The Global Implications *of a* Dollar Collapse

BY SAMUEL BRITTAN

The dean of London's journalistic/financial strategy community sets the table.

When asked to write about the global implications of a serious dollar collapse, I accepted with alacrity as a refreshing change from the usual question about if and when such an event will occur. Anyone can recite the bald fact of the United States heading towards a current account deficit equivalent to 7.5 percent of GDP, now mostly financed by the accumulation of dollar reserve assets by Asian and other monetary authorities.

But the truth is that we do not know how long this state of affairs can, will, or should continue. The predictions provided are usually a matter of temperament. They reflect partly their authors' instinctive pessimism or optimism, and also whether the author is inclined to give market forces the benefit of the doubt or is happier with a managerial type of world capitalism which central bankers, finance ministries, and their economic advisers attempt to regulate.

Asking about the implications of a dollar collapse takes us into a different ballgame. Instead of hopeless crystal gazing, we can ask what such an event would mean and what kind of policy should be adopted in

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

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response. Such a hypothetical exercise has something in common with the hypothetical narratives in which speculative historians have indulged. Suppose that the assassin's bullet had missed the Austrian Archduke in Sarajevo in 1914. Or, to take a narrower but more promising question: Suppose that Britain had stayed out of World War I, which it came nearer to doing than popularly imagined. This is indeed the question that Professor Niall Ferguson has investigated in his book *The Pity of War*.

The exercise I have in mind is more like the "scenarios" pioneered by Royal-Dutch Shell economists than the "simulations" of the econometricians. Indeed, at one time the rush of disillusioned forecasters to emulate Shell was so great that the word "scenario" was banned from appearing in the *Financial Times*.

Economic scenarios differ from counterfactual history in being concerned with the future rather than the past; and the time span of a potential dollar crisis is a good deal shorter than some of the corporate exercises which stretch ahead for decades and quarter centuries.

In early 2006, the British Treasury, the Bank of England, and the U.K.'s Financial Services Authority conducted an exercise together with their European Union partners in which they reacted to some hypothetical threat to financial stability, arising for instance from a collapse somewhere in the system. I am told that the exercise produced satisfactory results; but as the details have not been published I can give no supporting evidence.

Such exercises have not always achieved official approval. When I wrote a book on the British Treasury in the 1960s, I originally intended to include a chapter on how the British authorities would react to a sudden run on the sterling. I knew that a direct approach would not be appreciated. So I wrote a dummy chapter on the basis of general knowledge and the positions that various people held, in the hope that this would stimulate officials to correct and improve my account. In fact the Treasury, with whom I had a loose but intermittently friendly working relationship on the rest of the book, was absolutely horrified and informed me that the Bank of England's reaction would be indescribably more severe. At that time the Bank regarded itself as socially superior to mere civil servants who had reached their position by competitive examinations; and even the highest Treasury officials did not dare show my draft to the Bank. So despite the urgings of my brother Leon, who had not yet become a senior Conservative statesman, I reluctantly dropped the chapter. There should be no such inhibition on the analysis of a hypothetical future event when both the dollar and sterling enjoy a floating rate of exchange.

There are, however, other difficulties. What, for instance, constitutes a "serious dollar collapse"? Is it a fall of 5 percent or 10 percent, 20 percent or 40 percent? And in terms of what index? A good deal would depend upon whether the drop was concentrated into a few days or spread out over weeks and months. It is an unfortunate aspect of both financial commentary and journalism that a 5 percent movement up or down in any key variable in one day would create huge excitement, whereas a much bigger movement spread gradually over a couple of months, with many temporary reversals of direction, may hardly be noticed by day-to-day commentators.

The broad trade-weighted dollar index had already fallen by 20 percent from its 2002 peak by the end of 2005. The most sober advocates of a balance of payments policy, such as the Institute for

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Jacques Chirac

If the Dollar Collapsed…

One result could be an offsetting boost given to demand in the euro area and in Asia. At the other extreme, the United States would be accused of deliberately weakening its own currency for domestic political reasons; and politicians like **President Chirac** of France—if still in office—would be amenable to ideas for retaliation, whether raising protectionist barriers, attempts at competitive devaluation, or ill-conceived taxes on international capital movements.

—S. Brittan

International Economics in Washington, advocate a planned further 20 percent depreciation, internationally agreed upon and with accompanying domestic measures (W. R. Cline, *The United States as a Debtor Nation,* 2005). To fix ideas, let us define a dollar collapse as a dollar depreciation of at least 20 percent, but occurring within a short period of weeks, triggered by market movements rather than internationally coordinated policies, and accompanied by frenzied discussion of whether the "bottom was dropping out" of the market. Initially the drop would be mostly against the euro, but such a drastic fall in the dollar's external value could well be the signal for Asian authorities to cease stockpiling assets and even start dumping them. Then the U.S. Administration would learn the truth of the old Chinese proverb, "Be careful what you wish for. It may be granted."

Most important, however, are the circumstances in which the crash occurs. The assassination of the Austrian Archduke might have had a very different effect if not for the prior arms race of the European Great Powers who were already grouped in a competitive system of alliances. But as someone who has been somewhat skeptical of the current talk of international imbalances and even more skeptical of some of the supposed remedies, maybe I will be forgiven if I begin with a benign scenario.

At the time of writing, the most likely trigger for a dollar collapse would be a collapse—or perhaps just stagnation—of the U.S. housing market. This would hit the dollar in several different ways. Much of the inflow of short-term and central banking funds to the United States is predicated on the assumption that the United States will continue to be a rapidly growing economy. A few quarters in which U.S. GDP grows slowly or even falls could easily deter many fund holders who are incurable short-term operators. There would be other effects as well. A housing setback would be likely to trigger a setback to U.S. consumer spending. This would make the Fed pause or even reverse its present policy of gradually inching higher on short-term interest rates. Well before he became Fed chairman, Professor Ben Bernanke insisted that the Fed could stop a deflationary spiral, but the means of doing so—involving cheaper money and even helping to fund the Federal Budget—would put further downward pressure on the dollar.

So both the immediate economic prospects and the behavior of international interest rate differentials would be bearish for the dollar. And even without the Fed and U.S. Treasury doing anything very special, the bond market would decline and both real and nominal long-term interest rates rise, thus contributing further to the recessionary impact. Nevertheless, the results for the U.S. economy need not be entirely adverse. The whole scenario starts with the weakening of the domestic economy. In these circumstances, the depreciation of the dollar would provide an offsetting external stimulus. But it does mean that the U.S. economy could not continue growing each quarter at an annualized 3 to 4 percent rate. A major shift of resources from supplying domestic demand of consumers to supplying external markets or providing import substitutes could not take place without some dislocation and a domestic slowdown.

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How severe that would be would depend partly on developments in the rest of the world. According to the Fabian Benthamite view of government, in which so many international economists still believe, instead of retaliation, an offsetting boost would be given to demand in the euro area and in Asia. At the other extreme the United States would be accused of deliberately weakening its own currency for domestic political reasons; and politicians like President Chirac of France—if still in office—would be amenable to ideas for retaliation, whether raising protectionist barriers, attempts at competitive devaluation, or ill-conceived taxes on international capital movements.

More likely than either of these extremes is that dollar depreciation might come at a time when the rest of the world is still enjoying an economic upsurge along the lines predicted by the International Monetary Fund, the OECD, and similar organizations. In that case it would not be such a tragedy if Europe or Asia failed to take offsetting demand boosting measures. Indeed, if the world is experiencing excess demand, as the pressure on oil and commodity markets and the abundance of credit suggest, a modest recessionary movement in the United States might be just what the doctor ordered.

It follows from this that if there is to be a dollar crash, the sooner the better. Retaliation and perverse reaction would be less likely while Europe and Asia are enjoying an upsurge than later on when these other parts of the world may be slowing down or in recession.

But I must say a bit more to satisfy the demand for pessimism. So far I have been dealing with normal economic conjunctures if on a larger scale then normal. But really worrying developments would occur if the price of oil, so far from falling back as optimists suggest, were to rise to $100 or more. This could happen without any dramatic political moves simply because the production of oil, gas, and key raw materials could not keep up with world demand. In the past the inflationary trigger was often provided in many countries by the labor market- and trade union-inspired wage push which was a signal that demand was excessive in the prevailing institutional structure. There is now much less danger on the labor front—for all the obvious reasons due to a combination of international competition and weakening of unionization—but the constraint on growth could come from other parts of the supply side. Central banks might then have to rein in demand even while there was a physical surplus of industrial capacity and little sign of over-full employment. This would basically be a world problem rather than just a U.S. one. But the dollar could be more severely affected because U.S. energy imports are much greater per dollar of GDP than for other parts of the developed world except Japan.

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The worse scenario goes well beyond conventional economics and would occur if for instance the Straits of Hormuz at the mouth of the Persian Gulf were to be closed. The action would then move to the political and military front. But the world financial community could be forgiven if it reacted with a horse laugh to any Pentagon talk of a quick, clean strike to reopen the Straits.

In these circumstances the dollar would be the least of our worries. As in past such crises, one might expect a shift from currencies into gold, land, jewelry, cowrie shells, and other such assets. But for what it is worth the dollar would be likely to suffer relative to the euro and sterling, thus creating in a more severe form the problems already discussed in relationship to the more benign kind of crisis. ◆