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The IMF and the Ruble Zone: Response to Odling-Smee and Pastor

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This commentary examines how closely Odling-Smee and Pastor (2002)'s account and their defense of the IMF's role matches the known facts and evidence on the Ruble Zone. This evidence shows that in the 12-24 months following the Soviet collapse, the IMF took the view that the prompt introduction of new currencies in the successor states would be more dangerous and damaging than sticking to the ruble. This article questions the assumptions behind this view, and argues that it was not correct for the IMF to confine itself to advising on the pros and cons of either course. The decisions by Post-Soviet states on the currency issue had a key bearing on whether IMF financial assistance would be forthcoming making, the IMF's 'neutrality' as recorded by the authors objectionable in principle. The bias of IMF advice in favor of retaining the Ruble Zone reflected many other interests besides Russia's own. The real aim of this commentary is not point-scoring in long-past debates, but to share an historical understanding.

Our role at the IMF is not to wait for all such risks to be eliminated before taking action, but even in chaotic circumstances of history to sit down with the authorities of a member country and see how we can help.

Michel Camdessus (1995)

I. Introduction

The paper by Odling-Smee and Pastor (2002) aims to set the record straight regarding the IMF's role in the decision of the successor states of the former U.S.S.R. to prolong monetary union after the collapse of the Soviet Union. In the process of explaining and defending the advice and actions of the IMF in 1992-93, the authors also touch on many wider political considerations and economic factors. These factors influenced decision-making within the main Former Soviet Republics (FSRs) (mainly Russia), influenced the negotiations between various republics and influenced negotiations with the West.

While it would be difficult to challenge the authors' ultimate contention that "things could not have been otherwise" in the sense of producing a plausible counterfactual scenario, their account is in some respects evasive and, perhaps inadvertently, reveals logical inconsistencies in the IMF's position which were quite apparent at the time. The first task of this commentary is to examine how closely the authors' account and their defense of the IMF's role matches the known facts and evidence (Section II).

The authors' main concern is to address subsequent criticism of the IMF's support for the Ruble Zone in 1992 as undermining the stabilization efforts of the first reformist government of Russia in 1992 and thus preventing the Russian government from gaining access to large-scale financial support from the IMF. That criticism has been made by some senior members of the 'Gaidar government' and its western economic advisers, including the author of this commentary (Granville, 1995) and will be re-visited in Section III.

The real aim of this commentary is not point-scoring in long-past debates. My concluding remarks, therefore, reflect much more importantly on the lessons from broader issues than the specific role of the IMF. In the course of their valuable chronological account of the dissolution of the Ruble Zone, Odling-Smee and Pastor touch on many of these issues. The scope of their paper, however, does not always permit the broader discussion which these deeper issues deserve. At the same time some key factors, especially the specific legacy of central planning and general nihilism bequeathed by the Soviet system, are barely hinted at or are omitted altogether.

II. The 'Facts'

The authors state that the IMF remained neutral as regards the currency options facing the FSRs in 1992. They correctly recall that there existed three main options:

1. a cooperative ruble area arrangement in which all participating central banks would have a say in credit and monetary policy for the ruble area;
2. introducing national currencies;
3. a Russia-dominated ruble area in which the CBR would be solely responsible for monetary and exchange-rate issues.

In the authors' account, the IMF first advised the FSRs on the currency regimes best suited to their respective needs (pointing out the pros and cons of each option), and then helped them implement their choice.

Option 1 was a chimera. It contributed to undermining the monetary stabilization efforts of the Russian authorities since, as the authors note, the problems of monetary and fiscal free-riding on Russia by the other FSRs proved insurmountable. By implication at least, the authors show that this reality did not need the benefit of hindsight to become visible. They record that commentators (Havrylyshyn and Williamson, 1991) as early as 1991 started pointing out this fatal flaw. They also reveal that people inside the Fund were arguing from early 1992 that such an arrangement was doomed to fail.

Only by implication (pp. 13, 15) do they admit that the IMF was not, in fact, neutral as between the options. Other things being equal (i.e. with a few, mainly Baltic, exceptions where there was a clear political decision in favor of a new national currency), the IMF began by favoring Option 1: the continuation of the Ruble Zone.[1] This position was clearly acknowledged at length by the IMF (International Monetary Fund, 1992a) and then summarized in the same document:

> The staff has in general supported cooperative solutions as the surest way of minimizing the damage to trade and financial stability arising from interrepublic frictions. While acknowledging that some republics wish to pursue independent monetary policies in the longer term, the poor state of readiness in nearly all republics has prompted the staff to warn about the risks of premature departure from the Ruble Zone. It is also apparent that, in the sensitive early stages of political independence, frictions in one policy area – for example in monetary arrangements – might lead to unnecessary disruptions in others – such as trade.
>
> It is clear, nevertheless, that a number of republics intend to pursue fully independent economic policies, in particular separate monetary and fiscal policies. While warning them of the risks, the staff has not attempted to discourage this as a long-term objective. Rather, it has offered advice on timing and transition arrangements in order to facilitate change while minimizing disruptions to interrepublic relations and to the economic and financial conditions in the republics concerned.
>
> The commitment to interrepublican economic cooperation varies from republic to republic. It may well not be strong enough in some of the republics to ensure that the recommendations discussed in this section are followed, except, perhaps, among some subsets of republics. But as long as this remains in doubt, the international community should continue to emphasize the economic benefits to be obtained from more cooperation. (p. 32)

The emphasis on close economic relationships between the FSRs and more specifically, “coordination of monetary and fiscal policies” (International Monetary Fund 1992a, p. 17) was reflected in the IMF paper for the Tashkent meeting of the Interbank Coordination Council of FSU central bank heads in May 1992. Unfortunately, the staff of the IMF, in its attempts to correct the 'misrepresentation' of its attitude towards the Ruble area, show clearly its bias against Russia:

> To make a long and complicated story short, the Fund staff did not try to "save" the ruble area, as it sometimes alleged. Rather, it tried to eliminate the inflationary bias built into the ruble area by proposing at the interstate conference of Tashkent, in May 1992, a set of rules for a coordinated monetary policy. The proposal failed, largely because it was torpedoed by the Russian delegation. (Hernandez-Cata, 1995, p. 119).

The whole IMF plan rested on Russia taking the lead on the monetary arrangement. That meant taking the risks, and facing the certainty that regardless of whatever rules were proclaimed, the reality would be FSR free-riding. It seems inappropriate, therefore, to use the term 'torpedoed' as Hernandez-Cata does. His use of such strong language suggests that the IMF had strong reasons for taking this position. One reason was simply because it seemed easier, and altogether less trouble to shift responsibility onto Russia. As International Monetary Fund (1992a) states:

> While the Fund is now dealing with 15 separate countries in the area of the former USSR, a successful transition of these economies will be made easier by the maintenance of the close economic relationship between the individual republics. (p. 2)

As part of their *apologia*, the authors are justified in pointing to factors in support of this mistaken position which had nothing to do with the IMF management and staff. Two of these factors were powerful.

The first was the support for the Ruble Zone from several major Western government shareholders of the IMF. As the authors note, this position was motivated by a desire to reduce calls for balance-of-payments aid from Western governments to the FSRs. It was based on the (mistaken) belief that a continuation of the Ruble Zone would support the crumbling trade links between the FSRs. (There were also fears that a nuclear power would be destabilized). The authors do not record, however, that another motivation in the case of Western European governments was ideological, i.e. the Treaty of Maastricht etc. It was argued that since the FSRs would have no use for each other's new national currencies, payments would be made in hard currency, draining already meager reserves. This leads naturally to consideration of a payments union, while ignoring the risks entailed in such an approach. These include putting off the introduction of convertibility and delaying the exposure of the FSRs economies to the world market. This approach encouraged trade on a passive basis, relying on the same supports as the old central planning regime, and delayed development of comparative advantage. (Granville, 1993)

The second factor beyond the control of the Fund staff was the internal Russian resistance to the rational ‘Russia-first’ policies of the Burbulis-Gaidar government. This resistance stemmed from deep-seated ideological (conservative-imperialist) and enterprise interests (i.e. factories tied by the old central planning system to suppliers and off-takers in other republics). These forces were too powerful to be ignored, even at the height of the reform drive from mid-1991 through mid-1992. When considering Russia’s need to push the other republics out of the Ruble Zone, recall that even Yeltsin was unable to take the initiative to wind up the Soviet Union itself. He was only able to act in response to the *fait accompli* of the Ukrainian referendum on independence of 1 December 1991. As the authors note (quoting Alexei Ulyukaev), that in addition to the ideological issues and the pressures from vested interests, there were also technical obstacles to freeing Russia from a single currency with the other republics – namely, the difficulty of separating FSR enterprise accounts in the Gosbank system.

Nevertheless, there were contradictions in the Fund staff’s own position as described by Odling-Smee and Pastor. They argue that it would not have been appropriate for the IMF to agitate for the FSRs to be pushed out of the Ruble Zone, for this would have seemed too pro-Russian. They argue that it was important for the Fund to appear even-handed to preserve its influence in all the successor states. The fact remains, however, that Russian monetary policy was being undermined by the ability of the other countries to create credits in rubles, by booking debits (i.e. unilaterally running up overdrafts) in their old Gosbank correspondent accounts. So this even-handed IMF approach was not very even for Russia. Did the Fund not have a duty also to Russia, to advise on what currency regime would be best for it? According to the authors, that duty existed and, they imply, was implemented. The facts suggest otherwise.

The IMF staff penalized Russia further by assigning Russia, *precisely because of its greater commitment to reform,* with a burdensome responsibility for FSRs who had just broken away from Russia. They were out only to obtain whatever credits they could out from Russia, while giving nothing in return. All common cause was abandoned. This emerges from the authors’ paper:

> In view of the size of Russia and its commitment to seek macroeconomic stability, and the absence of similar commitments elsewhere, it seemed in the first half of 1992 that a cooperative ruble area arrangement in which Russia would de facto provide the nominal anchor would be more likely to produce macroeconomic stability in most countries in the region than a system of national currencies. (p. 15)

Clearly, the IMF should have helped the reformers in early 1992 by presenting the case for rapid establishment of a Russian ruble and de-monetization of Soviet banknotes. In other words, accelerating the process that actually unfolded 18-24 months later. The refusal of Ukraine to liberalize prices alongside Russia in January 1992, and the introduction of the Ukrainian coupon should have been enough to convince anyone, especially IMF experts in Washington, that the survival of the Soviet ruble was dangerous for Russia. As the authors state, while the Ruble Zone in general contributed less to high Russian inflation from mid-1992 onwards than the expansionary policies of the CBR itself, the contribution of Ukraine in exporting inflation to Russia was significant and damaging from as early as the second quarter of 1992.

To be sure, rapid de-monetization of Soviet rubles in early 1992 would have created massive political problems. There would have been an outcry in Russia that such a move would have abandoned all the Russians perceived as stranded in the FSRs. Meeting these objections would have required strong, clear decision-making and planning (eg three-month lead time). Perhaps not even the Yeltsin-Burbulis-Gaidar government could ever have succeeded here. But the IMF should certainly have been advising them that this was the only rational economic course.

III. Deeper Contradiction: Combining IMF Program with the Ruble Zone

There was a fundamental contradiction in the IMF advice to Russia between the primary IMF program objective of monetary stability and the stated preference for monetary co-ordination between FSRs. In other words, while the key to international financial assistance to Russia depended on compliance with IMF program conditionality, Russia could not comply partly because of the very constraints imposed by the monetary cooperation option favored by the IMF. How was Russia supposed to achieve a low inflation target while other central banks in the FSRs were allowed to issue credits over which the Russian central bank had no control? The IMF held the key to G7 financial assistance to Russia, but the advice the IMF gave to Russia worked against this aim.

This was clear to many observers. In a European Commission memo describing “the remaining obstacles to an agreement with the IMF”, the Ruble Zone issue received prominent attention:

> a) <u>The Ruble Zone:</u> The IMF staff insists that a clear agreement on the monetary system is a precondition for sending a financing proposal to the Board. This is meant to be either a cooperation agreement with other Ruble Zone states (see below), or an interim agreement to assign monetary policy responsibility to the Central Bank of Russia, but a clear system is an absolute precondition.
>
> But Russia cannot prevent the other republics (Ukraine, Latvia, now Belarus) from issuing surrogate rubles (coupons). Worse, it has no

> control over the credit policy of the other central banks.[…] There is no way in which the Central Bank of Russia can check the behavior of other central banks.[…]At a recent meeting on monetary cooperation within the ruble zone, the IMF has tried to reach an agreement on monetary coordination. According to Russian sources, the conference ended without an agreement on decision making procedures for the management of the ruble zone. (Pisani-Ferry, J. and M. Rocca, 1992, pp. 1-2.)

The difficulty of operating a cooperative ruble area arrangement that could deliver low inflation is fully acknowledged by Odling –Smee and Pastor (p. 11) Still it seems that they were blinded by the perceived benefits of a common currency area. The fact that the ruble was not convertible, did not perform any money functions, and Soviet trade was not based on comparative advantage, do not seem to have been questioned. Monetary stability for each republic (including Russia), not trade, should have been the absolute priority in accordance with the design and aim of the IMF program.

Next, I discuss the IMF program for Russia and show how credit targets were derived and how these credits to FSRs exerted pressure on the inflation target. Then I turn to the cost of maintaining trade links with FSRs.

The primary objective of IMF programs is to set a low inflation target. Everything else is viewed to be of secondary importance (International Monetary Fund 1987). To limit inflation, the IMF sets credit targets. In this model, inflation depends directly on the growth rate of the money supply. The inflationary pressures in the Russian economy can then be described by using the following accounting identity (1):

(1) $MB = NDA + NIR$

where MB, the monetary base is backed by domestic credit (NDA) and international reserves (NIR).

Equation (1) is essentially the balance sheet of the Central Bank of Russia (CBR), Table 1.

Table 1:
Balance Sheet of the Central Bank of Russia

Assets	Liabilities
NIR (= GIR – GIL)	MB (= C + RR + ER)
NDA (= NCG + GCB + NCFSR)	
OIN	
Total Assets	Total Liabilities

In this formulation Net International Reserves (NIR) are calculated as the difference between Gross International Reserves (GIR) and Gross International Liabilities (GIL). GIR includes central bank and government holdings of gold, foreign exchange and SDRs; the reserve position in the IMF; and claims on non-resident financial institutions denominated in convertible currencies. GIL include liabilities in convertible currencies to non-residents with an original maturity of up to one year, as well as all liabilities arising from balance-of-payments support borrowing from foreign banks, institutions and governments, irrespective of their maturity. Net Credit to the Government (NCG) is the monetary financing of the budget deficit. NCG equals credits to the government minus government deposits. GCB is Gross credits to Commercial Banks. In 1993, the IMF advised the CBR to change its methodology and to count net credits to the banks (that is gross credits minus excess reserves) rather than gross. NCSFR are Net Credits to the Former Soviet Republics.

The balance sheet shows how operations of the Central Bank affect the monetary base (MB) or reserve money. This is defined as the sum of currency outside banks (C) plus banks’ cash and deposits at the CBR. In its narrow sense it includes (besides currency outside banks) only the minimum reserve requirements (RR) of commercial banks; in a broader sense it includes any excess reserves (ER) of the banks as well. Purchases of foreign currency for rubles (intervention in the foreign exchange market) raise the monetary base and increase gross international reserves. Sales of foreign exchange for rubles reduce the monetary base.

The IMF program sets a floor on the accumulation of net international reserves, and a ceiling on the issue of credit to the economy by the Central Bank. The program placed a limit on credit to the government by the whole banking system, and a limit on credit from the Central Bank to the economy. The IMF program does not limit the increase in the monetary base. Since there is a floor on net international reserves, it is possible for the Central Bank to issue money by purchasing foreign reserves.

The aim of credit targets is to limit inflation. The first step for calculating a credit limit is the inflation target.

From the balance sheet above, it is a simple exercise to calculate credit limits:

$$DMB = DNIR + DNCG + DGCB + DNCFSR + DOIN$$

where D is the change over the target period of the variable.

In this categorization, all items on the balance sheet which are not explicitly included here are compiled in “Other Items Net” (OIN). This includes the retained earnings and fixed assets of the central bank, etc. Since the profits of the central bank are a liability of the central bank, increases in retained earnings lead to a decline in OIN. After calculating the change in the monetary base which is consistent with the inflation target, the change in OIN must be forecasted. Most of the items will not change or will be easy to forecast. Then a target for the change in Net International Reserves (NIR) can be determined.

The change in domestic credit (CE) to the economy is

$$DCE = DNCG + DGCB + DNCFSR = DMB - DNIR - DOIN$$

The total amount of domestic credit which is consistent with the inflation target can be calculated. The Government and the Central Bank must then decide how to divide this between credits to the government budget, credits to the commercial banks, and credits to FSRs.

Several other issues arise in calculating targets. These include the choice of the monetary aggregate, the exact definition of the monetary base, leads and lags in inflation effects of money, etc. These factors can be important in fine tuning inflation forecasts and credit targets, but in a very high inflationary environment as in 1992 and 1993, these issues were relatively unimportant. At first the CBR had only direct monetary instruments at its disposal: directed credits and mandatory reserves.

The relation between the monetary base and the money supply, M, (i.e. the money multiplier) depends chiefly on the commercial bank reserve requirement ratio, the amount of excess reserves held by the banks and interest rates.

Russia’s large budget deficit, together with quasi-fiscal expenditures and credits to the Ruble Zone, was financed almost exclusively by money creation, leading to very high and volatile inflation.[2] The budget deficit (D) is financed by money creation or internal or external borrowing.

$$(2) \quad D = DM + DB + DF$$

DM is money creation or borrowing from the Central Bank. This is 'monetizing' the deficit, and excessive money creation leads to inflation.

DB is domestic borrowing. Excessive domestic borrowing leads to high real interest rates. The market for T-bills (GKOs) only started in May 1993. Demand for GKOs was at first very thin both because of high inflation and the resulting capital flight, and because foreigners were denied access. Central-bank credit auctions designed to provide short-term liquidity to the banking system on market-related terms were begun in February 1994.

DF is borrowing abroad or running down foreign exchange reserves. Excessive foreign borrowing leads to an external debt problem, and depletion of reserves leads to an exchange rate crisis. In 1992, Russia had no access to external financing. In December 1991, the Soviet Vneshekonombank, which was responsible for the country's external and foreign currency obligations, declared bankruptcy. This involved total default on all its liabilities, including short-term trade debt.[3]

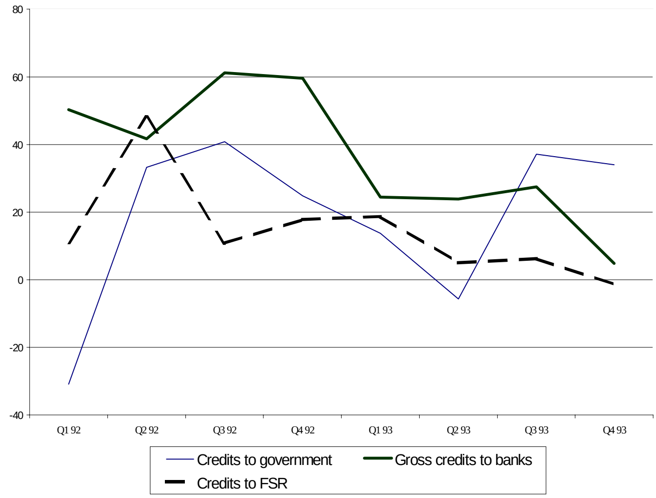
During 1992-93, monetary base expansion reflected mainly the growth of Net Domestic Assets (NDA). Only, during the second quarter of 1993 was a leading role played by external reserves, NIR. Within NDA, until mid-1993 changes in *credits to commercial banks* (GCB) had the most influence. These credits were designed not merely to provide liquidity to banks through the refinancing, they also included quasi-fiscal outlays in the form of subsidized credits channeled through the banking network to state enterprises. After mid-1993, credits to the government became the main source of domestic asset growth. Within NDA, a large part of the monetary base expansion was due to *Credits to Former Soviet Republics* (NCFSRs), especially in the second quarter of 1992 (Table 2 and Figure 1).

Table 2:
Percentage Change in Base Money Generated by Growth of Domestic and External Claims Respectively, 1992-93.

	NIR	NDA= NCG+GCB+CSFR	NCG	GCB	NCFSR	OIN	MB
Q1 92	1.4	30.4	-30.9	50.3	11	24	55.8
Q2 92	12.5	123	33.2	41.7	48.1	-29.7	105.8
Q3 92	29.9	112.8	40.8	61.2	10.8	-16.3	126.4
Q4 92	22.9	102.2	24.8	59.6	17.8	-63.3	61.8
Q1 93	36.7	56.8	13.7	24.4	18.7	-44.8	48.7
Q2 93	56.7	23.2	-5.7	23.9	5	-29.6	50.3
Q3 93	12.3	70.8	37.1	27.5	6.2	-24.7	58.4
Q4 93	2.4	37.4	34	4.8	-1.4	8.2	48

Source: Balino, Hoelscher *et al.* (1997), Table 3, pp. 15-16.

Figure 1:
Percentage Change in Base Money Generated by Growth of Various Domestic Claims, 1992-93



Source: Calculated from Balino, Hoelscher *et al.* (1997), Table 3, pp. 15-16.

The Ruble Zone owed its peculiarity to the monetary system inherited from the centrally-planned economy; namely, the dichotomy between cash and non cash.

Each republic had a branch of Gosbank on its territory, but when the FSRs declared their independence/sovereignty (1990-91), they each took over the Gosbank branch and made it the national central bank. However, they could only issue credits: so-called non-cash rubles. The emission of cash rubles remained the privilege of the CBR. Russia was able physically to control all cash ruble emission because all Gosznak bank note printing plants were located on Russian territory.

The dichotomy between cash and non-cash rubles led to a situation where there was a single cash currency: the cash ruble whose emission was controlled by the CBR. On the other hand, there were as many non-cash rubles as independent central banks wished to issue. The CBR provided both non-cash and cash credits to the countries of the 'near-abroad' to allow their enterprises to continue trading with Russian partners.[1] The credits financed these countries' imports from Russia and thus had much the same effect as direct subsidies to Russian industries. At the same time, central banks of the

FSRs were themselves able to issue ruble credits to be spent in Russia, thus further contributing to the growth of Russia's money supply and inflation.

In an attempt to restrain FSRs from issuing credits, Russia introduced a decree on the 1 July[2] limiting the growth of correspondent accounts.[3] The national banks of the FSRs could only withdraw credits from correspondent accounts held at the CBR on condition that there existed deposits to cover the transaction. A new line of credits called 'technical credits' was opened for trade purposes. These credits were subject to negotiation. However, the central banks of the FSRs kept issuing credits. This was possible because of the lobbying efforts of Russian firms which traded in the FSRs. These firms wanted to be paid. A second factor was the appointment of Viktor Gerashchenko as head of the CBR on 17 July 1992. He made no attempt to hide his policy of acceding to the requests for new credits. He professed that the aim was to protect commercial ties with the FSRs. Another factor was that the Central Bank was constitutionally subordinate to the Supreme Soviet which opposed the government's policy of ending the Ruble Zone. The result was that credits to FSRs went on.

At the beginning of 1993, Boris Fyodorov was appointed Deputy Prime Minister and Minister of Finance. The fight against inflation became a major priority and credits to the FSRs a major target. The incentive to limit the cost of the Ruble Zone was reinforced by the negotiations with the IMF on a new credit line facility especially designed for Russia (the Systemic Transformation Facility - STF). By this time, the IMF had recognised the necessity for each of the FSRs to introduce their own national currency. The level of most technical credits extended had reached the limits and needed negotiation. It was, therefore, easy not to renew them. In April 1993, the government and Supreme Soviet of Russia, in agreement with the IMF, decided to abolish technical credits. All previous credits to the FSRs accumulated over 1992-93 were transformed into state debts, denominated in US dollars with interest rates expressed in Libor. The advantage of such a measure was that state debts were channelled through the budget. Then the Ministry of Finance (Fyodorov) was in a position to exercise direct control over the level of financial transfers to the FSRs.

With the unification and the declaration of a Russian exchange rate in July 1992, new bank notes, with the Russian flags, were issued. The new notes circulated in parallel with the old Soviet ones, depicting Lenin, but only old Soviet notes were delivered to the FSRs. With the tightening of the credit policy to the FSRs, the demand for cash increased dramatically and became the major source of transfers to the FSRs and a major threat to Russian monetary stability. The Lenin bank note had to go. This was done on 24 July 1993. The CBR implemented a monetary reform aimed at isolating its cash circulation from the other FSRs. Pre-1993 Soviet rubles were withdrawn, and those countries in the Ruble Zone still using these old notes found themselves with money that ceased to be legal tender in Russia.

In the first quarter of 1994 inflation performance improved, with the average monthly inflation rate (12%) which was approximately half the level of the equivalent period in 1993 (23%). A reason for this was the end of the Ruble zone in the autumn of 1993. The Ruble zone had been especially costly in 1992. Credits to FSRs reached 11.65% of Russian GDP (8.5% of GDP if delivery of cash was excluded).

Regarding trade links with FSRs in 1992, it is revealing to read the appraisal of the IMF staff written on July 24, three weeks after the introduction of the 1 July decree introducing limits on the growth of correspondent accounts:

> The staff well recognizes the difficulty of carrying out an appropriately tight monetary policy in the absence of well-defined rules and institutions for ruble area coordination. It urges the authorities to make every effort to resolve these issues and to normalize monetary and trade relations with other states of the former USSR as soon as possible, and to ensure that the interstate credit limits introduced on July 1 will be of only a temporary nature.[…] Russia has a special responsibility –given its size – for promoting mutually acceptable solutions to issues of monetary cooperation and maintaining mutually beneficial trade links through a liberal trade regime.” (International Monetary Fund, 1992b, p. 40)

Note that ‘beneficial trade links’ are emphasized. Who benefited? Certainly not Russia, as was well recognized by Sergei Ignatiev (presently chairman of the Bank of Russia), head of the Russian delegation at the Tashkent conference in May 1992, when he ‘torpedoed’ the Tashkent agreement!

The cooperative ruble area arrangement assumed that Russia would continue to offer subsidies and aid to the other republics. While this aid was substantial, the IMF pushed for its continuation; notwithstanding the costs to the Russian economy. As stated in a later report:

> Financing extended by the Central Bank of the Russian Federation (CBR) amounted to rub 1 trillion (or US$5 billion at the average market exchange rate) through the correspondent accounts and so-called technical credits. In 1992, Russia extended implicit price subsidies to other FSU states as a group due to many traded goods, particularly energy, being priced below world market levels. These price subsidies, in net terms, are estimated by the authorities at rub 2.4 trillion or US$12 billion at the average market exchange rate. (International Monetary Fund, 1993, p. 7)

These huge costs for the Russian economy led to the following IMF advice, in the same document:

> The projected improvement of Russia's terms of trade vis-à-vis the other FSU states as energy prices move toward world market prices would tend to increase Russia's trade surplus with these states, provided it could be financed either by Russia or other external creditors. The staff would urge the Russian authorities to be as definite and transparent as possible about its trade and pricing policies as well as the amount and terms of the foreign assistance it is willing to extend. A sharp reduction in the real amount of such assistance should be avoided because of the disruption it would cause to the links between still interdependent economies. (p.15)

In another IMF document, it is stated:

> An immediate and generalized move by the Russian Federation to world market oil prices for sales to other republics, while having a major positive impact on the Russian budget, would also have a major adverse impact on the economies and tax bases of the other republics – and indeed a subsequent depressing effect on the demand for Russian exports. A gradual transition, as is being applied within Russia, will help to minimize the extent of trade and fiscal distortions in many of the republics. (International Monetary Fund, 1992a, p.18)

This advice was given to a country, Russia, which itself had a large budget deficit. It was not only large, but difficult to measure, due to the extent of fiscal and quasi-fiscal expenditures. Still, the 1992 general government budget deficit was estimated at 18.2% of GDP by the IMF and at over 20% by the World Bank. From these figures, it seems clear that Russia was in no position to 'minimize trade and fiscal distortions' in the other FSRs.

Interrepublican trade cost Russia dearly in terms of losses for the Russian budget and, therefore, in terms of inflationary financing. The IMF advice should have been to move commodity prices to world market levels for exports to the other republics. Russia could not afford to subsidize the other republics at the expense of its own monetary stability. The movement of oil and other commodity prices towards world market levels would have had an impact not only on the magnitude but also the distribution of external financing requirements among the FSRs. Providing the G7 with reliable estimates of the external financing requirements of each of the FSRs' was one of the main tasks of the IMF, and yet one can see that the IMF was more concerned with limiting the risk to the IMF by urging Russia to take on the burden.

Conclusion

The cooperative ruble area arrangement favored by the IMF in 1992, would have required all FSRs central banks to cooperate on monetary policy.

Even making the heroic assumption of bona fide cooperation (rather than cynical free-riding on the part of the FSRs), this would still have subjected Russia to political pressures to attune its interest rates, not according to its own domestic monetary constraints, but to its 'trading partners,' which were deficit countries. The hopelessness of the project of creating "a cooperative ruble area, in which all central banks would have a say" should have been clear from the outset, based on an understanding of Soviet central planning. Even with the benefit of hindsight, the authors admit only that the chances of this project were undermined by the chaotic conditions of the Soviet meltdown (p. 11). Even now, they do not see that even if the system had ended with less chaos, a "cooperative ruble area" would have been untenable. Two reasons for this are:

> (1) The virtual economy of non-viable enterprises (bad products, cost-free transport of components from one end of the Soviet Union to the other, etc.) meant that they would continue to absorb credits until stopped. This happened both inside Russia and in the Ruble Zone, until Russia put a stop to it.
>
> (2) The sheer nihilism left by the Soviet system meant that former fraternal comrades would never be guided by any higher interest than grabbing as much as they could for themselves.

The authors mention (p. 15) that the basic principles regarding the introduction of national currencies were presented by the Fund staff at a February 1992 conference in Brussels on Codes of Conduct for Interstate Economic Relations:

> Indeed, if the conditions required to run a successful anti-inflationary monetary policy are not met, the introduction of a new currency could well lead to increased instability. For this reason, new currencies should not be introduced hastily, and certainly not before conditions have been established domestically to ensure the stability of the currency. To be sure, the political pressures for separate currencies are strong in a number of republics. However, the introduction of a new currency before meeting the essential preconditions could, if it led to uncontrolled inflation and economic disruption, have major adverse political repercussions." (Hernandez-Cata, 1992, p.64)

What is not clear in these "basic principles" is why Hernandez-Cata seemed to assume that haste in introducing a new currency would be more damaging than sticking to the ruble? Did he really believe that given all the information and data at the IMF's disposal, that politically, the introduction of national currencies would lead to more chaos than keeping the ruble? If that is truly the case, this casts doubt on the quality of the IMF's policy advice.

The experience of the EMU highlights the need for a political commitment to the discipline required for a workable common currency area, and this political commitment was lacking in the Ruble Zone. Moreover, the EU accession countries are learning that sharing a common currency involves macroeconomic stability and convergence at the outset. These were lacking in the ruble area formed under the former socialist regime based on artificial terms of trade. As Dornbusch (1992) has put it:

> It is a quite awful idea to maintain a currency area between sovereign nations based on an unstable center currency. Moscow is at the center and may control the note issue, but there is clearly no control of what might be printed elsewhere. (p. 419)

In the conclusion, the authors give some thought to the fate of the efforts of the Russian reformers:

> While the stabilization of inflation and strong financial support from the international community would have been significant counterweights, it is not obvious that they would have been sufficient to overcome the growing domestic reaction against reforms. (p. 24)

Even if this assessment is granted, it cannot retrospectively redress the IMF's failure as regards Russia to fulfil its mandate to give its member countries the best advice on monetary and exchange rate arrangements. The IMF was not founded to give the pros and cons of policies. Such discussions are for academics. The decision a country makes determines whether IMF money is forthcoming. So the IMF's 'neutrality' as recorded by the authors seems objectionable in principle:

> While encouraging countries to make the choice between national currencies and a cooperative ruble area arrangement, and explaining the arguments on both sides, the IMF was formally neutral between the two options." (p. 17)

It was also damaging in practice. 'Neutrality' is a dereliction of responsibility when the whole financial assistance package depended on Russia being able to meet the inflation targets. The mandate of the IMF is not to show that the IMF "was not taking sides" (p. 18), but to assist its member states with advice and financial support, including advice on how to qualify for that support. The entire IMF strategy appears to have been based on the fear that stabilizing Russia and the FSRs was beyond expertise of the IMF staff and on the fear that their financial assistance might go wrong. Perhaps, the most dubious aspect of the whole IMF position on this matter was the assumption that the burden of stabilization of the other FSRs should rest on Russia. As I have stressed:

> National convertible currencies and free trade at free prices are necessary conditions for a successful stabilization program in these countries. If Russian aid to other FSRs cannot be stopped altogether, assistance should be financed from non-inflationary measures backed by some collateral, preferably not by Russia. All FSRs have become members of the IMF. Their IMF membership can facilitate external financing of comprehensive reform programs, and therefore is a crucial element in a successful transition to a market economy. Other international organizations could contribute as well. (Granville, 1995a, p. 79)

Finally (p. 24) the authors express one hope:

> The critical elements were the political and, to a lesser extent, economic judgements of the key actors in all the ruble area countries, judgements that mostly rested on analyses and world views that the IMF had little ability to influence. Nevertheless, it will be important that the full story of the dissolution of the ruble area, when it comes to be written, portrays the IMF's specific role accurately. We hope that this paper will contribute to this.

I share that hope as regards my own commentary set out here.

Appendix

In 1992, various IMF papers seem to corroborate the view that the IMF favored maintaining the Ruble area.

> Interrepublican relations vary considerably. Russia has entered into agreements with Kazakstan and Belarus and is now in the process – with our strong encouragement – of doing so with some other republics, aimed at maintaining close economic and financial links." […] "I might add that last Saturday I had an opportunity to discuss these and other issues with Mr. Gaidar, First Deputy Prime Minister in charge of Finance and Economy for Russia. During our brief meeting, we discussed Russia's economic policies, and I stressed the importance that the Fund attached to the need for monetary and fiscal restraint,

> an acceleration of the privatization process, and interrepublican co-operation. (International Monetary Fund, 1992d, p.4)

The extracts of IMF documents which follow were all approved by Mr. Odling-Smee or Mr. Hernandez-Cata.

> With regards to the coordination of monetary policy with other central banks, various alternative frameworks could be adopted and these are discussed later in sections V.1. Over the long term, the republics are likely to achieve the most effective coordination under a joint-decision framework along the lines of the US Federal Reserve System, accepting Russia as the leading member. In the short term, however the authorities should adopt simple ground rules that will help to restrain overall credit if followed by the majority of republics. Within the constraints of Ruble Zone policies, the authorities should liberalize interest rates, set the central bank refinancing rate at a positive real level, and set quantitative limits on both central bank and commercial bank credit. They should also refrain from influencing the sectoral distribution of credit.

> An important related development in the monetary area has been the announced intention by some republics to introduce separate currencies. This, has resulted partly from the monetary policy coordination problems being experienced in the ruble area, but also from inadequate supplies of ruble banknotes coming from Moscow and a failure to agree on a fair division of the ruble seignorage. The desire to create a national identity has also been an important contributing factor. This issue is discussed more fully in sections IV.4 and V.2. (International Monetary Fund, 1992a, p.5)

Armenia: (Mr. Pastor was one of two people responsible for answering technical or factual questions relating to this paper prior to the Board discussion.)

> The staff recognizes the recent pressures stemming from elsewhere in the ruble zone that have led the authorities to consider actively the introduction of a national currency. Whether, and to what extent, these pressures will continue, will become clearer in the months ahead. The authorities realize the technical and institutional requirements for the successful introduction of a new currency, and specific technical assistance from the Fund has been requested for this purpose. However, the national currency option should not be viewed as a panacea and if a strong political commitment is not present to pursue tight financial policies to protect the value of the currency, an already

> difficult situation would become even worse. (International Monetary Fund, 1992h, p.16)

<u>Kazakhstan</u>

> Four technical assistance missions have visited Kazakhstan since November 1991. The missions offered advice in the areas of tax reform and social expenditures, public expenditure management, central banking, and statistics. This appendix provides a brief description of the missions' activities, main findings and recommendations. (International Monetary Fund, 1992e, p.20)

Let us now move to the section 3 of VI. Fund Technical Assistance Activities, where the advice on central banking is given:

> CBD[4] provided advice to the National Bank of Kazakhstan in the context of an advisory mission that visited Alma Ata during November 1991 and through participation in the January 1992 EURII mission.[…] The advice of CBD mission on the requisite legal framework was conditioned by the ongoing discussions on the creation of a monetary union based on a banking union agreement. It therefore focussed on the broad legal concepts necessary to ensure the supremacy of regulations and directives issued by the proposed banking union, while also pointing out the deficiencies in the existing financial legislation. (p.21)

<u>Moldova:</u>

> The reasoning behind the plans to introduce a national currency is understandable in the current circumstances, although the costs are likely to be considerable. The staff urges the authorities to refrain from precipitous action, since the introduction of a currency in an ill-prepared manner is likely to make matters worse. The capacity of the National Bank to successfully conduct both monetary and exchange rate policy, as well as administer an exchange system, will be critical. But more fundamental is a political resolve to implement tight financial policies (and, in particular, to eschew bank financing of any fiscal deficit), in order to protect the internal and external value of the currency. (International Monetary Fund, 1992f, p.17)

<u>Turkmenistan</u>

> An effective stabilization policy for the ruble zone as a whole calls for close coordination with other member countries on the design and implementation of monetary policy. But even to implement a commonly agreed policy, Turkmenistan will first need to develop an ad-

> equate institutional framework, notably by strengthening the State Bank of Turkmenistan. […] Within a cooperative framework in the ruble zone, the authorities need to exercise caution in making credit available to the economy in the coming months, so as to contribute to a reduction in inflation and preserve the positive effects of price and trade liberalization on the reallocation of resources. (International Monetary Fund, 1992g, p.29)

Notes

1. More details on the IMF position is provided in the Appendix.
2. See Granville (1995b) for more details on the high inflation period of 1992-95.
3. "At the end of January 1992, foreign exchange reserves of the central bank amounted to only US$12 million." (International Monetary Fund, 1993c, p. 23)
4. See Granville (1995a) for a comprehensive account of the impact of the Ruble zone on Russia's stabilization efforts.
5. This followed the announcement by Ukraine on 12 June 1992 of a massive increase in credit approximately doubling its money supply. This was done to clear inter-enterprise arrears. The Russian government was not consulted.
6. As of 1 January 1992, commercial banks were instructed to direct all transactions with FSRs through correspondent accounts at the CBR. The correspondent accounts of the central banks of the FSRs centralized the payment clearing system for inter-republican transactions. Payments were supposed to take place only on the basis of availability of funding. In fact, since traditionally the FSRs had a trade deficit with Russia, they were able to finance their deficits by money creation in Russia.
7. CBD: Central Banking Department.

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