberalizing trade among the CMEA5.) Even if a small EEPU was successful in encouraging the CMEA5 to liberalize trade within Eastern Europe, the volume of trade might not grow very fast or lead to large imbalances within the area. Hence, the CMEA5 should be able to get along easily without an EEPU and should use convertible currencies to settle imbalances among themselves.

A large EEPU might be more effective. Its effectiveness in the short run, however, would reflect the size of its contribution to the financing of prospective imbalances between the CMEA5 and the USSR and would therefore depend on the willingness of the USSR to lend to an EEPU. This possibility should not be ruled out. Participation would be costly for the USSR, which cannot readily forgo convertible-currency earnings. Refusal would be costly too, however, because it would burden the countries of Eastern Europe with a serious payments-of-payments problem just when they are trying to stabilize and reform their economies. Furthermore, trade between the CMEA5 and the USSR will continue to be mutually beneficial. Eastern Europe can provide manufactured goods that the USSR will continue to require, and it would be expensive for the USSR to divert its oil and other exports to more distant markets. The CMEA5 and the USSR want to expand their trade with the West but should not want to disrupt their trade with each other.

It may be necessary to make "side payments" to the USSR to induce it to participate in an EEPU, much like the payments made to Belgium in 1950, when it was reluctant to be a "structural creditor" in the EPU. In that case, however, the value of the exercise will come to depend on a judgment about the comparative merits of making balance-of-payments credit available to Eastern Europe through the USSR and an EEPU and making the credit available directly, through the IMF and other institutions. A strong case can be made for following the second course (and thus attaching appropriate conditions to the use of the credit), rather than setting up a new institution and compelling the governments of Eastern Europe to cooperate closely with the USSR in monetary matters.

Debate about this issue, however, should not be allowed to obscure the fundamental problem posed by the impending shift to trade at world prices. Eastern Europe will experience a significant deterioration in its terms of trade with the USSR and is likely to run large balance-of-payments deficits that will have to be settled in convertible currencies. The magnitude of the problem will depend on the speed with which the shift takes place--whether it occurs abruptly in 1991 or is phased in gradually over two or three years. The problem could be mitigated, moreover, if the USSR could be persuaded to make modest amounts of medium-term credit available on an ad hoc basis--something it might be prepared to do even if it did not want to join a full-fledged payments union. Whatever the size and timing of the problem, however, the countries of Eastern Europe will need help to solve it--financing for adjustment to the terms-of-trade shock and for long-term industrial restructuring.

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