

Currency Boards in Retrospect and Prospect

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Preface

Currency boards, more so than other exchange rate regimes, have come in and out of fashion. Defined by a fixed exchange rate with full convertibility, central bank liabilities backed by foreign exchange reserves, and a high cost of exiting the regime, currency boards were common in colonial times—falling into disuse as these countries gained independence. But in the 1990s, currency boards enjoyed a dramatic comeback as the cornerstone of various macroeconomic stabilization programs, including many in European transition economies—only to fall into disrepute again with the collapse of the Argentine regime in 2002, which overshadowed their continued successes elsewhere.

In this book, we try to cut through the hype and examine why currency boards might be expected to foster monetary stability, whether they in fact deliver low inflation and—if so—at what cost, and what role they have played in the transformation of various central and eastern European countries from centrally planned to market economies, and what role they may play in obtaining eventual membership in the Economic and Monetary Union (EMU).

We begin with a brief look at the antecedents of the modern currency board arrangements, the early currency boards widely used in the first half of the twentieth century. We then develop a simple theoretical framework that articulates the advantages and drawbacks of currency boards compared to both flexible regimes and traditional pegs, and conclude part I with a closer look at the institutional structure of modern currency boards to see how theoretical constructs map into operational practice.

In part II, we make use of a large panel dataset—covering virtually all International Monetary Fund (IMF) member countries over the period 1970–2002—to examine the performance of key macroeconomic variables such as inflation, real GDP growth, and output volatility

under currency boards relative to other regimes, using several robustness tests to examine the importance of regime endogeneity.

The evidence suggests that currency boards are indeed robustly and causally associated with lower inflation. The difference reflects both discipline effects (lower monetary growth) and credibility effects (lower inflation for given rate of monetary growth). The better inflation performance does not come at the cost of slower growth or a worse trade performance. Indeed, if anything, growth is higher than under other exchange rate regimes, though this may reflect a rebound from the depressed levels typically found at the time when currency boards are adopted. While output volatility is greater than under flexible exchange rates, it is no higher than under other pegged exchange rate regimes. Finally, currency boards are not associated with any greater susceptibility to financial crises.

The panel evidence on currency boards is thus quite strong. Yet what about Argentina? In the early 1990s, supporters of currency boards were quick to claim credit for Argentina's disinflation success, while skeptics argued that the stabilization, if it held, reflected a fundamental shift in fiscal preferences, and would have also taken place under a traditional peg. In a mirror image, the spectacular collapse of the Argentinean convertibility regime in 2002 was seized upon by skeptics as proof that—whatever their temporary benefits—currency boards lack staying power and dissolve in costly crises, while proponents argued that the crisis occurred not because of, but in spite of, the currency board, and reflected a fundamental absence of fiscal discipline. Whatever view one ultimately takes, any comprehensive discussion on the (de)merits of currency boards must confront this episode. To this end, we round out part II with a close look at Argentina's experience under its currency board regime.

In part III, we turn to the four most recent European currency boards: Estonia (1991), Lithuania (1994), Bulgaria (1997), and Bosnia and Herzegovina (1998). Next to Argentina, these central European currency boards have received most attention. Although adopted for different reasons and in somewhat different circumstances, they aim for the same ultimate exit from their currency boards into Eurozone membership. To be sure, time frames vary widely. Estonia and Lithuania entered the EU in May 2004 and ERM-II a month later. Subject to satisfying the inflation convergence criteria, Estonia and Lithuania are expected to join the EMU in the not too distant future. For Bulgaria, which entered the EU in January 2007, EMU membership will likely

not come before 2010, while for Bosnia and Herzegovina even EU membership is presently far off.

The expectation that these countries will eventually adopt the euro allows them to sidestep the Argentinean challenge of maintaining credibility in the face of public debate about whether, when, and how to exit. The gain comes at the cost of some additional complexity, notably the timing and mechanics of transition from a currency board to full-fledged EMU membership. In part III, we explore the structure, performance, and likely future of the European currency boards in comparative perspective.