The Weaponisation of Finance and the Future of the International Monetary System

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Since the onslaught of the Russian invasion of Ukraine, and the decision of many democratic countries to impose financial sanctions on Russia (not least, denying the Russian central bank access to a significant proportion of its FX reserves), there has been huge interest in whether these measures might spark a retreat from the use of the dollar in the international financial system. I will discuss this issue but would first like to dwell on a still more dangerous set of possibilities affecting the dollar. My comments will be in three parts

First, there is a reasonable chance that the global economy will eventually (perhaps shortly) face a severe economic and financial crisis.

Second, there is a smaller but still reasonable chance that this could turn into a dollar crisis as well.

Third, whether a dollar crisis occurs or not will determine whether it is business as usual, with the dollar and perhaps other national currencies at the centre of the international financial system, or whether a variety of more radical alternatives might present themselves. Some of these more radical possibilities might provide better outcomes than the current International Monetary Non-System (to use Jose Ocampos' phrase), which has many shortcomings. However, other possible outcomes might be much worse than the current Non-System.

First, there is a reasonable chance that a global economic and financial crisis is coming

Monetary systems that are driven by private credit expansion are inherently unstable. Today, prospective problems are linked to the fact that the dollar is at the heart of the global financial system and US monetary policy has been excessively stimulative for decades. This should have led to a weakening of the US

1 Webinar presentation at the C D Howe Institute, Toronto, Canada on 20 April, 2022. Other related presentations can be found at www.williamwhite.ca

dollar (and to some degree it has), but other countries have resisted the associated strengthening of their currencies with exchange rate intervention (mostly emerging markets) while others (mostly advanced markets) have resisted by also following stimulative monetary policies. There are now many indicators of growing economic and financial instability at the global level arising from these policies.

- Record high debt levels of decreasing quality
- Stability of many financial institutions (especially unregulated non-banks) questionable
- Asset prices historically high, especially residential real estate
- Markets functioning badly, even for US Treasuries, with episodes of reduced liquidity
- Resurgence of fraud and outright delusion
- Slow growth of investment and productive potential
- And now uncertainties driven by the pandemic and the Russian invasion of Ukraine

Moreover, given the high degree of global integration (trade, finance and information) troubles anywhere are likely to spread everywhere.

Current inflationary problems are not "transitory" but will be sustained by a host of overlapping and negative supply side shocks

- Recognition of pre pandemic resource misallocations
- Post pandemic "hysteresis"
- Population aging in both advanced and emerging markets
- Climate change and the heavy costs of both adaptation and mitigation
- Commodity price increases aggravated by the invasion of Ukraine (especially food)
- Deglobalisation in pursuit of "resilience" and US/China decoupling

And this could lead to sharply higher interest rates that would reveal all of the underlying fragilities that have built up over the years.

Nor are we well placed to manage another global crisis. Political problems are lurking under the surface almost everywhere.

- US and UK (and elsewhere) have become sharply partisan and increasingly hard to govern
- Europe suffers from institutional shortcomings (analytical, executive and democratic deficits)
- China needs to change its growth model but the old model (based on land sales, corruption and heavy industry) has many defenders
- Global cooperation is increasingly threatened by democratic/authoritarian rivalry

And our crisis management tools are heavily constrained or otherwise inadequate

- Fiscal policy constrained by high debt levels
- Monetary policy constrained by low interest rates and swollen central bank balance sheets
- Liquidity infusions constrained nationally by populist concerns about "bailing out banks", and internationally by the Fed being the only provider of dollars. Would they further extend swap arrangements? Would Congress allow them to?
- Debt restructuring constrained by inadequate laws and administrative procedures, court capacity and lack of experienced judges.

In a nutshell, "if I were you, I wouldn't start from here".

Second, there is a reasonable chance that this could lead to a dollar crisis as well

This probability seems "reasonable" but significantly less than the probability of a coming economic and financial crisis. Recall that Robert Triffin predicted the inevitable end of the dollar-based regime over 60 years ago and we are still waiting. Moreover, Nouriel Rubini and many others predicted in 2006-7 that a dollar crisis would be triggered by the US current account deficit, and that this would lead to a global crisis. Well, the global crisis did arrive, indeed triggered by events (sub prime) in the US itself, but the dollar nevertheless strengthened given its safe haven status.

Might this be repeated should there be a new crisis? On the one hand, there are grounds for belief that the "safe haven" status of the dollar **will not** be maintained.

- Resentment and fear over the use of the US dollar as a geopolitical "weapon", now in an extended way to punish Russia.
- Alternative payment systems (eg, China's Cross-Border Interbank Payment System) are evolving[2] to replace dollar payment systems
- US share of global GDP continues to shrink
- US has a relatively more serious inflation problem and growing international net liabilities
- The Fed's reluctance to tighten monetary policy has deep roots (not least, the "debt trap") implying inflation might not be adequately resisted
- Massive increases in US government deficit and debt inviteconcerns over "fiscal dominance". Moreover, bipartisanship implies this fiscal problem might not be easily controlled.
- Charting trends of previous lows indicates the dollar is currently significantly overvalued.

On the other hand, there are grounds for belief the dollar **will retain** its "safe haven" position

- Could take years to fully develop a non-US dollar linked international payment system
- US sovereign debt ratio could rise much higher (Japan?) before triggering flight
- Alternative currencies are not yet attractive. Sovereign debt markets too small (euros?) or too constrained (China?). Both China and Europe have significant political and macroeconomic (especially debt) problems of their own.
- US does not want the dollar-based system to collapse and will support it with LOLR both domestically (expanded safety net) and internationally (dollar swap arrangements).[3]
- Other countries have resisted significant appreciation, for fear of losing competitiveness, and will do so again

[2] This position is evolving. CIPS still relies on SWIFT and has only 10 percent as many bank participants as SWIFT

[3] If holders of long term dollar assets finance them by rolling over short term dollar loans, then they will have to sell the long term positions if they cannot get short term financing. The Fed provides such financing (via swaps) to avoid these fire sales.

- Finally, dollar liquidity shortages (like 2008) could strengthen the dollar in a crisis

With all these competing arguments, “who knows what might happen”.

Alternative futures for the international financial system

If there is **not a dollar crisis**, then the current system based on national monies will likely continue to prevail. This might continue to be a dollar-based system, or eventually a system based on a number of currencies.

As Barry has already noted, the share of dollars in global FX reserves has continued to shrink. Interestingly, the euro share has not risen significantly, although the renmimbi share has risen a little. Instead, a number of smaller currencies (with improving domestic market liquidity) have gained share. This phenomenon is also linked to reserve levels rising above those thought likely to be needed (in most liquid form) in an emergency. Reserve mangers are increasingly focussed on investing excessive reserves at higher risk-adjusted returns. This could well continue.

Alternatively, as the euro area and China deal with the internal problems inhibiting the use of their currencies, one could imagine three competing monetary blocks. Exchange rates would be increasingly fixed within blocks and flexible between blocks. The central bank at the heart of each block would have to extend its safety net provisions, as the Fed does today.

If there **were to be a dollar crisis**, and the dollar-based international monetary system ended, what might replace it?

One possibility might be a cooperatively agreed replacement system This system would be designed to avoid the recognized defects of the current system. These include

- No automatic adjustment of current account imbalances
- Significant spillovers from national policy changes (especially the US)
- No nominal anchor
- No assured lender of last resort

The new system would not be based on a nationally issued money, but on something issued internationally (SDRs, Bancor etc.). Exchange rates would be

fixed but flexible. Constraints on capital flows would be more binding. This might be something like the Keynes Plan proposed at Bretton Woods.

Of course, another possibility might be a collapse of the dollar-based system without any international agreement as to what should replace it. In this case, international trade and international financial transactions would be severely constrained and both growth and job creation would be as well. The implications for political order, in particular the democratic order, could be immense. In such a world, environmental concerns would also likely be ignored.

Individual states would choose their own strategies to cope in such an autarchic world. However, there would likely be a reimposition of controls and regulations to prevent the credit based excesses that caused the system to collapse in the first place. Shadow banking and off-shore banking would be significantly reduced. Specific policy initiatives might range from more active use of monetary and macroprudential policies to combat credit cycles to the imposition of “narrow money” regimes as suggested in the 1930’s by the Chicago School. Whether this disorder would eventually end in a new demand for “order” is another possibility, but by then enormous damage would already have been inflicted.