Key Problems of Creating a Central European Payments Union *

The reforming countries of Eastern Europe[1] (here identified as the planned economies in transition or PETs – no pun intended), faced with the prospect of transforming their economies to the market system over the next few years, today find themselves in a peculiar bind. On the one hand, they would like to promote indirect economic coordination of the decisions of economic agents, including in foreign trade, as an essential ingredient of the transition towards a market economy (ME). But they are seriously handicapped in doing so quickly by domestic and external constraints. These countries would like to substitute the transferable rouble (TR) settlement regime and TR prices (TRPs) that survived until the end of 1990 with trade at current world market prices (WMPs) and settlement of all financial and commercial transactions in convertible currencies. But such a move is inhibited by the lack of foreign exchange and reluctance to earmark what is available to defray transactions that used to be priced and settled in TRs.

In this paper I analyse the pros and cons of assisting Eastern Europe with some payment facility. (For further background the reader may refer to Brabant 1990a, b; 1991a, b, g.) Section 1 provides the rationale underlying the scheme. It also summarizes the varied criticism that such proposals have elicited.[2] In the following three

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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.

[1] In what follows, Eastern Europe denotes 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. Of course, in considering the future of Eastern Europe as a distinct geographical and political grouping, the *ex*-GDR is no longer a factor to be reckoned with. But there are lingering economic problems with the *ex*-GDR that deserve to be touched upon.

[2] This contribution was prompted by Bofinger's (1991a) analysis and the exchange between him (1991b) and me (1991f) around it in an earlier issue of this *Review*.

sections, I present the arguments for coming to grips with the prevailing and emerging external-payment constraints of the reforming countries, the original proposal for a payments facility, and some concrete data on what precisely will be involved in terms of capital commitments, credit facilities, and behavioural constraints under international surveillance. Section 5 provides a summary of the most cogent comments made on the proposal and some brief reaction to them. The paper concludes with an indication of the proposed scheme being acted upon.

1. Backdrop to the creation of a payments union

In early 1990, it became evident that there would soon be major obstacles to clearing the conventional intragroup trade and payments of the members of the Council for Mutual Economic Assistance (CMEA).[3]

There were four possible solutions to this problem. One would be simply to cut out most of the traditional intragroup trade through deflation. A second avenue would be through rapid trade diversion to the west, regardless of the sociopolitical and economic costs emanating from the painful restructuring and inevitable economic recession that this would require.[4] Deflation and recession could conceivably be averted through structural-adjustment loans. But this could work only if the absorptive and adaptive capacity of the PETs in the 1990s were noticeably better than it was in the preceding two decades. Otherwise, borrowing would only postpone adjustment and aggravate foreign indebtedness. Finally, a mechanism could be found that would maintain the existing trade flows of these countries justified on economic grounds, while enacting rapid adjustments in external trade and payment.

Although the latter option could be pursued through various payment facilities, the most constructive for east and west alike

[3] I prefer this 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 am concerned solely with the active European members – Eastern Europe as defined.

[4] Bofinger (1991b, p. 100) lauds the improvement in the current-account that may occur. But that is almost irrelevant for my analysis is based on the welfare cost of such trade diversion and what it may augur with respect to reform consensus.

appears to be a Central European Payments Union (CEPU). This could have been achieved in conjunction with the radical transformation of CMEA cooperation promised in the January 1990 Council Session of the CMEA. An integral component of such a constitutional CMEA reform could have been the establishment of a Central European Economic Union (CEEU). Both institutions were in the first instance addressed to Czechoslovakia, the GDR, Hungary, and Poland. The GDR, as the second largest CMEA partner with a key role in the formation and maintenance of the machine park of the rest of the CMEA, could have been included because at that time the particulars of the then just announced intention to establish economic and monetary union between the two Germanies had not yet been fleshed out.

Initial versions of these ideas were first published in two standard United Nations publications[5] as well as in Brabant 1990a, b. They have produced considerable criticism. Some can be attributed to the fact that the original proposals were presented without sufficient technical detail on the envisaged clearing, the type of macroeconomic surveillance to be enacted, and the main purposes of the scheme, although these publications left no doubt that the payments union should be wound up relatively quickly and the economic union should at best be transitional, pending closer association with the European Communities (EC).

A general lack of understanding of the specific conditions of Eastern Europe, and the PETs in particular, has also been responsible for much of the confusion concerning the aims of the two unions. Since then, I have further elaborated on the scheme (*e.g.* Brabant 1991a, b, g). In the process of amplifying and refining the proposal, I have received numerous comments and suggestions. Some refer to the intrinsic merit of a payments union, others to the tactics of fostering economic reform through western assistance, and yet another set argues that the proposal has already been overtaken by events.

Of course, events in Eastern Europe have been progressing very quickly since early 1990 and the international environment for PET

[5] As usual, individual contributions to these publications must perforce remain anonymous since all such documents are issued under the Secretary-General's authority. The more complete version of the proposals for a CEPU and CEEU written in conjunction with the staff of the Economic Commission for Europe is in ESE 1990, pp. 147-50. A heavily truncated version of the logic of moving towards such a form of assistance is in WES 1990, p. 98.

reforms has changed dramatically in more than one respect. Because of the pervasive sociopolitical and economic chaos in the Soviet Union, the stalemate over decisive reform in several Eastern European countries, the much slower than anticipated response to reform in the PETs, the resulting slowdown in the intensity of reform, the utter collapse of the TR trade and payment regimes, and the potential disintegration of the Soviet – and also Yugoslav – federation, it is necessary to modify my frame of reference. But these developments strengthen the argument for innovating a cooperative payment scheme to come to grips with the problems of reform in Eastern Europe, the switch in CMEA trade and payment regimes, and the desire to divert trade to western markets.[6]

2. The reasons for creating a CEPU and CEEU

Because of the unprecedented wave of political and institutional changes since mid-1989, several Eastern European countries are now envisaging, or have already embarked upon, genuine market-oriented reforms. Many are hoping soon to find common ground with the "European Economic Space" and indeed the EC. Whereas political achievements have been breathtaking and the aspirations of many of these countries are very ambitious, economic realities argue strongly in favour of a more sober approach, especially in the near term.

Before the PETs can fully integrate themselves into the western economic community at levels of living that they find acceptable, but cannot now support on their own strength, they need to remould economic structures incisively. Furthermore, these transformations can be sought only through a comprehensive revamping of the entire framework of economic decision making. The difficulties of transition towards competitive markets are actually being sharply compounded by prevailing constraints on maintaining buoyant intragroup trade and payments, due in part to the collapse of the CMEA (Brabant 1991b, c), something that will formally be acknowledged only later in 1991.[7]

[6] There are also problems with external payments that stem from other sources, which I shall ignore here.

[7] Meetings to do just that were scheduled four times in January-April 1991 alone, only to be deferred at the last minute. It is not clear whether any such meeting will be convened later this year. If not, the CMEA will remain informally dead.

Since late 1989, CMEA economic relations, which used to constitute the vast bulk of total trade of the reforming countries, have been constrained by two sets of developments. One is the severe problems that have developed in clearing their reciprocal trade. Increasingly, commitments made in trade protocols have not been respected. One reason is that shifts in the terms of trade have made it difficult for potential surplus countries to honour trade commitments. Moreover, unanticipated developments in output levels and shifting export priorities, including of Soviet oil production, have further aggravated bilateral imbalances. Because TR surpluses are difficult to mobilize (see Brabant 1987a), several former CMEA members were reluctant to incur them, preferring instead the introduction of unprecedented domestic policy measures to stem exports to the TR area in general and the Soviet Union in particular.[8] The result of these contract violations was a gradual cut in intragroup trade in 1989 and a sharp contraction of about one fifth in 1990; the forecast for 1991 is for an even larger drop. All these events are coming to the fore when import possibilities from MEs have been under severe payment constraints.[9]

Intragroup relations have also been buffeted on account of divergences in economic mechanisms. Countries that seek to adjust their economies rapidly according to market criteria encounter problems in dealing with partners that, by and large, still adhere to detailed administrative planning or whose economies are in profound disarray. Inasmuch as these countries are still heavily interdependent, increased autonomous microeconomic decision making, coordinated through proper macroeconomic policies, can proceed only if intragroup relations too are placed on a solid economic footing.

[8] One striking example. Poland revalued the rouble in terms of the złoty, with the implicit rouble-dollar exchange rate now (since late May 1990) being 9.5 for transactions outside the protocol and 4.5 for transactions within the protocol (this rate was introduced in early 1990 for all rouble transactions) as compared to 2.2 in early 1989, 2.5 in mid-year, and 3.2 in December 1989; on 30 July, this cross-rate was reset at 19 only to be reduced to the earlier 9.5 on 24 September 1990. For a brief period the cross-rate was actually 95! On 18 March 1991, the latter rate was reintroduced for TR transactions falling outside the protocol with the Soviet Union; the rate for residual TR-denominated trade with other former CMEA members conducted outside formal intergovernmental arrangements is apparently 19. That rate seems to have been set in September 1991, probably when the one for rouble trade with the Soviet Union was altered, as noted.

[9] Bofinger (1991b, p. 100) contends that not a single "reforming country was confronted with a balance-of-payments problem" in 1990. Either he has not looked at Eastern European behaviour or his understanding of the core external "problem" is different from the conventional one, namely the need to impose restrictions on payments because of difficulties, actual or perceived, with balancing external accounts.

Unfortunately, even the most critical questions of how in practice to place intragroup trade on world-market criteria have yet to be resolved. In the meantime, regional trade is being needlessly compressed. This is basically due to the difficulties in accommodating payments. Furthermore, the unconventional ways in which intragroup relations are still being conducted weigh heavily on the pace and direction of the more ambitious national economic reforms. For that reason, the reforming economies have expressed a strong preference for limiting such heavy intragroup dependence and to maximize the amount of intragroup trade conducted in convertible currency and at current WMPs. This gives rise to two vexing conundrums. One concerns how to divert trade. The other addresses the question of conducting intragroup trade in convertible currency.

Trade diversion has been very costly in the short run, given the very tight interlinkages that used to exist in those countries: between 40 to 80% of their total trade until 1989 was intra-CMEA.[10] Furthermore, the economic structures in place, including the capital stock, can be redesigned for western markets and many of the skilled workers can be retrained in support of such a renovated production profile only at a high cost. Much of the available knowledge and embodied technology would need to be scrapped altogether in the event of large and quick trade diversion. Furthermore, the transportation infrastructure in the wide sense (including railroads, roads, oil and gas pipelines, electrical powergrids, and ships) is overwhelmingly oriented towards intragroup relations. The alternative would be to amortize gradually those assets that still produce competitive goods for the region, but for which there is little, if any, demand elsewhere and to retrain employees gradually as new opportunities arise.

Even if these countries wanted to incur such costs instantly because they thought it politically opportune to pursue this goal, for practical purposes the adjustment cost could only be absorbed gradually. A considerable demand would still remain, for example, for spare parts, components, maintenance, and service to keep the relatively obsolete machine park running, at least to supply internal needs for as long as variable costs could be recouped. Furthermore, unloading and processing facilities for critical fuels and raw materials

[10] Trade data at official exchange rates, especially of reporters that still clung to notional commercial exchange rates (then mainly Bulgaria and the Soviet Union), tend to overstate the CMEA's share. Even if corrected for that distortion, Eastern Europe used to be extraordinarily dependent on the CMEA.

other than those directly linked to regional, especially Soviet, supplies are simply inadequate to support rapid trade diversion.

Even if a dramatic change in the distribution of trade were to be an explicit policy objective, the paramount technical issue of how to accommodate the remaining intragroup relations until world conditions can be introduced domestically remains to be addressed. It would be even more difficult to do so for transactions with unreformed partners than for those actively reforming their economies. One can properly speak of market-clearing prices being applied in intragroup trade once domestic prices are aligned with those observed in east-west trade (to avoid arbitrage that is macroeconomically undesirable) only if firms of market-oriented countries negotiate prices and quantities on the basis of their own profit. These prices will then converge towards the structure of world prices, given the PET's ambition to align domestic prices with WMPs through a proper exchange rate. Individual economic agents in such an economy should not be concerned about the selection of exchange rates and the settlement of imbalances – both tasks for macroeconomic management.

Placing settlements for such trade on a dollar cash basis creates two difficulties in the short run. One stems from the need to raise the size of scarce foreign exchange reserves. The other arises from the distinct possibility that the country may exacerbate its deficit and thus have to increase its convertible-currency reserves. Both problems could be attenuated through some multilateral clearing scheme that enforces the discipline of moving steadily towards convertible-currency trade.

Transactions with CMEA countries that do not even remotely possess genuine markets nor autonomous firms cannot be conducted on an interfirm basis. Prices in such transactions must of necessity be negotiated, usually at a fairly high administrative level.[11] There may be a desire to emulate WMPs. But the current debate on the economic desirability of doing so revolves entirely around "imputed" WMPs, which reflect underlying scarcities in either partner only by chance. They will most likely be derived from documented prices charged by "leading" western firms. This has in the past given rise to numerous disputes

[11] Certainly, there were firms, notably Hungarian, actively involved in CMEA trade negotiations for years and these may even have imparted their microeconomic interest into the process. However, inasmuch as the framework of trade (including volume, broad commodity composition with some goods concretely specified, and TR trade and payment conditions) was set at a high administrative level and partner enterprises, for the most part, did not dispose of the same latitude as Hungarian firms, for example, the trade deals negotiated yielded scarcity prices only by fluke.

that have needlessly aggravated trade relations (Brabant 1987b, pp. 113-30).

Perhaps more fundamental than short-term dependence is the presence of static comparative advantages in Eastern Europe. Since producers previously had only limited opportunities to explore each other's markets, planners' priorities tended to focus on exchanging investment goods against raw materials, and the decisions of ministerial bureaucrats revolved around Soviet needs, unreaped comparative advantages must exist. To exploit them, proper institutions, trade policies, and commercial-policy instruments are urgently required to guide the reforming economies into choosing trade lines in which they have, or hope soon to have, a true comparative advantage. Furthermore, as national reforms proceed and succeed in introducing structural change, dynamic comparative advantages are also bound to appear. These can be best exploited by independent firms. Processes that cannot be justified on solid economic grounds must be phased out as quickly as politically and economically feasible.[12] Others that ought to be fostered on comparative-advantage grounds are in need of more suitable accommodation than these countries could thus far accomplish.

In moving away from existing trade and payment regimes, it is important that reforming Eastern European countries allow their firms to take their own profit into account in assessing trade opportunities (Brabant 1990a). But a solution must be found for the prevailing imbalances and those likely to emerge during the transition. The argument for greater regional economic and payment cooperation with western assistance could be enormously strengthened if the Soviet Union were to be fully committed to instituting market-oriented reforms.[13] There is some possibility that this may be occurring even though, perhaps for now but chiefly at the level of key republics. Also Yugoslavia (or its successor republics) could participate if the dash towards dinar convertibility initiated in December 1989 were to founder, as it apparently did in early 1991, following two strong devaluations. This offers the international community a unique opportunity to look for a regional solution that will

[12] That is not to say that such activities should be suppressed forthwith. The reforming economy may find it cheaper temporarily to subsidize production than to provide social-welfare benefits in a situation where short-term supply is rather inflexible and the danger of chronic unemployment, as a result, serious.

[13] Bofinger (1991b, p. 100) is prepared to include nonreforming countries into a union as well. How this could foster trade and market-oriented reform is, however, not spelled out.

eventually prepare existing, and perhaps newly created, countries[14] for regular participation in fully multilateralized trade and payments at the global level.

Perhaps the key issue is agreement on what the current trading and payment constraints of the PETs are. My own view is that these economies will not be able to disengage from their primary trading markets in the near future nor to base trade settlement on convertible currencies if levels of economic activity of, say, the mid-1980s, are to be maintained. These are admittedly conjectures, but they are based on facts such as the increasing difficulty that the PETs have encountered in clearing their own trade. In addition, although arrangements have been made to adjust to market prices and payments, current commerce is being "managed", and involve barter and clearing transactions, as well as cash-based deals at various levels. The adjustments are also causing serious current-account problems. Thus a series of *ad hoc* arrangements are currently being elaborated particularly for trade with the Soviet Union. In my view, most of these only impede proper decisions on restructuring these economies in ways which will allow them to attain positive economic growth.

Most ominous in this respect is the increasing use of bilateral trade and payments agreements in Eastern Europe, which in some cases extend to the enterprise level and are, in effect, pure barter. This tends to place commerce at the level of the lowest common denominator and limits the potential benefits from abandoning the TR regime. Switching to bilateral convertible-currency clearing may pose a key constraint if no provision is made for the settlement of imbalances that are bound to occur once trading is left to negotiations between individual firms. A tendency will emerge to seek such balance in any single deal. The payment problems of Eastern Europe, in the narrow sense, are by no means confined to the shift in economic systems, however. But the bulk of the latter, structural payment problems cannot be coped with through a payments union.

There are then multiple, conflicting demands on the limited foreign exchange available to these countries. Analytically, they consist of raising the transaction demand for convertible-currency reserves necessary to finance ordinary payments, as well as increasing the precautionary demand for reserves necessary to finance deficits.

[14] If the Soviet federation were to disintegrate into several *de facto* trade and payment regions, the problems being faced by the PETs would multiply, yet be easier to resolve provided an accommodating mechanism is put in place. Likewise in case of a collapse of the Yugoslav federation.

In addition, the demand for reserves to offset adverse terms-of-trade shifts in the level of trade, the commodity composition of trade, and the geographical direction of trade, will also increase.

Undoubtedly, the most critical external-payment problems arise from intragroup relations not yet being conducted in convertible currency. Short of a groupwide "big bang", which presents too many risks for most PETs, it might be useful to reconsider the experience of the European Payments Union (EPU)[15] introduced after World War II. This sought to alleviate the dollar shortage which was the key constraint on economic policy in Western Europe. True, this constraint had various origins, including inflexible domestic policies, overvalued exchange rates, and trade restrictions. To manage such trade, however, these countries found it necessary to resort to a wide spectrum of exchange and trade controls, including bilateral clearing, so as to avoid chronic payment problems. Both tended to inhibit the mutually reinforcing benefits accruing from buoyant intragroup trade. The EPU was created precisely to bolster trade opportunities by eliminating bilateral agreements, to guide these economies back to currency convertibility, to stimulate regional integration, and to wean them of tight government interference in economic affairs. A critical ingredient was the initial capital made available by the United States to encourage export-promotion policies. By requiring that intragroup payments be increasingly effected in fungible assets managed through the EPU (Kaplan and Schleiminger 1989; Tew 1967, pp. 109-23; Triffin 1957, pp. 168ff.), Western Europe regained nonresident convertibility around 1958.

The core short-run objective in Eastern Europe is not so much to bolster the opportunities for trade through multilateral arrangements, as in the case of the EPU, but rather to obtain support for revamping intragroup trade in all of its facets, to support buoyant economic interchanges on the basis of rational economic decisions while domestic economies are being restructured at a measured pace, and to facilitate the integration of these economies into the global economic framework. The severe shortage of foreign exchange is a binding constraint to the move towards full-fledged market systems. A CEPU

[15] Whether this was instrumental in European recovery is not the point here. Economic historians and others (Diebold 1988; Hogan 1987; Kaplan and Schleiminger 1989; Knapp 1981; Milward 1987, 1988, 1990; Rees 1963; Wexler 1983; Wood 1986) have been waging an at times acrimonious debate on whether the Marshall Plan was all that important in explaining European recovery. Few have contested the usefulness of the EPU, however.

with outside financial support and supervisory muscle offers a useful intermediate policy choice between outright convertibility and managed bilateral exchange. Initially it would seek to organize trade within Central Europe. But it need not remain so exclusive, as other countries in the region introduce market systems in order to enhance their integration into the world economy.

3. The mechanics of a CEPU

The central purpose of a CEPU, as it was for the EPU, is to accommodate bilateral imbalances by transforming them into multilateral ones and to ensure that the net imbalances *vis-à-vis* all participants remain manageable. The latter means that the union should have sufficient funds to finance reasonable imbalances and adequate supervisory power to sanction participants in order to promote mutually reinforcing trade behaviour. A payment scheme that does not allow for the rapid emergence of more rational trade and domestic prices is bound to undermine any multilateral clearing system, regardless of how sophisticated the technical provisions may be. Disparities among relative prices not justified on scarcity grounds have been the bane of all previous attempts to introduce multilateral intragroup trade and payments (Brabant 1987a, pp. 273-8).

Of course, many difficult questions related to the CEPU proposal remain: How long will it take to reach convertibility? What conditions need to be met to ensure that the clearing agency can operate in a stable environment? What is to be done with the inherited imbalances, including those incurred on account of voluntary and other loans? Who would exercise surveillance and according to what rules? What kind of interest rates should be applied? How best to avoid quickly depleting the capital fund? What should be done with the remaining capital resources available when the clearing fund is no longer required? These offer but a sample of the wide range of issues yet to be tackled. Some are of a highly technical nature and can be settled only through negotiations among potential participants. As an outsider, one can at best speculate about what might be the most desirable features of the CEPU. I have done so elsewhere (see, for example, Brabant 1991a, b, g), so the present discussion will be limited to the essence of the more important technical matters.

i) With respect to the duration of the clearing mechanism, I recommend a single negotiated term of five years.

ii) The tasks of Clearing Agent should be entrusted to an existing institution, such as the Bank for International Settlements which served the EPU. Participants grant each other unlimited credit with net balances periodically reported to the Clearing Agent; with modern telecommunications, this can be done daily, if desired. If so, only the Clearing Agent needs to assess interest charges, using international market rates.[16]

iii) Transactions should be limited to those incurred on current account, excluding debt-service obligations. Imbalances incurred either in TRs, be they loans or current trade imbalances,[17] embody disparate TRPs, hence cannot be cleared multilaterally without disadvantaging some partner. Convertible-currency debts for some PETs are so large that they threaten to pose a constant drain on any intragroup surpluses. These issues should preferably be addressed outside the payment framework for otherwise the pressure to divert intragroup surpluses to settle external deficits will be insuperable.

iv) The settlement mechanism should be conceived in such a way that, on balance, the demand for resources from the central fund required for the orderly conduct of flexible trade decreases over time as a steadily rising proportion of the cumulative imbalances is paid in convertible currency to augment the resources available to the fund. A relative increase in imbalances in the initial phases on account of rapid trade expansion should be accommodated through extra external finance, preferably in exchange for greater supervisory authority.

v) The ECU should be adopted as the currency unit of account for the CEPU. Translation of national currencies into the ECU is, for now, conducted at the discretion of each participant as there is no ideal solution for determining the "proper" – let alone

[16] Initially, some marginal edge may be useful simply to encourage surplus countries to maintain their balances on deposit with the union.

[17] If the USSR were to join a CEPU, the renegotiated balances could be brought into the union to bolster its financial base, given that the USSR has been a debtor to Eastern Europe during the past three years and is likely to become a creditor at least in the short run.

fixed[18] – exchange rate for Eastern European currencies in a period of drastic restructuring. The ECU offers a pragmatic solution that may have several salutary implications (see Brabant 1991d).

vi) Settlements of net imbalances consist of loans and payments within the provisions of an overall quota against which participants can draw. The quota is distributed into multiple tranches with increasing difficulty of access. Low quota drawings preferably consist of less currency being paid by the debtor than received by the creditor in order to encourage intragroup exports. The precise shares and level of asymmetry as well as their movements over time towards 100 percent payment need to be negotiated.

vii) To make such a scheme manageable in the sense defined, there must be external financial resources to support asymmetric settlements as well as supervisory authority to keep the scheme manageable. Both should be entrusted to the EC or a "European" body associated with it. Supervision is delegated to up to a dozen macroeconomists, some of whom must be proficient in the affairs of Eastern Europe and who may even come from the region. A few should be diplomats capable of negotiating in a constructive, nonadversarial manner with participants and the bodies to whom ultimate responsibility is owed.

viii) Tight supervision is desirable to "manage" the financial resources with a view to ensuring that the facility promotes market-oriented reform commitments, including domestic price liberalization and a significant relaxation of the presently prevailing trade and foreign-exchange controls.

ix) At times, management of the union may temporarily slow down, or even reverse, trade and exchange liberalization, and may include temporary trade discrimination, provided such events are strictly limited and introduced in order to safeguard the general beneficial effects of the transition process towards operational market decision making.

Even if a solution can be found for the inherited imbalances, it remains true that the major external-payment flows of Central Europe are with nonparticipants in the CEPU. On the one hand, the key

[18] Many observers assume that one could quickly establish fixed exchange rates for Eastern Europe (see Ecu Banking 1990, p. 60). This is fundamentally flawed, although for more complex reasons than adduced, for example, in Cooper 1990, pp. 144-5 and Frenkel 1990, p. 155.

partner in the CMEA is the Soviet Union, with whom trade is conducted in a bewildering array of payment arrangements, ranging from strict barter to convertible currency. To regularize this it would be desirable to bring the Soviet Union into the payment scheme, provided some minimal reform commitments are accepted. On the other hand, Western Europe constitutes the key partner with whom trade is conducted in convertible currency. This might tempt participants to erode the clearing fund's base by appropriating surpluses to pay for convertible-currency deficits. Only concerted action on the part of the major convertible-currency partners, chiefly through the Commission of the EC, could counter this temptation.

4. The capital costs and drawing facilities

Two major concerns of a payments union are how much it will cost and what can be obtained for any given outlay. The latter subject is taken up below. Before suggesting capital-cost magnitudes, it is useful to bear in mind that intragroup trade of the European CMEA countries expressed at prevailing official exchange rates amounted to some $ 82.3 billion in 1989. Half of the absolute sum of the intragroup imbalances was around $ 4.2 billion, and was accounted for by Soviet trade and the unusual terms at which trade in 1989 was conducted. Looking only at the PETs of early 1990, the volume of trade among Czechoslovakia, the GDR, Hungary, and Poland in 1989 was roughly $ 16 billion; half of the absolute imbalances within the group amounted to less than $ 0.3 billion.[19] True, the lifting of bilateral constraints on trade among countries that increasingly devolve decision making to independent firms would probably lead to greater intragroup imbalances. Given the difficulties involved in estimating the imbalances that may have to be supported, no reliable estimate can be made of the financing required once trading arrangements are sufficiently loosened to enable enterprises to negotiate under competitive conditions.

[19] Imbalances actually to be financed would probably be smaller, owing to offsetting merchandise-related service and other transactions (such as tourism, unrequited transfers, and payments of royalties, alimony payments, and stipends). Their precise magnitude is, unfortunately, not known.

Even allowing for the possible increase in imbalances that may initially emerge on account of the liberalization of trade, the orders of magnitude of recent intragroup flows suggest that the cost of financing imbalances would not be excessively large, compared to the amount of aid that has been pledged for Eastern Europe. Precisely how large the capital fund should be depends critically on what the CEPU can accomplish. The central guideline, in my view, should be that the CEPU ease the payment problems of these countries, yet also nudge policy makers into adopting proper macroeconomic policies so that, over the time period envisaged, the solid groundwork for current-account convertibility is laid and firms are encouraged to explore comparative advantages, including those within their primary trading region.

It may none the less be instructive to ponder the claims on outside resources that would have prevailed if recent imbalances among various combinations of Eastern European countries had been cleared within a payments union of the EPU type. The initial[20] EPU parameters (Triffin 1957, pp. 170-2) were that 60 percent of the established quotas, which were based on 15 percent of visible and invisible trade turnover among the EPU members in 1949, could be utilized as maximum credit. Furthermore, credit would be available symmetrically for the first 20 percent of the cumulative imbalances existing at the end of each month. Beyond that, creditors had access to currency (or gold) and credit up to 50 percent, yielding a maximum claim on the union of 60 percent. Similarly, for each successive tranche of 20 percent beyond the first, debtors had to pay 20, 40, 60, and 80 percent in currency (or gold), again yielding a maximum loan equal to 60 percent. In principle, imbalances in excess of quotas had to be settled fully in convertible currency, although this sanction was only rarely imposed.[21]

Utilizing these parameters, it should in principle be easy to compute both the quotas and the kind of imbalances that might have to be supported. Actually, matters are not that simple. Perhaps the most mundane reason is that current exchange rates of Eastern Europe are disequilibrium rates and cross-rates to convertible currencies are far from even approximately uniform (EBE 1991, p. 30). As a result, trade statistics leave a lot to be desired. Second,

[20] Tranches were periodically reexamined, especially in 1954 and 1955, with a view to "hardening" settlement constraints (see REES 1963; TEW 1967, pp. 111-14).

[21] Financial diplomacy was key to resolving such conflicts. For a useful description of how it worked in the EPU, see KAPLAN and SCHLEIMINGER 1989 and REES 1963. Note that ALAN S. MILWARD 1990 has strongly criticized the first account of the EPU's management; BRIAN TEW 1990 has applauded it, however.

present trade has been attained under heavily constrained circumstances. Using 1989 as a point of reference, because the most recent comprehensive data are for that year, the bulk of trade was still conducted under BTPAs. That is to say, imbalances occurred in principle only when countries agreed *ex ante* to grant loans, thereby evading part of their obligations under the BTPA, or raised their net exports above levels foreseen in the agreement. Finally, recent trade years were rather unusual in part because of violations of the TR settlement conditions and the inability of the countries to come to grips in a structured manner with the volatility in the terms of trade induced by marked shifts in world prices.

Notwithstanding these caveats, I estimated claims on outside funding on the assumption that recent trade had been cleared according to the EPU's initial parameters, using quotas based on half of the sum of reported and mirror trade levels for countries ranked in English alphabetical order.[22] Quotas were calculated for 1989 alone and for the average of the years 1987-1989. These calculations yield magnitudes for claims on the capital fund for 1989 from $ 5.9 million (with only three Central European participants) to $ 1.7 billion for all of Eastern Europe; the comparable data for the 1987-89 average are $ 19.8 and $ 705.9 million. These are the sums that would have had to be financed since surplus countries could have taken out of the union more than the deficit countries paid in.[23]

Because the Soviet Union was *the* major unbalanced economy in the late 1980s, to make any prediction about likely imbalances to be settled in a union with Soviet participation, it is necessary to gain some perspective on the switchover in the TR regimes and the imbalances to be incurred over the next few years. Unfortunately, that is not a simple matter. All we know is that current imbalances are bound to change drastically in 1991 and beyond, provided present fuel prices hold, Soviet energy output can be maintained at a high level, and the federation holds together. Even so, the hypothetical computations suggest that the amount of money required to finance the pattern of intragroup trade typical of the late 1980s is rather small, perhaps several million dollars without the Soviet Union and perhaps $ 1.5 billion with the Soviet Union included. To allow for

[22] Because I have only annual data, I am implicitly assuming that the periodicity of settlements is once a year.

[23] The assumptions underlying these computations as well as alternative estimates as regards the base year and quota arrangements are in BRABANT 1991g.

larger imbalances, a capital fund on the order of $ 2.5 billion would constitute an adequate basis, provided the supervisory authority functioned as stipulated.

This comparatively small commitment needs to be seen against the backdrop of the constructive benefits a clearing scheme may yield. Perhaps most important, it would reinforce the trade relations of the reforming countries, especially if those were to be buttressed through a CEEU. This would be very helpful in shoring up the restructuring of trade *pari passu* with industrial change mainly as a result of independent firms trading on their own account. Not only would it support the reform trends from within and strengthen intragroup economic relations, it would also transfer assistance in a form that would least interfere with the emerging economic incentives for microeconomic agents and the macroeconomic framework that is being elaborated. Finally, it would stave off either the pressure on western markets to accommodate significant trade diversion or the contraction in levels of domestic activity in the reforming countries during the restructuring process. Prevailing supply rigidities would render the latter option rather expensive.

5. Comments and their merits

I cannot detail all of the comments, criticisms, suggestions, and inquiries concerning the CEEU and CEPU, or indeed spell out each counterargument in detail.[24] The following twelve points sum up the salient arguments.

First, many emotional and political objections have been raised. They usually allege that my proposals view Eastern Europe, or a subgroup thereof, as a "bloc", a special region somehow deserving a separate treatment that falls outside the mainstream of the global economic context. It also imputes to me a desire to perpetuate the ossified economic structures and deliberately keep the PETs from undertaking technological and structural changes that would bring them into the mainstream of global economic relations.

[24] Many criticisms were made in oral commentary on the proposals or hidden in rather obscure preliminary publications that I cannot cite here. I have dealt with these sources in some detail in BRABANT 1991b.

It would be extraordinary to gloss over the fact that the PETs *are* in Eastern Europe, and that all of them face comparably daunting adjustment problems. But there is no reason to believe that my cooperation proposals are intended to prolong the "old CMEA" or seek to reconstitute that order, encourage the maintenance of "bloc-formation thinking", deliberately deny the PETs access to the EC or integration in the global economy, induce Eastern Europe to further petrify its outmoded economic structures, or withhold from the PETs the right to undertake major structural changes in line with world-market conditions. My point of departure is quite different, and I should like to have that unambiguously registered *and* heeded in future commentary on the proposals.

Briefly put, in transiting towards market conditions, the PETs are encountering a range of obstacles, among which a severe liquidity shortage is but one. This cautions policy makers against moving swiftly towards trade liberalization and market mechanisms especially in intragroup relations, thereby delaying or sharply slowing down reform. The payment facility has been proposed to foster progress towards reform by relaxing the foreign-exchange constraint. It would also encourage those economies proposing radical reform *not* to deny their emerging autonomous firms from exploiting their perceived advantages in neighbouring countries (including goodwill and market knowledge) because of foreign-exchange shortages. Furthermore, such a facility would permit the PETs to avoid some of the costs associated with trade diversion. Finally, moving towards convertibility requires that the underlying economic infrastructure maintain current-account balance at least over the medium run. This is not now the case. A payments union would help these countries to work off the sacrifices required to undertake the structural changes necessary to open up their economies.

Second, many commentators feel that the proposal is devoid of an economic rationale and might even be "lethal" (Thompson 1990) to economic recovery in Eastern Europe by accommodating harmful trade diversion. This seems to ignore the fact that after the considerable compression of imports from convertible-currency countries in the 1980s, there is not much trade left to be diverted. Indeed, the very purpose of the above-mentioned proposals would be to avert trade destruction on account of payment constraints or the diversion of trade to Western European markets regardless of the domestic sociopolitical and economic adjustment costs in the short run. What is

currently going on in many PETs is that reverse or internal trade diversion is being fostered through the deliberate, if not very logical, imposition of all kinds of constraints on intragroup trade. These not only include typical commercial-policy instruments, but also surcharges, turnover taxes, and administrative hindrances to trade that previously was not subject to such cost elements. To the extent that these measures are taken for metaeconomic reasons, they may have a rationale, but one that cannot be dealt with in an economic context. At any rate, these decisions entail, possibly substantial, costs that can be ill-afforded at this juncture.

Furthermore, the economics of cooperation in Eastern Europe is often misunderstood. The competing (or better the quite similar) economic structures in place are held to render cooperation among these countries undesirable because they are assumed to inhibit the emergence of trade. Regional cooperation would allegedly delay modernization, perpetuate obsolescence and uncompetitive economic structures, and impede these countries from integrating themselves into the world economy. I find this a very odd position.

The existence of comparative advantages among these countries themselves should not be ignored. These have not been fully exploited in the past because of lacking institutions, faulty policy instruments, or policies that sought to shape trade according to criteria that the market would simply not have validated. Some of these advantages are strictly temporary, either because of goodwill (such as knowledge of markets and linguistic abilities) or demands (such as for servicing the existing machine park and taking advantage of the transportation infrastructure in place) that will shrink over time. Also, as a result of changes in comparative costs, including factor-productivity gains obtained from the reform, the developed countries will in any case become less cost-competitive and thus provide greater trading opportunities to other PETs; their exploitation should be encouraged on economic grounds.

Third, a cooperative solution among the reforming countries is not even being considered at this stage. Instead, the former CMEA members are reinforcing *ad hoc* bilateral solutions that fall short, at least at present, of placing the economic exchanges involved on a convertible-currency basis at market-clearing prices. I find the wholehearted encouragement of bilateral solutions to regionwide problems in many ways a throwback in economic thinking and policy making (Vries 1969b). Surely, if the radically reforming countries were bent on catching up with world markets as quickly as possible and gaining full entry there, the last thing to recommend to them would be the avid pursuit of bilateral solutions. This position, in my view, is particularly pertinent when one of the partners is bound to be the Soviet Union, where market-clearing behaviour is unlikely to be introduced in the near future.

Fourth, the CEPU is proposed as an integral buttress to a CEEU. This has elicited conflicting criticism. Some agree with the reconstitution of some transitory economic union among the PETs, but then reject the merits of a CEPU. One elementary requirement of operating any economic union, just as in an integrated domestic market, is that the currency be transferable. Convertibility of all currencies would accomplish just that. But if that cannot be reached, the need for a transferable currency remains. It can be met through a CEPU or a similar payment facility.

Others reject both the CEPU and the CEEU or only the latter. I maintain that the virtues of a CEEU could have been explored much more vigorously by the rapidly reforming countries to buttress their domestic reforms (Brabant 1989b). Especially the PETs stand to gain considerably from actively pursuing regional integration, perhaps through a customs or economic union. At present, finding the proper ways and means of exploiting their comparative advantages would seem to direct attention chiefly towards trade with the west. Yet the economic merits (perhaps as distinct from foreign-policy considerations) of a CEEU (Brabant 1989a) are fairly obvious. The trade among these countries is essentially in manufactured goods. MFN tariffs on this trade, certainly as newly applied by Hungary and Poland,[25] are fairly high (on average some 20-25 percent). Czechoslovakia began to apply a high tariff with surcharges in 1991. Relations with the former GDR have, of course, become subject to the EC's external tariff, which on average is low, but not for many exportables of direct interest to Central Europe. In addition, countries have levied sizable surcharges and introduced extraordinary administrative measures to compress intragroup trade.

[25] As of 1 July 1990, Poland suspended many tariffs and reduced most others to a fraction because they had been providing high protection for state monopolies. Policy makers had hoped to have in place a new tariff by early 1991, but discussions with the GATT on renegotiating Poland's terms of accession have taken more time than forecast, perhaps owing to the convoluted domestic political situation of late 1990. For the time being, the tariff suspension has been extended into 1991.

All this is placing incremental restrictions on intragroup commerce. The PETs have a similar machine park that is dependent on each other's parts, components, maintenance, and servicing. Furthermore, there is plenty of room for building up scale economies, albeit in products that for now are difficult to market in the west, but not only because of inferior quality. Such effective regional specialization would enable these countries to maintain fairly buoyant trade while they forcefully restructure their economies in line with world-market conditions. There might be room to consider how best to provide financial support and supervisory discipline to guide this process, which is precisely one of the purposes of the CEPU.

Fifth, a key criticism of any suggestion to ease the adjustment burden by facilitating gradual changes in the existing trading patterns has been that these patterns are deemed to be without economic merit. They are said to have emerged largely because of significant implicit preferences granted through mechanisms that should be suppressed in the process of marketizing these economies. In this connection, many commentators have sided with the "big-bang" libertarian approach to managing the transition in the PETs, making arguments that are reminiscent of the debates between adherents of full multilateralism and the EPU in the early 1950s (Vries 1969a). Their argument is that the PETs need integration into the global economy and that they risk being sucked into a "poor man's club" (Lipton and Sachs 1990, Sachs 1990), if such integration were possible only by the perpetuation or institution of new preferential arrangements through a CEEU. It may well be the case that upon a rationalization of the trading patterns of the PETs, a very different level, commodity composition, and geographical direction of trade would emerge. I doubt, though, that on rational economic grounds a more optimal division of labour would reduce trading with the regional partners to nil. I am even less convinced that taking advantage of trading opportunities within a "poor man's club" is an undesirable way of capitalizing on comparative advantages, particularly when that club is being avidly courted by outsiders. The example of the Benelux in the late 1940s (which had only one third the population of and was then not more developed than Central Europe)[26] immediately comes to mind.

[26] However, Benelux at the time was facing a world in which only a few countries, notably the United States, were more developed and offered trade access without major impediments. This is not so for Central Europe today.

Whether it would be desirable to avoid preferential arrangements within a CEEU is a serious matter, particularly if it is argued that such arrangements should be put in place in the east-west context. I am firmly convinced that there are considerable opportunities for creating trade within Eastern Europe that have not so far been exploited because of inadequate or faulty policies, institutions, and policy instruments. These could be reaped regardless of whether postwar regime of trade preferences are maintained. Positive discrimination against intragroup trade would, of course, compress the pool of profitable trade. If substantial trade can be created and its impact on global supply eased through cooperation, would it not be in the interest of both east and west to pursue it?

Normal customs-union considerations suggest that a CEEU would primarily be trade creating, because the underlying economic structures of these countries are more competitive than complementary. Furthermore, their trade with each other and with outside markets has been constrained for systemic reasons. This suggests that there could be substantial economies of scale to be reaped. Apart from these gains, such a customs or economic union would strengthen the market orientation of these economies and enable them to enact structural adjustments in a somewhat more orderly fashion and at a lower short-term sociopolitical cost than under conditions of full, abrupt competition.

In this connection, it is also argued that any special post-CMEA preferences are contrary to obligations under the GATT. That a CEEU would be against GATT rules is a poor argument, given that trade among the former socialist countries has on the whole remained outside the GATT framework, in some cases quite explicitly. Furthermore, a well conceived regional economic cooperation mechanism could be easily brought under the terms of reference of article XXIV of the GATT (Brabant 1991e). If in the interest of Contracting Parties, it would probably find considerable support, even temporary waivers.

Furthermore, it is argued that any discrimination in trade and payment policies, given disequilibrium exchange rates, will prevent the scheme from reaching its principal objective(s). I do not, of course, deny that management of a CEPU and a CEEU will be a major challenge. Indeed, formulating proper commercial policy and engaging in financial diplomacy in support of the reform processes embedded in the aspirations of present policy makers of PETs are daunting tasks. But that has little to do with the organization of a union *per se*.

Sixth, virtually all criticism revolving around the special-preference issues depends on the conjecture that the PETs can adopt convertibility (at least for merchandise and related transactions) and can otherwise merge quickly into the global economy. If this could be attained rapidly then a CEPU would be superfluous. Unfortunately, none of the PETs can quickly establish full convertibility for all (including intragroup) current-account transactions or for that matter integrate themselves into the global economy without incurring a very sharp drop in levels of living. The latter would stem, among others, from scrapping a large component of the capital stock and idling a substantial share of the labour force because their services are uncompetitive in global markets or they could not be utilized for lack of inputs. Thus, provisioning these countries with critical fuels and raw materials from other sources than the Soviet Union could be ensured only after some time as transport facilities are put in place. If policy makers feel they have a mandate to incur such costs quickly and they can overcome the technical constraints, then indeed there would be no need for a CEPU.

Even if the PETs were in a position to withstand the necessary costs on the way to quick convertibility and trade diversion, it would not necessarily be true that on economic grounds the gain accruing from exploring something like a CEEU as a means to enhancing the exploitation of comparative advantages would be negligible. This would require either the recognition of existing preferences and translating them into transparent market criteria, or at least avoid the imposition of considerable impediments to intragroup trade.

Seventh, especially eastern commentators and politicians are against participation in a CEPU. They find ample western support in particular from those who argue that Eastern Europe is able to introduce current-account convertibility for merchandise and related transactions in the very short run. Some variants of this position even argue that the PETs can merge themselves into global competition without great difficulty. This easing of the adjustment burden is also taken for granted on account of the replacement of the TR regimes.

Obviously, if policy makers really do not wish to take advantage of something like a CEPU, there is no point in forcing them to do so. Clearly, countries have to examine *all* their options including second-best solutions. If after measured consideration of all possibilities they continue to cling to the "no deal", then obviously no CEPU should be attempted. The consequences for intragroup trade and the diversion of trade to the west will need to be taken into account, of course. Such a stance would certainly weaken the credibility of requests for western assistance.

Eighth, perhaps the most cogent technical criticism is that the union would be too small to matter in terms of the need of the participants for convertible currency and the pressures that are bound to emerge from within to make the union work, especially now that the GDR could no longer be involved in any clearing system.[27] However, smallness is often measured as the share in total commerce with potential CEPU members. True, until 1989, this hovered around 10-15 percent at most; it has since shrunk precipitously. But this is not the proper comparison.

Placing trade among the CEPU members on a convertible-currency basis raises the effective demand for foreign exchange; the share of convertible-currency trade in total trade in 1989 amounted to much less than 100 percent of non-CMEA trade! In fact, trade effectively conducted in convertible currency has traditionally been comparatively small. At the recently introduced commercial exchange rates, the share of trade among the Central European countries relative to trade with convertible-currency partners in 1989 was between 25 and 100 percent – not at all a negligible rise in the demand for convertible currency to be met by generating export surpluses now or in the future. Furthermore, as argued, there are considerable opportunities for expanding intragroup trade. Moreover, if market reforms were to be introduced in the Soviet Union or its successor republics, and the Yugoslav dash towards dinar convertibility were to falter, as now seems inevitable, the scale of a CEPU could be substantially expanded.

Ninth, some critics contend that a CEPU could not be set up without the Soviet Union. Politically it might well be difficult to do so and perhaps it might not be wise to deliberately exclude the Soviet Union. From an economic perspective, however, there simply cannot be room for egregious nonmarket trading relations in a CEPU. On the other hand, the CEPU could usefully be conceived in such a way that all countries with credible market-oriented reforms could be accommodated soon after they start the process of transition.

Tenth, many commentators argue that any payment facility for the radically reforming countries makes members dependent on financial aid that the west would be reluctant to grant. This argument

[27] But this issue could have been taken care of (see BRABANT 1991b).

can be dismissed quickly unless the western countries were prepared either to finance the Eastern European adjustment process, as it did during the 1970s, or to let these economies recede into deep depression. This does not seem to be the attitude of responsible western leaders.

In this context, it is also alleged that a CEPU would be too costly, and would not provide an effective return on scarce assistance ECUs; and even if it were not too costly, a payments union would be too slow to produce results to be of any assistance, given the precarious situation of the PETs and the policy aspirations of the new Eastern European leaders. The cost assessment has apparently three components: the capital required to make the payments union function, arranging technical clearing, and exercising surveillance so that policy advice gets implemented in a timely fashion.

Judging by the EPU's experience, the administrative cost of running a smooth accounting agency would be rather small. That it might take a long time to negotiate a CEPU and put it in place is something that speaks for working on a CEPU as quickly as possible, rather than jettisoning the proposal as inherently undesirable or even unworkable. In fact, as suggested, the CEPU's technical arrangements should be as simple as possible, certainly far less complex than the EPU's. Whether the CEPU would slow down the adjustment process of participants is something that depends on the ability of these countries to absorb the adjustment burden of moving towards full convertibility. Clearly, if policy makers had a realistic mandate to do so in one year it would be counterproductive to place them on a five-year schedule simply to ease the burden for other PETs. The latter's concerns could, under certain conditions, be better met through bridging loans, perhaps by applying the orthodox IMF adjustment regime.

Because the CEPU would be smoothed in part through outside capital, it is true that for as long as the PETs cannot trade among each other in convertible currency, external assistance and supervision is required to maintain their trade. But that is precisely the purpose of the CEPU, provided the notion of moving towards *full* participation in global trade and finance is not lost from sight. The alternative is either deflationary domestic policies to cut out import demand or reliance upon external financial flows to support deficits. Clearly, the latter would be a multiple of what a CEPU scheme requires. Furthermore, as was evident in the 1970s and 1980s, blanket external financial support would not necessarily move these countries to desirable market-oriented reforms through incisive structural adjustments; in a number of respects, the process of buttressing a market-economic decision making could be significantly retarded.

Some commentators have invoked the argument of the west's reluctance to be the financial and "spiritual" sponsor of a payment scheme because it would not be in a position to exercise surveillance over the reform process in the PETs. The key aspect of the criticism is apparently not that the west would be unable to formulate proper macroeconomic policies for PETs, although that too is at times invoked, but that the PETs would be unwilling to heed policy advice, thereby debilitating the payment facility once the first member exhausts its quota.

Also, this argument is unconvincing. If the west were to mount a major assistance drive without exercising influence on policy makers in PETs on how that assistance would be utilized to favour the introduction of democratic institutions, and market systems, then the assistance effort would be poorly conceived and would not receive the necessary domestic support. One must expect that western political and economic decision makers are capable of doing much better.

Rather than the costs being too large, greater subregional cooperation would in all likelihood elicit considerable additional support in Western Europe for two reasons. It would postpone the diversion of substantial volumes of trade to western markets, which would be difficult to accommodate in the short run, given the other priorities and adjustment problems of the EC. Also, intragroup cooperation with western support might facilitate the transition to markets in the PETs and thus accelerate their full integration into the EC. Because of the time gained, orderly – and credible – accession deliberations could be scheduled. It would in any case be unrealistic to expect serious negotiations to get under way before late in the decade, given the EC's already complex negotiating agenda for the coming years and the problems the PETs face in transforming themselves into MEs.

A peripheral comment under the heading of western assistance has been that it would be far more desirable to make the PETs subject to the rules of the European Monetary System and tie their currencies to the ECU regime at the earliest opportunity (see Brabant 1991d), rather than to create a separate arrangement for intragroup payments. Clearly, once these countries reach macroeconomic stability and rearrange their domestic economic structures, it might well

be highly desirable to introduce these economies into a more strenuous monetary regime, if only because it would constrain policy makers to embrace proper macroeconomic policies for domestic and external balance. But bringing the PETs under this umbrella prior to fundamental stabilization would accomplish little more than putting a European veneer on political aspirations (Brabant 1991d). It certainly would contribute little to solving the technical problems of transition.

Eleventh, in a peculiar *non sequitur*, some Eastern European commentators stress that a payments union would be too expensive in part because of budgetary problems.[28] This criticism can be quickly dismissed. Certainly, there will be such financial implications, but these are bound to emerge regardless of whether there is a payments union. They derive in essence from adjustments in terms of trade that will eliminate the gap between WMPs and TRPs. Budgetary revenues will in any case have to be raised through other measures. But that is primarily a matter of domestic macroeconomic policy, not of regional or interregional economic cooperation.

One final observation is that Czechoslovakia, Poland, and Yugoslavia have instituted some modicum of currency convertibility. Some commentators contend that having them participate in a CEPU would be discriminatory and would set back the reform process. The key issue is that these countries have liberalized trade with convertible-currency partners – not all MEs, of course – but not trade among themselves. Inasmuch as these countries are not willing or able to conduct their mutual trade in convertible currency at once and cannot divert their trade without sustaining measurable terms-of-trade and export-revenue losses, the 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. Removing bilateralism would *raise* the degree of convertibility, not lower it. Also, absolute discrimination between domestic and outside agents would be *reduced*, except for temporary retreats to keep the

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[28] The TRP regime in recent years brought considerable price-equalization subsidies into the government budget of several PETs. The bulk of these "gains" arose from the effectively lower price of Soviet oil as compared to the domestic price, which came close to the east-west price plus markups.

scheme manageable. Of course, relative discrimination against the west would increase, while that against the east would shrink. That might well be a desirable price to pay in exchange for the rapid inclusion of all trade in a multilateral framework. It is difficult to see how this would set back the reform process, unless, of course, the PETs had the option of moving directly to all-around convertibility (except for nonreforming CPEs) or costless trade diversion – both rather unlikely events.

Those (especially Polak 1991) who argue that a CEPU would be an undesirable backtracking on reform measures already introduced apparently assume that the reforming countries either have a licensing-free system for all trade or can divert at little cost all of their trade subject to controls to convertible-currency markets. If so, a discriminatory regime for import permits would be required under a payments union. However, neither applies. Discrimination through currency would thus aim primarily to avert trade destruction rather than encourage trade diversion.

Conclusions

It is to be hoped that the above amplifications of the purposes and mechanics of the CEEU or CEPU as shorthands for the type of cooperation that can be sought among the PETs will once and for all lay to rest imputed attributes that reflect neither the letter nor the spirit of the proposals. All that the proposals hope to accomplish is a further facilitation of the transition phase at a time of severe and tightening external-payment constraints. In particular, the proposals should not be seen as an alternative to joining "Europe". Quite the contrary: I see them essentially as a temporary stage to facilitate the transition, both in terms of the time required and the costs incurred in the process, towards becoming fully integrated members of a united Europe by the end of the century.

Of course, this begs the question of whether the conditions under which the EPU succeeded are likely to be replicated in Central Europe. Given the disarray in Eastern Europe, these countries as a group are not at all imbued with a great deal of mutual trust at this juncture. This may emerge once the uncertainty about future policy,

including the uncertainties in the Soviet Union, dissipates. Because this lack of confidence is much less pronounced for the PETs, a CEPU would cater to shared political interests and commitments "to making it work", although the degree of overt commonality for now remains rather shallow, owing in part to lingering social and political revendications. Most, but not all, of them are legacies of the prior political organisation of the region. Given political liberalization they should become less important as democratic conditions are strengthened introduced and come to be seen as permanent.

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