THE RUBLE PROBLEM: A COMPETITIVE SOLUTION

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The most critical challenge for the republics of the former Soviet Union and for the Commonwealth of Independent States (CIS) is the creation of a monetary system that will serve economic reform and the transition from socialism and central control to a market economy.

The purpose of this paper is to present the case for competitive currency issue by private banks as the best solution to the current monetary and economic crisis. This objective is at once less demanding than presenting the theoretical case for competition in currency issue as the ideal monetary system for all countries at all times, and at the same time more demanding, because it is a specific policy recommendation about what real people in real trouble should do in their current circumstances; and what they do will matter.

The criterion for evaluating this policy option is whether or not it is the best option for facilitating economic recovery and growth in the next one to five years in the context of the effort to make the transition to a market economy.

The Current Situation

Trade both within and among the republics has broken down because of the absence of acceptable means of exchange. Hyperinflation is partly responsible; the difficulties of making contracts and planning for the future when inflation is high and variable, and of perceiving relative price signals amid overall price increases, are of course a problem. But the heritage of a Leninist banking system is also taking its toll.

Ruble deposits of enterprises are not freely convertible to currency; under central planning, the use of currency was limited primarily to

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the payment of wages. Payment for materials and supplies had to be made by bank transfer. The presidium of the Russian Parliament reinstated these restrictions, which had been breaking down, in late January 1992 (Bush 1992). Writing in mid-1990, while inflation was still in double digits, the authors of the 500-Day Plan noted this lack of "fungibility," commenting that the exchange ratio of deposits for currency was often 3 to 1 (Yavlinsky et al. 1991, p.75). Similar exchange ratios continue to exist for transactions on the new commodity exchanges.

The purpose of the state bank under central planning was not to make and collect commercial loans (or even to control the money supply) but to ratify the orders of the central planners by extending such credit as was consistent with plan fulfillment. Output was delivered to the state and the state in turn supplied inputs; it ran a central barter system. Ministries co-owned the deposits of enterprises.

After the failure of one attempt, initiated in July 1987, to create commercial (but still state-owned) banks by transferring loan assets of the state bank to new banks, in 1990 ministries and state enterprises began to create banks (IMF 1991:2, pp.107–115; Vadilov 1991). These banks are designed to lend to their owners and are not likely to function as independent commercial banks in business for profit; the state bank can make interbank loans to them. Thus the financial system does not yet shift the investment decision from the government to the market. The new cooperatives—many of which have been created within state-owned enterprises—have established a number of cooperative banks. They also lend to their owners, but have a greater potential for competitive operation.

In one of the more bizarre episodes of central banking, as of late 1989 the individual republics had established their own "central" banks, at least some of which added to the supply of rubles by financing the deficits of their respective republican governments. The head of the state bank claimed that the Russian republic was a major offender (Lloyd 1991). It seemed as though the republics were competing to issue rubles as fast as they could before the rubles lost their value.[1] Meanwhile the central government was financing its own deficits by printing rubles.

Whether or not Russia or the CIS has in fact regained control of the creation of rubles, one motive other republics, especially Ukraine, have expressed for issuing their own currencies is to preclude an

[1]Benjamin Klein (1974, p. 439) comments that "Historical examples of competitive producers of a single money . . . are rare, but the available examples reveal the incentive to overissue." The former Soviet republics provide another example of that phenomenon.

influx of rubles from Russia. Ukraine began issuing coupons in January 1992 that could form the basis of a national currency (Uchitelle 1992). The future of this scenario is a Ukraine with its own eventually stable currency trading against an eventually stable ruble, at which time inter-republic trade will be able to revive. The future may be a long time coming.

The current legacy of the communist banking and trading systems and hyperinflation is barter, which is now legal. A major aircraft manufacturer has begun making aluminum pots and other consumer items so that it has something to trade for the supplies it needs. Meat can be exchanged for almost anything, as enterprises want meat to feed their employees. High-value items like automobiles are sometimes quoted on the commodity exchanges in units of wheat (Barringer 1991). Coal miners in the Kuzbass spent weeks in the winter of 1991–92 trying to negotiate an exchange of coal for sugar. Associations of private farmers barter produce and meat for flatbed trucks and cinderblock (Banerjee 1991). Even nondrinkers stock vodka for its use in exchange (Albright 1991). Both enterprises and consumers want to be in goods rather than rubles; hoarding is standard.

Trade among the republics is especially important in the ruble area because of the excessive concentration of industry, where often one supplier in the entire territory of the former Soviet Union accounts for 85–100 percent of output of a product (IMF 1991:2, pp. 16, 40). In July 1991 a small enterprise in Russia's Far East reported that it was having difficulty obtaining materials to build water heaters; and yet it was the only plant in the Far East making water heaters and supplied them to not only that region but the entire country (FBIS 29 July 1991, p. 53). Inter-republic trade exceeded 30 percent of output for all republics except Russia in 1988, and over 40 percent for 12 of the republics (*The Economist* 1991, p. 77).

Because of the rapidly depreciating ruble, the U.S. dollar and other hard currencies are being used in trade.[2] The holdings of the population of dollars and other hard currencies are variously estimated at $2 billion to $10 billion or more. The distrust of government on monetary matters is summed up in the February 1992 statement of a Russian traveling in the United States on official business: "I keep my hard currency at home." The desirability of dollars is reflected in their high purchasing power in comparison to the ruble at current rates of exchange, both legal and black market (Ignatius and Hays 1992). At the same time, the successor states of the Soviet Union have inherited a hard currency debt of over $60 billion.

[2]See Copetas (1991) for the flavor of the current business climate.

In conclusion, the republics are suffering from the absence of effective means of exchange within and among them. They need money that works as a means of exchange internally and across their borders; they need it quickly, to enable them to utilize the economic resources currently available to them; they need a commercial banking system; and they should make use of the hard currency resources held by their citizens.[3]

Free Banking: The Record

The characteristics of a free banking system are freedom of entry and freedom of note issue with minimal government regulation. The role of the government (beyond enabling legislation) is the enforcement of contracts and of laws against fraud and other criminal activity. A free banking system has no central bank and no lender of last resort.

Since F. A. Hayek's publications on competitive currencies in 1976 and 1978, the history and record, as well as the theory, of competitive private currency issue have received renewed attention from Western economists. Historical examples continue to come to light.[4] In most of these cases the monetary standard—the reserve or base money into which the notes were convertible—was the same for all the banks in the system. What Hayek proposed was competition among currencies denominated in different units. He foresaw the possibility that such competition would lead to a monetary standard kept constant in terms of the values of a group of commodities. The essential point he and others have made is that government monopoly of currency issue and the monetary standard has been so pervasive that the market has never had the opportunity to experiment with providing the kinds of money consumers might want.

Whatever the characteristics of the ultimate competitive monetary system, the historical record demonstrates what can be expected of competitive private currency issue, whether or not all banks use the same monetary standard.

The most important historical experience with free banking is that of Scotland between 1716, when the monopoly of the Bank of Scotland lapsed, and 1845, when legislation leading to a monopoly of note issue by the Bank of England was passed. White (1984) summarizes this experience and compares it to that of England. No

[3]McKinnon (1979, pp. 251–54) attributes the success of the Marshall Plan in Europe in part to the European Payments Union (EPU) established with a U.S. contribution of $350 million. The EPU made Europe's currencies convertible, with the dollar as the unit of account, and revitalized trade. Transfers of U.S. capital contributed only about 4 percent of GNP.

[4]See Vaubel (1984) for a summary of the history of private competitive note issue.

barriers were erected to entry into Scottish banking. All but three banking firms were established as unlimited liability enterprises whose owners were called upon to meet the claims of deposit and note holders in the event of a failure. As of 1765, small note issues were prohibited, the law required that notes be redeemed on demand, and the option clause (giving a bank the option of redeeming notes in six months with payment of interest rather than immediately) was outlawed. These were the only regulations.

England, by contrast, forbade banks to issue their own notes if the bank had more than six partners during most of this time period; after 1826 for a time banks could issue notes if more than 65 miles from London. The failure rate was over four times that in Scotland and losses often fell on note holders, whereas in Scotland losses were almost entirely covered by partners (White 1984, p. 47).

In the United States, "free" banking meant freedom of entry without a specific act of the state legislature, rather than free enterprise. The U.S. experience is in fact multiple experiences with different state laws, some of which worked well and some of which were disastrous. In general, branch banking was forbidden even within a state. Several states used the banks as a market for their bonds, requiring them to purchase state bonds as collateral for note issues but valuing the bonds at par rather than at market. Note issues were restricted to the par value of the bonds; if the par value exceeded the market value, an immediate profit could be made (even as the bank failed) by issuing notes supposedly backed by state securities. This legal restriction is, according to Rockoff (1975), the origin of wildcat banking, which occurred in some states and not others; it was also the origin of the inability of banks to redeem notes as values of state bonds fell, since their assets were thus not well diversified and subject to the problems of the states whose bonds they held. Some states also failed to close down banks unable to meet their obligations.

New England, however, established a stable free banking system that evolved in the same direction as the Scottish system—competitive note issue, notes circulating at par, and clearing arrangements (started by the Suffolk Bank in Boston) among the banks.

New York, the nation's leading center of commerce and industry, also established a stable system. As of 1840, New York's free banking law made the market value of bonds backing note issues the legal value. It specified limited liability unless expressly given up. A minimum paid-in capital was required, and if any of the original capital was withdrawn while debts of the bank remained unsatisfied, no further dividends or dispersions could be made to the owners until

the capital was restored; if such dispersions were made the bank could be liquidated. New York's law also required a 12.5 percent specie reserve against notes and bills circulating as money, and provided damages for note holders whose notes were not redeemed on demand (Rockoff 1975, pp. 70–79, 81).

In Sweden, privately owned commercial banks with unlimited liability (enskilda banks) issued their own bank notes from 1830 until they were forbidden to do so in 1904; currency issued by the government bank circulated at the same time (Sandberg 1978, pp. 657–65). One of these banks played an especially important role in the development of new Swedish industries. Sandberg (p. 651) attributes Sweden's economic success—including the highest per capita GNP growth rate in Europe between 1870 and 1914—in part to its banking system. No bank failed (Selgin 1988, p. 7).

The cantons of Switzerland permitted banks to issue their own notes between 1826 and 1850, an example of interest because Switzerland had not adopted a single monetary standard at the time. The banks were therefore free to decide in which monetary standard their notes would be denominated. Eight banks of various forms of ownership were established using four different standards. The bank in Basel, which issued currency denominated in French francs, and the bank in Zurich, which denominated its notes in brabanterthaler, accepted each other's notes at a rate of exchange specified by the issuing bank. No failures occurred; some suspensions of convertibility by private nonbank issuers of currencies did happen from time to time (Weber 1988). Regulations limiting note issue and reserve requirements did not affect the behavior of the banks as their note issues were well below the permitted amount and reserves were on average considerably higher.

The record of free banking in a number of countries over periods of time exceeding, in the case of Scotland, a century, and in the United States between 1838 and 1860, is far better than the wildcat banking stories would alone suggest. Nevertheless, one of the essential lessons in the historical record should be how to avoid the conditions that lead to wildcat banking (that is, banks established with fraudulent overissue as the prime purpose).

The theory of free banking has developed side-by-side with the historical re-examination. That theory addresses the significant free banking issues and concludes that (1) a free banking system would not be inflationary (leading to systematic overissue of currency), (2) would not lead to an infinite or indeterminate price level, (3) would not lead

to monetary disequilibrium or fluctuations in the value of money, (4) would not be unstable (subject to runs and panics), and (5) would not use resources inefficiently.[5]

Both the historical record and theory support the market as an efficient and effective supplier of money. The historical record also demonstrates that when governments decide to end a free banking regime, they (unfortunately) have no problems doing so, and they do so for their own purposes—in order to obtain the benefits for themselves of monopoly issue and the ability to inflate the currency.

A Free Banking System for the CIS

Under a free banking system, each of the states of the CIS, at its own option, would pass legislation permitting private banks to accept deposits of hard currency, gold, or other valuables and to issue notes and establish deposits convertible into a hard currency, a basket of hard currencies, gold, or the current market value of one or more internationally traded commodities such as oil. Each state would further specify that no restrictions be placed on the use of the deposits or notes of private banks in transactions or contracts; that the government provide specific-performance enforcement of those contracts in the same manner and with the same care it enforces contracts in the ruble or any currency issued by, or under the auspices of, the government; and that it enforce laws concerning fraud and counterfeiting.

A license or charter to create a private bank would be based on meeting certain specific and minimal requirements—the names, addresses, and character of the owners (people with a criminal record under current law could be excluded), a copy of the by-laws of the bank representing its contractual commitments and relationships to shareholders, depositors, and note holders, and the names and addresses of its auditors. Each bank could be required to include in its name a standard phrase, such as "non-state," indicating that the bank was not government-owned or backed and that its deposits and notes were not insured by the government. The states might choose to make foreign individuals and enterprises eligible for bank licenses, either as sole or partial owners of a bank.

The enabling legislation in each state would require that contractual commitments to note holders and deposit holders be met. In the event they were not, the government would close down the bank

[5]See Klein (1974), Glassner (1989), Rockoff (1975), Salsman (1990), White (1984, 1989a, 1989b), Selgin (1988), and Vaubel (1987). Selgin (chap. 2, pp. 16–34) and White (1989b) describe hypothetical free banking systems drawing on the historical record and theoretical work.

according to pre-established rules on the bankruptcy of private banks and the bank's own by-laws on priority of claims.

Each republic could require that every bank provide frequent (perhaps even daily) audited public information on the condition of the bank in accordance with a defined format, posted in all public offices of the bank and made available to the financial press for publication. Further public information requirements would be that the banks post and inform the government of the quantity of all bank notes printed, and that all enterprises printing bank notes for such banks be required to inform the government and the public of the printing of such notes. The provision of public information would probably evolve even if not required by regulation. The assumption here is that a specific requirement can eliminate the time required for market participants to generate the demand for the kind of information they need to evaluate private banks.

Beyond the initial licensing and public information requirements, the governments of the republics would not further regulate private banks. No restrictions would be placed on branching or other geographical activity or the financial services that could be provided (including clearinghouse activities). No reserve requirements would be established and no limits would be placed on interest rates on deposits or loans, the amount of reserves a bank must hold, or the kinds of loans (or even equity participations) a bank could make. (The banks should not be precluded from lending to state enterprises or accepting their deposits. But the government, as owner of state enterprises, may forbid all or some state enterprises to borrow from private banks or hold accounts in them.)

No limitations other than minimal licensing requirements would be placed on entry into the industry (with the possible exception of minimum capital), since competition is the essential regulator of a free banking system. No restrictions would be placed on the conversion of deposits to currency or on the use of devices such as checks, electronic transfers, teller machines, and the like. Nor would restrictions be placed on the nature of the bank's contractual commitments to deposit and note holders, including whether or not it was created as a limited or unlimited liability joint stock company. A bank might or might not choose to issue currency with a delayed redemption clause—one that permits the bank to redeem within six months, for example, rather than immediately. A bank might or might not choose to honor currencies issued by various other banks at one time or another. Clearinghouses would also be free to make judgments about the banks they would accept as members. Currencies issued by banks would trade freely against each other and the ruble.

To encourage the development of the system, the governments of the Commonwealth states might find it desirable to institute an amnesty, possibly temporary, for depositors of dollars and other hard currencies with respect to the origin or sources of their funds. The state governments may also need to issue guarantees against confiscation or monetary "reform" in which deposits are written down. But the governments would not guarantee deposits or the redeemability of bank notes. Nor would they require the banks to hold any particular assets—especially not government debt or bonds.[6]

The governments of the republics might be tempted to specify or limit the backing for the deposits and notes of private banks. The dollar is the obvious choice, but it is not at all clear that it would be the choice throughout the ruble area or at the end of the decade. The Deutsche mark in the west, the yen in the east, the Finnish marka in the St. Petersburg area, and eventually the ECU are all contenders. Leaving the choice open also allows for gold and for a currency convertible into, for example, dollars but based on the spot price of oil. As Milton Friedman (1991) put it, "Let a common money develop the way a common language has developed, by voluntary cooperation. . . . [T]here is more hope for a viable common money by voluntary cooperation through a market process than by government-enforced cooperation through a political process." New forms of money, as envisioned by Hayek and others, might also emerge.[7]

The CIS formed by 11 of the republics of the former Soviet Union has considered monetary issues. Russia wants to keep the ruble and try to establish it as a sound currency, while other republics—especially Ukraine—are interested in establishing their own currencies. Whether or not the Commonwealth states continue to have the ruble in common, they could agree on the following: (1) to permit the use of currencies issued by private banks across state borders by individuals and enterprises at their option; (2) to determine state by state whether to accept the notes of banks of other republics for tax purposes; (3) to consider whether to permit local branches of banks headquartered in other republics; and (4) to decide whether to provide enforcement of contracts written in the currencies of banks of other republics (a contract would always be enforceable somewhere). If these issues could be agreed upon, then private bank notes redeemable in hard currencies would serve as a medium of exchange among the states of the CIS whether or not the ruble (or any new

[6]A cautious approach to free banking would be to adopt the basic legislation but allow a region, such as a province, to decide whether or not to permit free banking.

[7]See Greenfield and Yeager (1987), Hall (1983), Hayek (1976), and Yeager (1987) for possibilities.

currency issues of the republics) was sound and whether or not individual republics decided to establish currency boards.

In fact, the CIS might adopt the statement F. A. Hayek (1976, p. 17) proposed for the European Common Market:

> The countries of the Common Market [Commonwealth] . . . mutually bind themselves by formal treaty not to place any obstacles in the way of the free dealing throughout their territories in one another's currencies (including gold coins) or of a similar free exercise of the banking business by any institution legally established in any of their territories.

For their part, the banks would exchange hard currencies for their own deposits or notes. A bank would agree to redeem deposits and notes for its selected reserve currency (say dollars) on demand (or after a specified period of time). Its hard currencies would be converted, in this example, to dollars and invested in (generally) short-term dollar-denominated securities—U.S. Treasury bills or commercial paper. In a competitive system, banks would pay interest on most deposits.

The bank would make loans in its own currency, thus increasing the money supply. But as the deposits were converted to notes and spent, or transferred to others by check, the bank would have to pay out reserves or satisfy claims against it by claims it had acquired on other banks—notes it had accepted or checks to be cleared—thus limiting the expansion of its liabilities to amounts people were willing to hold. Eventually an organized clearing system would develop among the banks, and the clearinghouse or individual banks would make loans to banks temporarily in difficulty.

The Wild East

The free banking system proposed for the CIS differs from historical experience in several respects.

First, in all the known historical instances of private bank note issue, except that of Switzerland, the notes issued by the various banks were all redeemable in the same reserve medium—generally either gold or silver coin, or possibly a government bank note in turn redeemable in gold or silver coin. There was thus a single monetary standard or unit of account. A free banking system would be expected to converge on a favored standard, although this standard might vary geographically (the Soviet Union covered 11 time zones) and over time, and might take a number of years to emerge. The confusion of money denominated in rubles, dollars, marks, yen, and perhaps even

more currencies is not, however, particularly different from the current situation; it would simply make it legal and open rather than covert.

The legalization of transactions in different monetary standards should move these transactions out of the black market and make them easier to observe and thus to tax. How to tax is more complicated, but the convenience of the government should not be grounds for rejecting an otherwise beneficial policy. If revenues exceed expenses (or value added is positive) in each monetary standard in use, taxes can be paid at the required rate in each standard. If not, each taxpaying entity could be required to select a unit of account and convert transactions in other currencies to that unit—using the actual purchase price, the average for the period, or the value at the end of the period. Alternatively, a republic could require that its official currency remain the unit of account and the currency for tax payments.

Another difference between the proposed reform and the historical record is the recommendation that free banking legislation go into effect while the ruble (and other currencies that may be issued by other republics) continue to exist. The government of Russia appears committed to the ruble as its currency (and if possible, that of the CIS) and to the effort to make it sound. The question then arises of the fate of the ruble in the event free banking is successful and currencies convertible into dollars, marks, yen, gold, or whatever are successfully issued and circulate.

Leland Yeager (1985, p. 105) discusses a transition to a different kind of system in the United States: "The appearance of attractive alternatives would collapse the demand to hold money of the present type." White (1989a), on the other hand, tends to think that government fiat "outside" money would not immediately lose its value if private substitutes were permitted. Hayek (1976, p. 93) comments:

> For government . . . the chief task would be to guard against a rapid displacement and consequent accelerating depreciation of the currency issued by the existing central bank. This could probably be achieved only by instantly giving it complete freedom and independence, putting it thus on the same footing with all other issue banks, foreign or newly created at home, coupled with a simultaneous return to a policy of balanced budgets, limited only by the possibility of borrowing on an open loan market which they could not manipulate.

The ruble is already challenged by foreign hard currencies. The ends of four major hyperinflations of the post–World War I period (Austria, Hungary, Poland, and Germany) occurred not when the central banks of those countries reduced their note issues, but when

their governments made credible commitments to not finance their deficits by central bank borrowing and to bring their budgets into balance. As Sargent (1982, p. 89) writes, "The essential measures that ended hyperinflation in each of Germany, Austria, Hungary, and Poland were, first, the creation of an independent central bank that was legally committed to refuse the government's demand for additional unsecured credit and, second, a simultaneous alteration in the fiscal policy regime." Presumably it is the same circumstances that are critical to the ruble, and not the absence of alternative currencies or stabilization funds provided by international financial institutions.

Russians to whom I have spoken are convinced that alternative means of exchange would lead to the further erosion of the value of the ruble. But the source of this erosion will be the government's unwillingness to give up its power to finance its deficits by monetary creation and to redistribute income by selectively raising wages or other payments. Under a free banking system, the greater availability of money redeemable for hard currencies would put downward pressure on the ruble/dollar exchange rate. If the government succeeds as well in controlling the issuance of rubles, the ruble should stabilize against foreign hard currencies and bank notes convertible to those currencies. As the government acquires redeemable bank money through tax payments, it can use those notes to purchase and retire rubles. The total money supply would include the notes and deposits of private banks as well as government-issued rubles. (The money supply already includes foreign currencies. Loans issued by private banks should reduce the demand for ruble loans.)

Third, circumstances in the ruble area differ from those in Scotland, Switzerland, Sweden, and the United States during their respective free banking eras. One obvious difference is that modern communications—radio, television, electronic transmissions—exist in the former Soviet Union, even though they are not as pervasive as in Western Europe or the United States. Information need not travel by post, nor bank notes by pony express rather than air.[8] Although Russia (and even more so, the CIS) is vast, it can be assumed that notes would come back to the issuing bank relatively quickly even if circulated at a distance, and information on the condition of various banks would be available throughout the area where notes might circulate. Modern communications mitigate against Friedman's concern that "individuals may be led to enter into contracts with persons

[8]See Gorton (1992) for a discussion of the importance of technology in the pricing of bank notes.

far removed in space and acquaintance, and a long period may elapse between the issue of a promise and the demand for its fulfillment" (Friedman 1960, p. 60).

Another difference is that the principle of private wealth is not as established or secure as it was in Scotland when the unlimited liability of owners protected so well the deposit and note holders of Scotland's banks, or in the United States where some states passed unlimited liability requirements for owners of banks and consequently made a dead letter of their banking laws. The alternative may be a paid-in capital requirement, not to protect customers against overissues or errors in lending decisions, but to ensure that owners have something of their own at risk and thus have an incentive to make the bank successful.

The problems of establishing confidence in a bank—and its owners—in the republics of the former Soviet Union are also likely to differ from those encountered elsewhere. In this challenging process, the republican governments would be wise not to promise the public that private banks are safe, or in fact to take responsibility for their safety, but only to ensure that information about them is readily available. The first private banks may need to be established by foreign banks of recognized name and reputation or by individuals recognized for their acumen and integrity.

Why a Currency Board Is Not Enough

I have no objections to currency boards, and a government-issued currency convertible into one or more foreign currencies would be a useful adjunct to a free banking system. Without new banking legislation, however, the convertible currency would become entrapped in the existing state-owned banking system with its restrictions on conversion of deposits to currency and its credit and interest rate controls. What is needed is not only a parallel currency or currencies, but a parallel banking system.

The minimal system would permit the establishment of banks under the regime described above but without the power to issue their own notes. Currency issued by the board would be the sole currency other than the ruble. The restriction on note issue would be an artificial restriction on the public's demand for currency to hold in an environment in which individuals are not accustomed to using checks and bank transfers are slow.

A more liberal system would permit private banks to issue their own currencies backed by the currency issued by the board. This system would provide additional flexibility in the supply of circulating currency, but it would still require banks to tender their hard

currencies to the currency board to obtain reserves. Private banking may attract more hard currency deposits (and thus more rapidly eliminate the seigniorage now enjoyed by foreign governments whose currencies are held in the states of the CIS) if there is no currency board to which a bank is likely to turn over hard currency deposits. This point rests on the possibility of public distrust of a currency board. A currency board is, after all, a creature of the government that creates it, and Soviet history provides many examples of the use of confiscation as a tool of monetary policy. The risk is that the government could seize the assets of the currency board and declare its notes to be legal tender (final payment for debts public and private) inconvertible to the reserve currency. (A currency board run by the IMF would eliminate this risk.)

Competitive currency issue with freedom to choose the monetary standard is no more risky than competitive currency issue limited to a currency board issue as the sole monetary standard and ultimate reserve currency. The advantage of free banking with the right to select the monetary standard as well as issue notes is that it allows competition among alternative reserves. The preferred monetary standard is likely to differ geographically and to change over time, and competing banks are likely to respond more quickly and effectively to changes in demand than a currency board. The variety of monetary standards that would at least initially exist would facilitate trade among the states of the CIS and with the nations of Eastern Europe. A fully free banking system might also attract more new entrants, both foreign and domestic, and thus more rapidly remonetize the economies of the Commonwealth and provide resources to new private enterprises. Finally, free banking offers the potential of developing monetary standards not based on other countries' currencies. Gold is a possibility, as well as the variety of standards having constant commodity purchasing power envisioned in the theoretical literature.[9]

The Transition

The standard approach of Western economists to the transition of a centrally controlled socialist economy to a market economy is to propose conversion of existing institutions of the command economy

[9]In the event ruble stabilization is successful, the monetary authorities in charge of the ruble have an option suggested by Milton Friedman (1984, pp. 48–52) as a way to make the transition to a monetary system without a central bank: that of freezing the supply of ruble notes and non-interest-bearing ruble deposits at the central bank (high-powered money). The ruble would then become one of the competing reserve currencies for private banks.

to their presumed counterparts in a market economy. Take the state bank and turn it into a two-tiered banking system: an independent central bank and competing commercial banks. Convert the defense establishment to competitive producers of consumer goods. Turn state-owned monopolies into joint stock companies, compensate the managers on the basis of profits, and hope the enterprises behave like competitive private corporations. Sell the flats in government-built housing and call them condominiums. Take the organization that mediates disputes among enterprises with the objective of meeting the goals of the central plan and transform it into a court hearing commercial disputes among private enterprises.

These conversions may or may not work. A parallel approach would permit and facilitate the development of the institutions of a market economy "from scratch." Then, if conversion fails, the old institutions can eventually be shut down, torn down, written off, liquidated, or simply allowed to wither away as new institutions take their place. Money and banking are a good place to start.

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