THE BENEFITS AND COSTS OF CURRENCY BOARDS

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Steve Hanke and Kurt Schuler have written another interesting paper on currency boards. I agree with most of what they say. Like them I believe that, currently, a currency board would be a better foundation for the monetary system of Russia and other former Soviet states than a central bank, commodity money, or free banking.

This is inevitably a judgment. Economic theory does not permit us to say that a currency board is always an optimal arrangement or when it would not be. No one has described the circumstances under which a currency board, or more generally a fixed exchange rate system, is optimal. Hanke and Schuler suggest that information, credibility, and the size and strength of the banking system are relevant for the choice. These are surely some of the relevant criteria.

Establishing a Currency Board

The main point on which I disagree with Hanke and Schuler concerns the method of introducing the currency board. They set up a parallel currency with full backing. The new money is distributed equally to everyone and circulates along with the existing currency at a fluctuating rate.

To me, the more appealing way is also more direct. Russia's central bank should acquire foreign exchange by selling Russian assets for foreign exchange until it has sufficient reserves to fix the exchange rate against a reserve currency, close the central bank, and offer to exchange rubles for the reserve currency on demand. These reserves would be invested in foreign securities so they earn income.

Since I agree with most of what Hanke and Schuler say, I want to take up some issues that they do not address. I will discuss, among

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others, budget problems, the inconsistency of trying to fix both nominal wages and the exchange rate, the absence of a lender of last resort, and the pro-cyclicality of money under a fixed exchange rate system. Several of these problems arise in any fixed exchange rate system, but the chief advantages of a currency board—such as heightened credibility, relative certainty about the external value of money, and elimination of discretionary action—impose costs as well as benefits under some conditions.

Budget Problems

There are two budget problems. One arises from the loss of inflation tax revenue. The social benefits of lower inflation contribute to welfare, but the loss of revenues must be offset or the budget deficit will increase. This brings us to the second budget problem—the need to close the budget deficit when the currency board is established. Government borrowing cannot be larger than the amount that can be financed from domestic saving and foreign lending. The use of saving to finance government spending will have consequences for resource use, efficiency, and future living standards. A currency board can operate if these costs are acceptable, but it cannot survive if the budget deficit is too large relative to the available nonmoney financing.

The Problem of Inconsistency

Many proposals for stabilization in Eastern Europe fix both the nominal wage rate (or nominal wage rates in the state industries) and the exchange rate. Hanke and Schuler are silent about wages, but the issue is too important to ignore.

A system with fixed nominal wage rates and fixed nominal exchange rates has been proposed in a recent study (Fischer and Gelb 1991) and adopted in Poland and other countries. This system is inconsistent. The economic system cannot in general reach a stable equilibrium at full employment with two fixed prices. Equilibrium is indeterminate. Whether prices fall, rise, or remain unchanged— and whether there is persistent unemployment—will depend on where the exchange rate and the wage rate are set. The reason is that the exchange rate determines the money stock and the price level. Therefore, employment and real wages will be determined by the fixed nominal wage and the fixed exchange rate. A currency board cannot devalue to resolve the problem.

In general, nominal and real wages must be sufficiently flexible to maintain unemployment at a politically acceptable rate. Otherwise pressure for devaluation is likely to destroy a currency board system.

Absence of a Lender of Last Resort

A currency board does not permit the government to serve as lender of last resort. This problem arises because domestic bank deposits can be converted during a financial panic into domestic currency and then exchanged for foreign currency. Usually, currency reserves are much smaller than deposits, so this adds to the panic and the bank run. Two main solutions to this problem have been used in other contexts. The government can arrange standby borrowing facilities, as I believe principal Scottish banks did during the so-called free banking period. Or the currency board can ask the government to suspend foreign exchange payments as the Bank of England did on several occasions in the 19th century.

Shortcomings of a Fixed Exchange Rate System

A currency board has the disadvantages associated with any fixed exchange rate system. We know that fixed exchange rates are not an optimal arrangement under all circumstances or for all countries. Money growth is pro-cyclical, as under a classical gold standard. Export booms produce more rapid growth of money, raising domestic prices and encouraging imports, reductions in money, and a subsequent fall in prices. This suggests that with less than fully flexible prices of goods and services, the variability of output may be above an attainable minimum. Also, there is a risk of changes arising from inflation, disinflation, or changes in real exchange rates abroad. These problems are not unique to a currency board arrangement; they arise in any fixed exchange rate system.

No one can establish that any fixed exchange rate system, including a currency board, is optimal for Russia or other former socialist states. Further, not enough is known about the dynamics of the disinflation process to predict the costs of a permanent disinflation or the length of time required to make the benefits of disinflation larger and more apparent to the public than the costs.

A currency board would lower the costs of achieving credible disinflation, particularly if the government adopts a fiscal program that reduces the deficit to near zero. This allows domestic saving and foreign borrowing to be used for investment and economic development—including productive government investment in infrastructure.

Limiting the currency issue to the amount consistent with foreign exchange purchases and sales restricts the government's ability to finance future deficits. This is a step toward a time-consistent policy.

Conclusion

Unlike dollarization, a currency board retains the seigniorage and the value of lost or destroyed currency for the home country and satisfies nationalistic desires for a home country currency. As in any credible fixed exchange rate system, the currency board provides the public good of enhanced stability of the internal and external value of money. By allowing a parallel foreign currency (the dollar) to be used domestically, the government can augment the credibility of the currency board. The advantages of a currency board are purchased at the costs associated with any fixed exchange rate regime. For Russia, these costs seem to me much lower than the benefits from credible disinflation and a strong commitment to stability of internal and external money values.

Reference

Fischer, Stanley, and Gelb, Alan. "Issues in Socialist Economic Reform." *Economic Perspectives* 5 (Fall 1991): 91–105.