Currency Board: Salvation for Lebanon's Woes?

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Currency Boards: Salvation for Lebanon's Woes?

- ✓ **What are Currency Boards? Main characteristics.**
- ✓ **Currency boards in history and practice: colonial history, recent examples**
- ✓ **Macroeconomic requirements for a sustainable currency board**
- ✓ **Is a Currency Board feasible for Lebanon? Reforms and requirements**
- ✓ **A Currency Board is not a salvation for Lebanon's woes**

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Exchange rate regimes can give nations varying levels of autonomy over monetary policy

(exchange rate regimes as of 2018)

No exchange rate flexibility	**Currency union** *Agreement where two or more nations share the same currency*	**Member states of the euro area***		No monetary policy autonomy
	Currency board *Board backs local currency with foreign currency and fixes rate to that currency*	(USD) **Hong Kong**		
	Peg *Fixed rate pegged to foreign currency*	(Euro) **Denmark**	(USD) **Saudi Arabia** **Jordan**	
Some exchange rate flexibility	**Stabilized arrangements** *Pegged exchange rate that can be adjusted for market conditions*	(USD) **Vietnam****	(Currency basket) **Morocco**	Least
	Fixed currency band *Pegged exchange rate that floats within a fixed band*	(Historically, 1990–92) **UK**		
	Adjustable band *Pegged exchange rate that floats within a periodically adjusted band*	(Currency basket) **China** **Botswana**		Degree of monetary policy autonomy
Flexible exchange rates	**Managed float** *Central banks influence the floating rate by trading currency*	**Korea** **Turkey** **India** **Brazil**	**Argentina** **Indonesia** **Israel** **South Africa**	
	Free float *Exchange rate fluctuates based on market conditions as central bank targets domestic macroeconomic objectives*	**US** **UK** **Japan** **Russia**	**Australia** **Canada** **Mexico** **Sweden**	Most

Source: Obstfeld (2020): "Harry Johnson's "Case for Flexible Exchange Rates"—50 Years Later", PIIE Working Paper, Jul https://www.piie.com/system/files/documents/wp20-12.pdf

Currency Board Arrangements

- **Four characteristics:**
  - Fixed exchange rate peg to an anchor currency: no monetary policy independence (cannot use R, or ER for macro stabilisation); requires domestic wage and price flexibility
  - Unrestricted convertibility of domestic currency to anchor currency @ fixed rate
  - Prohibition of domestic credit creation; no lender of last resort function
  - Long-term legal commitment set out in a central bank law
- **Four conditions must be satisfied:**
  - Sufficient FX reserve backing of CB monetary liabilities (M0)
  - Sufficiently restrictive fiscal policy
  - Healthy financial system and willingness to let banks/financial institutions fail
  - Political will and commitment

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Examples of Currency Boards I

Currency Boards were instituted to **address a range of specific economic challenges**:

- Facilitating transition from formerly centrally planned economies (Estonia, Lithuania)
- Arresting hyperinflation (Argentina, Bulgaria)
- Restoring exchange rate stability after a political & banking crisis (Hong Kong)
- Providing a stable institutional framework in post-conflict reconstruction (Bosnia)

	Hong Kong	Argentina	Estonia	Lithuania	Bulgaria	Bosnia and Herzegovina
Year of inception	1983	1991	1992	1994	1997	1997
Political status at inception	British colony	Independent	Newly independent	(Newly) independent	Independent	Independent
Current status	SAR,[1] China	Independent	Independent	Independent	Independent	Independent
Previous regime	Floating	Floating	Rouble area	Floating	Floating	Mixed
Reason for inception[2]	Restore confidence	Macro stabilisation	Macro stabilisation	Macro stabilisation	Macro stabilisation	Postwar re-construction
Authority in charge	Exchange Fund[3]	BCRA[4]	Bank of Estonia	The Bank of Lithuania	Bulgarian National Bank	CBBiH[5]
(year established/ independent)	(1935)	(1935)	(1919/1990)	(1922/1990)	(1879/1991)	(1997)

[1] Special Administrative Region. [2] Except for Hong Kong and Bosnia and Herzegovina, the stabilisation efforts of the other economies included fighting high to hyperinflation. [3] The Exchange Fund became a part of the Hong Kong Monetary Authority (HKMA) in 1993. [4] Banco Central de la República Argentina. [5] Central Bank of Bosnia and Herzegovina.

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Source: "A survey of the institutional and operational aspects of modern-day currency boards", BIS Working Paper, Mar 2002

Examples of Currency Boards II

- **Lebanon had the equivalent of a CBA under the French Mandate** when the SP and subsequently the LBP were pegged to the FFR (1926-41) and STG until 1949. Lebanon then had a long history of a flexible exchange rate until the hard peg in 1997.
- **CBA of Estonia, Lithuania and Bulgaria are examples with an anchoring of expectations based on governments willing to accept constraints** (e.g. fiscal discipline) & undertake structural reforms in order to achieve EU accession and euro adoption. Gained political and economic credibility and achieved macroeconomic stabilisation as a result of an ultimate objective.

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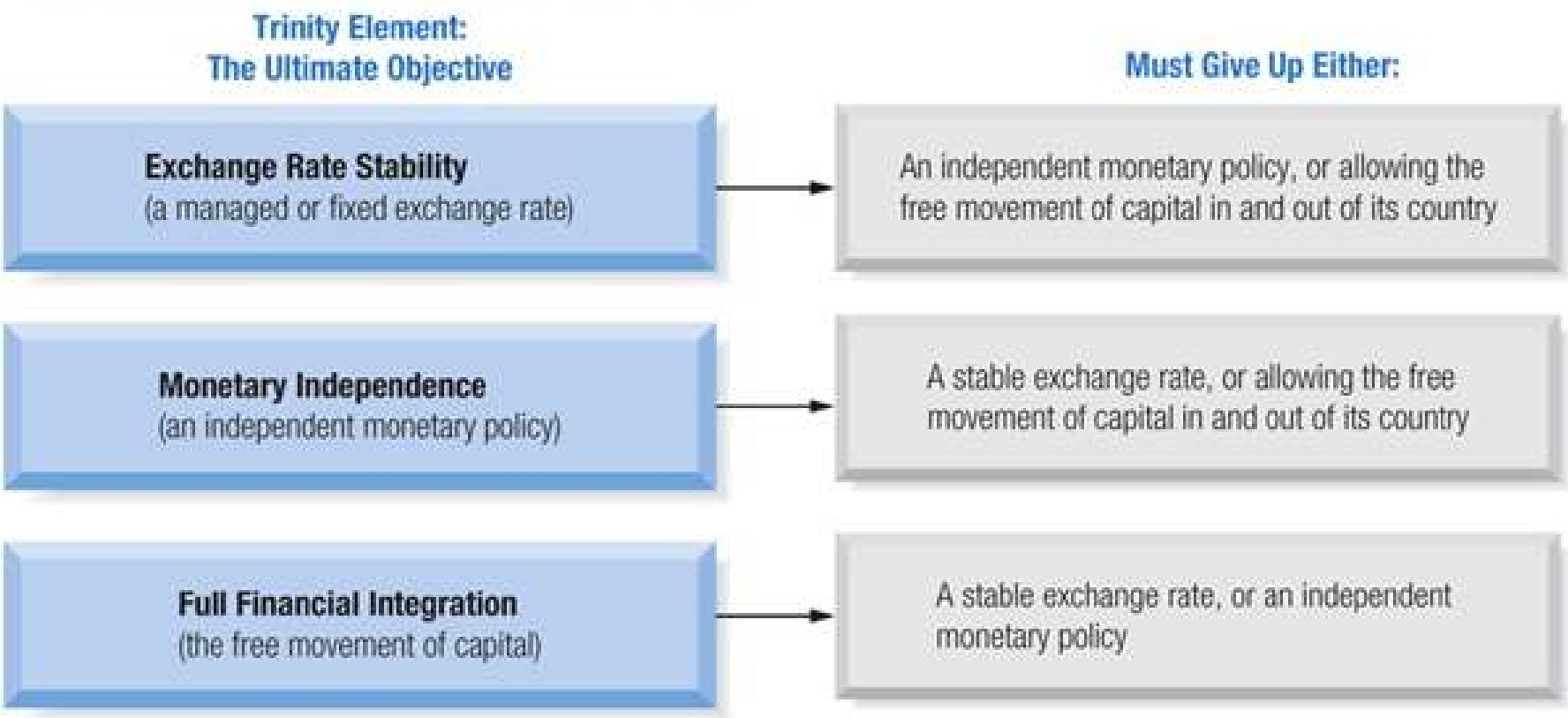
The Impossible Trinity – the Policy Trilemma



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Advantages & Disadvantages of a Currency Board

Advantages

1. **Convertibility** is ensured
2. **Macroeconomic discipline** is instilled: currency boards cannot finance budget deficits, so govts must either maintain budgetary discipline or borrow from the public
3. A **guaranteed payment adjustment mechanism**

⇒ Raise confidence in monetary system

Disadvantages

1. The **seigniorage problem**. Currency boards earn interest on foreign currency holdings, but those holdings could've been used to make investments at home; difference in yield could represent a loss.
2. The **startup problem**. Not easy to gather enough reserve currency to back monetary base 100%.
3. The **transition problem**. The local currency may become overvalued in a high inflation economy. The fixed exchange rate will eventually bring inflation under control: how long will transition last?
4. The **adjustment problem**. It's costly to correct BOP imbalances – adjustments would be automatic under a flexible rate system.
5. The **management problem**. Normal monetary policy tools are off the table.
6. The **crisis problem**. The currency board cannot serve as the lender of last resort, so banking crises may be difficult to head off.
7. The **political problem**. Will the government actually balance its budget? Currency boards have no authority to force them to do so.
8. The **monetary sovereignty problem**. The normal monetary policy tools are off the table; "anchor" economy will be dominant

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Lessons from Recent Experiences

Boards deliver short-term stabilization and an extended honeymoon period. Whether stability lasts depends on policy choices during the honeymoon period

Successful	Unsuccessful
• Currency boards have a long history, much of it in (mostly British) colonies and dependencies, typically smaller & more open economies • These nations succeeded in maintaining exchange rate stability, controlling inflation and facilitating trade, <u>at the cost of tying up reserves and restricting the scope for monetary policy</u>, with more ambiguous evidence on their broader economic impact • Countries using the good times to achieve lasting fiscal balance while vigilantly counteracting real appreciation and prudently managing capital inflows stand to reap longer-term benefits at modest costs	• **Both Argentina and the Baltics eventually faced crises** reflecting external developments aggravated by domestic political choices • The **Baltics**, with a clear exit path to the Euro, doubled down on the boards and eventually achieved a smooth transition • **Argentina**, lacking a clear longer-term transition perspective, shifted to a flexible exchange rate

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Debunking 10 Myths about the Benefits of Currency Boards

(Source: Nouriel Roubini, http://www.geocities.ws/mugajava.geo/jurus/vs-cbs.htm)

Myth 1: Speculative attacks against a currency do not occur in a currency board system because you are credibly committed to fixed exchange rates

Speculative attacks => expectation of a devaluation force monetary authorities to sharply increase interest rates to credibly show their commitment to the peg parity

Myth 2. Currency boards are good for the stability of the banking and financial system

Everything else equal, fragility of the banking system is an important factor to consider when deciding whether to introduce a CB: the weaker the banks the more dangerous a CB

Myth 3. Fixed exchange rate regimes, and CBs in particular, work better than more flexible exchange rate regimes

The big currency crises of the 1990s occurred with fixed rate regimes (a close cousin of currency boards), not under more flexible exchange rate regimes.

Myth 4. Currency board are good for countries exporting world commodities priced in foreign currency because such countries cannot use the exchange rate to affect their real exchange rate

High volatility of the terms of trade & high dependence on primary exports requires a central bank that is able to sterilize capital flows. A currency board would lead to large fluctuations in the monetary base => destabilizing influence

Myth 5. Currency boards are better than monetary unions

If a country really wants to have truly credible fixed exchange rates, it might as well give up altogether its national currency & go the extra step: form a monetary union or adopt anchor currency.

Myth 6. Currency boards avoid destabilizing international capital flows.

In a currency board the central bank is not allowed to sterilize the effects of large capital flows on the monetary base & this is destabilizing: when capital flows out, base money falls, interest rates are forced to dramatically increase, the banking system comes under strain and a major recession may ensue.

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Debunking 10 Myths about the Benefits of Currency Boards

(Source: Nouriel Roubini, http://www.geocities.ws/mugajava.geo/jurus/vs-cbs.htm)

Myth 7. Currency boards prevent real appreciations and loss of competitiveness

Empirical evidence suggests the contrary: fixed exchange rate regimes + currency boards are associated with real exchange rate appreciation, loss of competitiveness, worsening of the trade balance & current account

Myth 8. Currency boards cannot collapse because the monetary base is fully backed by the foreign reserves of the country

A currency board where base money (M0) is fully backed by foreign reserve would not be able to prevent a speculative attack from succeeding because in the event of an exchange rate crisis or panic, all liquid money assets (such as M1 and M2) can be converted into foreign exchange and they are an order of magnitude larger than foreign reserves.

Myth 9. Currency boards leads to lower inflation rates than flexible exchange rates

A causality issue: does central bank independence lead to low inflation or is it that countries that decide to rely less (more) on seigniorage and inflation will choose more independent (dependent) central banks ?

Myth 10. Currency boards lead to more fiscal discipline than flexible exchange rate regimes

Two arguments: 1. If political biases or structural causes of deficits remain, less monetization of deficits will lead to greater reliance on debt-financing of such deficits. A currency board, by itself, cannot solve such political biases. 2. Flexible exchange rates provide more discipline because, under such regime, any bad fiscal policy leads, right away, to a punishing currency depreciation.

Bottomline: Fixed rates and currency boards without sound & sustainable macroeconomic policies and structural liberalization policies lead to currency collapse and economic disaster.

Conversely, **if sound economic policies are followed, there is no need for a currency board**: will do as well without one + adopting one may hurt when truly exogenous shocks require an adjustment of nominal exchange rate parity

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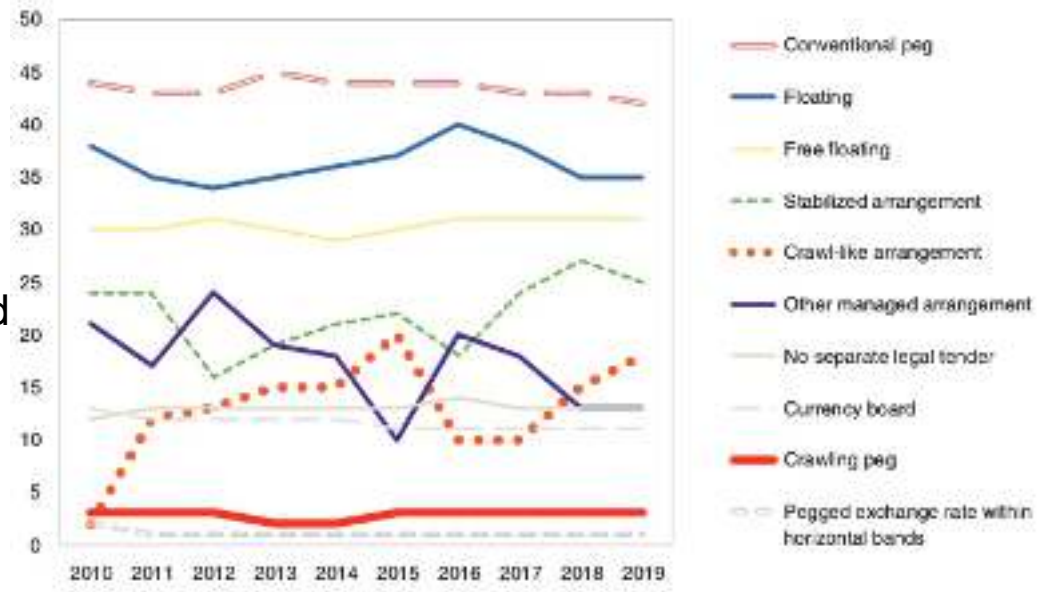
What is needed for a successful & sustainable stable currency board arrangement?

- Reform of public finances + strict fiscal discipline
- Reform of banking system
- Setting up of contingencies (for banks and treasury) in case of financial crises
- Labour market flexibility and wage flexibility
- Peg is chosen at a level that is neither overvalued nor undervalued
- Traded economic sectors should make up the most significant component of domestic economic structure
- Adequate supply of reserve assets is growing at a slow and stable rate

Bottomline: requires adequate level of reserves, fiscal discipline, healthy & well supervised banking & financial system, rule of law and political commitment

Exchange Rate Arrangements, 2010–19
(# of countries as of end-Apr)



Source: Annual report on exchange arrangements and exchange restrictions, IMF Aug 2020
*Currency Boards exist in 11 nations. USD as exchange rate anchor: Djibouti, Hong Kong SAR, ECCU, Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines. **Euro as the anchor:** Bosnia and Herzegovina, Bulgaria*

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Some questions for a Lebanon CB

- How to achieve a sustainable reduction in fiscal deficit from current rates of 10-12% of GDP down to 1%?
- What ER conversion rate will be used for CB fixed rate?
- How will trade and current account deficits be reduced to sustainable levels?
- How will public and BDL debt be restructured?
- Is there political will for deep and sustained reforms, including institutional reform?

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Lebanon needs comprehensive macro-fiscal-financial and deep structural reforms for economic stabilisation & revival

Comprehensive National Macro-Fiscal-Financial-Banking reform plan	Fiscal Reform, Public sector restructuring, Structural Reforms	Public debt (government & BDL) restructuring (haircut)	Monetary & Exchange Rate Reform	Bank Recapitalisation & bail-in
•Multilaterally funded Economic Stabilisation & Liquidity fund and program •Under the aegis of the IMF •Provide BoP support, CB swaps, debt guarantees, fiscal support... •Est size: $25-30bn+	•Tax collection •EdL reform •Cash transfers •Reduce cost of doing business •Government procurement •Pension system reform •Civil services pay and benefits •'Ghost workers'	•Reduce principal •Reduce interest rates •Extend maturities •Convert $ to LBP	•Move to flexible exchange rate •Phase out all quasi-fiscal operations & government financing •Strengthen BDL's governance and internal controls framework •Amend Money & Credit Code •Capital Control Law •Undertake Forensic Audit (BDL)	•$25bn bank recapitalization •Abolish Bank Secrecy Law •Consolidation: M&A •New Insolvency Law & 'Bad Bank Act'

Economic & Financial Governance

Establish a Social Safety Net

Establish a National Wealth Fund to include all SOEs, GREs & future Oil & Gas Revenues

Anti-Corruption program and Stolen Asset Recovery Initiative (StAR)

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Monetary Reforms

- New Monetary & Credit Code
- Abolish Banking Secrecy Law
- Move to Flexible ER regime & Inflation Targeting
- No public sector financing or quasi-fiscal financing
- Governance reforms: limit Governor & VG terms to 4 years, only once renewable; no cumulating of functions (CMA, SIC, etc.);
- Accountability: report on policy to CoM and Parliament
- Transparency & Disclosure: audited and published accounts; publish MoM of Central Council
- Independence of Banking Control Commission, including budget & funding
- Develop financial markets
- Independent public debt office
- Establish an independent Special Banking & Financial Court

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A Currency Board is no salvation for Lebanon's woes

- Lebanon needs:
  - A comprehensive macro-fiscal-financial stabilisation and liquidity programme under the aegis of the IMF to address internal (fiscal and debt unsustainability) & external imbalances
  - Deep Fiscal Reform
  - Structural reforms
  - Restructure its Public
  - Restructure BDL and its debt
  - Restructure Private sector debt
  - Monetary & Exchange Policy reform: gradual move to flexible rates and inflation targeting, with appropriate policy sequencing
- **Lebanon does not need a CB to achieve macro & monetary stability if the above reforms are undertaken**

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Thank you

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