Global Policy Forum

Fall of the Dollar

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August 2003

The dollar has been losing value, weakening its status as the world's major currency and setting off jitters in the international financial system. The falling dollar is not just a technical matter for financial market experts: trillions of dollars in value have shifted in the course of about eighteen months, reducing the reserves of the world's central banks and knocking down the value of all US assets on the international marketplace. Analysts worry that a serious dollar selloff could create panic in the markets and lead to a global financial meltdown. Even if the worst-case is averted, a declining dollar may weaken the power of the United States, reorganize global markets and shift strategic power in the international system

After rising sharply against the Euro during 1999 and most of 2000, the dollar started to tumble in late 2001 and it continued its decline through mid-2003, losing more than a quarter of its value against the euro (see "The Dollar's Ebb and Flow"). After a brief rally in the summer, the dollar started another steep retreat that is likely to continue. Many financial analysts expected the dollar to weaken because of the growing US trade deficit on its "current account," which includes goods and services, income payments such as interest and dividends and unilateral transfers such as foreign aid and worker remittances (see chart). But few thought the dollar would fall so far and so fast.

Soaring Trade Deficits

The biggest single factor in the dollar's fall has been the soaring deficit in US trade. The United States imports far more than it exports in goods and services. US consumers have a strong appetite for Japanese automobiles, Chinese clothing, German machinery and Finnish mobile phones. Oil imports, by far the largest item, grow steadily. US companies are not able to export products and services of the same value. While Microsoft, Coca Cola, Boeing and Hollywood may wrack up large earnings and gain high visibility for US exports, they simply cannot match the foreign products and services purchased by US companies and consumers. In 2002, imports of goods and services totaled $1,652 billion, while exports amounted to only $1,203 billion. The difference is made up by net foreign lending and investments.

Historically, the United States did not always run a trade deficit. The US ran large trade surpluses for many decades, especially after World War II, when US exports faced little competition from war-torn Europe and Asia. Gradually, the trade balance shifted, though, as foreign economies grew, as foreign investments began to flow into the US and as US consumers bought more foreign goods and services. In the 1960s, imports of Japanese cameras and European cars began to grow, while jet aircraft spurred US tourism overseas. The huge international US military presence, swollen by the Vietnam war, added to the pressures on the US payments position, forcing Washington in 1971 to suspend conversion of the dollar into gold. Those were the first tremors. Then in the 1980s, as global trade grew and manufacturing migrated from the US to lower-cost lands, increasing deficits appeared. Imports from emerging low-cost export areas such as Mexico, Malaysia and China steadily widened the US trade gap. Today, China alone accounts for over $100 billion of the deficit, but rich exporters like Japan and the European Union run large surpluses with the United States as well.

The current account gap – and the foreign funds to pay for it – rose to a record $481 billion from $393 billion the previous year. In 2003, the deficit continued at the very high rate of $136 billion in the first quarter. Each business day, the US must attract about $2 billion in net lending and investments to pay for the trade gap and keep the economy afloat. Though some of the incoming investments promote long-term economic growth, most of the funds finance government deficits, contribute to stock speculation, or finance consumer credit lending. Some observers refer to this inflow as an international subsidy to US over-consumption, a kind of credit card for Uncle Sam. As global investors grew wary of the subsidy system and saw it as unsustainable, the dollar started its decline.

Beyond the Trade Deficit

Several other factors have influenced the fall of the dollar, magnifying the primary effect of the trade deficit. Firstly, the accounting scandals at Enron, Tyco, WorldCom and many other companies revealed serious weaknesses in the US reporting and regulatory system, leading to falling confidence in US stocks, bonds and other investments. Plunging values in these markets beginning in 2001, and the consequent enormous investment losses, further shook foreign investor confidence. As a result, foreign investors stopped sending a net inflow of investment funds into US markets. Instead, they began to liquidate their portfolios, causing a net funds outflow.

The sharp increase in US government budget deficits (see chart) also undermined investor confidence. After several years of government budget surpluses, the Bush administration cut taxes dramatically and increased military spending, setting off a deficit that is estimated to reach $455 billion in 2003 (up from $153 billion in 2002), making the 2003 deficit by far the largest on record. State and local governments have also run high deficits, further compounding the federal imbalances and pushing state and local debt to a historic high of over $1,400 billion in 2002 (see chart). US households have increased their debt (for houses, education and consumer spending) an unsustainable level of $8,454 billion in 2002 (see chart). An overinflated housing market destabilizes the US economy, since falling real estate prices could trigger widespread defaulting on these loans, pulling down banks and other mortgage lenders. Finally, there is the effect of Washington's unilateral global posture and its far-flung military operations, which introduce uncertainty about the future. These and other factors have combined to put powerful downward pressures on the dollar, pressures that are expected to continue well into the future.

What Kept the Dollar High?

In spite of weak fundamentals, the dollar remained very strong in the 1990s. The strong dollar worsened the current account balance by pricing US goods out of world markets, but somehow that didn't dampen the enthusiasm of investors and currency traders. The euphoric nineties can be explained by a number of special factors that temporarily kept the dollar high.

The US stock market bubble during the 1990s sucked in billions of dollars in foreign investments, as foreign companies and individuals hoped to ride rising stock prices to riches. Other world markets were rising as well, but given that US markets represent nearly half of total world market capitalization, they soaked up a proportionately large share of total world investment funds. Foreign investors also preferred US investments because they saw them as exceptionally dependable, safe from political risk and financial uncertainty. As the peso crisis, the Russian crisis and the Asian crisis eroded international financial stability and confidence, foreigners saw US investments as a reliable "safe haven" in a stormy era.

With the Japanese economy weak, the yen did not offer a strong alternative to the dollar, in spite of sizeable trade surpluses. Further, the movement towards a European single currency encountered many pitfalls. When the Euro was first introduced in early 1999, investors were doubtful about its viability, forcing it down steadily. Meanwhile, the US dollar's role as the world's reserve currency strengthened. Central banks worldwide hold various currencies as reserve assets, but the US dollar climbed from 57% of total reserves in 1995 to 68% in 1999. Use as reserves created demand for dollar-denominated investments, mainly US government Treasury securities.

The dollar also benefited from its function as the world's primary physical currency, used as legal tender in many countries outside the United States and circulating as parallel currency nearly everywhere. According to Federal Reserve estimates in 2003, of $680 billion of US currency in circulation, $400 billion was held outside the United States. Large international demand for US currency bills in the 1990s gave the US government a unique and inexpensive-to-produce export. According to press reports, Russians were so fond of the dollar that weekly airlifts from New York brought crates full of crisp new $100 bills to Moscow, fresh from US government printing presses. The US exported a net $24 billion in currency in 2001 and $22 billion in 2002.

Mysterious sources also pumped up the dollar. In the 1990s, US accounts included increasingly large sums on the income side that were entered as "adjustments" – that is, they were unaccounted for. These sums, believed by many to be capital flight from poor countries, siphoned into the US economy through offshore banking systems and possibly also through the direct importation of undeclared cash. Such sums, amounting to $21 billion in 2001 and no less than $46 billion in 2002, doubtless contributed to the financial crisis in many of the world's poorest countries.

Delusionary theories boosted the dollar as well. During the 1990s, many believed that a "new economy" had arrived and changed many of the old rules, making concern for old fashioned problems like trade imbalances immaterial in the new world of the internet. Such theories reassured dollar investors and gave them confidence even though market "fundamentals" gave cause for concern. Finally, when technology stocks began to plummet and the broad stock markets followed suit with huge declines, "new economy" theories lost credibility and investors discovered that "fundamentals" were very important after all.

If any other country had run such persistent payment imbalances, the International Monetary Fund would have stepped in and insisted on "structural adjustment" measures, such as government budget cuts, public pension reductions, and currency devaluations. In the case of the United States, however, the Washington-based IMF looked the other way and allowed the US to continue on its spendthrift ways. IMF complicity enabled the dollar â€˜bubble' to endure.

Warnings and Alarms

As US deficits worsened in the late 1990s, officials and economists began to take note. US Federal Reserve Chairman Alan Greenspan, in testimony to Congress on February 17, 2000, said bluntly that widening current account deficits and ever-larger foreign investments "cannot continue without limit." A sharp drop in the dollar-euro exchange in late 2000 seemed to be the beginning of a longer decline, but the dollar rallied again, fell again and rallied for the second time, peaking in March, 2002. Was the dollar impregnable? Some thought so. In early 2001, for instance, the *Federal Reserve Bank of Kansas City Economic Review* ran an article by Jill Holman, one of the bank's senior economists, who argued that the deficit was not alarming, that it was (contrary to Greenspan's remarks) "sustainable," and that it would probably decline over the next three years.

Concern did not go away, though. The respected Brookings Institution in Washington organized a special panel on March 29 and 30, 2001 that assembled leading economists to consider the deficit. Again, some participants shrugged off the negative numbers, arguing that the special status of the dollar as the world's reserve currency and other special factors offset pressures that the deficit caused. Richard Cooper of Harvard, however, warned that the Federal Reserve should be ready to intervene in the markets to stabilize the dollar and he referred unambiguously to a "significantly depreciated dollar" in the time ahead.

Alarm increased as the dollar began an even more sharp and continuous decline after April, 2002. The Financial Markets Center's 2nd Quarter 2002 publication *Flow of Funds* asserted that US growth depended "to an uncomfortable degree on ever-increasing inflows of foreign capital," and speculated that reducing that dependence could mean higher interest rates, debt defaults, and economic stagnation.

Foreign inflows of hundreds of billions of dollars per year came to the US from a variety of foreign sources – central banks, other government bodies, private banks and financial institutions, other large corporations, and, of course, private investors. They bought US government securities like Treasury Bills, as well as US stocks and bonds, and they made direct investments in real estate, factories and other tangible assets. Because of many previous decades of surplus, the United States economy continued to hold net international assets most years until 1983, when the account slipped permanently into the red (see chart). Since then, the negative numbers have moved up and down, but the long-term trend has been in a dangerous direction. By 2002, the US had accumulated net financial liabilities of $528 billion and overall liabilities of about $3 trillion. The crisis had truly arrived.

The long silent International Monetary Fund finally began to express concern. The Fund's *World Economic Outlook*, published at the time of the fall meetings of the Bretton Woods Institutions in September, 2002, warned that external trade deficits in several industrialized countries, most prominently the US and the UK, may present a problem for the world economy.

Implications of the Dollar's Decline

As the dollar has continued to fall, US authorities have not intervened to prop it up. Bush administration officials, including Treasury Secretary John Snow, have said that they welcome the decline of the dollar and have made it clear that they are abandoning the previous "strong dollar" policy. In early May, 2003, Snow noted that a weaker dollar was helping US exporters, putting a squeeze on US trade partners and potentially stabilizing the US balance of payments. But such arguments seem implausible. Instead, it seems that the administration has been caught in a financial crisis for which it had no plan and no ready solution. The dollar's fall will reduce the huge international subsidy enjoyed for two decades by the US economy, ultimately shrinking the standard of living of US citizens. At the same time, falling US demand for imports will likely harm economies everywhere else and set off further currency devaluations, trade pressures and financial instabilities -- all with dangerous consequences.

We must ask: What will be the effect of a crumbling dollar on the US stock markets and other investment vehicles, as foreigners withdraw their funds out of fear that the dollar may fall further? And how may this all affect US foreign policy, Washington's enormous military apparatus, and the costs of campaigns in Afghanistan, Iraq and elsewhere?

The US can scarcely prevail as the global superpower if its economic fundamentals are weak. Britain's two hundred years of global supremacy were based on a strong currency, a large trade surplus and growing foreign investments. Trade decline in the late nineteenth and early twentieth century gave a clear sign that Britain's empire was on the wane. Today's trade and payments deficits, and the falling dollar, may point in the very same direction for the global order based on US dominance.

See Global Policy Forum's charts and tables on the US current account deficit and US government budget deficit.