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THE CASE FOR A RUSSIAN CURRENCY BOARD SYSTEM

by Steve H. Hanke

Executive Summary

The devaluation of the Russian ruble this year was predictable, especially considering Russia's poor monetary history. State-manipulated money has been a Russian hallmark since the time of Peter the Great and shows that the country's money problems are endemic and do not depend on who controls the central bank. Czarist, Soviet, and post-Soviet governments have used the central bank printing press to finance deficit spending, resulting in high inflation, confiscation of savings, capital controls, or a combination of the three.

To establish monetary stability, Russia should allow the dollar to circulate legally with the Russian ruble and institute a currency board that would issue rubles. The rubles would be fully convertible on demand at a fixed exchange rate with the dollar and be backed 100 percent by the dollar. Both practical measures would create sound money immediately. They would also gain immediate popularity as they did when they were implemented in the past. For a Russian currency board system to work, however, it must not be allowed to deviate from ultraorthodox rules as do the currency-board-like systems of other countries.

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In March 1998 I concluded that "by midyear, if not before, Russia's foreign reserves will reach alarmingly low levels" and that "either interest rates will have to go to the moon to keep foreign money from quitting Russian treasury bills or Russia will have to abandon its pegged exchange rate."¹ Like clockwork, the disaster unfolded in Russia as anticipated. It all reminds me of a passage from Oscar Wilde's The Importance of Being Earnest: "The chapter on the Fall of the Rupee you may omit. It is somewhat sensational."²

Russian Monetary History, Some Remarks

To put the current ruble crisis into perspective, some brief remarks about Russia's monetary history are in order.

That history shows that Russia's money problems are endemic and have little to do with who controls the central bank.³ State-manipulated money has always been a Russian hallmark, regardless of the regime or alternative modes of control. In the days before paper currency, a number of czars, including Peter the Great, debased the coinage. After Catherine the Great issued ruble notes in 1769, little changed. For example, rubles became inconvertible in 1777, when they had no determinate exchange rate with gold, silver, or copper. Convertibility was not restored until 1839, and it was again suspended in 1853.

Central banking began in Russia in 1860, when the government founded the State Bank of Russia. The new central bank inherited responsibility for ruble notes, which previously had been issued by the Ministry of Finance.

In 1862 the central bank attempted to establish convertibility of the ruble into gold, but that ended in failure in 1863. Convertibility into gold was finally established in 1897. Consequently, Russia began a period of substantial economic progress, which was interrupted from 1904 to 1906 by the Russo-Japanese War and the political disturbances that followed. Indeed, from 1905 to 1906, Russia imposed the first modern capital controls.

When Russia entered World War I, the central bank suspended the convertibility of the ruble again. During the war, the czarist government and the democratic government that briefly replaced it used the central bank to finance wartime deficit spending. When the Bolsheviks took power in 1917, one of their first steps was to take control of the central bank. It soon created one of the worst inflations

in history. By 1924, it took 5 billion rubles to buy what one 1914 ruble had bought.

The Bolsheviks eventually ended the hyperinflation by issuing a parallel currency, the chervonets, which circulated alongside the existing hyperinflationary ruble, or sovznak, and had limited convertibility until 1926. The chervonets was somewhat stable, drove the inferior currency out of circulation, and set the stage for a Russian economic recovery.

When Russia entered World War II, another inflation broke out. In response, the government undertook a currency reform in 1947. The reform mandated that, beyond a ceiling of 10,000 rubles (about three months' wages), old rubles had to be converted into new rubles at a rate of two to one. Consequently, the bulk of Russians' savings was confiscated.

From 1947 to the early 1970s, the ruble remained inconvertible and the central bank created little apparent inflation. By the mid-1970s, however, the economy had begun to stagnate and the government began to incur significant budget deficits, which were financed by the central bank's printing presses. The resulting inflation manifested itself in the form of unconscionable shortages of goods at existing, controlled prices.

To reduce "repressed" inflation, the Gorbachev government, in January 1991, implemented a currency reform similar to that of 1947. It required the public to convert 50- and 100-ruble notes, then the largest denominations in circulation, into smaller bills. Conversions were limited to 1,000 rubles a person. Again, the savings of many Russians were confiscated.

The confiscation of ruble savings by the Gorbachev government's ruble conversion destroyed what little confidence the public had in the ruble and its use as a store of value. Indeed, the demand for rubles collapsed and so did the ruble's foreign exchange value. The Russian people began to dollarize the economy, and they have continued to do so with a vengeance. In 1997, a year in which the ruble was relatively stable and the inflation rate was falling like a stone, the Russians swapped a whopping \$13 billion worth of rubles for dollars in cash. That amounted to a capital export that exceeded all capital imports into Russia in 1997.

At present, Russians hold about \$40 billion in dollars. That dwarfs the supply of rubles in circulation. Those

Table 1
Annual Currency Dilution (percentage)

Currency	Year						
	1991	1992	1993	1994	1995	1996	1997
Russian ruble	33.0	87.8	91.8	85.7	71.1	54.3	23.8
U. S. dollar	4.6	3.5	2.9	2.7	2.6	2.8	2.6

Note: Currency dilution is calculated by the following formula: $D = \text{Inf}/(1 + \text{Inf})$, where D is annual currency dilution in year t and Inf is average rate of consumer price inflation between year $t - 1$ and year t .

figures are truly astounding, particularly considering that the Yeltsin government officially de-dollarized Russia in 1997. Consequently, legal retail transactions can be conducted only in rubles and the Russians' hoard of dollars can legally be used only as mattress money.

The 1990s have, indeed, been the decade of dollarization in Russia and for good reasons. The data on currency dilution in Table 1 support that conclusion. Dilution measures the reduction in the real value of money, which is caused by inflation. If inflation is 100 percent per year, the dilution is 50 percent.

In 1997, which was a relatively good year for the ruble, inflation in Russia diluted the ruble's value by 23.8 percent. That is, if a Russian had 1,000 rubles on January 1, 1997, he could purchase a basket of consumer goods with a total price tag of 1,000 rubles. But if he held onto the 1,000 rubles until December 31, 1997, their purchasing power would have melted away, and he would have been able to buy only a much smaller basket of consumer goods, one that would have had a total price of 762 rubles on January 1, 1997. So, even in a relatively good year, the ruble was a lousy store of value. It's no wonder the dollar has become the mattress money of choice in Russia. After all, the dollar was diluted by only 2.6 percent in 1997.

Russia has had a long history of state-manipulated money. With virtually no credibility, the Central Bank of Russia is extremely unlikely to be able to provide the country with a stable, convertible currency in the near future. Regardless of who asserts control over the central

bank, its policies, in all likelihood, will continue to conform with the dominant traditions of Russian monetary history.

A Competitive Currency Regime

There is a practical way to provide Russia with a stable, convertible currency. The process of supplying money must be depoliticized. That can be accomplished only by allowing foreign currencies to circulate legally and by replacing the Central Bank of Russia with a monetary institution that can be protected from political control.

The establishment of sound money in Russia will be a Herculean task, however. Russia has entered a prerevolutionary political phase. The economy is neither a communist system nor a capitalist one. And Russia has not been moving toward a market economy. Today the Russian economy is a totally dysfunctional mutation of the old communist system.

Instead of worrying about dollar mattress money and threatening to confiscate it, the Yeltsin government should be jumping for joy. Thanks to the hoard of dollars in Russia, President Yeltsin can deliver a much needed monetary quick fix. He can do this by granting the dollar legal currency status immediately, so that the dollar can circulate and be used on an equal basis with the ruble.

Adopting such a competitive currency regime would mobilize the Russian mattress money. That would pump a bit of life into the beleaguered economy. In addition, Russians would be able to freely choose and use either the ruble or the dollar. Consequently, the suffering people would end up with a high-quality currency.

A competitive, parallel currency system is just the type of quick fix the doctor ordered. It is simple and could be implemented immediately. No objections could be raised to its practicality. A parallel currency system wouldn't even raise ideological eyebrows in Moscow because both the right and the left have employed it successfully before in Russia.

The first time a parallel currency system was used was during the Russian civil war. The anti-Bolshevik government of the region around Archangel and Murmansk established a currency board in cooperation with its ally, the British government. Rubles issued by the North Russian currency board were fully backed by British pounds sterling and had a

fixed exchange rate with the British pound. As its initial foreign reserves, the currency board held a deposit in British pounds sterling at the Bank of England. The British government provided the deposit as a gift to establish the currency board.

The North Russian currency board was the idea of none other than John Maynard Keynes, who at the time was an official in the British Treasury. Keynes's North Russian currency board was the only issuer during the Russian civil war whose currency was stable and fully convertible. Currency board rubles drove the rubles of other issuers--and there were more than 2,000 of them--out of circulation in North Russia because the sterling-backed rubles were a superior currency.

The currency board had a brief life. It lasted only from 1918 to 1920, because the Bolsheviks conquered North Russia and replaced the sterling-backed ruble with their own inconvertible ruble. Nevertheless, while Keynes's currency board lasted, it performed very well under the most trying conditions.

A parallel currency system was also used by the Bolsheviks after they had conquered their foes in the civil war. In the early 1920s Russia suffered a hyperinflation comparable in extent and effect to the German hyperinflation of the time. To end hyperinflation, the Soviet government, under orders from Lenin, issued a parallel currency, the chervonets, alongside the existing, rapidly depreciating sovznak. Although not fully convertible, the chervonets was backed by a minimum of 25 percent reserves in gold and foreign currencies. The chervonets was introduced in 1922. The Soviet government at first continued to pay some workers with sovznaks, but by 1924 the chervonets had displaced the sovznak so completely that the government ceased issuing sovznaks.

The introduction of the chervonets stimulated a remarkable economic recovery. Production of many goods soon reached levels that had not been seen for a decade. Remarkably, the recovery occurred while the sovznak was experiencing hyperinflation. The existence of the parallel, fairly stable chervonets enabled the Soviet people to protect themselves from the worst effects of hyperinflation by using chervonets. Alas, the stability of chervonets was not permanent. Unlike the sterling-backed ruble issued by Keynes's currency board, the chervonets was issued by a central bank without credibility. Consequently, it fell

victim to the discretionary policies of the central bank and became inconvertible in July 1926.

The North Russian currency board's ruble and the cher-vonets were not just economic successes; they were also political successes. The North Russian and the Soviet governments gained popularity by issuing stable currencies.

President Yeltsin could also quickly gain popularity for the present government by embracing a competitive currency regime.

A Currency Board System

To put the ruble on a sound competitive footing, the Russian government should enact a currency board system (CBS) law immediately and announce that it will be implemented as soon as possible. And, to work in Russia, a CBS must be ultraorthodox. Indeed, if it is modeled after the "currency-board-like" systems in Hong Kong, Argentina, Estonia, Lithuania, Bulgaria, and Bosnia, it will probably fail.⁴

An orthodox CBS is a monetary institution that issues notes and coins. Those notes and coins are backed with a minimum of 100 percent, up to a maximum of 110 percent, of foreign reserve currency, and they are fully convertible into the reserve currency at a fixed exchange rate on demand. As previously noted, currency-board-like systems deviate from orthodoxy. Most notably, they possess the power to act as lenders of last resort. An orthodox CBS

- usually supplies only notes and coins,
- has a fixed exchange rate with a reserve currency,
- has foreign reserves of 100 percent (minimum) up to 110 percent (maximum),
- offers full convertibility,
- follows a rule-bound monetary policy,
- is not a lender of last resort,
- does not regulate commercial banks,
- is transparent,

- is protected from political pressure by a monetary constitution,
- earns seigniorage only from interest on reserves,
- does not engage in forward-exchange transactions or purchase equities,
- cannot create inflation,
- cannot create credit,
- is not subject to speculative hot-money flows, and
- has a small staff.

To implement a CBS in Russia's truly unique situation, ultraorthodoxy must be embraced so that the CBS commands the respect and confidence of the justifiably skeptical Russian people. At present, there is a great debate raging about the suitability of a CBS for Russia. Unfortunately, the debate is meaningless without a CBS law to debate. The following orthodox CBS monetary constitution (law) is complete and suited for Russia's truly unique conditions:

1. The Russian CBS is hereby created. The purpose of the CBS is to issue notes and coins in CBS rubles, and to maintain them fully convertible at a fixed exchange rate into a reserve currency as specified in paragraph 6.
2. The CBS shall have its legal seat in Switzerland.
3. Governance
 - a) The CBS shall be governed by a board of five directors. Three directors shall be non-Russian citizens appointed by the Bank for International Settlements (BIS) in Basel. They shall not be employees of the International Monetary Fund or its member governments. Two directors shall be appointed by the government of Russia.
 - b) A quorum shall consist of three members of the board of directors, including at least one of the directors chosen by the government of Russia. Decisions shall be by majority vote, except as specified in paragraph 15.
 - c) The first two directors appointed by the Russian government shall serve terms of one and four years. The first three directors appointed by the BIS shall

serve terms of two, three, and five years. Subsequent directors shall serve terms of five years. Directors may be reappointed once. Should a director resign or die, the BIS shall choose a successor to complete the remainder of the term if the former director was a foreigner, or the Russian government shall choose the successor if the former director was a Russian.

4. The board of directors shall have the power to hire and fire the CBS's staff, and to determine salaries for the staff. The by-laws of the CBS shall determine salaries for the directors.

5. The CBS shall issue notes and coins denominated in CBS rubles. The notes and coins shall be fully convertible into the reserve currency. The notes shall be printed outside Russia. The CBS may accept deposits of the reserve currency.

6. Reserve currency

a) The reserve currency is the foreign currency or the commodity to which the CBS ruble has a fixed exchange rate. Initially, the reserve currency shall be the U.S. dollar and the fixed exchange rate shall be one CBS ruble to one dollar.

b) Failure to maintain the fixed exchange rate with the reserve currency shall make the CBS subject to legal action for breach of contract according to the laws of Switzerland. This provision does not apply to embezzled, mutilated, or counterfeited notes, coins, and deposits, or to changes of the reserve currency in accord with paragraph 13.

7. The CBS shall charge no commission for exchanging CBS rubles for the reserve currency, or the reverse.

8. The CBS shall begin business with foreign reserves equal to at least 100 percent of its notes and coins in circulation and deposits with it. It shall hold its foreign reserves in securities or other forms payable only in the reserve currency. These reserves shall be held on deposit at the BIS. The CBS shall not hold securities issued by the national or local governments of Russia, or by enterprises owned by those governments.

9. The CBS shall pay all net seignorage (profits) into a reserve fund until its unborrowed reserves equal 110 percent of its notes and coins in circulation and deposits. It

shall remit to the government of Russia all net seigniorage beyond that necessary to maintain 110 percent reserves. The distribution of net seigniorage shall occur annually.

10. The head office of the CBS shall be in Moscow. The CBS may establish branches or appoint agents in other cities of Russia. The CBS shall also maintain a branch in Switzerland.

11. The CBS shall publish a financial statement, attested by the directors, monthly or more often. The statement shall appraise the CBS's holdings of securities at their market value.

12. The CBS may issue notes and coins in such denominations as it judges to be appropriate.

13. Should the annual change in the consumer price index in the reserve country fall outside the range -5 percent to 20 percent for more than two years, or -10 percent to 40 percent for more than six months, the CBS must, within 60 days, either

a) devalue (if the change in the index is negative) or revalue (if the change in the index is positive) the CBS ruble in terms of the reserve currency by no more than the change in the index during the period just specified, or

b) choose a new reserve currency and fix the exchange rate of the CBS ruble to the new currency at the rate then prevailing between the new reserve currency and the former reserve currency.

14. If the CBS chooses a new reserve currency in accord with paragraph 13, it must convert all its foreign reserves into assets payable in the new reserve currency within one year.

15. The CBS may not be dissolved nor may its assets be transferred to a successor organization except by unanimous vote of the board of directors.

16. Beyond an initial loan of reserves from the International Monetary Fund, the CBS may not accept loans or grants of reserves from international agencies or foreign governments.

17. Exchanges of currency by the CBS shall be exempt from taxation by the Russian government.

18. CBS rubles and the reserve currency shall be legal tender for paying taxes and settling debts in Russia. However, they shall not be forced tender for contracts between private parties.

In addition to legalizing the use of foreign currencies and adopting a currency board law, the Russians must amend Russian contract law. With a currency board, the ruble-dollar exchange rate would be absolutely fixed. Consequently, for relative price adjustments to take place, all other prices in Russia should be allowed to fluctuate freely in relation to the fixed price of the ruble. The indexing of contracts in Russia should, therefore, be strictly prohibited.

The devil is always in the details, particularly in Russia. Anything less than an ultraorthodox CBS will not command the confidence of the Russian people and will therefore doom a Russian CBS.

Notes

1. Steve H. Hanke, "Is The Ruble Next?" Forbes, March 9, 1998.
2. Oscar Wilde, The Importance of Being Earnest, in Five Major Plays (New York: Airmont, 1970), p. 252.
3. For a more extensive review of the record of central banking in Russia, see Steve H. Hanke, Lars Jonung, and Kurt Schuler, Russian Currency and Finance: A Currency Board Approach to Reform (New York: Routledge, 1993), pp. 42-62.
4. For a discussion of orthodox currency boards versus currency-board-like systems, see Steve H. Hanke, "A Field Report from Sarajevo and Pale," Central Banking 7, no. 3 (Winter 1996-97): 36-40; and Steve H. Hanke, "Bank on the Currency Principle," Central Banking 8, no. 1 (Summer 1997): 26-30.