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RUSSIAN CURRENCY AND FINANCE

A currency board approach to reform

Steve H. Hanke, Lars Jonung, and Kurt Schuler

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PREFACE

This book offers a strategy for ending extreme inflation in Russia and providing Russia with a stable, credible, fully convertible domestic currency. It proposes to reform the Russian monetary system by means of a currency board. A currency board is a monetary institution that issues notes and coins fully backed by a foreign 'reserve' currency and fully convertible into the reserve currency at a fixed exchange rate on demand.

The most likely reserve currency is the US dollar. A currency board rouble issued according to our proposal will be as stable and credible as the dollar. The currency board will thereby end extreme inflation in Russia. It will also reverse the now widespread unofficial dollarization of the Russian economy, in which dollars are preferred to roubles and many goods cannot easily be purchased with roubles. Unlike use of dollar notes, use of currency board rouble notes and coins will earn seigniorage (a profit from issue) for the Russian government.

In our proposal, the Central Bank of Russia will be converted into a currency board or the currency board will issue a distinct currency parallel to that of the Central Bank. In the parallel currency approach, the Central Bank rouble and the currency board rouble will circulate at exchange rates determined by market conditions. Russians will have an unrestricted choice of using the Central Bank rouble or the currency board rouble. Competition will induce the Central Bank of Russia to reform; if it does not do so it will tend to wither away as an issuer of currency, as Russians use the currency board rouble exclusively.

Establishing a currency board to replace or compete with the Central Bank of Russia is a drastic step. It is justified, however, by the unsatisfactory performance of the Central Bank of Russia. The Central Bank has created the current inflation; its predecessors in Russian and Soviet history have had unsatisfactory records also. Attempts to stabilize the rouble by reforming the Central Bank of Russia have little immediate chance of success, because the current monetary policy of the Central Bank is subject to strong and successful political pressure for inflation. The currency board system, in contrast, has in the past successfully provided stable currencies in Russia and elsewhere, and continues to provide stable currencies where it exists today. The currency board system protects monetary policy from political pressure. The domestic currency can then become a means for economic prosperity rather than a tool of political manipulation.

Our earlier book *Monetary Reform for a Free Estonia: A Currency Board Solution* (Hanke *et al.* 1992b; published in Estonian as Hanke *et al.* 1992a) explained how a small, newly independent country with no central bank could establish a currency board to provide a stable currency. The book originated from Lars Jonung's involvement in Estonian discussions in 1991 about the future of the Estonian monetary system, and the independent work of Steve Hanke and Kurt Schuler in proposing the currency board system in other East European countries. The Estonian monetary reform of June 1992 had some of the features we advocated in our earlier book, but it did not establish a currency board system (see chapter 4).

This book explains how a large country that already has a central bank can establish a currency board. It is more than three times as long as our earlier book. It adapts the approach of our earlier book to address Russia's status as the core of the former Soviet Union, and the persistence of Soviet monetary institutions in a new guise, which was less of a problem in Estonia. We have tried to be understandable to both Russian and Western readers. Our explanations of some topics may seem elementary to some readers, but we think that almost all readers will find much that is new to them in this book. Readers who desire more detailed explanations of some technical points are advised that we are writing another book (Hanke and Schuler forthcoming) on the history and theory of the currency board system.[1]

We finished writing this book in April 1993, although we were able to update some passages just before the book went to press. Russian politics and the Russian economy are changing quickly, and some details of our description of current monetary conditions in Russia may already be outdated when the book is published. Even so, the basic problem of the Russian monetary system – the susceptibility of monetary policy to political pressure – has existed for decades and will persist for many years, unless a reform such as we propose is adopted.

We thank the following people for commenting on the manuscript of this book or for discussing currency boards and the Russian monetary system with us: Michael D. Bordo, S. O. Johansson, Axel Leijonhufvud, Kent Osband, Anna J. Schwartz, Ingemar Ståhl, Joakim Stymne, and Alan A. Walters. Kurt Schuler thanks the Earhart Foundation for a grant to support his work on this book.

Steve H. Hanke
Lars Jonung
Kurt Schuler
April 1993

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CONCLUSION

Central banking in its current form in Russia has resulted in an unsound currency, extreme inflation, and economic decline. The Central Bank of Russia has no definite plan for providing a sound currency. Even if reformed, the Central Bank of Russia is unlikely to provide Russia with a sound currency soon. Therefore, we recommend that Russia establish a currency board. The currency board can be established by the Russian government alone, or in collaboration with the IMF if the IMF provides some of the initial foreign reserves. The currency board system, as used in Hong Kong and elsewhere, is a well-proven means of providing a stable, credible, fully convertible currency, and of encouraging rapid economic growth.

A currency board has many advantages for Russia today. It can be established quickly, it will be simple to operate, it will be a credible monetary authority that will issue a stable, fully convertible currency, and it will tend to encourage international trade and investment in Russia. A currency board has advantages for the West as well: it will ensure that the IMF stabilization fund is used to provide a sound currency rather than to earn profits for currency speculators, and it will create an institution that will enable subsequent foreign investment to be most beneficial for the Russian economy. A currency board will solidify the emerging market economy in Russia. Without a currency board, the rapid macroeconomic stabilization and microeconomic restructuring necessary to encourage economic growth may be delayed, and Russia will probably for a long time remain a poor country dependent on foreign aid to maintain even the current low standards of living for its people.

This book has proposed two ways to establish the Russian currency board: by converting the Central Bank of Russia into a currency board, or by establishing the currency board as the issuer of a parallel currency. The conversion approach tends to impose hard budget constraints immediately. The parallel currency approach allows a brief transition period during which budget constraints harden and during which the Russian government can continue to collect some revenue from inflation in the Central Bank rouble. At the same time, the existence of the parallel currency board rouble will enable much of the Russian economy to protect itself from extreme inflation.

The proposal for monetary reform in Russia made in this book is detailed and requires the Russian government to take action on many points. The most important elements of the proposal are that the currency board be established, and that the currency board be protected from political pressure to convert it into a central bank. Appropriate safeguards to protect the currency board can be devised (see chapter 6).

The hard budget constraints that the Russian currency board will tend to impose will create momentum for further reforms of government finance, state commercial banks, and state enterprises. The currency board will best promote economic growth if all the reforms proposed in this book are achieved quickly; however, the proposal is robust enough to survive and help the Russian economy even if political pressure temporarily delays elements of reform other than the currency board itself. The currency board will tend to force other monetary and economic reforms to occur rapidly because it will tend to eliminate the soft budget constraints that perpetuate the current monetary system.

Monetary reform is now the most important step for establishing a market economy that will generate growth and progress for Russia, and a currency board is the most promising means of achieving a durable, beneficial monetary reform.