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A Dollar Standard That the World Loves to Hate

By Ronald McKinnon

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Since World War II's end, the U.S. dollar has been used to invoice most global trade, serving as the intermediary currency for clearing international payments among banks and dominating official foreign exchange reserves. This arrangement has often been criticized, but is there any viable alternative?

The problem for post-World War II Europe, mired in depression and inflation, was that it lacked foreign reserves, which meant that trade carried a high opportunity cost. To facilitate trade without requiring payment after each transaction, the Organization for European Economic Cooperation created the European Payments Union, or EPU, in 1950. Supported by a dollar-denominated line of credit, the EPU's 15 Western European member states established exact dollar exchange-rate parities as a prelude to anchoring their domestic price levels and removing all currency restrictions on intra-European trade.

Today, most developing economies, with the exception of a few Eastern European countries, still choose to anchor their domestic macroeconomic arrangements by stabilizing their exchange rates against the dollar, at least intermittently. Meanwhile, to avoid exchange-rate conflict, the U.S. Federal Reserve typically stays out of the currency markets.

But the dollar's role as international anchor is beginning to falter, as emerging markets everywhere grow increasingly frustrated by the Federal Reserve's near-zero interest-rate policy, which has caused a flood of "hot" capital inflows from the U.S. That, in turn, has fueled sharp exchange-rate appreciation and a loss of international competitiveness — unless the affected central banks intervene to buy dollars.

Indeed, since late 2003, when the Federal Reserve first cut interest rates to 1 percent, triggering the U.S. housing bubble, dollar reserves in emerging markets have increased six-fold, reaching $7 trillion by 2011. The resulting expansion in emerging markets' monetary base has led to much higher inflation in these countries than in the U.S. It has also led to global commodity-price bubbles, particularly for oil and staple foods.

But the U.S. is also unhappy with the way the dollar standard is functioning. Whereas other countries can choose to intervene to stabilize their exchange rates with the world's principal reserve currency, the U.S., to maintain consistency in rate setting, can't intervene and lacks its own exchange-rate policy.

Moreover, the U.S. protests other countries' exchange-rate policies. Two decades ago, Washington pressed the Japanese to allow the yen to strengthen against the dollar, claiming that Japan's unfair exchange-rate policies were responsible for the United States' ballooning bilateral trade deficit. Likewise, today's "China-bashing" in the U.S., which has intensified as China's contribution to the U.S. trade deficit has soared, is intended to force the Chinese authorities to allow faster yuan appreciation.

Herein lies the great paradox. Although no one likes the dollar standard, governments and private market participants still consider it the best option.

In fact, U.S. trade deficits are primarily the result of insufficient, mainly government, saving — not a misaligned exchange rate, as economists have led policymakers to believe. Large U.S. budget deficits during Ronald Reagan's presidency generated the famous twin fiscal and trade deficits of the 1980s. This, not an undervalued yen, caused the bilateral deficit with Japan to widen in the 1980s and 1990s.

The much larger U.S. fiscal deficits of the new millennium, courtesy of Presidents George W. Bush and Barack Obama, portend large, indefinite trade deficits. But U.S. policymakers continue to blame China, claiming that the yuan has been undervalued for the last decade.

The claim that exchange-rate appreciation will reduce a country's trade surplus is false, because in globally integrated economies, domestic investment falls when the exchange rate appreciates. So the ill will that China-bashing is generating is for nothing. Worse, it detracts political attention from the United States' huge fiscal deficit — $1.2 trillion in 2012.

Some contend that large fiscal deficits do not matter if the U.S. can exploit its central position under the dollar standard — that is, if it finances its deficits by selling Treasury bonds to foreign central banks at near-zero interest rates. But the United States' ongoing trade deficits with highly industrialized countries, particularly in Asia, are accelerating deindustrialization in the U.S., while providing fodder for U.S. protectionists.

Can large U.S. fiscal deficits and near-zero interest rates be justified because they help to revive domestic economic growth and job creation? Five years after the credit crunch of 2007-08, it seems that they cannot. Without even that justification, the latest wave of criticism of the U.S. dollar standard appears set to rise further — and to stimulate the search for a "new" arrangement.

But the best new arrangement would follow an old formula. As in the 1950s and 1960s, the U.S. would set moderately positive and stable interest rates with sufficient domestic saving to generate a small trade surplus. The cooperation of China, now the world's largest exporter and U.S. creditor, is essential for easing and encouraging the transition to this nirvana. Apart from the ongoing euro crisis, a stable yuan-dollar exchange rate is the key to renewed dollar exchange-rate stability throughout Asia and Latin America, which was envisaged in the original 1944 Bretton Woods Agreement.

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