Lessons from the Collapse of the Transferable Ruble System and the Joint Currency of Former CMEA Countries for the Eurozone

Patrick Conway*

The similarities were obvious: countries linked by a free-trade area and a common currency were divided into 'haves' and 'have-nots' by their ability (or inability) to finance budget and trade deficits. The tension between the goal of convertibility at par of the common currency and the desire to reduce the sovereign indebtedness of members led to increased pressure on the 'have-nots' to exit the common currency area. In the Council for Mutual Economic Assistance (CMEA) case (referred to here as the ruble zone), the desire to reduce exposure to sovereign debt won out and the members exited the area. Are there lessons from that case for the current situation of the Eurozone?

I conclude that although there are important similarities, there are also key differences in the two cases. While exits from the ruble zone were almost inevitable given the unstable economic conditions of all its members, the Eurozone offers a more stable environment for members and stronger economic partners. Should there be an exit, the member may well claim it was forced to leave; just as in the ruble zone, such an exit will be in response to a tightening of conditions for indebted members due to a perception that the latter were using low-cost borrowing arrangements without undertaking the budgetary adjustment necessary to re-attain a responsible membership position.

The Eurozone countries following the international financial crisis

To understand the sovereign-debt crisis in the Eurozone that began in 2010, it is necessary to return to the creation of the euro in 1 January 1999. As Thomas (2014) puts it:

> "In order to join the Eurozone, each prospective member agreed to adhere to a common set of standards pertaining to budget deficits and debt levels, price level behavior, bond yields, and other key economic variables. Leaders of the euro movement implicitly assumed that characteristically divergent economic behavior and performance across Eurozone nations would thus be reduced to manageable differences.
> This optimism turned out to be unwarranted. Peripheral Eurozone nations such as Greece, Ireland, Portugal, Spain and Italy continued to experience slower productivity growth and more rapid increases in price levels after joining the currency union than did stronger, northern members like Germany, Austria, the Netherlands and Finland.
> Induced in large part by the abnormally low interest rates that financial markets made available to such traditionally high interest-rate nations upon the 1999 introduction of the euro, major bubbles in credit and house prices were inflated in Spain and Ireland. These same low borrowing rates led to government spending sprees in Greece, Italy and Portugal".

The trigger for the international financial crisis that primarily affected advanced economies as of 2008 was the downturn in housing values in US real estate markets in the mid- to late-2000s. At its base, this crisis was rooted in a speculative bubble. Kindleberger (2000) was an early expositor of speculation, and documented that it would lead to a rapid run-up in price followed by a crash. In this case the primary bubble formed in the US real-estate market. While speculators believed that their purchase of credit default swaps had hedged their risks, the failure of the American International Group (AIG), the major issuer of these swaps, appeared to return the risk to the speculators. Many of these speculators were European banks. As Blinder (2014, 410) puts it, "when the housing and bond market bubbles burst, recession quickly descended upon Europe".

The sovereign debt crisis followed the international financial crisis by two years. With the deep recession,

* University of North Carolina at Chapel Hill.

Greece, Italy and Portugal found it necessary to expand their budget deficits still further as tax revenues fell and social-protection expenditure rose. Ireland and Spain chose to guarantee delinquent private debt, thus greatly increasing their sovereign debt obligations. Financial market participants began to lose faith in the GIPSI governments' ability to service their obligations, leading to higher interest rates on their debt denominated in euros than the rates demanded of fellow Eurozone members Germany or the Netherlands. Serious thought has been given to the Grexit – the possible decision by Greece to leave the Eurozone. Should this occur, the other GIPSI members would be candidates too.

The CMEA countries and the convertible ruble

The CMEA (or Comecon) was established in 1949 as an analog and counterweight to the Marshall Plan in Western Europe. Its original members were Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the republics of the Soviet Union. As Europe united within the European Economic Community (EEC), CMEA also attracted new members as its socialist alternative. As of 1987 the members of CMEA were Soviet Union, Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Romania, Poland, Cuba, the Mongolian People's Republic, and Vietnam.

The stated purpose of the organisation was to enable member states to exchange economic experiences, extend technical aid to one another, and to render mutual assistance with respect to raw materials, foodstuffs, machines, equipment, etc. (Curtis 1992). International trade between countries was arranged in terms of physical quantities for a five-year period. The price for these goods was set by averaging the world price of the product or commodity in question over the five years previous to that arrangement. Trade was 'free', in the sense of occurring without tariffs, although the economic plans on which it was based effectively set quotas on bilateral trading volumes.

The International Bank for Economic Cooperation (IBEC) was established by the CMEA members in 1963 to facilitate international transactions among CMEA members, and between CMEA members and the rest of the world. IBEC's functions included making multilateral settlements, advancing credit to members to finance temporary trade imbalances, accepting deposits of uncommitted funds, accepting gold and convertible currencies on deposit, and conducting arbitrage and other financial operations with them (Prust 1993, Appendix 3).

In 1964 the IBEC introduced its common currency for denominating transactions among members: it called this currency the transferable ruble (TR). Each member's currency was linked to TR through administratively set fixed exchange rates and comprehensive exchange controls. The TR was defined to be equal in value to 0.987412 grams of pure gold, but it was never exchanged for gold by the central banks of these countries; nor was it exchanged for banknote (i.e. cash) rubles. Transactions at IBEC were government to government; very few non-governmental entities held correspondent accounts at IBEC. (Prust 1993, Appendix 3).

Curtis (1992) states:

> "Although the bank provided a centralized mechanism of trade accounting and swing credits to cover temporary imbalances, it could not establish a system of multilateral clearing given the centrally planned nature of the members' economies and the inconvertibility of their currencies. In 1987 the transferable ruble remained an artificial currency functioning as an accounting unit and was not a common instrument for multilateral settlement. For this reason, this currency continued to be termed 'transferable' and not 'convertible'".

While the TR was called 'transferable', it was non-transferable in an important sense. As Kenen (1991, 238) puts it, "if Poland built up a credit balance with IBEC by running a trade surplus with Hungary, it could not use the credit to finance a deficit with Bulgaria. For this and other reasons, each CMEA country sought to balance its trade bilaterally with each CMEA partner". Due to the essentially bilateral nature of transactions accounting, a 1 TR credit held by Poland was worth about 0.34 US dollars in Western imports in 1989, while at the same time a 1 TR credit held by Czechoslovakia was worth about 0.66 US dollars in Western imports. At that time, the 'official exchange rate' was 1 TR = 1.60 US dollars (Kenen 1991).

Among international reserve assets, the most similar is probably the Special Drawing Right (SDR) of the International Monetary Fund. Kenen (1986) provides a short description of this reserve asset, first authorized in a 1969 amendment to the IMF Articles of Agreement. It too was an accounting asset without

physical counterpart, and it too was only used in government-to-government transactions. The SDR had the advantage of true transferability, in that a credit earned in transaction with one country could be used to offset a debit to another country. It also differed from the TR in that it was distributed to IMF members strictly in proportion to their quota. While there was discussion in the 1970s and 1980s of a 'SDR-aid link' – a distribution of newly created SDRs to developing countries – this innovation was never approved by the members. With the TR, by contrast, the Soviet Union used TR creation to offset persistent bilateral trade deficits (often in energy products) between itself as exporter and other CMEA members as importers.

The IBEC phased out its accounting for trade transactions in TR as of 1 January 1991. From that point on, the unit of account was the European Currency Unit (ECU) – and as of 1 January 1999, the euro.

The centrifugal force of the ruble zone

The last years of the Soviet Union saw increasing Soviet budget deficits. These were financed through foreign borrowing and through the seigniorage captured by the accelerated creation of money and credit. In a market economy, this demand pressure will translate into increased consumer prices. In the Soviet Union of the time, there were price controls in place. This led to shortages of goods and services and forced saving by consumers unable to find goods and services at the stated prices. This forced saving translated directly into the seigniorage captured by the government in each period through creation of both cash rubles and bank balances (Conway 1995).

The TR was discontinued on 1 January 1991, but the use of rubles among the republics of the Soviet Union continued. The central bank of the Soviet Union, Gosbank, remained the monetary authority and hosted accounts for clearing inter-republican transactions. While Gorbachev's perestroika had led to greater autonomy in productive decisions, the history of central planning resulted in substantial inter-republican trade in raw materials and semi-finished goods, as well as in final products: payments for that trade from one republic to another continued to flow through Gosbank.

With the dissolution of the Soviet Union at the end of 1991, the ruble zone was created by the new political reality. Each republic established its own central bank based on the republican office of Gosbank. The Central Bank of Russia (CBR) also assumed the responsibilities of monetary authority for issuing cash rubles and served as the clearing-house for inter-republican transactions. The ruble zone of 1 January 1992 thus included all the former republics of the Soviet Union.

The economic difficulties facing these new countries are presented in detail in Conway (2001). They can be summarised as follows:

- Hyperinflationary pressures from the ruble overhang once price controls were removed.
- Ruble cash shortages in the ruble zone, as CBR cash issuance did not keep pace with demand for liquidity.
- A large fall in output due to the breakdown of normal commercial relations between suppliers and purchasers (often in different republics).
- The loss of financial transfers from the Soviet government to the republican government. In return, the republican government had rights to turnover tax revenues on commercial transactions. However, these revenues fell substantially during the post-independence period.
- Financial repression due to the negative real interest rates offered on saving instruments.

The governmental response in these republics to the resulting recession was, in most cases, to maintain consumer subsidies and social-protection expenditure, despite the large fall in tax revenues, thus giving rise to large republican budget deficits that were financed through the republican central bank.

The republican central bank had three avenues for refinancing this deficit. Firstly, it received seigniorage from paying out any cash rubles shipped to it from the CBR. Secondly, in many republics the central bank issued its own cash supplement, or coupon, to meet the demand for liquidity. Thirdly, the republican central bank ran a deficit, or overdraft, on its correspondent account at the CBR.

These overdrafts were pervasive among ruble zone members. The CBR as the monetary authority of the ruble zone went through four stages in its response to these overdrafts. At the beginning of the crisis (in the first half of 1992) it accepted the overdrafts and extended zero-interest 'technical credits' to overdraft countries. In mid-1992 it changed its policy and imposed ceilings on the size of overdrafts. In early 1993 it

refinanced overdrafts with Russian state credits with positive real interest rate and short maturity. The evolution of this policy reflected the Russian recognition that the maintenance of the common currency required fiscal responsibility by all members: if members could not be responsible, they should exit the ruble zone. As Conway (1995) notes, this evolution in attitude was also evident at the IMF and the World Bank. They initially supported maintaining the initial membership of the ruble zone, but shifted their position by mid-1993 to encouraging the introduction of national currencies.

The Baltic republics were among the first to introduce national currencies: Estonia in June 1992 and Latvia and Lithuania in June 1993. The other former Soviet republics followed shortly after, ending with Ukraine in 1996 and Tajikistan in 2000.[1]

Lessons of the ruble zone for the Eurozone

The most important lesson of the ruble zone for the Eurozone was probably observed in real time by the Maastricht Treaty negotiators in 1991 and early 1992. A common currency area depends upon the fiscal responsibility of its members for its sustainability: the ruble zone members' inability to deliver that responsibility was the centrifugal force that spun the member countries out of the area one by one.[2] The Maastricht Treaty, which defines the roadmap for the introduction of the euro in 1999, includes limits on government debt/GDP and the fiscal deficit/GDP ratios that will, when upheld, preclude the strategic exploitation of the Eurozone observed by ruble zone members.[3]

A second lesson of the ruble zone is that a negative economic shock common to all members of the zone will put great pressure on the zone. Even with responsible fiscal policies in place in all members, the zone will either require resource transfers from the less-hard-hit to the harder-hit, or the availability of financing for a period of adjustment. The cost of these transfers, and of this financing, was too high for the newly independent Russian republic – and this led to the downfall of the ruble zone.

The Eurozone had far greater resources in place for the highly indebted countries of the Eurozone in 2010 and 2011. The Council of the European Union created the European Stabilisation Mechanism 'to present financial stability in Europe' by providing guarantees of up to 500 billion euros in sovereign borrowing from international capital markets (Europa 2010). Simultaneously, Greece reached an agreement with the IMF, the European Commission and the ECB on a focused program to stabilise its economy with the support of a 110-billion-euro financing package. Ireland and Portugal followed shortly thereafter with similar agreements.

A third lesson of the ruble zone is that the provision of no-cost overdraft privileges to the members' central banks led to overspending and strategic manipulation of the common currency (Conway 1995), as well as to the eventual demise of the ruble zone. The President of the ECB during the initial years of the debt crisis, Jean Claude Trichet, had absorbed this lesson; while the ECB bought modest amounts of GIPSI sovereign bonds in 2010 and early 2011, it eschewed larger interventions for the potential cost in inflation that they represented (Blinder 2014). The next President of the ECB, Mario Draghi, expanded these existing purchases both in size and in maturity. With the 'Outright Monetary Transactions' program the ECB expanded sovereign-debt purchases still further, so long as the benefiting member agreed to budgetary conditions defined in negotiation with the staff of the European Stability Mechanism (Blinder 2014). In this case the Eurozone, and particularly the ECB, has learned a more nuanced lesson. In the ruble zone crisis, there was a pre-existing cause of inflation that was exacerbated in its impact by strategic manipulation. The ECB has evidently concluded, based upon the Federal Reserve's experience in the United States, that the threat of inflation in the current international environment is quite low. Furthermore, the EU and ECB have negotiated carefully to obtain conditions on budget performance in the GIPSI countries that they believe will minimise the risk of such strategic deficits.

Important differences between the zones

There are a number of important differences between the situations of the ruble zone and the Eurozone that

[1] Ukraine stopped receiving cash shipments of rubles in late 1992, and from that time until 1996 relied upon its coupon, called the Karbovanets, as its currency. It remained with the *Karbovanets* until it had established rough budget balance, and then introduced the new currency, the *hryvnia*.

[2] It is important to note that the first exit from the ruble zone, by Estonia, was probably due to the fact that the Estonians were more fiscally responsible than the Russian government was prepared to be at the time. By exiting early with a budgetary balance, the Estonian economy was able to avoid most of the hyperinflation shared by ruble zone members in 1992–1993 (Conway 1995).

[3] See also http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Axy0026.

will diminish the importance of any lessons drawn from the ruble zone.

- Membership of the Eurozone has greater benefits to its members in international transactions than the ruble zone offered its members. The ruble was not a convertible currency during the first few years of independence, while the euro is fully convertible. Membership of the Eurozone has led to significantly lower international borrowing costs for members, even for the GIPSI countries; no such benefit was evident in the ruble zone.
- The management of the ruble currency in 1991–1993 was not designed to maintain stability, but to accommodate inflationary pressures. Remaining in the ruble zone implied that the member would import the inflationary pressures generated by the accommodating Russian monetary policy. The management of the euro in recent years has been more focused on price stability – despite the large expansion of liquidity.
- The central members of the Eurozone have recovered from the financial crisis and thus represent a strong anchor for the zone. In the ruble zone, Russia as an anchor was itself in economic free-fall and found its ability to assist its fellow-members to be limited.
- The financial markets of the Eurozone remain in stable health. While there are large and growing holdings of sovereign GIPSI debt in European financial institutions, there is none of the financial repression or inconvertibility of the common currency evident in the former Soviet economies that led to the fragility of those financial markets.

Conclusions

Policy-makers in the Eurozone will do well to look back on the demise of the ruble zone as they ponder the way forward with their heavily indebted members in the GIPSI group. The ruble zone was a currency area of long standing and its members were comfortable with their common currency: the Soviet ruble. The break-up of the Soviet Union, however, made the maintenance of the ruble zone too costly for its members; one by one they were thrown out of the ruble 'orbit' until only Russia remained. Can such a scenario be envisaged in the Eurozone?

While the Grexit debate indicates that such an outcome is possible for at least some members of the Eurozone, there are three main reasons why the mechanism observed in the ruble zone will not be determinant in the Eurozone. In the ruble zone,

1. The benefits of remaining with the ruble were small. The ruble was non-convertible on international markets, and the currency under Russian management of the time was in the midst of a hyperinflationary period.
2. The 'anchor member' (Russia) was itself in deep recession and was unable to divert substantial resources to ruble zone members through overdraft privileges or technical credits. International resources for members (e.g. from the IMF or the World Bank) were also small in magnitude.
3. The financial repression and hyperinflation of the time led to little ongoing reliance by the population on ruble-denominated assets.

In the Eurozone, members recognise the high value of membership. They have fellow members in the EU with the ability to provide substantial funding during the period of adjustment from large fiscal deficits to fiscal balance, as well as strong support from international financial institutions. They continue to have a well-functioning banking and financial system that provides proper incentives for euro-denominated saving and investment.

There is one question on which the jury is still out: will the availability of low-cost resources from the EU, the IMF, the European Stability Mechanism and the ECB lead to the same degree of strategic exploitation of monetary authority observed in 1992 in the ruble zone? If so, the ECB is likely to respond in a similar way to the CBR in 1992 and 1993 – by tightening credit conditions, which prompted ruble zone members to exit the currency area.

References

Blinder, A. (2014), *After the Music Stopped – the Financial Crisis, the Response, and the Work Ahead,* New York: Penguin Books.

Conway, P (1995), *Currency Proliferation: The Monetary Legacy of the Soviet Union,* Princeton: Princeton University Press.

Conway, P. (1997), "Ruble Overhang and Ruble Shortage: Were They the Same Thing?", *Journal of Comparative Economics* 24, 1–24.

Conway, P. (2001), *Crisis, Stabilization and Growth: Economic Adjustment in Transition Economies,* Boston: Kluwer Academic Publishers.

Conway, P. (2013), "The Role of the IMF in the International Financial and Eurozone Crises", in: DeBardeleben, J. and C. Viju

(eds.), *Economic Crisis in Europe: What It Means for the EU and Russia,* New York: Palgrave MacMillan (Chapter 7).

Curtis, G. (ed. 1992), *Czechoslovakia: A Country Study*, Washington DC: Federal Research Division of the Library of Congress.

Europa (2012), *The European Stabilization Mechanism,* http://europa.eu/rapid/press-release_DOC-12-3_en.htm.

International Monetary Fund (IMF, 2012), https://blog-imfdirect.imf.org/2012/04/18/global-financial-stability-whats-still-to-be-done/.

Kenen, P. (1986), *Financing, Adjustment and the International Monetary Fund,* Washington DC: Brookings Institution.

Kenen, P. (1991), "Transitional Arrangements for Trade and Payments among CMEA Countries", *IMF Staff Papers* 38, 235–267.

Kindleberger, C. (2000), *Manias, Panics and Crashes,* 4th ed., New York: John Wiley and Sons.

Prust, J. (1993), "The Czech and Slovak Federal Republic: Government Finances in a Period of Transition", in: Tanzi, V. (ed.), *Transition to Market: Studies in Fiscal Reform,* Washington DC: International Monetary Fund.

Thomas, L. (2013), *The Financial Crisis and Federal Reserve Policy,* New York: Palgrave MacMillan.