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"Independent Currency Authorities: An Analytic Primer"
by Kent Osband and Delano Villanueva

This paper describes the functions of an independent currency authority (ICA). An ICA issues and redeems notes and coins in exchange for a standardized commodity like gold or a foreign currency. Typically, the exchange rate schedule is preannounced, and new issues of currency are covered 100 percent by reserves. The difference between the yields on assets denominated in the reserve currency and the generally small administrative costs of the ICA accrues as profit to the government owner. For a country interested in having its own currency, an ICA offers a shortcut to monetary stability and convertibility.

An orthodox currency board establishes a fixed exchange rate with a foreign currency and fully backs the entire currency stock with reserves. In a sense, the domestic currency serves as a proxy for the foreign currency, but the currency board intercepts the seigniorage that would otherwise go to the foreign country. A crawling peg currency board allows the exchange rate to change gradually over time. In any case, an ICA retains monetary flexibility in terms of the option to change the reserve currency to which it pegs or to expand into a full-fledged central bank.

An ICA forbids the discretionary printing of money, which eliminates some potentially desirable options for financing the budget. At the same time, it encourages more responsible budget planning. To restore budgetary flexibility under an ICA, the government needs to build up its own financial reserves and demonstrate a determination to repay its debts fully.

The smooth operation of an ICA also requires that the banking system hold sufficient reserves of domestic currency or of assets that can be converted into domestic currency at the ICA. To help achieve this goal, international branch banking should be encouraged, or a separate monetary agency with substantial foreign reserves and credit lines abroad should be established that can offer emergency liquidity to commercial banks.

A crawling peg currency board would appear to have little long-term merit, unless the peg is used to keep domestic inflation below inflation in the reserve currency country. Nevertheless, for a country that is attempting to stabilize an initially high domestic inflation rate, an ICA that operates a crawling peg arrangement involving a preannounced, decelerating rate of depreciation might prove useful as a transitional mechanism to slow inflation gradually.

Historical experiences suggest that, provided supporting fiscal and monetary arrangements are put in place, ICAs do indeed facilitate monetary stabilization and convertibility. In the process, they have helped to encourage saving, investment, and efficient growth.