

## Dollar Standard: The Mechanism Behind the Bubble

*With vast experience in analyzing the U.S. and the Asian economies in the past decade, in his book “The Dollar Crisis: Causes, Consequences, and Cures” Richard Duncan explains how the international monetary system works and how the U.S. trade deficit results in a global credit bubble. In a clear and uncomplicated manner, Mr. Duncan provides a crisp analysis of the otherwise knotty global economic picture.*

### **Q: What inspired you to write this book?**

**A:** The theme of the book is how the U.S. current account deficit is destabilizing the global economy. The deficit has become so large, about \$850 billion last year, that the countries with surplus current accounts are developing economic bubbles. Those dollars are reinvested in the United States and thereby also blow the US economy into a bubble. In other words, the trade surplus results in a global credit bubble. The book deals with the mechanism behind the bubbles and examines how foreign exchange reserves grow.

I am an American, but I have spent most of my career in Asia, including Thailand, where my experience was crucial for understanding the bubbles. In 1998 I went to work for the World Bank in Washington and I spent a couple of years on issues related to the Asian crisis. The book came out in 2003, followed by an updated edition in 2005.

What I realized in Thailand is that anytime a country experiences a very rapid buildup in its foreign exchange reserves, it tends to develop an economic bubble. For example, after the Bretton Woods Agreement broke down in the early 70s, Japan developed a very large trade surplus with the U.S. Its foreign exchange grew rapidly and, by the end of the 1980's, the bubble was so great that the Imperial Gardens in Tokyo were valued higher than California.

In the 90's the Asian countries experienced a rapid buildup in their foreign exchange reserves and they all turned into bubbles. Today China is the best example because it is the extreme

case. Now the country has almost \$1.5 trillion in foreign exchange reserves. Just over the last year the increase has been half a trillion dollars. The dollars go into China because of its large trade surplus with the U.S. and because of the substantial direct investment in building factories there.

Because the Central Bank of China does not want the Chinese currency to appreciate, it intervenes to buy up all the dollars that come into the country. The result is rapid deposit growth, which leads to rapid loan growth, which eventually leads to economic overheating and bubbling. To get enough money to buy all the dollars coming into the country, the Central Bank of China does what all central banks do - they wave their magic wand, which means printing money. That's how the foreign exchange reserve grows.

Once the dollars are in the reserve, they need to be reinvested into dollar-denominated assets to produce interest. So the dollars end up flooding back to the U.S. as China buys Treasury, agency, corporate bonds, and asset-backed securities. The reinvestment is so large that it blows the U.S. into a bubble as well and the result is a global credit bubble.

### **Q: Would you explain to our readers how the international monetary system works?**

**A:** Under the Bretton Woods system, which maintained a gold standard, such large trade imbalances were impossible over a long period of time. At the time classic economic theory was developed, if England had a big trade deficit with France, England's gold would be shipped to



**RICHARD DUNCAN** is the author of the best-selling book *The Dollar Crisis: Causes, Consequences, Cures* (John Wiley & Sons, 2003, updated 2005), which describes how flaws in the international monetary system have destabilized the global economy and led to the current crisis in credit markets. He is also a partner at Blackhorse Asset Management in Singapore.

Duncan has worked in the investment industry for more than 20 years for a number of leading institutions, including the World Bank, as well as investment firms in Asia —James Capel, Salomon Brothers, and Indosuez WI Carr.

Before joining Blackhorse, Duncan was Global Head of Investment Strategy at ABN AMRO Asset Management, based in London. He graduated from Vanderbilt University (BA) in 1983 and Babson College (MBA) in 1986.

**“Every bubble pops because eventually prices become so high that the underlying income of society is insufficient to finance the interest on the debt that is fueling the bubble. That is why the US property bubble is now popping. Bubbles are inherently unstable. They continue only so long as credit is expanding.”**

France to pay for the deficit. The size of the country's credit was a function of how much gold its banks had. If the gold left England, then credit would contract and the economy would go into a recession. Unemployment would go up, wages would drop, and prices would fall due to deflationary pressures.

The opposite would happen in France, which would have more gold, expanding credit and economy, and inflation. It wouldn't take long before the rich people in France start buying more products from England, where the prices are falling. And at the same time, the English demand for French products would decrease. So the trade balance would adjust through the automatic mechanism inherent in the gold standard.

This automatic adjustment mechanism broke down with the Bretton Woods system. We have seen the countries with surpluses, such as Japan, reach extremely high levels of asset price inflation. Deficit countries, such as the U.S., are not deflating, however, because, unlike under a gold standard, there is no limit on the amount of paper dollars or the Treasury bonds denominated in dollars that can be issued.

Since there is no formal arrangement to replace the Bretton Woods system, the current international monetary system can be probably best described as The Dollar Standard because the dollar is the main globally accepted currency. However, the dollar standard cannot prevent the trade imbalances, which have resulted in bubbles both in the surplus and deficit countries.

**Q: Is there any inherent correction mechanism in the dollar standard? The Japanese economy, for example, eventually did correct itself.**

**A:** Eventually, every bubble pops because prices become so high that the underlying income is insufficient to finance the mortgages raised, for instance. That has been the case in Japan and that's the case in the U.S. Bubbles are inherently unstable once they become big enough. They continue only so long as credit is expanding.

In the Japanese case, the bubble popped around 1990, when the government had a relatively low level of debt at about 40% of the GDP. Today, after 15 years of recession, the debt level has increased to 185% of GDP. It is the aggressive increase in government spending that prevented Japan from having a complete economic depression.

**Q: Would you agree that the current dollar standard is exporting inflation around the world, especially in Asia? What are the consequences of the fact that the U.S. can keep printing dollars?**

**A:** It is a very interesting issue to discuss. Certainly, the U.S. plays a leading role in this process, but we must not overlook the role of China, India, and other countries, which print their own currencies, even at higher rates than the Fed. There are two sides of this coin - the U.S. trade deficit flooding the world with dollars and the global central banks printing their own money to buy those dollars to prevent their currencies from appreciating.

Those two events cause inflationary pressures, which aren't too acute now, but can get worse. If they do get worse, the Fed will have a very difficult choice. It will be forced to increase interest rates to stamp out the high levels of inflation, but the increasing rates would cause the property market to crash even worse and would throw the U.S. into a recession. That would definitely cause a global recession.

Then we would very quickly move from inflationary pressures to a deflationary environment and we would suddenly realize that there's a tremendous excess capacity across most industries. And deflation is worse than inflation because it is not at all certain that the central banks know how to stop deflation. After all these years, Japan is still in deflation.

The other choice open to the Fed would be to ignore the higher rate of inflation. In that case, inflation in the United States could return to the levels hit in the 1970s when CPI inflation reached 15%.

**Q: Historically, has there been any country that can sustain a growing large amount of trade deficit for more than 30 years?**

**A:** This is really unprecedented and it started with the breakdown of the Bretton Woods Agreement. During the 70's the U.S. deficit was relatively moderate. In the 80s, however, President Reagan started to cut taxes and to increase the military expenditure, while sustaining a large budget deficit. The budget deficit stimulated the economy and led to a larger trade deficit, which reached 3.5% of the GDP by 1985.

That was an alarming number at the time and global policy makers met to reach the Plaza Accord in 1985. Following that agreement, the Yen and the German Mark appreciated by 50% against the dollar over the next two years. That was enough to prompt a correction of the U.S. current account deficit, and by 1990 it was back in balance.

Then, globalization began to facilitate trade between countries like China and the U.S., or between countries with very high and very low wages. With the fall of communism, the political tensions were removed and international trade was boosted. China's trade surplus with the US started to grow significantly to reach more than 10% of its GDP last year. In the 1990s Mexico and all the Asian crisis countries were allowed to devalue their currencies against the dollar.

These developments had a negative impact on the U.S. trade deficit, which has now reached 7% of the GDP, or is twice as high as at the time of the Plaza Accord. Today, however, there is no clear solution because the discrepancy between the wages in the U.S. and China is huge, i.e. \$200 per day versus \$5 per day. Even if the Yuan appreciates by 50%, that would only take Chinese wages up to \$7.50 per day and wouldn't prevent the Chinese surplus from growing further. So the imbalances today are not only larger, but also much more difficult to resolve.

**Q: You use three very important words in the title of the book - causes, consequences, and cures. If China cannot correct the imbalance by appreciating its currency by 50%, what else could happen?**

**A:** As long as the imbalances persist, the global financial system will become increasingly unstable. We have seen the bubbles on the surplus side blow up in Japan and Asia, and I believe that will see the bubble in China blow up. More

interestingly, on the deficit side we are now seeing the U.S. bubble beginning to implode. This has potentially very severe consequences, such as a large sector of the mortgage market defaulting, combined with troubles in structured finance products.

It seems that the U.S. government will have to intervene further and all the Western central banks have to inject liquidity into their credit markets to prevent a systemic meltdown. So far, the injections have been close to half a trillion dollars, which is significant, but it only addresses the fear gripping the credit markets. It doesn't address the fundamental problem with the U.S. economy, where all the dollar surpluses have been reinvested in dollar assets, thus facilitating the property bubble.

The annual current account deficit of \$850 billion roughly equals the amount that global central banks accumulate as foreign exchange reserves each year. Treasury bonds are typically the first choice for reinvestment, but the budget deficit was only \$160 billion last year. Even if the surplus countries had bought every new Treasury bond issued, they would still have \$700 billion to invest somewhere else.

In other words, the imbalance provided financing for the entire sub-prime market because there were ready buyers for those loans. Now that the loans are blowing up, we are finding that the losses are much greater than anyone on Wall Street had been brave enough to estimate. Countrywide Financial has fallen from about \$45 to roughly \$5, and this company originated one of every six mortgages in the U.S. last year. You can imagine the amount of debt they have issued and the repercussions of a possible default on such a large amount of bonds.

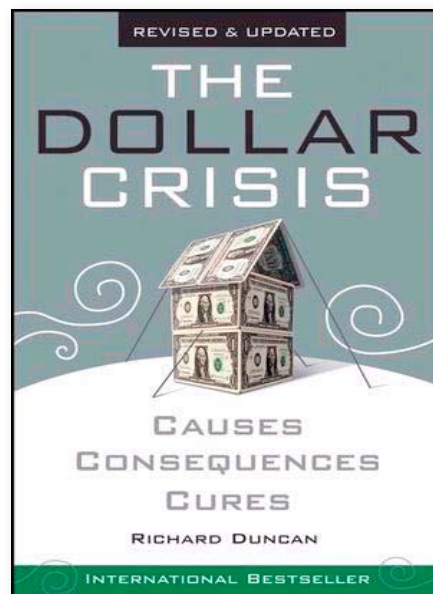
In addition, Fannie Mae and Freddie Mac, the agencies that own or guarantee 43% of all the mortgages in the United States, have a very thin level of capitalization. With mortgage defaults becoming so high, there is a clear risk of erosion on whatever capital they have. The share prices of the insurance companies that guarantee the bonds are also dropping and there is considerable speculations about their solvency. These are big organization with an enormous role in the financial system. If any of them fails to meet its obligations on their bonds, we would face a systemic financial sec-

tor crisis. In my view, these imbalances are a direct consequence of the U.S. current account deficit.

**Q: Based on preliminary numbers, we potentially face losses of \$250 billion related to sub-prime loans. What scenarios do you foresee here?**

**A:** The defaults would not affect just the sub-prime loans, but also the prime mortgage market, the credit card industry, the automobile loans, and the structured finance products. So, it is a much bigger problem than the \$250 billion in sub-prime losses and it will require government intervention.

Basically, credit growth drives economic growth, and we have had excessive credit growth, which



led to unsustainably high economic growth. The total credit in the U.S. has been going up steadily and rapidly to reach about 360% of the GDP today. If the credit/GDP ratio contracts due to defaulting, it is quite certain that the economy will have a severe recession, and the government will quickly realize that it has a limited number of options.

One of the options is to allow Fannie Mae and Freddie Mac to buy up more mortgages in the country and grow their balance sheets. If they do, however, they will push up the property prices and issue more debt. This is a very short-term fix because it's not possible to keep the property bubble inflated indefinitely.

Direct government spending is a viable solution, but a very uncomfortable one because it will require increasing government debt. So the money spent to keep the economy out of a recession


should be spent wisely and for projects that generate returns for future generations, such as infrastructure or sustainable energy projects or on education. Ultimately, the future generations are the ones who will end up repaying this debt.

In that sense, I don't think that the government should be bailing out the people who default on their mortgages or the bankers who lent them the money for mansions they cannot afford. There is moral hazard involved, and it wouldn't work anyway. The bubble would still pop, but the bill would be much larger when it does.

**Q: If the U.S. doesn't find its way out of the recession, can Asia continue to grow on its own? Do you believe in the arguments on decoupling?**

**A:** In this case Asia would have a prolonged recession, as there is no decoupling. The mild recession in 2001, when U.S. imports went down by only 6%, caused global commodity prices to collapse. Asia went into a recession, the stock market crashed, and interest rates fell to very low levels. Nothing has changed in the last five or six years. The U.S. economy represents about one-third of the global GDP, and if there is a recession in the U.S., the world has a recession too.

**Q: How likely is a global demand for restoring the gold standard?**

**A:** I think that going back to the gold standard is not likely unless, of course, all the paper money regimes totally implode. The gold is a hard asset that nobody can control; credit will be extremely restricted and will lead to deflationary pressures. So, that's unlikely to happen unless the dollar standard completely breaks down. Hopefully, we won't reach that stage. Indeed, policy makers need to reconvene and decide on a global monetary system that is sustainable, not as flawed as the dollar standard, and able to prevent large trade imbalances. That wouldn't be easy, but harder things have been done. 

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