



DAVID HALE GLOBAL ECONOMICS

The US Dollar and the SDR

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The global role of the dollar has been a controversial issue since the 1960's. French President Charles de Gaulle described it as an "exorbitant privilege," and tried to undermine it by having his central bank swap dollars for gold.

The suggestion in late March by the Chinese central bank Governor Zhou Xiaochuan that the dollar's global role should decline, and be replaced by a super sovereign reserve currency such as the Special Drawing Right (SDR) is the latest chapter in this ongoing debate. It is not surprising that China should be concerned about the dollar. The Obama administration has embarked upon an expansionary fiscal policy which could produce deficits approaching \$10 trillion over the next nine years. At the same time, the Federal Reserve is pursuing an accommodative monetary policy which could expand its balance sheet from \$900 billion last August to \$4 trillion by this August. Federal Reserve Chairman Ben Bernanke is pursuing such a policy to fight the risk of deflation, but it is unclear how he will reverse these actions when conditions normalize next year. If the government's large borrowing requirement forces him to keep policy accommodative, inflation expectations could rise and the dollar could decline. As China has over \$1.3 trillion of its reserves invested in dollar securities, it is naturally concerned about the dollar's value.

There have been two dominant global currencies since the mid-19th century. The first was the British pound sterling. It became ascendant when Britain went on the gold standard and the UK economy accounted for 60% of global trade in 1860. The French franc enjoyed a brief role as a competitor when Russia kept

large reserves in Paris because of French capital flows to that country, but it was never a serious rival. The dollar eclipsed sterling during the mid-1920's as a result of the burden imposed on the UK economy by World War I and the rise of US economic power. The US also finally had a central bank. In the 1930's, there were devaluations of sterling and the dollar which caused most countries to reduce forex reserves and buy more gold. The dollar's true period of dominance came after 1945 when Britain was crippled by huge debts, most countries had capital controls, and the US economy was supreme.

The dollar remains dominant today because of the depth and liquidity of the US financial markets, the size of the US economy, and the United States' role as a military superpower. In the 1960's, the US had a formal offset program with Germany in which the Bundesbank agreed to stockpile dollars as compensation for US military spending in that country. Today, the US has implicit offset programs with Saudi Arabia and Japan in which they also stockpile dollars in return for US military protection.

The SDR is an unlikely replacement for the dollar because it is an accounting creation of the IMF without any market instruments. The total stock of SDR issuance has thus far been only 21 billion units which are worth \$35.5 billion. China could actually duplicate the market weighting of the SDR by investing its reserves 44% in dollars, 34% in Euros, 11% in yen, and 11% in pounds.

It is natural that China would now become more outspoken about the evolution of the global financial system. China will soon have the third largest economy in the world. It now has the world's three largest banks as measured by stock market capitalization. Its foreign exchange reserves are nearly \$2 trillion or larger than the next five countries combined. But if China were to dethrone the dollar, it would jeopardize its own development model based on export-led growth. Dethroning the dollar would greatly complicate the ability of the Obama administration to finance its large fiscal deficits. During the past five years,

foreign investors led by central banks have purchased 70% of the debt at Treasury auctions. Without access to foreign funds, the US would be forced to pay much higher interest rates on its debt, prolonging the current recession in consumption and construction. China would have to significantly boost domestic consumption if it wanted to sustain a high growth rate without a robust US consumer.

The Obama administration will have to protect the dollar's global reserve currency role in order to fund its deficits. The best way to maintain confidence in the dollar will be to guarantee the independence of the Federal Reserve. Mr. Bernanke has compromised the Fed's independence during the past eighteen months in order to contain the financial crisis, but he understands what will have to be done when conditions normalize. If the administration wants to retain the confidence of global investors, it should reappoint Mr. Bernanke rather than naming one of its own economists when his term ends in eight months.

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