

MONEY, STABILITY, AND FREE SOCIETIES

Steve H. Hanke

Monetary instability poses a threat to free societies. Indeed, currency instability, banking crises, soaring inflation, sovereign debt defaults, and economic booms and busts all have a common source: monetary instability. Furthermore, all these ills induced by monetary instability bring with them calls for policy changes, many of which threaten free societies. One who understood this simple fact was Karl Schiller, who was the German Finance Minister from 1966 until 1972. Schiller's mantra was clear and uncompromising: "Stability is not everything, but without stability, everything is nothing" (Marsh 1992: 30). Well, Schiller's mantra is my mantra.

I offer three regime changes that would enhance the stability in what Jacques de Larosière (2014) has asserted is an international monetary "anti-system." First, the U.S. dollar and the euro should be formally, loosely linked together. Second, most central banks in developing countries should be mothballed and replaced by currency boards. Third, private currency boards should be permitted to enter the international monetary sphere.

On the Dollar-Euro Linkage

In 1944, the Bretton Woods agreement established a new global monetary system. Its hallmark was exchange rate stability. That stability was accompanied by a general acceleration of growth in the

Cato Journal, Vol. 40, No. 2 (Spring/Summer 2020). Copyright © Cato Institute. All rights reserved. DOI:10.36009/CJ.40.2.17.

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postwar golden age. By 1973, the system had been swept into the dustbin by the broom of President Richard Nixon. With that, the world entered an era of flexible, unstable exchange rates, de Larosière's anti-system.

This exchange rate instability creates problems—big problems. Just look back to the onset of the Great Recession in 2008. As it turns out, one of the few who had a laser focus on what he deems the most important price in the world, the dollar-euro exchange rate, was Robert Mundell. A founding father of supply-side economics, Mundell is always focused on prices. That certainly separates Mundell from Ben Bernanke, who was chairman of the Federal Reserve back in September 2008. Bernanke saw fit to ignore fluctuations in the value of the dollar. Indeed, changes in the dollar's exchange-rate value did not appear as one of the six metrics on "Bernanke's Dashboard"—the one the chairman used to gauge the appropriateness of monetary policy (Wessel 2009).

Just what did Mundell take stock of in the months surrounding the collapse of Lehman Brothers, Inc. (Mundell 2009)? He observed a wild swing in the dollar-euro exchange rate (see Table 1). In the July–November 2008 period, the greenback appreciated almost 24 percent against the euro. Accompanying that swing was an even sharper one in the price of oil. It plunged by 57 percent. Gold, too, had a sharp fall of almost 22 percent. And, consistent with Mundell's supply-side theories, changes in exchange rates transmit inflation (or deflation) into economies, and they can do so rapidly. Not surprisingly, then, the annual rate of inflation in the United States moved from an alarming rate of 5.6 percent in July 2008 to an outright deflation of 2.1 percent a year later. This 7.7 percentage-point swing is truly stunning.

So, in terms of monetary policy, Mundell saw the obvious: the Fed was too tight—massively too tight. The dollar was soaring and commodity prices were collapsing. Fed Chairman Bernanke saw none of this because exchange rates weren't even on his dashboard. Alas, the Fed's massive monetary squeeze and resulting unstable dollar plunged the United States into what would become known as the Great Recession. The instability also generated an avalanche of legal and regulatory changes, such as the Dodd-Frank legislation. These changes restricted economic freedom.

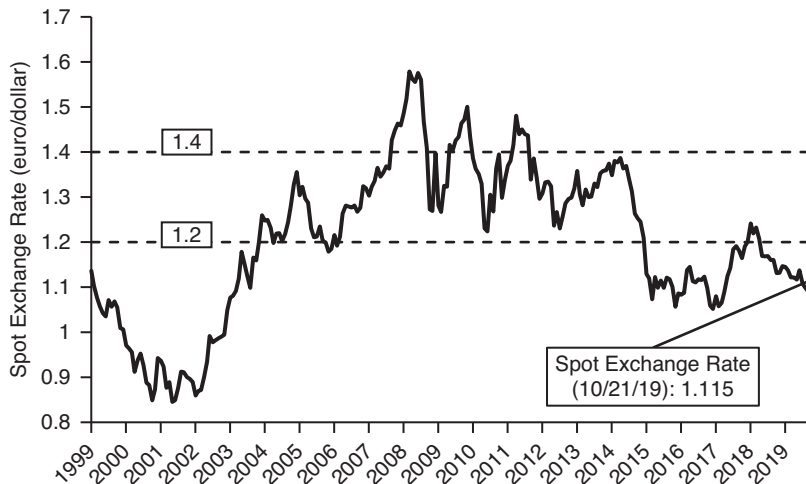
So, in the interest of stability and economic freedom, it is time to jettison the international monetary anti-system. Just what has to

TABLE 1
THE 2008 CRISIS: A SUPPLY-SIDE DASHBOARD

	Euro/USD (\$ per €)	USD/Euro (€ per \$)	Price of Gold (per oz)	Price of Oil (per bbl)	CPI (YoY change)
July 2008	1.5758	0.6346	\$925.40	\$133.37	5.6%
November 2008	1.2744	0.7847	\$723.85	\$57.31	1.1%
% Change	-19.13%	+23.66%	-21.78%	-57.03%	
Change in % Points	Sharp Euro Depreciation	Sharp USD Appreciation	Sharp Price Decline	Sharp Price Decline	-4.5% pts Sharp CPI Decline

SOURCES: U.S Bureau of Labor Statistics, Federal Reserve (FRED), and Bloomberg.

FIGURE 1
EURO/DOLLAR EXCHANGE RATE
(\$ PER €)



SOURCE: Bloomberg.

be stabilized? The world's two most important currencies—the dollar and the euro—should, via formal agreement, trade in a zone of stability (\$1.20–\$1.40 per euro, for example). Under such an agreement, the European Central Bank (ECB) would be obliged to maintain this zone of stability by defending a weak dollar via dollar purchases. Likewise, the U.S. Treasury (UST) would be obliged to defend a weak euro by purchasing euros. Just what would have happened under such a system (counterfactually) since the introduction of the euro in 1999 is depicted in Figure 1. When the euro-dollar exchange rate was less than \$1.20 per euro and the euro was weak, the UST would have been purchasing euros (in the 1999–2003 and the 2014–2019 periods). When the euro-dollar exchange rate was above \$1.40 per euro and the dollar was weak, the ECB would have been purchasing dollars (in some of the 2007–2011 period).

On Currency Boards for Developing Countries

Although widespread today, central banks are relatively new institutional arrangements. In 1900, there were only 18 central banks in

the world. By 1940, 40 countries had them. Today, there are nearly 200 central banks. Most issue currency and have wide discretion over monetary policies. There are a few countries that are “dollarized.” Their central banks do not issue currencies and do not conduct monetary policies. In addition, there are also a few countries in which central banks issue their own currencies but are bound by currency board rules. In those rule-bound systems, central banks do not have the ability to conduct monetary policies.

Central banks that operate in developing countries have poor records. They are frequently the source of “high” inflations (Schuler 1996; Hanke and Boger 2018) or hyperinflations (Hanke and Krus 2013). Currency and banking crises are also commonplace in developing countries with central banks. Fiscal deficits and debt levels are relatively high in these countries, too. These elevated debt levels often lead to sovereign debt defaults because borrowing is typically in debt that is denominated in a foreign currency. Not surprisingly, capital and exchange controls are prevalent. And if all this is not bad enough, developing countries with central banks typically experience unstable growth because their central banks engage in procyclical monetary policies.

Developing countries have not always suffered from the instability that has been visited on them by central banking. Indeed, the pre-central banking era was one of a relative calm. This result was obtained because, before central banks, currency boards were the monetary institutions relied upon throughout much of the world. And according to Sir John Hicks, currency boards rested 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 currency board was established in the British Indian Ocean colony of Mauritius. Since then, over 70 currency boards have operated in most parts of the world. Indeed, by the 1930s, currency boards were widespread among the British colonies in Africa, Asia, the Caribbean, and the Pacific islands. They have also existed in a number of independent countries and city-states, such as Danzig and Singapore. One of the more interesting currency boards was installed in North Russia on November 11, 1918, during the civil war. Its architect was none other than John Maynard Keynes,

a British Treasury official responsible for war finance at the time (Hanke and Schuler 1991).

Although ignored by most observers, that rich history has been overwhelmingly characterized by success. Even in the most trying times, currency boards always produced stable money and maintained full convertibility (Hanke, Jonung, and Schuler 1993). Countries with currency boards also kept their fiscal houses in order and realized respectable economic growth rates (Hanke 2002a). 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 currency boards, early in the 20th century, “We do in fact find that in the days of [Alfred] Marshall and [Francis Ysidro] Edgeworth financial crises were mild; the financial cycle was almost disappearing” (Hicks 1989: 98).

So, just what constitutes a currency board? An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels (both floors and ceilings) are set by law and are equal to 100 percent, or slightly more, of its monetary liabilities (notes, coins, and, if permitted, deposits). A currency board’s convertibility and foreign reserve cover requirements do not extend to deposits at commercial banks or to any other financial assets. A currency board generates profits (seigniorage) from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.

By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. It has an exchange rate policy (the exchange rate is fixed) but no monetary policy. A currency board’s operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency. Since the domestic currency issued via a currency board is a clone of its anchor currency, a currency board country is part of an anchor currency country’s unified currency area.

Several features of currency boards merit further elaboration. A currency board’s balance sheet only contains foreign assets, which are set at a required level (or tight range). If domestic assets are on

the balance sheet, they are frozen. Consequently, a currency board cannot engage in the sterilization of foreign currency inflows or in the neutralization of outflows.

A second currency board feature that warrants attention is its inability to issue credit. A currency board cannot act as a lender of last resort or extend credit to the banking system. It also cannot make loans to the fiscal authorities and state-owned enterprises. Consequently, a currency board imposes a hard budget constraint and discipline on the economy.

A currency board requires no preconditions for monetary reform and can be installed rapidly. Government finances, state-owned enterprises, and trade need not be already reformed for a currency board to begin to issue currency (Hanke 2000).

Given the superior performance of currency boards, the obvious question is “What led to their demise and replacement by central banks after World War II?” The demise of currency boards resulted from a confluence of three factors. A choir of influential economists was singing the praises of central banking’s flexibility and fine-tuning capacities. In addition to changing intellectual fashions, newly independent states were trying to shake off their ties with former imperial powers. Additionally, the International Monetary Fund (IMF) and the World Bank, anxious to obtain new clients and “jobs for the boys,” lent their weight and money to the establishment of new central banks. In the end, the Bank of England provided the only institutional voice that favored currency boards.

Currency boards have witnessed something of a resurgence. In terms of size, the most significant currency board today is Hong Kong’s. It was installed in 1983 to combat exchange rate instability (Greenwood 2008). In the wake of the collapse of the Soviet Union, several countries adopted currency boards. They were installed rapidly and without any preconditions (Hanke 2000). Indeed, in most cases, implementation took a month or less. The reasons for the post-Soviet adoption of currency boards varied. In Estonia in 1992, the overriding objective was to rid the country of the hyperinflating Russian ruble and replace it with a sound currency. In 1994, Lithuania desired to put discipline and a hard budget constraint on the government’s fiscal operations. Hyperinflation was ravaging Bulgaria in early 1997, and the Bulgarians wanted to stop it. As a result, Bulgaria adopted a currency board in July 1997 (Hanke and Tanev 2020). In Bosnia and Herzegovina in 1997, a currency board

was mandated by the Dayton Peace Accords, which ended the Balkan Wars (Hanke 1996/97; Coats 2007).

None of these modern currency boards has failed to maintain convertibility at their fixed exchange rate. Indeed, no currency board has ever failed, and this includes Keynes's Russian currency board in Arkhangelsk (now Archangel). The so-called Russian ruble never deviated from its fixed exchange rate with the British pound. The board continued to redeem rubles for pounds in London until 1920, well after the civil war had concluded (Hanke, Jonung, and Schuler 1993).

At present, the following countries use orthodox currency boards: Bermuda, Bosnia and Herzegovina, Brunei, Bulgaria, the Cayman Islands (Hanke and Li 2019), Djibouti, the Falkland Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Lithuania, Macau, and Saint Helena (Hanke and Sekerke 2003). Note that Estonia and Lithuania are not included in the list because both transitioned from currency board systems to the eurozone in 2011 and 2015, respectively (Hanke and Tanev 2020). This was done with ease because both countries were already unified with the eurozone via their currency boards.

Even though their performances have been superior, currency boards have been entangled in controversy. Perhaps the most controversial episode occurred in Indonesia in 1998, when President Suharto indicated that he was going to adopt a currency board to stop surging inflation and the ensuing food riots (Hanke 2002b). This seemed particularly attractive because the installation of currency boards had worked well to stop inflation in Bulgaria and Bosnia and Herzegovina less than a year earlier (Hanke 2016). Both currency boards had been enthusiastically supported by the IMF, and one had been mandated by an international treaty.

But in Indonesia, the currency board proposal spawned ruthless attacks. Suharto was told in no uncertain terms—by both the president of the United States, Bill Clinton, and the managing director of the IMF, Michel Camdessus—that he would have to drop the currency board idea or forgo \$43 billion in foreign assistance.

Economists jumped on the bandwagon as well. Every half-truth and nontruth imaginable was trotted out against the currency board idea. Those oft-repeated canards were outweighed by full support for an Indonesian currency board from four Nobel laureates in economics: Gary Becker, Milton Friedman, Merton Miller, and

Robert Mundell, as well as Prime Minister Margaret Thatcher's personal economic adviser, Sir Alan Walters.

Why all the fuss over a currency board for Indonesia? Nobelist Miller understood the great game immediately. As he wrote, the Clinton administration's objection to the currency board was "not that it would not work but that it would, and if it worked, they would be stuck with Suharto" (Tyson 1999: 2). Much of the same argument was articulated by Australia's former prime minister, Paul Keating: "The United States Treasury quite deliberately used the economic collapse as a means of bringing about the ouster of President Suharto" (Agence France-Presse 1999). Former U.S. secretary of state Lawrence Eagleburger weighed in with a similar diagnosis: "We were fairly clever in that we supported the IMF as it overthrew (Suharto). Whether that was a wise way to proceed is another question. I'm not saying Mr. Suharto should have stayed, but I kind of wish he had left on terms other than because the IMF pushed him out" (Agence France-Presse 1998). Even Camdessus could not find fault with these assessments. On the occasion of his retirement, he proudly proclaimed, "We created the conditions that obliged President Suharto to leave his job" (Sanger 1999: C1).

As if the Indonesian controversy were not bad enough, the currency board idea became engulfed in even more controversy in Argentina, starting in 1998 and lasting until Argentina ended its Convertibility System in January 2002. Convertibility had been introduced in Argentina in April 1991 to stop inflation, which it did. The system had certain features of a currency board: a fixed exchange rate, full convertibility, and a minimum reserve cover for the peso of 100 percent of its anchor currency, the U.S. dollar. However, it had two major features that disqualified it from being an orthodox currency board. It had no ceiling on the amount of foreign assets held at the central bank relative to the central bank's monetary liabilities. So, the central bank could engage in sterilization and neutralization activities, which it did. In addition, it could hold and alter the level of domestic assets on its balance sheet. So, Argentina's monetary authority could engage in discretionary monetary policy, and it did so aggressively.

Since Argentina's Convertibility System allowed for both monetary and exchange rate policies, it was not a currency board (Hanke 2008). Most economists fail to recognize this fact. Indeed, a scholarly survey of 100 leading economists who commented on

the Convertibility System found that almost 97 percent incorrectly identified it as a currency board system (Schuler 2005).

Currency boards' historical performances have been outstanding. Even after the Indonesian and Argentine controversies, interest in currency boards continues to grow. And rightfully so. Indeed, the second leg of my proposal to enhance stability and economic freedom is to replace central banks with currency boards in most developing countries.

On Private Currency Boards

For many years, my long-time currency board collaborator Kurt Schuler and I have advocated on behalf of private currency boards (Hanke and Schuler 1994). In our draft law for such a currency board, we proposed that its home offices and reserves be located in Switzerland and that it be governed under Swiss law.

With the advent of cryptocurrencies, the prospect of our idea, or something close to it, is close to becoming a reality. Indeed, the white paper issued by the Libra Association (2019) explicitly states that the Libra cryptocurrency would be similar to a currency board. In broad terms, that is correct. However, Libra is not yet a reality and, as Steve Forbes (2019: 15) recently pointed out:

Nonetheless, regulatory pressures have forced a number of companies that were partnering with Facebook on this project to drop out. And this gets to the real reason the idea of Libra is so troubling to so many politicians, government bureaucrats, banks and economists the world over: Libra could do to central banks what Uber and Lyft did to the taxi cartels—bust up their monopolies, or, to coin a phrase, give them a run for their money.

Central banks are clearly feeling the competitive threat posed by the prospect of private currency boards (like Libra). Indeed, a recent report on digital currencies by the Official Monetary and Financial Institutions Forum in London and IBM presents results from a survey of 23 central banks (OMFIF and IBM 2019). Half of the respondents indicated that they perceived the widespread use of decentralized, private digital currencies as a real threat. As the central bankers put it, private currencies would potentially “disturb the global financial system and undermine the sovereignty of monetary authorities” (OMFIF and IBM 2019: 19).

Not surprisingly, the Bank for International Settlements (BIS) has recently changed its position toward digital currencies. The BIS had been opposed to the introduction of such currencies, whether they be private or public. Now, the BIS has tasked Benoît Coeuré, who sits on the BIS Executive Board, with the development of central bank digital currencies to combat private challengers. As *Financial Times* reportage recently recounted: “BIS officials believe central banks should pool their resources to fend off potentially disruptive competition from better funded private sector rivals” (Kaminska 2019: 4).

Conclusion

To thrive, free societies must experience stable money. With the advent of central banking, particularly in developing countries, a great deal of instability ensued. And with instability, laws and regulations have been introduced that have restricted individuals’ economic freedom.

Stability in the monetary realm would be promoted if the center was made stable by linking the U.S. dollar and euro exchange rates. The periphery would be made stable by mothballing central banks and replacing them with currency boards that issue currencies that are clones of the currencies issued at the center—the U.S. dollar or euro. The prospect of private currency boards—which are backed by fiat currencies, baskets of currencies (like SDRs) or gold—appear to be a promising reality. The competitive forces that will be unleashed by the private alternatives would be a great stabilizer and enhance economic freedom and free societies.

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