BUFF/97/7

January 29, 1997

Concluding Remarks by the Acting Chairman
Currency Board Arrangements—Issues, Experiences, and Implications for Fund-Supported Programs
Executive Board Seminar 97/1—January 24, 1997

Directors welcomed the opportunity to discuss currency board arrangements (CBAs) in an Executive Board Seminar, and commended the staff for producing a set of comprehensive and well-balanced papers. They broadly endorsed the conclusions of the papers. Directors observed that CBAs entailed advantages and disadvantages that needed to be carefully weighed. They agreed that CBAs could be useful for certain purposes: to bolster the credibility of a stabilization program—especially in countries emerging from high inflation where there was an urgent need for a complete break with an existing policymaking process, or where the authorities had not had the time to establish a strong policy record; to serve as a transitional arrangement in newly-independent countries or those in a post-conflict situation until the expertise could be developed to operate a conventional central bank; and to facilitate the integration of a small open economy with a currency area or broader trade zone. It was also suggested that widespread dollarization might ease the introduction of a currency board arrangement.

In discussing the strengths of CBAs, Directors emphasized the usefulness of such rule-based arrangements in enhancing transparency and in encouraging financial discipline. Those were key elements in providing an institutional framework for good policy management, thereby bolstering credibility and facilitating the success of stabilization policies. At the same time, noting that policy content mattered more than the policy framework, Directors stressed that a CBA by itself could not create credibility. The advantages of a CBA could obtain only if it was backed by the necessary strong macroeconomic and structural policies and the will and ability to minimize deviations from stated policy objectives.

Directors noted that the drawbacks of CBAs were closely related to the rigidity of the arrangement. That was most evident in instances where the fixed conversion rate resulted in exchange rate misalignment—a fact which underscored the importance of carefully selecting the peg currency and the initial level of the exchange rate, as well as the encouragement of flexibility in labor and goods markets. It was also observed that CBAs limited the range of tools that authorities had for dealing with shocks and with situations such as financial fragility. Some Directors stated that CBAs were less well suited for coping with a global environment of increasing capital flows and modern and dynamic financial markets.

Directors emphasized that all policy options must be weighed carefully before the entry of a country into a CBA, as the costs of failure could be severe. In particular, the introduction of a CBA should proceed in the context of a comprehensive policy package of macroeconomic and structural reforms and where there existed the political will and public support to implement the necessary policy adjustments. Directors noted that strong fiscal policy, flexibility in labor and goods markets, and a sound banking system helped reduce the likelihood of exchange rate misalignment or a banking crisis that could jeopardize the arrangement's credibility. In that context, a few Directors observed that, as countries wishing to adopt CBAs might well have banking systems in need of restructuring and modernization, the implicit and explicit costs of cleaning up banking systems and measures to strengthen them must be carefully factored into the design of stabilization programs with CBAs. Some Directors observed, however, that the absence of a sound banking system need not unduly constrain the adoption of a CBA, provided that early reforms were initiated in that area.

Directors discussed whether CBAs should allow for typical central bank functions, including money market operations and the lender of last resort (LLR) function. Some Directors argued that a "pure CBA" limited solely to the exchange of domestic currency for foreign exchange at a fixed rate would be preferable because any flexibility introduced into a CBA would come at the cost of lost credibility. However, many other Directors agreed that allowing limited central bank functions with appropriate safeguards would, in many cases, make a CBA more resilient and thereby more credible and viable.

Those Directors considered that a limited role for monetary operations could be justified under a currency board in order to avoid excessive volatility in interest rates. Directors also thought that, given the fragility of the banking systems in many countries, it would generally be useful to have some limited LLR facility available, partly to accommodate interbank settlement needs and thereby limit potential systemic liquidity crises. In discussing possible reactions of a CBA to systemic banking distress, Directors drew attention to the successful actions of the Argentine authorities in protecting their CBA in the aftermath of the Mexican crisis during 1995, which had included, inter alia, setting up specific funds outside the central bank to restructure the banking system. Directors stressed the importance of such actions to safeguard banking sector soundness and preserve the credibility of the CBA.

In order to preserve the credibility of a CBA, any built-in flexibility to carry out central bank functions should be transparent and carefully designed, and only reserves in excess of the currency backing should be used. In particular, such functions should be limited and be accompanied by explicit financial arrangements, such as the creation of a buffer of international reserves, as in Estonia, or contingent credit arrangements, as in Argentina. Such separate financial facilities would give markets confidence in the authorities' ability to undertake the required operations without infringing upon the legal constraints imposed by the CBA.

Directors generally considered that in most cases CBAs should be regarded as a transitional arrangement. Thus, it would be important to consider orderly exit strategies. A suggestion was made to establish at the start of the CBA a target date for exiting the arrangement, with the exit date conditional on achieving specific economic and financial targets. However, some other Directors were concerned that establishing a termination date risked undermining the very credibility that the CBA was intended to strengthen. It was also difficult to establish, a priori, and even ex post, when the necessary credibility would be achieved. In terms of timing, it would, of course, be better for a country to exit from a position of strength rather than weakness. Some Directors thought it was appropriate for a country to exit from a CBA if the economy—and the credibility of the authorities—had strengthened sufficiently to persuade markets that tight discipline would be maintained in the absence of a CBA. One indication of such circumstances might be when there were prospects for the country's currency to appreciate relative to the peg currency. Directors stressed that attempts to exit a CBA under conditions of currency weakness could engender an adverse market response, leading to capital outflows, downward pressure on the exchange rate, and reversal of many of the gains achieved by the CBA. Where a country found the constraints of a CBA excessive, that might well indicate that the underpinning policies had not been sufficient. In those circumstances, it would be preferable to strengthen policies rather than abandon the arrangement. Some Directors considered that a CBA could be a superior permanent arrangement for a few, particularly very small economies. In the case of Hong Kong, it was noted that the CBA was introduced to strengthen credibility in response to the political situation and had proven effective over a sustained period.

Directors believed that the Fund should be prepared to provide technical and financial assistance to member countries with, or wishing to establish, CBAs on the same basis as that for member countries with other monetary–exchange rate arrangements. It was stressed that the Fund should not provide incentives to adopt any particular monetary–exchange rate arrangement. Some Directors considered that the Fund should exercise prudence when recommending CBAs, as the conditions for success were onerous and the costs of failure could be exceptionally high, including for the credibility of the Fund, to the extent that the Fund was seen as having recommended a CBA. In discussing the design of Fund-supported programs under a CBA, Directors noted that rigid policy constraints under a CBA implied that there might be a need for both particularly tight macroeconomic and structural policies, as well as the very strong commitment of the authorities and support of the public to implement those policies. Some Directors also thought that the Fund should assist member countries, if needed, to create new institutions and strengthen existing ones to prepare their economy for an orderly exit in due course from a CBA.

Regarding Fund financial support of CBA-anchored programs, Directors generally considered existing facilities and policies on the use of Fund resources to be adequate. A few Directors thought that there might be grounds for providing additional and/or automatic access in the context of such programs in cases of particularly strong unanticipated liquidity pressures, with an early repurchase expectation once a member had developed an adequate reserve cover, although they also stressed that such support should be extended with great caution. Some other Directors, however, did not believe it was appropriate for the Fund to play the role of lender of last resort to save a CBA, or to introduce any automaticity in the provision of financial assistance, unless it was clearly conditional on well-specified performance criteria: more analysis would be needed before consideration could be given to proceeding further with any such feature in a CBA-anchored program. Directors emphasized that conditionality of Fund assistance should not be compromised under any circumstances, in order to prevent moral hazard and to ensure the member's ability to repay the Fund.

This has been an interesting and rich discussion on a topic that is at the core of the Fund's business. As requested by several Executive Directors, we will continue to think more deeply and discuss the costs and benefits of alternative monetary and exchange rate arrangements. As suggested by several Executive Directors, we will request the staff to prepare a version of the study for publication, which would take into account the views expressed during this seminar.