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The Dilemma of the Dollar

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The recent decline of the dollar against major currencies such as the euro and the Japanese yen has been spectacular. Even more spectacular, but often forgotten, is the long-run decline of the dollar against the major currencies in the world. Since 1960 the currency has lost two-thirds of its value against the Japanese yen, the Swiss franc and the German mark (since 1999, the euro).

The long-term decline of the dollar appears to be quite surprising especially considering that at least since the early 1990s the US has been seen to produce superior economic results, i.e. a higher productivity growth than most of Europe and Japan with more or less the same rates of inflation. Yet despite the appearance of superior economic performance, the dollar has gone on losing value against currencies of countries deemed to have an inferior economic system. Where does this paradox come from?

My explanation is based on the existence of a dilemma for a world currency. The world (especially in Asia) has been rapidly growing fast over the past 25 years, and will continue to do so. A fast-growing world economy is in need of lots of liquidity. World liquidity must be provided by the world currency. There is only one currency that provides this function and that is the dollar.

The dilemma for the US authorities now pops up in the following way. The US monetary authorities pursue a policy aimed at keeping inflation low. It's not an explicit inflation target a s in the case of the UK or the eurozone, but it is certainly an implicit one. This implicit inflation target is close to 2%, which implies that when the Federal Reserve issues dollars it gives an implicit promise that these dollars will buy a basket of US goods and services that is approximately constant (i.e. declines by only 2% per year). Given that the US economy grows on average at a rate of close to 3% per year, this implies that the yearly increase in the supply of dollars should be close to 5% (2% inflation plus 3% economic growth).

This commitment to price stability, however, conflicts with the international role of the dollar. The worldwide demand for dollars increases at yearly rates that by far exceed the 5% money supply growth rate that will keep prices in the US approximately stable.

Thus, the US monetary authorities have to choose between a policy that accommodates the high demand for dollars in the world, but one in which the supply of dollars will increase much faster, over one that will maintain the approximate price stability in the US. Alternatively, the US can stick to the inflation target, but this requires limiting the supply of dollars to a much lower level, frustrating the high demand for dollars worldwide.

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This situation resembles the dilemma that existed during the period of the gold-dollar standard in the 1960s. At that time, the US guaranteed that dollars would be convertible into gold at a fixed price. Since the demand for dollars increased quickly while the stock of gold was approximately constant, it became increasingly clear that if the US accommodated the high worldwide demand for dollars, it would be unable to maintain the convertibility of dollars into gold. Too many dollars were chasing a fixed stock of gold. This dilemma was first analysed by the Belgian-American economist Robert Triffin, who predicted in the 1960s that the US would have to abandon the convertibility of the dollar into gold.

The modern version of this dilemma therefore predicts that the massive amounts of dollars created by the US authorities to satisfy the world demand for dollars is inconsistent with the promise that these dollars will be convertible into an approximately fixed basket of US goods and services.

As in the old Bretton Woods system, there are two ways for the US to get out of this dilemma. The first consists of reneging on this implicit promise, which amounts to abandoning the commitment to price stability. The second way out of the dilemma is for the US to stick to price stability and to dramatically reduce the supply of dollars (including US Treasury securities) to the rest of the world. This is likely to turn the world economy into a deep recession.

The market bets that the US will choose the first way out of the dilemma, i.e. that the US will abandon its commitment to price stability. It is a reasonable bet because the massive supply of dollars is also an extremely attractive privilege for the US authorities, which allows them to finance budget deficits at conditions that no other country can obtain. But this choice also means that the US dollar will continue its secular decline relative to the major currencies in the world.