Farewell to the Currency Board

by Elena Leontjeva, LFMI President,
"Baltic Times", October 1998

"The currency board is to die", "The currency board is being buried", "The currency board is but a ghost"- such headlines have marked the closing chapter of Lithuania's reform celebrity. Regrettably symbolic, it happens to have coincided with the recent Southeast Asian currency crisis. This poses a host of questions over why Lithuania has opted to dismantle its reliable monetary regime.

A currency board, to put it simply, is a hundred percent backing of national money with foreign currency and gold reserves and thus full convertibility. A fixed exchange rate, which is commonly believed to be the cornerstone of this arrangement, is not an end in itself, but only a tool for it to operate. By installing a currency board in April 1994, Lithuania renounced discretionary monetary policy in favour of strict, political-pressure-proof rules. Interestingly, the new system was introduced against the will of the Bank of Lithuania. An inconsistent approach and run-of-the-mill compromises made it fall short of classic precepts-traditional central bank powers were integrated with strict currency board principles. It is no secret therefore that the new arrangement was safeguarded not so much by Lithuanian law but by a memorandum with the International Monetary Fund. The Memorandum expired in October this year.

Having been in the thick of championing and implementing the currency board, I continue to recall the initial public scepticism that "the ruling ex-communists would venture such a radical free-market reform and forgo the power to print money." Small wonder the supporters were few in number. Nonetheless we kept piloting the reform until one day we realised that it had gained momentum and was bound to happen. The legacy of those in power did not prevent them from acknowledging the merits of free market reforms. Inspired by the debates and extensive media coverage, society extended its concerns to embrace the fundamentals of monetary policy. These ceased to be the arcane domain of central bankers.

The Lithuanian currency board, to do it justice, demonstrated a flawless performance for close to four years. It bestowed on Lithuania accomplishments which none of the leading Central European countries can boast of. Unlike arbitrary government devices, the currency board provided a mechanical goad to curb inflation, secure full convertibility, and lower interest rates. Experienced bankers and investors told me those days that the actual drop in interest rates surpassed all their expectations. Unrestricted convertibility was taken in Lithuania almost for granted at the time when Central Europe was trying real hard to achieve it. Some of the countries, like Hungary, are still trying.

The currency board is especially dear to free-marketeers for its underlying principle of limited government. With the central bank shorn of its discretion, the society is safeguarded from the dilution of money and manifold interventions. It puts a stop to the ill practice of manipulating money to benefit the few at the expense of the many. I don't mean to say that a currency board stamps out all the evils. It does not-but it does put in order at least one area, showing the way for reforming all the rest. The lesson of limited government, clear-cut rules and transparency is precious to business regulation, taxation, privatisation and many other fields that are still governed by sheer discretion.

Why, then, are we taking a step backward to a traditional central bank, a ministry of money, so to speak? For this ministry craves what we call the power of commander and interventionist and what they call classical central banking, the power of regulation. The legend of the European integration serves to sugar-coat these ends.

Obviously, the essence of currency boards presents no drag on the integration. The selected anchor currency, the US dollar, may be a nuisance and is already viewed as such by some business people active in the European market. I must say it is an easy, rather technical task to switch to another anchor, say, Deutchmark or EURO. It has nothing to do with the fundamentals of a currency board. Estonians, who, unlike Lithuania, stand on the threshold of the EU, do not consider their currency board a snag to bother about.

However sincerely our central bankers wish to compare with Bundesbank, they are much more likely to end up resembling the Thai central bank. This and other traditional monetary authorities in Southeast Asia proved that they not only fail to ensure stability but often times throw their countries into disarray. In the face of the inner and outer shambles, the Hong Kong dollar, the spokesman for currency boards in Asia, remains sound. I can't say sound and safe, for its safety is in the hands of politicians. As long as they do not tamper with it, it is trustworthy and does not run its course. Such it is. Such it was in Lithuania.