Jeffrey E. Garten

The Almighty Dollar is Back

UNTIL A FEW WEEKS AGO, THE DOLLAR BULL WAS A RARE animal. Most currency watchers thought the dollar was in long-term decline, due to rising U.S. trade and budget deficits. The only question the majority seriously entertained was whether the decline could become a crash, if foreign financiers began to tire of supporting U.S. borrowing, and did so in a stampede.

Yet since January the dollar has risen 12 percent against the euro, and 7 percent against the yen. A growing number of dollar bears are turning bullish, and I'm one of them. This may be the start of something big. For three reasons, we may be seeing a fundamental shift with enormous implications for the United States and the world.

First, for global investors looking for long-term value and security, there is now no real alternative to the dollar. The euro used to be the key option, but after the recent French and Dutch vetoes of the proposed constitution for the European Union, there is talk among financial officials that the agreements that underlie the euro itself may be shaky. Neither the Japanese yen nor the Chinese renminbi is even close to being a major alternative to the dollar. The truth about these Asian giants is that their stock and bond markets are too weak to attract major funds from around the world.

Second, France, Germany and Italy have been stuck for years with anemic growth and double-digit unemployment. They have demonstrated no political will to restructure their economies for global competition, and there is a good chance that the European Central Bank will be strong-armed into lowering interest rates. This could occur at the same time as the U.S. Fed continues to increase American rates. The differential will make America much more attractive to foreign lenders.

Third, Asian governments are unlikely to give up their mercantilist policies, which rely on cheap currencies to stimulate exports. Asians use their enormous savings, denominated in their own currencies, to buy dollars. This drives down the value of the yen and the won, and holds up the greenback. They accumulate billions of dollars, which they then lend to the United States so Americans can buy Asian exports. It's increasingly clear that Asian lenders—particularly central banks that now account for about 70 percent of foreign loans to the United States—don't seem to mind holding U.S. debt as long as the American economy is expanding, which seems likely for the foreseeable future.

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An ever stronger dollar would delay the arrival of a global monetary system with two or three major currencies at its center. This has been the prediction of most international economists ever since the post World War II recovery of Japan and Germany. Now there is likely to be a totally different model—a world dominated by the dollar in ways not seen since the early 1950s. At first, with confidence in the dollar mounting, more foreigners would invest in U.S. bonds and stocks, pushing the greenback even higher. It would keep interest rates low, possibly encouraging another long business boom. American firms would be on the prowl for acquisitions abroad, because they would be cheap.

But a strong dollar would also undercut U.S. exports, increase U.S. imports and therefore widen the trade deficit—now approaching $700 billion a year—and run up the foreign debt, already close to $3 trillion. U.S. firms could well accelerate the outsourcing of jobs abroad, where costs would be falling in dollar terms.

The increase in purchasing power would make America a richer and more powerful nation. Because the U.S. would be borrowing in dollars, and repaying those debts in dollars, it would incur no currency risk, as every other country does. This privileged position means that America could become an even more undisciplined debtor—a scary thought.

In a world where the dollar is supreme, Uncle Sam should be more responsible for international financial stability, not less. There would be an increasingly compelling argument that the Federal Reserve should see itself as a global central bank, and the Congress and White House should see U.S. trade and financial policy as keys to global stability, not tools to further U.S. interests. On a recent visit to Yale, the mayor of Beijing said—only half jokingly—that it would make sense if the whole world had a vote in American elections, because U.S. decisions have so large an impact worldwide.

When historians look back on this period they may well give more weight to the power that a one-currency world conferred on the United States than to that granted by our men and women in uniform, serving in Afghanistan and Iraq. But whether Washington will recognize the responsibility that comes with this power—well, that will be the big question.

GARTEN is dean of the Yale School of Management.