Integration Formations in the Monetary Sphere: the Possibility and the Necessity for Monetary Integration in the Post-Soviet Region

Anastasiya Luzgina, BEROC
November 2013

This policy brief addresses the possibility of monetary integration in the post-Soviet region. It provides a short overview of the literature devoted to the formation and development of the monetary unions, and argues that, based on this literature and real-world experiences, monetary integration can be of substantial value for the CIS states. However, such monetary union is not feasible in the near future due to weak economic integration of the national economies of the CIS countries, significant difference in their development level, and imbalances in allocation of bargaining power between the states. This policy brief suggests that a first step towards monetary integration could be an adoption of a supranational unit of account on the territory of the Customs Union between Russia, Belarus and Kazakhstan.

The modern world has observed formation of a number of economic and monetary integration communities. Their performance varies greatly: some of them are developing successfully, others, on the contrary, are stagnating. Questions concerning the possibility of economic and monetary integration in the post-Soviet space are constantly addressed both by policymakers and by academic economists. Taking into account theoretical concepts and international experience, this brief addresses the possibility and desirability of the integration of the monetary sphere of the post-Soviet region. Based on Luzgina (2013a,b), this brief proposes a form of representation of monetary integration on the early stages of its development. In this case, an early form of monetary integration may be achieved via adoption of a single supranational unit of account on the territory of (a subset of) countries; the national currencies would continue to coexist with the new supranational currency. This approach to integration would allow preserving the independence of economic policy for the involved member states. At the same time, countries would benefit from a reduction in transaction costs and increasing convergence of national economies.

Background: Theoretical Concepts and World Experience of Monetary Integration

Ideally, the monetary union should have the form of an optimum currency area (OCA), a territory of one-currency domination with high level of integration and unification in different economic spheres. Modern economic science provides two main approaches considering the possibility of constructing an optimal currency zone on the territory of several states. The first suggests that optimality should be determined on the basis of implementing a specific group of criteria by countries. Among the main criteria, freedom of goods movement, labor and capital, openness and diversification of the economy, the synchronization inflation rates as well as integration in the financial sector can be mentioned. The second approach is based on a comparison of the benefits and costs in terms of the monetary union formation of the country with the highest economic potential. In practice, when studying the effectiveness of monetary integration, a synthesized approach is used. It includes evaluating by criteria, as well as taking into account costs and benefits that a country accrues in case of entering a particular monetary group. The main benefits of a monetary union include a reduction of transaction costs, trade relations enlargement, improving the discipline in the monetary sphere, and a reduction of the rate of international reserve sufficiency for every country-member. At the same time, there are some negative aspects of deep integration, such as loss of monetary policy independence, economic imbalances in case of weak convergence of national economies, loss of (part of) seigniorage income, and a possible negative public reaction to the adoption of a single currency.

When discussing the concept of monetary integration, it is important to understand the distinction between a monetary union and an optimum currency area. A monetary union is one of the most developed forms of a currency area, which implies a rigid anchor of national currencies to each other with a possible further transformation into the currency of the leading country, or to a single supranational currency (as in the case of the European Union). In this case, a monetary union can be formed of asymmetrical economies. Instead, the optimum currency area requires mandatory implementation of the main convergence criteria, and thereby, more symmetry/alignment among the members. Thus, a monetary union does not necessarily have to be an optimum currency area, while the optimum currency area has every opportunity to be transformed into a full-fledged monetary union1.

Historically, there have been several examples of monetary union formations. The Italian monetary union (1862-1905), which was formed through the merger of disparate Italian lands, is among them. We can also identify the Scandinavian Monetary Union, which united Norway, Denmark and Sweden (1875-1917). The Austro-Hungarian monetary union existed in the period from 1867 to 1914. Currently, we observe formations of monetary unions in Africa, Latin America and the Arab states.

Despite the implementation of a number of integration projects within the various groups of countries over the past century, only the European states were able to achieve the highest form of monetary integration. It took them more than 50 years to do this, and the integration processes in the economic and monetary fields are continuing with new Member States joining the European Union. However, despite the detailed development plans for the implementation of a monetary union, the Eurozone countries face a number of difficulties and obstacles on the path of economic development. European monetary integration brings not only benefits, but also some costs. For example, the loss of independence of monetary policy creates obstacles in regulations of economic processes.

This discussion suggests that an assessment of the potential formation of a monetary union – that is, of desirability, feasibility and level of monetary integration within a particular group

[1] Chapligin V.G. Theory and methodology of currency alliance formation/ V.G. Chapligin - St. Petersburg.: Publishing house SPbGUAF, 2003.- 193 p.

of countries – should be based on relating theoretical concepts and features of the countries in question, as well as a in-depth research of the experience of other currency unions.

Integration Processes in the Post-Soviet Space

At the territory of the former Soviet Union, integration projects have been implemented for more than 20 years. After the collapse of the Soviet Union, such integration formations as the Commonwealth of Independent States and the Eurasian Economic Community were created. Belarus, Kazakhstan and Russia have built a Customs Union (CU) and a Common Economic Space (CES). There is also a possibility of making a transition to the highest form of integration – a monetary union. However, this raises a number of questions: which CIS countries should join a monetary union, when should this be done, and what is the optimal form of monetary union for integrating countries.

Luzgina (2013b) shows that, within the framework of the CIS countries, that there are significant differences in many of the macroeconomic indicators. Countries differ in terms of GDP and the growth rates of investment and prices. For example, Belarus has the highest inflation in the post-Soviet region. The source of growth also differs: for example, a number of countries, such as Azerbaijan, Russia and Kazakhstan, owe a significant part of their economic growth to the availability of natural resources, but this is not universally true within the CIS. Dynamics of population income is also significantly different among the countries. Here, Russia occupies the leading position with its average wage at the beginning of 2012 reaching 780 USD. At the same time, in Tajikistan, the average wage amounts to only 110 USD.

Another concern is that the formation of an economic and monetary union implies free movement of labor and capital. However, at this stage of development, it can lead to some negative consequences. Free movement of labor could involve a massive flow of labor from depressed areas to regions where incomes are much higher. This may create pressure on health and social services in the latter regions. In turn, free movement of capital may cause speculative attacks on the financial markets. At the same time, the CIS countries, except Russia, Kazakhstan and Ukraine, do not have large gold reserves. Therefore, the free movement of capital flows without additional support may cause a crisis within the national financial systems. Out of all the gold reserves of the CIS countries, more than 85% of the total volume is owned by Russia. In the case of an abolition of restrictions on capital flows, countries that are exposed to speculative attacks are likely to ask Russia for help. Such a situation would require Russia to use its own financial resources, which would create an additional pressure on its international reserves.

Table 1. International reserves in the CIS countries, (million US dollars)

Country	2008	2010	2012
Azerbaijan	6467,2	6409,1	11277,3
Armenia	1406,8	1865,8	1799,4
Belarus	3063,2	5025,4	8095
Kazakhstan	19883,1	28264,7	28299,4
Kirgizstan	1225,1	1720,4	2066,7
Moldova	1672,4	1717,7	2515
Russia	426278,8	479222,3	537816,4
Tajikistan	163,5	403,1	630,7
Ukraine	31543,3	34571,3	24552,8

Note: The author's own calculation based on data from the World Bank

Russia is leading among the CIS countries in terms of population and territory, with other countries lagging substantially behind. For example, Belarus owns less than 1% of the total territory of the CIS countries and less than 4% of the population.

Relying on the above quantitative indicators it is natural to expect that in case of a formation of a monetary union with a single emission center, the distribution of votes in the decision-making of the development and implementation of monetary policy is likely to be unequal. The leading role would likely belong to Russia, which has the largest economic potential. However, other countries in this case may be in a less advantageous position as Russia's decisions may lead to undesirable consequences for the economies of other countries, given the lack of a sufficient degree of synchronization of national economic systems.

Thus, a weak degree of economic integration of the national economies of the CIS countries, different levels of development, as well as the superiority of the economic potential of Russia over the other states gives reason to argue for a non-feasibility of monetary integration within the CIS countries in the short term.

On the other hand, it may be reasonable to consider the possibility of integration in the monetary sphere on the basis of the most economically integrated countries, namely Russia, Belarus and Kazakhstan. These countries have created a Customs Union and are implementing a project of forming a Common Economic Space. There are plans of creating the Eurasian Economic Union. In addition, based on the experience of European countries, it might be easier to start the integration within a limited number of participants, which satisfy the required convergence criteria. Later, more countries may enter the monetary union.

Prospects for Monetary Integration of Belarus, Kazakhstan and Russia

Taking into account the experience of the European Union, we note the need for close trade and technological relations, as well as a market type of economy, and unification of the legislation in the economic sphere. Some of these elements of monetary integration are observed within the CU. After the collapse of the Soviet Union, economies of the former Soviet states switched to paths of market reforms. In addition, the CU countries have rather close trade relations; they have restored the old and created new means of communication. At the same time, there is a weak degree of diversification of exports and imports. A large part of export and import are represented by raw materials.

The second important point of the monetary integration is the comparability by size of the emerging economies. In the framework of the Customs Union, Russia is the only leader. Harmonization of relations between the alliance partners would be easier in the case of smaller countries coordinating their efforts, which would allow them to defend their interests along with the large member-states.

Finally, obligatory condition of monetary integration is the fulfillment of convergence indicators (certain values of macroeconomic indicators) by all association members. In Luzgina (2013b), we compare a range of such indicators, as based on the experience of the European Union. We use indicators such as the inflation rate, public debt, budget deficit, and the dynamics of exchange rates for comparison. The study reveals that the main differences lie in the monetary indicators, namely the rate of inflation and exchange rate. In addition, there are certain differences in the structure of the economy and the share of private ownership in GDP.

Figure 1. Exchange Rate (average for a year), as % of the previous year

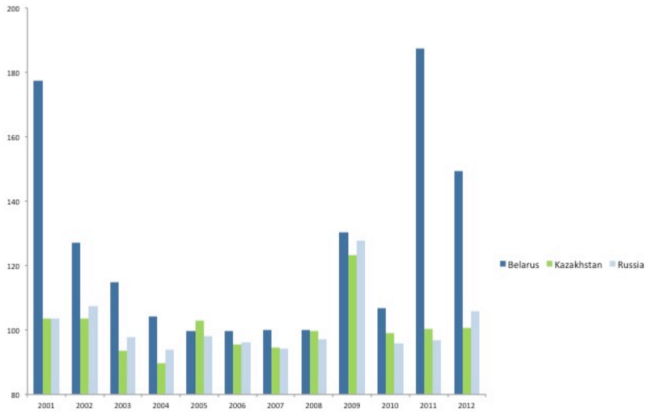
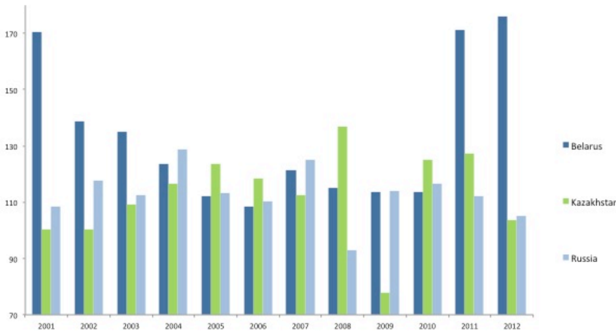


Figure 2. Industrial Producer Price Index (average for a year), as % of the previous year



Source: Data of the Interstate Statistical Committee of the Commonwealth of the Independent State

The persistence of significant differences in the values of convergence indicators at the macro level makes a full-fledged monetary union highly unlikely in the short term, even within the framework of the three most economically integrated states. At the same time, it is appropriate to consider the option of monetary integration in its mild form, i.e. in the form of monetary integration on the basis of a single unit of account. A single unit of account is usually calculated on the basis of the basket of national currencies, and is mostly used for international payments and credits.

The attractiveness of monetary integration in the form of monetary union on the basis of a supranational unit of account is motivated; first of all, by the preservation of the economic sovereignty of all countries. Circulation of the unit of account would take place in parallel with national currencies. Member states would retain the possibility of implementation of independent monetary and fiscal policies. Furthermore, the unit of account may fulfill the role of a training tool. The supranational payment unit can be used on the national level. Using this unit of account, legal entities may carry out transactions and individuals may hold their savings. It can also be actively implemented in the inter-state calculations. A part of gold and forex reserves of member countries can be held in the supranational unit of account. Inter-state loans can be issued in this unit as well. This type of monetary union would reveal the feasibility of further deepening of integration in the monetary sphere and determine the timing of the formation of a full-fledged monetary union. In case of serious problems, the dismantling of the currency union will not cause major adverse changes in national economies, unlike in the case of a collapse of a monetary union with a single currency. In addition, the operation of a single unit of account allows for the anticipation of potential problems associated with the functioning of economies under a single monetary system, and a solution before the introduction of a supranational currency.

Last, but not least, this form of integration seems to be a relatively feasible option as the process of convergence on the territory of the CU countries in the monetary sphere has already begun. There is an increased use of national currencies in bilateral trade, harmonization of national legislation is taking place in the monetary sphere, and international agreements in the monetary sphere are ratified. These activities are gradually building a base for the realization of the monetary integration project of the union countries.

Conclusions

Economic and monetary integration allows the countries to get the maximum benefit from mutual cooperation. However, the deepening of the integration process is usually accompanied by certain difficulties. Convergence of economic systems requires transformation of economic institutions, changes in legislation and principles of management, all of which are costly to achieve. The better the preliminary harmonization is performed, the easier the process of adaptation of national economies to function within a particular economic and monetary union will be.

The post-Soviet countries are implementing several projects of economic integration. However, their economies have major differences according to a number of macroeconomic indicators. The greatest degree of convergence is reached only by three CIS states, namely Belarus, Russia and Kazakhstan. Rather high level of economic integration, as well as a continuation of the process of unification and harmonization of national economies allows us to study the feasibility of realizing the lightweight form of a monetary integration based on a single supranational unit of account on the territories of Belarus, Kazakhstan and Russia.

▪

References

Butorina O.V. International currencies: integration and competition / O.V. Butorina.- Moscow.: Publishing house "Delovaia literatura", 2003.- 368 p.

Chapligin V.G. Theory and methodology of currency alliance formation/ V.G. Chapligin - St. Petersburg.: Publishing house SPbGUAF, 2003.- 193 p.

Drobishevski S.M., Polevoi D.E. The problems of creating a single monetary zone in the CIS countries / S.M Drobishevski, D. I. Polevoi – Moscow.: EAPP,- 2004. - 152 p.

Euro – a baby of Mandell? The theory of optimum currency areas: collection of papers: translation from English.- Moscow.: Delo, 2002.- 368 p.

European monetary union: transition, international impact and policy options/ edited by Paul J.J. Welfens.- Berlin.- Springer.- 1997.-470 p.

Eurasian Economic Community on-line database [Electronic resource]- Moscow.- 2005.- Mode of access: www.evrazes.com.- Date of access: 17.02.2012

Evstigneev V.R. Currency and finance integration in EU and CIS. Comparative semantic analysis. /V.R. Evstigneev -M.: Наука.- 1997.—271 p.

International monetary fund on-line database [Electronic resource] - Washington.- Mode of access: www.imf.org.- Date of access: 07.11.2012

Kondratov D.I. Finantial integration: international experience and perspectives of CIS countries development/D.I. Kondratov// Economic Journal of HSE.- 2012.- №1.- p. 105-142.

Luzgina A.N. Prospects of economic and monetary integration of the CIS member states/ A.N. Luzgina // Bank Bulletin Magazine. – 2013a.-№ 19 (600).- p. 21-26.

Luzgina A.N. Model of monetary integration involving the Republic of Belarus / A.N. Luzgina // Bank Bulletin Magazine. – 2013b.-№ 20 (601).- p. 39-46.

Mandell R. A theory of optimum currency areas/ R. Mundell// Interntional economics [Electronic resource].- New York: Macmillan.- 1968.- Mode of access: http://www.columbia.edu/~ram15/ie/ie-12.html. - Date of access: 23.05.2013.

Monetary unions: theory, history, public choice/ edited by Forrest H. Capie and Geoffrey E. Wood.- London: Routledge, 2003.- 198 p.

Statistical Committee of CIS on-line database [Electronic resource] - Moscow, 2013.- Mode of access: www.cisstat.com.- Date of access: 03.09.2012

Struk T. Concepts of reforming the world currency system/ T. Struk// Bank Bulletin Magazine- 2012.-№16 [561].- p.7-14.

World Bank on-line database [Electronic resource].- 2013.- Mode of access: http://worldbank.org.- Date of access: 27.06.2013

Anastasiya Luzgina

Research Economic
Research and Outreach
Center (BEROC)
Luzgina@beroc.by
http://www.beroc.by

Luzgina finished the Belarusian State Economic University with honors in 2001. She has a Bachelor's degree in finance and banking. In 2007, Luzgina finished the graduate program in economic theory at the Belarusian State University (BSU).

She has worked as an economist in Vneshtorgbank (2000-2001), leading economist in the National Bank of the Republic of Belarus (2001-2007), and as economist in the Resident Representative Office of IMF in Belarus (2007-2009). Starting from 2003, Luzgina holds a position as a senior teacher at the BSU. Since 2010, she works as a researcher at the Belarusian Economic Research and Outreach Center (BEROC).