Cato Institute Foreign Policy Briefing No. 17: Currency Convertibility: A Self-Help Blueprint for the Commonwealth of Independent States

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Executive Summary

The nations of the Commonwealth of Independent States are gathering in Washington on January 22 and 23, 1992. The U.S. Department of State has called the conference to organize aid for the new nations. Even though the State Department has indicated that the conference will be restricted to discussions about so-called humanitarian aid and self-help programs, it may be politically difficult for Secretary of State James A. Baker III to hold off the foreign aid lobby. Led by Professor Jeffrey Sachs of Harvard University, the aid lobby is in full swing. Sachs claims that the transition from socialism to capitalism in the member states of the CIS will be impossible without significant amounts of foreign aid.[1]

In making his case to limit the scope of the conference, Baker should recall that Sachs and the aid lobby are employing smoke and mirrors, rather than economic analysis, to make their case. The most notable examples of successful transformations from socialism to capitalism are Chile and China's Guangdong province, which is located directly north of Hong Kong. In neither case was aid required.[2] In contrast, the two recipients of the most U.S. largesse, Israel and Egypt, have been unable to transform their largely socialist economies.[3] Foreign aid is not necessary for economic transformation, and the evidence strongly suggests that it is an impediment.

If the West is serious about helping the people of the CIS to help themselves, it should give top priority to seeing that those nations have sound, convertible currencies. As long as they continue to use the inconvertible ruble, or the inconvertible successor currencies now in the works, they will be unable to have true free-market economies. Without free-market economies, they will be unable to produce rapid economic growth.[4]

A sound currency serves as a satisfactory store of value, a medium of exchange, and a unit of account. An unsound currency, such as the ruble, does not serve any of those functions. An unsound currency is not a reliable store of value because inflation makes its value highly unpredictable. As a result, people save by hoarding bricks, timbers, food, and other commodities, which retain value better than money and other financial assets. Although commodity hoarding is rational for people in the CIS at present, it slows economic growth. In addition to hoarding commodities, people in the CIS also use U.S. dollars and German marks as substitute stores of value because the ruble is unsound. Indeed, "dollarization" is significant and accelerating. The Federal Reserve estimates that $10 billion to $15 billion in greenbacks leaked out of the United States last year; most of that money ended up in Eastern Europe and the CIS. Large amounts of German marks have also flowed to Eastern Europe and the CIS.[5] The use of dollar or mark currency is costly. It requires people in the CIS to give up real goods and services to obtain bits of paper that the U.S.

and German governments print at almost no cost, generating a perverse form of foreign aid that flows from the CIS to the United States and Germany.

An unsound currency is not a good medium of exchange. The outside world refuses to accept it. That impedes Western investment, which could jump-start the economies of the CIS. Inconvertible currencies also impede foreign trade, which is needed to provide competition for the inefficient monopoly enterprises in the CIS. Even trade within the CIS and the Baltic states is collapsing because the ruble is such a poor medium of exchange. For example, there are reports of urban food shortages because farmers refuse to accept city dwellers' rubles.[6] The purported food shortages do not result from lack of food supplies but from lack of a sound currency.

An unsound currency is not a good unit of account. Inflation distorts prices and makes business calculations difficult. Without a reliable unit of account, it is impossible to make meaningful accounting calculations or to write contracts. Even with a reliable unit of account, the CIS will have serious problems training people to perform elementary bookkeeping and accounting according to Western standards. (To give an idea of the magnitude of the task, in Yugoslavia there are 27 accountants trained to Western standards, whereas the economy needs about 6,000.)[7] The additional accounting complications that inflation causes will destroy any possibility of accurately keeping the accounts required in a smooth-running market economy.

In sum, an unsound currency prevents important elements of a market economy from working. If the CIS nations cannot establish sound currencies quickly, the repercussions will be severe both at home and in Western Europe. Inconvertibility will prevent competitive markets from functioning and foreign money from being invested, which would raise living standards. Consequently, hundreds of thousands or perhaps millions of workers in the CIS will emigrate to Western Europe in search of better conditions, thereby aggravating West European unemployment and increasing support for xenophobic political parties.[8]

Central Banks Will Not Deliver Sound Currencies

Governments in the CIS and the West are pinning their hopes for establishing convertibility on the central banks that have sprung up to replace the USSR State Bank (Gosbank). The Bank of England[9] and the Bank of France are training aspiring central bankers from the CIS and the rest of Eastern Europe. However, Paul Volcker, former chairman of the Federal Reserve, has voiced skepticism about central banks in Eastern Europe.[10] We share his skepticism. There is no reason to expect that the new central banks will be any more successful than the Gosbank was. The Gosbank's legacy is decades of inconvertibility and recent skyrocketing inflation.

Central banking's record in the USSR was in line with the overall record of central banks in socialist countries and the Third World. In the 99 nations that the World Bank classifies as low and middle income, average annual inflation was 16.7 percent from 1965 to 1980 and 53.7 percent from 1980 to 1989.[11]

To establish sound currencies, the new central banks in the CIS must establish credibility. However, that will be a difficult task because years of communist rule have created mistrust at all levels of society. No one believes anyone, particularly not government officials. It is not surprising, therefore, that many people have already conducted their own unofficial monetary reform by substituting Western currencies for the ruble.

In the unlikely event that the new central banks establish and maintain currency stability by adopting fixed rates of exchange with Western currencies, the consequences could be devastating. Because the new central banks lack credibility, people will remain skeptical of them for years. To gain credibility, the central banks must keep real (inflation-adjusted) interest rates high and their currencies overvalued. That will plunge their countries further into depression.

One alternative to a central bank's maintaining a fixed exchange rate is a floating exchange rate. Although a floating exchange rate balances supply and demand for domestic currency against foreign currency, it does not restrain the central bank's power to create credit. Instead, it likely to lead to South American-style hyperinflation. A floating exchange rate does nothing to plug the "soft budget constraint" of government ministries and enterprises. With floating rates, political pressure in the CIS will force central banks to finance "soft budgets."

An Alternative to Central Banks: Currency Boards

To solve the problem of credibility, the nations of the CIS must replace their central banks. We propose that they do so by establishing currency boards, such as now exist in Honq Konq and (in modified form) Singapore.

A currency board is an institution that issues notes and coins convertible into a foreign "reserve" asset at a fixed rate and on demand. A currency board does not accept deposits. A currency board's reserve asset can be a currency such as the U.S. dollar, the German mark, or the European Currency Unit (ecu) or a commodity such as gold. A currency board's reserves consist of high-quality, interest-bearing securities denominated in the reserve asset.

Reserves are set by law at 100 percent or slightly more of a currency board's notes and coins in circulation. (It is important to note that commercial banks in a currency board system do not hold 100 percent foreign assets against their deposits.) The currency board generates profits (seigniorage) from the difference between the interest earned 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 cover its expenses and to maintain its reserves at the level set by law.

By design, a currency board has no discretionary powers. Its monetary policy is completely automatic; it can only exchange its notes and coins for the reserve asset at a fixed rate. Its policy of keeping 100 percent reserves in reserve currency assets ensures that it will always be able to meet demands to exchange its notes and coins for reserve currency. Many currency boards have also held an additional reserve of up to 10 percent to provide against potential losses in the value of the bonds they have held. Because it has no discretionary powers, a currency board cannot act as a tool of inflationary government finance, nor can it offer enterprises a soft budget constraint. The fixed rate of exchange with the reserve asset ensures that if the reserve asset is, say, the German mark, interest rates and inflation in the currency board country will be about the same as-in Germany.

What a Currency Board Is Not

A number of prominent economists have recently voiced support for currency boards in Eastern Europe. Among them are Milton Friedman, Sir Alan Walters (former personal economic adviser to Mrs. Thatcher), and Robert Hetzel of the Federal Reserve Bank of Richmond.[12] However, the currency board system is not yet well known to most economists or the general public. Some monetary systems that in fact are not currency boards have been called currency boards.

A currency board is not a central bank. A central bank that maintains a fixed exchange rate is not a currency board because it lacks the 100 percent foreign asset reserve requirement and because its promise to maintain a fixed exchange rate is not legally binding. Argentina's present monetary system maintains a one-to-one rate of exchange between the peso and the U.S. dollar and requires the central bank to hold at least 80 percent of its assets in dollars. Nevertheless, it is not a currency board system because the government can alter the exchange rate whenever it wishes, and judging from Argentina's monetary history, it will probably do so soon. The central banks that issue the CFA franc in former French African colonies are not currency boards either. Their currencies require French franc reserves of only 25 percent, and on occasion they have gone below that ratio, resulting in bailouts at French taxpayers' expense.

A currency board does not act as a lender of last resort to commercial banks. The currency board system seeks to ensure that the banking system remains solvent by allowing unrestricted branch banking, at home and abroad, and by promoting access to foreign financial markets by means of currency convertibility. The government may act as a lender of last resort by providing deposit insurance, but most currency board countries have not done so. Even so, they have experienced extremely few bank failures. In fact, lack of deposit insurance seems to have made banks in currency board countries more prudent than U.S. banks, which results in more stable financial systems.

Record and Benefits of Currency Boards

Currency boards exist today most notably in Hong Kong and (in modified form) Singapore. In the past currency boards existed in many nations, including Argentina, the Philippines, Danzig (now the Polish city of Gdansk), and North Russia. The region around Archangel and Murmansk had a currency board in 1918 and 1919, during the life of an anti-Bolshevik government in the region. The board was the idea of John Maynard Keynes. It issued a very successful,

stable currency redeemable in pounds sterling. Its currency circulated parallel to the inconvertible, unstable currencies issued by other Russian governments and drove those currencies out of circulation because it was preferred by the inhabitants of the region.[13]

Currency board systems had excellent records. No currency board ever failed to maintain convertibility at the fixed rate of exchange with its reserve asset. Currency boards in North Russia and Burma even managed to maintain fixed rates during civil wars. Most countries enjoyed remarkable economic growth under currency boards. In Singapore average annual growth in real gross domestic product per person was 7.0 percent from 1965 to 1989, and in Hong Kong it was 6.3 percent. Moreover, Hong Kong and Singapore maintained relatively low inflation rates.

Steps to Establish a Currency Board

The steps for establishing a currency board are simple. We have discussed the details elsewhere,[14] so we shall just sketch the outline here. We assume that the currency issued by the currency board circulates in parallel with the ruble. It seems hopeless to expect to reform the ruble itself, since it is close to utter collapse and CIS members other than Russia have already announced that they intend to issue new currencies.[15] The necessary steps follow.

1. Fix an exchange rate with the reserve asset and issue currency equal to the currency board's reserves. The exchange rate merely determines the units in which the new currency is denominated. It does not have any other effect. The new currency and the ruble will circulate in parallel, at floating exchange rates. It will be up to individuals to decide if they want to continue to use the ruble or switch to the new currency. Presumably, the new currency will eventually drive the ruble out of circulation because the new currency will be more stable, but the pace of change will be determined by the market. People will be able to exchange the two currencies at floating market exchange rates because the next step in the reform, which is simultaneous with the first step, is to

2. Remove all foreign exchange restrictions.

3. Distribute the new currency according to some formula. The new currency could be given to people on a per person or per household basis. Once it has been distributed, people will start depositing it in banks and using it in payments, so there will be a dual system of bank accounts and prices in rubles and in the new currency, with freedom to switch from one currency to the other at market exchange rates. The government may require payment of taxes in the new currency, but it should allow private transactions to occur in whatever currency is agreeable to the parties involved. If the government wishes to switch its own payments and revenues into the new currency, it should make the conversion using the floating exchange rate. For instance, if the new currency--call it the "stabilus"-- has a fixed exchange rate equal to 1 German mark and 1 mark trades at a floating exchange rate of 100 rubles on the day that the government makes the conversion, all payments of 100 rubles become payments of 1 stabilus.

It should be possible to establish new currency boards very quickly. Keynes's North Russian currency board opened 11 weeks after it was first proposed, under conditions even more difficult than those the CIS faces today. Most of the delay was due to the fact that the notes had to be printed in England and shipped to North Russia.

Establishing currency boards would not require enormous foreign reserves. To introduce the new currency, for example, the CIS governments could distribute the equivalent of $15 to each citizen. Although $15 does not appear to be much at first glance, it exceeds a month's wages for the average worker at present market exchange rates. Since there are about 275 million persons in the CIS, the total amount needed to provide 100 percent reserves for new currency boards would be just $4.1 billion. Past currency reforms (such as the German reform of 1948) were able to restart economic activity by using similarly small amounts of new, sound money.

With the rather small amounts of foreign reserves required to establish currency boards, the CIS governments could successfully start currency boards and issue sound, convertible currencies without a dime of Western aid. The CIS governments have some foreign reserves, though the precise amount is hard to determine. The outlawed Communist party may also have several billion dollars stashed in banks abroad.[16] Those funds rightly belong to the people of the CIS, from whom they were extracted. What better way to use those funds than as currency board reserves, which would be distributed "free" as new currency board notes to the citizens of the CIS? If the CIS governments wish to distribute even more new currency board notes initially, they have plenty of state property that they could sell to raise

further hard-currency reserves.

It may seem that a currency board system would need to run continual balance-of-payments surpluses to enable the real value of its domestic money supply to grow. However, as the experience of Hong Kong and Singapore shows, surpluses are not necessary. Hong Kong and Singapore have run balance-of-payments deficits for decades at a time yet have been able to increase their domestic money supplies rapidly and to enjoy strong economic growth. The currency board system, coupled with good investment opportunities, has encouraged massive foreign capital flows into Hong Kong and Singapore, which have financed their balance-of-payments deficits.

Insulating Currency Boards from Political Pressure

To perfect the restraint that the currency board system imposes on government deficit spending and on inflation, we propose that currency boards in the CIS combine several features of past currency boards.

A majority of the directors of the new currency boards should be foreign nationals, chosen by private institutions in their home countries. Important decisions should require approval of two-thirds or more of the directors. The currency boards should be incorporated and their assets should be held in a safe-haven country such as Switzerland. The boards' assets should belong to the boards themselves, not to the CIS governments. It is important to recall that the assets of the board are offset one-to-one by noteholders' claims.

The new currency boards should earn the trust of citizens of the CIS nations in open competition with foreign currencies. People should be permitted to make contracts in and to use any currency that they find mutually agreeable. That freedom is already enjoyed in many Western nations and under the currency board systems of Hong Kong and Singapore.

A major source of dissatisfaction with past currency boards was that they had no organized procedure for resetting their exchange rates if the reserve asset to which they were tied became unstable. British colonial currency boards devalued their currencies with the pound sterling in 1949, 1967, and 1972 even though devaluation raised the cost of the foreign goods that the colonies needed for economic development. To avoid such problems, a currency board could be allowed to change its reserve asset if annualized inflation, measured by a wholesale price index, fell outside some range or if the reserve asset country changed the value of its currency by more than some specified percentage against third currencies. The procedure for resetting the exchange rate should be known and definite, rather than vague and ad hoc.

The following model currency board law is based on the constitutions of past and existing currency boards.

A Model Currency Board Law

1. The [name of country] Currency Board is hereby created. The Currency Board's purpose is to issue notes and coins and to exchange them at a fixed exchange rate as specified in paragraphs 5 and 6.

2. The Currency Board shall have its legal seat in Switzerland. The Currency Board shall hold its assets in Switzerland.

3(a) The Currency Board shall be governed by a board of five directors. Two directors, including the chairman, shall be persons chosen by the government of [name of country]. One director shall be a German national chosen by the Deutsche Bank; one director shall be an American national chosen by the Morgan Guaranty Trust; and one director shall be a Japanese national chosen by the Dai-Ichi Kangyo Bank.

(b) A quorum shall consist of four members of the board of directors, including the two chosen by the government of [name of country]. The board of directors may meet at the board's legal seat and such other locations as they may designate. Decisions shall be by majority vote, except as specified in paragraph 14.

(c) The first chairman and the first other member of the board of directors chosen by the government of [name of country] shall serve terms of five years and one year, respectively. The first German national shall serve a term of two

years. The first American national shall serve a term of three years. The first Japanese national shall serve a term of four years. Later members of the board of directors shall serve terms of five years. Directors may not be reelected. Should a director resign or die, the appropriate organization as specified in paragraph 3(a) shall choose a successor to fill the remainder of the term.

4. The board of directors shall have the power to hire and dismiss the Currency Board's staff and to fix salaries for itself and the staff.

5. The asset with which the fixed exchange rate is maintained is hereafter called the reserve asset. Initially, the reserve asset shall be the [German mark, for instance] and the fixed exchange rate shall be [1 mark = 1 stabilus, for instance].

6. The Currency Board may set a minimum size for transactions, not to exceed 100,000 units of the reserve asset. It may adjust the size upward in the same proportion as increases in the wholesale price index in the reserve asset. The Currency Board may not charge any commission for transactions of the minimum size or larger.

7. The Currency Board shall begin business with assets equal to at least 100 percent of its notes and coins in circulation. It shall hold those assets in investment-grade securities payable only in the reserve currency. The Currency Board shall not hold any securities issued by the national or local governments of [name of country] or of enterprises owned by those governments.

8. The Currency Board shall pay all net profits into a Surplus Fund until its unborrowed reserves equal 110 percent of its notes and coins in circulation. It shall remit all net profits beyond those necessary to maintain 110 percent reserves to the government of [name of country]. The distribution of profits shall occur annually.

9. The Currency Board's head office shall be at [name of country's capital]. The Currency Board may establish branches or appoint agents in such other cities as it sees fit.

10. The Currency Board shall publish a financial statement, attested to by the directors, quarterly or more often. The statement shall appraise the Currency Board's securities holdings at their market value.

11. The Currency Board may issue notes and coins in such denominations as it sees fit.

12. Should the change in the wholesale price index in the reserve asset fall outside the range of -5 percent to 25 percent for more than two years or -10 percent to 50 percent for more than six months, within 60 days the Currency Board must either:

(a) Devalue (if the index's change is negative) or revalue (if the index's change is positive) its currency in terms of the reserve asset by no more than the amount of the index's change over the period specified above or

(b) Choose a new reserve asset and fix the exchange rate at the rate then prevailing between that asset and the original reserve asset.

13. If the Currency Board chooses a new reserve asset, within one year all its reserve assets must be denominated in the new reserve asset.

14. The Currency Board may not be dissolved or its assets transferred to a successor organization except by unanimous vote of the board of directors.

Notes

[1] Jeffrey Sachs, "Helping Russia: Goodwill Is Not Enough," The Economist, December 21, 1991-January 3, 1992, pp. 101-4.

[2] Steve H. Hanke and Rolf Luders, "Chile 'democracia protegida' y esquena economico," Vision, September 19, 1988, pp. 6-16; Mario Blejer, David Burton, Steven Dunaway, and Gyorgy Szapary, "China: Economic Reform and

Macroeconomic Management," Occasional Paper 76, International Monetary Fund, Washington, 1991, p. 38.

[3] Steve H. Hanke, Alvin Rabushka, and Yakir Plessner, "Israel's War against Capitalism," in Toward Growth: A Blueprint for Economic Rebirth in Israel, ed. Steve H. Hanke and Alvin Rabushka (Jerusalem: Institute for Advanced Strategic and Political Studies, 1988); Bruce Bartlett, "The Rise and Fall of Egyptian Socialism," Journal of Economic Growth 4, no. 1 (Spring 1990).

[4] See Gerald W. Scully, "The Institutional Framework and Economic Development," Journal of Political Economy 96, no. 3 (June 1988): 652-62.

[5] Steve H. Hanke, "Dollarization of Bond Yields," Friedberg's Commodity and Currency Comments 12, no. 7 (August 5, 1991): 6; Peter Norman, "The Mystery of the D-Marks That Disappear," Financial Times, October 14, 1991.

[6] "Food Shortage Hits Capital of Estonia; Rationing Set," Wall Street Journal, January 10, 1992.

[7] Steve H. Hanke, Reflections on Yugoslavia's Transition to a Market Economy (Fairfax, Va.: Atlas Economic Research Foundation, 1990).

[8] Steve H. Hanke and Kurt Schuler, "The Ruble and Europe's Immigration Bomb," The Political Economy in Perspective (Boston: H. C. Wainwright & Co. Economics, Inc., November 20, 199 1) .

[9] "Bank of England Training E. Europe Central Bankers," Financial Times, September 26, 1991, p. 1.

[10] Paul Volcker, "The Role of Central Banks," in Central Banking Issues in Emerginq Market Economies (Kansas City: Federal Reserve Bank of Kansas City, 1990).

[11] World Bank, World Development Report 1991: The Challenge of Development (Oxford: Oxford University Press, 1991), p. 205.

[12] "Milton Friedman: 'Precis vad Estland behover,'" Dagens Industri (Stockholm), December 17, 1991, p. 9; Alan Walters, "A Hard Ruble for Boris," London Evening Standard, November 22, 1991; Robert Hetzel, "Free Enterprise and Central Banking in Formerly Communist Countries," Federal Reserve Bank of Richmond Economic Review 76, no. 3 (July 1990): 13-19.

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

[14] Steve H. Hanke and Kurt Schuler, "Currency Boards for Eastern Europe," Heritage Lecture no. 355, Heritage Foundation, Washington, 1991. We have written specific proposals for parts of the former USSR in Kurt Schuler, George Selgin, and Joseph Sinkey, Jr., "Replacing the Ruble in Lithuania: Real Change versus Pseudoreform," Cato Institute Policy Analysis no. 163, October 28, 1991, and in Steve H. Hanke, Lars Jonung, and Kurt Schuler, Monetary Reform for a Free Estonia: The Currency Board System (forthcoming). See also Steve H. Hanke and Kurt Schuler, Monetary Reform and the Development of a Yugoslav Market Economy (London: Centre for Research into Communist Economies, 1991).

[15] In "Currency Boards for Eastern Europe," which was written before many of the CIS members announced their intention to establish new currencies, we also discuss how a currency board could make existing rubles convertible. David Goldman, "Why a 'Currency Board' Would Be a Mistake for Russia," Polyconomics, Inc., Morristown, N.J., January 2, 1992, criticizes the idea of parallel currencies issued by currency boards, but that is not a criticism of the currency board system itself.

[16] John Lloyd, "Hunt for the Missing Roubles," Financial Times, September 11, 1991.