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How the US dollar destabilises the world

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A formal agreement between the US dollar and euro, and adoption of currency boards by other countries, could end damaging hot money flows

Karl Schiller, West Germany's economics minister between 1966 and 1972, pithily pronounced that "stability is not everything, but without stability, everything is nothing".

I agree. And I think the world's great destabiliser is the United States.

How could this be? In the post-second world war era, the world has been on a US dollar standard and the US Federal Reserve the world's de facto central bank.

But the world's central bank functions, for the most part, as if it were operating in a closed economy - one in which the rest of the world doesn't exist.

The Fed's disregard for the rest of the world results in policies that trigger huge hot-money flows, which create an enormous amount of instability.

Ronald McKinnon captured this picture in his most recent book: *The Unloved Dollar Standard: From Bretton Woods to the Rise of China.*

In addition, he explains how China has been a major force for stability by smartly, and ironically, linking the yuan (more or less) to the dollar since 1995.

China has coupled this currency link with a countercyclical financial policy, so whenever there has been a potential slowdown, China has expanded bank money and the economy has motored smoothly over the bumps.

As a consequence, since 1995, the annual rate of real growth in China's gross domestic product has ranged from a low of 7.6 per cent (1999) to a high of 14.2 per cent (2007), and the country has enjoyed the greatest boom in world history.

The bad news is that despite a change of chairman, there is little likelihood of a shift in the Fed's policymaking mindset.

In her initial testimony before the US Congress, Janet Yellen went out of her way to indicate that she was going to follow in the footsteps of her predecessor, Ben Bernanke.

So the Fed will stay lashed to a totally unrealistic (read: wrong) closed-economy model. And, yes, the Fed will continue to ignore the obvious fact that, by manipulating interest rates, it fuels hot-money flows that create boom-bust cycles throughout the world.

If that wasn't bad enough, Yellen has also indicated that she favours stricter capital rules for banks, embracing regulatory change that will force banks to continue to deleverage.

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Since about 80 per cent of US money supply, as measured by M4, is produced by banks, it means that money will remain tight. M4 is growing at a paltry annual rate of just 0.8 per cent.

Such a tight monetary stance in the face of economic weakness amounts to a wrong-headed, pro-cyclical approach.

One thing Yellen was clear about on Capitol Hill was that the Fed bore no responsibility for the boom-bust cycles in emerging markets. Indeed, she didn't venture into the debate on so-called currency wars.

But these wars erupt when the Fed pushes interest rates to levels below their market or natural levels. In a search for yield, the hot money flows to higher-risk, higher-interest-rate environments.

This tends to strengthen the local currencies relative to the greenback. It also adds to the recipient countries' foreign exchange reserves and boosts their domestic money supplies. Asset booms and inflation follow.

It was exactly this sequence that prompted both Brazil and China in 2010 to complain loudly about the impact of US policy on global capital flows. Be ready for more complaints now the Fed has signalled its intention to tighten policy and the capital has begun hurtling out of emerging markets.

Since last summer, Argentina and Venezuela have been in economic intensive care wards. Brazil, the first country to complain about hot-money flows, is weak and vulnerable, according to the World Bank's ease-of-doing-business metric.

Indonesia is also vulnerable. Turkey's lira, meanwhile, put in one of the world's worst performances last year. What characterises all of these countries is that they failed to reform while the hot money flowed in. In consequence, all are vulnerable as the hot money flows out.

Some people think this state of international monetary affairs will be solved by digital currencies - like bitcoin. These are private currencies passed directly between two people without the need for a trusted third party. So, even though electronic, they resemble banknotes.

While private digital currencies may yet have their day in the international financial system, it won't be soon. Bitcoin is a highly volatile speculative asset. It's missing a necessary ingredient required to push the US dollar aside: stability.

So what to do?

The world's two most important currencies - the dollar and the euro - should, via formal agreement, trade in a zone; US$1.20-US$1.40 to the euro, for example. The European Central Bank would be obliged to maintain this zone of stability by defending a weak dollar and the Fed would be obliged to defend a weak euro.

The East Asian dollar bloc should be reborn, with the yuan and other Asian currencies tightly linked to the greenback.

As for other countries (Argentina, Brazil, and Venezuela, for example), they should adopt currency boards linked to either the dollar or euro, or they should simply adopt the greenback or the euro.

This could put an end to the volatile and damaging flows of hot money.

When it comes to exchange rates, stability might not be everything, but everything is nothing without stability.

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