The Oil Drum: Europe
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London G20 Meeting: The Last Chance?

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As the G20 meeting that is supposed to "rebuild the Global Economy" begins, this post presents a few reflections on the likely major problem the world leaders face today: the damaged state of the world reserve currency system.

On the 24th of March, Frank Biancheri, head of the European think tank LEAP2020, published in the Financial Times the following open letter directed to the G20 leaders gathering in London on the 2nd of April:

> Ladies and Gentlemen, Your next summit takes place in a few days in London; but are you aware that you have less than half a year to prevent the world from plunging into a crisis that will take at least a decade to resolve, accompanied by a whole series of tragedies and ferment? Therefore, this open letter by LEAP/E2020, who saw the arrival of a « global systemic crisis » as early as three years ago, intends to briefly explain why it happened and how to limit further damage. [...]

An audio version of this post can be downloaded here.

> Until now you have merely been concerned with the symptoms and secondary effects of this crisis because, unfortunately, nothing prepared you to face a crisis of such a historic scale. You thought that adding more oil to the global engine would be enough, unaware of the fact that the engine was broken, with no hope of repair. In fact, a new engine must be built, and time is running out, as the international system deteriorates further each month.
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> [...]
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> LEAP'S THREE STRATEGIC RECOMMENDATIONS
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> 1. The key to solving the crisis lies in creating a new international reserve currency!
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> The first recommendation is a very simple idea: reform the international monetary system inherited post-WWII and create a new international reserve currency. The US Dollar and economy are no longer capable of supporting the current global economic, financial and monetary order. As long as this strategic problem is not directly addressed and solved, the crisis will grow. Indeed it is at the heart of the crises of derivative financial products, banks, energy prices... and of their consequences in terms of mass unemployment and collapsing living standards. It is therefore of vital importance that this issue should be the main subject of the G20 summit, and that the first steps

> towards a solution are initiated. In fact, the solution to this problem is well-known, it is about creating an international reserve currency (which could be called the « Global ») based on a basket of currencies corresponding to the world's largest economies, i.e. US dollar, Euro, Yen, Yuan, Khaleeji (common currency of oil-producing Gulf states, to be launched in January 2010), Ruble, Real..., managed by a « World Monetary Institute » whose Board will reflect the respective weight of the economies whose currencies comprise the « Global ». You must ask the IMF and concerned central banks to prepare this plan for June 2009, with an implementation date of January 1st, 2010. This is the only way for you to regain some control over currently unwinding events, and this is the only way for you to bring about shared global management, based on a shared currency located at the centre of economic and financial activity. According to LEAP/E2020, if this alternative to the currently collapsing system has not been initiated by this summer 2009, proving that there is another solution than the « every man for himself » approach, today's international system will not survive this summer.
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> If some of the G20 states think that it is better to maintain the privileges related to the « status quo » as long as possible, they should meditate on the fact that, if today they can still significantly influence the future shape of this new global monetary system, once the phase of global geopolitical dislocation has started they will lose any capacity to do so.
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Further detail of LEAP2020's analysis was given by Frank in an interview to the Guns and Butter radio show.

There will be other issues discussed at the meeting: tax heavens, shadow accounting practices, reserve requirements, but the global reserve currency system (that, as was known during at least the last 40 years, seems to have ceased to exist) is the most important of all.

How did the monetary system get here

The first attempt to reach a global monetary system was held at Bretton Woods in the US in the summer of 1944, with the end of the Second World War in sight. An agreement was reached between 44 nations on the Allies' side, that enacted the IMF, the prototype of the World Bank and a new monetary system for commercial relations. This system (named Bretton Woods) established fixed exchange rates between currencies, defining narrow fluctuations of paper currencies against gold.

This Bretton Woods system lasted for more than two decades during which countries kept on increasing paper currency supply, but managed to maintain gold prices under control by injecting reserves into the market. The system began to fail in May of 1968 when world wide panic closed down most gold trading markets. Investors had lost faith in central banks' ability to redeem the fiat currency they had issued. In the Summer of 1971, bending on the weight of increasing energy imports and the Vietnam war, the US was forced to pull out of the Bretton Woods system, abandoning the direct convertibility of the US dollar into gold.

During the following months, with the dollar losing half of its value against gold, most other countries abandoned fixed exchange rates against the dollar. A new system emerged, with major currencies that were used in international trade adopting floating exchange rates.

Next came a period of about ten years between the first oil shock and the peak of the early 1980s recession, when currencies slowly depreciated without much economic growth happening in the western world. During this time, the foundations of the present system were launched. Perhaps the most important action towards it was the birth of the Carter Doctrine. As the economic crisis was overcome, a symbiotic relationship developed between the Middle East and the West. In exchange for military protection (maintaining the ruling elites), oil producers provided easy oil that fostered economic growth that in turn reinforced the military power. Oil producing countries stored their wealth in US Treasury bonds and other debt instruments becoming creditors of the military power that kept them safe; the flow of cheap oil allowed the economic growth that justified the faith on the US currency. This was the Petro-dollar system.

In a different way, US allies who were members of NATO (also Japan and Oceania) ended up also benefiting from this new system. They couldn't export debt as the US did, but benefited both from the flow of cheap oil and of the rising protective military power at the western side of the Atlantic. Two decades of unprecedented economic stability and growth unfolded.

But history marches on. By the mid 1980s, this system was being used chiefly in the Atlantic – Middle East trade, with the USSR and its allies still in place, and in a trade environment much narrower than today. As oil prices collapsed in 1985, events were set in motion that brought down the USSR in political, military and economic terms; in 1989 the Berlin wall fell and in 1991 Russia detached from the former republics of the Warsaw Pact. In 1992 the Maastricht Treaty created a new international market; in 1999 the Euro was born; and in 2001 China joined the WTO, paving the way far a major, now liberalized, economy entering the world market. At the same time other important players emerged, with Russia becoming again the world's largest oil producer and a major energy exporter, and countries like Brazil and India playing major roles as well.

What started as an agreement between two regions became the system that prices global trade today. Not only did the use of the US dollar as a reserve currency become global, it also became much more extensively used because of the growth in imports and exports in the last 20 years. This arrangement resulted in the US Federal Reserve setting monetary policy for the whole world, while in fact its targets and gauges were solely based on the US economy.

Recent years

After 2000 the US embarked on a monetary and fiscal policy expansion with little parallel in history: interest rates were brought down to a very low level; the monetary supply grew in excess of 10% annually; an expansionary budget stimulated demand for goods and services, many of them imported from countries that accumulated US bonds and other forms of fiat currency. From 2002 to 2007, reserve currency held by central banks grew in excess of 20% annually. In parallel, lax financial regulations and reserve requirements helped create a pile of invisible debt (off balance sheet) reflecting that expanding demand and monetary supply, according to some amounting today to more than the world's annual GDP.

Did this incredible expansion end because oil production plateaued? That's an interpretation, although other views are possible. Oil prices started rising in 2004. In 2005, raw material prices began to rise, and in 2006 food prices. No matter what the underlying reason, the supply side stopped following the demand expansion. When Ben Bernanke became chairman of the US Federal Reserve and tried to change course by raising interest rates, so that at least some limitation would come to the monetary expansion, it was already too late: the US economy couldn't expand any more in order to generate the wealth promised by all the debt issued in previous years.

Without that physical growth, the result was simply default on debt. Without the proper leadership from either the US government or the Federal Reserve, panic took over last September. During the next two months, the world experienced one of the sharpest demand retractions in history. The problem of the moment is that in order to stimulate demand once more, the prescription of the US seems to be an expansionary budget and monetary policy. And here's the main problem: this policy threatens the value of US dollar reserves held abroad.

There is another side to the present crisis worth observing: countries that followed monetary policies most unlike those set by the Fed seem to be suffering the most. Those that opted for high interest rates in order to prevent price inflation and/or excess demand enjoyed an influx of foreign investment, seeking easy profits. When the crisis hit, that investment simply vanished--examples were Iceland, and Russia to some extent. At the other extreme were countries like Japan, that during this decade had been battling problems of employment or lack of internal demand, employing expansionist measures even sharper than the US; they are now facing an influx of currency that threatens to engulf demand (raise prices) and massively destroy employment.

In conclusion: a regional currency running world trade had two main negative effects: (1) it impaired specific monetary policies in other regions, forcing them to conform to the policy of the issuing region, and (2) it pegged the stored wealth to the economic health of a single region: the issuer. Exacerbating these problems is the hegemonic position the currency issuer gets, allowing it to live beyond its means - what Frank Biancheri calls the reserve currency curse – the budget and trade deficits can apparently be expanded without limit. But at some point it makes foreigners wonder, and when that time comes the issuing region is engulfed in debt. A global economy running on a regional currency seems almost like a scheme designed to self destruct.

Confidence wanes

The policies needed to bring the US economy back into contact with reality have thus the parallel effect of reducing the wealth stored by those economies that grew on exports during the past few years: be it expensive lasting goods (e.g. Germany, Japan), consumer goods (e.g. China) or energy (e.g. Middle East, Russia). The confidence on the US dollar as a reserve currency is severely damaged and as the LEAP2020 implies, it will probably never come back. No wonder then that China is openly calling for a new reserve currency system:

> Zhou Xiaochuan, governor of China's central bank, has proposed to create a super-sovereign reserve currency as part of reform in the international monetary system.
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> The desirable goal of the international monetary system is to "create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies," he said.
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> Zhou said the Special Drawing Right (SDR) of the International Monetary Fund (IMF) has the potential to act as a super-sovereign reserve currency in a signed article posted on the website of the People's Bank of China Monday.

This reinforces earlier calls from another major holder of reserve currency, Russia, that seems to be heading a group of nations with the same intent:

> China and other emerging nations back Russia's call for a discussion on how to replace the dollar as the world's primary reserve currency, a senior Russian government source said on Thursday. Russia has proposed the creation of a new reserve currency, to be issued by international financial institutions, among other measures in the text of its proposals to the April G20 summit published last Monday.
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> Russia met representatives of China, India and Brazil ahead of the G20 finance

> ministers meeting last week, as the big emerging powers seek to increase their influence on decision making globally. Their first ever joint communique did not mention a new currency but the source said the issue was discussed.
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> "They (China) did not formally put forward their position for the G20 summit but unofficially they had distributed their paper regarding the same ideas (the need for the new currency)," the source told Reuters, speaking on condition of anonymity.

But China has not stuck solely to articles in the western press and meetings with other reserve currency holders. Ever since the country announced its intention to make the Yuan a reserve currency, several currency swaps have been announced with its main commercial partners, Argentina being the last of a list that includes South Korea, Malaysia, Hong Kong and Belarus.

What could happen then if a new coordinated reserve currency fails to emerge? The answer is simple: the US dollar will stop being the world trading benchmark. A period will then unfold during which trading nations won't have a clear worldwide unit to value their goods, much less to store value for future trading. Possibly, some regional currencies might be tried on a limited geographical basis. Another alternative might emerge, using a currency for which there isn't much policy required: gold. The consequences of such a transition will be immense; a Hungarian mathematician called Antal Fekete, claims to already be getting signals that this is the case, with gold futures entering *backwardation* late last year. This is a rather technical issue, way beyond the aims of this simple essay, but with or without *backwardation*, it is important to know what Fekete foresees [pdf!] in case the present system ceases to exist without a clear replacement:

> I have to go back to the collapse of the Western Roman Empire after the abdication of the emperor Romulus Augustus on September 4, 476 A.D. It was followed by the Dark Ages when the rule of law, personal security, trade of goods against payment in gold and silver could no longer be taken for granted. Gold and silver went into hiding, never to re-emerge during the lifetime of the original holders. It is plausible to see a causal relationship between the fading of the rule of law and the complete disappearance of gold and silver from trade. Virtually all observers say that the first event caused the second.
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> I may be in a minority of one to say that causation goes in the opposite direction. The disappearance of gold and silver coins as a means of exchange was a long-drawn-out, cumulative event. In the end, no one was willing to exchange gold and silver coins for the debased coinage of the empire. At that point, the empire was bankrupt; it could no longer pay the troops that defended its boundaries against the barbarians threatening with invasion. This is not to say that the empire did not have other weaknesses. It did, plenty of it. But the overriding weakness was the monetary weakness. Centuries after centuries the Mint of the empire could attract less and less gold and silver. Because of this, the empire was forced to debase its coinage and the deterioration continued until the bitter end, when the gold flow to the Mint completely dried up.
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> [...]
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> The history of the monetary system of the United States [and of the World] shows an ominous parallel to that of the Western Roman Empire. As long as gold and silver was still used in trade at least to some extent, the Western Roman Empire was limping along. The modern equivalent of the disappearance of gold and silver is epitomized by the progressive vanishing of the gold basis [meaning the vanishing confidence in the US dollar as an effective long term wealth storage medium].

Coming from a different perspective, this scenario ends up remarkably close to what Frank Biancheri calls “every man for himself”: the break down of global commercial bonds, a drastic reduction in global trade and the emergence of several regions of influence deploying different economic and monetary policies, in a world resembling Europe in 1914.

A small but important sign of this emerging change of the world's monetary system is the recent news that the US State of Montana is considering a return to gold and silver as means of payment and state accounting units.

Europe

Europe has possibly the most complex stake in this meeting. On one hand, it is home to about one-third of the world's reserve currency, having to some extent benefited from the advantages of being a reserve currency issuer (although in its case the reserve currency issued is a relatively small fraction of total currency in circulation). On the other hand, it holds the third largest foreign currency reserve in the world, being a major creditor of the US.

Two other issues are worth nothing in Europe's stake. First, it is heavily dependent on energy imports, thus being highly vulnerable to world trade disturbances, and more so when its major fossil fuel suppliers are entering terminal decline: Norway, in the case of oil and gas, and Russia in the case of oil. Another important point is that about half of the world's reserve gold is in Europe, including considerable sums in privately owned bullion and monetary jewelry.

All things considered, Europe is possibly the region having most to benefit (or the most to lose in the opposite case) from a new reserve currency system which does not rely on a single regional issuer. Most importantly, such a new reserve currency system would prevent serious impact on world trade and the possible consequent disruption of energy imports. Furthermore, it would prevent the Euro from somehow becoming a substitute for the dollar, shifting the “reserve currency curse” to the eastern side of the Atlantic.

Enter the Khaleeji

There is still another possibility that might unfold if a new reserve currency system isn't put in place. After several years of talks and on/off reports in the press about its arrival, the Gulf Cooperation Council states decided in the wake of the present crisis to create its own common currency, the Khaleeji. This is another sign of the break-down in confidence in the US dollar as a reserve currency, from countries that thus far have had their currencies pegged to it. It is shaping up to be something like the Euro, governed by a Middle East Central Bank. Interestingly, there's only one country from this block attending the G20 meeting, Saudi Arabia.

Speculation has come about regarding this new currency being backed by a physical entity, in contrast with the other fiat currencies of the main world trading blocks. Gold is the usual suspect, but that's unlikely, for the region doesn't hold much gold (compared to Europe) and a good part of what it has is non-monetary jewelry.

The important thing about the Khaleeji is that it will be backed by the economic health of countries whose main economic activity is energy production and export. This makes it a real improvement over the US dollar, the Yuan or the Euro, and a potentially emerging reserve currency in case an agreement fails at the G20.

Beyond a new reserve currency system

The last paragraph contains an obvious caveat: if the Khaleeji comes to be a fiat currency, its backing by energy is purely abstract, shakily built on confidence. And that is the main problem world leaders face today, regardless of what role energy prices have had on the crisis unfolding, one thing is certain: if the energy flow to the world economy can't grow anymore, then all abstract currencies are condemned as long term wealth storage media.

Without economic growth to support their expansion, abstract currencies lose their main advantage over commodities: a supply totally detached from economic activity allowing for monetary policies supporting employment, wealth or international relations. As expansionary measures are put forward to revive an economic growth that might no longer be possible, paper currencies will rapidly deteriorate in value, reducing public confidence invested on them.

A new world reserve currency, resembling the old Ecu for instance, could indeed reinstate balance in world trade, but it won't be in any way a solution for the declining value of abstract currencies and the policies founded on them. But it would at least bind international players together to finding a way forward.