Lessons from the Collapse of the Ruble Zone and the Transferable Ruble System

Brigitte Granville*

Introduction

The history of the short-lived ruble zone (RZ) from late 1991 to early 1994 throws many of the fundamental problems of monetary unions between sovereign states into sharp relief. This paper attempts to draw out those lessons, which involves recalling the circumstances of the collapse of the USSR and the monetary and fiscal legacy of Soviet-style central planning – circumstances that, it may be supposed, are so specific and remote as to very considerably limit the episode's wider relevance. This paper aims to show that, on the contrary, and for all its specificity, the monetary experience of the first tumultuous years of post-Soviet Russia and the other Former Soviet Republics (FSRs) provides an interesting case history from the standpoint of present-day concerns.

The first peculiar feature of the RS is that it did not come into existence by design. As the Soviet Union melted down in the period between the failed coup in Moscow against Mikhail Gorbachev on 19–21 August 1991 and Gorbachev's resignation on 25 December, the fifteen new independent states that emerged from its ruins inherited the ruble as a common currency.

This passivity was camouflaged by a semblance of decision making. By October of that year, a draft *Treaty on Economic Union* prepared by a group headed by the Russian economic reformer Grigory Yavlinsky was adopted by the State Council of the USSR as the basis for discussions with the FSRs. This led to the *Treaty on Economic Community* signed on 18 October 1991 by eight republics (the exceptions were the Baltic states, Ukraine, Moldova, Georgia and Azerbaijan). The hope was that the policy coordination required to form a common market would help to overcome the economic crisis (Mashits 1993). The specific monetary component of this 'economic community' was only introduced in the aftermath of the 8 December meeting between the leaders of Russia, Ukraine and Belarus in Belovezhskaya Pushcha (Belarus) at which it was decided to dissolve the USSR. This led to the creation of the Commonwealth of Independent States (CIS) in Alma Aty on 21 December, and the CIS's founding document included a provision that the participating states (all the FSRs bar the Baltic states) would share the ruble as a common currency.

To some extent, the passive acceptance of monetary union by all the FSRs was no more than a pragmatic recognition of necessity and therefore without deeper significance. It would have been a practical impossibility to introduce national currencies virtually overnight in December 1991 (Odling-Smee and Pastor 2002). Even the Baltic states, which did not join the CIS and the RZ, had to continue using the ruble for a few months before launching their own currencies in mid-1992.

The contrast between the Baltic states and the other FSRs is instructive. Important as it is to record that the RZ was not very actively willed into existence, neither was the RZ willed *out* of existence by those other FSRs, which could have followed the example of the Baltic states, but chose not to. This applied to FSRs like Ukraine with strong national aspirations as much as to others for which the decision to embrace the RZ might seem more natural since political independence had not been a prior goal and fell into their laps as the USSR ceased to exist (Brzezinski 1997). It is also important to note that even those FSRs that unexpectedly found themselves endowed with sovereignty took little time to become protective of this political windfall. The asymmetric nature of the CIS given the relative dominance of Russia and the memory associated with the former Soviet rule made all the FSRs ambivalent about post-Soviet integration. In some areas, integration was rejected by all FSRs from the outset. The best example here is the military. In January 1992, the

* Queen Mary University of London. The article draws on previous publications (Granville 1993, 1994, 1995 and 2002; Granville and Lushin 1993).

Yeltsin administration – apparently concerned about unrest in the ranks of the former Red Army where the end of the USSR was widely deplored – made clear its preference for preserving military links between the republics. This was ignored, as the personnel and (non-nuclear) equipment of the Soviet armed forces physically present in each of the FSRs were unceremoniously nationalized. But all the (non-Baltic) FSRs preferred not to 'nationalize' their money as soon as practically possible in the way that the Baltic States did. The FSRs must therefore have had strong reasons for favouring the RZ, despite the (for them) distasteful political symbolism of the common currency as 'the last Soviet institution' (Åslund 2002).

Lesson one: monetary union to extract rent and avoid painful reform

A good starting point for understanding the attractions of the RZ for FSRs is to recall another of their instant nationalizations – and one that, unlike the military, is directly relevant to our theme: that is, central bank nationalization.

The State Bank of the USSR ('Gosbank') was the sole cash, credit and settlement centre of the Soviet economy up until 1988 (Garvy 1977).[1] Financial flows were assigned by Gosbank as directed by the credit plan to governments and enterprises, and by the cash plan to households (Goldberg, Ickes and Ryterman 1994). Each Soviet Republic had its own branch of Gosbank. When the FSRs declared their independence/sovereignty (1990/91), they each took over the Gosbank branch and made it their national central bank (IMF, IBRD, OECD and EBRD 1990).[2] These so-called central banks could issue credits (non-cash rubles), but the emission of cash rubles remained the monopoly of the Central Bank of Russia (CBR), which, Russia (then formally still the Russian Soviet Federative Socialist Republic (RSFSR)) had also taken over from the Soviet Gosbank in the six months following its June 1990 declaration of sovereignty *vis à vis* the USSR. The reason for the Russian monopoly on cash was simply that all the Gosznak banknote printing plants were located on the territory of the former RSFSR.

The RZ thus inherited the monetary system of the Soviet Union and the divide between cash and non-cash rubles contained the seeds of the challenge for the control of monetary policy (Goldberg, Ickes and Ryterman 1994). This dichotomy between cash and non-cash rubles led to a situation whereby there was a single currency – the cash ruble whose emission was controlled by the CBR on the one side, and as many non-cash rubles as FSR central banks over which the CBR had no control on the other (Dornbusch 1992b).

At this point, we must step back to take a fix on what was involved in this Soviet practice of non-cash ruble credits to enterprises. Under Soviet central planning, money was primarily an accounting tool for the planning authorities ensuring that "the purchases and sales of goods by each enterprise conformed with the plan" (McKinnon 1991, 63). In this 'passive' monetary system, Gosbank made loans – at a zero or very low interest rate – to enable enterprises to buy the inputs they needed to fulfil the approved plan. Gosbank was thus 'the government's fiscal agent' (Spulber 2003) – and its directed credits were accordingly termed (by the IMF and others) 'quasi-fiscal' operations. Under the 'soft budget constraint' (Kornai 1979) of the passive monetary system, "enterprises had no incentive to economize on inputs" and "were not subject to effective quality control through market discipline" (McKinnon 1991, 69).

Alongside this 'credit plan' for governments and enterprises, the Gosbank also managed the 'cash plan' for households (Goldberg, Ickes and Ryterman 1994). Two means of payments therefore coexisted: cash for household, agricultural and small private business sectors and non-cash to the state enterprise sector. The two sides were linked through wages and social security payments and through retail sales (Williamson 1993; Granville 1994).

As far as credits to government budgets and quasi-fiscal transfers to enterprises were concerned, the central banks of the newly independent FSR therefore had unlimited access to the printing press of the common central bank, and an incentive to run budget deficits that were as large as possible (Bofinger 1993). For as long as the CBR was unable to control the monetary

[1] A reform in 1988 established five 'specialized' banks mandated to deal with certain sectors (such as Promstroybank for lending to industry and construction, and Sberbank for taking household deposits); but the primacy of Gosbank was upheld. In March 1989, the transfer of the specialized banks to full cost-accounting and self-financing required Gosbank to provide them with targets for the amount of credit to be extended, household savings taken on deposit, and the share of foreign-currency receipts and payments in total banking operations. So Gosbank's control remained in practice untrammelled.

[2] According to the 1977 Soviet constitution, the 15 republics had the right to secede and to enter into relations with foreign states. By December 1990, all 15 republics had declared their independence or the sovereignty of their laws over those of the union.

policy of the FSRs, the latter were free riders motivated by the desire to acquire a share of seigniorage, as the inflationary impact of FSR budget deficits was shared with the other RZ members through the issue of ruble credits which, given the absence of non-monetary financial assets, were necessarily financed out of money created by the CBR (Goldberg, Ickes and Ryterman 1994; Conway 1995). From the outset of the RZ, Russia strove to assert some control over the FSRs' monetary policy. As far as cash was concerned, this was easier to achieve.

The price liberalization launched in January 1992 in Russia triggered a surge in inflation: producer prices by 382 percent that month as measured by the urban price change and consumer prices by 296 percent and 245 percent as measured by the so-called hybrid CPI (Koen and Phillips 1993; Granville and Shapiro 1994). This was very largely the result of the monetary overhang and high inflationary expectations. The CBR responded by restricting liquidity by controlling the cash money supply. Given the importance of cash in the absence of a well-developed monetary and banking system (Mashits 1993), this cash shortage made a strong impact on the FSRs. The problem had already become apparent in 1991, leading various FSRs – notably Ukraine – to respond by issuing coupons, ration cards, and other money surrogates as additional money to pay for wages, pensions and consumer goods.

Russia attempted to discipline transactions with the FSRs across the board by introducing on 1 January 1992 correspondent accounts held by FSRs central banks with the CBR (Granville 1994). Under this system, RZ members could only increase cash rubles by running a balance of payments surplus with Russia, or paying an interest set at 20 percent for any overdraft required to obtain additional rubles (IMF 1994). FSRs trade deficits with Russia were settled in the corresponding accounts, but only to the limit of the credit allocated by the CBR. However, given the lack of enforcement mechanism, other FSRs did not respect overdraft limits (Goldberg, Ickes and Ryterman 1994). On 12 June 1992, Ukraine proceeded to a massive increase in credit, approximately doubling its money supply to clear inter-enterprise arrears without consulting the Russian government. The Russian government, to limit further credit increase by other FSRs and inflationary effects, responded by 21 June decree effective from 1 July limiting FSRs correspondent accounts' growth: FSR's central banks could only withdraw credits from correspondent accounts held at the CBR on condition that they had the necessary deposit to cover the transaction. All National Banks were notified of this measure on 29 June 1992 (Granville 1994). A new line of credit called 'technical credits' was opened for trade. These credits were subject to negotiations. The rate of interest charged was the current CBR refinance rate. The CBR encouraged FSR commercial banks to clear payments by establishing correspondent accounts with each other and without recourse to the CBR (Granville 1994).

This step aimed to limit the impact of an increase in credit in a FSR to that same FSR, thereby containing access to additional cash and seigniorage and hence the wider inflationary consequences. It thereby brought about the first serious fracture in the RZ, as non-cash rubles FSRs became separate and non-convertible (IMF 1994). This led to non-uniform discounts on the FSRs non-cash (deposit) rubles depending on the extent of their ruble excess demand. This effectively made their deposits mutually inconvertible. With growth limits on each correspondent account of the FSRs, the price of the non-cash ruble started to vary from FSR to FSR. The price depended on differentials between FSR deposit demand, which itself depended on the possibility of converting this deposit into either purchasing power in Russia or cash. The determining factor, therefore, was the availability of credit and cash in the correspondent account of the FSR concerned.

But no sooner had the CBR imposed this level of control than it became extremely liberal in its credit policies as regards both domestic enterprises (with high monthly inflation rates resulting from monetary-financed fiscal and quasi-fiscal expenditure) and the FSRs. This reversal of policy was instigated by the end of August 1992 by Viktor Gerashchenko, former head of the Soviet Gosbank, who had succeeded Georgy Matyukhin as CBR chairman on 17 July.

Following the Ukrainian example, Gerashchenko set about providing credit to clear inter-enterprise arrears and to support production and employment (Ferguson and Granville 2000). The CBR was constitutionally subordinate to the parliament as Russia inherited the 1977 constitution, which remained in force until late 1993, meaning that most matters were under the authority of Congress of People's Deputies elected in February 1990 (Ferguson and Granville 2000) where the big employers' lobby – the 'Union of Russian Industrialists and Entrepreneurs' – was strong. The

Russian government's fear of unemployment allowed powerful industrial interests to pay wages for activities, which were either useless or non-existent (Granville 1995).

Mirroring this monetization of inter-enterprise arrears – which fell from 66 percent of GDP in June to 5 percent in September (Granville 1993a and 1995) – Gerashchenko openly favoured maintaining commercial ties with the other FSRs. The result was a jump in the stock of technical credits to FSRs (i.e. excluding cash deliveries) increasing from 325 billion rubles at the end of June 1992 to 1,545 billion rubles (8.5 percent of Russian GDP) at the end of 1992 – despite the Russian government having agreed with the IMF on limiting this increase during the second half of 1992 to 215 billion rubles. Additional financing for the FSRs in the form of arrears and commercial bank lending amounted to another 0.8 percent of Russian GDP (IMF 1994, Table 2). The main beneficiaries of these credits were Ukraine with 56 percent, Kazakhstan with 15 percent, Uzbekistan with 7.6 percent and Turkmenistan with 7 percent (Granville 1994). These credits were free of interest and penalty and therefore 'represented an attractive source of finance in a high inflation environment' for the FSRs (Conway 1995).

This part of the story may be summed up as follows: the RZ periphery (FSRs) tapped the core (Russia) for inflationary bailouts and thereby avoided painful reform. Russia's natural response of trying to establish a rules-based transfer union was compromised by its own unwillingness to grasp the nettle of reform.

Lesson two: economic rationales for monetary union are often spurious

The RZ was supported by the West. In the case of what was about to become the EU, this support had a political sub-text. The USSR collapsed within days of the signing of the Maastricht Treaty: so precisely at this the moment when Europe had agreed to launch a monetary union between sovereign states, the last thing European officials wanted was the awkward spectacle of the failure of a similarly constituted monetary union on Europe's doorstep. The IMF (hence also the US government) also began to support the RZ.

A popular economic argument was that since the FSRs would have no use for each other's new national currencies, payments in the absence of a RZ would be made in hard currency, thus draining already meagre reserves. This line of reasoning naturally led to consideration of a payments union (Gros 1991), while ignoring the risks entailed by such an approach, including postponing the introduction of convertibility and delaying the exposure of the FSRs economies to world market. This approach encouraged trade on a passive basis, relying on the same supports as under the old regime of central planning, and delayed the development of comparative advantage (Granville 1993 and 2002). The argument based on protecting trade links among the FSRs was flawed on several counts:

Trade links were not based on comparative advantage
All commercial relations within the Former Soviet Union (FSU) were fixed by the Soviet central planners, resulting in the share of inter-republican trade in total trade ranging from 31 percent (Kazakhstan) to about 70 percent for Belarus (Havrylyshyn and Williamson 1991). Intraregional trade before price liberalization was mispriced and mostly done on a barter basis, leading to hoarding, black markets and shortages (Dornbusch 1992a). Most of the Soviet trade was based on products for which there was no demand. FSRs state enterprises acted under a 'soft budget constraint' (Kornai 1979) free of competitive market constraint, they supplied goods to other republics, regardless of their needs, capacity to pay, banking on the CBR credits to settle the transaction. They "survive *despite* their performance rather than because of it" (Gaddy and Ickes 2002, 3). To argue like the Western powers did in 1991 and 1992 that the RZ had to protect Soviet-era trade relations to avoid short-term supply disruptions therefore amounted to telling the FSRs to maintain the Soviet Union and the artificial economic mechanisms on which it was based.

FSRs have no use for each other's national currencies
This reasoning was fallacious as the degree of intra-regional dependency in trade among FSRs and the introduction of national currencies was misleading. In intra-regional trade, the key was free trade at free prices, as "price reform is the only absolute prerequisite to maintain trade […] without price reform goods will not move, at least not in official hands" (Dornbusch 1992a, 7) and introducing convertibility. Once FSRs introduced their own national convertible currencies and let their currencies float (Sachs 1993a), their exchange rates could move to a level eliminating both internal and external imbalances. Nor did FSR national currencies threaten supply chains in Soviet-era industries anchored in Russia: as long as these currencies were

convertible for trade transactions, payments could be made in rubles (Granville 1992; Michalopoulos and Tarr 1992; Sachs and Lipton 1992).

While there was a gravity argument based on the distance between the FSRs (Dornbusch 1992a), once national currencies were introduced and prices liberalized, FSRs' inter-republican trade decreased (from 57 percent in 1992 to 33 percent in 1997) (Åslund 2002). Resource allocation improved when trade started to be valued at world prices and barter diminished (Michalopoulos and Tarr 1992).

Russia should provide cheap energy to other FSRs
As stressed by Michalopoulos and Tarr (1992), introducing international prices for trade was essential to improve resource allocation, but this meant that raw materials and energy exporters such as Russia and Turkmenistan would see huge terms of trade gains, while importers like Belarus, Moldova and the Baltics would suffer losses estimated at anything between 10 and 20 percent of GDP. The solution for Western powers was that, given that these FSRs could not afford raw material and energy imports from Russia at world prices, Russia should shoulder the burden.

Direct budgetary transfers were thus complemented by implicit trade subsidies to the other FSRs in the form of underpriced oil and raw materials (IMF 1994). Russia, Kazakhstan, Turkmenia, and Azerbaijan provided implicit trade subsidies to the other FSRs in the form of underpriced oil and gas (IMF 1994), while Russia, as well as Ukraine, Uzbekistan, Kyrgyzstan and Kazakhstan, provided transfers by accepting overpriced imports of non-oil and gas goods (Orlowski 1993). Orlowski (1993, 3) estimated that "in 1990 the oil and gas sector accounted for almost 61.5 percent of total transfers through underpriced exports". In the chaos of the early 1990s these republics were able to exploit the price differential with world prices and to re-export cheap energy and raw materials to the world market, making a substantial profit.

Åslund (2002) compares the estimates of Orlowski (1993) and Tarr (1994) showing how close these estimates were, but also reveals the burden of these implicit transfers on Russia (Table 1).

Western countries restricted trade access
While trade was essential to the FSRs in this period of transition, access to western markets was restricted,

Table 1

Interrepublican implicit transfers of GDP, 1990 (% of GDP)

	Tarr (1994)	Orlowski (1993)
Armenia	– 11.1	– 9.2
Azerbaidjan	– 6.7	– 10.1
Belarus	– 11.4	– 8.9
Estonia	– 13.5	– 12.1
Latvia	– 11.6	– 10.4
Lithuania	– 15.6	– 17.1
Georgia	– 12.1	– 16
Kazakhstan	3.4	– 0.5
Kyrgyzstan	– 1.3	– .7
Moldova	– 18.8	– 24.1
Russia	4.5	3.7
Tajikistan	– 6.9	– 6.1
Turkmenistan	15.9	10.8
Ukraine	– 6.9	– 3.6
Uzbekistan	– 1.9	– 1.3

Sources: Åslund (2002) compiled with data from Tarr (1994) and Orlowski (1993).

contributing to an almost 10 percent decline in FSU exports to OECD countries from 1991 to 1992 (Teplukin 1993). Partnership and Co-operation Agreements (PCA) between the EC and Russia and Ukraine were postponed. Russian demands for a free trade agreement (beyond the Most Favorable Nation – MFN - and Generalized System of Preferences conditions provided by the Agreement) ended up with the inclusion of an explicit statement in the PCA that a free trade area was its aim.

Restrictions on market access were imposed on textiles, steel, aluminum, coal, uranium and high-tech goods. In 1992, about twenty anti-dumping cases were filed by both the United States and the EC. The cost of these protectionist measures against Russia is estimated by the IMF to be equivalent to 1 billion US dollars, which is broadly equivalent to the amount of bilateral credits provided by the West in that year (IMF 1993; Granville 1995).

Lesson three: monetary unions may dissolve when economic realism prevails in the core

A warning signal that deserves attention is a division of opinion between the IMF staff and the Fund's major Western government shareholders. By the end of 1992, Russia was on the brink of hyperinflation owing to the actions of the CBR under Gerashchenko. The late Boris Fyodorov (1958-2008) was appointed Deputy Prime Minister and Minister of Finance. Fyodorov prioritised the fight against inflation and credits to FSRs were a major target. The incentive to

limit the cost of the RZ was strengthened by negotiations with the IMF on a new credit line facility especially designed for Russia (the Systemic Transformation Facility - STF). By this time, the IMF had recognised the need for each of the FSRs to introduce their own national currencies (Granville 2002).

Most of Russia's negotiated technical credits to the FSRs had reached their limits; it was therefore easy not to renew them. In April 1993, the government and Supreme Soviet of Russia in agreement with the IMF decided to abolish technical credits; and all previous credits to FSRs accumulated over 1992/93 were transformed into state debts (denominated in US dollars and with an interest expressed in Libor) and all new credits were channelled through the budget in accordance with government agreements. This gave Fyodorov direct control over the level of financial transfers to the FSRs. The total credit lines opened to FSRs in 1993 were limited to 895 billion rubles, but in fact never exceeded 595 billion rubles (Ministry of Finance report, 'Russian Finances in 1993' quoted in *Voprosy Ekonomiki* 1994, 1, 76). In addition, unlike the previous technical credits, these new credit lines were tied to purchases of specific Russian goods.

The only remaining loophole for the FSRs seeking rents from the RZ was cash. From the end of 1992 onwards, cash supply became less regulated than non-cash rubles – reaching 3.1 percent of Russian GDP by the start of 1993 compared to 2.1 percent of GDP during the first nine months of 1992 (Granville 1994). Cash shortages in the RZ during the first half of 1992 had been eliminated in the third quarter of 1992 by the printing of bank notes with larger denominations. The CBR provided cash rubles on demand, with the restriction that only bank notes issued between 1961 and early 1992 (with a denomination of less than 10,000 rubles) were delivered to FSRs. The FSRs' demand for cash increased sharply in the second half of 1992 and continued to rise in 1993 in the face of the tightening of credit policy to FSRs described above (IMF 1994). In the second quarter of 1993, cash issued to non-Russian members of the RZ increased by Rb674 billion compared with Rb97 billion during the first three months of that year. With non-cash rubles under control, cash rubles now became the main danger for Russian monetary policy. With the tightening of credits, most of the RZ members introduced coupons as a complement to cash ruble, freeing up some of the liquidity to be spend in Russia.

In the end, the CBR itself took the initiative to put a stop to this situation by unilaterally announcing the withdrawal of pre-1993 ruble notes from circulation on 24 July. This final blow to the RZ was thus inflicted by its staunch defender – Victor Geraschenko – although his motives were unclear (Åslund 1995). The FSRs of the ruble area still using these notes found themselves in a situation where their money ceased to be legal tender in Russia. The 1993 banknotes were therefore only distributed in Russia to withdraw the circulation of the pre-1993 notes meant to introduce a Russian national currency. The FSRs were forced to choose between: introducing their own currencies; or opening negotiations with Russia on a 'new style ruble zone' (NSRZ).

A NSRZ agreement was signed on 7 September 1993 by representatives of Russia, Kazakhstan, Uzbekistan, Tajikistan, Belarus and Armenia (Granville and Lushin 1993). The next step was the signing of standardised bilateral agreements on the harmonisation of economic policy and legislation between Russia and the above mentioned states. Kazakhstan signed such an agreement on 23 September 1993.

The Russian motivation for exploring the possibility of a soundly-based monetary union was partly political – to do with the fate of the large minorities in the FSRs, which were ethnic Russian or simply thought of themselves in national terms as Russian - and weigh considerably on the decision to create the NSRZ. The motive of the FSRs was to avoid any abrupt interruption of their source of easy credit, even if the price to be paid was some loss of control to Moscow.

From the start, it was clear that the fixed deadline of end-1994 to achieve the targeted convergence of legislation and regulatory mechanisms was unrealistic. During the transition the future members of the NSRZ were supposed to unify their economic legislation with Russia and demonstrate that their monetary and fiscal policies were in line with those of Russia. If this and only if this was successful, Russia would replace cash money with 'new' rubles and transfer the bank account balances from national currencies into rubles.

Fyodorov succeeded in rallying considerable support from all parts of the government and from the President's office, further isolating Gerashchenko in his desire to revive the RZ. It became clear to all parties that macro-stabilisation could not take place in

Table 2

Introduction of FSRs national currencies

	Coupons	New currencies
Armenia		dram: 22 November 1993
Azerbaijan	manat: 15 August 1992	manat: 1 January 1994
Belarus	rubel: 25 August 1992 'Zaichik'	Belarusian ruble, 1 January 1994
Estonia		kroon: 20 June 1992
Georgia	coupons: 5 April 1993	lari: 2 October 1995
Kazakhstan		tenge: 15 November 1993
Kyrgyzstan		som: 10 may 1993
Latvia	rublis: 7 May 1992	rublis: 20 July 1992
	lats: 28 June 1993	lats: October 1993
Lithuania	talonas: 1 May 1992	talonas: 1 October 1992
		litas: 15 June 1993
Moldova	coupons: June 1992	leu: 29 November 1993
Tajikistan		pre-1993 ruble: 8 January 1994
		somoni: 30 October 2000
Turkmenistan		manat: 1 November 1993
Ukraine	karbovanets: November 1991	karbovanets: November 1992;
		hryvnia: 2–16 September 1996
Uzbekistan	coupons: 16 November 1993	som: 1 January 1994

Sources: Press reports; Interfax; IMF (1994), Annex 3; national banks.

Russia in the face of a disorderly arrangement with the FSRs. The position of the Russian government hardened after the violence that followed Yeltsin's decision to dissolve the Supreme Soviet on 21 September 1993. During the visit of Russian negotiators to Alma Aty and Tashkent on 22–24 October, the Russian side declared that the mere unification of economic legislation was not enough; and that real economic convergence was necessary. It was stated that this should be achieved by the FSRs first introducing their own national currencies and demonstrating over a period that monetary convergence could be achieved.

The controversy between the members of the NSRZ culminated on 26-28 October 1993 when the Russians responded to pressure from the Uzbek and Kazakh governments to deliver cash in new ruble bank notes by issuing the following conditions (Lushin 1993): cash would be provided on credit for half a year with 210 percent annual interest payments (the CBR refinance rate); one half of the cash delivery should be backed by gold and hard currency as collateral; countries receiving Russian cash should commit themselves not to introduce their own currency for five years; if after 6 months the Russian conditions for monetary integration were not met, the whole credit should be paid back in hard currency or precious metals. If integration proved possible, state debt should be designated as non-interest state credit.

In the face of such tough conditions Kazakhstan and Uzbekistan decided to introduce their own currencies on 15 November 1993. By early 1994, all other RZ countries followed this lead, with Belarus bringing up the rear. The only exception (until 2000) was Tajikistan, which decided from the start to remain in the NSRZ, whatever the conditions (and thus effectively confirming its status as a Russian protectorate).

Lesson four: the mirror image of lesson three

What this story of the abortive NSRZ shows is that, when confronted with the reality that monetary union to avoid intolerable economic consequences must entail political union, countries on the periphery of the currency zone preferred to opt out of the monetary union rather than sacrifice their sovereignty. An authoritative body of economic literature supports this conclusion: "political unity is the glue that holds a monetary union together. Once it dissolves, it is most likely that the monetary union will dissolve" (Bordo and Jonung 1999, 25). Similarly, Bela Balassa's theory of economic integration (1961) also stresses that monetary unions do not work without political integration. The viability of monetary unions depends on the participating countries acting like the good citizen imagined by John Stuart Mill in *On Liberty* – that is, that they are willing:

> "to be guided, in case of conflicting claims, by another rule than his private partialities; to apply at every turn, principles and maxims which have for their reason of existence the common good" (Mill 1946[1861], 150).

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