The Disregard for Currency Board Realities

Steve H. Hanke

According to former President Ronald Reagan, an economist is "someone who sees something happen and wonders if it would work in theory" (quoted in D'Souza 1997: 111). As is so often the case, Reagan's quip contains more than a kernel of truth. Indeed, D. N. McCloskey devotes an entire chapter in a recent book to "The Futility of Blackboard Economics" and a critique of economists' obsessive pursuit of economic theory (McCloskey 1996). And she is not alone. Ronald Coase (1994) and Peter Bauer (1976), to name but two distinguished economists, have spent most of their professional lives elaborating on the essence of Reagan's remark and the cul-de-sac that it has led economics into.

Errors of Omission and Commission

Not surprisingly, most economists who write about Currency Board Systems (CBSs) have been unable to shake off bad habits and the type of scientism alluded to by Reagan. In consequence, the burgeoning literature on CBSs often suffers from a reckless disregard for reality. Much like the Bourbons after the French Revolution, most of those who toil in the CBS cottage industry have learned nothing and forgotten nothing. By eschewing history and contemporary "facts on the ground," their works are largely devoid of information about how CBSs have actually operated and performed in practice. Accordingly, their theoretical speculations are, at best, misleading. Indeed, they are typically little more than musings about problems that could be (but have not been) created by CBSs. In what follows, I attempt to

---

Cato Journal, Vol. 20, No. 1 (Spring/Summer 2000).

Steve H. Hanke is Professor of Applied Economics at The Johns Hopkins University and Chairman of the Friedberg Mercantile Group, Inc. in New York. He thanks Michael I. Morgenstern for his assistance in preparing the tables for this paper.

cast some light on CBS realities and thereby put to rest the product of these speculations.

Contrary to the impression given in the contemporary CBS literature, CBSs have an impressive theoretical pedigree. Sir John Hicks makes that perfectly clear. According to Hicks, the CBS rests soundly on the strand of classical monetary theory developed by David Ricardo (1772–1823). "On strict Ricardian principles, there should have been no need for Central Banks. A Currency Board, working on a rule, should have been enough" (Hicks 1967: 167–68).

Those Ricardian principles were put into practice in 1849, when the first CBS was established in Mauritius. Since then, over 70 CBSs have operated in most parts of the world. Although ignored by most observers, that rich history has been overwhelmingly characterized by success. Even in the most trying times, CBSs always produced stable money and maintained full convertibility (Hanke, Jonung, and Schuler 1993). Countries with CBSs also kept their fiscal houses in order and realized respectable economic growth rates. In addition, they fostered stable banking systems in which financial crises were rare. When they did occur, they were mild. As Hicks recounts, at the zenith of CBSs, early in the 20th century, "the financial cycle was almost disappearing" (Hicks 1989). Alas, even an allusion to this exemplary historical record is absent from the contemporary literature (see, for example, *The Economist* 1997a, 1997b, 1998, 1999, and Williamson 1995).

If this disregard for reality is not bad enough, egregious errors of commission are also contained in much of the CBS literature. When it comes to discussions of exchange rates, this is nothing new. T. W. Hutchison (1977), in a 45 page appendix, "Economic Knowledge and Ignorance in Action: Economists on Devaluation in Europe, 1964–74," carefully documents sins of commission committed by distinguished economists who have engaged in debates about exchange rates.

To illustrate this pathology in the CBS context, one example will suffice. The Federal Reserve Bank of Minneapolis conducted a wide-ranging interview with the distinguished economist, Arnold Harberger, in the March 1999 issue of *The Region*. One question was: "What are your thoughts on [the] currency boards that economist Steve Hanke promotes?" The first two sentences of Harberger's reply were: "Well, I think Mr. Hanke has a lot in common with the Austrians. To him, the virtues of the currency board come from on high; the currency board can do no wrong" (Harberger 1999: 43). Harberger then elaborates on the Mexican peso crisis of 1995 and some of the problems encountered in Argentina, which employs a currency board-like system.

Harberger's remarks are preposterous. As an advocate of CBSs, I have not had to rely on Providence for guidance. The basis for my advocacy rests solely on my reading of the laws that have established CBSs, a study of the history and workings of CBSs, and most importantly, analyses of the empirical results produced by CBSs (see, for example, Hanke, Jonung, and Schuler 1993; Schuler 1996; and Hanke 1999). As far as Argentina is concerned, I have been critical of its currency board-like system because it deviates in major ways from the orthodox system that Kurt Schuler and I first proposed (Hanke and Schuler 1991a, 1991b). Indeed, I anticipated that the deviations from orthodoxy would create problems (Hanke and Schuler 1999) and have documented those resulting from the Mexican peso crisis in some detail (Hanke 1999). To put it politely, Harberger's characterization of my work is simply one of those typical errors of commission. It has no connection to reality.

The Recent Record

Many CBSs were replaced by central banks after World War II. Politics, not the economic record, prevailed (Hanke 2000). The 1990s witnessed a revival of CBSs. They were established in Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia and Herzegovina (1997). While all deviate from orthodoxy to varying degrees, they are in essence CBSs. How should we judge their performance? As a guide, I use the criterion laid down with great pithiness by Karl Schiller, the West German Social Democrat's economics minister between 1966 and 1972. As Schiller put it, "Stability might not be everything, but without stability, everything is nothing" (quoted in Marsh 1992: 30).

This criterion is particularly relevant when judging the CBSs of the 1990s because all were installed in countries that were politically and/or economically very unstable. Furthermore, prior to the installation of CBSs, all countries had soft budget constraints and faced the prospect of continued instability. Argentina was attempting to cope with repeated bouts of hyperinflation. Estonia had just gained independence from the U.S.S.R. and was still using the hyperinflating Russian ruble. Lithuania was in the grip of a collapsing real economy and very high inflation. To make matters worse, its new political institutions could not effectively control what threatened to be a runaway fiscal deficit. Bulgaria had defaulted on its international debt, narrowly escaped a revolution in late 1996 and was battling hyperinflation that had virtually wiped out its banking system and sent the real economy into a free-fall. Finally, the newly independent

Bosnia and Herzegovina had just come out of a bloody civil war, one that had disrupted and displaced most of the population, destroyed 18 percent and damaged 60 percent of the housing stock and covered much of the territory with land mines. Its economy was in shambles, declining to about 20 percent of the 1990 level. With the exception of the deutsche mark, the other three currencies in circulation—the Bosnia and Herzegovina dinar, the Croatian kuna, and the Yugoslav dinar—were either unstable or very unstable.

All five countries were in desperate need of stable money and an institution that would deliver a hard budget constraint. As someone who was active, as an official and unofficial advisor, in these countries, I counseled CBSs in all cases, and did not rely on Providence. My inspiration came instead from John Maynard Keynes. In 1918, Russia was embroiled in a civil war and there were over 2,000 separate issuers of rubles. All were floating, depreciating currencies that were not convertible into gold. Currency chaos and very high inflation were the order of the day. In an attempt to bring order to the monetary sphere in North Russia, the allies called on Lord Keynes, who was then a Ricardian and a British Treasury official responsible for war finance. Lord Keynes met the challenge by designing a CBS for a sterling-backed ruble in a telegram dated September 11, 1918. The North Russian CBS was installed on November 11th of that year and delivered instant stability. Indeed, within weeks, the CBS ruble ruled the roost in North Russia (Hanke and Schuler 1991c).

Have the CBSs of the 1990s delivered stability? Initially, I thought the precise answer to this question could be arrived at in a matter of hours, at most. That judgment was based, in part, on the International Monetary Fund's repeated claims that it demands transparency, and that the authorities are complying (Fischer 2000). These claims about compliance have no connection to reality. The basic macroeconomic and financial data that I thought would be appropriate indicators of stability before and after the installation of the 1990s CBSs were not available with a few clicks. It took weeks of painstaking work to construct Tables 1–5. The data for the five CBS countries required a review of over 100 documents. In the end, 40 separate documents were required to piece the time-series together.

For each country that installed a CBS in the 1990s, Tables 1-5 contain data for annual inflation, real GDP, interest rates, fiscal balance, and foreign reserves. The time-series begin two years prior to the introduction of the CBSs and continue through 1999. In each case, consistent with my counsel and plainly apparent, the CBSs delivered stability.

Although these basic data speak for themselves, several points

TABLE 1

ARGENTINA: BEFORE AND AFTER SETTING UP A CURRENCY BOARD (APRIL 1, 1991)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Annual Inflation (End-year %)	4,928.6	1,344.5	84.0	17.5	7.4	3.9	1.6	0.0	0.3	0.7	–1.8
Change in Real GDP (%)	–6.9	–1.8	10.6	9.6	5.7	5.8	–2.8	5.5	8.1	3.9	–3.1
Interest Rates (Money market rate, % per annum, at end-year)	1,387,179	9,695,422	71.33	15.11	6.31	7.66	9.46	6.23	6.63	6.81	6.99
Fiscal Balance (% of GDP)	–7.6	0.1	–0.1	–0.2	0.9	–0.3	–1.0	–2.2	–1.5	–1.4	–2.5
Foreign Reserves (Billions of U.S. dollars)	3	6	7	12	15	16	16	20	22	25	26.4

NOTE: The fiscal balance is calculated on a cash basis and excludes privatization revenues. The arrears were very high in 1990, suggesting that the cash deficit as a percentage of GDP would have been quite high in 1990 if the government had been paying its bills on time.
SOURCES: Argentine Ministry of Economy, Banco Central de la Republica Argentina, International Monetary Fund, Lehman Brothers.

TABLE 2

ESTONIA: BEFORE AND AFTER SETTING UP A CURRENCY BOARD (JUNE 20–24, 1992)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Annual Inflation (Annual avg. %)	23.1	210.5	1076	89.0	47.7	29.0	23.1	11.2	8.2	3.3
Change in Real GDP (%)	–6.5	–13.6	–14.2	–9.0	–2.0	4.3	3.9	10.6	4.7	–1.1
Commercial Banks' Average Lending Rates (Short-term, 1–3 months, %)	NA	NA	59.2	36.6	24.6	19.0	15.0	14.6	10.9	8.0
Fiscal Balance (% of GDP)	2.9	4.7	–0.3	–0.7	1.3	–1.2	–1.5	2.2	–0.3	–4.8
Foreign Reserves (Millions of U.S. dollars)	NA	NA	196	389	447	583	640	760	813	943.3

NOTE: Reliable data for interest rates and foreign reserves are not available for 1990 and 1991 because Estonia was still part of the U.S.S.R. during most of that period. A referendum was held in March 1991 and 77.8 percent of the votes cast favored Estonian independence. Estonia declared independence on August 20, 1991, and an independent status was conceded by the U.S.S.R State Council on September 6, 1991. When the currency board was established in June 1992 and the kroon replaced the Russian ruble, foreign reserves were $98.1 million.

SOURCES: Estonian Central Bank, European Bank for Reconstruction and Development, International Monetary Fund, Lehman Brothers.

TABLE 3

LITHUANIA: BEFORE AND AFTER SETTING UP A CURRENCY BOARD
(APRIL 1, 1994)

	1992	1993	1994	1995	1996	1997	1998	1999
Annual Inflation (End-year %)	1,175	188.8	72.2	35.5	13.1	8.4	2.4	0.3
Change in Real GDP (%)	–21.3	–16.2	–9.8	3.3	4.7	7.3	5.1	–4.1
Commercial Banks' Average Lending Rates								
(Short-term, 1–3 months, %)	135.2	91.6	33.0	29.5	20.0	13.0	10.4	12.0
Fiscal Balance (% of GDP)	0.5	–5.3	–4.8	–4.5	–4.5	–1.8	–5.8	–7.9
Foreign Reserves (Millions of U.S. dollars)	107	412	587	819	850	1063	1462	1242

SOURCES: European Bank for Reconstruction and Development, International Monetary Fund, Lehman Brothers.

TABLE 4

Bulgaria: Before and After Setting Up a Currency Board (July 1, 1997)

	1995	1996	1997	1998	1999
Annual Inflation (End-year %)	32.9	310.8	578.5	1.0	6.2
Change in Real GDP (%)	2.1	−10.9	−6.9	3.5	2.5
Interest Rates (Money market rate, % per annum)	53.09	119.88	66.43	2.48	2.93
Fiscal Balance (% of GDP)	−5.6	−12.7	−2.5	0.9	−0.9
Foreign Reserves (Millions of U.S. dollars)	1,545	793	2,468	3,056	3,222

Source: International Monetary Fund.

merit attention. For each of the five countries, the foreign reserves increased dramatically after the CBS was introduced. Given that the monetary liabilities of the CBSs are solely a function of the demand for those liabilities and given that they must be backed by a minimum of 100 percent foreign reserves, the demand for the CBS currency, as indicated by foreign reserve levels, increased dramatically after the introduction of the CBS.

The imposition of a hard budget constraint by the CBSs is not fully revealed by the fiscal balance data. These data show fiscal balances on a standard cash basis, which excludes revenues from privatization. In the years prior to the introduction of the CBSs, the fiscal authorities were all running up large arrears. This practice stopped after the CBSs were installed. Consequently, the fiscal deficits prior to the CBSs would have been larger if bills had been paid on time. Additionally, in the years subsequent to the introduction of the CBSs, privatizations increased significantly. If these were included in the fiscal data, the deficits after the installation of the CBSs would have been smaller. Therefore, the fiscal effects of the CBSs are much more impressive than is implied by the standard data presented in Tables 1–5.

Time to Accept Reality

In addition to showing that CBSs deliver stability, the data clearly contradict the preconditions dogma that is embraced by the Interna-

TABLE 5

BOSNIA AND HERZEGOVINA: BEFORE AND AFTER SETTING UP A CURRENCY BOARD (AUGUST 11, 1997)

	1995	1996	1997	1998	1999
Annual Inflation (Annual avg. %)	–4	–25	14	5	0
Change in Real GDP (%)	21	69	30	12.4	10
Commercial Banks' Median Lending to Households (Short-term, 1–3 months, %)	146.7	55.6	29.6	25.8	28.0
Fiscal Balance (% of GDP)	0	–3	–1	–2	–2
Foreign Reserves (Millions of U.S. dollars)	207	235	80	175	475

NOTES: Interest rate data for 1996 are for April. All interest rates are for the Federation only; Between 1995–10 August 1997, the National Bank of Bosnia and Herzegovina (NBBiH) operated and issued a Bosnia-Herzegovina dinar (BHD). That currency was pegged to the German mark at BHD = 100 DM. During that period, the NBBiH operated as a pseudo-currency board. However, there were some deviations in which credits were issued to the government. Moreover, those credits were not fully backed by DM assets. On August 11, 1997, the Central Bank of Bosnia and Herzegovina (CBBiH) was established and the convertible marka (KM) became the unit of account. The CBBiH operates under currency board-like rules. On June 22, 1998, the KM notes were put into circulation and on December 9, 1998, KM coins were put into circulation. On July 7, 1998, the BHD ceased to be legal tender. The last cease-fire agreement in the civil war was signed on October 10, 1995 and the Dayton-Paris Treaty that ended the war was initialed in Dayton on November 21, 1995 and signed in Paris on December 14, 1995.

SOURCES: Central Bank of Bosnia and Herzegovina, International Monetary Fund.

tional Monetary Fund and other Washington cognoscenti. Their dogma, which is invoked to allow the cognoscenti to operate as the final arbiters over whether a country is a suitable CBS candidate, states that certain preconditions must be satisfied before a CBS can be successfully installed. As the President's Council of Economic Advisors put it, "A currency board is unlikely to be successful without the solid fundamentals of adequate reserves, fiscal discipline and a strong and well managed financial system, in addition to the rule of law" (*Council of Economic Advisers* 1999: 289). The data in Tables 1–5, as well as the North Russian CBS experience, unambiguously refute this nonsense.

By ignoring critical and contrary opinion—or as I have put it, reality—the cognoscenti are in sad shape. It is time for economists to stop worrying about whether Currency Board Systems can work in theory and to start accepting and grappling with reality.

References

Bauer, P.T. (1976) *Dissent on Development*. Revised ed. Cambridge, Mass.: Harvard University Press.

Coase, R.H. (1994) *Essays on Economics and Economists*. Chicago: University of Chicago Press.

Council of Economic Advisers (1999) *Economic Report of the President.* Washington, D.C.: U.S. Government Printing Office.

D'Souza, D. (1997) *Ronald Reagan How an Ordinary Man Became an Extraordinary Leader*. New York: The Free Press.

The Economist (1997a) "The Great Escape." *The Economist*, 3 May.

The Economist (1997b) "The ABC of a Currency Board." *The Economist*, 1 November.

The Economist (1998) "By the Board." *The Economist*, 5 September.

The Economist (1999) "No More Peso?" *The Economist*, 23 January.

Fischer, S. (2000) "Managing the International Monetary System." Speech before the International Law Association Biennial Conference, London, England, 26 July. (http://www.imf.org/external/np/speeches/2000/072600.htm).

Hanke, S.H. (1999) "Some Reflections on Currency Boards." In M. Blejer and M. Skreb (eds.) *Central Banking, Monetary Policies, and the Implications for Transition Economies*. Boston: Kluwer Academic Publishers.

Hanke, S.H. (2000) *Testimony before the Subcommittee on International Trade and Finance*. U.S. Senate, Committee on Banking, Housing, and Urban Affairs, 27 April. (http://www.forbes.com/columnists/hanke/hanke0501.htm).

Hanke, S.H., and Schuler, K. (1991a) *Banco central o caja de conversion?* Buenos Aires: Fundacion Republica.

Hanke, S.H., and Schuler, K. (1991b) "Argentina Should Abolish Its Central Bank." *Wall Street Journal*, 25 October, p. A15.

Hanke, S.H., and Schuler, K. (1991c) "Keynes's Russian Currency Board." In S.H. Hanke and A.A. Walters (eds.) *Capital Markets and Development*. San Francisco: Institute for Contemporary Studies Press.

Hanke, S.H., and Schuler, K. (1999) "A Monetary Constitution for Argentina: Rules for Dollarization." *Cato Journal* 18(3): 405–19.

Hanke, S.H.; Jonung, L.; and Schuler, K. (1993) *Russian Currency and Finance: A Currency Board Approach to Reform*. New York: Routledge.

Harberger, A. (1999) Interview. Federal Reserve Bank of Minneapolis, *The Region* (March).

Hicks, J. (1967) *Critical Essays in Monetary Theory*. Oxford: Clarendon Press.

Hicks, J. (1989) *A Market Theory of Money*. Oxford: Clarendon Press.

Hutchison, T.W. (1977) *Knowledge and Ignorance in Economics*. Chicago: University of Chicago Press.

Marsh, D. (1992) *The Bundesbank: The Bank that Rules Europe*. Great Britain: Mandarin.

McCloskey, D.N. (1996) *The Vices of Economists—The Virtues of the Bourgeoisie*. Amsterdam: Amsterdam University Press.

Schuler, K. (1996) *Should Developing Countries Have Central Banks?* London: Institute of Economic Affairs.

Williamson, J. (1995) *What Role for Currency Boards?* Washington, D.C.: Institute for International Economics.