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Currency Boards: Monetary Magic?

Over the course of 1997, the currencies of Indonesia, Malaysia, South Korea and Thailand lost at least one-third of their value against the U.S. dollar. But although the Hong Kong stock market fell significantly and interest rates rose sharply for a time, the value of the Hong Kong dollar remained remarkably stable relative to the U.S. dollar. Hong Kong's avoidance of the precipitous currency devaluations befalling its neighbors has been attributed, at least in part, to the fact that it has a currency board. After the sharp depreciation of the Indonesian rupiah, the government of Indonesia also considered installing a currency board to stabilize its exchange rate. But although such boards have a history of bringing monetary stability to sometimes volatile situations, many economists argue that Indonesian adoption of a currency board would be unwise.

Essentially, a currency board helps to stabilize the exchange rate by ensuring that the money supply is fully backed by foreign exchange reserves. Like any exchange rate peg, a currency board makes a commitment to fix the value of the domestic currency relative to a foreign currency. With full backing, the currency board is able to make this commitment believable because it is literally able to redeem domestic currency for foreign currency at a fixed rate. However, the resulting stability carries a price. Most important is the fact that a country loses independent control of its monetary policy under a currency board, tying its fate to that of the "hard" currency to which it is pegged. Without independence, the monetary authority also loses its ability to serve as a lender of last resort during liquidity crises.

All monetary authorities seek credibility, whether through reputation, explicit inflation targets, or exchange rate pegs. Currency boards help to establish credibility by ensuring full currency backing. In countries such as Argentina that have experienced chronic high inflation, they have brought monetary stability. And in emerging economies such as Estonia, Lithuania and Bulgaria they have helped to stabilize exchange regimes by establishing and maintaining credibility. However, critics of Indonesia's plans for a currency board argue that Indonesia's problems were not brought about by a lack of credibility. On the contrary, its monetary policy was generally considered to be sound. Moreover, the implementation of a currency board would be complicated by a lack of sufficient foreign reserves even if an appropriate exchange rate peg could be determined. A currency board without sufficient reserves would be more likely to come under strong speculative pressure. In addition, the inability of the monetary authority to serve as a lender of last resort could be a critical limitation to a country with a weakened banking sector.

Currency boards are one particular monetary arrangement among many for establishing and maintaining confidence in a national currency, but they may not be the best choice in all situations.

—Michael R. Pakko