Currency Union and Disunion in Europe and the Former Soviet Union

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More or fewer currencies in Europe?

Across Europe and the former USSR, there are more currencies in use today than a quarter of a century ago. For most Europeans the central focus has been on the long-running saga of creating a single currency for the European Union (EU), a process that can be traced from the 1970 Werner Report through the Snake and European Monetary System (EMS) to the current situation whereby twenty-one European countries use the euro, which is the official unit of account of the EU.[1] Yet, dissolution of the Yugoslav, Soviet and Czechoslovak currency unions more than offset adoption of the euro, at least by the simple measure of the total number of national and common currencies in use: 27 in 1991 and 29 in 2016 (Tables 1 and 2).

This paper first asks why the ruble zone broke up, despite efforts by twelve of the former Soviet republics to maintain the common currency after the dissolution of the USSR in December 1991, and whether the currency break-ups in former Yugoslavia and Czechoslovakia were similar in nature. The paper then examines the currency union process within the EU to ask what lessons can be drawn for the Eurozone from the dissolution of the ruble zone, and in what ways the Eurozone is a significantly different type of currency union.

Was the ruble zone an optimum currency area?

The unanticipated dissolution of the Soviet Union in December 1991 created a dilemma for policymakers in the new independent states. While creating national institutions, they wanted to temper the inevitable economic chaos following the collapse of central planning as supply chains and demand links were disrupted in the formerly integrated Soviet economy. The desire for an anchor of stability was most apparent with respect to the common currency. Apart from the three Baltic states, the Soviet successor states continued using the ruble through 1992 and generally seemed accepting of the situation.[2] By the end of 1993, however, the ruble zone had collapsed. Why was the collapse so sudden and complete, and why was the main technical tool used by economists to analyse the common currency a poor guide?

The dissolution of the USSR was unexpected and leaders of the new independent states attempted to maintain the common currency in order to reduce economic disruption. Continuation was encouraged by the IMF, which provided technical support with analysis based on optimum currency area (OCA) theory.[3] The OCA analysis assumes effective management of the common currency, but the ruble zone's institutional framework was unstable because of the free-rider problem.[4] Failure to recognise that institutional weakness meant that the collapse of the ruble zone took two years, during which serious monetary stabilization was not really possible for countries in the ruble zone. Even as late as September 1993,

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[1] 'EU' is used here to also cover the EU's predecessor organisations since the Treaty of Rome.

[2] The three Baltic states moved quickly to establish separate currencies (the Lithuanian *talonas* in April 1992, the Latvian *ruble* in May 1992, and the Estonian *kroon* in June 1992), although it was not always clear when these transitioned from being coupons or parallel currencies to a sole legal currency, e.g. the Latvian lats and the Lithuanian litas were declared 'permanent national currencies' in May and July 1993 respectively.

[3] The paper *Integration and Trade Policy in the Former Soviet Union* prepared by Max Corden for the UNDP/World Bank Trade Expansion Program in January 1992 was particularly influential. Corden, one of the leading international economists of his generation, had been Senior Adviser to the IMF in 1986-88 and in 1992 was appointed Professor of Economics at the Johns Hopkins University School of Advanced International Studies in Washington DC. The paper was widely cited in Washington, and circulated by both the UNDP and the World Bank (Corden 1992). For a retrospective debate on the IMF's role, see Odling-Smee and Pastor (2002) and Pomfret (2002).

[4] This had been recognised in other contexts (Casella and Feinstein 1989; Flandreau 1993). Optimal currency area theory dating from Mundell (1961) and McKinnon (1963) addressed the trade-off between the microeconomic benefits of reduced transactions costs with a universal currency and the macroeconomic benefits of an independent monetary policy and exchange rate flexibility. In practice, OCA theory has been dominated by macroeconomists arguing about conditions under which independent monetary policies are effective (Kenen 2002; Alesina and Barro 2002), with few economists emphasizing the micro benefits from common currencies (Krugman 1993; Rose 2000; Rose and van Wincoop 2001).

Table 1

European and Central Asian countries' currency, January 1991

Country	Currency	Country	Currency
Belgium*	Belgian Franc	Bosnia & H	Yugoslav Dinar
France*	French Franc	Croatia	Yugoslav Dinar
Germany*	Mark	Kosovo	Yugoslav Dinar
Italy*	Lire	Macedonia	Yugoslav Dinar
Luxembourg*	Belgian Franc	Montenegro	Yugoslav Dinar
Netherlands*	Guilder	Serbia	Yugoslav Dinar
Denmark*	Danish Krone	Slovenia	Yugoslav Dinar
Ireland*	Punt		
UK*	Pound		
Greece*	Drachma	Armenia	Soviet Ruble
Portugal*	Escudo	Azerbaijan	Soviet Ruble
Spain*	Peseta	Belarus	Soviet Ruble
		Estonia	Soviet Ruble
Austria	Schilling	Georgia	Soviet Ruble
Finland	Mark	Kazakhstan	Soviet Ruble
Sweden	Swedish Krone	Kyrgyz Rep	Soviet Ruble
Cyprus	Cyprus Pound	Latvia	Soviet Ruble
Malta	Maltese Pound	Lithuania	Soviet Ruble
Iceland	Icelandic Krone	Moldova	Soviet Ruble
Norway	Norwegian Krone	Russia	Soviet Ruble
Switzerland	Swiss Franc	Tajikistan	Soviet Ruble
Liechtenstein	Swiss Franc	Turkmenistan	Soviet Ruble
		Ukraine	Soviet Ruble
Albania	Lek	Uzbekistan	Soviet Ruble
Bulgaria	Lev		
Czechoslovakia	Krona		
Hungary	Forint		
Poland	Zloty		
Romania	Lei		
Notes: * EU member. Number of independent currencies = 27.			

Source: Author's own collection from different national information.

Armenia, Belarus, Kazakhstan, Russia, Tajikistan and Uzbekistan reaffirmed their commitment to a renewed ruble zone in a Moscow summit. However, once the collapse started in November 1993, the *dénouement* was rapid. Turkmenistan abandoned the ruble on November 1, Kazakhstan and Uzbekistan on November 15, Armenia on November 22, and Moldova on November 29.

In January 1992 all fifteen Soviet successor states used the ruble, and each of the new nations was a credit-creating center. Each government gained all the seigniorage from its own credit creation, but only bore a fraction of the inflationary costs, which were spread over the whole ruble zone. This created a free-rider problem, unless one country could impose its leadership or all countries agreed on monetary policy decision-making; and neither was possible in the ruble zone.

Russia had by far the largest economy in the ruble zone and controlled the issue of banknotes, but not the creation of credit. By delivering banknotes to other countries for just a one percent service charge and by underpricing some exports to ruble zone members, notably oil, Russia encouraged retention of the ruble zone in 1992, but fretted at the size of transfers to other members (estimated at 8 percent of Russian GDP in 1992 by Schoors (2003)). Meanwhile, some members objected to the political use of the levers; Azerbaijan, for example, believing Russia to be restricting delivery of banknotes, issued *manat* as a parallel currency. Other countries issued parallel currencies or coupons, most profligately Ukraine, where the ruble ceased to circulate by November 1992. Central banks increasingly differentiated ruble credits by the issuing country, discounting those from freer spending countries.[5] In July 1993, Russia issued new banknotes featuring the Russian flag, declaring the old Soviet banknotes no longer legal tender. The currency situation became increasingly complex and chaotic, nullifying the advantage of a common currency as a means of exchange.

[5] The Latvian central bank adopted this practice in July 1992 and it was gradually followed by other ruble zone countries.

Table 2

European and Central Asian countries' currency, and status with respect to the EU and Schengen, 2016

Country	EU	Schengen[a)]	Currency	Country	Status	Schengen[a)]	Currency
Belgium	1957	1995	euro	Iceland	EFTA/EEA	2001	ISK
France	1957	1995	euro	Liechtenstein	EFTA/EEA	2011	CHF
Germany	1957	1995	euro	Norway	EFTA/EEA	2001	NOK
Italy	1957	1997	euro	Switzerland	EFTA	2008	CHF
Luxembourg	1957	1995	euro	Albania	C2014	x	ALL
Netherlands	1957	1995	euro	Bosnia & H		x	BAM
Denmark	1973	2001	DKK	Kosovo[b)]		x	euro
Ireland	1973	x	euro	Macedonia	C2005	x	MKD
UK	1973	x	GBP	Montenegro[b)]	C2010	x	euro
Greece	1981	2000	euro	Serbia	C2012	x	SRD
Portugal	1986	1995	euro				
Spain	1986	1995	euro	Armenia	x	x	AMD
Austria	1995	1997	euro	Azerbaijan	x	x	AZN
Finland	1995	2001	euro	Belarus	x	x	BYR
Sweden	1995	2001	SEK	Georgia	x	x	GEL
Cyprus	2004	x	euro	Kazakhstan	x	x	KZT
Czech Rep	2004	2007	CZK	Kyrgyz Rep	x	x	KGS
Estonia	2004	2007	euro	Moldova	x	x	MDL
Hungary	2004	2007	HUF	Russia	x	x	RUB
Latvia	2004	2007	euro	Tajikistan	x	x	TJS
Lithuania	2004	2007	euro	Turkmenistan	x	x	TMT
Malta	2004	2007	Euro	Ukraine	x	x	UAH
Poland	2004	2007	PLN	Uzbekistan	x	x	UZS
Slovakia	2004	2007	euro				
Slovenia	2004	2007	euro				
Bulgaria	2007	x	BGN				
Romania	2007	x	RON				
Croatia	2013	x	HRK				

Notes: [a)] Schengen is from date of implementation; [b)] Kosovo and Montenegro use the euro but are not members of the Eurozone (i.e. cannot issue euros or participate in Eurozone decision-making); x = non-participant; C = date when EU candidacy was accepted (Kosovo and Bosnia and Herzegovina are considered to be 'in the queue' even though the EU has not yet accepted formal candidacies). EFTA = European Free Trade Association; EEA = European Economic Area.
Number of independent currencies = 29.

Source: Author's own collection from different national information.

Between May and November 1993, the non-Baltic former Soviet republics issued their own national currencies.[6] Kyrgyzstan, the most reformist successor state, quit the ruble zone in May because it wished to control inflation in order for the market economy to function more effectively, while Ukraine was keen to issue its own currency in order to have greater freedom to support uncompetitive enterprises or to fund price subsidies.[7] Once the extent of divergence in monetary policies became apparent, the collapse of the ruble zone was rapid. The striking feature of this history was the impossibility of having a common currency with multiple centres of credit creation pursuing vastly different monetary goals.

A second striking feature was the failure of the IMF to foresee the outcome in 1992. This was largely because internal discussion was within the framework of OCA theory, which identifies optimum currency domains in terms of a trade off between the micro benefits from lower transactions costs and the macro benefits of having the exchange rate as an effective macropolicy instrument. This framework for analyzing micro and macro benefits was irrelevant with an institutional framework where the free-rider feature provided a catalyst for hyperinflation (monthly price increases over 50 percent) in 1993. OCA theory was inapplicable to a dysfunctional currency arrangement.

[6] Pomfret (1996) provides details of the breakdown and further references. The Soviet ruble continued to circulate in war-torn Tajikistan, which did not issue a national currency until 1995. Given the new Russian banknotes, Tajikistan effectively had its own currency even if it did not control the money supply.

[7] Similar differences underlay the dissolution of the Czechoslovak common currency. In Yugoslavia, money creation to finance Serbia's fisal deficits became even more confrontational as the republics fought one another.

What are the lessons for the Eurozone?

The superficial lesson for the Eurozone concerns the need for a single central bank whose policy decisions are accepted by all zone members. This lesson has been learned, and the eleven national governments forming the Eurozone had much more similar ideas of desirable monetary policy than the disparate ruble zone governments.

On a deeper level, the collapse of the ruble zone fitted in with the common observation that almost all nation states have their own currencies. The exceptions are microstates, and the francophone African and Pacific states whose currency unions benefit from French support or the rand zone, whose smaller members benefit from South African support (Pomfret 2005). Russia was no longer willing to support the ruble zone after mid-1993, and the remaining ruble-zone members were large enough to consider national currencies as a feasible option.

An even stronger law of currency areas is that nations seldom have more than a single currency. A powerful argument for the one country – one currency pattern is that it is difficult to negotiate national budgets if sub-groups have a choice of currency in which to pay taxes or receive expenditures. This argument was illustrated within the EU by the speed with which disintegration of the Snake in 1976 was followed by establishment of the EMS after high-level negotiations in 1977/78. The common agricultural policy based on free internal trade at prices agreed upon after difficult negotiations was unstable when bilateral exchange rates fluctuated; and hence the fixed prices in national currencies varied (Pomfret 1991; Basevi and Grassi 1993). The EMS existed for two decades as a system of more or less stable bilateral exchange rates until it was replaced, for most of its members, by the euro as a common currency.

The history of western European monetary integration differed from the dissolution of monetary unions in eastern Europe (in former Yugoslavia and Czechoslovakia, as well as in the ruble zone) because the EU was headed towards closer integration. For the EU members committed to this vision, a common currency was a necessary counterpart to increasing policy and institutional collaboration and to the need for public-sector price comparability across members; the OCA micro benefits from reduced private-sector transactions costs were an added bonus, but not the *raison d'être* of the euro. Some EU members with strong commitment to lower trade costs remained outside the Eurozone, because they were less enthusiastic about the goal of ever closer union.

The logic of the EU integration project is that members should adopt the euro if they want to be part of the closer union. Otherwise, countries can use the euro for its transactional convenience, but should not have equal access to the integrated EU market (as Kosovo and Macedonia currently do, and as 'dollarized' economies such as Panama or Timor-Leste do with the US dollar on other continents), or they can be part of the integrated market with no input into determining the common policies (perhaps by paying an entry fee as Norway does to the EU).[8] Neither of these options can be considered as membership of the currency zone.

Conclusions

Although the leaders of the non-Baltic Soviet successor states were keen to maintain the ruble zone, or at least postpone its demise, the collapse of the ruble zone in 1993 was rapid and complete. The proximate cause was the existence of multiple centres of money creation. The deeper cause was lack of agreement among the leaders about desirable monetary policy; Russia had no means of imposing a common policy and was ultimately unwilling to buy compliance by other ruble zone members, while the other governments had widely differing views about the desirable monetary policy (or in some cases did not have a well-formulated view). In essentials, the collapse of the ruble zone resembled the collapse of Czechoslovak and Yugoslav common currencies, albeit more wrenching than the former and less violent than the latter.

The contrast between currency area disintegration in eastern Europe and currency area formation in western Europe over the last quarter century is striking. The simple lesson is that voluntary currency union requires agreement on the conduct of monetary policy, as in the case of the establishment of the European Central Bank. More fundamentally, the global pattern of one country – one currency had few exceptions in the late twentieth century. With the dissolution of Czechoslovakia, Yugoslavia and the Soviet Union as nation states, and their replacement by successor states with disparate economic and political goals, it

[8] On dollarization see Salvatore *et al.* (2003).

was inevitable, that the successor states would adopt national currencies (as had happened in the new states created after 1918). The Eurozone breaks that pattern because the EU is moving towards deeper integration and at some stage that process is at odds with independent currencies. In 2016 nineteen of the EU's twenty-eight members have accepted the logic of deeper integration requiring a single currency, while one EU member has decided it wants no further part in the process; the other eight face a difficult, but unavoidable, decision.

A final observation

Coverage of new currencies by the financial press in 1992/93 was overwhelmingly, and misleadingly, pessimistic. The *Financial Times* (15 May 1992) described the introduction of the Latvian ruble as 'a suicidal step'. A year later the *Wall Street Journal* ran a story on the difficulty of internal acceptability of Kyrgyzstan's new currency, while the *Far Eastern Review* ('Out of Steppe') and *The Economist* ('The Battle of the Som') also ran negative headlines. The New York and London-based media have been similarly pessimistic about the euro, even although it has now lasted for almost two decades and the number of Eurozone members has increased from eleven to nineteen, with no exits. For some reason, it seems difficult for commentators to accept that any change to the *status quo* might be an improvement, despite the fact that we live in a world of rapidly evolving international economic relations and have an international financial system that can scarcely be viewed as the finished item.

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