Dollar Supremacy Illusion

Its cracks are visible. Its global role is mainly due to lack of an alternative. But will that continue?

BY JØRGEN ØRSTRØM MØLLER

The uncertainty about the U.S. debt ceiling and the depreciation of the U.S. dollar versus other major currencies raise the prospect of currency turmoil later this year. Something that may spell the beginning of the end of the dollar's uncontested reign, albeit not its role as the most important international currency. A worst-case scenario is an economic crisis with a dramatic fall in global economic growth. U.S. lawmakers seem oblivious to the task they face: Redress the strong imbalances haunting the U.S. economy and manage the decline of the international role of the U.S. dollar. The Federal Reserve System also seems oblivious, mapping out a U.S.-only monetary policy.

In 1917, the U.S. Congress established a debt ceiling limiting federal government borrowing without Congressional authorization. There was bipartisan agreement, albeit with nuances, that the United States should live within its means; outlays not higher than what is received through revenues. The problem is that never has either party abided with that principle while in power. Instead, there has been broad agreement on two things: first, run a country while financing broadly speaking around 25 percent of GDP, and second, keep federal revenue a couple of percentage points below that figure. This circle could not and has never been squared. Lawmakers didn't want to do it. Instead, the debt ceiling has repeatedly been raised accompanied by bravado, political statements lamenting it, and choreography trying to hide the ghastly truth that the country was and is living beyond its means. Over the past fifty-three

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Jørgen Ørstrøm Møller is a former state-secretary for the Royal Danish Foreign Ministry and the author of Asia's Transformation: From Economic Globalization to Regionalization *(ISEAS, 2019) and* The Veil of Circumstance: Technology, Values, Dehumanization and the Future of Economics and Politics *(ISEAS, 2016).*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

years (since 1970), the federal budget has only been in surplus four times, and small surpluses at that.

Sixty years ago, the debt ceiling was fixed at US$305 billion (49.7 percent of GDP). Since then, it has been raised seventy-eight times, forty-nine under a Republican president and twenty-nine under a democratic president.

U.S. Secretary of Treasury Janet Yellen announced the need to raise the debt ceiling from its current level of US$31.4 trillion (133 percent of GDP). In other words, in sixty years the debt ceiling has gone from a level of half the U.S. GDP to more than two-and-a-half times the U.S. GDP.

Redress the strong imbalances haunting the U.S. economy and manage the decline of the international role of the U.S. dollar.

It is uncertain, however, that a solution will be found. If so, it will almost certainly be an interim one, authorizing the Biden administration to continue borrowing. And the deal will probably first be hammered out in the summer. If it doesn't happen, the United States will fry in its own fat, but unfortunately drag the rest of the world with it into the unappetizing stew.

The short-term alternative to a solution is a federal government shutdown. This has happened ten times since 1980 and twice with about 800,000 federal employees furloughed. After a short time, the debt ceiling was raised. This carousel has gone on with the United States and its economy surviving.

WHY SHOULD IT BE WORSE THIS TIME?

The U.S. political system has lived by heeding an utterance often attributed to President Abraham Lincoln: "You can fool all the people some of the time and some of the people all the time, but you cannot fool all the people all the time."

The United States cannot go on forever systematically underfinancing its public finances. Sooner or later the birds let loose will come to roost.

Every time a shutdown takes place, creditors question how safe is the money put into U.S. Treasury bonds. So far, the answer has been safe enough, but that is to a large degree due to the fact that the alternative is somewhat difficult to spot. Creditors have also been interested in underpinning the global economic role of the United States. That may still be true, but the eternal recurrence of the United States going around with its hat in its hand is testing creditors' willingness. Every year, the role of the United States as the ultimate consumer and ultimate importer becomes more and more precarious. It worked when the United States accounted for one-third of global GDP. Will it work when that share falls to 20 percent?

NET INTEREST BURDEN

There is a saying that the United States can just print money due to the role of the U.S. dollar as the global reserve currency; that is correct, up to a point. The caveat is that interest has to be paid every year. As of 2023, the net interest burden is a bit below 2 percent of GDP. In ten years' time it may be above 3 percent. This prognosis rests on benign assumptions about GDP growth and the size of interest rates. Only a few points to either side will produce a totally different picture. And the odds are that it will go the wrong way—lower growth and higher interest rates than used by forecasters.

In fact, the Congressional Budget Office backpedaled in November 2022 on its fairly rosy assumptions for the U.S. economy for 2023. Compared to its baseline assumption put forward in May 2022, GDP growth will be lower, unemployment higher, inflation higher, and the three-month Treasury bill rate almost double (3.4–5.6 percent compared 2 percent). For 2023, the deficit on the federal budget is estimated to be between 20 percent and 30 percent higher than forecast in May 2022, and for 2024 (more uncertain) between 20 percent and 46 percent higher. CBO says that "increases in net interest costs in almost every case are the primary contributor to greater deficits." It is an omen of what is in store for the United States and the

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U.S. dollar. The market will be flooded with Treasuries. Will they be bought, and if so by who and at what price?

With rising debt putting more Treasury bonds on the market, it is possible, maybe even likely, that creditors will ask for a higher price to bail the United States out. With a higher interest rate and even more so a lower growth rate, the net interest burden may go up to 4 percent. To put that in perspective, the United States spends every year a bit above 3 percent on national defense. It is perfectly possible that in 2033, the United States will spend more on its net interest burden than on defense. And it is almost certain that this will be the case beyond 2040.

WHO IS BAILING THE UNITED STATES OUT?

The current account has been in deficit since 1980, only showing a surplus once, running up an accumulated deficit of no less than US$56 trillion (almost three times current U.S. GDP).

The current picture is not exactly rosy. According to the World Bank, the deficit on the current account fell from 5.9 percent in 2006 to 2.1 percent in 2019. That was a remarkable improvement, but the situation didn't last. According to the U.S. Department of Commerce, from first quarter of 2020 until first quarter of 2022 the current account deficit went up to US$250 billion (4 percent of GDP), whereafter it has fallen slightly to US$217 billion (3.4 percent of GDP).

The brutal fact is that the United States is dependent on overseas creditors. Foreign creditors have the capability to create havoc in U.S. financial markets. They have not done so because it is not in their interest, but what happens if things change and it does become in their interest? Purely economic analysis may show that such a turnaround in expectations is unlikely, but overlooks that some foreign creditors may integrate non-economic factors in their policies. For geopolitical reasons, they may wish to harm the United States and swallow an economic price for doing so. The United States did not hesitate to weaponize its control of global finances against Russia. Fine. But countries not friendly to the United States may take a leaf out of that manual and contemplate tit-for-tat. The saying "people who live in glass houses shouldn't throw stones" may enter global finances and the role of the U.S. dollar.

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As of 2021, according to the World Bank, the United States ran a deficit of US$846 billion. For 2022, the deficit reached a record high of US$948.1 billion, equal to 4 percent of GDP. The main five surplus countries to finance this deficit (2021 figures) are China (US$317 billion without counting Hong Kong's US$41 billion), Germany (US$313 billion), Japan (US$157 billion), Russia (US$122 billion), and Korea (US$88 billion). The amount of U.S. Treasuries held by foreigners is US$7,273.6 billion. The biggest overseas holders acccording to U.S. Treasury statistics are Japan with US$1,082.2 billion (a fall of 18.5. percent from November 2021 to November 2022) and China with US$870.7 billion (a fall of 19.4 percent from November 2021 to November 2022) plus Hong Kong with US$200.9 from November 2021 to November 2022 (a fall of 14.5 percent). The only country with a sizeable holding having increased its stock (3.8 percent) is the United Kingdom with US$645.8 billion. With all due respect, in view of this country's economy, it hardly looks like a major investor in the future.

U.S. DOLLAR AS A RESERVE CURRENCY

The U.S. dollar is still regarded as the king of the game. But is it? The International Monetary Fund recently disclosed figures showing that since 1999, a fall of more than 10 percent of total foreign exchange reserves—72 percent to 59 percent—has taken place. Its main competitor is the euro, which, with fluctuations, accounted for about 20 percent. Behind the veil the Chinese renminbi lurks, increasing steadily its share of foreign exchange reserves. It accounts for one-quarter of the shift out of the U.S. dollar and is held, not surprisingly, by Russia, Brazil, Switzerland, Mexico, Chile, and South Africa. And please take note. This is happening irrespective of its status as a non-convertible currency, meaning that it cannot be freely traded in spot and forward currency markets. One wonders what will happen if or when the renminbi shifts to convertibility, which may happen if some day—fortunately for the U.S. dollar not likely in the immediate future—the policy of managing the currency rate is abandoned.

The share of economies with a U.S. dollar anchor has declined slightly by 4-5 percentage points over the last twenty years; the fall gained pace after the financial crisis of 2008–2009.

SWIFT has revealed that in 2022, the renminbi competed with the yen for third place in international settlements, albeit still only 2–3 percent, compared to the U.S. dollar and the euro both at around 40 percent.

So far, a low-key potential competitor, while not necessarily replacing SWIFT, has been eating into its market share. It is called mBridge and is a platform for cross-border payments using distributed ledger technology. Among central banks participating are the People's Bank of China, the Hong Kong Monetary Authority, the Central Bank of the United Arab Emirates, and Bank of Thailand.

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In January 2023, Saudi Arabian Finance Minister Mohammed Al-Jadaan announced that the kingdom would be willing to discuss oil trade settlements in other currencies than the U.S. dollar, an idea floated by Chinese President Xi Jinping during his recent official visit. Recalling that the Saudi-Arabian currency, the riyal, is pegged to the U.S. dollar, such a move, if it gains momentum, would be a serious challenge to the U.S. dollar. China and Russia have long worked to denounce the U.S. dollar in their bilateral trade. Some Central Asian countries have flirted with a shift to the renminbi—at least for some of their trade. India has also been on the prowl to market the rupee as a currency for trade, in particular involving India. How serious these flirtations are is difficult to gauge, but it is one more thread in the tapestry of the U.S. dollar starting to unravel.

THE EXCHANGE RATE AND BALANCE OF PAYMENTS

Over the last twenty-five years, the U.S. dollar index reached its highest real effective exchange rate in October 2022 with 112.98 (100 at 2020). The crucial observation is that it rose from 78 in 2011, which amounts to a hike of about 43 percent. This strong increase benefited the global economy. A large number of countries saw their competitiveness considerably enhanced, which served as some kind of manna from heaven considering the slump in domestic demand. The negative effect due to oil and some other resources traded in U.S. dollars does count heavily against this. For the United States, it aggravated imbalances visible over decades, but not addressed.

Now the roulette color has changed. Since October 2022, the U.S. dollar's real effective exchange rate has fallen close to 10 percent. That will significantly alter the outlook for 2023, not only for the United States, but for a large number of countries, indeed the global economy. It has fallen 11.5 percent *vis-à-vis* the euro and the 7.5 percent against the renminbi, denting the competitive advantage gained by the EU members and China. Figuring in the advantage enjoyed by the United States with lower energy prices, it should be enough to reconsider growth prospects, especially for the Europeans.

The special status of the U.S. dollar has allowed the United States to run significant deficits in its balance of payments, which were easily financed by selling Treasury bonds. It is unlikely that this carousel can go on indefinitely as the U.S. economy is harassed by imbalance, indicating that it is out of tune with reality.

COMMITMENTS OUT OF TUNE WITH CAPACITIES

The imbalances and weaknesses of the U.S. economy are one thing. Another is that they grow at a time when the United States faces rising and crucial challenges. The political system has been described as dysfunctional. America takes on more and more costly responsibilities on a global stage including assistance to Ukraine and a costly posture versus China over Taiwan. These are only sustainable because creditors, including China, are willing to bail it out. At the time when the United States was strong, with bipartisan agreement about major foreign policies issues and a coherent country, the economic weaknesses may have been put aside. But the decline in its ability to govern itself aggravates the risk of some kind of an economic crisis. Maybe, as several times in the past, this is a false cry of wolf, but at the end of Aesop's fable the wolf actually comes and eats all the sheep. ◆