

Likelihood of a New Reserve Currency Is de Minimis

Dr. Sherry Cooper, Chief Economist

There has been much speculation, especially by the Chinese, that the U.S. could or should lose its reserve currency status, but there is simply no reasonable alternative to the dollar and there won't be for the foreseeable future. No one would seriously consider a return to the gold standard, and no other currency in the world has the depth, breadth and acceptance of the U.S. dollar. The greenback is backed by a central bank (and presumably government) that is fully committed to price stability. Barring a public debt crisis, it should maintain its reserve status for many years to come. Certainly the renminbi is a long way from attaining that stature and the Chinese government will not allow its currency to rise to the levels that market forces would warrant were the currency to be unpegged. Moreover, China lacks the financial and legal infrastructure essential for reserve currency status.

The yen also is not a contender, as Japan's economy is in secular decline. One might consider the euro. However, members of the EMU have widely divergent fiscal and political policies that could be highly destabilizing in times of crisis. As well, it is not even clear if the euro will survive as member countries squabble over the so-called Maastricht requirements for debt and deficit levels and new entrants are relatively poor countries with serious demographic problems.

Some have suggested that another possible alternative would be a 'constructed' currency similar to Special Drawing Rights (SDRs). The SDR is an international reserve asset, created by the IMF in 1969 to support the Bretton Woods fixed exchange rate system. A country participating in this system requires official reserves—government or central bank holdings of gold and widely accepted foreign currencies—that could be used to purchase the domestic currency in foreign exchange markets, as required to maintain its exchange rate. But the international supply of two key reserve assets—gold and the U.S. dollar—proved inadequate for supporting the expansion of world trade and financial development that was taking place. Therefore, the international community decided to create a new international reserve asset under the auspices of the IMF.

However, only a few years later, the Bretton Woods system collapsed and the major currencies shifted to a floating exchange rate regime. In addition, the growth in international capital markets facilitated borrowing by creditworthy governments. Both of these developments lessened the need for SDRs.

The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Its value varies with the exchange rates of the underlying currency, providing little more certainty and stability than we have now. The fact is that, in a flexible exchange rate regime, the reserve currency necessarily depreciates over time to accommodate global growth. Currently, however, the burden of the dollar's fall is unfairly heavy on the Canadian dollar, the euro, yen and other major currencies because the number-one exporter to the U.S., China, has fixed its currency relative to the U.S. dollar for more than a year. Rather than calling for a new reserve currency, China must allow the renminbi to rise more rapidly to reduce the global trade imbalance.

What Would Be the Consequences of the U.S. Dollar Losing Its Reserve Currency Status?

- The U.S. government would need to pay more to borrow, making it harder to sustain its debt, resulting in bigger tax increases and spending cuts to restrain the deficit.

- U.S. interest rates would generally be higher than otherwise, constraining economic growth.
- Gold and other hard commodities would likely receive some further price lift.

What is the Impact of Further U.S. Dollar Weakness on America's Economy?

Positives:

- Will help the economy de-leverage (by raising import costs).
- Will help the economy return to full health faster. A weaker dollar, together with recent strong productivity gains, has likely given the U.S. a big competitive advantage over some other countries (including Canada and the Euro area).

Negatives:

- Could spur inflation, but that seems remote given the wide output gap.
- Could push interest rates higher. Global investors would demand higher U.S. rates to compensate for potential currency devaluation. As well, could compel the Fed to take back the stimulus sooner and faster.

Misconceptions of the U.S. Dollar's Role

Many have suggested that the fall in the U.S. dollar is reflective of the sad state of American economic affairs replete with surging budget deficits, profligate consumer spending, overleveraged banks, an enormous current account deficit and an increasing reliance on foreign capital inflows to finance the overspending. The reality, however, is that the role the U.S. dollar plays as the world's sole reserve currency ensured that such imbalances developed, otherwise the growth in global reserves would have been impossible. Think of it this way: a growing global economy requires a growing global money supply to provide the liquidity necessary to finance rising activity. The U.S. provides that underlying liquidity to the world by spending more than it saves or, in essence, spending more than it

can finance domestically. The U.S. became the consumer (importer) of last resort, providing currency to the rest of the world. This currency has been at least partially recycled back to the U.S. in the form of foreign purchases of private and U.S. government and agency debt. Without this recycling, the other currencies of the world would strengthen rapidly vis-à-vis the U.S. dollar, rendering these foreign exporters less competitive, returning the system to balance. The fall in the U.S. dollar is the equilibrating mechanism that reduces the net imports of the U.S., thereby reducing its current account deficit and, ultimately, its demand for foreign capital.

The broad trade-weighted U.S. dollar began falling in February 2002 and bottomed in July 2008 (*Chart 1*). With the onslaught of the credit crisis, the flight to quality (safe-

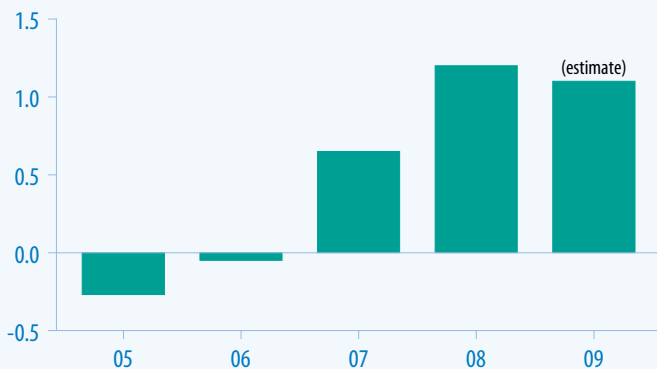
CHART 1
U.S. DOLLAR VULNERABLE
(as of November 19, 2009)

Broad Trade-weighted US\$



CHART 2
IMPROVED TRADE BALANCE BIG CONTRIBUTOR TO GDP

United States (ppt contribution to real GDP)

Net Exports of Goods and Services

TABLE 1
CURRENCY PERFORMANCES

(% chng vs US\$: as of November 19, 2009)

	Feb '02 Peak to Present	2009 Year-to-date
AUSTRALIAN \$	78.5	30.9
EURO	72.4	6.8
SWISS FRANC	68.3	5.4
CANADIAN \$	51.2	14.6
JAPANESE YEN	50.8	1.8
CHINESE YUAN	21.2	0.0
UK POUND	17.4	14.2
TRADE-WEIGHTED US\$	-22.3	-5.9
MEXICAN PESO	-30.2	4.9

haven flows) into Treasuries boosted the trade-weighted dollar to a peak in early March of this year when the stock markets bottomed. As the financial crisis dissipated and stocks rebounded sharply, the dollar resumed its decline, reflecting the success of the global authorities—especially the Fed and the U.S. Treasury—in averting disaster. The recovery in economic activity was beginning, as reflected in stocks and commodity prices. The reduction in the U.S. trade deficit has been an important contributor to GDP performance (*Chart 2*).

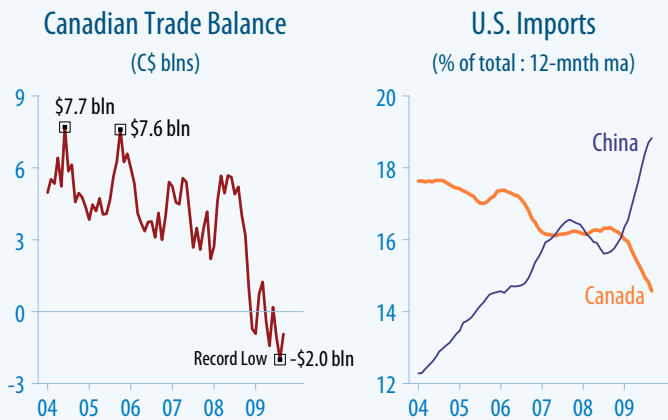
Even with the dramatic decline in the U.S. dollar since March, the trade-weighted dollar is still about 5% above its summer-'08 trough. Year-to-date, the Canadian dollar has risen 15%, but that is less than a number of other major currencies, particularly the Aussie dollar, which is up over 30% (*Table 1*). These commodity-related currencies have benefited from the economic revival, especially in China. Even so, the Canadian dollar, at over 93 cents, remains below the peak of \$1.10 hit in November 2007.

I expect the U.S. dollar to continue to decline—not because of American profligacy per se; but, because, under the current global monetary system, a fall in the dollar is the only way to reduce the global imbalances. The huge net inflow of foreign capital to the U.S., especially from China, facilitated America's overleveraging and underpricing of risk.

Ever since the Asian crisis in the late 1990s, emerging Asia (China) has been pursuing a policy of export-led growth by maintaining their currencies at undervalued levels. The U.S.'s consumption-led growth is the flipside of China's

export-led growth, taking consumption to a record high 71% of U.S. GDP. Thanks to enormous foreign capital inflows, capital in the U.S. was cheap and plentiful and risk was woefully underpriced, so consumers were incentivized to borrow. And borrow they did—extracting homeowner equity and running up huge credit card bills. Similarly, because of the inordinately low interest rates and risk premiums, investor demand for higher-yielding assets such as collateralized debt obligations (CDOs) surged, financing the subprime mortgage debt and housing bubble. The rest is history.

Being the sole reserve-currency country forced the U.S. into a current-account-deficit position, which by definition, ironically, weakens the currency over time. As long as the U.S. economy was strong, and the federal budget deficit was under control, no one worried much about the safety and soundness of the U.S. dollar. But with the explosion in U.S. government spending that was precipitated by the crisis and subsequent recession, the government deficit skyrocketed. Many began to worry about the

CHART 3
CHINA NOW BIGGEST SUPPLIER OF IMPORTS TO U.S.


ultimate inflation that might result if it were the only way to finance the deficit and so the currency weakened.

As the reserve-currency nation, the U.S. is the lender of last resort to the world. The Fed and the Treasury had to spend whatever it took to avert a global financial meltdown. Thus, in bad times, the dollar is necessarily vulnerable to inflation worries and ultimate devaluation. Right now, there are no other serious contenders to replace the U.S. dollar as the world's reserve currency.

It is essential that the Fed remain independent with no predilection or authority to conduct monetary policy in response to the dollar's fate; it is also required that the U.S. federal government remain solvent. That is certainly the case now, and will be for the foreseeable future. But the pessimists are very vocal and the media is increasingly

espousing their views that the Fed will run the printing presses for too long, thereby devaluing the dollar and using inflation to reduce the cost of deficit financing. Never mind that inflation is nowhere to be seen.

The enormous excess capacity in the U.S. economy and the downward pressure on real wages suggest, as the Fed avers, that there is a greater likelihood of falling inflation than rising inflation. The lower dollar helps to reverse these disinflationary pressures and improve the U.S. trade deficit, thereby boosting the economy. But sentiment is important, and the growing sense that the U.S. dollar is a "debauched" currency (similar to those in the 'Banana Republics' of the past) can become self-fulfilling if it triggers a dollar crisis. The unlikely, but possible, rout in the dollar could drive U.S. interest rates high enough to snuff out the recovery, debilitating the rest of the world's recovery. That is why it is so important to discredit the Chicken Littles.

Bottom Line: An orderly decline in the U.S. dollar is necessary to a sustained rebalancing of the global economy, which is a necessary precursor to a sustained global economic and financial recovery. The only way the American economy can de-leverage gradually over time is for the overspending to cease, which also goes hand-in-hand with a weaker American dollar. The U.S. must encourage some export-led activity and China must encourage some consumer-led activity, which means a smaller U.S. trade deficit and a smaller trade surplus in the rest of the world. We see this in spades in Canada where our record trade surplus has now melted into a record trade deficit (*Chart 3*). Products from China now account for a meaningfully larger share of U.S. imports than goods and services imported from Canada. Our exporters have been adjusting to this new reality since 2003 and further adjustment is necessary. Canadian business must raise productivity growth and add value to the goods and services we export. We must also broaden our export horizons, especially to the rapidly growing emerging economies of Asia.

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