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Goodbye to the Dollar?

BY KENNETH ROGOFF

But timing is everything.

As the world's financial leaders meet in Washington this April at the World Bank-International Monetary Fund annual meeting, perhaps they should be glad there is no clear alternative to the dollar as the global currency standard. If the euro were fully ready for prime time, we might well be seeing its dollar exchange rate jump to over $2.00, and not just to $1.65 or $1.70, as it seems poised to do anyway. You can't treat your customers as badly as the United States has done lately if they can go elsewhere.

Over the past six years, the value of the trade-weighted dollar has fallen by more than a quarter, as the United States has continued to rack up historically unprecedented trade deficits. With a soft economy, a badly compromised financial system, and serious concerns about rising inflation, the long-term dollar trend is downward, however the current crisis ends. And it is not over.

The Federal Reserve's bailout of the financial system is unlikely to stand up unless banks find fresh capital, and lots of it. Ultra-rich sovereign wealth funds have the cash to rescue U.S. banks. But they are unlikely to want to do so at this point, even if the U.S. political system allowed it. Instead, as the credit crunch and housing price decline continue, an epic mortgage bailout appears increasingly likely, possibly costing U.S. taxpayers a trillion dollars or more. The problem is that after so many years of miserable returns on dollar assets, will global investors really be willing to absorb another trillion dollars in U.S. debt at anything near current interest rates and exchange rates?

Fortunately for the dollar, the euro seems to have its own problems.

U.S. debt hardly looks like a bargain right now, even without the sinking dollar. Far-flung military misadventures continue to stretch the country's fiscal

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resources, with costs potentially running into many trillions of dollars, according a recent study by Linda Bilmes and Joseph Stiglitz.

Next year will almost certainly see a massive rise in U.S. corporate defaults, even though many firms entered the recession with relatively strong balance sheets. State and municipal finances are in even worse shape. With tax revenues collapsing due to falling home prices and incomes, dozens of U.S. municipalities could well go into receivership, as New York City did in the 1970s. U.S. municipal bonds are already trading at huge risk premia, and the first big government default hasn't even hit yet.

The Texan Finger

In 1971, as the dollar collapsed towards the end of the post-World War II fixed exchange-rate system, U.S. Treasury Secretary **John Connally** famously told his foreign counterparts that "the dollar is our currency, but your problem." And the dollar's exalted global status has survived ever since, despite many episodes of neglect and abuse.

—K. Rogoff

Of course, if the dollar were to fall off its perch as the world's dominant currency any time soon, the euro would be the only serious alternative. The yuan may well supplant the dollar in the second half of this century. But China's draconian capital controls and massive financial repression currently disqualify it from anchoring the global economic system.

Fortunately for the dollar, the euro seems to have its own problems. European banks remain balkanized, with a patchwork of national regulators seeking to promote their own champions. European governments' debt may all be denominated in euros, but German and Italian debt are hardly the same thing, so the government euro-bond market lacks the depth and liquidity of the U.S. Treasury bill market.

If the eurozone can persuade Great Britain to become a full-fledged member, thereby acquiring one of the world's two premier financial centers (London), the euro might really start to look like a viable alternative to the dollar.

Moreover, international investors can buy and sell real estate far more easily in the United States than in most of Europe. And the absence of a Europe-wide fiscal policy creates significant uncertainty about how the European Central Bank would finance itself if it suddenly faced large losses on junk bank debt after a big bailout.

But the euro does have growing strengths. At current market exchange rates, the European Union is now larger economically than the United States. New central and eastern European members are bringing enormous dynamism and flexibility. At the same time, the European Central Bank has gained considerable credibility from its handling of the global credit crisis. Indeed, if the eurozone can persuade Great Britain to become a full-fledged member, thereby acquiring one of the world's two premier financial centers (London), the euro might really start to look like a viable alternative to the dollar.

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World currency standards have enormous inertia. The British pound only forfeited its role to the U.S. dollar after more than fifty years of industrial decline and two world wars. But the dollar's demise could happen a lot faster. As central bankers and finance ministers ponder how to intervene to prop up the dollar, they should also start thinking about what to do when the time comes to pull the plug. ◆