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The reserve currency curse

Is reserve currency status a blessing or a curse? The answer might seem obvious, as reserve currencies have been shown to confer lower borrowing costs on their issuers. But what of the borrower who, enticed by low interest rates, borrows more than they can pay back? Naturally the result will be a default. However, for the issuer of a reserve currency that is unbacked by a marketable commodity, such as gold, in the event that they borrow too much, they can just print more reserves. While this avoids default indefinitely, it also hollows out the economy, erodes the capital stock, reduces the potential growth rate and, eventually, leads to a dramatic devaluation of the currency and loss of reserve status. History has not been kind to countries that have followed this path, nor to their financial markets. In my view, the grave investment risks associated with the possible eventual loss of the dollar's reserve status are not priced into financial markets.

JOHN BUTLER
RESEARCH@GOLDMONEY.COM

RESERVE CURRENCIES, TRADE IMBALANCES AND THE 'TRIFFIN DILEMMA'

Having written a book about international monetary regime change past, present and future, I weigh in here on what is gradually becoming a more mainstream debate about whether or not the US dollar is at risk of losing reserve currency status; what currencies, if any, might replace it; and, should that happen, what general economic and financial market implications this would likely have.

As it happens, I have a rather strong opinion on all of these matters. But first, let's consider what a reserve currency is and what it is not. Second, let's distinguish carefully between reserve currencies that are backed by a marketable commodity, such as gold or silver, and those that are not. Third, let's take a look at shifting global economic power and monetary arrangements. Then we can move into what I think is going to happen in future, what this implies for financial and commodities markets, and what investors should do to prepare.

What, exactly, is a reserve currency? It is an international money 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 invested in some way, for example, in bonds issued by the importing country. In this way the currency reserves earn some interest, rather than sit as paper scrip in a vault.

Beyond a certain point, however, accumulated reserves will be perceived as 'excessive' by some in the exporting country, in that they would prefer to purchase something with this accumulated savings instead. In this case they have a choice: Either they can purchase more imports from the net-importing country, thereby narrowing the trade imbalance, OR they can exchange their reserves with another entity at some foreign-exchange rate. For this reason, other factors equal, as reserves accumulate, 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. It can also result in chronic imbalances and the associated accumulation of excessive, unserviceable debts.

'CANTILLON EFFECTS' AND THE NON-NEUTRALITY OF INTERNATIONAL MONETARY RESERVES

Now let's combine Triffin's insight with that of Richard Cantillon, a pre-classical 18th century economist, that money is not 'neutral': New money enters the economy by being spent. But the first to spend it does 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.

Extrapolated to the global level, this non-neutrality of money implies that an issuer of a reserve currency is the primary beneficiary of the 'Cantillon effect'. First in line for the new international money you have the owners of capital in the reserve issuing countries, which 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 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 labour 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 monetary inflation, rather than natural, non-inflationary economic integration, the Cantillon effects discussed earlier result in wages converging downward rather than upward, implying a global wealth transfer from 'owners' of labour—workers—to owners of capital.

So-called anti-globalists disparaging of free trade 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 labour, 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.

RESERVE CURRENCIES, COMMODITY-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 of pounds 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 not a '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 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. Hardly a week goes by without some senior official in an up-and-coming country rich in natural resources or with competitive labor costs criticizing 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.

Back in 2012, Prime Minister Erdogan of Turkey--historically a 'swing-state' in its global orientation, yet currently a member of NATO and thus at least a nominal US ally--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.

Historians will note that back in the 1960s, 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 punishingly 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 another 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 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.

THE RESERVE CURRENCY CURSE IN DISGUISE

Let's pause this discussion here for a moment. 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 wrote, "Power tends to corrupt. Absolute power corrupts absolutely." By corollary, absolute monetary power corrupts absolutely. And to the extent that monetary power that is held nationally is exercised internationally, then the corruption thereof can have 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 typical 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?

For those who think that a capitalist, free-market economy would never willingly consume its own capital, you may be right. But what of an economy that merely pretends to be capitalist and free market, but that sets the price of money by decree at an artificially low level such that there is little incentive to save?

It is highly intuitive to reason that, if an authority mandates a price ceiling below the natural, market-determined price for a given product, less of it will be provided and a shortage will result. Holding the 'price' of money—the interest rate—artificially low over a sustained period of time leads to a shortage of savings and, thus, to low rates of investment net of depreciation. Severely low or even negative rates would almost certainly lead to capital consumption and, unavoidably, a lower standard of living in time.

Notwithstanding the power of basic economic logic and empirical evidence of historically low rates of fixed (non-inventory) business investment, the US Fed may honestly believe that its neo-Keynesian models are right. Alternatively, even though its forecasts of recovery have been off the mark for many years, perhaps it is simply not willing to admit that the models, or the entire theory, are wrong. Back in 2012, the International Monetary Fund, for what it is worth, already determined that its models are flawed, although they also admitted they had little idea what to do about it other than to shoot in the dark, something that is not exactly reassuring.

THE TURKEY IN THE GOLD MINE

Today, as the dollar is not convertible into gold, there could not be a run on the US gold stock. But there is no reason why central banks around the world can not diversify out of dollars and into gold, something that would have much the same result: The dollar would decline versus gold and real assets generally, US imports would become more expensive and economic growth, to the extent that the US can grow at all given its structural problems at present, would be highly 'stagflationary', just as was the case during the 1970s, in the aftermath of a substantial dollar devaluation.

As it happens, these developments are already underway. According to various reports, many central banks have been and continue to accumulate gold, including Russia, China, Brazil, India, Bangladesh, Mexico, South Korea, Kazakhstan Turkey and Indonesia. While central banks must report their gold reserves to the IMF, the sovereign wealth funds of these countries are under no such obligation and, as sovereign wealth funds occasionally operate in effective if unofficial collaboration with their respective central banks, it is highly likely in my opinion that there is much more official gold accumulation taking place than is officially reported.

As they are not free-market, profit-maximizing entities in the same sense as independent private investors, these official gold buyers are not as price sensitive. If they are instructed by their political leadership to diversify their reserves out of dollars in some amount, or at some regular rate, they are going to carry out that mandate, regardless of the price, until that policy changes. This is strategic, not tactical gold buying, as it were.

This is just one of many reasons why the gold price has resumed an uptrend. The most fundamental is simply that the values of currencies, now including the dollar for the first time in awhile, are going down as a result of endless quantitative easing (QE), negative interest rates or other forms of monetary expansion. That the agents swapping their dollars for gold happen in some cases to be price-insensitive official institutions is just one mechanism by which a global shift out of paper into hard assets has been an, in my opinion, will continue taking place.

I don't pretend to know exactly what is going to happen from one day to the next. But when you step back and see the larger picture of one country after another expressing disapproval with the dollar reserve standard, you can't help but notice that the game is changing. Central bank or other forms of official gold buying is but one aspect. Another is the growing official collaboration on monetary and other economic matters by the BRICS. Then there are the various bilateral currency arrangements between an increasingly number of countries that allow them to reduce dependence on the dollar for bilateral trade.

Turkey's previous admission that it was paying for imports of Iranian natural gas with gold in order to avoid US sanctions may seem a small, insignificant development by comparison but within the larger context it could have a disproportionate impact. Indeed, Turkey may have been only one of several countries monetizing gold for use in importing Iranian gas or other goods. As a canary signals danger in a coal mine, might Turkey be signaling something rather more significant for international monetary relations?

Quite possibly. Game theory is highly instructive as to how international policy regimes, once destabilized by changing conditions or incentives, can suddenly shift to, or collapse into, a new equilibrium, sometimes in response to seemingly insignificant developments. When countries that comprise in aggregate about 1/3 of all global trade flows express dissatisfaction with the dollar and the IMF, the current international monetary regime is clearly unstable. When a medium-sized player such as Turkey moves from one side of the game board to the middle, or to the other side, there is always a chance that this represents the proverbial 'tipping point' from one equilibrium to another. In this case, if history is a guide, then as the world moves away from the current, dollar-centric reserve standard system it will move to one based on multiple currencies, yet with an explicit reference to gold.

Why gold? Part I of my book, The Golden Revolution, concludes with a discussion about why gold has by far the strongest claim as a future international monetary reserve replacement for the dollar. While historical precedent is important, there are also two important theoretical points to consider. First, there is no existing fiat currency alternative to the dollar at present, in the way that the US dollar provided an obvious alternative to the pound sterling following WWI. Second, given the increasingly obvious breakdown in cooperation in international monetary relations, it is highly unlikely that, as the dollar's role diminishes, there could be a universal agreement about how to construct or implement a global currency alternative to the dollar. Yes, the IMF has proposed precisely this and (no surprise here) has put itself forward as the bureaucracy that could manage it, but as discussed above, Turkey, the BRICS and a handful other nations don't necessarily trust the IMF to act in their national interest.

As a medium of exchange that cannot be printed, devalued or otherwise manipulated by any one country to somehow exploit others, gold holds more than just a historical claim to a future role as international money. It provides a basis for mutually-beneficial international trade when trust in monetary stability in general is lacking, as is increasingly the case today. The answer to the question of what currency or currencies can provide the future international reserve is thus as paradoxical as it is elegant: Every currency, if linked to gold, and none, as gold itself provides the trust.

The classical gold standard was so successful for this very reason. As the industrial revolution spread globally, cross-border trade and investment volumes soared. Without stable prices, however, high rates of investment would have been short-lived or completely unobtainable as businesses would have had insufficient confidence to take the long-term, cross-border risks required to develop what were becoming multinational industries and the first properly multinational firms. Indeed, it is difficult to imagine how the Industrial Revolution could have occurred at all, if not on a sound monetary foundation. Imagine otherwise, that 18-19th century industrialists had faced the uncertainties associated with zero-rates, currency volatility, QE or even negative rates. No doubt they would have mostly sat on the sidelines and hoarded gold as many wealthy investors are increasingly doing today as they seek to preserve wealth in a highly uncertain world.