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Toward a post-dollar world

By Jeffrey Garten

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Just as we continue to analyze the causes and consequences of the 1929 stock market crash, historians will be assessing and reassessing the global credit crisis that began in 2008 and the Great Recession that followed. As they do, my guess is that the behavior of financial institutions and the post-crisis banking reforms will prove to be far less significant than two far-reaching structural changes in the global economy. The first of these will be the massive deficits and debts of the United States, and the second will be the shift of economic power from west to east. The financial debacle didn't start these two trends, but it accelerated them and magnified their consequences. Taken together, these two changes will have resulted in a rapid decline of the world's key currency—the US dollar. And that will have changed everything, including the prices for every product and service, the location of manufacturing and R&D, flows of capital and trade, composition of monetary reserves, behavior of investors, and the distribution of economic and political power. The world as we have known it for many decades will be radically altered, with a new distribution of winners and losers.

That much we can reasonably predict. What is not knowable is how the dollar will depreciate. Will it be gradual and easily accommodated or abrupt and destabilizing? Will governments try to smooth the way with the establishment of a new currency regime or will they throw up their hands and let the market take over? Or will their actions fall

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somewhere in between?

The roots of this situation are well known. Due to a combination of tax cuts, escalating military burdens, recession, and massive government intervention to bail out financial institutions and to stabilize the economy, the US budget deficit of this past fiscal year reached 10 percent of gross domestic product, the largest since the aftermath of the Second World War. Meanwhile, the net external debt of the United States increased by a third last year to reach $3.5 trillion and is projected to increase by nearly $1 trillion every year for the next decade. The Congressional Budget Office, a nonpartisan analytical group, has projected that within a decade, the United States could be borrowing close to $750 billion a year just to pay interest on the debt. All these problems underestimate the deficits and debts that are likely to accumulate because of the need to address the deterioration of the nation's physical infrastructure and the massive fiscal problems of many key states such as California and New York.

To close the gaps while keeping the dollar at its current strength, taxes would have to be raised to sky-high levels and spending brutally slashed. The gigantic health care package that seems likely to pass would have to be revised so that in addition to increasing coverage it also decreases medical costs, which it does not now do. The Social Security and Medicare entitlements that are slated for seniors, whose ranks will swell by 75 million more people over the next few decades, would have to be seriously curtailed. The military budget would have to be slashed. The entire tax system, overdependent as it is on income tax and riddled with loopholes, would have to be revamped to include major consumption-oriented taxes, including those on gasoline and carbon. All this would require a level of political imagination, courage, and cooperation not seen since the founding fathers. It would take a miracle for the United States' political system—one rife with vicious partisanship and riddled with well-financed special interests—to rise to the occasion.

Washington will therefore have little choice but to take the time-honored course for big-time debtors: print more dollars, devalue the currency, and service debt in ever-cheaper greenbacks. In other words, the United States will have to camouflage a slow-motion default because politically it is the easiest way out. Given the political realities, it's the only way out.

There is another factor pushing the United States toward a weaker dollar: lacking the domestic consumer demand that came with the unrestrained credit of the last 15 years, the United States is desperate to find buyers abroad, especially in emerging markets where the middle class is growing and infrastructure requirements are soaring. A cheaper dollar could make US products and services more competitive, although in a hypercompetitive global environment, the extent of any new US advantage will have to be seen. But, at least initially, Washington's intent will be to keep what manufacturing now exists and to attempt to regenerate some of what has been lost.

Meanwhile, the financial crisis has strengthened the already soaring trajectory of the big emerging markets of Asia—and they will soon be searching for alternatives to the dollar. In the next decade, they will be growing twice as fast as the United States and three times faster than the European Union. By 2020, China, India, Indonesia, Korea, and Vietnam together could generate more wealth than the United States, Japan, and the European Union combined. China, India, and South Korea have all been amassing dollar reserves. Keenly aware of the United States' growing debilities and lacking all confidence in the ability of their political system to implement deep reforms, Asian central banks and investors will not be anxious to accumulate any more dollars and will no doubt be looking to reduce their holdings. While imports into leading industrial countries have slowed, intra-Asian trade is booming and Asian currencies will become more widely used in trade. There is another and much more recent factor that will make governments and investors in the big emerging markets more leery of the dollar's prospects. For the first time in many decades, the US Congress is seriously questioning the independence of the Federal Reserve and there is a real likelihood that its powers will be curtailed in legislation that will pass in 2010. Around the world, this is the one US institution that continues to inspire respect and confidence. The specter o-f seeing it attacked in Washington should rattle anyone who is holding dollars for the long term. The bottom line is that their currencies are sure to substantially strengthen against the dollar.

Even though it is inevitable, a much cheaper dollar is a sad development for the United

States. It will make its citizens poorer, since they will pay higher prices for everything they buy from abroad—clothes, computers, cars, toys, food, you name it. Although commodities are priced in US dollars, as the greenback depreciates, OPEC and others are likely to increase prices to make up for dollar losses or they may switch to pricing in a basket of currencies. A depreciating dollar will make the US military presence abroad more expensive, since the cost of contractors and local suppliers will escalate in dollar terms. It will slow imports, removing competition that is essential to holding down the general price level in the United States, thereby making inflation more likely. It will send the wrong price signals for a country that prides itself on creating sophisticated, highly valuable products, since a low dollar will encourage producers to compete more on price than on quality. A weaker dollar will make the United States a bargain basement for foreign direct investors, allowing them to pick off the nation's most prized corporate assets. It will diminish the political influence and prestige that the Unites States has had while the dollar has been king.

Among the most fundamental challenges posed by a permanently weak dollar is this: foreign governments and investors may demand new terms for extending credit. That could entail higher interest rates. It could also mean that the United States can no longer repay its new obligations in dollars but must do so in the same currency in which the loans were made. Were that to happen, Washington could not just print new dollars as it now does. It would have to go into the market and use more and more dollars to buy the currency it needs to satisfy foreign creditors. This would bring US profligacy to a screeching halt. In fact, the consequences of this all-too-possible scenario are almost unimaginable.

Moreover, the US dollar has been at the heart of the global economy for well over half a century. Its decline, if not smooth and gradual—hardly certain—could lead to an era of competitive devaluations and other mercantilist trade policies. After all, other countries—many that are more dependent on exports than the United States—are unlikely to cede export markets gracefully or quietly. The competitive battlefield will encompass traditional trade, such as agriculture, where subsidies or import barriers could be raised, and it is likely to include new arenas, such as the race to dominate alternative-energy products or other environmental technologies.

An alternative to a global monetary system that has been centered on the dollar is thus now imperative. That means a multicurrency framework including the euro, the yen, the renminbi, and significant issuance of an IMF-backed currency called “special drawing rights.” This regime will take time to devise, but it should start now.

Some critics are apt to say that governments are in no position to create a new regime, since global financial markets will march to whatever drummer they wish and can always overwhelm public policy efforts. This extreme free market view is not valid, however. Governments set the price of currencies with their printing presses and their monetary policy. If they coordinate their efforts, they can have an overwhelming influence on the framework for global currency. That’s why they should act now.

Tim Geithner, US Treasury secretary, should invite his colleagues in the United Kingdom, the eurozone, Japan, China, and Saudi Arabia to meet on the sidelines of a G-20 or IMF meeting. It would be advantageous to the United States for Washington to take the lead while it has the clout to devise arrangements it can live with. It would be best if the initial discussions could be out of the limelight and off the record, despite the clamor for transparency, because just the hint of such a meeting would get markets overexcited. But however the initial meeting is arranged, the big question is the same: what kind of monetary system will best serve the world given deep-seated changes in the balance of economic power, and what process can be followed to develop it?

Companies and investors everywhere ought to be planning for this new world, too. They should at least be analyzing how competitive advantage will change as the dollar declines over the next several years. Given the enormous uncertainties about how these trends will play out, a scenario planning exercise, kept under constant review, would not be a bad place to start. Some of the key questions that need to be dealt with would be: What should be my portfolio of business and where should it be located? Who will be my new competitors? For investors, one big issue the issue is, how do I take advantage of changing currency relationships? In both cases, strategic hedging strategies will be essential.

There is a huge research agenda for universities and think tanks. A world in which the dollar has lost a good deal of its strength will have profound impact on geopolitics, the global economy, and global trade and finance. It will mark the end of the American Empire and usher in something as yet undefined. Little thinking has been done on what all this will mean, and how it is best handled. It's time that changed.

Since the late 1980s, I have believed that a strong dollar was in the United States' and world interest. Now, however, the context has fundamentally changed. The issue is no longer whether the dollar is in long-term decline but which of two options will be taken. Should Washington and other capitals calmly and deliberately manage the transition to a new era, or, by default, should they let the market do it, with the risk of massive financial disturbances. Today, governments have a choice. Soon they may not. Companies and investors, too, need to decide whether they wish to confront the future head on, or whether they will remain passive.

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