

# **NEW FRONTIERS OF MONETARY IDEOLOGY**

*Boris Lvin*  
*World Bank, Russia*

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The following note explores a few issues of monetary policy in view of latest international developments.

My basic premises are those of traditional Austrian monetary theory, particularly the Austrian theory of business cycle. I believe Murray Rothbard was right when he said that the Austrian (i.e., correct) theory of money “virtually begins and ends with Ludwig von Mises’s monumental *Theory of Money and Credit*.”<sup>1</sup>

The modern Austrian approach to monetary policy debates (as exemplified by what might be called the “Rothbardian tradition”) is that the fiat paper standard, unlike the gold standard, is inherently prone to inflation. The gold standard is suggested as the instrument to prevent the overissue of paper money by the Central Bank. In other words, a social institutional arrangement (the gold standard) is seen as a means to limit human will and discretion (desire to manipulate the monetary stock). We are talking not about a single human being or a small group of individuals, but about a dominating public opinion. To me, this idea stands contrary to what I believe is a classical Austrian approach developed by Mises – namely, that society is driven by ideas, and not by institutions, which simply embody in their actions the prevailing ideology. Therefore, social institutions are not inherently right or wrong; their actions and effects are simply a result of ideas and views that dominate society at every moment.

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<sup>1</sup> Murray Rothbard, *The Austrian Theory of Money* in: Murray Rothbard, *The Logic of Action I: Method, Money, and the Austrian School* (Cheltenham, UK: Edward Elgar, 1997), p. 297.

This Misesian approach is both optimistic and pessimistic at the same time. It is optimistic because knowledge tends to be accumulated over time and there are reasons to believe that sound ideas, once developed, will gain more and more popularity. It is pessimistic because no institutional solution or arrangement, regardless of political effort and amount of support invested in its establishment, can guarantee that erroneous ideas and flawed theories (new or resurrected and reformulated old ones) do not carry the day.

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From this angle my understanding of modern monetary developments and prospects of return to the so called classical gold standard are also both optimistic and pessimistic.

My optimism is based on the fact that there are clear signs of changes in the prevailing global attitude towards monetary policy, in what I call the monetary ideology. This monetary ideology is present in the minds of policy-makers and popular masses alike. In the Misesian framework, any government -- whether democratic or not -- in the long run must carry out policy supported by the mass opinion of its country. Thus, modern monetary ideology has its “high representation” in the academic journals and university departments and “mass representation” in the actual policies of the governments relying on popular support. Influenced and shaped by this ideology, institutions of fiat monetary standard today tend to behave in quite a different way compared to their predecessors many decades ago.

My pessimism is based on the fact that this prevailing ideology still contains a number of serious flaws. Moreover, some developments of the last few years have demonstrated the very limited power of institutions and legislation over the public mood. That is why I for one do not subscribe to the traditional Austrian demand for immediate introduction of the gold standard, and do not see it as a necessary instrument of sound monetary policy.

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Before turning to a more detailed explanation of my views, I would like to pinpoint a number of general issues of a more general framework. Specifically, there is a certain pattern of the way freedom comes into our lives. One can very roughly distinguish three consecutive stages, which can be found in almost every area of social activity.

- ***First***, our ancestors enjoyed a sort of freedom-by-default, for the state had no technological power to impose regulation. Some liberties exist simply because there is no other choice to exercise particular activities concerned. Therefore, there is no alternative to freedom which is not valued as a special way of conduct preferred to some other ways.
- ***Later***, technological progress made it possible for the state to start regulating what had been previously unregulated. Some liberties of the previous era are getting curtailed because people do not perceive their comparative advantages.

- *Still later*, people slowly come to understand the true meaning and value of the freedoms lost. They change their preferences and re-establish old liberties. However, now these liberties are fully acknowledged; they are supported by public opinion, and exist as a result of choice. People know that it is technically possible to run things in a more regulated way but consciously prefer the liberal option.

While the very existence of the cycle liberty-by-default – curtailed-liberty – liberty-by-choice gives a rise to historical optimism, some degree of pessimism is derived from the observation that these cycles are not irreversible. Historically, one may point to many instances when the optimistic trend had been reversed, although today we are happy enough to declare that most of these instances happened to be rather short-lived (and extremely costly). Histories of free press and censorship, freedom of movement and visa regime, free trade and protectionism, peaceful coexistence, democratic government, and so on are well known and need not to be recalled here.

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Monetary history follows a similar pattern of resurrecting once-natural freedom, also with a number of unfortunate reversals. Original monetary freedom meant unregulated, or weakly regulated metal money. Technological progress enabled governments to enforce a growing number of restrictions and limitations, which ultimately led to what seemed to be a final ascendancy of fiat money. However, almost immediately after such a sweeping

victory of the fiat money regime people started to recognize various flaws associated with it. Thus starts the process of monetary awakening. Step by step, mostly without being guided by the Austrian theory, many countries move closer to the gold standard principles.

An important aspect of this process is melting down of the traditional rationale for central banking. One may call this aspect, in a Kuhnian fashion, an undermining of the formerly dominant paradigm. Adoption of the currency board mechanism by a number of countries must be viewed in this context as an extremely important element of this process, as a creation of a new paradigm, although the role and story of modern currency boards to date is far from straightforward – mostly due to the Argentinean crisis of 2001-2002, which I shall deal with later.

One comparison vividly demonstrates the great difference between the era when the art of central banking was still emerging, and now when it seems fully dominant (but actually standing on a shaking foundation). This is the comparison of two Baring's crises – that of 1890 and of 1995. In 1890 it was deemed necessary to arrange an almost global rescue scheme for the failed bank, and for that purpose to mobilize the greatest contemporary central banks<sup>2</sup>. By contrast, in 1995 the same bank was simply sold for a nominal price of 1 pound sterling to the foreign bidder (ING bank of the Netherlands). Of course, this comparison reveals not only ideological changes, but also different relative importance of this single bank within the British and global financial systems. However I believe that

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<sup>2</sup> Brief description of these events can be found, for example, in: Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression* (New York: Oxford University Press, 1995), pp. 49-50.

the symbolic aspect of these events should not be brushed away. And, as if it were done intentionally to soften the note of optimism and to demonstrate the possibility of reversal, in just a few years we see a totally unnecessary bailout of the LTCM hedge fund.

The dominant element of the new monetary ideology is the widespread belief that inflation (which is now understood by all except the Austrian school as a rising price level, not as a growing amount of money) is a bad thing to be avoided, suppressed and prevented. This belief is indeed of a very recent origin. Up until recently one could hear from Nobel prize winners like J. Stieglitz statements about supposedly beneficial role of inflation up to 20 percent annually. Many governments worldwide found it appropriate to solve various problems with persistent two-digit inflations – and the only reason they could do this so frequently and for such long periods of time was the general public approval of these policies. In other words, monetary ideology used to be strongly inflationist – but no longer.

This tendency can be demonstrated by the global trend of lower inflation rates across a whole range of countries during the last decade or two. For instance, the IMF calculates that for industrial countries, average annual inflation was about 8 % in the 1970s, about 6 % in the 1980s, and just a little over 2 % in the 1990s. In developing economies this trend is even more pronounced – 10 % in the 1970s and 1980s, 8 % in the 1990s, and just 4 % in 2000-2003.

However, the most striking and convincing evidence can be drawn from examining the two dramatic crises of the last several years – namely, the 1998 Russian crisis and the 2002 Argentinean crisis. Close analysis of these two events is extremely instructive because it tells volumes both about changes in public opinion and about serious problems in public and professional understanding of monetary matters. What is so special about these crises, what makes them so similar to each other and so different from many earlier episodes of exchange rate failure in these and other countries?

On the one hand, when these crises were unfolding the prevailing expectation had been that the crash of stable exchange regimes had to usher a relatively long period of unfettered inflation. Such an expectation was only natural in view of earlier episodes of monetary disorder in both countries. Indeed, the notion that Argentina was doomed to live with steady inflation was commonplace at the end of the XIX century, while in Russia in the early 1990s double-digit monthly inflation was seen by many as something unavoidable. Instead, both Russia and Argentina underwent a short price and exchange rate adjustment, after which they promptly returned to more or less stable monetary policy. Clearly, this unanticipated course of events could materialize only due to the emergence of a strong national anti-inflationary consensus so conspicuously absent just a couple of decades before. Moreover, it should be noted that this adjustment in both countries took place with practically no external assistance from the IMF or the World Bank. Also, there has been no serious attempt to reverse numerous economic reforms instituted in these countries in the pre-crisis years. Administrative measures and limitations (like the famous Argentinean *el corralito*) turned out to be short-lived; trade

and labor liberalization, privatization, deregulation – all remained in place. In other words, the immediate post-crisis developments in these countries give rise to optimism

On the other hand, the crises themselves were managed by the governments of the two countries in such a hapless manner that serious pessimism must be in order. One may say that when facing the difficult, albeit unavoidable choice between sharp devaluation and default on government debt, the two governments managed to choose both. The reason why they did so was that they failed to comprehend what was going on. The governments (and the public at large) did not realize that the key task was to separate fiscal problems from the monetary ones, to prevent contamination of one area by another.

Specifically, in Russia the key issue was the unsustainable exchange rate unsupported by adequate foreign reserves. The exchange rate was fixed even though there was no legal obligation to maintain it. Investors dealing with the government debt clearly understood this fact. They were gambling against devaluation and it was the exchange rate risk which kept interest rate paid by the treasury extremely high. The most obvious policy for the new government which took office in the early 1998 had been to devalue the ruble to ensure that reserves support the money base and the real stock of government debt is reduced to more comfortable levels. Instead, every effort was made to maintain an unrealistic exchange rate. Unbelievably, the IMF strongly supported this suicidal policy until the very end, when the government let the ruble float and announced default on its debt.

In Argentina the key issue was the accumulation of government debt – partly due to the previous stock inherited from the pre-reform era, but mostly contracted in the 1990s in order to finance large off-budget outlays. In contrast to Russia, base money was sound and covered by the currency board reserves. The risk was one of default, not of devaluation. Incredibly, the united chorus of pundits around the world was suggesting that it was the currency board that was the single most important cause of economic difficulties. With the benefit of hindsight, the recent IMF study on the lessons of Argentine crisis grudgingly acknowledges that “serious consideration should have already been given to an involuntary debt restructuring” while “abandoning the currency board in 1999/2000 would have provided little relief on financing costs and would have been unlikely to rescue the economy from the slump”.<sup>3</sup> These very correct observations were nowhere to be seen in 2001-2002. Instead, in 2001 the government initiated de facto weakening of the currency board and instituted multiple exchange rates in disguise. Ironically, this disastrous policy was carried out by the very same Cavallo who successfully introduced the currency board in 1992. All in all, Argentina had devalued its currency and defaulted on its debt when it was perfectly sufficient (and much more pro-poor) to do the latter and to keep the monetary arrangement intact.

Another important aspect of the Russian and Argentinean crises is that they have effectively destroyed the once popular theory of “contagion”. Just a few years earlier, during the 1994-1997 financial crises in Mexico and East Asia this theory was routinely invoked to justify massive intervention. The global financial system was presented as

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<sup>3</sup> *Lessons from the Crisis in Argentina. Prepared by the Policy Development and Review Department. IMF. October 8, 2003* (<http://www.imf.org/external/np/pdr/lessons/100803.htm>)

inherently fragile and in permanent need of state support (and, of course, state support cannot come but hand in hand with detailed regulation). Such support was supposedly so great a challenge that it had to be carried out on a global level, as a concerted effort of all governments. However, some country-specific circumstances of Russia and Argentina have led to an surprising lack of such support (one of the reasons was the fact that these two countries had already received a substantial amount of concessional financing, thus making extension of additional assistance politically complicated). As a result, the contagion theory turned out to be pure imagination with no relation to reality. It is only reasonable to deduce that if “systemic contagion” failed to materialize at the global level, it is likely to be similarly bogus at the national level.

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There is no doubt that low-inflation policies of the central banks were triggered and supported exclusively by public perception of inflation as a social vice and by clear understanding that it is the monetary policy which is the cause of inflation. It demonstrates that there is nothing inherently inflationist in the so called fiat regime. In fact, we may start from this point to show that there is no intrinsic difference between the so called commodity money and fiat money, thus putting to rest the old and familiar juxtaposition of the two monetary regimes.

Recent innovations in the area of electronic information technology and payment mechanisms gave rise to renewed attempts to draw a line between different kinds of

money – commodity money, paper money, electronic money. Close examination however reveals that there is no such thing as non-commodity money; all money has to be commodity-based. Money is a specific good delinked from its immediate usage and important only to the extent it represents exchange value. To be usable in exchange, money must be predictable. Specifically, agents must know not only the fact that this kind of money has been and remains in use; they need to be sure that this usability will remain for some time in the future. The critical element of this future usability is the ability of the agents to expect that the overall amount of money will not be dramatically changed over some time. In other words, money must be difficult to create. This difficulty can be assured by various means: by the natural fact of scarcity of particular metal or mineral; by the complexity of, and risk of punishment for, counterfeiting; and by political control of the monetary authority who has the exclusive access to the carriers of electronic information. In all these cases the money is material, i.e. made of some kind commodity, be it precious metal, specially printed paper, or magnetic clusters on the computer hard drive. Material nature of money allows for independent objective verification of whether the object in question is money, and how much money is available.

Therefore, the critical point is not transition from one monetary material to another but the ways the public can be assured of the relative stability and predictability of its amount. That is why both paper and electronic money are no more inflation-prone by their nature than gold coins. Paper and electronic money are clearly more convenient in many aspects relative to coins and bullions, their invention must be regarded as great

progress. It is not the technical innovations but only public acceptance of inflation that made it possible.

Now it is very common to hear assertions that the preeminent task of the central bank in the division of labor within the state machinery of economic regulation is to keep inflation in check. All central bankers repeat again and again that all other tasks are only secondary to the sacred duty of fighting inflation. This bizarre idea is now widely accepted and reflects depressed and truly defensive way of thinking in the non-Austrian monetary circles. Surprisingly, this idea – i.e., that central banks must fight inflation– somehow co-exists with the notion of modern inflation being exclusively a monetary phenomenon. Moreover, this notion is used to argue that inflation as a matter of policy ought to be dealt with solely by central banks.

Why do I dare call this idea bizarre? Because it is only the existence of the central bank that makes modern inflation possible. Indeed, there is some kind of absurdity in praising leading central bankers of our time for relatively low inflation. Practically all other state institutions, however oppressive they may be, can reasonably claim at least partial credit for tackling problems existing prior to their intervention: one cannot deny that police prevents *some* crimes even in the most tyrannical states; that social security helps *some* poor people even in the most wasteful schemes; that tariff protection benefits *some* failing firms even in the most ineffective economies. Central banks on the other hand can claim a rare distinction of being the sole source of the evil they are supposed to combat – namely, modern inflation.

Central banks were established for a number of reasons, such as to shore up unsound fractional-reserve institutions; to provide the economy with cheap and abundant credit; to support fiscal deficits and national debt. They also perform a number of useful technical functions, such as auditing of some financial institutions; designing and maintaining national payment system; storing national gold reserves; and so on. It is however a fact that all these functions of central banks are now viewed as subordinate to their great mission of keeping inflation low.

The puzzling question is why, if inflation is so widely perceived as a threat, neither the general public nor the policy makers consider the option of full-reserve banking and the gold standard? I cannot agree with those answers which point primarily to the vested interests of the banking community and politicians, bureaucrats and other redistributionists. I believe that Rothbard was not entirely correct when he paid so much attention to the personal interests of the architects of the modern financial system.<sup>4</sup> In doing so he implicitly followed the reasoning of public choice theorists, which he so successfully refuted elsewhere. I think that a truly Misesian approach would require us to concentrate on the ideological factors, on the popular fallacies shared by the public and the bulk of the economic profession alike. It is only due to these widespread theoretical fallacies that some groups are able to pursue their vested interests with a broad national approval.

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<sup>4</sup> See, for instance, Murray Rothbard, *The Case against the Fed* (Auburn, Ala: Ludwig von Mises Institute, 1994), pp. 86-118.

I see several basic deep-seated fallacies in this area:

- **The first fallacy** is a totally dominant and absolutely erroneous belief that there is such a thing as a price level that can be measured with a degree of accuracy similar to physical parameters of the natural sciences.
- **The second**, and closely related to the first, is another dominant and erroneous opinion that this general price level should be kept constant rather than falling or rising. The view that falling prices (called “deflation”) and rising prices (called “inflation”) are both harmful to the public welfare, while stable prices are allegedly most propitious for a thriving economy, is now a kind of mass religion and basic self-evident truth which does not require any further theoretical verification.

Personally, I tend to believe that these two fallacies are the most dangerous tenets of the twentieth century – much more than the racial, totalitarian, and communist doctrines – precisely because they are so widely accepted and almost never subject to critical examination. Without having these fallacies exposed and refuted one can present no rational explanation of the business cycle; and it is the phenomenon of the business cycle that continues to fuel popular belief in the “inherent deficiencies of free capitalism.”

- Nevertheless, there is **one more implicit fallacy** which is to blame for having no serious discussion of the alternative monetary regimes at the political level. This

fallacy consists of the opinion that discretionary monetary policy of the central bank is a major achievement of the scientific technology and our civilization; that it is to the hands-off mechanism of the gold standard as automobiles of our time are to horse drawn carriages of the bygone era.

As a result, most people, and particularly those who identify themselves with influential academic, media, and political quarters, tend to dismiss any references to the gold standard. For them, the very idea that the “monetary policy” requires neither modification nor reform, but should be simply abolished, looks like sheer nonsense. These people may agree that failing banks must be ruthlessly liquidated, that budget deficit must be eliminated altogether, that payment system can be privatized, and so on. But independent (though internationally coordinated) monetary policy is still regarded as an indispensable element of sovereignty and civilization.

I believe this third fallacy, and not the vested interests, is the major reason why libertarians are failing to put the idea of abolishing central banking on the agenda of practical policy discussion. It should be noted that return to the gold standard is in principle fully compatible with the traditional *laissez faire* vision of limited state power. It does not require any reference to the doctrine of anarcho-capitalism which may look overly radical to many practical politicians and the media. And still, champions of the gold standard find themselves to be a hopeless minority whose views – sometimes believed to be curious but invariably impractical and outdated – are not to be taken seriously.

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In this respect the new phenomenon of modern currency board mechanism may offer us some important insights.

There is a tradition to start the story of currency boards from colonial institutions established by the British in the nineteenth century. This tradition makes serious disservice to the correct understanding of this phenomenon by making these institutions look like just an element of colonial rule and, therefore, a mark of national inferiority and underdevelopment. Despite their common name, it would not be entirely correct to place modern currency boards and their colonial predecessors into the same category.

As demonstrated by Kurt Schuler,<sup>5</sup> old British currency boards were institutions of note issue created by colonial administrations only where there was no local private banking system and no appropriate self-government capable of chartering private banks. It was the era when private note emission was the rule rather than exception. Therefore, these currency boards were viewed as an administrative remedy of insufficient private sector development, not as an embodiment of some new policies.

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<sup>5</sup> He maintains a special web-page devoted to the issue of currency boards (<http://www.erols.com/kurrency>); his 1992 dissertation *Currency Boards* presents excellent historical research in this area and can be found at <http://www.erols.com/kurrency/webdiss1.html>

Thus, the true story of modern currency boards ought to be started from the Argentinean innovation, Caja de Conversion, established in 1900. This currency board was created with the explicit goal to restore credibility of the national currency. Unlike in the British colonies, this move was not an introduction of modern money into a hitherto undeveloped society but clear transition from the fiat money to the 100 % reserve policy (to be more precise – to the 100 % *marginal* reserve policy). It is well known that Argentina at that time demonstrated extremely rapid economic development. However, when later it fell victim to wrong economic doctrines, its economy became tightly regulated and heavily protected. Not surprisingly, rigid rules of currency board were incompatible with such steady socialization, and it was finally abandoned in 1929 (after being briefly restored following 1914-1927 suspension.)<sup>6</sup>

Currency boards tradition in some former and existing British colonies survived well into the after-WW2 period. With some modifications it continued to exist, for example, in Hong Kong and Singapore. However, the experience of these economies was by and large dismissed as irrelevant. It was assumed, without much argumentation, that what was good for small city-states with heavy reliance on foreign trade is not suitable for more “balanced” economies. The case of Hong Kong was particularly emblematic for this approach. Its economic policies were so different from what almost all other countries

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<sup>6</sup> It must be noted that the revolutionary nature of this approach has not been fully appreciated until recently. Even Alec Ford, in his great book *The Gold Standard 1880-1914. Britain and Argentina* (Oxford: Clarendon Press, 1962) devotes only a few paragraphs to the discussion of this institutional arrangement, which he calls “the *Caja* system”. Although he notes that “the history of Argentine banking is one of persistent failure as regards domestic banking in the nineteenth century, and of greater stability after 1900” (p. 98) he immediately attributes this to the fact that “Argentina prospered and became less of a frontier economy”. It seems obvious that such factors as prosperity and frontier economy have nothing to do with bank stability, as was amply demonstrated by the same Argentina *after* the currency board had been

did, and its success so manifest, that one may talk about a sort of collective myopia among economists. It was much more convenient to regard this case as a special deviation to be explained by some other obscure factors or, better still, comfortably excluded from review, rather than a lesson for a full-fledged sovereign state.

Genuine revival of currency boards starts only in the 1990's, when this policy was adopted again by Argentina, and by Estonia shortly thereafter. In both cases the choice of the currency board option with its full backing of the monetary base by foreign currency reserves was motivated by the widely held desire to break with resented monetary mismanagement. It is characteristic that both cases took place in the regions with a relatively recent but already entrenched tradition of currency substitution, often called dollarization – namely, Latin America and Eastern Europe. On the one hand, population of these regions became very familiar with foreign currency (usually dollars); on the other hand, it was universally believed that a “normal” country should have a currency of its own. Thus, the desire to have a currency as good as the dollar led reformers to the dramatic decision to establish currency boards. In both cases there was a clear demonstrational element – the idea was to underscore the seriousness of reform, to draw the line between the past and the future.

I have no indication that these reformers were driven by any theoretical insights about the superiority of a 100-percent reserve policy over the fractional-reserve one. Rather, it was an expediency made necessary by the fact that previous inflationist policies had been

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abolished; it seems also obvious that changes in these factors cannot occur instantly (?) within one particular year.

totally discredited. However, spectacular achievements of these reforms made the currency board mechanism – until recently just a fringe arrangement suitable only for exotic territories – look like a more respected instrument. Currency boards are now associated with a broad notion of radical economic reform. The number of countries which have chosen this or similar arrangement is constantly rising and includes such diversified economies as Lithuania and Bulgaria.

It should be noted that in the real world there is no absolutely distilled case of pure currency board; some minor (or even not-so-minor) deviations are allowed in all currency board countries, which is totally natural given the necessity to foster some political compromise. For instance, the Convertibility Law in Argentina (which effectively established the currency board) formally allowed dollar-denominated sovereign debt issued by Argentina to be counted as its legally required reserves subject to an upper limit of 15 percent of total reserves. It must be noted however that the government never fully resorted to this provision. In the case of Hong Kong with its overly complicated mechanism of money issue the Monetary Authority retains some means to influence interest rates and, therefore, to pursue a discretionary monetary policy, albeit with extremely limited dimensions. Turning to Estonia (and Bulgaria, which modeled its currency board mostly on the Estonian example) we see that the central bank elected to keep some reserves beyond the required base money cover, thus creating some ambiguity about its possible commitments to the banking sector (interestingly, this case bears some

similarity to the first currency board experiment in Argentina, where substantial extra reserves were kept in a separate institution – Banco Nacion).<sup>7</sup>

On the other hand, there is a number of border-case countries (like Singapore, Taiwan, and Latvia) which carried out what is essentially a currency board policy, although without formal announcement or legal commitment. The most distinctive feature of these economies is that they traditionally maintain full reserve cover of their base money, thus earning a high degree of credibility for their currencies. The problem here is that the public can assume that the monetary authorities might use their funds for various purposes different from providing full backing of the monetary base.

Another issue for the not-fully-explicit currency boards is that they usually have no provision of keeping their reserves in a single currency. Sometimes they wish to maintain a link to a currency basket like the SDR or, until recently, the ECU; they may be lured by desire to earn more seigniorage if they diversify their portfolio. Thus, there is a risk of suddenly having less than full cover for reasons outside the authorities' control.

One major point should be made in this connection. Most, if not all, economists and practical politicians who were active in putting in place currency boards were unfamiliar with the Austrian theory; most likely they never even heard about its existence. They were concerned with curbing rampant inflation, usually on a verge of hyper-inflation.

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<sup>7</sup> For details, see, e.g. Adam G. G. Bennett, *Currency Boards: Issues and Experiences in: Frameworks for Monetary Stability*, ed. By Tomás J. T. Baliño and Carlo Cottarelli (Washington, D.C.: International Monetary Fund, 1994), and *Currency Board Arrangements. Issues and Experiences, Occasional Paper 151* (Washington, D.C.: International Monetary Fund, 1997)

Therefore there is a dominant tendency to regard currency boards as just a special “strengthened” case of the fixed exchange rate regime. Moreover, they are often viewed as an overly rigid arrangement, which should be “enhanced” and transformed into a full-fledged fixed exchange rate mechanism (i.e., with less than full reserve cover, and with discretionary interest rate policy) as soon as circumstances permit.

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My experience in the IMF and the World Bank convinced me that these institutions tend to see currency boards as only temporary and transitional expedients, and their advice to the currency board countries is usually to consider “exit strategies”, develop “modern monetary management”, etc.

Price developments under the currency board regime are routinely confused with those under conventional monetary management. It is only understandable, in the present political climate, that when governments establish their currency boards they are strongly tempted to err on the conservative side while deciding about their linked exchange rate. In other words, they prefer to make this exchange rate somewhat undervalued. They see immediate and sizeable capital inflows as an important outcome that would reinforce their political stance. Besides, it is common for these countries to have a very limited initial presence on the external markets, and still prevalent protectionist policies on the part of their industrial trade partners prompt them to give their would-be exporters a somewhat better starting position. What follows is usually a process of price adjustment,

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which many observers consider to be a regular inflation that should be fought by means of interest rate policy as well as by “sterilizing ” the inflows. All these recommendations tend to undermine the substance and the spirit of currency boards rather than support them.

What is particularly important in the case of modern currency boards is that their achievements are so clear that they cannot be denied even within the traditional framework adopted by economic empiricists. Austrian theorists do not need to look into these cases to prove their theorems; however most contemporary economists would demand statistical proof. And such statistical proof is so obvious and abundant that it might be elevated to the level of famous and overwhelming argumentation in favor of capitalism – when West Germany was compared to GDR, South Korea to North Korea, Czechoslovakia to Austria, and so on. These arguments carry no theoretical weight but are immensely convincing for the laymen and professionals alike. That is why some proponents of currency boards (Steve Hanke being the most vocal among them <sup>8</sup>) try to prove their case by means of historical research and econometric calculations. They assemble data for economic developments in the currency board countries and in the conventional ones; they show that the former usually fare much better than the latter. However valuable their research, it might always be challenged by their opponents.

These opponents may still claim that all historical achievements of the currency board countries can be explained by some other circumstances – for instance, by fiscal

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<sup>8</sup> See, for instance, Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance. A Currency Board Approach to Reform* (London: Routledge, 1993)

discipline. Since we have no means to discern and measure the influence of each and every factor, this discussion will lead to a stalemate. Moreover, there is even more important drawback in the argumentation of these non-Austrian currency board champions. They tend to present the choice between currency board and other options as a sort of a trade-off. While the Austrians see central banking as harmful, these non-Austrians emphasize “inappropriate” policies pursued by particular central bankers. Thus, currency board is suggested as a substitute for bad politicians, bureaucrats and central bankers. There is a sort of tacit assumption that if it were not for these “bad guys” and weak institutions, currency boards would become redundant and the economy would enjoy fuller employment of otherwise “idle” reserves. It is clear that this logic only invites attacks from those who want to get rid of strict currency board rules as soon as possible.

More generally, this conventional, i.e. “macroeconomic” analysis of currency boards has one important weak point – specifically, the fact that this arrangement is recommended to the developing countries only. These countries are urged to link their currencies to those of major industrial economies, while the latter are supposed to be run in a traditional central-banking manner. It seems that this is exactly what Mises used to call a fallacy of “polylogism” – that some general economic principles are good only for one kind of countries while others should follow another set of principles. It is precisely this fallacy that keeps alive the whole edifice of “developmental economics”, which was so many times destroyed by Peter T. Bauer. Unfortunately, the implicit doctrine of “restricted” currency board, i.e. with no attempt to apply this principle to *all* countries and *all*

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currencies, only undermines the case it attempts to uphold. On a more practical level, it creates impression that currency board is a mark of some inferiority of the country, for the first-rate countries allegedly do not need to limit their own monetary discretion so tightly.

In fact, the opposite is the case. Modern currency boards operate very much like the ideal and almost never existing “Misesian” gold standard – in other words, they are superior to the gold arrangements of post-Peel Act era. Indeed, modern currency boards openly abandon practically all active and discretionary monetary policies. Their “policy” is so simple and automated that one can hardly call it policy at all.

- They cover not only notes (currency in circulation) but also all balances held in the central bank. Therefore, they do not repeat a disastrous mistake caused by the Banking School fallacies in England and elsewhere.
- They usually provide full reserve cover for *all* base money and not only for amounts beyond the core issue.

This second difference might seem insignificant as long as marginal 100 % cover rule is strictly adhered to; but it is known that all numerical “exemptions” are quite likely to be abused and extended. Politically a proposal to legalize one percent extension of the fiat core money is much easier to accept than a violation of the full cover principle.

That a currency board presupposes no fiscal deficit and usually even a small surplus, is well known and need not be discussed here. It is more interesting to analyze how the currency board arrangement influences individual behavior. Since economic agents (including bankers) know that accumulated reserves cannot be used for fiscal and quasi-fiscal purposes, they pursue a policy much different from what is common in other countries. One may conclude therefore that if they can easily and successfully adjust their policies to be in conformity with currency board settings, than the eventual adoption of the full gold standard would also cause no problem.

There are very robust data supporting the claim that commercial banks in the currency board countries behave much more conservatively than elsewhere. They keep a higher reserve ratio and generally eschew risky lending strategies. Of course, one should always take into account the distinction between the legacy of previous monetary regime in the banks' portfolio, and the results of their behavior after the introduction of the currency board.

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It has already been noted that many analysts view currency boards as a special case of fixed exchange rate regime. Consequently, traditional mechanisms of such a regime are expected to be used in the currency board countries. For instance, capital inflows are to be sterilized, and lack of public debt is viewed in this context as a disadvantage, for there is no instrument to be used for the purposes of sterilization. Notion of fundamental

difference between the currency board (and full gold standard, for that matter), on the one side, and fixed exchange rate regime (and “historic” gold standard), on the other side, is still found only occasionally. It was only very late in his career that Milton Friedman asserted, at the conference in Hong Kong, that currency boards are as different from the fixed regime as they can be.<sup>9</sup>

Indeed, the fixed regime *and* the floated regime must be theoretically lumped together and opposed to the currency board regime. Any fixed exchange rate regime which is supported by any means different from the automatic full reserve mechanism is subject to political limitations imposed on its defenders. It is bound to be amended in favor of floating, at least for some time. Thus all economic agents must be constantly gambling about when this breakout is to occur and what will be the magnitude of exchange rate “realignment” and “adjustment”. Those who are too optimistic and complacent will pay dearly as we shall see in the next section, while those who try to be overly cautious will miss some opportunities. In short, the fixed exchange regime policy introduces an important and harmful uncertainty in the economy – which is already full of natural uncertainties and must be spared from the artificial ones.

Turning to the floating regime, however, we see that the very notion of “free float” is absolutely impractical and unrealistic. There were no cases when central banks did not pay attention to exchange rate movements and did not try to influence them. Even when exchange rate seems to move freely against some major anchor currencies, accurate

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<sup>9</sup> Milton Friedman, *Do We Need Central Banks?* in: *Proceedings of the Seminar on Monetary Management organized by the Hong Kong Monetary Authority on 18-19 October 1993* (Hong Kong: Hong Kong

examination reveals that central bank authorities watch it closely and are ready to intervene when it moves beyond what they believe are reasonable margins. Thus a new problem for market participants arises, for they have to guess what central bank managers think about “appropriate” exchange rate levels. This situation introduces yet another sort of uncertainty, quite profitable for some (mostly for economic “analysts”, for those employed in an otherwise redundant layer of financial intermediaries, and for enigmatic central bankers themselves) but very detrimental for the general public. Therefore, sooner or later political will arises in favor of an “orderly currency system”, which traditionally means another round of fixed exchange rates, preferably supported by some sort of international agreement.

None of these uncertainties are present in the currency board regime. There is certainly a risk of changes in popular mood and political regime, which may lead to abandoning of the currency board; but this risk is not specific to any monetary arrangement, at least until we have no anarcho-capitalist society around. Of course, there is another risk of the anchor currency being suddenly inflated and/or devalued. This is precisely what happened to the currencies of Singapore and Malaysia when the British sterling started to slide down - they cancelled their link to this former anchor currency. However, as long as the principle of full reserve cover is still in place this country still shares the most important attributes of the currency board.

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When a country switches to a currency board mechanism, it foregoes its own “monetary independence” (in other words, its ability and readiness to create fraudulent money). However, it is now dependent on the monetary policies of the anchor currency country. There is nothing bad in this – as long as this anchor currency country policy is more predictable and less discretionary than what could be expected in the country before the currency board was established. This reasoning should be extended one step further. If the lack of monetary discretion appears good for a currency board country, why should it be different for the anchor country?

Mises in 1952 proposed a scheme of eventual transition of the US to the gold standard.<sup>10</sup> Now his proposal looks strikingly similar to what is practically done by the currency board countries. These countries’ experience, therefore, must be referred to in the context of ideological debates elsewhere – they demonstrate the feasibility and practicality of this proposal.

It might be asked, why the currency board country should turn to the anchor currency in the first place, instead of jumping directly to the gold standard. This course of events is highly unlikely. In our world gold is *not* money. The global monetary standard is based primarily on the US dollar, with some important role played by the yen and the euro. As long as the US monetary policy appears to be the most predictable in the longer perspective, the likely scenario will be as follows. More and more countries will become permanently dollar-based; exchange rate considerations will become more and more

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<sup>10</sup> Ludwig von Mises *The Theory of Money and Credit* (Indianapolis, IN: LibertyClassics, 1980), pp. 490-495.

irrelevant; the idea of having no central bank will become more and more entrenched in the public opinion; cessation of discretionary monetary policy becomes the practical issue of the day; the US dollar returns to the gold parity, this time fully backed by metal reserves.

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In this regard one could expect that the chain of financial crises in East Asia in the mid-1990s should become a turning point in the history of relationship between the Austrians and the rest of the economic profession in relation to monetary issues. The very magnitude of the Asian crisis has attracted universal attention, but it is only the Austrian insights that can adequately explain its nature. The Austrians however have failed to make their case forcefully enough, so that the misconceptions about the nature of the Asian crisis still thrive. Thus, it makes sense to repeat the Austrian understanding of the events.

One must strongly dismiss all suggestions about any sort of general failure of the East Asian economies allegedly revealed by the crisis. It is precisely the spectacular successes of these countries that indirectly caused the crisis. In that, they can be compared to the extremely severe Chilean crisis in 1982, when most observers believed that the then unorthodox market-oriented policy had failed.

The specific and most troublesome aspect of the Asian crisis was the accumulation of short-term foreign debt, which caused severe balance of payments crisis. It is unfortunate that notions like “irrational behavior of economic agents”, “crony capitalism”, “contagion effect”, or “inadequate supervision of the financial sector” became so popular as if they possessed any explanatory value. In fact they do not. Would it have been more rational to stick to the baht or the won when others tried to get rid of them? Was there any rational warning coming from respectable observers about the imminent crisis, and what is more important, about its timing? Or is it to be believed that regulators are equipped with some special mental faculties, denied to those who are regulated, which make the regulators better suited to evaluating risks?

The media and professional economists persistently called the crisis “Asian” or “East Asian”, as though it engulfed all economies of the region in the same way. It became a common and unfortunate tradition to create these simplifying denominators (the previous case was when there was much talking about “Latin America's tequila effect” in 1995, while some countries like Chile and Columbia were evidently much better off than others.) This unfounded generalization obscured the most obvious idea to contrast two sets of economies in the region – those often called “East Asia 5”, which required large-scale international assistance and bailout (Thailand, Korea, Indonesia, Malaysia, and the Philippines), and the rest, i.e. Singapore, Hong Kong, and Taiwan which we may call “East Asia 3”. This comparison however is seldom made. Characteristically, of the famous “tigers” group (which were summarily and somewhat joyfully condemned by the

very use of notions like “the Asian crisis”) only Korea belongs to the sub-group of those really damaged by the crisis.

In reality there is one thing that made these two sub-groups substantially different, that is what I call their implicit monetary constitution. All other features are distributed in a way that does not correspond to the sharp division observed between the countries severely hit by the crisis and others who were spared this man-made calamity. The economies where the monetary authorities were strictly limited in their discretion proved insulated from the short-term credit flood and subsequent reversal.

All transactions require at least two participants, and the dramatic story of short-term lending to the East Asia was no exception. It involved foreign lenders and domestic banks. Both must be expected to know what they were doing. Both were led not by irrational instincts but by reasoning and calculation based on existing political realities. And this reasoning, which so dramatically discriminated between the “East Asia 5” and “East Asia 3”, appears to have been largely driven by whether the country had a “regular” central bank, or a currency board-like arrangement. There are evidently two sides to this picture.. On the one side there were investors with their swollen loanable funds artificially boosted by the Fed’s inflationary policies. On the other side there were financial intermediaries ready to finance their long-term assets with short-term liabilities on a very large scale.

The Austrians can easily recall the famous Rothbard's research, which found the causes of the Great Depression and economic disarray of the 1930's in the hidden Fed-fuelled inflation of the 1920's.<sup>11</sup> It is exactly that time when the stable prices of traded goods begun to be erroneously seen as a true measure of inflation; when great advances in productivity made people forget that fiat money expansion cannot be but inflationary; when the US monetary policy continued to bolster domestic stock market and overvalued foreign currencies until both collapsed. Thus, the correction of stock prices and investment decisions became unavoidable, necessary and healthy. In this situation, the asset and real estate depreciation in any country, be it the US or Hong Kong, is a welcome development, and not something to be feared and prevented by the state.

The crucial elements of the East Asian story, in a stylized fashion, look as follows:

- East Asian economies demonstrate exceptional dynamism, quality of their labor, prowess of their entrepreneurs, and stability of their governments, when compared to other emerging markets.
- Abundance of cheap capital in the major industrial countries (primarily the US), caused by their monetary policies, makes the East Asian economies even more attractive.

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<sup>11</sup> See: Murray N. Rothbard, *America's Great Depression* (New York, NY: Richardson & Snyder, 1983).

- Currencies of these economies are more or less explicitly geared toward keeping dollar parity fixed or predictable (which was perhaps the only reasonable approach.)
- Capital is poured into these economies in many forms.
- In some of these countries, central banks are viewed by economic agents as being flexible enough in terms of discretionary power to rescue illiquid financial institution in the case of eventual trouble, and strong enough to make good on these explicit or implicit guarantees.
- Such a conjunction makes it tempting to pile up longer-term assets on short-term liabilities. All gains are expected to be internalized, while losses are expected to be, at least partially, socialized.

Note that it is only the combination of all these factors that was able to produce the “East Asian crisis”. Indeed, if these countries were not sufficiently advanced and liberalized, they would not have attracted so much capital. If it were not for the loose monetary policy in the US, <sup>12</sup> there would have been no excessive funds available. Finally, if it were not for the perceived abundance of foreign exchange reserves of the central banks

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<sup>12</sup> To illustrate this point, one should better look not into the statistics of murky monetary aggregates but simply inspect the dynamics of reserve money (called sometimes “high-powered money”, and sometimes “monetary base”). These data reveal actual money pumping by the FRS. In the nineties the growth rate of reserve money was: 9 % in 1990, 3.7 % in 1991, 8.6 % in 1992, 9.2 % in 1993, 8.5 % in 1994, 4.4 % in 1995, 4.9 % in 1996, and 8.0 % in 1997 (calculations mine, data see in: *International Financial Statistics Yearbook*, Vol. LI, 1998 (Washington, D.C.: International Monetary Fund, 1998), pp. 890-891.)

and wide belief in their willingness to spend these reserves if a private financial institution finds itself in trouble, there would have been no massive practices of maturity mismatch between short-term foreign liabilities and longer-term domestic assets created by these financial institutions.<sup>13</sup>

Specific patterns of the crisis were different in each and every country. For instance, in Thailand the central bank actively participated in forward forex trading and provided guarantees and assistance to financial companies that heavily invested in real estate. In Korea, the central bank effectively guaranteed foreign bank loans, which were onlent to major corporations for longer maturities without much risk assessment. In Indonesia, implied and explicit guarantees were often extended directly to corporations. However, all these cases have very much in common – namely, that reserves of the central bank (usually quite sizeable) were used for purposes other than backing the national currency. Thus, it was of lesser importance what was the prevalent nature of the inflated assets, whether they were mostly in the form of industrial investment like in Korea, or in the real estate loans like in Thailand. What matters most is the maturity mismatch and the fact that the nominal value of these short-term liabilities was fixed in terms of dollars.

This last point is important. Only banks and bank-like institutions fix the value of their liabilities, thus making run on the deposits feasible (in the case of East Asia it meant

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<sup>13</sup> More detailed description of these events might be found in publications like *Global Development Finance. 1998. Analysis and Summary Tables* (Washington, D.C.: The World Bank, 1998), and *World Economic Outlook, May 1998. A Survey by the Staff of the International Monetary Fund* (Washington, D.C., International Monetary Fund, 1998). One must remember however that data on international capital flows used in these publications are of highly imprecise and conjectural nature. Accuracy and quality of these data are substantially inferior to the balance sheet data of reserve money.

concerted refusal of the foreign lenders to roll-over their short-term debt). In the countries where banks were too cautious to embark on similar policies, capital outflow also took place (primarily from Hong Kong). But this capital was mostly in the form of direct or portfolio investment. Therefore, capital loss was more or less evenly distributed between capitalists (lenders) and entrepreneurs (borrowers) with no danger to the monetary authorities.<sup>14</sup>

Some people suggest that the short-term foreign bank loans should be prohibited or regulated. They do not realize that this policy would deprive the economy from appropriate resources that can be used to finance legitimate short-term borrowing needs.

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Therefore, we arrive at the following conclusions:

- Maturities mismatch is of greater importance than pure currency mismatch (this observation is, as it were, of special Austrian nature).

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<sup>14</sup> One must note that the countries of “East Asia 3” (Hong Kong, Taiwan, Singapore) allowed for some deviations from the hands-off approach. For instance, Hong Kong monetary authorities tried to manipulate interest rates, while Singapore and Taiwan slightly devalued their currencies, apparently to keep them in line with the yen. It can be easily demonstrated that these policy deviations, though widely approved by the financial analysts, were hardly appropriate, for they simply socialized losses made by sectors with less competitive edge, thus making the necessary adjustment longer and costlier.

<sup>15</sup> It became a tradition to point to the Chilean policy of heavily taxing short-term foreign borrowing by means of special reserve requirements. It is implied in this reasoning that if even Chile – a showcase of market-oriented reforms – pursues this regulatory intervention, then there can be no objection on the part of champions of capital account liberalization. However, this policy was adopted in Chile precisely when her banking system was still recovering from the extremely severe banking crisis of 1982. Public sentiment against “speculative practices” was very strong. Besides, the monetary policy was arguably the weakest aspect of otherwise truly remarkable and path-breaking reforms. Perhaps it is due to the fact that Chicago tradition, so influential among the Chilean reformers, is quite successful in the area of trade, labor, regulatory, privatization and other policies, but remains rather unsatisfactory in the monetary area.

- A limited mandate of the central bank that prevents it from creating fiat money at will does not seem to hinder economic development but serves as a strong reminder to the banking lenders and borrowers of the need to exercise caution and prudence. On the other side, any *ex ante* regulation and supervision would, by definition, imply some level of *ex post* responsibility for eventual failure.
- If there is something to be called irrational, it is the attempts by the authorities to defend their currencies by a means of interest rate policy instead of devaluing it or passively letting reserves drop. The devaluation recipe is good for the non-currency board countries; the sooner they devalue, the closer they are to the point where the currency board is possible. Total passivity is, of course, the only appropriate policy for the “currency-boarders”.

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Admittedly, currency boards are nowadays not as popular as they used to be just five years ago. The reason is obvious – both media and academia blame the latest crisis in Argentina on the currency board arrangement. Even though the IMF agrees that abandoning the currency board was not a solution to the accumulated fiscal problems, it shies away from openly stating that it has been a serious mistake to undermine the currency board and to call for its replacement with a “flexible regime”. The misleading

concept of real exchange rate appreciation as supposedly damaging for the economy is traditionally invoked to justify such a replacement.

The familiar Austrian approach will demonstrate the erroneous nature of this reasoning if we look at the level of individuals and firms instead of an abstract “national economy”. It is not “economy” which produces goods for export; it is the firms and individuals who own and work at these firms. At every exchange rate some of them are more efficient than others. If we do not mess with the exchange rate, the less efficient will eventually give way to their competitors. However, if we devalue the currency, the only effect will be an indirect subsidization of the less efficient by the more efficient producers. Indeed, devaluation will have any lasting effect only to the extent that it diminishes the real value of the cash balances; therefore, the cash element of the wealth of more efficient producers will be instantly reduced, along with their claims on the real resources for which they compete with less efficient producers. It seems clear that such involuntary transfer of wealth from the more efficient to the less efficient is by no means an appropriate policy to increase the overall efficiency of the economy.

Post-devaluation growth easily captured by statistics should not be taken in isolation from the devaluation-driven reduction of perceived and real wealth, which national statistics tends to ignore. When economy registers post-devaluation growth, it can be to a large extent compared with an individual’s behavior immediately after a fire destroys his house. Such an individual will likely cut on his leisure time and start working more in order to raise extra income just to compensate for the losses; however, if only flows and

not stocks are taken into account, an absurd conclusion can be made that destruction is conducive to growth.

Moreover, the critical aspect of the alleged failure of the Argentinean currency board is easily overlooked – namely, that after the exchange rate has stabilized at the new level the country almost returned, if not to the currency board arrangement, to the full foreign reserves cover of the monetary base. In other words, while the rhetoric of currency board is out, at least for some time, its essence is still safely in.

The lesson that must be learned by the public from the Argentinean crisis is that the monetary policy should be explicitly and forever delinked from the fiscal one. Monetary manipulations cannot and should not address the underlying structural and fiscal issues; they can only make them worse

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There is another interesting comparison between modern currency boards and the classical gold standard. They both may seem to be an old, outdated, primitive way of managing monetary matters, while in fact they were a product of conscious design. Just like modern currency boards have very little to do with the old British institutions from which they derive their name, the classical gold standard of the XIX century was by no means a simple continuation of spontaneous metal circulation of previous millennia. Quite the opposite: the classical gold standard has been adopted by the countries mostly

as a result of serious deliberations and theoretical discussions, usually after a prolonged experience of the fiat regime. Restoration of gold in Britain followed a long suspension period of 1797-1821 and played a catalytic role in inspiring debates on monetary theory that in many aspects are as relevant today as they were two hundred years ago. The creation of the Latin Monetary Union in 1865 and its formal and informal expansion in the following years up to the World War I was only partially a result of political expediency; largely it was a great international experiment of cooperative establishment of a sounder monetary regime. This experiment can be judged more favorably than the attempts of similar cooperation in the XX century, from the economic conferences of 1920s and 1930s to the twisted history of the Bretton Woods and post-Bretton Woods systems.<sup>16</sup>

This comparison can be seen as supporting both optimistic and pessimistic aspects of Misesian theoretical framework.

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Another recent development that must be (and is) explained by the Austrians is the renewed uproar about the alleged dangers of deflation. Just as inflation seems to be in check, implicit inflationism of mainstream economics finds it necessary to express itself in the deliberations of deflation and advice to the central banks to do everything possible

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<sup>16</sup> The best account of this fascinating history can be found in: Luca Einaudi, *Money and Politics. European Monetary Unification and the International Gold Standard (1865-1873)*. Oxford University Press, 2001.

to combat it. Unfortunately, the IMF has joined this trend by presenting a study on deflation,<sup>17</sup> which is now a sort of compendium of mainstream opinion on the subject.

The authors argue that deflation impedes growth and production, and thus must be avoided even by the means of “unorthodox” policies by the central bank – i.e., by purchases of any marketable good, from private bonds to equity and real estate. Such a vast expansion of state interventionism is presented as justified by macro analysis and historical evidence. Unfortunately, crude macro models of the report do not have much in common with economic reality due to numerous caveats and assumptions (most of which remain implicit). Historical analysis also suffers from serious simplifications and distortions. For instance, the authors lump together the entire XIX century and announce that it was characterized by both deflation and low growth. The reader is not told that GDP calculation for the XIX century remains a highly speculative exercise, and that the more relevant way of analysis would be to concentrate on particular countries, particular decades, and on more measurable indicators (monetary statistics, price and wage statistics, and physical output in selected sectors). Such analysis would render very different results.<sup>18</sup>

As for historical arguments, they usually boil down to the reference to the Great Depression, which was caused, per consensus opinion of mainstream economics, mostly by wrong deflationist policies of the Federal Reserve. This traditional opinion usually

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<sup>17</sup> *Deflation: Determinants, Risks, and Policy Options*. Occasional Paper 221. IMF, 2003

<sup>18</sup> For details see: George Selgin, *Less Than Zero. The Case for a Falling Price Level in a Growing Economy*. The Institute of Economic Affairs. 1997, and the special issue of *The Quarterly Journal of Austrian Economics* devoted to deflation (Winter 2003, Vol. 6, Number 4).

ignores the example of severe price contraction during the previous crisis just a few years earlier, in 1920-1921, although in that case deflation proved to be a short-lived and beneficial instrument of post-war reallocation of resources. As convincingly demonstrated by Richard Vedder and others, the critical policy blunder that turned the crisis segment of business cycle of the late 1920s into a real decade-long depression laid not in the area of monetary management (which was rather inflationist) but in the area of labor regulation.<sup>19</sup>

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At the moment the short but turbulent history of modern currency board arrangements and their fate during the consecutive waves of financial crises leads us to the following observations.

We see that purely institutional, legal arrangement cannot prevent the state from indulging in irresponsible spending and inflationist taxation. Therefore, excessive emphasis on the legal and technical elements of currency boards and similar regimes are not as warranted as it may have seemed a decade ago.

On the other hand, ideological changes turn out to be much more forceful and enduring. As a result, there is a strong public sentiment in favor of maintaining large foreign reserves up to full cover of the base money, which is very close to the orthodox currency

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board scheme and is, in fact, its key element. Characteristically, many mainstream economists fail to distinguish these reserves, i.e., money, from capital and see this accumulation of reserves as “export of capital” from developing countries to reserve currency countries. This theoretical failure, along with the bogus “threat of deflation”, serves as an additional argument in favor of new inflationism.

Therefore, the Austrian economists must point to the great practical superiority of currency board mechanism over all other existing monetary regimes. They must point to the fact that adoption of the currency board is somewhat like an attempt to quit a bad habit: the attempt may fail due to insufficient political commitment but will do no harm in any case.

They must demonstrate that the existence and continuous success of currency board countries dispel all arguments against the full-fledged gold standard. All attempts to dismiss the Austrian theoretical argumentation as unrealistic and/or too abstract must be refuted by the reference to actual currency boards.

They must demonstrate the inconsistency of those who argue for adoption of currency board system only in the “second-tier” countries – primarily developing, post-socialist, and small ones, without calling for similar reform in the US and other anchor countries.

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<sup>19</sup> Richard Vedder et al. *Out of Work: Unemployment and Government in Twentieth-Century America*. Holmes & Meier Publishers, Inc. 1993

They must remember that the third step described at the beginning of this paper - i.e., conscious choice of freedom over state regulation - cannot arrive without clear theoretical understanding of specific nature of the phenomena involved. Therefore, the situation with the currency boards now can be compared to a general fate of socialism. The latter was discredited and abandoned on account of its practical outcomes, not because of wider realization of its doctrinal shortcomings as revealed by authors like Mises in Germany and Bratskus in Russia. As long as theory of socialism is not fully internalized by the academia, media, and public, it is still possible that future socialists will try to describe themselves as having nothing in common with villains like Stalin, Hitler, and Pol Pot. It is also possible that gold standard-like features of the modern currency board will be abandoned in favor of “scientific” monetary management. The role of Austrian theory thus remains absolutely critical.