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*The Global Economic Crisis and the Future of the Dollar*¹

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The capitalism under which we live has long been the object of two rival views. One is the view of the classical (or neoclassical) school of economists starting with Adam Smith: If we trust in the “invisible hand” of the market, bring the economic system ever closer to pure capitalism, and spread free markets across the entire globe, we will approach an ideal state that provides both efficiency and stability. The root of all evils consists of the “imperfections” that keep all markets from operating smoothly. These include the various customs and standards that impede the free movement of people in the labor market and the many regulations and laws that impede the movement of funds in the capital market. If these impurities were removed, capitalism would operate efficiently and stably. Milton Friedman (1912–2006) of the University of Chicago was the twentieth-century champion of this classical view of capitalism.

The other view is that of the “disequilibrium dynamics” school represented by John Maynard Keynes (1883–1946). Though not as well known as Keynes,² the Swedish economist Knut Wicksell (1851–1926)³ played a key role in the formation of this school. As one of his few intellectual descendants in our day, I have written such works as *Disequilibrium Dynamics*,⁴ *Ontology of Money*⁵, and *On the 21st Century Capitalism*⁶. According to this view, there is no “ideal state” of capitalism. As capitalism is made purer, efficiency increases, but stability decreases. The capitalist system, while going through numerous crises, such as the Great Depression, has managed to maintain a certain degree of stability only because of the “imperfections” that have impeded free movement in the market, such as the rigidity of monetary wages and the regulation of speculative activities. To be sure, these impediments have their costs, such as higher levels of unemployment and inefficiency. The quest for efficiency under capitalism leads to instability, and the quest for stability leads to inefficiency—in other words, there is a trade-off between efficiency and stability.

During the nineteenth century, which has been called the century of liberalism, the laissez-faire ideology of the classical school of economics was dominant. But in 1936, when the world was in the throes of the Great Depression, Keynes published his *General Theory of Employment, Interest, and Money*, marking the onset of the “Keynesian

1 This essay is slightly abridge translation of an interview article: Katsuhito Iwai, “Kijiku Tuuka Doru ga Taii Suru Hi,” BUNGEI JUNJU, January 2009, pp. 170-180 (in Japanese). [A note added in 2011/10/01: A full article elaborating the main themes presented in this essay has since been published under the title of “The Second End of Laissez-Faire – The Bootstrapping Nature of Money and the Inherent Instability of Capitalism,” Chap. 14 in Heiner Granssmann ed., *New Approaches to Monetary Theory: Interdisciplinary Perspectives*, (London: Routledge, 2011). Its longer version is downloadable from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1861949]

2 John Maynard Keynes, *The General Theory of Employment, Interest, and Money*, London: Macmillan, 1936.

3 Knut Wicksell, *Interest and Prices*, first English edition, 1936; Original edition: (1898) *Geldzins und Güterpreise*, Jena: Gustav Fischer, and, *Lectures on Political Economy, Vol.2 Money*, English edition, Routledge & Kegan Paul: London, 1935; Original edition (1906)

4 *Disequilibrium Dynamics -- A Theoretical Analysis of Inflation and Unemployment*, Cowles Foundation Monograph 27, (New Haven: Yale University Press, 1981). [downloadable from <http://cowles.econ.yale.edu/P/cm/m27/index.htm>]

5 *Ontology of Money (Kahei Ron)*, (Chikuma-shobo,1993. 3; Chikuma-Gakugei-Bunko, 1998.3, in Japanese)

6 *On the 21st Century Capitalism (21 Seiki no Shihonshugi Ron)*, (Chikuma-Shobo,2000.3; Chikuma-Gakugei-Bunko, 2006.7, in Japanese)

revolution.”⁷ Keynes’ ideas were reflected in New Deal policies of US President Franklin D. Roosevelt, and for several decades thereafter Keynesian thinking was influential in both the academic and policymaking worlds.

Thanks to the Keynesian revolution, capitalism was able to regain its stability, but then the neoclassical school led by Friedman mounted a counterrevolution, gaining the upper hand in the 1970s. During the 1980s the administrations of US President Ronald Reagan and British Prime Minister Margaret Thatcher, which were strongly influenced by the ideas of Friedman and his camp, shifted course sharply in the direction of laissez-faire economic policies. Under the banner of achieving greater efficiency, deregulation was implemented in many fields, and a financial revolution occurred. Risks of every sort were securitized, and then the risks of the newly created securities were themselves securitized. And the process of globalization got underway, spreading the market economy across the entire world. Globalization was a grand experiment of the fundamental notion of the neoclassical camp that making capitalism increasingly pure would raise both efficiency and stability, taking the economy closer to an ideal state.

The present financial crisis, set off by the subprime lending meltdown in the United States, represents the grand failure of this grand experiment. Globalization did indeed raise the efficiency of capitalism and bring about a high level of growth on average for the world as a whole. At the same time, however, it produced great instability, demonstrating the trade-off relationship between efficiency and stability under capitalism.

A SYSTEM BUILT ON SPECULATION

So why is there a trade-off between efficiency and stability? This is because capitalism is a system built on speculation.

Speculation basically means buying things not for one’s own use but for future resale. Business activity inherently involves certain elements of speculation. First of all, a business enterprise naturally produces things not for its own consumption but for sale to customers. Second, financial markets have developed to provide the funds that businesses require as they conduct their activities in the real economy and to allow them to avoid risks; these markets also involve speculation—they are in fact arenas in which professional speculators compete fiercely with each other. Third—and most importantly—as I will explain below, the very money on which capitalism is premised is itself purely speculative.

If Milton Friedman were still alive, he would probably offer the following sort of explanation: What causes market instability is speculation in which people sell things when they are cheap, driving prices down even further, or buy things when they are expensive, driving prices up even further. But speculators who buy high and sell low will lose, and they will soon be weeded out of the market. The speculators who will remain are those who behave rationally, buying low and selling high. So markets will be stable even in the face of speculation—or, rather, speculation in fact makes markets more stable.⁸

A fundamental objection to Friedman’s view of speculation, however, was published before his time. This was the “beauty contest” concept that Keynes presented in his *General Theory*.⁹ Instead of the usual sort of beauty contest, where women parade in front of a panel of judges, who pick one of them to be Miss Something-or-other based on a certain set of standards, this is a contest with audience participation; every member of the audience can vote for a contestant, and the voters who pick the contestant receiving the largest number of votes win big cash prizes. A voter who aims to win cash cannot simply pick for a contestant based on an objective set of beauty standards or his or her own personal opinion of

⁷ Keynes, *op. cit.*

⁸ Milton Friedman, “The case for Flexible Exchange Rates,” in *Essays in Positive Economics*, Chicago: University of Chicago Press (1953).

⁹ Keynes, *op. cit.* Chapter 12.

who is prettiest. Instead the voter must forecast which contestant will be judged most beautiful by the average voter. And if the other voters are also aiming to win cash prizes, then the voter must forecast which contestant will be picked by the average voter based on the average voter's forecast of which contestant will be picked by the average voter. Some voters will surely take this process of forecasting forecasts to an even higher level.

The contestant selected as the winner of this beauty contest is picked on the basis of voters' forecasts of who will be picked. In other words, the selection is a product of *circular logic*.

As Keynes saw it, the stock market and other financial markets in which professional speculators vie for profits are controlled by the same principle as this beauty contest. These markets are inherently unstable, being subject to huge sudden fluctuations in response to minor bits of news or unreliable rumors, totally apart from movements of supply and demand in the real economy. If everybody thinks everybody thinks prices will rise, purchase orders come rushing in, and prices do indeed surge—in other words, a speculative bubble forms. Conversely, if everybody believes everybody believes prices will fall, the sell orders pile up, and prices plunge—a panic. The key point here is that bubbles and panics look irrational at the macroeconomic level, but the behavior of the individual speculators—buying when they expect prices to rise and selling when they expect them to fall—is rational on the microeconomic level.

So whose view of speculation comes out ahead, Friedman's or Keynes'? Friedman was thinking of idyllic markets, such as the market for fruit, where speculators buy produce from farmers and sell it to consumers. In this sort of market, speculation is indeed likely to contribute to stability. Keynes, by contrast, was considering the stock market, futures market, and other financial markets. Using the futures market, an oil producer, say, can sell a contract for oil that is still in the ground, promising to deliver it a year in the future and thereby avoiding the risk that the price will fall in the interim. The producer pays a premium for this contract, but in return it is assured of being able to sell the oil for the contracted price regardless of subsequent movements in the market. This is possible only because of the presence of many counterparts willing to take on the risk of price movements. In other words, the futures market can function only thanks to the participation of many speculators ready to accept risks in the hope of making big profits—in contrast to ordinary producers, who participate because they do not want to take such risks. And in the markets for financial derivatives, such as bond and currency futures and options, where the risks being traded involve movements not in the real economy but in financial markets, the participants are almost exclusively professional speculators.

Futures markets have existed for centuries. For example the Dôjima Rice Exchange was established in Osaka in 1730. But the markets for financial derivatives are much younger; the first one to be created was the International Monetary Market, a market for currency and other futures trading set up within the Chicago Mercantile Exchange by a person sympathetic to Milton Friedman's thinking in 1972. The financial markets subsequently achieved tremendous growth, propelled by the current of laissez-faire thinking and by the development of financial engineering based on the application of classical economic theory. Ironically, this development ultimately proved the correctness of not Friedman's but Keynes' view of speculation.

Financial markets inherently contain the instability of a Keynesian beauty contest; they are thus constantly exposed to the risks of bubbles and panics. This instability came into clear view with the subprime mortgage meltdown. The crisis that has resulted might seem to be essentially no different, albeit broader in reach, than the collapse of Japan's bubble economy in the early 1990s or the Asian currency crisis of the late 1990s. But in fact it is a special sort of crisis. Above I noted that business activity under capitalism is inherently speculative in three ways; the crisis we are now experiencing relates to the third of these speculative elements, namely, the money that is the lifeblood of the system.

THE PURELY SPECULATIVE NATURE OF MONEY

People are happy to receive a ¥10,000 bill not because they intend to munch it like a goat or because they want to admire the likeness of Fukuzawa Yukichi depicted on it but because they expect to be able to give it to somebody else in exchange for something they want. In other words, people accept money as money because they expect everybody else to accept money as money.¹⁰ Here we find exactly the same circular logic that we saw in Keynes' beauty contest.

In the case of financial markets, though the items being traded by speculators may be in the form of futures, options, or other derivative products, they are ultimately tied to some sort of real economic activity. Money, by contrast, has no inherent value as an object. People acquire it not in order to use it but in the expectation of giving it to somebody else in exchange for something else in the future. In other words, holding money is a purely speculative activity.

Inasmuch as money is purely speculative, it is subject to bubbles and panics. A monetary bubble is liable to occur when the real economy is in a recession or a depression. People may come to have more desire for money, which is inherently no more than a medium of exchange for the purchase of goods, than for actual goods. During the prolonged post-bubble downturn in Japan in the 1990s, people were more inclined to squirrel cash in their dresser drawers than to spend it. This sort of behavior causes deflation, with prices continuing to decline, meaning that the value of money rises in relative terms. This in turn makes people even more inclined to hoard their cash. At its most extreme, this course of events can cause a crash, leaving nobody wanting to buy anything.

A monetary panic, conversely, is liable to occur when people start to lose their confidence in money, suspecting that it is no more than pieces of paper. They try to get it off their hands quickly by using it to buy things, and this behavior sets off inflation. Fearing further price rises to come, people stampede to unload their cash, and inflation accelerates. At its most extreme, this course of events can bring on hyperinflation and make people unwilling to accept money as a medium of exchange, reducing them to barter transactions.

The invention—or, rather, the discovery—of money was the original move toward greater efficiency in economic activity, freeing people from the inconvenience of barter. Without money, the grand economic structure of global capitalism could not stand. But money makes it possible for crashes and hyperinflation to occur. So, under capitalism, there is a fundamental trade-off between efficiency and stability.

THE WONDER OF LIQUIDITY

The biggest lesson of the Great Crash of 1929 was that banks must be regulated. To understand this point, we need to look at the relationship between banks and money.

When economists measure the supply of money (more precisely, M1), they count not just bills and coins in circulation but also highly liquid bank deposits. Saying that my bank deposits are “highly liquid” means that I believe I can go to an automated teller machine and withdraw cash from my bank account whenever I want to. I can thus confidently deposit my cash in the bank until I need it. Many other depositors do the same, leaving their money in the bank in the belief that they can withdraw it at any time. The bank taking the deposits needs to keep only a fraction of the

¹⁰ See my “Evolution of Money,” in Ugo Pagano and Antonio Nicita eds., *Evolution of Economic Diversity*, London: Routledge (2001) or “The Bootstrap Theory of Money – A Search-Theoretic Foundation of Monetary Economics,” *Structural Change and Economic Dynamics*, 7(4); “Corrigendum,” 9(2), (1998). Both papers are based upon an unpublished manuscript circulated earlier as “The Evolution of Money – A Search-Theoretic Foundation of Monetary Economics,” *CARESS Working Paper #88-03* (University of Pennsylvania) 1988.

deposited money on hand as cash to cover withdrawals; it can lend out the rest. And much of the money it lends out gets deposited again in a bank somewhere, which can again lend the bulk of it out. Through this multiplier effect, my original deposit can generate an amount equal to many times—or even tens of times—its value in additional deposits, a process called “credit creation.”

But the liquidity on which this mechanism is based is highly unstable. I consider my bank account liquid because I believe I can withdraw cash from it at any time. And the reason I believe this is because I believe that many other depositors are confidently leaving their money in the bank. If, however, the depositors all started to doubt the liquidity of their deposits, they would all move to withdraw their money. The bank would quickly run out of cash, and most of the depositors would be unable to make withdrawals. The liquidity of the deposits would vanish without a trace.

This brings us back once again to Keynes’ beauty contest. The liquidity of bank deposits is also supported by the same sort of circular logic that underlies money—the willingness of people to accept money as money because they believe other people will accept money as money. In the case of bank deposits, the only reason they are liquid is that most depositors believe that most other depositors believe they are liquid.

In the financial crisis that struck after the stock market crash of 1929, many US banks, which up to then had been operating relatively free of regulatory constraints, suffered runs and went under. These bank failures caused a major contraction of the money supply, and the real economy suffered a terrific blow that lasted for years. The stock market crash and the subsequent panic revealed the fundamental instability in the liquidity of bank deposits.

On the basis of this lesson, the United States adopted the Glass-Steagall Act of 1933 as part of the New Deal. This law established a distinction between two types of financial institution: (1) deposit-taking commercial banks involved in the creation of credit and (2) investment banks (securities companies). Deposits in commercial banks were covered up to \$10,000 by federal deposit insurance, and in return for this coverage, these banks were required to undergo strict regulation by the Federal Reserve Board. The inherent instability of bank deposit liquidity was controlled through the application of regulations.

Amid the wave of deregulation and financial innovation starting in the 1980s, however, financial market figures and experts in financial engineering came to argue that the only form of regulation that financial markets required was controls to prevent frauds and swindles, such as window dressing in financial accounts and insider trading. After all, these people asserted, financial markets exist as places to trade risks as products, and they can securitize risks of any sort, whether they arise from manufacturing activities or from financial transactions. The resulting securities can be sold, thereby spreading the risks around. In other words, these people argued, financial markets can control their own risks. And under the force of their arguments, the United States effectively repealed the Glass-Steagall Act in 1999.

GLASS-STEAGALL’S REVENGE

The twenty-first century brought the subprime mortgage problem. Subprime mortgages are housing loans extended to people without steady incomes or with poor credit records. These people bought homes financed by loans of amounts that they could not reasonably expect to repay; they did so because they expected that the housing bubble would continue, enabling them to sell their homes for considerably higher prices. And banks extended them loans in the belief that they could average out the risk of default by bundling many such loans into mortgage-backed securities. Financial engineering was then used to process the risks and turn the mortgage securities into complex derivatives, which were incorporated into numerous investment funds and scattered around the world.

Even these extraordinarily risky securities, built on the dubious assumption that the housing bubble would continue indefinitely, were treated as if they were highly liquid instruments that could be cashed in at any time, and many people came to hold them with confidence—as a result of which they became more liquid. This in turn led more people to hold them, making them ever more liquid. Through the workings of this circular process, the financial market as a whole was able to create credit, as if it were a bank.

Particularly fast growth was seen in what are called “credit default swaps.” These are financial derivatives created by pulling out just the risk that the issuer of an original security will fail and packaging it as a separate instrument. CDSs were hailed as the ultimate means of avoiding risk, and at their heyday in 2007 the volume of the CDS market was a massive \$42 trillion. This is an amount on the same scale as the gross domestic product of the entire world, which is approximately \$55 trillion.

If one looks at the ownership of these derivatives, though, one finds that only 3% are held by investors other than financial institutions. In other words, there was nobody actually covering the risks of financial institutions’ failures. The institutions merely took on each other’s risks and lulled themselves and each other into a false sense of security. Then, in 2007, when the housing bubble showed signs of weakening, the circular logic underlying the liquidity of the CDSs began to crumble. Suddenly everybody wanted to sell off these derivatives, and then they started trying to sell off their holdings of regular financial products like stocks and bonds as well. This amounted to a run on the financial market as a whole. The swollen supply of credit contracted sharply, and all that was left in the debris of the marketplace was the reality of defaulted mortgages.

The Great Crash of 1929 left the lesson that credit-creating banks need to be regulated. The crash this time has highlighted the fact that credit is created not just by banks but by the financial market as a whole. So the biggest lessons to be drawn from it are that governments should not hesitate to intervene in the face of short-term crises by buying up bad loans from financial institutions and injecting public funds into them, and that long-term stability requires the imposition of various forms of regulations on the entire financial system, including disclosure requirements and minimum reserve requirements. In order to save capitalism, we must free it from the bonds of laissez-faire ideology.

Ironically, the current crisis has resulted in the total disappearance of pure investment banks from the United States. They have all either gone under or converted themselves into commercial banks. This is nothing other than the revenge of the eliminated Glass-Steagall Act.

THE DOLLAR’S SHAKY POSITION

I still have not touched on the biggest issue relating to the current financial crisis. This is the issue of the dollar’s position as the key currency in the international monetary system.

The fact that people and businesses around the world hold large amounts of dollars for use in buying things from the United States does not suffice to earn it the label of the key currency. This merely makes it a strong currency, like the euro and the yen. Its status as the key currency comes from the fact that it is used by countries other than the United States as the means of settlement for their mutual trade and capital transactions. For example, a Japanese company buys something from a South Korean company and pays for it in dollars. The South Korean company accepts payment in dollars because it expects to be able to use the dollars for a capital transaction with a Brazilian company. The Brazilian company accepts the dollars because it expects to be able to use them to pay for a purchase from a German company—

and so on. Companies around the world accept dollars as the key currency because they expect other companies around the world to accept dollars as the key currency. Here again we see the circular logic of money at work.

The dollar gained the position of the world's key currency thanks to the overwhelming strength it boasted after World War II. At that point America accounted for half of the world's GDP, and with Europe and Japan left in rubble by the war, it was the only country with a major manufacturing capacity. People all around the world wanted US products, and they desperately sought the dollars they needed to buy these products.

Then, as Europe and Japan recovered, America's relative economic strength started to decline. By the latter part of the 1960s, as it became drawn deeper into the Vietnam War, the United States began to consider its role as the key-currency country a burden. And in 1971, under President Richard Nixon, it declared the end the convertibility of the dollar into gold and started a process that led to the replacement of fixed exchange rates with floating rates determined freely by the market. This was the so-called Nixon shock. The intention was to remove the dollar from its position as the key international currency and turn it into just one of the many national currencies in the international monetary systems.

Contrary to the US authorities' intention, however, the dollar continued to circulate as the key currency. In fact, its international status became even more elevated. This demonstrates the fact that the key currency in the international economy, just like the money within a national economy, is supported by circular logic. Once a particular nation's currency has become accepted as the key currency, it can hold on to that status regardless of changes in the strength of that nation's economy.

The country whose currency has this special status enjoys substantial benefits as a result. For example, even if someone in Japan is able to use a ¥10,000 note to buy something from another country, that ¥10,000 will probably be used right away to buy something from Japan. This is because the yen is not the key currency. If, by contrast, an American uses a \$100 bill to buy something from abroad, since the dollar is the key currency, in many cases the bill will continue to circulate around the world and not return to the United States for a considerable period. There are in fact statistics indicating that some 70% of the dollar currency notes issued by the US Federal Reserve Board are circulating outside the United States. This means that Americans have been able to purchase that amount in goods from other countries without providing any US-produced goods in return. The amount in question is said to be \$600 billion; this is certainly a major gain for the United States.

Since the Nixon shock, as globalization has progressed, the United States has come to recognize the advantage of being the key-currency country. But the financial crisis we are now experiencing has dealt a major blow to America's economic strength as the financial center of global capitalism, and the dollar's international position has become shaky, as highlighted by French President Nicolas Sarkozy's statement that the dollar can no longer claim to be the "only global currency." I do not believe that the present system, in which the dollar is central, will soon collapse. But I do believe that the present crisis has brought the start of a process of movement toward a new system.

In response to the lessons of this crisis, we can expect to see various measures to tighten financial regulation on a global scale. These may restore a degree of stability to the global financial market for a while. But if this stability continues, the lessons of the crisis will eventually be forgotten, and we will probably see Friedman's laissez-faire ideology rearing its head again, leading to a return to deregulation. After some decades have passed, another major financial crisis will occur, and the dollar's position will come under attack.

If and when such a dollar crisis occurs, an international syndicate may be formed to rescue US financial institutions from imminent bankruptcy. Perhaps this syndicate will issue convertible securities backed by the capital subscribed by its member countries to conduct this rescue operation. This would be a very ad hoc arrangement, but it

might bring the start of a move toward adoption of a currency for international settlements backed by reserves consisting of a basket of multiple currencies. This would represent the birth of a new key currency.

Another conceivable approach would be to set up a global central bank or similar institution to issue a new key currency. But it would be hard to create such an institution from scratch. This is because the rise of the emerging economies has created a great increase in the number of countries whose economic weight entitles them to a say in international monetary affairs, making it terribly difficult to reconcile the conflicting interests of all the parties involved. So it seems much more likely that we will see the birth of a new key currency to replace the dollar as the result of emergency moves to deal with a crisis.

This scenario is only a figment of my imagination at this point. But clearly the current US-born financial crisis represents the beginning of the end for the dollar as the key currency.