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Daniel Gros\*

# Regional Disintegration in the Soviet Union: Economic Costs and Benefits

*The disintegration of the Soviet Union as a political entity has already begun. As an economic entity it is still intact. The following article examines the advantages and disadvantages facing the republics if they choose to break away completely.*

What keeps a "Union of Sovereign (ex-Soviet?) Republics" together? The dissolution of the communist party and the wave of declarations of independence that followed the aborted coup attempt of August 1991 show that socialism cannot provide a glue to keep the Soviet empire intact. However, Western experts (and the central union government) have often argued against granting individual republics independence on the ground that this would involve large economic costs. The purpose of this paper is therefore to discuss whether this is indeed true, i.e. the paper tries to determine whether some republics would gain by leaving the Soviet Union. In analytical terms this is equivalent to asking whether economic considerations could provide a justification for keeping the Soviet Union at least an economic and monetary union.

The short answer is no: the more developed republics west of the Urals would probably gain from leaving the Soviet Union. These republics would want to liberalise their economies faster, they would have a stable currency and they can expect to trade more with the outside world than with the rest of the Soviet Union once their economies have been liberalised.

The Commission of the European Communities has recently published its findings on the Soviet economy arguing that it would be preferable to keep the Soviet Union an economic and monetary union (EMU). This paper comes to a different result because it considers explicitly an alternative which was neglected (perhaps for obvious political reasons) in the report of the Commission, namely that some republics might prefer to integrate their

economies more with the emerging European EMU than the rest of the Soviet Union.

This paper begins by discussing the issue that dominates the present political agenda, namely whether a centralised approach to reform is preferable to leaving this decision to individual republics in order to introduce competition in reform. It then analyses the importance of the "Soviet" common market, i.e. the costs and benefits for any individual republic of participating in a Soviet customs union, and discusses the incentives for individual republics to keep the rouble as their currency. Finally, a comparison is made of the integration process in the EC and the disintegration process in the Soviet Union.

## Centralised Reform?

The Union vs. republics controversy has undoubtedly delayed the implementation of fundamental reforms, but this does not necessarily imply that a centralised reform plan is the best option. Fundamentally the issue is the following: at present there is a vast economic area with completely distorted prices and without the necessary legal and institutional framework for a market economy. Can any sub-unit of this area gain by implementing reforms on its own and thus allowing its inhabitants to trade freely at "true" market prices? In general the answer should be yes.

It is often alleged that price reform has to be implemented at the union level because differences in prices would lead consumers to buy where the goods are cheapest. As long as the rouble remains the common currency of the Soviet Union, and there are no restrictions on inter-republican trade, price reform in one republic alone would indeed make it profitable to arbitrage price differences. However, this arbitrage is the essence of a market economy and should thus not be viewed as a cost.

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If any republic were to implement a radical reform programme<sup>1</sup> its price structure would be different from that of the rest of the Union. Residents of other republics would then certainly come to "plunder" its shops for those goods that are cheaper in that particular republic. However, this "plunder" is in reality an advantage since all these goods will be sold at their marginal cost of production and an increase in demand can only lead to an increase in the surplus of domestic producers.<sup>2</sup> Vice versa, consumers from the republic that initiated a reform in isolation would gain by buying goods in the rest of the Union at the old subsidised prices.

In reality, however, shops in the Soviet Union are now mostly empty. This implies that the impact of a radical reform on the supply of new goods and the distribution system should be more important than changing the price structure of the limited number of old goods that are actually available at their official price. Entrepreneurs in a republic that was the first to implement fundamental reforms would therefore gain by being able to satisfy a pent-up demand for diversified products coming from the entire union area.

The rest of the Union loses from an uncoordinated reform process to the extent that residents of the republic that initiates reforms on its own then buy more Union goods that are priced below cost. However, this is a consequence of the distorted Union price structure and should not be regarded as a cost of an uncoordinated price reform. On the contrary, this effect has the advantage that it is an incentive to implement reforms in the remainder of the Union as well.

The spill-over effects through goods arbitrage that arise from an uncoordinated reform process thus do not constitute a valid argument for a centralised reform process. Moreover, experience has shown that a credible reform strategy has to be adapted to the specific local circumstances. Some competition to find out the best way towards a market economy should therefore be beneficial.

A further argument for allowing the republics to implement their own reforms is that the creation of a market economy is impossible without support from an administration that executes and interprets the new laws in the new spirit.<sup>3</sup> It is much easier to set up and control such

an administration in a small Baltic state than for the entire Soviet Union whose total administrative body runs into the millions.

These arguments suggest that the implementation of the reforms should also be left to the republics. However, in the present highly uncertain legal and political framework, the bureaucracy of the Union and the remnants of the KGB can deter entrepreneurs from exploiting opportunities created by the laws of the republics. A new Union treaty to establish the rule of law and clear up some of the legal uncertainties seems therefore to be a precondition for an effective devolution of the reform process.

### A "Soviet" Customs Union?

Despite the customs administration instituted by some smaller republics, goods and services can still freely cross republican boundaries. The Soviet Union is thus still an *economic union*, which is usually defined as a unified market inside which goods, services, capital and people can move without any obstacles. It has been estimated that the elimination of the remaining, small, barriers to intra-EC trade by the 1992 programme will bring large economic benefits (up to 4–6% of the Community's GDP<sup>4</sup>). The kind of trade barriers contemplated by some republics would thus imply very large economic costs indeed. There is therefore, *a priori*, a strong case against the imposition of customs borders between republics, which would break up the Soviet economic union.

However, even recognizing that trade barriers between republics are not warranted, a number of republics might want to conduct their own commercial policies because any republic that participates in the Soviet economic sphere would have to adopt the same barriers (tariffs or quotas) for trade with the rest of the world as the rest of the Soviet Union.<sup>5</sup> Once the transition period is over (during the transition regional protectionism may in certain special cases be justified<sup>6</sup>) the fundamental question for each republic is whether it gains more from participating in world trade on its own than from participating in free trade within the Soviet Union but adopting the Union's trade barriers vis-à-vis the outside world.

<sup>1</sup> Cf. D. Gros, A. Steinherr: From Centrally-planned to Market Economies: Issues for the Transition in Central Europe and the Soviet Union, CEPS Paper 51, Centre for European Policy Studies and Brasseys, 1991, for the required steps to prepare the introduction of a market economy.

<sup>2</sup> This argument holds under the assumption that the price reform had been implemented together with the other structural reforms outlined here. See further below for an exception to this argument.

<sup>3</sup> Cf. D. Gros, A. Steinherr, *op. cit.*, for a further discussion.

<sup>4</sup> Cf. M. Emerson: The economics of 1992, in: European Economy, No. 35, October 1988.

<sup>5</sup> Another, more remote, possibility, which is not discussed here, is that of a mere free trade area without any common external trade policy. A free trade zone would represent the optimal solution from a theoretical point of view, but this is a policy any republic could pursue even in isolation by a policy of unilateral free trade with all trading partners.

<sup>6</sup> Cf. D. Gros, A. Steinherr: Economic Reform in the Soviet Union: Pas-de-Deux between Disintegration and Macroeconomic Destabilization, Princeton Studies in International Finance, Princeton University, to be published shortly.

The standard analysis of customs unions shows that the benefits from joining a customs union depend on a number of factors:

- ☐ the degree of protectionism practised by the union,
- ☐ the size of the union,
- ☐ the size and economic structure of the participating economies.

With all likelihood it will be some time before the Soviet Union adopts a liberal trade regime. This implies that the first factor is already an argument for smaller republics to opt out to conduct their own commercial policy. Inside a Soviet customs union they would import more high cost products from the other republics and would thus lose on account of the so-called trade diversion effect.

The size of the union is also an important factor because the larger the customs union the more likely it is that it contains the lowest cost producers of most goods and therefore the less likely it is that trade diversion takes place. However, despite its large size in geographical terms this aspect does not favour the Soviet Union because it represents a market that is less than one fifth of that of the European Community. Moreover, the Soviet Union will also for some time not be the lowest cost producer for the capital equipment that most republics need to modernise their manufacturing industries. Remaining in the Soviet customs union would thus imply potentially important economic costs due to trade diversion.

For these two reasons alone the Soviet Union in its present form is not an attractive area for a customs union. But other considerations suggest even more strongly that some republics would definitely gain from leaving the Soviet customs union.

### The Latin American Experience

A by now widely accepted synthesis of the traditional comparative advantage view and the modern view based on economies of scale and product differentiation suggests that there will be intensive intra-industry trade between highly developed countries and that there will also be inter-industry trade between countries with

different capital/labour ratios.<sup>7</sup> By the same token, there should be little trade between countries with a similar capital/labour ratio that are not developed enough to specialise in the industrial goods exchanged within the group of rich countries.<sup>8</sup> In this view the trade between developed countries consists of the exchange of differentiated industrial goods produced with economies of scale but similar capital intensities, whereas the trade between rich (high capital/labour ratio) countries and less developed countries (low capital/labour ratio) consists of the exchange of products with different capital/labour ratios.

This view of international trade can explain why regional integration in Latin America has consistently failed. Numerous attempts to create customs unions in Latin America have all failed, suggesting that regional integration among less developed economies is not very useful. The richer Latin American countries are a particularly useful base for comparison because they have a GDP per capita that is close to estimates for the Soviet Union of about US\$ 2,000. A simple comparison of trade flows is very instructive.

As shown in panel A of Table 1, Chile for example conducts only 20% of its trade with all of Latin America, but over 27% with the European Community and another 20% with the United States. The bilateral trade flows between Argentina and Brazil are also interesting because these two countries are in a similar relationship to the Ukraine and Russia, in terms of population and GDP:<sup>9</sup> only about 11% of Argentina's foreign trade is with Brazil, but more than 28% is with the European Community. A customs union between these two countries is therefore not likely to yield large economic benefits (unless the common external rate of protection is much lower than the present average of the two national tariffs and quota systems). On the contrary, such a customs union might actually be welfare-reducing because it might lead to more trade diversion than trade creation.

### Differences between Republics

The data in panel B of Table 1 on three European countries (Finland, Greece and Yugoslavia) confirm that trade with the Community is very important even for countries that are at its periphery. Indeed, Germany alone is almost as important as the Soviet Union even for a country like Finland which is not a member of the Community and which had to trade with the Soviet Union for political reasons.

<sup>7</sup> Cf. E. Helpman, P. Krugman: *Market Structure and Foreign Trade*, MIT Press, Boston, Massachusetts, 1985.

<sup>8</sup> Balassa and Bauwens contains extensive tests of this view. Möbius and Schumacher provide a sectoral analysis of the trade of Eastern European countries that also confirms this general view. Cf. B. Balassa, L. Bauwens: *Changing Trade Patterns in Manufactured Goods: An Econometric Investigation*, Amsterdam, 1988; U. Möbius, D. Schumacher: *Eastern Europe and the EC: Trade Relations and Trade Policy with regard to Industrial Products*, paper for the Joint Canada Germany Symposium, Toronto, November 1990.

<sup>9</sup> The population of the Ukraine is 55 million (versus 30 million for Argentina) and that of Russia is 140 million, the same as Brazil.

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The Finnish example is particularly revealing because the Baltic republics are in a similar position and of a similar size (Lithuania has about the same population as Finland). This example suggests that the Baltic republics would trade primarily with Western Europe if they were to become independent (and if the Community were to accord them the same trade preferences as Finland, which is a member of the European Free Trade Association). Hence, these republics have nothing to gain from participating in a Soviet customs union.

The Central Asian Republics seem to represent another clear case. They can be expected to trade intensively with the Soviet Union because of their different level of development and their geographical position. However the gravitational attraction of the countries along the southern border (Iran, India) should not be underrated.

The Ukraine, Belorussia and the Trans-caucasian republics are in an intermediate position. The Ukraine and Belorussia have an industrial structure that opens up the possibility of intensive trade with Western Europe, but geography and cultural factors favour strong integration with Russia. In view of the Argentina-Brazil example reported above, however, the first effect might be stronger. Geography suggests that the Trans-caucasian republics would trade intensively with the Soviet Union but also with the Middle East.<sup>10</sup>

**Table 1**  
**Trade and Economic Centres**

Percentage of trade (average of imports and exports) of country listed on the left with the countries in the top row

| Panel A    |         | Latin America |      |      |  |
|------------|---------|---------------|------|------|--|
|            | Brazil  | Latin America | USA  | EC   |  |
| Argentina  | 11.0    | 26.7          | 15.5 | 28.7 |  |
| Chile      | 7.6     | 20.5          | 20.7 | 27.5 |  |
| Panel B    |         | Europe        |      |      |  |
|            | Germany | USSR          | USA  | EC   |  |
| Finland    | 13.5    | 16.4          | 5.5  | 41.8 |  |
| Greece     | 21.6    | 2.3           | 5.3  | 60.2 |  |
| Yugoslavia | 12.9    | 19.9          | 5.7  | 33.3 |  |

Source: International Monetary Fund: Direction of Trade Statistics 1989 Yearbook. All data refer to 1985-88 average.

**Table 2**  
**Regional Distribution of Yugoslavian Trade**

| Trading Partner | in %    |      |         |      |
|-----------------|---------|------|---------|------|
|                 | Exports |      | Imports |      |
|                 | 1982    | 1988 | 1982    | 1988 |
| EC              | 21.0    | 38.7 | 34.6    | 40.5 |
| CMEA            | 44.8    | 26.3 | 29.8    | 21.0 |

Source: International Monetary Fund: Direction of Trade Statistics 1989 Yearbook.

It has been argued so far that the trade patterns of established market economies suggest that a number of republics on the western edge of the Soviet Union might in the future trade much more with Western Europe than with each other. This argument is, of course, valid only if the trade links created in the past can be changed rather quickly. Indeed Krugman<sup>11</sup> suggests that historical accidents may have a permanent impact on trade. It is therefore interesting to consider the case of Yugoslavia, where the reform process started earlier. The Yugoslavian experience can thus be taken as an indicator of the speed with which the regional distribution of trade can change. The regional distribution of Yugoslavian trade in 1982 and 1988 is shown in Table 2.

### CMEA Experiences

Between 1982 and 1988 the share of trade with the CMEA countries (including the Soviet Union) declined from 44.8% to 26.3% on the export side and from about 30% to 21.0% on the import side. At the same time the share of the Community increased from 21% to almost 40% on the export side and from about 35% to over 40% on the import side. This rather substantial change in relative trade patterns (the Community and the CMEA essentially switched places) as a result of only partial reforms suggests that radical reforms might have a very substantial impact on the trade patterns of some republics in the five years which the Union government considers to be necessary for a smooth transition to independence.

The experience of Poland shows, however, that the redirection of trade pattern can at times be much more dramatic. In only one year, 1987/88, the share of industrial countries in Polish exports increased by over ten percentage points (from 33% to 44%). This allowed the share of imports from this group of countries to increase by almost 15 percentage points (from 29% to 44%). The reform of 1990 only continued this movement and led to an increase in Polish exports to industrial countries of about 50%.<sup>12</sup>

<sup>10</sup> An interesting application of a gravitational indicator to trade among Soviet republics and CMEA countries is contained in: Commission of the European Communities: Stabilisation, liberalisation and devolution: assessment of the economic situation and the reform process in the Soviet Union, in: European Economy, No.45, December 1990, Annex VII.

<sup>11</sup> P. Krugman: Increasing Returns and Economic Geography, in: Journal of Political Economy, No. 3, Vol. 99, June 1991, pp. 483-499, University of Chicago Press.

<sup>12</sup> For an account of the Polish experience, cf. D. Lipton, J. Sachs: Creating a Market Economy in Eastern Europe: The Case of Poland, in: Brookings Papers on Economic Activity, Vol. I, 1990, pp. 75-135; and J. Sachs: Political and Economic Reconstruction in Eastern Europe and the Soviet Union: The Role of the European Communities, paper prepared for the Seventh Annual Conference of CEPS, November 1990.

Redirecting trade flows on this scale involves, of course, substantial adjustment costs which might be lower if the adjustment is slower than in the case of Poland. But the data presented here suggest that trade with the West can very rapidly displace the established, planned, trade flows.

### A "Soviet" Common Currency?

The introduction of a national currency would represent for some republics an important symbol of their independence. However, the analysis below shows that for some republics the introduction of a national currency can also be justified on purely economic grounds.

The literature on optimal currency areas argues that the main advantage of having a national money is that the exchange rate can be a useful adjustment instrument in the case of nationally differentiated shocks.<sup>13</sup> However, these advantages have to be weighted against the gains from the ultimate degree in economic integration provided by a common currency.<sup>14</sup> This standard economic analysis of the costs and benefits of a monetary union can also be applied to the case of the Soviet Union.

Introducing separate republican currencies would create a barrier for inter-republican trade because it would increase transactions costs. The importance of this disadvantage of splitting up the rouble area depends on the intensity of (inter-republican) trade and the efficiency of the payments and clearing system conducted in rouble.

Estimates of intra-republican trade based on domestic prices are given in Table 3. It amounts to more than 30% of the output of most smaller republics (including the three Baltic republics for which it amounts to about 50% of output). They should therefore be the ones with the strongest interest in retaining the rouble. At present, however, the rouble does not provide any of the advantages of a common currency since inter-republican trade is not conducted by enterprises working through the market, but rather through a complicated web of contracts that involve republican and regional ministries (or other official bodies) as well as individual enterprises which are owned by the state (the Union, republic or region). In trade among republics the rouble thus does not fulfil the main function of money (i.e. it is not the medium of exchange) and cannot therefore provide the benefits that otherwise arise from a common currency.

<sup>13</sup> This is the fundamental insight from R. Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, September 1961, pp. 657-665.

<sup>14</sup> For a recent evaluation of the economic costs and benefits of forming an economic and monetary union in the European Community, cf. M. Emerson et al.: One Market, One Money, Oxford University Press, Oxford 1991.

This situation is not likely to change in the near future. Only in the long run, when all parts of the Soviet Union have become a market economy and are integrated in the world economy, can one expect the rouble to function effectively as a common currency.

This judgement might seem to suggest that the smaller republics, which are already now very open to trade, should have at least a long-run interest in remaining in the rouble area. Yet, even a small republic that is not a viable currency area on its own has an alternative to remaining in the rouble area: it can join another currency area. Whether this is an attractive alternative depends on the geographical distribution of its trade. At present all republics trade more with each other than with the outside world. For example, only about 15 to 20% of the total trade of the Baltic republics is now with the outside world.

However, as argued above, this is likely to change radically. For example, once the Baltic republics are integrated into the world economy their trade patterns are likely to resemble that of Finland today which trades four times more with the EC than with the Soviet Union. In that case they would gain more from joining the emerging European economic and monetary union (EMU) than from remaining in the rouble area. However, this would not be the case for the Central Asian and Trans-caucasian republics, for which it is more likely that they will trade more with (the rest of) the Soviet Union than the EC (or other industrialized countries).

For the larger republics, i.e. mainly the Ukraine, intra-Soviet Union trade is, at present, less important relative to

Table 3

### Soviet Republics: Trade with the Union and the Rest of the World in 1988

(Trade as a % of GNP<sup>1</sup>)

|              | Total | Domestic | Foreign | Population (million) |
|--------------|-------|----------|---------|----------------------|
| USSR total   | 30    | 21       | 8       | 284.5                |
| RSFSR        | 22    | 13       | 9       | 146.5                |
| Ukraine      | 34    | 27       | 7       | 51.4                 |
| Belorussia   | 52    | 45       | 7       | 10.1                 |
| Uzbekistan   | 40    | 34       | 5       | 19.6                 |
| Kazakhstan   | 34    | 29       | 4       | 16.5                 |
| Georgia      | 44    | 38       | 5       | 5.3                  |
| Azerbaijan   | 41    | 35       | 5       | 6.9                  |
| Lithuania    | 55    | 47       | 7       | 3.7                  |
| Moldavia     | 52    | 46       | 6       | 4.2                  |
| Latvia       | 54    | 47       | 7       | 2.7                  |
| Kirghizia    | 46    | 40       | 5       | 4.2                  |
| Tadzhikistan | 44    | 38       | 6       | 5.0                  |
| Armenia      | 54    | 48       | 5       | 3.5                  |
| Turkmenistan | 42    | 38       | 4       | 3.5                  |
| Estonia      | 59    | 50       | 8       | 1.6                  |

<sup>1</sup> Assuming the same GNP/NMP ratio as for the USSR as a whole.

Source: Statistical Year Book of the Soviet Union, 1990.

output (a bit under 30%, comparable to the foreign trade ratio for France, which has approximately the same population) so that the economic argument against a separate currency is weaker. The larger republics are therefore probably viable currency areas of their own. Moreover, as was argued above, a republic like the Ukraine might trade more with western Europe than with Russia once the transition to a market system is completed. Hence, even for the Ukraine it is unlikely that it would gain from keeping the rouble.

In summary, the main argument against the introduction of republican monies does not apply in the Soviet Union as long as the transformation into a market economy remains substantially incomplete. A fast reform process would therefore increase interest in keeping the rouble on the part of those republics best prepared for a market economy. However, even in the long run only those republics that expect to trade more intensively with the rest of the Soviet Union than with the European Community would prefer the rouble to the ecu as the alternative to a national ("Republican") currency.

## The Case Against Monetary Union

Three additional considerations reinforce the case for breaking up the Soviet monetary union.

The main cost of a common currency is that exchange rate changes can facilitate the adjustment to nationally differentiated shocks. This argument is particularly relevant in the case of the Soviet Union, since the reform process will provide a source for large regionally differentiated shocks.

The domestic aspects of the reform process are already a source of regionally differentiated shocks because price reform will lead to large changes in relative prices and therefore an important redistribution of income given the high degree of specialization of many republics and regions. Moreover, important aspects of the overall reform process might be determined and implemented at the level of the republic (or even region). Smaller republics with a more developed administrative structure would therefore be able to reform their economies much faster than the larger ones. But this implies that their real exchange rates vis-à-vis the rest of the Soviet Union might have to adjust considerably.

Labour mobility is an important criterion according to the optimum currency area literature: a lack of wage flexibility could be made up by migration instead of being

offset by exchange-rate changes. However, labour mobility will probably remain limited due to the housing shortage for some time even though there are few legal obstacles to labour mobility within the Soviet Union.<sup>15</sup> Moreover, in some republics large-scale migration would not be acceptable on political grounds.

Finally and most important, a common currency also implies a common inflation rate in the long run. In the Soviet Union inflation is already now at the double-digit level and a period of hyper-inflation cannot be ruled out. Since all republics that retain the rouble would have to share in this inflation there is a strong incentive for those republics that may be able to avoid the causes of hyper-inflation (excessive fiscal deficits, wage indexation) to introduce their own currencies.

## Conclusions

This paper suggests that economic arguments cannot be expected to provide an underpinning for a "Union of Sovereign Republics" covering the entire area of the old Soviet Union. This seems to be in contrast to developments in Western Europe where the construction of the Community has always been underpinned by strong economic arguments. What accounts for this difference?

In short, the crucial difference between Europe and the (ex-?) Soviet Union is that in Europe the centre in geographical and economic terms (corresponding roughly to the original narrow band EMS countries) is also the strongest part of the Community, not only in terms of income, but also in terms of macroeconomic stability. The centre therefore not only attracts most trade flows but it also provides an anchor in terms of sound macroeconomic stability for the weaker, peripheral regions. In the Soviet Union there is no such centre. Russia is less developed than some of the peripheral republics and is also not necessarily more stable. This implies that for the western republics integration with the Community is more attractive, from an economic point of view, than integration with Russia. The Central Asian republics do not have an alternative large economic area into which they could integrate, they are therefore more interested in remaining in the Soviet EMU.

A final warning seems appropriate. The economic arguments that justify the introduction of autonomous economic policies for a number of republics do not justify an extreme nationalism in economic policy nor a precipitous break-up of the existing economic links. The living conditions of the citizens of all republics would only deteriorate further if the enforced unity of the past were to be followed by an indiscriminate trade war among republics. Fortunately, however, it seems that most republican leaders recognise this danger.

<sup>15</sup> Residence permits for Moscow, which are accorded only in special cases, constitute one example of legal restrictions to labour mobility within the Soviet Union.