Kazakhstan and the Ruble (A)

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Introduction.

On 1 January 1992 President Nursultan Nazarbayev and the leaders of Kazakhstan faced a challenging and novel new year. During much of 1991 (and indeed since the 1920s) Kazakhstan had been a constituent republic of the Soviet Union (USSR). In this union, the government in Kazakhstan was charged solely with the implementation of policy formulated in the Soviet capital of Moscow. With the dissolution of the USSR in late 1991, Alma Ata has become not only the capital city of Kazakhstan but a seat of independent policy-making. The course of policy in 1992 depended upon the choices of President Nazarbayev and his advisers.

One of the more contentious decisions necessary was the choice of currency for economic transactions in Kazakhstan. During the period of the Soviet Union, Kazakhstan used the Soviet ruble; however, with independence this choice could be reconsidered. The two dominant alternatives were the continued use of the ruble and the creation of a new Kazakhstan currency. Each had its following, with supporting arguments drawn both from politics and from economics. However, everyone recognized that the choice must be made immediately: without a clearly defined medium of exchange, domestic and international transactions would be stifled.

Background information.

Kazakhstan is a large landlocked economy of Central Asia. Its southern border is shared with Iran and Commonwealth members Turmenistan, Uzbekistan and Kirgizstan. China borders the country on the east, while to the west and north lies Russia. Its landmass is 2.7 million square kilometers, or just smaller than that of India, while its population of 16.8 million leaves it relatively underpopulated. There are a large number of ethnic groups represented. The Kazakhs now represent only 40 percent of the total population, with ethnic Russians almost as numerous. The balance is a mix of people of German, Chinese and Turkic descent.

The economy is richly endowed with natural resources. Among the mineral resources found in exploitable amounts within the economy are oil, associated gas, coal, copper, nickel, gold, titanium, tungsten, molybdenum, lead, zinc, manganese, aluminum and iron ore. Its vast lands support a wide variety of rainfed (in the north) and irrigated (in the south) agriculture. Livestock husbandry is the traditional industry of the indigenous Kazakh people based upon the extensive opportunities for grazing.

Industrialization has largely been natural resource-based. Processing plants for both ferrous and non-ferrous metals have been developed, especially in the northern and eastern sections of the economy close to the mineral deposits. Refineries and petrochemical plants also take advantage of the existing hydrocarbon resources. Agro-industries exploit the southern crops of cotton and sugar beets as well as the harvests of fruits and vegetables throughout the economy.

Characteristics of International Trade and Payments.

The economy of Kazakhstan is tightly integrated with those of Russia and the other republics of the former Soviet Union (now referred to as the Commonwealth of Independent States). The transport and communication grids tend to connect points in Kazakhstan with points in Russia, for example, more easily than with other points in Kazakhstan.

Kazakhstan's economic isolation from countries outside the Commonwealth parallels its integration with the former republics. It shares a common border only with China, with whom it had often-antagonistic relations during the past 50 years. The geography of desert and mountains to the south discouraged trade with Iran, Pakistan, Afghanistan and the rest of south Asia. The small share of exports and the few air connections to destinations other than the republics testify to this isolation.

As a result, trade outside the Soviet Union had historically been a very small portion of total Kazakhstan trade, with shipments to and from other republics of the Soviet Union being much more important to the Kazakhstan economy.

Inter-republican and International Trade
(at domestic prices, millions of rubles)

	1987	1988	1989
Exports			
Inter-republic	8337.3	8337.1	8201.1
Rest of World	473.8	827.1	892.8
Imports			
Inter-republic	13768.3	13686.4	14570.7
Rest of World	2583.7	2733.7	2998.3

Source: GOSKOMSTAT USSR

Kazakhstan ran substantial trade deficits with both sets of partners during the periods in question.[1] This continued as well through 1990 and 1991.[2]

Russia is its major trading partner. Exports to Russia when evaluated in domestic prices are 60 percent of total exports, while imports from Russia account for over two-thirds of total imports. The high degree of integration of the former Soviet republics led to quite active and diffuse international trading patterns among Commonwealth countries. The pattern of trade has been largely constant in the last 20 years, with imports mainly machinery and consumer goods while exports are predominantly agriculture, heavy industry, crude oil, non-ferrous metals and meat. China is the largest non-Commonwealth trading partner, with Eastern Europe also important. The articles purchased on world markets were by and large manufactured equipment and producers' goods, while the exports to non-Commonwealth markets were mainly resource-based.

International Payments Mechanisms. Settlement of payments for inter-republican flows within the Soviet Union took place through the correspondent balances of the republican national banks with GOSBANK.[3] Trade between the republics had been denominated in rubles. The clearance time has ranged from 3 days to 2 months, but with the value of the ruble stable this wait was not in the past an exorbitant burden. Trade with the rest of the world has been coordinated by state trading organizations, with settlements of international payments taking place through the Foreign Trade Bank centered in Moscow with branches in republican capitals.

Exchange of rubles for foreign exchange in January took place at a substantial premium in informal markets. The government used 2 rubles/US dollar as a conversion rate for national accounts. 4.5 rubles/US dollar became the official Commonwealth quote while the informal rate was 100-120 rubles/US dollar.

Legacies of Soviet political and economic policies. USSR President Gorbachev's policy of perestroika mandated a transition from command to market economy that was quite disruptive to the economy of Kazakhstan. A downward trend in real output in Kazakhstan is datable in part to a 1988 revision in the law governing the Ministry for supply and distribution of goods in the Soviet Union (GOSSNAB). International trade that once depended upon the "command" instrument of trade agreements among republics was faltering as the country searched for a "market" equivalent.

[1] Domestic pricing of these products does not provide a reliable indication of the actual resource transfers, but similar calculations using world prices provide the same conclusion: Kazakhstan was a large net importer from both other republics and the rest of the world.

[2] At least one source -- trade agreements among republics -- reaches the diametrically opposed conclusion. However, the preponderance of statistical evidence agrees with the conclusion of large deficits.

[3] The settlement accounts were held by the MFO, affiliate institutions of each of the GOSBANKs.

Retail prices in Kazakhstan: inflation by quarter, 1991

	1991 First	1991 Second	1991 Third	1991 Fourth
All goods	12.4	95.8	106.1	127.3
Foodstuffs	8.8	87.0	99.0	116.7
Non-food	15.8	103.5	111.6	136.7
Services	0.9	61.3	73.4	86.9

Source: GOSKOMSTAT Kazakhstan

The government of the Soviet Union during 1990 and 1991 embarked upon a fiscal policy characterized by large budget deficits. The monetary integration of the republics within the USSR became a source of inflationary pressure in Kazakhstan. Budget deficits within the Soviet Union, and later Russia, were financed through bonds sold to the State Bank (GOSBANK). The subsequent increase in currency in circulation caused inflationary pressures throughout the USSR. These were repressed through government controls over prices, but surfaced in the form of rationing and queuing to purchase the scarce goods.

The USSR government raised its controlled prices twice during 1991 but maintained strict controls over the prices of goods and services.

The 1991 budget of Kazakhstan was strongly in deficit as well and totalled 46 percent of total revenues.[4] This contributed to the inflationary impetus of Soviet fiscal policies as intra-Union transfers provided the resources to balance the budget. The planned state government budget deficit for 1992 of 10.9 billion rubles was 13 percent of government revenue.

Institutional responses to the breakup of the USSR. In macroeconomic decision-making, Kazakhstan followed the sensible course of assigning responsibility to the local agencies of formerly Union-wide ministries. This led, however, to some irregularities by international standards -- for example, official foreign-exchange holdings are placed in the Foreign Trade Bank rather than in the National Bank.

Kazakhstan maintained the USSR's common tariff on trade with non-Commonwealth countries. It remained in the ruble monetary zone. There was also an agreement among Commonwealth members to share responsibility for the international debts incurred by the Soviet Union.

[4] This includes both revenues and Stabilization Fund contributions.

The break-up of the banking system of the Soviet Union was not accompanied by a distribution of assets, either domestic or foreign, to the constituent republics. Rather, in most cases the Russian republic's financial system appropriated those assets. The Foreign Trade Bank of Kazakhstan, for example, at that time had only minor holdings of foreign assets that were not claims on foreign exchange held in the Russian Foreign Trade or Central Bank.

Commodity price liberalization occurred more rapidly in Russia than in Kazakhstan during the last quarter of 1991. This led to price discrepancies for staple goods and caused large flows of goods from Kazakhstan to Russia in arbitrage (smuggling). The government's response has been to close the border to all trade with Russia (effective December 16) and to initiate talks for coordination of price liberalization. This led to a communication by Mr. Gaidar, Vice-Minister of Economics in Russia, that gave the economics officials of Kazakhstan advance warning of Russia's price liberalization announcement of January 2.

Decision-making framework.

The President's economic advisors informed him that the choice of currency for Kazakhstan is closely related to questions raised in the theoretical economic literature on the choice of exchange rate regime (see Annex A). The theoretical and practical discussions in the European Community context on "optimal currency areas" (Annex B) also outline costs and benefits associated with his decision. A thorough analysis of the country's monetary dilemma required summary of and a decision rule derived from these sources.

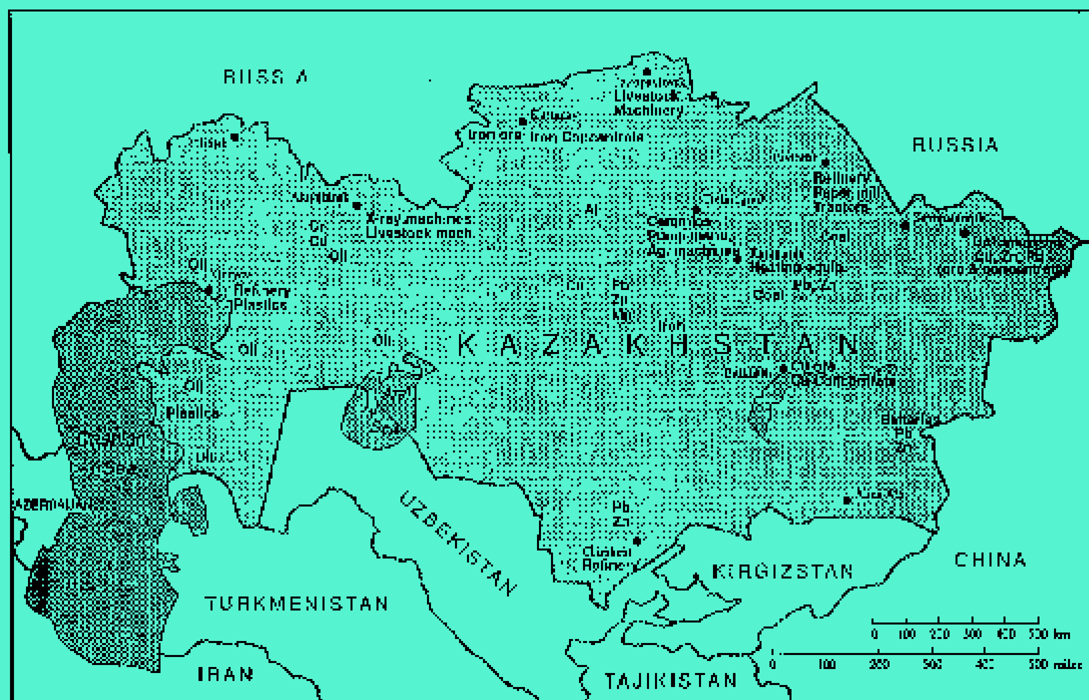
The President had two objectives to satisfy through his choice. He was convinced of the importance of export orientation in this period of economic transformation, and looked for a policy that furthered this goal. He was also cognizant, however, that he had to foster national identity and unity.

Other institutional decisions were highly interdependent with this choice. The price liberalization decision had to be taken concurrently, as discussed above, and this involved recognition that the effect of inflation in Russia and other trading partners depends upon the choice of exchange rate regime. Kazakhstan had further up to that time relied for international trade on markets and suppliers in the republics of the former Soviet Union, but the officials of the Ministry of Foreign Economic Relations advised that international obligations (e.g., for servicing the Soviet debt) required a large jump in exports to countries which paid in foreign exchange.

This case study does not represent historical meetings or conversations within the government of Kazakhstan. It is constructed from the author's reading of events in this country to highlight the choices actually facing that government at a time of crisis for pedagogical purposes. It should not be interpreted as a historical text.

Map of Kazakhstan

FIGURE 1



Annex A: Theoretical References on the Choice of Exchange Rate Regime.

Possible exchange rate regimes.

Review your international economics text.

Arguments in favor of various regimes.

You may find useful the following:

R. McCullough: "Unexpected Real Consequences of Floating Exchange Rates", in Adams, J.: The Contemporary International Economy: A Reader, 2nd edition. New York, NY: St. Martin's Press, 1985.

Niels Thygesen, "Exchange-Rate Experiences and Policies of Small Countries: Some European Examples of the 1970s", Princeton Essays in International Finance 136, December 1979.

Pierre-Richard Agenor, “Capital Market Imperfections and the Macroeconomic Dynamics of Small Indebted Economies”, Princeton Studies in International Finance 82, June 1997.

Causes of High Inflation.

You may find useful the following:

R. Dornbusch, F. Sturzenegger and H. Wolf: "Extreme Inflation: Dynamics and Stabilization", Brookings Papers on Economic Activity 2/1990.

Michael Bruno, "High Inflation and the Nominal Anchors of an Open Economy", Princeton Essays in International Finance 183, June 1991.

Economic Reform in the former Soviet Union.

For further readings in these areas examine the following:

Symposium on the Soviet Economies after Communism, Brookings Papers on Economic Activity 1991/2.

Symposium on Economic Transition in the Soviet Union and Eastern Europe, Journal of Economic Perspectives 5, Fall 1991.

David Lipton and Jeffrey Sachs, "Prospects for Russia's Economic Reform", Brookings Papers on Economic Activity 1992/2.

Simon Johnson, Daniel Kaufmann and Andrei Shleifer: The Unofficial Economy in Transition, Brookings Papers on Economic Activity 1997/2.

Patrick Conway, Crisis, Stabilization and Growth in the Transition Economies, 2000.

Annex B: Literature on Optimal Currency Areas

Traditional sources of information about this include :

Ed Tower and Thomas Willett, "The Theory of Optimum Currency Areas and Exchange Rate Flexibility", Princeton Essays in International Finance 11, 1976.

Y. Ishiyama, "The Theory of Optimum Currency Areas: A Survey", IMF Staff Papers, July 1975.

More recently:

Alberto Giovanninni, "The Transition to European Monetary Union", Princeton Essays in International Finance 178, November 1990.

Matthew Canzoneri and Carol Rogers, "Is the European Community an Optimal Currency Area? Optimal Taxation vs. the Cost of Multiple Currencies", American Economic Review 80, 1990, pp. 419-433.

Charles Wyplosz, “EMU: Why and How it Might Happen”, Journal of Economic Perspectives 11/4, Fall 1997.