SCIPOD

////Title: Resisting Economic Crises with the Grondona System of Currency Convertibility

////Standfirst:

Currency crises are a major feature of the world economy we live in, and many governments face the challenge of defending their currency's exchange-rate. A system of currency and money needs a standard of value to be stable, but no such system has existed since the end of the US Gold Standard in 1971. Professor Patrick Collins of Azabu (Azah-boo) University in Japan and his colleagues perform detailed simulations and argue that the Grondona system of conditional currency convertibility is the only practical method to stabilise currencies in our modern world.

////Main text:

Currency can easily be converted into another currency, and the amount of currency we receive in return depends on the exchange-rate. Exchange-rates fluctuate every day and the prevailing rate depends on the economic and political climate.

The historical means of stabilising the value of money was to guarantee its convertibility into selected commodities. Convertibility of the currency into gold provided stability to the UK's Pound Sterling and the US Dollar during their periods of economic world dominance. However, since the abandonment of the Gold Standard, the world economy has suffered from unprecedented inflation and economic instability.

The most visible and best-known aspect of a currency crisis is a sharp fall in the exchange-rate. For example, the South-East Asian currency crisis of 1997–1998 originated with the collapse of the Thai Baht, the official currency of Thailand. The crisis featured many characteristics that make a currency crisis difficult to stop in its tracks, such as rapidly developing events, contagion between countries, and uncertain policy responses. Indeed, during the crisis, there were fears of a worldwide economic meltdown.

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The Gold Standard was a monetary system that directly linked a currency's value to a specific amount of gold. For example, from 1944 to 1971, the US set the price of gold at $35 an ounce, so the value of the dollar was one thirty-fifth of an ounce of gold.

However, in 1971 the Gold Standard was abandoned and completely replaced by fiat money, a term used to describe modern currency that is not backed by a physical commodity such as gold. For example, the US Dollar is fiat money issued by the Federal Reserve, and in the UK the Pound Sterling is fiat money issued by the Bank of England. Neither is backed by anything: their value is not defined. This matters for ordinary people in our everyday lives, because decades of inflation since then have greatly reduced the value of our savings.

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In a paper recently published in the *Journal of Risk and Financial Management*, Patrick Collins, Emeritus Professor of Azabu University in Japan, and his colleagues in Malaysia and Pakistan, argue that, based on historical experience and on theoretical grounds, only the resurrection of currency convertibility offers the realistic prospect of returning to a stable money system. However, convertibility using gold is only a special case, and although it preserved the value of money for generations, it is not sufficient on its own to solve the challenges of the modern world economy.

After critically reviewing a range of proposals for how currency convertibility can make a return, Professor Collins and his colleagues support the neglected proposal of the lesser-known Australian economist, Leo St. Clare Grondona (Gron-doh-nah), who devised an innovative and simple system in the 1950s.

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In their research, Professor Collins and his team have analysed how Grondona's system of conditional currency convertibility will work in practice, and how countries can safely implement the system without economic upheaval.

By simulating various scenarios using past data on the Indonesian Rupiah and commodity prices such as cotton, coffee and aluminium, the researchers have confirmed that the system would have a stabilising influence on the value of the Rupiah under all realistic conditions.

Under the Gold Standard, a specialised department in the Central Bank stood ready to exchange the national currency for gold of a specific quality, in specific amounts, and at specific, fixed prices. In contrast, the 'conditional commodity standard' of the Grondona system is inherently more flexible. The team has outlined how a 'Commodities Reserve Department' would be created to exchange currency for specific commodities, of specific quality, in specific amounts, but crucially at **conditional** prices. For each commodity involved, the Commodities Reserve Department would publish a **price schedule**, where the prices on offer adjust in proportion to the current level of reserves of the commodity.

Implementing the underlying principle of guaranteeing the convertibility of currency in this way has important benefits for a wide range of economic policy issues, including control of inflation, and stabilisation of the business cycle and exchange-rates. Convertibility of some kind based on commodities has been recommended for this reason by many influential economists, notably including both Keynes and Hayek, who on other economic issues were the leaders of opposing schools.

In our modern world, a major advantage of the Grondona system is that any sovereign country can initiate it independently, free of geopolitical considerations, and using only their national currency. As a result, the Grondona system is much easier to implement than other competing proposals, with greater benefits, and far less stress on the economy and government. In fact, the UK parliament and the British press had previously been highly complimentary of Grondona's idea, but in the end, the UK government never implemented it.

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A key feature of the Grondona system is that the influence it exerts to resist a currency crisis is 'automatic', being driven by changing commodity market prices, not fallible political decisions. Hence, Professor Collins argues that it is a genuinely practical means of implementing currency convertibility based on primary commodities, thereby offering a useful step towards resisting future currency crises.

The simulations developed by his team represent an essential tool for governments that are considering implementing the Grondona system, as they offer a straightforward way of modelling various different possible conditions, to find the optimum way of implementing the system in a given country.

This SciPod is a summary of the paper 'Simulation of the Grondona System of Conditional Currency Convertibility Based on Primary Commodities, Considered as a Means to Resist Currency Crises', from the *Journal of Risk and Financial Management.* doi:10.3390/jrfm12020075

For further information, you can connect with Professor Patrick Collins at collins@azabu-u.ac.jp.

His colleagues in this research are Dr Jameel Ahmed, Professor of Economics at the University of Baluchistan in Pakistan, and Dr Akameel Meera, former Dean of the Centre for Islamic Finance at the International Islamic University of Malaysia.