

Mayes, David G.; Korhonen, Vesa

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## The CIS: does the regional hegemon facilitate monetary integration?

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David G Mayes and Vesa Korhonen

The CIS – does  
the regional hegemon  
facilitate monetary integration?



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## Contents

Abstract .....	3
Tiivistelmä.....	4
1    Introduction .....	5
2    The context for monetary union .....	6
3    Benefits.....	11
4    Costs .....	14
5    Choice.....	17
6    Concluding remarks .....	18
References .....	21

All opinions expressed are those of the authors and do not necessarily reflect the views of the Bank of Finland.

David G Mayes\* and Vesa Korhonen\*\*

## The CIS – does the regional hegemon facilitate monetary integration?

### Abstract

We consider the likely economic impact and prospects for monetary integration among Belarus, Kazakhstan, the Russian Federation and Ukraine as part of the Single Economic Space they have agreed to set up. A monetary union among these countries poses three interesting issues for the structure and process of integration: they have already been members of a wider currency union that collapsed, so it is necessary to handle the problems of history; secondly the union would be of very unequal size with the Russian Federation outweighing the others taken together, so we must consider how the national interests would be balanced; lastly natural resources, particularly oil and gas pose problems for dependence and for the determination of the external exchange rate.

JEL codes: F16, E63, E42

Key words: Monetary union, CIS, economic integration

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\* Corresponding author David G Mayes, Bank of Finland, PO Box 160, 00101 Helsinki, Finland, email david.mayes@bof.fi currently Visiting Professor Department of International Business, University of Auckland, Private Bag 92019, Auckland Mail Centre Auckland 1148, New Zealand d.mayes@auckland.ac.nz tel +358503443453. We are grateful Gunter Schnabl, George von Furstenburg and Iikka Korhonen for comments. The views expressed are those of the authors and may not coincide with any held by the Bank of Finland. \*\* Vesa Korhonen, Bank of Finland, Institute for Economies in Transition (BOFIT)

## David G Mayes and Vesa Korhonen

### The CIS – does the regional hegemon facilitate monetary integration?

#### Tiivistelmä

Tässä tutkimuksessa tarkastellaan rahataloudellisen integraation todennäköisiä vaikutuksia Valko-Venäjän, Kazakstanin, Venäjän ja Ukrainan muodostamalla talousalueella. Mahdollinen rahaliitto näiden maiden kesken nostaa esiin kolme kiinnostavaa näkökulmaa: Kaikki maat ovat jo olleet jäseninä rahaliitossa, joka hajosi, eli yhteinen historia saattaisi aiheuttaa ongelmia. Mahdollinen rahaliitto olisi myös varsin tasapainoton, koska Venäjän talous on yksinään suurempi kuin muiden talouksien yhteenlaskettu koko. Tämän takia eri maiden etujen yhteensovittaminen saattaisi olla varsin vaikeaa. On myös otettava huomioon, että raaka-aineiden – etenkin öljyn ja kaasun – hintakehitys vaikuttaisi paljon valuuttakurssin määrytymiseen mahdollisessa rahaliitossa.

Asiasanat: rahaliitto, Itsenäisten valtioiden yhteisö (IVY), taloudellinen integraatio

# 1 Introduction

After the Soviet Union collapsed in 1991, eleven of the former constituent republics immediately established the Commonwealth of Independent States – the CIS – with a 12<sup>th</sup> former republic joining slightly later, while Estonia, Latvia and Lithuania went their way and became members of the European Union, and are hoping to join the euro area shortly. Succinctly, the CIS has been handling the disintegration and integration between the members, covering in principle a vast range of areas and issues over time. As a step of market integration, eleven CIS countries concluded a regional free trade agreement in 1994, although the regional free trade area (for goods) set up became partly confused by the emergence of some 30 bilateral free trade agreements between the CIS countries in the course of the 1990s. In addition, three countries signed an agreement in 1995 with the aim of creating a customs union (now increased to six, Kyrgyzstan and Tajikistan being the other two members and labelled the Euro-Asian Economic Community).

In 2003, four CIS countries (Russia, Belarus, Ukraine and Kazakhstan) established the Single Economic Space in principle. This involves the forming of a single market, including an objective of creating a monetary union. As this is an agreement in principle, the details of what would constitute a 'single market' are not spelt out and it is not clear that all the signatories have the same interpretation of it (Sushko, 2004). Since then, Kazakhstan has at times expressed rather strong hesitation about staying in the enterprise, while the position of Ukraine has changed to virtual rejection of the idea especially since the election of President Yushchenko at the beginning of 2005. Belarus on the other hand has developed a clear agreement in principle for monetary union with the Russian Federation, whose date for completion is reviewed annually. The Union State Treaty of 1999 gave January 1, 2008 as the date (Gulde et al., 2004). Progress seems to have stalled at present because of the difficulty in finding a balance between the recognition of the sovereign rights they each have as independent countries and the economic dominance of the Russian Federation in practice. At present each of the four countries has its own currency and is practising a form of exchange rate targeting that is resulting in relatively stable nominal exchange rates. Although Ukraine has introduced more flexibility and expressed a longer term wish to move to inflation targeting IMF (2005b).

The situation has changed dramatically since the Russian crisis and default in 1998. Inflation is under control in all countries, although the position in Belarus is fragile, and



economic growth is strong. It is not clear how much of this is a recovery from an unusually depressed state and how much an improved growth path that will continue. Coupled with the trauma of the years following the collapse of the Soviet Union it is very difficult to find a basis in data that is very relevant for assessing the prospects for a sustainable monetary union. Not only that but the usual problem applies that it is necessary to take account of the Lucas critique and ask how, in the event of membership, would behaviour change to meet those new circumstances (Frankel and Rose, 1998; De Grauwe and Mongelli, 2005). This is perhaps the only area where the major disruptions of the last few years might provide useful data as they do at least show how the countries have responded to major regime change, economically, politically and socially.

## 2 The context for monetary union

There are two questions that need to be addressed in assessing the economic context for monetary union. The first is whether the loss of the nominal exchange rate as an adjustment mechanism is likely to impose significant costs on a country. These derive from a combination of whether the country is likely to be exposed to different shocks from the union as a whole, to which monetary policy responds and the way in which the country is likely to respond to shocks when inside the union. The second is the extent of the possible gains from integration. This is all forward-looking. While the OCA and related criteria, such as the convergence criteria laid down in the Maastricht Treaty for membership of the euro area, are helpful guides to spelling out the detail of what this may involve they tend to be backward-looking (Schelkle, 2001). In this assessment of the suitability of the four CIS countries for monetary union on the basis of their existing characteristics, it may be helpful to compare them to both the OCA and Maastricht criteria.

There is no accepted list of the OCA criteria following Mundell's (1961) exposition so we list the 10 criteria set out by Edwards (2006), as this is one of the broader considerations. This does not imply support for any particular list.

### Optimal Currency Area Criteria (Edwards, 2006)

- Factor mobility, particularly labour, across the union
- High level of trade across the union
- Different/diversified composition of output and trade across countries
- Price and wage flexibility across members of the union
- Similar inflation rates across countries
- Financial markets integrated across countries
- No ‘fiscal dominance’ in the individual countries
- Low and similar levels of public debt in the different countries
- Countries exposed to similar or synchronised external shocks
- Political co-ordination across countries

However, these criteria are only a guide. Their applicability also depends on what the outside option is. The scope for further gain may be small if much of the ingredients of a union are already in place (as for countries such as Estonia that are operating a long-standing currency board backed by the euro inside the EU). The likelihood of any such union taking place or being sustained is much more a political concern and we address that in a later section of the paper. Here we simply run through the economic characteristics of the four countries in this context.

The most obvious issue is disparity in size. The Russian Federation is not only twice as large as its prospective partners in terms of population (145 million compared to the 75 million – Belarus 10, Kazakhstan, 17, Ukraine, 48) but it has a much higher GDP per head (Figure 1), nearly double that of Belarus and getting on for three times that of Ukraine, if we take US dollar nominal values, and 40 to 50% higher even if we consider GDP per capita based on purchasing-power-parity. Kazakhstan is growing more rapidly (Figure 2) so the gap is closing. Despite the fact that the Russian Federation itself has been growing by over six percent a year recently, the other countries have been outperforming it, with the exception of Ukraine in 2005. Thus the relationship among the partners will be rather different from that in a modern currency union and would be somewhat more akin to early colonial currency unions, where the home country was dominant. Given the lack of wish to recreate history, clearly a new union would have to be rather more sensitive to the

position of the smaller countries as independent sovereign entities, which may not be likely.

Some other economic indicators show greater convergence. Inflation in Kazakhstan (Figure 3) has been relatively low despite economic growth of around 10 percent a year, assisted by its role as an oil producer. Performance in Ukraine has been worsening somewhat, while Belarus has seen a successful reduction from very high levels and is hoping to reach single figures. However, it is worth noting how this last adjustment has been achieved (Figure 4) as Belarus has been managing its real exchange rate over the period and thereby seeing a substantial but smooth nominal adjustment with respect to both its potential partners and with respect to the US dollar. Since the other countries have in effect been managing their exchange rates, mainly with respect to the US dollar, they have not moved markedly with respect to each other. Nevertheless, inflation in the region was still above 10 percent in 2005 and substantial macro-economic adjustment would be required to bring it to the levels prevailing in many of the other European transition economies.

Taken together therefore these factors give a relatively favourable outlook on nominal convergence if the countries continue to move in the same relative directions, provided that the adverse movement of Ukraine is temporary and the countries, Belarus in particular, do indeed get inflation down, although the fact that the share of administered prices in the countries varies considerably (from around zero in CPI in Kazakhstan to 13% in Russia and 27% Belarus according to EBRD (2005)) which could bring complications to the convergence path. However, while the consequences of a real appreciation under a fixed nominal exchange rate might be very unpleasant for Belarus, it might be a practical way of bringing the relative inflation to an end. Such fixing proved effective in a number of other former members of the Soviet Union. Furthermore the fact that three of the countries have something close to fixed exchange rates anyway suggests that the extra step of monetary union may not be very drastic economically. Governments have already decided that fixity offers greater benefits than adjustment, although it should be recognised that in Russia, Kazakhstan and Ukraine the authorities have contained the upward pressures arising from external surpluses on the nominal exchange rate, which has made disinflation elusive. Monetary union should be a much more credible peg than present arrangements.

The current account position (Figure 5) is also promising, as the Russian Federation and Kazakhstan are running substantial surpluses as a result of the strength of their raw material prices, and Ukraine and Belarus are close to balance. However, those latter bal-

ances would be ephemeral if the Russians were to charge full world prices for their oil and gas exports, and disputes with Ukraine over the last year suggest that this is an important bargaining counter that can be used in the inter-country bargaining. (Ukraine is now on the way to having to pay for its Russian gas imports at prices approaching the world level.) Not surprisingly given their size, the Russian Federation is much more important as a trade partner to the others than they are to it (Table 2). (Imports from the Russian Federation are 30% of the total in Ukraine, 45% in Kazakhstan and 60% in Belarus, whereas the reverse flows are only 5-8% of Russian imports, giving a total share of 20%, which is significant but not overwhelming.) Other bilateral shares did not exceed 5% in 2003.

If we consider bilateral trade balances the position is different, but this is no longer relevant in the same way once the union has been formed. The accumulation of regional claims within the union is of no different concern than within a country, although, of course, without any federal regional policy this will be accounted for by private sector claims and national structural and fiscal policies. It is instructive that the current balance does not feature in the convergence criteria for the euro area, it is the overall ability to maintain a largely unchanged exchange rate without undue strain that is the relevant criterion. Nevertheless one serious worry in the background must be that because of the 1998 problems *inter alia*, the ruble appears to be undervalued (IMF, 2005a). This implies, that as time passes the base for all of the countries with respect to third currencies will tend to rise – this would be in addition to the general rise in the price level that can be expected as income per head rises relative to that in the more advanced countries.

Nevertheless, such undervaluations (and overvaluations for that matter) can be very persistent and while the ruble is towards the edge of the distribution, other transition countries, such as the Czech Republic, are similarly below the average relationship (IMF, 2005a, Box 2). This would imply that the region could suffer from the Dutch disease, although the extensive reinvestment of oil income in a fund, like that in Norway, helps reduce the pressure. However, the IMF (2005b) also believes the hryvnia to be undervalued so the major question may relate to real exchange rate between the Russian federation and its partners. In the case of Kazakhstan, there appears to be little worry (IMF, 2006) as the tenge is in the view of the IMF even more undervalued and likely to continue to appreciate. Indeed the issue is whether there would be sufficient appreciation before any permanent fixing to the ruble.

Figures 6 and 7 cover what have been the most contentious convergence criteria in the EU, namely, government debt and deficit ratios. Here again the position is relatively promising. The Russian default reorganised the basis for sustainable fiscal policy and with strong revenues as a result of the surge in oil and other raw materials prices, the economy has been seeing surpluses and a run down in debt. Total government debt is now approaching 10% of GDP, a small proportion of the EU criterion and the surplus in 2005 was approaching 8%. Since some of the revenue base is subject to substantial fluctuation, not expanding spending to meet the recent increases is prudent. Kazakhstan is in the same position with respect to the deficit (surplus) the government has accumulated even slightly less debt and external debt is falling rapidly. Belarus is also in a favourable government debt position, with a debt ratio of less than 10% and trivial external debt. While it has been running deficits, these are clearly within the EU guideline, and with a strong growth rate should be sustainable. The Ukrainian government debt, at well over 20%, and deficit ratios are also within the normal bounds, although their position is the weakest of the four countries. The IMF (2005a,b) has expressed concern about the fragility of the position once current favourable economic conditions cease. Even so, the EU criterion is itself a decidedly arbitrary number based on the average position at the time and expected growth rates, and this may not be much of a concern.

The four countries have a substantial industrial sector (Table 1). While Belarus and Ukraine have similar shares of manufacturing to most of their western European neighbours, both the Russian Federation and Kazakhstan have much stronger natural resource sectors. This becomes obvious if we consider exports (Figure 8). The dominance of oil in Kazakhstan is obvious, substantially exceeding even the high share in Russia, even if metals, metal products and precious stones are added in. It is also clear that metals feature strongly in the export structure of the Ukrainian economy, although in the Ukrainian and also Belarusian case it is the importance of agriculture which distinguishes it from the other three countries. However, what seems surprising at first blush is the fairly strong showing of Belarus in oil products. The source of this is clear from Figure 9. Belarus is importing oil and gas from the Russian Federation and exporting the products after refining – a reflection of the structure of its industry in the Soviet Union days.

One aspect of the difference in the economies worth pointing out is the continuing dominance of the state in Belarus, with state banks dominating the financial system and state firms much of the productive sector. The role of market mechanisms in adjustment

has so far been and probably will still for some time to come be clearly small and hence ‘asymmetric’.

If we move beyond trade, it is clear, Table 3, that mutual FDI by the Russian Federation and the entire CIS is small compared to Russian FDI as a whole. However, Belarus, Kazakhstan and Ukraine are clearly the most important partners among the CIS in this regard (Table 4). Thus although the sums may be relatively small they do indicate the relative importance of the relationships.

### 3 Benefits

Chaplygin *et al.* (2006) provide a helpful analysis of how a monetary union among the Russian Federation, Belarus, Kazakhstan and Ukraine might work out. They focus in a sophisticated manner on the nature of asymmetric shocks and responses that might be expected, which tends to be the key feature of modern assessments of the potential gains/costs from integration. However, they have a strong focus on what they see as costs ‘a currency union ... is likely to be expensive in terms of increased instability and lost performance.’ (p.64). They are concerned that the Russian Federation is likely to be a source of supply shocks and that because of its dominant position the other three countries will have to adjust. They argue (p.63) that for the costs of forming a monetary union to be small, the within group cyclical correlations must approach unity and the shocks must have roughly equal variances. They are very clearly far from this and hence the authors conclude that ‘the costs for each country will be at least one standard deviation larger than the adjustment costs which that country would have faced with floating exchange rates. A currency union will not come cheap.’ (p.64).

However, there is little discussion of whether there are likely to be any compensating benefits or whether behaviour, including policy, would be different if the countries were to form a monetary union. As is clear from the foregoing discussion, the structure of the four countries and their trade in particular is fairly different (‘asymmetric’ in the jargon of the literature) being largely dominated by inter rather than intra-industry trade. Kazakhstan is a supplier of inputs to the Russian Federation and the Russian Federation a supplier to Belarus, which gives an indication of the sequence of effect of supply shocks, while de-

mand shocks are quite well correlated between the Russian Federation and Belarus, giving a clear reflection of their close integration in a wide range of products.

What we see therefore is a group of structurally different countries, with more limited mutual trade than one might expect given their location and previous relationship. There is some capital mobility but, on the whole, limited labour mobility (although there have been some fairly substantial outflows from Kazakhstan to Russia (Chaplygin *et al.*, 2006, Table 3). The authors take this to imply that the mechanisms for flexible wage and price adjustment are limited. They also note that there are no fiscal transfers, although one might wish to argue that the pricing of oil and gas exports from the Russian Federation represented an element of fiscal transfer and one that fluctuates in response to what would otherwise be energy shocks.

One way of looking at the issue therefore would be to suggest that there could be substantial payoff from a closer union, with production patterns being turned towards a more efficient structure and competition being increased to heighten this improvement. Chaplygin *et al.* argue that hegemony means that rather the opposite is likely to occur. It would be difficult for the smaller states to develop new industries that would be able to compete effectively with their Russian counterparts. Furthermore, some of the major benefits that emerge for small countries, from lower interest rates may not be present if the hegemon itself does not enjoy these rates. To some extent a larger country gets a lower risk premium simply because it is large enough and diversified enough to absorb many of the shocks that hit economies. This is clearly the case for the Russian Federation with its considerable geographical spread, natural resource base and sheer economic size. In any case the importance of the Russian Federation in Belarus's trade is already so large that the scope for net trade creation will be limited.

Since the difficulties culminating in the 1998 crisis and default the economic stability and fiscal strength of the country has improved considerably and it is no longer the case that it offers a worse prospect to other countries, as it did earlier. Indeed, other than Kazakhstan, the other countries show typical signs of the weakness that all transition economies face, with revenue earning being a consequence of economic success but the costs of transition being felt up front. Several of the new EU member states are still facing the same difficulties. As IMF (2005b) notes, Ukraine has been finding that exchange rate fixity with the US dollar has not been offering a satisfactory anchor for inflation. Although allowing

the rate to appreciate and move more closely with the euro has helped, finding an effective substitute anchor is still to come as full inflation targeting is still something for the future.

If monetary union itself has conditions for fiscal discipline then it could be that the agreement would act as a more credible restraint on fiscal excess than national forces. Unfortunately, the experience in the European Union gives only a limited signal in this regard. Behaviour in the convergence period was much more sustainable than that in the years that preceded it. Although there has been some clear weakening in resolve compared to the Stability and Growth Pact, nevertheless performance remains a great deal more prudent than that in the pre-convergence years. Restraint is far less than that imposed within federations when often the lower levels of government are heavily restricted in the borrowing they can undertake and may have balanced budget requirements that are clearly enforceable. However, it is not clear that the net impact on the countries other than the Russian Federation would be negative in this regard. Nevertheless it is inherent in the term 'hegemony' that the Russian Federation could have strong bargaining power over its partners. The importance of the pricing of energy inputs has already been felt. With a strong role for the state and concentrated industry, the ability to use economic power as a negotiating device would be considerable.

It is thus possible that in addition to the typically small gains from reduced transactions costs, lower barriers, economies of scale and increased efficiency through competitiveness, the smaller states might gain considerably from importing the financial market benefits of the Russian economy's diversification and strength, and further credibility from restraint on their ability to run up unsustainable debt. However, with the levels of efficiency estimated for Ukraine (IMF, 2005b) at two thirds of that in the Russian Federation and less than half that in neighbouring Hungary, the efficiency gains could also be large. There is bargaining power on both sides. Not only does Kazakhstan have considerable natural resources itself, which make it a desirable partner for others, but both Ukraine and Belarus have an alternative EU option as a partner, even though this is somewhat distant at present. The Russian Federation sets some store by having its immediate neighbours in its sphere of influence. The costs it might pay by having them in a single market and a monetary union may well be thought small in comparison.

All of these remarks are tentative and the opposite line of argument could be followed. Nevertheless there is clear scope for a change in behaviour that would result in the



four countries moving increasingly towards the conditions felt necessary for an optimum currency area. Gulde *et al.* (2004), looking just at the possible monetary union between the Russian Federation and Belarus, come to a similar conclusion that the pressures entailed might result in Belarus making many of the changes necessary to have a more stable and sustainable range of economic policies. One of the problems with the credibility of any such moves (Odling-Smee, 2003) is that it is how investors view it that matters, not simply what the authorities chose to do or how they present it. There are many opportunities in the transitional period when union is not certain but Belarus is moving away from its present regime for a loss in credibility to make finding a new anchor difficult (Schipke, 2002). Schnabl (2005) argues that if anything the four countries' exchange rate regimes are diverging at present. Their weaknesses suggest that they need a joint external anchor. While until recently this might have been the US dollar, the movement towards the euro by the Russian Federation makes this more complicated.

## 4 Costs

The major problem for the countries is the unequal importance of the partners. It is by no means clear that a union would involve all countries at the same time, especially considering the fluctuating opinions in Ukraine where the President is currently clearly opposed. If we take therefore the most realistic possibility of the union between the Russian Federation and Belarus the major problem is to come up with a structure where both the relative size of the countries is acknowledged but the fact that they are both sovereign countries is also taken into account. Thus from the point of view of monetary policy it is clear that it should be aimed at the area as a whole in terms of its relative economic importance. Thus Belarus would be no more important in the total calculation than an oblast in the Russian Federation of equivalent size. This does not mean that all regions should be given equal weight any more than it does in the EU (Mayes and Virén, 2006).

The responsiveness of 'regions' to changes in the setting of the instruments of monetary policy varies across the union. Furthermore it appears that responsiveness varies nonlinearly with economic circumstances. When (regional in the sense of members of a monetary union) economies are doing well inflation is much more responsive to changes in economic pressure (whether measured by the output gap or other indicators). When the

economy is doing badly, however, inflation is virtually invariant to fluctuations in the real economy. In some sense there is a floor to the relationship. Hence, if the parts of the whole economy are out of phase then their position in the economic cycle must be taken into account in setting policy, rather than the simple calculation of an arithmetic average. Nevertheless in a comparison of the behaviour of Belarusian and Russian Federation monetary policies Pelipas and Tochnitskaya (2006) find noticeable similarities.

Thus when it comes to the setting of policy within an agreed set of rules all parts of the union should be treated in the same way whether they are parts of a single country or independent countries. However the balance about who takes decisions and decisions over how policy is to be set need to be a much closer reflection of the number of sovereign countries involved. Thus when setting the rules the Russian Federation could well expect to be outvoted if there are several members or at least require an agreement if there are only two parties. Chaplygin (2006) provides a discussion of some of the issues affecting the decision.

In practice both sides of this arrangement are difficult for members. Belarus would like a more equal consideration in the setting of policy while the Russian Federation would prefer to be able to decide all issues. This is a difficult relationship where it is difficult to find precedents. If one country is a hegemon then it will tend to wish to exert hegemony (tautology ignored). For this not to be the case the larger partner needs to be clear that decision-making will be run on the basis of respect for the rules and for its economic importance.

The most obvious issue is stability, particularly financial stability. If the stability of the junior partner is at stake will special measures be taken? For the junior partner to agree the answer has to be yes. For the senior partner to agree there has to be adequate restraint on the junior partner from taking risky decisions. While this will obviously include fiscal policy, it is not clear how far it will extend into structural policy and other factors affecting the stability of the economy. Kittlemann et al. (2006) suggest that there were alarm signals of financial instability in Russia in 2003 and 2004 (the end of their data period) but not in Ukraine after 2001, although complete regime shifts from stability to crisis are possible within the course of single year according to their models. The Stability and Growth Pact plus the arrangements for coordination of policy in the EU are a good example. The ideas of open coordination and the cooperation of countries on employment and other topics

show that union needs to be far more than the monetary if the monetary union is to work. This is difficult enough to achieve with equal partners. With a bilateral union of unequal partners it is a major requirement for the hegemon to take such an altruistic approach – it needs to have a lot to gain to cede this much discretion.

It is difficult to think of any voting arrangements that would be viewed favourably by all parties under a strong hegemony. The ideas of implementing voting systems for monetary policy where double majorities apply, which is the easiest way to protect both the large and the small, does not work sensibly for this group. In a double majority system, for a measure to be passed it must not simply be the wish of the majority of the states involved but also of a majority of the population. In heavily unequal union, as envisaged here, this may simply convey a blocking majority for the largest country. Thus the majority of states argument only works as a block in the opposite direction, preventing the major country from having its way when none of the others agree with it. This could be a recipe for a serious stalemate. Even if major decisions, such as design of the currency can be postponed when the parties disagree, being unable to agree on what to do with regard to monetary policy is not a viable option. The pace of decision making in the Eurosystem, where consensus is the form of majoritarian rule selected, has not on the whole showed signs of causing undue delay, so problems can be overcome. See Mayes (2004) for an exposition of how an unequal monetary union could be implemented.

The problem comes with systematic asymmetries of need in the timing of policy, as set out in Chalpygin et al. (2006) for the four CIS countries in the study. If one country systematically lags another in its response to shocks, policy aimed largely at the leading country could diminish the opportunities of the follower. However, such an impact would tend to alter the cyclical behaviour of the following country in anticipation of this outcome, thereby making the cycles more correlated after the event. In Crowley et al. (2006) we show that there has been considerable increasing correlation of business cycles among the main EU countries and also increasing correlation at a much wider range of frequencies. However, clear differences remain at shorter frequencies similar to that over which monetary policy has its main effect

## 5 Choice

The rather more active discussion between Belarus and the Russian Federation illustrates the difficulties (Gulde *et al.*, 2004). The Central Bank of the Russian Federation (CBR) would like to see a centralised set up where it sets the conditions (including a minority of Belarusian members on the decision making body and the National Bank of the Republic of Belarus (NBRB) implemented the policy in Belarus. The NBRB on the other hand sees co-ordinated monetary policy by the two central banks with equal representation on the decision making body (but a Russian Chairman to resolve disagreement). Monetary actions would be in proportion to GDP and undertaken by the two central banks in their own territories on an equal footing. (The Belarus-Russian Federation union is planned to take place in two steps. In the first instance, the Russian rouble is introduced in Belarus and Belarusian rubel withdrawn. Then the new joint currency would be issued, replacing the ruble. There must be some concern that only the first step will be completed. Clearly there are problems in how the NBRB receives its share of the seignorage in a system where the gains are routed through the CBR.)

The extent of the difficulty is revealed in President Lukashenko's reported remarks (Pravda, 2003) 'The introduction of a single currency ... effectively means a political union with Russia as well. ... Moreover, if we accept a foreign currency, no matter how the agreement is worded, we will basically assume the role of a puppet state. As the President of this country I am afraid of taking this step and will do everything I can to avoid it. As a result we are now holding difficult talks with Russia.' In other words he did not believe that a relationship would have much in the way of equality to it in practice. The Russian Federation itself has varied the message, with President Putin 'surprising' Belarus in 2002 by suggesting a speeding up in the implementation of monetary union by a year under a scheme where either the seven Belarusian oblasts were incorporated into the Russian Federation or there was a form of subsidiarity for Belarus along the lines of that in the EU (Richardson, 2003).

Thus although there may be problems with the fiscal sustainability of the Russian Federation, Gulde *et al.*, argue that if Belarus were to move to a similar standard that would be a substantial improvement. Belarus has all the disadvantages of a small market and monetary union would at least give it proper access to international financial markets.

It seems from the controversy generated by the discussions over the Single Economic Space in Ukraine that feelings have been even stronger (Sushko, 2004). There clear political divisions in the country and even though the Supreme Rada clearly approved the principle in the time of President Kuchma in 2003, even he had described monetary union as a ‘mythical project’.<sup>1</sup> However, one might liken it to some of the ideas in the launch of the EEC with the Treaty of Rome on 1956. Many of the objectives would have been widely regarded as very intangible and not likely to be achieved within any planning horizon, even though 50 years on they are a reality. As Sushko suggests the other three countries primarily regard the arrangement as a means of getting good access to the large Russian market, whereas there are many in the Russian Federation who see it less as an economic arrangement but more as reinforcing a sphere of influence. Anatoly Chubais (2003) talked of a ‘liberal empire’ saying that the SES ‘will be a direct step towards the establishment of the empire’.<sup>2</sup> Apparently even moving as far as a customs union from the idea of a free trade area was a step too far for the Vice-Premier at the time Mykola Azarov (p.127).<sup>3</sup>

A clearer idea of where the balance of power is going to lie in the SES can be found in Article IV of the Treaty, relating to the single regulatory body, whose decisions will be binding on all of the parties. ‘The decisions of the regulatory body will be taken by weighted vote. The number of votes of each party is to determined taking into account its economic potential’<sup>4</sup> As George von Furstenburg forcefully pointed out to us in his comments on the original draft, it is inherent in the concept of hegemony that the hegemon exploits its position to its own rather than the joint benefit. The hegemony exists up to the point that the other countries can get away.

## 6 Concluding remarks

It is very easy to agree with the conclusion in Gulde *et al.* (2004, p.29) ‘The long-run net economic effect[s] of a proposed currency union between Belarus and Russia is not clear.’ Odling-Smee (2003, p.1) puts it ‘... on economic grounds alone – it is not really possible to say whether Belarus will benefit from monetary union.’ Indeed that remark could be applied to a lot of monetary unions, since the outcome depends on how the members choose

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<sup>1</sup> Sushko (2004) cites this as available at <http://rus.for-ua.com/news/2003/03/26/152310.html>.

<sup>2</sup> *The Russia Journal Daily: Politics*, September 26, 2003.

<sup>3</sup> See also <http://rus.for-ua.com/news/2003/124125.html>.

to react both in terms of public policy and in the private sector. It represents a regime change. The ingredients for success and failure, loss and gain are all present. All one can readily do is list them and perhaps assign some tentative probabilities. However, the authors go further and suggest that either Belarus effectively has to ‘rubleise’ and adjust itself to the monetary policy of the Russian Federation or that the Russian Federation has to view the process of integration as something more comprehensive and be prepared to assist in the development of Belarus, including the use of fiscal transfers to offset some of the costs of change in a more federal approach. ‘Anything in the middle is bound to fail.’

We can extend this analysis to a monetary union including Kazakhstan and Ukraine as well. Because the Russian Federation is so much larger than the other economies combined, it will effectively choose how the system is to be run. In any case with the energy links between the Russian Federation and Belarus and Ukraine there is already an important element of economic hegemony. Even Kazakhstan with its own resources is somewhat limited in the policies it can apply because of its location with a long border with the Russian Federation. It is easy to recall the caution of Finland in the period of the Soviet Union, even though in geographic terms Finland is completely open to the west. However, such caution did not apply to monetary policy, which had been independent right from the time that Sweden ceded Finland to Russia in 1806. While the ruble was legal tender in Finland, people tried to avoid using it because it was a weaker currency. This judgement can no longer be made with respect to the group of countries we are considering here. The Russian Federation could be a source of strength, cutting the cost of finance through reducing the risk premium and providing greater economic stability through a more diversified economy.

Gulde *et al.* (2004) argue that joining the monetary union and the knowledge that it is going to happen could act as shock therapy to ensure that the necessary changes are made in the constituent member states to enable them to compete. This argument was advanced in the case of Finnish membership of the euro area (see Pekkarinen *et al.* (1997) for the government sponsored report) and appears to have been the case in subsequent behaviour (Mayes and Suvanto, 2002). However, this view is not universally shared *ex ante*. Sweden, which in many respects was likely to be a better case for euro zone membership in terms of the OCA criteria laid out in Section 2, came to the opposite conclusion in its

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<sup>4</sup> Taken from Sushko’s (2004) translation of [www.obozrevatel.com/?r=subject&t=107&id=96877&p=5](http://www.obozrevatel.com/?r=subject&t=107&id=96877&p=5).

report on the likely costs and benefits (Calmfors *et al.*, 1996). They argued that there was a danger that Sweden would not only get locked in to its then high rate of unemployment but that the process of integration might make it worse. Hence adjustment should occur first and membership second. It is also worth noting that such perfectly sensible economic reasons for timing get readily wrapped up in the political decision making (Mayes and Suvanto, 2006). Monetary union for Sweden is now well over the political horizon after membership was rejected in a referendum in 2004, despite the fact that the economic concerns had by then been answered. Much of what is required for monetary union is political will and no doubt this will be the main characterisation of the decision over any monetary union among the four CIS countries considered here.

For the Russian Federation there is a decision to be made about the relative economic costs and benefits of having the three partners go in a different direction compared to the level of support that may prove necessary to hold the union together in the face of economic and political shocks. The straight economic gain from a larger market reduced transaction costs and possibly competition would probably be small by comparison. The choice for the other three is more difficult. They have to make judgements about the long-run economic and foreign policy of the Russian Federation. How favourable will policy, directed to the benefit of the Russian Federation and at worst (best?) neutral with respect to the partner countries, be compared to one that treats them as independent countries, especially if they choose alliances with other groupings?

Currently policy is mainly one of a close relationship with the ruble, limiting fluctuations rather than a hard fix. It is reminiscent of the position of the EU countries in their earlier steps towards monetary union. The subsequent developments might also follow the same pattern, with some ebb and flow, but ultimately with some choosing union and some not. While economics may be the line of argument advanced to support the decision it is unlikely that very firm conclusions could be drawn.

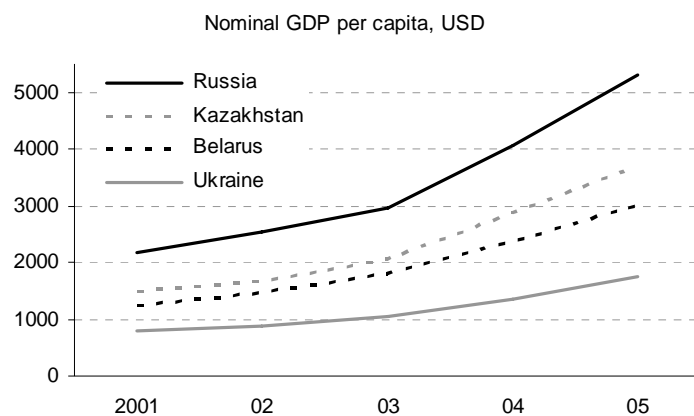
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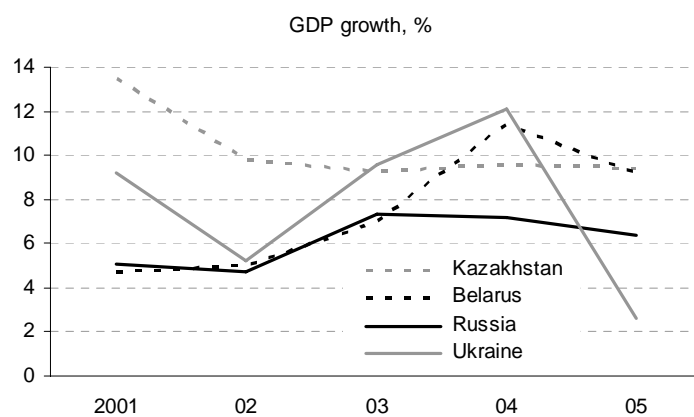
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Figure 1 Real convergence



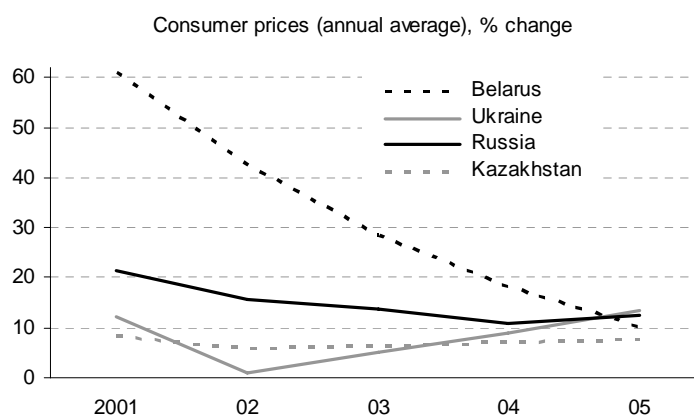
Sources: National statistical offices, IMF

Figure 2 Rapid Growth



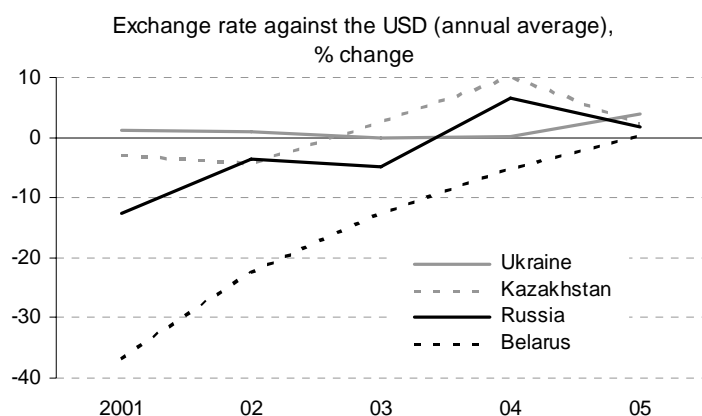
Sources: National statistical offices, IMF

Figure 3 Inflation



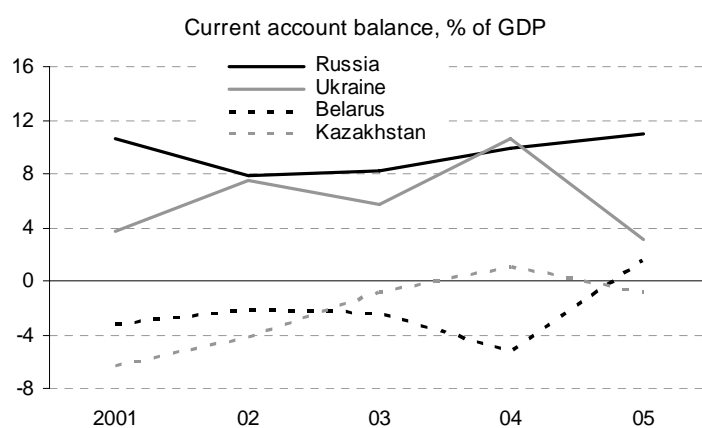
Source: IMF

Figure 4 Exchange rate movements



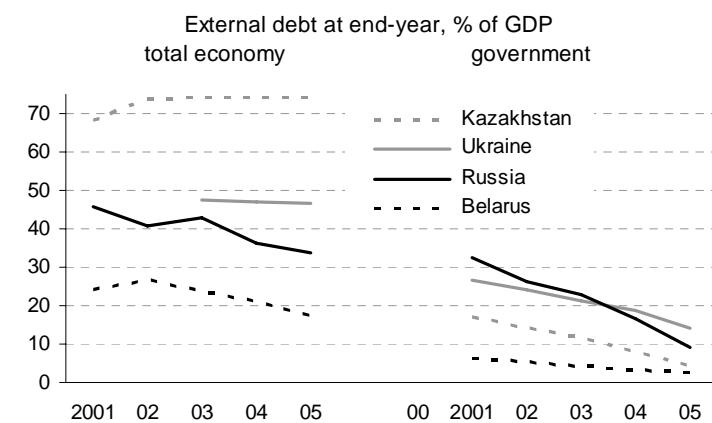
Source: IMF

Figure 5 The current account



Sources: National central banks, IMF

Figure 6 Debt



Sources: National central banks, IMF

Figure 7 The government deficit (surplus) ratio

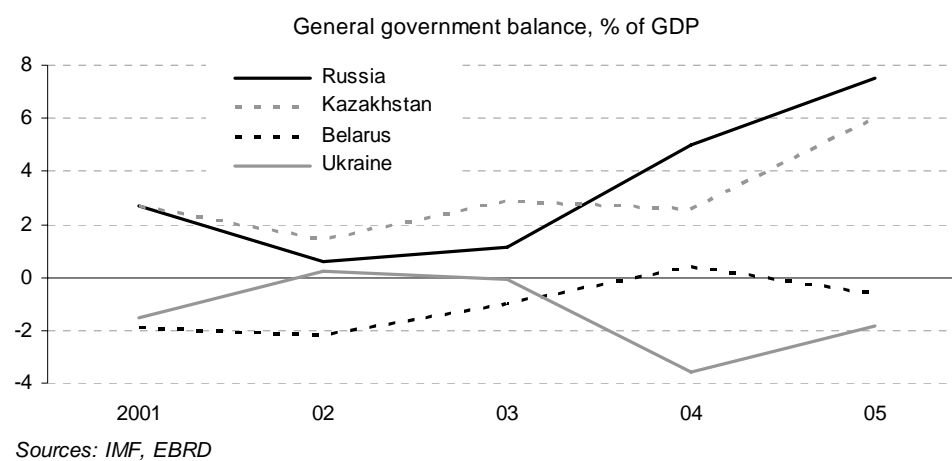
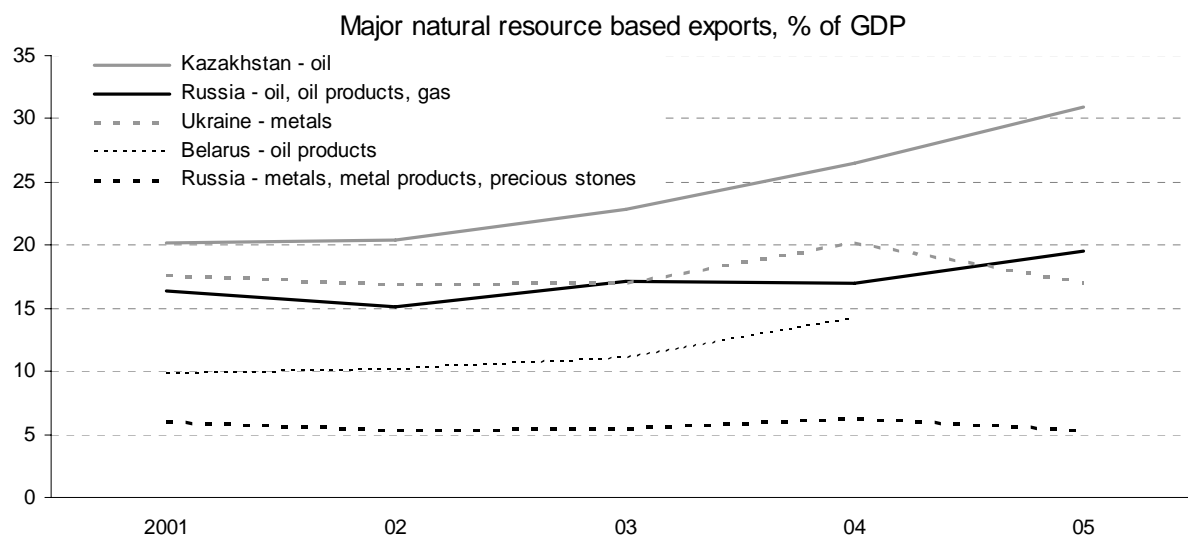


Table 1 Economic structure

<b>GDP structure in 2004, % share</b>	<b>Russia</b>	<b>Belarus</b>	<b>Ukraine</b>	<b>Kazakhstan</b>
Agriculture	5.4	9.5	10.8	7.0
Industry	27.2	26.8	28.3	29.4
- mining and quarrying	8.5		3.6	13.6
- manufacturing	15.6		18.6	13.3

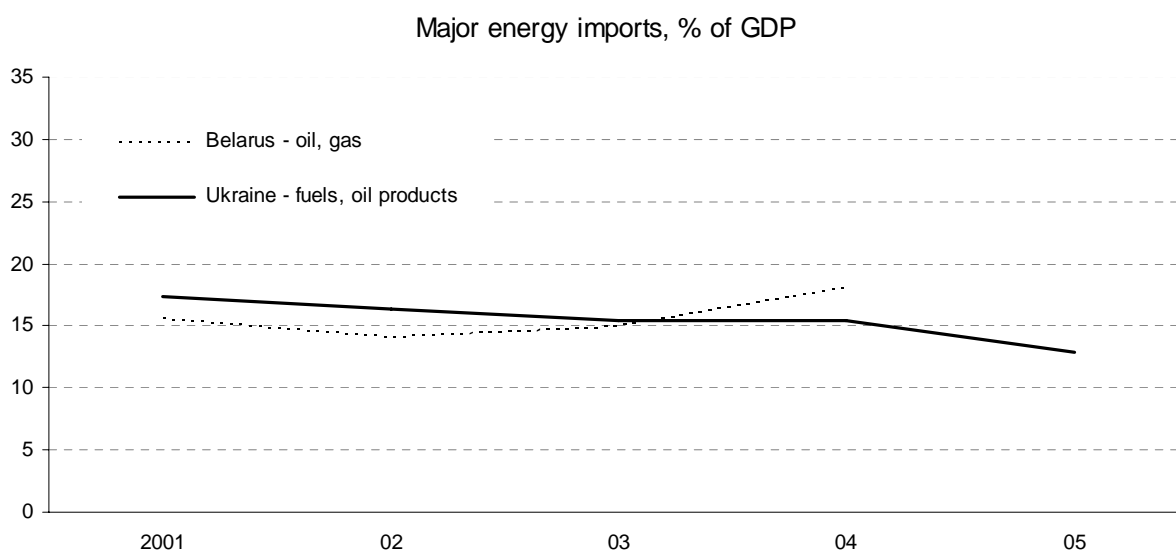
Sources: National statistical offices, IMF

Figure 8 The natural resource base



Sources: National statistical and customs offices, IMF

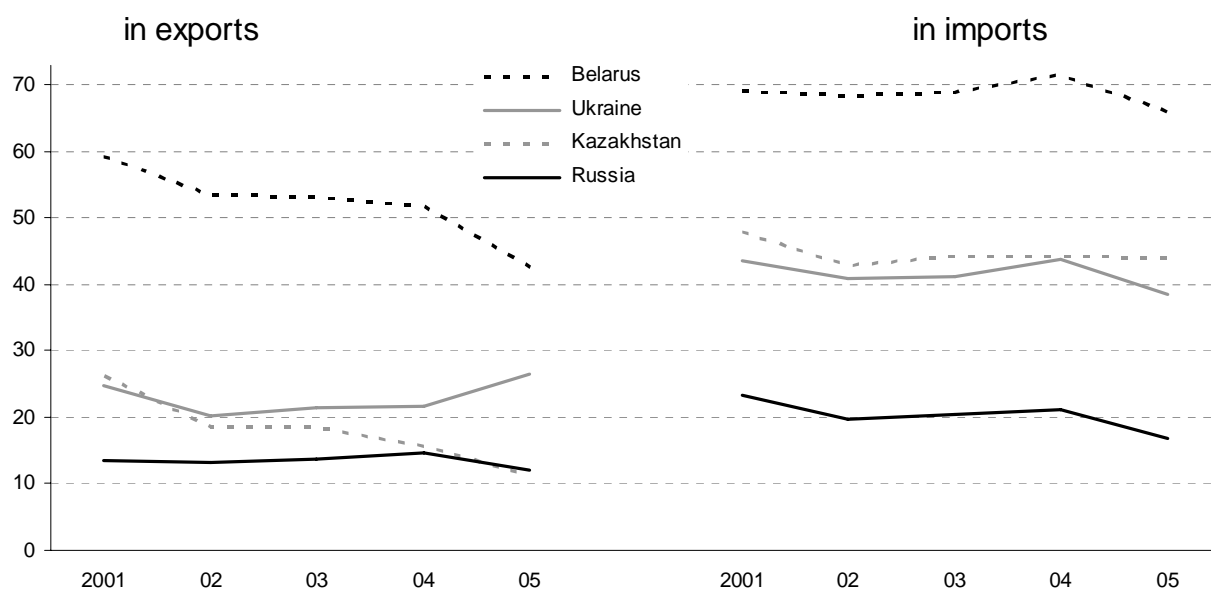
Figure 9 Energy dependency



Sources: National statistical and customs offices, IMF

Figure 10 Mutual trade

Share of the other three countries in the country's foreign trade, %



Sources: National statistical and customs offices, IMF

Table 2 Bilateral trade as a percentage of total trade (2003)

<i>Exporter</i>	<i>Importer</i>	Belarus	Kazakhstan	Russian Fed	Ukraine
Belarus		-	< 5	59	5
Kazakhstan		< 5	-	45	< 5
Russian Fed.		8	5	-	7
Ukraine		2	< 2	28	-

Source: Chaplygin *et al.* (2006)

Table 3 FDI flows of the Russian Federation

TOTAL FDI.	1997	1998	1999	2000	2001	2002	2003	2004	2005	1Q06
From Russia	-3 184	-1 270	-2 208	-3 177	-2 533	-3 533	-9 727	-13 782	-12 393	-5 006
To Russia	4 865	2 761	3 309	2 714	2 748	3 461	7 958	15 444	14 183	6 503
NON-CIS:										
From Russia	-2 784	-1 142	-1 690	-2 898	-2 035	-3 259	-9 033	-12 837	-11 473	-4 408
To Russia	4 854	2 754	3 304	2 708	2 746	3 657	7 913	15 409	14 104	6 503
CIS:										
From Russia	-400	-128	-518	-278	-498	-274	-694	-945	-920	-598
To Russia	11	7	6	6	3	-196	46	36	79	0

Source: Vestnik Bank

Table 4a Investments of Russia in the economy of the CIS countries (incl. loans)

	2000		2003		2004		2005	
	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total
<b>Total</b>	<b>130981</b>	<b>100</b>	<b>544141</b>	<b>100</b>	<b>713016</b>	<b>100</b>	<b>620522</b>	<b>100</b>
of which in the economy of:								
Azerbaijan	26	0.0	1613	0.3	2379	0.3	6734	1.1
Armenia	5	0.0	7650	1.4	1032	0.2	138185	22.3
Belarus	77238	59.0	243355	44.7	280193	39.3	102438	16.5
Georgia	133	0.1	1182	0.2	285	0.0	60	0.0
Kazakhstan	3453	2.6	27135	5.0	84104	11.8	204314	32.9
Kyrgyzstan	7	0.0	608	0.1	628	0.1	1247	0.2
Moldova	31224	23.8	372	0.1	6600	0.9	4904	0.8
Tadjikistan	-	-	18	0.0	3067	0.4	496	0.1
Turkmenistan	2934	2.3	857	0.2	1865	0.3	-	-
Uzbekistan	929	0.7	582	0.1	138547	19.4	6968	1.1
Ukraine	15032	11.5	260769	47.9	194316	27.3	155176	25.0

Table 4b Investments of the CIS countries in the economy of Russia (incl. loans)

	2000		2003		2004		2005	
	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total	Thou. USD	Per- cent of total
<b>Total investments</b>	<b>22375</b>	<b>100</b>	<b>889617</b>	<b>100</b>	<b>1097148</b>	<b>100</b>	<b>1665257</b>	<b>100</b>
of which from countries:								
Azerbaijan	831	3.7	6234	0.7	8962	0.8	54983	3.3
Armenia	5	0.0	131	0.0	367	0.0	4541	0.3
Belarus	1007	4.5	419803	47.2	292215	26.6	447135	26.9
Georgia	207	0.9	4147	0.5	11265	1.0	7902	0.5
Kazakhstan	5632	25.2	195473	22.0	438977	40.0	732788	44.0
Kyrgyzstan	839	3.8	31117	3.5	65590	6.0	140168	8.4
Moldova	1069	4.8	124	0.0	3051	0.3	18100	1.1
Tadjikistan	27	0.1	307	0.0	2294	0.2	13843	0.8
Turkmenistan	1024	4.6	4066	0.4	2125	0.2	2288	0.1
Uzbekistan	2738	12.2	88780	10.0	131500	12.0	10639	0.6
Ukraine	8996	40.2	139435	15.7	140802	12.9	232870	14.0

Source: Rosstat.

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Bank of Finland  
BOFIT – Institute for Economies in Transition  
PO Box 160  
FIN-00101 Helsinki

 + 358 10 831 2268  
bofit@bof.fi  
<http://www.bof.fi/bofit>