

RUBLE REFORM: A LESSON FROM KEYNES

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Introduction

In the past two years, the production of monetary reform proposals for the USSR has grown into a cottage industry. The USSR's proclaimed intention to develop a more market-oriented economy and its recent problems with rapid money supply growth have prompted that flurry of activity among economists.

The inconvertibility of the ruble is at the heart of the USSR's economic problems. A market economy requires a currency that people can use to purchase a wide variety of goods and services ("internal convertibility"), that is readily convertible into foreign exchange at free-market rates ("external convertibility"), and that is a reliable store of value. Only such a currency can be a fully effective tool of decentralized, market decisionmaking. Until the ruble becomes a convertible currency, market-oriented reforms will be difficult and the USSR's economy will continue to stagnate.

The most prominent reform proposals (such as Angell 1989, Shmelev and Popov 1989, the Shatalin plan, Brada et al. 1990, and Wanniski 1990) suggest a great variety of methods and timetables for achieving ruble convertibility. However, they have one thing in common: all explicitly or implicitly propose to achieve convertibility through a central bank, whether the present USSR State Bank or a Western-type central bank. The reformers' common element, a central bank, is curious in the Soviet context, since historical experience strongly suggests that it will fail to maintain convertibility. Russia has had government currency issue since 1768, and a central bank

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since 1860. However, it has had a fully convertible currency for only 35 of those years.

The czarist government suspended fixed-rate convertibility of the ruble into silver in 1786. It made several half-hearted attempts to restore convertibility in later decades, but always retreated under the pressures of war finance. It established fixed-rate convertibility into gold in 1897 during the term of the reformist finance minister Count Sergei Witte. That gold standard worked well while it lasted. However, when Russia entered World War I in 1914, it went off gold and adopted a regime of inflationary finance.

In the first years of Bolshevik rule, inflation turned into hyperinflation, which along with the ravages of war wrecked the economy. To revive the economy, the Bolsheviks in 1922 introduced a parallel currency, the chervonetz. Though not redeemable at a fixed rate for gold, the chervonetz was nominally backed by the government's gold reserves. That monetary reform and simultaneous reforms in other areas allowed limited free-market activity. In consequence, the Soviet economy achieved its highest growth rate ever (Shmelev and Popov 1989, pp. 37–40, 288–89). However, by 1928 the Soviet government ceased foreign transactions in the chervonetz and outlawed the most important forms of free-market activity. Ever since, Soviet currency has been the internally and externally inconvertible currency that it is today.

The Currency Board Alternative

Lack of success in maintaining a convertible currency is not unique to the Russian and Soviet central banks. It has also characterized Western central banks (as in the breakdown of the Bretton Woods system) and Third World central banks (many of which impose exchange controls and cause periodic bouts of hyperinflation). Therefore, rather than rely on a central banking system for convertibility, we should explore other systems. Several writers (Gressel 1989, Hanke and Walters 1990a and 1990b, Hetzel 1990) have suggested that the best means to achieve and maintain convertibility would be a currency board system.

The principal attributes of currency boards are (1) issue of domestic currency readily convertible into a foreign-reserve currency (or commodity) at a specified and fixed rate, (2) a domestic currency backed by liquid reserves held by a board and denominated in a foreign-reserve currency, and (3) reserves equal to or greater than the value of the domestic currency issued (Walters 1988). The discipline of convertibility at a fixed rate and reserve-currency backing establish

stability and confidence in the domestic currency, which thus make it suitable as a basis for free-market economic activity.

As evidence that these results would be obtained, we need only look at the record of currency boards. Boards were ubiquitous in the British colonial regimes of Africa, Asia, and the Caribbean. As colonies became independent states in the 1950s and 1960s, many institutions that were identified as "colonial" were maligned and condemned. In consequence—with the notable exceptions of Singapore, Brunei, and Hong Kong—currency boards were discarded in favor of central banks. This was unfortunate because the currency board system had a number of important advantages. For example, under the currency board system, exchange rates were fixed; colonial monetary policies were passive; and transactions on both current and capital accounts were relatively unimpeded. In consequence, colonies always enjoyed roughly the same relatively low rates of inflation as the metropolitan centers that they were linked to. Colonies with currency boards did not have central banks; hence they simply did not have the means to create money, manipulate exchange rates, and finance government deficits by borrowing from central banks. By depoliticizing the monetary system and insulating the public purse from rapacious politicians, the currency board system gave credibility to the fixed exchange rate. This allowed citizens to willingly hold both currency and deposits knowing that their value would be maintained.

The currency board system had another major virtue. It facilitated natural linkages between the colonies and metropolitan capital markets. Branch banks from the metropolitan centers were found in most colonies. With these banks and unimpeded capital flows, colonial residents had access to large pools of capital, which were available on competitive terms. Hence, interest rates in the colonies were somewhere near those that existed in the metropolitan centers.

In addition to the advantages associated with linkages to metropolitan markets, the colonies had easy access to metropolitan financial expertise and training. In consequence, indigenous firms, often with correspondent arrangements in the home countries and markets, developed to intermediate between local savers and investors. Finally, boards captured non-inflationary seignorage. This resulted because their liabilities (notes) were non-interest bearing, while their reserve assets were, in large part, interest-bearing government bonds, which were held on deposit in metropolitan central banks.

The financial arrangements that currency boards fostered led to an extraordinary expansion of savings, investment, exports, and income in many countries in colonial Africa and Southeast Asia. For example,

before 1885, there was not a single rubber tree in Malaya (now Malaysia) nor a single cocoa tree in British West Africa. By the 1930s, however, rubber, cocoa, and other export crops were being produced on millions of acres, and most of them were owned and cultivated by non-Europeans. Such a transformation, from subsistence to market agriculture, required a massive capital investment. Although considerable capital flowed into these enterprises from abroad, much of it was generated by indigenous savings. This is clear evidence that freedom and financial stability—which accompanied the liberal economic order and specifically the currency board system—were crucial elements in stimulating sound investments in projects with very long maturities.

What makes the currency board system of even greater interest for the USSR today is that it has been tried and has succeeded in Russia. A currency board existed in 1918 and 1919. It issued currency for the anti-Bolshevik government of North Russia. Surprisingly, the North Russian currency board was the idea of none other than John Maynard Keynes.

There are no references to Keynes's scheme in the standard biographies about him or in his *Collected Writings*. The only published discussion of Keynes's North Russian currency reform of 1918 is an article by Dominick Spring-Rice that appeared in the *Economic Journal* of September 1919. Spring-Rice was an official sent by the British War Office to advise the Allied forces on financial matters. His grasp of currency matters was solid, and he wrote from first-hand knowledge of most of the events he discussed. Although his article is quite useful, it only represents a progress report rather than an analysis of a completed episode. The Bolsheviks overran North Russia and the North Russian currency went out of circulation *after* Spring-Rice wrote. We shall supplement Spring-Rice's description and partial account with information from British Foreign Office archives.

The Emission Caisse

In consequence of a series of accidents and blunders, the World War I Allies became entangled in the Russian civil war, supporting the Northern provisional government headquartered in Archangel. Allied troops in North Russian made a force of about 10,000 troops. One of the force's pressing needs was how to pay for local services it needed. Currency in the North was quite heterogeneous: czarist, Kerensky, Bolshevik, and local White government notes all circulated (v. 3295, p. 102—citations that list a volume and page number

but no author are from Great Britain, Foreign Office, Russia correspondence). The Russian State Bank branch at Archangel declared itself independent of the Petrograd head office after a White coup and issued its own notes as the State Bank of Northern Russia. Even though none of the currencies had a reliable value—they were inflated or often forged—the Allies sometimes lacked adequate supplies of notes to pay dock and railway workers. The Allies were forced to acquire notes by selling imported goods locally. Indeed, on occasion, the Allies were so desperate for notes that they dumped goods on the market for less than they had paid.

Spring-Rice began thinking immediately of how to improve the Allies' financial situation. In a memorandum written on July 3, 1918, at Murmansk, he suggested that "the task of providing currency for local needs should, if possible, fall on the local authority," perhaps in combination with a loan to the provisional government in British pounds (v. 3344, pp. 249–50). On July 9, the British general at Murmansk asked the British government to print notes for British military use at Murmansk (Spring-Rice 1919, p. 282).

John Maynard Keynes, who at the time was a British Treasury official responsible for war finance, became involved in establishing a North Russian currency in August. Both Spring-Rice (1919, p. 284) and Foreign Office records (v. 3970, p. 22) credit Keynes with thinking up the details of the currency issue scheme. Indeed, Keynes wrote two notes on the subject, which we discovered in the Foreign Office archives (v. 3295, pp. 52, 62–4). On September 11, the British commissioner in Archangel received a telegram outlining Keynes's scheme (Spring-Rice 1919, p. 284).

The essential elements of the note issue scheme were set forth in a resolution of the Northern provisional government's Financial and Economic Council on October 9. The following points were officially published November 11 (Spring-Rice 1919, p. 286).

The provisional government established an agency called the National Emission Caisse (North Russia). ("Emission Caisse" is the French term for "note issue office.") The Caisse was to be an organ of any successor government to the Northern provisional government. The president of the Caisse for the first six months was to be a British banker, Ernest M. Harvey.

The Caisse was to issue notes for 1 to 500 rubles and small-change coins or notes. It was to exchange its rubles for British pounds at a fixed rate of 40 rubles per pound by issuing checks on banks abroad (mainly in London). The Caisse was also to accept U.S. dollars and French francs in exchange at their rates against the British pound. Anyone wishing to buy the Caisse's notes had to do so with foreign

currency. The provisional government guaranteed the notes with its whole property. But, more important, the Caisse's note issue was backed with a pound sterling reserve equal to at least 75 percent of the issue. This reserve was on deposit with the Bank of England. The Bank of England deposit was the Caisse's inviolable property, and hence could not become a Bolshevik possession should the provisional government fall from power. The Caisse was also allowed to buy the provisional government's bonds up to 25 percent of its note issue.

The Caisse was expected to make profits from its deposit at the Bank of England and its holdings of provisional government bonds, since both paid interest, while the notes it issued did not. The Caisse and the government were to share profits (50–50) until the Caisse accumulated a further reserve of 10 percent of its note issue. Any profits beyond that were to go entirely to the government (v. 3295, pp. 343–47, 529–31).

The Caisse worked like the West African Currency Board, which had been established for Britain's colonies in that region in 1912. The West African Currency Board became the model for many similar boards in other British colonies in the first half of this century. Keynes was familiar with the West African Currency Board: he wrote a review in the *Economic Journal* of the report establishing the board (Keynes 1983 [1913]). He was also an expert on the somewhat similar Indian monetary system, having served on a British government commission of inquiry into it and published his first book on the Indian system (*Indian Currency and Finance*, 1913). The idea behind the colonial currency boards was to enable local governments to capture the seignorage from note issue that would have accrued to the Bank of England had its notes been used instead.

It was typical of currency boards to only issue notes and coins. Indeed, they usually did not conduct deposit business. In addition, British currency boards maintained a fixed exchange rate between local currency and the British pound. Orthodox currency board practice called for keeping reserves of 100 percent to 110 percent in pounds sterling in London (Walters 1988). The rationale for keeping reserves in excess of 100 percent was to provide a cushion should the bonds or other sterling assets suddenly fall in value. Some later currency boards operated with reserves of less than 100 percent, as did the North Russian Caisse.

The Emission Caisse in Operation

The British government bought 100 million rubles in notes from the Emission Caisse to provide for the Caisse's reserve. The notes

entered circulation at Archangel, where the Caisse had its headquarters, and at Murmansk, by British military payments to the local populace. The first shipment of notes arrived in Archangel about November 3. Because the printers had made the notes as quickly as possible, they had used plates of czarist notes for the basic design. In their haste, the printers had not noticed that the notes still bore czarist insignia. To circulate the notes as they were would have upset anti-monarchists and would have been an enormous propaganda blunder. Hence, several days were lost while the Caisse's staff blotted out the imperial insignia by hand on each note (v. 3295, pp. 273, 276; Ironside 1953, p. 81). The Caisse's board of directors met for the first time on November 27, 1918, and the official gazette announced the Caisse's opening for business the next day (v. 3295, p. 527).

The British commissioner in Archangel estimated that as of mid-October 1918, about 600 million rubles of all types were in circulation in North Russia (v. 3295, p. 89), which had a population of about 600,000. When the new Emission Caisse rubles were introduced, British military authorities, who still needed old rubles for some purposes, fixed the exchange rate at 48 old rubles for 40 new rubles (= £1) as the Caisse directors and British government officials had proposed. (The prewar rate had been 9.57 rubles per £1.) Curiously, the Northern provisional government and the State Bank of Northern Russia tried to prop up the exchange rate at 45 old rubles to 40 new rubles, perhaps because they had issued some of the old ruble notes in circulation. They were waging a losing battle, however, because the supply of old rubles was growing rapidly as the Bolsheviks and White governments elsewhere inflated rapidly to finance their civil war expenditures. At this time, there were over 2,000 separate issuers of fiat rubles, and all the old rubles issued by them exchanged at the same rate. The rate that the British military offered for 40 new rubles stayed at 48 old rubles until April 1919, when it fell to 56. By the beginning of May it was 64, by mid-May, 72, and by the second half of June, 80 (v. 3969, p. 455; v. 3970, pp. 48, 80, 149). The depreciation of old rubles overcame the initial reluctance of many people to use the unfamiliar new ruble, which was maintaining its purchasing power (v. 3970, p. 23). Indeed, by mid-April 1919, the circulation of old rubles in North Russia had fallen from 600 million, when the Caisse began operation, to about 300 million (v. 3969, p. 478). The Caisse's notes were driving the old inferior rubles out of North Russia.

The End of the Emission Caisse

The Allied intervention in Northern Russia became increasingly unpopular in the Allied countries after World War I ended in

November 1918. The intervention no longer served any purpose related to war against Germany, and it entangled the Allies in a bloody civil war. The British government decided in March to withdraw its troops from North Russia. The other Allies took similar action. By September 27, the last Allied troops left North Russia (Rhodes 1988, p. 121).

The Caisse announced that it would close in Archangel and redeem all the notes presented to it. The British military command still held about 55 million unused ruble notes. To prevent them from falling into Bolshevik hands, the War Office instructed the British military commander to burn them. Because the notes were wrapped in bundles, which the weather had made damp, the notes would not burn. In consequence, they were dumped at sea (Ironsides 1953, p. 81), and the British received a book-entry credit for the destroyed notes.

The Caisse officially closed to the public in Archangel on October 4, 1919, despite the provisional government's protest. It continued to redeem notes collected by the provisional government and the State Bank of Northern Russia until October 15 (v. 3970, pp. 492, 498). The Caisse moved to London. Its main business there was redeeming the 55 million rubles that the British government held as a book credit. About 13.5 million rubles remained in the hands of the public. British troops returning from Northern Russia held a small amount of rubles, but most rubles were still in Russia. The Caisse's president suggested that the North Russian provisional government and a bank that was serving as the Caisse's agent in Norway be allowed to redeem notes as long as Archangel did not fall to the Bolsheviks. He proposed accordingly that the British government refrain from redeeming all the rubles it held. Such action would have provided a sufficient reserve for the rubles still in the hands of the public. He argued that "the assertion of our financial integrity is well worth £300,000. The Northern Rouble is known throughout North Russia and Scandinavia as the English Rouble. . . . It is the only good money seen in Russia since the Bolshevik revolution" (v. 3970, pp. 507-21).

Without Allied troops, the existence of the North Russian provisional government was precarious. It held on for several months because the Bolsheviks were concentrating their forces elsewhere. When the Red Army mounted a campaign in North Russia early in 1920, the provisional government's army disintegrated. The government fled on a ship to England on February 19, and two days later the Bolsheviks entered Archangel. The Emission Caisse remained open in London until April 30, 1920 (v. 3970, p. 597). After that date, it ceased note redemption. There seem to be no records of the

Caisse's final disposition in Foreign Office archives, but judging from correspondence from the last few months of its existence, most of the 13.5 million rubles in the hands of the public never were redeemed, inflicting a loss on their holders. The British government, therefore, ended up losing about 15.5 million rubles (£378,500), the difference between the now worthless North Russian government bonds the Caisse held and the notes that were never redeemed.

The Emission Caisse's Relevance for Today

The North Russian currency issue scheme was on the whole quite successful. The currency never deviated from its fixed exchange rate with the British pound. In contrast to currencies being issued by other Russian governments at the time, the Northern currency was a reliable store of value. In consequence, the Caisse's rubles tended to drive the others out of circulation in North Russia. With the North Russian currency, the Allied army was able to buy and sell goods almost as easily as if it had been at home on maneuvers.

As well as its usefulness to the Allies, the Caisse could have earned profits for the North Russian government had the government and the Emission Caisse continued to exist. During its first and only year, the Caisse suffered a loss because of the excessive cost of printing notes quickly and because its North Russian government bonds became worthless. Had it continued to exist, it would have probably shown a profit from its second year forward. The cost of printing the first batch of notes was an atypical expense. Later issues could have been printed less quickly at lower cost. Furthermore, many of the notes would have stayed in circulation for years before wearing out and needing to be replaced. The North Russian government bonds that the Caisse purchased at the start of its operations would have been redeemed had the Whites triumphed over the Bolsheviks.

The currency scheme suffered from only one defect: the purchase of North Russian government bonds as collateral for 25 percent of the note issue. Using local government bonds as collateral was the sole respect in which the Emission Caisse deviated from orthodox currency board practice, which required a reserve of at least 100 percent, held in foreign exchange only. British colonial currency boards, which resembled the Emission Caisse in other respects, generally kept a 105 or 110 percent reserve. When the time came to liquidate the Caisse, the worthlessness of the North Russian bonds left it bankrupt. Fortunately for the British government, the major holder of the Caisse's notes, some notes were in circulation too

far away to make redemption in London feasible before the Caisse closed. That reduced the British losses.

When we consider how difficult the circumstances that faced the Caisse were, we must conclude that the scheme worked well. In consequence, the Caisse's performance deserves a close look today. Indeed, its experience suggests how the USSR could make the ruble a convertible currency.

A currency board would replace a central bank. The new board would set aside foreign exchange assets in hard currencies sufficient for a 100–110 percent reserve against a new note issue. How much foreign exchange the currency board would need would depend on the exchange rate between the new notes and hard-reserve currencies. This rate would best be determined by allowing old currency to float against hard currencies. After a prudent period of observing floating exchange rates, the currency board could fix a "proper" rate for the new currency vis-à-vis its reserve currency. If the government did not have enough foreign exchange, it could borrow from Western governments and/or multinational organizations, pledging to repay from the interest from the currency board's holdings of foreign exchange assets. Recall that a board's gross profits would arise from the difference between interest on its investments and its note issue, which would pay no interest to noteholders. As long as the interest rates on a board's investments exceeded its borrowing rates, it could probably raise a considerable amount of foreign exchange for backing of note issues.

A fixed exchange rate with a reserve currency is vital. All successful currency boards have had a fixed exchange rate. The fixed rate enforces a discipline that presumably would not be so strong under purely discretionary monetary policy. The reserve currency could be a single foreign currency (most likely the U.S. dollar or German mark), a basket of currencies (such as the ECU), or gold¹; present and past currency boards have used each type of reserve currency successfully.

A potential weakness of *government* currency boards is the fact that there is no absolutely binding way to keep the government from forcing the board to devalue for domestic political reasons (Hetzel 1990). Perhaps one way to insulate currency boards from the possibility of political meddling with their exchange rates would be to fran-

¹A well-organized market for lending physical gold has recently come into existence in London. The *Financial Times* publishes daily the loan rates established in the gold market. Hence, through gold loans, a currency board could earn interest on its gold reserves.

chise a *private* currency board. The franchise would be awarded on the basis of competitive bidding (Demsetz 1968). The franchisee would be entitled to issue private domestic notes based on specific terms contained in the franchise agreement. A private board would probably operate more efficiently and instill more public confidence than a government board.

Another way to depoliticize currency issue would be to allow banks to issue their own notes in competition with the currency board (whether the board were privately owned or government owned), as happened in some British Caribbean colonies. None of the notes would be a forced legal tender, so people would be at liberty to use the notes that they preferred. Under that arrangement, the currency board system would function as an incubator for what could evolve into a fully deregulated "free banking" financial system.

Currency boards have worked well in the past in many countries, mostly British colonies or former colonies, but also a handful of quite diverse countries. They were replaced by central banks, mainly for *political* reasons, not economic ones. Hong Kong and Singapore, two of the world's fastest-growing economies since World War II, have currency board systems. The experience of the Emission Caisse of Northern Russia provides a particularly interesting model for the USSR and other countries that are attempting to liberalize their economies and establish sound, convertible domestic currencies.

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