

Cayman Financial Review

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A large pile of US dollar bills, including \$100 and \$10 bills, is shown falling from the sky into a green field. The bills are scattered across the sky, creating a sense of a financial crisis or a massive loss of money. The background is a bright blue sky with white clouds, and the foreground is a lush green field.

Before The Next Crisis:

**Monetary Policy, Debt &
Demographic Change**

**Regulatory sandboxes
for Fintech**

**Dying to close an
offshore account**

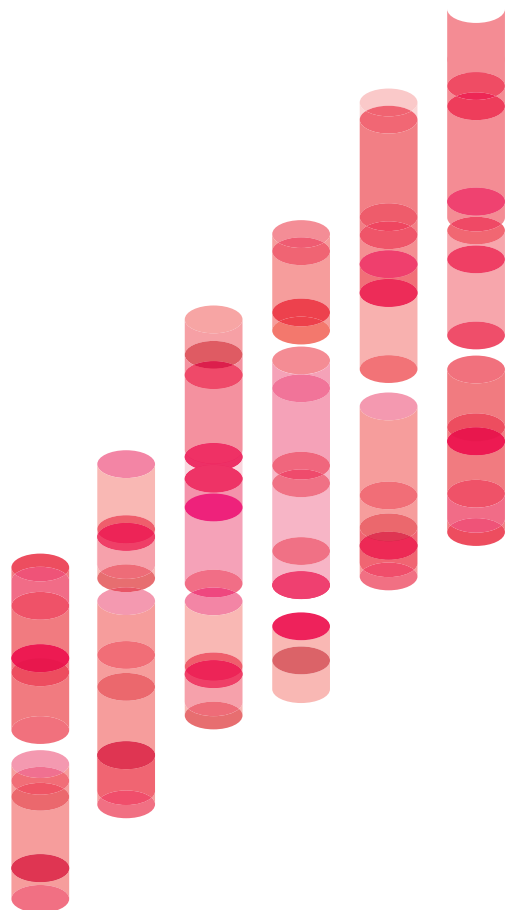
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Before the next crisis

These should be the best of times. World poverty is at a record low, and world incomes are at a record high. People in most countries have never had greater economic opportunity and prosperity, yet a great disquiet is unsettling many around the globe.



Richard W. Rahn
MEMBER OF THE EDITORIAL BOARD

Global net government debt is at a record high and growing. The great curse of democracies is that the people demand that their political representatives give them more “free stuff” in terms of healthcare, retirement and poverty protections, etc. Yet tax rates in many countries are already above the long-run maximizing rate. Responsible fiscal policies are evaporating country by country.

Populations are aging throughout the world, resulting in an increasing percentage of elderly who must be cared for by a shrinking proportion of working-age populations. Many are growing increasingly pessimistic about the debt/demographic dilemma.

Monetary policy seems to have hit a wall. During the Great Recession, major central banks greatly increased their holdings of government securities, without developing a coherent plan for unwinding what they had done. Traditional monetary policy is now dead!

I recently received a note from a colleague who is one of the best economists that I know and who has held a number of high-level government positions. He observed: “The entire system has become so illogical, so convoluted and built by repeated applications of flawed government policies attempting to solve previous problems created by government efforts to correct still earlier problems it created ad infinitum, that economic theory offers no explanations/predictions inside the limits.”

The only thing that is clear is that the present situation cannot continue forever. One can only speculate how it will end – a general collapse, a rolling readjustment (as has happened in Greece) country by country, or a wake-up in some key countries whereby some courageous and knowledgeable leaders are elected to effect the necessary fiscal changes.

In this issue, Dennis Richardson observes that the “Fed seems to be in a desperate race toward normalization before a downturn in the economy arrives so that it has some tools to help fight the recession. The Fed’s conundrum is whether it can achieve normalization without causing the economic downturn for which it is trying to prepare.” Richardson presents a brief history of how the Fed got where it is, and then reviews the various alternative actions the Fed can now take, including doing nothing.

The policy dilemma that U.S. policy makers are facing is modest compared to what the Japanese officials now confront. Orphe Pierre Divounguy gives what can only be characterized as a depressing overview of the Japanese situation. “For the past decade, Japan’s population has been declining. This decline has been driven by decades of extremely low fertility rates and a recent uptick in the number of deaths among the oldest population in the world.”

The working-age population is now declining, while entitlement spending on an aging population is increasing. The debt burden is already at world record highs, and any further increase in taxes will only slow growth even more, reducing real tax revenues and making the situation worse. Old-age pensions and entitlements need to be reduced, but this is a political non-starter as the young correctly understand that if the state is not taking care of their parents and grandparents, they will have to – resulting in a reduction of their living standards.

The Japanese situation is only a forerunner of what many of the world’s advanced economies are facing. Parts of Europe are now suffering from negative population growth, and it is only a matter of time before Europe as a whole and eventually even North America have a declining population. More dependent old people

Continued on page 4



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and few workers will lead in one way or another to falling living standards – with no obvious way out – other than increasing birth rates and cutting entitlements.

Various schemes by governments to increase birth rates, such as tax credits for children, have not shown great success where they have been tried. One of the ironies is that as pay between men and women increasingly reaches parity, the opportunity costs for a women to drop out of the work force to have children greatly increases – and a tax credit to fully offset this cost is likely to be so high as to undermine what is increasingly becoming a shrinking tax base.

To avoid cutting pensions, governments could do more to reduce or even eliminate other government programs, but each of these also has its own political constituency, which will resist any reductions – the education, medical, infrastructure and defense spending lobbies are not going to wither and go home without a fight.

A major target of those seeking to obtain more revenue for governments are “greedy” rich people and corporations, particularly those who shop the globe for tax advantageous reasons. Many of those in governments seeking to “get the rich” fail to distinguish between the negative effects of an increase in the tax on capital and one on consumption, leading to many unnecessarily destructive taxes.

As government tax officials have become more and more aggressive in their pursuit of tax avoiders and evaders, the personal and financial risk for taxpayers with “offshore accounts” has grown. Tax lawyer, Dan Mastromarco, describes the dangers and hoops that people seeking to close their accounts and otherwise avoid risk needs to go through in order to protect themselves. Part of the problem is that some of the rule changes are retroactive, so people who operated in good faith at some time in the past now find themselves liable for actions which seemed perfectly legal at the time. An even greater problem is the number of governments and their administrative organizations who now claim the right to demand data and forms from those who have financial accounts in more than one jurisdiction. The complexity has grown to the point where it is nearly impossible for any one person to know all of the things he or she may be required to do or all of the potential liabilities they may face.

And oh, by the way, your death may not absolve your heirs for being responsible for some of your tax and other alleged financial sins.

The good news is, as I noted in the first sentence, that the world is getting more prosperous, despite the best efforts of many of those in government to throttle success. History shows that many insolvable problems are indeed solved by very clever people – so do not despair and applaud the clever.



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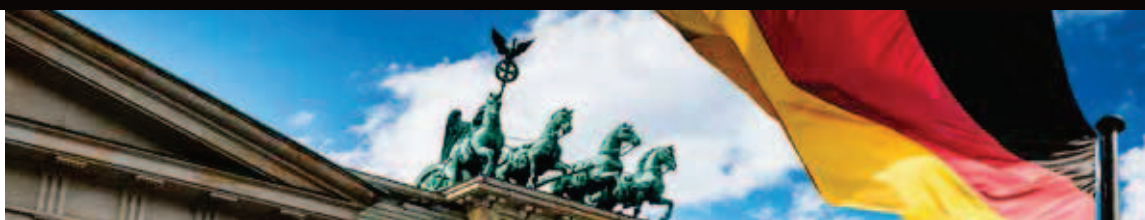
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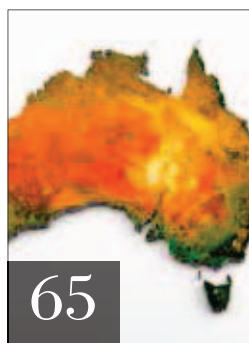


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The Cayman Currency Board: An island of stability

The Cayman Islands and Hong Kong are two of the world's great financial centers. They both owe a great deal of their success to the fact that they employ currency boards. Their currency boards allow them to issue the Cayman and Hong Kong dollars. Both of these domestic currencies are, in fact, clones of the mighty U.S. dollar—the world's dominant international currency.

Currency boards have existed in over 70 countries. The first one was installed in the British Indian Ocean colony of Mauritius in 1849. By the 1930s, currency boards were widespread among the British colonies in Africa, Asia, the Caribbean, and the Pacific islands. They have also existed in a number of independent countries and city-states, such as Danzig and Singapore. One of the more interesting currency boards was installed in North Russia on Nov. 11, 1918, during the civil war. Its architect was none other than John Maynard Keynes, a British Treasury official responsible for war finance at the time.

Countries that have employed currency boards have delivered lower inflation rates, smaller fiscal deficits, lower debt levels relative to their gross domestic product, fewer banking crises, and higher real growth rates than comparable countries that have employed central banks.

So, just what is a currency board? An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-

“Countries that have employed currency boards have delivered lower inflation rates, smaller fiscal deficits, lower debt.”

bearing bonds denominated in the anchor currency and typically some gold. The reserve levels (both floors and ceilings) are set by law and are typically kept between 100 and 120 percent of its monetary liabilities (notes, coins, and, if permitted, deposits). A currency board's convertibility and foreign reserve cover requirements do not extend to deposits at commercial banks or to any other financial assets. A currency board generates profits (seigniorage) from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.

By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. It has an exchange rate policy (the exchange rate is fixed) but no monetary policy. A currency board's operations are passive and automatic. The sole function of a currency board is to exchange

the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency. Since the domestic currency issued via a currency board is a clone of its anchor currency, a currency board country is part of an anchor currency country's unified currency area.

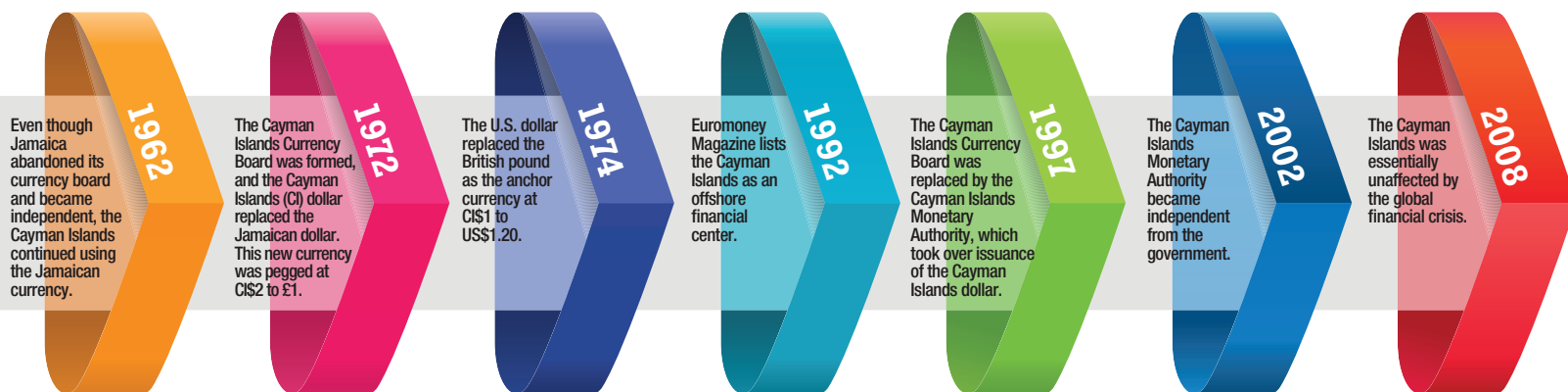
A timeline of the major events in the evolution away from the use of a foreign currency to the issue of the Cayman dollar via a currency board that has become more orthodox over time is presented in Figure 1. See figure 1

Before the establishment of its currency board, the Cayman Islands used the Jamaican currency, which remained the only legal tender, even after Jamaica abandoned its currency board and became independent in 1962. Concerned about the stability of the Jamaican currency, Caymanians eventually realized that it would be necessary to introduce their own separate currency.

In September 1970, the United Kingdom granted the Cayman Islands formal permission for the issue of a new, independent currency. The Currency Law of 1971, which was formally approved in October of that year, led to the formation of the Cayman Islands Currency Board. Initially, the Cayman dollar was anchored to the British pound. In a quest for more stability, the Cayman dollar's anchor was changed from the British pound to the U.S. dollar under the

Timeline of Major Currency Developments in the Cayman Islands

FIGURE 1



Currency Law of 1974. This illustrates the fact that, with a currency board, a country might have no (or little) discretionary monetary policy, but it has monetary sovereignty. It also illustrates, once again, the high priority the Cayman Islands have placed on currency stability.

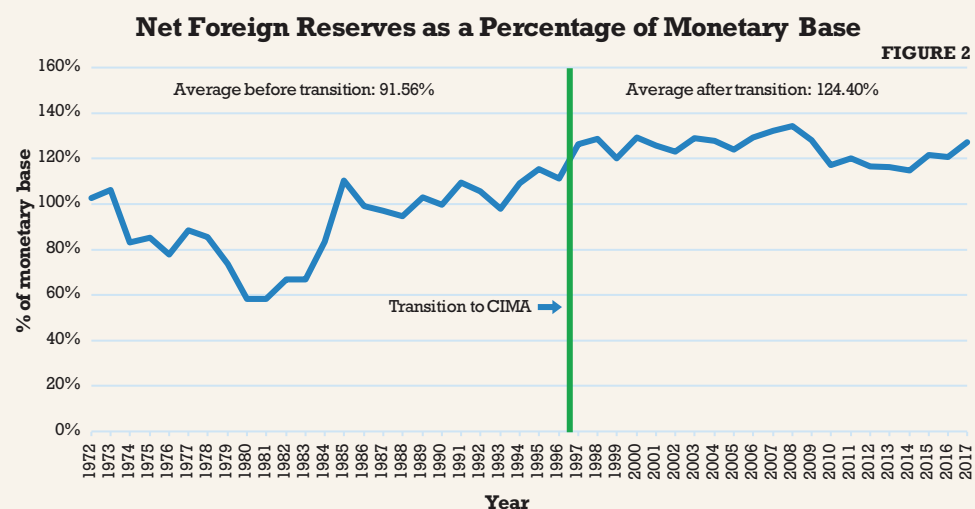
Following Euromoney Magazine's designation of the Cayman Islands as an offshore financial center, the Monetary Authority Law of 1996 replaced the Cayman Islands Currency Board with the Cayman Islands Monetary Authority (CIMA). The Cayman Islands Monetary Authority took over the responsibilities of the Currency Board in addition to the responsibilities of the Financial Services Supervision Department.

As the monetary authority of one of the world's most important financial centers, CIMA devotes the majority of its staff to financial regulation. Today, its monetary functions are handled solely by its Currency Operations division (the currency board), which, as of Dec. 31, 2017, consists of only seven staff members. On the other hand, the Authority's regulatory functions are handled by its Banking Supervision, Fiduciary Services, Insurance Supervision, Investments Supervision, and Securities Supervision divisions, which together, as of Dec. 31, 2017, have 109 employees.¹ The Cayman Islands, therefore, illustrates an important feature of currency boards: unlike central banks, currency boards require tiny staffs. Indeed, only seven staff members man the Cayman's currency board operations.

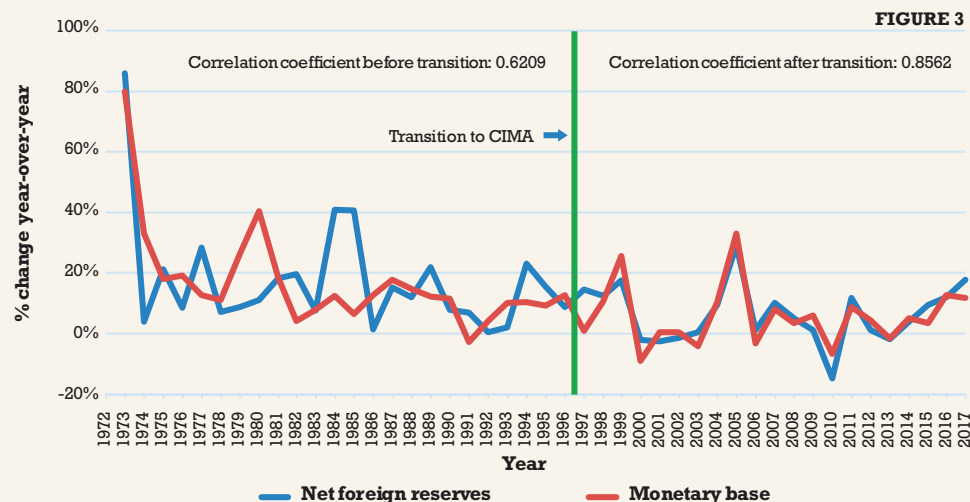
Now, let's turn to the evolution of the currency system in the Cayman Islands. In a move towards orthodoxy, section 32 of the Monetary Authority Law of 1996 mandates that external assets should not fall below 90 percent of the demand liabilities (monetary base) of the Authority. This means that net foreign assets as a percentage of the monetary base should always be 90 percent or above, which represents a stricter limit than had existed under the currency laws of the 1970s. The following analysis indicates that the currency board operations have become more orthodox over time.

Figure 2 shows net foreign reserves as a percentage of the monetary base from 1972 through 2017. The vertical line marks the end of the Cayman Islands Currency Board and its replacement by the Cayman Islands Monetary Authority in 1997. Orthodox currency boards typically have net foreign reserves between 100 and 120 percent of their monetary base.

During the period of operation under the Cayman Islands Currency Board from 1972 to 1996, the ratio of net foreign reserves to monetary base ranged between 58 and 115 percent and averaged 92 percent. After the transition to the Cayman Islands Monetary Authority,



Annual Percentage Change in Net Foreign Reserves and Monetary Base FIGURE 3



the ratio was much higher and tighter, ranging from 115 to 134 percent and averaging 124 percent. The Monetary Authority Law of 1996 made currency board operations much more orthodox.

The move to orthodoxy, with the introduction of the CIMA, is also on display in Figure 3, which compares the percentage changes in monetary base and in net foreign reserves. The correlation coefficient between the two metrics increases from 0.6209 to 0.8562 after the transition to the CIMA. This indicates much less monetary discretion.

The Cayman Islands currency story is one of stability. Indeed, the Cayman Islands realizes that, when it comes to currency, stability might not be everything, but everything is nothing without stability. After Jamaica abandoned its currency board, the Caymans rightfully anticipated that the Jamaican dollar would become a third-rate Caribbean currency. In consequence, the Caymans dumped the Jamaican dollar and replaced

it with a Cayman dollar issued by a currency board in 1972. Shortly thereafter, Cayman realized that the British pound, which was the anchor for the original Cayman dollar, was unstable. So, in 1974, the anchor was changed from the British pound to the U.S. dollar. Finally, after the Cayman Islands became recognized as an offshore financial center, today's Cayman Islands Monetary Authority took over the currency board operations in 1997. With that, the currency board operations became even more orthodox. In consequence, stability has become more deeply entrenched. This allowed the Cayman Islands to weather the global financial crisis of 2008 largely unaffected.²

ENDNOTES

¹ Cayman Islands Monetary Authority Annual Report, 2017, pp. 12-13.

² Anthony Travers, "An Open Letter to President Obama from the Cayman Islands Financial Services Association," May 5, 2009.

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