Question mark over US dollar's global role

Nick Beams 8 December 2004

As the US dollar continues its fall on currency markets, questions are starting to be asked about its role as the world's dominant international reserve currency. This was the subject of an article in the December 2 edition of the *Economist* entitled "The passing of the buck?"

It began by noting that since the middle of October the dollar has fallen by around 7 percent against other main currencies, hitting an all-time low against the euro and a five-year low against the yen. Since its peak in February 2002 the dollar has lost 35 percent against the euro and 17 percent against a broad range of currencies.

This decline has brought warnings that foreign investors and central banks may begin to move out of dollar assets and led economists to "ponder the once unthinkable: might the dollar lose its reserve-currency status?"

Noting that the dollar's share of foreign exchange reserves has already fallen from 80 percent in the mid-1970s to around 65 percent today, the *Economist* pointed out that questions about the dollar's role were raised in the early 1990s, but its pre-eminence survived. However at that time there was no alternative. Today one exists in the form of the euro.

"The requirements of a reserve currency are a large economy, open and deep financial markets, low inflation and confidence in the value of the currency. At current exchange rates the euro area's economy is not that much smaller than America's; the euro area is also the world's biggest exporter; and since the creation of the single currency, European financial markets have become deeper and more liquid. It is true that the euro area has had slower real GDP (gross domestic product) growth than America. But in dollar terms the euro area's economic weight has actually grown relative to America's over the past five years."

Over the longer term the dollar's biggest failure has been as a store of value. Since 1960 it has fallen by around two thirds against the euro (using the German currency as a proxy for the years prior to 1999 when the euro was established) and the Japanese yen. "The euro area, unlike America, is a net creditor. Never before has the guardian of the world's main reserve currency been its biggest net debtor. And a debtor may be tempted to use devaluation to reduce its external deficit—hardly a desirable property for a reserve currency."

The *Economist* dismissed a series of arguments that America's balance of payments deficit, and the \$2.6 billion a day capital inflow needed to finance it, do not signify a growing weakness that threatens the dollar's reserve currency status.

Contrary to the claim, favoured by the US Treasury, that the capital inflow into the US reflects the higher returns on investment in the American market, the magazine pointed out that, while there may have been some truth to the argument in the late 1990s, it was no longer the case. There has been a net outflow of long-term direct and equity investment over the past year and in the past few years America has had lower returns on foreign direct investment, equities and bonds than Europe or Japan.

"The current-account deficit is now being financed by foreign central banks and short-term money. In the year to mid-2004, foreign central banks financed as much as three-fifths of America's deficit. The recent purchase of reserves by central banks is unprecedented. Global foreign-exchange reserves ... have risen by \$1 trillion in just 18 months. The previous addition of \$1 trillion to official reserves took a decade. These reserves have nothing to do with the prospective returns in America, but are aimed at holding down the currencies of the purchasing countries."

Another frequently advanced argument is that America's balance of payments and debt position would improve if only demand increased in the rest of the world, especially Europe and Japan. But this ignores the fact that in 2001 when domestic demand in Europe and Japan grew slightly faster than in the US, the deficit barely moved. With imports already 50 percent higher than exports, exports need to increase at one and a half times the rate of imports just to prevent the deficit from growing.

Recently the claim has been made that the American deficit is not a problem because the financial system has evolved into a new version of the post-war Bretton Woods system of fixed exchange rates, in which Asian central banks buy US dollars in order to push down the value of their own currencies and so retain export markets.

But this argument ignores the fact that under the Bretton Woods system, the US ran a current account surplus and the value of the dollar was pegged to gold. The present system is only able to continue so long as Asian banks keep purchasing dollars, exposing themselves to ever-greater risk of massive losses in terms of their own currency should the dollar experience a sharp fall.

The *Economist* noted that while the marked fall in the US dollar in the late 1980s had few ill effects on the economy, there is more cause for concern in the present situation. This is because the US current account deficit, running at close to 6 percent of GDP is almost twice as big as at its peak in the late 1980s and will keep widening. Furthermore, at that time the US was still a net creditor nation. Today it is the world's biggest debtor, with borrowing sucking in around 75 percent of the world's balance of payments surpluses and with foreign liabilities expected to reach \$3.3 trillion, or 28 percent of GDP, by the end of this year.



To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact