

Goldmoney Insights® Special Edition

The Golden Revolution, Revisited: Chapter 10

This Insight continues the serial publication of the new, Revisited edition of my book, *The Golden Revolution* (John Wiley and Sons, 2012). (The first instalment can be found [here](#).) The book is being published by Goldmoney and will also appear as a special series of Goldmoney Insights over the coming months. This instalment comprises the fifth chapter of Section II.



An Unstable Equilibrium

“A Nash equilibrium is defined as a strategy combination with the property that every player’s strategy is a best reply to the other players’ strategies. This of course is true also for Nash equilibria in mixed strategies. But in the latter case, besides his mixed equilibrium strategy, each player will also have infinitely many alternative strategies that are his best replies to the other players’ strategies. This will make such equilibria potentially unstable.”

ECONOMIST JOHN HARSANYI AT THE NOBEL PRIZE SEMINAR IN HONOR OF
MATHEMATICIAN AND ECONOMIST JOHN NASH, 1994

While as a separate sub-discipline within the economics profession, game theory is relatively new, some of the basic tenets have been around for as long as society itself. At its core, game theory is nothing more than the study of how individuals act in social situations in which there is some degree of competition. Bargaining and haggling

JOHN BUTLER
RESEARCH@GOLDMONEY.COM

are terms that come to mind. But what sets game theory apart is that it attempts to calculate precisely what the outcome of a given bargaining or haggling session is likely to be.

To do so, game theorists need to make certain assumptions, for example:

- What are the true interests of the players?
- What are their alternatives?
- How might the interests and alternatives of one player be taken into account by the other players?

It is this last question that is at the heart of John Nash's concept of an equilibrium that can be applied to a game with a potentially infinite number of participants. A system (game) can be said to be in equilibrium when no player has a better alternative to their existing behavior (strategy), given the interests and alternatives of the other players.

By way of an example, in a scene from the 2002 film *A Beautiful Mind*, the young John Nash is at a bar with several fellow male PhD students, enjoying a few beers, when in walks a stunning, beautiful, young blonde lady, as well as a few of her perhaps slightly less stunning (if hardly unattractive) brunette girlfriends. At once, he and each of his buddies notice heads turning in unison toward the stunning young lady, then back to each other. The unasked question among the group is "Who is going to be first to approach her?"

As they all stand up and begin moving toward the stunning blonde, young Nash realizes there is a potential problem with what he and his friends are about to do. If all of them try simultaneously to engage the stunner in conversation, thereby essentially ignoring her friends, then it is highly unlikely that she is going to want to remain so engaged for long, regardless of how interesting she might find it personally, as she will be in the uncomfortable position of having the attention of several men at once while her friends have none. The obvious risk is that she and her friends are collectively put off to the point of avoiding the entire group of young men or summarily departing the bar entirely. As such, in the game of determining which of Nash and his friends should first engage the blonde in conversation, the solution is . . .

. . . wait for it . . .

None of them!

Why is that? Consider: While the stunner might enjoy the attention were all the young men to approach her simultaneously, her friends would feel left out and put off and most probably avoid Nash and his friends. They might even leave the bar with the stunner in tow. Taking all relevant factors rationally into account, the best ‘solution’ to this ‘game’ is for the men to avoid the stunner and approach her friends instead. This may seem a suboptimal outcome from the isolated perspective of any one of the young men, in that not one of them will have the opportunity of chatting up the stunner, at least not at first. At a minimum, however, they will be chatting up her friends, something they would all agree is a far better alternative to just sitting at their own table and chatting with each other, as on any other normal evening. The strategy that is the best reply to the other players’ strategies provides the Nash equilibrium, in this case, the strategy of approaching the stunner’s friends and ignoring the stunner entirely.

With that example in mind, we can now apply the concept of a Nash equilibrium to international monetary relations—in particular, the historical regime changes from one reserve currency to another—and consider how recent global economic and financial developments have destabilized the current, fiat-dollar reserve system. Let us begin with the pertinent historical example of the rise of the dollar—backed by gold—as a challenger to sterling’s nearly exclusive reserve status in the early twentieth century.

HOW WORLD WAR I DESTABILIZED THE CENTURY-OLD STERLING RESERVE CURRENCY STANDARD

Although previously linked to gold, the dollar has been the dominant global reserve currency since the 1920s, when it assumed this role from the pound sterling. Already by the end of the nineteenth century, the US economy had surpassed that of the United Kingdom in both industrial power and agricultural output. The British Empire in its entirety was still much larger; however, the cost of maintaining it was vast and growing, amid regional instability and growing military commitments.

The pound sterling assumed global reserve status following the hard-won victory over Napoleonic France in the early nineteenth century. For decades, it had been rather touch-and-go as to whether Britain or France would emerge victorious on the continent and, hence, have the upper hand when it came to expanding the colonial empires that both countries had acquired over the course of the prior two centuries. With Napoleon vanquished, Britain had a relatively free hand in much of the world, with the notable exceptions of the Americas and central Asia. It was not for want of trying, however. Britain took on the young United States for a second time in 1812, only to be fought, yet

again, to a stalemate. And Britain had a go at Russia in Crimea in the mid-1800s, which turned out more of a defeat, as did its occupation of Afghanistan.

By 1907, as a result of a series of crises in which both the British and French began to regard their respective empires as under threat from an increasingly powerful, unified, and assertive Germany, there was a realignment in European geopolitics. Both the British and French allied with Russia to keep Germany contained (or eingekreist—encircled, from the German perspective). When Russia and Germany subsequently clashed in August 1914 over how to respond to the assassination of Austrian Archduke (and heir to the throne) Franz Ferdinand, a general European war broke out.

Regardless of who was most responsible for starting it, World War I was hugely expensive and destructive for all European participants and, tragically, killed or severely injured a substantial portion of the young, productive British workforce. By contrast, although the United States entered the war in 1917, it did so from a position of relative strength, with both sides already nearing exhaustion. By late 1918, US troops began heading home. Although Britain won the war, its government finances did not. By the early-1920s, it was increasingly clear that Britain's economy was struggling to grow while shouldering the twin financial burdens of servicing the huge war debt and maintaining the vast overseas empire.

Having abandoned the gold standard and inflated the currency to help finance the war, Britain did attempt to return to gold in 1925 (although this was poorly executed, as it happens, as we discuss at some length later). Yet the writing was on the wall. Also on the gold standard, yet now with a much larger economy and far sounder government finances behind it, the US dollar was used increasingly in international transactions and as a reserve currency for the global banking system. When in 1931 the British retreated from their return to gold and devalued the pound sterling versus the dollar, it was an acknowledgment of what had been occurring beneath the surface of the global economy for years. A new monetary equilibrium had been found with the dollar, not the pound sterling, at the center.

Let's return to Nash and consider how World War I changed the environment in which the game of global monetary relations was being played. One player, Britain, found its economic position severely weakened. Another, the United States, continued to grow rapidly. Not only was the population growing, so was per capita income. As for other countries, most of them now found they were trading relatively more with the larger and more rapidly growing United States and relatively less with the smaller and stagnating Britain.

Table 10.1 Real GDP per capita ratios for selected country pairs

	UK/US	UK/Germany	UK/France
1870	131	174	170
1913	93	135	141
1929	80	136	117

Source: Angus Maddison historical database.

Therefore, it was only natural that more and more trade was not only transacted in dollars but also invoiced and accounted for in dollars. Moreover, with a larger, healthier economy standing behind it, the dollar was now also regarded as a more reliable store of value, less likely to be suddenly devalued (as sterling was in 1914–18 and again in 1931). As such, for managing risk, the dollar was increasingly seen as the natural reference point and reserve to hold against potential loss, the preferred reserve currency.

The dollar reserve standard thus became the new global monetary equilibrium, although, of course, the dollar was backed by gold, at a rate of \$20.67 per troy ounce. As the United States became increasingly prosperous in the 1920s—the Roaring 20s—it began to import relatively more and export relatively less to the rest of the world, and the gold reserve began to flow out. In 1926, the United States held an estimated 45 percent of the entire world’s official monetary gold supply (excluding Russia). Yet by the early 1930s, this share fell to under 35 percent.

Following World War II, one consequence of which was a huge accumulation of gold by the United States, the share increased briefly to over 60 percent. Yet once again, as the postwar prosperity set in and the United States began to import and consume more and export relatively less, the share declined steadily thereafter, sinking below 50 percent by the late 1950s. By the mid-1960s, US gold holdings were less than its foreign liabilities. It was precisely this development that so worried the French and other Europeans and led Jacques Rueff, among other economists, to predict the imminent demise of the Bretton Woods system.¹

HOW THE 2008–2009 GLOBAL FINANCIAL CRISIS DESTABILIZED BRETTON WOODS II, OR THE FIAT-DOLLAR RESERVE STANDARD

While World War I and the financial crisis of 2008–2009 are hard to compare in many

¹ For the historical data cited here, see Henry Hazlitt, *What You Should Know about Inflation* (Princeton, NJ: D. Van Nostrand, 1964).

respects, such as the devastation they wrought or their political consequences, they have certain things in common. Both had a huge impact on the health of economies, including that of the country providing the global reserve currency. Both led to economic policy decisions at the national level that were clearly not in the interest of other nations. As such, both destabilized the Nash equilibrium required to maintain a reserve currency standard.

It is not yet generally understood, however, the extent to which the 2008–2009 financial crisis and global economic policy responses to it have already fatally undermined the fiat-dollar standard equilibrium. This is due primarily to a misconception within the economics profession that for most, if not all, of the key players involved, the costs of moving away from the fiat-dollar standard still far exceed the benefits.

This view has been the conventional wisdom for some years. In late 2003, three prominent economists, David Folkerts-Landau, Michael Dooley, and Peter Garber, published a paper making the case that the so-called Bretton Woods II arrangement of fixed or generally managed emerging market exchange rates vis-à-vis the dollar—a system that had been more or less in place following the various Asian currency crises of 1997–1998—was a stable equilibrium for a variety of reasons. The most important reason given was that the emerging markets were undergoing a long-term structural investment boom that could be properly financed only through export-led growth, much as had been the case under the original Bretton Woods arrangements in the 1950s and 1960s, when Western Europe and Japan exported their way to renewed postwar prosperity. As such, notwithstanding a declining share of global economic output and rising fiscal and current account deficits, the fiat dollar was likely to remain the world's preeminent reserve currency for the foreseeable future, indeed, for decades to come.

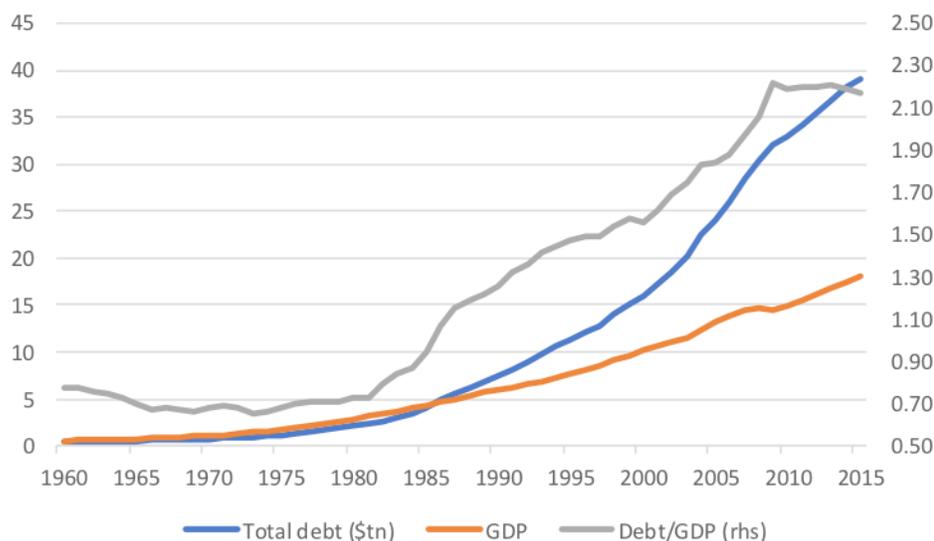
Here is the abstract to the paper on the NBER website, which originally appeared in the *International Journal of Finance and Economics*:

The economic emergence of a fixed exchange rate periphery in Asia has reestablished the United States as the center country in the Bretton Woods international monetary system. We argue that the normal evolution of the international monetary system involves the emergence of a periphery for which the development strategy is export-led growth supported by undervalued exchange rates, capital controls and official capital outflows in the form of accumulation of reserve asset claims on the center country. The success of this strategy in fostering economic growth allows the periphery to graduate to the

center. Financial liberalization, in turn, requires floating exchange rates among the center countries. But there is a line of countries waiting to follow the Europe of the 1950s/60s and Asia today sufficient to keep the system intact for the foreseeable future.²

I was not alone at the time in being somewhat skeptical that this was indeed a stable equilibrium. As a result of maintaining fixed or managed exchange rates with the United States, not only were the emerging markets growing much faster than the United States but also accumulating vast dollar reserves that were then reinvested in US assets, thereby pushing down dollar interest rates and pushing up asset valuations, including, of course, house prices, to levels inconsistent with US household income growth. But with consumer price inflation low as a result of cheap manufactured goods from abroad and low rents at home—the flip side of the increasing rate of home ownership, courtesy of low interest rates—the US Federal Reserve saw no need to raise interest rates in response to the domestic credit, housing, and consumption boom, which ultimately originated from the Bretton-Woods II regime.

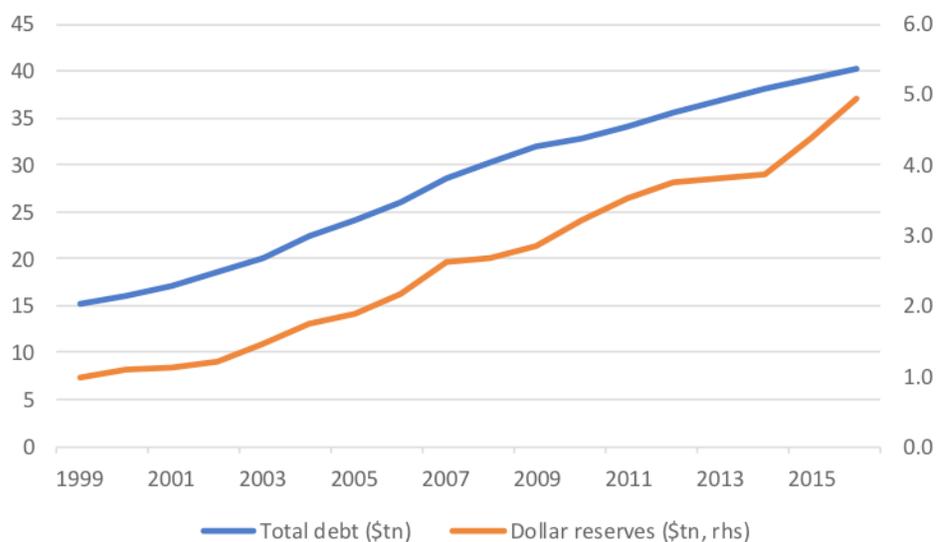
Figure 10.1 The Fed has stood by, amid low CPI, facilitating the growth of a colossal debt bubble



Source: Federal Reserve

² This paper can be accessed at www.nber.org/papers/w9971.pdf.

Figure 10.2 The debt bubble is financed in large part by foreign countries accumulating dollar reserve balances



Source: Federal Reserve

It is now generally accepted by the economic mainstream that the Fed's decision to hold interest rates low for a sustained period in 2003–2005 was the key contributing cause of the growth of the US housing bubble that burst in 2007, thereby triggering the subsequent global financial crisis. As the bubble was inflating, Fed officials repeatedly claimed that not only was the rise in house prices not a bubble but also that low interest rates had little if anything to do with it. In 2005, Ben Bernanke, who had only recently assumed the Fed chairmanship, claimed that low US borrowing costs were the result of a “global savings glut,” in particular in rapidly growing Asian countries, rather than a function of Fed monetary policy. But the global savings glut and Fed policy should never have been separated in this way. The latter directly enabled the former.

By focusing on consumer price inflation only, rather than money and credit growth generally, the Fed completely missed the connection between US interest rates, global savings, investment, and asset prices. It therefore failed to see that its policies were the ultimate cause of the housing bubble and that the global savings glut was just one link in a long money-and-credit chain that had become unanchored. The late great Austrian economist Kurt Richebächer recognized clearly that this was the case. As he wrote in April 2005:

In earlier studies published by the International Monetary Fund about asset bubbles in general, and Japan's bubble economy in particular, the authors

repeatedly asked why policymakers failed to recognize the rising prices in the asset markets as asset inflation. Their general answer was that the absence of conventional inflation in consumer and producer prices confused most people, traditionally accustomed to taking rises in the CPI as the decisive token for inflation.

It seems to us that today this very same confusion is blinding policymakers and citizens in the United States and other bubble economies, like England and Australia, to the unmistakable circumstance of existing rampant housing bubbles in their countries.

Thinking about inflation, it is necessary to separate its cause and its effects or symptoms. There is always one and the same cause, and that is credit creation in excess of current saving leading to demand growth in excess of output. But this common cause may produce an extremely different pattern of effects in the economy and its financial system. This pattern of effects is entirely contingent upon the use of the credit excess—whether it primarily finances consumption, investment, imports or asset purchases.

A credit expansion in the United States of close to \$10 trillion—in relation to nominal GDP growth of barely \$2 trillion over the last four years since 2000—definitely represents more than the usual dose of inflationary credit excess. This is really hyperinflation in terms of credit creation.

In other words, there is tremendous inflationary pressure at work, but it has impacted the economy and the price system very unevenly. The credit deluge has three obvious main outlets: imports, housing and the carry trade in bonds. On the other hand, the absence of strong consumer price inflation is taken as evidence that inflationary pressures are generally absent. Everybody feels comfortable with this (mis)judgment.³

The mistake made by Folkerts-Landau, Dooley, and Garber was that they failed to see back in 2003 that the Fed's easy money policy was fueling rampant money and credit growth that, in time, would lead to a colossal global credit crisis. To be fair, the entire economic mainstream missed it too. But this just begs the question of why. The best explanation is that the modern economics profession focuses primarily on consumer price inflation as a potential source of economic instability, rather than money and

³ See www.gold-eagle.com/gold_digest_05/richebacher042305.html.

credit growth generally. Austrian School economists, such as Richebächer, know better. He was hardly the only Austrian economist to predict the crisis.

THE FUTILITY OF INFLATION TARGETING

The fact is, inflation targeting is not a valid way in which to maintain economic stability. Yet the bulk of the developed economies' central banks follow some sort of inflation-targeting policy regarding consumer price inflation. The Fed and the European Central Bank (ECB) both have dual mandates, although these are somewhat different. In the Fed's case, the goal is to maintain low and stable inflation while also achieving full employment. In the ECB's case, the goal is also to maintain low consumer price inflation but also to prevent money growth accelerating to levels that would imply potentially destabilizing credit growth.

The Fed's mandate is in effect a Keynesian one, in that it assumes that there is some theoretical trade-off between inflation and employment and that the central bank can manage this trade-off in practice, thereby maintaining economic stability and achieving a healthy, sustainable rate of economic growth. As we have seen, however, the Fed has failed to do so, primarily because of the serial bubbles and busts that it has engendered by failing to maintain stable money and credit growth and encouraging excessive risk taking with repeated bailouts. As such, the Fed's mandate is misspecified: Not only is there no simple trade-off between inflation and unemployment, as demonstrated by the stagflationary 1970s and are seeing again today, but by the time excessive money and credit growth show up in the consumer price index (CPI), enormous damage may already have been done to the financial system. The CPI is inflation past. Money supply growth is inflation present. And as we shall see later, fiscal deficits are inflation future. The ECB's mandate, on the other hand, recognizes that there must be some link between money and credit growth, on the one hand, and price stability on the other. It has no set monetary rule but, rather, uses money and credit growth aggregates as an important guide to policy. Thus the ECB's mandate leans a bit in the direction of the Austrian economic tradition.

As it turns out, in sharp contrast to the Fed, the ECB has generally met its inflation target in the decade for which it has been in existence. On multiple occasions, the ECB has raised interest rates, not because growth was particularly strong nor because consumer price inflation had risen significantly, but rather because money and credit growth were strong and accelerating, implying a rising risk of economic instability in future. Yes, the ECB came under much criticism at these times, as money and credit targeting had generally fallen out of favor. But the results speak for themselves. In the

years 1999 through 2011, the ECB has done the better job.

Recently, the euro area has been beset by a series of sovereign debt crises that threaten the European monetary union (EMU). However, the ECB is not responsible for the chronic overborrowing of various European governments. These crises are fiscal in origin, rather than monetary. It is true that a number of European banks hold large amounts of sovereign debt that is likely to be restructured in some way and that in some cases the banks lack sufficient capital to take the necessary write-downs and still remain solvent. But here, too, it would be incorrect to blame the ECB, which is not the European banking regulator. Within the EMU, bank regulation remains at the national level.

The relative experience of the Fed and the ECB in recent years demonstrates that central banks' focus on inflation targeting is misplaced. The focus must instead be on money and credit growth, as the Austrian Economic School has been arguing for the better part of a century.

As can now be seen around the globe, economic instability can take many forms. In some cases it might be associated with consumer price inflation but in others it might not. In all cases, however, it is associated with unstable money and credit growth. With the Federal Reserve at the center of the international monetary system, it is the ultimate source of the international monetary base and, hence, the credit growth, boom, and bust that takes place on top of it.

One by one, various countries are beginning to recognize that the aggressive, unconventional monetary policy of the Federal Reserve may no longer be appropriate for their own economies; yet, as participants in the international monetary system, it would seem they have little alternative. A country refusing to use dollars for trade, for example, risks economic isolation.⁴ This helps to explain for example why the BRICS are increasingly cooperating with one another in international economic and monetary affairs, as they have more leverage together than apart. But whether the BRICS or other countries are increasingly dissatisfied, the problem then becomes, if the Fed, the issuer of the world's reserve currency, is not willing to change its ways and follow a mandate that can provide a more acceptable degree of global monetary stability, what is the world to do? Switch to the euro? Unfortunately, the various, escalating euro-area sovereign debt crises obviate that possibility. The yen perhaps? Few would take that possibility seriously, given the chronic quantitative easing and foreign exchange

⁴ This is one reason why the US relies heavily on economic sanctions in its foreign policies, as these can have real teeth. In severe cases, such as with Iran, the US simply forbids other countries to do business with the sanctioned country. As the US authorities can see all US dollar transactions moving through the international banking system, as these must all eventually clear through US banks, they can keep an eye out for countries not honoring the sanctions, and penalize them accordingly. This happened with big French bank BNP back in 2015, which was fined a record \$8.9bn for providing financing to Iran, among other sanctioned countries.

intervention of the Japanese authorities.

The Swiss franc? No, the Swiss economy is just too small and its domestic securities markets would not provide sufficient global liquidity to be the dominant global reserve currency.

What of other candidates? Is there any currency out there that both represents a stable economic area and is also managed in a way that would provide sufficient global monetary stability? While there is no national currency that ticks both of those critical boxes, there has been some discussion about turning to the special drawing rights (SDR) unit of account used by the IMF, which could, in theory at least, provide a global fiat reserve currency alternative to the dollar.

THE SDR NON-SOLUTION TO GLOBAL MONETARY INSTABILITY

The SDR is a basket of IMF member countries' currencies and is used as a unit of account in the IMF's financing and lending activities. As it stands now, the dollar is the largest part of the SDR basket. However, the basket is reweighted whenever member countries' relative capital contributions to the IMF change, as happened in 2015 when the Chinese renminbi was included in the SDR basket for the first time. Were the BRICS in general to contribute substantial capital to the IMF, then their currencies could be a substantial portion of the SDR basket. As such, so the thinking goes, the SDR is well-suited to accommodate the shifting, global economic and monetary power equilibrium and therefore provide a proper global fiat currency to succeed the fiat dollar.

However, to turn the SDR from a mere unit of account into a true global reserve currency would take a series of steps, some of which would be politically difficult due to the degree of cooperation required. First, the IMF would go from being a supranational bank to supranational central bank, with the authority to print and control the global, SDR-denominated money supply. As was the case with the euro at inception, this would not require that actual printed SDR currency circulates; rather, it could be done by the IMF fixing the exchange rates between all member currencies to the SDR reference basket. Recall that from 1999 to 2002, the euro existed as an electronic currency only, with the printed national legacy currencies providing the circulating notes and coins. But from 1999, the ECB nevertheless controlled the collective money supply and set a single interest rate for the entire euro-area banking system. The same could be the case with the SDR indefinitely. National currencies need never be replaced.

In theory, this solves the dilemma of the current fiat dollar reserve system in that it would no longer be the case that a single national central bank indirectly sets international interest rates and controls the de facto global monetary reserve base. Rather, the supranational IMF would set interest rates and grow the money supply in a way that would supposedly serve the broader interests of all IMF member countries. As the IMF describes the proposal in a recent working paper on the topic:

A limitation of the SDR . . . is that it is not a currency. Both the SDR and SDR-denominated instruments need to be converted eventually to a national currency for most payments or interventions in foreign exchange markets, which adds to cumbersome use in transactions. . . .

A global currency . . . issued by a global central bank would be designed as a stable store of value that is not tied exclusively to the conditions of any particular economy. As trade and finance continue to grow rapidly and global integration increases, the importance of this broader perspective is expected to continue growing. . . .

If [a global currency] were to circulate as a parallel currency but in a dominant role in place of the US dollar, then as in the [system] described above, current account imbalances that reflect today's situation—namely, surplus countries pegging to [the global currency] with deficit countries floating against it—would adjust more symmetrically, and perhaps more automatically, than the current [system] since the since the deficit currencies would be expected to depreciate against [the global currency]...⁵

While this sounds nice on paper, consider it in practice, with the experience of the euro area since the introduction of the single currency as a relevant example. The euro was intended to replace national currencies and to facilitate intra-euro-area balance-of-payments adjustments as described previously. Yet it hasn't worked. One monetary policy has not been suitable for all member countries, notwithstanding a tremendous degree of European economic integration. Yes, the ECB has arguably done a respectable job at balancing the contrasting economic conditions across the euro area and maintaining a relatively high degree of consumer price stability, but it is precisely this apparent operational competence that exposes the systemic flaw for all to see. The fact is that labor and capital have not been mobile enough in the euro area, resulting in local asset bubbles and excessive wage growth in the periphery. Fiscal policy has not

5 "Reserve Accumulation and International Monetary Stability," IMF Policy Paper, prepared by the Strategy, Policy and Review Department, in collaboration with the Finance, Legal, Monetary and Capital Markets, Research, and Statistics Departments and consultation with the Area Departments, April 13, 2010.

been sufficiently uniform and has been too loose in many countries. And as the years have rolled by, the related, cumulative imbalances have grown to the point that the currency union, as currently structured, cannot long continue.⁶ Either there must be a far greater degree of economic integration—something you cannot force by policy over any reasonable time horizon—or there must be a formal fiscal and banking union, with automatic transfer payments from wealthy regions to poorer ones and pooled bank deposit insurance underwritten by the stronger economies such as Germany.

Notwithstanding close political ties across borders, few observers believe that the euro area could implement the degree of fiscal and banking integration required to make the currency union sustainable without subverting democracy to a point that would begin to look autocratic and arbitrary and, as such, blatantly incompatible with modern European democratic traditions. The May 2016 decision by the United Kingdom to exit the European Union is but one high-profile example of how, in fact, the trend in European politics is increasingly centripetal. Movements to either leave the EU or fundamentally renegotiate membership terms are large and growing in nearly all EU member states, including the largest and most important, even Germany and France.

Now extrapolate this to the global level. Labor and capital are far less mobile around the world than within the euro area. Fiscal policy is far from uniform. Indeed, there are completely different economic models followed across the world, even if, in general, there has been a trend toward greater liberalization of labor and capital markets in recent decades. Imagine now that a push was made for fiscal and banking union among IMF member countries. It is difficult to believe that democratic countries would choose to move in that direction. As for more autocratic ones, some might and some might not, but few could doubt that such decisions would be driven by raw national interest and not some misplaced hope that what has failed demonstrably at the European level would somehow fare better globally.

In my opinion, the degree of cooperation involved to move the world toward an SDR-based single currency is insurmountable in the current global political, social, and economic context, no matter how much monetary sense it might theoretically make. That said, even on the purely monetary side of the issue, it is highly questionable that even the most qualified central bankers in charge of a hypothetical global central bank could possibly make consistently sensible decisions for how to set global interest rates, grow the money supply, act as a lender of last resort in a crisis, and so on.

⁶ A good reference point for the growth and scale of intra-euro-area imbalances are the cross-border claims referred to as “Target 2” by the ECB. Among others, prominent German economics professor Hans Werner-Sinn refers to the Target 2 imbalances when making his case that the euro-area, as currently structured, is an unstable and unsustainable currency union. His book, *The Euro Trap* (2014), is a comprehensive treatment of the subject.

Among others, Nobel laureate and so called father of the euro Robert Mundell is highly critical of the possibility that the SDR could somehow replace the fiat dollar as the new primary global monetary reserve asset. As he said in March 2011:

Today there is no possibility of the SDR or any variant of it becoming a world currency in the sense of a substitute for the role of the dollar in its heyday.⁷

When Mundell refers to the “heyday” of the dollar he is talking about the Bretton-Woods experience, with the dollar not only at the center but backed by gold. The IMF has at no point suggested that an SDR global currency would be gold-backed. But it is understandable that the IMF is making a push to become the issuer of a global currency and serve as the world’s central bank. Bureaucrats are naturally drawn to bureaucratic solutions to real-world problems. But as just demonstrated before, a single global fiat currency, based on the SDR or some other arbitrary unit of account, is nothing more than a bureaucratic pipe dream. It is highly unlikely that a global political consensus could be reached for how to construct, share power, and implement policy through a global central bank. And if it were, the large cracks in this highly unstable Nash equilibrium would spread rapidly at the first signs of crisis, with one country after another defecting, and the entire thing would collapse, leaving the world no better off than it was under the fiat dollar reserve system, and arguably even worse.

The ever-prescient Jacques Rueff was making precisely these points back in the late 1960s, when the newly created SDR unit of account was already seen as a potential successor to the fiat dollar. In particular, he noted that an SDR reserve system would implicitly reward countries that ran budget and trade deficits and penalize those that did not. This is because SDRs could be created to settle balance-of-payments deficits. Those countries running deficits would be the first to receive the new SDRs. In time, however, these new SDRs, a form of global monetary inflation, would contribute to asset bubbles, resource misallocation, and consumer price inflation. As such, countries exercising restraint in domestic fiscal and monetary policy would bear the costs for others’ profligacy. He was particularly concerned about what would happen when a crisis arose:

Any international monetary crisis, any major outflow of capital...will provide an opportunity for an inflationary issue of SDRs. This in turn will lead to powerful surges of inflation in creditor countries.⁸

⁷ Presentation to the China G-20 Seminar, Nanjing, China, March 31, 2011. Mundell does, however, see it as possible, and desirable, that the United States, euro area, and China agree to fix their exchange rates, so as to provide a stable, global currency anchor for all others. This, he believes, would be a viable replacement for the fiat dollar. In my opinion, given the demonstrably divergent domestic monetary incentives between the United States, China, and within the euro area itself, it is unrealistic to believe that the actors involved could achieve the degree of agreement and cooperation required to maintain fixed exchange rates for long.

⁸ Jacques Rueff, *The Monetary Sin of the West*, (New York: The Macmillan Company, 1970), 171.

An SDR-based system would thus suffer from an inherent moral-hazard problem encouraging deficit spending and domestic inflation, which would periodically spill over into international monetary crises. Under Bretton-Woods, only the United States enjoyed the “exorbitant privilege” of being able to effectively force creditor countries to finance its trade and budget deficits at low interest rates. Under an SDR-based system, any country running trade and budget deficits would have the privilege.

The idea that China, Japan, Russia, oil exporters, or other creditor countries would go along with such a scheme is absurd. Absent a hegemon to impose it, the idea that agreement could be reached to enact such an arrangement and sustain it thereafter is far-fetched indeed.

Were Jacques Rueff alive today, he would probably see an SDR-based solution as even more unworkable than in the late 1960s, given the current degree of monetary instability and lack of global cooperation in economic and monetary affairs, both of which are an order of magnitude greater. Fortunately, no fiat currency, national or global, is required to serve as the primary global reserve. History presents the world with an existing, tried, and tested alternative: gold.

THE EMERGENCE OF THE CLASSICAL GOLD STANDARD IN THE 1870S

At this point, it is instructive to consider how the classical gold standard came into existence in the 1870s. Consider that following the various European revolutions of the 1840s and 1850s and the Franco-Prussian war of 1871, the European political landscape had been transformed. A new balance of power had been established on the continent. Economic hardship was giving way to an era of growth, trade, and integration.

There was, however, no dominant economic power, no hegemon to provide a reserve currency for all. The United Kingdom had a global empire and a formidable navy, to be sure, but its ability to project power, economic or otherwise, into the Baltic region or the interior of Eurasia was becoming limited, as demonstrated by the growth of the Prussian-led, central European economic Zollverein and, rather more painfully, by the Crimean War.

It was out of this increasingly non-hegemonic political environment, characterized by growing international trade, that the classical gold standard emerged. Rather than being somehow imposed from above by any one country or group of countries, as was the case with the Bretton-Woods system, it arose from the bottom up. Gold provided an objective, universal reference point for cross-border trade between countries that were

once and future economic competitors and, at times, military adversaries. Indeed, as one prominent study of the classical gold standard puts it:

[T]he regime dynamics of the classical gold standard were founded on neither cooperation nor hegemonic leadership. Both the origin and stability of the gold standard, in fact, resulted from much more diffuse or decentralized processes (i.e. not managed at the international level). . . .

Contrary to many visions of the gold standard, the regime dynamics upon which it was founded showed a strongly diffuse character. Moreover, the managerial elements that did show up were quite different from the conventional visions of hegemony and cooperation in the literature on international regimes. The nature of hegemony was much more unintentional and non-state than prevailing theories of hegemonic regimes can account for

Cooperation, too, fails to explain the origin and stability of the regime. In fact, **it was a failure to cooperate that led to the emergence of the regime in the 1870s. . . . Moreover, it is not clear that more cooperation would have produced a more stable regime.** The lack of cooperative schemes effectively limited the degree to which authorities could allow their macroeconomies to arrive at conditions that would have threatened convertibility (i.e. moral hazard and adverse substitution leading to inflation and fiscal deficits). . . .

In sum, the gold standard showed very little cooperation among national governments in the process of formal regime building. The rise of the gold standard can be seen more as a case of a regime emerging from the failure to cooperate. (emphasis added)⁹

There are, thus, strong parallels between the 1870s and today. The United States began to lose hegemonic status in the 1960s, to which the outflow of gold and the gradual decline in the US share of global economic output attest. The closing of the gold window in 1971 was an important signpost in this regard. More recently, the fiat-dollar standard has demonstrably destabilized the global economy and led to a series of escalating monetary and currency disputes. The global economy is in desperate need of a new, more stable monetary order, yet it must be one that can function absent a hegemon and without an established, institutionalized basis for cooperation.

9 Guilio Gallarotti, *The Anatomy of an International Monetary Regime: The Classical Gold Standard 1880–1914* (New York: Oxford University Press, 1995), 218–227.

Back in 1997, over a decade before the 2008–2009 global credit crisis, Nobel laureate Robert Mundell observed that:

We can look upon the period of the gold standard...as being a period that was unique in history, when there was a balance among the powers and no single superpower dominated. [Emphasis added]¹⁰

As it now appears, following decades of relative decline of the US economy and the rise of the BRICS and a handful of other nations, the “balance among the powers” to which Mundell refers may not be so historically unique after all. Indeed, the stage for gold has been set.

¹⁰ Robert Mundell, “The International Monetary System in the 21st Century: Could Gold Make a Comeback?” Lecture delivered at St. Vincent College, Letrobe, Pennsylvania, March 12, 1997.