

Common Currencies and Reserve Currencies: *A Different View*

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Summary

On common currencies:

Economic integration is *not* about the unit of account,

it's about *economic integration*:

common markets in labor, goods, services, property rights, corporate control and credit.

On reserve currencies:

Reserve currency status is *not* about the unit of account,

it's about *the asset*:

a widely-accepted means of exchange and store of value used as the base asset in money creation (high-powered money).

Basics: one market for capital

One pool of capital in the world

- Deployed in different places and to different ends

But common benchmark for us all

- All investments are compared to the highest return / lowest risk
- Differences in anticipated, risk-adjusted returns will be reflected somewhere

Exchange rates are one means of reflecting these differences

- If these differences are not to be found in exchange rates they will be reflected in other market prices and economic outcomes

Rates of exchange and economic integration

Eliminating currencies does not eliminate the differences in returns

- Only eliminates one means of *expressing* those differences

To eliminate the *differences* in risk-adjusted returns

- Must create genuinely common markets
- Labor, goods, services, property rights, corporate control and credit

A common currency is neither sufficient nor a necessary condition

- A common currency and common central bank *may* facilitate the development of common market in credit
- But it is not a guarantee of integrated markets - no assurance of converging risk-adjusted returns to either labor or capital

An example: U.S. economic integration

1861-65: Civil War fought over principle of labor market mobility

- Created a strong Federal government
- Committed to the free movement of free labor across continent

1865-1940: Judicial development of a common market

- States not permitted to restrict inter-state commerce
- Goods, services, ownership of property and corporate control

1931-1945: Continent-wide fiscal stabilizers

- “New Deal” response to Great Depression
- Counter-cyclical policies; social and corporate welfare
- War economy

U.S. financial integration

1800s: Common currency (unit of account): the dollar

- 1830s to 1914: no central bank
- Monetary conditions reflected capital strength of local banks
- “Rates of exchange” between state bank notes and gold
(Called “credit spreads” today)

1914: Created Federal Reserve System

- Intended *regional* monetary policies by 12 reserve banks
- Created national overnight funds market *by accident*
- Created national monetary policy in law only in 1930s
- Prohibited “inter-state” banking until 1980s

Only in 1980s & '90s did U.S. create real common market in credit

A common currency is only an opportunity to integrate

A common unit of account will not create economic integration.

If the goal is to reduce disparities in economic growth and in risk-adjusted returns, eliminating exchange rates is not a short-cut.

Eliminating the exchange rate will also eliminate an adjustment mechanism, putting more pressure elsewhere.

- Differences will be reflected in other economic outcomes.
- Making it more (not less) important to have truly common markets in labor, goods, services, property rights, corporate control and credit.

Be careful what you wish for!

Reserve currency status: it's about the asset

Reserve currency status is not about the unit of account.

Size or importance of an economy is an imperfect proxy.

Reserve currency status: availability of a "reserve" asset:

- Widely-accepted means of exchange and store of value
- Held on balance sheet by credit intermediaries
- Leverage point in money creation - "high-powered money"
- Available in sufficient volume to correspond to growth in demand for credit and aggregate demand

An example: 19th century United Kingdom

Sterling was the reserve currency (unit of account)

But the reserve asset was GOLD (not gilts)

- British banks had origin in London-based gold market
- Banks liquefied gold; sterling the unit of account of banks

Sterling lost reserve currency status after the First World War

- Economic decline but also the end of the gold standard
- Gold lost status not because of decline in value but because supply did not expand with credit needs
- British banks & sterling lost special connection to reserve asset

Evolving source of U.S. dollar's status

Early years of U.S. dollar as reserve currency:

- 1930s-'40s: default from Sterling; Depression; WWII
- 1950s-'60s: matter of "law" - Bretton Woods system
- 1970s: collapse of Bretton Woods
 - The end of the U.S. dollar's reserve currency status?
 - The Swiss franc as a reserve currency?

Rising U.S. budget and current account deficits (1980s to present):

- Reserve currency status *in spite* of twin deficits?
- Or, perhaps, is the U.S. dollar's reserve currency status *because* of current account deficit and federal borrowing?

Dollar's role expanding even as its end predicted

U.S. Treasury securities as high-powered money:

- Not central-bank liabilities but central-government liabilities
- Store of value (payment of interest)
- Most liquid market (ever)
- Good enough for asset side of the Fed's balance sheet
- Did rapid growth in supply meet growth global credit demand?
 - 1970s to 1995: inflation threatened; volatile markets
 - 1995 to date: low and stable inflation and accelerating use of U.S. Treasuries as reserve asset of choice

U.S. Treasuries and close substitutes provide base asset:

- Banks liquefy those assets
- Dollar = unit of account for U.S. capital markets

Regime change or changes at the margin?

Dollar's "bold bid" for market share in reserve currency game:

- Accumulated current account deficit in trillions

Under what conditions will this regime continue or be lost?

- Dollar/Treasuries' retain status (deficits continue):
 - Liquid store of value: U.S. avoids accelerating inflation
 - Supply grows with aggregate demand and need for credit
- Loss of status: loss of liquidity, loss of store of value (inflation)
 - If supply does not grow fast enough
 - If an alternative develops that better serves needs

Big markets, changes at the margin are still seem quite large

Conclusion

Economic integration is not about the unit of account,
it's about economic integration.

Reserve currency status is not about the unit of account,
it's about the asset.