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After the Fall: Building Nations out of the Soviet Union

The Russian Federation, covered in the preceding chapter, was the largest but not the only country to emerge from the Soviet Union as an independent state. In a span of 12 months starting in May 1992, all 12 of the former Soviet Socialist Republics that had constituted the core of the Soviet Union, and the three Baltic states that had been forcibly annexed in 1940, joined the IMF. This influx of new members created new challenges for the Fund and put unprecedented pressures on its staff and its ability to cope. To some extent, the challenges were regional—maintaining economic activity and trade after the collapse of the Soviet-bloc trading arrangements, dividing up the assets and liabilities of the union among the newly independent states, and conducting international finance without the Soviet ruble as a regional currency. Once those broad issues were settled, attention could turn more fully to the needs of the separate states as they began making the transition from central planning to market economics.

The transition proved to be brutal throughout the region, though some countries handled their trials better than others. At one extreme, estimated real output per capita in Tajikistan fell by more than two-thirds from 1991 to 1996. The level averaged less than \$150 a year for much of the decade, and incomes recovered only slightly by the end of the 1990s (Table 8.1). Even allowing for the probable bias toward overestimation, the decline was dramatic and brought on severe economic hardships.¹ At the other extreme—geographically as well as economically—Estonia's real output per capita recovered quickly after an initial drop of 22 percent in the first two years of independence. By the end of the decade, output in Estonia exceeded \$4,000 per capita, far above its preindependence level. Between the two is found a great variety of experiences in countries bound together by a shared history that, for a time, forced them to cope together with regional issues.

¹These data are subject to very large measurement errors, but the general pattern is well established. For analyses, see De Broeck and Koen (2000); and Havrylyshyn (2001).

Table 8.1. Per Capita GDP in the Baltic Countries, the Russian Federation, and Other Countries of the Former Soviet Union, 1991–2000

Country	Annual Average 1991–2000 (Dollars)	Maximum Real Decline from 1991 (Percent)	Year of Lowest GDP	1991–2000, Percentage Change
Russian Federation	1,789	39	1998	–28
The Baltic countries				
Estonia	2,764	22	1993	14
Latvia	2,093	34	1993	–3
Lithuania	2,065	40	1994	–20
Other middle-income countries				
Belarus	1,007	34	1995	–9
Kazakhstan	988	28	1995	–14
Turkmenistan	852	53	1997	–33
Ukraine	707	53	1998	–50
Low-income countries				
Moldova	368	56	1999	–55
The Caucasus region				
Armenia	346	45	1993	–12
Azerbaijan	404	60	1995	–46
Georgia	785	63	1994	–45
Central Asia				
Kyrgyz Republic	286	46	1995	–34
Tajikistan	148	68	1996	–64
Uzbekistan	474	25	1996	–16

Source: World Development Indicators (World Bank).

Regional Issues

As recounted in Chapter 6, the overarching economic challenge for the countries that emerged from the Soviet Union was to shift production and trade from the artificial and arbitrary practices of the past several decades to a more efficient market system that would be compatible with the world economy. That effort would take several years. Until sufficient progress could be made to enable these countries to integrate economically with western Europe and other market economies, conventional wisdom held that it was necessary to try to preserve trade among the former republics. If continuation of regional trade failed, even more precipitous drops in output and employment were feared.

In December 1991, the three republics that had first banded together in 1922 to form the Soviet Union—Russia, Ukraine, and Byelorussia (Belarus)—met outside Minsk to proclaim the death of the political union and to replace it with a new and looser entity, the Commonwealth of Independent States (CIS). Most of the other republics, with the exception of the Baltic countries, joined the CIS before the end of 1991, a step that declared both their political sovereignty and their intention to retain close economic and other ties. With a few changes in membership, the CIS remained

in effect throughout the rest of the decade and served as an umbrella organization (headquartered in Minsk) for promoting cooperation on a wide range of economic and political issues.²

The primary external advisors and providers of financial assistance for restructuring production and the direction of trade and for related structural issues such as the privatization of state-owned enterprises and other property were the World Bank, the newly established European Bank for Reconstruction and Development (EBRD), and western European and other bilateral donors. Although the Fund was inexorably drawn into dealing with nonfinancial structural issues, its main responsibility in this region—as elsewhere—was to help each country achieve macroeconomic and financial stability. As a prerequisite, two regional financial problems had to be resolved quickly. First, some means had to be found for allocating and servicing the external debt incurred by the Soviet government. Second, each country had to decide whether to continue using the ruble (the common currency of all the Soviet republics) or establish its own national currency, and then a structure had to be set up for managing whatever common currency area (the “ruble area”) remained. For these tasks, the IMF embarked on playing an important—though often controversial—advisory role.

Settling the Soviet Debt

As the Soviet Union unraveled throughout 1991, its economic system crumbled with it. The region badly needed financial assistance from international agencies and from major creditor countries, and that assistance depended first on finding a way for Russia and the other republics that were assuming at least partial sovereignty to continue to service and ultimately repay the Soviet debt. Until the republics reached debt-servicing agreements with official creditors, they would not be able to undertake new borrowing from the IMF or others.

As the first step in this process, the finance officials of the Group of Seven (G7) countries acted as a kind of steering committee for discussing with the Soviet Union and its republics by what method responsibility for Soviet external debts should be apportioned. In October and November 1991, the deputies to the G7 finance ministers, chaired by Nigel Wicks of the United Kingdom, met with Soviet officials in Moscow in two series of meetings to try to forge an agreement on how the separate republics were going to service the Soviet debts, and the extent of debt relief and other financial assistance the creditors might be willing to grant. John Odling-Smee (Deputy Director, European Department) and Benedicte Christensen (Assistant to the Director

²In addition to the three founding states, Armenia, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, and Uzbekistan signed the CIS protocol in December 1991. Azerbaijan and Georgia joined in 1993. For a detailed reference on the origins, structure, and early history of the CIS, see Brzezinski and Sullivan (1997).

of the Exchange and Trade Relations Department, or ETR) represented the Fund as observers and helped to clarify the facts.

The difficulty in establishing responsibility was that official creditors worried that some republics would simply repudiate their share of Soviet debt. The matter appeared to be resolved once the Russian government suggested that all the republics be jointly responsible for all of the debt. The G7 deputies readily embraced this idea, which was encapsulated in an expression borrowed from English law: each republic would be “jointly and severally” responsible for servicing the debts. As a practical matter, this language had little meaning because none of the smaller republics could conceivably have taken up the slack if Russia or even Ukraine (the second largest of the new states) had defaulted. Within months, Russia would accept full responsibility in exchange for laying claim to overseas assets, including both financial assets such as gold and foreign exchange reserves and real assets such as Soviet embassies (a solution that became known as the “zero-option” agreement).³ At the time, however, the concern was just to establish and agree on an equitable formula.

A second and related issue—debt relief from official creditors—proved more difficult, because the G7 members had conflicting interests. At one end of the spectrum, the United States, represented in the finance deputies’ group by David Mulford, pushed the group to forgive a large part of the debt, the lion’s share of which was held by German banks. At the other end, the German government, represented by Horst Köhler, was understandably less enthusiastic about that proposal. Meeting in Bangkok in mid-October in the margins of the IMF/World Bank Annual Meetings, the G7 apparently reached agreement on basic principles, notably that they would not forgive the debt and that they wanted to have a single party held responsible for servicing it—not 15 individual states—if the union continued to break up.

Discussions with Soviet officials continued in Moscow. Finally, at a meeting in the middle of the night in a swelteringly hot room in the basement of the British embassy, the deputies reached an understanding that the G7 would support a generous rescheduling—but not forgiveness—of the Soviet debt, contingent upon Russia (or the Soviet Union, if it survived) agreeing to implement an economic reform program to be worked out with the IMF.⁴ Commercial bank creditors, meeting as the London Club under the chairmanship of Deutsche Bank in Frankfurt, agreed in mid-December to

³For background and details on these agreements, see Christensen (1994), pp. 21–25.

⁴The G7 deputies and their Soviet counterparts agreed on these points in principle in Moscow on October 28, but some on the Soviet side then began to question the financial arrangements. The G7 deputies met among themselves in Paris in early November and with the Soviets back in Moscow, November 18–21. The agreement was signed at the end of those meetings; see “Report on the Agreement on the Deferral of the Debt of the U.S.S.R. and its Successors to Foreign Official Creditors,” SM/92/5 (January 9, 1992); and the minutes of EBM/92/3 (January 10, 1992). For further details, see memorandums from Odling-Smee to the Managing Director, “USSR—G7 Meetings in Moscow” (October 30, 1991) and “USSR—G7 Meeting” (November 19, 1991); IMF archives, “Russia 1991-(2) Country Files,” Box 21980, Accession 1995-0180-0007. Also see Braithwaite (2002), pp. 259–60, for a memoir by the British ambassador.

reschedule their loans. The final step was a rescheduling agreement by official Paris Club creditors (17 countries) on January 4, 1992, following closely on the heels of the official dissolution of the Soviet Union in December.

Dissolving the Ruble Area

Upon the dissolution of the Soviet Union and its replacement by 15 independent countries at the end of 1991, the Soviet State Bank, or Gosbank, was similarly replaced by 15 independent central banks, each of which had the power to issue its own monetary liabilities. Initially, the entire region used just one currency, the ruble. The Central Bank of Russia (CBR, the successor to the Gosbank in Moscow) continued to supply rubles to the other central banks to finance bilateral payments imbalances. As a transitional measure, this practice was intended to help sustain trade and financial relationships across the former Soviet region, but it also enabled each country to pursue policies leading to unrestrained inflation. The CBR's attempt to tighten monetary policy in mid-1992 was overwhelmed by transfers to the other ruble-emitting countries. These transfers were estimated to approach 10 percent of Russian GDP (Gaidar, 2002, p. 33).

IMF officials recognized from the outset that whether, how, and when the newly independent countries should establish their own currencies would be crucial decisions in the post-Soviet transition and that those decisions would depend on political as well as technical considerations. Even before the dissolution of the union, IMF Executive Directors questioned Managing Director Michel Camdessus as to what the Fund's view should be on retaining the region's common currency. The Managing Director (himself a former central bank chief) replied that although the Fund could provide good technical advice, "the Fund's theoretical views about the optimal size of a monetary union or economic space would not be a predominant consideration in the solution which ultimately prevailed. The Fund could make available to the USSR the judgments which came from its rich experience, but whatever the quality of the judgments, the final decisions will probably be taken for reasons unrelated to them." Six months later, he made the point even more forcefully. "The Fund's position should be absolutely pragmatic, if not agnostic," he told the Board. "The choice of a currency is a sovereign choice. Although from an economic standpoint, choosing to introduce a national currency might not be the best solution, economic rationale cannot operate independently of a given national tradition."⁵

As the Fund geared up to provide policy advice to the emerging countries, the staff took what it considered to be the pragmatic view, that for the early part of the transition preserving the ruble area would be in the interests of the countries of the former Soviet Union outside of the Baltic states and Russia. The proposed work program for the region, as set out in November 1991, recommended

⁵Minutes of EBM/91/147 (November 6, 1991), p. 8; and EBM/92/49 (April 9, 1992), p. 16.

maintaining the ruble monetary union in 1992—not because we are opposed to national currencies, but on the pragmatic grounds that satisfying the preconditions for the credible introduction of such currencies will take time. . . . Even though republics may resent a Russian dominated monetary authority, it would be in their own interests to cooperate with it in the short term, as long as it pursued anti-inflationary policies.⁶

The situation evolved rapidly and often chaotically, and the Fund's views evolved, too. The first opportunity to present a general overview to the monetary authorities in the region came at a conference in Brussels in February 1992. Ernesto Hernandez-Catá (Deputy Director of the newly formed European II Department, or EU2) represented the Fund and presented its policy advice. In written remarks for the meeting, he explained the steps and preconditions that would be needed if a country wanted to establish its own currency. That avenue would make sense only if the country's monetary authority could do a better job than the central authority (the CBR) at maintaining price stability. In sum, "new currencies should not be introduced hastily, and certainly not before conditions have been established domestically to ensure the stability of the currency."⁷

At the end of March 1992, seven CIS member states signed a protocol in Minsk, Belarus, establishing the Interbank Coordinating Council of the Heads of National Banks (ICC). The other emerging states soon joined or affiliated themselves with the ICC. On May 20, representatives of all 15 central banks gathered in Tashkent, Uzbekistan, along with a delegation of IMF staff led by Odling-Smee (now Director of EU2) and Hernandez-Catá, to develop a plan for coordinating monetary policies in those countries still within the ruble area. At that time, all 15 countries still used the ruble. Five of them—Estonia, Latvia, Lithuania, Moldova, and Ukraine—had announced their intentions to establish their own separate currencies in the near future,

⁶Memorandum from Odling-Smee to the Managing Director, "USSR—Program Work in the Republics" (November 22, 1991); IMF archives, DMD, Accession 1995-0180-0007, B7632, "USSR (3) 1991."

⁷Attachment to memorandum from Hernandez-Catá to Mussa and others, "Paper on New Currencies," February 10, 1992, p. 3; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. A revised version of the paper was published as Hernandez-Catá (1992); in that version, the quotation appears on p. 64. The paper expressed the views of the author rather than the Fund, but a preliminary draft was reviewed by the Research, ETR, and Central Banking Departments. At least three readers provided comments critical of parts of the argument, but none questioned the assessment quoted here. Because some IMF staff were more disposed to favor the establishment of new currencies, Jack Boorman (Director, ETR) cautioned EU2 "to avoid giving the impression that the Fund is pushing for the introduction of national currencies while others are working toward the preservation of the ruble zone and inter-republican trade"; memorandum from Boorman to Odling-Smee, "Paper on the Introduction of a National Currency for the Forthcoming Conference in Brussels" (January 22, 1992); Historian's files. In a later review, Odling-Smee and Pastor (2002) pp. 14–16, asserted that the staff position at the Brussels conference was neutral and was limited to advising countries on how to implement policies, regardless of whether they chose to remain in the ruble area or to introduce a national currency.

but the understanding of the IMF staff was that most of the others had “indicated that they intend to remain in the ruble area, at least for some time.”⁸

One option G7 officials were considering as a way to preserve the viability of the ruble area was for participating countries to set up currency board arrangements similar to those used by Argentina, Hong Kong, and a few other countries. In May 1992, right after the Tashkent meeting, Thomas C. Dawson II (Executive Director, United States) informed Camdessus that British officials were proposing such a scheme, apparently with the support of the U.S. Treasury.⁹ As events unfolded, however, nothing more came of the idea.

While preparing for the Tashkent meeting, the IMF staff broke into something close to bureaucratic warfare over their differing assessments of the viability of the ruble area. Research Department staff, led by David Folkerts-Landau (Chief, Capital Markets and Financial Studies Division), circulated a draft paper that assumed the common currency area was about to collapse. In a covering memorandum to other departments, the Director of Research, Michael Mussa, observed that the “sufficient conditions for the breakup of the ruble zone—high inflation in the common currency and perceived inequities in the sharing of seigniorage—are satisfied.” That provoked an angry reaction from Hernandez-Catá, who reportedly attacked the paper as “flying in the face of G7 and Fund policy.”¹⁰ The paper was never finalized or circulated more widely, but the episode revealed a deep rift that contributed to ambiguities in, and misunderstandings about, the Fund’s views on this delicate issue.

The IMF’s objectives for the Tashkent meeting were to help the countries find a way to make the ruble area work and to promote and assist cooperative policies even for those countries about to strike out on their own. On the eve of the meeting, Odling-Smee and Hernandez-Catá met with Georgi Matyukhin, the head of the CBR. When Matyukhin explained that his concern was to ensure that Russia could control the issuance of money throughout the area, Odling-Smee replied that insistence on this point would doom the system. Cooperation, not unilateral decision making, was essential.¹¹ The Russians were unconvinced, and—for the reason that Odling-Smee

⁸Draft paper by Hernandez-Catá, “The Coordination of Monetary Policy in the Ruble Area,” April 27, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

⁹Memorandum from Dawson to the Managing Director, “Currency Boards,” May 22, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

¹⁰Memorandum from Mussa to John T. Boorman and others, “Currency Reform Paper,” May 8, 1992, covering a preliminary draft of the paper, “The Economics of Currency Reform in the CIS”; and memorandum for files by Folkerts-Landau, “Mr. Hernandez-Catá’s Informal Remarks about the Currency Reform Paper,” May 22, 1992. Also see memorandum from Mussa to Boorman and others, “Comments on ‘The Economics of Currency Reform,’” June 9, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. Parts of the paper dealing with historical precedents were issued as an IMF working paper and later were published externally (Garber and Spencer) 1994.

¹¹Memorandum from Hernandez-Catá to the Managing Director, “Meetings with Central Bank of Russia Officials on Monetary Policy in the Ruble Area,” May 26, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

foresaw—the conference failed. In principle, the ICC accepted the Fund’s guidelines for a rules-based system for coordinating monetary policy, but several delegations refused to sign the draft communiqué, which was not formally issued.

Two weeks later, at a follow-up meeting in Tallinn, Estonia, Russia’s insistence on centralized control came out even more clearly, effectively burying the Fund’s proposed guidelines.¹² Camdessus then had a testy meeting with Konstantin Kagalovsky, Russia’s representative at the IMF, in which he asked him to explain the variance between the Tashkent communiqué and Russia’s subsequent position that the ruble area was no longer workable and should be dissolved as quickly as possible. Kagalovsky reportedly replied that “Russia was not willing to sacrifice its own reforms for the sake of foreign countries.” The Managing Director pleaded in vain for Russia to cooperate in promoting “a good monetary policy . . . throughout the ruble area” and an orderly transition period for those countries that wanted to leave the area.¹³

For the most part, after Tashkent the IMF just tried to advise the CIS countries on how to run the ruble area effectively, *if they chose to try to preserve the area*. Despite the staff’s skepticism about the institutional capacity of many of these countries—other than the Baltic states—to issue their own stable currencies, the Fund recognized the difficulties of maintaining the status quo and in most cases did not actively discourage countries from trying to extract themselves from the ruble. The Tashkent guidelines implied that if countries continued to use the ruble, their adherence to the guidelines would be a condition for financial assistance from the IMF. The Fund also stressed to the Russian authorities that they would have to “put in place a system of monetary policy cooperation [with the countries in the ruble area] before an arrangement can be agreed with the Fund.”¹⁴ The policy requirements for countries leaving the area were to be discussed later on a case-by-case basis.

The three Baltic countries were the first to leave the ruble area. Of all those involved, they had the best institutional structures in place for managing their own currencies. They also had the keenest desire to establish separate currencies, as a matter of national pride and as a way of stating boldly that they were fully independent from the country that had controlled them for half a century. Estonia led the exodus,

¹²See “Statement by the Managing Director on Monetary Policy Cooperation in the Ruble Area, Executive Board Meeting 92/72, June 12, 1992,” BUFF/92/99 (June 12, 1992); and “Monetary Policy in the Ruble Area,” EBD/92/117 (June 12, 1992). The latter document contains the Fund’s guidelines. Also see memorandum from Malcolm D. Knight (Assistant Director, Research Department)—one of the eight members of the IMF delegation in Tashkent—to Mussa, “Tashkent Meetings on Monetary Cooperation in the Ruble Area,” May 26, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. The draft communiqué is attached to Knight’s report. The guidelines and the communiqué were drafted primarily by Hernandez-Catá.

¹³File memorandum by Vincent R. Koen (Economist, EU2), “Meeting of Mr. Kagalovsky with Management, June 2, 1992,” June 4, 1992; IMF archives, Russia Country Files, EU2, Accession 96/194.

¹⁴“Statement by the Managing Director on Monetary Policy Cooperation in the Ruble Area, Executive Board Meeting 92/72, June 12, 1992,” BUFF/92/99 (June 12, 1992).

introducing the kroon in June 1992, just a few weeks after the ICC meeting in Tashkent. Latvia followed with its own ruble in July, and Lithuania introduced the talonas in October. Ukraine and the Kyrgyz Republic soon followed suit, but the biggest catalyst came in July 1993. That month, the Russian government suddenly announced—without any prior consultation with the IMF and after almost no notice to the other states using the ruble—that it was issuing a new ruble to replace the Soviet-era notes (which still featured Vladimir Lenin’s picture). It allowed Russian residents just a brief period to make the exchange.¹⁵ Although the conversion rules were quickly relaxed, the potential still existed for Russian residents to try to dump their old rubles by spending them in neighboring countries where they were still in circulation. Even worse, in the short run those countries had no assured official supply of new rubles. Suddenly, even those countries that had planned to remain in the ruble area realized the currency union was no longer viable. By the end of 1993, all but Tajikistan had introduced national currencies either to replace or to supplement the Russian ruble in domestic exchange (Table 8.2)¹⁶

The views of the Fund staff working on these countries evolved throughout 1992, from mild opposition to the early introduction of national currencies toward cautious support. By July, the staff realized its technical advice on whether and when to leave the ruble area was of secondary importance, because each country was making its decision primarily on political grounds or in reaction to the breakdown of policy coordination across the whole region.¹⁷ The failure of a CIS summit meeting in Bishkek, Kyrgyz Republic, to establish credible limits on credit expansion made the outlook for the area even gloomier. In a letter sent to all regional central banks in November, Odling-Smee argued that the region’s strategy of trying to coordinate monetary policy among countries had failed. Every country now had to decide whether “to remain in a single currency area with a common monetary policy or . . . to introduce a separate, national currency. There are no other viable alternatives.”¹⁸

¹⁵See “Russian Federation—Recent Economic Developments and Policy Outlook,” EBS/93/161 (September 24, 1993), p. 4, which notes that the announcement caused “considerable chaos and a political outcry.” Also see a statement by Richard D. Erb (Deputy Managing Director) to the Executive Board, regretting the lack of consultation and planning and the “unnecessary degree of uncertainty” that it caused, “both within Russia and in a number of other . . . states” in the ruble area; minutes of EBM/93/107 (July 28, 1993), pp. 5–7. Russian President Boris Yeltsin later acknowledged that the ruble conversion was mishandled, but he shifted the blame to Matyukhin’s successor as central bank governor, Viktor Gerashchenko, for managing it badly; see Yeltsin (1994), pp. 217–24.

¹⁶For further background, see Odling-Smee (1994) and Wolf (1994).

¹⁷Report by the Deputy Managing Director, Richard D. Erb, at EBM/92/94 (July 24, 1992), pp. 5–6.

¹⁸The letter to Gerashchenko was reproduced in Odling-Smee and Pastor (2001), pp. 42–44. Similar letters were sent to the central bank governors in all countries still using the ruble. Earlier, in October, Camdessus made the same point in meetings with the presidents of Kazakhstan and the Kyrgyz Republic; see his report to the Executive Board at EBM/92/127 (October 21, 1992), p. 3.

Table 8.2. Dissolution of the Ruble Area, 1992–95

Country	Currency	Introduction of Parallel Currency	Introduction of National Currency	Initial Exchange Regime
Armenia	dram	n.a.	November 1993	float
Azerbaijan	manat	August 1992	January 1994	peg to U.S. dollar ^a
Belarus	rubel	May 1992	September 1993 ^b	managed float
Estonia	kroon	n.a.	June 1992	currency board, pegged to deutsche mark
Georgia	coupon ^c	April 1993	August 1993	managed float
Kazakhstan	tenge	n.a.	November 1993	float
Kyrgyz Republic	som	n.a.	May 1993	managed float
Latvia	ruble ^d	May 1992	July 1992	float ^e
Lithuania	talonas ^f	May 1992	October 1992	float ^g
Moldova	leu	June 1992	November 1993	float
Russian Fed.	ruble	n.a.	July 1993 ^h	float
Tajikistan	Tajik ruble ⁱ	n.a.	May 1995	float
Turkmenistan	manat	n.a.	November 1993	de facto peg to U.S. dollar ^j
Ukraine	karbovanets ^k	January 1992	November 1992	float
Uzbekistan	sum ^l	November 1993	January 1994	managed float

Source: IMF staff reports. Some previously published tables, including those in Odling-Smee and Pastor (2002) and Pomfret (2002), give different dates from those in this table. Where they differ, the IMF staff-report sources for this table are as follows: For the absence of a parallel currency to the ruble in Armenia before the introduction of the dram, see the unnumbered technical assistance report, "Armenia: Management of an Independent Currency," December 31, 1993, pp. 2–3. For January 1, 1994, as the effective date that the manat became the sole legal tender in Azerbaijan, see "Azerbaijan Republic—Staff Report for the 1994 Article IV Consultation," SM/94/116 (May 11, 1994), p. 5. For January 1994 as the date that rubles ceased being legal tender in Uzbekistan, see "Republic of Uzbekistan—Staff Report for the 1993 Article IV Consultation," SM/93/259 (December 20, 1993), p. 7. For June 28, 1993, as the date that the lats replaced the Latvian ruble, see "Latvia—Representative Rate for the Lats," EBD/93/127 (July 23, 1993), p. 1.

Note: n.a. = Not applicable.

^aAzerbaijan abandoned the dollar peg in March 1994, pegged briefly to the Russian ruble, and floated the manat at the end of May 1994.

^bConvertibility into rubles was suspended at this time; the rubel officially became the sole legal tender in May 1994.

^cThe coupon (introduced as a temporary currency) was replaced by the lari in October 1995.

^dThe Latvian ruble was replaced by the lats in June 1993.

^eLatvia pegged the lats to the SDR in February 1994.

^fThe talonas was replaced by the litas in June 1993.

^gLithuania established a currency board and pegged to the U.S. dollar in April 1994.

^hSoviet-era rubles were replaced by new Russian ruble notes.

ⁱThe Tajik ruble was replaced by the somoni in October 2000.

^jOfficially classified as a managed float.

^kThe coupon was introduced as a parallel currency in January 1992. The karbovanets was introduced in November 1992 and was replaced by the hryvnia in September 1996.

^lThe sum was first introduced as a coupon and was converted to a regular currency in July 1994.

In the field, staff missions were making this argument country by country.¹⁹ Which option to choose was up to the country authorities, but the Fund was not prepared to do any more than minimal lending until that decision was made. Those discussions are summarized below, in the context of the Fund's overall policy advice to each country.

Much of what has been written about the IMF's policy advice on the ruble area, even by those who were closely involved in the discussions, is at least partially contradicted by the archival record. Contentions range from those that claim the Fund actively opposed and effectively obstructed the dissolution of the area to those that assert the Fund never discouraged countries from leaving it.²⁰

An early report written for the Bank of Finland got the story almost right. The authors noted that, "While the IMF recommended careful consideration to the Baltic countries in early 1992, the Fund was already by early 1993 understood to be pushing such unwilling former Soviet republics as Belarus and Kazakhstan towards the introduction of national currencies as a condition for full-scale financial support" (Lainela and Sutela, 1994, p. 37). This description of the timing of the evolution is accurate, but it overstates the point. As discussed below (pp. 379–80, and 384), the IMF did not "push" these countries, and it did not make a specific outcome a condition for any of its lending. Rather, it insisted that each country had to decide whether to introduce its own currency or to find a viable way to manage monetary policy within the area.

In retrospect, the Fund's ambivalence toward the ruble area and its sharp internal divisions on the general policy issue and on advice to individual countries had limited practical consequences. More active support for the establishment of new currencies might have hastened and abetted the process, but probably not substantially. For the most part, as Camdessus had predicted, these countries paid little attention to the Fund's advice on whether to stay in or jump out and were guided primarily by domestic political considerations and by Russia's reluctance to engage in a cooperative system. They did, however, call on the Fund for technical assistance and advice on managing whatever monetary systems they chose.

¹⁹Toward the end of 1992, an overview report to the Executive Board noted that "the staff has recently been recommending that, while making every effort to make the ruble area work effectively, the case for and against the separate currency option should be examined objectively, and preparations to introduce a new currency should be made, at least on a contingency basis"; "Interstate Monetary and Payments Arrangements in the Former Soviet Union," EBS/92/205 (December 8, 1992), p. ii.

²⁰For examples of the former, see Granville (1995) and Åslund (1995), pp. 111–19. Åslund's assertion (p. 118) that the Fund "resisted every currency reform until each had already been initiated" is particularly wide of the mark. For the opposite view, see Hernandez-Catá (1993), p. 54n, and (1994), p. 7n; and Odling-Smee and Pastor (2002). The 2002 paper by Odling-Smee and Pastor, originally circulated as an IMF Working Paper a year earlier, claimed that the Fund's position was neutral and was limited to explaining the pros and cons of leaving the area. That provoked Åslund (2002) and several other critical responses that were published along with it. Also see footnote 31, below.

Even if the IMF's advice on this issue was not decisive, whether the IMF's analysis of the ruble area was sound remains an important question. The staff certainly got it right in insisting a country needed to develop the ability and the will to manage its own currency better than the central authority before it broke away. The chief difficulty in that regard lay in guessing at Russia's level of success at stabilizing its own policies.²¹ In hindsight, it appears that those who argued initially for delay underestimated three risks: the risk that preserving the ruble area would weaken the incentive for countries to reform their economies and move forward, the risk that the absence of a regional fiscal authority would undermine monetary stability and lead to rampant inflation, and the risk that Russia would refuse to support a cooperative federal system for controlling the currency supply. Nonetheless, even if everyone understood that relying on Russia to anchor regional monetary policy was not ideal, it was reasonable to conclude at the time that monetary independence at the outset of an arduous transition process would be dangerously risky for many of these newly emerging countries.

The Managing Director certainly got it right in his assessment that political rather than financial concerns would likely predominate in the decision process. Here, the difficulty lay in guessing at the extent of Russia's willingness to serve regional interests when doing so would be expensive. And the biggest difficulty may have arisen because the staff judged correctly that the issues were multifaceted, that either option was risky and success was uncertain, and that the balance of risks was different for each country. Consequently, the Fund conveyed a complex message that convinced many of the authorities the Fund did not want them to strike out on their own.

What destroyed the ruble area? The failure had many fathers. Three distinct factors stand out.²² First, as discussed in Chapter 7, Russian monetary policy in 1992 was poorly managed. Without a clearly communicated and effectively implemented policy by the dominant central bank, the other countries quickly lost confidence in the system. Second, several countries took advantage of the lack of central control to draw excessively on the CBR to finance their own inflationary policies. As noted above, this inflationary bias imposed very heavy costs on Russia, whose government soon wearied of supporting its neighbors in such an unproductive way. Third, and most crucial, Russia's unilateral decision to introduce a new ruble in 1993 manifested its final refusal to share control with the other countries in the area. The technical shortcomings of the ruble area have been well documented in the

²¹An influential paper by Rudiger Dornbusch, first delivered as a lecture in June 1992, examined the lessons from the breakup of the Austro-Hungarian empire for the future of the ruble area. Dornbusch concluded that it "is a quite awful idea to maintain a currency area between sovereign nations based on an *unstable* center currency. . . . A clean break is far better and the sooner it is done, the better" (Dornbusch, 1992, p. 419); the emphasis on "unstable" is in the original.

²²For more detailed discussions, see Wolf (1994); Åslund (1995, Chapter 4); and the symposium published in conjunction with Odling-Smee and Pastor (2002).

literature, but the overriding problem was a lack of political commitment to devise an equitable and effective system based on federal principles rather than central control.

The IMF did not in any sense lead or guide the dissolution of the common currency area, but as the area's weaknesses became apparent, the Fund's policy shifted accordingly. In December 1992, the staff concluded that the "present system cannot continue."²³ From that point on, the Fund's efforts focused on helping countries establish their own currencies, although the specific advice varied depending on the country's progress toward meeting the preconditions.²⁴

The Baltic Countries

The three small countries stacked up on the eastern shore of the Baltic Sea—Estonia to the north, then Latvia and Lithuania—were different from the rest of the Soviet Union for two reasons. First, they had been forcibly annexed into the USSR in 1940 after being occupied by Soviet troops. Much of the international community had never recognized this annexation and had regarded it as illegal. By 1989, even the Soviet government in Moscow was taking steps to grant the region more autonomy. Second, this region had a deeper tradition of democracy and market economics than most of the Soviet Union. Popular sentiment in the Baltic countries strongly favored establishing economic and political ties with western Europe. Inevitably, reforms would take place more quickly and more forcefully here, and these three countries would be a crucible for testing the changes that would come more gradually to the south and east.

In 1992, all three joined the IMF, began borrowing from it and making extensive use of its technical assistance and policy advice, and introduced their own national currencies. Just 12 years later, these three small countries had repaid almost all of their IMF debts and had become fully integrated with the west by joining the European Union (EU) as part of its expansion of May 1, 2004.²⁵

²³"Interstate Monetary and Payments Arrangements in the Former Soviet Union," EBS/92/205 (December 8, 1992), p. ii.

²⁴See, for example, Abrams and Cortés-Douglas (1993), which was "designed as a working document for those involved with currency reforms to help ensure that all the necessary steps are taken before, during, and immediately after a new currency is introduced" (p. iv). Also see Bredenkamp (1993), the aim of which was to "consider the options that might . . . face an FSU country . . . which elects to introduce its own independent currency" (p. 1); and Hernandez-Catá (1993), which sets out the various practical options. In November 1993, after Kazakhstan introduced its own currency, Camdessus issued a news brief that "reiterated" the IMF's support for the practice across the region provided that it was underpinned by appropriate economic policies; see "Camdessus says IMF Supports Introduction of New Currencies in the Former Soviet Union," NB/93/16, November 15, 1993.

²⁵For an overview, see Knöbl and Haas (2003).

The Baltic countries suffered enormous losses of trade and production during their first years of independence, but by 1994 they all were growing again. The issuance of national currencies and the corresponding achievement of financial stability played an important role in this turnaround. Immediately after regaining its independence, Estonia established a currency board arrangement to stabilize its currency. Latvia and Lithuania soon set up similar systems. Advising the authorities and assisting with this process became a key element in the IMF's work in the region.

Estonia

The IMF and Estonia had an unusual but generally positive relationship in the first few years of the country's membership. Instead of encouraging or pushing the authorities to stabilize and reform the economy, the Fund found itself trying to caution them not to move too quickly and to temper their enthusiasm for unfettered markets. The authorities rejected that advice, but the Fund soon came to play a valuable supporting role in one of the world's most radical free-market reform programs.

The economic reform movement in Estonia began in 1987, when a group of economists led by Siim Kallas (then working as a journalist; later to become a senior official and eventually prime minister) published a proposal calling for full economic autonomy from the Soviet Union. When the Soviet Union granted economic sovereignty to the Baltic states in November 1989, Estonia already had done much of the planning and could move rapidly to hold legislative elections, reestablish a central bank, and put the country on a path to independence. Plans to introduce a national currency were set in motion in March 1991. Six months later Estonia gained its political independence with the concurrence of the central government in Moscow.²⁶ Before the end of September 1991, Estonia had become a member of the United Nations, had applied for membership in the Fund, and had received a promise of financial aid from the United States.

The IMF responded quickly to these developments. In the last week of September 1991, the Deputy Managing Director, Richard D. Erb, met with the prime minister, Edgar Savisaar, in Tallinn. A staff visit followed in November, then a full-scale membership mission occurred in January 1992, led by Adalbert Knöbl (Chief of the Baltic Division, EU2). The membership mission coincided with the declaration of an economic emergency—the sudden liberalization of prices in Russia at the beginning of January had immediately destabilized prices in Estonia. That situation brought down the Savisaar government, which was replaced by a transitional coalition government headed by Tiit Vähi. Although it was essentially a caretaker until new elections could be held and a constitution drafted, and although it was to some extent sympathetic to the old central-planning model, Vähi's government pushed ahead with economic

²⁶For more on these developments, see Kukk (1997) and Laar (2002).

reforms. Simultaneously, the IMF proceeded with the formalities of the membership process. Estonia became a member of the IMF on May 26, 1992.

As with the other new states, the newly independent Estonia took control of its own finances as one of its first tasks. The long-standing dream of establishing a national currency would have to be a high priority for whatever government was in power. The IMF initially was cool to that idea, as were the governments of the neighboring Nordic countries, particularly because of the highly unstable state of Estonia's finances while the economy was being buffeted by the uncertainty of developments in Russia. During the January 1992 membership mission, Knöbl strongly advised the authorities to proceed slowly on currency reform until they could make substantial progress on fiscal control, develop a strategy for sustaining trade with the other newly emerging countries, and devise a viable exchange regime.²⁷ As late as May of that year, when Kallas (who had become the central bank governor) was in Washington to sign the Articles of Agreement on behalf of the new member, Camdessus tried to talk him out of taking the risky step of issuing a national currency too early.²⁸ The Fund's economic arguments, however, clashed with Estonia's political ambitions and fell on deaf ears.

To the authorities, the only real issue was the type of currency regime to establish, with the aim of stabilizing the price level as rapidly and as firmly as possible. Because Estonia had set about recovering substantial gold reserves that had been held abroad during the Soviet era, Kallas proposed adhering to the gold standard.²⁹ That idea would have been in conflict with Article IV of the IMF charter, and all the outside experts advising the authorities counseled against it. The IMF staff suggested allowing the new currency, to be known as the kroon, to float long enough to reach an equilibrium level and then pegging the rate. Kallas thought the scheme too complicated to be understood by the populace, and rejected the idea.

In April 1992, as debate about these options continued, Harvard Professor Jeffrey Sachs and his colleague Ardo Hansson arrived in Tallinn to offer independent advice. (Hansson was an American whose parents were Estonian. He had studied under Sachs at Harvard and later would become an advisor to the prime minister.) Drawing on the initial success of the contemporaneous Argentine stabilization program (Chapter 9),

²⁷See memorandum from David Burton (Advisor, Exchange and Trade Relations Department) and Adalbert Knöbl to the Managing Director, "Estonia—Meeting of the Monetary Reform Committee," January 13, 1992; IMF archives, OMD-AD, Accession 1996-0187-0002. Also see Knöbl, Sutt, and Zavoico (2002), p. 8.

²⁸Memorandum from Eduard Brau (Deputy Director, EU2) to the Managing Director, "Estonia—Lunch with Governor Kallas: May 26," May 21, 1992. Also see letter from Richard D. Erb (as Acting Managing Director) to Prime Minister Vahi, May 7, 1992. Both items are in IMF archives, OMD-AD, Accession 1996-0187-0002. Additional details are from interviews.

²⁹On the sources of the gold reserves, see Bennett (1993), p. 462.

they recommended that Estonia set up a currency board.³⁰ Kallas liked that idea because it was closely akin to his preference for a gold standard. A currency board would insulate monetary policy from pressures to help finance government spending, ensure stability against the key western European currencies, and be easy to explain publicly. Knöbl, in Tallinn at the time with a staff team, told Kallas the IMF could support this proposal, though he warned it could work only if the government got fiscal policy under control.³¹

Kallas decided to adopt the basic thrust of the currency board proposal without abandoning the traditional role of a central bank in overseeing the currency and the banking system. That setup made the regime more like a conventional exchange rate peg, though with a stronger commitment mechanism. (The exchange rate could be changed only by an act of parliament.) In this respect, it was quite similar to the Argentine system. The critical element, though, was that the central bank would be required formally to limit the monetary base to the size of the official foreign exchange and gold reserves.³² Kallas also accepted the advice of the IMF to delay the reform by a month, to allow time for implementation of supporting policies.

On June 20, 1992, less than four weeks after joining the IMF and not even nine months after gaining independence, Estonia began withdrawing rubles from circulation and replacing them with krooni, the first national currency to be established in a country of the former Soviet Union. Residents could obtain currency at a fixed rate of 1 kroon

³⁰Several months earlier, Lars Jonung (professor of economics at the University of Stockholm) had proposed that Estonia establish a currency board jointly with the Swedish government. Under that scheme, which was quite different from the one finally adopted, Sweden would have donated a sum of its own currency to serve as Estonia's stock of reserves and as backing for the monetary base. The kroon would have been pegged to the Swedish krona, and Russian rubles would have circulated alongside the kroon as a parallel currency with a floating exchange rate; see Hanke, Jonung, and Schuler (1992).

³¹Hansson and Sachs (1992) noted correctly that the IMF "tried at first to delay the introduction of" the kroon, but they exaggerated in asserting that the Fund argued "that the currency should be introduced late in 1992, or in 1993" (p. 2). In response, Odling-Smee (1992) called that description a "travesty" and implied that the Fund had not tried to delay the reform. His characterization was that the staff had "explained what was involved and that certain key elements would need to be in place to improve the chances for success" (p. 9). In fact, the April 1992 staff mission told the authorities that the Fund would not support the reform except as one component of a "broader stabilization program," that Kallas's proposal to introduce the currency in the second half of May was not feasible from that perspective, and that the earliest the Fund could offer its support would be late in June; memorandum from Knöbl to the Managing Director, "Estonia: Preliminary Policy Discussions—Back-to-Office Report," April 16, 1992; IMF archives, OMD-AD, Accession 1996-0187-0002. Also see Hansson (1993); and Knöbl, Sutt, and Zavoico (2002), pp. 11–12.

³²Because it would take some time to repatriate reserve assets from the various countries holding them, the government took the unorthodox step of transferring control of certain parts of the national forests temporarily to the Bank of Estonia. For the next few years, the commercial value of those timber resources thus supplemented the central bank's reserves and helped build confidence in the stability of the currency. Fortunately, the efficacy of this unique "timber standard" was never tested, and in 1997 full control over the forests returned to the government.

per 10 rubles, and the kroon could be exchanged freely for other currencies at a fixed rate of 8 krooni per deutsche mark. These ratios corresponded roughly to the prevailing market rate (about 80 rubles to the mark) and satisfied Kallas's penchant for simplicity.

To this point, the IMF had played a mostly reactive supporting role on the currency issue. The authorities had followed their own course rather than taking much of the Fund's advice. Now they had to get the economy onto a path of sustainable growth. In this task, too, they would find themselves out in front of the Fund with regard to their determination to implement strong and sustainable macroeconomic policies and to reform the economy.

When currency speculation by domestic banks led to a crisis that wiped out some 40 percent of the money supply in December 1992, the government—now led by Mart Laar, as firm an advocate of free markets as could be found anywhere in the world—rejected advice to bail out the banks and their depositors. Instead, the government simply let the banks fail. A few months later, it instituted a flat tax on individual and corporate incomes, rejecting advice that the system would generate insufficient revenues. As soon as the Fund staff saw that these policies were working, they got in step and provided technical assistance on implementation. On other policies, such as the critical decision to open up trade and finance fully to international competition, the staff and the authorities were more in tune from the beginning.

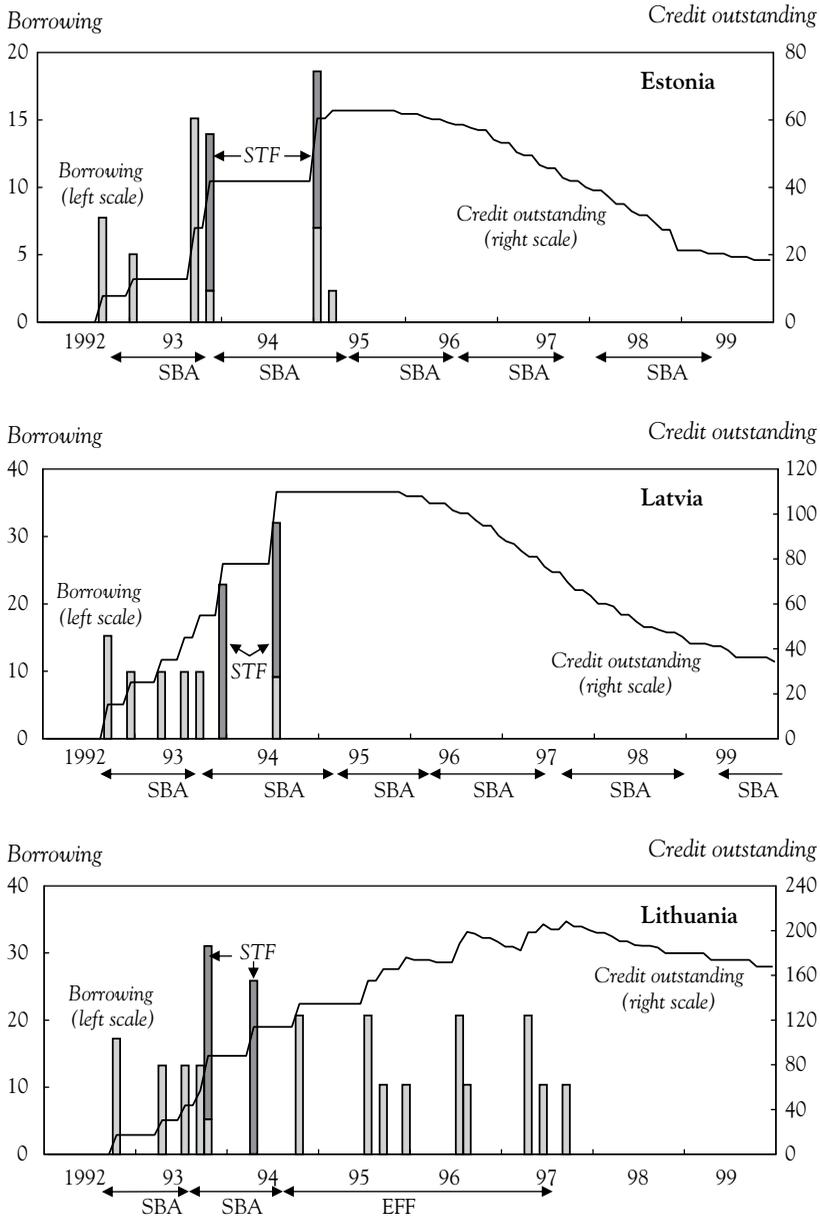
Throughout the decade, Estonia needed the Fund primarily for its seal of approval for the actions the authorities decided to take. Over a period of two and a half years beginning in September 1992, Estonia borrowed about \$90 million from the IMF (SDR 62.8 million, or 135 percent of quota), through two stand-by arrangements and two drawings on the Systemic Transformation Facility (STF) (Figure 8.1). Estonia used that money only to bolster its reserves. The authorities ran the currency board arrangement skillfully and even managed to balance the government budget while restoring growth in real GDP. After those initial arrangements expired, Estonia had no further need to borrow, but it did request and obtain four more stand-by arrangements on a precautionary basis, which the Fund readily approved. The Fund's continuing support helped Estonia weather a stock market bubble that burst in the last quarter of 1997 and the Russian financial crisis that hit a few months later.

Latvia

Beginning in 1987, Latvia developed an even more aggressive pro-independence movement than that in Estonia. On May 4, 1990, the newly elected parliament unilaterally declared the country's independence from the Soviet Union. The United Nations admitted Latvia as a member on September 19, 1991, and the government applied for IMF membership the same day.

From the outset, the Fund approved Latvia's plan to introduce a national currency, but the staff advised the authorities first to establish a proper central bank and a functioning system of private banks. The need to cope with a severe shortage of ruble banknotes from Russia soon overtook this cautious approach. A real central bank

Figure 8.1. Baltic Countries: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
 Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

quickly took form, led by Einars Repše—a 30-year-old physics graduate who had taught himself economics by reading Paul Samuelson’s elementary textbook. With the conviction of the revolutionary, Repše decided that this was all the economics he needed to convert Latvia to a western monetary system. By the time the country joined the IMF in May 1992, the new and independent Bank of Latvia had already taken the risky and potentially calamitous step of circulating Latvian rubles in parallel with those from Russia (freely exchangeable at par).

The gamble paid off, owing to two supporting measures. First, with technical assistance and policy advice from the IMF, the government maintained fiscal discipline and established a tax system capable of generating adequate revenues. Second, the repatriation of gold that had been held by western central banks provided Repše with enough reserves to completely back the currency he was putting into circulation. Although not formally a currency board arrangement, it was based on the same level of discipline. Against all expectations, the Latvian ruble was rapidly accepted throughout the country, and foreign exchange reserves increased further.

Two months later, the authorities abandoned the peg against the Russian ruble, declared the Latvian ruble to be the sole legal tender, and let the exchange rate float. Though still worried about the infant central bank’s capacity to run a stable monetary policy, the IMF endorsed these actions and viewed them as key steps toward establishing a market economy.³³

Latvia entered into six stand-by arrangements with the IMF in the 1990s, but all of its borrowing occurred in the first two years (Figure 8.1). The first arrangement, approved in September 1992, came at a time when output was falling sharply. Latvia was suffering severely from the disruptions caused by the collapse of both the ruble area and the Soviet-era trade arrangements, known as the Council for Mutual Economic Assistance (CMEA). That first stand-by arrangement, for \$80 million (SDR 54.9 million, or 90 percent of quota), was fully used to help build the central bank’s foreign exchange reserves. The Fund approved a second stand-by arrangement in December 1993, for \$32 million (SDR 22.9 million, or 25 percent of quota), along with an STF drawing of the same amount. As domestic output continued to fall, Latvia made the first two drawings on the stand-by arrangement plus a second STF drawing. By then the economy was beginning to grow and foreign capital was beginning to return.

³³The March 1992 premembership economic report noted that although “monetary policy will have to be coordinated with that of the ruble zone in the immediate future, it would become a key element in macroeconomic policy in 1992 if the authorities were to introduce a Latvian currency.” Five months later, when Latvia requested its first loan from the Fund, the staff concluded approvingly that the introduction of a national currency had “created the necessary conditions for the pursuit of an independent monetary policy,” but it warned of “considerable uncertainty concerning the proper stance of monetary policy in the current circumstances.” See “Latvia—Pre-Membership Economic Review,” SM/92/46 (March 6, 1992), p. 9; and “Latvia—Request for Stand-By Arrangement,” EBS/92/131, Suppl. 1 (August 24, 1992), p. 19.

To preserve the country's credibility with foreign investors, the authorities obtained four more stand-by arrangements throughout the rest of the decade, announcing in each case that they intended not to borrow any of the money. As the economy continued to grow and the lats (the successor to the Latvian ruble) continued to appreciate, the authorities were able to stabilize further by pegging the currency to the SDR in 1994 and then to the euro in 2005. Latvia repaid its IMF loans on schedule, completing the cycle in 2004, the same year that it joined the EU.

Lithuania

Lithuania began openly seeking independence in June 1988, and it declared its sovereignty unilaterally in March 1990. The Soviet Union objected and imposed an economic blockade, which forced the government to back off and enter into negotiations. As with the other two Baltic countries, the real dawn came in the wake of the aborted coup against Gorbachev in August 1991, which induced the weakened government in Moscow to grant independence. Lithuania became a member of the UN in September and immediately applied for IMF membership.

The staff (led by Knöbl) held intensive policy discussions with the Lithuanian authorities in February 1992, covering a wide range of issues on the transition to a market economy: procedures for privatizing enterprises and housing, liberalization of the few remaining controlled prices, using incomes policies to stop the wage-price spiral the initial liberalization had started, loosening fiscal policy in reaction to the sharp decline in output and employment, determining when to introduce a national currency, preserving trade with the other republics, and retaining a social safety net while eliminating wasteful subsidies.³⁴ Separately, several staff missions spent considerable time in Vilnius providing technical assistance on central banking, fiscal, statistical, and general macroeconomic issues. All of this early advice from the IMF was given in the context of an extremely bleak economic situation, in which trade and output were collapsing while prices were rising rapidly in response to the end of central controls.

Even before they applied to join the IMF, the Lithuanian authorities had committed themselves to leaving the ruble area as quickly as possible. By the time the first IMF staff mission arrived in Vilnius in November 1991, the central bank was already taking delivery of new banknotes that had been printed in the United States. Knöbl nonetheless urged them to go slowly down this road. While the Lithuanians were worried about importing monetary instability from Russia, the Fund was more concerned about whether Lithuania had the technical expertise it would need to stabilize on its own. When Knöbl and his team arrived in February 1992, the authorities agreed to wait until they could devise a stabilization program the Fund could support. A month later, the Executive Board reinforced this advice, concluding “that the introduction of a

³⁴For a detailed report on the Fund's advice on these issues, see “Lithuania—Pre-Membership Economic Review,” SM/92/60 (March 13, 1992), pp. 9–15.

separate currency without adequate preparation to exercise financial control would be premature and would not by itself stabilize prices and the economy.”³⁵

As soon as negotiations began on the terms for IMF financial support, the emphasis shifted toward creating the necessary conditions for successful introduction of the new currency. On May 1, 1992, the authorities began issuing coupons, known as the talonas, to circulate as legal tender alongside the ruble. That gave the central bank some experience at managing currency, while the Fund sent a team of specialists to offer technical assistance. When rubles began to pour into the country from Ukraine and elsewhere, the authorities reacted forcefully by declaring on September 23 that the ruble would cease to be legal tender in Lithuania as of October 1. The Fund supported that move, and on October 21 the Executive Board approved Lithuania’s first use of Fund resources.

Lithuania borrowed steadily from the IMF for the next five years, with peak indebtedness of \$295 million (SDR 208.2 million, or 201 percent of quota) reached in September 1997 (Figure 8.1). Although the Fund interrupted disbursements for a time in 1994 owing to fiscal excesses, it generally pronounced itself satisfied with the implementation of policies. A key early development in the stabilization of the Lithuanian economy was the April 1993 decision by Adolfas Šleževičius—newly appointed as prime minister—to limit wage increases to a rate below that of price inflation. Knöbl’s mission team had just arrived in Vilnius when the prime minister announced his intention to allow a 40 percent increase. After discussions with the mission, he scaled the increase back to 15 percent. That decision kept the program on track and quickly reduced the rate of consumer price inflation.³⁶

The first stand-by arrangement was fully drawn on schedule, enabling the economy to stabilize enough for the authorities to introduce a national currency, the litas, in June 1993. Soon afterward, however, the government was besieged by opposition pressures to ease up on monetary policy. To counter that pressure, the authorities decided to switch from a floating exchange rate to a currency board arrangement and use it to peg the value of the litas firmly to the U.S. dollar. The staff strongly supported this move, calling it “a momentous step toward achieving lasting financial stability.”³⁷

The currency board took effect in April 1994, after which confidence returned and the economy stabilized and began to grow. That fall, the Fund replaced the stand-by arrangement with a larger three-year extended arrangement, which was well implemented and fully used despite the setbacks from a major banking crisis at the end of 1995. The expiration of that arrangement in 1997 brought Lithuania’s borrowing to a close, but the IMF continued to provide a large and varied amount of technical assistance.³⁸ From 1992 through the end of the decade, the Fund sent a stream of staff

³⁵Minutes of EBM/92/41, p. 14.

³⁶See “Lithuania—Review Under the Stand-By Arrangement,” EBS/93/86 (June 7, 1993).

³⁷EBS/94/60 (March 23, 1994), p. 18.

³⁸Lithuania had two subsequent stand-by arrangements, approved in 2000 and 2001, but those arrangements were precautionary, and no drawings were made on them.

missions to advise on central banking, fiscal administration, and statistics. In addition, the Fund helped train a great many officials through courses offered in Washington and Vienna, and it temporarily placed resident advisors at the Bank of Lithuania and the ministry of finance.

Like its two northern neighbors on the Baltic Sea, Lithuania enjoyed good economic performance throughout much of the second half of the 1990s, interrupted by the effects of the Russian crisis of 1998. That setback, however, did not force Lithuania to resume borrowing from the IMF, and the economy soon got back on its growth path.

Other Middle-Income Countries

Four other countries that emerged from the breakup of the Soviet Union were classified as middle income: Belarus, Kazakhstan, Turkmenistan, and Ukraine. Turkmenistan had no need for IMF financing, but each of the other three had at least one stand-by arrangement in the first few years of their membership in the IMF. Ukraine—easily the largest economy in the region aside from Russia—borrowed almost continuously from 1994 through 2002.

Ukraine

In important respects, Ukraine embarked upon independence in the most precarious situation of all the countries of the former Soviet Union. It had been pressured to accept the “zero-option” agreement, under which Russia assumed responsibility for all Soviet debt and took ownership of all external assets. That left Ukraine largely free of debt but with no liquid reserves. Ukraine had none of the essential institutional structure for running a market economy, nor any relevant national history upon which it could draw. Under the Soviet system, Ukraine’s industry had been developed with the primary aim of exporting industrial and military goods to Russia. Agriculture was totally collectivized, and all land was owned by the state. As for finance, monetary control had been centralized in Moscow. A splendid building in central Kyiv housed the Ukraine’s branch of the Soviet Gosbank, but its staff had no responsibility for, nor training in, the policy functions of a central bank.

In addition to having no resources and no usable training, Ukraine had few friends willing and able to help it. To the east, Russians were not ready to forgive Ukraine for its strong and early insistence on independence, and their resentments and suspicions drew on a long history of disputed borders and strained relations. In practical terms, the economic size and political importance of Ukraine—independent and possessing nuclear weapons—posed challenges that Russia could not afford to ignore. To the west, the U.S. government had made no secret of its preference for a modernized and less centralized Soviet Union rather than full dissolution into a balkanized region. In the

midst of Ukraine's drive for independence in August 1991, President George H.W. Bush went to Kyiv to address the Ukrainian parliament. Implicitly, he urged them to reconsider the course on which they had embarked. Better, he suggested, to continue to develop democracy gradually within a less centralized Soviet Union than to insist upon independence for its own sake.³⁹ Three weeks later, the attempted coup in Moscow rendered that option moot, but the memory of the *defi american* persisted.

Into the IMF, Out of the Ruble

Despite the obstacles, Ukrainians were determined to chart their own course. The parliament first declared the country's sovereignty in July 1990. Ukraine then continued as a Soviet republic, but on August 24, 1991, it unilaterally declared independence. One of its first acts as an independent state (though it was not yet recognized as such) was to enter into a secret arrangement with a Canadian firm to print banknotes for a Ukrainian currency, to be known as the hryvnia. The authorities in Moscow learned of it quickly, but they were powerless to stop Ukraine from having the new notes printed in 1992 and shipped to Kyiv. The currency was hidden away until such time as the government would feel ready to put it into circulation. In the euphoria of independence, replacing the ruble with the hryvnia would provide a powerful symbol of statehood.

Although the staff knew about the banknotes,⁴⁰ the Fund's official position was that Ukraine should continue to use the ruble as its currency until it had established a well-functioning financial system backed up by stable macroeconomic policies. A "prediagnostic" mission in November 1991, led by Jean Godeaux (a former governor of the National Bank of Belgium) and staffed by the Fund's Central Banking and Legal Departments and by western central banks and the World Bank, concluded that "the sharing of a common currency is desirable at least during a transitional period."⁴¹ A few weeks later, Deputy Managing Director Erb was in Kyiv, where he met with the newly elected president, Leonid Kravchuk, and other senior officials. When told that Ukraine intended to issue the hryvnia as soon as the Canadians could finish printing the banknotes, Erb expressed skepticism and tried to dissuade them.⁴²

Kravchuk soon submitted an application for membership, and the IMF sent a staff mission—led by Peter C. Hole (Assistant Director, European Department)—to gather

³⁹Remarks to the Supreme Soviet of the Republic of Ukraine in Kiev, Soviet Union," August 1, 1981; Public Papers, George Bush Presidential Library and Museum; accessed at http://bushlibrary.tamu.edu/research/public_papers.php?id=3267&year=1991&month=8.

⁴⁰In September 1991, Thomas Dawson (United States) learned about the Canadian printing contract while on a visit to the Soviet Union with the secretary of the U.S. Treasury. He reported the information to the Executive Board on his return; see minutes of EBM/91/132 (September 25, 1991), p. 17.

⁴¹Unnumbered technical assistance report, "Ukraine – Monetary and Supporting Central Banking Reforms: Preliminary Findings and Recommendations, and Future Technical Assistance – Aide Memoire," December 1991.

⁴²Minutes of EBM/91/171 (December 20, 1991), pp. 4 and 7.

information and hold preliminary policy discussions. Hole was dismayed to find a largely dysfunctional economy, with no real data and no officials with any understanding of market economics. The government did not yet have its new banknotes, and it was facing a severe shortage of cash rubles. It was issuing coupons as a kind of scrip, which served as legal tender alongside rubles. The staff worried that this practice would just free up hoarded rubles to flood the neighboring ruble-area countries. Although the parallel-currency scheme was “badly flawed,” Hole recommended that it be continued for the time being but with strict limits on supply.⁴³ That was followed almost immediately by a mission from the Central Banking Department, which concluded that the authorities had a “formidable task” ahead to convert its branch of the Gosbank into a true central bank. That transformation would be “an essential precondition for a successful currency issue and monetary reform.”⁴⁴ (Emphasis in the original.)

Events soon overtook this analytical model. In Moscow, the Russian parliament voted on March 24, 1992, to force Ukraine out of the ruble area. Russia’s concern was that Ukraine was abusing the system by drawing excessively on Gosbank credits and flooding itself and its neighbors with rubles. Although Russia’s preemptive act was in accord with Ukraine’s own desire for monetary independence, it forced the government’s hand when the newly established National Bank of Ukraine (NBU) was still completely unprepared to take over responsibility for monetary control.

After several months of trying to cope with the temporary ruble-plus-coupon system, Ukraine formally abandoned the ruble in November 1992. Although the government had already stockpiled its new banknotes, it decided to keep them in storage until the NBU had gained more experience managing a monetary system. Instead, it issued an interim currency, called the karbovanets (the term commonly used for the ruble in Ukrainian). This move gave Ukraine a measure of financial independence, but the effort foundered because the authorities failed to take action to stabilize the currency with sound macroeconomic policies. As one official described the situation in an interview for this book, “we made all possible mistakes.” As a result, inflation became rampant, reaching 10,000 percent in 1993. Tax evasion, expenditure overruns, and monetary financing prevailed. Two years passed before policies and the economy stabilized enough for the Fund to start lending. In that time, output in Ukraine fell to a level not much above half of the estimated preindependence level.⁴⁵

⁴³“Ukraine—Pre-Membership Economic Review,” SM/92/40 (February 28, 1992), pp. 24 and 30. For a description of how the coupon system worked in this initial stage, see SM/92/40, Suppl. 1 (March 5, 1992), pp. 14–15.

⁴⁴Unnumbered technical assistance report, “Ukraine – National Bank of Ukraine: Preparation for Currency Issue / Monetary Reform and Related Institution Building,” April 1992.

⁴⁵These inflation and output figures are IMF staff estimates; see “Ukraine—Staff Report for the 1994 Article IV Consultation and Request for a Purchase Under the Systemic Transformation Facility,” EBS/94/203 (October 19, 1994), p. 24.

First Steps Toward Reform

By mid-1994, Ukraine's economic decline was so deep that the Kravchuk government could no longer survive. To drive home the importance of policy reform with a sizeable carrot, the communiqué of the G7 summit in Naples, Italy—issued just 10 days before elections were scheduled to take place in Ukraine—offered financial assistance of up to \$4 billion via the IMF, the World Bank, and the EBRD, but only “following the commencement of genuine reforms.” In short order, Kravchuk lost the July 19 election to Leonid Kuchma, who had served as prime minister since 1992. Before the month was over, Camdessus responded to an invitation from Kuchma by going to Kyiv to meet with him.⁴⁶ Over dinner with the president, Camdessus stressed the need for specific economic reforms and offered the Fund's help in designing and financing them.

Kuchma was determined to make a real break with the economic mismanagement of the preceding regime. Camdessus, impressed by Kuchma's resolve, sent a staff mission, again led by Hole, to Kyiv in mid-August to negotiate terms for an STF loan. The team stayed for nearly six weeks and negotiated an unusually detailed and comprehensive program for an STF arrangement. The STF had been designed to accommodate countries in the early stages of economic transformation. The staff report for Ukraine acknowledged that the program, while impressively “comprehensive, coherent, and strong,” was probably overly ambitious. The government was unlikely to be able to carry it out in full. Nonetheless, the staff recognized a genuine commitment by the government that merited support from the IMF.⁴⁷

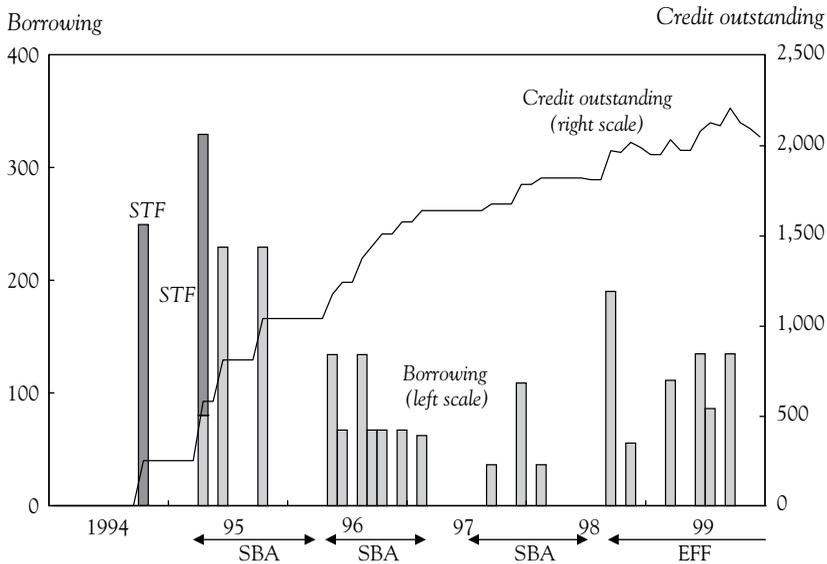
On October 11, 1994, Kuchma launched the program with a speech to parliament that outlined a path toward “radical economic reform.” Parliament approved the key points the next day, and international support followed quickly. Fischer hosted a meeting of bilateral donors at the IMF on October 18, which generated enough financing assurances to enable the Fund to approve immediate disbursement of an STF loan for \$365 million (SDR 249.3 million, or 25 percent of quota).

The Fund's confidence in the government was justified. The authorities met almost all of their commitments over the next several months. Macroeconomic performance, however, responded very little in the short run. Ukraine still had only the merest rudiments of a market economy, and both the authorities and the staff recognized that much work remained. The IMF approved a second STF drawing in April 1995, along with a full stand-by arrangement. That combination enabled Ukraine to borrow just over \$1.2 billion (SDR 788 million, or 79 percent of quota) in 1995 (Figure 8.2). By the end of the year, inflation had fallen sharply, but it remained high, and output was

⁴⁶Åslund (2009) pp. 88–89, notes that Camdessus was the first “major international visitor” to Ukraine after Kuchma's election, followed soon afterward by U.S. Vice President Al Gore.

⁴⁷“Ukraine—Staff Report for the 1994 Article IV Consultation and Request for a Purchase Under the Systemic Transformation Facility,” EBS/94/203 (October 19, 1994), pp. 17–19.

Figure 8.2. Ukraine: Use of Fund Credit, 1994–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

continuing to fall. Inevitably, adjustment fatigue was settling in, and program implementation soon faltered.

Reforming the structure of an economy as complex as Ukraine's, and as misdirected as it had been, was testing the abilities of everyone concerned. Reforms that seemed well designed sometimes just did not work in this context. For example, in 1996, the government accepted a staff recommendation to abolish a complicated system of quotas and licenses for exporting grain, despite misgivings that a surge in grain exports could lead to shortages for domestic consumption. As it happened, many farmers preferred to continue selling grain to the state at relatively low prices rather than to take their chances on an open market they did not understand. This and many other inefficiencies endured throughout the 1990s, delaying the return of economic growth.⁴⁸

Events in 1996 brought some relief. A second IMF stand-by arrangement, approved in May, provided both more reserves (some \$864 million, fully drawn over nine months) and renewed credibility to the reform program. Prices finally stabilized enough that the government could dust off the banknotes it had stored away in 1992 and retire the karbovanets. In September, the NBU introduced the hryvnia as the national

⁴⁸For a detailed examination of this period, see "Kuchma's Stagnation, 1996–99," Chapter 4 of Åslund (2009).

currency, replacing the karbovanets at a rate of 1 hryvnia per 100,000 karbovanets. The new currency traded initially at 1.76 per U.S. dollar, with the NBU intervening to keep the rate within a narrow band. At the same time, most current account exchange controls were abolished, and Ukraine formally accepted the obligations of the Fund's Article VIII. In November, negotiations began on a more comprehensive program for 1997 designed to qualify for EFF support.

This benign period continued through most of 1997, though with no respite from stagnation in output. Despite some slips in fiscal policy, macroeconomic conditions were reasonably stable, but the Fund was not yet satisfied with the government's ability to implement a wide range of structural reforms. In particular, the continued dominance of large and inefficient state-owned enterprises was seen as a substantial barrier to progress. After several months of negotiations in both Kyiv and Washington, the two sides temporarily gave up on formulating a program for EFF support and agreed to enter into another relatively small stand-by arrangement instead. The Executive Board approved that outcome in August, after which talks resumed on a broader structural package.

The Crisis of 1998

The real trouble in Ukraine began late in 1997, when investors began reducing exposure in emerging markets in response to the financial crises in East Asia. At the same time, the Ukrainian government was trying to shore up support at home as the March date for parliamentary elections approached. Implementation of the Fund-supported program lapsed, negotiations stalled, and the staff became increasingly disillusioned. By this time, according to a later staff summary, Ukraine was "stuck in an under-reform trap, with constrained growth dynamics, an expanding shadow economy, and a pervasive non-payment culture."⁴⁹

A window of opportunity opened in April 1998. As soon as the elections concluded, Kuchma signaled his commitment to get the reform program back on track. A staff mission, led by Mohammad Shadman-Valavi (Assistant Director, EU2), succeeded in getting agreement on "most elements" of a program sufficiently strong to warrant sizeable EFF support from the Fund.⁵⁰ News of this progress, which persuaded major private creditors to put aside their fears of an economic collapse, temporarily reduced the external pressure on the exchange rate.⁵¹

⁴⁹"Ukraine—Ex Post Assessment of Longer-Term Program Engagement," October 18, 1995, p. 4; accessed at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=18717.0>.

⁵⁰Memorandum from Odling-Smee to the Managing Director, "Ukraine—Outcome of the Mission," April 21, 1998; IMF archives, OMD-ND, Accession 2001-0206-0001, Box 22107.

⁵¹In May, the G7 issued an ambiguously cautious communiqué stating that the summit leaders "look forward to the Ukrainian government and parliament taking the steps necessary to agree on an [EFF arrangement] with the IMF"; "G7 Chairman's Statement," released at the Birmingham G8 summit, May 15, 1998; accessed at <http://www.g8.utoronto.ca/summit/1998birmingham/chair.htm>. Around this time, creditors reportedly began referring to Ukraine as a possible "moral hazard play," meaning that one could take large risks in the expectation that the Fund or G7 governments would bail them out; see Blustein (2001), pp. 246–47.

Three difficulties stood in the way of early approval of the proposed loan. First, parliament was reluctant to enact the more than 40 proposed laws giving force to the fiscal and structural changes the president and his ministers had approved. As in Russia, the Ukrainian constitution gave the president the right to issue decrees, but parliament had the right to review and possibly overturn them. Kuchma fully supported the program and was already issuing the necessary decrees, but the Fund had no assurance that they would hold for longer than the 30-day parliamentary review period. Not until late July did the staff receive confidential written assurances that the decrees were legal and that parliament would not object to them.⁵²

Second, the central bank, in trying to hold the exchange rate within the announced band against the U.S. dollar, was beginning to run short of reserves. Fischer was sympathetic to the notion that a devaluation or a free float would ruin many of Ukraine's banks, but by August it was getting harder to stave off the inevitable. The more widely held view on the staff was that the NBU should stop intervening altogether, but the authorities insisted on hanging on as long as possible.⁵³

Third, the Fund needed assurances that private foreign creditors would not take advantage of an influx of official financing as an opportunity to take their profits and pull out their own money. Three large investment banks, two based in the United States and one in Japan, held the majority of Ukraine's official debts to nonresidents. Ukraine's intensive talks with all three, some involving IMF officials, continued throughout July and early August with little progress. Surmounting this stalemate was especially important because the Fund had specified the financing assurances as required prior actions before the Managing Director would schedule a Board meeting to consider the arrangement. By the second week in August, when the authorities submitted a Letter of Intent to the Fund, the staff was optimistic enough about cooperation from creditors that management set and announced a tentative Board date of August 26.⁵⁴

The Russian default on August 17 (see Chapter 7) upended this timetable and created a financial crisis. Pressure on the hryvnia intensified immediately, leaving the authorities with very little time to secure official support to stave off a ruinous currency collapse. Fortunately, by that time Kuchma's decrees had found solid legal footing and

⁵²The gist of these letters was explained to the Executive Board by Shadman-Valavi at EBM/98/94 (September 4, 1998), p. 96.

⁵³For an internal exchange of views on exchange rate policy, see memorandum from Odling-Smee to the Acting Managing Director (Fischer), "Ukraine—Draft Briefing Memorandum for Staff Visit," July 16, 1998, with Fischer's handwritten reply dated July 21; and memorandum from Jorge Márquez-Ruarte (Deputy Director, EU2) to the Acting Managing Director, "Ukraine—Towards an Early Resolution and Other Matters," July 22, 1998; IMF archives, OMD-ND, Accession 2001-0206-0001, Box 22107.

⁵⁴With the consent of the authorities, the Fund published the detailed program on its website, and it ran an upbeat story in its biweekly newsletter; see "Ukraine: Memorandum of Economic Policies," at <http://www.imf.org/external/np/loi/081198.htm>; and "IMF Mission Reaches Tentative Agreement on Stabilization, Structural Program for Ukraine," *IMF Survey*, Vol. 27, No. 16 (August 17, 1998), p. 253.

were succeeding in stabilizing the government's own finances. Unfortunately, the willingness of the three main private creditor banks to agree to a voluntary rollover or to new lending had plummeted. In the aftermath of the Russian default, G7 finance officials adamantly insisted that the Fund not resume lending to Ukraine without firm commitments from those creditors. Although arguably a necessary precaution, that position effectively put the Fund and the authorities at the mercy of the banks.

The August 26 Board meeting was no longer possible. Discussions were deadlocked throughout the second half of August, by which time Ukraine's financial situation was truly desperate. Camdessus was as fully engaged as he could be while simultaneously trying to contain the crisis in Russia and the spread of contagion elsewhere. He met with Kuchma in Crimea on August 26 in the margins of his meeting with the Russian leader, Viktor Chernomyrdin (Chapter 7, p. 338), and the two spoke several times by telephone over the next few days, but he was not yet willing to ask the Board to approve the EFF arrangement without financing commitments from the banks. Success on that front depended in turn on what happened next in Russia. If Russia descended into "chaos," which was still a real possibility in late August, then Ukraine had no hope of restoring financial stability.⁵⁵

The rapid dwindling of Ukraine's foreign exchange reserves became the prevailing issue. The central bank governor (and future president), Victor Yushchenko, signaled his willingness to devalue and widen the band on the exchange rate, but not before IMF approval of the arrangement. Otherwise, he feared, investor panic would quickly ensue. If the Executive Board did not meet by Friday, September 4, this plan would collapse for lack of reserves. The Fund's major shareholders, however, were unwilling to go along. As late as September 1, the internal debate still raged at the Fund on whether to act quickly or wait for support to gel.

Intervention by the French president, Jacques Chirac, finally broke the impasse. When Chirac went to Kyiv on September 2 to discuss plans for nuclear cooperation, Kuchma took the opportunity to plead with him to intervene with Camdessus for a quick decision on the EFF arrangement. Chirac reportedly called Camdessus right away.⁵⁶ Whether that call swayed Camdessus is impossible to judge, but at the very least it signaled a split among creditor countries that made a request to the Executive Board more likely to succeed.

In a highly unusual acceleration of normal procedures, Camdessus agreed on Thursday September 3 to schedule the Board meeting for the next day. In Kyiv, also on the third, Shadman-Valavi and the authorities agreed on revisions to the program, including a plan to try to stabilize the exchange rate by devaluing and widening the band.

⁵⁵See the Managing Director's report to the Executive Board at EBM/98/90 (August 28, 1998), p. 5.

⁵⁶Upon arriving in Moldova on September 4, Chirac told reporters that he had spoken with Camdessus by telephone to argue the case for early approval of Ukraine's program; see "French President Chirac given warm welcome in Moldova," Agence France-Presse, September 4, 1998; accessed at <http://global.factiva.com>.

If the exchange rate failed to steady, they agreed, then it would be allowed to float after a few weeks. Within hours, the revised documents were cleared by Fischer in Washington and were circulated to Executive Directors for the Friday meeting.

Although negotiations with two of the main creditor banks had not yet concluded,⁵⁷ the EFF arrangement was written so as not to allow any leeway in those talks. Any repayment of principal would constitute a violation of the arrangement that could prevent Ukraine from drawing on it after the initial disbursement. That provision satisfied most Directors, although many of them still viewed approval as a highly risky gamble, one that Jean-Claude Milleron (France) frankly called “kind of a bet,” but “a bet worth making.” Roberto F. Cippà (Switzerland) abstained from voting because the Swiss authorities (though not Poland, the other large country in his constituency) objected to lending without solid financing assurances, especially in the absence of broad political support within the borrowing country. The Swiss judgment was that “the chances of success . . . are too small to risk another blow to the credibility” of the IMF. With that one exception, the Board approved the request.⁵⁸

The extended arrangement immediately added \$260 million (SDR 190 million) to the foreign exchange the NBU had at its disposal, and it committed a total of \$2.25 billion (SDR 1,645.55 million, or 165 percent of quota) over the next three years. Drawings on it would be contingent on obtaining the assurances of external financing discussed above, and also on the authorities’ ability to carry out an extensive reform program.⁵⁹

The EFF-supported program in Ukraine was in some respects even more complex than the much-criticized one that Indonesia had undertaken earlier in the year (see Chapter 11). Ukraine’s program included 88 separate measures to be taken by the authorities, with some 150 “sub-measures” serving as additional benchmarks. Completing the program fully in three years would probably have been beyond the capacity of any government, let alone one still at an early stage of administrative and political development and contending with substantial domestic opposition. Some highly specific measures, such as a requirement to eliminate an export tax on sunflower seeds

⁵⁷By this time, the government had repaid the balance due to one of the three major creditors, Nomura, because Nomura was refusing to negotiate. The other two creditors, Merrill Lynch and Chase Manhattan, were unwilling to commit to a rollover but were still discussing the possibility and negotiating terms; see “Ukraine—Request for Extended Arrangement,” EBS/98/144, Suppl. 1 (September 3, 1998), pp. 1 and 5.

⁵⁸Minutes of EBM/98//94 (September 4, 1998), pp. 90–122. Milleron’s remark is on p. 99; Cippà’s statement is on pp. 102–04.

⁵⁹Agreements with Merrill Lynch and Chase Manhattan were concluded in October 1998; see “Ukraine—Extended Arrangement—Financing Assurances Review, and Request for Waivers and Modification of Performance Criteria,” EBS/98/176 (October 22, 1998) and Suppl. 1 (October 27, 1998). For an analysis of Ukraine’s rescheduling agreements, see Sturzenegger and Zettelmeyer (2006), pp. 115–33.

(reminiscent of the demand that Indonesia dismantle its monopoly on clove exports), were widely ridiculed and were subsequently dropped from the program.⁶⁰

Nonetheless, Kuchma's government did a reasonable job of maintaining forward progress. The Fund delayed some disbursements, and the arrangement was extended to four years to give the authorities more time, but much of the job was eventually completed. When the arrangement expired in 2002, Ukraine had used it to borrow nearly \$1.6 billion (SDR 1,193 million), which they repaid gradually over the next several years, once reform finally began bearing the fruits of strong growth.⁶¹

Belarus

Belarus—the third largest economy in the region and one of the wealthiest—had been an industrial center within the Soviet Union, producing a wide range of consumer, industrial, and military goods using raw materials imported primarily from Russia. The breakdown of the union left this specialization in shambles, reduced access to formerly captive export markets, and sharply raised the cost of importing energy and materials. The newly elected government feared that rapid economic liberalization would exacerbate these already severe problems and result in massive unemployment. From this vantage point, maintaining close relations with Russia and preserving as much of the old system as possible during a steady but gradual transition would offer the country the best hope for avoiding a total economic and political breakdown. The Fund, in contrast, feared that this strategy would merely perpetuate stagnation and would seriously delay the country's integration into the world economy. It urged the authorities to move much more quickly to establish a market-oriented system. Tension set in that persisted throughout the rest of the decade.

On gaining independence and joining the IMF, Belarus informed the Fund that it preferred to remain in the ruble area, “but not at any cost.” Staying in would enable Belarus to continue buying oil, gas, and other inputs at highly subsidized ruble prices. If they had to go onto the open market and pay in a hard currency, they would face a massive external deficit with no realistic way to finance it. The authorities worried, however, that instability in neighboring countries might lead to a flood of rubles into Belarus as people sought to buy scarce goods, and they were distressed that Russia insisted on having sole control over the issuance of currency.⁶² As a precaution, they

⁶⁰For a staff analysis, see “Ukraine—Ex Post Assessment of Longer-Term Program Engagement,” October 18, 1995; accessed at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=18717.0>. For a subsequent independent evaluation, see Independent Evaluation Office (2009), pp. 170–79.

⁶¹The global financial crisis of 2008 interrupted this progress and induced the government to obtain a new stand-by arrangement from the Fund.

⁶²See memorandum from the mission chief, Peter C. Hole (Assistant Director, EU2), to the Managing Director, “Belarus—Staff Visit,” August 3, 1992; IMF archives, OMD-AI, Accession 1994-0070-0001, Box 6276.

introduced the Belarusian rubel as a parallel currency with a fixed conversion rate into the ruble. A year later, after Russia demonetized the old rubles, Belarus stopped allowing conversion into rubels. With the ruble area collapsing all around them, the authorities entered into negotiations with Russia to try to establish a monetary union of the two countries, with monetary control to be shared between their central banks. Russia signaled its willingness to share a currency, but only if the CBR had exclusive control over monetary policy. Negotiations broke down, and in May 1994 Belarus declared the rubel to be the sole legal tender within its borders.⁶³

This evolution coincided approximately with the Fund's own growing disillusionment with the ruble area. Throughout the second half of 1992, the staff responded to inquiries from the authorities by stating that the choice of whether and when to introduce a national currency was a "sovereign decision" and that the Fund's lending conditions would be "much the same" in either case. The Fund only wanted a "clear decision" for one option or the other.⁶⁴ By March 1993, the Fund had accepted that the ruble area might be too unstable to survive, and the staff was concerned about the sluggish pace of reforms in Belarus. Consequently, the staff began urging the authorities to move more rapidly to introduce a national currency, but still agreed that either option was acceptable.⁶⁵ As late as June 1993, management approved a mission brief that advised that "Belarus will be encouraged to move quickly to either a separate national currency or a full reintegration in the ruble area. Staff will continue to prefer the first of these two alternatives." Nonetheless, the economic program the staff discussed with the authorities assumed Belarus would continue to use the ruble.⁶⁶ Russia's demonetization of rubles a few weeks later made that option untenable. For the most part, throughout this period the Fund had maintained a neutral stance and had restricted its advice mostly to the technical issues of managing whichever monetary system prevailed.

Lending decisions were more controversial. Belarus asked for a stand-by arrangement immediately after joining the IMF in July 1992, but the Fund responded cautiously and continually pressed the authorities to stabilize and reform the economy

⁶³Discussions between Belarus and Russia on reestablishing a common currency area resumed in the later 1990s; see Gulde, Jafarov, and Prokopenko (2004).

⁶⁴For "sovereign decision," see memorandum from Odling-Smee to the Managing Director, "Belarus—Briefing Paper," October 26, 1992. For "much the same," see memorandum from Peter J. Quirk (Division Chief, Monetary and Exchange Affairs Department) to the Acting Managing Director, "Belarus: Monetary and Exchange Reforms," August 20, 1992. For "clear decision," see memorandum from Hole to the Managing Director, "Belarus—Staff Visit," November 24, 1992. All three documents are in IMF archives, OMD-AI, Accession 1994-0070-0001, Box 6276.

⁶⁵Memorandum from Grant Spencer (Consultant in EU2) to the Managing Director, "Belarus: Back-to-Office Report, Article IV Mission," March 23, 1993; IMF archives, OMD-AI, Accession 1996-0129-0001, Box 8701, file "Byelarus."

⁶⁶See attachment to memorandum from Eduard Brau (Deputy Director, EU2) to the Managing Director, "Belarus—Briefing Paper for STF Negotiations," June 4, 1993; and memorandum from Spencer to the Acting Managing Director, "Belarus—Back to Office Report," June 28, 1993; IMF archives, OMD-AI, Accession 1996-0129-0001, Box 8701, file "Byelarus."

more aggressively. In the summer of 1993, a staff mission headed by Henri R. Lorie (Advisor, EU2) negotiated a 12-month program to be supported by a drawing under the STF. That drawing, for 25 percent of quota (SDR 70.1 million, equivalent to \$98 million), occurred in August. Subsequently, however, the authorities fell short of carrying out the program, especially the structural reforms aimed at shifting from state control to open markets. Lorie and his team returned to Minsk in the spring of 1994 to try to get an agreement on accelerating reform efforts, with only partial success.⁶⁷ Reviewing the situation in July, the Executive Board expressed “deep concern [over] the deterioration in Belarus’s economic performance,” which it attributed primarily to the government’s “wavering commitment to systemic market reforms.” Although the Board acknowledged that Belarus needed help coping with difficult external circumstances, it insisted that further financial assistance be put on hold until the authorities strengthened economic policy.⁶⁸

To this point, Belarus had been governed by a Supreme Soviet elected in 1990 and dominated by the Communist Party. A week before the July 1994 Board meeting, Alexander Lukashenko was elected president by a strong majority, reflecting popular disenchantment with economic performance under the transition government. Two years later, Lukashenko would push through legal reforms giving him authoritarian powers and ultimately allowing him to override the original constitutional limits on the presidential term of office. By the end of the decade, he would become a symbol in western Europe of Belarus’s nostalgia for central control and of its resistance to economic and political integration with the world economy. In July 1994, however, he was viewed as a refreshing replacement for the previous government, and a likely economic reformer. The Executive Director representing Belarus, Willy Kiekens (Belgium), told his colleagues that Lukashenko and his government “were fully aware that further delay in implementing a strong program would be only a recipe for disaster.” Speaking for the staff, Lorie concurred, observing that Lukashenko “appeared to have an open mind on the future course of economic policies [and] had indicated a willingness to continue working with the Fund and to rely on Fund technical and financial assistance.”⁶⁹

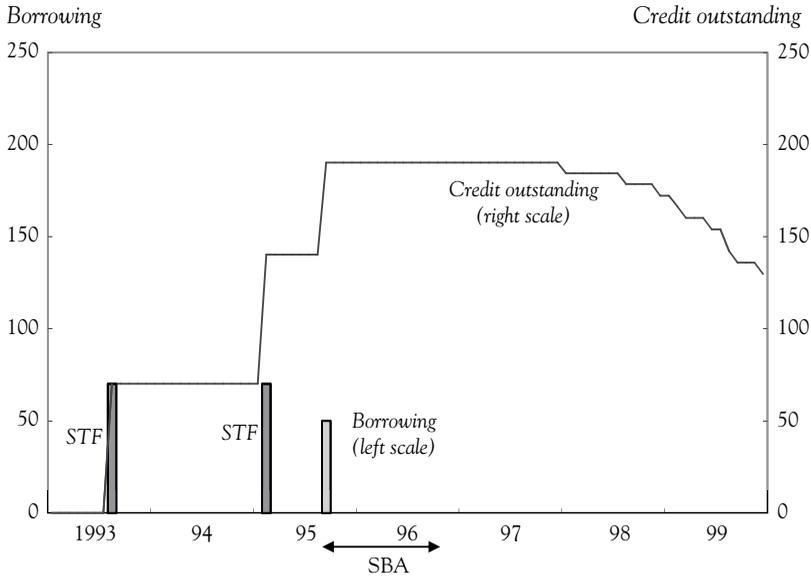
The Lukashenko government and the Fund tried to work together, and an economic program for 1995 was negotiated and signed in December 1994. At that time, the Fund expected to support the program with a stand-by arrangement plus a second STF drawing. To finance the program fully, however, Belarus also needed substantial bilateral support from donor countries. The Fund convened a creditors’ meeting in Washington on December 15. Although everyone who attended expressed admiration for what Belarus had achieved, the meeting generated only about a third of the

⁶⁷These developments are summarized in “Republic of Belarus—Staff Report for the 1994 Article IV Consultation,” SM/94/157 (June 24, 1994). Note that an STF-supported program gives the Fund relatively little leverage to induce the authorities to carry out their policy intentions, given that the loan is disbursed entirely at the outset.

⁶⁸Minutes of EBM/94/64 (July 18, 1994), pp. 116–18.

⁶⁹Minutes of EBM/94/64 (July 18, 1994), pp. 107 (Lorie) and 116 (Kiekens).

Figure 8.3. Belarus: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

required amount of pledges. The Fund's management then had no choice but to pull the proposal from the agenda.⁷⁰

The situation did not improve. Lukashenko's drift into authoritarian rule and his increasingly evident aversion to economic reform cost him both international political support and policy credibility. Nonetheless, the Fund continued to offer its technical and financial assistance throughout 1995. The staff provided technical advice on foreign exchange management and central bank operations, and the Board approved a second STF drawing on January 30 (just a week before the facility was due to expire) and a stand-by arrangement on September 12. By the latter date, Belarus had tightened policies considerably and had managed to cover the expected financing gap without recourse to the extensive rescheduling agreements that had earlier been thought necessary. Although many in the IMF still harbored doubts about the authorities'

⁷⁰Minutes of EBM/94/112 (December 19, 1994), pp. 39–40. Before the December 15 meeting, the staff calculated that the 1995 program was underfinanced by \$460 million. The meeting yielded only \$150 million in pledges, with the European Union and Japan being the main holdouts.

commitment to economic liberalization, the very real macroeconomic successes of 1995 were clearly sufficient to merit the Fund's support.⁷¹

The September 1995 drawing raised Belarus's debt to the Fund to \$282 million (SDR 190.2 million, or 68 percent of quota; see Figure 8.3). That turned out to be the peak because the authorities were unable to implement the program. Along with most other official creditors, the Fund ceased lending to Belarus. For a while, the government was able to sustain economic growth by rebuilding trade relations with Russia and by pursuing inflationary macroeconomic policies, but the growth strategy soon led to balance of payments pressures and bottlenecks. Adverse weather for crop production in 1998, followed closely by the Russian financial crisis, badly weakened the economy and brought the authorities back into negotiations for financial help from the IMF. With policy implementation still below standard, those discussions broke down, and the decade closed without further progress.⁷² Nonetheless, Belarus repaid its IMF loans on time, completing the process in February 2005.

Kazakhstan

Three time zones east of Moscow, Kazakhstan dominated the southern side of the former Soviet Union. Roughly the size of western Europe, it was the second largest territory among the republics, third in value of output, and fourth in population. When Kazakhstan became a member of the IMF in July 1992, Camdessus regarded it as the linchpin to stability in central Asia.

In Nursultan Nazarbayev, Kazakhstan had a president who was prepared to try to lead the country into the world economy, a man with whom the IMF could work effectively. Nazarbayev had assumed the chairmanship of the Supreme Soviet in Kazakhstan in 1990, had campaigned actively for independence and the breakup of the Soviet Union, and had won the presidency of the newly independent state in December 1991. Allied with Boris Yeltsin by this time, he launched a privatization program in the summer of 1991 and began 1992 by liberalizing prices and implementing other market-oriented economic reforms in parallel with Moscow. He urged economic reformers in the government to develop market institutions, and he encouraged foreign direct investment from the west. Over time, the IMF became increasingly concerned about the pervasive culture of corruption in Kazakhstan, but it did not view the problem as

⁷¹Approval of the stand-by arrangement was nearly derailed in late August 1995, owing to excessive monetary creation in the previous months. The Board meeting was delayed by three weeks to give the authorities time to correct the overrun, and the Acting Managing Director (Stanley Fischer) issued a reassuring news bulletin designed to negate the fears that might otherwise have resulted from the delay. By September 12, the monetary base was comfortably on target; see NB/95/14, "IMF Praises Belarus Economic Policy, Sees September Stand-By," August 24, 1995; and minutes of EBM/95/85 (September 12, 1995).

⁷²For an overview of the last two years of the decade, see "Republic of Belarus—Staff Report for the 1999 Article IV Consultation," SM/99/169 (July 12, 1999).

outweighing the strengths of the government's economic management, nor as undermining the effectiveness of structural reforms.⁷³

At the outset, Nazarbayev worked to preserve the ruble area within the CIS as a means of maintaining good relations with Moscow and limiting the breakdown of trade and finance in the former Soviet Union. Although Kazakhstan had huge oil and gas reserves, good agricultural output, and a wide range of heavy industry, it had no effective or economical means of exporting its output except within the Soviet region. The key to preserving that system and its advantages to Kazakhstan was to develop a stable interstate monetary system, which in 1992 meant building a cooperative system for controlling the issuance of ruble notes and credits. Nazarbayev thus lobbied the Russian authorities for a ruble-area central bank in which each member country would have an equal vote. That proposal was anathema in Moscow, and it failed to gain any traction in regional discussions.

As noted above, in the first half of 1992 the IMF staff urged many of the countries emerging from the former Soviet Union to continue using the ruble as a common currency for the region until they were capable of managing their own currencies. In January, the Kazakh authorities told the staff they wanted to stay in the ruble area "for the foreseeable future" but were concerned about the "lack of adequate consultation and co-ordination within the monetary union" and the risk that some member states would fail to exercise "fiscal prudence and monetary restraint." Nonetheless, and despite their "marked preference for remaining in the ruble zone and maintaining a common economic space with other republics" in the CIS, the authorities were concerned enough about the weaknesses in the system "to begin preparing the ground should it becoming necessary" to establish a separate national currency. The Fund's premembership staff mission, led by Ishan Kapur (Division Chief, EU2) advised against "precipitate" action to leave the ruble area, and stressed "that adequate institutional and policy mechanisms must be in place" before taking such action.⁷⁴

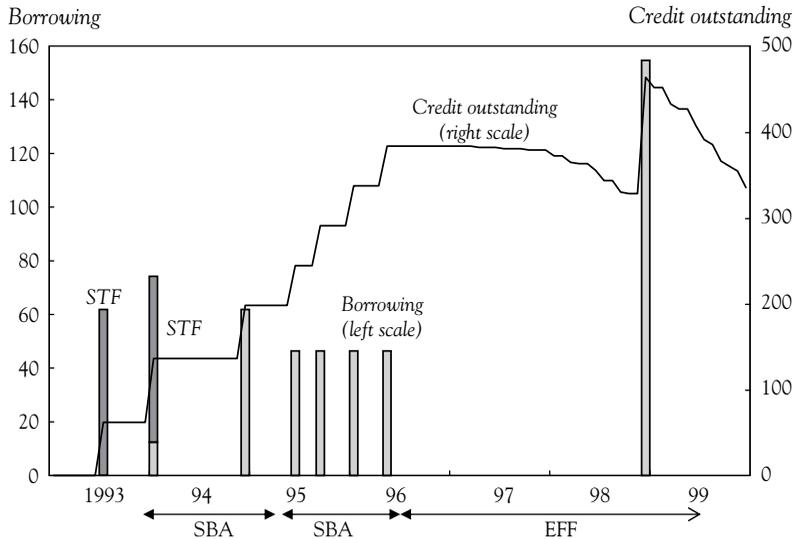
As 1992 progressed and the systemic weaknesses in the ruble area became increasingly apparent, the IMF staff gradually lost its enthusiasm for the ruble, but the Kazakh authorities hung on for a while longer. Camdessus met with Nazarbayev in Almaty in October, in the middle of negotiations on a possible Fund-supported economic program. In the course of several meetings, Camdessus told the president that "workable monetary arrangements would need to be in place, whether [Kazakhstan] stayed in the ruble area or introduced a separate currency, before the Executive Board would be prepared to approve a program."⁷⁵ Because the ruble-based system was not working,

⁷³Wolf and Gürgen (2002) reported that, in a group of 23 transition countries, Kazakhstan had one of the highest levels of corruption but was right in the middle with regard to the extent to which each country had implemented market-oriented economic reforms.

⁷⁴"Kazakhstan—Pre-Membership Economic Review," SM/92/41 (February 28, 1992), pp. 19 and 23.

⁷⁵Managing Director's report to the Executive Board; minutes of EBM/92/127 (October 21, 1992), p. 4. Program negotiations had begun in April 1992, and in July Erb had told the Board that "we foresee a realistic possibility of reaching agreement on a program within the next few months"; minutes of EBM/92/94 (July 24, 1992), pp. 6–7. Also see "Kazakhstan—Staff Report for the 1993 Article IV Consultation," SM/93/60 (March 23, 1993), p. 1n.

Figure 8.4. Kazakhstan: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

and because the authorities were not yet ready to introduce their own currency, further discussion of IMF lending was put on hold.

Meanwhile, the IMF continued providing a regular flow of technical assistance on statistical, monetary, and fiscal systems and policies, and it set up a full-time office in Almaty. In January 1993, Kapur and a team of EU2 economists returned to Almaty to hold discussions for Kazakhstan's first Article IV consultation with the Fund. By the middle of 1993, even though Kazakhstan still had not met the "either this or that" condition on its currency, the Fund was satisfied that economic policies and conditions overall were moving in the right direction and offered an initial STF loan, for \$86 million (SDR 61.9 million, or 25 percent of quota). At that time, the government still planned to remain in the ruble area "for the immediate future," but it was making contingency plans to roll out a new currency within a few months if rampant inflation continued in the area as a whole.⁷⁶ As it turned out, inflation did continue, and Russia forced the issue by demonetizing old rubles. Kazakhstan introduced its national currency, the tenge, in November.

From that point through the end of the decade, Kazakhstan had a regular program relationship with the IMF, though with a declining need for the Fund's money (Figure 8.4). Shortly after the rollout of the tenge, the Fund approved a second STF

⁷⁶"Kazakhstan—Use of Fund Resources—Request for Purchase Under the Systemic Transformation Facility (STF)," EBS/93/113 (July 12, 1993), p. 9.

loan and a stand-by arrangement, together totaling \$255 million (SDR 185.6 million, or 75 percent of quota). Both budgetary and monetary policies suffered poor implementation in the first half of 1994, but the authorities made great efforts to get matters under control later in the year. The Fund granted a second disbursement under the stand-by arrangement in December, after which economic performance gradually strengthened for the rest of the decade.

A second stand-by arrangement, again for 75 percent of quota, was approved in June 1995 and was fully drawn. In July 1996, the Fund approved an extended arrangement, but by this time Kazakhstan was enjoying strong capital inflows on its own and no longer needed to draw on Fund resources. For the next year, it treated the arrangement as precautionary, made no drawings on it, and used it primarily as a signal of official international support.

The Russian financial crisis of August 1998 interrupted the country's progress, but only briefly. Exports to Russia and other affected countries fell sharply for a time, and capital inflows dwindled. Fortunately, Kazakhstan had built up a cushion by not drawing on the EFF arrangement and by pursuing prudent macroeconomic policies for three solid years. In December, the Fund renewed its endorsement of the policy program, and Kazakhstan drew down half of the total amount available all at once.⁷⁷ As oil production and prices recovered, that turned out to be Kazakhstan's last use of Fund resources. The authorities undertook one more precautionary three-year arrangement, beginning in December 1999, and repaid all outstanding obligations to the Fund by the following August.

Turkmenistan

When Turkmenistan gained independence in 1991, the authorities intended to remain in the ruble area. Within a year, they began having second thoughts. While attempting to implement stabilizing macroeconomic policies, they found they were importing inflationary and destabilizing pressures from the rest of the area. Throughout this period, the staff took a neutral stance and merely advised the authorities to focus primarily on having strong supporting policies. In the staff view, "irrespective of the monetary arrangements to be used, sound financial policies had to be in place to ensure that stabilization was achieved and the full benefits of the reform effort realized."⁷⁸ When Russia demonetized the old ruble in July 1993, Turkmenistan had already done much of the necessary contingency planning, and it was able to introduce its new currency, the manat, on November 1

⁷⁷For the background to this activation of the arrangement, see "Republic of Kazakhstan—Fifth Review Under the Extended Arrangement, and Request for Waiver of Performance Criteria," EBS/98/212 (December 7, 1998); minutes of EBM/98/127 (December 15, 1998); and "IMF Executive Board Completes Fifth Review of Kazakhstan's Economic Program—Next Loan Tranche Approved," NB/98/53 (December 15, 1998); accessed at <http://www.imf.org/external/np/sec/nb/1998/nb9853.htm>.

⁷⁸"Turkmenistan—Pre-Membership Economic Review," SM/92/77 (March 29, 1992), p. 21.

without much difficulty. A few weeks later, Camdessus went to Ashgabat to express his support both to the authorities and in public.

Of the 15 countries that succeeded the Soviet Union, only Turkmenistan did not borrow from the IMF in the 1990s. On the surface, the main reason was that Turkmenistan—a large but sparsely populated and mostly desert country—had a wealth of natural gas and other resources. That advantage, however, is notoriously difficult for any country to exploit and benefit from, and Turkmenistan was no exception. Within the Soviet Union, Turkmenistan's natural gas had been sold to other republics at artificially low prices, and the forced regional specialization had limited the development of domestic industrial production. When the newly independent government raised export prices to world market levels (despite warnings from the IMF), its traditional buyers—notably Ukraine and other neighboring countries within the former Soviet area—were unable to pay.⁷⁹ By 1994, payments arrears on gas exports were equivalent to nearly three-quarters of Turkmenistan's GDP. On paper, the country was relatively wealthy, but the government would not begin to reap the benefits until it developed the pipeline capacity to ship natural gas in new directions or until its close neighbors made enough economic progress to settle their arrears.⁸⁰

The second reason for Turkmenistan's relative success was that the authorities realized early on that they had to create a market economy. For the first few years of independence—despite the reluctance of the eccentric and erratic president, Saparmurat Niyazov (self-named Turkmenbashi)—they appeared to pursue reasonably sound fiscal policies. Aided by a serendipitous rise in the price of natural gas, they succeeded in generating surpluses in the balance of payments that they used to build up their foreign exchange reserves. When the payments arrears on natural gas exports led to serious financial difficulties in 1994, the government was able to borrow from private creditors—mostly German and U.S. banks—and avoid asking the IMF for assistance.⁸¹ The country's severe structural problems, of which the reliance on selling natural gas to bankrupt customers was only the most glaring, gradually undermined the government's early commitment to implement stabilizing reforms. In the second half of the 1990s, those structural problems led to an unfortunate focus on short-term solutions that

⁷⁹The staff expressed skepticism about the efficacy of market pricing during the 1993 Article IV consultation and warned the authorities that their major trading partners were already experiencing difficulty paying the lower price (which was about half the world market price) and would probably have to cut import volumes, run up arrears, or both; see "Republic of Turkmenistan—Staff Report for the 1993 Article IV Consultation," SM/93/247 (November 24, 1993), p. 19. The Fund, however, acknowledged the complexity of the problem and did not advise the country to continue selling gas at highly subsidized prices; see minutes of EBM/93/172 (December 17, 1993), pp. 3–36.

⁸⁰A pipeline to the Islamic Republic of Iran became operational in 1998.

⁸¹In 1993, the authorities and the staff discussed the possibility of entering into a precautionary stand-by arrangement as a way of encouraging private capital inflows, but those talks broke down when the staff insisted on a more comprehensive liberalization policy than the authorities were willing to try; see "Republic of Turkmenistan—Staff Report for the 1993 Article IV Consultation," SM/93/247 (November 24, 1993), p. 1.

further weakened the economy and lengthened the transition. External creditors nonetheless continued to support the regime.

The IMF provided substantial technical assistance to Turkmenistan, as it did to the other new members in the region. In addition, it helped contain the accumulation of overdue payments for natural gas by conditioning financial assistance from the Fund to Armenia, Georgia, Ukraine, and others on their promises not to incur any new external arrears. But the Fund was critical throughout the 1990s of Turkmenistan's gradualist approach to market openness and of its accumulation of external debt.⁸² By the late 1990s, external debt service was absorbing more than half of all export revenues, and extremely high inflation had forced the exchange rate to depreciate from 2 manat per U.S. dollar when the currency was introduced in November 1993 to a peak of 19,000 per dollar in April 1999. The situation certainly appeared to be unsustainable, yet the government sustained it well enough to avoid having to ask for a Fund-supported program.⁸³

At the end of the 1990s, progress on reforming the Turkmen economy remained limited. On two occasions, the authorities temporarily cut off export shipments of natural gas in a futile attempt to force customers to pay their bills; the 1998 financial crisis in Russia weakened confidence and caused the exchange rate to depreciate sharply; and domestic political disputes weakened the reformers' ability to ease restrictions on economic transactions. The Fund repeatedly urged the authorities to shift from reliance on administrative controls and to diversify and open up the economy more aggressively, but as long as other creditors were available, the government saw little reason to heed the Fund's advice.

Low-Income Countries

Nearly half of the newly independent states faced overwhelming problems of poverty and underdevelopment simultaneously with embarking on a transition toward market economics. In the first few years of their membership, the IMF assisted these countries with the same set of tools—technical assistance in areas of Fund expertise, advice on implementing sustainable macroeconomic and financial policies, and lending through stand-by and similar arrangements—that it used for the middle-income countries discussed above. As the transition progressed, the problems of underdevelopment rose to the fore, and the Fund adapted its approach accordingly. By the end of the 1990s, the IMF and other multilateral agencies were focusing on the common development problems and debt burdens of this group of countries in what came to be known as the “CIS-7” initiative. In the initial years

⁸²The staff criticism of external debt accumulation is detailed in “Turkmenistan—Staff Report for the 1994 Article IV Consultation,” SM/95/14 (January 20, 1995), pp. 5, 9–10, and 12.

⁸³As of 2009, Turkmenistan had had no financial transactions with the IMF since it joined in 1992.

of the decade, however, the focus was more on how each country could best make the transition within the constraints of its own background.

Much as the Soviet Union as a whole had been, the CIS-7 countries were scattered across a vast geographic area. They included Moldova to the west; Armenia, Azerbaijan, and Georgia in the southern Caucasus; and the Kyrgyz Republic, Tajikistan, and Uzbekistan in central Asia.

Moldova

When the first IMF mission arrived in Chisinau in February 1992 to discuss the terms on which Moldova would join the institution, the authorities had already decided to replace the ruble with their own national currency. Although they knew it would not be easy and that they lacked the experience to do it smoothly, they feared that not doing so would be even riskier. The Trans-Dniester region (also known as Transnistria) bordering Ukraine was occupied by a large contingent of Russian troops and was in armed rebellion against the Moldovan central government. Consequently, the Moldovan economy risked being swamped with a flood of rubles from the region. In response, the staff “recognized the very real concerns of the Moldovan authorities in current circumstances, but pointed out that the considerable costs involved [in establishing a national currency] should be carefully weighed.”⁸⁴ When the Executive Board met to discuss the matter in early April, the Fund expressed this cautionary message more directly:

With regard to the question of the possible introduction of a national currency, in view of the sizable cost and risks involved, Directors cautioned against precipitous action: it was essential to have in place the institutions and the instruments, and above all, to demonstrate the firm resolve to implement tight fiscal and monetary policies in order to protect the internal and external value of the currency. Directors also stressed the importance of coordinating monetary and interest rate policies with other members of the ruble area until Moldova introduced its own currency.⁸⁵

Over the next few months, the authorities reconsidered and decided instead to begin issuing coupons to circulate in parallel with the ruble. Although still committed to replacing the ruble, they were prepared to proceed slowly unless circumstances forced them to act more quickly. The Fund’s advice also evolved. In August 1992, a different team of Fund experts (from the Monetary and Exchange Affairs Department, or MAE) went to Chisinau to advise the Moldovan authorities on issues involved in introducing and managing their own currency, to be called the leu. This staff team broadly supported the authorities’ decisions and encouraged them to introduce a national currency as soon as they were ready: “A cautious approach to the introduction of the new currency seems appropriate; however, it is important to continue preparations in earnest, to maintain freedom of action in case circumstances indicate a faster introduction of

⁸⁴“Moldova—Pre-Membership Economic Review,” SM/92/44 (March 6, 1992), p. 14.

⁸⁵Minutes of EBM/92/43 (April 2, 1992), p. 14.

the leu.”⁸⁶ Moreover, the staff clearly acknowledged the shortcomings of a Russian-dominated ruble area:

A serious difficulty with present ruble area arrangements is the absence of workable operational arrangements that would give member states confidence on the soundness of monetary policy in the area. In the absence of those arrangements, individual member states, such as Moldova, have little influence over monetary policy. Moreover, such absence can encourage individual members to run excessively expansionary policies. A special responsibility falls on the Central Bank of Russia, given its particular position as the sole issuer of ruble banknotes: the amount of ruble banknotes that it puts in circulation and the size of the correspondent account overdrafts that it allows other members to run are key factors in monetary developments and in the distribution of seigniorage among central banks in the area. The potential exists, therefore, for ruble area conditions to become so unstable to thwart efforts from individual countries to stabilize their economies. In those circumstances, issuing the leu could become a prerequisite for implementing a successful stabilization program in Moldova.⁸⁷

By mid-1993, as Moldova faced increasing difficulty obtaining sufficient ruble notes from Russia, some 80 percent of the currency in circulation consisted of locally printed coupons. When Russia suddenly removed the old rubles from circulation on July 24, Moldova had no choice but to take the “precipitous action” that it and the IMF had sought to avoid. The National Bank of Moldova (NBM) withdrew all rubles from circulation in exchange for coupons and declared them no longer to be legal tender. The exchange rate of the coupon—renamed the Moldovan ruble—was allowed to float against the Russian ruble, which effectively committed the NBM to establishing its own monetary policy. The IMF staff fully supported this reaction: “Moldova can and should insulate itself from the effect of expansionary financial policies elsewhere in the ruble area by adhering strictly to the monetary program and by proceeding in parallel with the plans to introduce the leu.”⁸⁸

From that point on, the challenges for Moldova were to master the technical conversion to a regular currency and simultaneously to stabilize monetary and fiscal policy. (Inflation, at about 20 percent a month, was higher than that in Russia.) The Fund’s MAE Department continued to provide technical advice throughout 1993, while EU2 staff helped the authorities devise a stabilization program the Fund could support with financial assistance. Moldova finally rolled out the leu to replace the ruble coupons on November 29, 1993, with the “full support” of the IMF—both in words (through a press release⁸⁹) and in deed (through a stand-by arrangement approved in mid-December).

⁸⁶“Moldova—Issues Related to the Introduction of a New Currency and Institution Building at the National Bank of Moldova” (unnumbered technical assistance report), September 30, 1992, p. 1.

⁸⁷“Moldova—Issues Related to the Introduction of a New Currency and Institution Building at the National Bank of Moldova” (unnumbered technical assistance report), September 30, 1992, p. 2.

⁸⁸See “Republic of Moldova—Use of Fund Resources—Request for Purchase Under Systemic Transformation Facility,” EBS/93/149 (September 1, 1993), pp. 4–5 and 19.

⁸⁹See “IMF Supports the Introduction of Moldova’s New Currency,” NB/93/17 (November 28, 1993).

Moldova began borrowing from the Fund in February 1993 and continued to do so throughout the rest of the decade. Its first loan was through the Compensatory and Contingency Financing Facility (CCFF), so the Fund could help the government cope with a disastrous crop failure, the result of the country's worst drought since 1946.⁹⁰ This loan was for \$18.5 million (SDR 13.5 million, or 22.5 percent of quota). At the time, the government of Moldova was not yet ready to implement a viable macroeconomic stabilization program, and the CCFF provided a means for the Fund to offer at least some small financial help quickly.

That initial loan was followed in September 1993 by a somewhat larger one (SDR 22.5 million; roughly \$32 million) through the STF, which helped bolster the NBM's foreign exchange reserves as it prepared to begin issuing its own currency. In December, following the introduction of the leu as the national currency and the corresponding adoption of a comprehensive program of macroeconomic policies, the Fund approved a 15-month stand-by arrangement for \$72 million (SDR 51.75 million, or 58 percent of the newly increased quota). The authorities successfully carried out the agreed-on stabilization program and drew out the full amount of the arrangement. They also borrowed a second time through the CCFF, in response to yet another drought-induced crop failure in 1994.

By 1996, Moldova was beginning to make progress toward establishing a market-based economy, although barter and other nontransparent transactions remained commonplace. In May, the Fund agreed to support the reform effort more substantially, through a three-year EFF arrangement for \$195 million (SDR 135 million, or 150 percent of quota). The reform program supported by that arrangement began well, but political paralysis set in after the December 1996 elections. The fiscal deficit failed to decline as programmed, and in the latter part of 1997 the Fund decided to stop disbursing (Figure 8.5) until the new government could establish a track record of fiscal control.

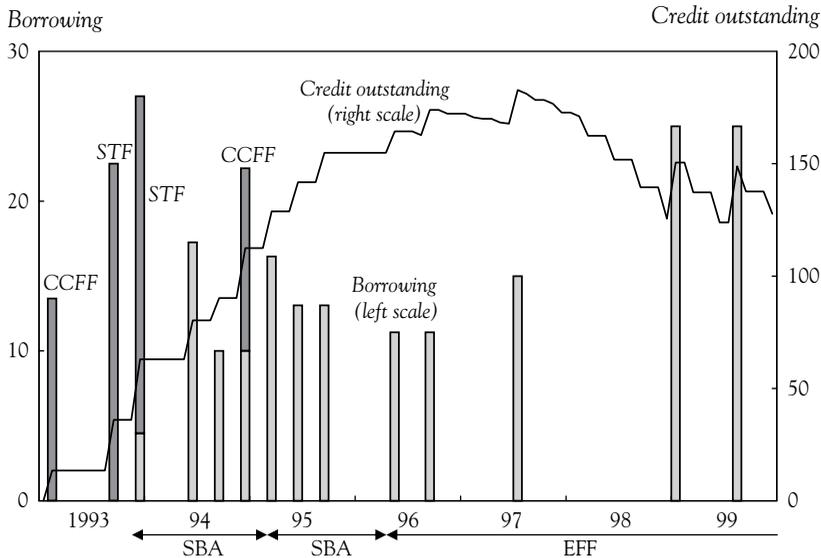
Moldova suffered a further setback in the summer of 1998 as a result of the financial crisis in its largest export market, Russia. Export receipts quickly dried up, and the government was driven to the brink of default on its outstanding debts. The NBM managed to bail out the government through extensive monetary financing, but its foreign exchange reserves dropped precipitously as it tried to resist a depreciation of the currency. That effort was abandoned in November, after which the exchange value of the leu plummeted. For the year, real GDP fell by 8.5 percent.⁹¹

The long-run picture was not much brighter. Per capita GDP in 1998 was estimated at just more than \$500 and had been essentially flat throughout much of the decade.

⁹⁰"Moldova—Use of Fund Resources—Request for Purchase Under Compensatory and Contingency Financing Facility," EBS/93/8 (January 15, 1993).

⁹¹See "Republic of Moldova: Recent Economic Developments," IMF Staff Country Report No. 99/110, September 1999, pp. 18–21; accessed at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=3232.0>.

Figure 8.5. Moldova: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

The lack of progress was partly due to the country's fractured political condition and the persistence of domestic opposition to market reforms, and partly to the sheer magnitude of the economic and political transformation being undertaken. The government signaled its continuing commitment by successfully implementing a set of prior actions specified by the IMF, and the Fund responded by resuming lending in January 1999 and extending the EFF arrangement to a fourth year (through May 2000).

Despite seven years of trying to put the economy on a forward course, supported by the IMF through nearly continuous lending and extensive policy advice, Moldova was still mired at the end of the decade. Recognizing that a more generous and longer-term approach was needed, the IMF agreed in March 1999 to add Moldova to the list of low-income countries eligible for concessional loans.⁹² Moldova made one more drawing on the EFF arrangement, in August 1999. In the succeeding years, it needed to continue to borrow from the Fund, but at least it had recourse to the less expensive loans of the Poverty Reduction and Growth Facility.

⁹²Early in the decade, the World Bank estimate of Moldova's per capita GDP—the primary datum used by the IMF for determining eligibility for concessional loans—was well above the threshold. That initial estimate turned out to be overly optimistic. By 1999, it was apparent that Moldova had started its independent life at a lower income level and then had declined greatly from there; see “Republic of Moldova—ESAF Eligibility,” EBS/99/43 (March 17, 1999). The criteria for and experience with ESAF eligibility is discussed more generally in Chapter 13.

The Caucasus Region

Three of the poorest countries were crowded together in a conflict- and earthquake-prone belt on the southern edge of the Caucasus Mountains, between the Black and Caspian Seas, and bordered by Turkey and the Islamic Republic of Iran to the south and by Chechnya and other restless regions of the Russian Federation to the north. In the 1990s, the IMF assisted these countries with a steady flow of technical assistance and policy advice, particularly on introducing national currencies and establishing effective central banks, fiscal agencies, and statistical systems. The Fund also lent steadily to all three countries, first through its regular credit facilities and then through the Enhanced Structural Adjustment Facility (ESAF) (Figure 8.6).

Armenia

Armenia joined the IMF in May 1992, saddled with a host of ills in addition to the baggage of its history in the Soviet system. A deadly earthquake had hit in December 1988, displacing more than a half million people and leaving much of the country's infrastructure in tatters. The dissolution of the Soviet Union allowed a long-simmering conflict with Azerbaijan over control of the Nagorno-Karabakh region to re-erupt. That area had been a self-governing part of the Soviet republic of Azerbaijan for more than a half century, but it was populated largely by ethnic Armenians. Turkey, in support of Azerbaijani interests, imposed a trade embargo on Armenia, which remained in effect throughout the rest of the decade. By the time a temporary cease-fire was signed in 1994, an estimated 1 million people had been displaced and had become refugees, mostly on the Azeri side of the border. To the north, civil conflicts in Georgia further destabilized the region.

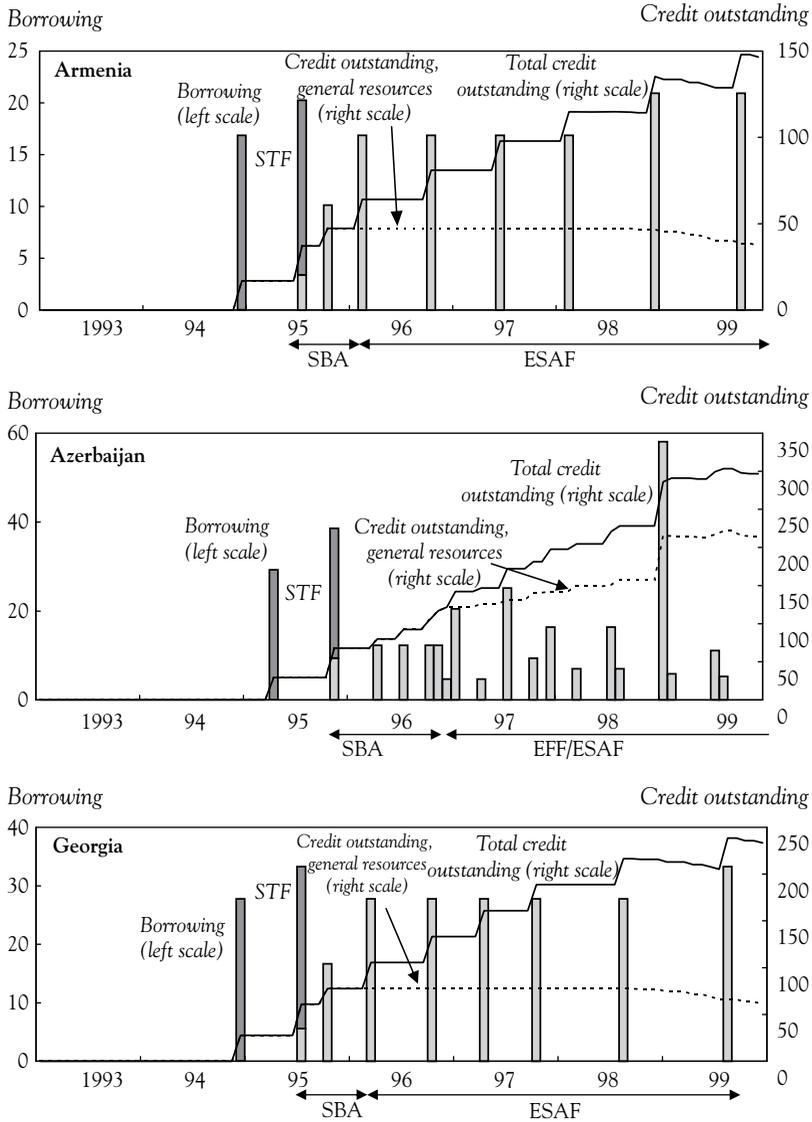
Armenia suffered devastating economic effects. In 1991–92 alone, output was estimated to have fallen by half. Inflation soared, and food shortages occurred throughout the country. The government's efforts to establish a market-based economy with assistance from the IMF and other agencies were totally overwhelmed by circumstances. In December 1992, President Levon Ter-Petrossian declared a state of "national disaster" and appealed to world leaders for help.⁹³

This situation placed Armenia in a somewhat different position vis-à-vis the ruble area from that of the larger middle-income countries. Although it was true, as elsewhere, that the authorities could not contain inflation so long as they remained in the unstable system, it was also true that Armenia could at least try to use an influx of ruble credits to finance its external deficit and alleviate its development needs. As a small and very poor country, its reliance on the ruble posed no real systemic problems for Russia or the other large members of the area. On balance, therefore, the authorities

⁹³For an overview, see "Armenia—Staff Report for the 1992 Article IV Consultation," SM/93/15 (January 22, 1993).

Figure 8.6. Low-Income Countries in the Caucasus Region: Use of Fund Credit, 1993–99

(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

“Credit outstanding, general resources” excludes ESAF loans.

preferred to stick with the ruble for the time being, and the Fund staff signaled its support for whichever choice they might make.⁹⁴

Russia's decision in mid-1993 to stop accepting Soviet-era ruble notes forced the hand of the Armenian authorities. They could not obtain enough cash in new rubles to sustain the economy, but by continuing to accept old notes they opened themselves to inflows from neighboring states. In the fall of 1993, those inflows turned into a flood that sparked higher inflation and further shortages. In November, the still-unprepared government had no choice but to introduce its own national currency, the dram, and withdraw from the ruble area. An IMF mission had just spent two weeks in Yerevan advising officials in the central bank on a plan to use coupons during a transition period until adequate preparations could be made, but that plan had to be scrapped in favor of an immediate withdrawal of rubles from circulation.⁹⁵

The collapse in Armenia's output in 1991 and 1992 pushed it below the threshold that the World Bank used for determining eligibility for concessional loans from the International Development Association (IDA), but not so far as to qualify it for "IDA-only" borrowing. That is, in 1993 the Bank placed Armenia in a category eligible for a blend of IDA credits and nonconcessional loans from the main World Bank lending agency, the International Bank for Reconstruction and Development (IBRD). The IMF responded accordingly by making Armenia eligible for ESAF loans but with the intention of possibly lending to it from its general resources as well.⁹⁶

For the first three years of Armenia's independence, the IMF helped primarily by providing intensive technical assistance: 26 separate missions, seminars, or courses in 1992–94, involving staff from four departments and assisted by outside experts. IMF lending to Armenia began in December 1994, once the new currency was successfully in circulation and a measure of fiscal and monetary discipline had been established. After three years of sharp declines, output began growing in 1994 and continued throughout the rest of the decade.

Although Armenia was eligible to borrow on concessional terms, doing so required agreement on a comprehensive three-year structural adjustment program.⁹⁷ The authorities were not yet able to formulate such a program, so the Fund began with a simple STF drawing for 25 percent of Armenia's quota (SDR 16.875 million, or \$24.5 million). This amount was small in relation to Armenia's financing needs, but it helped catalyze larger support from other agencies and governments, including an

⁹⁴"Armenia—Staff Report for the 1992 Article IV Consultation," SM/93/15 (January 22, 1993), pp. 7–9.

⁹⁵"Armenia: Management of an Independent Currency," unnumbered technical assistance document (December 31, 1993).

⁹⁶See "ESAF Successor—Operational Modalities and Program Design Issues," EBS/93/178 (November 16, 1993), pp. 2–4.

⁹⁷Technically, two facilities—the SAF and the ESAF—were available, and only the ESAF required a comprehensive three-year program. By December 1994, however, all the funds remaining in the SAF were committed to other countries; see Chapter 13, p. 641.

agreement by a group of donor countries to provide additional bilateral financial assistance totaling at least \$140 million.⁹⁸

Development of a comprehensive program took another 14 months. In the interim, the Fund approved a one-year stand-by arrangement, supplemented by a second STF drawing, in June 1995. The authorities carried out that program successfully, and it was replaced by a three-year ESAF arrangement in February 1996 (see Figure 8.6). Despite a serious financial setback after the 1998 Russian crisis, the three-year program also was completed successfully, and the arrangement was fully drawn just months behind the original schedule.⁹⁹

Azerbaijan

When Azerbaijan joined the IMF in September 1992, it was well endowed with natural resources, including fertile agricultural land and mammoth oil and gas reserves. However, internal conflicts and the usual post-Soviet administrative weaknesses and corruption held it back from realizing its potential. The civil war in the Nagorno-Karabakh region, which was also destabilizing conditions in Armenia (see above), posed the biggest single problem. For this and other reasons, the World Bank estimated that per capita GDP in Azerbaijan fell by about 60 percent from 1989 to 1995. Though much less steep than the income decline in Armenia, the cumulative effect was greater. The Fund initially (in 1993) declined to make Azerbaijan eligible for concessional assistance through the ESAF, but it agreed to keep the issue under review. When incomes continued to fall, it declared the country to be ESAF-eligible in May 1995.¹⁰⁰

Shortly before joining the IMF, Azerbaijan introduced a national currency, the manat, to circulate alongside the ruble. When Russia stopped redeeming old rubles in July 1993, Azerbaijan began withdrawing them from circulation. In November, the authorities tried to stabilize prices by pegging the manat to the U.S. dollar, and in January 1994 they declared the manat to be the country's sole legal tender. The Fund staff supported the introduction of the currency, but it advised against pegging it to a hard currency at that time. The manat simply was not strong enough to sustain the peg, and it was trading at a huge discount on the black market. The authorities accepted the Fund's advice, and in March 1994 they went back to pegging the manat to the ruble.

⁹⁸For details, see "Republic of Armenia—Use of Fund Resources—Request for a Purchase Under the Systemic Transformation Facility," EBS/94/218, Suppl. 2 (December 12, 1994).

⁹⁹All obligations to the Fund's general account arising from the STF and stand-by drawings were repaid by 2005. Armenia continued to borrow from the IMF on concessional terms for several more years, through two fully utilized PRGF arrangements, 2001–04 and 2005–08, and a third PRGF arrangement in 2008–09. In March 2009, Armenia resumed borrowing from the general account through a stand-by arrangement.

¹⁰⁰The background to Azerbaijan's ESAF eligibility is explained in "ESAF Eligibility—Azerbaijan Republic and the Republic of Congo," EBS/95/86 (May 24, 1995).

Two months later, they let the exchange rate float until it reached a new—greatly depreciated—level, and then they repegged successfully to the dollar.¹⁰¹

IMF lending to Azerbaijan started only in April 1995, through an STF loan, but it then continued with frequent disbursements through the rest of the decade (Figure 8.6). Until the authorities could formulate a comprehensive medium-term program, lending had to be done on nonconcessional terms. A one-year stand-by arrangement approved in November 1995, along with a second STF loan, was fully drawn. A three-year ESAF arrangement, approved in December 1996, was almost fully drawn after a brief extension. In this case, however, the Fund decided to limit the amount of concessional lending and supplement the ESAF arrangement with a concurrent (1996–99) EFF arrangement financed with the Fund’s general resources. Although Azerbaijan had a very low level of per capita income, its growth prospects—deriving largely from its petroleum reserves—were considered quite good. Once that growth was realized, the government would be able to afford to pay a market interest rate on at least part of its debts.¹⁰²

Georgia

When Georgia became a member of the IMF in May 1992, the Fund had high hopes for reform and economic progress in this small, poor country. The main basis for optimism was what the staff came to call the “Shevardnadze effect.” Eduard Shevardnadze had acted as a strong force for political reform in the Soviet Union while serving as foreign minister under Mikhail Gorbachev (1985–90 and briefly again in 1991). After the breakup of the Soviet Union, a military coup against the initial government in Georgia created an opening for Shevardnadze. He became head of government in 1992, eventually winning the presidency once a new constitution was adopted in 1995. He held that post until he was forced to resign in 2003 amid allegations of election irregularities and other corruption charges. Throughout the 1990s, however, he maintained wide respect as a reformist leader with whom the international community was eager to work.

At the outset, Georgia’s immediate prospects for either stability or growth appeared dim. A simmering civil war and a major earthquake in 1991 added to the devastating effects on output and trade from the collapse of the CMEA. Before joining the IMF, the authorities decided to remain in the ruble area for the time being but—owing to political tensions with Russia—not to join the CIS. By the time of the first Article IV consultation discussions in January 1993, however, the Shevardnadze government had already decided that leaving the ruble area and establishing a national currency was

¹⁰¹See “Azerbaijan Republic—Staff Report for the 1994 Article IV Consultation,” SM/94/116 (May 11, 1994), and Suppl. 1 (June 6, 1994).

¹⁰²A boom period, fueled by oil exports, materialized in the following decade. Azerbaijan completed a PRGF arrangement in 2005 and then did not borrow during the next few years.

“desirable and inevitable.” The only question was how soon the country would be ready.¹⁰³

The staff mission, led by Donal Donovan (Assistant Director, EU2), took a neutral position on whether and when Georgia should strike out on its own financial path. It emphasized, however, that the economy could not continue on the course it had taken in the first year of independence. The instability of the ruble area, combined with Georgia’s excessive fiscal deficit, made the status quo unsustainable. Donovan recommended introducing coupons alongside the ruble “as a transitory step” until the authorities could get reforms in place and could see a level of financial stability sufficient to make a new national currency credible.¹⁰⁴

Georgia began issuing coupons in April 1993, to circulate alongside rubles. Rubles by then were already in short supply, and they became much more so three months later when Russia stopped redeeming them. For the next two years, the coupon was the only legal tender in Georgia, but the government’s inability to discipline itself in issuing them as a means of financing its own spending soon made them virtually worthless. The ruble reasserted itself as the principal medium of exchange, and hyperinflation followed inevitably.¹⁰⁵

When Georgia approached the IMF for an initial STF loan in 1994, its economy was in shambles. The authorities acknowledged that they would have to make a complete turnaround in economic policies if they were to have any hope of securing international assistance and gaining control over their economic fortunes. As one indication of how unrealistic prices had become, and therefore of how massively the practically bankrupt government was subsidizing basic commodities, in September 1994 the government raised the price of bread from 700 coupons per kilogram to 200,000 coupons! Many other subsidies were similarly cut and replaced by a much more limited social safety net targeted at the poor and the elderly. Those encouraging moves persuaded the Fund to approve an STF loan of about \$40 million (SDR 27.75 million, or 25 percent of quota) in December. More important, a tightening of monetary policy, the rationalization of basic commodity prices, and a program to begin privatizing agriculture quickly ended the hyperinflation and offered some hope for the future.¹⁰⁶

In-depth economic and political reform began in 1995, culminating in adoption of a new constitution in August and the rollout of a new national currency (the lari, exchanged for coupons at a rate of 1 million to 1) in September. The introduction of the lari was a watershed moment for the Georgian economy, suddenly halting and reversing the public’s preference for using U.S. dollars and deutsche marks instead of domestic currency. Some \$100 million in foreign exchange soon flooded into the

¹⁰³“Georgia—Staff Report for the 1993 Article IV Consultation,” SM/93/76 (April 12, 1993), p. 10.

¹⁰⁴“Georgia—Staff Report for the 1993 Article IV Consultation,” SM/93/76 (April 12, 1993), p. 10.

¹⁰⁵Monetary developments in 1993 and the first part of 1994 are reviewed in “Republic of Georgia—Staff Report for the 1994 Article IV Consultation,” SM/94/143 (June 8, 1994), pp. 7–10.

¹⁰⁶For an analysis of the hyperinflation and the subsequent stabilization, see Wang (1999).

central bank, tripling the size of Georgia's foreign exchange reserves and raising them to a comfortable level. IMF staff and consultants provided technical assistance on the rollout and even arranged for an airplane to fly the cash to Germany, where it could be held in secure reserve deposits.¹⁰⁷

The Fund responded financially to these developments in June 1995 with a stand-by arrangement, designed to serve as a bridge to larger and less expensive ESAF lending as soon as the authorities could formulate a comprehensive three-year program. That promise was fulfilled in February 1996 (see Figure 8.6). The authorities succeeded in carrying out the three-year program, and the Fund disbursed the full amount of the ESAF arrangement. Output, which began growing in 1995, continued to grow throughout the rest of the decade, although growth slowed sharply for a time after the Russian financial crisis of 1998. By the end of the 1990s, Georgia still faced formidable challenges but appeared to be on the right track toward strengthening its economy and its ties with the international community.

Central Asia

Of the five central Asian nations to emerge from the Soviet Union, two—Kazakhstan and Turkmenistan—benefited from a wealth of natural gas and other mineral resources. The Kyrgyz Republic, Tajikistan, and Uzbekistan were much poorer and faced much greater obstacles to their ability to mature as independent economies. Working with each of these countries, the IMF first helped them develop market institutions and establish their own national currencies and then provided at least small amounts of financial assistance. The degree of success varied, owing foremost to the different political choices and the different external and internal disturbances faced by each country.

Kyrgyz Republic

The Kyrgyz Republic¹⁰⁸ started its history as an independent post-Soviet country with great promise. Its president, Askar Akayev, was a highly respected academic physicist. He was also known as a reformer, and his government quickly established an open and apparently democratic system. The IMF responded by providing substantial technical assistance, notably to modernize the central bank, and by providing a series of loans starting in 1993.

During membership discussions with IMF staff early in 1992, the authorities indicated that they intended to continue to use the ruble as the Kyrgyz currency. Much of the technical discussion with the staff concerned the best way to coordinate monetary policy and credit creation with other countries in the ruble area. Soon after joining the

¹⁰⁷See "Georgia—Recent Economic Developments," SM/96/231 (September 9, 1996), pp. 26–27. Additional information is from interviews with staff.

¹⁰⁸For the history of the name of this country, see the Appendix to Chapter 2.

IMF in May 1992, however, the authorities grew disillusioned with that arrangement, finding it difficult to develop satisfactory relations with Russia for managing monetary policy, and Russia's own monetary management was being increasingly called into question. Even if they lacked the administrative capacity to issue and manage their own national currency, the authorities realized that sticking with a currency and a system as unstable and inflationary as the ruble area had become was not sustainable.¹⁰⁹

Staff views evolved in parallel with those of the authorities. After initially accepting the decision to continue using the ruble, the staff soon had second thoughts. In this case, the staff missions, led by Peter M. Keller (Advisor, EU2), took a relatively proactive stance, urging the country to leave the ruble area and establish its own currency. When the authorities requested a stand-by arrangement in the summer of 1992, the staff responded by warning them that in the then-current conditions of instability, "it would be difficult for the Fund to agree to a program with a member of the ruble area."¹¹⁰

Akayev was reluctant to take quick action to abandon the ruble, primarily because of concern that Russia would respond with hostility (as it had when the Baltic countries left the ruble area). After high-level consultations with Russia and technical discussions with officials from the Baltic countries, the president and his government were satisfied that they could convert successfully to a new currency. By March 1993, they had formulated a comprehensive economic program and were making plans to launch the currency, the som. With that plan on the table, negotiations were completed for IMF support. Issuance of the currency began on May 10, and two days later the Executive Board approved an 11-month stand-by arrangement and an initial STF loan, which was the first use of the newly established facility by any country (see Chapter 5).

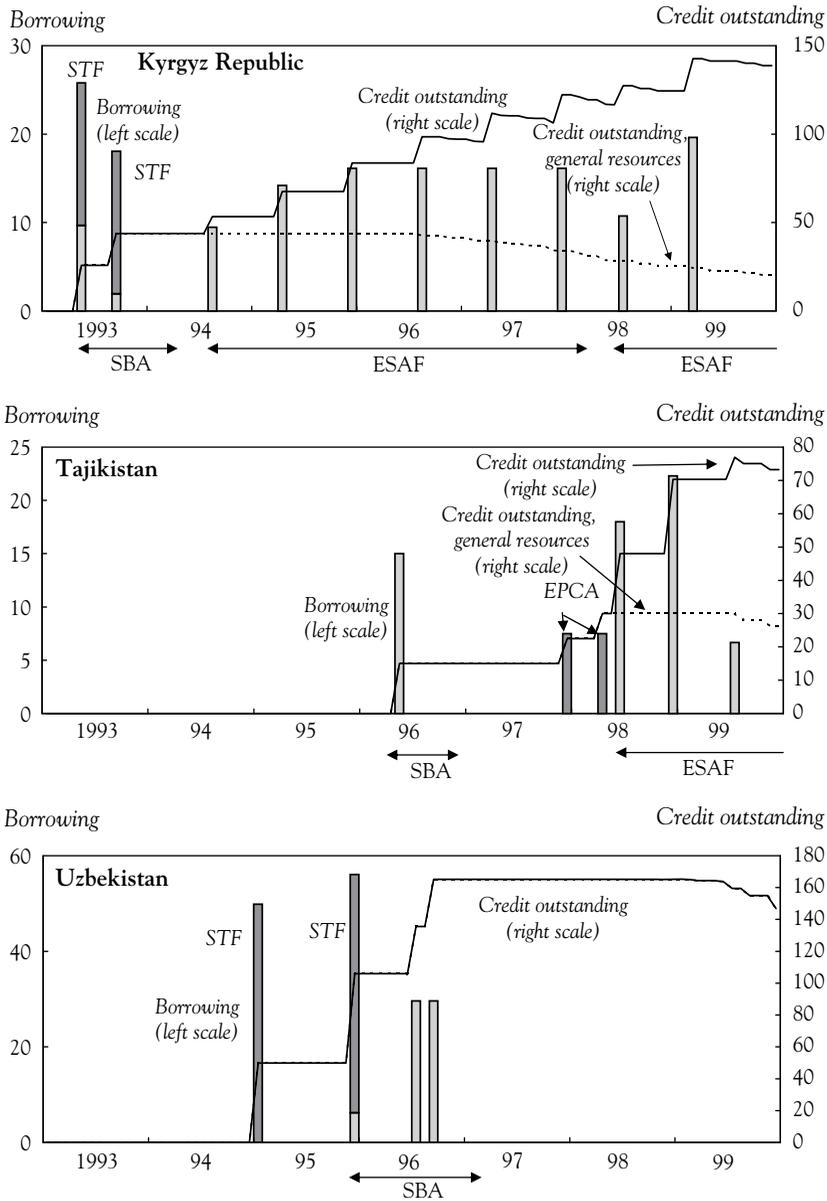
For the rest of the decade, the Fund extended loans annually to the Kyrgyz Republic, with only minor delays (Figure 8.7). Implementation of the policy program flagged in the second half of 1993 but then resumed sufficiently for the IMF to approve a three-year ESAF arrangement in June 1994. From that point on, the Fund supported the country exclusively through loans on concessional terms from its administered accounts, which continued at least through the next decade. Economic performance deteriorated in the late 1990s, partly because of governance problems, but also because of external problems beyond the authorities' control. Chief among the external shocks was the Russian financial meltdown in 1998, which caused capital flows to the Kyrgyz Republic to dry up, severely reduced exports to Russia and other neighboring countries,

¹⁰⁹The authorities' evolving views are reported in "Kyrgyzsta—Pre-Membership Economic Review," SM/92/64 (March 18, 1992) and "Kyrgyzstan—Request for Stand-By Arrangement," EBS/93/54, Suppl. 1 (April 16, 1993).

¹¹⁰Memorandum from Odling-Smee to the Managing Director, "Staff Visit to Kyrgyzstan, September 1–11, 1992," September 16, 1992; IMF archives, Accession No. 1996-0187-0004, OMD-AD, B9108, "Kyrgyzstan 1992."

Figure 8.7. Low-Income Countries in Central Asia: Use of Fund Credit, 1993–99

(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; EPCA = Emergency Postconflict Assistance; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

and precipitated a crisis in the Kyrgyz banking system. Even so, output continued to grow, albeit slowly, and the overall economic record remained modestly positive.

Tajikistan

Tajikistan declared its independence in September 1991, joined the CIS when the group was formed in December, and applied to join the IMF in February 1992. Its economic prospects, never very bright, dimmed considerably when civil war erupted. As noted in Chapter 2, Fund membership was delayed until April 1993, and the first Article IV consultation with Tajikistan did not take place until mid-1994.

Reforming the economy in the absence of the structure and support the Soviet Union had provided for more than six decades was a daunting task for all these countries, and it was one for which the Tajik authorities were especially unprepared. They presided over an extremely poor country, with the lowest per capita income in the region. Landlocked and mountainous with very little arable land or modern infrastructure, Tajikistan began with practically none of the attributes of a functioning national economy.¹¹¹

For the first year of Tajikistan's membership, the staff focused mainly on providing technical assistance, particularly on transforming the National Bank of Tajikistan into a modern central bank. When the first Article IV mission arrived in Dushanbe in May 1994, the civil war was still ongoing, but the government—with support from Russia—had gained control over most of the country. Financially, the most significant issue, as in other countries of the former Soviet Union, was how to remonetize the economy after the ruble area crumbled. In this case, the authorities were negotiating with Russia to establish a formal monetary union. As an interim policy, Tajikistan officially was using the Russian ruble (the new one, which supplanted the old Lenin notes in 1993). Instead of supplying the central bank with Russian banknotes, however, Russia was printing specially marked ruble notes for use only in Tajikistan.

The 1994 staff mission was led by Peter Keller, who was also handling the Kyrgyz Republic. Accommodating the authorities' preferences, Keller took a more neutral position on the currency issue than he had in the neighboring country. For Tajikistan, the Fund advised that a successful ruble-based system would require a formal agreement with Russia covering the supply of money and the conduct of monetary policy. If that was not possible, then Tajikistan would be well advised to change course and issue its own national currency. The authorities informed Keller that they wanted financial

¹¹¹For the staff's overview, see "Tajikistan—Pre-Membership Economic Review," SM/92/70 (March 23, 1992).

assistance, but he responded that they would first have to settle the currency issue and strengthen their finances.¹¹²

Before long, negotiations on a monetary union with Russia broke down, and at the end of 1994 Russia stopped shipments of rubles to Tajikistan altogether. That forced Tajikistan to introduce its own currency and left precious little time for proper planning. The IMF sent a staff mission to Dushanbe in January 1995 to advise on both the technical aspects of currency conversion and on the design of supporting policies. The crucial elements of the latter were to be a liberalization of consumer prices and a six-month freeze on credit extension by the central bank, to prevent the liberalization from leading to an inflationary spiral. A second mission went in April and May to oversee the rollout of the new currency, the Tajik ruble.¹¹³ With that launch, all the countries emerging from the former Soviet Union had their own separate national currencies.

Relations between the IMF and Tajikistan in the second half of the decade turned to financial assistance (see Figure 8.7). By this time, the STF had expired, but the Fund could still provide an initial loan on similar terms simply by granting a “first-tranche” stand-by arrangement for 25 percent of quota and disbursing the full amount immediately. Tajikistan requested such an arrangement in 1995, but discussions did not go well. The tight monetary and fiscal policies advised by the IMF proved to be far too draconian for the authorities, who had to cope with falling output and soaring price pressures while containing civil unrest that had continued for more than four years. (By this time, an estimated 600,000 people—more than 10 percent of the population—had been displaced by the conflict.) The credit freeze was quickly abandoned, and a staff-monitored program that began in September 1995 failed almost instantly. After the installation of a new prime minister in February 1996, negotiations took a more positive turn, and the Executive Board finally approved a first-tranche stand-by arrangement in May 1996.¹¹⁴

Policy implementation flagged again over the next year, but matters took a distinct turn for the better upon the signing of a peace accord in June 1997. The Fund then disbursed postconflict assistance in two tranches totaling 25 percent of quota, and then set about to help the authorities develop a longer-term program suitable for ESAF support. The Fund approved a three-year ESAF arrangement in June 1998, after which economic growth and the pace of structural reform both gradually increased. The Fund

¹¹²“Republic of Tajikistan—Staff Report for the 1994 Article IV Consultation,” SM/94/204 (August 2, 1994). In September, the Executive Board concurred with the staff’s advice, though tilted more toward encouraging the authorities to strike out on their own; see minutes of EBM/94/84 (September 14, 1994), pp. 51–62.

¹¹³“Republic of Tajikistan—Introduction of a National Currency,” SM/95/141 (June 8, 1995).

¹¹⁴These various developments are described in “Republic of Tajikistan—Staff Report for the 1996 Article IV Consultation and Request for First Credit Tranche Stand-By Arrangement,” EBS/96/65 (April 23, 1996).

continued to support Tajikistan with loans on concessional terms for the next several years.

Uzbekistan

Much like its two close neighbors, when Uzbekistan first began discussions on joining the IMF, the authorities expressed a preference for continuing to use the ruble as part of a common currency area with Russia and other newly independent states. The authorities recognized, however, that the system might collapse and that they would have to prepare for the contingency of going it alone. The IMF staff, led by Ishan Kapur (who was also leading missions to Kazakhstan), cautioned that such a step “would need to be preceded by careful technical preparation.” In any event, the staff view was that Uzbekistan’s primary and immediate challenges were “strong macroeconomic discipline and fundamental structural reforms.”¹¹⁵

Soon after Uzbekistan joined the IMF in September 1992, the difficulty of establishing cooperative payments arrangements within the ruble area forced the authorities to consider alternatives. The Fund responded in December by sending a team of experts from MAE. They supported the authorities’ intention to consider ways to respond if Uzbekistan was forced to withdraw from the ruble area, and provided detailed technical assistance on the necessary steps to take if the occasion arose.

The trigger, as for several other states, was Russia’s decision in July 1993 to stop accepting the old rubles. As cash became increasingly scarce, the Uzbek authorities started issuing coupons in November 1993 to circulate alongside both old and new rubles as means of payment. Two months later, the ruble was dropped as legal tender. Finally, in July 1994, a new currency, the sum, replaced the coupons.¹¹⁶

Relations between Uzbekistan and the IMF were uneasy throughout the 1990s. The government, led by the former Communist Party chief, Islam Abduganievich Karimov, opted to retain much of the Soviet-era economic structure and many of its political institutions. It resisted much of the Fund’s advice on market-oriented structural reforms and was unable to stabilize macroeconomic policies. In the first few months after the launch of the sum as a national currency, rapid monetary expansion induced a depreciation of the exchange rate from 7 sum per U.S. dollar in July 1994 to about 30 in November. By that time, the authorities were ready to try to stabilize the currency and begin a reform program.

In 1995, the IMF agreed to begin lending to Uzbekistan on a small scale. The Executive Board approved a first STF loan in January, after which negotiations started on a stand-by arrangement. Three staff missions spent a total of six weeks meeting with the authorities in Tashkent, and Camdessus met with Karimov and other senior officials there in May. In the end, the Fund was convinced that the government was

¹¹⁵“Uzbekistan - Pre-Membership Economic Review,” SM/92/80 (April 3, 1992), p. 17.

¹¹⁶Coupons, which also were known as the sum, were exchanged for the new currency at a rate of 1,000:1.

committed to carrying out its stabilization program. The structural reform agenda was not very ambitious, but the staff (now led by Leif Hansen, Division Chief, EU2) accepted “the judgment of the authorities that the envisaged program represents the pace of adjustment best suited to maintaining political and social stability in the country.”¹¹⁷ The Executive Board concurred, and the stand-by arrangement—along with a second STF loan—took effect in December 1995.

Midway through the 15-month stand-by arrangement, in the fall of 1996, the government abruptly changed course. The imposition of exchange and trade controls and a surge in government expenditure violated the terms of the arrangement with the IMF, which eventually expired with no more drawings being allowed. Discussions with the staff led nowhere until Fischer went to Tashkent in May 1997 in response to a personal invitation from Karimov. After a tense three-hour meeting, the president finally committed himself to “the unconditional fulfillment of outstanding commitments under the stand-by arrangement.” Fischer agreed that once that condition had been met, including the elimination of exchange controls, the Fund would consider new lending, possibly on a larger scale than before.¹¹⁸ For the rest of the decade, however, policies remained on a course that the staff considered insufficiently strong to warrant Fund support.¹¹⁹

In the background throughout all the discussions of IMF financial support for Uzbekistan was the Fund’s decision not to make the country eligible for concessional loans. The issue first arose in November 1993, in the context of a review of the ESAF in which seven other countries were added to the eligibility list. The staff acknowledged that both Uzbekistan and Azerbaijan had per capita incomes estimated to be in the same range as the other countries being added, but they drew the rather strained distinction that for these two countries, income was not on a “declining trend.”¹²⁰ Two months later, in the context of the first Article IV consultation, the Executive Board noted that Uzbekistan’s status as a major producer of two valuable commodities—cotton and gold—gave it “considerable . . . economic potential, . . . provided that reforms necessary for rapid economic transformation were actively pursued.”¹²¹

The denial of access to concessional loans stood until 2003, when Uzbekistan finally was made eligible. In the meantime, the economy did not perform too badly, at least relative to other countries in the region (see Table 8.1). The Fund continued to push for deeper reforms, on the grounds that Uzbekistan’s relative success was attributable to its natural resources and could be greatly strengthened with better policies.¹²²

¹¹⁷“Republic of Uzbekistan—Requests for a Stand-By Arrangement and for a Second Purchase Under the Systemic Transformation Facility,” EBS/95/191 (November 27, 1995), p. 17.

¹¹⁸Report by Fischer at EBM/97/47 (May 7, 1997), pp. 3–4.

¹¹⁹Uzbekistan repaid its financial obligations to the IMF, all of which stemmed from the two STF loans and the 1995–97 stand-by arrangement, by 2006.

¹²⁰Statement by Jack Boorman at EBM/93/162 (November 29, 1993), pp. 53–54.

¹²¹Chairman’s Summing Up, minutes of EBM/94/4 (January 21, 1994), p. 56.

¹²²For an analysis, see Zettelmeyer (1999).

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8 AFTER THE FALL: BUILDING NATIONS OUT OF THE SOVIET UNION

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