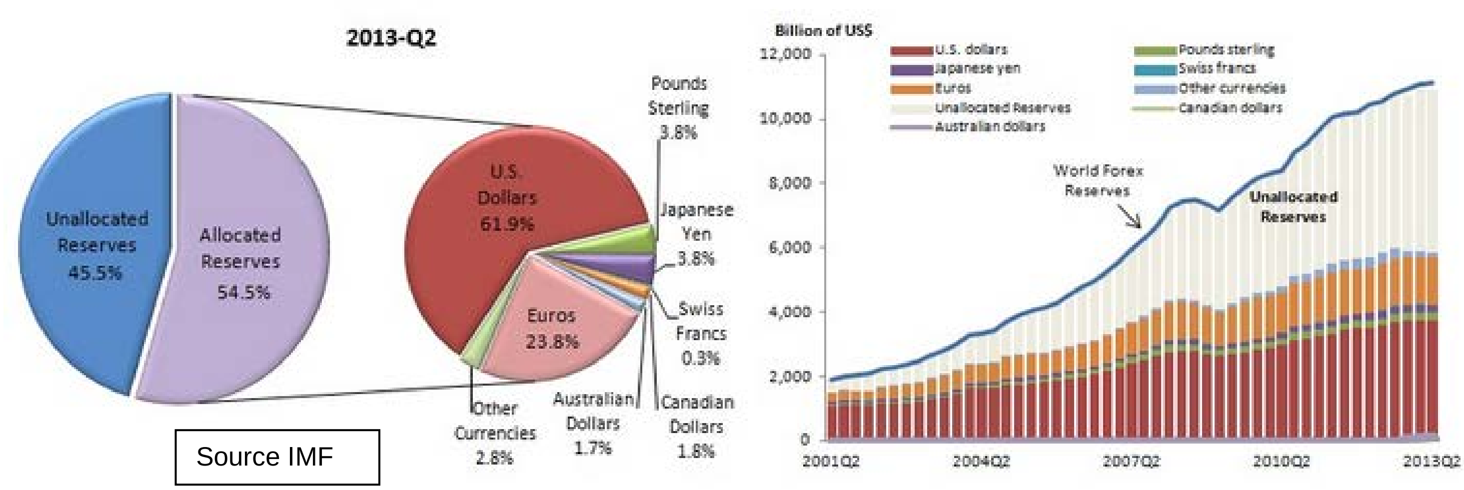
Mark Sibthorpe's guide to USD as reserve currency: a cheat sheet for the rest of us

Readers of this document will be presented with monetary policy issues and facts that show the USD will likely remain the dominant reserve currency, despite questionable Chinese practices, record US debt levels, and a shaky economy.

USD as a reserve currency

Chart 1, showing USD becoming less dominant as measured against total global reserve currencies



USD is the worlds currency. The following are some key facts to note about reserve currencies:

1. Chart 1 shows the Euro growing in prominence and unallocated currencies at about 45% of total currency reserves.
2. Despite the US total value of reserves becoming proportionately reduced, currently, [85% of FX transactions] are trades of other currencies for dollars.
3. Long-term growth for most countries as measured from 1990 to 2005 has been significant. During this period, China's GDP grew approximately 325%, according to the IMF.

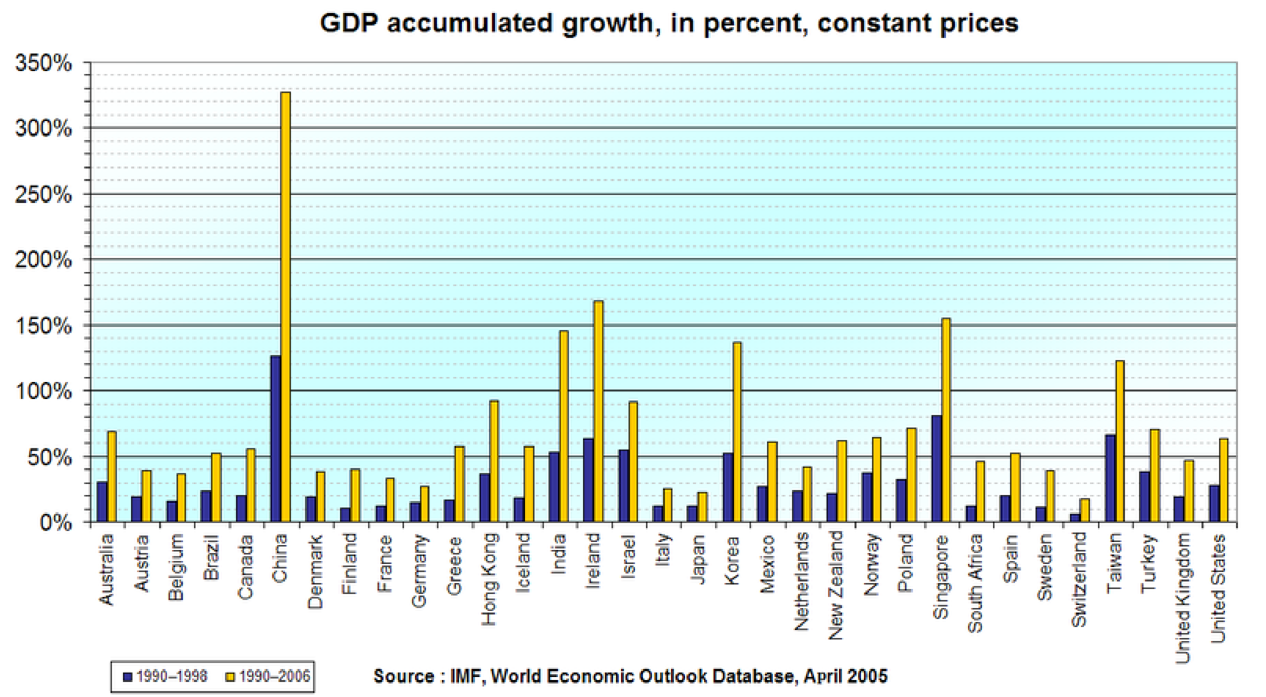


Chart 2, long-term GDP growth from 1990 - 2005

As a proponent of GDP growth, the importance of USD is made clear in the extract below. This extract is from an article that appeared in the Walls Street Journal. The author, Barry Eichengreen, predicted the demise of USD as the dominant global reserve currency within 10 years.

Eichengreen describes the impact of USD as reserve currency

When a South Korean wine wholesaler wants to import Chilean cabernet, the Korean importer buys U.S. dollars, not pesos, with which to pay the Chilean exporter. Indeed, the dollar is virtually the exclusive vehicle for foreign-exchange transactions between Chile and Korea, despite the fact that less than 20% of the merchandise trade of both countries is with the U.S.

Chile and Korea are hardly an anomaly: Fully 85% of foreign-exchange transactions world-wide are trades of other currencies for dollars. What's more, what is true of foreign-exchange transactions is true of other international business. The Organization of Petroleum Exporting Countries sets the price of oil in dollars. The dollar is the currency of denomination of half of all international debt securities. More than 60% of the foreign reserves of central banks and governments are in dollars.

The greenback, in other words, is not just America's currency. It's the world's.

China cry 'Triffin Dilemma'

As per the IMF data shown in Chart 2, and judging purely by GDP growth, China, by a huge margin, has been the long-term winner in a USD dominated world. Under USD, China has become the world's leading global exporter, especially when balance of trade with the US is considered.

Despite its astronomical economic growth, largely due to US market access, China has been more than willing to bite the hand that feeds it. China, also devastated by the credit crisis, has been vocal in its cries of foul play by US policy makers. A cry guised in the voice of Robert Triffin, an economist that in the 60s was concerned about the possibility of the US putting its short-term domestic issues ahead of international monetary objectives: known as the Triffin Dilemma.

Zhou Xiaochuan, governor of the people's bank of China (PBOC), on 29 March 2009 specifically referenced the Triffin Dilemma as it passed blame on US monetary policy for the world's economic disorder. Subsequently, China has campaigned effectively to draw support for alternatives to USD reserves. Concrete results of its initiatives include advocating for 'strengthening existing global currency controls, such as, creating Special Drawing Rights (SDR), basically a reserve based on a basket of currencies, through the IMF'.[1][2] The implications of this, and effectiveness of its campaign are discussed in the following papers:

- April 13, 2010, INTERNATIONAL MONETARY FUND: **Reserve Accumulation and International Monetary Stability,** Prepared by the Strategy, Policy and Review Department, Approved by Reza Moghadam
- Spring 2013, Mario W. Cardullo, **Development of Information and Knowledge Architectures and an Associated Framework and Methodology for System Management of a Global Reserve Currency**: A dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy at George Mason University

According to Simon Rabinovitch of the Financial Times:

China has recently unchained its currency which had previously been pegged to be weaker than USD. As a result, many Renminbi (Yuan) exchanges have started to pop up.

Rabinovitch points out that 'In the past month alone, the Chinese central bank established a Rmb350bn ($57.5bn) currency swap line with the European Central Bank, granted London an Rmb80bn quota for investing the city's renminbi assets in Chinese markets and then awarded Singapore a similar, if slightly smaller, Rmb50bn package.'

Rabinovitch is quick to point out that the real value of this exchange is not a game changer. One main effect being that 'Renminbi holdings in Hong Kong 'shot up from 1 per cent of overall deposits in Hong Kong in late 2009 to 10 per cent by mid-2011'.

Since this time the holdings have remained stagnant. In fact, Rabinovitch argues that the renminbi trade is somewhat deceptive. The growth is strong, but it is starting from a very small base to begin with.

'Calculations show that renminbi holdings account for just about 5 per cent of banking deposits in Singapore, a little more than 1 per cent in Taipei and a vanishingly small 0.4 per cent in London'.

'Liu Ligang, an economist with ANZ. "At this point it's more diplomacy than real finance.'

A recent announcement by JP morgan that appeared in the Wall Street Journal confirms that 'Mirae Asset, a JP Morgan Unit received investor licenses for four financial firms, allowing them to invest in the nation's capital markets with yuan-denominated funds raised overseas'.

Apart from pressuring the IMF to offer alternative to USD reserves, China has initiated several concurrent strategies in its effort to mitigate USD currency risk and related transaction cost. Below is a summary of its actions:

- China advocating SDR
- De-coupled the yuan from the dollar
- Promote Renmimbi exchanges resulting in daily yuan transactions surged to $120 billion in April 2013, from $34 billion in 2010, making it the ninth most-traded currency in the world, according to a September report by the Bank for International Settlements in Basel, Switzerland.
- Funding BRICS bank as an alternative to the World Bank
- Agreements with other sovereigns such as Russia and Brazil to swap currencies (for oil trade)

Based on these deliberate initiatives, it is clear that a rebalancing of economic power is underway. Of course as past observations reveal, this is just more of the same. Table 1 depicts several well-known examples of crisis, actions and results, often ending in major structural change.

Table 1, History of US dominated monetary system: issues, actions and consequences

Issue	Action	Result
Depression	Roosevelt removed free market for gold, imposed austerity measures	Economic collapse
1944 Breton Woods	• Rebuild the main international economic system while World War II was still raging • 730 delegates from all 44 Allied nations gathered at the Mount Washington Hotel in Bretton Woods, New Hampshire • Setting up a system of rules, institutions, and procedures to regulate the international monetary system • Established the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), which today is part of theWorld Bank Group.	• Supported stability that lasted until August 15,1971, • War destroyed Britain's credit position and ushered in a US dominated financial era.
1970s Dollar crisis	Nixon closed gold window and refused to redeem gold for dollars.	• Essentially the US declared itself insolvent while they devised alternative monetary systems • 1971 interest rates 21%

		• Near dollar collapse • Move from gold to 'fiat' (faith) money
1980s Argentina / Brazil inflation eroded the value of money	Rebased currency	• Dollarization of economy • Loss of faith in currency • Use of USD meant Govt lost monopoly on printing money
1992, George Soros shorted the British pound	Soros risked $10 billion on a single currency speculation	• Profit on the transaction almost reached $2 billion. Became known as "the man who broke the Bank of England." • Ended England's fixed exchange-rate system which included other European countries • Pound devalued
1997 Asian currency crisis	Malaysia blocked foreign purchases of its currency to prevent short-sellers from covering their bets by buying the ringgit at a lower price after central bank's reserves depleted	•
Credit crisis	Most nations turn to printing press and/or implement austerity measures. 2% inflation target Proposed reserve currency based on basket of currencies	• Increasing distrust of paper currency, • gold prices rise from $550 in 2006 to $1,600 in 2013 • Global depression/recession • 1/3 negative equity real-estate • Increased US savings rate 3% from zero • Zero sum game mentality • Continued high salaries and bonuses to FI sector
QE	Buying bonds	• Banks buying shares from the public • Create asset bubbles • Cause inflation in developing world • China decouples its currency from USD

Power

In June, 2010, a special report that appeared in the Economist made the point that, 'Europe may now be realizing that debt transfers power from the borrower to the creditor'.

If the Economist is to be believed, clearly the US ought to have lost a lot of power due to the atrocious indicators on table 2. In particular, government debt of $54,654 per citizen = debt to GDP ratio of 105%. Astronomical figures when compared to other sovereigns, placing the US along the lines of Spain, Brazil and Cyprus, although somewhat better off than Italy and Greece.

Whether or not this actually gives China power can be debated, but one fact is certain, as the 'best buyer' of US treasuries, according to Rickards, China has been given privileged access to a network of primary USD treasury dealers. The result being that China has a powerful economic weapon: it owns about 1/3 of US government debt.

The corollary being the counter-threat of the US devaluing its currency or defaulting on its debt before China's alternatives to USD can be put in place.

Fortunately, China seems to be moving in a different direction. Evidence is emerging that depicts a China opening up and freeing its markets. Meanwhile the US is becoming more like China by imposing sacrifice on the masses in the form of severe austerity measures. Like a romantic couple, China and the US may have discovered compromise with both acknowledging a degree of fault, even though they both know they are right. All this to say, the only sure losers as a result of US-China posturing will be the other 99% of us.

Table 2, Recent indicators	US
Indicators for future ability to tax	
• **Pop 65 and older by 2025**	18.7%
• **GDP Growth**	1.09%
• **Median unemployment**	7.2%
2012 Trade balance	($487bn)
Total GDP	$16.6tn
Debt current	$16.74tn
Debt 2006	$8.5tn
Interest to service debt **Cost to service / yr**	2.43% $222.8bn
Tax revenue 2013 **versus spending**	$2.77tn $3.45tn
Citizen share of debt	$54,652
Govt rev v deficit %	-31%
Debt as a % of GDP	105%
Inflation	1.2%
Household debt to income 2012/13	136%
Gold reserves tons	8,133
Gold reserve value @ $1,300 / oz	$338bn