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The Golden Revolution, Revisited: Chapter 5

This Insight is the sixth in 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 I.

The "Reserve Currency Curse" amd the International Aspects of Cantillion Effects

"The fact that many countries as a matter of principle accept dollars to offset the US balance-of-payments deficits leads to a situation wherein the United States is heavily in debt without having to pay. Indeed, what the United States owes to foreign countries it pays—at least in part—with dollars that it can simply issue if it chooses to. It does so instead of paying fully with gold, whose value is real, which one owns only because one has earned it, and which cannot be transferred to other countries without any danger or any sacrifice. This unilateral facility that is available to the United States contributes to the gradual disappearance of the idea that the dollar is an impartial and international trade medium, whereas it is in fact a credit instrument reserved for one state only."

FRENCH PRESIDENT CHARLES DE GAULLE, FEBRUARY 1965

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Having shown that monetary Cantillon effects can have a material impact on economic inequality within an economy, it remains to consider how these effects can also spill over internationally. As the issuer of the primary global reserve currency, the US Federal Reserve may be the source of significant international Cantillon effects. Indeed, I believe that these effects are in certain respects easier to identify than those observed domestically. There have also been some major studies supporting this view. First, let us consider the important role played by a reserve currency in the international monetary system.

What, exactly, is a reserve currency? It is one that is used to pay for imports from abroad and is then subsequently held in "reserve" by the exporting country, as it does not have legal tender status outside of its country of issuance. In the simple case of two countries trading with one another, with one being a net importer and one a net exporter, over time these currency "reserves" will accumulate in the net-exporting country. In practice, as reserves accumulate, they are initially held as bank deposits but are subsequently invested in some way, for example, in government bonds issued by the importing country or perhaps purchases of corporate securities. In this way, the currency reserves earn some interest and possibly realize some capital gains, rather than just sit as paper scrip in a vault.

Beyond a certain point, however, accumulated reserves will be perceived as excessive by large holders in the exporting country, in which case they can either reverse the net trade position and start paying for net imports with the accumulated reserves, or alternatively they can exchange a portion of their reserves with another country or entity at some foreign-exchange rate. For this reason, other factors equal, as the supply of reserves accumulate, but with demand constant, the reserve currency will depreciate in value.

As time goes on, trade imbalances and reserve balances grow in tandem, as does the natural downward pressure on the value of the reserve currency as described above. This leads to what Belgian economist Robert Triffin called a "dilemma": for trade to expand, the supply of reserves must increase. Yet this implies a weaker reserve currency over time, something that can lead to price inflation. Indeed, under the Bretton Woods system of fixed exchange rates, the supply of dollar reserves grew and grew, price inflation increased, and, eventually, as one European central bank after another sought to exchange its "excess" dollar balances for gold, this led to a run on the remaining US gold stock and the demise of that particular monetary regime. While hailed as an important insight at the time, Triffin was pointing out something rather intuitive: printing a reserve currency to pay for net imports is akin to owning an international "printing press," the use of which causes net global monetary inflation and, by association, some degree of eventual, realized price inflation.

FROM TRIFFIN BACK TO CANTILLON

Now let's combine Triffin's insight with that of Cantillon. As discussed in previous chapters, money enters the economy by being spent. But the first to spend it do so before it begins to lose purchasing power as it expands the existing money supply. The money then gradually permeates the entire economy, driving up the overall price level. Those last in line for the new money, primarily everyday savers and consumers, eventually find that, by being last in line for the new money, their accumulated savings are being de facto "diluted" and the purchasing power of their wages diminished. Increased inequality is the result.

Extrapolated to the global level, this non-neutrality of money implies that an issuer of a reserve currency is the primary beneficiary of the international Cantillon effects. First in line for the new international money you have the owners of capital in the reserve-issuing countries, who use the new money to accumulate more global assets, and on the other you have workers the world over who receive the new money last, after it has placed general upward pressure on prices. Growing global wealth disparity is the inevitable result.

Another way to think about the benefits of issuing the reserve currency is that it generates global seignorage income. Federal Reserve notes pay no interest. However, they can be used to purchase assets that do bear interest. No wonder the Fed always turns a profit; it issues dollars at zero interest and collects seignorage income on the assets it accumulates in return. But in a globalized economy, with the US a large net importer and issuer of the dominant reserve currency, this seignorage income is largely if indirectly sourced from abroad, via the external accounts.

This becomes particularly notable in the event that domestic credit growth is weak relative to that abroad. The Fed may print and print to stimulate domestic credit growth, but if that printing does not get traction at home, it will instead stimulate credit growth abroad and, eventually, contribute to higher asset and consumer price inflation around the world.

Over time, this will impact the relative competitiveness of other economies, where wage growth is likely to accelerate, eventually making US labor relatively more competitive. That may sound like good news, but all that is really happening here is that US wages end up converging on those elsewhere, something that should happen in any case, over time, between trading partners as their economies become more highly integrated. But as mentioned above, to the extent that this wage convergence process is driven by artificial global monetary inflation, rather than natural, noninflationary economic integration, the Cantillon effects discussed earlier result in real wages converging downward rather than upward, implying a global wealth transfer from "owners" of labor—workers—to owners of capital.

So-called anti-globalists disparaging of free trade and economic interaction are thus not necessarily barking mad—well, perhaps some are—but they are barking up the wrong tree. The problem is not free trade; the problem is trade distorted by monetary inflation. If you want workers around the world to get fairer compensation for their labor, shut down the reserve currency printing press. And if you also want them to have access to the largest possible range of consumer goods at the lowest possible cost, remove trade restrictions, don't raise them.

ON RESERVE CURRENCIES, BACKED AND UNBACKED

As it happens, prior to the First World War, the bulk of the world was on the classical gold standard. Although the British pound sterling was the dominant reserve currency, it was not possible to print an endless amount to pay for endless imports, as external reserve currency balances were regularly settled in gold. The British pound thus held its value over time, as did other currencies on the gold standard, and there was no "Triffin Dilemma" resulting in growing, unsustainable trade imbalances. Moreover, absent monetary inflation, there were no insidious Cantillon effects taking place. Industrial wages were generally stable through these decades, which were characterized by mild consumer price deflation. This implied an increase in workers' purchasing power and standards of living. So while there are certain parallels between sterling's previous, gold-backed role as a reserve currency and that of the unbacked, fiat dollar today, there are even greater differences. (For those curious how such a stable and successful international economic order could break down so completely in such a short period of time, please turn to the extensive literature on the causes and consequences of WWI, arguably the greatest tragedy ever to befall Western civilization.)

Returning to the present, countries that have been exporting to the US and accumulating dollars in return are increasingly getting the joke, but they aren't laughing. In recent years, senior officials in a number of countries, including those rich in natural resources or with competitive labor costs, have criticized US monetary policy while suggesting that gold should play a greater role in international monetary affairs. The BRICS (Brazil, Russia, India, China, now joined by South Africa), individually and together, have already made numerous official, public statements to this effect. One can only imagine what is being discussed in private, behind closed doors.

In 2012, the BRICS' monetary concerns were shared openly by the prime minister of Turkey, historically a "swing state" in its global orientation, yet currently a member of NATO and thus at least a nominal US ally. PM Erdogan, who may be somewhat controversial in the opinion of Western leaders, yet is more popular with the electorate in his country than most of his counterparts are in theirs, had this to say in criticism of the International Monetary Fund (IMF):

> The IMF extends aid on a who, where, how and on what conditions bases. For example, if the IMF is under the influence of any single currency then what, are they going rule the world based on the exchange rates of that particular currency?
>
> Why do we not switch then to a monetary unit such as gold, which is at the very least an international constant and indicator which has maintained its honor throughout history. This is something to think about.[1]

Historians will note that once upon a time, France was also a full member of NATO, but following President De Gaulle's decision to challenge the dollar-centric Bretton Woods system in the mid-1960s, there erupted a series of dollar crises that culminated in the collapse of the Bretton Woods regime in the early 1970s. Is history about to repeat? (Incidentally, history has already nearly repeated at least once before, in 1979–80. While the mainstream historical economic narrative about this period is that the Fed resorted to putatively high interest rates to fight the high rate of domestic price inflation, one look at the behavior of the dollar in 1979 and 1980 tells a different story, that the air of crisis at the time had an important international dimension. FOMC meeting transcripts also reinforce this arguably "revisionist" historical view that the dollar's international role was at risk.)

Clearly there is growing dissatisfaction with the current set of global monetary arrangements, which allow the US to print the global reserve currency to pay for imports, an "exorbitant privilege" as it was termed by another French president, Valery Giscard d'Estaing. Under the Bretton Woods system, France or any participating country for that matter could choose to exchange its accumulated dollars for gold. As

1 "Erdogan suggests shift from dollar to gold," *Daily Shabah*, 10 November 2012.

predicted well in advance by French economist Jacques Rueff, a contemporary of Robert Triffin, the exercise of this choice to exchange dollars for gold by not only France but a handful of other countries led to a run on the US gold stock in 1971 and an end to the dollar's gold convertibility.

IS RESERVE CURRENCY STATUS A CURSE IN DISGUISE?

Let's now change tack in this discussion. Is reserve currency status a blessing or a curse? The answer may seem obvious. After all, isn't it nice to hold the power of the global printing press? To enjoy relatively lower borrowing costs and greater purchasing power? To possess the "exorbitant privilege," as it were? On the surface yes, but what lies beneath?

As Lord Acton is purported to have said, power tends to corrupt. By corollary, absolute power corrupts absolutely. And to the extent that a power that is held nationally is exercised internationally, then the corruption thereof has a deleterious international economic impact.

In the case of a reserve currency, the benefits of lower borrowing costs and cheap imports accruing to the issuing country appear to result in overborrowing and overconsumption relative to the rest of the world, eroding the domestic manufacturing base over time and widening the rich-poor gap to levels that are socially destabilizing. Trade wars, currency wars, or other forms of economic conflict are the inevitable result. In some cases, actual wars follow. In others, they don't. But in all cases, the reserve currency curse is recognized only too late, when an economy begins consuming its own capital in a desperate and unsustainable attempt to maintain its previous standard of living. Austrian economist Ludwig von Mises described capital consumption as akin to "burning the furniture to heat the home." Sure, it might work for a time, but what comes next? The walls? The floorboards? The roof?

Returning to the economy, both creating and maintaining a capital stock requires savings. Now what happens if there IS no savings? What if, for example, the financial assets, which are claims on the present and future productive value of the capital stock—net of depreciation of course—rise in value to the point that the holders thereof feel themselves "richer" and neglect to save? What if, for whatever reason, the central bank holds interest rates artificially low, such that there is little incentive to save? What if, in response to an unusually prolonged slump in economic activity, the central bank starts directly and artificially propping up asset prices by buying securities, thereby making it even less attractive to save?

Well, guess what? Amidst artificial disincentives to save and asset price distortions that make people feel "richer," what, exactly, is going to happen to the capital stock? Rather than grow, or even be properly maintained, it is going to depreciate, lowering the potential future growth rate. Capital consumption is just about the worst thing that can happen to an economy, and it is particularly tragic if it is not caused by some external shock such as a war or natural disaster but rather is self-inflicted as a result of failing to save enough to maintain the capital stock.

Don't be surprised when you look around and see crumbling infrastructure, whether public or private, in the US and certain other supposedly well-developed, mature modern economies. With asset prices artificially high, discouraging investment, and the return on savings artificially low, discouraging savings, there is naturally little in the way of incentives and resources available to maintain the existing capital stock, much less expand it. And don't be fooled into thinking that somehow higher taxes would help. Is the private sector going to save more, or less, if the tax burden rises? The answer to that is obvious. No, there are only two ways in which the existing capital stock can be properly maintained: with either a higher private savings rate, presumably a result of higher after-tax interest rates or, alternatively, for the government to redirect existing entitlement spending—consumption—toward infrastructure instead.

There is also another important implication. The currencies of countries that experience capital consumption tend to lose value over time. This is most often because, in response to the implied weaker growth, the authorities tend to get more aggressive in their attempts to compensate with monetary policy. This chronic currency weakness naturally leads to international investors being unwilling to hold the currency and perhaps unwilling to invest in the country at all. But what if we are talking about the country issuing the reserve currency? What if we are talking about the US today? If international investors are unwilling to hold it, well then beyond a certain point, it will cease to serve as the reserve currency. Without sufficient acceptance, it will be replaced by something else. What I believe that something else is—gold—and how the transition will quite possibly come about, comprise the core topics of the following two sections of this book. But first, some additional monetary history is in order, to bring us fully up to date in international monetary affairs.