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How Sound Is the Cayman Dollar?

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The Cayman Island Monetary Authority operates a currency board to ensure adequate backing for the Cayman Islands currency and that enough paper currency and coin is available to meet the demands of the market.

In 1971, the political leaders in Cayman and the UK decided that the Cayman Islands economy had grown sufficiently to support its own currency, through the use of a currency board and that such a currency would be in the political and economic interests of the Cayman Islands. CIMA is responsible for the issue and redemption of Cayman Island currency. CIMA accomplishes this function through agreements with several banks and the Royal Bank of Canada.

CIMA operates a currency board and not a traditional central bank like the US Federal Reserve Bank or the Bank of England. Most central banks are wholly owned by the government and operate separately from the finance ministry. They have a monopoly on issuing legal tender (notes and coins). Legal tender is the term for the money in which government pays its bills and receives its taxes and in which private parties must pay their debts (unless they have made other private arrangements to pay it in a foreign currency, gold, etc.).

Central banks operate what is known as monetary policy in which they decide how much money to create through the banking system. Monetary policy can have multiple targets, such as price stability and full employment, which is what the US Fed is charged with, or the single target of price stability, which is the primary goal of the European Central Bank. Central banks did not become widespread until the 20th Century and became very common after most countries abandoned the gold standard.

Modern day currency boards trace much of their heritage to currency boards established by the British in a number of their colonies. Cayman government officials could create a currency, usually with the symbols of the colony on the bank notes and coins, which was fixed to the pound sterling. That is, the local currency could be exchanged for the pound, and vice versa, at an agreed upon price. The currency board was normally required to hold 100 per cent reserves in approved UK government bonds so there would be no run on the local issuing currency board. Bermuda has had a currency board since 1915, and in recent years countries like Bosnia, Bulgaria, Estonia and Lithuania have adopted them.

A classic currency board issues notes and coins that are convertible into a foreign currency or commodity at a fixed rate upon demand. A pure currency board neither accepts deposits nor lends to the government (unlike central banks) or anyone else. It is passive in its operations, producing only as much money as demanded by the market. Many countries have institutions that they refer to as currency boards, but those boards keep less than 100 per cent reserves, or operate in other non-classic ways.

Cayman has a classic currency board. Its anchor currency is the US dollar. The Cayman currency board keeps more than 100 per cent reserves in US government obligations – US Treasury notes, bonds, etc. In recent years, CIMA has kept reserves at over 120 per cent, which protects it from fluctuations in the price of the bonds. CIMA, and ultimately the Cayman government, earns interest on the bonds and notes that it holds, and this sum is normally (depending on the interest rates) sufficient to offset the printing and other costs of operating the currency board. As of this writing, Cayman has approximately $80 million in currency outstanding with reserves of approximately $105 million.

The paper currency that Cayman uses is printed by the British bank note firm De La Rue. The basic ingredient in the paper note is not wood pulp, but cotton. Banknotes are a rather complex product in that they have to be made to be both flexible and stiff, and be sufficiently durable to handle abuse and hostile environments (e.g. damp and dirty clothing). They contain many anti-counterfeit measures, such as water marks, complex design, metallic threads that contain information, and some with even holograms. The higher the value of the banknote, the more costly anti-counterfeit measures are included in it. A $100 note will be made more counterfeit proof than a one dollar note. When deciding how many anti-counterfeit devices to put into a banknote, the Monetary Authority does a cost benefit analysis, given that the cost of a banknote can vary considerably depending upon what features it contains. Paper currency does wear out and CIMA regularly replaces dirty, torn, or worn bills.

Cayman has a unique advantage in that many tourists like to keep some of the Cayman currency as souvenirs, particularly the one dollar bills. When they do this, they are in effect giving Cayman a perpetual interest free loan. Thus it is important for Cayman to produce an interesting looking currency that people will want just because of its appearance. CIMA, unlike the money issuing authorities in some countries, maintains a clean bill standard, which gives a better image, and also makes it more desirable for people to want to hold the physical currency. However, the liability for non-redeemed banknotes is still kept on the books of the Cayman Monetary Authority.

The Cayman Monetary Authority also supplies coins in denominations of less than one dollar, plus occasional high value commemorative coins. Coins are expensive to produce but have the advantage of durability. As a result of inflation in the US dollar and most other currencies, some low-value coins like the penny cost more to produce than they are worth. This problem has caused some countries to stop producing pennies and other low-value coins. The increasing movement to electronic forms of payment – credit, debit, and smart cards, etc. does serve to reduce the problem of the cost of coinage (and banknotes).

Currency boards need an anchor currency and/or gold or some other commodity. The choice of the anchor currency depends upon predominate economic relationships, expected stability, and international acceptability. The eastern European countries that have set up currency boards have now all opted for the euro as their anchor, even though many of them originally choose the D-mark.

Cayman quite appropriately selected the US dollar as its anchor. The reason is obvious: most Cayman business is done in US dollars, most of its imports come from the US and most of its tourists come from the US. The US dollar has also been the world reserve currency for the past 60 years. There are now three global currency blocks – the US dollar, the euro and the Japanese yen, plus two smaller internationally used currencies, the UK pound and the Swiss franc. Most central banks and currency boards have either a loose or hard fix to one of the three global currency blocks. When the dollar was dropping against the euro and pound, a few in Cayman advocated looking at other currencies, but now with the recovery of the dollar, the issue has sensibly gone away.

Cayman, by using the dollar anchor, is held hostage to US monetary and fiscal policy. But if it switched to some other currency, it would have the same problem, only with some other big brother or sister. And despite all of its problems, over the decades the US dollar has performed as least as well if not better than the competing currencies.

Cayman could set up a classic central bank and try to run its own monetary policy. Virtually no small country has been successful at this over the long run, except for Switzerland, which is more than 100 times larger than Cayman. If Cayman was successful in running an independent central bank, it would probably not provide much added benefit, but if the bank governors made a major mistake, which is easy to do when running a central bank, the results for Cayman could be disastrous. (One only needs to look at what recently happened to Iceland.)

In theory, Cayman could go on gold or some other commodity standard, but trying to do so alone and given the country's small size, it is not practically feasible. One only needs to look at the swings in world gold prices over the last several years to imagine the kinds of problems Cayman would subject itself to if it adopted such a standard.

Cayman could also drop its own currency and dollarise its economy, the way some other countries have done (such as Panama). It would be feasible and simple and not cause any adverse financial problems (other than the ones it already has having a currency fixed to the dollar).

Dollarisation would have the advantage of providing simplicity, by not having to convert numbers and transactions back and forth between the US dollar and the CI dollar. It would have the disadvantage of taking away the foreign exchange transaction fees that some Cayman citizens enjoy, and the profit Cayman makes (through CIMA) from having its own currency.

The tourist industry may be enjoying some additional benefit by Cayman having its own currency, because it makes the islands seem more foreign and exotic.

On the other hand, the financial industry might benefit slightly from dollarisation because of the additional simplicity. However, this small benefit probably does not offset the additional pride and feeling of independence Cayman citizens get from having their own currency. The Cayman currency board has worked well for 36 years and as they say, “If it is not broken, why fix it?”

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http://www.compasscayman.com/cfr/2009/01/05/How-sound-is-the-Cayman-dollar-/