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Discretion with Rules? Lessons from the Currency Board Arrangement in Lithuania

by

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Abstract

This paper examines the scope for discretionary monetary policy under a currency board arrangement, and argues that any policy flexibility should be used sparingly, if at all. The paper uses the design of the Lithuanian currency board arrangement, introduced in April 1994, and Lithuania's early experience with it, to illustrate the issues that arise. While the monetary authorities may be technically able to influence monetary conditions, it may be difficult to do so without raising questions about the ultimate aims of the authorities. As the currency board arrangement is often used to substitute for loss of the monetary authorities' own credibility, discretionary action risks forfeiting the arrangement's distinctive benefit.

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I. Introduction

From the menu of possible monetary and exchange regimes which nations may adopt, the currency board arrangement is perhaps the one which offers the monetary authorities the least scope for discretionary policies. By requiring that all of the monetary liabilities of the bank of issue be fully backed by convertible foreign assets, the currency board arrangement would appear to sharply circumscribe the authorities' scope for independent monetary policy. Indeed, a wish to remove monetary policy from the sphere of policy debate can be the main reason for instituting such an arrangement. Nevertheless, in the design of such an arrangement, there are options which can give the authorities room for discretionary monetary action or for the exercise of lender of last resort functions.

A range of institutional arrangements encompassing a wide variety of practices have been called currency boards. Nevertheless, the most publicized feature of these arrangements has been the free exchange of currency board liabilities (principally banknotes) without limit at an established exchange rate for the currency against which a peg has been established. This can also be said, in principle, about a conventional fixed exchange rate regime. The features of currency boards which (though not always adhered to) distinguish such an arrangement from a conventional fixed exchange rate are (1) the adoption of a clear and publicly observable monetary rule that links the central bank's monetary liabilities to its foreign assets, and (2) the provision of sufficient foreign exchange reserves to credibly support that rule under any circumstance. These conditions typically constrain the monetary authorities from extending credit to the Government or the banking system. Indeed, this constraint is one of the most conspicuous--and sometimes controversial--features of currency board arrangements.

Currency board arrangements are often introduced when the authorities' policy credibility has been compromised and the introduction of clearly visible rules promises more stable monetary conditions. Under these circumstances, making use of the flexibility available in a currency board arrangement can threaten the credibility gains from the arrangement.

This became uncomfortably evident in Lithuania, the most recent country to introduce a currency board arrangement. Thus, this paper begins with a review of the extended public discussion which preceded the decision to introduce a currency board arrangement in Lithuania, describes the modalities of that arrangement, and recounts the experience during its first year and a half. The way in which Lithuania reached its decisions on why and how to adopt such an arrangement, and the policy course it followed thereafter, shows the apparent trade-offs involved in currency board design and their illusory nature. The analysis that follows identifies the sources of flexibility in the design of currency board arrangements and the hazards created by their use.

II. The Design of a Currency Board Arrangement: The Case of Lithuania

1. The adoption process

Lithuania introduced a currency board arrangement on April 1, 1994, following final Parliamentary passage of the Litas Stability Law (Appendix) and signature into law by the President in March. The Prime Minister had announced an intention to peg the exchange rate, which had been floating, "in the Estonian manner" 1/ at a press conference at the end of October 1993. In between, a lively public debate took place, encompassing many of the features of the prospective arrangement.

The debate over the establishment of a currency board arrangement brought out the views of many different interest groups and intellectuals, some in favor of more, and some of less discretion in the management of the currency board arrangement. The initial impetus came from the Prime Minister, to whom many of those seeking credits from the central bank or depreciation of the exchange rate appealed to get results. The fact that the key policymaker was looking to tie his own hands, and the subsequent support from the Bank of Lithuania Governor who had his own hands tied, underscores the value of such an arrangement to a Government seeking to apply consistent policies to stabilize the economy. Nevertheless, the pressures under which the arrangement would need to be sustained were made clear even as the arrangement was being put in place.

At the time the Prime Minister announced the intention to adopt a currency board arrangement, there was widespread public support for a fixed exchange rate as a result of recent exchange rate volatility. In the seven months following Lithuania's currency reform of October 1992, the currency fell by over 50 percent against the U.S. dollar (from the equivalent 2/ of

1/ A currency board arrangement was introduced in Estonia in June 1992. See Bennett (1993) for a discussion of the Estonian experience.

2/ From October 1992 until June 1993, the currency of Lithuania was the talonas (coupon), which was introduced at par with the ruble. When the litas was introduced in June 1993, all conversions were made at a rate of 100 talonai per litas.

2.5 litai per U.S. dollar to more than 5 litai per dollar). A tightening of monetary conditions in early May 1993 led the exchange rate by mid-August to regain more than half of the value it had lost (to Llt 3.5/US$). At that point, increasingly aggressive Bank of Lithuania exchange market intervention succeeded first at partly reversing the appreciation and then at stabilizing the nominal exchange rate at around 3.9 litai per dollar by the end of October 1993.

The inclination of the Government was to model the prospective currency board arrangement on the Estonian one as closely as possible. The working group appointed by the Prime Minister to draft the Litas Stability Law, 1/ which included IMF staff, 2/ was directed to use Estonia's Kroon Security Law as a model. The resulting draft would have given the selection of an anchor currency and initial exchange rate to a committee composed of the President, Prime Minister, and Governor of the Bank of Lithuania, and included language that "the exchange rate of the Litas cannot be changed."

The idea of a currency board arrangement found little support in the Bank of Lithuania. At the time the idea was first floated, the Bank of Lithuania was under the direction of an Acting Governor. When, in November 1993, a new Governor was appointed, the Bank of Lithuania began to speak out against the currency board concept. The view of the Bank was that an active monetary policy had been successful at reining in inflation and that, after a period of fluctuation, the Bank had become successful at stabilizing the

1/ Prime Minister of Lithuania, Decision #815, December 13, 1993.

2/ Fund staff worked closely with the authorities in the development of the currency board arrangement, providing extensive advice on the policy implications of the arrangement and on the institutional and technical arrangements.

nominal exchange rate under a de facto peg. Hence, the Bank viewed a currency board arrangement as an unnecessary infringement of its prerogatives, both under the Constitution and under existing legislation, in the sphere of monetary management. Indeed, the Governor continued to oppose the arrangement up until the time of its implementation. 1/ In this, he was also supported by the previous Governor of the Bank of Lithuania, who had been removed from office by the Parliament in October 1993.

Also publicly opposed to the Government's proposals for an Estonian-style currency board arrangement, though for different reasons, was the influential president of the Lithuanian Free Market Institute. She argued strongly that only a pure currency board could be sustainable in Lithuania (Hanke and Schuler, 1994). She argued for the effective dissolution of the Bank of Lithuania, proposing that the currency board and its assets be moved abroad, where the Government would be unable to interfere in its operation. In her view, the operation of the currency board arrangement would be most successful if the hands of the Government were fully tied, and the operation of the monetary arrangement were fully transparent, without any room for discretionary policy at all.

Other voices were also heard. One expert, testifying before a parliamentary committee, proposed that a currency board arrangement be established without pegging to any one currency. Instead, he proposed that the value of the litas be continually adjusted in line with the change in the value of the Bank of Lithuania's foreign exchange portfolio, which would

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1/ In an interview a few months after the arrangement was introduced, the Governor spoke out strongly in favor of maintaining the arrangement, and holding the existing exchange rate, given that it was in place.

be invested in a mix of dollar and deutsche mark securities (Fenkner, 1993): in effect, a variable basket of currencies. The Federation of Industrialists, voicing concerns about Lithuania's competitiveness in international markets, expressed a desire for a highly depreciated exchange rate. The Association of Commercial Banks, whose members had been earning large profits trading foreign exchange, opposed the proposal completely.

The Parliament, which began to consider the Litas Stability Law in January 1994, introduced its own concerns. The version of the law which was finally approved differed from the Government draft in important ways. Establishment of the initial peg was to be entrusted to the Government, "in consultation with the Bank of Lithuania." More significantly, the Parliamentarians moved responsibility for changing the rate from themselves (the "cannot be changed" language in the original draft implied that Parliamentary action would be necessary) to the Government, again in consultation with the Bank of Lithuania. 1/

2. Characteristics of the Lithuanian arrangement

The arrangement which was put in place in Lithuania was set up to maintain, to the extent possible, the existing monetary institutions. The Bank of Lithuania was entrusted with the operation of the currency board arrangement, using the existing International Department and Monetary Policy Department to conduct the required operations. While the Bank of Lithuania

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1/ Facing a court challenge to the Bank of Lithuania's Constitutional right to control money emission, the Litas Stability Law was amended in June 1994 to assign the power to change the exchange rate to the Bank of Lithuania "in consultation with the Government".

has developed an alternative presentation for its balance sheet which distinguishes the operation of the currency board arrangement for analytical purposes, there is otherwise no institutional difference between the currency board arrangement and the previous regime. Only licensed banks are permitted to exchange money directly with the Bank of Lithuania, thereby preserving the existing foreign exchange retail network as well. Although credit to the Government was ruled out by the currency board arrangement, this did not represent a change in practice, as the Government had no outstanding credit from the central bank.

Under the arrangement, the Bank of Lithuania provides U.S. dollars both for currency and for all of the other liquid liabilities of the Bank upon demand at a rate of Llt 4 = US$1. These include reserves and other deposits of commercial banks, Government deposits, and litas-denominated correspondent balances of other central banks, and totalled approximately Llt 1.3 billion, or $330 million, at the outset. Reserve requirements, both on foreign currency- and litas-denominated deposits, were retained.

The Bank of Lithuania did not, at the outset, have enough foreign exchange of its own (net of foreign liabilities) to fully cover the liabilities of the currency board arrangement. As a result, the currency board arrangement draws some of its backing from resources borrowed from the Fund under successive arrangements beginning in 1992. The liabilities to the Fund are long term, with maturities of up to 10 years, while potential claims of the currency board arrangement at any point in time are immediate. This makes Fund resources a suitable source of backing for the arrangement, though resources with which to make repurchases from the Fund might need to be sought in due course. In this particular case, however, the deficiency is sufficiently modest that, by retaining the seigniorage revenue (interest earnings on foreign exchange) in the Bank of Lithuania over a number of years, it would be possible to phase out reliance on borrowed resources entirely.

Lithuania's existing gross foreign reserves (including borrowings from the Fund) at the time the currency board arrangement was established were, however, approximately $70 million above the requirements of the currency board arrangement. 1/ While the Bank of Lithuania could, in principle, use these excess funds to further expand the stock of base money by extending credit, it elected to hold them in reserve, instead. Conscious of the inexperience of the banking community in working within a market environment and the financial weakness of many bank customers, the Bank opted to maintain a capability to carry out operations as the lender of last resort, should that prove necessary.

3. Early experience with the arrangement

Immediately following the establishment of the currency board arrangement on April 1, 1994, Lithuania experienced rapid growth in reserve money as foreign exchange poured in through the arrangement: the $50 million inflow in the first two months was equal to over 20 percent of

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1/ That is, the liabilities of the Bank of Lithuania, converted into dollars at the fixed rate chosen, were substantially less than the gross foreign assets of the Bank of Lithuania. Central bank profits, and net repayment on domestic credit outstanding at the time the currency board arrangement was established (equivalent to about US$40 million), may add to this margins over time.

currency in circulation. Thereafter, foreign exchange continued to flow in, at a decreasing rate, through November 1994 (Chart 1).

Given the strong growth in reserve money, the Bank of Lithuania moved to slowly tighten monetary conditions. It did so by gradually reducing the stock of credits outstanding, from the equivalent of about $40 million when the currency board arrangement went into effect to $25 million by mid-1995, rolling over some maturing credits but accepting repayment on others.

In the face of the rapid remonetization of the economy that accompanied the stabilization of the economy, the Bank of Lithuania built up its surplus foreign reserves still further, by adding fresh purchases from the Fund to international reserves as well as by reducing currency board obligations by accepting loan repayments on old loans. This was done principally in order to maintain lender of last resort capabilities equal to around 15 percent of total deposits in the banking system. This capability was not put to use until mid-1995, however, despite the failure of several small banks, and then only in a very limited way. 1/

Despite this otherwise prudent stance, however, late 1994 saw the Lithuanian authorities attempt to stretch the bounds of the currency board arrangement in several ways. First, the largest bank in Lithuania (the Bank of Agriculture) was given, in exchange for a $12.5 million loan to the state energy system, an offsetting exemption from reserve requirements. Second,

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1/ In mid-1995 a medium-size bank experienced difficulties which, when reported in the press, led to substantial depositor withdrawals. At that time, the Bank of Lithuania provided modest liquidity loans, most with Government guarantee. There appears to have been little effect on the operation of the currency board arrangement as a result of this operation, however.

banks were permitted in late December to count newly-issued Treasury bills--about $12 million of such bills were placed with banks--towards reserve requirements. 1/ These exceptions to the reserve requirement regulations did not undercut the currency board arrangement directly--though they certainly went against its spirit--but were substantial in relation to aggregate reserve requirements at the end of 1994 (which were the equivalent of around $90 million). Additionally, in a further compromise of the spirit of the arrangement, in December the Government decided to borrow $30 million from a German bank, pledging foreign exchange reserves of the Bank of Lithuania as collateral. 2/

It is possible that these actions could have been taken without disturbing the markets in a period of calm. Unfortunately, they were undertaken at a time when other developments were bringing the future of the currency board arrangement into question. Beginning in mid-November 1994, rumors of an impending devaluation of the litas led to an outflow of foreign exchange from the Bank of Lithuania. Occasional devaluation rumors during the first eight months of the arrangement had passed with only a brief slowdown in foreign exchange inflows. This time, however, the rumor was accompanied by disquieting statements by central bank officials suggesting the authorities might not be committed to maintaining the existing parity. In addition, an open letter signed by 32 of the 141 Members of Parliament calling for a devaluation of the currency and the placement of Lithuania's

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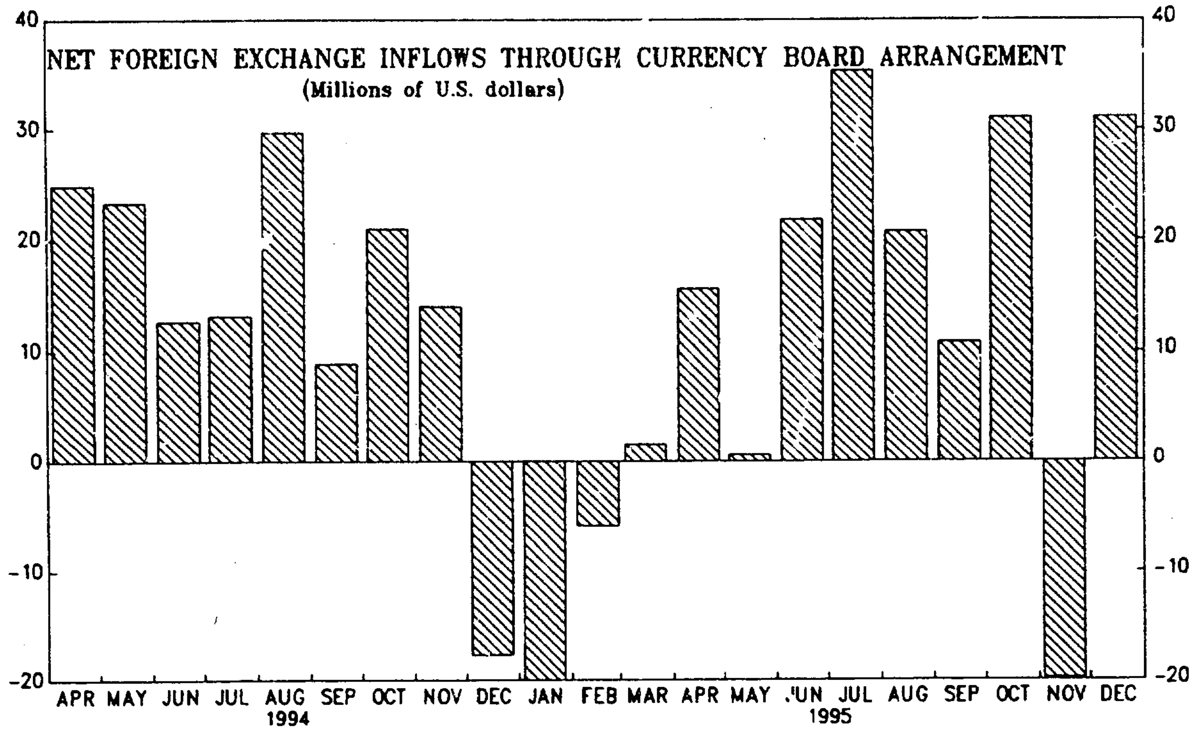
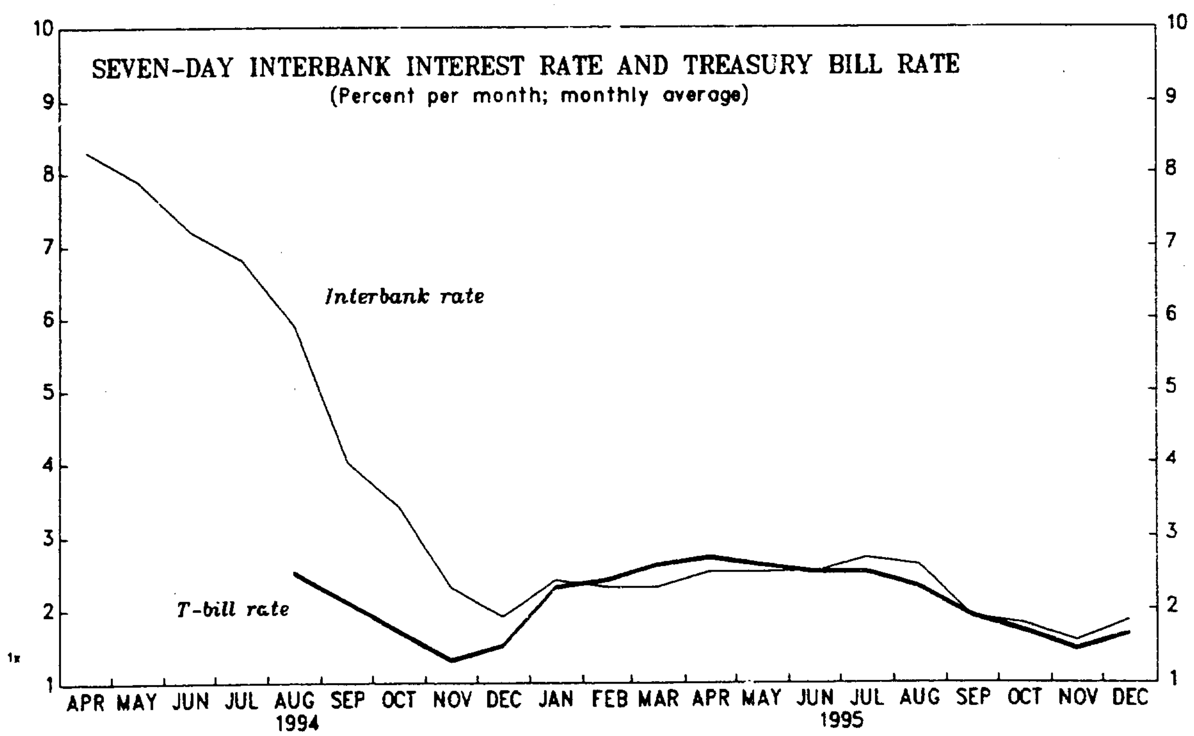
1/ This was tantamount to a relaxation of reserve requirements. It was, however, quickly discontinued, once it became clear that the rule change did not significantly increase the bids at the treasury bill auctions.

2/ This loan was ordered repaid prior to term (by end-1995) under a Government resolution approved in June 1995.

CHART 1
LITHUANIA
OPERATIONS OF CURRENCY BOARD





Sources: Data provided by the Lithuanian authorities; and staff estimates.

foreign exchange reserves with domestic banks, was published in the press in early December. Despite the deteriorating situation, neither the Government nor the Bank of Lithuania spoke out to reassure the market of their intentions regarding the future of the exchange system. With the three attempts to squeeze financing for the public sector from the monetary system further undermining confidence, the foreign exchange outflows became substantial, with $50 million leaving the Bank of Lithuania between mid-November and mid-February. Only at that point did the authorities issue a strong and categorical denial of a pending devaluation and speak out in support of the currency board arrangement and the existing exchange rate.

Following that denial, foreign exchange outflows promptly ceased, and $20 million flowed back in between mid-February and the end of April 1995. In April, reserve requirements were lowered from 12 percent to 10 percent of bank deposits. This loosening of monetary conditions had a direct impact equivalent to about $16 million (about 4 percent of currency board liabilities). This time, however, there were no other indications that the arrangement was under threat (the reduction in reserve requirements was undertaken to improve the efficiency of the financial system, and had been under consideration since early 1994). Hence, this increase in banking sector liquidity only affected net inflows in May, which were close to nil; inflows rebounded strongly in June and July.

Nevertheless, the credibility of the arrangement had been shaken by the event of Winter 1995, and the confidence in the its future remained fragile. While interest rates on Treasury bills rose from 15-20 percent per annum in October-November 1994 to 25-30 percent by mid-December, these rates remained at the higher level for months after the devaluation rumors were dispelled. Thus, even though the authorities were able to quickly halt the capital outflows, they still had to pay a price for the period of policy drift, both in terms of their own policy credibility and, tangibly, of the cost of Government debt.

III. Currency Board Design and the Scope for Discretionary Action

There are many choices that must be made once the decision to implement a currency board arrangement is made: the selection of an anchor currency and the rate of exchange against it; the degree of foreign exchange backing to provide; how to administer the arrangement; and many others. 1/ One of the most important, as the Lithuanian experience shows, is how much flexibility to give the monetary authorities in influencing monetary conditions.

One of the advantages often cited for currency boards is the benefit of effectively adopting an existing stable currency as one's own while at the same time collecting seigniorage by investing the assets of the currency board in interest-bearing securities (see, for example, Fischer (1982) and Fieleke (1992)). Many currency boards have been limited to this pure seigniorage-catching form. The much-cited North Russian currency board set up by Keynes, which, because it was based in London, was able to pay off note-holders even after the victory of the Reds in the Russian Civil War, was indeed one of these. The design of other currency board arrangements, however, including Hong Kong, Argentina, Estonia, and a number of the

1/ Most of these issues are succinctly discussed in Bennett (1994).

colonial currency boards that operated in the heyday of this type of arrangement (Fieleke, 1992), include various features that depart from a pure currency board. In that, they resemble in varying degrees a conventional pegged exchange rate.

1. Flexibility in Currency Board Design

Deviations from the classical currency board model result in a spectrum of arrangements. What they all share, however, is a commitment to eschew the creation of fiat money. The centrality of this point can be analyzed by enumerating and examining the principal institutional features of a currency board arrangement: (1) a fixed exchange rate against an anchor currency; (2) unrestricted convertibility; (3) foreign exchange backing for high-powered money. None of these features is indispensable to this type of arrangement, and most currency board arrangements make use of the flexibility gained by deviating from one or more of these features. The need to maintain the integrity of the arrangement, however, has meant that no currency board arrangement has abandoned all three. Doing so would almost certainly call into question the authorities' will to adhere to the central principle of renouncing the creation of fiat money, as far lesser deviations by the Lithuanian authorities seem to demonstrate.

Fixed exchange rate. A fixed exchange rate against an anchor currency--particularly a strong one--plays a special role for currency board arrangements. The fixity of the exchange rate can be an important element in building public confidence in a currency board arrangement. 1/ It is readily observable in a way that a currency basket approach to fixing (as was part of one currency board proposal in Lithuania) is not, and provides the public with certainty about the value of the domestic currency. Where currency boards are instituted in response to a loss of confidence in the policies of the authorities, this factor can prove important to the ultimate success of the arrangement.

Unrestricted convertibility. Exchange controls are not necessarily incompatible with a currency board arrangement. However, the advantages of the currency board arrangement--stable prices for tradeable goods and interest rate convergence with the anchor currency--will be more readily attained with a liberal system, and free capital mobility is also likely to reduce the risk-based interest rate differential against the anchor currency. At the same time, a liberal exchange system may serve as a visible signal of the authorities' faith in the exchange arrangement, and increase public confidence in the currency board. 2/

Foreign exchange cover for high-powered money. This is a condition which is satisfied by all currency boards at the margin. That is, increases in

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1/ With a restriction on the creation of fiat money, a currency board without a fixed exchange rate could, in principle, continue to create monetary base by depreciating the currency. Full foreign exchange backing can provide the market with a certain degree of confidence that a sharp drop in the exchange rate cannot be generated by speculative attack. The Monetary Authority of Singapore is seldom referred to as a currency board precisely because it does not have a fixed exchange rate, though it does provide full cover.

2/ Capital controls were imposed in Estonia in 1992/93, with the intention of preventing capital outflows from causing a run on the currency board. These restrictions, however, were removed within 18 months in the interest of greater capital mobility.

reserve money must be matched by a corresponding inflow of foreign currency. It is not, however, always true for the initial stock of high-powered money. Looking to the past, the interwar East African Currency Board suffered heavy losses in the introduction period due to broken cross rates among the multiple currencies it was replacing. Without full backing for the currency on hand, the Government issued an explicit pledge to borrow in London if necessary to meet demands on the currency board. This pledge was itself sufficient to permit the continued operation of the arrangement. More recently, the Argentine currency board is permitted to employ a limited amount of government securities as backing. The Lithuanian currency board arrangement, as we have seen, relies on resources borrowed from the Fund to ensure full backing for the liabilities of the Bank of Lithuania under the arrangement. These examples suggest that the credibility of the arrangement need not be jeopardized by the use, <u>ex ante</u> or <u>ex post</u>, of borrowed resources.

Thus, so long as the public has confidence in the primacy of its monetary claims on the assets of the monetary authority, full backing may not be necessary. Less-than-full backing may indeed be sufficient to defeat even a heavy speculative attack. Since a loss of currency board reserves is matched by a contraction in reserve money, an automatic tightening of monetary conditions will occur. This stands in marked contrast with conventional fixed rate systems, where the monetary authorities will often sterilize their foreign exchange losses in order to prevent such a contraction.

2. The Scope for Discretionary Action

Under many currency board arrangements, the authorities can and do manipulate monetary conditions to some degree. These most commonly take the form of day-to-day smoothing operations, as in Argentina and Hong Kong. The technical ability of the authorities to conduct effective monetary operations under a currency board arrangement requires only imperfect capital mobility. Moreover, even under a currency board arrangement--and in the absence of capital controls--perfect capital mobility may remain elusive. 1/

The Lithuanian experience is instructive in showing how liquidity can be injected into an economy under a currency board arrangement. Broadly speaking two channels, common to almost all monetary systems, can be used. First, changing reserve requirements: lowering them creates excess reserves for banks, while raising the requirement reduces them. 2/ In the case of Lithuania, and of Estonia as well, performance criteria under successive Fund arrangements have been applied to the required reserve ratio in order to assist the authorities to resist pressures for monetary easing through this channel.

The second major channel for altering bank liquidity is through the direct injection or withdrawal of bank reserves, whether through open market operations or by more direct means. In principle, any market participant

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1/ For example, capital mobility would be constrained if market participants have suspicions about the durability of the exchange rate peg. In this instance, it may be difficult to compensate investors perfectly through interest rate differentials for the risk of a large discrete move in the exchange rate.

2/ It also will affect the money multiplier, changing the stock of broad money that can be supported by a given stock of high-powered money.

would have an equal opportunity to alter monetary conditions by triggering an unusually large foreign exchange inflow or outflow. In practice, however, not only is the central bank in a better position to use its own foreign exchange (and foreign exchange it may be able to borrow) for this purpose, but it may also have additional instruments not available to others.

The important difference in the case of currency board arrangements is that this is not a symmetric tool for the monetary authorities, as injecting liquidity is more problematic than draining it. Under a currency board arrangement, with no creation of fiat money, any injection of liquidity would require foreign assets which could be converted into domestic money. Monetary authorities operating a currency board arrangement may come by the necessary resources for this purpose in a variety of ways. Not only do many currency board arrangements have funds set aside in excess of currency backing, but most central banks can borrow substantial amounts in international markets with which to inject liquidity through the currency board arrangement.

Liquidity may, of course, be drained from the system without having a stock of foreign exchange not yet committed to the currency board arrangement. In currency board arrangements which are established on the basis of a preexisting central bank, there would typically be, as there were in Lithuania, outstanding credits to banks, which would reduce base money and tighten monetary conditions if they were repaid and not lent out again. The monetary authorities may also issue certificates of deposit or other securities to drain liquidity.

While the monetary authorities of a currency board arrangement may have the capacity to drain or to inject substantial amounts of liquidity, it is unclear what the value of such activity would be, beyond smoothing short-term fluctuations. These actions may be effective means of reducing inflation in the short run--or of providing added credit for government purposes, as occurred in Lithuania. However, the visible use of these instruments, as in Lithuania, may raise questions about possible reversals of policy and the authorities' commitment to the automatic adjustment mechanisms of the currency board arrangement.

The currency board is a tool to establish credibility of a nation's money by providing full backing for the currency and by removing the element of discretion from the authorities, typically in order to boost confidence in the durability of the exchange rate. Extensive and public manipulation of monetary conditions would undermine the attainment of these objectives. Indeed, Lithuania, and Estonia as well, has limited its own freedom in this regard by making public their commitments, under programs with the Fund, not to inject liquidity in such a manner. The important question for a monetary authority operating a currency board arrangement may therefore not be <u>how</u> to act effectively, but <u>whether</u> to act at all. The greatest challenge may be to <u>credibly</u> renounce the scope for independent action that is available.

IV. <u>Conclusions</u>

There is a continuum of options for the design of a monetary and exchange regime which lie in between a pure, seigniorage-catching currency board and a conventional fixed exchange rate arrangement. The debate as to how much independence there may be in monetary policy without endangering a conventional exchange rate parity is a subject of longstanding discussion, and is beyond the scope of this paper. However, although there is certainly some scope for discretionary monetary policy within the framework of a currency board arrangement, such activity is fundamentally at odds with the purpose of a currency board. Any such activity should be sharply circumscribed, and at most limited to smoothing fluctuations in money demand on a day-to-day basis. The experience of Lithuania, where the authorities briefly subverted the spirit of the arrangement and permitted their commitment to the currency board arrangement's exchange rate peg to be questioned, illustrate the dangers of pursuing flexibility too far. In such a case, the value of the currency board regime as a builder of credibility is reduced, and the unique advantages of such an arrangement may be squandered.

Appendix

The Litas Stability Law 1/

Article 1: Guaranteeing the Credibility of the Litas

The Litas put into circulation by the Bank of Lithuania if fully covered by gold and foreign exchange reserves of the Bank of Lithuania.

Article 2: The Amount of the Litas in Circulation

The Bank of Lithuania shall guarantee that the total amount of the Litas put into circulation does not exceed the gold reserve (at market prices) and foreign exchange reserves (according to the official exchange rate of the Litas) of the Bank of Lithuania at any time.

The total amount of the Litas put into circulation shall consist of:

(1) bank notes and coin in circulation;
(2) the sum of the balances of nominal accounts of other banks and holders of litas accounts kept with the Bank of Lithuania; and
(3) the sum of the securities and other promissory notes of the Bank of Lithuania in Litas.

Foreign exchange reserve shall consist of:

(1) bank notes and coins of convertible currency held by the Bank of Lithuania;
(2) the amount of convertible currency held by the Bank of Lithuania in the correspondent accounts in foreign banks and the International Monetary Fund; and
(3) promissory notes, certificates of deposit, bonds, and other debt securities payable in convertible currency, which are held by the Bank of Lithuania.

The Bank of Lithuania may change the total amount of the Litas in circulation only by changing gold and foreign exchange reserves respectively.

Article 3: The Official Exchange Rate of the Litas

The official exchange rate of the Litas shall be established against the currency chosen as the anchor currency.

1/ Law of the Republic of Lithuania I-407, as enacted March 23, 1994. Official translation. Note that the law was amended slightly in mid-1994; see text for details.

The official exchange rate of the Litas and the anchor currency shall be established or changed by the Government of the Republic of Lithuania upon coordination with the Bank of Lithuania.

Article 4: The Exchange of the Litas

The Bank of Lithuania shall guarantee to the extent of its gold holdings and foreign exchange reserves free exchange of the litas specified in Paragraph 2 of Article 2 into the anchor currency according to the official exchange rate of the Litas, as well as free exchange of the anchor currency into the Litas within the territory of the Republic of Lithuania.

Other foreign currencies shall be exchanged into the litas and litas shall be exchanged into other foreign currencies according to the market exchange rate.

Maximum amounts of charges for exchange operations shall be established by the Bank of Lithuania for all banks.

Commercial banks shall be liable under the law for the violation of the procedures of exchange operations.

Article 5: Information on the Litas

The Bank of Lithuania shall publish information on the total amount of litas in circulation, gold holdings and foreign exchange reserves in the "Valstybes zinios" (Government Records) at least once a month.

Article 6: Entry into Force

This law shall become effective as of 1 April 1994.

Article 7: Validity of the Law of the Bank of Lithuania and the Statute of the Bank of Lithuania

The Law of the Bank of Lithuania and the Statute of the Bank of Lithuania shall be valid until the adoption of a new law of the Bank of Lithuania and to the extent it complies with the provisions of this law.

I promulgate this law adopted by the Seimas of the Republic of Lithuania.

/s/
Algirdas Brazauskas
President of the Republic

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