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Currency Boards for Eastern Europe

By Steve H. Hanke and Kurt Schuler

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by

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CHAPTER 1

MONETARY REFORM AND THE DEVELOPMENT OF A MARKET ECONOMY

Eastern Europe and the former Soviet Union (which we shall simply call the USSR) are struggling to throw off the shackles of socialism and to embrace capitalism. To do so successfully, they must rid themselves of their unsound currencies and establish stable, convertible currencies. The "new" currencies should be convertible into one of the major international hard currencies.

A sound currency, which is vital for a well-functioning market economy, serves as a satisfactory store of value, medium of exchange, and unit of account. An unsound currency does not fulfill any of those functions. An unsound currency is not a reliable store of value because inflation makes its value highly unpredictable. As a result, people save by hoarding bricks, timbers, food, and other commodities, which retain value better than money and other financial assets. Although commodity hoarding slows economic growth, it is rational for people in nations with unstable currencies. U.S. dollars and other stable currencies also serve as substitute stores of value in nations with unstable currencies. For example, individuals and enterprises in the USSR probably hold over $10 billion of foreign currency, which is more than the real value of the ruble money supply. "Dollarization" is costly. It requires Soviet citizens to give up real goods and services to obtain bits of paper that Western central banks print at almost no cost, generating a perverse form of foreign aid that flows from the USSR to Western central banks.

An unsound currency is not a good medium of exchange. The outside world refuses to accept it. That impedes foreign investment and trade, and hence competition and economic growth. Nor is an unsound currency a good unit of account. Inflation distorts prices and makes business calculation more difficult. Without a good unit of account, it is impossible to make meaningful accounting calculations or to write contracts. In sum, then, an unsound currency prevents important elements of a market economy from working.

Eastern Europe and the USSR have primitive financial systems that cannot intermediate efficiently between savers and investors because their currencies are unstable and inconvertible. The status of their currencies also explains why they have limited trade with the outside world. As long as Eastern Europe and the USSR have unsound currencies, they will be unable to transform themselves into market economies.

A sound, convertible currency allows people to carry out decentralized planning, which is more efficient than central planning. In nations with so-called internally convertible currencies, all that is usually required to buy goods domestically is to have currency to pay a domestic seller. Internal convertibility implies that it is not necessary to obtain authorization from any central planner to buy or sell goods that are available inside the country. The exchange of goods is much more extensive, rapid, and efficient where internal convertibility exists, as in the United States, Germany, and Poland, than where it does not, as in Albania and the USSR.

The foreign trade counterpart of internal convertibility is external convertibility—the ability to convert as much domestic currency into foreign currency as one wishes, as market rates rather than at much higher or lower official rates. External convertibility can be unlimited, as in the major Western countries, or it can be limited, as in Czechoslovakia and Poland at present. Czechoslovakia and Poland allow most current account purchases, in which people buy foreign goods for import, but they prohibit many capital

account transactions, in which people buy foreign financial assets. Current account convertibility exposes domestic producers to foreign competition and helps introduce the structure of prices that prevails in world markets. That induces a nation to specialize in making the goods it is best at producing and then trade abroad for other goods, which increases wealth all around. Capital account convertibility helps attract foreign investment, because unless foreigners can repatriate profits they will be reluctant to invest. Foreign capital investment can offset a large current account deficit and speed the introduction of urgently needed foreign goods to modernize the economy.

The ability to purchase both domestic and foreign goods readily is what makes Western currencies fully convertible "hard" currencies, and what makes them so highly prized in Eastern Europe and the USSR. To reap the full benefits of participating in world markets, Eastern Europe and the USSR themselves need to establish fully convertible currencies. Their present monetary systems are obstacles to a market economy. Inflation is in mid double digits or higher throughout the region. In the USSR, inflation is projected to surpass 200 percent this year. Even in Poland, which has allowed most formerly subsidized prices to rise to market levels and has linked the zloty to the U.S. dollar, inflation remains above 40 percent per year.

Inflation will remain high, even in nations that follow Poland's course, because central banks in the region have no credibility. They have long histories of bowing to political pressures for inflation. For instance, the USSR has had government currency issue since 1768, and a central bank since 1860. In all that time it has had a fully convertible currency for only 35 years, the last year being 1914. All East European central banks, except in the Baltic nations and Albania, caused hyperinflations in the 1920s, and some caused hyperinflations again in the late 1940s. The new central banks established in various former Soviet republics do not have the handicap of bad past performance to undermine their credibility, but they face other problems. So far, none has announced any definite plan for keeping its currency stable. Also, the general experience of central banks in developing nations suggests that both the established central banks and the new central banks will face ferocious political pressures for inflation. For the 99 nations that the World Bank classifies as low-and middle-income, average annual inflation was 16.7 percent from 1965 to 1980 and 53.7 percent from 1980 to 1989.

This poor performance explains why Paul Volcker, the former chairman of the U.S. Federal Reserve System, has indicated that he has little faith that central banks in Eastern Europe and the USSR can achieve full convertibility. Addressing central bankers in Jackson Hole, Wyoming last year, Mr. Volcker notes that markets developed long before central banks, and stressed that Eastern Europe and the USSR might actually retard their transition to markets by relying on central banks.[1] Central banks are essentially not market institutions, which is why Marx and Engels said in the *Communist Manifesto* that one of the steps for achieving communism was "Centralization of credit in the hands of the state, by means of a national bank with state capital and an exclusive monopoly."[2]

To gain credibility, central banks in Eastern Europe and the USSR must painstakingly establish good track records. The lack of credibility of official promises has already led people throughout the region to conduct their own unofficial monetary reform. They have dollarized local economies. To the extent that dollars and other hard currencies are unavailable, some transactions are even taking place in barter, because barter is the only way for people to prevent domestic currency inflation from robbing them of their savings. The shift to barter is particularly disruptive in the USSR, where it is choking trade among

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1 Volker 1990.
2 Marx and Engels (1848) 1948, p. 30.