

Eastern Europe Needs a Parallel Currency

By RICHARD W. RAHN

The Soviet Union and East European countries are experiencing the monetary equivalent of a nuclear meltdown. It has been reported that the black market exchange rate for the ruble has fallen as low as six cents, compared with the official rate of \$1.52. The currency crisis has become so acute that the Baltic republics have been demanding for the right to create their own money.

Communist currencies fail to provide the basic functions of money. They are not convertible into other currencies, their purchasing power is continually eroded by high rates of overt and repressed inflation, and they cannot be used to buy many desired goods. The last factor is a result of centrally administered prices that cause shortages in many goods at the official price levels.

To correct these problems, East European governments would have to institute radical price reform and alter the monetary relationships within the East European trading bloc. The political cost of these necessary changes would probably be unacceptably high to Communist regimes in the foreseeable future. This presents a dilemma for those governments that are facing growing pressure from their citizens for an improvement in the standard of living. The only way out is to move toward a free-market system and expanded trade with and investment from the West. This could be accomplished, in part, by allowing a non-regulated, freely circulating, competing currency.

These governments could decide simply to use existing convertible currencies, such as the American dollar or the West German mark. To some extent this is already happening, particularly in Poland, where prices are frequently quoted in dollars and many citizens are hoarding greenbacks.

Several nations do use the dollar as their money. But using another country's currency has a number of disadvantages. Among these are the loss of national prestige and a vulnerability to adverse political events in the issuing country.

Thus there is an immediate market need in Eastern Europe for a currency that could compete with the government's monopoly currency. Such a new money would serve as a store of value and would allow free convertibility into other currencies. As this would facilitate the development of a free-market economy in parallel with existing socialist ones, it would probably be the least destabilizing way to allow economic growth as it would not stage a direct assault on the existing political order.

Such a money would be backed by a basket of real goods: tradeable commodities and high-grade securities issued throughout the world by companies and governments, with a rate of return in excess of the inflation rate for the currencies in which they are denominated.

There are four factors that make the creation of an alternative money today not only possible but also practical.

- The first is the proliferation of commodity exchanges where both the cash and futures prices of the various commodities are determined by supply and demand in open auction.

- The second is the emergence of international markets, in which a number of commodities and services - such as transatlantic telephone calls, casualty insurance

and shipping rates - have a so-called "one world price."

- The third is the development of money market funds throughout the world that enable investors to insure themselves against inflation in general and against changing rates of inflation specifically in the currencies in which the funds are denominated. The existence of these money market funds would enable the issuer of a surrogate money in part to back his currency by the acquisition of money market assets in a variety of locations and funds based in several different nations.

- The fourth factor is the existence of tax havens where bank secrecy laws prevail, such as Switzerland, the Bahamas, Cayman Islands, Hong Kong and Liechtenstein.

The issuing body, a non-governmental organization, would be a private bank based in a country that levies no capital gains taxes, has bank secrecy laws and has a long history as well as good prospects for political stability. The bank would be owned by its users - individuals, private institutions, or government-owned companies or organizations. The bank would back the money, in part, with a basket of commodities whose historic price increases generally equalled the rate of inflation.

To ensure that no one commodity would have a disruptive influence as a result of extreme price swings, the basket would contain perhaps a dozen different commodities, such as oil, gold, wheat, corn, tin, rubber, and the like. In addition to the commodity basket, the currency would be backed with high-grade financial paper, that is, stocks, bonds and money market funds from a number of politically and economically stable countries. The value of the new money surrogate would be defined as the amount of dollars, pounds, marks, yen, etc. necessary to purchase a specified market basket of goods and services having a one world price.

The new bank initially would operate much like a mutual fund except that it would be a fund of funds. The bank's managers would accept any convertible currency that in turn would be used to buy shares in commodities, stocks, bonds and money market mutual funds in various countries. The managers would be responsible for determining what share of the assets would go into the different types of funds. They would have to select the specific funds and make sure that these were widely diversified by location and by currency denomina-

tion. The bank's managers would have a simple operational goal: making certain that the rate of return is at least marginally higher than the rate of inflation for whatever currency the fund's investment is denominated in.

Individual or business clients would bring any convertible currency to the bank and exchange it for a bank note that might be called the "NIM," for New International Money. Clients would have an incentive to use the new bank provided that they are assured that the bank notes they hold will protect them against inflation and that the bank's assets are of adequate value and sufficiently liquid. A large demand for such bank notes could come from those who have access to convertible foreign currency but are in countries whose own money is neither convertible nor stable - a fair description of Eastern Europe today.

There would be a great incentive for state-operated companies in Eastern Europe to make long-term contracts with Western corporations or individuals quoted in NIMs, as this would largely cover foreign-exchange and inflation risks. Such arrangements may be practical even between state-owned companies, given that the existing price mechanism often fails to function.

As more and more market activity is allowed in the statist countries of Eastern Europe there would be considerable incentive among the private entrepreneurs and individuals to quote prices in NIMs to avoid the distortions caused by the existing state pricing mechanisms. Bargains then could be struck at a more realistic market rate for the existing state currency against their set NIM price.

NIMs may become widely accepted in a country once political authorities recognize that such circulation will reduce the necessity for the population to hoard foreign currencies. The issuing bank itself, having an international board of directors and being in effect a mutual fund, could be viewed as a superior alternative to the use of another government's currency. Success for this approach in one country alone could start a trend, offering hope to a number of small countries that need a major and stable international currency.

Mr. Rahn is vice president and chief economist at the United States Chamber of Commerce in Washington.