



Currency Wars and the Future of Money

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When in 1992 Francis Fukuyama published his best-seller "The End of History and the Last Man," he made the case that the success of Western Liberal Democracy was going to sign the end of man's evolution toward its final form of government and so mark the end of history.

The book made me chuckle then and even more today while not only can't we agree on a final form of social organization but we can't even agree on a global payment system. The remaining and now most pressing legacy of the 2008 global financial crisis seems to be the determination of the future for the International Monetary System (IMS) or in layman terms the way we trade and pay each other globally.

Historically, every major financial and social crisis ended with a re-designing of the IMS; WWI marked the end of the first wave of globalization and virtually ended the pure global gold standard which was forever abandoned after the Great Depression; at the end of WWII, the Bretton Woods agreement established the US Dollar as the global reserve currency and the only currency convertible into gold. This convertibility ended amidst the stagflation crisis of the 1970 when Nixon closed the conversion window in 1971.

Here we are, forty years later, staring down the abyss hoping for a global flash of ingenuity and a new mantra to fix a badly imbalanced monetary system.

So what went wrong?

During the Bretton Woods agreement, J. M. Keynes advocated the creation of a global currency, the Bancor, to be utilized to settle all international trade. The Bancor would also have required the creation of a global Clearing Union which would have managed the inevitable trade surpluses and deficits among nations. The Union would have implemented rules to curb such imbalances and hopefully pushed the system toward more equilibrium. Ironically but understandably, the US opposed such view and successfully lobbied for the Dollar to virtually become THE global currency. I suppose winning a global war while retaining intact all of your production facilities and storing most of the available reserves of gold would give you such a negotiation advantage...

Being the provider of the global currency allowed the US great financial benefits, at least for a few years. The constant demand for Dollars to settle international trade lowered the US cost of financing and allowed for larger trade and fiscal deficits that would have been possible otherwise. Another by-product of this position was to practically impose globally our monetary policy; as John Connally, Secretary of the Treasury during the Nixon administration, famously said to a delegation of European politicians: "The Dollar is our currency but your problem."

Or is it?

In light of today's crisis we may rephrase: the Dollar is our currency and everybody's problem. The initial advantage, I referred earlier, to run larger deficits thanks to the currency role as a global reserve unit, led to the Triffin Dilemma. Triffin warned that a country providing the global reserve currency would have had eventually an incentive in running TOO large deficits and then inflate its way out them. A perhaps unforeseen element a few years ago might have also accelerated the process; not only the US was incentivized to run large trade deficits but many emerging markets decided

to marry their fortunes to the “*produce-at-the-lowest-cost-and-export*” model and heavily manipulated their currency vis-à-vis the dollar to achieve trade advantages. Systemic and chronic imbalances were created.

We are now locked into an unsustainable global position where the large exporting countries feel they cannot succeed without a constantly undervalued currency, the US will eventually inflate its way out of trouble and virtually all players will engage in some form or another of currency wars. The high stakes poker game is on.

While short term solutions vary from allowing for a faster appreciation of the Chinese Renminbi (China running the largest trade surplus) to a diversification of global reserves from just the USD to include other currencies, the question remains on what kind of system we can agree globally that might, in the long term, be more stable than the present one.

A nostalgic fringe has been calling for a restoration of the gold standard but this is impractical for a number of reasons. A pure gold standard tends to be deflationary (albeit proponents of this solution might actually find this a plus) and probably would not really end mercantilist policies. The present geographical distribution of the metal would also pose logistical and political problems during the transition to the new system. A not so pure gold standard based on paper claims or other types of derivatives would eventually end up manipulated just as our current currency system***. Yet gold does have certain characteristics that might help finessing the system. It has been accepted globally for thousands of years as a store of value and a medium of exchange; it is finite, it does not decay, it is malleable. And its price responds to perceived instability and global inflationary pressures.

If gold is not the answer then is a global currency, just like Keynes advocated seventy years ago, a workable and likable solution? Possible - but with a number of precautions. Common currencies are complicated affairs; think of the Euro and it's disconnecting between the monetary union it represents and the fiscal disunion that characterizes it. A common currency requires to some degree a loss of sovereign power; another famous macroeconomic dilemma or better “trilemma” highlights the three major objectives a government will want to achieve while only able to achieve two of them:

- An open current account
- Stable currency
- Domestically oriented monetary policy.

In other words, a global currency will require some sort of supranational oversight in terms of trade policy, like limiting surpluses and monetary/fiscal policy in order to avoid inflationary temptations.

Robert Zoellick, President of the World Bank, has recently called for a mixed system of different major currencies, including a liberalized Renminbi and gold as an international reference point for global monetary policy. The details are vague and it is unclear which entity would enforce the given parameters; in fact it is unclear whether any country would trade domestically oriented monetary policy for FX stability.

Will we need another crisis to force us into a disciplined approach?

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Sources:

Robert Zoellick, *The G20 must look beyond Bretton Woods II*, Financial Times, November 7, 2010

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Disclaimer: as a money manager I trade a gold based strategy.

Posted by Prof. Davide Accomazzo at [9:20 AM](#)

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