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Currency regimes and currency crises: What about cocoa money?

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Abstract

Since the mid-1990s, there has been a significant shift towards floating exchange rate regimes by developing nations, primarily due to the lack of a viable alternative. Hard-peg systems, which both eliminate independent monetary policy and, if not credible, are subject to speculative attack, are increasingly viewed as a poor choice. This paper explores, theoretically and empirically, the potential benefits and drawbacks of an alternative: commodity-backed money. While proposals for commodity-based money in the industrialized world date back to 1934, with the seminal work by Benjamin Graham, this work analyzes its application to the developing world and its key commodity products.
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1. Introduction

Recent currency crises have called into question the advisability of utilizing certain currency regimes, at least in developing nations. The most notable, the Asian crisis of 1997–98, demonstrated the problems with pegged, inter-dependent currencies. This was followed by the Ecuadorian Sucre crisis of 2000, which ultimately resulted in the dollarization of that economy. Most recently, the collapse of the dollar-standard in Argentina illustrates the drawbacks of this regime. Since the demise of the fixed exchange rate system in 1973, developing nations have used

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a variety of means to avoid floating their currencies. Pegged systems have been the most popular, with countries fixing their currencies against the U.S. dollar or an alternative, such as SDRs. In Africa, pegging has taken the form of a currency zone, with contiguous nations pegging against the French Franc (until its replacement with the euro). This search for stability has exposed the inherent problem with most fixed regimes: their susceptibility to speculative attack. The result has been a recent trend towards floating exchange rates—not because of their inherent attractiveness, but simply to avoid the drawbacks of pegged systems.

The recent instability in currency markets has led to renewed interest in alternative regimes. One such alternative is the utilization of commodity-backed money, a concept that dates back to 1937, starting with proposals by Benjamin Graham to adopt a currency backed by a basket of commodities (Graham, 1997). As recently as 1999, the issue of securing currencies with some form of tangible asset was raised once again (see Haussmann, 1999). Although Graham originally favored the adoption of a commodity-backed currency in the industrialized world, the developing world's poor experience with existing currency regimes suggests this would be a more fruitful place to examine commodity money. In addition to bringing about currency stability, a commodity-based currency would offer a solution to one of the problems that has plagued developing nations since the 1960s; commodity price instability.

This paper will examine, theoretically and empirically, the advantages and disadvantages of adopting a commodity-backed currency within certain nations in the developing world. Although a number of commodities could potentially act as the backing for such a currency, cocoa has been chosen because of the unique characteristics of this particular market (see Section 7). The intent will be to demonstrate the feasibility of such a system, yet expose some of its inherent flaws.

2. Alternative currency regimes—advantages and disadvantages

As will be demonstrated in the section that follows, there has been a general movement towards floating exchange rate regimes, whether fully flexible or lightly managed. This is partly due to the advantages of flexible rates: The ability to utilize monetary policy, insulation from international economic shocks, and freedom from the threat of currency crises. Undoubtedly, it is also attributable to the poor experience developing nations have had with fixed exchange rates. The disadvantages of floating rates, volatility that impacts foreign trade and bias towards excessive monetary growth, have been overshadowed by the advantage of not facing a currency crisis.

Actively managed ("dirty") floats are designed primarily to eliminate exchange rate instability, not to direct the path of currency valuations. A successful managed float requires significant international reserves, as the monetary authority will be intervening regularly to counteract short-term market fluctuations. Nations that use managed floats are unlikely to be subject to currency crises, since there is no commitment to maintaining a currency's value. As with flexible exchange rates, control over monetary policy is maintained.

Pegged systems, Crawling and Pegged with Bands all reduce the uncertainty of exchange rate movements, with the latter performing nearly as well as fixed exchange rates. All pegged systems are, however, vulnerable to currency crises, and all require the holding of significant international reserves to achieve target exchange rates. Nations utilizing pegged systems can apply monetary policy only sparingly, and international disequilibria will be corrected through real sector adjustments. In the past, the attractiveness of pegged systems in the developing world resulted from a search for both stability, and a means of taming inflation that resulted from imprudent monetary policy.

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