The Exorbitant Burden

The Impact of the U.S. Dollar's Reserve and Global Currency Status on the U.S. Twin-Deficits

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By

Dr. Taranza T. Ganziro
Independent Scholar, Centreville, VA, USA

Dr. Robert G. Vambery
Pace University, New York, NY, USA

Emerald

United Kingdom – North America – Japan
India – Malaysia – China

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Summary

It is neither simple, nor inexpensive to be the home of a leading reserve and global currency at the epicenter of the world economic system. The US dollar is the living history of this paradox and its dual role – as both a national and a global reserve currency – has set off a plethora of competitive analyses and debates in demonstrating that a global monetary system that is dollar-centric is inherently unstable because the dollar is first and foremost a domestic currency subjected to the monetary and fiscal policies and national interests of the United States.

It has been often opined that the US policies – even if they are domestically sound – are not necessary concomitant with the global interests of the rest of the world which however remains inextricably under their influence. This is because – given the dominant status of the US dollar as an international reserve asset and global currency – the US policies naturally reverberate globally through the dominance of the US dollar over the global economy and inevitably generates significant externalities for the rest of the world; thus making the dollar-dominated global financial system vulnerable to US domestic monetary and fiscal policies.

Dismayed by the vulnerability of global financial system to US policy through the US dollar dominance, the World Bank (2011) went on to argue that the Multipolarity in the world in terms of security and economic relations should be matched by a Multipolar Reserve Currency System simply because the transformation of global patterns of economic growth necessarily drive change in the international monetary system.

To comply with such Multipolarity, the SDR (Special Drawing Rights) became in the view of many analysts, the natural alternative reserve currency because – being a basket of currencies – it is assumed that it can stabilize the global financial system preached by the World Bank and be able to impartially enforce discipline on both the deficit countries and surplus countries that respectively issue and relentlessly accumulate reserve currency-denominated assets that entertain the global financial imbalances.

Reference is often made to the historical rise and fall of British Pound – the last monarch on the international reserve currency throne – as a useful lesson of experimental decadence that the

United States should be acquainted with, if it wants to avoid the fatal end of the British Pound to befall upon the Dollar.

No one can deny that Britain did indeed reach its hegemonic pinnacle upon which the Sterling was the reigning currency. Not only Britain was the Ruler of the World with at least one in every four people on the planet under British rule or influence; but also Britain was undeniably the banker of the world with a portfolio of £3.8 billion of foreign direct investments (FDIs) back in 1914 – representing between two-fifths and a half of all known foreign assets holdings in the world (Ferguson, 2004). At the height of its apogee, Britain was truly an Empire spanning over the four corners of the Planet with a shipping power and navigation supremacy over the oceans second to none.

The United States – more than any other British colonial possessions – not only was deeply and permanently marked with British language and cultural norms – but also it became its successor as a dominant power on the world stage and inherited most of the attributes of British superpower such as a capitalist economic system, a leading global reserve currency, a vibrant financial markets, an appealing government system with parliamentary institutions – except that the rising US Republic forcefully rejected the British Monarchy model. There is therefore so much to learn from Britain and its currency.

When the United Kingdom went into rampage in its international borrowings – mainly from the United States – primarily to fight both the World Wars I and II along with the noxious socio-economic distress inflicted by the 1929 Great Depression and the loss of its geopolitical power due to its subsequent unraveling grips over its vast colonial empire – the Britain's economic preeminence tremendously declined and its military power and other international hegemonic peripherals went into the historical annals – virtually bankrupting the entire British Empire.

Armed with the above UK's decadence as a showcase, many economists and experts have been interpreting the US twin-deficits, the twin-wars in Iraq and Afghanistan, the current inconclusive embroilment in the Middle East and other hot spots on the Planet, the 2008 Great Recession – that escalated the US debt to vertiginous altitudes – as the signs of time that the dollar is now set to repeat the history of the British Pound.

In the opinion of Kemp (2009), the Grand Recession presaged a cataclysmic shift that marked the passing of an era of the US dollar as an undisputed dominant reserve and global currency for the world monetary system – just as the outbreak of the First World War heralded the Sterling's demise as a reserve currency or the suspension of gold convertibility in 1971 marked the end of Bullion's monetary role.

The view of Kemp found solace in Kennedy (1989) theorizing that there exists a strong correlation between the economic power and military power by arguing that the former is always needed to underpin the latter, which – in a complete circle – is highly required to acquire and protect wealth that the superpower status commands.

The problem arises when a disproportionate share of the national economic resources is increasingly diverted from wealth-creation to military purposes. The resulting outcome in the long run is the weakening of the economic backbone supporting the very superpower toward its eventual collapse. In other words, the greater the superpower status, the larger the proportion of resources is likely to be devoted to military apparatus to maintain that status at the detriment of economic growth – which decline – leads to the weakening the economic pillar the above superpower stands on.

In his diagnosis, Kennedy (1989) argued that the United States has shown the typical signs of a declining superpower the Great Britain displayed prior to World War I by failing to balance its act between defense expenditures and investments for economic growth as its growing military commitments to every continent and the growing cost of its military disproportionately consume the national resources – severely limiting available resources to nurture a comprehensive economic growth.

Based on the above metrics, one can seemingly conclude that the US dollar is ending its cycle as a global unit of account, store of value, and medium of exchange – roles that are expected from a global currency that serves as an international reserve asset – and its replacement should therefore be in the making.

However, with a closer analysis, one finds that the current Fiduciary Dollar System many experts complain about; doesn't seem to fit the description and the image the alarmists portray in the mass media and has indeed been performing well in the course of its enduring lifespan since 1973 and has shown incredible resilience and flexibility during the toughest financial crises such as the 1973-OPEC's oil embargo, the 1979-oil crisis in the wake of the Iranian Revolution, the 2000s-dot-com bubble crisis, the 2008 Great Recession, the twin wars in Afghanistan and Iraq (Zoffer, 2012).

Given the role the dollar has played and continues to play in the international economy and the stability and flexibility the Dollar-Centered Fiduciary Standard has provided to the global financial system across stable and upheaval financial tribulations, Zoffer went on to argue that the world should be more appreciative toward the United States for providing such great global public good.

This study strongly believes that the US dollar will continue to be the enduring leading world reserve currency and a persistent dominant safe asset purely because the United States holistically has such cutting-edge technological landscape, such rapidly changing society, such inner strength, such trade and financial openness, such powerful and influential private sector, such engaging and inclusive political system, such technology-driven military with global presence, such free speech and liberal media to stay an appealing dominant global superpower supported by such balanced geopolitical power makeup that allows American economy to gain stronger position as its partners such as South Korea, India and China rise (Lee, 2009).

Furthermore, in spite of a tidal wave of demonization of American capitalism pointing to the brazen income inequality with 1% of the population holding 40% of the wealth (Adelman, 2014); the American capitalistic mixed economy – in which the government plays an important role along with private enterprise – has been an amazingly successful economic system in comparison with the dismal fiasco of Communism.

Indeed, the massive economic and scientific revolution and high standards of living unleashed since the Capitalistic Industrial Revolution compelled Adelman (2014) to believe that capitalism provides the strongest economic platform for a modern political superstructure and advanced society and further pointed out that – with one million of immigrants a year coupled with its world's leadership in terms of destination of FDI, its technological innovation at Silicon Valley, its world largest financial markets at Wall Street and its top-rated entertainment industry at Hollywood; the United States – in spite of being inhabited by less than 5% of the world's population – has been transformed by modern capitalism into the world's only global superpower.

On the merits of the United States capitalistic mixed economy, Beinhocker and Hanauer (2014) further emphasize that capitalism is a genius economic system simply because it has been so far an unmatched evolutionary system for finding solutions to solve the most problems for the most people in the quickest manner.

This study disagrees with the contention that – the United States took advantage of its privileged position in the global governance at the confluence of economic and geopolitical forces to become the Global System Maker and Privilege Taker (Mastanduno, 2009); thus sucking savings from the Rest of the World and squandering them into reckless consumptions just because of the dollar global reserve currency status.

The rationale behind the status that is supported by this study is the capability, commitment, and willingness of the United States to step up into the international plate and put its currency forward to serve as a global and reserve currency for the global public good and bear the costs that go with such status.

Many analysts contend that China is around the corner at a striking distance to overthrow the United States as the leading superpower and hastily conclude that the Renminbi is about to take the lead over the dollar as the global reserve currency. Subramanian (2011) has theorized that the dominance of China is imminent, larger, and broader in scope and the rise of the RMB is conditionally imminent on the path to becoming the premier reserve currency in the next 10 years or soon after and concluded that the current US open economic system may not survive the rise of China!

To verify such kind of claims, this study investigated the much-aired candidates – Euro, Yen, Renminbi, and SDR – that are supposedly destined to take the US dollar's pedestal at the center stage of the global financial landscape. It found that – not only do all these candidates have constraining and self-defeating flaws – but also their readiness to ascend to the world currency's throne, is seriously challenged by the lack of key supporting prerequisites by their issuers – especially in terms of strong global geopolitical superpower; robust and reliable financial regulator and lender-of-the last resort, open, deep, and liquid financial markets; and trade openness – thus leading to the logical conclusion that there is no viable alternative to the US dollar on the dais of global and reserve currency in the seeable future.

Furthermore, the barriers to displace the US dollar leadership on the global stage have been and continue to be complicated by the accelerated pace of financial globalization. Besides the inertia barricade built out of the depth and width of the US dollar's network of externalities, the United States has added to its primary function as (1) the World Banker that provides liquidity through its current account deficits to the world economy – especially to the Emerging economies articulated on export-led growth strategy; another important role as (2) the World Venture Capitalist that provides long-term capital to the development of the emerging markets according to Gourinchas and Rey (2005).

By borrowing short using risk-free and lower yield US Treasuries and investing long in high yield assets such as equity and FDI, the US effectively recycles the savings from the Rest of the World into more refined and investable funds. This international financial intermediation is supported by the US Treasury Markets – the largest and most liquid debt market unmatched by any other country on the Planet (Gourinchas and Rey, 2005).

Further empirical evidence doesn't suggest that the US dollar has lost either its leading role as the reserve currency in the global financial markets, or its centrality in the international trade and FX transactions, or its safety attractiveness in times of financial distress, or the United States is shrinking from its duty in the above international financial intermediation.

But this global responsibility is not an easy endeavor or cost-free – even if the cost doesn't seem to be evident. Just as it is reassuring to live in a country in which it is safe, to drive on roads that are well-designed and maintained; it is likewise fulfilling to take the US dollars on a trip abroad because the traveler has confidence that he can exchange them into any currency across the globe or the exporter is convinced that to price his exports into the dollar is the most secure channel because of the stability, cost effectiveness and exchange risk mitigation the US dollar has demonstrated over years.

However more often than not, people don't bother to think deeper about **what it takes** to establish and maintain that worries-free safety in terms of judiciary and police system costs, in terms of school systems that form good citizens, in terms of monetary and fiscal policy, in terms of financial markets liquidity, in terms of trade openness, in terms of providing liquidity to the global economy, in terms of maintaining global geopolitical leadership, etc.

If this is the case, is really the role of the dollar – as a global currency and an international reserve asset – actually rewards the United States with an exorbitant privilege as the economic orthodoxy and the epithet of System Maker and Privilege Taker suggest, or as the Russian President Vladimir Putin blatantly decried that the dollar hegemony has been allowing the United States to live like parasites off the global economy (Zoffer, 2012)?

This is a multilayered question this study is set to explore: (1) Can the United States continue to provide the necessary liquidity to the $100 trillion-world economy (in PPP prices) and $5 trillion daily Forex market and let the dollar serve as a major pricing currency in the global trade and be subject of voracious accumulation of foreign reserves by most of the emerging markets without incurring corresponding costs? (2) Can the United States extend the dollar's domestic functions of serving as a store of value, medium of exchange and unit of account to the volatile international financial arena, without sacrificing its internal monetary and fiscal agenda? (3) Did the IMF-Bretton Woods Agreements – which crowned the US dollar as the world reserve currency – rather officially tied an ever-increasing heavy burden on the back of the US economy as the United States must incur both quantitative and qualitative costs in its engulfing role to provide the liquidity that fuels the global financial system instead of conferring on the United States an exorbitant privilege?

The focus of this study is – not only in sharp contradiction with the unwarranted claims that the US has been unduly enjoying an exorbitant privilege by merely being the home of the premier reserve currency – but that also at the opposite end of exorbitant privilege spectrum: the exorbitant burden – the cost the very dollar reserve status impacts on the US economy.

This study argues indeed that – even though there are some benefits attached to a reserve and global currency status – the assumed free ride in terms of the much-publicly proclaimed exorbitant privilege – that appalled some European governments – led by France – back in 1960s; fades away before the overwhelming quantitative and qualitative costs the United States has to incur in its international role in providing the dollar-liquidity that fuels the ever-growing global economy.

The French were so convinced that the global financial system was asymmetrically skewed toward the interests of the United States and they were swayed that the US was using the system to finance its domestic and global ambitions by supplying to the world its low-yield debt instruments and that the status of the dollar was shielding the United States from ensuing macroeconomic adjustments. Armed with such conviction, the Europeans sent their navies to collect gold from the US treasury Department's Gold Window against the dollar-denominated claims they held in their central banks!

Was the above French assessment regarding the exorbitant privilege right to the point to run on US gold reserves? This study has deep doubt about it and it is therefore set to investigate the burden inflicted on the US economy by the dollar reserve status through the twin-deficits.

In their December 2009 – Discussion Paper titled "An exorbitant privilege? The implications of reserve currencies for competitiveness, McKinsey (2009) believed that nobody had investigated this fundamental question on costs of being a global reserve currency; and considered their paper to be the first attempt at an assessment of the costs and benefits of reserve currency status.

This study is part of the pioneering endeavor to decipher the burden on the back of the US economy – not because the United States sought to wear this burden in pursuit of some exorbitant privilege – but because, due to historical circumstances, no other country – up to now – could meet the hard to achieve economic and geopolitical fundamentals required to perform the above global public good by providing the vital global liquidity and have the willingness to expose its currency to the swings of global demand in search for the reserve currency for official reserve accumulation and for the financial fueling of ever-increasing international trade and the enormously-growing Forex trading transactions.

The study will be evaluating the quantitative impact of the key determinants of the US Dollar Reserve and Global Currency Status – namely US Dollar Share in the Global Foreign Reserve Holdings (dollarshare), 10-Year Treasury Constant Maturity Rate (treasrate), US Financial Openness (finopen), US Geopolitical Power (geopower), Inflation Rate (inflarate), US Global Trade Openness

(tradeopen) – and their dynamic causal chain in the context of the US External Debt (extdebt) as a proxy of the US Twin-Deficits.

The path followed by the study's quantitative model starts with an empirical evaluation of the properties of the time-series data of the variables incorporated into our model, followed by OLS Regression to check out if the model reveals potential spuriousness; followed by stationarity checking via Unit Roots Testing through Augmented Dickey Fuller (ADF) Tests; to be followed by Cointegration Tests through Johansen Maximum Likelihood.

The methodology is culminated by a Vector Error Correction Model which is aimed to capture the causality-channels among the variables in our model so as to determine if they are linked in some kind of long-run equilibrium relationship upon which we are able to choose a meaningful cointegration equation (Johansen, 1988; Johansen and Juselius, 1990) – capable to proficiently assess the impact of the determinants of the US Dollar Reserve and Global Currency Status on the US External Debt during the period under review.

Finally, the methodology – which is applied to time series data of the variables theoretically selected from the US economic statistics for the period 1971–2011 – undertakes a series of postestimation diagnoses such as – Linear Hypothesis Test, Lagrange Multiplier Test, and Jarque-Bera Test – to ascertain for normality, significance and causality using Stata Data Analysis and Statistical Software.

The results of the quantitative analysis conducted by this study rejected the Null Hypothesis that the US dollar reserve and global currency has no significant negative impact on the US economy in favor of the Alternative Hypothesis which advocates that this status indeed imposes a significant burden on the US economy via the twin deficits channel.

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CHAPTER

1 Introduction

The field of reserve currency has been not only a topic of extensive research but also an unending concern for many policy-makers. First and foremost, is it genuine a question to ask – if most countries have their national currencies – why do they have to go through a third party's currency to incur extra costs in order to settle their international transactions?

While it is conceivable for a Rwandan exporter to accept Yuans from a Chinese buyer of his coffee, but it is not expected such payment to be the global norm. You might carry Chinese Yuans – or even Euros – to Africa; but you might stay hungry as most restaurants might decline them for payment.

A Zimbabwean dollar – which broke the Guinness World Record with One Hundred Trillion Bank Note (100,000,000, 000,000,000) back in 2008 when the inflation hit 500 billion (Half Trillion) percent in Zimbabwe – would have taken you not that much far beyond its borders as this gigantic face value is currently worth an infinitesimal $0.40 – that is 40 cents (Reuters, 2015).

Even with the U.S. dollar – the widely used currency in the world – you might need to exchange it into local money to buy a glass of Italian wine while in Rome or buy shares issued in Rupees by an Indian corporation. Then, if this is the case, what does justify the supremacy of the dollar over the Zimbabwean dollar or the Yuan?

The superiority of the U.S. dollar lays in the confidence the whole world places in it; which greatly contributes to its convertibility into almost all currencies – at least officially in all Exchange Bureaus anywhere in the world. Just as the English is spoken in many parts of the world and is recognized as a global business communication language, the reserve currency is equally important in the global financial discourse as a common denominator.

By definition, a currency is a symbol of value – any form of money such as coins and paper notes – which is issued by a government body (usually the Central Bank) and circulates within an economic jurisdiction as a legal tender. Its use in an open economy provides massive savings in transactions costs as opposed to autarkic rigid transactional exchange process and unstandardized medium of exchange.

A currency within a domestic economy is often likened to a blood circulation in the human physical body. It has been equated to the cardiovascular system by Fisher (2010) who pointed out that money and credit play a vital role in maintaining a healthy economy. In his analogy, the central bank would be the heart, the currency the lifeblood, and financial markets the arteries and capillaries that provide critical sustenance to the muscles that represent the makers of goods and services and the employment creators.

A well-functioning cardiovascular system obviously nurtures a healthy body growth. However, if that system is mal-functioning, the body system might break down. Similarly, the international reserve currency can be imaged as the blood circulating in the international economic body. The reserve currency is therefore vital for the well-functioning – and even the survival – of the international economy.

Since most of the money creation is through the banking system, the banking institutions play a very important role not only in a given domestic economy but also in the international economy as well – making the health of the economy greatly dependent to the soundness of the banking system – both domestically and globally. One can argue that the sounder the global banks – as facilitators in the process of production, distribution, exchange, and consumption worldwide – the healthier the international economy and the better the role accomplished by a leading reserve currency in providing global liquidity.

Globally, international banks are the heart of the international economic structure and the capital – in terms of global and reserve currency-denominated assets – is the blood in the global system. As long as this blood – the major reserve currency – circulates properly and is distributed efficiently, the organs of the international economic body will breathe soundness and strength.

Since countries need to pay for the international goods and services required by their citizens and carry out various financial transactions in the global marketplace, they are therefore expected to hold a currency in which most international trade transactions are invoiced and payments are settled. If there was no such reference-currency that is recognized globally and acts as an efficient and cost-effective medium of monetary communication in terms of international trade, payments, and settlements, the global economic activities and exchanges would be seriously hindered.

Even though non-internationally convertible domestic currencies are part and parcel of the national regalia and iconic expression of State pride; but they can constitute a serious impediment to international trade and financial transactions if there were no such unrestricted reference-currency within the international system that provides a monetary exchange mechanism to explicitly or implicitly regulate the key dimensions of balance of payments such as capital flows, current payments, international reserves, exchange rates.

In 2013, the IMF identified about 45 countries that maintained a total of 111 restrictions and multiple currency practices ranging from restrictive exchange measures, restrictions on payments for imports, to restrictions on payments for invisibles such as education, medical, and travel services up to transfers of wages, remittances, and even limits or freezing of foreign currency accounts (IMF, 2014). Fortunately, these countries command a small share in the global economy and international trade to the tune of 20–24% respectively – making the effects of these restrictions on global trade and integration not very significant.

The worldwide foreign exchange markets – in which the dollar is centric to the tune of 86% in all transactions – reflect this global exchange mechanism. This means that the dollar is not only at the center of the global financial system but also a unique common denominator through which the world – governments as well as private agents – can financially interconnect and settle their trade and financial transactions.

The dollar-facilitator of international economic exchanges is also the dollar which is primarily domiciled in the United States which has its own domestic agenda articulated on its national monetary and fiscal policies like any other country. If this U.S. domestic policy agenda can be fully aligned to the dollar-demands from the rest of the world, this would be the best of both worlds. But, can the United States have balanced external accounts and promote its international trade competitiveness through monetary policy and still meet the ever-increasing demand of dollars to oil the global economy?

Triffin (1960) came up with the shortest and poignant answer: No. He claimed that such balances are at odds with the dollar reserve status because for the rest of the world to accumulate the dollars, they must run persistent trade surpluses with the