

# Free exchange | It's been a privilege

As America grows weary of dollar dominance, the world grows nervous

**T**RUMPISM is in part an expression of American exhaustion at bearing burdens it first took up 70 years ago. Donald Trump has moaned less about the dollar than about shirking NATO allies or cheating trade partners. Yet the dollar standard is one of the most vulnerable pillars of global stability. And the world is far from ready for America to ditch its global financial role.

Unlike other aspects of American hegemony, the dollar has grown more important as the world has globalised, not less. In the Bretton Woods system devised for the post-war world, Western economies fixed their exchange rates to the dollar, which was in turn pegged to the price of gold. After the fracturing of this system under the inflationary pressures of the 1970s, the dollar became more central than ever. As economies opened their capital markets in the 1980s and 1990s, global capital flows surged. Yet most governments sought exchange-rate stability amid the sloshing tides of money. They managed their exchange rates using massive piles of foreign-exchange reserves (see chart). Global reserves have grown from under \$1trn in the 1980s to more than \$10trn today.

Dollar-denominated assets account for much of those reserves. Governments worry more about big swings in the dollar than in other currencies; trade is often conducted in dollar terms; and firms and governments owe roughly \$10trn in dollar-denominated debt. New research by Ethan Ilzetzki, of the London School of Economics, and Carmen Reinhart and Kenneth Rogoff, of Harvard University, concludes that the dollar is, on some measures, more central to the global system now than it was immediately after the second world war. It remains the world's principal "anchor" currency, against which others seek to limit volatility.

America wields enormous financial power as a result. It can wreak havoc by withholding supplies of dollars in a crisis. When the Federal Reserve tweaks monetary policy, the effects ripple across the global economy. Hélène Rey of the London Business School argues that, despite their reserve holdings, many economies have lost full control over their domestic monetary policy, because of the effect of Fed policy on global appetite for risk.

Leaders of other economies bristle at this. During the heyday of Bretton Woods, Valéry Giscard d'Estaing, a French finance minister (later president), complained about the "exorbitant privilege" enjoyed by the issuer of the world's reserve currency. America's return on its foreign assets is markedly higher than the return foreign investors earn on their American assets (foreign govern-

ments hold vast amounts of safe but low-yielding dollar assets, like Treasury bonds, as reserves). That flow of investment income allows America to run persistent current-account deficits—to buy more than it produces year after year, decade after decade.

This has become a privilege America seems eager to discard. An overvalued currency and persistent trade deficits are fine for America's consumers, but painful for its producers. The reserve accumulation of the past two decades has gone hand-in-hand with a soaring current-account deficit in America. Imports have grown faster than exports; new jobs in exporting industries have not appeared in numbers great enough to absorb workers displaced by increased foreign competition. Tariffs cannot fix this problem. The current-account gap is a product of underlying financial flows, and taxing imports will simply cause the dollar to rise in an offsetting fashion.

America's privilege also increases inequality, since lost jobs in factories hurt workers while outside investment performance benefits richer Americans with big portfolios. Because the rich are less inclined to spend an extra dollar than the typical worker, this shift in resources creates weakness in American demand—and sluggish economic growth—except when consumer debt rises as the rich lend their purchasing power to the rest.

Chalk the headaches generated by low interest rates up to the dollar standard, too. Some economists reckon they reflect global appetite outstripping the supply of the safe assets America is uniquely equipped to provide—dollar-denominated government bonds. As the price of safe bonds rises, rates on those bonds fall close to zero, leaving central banks with ever less room to stimulate their economies when they run into trouble.

## A new golden age

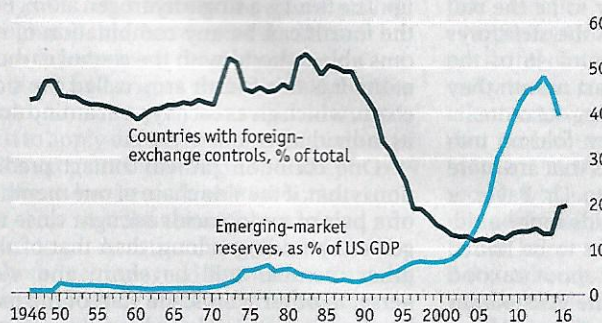
A benign solution seems obvious: the dollar should share its role with other currencies. But one candidate to share the load—China's yuan—is inhibited by tight limits on Chinese financial markets. Nor is increased dependence on China an attractive option for governments seeking to reduce their exposure to authoritarian-minded, transparency-averse regimes with unclear motives. The role of the euro, the other logical option, is constrained by existential political risk and the scarcity of safe euro-denominated bonds. What is more, the world's big economies have much to lose from an end to American monetary hegemony. Their politically convenient trade surpluses for one; the value of the enormous piles of dollar-denominated assets for another.

History suggests two ways in which Mr Trump might undermine the dollar's role. Bretton Woods broke apart as a result of a fatal flaw: governments were desperate for dollars, but in creating more of them America fanned inflation, which made its gold peg unsustainable. Similarly, should Mr Trump's efforts to make America great again through tax cuts and spending lead to ever larger budget deficits and rising inflation, American assets might lose their lustre. America might resemble the 1970s again: with soaring prices and interest rates, but free of its exorbitant burden.

Alternatively, the dollar might go the way of the inter-war gold standard. That collapsed amid a breakdown in international co-operation, as governments of uncompetitive economies put up tariffs and then withdrew from the system altogether through the erection of capital controls. It would be tragic if history's lessons were forgotten and had to be learned all over again. ■

## The cost of freedom

Exchange-rate management



Sources: IMF; Bureau of Economic Analysis