

CURRENCY BOARD

THE POLITICAL ECONOMY OF CURRENCY BOARDS *Theses about the political environment of fixed national currency flow*

A Methodological Essay

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Abstract

This paper presents methodological theses for a non-standard study of currency boards performance in terms of their political dimensions. These theses refer to the domestic and foreign policy frameworks of the creation, management and termination of the currency board arrangements. The theses are designed as to allow the best possible comparison between countries with different currency arrangements. This essay does not set as many hypotheses as it seeks to provoke reflection and dialogue within the scientific community for the exploration of important phenomena in today's globalizing world.

- The political economy of currency boards is an uninvestigated phenomenon. There exist many purely economic studies on currency boards that explain their narrow economic role. At the same time, their political nature remains unexplored.

- It seems that the approach to currency boards from the perspective of political economy does not conflict with the Keynesian view of the government's positive role in creating economic trends, with the Central bank being a priority. Currency boards are just the same, though bearing the opposite sign: they suggest a positive role for the government as well, however not relying on the Central bank, but on the contrary, self-restraining itself by restricting the Central bank's actions to curb hyperinflation and its consequences. Thus, the government is active in the Keynesian tradition by making a choice of “lesser evil” – better without a fully functioning Central bank rather than with hyperinflation.

- Why is the topic of political economy of currency boards important -- this is an open question. It is important to determine the focus of the political study of currency boards: the Board, or Politics, is the independent variable determining the other? Which of the two will explain the other, or there is something “third”? The notion of “economy” usually refers to a narrow study of the economy without other political and social considerations, while the term “political economy” is a separate approach containing many more aspects (political, legal, cultural, sociological) whereby it is not economy that defines politics but rather the opposite --

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politics determines economy (and without this happening necessarily in a revolutionary situation or other emergency where politics typically precedes economy). Political economy most often refers to interdisciplinary research based on economics, sociology and political science aimed at the explanation of how the political institutions, the political environment and the economic system interact one with the other. It should be kept in mind that, as opposed to pure economic approach, political economy deals with three particular themes: (1) the role of governments and power relations in the allocation of resources, (2) the economic impact of international relations (international political economy) and (3) economic models of political processes. Each of these thematic circles is central to the study of currency boards as a political phenomenon.

- Currency boards as a political phenomenon are directly related to the political sphere, to law (law), culture (public values, habits, traditions). In other words, currency boards reflect many other things -- culture, history and social psyche, politics, power and governance, internal and external politics. The adoption of the bill of currency board in Bulgaria is a good example – all different aspects are reflected in the debates, in the claims for authorship of the Board, etc. The obedience of all political forces all the time of existence of the Bulgarian currency board to the idea of a “future after the currency board when joining the common European currency” discloses a feature of the national character of a sense of inferiority, as if “Europe is watching at us”.

- The political economy approach to currency board analysis reveals the transition from the borders of the nation state out to the supranational space, though the latter space is limited to a system of two economies - a “donor” and a “acceptor” of stability.

- Currency boards are a tool for politicians to use (especially the ruling, but not only). When successful they compete with claims to be its founding fathers. Currency boards should be seen as an instrument of political survival, means in inter-party collisions, a matter of political strategy extended beyond current mandates, etc. The common and different between countries that have adopted the Board (for example, Bulgaria and Argentina) would serve as source of inferences in that overall context.

- The main political question is what is the attitude of political institutions and the rest of elements of the political systems (parties - ruling-opposition, big-small, conservative-radical, democratic-ultranationalist, etc.; parliaments, the government-president binom) and their attitude to crisis management through currency boards.

- From the point of view of political analysis, it is important, above all, who the stakeholders are (with their managerial, power, etc. potential), their position and even more their intentions (whom they conceal or clearly defend in rejecting or supporting the currency board in a clear or hidden way). Stakeholders can be found in all three sectors – the private, state and civil – respectively: private sector – small, medium and big businesses, gray / shadow economy or overt economy, foreign or local capital; state sector -- political parties and opposition, political forces supporting or opposing the Board, foreign political interests, external influences, the clash or cooperation between government and presidential institution; civil sector - poor-rich, young-old, citizens-peasants,

- A second major political question is what is the relationship between the currency board and international politics, supranational political and financial institutions. In this sense, the main political question is the so-called “Cross-border effect”: one currency is “hooked” to another because an economy, but also a society and government is more unstable than another economy, society and state (mostly politics, i.e. the independent variables are mostly the political actions, the cultural factors and, to a lesser extent, and economic ones to the least). There is a cascade overflow of stability (sustainability, hence socio-political consent as a consequence). If boards

exist only in donor-acceptor of stability “pairs” this effect will be maximum; if, conversely, (the ultimate option -- the existence of a world currency which obscures who are the donors and who are the acceptors) -- the effect of the “coupling” of national currencies would be minimal. In this sense, it is important to make a comparison with the effects of the German mark in a situation of united Germany with its single Central bank -- how are they merging and how is stability in the economy in the East of the country secured? How does the Euro stand in Greece as opposed to Germany?

- An important though not fundamental political question is what are the main political and quasi-political arguments (usually expressed in economic form) in support or rejection of the Board arrangement? Do they differ in different cases of currency board? The arguments in support of the CB arrangement are related to the significant anti-inflationary effects: hyperinflation disappears everywhere in the very first few months or years after the adoption of the currency board and is kept at a low level afterwards. Obviously, the reason for the sharp fall of inflation is due mainly to the confidence in the currency board. However with regard to gross domestic product, we can see also positive consequences in the form of a general trend of growth that varies between countries depending on political stability and the commitment to economic reforms and a healthy macroeconomic environment.

- Another political question is to examine the timing of the Board and, respectively, the stages that determine the different consecutive types of political decisions: first comes a crisis (caused by internal policy failures often in relation to the external circumstances that lead to an economic crisis) → a decision to adopt a currency board (internal political debates on the outcome and the choice of tools to tackle hyperinflation as well as the direct impact of external political and economic factors on domestic politics, such as international banks, foreign governments) → decisions concerning the government in all public areas resulting from the CB → decision to terminate the CB (once again the influence of internal and external political factors).

- Other political issues are: Which / what (internal) political actions typically lead to an unmanageable crisis that requires the introduction of a currency board and how that rate of instability is generated, what are the steps leading to that state? Which foreign policy influences typically initiates / catalyzes / encourages the introduction of a currency board -- like reports by global financial institutions, international banks, but also some specific foreign governments? Where from (source) comes the decision to end the currency board arrangement? Is the Bulgarian Board an orthodox one and are there orthodox Boards at all, or is it only an ultimate theoretical ideal?

- The results of a currency board's functioning are politically attractive. As a rule, CB leads, besides limiting inflation, to rising real GDP growth rates, and also to a sharp fall in government bond yields, resulting in a huge reduction in government spending and a better redistribution of government resources. CB cuts the two major hyperinflation channels -- the Central bank's loans to government and commercial banks. In this way the state is hampered by excessive behavior, the Central bank under the conditions of the CB imposes strict discipline on banks which altogether leads to limiting hyperinflation. A central bank that can fight inflation can commit more credibly by fixing the exchange rate. When workers and corporate managers have low expectations of inflation, they set their wages and prices accordingly. The result is that the country is able to achieve a lower level of inflation for any given level of output. Bearing in mind that the currency board is the most credible form of the exchange rate, according to the postulates of economic theory, it should be expected that the countries under this arrangement have the lowest rate of inflation. This has been confirmed by a number of empirical studies.

Schuller (1992) concluded that inflation has generally been lower and GDP growth per capita higher under currency boards than under central banks. However, comparative economic research shows that the nominal rate of exchange rate fixation is very efficient in terms of hyperinflation or high inflation, while its efficiency is lower at lower rates of inflation.

- The political influence of CB is also evident from its “Placebo” effect: in that regard it is interesting to mention that inflation in Bulgaria decreased significantly in April 1997, i.e. after the decision to introduce a CB was made but two good months before its official introduction. The reason for this is most possibly the currency board's impact on the increase in financial discipline which is reflected in curbing money supply growth and increasing confidence that affects the inflation expectations built into the expected rate of return after the announced cash (Beck et al., 2003). Generally, in its full form, CB is an outcome of crises of several types:

- The transition from war to peace economy,
- The transition from planned to market economy and
- The transition from the status of a former dependent state to an independent state.

It is no coincidence that the transition to CB in Bosnia and Herzegovina was fixed in a political document of paramount importance - the Dayton Peace Accord, which is a political document that sets above all a political outcome from a dramatic socio-political crisis.

- CB is an exclusive state and not other type of regulation. CB is a specific part of regulatory economy (or economy of regulation). In principle a large part of it deals with the implementation of the law by the government agencies for various purposes, including the elimination of market failures and variants of more or less centralized management of the economy in order to change existing economic behavior. In the case of currency boards the state regulation exceeds by far the standard for every other government regulation like the sale of alcohol or prescription medicines, food controls, control over housing conditions, public transport, construction, television, and so on. As measures, it also transcends standard forms such as state licensing, standardization or state inspection of some kind. Thus, currency boards are passive and automated regulatory government policies. Such should be their definition in their political-economic research.

- The axiom is that only politicians take the strategic decisions about the currency board: decisions about its introduction, its management, its termination, the choice of currency to which the national currency is attached, decisions to carry out the domestic political struggles in order to withhold the CB arrangement, decisions related to the future after the Board, etc. Political is the question of negotiations between the parties -- above all between the government and the Central Bank – covering themes such as the strength of the currency board (its proximity or distance from the ultimate form of an orthodox currency board) with a view to securing some degree of fiscal policy (see, the negotiations in Lithuania in 1994 - (Alonso-Gamo, et al., 2002) - where, as a result of political negotiations with the government, the Central Bank managed to retain the function of a lender of last resort and the function of money market operations controls the liquidity of the country's financial system). Unlike political strategists, economic agents (from the Central Bank, etc.) make, above all, tactical (technical) decisions following from strategic decisions. Economists, unlike politicians, think in rational schemes of “if-then,” and a premise in all their judgments is rational behavior; however, behavior is not such in the actual life -- there is both irrationality as well as value rationality which largely differs from instrumental rationality on which economists emphasize. However, remoteness from the hard-line version of CB leads to problems (see, for example, Lithuania where some concessions have been agreed, the board has led to a fall in inflation relatively quickly, but then other important

issues remained as a result of the CB's reserved policy). In a nutshell, political is the question of the slow or insufficiently rigid financial reforms, as well as the residual paternalistic behavior of the government towards the economy. Political is the question of the CB as an instrument for imposing discipline preventing private banks to distribute bad loans as a matter of politics (Bulgaria in the 1990s).

- CB is a possible political norm in small and emerging economies facing macroeconomic crisis due to slow, timid or improper attempts at financial reform. In the past, it was only a fiscal policy of a domination (mainly the British Empire) over colonies. It is the inflationary pressure that occurs in such small countries as a result of price liberalization after the transition to a market economy, the lack of automatic macroeconomic balance of supply and demand, the problem of chronic shortage of money, the loss of the bulk of the export market (for example, the loss of exports to the CEA for the former Soviet bloc countries). When the economic crisis is particularly large and parallel with a political crisis, governments are looking for internationally recognized and accepted means such as CB. At the same time, CB offers a so much desired by politicians in troubled economies quick “instantaneous” solution when it comes to emerging from a deep and unsolvable crisis. All of this is catalyzed by the failure of other stabilization attempts made before the introduction of a CB.

- Historically, given the fact that currency boards have been established in territories under British domination, as a reaction the desire in the past was for an independent central bank, imposed as one of the key aspects of newly acquired independence and separation from the colonial past. Today, however, CB's role is reversed, often aimed at promoting political independence. For example, in the Baltic countries (first Estonia), the role of the Boards is obviously both economic and a matter of foreign policy. Since 1991, all these countries have sought to insure themselves against Russian influence. All of these are simultaneously political as well as economic factors for the existence of CB.

- In some sense, after politicians bring by their actions a deep crisis that leads to the introduction of a currency board, it happens when they “have lost their teeth “ -- for example, the introduction of the CB in Bulgaria took place under severely reduced political activity -- no functioning parliament, a provisional government, while at the same time the political crisis has exhausted political opponents. However does this same happen everywhere while introducing a CB? Does this also have to be the condition under which the decision to end with the currency board arrangement is made?

- When is a board successful from a political point of view: presumably when its economic, social and, above all, political consequences last after it has ceased; if the positive consequences quickly pass, politicians cease to recognize the CB as a success and as their own achievement.

- What are the criteria for introducing a board (still, this is clearer) and terminating its mode (that's less clear)? The beginning (possibly the end) of a Board is a matter of political situation, respectively the phases of the situation, with the “joint constitution of meaning” followed by an allocation of roles and eventually the corresponding automated action from this moment on.

- The research on the currency board has a direct relationship with theory of risk and uncertainty (overcoming the uncertainties of the future). It is possible to gradate the degree of uncertainty that leads to the decision to introduce the Board.

- The fact of the existence -- or absence -- of an alternative possibility of a stable national currency throughout the existence of the currency board arrangement is of paramount importance, as is the case with Bulgaria. Bulgaria faces the possibility of being accepted in the Eurozone, a fact that influences strongly all political forces at any moment of existence of the

currency board in the country; respectively, the lack of prospect of monetary stability “after” the CB is the same factor bearing the opposite sign. The word is about the presence or absence of additional factors, such as financial discipline, political consensus, national unity regardless of political opposition ...

- What is the Model of Exit from the Board arrangement (or is the Board once introduced to be “eternal”?) -- what is the basic point of view and what are the auxiliary points of view: whether this is an ideal, for example, extracted by theory, or the basis for the solution is to achieve what is “good for all citizens” (how such a state is defined in terms of the Condorcet’s Paradox, etc.) or, rather, good for the small or the big business, the local or the foreign one, the overt or the shady business, the politicians, for the political consensus, for the government (whatever it is) ... is there a state that is “good for all” made possible by the currency board?

- The currency board is a matter of national security: the currency is a pillar of statehood, but not necessarily the national currency – currency flow stability whatever the currency alone secures legitimacy to the state (preventing people “trampling gold coins in jars”); the currency board is an instrument of trust, and for the formation of a civil society.

- The currency board policy is related to the issue of distributional justice.

- The board is above all a tool for reaching socio-political consent within a society fragmented by a economic crisis and creates socio-political and economic comfort. However, the board hinders some of the business (certain business segments) and hence the question arises about the balance between the two sides -- public-political consent and economic circles self-isolated from that consent?!

- Currency independence has a different level of success for small and large countries. It can be assumed that success in smaller ones is more guaranteed.

- The CB is protected from political pressure, while an acting central bank, on the contrary, is a highly politicized body, this is why CB policy leads to depoliticizing the macroeconomic framework of the national economy. The government refuses to finance through central bank loans and to gain by creating inflation, against which it gains predictability, credibility, and, above all, fast and efficient financial reform.

- The political price of a currency board: this is the rejection of other instruments of financial governance (internally against the opposition and externally against superpowers who do not support the government).

- Possible parts of a future study of the political economy of currency boards: Political institutions and the CB; Currency board ideologies (i.e. whether it is important to have free national currency flow and to what extent and in what respect, for smaller or larger countries); The state, private and civil sectors and the CB, and so on.

- Important is to compare not only between government policies in countries with a currency boards but also between government policies in countries with different currency systems -- on the one hand currency board countries and on the other at fixed exchange rates, managed float, and free floating.

Fixed exchange rate arrangements (currency board being the most rigid form) lead to overestimation of national currencies over time, which could stimulate imports and discourage exports. Therefore, based on theoretical assumptions, it will be reasonable to expect that countries in the currency board arrangement will have a higher external current account deficit (expressed as % of GDP) compared to countries with the free floating exchange rate arrangement in place. Namely, in the CBA, the exchange rate is a not variable that the state can use in order to

depreciate undesirable developments in the balance of payments, therefore, the appearance of the current account deficit is imminent in this monetary arrangement.

The currency board arrangement is usually introduced when the current monetary arrangement does not give satisfactory results, especially in the form of low credibility and high inflation. This arrangement, which has a long history, is applied now to four European economies in transition. This arrangement has proved very efficient when it comes to lowering high inflation. Therefore we can conclude that in the period of its introduction, this arrangement achieved good results in all four observed European transition economies.

Given the fact that the European economies in transition continued to apply this arrangement for many years after the lowering of inflation, there is a question of whether it is efficient in a relatively stable environment, that is, whether an “exit option” should be pursued.

Some authors have concluded that the application of this arrangement in the long run leads to overvaluation of national currencies and thus the current account deficit is almost twice as big as that of countries with the fluctuating exchange rate. As for the inflation rate, it turned out that countries in this arrangement have almost 1.5 percentage point higher rate of inflation than countries under the floating exchange rate arrangement. One can therefore conclude that the currency board arrangement is less efficient in stable conditions.

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