The Oil Drum: Europe
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

A Change Coming to the World Monetary System?

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Thoughts related to the world monetary system, and where it may be headed, below the fold.

Thoughts related to the world monetary system, and where it may be headed, below the fold. *This is an expanded version of a short post I wrote for the EuropeanTribune. Given the amount of interest the price of gold is generating, today's developments in the currencies market, and the connection to finite resources, The Oil Drum editors thought it might be worthwhile to bring this up for discussion here, as well.*

CNBC invited Jim Rickards, a senior managing director at a firm called Omnis to comment on the latest G-20 meeting and the future of the dollar. His testimony shows some rare lucidity about the present problems with our monetary system. He is bearish on the dollar, bullish on gold, but don't mistake him for a gold bug, for he is well aware of the consequences of a flight to the “barbarian's relic".

> If gold goes to 1500$ [...] it has to do with the fact that the dollar is imploding [...]

Rickards links an oped article at the Wall Street Journal penned by Federal Reserve governor Kevin Warsh to the G-20 meeting in an interesting way: it is a camouflaged warning against a fast drop of the dollar against other currencies, especially gold.

> The Fed needs the dollar to get down by about half in the next 14 years. We have 60 trillion dollars of liabilities [...] there's no feasible combination of growth and taxes than can fund those liabilities. [...] They need to do that, but that's a dynamically unstable process. They would like to do it gradually, and that's the plan, but if the market gets ahead of it, if the market sees this playing (which probably they will), you could have a very rapid collapse of the dollar [...]

The secular declining trend of the dollar has been resuming since early September, fueled by the carry trade encouraged by null interest rates in the US. This is leaving a lot of people uncomfortable, both those issuing the dollar as those piling it up.

It is important to understand that pretty much all of the major players in the international market (read G-20) are beginning to believe that their main unit of account and medium of exchange is entering a downward spiral. This is where the SDR (Special Drawing Rights) comes about, a remnant of one of Keynes' bold ideas that may be materializing today.

> The IMF is being sort of anointed as a Global Central Bank. They are now running a balance sheet, they've issued debt for the first time in History, they are issuing SDR, the last time they were issued was in 1980 or 1981 [...] they are printing money, there's nothing behind these SDR.

An abstract version of the Bancor seems to be already in active duty, but is it the solution for the problem? It may be if the problem is simply one of having a regional entity (the Federal Reserve) managing the global monetary policy. But there is more to it.

> In order to stimulate world trade and the world economy some hard currency country has to run persistent large deficits, but if you run persistent large deficits you eventually go broke. [...] 50 years later the US is getting closer to going broke; we fueled the world economy the last 50 years.

The US is not “going broke" only because it ran persistent large deficits. Fifty years ago the US was the largest world oil producer, one of the largest energy and food exporters and held considerable amounts of gold; today it is the largest world energy importer and its gold reserves have become of little relevance. The physical basis of the world's medium of exchange has been depreciated to a point where international trade players have lost faith in it.

> So how do you get out of that? The US can get its own house in order, but that would cause world trade to contract. What you need to do is to kick the problem upstairs. We gonna use SDR to fuel the global economy, so that we can take the dollar off into a corner and depreciate the dollar to solve our own debt problems.

Rickards also makes some sharp points on US security, although taking into account its nuclear arsenal, the US will still be a super-power if the SDR comes to be the new world reserve currency. The problem is: if the US can't print money as before, wars like the ones being fought in Iraq and Afghanistan may not be possible anymore.

> Warsh is saying: “We are not going to let that happen [...] we sort of have to trash the dollar, but if the market gets ahead of us and we see gold from 1500$ to 2000$ we are going to raise rates a lot, maybe 50 or 75 basis points to defend the dollar".

That was largely what happened in 1980, when panic drove gold prices over 800$, well beyond 2000$ at today's prices. That same year the Federal Reserve pushed interest rates to 20%; after that the deepest world recession since WWII unfolded.

> The problem is, when you own gold you are fighting every Central Bank in the World. Central Banks hate gold because it limits their ability to print money. But the market is the market. The market will do what it wants, and even Central Banks aren't bigger than the market.

Quite true, all Central Banks in the world are today working with paper, not precious metals. Moreover, many Central Banks have been dumping their gold reserves during these past decades of growth.

This is crux of the matter, Central Banks have very limited options regarding gold; being it a resource in very limited supply, the sort of expansionary monetary policies run especially since the early 1980s are impossible with it. With paper monies Central Banks can cast a floor on Velocity with Inflation (this means monetary mass expansion) guaranteeing that paper's function as wealth storage is limited in time. While with paper investors are compelled to feed their money into the economy, so to avoid its continuous loss of value, with gold such isn't the case – its limited supply and resilience to forgery make it a wealth storage medium for the very long term. With gold, investors simply do not have the same incentive to feed the economy. They can opt to simply sit on it, killing Monetary Velocity and imparing economic activity. From a Keynesian perspective, the Great Depression can be explained as a consequence of the post-WWI re-introduction of gold as de facto currency in Europe. Investors lost the incentive to invest; portfolios moved towards liquidity (gold is the most liquid of all assets, even without legal tender it is more liquid than paper) and Velocity collapsed.

This morning The Independent printed this news bite:

> The demise of the dollar In the most profound financial change in recent Middle East history, Gulf Arabs are planning - along with China, Russia, Japan and France - to end dollar dealings for oil, moving instead to a basket of currencies including the Japanese yen and Chinese yuan, the euro, gold and a new, unified currency planned for nations in the Gulf Co-operation Council, including Saudi Arabia, Abu Dhabi, Kuwait and Qatar [this is the already famous Khaleeji, the Arab nations' counterpart of the Euro, that was originally set to be adopted next year].
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> Secret meetings have already been held by finance ministers and central bank governors in Russia, China, Japan and Brazil to work on the scheme, which will mean that oil will no longer be priced in dollars [...]
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> The Americans, who are aware the meetings have taken place - although they have not discovered the details - are sure to fight this international cabal which will include hitherto loyal allies Japan and the Gulf Arabs. Against the background to these currency meetings, Sun Bigan, China's former special envoy to the Middle East, has warned there is a risk of deepening divisions between China and the US over influence and oil in the Middle East. "Bilateral quarrels and clashes are unavoidable," he told the Asia and Africa Review. "We cannot lower vigilance against hostility in the Middle East over energy interests and security."

This article is far fetched. There's nothing secret about the Khaleeji or about the currency swap agreements China is making with its closest trade partners. Even if the news really originated from Chinese officials, it should be taken more as pressure on the US than anything else. The only reason for these nations to work on their own is in case the US is unwilling to cooperate, which doesn't make much sense. Cooperating with the lender nations is the best way to avoid the dollar's collapse. The lender nations will possibly first de-peg their currencies from the dollar and peg them to the SDR. This still leaves a lot of control for the US, given that the dollar still makes up more than 40% of the SDR. Afterwards the lender nations could slowly enter the SDR with small weights and then expand from there (the Khaleeji, the Real, the Ruble and the Yuan should be the first to enter the SDR).

By not cooperating, the US can obliterate the IMF. If this happens, it seems likely a number of regional currencies will pop up, over which the US has no control. It seems unlikely that any Central Bank will move openly to a commodity currency at this stage (even if solely as reserve).

For one reason or another, possibly because of this news, gold climbed 2.5% in intraday trading to set a new record against the dollar, at the time of writing, just below 1044$. It is interesting to note that against the euro, gold is also setting high values, piercing through the 700€ barrier, but it is still 10% off the all time record. Another noticeable development is the euro nighing on 0.93 against the sterling.

Going back to the SDR, kicking the problem upstairs can indeed deal with the dollar's expiration as world reserve currency. A new reserve currency system seems to be well on its way to development, similar in approach to the old Ecu. Such a development might make way for an orderly shift away from the dollar.

But as I wrote last time on this issue, there's more to this problem than simply finding a new reserve currency system. What Rickards seems not yet to be aware of is that the problems the US is facing today may soon become common to all other international players, even those adopting the SDR as reserve currency. *What if there's no more growth, in physical terms?*

If the flows of energy and matter to the economy fail to grow during an extended period of time, Central Banks will be caught between a rock and a hard place; they can either continue with present expansionist policies and be left powerless to the degradation of their currencies (and rise of precious metals) or they can limit the abstract currency supply and treat it essentially as a commodity currency. Whatever the option, in the long run, Central Banks will be dealing with limited supply currencies.

In the case of gold, Central Banks still have some options, like opening the Mints and mobilizing the dozens of tons of monetary jewelry worldwide into the bullion pool, thus effectively expanding supply (and even increasing velocity). But for the other precious metals this is not an option. Silver, for instance, may become a serious problem. Industrial usage depleted the world stock to the point that in weight terms, it is now down to less than a sixth of the world gold stock[1]; compounding that is the traditional lack of silver reserves at Central Banks. Silver is easy to falsify, having a density similar to that of lead, but in small bullion pieces it is still safe. With newer precious metals such as palladium or platinum the situation is similar. Platinum especially is even denser than gold and also impossible to falsify in practical terms.

The End of Growth may bring to an end a monetary system that existed during a brief period of time from a historical perspective--officially during the last four decades--in practice since WWII. It was fed by growth and in its turn fed growth itself, in a feedback loop that brought about the world of today--a world that tomorrow will be the past.

[**Update 07-10-2009**] Closing a day fertile in currency and macro-economic news was this:

> UN calls for new reserve currency The United Nations called on Tuesday for a new global reserve currency to end dollar supremacy which has allowed the United States the "privilege" of building a huge trade deficit.
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> "Important progress in managing imbalances can be made by reducing the reserve currency country?s 'privilege' to run external deficits in order to provide international liquidity," UN undersecretary-general for economic and social affairs, Sha Zukang, said.
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> Speaking at the annual meetings of the International Monetary Fund and World Bank in Istanbul, he said: "It is timely to emphasise that such a system also creates a more equitable method of sharing the seigniorage derived from providing global liquidity."
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> He said: "Greater use of a truly global reserve currency, such as the IMF?s special drawing rights (SDRs), enables the seigniorage gained to be deployed for development purposes," he said.

As a final note to this ever expanding post it must be said that the US issued the World's reserve currency for the past six decades not because it is an evil country. In the 1940s the US had the largest energy, industrial and resource base in the world and efficitivelly avoided totalitarian regimes from taking over.

Unfortunatelly, both the US and its allies lacked the vision to update the monetary system they enacted in 1944, negligently assisting to its demise in 1971 with arms folded.

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[1] World gold stocks are around 160 000 tones. World silver stocks are calculated to be circa 25 000 tones.