Currency Boards in Retrospect and Prospect

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1 Introduction

The record shows that, for a country with a history of extreme monetary disorder, introducing a currency board is a way to gain credibility for monetary policy more rapidly and at a lower cost than appears possible any other way.

—Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?"

There are countries in which they [currency boards] *seem to work for a while; however, these countries are successful not because of the CB system itself but rather because they follow macroeconomic policies and structural liberalization policies that are consistent with the maintenance of fixed rates.*

—Nouriel Roubini, "The Case against Currency Boards: Debunking 10 Myths about the Benefits of Currency Boards"

In addition to showing that CBSs [Currency Board Systems] *deliver stability, the data clearly contradict the preconditions dogma . . . It is time for economists to stop worrying about whether Currency Board Systems can work in theory and to start accepting and grappling with reality.*

—Steven Hanke, "The Disregard for Currency Board Realities"

Much like the haute couture paraded down the catwalks of Paris and Milan, exchange rate regimes waft in and out of fashion. Currency board arrangements (CBAs) provide a telling illustration. This type of exchange rate arrangement—defined by a fixed nominal exchange rate (with full convertibility), a coverage rule whereby central bank liabilities are backstopped by foreign exchange reserves, and a high cost of exiting the regime—originated in colonial times and was once one of the dominant regimes in small open dependent territories, but was soon abandoned as these countries gained independence. After enjoying a dramatic comeback during the 1990s as the cornerstone of various macroeconomic stabilization programs—including several

in central and eastern European transition economies—they have again fallen into disfavor after the collapse of the Argentine currency board.

These shifting fortunes played out against the backdrop of the broader debate on the merits of fixed versus floating exchange rates. The demise of Bretton Woods ushered in an era of floating exchange rates seemingly promising an end to the traumatic balance of payments crises of the 1960s and the freedom to pursue activist stabilization policies. Yet the experience of the 1970s and 1980s showed how easily policy discretion could also be abused. Against the background of rising inflation—even hyperinflation in some cases—the pendulum swung back; pegging the nominal exchange again became a fashionable way to stabilize the economy by importing the credibility of the anchor currency. But the renaissance of traditional adjustable pegs was short-lived, rudely disrupted by the spectacular collapses of the Asian pegs in 1997–1998, followed closely by those in Russia and in Brazil.

Observers of these episodes drew starkly different lessons. Some attributed the collapses to a fundamental weakness of fixed exchange rate regimes in a world of high capital mobility, seeking the solution in more flexible exchange rate regimes. Others, while sharing skepticism about the sustainability of traditional pegs, drew a rather different conclusion. For them, the weakness of traditional pegged exchange rate regimes stemmed from their inability to restrain fiscal mischief and doubts about whether the monetary authorities would really have the stomach to defend the parity by raising interest rates aggressively should the need arise. The solution was therefore to be found not in more but in less flexibility, replacing traditional adjustable pegs by hard pegs.

Alongside dollarization,[1] currency boards have been the hard-peg regime of choice. Their renaissance was unexpected. While early currency boards had performed well, delivering monetary stability and generally sound macroeconomic performance, they were tainted by their colonial roots and had been abandoned in the 1950s and 1960s in the course of independence movements.[2] By the mid-1970s, currency boards appeared headed for the monetary curio cabinet, with only a handful of these arrangements remaining, mainly in very small, very open economies.

The revival began in Asia. Hong Kong, the last significant economic power to operate under a currency board, had exited the arrangement

in 1972.[3] But during the subsequent decade of increased inflation and financial instability, the currency board regained appeal, eventually prompting Hong Kong to return to a currency board system in 1983. While notable, Hong Kong's special economic and political circumstances limited the impact of its decision on the global debate. By contrast, Argentina's decision in 1991 to readopt[4] a currency board as a last-ditch effort to stabilize an economy wrecked by repeated bouts of hyperinflation and failed stabilizations, together with its initial dramatic success, captured the world's attention—much as its collapse a decade later would overshadow the continuing success of similar arrangements in other countries.

By the late 1990s, the currency board club had grown to include Bosnia and Herzegovina, Bulgaria, Estonia, and Lithuania, alongside the small set of surviving near-classical boards in Brunei, Djibouti, the Falklands, and St. Helena as well as the multicountry Caribbean board.[5] Currency boards were also actively debated—though ultimately not adopted—in a number of other countries going through economic or political turmoil, including Indonesia during the 1997–1998 East Asian currency crisis,[6] Russia in the aftermath of the August 1998 devaluation,[7] Brazil during the 1999 defense of its exchange rate peg,[8] Mexico,[9] Poland[10] Iraq,[11] Palestine,[12] as well as numerous smaller countries or territories (Ecuador, El Salvador, Kosovo, Mongolia, Montenegro, Nepal, the West Bank and Gaza, and East Timor).

Despite their newfound popularity, currency boards also faced profound skepticism long before the 2002 Argentine crisis.[13] The (continuing) debate centers on whether currency boards can truly deliver low inflation in situations where policy credibility may be severely lacking. And, if so, can these gains be achieved at an acceptable economic and social cost?

In theory, yes. The defining characteristics of a currency board should all contribute to policy discipline and credibility. The fixed exchange rate provides a highly transparent and easily verifiable metric of the value of the domestic currency; the backing requirement guarantees that the central bank is always able to honor its monetary liabilities (and cannot simply "print money" unless it has excess reserves to back them). The high exit cost generates a significant political penalty for monetary or fiscal mischief that threatens the viability of the regime. Together, these features of currency board arrangements should therefore serve to lower inflationary expectations and reduce the cost of achieving disinflation.

Skeptics counter with three arguments. First, currency boards are only one of a range of mechanisms to establish credibility and lower inflation expectations. Whether they dominate the alternatives—such as central bank independence or capital account convertibility—is not evident. Second, even if there is empirically a positive association between the adoption of a currency board and good inflation performance, this may simply reflect "reverse" causality as countries that are better able and more willing to achieve and maintain low inflation are more likely to adopt a currency board. Put differently, countries that adopt currency boards may be those that have the political will and the institutions to generate good macroeconomic outcomes regardless of their exchange rate regime.

Finally, skeptics like to point out that even if currency boards help bring down inflation, this does not necessarily make them worth adopting, due to their potentially high costs. In particular, a small trend inflation differential relative to the anchor currency could lead to a trend appreciation of the real exchange rate, undermining export performance and slowing economic growth. At the same time, the loss of the nominal exchange rate as an adjustment tool might increase real volatility. Relative to traditional pegged exchange rate regimes, moreover, the additional strictures of a currency board reduce the scope for the central bank to stabilize output (through discretionary monetary policy) or to act as lender of last resort (LOLR) in a financial crisis.

Reflecting these debates, the cost-benefit calculus of currency boards thus is ultimately an empirical issue that depends on three concrete questions: First, do countries with currency boards enjoy significantly lower inflation than countries with other exchange rate regimes? Second, can any such outperformance be causally linked to the exchange rate regime? And, third, do currency board countries suffer from poorer economic performance—output growth, exports, susceptibility to financial crises—than countries with other regimes? In this book, we seek to answer these questions.