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Decline of the U.S. Dollar: Asian Initiative to Create Commodity Based Currency? 20 comments

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No, I don't have any inside information, but I believe that China and other Asian countries will decouple from the United States during the next five years, partly because the American economy will remain moribund, partly because American policy will continue to be incompetent, and partly because their own domestic market and financial systems will be able to bear the burden. Regional cooperation among Asian currencies passed a major milestone on May 3, as the Far East Economic Review reported yesterday:

> **On May 3**, the finance ministers of the Asean Plus Three group—which consists of the 10 member countries of the Association of Southeast Asian Nations as well as China, Japan and South Korea—agreed in Bali on the governing mechanisms and implementation plan for the multilateralization of the Chiang Mai Initiative (CMI). What at first might sound rather unspectacular is in fact a major milestone on the road toward East Asian financial and macroeconomic cooperation.
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> The CMI was launched in May 2000 in Chiang Mai, Thailand, as a response to the Asian financial crisis. The idea was to provide short-term financial support for neighboring countries which experience balance of payments problems. The CMI consists of the Asean swap arrangement and a network of bilateral swap arrangements among Asean Plus Three countries. The Asean swap arrangement is now $2 billion in size, while some 16 bilateral swap arrangements have been successfully concluded among eight countries with a combined total size of $90 billion.
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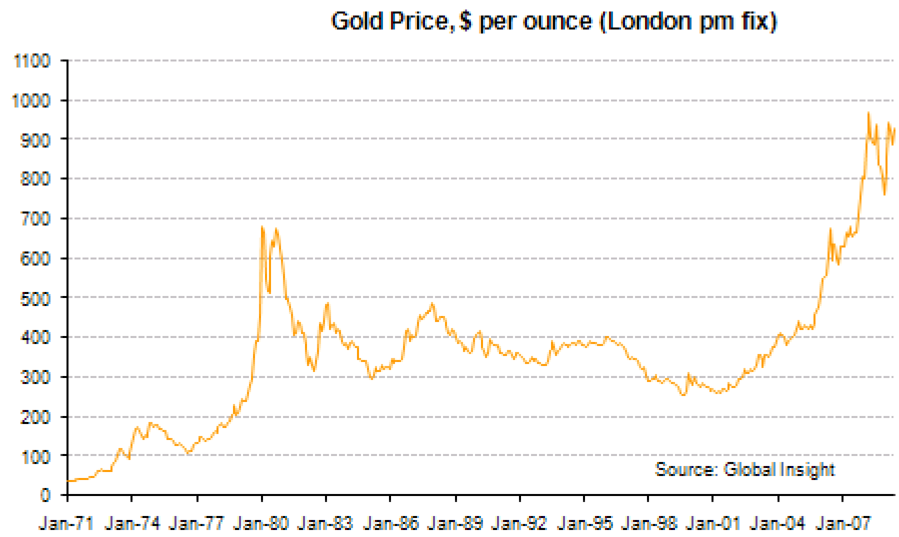
> These bilateral currency swap agreements will now be transformed into a single regional pooling arrangement, comprising at least $120 billion of reserves. 20% of the funds will be provided by the 10 Asean members and the remaining 80% by the Plus Three countries. The Asean Plus Three finance ministers also agreed to create an independent surveillance unit to monitor and analyze regional economies and support CMI decision-making processes.

Less important than the specifics of the agreement is the fact that it includes all the countries of the region. This is a major challenge to the International Monetary Fund, which always objected to a regional Asian initiative outside its purview, as well as to the United States.

The Asian exit from the dollar will be turtle-slow and gradual. China and Japan between them have nearly $2 trillion worth of US Treasury securities and will do nothing to jeopardize their existing investment. But the collapse of governance in the United States and the Obama administration's response have turned the US into a zombie economy, and the dollar into a zombie currency. The euro offers no alternative. Demographically Europe is dying, and Europe's economic misery is worse than America's. Robert Mundell, the 1999 Nobel Prize winner who might be China's favorite Western economist, told Bloomberg News June 1 that the euro will decline substantially in the near future.

Apart from the problem of protecting a massive existing investment in the dollar, Asia has another problem in exiting from the dollar: there exists no natural alternative. An alternative would have to be constructed. With the United States the unchallenged world superpower, the US dollar became the unchallenged world reserve currency after the fall of Communism. But it is easy to forget how challenged the dollar was prior to the fall of Communism. The sharpest rise in the price of gold occurred in 1979 when the Soviet Union invaded Afghanistan, leaving the confused Carter Administration looking weak and feckless. Most European leaders at the time expected NATO to collapse and the Soviet Union to emerge as the stronger contender. That's why gold doubled in price around the Afghanistan episode (*click on chart to enlarge*).



Lack of trust in central banks, individually and collectively, persisted into the end of the 1980s. Under Treasury Secretary James Baker III, the (first) Bush administration seriously considered the merits of a commodity-based currency standard, in which monetary policy would be guided by the movements in the auction prices of traded commodities. Robert Mundell advocated such a system. So did Richard N. Cooper, the former Undersecretary of State for Economic Affairs and Yale Professor, who wrote an influential study of commodity-based currencies for the CATO Institute. Another advocate was Manuel Johnson, Vice-Chairman of the Federal Reserve Board of Governors.

Interest in commodity-based currencies faded as the Reagan boom continued into the 1990s with low inflation. Nonetheless, the advantages of a commodity standard are clear in the context of lack of political agreement: it provides central banks with a means of targeting inflation in a far more sensitive and credible way than examining inflation indices, which are not only backward-looking but manipulable.

Asia may have passed a milestone in monetary cooperation, but China, India and Japan never will establish the sort of political rapport that allows for currency union along European lines. To link their currencies would require an agreement to employ an objective benchmark for monetary policy, and the obvious choice would be some basket of commodities.

This is a five, perhaps a ten-year project, to be executed very gradually and very carefully as the Treasury's largest foreign investors gradually reduce exposure to the US market and create their own financial markets. A useful comparison would be to England, whose role as reserve-currency provider attenuated gradually over thirty years. America has a dose of the British disease, using the finances of the state to protect superannuated industries in order to curry favor from large trade unions. Were this to continue, the logical consequence would be British-style decline. Asia will rely on its own 3.5 billion people as an internal market, and create its own monetary arrangements.

Disclosure: None