EURODOLLARS: A TRANSITION CURRENCY

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The Problem

What can the people and firms in the former Soviet republics and the newly independent Eastern European republics, each with its own untested national currency and poorly developed banking system, use for money in trading with each other and with the rest of the world?

When the Soviet Republics were parts of one large country, exchanges of goods and services among them were directed from Moscow and were paid for with rubles and with barter trading. All of the republics had a large fraction of their economic activity dedicated to inter-republic trade, partly because Soviet plants were geographically specialized (Peck and Richardson 1991, p. 20). Much of the trade of Eastern Europe was also oriented toward Moscow in the Council for Mutual Economic Assistance (COMECON or CMEA).[1]

Under the old regime, production was organized so that a tractor factory near Moscow, for example, had to depend for wheels upon a single source in Ukraine. Now that Russia and Ukraine are separate countries, buying wheels for the tractors has become an international trade transaction. If the Ukrainian factory managers are unwilling to accept Russian rubles or Russian goods in exchange for the wheels, tractor production in the Russian plant will be stalled until the

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[1]According to Stanley Fischer and Alan Gelb (1991, p. 97), "At the start of the reform process, about half the exports of the Eastern European nations went to countries in the COMECON or CMEA system, with the smaller countries mostly exporting manufactured goods and importing energy and raw materials from the USSR."

managers find another wheel factory that will accept rubles or trade goods. Meanwhile, tractors sit outside the plant without wheels. In 1991, a piano factory in Czechoslovakia stacked up pianos all over the plant, hoping old customers in the Soviet Union would find ways to pay for pianos.[2]

Much of the trade within COMECON was an inferior use of resources, if it had been valued at world prices and costs. Nevertheless, these countries must continue to exchange goods and services with one another for their mutual benefit. The terms and volumes of this trade remain to be determined by competition in world markets. Perhaps even more importantly, Eastern Europe and the ex-Soviet republics must open trade with the rest of the world as rapidly as possible.

In writing about the Soviet economy before its 1991 disintegration, Richard Cooper (1991, p. 116) stated, "The opening of the Soviet economy should be an integral part of the domestic economic reforms from the outset and not delayed until many of the other reforms have become effective." He emphasized that foreign competition would strongly reinforce other measures for establishing effective competition; a flexible, innovative economy requires competitive markets to transmit information on changing demands and technological developments through price signals. He also noted that opening the economy through early introduction of currency convertibility would encourage alignment of Soviet prices with world prices from the beginning. Finally, he pointed out that opening the economy to imports would provide goods for workers whose incentive to work is adversely affected by shortages and would increase the quality and quantity of inputs available to Soviet enterprises.

All of Cooper's points on the importance of opening markets clearly apply to Eastern Europe as well as to the ex-Soviet republics. An early opening of their economies to one another and to the rest of the world is essential to progress on all other aspects of their transition from centrally planned economies to market economies. But what will they use for trading currencies?

[2]The tractor factory story is from an anecdote told by Marshall Goldman at a Harvard Club of Princeton dinner (8 November 1990). Ukrainian managers had already balked at being paid in rubles for wheels, although Ukraine was still part of the USSR. I don't know whether or not tractors are still sitting outside the plant without wheels, but I doubt that Ukrainian managers would be any happier today to be paid in rubles. I heard the piano factory story in Prague in November 1991, from an American businessman who had just visited a piano factory. Upright pianos, formerly a standard item for sale in the USSR, were stacked wherever there was any vacant space. The managers had chosen to continue producing upright pianos, until they ran out of storage space, rather than shut down the line. They had plenty of orders for fine grand pianos from Western European customers.

Before the Soviet Union dissolved, the ruble was rapidly depreciating in purchasing power, was subject to brutal so-called currency reforms, and was barely convertible even into domestic goods. Ruble prices were very poor guides for allocating resources. The ruble's market standing under new management has yet to be refurbished. The currencies of the other newly independent republics and the banking systems supporting them are in various stages of development and have been little tested in international trade.

To reestablish trade relations within the former Soviet Union and COMECON, and to develop new trade with the rest of the world, the newly independent republics need an international trading currency, and they need it now.

The Solution

My proposed solution to the currency problem is to use Eurodollars (or another Eurocurrency) for international transactions, with free trade, free capital movements, independent currencies, full currency convertibility, and market-determined exchange rates.

This solution does not have to be applied by all of the countries at the same time. It is instead a prescription for one country, or a few countries, to follow while the ultimate monetary arrangements for the group evolve. It would allow the people and firms of the republics to choose among competing monies: national currencies—largely for domestic use—and dollars—for trade and capital movements among republics and with the outside world. The use of Eurodollars would provide valuable information on world prices and interest rates to entrepreneurs and consumers for guiding resource allocation, not only for internationally traded goods, but throughout the economy of each republic.

Why Eurodollars and not just dollars? A Eurodollar is a dollar deposited in a bank outside the United States. In the foreign exchange markets, differences between Eurodollars and dollars in U.S. banks are not important. A dollar is a dollar is a dollar in foreign exchange trading. But for international trade transactions and for international investment transactions, Eurodollars offer some transaction-cost advantages. They are not so heavily burdened with the reserve requirements, deposit insurance premiums, capital requirements, prohibitions on certain classes of transactions, SEC registration requirements, and other regulations that handicap U.S. financial institutions in international competition. Consequently, Eurodollar markets operate with narrower interest-rate spreads in many dollar transactions than U.S. banks can afford to offer at home. The Eurocurrency markets are intensely

competitive, with thousands of traders continually searching worldwide for the lowest-cost solutions for financial problems. That should be good for potential users in the ex-Soviet republics and Eastern Europe.

Much of what will be said here about Eurodollars could be said also about Deutsche marks. For many reasons, propinquity for one, people in the newly independent republics might prefer to use marks instead of dollars for international trade and investment transactions—or to use marks along with dollars. That would not contradict the argument of this paper. The key conclusion of this paper is that the newly independent republics do not have to rely solely on their own currencies or on their own banking systems in order to trade with one another or with the rest of the world. The rest of this paper will discuss use of Eurodollars, with the understanding that Deutsche marks or some other currency might replace dollars if that is what people in the market prefer.

Solutions to many of the monetary problems of the former Soviet Union and Eastern Europe that Western advisers agonize over are right under their noses in the Eurocurrency markets. These advisers may overlook the advantages of Eurocurrencies and Eurocurrency markets for the newly independent republics because they are accustomed to relying on governments and international agencies to manage the monetary machinery for international trade and capital transactions.

The Eurocurrency markets have long escaped efforts of governments to manage them. The Eurodollar market developed in the 1950s largely as a way for Soviet bloc countries to keep their dollar balances safe from being blocked or seized by the U.S. government (Yeager 1976, p. 431). It ballooned in the 1960s as U.S. banks and corporations struggled to avoid U.S. interest-rate controls and capital controls. To a considerable degree, the Eurocurrency markets still operate outside of the governmentally installed and managed systems that preoccupy many academic and government experts on international monetary arrangements. The Eurocurrency markets are thus likely to be viewed as problems rather than as resources by some policymakers and their advisers.

Just how powerful and how versatile these market resources have become in recent years may not be fully recognized even by people who are deeply immersed in their daily operations. The Eurodollar market, and its offshoots, such as the Eurobond market and the Asian dollar market, have undergone a forced-draft evolution since the 1960s in order to cope with inflationary and recessionary shocks (Meigs 1990). Their evolution, like that of world financial markets in

general, has gone in four major directions: (1) the time required to react to new information about economic policies and prospects has shortened; (2) new instruments and facilities for hedging against what cannot be forecast or quickly unwound have appeared; (3) securitization of lending and borrowing has increased; and (4) global market interrelationships that cushion shocks and distribute risks more widely have developed. In trying to solve their financial problems, Eastern Europe and the ex-Soviet republics should take note of these important changes.

The arguments of this paper should be viewed more as predictions than as recommendations. Although some expert advisers may overlook the potential usefulness of the Eurocurrency markets, I believe people who have their own fortunes at stake—the emerging capitalists and business managers of Eastern Europe and the ex-Soviet republics—will enter these markets to help them break out into the broader world.

Why Not Hire a Banking System?

It is widely recognized that Soviet-style banking systems require drastic restructuring if they are to serve the needs of consumers and firms in a market system (Brainard 1991). For years banks were used largely to monitor state enterprises' compliance with central plans. In the Soviet Union and Eastern Europe, banks passively loaned to money-losing state enterprises and acted as liquidity generators or engines of inflation for central governments. In short, banks really were not financial intermediaries in the Western sense.

Western advisers are generally pessimistic about the prospects for reforming and liberalizing the banking systems of Eastern Europe. Ronald McKinnon (1991, p. 121), for example, writes, "In the optimum order of liberalization, . . . the development of ordinary commercial banking may well have to be deferred for some years after liberalization begins, and to wait until overall monetary and fiscal control is secured." Stanley Fischer and Alan Gelb (1991, p. 98) write, "Even more so than other sectors, financial markets depend on underlying legal and informational systems and skills that barely exist at the start of reform." The time chart for the phasing-in of reform for finance and banking shows a four-year period of "preparation" followed by another two years of liberalization (p. 102).

The obstacles to developing efficient banking systems for Eastern Europe and the former Soviet republics that Brainard, McKinnon, Fischer and Gelb, and others identify are indeed formidable. However, the transition to market economies need not wait for each republic to build its own Western-style banking system. Banks in the

Eurocurrency markets will be able to provide a large part of the banking services that the people and the businesses of the republics need, while the banks of Eastern Europe and the ex-Soviet republics learn their new roles. Eurobanks can mobilize deposits, extend credit, transfer funds, buy and sell foreign exchange, provide market information, trade in the securities of ex-Soviet and Eastern European firms, underwrite new issues for them, aid in risk management, and help to teach their ex-Soviet and Eastern European bank correspondents how to run banks. The governments of the republics should welcome the Eurobanks' assistance in accelerating their transition to market economies.

Eurobanks should not be expected to lend with enthusiasm to governments of the republics, or to government-owned enterprises, while an estimated $65–70 billion in debts of the former Soviet Union remain to be settled. But these debts were incurred by governments. Governments in many parts of the world have proved to be notoriously poor credit risks. However, new loans to privately owned enterprises, in countries that protect property rights, will be much more attractive business for Western banks. Credit risks may be higher for a time than on loans in these banks' home countries, but returns and opportunities for asset growth should be commensurately higher also.

Using Eurodollars, without exchange controls, would greatly speed up the clearing of international trade and capital transactions. That would be extremely beneficial to people and firms who cannot afford to wait weeks for transactions to clear, as many must do now. Efficient machinery for settling and financing international trade and investment transactions is already in place in the Eurocurrency markets.

Most world trade and international investment transactions are settled in dollars (Campbell 1990, p. 2–28). Although other currencies, such as the mark, account for a growing share of international transactions, the dollar is still preeminent. No other country can yet match the size, depth, and resiliency of the U.S. economy and U.S. financial markets on which the dollar is based. The dollar is always convertible into a wide range of U.S. goods and services and financial assets. It is welcome everywhere.

Many of these international transactions come into focus in the Clearing House Interbank Payments System (CHIPS) in New York, which processes payments messages with a daily average value of about $1 trillion. Most of the transactions processed by CHIPs are related to the settlement of foreign exchange transactions and international trade and investment activity (U.S. Treasury 1991, p. III–32). With CHIPS and with all the banks and other institutions

of the Eurocurrency markets available to them, the republics and their banks do not have to erect much new machinery for international transactions. They merely need to get out of the way so their people can use the international payments machinery that already exists, as most other people in the world do when they have international transactions to execute.

Turning to the Eurodollar Market Would Speed Reform

One of the major advantages of using Eurodollars for settling international trade and investment transactions is that it could begin as soon as one or more countries are ready to try it. The republics cannot all be expected to move together to a new monetary system. Not one is ready now to join a new area-wide payments system, such as the European Monetary Union (EMU). Some of them may never be ready.

In the interim, countries such as Poland or Ukraine could allow their people and firms to conduct their external trade in Eurodollars. Their governments would not have to set up exchange controls, or operate exchange stabilization funds, or to borrow from the IMF, or even to hold foreign exchange reserves, if they would allow full convertibility and would allow the markets to determine the exchange rates between their currencies and the dollar or Deutsche mark.

A country would not have to yield any of its national sovereignty over its domestic currency. Nor would it have to peg its currency to the dollar or to any other currency, unless it chooses to do so. Free trade and decentralized monetary management would provide maximum scope for policy innovation and experimentation in individual countries.

Evolution of the new trading and payments system would be market-driven. Traders, for example, could initiate transactions with their customers or suppliers to be settled in dollars and could arrange to hold or obtain dollars in banks in their own countries or any other country. Entrepreneurs will have powerful incentives for finding these solutions, if they are free to do so. They have more detailed knowledge of their domestic and international markets than any government could have.

The Eurocurrency markets would provide an automatic, nonpolitical system for grading the republics on their performance in monetary and fiscal policies and on other transition policies that would influence risks and returns. Another of the advantages of the Eurocurrency markets, therefore, is that they would be open to the people and firms of poorly governed republics as well as to the

well-governed—at varying prices. Hundreds of experts in appraising country risks would judge the paper offered them by entrepreneurs and firms of Eastern Europe and the former Soviet republics. People in the well-governed republics accordingly would pay less for credit and other Eurocurrency market services than would people in republics that were slow to master transition problems. That should provide compelling incentives for governments to do whatever would improve access to the Eurocurrency markets for their entrepreneurs and firms. Furthermore, the Eurocurrency markets would supply governments of the republics with market checks on the judgment of IMF officials and other international civil servants who might have set conditionality tests for them.

Entrepreneurs Will Lead If They Are Given Their Freedom

The proposal to rely on Eurodollars or marks for international transactions assumes that the republics will depend heavily on entrepreneurs to supply growth in output and employment by starting new businesses. Many of the large state-owned enterprises are stranded whales that may not survive in their current form even if privatized. As Fischer and Gelb (1991, p. 92) point out, many were built along Soviet lines. They were organized as large monopolistic firms, in order to facilitate central control. Their international trade was shaped by state agreements rather than by market considerations. But they now employ skilled managers, engineers, and workers who have never had enough freedom to use their talents fully. Many of these people could become entrepreneurs or go to work for new businesses. They own a large stock of underemployed human capital that is ready to be upgraded.

The new businesses should be seen from the beginning as operating in wider markets than any one nation. They must buy resources wherever they can find them and sell wherever they can find buyers. Why not let them make their own arrangements on prices and exchange rates without restrictions? For example, a manufacturer could sell his products for dollars or marks in a neighboring or distant country, basing negotiations on what he can find out about world dollar prices for similar products and for the resources needed to produce them.

Given unrestricted access to Eurodollars or Euromarks, the managers of an exporting firm would not have to worry about the many exchange rates between their country's currency and the currencies of their customers' countries. Nor would the firm have to tie up capital by holding balances in these other currencies. The firm would use

dollars as a vehicle currency instead (see Swoboda 1968). Getting the dollars to pay the exporter would be the customers' problem. No dollars, no deals. Getting their local currency for the dollars would be the exporters' problem—if and when they want to convert. They might use the dollars to buy their materials and equipment from outside. A free market in the local currency then could tell the managers whether they had been using the right production costs in their planning, or producing the right products, or buying their inputs in the right markets to be efficient in the world market.

Entrepreneurs would discover the dollar or mark exchange rates that clear the markets, instead of having to use exchange rates imposed on them by governments. Governments will have more than enough to do trying to maintain stability in the domestic purchasing power of their currencies without trying to manage exchange rates too.

Market-determined exchange rates would insulate individual countries from much of the harm done by monetary policy errors in other countries. Individual countries would have an incentive to strive for stable-value currencies in order to maximize benefits from international trade and investment.

Some Alternatives

Many Western academic economists, politicians, and international civil servants would prefer to see the republics of Eastern Europe and the former Soviet Union adopt some variant of the Bretton Woods System, the EMU, or a common currency (Bergsten and Williamson 1990, McKinnon 1991, Shelton 1991). Some of the people giving this advice have been employed for most of their careers in trying to improve elaborate monetary superstructures in the West. It is natural for them to carry this intellectual capital with them when they go East, but applying their advice would require time-consuming, arduous negotiations among the republics. Macroeconomic policies would have to be coordinated, exchange rates would have to be adjusted and supervised, and some form of centralized authority would have to be sanctioned.

These grand solutions are not feasible near-term alternatives for Eurodollars in international transactions, given the difficulty of achieving agreement among new governments that have widely differing political foundations, poor understanding of international markets, and low confidence in one another's willingness to abide by agreements. Who would soon trust officials in Moscow, or Kiev, or Minsk, or some other power center, to run a sound monetary policy to which all of the member republics must conform? Mistakes at the center would have painful consequences over the whole area included

in the monetary union, as did mistakes made in Moscow before 1991. Leaders of the republics have abundant reasons for distrusting central authorities.

Constructing a monetary union and/or a common currency, with or without the Soviet republics, would take far too long to be of much use in opening international trade and investment. The governments and central banks of Western Europe, despite their long experience and their armies of skilled monetary technicians and negotiators, have not yet been able to agree fully on an acceptable common currency after years of trying.

Another proposal popular in the West is to peg each republic's currency to one strong foreign currency, such as the dollar or the mark, through use of a currency board or through a central bank (Hanke and Schuler 1991, Hetzel 1990, Jordan 1991, Meltzer 1991). Pegging a currency to the dollar or the mark would mean, in effect, that dollars or marks would be used for international trade and investment transactions. That would indeed solve the problem of finding a currency for international transactions. Furthermore, it should not interfere with use of the Eurocurrency markets.

Pegging to a strong currency would provide world price information for guiding resource allocation decisions within each country and would automatically force domestic wages and prices toward alignment with world wages and prices. It might provide more nearly stable exchange rates for international trade and capital movements than would a system of freely floating rates.

Its chief advantage is that it would give credibility to a government's desire to maintain domestic price stability, by taking monetary policy decisions out of the government's hands and putting them into the hands of a more respectable government. That is the major argument for current arrangements in the EMU, in which the currencies of member countries are essentially pegged to the mark.

Although the contribution to credibility of domestic monetary policy would be desirable, pegging to another currency at the wrong exchange rate could be too great a shock in some countries. It might require too sharp a deceleration in domestic money growth. There are real costs in a sudden deceleration of money growth, as U.S. experience has shown. The Chileans found this out too, when they pegged to the dollar (Friedman 1992, pp. 234–44). Or it could lead to domestic inflation, as it did when the United Kingdom entered the European Monetary System (Walters 1991). The past history of prices in the republics would provide poor guidance in setting the initial official exchange rates. A country that already has a low inflation rate might peg to the dollar or the mark with small domestic adjustment

costs. But countries with high inflation rates could find the transition to a pegged system more costly in output losses and unemployment than would be politically acceptable.

Furthermore, most of the successful recent experiments with pegging a national currency to a strong currency such as the dollar have been conducted in small countries—Hong Kong or Singapore, for example—in which foreign trade is overwhelmingly important. Russia and Ukraine, however, are not small countries. They are large, proud countries in which foreign trade is important but not dominant. Operating a pegged system could lead to the exchange controls and trade interventions that these countries are trying to escape. Whether Westerners approve or not, the newly independent republics are unlikely to cede control over their domestic currencies to outsiders in the near future.

When and How to Establish Currency Convertibility

How soon and how much entrepreneurs and firms in the newly independent republics can benefit from employing Eurodollars or marks will depend crucially upon when and how the currencies of their countries become convertible. Although most Western experts agree that early convertibility of some sort is essential for the republics' transition programs, many of them advise limiting convertibility to transactions on current account (merchandise trade and service-related transactions) at first. Not until later, after domestic financial markets have matured and various fiscal and monetary stabilization objectives have been achieved, should convertibility on capital account (international investment transactions) be permitted (see Bergsten and Williamson 1990; Cooper 1990, 1991; Feige 1991; Frenkel 1990; Harberger 1990; and McKinnon 1991). Holders of this general view are afraid that if the people of the republics were permitted to invest abroad or to hold money in banks abroad, the savings of their countries would flow out.

Bergsten and Williamson (1990, p. 38) expressed a conventional view when they said, "Unrestricted convertibility enables capital to flee from where it is needed, which is at home in the period of economic reconstruction that lies ahead." Ronald McKinnon (1991, p. 122) suggested another reason for limiting convertibility on capital account when he said that if newly liberalized enterprises in the Soviet Union "could freely borrow (or deposit) abroad," domestic credit restraints would be undermined. I believe that limiting convertibility on capital account for either of these reasons would be like restricting the flow of air to divers in order to save on fuel costs for the air compressors.

In his advice on opening the Soviet economy, Richard Cooper (1991, pp. 118–19) wrote: "Soviet enterprises and households should have free access to foreign exchange for purchase of foreign goods and services, but not for the purpose of buying assets abroad or holding foreign currency." A system of monitoring would be required to ensure that foreign currency would be used for permitted purposes. In practice, this might require a limit on the amount of foreign exchange citizens could acquire for foreign travel. But Cooper made a major concession when he said, "It will be necessary, however, to have some procedure for Soviet enterprises to invest abroad in distribution and servicing channels for the sake of promoting exports. In today's world some foreign investment is often required for effective marketing of national products" (p. 119).

If we recognize money as a capital asset in a portfolio of assets, dollars or other foreign currencies held by people and firms of the ex-Soviet republics and Eastern Europe can be seen as crucial investments for the sake of promoting exports (and imports). The currencies of the ex-Soviet republics and Eastern Europe are not yet widely acceptable for international transactions inside or outside the former Soviet bloc. Other currencies, including the Eurodollar or the mark, are clearly superior as trading currencies at this time. Exporters and importers, wherever they are, must invest in a stock of one or more of these currencies in order to conduct trade and investment transactions. Therefore, limiting the opportunities of ex-Soviet and Eastern European people and firms for acquiring dollars, by enforcing capital controls, in effect would limit their opportunities for exporting and importing goods and services and for attracting capital investment. That would be like limiting their air supply.

Limiting convertibility to certain classes of transactions is an outdated mercantilist approach that has succeeded mainly in building intrusive bureaucracies that obstruct trade and capital flows. Exchange controls require bureaucrats to examine transactions to determine whether or not they comply with the regulations, thus slowing the flow of payments. They also induce transactors to use time and resources to circumvent the controls. Business managers who earn dollars or marks by selling glassware or auto parts in another country are unlikely to bring all of the proceeds back into their country if they have to turn part or all of them over to the government and then have to get into line to buy them back the next time they need foreign exchange.

It is doubtful whether Western advisers have adequately weighed the expected benefits of attempting to limit capital flights through abridging property rights with exchange controls against the expected

benefits of protecting property rights across the board. This calculus is especially doubtful when one considers that even advocates of exchange controls on capital transactions must realize that they leak (McKinnon 1991, Frenkel 1990, and Harberger 1990). Yeager (1976, pp. 138–57), who is obviously not an advocate, presents a devastating compendium of methods used in various countries for avoiding capital controls. One of the few Western advisers to recommend early convertibility on capital transactions is Alan Walters (1991, p. 131), who says, "I would argue also for capital convertibility in order to bolster confidence in the newly free currency."

A policy of restricting convertibility for capital transactions would undermine efforts to establish the secure private property rights that are crucial for success in the transition to market economies. For example, if a firm were to receive a carload of toys from another country in exchange for a shipment of textiles, there would be no question about who owns the toys or what the firm could do with them. But if the firm were to be paid dollars, or other foreign currencies, many Western advisers assume that all or part of the foreign currencies should be turned over to the government. Property in the form of foreign exchange would not receive the protections accorded to toys. Alan Walters (1991, p. 12) says in rebuttal:

> Another way of looking at the issue is to say that restricted capital convertibility ensures that it is still possible for the government to draw a ring fence around its subjects and expropriate them at will. . . . I would suggest that capital convertibility, whether with pegged or free exchange rates, as such is a useful restraint on the power of governments to rob their subjects.

When one considers the importance of secure property rights for motivating people to work, save, and invest, a case could be made for allowing the people of the newly independent republics to hold their financial assets wherever they are satisfied with the risks and returns, whether in their own countries or elsewhere. The new capital they would generate by working harder and more productively, and the capital they could attract into their countries from outside, would far exceed the small stock of savings they have been able to accumulate working under their former rulers. It would be far more beneficial for the republics to encourage people to employ their human capital fully than it would be to impound their financial savings.

Foreign investors who want to bring capital in or nationals who want to bring their flight capital back would be encouraged if they believed there would be no restrictions on their freedom to take profits out, or to withdraw capital from losing propositions. Exchange controls have seldom, if ever, worked as advertised to prevent capital

flights where people have had an incentive to send their capital abroad. The way to prevent capital flights is to apply domestic policies that protect property rights, encourage investment, and maintain stable purchasing power in domestic currencies. Latin American countries that are taking steps along these lines find flight capital returning.

Getting Dollars to Trade[3]

Where will the people and firms of Eastern Europe and the former Soviet republics get dollars to trade?

First, there already is a substantial stock of dollars hidden away in Eastern Europe whose owners have been hesitant to bring them to light. The unusual outflows of currency from Federal Reserve banks in recent years suggest that some U.S. residents have shipped bales of dollars to friends and relatives in their ancestral homelands. Furthermore, the Institute of International Finance has estimated that Soviet state-owned exporters kept about $14 billion of export earnings abroad in 1991, instead of remitting them to the central government in Moscow (*Wall Street Journal* 1992). There may be other such hoards to be retrieved, for some ex-Soviet officials have been in the Eurodollar markets since the 1950s (Yeager 1976, p. 434).

Second, the people and firms of these countries will have assets that they can exchange for dollars or marks after state-owned businesses and other property are privatized. They also should be able to use some of these assets as collateral for borrowing dollars or marks. This underscores the need for privatizing state property as rapidly as possible in order to supply everyone with a stock of negotiable assets.

Third, entrepreneurs will create new assets in the form of goods and services that they can sell in export markets for dollars. Financing these exports with dollars should be attractive business for American, European, and Japanese banks. Short-term trade finance is bread-and-butter business for banks.

Fourth, banks and investors in other countries will supply dollars for investments in these countries, once they are assured that property rights are secure and that there will be no restrictions on their ability to draw out earnings and principal. North American investors in particular probably will view some of the republics as turnaround opportunities, as some now view investment opportunities in Latin America.

[3]This section draws on suggestions made by Robert Hetzel and Charles Plosser (see Plosser 1991).

Conclusion

The newly independent republics of the former Soviet Union and Eastern Europe desperately need broadly acceptable, convertible currencies for settling international trade and investment transactions, both within the old Soviet Bloc and with the rest of the world. Their national currencies and their developing banking systems lack the necessary acceptability and experience to serve them well in international trade and investment transactions. Yet opening international trade is crucial to the success of all of their other transition policies.

Many Western advisers on transition policies recommend that the republics build multilateral currency arrangements similar to the European Monetary Union or a common currency for several or all of the republics. Other Western advisers recommend that the republics peg their currencies to a strong Western currency such as the dollar or the mark through a currency board or a central bank. Both of these measures would provide them with dollars or marks for settling international transactions. Although such institutions may ultimately evolve, the republics do not have time to wait for them before finding a way to enter world markets.

The people and firms of the republics are more likely to find an interim solution to their need for international trading and investing currencies in the Eurocurrency markets. The Eurocurrency markets can supply dollars or Deutsche marks for settling international trade and investment transactions. They can supply rapid, efficient clearing of transactions. They also can supply financing for many transactions.

To expedite their transition to market economies by using Eurodollars, the governments of the republics would not have to create any new institutions. They merely would have to get out of the way and allow entrepreneurs of their countries to make their own arrangements. They would realize maximum benefits from use of the Eurocurrency markets if they would make their currencies fully convertible, avoid all exchange controls, permit free trade and capital investment, protect property rights, maintain stable domestic purchasing power for their currencies, and let their exchange rates be determined in free markets.

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Monetary Institutions during the Transition to a Market Economy

William A. Niskanen

Money in Transition

There has been a great deal of intelligent discussion about the effects of alternative monetary institutions for the new governments of Central and Eastern Europe. Most of that discussion, whether recognized or not, addresses the issues that bear on the choice of monetary institutions for the long run. The paper by Jim Meigs, however, addresses a more urgent task, namely, the choice of monetary institutions during the *transition* to a market economy.

Leaders in ex-communist countries (ECCs) do not have the luxury of an extended academic debate on the issues that bear on the choice among alternative monetary institutions. They must get on with their job under conditions that most of us would regard as chaotic. What should the officials of these new governments do? Meigs gives an answer that should resonate with market liberals: Get out of the way! Specifically, Meigs recommends that the governments of these countries allow their individuals and firms to conduct *international* transactions in the markets for both goods and capital in some Euro-currency—immediately and without exchange controls.

One should not wait, he recommends, for the development of a stable domestic currency, which will take time and will depend critically on establishing a fiscal policy that is not dependent on central bank financing. For international transactions, any person or firm can immediately "borrow" the monetary policy of the Federal Reserve or the Bundesbank.

One should also not wait for the development of a domestic banking system. Again, for international transactions, any person or

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firm can "borrow" the developed banking institutions of the West.

Abolish Exchange Controls

Meigs also argues, I believe correctly, against any exchange controls on the flow of capital. There is reason to be concerned about capital flight, about "our" saving being used for investment abroad when it should be invested at home. In response, Meigs makes three arguments:

1. Exchange controls raise the cost of moving capital across national borders but are not very effective in limiting capital flight when domestic conditions substantially reduce the security of property rights.
2. Foreign private investment in ECCs is important to promote export sales.
3. Most important, exchange controls discourage foreign investment in the home country, by restricting the repatriation of earnings and the liquidity of the investment.

For these reasons, the termination of exchange controls usually leads to an increase in capital flows in both directions and often to a net inflow to the nation ending these controls.

Benefits of the Meigs Approach

In summary, I suggest, the Meigs approach is the best approach to financing international transactions in the transition period. This approach does not resolve the choice among alternative long-term monetary institutions, but it avoids the different down-side risks of a premature commitment to a specific long-term alternative. One attractive side-effect of this approach is that it would permit the finance ministers of the new countries to tell the boys from the IMF to go home, or go to hell, whichever is closer. I can hardly wait.