Policy Analysis

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Executive Summary

In early August 1991 we visited Lithuania at the invitation of Prime Minister Gediminas Vagnorius. George Selgin and Kurt Schuler had previously visited Lithuania in October 1990 at the invitation of the Lithuanian Bank of Industry and Construction. They met with the president and prime minister and suggested ideas for monetary reform in a memorandum to the Lithuanian government that has since been translated into Lithuanian.[1]

This paper extends those ideas in light of what we observed on our recent visit and what has happened since the failed Soviet coup. Lithuania has achieved independence but remains linked to the Soviet economy and to the Soviet ruble. The ruble is becoming less and less acceptable in trade, and as a result, parts of the Soviet economy have reverted to barter. The need for a stable, convertible currency in Lithuania is more urgent than ever. However, the actions the Bank of Lithuania and the Lithuanian government have taken so far will not produce such a currency. This paper explains how Lithuania can successfully establish a sound currency to replace the ruble.

Hyperinflation: A Desperate Situation

The Soviet ruble is at the heart of Lithuania's present monetary problems. The Soviet government is printing more rubles every month than it had originally planned to print during the entire year. In consequence, and despite extensive price controls, inflation is in triple digits. Soviet officials apparently do not understand that they are causing hyperinflation. In the simplest terms, the present hyperinflation is due to a rapidly increasing supply of rubles chasing a shrinking supply of goods. The only way to stop hyperinflation is to stop printing so many rubles. Because Soviet officials do not acknowledge that fact, no effective upper limit to the supply of rubles exists. Since the failed coup, inflation has accelerated, and the ruble is heading for total collapse.

A price system can be only as good as the currency in which prices are expressed. Other countries that have experienced hyperinflation, such as Argentina and Brazil, have found that it so distorts price relations as to make price calculations in domestic currency of little use for guiding economic activity. If the hyperinflating ruble remains the sole legal currency, price reform will continue to be unpopular in both Lithuania and the Soviet Union, for it will only replace one inefficient price system with another. But price reform is crucial for establishing a market economy.

As unsound as the ruble is, it has the advantage of being a common currency. Until recently it was acceptable throughout the Soviet Union and linked the Soviet republics into a common trade area in which goods could move somewhat freely. That enabled the Soviet Union to achieve economies of scale in production that present policies are endangering. Just when Western Europe is developing an integrated market to promote economic growth, the Soviet republics and the Baltic nations are moving in the opposite direction. The tariffs and quotas that they are imposing will destroy important economies of scale that now exist in production. If in addition the Soviet republics and Baltic nations replace the ruble with separate inconvertible currencies, they will destroy the existing division of labor and make trade among themselves collapse, as it has among the members of the former Council for Mutual Economic Assistance. The results will be massive unemployment and a further fall in output.

The solution to those problems is free trade and convertible currencies. Since our focus is on currency, we shall say no more about free trade here, except to note that large-scale trade can revive only if the Soviet republics and the Baltic states do not erect barriers to it. Price reform will be more popular if it is linked to a currency reform that introduces a stable currency, which can be the basis of a reliable price system. In addition to promoting economic development within the former Soviet Union, con vertible currencies will also integrate the newly autonomous republics into world markets. If the new currencies that emerge are not convertible, outsiders will not accept them, and trade with the rest of the world will be limited to barter, just as it is now under the ruble.

It would be best for Lithuania if the Soviet republics would quickly establish convertible currencies, or better yet a common convertible currency. At the moment that seems unlikely. Lithuania will have to establish a convertible currency by itself or perhaps at the same time as Estonia and Latvia. Lithuania's extensive economic links with the Soviet Union mean that if the Soviet republics follow unwise policies, Lithuania's economy will inevitably suffer. Only a convertible currency can offset the dislocations that will follow. Only with a convertible currency can Lithuania reorient its trade toward the West and encourage large-scale foreign investment. A convertible currency will also be vital for keeping Lithuania supplied with oil, coal, and natural gas, which it receives from the Soviet Union. Lithuania now has a trade surplus with the Soviet Union because it buys energy at prices far below world market prices. When the Soviet Union starts charging world market prices, Lithuania's balance of trade with the Soviet Union will shift to a deficit. If Lithuania's currency is convertible, Lithuania can attract foreign investment to offset its trade deficit, just as Hong Kong--a currency board economy with no natural resources--did for many decades. If its currency is not convertible, Lithuania will be reduced to trying to make inefficient barter deals for energy, as other East European nations do.

Coupon Money: Symbol without Substance

In early August 1991 the Lithuanian government introduced ration coupons as a way of laying the groundwork for a separate Lithuanian currency and avoiding price hikes on goods sold in state stores. Prime Minister Vagnorius hatched the coupon scheme quite suddenly in response to public discontent with inflation. He apparently did not consult with specialists, many of whom severely criticized the scheme in conversation with us. The scheme even took other members of the cabinet by surprise. But such are Vagnorius's energy and force of personality that he persuaded the Lithuanian parliament to approve the scheme.

Under the scheme, each Lithuanian receives coupons equal to 20 percent of his ruble salary, up to a maximum of 200 rubles in coupons. People with incomes of 80 rubles a month or less may receive coupons for more than 20 percent of their incomes. To buy consumer goods other than food in state shops, people need to pay one ruble in coupons for each ruble in currency. So if a coat costs 300 rubles, the purchaser pays 300 rubles in currency plus 300 rubles in coupons. The Bank of Lithuania also has a limited stock of coupons. At first the bank announced that it would make even exchanges of coupons for rubles or rubles for coupons while supplies lasted. Before the coupon scheme took effect, though, the bank announced that the rate would be two rubles in currency to one ruble in coupons.

The coupon scheme is a way of rationing goods without raising ruble prices in state shops. Initially, coupons also served as a symbol of defiance of the Soviet government, a purpose that has become superfluous since Lithuania achieved independence. The coupon scheme may have been politically expedient, but it did nothing to correct the underlying causes of the shortage of goods at official prices. In addition, it has other defects, which Elena Leontjeva, an economics professor at the University of Vilnius, has explained in a series of articles in a Lithuanian newspaper. One defect is that people who wish to buy refrigerators and other expensive consumer goods will now need to save a considerable amount in coupons as well as rubles. There may be temporary surpluses of such goods in state shops--an unusual phenomenon under socialism--because people lack enough coupons to buy the goods, even though they have enough rubles. That will have effects all along the chain of production and distribution, requiring the Lithuanian government to counteract the coupon scheme's effects by issuing additional instructions to state-owned enterprises. The coupon scheme thus requires more government involvement in the economy at precisely the time when Lithuania is trying to move away from socialism.

Another defect of the coupon scheme is that it cannot prevent hyperinflation of the ruble, because the coupons are not really an independent currency. Rather, coupons are a supplementary currency with a fixed exchange rate for rubles. Coupons are a way of trying to prevent Lithuanians from spending 80 percent of their ruble incomes. Like water behind a dam, the unspent rubles will continue to accumulate, leading to inflation in the prices of goods that are not purchased with coupons (for instance, goods on the black market) and to a black market for coupons.

The Ukraine tried a coupon scheme similar to Lithuania's last year and was unsuccessful. (It has since reintroduced coupons.) Last summer the Estonian parliament considered a coupon scheme but rejected it on the grounds that it might complicate introducing an independent currency. The coupon scheme will not solve the problems it addresses.

The Bank of Lithuania: A Lithuanian Gosbank?

The Lithuanian government has also established the Bank of Lithuania, whose ultimate goal is to issue an independent currency. The bank combines central banking and commercial banking functions. Originally, it was nothing more than the Lithuanian branch of the USSR State Bank (Gosbank), charged with supervising other state-owned banks. Its origins as an independent bank date from the autumn of 1989. Under perestroika the Baltic republics were entertaining ideas of greater economic independence. Zilevicius, the local head of the Gosbank, a member of the Lithuanian parliament, and, naturally, a Communist, drafted a bill elevating the Gosbank branch into the quasi-independent Bank of Lithuania. He expected to become its first president. The bill passed, but Zilevicius was disappointed because in February 1990, before the bill took effect, Lithuanians elected a new non-communist parliament in their first free elections in half a century.

The new parliament faced the problem of whether to revoke or confirm the old parliament's last acts. Vilius Baldisis, a professor of economics at the University of Vilnius and a member of the new parliament, cleverly pushed a near-copy of the old Bank of Lithuania bill through parliament when the most prominent opponents of the bill were out of town. Baldisis subsequently was appointed the bank's president. Stasys Uosis, also a professor of economics at the University of Vilnius, is commonly regarded as Baldisis's idea man. He has written many newspaper articles supporting the bank's policies and is one of its directors.

At the time of our first visit, the Bank of Lithuania had no real power. It was vainly trying to assert its authority over the state-owned banks. It was embroiled in a contest with the Gosbank's Lithuanian branch, which remained open because Moscow did not recognize the new Lithuanian parliament's actions as legitimate. As the Lithuanian independence movement gained strength, so did the Bank of Lithuania. To give the bank some real power, the parliament, at Baldisis's urging, allowed it to take over the Lithuanian Bank of Industry and Construction and the Bank for Social Development, which had recently become independent from their Moscow parent banks. The Bank of Industry's top managers fought the takeover; after losing, most left in January 1991 to form a private commercial bank, Litimpex Bank.

The Bank of Lithuania now also controls the local assets of the Savings Bank, which under the Soviet system was the only bank that accepted consumer deposits. The Bank of Lithuania does not let the Savings Bank lend to other banks. Some 7 billion rubles of the Savings Bank's deposits are immobilized at its former Moscow parent bank, but there is some prospect that the Lithuanian Savings Bank will get the money back. (By the time it does, the money may not be worth much.) Another state-owned bank, the Agricultural Bank, is trying to convert itself into something like a private commercial bank, with some independence from the Bank of Lithuania.

The remaining bank left over from the Soviet system, the USSR Bank for Foreign Economic Relations, successfully evaded the Bank of Lithuania's control since almost all of its assets were in Moscow. The Bank of Lithuania was able to monopolize the foreign currency transactions of enterprises owned by the Lithuanian government, but not those owned by Moscow, and of other parties within Lithuania. During our visit, the Lithuanian government was considering making Lithuanian government-owned enterprises and private firms pay up to 30 percent of their hard currency earnings into a fund managed by the Bank of Lithuania.

The Bank of Lithuania is by far the dominant commercial bank in the country. As the central bank, it also has extensive regulatory powers, though it does not yet issue currency. Indeed, its regulatory powers far exceed those of any Western central bank. The Bank of Lithuania has powers similar to those of the Gosbank, which is surely not a good model to emulate. At the time of our visit, the bank was regulating the banking system by simply translating into Lithuanian the decrees the Gosbank had issued in Russian.

Among the Bank of Lithuania's regulatory powers, as set forth in the law establishing it, are the powers to deny licenses to other commercial banks, to set minimum capital requirements for them, to set maximum and minimum interest rates, and to control foreign exchange transactions. The bank has been active on all those fronts. It has dragged its feet about granting licenses to commercial banks that meet the requirements for going into business--it took three months to grant Litimpex Bank's license. The Bank of Lithuania can also prohibit other commercial banks from opening branches that would compete with its own branches. Because the bank has imposed a maximum rate of 25 percent on commercial bank loans, banks cannot afford to pay more than 25 percent minus a margin to cover their costs. (Deposits in the Savings Bank, however, are somewhat indexed against inflation.) Inflation is 300 percent, according to the Lithuanian Free Market Institute's estimate. Consequently, loans greatly subsidize the enterprises that receive them, and private commercial bank depositors have no hope of keeping even with inflation. Originally, the Bank of Lithuania set the minimum capital requirement for commercial banks at 30 million rubles, which would have prevented any privately owned banks from forming. It later reduced the requirement to 10 million rubles. Unlike the Bank of Estonia, which was trying to introduce a free-market element into foreign ex- change dealings by holding auctions of hard currency for rubles, the Bank of Lithuania during our visit was enforcing the regulations of the Gosbank.

In its current form, the Bank of Lithuania has grave defects. The most important is that it has announced no definite plan for establishing and maintaining the value of the proposed Lithuanian currency, the litas. The Bank of Lithuania has all the important powers that the Gosbank has. Among them is the power to inflate the litas just as the Gosbank is now inflating the ruble. The law establishing the Bank of Lithuania authorizes the bank to purchase Lithuanian government debt "not exceeding the parliament's set limits," but the parliament can change those limits at any time. There are no limits to the bank's power to lend to commercial banks, including its own commercial banking operations. Therefore, the law imposes no effective limits on the bank's powers to create money. Bank officials have not announced how they plan to keep the litas's value stable. Other aspects of their behavior also inspire little confidence. Lithuania has been cut off from the outside world for so long that the knowledge of how to read a balance sheet, let alone manage a central bank, is almost nonexistent. We were unable to get bank officials to meet with us during our recent visit, though we had met with Baldisis in October 1990.

A previous Bank of Lithuania, which existed during Lithuania's period of independence between the world wars, issued a litas convertible into gold at a fixed rate. The present litas will not be convertible into anything. The experience of other newly independent nations indicates that pressures for financing government deficits will probably be too great for the bank to be able to adhere to any rule that purports to limit the quantity of money (such as a rule limiting the growth of currency plus deposits to 8 percent per year). Lithuania runs the danger of replacing the inconvertible ruble with the inconvertible litas.

Another defect of the Bank of Lithuania is the conflict of interest between its roles as a commercial bank and as the regulator of other commercial banks. Western central banks that once had commercial banking functions, such as the Bank of England and the Bank of France, gradually abandoned them because it came to be recognized that the possibility for abuse of power was great.[2] Policymakers in the West came to realize that when a central bank competes directly with commercial banks, it may use its regulatory powers to suppress them. During our visit many businessmen expressed opposition to the bank's inordinate powers but said that they were afraid to speak out against it for fear that it would deny them loans and access to foreign exchange. (Politicians have also been reluctant to criticize the Bank of Lithuania, for fear of being accused of lacking patriotism. Last year a prominent bank official publicly declared that to be opposed to the bank was to be opposed to Lithuania itself.)

The Bank of Lithuania's control extends far beyond banking to all spheres of economic activity. As monopolist of the foreign exchanges, it has the final say on all foreign trade. As the dominant commercial bank, it has the power to dictate which enterprises shall prosper and which shall not, independent of what competitive market conditions may determine. As the regulator of interest rates, it can rob depositors of their savings and create shortages of funds for lending at below-market rates, which will perpetuate the system of political favoritism that the Soviet banking system now uses to allocate credit. The bank is potentially more powerful than the Lithuanian government.

The Bank of Lithuania is nominally answerable to the Lithuanian parliament, but given the long terms of office of the bank's president (seven years) and directors and the relative lack of economic knowledge of persons in the government who might monitor the bank, the parliament is unlikely to impose effective checks on the bank's behavior. The bank is neither politically accountable nor subject to the market test of competition; nor does Lithuania have a reassuring recent tradition of fairly competent central banking. All those things make it extremely unlikely that the Bank of Lithuania will be capable of issuing a stable, convertible currency.

Private Commercial Banks: Cause for Hope?

Recently, a number of "private" commercial banks have sprung up in Vilnius and Kaunas. At the time of our visit, eight such banks were operating. The largest has capital of 18 million rubles. Some have separate foreign currency accounts abroad, which they keep distinct from their Lithuanian business because of foreign exchange regulations. Those banks are not privately owned in the Western sense; their major stockholders are state-owned enterprises, and in one case also the Ministry of Finance. However, they are independent of the Bank of Lithuania and of the Lithuanian government. The bank managers own shares, and their voting power is important because some banks do not allow all shares equal voting rights.

Despite their independence, the private commercial banks are under the Bank of Lithuania's thumb because their legal status is uncertain. At present, they operate under the law on joint stock companies, although a provision of that law states that it does not apply to banks. The Bank of Lithuania has broad powers over them; in addition to setting reserve and other requirements, it can prevent them from opening branches and can revoke their licenses at will. The parliament is scheduled to debate a law on private commercial banks this autumn. The Bank of Lithuania has proposed one draft version of the law, and the Lithuanian Free Market Institute has proposed another. The Free Market Institute's version is less restrictive and would more effectively promote competition in banking. We recommend that the parliament enact it rather than the Bank of Lithuania's version of the law.

As is the case with the managers of the Bank of Lithuania, lack of contact with the outside world has left a void in the education of private commercial bankers. They and other Lithuanian businessmen need to become familiar with Western bookkeeping and accounting practices and with the principles of financial management of banks. American and Canadian bankers and accountants of Lithuanian descent could do a great service by sharing their expertise with their Lithuanian counterparts, as some already are doing.

Reforming the Banking System

Lithuania's present banking system is largely a continuation of the Soviet system. Unless Lithuania changes the powers of the Bank of Lithuania and gives commercial banks a more independent legal basis than they now have, its banking system will never be any better than the Soviet system.

In our previous memorandum we argued that licensing requirements, if any, should be liberal; that foreign banks should have the same freedoms as Lithuanian banks; that banks should be allowed to establish branches wherever they wish; that banks should be allowed to undertake any other lines of business they wish, such as insurance and stock underwriting; and that there should be no reserve, interest rate, or foreign exchange controls. We argued against deposit insurance, which shifts responsibility for bank managers' mistakes onto taxpayers at large. We also recommended that banks in Lithuania publish accurate financial statements frequently. The financial disclosure requirements should be modeled after American and British practice, not after German and Swiss practice that allows banks to keep "hidden" reserves off balance sheets. Stringent disclosure requirements plus the ordinary penalties on fraud should keep embezzlement at an acceptably low level. We reiterate those recommendations here.

We recommend that private commercial banks be licensed by the Ministry of Finance, not the Bank of Lithuania. Licenses should be granted automatically to all banks that meet the disclosure requirements. Private commercial banks should not need the Bank of Lithuania's permission to establish branches. The statutory reserve requirements that the bank imposes are an unnecessary and inefficient tax on banks. Interest rates should be decontrolled to end the present artificial shortage of credit at below-market rates. Foreign exchange should also be decontrolled; now that Lithuania is no longer part of the Soviet Union there is no reason for it to prop up the Soviet ruble. Finally, the Bank of Lithuania's commercial banking functions should eventually be privatized. It may be possible to make many of those changes by inserting clauses in the law on private commercial banks that the parliament is considering this autumn. If not, the government should amend the law that established the Bank of Lithuania appropriately.

Right now, state-owned enterprises are the major depositors and borrowers as well as the major shareholders of private commercial banks. They deal with private commercial banks because they do not want to depend entirely on the Bank of Lithuania. The private commercial banks would like to lend to private businesses and to individuals but have difficulty doing so because property rights are poorly defined and no real bankruptcy law exists. There is as yet very little private property in Lithuania, though the government has begun privatization. The parliament is scheduled to debate a bankruptcy law this autumn.

Clear property rights and private property ownership are vital to a well-functioning free-market banking system. To enable individuals to borrow at reasonable rates, it is particularly important that, as part of Lithuania's privatization scheme, they receive unrestricted title to their apartments or agricultural land. Their apartment or the land they till will be the most valuable thing most people own. We recommend that people have complete freedom to rent, sell, or mortgage the property they receive through privatization schemes. That will enable persons who want to start small businesses, for instance, to pledge their apartments as collateral against bank loans and will thus encourage economic growth. It makes no sense to prohibit people from selling their property until several years after receiving it, as one privatization scheme proposes doing.

The Currency Board Alternative

Long-term credit, unlike short-term credit, can only be encouraged by the introduction of a sound currency. At present, the private commercial banks limit themselves to short-term loans because of the hyperinflation of the ruble and uncertainty about the future shape of the Lithuanian monetary system.

The ruble is a bad currency that is getting worse every day. However, the litas is not likely to be any better if it is issued by the bank of Lithuania. The bank has no plan for achieving a stable, convertible currency and no competence in central banking. Lithuania does not need a central bank to issue or regulate a new currency. Instead, we propose that it establish a "currency board" to accomplish those goals while avoiding the dangers inherent in central banking. In our previous memorandum we explained how to establish a currency board, and a forthcoming monograph discusses at length how a currency board works and how to establish and operate one.[3] Rather than repeat ourselves, we shall just sketch our ideas to make the basic points clear to readers who are unfamiliar with currency boards.

A currency board is not a bank at all, nor does it regulate commercial banks. Its only purpose is to issue notes (paper currency) and coins convertible on demand into a foreign asset at a fixed rate of exchange. The foreign asset can be a foreign currency, gold or some other commodity, or a currency or commodity basket. A currency board does not grant loans (except perhaps in serving as a clearinghouse for bank checks) or accept deposits. As reserves it holds high-quality, interest-bearing securities denominated in the foreign asset. Its reserves must be a fixed proportion (at least 100 percent) of its notes and coins in circulation. A currency board makes profits from the difference between the interest on the securities that it holds and the expense of maintaining its notes and coins in circulation. It remits to the government all profits beyond what it needs to pay its expenses and to maintain its reserves at the level set by law.

More than 60 countries have had currency boards during this century. Most have been British colonies or former colonies. In 1918 and 1919, during the civil war, a Russian currency board existed in the northern region occupied by the British and other Allies. It issued a ruble currency with a fixed exchange rate to the British pound.[4] All currency boards maintained convertibility except when their countries were actually overrun by enemy armies. Even then the boards' assets were safe from seizure, because they were held abroad. Despite the success of currency boards, they exist today in only a few places, most notably Hong Kong. Other countries that once had currency boards replaced them with central banks, chiefly because central banking enabled governments to manipulate the money supply for political and fiscal purposes.

The currency board system works like the gold standard or the gold exchange standard. Market forces determine the amount of notes and coins that a currency board supplies as well as the amount of deposits and other forms of credit. The supply of reserves is determined by the actions of the supplier of the reserve asset--the foreign central bank to which the currency board currency is linked, or commodity producers if the reserve asset is a commodity. Competition among commercial banks determines the distribution of (demand for) the reserves, including how much becomes the foreign currency reserve of the currency board country. The currency board has no role in determining the supply of reserves, because its 100 percent reserves make it merely a sort of warehouse for reserves. The only way to acquire new reserves, obviously, is to obtain assets from the reserve currency country, which in its simplest form requires running a trade surplus. Changes in the balance of trade tend to change the domestic money supply in the same direction. The need to acquire reserves from abroad limits credit expansion in the banking system, since commercial banks must have reserves to make interbank payments and to meet customers' occasional demands for cash. The need to acquire reserves from abroad also keeps inflation roughly in line with inflation in the reserve currency country.

Some economists have criticized the currency board system for its allegedly restrictive monetary policy, which they have claimed hinders economic growth.[5] That view rests on a misunderstanding of how the currency board system works. In an economy in which capital flows can occur (which is to say, any economy with a convertible currency that has few barriers to foreign investment), the balance of trade does not impose any strict limits on a currency board system's ability to expand the money supply. Instead, a more complex but still completely market-based form of limi tation, based on people's estimates of profitability, applies.[6] (Even under floating rates a somewhat similar process is at work. A central bank operating a floating-rate currency has little or no power to stimulate the economy in an economically beneficial manner, though it can cause a temporary boom, to be paid for later with a depression.) Hong Kong and Singapore experienced trade deficits for decades under their currency board systems, yet their money supplies expanded all the while.

The currency board system is particularly well suited to overcome the problems of establishing confidence that a new currency faces. The currency board system guarantees that government's ability to manipulate the supply of currency will be extremely limited. A central bank, even one that is allegedly independent of the government, carries no such guarantee. Experience shows that all central banks bow to political pressure. Even the German Bundesbank has done so several times in the last few years. Also, central banks have a direct incentive to create high inflation so as to maximize their own profit from money creation, even if they do not finance the government debt. The people proposing a Lithuanian currency issued by a central bank seem to be unaware of those problems. We doubt that a new currency issued by a Lithuanian central bank would gain confidence at home or abroad.

Establishing the Currency Board

As the experience of more than a dozen past currency boards indicates, it is simple to replace a central bank with a currency board. The way to do so is to separate the Bank of Lithuania's currency issue, bank regulation, and commercial banking functions. The currency board would take over the currency issue functions; the Finance Ministry would take over the regulatory functions; and the commercial banking functions would become a commercial bank like any other, eventually to be privatized.

Lithuania is regaining gold that the old Bank of Lithuania owned abroad before the Soviet invasion of 1940. Depending on the arrangements that the foreign central banks holding the gold make with Lithuania, the value of the gold or compensation paid in its place will be $50 million to $100 million. The gold can provide Lithuania with the reserves necessary to establish a convertible currency. If used to establish a currency board, it will be the basis of a lastingly stable currency. If given to the Bank of Lithuania, it is likely to be frittered away, leaving Lithuania without hard currency reserves or a convertible currency.

In our memorandum we suggested that the most satisfactory reserve asset for a Lithuanian currency board is probably the German mark. The European Currency Unit (ecu) is also worth considering, because it offers the advantages of a somewhat diversified currency basket. If the ruble continues to be inconvertible, Western Europe will be Lithuania's main source of hard currency export earnings and investment, so it is desirable that its reserves be linked to the West European currency system. If Lithuania adopts the mark or ecu as its reserve asset, it should sell its gold and invest the proceeds in high-quality mark-denominated or ecu-denominated bonds, as the case may be. Although there is no actual ecu currency, there is a large and active market in ecu bonds. Until Lithuania sells its gold, it can earn interest on the gold by lending it in the London gold loan market, whose interest rates are published daily in the Financial Times.

The Lithuanian currency board will exchange its notes and coins on demand at a fixed rate into or from marks or ecus. It need not actually accept or pay hard foreign currency notes and coins; it could instead accept and pay out hard foreign currency-denominated bonds. It could establish a minimum amount for transactions, such as DM20,000 or 10,000 ecus, to cut its handling costs and restrict dealings to large blocks of foreign exchange. People who wish to transact smaller amounts will still be able to do so through banks, of course.

Judging from the experience of past currency boards, the annual cost of running the Lithuanian currency board should be less than 1 percent of the board's total assets. The board will make profits from the difference between its interest earnings and its expenses. All profits should go to building up unborrowed reserves until unborrowed reserves are at least 100 percent of the board's notes and coins in circulation. The board might accumulate an "equity reserve" equal to another 5 percent of notes and coins in circulation, as the Hong Kong currency board has, to provide it with extra funds in case its reserve assets should decline in value. Profits beyond that will go to the government.

We suggest that the currency board have its legal seat in Switzerland. That will prevent a Soviet takeover from jeopardizing the board's assets, as happened to the old Bank of Lithuania. The board will have its headquarters and its actual operations in Lithuania. To insulate the currency board as much as possible from politics, its directors should serve staggered terms, so not all can be replaced at the same time. A majority of directors could be required to be foreign nationals, chosen by institutions in their home countries. Furthermore, the law establishing the currency board should make clear that the board's assets belong not to the Lithuanian government but to the board itself. The board should be required to publish regular, detailed financial statements. In our previous memorandum we included a model authorizing statute for a Lithuanian currency board.

Issuing the Litas

In our previous memorandum we also suggested a method by which Lithuania could convert rubles into litas. Here we shall suggest an alternative method for introducing the litas: circulating it as a parallel currency. A possible advantage of introducing the litas as a parallel currency is that doing so may be administratively simpler than converting rubles into litas. The Lithuanian government could also use some combination of methods, as the German government did during monetary unification. The Lithuanian government could convert some rubles into litas and distribute other litas by the method we suggest here. Indeed, any politically acceptable method of introducing a currency board-issued litas would work.

If the currency board has DM165 million ($100 million at current exchange rates), it can issue up to that amount in notes and coins. It should declare that one litas equals one mark (or one ecu, if the ecu is the reserve asset). That will be a sign that the government intends to make the litas as good as the mark rather than as bad as the ruble. It will also take fullest advantage of the savings in international transactions costs that can be realized by having a linked currency.

The currency board can distribute the litas to the public according to some simple plan; for instance, it can give every citizen of Lithuania approximately 40 litas (DM40). The public will spend some of the litas its receives, hold some, and deposit some at banks in new litas accounts. Banks will begin to make loans in litas. The litas and the ruble will at first exist side by side as parallel currencies, with a freely fluctuating exchange rate determined by market conditions. Ruble bank deposits can be converted into litas deposits at the market rate of exchange, if both bank and depositor wish. Ruble interest rates will have been freed to reach market levels. After adjusting for inflation, they should be no lower than litas rates, so that not everyone may want to convert ruble deposits into litas deposits. Prices may be expressed in litas or rubles depending on the wishes of sellers. Wages should be converted into litas at workers' request. People who do not have litas can acquire them by exchanging their rubles for litas at the freely fluctuating market rate at banks or other dealers in foreign exchange.

Taxes should be payable only in litas. Ruble income should be taxed at its current equivalent in litas at market exchange rates. Ruble subsidies to consumers and enterprises could be continued. As the ruble continues to depreciate, ruble subsidies will eventually be self-eliminating if they are not increased. Litas prices should not be controlled. If the government follows that advice, there will be a growing litas sector with unregulated prices and a shrinking ruble sector with controlled prices. The end of the controlled sector will be gentler and perhaps less politically unpopular than if all prices were decontrolled at once.

The currency board litas will be a better currency than the ruble and should quickly drive the ruble out of circulation in many uses. That will be a spontaneous market process; there will be no need to force people to use the litas. The litas should be, so to speak, democratically chosen by the Lithuanian people. Furthermore, allowing the ruble to circulate as a parallel currency will facilitate trade with the Soviet Union.

Distributing free litas to the public would be extremely simple. Litas notes have already been printed. Under this proposal, they could be distributed to the public, and Lithuania could have its own stable, fully convertible currency within a few days of establishing a currency board. It is not necessary to wait years or possibly forever for a convertible currency, as plans for a central bank-issued litas envision.

With a stable currency in existence, the Lithuanian government could undertake price reform by freeing prices to rise to market levels. As part of the price reform, the government should abolish ruble coupon money.

The Ultimate Goal: Free Markets in Currency and Banking

Both theory and evidence strongly indicate that financial institutions and markets work best and contribute most to economic growth where they are freest.[7] Western nations are gradually relearning the advantages of freedom for financial markets. Lithuania would do well to avoid slavishly imitating Western financial regulations, which have often hindered growth without producing any general benefits. Instead, it should proceed directly to the goal that Western nations have not yet fully achieved: complete freedom for financial institutions to compete with each other as Western companies in other types of business do.

As well as the particular freedoms for banks that we advocate above, we wish to stress again that Lithuania should not erect barriers to foreign financial institutions that wish to do business in Lithuania, even to own Lithuanian banks. It is common for public opinion in newly independent nations to oppose so-called foreign economic domination. For Lithuania to succumb to such ideas would be unwise and costly. Much of the property in Lithuania that before independence was owned by the government in Moscow was forcibly seized. In contrast, since sales of property by Lithuanian citizens to foreigners will be voluntary, with no element of coercion, there is no reason for the Lithuanian government to interfere with those transactions.

If foreigners wish to invest in Lithuania, Lithuanians should be glad, because it means that foreigners think Lithuania has good economic prospects. For more than a century after independence, British investment in the United States was so large that some Americans feared British economic domination. Nothing of the sort happened; in fact, British investment sped America's rise as the world's greatest industrial nation. Lithuania preserved its culture during half a century of occupation by a foreign army. Surely it has nothing to fear from the peaceful activities of a few business people whose intent is to make deals that both they and their Lithuanians counterparts find beneficial.

We also wish to stress that Lithuania needs no law to prevent people from using the ruble or other foreign currencies if they prefer once the litas is introduced. (Fratianni, Davidson, and von Hagen, on the other hand, wish to prevent people from using other currencies.)[8] If the ruble continues to be a bad currency, it will die a natural death in competition with the superior currency board-issued litas. As it is in other aspects of economic life, competition in currency is the best guarantee of consumers' interests. Competition in currency should extend even so far as allowing commercial banks to issue their own bank notes, convertible into the currency board litas or directly into the mark or some other foreign currency. That could result in lower and smoother interest rates by keeping as much base money as possible in bank reserves. Such competitive currency issue systems have worked well in dozens of cases in the past.[9]

Conclusion

The ruble is rapidly losing value. The Bank of Lithuania has no definite plan for producing a stable, convertible currency. The experience of many newly independent countries indicates that probably no form of central bank can produce a stable, convertible currency.

As an alternative monetary institution, we propose that Lithuania establish a currency board. The currecy board system, as used in Hong Kong and elsewhere, is a simple and proven vehicle for promoting economic growth.

To summarize, we recommend that Lithuania take the following steps.

- Establish clear property rights, which will allow individual people and enterprises to offer their property as collateral for bank loans. Allow people to sell, rent, and mortgage privatized state property immediately.
- Pass a bankruptcy law, as the parliament is scheduled to do.
- Pass the version of the private commercial banking law proposed by the Lithuanian Free Market Institute rather than the version proposed by the Bank of Lithuania.
- Remove restrictions on interest rates for loans and deposits.
- Allow free trading in all foreign currencies.
- Abolish most of the Bank of Lithuania's regulatory powers over private commercial banks. Transfer the remainder, if any, to the Ministry of Finance.
- Separate the Bank of Lithuania's commerical banking functions from its other functions, and privatize its commercial banking functions.
- Establish a Lithuanian currency board to issue the litas. The litas should equal one German mark or one ecu.
- Sell Lithuania's prewar gold reserves for mark- or ecu-denominated assets.
- Distribute litas notes and coins to the public.
- Abolish the coupon scheme.

Notes

[1]. Kurt Schuler and George Selgin, "A Proposal for Reforming Lithuania's Monetary System" (Unpublished paper, November 1990).

[2]. Charles Goodhart, *The Evolution of Central Banks* (Cambridge, Mass.: MIT Press, 1988), pp. 45-46.

[3]. Steve H. Hanke and Kurt Schuler, *Currency Boards for Eastern Europe* (Washington: Heritage Foundation,

forthcoming).

[4]. Steve H. Hanke and Kurt Schuler, "Ruble Reform: A Lesson from Keynes," *Cato Journal* 10, no. 3 (Winter 1991); 655-66.

[5]. Michele Fratianni, Lawrence S. Davidson, and Jurgen von Hagen, "Currency Reform in the Baltic Republics" (Hudson Institute, Indianapolis, Ind., September 13, 1991, Mimeographed), p. 20.

[6]. Hanke Schuler, *Currency Boards*, appendix B.

[7]. See Rondo Cameron et al., *Banking in the Early Stages of Industrialization: A Study in Comparative Economic History* (New York: Oxford University Press, 1967); Rondo Cameron, ed., *Banking and Economic Development: Some Lessons of History* (New York: Oxford University Press, 1972); Kevin Dowd, *The Experience of Free Banking (London: Routledge, forthcoming); Maxwell Fry*, Money, Interest, and Banking in Economic Development (Baltimore: Johns Hopkins University Press, 1988); Ronald McKinnon, *Money and Capital in Economic Development* (Washington: Brookings Institution, 1973).

[8]. Fratianni, Davidson, and von Hagen, p.34.

[9]. Dowd.