Intelligence MEMOS

From: William White

To: International Currency Watchers

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Re: **The Weaponization of Finance and the Future of the International Monetary System**

The recent use of financial sanctions by the US, against the central bank of Russia, initially raised fears that other countries might try to protect themselves by reducing sharply their reserve holdings of US dollars.

Going further, some even suggested that such sanctions could trigger the end of the current, dollar-dominated international monetary system. To date, the sharp appreciation of the effective value of the US dollar has put those concerns to rest. Nevertheless, The Weaponization of Finance and the Future of the International Monetary System another global economic and financial crisis might yet revive such worries.

Indeed, there is a reasonable chance of such an outcome. Monetary systems 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 significant weakening of the US dollar, but other countries resisted the associated strengthening of their currencies through either exchange rate intervention or by equally stimulative monetary policies. There are now many global indicators of growing economic and financial instability arising from these policies; record high debt levels of decreasing quality, historically high asset prices, and slowing growth rates of economic potential.

The negative economic effects of the recent pandemic and the invasion of Ukraine could yet prove as devastating as the effects of Covid on an individual with previous comorbidities.

Moreover, current inflationary problems are not "transitory" but seem more likely to be sustained by a host of overlapping and negative supply side shocks; pre-pandemic resource misallocations, post-pandemic hysteresis, population aging, climate change, commodity price increases and also deglobalization.

Persistently high inflation would then likely lead to sharply higher real 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 and our crisis management tools are heavily constrained or otherwise inadequate. For example, at the international level we lack basic principles to guide sovereign debt restructuring. As well, discretionary Fed swaps are the closest thing we have to an international lender of last resort. Together with the absence of a nominal anchor, and the failure of exchange rate changes to minimize both spillover effects and persistent current account imbalances, these features constitute fundamental flaws in the current international monetary system.

In the event of another serious economic and financial crisis, particularly if its epicentre were in the United States, there are grounds to think the dollar might lose its safe haven status. Resentment over the repeated use of the dollar as a geopolitical weapon could finally trigger a reduction in its use as a reserve currency.

By then, alternative payment systems (like China's Cross-Border Interbank Payment System) could also reduce its use for transaction purposes. Moreover, as the US share of global GDP continues to shrink, its capacity to service a growing stock of international debt (the Triffin dilemma) would be increasingly questioned.

Closely related, massive increases in US government debt have already raised concerns about prospective fiscal dominance in the US. Political partisanship and the Fed's long-standing reluctance to tighten monetary policy indicate this last problem might not be easily controlled.

Should a dollar crisis threaten the maintenance of the current system, a spectrum of alternatives presents itself. At one end, we have the possibility of a cooperatively agreed replacement system based on a money that was not created nationally. This system would be constructed to avoid the defects of the current system. However, at the other end we might have an autarchic outcome with both trade and international financial transactions being severely constrained.

Such economic chaos would likely have devastating effects on political order, especially in the democratic countries, and on our collective capacity to resist climate change.

Given this possibility, it is comforting that many persuasive arguments support the view that the current, dollar-based system will muddle on even if a global crisis should emerge. Japan has demonstrated that sovereign debt ratios can reach extremely high levels without triggering a currency crisis. Moreover, alternative currencies to the dollar are not yet attractive, with other sovereign debt markets either too small (euros?) or too constrained (China?). As well, the euro area and China each have significant political and macroeconomic problems. Finally, no major government wants the current system to collapse. The US will support the existing regime both domestically (through expanded safety nets) and internationally (through dollar swap arrangements). As for other important countries, they have repeatedly resisted significant appreciation against the dollar, for fear of losing competitiveness, and will likely do so again.

While mere maintenance of the status quo might seem far from a perfect outcome, it might nevertheless still beat the alternatives.

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