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The Geopolitics of the Reserve Currency: Part 1

One of the more interesting developments in this presidential political cycle has been the near total abandonment of free trade. Neither presidential candidate supports the Trans-Pacific Partnership (TTP) or the Transatlantic Trade and Investment Partnership (TTIP), the topic of last week's report. The primary reason for this backlash against free trade is the fear that U.S. employment is adversely affected by trade.

Some of the earliest work in economics was on trade. For example, the trade theory of comparative advantage was developed by David Ricardo in 1817. With perhaps the exception of Marxism,[1] most economists assume that trade is positive for economies. Most polls seem to suggest Americans still support free trade, but clearly the political class has concluded that supporting free trade is a risky stance. So, how did we get here?

We believe that the general misunderstanding of the U.S. superpower role is behind the backlash against free trade. In pure theory, it's hard to argue against free trade. Most economists adhere to the position that efficiency is an undisputable good. However, the way trade works in the real world isn't exactly how it works in the classroom. Often, political pundits will contend that the growing rejection of free trade is due to the fact that the benefits are broad but the costs fall disproportionately on workers who are adversely affected directly by import competition. Although this is a partial explanation, it is critical to understand that the global hegemon faces specific costs that are generally unappreciated.

In this report, we will begin with a narrative describing the use of the reserve currency in trade. Next, we will offer a short history of the dollar's evolution as a reserve currency. In the next section, we will examine the reserve currency as a global public good, provided by the superpower. Next week, we will discuss the economics and geopolitics of the reserve currency and, as is our usual fashion, we will conclude with potential market ramifications.

The Reserve Currency in Trade

Imagine that a chocolatier in Paraguay wants to purchase a ton of cocoa beans. He calls a dealer in Côte d'Ivoire for a price; the seller offers $2,675 per ton. The buyer in Paraguay notes he does not have U.S. dollars but does have Paraguayan guaraní. The seller does not want the Paraguayan currency because it would restrict his purchases to Paraguay only. The seller in Côte d'Ivoire would have a wider variety of goods he could buy from selling cocoa if he receives dollars instead.

So, how does the chocolatier in Paraguay get dollars? The most efficient way would be to export chocolate to a U.S. buyer, then use the dollars he receives to buy cocoa beans from Côte d'Ivoire. Because the reserve currency has widespread acceptance, non-reserve currency nations have an incentive

[1] Some Marxists hold that trade is a form of imperialism and is another tool for capital to subjugate labor.

to run trade surpluses with the reserve currency nation to accumulate the reserve currency, which allows them to pay for imports from around the world.

The Bank for International Settlements (BIS) reports that more than 80% of trade-related letters of credit are denominated in U.S. dollars, significantly more than the second most used reserve currency, the euro, at 10%.[2] That means most global trade is conducted in dollars, usually between nations other than the U.S. ***Essentially, the reserve currency nation must run constant trade and current account deficits in order to provide liquidity for global trade***. Thus, the U.S. doesn't run trade deficits because we "under-save" as is often heard by pundits in the financial media. Strictly speaking, this is true but it is mostly in response to foreign nations over-saving and moving that saving to the U.S. in the form of exports. If the U.S. were to run persistent trade surpluses, it would act as a global monetary tightening. In other words, by pulling dollars from world markets, the global trading system would face a contraction of available liquidity. If the reserve currency nation refuses to provide enough of its home currency to global markets, world trade is effectively reduced to barter, or counter-trade, meaning that nations can only engage in bilateral trade relations. Using the above example, the Paraguayan chocolatier can only acquire cocoa beans from Côte d'Ivoire if the seller there has something specific he would like to "swap" from Paraguay. Simply put, global trade would fall sharply if a reserve currency is unavailable.

The History of the Dollar's Reserve Currency Role

In July 1944, while the Second World War was raging, 44 nations met at a resort in New Hampshire to sketch out the postwar financial system. Their goal at Bretton Woods was to avoid a depression after the war. After World War I ended, the global economy fell into a slump. There was great fear that the prewar depression would resume once World War II ended. After all, the U.S. economy had been bolstered by the war effort and when the industrial sector no longer needed to produce war materials, a slowdown seemed likely.

The delegates believed that one of the reasons for the depression was widespread trade protection. With most of the developed world on the gold standard, there was a raft of devaluations against gold during the 1930s. These "beggar thy neighbor" policies tended to help the devaluing economy in the short run, but usually prompted other nations to respond with their own devaluations, or to block trade with other countries through tariffs and quotas.

The Bretton Woods agreement was designed to discourage anti-trade policies by linking the developed world's currencies to the U.S. dollar. The dollar was pegged to gold and foreign central banks could redeem their dollars for gold upon request. In effect, the United States was, after this agreement, firmly in control of free world international trade.

After WWII, with Europe and Asia severely damaged by the conflict, the United States dominated world trade. In fact, in the early 1950s, there was great concern about a global "dollar shortage." But as devastated nations rebuilt, the flows began to reverse over time and the United States began to run persistent trade deficits. For the global financial system to operate, the United States must act as the "importer of last resort" to ensure ample global liquidity.

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[2] http://www.bis.org/publ/cgfs50.htm

This meant that the United States would need to run persistent trade deficits to ensure sufficient global liquidity.

The United States could avoid the devaluations and economic contractions that other nations would have faced with persistent trade deficits. Other nations were willing to hold dollar balances because of the deep U.S. financial markets (allowing these dollars to be easily invested in the United States) and for its easy convertibility into other currencies. In addition, dollars could be used to buy commodities. In effect, a reserve currency nation gets to "submit checks for purchases that nobody cashes."

However, in the late 1960s, a number of European nations, concerned about their rapidly expanding reserve balances, began to convert their dollar balances into gold. In response, the Nixon Administration ended the convertibility of the dollar into gold on August 15, 1971, effectively ending the period of fixed exchange rates. Since then, the world has operated with a non-fixed currency system. It isn't a pure "float" because many governments actively intervene to manipulate their currency exchange rates.

Since 1971, the dollar has remained the global reserve currency despite the loss of the link to gold. Although nations have occasionally complained about U.S. domination via the reserve currency, there is still no obvious candidate for replacing America in this role. This is because other countries are not willing to accept the costs of providing the reserve currency, as we will discuss below.

The U.S. ran persistent current account deficits to ensure there was ample global liquidity. During the 1997-98 Asian economic crisis, U.S. consumption supported economic growth. The U.S. spearheaded bailouts in Latin America and Asia in the 1980s and 1990s. Although the U.S. has neglected the dollar at times, when the currency markets are at extremes it has also led efforts to return those markets to a more sustainable level. The Plaza, Louvre and Halifax Accords in the 1980s and 1990s are examples of U.S. foreign exchange market leadership. The U.S. financial system has provided deep and fair financial markets, which has encouraged foreign investors and governments to hold Treasuries as a risk-free asset. Overall, the dollar's reserve currency status has been one of the key supports for globalization.

The Reserve Currency's Public Good

Economists define a public good as a product or service that must be provided by governments because the private market won't provide the good, or will provide the good in less than optimal amounts. There are seven public goods a reserve currency nation should provide:

1. Act as a consumer (importer) of last resort;
2. Coordinate global macroeconomic policies;
3. Support a stable system of exchange rates;
4. Act as lender of last resort;
5. Provide counter-cyclical long-term lending;
6. Provide a truly riskless AAA asset for benchmarking purposes;
7. Supply deep and predictable financial markets.

Charles Kindleberger, the famous economist who studied asset bubbles, identified the first five and Mohamad El-Erian, the chief economic adviser at Allianz, noted the last two.

Economist Robert Triffin described the reserve currency country problem in the 1960s. Because the reserve currency provides global liquidity, the reserve currency country must run a persistent current account (trade) deficit. As noted above, if the reserve currency nation runs a surplus, it would act as a global monetary policy tightening. However, this deficit would need to be "manageable." If it becomes too large, it could shake foreign investors' confidence in whether the risk-free asset is truly risk free.

Conclusion

Next week, we will finish this report with an examination of the economics and geopolitics of the reserve currency.

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