Currency Board and Dollarization

1 Currency Board

Only a few countries, mainly in Europe, had central banks before the twentieth century. Central banking did not became widespread in the Americas until the period between the First and Second World Wars, and did not become widespread in Africa and Asia until after the Second World War.

There were certain arrangements of monetary authorities alternative to central banks. Among these alternative monetary systems that once were widespread were **currency boards**. After decades of decline, currency boards have enjoyed a revival in the 1990s among those countries that had suffered high inflation and those newly became independent from the soviet union.

1.1 What Is a Currency Board?

The main characteristics of a currency board are as follows.

(1) Anchor Currency

The domestic currency maintains a **fixed exchange rate** to an anchor currency (British pound sterling, U.S. dollar, Euro etc.), and the **note-issuing is 100% backed by foreign assets**. A currency board is a variant of fixed exchange rate targeting in which the **commitment** to the fixed exchange rate is by design permanent and is particularly strong. A currency board maintains **full, unlimited convertibility** between its notes and coins and the anchor currency at a fixed rate of exchange.

(2) Reserves

A currency board's reserves are equal to 100 percent or slightly more of its notes and coins in circulation, as set by law. As reserves, a currency board holds low-risk, interest-bearing bonds and other assets denominated in the anchor currency.

(3) Monetary Policy

By design, a currency board has **no discretionary power in monetary policy**; market forces alone determine the money supply. Its operations are completely passive. The sole function of a currency board is to exchange its notes and coins for the anchor currency at a fixed rate. **Unlike a central bank, an orthodox currency board does not lend to the domestic government, to domestic companies, or to domestic banks. A currency board does not try to influence interest rates** by establishing a discount rate like a typical central bank, nor does have responsibility for acting as a **lender of last resort** to commercial banks.

1.2 A Brief History of the Currency Board System

The first successful attempt to establish a currency board occurred in the British Indian Ocean colony of Mauritius in 1849. After some experimentation, the currency board system achieved its mature orthodox form with the **West African Currency Board**, established in 1912 for the British colonies of Nigeria, the Gold Coast (Ghana), Sierra Leone, and the Gambia. The West African Currency Board was a model for many later currency boards. By the 1930s, currency boards were widespread in British **colonies** in Africa, Asia, the Caribbean, and the Pacific islands.

Currency boards have also existed in a number of independent countries as diverse as Argentina in the early 1900s, the free city of Danzig (today Gdansk, Poland) in the 1920s, and Yemen. The recent currency board-like systems, discussed below, have all been in independent countries.

The currency board system reached its greatest extent in the late 1940s, when about 50 economies had currency boards. Currency boards started to disappear when British colonies achieved independence. In the 1950s and 1960s, some other currency board systems were also abolished, in favor of central banking.

1.3 Some Examples

1.3.1 Hong Kong

The most prominent currency board today is the *Hong Kong* Monetary Authority (HKMA). The Hong Kong dollar is linked to the U.S. dollar at $US\$1 = HK\$7.78$ since 1983 and $US\$1 = HK\$7.75$ since 1998. The Hong Kong currency board system was established in 1935, replacing free banking, which had existed since the first bank opened in 1845. The Hong Kong dollar was linked to pound sterling.

When the Bretton Wood system collapsed in 1972, the HK dollar was temporarily fixed to US dollar for two years. Afterwards HK dollar underwent a free floating period during 1972-1983. Beginning 10/1983, HK dollar again was linked to US dollar, according to US$1=HK$7.75.

The Hong Kong system is not completely orthodox. Since 1988, the government of Hong Kong has gradually increased the power of the Hong Kong Monetary Authority to act like a central bank in some respects. The law does not require the HKMA to maintain 100 percent foreign reserves or a fixed exchange rate (the actual exchange rate fluctuates in a small range around US$1=HK$7.8). HKMA does not even explicitly guarantee full convertibility. In fact, HKMA is **allowed to sell foreign reserves for domestic currency** in case of enormous pressure from the foreign exchange market.

1.3.2 Currency Board-Like Systems

Since 1991, a few countries have established *currency board-like* systems. *Argentina* did so on 1 April 1991, linked to the US dollars. But its currency board system collapsed in 2001. *Estonia* followed by establishing an exchange rate fixed to German mark (DM) on 20 June 1992, and is now linked to the euro. *Lithuania*, influenced by Estonia's success, did likewise on 1 April 1994, establishing an exchange rate of $4 litas = US\$1$. However, in 1997 the Bank of Lithuania began steps to replace the currency board-like system with the same central banking arrangement. Since 2002 the litas was pegged to the euro. To reverse a high rate of inflation and a shrinking economy, *Bulgaria* established a currency board-like system on 1 July 1997, linked to German mark (DM), and now to the euro.

These systems are not orthodox currency boards, but currency board-like systems—

central banks that retain many of their old powers, but are **constrained by currency board rules regarding the exchange rate and reserves**.

The potential problem with currency board-like systems is that they have loopholes that allow the central banks considerable **discretionary power**. In Argentina, for example, the minimum foreign reserve ratio is not 100 percent, as for an orthodox currency board, but 66 percent. Though the actual foreign reserve ratio hovers around 90 percent, the legal freedom the central bank has to reduce foreign reserves has at times **created speculative attacks** on the currency.

Singapore had a currency board until 1973, but since then the Monetary Authority of Singapore has maintained a floating exchange rate. Though the Monetary Authority of Singapore holds net foreign reserves equal to about 100 percent of the monetary base, it is an unusual central bank rather than a currency board.

1.4 Advantages and Disadvantages

Advantages

(1) Domestic currency expands only when foreign exchange reserves rise. Thus, there is no way that the monetary authority can use money financing to support government spending.

(2) A currency board system is a solution to the problem of lack of **transparency** and **commitment**. A currency board involves a strong commitment to the fixed exchange rate regime and can be effective in bringing down inflation quickly and in decreasing the likelihood of a successful speculative attack against the currency.

Disadvantages

(1) A loss of the monetary authority's independent monetary policy. The monetary authority can no longer create money and act as lender-of-last-resort.

(2) An increased exposure to shock from the anchor economy.

(3) When the currency is under speculative attack, the unlimited exchange of domestic currency for foreign currency leads to a sharp contraction of money supply.

2 Dollarization

Dollarization adopts a strong currency (not necessarily US dollars) as the country's official currency. It can be considered as a variant of fixed exchange rate regime with an even stronger commitment mechanism than a currency board.

Advantages

(1) Dollarization can completely prevent the possibility of speculative attacks.

Disadvantages

(1) Besides the country has no independent monetary policy, it also loses **seigniorage**, i.e., the revenues that a government receives by issuing money.