A Multilateral Payments Union for Eastern Europe? *

1. Introduction

Convertibility of East European[1] currencies is presently one of the main topics on the agenda of economic reform. In this context, the model of a multilateral payments union (PU) between member countries of the Council for Mutual Economic Assistance (CMEA) is discussed as an intermediate solution facilitating the transfer to a full freedom in international transactions.

The paper starts with an analysis of the main functions of a multilateral payments union. It discusses a PU's advantages and disadvantages in comparison with bilateralism and identifies the rationale for maintaining bilateralism in relation to an outside group. It shows that a positive assessment of a PU crucially depends on the assumption of a balanced trade between member countries and a fundamental current account deficit *vis-à-vis* the rest of the world. The main analytical question is whether a payments union with restricted convertibility *vis-à-vis* outside countries is superior to a shock therapy of rapidly liberalizing foreign trade, services and financial transactions. To assess this issue, the paper compares the underlying economic conditions in the member countries of the European Payments Union (EPU) with the situation in a prospective East European Payments Union (EEPU). At the end of the paper a tentative proposal is developed which aims at a synthesis of the positive elements of a payments union with the advantages of complete liberalization.

[1] For reason of simplicity, the paper addresses present CMEA countries under the heading of "East European" countries, although they also include countries in Central Europe.

2. The main functions of a payments union

To describe the functions of a payments union, it seems useful to start with a negative assessment: A payments union has nothing in common with an international or interregional monetary system nor does it serve as a substitute for such arrangements.[2] As the example of the European Payments Union shows, such an arrangement has to be embedded in and derives its rationale from an existing supranational monetary order with relatively fixed exchange rates.[3] Defining its role in a positive way, a payments union can be regarded above all as an institutional device facilitating a regionally limited trade liberaliz-ation[4] in an environment of inconvertible currencies. Thus, a payments union can only have positive effects on trade if existing trade restrictions do not constrain an expansion of member countries' imports.[5]

In the case of Europe at the beginning of the 1950s, EPU member countries undertook the obligation to increase the degree of liberalization of their imports from 50% (agreed in October 1949) to 60% by the end of 1950 and to 75% on February 1, 1951. And what is equally important, they agreed to switch from a highly discriminatory trade system to the principle of non-discrimination[6] *vis-à-vis* EPU members.

Thus, the main objective of a PU is to safeguard that the process of trade liberalization is not impaired by the emergence of bilateral trade imbalances. To that purpose it provides three functions:

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[2] This aspect is sometimes disregarded in literature. See *e.g.* SOLDACZUCK (1990), who proposes a PU which limits margins of fluctuations of exchange rates. A similar view is adopted by ECONOMIC COMMISSION FOR EUROPE (1990, p. 149), which maintains that a payments union for East and Central Europe on the basis of the ECU would subject its members to the discipline of the EMS.

[3] See, above all, KAPLAN and SCHLEIMINGER (1989, p. 357): "Ingenious as was the EPU's automatic mechanism, it was obviously time-bound to an era of fixed exchange rates (...)". In the first instance, the EPU was created as an auxiliary institution for liberalisation.

[4] See, for instance, EMMINGER (1951, p. 619): "In the first instance, the EPU was created as an auxiliary institution for liberalisation".

[5] An opposite function of a payments union is suggested by MICHALOPOULOS (1990, S. 7), who considers clearing arrangements as an instrument to regulate the reduction of trade over time. This could be easily achieved, however, within the existing framework of bilateral agreements.

[6] This principle was embedded in the OEEC codex on the liberalisation of trade, which was agreed on July 7, 1950.

– a clearing of bilateral balances in (non-convertible) PU member currencies, which makes these currencies convertible within the union;

– an automatic credit mechanism for countries with an ag-gregate PU deficit, which is unlimited between and limited at the settlement dates;

– a coordination mechanism overcoming the externalities of an uncoordinated transition to currency convertibility.

2.1. *The clearing mechanism*

The most important function of a multilateral PU is the widening of the strict budget constraint, which characterizes a system of inconvertible currencies and bilateral trade agreements. In its extreme, bilateralism requires an almost instantaneous equalization of bilateral imports and exports. Such arrangements were practiced above all in the 1930s under heading of "bilateral clearing agree-ments".[7] All export and import transactions between two countries were settled via a collective account. If a country's amount of export payments falls short of the amount of import payments, exporters have to wait until additional imports accrue. If such a system includes n-countries, each individual country i faces a series of bilateral budget constraints *vis-à-vis* all other countries:

$$(1) \qquad\qquad X_{i/j} = e_{i/j} M_{i/j} \qquad\qquad (j = 1 \ldots n-1)$$

Nominal exports from country i to country j ($X_{i/j}$) have to be equivalent with nominal imports ($M_{i/j}$) obtained by country i from country j, calculated at an exchange rate ($e_{i/j}$),[8] which has to be agreed between the two countries. If trade restrictions are reduced, this budget constraint allows an expansion of exports and imports only to the degree that their growth is bilaterally balanced.

A more advanced form of bilateralism are bilateral payments agreements, which were practiced in the second half of the 1940s. The instantaneous budget constraints is relaxed by the provision of bilateral credit facilities which are unlimited between settlement dates

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[7] For a more detailed description see BLANCPAIN (1962, pp. 45-97).

[8] In the paper it is assumed that all exports are denominated in the currency of the exporting country, which implies the opposite for imports.

and limited at the date of settlement ("swing credits"). This allows much more flexibility in bilateral transactions, because private agents can now buy products from the partner country (within the limits set by trade restrictions) without being required to wait for corresponding import receipts. The greater room for maneuver of exporters and importers can lead to situations, however, where the bilateral deficits surpass the limits of the swing credit. In principle, these imbalances had to be settled by the deficit central bank with convertible currencies or gold. But in order to avoid this, debtor countries either tried to increase their credit limits or restricted trade with the respective country.[9] With bilateral payments agreements, the series of bilateral budget constraints of country i becomes:

$$(2) \qquad X_{i/j} = e_{i/j} M_{i/j} \pm e_{i/j} S_{i/j} \pm e_{i/z} R_{i/j} \qquad (j = 1...n-1)$$

where $S_{i/j}$ is the maximum swing credit agreed between countries i and j and $R_{i/j}$ is the transfer of convertible reserves from central bank i; to central bank j, which have to be converted in the domestic currency by using the exchange rate $(e_{i/z})$ between the domestic currency and the currency (z) in which outside reserves are held. The budget constraint shows that imports and exports have to be constrained by means of trade policy if bilateral disequilibria surpass the amount of swing credits and if countries want to prevent a transfer of reserves. In fact, at the end of the 1940s, European trade relations were characterized by an uncoordinated and discriminating liberalization (Emminger 1951, p. 615).

With the establishment of a multilateral payments union the series of bilateral budget constraints is reduced to a single budget constraints *vis-à-vis* the group of PU member countries. Assuming that k of the n countries participate in the PU, most of the foregoing bilateral budget constraints of country i can be added up to:

$$(3) \qquad \sum_{j=1}^{K-1} e_{i/UPU} X_{i/j} = \sum_{j=1}^{K-1} e_{i/UPU} M_{i/j} \pm S_{i/PU} \pm e_{z/UPU} R_{i/PU}$$

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[9] KAPLAN and SCHLEIMINGER (1989, p. 23) describe this situation for the post-war situation as follows: "By 1947, the credit lines were near exhaustion, with little chance of repayment. Debtors sought new credits and, when they were not forthcoming, cut back their imports. The expansion of intra-European trade came to a halt. Payments arrangements became completely jammed as each country sought bilateral balance".

The compensation mechanism of the union requires a common unit of account (UPU). Thus, exports of country i have to be converted in this unit by using the exchange rate between its currency and the unit $(e_{i/UPU})$, while its imports are converted with the exchange rate of the other members' currencies *vis-à-vis* this unit $(e_{j/UPU})$. The bilateral swing credits are replaced by the credit granted to or provided from the payments union $(S_{i/PU})$, which is denominated in the common unit of account. Bilateral asset settlement is substituted by a transfer of reserves between the union and individual member countries $(R_{i/PU})$, which have to be converted with the exchange rate between the outside reserve currency (z) and the PU's unit of account $(e_{z/PU})$.

In relation to the countries not included in the PU the bilateral budget constraints of country i remain as before:

$$(4) \qquad X_{i/j} = e_{i/j} M_{i/j} \pm e_{i/j} S_{i/j} \pm e_{i/z} R_{i/j} \qquad (j = k + 1...n)$$

Thus, the main effect of a multilateral payments union is that it makes inconvertible member currencies convertible within the union. This avoids or reduces the settlement in outside reserves,[10] which also reduces the central banks' precautionary demand for foreign exchange reserves. In other words, the wider PU budget constraint is compatible with bilateral disequilibria as long as aggregate PU exports and imports of a country are balanced. In the context of trade liberalization, it is evident that this less binding constraint allows a stronger expansion of overall trade than the series of bilateral constraints. As a reserve loss is only incurred by having an aggregate trade deficit surpassing the PU credit lines, bilateral trade balances are replaced by the aggregate PU balance as the main target of trade policy, which almost automatically substitutes discriminating policies by non-discrimination.

2.2 *The credit mechanism*

Even a pure clearing system has to provide unlimited credit between settlement dates. It requires, however, complete repayment

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[10] During the existence of the EPU bilateral positions totalled 46.4 billions unit of account. An amount of 20 billion could be settled in the form of multilateral compensation. See *Final Report* of the European Payments Union: ORGANISATION FOR EUROPEAN ECONOMIC COOPERATION (1959).

of outstanding balances at the time of settlement. In contrast to this approach, the EPU granted limited credit facilities to those countries which were aggregate EPU debtors at the end of the monthly settlement periods. The following table shows that deficits of less than 20% of a country's quota required no settlement at all. For the part of the (cumulative) deficit exceeding this amount, an increasing percentage had to be repaid in gold, which was designed as a disciplining effect on debtors.

TABLE 1

The cumulative deficit is in a range of ...% of the quota	Percentage of the respective part of the deficit which has to be settled in gold	Credit granted from the EPU
0 - 20%	0%	100%
20 - 40%	20%	80%
40 - 60%	40%	60%
60 - 80%	60%	40%
80 - 100%	80%	20%
more than 100%	100%	0%

EPU credits were granted mainly by EPU creditor countries,[11] which were required to hold at least parts of their EPU surpluses in the form of non-convertible balances with the EPU.

The table shows that the conditions for creditors also contained an increasing percentage of gold settlement, which remained smaller, however, than the percentage for major debtors and which led to increasing gold stocks of the EPU. The relatively low ratio of gold settlement to creditors can be regarded as a disincentive – in the spirit of ideas of Keynes' "Clearing Union" – preventing the accumulation of permanent multilateral balances.

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[11] The United States provided an original grant of $ 350 million.

TABLE 2

The cumulative surplus is in a range of ...% of the quota	Percentage of the respective part of the surplus which is settled in gold	Credit granted to the EPU
0 - 20%	0%	100%
20 - 40%	50%	50%
40 - 60%	50%	50%
60 - 80%	50%	50%
80 - 100%	50%	50%
more than 100%	undetermined, required discretionary decisions of the OEEC	

In the context of the credit function of a PU, the multilateralisation of settlement has the additional advantage that it leads to a more intensive use of previously existing bilateral credit facilities. This can be demonstrated by a simple numerical example:

TABLE 3

Current Account Surplus (Deficit)	of A	of B	of C
vis-à-vis			
A	–	+500	–900
B	–500	–	+300
C	+900	–300	–
Aggregate Surplus/Deficit	+400	+200	–600

If one assumes that the bilateral deficits in this example were identical with the maximum of bilateral swing credits in previous bilateral payments agreements, the aggregate credit volume under bilateralism would be 1700. As the consolidated multilateral balances show, in a multilateral agreement only a credit volume of 600 would be required to finance an identical volume of trade.

2.3 The coordination mechanism

The need for a coordination mechanism in the process of trade liberalization is due to the fact that bilateralism in trade relations has a tendency to perpetuate itself. If one country switches to inconvertibility of its currency, its trade partners lose a part of their income in convertible currencies. This creates an incentive for those countries to find ways of avoiding payments in convertible currencies, which have become more scarce for them. If they feel that their trade position is strong enough, they will also be inclined to make their currencies inconvertible. A vicious circle of this kind could be observed after World War II, when the number of bilateral agreements rose from 23 in 1945 to about 200 at the end of 1946 (Blancpain 1964, p. 85).

In the same way, an individual country, which wants to liberalize trade and capital movements in an environment with bilateral agreements, has to overcome a strong externality. It is constrained by the fact that most of its import receipts are in inconvertible currencies, while it has to expect at the same time that its partners will use (convertible) bilateral surpluses to increase their stock of (scarce) convertible currencies. This experience had to be made by the United Kingdom in 1947, which had to abolish its attempt at making the pound convertible unilaterally after heavy losses of dollar reserves.[12]

A multilateral payments agreement between a group of countries avoids the externalities which are associated with uncoordinated moves towards convertibility. By limiting convertibility to the group of member countries and by restricting the settlement in "hard" currencies, each country has a guarantee that liberalization will not deplete its stock of convertible currencies. However, this guarantee is only valuable for prospective PU debtor countries, while it has a negative impact on the union's creditor countries. Thus, the creation of a multilateral PU will be only of interest to a group of countries *ex ante*, if it is difficult for them to estimate the implications of libera-

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[12] See also EMMINGER (1951, p. 607): "As a matter of fact, in spite of the huge Dollar support for Western Europe – which helped to fill the largest gaps in the provision of goods – until 1949 no country, except of Switzerland and to some degree Belgium, dared to open its foreign exchange borders to other European countries, because they feared the unsaturated demand would immediately lead to enormous import flows and thus to an unsustainable gap of foreign exchange reserves".

lization on their future aggregate PU balance or if a prospective creditor country has the expectation that the positive effects of liberalization on its exports will outweigh this specific disadvantage.

3. A multilateral payments union compared with bilateralism

It is evident that the clearing function, the multilaterilisation of bilateral credits, and the coordination of individual liberalization measures provide important advantages compared with a situation of bilateralism. As already mentioned, the target of an equilibrium in bilateral trade balances is substituted by the target of an equilibrated aggregate trade balance *vis-à-vis* PU member countries, which above all tends to decrease trade discrimination.

It is also obvious that these advantages are increasing with the number of countries participating in the PU, which leads to the conclusion that the optimum payments union has to include as many countries as possible. Because a PU including all countries is in principle identical with full convertibility, we are facing the paradox that the optimum arrangement makes the institution of a PU more or less redundant. Therefore, if one regards a multilateral PU as an intermediate solution between a 2-country PU (bilateralism) and a n-country PU (full convertibility), there must be advantages of (limited) bilateralism which make a PU with a limited number of participants (and bilateralism against outside countries) superior to the situation with full convertibility.

In the case of the EPU, the main argument against full convertibility was the problem of the so-called dollar-shortage. European countries wanted to maintain bilateralism and strict trade restrictions with respect to the United States in order to control their trade balance *vis-à-vis* this country. At the beginning of the 1950s, European central banks had in fact extremely low gold and dollar reserves and the general assessment was that most European firms were not competitive against American importers. The unilateral discrimination against the United States reflects above all a general dollar overvaluation[13] of European currencies and the prevailing resi-

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[13] For the situation at the end of the 1940s see STEINHERR et al. (1990, pp. 50-52).

stance against parity adjustments during the period of the Bretton Woods system.[14]

This leads to the central argument for the maintainance of partial inconvertibility: At a given exchange rate and a specific macroeconomic policy mix, a group of countries expect that their trade deficit against another group of countries (together with prospective net private capital flows) will surpass their level of reserves in convertible currencies. Thus, their expected trade deficit under full convertibility would be unsustainable (Brunner 1954, p. 30).

For a general assessment of a PU the pivotal question is why such a fundamental current account deficit is not corrected by a devaluation or by a more restrictive stance of monetary and fiscal policies. Depending on the concrete situation in a specific country group, it cannot be excluded that a devaluation alone (or the choice of a low exchange rate at the inception of a new fixed rate system) is not sufficient to improve the current account and may only lead to inflation and a terms of trade loss. However, even if this were the case, a fundamental balance of payments disequilibrium can always be corrected by means of monetary and fiscal policies. The assumption of an unsustainable current deficit indicates by itself that monetary policy is too lax. As a country's current account deficit, which is not matched by private net capital inflows, is identical with individual balances, which are not financed under market conditions, there must be an institution (the central bank) which is willing to lend to private or official borrowers under "soft" conditions.

From this perspective a PU can only provide a temporary solution to symptoms of more deep-seated problems. As the maintainance of bilateralism has its costs, a multilateral PU seems only superior to full convertibility if the underlying causes for unsustainable current account deficits can neither be corrected by a devaluation nor by more restrictive macroeconomic policies. Only then, country group specific trade and capital restrictions can be justified to protect the central banks' stock of convertible reserves.

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[14] Another argument in favor of the EPU was that EPU countries could improve their terms of trade against the dollar zone by restricting their imports from the US. As HABERLER (1954, p. 28) points out, it seems rather unlikely that the conditions for this effect were given in the 1950s.

4. A multilateral payments union compared with full convertibility

In the foregoing discussion of the spectrum between a 2-member and a n-member PU, some advantages of a system with full convertibility have already become evident. But even if a PU of the EPU type were extended to all countries, it would not be identical with a situation of unlimited convertibility. The main difference is that the EPU only allowed convertibility for current transactions, while – at least in its first years – all restrictions on capital movements were maintained. This difference can be demonstrated if one defines a country's budget constraint under full convertibility:

$$(5) \qquad \sum_{j=1}^{N-1} X_{i/j} = \sum_{j=1}^{N-1} e_{i/j} M_{i/j} \pm \sum_{j=1}^{N-1} e_{i/j} C_{i/j} \pm \sum_{j=1}^{N-1} e_{i/z} R_{i/j}$$

After liberalization of capital movements, the budget constraint is supplemented by the term $C_{i/j}$, which reflects net private capital movements between country i and j. In contrast to the PU budget constraint, where PU deficits could only be financed by central bank credits,[15] the full convertibility solution restores the equilibrating function of private capital markets. From this perspective, the dollar shortage of European central banks in the early 1950s looks somewhat different: Variations of reserves – and reserve stocks – have to be higher if equilibrating private capital movements are completely prohibited. Thus, capital restrictions can only be justified by low reserve levels if one has to expect that net capital flows will aggravate existing balance of payments problems. In the situation of a current account deficit, this is to be expected above all if national monetary policy is not restrictive enough.

Under the aspect of balance of payments adjustment, the main difference between the PU and the full convertibility budget constraint is that a private financing of current balances automatically induces effects on interest rates which tend to reduce the trade imbalance, while central bank financing requires political decisions with all well-known flaws of discretion.

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[15] See EMMINGER (1951, p. 659): "Short-term private capital flows, which in the good old times equilibrated the major part of short-term balance of payments fluctuations – complementing national gold reserves – have now been supplemented by the organized credit lines of the EPU-System".

Due to the lack of automatic adjustment, it is not surprising that EPU was more and more confronted with "structural" deficits, where "structural" means permanent. The same experience was made in the Central American Common Market (CACM) clearing agreement in the 1980s, where Nicaragua emerged as large persistent debtor and Guatemala and Costa Rica as persistent creditors (Michalopoulos 1990, p. 8). If such situations arise, a PU gets the character of a zero-sum game: the advantages it offers to permanent debtors are matched by disadvantages for structural creditors, while a further expansion of intra-trade is hampered by the exhaustion of existing credit facilities. The obligation to hold inconvertible assets with the union is a special problem if a PU creditor country has a trade deficit in relation to non-PU convertible currencies. Therefore, critics of the EPU argued that countries which kept their house in order had to subsidize countries which were unable to do this.[16] Because of these problems it cannot be excluded that trade liberalization will be reversed, if the PU credit limits of some countries are exhausted permanently. In the concrete situation of the 1950s, this could be avoided above all because of the "good creditor policy" of the Federal Republic of Germany,[17] which in the period of the "economic miracle" could afford to ease tensions within the union by unilaterally liberalizing imports, reducing all export promoting measures and taxes and by removing all restrictions for the export of capital.[18]

In sum, the comparison between unlimited convertibility and a multilateral PU shows that the latter creates an unnatural rift between financial and current transactions, which impairs macroeconomic adjustment processes, especially the market reaction of interest rates. The risk is high that PU deficits become permanent, which can retard the process toward full convertibility. Even in Europe it took eight years to restore unrestricted convertibility for foreigners, and many European countries maintained controls for financial transactions of their own residents until the mid-1960s.

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[16] See BERLINER BANK (1953) and RÖPKE (1954, pp. 86-87). A different qualification can be found in ETHIER (1990, p. 7).

[17] When the EPU was liquidated in the end of 1958, Germany had a cumulative creditor position of 4,5 billion DM, which had not been settled by dollar or gold payments.

[18] See EMMINGER (1976).

5. Differences between EPU and a prospective EEPU

To evaluate the concrete arrangement of an EEPU it seems necessary to identify the main differences between the underlying conditions of Eastern Europe in the early 1990s and in the region of the EPU member countries at the end of the 1940s.

5.1 *Differences in size*

As the analysis of budget constraints shows, the positive effects of a PU increase with the number of participating countries. The EPU encompassed 18 OEEC member countries, including their colonies and countries which belonged to their currency areas, above all the Sterling Block. An EEPU would have a maximum of seven members if Yugoslavia were to participate. If it were restricted to the remaining CMEA members, it would count only six countries, without the Soviet Union only five. Thus, the relaxation of the bilateral budget constraints effected by an EEPU would have much weaker effects than in the situation of the EPU.

Associated with limited number of participants is the relatively small economic size of the whole CMEA trading region. While the intra-EPU trade (excluding trade with the sterling area) was about 25% of world trade in 1950, the respective percentage of intra-EEPU-trade (including the Soviet Union, but excluding the German Democratic Republic) was only 3.8% in 1988. Therefore, the overall improvement of the allocation process and the economies of scale which could be achieved by a regionally limited trade liberalization within Eastern Europe and which are the central argument for such an intermediate solution seem considerably lower than in the case of the EPU.

A central question is whether countries with fully convertible currencies could become members of an EEPU, which was suggested by Ethier (1990). Of special interest could be an EEPU membership of the enlarged Federal Republic of Germany. The main argument against an EEPU membership of Germany or any other country with a convertible currency is that it would be incompatible with the

principle of non-discrimination within the union. If non-discrimination is maintained and if East European enterprises are not competitive against German imports (which can no more be differentiated in East and West products after the formation of a single state), one cannot exclude that unsustainable current deficits of East European member countries would arise even within the EEPU. If an EEPU would allow unilateral discrimination against member countries with convertible currencies, it is difficult to see why these countries might be interested in such an agreement. Instead of export earnings in convertible currencies, they would obtain inconvertible earnings in convertible currencies, they would obtain inconvertible assets against the EEPU. At the same time they would not benefit from a possible EEPU trade liberalization. Thus, if a EEPU membership of countries with convertible currencies has only the effect of providing credits to East European countries, it would be preferable to use existing credit institutions and arrangements for this purpose instead of creating a rather perverted PU.

Another problem is whether the Soviet Union should be included in an EEPU. A Soviet membership is suggested by the very high share of East European exports to the Soviet Union (37.9% of their total trade in 1988) and of Soviet exports to this country group (49.0% of Soviet total trade). However, after converting the CMEA regime on world market prices, an aggregate current account deficit of at least some $5 billion annually for the six non-Soviet members of the CMEA is expected.[19] If such a "structural" deficit cannot be reduced before entering an EEPU, the union would be impaired by an early exhaustion of its credit facilities, which would prevent a process of trade expansion from the very outset. In addition, if structural deficits can be forecasted by all participants, it is almost impossible to convince the future creditor to participate in the arrangement, especially as the benefits from trade creation within the union seem relatively small for the Soviet Union with its large export share of raw materials, which it can easily sell on world markets. Again a payments union is not the adequate institution, if a specific country group is trying to obtain soft credits.

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[19] See, for instance, OECD (1990, p. 49).

5.2 Differences in the stage of economic transformation

Before entering the EPU, most European countries had been able to reduce the controls and the rationing characterizing their economies during the war period. The most evident example was the German currency reform of June 1948. In addition, in all economies the pre-war property rights on firms' capital had not been changed, so that a privatization was not necessary after the war.[20] The liberalization of trade thus occurred within an environment of market economies which allowed a restructuring of production processes according to existing comparative advantages. This would not necessarily be the case in the context of an EEPU. A mutual opening of economies, which are in relatively early stage of economic transition, does not grant a greater responsiveness of production processes to market signals, especially if major parts of the national enterprise sector are not privatized and set under hard budget constraints. In addition, because of the high degree of monopolisation, there is a risk that an EEPU will perpetuate the present – mainly politically determined – structure of intra-CMEA-trade, which considerably differs from the trade structure of these countries with non-CMEA countries (see table 4). The negative effects of trade diversion will outweigh the benefits of intra-trade creation.

In sum, intra-CMEA trade liberalization, which is the only rationale for the intermediate arrangement of an EEPU, does not necessarily shift the production structure towards a division of labor which corresponds to the comparative advantage of these countries under world market conditions. If this is the case, an EEPU only conserves the *status quo*. Instead of being an instrument facilitating the transition to full convertibility, it would retard the achievement of convertibility for the foreseeable future.

5.3 Differences in the macroeconomic situation

When the EPU started in 1950, almost all European countries had been able to reduce the very high inflation of the immediate post-war years to one-digit rates. This disinflation process had in general been supported by currency reforms reducing the monetary

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[20] See ECONOMIC COMMISSION FOR EUROPE (1990, pp. 1-10 and 1-11).

TABLE 4

PERCENTAGE DISTRIBUTION OF EXPORTS OF SELECTED EAST EUROPEAN COUNTRIES BY MAJOR COMMODITY GROUP, FOR THE CMEA AND OTHER DESTINATIONS, 1986-87

SITC Group	Czechoslovakia		Hungary		Poland		Yugoslavia	
	CMEA	Other	CMEA	Other	CMEA	Other	CMEA	Other
0 Food and live animals	0.9	6.2	15.2	17.5	3.8	12.1	4.8	9.8
1 Beverage and tobacco	0.5	0.2	2.6	0.6	0.4	0.7	0.8	1.2
2 Crude materials excluding fuels	2.3	5.4	1.8	6.9	3.2	8.2	2.5	5.8
3 Mineral fuels, etc.	2.0	7.6	0.6	8.0	10.8	13.1	1.1	2.5
4 Animal, vegetable oil, fat	0.0	0.2	0.5	1.3	0.0	0.2	0.0	0.1
5 Chemicals	4.8	9.1	8.6	14.3	7.6	6.3	10.6	12.1
6 Basic Manufactures	12.5	29.5	8.0	19.4	10.3	22.5	17.4	29.1
7 Machines, transport equipment	62.1	31.8	48.4	18.8	47.9	25.7	43.3	24.4
8 Misc. manufactured goods	13.0	9.0	13.3	10.5	8.9	7.0	19.5	14.7
9 Goods not classified by kind	1.8	1.0	1.0	2.5	7.2	4.2	0.1	0.3
All commodities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Calculations of FMELEKE (1990), on the basis of National Institutes of Health, COMPRO database and UN routine data. Data for Czechoslovakia are for 1986. Detail may not add to totals shown because of rounding.

overhang of war-financing.[21] This setting strongly contrasts with the situation in Eastern Europe, where

    – the more backward countries will be exposed to serious inflationary shocks due to price liberalization, as soon as subsidies and prevailing forms of rationing will be removed,
and where

    – the more advanced economies have either still serious problems of inflation or have not yet definitively stabilized domestic prices.

    The inflationary momentum of real sector reforms and the credibility and strategy problems which are associated with domestic nominal anchors (see Bofinger 1990) are an important argument against any strategy which aims at a regionally limited trade liberalization, while maintaining far-reaching trade-restrictions *vis-à-vis* countries with low inflation rates. If a stable macroeconomic framework for real sector reform can be established only by an exchange rate peg to a stable outside-currency, it is indispensable to reduce trade restrictions against the "anchor country" as far as possible in order to enhance the effects of the law of one price (level).

5.4 *Differences in the international framework*

    It has already been mentioned that the EPU was firmly embedded in the international monetary framework of the Bretton Woods system. Under this institutional arrangement, it was clear that convertibility[22] of a currency could only be defined as the right to convert the national currency in dollars at its fixed dollar parity. In the case of East European currencies with no formal link to major international reserve currencies, the concrete meaning of convertibility is undefined. From this perspective, it seems somewhat strange that the issue of convertibility is discussed today without a prior clarification of East European countries' future link to the international monetary framework. As the discussion of the dollar-

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[21] See especially the 15th annual report of the BANK FOR INTERNATIONAL SETTLEMENTS (1945) and subsequent reports.

[22] In the period of the international gold standard "convertibility" was defined as the unconditional right to exchange bank notes at a fixed rate in gold; see HABERLER (1954, p. 18).

shortage has shown, this issue has important implications for the assessment of processes leading to "convertibility".[23]

Thus, the intermediate role of a PU in Eastern Europe can be evaluated only if its members develop a clear concept for their future monetary integration with European or international monetary arrangements. This would provide the necessary framework for a forecast of possible fundamental current account deficits of East European countries *vis-à-vis* the rest of the world: The first step would be the development of a comprehensive exchange rate system for East European currencies themselves and for their relationship to the EMS currencies, which in both cases would have to be some kind of fixed rate arrangement.[24] As a second step concrete parities would have to be defined. On this basis one could forecast whether single East European countries or the whole country group will experience an unsustainable current account deficit under full convertibility. Then one would have to analyse the balance of payments effects of possible macroeconomic policy adjustments or a lower initial parity. The costs associated with this policies would have to be compared with the welfare losses (lack of a nominal anchor, distorted price structure) which are caused by partial inconvertibility.

6. A compromise solution

The main reason for a multilateral payments union is the expansion of intra-trade, which can facilitate the transition to full convertibility. These effects would be very limited in Eastern Europe due the relatively small economic size of this country group and the limited number of member countries, especially if the Soviet Union would not participate. In addition, it is questionable whether such

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[23] A different approach is suggested by STEINHERR *et al.* (1990, p. 53), who argue that "currency convertibility is independent from exchange rate arrangements which have their own far-reaching implications".

[24] If East European countries would establish a system of fixed rates between East European currencies but flexible (or fixed but easily adjustable) rates *vis-à-vis* the rest of the world the need for reserves would be zero. Under such a hypothetical scenario, it would be difficult to argue that import restrictions or capital controls for transactions between PU countries and outside countries are necessary to protect the PU central banks' stock of outside reserves. Convertibility in this sense (with fixed rates between East European currencies and flexible or easily adjustable fixed rates against outside currencies) could be achieved instantaneously without a need for a PU.

effects, if they would occur, would promote a real adjustment enhancing the international competitiveness of these countries, which all face rather similar distortions in output and trade, a high degree of monopolization and the unresolved issue of privatization. Under macroeconomic aspects, trade restrictions *vis-à-vis* outside countries would preclude monetary policy strategies relying on the exchange rate as nominal anchor. Thus, under micro- and macroeconomic aspects an openness of East European economies to the West seems indispensable.

The question remains whether some positive functions of a multilateral payments union could be achieved, even if these countries were to decide in favour of a shock-therapy, which rapidly restores convertibility. It is evident that the clearing function itself becomes obsolete as soon as full convertibility for foreigners is established. The clearing of individual imbalances is provided by private markets, and only aggregate imbalances between private commercial and financial transactions, which lead to tensions in a fixed rate system, have to be settled by foreign exchange interventions of central banks.

Two important functions of a PU remain even if a direct path to convertibility will be chosen: its credit mechanism and its coordination of individual liberalization measures. It has been shown that it is difficult for a single country to break out of the circle of widespread bilateralism. Therefore, it would be helpful, if all, or at least several, East European countries would coordinate their transition to convertibility, which has not been the case in the past and which would avoid the breakdown of intra-CMEA trade which was expected by some observers and which is now a major problem.[25] This would also require that the question of the future exchange rate system between their currencies and of their monetary relations to outside countries would be tackled in a more systematic way than at present. Within this framework it would be also possible to arrange a common credit facility – supported by grants from outside countries – which transfers credits in dollars or D-Marks from East European countries with a (global) current account surplus (Soviet Union) to East European deficit countries. But already this limited proposal shows that all such political initiatives require a willingness to maintain specific relations between the group of CMEA countries after

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[25] See SOLDACZUK (1990).

their transition to market economies, which seems not very plausible at the moment.

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