

Reforming the Global Reserve System

The global financial system is not working well, and it is especially not working well for developing countries. Money is flowing uphill, from the poor to the rich. The richest country in the world, the United States, seemingly cannot live within its means, borrowing \$2 billion a day from poorer countries.

Some of these dollars from the developing to the developed world go to pay off their enormous debts—the subject of the last chapter. Others go to buy bonds from the United States and other “strong” currency countries; these bonds will be added to the developing country reserves. They have an enormous advantage: they are highly liquid, so they can be sold quickly whenever the country needs cash; but they have an enormous cost: they earn a very low interest rate. Most of the bonds are short-term U. S. Treasury bills (usually referred to as “T-bills”), which in recent years have yielded as low as 1 percent interest. There is something peculiar about poor countries desperately in need of capital lending hundreds of billions of dollars to the world’s richest country. In 2004, the flow from China, Malaysia, the Philippines, and Thailand alone, mostly to build up reserves, amounted to a whopping \$318 billion.¹

We saw in the last chapter the harm that excessive debt brings to developing countries. We saw too that the huge volatility in the global

economy—including in interest rates and exchange rates—may quickly convert moderate debt into an unbearable burden. While money should be flowing from the rich to the poor and risk from the poor to the rich, the global financial system is accomplishing neither.

With poor countries left to bear the brunt of risk, crises have become a way of life—with more than a hundred crises in the last three decades.² It is the failings in the global reserve system that lie behind many of the failings in the global financial system, and a simple reform of this system would lead to a stronger and more stable global economy. Reform would also solve one of the world's biggest problems: the lack of funds to promote development, fight poverty, and provide better education and health for all.

All countries in the world hold reserves. They serve a multiplicity of purposes. Historically, reserves were used to back up a country's currency. Those who held South African rand or Argentinean pesos might feel more confident in the currency knowing that behind the currency the country held dollars or gold, that they might in fact be able to convert the currency into gold or dollars—which in turn can be used to purchase goods and services. Historically, gold was used as “money”—the medium of exchange in which people traded. People would buy and sell food or clothing in exchange for pieces of gold. Then it was discovered that “fiat money”—pieces of paper that could be converted into gold—was far more convenient, and governments and central banks issued this money. At first, it was thought that there had to be full backing—for every dollar of fiat money issued, the government or the central bank had to hold a dollar's worth of gold. Then it was discovered that this was not necessary; all that was required was confidence in the currency. Confidence meant that other individuals would be willing to accept the money in payment, and confidence could be achieved with only partial backing. At first, it was thought that confidence could only be achieved by using gold as backing; then it was realized that the currency (or debt) of strong economies—initially Britain's sterling, and for much of the period after World War II the U.S. dollar—could be used.

Reserves also help countries manage the risks they face, and this bolsters confidence in both the country and its currency. They can be

drawn upon in times of need. Reserves form a buffer against unexpected changes in the cost of debt caused by an increase in interest rates. There may be a sudden hardship, such as a crop failure, and the country can use reserves to import food. The amount of reserves a country needs varies, but a rule of thumb is that countries should have enough reserves to cover at least a few months of imports. Historically, developing countries held reserves to the value of three to four months' imports; more recently, they have held as much as eight months' imports.

In the last chapter I discussed another risk: many countries have borrowed in dollars from abroad short-term. Short-term lenders are often fickle. If a sudden fear that the country cannot meet its debt obligations sweeps the market, lenders demand their money back simultaneously, and so their fears turn out to be self-fulfilling as countries are usually unable to repay all their debts on such short notice. If a country has large reserves, investors are less likely to panic; and if they do panic, it is more likely that the country will be able to meet its debt obligations. Today, prudence requires countries to maintain reserves at least equal to their short-term dollar debts or debts denominated in other hard currencies, such as the yen or euro.³

Reserves can also be used to manage the exchange rate; without reserves, the exchange rate can fall, often quite dramatically, as fickle investors or profit-seeking speculators or currency manipulators sell a country's currency. Instability in exchange rates can lead to enormous economic instability. By countervailing these moves—buying the country's currency when others are selling or selling the country's currency when others are buying—governments can stabilize the exchange rate, and thereby stabilize the economy. But they can only sell dollars to buy the local currency if they have a reserve of dollars to sell.⁴

While countries have always held reserves, the amount they hold has been soaring. In just the four years between 2001 and 2005, eight East Asian countries (Japan, China, South Korea, Singapore, Malaysia, Thailand, Indonesia, and the Philippines) more than doubled their total reserves (from roughly \$1 trillion to \$2.3 trillion). But the real

superstar was China, which by mid-2006 had accumulated reserves of approximately \$900 billion—amounting to well over \$700 in reserves for every man, woman and child in the country. That accomplishment is all the more astounding given that China's per capita income at that time was less than \$1,500 per year. For the developing countries as a whole, reserves have risen from 6–8 percent of GDP during the 1970s and 1980s to almost 30 percent of GDP by 2004.⁵ By the end of 2006, developing country reserves are estimated to reach \$3.35 trillion.

While there is no agreement on the explanation for this huge increase, two factors are clearly important: the high level of global economic and financial instability, and the manner in which the East Asian crisis of 1997 was handled by the IMF. Countries felt a loss of economic sovereignty; worse, the policies the IMF imposed made the downturns far worse than they would have been otherwise. The East Asian countries that constitute the class of '97—the countries that learned the lessons of instability the hard way in the crises that began in that year—have boosted their reserves in part because they want to make sure that they won't need to borrow from the IMF again. Others, who saw their neighbors suffer, came to the same conclusion: it is imperative to have enough reserves to withstand the worst of the world's economic vicissitudes. Exchange rate management also plays a role in the buildup of reserves; a low exchange rate promotes exports, and a country can keep it low by selling the local currency and buying dollars.

As I have noted, historically reserves were held in the form of gold, and some countries still do this. However, virtually all reserves today are held in dollar-denominated assets, sometimes dollars themselves but, as we have noted, more likely U.S. Treasury bills, which can easily be converted into dollars. The popularity of the dollar in international reserves stems mainly from the dominance of the United States in the world economy and the fairly stable history of the currency. Whether the dollar can and should remain the basis for the international reserves system is one of the questions I will address. First, however, we need to come to grips with the staggering cost of reserves to developing nations.

For all the advantages of holding these accounts, countries pay for

the insurance they provide. Today, developing countries earn on average a real return of 1–2 percent or less on the \$3 trillion plus of reserves.⁶ Most developing countries are starved for funds. They have a myriad of high-return projects. If the money weren't being put into reserves, if it weren't being lent to the United States at such low returns,⁷ it could have been invested in these other projects, earning some 10–15 percent. The difference between the interest rates can be viewed as the cost of the reserves. Economists call these costs—the difference between what could have been earned and what was actually earned—“opportunity costs.”

Using a conservative estimate of 10 percent as the average percent difference between the two, the actual cost to developing countries of holding the reserves is in excess of \$300 billion per year. That's enormous.⁸ To put it into perspective: it represents three times the level of foreign assistance from the whole world. It represents more than 2 percent of the combined GDP of all developing countries; it corresponds roughly to estimates of what the developing countries need in order to achieve the Millennium Development Goals, including reducing poverty by half.⁹ It is much larger than the gains to developing countries from a *successful* pro-development Doha Round trade agreement. (As we noted in Chapter 3 what is likely to emerge, at best, will be of limited value to the developing countries.)

The costs to developing countries of the global reserve system can be seen another way. Assume an enterprise within a poor country borrows \$100 million short-term from an American bank, paying, say, 20 percent interest. Following the prudential guideline that countries should maintain reserves equal to short-term dollar-denominated debt, the government then—if it doesn't want to face the threat of an imminent crisis—must add \$100 million to its reserves: by buying \$100 million worth of T-bills, paying 5 percent interest. There is, in fact, no net flow of funds from the United States to the developing country as a result of the loan; it is simply a wash. But the U.S. bank charges much more for the \$100 million it sends than the U.S. government gives for the \$100 million it receives. There is a net transfer of \$15 million to the United States. This is a great deal for the U.S. bank and the United

States generally, but a bad deal for the developing country. It is hard to see how the net transfer of \$15 million to the United States by the developing country will enhance its growth or its stability.

In addition, there is in effect a transfer from the public sector in the developing country to the private. The private sector is better off (otherwise it would not have borrowed the money, even if the rate is high), but the government has had to spend money on building reserves that it could have used to build schools, health clinics, or roads.

In spite of these huge costs, the developing countries benefit from reserves—if they work as intended, an economy is less volatile than it otherwise would be. (That they are willing to pay such a high price indicates the huge costs of instability to developing countries.) But the real beneficiaries of the global reserve system are those in whose currency the reserves are held. They get low-cost loans; were it not for the demand for reserves, their costs of borrowing would likely be markedly higher. With between two-thirds and three-quarters of reserves being held in dollars,¹⁰ the United States is, in this sense, the major recipient of these benefits. If the interest rate America has to pay is just one percentage point lower than it otherwise would be on these nearly \$2 trillion of loans from poor countries, what America receives from the developing countries via the global reserve system is more than it gives to the developing countries in aid.

A Weaker Global Economy

The cost of the current global reserve system to the developing countries is the most conspicuous, but it is not actually the most important cost to the global economy. The global reserve system depresses the global economy and makes it more unstable. The current reserve system makes it difficult to maintain the world economy at full employment. The money put into reserves is money that could be contributing to global aggregate demand; it could be used to stimulate the global economy. Instead of spending the money on consumption or investing the money, governments simply lock it up.

To see the magnitude of the problem, note that the world's economies hold more than \$4.5 trillion of reserves, increasing at a rate

of about 17 percent a year. In other words, every year some \$750 billion¹¹ of purchasing power is removed from the global economy, money that is effectively buried in the ground. A strong global economy requires that there be a strong demand for goods and services—strong enough that it can meet the world’s capacity to produce. The total demand for goods and services (the sum of the demand by households for consumption, by firms for investment and by government) around the world is called global aggregate demand. If the world is not to face an insufficiency of aggregate demand—leading to a weak global economy—this has to be made up somehow. In the old days, many developing countries counteracted this through lax monetary and fiscal policy, leading to spending that was beyond the country’s means. While this spending made a “contribution” to global aggregate demand, loose fiscal policies gave rise to increasing government debts, which often precipitated costly crises, as we saw in the last chapter. With more than a hundred crises in the last three decades, most developing countries have learned their lesson.

There is one country that can make up for the inadequacy of aggregate demand that comes from burying purchasing power in the ground: the United States has become the consumer of last resort. It is able and, especially since 2000, willing to run huge deficits. There is a seeming unending appetite for reserve country bonds, and it is all too easy for governments of reserve currency countries to get more and more into debt to feed this appetite. The fact that others are willing to lend at a low interest rate creates a situation politicians find hard to resist. It is easy to run fiscal deficits, to spend more than one has. Since the dollar became the major reserve currency, the United States has twice—in 1981 and 2001—financed huge tax cuts through deficits. This helps to explain our peculiar observation earlier—that the United States is the world’s richest country, yet is living beyond its means. In this respect, it is doing the world a service. Without America’s profligacy, the fears of a weak global economy, possibly so weak that prices might actually start to fall—the fears of deflation that surfaced in the early years of this century, and which have plagued Japan for a decade—might have been realized.¹² The question is, for how long can

America continue to provide this service; that is, can it continue its spending spree? And are there alternative, more equitable ways of avoiding the global downward bias?

Insufficiency of aggregate demand in the reserve currency country

We have seen how the global reserve system leads to a problem of inadequacy of global aggregate demand. It also presents a special problem of inadequate aggregate demand in the reserve currency country.

A country whose currency is being used as a reserve must—if it is to continue to be used as a reserve—“sell” its currency (or more accurately, its T-bills or bonds) to other countries, who hold on to them.¹³ When a country sells a T-bill to another country, it is, of course, simply borrowing from that country. A government borrows when it spends more than it takes in; and it borrows abroad when its own citizens are not saving enough, at least relative to what they are investing. In this case, because there are not enough funds at home to finance government spending, it must turn to foreigners to finance its fiscal deficit.

Put it another way: a country, as a whole, borrows from abroad when the country as a whole is spending more than its income. This, in turn, means that the country is importing more than it is exporting—it is borrowing to finance the difference.

Trade deficits and foreign borrowing are two sides of the same coin. If borrowing from abroad goes up, so too will the trade deficit. This means that if government borrowing goes up, unless private savings goes up commensurately (or private investment decreases commensurately), the country will have to borrow more abroad, and the trade deficit will increase.

That is why economists often talk of the twin deficit problem: when government borrowing increases—that is, when the fiscal deficit increases—so too is it likely that the trade deficit will increase.¹⁴

The reserve country can be thought of as exporting T-bills; but the export of T-bills is different from the export of cars or computers or almost anything else: it does not generate jobs. That is why countries whose currency is being used as a reserve, and are exporting T-bills rather than goods, often face a problem of insufficiency of aggregate

demand. Or, to put it another way, we saw that the counterpart of borrowing from abroad (issuing T-bills) is a trade deficit, with imports exceeding exports. And just as exports create jobs, imports destroy them, and when imports exceed exports there is a real risk of insufficiency of aggregate demand. Aggregate demand that would have been translated into jobs at home is translated into demand for goods produced abroad.

Most democratic governments cannot sit idly by as unemployment grows. They intervene, typically by lowering interest rates or increasing government expenditure. Unfortunately, as America's slowdown of 2001–03 showed, even interest rates close to zero may not be sufficient to restore robust growth and full employment. Large deficit spending may be necessary.¹⁵ In this view, it is the trade deficit that leads to the fiscal deficit, not the other way around. Support for seeing the world of deficits through this lens is provided by looking at the pattern of trade and fiscal deficits during the past quarter century. What is remarkable about America is that it has had trade deficits through thick and thin—when the government has had a fiscal deficit and when it has not. The 1990s can be thought of as an exceptional period: an investment boom meant that the economy could remain at full employment even without a fiscal deficit, but the gap between investment and savings remained—the elimination of the fiscal deficit may have increased national savings, but national investment increased almost in tandem. So even as the fiscal deficit disappeared, the trade deficit remained strong as America continued to supply the world with the T-bills other countries wanted for their reserves.

From this perspective, underlying America's persistent trade deficit is its role as a reserve currency: others persistently stockpile America's T-bills. The problem is that the system is not sustainable. The mounting debt eventually undermines the confidence that is required to maintain the dollar as a reserve currency. Of course, America is able to pay back what is owed. But with increasing indebtedness, there is an increasing risk of a reduction in the real value of the debt through inflation. Even a slight increase in the rate of inflation can have large effects in "writing down" the real value of the debt. As I travel around the

world, talking to investors and central bankers, I hear this worry increasingly openly expressed. And with confidence in the dollar fragile, the value of the dollar becomes more volatile.

Instability

This brings me to the final set of major costs of the global reserve system, the instability to which it gives rise. Reserves are intended to reduce the costs of instability. But the irony is that, while the costs of instability for each country are reduced, directly and indirectly, the current global reserve system is a major factor behind the high level of global instability. And the level of global instability has been truly enormous. For instance, in less than two years, between February 2002 and December 2004, the value of the dollar relative to the euro plummeted by some 37 percent. This immense decline shook the financial world and debunked the then widely held notion that the almighty dollar was unassailable.

That unassailability had been questioned before. Too long ago for the memories of the young traders who determined the fortunes of exchange rates in the early 2000s, a previous crisis, in the early 1970s, provides a backdrop to today's anxieties. The United States had, in the years after World War II, felt that a speculative attack might be a problem for the weak countries of Europe, but not a problem that it would ever have to face. That was just wishful thinking. At the time, the United States had a fixed exchange rate—the dollar could be converted into gold at the rate of \$35 to the ounce. A speculative attack on the dollar forced the United States to give up on its commitment to the convertibility of dollars to gold; it would let the dollar float, let the market by itself determine the exchange rate.

The system has been working, if not working well. But there is a fundamental problem underlying the whole reserve system: it is self-defeating. The reserve currency country winds up getting increasingly into debt, which eventually makes its currency ill-suited for reserves.

Already, the current system is fraying at the edges. In early 2005, China announced that it is no longer committed to holding reserves in dollars. It had, in fact, already moved substantial amounts out of dollars (about a quarter of its reserves), but the announcement had

immense symbolic value. Other central bankers, more in keeping with their tradition of staying out of the public eye, quietly confided to me that they too were moving out of dollars.

These changes in central bank policies—the move out of the dollar—make sense. When it was believed that reserves had to be held in gold or in gold-backed dollars, no one thought about managing them. Since 2000, a major change in mindset has occurred. Central bankers have realized that they don't need dollars to back their currencies. With currencies freely convertible into one another, what is important is not the number of dollars but the amount of wealth in reserves. Then the question becomes, how best to manage that wealth—and the principles of wealth management, including diversification, are well known. With so much of reserves having been held in dollars, diversification means movement out of the dollar.

This change in mindset came, in part, because central banks had discovered that dollars were a bad store of value. Traditionally, central bankers have focused on inflation—no one wants to hold a currency whose value, in terms of the goods it can purchase, is being greatly eroded. With its low inflation, the dollar would seem an excellent store of value. But for those outside the United States, its value depends on the exchange rate. Central bankers and the IMF have failed—and failed miserably—to create a system of stable exchange rates. When the value of the dollar relative to the yen was relatively stable, the dollar was a good store of value for those in Japan. But as the volatility of the dollar has increased, as the exchange rate between the yen and the dollar fluctuates enormously, the dollar has lost its ability to be a good store of value for Japan. Similar arguments apply to Europe and elsewhere: the increasing volatility of the dollar has meant that it is no longer a good global store of value.

For instance, in the span of a few months in 1995, the dollar lost 20 percent of its value relative to the yen. There was little inflation in the United States, but those in Japan who had put their money into dollars discovered that they could buy far fewer goods in Japan in April 2005 than they had been able to buy in January. There have been even larger losses over a longer period of time relative to the euro. The opportunity cost also was huge—had they held their money in euros

rather than dollars, reserve holders would have been much better off. The opportunity cost perspective becomes particularly important for the countries of East Asia, who held some \$1.6 trillion of hard currency reserves (mostly in dollars) at the end of 2003. Had they held their reserves in euros during the following year, rather than in dollars, their balance sheets would have been some 11 percent larger—some \$180 billion. That's a lot of money to throw away.

Of course, no one can predict exchange rate movements, but that's why the modern theory of portfolio allocation emphasizes diversification: don't put all your eggs in one basket. A dynamic has been set in motion that is not good for the dollar: as central banks move out of the dollar, the dollar weakens, reinforcing the view that the dollar is not a good store of value.

The emergence of the euro has accelerated the fraying of the dollar reserve system. Although Europe has been plagued with problems such as low growth, high unemployment, and a constitutional crisis, the euro has been a strong currency. The logic of diversification says that, however one assesses the prospects of Europe versus America, one should carry significant amounts of one's reserves in each.

Early on, Europe was pleased by this development. It had looked with relish at the prospects of the euro becoming a reserve currency because it wanted the new currency to be treated with respect, and its adoption as a reserve currency signaled this. But as the reality of what this status entails has become increasingly clear, not everyone in Europe has been so enthusiastic. As central banks hold more euros as reserves, the value of the euro will increase, making it harder for Europe to export and opening it up to a flood of imports.¹⁶ It will have an increasingly difficult time maintaining full employment. And with unemployment already so high, and with its central bank focusing exclusively on inflation and not at all on unemployment or growth, there is good reason to be worried about Europe's macro-economic prospects.¹⁷

Scenarios—from evolving instability to crisis

That there is a problem with the global reserve system seems clear. There is less certainty about how all of this will unfold. There are several different scenarios—from crises to gradual evolution.

Here is a picture of what might happen over the next few years: As American debt mounts, doubts about the soundness of the dollar increase. At first, a few investors think they would be better off putting their money elsewhere. As they do this, the dollar falls. (The partial recovery of the dollar in 2005 is at least partly due to the repatriation of profits; profits repatriated during the year were given specially low tax rates, which induced abnormally high levels of repatriation. By mid-2006, the dollar has started to weaken again.) When the losses in the value of the dollar are taken into account, keeping money in dollars appears foolish; returns are just too small to justify the risk. There is, of course, no such thing as a safe bet; but, perceiving the riskiness of the dollar, more and more investors will decide to shift more and more of their money out of dollars into euros, yen, or, where possible, the yuan, China's currency. (In spite of capital controls, there was an inflow of some \$100 billion into China, in addition to foreign direct investment, in 2004.) As this happens, more and more downward pressure is put on the dollar. Simultaneously, as investors pull their money out of American securities, stock prices will fall or stagnate. Keeping money in the United States will look increasingly like a bad bet.

The consequences of increases in medium- and long-term interest rates may be particularly serious, given the high level of indebtedness of individual households, many of whom took out large mortgages in response to the unusually low interest rates. What matters is not the average level of indebtedness but the number of households that will face difficulties in meeting their debt obligations. The increasing fraction of mortgages having interest rates that are variable makes this particularly worrisome.

The march out of the dollar may be orderly and smooth, occurring over a period of months, perhaps even years. Or it may be disorderly, a crash. In the former case, the U.S. stock market may simply go through a malaise; it may even continue to climb, but simply at a lower rate than otherwise would have been the case. In the latter case, the U.S. economy would go into a downturn. If there is to be a crash, it is, as always, difficult to predict what kind of event might precipitate it. Even in retrospect, it is hard to identify any single event that caused the crash of October 1987, which wiped out 25 percent of the value of

U.S. equities in a day. But there are plenty of events, including baseless rumor, that could do the trick. Events in the Middle East might turn out even nastier than they have been. A new terrorist attack in the United States might show that, for all the money that has been spent, America is still vulnerable.

While America's increased indebtedness—the predicted historical course for the reserve currency country—is a major source of the global financial instability facing the world today, the counterpart to this indebtedness—the large holdings of dollars by China and Japan—has been a force for stability. Together, they have increased their holdings of reserves enormously, by over \$1 trillion from 2000 to 2006 alone. As I have already noted, sound portfolio management suggests moving out of dollars, putting more into euros—and China has already been moving in that direction. But here's where China and Japan have a problem: their dollar holdings are so large that were they to sell significant amounts quickly, it would put downward pressure on the dollar—causing losses on their remaining holdings. China and Japan's central banks have an interest in maintaining stability, and they are not subject to the panics, the attacks of irrational pessimism and optimism, that mark markets.

Moreover, there is a political dimension to all exchange rate policy, especially that of China. There is an element of mutual hostage in U.S.-Chinese economic relations. China has a huge bilateral trade surplus with the United States, selling far more than it buys. But China makes it possible for the United States to sustain its deficit spending, by buying billions and billions of dollars' worth of America's bonds. America and China know the nature of their mutual dependence; that's why matters seldom get beyond the rhetoric.

America has been highly vocal, blaming China's unfair exchange rate policy for its trade deficits. Though China has let its exchange rate appreciate slightly, it knows that even a more significant increase will only decrease the bilateral trade surplus a little. A change in the exchange rate would not, moreover, affect the United States' overall trade deficit, which is related to its macro-economic imbalances—the fact that it is saving less than it is investing, a problem exacerbated by the huge fiscal deficit. Americans would simply buy more textiles from,

say, Bangladesh. At the same time, a significant appreciation of the currency would lower prices for agricultural goods, which are depressed due to the distortion of global prices by U.S. and EU subsidies, as we saw in chapter 3; this would make life more difficult for those in the rural sector—a part of China that is already falling behind. China could offset the effects through subsidizing its farmers, but this would divert money badly needed to promote its development. In short, China knows that there would be high costs to it—and little benefit to the United States—were it to allow its exchange rate to appreciate. And presumably, America understands this too.

Although China and the United States need each other, there is, of course, always the fear that political forces will get out of control: some American politician, in a district where there is an especially large loss of jobs as a result of Chinese imports, might try to make hay of China's allegedly unfair trade policies; or America might come to the side of Taiwan, as some Taiwanese politician stirs the murky waters of Taiwan-China relations. Will it be acceptable, under these circumstances, and given China's political system, for China to be seen as helping the United States by lending it several hundred billion dollars? Will there be pressure on the Chinese government to divest itself of at least significant amounts of U.S. dollars, even if there is a cost to doing so? Though central banks strive for stability, politics can trump economics, forcing actions that might not be in the best economic interests of anyone. The possibility of political forces inducing a sell-off of dollars cannot be dismissed, and if that happens, we could see the dollar plunge. Economists might like to believe that economic forces underlie all prices, but the prices of national currencies, at least, are determined as much by politics as by economics.

Though reasonable people in both countries understand the facts, there is an important asymmetry: China doesn't really need to send its goods to the United States in return for pieces of paper of diminishing value used to finance America's deficits. There is a certain irony in China having, in effect, funded a tax cut for the richest people in the richest country on earth. Rather than lending money to the United States to increase consumption by these people, it could lend its money to its own people or it could finance investment in its own country. It

would be far easier for China to redirect production toward its own consumers or investment than it would be for the United States to find an alternative source of cheap funding for its deficits.

Fortunately, however, the long-term economic consequences of tensions in U.S.-China relations are today but a shadowy cloud on the distant horizon. They merely add one further layer of uncertainty in a global financial system that is already straining.

MAKING GLOBALIZATION WORK: A NEW GLOBAL RESERVE SYSTEM

The dollar reserve system may not be the only source of global financial instability, but it contributes to it. The question is, will the global economy lurch from the current system to another—such as the two-currency reserve system toward which the world now seems to be moving—equally beset with problems? Or will something be done about the underlying problem?

There is a remarkably simple solution, one which was recognized long ago by Keynes: the international community can provide a new form of fiat money to act as reserves. (Keynes called his new money “bancor.”)¹⁸ The countries of the world would agree to exchange the fiat money—let’s call it “global greenbacks”—for their own currency, for instance in a time of crisis.

Not only is this a theoretical possibility, but at the regional level, in Asia, there is already an initiative underway that employs some of the same concepts. The origins of the initiative go back to the East Asian crisis. At the peak of the crisis, Japan proposed establishing an Asian Monetary Fund, a cooperative movement among the countries of Asia, and generously offered to put in \$100 billion to help finance it—funds badly needed to help restore the economies in the region. The United States and the IMF did everything they could to stop this; both were worried that an Asian Monetary Fund would undermine their influence in the region, and both were willing to put their own selfish concerns above the well-being of those countries. They succeeded in scuppering the proposal, but only a few years later, in May 2000, the members of the Association of Southeast Asian Nations (ASEAN), plus

China, Japan, and South Korea, meeting in Thailand, signed the Chiang Mai Initiative, agreeing in effect to exchange reserves, to set up the beginnings of a new regional cooperative arrangement that would enhance their ability to meet financial crises.

The IMF's management of the 1997 crisis laid bare the divergence of interests between it—and, by extension, the United States—and the countries of the region. These countries naturally asked, why should we put the money in our sizable reserves in Western countries that treated us so badly, when we could just keep reserves in the region, with each holding the currencies of the others? We need more investment, and if we are going to lend to enhance someone's consumption, why not lend to support the low level of consumption of our people, rather than the profligate consumption of the United States?

There were both economic and political dimensions to the initiative. The fact that, in the dollar reserve system, they received lower interest rates on what they lent than on what they borrowed was particularly galling, given that they were saving more and pursuing far more prudent fiscal policies than the United States and other advanced nations. They have, moreover, repeatedly been on the losing side of exchange rate instability. As debtors, their falling exchange rate in the 1990s meant that, in terms of their own currency, they had to repay far more than they borrowed; in 2000, with the falling dollar, as creditors they would be repaid in real terms far less than what they had lent.

As of November 2005, around \$60 billion in currencies had been made available for exchange between various Asian nations, with agreements in place to expand that amount even further. As this initiative illustrates, reserves can be viewed like a cooperative mutual insurance system. The holdings of one another's currencies in reserves has the same effect as a line of credit, a commitment on the part of other countries to allow the country access to resources in times of need.

The international community has already recognized that it can provide the kind of liquidity that Keynes envisioned, in the form of special drawing rights (SDRs). SDRs are simply a kind of international money that the IMF is allowed to create.¹⁹

The global greenbacks proposal simply extends the concept. I refer to the new money as global greenbacks to emphasize that what is being

created is a new global reserve currency, and to avoid confusion with the existing SDR system, which has two problems: SDRs are only created episodically, while global greenbacks would be created every year; and SDRs are given largely to the wealthiest countries of the world, while global greenbacks would be used not only to solve the world's financial problems but also to combat some of the deeper problems facing the world today, such as global poverty and environmental degradation.²⁰

Here is a simplified description of how the system might work. Every year, each member of the club—the countries that signed up to the new global reserve system—would contribute a specified amount to a global reserve fund and, at the same time, the global reserve fund would issue global greenbacks of equivalent value to the country, which they would hold in their reserves.²¹ There is no change in the net worth of any country; it has acquired an asset (a claim on others) and issued a claim on itself. Something real, however, has happened: the country has obtained an asset that it can use in times of an emergency. In a time of crisis, the country can take these global greenbacks and exchange them for euros or dollars or yen; if the crisis is precipitated by a harvest failure, it can use the money to buy food; if the crisis is precipitated by a banking failure, the money can be used to recapitalize the banks; if the crisis is precipitated by an economic recession, the money can be used to stimulate the economy.

The size of the emissions each year would be related to the additions in reserves. This will undo the downward bias of the global reserve system. Assuming that, going forward, the ratio of reserves to GDP remains roughly constant, and that global income grows at 5 percent a year, with a global GDP of approximately \$40 trillion, annual emissions would be approximately \$200 billion. On the other hand, if the ratio of reserves to imports stays constant, with imports growing at roughly twice the rate of GDP, annual emissions would be as much as \$400 billion.

Normally, of course, these exchanges of pieces of paper make no difference. Each country goes about its business in the same way as it did before. It conducts monetary and fiscal policy much as it did before.

Even in times of emergency, life looks much as it did before. Consider, for instance, an attack on the currency. Before, the country would have sold dollars as it bought up its own currency to support its value. It can continue to do that so long as it has dollars in its reserves (or it can obtain dollars from the IMF). Under this new regime, it would exchange the global greenbacks for conventional hard currencies like dollars or euros and sell those to support its currency.

(There is an important detail: the exchange rate between global greenbacks and various currencies. In a world of fixed exchange rates [the kind of world for which the SDR proposal was first devised], this would not, of course, be a problem; in a world of variable exchange rates, matters are more problematic. One could use current market rates; alternatively, the official exchange rate could be set as the average of the exchange rates over, say, the preceding three years. In such a case, to avoid central banks taking advantage of discrepancies between current market rates and the official exchange rate, restrictions could be imposed on conversions [for instance, conversions could only occur in the event of a crisis, defined as a major change in the country's exchange rate, output, or unemployment rate]. I envision global greenbacks being held only by central banks, but a more ambitious version of this proposal would allow global greenbacks to be held by individuals, in which case there would be a market price for them and they could be treated like any other hard currency.)

Because each country is holding global greenbacks in its reserves, each no longer has to hold (as many) dollars or euros as reserves. For the global economy, this has enormous consequences, both for the former (current) reserve currency countries and for the global economy.

We noted earlier the self-destructive logic of the current system, where the reserve currency country becomes increasingly in debt, to the point at which its money no longer serves as a good reserve currency. This is the process that is currently in play with the dollar. Because the global reserve system would no longer rely on the growing debt of a single country—the basic contradiction of the current system, which makes instability almost inevitable—global stability would be enhanced.

There is a second reason that the system of global greenbacks would

bring greater global stability. A major factor in the repeated crises of recent decades has been trade deficits; when countries import more than they export, they have to borrow the difference. So long as trade deficits continue, foreign borrowing continues; but at some point lenders worry that the country is too much in debt, that it may not be safe to continue to lend. When these questions start to get asked, there is a good chance that there will be a crisis around the corner.

Obviously, if one country exports more than it imports, then other countries must import more than they export. In fact, apart from statistical discrepancies, the sum of the world's trade deficits and surpluses must equal zero. Put another way, trade deficits must collectively match trade surpluses. This is the iron law of global trade deficits. Accordingly, in order for a country like Japan, which insists on running a surplus, to achieve that surplus, some other country or countries must have a corresponding deficit. Similarly, if some countries get rid of their deficit, either the deficits of other countries must increase or the surpluses of other countries must decrease, or a combination of the two.

In this sense, deficits are like hot potatoes. As South Korea, Thailand, and Indonesia eliminated their trade deficits after the East Asian crisis and turned them into surpluses, it was almost inevitable that some other country or countries would wind up with a very sizable deficit to offset their gains. In this case, the country was Brazil. But just as South Korea and Thailand could not sustain a trade deficit, neither could Brazil. As investors saw Brazil's deficit rise, they acted as they had so often before: debts were recalled, precipitating a crisis. As Brazil's economy plunged into recession, imports contracted, and Brazil's deficit was converted into a surplus; again, that surplus means a same-sized deficit was created somewhere else in the global system.

While the IMF—and the financial community generally—has focused on countries with trade deficits as the problem giving rise to global instability, this analysis suggests that trade surpluses are just as much the problem. In fact, Keynes, thinking about the problems of the global financial system sixty years ago, went so far as to suggest that there should be a tax levied on countries running a trade surplus, to discourage them from letting it grow too large.²²

As badly as the system has functioned, matters could have been worse. There is one country that can—so far—maintain a trade deficit without precipitating a crisis, and that is the United States. The United States has become not just the consumer of last resort, but also the deficit of last resort. It has been able to get away with this because it is the richest country in the world and because other countries have wanted to hold dollars in their reserves. But even if the United States can mount deficits longer than other countries, it cannot do so indefinitely. There will be a day of reckoning.

The global greenback system breaks the zero-sum logic that has resulted in one crisis following another. Of course, it would still be the case that the sum of the trade deficits equals the sum of the surpluses, but there would be an annual emission of global greenbacks to offset—to pay for—the deficits. So long as deficits remained moderate, there would be no problem. There would be a cushion equal to the emission of global greenbacks. The game of hot potato deficits would effectively be stopped, and a buffer would be created, to stabilize the global economy in the face of the inevitable shocks it faces.

The United States might think that the global greenbacks system would make it worse off because it would no longer effectively get cheap loans from developing countries. There is, of course, something unseemly about the poorest countries providing low-interest loans to the richest. However, the United States would benefit from the greater global stability, along with the rest of the world. The global greenbacks system would make it easier for the United States to maintain its economy at full employment without massive fiscal deficits (undoing the forces described earlier, by which increased dollar reserve holdings abroad lead to weaker aggregate demand within the United States).²³

If the United States cannot be persuaded to join the new Global Reserve System, there is another, tougher approach. The rest of the world could agree to move to this system, a form of cooperative mutual help, and, in doing so, agree that they would gradually shift more of their reserves to countries that are part of the co-op. As the benefits to the United States from exploiting the developing countries diminish, the United States would face increasing incentives to join.

Reform and the Broader Globalization Agenda

Who would receive the annual emissions of global greenbacks? The answer to this has enormous consequences for global well-being.

Here is an opportunity for the global community to make globalization work so much better.²⁴ Globalization entails the closer integration of the countries of the world; this closer integration entails more interdependence, and this greater interdependence requires more collective action. Global public goods, the benefits of which accrue to all within the global community, become more important. These include, for instance, health (finding a vaccine against malaria or AIDS) and the environment (reducing greenhouse gas emissions, maintaining biodiversity in rainforests). These should be first priorities for the funds.

The new global reserve system could not only solve the problem of how to finance global public goods, it could demonstrate the global community's commitment to global social justice. After providing funds for global public goods, the bulk of the remaining funds could go to the poorest countries of the world. This would be a major change in philosophy from that underlying the IMF, which recognized the need for greater liquidity, through the issuance of SDRs, but based it on the principle "to he that hath, more shall be given." The rich got the lion's share.

There are many ways in which the funds could be administered. Inevitably there will be disagreements about the best way, but we should be careful not to let the perfect be the enemy of the good.²⁵ Probably it makes the most sense to have a combination of approaches. One approach would be to allocate funds to different countries on the basis of their income and population (consistent with principles of social justice, poorer countries would get a larger allocation per capita). Given the failure of conditionality in the past, the only condition that should be imposed relates to global externalities—costs that countries impose on others. The most important is probably nuclear proliferation—only countries that commit themselves fully to a non-nuclear regime would be eligible. Other conditions might involve global environmental externalities, such as greenhouse gas emissions, emissions of gases that destroy the ozone layer, ocean pollution, abiding by international agreements on endangered species, etc.

In a second approach, funds would be distributed through international institutions, either existing ones or newly created “special trust funds” established under the auspices of the United Nations. They could be issued to individual countries, who would agree in turn to make a contribution of an equivalent amount to the UN trust funds. A portion might be used to help achieve the Millennium Development Goals—the goals the international community set for itself in reducing poverty by 2015,²⁶ including promoting health, increasing literacy, and improving the environment in developing countries. Take, for instance, the area of health. The record of the World Health Organization is impressive. Some diseases, including smallpox, polio, and river blindness, have been virtually eliminated. With more money, much more could be done at relatively low cost.²⁷ We already know that the incidence of malaria can be greatly reduced by draining stagnant pools of water and using impregnated mosquito nets. I have visited smoke-filled huts around the world, where indoor pollution leads to lung and eye diseases; they need only chimneys. As I mentioned in chapter 2, great advances in public health can be achieved simply by teaching people to build latrines downhill from sources of drinking water. These are small changes that could make big differences in the lives of millions of people, and more money would help enormously.

Some of the money could, similarly, be used to achieve literacy for all. Today, some 770 million people around the world remain unable to read or write; one of the Millennium Development Goals calls for every child in the world to complete primary education by 2015. The cost would be small, between \$10 billion and \$15 billion a year,²⁸ but so far the international community has not been forthcoming with the money needed. Issuing some of the new global greenbacks to a special UNICEF education trust fund could make an enormous difference.

As we saw in chapter 6, global warming is a global problem. The international community has established a global environment lending facility to help pay for the incremental costs associated with reducing greenhouse gases and other good environmental policies, but it is vastly underfunded. Some of the global greenbacks could go there.

A third approach might involve competitive allocations for development-oriented projects, for which governments and NGOs

could apply. Competition might spur innovation in schemes to enhance the well-being of those in the developing world.

A fourth alternative, direct distribution to individuals, is perhaps too problematic to be practical. Aside from the difficulties of getting the money to the poorest individuals, it makes little sense to give money to people and then charge them for basic health and education. Both sides of the transaction are wasteful and imperfect. Better simply to use the money to provide education and health services for the poorest.

As I have broached the idea of a reform in the global reserve system in seminars around the world, I have been heartened by the extent of support. George Soros has advocated the onetime use of SDR emissions for financing development.²⁹ But why restrict emissions to a one-time event?

The problems of the global financial system are systemic and have much to do with the global reserve system. The world is already moving out of the dollar system, but that doesn't mean that it is moving toward a better system—and, sadly, little thought has been given to where it is going or how it should evolve. This single initiative could do more to make globalization work than any other. It would not eliminate the problems faced by developing countries, but it would make things better. It would enhance global stability and global equity. It is not a new idea, but it is an idea perhaps whose time has come.