

The Liberalization of International Trade and Payments in Eastern Europe

Few events can match the opening of the Berlin Wall as an historic symbol. Among the many things promised by that opening was the liberalization of trade that had been closely controlled for many years by the communist governments of Eastern Europe. This promise has virtually been realized in East Germany as that nation has unified with its neighbor to the West. Progress in other East European countries (including the Soviet Union) is uneven, however, because of concern over the costs of adjusting to freer trade.

This article examines the nature, motivation, and consequences of state-directed trading as it has been practiced in the centrally planned economies of Eastern Europe. Attention is then given to the issues involved in liberalization. Some general considerations suggest that state direction of foreign commerce may prove to be a tenacious legacy in at least some of the countries under consideration.

Foreign Trade under Central Planning: The Tail of the Dog

In the typical centrally planned economy, foreign trade is the tail—not the proverbial tail that wags the dog, but a more ordinary tail without much influence on the rest of the dog. The means of production are owned almost solely by the state, and central planners decide not only what will be produced by the state enterprises, but from whom the enterprises will obtain their inputs and to whom they will sell their output—and at what prices. The planners thus must balance supplies and demands for thousands of commodities. Goals are specified in terms of output quantities and are commonly unrealistically high, and prices bear little relation to those that would be set by free markets.

In this system imports are viewed more or less as necessary evils to allow fulfillment of the plan at acceptable costs. One reason for this attitude is that central planning was adopted in the first place in order to

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exercise detailed control over the domestic economy, and such control is generally considered vulnerable insofar as the economy is dependent on goods from abroad. Thus, planners are loath to rely upon foreign goods unless the resource cost of domestic substitutes is substantially greater. Similarly, exports, far from being a source of pride, are perceived as a resource drain that must be endured in order to pay for imports needed to fulfill the plan.

So that it can be subjected to detailed control, the foreign trade of the centrally planned economy is carried out chiefly by state-managed foreign trade organizations. Each reports to the Ministry of Foreign Trade and has exclusive responsibility for trade in a specified range of products. The volume, commodity composition, and geographic pattern of trade to be undertaken by each foreign trade organization is specified in plans approved by the central authorities.

Because the foreign trade organization must acquire the imports indicated for it in the plan, it is not free to bargain with foreign suppliers over the aggregate amount to be purchased, although it may encourage competition among them over the price. By contrast, in marketing its exports the foreign trade organization must meet a revenue rather than a

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quantity goal, and might restrict the total quantity sold below that contemplated by the plan if the result were to raise the price enough to compensate for the diminished quantity.

Unlike free marketeers, central planners need to prescribe what goods will be given up to the rest of the world and what will be obtained in return. In order to regulate closely the quantities of imports and exports, and in order to assure that exports yield a desired level of imports, planners often enter into barter-like agreements and attempt to balance their trade not only worldwide but also country by country. Such barter and bilateral balancing agreements

are, of course, more common in trade among centrally planned economies than in trade between centrally planned and market economies, which rely much more heavily on free markets to allocate resources.

To enforce their controls over exports and imports, central planners rely in part on controls over the use of currency for transactions relating to foreign trade. Foreign residents holding balances of a centrally planned economy currency are allowed to use them only for specified purposes. Because such foreign-held balances may not be expended for the purchase of many commodities, these balances are cursed with what is called "commodity inconvertibility." It is even more difficult for a foreigner to convert the currency of the typical centrally planned economy into freely usable currencies; thus, its currency also suffers from "currency inconvertibility."

Residents of the centrally planned economy, too, are strictly regulated in their purchases of foreign currency. Were they allowed freely to acquire foreign-currency balances, they would use those balances in part to purchase and import foreign goods, and might well spend less on domestically produced goods than projected in the central plan. Thus, foreign-currency balances accruing to foreign trade organizations in exchange for their exports must be channeled to the foreign-exchange control authority, which then allocates those balances for approved uses.

In countries that have embraced this system, the adverse consequences are plain to see. Because of the central planners' desire to minimize imports, domestic producers in these economies encounter very little import competition. This protection from foreign competition, combined with a dearth of domestic competition, allows the typical domestic producer to concentrate on satisfying the quantity goals set for it with goods that are decidedly inferior to those available in world markets. Nor is there much incentive to innovate, or to specialize in product lines for which perceived domestic demand and quantity goals are relatively low, however great the demand in the rest of the world.

Lacking the goad of competition, the typical centrally planned economy also lacks the price structure that would be set by competitive markets reflecting the underlying preferences of consumers and the true costs of production. This is not to say that such underlying preferences and costs are perfectly reflected by prices in the ordinary market economy, but the distortion is much greater in the typical

centrally planned economy. Nowhere is the distortion more obvious than in the long queues of customers seeking meat and other goods whose supply falls far short of the demand at the controlled price.

In sum, central planning seeks to manage the flow of goods and services, so planners strive to insulate their economies from foreign developments they cannot control. Thus, foreign trade and the use of currencies for foreign trade are closely regulated; prices diverge widely from those prevailing in world markets; and domestic producers experience neither the competitive pressures nor the profit incentives that exposure to foreign markets has to offer.

The Council for Mutual Economic Assistance

Imagine the centrally planned economy writ large, embracing a number of such countries, and you have something like the CMEA (Council for Mutual Economic Assistance, also known as COMECON). The CMEA was founded in 1949 by the Soviet Union, Bulgaria, Czechoslovakia, Hungary, Poland, and Romania; the German Democratic Republic joined in the following year. It is these countries on which this article focuses, although the CMEA was joined by Mongolia in 1962, Cuba in 1972, and Vietnam in 1978.

The CMEA functioned into early 1991, and oversaw trade among its members. The organization's aims, principles, functions, and powers were set forth in its charter, which is worth quoting both for its ambitious scope and for its socialist vernacular (Paxton 1989, p. 48):

Article 1. Aims and Principles: 1 'The purpose of the Council is to promote, by uniting and co-ordinating the efforts of the member countries, the further extension and improvement of co-operation and the development of socialist economic integration, the planned development of their national economies, the acceleration of economic and technical progress in these countries, higher level of industrialization of the less industrialized countries, a continuous increase in labour productivity, a gradual approximation and equalization of economic development levels and a steady improvement in the wellbeing of the peoples.'

Article 3. Functions and Powers: to (a) 'organize all-round . . . co-operation of member countries in the most rational use of natural resources and acceleration of the development of their productive forces'; (b) 'foster the improvement of the international socialist division of labour by co-ordinating national economic development

plans, and the specialization and co-operation of production in member countries'; (c) 'to assist in . . . carrying out joint measures for the development of industry and agriculture . . . transport . . . principal capital investments . . . [and] trade'.

The supreme authority of the CMEA was the annual Council of prime ministers. Council decisions had to be unanimous.

Almost from its inception, the CMEA failed to pursue its professed goal of region-wide economic integration. Instead, the member countries sought a high degree of self-sufficiency, with national economic policies formulated under the supervision of the Soviet Union rather than the Council, and with trade among the members regulated by bilateral agreements. By the second half of the 1950s, it had become clear that the costs of the autarkic policies being followed were very high. Thus, CMEA members tried to breathe new life into the Council and formulate a more genuinely regional economic policy, especially by agreeing upon product lines in which each member country would specialize and by agreeing to promote the regional mobility of factors of production as well as goods. These agreements were not carried out, however, and the economic plans of the member countries were not coordinated in keeping with any formal assessment of underlying comparative advantages.

In 1971 CMEA members strengthened their avowed commitment to economic integration, agree-

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ing to eliminate gradually the obstacles they had imposed against the free intra-regional flow of goods and services, and agreeing also to reduce barriers against the movement of productive factors. Two principal instruments were to be employed to foster integration. Foremost was to be the coordination of national economic plans while the plans were still in the draft stage. The second instrument was to be a larger role for market forces in determining prices,

interest rates, exchange rates, and the allocation of resources. Again, the rhetoric far exceeded the results, and in February 1986, Mr. Gorbachev assailed the CMEA's "armchair administration" and "endless committee deliberations." (U.N. Department of International and Economic Affairs 1989, p. 123.) Despite the criticism, by 1988 the best that the CMEA members could do was a communique reaffirming (with Romania demurring) an "earlier decision regarding the stepwise establishment of the conditions for the mutual free movement of goods, services and other production factors with the goal of creating eventually a unified market, after the preconditions thereof have been examined." (p. 128.)

What the CMEA actually embraced bore little resemblance to a free and unified market. Instead, trade among the members was closely controlled. Each country negotiated with every other member country an agreement specifying the composition and the volume of trade. Because prices within CMEA countries failed to reflect true underlying costs, the prices at which goods were exchanged were usually negotiated around a moving average of prices observed in other, freer markets. The prices so negotiated by differing pairs of countries were not identical, however.

On occasion the negotiated prices were clearly more favorable to some CMEA countries than current world prices would have been. The outstanding example is the relatively low price reportedly charged by the Soviet Union for its exports of petroleum and other raw materials to other CMEA members for

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many years. Soviet subsidies in this form seem to have been extended in much larger amounts to some East European countries than to others, perhaps as a reward for political allegiance to the Soviet Union. Had such rewards been paid openly as lump-sum transfers, they might have been resented by the populaces of both the Soviet Union and the East European nations (Marrese and Vanous 1988, pp. 185-220).

It would be a grave mistake to take these subsidies as the measure of net economic benefit or cost of the CMEA to the members receiving or paying them. As already noted, centrally planned economies generally suffer from their insulation from foreign competition, and the CMEA provided such insulation. Indeed, it was a vehicle for sustaining production techniques and output decidedly inferior to those in other industrial countries (Hillman and Schnytzer n.d.).

The differences in prices—and real wages—between CMEA countries provided an incentive to shift both goods and labor from low-price or low-wage countries to the higher-price or higher-wage countries. Such shifts, which would tend to establish roughly the same price for a good throughout the CMEA, are a sine qua non for economic integration, but they would have disrupted the detailed economic plans promulgated by the authorities and, therefore, met with official resistance. Thus, controls were imposed over the very movements of goods and labor that were crucial for progress toward the professed goal of economic integration.

The shortcomings and contradictions of the CMEA were epitomized in its approach to making payments between nations and settling imbalances in international accounts. Even though central planners generally strive to avoid exporting more than is required to pay for planned imports, and thus incline to bilateral balancing, circumstances might lead a CMEA country to realize a trade surplus, even with another CMEA member. For example, one CMEA country might fail to deliver all the exports promised another during a year. CMEA procedure was for the country with the export surplus to be credited with a "transferable ruble" balance in the International Bank for Economic Cooperation (IBEC) in Moscow, while the deficit CMEA member incurred an equivalent indebtedness to the IBEC, or a reduction in its transferable ruble holdings.

The transferable ruble is considered an inferior means of payment, however. Rather than rubles, goods are what the authorities in the surplus country wanted; and the transferable ruble balance cannot be exchanged for goods without first negotiating the exchange in the form of another bilateral trade agreement, which again may go unfulfilled. Further undermining the value of the transferable ruble balance is its failure to yield interest that can be converted into merchandise any more readily than the principal.

The general failure to use a convertible currency

in CMEA transactions reinforced the tendency toward bilateral barter and blocked progress in knitting together the economies of the member countries. A CMEA country that found itself accumulating a significant transferable ruble balance had good reason to intensify its controls over trade and payments, especially its exports, in order to forestall further trade surpluses within the CMEA, while CMEA debtor countries, which were receiving essentially

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interest-free loans, had little incentive to increase their exports so as to repay their debts. On these counts, the CMEA tended to shrink rather than expand trade within its area.

Moreover, because the prices at which goods were exchanged within the CMEA were not appropriate to equate supply and demand, chronic shortages developed for some goods and chronic surpluses for others. The goods in short supply could readily be sold in world markets for convertible currencies at no discount from their CMEA prices and were dubbed "hard" goods, but goods in excess supply could be sold for convertible currencies only at a discount, often sizable, and were dubbed "soft" goods. Of the goods produced within the CMEA, fuels, food, raw materials, and various semi-manufactures typically qualified as hard goods, while other semi-manufactures and finished manufactures commonly fell into the soft goods category. Not surprisingly, CMEA members generally preferred to obtain hard goods in exchange for any hard goods that they exported, so that a tendency developed to balance not only the total trade, but trade in hard goods, between pairs of CMEA countries. This "structural bilateralism," as it was called, nicely illustrates the proclivity for one government control to beget another. The net result of such practices was that "socialist economic integration" proceeded little further than the lips of CMEA officials.

Steps toward Liberalization

The dubious value of the transferable ruble led some CMEA countries that were accumulating them to seek more nearly convertible payments for their exports to other CMEA countries and to channel more of their exports to non-CMEA countries in exchange for convertible currencies. This, however, was only the tip of the iceberg. As the 1980s drew to a close, dissatisfaction with the CMEA had become widespread and profound among the membership, as had dissatisfaction with central planning more generally. Calls were heard for radical reform or abandonment of the organization, and in January 1991 its termination was announced. Its passing should not be mourned.

For years the subject of reform had been debated within the CMEA without significant results; 1990 witnessed a turning point. Failing to agree on the recommendations tabled by a special reform commission in January 1990, the members of the CMEA appointed still another reform commission, this time to prescribe "radical" reforms. This latter commission proposed that the CMEA be downgraded into something like a regional economic secretariat, carrying out research and disseminating data, and playing little or no role in trade and payments negotiations among the members.

Also, in June 1990 CMEA officials reportedly adopted the goals of valuing their trade flows at world market prices and of settling imbalances in convertible currencies rather than in transferable rubles, although no precise timetable was promulgated. The Soviet Union is reported to have entered into agreements to start conducting its bilateral trade on this basis with the former German Democratic Republic, with Czechoslovakia, and with Hungary as early as January 1, 1991, although it is likely that the transition will require some time, with many initial exceptions to the new valuation and settlement rules.

In addition, several CMEA countries have eased, in varying degrees, their centralized control over their international trade. Producing enterprises have been allowed more latitude in selecting the foreign trade organizations with which they deal, and in some cases have even been allowed to deal directly with foreign firms. The result has been a relaxation, sometimes significant, of the state monopolization of foreign trade.

Perhaps the most publicized of these decentralizations occurred last year in the Soviet Union, where enterprises were granted widespread autonomy to

trade directly with foreign partners without intermediation of the foreign trade organizations. The international payments system employed by the country was not revamped accordingly, however, and partly because of this failing the Soviet Union soon fell deeply into arrears on its foreign debt. This incident affords but one illustration, among many that could be cited, of a much debated and very thorny problem: how to sequence the various liberalizing reforms that are required to convert a centrally planned economy into a market economy. Although the issue is too complex to be treated comprehensively in this article, we can at least explore some approaches to reform, continuing to concentrate on the realm of international trade and payments.

What Next? Some General Considerations

Many issues of economic policy are too complex to allow unambiguously correct diagnoses and prescriptions to be drawn from the corpus of economic theory and experience. And on the question of the sequencing—including the speed—of liberalizing reforms, would-be analysts and policymakers soon discover that the accumulated knowledge to which they can appeal is extremely limited. As was stated in a recent publication of the International Monetary Fund (IMF 1990, May, p. 70), "There is no theory of the transition from a centrally planned to a market economy. Nor are there yet examples of centrally planned economies that have successfully made such a transition."

With so little guidance from both theory and experience, it seems appropriate to begin with the hypothesis that liberalization should be introduced quickly rather than being phased in gradually, sector by sector. If it is true, as widely believed, that centrally planned economies have suffered from the government controls that pervade their economies, the remedy would seem to be to relax those controls immediately, just as one would remove a straitjacket. The IMF makes the case as follows (p. 71):

For a number of reasons, a rapid implementation of market-oriented reforms may be preferable to a gradual approach. The more rapid the reforms, the less those who benefited from the old system and other interest groups will be able to obstruct or slow the implementation of the reform program. In addition, public consensus in support of reform . . . can best be maintained by ensuring that the tangible benefits of reform become visible as soon as possible. There is no convincing

argument that the transitional costs of structural reform would be reduced if the reform process were prolonged or delayed

The transitional costs . . . will . . . depend on the expectations of market participants . . . and on the credibility of the policy itself The credibility of an economic reform package, and hence the probability of it succeeding, is likely to be greater if it is comprehensive. Given the linkages in the economy, comprehensive reform increases the likelihood that each element of the program will reinforce other elements. Moreover, comprehensive reform helps ensure that the costs and benefits of economic transformation are broadly shared rather than concentrated on specific segments of society

In practice, of course, everything cannot be done at once, and even a rapid approach to reform will involve short-run choices concerning the pace of implementation of specific measures It would seem to be particularly important . . . that the establishment of macroeconomic stability and institutional changes such as modifications to the legal system, the creation of social safety nets, and the establishment of financial discipline on [government] enterprises be emphasized at an early stage.

This is one of the most cogent and succinct statements of the case for rapid liberalization. From this and other arguments, it seems clear that strong public support will be a crucial condition for success. Such support must extend to tolerance of occasional errors committed by well-intentioned policymakers who have the courage to embark on these uncharted waters, and tolerance of at least temporary reductions in income for many who will become exposed to more intense competition as government intervention is reduced.

To forestall harsh opposition from those disadvantaged by the reforms, the beneficiaries may have to contribute heavily to unemployment benefits, retraining programs, and the like. Even in wealthy market economies, it is uncommon for significant income-redistributing liberalizations to be introduced precipitously and without compensation for those distressed. Tariff reductions, for example, are generally phased in over several years so as to allow the adversely affected to make an orderly adjustment, and—at least in the United States—have been accompanied by generous adjustment assistance.

While most liberalizing countries may well decide against the immediate adoption of free trade, an early and substantial relaxation of controls over international trade and payments is probably critical to the rapid development of competitive markets. It is likely

to take some time for markets to flourish within these countries and to establish relative prices that channel resources with great efficiency. In particular, monopolistic government enterprises cannot be broken down into smaller units and converted to private ownership in the twinkling of an eye. In the meantime enhanced foreign competition can exert a salutary discipline on these enterprises.

The opening up of trade will introduce the competitive price structure—or set of relative prices—that predominates for goods traded throughout the rest of the world. The importance of this reform can hardly be exaggerated. A key impediment to economic progress within the CMEA was an inappropriate allocation of resources (including, of course, human effort), as central planners failed to perform this allocative function as well as competitive markets. It is world prices to which the liberalizing economies must adapt if they are to reap the benefits of integration with the international economy.

The Issue of Convertibility: A Payments Union?

As already noted, it has been the practice within centrally planned economies to restrict the use of the domestic currency, both for the purchase of domestic goods and for the purchase of foreign currencies. Until these countries allow their currencies to be exchanged freely for goods and for foreign currencies, their domestic prices will fail to reflect world prices, and the inefficiencies associated with this failing will persist. In addition to the inefficiencies already mentioned, foreign investment in the centrally planned economies has been greatly discouraged by the obstacles that prevent investors from earning and repatriating profits in convertible currencies.

In the typical country whose currency is inconvertible, many domestic prices are lower than would be the case with convertibility and efficiency. Indeed, one of the purposes of inconvertibility is to assist the government in suppressing prices below their free market levels. By restricting the use of the domestic currency to purchase foreign exchange, the authorities limit any bidding up of the price of foreign exchange, and of the domestic currency price of foreign goods, by those who would like to enter the market. This practice, of course, contributes to the widespread shortages, queues, and black markets.

Suddenly to allow convertibility and the associ-

ated free-market determination of prices would be to risk a sharp depreciation of the country's currency in the foreign-exchange market (or rapid exhaustion of the foreign-exchange reserves that the government could supply to the market in an effort to prevent the depreciation), a quantum leap in the general price level, and a marked rise in unemployment as the changing prices rendered many lines of activity less viable. These consequences are not idle fears but have in fact materialized in more than one country undertaking liberalization.

Seeking ways to minimize such transitional costs, many analysts have stressed the importance of pursuing anti-inflationary policies and of reforming the laws on private property, taxation, and commerce to provide a seedbed for private enterprise prior to any substantial liberalization. Others, doubting the adequacy of such measures, have proposed that the East European countries should ease the transition to freer international trade and payments by following the example of West European countries after World War II: they should form a payments union designed not only to conserve their scarce foreign-exchange reserves but also to transform their system of predominantly bilateral balancing into one of multilateral balancing, with the transformation occurring gradually over a period of years and culminating in full currency convertibility. The balance of this paper examines this proposal and finds it wanting, in spite of its cosmetic appeal.

Eastern and Western Europe: Historical Analogies

The reference to postwar Western Europe is intriguing, because the situation of the East European countries today is in many respects similar to that of their West European neighbors shortly after World War II. At controlled prices and exchange rates, shortages were widespread in Western Europe. To insure that their limited supplies of convertible foreign exchange would be used to acquire goods deemed essential, governments in the area generally exercised tight control over international trade and payments. Trade carried on by government monopolies could, of course, be regulated directly, just as in the centrally planned economies. Trade by private parties was controlled through the issuance of licenses authorizing the exportation or importation of specified quantities or values of merchandise.

International payments were regulated by ex-

change controls administered through the banking system. Businessmen were to sell to their domestic banks the foreign exchange they earned from foreigners, and they might buy foreign exchange from the banks for authorized purposes. If a commercial bank ran low on foreign exchange demanded by customers for approved transactions, the bank could acquire more at the country's central bank, while a commercial bank that accumulated excess foreign exchange could sell it to the central bank.

In order to avoid incurring deficits on their international transactions that would have drained their foreign-exchange reserves and stifled their trade, the countries of Western Europe entered into bilateral trade and payments agreements with one another, just as the CMEA countries did. Such an agreement specified the trade to be permitted between the two signatories and the exchange rate between their currencies.

Of course, in the event, trade between the parties to these agreements was less than perfectly

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balanced, and as a practical matter could not have been balanced on a daily basis. To allow for such imbalances, each central bank maintained an account with overdraft privileges at the other country's central bank. A central bank that was exhausting its stock of the other country's money could draw an overdraft on the other's central bank; the drawing bank would then credit an equivalent amount in its own currency to the foreign central bank. These overdrafts provided a "swing" that accommodated temporary imbalances, just as additional governmentally owned foreign exchange would have done.

A central bank on which overdrafts were drawn was, of course, extending credit, accepting in return deposit balances in the other country's currency. As these balances mounted, negotiations would commence on how the imbalance in trade might be

eliminated or reversed or on how much of the debtor country's indebtedness (that is, of its currency held by the creditor's central bank) would be paid off in gold or in some currency acceptable to the creditor. To avoid accumulating balances of inconvertible currencies, a West European country was inclined to discriminate in favor of imports from the countries with which it was running trade surpluses. Again, the parallel with the CMEA is clear.

The European Payments Union

In an effort to reduce this incentive for bilateral balancing, the West European nations embarked on an historic international financial arrangement known as the European Payments Union (EPU). Established in September 1950, the EPU functioned through December 1958. Because it fostered the revival of multilateralism in trade and payments among the countries of Western Europe, it became a model for proposed regional payments arrangements among countries with inconvertible currencies—including, most recently, an arrangement for Eastern Europe.

The rules and procedures of the EPU were complex and were modified as time went by, and only some of the salient features are summarized here. The cornerstone of the EPU was multilateral rather than bilateral settlement of payments imbalances among the members. As before, each member's central bank stood ready to lend its own currency to other member central banks in order to satisfy the demand for that currency at the agreed exchange rates. Each month the net amount of such lending or borrowing by every member vis-à-vis all the other members as a group was tallied by the Bank for International Settlements and recorded as a claim on or debt to the Union, expressed in an agreed unit of account. This procedure economized on the use of scarce foreign-exchange reserves and diminished the proclivity for bilateral balancing, since each country could offset a deficit with another country or countries with any surpluses it might have with still other countries. Confidence was inspired by the fact that each country's net claims or net debt were now with the Union rather than with other individual countries, meaning that credit risks were assumed by the group as a whole. Interest was paid to creditors and collected from debtors at rates rising with the duration of the debt.

Once a country's net debt to or claims on the

Union exceeded a limit calculated by an agreed formula, the country was to make or receive settlement in gold or dollars for at least part of the excess. As time passed the requirement for settlement in gold or dollars was stiffened, a modification that put greater pressure on chronic deficit countries to reduce their overall deficits and also reduced the incentive to discriminate against imports from non-Union countries settling payments in convertible currencies, primarily the United States.

It is noteworthy that the liberalizing intent of the West European countries was manifested in 1950 not only by the establishment of the EPU but also by the initiation of a program to reduce nonmonetary barriers to trade within Western Europe. In October of that year the West European countries agreed to eliminate quantitative restrictions in a nondiscriminatory fashion from at least three-fifths of their imports from one another. Import quotas were further relaxed in subsequent years.

Despite the good intentions, the transition to convertibility was neither rapid nor uninterrupted. Early on, both the trade liberalization program and the credit facilities of the EPU were tested by large payments imbalances. The West European countries met the challenge largely by increasing the amounts to be loaned and borrowed under the aegis of the EPU, and by adapting the pace of trade liberalization (reversing it for deficit countries and accelerating it for surplus countries), thereby buying time for other balance-of-payments adjustment measures to take effect. Also, the claims on and debts to the Union of some countries were converted into claims on and debts to other individual members. Without such flexibility the EPU would surely have foundered.

Progress toward convertibility was facilitated not only by this flexibility but also by U.S. aid and large overall deficits in the U.S. balance of payments. The counterpart of much of these deficits was an increase in the gold and dollar reserves of West European central banks. As these reserve stocks mounted, their holders became more disposed to making sales from them in exchange for their native currencies.

Thus, some eight years after the founding of the EPU—on December 27, 1958—the major step toward formal convertibility was at last taken. Belgium-Luxembourg, France, Italy, the Netherlands, the United Kingdom, and West Germany, soon followed by other West European nations, announced that their currencies would be convertible for foreign residents. A nonresident of any one of these countries who earned its currency in a current-account transaction

(such as exporting) could thereafter freely sell that currency in exchange for any other currency, including dollars, at the officially supported rates of exchange. Having performed its function, the EPU was then terminated.

A Model for Eastern Europe?

From this capsule review, it is clear that the EPU was successful, albeit slow, in dealing with some of the same maladies that have afflicted the East European countries, although the dislocations within the EPU economies originated chiefly in a devastating

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war rather than in the failures of central planning. Maladies common to both sets of countries have included a perceived shortage of convertible foreign-exchange reserves, bilateral balancing of international trade, foreign-exchange rates and internal prices distorted by controls, and inconvertible domestic currencies. If, as widely believed, the EPU materially assisted its members in overcoming these ailments, should the East European countries establish a similar union?

Despite the similarities between some of the problems faced by the countries of the EPU and Eastern Europe, closer scrutiny reveals differences that raise serious doubts about the usefulness of a payments union for Eastern Europe. To begin with, the EPU embraced a much wider trading area, and accounted for a much greater share of the members' total trade, than is true of the East European countries likely to favor a payments union. Proposals for an East European Payments Union (EEMU), have generally contemplated including Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Romania, and the Soviet Union. Now, of

course, the German Democratic Republic is no more; and the Soviet Union might well remain outside an EEPU, largely because, as a member, it would likely encounter requests for substantial ongoing credit from other members, especially as they begin to pay for Soviet oil in convertible currency at something like world prices.

Moreover, as the record clearly shows, past actions and relationships within the CMEA would be

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a poor foundation on which to begin the construction of a liberal trade and payments regime. In particular, a multilateral payments system could have been developed within the CMEA around modifications of the International Bank for Economic Cooperation (IBEC) and the transferable ruble, but the opportunity went unexploited. The IBEC could have played a role similar to that of the Bank for International Settlements in facilitating multilateral rather than bilateral settlements, and the transferable ruble could have been made truly transferable among CMEA members in exchange for goods. Now the erstwhile CMEA members are liberalizing at widely differing paces, and some have already introduced a high degree of currency convertibility. If history offers any guide, to combine them into a payments union would be to run a high risk of slowing the pace of overall liberalization to that of the most reluctant members.

Finally, during the years of the EPU, central banks generally strove to restrain exchange-rate movements within very narrow ranges, while today many exchange rates are allowed to move much more freely under the influence of market forces. Were the East European countries to tolerate relatively free movement of their currency exchange rates in open markets, they would both establish convertibility for their currencies and obviate the need for complex and dubious transitional mechanisms such as payment unions. Of course, for exchange rates to settle at levels that reflect domestic market equilibrium prices, prices within Eastern Europe must be substantially freed from controls—as some of the countries have recently done—and measures supporting the development of free markets must be promptly introduced. To ease this difficult transition, industries that are particularly vulnerable to newly encountered foreign competition might be granted temporary tariff protection, to be phased out according to a well-publicized schedule.

Conclusion

Current experience is demonstrating that the transition from a centrally planned to a relatively free market economy is far from costless. However, the cost represents an investment that should yield immense returns in the longer run. Crucial to a rapid transition is the adoption of relatively liberal foreign trade and payments arrangements, including a high degree of currency convertibility.

A clear and present danger is that the countries undertaking the transition will fail to follow through as the adjustment costs materialize. State enterprises and controls have provided a livelihood for many who will resist their demise. Nonetheless, market-oriented systems will probably be adopted eventually in view of their demonstrated superiority, and countries that falter in their reforms may therefore merely prolong their agony.

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