How to Establish Monetary Stability in Asia

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The International Monetary Fund failed to anticipate Asia's financial crisis. Then, to add insult to injury, the IMF misdiagnosed the patient's malady and prescribed the wrong medicine. Not surprisingly, the patient's condition has gone from bad to worse.

What the IMF has failed to realize is the fact that all of the countries in Asia where it intervened in 1997—Thailand, Philippines, Indonesia, and South Korea—had the same type of fatally flawed exchange-rate systems. Although the dramatic events in Asia have generated a torrent of commentary about exchange rates, most of that commentary has either been half-baked or flat out wrong.

Exchange-Rate Regimes

There are three types of exchange-rate regimes: floating, fixed, and pegged rates. Each type has different characteristics and generates different results. Although floating and fixed rates appear to be dissimilar, they are members of the same family. Both are free-market mechanisms for international payments. With a floating rate, a monetary authority sets a monetary policy, but has no exchange-rate policy—the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a monetary authority. Whereas, with a fixed rate, a monetary authority sets the exchange rate, but has no monetary policy—monetary policy is on autopilot. In consequence, under a fixed-rate regime, the monetary base is determined by the balance of payments. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa. With both of these free-market exchange-rate mechanisms, there

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cannot be conflicts between exchange-rate and monetary policies, and balance-of-payment crises cannot rear their ugly heads. Indeed, under floating- and fixed-rate regimes, market forces act to automatically rebalance financial flows and avert balance-of-payments crises.

While both floating- and fixed-rate regimes are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries because these countries usually have weak monetary authorities and histories of monetary instability. For a recent dramatic example, we have to look no further than Indonesia. It floated the rupiah on July 18, 1997. Unfortunately, but not surprisingly, the rupiah has not floated on a sea of tranquility. Indeed, the rupiah has fluctuated wildly and has lost 75 percent of its value against the greenback. In consequence, chaos has broken out, with people hoarding toilet paper, rice, and cooking oil.

Fixed and pegged rates appear to be the same. However, they are fundamentally different. Pegged rates are not free-market mechanisms for international payments. Pegged rates, such as those that were employed throughout most of Asia before the recent currency crises, require a monetary authority to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components. Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange-rate and monetary policies (Walters 1990). For example, when capital inflows become "excessive" under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. And when outflows become "excessive," an authority attempts to offset the decrease in the foreign component of the base with an increase in the domestic component of the monetary base. Balance-of-payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradictions between exchange-rate and monetary policies and force a devaluation. That is what happened in Mexico in 1994 (Hanke and Walters 1994). It is also exactly what happened last summer in Thailand and in the other Asian countries with pegged exchange rates. Table 1 summarizes the main characteristics and results anticipated with floating, fixed, and pegged exchange rates.

The Proof of the Pudding Is in the Eating

Base money is the purview of monetary authorities, either central banks or currency boards. Central banks have broad latitude to create

TABLE 1

Exchange-Rate Regimes

Type of Regime	Exchange-Rate Policy	Monetary Policy	Source of Monetary Base	Conflicts between Exchange-Rate and Monetary Policy	Balance-of-Payments Crisis
Floating Rate[a]	No	Yes	Domestic	No	No
Fixed Rate[b]	Yes	No	Foreign	No	No
Pegged Rate[c]	Yes	Yes	Domestic and Foreign	Yes	Yes

[a]Floating rates are employed in most developed countries.

[b]Fixed rates are employed in several developing countries or regions: Hong Kong (1983), Argentina (1991), Estonia (1992), Lithuania (1994), Bosnia (1997), and Bulgaria (1997).

[c]Pegged rates are employed in most developing countries and also among the countries that are members of Europe's Exchange Rate Mechanism.

base money. Currency boards do not have that flexibility. A currency board system requires that domestic notes and coins, as well as deposit liabilities at the monetary authority, be fully covered (usually at 100 percent to 115 percent) by foreign reserves denominated in a foreign anchor currency, and that the domestic currency must trade, without restrictions, at an absolutely fixed exchange rate with the anchor currency. An orthodox currency board cannot create credit. Therefore, it cannot extend credit to the fiscal authorities or act as a lender of last resort to the banking system. Currency boards run on automatic pilot, with changes in the monetary base determined solely by changes in the demand for domestic base money—driven by changes in the balance of payments. Table 2 presents the characteristics of currency boards and contrasts them with those of central banks.

The first currency board was established in 1849, and beginning about 1913, that system spread rapidly throughout most parts of the world. In the 1950s and 1960s, many currency boards were abandoned and replaced by central banks, which was a remarkable development. The performance of currency boards had been excellent. All had maintained full convertibility into their anchor currencies. Furthermore, countries with boards had realized price stability, respectable economic growth, and balanced government budgets (Hanke, Jonung, and Schuler 1993).

The demise of currency boards resulted from a confluence of three factors. A choir of influential economists was singing the praises of central banking's flexibility and fine-tuning capacities. In addition to changing intellectual fashions, newly independent states were trying to shake off their ties with former imperial powers. And the IMF, anxious to obtain new clients and "jobs for the boys," lent its weight and money to the establishment of new central banks. In the end, the Bank of England provided the only institutional voice which favored currency boards. That was obviously not enough. Politics, not the economic record, prevailed.

The picture began to change in 1983. After the currency crises of May-September 1983, Hong Kong stopped floating and reestablished its currency board system. This was followed in the 1990s, when Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia (1997) established currency board systems.

Those developments trouble some analysts who fret about the inflexibility of currency boards. *The Economist* summarized these sentiments in a piece, "The Great Escape," which appeared in the May 3, 1997, issue. That article asserted that currency boards cannot cope with external shocks; that they are vulnerable to surges in inflation

TABLE 2

MAJOR FEATURES OF A CURRENCY BOARD VERSUS A CENTRAL BANK

Typical Currency Board	Typical Central Bank
Usually supplies notes and coins only	Supplies notes, coins, and deposits
Fixed exchange rate with reserve currency	Pegged or floating exchange rate
Foreign reserves of 100 percent	Variable foreign reserves
Full convertibility	Limited convertibility
Rule-bound monetary policy	Discretionary monetary policy
Not a lender of last resort	Lender of last resort
Does not regulate commercial banks	Often regulates commercial banks
Transparent	Opaque
Protected from political pressure	Politicized
High credibility	Low credibility
Earns seigniorage only from interest	Earns seigniorage from interest and inflation
Cannot create inflation	Can create inflation
Cannot finance spending by domestic government	Can finance spending by domestic government
Requires no "preconditions" for monetary reform	Requires "preconditions" for monetary reform
Rapid monetary reform	Slow monetary reform
Small staff	Large staff

NOTE: The characteristics listed are those of typical actual currency board or central bank, especially one in a developing country, not those of a theoretically ideal or exceptionally good currency board or central bank.

triggered by capital inflows; and that with limited lender of last resort capacities, they cannot deal effectively with financial emergencies.

The evidence does not support these oft-repeated assertions about the alleged drawbacks of currency boards. Post-1971 data from developing countries show that countries with currency boards or board-like systems (fixed exchange rates) have had average growth rates that were 2.1 times higher than those with central banks (pegged exchange rates), and that the variability of those growth rates (measured by their standard deviations) was virtually identical. As for inflation, currency boards were also superior to central banks, with average inflation rates being 3.2 times higher and 4.7 times more variable in central banking

than in currency board countries. Financial emergencies have also been much less frequent and less severe in countries with currency boards than in those with central banks (Schuler 1996; Ghosh, Gulde, and Wolf 1998).

It's Time to Lift a Page from the Past

To establish stability in Asia, a page must be lifted from the past. Hong Kong floated the HK dollar in November of 1974, when the HK dollar was trading at about 5HK$/US$. The HK dollar did not float on a sea of tranquility, however.

Given the political unrest in China and Hong Kong, the HK dollar was wildly volatile and steadily lost value relative to the U.S. dollar. The volatility reached epic proportion in late September 1983, after the end of the fourth round of Sino-British talks on the future of Hong Kong. Indeed, financial markets and the HK dollar went into tailspins.

At the end of July 1983, the HK dollar was trading 7.31HK$/US$. By "Black Saturday," September 24th, the HK dollar had fallen to 9.55HK$/US$, with dealer spreads being reported as large as 10,000 basis points. Hong Kong was in a state of panic, with people hoarding toilet paper, rice, and cooking oil.

The chaos ended abruptly on October 15th, when Hong Kong introduced a currency board system. Under this free-market regime, the HK dollar began to trade freely with its new anchor currency, the U.S. dollar, at an absolutely fixed rate of 7.8 HK$/US$. And credibility was insured because each HK dollar was fully backed by U.S. dollar reserves. Hong Kong no longer had an independent monetary policy. It was on a monetary autopilot, with the supply of HK dollars being determined solely by the demand for them (Culp and Hanke 1993).

Apparently, Hong Kong's experience with stopping chaos and establishing stability has been lost on the IMF. This is unfortunate. Stability might not be everything, but without stability, everything is nothing.

IMF Funding

On October 6, 1992, the U.S. Congress passed legislation that directed the IMF to use U.S. quota contributions to establish currency boards, if appropriate (Public Law 102–391, *U.S. Statutes at Large* 106: 1636). Although this legislation was a step in the right direction and motivated the IMF to become more "currency-board friendly," it did not go far enough. The U.S. Congress should not advance further replenishment funding to the IMF unless the Congress imposes conditionality on that funding. Specifically, the Congress

should not provide replenishment funding to the IMF, unless the IMF mandates currency boards for developing countries that receive IMF credits. This condition would require the IMF to do what it did with Bulgaria in 1997: a currency board or no IMF credits. Currency boards are the only foolproof way to stop currency chaos, limit corruption, and establish stability in developing countries. And stability is a necessary condition for countries to design and implement their own economic reforms, reforms that do not require U.S. taxpayer money and U.S. bullyboy tactics.

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