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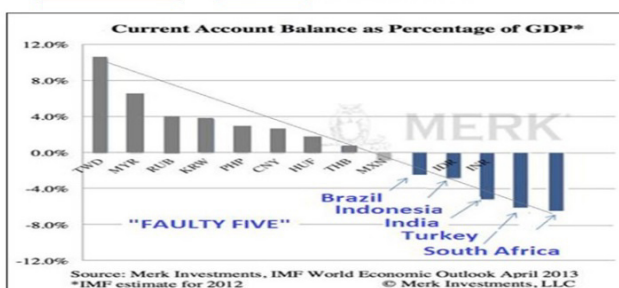
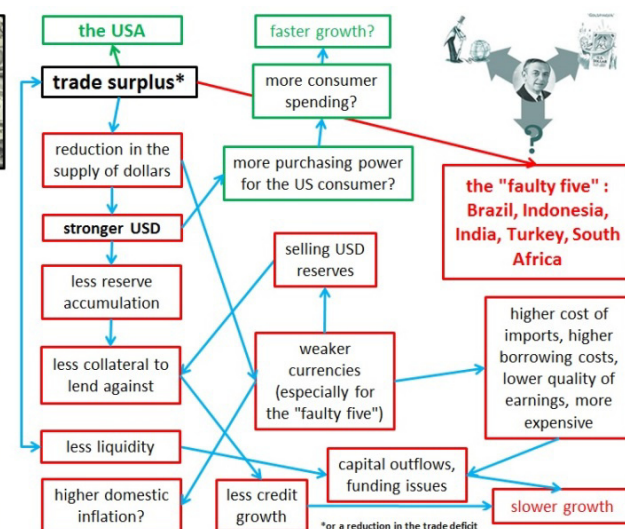
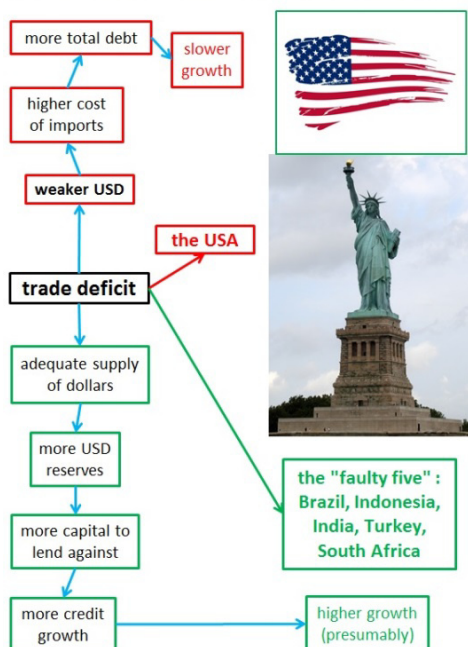
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Triffin's Dilemma: the 2014 edition

Shane Obata-Marusic



What does it mean to be the world's reserve currency?

Everbank's Chuck Butler sums it up nicely in the following quote:

"Remember, the country with the reserve currency gets to receive loans at discounted borrowing costs. Also, commodities are priced in the reserve currency, meaning central banks around the world must hold the currency in their reserves to facilitate trade."

[source](#)

Furthermore,

"Trading nations need dollars to lubricate trading and as foreign exchange reserves that bolster the value of their own currency and provide the asset base for the expansion of credit within their own nation"

[Charles Hugh Smith](#)

Triffin's Dilemma (cont)

Many different currencies have held reserve status throughout history.

This is important to note because it goes to show that, just like everything else, reserve currency status doesn't last forever.

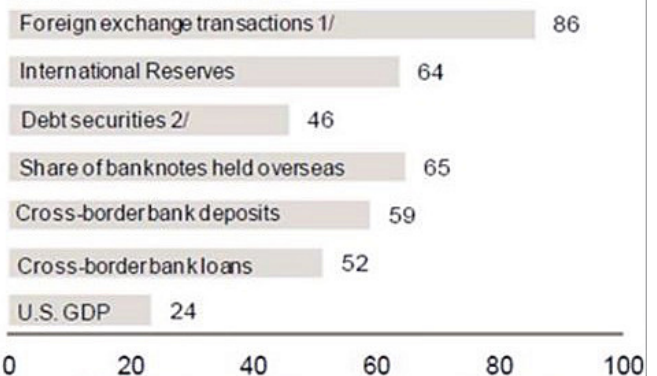
	Period when currency held reserve status	Duration
Portugal	1450-1525	75 years
Spain	1525-1635	110 years
Netherlands	1635-1710	75 years
France	1710-1815	105 years
UK	1815-1925	110 years
US	1925-present	88 years

click for source

At present, the US dollar is the world's main reserve currency.

[11-06-12 Macro Analytics - Triffin's Paradox - Rule of Law - Charles Hugh Smith : youtube](#)

Figure 4: The Dollar in the World (percent of world totals)



Sources: ECB (2009), BIS (2007), Goldberg (2010), COFER.
 1/ Share from 200 (each transaction involves two currencies).
 2/ Foreign currency debt sold outside the issuer's home country (which corresponds to the ECB's "narrow measure").



Triffin's Dilemma (cont)

That status has been a gift for the US: it has allowed it to run a deficit in perpetuity.



Macro Analytics
November 6th, 2012

Triffin's Paradox

The issue facing the modern United States is that since the rest of the world uses the US dollar as a reserve behind their own currencies, that **demand has allowed the United States to run a deficit in perpetuity and the mechanics of this trade has allowed the US to export price inflation abroad.**

Quite simply:

1. The US imports real goods in excess of the real goods it exports.
2. The deficit balance minus service exports is made up with printed US dollars.
3. Our trade partners ship/recycle the same dollars back to the United States in exchange for US Treasury Debt.
4. The US Treasuries are held as reserves on the balance sheet of their central bank, and local currency printed against those new reserves.
5. This process, although inflationary for our trade partner, allows them to keep their currency weak vs. the US Dollar and prices cheap for US consumers.

ARTICLE: Gold & Triffin's Dilemma Joe Yasinski and Dan Flynn of GBI (October 5, 2012)

Listen to the original podcast for this slide at www.GordonLong.com/Macro_Analytics

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[11-06-12 Macro Analytics - Triffin's Paradox - Rule of Law - Charles Hugh Smith : youtube](#)

But it has also been a [curse](#):

“The demand for safe assets feeds that exorbitant privilege enjoyed by the United States. This contributes to a weakening of US policy discipline as the country tends to excessively rely on easy credit in normal times and very expansionary macroeconomic policies in times of crisis. The outcome is excessive US indebtedness. The corporate sector was in debt prior to the burst of the dot-com bubble in 2001; so were the household and financial sectors before the eruption of the sub-prime crisis in 2007-08; and the official sector is in debt today.”

Triffin's Dilemma (cont)

Moving on.

Let's assume for a moment that the US recovers, the dollar appreciates in value relative to other currencies, the trade deficit shrinks, and QE comes to end.



Trade-weighted US Dollar vs. Major Currencies August 1971-October 2013



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That all sounds good, right? Yes, but maybe not for other countries – specifically those with current account deficits.

The end of easy money and artificially low interest rates will not bode well for the emerging markets.

The “faulty five” – aka the “BIITS” – Brazil, India, Indonesia, Turkey and South Africa are particularly vulnerable because they rely on external financing to operate.

A stronger USD has multiple negative implications for their economies.



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Triffin's Dilemma (cont)

Before we continue let's introduce the idea of Triffin's Dilemma.

Triffin's Dilemma

Testifying before the U.S. Congress in 1960, economist Robert Triffin exposed a fundamental problem in the international monetary system.

If the United States stopped running balance of payments deficits, the international community would lose its largest source of additions to reserves. The resulting shortage of liquidity could pull the world economy into a contractionary spiral, leading to instability.



If U.S. deficits continued, a steady stream of dollars would continue to fuel world economic growth. However, excessive U.S. deficits (dollar glut) would erode confidence in the value of the U.S. dollar. Without confidence in the dollar, it would no longer be accepted as the world's reserve currency. The fixed exchange rate system could break down, leading to instability.

Triffin's Solution

Triffin proposed the creation of new reserve units. These units would not depend on gold or currencies, but would add to the world's total liquidity. Creating such a new reserve would allow the United States to reduce its balance of payments deficits, while still allowing for global economic expansion.

"A fundamental reform of the international monetary system has long been overdue. Its necessity and urgency are further highlighted today by the imminent threat to the once mighty U.S. dollar."

Robert Triffin
November 1960

(cont pg.26)



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Triffin's Dilemma (cont)

And now for a bit of history:

“Prior to the 1944 Bretton Woods agreement, central banks used gold as the asset to back their currencies. By the end of World War II, the United States had established itself as the world’s creditor and largest holders of gold. Under the 1944 Bretton Woods agreement, the US Dollar was fully backed by gold at a fixed value of 1/35th an ounce per dollar, and foreign Central Banks could use US Dollar assets as reserves backing their currency, in lieu of gold. This agreement avoided the inevitable deflationary pressure a return to pre-war gold/currency ratios would have forced just as Europe was beginning to rebuild, and allowed US debt held abroad to be used as an asset by central banks against their local currencies. (- Zero Hedge)

After WW II, America was the only industrialized country still intact. Through the Marshall Plan and rebuilding Japan and later South Korea, America was lending huge amounts of dollars to other countries, which in turn were used to collateralize their own currencies. America was able to run huge trade surpluses and our economy was booming. But, then Triffin’s Dilemma came into play. The demand for dollars around the world exceeded America’s ability to back it with gold. Those sneaky folks at the Federal Reserve printed more dollars anyway. And, when other countries figured out what was happening there was a run on America’s gold reserves and so President Richard Nixon had no choice but to stop backing the dollar with gold. However, the dollar remained the world’s reserve currency because of the size and strength of the US economy.”

[source](#)

Despite the fact the US dollar is still the world’s reserve currency, “The IMS [international monetary system] is not in a better situation today. The quandary under the BW system – the lack of a credible anchor for international monetary and financial stability – continues to exist. Key issuers and holders of reserve currencies pursue domestic objectives independently of what would best serve the global system and even their longer-run interest. To the extent that these policies pay insufficient attention to negative externalities for other countries and longer-term macroeconomic and financial stability concerns, they tend to produce unsustainable imbalances and fuel vulnerability in the global financial system. In particular, a large body of literature supports the view that a worldwide glut of both liquidity and planned savings over investment – stemming from, respectively, reserve-issuing and reserve- accumulating economies – was a key driver of the hazardous environment at the root of the global financial and economic crisis which broke out in summer 2007”

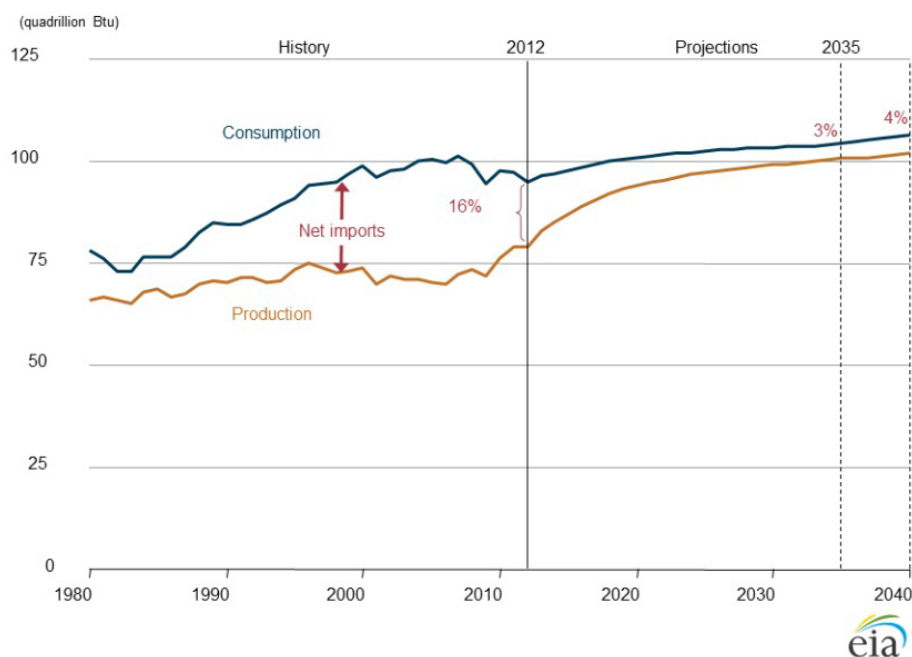
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Triffin's Dilemma (cont)

Will Triffin's dilemma be relevant again in 2014 and going forward? Many people believe that it will.

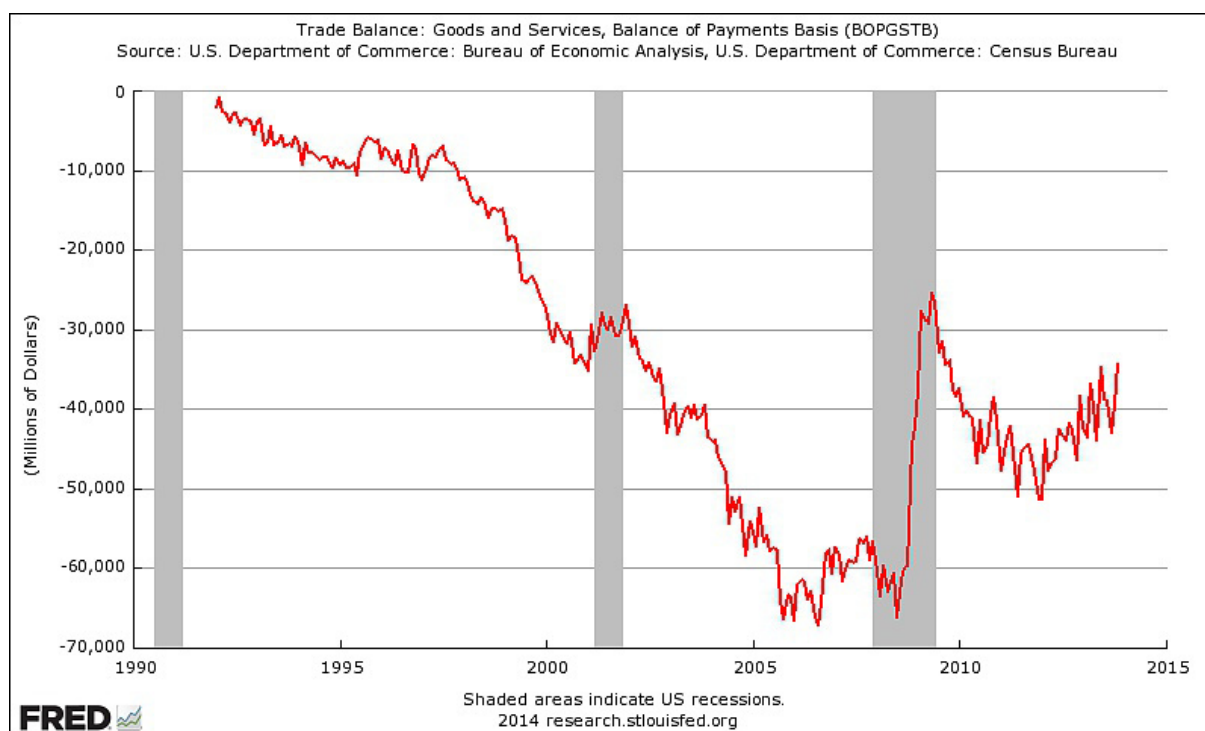
The US is now producing a lot more energy and importing a lot less - on a net basis.

Figure 10. Total energy production and consumption, 1980-2040



eia

This is causing their trade deficit – which has been negative for the better part of 50 years – to shrink.



Triffin's Dilemma (cont)

If we think of the trade balance as part of the supply of US dollars then – as a result of the dollar's world reserve currency status – a reduction in the trade deficit means fewer US dollars leaving the country.

This has implications for other countries because they use USDs to buy US assets and for reserves.

Triffin's Dilemma is that the country that issues the world's reserve currency will have to choose between:

1) running a trade deficit in perpetuity - risking of a loss of confidence in its currency and solvency while the rest of the world enjoys an adequate supply of USDs.

or

2) running a trade surplus and enjoying an appreciation in the value of the dollar while the rest of the world suffers from a lack of liquidity and collateral.

Either way, there are negative implications for world growth. In the first example – in which the US runs a trade deficit in perpetuity – the US continues to add to its debt and risks undermining its ability to pay off that debt. In the second example – in which the US runs a trade surplus – emerging market currencies are put under pressure by the USD potentially leading to capital outflows, a higher cost of debt, and global financial instability.

When Bernanke first mentioned the possibility of a reduction in asset purchases in May of 2013, emerging market currencies – in particular the BRICS – sold off in a big way.

Brazilian Real (R\$) ⇒ US Dollar (US\$) (BRLUSD)

US\$ ⇒ R\$

1 BRL = 0.4171 USD +0.00043 (0.104%)

Jan 24, 8:00PM GMT



Triffin's Dilemma (cont)

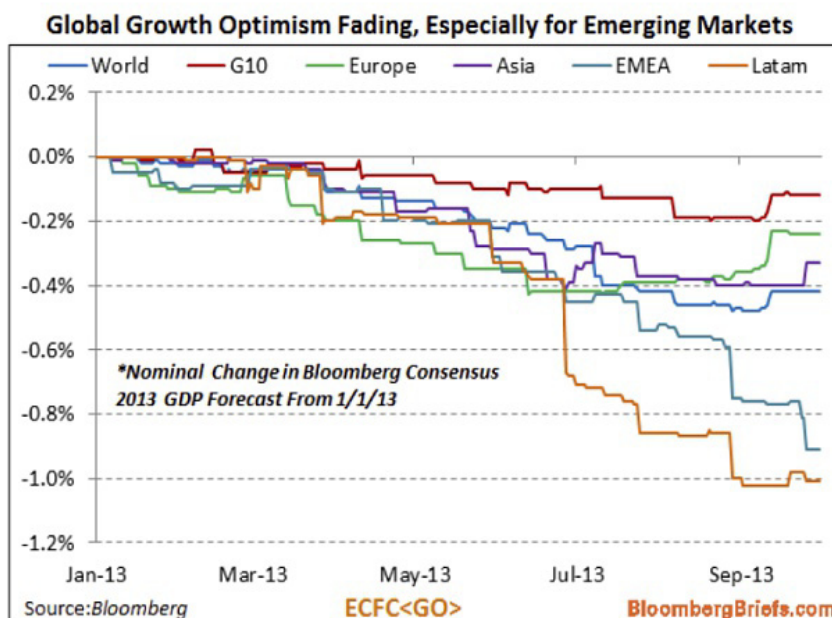
At the same time, GDP forecasts for the emerging markets (started to get) (were) revised downwards.

The Taper's Ripple Effects Across The Globe

"The threat of tapering and eventual normalization of the Fed Funds target rate will likely help continue pushing up U.S. Treasury yields. This had led to a reversal in capital flows to some emerging market nations and will likely have an adverse effect on economic and financial conditions, especially in those countries with large current account deficits. This shifting dynamic is clearly evident in economists consensus growth forecasts for regions across the world."

—Michael McDonough, Global Head of Economics and Chief Economist at Bloomberg LP

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That was the tell.

What I mean is that that's when we first got a glimpse of what would happen if and when this giant monetary experiment came to an end.

In other words, the end of easy money isn't going to be easy.

If emerging market currencies continue to depreciate then the relative value of the cash flows of companies that operate within those countries will fall.



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Triffin's Dilemma (cont)

In that case, it's likely that net capital outflows from those markets would continue.

Table 1**Emerging Market Economies: Capital Flows**

\$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>1206</u>	<u>1250</u>	<u>1092</u>	<u>1092</u>
Private Inflows, Net	1145	1215	1062	1029
Equity Investment, Net	595	660	625	622
Direct Investment, Net	590	536	574	529
Portfolio Investment, Net	5	124	51	93
Private Creditors, Net	550	555	437	407
Commercial Banks, Net	197	105	127	140
Nonbanks, Net	353	450	310	267
Official Inflows, Net	61	35	29	64
International Financial Institutions	17	2	-3	26
Bilateral Creditors	43	33	32	37
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-1480</u>	<u>-1321</u>	<u>-1340</u>	<u>-1393</u>
Private Outflows, Net	-810	-962	-984	-983
Equity Investment Abroad, Net	-265	-323	-404	-367
Resident Lending/Other, Net	-545	-639	-580	-617
Reserves (- = Increase)	-670	-359	-356	-410
<i>Memo:</i>				
<i>Net Errors and Omissions</i>	<u>20</u>	<u>-209</u>	<u>0</u>	<u>0</u>
<i>Current Account Balance</i>	<u>254</u>	<u>280</u>	<u>249</u>	<u>301</u>

e=IIF estimate, f=IIF forecast

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This flight of capital could force emerging market countries to increase their interest rates in an attempt to remain competitive for acquiring external financing.

With more money going towards interest payments, growth will be limited even further. What's more is that an increase in the relative value of the USD will cause the price of imports, financial assets, and external debt to rise in local currency terms.

Lastly, and arguably most importantly, a smaller trade deficit or trade surplus will result in a reduction in foreign exchange reserves held at emerging market central banks.

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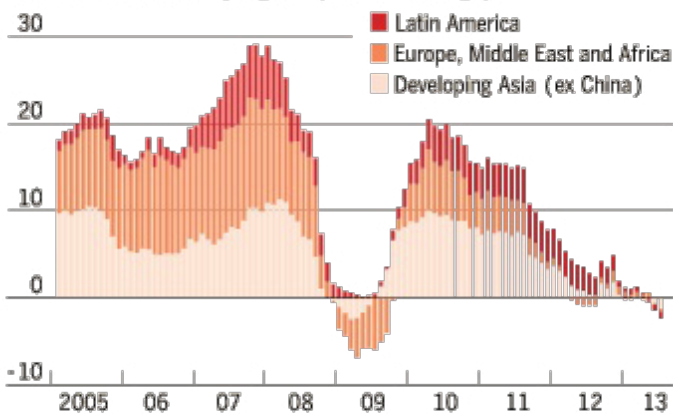
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Triffin's Dilemma (cont)

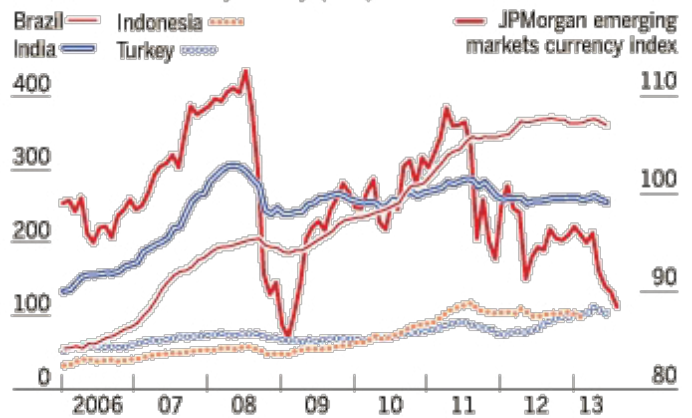
Emerging markets defence

Central bank reserves by region* (annual % change)



* Constant exchange rates, assuming COFER weights

Central bank reserves by country (\$bn)



Sources: Morgan Stanley; Thomson Reuters Datastream

[source](#)

As those banks use their dollar reserves to buy back their domestic currencies in an effort to curb inflation they will 1) reduce their ability to “protect” their currency in the future and 2) reduce the asset base against which bank reserves are backed..

In conclusion, the falling trade deficit in the US is likely to increase the relative value of the dollar.

If, in addition to an improving balance of trade, the fed continues to taper its asset purchases, then it's likely that emerging market currencies and ETFs will face increasingly negative pressures.

iShares MSCI Brazil Index (ETF) (NYSEARCA:EWZ)

Add to portfolio

39.97 -1.22 (-2.96%)

Range 39.76 - 40.35 Div/yield 0.59/3.60
 52 week 39.76 - 57.76 EPS -14.36
 Open 40.31 Shares 99.65M
 Vol. 7.03M Beta 1.34
 Mkt cap 3.98B Inst. own 93%
 P/E -

g+1 16

Jan 24 - Close
 NYSEARCA real-time data - Disclaimer
 Currency in USD



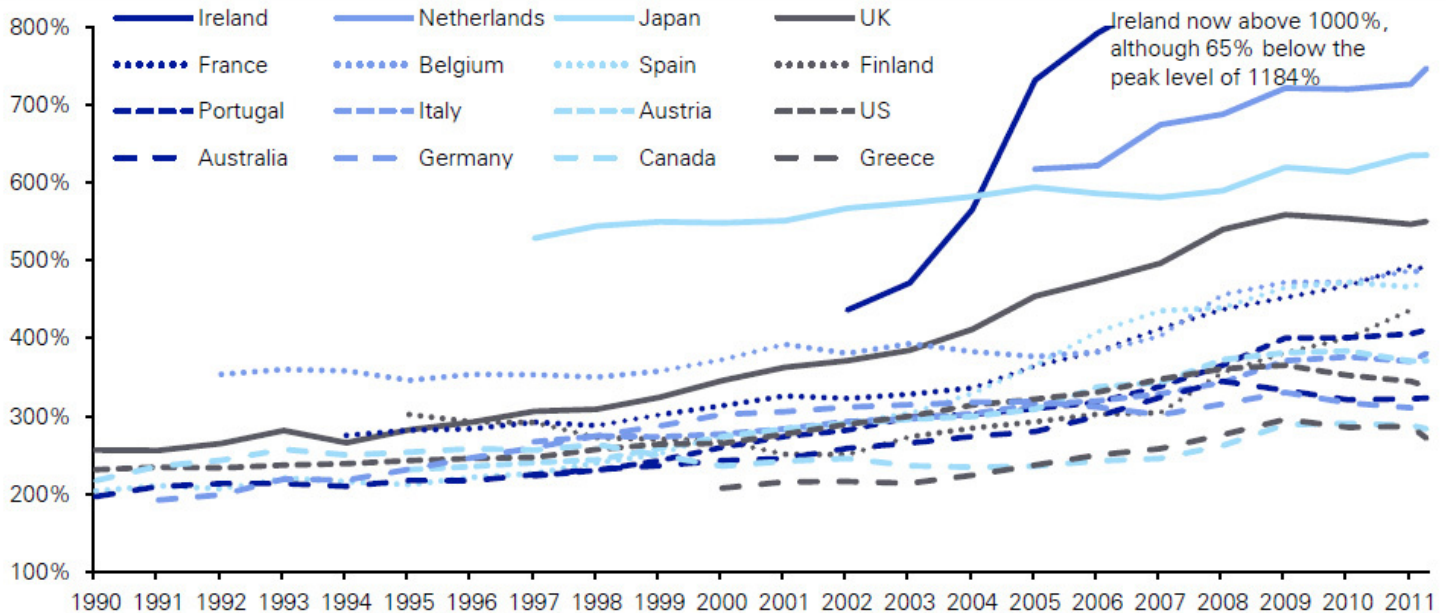
(cont pg.32)

Triffin's Dilemma (cont)

Basically, there is no easy way out of this giant moral hazard driven debt bubble that the world's central banks, and in particular the fed, have created.

I am hoping for the best but I'm not sure how this will play out. The entire world is in way over its head in debt...

Figure 37: Total (Government+Financial+Corporate+Household) Debt to GDP

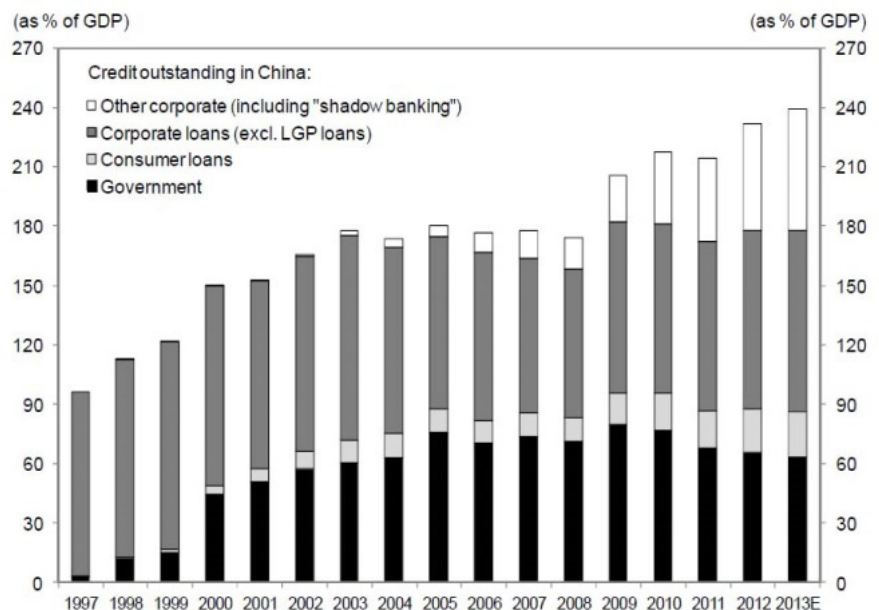


Source: Deutsche Bank, Haver

[source](#)

Exhibit 2: China's post-crisis credit boom

and somehow, whether it's deliberate or forced, we need to get rid of it all.



Source: CEIC, GS Global ECS Research.

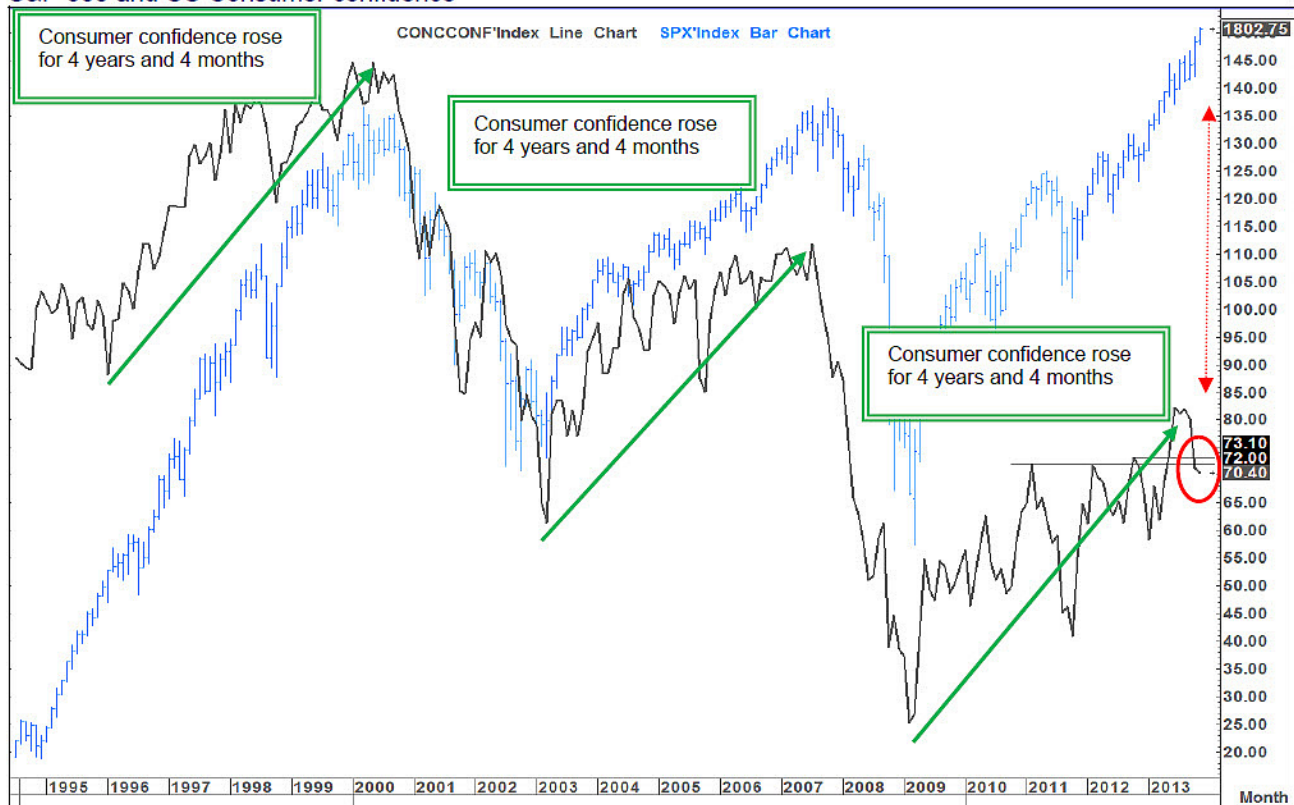
[source](#)

Triffin's Dilemma (cont)

What used to be known as the business cycle – i.e. a cycle wherein a period of expansion is followed by a recession which cleanses the system of malinvestment – doesn't exist anymore. Currently, the entire economic system is centrally planned. Instead of letting the nature run its course, the world's "best and brightest" minds in economics – the central bankers – have decided to try and outsmart it. If the US continues to operate without regard to the effects on the rest of the world, then world growth will be negatively affected.

Triffin's dilemma: the 2014 edition might turn out to be a prime example of the negative consequences of keeping money too easy for too long – i.e. suppressing interest rates and monetizing deficits. Unfortunately, policies that were intended to "smooth out" the economic cycle have only resulted in bigger booms and busts.

S&P 500 and US Consumer confidence

[source](#)

Someone's going to be left holding the bag. Try not to let it be you.



Shane Obata-Marusic

A graduate from the University of Western Ontario, I am actively pursuing a career in the markets with a focus on macroeconomics. Having completed the Canadian Securities Course and the CFA level 1, I am seeking any opportunities. Previously I have researched and written reports as an Equity Research Intern for Euro Pacific Canada (Toronto).

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