GMO White Paper

Apr 2017

The Reserve, Part II
The US Dollar: Still the Cleanest Dirty Shirt?

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Executive Summary

In Part I of this series,[1] we reviewed several features of reserve currency regimes: the rise of the dollar, the critical components that make up a reserve currency, and the myths that currently exist in sovereign debt analysis. In the meantime, we've seen a Chinese government that is beginning to understand the implications of a more open capital account and financial stability: Chinese savers have sought to diversify away from renminbi, periodically adding to volatility and capital flight. All of this makes the process of the internationalization of the renminbi particularly fascinating. Additionally, the drumbeat of protectionism resounding from within the United States may have longer-term implications for the dollar. Yet, despite the lack of clarity regarding forthcoming US policies and other issues, it is likely that the US dollar will retain its premier position against its nearest competitors.

[1] Amar Reganti, "The Reserve: The Dollar, the Renminbi, and Status of Reserve," September 13, 2016. This GMO white paper is available with registration at www.gmo.com.

Introduction

When we initially undertook to write this series, the goal was to provide context for GMO's clients who operate in a marketplace dominated by the US dollar, first by examining its path to becoming a reserve currency, and then by looking at its current status in the global economy. Additionally, we hoped to continue to dispel myths about sovereign debt in developed countries. As we showed in Part I, current metrics of sovereign debt sustainability appear to be rather meaningless for a developed country sovereign that issues in its own currency.[2] Part II is meant to be read in conjunction with Part I, resulting in a foundational treatment regarding reserve currencies and sovereign debt.

At our 2016 Fall Client Conference, I presented a workshop on this current series. An astute client asked the critical question, "What can change the dominance of the dollar?" I answered quickly (too quickly, in hindsight), "By doing something self-destructive, such as defaulting on our debt." Before jumping right into Part II, I would like to expand on that answer. We can also hasten the demise of the dollar if we deliberately limit its usefulness and its associated securities market (namely, the Treasury market): 1) diminish trade conducted in dollars;[3] 2) deliberately limit or inhibit the usage of the Treasuries' market, particularly on the collateral side, by encouraging scarcity of Treasury bills;[4] 3) allow a critical global resource, such as oil, to be priced and traded in another currency; or 4) abandon the "strong dollar" language of the executive branch for a prolonged period of time, thus adding additional volatility into dollar exchange rates.

Renminbi

On November 30, 2015, IMF staff endorsed the renminbi (RMB) as a part of a basket that makes up the Supplementary Drawing Rights (SDR). The SDR is defined as "a potential claim on the freely usable currencies of IMF members." Achieving SDR status has traditionally meant that a currency is in an exclusive club of international reserve currencies, which are currencies that are held as reserve assets by other countries. Member countries of the IMF are allotted an amount of SDRs that theoretically serve as financial assets for those countries. Countries with SDRs may use them to obtain the underlying currencies.[5] The addition of the RMB to the SDR basket is a significant, albeit symbolic, step in the internationalization of the RMB. The criteria for inclusion in the SDR, as defined by the IMF staff, "are the currencies that are issued by members or monetary unions whose exports had the largest value over a five-year period, and have been determined by the IMF to be 'freely usable.'"

However, inclusion within the SDR does not necessarily mean a currency has become internationalized. What's more, internationalization does not necessarily mean achieving the status of a reserve currency, as discussed in Part I. Specifically, inclusion in the SDR does not mean the RMB will be the desired currency of a waiter in, say, Mumbai, the preferred collateral currency of a clearing house, or the liquid reserves of a central bank reserve manager.

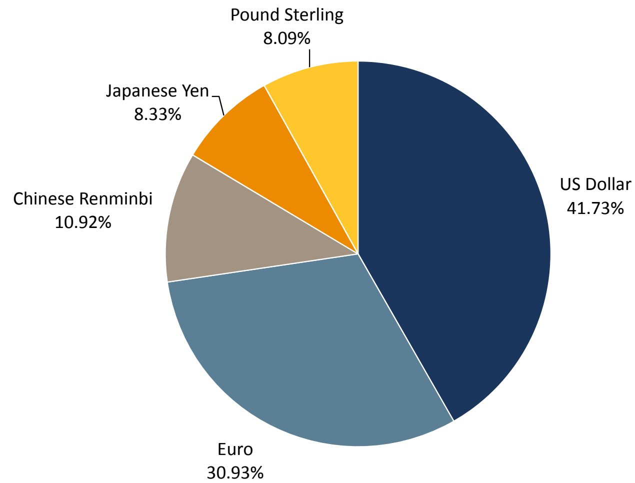
[2] We noted that relationship between an issuing Treasury and a central bank, and also provided the real world example of Japan. Indeed, in a recent discussion at The Harvard Law School that included Stephanie Kelton, we discussed the mechanics of government debt, which doesn't need to use even the securities market, but employs intra-governmental balances. See the Appendix for an illustration of such a mechanism.

[3] Remember from Part I, current account deficits are one way the rest of the world actually garners dollars. Protectionism might lead to a short-term rally in the dollar, but over the longer term may reduce the usefulness of the world's reserve currency.

[4] The absolute best book I have ever read on the topic is Manmohan Singh's Collateral and Financial Plumbing. It is a must read for anyone interested in these issues.

[5] This can be done according to the IMF, either by trading the SDR with other member countries, or by the IMF designating a member country with a strong external position to purchase the SDR from said country. http://www.imf.org/external/about/sdr.htm

Exhibit 1: SDR Composition Percentages

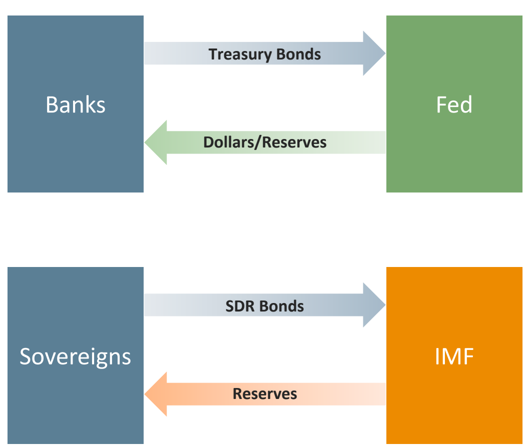


Source: IMF

But is an SDR a reserve currency?

The short, though nuanced answer, is no. The IMF cannot simply create more SDRs; it cannot take in assets and deliver SDRs through open market operations (the so-called "discounting of commercial paper" that is listed in the Federal Reserve charter discussed in Part I). Without being able to add to the flexibility of the currency, or having a central bank that will deliver the basket upon receipt of assets, the SDR is not, and unfortunately for the IMF, cannot be, an alternative currency. Indeed, even if the IMF were able to convince one central bank to accept SDR-denominated assets as collateral, the simple fact is that that particular central bank could only supply an infinite quantity of its own currency, not the other currencies within the SDR. Exhibit 2 illustrates a number of ways that a central bank can increase its currency outstanding, and also shows what the IMF cannot do.

Exhibit 2: Making a Currency Elastic



Source: GMO

The exchanges between banks and the Fed depicted in Exhibit 2 can be conducted almost *infinitum*, because the Federal Reserve can create dollars and reserves at will. The transactions with the IMF shown in the second diagram cannot because the IMF itself has only a limited number of reserves and cannot simply "create" new reserves to deliver to financial institutions. While the IMF can designate members to purchase SDRs in order to maintain the functioning of the SDR system, triggering such a mechanism is likely to be fraught with political danger. Indeed, it would involve coordination between several central banks whose currencies each make up the SDR. Such coordination, even in the best of times, is not something that can be counted on and assuredly would weaken any attempt at making an SDR a substitute for the current reserve currency regime. Furthermore, as the IMF states, "Additional hurdles to the development of an SDR-based system include potential resistance from reserve issuers who have no direct use of SDRs…the lack of deep and liquid markets; the need to convert SDRs into a freely usable currency for most payments transactions."[6]

So, why not the euro?

Looking at the SWIFT data presented in Part I, one might assume the euro would challenge the dollar as a transactional currency. However, it broadly breaks the conditions discussed in the "Do Credit Ratings Matter?" section of Part I: The Eurozone is not one country, but rather a group of sovereignties operating with a common currency. In effect, each of the sovereign countries is issuing debt in a *foreign* currency, with a central bank that needs to consider the interests of all members, not any one member. In addition, in practice, the debt of each sovereign entity is not particularly fungible with another. Woe to the dealer who delivers to his client a French 10yr OAT or Italian BTP instead of a 10yr German *bund*. In reality, the fragmentation of the European sovereign market is more reminiscent of the US municipal market for state General Obligation bonds. Without a deep, liquid, and *fungible* market for government securities, the euro has little chance of becoming a genuine reserve currency as we have defined it in this series. The economic tragedy of Greece exemplifies the weakness of the common currency. For the euro to be considered a genuine reserve currency, it will need to engage in a more aggressive fiscal union.

So, why not the yen?

The yen exhibits some safe-haven characteristics, but it lacks several others related to a reserve currency. For example, the yen is still a relatively small portion of global reserve balances. In addition, it is unclear whether the Japanese government actually wants a stronger yen given its export-oriented economy. In the US, when the Secretary of the Treasury is asked to comment on the dollar (indeed, the only one authorized to speak on the value of the dollar), he generally states that the US operates with a strong dollar policy. That type of language is generally not spoken by the Ministry of Finance in Tokyo, and indeed, a stronger yen generally leads to more heartburn for Japanese economic policymakers.[7]

A quick word on bitcoin

In recent years, the development of bitcoin and other "alternative" currencies has led to the speculation that traditional currencies of sovereign nations were becoming *passe*. It's important to note that one can use a number of different things as mediums of exchange, including notches on a tally stick and whale bones. Two of the most important features as to whether a currency can be universally used within a monetary system is whether that currency is acceptable for tax payments[8] and whether that currency is acceptable for a central bank to "furnish an elastic currency, and to afford means of discounting

[6] p.22 http://www.imf.org/external/np/pp/eng/2010/041310.pdf

[7] Policymakers in the US should be wary of abandoning the rhetoric around a strong dollar. It appears there is now substantial debate in Washington with regards to moving away from the language that reinforces the reserve currency status of the dollar: https://www.ft.com/content/67be8118-df3c-11e6-86ac-f253db7791c6

[8] As noted in Part I, Randall Wray clearly articulates this paradigm.

commercial paper." In short, can this alternative currency be used to pay my taxes or in transactions with the central bank? If not, then bitcoin is merely a form of alternative commercial paper.

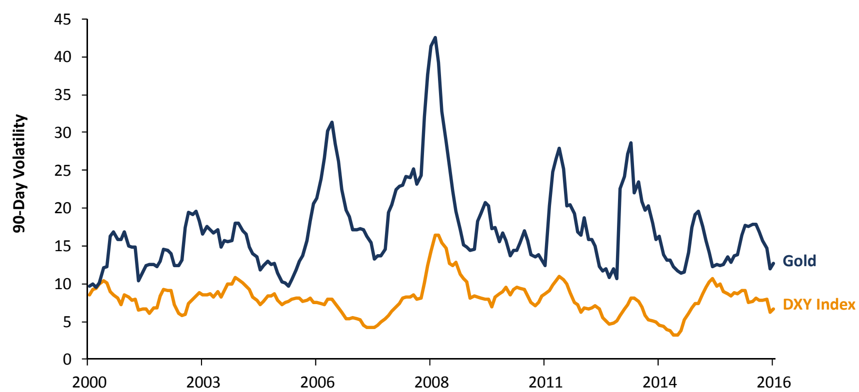
Gold

There is nothing wrong with loving something, just make sure you know what you're loving. "Gold bugs" cite the enduring love of gold throughout the centuries and the stock of reserves held in gold. We find several problems with gold:

1) While physical gold bullion is not hard to trade, it carries the added headache of storage and custody. There is a reason why numerous nation states allow the Federal Reserve Bank of New York to act as the physical custodian of their gold holdings.[9] Believing in gold as the last resort due to a systemic failure, yet being unable to physically access it due to how it is custodied, might be a problem. Some market participants look back at the era of the gold standard with rose-tinted glasses. We beg to differ.[10] As aptly noted by Pilkington: "When household consumption collapsed in the wake of 2008 the government had to step in to provide spending to keep the economy afloat and the unemployed fed. A gold standard would merely lash constraints on government finance, cut off this lifeline, and send the world economy into a tailspin."

2) Gold prices are actually shockingly volatile for an alleged "safe" asset. Exhibit 3 compares the volatility of gold versus the volatility of the DXY Dollar index.

Exhibit 3: Volatility Comparison: Gold vs. DXY Dollar Index



Source: Bloomberg

This does not mean gold has no place in an asset portfolio, but that it is simply that: an asset, with all of the associated volatility of an asset. Indeed, some research suggests that having gold in your portfolio can have some positive benefits.[11]

[9] For a treat, I recommend a tour of the gold vaults at the Federal Reserve Bank of New York. It's actually rather stunning how heavy gold is in bar form. https://www.newyorkfed.org/aboutthefed/visiting.html

[10] https://newint.org/features/2014/09/01/bunker-economics-worshipping-gold/

[11] Matt Lehmann, "Gold in Asset Allocation," J.P. Morgan & Co., July 11, 2012.

How does the RMB compare, and what next?

The Chinese government has made strong efforts to increase RMB utilization, despite being in the early stages of a country's financial market development.[12]

These efforts include:

- The development of the "dim sum" bond market was an important step toward a more accessible fixed income market. Early participants in that market were highly-rated US corporations such as McDonald's and Caterpillar.
- The establishment of the bilateral swap lines (whereas the PBOC lends RMB to another country's central bank, and receives its currency at a predetermined rate) between the PBOC and other central banks encourages the use and invoicing of goods and services in RMB.
- The passage of the Enterprise Bankruptcy Law (EBL) has shown a willingness on the part of the Chinese authority to allow more predictable outcomes in bankruptcy. However, time will tell if this allows a more predictable set of bankruptcy outcomes in China.
- Managing the exchange rate toward a more balanced basket of currencies that reflects China's actual trading relationships, rather than just the dollar.
- The development of alternative settlements infrastructure, China International Payments Systems (CIPS) versus SWIFT.[13]
- Acceptance as collateral by clearinghouses such as the Chicago Mercantile Exchange (CME).
- The development of a local currency bond market that will be accessible to foreign investors.
- Finally, a more open capital account that is accompanied by a freely floating or managed float exchange rate.

Chinese policymakers have endured a great deal of criticism for some of the perceived policy missteps that have taken place over the course of the last year. However, I believe that criticism of those missteps has been unduly harsh. As noted in Part I, in the summer of 1914, in order to slow the repatriation of foreign capital from the United States at the start of the war, Secretary McAdoo used his moral suasion to shut the New York Stock Exchange for nearly two months. Such a move today would provoke an extraordinary outcry, yet it does not differ a great deal from some of the actions undertaken in China. However, in the near term, my view of actions taken thus far signal that Chinese policymakers will likely be more cautious in the opening of the capital account. Hovering over this entire process, after all, is the specter of a large-scale devaluation.

One of the many goals of the above steps is to increase the use of RMB in trade. This follows the lesson discussed in Part I that a reserve currency can only exist if it achieves a certain scale in financial

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[12] For a thorough treatment of policy steps taken by Chinese policymakers, see "The Renminbi's Role in the Global Monetary System," by Eswar Prasad and Lei Ye, Brookings, February 27, 2012. Additionally, the most thorough read on the matter comes in the recently published book by Prasad, Gaining Currency: The Rise of the Renminbi, sadly, unavailable when Part I was written, but definitely a more in-depth look at several of the topics covered in that piece.

[13] http://www.ft.com/intl/cms/s/0/84241292-66a1-11e5-a155-02b6f8af6a62.html#axzz3wfJdBTfq

markets. Another goal is to develop more robust internal financial plumbing. For example, within the US, the Fedwire and National Book-Entry System (NBES) are considered robust infrastructure for the payment and exchange of currency and securities.

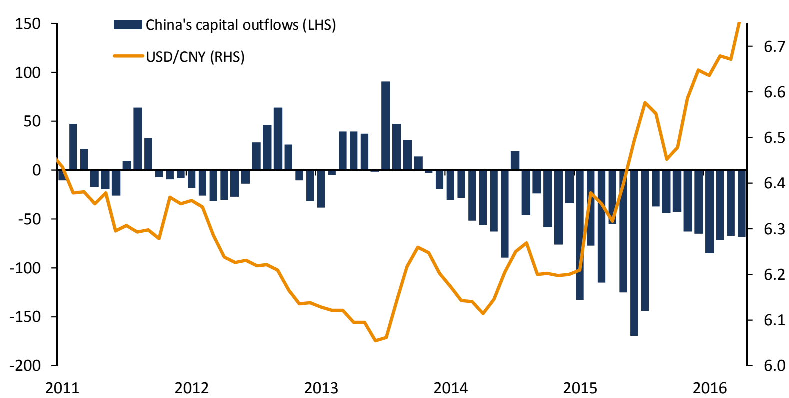
However, several of the above steps require much deeper institutional reform. For example, it is still unclear what the long-term impact of reform on Chinese bankruptcy law will entail. The EBL was a key first step, but market participants appear to still be challenged by the process involving default and recovery. As noted in Part I, a strong bankruptcy system is a necessary precondition to having a diverse credit market. Additionally, a more robust system will only aid in the development of a more sophisticated private bank lending market.

Be careful what you wish for

As my former colleague Brad Setser aptly stated, "There is a fundamental conflict between preserving stability and allowing the freedom and flexibility required of a global currency. Now that the cost is becoming clear, Chinese policymakers may be realizing they are not willing to do what it takes to maintain a global currency."[14]

The issue Brad was referencing had to do with the recent decline in RMB usage, settlement activity, and cross-border payments. In part, market commentators note that there is a desire for Chinese households to diversify away from RMB at a time of uncertainty about domestic asset prices. Overall, this uncertainty, as well as the management of the exchange rate by the State Administration for Foreign Exchange, has reduced Chinese USD reserves in an attempt to slow the decline of RMB levels to a manageable level. This can be seen in Exhibit 4, which was created by my colleagues, Matt Lehmann and Van Le.

Exhibit 4: China Capital Flows



Source: GMO, Bloomberg

What does this mean for investors?

We posit the following:

- Regardless of short-term fluctuations in Chinese equity markets and currency, the government of China has placed itself on the long-term road to attaining an international currency, but that progress is likely to come in fits and starts. Initially,

[14] https://www.ft.com/content/e480fd92-bc6a-11e6-8b45-b8b81dd5d080

there will be challenges, such as the recent clampdown on capital transfers overseas. As noted in Part I, countries have long histories of undertaking certain extraordinary capital markets actions in order to preserve stability, but markets appear to have forgiven those actions in several years. Indeed, in the case of the US, the reward came during the summer of 1914.

- In the long run, if China seeks to move away from being a primarily export-driven economy, it will need to issue more securities that are suitable for both domestic and foreign investors, and move from the status of a purely export-driven country to one with a substantial capital account investment.
- Additionally, China will have to one day fully embrace an open capital account. Today, the country is grappling with a need for its domestic investors to diversify their holdings. If China does not embrace an open capital account, it will need to decide how to get RMB in sufficient quantities to the outside world.
- In order to have these securities available for foreigners to purchase, there will have to be continued work on enhancing confidence in the development of private credit markets. The advent of the foreign issuers, issuing in RMB, show the "dim sum" market to be a good start despite the recent slowdown in issuance. For issuers, it serves as a source of funding when their use of funds is in the same currency.
    - Specifically, the Chinese government will need to continue to enhance bankruptcy law. The decision to enhance bankruptcy law provisions, and to encourage the usage of bankruptcy law, is likely to have future implications for the development of civil law.
- US Treasury securities still remain the instrument of choice in moments of flight to quality and liquidity crunches. The Treasury's regular and predictable issuance schedule, the plethora of uses of Treasury securities, and the extraordinarily wide acceptance of the securities as collateral allow them to dominate every single other currency's benchmark security.

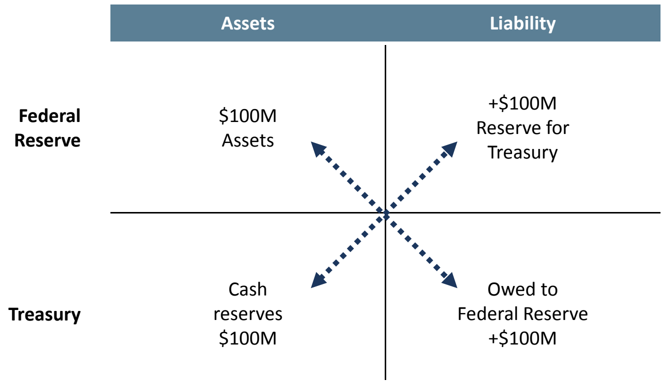
Conclusion

It is highly likely that the dollar will remain the reserve currency of choice for a long time to come. Part of this paper's purpose was to show the enormous amount of work that needs to be done by currencies that aspire to the status of "the reserve." However, it is important to note, as initially done in Part I, that policymakers should not become complacent. Indeed, critical missteps, such as reducing trade with other countries, abandoning a strong dollar policy, and adding uncertainty to the safety and soundness of Treasuries all would serve as accelerants for a move away from the dollar as a reserve currency, and provide potential benefits to other currency regimes.

The largest danger of having a reserve currency is a sudden substitution away from it, as England experienced in the post war era. Some economists, such as my colleague here at GMO, Phil Pilkington, make impassioned arguments for a thoughtful industrial policy that will develop US industries in preparation for that day. Using the current privileged status of the US to prepare for the future would be useful policy work. In the meantime, investors can prepare themselves to deal, over time (and inevitably with a number of speed bumps), with more Chinese securities and asset classes.

Appendix

Borrowing without issuing marketable debt: the "overdraft" mechanism



The majority of the readers of this paper use a bank for their everyday financial services. The Federal Bank of New York serves as the "fiscal agent" for the Treasury Department. Like any bank, it used to grant overdraft protection to the Treasury. That meant, should Treasury at any point unexpectedly require cash to spend without enough time to conduct an auction, that it could overdraft its Federal Reserve Account. This practice ended in 1981, but had existed for many years in the past. If Treasury still had the power to overdraft, it could technically borrow funds without having to issue any Treasury bonds.[15]

Example: Starting from the top left and moving down, the Federal Reserve allows a $100M overdraft to the Treasury, creating an asset on the Fed's balance sheet, which becomes $100M for the Treasury. On the bottom right, we note that Treasury still owes the Fed $100M, so that's a liability, and because Treasury maintains an account at the Federal Reserve, that $100M deposit is a liability of the Federal Reserve (just like any deposit is a liability at a bank).

While that may not be good for US capital markets, which depend upon Treasury securities for safe-haven and benchmark needs, it once again (see Part I) puts to rest the concept of the "creditworthiness" of a developed country sovereign that issues debt in its own currency.

[15] Kenneth D. Garbade, "Direct Purchases of U.S. Treasury Securities by Federal Reserve Banks," Federal Reserve Bank of New York Staff Reports, Staff Report No. 684, August 2014.

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