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Currency Boards

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Many controversies in economics stem from ill-defined, vague terminology. Indeed, the debasement of language has gone to such lengths that words—like *currency boards*—have almost lost their meaning. To avoid these semantic problems, the important features of orthodox currency boards are presented first.

An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels (both floors and ceilings) are set by law and are equal to 100%, or slightly more, of its monetary liabilities (notes, coins, and, if permitted, deposits). A currency board's convertibility and foreign reserve cover requirements do not extend to deposits at commercial banks or to any other financial assets. A currency board generates profits (seigniorage) from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.

By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. It has an exchange rate policy (the exchange rate is fixed) but no monetary policy. A currency board's operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency. Since the domestic currency issued via a currency board is a clone of its anchor currency, a currency board country is part of an anchor currency country's unified currency area.

Several features of currency boards merit further elaboration. A currency board's balance sheet only contains foreign assets, which are set at a required level (or tight range). If domestic assets are on the balance sheet, they are frozen. Consequently, a currency board cannot engage in the sterilization of foreign currency inflows or in the neutralization of outflows.

A second currency board feature that warrants attention is its inability to issue credit. A currency board cannot act as a lender of last resort or extend credit to the banking system. It also cannot make loans to the fiscal authorities and state-owned enterprises. Consequently, a currency board imposes a hard budget constraint and discipline on the economy.

A currency board requires no preconditions for monetary reform and can be installed rapidly. Government finances, state-owned enterprises, and trade need not be already reformed for a currency board to begin to issue currency.

Currency boards have existed in about 70 countries. The first one was installed in the British Indian Ocean colony of Mauritius in 1849. By the 1930s, currency boards were widespread among the British colonies in Africa, Asia, the Caribbean, and the Pacific islands. They have also existed in a number of independent countries and city-states, such as Danzig and Singapore. One of the more interesting currency boards was installed in North Russia on November 11, 1918, during the civil war. Its architect was John Maynard Keynes, a British Treasury official responsible for war finance at the time.

Countries that have employed currency boards have delivered lower inflation rates, smaller fiscal deficits, lower debt levels relative to the gross domestic product, fewer banking crises, and higher real growth rates than comparable countries that have employed central banks.

Given the superior performance of currency boards, the obvious question is “What led to their demise and replacement by central banks after World War II?” The demise of currency boards resulted from a confluence of three factors. A choir of influential economists was singing the praises of central banking’s flexibility and fine-tuning capacities. In addition to changing intellectual fashions, newly independent states were trying to shake off their ties with former imperial powers. Additionally, the International Monetary Fund (IMF) and the World Bank, anxious to obtain new clients and “jobs for the boys,” lent their weight and money to the establishment of new central banks. In the end, the Bank of England provided the only institutional voice that favored currency boards.

Currency boards have witnessed something of a resurgence. In terms of size, the most significant currency board today is Hong Kong’s. It was installed in 1983 to combat exchange rate instability. In the wake of the collapse of the Soviet Union, several countries adopted currency boards. They were installed rapidly and without any preconditions. Indeed, in most cases, implementation took a month or less. The reasons for the post-Soviet adoption of currency boards varied. In Estonia in 1992, the overriding objective was to rid the country of the hyperinflating Russian ruble and replace it with a sound currency. In 1994, Lithuania desired to put discipline and a hard budget constraint on the government’s fiscal operations. Hyperinflation was ravaging Bulgaria in early 1997, and the Bulgarians wanted to stop it. As a result, Bulgaria adopted a currency board in July 1997. In Bosnia and Herzegovina in 1997, a currency board was mandated by the Dayton Peace Accords, which ended the Balkan Wars.

None of these modern currency boards has failed to maintain convertibility at their fixed exchange rate. Indeed, no currency board has ever failed, and this includes Keynes’s Russian currency board in Archangel. The so-called Russian ruble never deviated from its fixed exchange rate with the British pound. The board continued to redeem rubles for pounds in London until 1920, well after the civil war had concluded.

At present, the following countries use orthodox currency boards: Bermuda, Bosnia and Herzegovina, Brunei, Bulgaria, the Cayman Islands, Djibouti, the Falkland Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Lithuania, Macau, and Saint Helena. Note that Estonia and Lithuania are not included in the list because both transitioned from currency board systems to the Eurozone, in 2011 and 2015, respectively. This was done with ease because both countries were already unified with the Eurozone via their currency boards.

Even though their performances have been superior, currency boards have been entangled in controversy. Perhaps the most controversial episode occurred in Indonesia in 1998, when President Suharto indicated that he was going to adopt a currency board to stop surging inflation and the ensuing food riots. This seemed particularly attractive because the installation of currency boards had worked well to stop inflation in Bulgaria and Bosnia and Herzegovina less than a year earlier. Both currency boards had been enthusiastically supported by the IMF, and one had been mandated by an international treaty.

But in Indonesia, the currency board proposal spawned ruthless attacks. Suharto was told in no uncertain terms—by both the president of the United States, Bill Clinton, and the managing director of the IMF, Michel Camdessus—that he would have to drop the currency board idea or forgo \$43 billion in foreign assistance.

Economists jumped on the bandwagon as well. Every half-truth and nontruth imaginable was trotted out against the currency board idea. Those oft-repeated canards were outweighed by full support for an Indonesian currency board from four Nobel laureates in economics: Gary Becker, Milton Friedman, Merton Miller, and Robert Mundell, as well as Prime Minister

Margaret Thatcher's personal economic adviser, Sir Alan Walters.

Why all the fuss over a currency board for Indonesia? Nobelist Miller understood the great game immediately. As he wrote, the Clinton administration's objection to the currency board was "not that it would not work but that it would, and if it worked, they would be stuck with Suharto" (Tyson, 1999, p. 2). Much the same argument was articulated by Australia's former prime minister, Paul Keating: "The United States Treasury quite deliberately used the economic collapse as a means of bringing about the ouster of President Suharto" (Agence France Presse, 1999). Former U.S. secretary of state Lawrence Eagleburger weighed in with a similar diagnosis:

We were fairly clever in that we supported the IMF as it overthrew (Suharto). Whether that was a wise way to proceed is another question. I'm not saying Mr. Suharto should have stayed, but I kind of wish he had left on terms other than because the IMF pushed him out. (Agence France Presse, 1998)

Even Camdessus could not find fault with these assessments. On the occasion of his retirement, he proudly proclaimed, "We created the conditions that obliged President Suharto to leave his job" (Sanger, 1999, p. C1).

As if the Indonesian controversy were not bad enough, the currency board idea became engulfed in even more controversy in Argentina, starting in 1998 and lasting until Argentina ended its Convertibility System in January 2002. Convertibility had been introduced in Argentina in April 1991 to stop inflation, which it did. The system had certain features of a currency board: (a) a fixed exchange rate, (b) full convertibility, and (c) a minimum reserve cover for the peso of 100% of its anchor currency, the U.S. dollar. However, it had two major features that disqualified it from being an orthodox currency board. It had no ceiling on the amount of foreign assets held at the central bank relative to the central bank's monetary liabilities. So the central bank could engage in sterilization and neutralization activities, which it did. In addition, it could hold and alter the level of domestic assets on its balance sheet. So Argentina's monetary authority could engage in discretionary monetary policy, and it did so aggressively.

Since Argentina's Convertibility System allowed for both monetary and exchange rate policies, it was not a currency board. Most economists fail to recognize this fact. Indeed, a scholarly survey of 100 leading economists who commented on the Convertibility System found that almost 97% incorrectly identified it as a currency board system.

Currency boards' historical performances have been outstanding. Even after the Indonesian and Argentine controversies, interest in currency boards continues to grow.

See also [Central Banks](#); [Dollarization](#); [Inflation](#); [International Monetary Fund \(IMF\)](#); [Monetary Policy](#)

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