The Reserve-Currency Curse Revisited
by Lewis E. Lehrman and John D. Mueller
The Wall Street Journal, September 2014

For three decades we have called attention on this page to what we called the "Reserve-Currency Curse." Since some now insist that the dollar's official reserve-currency role is in fact a great blessing, we think it timely to revisit the issue.

In one respect, the history of money is simple. Since precious metal coinage began in the 7th century B.C., periods of price stability (and usually, healthy economic growth) followed adoption of money defined as a fixed weight of gold or silver: from the silver Roman denarius to Byzantium's golden *solidus*, to Alexander Hamilton's silver and gold dollars. Elsewhere, we have provided the evidence that the United States enjoyed the best performance of any monetary regime in our history under the classical international gold standard from 1879 to 1913 -- in long-term average price stability and strongest average real GDP growth, but also lowest year-to-year volatility in the CPI and real GDP.

But such stability was interrupted by periods when governments issued money to finance budget deficits; e.g., the later Roman Empire, warring medieval princes, the Revolutionary War, and the paper dollar exchange standard since 1971.

At the depth of the Great Depression in 1932, French Central Banker Jacques Rueff noted that the modern international gold standard began and ended with committees of experts meeting five centuries apart in Genoa. The first Genoa conference, held in 1445-47 after more than 90% devaluation of currencies during the Hundred Years War, agreed on a gold florin of 44 sols (harking back to Constantine's *solidus*) and that "banks will be obliged to pay in florins."

"The second committee met in April and May, 1922, also in Genoa," Rueff noted. Adopting a proposal from John Maynard Keynes' 1913 book *Indian Currency and Finance*, the 1922 Genoa conference recommended "some means of economizing the use of gold by maintaining reserves in the form of foreign balances," initially pound and dollar IOUs.

Rueff explained the basic change: when a foreign monetary authority accepts dollar claims instead of gold, purchasing power "has simply been duplicated, and thus the American market is in a position to buy in Europe, and in the United States, at the same time.... As a result, the gold-exchange standard was one of the major causes of the wave of speculation that culminated in the September 1929 crisis." Expansion of dollar reserves had inflated the prices of stocks and commodities; their contraction deflated both.

The gold-exchange feature was enshrined in the 1944 Bretton Woods agreement, under which prices roughly doubled before the U.S. suspended gold payments in 1971. And the economic crisis of 2008-9 was essentially similar to the one that triggered the Great Depression. This time, foreign monetary authorities purchased trillions of dollars in U.S. public debt, including $1 trillion funneled into the U.S. housing markets through mortgage-backed securities issued by Fannie Mae and Freddy Mac, causing the crude oil price to spike to $150 a barrel, a boom-and-bust in in foreign markets and housing prices.

Bryan Riley and William Wilson at the Heritage Foundation recently summarized what they claim are the "Four Advantages of Reserve-Currency Status":

namely, seignorage, low interest rates, lower transaction costs, and “power and prestige.” In a Cato Institute paper last year, Professor Larry White methodically listed and demolished the specious arguments in favor of the current fiat paper standard and against restoring the true gold standard, anticipating Riley and Wilson's.

Messrs Riley and Wilson baldly state the main issue: “The largest benefit has been 'seignorage,' which means that foreigners must sell real goods and services or ownership of the real capital stock to add to their dollar reserve holdings.” Indeed, the *whole* monetary debate has been essentially about seignorage -- foreign *and* domestic.

Seignorage, as the American Heritage Dictionary explains, is "the profit or revenue taken from the minting of coin,... usually the difference between the value of the bullion and the face value of coin," and that in Middle English seignorage was "the duty imposed by a lord as his prerogative."

The seignorage claim is as technically backward and morally corrupt in the 21st century as it was in the 15th. Nicholas Oresme summarized its essential fallacy when medieval princes claimed their "rights" of seignorage during the Hundred Years War: Since "money belongs to the community and to individuals," not the sovereign who may issue it, Oresme pointed out, "the community alone has the right to decide if, when, how, and to what extent this [monetary] ratio is to be altered, and the prince may not in any way usurp it." Likewise for today's U.S. Congress.

Riley and Wilson err also in assuming all transactions are voluntary exchanges, ignoring involuntary transactions, including seignorage. This error can be dispelled by dividing US international transactions into US residents' private transactions with foreigners and US public borrowing from foreign monetary authorities. As the nearby chart shows, the books of US private residents went from net foreign assets worth 10% of U.S. GDP in 1976 to balance with the rest of the world in 2013, while the total US international investment position declined from about +10% to -30% of GDP. This means that the entire decline in US net international investments was due to Federal borrowing from foreign monetary authorities -- federal deficit financing through the dollar's official reserve-currency role.

Riley and Wilson's ire was occasioned by the proposal of Jared Bernstein, an economic adviser to Vice President Joe Biden, to "dethrone King Dollar." We say, if someone wants to swear off booze, the appropriate response is to point him to a 12-step program, not dismiss him for having been a drunk or a Democrat.

Finally, Riley and Wilson argue that "no other global currency is ready to replace the U.S. dollar." The world's monetary authorities still hold nearly 900 million ounces of gold, which is enough to restore the classical gold standard: the least imperfect monetary system in history.

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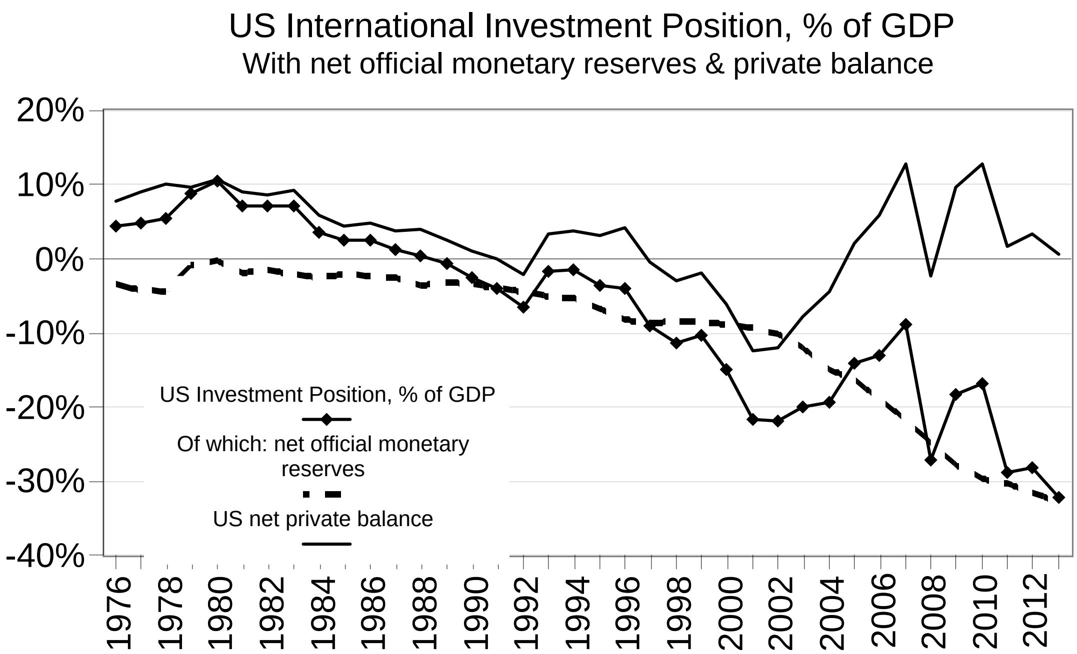

US International Investment Position, % of GDP
With net official monetary reserves & private balance
20%
10%
0%
-10%
-20%
-30%
-40%
US Investment Position, % of GDP
Of which: net official monetary reserves
US net private balance
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012