Dr. Xiaochuan or: How I Learned to Stop Worrying and Love the Super-Sovereign Reserve Currency

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Introduction

"Mandrake, come over here. The Red Coats are coming. Come on!"

- General Jack D. Ripper

The governor of the People's Bank of China recently called for a move away from the dollar and towards its replacement by a super-sovereign reserve currency[1]. The idea has sparked discussion and the current anti-U.S. international zeitgeist has fueled further interest in such a debate. In examining this proposal, two issues will be considered: (1) the problems associated with the current system; and (2) the potential benefits of replacing it.

The Current System

Background

The fundamental role of finance is the efficient allocation of scarce capital and resources, and the system we have in place undermines this very basis of the financial system. The most concise way of framing the core problem of the current system is a tension between domestic and international goals in the execution of monetary policy. This problem was first exposed by economist Robert Triffin and is now referred to eponymously as the "Triffin dilemma." In testimony before Congress, Triffin identified a paradox. If the United States stopped running deficits, liquidity would be sapped from the global economy and this could devolve into a widespread contraction. If the United States continued running deficits, however, the value of the dollar would continue to weaken until the tipping point when confidence in its stability would be abandoned and chaos would ensue[2].

[1] Source: The People's Bank of China—Speeches: Reform the International Monetary System

[2] Source: An IMF Exhibit—The Importance of Global Cooperation (http://www.imf.org/external/npr/exr/cenet/mm/eng/mm_sc_03.htm)

"A fundamental reform of the international monetary system has long been overdue. Its necessity and urgency are further highlighted today by the imminent threat to the once mighty U.S. dollar."

- Robert Triffin, 1960

Triffin outlined the inevitable long-run effect of the dollar's status as the international reserve currency. We have not yet reached this end-game scenario, but recent manifestations of the aforementioned tension have made Triffin's concerns seem prophetic. The monetary policy of the United States has in recent years contributed to worldwide malinvestment and fueled two speculative bubbles that ruptured and shook the global economy to its core.

Analogize the inanity of current situation to the absurdity of the arms race during the Cold War. The very purpose of defense (ostensibly to make the world safer) was undermined by the policies pursued in its interest (a proliferation of weapons of mass destruction). The scenario is ludicrous in retrospect, and the notion of the dollar as a reserve currency may too become anachronistically silly someday in the future.

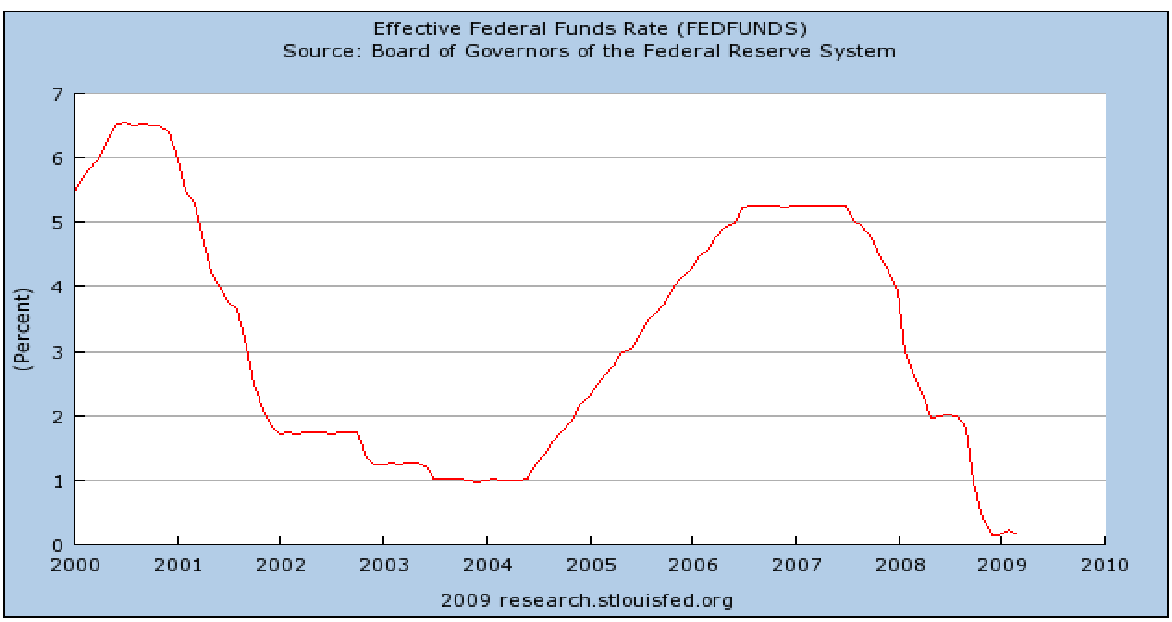
These two groups may be more similar than you think.

Problems in Action

The events of the new millennium are instructive. In the aftermath of the tech bubble, a problem exacerbated by the events of September 11, the Federal Reserve drastically cut interest rates to spark the economy. This should have led to an exodus from the dollar as investors would be expected to seek better yields and fear future inflationary pressures. The Fed would then have to raise interest rates to re-attract investment.

Yet this couldn't happen on the scale that it should have – surplus countries have little choice but to place most of their spare funds in the reserve currency since it is used to settle international trade and has the most liquid bond market[3]. This artificial demand allowed the Fed to keep interests rates low for much longer than was prudent. These low interest rates, in turn, helped facilitate booming housing prices, specifically a surge in the popularity of adjustable rate mortgages (ARMS), and overinvestment in the U.S. housing industry. An unsustainable run-up in housing prices occurred and the subsequent collapse rattled the global economy.

Effective Fed Funds Rate This Decade



[3] "The Dollar as a Reserve Currency—Handle With Care, *The Economist*, March 26, 2009

Positive Feedback – Increasing Returns Compound the Problem

One bubble is bad enough. But the Fed's response to the housing collapse is illustrative of the way in which one poor policy can be borne of another. The economy weakened as housing prices stagnated then fell and the Fed again slashed interest rates as a stimulative measure. At this point the crisis seemed quarantined in the U.S. and the dollar fell to historic lows against other currencies. Because commodities are priced in dollars, by definition, they must rise in price when the dollar weakens. In less than a year (August 2007 – July 2008), the price of oil more than doubled from $70 to $147. The roller coaster ride, though, was just beginning. As the financial contagion spread to other economies, the dollar strengthened in a flight to the safety of U.S. Treasuries. By October 2008, the price of oil crashed to where it began 14 months prior and it has continued down to a recent trading range in the $40s.

Crude Oil Prices This Decade

The Tipping Point

"Gee, I wish we had one of them doomsday machines."

- General "Buck" Turgidson

Are we nearing the tipping point which will ultimately lead us away from the dollar? It seems possible. Prognosticators across the globe are heralding the end of the United States' dominance in international finance[4]. China has called for a move to a super-sovereign reserve currency and the IMF is quickly gaining power and influence, most recently at the G-20 summit via a commitment from a range of countries (the U.S. included) to bolster its coffers[5]. The confluence of these factors could conspire to finally allow the transition to a new currency.

Such a gradual transition away from the dollar is the best case scenario for the logistics involved with a tipping point. Far more worrisome (and perhaps likely) is a radical tipping point in which confidence in the dollar is lost precipitously. This scenario is an analog to the Cold War nightmare of "mutually assured destruction." A crash in the value of the dollar would harm not only the United States, but it would also wipe out the reserve funds of other nations and lead to a nearly certain global economic catastrophe. The comparison is not as tortured as it may viscerally appear; indeed, a professor at MIT's Sloan School of Business recently predicted that the next world war will be financial in nature[6].

[4] see i.e., "The End of Arrogance—America Loses Its Dominant Economic Role," *Spiegel*, September 30, 2008

[5] "G-20 Plans to Increase IMF Funding by $1 Trillion," *The Wall Street Journal*, April 2, 2009

[6] "The Next World War? It Could Be Financial," *Washington Post*, October 12, 2008

A New System

Implications – An Absurdist (or not) Hypothetical on the Individual Level

Consider Melvin Muffley. Earlier this decade, Melvin had a stable, well-paying engineering job and lived comfortably in his three bedroom home with his family. Unexpectedly, home prices began to skyrocket in Melvin's southern Florida hamlet. Realizing how much his house was worth, Melvin sold it and "traded up" to a more luxurious house. He did this two more times shortly after, each time plowing his gains into the next house. By 2007, home prices hit a plateau but this was of no immediate consequence to Melvin. Home prices always went up, after all, and his house was still worth more than he paid for it. Melvin took out a loan against this home equity and sought a suitable investment. Oil prices had just crossed the $100 mark, and ethanol companies seemed like the perfect play given the trend of increased cost of traditional energy sources…

In retrospect, Melvin's initial bad decision (speculating in the housing bubble) led to another bad decision (speculating in a falsely attractive ethanol industry). This parallels the increasing returns dynamic where irresponsible monetary policy choices lead to exponentially more pain in the future.

Note the myriad permutations of this scenario and the breadth of the effects. Melvin could have foregone trading up, simply borrowing against the radically increased equity in his original house and buying a Toyota Prius (a purchase that would have been economically rational only at inflated gas prices). He could have quit his job as an engineer and become a mortgage broker because of the more lucrative compensation the latter would have offered and invested his compensation in a company with drilling rights in the Canadian oil sands. (The technology necessary to access oil in these regions is extremely expensive and only profitable at very high crude prices). The possible manifestations of his malinvestment are legion.

An Absurdist (or not) Hypothetical Spreads to the Corporate Level

In the interest of brevity, the details of the hypothetical will cease. But a simple review of headlines and bylines from the *Wall Street Journal* over the past two years (grouped by topic) will demonstrate the perpetual impact of individual malinvestment and how it carries over to the corporate level.

Airlines Fly on Oil's Fall (11/14/07)
Airlines See Oil Bills Rise, Profits Decline (12/13/07)
Airlines Boosted as Fuel Prices Fall (04/23/09)

Giant Ethanol IPO on the Way (08/15/07)
VeraSun to Buy US BioEnergy (11/30/07)
Bubble's Burst: VeraSun's the Latest Victim of Tanking Commodity Prices (11/03/08)
Ethanol Producer Seeks Chapter 11 (04/08/09)

Statoil to Buy Canadian Oil Sands Firm for $1.96B (04/30/07)
Marathon Oil Agrees to Purchase Western Oil Sands in Canadian Deal (08/01/07)
The Coming Oil Investment Boom (06/04/08)
Low Oil Prices Could Deter Investments (10/29/08)
As Prices Slide, Oil Firms Save Cash (11/26/08)

It's very much in vogue to disparage managerial fecklessness in the current economic environment. But can you imagine trying to form a competent business strategy in the face of such volatility? These considerations, of course, should be mitigating as opposed to exculpating. Some executives have successfully traversed the current landscape, but I believe success would be more widely achieved in a more stable economic climate.

Rectifying the Absurdity

"Providing reserves and exchanges for the whole world is too much for one country and one currency to bear."

- Henry H. Fowler
(Former U.S. Secretary of the Treasury)

We have moved from an arms race to an ARMs race with little gain shown from either. While abandonment of the dollar's reserve status is not a panacea, it would ameliorate some of the pervasive perversion of investment decisions at the individual and corporate levels. The super-sovereign currency that would replace it would in theory be more stable. Just as there are adverse increasing returns involved in the current system, a super-sovereign currency could harbor the power of positive increasing returns.

A more efficient allocation of capital would reward the right businesses. These businesses would grow the American economy at a faster rate and employ more individuals. In turn, these individuals and firms could be more confident in their investments. Ultimately, the United States would be more accountable for its monetary policy decisions. Such a solution could be the impetus for a global boom period not seen since the post-World War II era. Bearing these implications in mind, it's impossible not to stop worrying and love the super-sovereign reserve currency.