The Economics of Rouble Convertibility. New Scenarios for the Soviet Monetary Economy[1]

1. Introduction

This paper tries to outline a possible transition process to external convertibility (EC) for the Soviet rouble. This is an issue which has recently attracted the attention of Soviet economists and policy-makers, in the light of the general discussion on *perestroika* (reconstruction).

It is commonly held, that EC has significant advantages. These include: benefits from multilateral trade, substitution of multiple exchange rate regime with a simpler one, providing policy-makers with a unique macroeconomic criterion with which to judge the economy's foreign trade performance, and a powerful instrument of economic policy.

Some regard EC as an instrument, a pre-condition for further reforms of the domestic economy and thus as a first step to be taken immediately. On the other hand, some consider EC as a target, and advocate radical changes in the economic system before moving to EC. This view emphasises the dangers involved in a rushing into convertibility.

The analysis which follows tries to go beyond this strict dichotomy. Convertibility is seen as a long-term process in which: (i) the evolution of the domestic economy (*i.e.*, the passage of the

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economy from a highly centralized system of planning and management to a more decentralized market-oriented one),[2] and increasing flexibility in trade practices are deeply interconnected, and (ii) trade and currency reforms are mutually dependent. In other words, it is hard to imagine the attainment of EC without a deep transformation of the traditional system of planning, but at the same time, the role of greater involvement in foreign trade and international financial relations in enhancing domestic changes cannot be overlooked.

This essay attempts to single out, in particular, the possible stages in the Soviet economy's transition process to EC and multilateralism. Reference will be made to the Soviet rouble, although some of the problems which characterise the transition phase of the Soviet currency also apply to other socialist currencies. The theoretical framework is drawn from the experience of those Western European countries which were able to shift from a condition of currency inconvertibility and widespread bilateralism to a system of currency EC and multilateralism in the late 1940s and 1950s.[3] Analysis of that experience suggests that the process of transition to EC is a gradual one, that the interdependence of trade and monetary liberalization is crucial, and that external financial assistance (both in form of loans and aid) is crucial in helping to achieve the final goals of multilateralism and EC.
In this respect, the post-war European experience seems relevant for the current Soviet economic situation for the following reasons:

i) as underlined above, Soviet integration in the world economy is linked to the developments of the domestic reform process. However, both the reform of planning and management at domestic level and the improvements in Soviet trade and monetary external relations must undergo a *gradual* process of development;[4]

ii) the need of a prudential approach is strengthened by the necessity to minimize the risks associated with too fast liberalizations of current account transactions and capital movements (deficits

[2] The firm is granted greater decision-making autonomy and, slowly, prices start to respond to signals from markets. The process of transition from central planning to market socialism has been described by NUTI (1988b).

[3] A more detailed analysis of this experience and its relevance to the socialist economies can be found in DAVIDDI-ESPA (1989a).

[4] In our view, the approach should also be gradual (and with careful control by central authorities) given the lack of *institutions* which can efficiently perform the tasks arising from a more decentralized system.

of the balance of payments, possible draining of reserves, price increases, etc.);

iii) the present dramatic state of the Soviet economy, with its problems of goods shortage and a situation of potential hyperinflation (given also the increasingly rapid lack of citizens' confidence in the purchasing power of the rouble), makes the inflow of fresh resources from abroad a vital necessity to proceed towards a successful decentralization. Foreign loans in significant quantities or, better, some kind of aid in the form of transfer of real resources (technology, human and financial capital) like in the post-war European experience, can decisively help to reduce inflationary pressures, either allowing a higher availability of imported goods in the domestic market, or avoiding further printing of money to finance the state budget deficit. The Marshall plan experience suggests how important in making smoother the transition to more liberalised forms of trade external help can be.[5]

The paper is organized as follows: the next section defines convertibility in general and in the particular context of a Centrally Planned Economy (CPE). Sections 3 and 4 discuss the relationship between convertibility, trade and monetary liberalization in the reform of the classic Soviet-type economy. Section 5 contains a detailed description of the stages of transition to EC. The main findings of the paper are then summarized.

2. Convertibility: definitions and issues

According to the definition of the International Monetary Fund (IMF), a currency is considered convertible if it meets three criteria:[6]

i) if it can be used without restrictions of a currency character for any reason whatsoever;

ii) if it can be exchanged for any other currency without restrictions of a currency character;

iii) if it can be used or exchanged at its par value, or at a rate of

[5] The problems connected with Western financial intervention in the Soviet Union are more fully analysed in DAVIDDI-ESPA (1989b).

[6] GOLD (1971), pp. 1-2.

exchange based on the par value, or at some legal rate of exchange defined in any other way considered desirable.

In other words, under Article VIII, sections 2, 3 and 4, of the IMF statute, members are obliged to avoid restrictions on current international transactions, multiple currency practice and discriminatory currency arrangements. Moreover, the monetary authorities of a member country must convert balances of their currency when those balances are presented for conversion by the monetary authority of another member.[7]

In reality, once the member has accepted the obligations of Article VIII, derogatory norms can be introduced and the member may impose restrictions of several kinds. It follows that various degrees of convertibility can be identified, depending on the effectiveness of exchange controls and restrictions, quantitative and financial barriers to external transactions, etc.

The experience of Western countries tells us that several factors (*i.e.* the risks linked to the destabilizing consequences of capital movements, short term in particular) have led to the establishment of a whole array of controls, limiting both quantities traded and types of transactions. Therefore, the concept of full convertibility does not apply to market economies too, though in recent years liberalization of capital movements has decisively gained importance.

When considering the practical experience of the Soviet economy, or more generally a CPE, different meanings, or at least different uses of the concept of convertibility should be taken into account. More precisely, we refer to:

i. the external convertibility of the rouble, which is comparable with the general definition given above;

ii. the convertibility of the Transferable Rouble (TR):[8] the parity of the TR may refer both to the currencies of the individual CMEA countries[9] (*e.g.* TR - Lev; TR - Florint; etc.) and to a purely theoretical exchange rate with currencies external to the area.

[7] Gold (1971), p. 58. As in the European experience of the fifties, EC is initially limited to non-residents.

[8] The transferable (*perevodnye*) rouble was created in 1963 as a means of promoting multilateralism even within the CMEA. In principle, when settling transactions inside this area, a surplus in roubles could be used for repaying a deficit; in reality there is inconvertibility even inside CMEA and the share of multilateral exchanges in total has remained very low. *Cf.* Brabant (1977) and (1987).

[9] In this paper we refer mainly to the seven active members of the Council for Mutual Economic Assistance (CMEA): Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Rumania and the Soviet Union.

However, the conversion of the TR inside the CMEA, and its further diffusion as a means of payment within the area, is not merely a matter of the technical determination of parities. It depends on a thorough reform of the decision-making process at the domestic and CMEA level, and in particular, on the attempt to overcome the constraints on goods convertibility, which will be analysed below;

iii. the possibility of freely converting money into goods (even at domestic level); goods inconvertibility is indeed peculiar to a CPE. The holding of a certain amount of currency (both foreign *and* domestic) as such, is not a sufficient condition to guarantee direct access to goods (outside the retail sector, and in some cases even within it): a document, *i.e.* a plan allocation, is needed for the acquisition of productive inputs;[10]

iv. mutual convertibility within the CMEA, that is the attainment of a situation in which each of the socialist currencies is convertible into any of the other CMEA currencies.

It is important to stress that in a CPE the main obstacle to the introduction of effective EC is goods inconvertibility. In this context, two different models can be identified: one characterised by highly centralized planning, commodity inconvertibility and bilateralism ("classic" CPE), the other by a more decentralized model of planning and management, goods convertibility and multilateralism (modified planned economy). The problem of meaningful convertibility arises only in the context of the transition to the second model. In the first, the selective and direct controls, the system of administrative orders linking customers and suppliers and the central allocation of resources, represent the main obstacle to the achievement of effective EC.

3. Central planning, trade and convertibility

In the classic CPE, foreign trade is part of the overall planning process: long-term planning involves provisions concerning the level of exports and imports, while short-term plans should contain

[10] For this reason, Berliner (1976) defines the Soviet Union as a "documonetary economy".

disaggregated administrative orders. In practice, however, from year to year, the level of import and export flows is for the most part a matter of marginal adjustments to previous flows. Theoretically, the centralized system of planning and management has all the advantages deriving from a direct and unified control of external trade, which allows a minimization of damages deriving from unanticipated variations of trade flows. However, structural deficiencies of existing CPEs make things less simple. With regard to the domestic sources of supply, the central authorities face strong pressure from below (*i.e.* branches, Ministries, enterprises) for additional imports, especially for investment goods. At the same time imports depend not only on the presence of a shortage, but also on the degree of priority given to the shortage product. Finally, the incentive scheme for managers and workers often makes production for the foreign market unattractive: the costs connected with the improvement of quality, delivery, servicing of exports are higher than the gains assured by the incentive system. The main consequence of inconvertibility is the large amount of trade that takes place on the basis of bilateral agreements. This does not involve money settlement and prices tend to be specially negotiated. In bilateral trade with other centrally planned economies prices used are supposed to reflect world prices, while intra-CMEA trade prices are now adjusted annually on the basis of "world" averages from the preceding five years.

Four features of a classic CPE financial system with respect to foreign trade are worth stressing.

First, the rouble does not link domestic to world prices and the structure of domestic prices can and does diverge sharply from that of foreign trade prices. The Foreign Trade Organization (FTO) pays the Soviet suppliers and charges Soviet purchasers appropriate wholesale prices, in such a way that the domestic operator never has foreign currency at his disposal. With the use of a price equalization mechanism, the wide disparity between domestic and *valuta* prices is adjusted via the state budget. Broadly speaking, from the microeconomic point of view, there are no price differences for firms whether they sell abroad or on the domestic market.

Second, there is no uniform criterion for determining the efficiency of foreign trade. Owing to the fact that the prices used do not reflect the desirability of a given transaction, the methodology for calculating the effectiveness of foreign trade is based entirely on "engineering" rules, rather than on an evaluation of costs and benefits.[11]

Third, the system offers few incentives to boost exports and to rationalize imports. This is in part the outcome of problems which often characterize a CPE, such as the positive correlation of incentives with volume and/or gross value of output and the lack of penalties correlated with the costs of production, which leads to an "unlimited" demand for resources, or to preference being given to investment as opposed to innovation. At the same time imports depend not only on the presence of a shortage, but also on the degree of priority given to the shortage product. Planners also face export constraints from below, in so far as special bonuses for exports are not sufficient to make production for the foreign market attractive. In particular costs connected with the improvement of quality, delivery and servicing of exports are higher than the gains assured by the incentive system.

Fourth, as outlined above, in many respects the domestic currency is not fully convertible into goods even within the country. Money alone is not sufficient to provide a claim on available goods.

4. Trade liberalization and convertibility in the Soviet economy

The Soviet economy can no longer be described as a classic CPE, since a more decentralized system is being built up. Schematically, the new system is characterized by a substantial improvement in planning and management, with increased individual responsibility for the results obtained, greater enterprise autonomy, and encouragement of various forms of private enterprise. A large part of production is however still subject to direct control, through state orders (*Goszakazy*); prices in the consumer markets are fixed administratively, and resources are only partially allocated through the market.

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[11] Schematically, the methodology for calculating the economic effectiveness of foreign trade is based, for exports, on a comparison of *valuta* earnings with costs in roubles, adjusted with a corrective coefficient to compensate for the inadequacy of internal prices. Imports are compared with analogous goods or with the cost of goods exported to pay imports (although it is almost impossible to identify which goods are exported).

The reorganization of the foreign trade sector has granted some enterprises the right to operate directly on the foreign market, *i.e.* without the mediation of the Ministry of Foreign Trade and the FTO.[12] Many Soviet economists maintain that the final aim of the reform is a dramatic transformation of the nature of foreign trade operations: the complete abolition of trade and currency monopoly and the introduction of trade in foreign currency based on a unified and realistic exchange rate.

Since January 1987, twenty Ministries and about seventy associations and enterprises have been able to import and export without the preliminary authorization by the Ministry of Foreign Trade (now the Ministry for Foreign Economic Relations). Subsequently, the right has been extended to a larger number of economic organizations (about 150 at the end of 1988) and, from April 1989, it applies to all economic units "whose output is competitive on the foreign market".[13] The enterprises which cannot enter directly the external market, can utilize specialized foreign trade organizations, which, however, will no longer be a branch of the Ministry, but specialized firms carrying out these operations with the necessary expertise. These enterprises are also authorized to retain and use part of the hard currency they earn, which is deposited in a special fund.

The reform has also attempted to increase exposure to international prices, by introducing some forms of shadow prices (differentiated currency coefficients - *DVK differenzirovannye valutnye koeffitsienty*). In theory, with the use of the *ex ante* coefficients the product bought or sold is no longer accounted for using the domestic wholesale price, but directly from the contractual price on the foreign market. Coefficients are differentiated according to imports and exports, geographical distribution of trade and type of product.[14]

The December 1988 Decree also announced the introduction of a unified exchange rate by 1991, as well as the introduction of a tariff

[12] For a more detailed description of the Soviet reform process in the foreign trade sector see DAVIDDI (1989a).

[13] *Cf.* POSTANOVLENIE (1988), art. 2.

[14] The number of coefficients is unclear, but there are certainly more than 3,000. They range from 0.2 to 6.6. See ASTRAKHANTSEVA-KUZNETSOV (1988). A number of articles have recently appeared in the Soviet press pointing out serious shortcomings in the coefficients. *Cf.* ANTONOV (1988); DORONIN (1988), esp. part I; GOLOVATYI-ANTONOV (1988); SHYRKALIN (1988); VALYUTNYE (1988); ZAKHAROV (1987).

system as an indirect way of regulating imports and stimulating exports and of closing the gap between internal and foreign trade prices.[15]

There are important implications that need to be figured out in the relationship between trade and monetary liberalizations, and, in particular, the consequences of trade liberalization on economic policy management. As discussed below, the transition to an indirect system of management necessitates the adoption of new instruments of economic policy, as well as a redefinition of some of the objectives to be pursued with them. Obviously, the dismantlement of direct controls has to be paralleled by the simultaneous introduction of indirect instruments: selective credit and investment controls, incomes policies, and, later on, tariffs, and exchange rate management. *Vice versa*, the evolution of targets and instruments of economic policy, which must parallel the decentralization process, seems to be missing in the debate among Soviet economists and policy-makers.

As we have seen above, in the classic CPE, policy intervention is essentially carried out through direct and selective controls of import and export flows, monopoly of FTO, etc. The price-equalization mechanism (import taxes and export subsidies) allows the differential domestic-foreign prices to be maintained and (theoretically) insulates the domestic economy from external fluctuations. In other words the planner, instead of promoting a microeconomic relationship between internal and external prices using one or more exchange rates, allows only a macroeconomic link, through the state budget. Thus, the exchange rate as an instrument for maintaining external balance is in many respects redundant; and this explains, at least partially, the possibility of maintaining dramatic overvaluation of the official rate in many CPEs.

When decentralization of the decision-making process takes place, the exchange rate not only regains economic significance, but becomes an essential instrument of economic policy. The co-existence of indicative and normative planning (and the increasing transformation of the first into the second) takes place during the transition period, when some objectives of economic policy (*e.g.* quantity of money in circulation, credit supply, etc.) can be managed almost exclusively through the use of the "new" instruments, while

[15] Those measures are seen as strengthening "the basis for international commercial negotiations with the GATT and EEC". POSTANOVLENIE (1988), art. 6.

others, like aggregate demand, may be influenced by direct and indirect ones. Moreover, the reform of monetary mechanisms in a CPE will only have effect if it is accompanied by measures of trade liberalization. The introduction of new forms of international payments goes hand in hand with the abolition of restrictive import policies; however, the gradual character of this process must be stressed once again: it would be dangerous to advocate an immediate passage from direct control of all trade flows, from the monopoly of foreign trade, to a completely liberalized system.

5. The process of transition to convertibility

With this in mind, we propose an analytical approach based on a sequence of stages describing the transition to convertibility, inspired by the experience of Western European countries from 1947 to 1958.

The post-war experience of Western European countries is characterised by four main aspects:[16]

i) The strict link between the development of trade liberalization and the increasing openness of the intra-European payments system. As a matter of fact, it immediately appeared clear to the European economic authorities that more advanced trade liberalization needed a less strict foreign exchange management. Similarly, financial liberalization would be of no use if traders' choices were limited by several types of restriction on foreign trade operations.[17]

ii) The crucial role played by external American financing in helping the European economies to overcome the wide array of difficulties faced during the transition to multilateralism. It seems difficult to challenge the view that the massive flows of external financial assistance decisively helped the European economies to recover very quickly from the ruins of the war; it is indeed hard to think that European countries would be able to substantially improve so fast their institutions of trade and monetary cooperation and to move towards multilateralism and EC without reduction of the economic burden imposed by the reconstruction and by the need to finance the essential imports (mainly from the US market) necessary for the reconstruction itself.

iii) The surprising steadiness which accompanied the gradual liberalization of commercial and financial operations. This may have been partly due to the British failure to go back to sterling external convertibility in the summer of 1947. This episode probably made many European governments wary of an excessively rapid return to freedom in foreign currency transactions. Obviously, the parallel improvement in the economic situation of European countries considerably helped the gradual consolidation of the process of monetary and trade liberalization.

iv) The flexibility in allowing temporary retreats from the process of trade liberalization. The new institutions of economic cooperation (the EPU in particular) and the agreements on import controls reductions were devised in a way to allow a country facing external imbalances the possibility of reintroducing higher import quotas on some commodities. A country resorting in the short-run to forms of trade discrimination did not face the danger of trade retaliation by other countries.

From a purely methodological perspective, the stage by stage approach seems useful since the sequence described below can be easily altered and supplemented by more detailed suggestions.[18] The logical sequence of stages (and the distinction between "regional" convertibility and convertibility with respect to Western currencies) is also a useful theoretical device to understand more clearly both the advantages and the drawbacks inherent in the decision to move towards a more liberalized system. *However, enlarged convertibility should not necessarily be interpreted as strictly dependent on the attainment of regional convertibility.* In other words the two processes may develop in parallel, even though it should be stressed that there are necessary preconditions that need to be fulfilled in order to make the whole evolution to EC feasible.

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[16] Historical details of this experience can be found among others in: Diebold (1952); Milward (1984); Triffin (1957 and 1961).

[17] This idea is clearly expressed by the following quotation from G. Carli, Chairman of the Managing Board of the European Payments Union (EPU) from 1950 to 1952: "The enlargement of the free exchange area requires the extension of an international multilateral payments system, *i.e.* that currency convertibility is widened; (...) currency convertibility is the means through which a system of multilateral payments can be built and this in turn creates an international market in which goods are exchanged on the basis of competitive rules. The re-establishment of an international market requires that the obstacles of quotas do not impede the exchange of goods; if convertibility were not associated to the obligation of renouncing policy measures involving quotas, it would just be an expression with no content at all"; Carli (1952), p. 936, also reprinted in Carli (1955), p. 208.

[18] The need for a stage by stage approach is also suggested, with reference to the West African Currency Union, by Mc Lenaghan *et al.* (1982).

Stage 1. Creation of effective mechanisms of monetary compensation within the CMEA; enhancement of the role of the International Bank for Economic Cooperation (IBEC).

Trade balances between CMEA nations, deriving both from bilateral agreements or from trade planning, are passed on to the International Bank for Economic Cooperation (IBEC). This bank calculates each country's total balances towards the IBEC itself and makes the monetary balance compensations using traditional compensatory techniques.[19] A country building up a credit position towards another CPE can use the positive balance to settle other debts arising from trade with other CPE.

These devices allow maximization of the advantages deriving from bilateral agreements: each CPE is able to avoid the constraint of not being able to use its surplus to settle a deficit arising from transactions involving other currencies.[20] It goes without saying that the existence of this mechanism of compensation could encourage bilateral trade agreements which are not fully balanced (*i.e.* allowing surplus or deficit for one or both the countries involved), as is the case with present intra-CMEA trade mechanisms. Those commercial transactions not included in bilateral agreements could be carried out and settled using foreign currency made available through specific allocations.

In this respect, two types of foreign exchange allocations may be envisaged: in the first one, the central bank, which retains its monopoly over currency operations, allocates specified amounts of foreign currency to firms needing particular imports; allocations are carried out according to priorities established in the economic plan. In the second one, part of the convertible currency could be allocated to importing firms through a system of competitive auctions. This system has the advantage of introducing an element of competitiveness among different firms: the high cost, in terms of domestic money, of acquiring foreign currency should induce the firms to

[19] The IBEC was created in 1964, as "a financial institution in charge of emitting the common currency and facilitating multilateral settlements" (Brabant, 1987, p. 274). For a discussion on the role and functions of the bank, see Francuz (1969); Brabant (1977 and 1987), esp. pp. 285-300.

[20] Moreover, given the peculiarity of intra-CMEA trade, it could be useful to distinguish between surpluses and deficits involving the distinction between soft and hard goods. In this way each CPE would keep different trade balances *vis-à-vis* the IBEC.

make efficient use of it. Moreover, the price finally set for the transactions, can convey to policy makers some idea of convertible currency excess demand.[21] However, one should also be aware of the fact that the first currency auctions would not necessarily indicate a realistic level of the exchange rate, because of the existing chronic excess demand for foreign currencies in CPEs.[22] Finally the currency auctions may influence the direction of commercial flows: if a CPE wants to increase the amount of imports from another country (because of an excessively high trade surplus), the supply of the deficit country's currency can be enlarged.

It is likely that the volume of commercial transactions will increase, when moving from a system of rigid bilateral agreements to a system such as the one outlined above; moreover, the costs of a foreign trade structure based on bilateralism could be minimized, though this would probably vary from country to country.

At this stage it is not strictly necessary to think of reforms of the exchange rate system, even if it is conceivable that each country would begin to undertake a simplification of the existing multiple exchange rate regime.

Stage 2. Reduction of quantitative controls on Soviet centrally planned imports from other CMEA countries; beginning of the process of trade liberalization inside the socialist economic area; introduction of forms of planned convertibility.

Some of the firms inside the Soviet Union can now have direct access to foreign markets; these firms do not need at this stage the intermediation of foreign trade central authorities and they can choose freely where to place their import orders. The import/export flows which are no longer centrally determined can be still part of bilateral agreements, or they can be totally autonomous (though in the limits set by an economic system still regulated by the central plan):

[21] A correct estimate of the excess demand is obviously strictly linked both to the way and the care with which foreign currency auctions are managed; for instance, the supply of scarce (excessive) quantities of foreign currency could easily lead to over(under)valued levels of the rates at which transactions take eventually place.

[22] In this respect, the recent Bulgarian experience is noteworthy; from June 1988, a system of competitive auctions for the allocation of foreign currencies has been introduced. The exchange rate at which demand and supply are settled is sometimes ten times higher than the official rate. *Cf. East European Markets*, 8 (16): 2-3. 1988. Similar measures will be introduced in the Soviet Union in 1989.

— in the former case, imports are internally allocated through a system of licenses; since they are determined *ex ante* on the basis of bilateral agreements, they will probably not be sufficient to meet the demand of all importers;
— in the latter case, the Soviet monetary authorities face the problem of which currency to use. If we rule out the solutions of barter and countertrade (though the latter has been widely practiced in recent years), four types of currency settlement can be envisaged, involving payment with:

a. the currency of the exporting country;
b. the currency of the importing country;
c. hard currency;
d. Transferable Roubles (TR).

In the first two cases countries will accept the payments only if they think that the amounts of foreign exchange received could be re-utilized.

The export earnings in foreign currency are deposited partly in a special fund created at a "foreign trade bank" (under the control of the central bank) and partly transferred (the percentage will increase as the process of liberalization proceeds) to an account which can be used by the firm to finance its own imports. These earnings can be reallocated by the foreign trade bank itself to finance the import operations of those firms which do not have direct access to foreign currency markets. Obviously, even autonomous firms can have access to these funds.

As far as hard currency payments are concerned, firms will certainly be willing to accept the currencies in exchange, given their effective convertibility into any other currency and their general acceptability as a means of exchange.

The introduction of a form of *de facto* convertibility, planned convertibility, may be envisaged should the TR be more widely used. In the case of multilateral clearing, as envisaged here, the emergence of creditor and debtor positions is still determined *ex ante*, or it arises because of unanticipated price changes which influence the final values. A mechanism could be introduced to allow the CPEs to exchange their currencies with the IBEC, when acquiring TRs; technical procedures would be similar to those used in the SDR's operations; either a single exchange rate or a system of several exchange rates (according to commodity groupings) could be applied to the transactions. The determination of these "parities" by each CPE would allow the creation of a parities grid which could obviously be revised whenever circumstances would ask for it.

It is plausible that the problem of unplanned trade and current account imbalances would arise as the number of firms directly engaged on the foreign markets increases. Policy makers should then make use of the indirect instruments typically utilized in the market economies, in order to overcome external disequilibria, particularly structural deficits (*e.g.* inflexibility of demand for imported commodities or agricultural products). The use of these policy instruments should aim to:

i. stimulate exports (either through credits, subsidies, fiscal benefits to the exporting firms, or a revision of IBEC parities);

ii. control imports (through selected quantitative reductions, tariffs, quotas, etc.). It is important to stress that the re-introduction of strict controls does not mean a return (or a confirmation) of the "plan philosophy". On the contrary: authorities intervene *ex post* to balance the disequilibria arising from unplanned and unexpected agents' actions.

At this stage the use of the traditional macroeconomic instruments for managing aggregate demand (fiscal policies, discount rate, ceilings on bank lending, etc.) seems premature, given the limited part played by the liberalized side of trade and the fact that the classic mechanism of internal planning still prevails.

Stage 3. Introduction of the first elements of a greater degree of free transaction between the rouble and the other socialist currencies and gradual increase both of trade outside quantitative planning and of the amount of currency freely available for commercial purposes. Slackening of the regulations concerning the use of currency for tourism, study abroad, other special purposes.

Trade between Socialist countries is now increasing and Eastern Europe is becoming an area in which the holding of a specific currency no longer constitutes an obstacle for a higher level of trade and monetary transactions. At this stage the problem of managing the exchange rate, as an instrument of economic policy, arises. Central monetary authorities retain control over the allocations of foreign currencies to firms.[23] In this respect, flexible use of the

[23] It is worth remembering that the currency is still used only for commercial purposes, a fact which guarantees a low degree of volatility of the exchange rate.

exchange rate may encourage competitiveness in specific geographic areas or commodities.

Progress towards the unification, or at least the simplification, of the present system of multiple exchange rates may run parallel to the strengthening of the domestic economic reform process. Finally, it is important to underline that at this stage every CPE would have to do something about the distortions in the structure of relative prices and the excessive differential between internal and external prices. The effect of such a distorting gap would be an equally distorted level of exchange rates, which would hamper the use of the exchange rate as an effective instrument of economic policy.

On the other hand, the abolition (or a decrease in the amount) of export subsidies would lead to a loss of competitiveness on foreign markets. Within the CMEA countries, this loss of competitiveness could be partially offset by a mutual reduction of subsidies, but the problem of a drop in competitiveness outside the trade area remains.[24] At this stage, firms have increasing freedom to buy from abroad. At the same time central monetary authorities can provide the necessary monetary resources, while retaining their function of supervision and coordination, using the new network of commercial banks, which would perform independently part of the technical operations previously implemented by the central bank itself.

The allocation of money for tourist purposes, study, etc., would now be carried out using more flexible criteria (*e.g.*, more realistic exchange rates, increase of the amount of currency allowed). Trade and external financial imbalances are now more likely to arise. Policy makers can intervene with the tools mentioned above, making more extensive use of tariffs and selective import credits. The use of the classical macro instruments for managing aggregate demand can be postponed until the proportion of free trade surpasses the planned portion of foreign trade.

Stage 4. Increase in the degree of freedom in managing foreign currency stocks held by the firms and centralization of hard currency funds by central monetary authorities.

[24] In this situation, it is likely that exporters will increase pressure for an exchange rate devaluation, at least for those goods for which the subsidies have been abolished. Obviously, given the need of high technology imports from market economies, a measure such as devaluation — in a context of growing price liberalization — does not seem an optimal solution for the CPEs' trade problems.

Firms enjoying a greater degree of autonomy from the central plan now face the problem of managing their foreign currency holdings both for purely commercial and financial purposes. In the last case the firm may decide to hold a specific currency portfolio, according to its expectations of changes in the parities of some of the socialist currencies.

The central bank can obviously retain strict control over the firms' financial behaviour, restricting or enlarging the amount of foreign currency freely available.

The firms' increased financial autonomy now makes the risk of external imbalances even greater. Cooperation among CMEA countries aimed at concerted action to ensure the stability of exchange rates becomes crucial. Trade and current account imbalances must obviously be financed. The methods used in coping with these problems will not differ very much from those typical of market economies: external credits from foreign governments, indebtedness on the private international financial markets, "swaps" between central banks, financial assistance from international bodies (the IBEC in particular, in this case, but also the IMF and the World Bank, if the intention to join them is finally implemented by the CMEA countries which still do not belong to multilateral organizations).

A further difficulty arises at this stage of the transition. The Central Bank needs to build up a stock of currency reserves, which can be used in the event of temporary exchange rate and balance of payments crisis. However, in the limited context of intra-CMEA convertibility, such a problem should not be too serious for the Soviet Union. The rouble will probably be the most widely accepted means of payments within the area, given the amount of transactions between the USSR and the other Socialist countries.

What is new, however, is the presence of an external channel which contributes to the creation of monetary base; this reinforces the need for a careful supervision of the reformed system by the central monetary authority.

In short: two parallel markets are now at work. One in which currency exchanges can be carried out using decentralized procedures, though subject to some forms of control by the center. The other, which plays an increasingly minor role, where direct management by the Central Bank and the system of competitive bids, grants access to hard currency even to the non-liberalized firms. The planner still retains some discretionary control over transactions: for instance, the question of whether transactions with country y (and therefore currency allocation) are preferable to transactions with country x is decided according to the surpluses or deficits of the balance of payments.

Stage 5. Creation of an effective foreign exchange market within the CMEA; authorized banks are allowed to trade freely in currencies even for purposes of arbitrage.

This stage is characterised by the transition from a multiplicity of exchange rates (or coefficients such as the DVK in the Soviet economy) determined by monetary authorities, to a simpler system. The final goal is the introduction of a unique exchange rate, linked to a greater extent to currency demand and supply. The Central Bank authorizes a limited number of commercial banks to carry out currency transactions, including arbitrage operations (within the narrow limits of fluctuations around fixed parities). These operations are for the moment of a short-term type (three, six months). Thus, the determination of the exchange rate is now partially independent from currency supply and demand arising from import and export flows. A fixed exchange rate regime, with limited oscillation bands, may be more appropriate at this stage.[25] An exchange rate parity grid among the various socialist currencies could be introduced. A Socialist Currency System (SCS) could be based on some of the main features of the European Monetary System (EMS):
— oscillation bands, if necessary diversified by country;
— currency realignment in response to excessively strong pressures on the existing parities;
— cooperation between central monetary authorities;
— possibility of some countries delaying their commitment to the currency agreement;
— use of a common unit of account.

The role of the Central Bank becomes more important, given the commitment to maintain SCS parity, as it has to manage a stock of foreign reserves, initially limited to the more powerful currencies

[25] A regime based on more pronounced exchange rate flexibility might have unacceptable consequences for the economy, particularly the emergence or the reinforcement of inflationary pressures.

which emerge within the area. At this initial stage of the SCS, the currency speculative manoeuvres will come exclusively from other socialist countries. It is important to underline the role which the IBEC can play in the case of unexpected trade and payments disequilibria. The mechanism of intervention could be similar to those of the IMF (creation of a pool of different currencies, credit advances in main currencies according to criteria based on conditionality). During the preliminary phase of the SCS more automatic credit concession may be envisaged, once the criteria according to which a disequilibrium of the balance of payments merits external intervention have been established.

The IBEC may transfer to CMEA deficit countries the surpluses in hard currencies accumulated against the rest of the world by surplus countries.[26] Countries with a structural deficit, or even in temporary difficulties, could have access to IBEC hard currency credits.

The TR could continue to play its role as the socialist intraregional currency, even though the possibility of arbitrage between the exchange rates of the various currencies with the TR and the grid of parities within the SCS would have to be avoided or reduced. The increasing role of market mechanisms in exchange rate determination should tend to "equalize" the various exchange rates, though the possibility of discrepancies cannot be ruled out *a priori*. The possibility of commercial and monetary crisis would now be even greater. However, at the same time, new instruments of economic policy may be used, *e.g.* controls on the aggregate demand in order to maintain external equilibrium. Such equilibrium can be strengthened by exploiting the remaining components of the traditional system of planning and management, as well as monetary and fiscal policies regulating global demand.

Stage 6. Completion of the commercial and monetary liberalization process within the CMEA, and decrease in importance of compensatory mechanisms.

This stage sees the gradual strenghtening of the tendencies described above, with respect both to the advantages deriving from

[26] Obviously, as long as convertibility of the kind described applies only to CMEA countries the system may work. Given the potential tendency to run up deficits with the rest of the world, and more specifically *vis-à-vis* the Western industrialized countries, more serious problems might arise in the event of more general convertibility (see below).

commercial and monetary liberalization, and to the risks linked to the balance of payments deficit and to possible currency crisis. The share of unplanned foreign trade surpasses the planned quotas (with a parallel increase in the decentralization of the decision-making process). The economy is even more exposed to pressures from the external sector: these circumstances lead to the need to enhance the use of classic instruments of macroeconomic control. In particular, the exchange rate is now both a possible source of disturbances and a major instrument for their correction.

One of the main problems facing the planners is the dichotomy between long-term planning and "management" of short term disturbances. In this environment planning tasks also change, with exchange rate stability and the maintainance of external equilibrium becoming increasingly important.

The coexistence of indicative and normative planning (and the increasing transformation of the latter into the former) may be envisaged at this point. Some sectors (*e.g.* priority ones) will still be subject to administrative orders. Some targets (quantity of money in circulation, credit supply, etc.) may be attained exclusively through the use of the "new" instruments of economic policy.

Stage 7. Strengthening of commercial and monetary liberalization with respect to Western countries.

The process of commercial and monetary liberalization *vis-à-vis* the rest of the world gives rise to more complicated issues, which are, however, similar to those already examined in the intra-CMEA liberalization process. The main problem is still the existence of a trade structure based on bilateral agreements, strictly regulated planning of trade flows, and currency inconvertibility.

It may be supposed that initially the Soviet economy will tend to maximize the advantages deriving from prevailing bilateral agreements. Given the impossibility of using a clearing house for compensating imbalances arising from trade with market economies (as was the case within the CMEA) it will become essential to relax the constraints of rigid trade and monetary controls at the firm level. In particular, stocks of hard currency can be supplied to firms either through a system of competitive bids, as indicated above, or through direct allocation by the planner. The system of bids, as well as signals coming from the black market for currencies, can give some

indication of a realistic level of the exchange rate.[27] Another possibility is the creation of economic enclaves in which firms are allowed to exchange foreign currency freely. The idea of so-called free zones, and the possible emergence of two monetary circuits, is part of the early phase of transition to a more enlarged form of EC.[28] In particular, a specific currency backed by gold, foreign currency reserves, and export earnings — the "gold rouble" — could be used as a means of payment inside the free zones and at the same time as a means of settling trade transactions with non-CMEA countries.

At a second stage, when presumably part of the excess demand for imported intermediate goods will have been mitigated both by the increased technological level of domestic production and by the parallel evolution of the decentralization process, decision-makers will tend to relax some of the restrictions concerning type and quantity of imported goods. A system of licences could act as a substitute for direct allocation in the distribution of imported goods.

There will, however, still be a strong degree of centralization in currency management, with the central bank retaining the exchange rate monopoly and, with the growing number of commercial banks, becoming responsible for the satisfaction of currency requests arising from the real side of the economy.

It may be supposed that removing some of the obstacles to domestic convertibility will help and accelerate the process of convertibility towards third countries. In particular we have already seen that one of the difficulties of the transition to convertibility was the definition of a proper exchange rate. Improvements in the domestic sector of the economy, the reduction of the differential between domestic and foreign trade prices, which have helped to achieve a more realistic level of the exchange rate within the CMEA, should speed up the same process with respect to the rest of the world.

Under conditions of greater external openness increasing freedom of Western partners to buy Soviet products may be useful, since it may provide Western countries with a good reason for holding, and transacting in roubles.

[27] Initially, if there is a tendency to import technologically advanced goods available only on markets outside the CMEA, supply of hard currency should be directed towards the more obsolescent firms.

[28] Similar proposals have been recently advanced by A. AGANBEGYAN (1989).

While the process of liberalization within the CMEA area should develop at the same time for all member countries, a similar process towards the rest of the world may be different from country to country. In this respect a crucial role may be played by the IBEC, which can influence the different speed of adjustment for some of the socialist countries.

Stage 8. Determination of rouble exchange rate on the international markets, according to the conditions prevailing on those markets when EC is introduced. Gradual abolition of restrictions on capital movements to market economies.

Socialist governments may now gradually open up to Western monetary systems.

Various hypotheses may be advanced:
— the TR is made externally convertible;
— the Soviet rouble is made externally convertible;
— all or some of the socialist currencies are made externally convertible.

This stage can be considered the final one in the process of transition to convertibility. The opening to international currency markets raises the problem of the adoption of a specific exchange rate regime. In the experience of Western European countries, the EMS monetary agreement among various states allows the determination of ratios between currencies on the basis of collective rules, rather than the behaviour of a single country. In the case of socialist countries, political, as well as economic considerations may suggest pegging each currency to EMS parities[29] or even to the ECU.

In the event of both convertibility of the TR and of all or some of the national currencies, such criteria could assure a greater stability of the exchange rate and could give indications of the variations in the degree of competitiveness towards the commercial area (Western Europe), which presumably will continue to be privileged.

All the problems concerning external shocks are still present, and it will be even more necessary to adopt an effective mix of monetary and fiscal policies to cope with them. However, the decentralization process of the economy will, hopefully, have proceeded to such an

[29] Even though this raises the problem of which specific EMS currency to use as a reference.

extent there will not be much difference between the kind of problems (and proposed solutions) characterising this environment, and a market economy with a strong state sector. The Central Bank is fully responsible for exchange rate management and the accumulation of hard currency reserves is now crucial in order to allow greater flexibility of convertibility for non-residents. The creation of currency reserves takes place in the usual way: international indebtedness in hard currency, trade surpluses, sale of gold stocks, and, in the event of participation to the IMF, through allocation of SDRs.

The introduction of greater freedom in capital movements can be considered an important step, but not a necessary condition for the attainment of convertibility.[30]

We have already advanced a few hypotheses concerning the development of an embryo capital market among socialist countries. At the present stage there are no more obstacles to a gradual widening of the capital market towards Western countries and inside the CMEA, depending on the success of measures which have made convertibility possible. The main problem here is the kind of controls to be adopted in checking capital movements, since it may be supposed that Soviet capital will move in relevant quantities towards more profitable markets, particularly in the first phase of the liberalization process. Controls may concern both medium and long-term financial investment by Soviet residents (firms, cooperatives, etc.) and, more especially, short-term capital movements. The adoption of gradual and selective criteria would seem appropriate in this context, as has been shown by the experience of many Western countries.

6. Conclusions

In this paper we have argued that the feasibility of the transition process to EC for the rouble depends both on the success of Soviet domestic reforms and on the gradual nature of the transition to

[30] Even in the experience of Western countries, capital movements are more regulated than trade transactions. In the Italian experience, for instance, direct and selective controls on non-commercial transactions were only abolished at the beginning of 1988 and effective and complete freedom of capital movements will be introduced in 1990, *i.e.* more than 30 years after the return to EC of the lira.

multilateralism and convertibility. As we have seen, the transition from a centralized system of planning and management to a decentralized one creates macro and microeconomic problems. Until today the centralized system of planning and the price equalization system reduced, or actually completely eliminated the role that the exchange rate plays in an open economy. The main instrument of economic policy is represented in a classic CPE by the state budget, which allows, through the mechanism of equalization mentioned above, the maintenance of a dual pricing system and the isolation of domestic and external flows (minimization of damages deriving from external shocks). When direct contacts between enterprises are introduced, firms are allowed to trade on foreign markets and the creation of joint ventures is encouraged, the convertibility issue starts to arise, as well as that of how to give "rationality" to the exchange rate (and more generally to the classic instruments of economic policy).

Drawing on the Western European experience of the 1950s, we have suggested an eight-stage approach to EC, with respect both to CMEA countries and to the rest of the world.

The main objection that may be raised to the transition process described above, is that an excessive attention is paid to commercial and financial liberalization within the CMEA. It can be argued that many of the difficulties facing the Eastern European CPEs are connected to the excessively closed nature of the Socialist system. The solution is often seen, even within the socialist countries, in a greater participation in international trade and integration in the world economy.

While this is true, it is important, however, to take into account that:

i) the process of socialist economic integration has to be strengthened using different instruments from the past;

ii) the process of transition to convertibility within the area must be paralleled by a similar gradual process of "opening up" to the rest of the world, and in particular to Western industrialized countries.

Within the context of growing polarization in international trade (trade areas, unified markets, and so on) it is not clear why socialist countries should give up the potential advantages of being part of a commercially (and in some respect politically) integrated area. In other words, why should what is perceived to be advantageous for Western European countries not apply *mutatis mutandis* to Eastern European ones? The advantages of being a member of an integrated

area are even greater at a time of structural modifications of the system of planning and management. Convertibility within the CMEA may be useful, despite the repercussions it might have for trade with the rest of the world. Let us take, for example, the opportunities deriving from such a phenomenon in joint ventures with Western partners. Convertibility within the area will allow a much greater availability of supply, and a potential market represented by all members countries of the prospective SCS.

To sum up, the CMEA, *once its tasks and path of development have been redefined*, can play a very important role in the process of opening up to the rest of the world by the socialist countries. It is true that the possibility of some CPE individually reaching the goal of EC with Western countries cannot be ruled out, but it is our belief that regional convertibility can help reduce the risks involved in such a deep process of transformation put in motion by domestic reforms and the decision to move towards enlarged EC.

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