A Market Approach to Monetary Perestroika

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Solving Russia's Monetary Crisis

Adam and Eve must be blamed for the fact that we live in a world of third bests, and that we economists can at most aspire to recommend some second-best reforms. In this paper I defend a fixed exchange rate for Russia, even though I have ever maintained that I wanted flexible exchange rates for Spain, rather than see the peseta join the European Monetary System (EMS); and that I wished the British had kept the pound sterling flexible rather than have it tied to the Deutsche mark within the self-same EMS; and that I lamented seeing the Chileans under Pinochet peg their currency on the Carter dollar. My only discipline in this imperfect world is to keep reminding myself of the unattainable first best, so that the solutions I propose tend to lead to it. This is what I want to do when I turn my attention to Russia.

As Allan Meltzer (1993, p. 709) has said, "We know that fixed exchange rates are not an optimal arrangement under all circumstances or for all countries." The problems of fixed exchange rates were discovered under the gold standard and led many distinguished economists, including Alfred Marshall, to propose some symmetallic money, whereby the value of the currency was anchored but had built-in shock absorbers.

Though the early 19th century currency school did not foresee it, it turned out to be the case that money is pro-cyclical, in that quasi-money and money substitutes overexpand in a boom and overcontract in a slump. These whiplash movements are more exaggerated the further away from the financial center a country is,

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Cato Journal, Vol. 12, No. 3 (Winter 1993).

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because information about the cycle arrives late and is distorted. If prices and wages are not fully flexible, the real economy suffers sub-optimal gyrations. That is why central bankers in the European Community (EC) are always going on about wages, though the level at which they want them fixed is sure to be wrong.

Also if there is to be a fixed exchange regime, what one ties the currency to is crucial: inflationary or deflationary shocks to the standard, and changes in the terms of trade, may affect the local economy harshly. Also, what is to be done in the case of a bank panic? Allow people to run on the banks to make use of the convertibility promise?

Finally, another problem arises under a fixed exchange rate. If the pegged currency is issued by the government, either the government balances its books sufficiently, or nobody will believe that it has forever renounced collecting the inflation tax. This question of who issues the currency is a separate one, and in fact is not a problem but a part of my solution.

Obviously, whatever the monetary regime proposed for Russia, it will not be perfect and one cannot assume it will be definitive. Let me put this in another way. The monetary regime proposed for Russia for the transition must be compatible with something nearer an optimal currency system in the long term. That is why I am going to propose a *modified* fixed exchange rate regime in Russia, because by starting with this modified system based on a non-monopolistic currency board, Russia could in the end find itself with a full-blown system of nearly self-stabilizing currency and banking competition—and by then the currency board might have withered away.

Having said all this, let me admit that money matters are very complicated and abstract. So I will try to simplify things a bit by first conveying a story I heard on the World Service of the BBC and then using the story to summarize the key monetary problems facing Russia during the transition period.

The BBC reporter had taken a Russian friend to one of the fast-food American restaurants on Red Square (if it is still called that). The friend, an ex-army officer, wistfully remarked that the hamburgers they were consuming cost as much as his car outside, which he had bought with his retirement compensation. For the benefit of his listeners, the journalist remarked that, though the ruble had lately revalued on the black market "for technical reasons," the undervaluation of the currency was destructive of the social bond. The stabilization of the ruble was overdue, he concluded, and it was urgent that the West arrange the loan of a large stabilization fund to defend a fixed parity.

The anecdote is revealing, in that it condenses the effects of a variety of problems:

1. The relative barter prices of goods and services in Russia are out of kilter. The law of one price does not hold because of restrictions and transaction costs imposed by administrative fiat, as happened with the car our Russian friend obtained cheaply from the military.
2. Cash for transactions at the current money prices is scarce. This is not unusual in an acute inflation, and especially so when coins are used for small payments, whose metal content suddenly is worth more than its face value; I have seen people pay with postage stamps in Italy.
3. The currency lacks internal convertibility. The hamburgers were being purchased with the journalist's dollars because the queue for the ruble side of the restaurant was much longer than for the hard currency parlor—and a queue is another way of reducing the convertibility and ultimately the value of a currency.
4. The currency lacks smooth external convertibility. Either there are many different exchange rates if the government can prescribe the use of the hard currency for certain transactions, or the relative money prices of goods and services do not correspond to their barter prices. In other words, the purchasing power of the hard currency is random.

On seeing these four problems, the foreign consultant is usually tempted to try to solve them at one blow. Like a central banking Alexander, the expert will want to cut the Gordian knot rather than stop to unravel it. If domestic barter prices have been freed, the consultant will say, why not fix the ruble exchange rate with the dollar, and peg it there with the help of a stabilization fund and a restrictive monetary policy?

Now, this solution encounters three major difficulties in Russia (I will not dwell on the difficulties a similar policy has caused in the newly unified Germany, or what lies in store for the EC when it will run a single currency). First, the other states apart from Russia that formerly belonged in the Soviet Union can run a deficit and de facto force the Russian central bank to monetize it by making a call for ruble shipments (though we know that Ukraine is no longer permitted to do that, since it parted from Russia after the referendum of 1991. Second, the Russian government itself is having grave difficulties balancing its budget, and the act looks increasingly difficult. Third, there is a question whether anybody will believe in the time consistency of the Russian government, whether anybody will expect that the fixed exchange rate eventually chosen will stick. And in front of perverse expectations fostered by the budget deficit, a stabilization fund can melt like snow in spring—I can think of better ways to use hard dollars than to give them away to ruble "bears," of which there are a great many on the Russian steppes.

Now comes the point when I can put a question mark on current orthodox proposals to give Russia and all the new republics of the East a sound currency or currencies. The Western-trained economist, especially if working for the IMF, will instinctively aim for a full-blown system of monetary intervention: there should be a Russian central bank able to refuse government calls for loans; the bank should choose the exchange rate for the ruble and make it externally convertible at a fixed rate with the help of a stabilization fund; the bank should also use its interest rates to correct balance-of-payments deficits, by dampening internal demand and attracting foreign capital; and the bank should act as a lender of last resort for the fractional reserve institutions of the second tier, and police the value of their loans.

On hearing this list, it is impossible not to have second thoughts. The Russian central bank may be forbidden to lend to the government, but by conducting open-market operations could it not underpin government bond prices in the secondary market? Who can guess the right fixed exchange rate before unemployment becomes unbearable? Is the stabilization fund supposed to be inexhaustible? Would not interest rates bear a large premium, equivalent to the discounted devaluation? And all this in the paradise of moral hazard.

You can guess from this list, and especially from my second thoughts, that I am skeptical. My skepticism is even greater given the likelihood of real shocks for a country undergoing an upheaval like Russia's, and the difficulty of accommodating those shocks with a single monopolistic currency whose exchange rate to the dollar is fixed. And to add to all this, the whole "central bankers' exercise" is well nigh impossible in Russia due to the government's lack of credibility after more than 70 years of communism and after repeated failure to institute real reform.

Some Misconceptions about Monetary Reform

The question of monetary reform in Russia lies not in deciding which is best between a currency board or a central bank, but which as between a monopoly issue of currency and competition of issue. Moreover, it is bad economics to install a transitional arrangement without regard for the achievement of a long-run steady state. Given the state of the country, it may be much more economical and effective to go the piecemeal way, rather than attempt a wholesale solution. Forget about pan-Russian monetary reform, budget balancing, and balance-of-payments stabilizing, and try to set up a nonmonopolistic currency board, which could slowly ease itself into the system by the spread of spontaneous acceptance, without the government even noticing what is happening. After all, Archimedes cried for a single fulcrum, and he would move the world; he did not ask for a Hercules to raise it bodily. Monetary reform in Russia does not call for a Napoleon and his *Grande Armée* but for some guerilla tactics.

To introduce this piecemeal way of reforming Russia's monetary system, I will try to dispell three misconceptions that I have spotted in the polemic between free bankers and central bankers.

The first misconception is to think that the proposal to establish a central bank governing a national payments and credit system is quite different from the idea of advocating a currency board. A central bank can be made to function like a currency board, and a currency board can easily drift into becoming a classic central bank (see Dowd 1993).

David Ricardo, in his 1816 work *Proposals for an Economical and Secure Currency*, proposed that the Bank of England be stripped of its issuing powers, and that the note issue be turned over to what in effect was a currency board. There would be a Treasury Note Department, issuing notes automatically on deposit of large ingots of gold, which soon were nicknamed "Ricardos." The scheme was not approved but the great man's intentions were clear. He believed that business cycles were caused by the financial misbehavior of private issuers. He therefore proposed that all rights to private issue should be withdrawn; country banks would become simple deposit and credit institutions; and base money creation was to be nationalized. Ricardo, however, knowing from experience during the suspension of specie payments, that it was dangerous to entrust the government, or even the bank directors, with the power to issue currency without a foolproof check, proposed what in fact was a constitutional rule. This "currency board rule" was not enacted in Ricardo's lifetime, and partial and imperfect free banking continued until the 1844 Bank Act. However, the Bank Act was a posthumous but ephemeral victory for Ricardo.

The 1844 act clearly separated the Discount Department of the Bank of England from the Issue Department, so that the issue of notes could only take place against a delivery of gold, and a withdrawal of gold had to lead to the cancellation of the corresponding notes. Hence, the Bank of England was supposed to function in effect as a currency board. But this currency board arrangement had one crippling defect: it vested the monopoly of issue in the Bank of England, constitutionally constrained though it may have been. When the 1865 recession came, the bank asked the government for permission to suspend convertibility temporarily—a perfectly acceptable, indeed recommendable, way to forestall a run on the banks, when the measure is taken in the context of monetary competition. However, if the central banker enjoys a monopoly, then nothing is easier for him than to blame his note-issuing competitors for the crash, assume the mantle of responsibility for conducting an anti-cyclical policy, and ask for the competitors to be eliminated. Not very much later Walter Bagehot (1873), in his classic *Lombard Street,* though a "free banker" at heart, gave in to the prejudice that there had to be only one monopolist central banker in charge of currency issue, and proceeded to accept and analyze the discretionary powers of the new monetary authority that had thus unwittingly been created.

The second misconception is that a balanced budget is necessary to have a sound currency, or that a sound currency necessarily forces a balanced budget on the government. If I may quote examples from Spanish history, the debts of Emperor Charles V led him to concede the exploitation of Venezuela to his Nüremberg bankers, the Fuggers. His son Philip II so overreached himself that he had to renege on his payments three times during his reign (he always excluded one or two foreign bankers from his bankruptcy, so that he could borrow next time round). But neither Charles V nor his son debased the currency, and the Spanish reals and doubloons reigned supreme as the commercial currency of the world for nearly 100 years. Thus, the answer of these two kings to their budgetary troubles was either payment in kind or rescheduling of the debt, not inflation. Later Habsburg kings, especially Philip IV, the patron of Velázquez, did debase the currency by mixing ever larger amounts of copper into the silver of his reals, an alloy deceitfully called "bullion," or *vellón* in Spanish. But in the last quarter of the 17th century, the son of Philip IV, the half-imbecilic Charles II, reformed the coinage to revalue it and make it sound again, with wondrous effects on the economy.

A clearer example of what I mean by there being no necessary relation between the government deficit and inflation is the plight of the great Spanish liberal minister of finance in 1868–70, Laureano Figuerola. He created the silver peseta and started 75 years of monetary stability. However, on taking office after the 1868 revolution, he found the treasury exhausted, a plight made worse on his being forced to abolish some consumption taxes by his ardent revolutionary mates. He considered the idea of committing suicide, but having thought better of it, leased the Almadén mercury mines to the Rothschilds as a fruit-bearing collateral for a loan. The interest on the loan was high, but the treasury escaped bankruptcy. Of course, during the whole of the 19th century there had been and would be repeated and less-reputable attempts to ease the treasury problem by setting up a national bank to which a monopoly would be granted in exchange for an overdraft for the treasury. But Figuerola did not stoop that low and the final and successful creation of the Bank of Spain had to wait until just after his time.

The lesson of all this is that in centuries past the possibility of leasing or selling government assets to reduce the debt, or at least to make new issues of debt by a broken treasury palatable to the public, was ever present in the minds of ministers. That is in fact why Spanish church and municipal lands were privatized in 1835 and 1865, respectively. The lesson for Russia, with its $3 trillion assets just waiting to be privatized or sold, is that there is no need for an inflation tax in this case.

The third misconception is that it is necessary to impose a deep deflation at the time of your monetary reform for the public to believe in the soundness of the new currency and to think that the government will not be time-inconsistent. A crisis of confidence in the new currency would occur only if the currency to be redeemed from bad opinion were the official ruble itself, with its huge circulation and its proven obeisance to treasury needs. But if a new parallel currency were introduced, and its reserves were placed beyond the reach of the government and its issue were put in the hands of a private company, or better, of an international institution such as the IMF or the BIS, then there would be no need to prove its soundness and sincerity by self-flagellation. This parallel currency could start in a small way, be floated against the ruble, and spread slowly and spontaneously with no thought for the *Konjunktur.* After all, in the case of John Maynard Keynes's brainchild, the Archangel-Murmansk *Caisse d'Emission*, the sterling-linked ruble notes of the British Expeditionary Force were accepted because it was expected that they would be true, as in fact turned out to be the case. They were redeemed despite the military rout, because the back-to-back guarantee was sited abroad (see Hanke and Schuler 1991).

The Question of Competition

In my view, a central bank functioning under a strict money-creation rule and a currency board issuing the only legal tender are very much a "second best" because they enjoy the dangerous privilege of a legal, not a natural, monopoly. Money has some of the traits of a natural monopoly, but this is not unlimited in time or space, if the state does not take it over. Even with a starting position of exclusivity, if there are no exchange controls, the monopoly positions of these two forms of currency creation are not totally without check or limit. But the removal of the legal monopoly of issue is crucial to make a "first best" attainable. The monopoly restriction having been lifted, the currency board standard will prevail only if people choose it.

Moreover, as Kevin Dowd (1993) has pointed out, the currency board will slowly lose its market share to private bankers that issue competing currencies denominated in the standard of the board. Thus, a full-blown free banking system may come to be. Likewise, when a central bank is one of many and ready to compete freely with other central banks, the residents in its zone will be free to use different currencies for each kind of transaction (Swiss francs for pensions and pesos for bus fare). The competing central bank enjoying the largest custom in the zone will tend to set the rule for money creation, since it must be responding to the wishes of its customers as regards stability and credit-worthiness.

In a way, the non-Russian republics of the CIS have already expressed a wish for not having a currency imposed on them. Like Molière's *Monsieur Prudhomme*, they are speaking garbled free banking prose without knowing it.

The crucial question is not whether we have a currency board or a central bank controlled by a constitutional rule, but whether virtual or actual currency competition is allowed to grow. And by "virtual" I mean new entrants, such as VISA, American Express, or the Bank of Hong Kong and Shanghai, actively considering when to come in and offer their own means of payment. After all, those three institutions are already in the business of supplying quasi-money or even actual bank notes.

The Role of Money

We have not gone deep enough into the reasons for the institutions of currency creation being so hotly disputed as they obviously are. To discover these reasons we need to delve into what money does, into the role money plays in modern societies. And the answers are not all economic.

If people are allowed to chose their preferred currency freely (and it is a big if), then a currency or currencies will appear over time performing the following two economic roles.

First, there will exist a *numéraire* against which to measure the relative prices of the goods and services of the economy and consequently of the world. This *numéraire* will help supply essential information with minimal calculation, but it has to be in the transactors' minds when effecting an exchange. It is in fact a mental construct, which, as Eugene Fama (1982) pointed out, could be a mere standard for book entry calculations. Such disembodied accounting standards have often existed: the *maravedí* in Imperial Spain, the *livre tournois* in 17th- and 18th-century France, the *guinea* in Saville Row. But its social dimension demands that it should somehow be institutionally defined, if possible, not by a political authority. The service of defining and maintaining such a *numéraire* will be in nobody's interest unless the definer also issues physical money and reaps a seignorage.

Second, there will be a medium of exchange fully convertible into local and international goods and services (and other international or national competing currencies). This medium of exchange will be anchored to its stable unit of account or *numéraire*, which cannot be varied at will by the authorities—it could be a foreign currency, or a precious mental, or a commodity basket. Because it is anchored, it may freely float against other currencies, even those that are denominated in the same monetary unit. This medium of exchange, if well serviced, can perform both important functions at the same time; that is, serve as a standard and dispense with the need for barter. The importance of such services explains why the currency will not usually be interest bearing for the holder. The issuer will reap the seignorage for this service, that is, the difference between the cost of issuing the interest-free currency and the interest it gets on the riskless bonds forming its 100 percent reserve (or 80 percent as in the Keynes's Archangel *Caisse d'Emission*).

It is traditional to speak of a third function as important, wrongly in my view: the function of the currency as a store of value. Though this function may be material in primitive nonfinancial economies, it will not mainly be performed by the currency, but increasingly by the portfolio-managing banking system, once financial markets develop (see Fama 1982).

Unfortunately, though the people may freely choose their *numéraire*, as they do today in Russia with the U.S. dollar, the medium of exchange can be chosen for them by the government. And when the standard is not stably embodied in the medium, then transaction costs shoot up. "The medium is the message," as Marshall McLuhan would say.

This being so clear, who could be against motherhood and apple pie, or what politician would not side with the angels? But this is not the whole story: there is a political side to currency creation that makes protestations of love for a stable price level sound like hypocrisy. The real role of money for people in government, even if they want to be reelected, is a political role. The currency in the political arena is not an instrument of price policy but an instrument of fiscal policy, with two dimensions: the increasing of government income, and the spreading of transfers.

The more familiar part is the role of currency creation in the expansion of government income. The legitimate seignorage, as described when dealing with the economic role of currencies, is expanded to become an inflation tax. Thus the tax base shrinks, so that there is a natural though costly limit to the amount of this surreptitious tax being levied. This is admiringly explained by John Maynard Keynes, with references to the use by Soviet authorities of variable inflation of the sovznak as a turnover tax, with the parallel issue by Lenin of the gold chervonets to avoid demonetizing the economy (Keynes 1923, chap 2, revealingly titled "Public Finance and Changes in the Value of Money").

A less-discussed part of the sinful relation between government and money is revealed by the Maastricht Treaty, which sets a date of January 1998 for monetary union. A single fixed exchange rate for European currencies is equivalent to a single currency, which will give rise to regional imbalances. These "imbalances" are one of the political "advantages" of an issue monopoly imposed over a large zone, because politicians will have a role to play in "correcting" the imbalances. Indeed, an annex to the Maastricht Treaty establishes a "Coherence Fund," whereby the governments of states suffering the same sickness now affecting the ex-DDR will receive transfers—the stuff of politics.

A Parallel Currency for Russia

All this should allow us to frame a realistic proposal for monetary perestoika in Russia. My proposal is to use a freely competing currency board to solve Russia's monetary problem. Such a reform should not be described as experimenting (see Klaus 1993, p. 527), but as using the experimental method. A private currency board should be set up in Russia to issue an anchored currency—but not one that would be legal tender, the official currency of the land, or a reformed version of the ruble. It would be a parallel, freely competing currency seen to have no connection whatever with the government and its budget deficit.

The currency board would not issue the official currency, as in Hong Kong. Rather, the parallel currency could be held to a fixed exchange rate with the dollar to start with, but might very well rehook onto a metal anchor once its credibility was established and the true nature of the dollar discovered. The new currency would float against other currencies, especially against the present paper ruble.

The currency board could bow out once a system of competing private currencies—with a single unit of account or perhaps with different units of account—was established (see Dowd 1993). If the currency board is as necessarily hidebound as Steve Hanke and Kurt Schuler (1993) have detailed for us—with very few branches, with no services except the exchange of paper for the anchor currency and the anchor for paper, and with little leeway in the investment of its backing reserve—then a fully active but reliable private supplier could displace the board, if the private agency issued visibly sound money. In fact, Kevin Dowd (1993, p. 565) is right in demanding that there should be a "sunset clause" to avoid self perpetuation and the transformation of the board into a central bank.

The attraction of a freely competing currency board is that one need not wait for the Russian budget to be balanced, or stop the other ruble republics from monetizing their debt with Russian money, or hope that people will form the right expectations about Yeltsin's anti-inflationary policy. All those desired ancillary aims could be delayed, because, as the experiment of the chervonets under Lenin tends to show, the parallel currency could still spread. Very possibly the bad practices would wilt in time and the accumulated deficits would be settled with asset sales.

The fund of hard currency needed to start issuing the new currency could be quite small compared with the figures implied by an attempt to rescue the present ruble. Steve Hanke and Kurt Schuler (1993, p. 693) think the new parallel currency could be started with a fund of as little as $4.1 billion. Thus, we might be able to solve the transition problem in a manner that would remove the currency from the clutches of politicians more effectively than by postulating the independence of the central bank or by proposing a constitutional amendment.

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