A gold-based currency board, please

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Until early in the 20th century, gold played a central role in the world of money. Gold had an incredible run – almost three thousand years. And why not? After all, Professor Roy Jastram convincingly documents in The Golden Constant just how gold maintains its purchasing power over long periods of time.

But, since President Richard Nixon closed the gold window in August 1971, gold has not played a formal role in the international monetary regime. Today, the "regime" is characterized by many as a chaotic non-system.

In the past decade, gold prices have surged and there have been noises in some quarters that gold's formal role should be re-established in the sphere of international money. Nobelist Robert Mundell has gone so far as to predict that "Gold will be part of the structure of the international monetary system in the twenty-first century."

Automatic Currency Boards versus Central Banks

Gold-based currency boards could transform Professor Mundell's prediction into a reality. Currency boards have existed in more than 70 countries and a number are still in operation today. Countries with such monetary institutions have experienced more fiscal discipline, superior price stability, and higher growth rates than comparable countries with central banks.

An orthodox currency board is a monetary institution that issues notes and coins (some currency boards have, however, also accepted deposits). Its monetary liabilities are freely convertible into a reserve currency (also called the anchor currency) at a fixed rate on demand. The reserve currency is a convertible foreign currency or a commodity chosen for its expected stability. For reserves, such a currency board holds low-risk, interest-earning securities and other assets payable in the reserve currency. Its reserves equal 100 percent or slightly more of its notes and coins in circulation, as set by law.

An orthodox currency board has no active role in determining the monetary base. A fixed exchange rate with the reserve currency and the requirement that the currency board hold foreign reserves equal to 100 percent of the monetary base prevents it from increasing or decreasing the monetary base at its own discretion. Nor does a typical currency board influence the relationship between the monetary base and the money supply by imposing reserve ratios or otherwise regulating commercial banks. An orthodox currency board system is passive and is characterized by automaticity. Regardless of the metric used, the money supply in a typical currency board system, therefore, is determined entirely by market forces—that is, the demands of money users who bring reserve currency to swap for local currency determine the amount of notes and coins that the currency board supplies.

In a currency board system and in a central banking system alike, commercial banks are entrepreneurs of credit. A commercial bank cannot lend more to borrowers than it can

borrow from depositors (or credit markets), in the form of deposits held instead of spent. If a commercial bank lends excessively, the borrowers spend the excess, for instance, by writing cheques. In the payments system, more funds flow out of the bank than flow into the bank. To prevent the outflow from bankrupting it, a commercial bank holds reserves. The loans of commercial banks are limited by their need to maintain sufficient reserves to enable depositors to convert deposits into cash (or reserves) on demand and to withstand outflows of reserves through the payments system.

A typical central bank, in contrast, can at its discretion increase or decrease the monetary base. It can lend to commercial banks, creating reserves for them, even if its foreign reserves are decreasing. More reserves tend to enable commercial banks to make more loans, which they do by creating deposits for borrowers. The money supply then increases. Decreasing the monetary base tends to have the opposite effect. Besides changing the monetary base, a typical central bank can also influence the supply of commercial bank loans by changing the reserve requirements for commercial banks.

Despite the inability of an orthodox currency board to create reserves for commercial banks at its own discretion, the money supply in a typical currency board system is quite elastic (responsive) to changes in demand, because the system can acquire foreign reserves. The rules governing a currency board merely prevent it from creating reserves for commercial banks in an inflationary manner, as a central bank can. Other sources of elasticity in the money supply are variability in commercial banks' ratio of reserves to deposits, the pooling of reserves among branches of commercial banks in the currency board country and the reserve country, interbank lending, and variability in the public's deposit-to-cash ratio.

In the past, currency boards have issued monetary liabilities that were fully backed by gold and were fully convertible into gold at a fixed rate on demand. The following gold-based currency board law is presented to indicate how a modern, independent, gold-based currency board could be established and would operate. As drafted, the law would allow for the creation of a publically-owned entity. But, with slight amendments, the draft law could support the establishment of a purely private currency board.

A Gold-Based Currency Board Law

1. The Currency Board of Country *X* ("the Board") is hereby created. The purpose of the Board is to issue notes and coins denominated in a gold currency unit, and to hold foreign reserves sufficient to maintain them fully convertible at a fixed exchange rate into gold.

2. The Board shall have its legal seat in Switzerland and shall be subject to the laws of Switzerland.

3. a. The Board shall be governed by five directors. Three directors shall be citizens of countries other than Country *X* , appointed by the Bank for International Settlements in Basel, Switzerland; by the World Gold Council; or a similar suitable organization, as determined by supplementary legislation. Two directors shall be citizens of Country *X*, one appointed by the Government of Country *X* and one by the Bankers Association of Country *X*. The directors appointed by the BIS shall not be employees of governments or multigovernmental organizations
   b. A quorum shall consist of three of the Board's directors, including the director chosen by the Government of Country *X* or the director chosen by the Bankers Association of Country *X*. Decisions shall be made by majority vote, except as specified in paragraph 15.
   c. The first director appointed by the Government of Country *X* shall serve a term of one year. The first director appointed by the Bankers Association of Country *X* shall serve a term of four years. The first three directors appointed by the BIS shall serve terms of two, three, and five years. Subsequent directors shall serve terms of five years. Directors may be reappointed once.
   d. Should a director resign or die, the organization that selected that director shall select a replacement to serve the remaining term.

4. The board of directors shall have the power to hire and fire the Board's staff, and to determine salaries for the staff. The bylaws of the Board shall determine salaries for the directors.

5. The Board shall issue notes and coins denominated in a gold currency unit to be determined by the Board prior to the date of first issuance. The notes and coins shall be fully convertible into gold. The notes shall be printed outside Country *X*.

6. a. Procedures for setting a conversion rate with the existing fiat currency of Country X, for the purpose of replacing that currency, may be set out in a separate law that accompanies this law.

b. Failure to maintain the fixed exchange rate with gold shall make the Board and its directors subject to legal action for breach of contract according to the laws of Switzerland. This provision does not apply to attempts to redeem embezzled, mutilated, or counterfeited notes, coins, and deposits.

7. The Board shall charge no commission for exchanging its currency into or out of gold.

8. a. The Board may assume the monetary liabilities and corresponding assets of the Central bank of Country X. The Board need not initially hold gold reserves against this stock of monetary liabilities if it has inherited no corresponding readily saleable assets from the Central Bank of Country X. Over time it shall dispose of any domestic assets initially held as counterparts to its monetary liabilities.
   b. The Board may not increase its monetary liabilities without gold or foreign reserves equal to 100 percent of the amount of the increase.
   c. The Board shall hold its reserves in gold or in highly rated and liquid securities either denominated in gold or fully hedged against changes in the fiat-currency price of gold. These reserves shall be on deposit at the BIS or at an internationally certified gold warehouse. The Board shall not hold securities issued by the national or local governments of Country X, or by enterprises owned by those governments. The reserves of the Board are the property of the holders of the Board's monetary liabilities and may not be appropriated by the Government of Country X.

9. The Board shall pay all net seigniorage (profits) into a reserve fund until its unborrowed foreign reserves equal 110 percent of its notes and coins in circulation and deposits. It shall remit to the Government of Country *X* all net seigniorage beyond that necessary to maintain 110 percent foreign reserves. The distribution of net seigniorage shall occur annually.

10. The head office of the Board shall be in the capital city of Country *X*. The Board may establish branches or appoint agents in other cities of Country *X*. The Board shall also maintain a branch in Switzerland.

11. The Board shall publish a financial statement, attested by the directors, monthly or more often on a publicly accessible Internet site. The statement shall appraise the Board's holdings of securities at their market value. An annual audit of the Board shall be made by an international audit firm and shall be published by the Board.

12. The Board may issue notes and coins in such denominations as it judges to be appropriate.

13. The Board may not be dissolved, nor may its assets be transferred to a successor organization, unless all of the following conditions are satisfied: two-thirds of the members of Country *X* approve, the President of Country *X* approves, all the directors of the Board approve, and all claims against its monetary liabilities can be satisfied.

14. [Optional] The Board may accept loans or grants of reserves from multigovernmental organizations or foreign governments to establish initial foreign reserve backing of up to 100 percent of the monetary base. The loans shall not exceed 100 percent of the monetary base. After establishing the initial backing, the Board may not accept loans.

15. Exchanges of currency by the Board shall be exempt from taxation by the government of Country *X* and all its subdivisions.

16. The Board's currency shall be legal tender for paying taxes and settling debts in Country *X*. However, private parties shall be free to contract among themselves in any currencies they wish to specify, and no currency shall be forced tender for such contracts.

17. The Board may not perform banking services for the Government of Country *X*, and it shall not be responsible for the financial obligations of the government.

18. Existing laws that conflict with this law are void.

19. This law takes effect immediately upon publication.

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