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CURRENT AFFAIRS

ANALYSIS
THE DOLLAR AND DOMINANCE

TRANSCRIPT OF A RECORDED
DOCUMENTARY

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WOODS

We’re living in economic chaos. Banks, homes, jobs, and businesses at risk. And at the centre of the crisis, America’s financial system. Yet curiously, the one thing that seems stable is the dollar. A symbol – and a lever - of American power and leadership. But is that changing?

PERSAUD

I think that today's financial crisis is going to hasten the end of the dollar as the world's reserve currency. For the first time ever we're now seeing that in the financial markets it costs money to guarantee you against a US government default. And that's a sign that the markets are saying that America's taking on an enormous burden in bailing out its banking system, in fighting its foreign wars and that maybe this is a burden too far.

WOODS

Is this the end of a sixty-year long Pax Americana? After the Second World War America laid the foundations of the world economy as we know it – exporting oil, capital, ideas, and Ford motor cars to Europe and beyond. It set up rules and institutions and encouraged governments around the world to use the dollar as the international unit of account. American leadership has shaped so much of the world around us, that we've long taken it for granted. Even now in a financial crisis which began in the United States, investors around the world are running back to the dollar – by long habit it's their safe haven in a crisis. But can the system we're all so used to continue? In this programme I'm exploring whether the dollar is in decline and what that might mean for American dominance – and the world around us. There's a lot at stake. As the world's reserve currency, the dollar underpins America's global power. It creates an almost limitless resource for America. How does that work? Avinash Persaud is Chairman of Intelligence Capital Limited based in London.

PERSAUD

Governments, corporations hold currencies in reserve in case there's a problem; that they need money in cash and liquidity. And that is what a reserve currency status means. It's a currency that people hold in reserve. But other people holding your currency in reserve is fantastic power because it's like being able to write cheques that no one ever cashes. If you look at your ten pound note or twenty pound note, it's actually a cheque. It says that the Bank of England promises to pay you ten pounds or twenty pounds. It's a cheque. So people have got all this cash - these notes, these cheques - but they're keeping it in their bank vaults, they're keeping it in reserve. And if you can write cheques that nobody ever cashes, you can pay for a lot of things.

WOODS

And is that what America's doing?

PERSAUD

America's been running current account deficits for almost twenty years non-stop. What is a current account deficit? A current account deficit is you are spending more than you are earning. It's very simple. And the way they can do that is because they give people these cheques that people

aren't cashing and that allows them to spend a lot more money than anyone else would be able to spend and it's arguable that's the way they financed the Vietnam War, the way they financed the Iraq War, the way they're financing the bank bailouts.

WOODS

We live in a world which – so far – has been giving America a blank cheque. For the American government there is simply no such thing as 'living beyond its means'. With the rest of the world demanding dollars, all the United States has to do is to keep printing them. This makes possible things that no other government could imagine – a power that America's rivals have historically denounced as an "exorbitant privilege". It might be a privilege, but the special position of the United States – because its dollar is the reserve currency - might also give it a unique capacity to deal with the current financial crisis. Barry Eichengreen is one of America's top professors of political economy.

EICHENGREEN

The Federal Reserve is not constrained by the exchange rate in how it responds to the crisis. If it has to flood the markets with liquidity and if one of the consequences of that is that the dollar weakens, we can say here in the US so be it. That's very different from the situation in Iceland or Hungary or Turkey or Vietnam where there are financial problems as well, but if you try to meet them by printing more money and the exchange rate declines that only makes the balance sheet problems of banks and firms even worse. So this is the exorbitant privilege of being the country that issues the international currency and having virtually all of the assets and liabilities of banks and firms and households in your country denominated in your own currency.

WOODS

The problem with the exorbitant privilege is that other countries resent it. Particularly when they disagree with the wider foreign policy goals pursued by the United States. The war in Iraq, the "War on Terror", and the ballooning American deficit have led to some resentment even among some of America's friends and allies. Might this spill over to the dollar? Think back to another time when Europeans were annoyed with America for an unpopular war, for spending too much, and for consulting too little. To learn from that episode we have to go back to the early 1970s.

MUSIC

American Pie: Don Mclean

WOODS

By 1971 French President Charles de Gaulle – and other European allies – had become thoroughly annoyed with America. Harold James is a historian of the global economy, at Princeton University.

JAMES

De Gaulle and his ministers criticised what Valery Giscard d'Estaing, who was at that time de Gaulle's finance minister, called "the exorbitant privilege" of the dollar. Giscard and de Gaulle believed that the United States was running up big deficits - budget deficits, trade deficits - paying for the expansion of its domestic social reform programme, President Johnson's great society, and at the same time paying for the Vietnam War on the basis of borrowed money. So what the French said, what other people said was that America is a super power, but it's all with other people's money.

WOODS

Actually back then the American government was committed to printing only as many dollars as they had gold to back. But the pressures of Vietnam and social spending began to strain this commitment. When the French suspected that there were more dollars than gold, they rebelled. De Gaulle sent a French battleship to New York to take delivery of gold – a very direct way to redeem French-held dollars. Within days the British made the same demand, claiming \$3 billion in gold from Fort Knox.

MUSIC

American Pie: Don Mclean

WOODS

President Nixon was furious. And his response was rapid. Four days later, America unleashed "The Nixon Shock" – dollars would no longer be redeemed for gold; and trade barriers would be used even against allies. In one announcement, America tore up the rules of the game. In charge of American policy was the reputedly "tough but charming" Texan John Connally. More than a month after the Nixon Shock, he launched a charm offensive, travelling to London to meet with other governments.

ARCHIVE

JOHN CONNALLY

We told that we were here as a nation that had given much of our resources and our material resources and otherwise to the World to the point where frankly we were now running a deficit and have been for twenty years and it had drained our reserves and drained our resources to the point where we could no longer do it and frankly we were in trouble and we were coming to our friends to ask for help as they have so many times in the past come

to us to ask for help when they were in trouble,. That is in essence what we told them.

WOODS

This almost sounds humble. But behind the scenes, it was brutally clear who was in charge. Connally's private message to European governments was so shocking that it remains in the annals of every economic commentator. It was quite simple: "It's our currency" said Connally "but it's your problem". This was not a message Europeans wanted to hear. At the time, there was no decent alternative to the dollar - in spite of a flurry of ideas about a new role for the yen or deutschmark or even the creation of a new international money - "butter money" - linked to the value of commodities such as wheat, butter, sugar, and rubber. Fast forward to today, it's a very different world. The Europeans now have their own armoury. They've built their own monetary system, and developed their own shared currency. This process has been closely watched by David Marsh, investor and former Financial Times correspondent. He's calling his forthcoming book "The Euro: The Emerging Global Currency".

MARSH

I think for many, many years the Europeans have wanted to have more independence from the Americans. You remember John Connally in 1971, Nixon's Treasury Secretary, saying "This is our currency, but your problem", and it's very much similar now where you could you have Mr. Paulson saying, "This is our crisis, but your problem" and clearly there's many people who think that the incredibly lax way that the Americans have run their monetary and fiscal policies over the last five or six years is a big black mark for the dollar and could cause it to weaken. And of course the dollar has weakened a lot against the euro over the last five years, since 2003.

WOODS

But is the euro emerging as the world's global currency?

MARSH

It certainly is a global currency, there's no two ways about that. It is absolutely now the second most important currency in the world after the dollar whether you look at reserve holdings of central banks or whether you look at the way it's traded on the foreign exchange markets or on the capital markets, whether you look at it in terms of asset management by many private sector institutions, and it's taken over a substantially greater role than that which was previously occupied by the D-mark.

WOODS

The euro's been on the rise, not least because in recent years the dollar has weakened. It makes sense for super-models on New York catwalks to demand their contracts be in euros. But a strong euro is not without problems. It makes every bottle of exported French wine and every German car sold abroad more expensive. It slows the growth of European export industries. And the euro would be even stronger if it became the world's reserve currency. For a region worried about its already sluggish growth, this would be seriously bad news. Small wonder European officials prefer to be rather quiet about the euro taking on a larger role. Without Europeans pushing their currency forward, what would have to happen for the euro to become the reserve currency of the world economy? I asked the historian of monetary policy, Berkeley's Professor Barry Eichengreen.

EICHENGREEN

For the euro to replace the dollar as distinct from simply sharing its role as a reserve asset and more broadly as an international currency, there would have to be very serious economic mismanagement in the United States not matched by equally severe problems in Europe. So we are seeing serious problems of the financial variety in the US, but equally serious problems now in Europe, so the ironic result has been a flight to the dollar rather than a flight away. It's still possible, although it's not in my view the most likely scenario, that there could be an even more serious and extended financial crisis in the United States while Europe manages to crawl its way out of this hole. In that case, I think the shift from the dollar to the euro could occur quite rapidly.

WOODS

When the financial crisis first began in the United States, you might have expected it to lead to a strengthening of the demand for euros. Yet it hasn't. And perhaps that's not surprising. For people to believe that this could be the world's next reserve currency, they would have to believe that the European Union was both willing and able to take up this role. But alongside its Economic and Monetary Union – or EMU - does Europe have the political unity to take up a reserve currency role? David Marsh.

MARSH

Some people thought that by bringing about EMU, you might pave the way for political union. That was certainly what Chancellor Kohl thought. That's turned out to be totally wrong and nobody anywhere in the EMU area - not the most federalist state, not the Luxembourgers, certainly not the Germans and absolutely not the French - wants a political union. And over time, the fact that there will not be a United States of Europe like the United States of America is potentially a death knell for the euro. Europe I think has got a much less vast set of ambitions than America has ever had. Most people in Europe just want to get on with a fairly peaceable life. They

don't want to run the world, they don't particularly want to have a reserve currency. The Germans never wanted to reserve currency. That is one of the reasons why we've got the euro - because the Germans actually didn't want the responsibility that would go with D-mark becoming the number two reserve currency in the world after the dollar. So if you like it's a kind of flight into a lack of ambition. That's the reason why we've got the euro.

WOODS

Europe has successfully created a global currency, but not the global currency. It doesn't seek – it couldn't use - the “exorbitant privilege”, enjoyed by the United States. If the euro were the world's reserve currency, global demand would keep it strong and that would be bad for already-embattled European exporters. So who might seize the dollar mantle? China? The world's fastest growing large economy, and holder of well over a trillion dollars worth of reserves? The thing about China is that it has a huge stake in the American economy – and in the dollar status quo. China's rise has depended on its access to American markets. And America now depends heavily on China's demand for dollars and American debt. The result is a bit of a Faustian bargain – a very new kind of relationship for the United States. Dr Albert Park is a specialist on the Chinese economy at Oxford University.

PARK

The very large accumulation of foreign reserves by the Chinese government has put them in a very strong position to influence the dollar if they made a decision to shift their assets to other currency denominated assets. That could be very destabilising for the US economy, putting pressure on the dollar and eventually interest rates. But many people feel that China doesn't have an interest in pursuing that type of extreme action because by doing so it would reduce the value of its own assets because the dollar would weaken and the value of those dollar assets would then fall, so it would be basically hurting its own pocket book.

WOODS

China has a new-found power over the United States. It's China's savings that are helping to finance America's deficits. The Chinese government holds over a trillion dollars worth of dollar reserves. That means it buys dollar assets – American government bonds and the like – and holds them in its central bank. China does this so that it can defend and manage its own exchange rate, and sometimes in part to support the value of the dollar. The result – the Faustian bargain – is something which has changed attitudes among American decision-makers, according to Professor Barry Eichengreen of Berkeley.

EICHENGREEN

We've already seen the rhetoric change, so contrast what Richard Nixon's Treasury Secretary John Connally said when there was the 1971 dollar crisis. He said: "it's our currency, but it's your problem." Now former Clinton Treasury Secretary, Lawrence Summers talks about "the balance of financial terror." The fact that if we threaten to abandon the strong dollar policy and push down the dollar, that will create serious problems for the rest of the world - capital losses for the People's Bank of China, other central banks. But if they threaten to dump dollars, on the other hand, that will create serious problems for US financial markets. So it's kind of like the idea of mutually assured deterrence. We hope that everybody becomes respectful of the financial power of the other side, but that such destructive power won't be deployed.

WOODS

The balance of financial terror, centred on the dollar, changes America's relations with other countries. Back in the '70s, a "tough but charming" Texan could tell Europeans that America's currency was their problem. Back then, America could change the rules on its own. Today, America needs to work very differently with its economic allies. In the news we see American officials talking to Congressmen and Congresswomen, to Wall St Bankers, to Presidential candidates. But might some of the most crucial conversations be private ones with China? I asked China specialist Albert Park

PARK

I think they talk frequently. The head of the central bank, Zhou Xiaochuan, is a well known pragmatist who speaks excellent English, who really understands these issues at a deep level and who has always had very positive interactions with Western economists and Western officials. More generally I think the US government has really put a high priority on increasing the contacts with China, so there was a recent economic summit in Washington earlier this year where all of the secretaries of various departments actually met with their counterparts on the Chinese side. The whole purpose of that was to start to increase these connections at a personal level and also to make sure both sides were aware of the pressures and concerns that each side has in terms of the issues that face both countries.

WOODS

A new kind of American economic diplomacy is already emerging. And not just in China. The United States is locked into a financial embrace with several emerging economies. Huge dollar assets are being held by India, Brazil, Russia, and – crucially – the Gulf States. They're not only holding dollars, but pricing their oil in "petrodollars". It's America's relations with all these countries which will determine the fate of the dollar.

One of the first people to identify this trend was Jim O'Neill, Head of Global Economic Research at Goldman Sachs. His former boss at Goldman Sachs, Henry – or Hank - Paulson is at the centre of the current crisis. Does Jim O'Neill think the Treasury Secretary has been engaging more with America's creditors of late?

O'NEILL

I think if you look at the statements and activities of the economic policymakers in the US, it is very clear that that kind of behind the doors diplomacy has been going on for most of this year. Treasury Secretary Paulson made two big speeches about the dollar from the Middle East.

WOODS

So what do you think those conversations feel like? What are they getting together to discuss? When Hank Paulson goes to the Middle East, what is that conversation and how is it different to one that might have been had five years ago?

O'NEILL

I think the conversation, which is dressed up in courtesy and diplomacy, goes like this. "Hank, what are you guys doing to the dollar? It's causing us tremendous problems with our oil revenues and that's why we need to undertake policies that might appear to be causing oil prices to rise even further. But, guess what, if you try and really support the dollar, we might produce more oil and oil prices won't go up." And that sounds to US policymakers like - that's the kind of deal we can do, which results in a different statement and some more serious effort to try and support the dollar.

WOODS

This sounds right. In June of this year Mr. Paulson took a four-day trip to Saudi Arabia, Qatar, and the United Arab Emirates. Mr. Paulson's concern as he travelled was this. The Gulf's six oil-exporting countries long pegged their exchange rates to the dollar, they price their oil in dollars. They hold reserves in dollars. Or they did. Last year this changed when Kuwait abandoned the dollar peg. And now other countries are murmuring about doing the same. "It doesn't make sense to stay linked to a currency that is declining while our economy is growing" a Qatar official was quoted as saying just before Paulson's trip. And strengthening their hand, the six Gulf states have reinvigorated their push towards monetary cooperation of their own. The result is that Mr. Paulson is on notice to keep the dollar strong. And listen to this statement earlier this year - it sounds like he's on message:

ARCHIVE

HENRY PAULSON

I believe very much that a strong dollar is in our national interest and you know our economy, like any other, has got its ups and downs but the, our long term fundamentals are strong and I believe it's going to be reflected in the currency market, they are going to be reflected in the currency market.

WOODS

The national interest Mr. Paulson is talking about is America's need to have other countries underwrite the dollar. The United States needs its exorbitant privilege, as Avinash Persaud of Intelligence Capital reminds us.

PERSAUD

If you're the world's reserve currency, you don't really have a budget constraint. You can borrow one trillion, two trillion, three trillion to bail out your banks. You could borrow a trillion dollars to fight your Iraq War. Any other country could not do that and the reason why they could not do that is not because they're big or small, but because they're not the world reserve currency.

WOODS

And do you think the United States will fight to keep the dollar the reserve currency?

PERSAUD

When you speak to Americans about this, they sort of shrug it off and say, "Oh we don't really care too much about being the world's reserve currency." I don't entirely believe that. I think the world reserve currency confers a lot of value. It may be that we tend to not notice the value until you begin to lose it. I think we will see America trying to use all its power to maintain that reserve status for as long as it can.

WOODS

But there's a serious problem. America can little afford to let the dollar slide too far if it wants the rest of the world to keep using the dollar as the reserve currency. If it wants to keep accessing those blank cheques. But a strong dollar is bad for American exporters. It makes every American car or computer sold abroad more expensive. It puts American jobs at risk. That's why the dollar has been allowed to slide in value over the last six years – and the weaker dollar has certainly boosted American exports. No American politician wants to give that up – in fact they're looking for ways to create millions of new jobs. Are they thinking about trade barriers? That worries Jim O'Neill:

O'NEILL

When I look at some of the emotive comments made about how they need to protect the US industry and US workers and sort of insulate themselves from the rest of the world, it's a really stupid time to do it because the US

consumer is kind of spent. And so if the US can't continue to grow its world markets, the future US leaders essentially are locking themselves into a multi-year period of very weak, possibly negative growth, and it would be a very unwise thing to do - one that of course would not be particularly good for the rest of the world too. But I would add, you know it's not inconceivable that if this is the path that the US goes down, the next phase of globalisation could even pass America by.

WOODS

America's predicament a classic one – like Britain's last century – and probably like China's in the future. Less than a century ago America was an emerging economy – it made toys, cars, and ships. It exported its way into the big league of economic powers – just as China is doing today - and the dollar became more and more central to the world economy. The stronger the dollar became, the more it pushed America out of manufacturing and into other lines of business. Out went factories – In came big American banks, investment and finance houses. This was a transition Britain had been through decades before. It put huge strains on Britain then – and now America finds itself similarly stuck. Its dollar is the reserve currency – but it does not have its own surpluses to back up that role. If it strengthens the dollar to attract creditors, it further reduces its export competitiveness. In the end what that means for dollar diplomacy is that America must persuade its allies abroad to accept a weaker dollar than they want. But that won't be easy. Jim O'Neill.

O'NEILL

What I think we are emerging into is this very hazy and slightly confusing and slightly worrying state of affairs where there isn't going to be any single country leading the world in the way the US has done and with it no single currency either, which is why - amongst other reasons - in my judgment we need some pretty radical reform of the system of global economic governance because it's not going to be possible for the US to just say under the disguise of the G7 or the IMF, this is what should happen; you guys get into line,

WOODS

The next American President has a very delicate balancing act ahead of him. He can't replay the Nixon shock tactics. If the 'guys' he's dealing with are China, Europe, and the Gulf States, there's no guaranteeing they'll stay in line for long – they're building alternatives as we speak. Instead, America will have to rely on a more subtle approach. In the longer term, America may well pass on the mantle of the reserve currency to China. Although most commentators say China's not ready for that yet, Avinash Persaud reminds us of how quickly things can change.

PERSAUD

In 1908, the British looked at America and said well they're growing quite well today, but they're quite immature in terms of their institutions; and that even if we in Britain are no longer the biggest economy, we have the institutions and they don't. And indeed in 1908 America didn't even have a central bank. The central bank, the Federal Reserve came in 1913 after the 1907 banking panic. So you could look back and say that America had the world's reserve currency just thirty odd years from just having a central bank. Britain had a central bank for hundreds of years. So these institutions can come up quite quickly. The institutions are not inherent. Institutions are partly a function of development, an economic development. China may not have the institutions today, but it will have in twenty or thirty years time.

WOODS

No-one doubts the eventual demise of the dollar. But the urgency of a financial crisis and recession require leadership now. For all the resentment of America the "hyper-power" – there is no other country willing or able to take up the role of reserve currency. And to manage the current crisis, America's exorbitant privilege – its unlimited power to print dollars - might be essential. As the world headed towards the Great Depression of the 1930s, the gold standard meant Britain couldn't pump money into the world economy.

But in today's world of the dollar and American dominance – we're free of those "golden fetters". And the dollar – once a symbol of unconstrained American power – is no longer their currency and our problem. It's now the world's currency - and mostly America's problem.