

# A Multilateral Payments Union for Eastern Europe? A Comment \*

## Introduction

Upon rereading Peter Bofinger's paper (1991b)<sup>1</sup> in preparation for this comment, I find it to be one of the more solid professional approaches to the debate on the Central European Payments Union (CEPU) that I am familiar with. Of course, I do not agree with him on all scores. It might, therefore, be instructive to set forth what these disagreements precisely are. Unfortunately, I am not in a position to explore the many reasons for this stance in a brief comment at this time. Neither can I render full justice to his piece in the available format. All I hope to do here is to highlight some of the critical issues that Bofinger either belittles or ignores.

## 1. Backdrop to the proposal

There is no point in spelling out the details for my change of heart about the contribution under examination here. But a few words may help to anchor my view of the CEPU as against Bofinger's. When I first proposed the creation of a CEPU in early 1990,<sup>2</sup> I was very apprehensive about the consequences for

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\* The opinions expressed here are my own and do not necessarily reflect those that may be held by the United Nations Secretariat.

<sup>1</sup> In what follows all page references without explicit indication of the source will be to this paper.

<sup>2</sup> Anonymously in two United Nations publications (UNECE 1990, WES 1990) issued under the authority of the Secretary General and two in my own name (1990a, b).

market-oriented reform of the abrupt collapse of trade within Eastern Europe<sup>3</sup> and the insuperable obstacles to reforming the Council for Mutual Economic Assistance (CMEA)<sup>4</sup> for countries in transition. I was also worried about the Herculean efforts required to reach the status of full-fledged market economy with current-account convertibility in the Central European countries that had set themselves that daunting policy ambition. Finally, I sought to galvanize the multiple metaeconomic considerations that had been contributing to the reluctance of the new leaderships in the reforming countries to cooperate with each other, even simply on the basis of emerging or envisaged market relations with accountable economic agents. Bofinger was much less concerned about these issues as opposed to the more technical and theoretical aspects at stake. His piece also contained a number of irritating misquotes and factual errors.<sup>5</sup>

Some of these features still linger at the root of my advocacy of a payments union. But I readily admit that I am presently much less sanguine than I was a year ago about the desirability of creating a payments union for the radically reforming countries of Central Europe. Regarding its relevance to the Central European reforms, I now view it at best as a contingent mechanism in case the dash toward convertibility of Czechoslovakia and Poland (and near-convertibility in Hungary) falters; the external environment will turn into a state that is far less congenial to assisting Eastern European trade and broader reforms than prevailed in early 1990; and the threat of the reform programs being eroded for vanishing sociopolitical support among widening layers of the populations. I see it also as a useful construct to bear in mind in case other former CMEA members were to find it necessary to seek market-oriented reforms without being in a position to establish a minimum of current-account convertibility. This would notably apply to the Soviet Union as a cohesive federation, which is unlikely to emerge any time soon, and, even more, if it were to break up into a weak coalition of *quasi*-independent republics, each with its own trade and payments problems even *vis-à-vis* one another. In that light, the potential usefulness of a payments union with Yugoslavia as full participant

<sup>3</sup> Reference to Eastern Europe through 2 October 1990 denote Bulgaria, Czechoslovakia, the German Democratic Republic (GDR), Hungary, Poland, Rumania, and the Soviet Union. Occasionally, I use the concept for the first six countries, in which case the context makes it clear that I have that subgroup in mind. More recently, Eastern Europe as a distinct group of countries with its own geographical, political, and reformist identity, of course, omits the ex-GDR.

<sup>4</sup> I prefer CMEA as acronym to the admittedly more euphonic Comecon. The latter is not only a politically loaded term chosen in analogy with Comintern and Cominform, it is also an incomplete abbreviation. In what follows, I concentrate on the cooperation problems of Eastern Europe as defined.

<sup>5</sup> One misquote is in footnote 2 (p. 70), where the proposal published in UNECE 1990 is alleged to have been suggested as a substitute for an international monetary system. Two factual errors are the size of the capital that the United States allegedly contributed to the European Payments Union (EPU) as stated in footnote 11 (p. 74) or the number of participants in the EPU (p. 81).

should be explored if the dash toward dinar convertibility launched in December 1989 were to fail, something that is almost bound to ensue from the ongoing political and economic erosion of the basics of the federation.

In this respect, my views emanate from a different set of concerns than Bofinger's. His approach is theoretical, searching for reasons to justify a multicountry payments union owing to its potential to provide gains over bilateralism on the way to institutionalized and policy-embedded convertibility. Mine starts from the more practical aspects of the reform, such as those enumerated earlier, and the required pragmatism to overcome obstacles to marketization in Eastern Europe. I am deeply convinced, and developments in 1990-1991 have borne this out, that the reforming countries in Eastern Europe face external-payment problems that they cannot weather on their own strength or for which full external balance-of-payments support in the requisite amounts and with the necessary supervisory mechanisms is unlikely to be forthcoming.

The problems that these countries encounter in balancing their external accounts at desired levels of economic activity, even after incisive austerity measures have been emplaced, have multiple origins. Any discussion of a payments union must abstract from the ramifications of the present crisis in the Persian Gulf. If that were to exert a lasting influence on fuel prices and levels of import demand notably in Western Europe, the reforming countries in Eastern Europe would have to undertake structural adjustments that simply cannot be financed from within a payments union.

Abstracting from this "structural" factor, the problems of balancing the external accounts in Eastern Europe in early 1990 stemmed from three sources: (1) difficulties in introducing changes in domestic policies, instruments, and institutions on the way to the market economy; (2) adverse terms-of-trade effects arising from abandoning the transferable-ruble regime in favor of current world prices and convertible-currency settlements; and (3) the desire of reforming countries to extricate themselves from intragroup commerce as soon as possible by diverting earmarked trade flows to the west in the hope of quickly joining the European Communities (EC). These are still pertinent factors today, although the relevant payment situation of most countries of Eastern Europe has become far more complex, even when the ramifications of the crisis in the Persian Gulf are dealt with separately. In this connection, I should like to make several brief comments on Bofinger's analysis. I shall group them into five rubrics; (1) comparative advantages, (2) surveillance and reform through adjustment, (3) the size of the union and its benefits, (4) the choice of multilateralism, and (5) moving toward convertibility.

## 2. Comparative advantages

First of all, Bofinger does not even entertain the desirability of providing room for maintaining economically warranted trade among the reforming

countries.<sup>6</sup> The argument that it would petrify the technological obsolescence of Eastern Europe, protract painful muddling to market-oriented reforms, and prevent the reforming countries from integrating themselves into the world economy (p. 83) is a red herring. As I have argued elsewhere (Brabant 1990a, 1991a), some economic union among the reforming countries would avert trade destruction in the short run and be trade creating, rather than trade diverting (as he maintains on p. 83), in a longer perspective. This interpretation of the state of economic affairs derives essentially from the fact that there is little trade left that could be diverted from west to east as a result of the simple protection available within an economic union. To the extent that the latter would be strictly temporary until fuller integration into the EC can be secured, even the argument that as growth picks up trade with the union would be favored over more efficient trade with outsiders, and therefore be discriminatory and induce specialization in the wrong direction, while unquestionably potentially true, is not very persuasive.

Perhaps more important, these countries have not fully exploited their static comparative advantages with each other and, with reform, should benefit from dynamic comparative advantages. Rather than impose all kinds of tariffs and administrative inhibitions on that trade, as occurred in 1990 and has been further aggravated in 1991, efforts should be made to assist the emerging self-accounting agents from capitalizing on prevailing and emerging comparative advantages almost regardless of the unquestionably sizable arbitrage opportunities that are bound to ensue in the process. Opening up intragroup trade, as pursued in trade with the west, to economic agents motivated by their own profitability would undoubtedly compress trade in the short run as flows that had previously been motivated for administrative or political reasons – certainly justified on poorly defined economic grounds – are excised.<sup>7</sup> But it would not eliminate all trade. To exploit such flows, the proper environment (policies, institutions, and policy instruments) needs to be instituted. To the degree that

<sup>6</sup> In fact, his interpretation (p. 77) of the EPU having been motivated "to control [Western Europe's] trade balance *vis-à-vis* the United States is odd. The key objective on the part of the United States was to foster trade expansion among the Western European countries in part precisely to alleviate the severity of the dollar shortage.

<sup>7</sup> This point is ignored by virtually all critics of the payments union. In an oral comment on my paper presented at the conference on "Currency convertibility in Eastern Europe" (Wien, 21 January 1991), Bofinger underlined his concerns about a payments union not being able to avert the disintegration of intragroup trade, the greater attractiveness for Eastern Europe to export to the west, and the potential for fostering specialization in the wrong direction. The first argument is true for past CMEA trade that lacked an economic rationale. I for one have argued for years that such trade flows ought to be eliminated. The second concern holds only if reforming countries have the potential to divert trade to the west without incurring sizable terms-of-trade losses – a rather improbable possibility. The last argument he cited is likely to merit serious concern only if the union is designed to be of considerable duration – which is not the case at all here.

reforms are not pursued with determination, the promotion of economic separatism among these countries might delay their swift submergence into the world economy. But that would occur even without intragroup efforts, for a slowdown or backtracking with the reform would necessarily involve less competitive pressures from world markets than otherwise.

### 3. Surveillance and adjustment

The key feature of a payments union is twofold. Bofinger correctly underlines the beneficial financing implications of the union. He ignores, however, the constructive role that surveillance in a payments union necessarily must play (Kaplan and Schleiminger 1989, Tew 1967, Triffin 1957). Only in this way can the problems he ascribes (as on pp. 80 and 82) be dealt with. Ensuring that the process of trade liberalization proceeds as expeditiously as possible is perhaps the paramount task of surveillance in a payments union.

To keep a payments union within manageable bounds, not only must adequate financial resources be mustered. Those resources must be utilized in such a way that participants do not simply exhaust their credit quota without impunity. Surveillance and the counseling on desirable fine tuning of macroeconomic and institutional policies are firm requirements. Such "advisory service" involves not only differential adjustment in the case of sizable imbalances of opposite sign with partners and other countries. It is also critical to synchronize the payment facility with the reform intentions of the participating countries, to foster trade liberalization, to avoid an increase in absolute discrimination, and to reduce the magnitude and frequency of raising relative discrimination. In some cases, conflicts can be reconciled only with a good deal of cajoling in part to overcome serious supply rigidities in the reforming countries of Eastern Europe. In other words, tight supervision is necessary to nurse along the process of creating market economies and enabling participants to fuse themselves fully into the world economy in general and the EC in particular.

Bofinger implies that a CEPU would aim only at regionally limited trade liberalization (pp. 83 and 85). This is, of course, at variance with realities. The reforming countries have been aiming at liberalization with respect to market economies but not with respect to each other. The CEPU was proposed as one vehicle that could buttress an economic union and hence the simultaneous moving toward global trade liberalization, albeit perhaps at a different pace with union members and others. The inherently discriminatory features of a payments union would *not* inhibit countries with domestic convertibility from extending it. Instead of the licensing for a plethora of bilateral deals that is currently required, the licensing of trade and payments with any reforming country in the context of the payments union would simply apply to the transactions not yet conducted in convertible currency and not yet slated to be included in such settlements.

#### 4. The size of the benefits

Bofinger is, of course, absolutely right that the smaller the number of participants in a payments union, the smaller the benefits will be. However, simply counting the number of countries presupposes that these units have fully integrated markets upon which bilateralism in external trade and payments has been imposed. The real measure of participants, however, should be payment flows coming under unintegrated regimes. Thus, although a CEPU could presently include at most seven countries (Eastern Europe as defined<sup>8</sup> and perhaps Albania), the interactions among any pair of these countries are conducted on heterogeneous bases. That certainly increases the number of trading circuits to be reconnected in an open multilateral environment. The latter expands also with the potential breakup of the Soviet federation and indeed that of Yugoslavia, something that has come within the realm of possibilities only more recently. In this connection, it bears to stress that like most commentators on the payments union Bofinger assumes that non-CMEA trade has traditionally been of necessity in convertible currency; hence any reasonable grouping of reforming countries would encompass a small share of trade of these countries.<sup>9</sup> The logical conclusion is that the benefits of a payments union under the circumstances must be miniscule and could easily be reaped through more general balance-of-payments financing, such as available from the International Monetary Fund.

But the premise for this conjecture is faulty. The relevant comparison should be trade in convertible currency, not non-CMEA trade. That has been a very small share of the total trade of most CMEA countries, ranging between some 10 percent for Bulgaria and Czechoslovakia and 25 percent for Hungary and Poland through 1989. The rest comprises trade on clearing account with other socialist and several developing countries. Even though these accounts may have been kept in convertible currency, the fact that no payments were ever made for imbalances suggests that these trade deals remained well removed from the transparency of "world market" conditions.

Bofinger, as so many, points out that a payments union should preferably include the Soviet Union. Inasmuch as this would give rise to structural deficits, a payments union would necessarily be undermined (p. 82) and degenerate into

<sup>8</sup> When I first proposed the CEPU there was a distinct possibility of accommodating the former GDR's trade relations with Eastern Europe. But this option is no longer available.

<sup>9</sup> I have my doubts about whether the small share of any grouping in world trade matters (p. 81) beyond the fact that if one purpose of the union is to guide participants into the global concert the divergence of facilities in a union as compared to global trade conditions should be held to a minimum by the very nature of the facility and even more by exercising tight surveillance. On the other hand, the share of trade of participants attributable to intragroup commerce is of paramount importance.

chronic debtor or creditor positions. The first point is clearly not based on economic considerations. A payment facility of the kind envisaged is necessarily motivated by the need to foster marketization, that is allow accountable economic agents to conduct their business without having to worry about exchange rates and settlement provisions. The second depends critically on whether the Soviet Union would be able to maintain its supplies of fuels and raw materials to Eastern Europe and the level of the world price of oil. I am less sanguine than he is about these conditions prevailing on a permanent basis in a CEPU. That the Soviet Union would be uninterested in running surpluses with a CEPU is based on the doubtful assertion (p. 82) that it can easily market its fuels and raw materials in world markets without depressing prices and running into transportation or severe processing problems.

#### 5. The choice of a multilateral regime

It is true that the EPU found part of its rationale in the *perceived* impossibility of most of the signatories of the Bretton Woods agreement, hence the fixed-exchange regime, to move toward current-account convertibility within a short period of time (p. 70). But this is not a required feature of a payments union. The necessary condition is that some group of countries is encountering intragroup current-account problems that cannot be overcome through freely floating exchange rates.<sup>10</sup> Putting it another way, if the countries in question cannot divert their economically warranted intragroup trade to third markets without incurring sizable terms-of-trade and export-revenue problems, the only alternative to multilateralizing trade, with some payment facility, is trade destruction.

Bofinger's argument on current-account *versus* complete convertibility may be cohesive in a textbook. But it is neither validated by past experience in the context of the Fund status nor is it currently being aimed at by any policy maker in Eastern Europe.<sup>11</sup> To presuppose that private capital flows for countries in fundamental transition would offset the trade imbalance (p. 79) under impulse of differential interest-rate movements is a shocking display either of obtuseness toward the real situation in Eastern Europe or ignorance, at least lack of understanding, of how these economies function.

<sup>10</sup> Presumably this is the rationale behind the rather tenuous assertion that "a fundamental balance of payments disequilibrium can always be corrected by means of monetary and fiscal policies" (p. 78), although in the next paragraph he sees ways in which "unsustainable current account deficits can neither be corrected by a devaluation nor by more restrictive macroeconomic policies"! Both statements cannot logically be true at the same time!

<sup>11</sup> Václav Klaus, the current Minister of Finance of Czechoslovakia, may be the only exception, although his views are hardly in the mainstream of actual policy making.

## 6. The moving toward convertibility

Perhaps the key argument that divides me and Bofinger (1990; 1991a, b) is his technocratic, monetary and unabashedly monetarist approach to Eastern Europe's economic problems, as in linking the inflationary problems and the credibility and strategy problems of reform to the undesirability of a CEPU. As against that, I would argue that Eastern Europe faces external-payment problems of the kind suggested earlier that can be met through austerity, borrowing abroad, or some cooperative strategy linked to reform. Producing austerity now or in the future because of misguided borrowing cannot but undermine the social consensus on absorbing the adjustment cost of reforms that is so vital to the credibility and sustainability of the reform effort.

In the same vein, Bofinger argues (p. 86) that the intermediate role of a CEPU "can be evaluated only if its members develop a clear concept for their future monetary integration with the European or international monetary arrangements". There is admittedly little doubt about what these countries covet in the medium to long run: full integration in the international monetary order in general and the European Monetary System in particular. These ambitions may be fulfilled once stability has been regained and the worst uncertainties of the transition have been overcome (Brabant 1991b). Leaving the timeframe somewhat vague at this stage should not inhibit these countries from moving steadily and as speedily as possible toward convertibility, perhaps through a cooperative strategy such as an external payment facility of the CEPU type. Active involvement of the EC in both the financing and the surveillance of the CEPU would give a critical impetus to clarifying where the reforming countries of Eastern Europe will eventually fit into the global framework.

Finally, Bofinger is, of course, right that it would be far more preferable to persuade the reforming countries to adopt convertibility and have this commitment backed up through a nondiscriminatory payment facility financed by "existing credit institutions and arrangements for this purpose" (p. 82). Two things are ignored in this context. One is the limited size of funding that can be mustered through official financial institutions. There is probably little that can be obtained from commercial institutions at this stage. Furthermore, to avoid the danger of repeating the borrowing sprees of the 1970s and part of the 1980s, strict surveillance should be attached to such new lending. Otherwise the effort may peter out in increased debt level and another payment crisis, both of which would be catastrophic for the pursuit of durable and sustainable market-oriented reforms.

## Conclusion

To conclude, Bofinger has clarified a number of useful theoretical points pertaining to the rationale of a payments union in the abstract. He has

formulated several cogent arguments against the wisdom of erecting discriminatory arrangements such as a payments union, especially in the case of Central Europe. But the last word on the merits and drawbacks of a payments union as a technical prop for the reform movement in Eastern Europe, in my view, has not yet been said.

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