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ON EXTENDING THE CURRENCY BOARD PRINCIPLE IN BULGARIA: LONG LIVE THE CURRENCY BOARD

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About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Founder and Co-Director of The Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu).

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In the past, Prof. Hanke taught economics at the Colorado School of Mines and at the University of California, Berkeley. He served as a Member of the Governor's Council of Economic Advisers in Maryland in 1976-77, as a Senior Economist on President Reagan's Council of Economic Advisers in 1981-82, and as a Senior Advisor to the Joint Economic Committee of the U.S. Congress in 1984-88. Prof. Hanke served as a State Counselor to both the Republic of Lithuania in 1994-96 and the Republic of Montenegro in 1999-2003. He was also an Advisor to the Presidents of Bulgaria in 1997-2002, Venezuela in 1995-96, and Indonesia in 1998. He played an important role in establishing new currency regimes in Argentina, Estonia, Bulgaria, Bosnia-Herzegovina, Ecuador, Lithuania, and Montenegro. Prof. Hanke has also held senior appointments in the governments of many other countries, including Albania, Kazakhstan, the United Arab Emirates, and Yugoslavia.

Prof. Hanke has been awarded honorary doctorate degrees by the Bulgarian Academy of Sciences, the Universität Liechtenstein, the Universidad San Francisco de Quito, the Free University of Tbilisi, Istanbul Kültür University, Varna Free University, and the D.A. Tsenov Academy of Economics in recognition of his scholarship on exchange-rate regimes. He is a Distinguished Associate of the International Atlantic Economic Society, a Distinguished Professor at the Universitas Pelita Harapan in Jakarta, Indonesia, a Professor Asociado (the highest honor awarded to international experts of acknowledged competence) at the Universidad del Azuay in

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On Extending the Currency Board Principle in Bulgaria: Long Live the Currency Board

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The year 1997 was both the worst and best of years for Bulgaria. The year started badly. In February, Bulgaria's hyperinflation peaked at the fantastic rate of 242% per month (Hanke and Krus, 2013). Then, things dramatically changed for the better. On July 1st, a currency board law was adopted, and the Bulgarian National Bank (BNB), specifically its Issue Department, began to operate under currency board rules. These rules required the lev to be fully backed by Deutschemark reserves (now euro reserves) and to freely trade at a fixed exchange rate with the Deutschmark (Hanke, 2016). With that, the lev became a clone of the Deutschmark, and good news followed:

- The currency board results were immediate and dramatic. The annual inflation rate collapsed to 13% by mid-1998. Interest rates collapsed, too, with the BNB basic rate falling from above 200% in early 1997 to 5.3% in October 1998. And, that is not all. The demand for the lev that the new currency board issued soared. And, as night follows day, the foreign reserves at the BNB soared, too. After all, the only way lev could be obtained was by exchanging Deutschmarks for lev at the stated fixed rate of exchange. The BNB's foreign reserves rocketed from $864.26 million USD at the end of 1996 to $2,485.36 million USD at the close of 1997 (Hanke, 2000).

- In addition to these immediate, positive results, Bulgaria's currency board allowed Bulgaria to weather all post-1997 external financial crises—including the collapse of the Russian ruble in 1998, the Greek Financial Crisis of 2009, and the Great Recession of 2009 (Hanke, 2018).

- The currency board also allowed Bulgaria to weather the 2014 banking collapse of the Corporate Commercial Bank (KTB) (Hanke and Sekerke, 2014). Yes. The KTB catastrophe was not caused by the currency board system (the BNB's Issue Department), but by the failure of the Banking and Supervision Departments of the BNB to properly regulate and monitor the KTB. Unlike most cases in which banking and currency crisis are joined at the hip, the KTB crisis did not disturb Bulgaria's currency. Thanks to the currency board system, Bulgaria did not witness a typical banking-currency crisis. Indeed, the crisis was restricted to the banking sector. So, Bulgaria's currency board mitigated the damage that accompanied the collapse of the KTB.

- Importantly, the currency board imposes fiscal discipline on Bulgaria's politicians and fiscal authorities because the government cannot borrow from the currency board (BNB's Issue Department). In consequence, since the installation of the currency board in 1997, fiscal deficits have been tightly controlled, and the level of Bulgaria's debt relative to its GDP has plunged. Indeed, Bulgaria's fiscal discipline and debt reduction have made Bulgaria a star fiscal performer in the 28-country European Union (Hanke, 2002 & 2018).

- The geopolitical aspects of Bulgaria's currency board should not be allowed to pass without mention. As former President Petar Stoyanov confided to one of us (Hanke): Bulgaria would have had much more difficulty entering the North Atlantic Treaty Organization (NATO) in 2004 and the European Union in 2007 if it were not for the confidence and stability created by Bulgaria's currency board (Hanke, 2016).

- It is not surprising that Bulgaria's currency board is highly respected and supported by the populace. Bulgarians are rightly proud of their lev and what is the most important post-communist Bulgarian institution: the currency board system (Hanke, 2018).

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With this record in the currency sphere, it is rather shocking that Bulgaria finds itself adrift, like a barge lazily floating down the Danube, occasionally putting out a boat-hook to avoid collisions, but a barge adrift nevertheless. In consequence, instead of Bulgaria running its own currency show, Brussels appears to be running the show. Yes. At present, Bulgaria, under directions from Brussels, is actually contemplating abandoning its own currency, the lev, and its currency board (BNB's Issue Department). These would be replaced by the euro and the European Central Bank (ECB). Such a dramatic move raises a number of troubling questions:

- Why would Bulgaria want to try to fix something that is not broken? No smart person would attempt to do so. Polling data indicate that Bulgarians are "smart." They are not too keen about the idea of abandoning their beloved lev and replacing it with the euro. This sentiment among the public should give Bulgarian politicians cause for concern about the potential adoption of the euro.

- Why in these times, when nationalist sentiments are running high, would Bulgaria contemplate giving up its monetary sovereignty? Indeed, the Bulgarian populace knows that by formally joining the eurozone, Bulgaria would give up its national sovereignty over its monetary system. This sovereignty is valuable, particularly if the euro encounters troubles. If that happens, Bulgaria could immediately switch its currency board's anchor from the euro to a superior anchor currency. Furthermore, Bulgaria could make this switch without asking for any other country's or organization's permission because, with its currency board, Bulgaria retains full sovereignty over its monetary system.

- Why would Bulgaria want to join and be locked into a club whose very future is uncertain? Formal entry into the eurozone would be like checking into the "Hotel California." That was the title of the Eagles hit song of 1976. As the Eagles' lyrics put it, "You can check out anytime you like, but you can never leave." At this time, the only country that could check into and then check out of the eurozone is Denmark. It has obtained a valuable opt-out option, something Bulgaria does not have and will never obtain.

- Why would Bulgaria want to incur the costs required to formally enter the eurozone? For example, when Lithuania abandoned its currency board and currency, the litas, to join the eurozone in 2015, Lithuania transferred a total of EUR 43,051,594 as part of its contribution to the ECB's capital. In addition, it transferred EUR 338,656,541 to the ECB's foreign assets, and EUR 162,454,493 into the ECB reserves and provisions. These transfers constitute a cost because these funds—once transferred to the ECB—while still Bulgarian assets, are tangled up in a web of ECB/EU rules and politics. So, a loss in freedom and flexibility accompanies the transfer of funds required for formal eurozone entry. (Lietuvos Bankas 2016 & Eesti Pank 2018).

- Why would Bulgaria want to give up known rules of the road and fiscal discipline for a moral hazard that encourages bad fiscal behavior? Yes. Entry into the eurozone brings with it a moral hazard, one that is not associated with a currency board. Just look at Greece. Interestingly, maybe that is exactly what some Bulgarian politicians who advocate formal membership in the eurozone are dreaming about. Maybe they are tired of the tight straitjacket that the currency board makes them wear. Of course, the Bulgarian populace likes the straitjacket feature of the currency board. Indeed, that is probably why the public justifiably harbors concerns about the adoption of the euro and the discarding of the currency board's straitjacket.

- Why would Bulgaria be pursuing formal entry into the eurozone when Bulgaria is already part of a unified currency area: the eurozone? Yes. By virtue of the fact that the lev is a clone of the euro, Bulgaria is in the eurozone, and it is "in" without having to carry the burden of any of the costs associated with formal entry.

- Does it make sense for Bulgaria to be contemplating entry into a club that is employing different standards for entry for Bulgaria than those that have been used for other members? Great care is required when dealing with organizations that apply double standards. Both Estonia and Lithuania employed currency board systems. These systems were similar to Bulgaria's and, not surprisingly, produced similar results. One of us (Hanke) knows this first hand as he was deeply involved in the design and implementation of all three currency board systems. But, when Estonia (in 2011) and Lithuania (in 2015) adopted the euro, it was clear sailing, as it should have been. After all, they were already both part of a unified currency area—the eurozone—as is Bulgaria. But, for mysterious reasons, the standards for formal entry into the eurozone that are being applied to Bulgaria are different than those that were applied to Estonia and Lithuania. Indeed, it has not been clear sailing for Bulgaria. In May 2019, Bulgaria was denied the right to enter ERM-2 by the European Commission. This suggests that, even if Bulgaria was to formally enter the eurozone, Bulgaria would risk not being treated on the same footing as other members.

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This brings us back to the KTB fiasco and Bulgaria's commercial banking sector. Thanks to Bulgaria's currency board, the damages associated with the collapse of KTB were mitigated (Hanke, 2018). Indeed, the KTB banking crisis did not spill over into a currency crisis, too. Accordingly, a typical banking and currency crisis was avoided. But, the damages were significant nevertheless. Importantly, the KTB was never, in fact, a commercial bank. If the KTB had been operated according to commercial banking principles, it would have been virtually impossible for KTB to destroy value on the scale witnessed by the independent auditors. As of 30 September 2014, the auditors estimated that 76% of the asset value in KTB's non-financial loan portfolio, which accounted for 80% of KTB's assets, had been lost. The KTB audit report tells a story in which KTB blatantly ignored the basic pillars of commercial lending. According to the report, there is little evidence that initial loan underwriting and subsequent credit monitoring ever took place at KTB. Indeed, the auditors stated that KTB lied to and misled BNB banking supervisors and engaged in transactions with no evident commercial purpose (Hanke and Sekerke, 2014).

The economic fallout from KTB was significant. Deposits had been guaranteed by the Bulgarian Deposit Insurance Fund (BDIF). But, the BDIF was undercapitalized. So, the government was forced to go to the international bond market to raise funds to recapitalize the BDIF so that it could meet its obligations to KTB depositors. In consequence, there were negative fiscal effects.

In addition, there were negative monetary effects following the collapse of KTB. Bulgaria's money supply measured by M3 from June 2014 to November 2014 actually contracted by 3.27%. And, credit to the private sector in Bulgaria contracted by a stunning 11.18% from June 2014 until May 2015. These contractions slowed Bulgaria's economy down.

It will not be banking supervisors and regulators, whether they are from Bulgaria or the European Union, who will ensure that banking problems of this magnitude do not occur in the future. No. Safety will be ensured by changing the rules that govern Bulgaria's banks.

As it turns out, the new rules were proposed by one of us (Hanke) over two decades ago on 1 February 1997 at the World Economic Forum in Davos, Switzerland (Hanke and Burstein, 1997). The proposal was to establish a currency board in Bulgaria and to extend the currency board principle into the commercial banking sphere. This proposal harks all the way back to the great British economist David Ricardo and the 1844 Bank Act that governed the Bank of England and British banks. So, it is not new, and it is widely recognized. Indeed, no less of an authority than a high priest of economic theory, Nobel laureate Sir John Hicks, did so in 1967 (Hanke, 2002).

If currency board rules were extended into the commercial banking sphere, the banks would be required to operate under currency board rules. Accordingly, the banks would have to fully back the demand deposits they accept with reserves. These required reserves would be deposited at the BNB, and the BNB would pay a market rate of interest on them. Under 100%-reserve banking, banks that accept deposits would essentially be transformed into money-market mutual funds. With lev bank deposits covered by 100%-lev reserves, bank money would be just as safe and sound as currency board money. Note that there are several ways in which currency board principles could be extended into commercial banking. In what follows, we only present the outlines of one of them.

Under 100%-reserve banking, depositors would no longer have to live in fear of being unable to withdraw their deposits because banks would have the liquid reserves to cover all withdrawals. Banking panics, system-wide banking crises, and taxpayer bail-outs would be things of the past. So, the BDIF and government insured bank deposits would be redundant and, therefore, unnecessary.

Another important advantage of 100%-reserve banking is that banks would need very little equity capital to cover the small risks associated with the matching of their assets and deposits. This makes the 100%-reserve system particularly well suited for Bulgaria, where banks have a history of being undercapitalized.

If the currency board principle is applied to both base (currency board) and bank money, all money would be sound. But how would credit be supplied? Merchant, or investment, banks would assume that function. They would intermediate savings and generate credit (not money) by issuing shares and subordinated debt instruments (unsecured bonds that have low-ranking claims on a company's earnings and assets). It is important to note that the merchant banking functions could be carried out by separate stand-alone merchant banks. Or, they could be carried out within existing commercial banks if those banks segmented and fire-walled their balance sheets into deposits that were fully reserved and investments that could be lent out.

This approach allows for expanding credit flows while separating money from credit. By doing so, safety and soundness would be injected into the credit circuit. Shareholders would provide an important source of market discipline to the merchant banks because the owners of these banks would risk losing their investments in the case of merchant bank failure.

The other element in the merchant banks' capital structure would, at least initially, be provided by subordinated debt. This debt also provides an attractive source of market discipline because, as distinct from depositors, the holders of capital notes cannot withdraw their funds on demand when bad news surfaces. The holders of subordinated debt, therefore, have an incentive to prefer safe, conservatively managed merchant banks. Investors will only purchase riskier capital notes at significantly higher interest rates, and these higher rates (the cost of capital) will impose a strong market discipline on risky merchant banks.

Again, merchant banking is nothing new. Indeed, it has a rich history. The names Baring, Rothchild, Hambro, Lazard, Schroder, Warburg, and Morgan all go hand-in-glove with merchant banking. The record of merchant banking is long and notable.

Bulgaria should stop aimlessly drifting into troubled waters. A Bulgarian captain must take control of the money and banking tiller and steer the "barge" into safe waters. Money and banking safety and soundness can be found by retention of Bulgaria's currency board system and by extending it into the sphere of commercial banking.

Baltimore
17 June 2019

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