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WOULD A CURRENCY BOARD IN LEBANON REQUIRE PRECONDITIONS?

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Johns Hopkins Institute for Applied Economics,
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About the Series

The Studies in Applied Economics series is under the general direction of Prof. Steve H. Hanke, Founder and Co-Director of The Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu).

About the Author

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In the past, Prof. Hanke taught economics at the Colorado School of Mines and at the University of California, Berkeley. He served as a Member of the Governor's Council of Economic Advisers in Maryland in 1976-77, as a Senior Economist on President Reagan's Council of Economic Advisers in 1981-82, and as a Senior Advisor to the Joint Economic Committee of the U.S. Congress in 1984-88. Prof. Hanke served as a State Counselor to both the Republic of Lithuania in 1994-96 and the Republic of Montenegro in 1999-2003. He was also an Advisor to the Presidents of Bulgaria in 1997-2002, Venezuela in 1995-96, and Indonesia in 1998. He played an important role in establishing new currency regimes in Argentina, Estonia, Bulgaria, Bosnia-Herzegovina, Ecuador, Lithuania, and Montenegro. Prof. Hanke has also held senior appointments in the governments of many other countries, including Albania, Kazakhstan, the United Arab Emirates, and Yugoslavia.

Prof. Hanke has been awarded honorary doctorate degrees by the Universidad San Francisco de Quito (2003), the Free University of Tbilisi (2010), Istanbul Kültür University (2012), the Bulgarian Academy of Sciences (2013), Varna Free University (2015), the Universität Liechtenstein (2017), and the D.A. Tsenov Academy of Economics (2018) in recognition of his scholarship on exchange-rate regimes. He is a Distinguished Associate of the International

Atlantic Economic Society, a Distinguished Professor at the Universitas Pelita Harapan in Jakarta, Indonesia, a Professor Asociado (the highest honor awarded to international experts of acknowledged competence) at the Universidad del Azuay in Cuenca, Ecuador, a Profesor Visitante at the Universidad Peruana de Ciencias Aplicadas (the UPC's highest academic honor), and the Gottfried von Haberler Professor at the European Center of Austrian Economics Foundation (ECAEF) in Liechtenstein. In 1998, he was named one of the twenty-five most influential people in the world by World Trade Magazine. In 2020, Prof. Hanke was named a "Knight of the Order of the Flag" by Albanian President Ilir Meta.

Prof. Hanke is a well-known currency and commodity trader. Currently, he serves as Chairman of the Supervisory Board of Advanced Metallurgical Group N.V. in Amsterdam and Chairman Emeritus of the Friedberg Mercantile Group, Inc. in Toronto. During the 1990s, he served as President of Toronto Trust Argentina in Buenos Aires, the world's best-performing emerging market mutual fund in 1995.

Prof. Hanke's most recent books are Zimbabwe: Hyperinflation to Growth (2008) and A Blueprint for a Safe, Sound Georgian Lari (2010), Juntas Monetarias para Paises en Desarollo (2015), Currency Boards for Developing Countries: A Handbook (2015), Gelişmekte Olan Ülkeler İçin Para Kurullari El Kitabi (2019), and مجالس النامیةدلیل البلدان ي النقد ف

Prof. Hanke and his wife, Liliane, reside in Baltimore and Paris.

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Would a Currency Board in Lebanon Require Preconditions?

Does a currency board have preconditions for establishment? In a word, "no." Rather than requiring preconditions to be successful, a currency board itself creates the conditions for other successful economic reforms when conditions are troubled.

Why currency boards are the mothers, not the daughters, of stability

Following the introduction of a currency board, stability is immediately established. This is accomplished by several complementary effects that move government finances from unsustainable to sustainable:

Reverses the Olivera-Tanzi effect. High inflation, reflected in currency depreciation, results in the Olivera-Tanzi effect, named after the two economists who first brought it most clearly to the attention of their peers. Inflationary financing of government spending reduces noninflationary financing by reducing the real value of taxes between the time they are assessed and the time they are paid. A vicious cycle ending in hyperinflation may ensue. Ending high inflation through currency stabilization, as a currency board does, creates a reverse Olivera-Tanzi effect, in which taxes retain their real value between assessment and payment and can therefore provide a solid, noninflationary basis for government finance.

Coordinates expectations. Currency stabilization is more credible through a currency board than through a central bank because of the currency board's stricter, more transparent rules. A currency board is therefore more likely to avoid the "peso problem" of high real interest rates and forward currency discounts caused by expectations of a devaluation in the near or medium term. The transition to a persistently lower level of inflation can therefore occur faster and with less disruption than would be the case with the Banque du Liban under its current institutional framework, which lacks credibility.

Improves the informational content of prices. Prices are signals that coordinate economic activity. When a currency is not trustworthy, such as in periods during high and variable rates of inflation, prices contain less signal and more noise that fosters discoordination. Currency stabilization eliminates considerable noise and promotes greater efficiency in the use of resources, promoting economic growth. The effect is especially pronounced for projects that require intricate marshalling of resources over long horizons.

Strengthens property rights. Money is the most widely held form of property. A reliable currency strengthens property rights in financial assets just as reliable maps and surveying strengthen property rights in land. Stronger property rights offer greater predictability, enabling people to undertake higher-risk but higher-reward projects, reap the benefits for themselves, and share the benefits with others by increasing the stock of capital, especially in infrastructure and other areas with long planning horizons.

Imposes a hard budget constraint. Because an orthodox currency board cannot finance government spending, it impels the government and state-owned enterprises to finance themselves

sustainably with taxes, user fees, and voluntarily granted market borrowing. The hard budget constraint that a currency board imposes makes governments examine their finances carefully and distinguish between what is important and what is merely nice to have.

Currency boards are therefore mothers, not daughters, of economic and fiscal stability. They stop high inflation from eroding the real value of tax revenue and create conditions that promote economic growth. Thus, currency boards lead to further increases in real tax revenue and allow governments to adjust to sustainable finances much less painfully than if hyperinflation ends with the general impoverishment of the population and no prospect for growth-creating reforms. Indeed, stability might not be everything, but everything is nothing without stability.[1]

Cases where currency boards have been used to end crises

Currency boards have ended various types of crises in these cases:

- Mauritius, 1849: The first currency board was established after the failure of a major local note-issuing bank plunged the island into a financial crisis. The currency board alleviated the shortage of notes, which were then very important as means of payment.
- Sri Lanka (Ceylon), 1884: As in Mauritius, the failure of a major note-issuing bank plunged the island into a financial crisis, and the currency board alleviated the shortage of notes.
- North Russia, 1919: The local anti-Bolshevik government, with support from the British government, established the North Russian ruble under currency board-type rules during the Russian civil war. The North Russian ruble replaced rapidly depreciating rubles issued by the Bolsheviks and by various groups opposed to the Bolsheviks. Of the dozens of currencies issued during the civil war, it was the only one that retained its value.
- Philippines, Hong Kong, Singapore, Brunei, and what is now Malaysia, 1945: Under Japanese occupation during World War II, all of these countries, which had currency boards before the war, suffered extreme inflation that made their Japanese-issued occupation currencies nearly worthless by the end of the war. Meanwhile, the currency boards held their reserve assets safely abroad, and the Japanese were not able to counterfeit their notes. Later, when the currency board currencies were reintroduced, monetary stability was immediately restored.
- Hong Kong, 1983: Reintroducing the currency board system immediately ended a currency crisis brought on by fear of a Chinese communist takeover after 1997.
- Argentina, 1991: The "Convertibility" system, which had elements of a currency board but also contained a number of loopholes, solidified a fragile currency stabilization after decades of failed stabilization attempts and a recent episode of hyperinflation under central banking.
- Estonia, 1992: The Estonian kroon, issued by the Bank of Estonia under currency board-type rules and fixed to the German mark, replaced the rapidly depreciating Soviet ruble. The new stable currency helped Estonia become the former Soviet republic that made the most rapid and successful transition to a market economy.

[1] Steve H. Hanke, "A Money Doctor's Reflections on Currency Reforms and Hard Budget Constraints," in Barry W. Paulson, John Merrifield, and Steve H. Hanke (Eds.), *Public Debt Sustainability,* Lexington Books, Lanham, MD, 2022.

- Bulgaria, 1997: The Bulgarian lev was suffering hyperinflation and a banking crisis under central banking. New currency board-type rules for issuance, which fixed the lev to the German mark, immediately stabilized the currency and smashed hyperinflation. In addition, within a year, the banking system had passed from a state of insolvency to solvency, and the country's foreign exchange reserves had tripled. The economy was growing rapidly under interest rates that had fallen to single digits.
- Bosnia and Herzegovina, 1997: Bosnia and Herzegovina's currency board was literally a provision contained in the Dayton-Paris Peace Agreement that ended the Balkan War. It quickly became the only reliable and stable institution in Bosnia-Herzegovina.
- In addition, there are some other cases, such as Lithuania (1994) in which there was no crisis, but currency boards were established precisely to institutionalize a hard budget constraint for the control of government spending.

On the other hand, there are no cases in which establishing a currency board failed to stabilize the currency. In all of the cases above, currency boards were established before or concurrent with other economic stabilization measures, rather than at the end of a reform sequence.

Thomas Sargent's well-known chapter "The Ends of Four Big Inflations" in Robert E. Hall's *Inflation: Causes and Effects* reviewed currency stabilizations in the early 1920s in Austria, Germany, Hungary, and Poland.[2] In each case, the stabilization, undertaken with a central bank, failed to last. In the mid and late 1940s, during and after World War II, all four countries again experienced high inflation and once more undertook currency stabilizations. Hungary and Poland yet again undertook currency stabilizations in their early years of transition away from central planning to market economies in the 1990s and did not achieve credible currencies until about 2000, when persistent depreciation against the U.S. dollar and the euro finally ceased being near-certain. Other than Argentina, discussed below, no currency board or quasi-currency board has failed to maintain long-term currency stability or has collapsed in crisis to be replaced by central banking.

What about Argentina?

Invariably, any proposal nowadays to establish a currency board provokes the question, "What about Argentina?" So, let's consider it.

The Banco Central de la República Argentina (BCRA) opened in 1935. Excluding the quasi-currency board period known as "Convertibility," it has been in operation for more than 75 years. During that time, it has been one of the major sources of trouble for the Argentine economy. Outside of the Convertibility period, annual inflation has been in single digits only in eight years—last in 2006—and has been in triple digits or higher in 15 years, leading to multiple economic crises.[3] The currency has depreciated from 3.88 "national pesos" per U.S. dollar in 1935 to 100

[2] Sargent, Thomas, "The Ends of Four Big Inflations," in Robert E. Hall, *Inflation: Causes and Effect,* University of Chicago Press, Chicago, IL, 1982, pp. 41-98.

[3] Crises since 1935 outside of the April 1991-early January 2002 convertibility period include defaults on foreign debt in 1951, 1956, 1982, 1989, 2014, and 2020, and banking crises in 1980-82, 1985, and 1989-90. Inflation crises, defined as years when inflation was at least 50 percent, occurred in 1951, 1958-59, 1975-90, and 2019. Currency crises, defined as at least a doubling of the main official exchange rate against the U.S. dollar, a substantial tightening of

present-day "convertible pesos" currently. Given that 1 convertible peso equals 10 trillion national pesos, the factor of accumulated currency depreciation is roughly 250 trillion. Typically, the peso has not been fully convertible, as evidenced by the existence of multiple official exchange rates or a black-market rate, 184 per dollar as of early October 2021. This performance, one of the worst in the world, has contributed mightily to Argentina's sluggish long-run economic growth by making Argentina's peso unreliable even for short-term economic calculations. To further illustrate Argentina's poor growth, GDP per capita in 2020 was below the level in 1998, leaving Argentina's population impoverished. According to the World Bank, 41% of Argentina's population lives below the national poverty line, and 10.5% lives below the extreme poverty line.[4] Argentina's experience is a powerful argument against central banking in any country.

This catalog of disasters attributable to the BCRA is not what is taught in textbooks about central banking, but it is a natural and even predictable outcome in an economy with weak public institutions. Conversely, a currency board provides a necessary hard budget constraint that establishes a stable starting point for upgrading the norms and behaviors in other parts of the economy, such as the fiscal arena in a failing state.

Often it has been claimed or implied that the collapse of the Convertibility system argues against currency boards generally (even though the Convertibility system was not a currency board),[5,6] but the same critics fail to acknowledge the logically equivalent claim that the abominable long-term and current performance of central banking in Argentina argues against central banking generally. If Argentina is Exhibit A against currency boards, though, it also must be Exhibit A against central banking. Moreover, there is no Exhibit B against currency boards, while for central banking there are exhibits B (Brazil), C (Congo), and so on all through the alphabet to Z (Zimbabwe).

Argentina's "Convertibility" system was from the start not an orthodox currency board either in law or in practice. It retained all of the structure of the central bank while imposing some new restrictions on the central bank's behavior. In particular, the central bank could continue to count some Argentine government bonds as "foreign" reserves and maintained some power to engage in discretionary, sterilized intervention. Those features made the money creation process somewhat different from an orthodox currency board system and created vulnerabilities not normally present in an orthodox currency board system. Through a series of missteps and unfortunate external events, the Argentine government unnecessarily spread its fiscal problems to the rest of the economy, including the monetary system, converting what could have been just a government default into an economywide crisis in 2001-02.[7] Accordingly, rather than seeing the experience of the convertibility system as a warning not to establish other currency boards, it is more accurate to see Argentina's experience as a warning against deviating from the orthodox currency board

exchange controls, or a temporary closure of the foreign exchange market, occurred in 1962, 1970, 1971, 1975-77, 1981-85, 1987-90, 2002, and 2018. The convertibility system saw crises in 1994-95 (banking crisis) and 2001-02 (combined banking, currency, and debt crises).

[4] Argentina: Poverty and Equity Brief, *World Bank*, Washington, D.C., April 2021

[5] Steve H. Hanke, "Why Argentina did not have a currency board," *Central Banking Journal*, v. 18, no. 3, 2008, pp. 56-58.

[6] Steve H. Hanke, "Argentina Should Abolish Its Central Bank," *Wall Street Journal*, 25 October 1991.

[7] Steve H. Hanke, "On Dollarization and Currency Boards: Error and Deception," *Journal of Policy Reform,* v. 5, no. 4, 2002, pp. 203-222.

system, which has worked well in all cases.

Finally, in case a reminder is needed, central banking has failed miserably in Lebanon

Under central banking, the market exchange rate of the Lebanese pound has depreciated from 1,500 to more than 22,000 per dollar. Lebanon's economy has suffered what the World Bank has characterized as one of the worst peacetime declines anywhere over the last 150 years. In the world today, the only country that has had a worse peacetime performance than Lebanon is Venezuela. Continuing with central banking means continuing with the system that has brought about the current disaster. It is rank dogmatism to neglect other possibilities in such circumstances.

Without a currency board, the likely course for the Lebanese pound is to slide into irrelevance as the country becomes unofficially dollarized to an even greater degree than it is now. The pound would continue to be the medium the government uses to pay salaries and receive some taxes, but everybody who is able to avoid using it would do so. Lebanon would be like a number of other countries, avoiding the worst effects of local monetary policy but not enjoying the benefits of full dollarization. The segments of the economy that the government is able to force to deal in Lebanese pounds would be second-class, and to some extent, the people in it will be second-class citizens compared to those who are able to deal mostly in dollar cash or offshore dollar bank accounts.