

Why the Dollar Is

BY CRITON M. ZOAKOS

Different

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China, unlike the United
States, are all locked into
export-driven policies
dependent on U.S. markets
and competitively cheaper
currencies. That's why
there are likely limits to
dollar depreciation.*

Dr. C. Fred Bergsten, America's most authoritative proponent of the theory that the U.S. dollar is "overvalued" and "overrated," on January 4, 2002, described the precise circumstances under which the dollar would be dethroned from its status as the world's international reserve currency.

Addressing the annual meeting of the American Economic Association, Bergsten argued that "at a fairly early point" the international net debtor position of the United States together with the growing current account deficit would trigger an average trade-weighted depreciation of the dollar of about 20 percent, and a depreciation against the euro "of perhaps twice that much." This would "almost surely" induce a structural portfolio diversification of \$0.5-\$1 trillion in favor of the euro and at the expense of the dollar, and "would mark the arrival of the euro as a major competitor to the dollar" in the role of a world reserve currency.

As luck would have it, a mere 26 days after this speech the dollar began a major decline. Between January 31, 2002, and June 15, 2003, the dollar depreciated by 23 percent against the index of all major trading currencies and by 38 percent against the euro, thereby meeting Dr. Bergsten's conditions. Nevertheless, not one of the consequences he predicted came to be.

Net portfolio capital inflows into the United States marked an all-time record high in 2002, and in 2003 to date are running \$150 billion ahead of 2002. During May and June 2003, net portfolio capital inflows into the United States were running at an annualized rate of \$1 trillion! Moreover, the sta-

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tus of the dollar as the world's international reserve currency has been *strengthened*. On April 2002, the dollar was 68 percent of international currency reserves, but in April 2003 it had further risen to 72 percent of international currency reserves.

This matter should give pause to any thoughtful person. The blunder was committed by a remarkable economist of formidable intellect, Dr. Bergsten, who, moreover, drew heavily from the work of Robert A. Mundell. Dr. Mundell was the 1999 Nobel Prize winner whom Bergsten cited extensively during his January 2002 presentation.

Why is it that contrary to the best economic theory, despite a stock market collapse that wiped out values the equivalent of 90 percent of GDP, despite growing current account and budget deficits, despite the massive body blow of September 11, despite a momentary decline of its exchange rate, despite (an admittedly mild) recession, and despite two major wars, the U.S. dollar today is more of a world reserve currency than it was before these events happened? And why is it that the dollar attracts even greater surpluses of foreign capital that outrun trade deficits by about \$100 billion per year?

The short answer is that the U.S. economy differs from all other economies in a crucial respect. The growth driver of the U.S. economy is a unique combination of entrepreneurship and high technology; the growth driver of every other economy is export demand.

Europe, Japan, China, and the Asia-Pacific region are all export-driven economies whose growth depends on U.S. markets. The U.S. economy depends for its growth on internal, entrepreneurial high-tech ferment. So long as this ferment keeps providing rates of return on capital higher than those in the rest of the world, international demand for U.S. investment assets will continue to be higher than U.S. demand for foreign goods and services. And American capital account surpluses will continue to *cause* American current account deficits.

More important, however, is the question: Is there a prospect for exchange rate stability anytime in the future? Where is the international system of currency exchanges head-

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ing, given this growing difference between the U.S. economy and the rest of the world?

THE NEXT TWELVE MONTHS

According to consensus estimates, a year from now the U.S. economy will likely be expanding at its sustainable 4 percent GDP growth rate or higher, Japan at about 2 percent, and the Eurozone at 0 percent. The official forecasts of the central banking authorities of the three areas more or less concur. The foreign exchange markets, however, have not priced into the exchange rates these consensus forecasts for a simple reason: there is widespread disagreement about the future course of inflation/deflation rates in the U.S. dollar area.

Simply put, the bond market in the United States believes that the Federal Reserve's commitment to keeping short rates low for a long time will produce inflation down the road. From

Why the Dollar Defies Conventional Thinking

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mid-June to date, the yield of the ten-year bond increased by 84 basis points and the spread between the three-month Treasury bill and the ten-year bond widened by 77 basis points, resulting in a yield curve quite steep by historical standards.

This is not the first time the bond market has made a major miscalculation about future inflation rates.

In the summer of 1982, when the steepness of the yield curve was at historically record levels, and again throughout 1992 when it recorded its second-greatest steepness, the market was predicting far greater inflation ten years out. Not only did the predicted inflation not materialize, but we had disinflation instead. The rate of inflation declined substantially ten years after 1982 and again after 1992. Both cases were in fact rather spectacular demonstrations of the divergence between the market's future inflation expectations and the actual inflation when reality overtook prediction.

A similar episode is currently unfolding. The market believes that the long-term inflation outlook is worsening, and the Fed believes that it is improving. I believe that the Fed is on to something here: the atypical prospect of high U.S. growth rates at low interest rates for a prolonged period of time. This would be made possible by secular, persistent, downward price pressures that pervade the entire world economy and especially China, Japan, and the Asia-Pacific, America's most important trading partners.

What Fed watchers missed during Alan Greenspan's testimony to Congress last July was a crucial exchange between the Fed chairman and Democratic Senator Charles Schumer of New York in the question-and-answer period on the second day of testimony. Schumer asked if the Fed were not concerned that, by keeping short rates low when the economy undergoes robust expansion, it might not trigger higher inflation down the road. Greenspan's reply was rather stunning. Without equivocation, without hedging, and without his trademark convoluted syntax, he flat-out asserted that both he and the Federal Open Market Committee have unanimously concluded that the world economy has entered a new era of downward price pressures and declining inflation rates and has left behind the age of inflationary

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End of an Inflationary Era



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concerns. This is why the Fed does not fear that low short rates in the emerging expansion will result in inflationary pressures. And it explains why the Fed has separated its assessments of future inflation from its assessments of future GDP growth.

Had he been pressured to elaborate, Greenspan might have pointed out that for at least the next five years, China, Japan and their satellite exporting economies of Asia will have no choice but to keep their currencies cheap. I would have. Enormous and growing domestic political pressures inside both China and Japan require that this be so, external pressures to revalue notwithstanding.

The Japanese yen and the Chinese renminbi yuan will either remain pegged to the dollar or could even depreciate against it somewhat far into the horizon of practicable forecasting. This is one major source of downward price pressures in the U.S. economy. The other is the ongoing U.S. productivity advances that will likely be further amplified with the next round of investments in new cost-cutting technologies.

This prospect produces a rather unorthodox picture of the world of currencies. The conventional model of a world made up of three currency zones—dollar, euro, and yen—does not hold up. The yen, for all practical purposes, is pegged to the dollar and so is the Chinese renminbi yuan. The international “content” of these two currencies is their U.S. dollar reserves. The same is the case with most other Asian currencies.

Under this arrangement, China, Japan, and the Asia-Pacific can be viewed as parts of the world “dollar zone,” with some local leeway for adjustment.

Rather than a world of three currency zones, we have at present a *de facto* (i.e., informal) world of two currency zones: the larger and faster-growing dollar zone—encompassing North America, Japan, China, and the Asia-Pacific—and the smaller, zero-growth euro zone.

A LITTLE HISTORY

From the dawn of history until August 15, 1971, mankind used commodity currencies or commodity-based currencies, with the most predominant commodity being gold. The Roman Empire maintained a gold-coin exchange system for about 1,500 years from its inception to its demise. The system continued in the years of fragmentation that ensued, until it was fully replaced by the “gold standard” system of the British-led Industrial Revolution, whereby banknotes replaced gold coins on the strength of the gold reserves in the vault of the issuing banks.

That system was essentially managed by the Bank of England and by Lombard Street, where most of the world’s savings and available liquidity resided. It lasted until the First World War whereupon it was replaced by the “gold exchange standard,” which differed from its predecessor in that it was the central banks’ gold reserves that regulated the supply of banknotes, and not those of private-sector banks.

The reserves of private-sector banks were in the form of central bank notes. The reserves of the central bank were in gold. The world’s major central banks agreed with each other on an initial gold-price of their currencies and thus fixed the exchange rates of their currencies. If a central bank were losing gold reserves, it would arrange for a depreciation of its currency; if it were increasing its gold reserves, it would arrange for its appreciation.

After the Second World War, the Bretton Woods system restored the gold exchange standard. The exchange rates that were initially set between the U.S. dollar and the European and Japanese currencies were understood to be temporary and subject to revision when the war-ravaged economies of Europe and Japan were restored to full capacity. The intent of the initial Bretton Woods exchange rates was to give a considerable comparative advantage to the destroyed economies.

When, however, Japan, Germany, and the other European countries had fully recovered, they refused to renegotiate their exchange rates with the United States. The deliberate—and by agreement temporary—overvaluation of the dollar at the end of the Second World War proved politically impossible to remedy, and soon gave rise to American trade deficits and the drain-



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Gold and the French

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To rub salt on the wounds, on August 4, 1971, France demanded that some \$190 million of American gold be used to repay the last installment of France's debt to the International Monetary Fund. It was eleven days later that Nixon announced the decoupling of the dollar from gold, ending the age of the gold exchange standard. For the first time in its history, mankind began to organize its transactions on the basis of fiat money alone. We called it the "floating exchange rate" system. A better name would have been the "fiat-money exchange standard" system.

The world is now in the fourth decade of managing this "fiat-money exchange standard" system and there is nothing on the horizon to replace it. What lessons can be drawn from the three previous decades of this type of monetary management?

The first decade, 1971–1981, was an unmitigated disaster. Governments throughout the world, with the United States at the lead, celebrated their liberation from the discipline of the gold exchange standard by printing money with abandon. This triggered worldwide inflation and stagnation. From this they learned that fiat-money is not a license to print.

The second decade, 1981–1991, was a struggle to tame inflation, with the United States again at the lead. Paul Volcker was appointed to the Fed with a mandate to defeat inflation. In the United States and the United Kingdom under Ronald Reagan and Margaret Thatcher, fiscal and regulatory policies in the form of tax cuts and entrepreneurial incentives became the stimulus tools of choice in place of the discredited tools of monetary stimulation. In Europe, runaway fiscal and monetary looseness (except for Germany) produced widespread stagnation.

The third decade, 1991–2001, provided the evidence that the value of any fiat-money currency to a large extent depends not on its trade balance but on its relative rate of return on cap-

ital and the capital account balance that this produces. Superior U.S. rates of return established and reinforced a "strong dollar" policy. The decade also produced the so-called "Washington consensus," which merely codified the Reagan-Thatcher lessons of the 1980s—namely that inflation, protectionism, and nationalizations of economies stunt growth.

In these three decades after the abandonment of gold, the international reserve role of the dollar became stronger. By the end of the first decade following Nixon's August 1971 abandonment of gold, the dollar depreciated some 28 percent against the trade-weighted index of all major currencies. Within a decade, the United States essentially achieved the level of realignment of exchange rates that had been provided for by the Bretton Woods agreements, but had been rejected by France and her monetary allies.

The dollar retained, however, and augmented its reserve currency role, as measured by the percentage of international transactions conducted in dollars and by the dollar-proportion of the world's central bank reserves. This happened despite the break with gold because the U.S. dollar, via London's Eurodollar market, was the most readily available and most liquid international medium of exchange, and for other reasons such as the size of the U.S. economy, the dependence of Europe and Japan on the United States for their defense, and the fact the German and Japanese mercantilist policies of maintaining trade surpluses prevented the rest of the world from accumulating deutschemark or yen that they could then use as reserves.

In the decade of the 1980s, the success of U.S. monetary, fiscal, and regulatory policies led to a major appreciation of the

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dollar by about 85 percent from 1980 to 1985. This led to the 1985 Plaza Agreement for the ordered depreciation of the dollar, which by 1990 returned to the level it had been in 1980, i.e., the post-Bretton Woods level preferred by U.S. policymakers.

Since then and throughout the 1990s, the U.S. dollar has moved against the trade-weighted index of major currencies in a narrow 15 percent fluctuation band around this historically preferred exchange rate level. This is the empirical thread that makes sense of the seemingly chaotic monetary history of the world since the end of the Second World War. The United States

had intended, from the outset of the Bretton Woods agreements, to renegotiate the major exchange rates once the war-ravaged economies had been reconstructed with American aid. The beneficiary countries refused to renegotiate, which led to the 1971 break with gold and the *de facto* achievement by the United States of its desired level of interest rates by the end of the seventies. This was immediately followed by the overshooting of this desired level due to the successful reforms of the 1980s, which neither Europe nor Japan was able to replicate. The overshooting was corrected by the Plaza Agreement and, since the end of the 1980s, the United States has managed the “floating exchange rates” system in a way that has kept the dollar close to this historically preferred exchange rate level.

The system has failed to secure the kind of exchange rate stability required for optimal economic performance. The reason for the failure is not economic, not technical/monetary, but political. The governments that are the major issuers of fiat-money currency disagree profoundly on what their mutual exchange rates should be, on who should perform the function of reserve currency, and on what the optimal economic, fiscal, regulatory, and trade policies should be. Many of these differences cannot be resolved by negotiation, compromise, or agreement and their solution is left to market outcomes. Hence we have the provisional “floating exchange rate” arrangement that, for the time being, allows markets to settle matters.

Entering the fourth decade of this provisional arrangement, the dollar seems to enjoy additional advantages, stemming from

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currencies. Moreover, their (and especially the euro’s) dependence on export surpluses does not allow third parties to accumulate their currencies in a way that would allow them ever to be used as international reserves in any meaningful quantities and levels of liquidity.

The crucial question is this: How long can the United States sustain its current account deficits?

The answer is political. If the world were on some kind of gold or other commodity-money standard, the U.S. current account deficits would have long ago wrecked the dollar. But the world is not on a gold standard, it is on a *de facto* dollar standard. Foreign central banks do not accumulate gold reserves to do their central banking business. They accumulate dollar reserves. And the U.S. current account deficit is the monetary transmission mechanism by which foreign central banks can obtain their reserves. Accordingly, there are three possible alternative outcomes regarding the U.S. current account deficit:

■ **First Alternative:** As long as the United States maintains a competitively superior rate of return on capital, foreign banks’ demand for dollar reserves will continue and U.S. current account deficits will be sustainable.

■ **Second Alternative:** If the U.S. rate of return on capital declines to European or Japanese levels, the U.S. current account deficit will not be sustainable and the existing world monetary arrangement will have a calamitous end.

■ **Third Alternative:** If European and Japanese rates of return on capital are raised to or near U.S. levels and robust economic expansion takes place there, then the U.S. current account deficits will begin to decline in rapid order and will no longer pose a problem.

Given the data available to date, I would assign an 80 percent probability to the first alternative. ◆