The Case Against Currency Boards

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The first aim of monetary policy must be to prevent government from embarking upon inflation and from creating conditions which encourage credit expansion on the part of banks.

-- Ludwig von Mises, Human Action, 1998

Currency boards have enjoyed a resurgence of interest recently. They were first established and adopted in economies in transition: Argentina (1991), Estonia (1992), Lithuania (1994), and Bulgaria (1997). The plethora of practical questions that policy-makers had to face stimulated scientific efforts to give a favorable assessment of this institution. Unfortunately, the accomplishments in this field have not been equal to the endeavors. Currency boards (CB) are still considered and advocated as an appealing alternative to modern central banking. Hanke and Schuler who initiated and have dominated the debate have been proposing the establishment of a CB as a universal panacea virtually wherever a monetary crisis has

1Since our analysis of currency boards deviates substantially from the commonly accepted view, the following passage borrowed from Hanke and Schuler will provide the reader with the necessary background:

A currency board is an institution that issues notes and coins convertible into a foreign "reserve" currency at a fixed rate and on demand. It does not accept deposits. As reserves, a currency board holds high-quality, interest-bearing securities denominated in the reserve currency. A currency board’s reserves are equal to 100 percent or slightly more of its notes and coins in circulation, as set by law. The board generates profits (seigniorage) from the difference between the interest earned on the securities that it holds and the expense of maintaining its note and coin in circulation. It remits to its owner (historically, the government) all profits beyond what it needs to cover its expenses and to maintain its reserves at the level set by law. The currency board has no discretion in monetary policy; market forces alone determine the money supply. (Hanke and Schuler 1991, p. 5)

erupted. In addition to their role in implementing the aforementioned CBs, they recommended such a system for Russia in 1993, Jamaica in 1995, and Indonesia in 1998. The objective of their proposal is nicely summarized in the introduction to one of their numerous monographs: "It describes the difference between how money is supplied in a currency board system and in a central bank system. It demonstrates why the currency board system is superior to a central bank system" (Hanke and Schuler 1991, p. 4).

Hanke and Schuler base their demonstration of this unqualified superiority upon four major arguments. First, CBs establish perfect convertibility between domestic money and foreign currencies, a task in which central banks, often forced to devalue, seldom succeed. This foreign convertibility, deemed inherently impossible under a central bank, is viewed as the basis for a stable economic context which is apt to enhance decentralized planning and give access to the international division of labor. In their words: "A currency board system is by nature a fixed exchange rate monetary system, while a central bank is not" (Hanke and Schuler 1991, p. 16).

The currency board system offers a degree of convertibility and predictability that central banking has difficulty matching. Consequently, the currency board system is more likely than central banking to encourage investment, especially foreign investment, and to result in sustained economic growth. (Hanke and Schuler 1991, p. 36)

Second, the board’s rule of holding 100-percent reserves in assets denominated in the foreign currency is tantamount to preventing the monetization of the government deficit and hence precludes any opportunity for active monetary policy. This constraint forces the government to practice financial prudence, eliminating inflation once and for all. As Hanke and Schuler write:

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3 Other literature does not fundamentally challenge this view. Rather, all authors concentrated their research on the discovery of the precise conditions under which a CB turns out to be preferable to central banking or to dollarization (euroization). Optimal currency area arguments (Zloch-Christy 2000), price flexibility (Williamson 1995), soundness of the banking sector (Santiprabhob 1997), and the ability to prevent currency crisis (Ho 1999) are some recurrent topics in the evaluation of the gains and costs relative to the institution of a CB. The cost-benefit analysis in these studies falls into the trap of holism since costs and benefits for different economic agents are compared and even summed up.

De Haan et al. (2000) even concluded that the policy-maker should choose between a CB and an independent central bank depending on the ability of each institution to reduce inflation in a particular context. This suggests that a CB is worth implementing only during the finite period that its superiority is effective.

CBs rapidly became considered the ultimate irremovable peg contrasting with the other extremity of conceivable monetary regimes, flexible exchange rates (Frankel 1999). They have also been integrated into and modeled in terms of the rules-versus-discretion debate (Irwin 2001).

A recent authoritative and very positive evaluation of this institution has been provided by Dornbusch (2001).

All of these studies differ in regard to the particular CB’s characteristic that they intend to examine. They also differ in their results due to methodological divergences and differences in the data sets used for empirical work. From this point of view the comparison between Schuler (1992) and Schwartz (1993) is striking. Nevertheless, they all share a fundamental common point inherited from the influential writings of Hanke and Schuler, that a CB is different from, indeed even opposed to, a central bank. Thus, CBs have been theoretically studied as an alternative to central banking and practically established with this belief.