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China and the Dollar

Markets don't like Treasury talking down the dollar's status.

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As if the dollar didn't have enough problems, Timothy Geithner took China's bait yesterday and said he was "quite open" to its suggestion this week to displace the greenback with an "international reserve currency." The dollar promptly fell and stocks followed, before the Treasury Secretary re-emerged to say "the dollar remains the world's dominant reserve currency. I think that's likely to continue for a long time."



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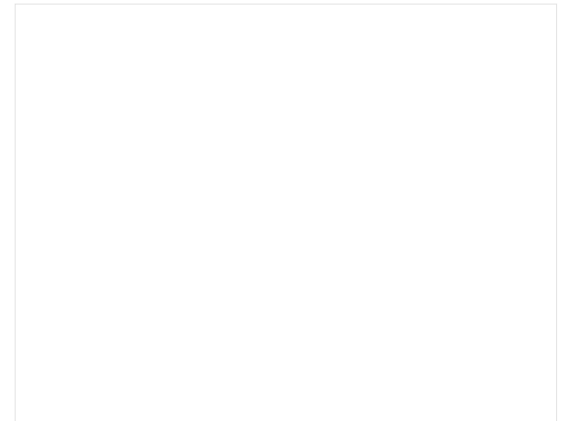
Mr. Geithner is learning on the job, and yesterday's lesson is that it isn't smart to fool with currency markets when you are already tempting fate with a gigantic U.S. refiation. Treasury and the Federal Reserve are flooding the world with dollars to break the recession, and the world is rightly getting nervous. The solution floated by Chinese central bank governor Zhou Xiaochuan -- an increased

role for the International Monetary Fund -- isn't desirable. But his warning about the dangers of dollar weakness and exchange-rate instability is still worth heeding.

Since the collapse of Bretton Woods in 1971, the global economy has tried to function with floating exchange rates, in which the "market" is said to set currency prices. As the world discovered in the 1970s and the Bush Treasury forgot, however, the market for currencies isn't the same as for apples or copper. Central banks control the supply of currencies through their monopoly on money creation. Often, as at the Alan Greenspan-Ben Bernanke-Donald Kohn Federal Reserve this decade, they get policy wrong, with disastrous consequences. Amid the global economic downturn, some central banks, like Vietnam's, are also turning to currency devaluation for a trade advantage.

Mr. Zhou may want to head off this potential train wreck. On Monday he proposed an international reserve currency "anchored to a stable benchmark and issued according to a clear set of rules." He wants the supply of money to allow for "timely adjustment" to "changing demand," and those adjustments to be "disconnected from economic conditions and sovereign interests of any single country." And he thinks the IMF can create a global currency by expanding the use of its already-existing Special Drawing Rights (SDRs), a synthetic currency linked to the underlying currencies of IMF states.

Yet who would determine the "right price" of the SDR -- the IMF? The multilateral institution's economic prescriptions have sent numerous nations into tailspins, particularly in Asia. There's



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nothing to say, too, that national monetary authorities wouldn't cheat and adjust their domestic money supplies as they saw fit -- or apply political pressure on the IMF to change the SDR's currency weightings in their favor.

But the main problem with the SDR is that it can't be used for anything in the real world. When the IMF allocates SDRs, recipient countries exchange them for local currencies at local central banks. That money is then used to buy real assets and facilitate trade. That exchange inflates the money supply of the domestic country that's accepting the SDRs in exchange for local currency.

There isn't consensus within China's central bank on the idea of empowering the IMF, though Beijing is eager to have more say at the institution. Hu Xiaolian, a vice governor of the bank, said Monday that "investing in U.S. Treasury bonds is an important component of China's foreign currency reserve investments." She added: "We are naturally relatively concerned with the safety and profitability of U.S. government bonds."

Ms. Hu isn't alone, and we only wish the Treasury, the White House and the Fed were equally as concerned. The dollar's status as a reserve currency gives the U.S. enormous advantages, and it should be protected ferociously by our public officials. It means we don't have to repay our debts in foreign currency and that our borrowing costs are cheaper. To the extent that the rest of the world follows a dollar standard, it also gives us far greater global sway.

It is this influence that Russia, China and others sometimes resent and would like to see displaced. The problem is that there really isn't an obvious successor to the dollar. No other economy is large enough, with deep enough capital markets. The euro might become an alternative down the road, but it remains too new and lacks the necessary underpinning of political cohesion.

Yet Mr. Zhou's demarche is also a warning that reserve currency status carries special obligations. It means the U.S. isn't conducting monetary policy only for itself but for much of the world. And it means that when the U.S. falls for the temptation to debase its currency, it sends shocks through the entire global trading system. The dollar's sharp but needless gyrations during this decade are in our view one of the major causes of the housing and commodity asset bubbles that led to the financial panic and global recession.

If Mr. Geithner meant yesterday that he is "open" to broader monetary and exchange-rate cooperation, that could be a step forward. But instead of abdicating to IMF bureaucrats, this would mean working with the world's most important governments and central banks -- for starters, the Fed, ECB, and the Banks of England, Japan and China. The world could use monetary reform, but the goal should be to reduce currency fluctuations and enhance price stability and world trade. In the meantime, the dollar's special status is an asset worth preserving.

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