Get Out While You Can

BY JØRGEN ØRSTRØM MØLLER

Why the U.S. dollar is doomed.

A reserve currency grows out of the strongest, largest, and most dynamic national economy spreading its wings over the global financial market. This is how the British pound sterling worked before 1914 and it is how the U.S. dollar has worked since 1945.

Other countries were ready to accumulate pounds and later dollars because they constituted a claim on British or American production or opened the door to invest in their companies. These two countries were—in the respective periods—the biggest economies with products in demand, envied by the rest of the world. Until about 1960, the key term in international economics was "dollar shortage." There was no hesitation in accumulating dollars because they were not hanging suspended in free air, but anchored in the real U.S. economy.

What happened to the United States over the last two or three decades (and to Britain after 1918) was a decoupling from the real economy. The rest of the world no longer wanted to buy American production, resulting in a high, persistent, and growing deficit in the balance of payments, and the incentive to buy American production was overshadowed by the drive of U.S. industry to invest abroad.

Even if the U.S. economy had lost its lure, foreigners might still be tempted to hold dollars if they were looked upon as some kind of global legal tender perceived in the sense of a generally accepted vehicle for settling payments.

For that to be the case, there needs to be confidence in a stable purchasing power. Nobody wants to accumulate a currency if they fear that some years down the road the purchasing power will deliver a smaller amount of goods and services than originally available.

U.S. economic policy has undermined that confidence. At the beginning of 2010, U.S. foreign debt is the same size as U.S. GDP. Even worse, total debt run up by U.S. pri-

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vate, business, and public sectors over the fat years amounts to almost 400 percent of GDP. Net interest on public debt accounts for approximately 7 percent of the federal budget, and according to optimistic forecasts will rise to approximately 20 percent in 2020. It seems almost inconceivable that a debt of that magnitude can be sustained. This leaves three options. The first is to service the debt by raising taxes, resulting in sluggish economic growth. The second is to introduce a levy on the yield flowing from Treasury bonds, hurting—deliberately—the creditors. The third is to print money, asking inflation to do the dirty job of making inroads into the real value of claims on the United States. None of these options appeals to the creditors. The signal is quite the contrary: get out while you can.

This spells doom for the U.S. dollar as the dominant reserve currency. How will the game unravel?

It will start with questioning of the role of the U.S. dollar as the unit of account for international trade in oil, gold, and commodities. Logically, these goods were denominated in dollars as long as the United States was the main buyer, but that now ceases to be the case. The first step to dismantling the U.S. dollar will be switching to an international unit of account composed of a number of currencies, a so-called basket of currencies like the Special Drawing Rights used by the International Monetary Fund. Currently, a group of oil-exporting countries contemplates just such a step.

For suppliers of commodities and purchasers except the United States, the effect of a shift away from the dollar will be price fluctuations less dependent upon the U.S. economy and more in tune with the global economy. For the United States, this will be one more straw on the back of the camel. The U.S. economy has been shielded from the effect on commodity prices of dollar fluctuations. A unit of account other than the U.S. dollar will remove that anomaly and allow fluctuations in commodity prices when the dollar moves on the currency markets to spill over into inflation, competitiveness, and wages. The United States is totally unaware of what that means, never having been exposed to it, and equally unprepared to deal with this further limitation of maneuvering room in economic policy.

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Next will come a switch out of passive investments in the U.S. dollar such as Treasury bonds. Contrary to much discussion, the alternative to the dollar is not other currencies. There are no obvious candidates. Neither the European nor the Japanese economies radiate more strength and inspire more confidence than the U.S. economy, so why should creditors want to replace one currency of dubious value with another equally dubious? Instead, creditors increasingly will put their money into oil, gold, and commodities and stock markets. By so doing, they will cast off their dependence on U.S. economic policy. These assets will be classified as safe investments. Commodity prices will be presumed to be on an upward curve, and stocks, representing not debt but a claim on future production, will trump bonds.

The uncertainty of the U.S. dollar implies not so much a move away from dollar-denominated assets as a switch into assets not dependent upon the U.S. government, the Federal Reserve System, and the policies they implement. What matters is not the currency label, but the character of the asset. Recent price levels for the assets mentioned above disclose that many creditors are following such a course, which is a bad omen for future bond markets.

Another unit of account will gradually take over in international financial transactions, crowding out the U.S. dollar. Companies will loan and borrow in SDRs and publicize their annual statements in SDRs. This can easily be done without an actual SDR currency being used. It reflects that with a less-important U.S. economy, it is not worthwhile to own claims on U.S. production or investment opportunities, which are not in demand, but claims on global production and investment opportunities.

The ultimate step in the decline of the U.S. dollar will take place if or when creditors feel that another economy has grown sufficiently strong to offer what the British economy did before 1914 and the U.S. economy did after 1945: namely, incomparable goods, services, and investment opportunities. It appears likely, but is by no means certain, that the Chinese economy may get there by the middle of this century.

Meanwhile, we all have to muddle through as best we can. ◆